Monitoring centrálních bank - září 2011

Česká národní banka
2011

CENTRAL BANK MONITORING – SEPTEMBER

2011

Monetary and Statistics Department
Monetary Policy and Fiscal Analyses Division

CNB CZECH NATIONAL BANK

In this issue

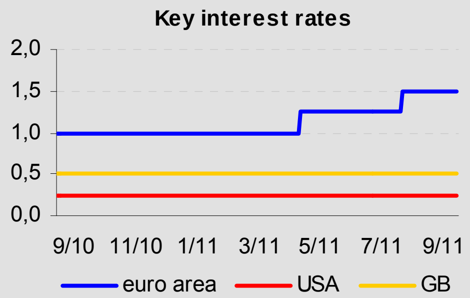
The global economic recovery slowed significantly, hinting at the possibility of a second, albeit modest, dip in economic activity, which would make the output curve W-shaped. The debt crisis in Europe, coupled with fiscal tensions surrounding the approval of the debt ceiling in the USA, had a negative impact on perceptions among financial market participants and contributed to declines in global equity markets. The ECB intervened in the government bond markets of the peripheral euro area countries. The ECB meeting in July produced a second increase in key interest rates in the euro area, but in the following months the ECB kept rates unchanged. The Swiss central bank intervened indirectly against the appreciation of the Swiss franc by reducing the interest rate corridor and supplying liquidity to the money market. At the start of September it set a minimum franc exchange rate against the euro. If this level is exceeded, it is prepared to buy foreign currency in unlimited quantities. Only Sweden recorded a further monetary tightening. The remaining central banks under review left their key rates unchanged. In Spotlight *we summarise the IMF's new spillover reports examining the impacts of national economic policies on other countries in the region and globally. Our selected speech presents Ben Bernanke's views – given at a symposium in Jackson Hole – on the current economic situation and monetary policy in the USA.*

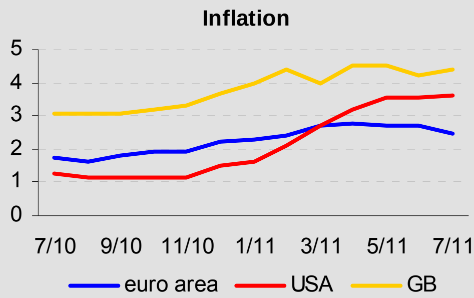
1. LATEST MONETARY POLICY DEVELOPMENTS AT SELECTED CENTRAL BANKS

Key central banks of the Euro-Atlantic area

	Euro area (ECB)	USA (Fed)	United Kingdom (BoE)
Inflation target	< 2%[1]	n.a.	2%
MP meeting (rate changes)	7 Jul (+0.25) 4 Aug (0.00) 8 Sep (0.00)	21–22 Jun (0.00) 9 Aug (0.00)	6–7 Jul (0.00) 3–4 Aug (0.00) 7–8 Sep (0.00)
Current basic rate	1.50%	0–0.25%	0.50%
Latest inflation	2.5% (Aug 2011)[2]	3.6% (July 2011)	4.4% (Jul 2011)
Expected MP meetings	6 Oct 3 Nov 8 Dec	20 Sep 1–2 Nov	5–6 Oct 9–10 Nov 7–8 Dec
Other expected events	8 Dec: publication of forecast	19 Oct and 30 Nov: publication of Beige Book	16 Nov: publication of Inflation Report
Expected rate movements[3]	→	→	→

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





At its July meeting, the **ECB** increased interest rates by 0.25 percentage point to 1.50% in the light of growing upside risks to price stability. The decision was also fostered by the ECB's efforts to keep inflation expectations firmly anchored below 2% over the medium term. At its subsequent meetings the ECB left rates unchanged. According to the current ECB forecast, the inflation rate should lie in a range between 2.5% and 2.7% for the rest of this year and decline to 1.2–2.2% in 2012. The ECB foresees only modest economic growth, subject to high uncertainty and intensified downside risks.

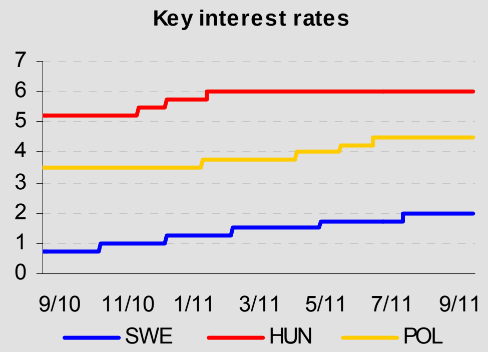
The **Fed** left its key interest rate unchanged and ended its quantitative easing in June (QE2). There had been speculation about a new round of quantitative easing, but this was not confirmed by the Fed. Nevertheless, the Fed announced a commitment to keep interest rates low until mid-2013. Economic growth remains slow (GDP growth was revised downwards), while labour market conditions remain slack, with the unemployment rate having edged up. The increased inflation rate during Q2 reflects commodity prices, the lagged effect of import prices, and supply chain disruptions caused mainly by shortfalls in imports from Japan.

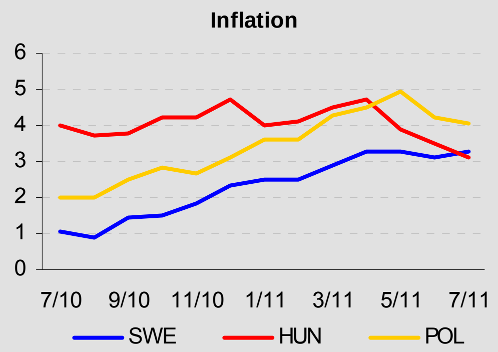
The **BoE** left its interest rate unchanged at 0.50% and maintained its stock of debt security purchases at £200 billion. Given the worse outlook for global economic growth, the BoE expects UK growth to recover only gradually. The inflation rate, which significantly exceeds the 2% inflation target, will probably rise even further this year but is expected to decline in the medium term as the factors which are temporarily boosting inflation (increases in energy prices and an increase in the VAT rate) dissipate and adverse developments in the labour market persist.

Selected central banks of inflation-targeting EU countries

	Sweden (Riksbank)	Hungary (MNB)	Poland (NBP)
Inflation target	2%	3%	2.5%
MP meeting (rate change)	5 Jul (+0.25) 7 Sep (0.00)	20 Jun (0.00) 26 Jul (0.00) 23 Aug (0.00)	5–6 Jul (0.00) 6–7 Sept (0.00)
Current basic rate	2.00%	6.00%	4.50%
Latest inflation	3.3% (Jul 2011)	3.1% (Jul 2011)	4.1% (Jul 2011)
Expected MP meeting	27 Oct 20 Dec	20 Sep 25 Oct 29 Nov	4–5 Oct 8–9 Nov 6–7 Dec
Other expected events	27 Oct: publication of Monetary Policy Report	1 Dec: publication of Quarterly Report on Inflation	Mid-Oct: publication of Inflation Report
Expected rate movements[1]	↑	→	↑

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





The **Riksbank** raised its key interest rate by 0.25 percentage point to 2.0% in July, but held the repo rate unchanged at its September meeting owing to a current reassessment of economic performance. The Riksbank expects a sharper slowdown of the Swedish economy compared to the July forecast, due to poorer global economic conditions. But next year growth is expected to recover. The labour market is worsening slightly, and both households and companies are more cautious in their investment and consumer decisions. Current inflation pressures are small.

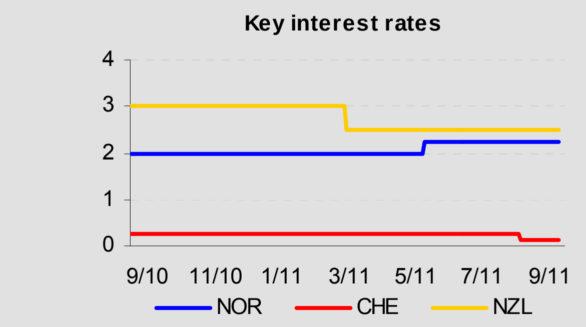
The **MNB** left its key rates unchanged. It expects to meet its inflation target by the end of 2012 even without monetary tightening, despite the cost shocks hitting the economy. Inflation fell to 3% in July, mainly as a result of a decline in food prices, but core inflation rose, due to the pass-through of higher commodity prices. Exports were the biggest contributors to Hungary's economic growth. The MNB expects output to remain below its potential over the next two years. It says that the falling contribution of exports to GDP growth may be partly offset by large-scale investment in the car industry. Household consumption is unlikely to pick up significantly, since households have been forced to increase expenditure on repayments of Swiss currency loans as a result of appreciation of the Swiss franc against the forint.

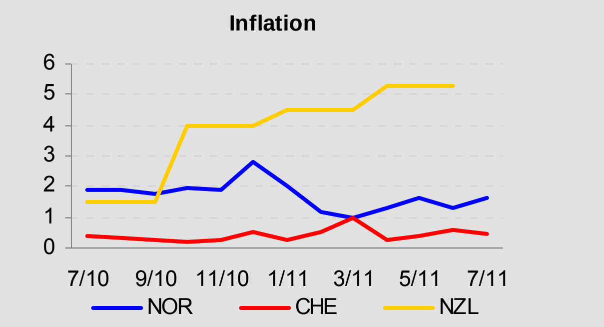
Following a series of rate increases in Q2, the **NBP** kept its key rates unchanged. In contrast to the global economy, domestic economic growth was relatively high and stable in 2011 Q2. The growth was fuelled by rising private consumption and accelerated investment growth. Inflation fell to 4.1% in July, but remains above the inflation target. The NBP expects inflation to remain elevated in the coming months, primarily due to a previous rise in commodity prices. In the medium term, inflation will be curbed by slower GDP growth, fiscal tightening (including reduced public investment spending) and interest rate increases in 2011 H1.

Other selected inflation-targeting countries

	Norway (NB)	Switzerland (SNB)	New Zealand (RBNZ)
Inflation target	2.5%	< 2%	2%[1]
MP meetings (rate changes)	22 Jun (0.00) 10 Aug (0.00)	16 Jun (0.00) 3 Aug (-0.50)	28 Jul (0.00)
Current basic rate	2.25%	0–0.25%[2]	2.50%
Latest inflation	1.6% (Jul 2011)	0.5% (Jul 2011)	5.3% (2011 Q2)
Expected MP meetings	21 Sep 19 Oct	15 Sep 15 Dec	15 Sep 27 Oct 8 Dec
Other expected events	19 Oct: publication of Monetary Policy Report	23 Sep: publication of Monetary Policy Report	15 Sep: 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.





The **Norges Bank (NB)** kept its key monetary policy rate unchanged at 2.25% in the previous period. The Norwegian economy maintained solid growth. House prices were still on the rise and the unemployment rate was stable. Inflation is lower than expected by the Norges Bank. Expected weaker growth internationally seems to be an adverse factor for the Norwegian economy going forward. The NB expects the interest rate to be in the interval 2.25–3.25% at the next monetary policy meeting (19 October), unless the Norwegian economy is exposed to new major economic shocks.

At an extraordinary meeting in August, the **SNB** lowered the target range for the interest rate (the Libor for CHF-denominated deposits) by 0.50 percentage point to 0.00–0.25%. The SNB also reacted to the appreciating Swiss franc. After initially supplying liquidity to the money market, it decided to set a minimum franc exchange rate against the euro (see *News* for details). The SNB foresees real GDP growth of around 2% for 2011. According to its mid-June forecast, the SNB expects an inflation rate of 0.9% for 2011, due to higher oil prices and higher import prices. For 2012 and 2013 it expects average inflation rates of 1.0% and 1.7% respectively.

The **RBNZ** left its key interest rate at 2.5%, commenting that economic growth was stronger than it had expected. According to Governor Bollard, it appears that the recovery is getting back on track, supported by a strong terms of trade. However, the situation around the US government's debt ceiling and the fragility in financial markets highlights the downside risk to trading partner activity. Provided current global financial risks recede and the economy continues to recover, the RBNZ does not foresee leaving rates at the current level. However, increases in the monetary policy rate in the short term may be jeopardised by the strong New Zealand dollar.

2. NEWS

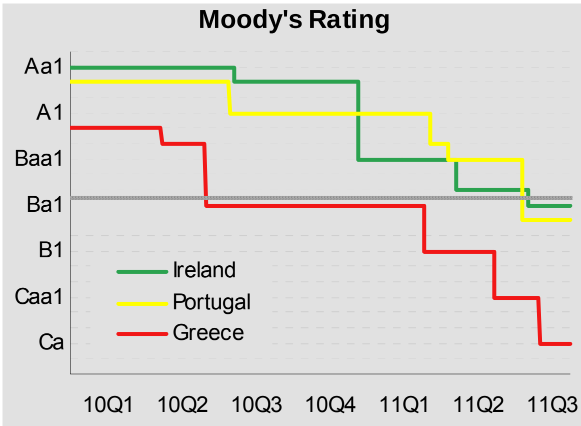
Review missions to Ireland and Portugal, unsatisfactory news from Greece

Staff teams from the European Commission, European Central Bank and International Monetary Fund reviewed the Irish economic programme in the first half of July. The first review mission to Portugal took place at the start of August. Ireland is being provided with assistance totalling €67.5 billion, while the Portuguese government's programme is supported by loans amounting to €78 billion. According to the conclusions of the review missions, both countries are on track with their reforms.

The conclusions from the visit to Athens, which took place in May and June, were far less satisfactory. Implementation of reforms had slowed sharply in recent quarters. Nonetheless, the fifth tranche of financial assistance was paid to Greece in July. The country has now been provided with €65 billion, i.e. more than half of the total planned amount of €110 billion. In addition, consultations are going on with Greece's creditors regarding voluntary private sector involvement. However, the Greek government has made the exchange of bonds conditional on 90% investor involvement. Staff teams are planning to visit Athens again in mid-September.

ECB suspends rating requirements for Portuguese government bonds...

The ECB suspended the application of the minimum credit rating threshold for the purposes of the Eurosystem's credit operations in the case of Portuguese debt instruments, as it had done previously in the cases of Greece (May 2010) and Ireland (March this year). The decision was disclosed shortly after Moody's downgraded Portugal's rating to speculative grade (Ba2).



...and buys bonds on markets

The ECB in August reactivated the securities market programme introduced in May of last year. The ECB justifies the purchase of bonds by the alleged need to supply liquidity to dysfunctional market segments. The objective of the operations is to restore an appropriate monetary policy transmission mechanism. In the final three weeks of August, the volume of bonds held by the ECB under the programme increased by €41.6 billion to €115.6 billion. The monetary impacts of these interventions are sterilised.

New monetary and financial statistics in EU

The ECB expanded the monetary and financial statistics in the area of data reported by monetary financial institutions (enhanced balance sheet data and data on reported interest rates, and new information on securitisations) and will also release quarterly balance sheet statistics for insurance corporations, pension funds and financial vehicle corporations. The new statistics are expected to contribute further to monetary analysis and to provide a new stimulus for the analysis of financial stability and financial integration.

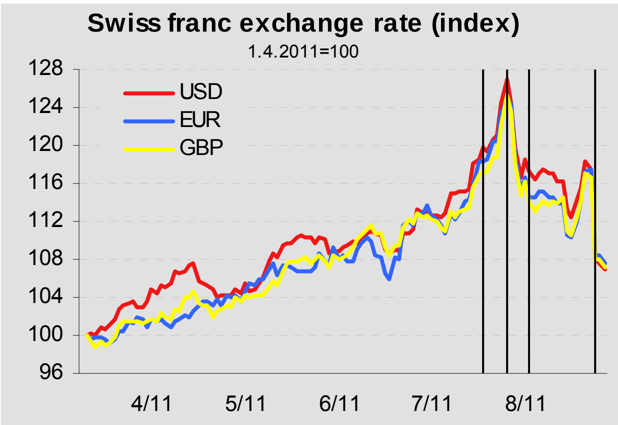
Central banks extend swap arrangements with Fed

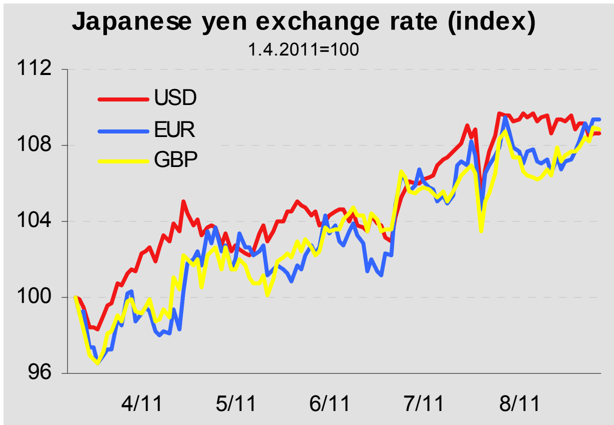
The central banks of Canada, Switzerland, the UK and the euro area again extended their dollar liquidity swap arrangements with the Fed. The measure to improve market functioning will be in place until August 2012. Japan, which had also been a party to the arrangements, decided against a further extension. The swap line between the euro area and the UK will also continue until September 2012.

Switzerland grapples with strong franc, Japan troubled by appreciating yen

The Swiss National Bank reacted on 3 August to the rapidly appreciating Swiss franc by deciding to narrow the interest rate target range (to 0.00–0.25%) and to significantly increase the supply of liquidity to the Swiss franc money market. On 10 August it announced a further increase and simultaneously decided to conduct foreign exchange swap transactions to accelerate the increase in Swiss franc liquidity. The SNB stepped up its measures on 17 August. However, when these efforts proved to be insufficient, the SNB on 6 September took strong action and set a minimum exchange rate of 1.20 CHF/EUR. If the rate falls below this level, it is prepared to buy foreign currency in unlimited quantities. Moreover, SNB Chairman Philipp Hildebrand stated that even at the said rate he regarded the franc as too strong, and he mentioned the possibility of further measures if the economic outlook and deflationary risks demand it.

Japan, too, is unhappy about the rising value of its currency. The Japanese finance ministry made interventions totalling JPY 4,512.9 billion (around $60 billion) against the strong yen in August.





IMF publishes first reports assessing global effects of national policies

The IMF, where Christine Lagarde was appointed managing director in July, published its first "spillover reports" examining the effects of the economic policies of large economies on other countries and also for the first time issued a study on financial stability in the euro area (EFFE). We look at the spillover reports in more detail in *Spotlight* in this issue of *Monitoring*.

Economic policy symposium takes place in Jackson Hole

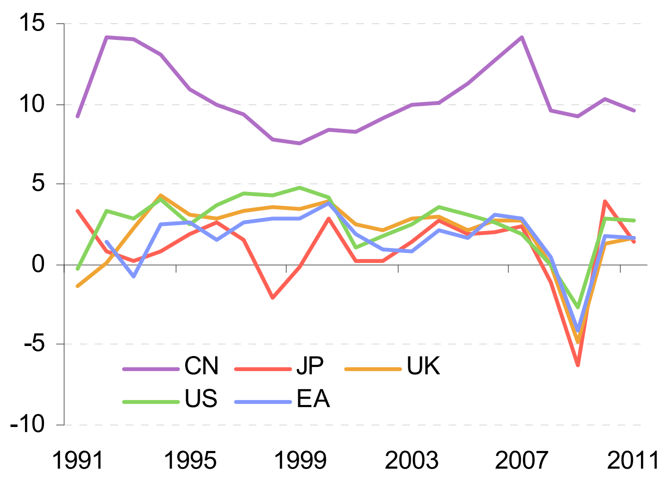
Central bankers, policymakers and academics from around the world gathered at the annual symposium held in Jackson Hole, Wyoming, in the last weekend of August. An eagerly awaited speech given by Fed Chairman Ben Bernanke (for more details see our selected speech on page 12) was followed by contributions from university professors. The speakers also included IMF Managing Director Christine Lagarde and ECB Governor Jean-Claude Trichet.

3. SPOTLIGHT: SPILLOVER REPORTS

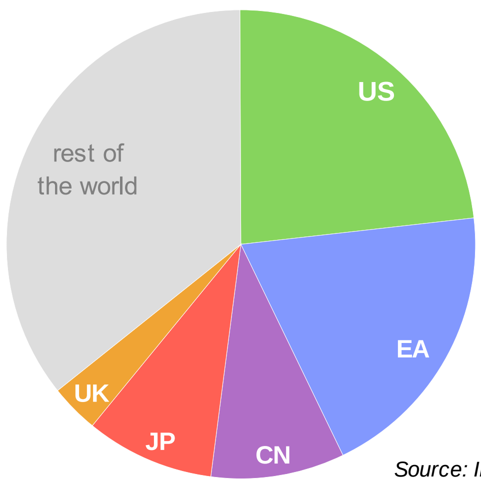
The International Monetary Fund (IMF) published its first "spillover reports" examining the effects of the domestic economic policies of the world's largest economies on the rest of the world. IMF staff teams communicated with key trading partners of the economies in question and with representatives of the countries themselves, focusing on issues raised during these discussions. The economies examined are China, the euro area, Japan, the United States and the United Kingdom. The aim of the reports is to stimulate further debate and serve as a basis for recommendations for the economies concerned. The following text briefly summarises the main messages of these five reports.

The importance of the five aforementioned economies in the world economy is due to their share in global trade (almost half the total volume) and global production (almost two-thirds). Moreover, they are – with the exception of China – strongly correlated. The position of the countries under review in the global financial system is also significant. The linkages between the various regions and the global impacts amplified by those linkages manifested themselves to an unforeseen extent during the global crisis. The monitored "five" have a major effect on events on the global scale and therefore also have the potential to generate and propagate economic shocks, be they positive or negative.

Real GDP Growth Rates, YoY



Share in World GDP(2010)



Source: IMF

The United States: the international role of the dollar

The global recession confirmed the strength with which economic shocks can spill over from the USA to the rest of the world. The IMF's standard simulations (capturing links via economic activity, international trade and exchange rates) generally show a fairly small effect on the economic growth of other countries, with the exception of Canada, Mexico and other close trading partners of the USA. But the results are very different when the effects of financial market ties, which are a major conduit spreading the impact of US policies, are included in the analyses. A change in US bond yields has a significant impact on yields in other countries, and the effect of share prices is larger still.

The role of dollar markets in the global economy is pivotal, as the dollar is the main reserve asset. The USA's net international liabilities are the largest in the world, implying large wealth spillovers. The central US role in financial intermediation consists in deep asset and money markets that channel liquidity globally. This explains the heavy foreign presence in the US banking system despite its focus on the domestic economy. Funds are channelled to the global banking system via major investment banks, often through the more internationalised UK markets. However, dollar markets stretch well beyond US borders, reinforcing spillovers while limiting the impact of US financial sector regulation. Pre-crisis, US regulations were often circumvented by investment banks moving trades to less regulated markets. The structural response to these pressures was embodied in the July 2010 Dodd-Franc Act, the biggest reform of US financial regulations since the 1930s. According to the IMF, this Act seems to have succeeded in its aim of reducing potential knock-on effects from major individual US banks to the global financial system. The subsequent market responses, however, may raise concerns about regulatory arbitrage between the United States and Europe. Markets may have seen these regulations as changing the relative competitive position of US and European banks. According to the IMF, the rules should be closely synchronised with other major international financial centres – especially the United Kingdom.

The IMF's analyses show that asset price links changed considerably over the crisis. Increases in US bond yields were usually consistent with higher growth prospects and expected monetary policy tightening. The dollar appreciated as capital flowed from other countries to the USA. In recent years, rising yields have become associated with better global financial sentiment and capital outflows from the USA. The timing of the return to more typical asset price relationships, and the nature of the "new normal", is a key uncertainty in assessing future policy spillovers. Rising US Treasury yields should at some point again become more an indicator of future US monetary policy tightening than of better global market sentiment.

A percentage point rise in the 10-year US Treasury bond yield

Pre-crisis

→ a 0.4 percentage point rise in advanced economy bond yields (the effect being larger for Australia and Canada and lower for Japan)
→ a rise of around 0.8 percentage point in emerging markets (except in China and India, where capital controls are applied)
→ a nominal depreciation against the dollar of 1–2% in open economies
→ a fall in commodity prices
→ little effect on global risk appetite
→ markets associated the rise with higher growth prospects and expected monetary tightening
→ capital inflows to the USA, dollar appreciation

Post-crisis

→ rising Treasury yields associated with better global financial sentiment and capital outflows from the USA
→ greater global risk appetite
→ higher commodity prices
→ higher equity valuations
→ depreciations of the dollar
→ the link between Treasury and emerging market yields disappeared

Concerns over monetary policy spillovers currently focus on the global impact of the end of quantitative easing (QE) and eventual Fed rate hikes. Although bond yields are the main conduit spreading the impact of monetary policy, spillovers from US monetary policy in any one country depend partly on their exchange rate policies. The IMF report mentions declines in foreign bond yields, appreciation of the dollar and higher US inflation expectations as the impacts of QE. Moreover, capital inflows to emerging countries increased after QE announcements. The estimated impacts of QE1 on asset prices are larger than the effects of pre-crisis measures or QE2. Moreover, unlike QE1, QE2 does not appear to be associated with an improvement in global financial conditions. A future monetary policy tightening by the Fed, including by draining liquidity, could cause a jump in Treasury yields and sharper outflows from emerging markets, particularly if the move was unexpected. Emerging markets are particularly susceptible to changing capital flows.

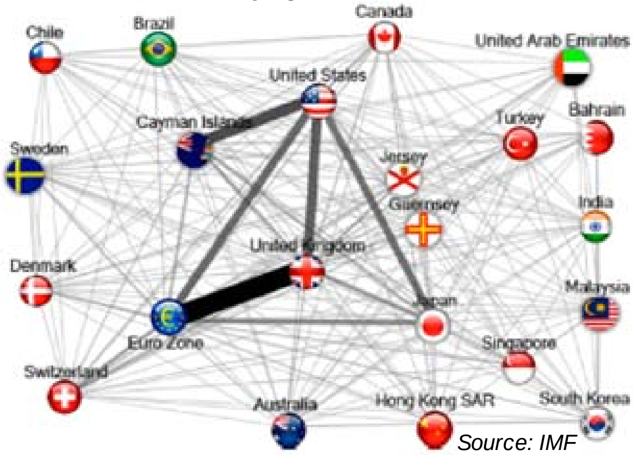
As regards public finances, the IMF sees the main risk in a loss of market confidence. US fiscal consolidation would create permanent positive growth spillovers via lower global real interest rates as well as short-term negative spillovers via losses in US activity. The long-term impact of fiscal consolidation on foreign output should be positive.

The United Kingdom: a large, globally interconnected financial sector

Although changes in the UK can have sizeable spillover effects via mutual trade (especially on euro area countries), the financial sector is the main channel for transmitting them. UK-based banks play a leading role in global financial intermediation. Moreover, the UK financial system is highly interconnected with the rest of the world. This makes it a potent originator, transmitter and potential dampener of shocks to the global system. A shock originating in the UK would have sizeable cross-border effects, particularly on global financial centres, and also have a large adverse impact on measures of global financial market risk (explaining around a quarter of its movements according to the IMF).

UK-based financial institutions accounted for more than half of global funding generation during the boom. However, they accounted for 27% of the decline in cross-border lending in the first half of 2009. IMF simulations suggest that such shocks are likely to have a severe effect on countries that depend on the UK for short-term funding, e.g. Hong Kong, Luxembourg and Cyprus. Ireland is the most extreme case.

Propagation of Shocks



Source: IMF

The bond market represents an additional important channel of transmission of financial shocks. This is driven by the large volumes of foreign bonds traded in London. According to the IMF's results, more than 50% of the initial yield shock in the UK spills over to euro area yields, and to a smaller extent to the US and Japan. Equity market spillovers, while significant, are smaller and less persistent.

In response to the crisis, the UK government has embarked on a major reform of financial market regulation and supervision. The tightening of liquidity rules will constrain SIFIs, dampen the credit cycle, and should help lower systemic risks. However, a consequence of this could be the emergence of trapped pools of liquidity, potentially detrimental to global financial stability. Higher capital requirements are likely to have only modest and probably transitory costs in the form of lower economic activity. The impacts of the reforms will also be influenced by the policies of other jurisdictions, especially Europe. The IMF draws attention to the possibility of financial activity being moved to other jurisdictions.

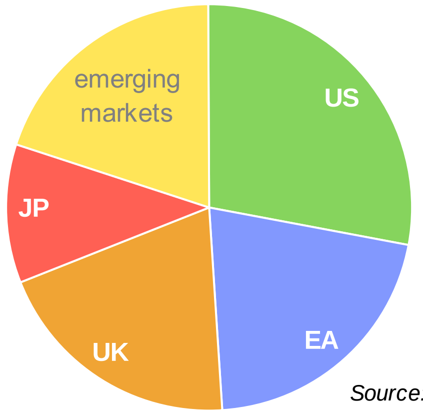
The IMF adds that the UK seems well placed to contribute to the implementation of global macroprudential policies. It has unique informational advantages, as a large number of global players are subject to UK oversight. However, regulatory arbitrage must be prevented with the aid of effective international cooperation.

The euro area: the need to cope with the debt crisis

Global risk, which is significantly affected by euro area (EA) developments (the IMF's estimate is about one-fifth), increased sharply in spring 2010 as pressures in peripheral European countries intensified, although the rise was not as severe as during the Lehman episode in late 2008. According to the IMF, direct spillovers from the sovereign bond markets in Greece, Ireland, Portugal and Spain to the rest of the world appear to be modest; volatility has spilled over mainly to markets of other EA countries. However, spillovers from stress in core EA financial institutions would be much larger. For example, the analyses indicate that if there is distress in a major bank, the probability of distress in many non-EA banks would exceed 40%. In addition, a modelling approach indicated that EA growth would fall by 2.5 percentage points relative to the baseline, while global growth would fall by about 1 p.p. over 2011–12.

The IMF report goes on to say that ECB exceptional liquidity provision has helped contain deleveraging by EA banks and corresponding spillover effects. A slightly faster pace of monetary tightening than markets presently expect would have generally limited impacts. By contrast, the repercussions of an early withdrawal of the exceptional long-term liquidity provided to banks could be significant. The scenario assumes that periphery banks' funding costs would increase by 500 basis points. The losses of Greek, Portuguese and Irish banks would exceed 20% of bank capital. The impacts on the EA would result in a contraction of the foreign activities of banks. The UK and some CEE countries (Poland, Romania, Bulgaria and Serbia) would be significantly affected.

Contribution of regions to risk commonalities
average over 8/07-2/11, in %



Source: IMF

Fiscal consolidation should have only slightly negative global demand effects that could be more than offset by credibility gains. According to the IMF, any deleveraging associated with higher bank capital requirements (under Basel III) is expected to have only modest spillovers. Shock transmission via the real economy would be particularly intensive for geographically close countries with strong trade ties to the EA (Russia and North African countries in addition to the rest of the EU).

China: sustainability of growth, undervalued exchange rate and huge forex reserves

China is a major trading partner of 78 countries. This means that it can transmit real shocks (domestic and external) widely. China's economic ascent has yielded growth effects in many parts of the world and brought benefits to consumers in terms of low prices, but there are concerns regarding the sustainability of China's growth. China itself recognises the problems of its export-oriented model. Greater reliance on consumption is official policy under the 12th Five Year Plan. China's current trajectory entails unprecedented gains in market share, potentially implying a price or profit squeeze in China's corporate sector and non-performing loans in banks. It will be difficult to accommodate price cuts within existing profit margins, so the question is how Chinese firms could respond to unexpected demand weakness. Continued high investment in China could create excess capacity, given uncertain demand prospects in advanced economies, thus risking a hard landing that reverberates beyond China.

Deterioration in the quality of corporate and financial balance sheets could hit many players through trade and investment. An increase in Chinese corporate default probability of 2 percentage points lowers industrial output by about 0.75% in emerging Asian economies and 0.5% in commodity exporters. The impact on most advanced economies is small (except Japan, where it would be 0.5%). Deterioration in China's banking sector produces similar effects.

As it has grown rapidly, China has also become a dominant commodity importer. This means it can significantly affect global commodity prices. By the IMF's estimation, China has accounted for 20% of the price rise since the end of 2004. A slowdown in China would have a significant impact on commodity exporters – a 3% reduction in the growth rate of industrial output would result in price declines of 6% for oil and base metals.

A renminbi correction (appreciation) is necessary to rebalance demand and lower the current account surplus. However, structural reforms are also needed to reduce savings. Renminbi appreciation would boost trading partners' growth, but producers in emerging Asia may experience a deterioration in their current account balance initially. The positive spillover from currency adjustment could be reinforced by additional policies. If domestic demand also were to rise with currency appreciation, the growth and trade balance effects would more than double. China would contract initially but the ultimate impact would be mildly positive.

The channels of China's influence on global asset prices are complex. On the one hand, that influence is greatly constrained by China's relatively closed capital account. On the other, the sheer size of China's savings and its rising foreign currency reserves play a role. As to the composition of China's foreign currency reserves, it is presumed that at least two-thirds are allocated to US dollar assets. The IMF's simple statistical analysis shows that if China gradually shifted $100 billion in dollar assets to emerging market securities, US long-term yields would rise by some 12 basis points, yields in other advanced economies would rise by about 6 basis points, and emerging market yields would fall sharply, by as much as 50 basis points.

The IMF also speculates that China might have affected capital inflows in emerging markets. Reserve accumulation depresses yields in advanced countries. Capital controls prevent investors from gaining exposure to China, thus diverting capital to other economies. It is unclear which way net flows would go if China were to open up its capital account. Chinese savers currently have few choices – bank deposits with zero to negative real returns, a volatile domestic stock market, and real estate whose prices have risen to a degree that the term "bubble" is often employed. The IMF adds that although China's policies can affect capital flows, that role is secondary to fundamentals such as emerging market country growth and advanced country liquidity conditions.

Japan: sophisticated products and high government debt

The March earthquake drew attention to Japan's role in the global production chain. Specialised, highly sophisticated components are produced in low volumes, and often one small company can have an 80% global market share. If it fails, the whole global supply chain can be thrown into disarray. Despite that, growth spillovers from Japan on the global economy are likely to be limited.

The impact of financial market shocks appears to be smaller. Japanese debt and equity markets are among the top five international markets in size, but are primarily geared towards domestic investors. Only 5% of Japanese government bonds are held by foreign investors. Given its domestic focus, Tokyo is not a major intermediator of global capital flows.

There are concerns about public debt. The growing debt stock is making Japan's fiscal position increasingly vulnerable to upward movements in interest rates. Delayed fiscal reform would increase the risk of a rise in yields. There is also a risk of unexpected shifts in the portfolio preferences of Japanese investors and of a fall in interest in holding domestic bonds. The IMF considers a hypothetical situation where Japanese investors sell $500 billion of Japanese government bonds and purchase instead US Treasury Bonds, German Bunds, UK Gilts and other advanced-market bonds. This shift would roughly double the stock of Japanese government bonds held by foreigners, raising Japanese interest rates by 160 basis points. A bond shock, particularly if accompanied by an equity price drop, could trigger deleveraging by Japanese banks. However, this would only materialise in the event of a major shock. In a stress test, Japan's top banks were found to be able to absorb a 300 basis point hike in yields. A rise in Japanese government bond yields could translate into higher interest rates elsewhere, especially in countries with large public debt.

The IMF also modelled a situation where the Bank of Japan continued its comprehensive monetary easing for another two years. This is expected to raise inflationary expectations and thus support demand; yet hardly any spillovers would be seen abroad. It is also not likely to have any effect on the exchange rate. Not even a sizeable nominal effective depreciation of the Japanese yen should have any impact on regional trade. Trade with the United States and Europe, on the other hand, would be more sensitive to exchange rate changes.

4. SELECTED SPEECH: THE NEAR- AND LONGER-TERM PROSPECTS FOR THE US ECONOMY

Federal Reserve (Fed) Chairman Ben S. Bernanke gave an eagerly awaited speech on the gradual recovery process in the USA at the Federal Reserve Bank of Kansas City Economic Symposium in Jackson Hole on 26 August 2011.

Mr Bernanke began his speech with an analysis of the current economic situation. He regards the banking system as being healthier now than it was before the crisis broke out in 2008. Banks have improved their risk management and transparency. Credit availability from banks has generally improved, though it remains tight for small and medium-sized enterprises. Households have started to save more and borrow less, which has reduced their debt burden. Notwithstanding these positive developments, however, aggregate output has not returned to its pre-crisis level. Unfortunately, economic growth is not leading to reductions in unemployment, which is fluctuating around 9%. According to Mr Bernanke, the recovery process is being slowed by two features which were absent from past economic crises, namely a very deep slump in the housing market and a crisis in the financial sector. These are affecting both households, which are experiencing financial hardship due to the mortgage crisis, and builders, who do not have access to capital for new home construction. Mr Bernanke regards the financial stress associated with property price volatility as another significant drag, as it is increasing general risk aversion in the financial sector and reducing households' willingness to spend.

In the part of his speech dedicated to monetary policy, Mr Bernanke repeated the Fed's decision to provide the public with information on the expected future path of the federal funds rate. The current macroeconomic outlook indicates the need to keep interest rates exceptionally low at least until mid-2013. Mr Bernanke said that the Fed has a range of tools that could be used to provide additional monetary stimulus to support the economic recovery, and that they will be discussed again at the meeting in September, which has been scheduled for two days (the 20th and the 21st) instead of one. Although Mr Bernanke made no mention of a further round of quantitative easing (a possibility expected by the markets), further discussion of this option is not ruled out.

Mr Bernanke believes it is the government's responsibility to stabilise the housing market situation and thereby overcome the present economic downturn. With regard to long-run economic growth, which affects living standards, he regards it as important for the government to return to the issues it started to address before the crisis. These issues include population ageing, reform of the primary and secondary educational system, and the costs of health care in the USA, which are the highest in the world. The central bank promotes economic growth in the long term through low inflation and financial market stability, but most tasks in the real economy area rest on the shoulders of the government, which has the power to make structural reforms. According to Mr Bernanke, to achieve economic and financial stability, the USA needs an immediate stabilisation (and in subsequent years reduction) of public debt. It is difficult to judge the impact on economic activity of the recent dramatic approval of the plan to raise the USA's debt ceiling. According to Mr Bernanke, however, there is little doubt that these events have hurt household and business confidence, thereby increasing the level of risk in the economy.

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