Monitoring centrálních bank - červen 2010

Česká národní banka
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CENTRAL BANK MONITORING – JUNE 2010

Monetary and Statistics Department
Monetary Policy and Fiscal Analyses Division

CNB CZECH NATIONAL BANK

In this issue

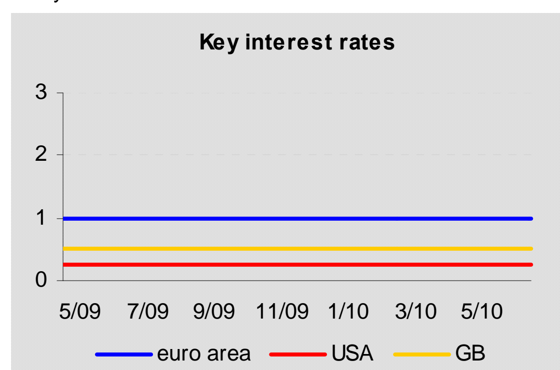
The past quarter saw considerable nervousness in the financial markets due to the debt crisis in Greece and concerns about it spreading to other countries. The Greek economic policy authorities responded by adopting budgetary and structural measures. The ECB and international institutions provided Greece with financial support to calm the markets and stop the problems spilling over to other indebted economies. As regards monetary policy, the Norges Bank and the RBNZ raised their key rates. The other monitored central banks left their rates unchanged, except for the Hungarian central bank, which lowered rates twice. In Spotlight *we take a look at the European Commission and ECB Convergence Reports, which this time assess in depth Estonia, which is seeking entry to the euro area in 2011. Our selected speech is the address given by Lorenzo Bini Smaghi from the ECB on the topical issues of public finance sustainability and the debt crisis in Greece.*

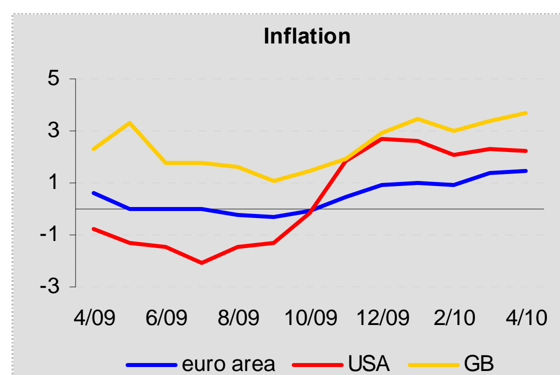
1. Latest monetary policy developments at selected central banks

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)	8 Apr (0.00) 6 May (0.00) 10 Jun (0.00)	16 Mar (0.00) 27–28 Apr (0.00)	7–8 Apr (0.00) 5–6 May (0.00) 9–10 Jun (0.00)
Current basic rate	1.00%	0–0.25%	0.50%
Latest inflation	1.6% (May 2010)	2.2% (Apr 2010)	3.7% (Apr 2010)
Expected MP meetings	8 Jul 5 Aug 2 Sep	22–23 Jul 10 Aug	7–8 Jul 4–5 Aug 8–9 Sep
Other expected events	2 Sep: publication of forecast	28 Jul: publication of Beige Book	11 Aug: publication of Inflation Report
Expected rate movements[2]	→	→	→

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

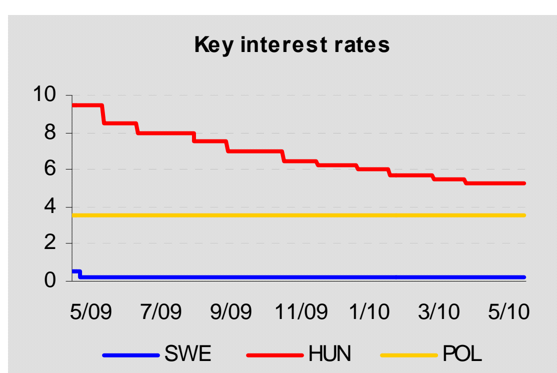


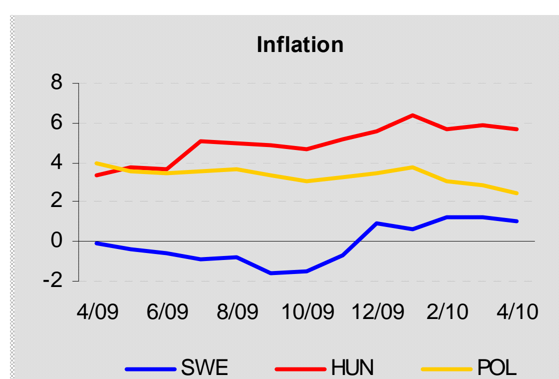


The **ECB** left its interest rates unchanged. In reaction to the “Greek crisis” the ECB started to purchase Greek, Irish and Portuguese government bonds (see *News*) and resumed its long-term refinancing operations with 3-month and 6-month maturities. The recovery in economic growth is continuing and the ECB expects real GDP to grow by 0.7%–2.2% in 2010 and 0.2%–2.2% in 2011. Subdued inflation is expected at the monetary policy horizon. The **Fed** left its key rate unchanged and reactivated its swap lines with some central banks. The economic recovery in the USA is continuing. Household consumption increased but is still being dampened by high unemployment, only modest income growth and tight lending conditions. Corporate investment in equipment and software recorded pronounced growth. The **BoE** left its key rate unchanged and maintained its stock of debt security purchases at GBP 200 billion (the finance ministry purchases debt securities against government bond issues).

Selected central banks of inflation-targeting EU countries

	Sweden (Riksbank)	Hungary (MNB)	Poland (NBP)
Inflation target	2%	3.0%	2.5%
MP meetings (rate changes)	20 Apr (0.00)	29 Mar (-0.25) 26 Apr (-0.25) 31 May (0.00)	30–31 Mar (0.00) 27–28 Apr (0.00) 24–25 May (0.00)
Current basic rate	0.25%	5.25%	3.50%
Latest inflation	1% (Apr 2010)	5.7% (Apr 2010)	2.4% (Apr 2010)
Expected MP meetings	1 Jul	21 Jun 19 Jul 23 Aug	29–30 Jun 27–28 Jul 24–25 Aug
Other expected events	1 Jul: publication of Monetary Policy Report	23 Aug: publication of Inflation Report	25 Aug: publication of Inflation Report
Expected rate movements[3]	→	→	→





The **Riksbank** left its key interest rate at 0.25% last quarter and expects rates to go up in summer or early autumn 2010. The Riksbank expects the Swedish economy to grow in 2010 and also expects a rise in exports given positive world economic growth. Low interest rates and expansionary fiscal measures supported household consumption. Employment began to increase and unemployment was flat, suggesting a labour market turnaround. However, according to the Riksbank, unemployment is still high, which means slow wage growth is expected in the future. Together with higher productivity and a stronger krona, the Riksbank expects rather subdued inflationary pressures over the coming years.

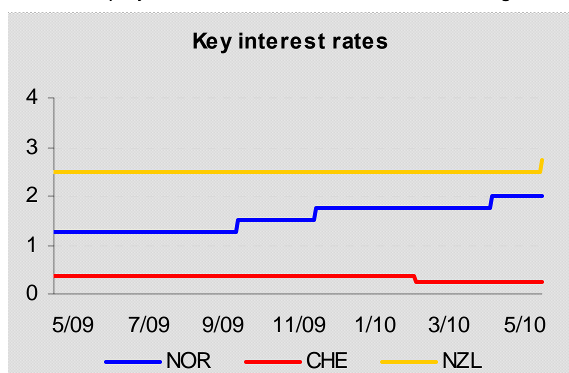
The **MNB** continued to ease monetary policy in March and April, lowering interest rates by 0.25 percentage points each time to 5.25% in the case of the key rate. At its May meeting, the MNB left rates unchanged, saying that risk perceptions associated with Hungarian financial assets had increased (owing to the debt problems in the euro area), as had the inflation risks. New data on the Hungarian economy suggested a faster-than-expected recovery. However, domestic demand remains weak, lagging behind export growth and its positive contribution to economic growth. The rise in inflation was fostered by energy prices and by the continuing effects of a rise in indirect taxes. The MNB expects inflation of around 4% in the second half of the year.

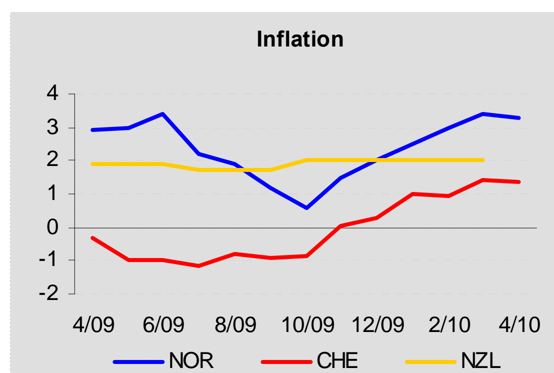
The **NBP** left its key rates unchanged. The Polish economy is continuing to recover. An upward trend in manufacturing has continued. Labour market conditions are improving, with preliminary data suggesting a decline in unemployment and a rise in new vacancies. Inflation fell again in April, reaching 2.4%, slightly below the inflation target. The inflation decline was largely driven by lower annual growth in food prices. According to the NBP, the probabilities of inflation running below or above the inflation target in the medium term are balanced. On 9 April 2010, the NBP intervened in the foreign exchange market by making foreign currency purchases. This was the first intervention since the introduction of the floating exchange rate in 2000.

Other selected inflation-targeting countries

	Norway (NB)	Switzerland (SNB)	New Zealand (RBNZ)
Inflation target	2.5%	< 2%	2%[6]
MP meetings (rate changes)	24 Mar (0.00) 5 May (+0.25)	11 Mar (0.00)	11 Mar (0.00) 29 Apr (0.00) 10 Jun (+0.25)
Current basic rate	2.00%	0–0.75%[5]	2.75%
Latest inflation	3.3% (Apr 2010)	1.4% (Apr 2010)	2% (Apr 2010)
Expected MP meetings	23 Jun	17 Jun	29 Jul
Other expected events	23 Jun: publication of Monetary Policy Report	25 Jun: publication of Monetary Policy Report	16 Sep: Monetary Policy Statement
Expected rate movements[3]	↑	→	→

[5] Chart displays centre of band; [6] centre of 1–3% target band.





The **Norges Bank (NB)** increased its key monetary policy rate by 0.25 percentage point to 2.00% in May. As the Norwegian economy is moving in line with the central bank's March forecast, which assumes a gradual raising of the key rate, the rate increase in May was consistent with the forecast assumption of a key rate in the interval 1.5–2.5% for the current period. According to Governor Svein Gjedrem, it is time to raise the interest rate further towards a more normal level, as inflation has moved in line with projections and the economy is picking up as anticipated.

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 in the lower part of the target range at around 0.25%. The recovery of the Swiss economy is becoming more tangible, being fostered by both the domestic sector and exports. In its forecast the SNB expects real GDP growth of about 1.5% in 2010 and inflation of 0.7% in 2010 and 0.9% in 2011. It remains prepared to actively enter the foreign exchange market if necessary and, given the appreciation of the CHF/EUR rate, appears to have done so.

The **RBNZ** increased its key interest rate by 0.25 percentage point to 2.75%. The economy entered its second year of recovery with broad-based growth supported by numerous factors, particularly exports. The current economic growth outlook is 3.5% for this year and the next. According to the forecast, inflation will fluctuate within the band around the inflation target. The June increase in the key interest rate had been signalled at the February meeting, where it had been stated that an increase would take place if the economy developed in line with the forecast.

2. News

Fed announces term deposit auctions

On 28 May 2010, the Federal Reserve announced a schedule of three auctions of term deposits through its Term Deposit Facility over the next two months. All auctions are scheduled as small-value ones and are intended primarily to inform depository institutions about this facility. The first auction will offer $1 billion of 14-day term deposits. The second auction will offer 28-day term deposits and the third auction 84-day term deposits. Additional details of the second and third auctions will be announced at a later date. The auctions involve both competitive bids and non-competitive bids designed for small depository institutions. The interest rate is derived from the auction method and the maximum rate will be set at the *primary credit rate.* According to the Fed, these auctions have no implications for the near-term conduct of monetary policy.

List of facilities discontinued by Fed

The following facilities introduced at the start of, or during, the financial crisis have been discontinued: Money Market Investor Funding Facility, ABCP MMMF Liquidity Facility, Commercial Paper Funding Facility, Primary Dealer Credit Facility, Term Securities Lending Facility, Term Auction Facility. This list does not include swap lines, as they have been reintroduced owing to the need for dollars (see below). The Term Asset-Backed Securities Loan Facility collateralised by commercial mortgage-backed securities (CMBS) will be discontinued on 30 June 2010. The Fed's balance-sheet assets currently consist mainly of mortgage-backed securities, agency debt and treasuries.

Central banks reactivate US dollar liquidity providing operations and swap lines

On 10 May, the Fed, the Bank of England, the Bank of Japan, the Swiss National Bank, the Bank of Canada and the ECB re-established their swap lines (details here) and short-term liquidity providing operations in response to strains in the US dollar short-term funding markets in Europe.

ECB announces change in eligibility of debt instruments issued or guaranteed by Greek government

On 3 May 2010, the ECB decided to suspend temporarily the application of the minimum credit rating threshold for the assessment of collateral eligibility of Greek debt instruments.

ECB decides to reactivate swap lines with Fed and provision of short-term liquidity…

On 10 May, the ECB decided to resume US dollar liquidity-providing operations at terms of 7 and 84 days. These operations will take the form of repurchase operations against ECB-eligible collateral and will be carried out as fixed rate tenders with full allotment. The first 7-day operation was carried out on 11 May 2010 and the first 84-day operation on 18 May 2010.

…and on 10 May the ECB decided on **further measures to address tensions in financial markets**

- **through public and private debt securities purchases (Securities Markets Programme)** in those market segments which are dysfunctional. The objective of this programme, according to the ECB, is to address the malfunctioning of securities markets and restore an appropriate monetary policy transmission mechanism. The scope of these interventions will be determined by the Governing Council and the debt securities purchases will be sterilised. According to as yet unofficial data the ECB bought €40.5 billion of Irish, Greek and Portuguese government bonds (as of 4 June 2010).
- by starting regular **3-month refinancing operations** (LTROs) with full allotment at a fixed interest rate. These operations will be carried out roughly every month, i.e. on 26 May, 30 June, 28 July, 25 August and 29 September 2010. The size of the operation executed on 26 May 2010 was €12.163 billion at a 1% interest rate
- by conducting a **6-month refinancing operation** with full allotment on 12 May 2010 (size: €35.667 billion).

ECB and European Commission publish their Convergence Reports 2010

On 12 May, the ECB and the European Commission published their Convergence Reports 2010, in which the economic and legal convergence of nine EU Member States is assessed: Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania and Sweden. These reports examine whether a high degree of sustainable economic convergence has been achieved in these countries. In addition, they gauge compliance with the statutory requirements to be fulfilled for national central banks to become an integral part of the Eurosystem (legal convergence). On the basis of the examinations contained in these reports, Estonia will probably become the 17th member of the euro area on 1 January 2011. The other countries did not meet the conditions for adopting the euro. More information on the ECB and European Commission Convergence Reports is given in *Spotlight*.

BoE Governor sends open letter to Chancellor

As the inflation rate in April 2009 reached 3.7%, i.e. more than one percentage point above the inflation target, BoE Governor Mervyn King sent a letter to the Chancellor of the Exchequer as he is required to do by law. In his letter the Governor gives the three main short-run factors explaining why the inflation target was exceeded: first, rising oil prices; second, an increase in the rate of VAT from 15% to 17.5%; and third, the continuing effects of the sharp depreciation of sterling in 2007 and 2008, which had led to a rise in consumer prices.

Riksbank to issue certificates with right of resale and longer maturity…

On 26 May 2010, the Riksbank decided to issue new certificates for commercial banks covered by a right of resale, against a fee, and with a longer maturity than the previously issued certificates with a one-week maturity. The new certificates will have a maximum time to maturity of roughly two months, corresponding to the date of the Riksbank's next monetary policy meeting. The certificates will be used to drain the structural liquidity surplus in the banking system resulting from the Riksbank's lending to individual banks since autumn 2008. The first certificate was issued on 1 June 2010. The issues will be continue as long as required and at least until the end of October 2010.

…and shortens maturity of loans provided to banks

In a further step to phase out its liquidity instruments the Riksbank decided to cease offering loans with maturities of three and six months and to replace them with variable-rate loans at a maturity of 28 days. These loans are offered against normal collateral and will be made available in conjunction with the approaching maturity of the three fixed-interest-rate loans of approximately SEK 295 billion provided by the Riksbank to banks. The auctions will be held approximately every fourth week so as to coincide with the maturity of the fixed interest-rate loans. The minimum interest rate on these loans is set as the average repo rate during the maturity of the loans plus 30 b.p. More detailed information is available here.

SNB and FINMA revise liquidity regime for large banks

The Swiss National Bank and the Swiss Market Supervisory Authority (FINMA), in collaboration with the two big banks Credit Suisse and UBS, revised the liquidity regime for big banks. The core element of the new liquidity regime is a stringent stress scenario defined by FINMA and the SNB. The scenario covers a financial crisis coupled with a loss of trust in the bank. The new regulations require that the banks – in particular by holding an adequate reserve of first-class liquid assets – are able to cover the outflows estimated in such a scenario over a period of at least 30 days. Starting on 30 June 2010, and then on a monthly basis, UBS and Credit Suisse must demonstrate that they are complying with these liquidity requirements.

3. Spotlight: Convergence Reports 2010

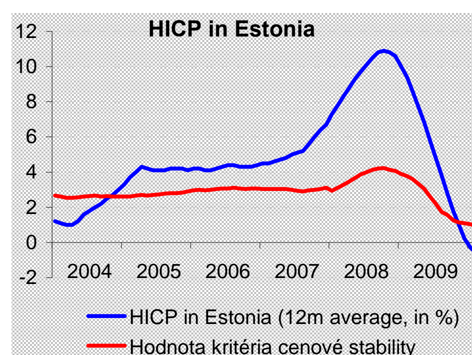
The Convergence Reports of the European Commission and the ECB assess the progress made in the fulfilment of obligations regarding the achievement of economic and monetary union at least once every two years or at the request of a Member State with a derogation. The Convergence Reports assess nine countries this year: Bulgaria, the Czech Republic, Estonia, Lithuania, Latvia, Hungary, Poland, Romania and Sweden. They look in depth at Estonia, which has announced its intention to enter the euro area in 2011 and which, according to the conclusions of this year's reports, is the only country that fulfils the conditions for adopting the euro. Unlike the previous reports, the current ones are specific in that economic developments in each country are examined in a context of global economic and financial crisis, which exacerbated the countries' overall situation and revealed their weaknesses. The crisis caused GDP growth to slow and inflation rates to drop significantly and even turn negative in many countries. Fiscal positions worsened sharply owing to falling output and government stimulus measures. Country risk premia rose significantly. Besides economic developments, the reports assess legal convergence. The priorities include central bank independence, the prohibition of monetary financing and the integration of national central banks into the Eurosystem.

ECONOMIC CONVERGENCE

The price stability criterion is fulfilled if the average rate of inflation does not exceed by more than 1½ percentage points that of, at most, the three best performing Member States in terms of price stability. According to the current Convergence Reports, the "best performers" were Portugal (average inflation of -0.8% between April 2009 and March 2010), Estonia (-0.7%) and Belgium (-0.1%). The calculation excluded only Ireland (-2.3%), which was judged to be an "outlier[1]". This marks a change in the approach of the European Commission, which previously excluded negative inflation rates from the calculation of the criterion, arguing that a negative inflation rate cannot be regarded the best performance in terms of price stability.[2] The average of the three values is -0.5% and, adding 1½ percentage points, the reference value is 1.0%, the lowest-ever figure.

Given this reference value, it is debatable whether "the achievement of a high degree of price stability" is truly being assessed.[3] For example, Sweden with its inflation rate of 2.1%, which is close to the Swedish monetary policy target and to the ECB's definition of price stability, is "outside price stability" from the perspective of the criterion calculated in this way. According to the Convergence Reports of the ECB and the Commission, however, the inflation rate is examined in relative terms and the criterion should take into account that common shocks can temporarily drive inflation away from levels compatible with price stability in the medium term.

According to this price stability criterion, inflation (the 12-month average inflation rate) is below the reference value in only three of the countries under review: the Czech Republic, Estonia and Latvia. In some countries it considerably exceeded the criterion, despite the current downturn in economic activity.



Estonia fulfilled the criterion with a relevant inflation rate of -0.7%. However, Estonia's inflation rate had been above the reference value in previous years. This should

[1] A Member State is considered to be an outlier if two conditions are fulfilled: (1) its 12-month inflation rate is significantly below the comparable inflation rates in the other Member States, and (2) its price developments have been strongly affected by exceptional factors.

[2] See the 2004 Convergence Report of the European Commission. Lithuania, with its 12-month average inflation rate of -0.2%, was excluded from the calculation of the price stability criterion on that occasion.

[3] Article 140(1) of the Lisbon Treaty.

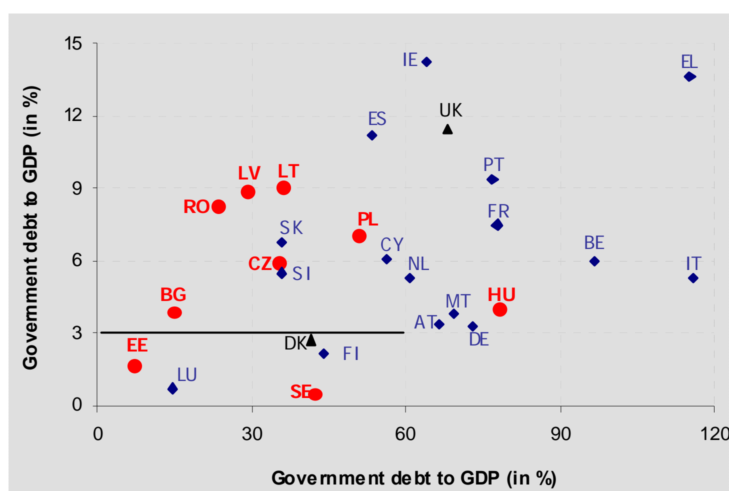
be seen in the context of strong growth in real GDP, while in 2008 higher world prices of food and energy played a role. It is also necessary to take into consideration that the Estonian currency is fixed against the euro and so convergence takes place only through the price channel. The global economic crisis therefore “helped” Estonia to fulfil the reference value last year. Inflation is likely to remain low in 2011, but the ECB expressed concerns about sustainability of the low inflation in Estonia.

The government budgetary position criterion focuses on the deficit-to-GDP ratio (which should not exceed 3%) and the government debt-to-GDP ratio (which should not exceed 60%).

The countries’ fiscal situation deteriorated strongly owing to the worsening conditions. Six of the nine countries under review are currently subject to a Council decision on the existence of an excessive deficit, implying non-compliance with the criterion; i.e. three more countries compared to 2008. Moreover, an excessive deficit procedure is also currently being initiated against Bulgaria. Only Estonia and Sweden recorded deficits below 3% of GDP in 2009. Only Hungary exhibited a general government debt ratio above the 60% of GDP reference value, but the debt ratios also increased substantially in the other eight countries under review in 2009, mainly because of the worsening macroeconomic situation and the fiscal policy response.

Government budgetary position in EU states

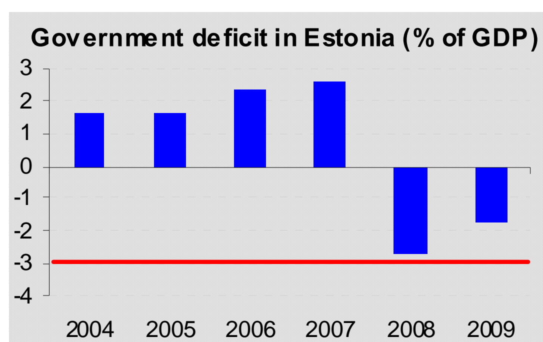
Of the nine countries under review, only Estonia and Sweden fulfilled both fiscal criteria in 2009 (i.e. they are located in the bottom left-hand rectangle in the Chart). The other states have large government deficits, with Hungary also exceeding the reference value for the ratio of general government debt to GDP.

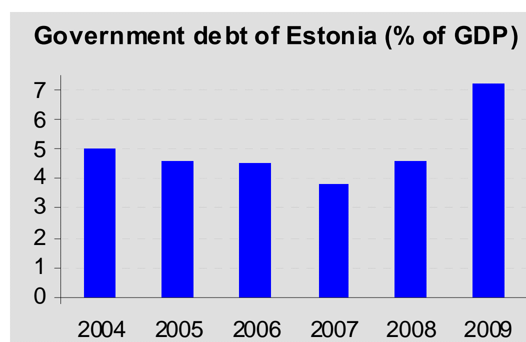


As the chart shows, government debt is a burden not only for countries seeking to join the euro area. On the contrary, they tend to be among the EU countries having below-average debt levels. Of the other EU countries, only Denmark, Finland and Luxembourg would fulfil the fiscal criteria.

AT: Austria, BE: Belgium, BG: Bulgaria, CY: Cyprus, CZ: Czech Republic, DE: Germany, DK: Denmark, EE: Estonia, EL: Greece, ES: Spain, FI: Finland, FR: France, HU: Hungary, IE: Ireland; IT: Italy, LT: Latvia, LU: Luxembourg, LV: Lithuania, MT: Malta, NL: Netherlands, PL: Poland, PT: Portugal, RO: Romania, SE: Sweden, SI: Slovenia, SK: Slovakia, UK: United Kingdom
The nine countries under review are shown in red, the current euro area countries in blue and the other states in black.

The charts depicting the fiscal indicators in Estonia show that it was one of the few countries to take advantage of the good times to improve its government budgetary position and create a strong starting position for itself for bad times. Moreover, the Estonian government went to great lengths to keep its budget deficit below 3% during the deep recession. In 2009 the general government debt was 7.2% of GDP and the government deficit 1.7% of GDP. The government budgetary position is very good in Estonia relative to the other EU countries.





As regards **<u>the exchange rate criterion</u>**, three of the countries examined are currently participating in ERM II. Estonia and Lithuania joined ERM II with their existing currency board arrangements in place. Their currencies traded at their respective central rates against the euro and fulfilled the required criterion throughout the period. The Latvian authorities committed to maintaining the exchange rate of the lats at its central rate against the euro with a fluctuation band of ±1%. Despite considerable market tensions and escalating problems in Latvia, the country decided to maintain the band, primarily because of its large volume of external debt. However, the strong pressures on the exchange rate meant that the conditions of the exchange rate criterion were not fulfilled.

The Bulgarian currency is also pegged to the euro within the framework of a currency board agreement, but it does not participate in ERM II. The currencies of the other countries all weakened significantly against the euro in the period under review. The Polish zloty recorded the strongest depreciation compared to the April 2008 average. In Sweden, investors' perceptions of the Baltic States, where Swedish banks are very active, contributed to significant downward pressure on the Swedish krona. The Hungarian forint also experienced significant downward pressure in November 2008. International institutions granted a loan to Hungary in this difficult situation.

The last but not the least economic requirement is **<u>the long-term interest rate criterion</u>**, which reflects the durability of economic convergence. The government bond market, too, was affected by the global crisis and the general reassessment of risk. Last year, only the Czech Republic and Sweden had average long-term interest rates below the reference value. In Latvia, Lithuania, Hungary and Romania interest rates were well above the reference value.

No harmonised long-term interest rate is available for Estonia, as its government debt is low and there is no market for long-term government bonds in Estonian kroons. For the purposes of examining convergence an analysis of financial markets and related macroeconomic variables was therefore performed and sovereign credit ratings were used. The Commission and the ECB believe that market participants had significant concerns regarding the sustainability of convergence in Estonia, especially during the peak of the global crisis, but market pressures have been easing since the end of 2009.

	HICP (12M average, in %)				Government deficit to GDP (in %)			Government debt to GDP (in %)			Currency participating in ERM II	Long-term interest rate (annual average)			
	2007	2008	2009	4/09 -3/10	2007	2008	2009	2007	2008	2009		2007	2008	2009	4/09 -3/10
reference value	*2.8*	*4.1*	*1.1*	*1.0*		*-3.0*			*60.0*			*6.3*	*6.2*	*6.0*	*6.0*
Bulgaria	7.6	12.0	2.5	1.7	0.1	1.8	-3.9	18.2	14.1	14.8	no	4.5	5.4	7.2	6.9
Czech Republic	3.0	6.3	0.6	0.3	-0.7	-2.7	-5.9	29.0	30.0	35.4	no	4.3	4.6	4.8	4.7
Estonia	6.7	10.6	0.2	-0.7	2,6	-2.7	-1.7	3.8	4.6	7.2	from 28.6.2004	-	-	-	-
Latvia	10.1	15.3	3.3	0.1	-0.3	-4.1	-9.0	9.0	19.5	36.1	from 2.5.2005	5.3	6.4	12.4	12.7
Lithuania	5.8	11.1	4.2	2.0	-1.0	-3.3	-8.9	16.9	15.6	29.3	from 28.6.2004	4.6	5.6	14.0	12.1
Hungary	7.9	6.0	4.0	4.8	-5.0	-3.8	-4.0	65.9	72.9	78.3	no	6.7	8.2	9.1	8.4
Poland	2.6	4.2	4.0	3.9	-1.9	-3.7	-7.1	45.0	47.2	51.0	no	5.5	6.1	6.1	6.1
Romania	4.9	7.9	5.6	5.0	-2.5	-5.4	-8.3	12.6	13.3	23.7	no	7.1	7.7	9.7	9.4
Sweden	1.7	3.3	1.9	2.1	3.8	2.5	-0.5	40.8	38.3	42.3	no	4.2	3.9	3.3	3.3

NB: The table summarises the fulfilment of the criteria in the past three years and, for the price stability criterion and the interest rate criterion, also in the period assessed in the current Convergence Reports, i.e. April 2009–March 2010.

LEGAL CONVERGENCE

Besides economic developments, the Convergence Reports also examine the compatibility of national legislation, including central bank statutes, with EU law. Key areas include (1) central bank independence and confidentiality, (2) the prohibition on monetary financing, the prohibition on privileged access by the public sector to financial institutions and the requirement for single spelling of the euro, and (3) the legal integration of national central banks into the Eurosystem.

When central bank independence is being examined, functional, institutional, personal and financial independence are assessed separately. Compared to the 2008 report, the text on financial independence in the ECB Convergence Report (in contrast to the European Commission report) has been expanded to include a requirement that "*any situation should be avoided whereby for a prolonged period of time an NCB's net equity is below the level of its statutory capital or is even negative*". In such an event, according to the ECB, the central bank should be provided with an appropriate amount of capital at least up to the level of the statutory capital within a reasonable period of time.

According to the ECB, such a situation occurred in the Czech Republic. However, ECB General Council Member and CNB Governor Zdeněk Tůma disagrees with the ECB's view. In a press release published on the CNB website[4] he says, "*Raising the issue of central bank capital as part of the ECB Convergence Report is an unjustified departure from the European Union's equal treatment principle. This issue has not been raised in any previous Convergence Report despite the fact that the issue of accumulated losses is not new, and has also been relevant to some of the euro area countries, in particular Slovakia. The ECB's recommendation in the Convergence Report is not based on any legal regulation and is not a convergence criterion. For this and other reasons – and also with regard to the CNB's actual situation reflected in our arguments – we do not agree with its inclusion in the Convergence Report. In the same way as it gradually formed, our accumulated loss will be gradually eliminated using future profits.*"[5]

As regards the legal convergence of Estonia, its legislation (namely the Law on Eesti Pank, the Law on currency and the Law on security for Estonian kroons) did not fully comply with all the requirements of the monetary financing prohibition and for legal integration into the Eurosystem at the time of the assessment. However, in April 2010 the Estonian Parliament replaced the two last-mentioned statutes with a Law on the introduction of the euro and also passed an amendment to the Law on Eesti Pank. All incompatibilities will have been removed once these laws enter into force.

In all the other countries under review, incompatibilities remain regarding the legal convergence criterion in the area of central bank independence (in particular institutional, personal and financial independence). In addition, in all countries under review except Lithuania there were incompatibilities as regards the prohibition of monetary financing as well as the legal integration of the respective central banks into the Eurosystem.

[4] http://www.cnb.cz/en/public/media_service/press_releases_cnb/2010/20100512_convergence.html

[5] The issue of the CNB's accumulated loss and its prospective coverage from future profits is examined in detail in an article in the latest CNB Economic Research Bulletin – see http://www.cnb.cz/en/research/research_publications/erb/download/ERB_No1_2010.pdf.

4. Selected speech: Challenges for the euro area and the world economy

Lorenzo Bini Smaghi from the European Central Bank gave a speech discussing the challenges on the road to sustainable economic recovery at the 63rd Plenary Session of The Group of Thirty in Rabat on 28 May 2010.

Mr Smaghi started by looking at sustainability of public finances in advanced economies, primarily in the light of expansionary fiscal policies in the aftermath of the Lehman failure. The initial rapid effect of the expansionary policies helped to avert a global depression. Their success led governments – encouraged by international organisations – to continue using expansionary fiscal policies to try pulling the economy out of the recession and getting it back to the pre-crisis level. However, this approach may not be appropriate and sustainable in the current conjuncture. The fiscal impulse was successful in avoiding a depression because it helped to coordinate agents' expectations and reduce uncertainty, but the direct impact on domestic demand may have been more modest. Potential growth might have been severely dampened by the crisis, so pre-crisis output growth might not be a sustainable objective. Moreover, the current level of public debt may have impaired the effectiveness of further expansionary fiscal policy.

Furthermore, Mr Smaghi links the euro area's institutional framework with the debt problem and sustainability of public finances. First, the monetary pillar implies that the ECB will not use an inflation tax to reduce the real value of government debt. Euro area governments have thus to rely on budgetary measures to address fiscal problems. These measures are difficult to adopt in some countries.

The second pillar of the euro area concerns the economic and fiscal dimension, which is based on four assumptions: (i) markets should exert strong pressure on euro area fiscal policies; (ii) if the first assumption were insufficient to discipline public finances, then the Stability and Growth Pact would do the job; (iii) if a member of the euro area were unable to implement sound fiscal policies, it would be left to its own devices; and (iv) national economic policies should be geared to ensure convergence among euro area economies. However, these assumptions turned out to be misplaced. Mr Smaghi gives the following explanations: as regards (i) markets did not impose the necessary discipline on the Member States; as regards (ii) the Stability and Growth Pact did not work as expected; as regards (iii) in the midst of the recent crisis, belief that a member country could be left to fail without affecting others proved wrong; and as regards (iv) the real convergence over the last 11 years was accompanied by divergence in nominal cost and price developments, which gave rise to large payment imbalances within the Union. The catching-up process thus took place amid excessive external borrowing and a decline in competitiveness. These developments were not offset by conservative fiscal policies to moderate domestic demand growth and to provide a buffer for any shocks.

According to Mr Smaghi, it is clear that Europeans have found out during this crisis that sharing a common currency entails much deeper links than they might have initially thought. Monetary Union is to some extent also a political union.

The course of the (Greek) crisis and the time it took to find a solution were strongly influenced by political factors. All in all, however, a series of decisions have been taken at both the national and European level over the last three months. Greece has negotiated an adjustment programme with the IMF, the European Commission and the ECB. The programme contains major structural measures and is accompanied by a €110 billion financial support package. Another measure designed to avert contagion is the establishment of a European fund consisting of €500 billion. Several countries have taken measures to speed up fiscal consolidation. Portugal and Spain have announced additional fiscal and structural measures. Finally, the ECB has decided to intervene in specific segments of the debt securities market to improve the functioning of the monetary policy transmission mechanism. Each of these measures had a positive, though short-lived, effect on market sentiment.

Mr Smaghi went on to analyse the arguments put forward by those who regard a Greek default as inevitable. The first argument is that the proposed programme is too harsh and will lead Greece into a recession and deflation. According to Mr Smaghi, however, this reasoning is voiced by those who have not examined the Greek problem in depth, unlike the IMF, which has produced a detailed

analysis of the programme, together with its risks. Mr Smaghi also doubts that there is such a thing as an orderly default and makes an indirect comparison suggesting that a potential Greek default could have similar effects as the failure of Lehman Brothers. The second argument for dealing with the situation by means of a Greek default is political, i.e. that the government's adjustment effort will sooner or later fade in the face of protests. However, this contrasts with the relatively swift reaction of the Greek government and parliament after recognising the problem. The third argument is that euro area governance has substantial weaknesses that undermine the viability of the single currency. Here Mr Smaghi referred to his previous discussion of the weaknesses of the euro area's functioning. At the same time, however, he drew attention to the above-average price stability and budgetary results in the euro area, although he admitted that this was true on average, but not for all the members.

By way of conclusion, Mr Smaghi noted that like the ECB, the 16 euro area countries believe that sticking to commitments, in particular in the case of the Greek programme, is essential for the credibility of the currency and the prosperity of its members, as would be the case for any other country. This is why euro area governments and the representatives of EU institutions will do all that is needed to preserve that credibility and prosperity.

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