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In this issue

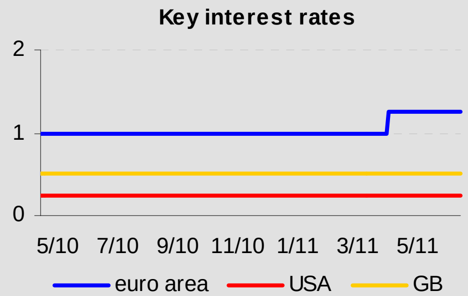
The global economic recovery is continuing, albeit at a slow rate. The debt crisis in Europe is entering a new phase. Discussions are going on at the EU, ECB and IMF level regarding the options for further financing the Greek debt and other methods of resolving this issue, including debt reprofiling. Growth in commodity and energy prices in the previous quarter caused inflation to rise in the economies under review. The ECB meeting in April brought the first increase in key interest rates in the euro area, but the following months saw no changes. Monetary policy was tightened further in Poland, Sweden and Norway. The remaining central banks under review left their key rates unchanged. The cycle of monetary policy tightening by major central banks outside continental Europe (Fed, BoE) will probably not start in the next quarter. In Spotlight *we take a look at monetary policy communication. Our selected speech presents the views of the former Bundesbank Governor Axel Weber on challenges for monetary policy in EMU.*

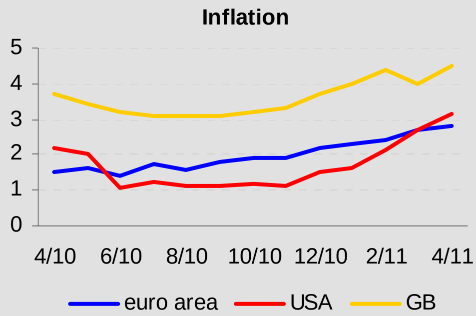
1. LATEST MONETARY POLICY DEVELOPMENTS AT SELECTED CENTRAL BANKS

KEY CENTRAL BANKS OF EURO-ATLANTIC AREA

	Euro area (ECB)	USA (Fed)	United Kingdom (BoE)
Inflation target	< 2%[1]	n.a.	2%
MP meetings (rate changes)	7 Apr (+0.25) 5 May (0.00) 9 Jun (0.00)	15 Mar (0.00) 26–27 Apr (0.00)	9–10 Mar (0.00) 6–7 Apr (0.00) 4–5 May (0.00) 8–9 Jun (0.00)
Current basic rate	1.25%	0–0.25%	0.50%
Latest inflation	2.7% (May 2011)[2]	3.2% (Apr 2011)	4.5% (Apr 2011)
Expected MP meetings	7 Jul 4 Aug 8 Sep	21–22 Jun 9 Aug	6–7 Jul 3–4 Aug 7–8 Sep
Other expected events	8 Sep: publication of forecast	27 Jul: publication of Beige Book	10 Aug: publication of Inflation Report
Expected rate movements[3]	↑	→	→

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





The **ECB** assessed the risks to inflation as being slightly on the upside in April and raised its key monetary policy rate by 0.25 percentage point. This took the rate back above the 1.00% level for the first time in two years. However, the rate corridor was left narrower than before the crisis, at ±0.75 percentage point. No changes were made to the monetary policy settings at the subsequent meetings in May and June. Refinancing operations will continue to be conducted as fixed rate tender procedures with full allotment at least until October.

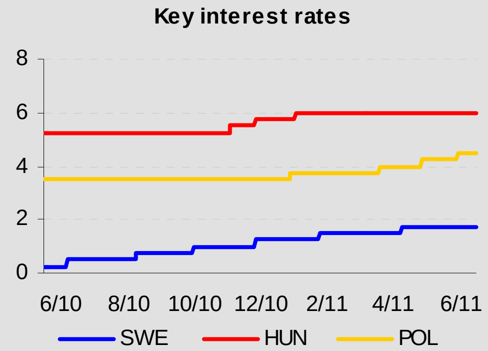
The **Fed** left its key rate unchanged and continued its quantitative easing (QE2), which, however, should be discontinued in June. Economic activity has been rising modestly in recent months and labour market conditions are gradually improving. Headline inflation was pushed up by large increases in food and energy prices, while core inflation remained subdued. Long-term inflation expectations remain stable.

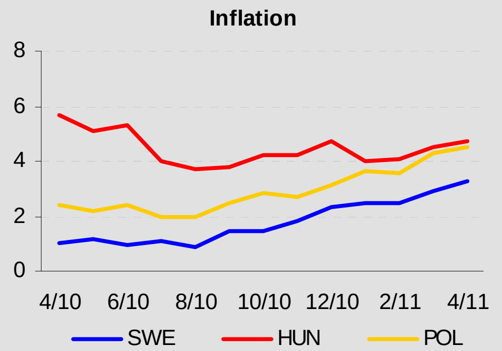
The **BoE** left its monetary policy rate unchanged at 0.50% in this quarter and maintained its stock of debt security purchases at £200 billion. Inflation is still high owing to global price pressures and increases in VAT. The BoE expects inflation to reach 5% by the end of this year, but to decrease next year. While there is a risk that upside factors will persist, uncertainty over the evolution of the still weak domestic demand is acting in the opposite direction. Three MPC members out of nine voted to increase rates at the May meeting, with one member even favouring an increase of 0.50 percentage point.

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 April 2011 (+0.25)	28 Mar (0.00) 18 Apr (0.00) 16 May (0.00)	4–5 Apr (+0.25) 10–11 May (+0.25) 7–8 Jun (+0.25)
Current basic rate	1.75%	6.00%	4.25%
Latest inflation	3.3% (Apr 2011)	4.7% (Apr 2011)	4.5% (Apr 2011)
Expected MP meetings	5 Jul 7 Sep	20 Jun 18 Jul	5–6 Jul 23 Aug 5–6 Sep
Other expected events	5 Jul: publication of Monetary Policy Report	22 Jul: publication of Quarterly Report on Inflation	6 Sep: 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 1.75% last quarter. The Swedish economy is continuing to grow strongly, supported by exports and domestic demand. Although current inflationary pressures are low, the Riksbank expects them to increase as economic activity in Sweden strengthens. The overall inflation rate is relatively high at present owing to rising commodity and energy prices. To stabilise inflation close to the target and to prevent the economy from overheating, the Riksbank decided to continue raising the repo rate.

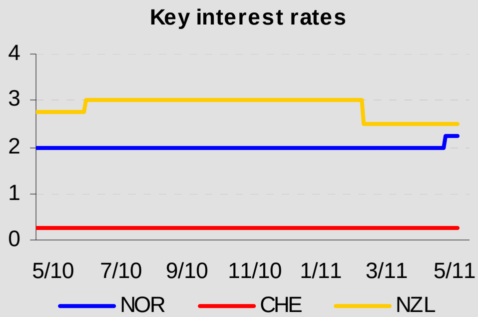
The **MNB** left its key rates unchanged in the previous period. It expects domestic economic growth to improve in the next six months, although the level of economic activity will remain below potential output. The inflation rate will stay above the inflation target in the near future due to pronounced domestic cost shocks but should fall back to the inflation target by the end of this year even without a monetary policy tightening.

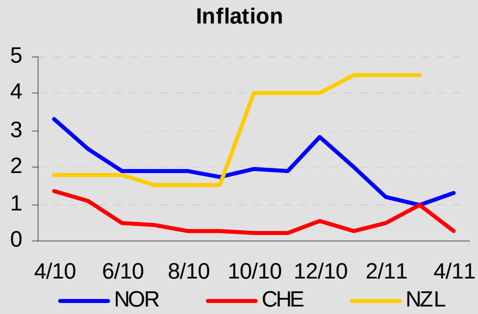
At its meetings in April, May and June, the **NBP** increased its key interest rates each time by 0.25 percentage point to 4.50% owing to an expected rise in inflation and wage pressures associated with relatively dynamic economic growth, which is being accompanied by falling unemployment. Inflation was 4.5% in April due to faster growth in prices of food, energy and other categories of goods and services. As a result, core inflation rose further. Inflation expectations are also relatively high.

Other selected inflation-targeting countries

	Norway (NB)	Switzerland (SNB)	New Zealand (RBNZ)
Inflation target	2.5%	< 2%	2%[1]
MP meetings (rate changes)	16 Mar (0.00) 12 May (+0.25)	17 Mar (0.00)	10 Mar (-0.50) 28 Apr (0.00) 9 Jun (0.00)
Current basic rate	2.25%	0–0.75%[2]	2.50%
Latest inflation	1.3% (April2011)	0.3% (April 2011)	4.5% (2011 Q1)
Expected MP meetings	22 Jun 10 Aug	16 Jun	28 Jul
Other expected events	22 Jun: publication of Monetary Policy Report	16 Jun: 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)** raised its monetary policy rate by 0.25 percentage point to 2.25% in May. The Norwegian economy is still benefiting from rising economic activity in its trading partner countries and from high prices of energy commodities on world markets. So far, the low interest rate level has not yet triggered an increase in household borrowing, but house prices have risen. The NB's forecast does not expect any significant rise in wages in 2011, but unemployment has recently been lower than expected.

The **SNB** left the target range for the interest rate (LIBOR on CHF-denominated deposits) unchanged at 0.00–0.75% and is keeping the LIBOR rates within the lower part of this range, i.e. at roughly 0.25% on average for the quarter. The Swiss economy recorded unexpectedly fast growth again in 2010 Q4, despite the strong Swiss franc. The SNB forecast currently expects economic growth of around 2% for 2011. Based on its forecast the SNB assumes a slight rise in inflation for 2011 due to high oil prices and dynamic domestic growth. Average inflation is expected to amount to 0.8% for 2011, 1.1% for 2012 and 2.0% for 2013.

The **RBNZ** reacted in March to the effect of the earthquake by lowering its key interest rate by 0.50 percentage point to 2.50%. At the meetings in April and June it left rates unchanged. Although some signs of recovery can be seen, economic growth will be dampened by high household debt and continued fiscal consolidation. Headline inflation is being affected by increases in indirect taxes and food and energy prices, and inflation expectations have edged up as well. Despite this, core inflation remains low. However, the RBNZ expects it to rise gradually in the future and foresees a gradual increase in rates over the next two years.

2. NEWS

G7 countries intervene in exchange markets following catastrophe in Japan

Japan agreed on concerted intervention with the other G7 countries (the UK, France, Italy, Canada, Germany and the USA) after it was faced, in addition to the consequences of the catastrophic earthquake and tsunami, with a rapid appreciation of the yen. These countries intervened in exchange markets on 18 March in order to reduce the increased volatility and stop the yen appreciating further and thereby help to restore economic and financial stability. In addition, since April the Central Bank of Japan has been providing special loans totalling JPY 1 trillion to financial institutions affected by the earthquake.

Central Bank of Ireland publishes planned financial measures…

At the end of March the Central Bank of Ireland presented a package of banking sector stabilisation measures approved under an agreement with the European Commission, the ECB and the IMF. Capital requirements and deleveraging plans, including numerous target ratios, have been set for specific banks on the basis of loan loss estimates and stress test results. Banks will be required to sell assets in a controlled manner between 2011 and 2013.

…ECB suspends requirement to assess rating of Irish government bonds…

At the same time the ECB decided to suspend the application of the minimum credit rating threshold in the collateral eligibility requirements for the purposes of the Eurosystem's credit operations in the case of debt instruments issued or guaranteed by the Irish government. The suspension applies to all outstanding and new marketable debt instruments. It will be maintained until further notice.

…and Irish economic programme is reviewed by international institutions

Representatives of the European Commission, the ECB and the IMF visited Dublin in the first half of April to review the economic programme that the new Irish government took over in March and pledged to continue implementing. The delegation welcomed Ireland's efforts so far, praising in particular its proposed banking system reforms and emphasising the need to ensure sustainability of public finances. Structural reforms, which should foster higher employment, were also assessed positively.

Financial assistance for Portugal

Financial aid conditions were agreed in May between Portugal and the European Commission, the ECB and the IMF. If the programme requirements – including structural reforms, fiscal consolidation and financial sector recapitalisation and deleveraging – are fulfilled, the country will be granted a loan totalling €78 billion. The programme will be financed by the IMF, the EFSM and the EFSF (€26 billion for each).

Fed to hold press briefings following monetary policy decisions

Fed Chairman Ben S. Bernanke will hold press briefings four times per year – following selected monetary policy meetings – to present the FOMC's current economic projections and to provide additional context for its monetary policy decisions. The introduction of regular press briefings is intended to enhance the clarity and timeliness of the Fed's monetary policy communication. Monetary policy communication is covered in more detail in *Spotlight* in this issue of *Monitoring* (see also the following news item).

Magyar Nemzeti Bank has new projection model

The MNB introduced a new projection model in 2011 Q1. Whereas its previous projections were based on an assumption of a constant monetary policy rate and exchange rate, the new model treats these variables as endogenous. The interest rate path is therefore the key output of the projection, although the MNB has decided not to publish it. The MNB will, however, provide verbal comments on the expected direction of interest rates.

Central banks of New Zealand and China announce currency swap facility

The RBNZ and the People's Bank of China (PBOC) agreed on a swap line worth RMB 25 billion (NZD 5 billion), which the RBNZ can use in situations where New Zealand's businesses do not have access to renminbi. Although there is no need to use the facility right now, both sides consider it useful in the event of market disruption. The facility has a three-year maturity and may be extended. The introduction of the swap line follows on from actions by the PBOC to facilitate the settlement of transactions with Chinese firms in RMB. Similar arrangements have been established in previous years with the central banks of other countries (see for example Singapore, Iceland, Hong Kong and Malaysia).

Central Bank of Iceland buys Icelandic krónur in auction

The Central Bank of Iceland started Phase I of its March capital account liberalisation strategy and invited selected economic agents to submit offers to sell Icelandic krónur in return for payment in euros. It offered to purchase a total of ISK 15 billion. The auction is the first step in the removal of restrictions on movement of capital introduced after the collapse of the Icelandic banking sector in autumn 2008. Concurrent with the auction, króna-denominated Treasury bonds maturing before end-May 2013 are being bought back.

3. SPOTLIGHT: CENTRAL BANK COMMUNICATION

The newly introduced Fed press conferences following interest rate decisions are a further step towards greater US monetary policy transparency. However, the Fed is no pioneer in this respect, as many central banks have long regarded press conferences, public statements and discussions with journalists as a matter of course. This move by the Fed can therefore be seen as a reflection of the long-running trend towards greater central bank openness and transparency, a trend that is described in this article.

The keywords of modern monetary policy are transparency, accountability and credibility. These values can only be achieved through effective – i.e. open and comprehensible – communication. Central bank independence is an important incentive for increased transparency. Such independence must be accompanied by a high degree of public accountability and by explanation of decisions and the reasons for them. Transparency helps market participants to understand monetary policy, making it more credible and effective. A credible central bank can steer the economy by "merely" communicating its intentions.

However, monetary policy transparency does not have a long history. As recently as the early 1990s, central bank decision-making was shrouded in a veil of secrecy. The Reserve Bank of New Zealand and the Bank of England were among the first central banks to bring in greater transparency. Since then, the level of monetary policy communication has developed significantly and the transparency of central banks around the world has increased greatly.

Effective communication has two main roles in monetary policy. First, it helps anchor long-term inflation expectations, and second, it reduces financial market volatility. Central banks can directly influence only very short-term interest rates, which are not themselves very important for economic agents' decisions. Rates with longer maturities, which are affected among other things by expectations about short-term rates, and thus by central bank communication, are of key importance for the transmission of monetary policy to the economy.

Communication as a means of influencing private sector expectations is extremely important at time of increased uncertainty. During the recent global financial and economic crisis, it was necessary in order to properly explain the use of unconventional instruments and above all to help restore the private sector's confidence in the economy and in the functioning of the markets. In an extreme scenario where monetary policy rates are nearing zero, communication is probably the most important monetary policy instrument.

Transparency is especially crucial in the inflation targeting regime, which is based on a publicly specified inflation target. Regular communication of the forecast, of the economic factors that speak in favour of leaving rates unchanged or of changing them, and of the risks going forward is an integral part of this regime. As monetary policy decisions pass through to inflation with a lag, policy must be forward-looking. This principle may not be easy for the public to understand, so it must be stressed repeatedly. Ex post assessment of deviations of inflation from the target and their causes is also crucial for central bank credibility.

Communication strategy

In order for communication to be effective, the different target groups must be addressed in specific ways through different communication channels. The messages sent out should not curb the room for future action. Communication should be directed at all market participants at the same moment in time. To prevent market distortion, nobody should be given preferential and/or earlier access to information. Transparency means more than just provision of information (information openness). Information must be communicated and structured in such a way that the public can understand it. Too much detail can be indigestible and counterproductive. Moreover, an overly dominant information position of the central bank may “crowd out” independent opinions in the private sector.

The primary long-term framework for communication with financial markets is the public announcement of targets and policy strategy. For example, the announcement of the inflation target upon switching to inflation targeting may itself significantly shape inflation expectations if this step is taken in a credible way and accepted by the markets. A quantitative target helps market participants to anchor their expectations. Even the ECB, which does not call its monetary policy inflation targeting, defines price stability in numerical terms. The Fed has a different strategy with two statutory objectives, namely price stability and full employment, but neither of these is quantified.

In addition to communication of future inflation, information about other economic indicators describing the real economy, the labour market and so on is important. It is normal these days for central banks to disclose forecasts for all these indicators, to hold press conferences after their policy meetings, and to publish the minutes of those meetings, often supplemented with information on how the individual monetary policy committee members voted. However, differences also exist. The Bank of England holds press conferences not after meetings on rate changes, but only upon publication of its Inflation Report. Neither the ECB nor the RBNZ provides minutes of meetings. Most central banks apply certain restrictions on communication (communication embargoes), especially before policy meetings, but also for some time following them when such communication could increase market volatility.

The transition of many central banks, such as the RBNZ, Riksbank, Norges Bank and the CNB, to an “unconditional” forecast (the endogenous interest rate path consistent with the forecast) was a new challenge (not only) for communication. Hungary’s MNB is a newcomer to this area, having introduced endogenous interest rates in 2011. Unlike the aforementioned central banks, however, the MNB does not currently publish its interest rate forecast and limits itself to a verbal description of the likely future path of interest rates, as was similarly the case of the CNB until 2007.

The main argument against publishing interest rate forecasts is that private entities might mistakenly view the rate outlook as a central bank commitment to achieving the forecasted rates. Experience has shown, however, that this risk can be minimised by appropriate communication. Opinions in favour of this step, moreover, say that it entails a high degree of transparency, having a significant impact on market expectations and helping the market to anticipate monetary policy decisions.

Central banks are also wary about publishing exchange rate projections. The RBNZ pioneered publication of the exchange rate path. It publishes an index of main trading partner currencies (the WTI), i.e. a nominal effective exchange rate. Other central banks (e.g. the BoE, Riksbank and Norges Bank) also publish effective exchange rate forecasts. The CNB is the only central bank in the world to publish a nominal exchange rate of the domestic currency against one specific currency, the euro. (Colombia’s central bank started to publish a nominal exchange rate path in 2003 but abandoned this practice a year later.)

Last but not least, it is important who communicates monetary policy decisions. In many central banks the individual monetary policy committee members vote on interest rates. This means that their communication is not always unified before or after the meeting. At the Norges Bank and the ECB, on the other hand, decisions are made by consensus, so it is understandable that these central banks do not publish voting information. The same goes for the RBNZ, where formally only the governor decides and the board has an advisory function. Although the literature mentions the “cacophony problem”, i.e. the risk that multiple different opinions of the board members will confuse the public, decision-making by voting is the dominant practice. An increasing number of banks are also publishing the minutes of their meetings, voting ratios or even attributed voting records (the Sveriges Riksbank even details the arguments of individual board members). In 2010, the Bank of Mexico and the Bank of Thailand started to publish minutes and the latter also started to disclose the ratio of the votes cast. The CNB started disclosing voting ratios in 2000 and attributed voting records in 2008.

Not only financial markets

The previous paragraphs focused on communication mainly with the financial markets and financial professionals. However, central banks also communicate in the monetary policy area with international institutions and other central banks and usually also make representations to parliamentary committees.

Central bank communication with the public is also important. It has two main objectives, accountability and effectiveness. The effect on inflation expectations and hence on wage bargaining is also important. Unlike analysts, who look up the central bank's communications themselves and carefully monitor them, the public usually has to be addressed actively. Besides publishing articles in the press and appearing in the media, central bankers organise open days. Many central banks organise exhibitions and lectures for the public. In recent years emphasis has also been placed on educating the public. This has included creating educational programmes for children and distributing educational games. The ECB, the Fed and the BoE, as well as smaller central banks such as the Bank of Finland, are particularly active in this area.

	Press conference following MP meeting	Minutes of MP meeting	Publication of voting information	Publication of interest rate forecast	Publication of exchange rate forecast
ECB	yes	no	no (collective decision)	no	no
Fed	yes	yes (after three weeks)	yes	no	no
BoE	after publication of the Inflation Report	yes (after two weeks)	yes	no	no
Sveriges Riksbank	yes	yes (after two weeks)	yes	yes	TCW index
Hungarian MNB	yes	yes	yes	no	no
Polish NBP	yes	yes (after three weeks)	yes	no	real effective exchange rate
Norges Bank	yes	no	no (collective decision)	yes	effective exchange rate
Swiss SNB	no	no	no	no	no
RBNZ	yes	no	no (governor decides)	yes	WTI index
Australian CB	no	yes (after two weeks)	no (collective decision)	no	no
Canadian CB	after publication of MP Report	no	no (collective decision)	no	no
Israeli CB	no	yes (after two weeks)	no* (governor decides)	yes	no
Czech National Bank	yes	yes (after eight days)	yes	yes	CZK/EUR

* Under the Central Bank Act of 2010, a monetary policy committee should be appointed and the ratio of the votes cast published.

4. SELECTED SPEECH: CHALLENGES FOR MONETARY POLICY IN EMU

Axel A. Weber, who ended his seven-year term as President of Deutsche Bundesbank at the end of April, presented his views regarding future monetary policy in the euro area on the occasion of the Homer Jones Memorial Lecture on 13 April 2011.[1]

Mr Weber opened his lecture by pointing out that in recent years academic researchers have been taking up leading positions at central banks. He mentioned some academics who went on to become central bankers: Mervyn King, Ben Bernanke and Janet Yellen, and added his own name to the list. He stressed that thanks to this trend academic insights had been swiftly applied in practical monetary policy during the financial and economic crisis. He believes that the crisis raised a number of new issues for academic research in the years ahead. He touched upon some of these issues in his speech and confronted the basic paradigms of monetary economics with the current state of monetary policy.

Mr Weber feels that a fundamental lesson from the financial crisis is that the banking sector needs to be included in the core analytical and forecasting models of central banks, which are the basis for adopting monetary policy decisions. Before the financial and economic crisis, many central banks assumed that capital markets were efficient on aggregate and that asset bubbles in financial markets could not be prevented using monetary policy instruments (interest rates). The former Bundesbank President believes that irregularities in the patterns of a number of variables will have to be studied, since uneven growth in loans and monetary aggregates can indicate a risk of excessive debt in a segment of the financial market. According to Mr Weber, the monetary policy horizon should be extended to take into account the cyclical evolution of the banking sector, as financial distortions build up over many years. Monetary policy would thus become more symmetrical over the financial cycle and make a contribution to financial stability. However, many independent tools will have to be used in the assessment of financial stability, and price stability will remain the primary objective of monetary policy.

In the second part of his speech, Mr Weber addressed the current problems of the euro area. In his view, the member countries' increasing heterogeneity (in terms of growth, inflation and competitiveness) is a non-issue given the similar heterogeneity across US states and given that the differences in growth are similar as in the first years of EMU. However, he does believe that the high level of debt is a problem. Many countries have neglected this issue for years. The debt conceals deeper unsustainable developments, such as too much public spending, unproductive use of capital inflows and losses of competitiveness. This undermines the foundations of EMU, which is based on the subsidiarity principle, meaning that member states are responsible for their economic policies and the resulting state of public finances. Structural reform and budget consolidation are therefore a necessary condition for a functioning single monetary policy. Mr Weber regards the use of unconventional monetary policy measures in response to the financial crisis as a temporary solution. He pointed out that monetary policy cannot persistently perform tasks that fall within the scope of fiscal policy.

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[1] The Homer Jones Memorial Lecture Series is organised by the Federal Reserve Bank of St. Louis to honour the memory of its former research director and vice-president Homer Jones (1906–1986). Every year since 1987 an invited academic or central banker has made a speech on a monetary policy topic.