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In this issue

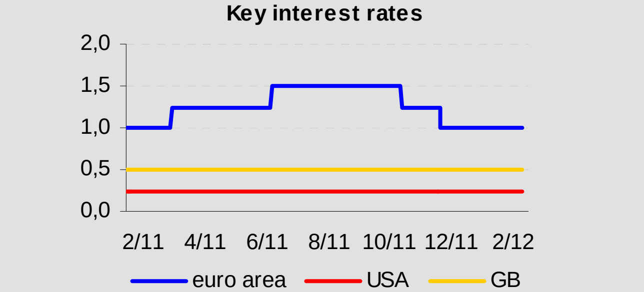
Economic activity in the Euro-Atlantic area remains subdued and future developments continue to be surrounded by uncertainty. Despite the approval of further financial assistance for Greece, the economic outlook is not very optimistic; moreover, the rating downgrades of many euro area countries are bad news. The ECB left its key interest rate at 1% and executed a three-year liquidity-providing operation totalling EUR 530 billion. The Bank of England increased the size of its asset purchase programme. The Swiss National Bank is still maintaining the minimum exchange rate of the franc to the euro at CHF 1.20/EUR. The central banks of Norway and Sweden have cut their policy rates by 0.50 percentage point in recent months. Monetary policy tightening was observed only in Hungary. The remaining central banks under review left their key interest rates unchanged. In Spotlight *we describe the most recent steps taken by the Fed on the road to greater monetary policy openness and transparency. The Bank of Japan also announced fundamental changes, the details of which, presented by Governor Masaaki Shirakawa, are summarised in our* Selected Speech*.*

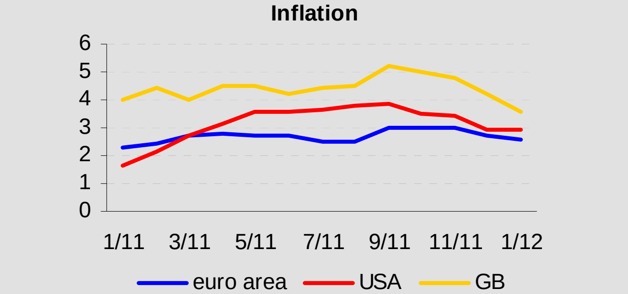
1. LATEST MONETARY POLICY DEVELOPMENTS AT SELECTED CENTRAL BANKS

Key central banks of the Euro-Atlantic area

	Euro area (ECB)	USA (Fed)	United Kingdom (BoE)
Inflation target	< 2%[1]	2%[2]	2%
MP meetings (rate changes)	12 Jan (0.00) 9 Feb (0.00) 8 Mar (0.00)	13 Dec (0.00) 24–25 Jan (0.00)	11–12 Jan (0.00) 8–9 Feb (0.00) 7–8 Mar (0.00)
Current basic rate	1.00%	0–0.25%	0.50%
Latest inflation	2.7% (Feb 2012)[3]	2.9% (Jan 2012)	3.6% (Jan 2012)
Expected MP meetings	4 Apr 3 May 6 Jun	13 Mar 24–25 Apr	4–5 Apr 9–10 May 6–7 Jul
Other expected events	6 Jun: publication of forecast	11 Apr: publication of Beige Book	16 May: publication of Inflation Report
Expected rate movements[4]	→	→	→

[1] ECB definition of price stability; [2] January 2012 definition of inflation target; [3] flash estimate; [4] direction of expected change in rates in coming quarter taken from Consensus Forecast survey.





The **ECB** left its key interest rate unchanged. A three-year liquidity-providing operation conducted at the start of March grossed EUR 529 billion. According to the new forecast, real GDP growth in a range between -0.5% and 0.3% is expected for 2012. Compared with the December 2011 forecast, the centre of the range was lowered by 0.4 percentage points. The inflation rate will stay above the price stability definition this year. Energy prices and tax increases were identified as short-term upside risks to inflation. In 2012, inflation is forecasted to be in a range between 2.1% and 2.7%. The centre of the range was shifted upwards by 0.4 percentage points compared to the December forecast.

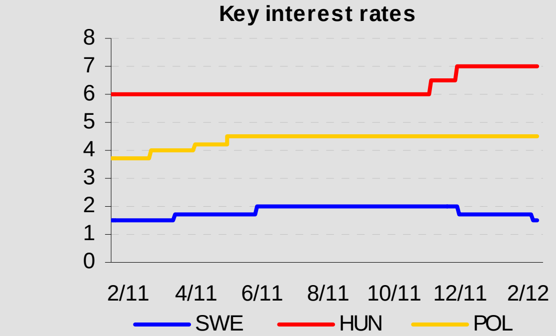
The **Fed** left its key interest rate unchanged. It is continuing to sell short-term Treasury bonds and finance purchases of long-term ones from the proceeds, so far to the tune of around USD 200 billion. Economic activity expanded moderately, while global economic growth slowed. Conditions in the labour market situation are improving gradually. The unemployment rate declined to 8.5% in December. Industrial production expanded in November and December. Consumer sentiment improved in early January but is still at the low levels. The Fed expects interest rates to stay exceptionally low at least until late 2014.

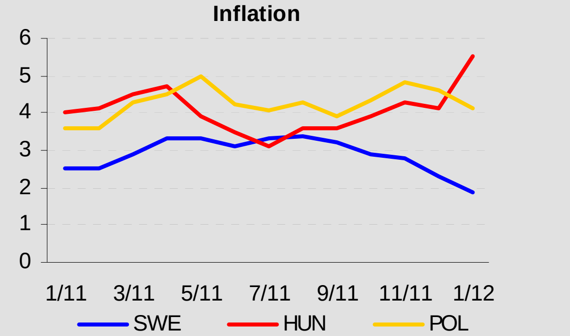
The **BoE** is maintaining its interest rate at 0.50%. At its February meeting, it decided to increase the size of its asset purchase programme by GBP 50 billion to GBP 325 billion. Inflation is 3.6%, i.e. above the inflation target. However, it should fall in the medium term as temporary factors such as the recent growth in energy prices and the January 2011 VAT increase unwind. This unwinding of upside factors has already begun, manifesting itself in a drop in inflation from 5.2% in September 2011 to the current level.

Selected central banks of inflation-targeting EU countries

	Sweden (Riksbank)	Hungary (MNB)	Poland (NBP)
Inflation target	2%	3%	2.5%
MP meetings (rate changes)	19–20 Dec (-0.25) 15–16 Feb (-0.25)	20 Dec (+0.50) 23 Jan (0.00) 28 Feb (0.00)	10–11 Jan (0.00) 7–8 Feb (0.00) 6–7 Mar (0.00)
Current basic rate	1.50%	7.00%	4.50%
Latest inflation	1.9% (Jan 2012)	5.5% (Jan 2012)	4.1% (Jan 2012)
Expected MP meetings	19 Apr	27 Mar 24 Apr 29 May	3–4 Apr 8–9 May 7–8 Jun
Other expected events	4 Jul: publication of Monetary Policy Report	27 Mar: publication of Quarterly Report on Inflation	Mid-March: publication of Inflation Report
Expected rate movements[1]	↓	↓	→

[1] Direction of expected change in rates in coming quarter taken from Consensus Forecast survey.





At the turn of the year, the **Riksbank** cut its key interest rate by 0.25 percentage point twice in a row, to 1.5%. It justified these steps with low inflation pressures in the economy and a weaker outlook for domestic economic activity due mainly to worse conditions in the world economy. Two members of the Riksbank Board (Karolina Ekholm and Lars E.O. Svensson) disagreed with the repo rate cut and with the future interest rate path. Both advocated a more aggressive lowering of the repo rate to 1.25% and a lower future interest rate path than in the Monetary Policy Report of 16 February.

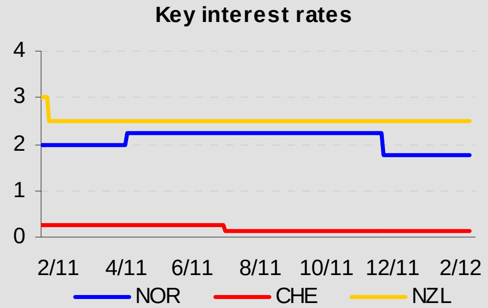
The **MNB** raised its base rate by 0.50 percentage point to 7.00% in December. This was due to a rising inflation outlook and an increase in the country's risk premium, which is a considerable threat to meeting the inflation target. At its latest meeting in February, the MNB left its rates unchanged. Inflation remains above the target, still reflecting the effects of higher taxes and year-on-year depreciation of the forint. The country's risk premium has been highly volatile and elevated recently. A decrease could be fostered by approval of the credit line currently being negotiated between the Hungarian government, the EU and the IMF.

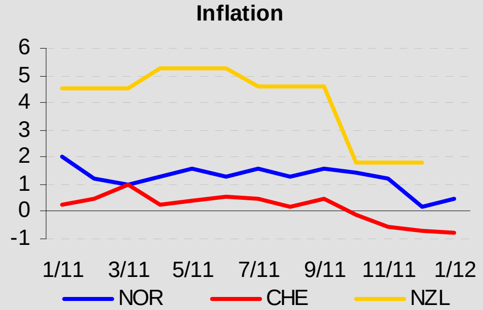
The **NBP** kept its key interest rates unchanged. Data on 2011 Q4 GDP as well as data on retail sales in early 2012 indicate that economic growth remained robust. However, leading indicators suggest that economic activity may weaken in the coming quarters. Inflation fell slightly compared to previous periods, but at 4.1% in January remained above the inflation target. Inflation expectations of households and financial sector analysts are elevated. The NBP estimates that inflation will remain above the target in the coming months, mainly because of the previously observed zloty depreciation and persistently high commodity prices.

Other selected inflation-targeting countries

	Norway (NB)	Switzerland (SNB)	New Zealand (RBNZ)
Inflation target	2.5%	< 2%	2%[1]
MP meetings (rate changes)	14 Dec (-0.50)	15 Dec (0.00)	26 Jan (0.00) 8 Mar (0.00)
Current basic rate	1.75%	0–0,25%[2]	2.50%
Latest inflation	0.5% (Jan 2012)	-0.8% (Jan 2012)	1.8% (2011 Q4)
Expected MP meetings	14 Mar	15 Mar 21 Jun	26 Apr 14 Jun
Other expected events	14 May: publication of Monetary Policy Report	21 Mar: publication of Monetary Policy Report	14 Jun: publication of Monetary Policy Statement
Expected rate movements[3]	↓	→	→

[1] Centre of 1–3% target band; [2] chart displays centre of band; [3] direction of expected change in rates in coming quarter taken from Consensus Forecast survey or, in the case of New Zealand, from RBNZ survey.





At the close of last year, the **Norges bank (NB)** decreased its policy rate by 0.50 percentage point to 1.75% in response to capital market turbulence and the external economic growth outlook. Economic activity in Norway remains robust, primarily driven by petroleum investment and construction. Inflation is low. The debt problems in the euro area appear to be an adverse factor, making funding more expensive and less accessible for Norwegian banks.

The **SNB** is maintaining rates in the lower part of the 0–0.25% corridor. At its December meeting, it confirmed its commitment to keep the minimum exchange rate at CHF 1.20/EUR and is still prepared to buy foreign currency in unlimited quantities if this limit is exceeded. The Swiss economy is being adversely affected by previous appreciation of the franc, weak foreign demand and uncertainty surrounding economic developments in the euro area. The SNB expects real GDP growth at 0.5% in 2012. The SNB forecast expects average inflation rates of -0.3% in 2012 and 0.4% in 2013, assuming a continued de facto zero interest rate and a further weakening of the franc.

The **RBNZ** left its key rate at 2.50%, commenting that inflation had settled near the target and inflation expectations had fallen. The domestic economy is showing signs of recovery. Household spending has picked up over the past few months and a recovery in building activity appears to be under way. High export commodity prices are also supporting economic growth. A marked appreciation in the New Zealand dollar has helped contain inflation, but the strong currency is reducing exporters' earnings, which may, in turn, affect other sectors of the economy.

2. NEWS

Fed announces new strategy principles and publishes rate projections

The US central bank published a revision of its monetary policy strategy in January. The Fed has clarified its idea of price stability by specifying a goal of 2% for inflation, as measured by the annual change in the price index for personal consumption expenditures. The Fed also commented on its other goal, i.e. that for employment, explaining that it would not be appropriate from the central bank's perspective to specify a target. It noted at the same time that its approach in promoting the two goals would remain balanced.

The Fed also decided to publish the monetary policy rate projections of the individual members of the Board of Governors and the presidents of the Federal Reserve Banks. These changes are covered in more detail in *Spotlight*.

ECB approves eligibility criteria for additional credit claims for seven NCBs

The Governing Council of the European Central Bank approved specific national eligibility criteria for collateral in Eurosystem credit operations for seven national central banks. Austria, Cyprus, France, Ireland, Italy, Portugal and Spain can thus use additional securities for borrowing in these operations. This measure follows up on the ECB decision of December 2011 to increase collateral availability.

Bank of Japan expands liquidity programme and sets inflation target

Following its February meeting, the Japanese central bank stated that it judged the price stability goal in the medium to long term to be within a positive range of 2% or lower, and set a goal at 1% for the time being. Previously, it had not quantified price stability.

The Bank of Japan also increased the total size of its asset purchase programme by JPY 10 trillion to about JPY 65 trillion. The entire increase is earmarked for the purchase of Japanese government bonds. The changes in Japanese monetary policy are dealt with in detail in our *Selected Speech*.

Bank of England increases size of asset purchase programme

The Bank of England's Monetary Policy Committee decided in February to further increase the size of its asset purchase programme. The quantitative easing was originally announced in March 2009 with a planned size of GBP 200 billion. The first increase took place in October 2011. The programme has now been increased by another GBP 50 billion to a total of GBP 325 billion. The Bank of England expects the purchases to take three months to complete.

MNB introduces new facilities to enhance banking system

The Hungarian central bank said it would introduce measures to boost liquidity in the banking sector to facilitate lending. It plans to introduce a two-year credit facility to encourage banks to lend to corporations. It also intends to make the relevant markets more efficient by introducing a mortgage bond purchase scheme. However, the amendment giving all credit institutions the right to issue mortgage bonds has yet to be passed by Parliament. The MNB will also expand the range of eligible collateral by linking the minimum credit rating limit for bank and corporate bonds to the lower rating of government debt instead of the current BBB-.

Swiss National Bank makes profit

The SNB reported a profit of CHF 13.5 billion for the 2011 financial year, in contrast to a significant loss in 2010. The profit was due primarily to a rise in the price of gold (CHF 5.4 billion) and to foreign currency positions (CHF 7.7 billion). Exchange rate effects were minimal (CHF -0.1 billion). Part of the profit will be distributed to the Confederation and the cantons.

Another EC, ECB and IMF review mission to Ireland

Another review of the Irish economic programme took place in January. Public finance consolidation and financial sector reforms are on track and steps are being taken to enhance competitiveness and support growth and job creation. Further progress will be challenging, however. Projected growth for 2012 has been revised down by 0.5 percentage point to 0.5% as a result of subdued domestic demand, high unemployment and slowing trading partner growth.

Further financial assistance and debt swap for Greece

After lengthy negotiations, ECB, EC and IMF representatives approved further financial assistance for Greece. The country managed to negotiate with private sector creditors an exchange of its existing bonds for new lower-value bonds. This means a de facto financial loss for investors of about 70% of the value of their Greek government bond holdings. The main rating agencies responded to the debt swap by cutting Greece's rating to "Selective Default", with Moody's expecting a high risk of default even after the debt swap. In connection with recent developments, the European Central Bank temporarily stopped accepting Greek bonds as collateral.

Rating downgrades in euro area

In the first two months of this year, Standard & Poor's and Moody's reacted to the still unfavourable debt situation in Europe by downgrading their ratings of euro area countries. Both agencies cut their ratings of Italy, Malta, Portugal, Slovakia, Slovenia and Spain; S&P also downgraded its ratings of France and Austria and changed its outlook for the other euro area countries to negative. The EFSF rescue fund's rating subsequently worsened as well.

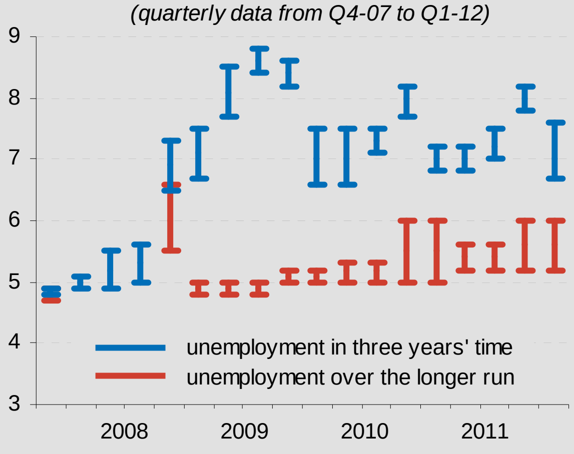
3. SPOTLIGHT: OPENNESS AND MONETARY POLICY STRATEGY OF THE FED

At its recent meetings the Federal Open Market Committee (FOMC) has discussed principles regarding its longer-run goals and monetary policy strategy and the further enhancement of its transparency. In January of this year it took two important strategic steps. The first step was to issue a statement on longer-run goals, in which the FOMC discusses price stability and employment and comments on the role of these two goals in monetary policy. The second step was to publish the Fed's interest rate outlook.

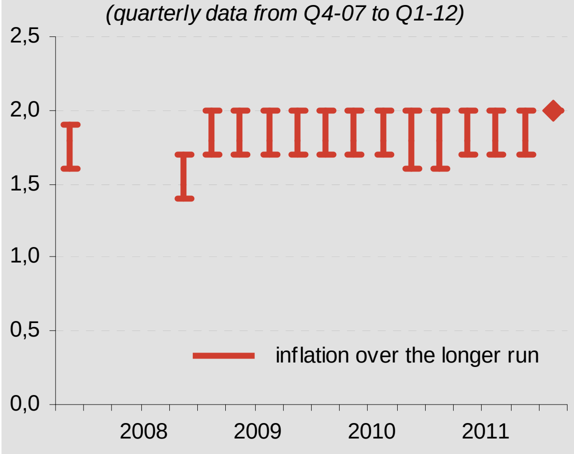
As regards its price stability goal, the FOMC specifically quantified this objective for the first time in January 2012, stating that inflation at the rate of 2% as measured by the price index for personal consumption expenditures was most consistent over the longer run with the Fed's mandate. The Fed believes that communicating this goal clearly will help to keep longer-term inflation expectations better anchored, thereby fostering price stability and moderate long-term interest rates and enhancing its ability to promote maximum employment in the face of significant economic disturbances. Previously, the FOMC had only published estimates of the longer-run rate of inflation, doing so in its Summary of Economic Projections (SEP). The regular SEP report contains projections – in the form of ranges – submitted by the members of the Board of Governors and the presidents of the Federal Reserve Banks. Besides inflation, it includes real GDP growth and the unemployment rate (the charts below show the "central tendencies", i.e. the ranges of the projections excluding the three highest and three lowest values).

In its January statement, the FOMC also comments on its goal of achieving maximum employment. While the inflation rate over the longer run is primarily determined by monetary policy, the maximum level of employment is largely determined by non-monetary factors that affect the structure and dynamics of the labour market. Consequently, the FOMC does not consider it appropriate to specify a fixed goal for employment; rather, it recognises that assessments of maximum employment are necessarily uncertain.

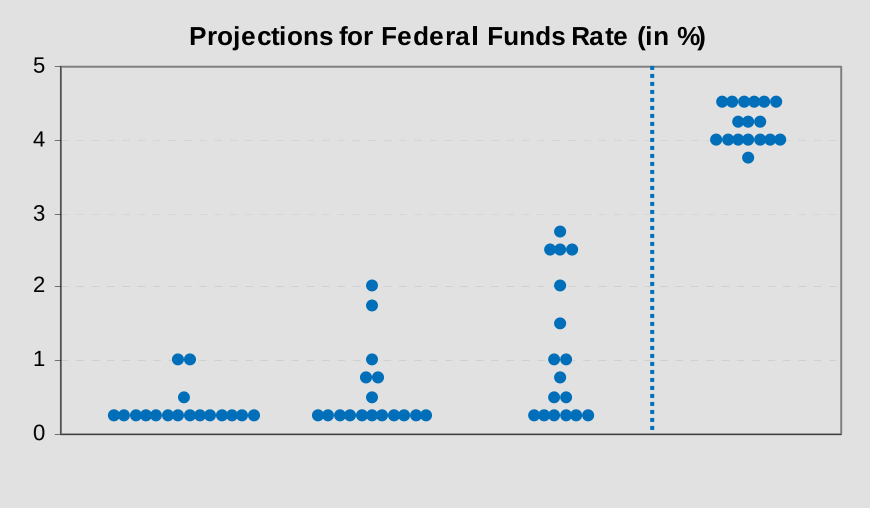
Projection for unemployment rate (in %)
(quarterly data from Q4-07 to Q1-12)



Projection for inflation (in %)
(quarterly data from Q4-07 to Q1-12)



The January statement reveals that the two goals have a balanced position in the decision-making of the Fed. In setting monetary policy, the FOMC seeks to mitigate deviations of inflation from its longer-run goal and deviations of employment from the estimated maximum level. In situations where these two objectives are in conflict, the FOMC decides on the basis of the magnitude of the deviations and the potentially different time horizons over which employment and inflation are projected to return to the required levels.



The other innovation made by the Fed in January, as mentioned above, is the publication of monetary policy rate projections. The Fed has been saying since January 2009 that if the current economic conditions continue it expects rates to stay exceptionally low into the future. The original wording "for some time" was soon changed to "for an extended period"; since August 2011, the FOMC had been expecting rates to remain low until mid-2013, and in January of this year it moved the time horizon to late 2014. The publication of the projections can therefore be regarded as further step in its efforts to influence the markets in a situation where interest rates have reached their minimum level. However, the FOMC members' current projections for 2014 are quite widely dispersed, with only six out of the 17 participants expecting rates to remain at current levels. In the longer run they expect the Fed's rates to be in a range of 3.75–4.50%.

The changes described above represent further milestones on the road to greater openness of the US central bank and its monetary policy. Before 1994, the Fed did not announce changes in targeted rates after its meetings. The markets therefore had to infer them during the weeks following the meetings from the type and size of the Fed's open market operations (as the decision was not published until after the following FOMC meeting). It was not until 1994 that an announcement disclosing the change in monetary policy was issued after the meeting. A year later, the Fed undertook to announce the changes on a regular basis. In May 1999, it started to state the future risks. The disclosure of the votes cast by the individual FOMC members as from March 2002 also fostered greater transparency.

The growing openness of Fed monetary policy communication

February 1993	Minutes published three days after following meeting
February 1994	First-ever announcement of monetary policy meeting outcome with qualitative description of change
August 1994	Qualitative announcement of change giving arguments for decision
February 1995	Announcement that all monetary policy changes would be communicated immediately to public
July 1995	Fed's target rate level communicated explicitly
May 1999	Risks to future rate path added to statement
January 2000	Risks to economic growth and inflation start to be communicated
January 2000	Statement issued after every meeting (even if monetary policy is unchanged)
March 2002	Voting of each FOMC member starts to be disclosed in statement
August 2003	Explicit statement of likely future rate movements in longer run
January 2005	Minutes published three weeks after meeting (previously three days after following meeting)
November 2007	Economic projections (SEP) published 4x a year and with extended time horizon
June 2009	Publication of regular reports on Fed's credit and liquidity programmes and balance sheet
April 2011	Press conferences 4x a year after FOMC meetings, presentation of projections and context of decision
January 2012	Revision of strategy + publication of FOMC members' interest rate projections

In August 2003, the FOMC explicitly stated the likely future monetary policy settings. A recent fundamental step towards greater openness was the launch of press conferences after monetary policy meetings. Ben Bernanke presented the economic projections and the context of the decision for the first time in this way last April. The table summarises the steps towards greater transparency taken by the Fed to date.

A trend towards greater openness can be seen in most central banks (including the CNB), and in many respects the Fed is following the lead of other countries. Setting an inflation target plays a key role in inflation targeting, and is by definition a vital part of the regime itself; however, the European Central Bank, too, has a definition of price stability. The Japanese central bank also updated its objective this year (for more details see the *Selected Speech* in this issue of Monitoring). Several central banks now also publish future interest rate paths, and press conferences are a matter of course at many central banks (see the June 2011 issue of Monitoring). Moreover, the Fed can be expected to make further changes in the future. This is indicated by the FOMC's January statement that it intends to reaffirm its strategic principles and make adjustments as appropriate each year.

4. SELECTED SPEECH: THE BANK OF JAPAN'S EFFORTS TOWARDS OVERCOMING DEFLATION

On 17 February 2012, Bank of Japan Governor Masaaki Shirakawa presented members of the Japan National Press Club with the central bank's strategy for overcoming deflation, which the bank's management approved at its last meeting in February.

In his speech, the Governor details three current monetary policy measures in Japan. The first concerns the definition and numerical expression of price stability. The Bank of Japan (Nippon Ginko, Bank of Japan, BOJ) aims to achieve price stability in the medium to long term. This goal is quantified as a positive range of 2% or lower in terms of the year-on-year rate of change in the CPI. However, a lower goal at 1% has been set for the time being. In 2006, the BOJ was expecting to exit soon from the quantitative easing policy that had been in place since 2001. At that time, the Policy Board members had different views on the definition of price stability and recognised the need to publish, as the Policy Board, the basic idea of price stability in numerical terms. As a result, the Board decided make public a range covering the rates that the individual members understood as price stability. The term "understanding of price stability" was then used in the Policy Board's statements. At the February meeting this expression was replaced by the term "goal". The terminological change is meant to reflect the fact that the goal represents the common stance of the Policy Board and not the views of its individual members. After careful consideration, the bank decided against the more usual "inflation target", as this would give the impression that it was pursuing its goal in an automatic manner.

Second, the BOJ has decided to focus on strengthening policy duration effects. When short-term interest rates are almost zero (the case in Japan since 1999), leaving little room for a further decline, there is a need to introduce measures that influence the entire yield curve, including the longer end. To this end it is appropriate to foster market participants' confidence that a central bank's commitment to monetary easing will continue for a long period of time. The Governor said that unlike the US Federal Reserve, which refers to a specific duration or timing of an exit (currently at least through to late 2014), the BOJ is tying an exit from quantitative easing to the condition of the economy (measured by the CPI inflation rate) instead of specifying a timing of the exit.

The third measure announced by Mr Shirakawa was the expansion of the asset purchase programme from JPY 55 trillion to JPY 65 trillion. The programme was introduced in October 2010 and is used for purchasing government bonds as well as some riskier assets. In addition to this programme, the BOJ regularly purchases Japanese government bonds at the pace of JPY 1.8 trillion per month. At the end of last year, the amount of Japanese government bonds held by the BOJ was 14.2% of GDP (for comparison, holdings of government bonds by the Federal Reserve and the ECB represented 10.8% and 2.2% of GDP respectively).

Towards the end of his speech, the Governor refuted speculation that the BOJ is responsible for the current deflation in Japan. Due to quantitative easing, the ratio of money stocks to GDP in Japan is now about 1.7, the highest among major economies. According to the Governor, the problem of Japan's economy is not a lack of money but rather a lack of business changes and growth opportunities. Mr Shirakawa says that the true causes of deflation are population ageing, failure to adjust to globalisation, and downward pressures on prices stemming from deregulation. Another cause of deflation is Japan's specific employment policy, under which employers and employees make wage adjustments for the sake of securing employment.

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