Monitoring centrálních bank - červen 2008

Česká národní banka
2008

CENTRAL BANK MONITORING – JUNE 2008

Monetary and Statistics Department
Monetary Policy and Fiscal Analyses Division

CZECH NATIONAL BANK

In this issue:

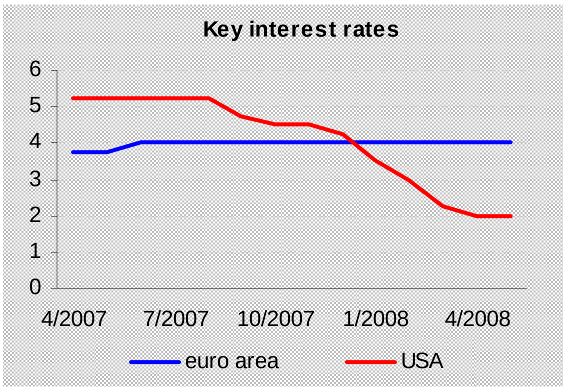
The past three months have seen the financial crisis subsiding only slowly and several central banks continuing to take coordinated actions, with oil prices still rising and agricultural commodity prices remaining volatile. In* Spotlight *we take a look at this year's European Commission and ECB Convergence Reports and examine their assessment of Slovakia's preparedness for the adoption of the euro. Our selected speech is Irma Rosenberg's (Riksbank) address on the monetary policy impacts of rising commodity prices.

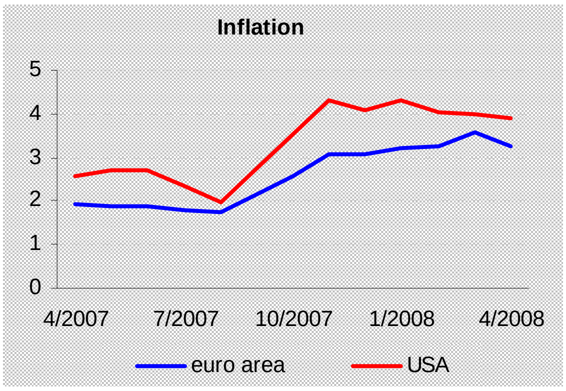
1. Latest monetary policy developments at selected central banks

ECB and Fed

	Euro area (ECB)	USA (Fed)
Inflation target	< 2%[1]	n.a.
MP meetings (rate changes)	10 Apr (0.00) 8 May (0.00) 5 Jun (0.00)	10 Mar (Unscheduled) 18 Mar (-0.75) 29–30 Apr (-0.25)
Current basic rate	4.00%	2.00%
Latest inflation	3.6% (May 2008)[2]	3.9% (Apr 2008)
Expected MP meetings	3 Jul 7 Aug 4 Sep	24–25 Jun 5 Aug
Other expected events	4 Sep: publication of forecast	11 Jun, 23 Jul: publication of Beige Book
Expected rate movements[3]	→	→

- The ECB left its rate unchanged at 4 %.
- The Fed continued lowering interest rates – as far as 2%. Weak economic activity, the property market slump and the persisting unease in financial markets are viewed as the motives for the cuts.

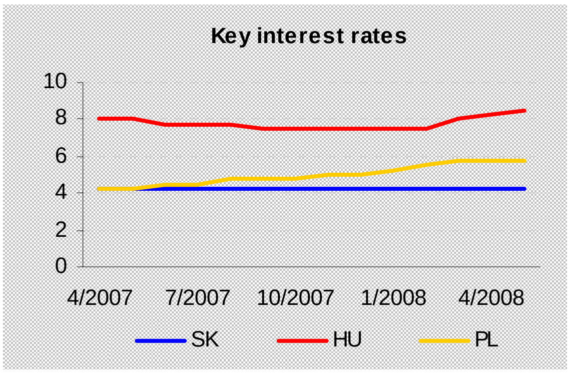


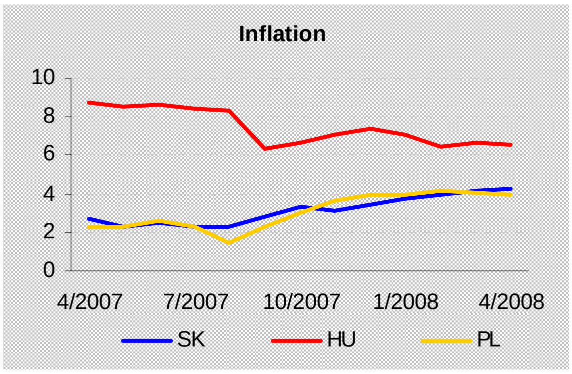


[1] ECB definition of price stability; [2] preliminary estimate; [3] direction of expected change in rates in coming quarter taken from Consensus Forecasts survey

Central European economies

	Slovakia (NBS)	Hungary (MNB)	Poland (NBP)
Inflation target	<2 %	3.0%	2.5%
MP meetings (rate changes)	25 Mar (0.00)[4] 29 Apr (0.00) 27 May (0.00)	31 Mar (+0.50) 28 Apr (+0.25) 26 May (+0.25)	25–26 Mar (+0.25) 29–30 Apr (0.00) 27–28 May (0.00)
Current basic rate	4.25%	8.50%	5.75%
Latest inflation	4.3% (Apr 2008)	6.6% (Apr 2008)	4.0% (Apr 2008)
Expected MP meetings	24 Jun 29 Jul 26 Aug	23 Jun 21 Jul 25 Aug	24–25 Jun 29–30 Jul 26–27 Aug
Other expected events	29 Jul: Report on Monetary Developments	25 Aug: publication of IR[5]	2nd half of Jul: publication of IR[5]
Expected rate movements[3]	↓	→	→



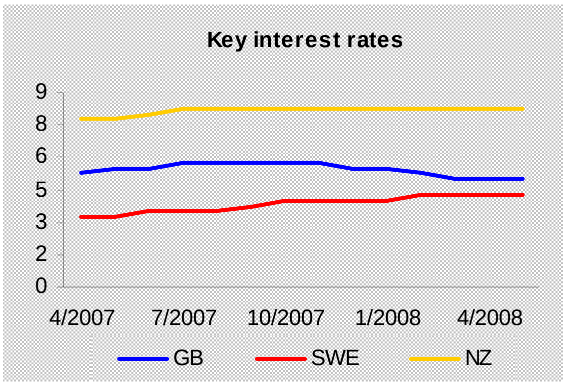


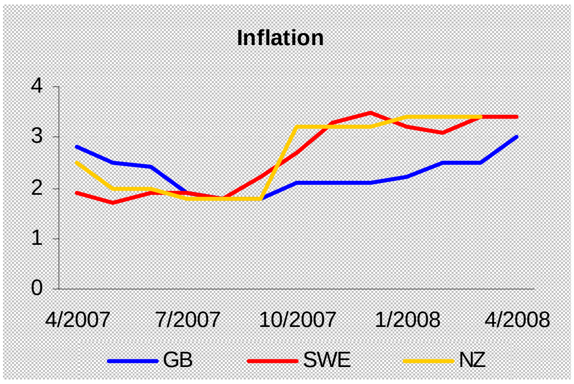
[4] The NBS decides on rates once a week; the dates given correspond to the expected dates of discussion of the Situation Report; [5] Inflation Report

The MNB raised its rates three times in a row – by a total of 1 p.p. to 8.50% – in response to concerns about the potential second-round effects of the persisting high inflation and in an effort to prevent a rise in inflation expectations. At the MNB's March meeting, concerns were raised about an increase in the risk premium on forint assets. This fact played a role in the subsequent increase in rates of 0.50 p.p. The NBS left its rates unchanged at 4.25%. The NBP raised its key rate by 0.25 p.p. to 5.75% in reaction to the rising inflation rate (driven by wage pressures) and on fears of inflation expectations staying high.

Other selected inflation-targeting countries

	United Kingdom (BoE)	Sweden (Riksbank)	New Zealand (RBNZ)
Inflation target	2%	2%	2%
MP meetings (rate changes)	9-10 Apr (-0.25) 7-8 May (0.00) 4-5 Jun (0.00)	22 Apr (0.00)	24 Apr (0.00) 5 Jun (0.00)
Current basic rate	5.00%	4.25%	8.25%
Latest inflation	3% (Apr 2008)	3.4% (Apr 2008)	3.4% (2008 Q1)
Expected MP meetings	9-10 Jul 6-7 Aug 3-4 Sep	2 Jul 3 Sep	24 Jul 11 Sep
Other expected events	13 Aug: publication of IR[5]	3 Jul: publication of IR[5]	11 Sep: publication of Monetary Policy Statement
Expected rate movements[3]	↓	→	→





The BoE lowered its key rate by 0.25 p.p. in response to the financial crisis and its possible manifestations in the real economy. The RBNZ and Riksbank left their rates unchanged (at 8.25% and 4.25% respectively).

2. News

Central banks continue giving financial institutions easier access to liquidity

In the *Spotlight* section of the March issue of *Monitoring* we looked at the coordinated actions taken by some central banks against the liquidity shortage in the banking system. On 11 March, one day after the March issue was published, the Fed announced that the central banks concerned (the Bank of Canada, the Bank of England, the ECB, the Fed and the Swiss National Bank) would continue to work together to restore the smooth functioning of financial markets. For this reason, we present a summary of the latest measures implemented by these central banks (between 11 March and 5 June).

Twice in a row (on 11 March and 2 May), swap lines were extended and their volumes increased to the present $50 billion in the case of the ECB and $12 billion in the case of the Swiss National Bank. The **Bank of England** also announced a continuation of its liquidity-supplying activities, in the form of a further two 3-month repo operations. In parallel, the **Bank of Canada** announced another two 28-day term purchase and resale agreements (PRAs).

The Fed expanded its Term Securities Lending Facility (TSLF) to $200 billion, which it is lending to primary dealers for 28 days (rather than overnight, as in the previous programme), and also expanded the range of securities that can be pledged in the TSLF. The amounts auctioned under the Fed's Term Auction Facility (TAF) were also increased in two steps to the current $75 billion. Fed representatives later unveiled further measures, including an increase in the maturity of liquidity-providing operations at the discount rate to 90 days from 30 days, an expansion of the range of eligible collateral, and finally the creation of a Primary Dealer Credit Facility (PDCF), under which primary dealers can obtain unlimited overnight collateralised liquidity at the discount rate.

Reserve Bank of New Zealand takes similar measures as G-10 central banks

Although the RBNZ was not involved in the joint actions of the G-10 central banks, it too announced in early May that it was adopting measures to improve liquidity in the banking system. The measures have similar features as the ones taken by the G-10 central banks, for instance an extension of the range of eligible collateral and an extension of the maturity of overnight reverse repo operations to 30 days.

Bank of England announces "Special Liquidity Scheme"

The BoE on 21 April 2008 launched a scheme to allow commercial banks to swap temporarily their high-quality (AAA-rated and mostly mortgage-backed) securities for UK Treasury Bills. The measure is designed to make it easier for banks to finance themselves and obtain liquidity. Under the Scheme, banks can, for a period of 1 to 3 years, swap assets that have become illiquid owing primarily to events on the mortgage market (banks are unable to sell or pledge such assets, as practically no one wants to buy them). The credit risk that such assets bear stays in commercial banks' balance sheets and thus does not transfer to the BoE. Usage of the scheme will depend on market conditions. The fee charged for the asset-swap facility is the spread between the 3-month Libor and the 3-month interest rate for borrowing against the security of government bonds, subject to a floor of 20 basis points.

European Central Bank and European Commission Convergence Reports 2008

The European Commission and the European Central Bank in early May published their regular Convergence Reports for 2008, in which they assess the economic and legal convergence of ten EU Member States (Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia and Sweden). As a hot candidate for adopting the euro in 2009, Slovakia is assessed in particular depth in these reports, and for the same reason we examine its assessment in the Convergence Reports in *Spotlight*.

Eurosystem, ECB and ESCB celebrate 10th anniversary

The Eurosystem, the European Central Bank and the European System of Central Banks were established on 1 June 1998. Six months later, the euro was introduced in the 11 countries of the then euro area (first as an electronic means of payment). To mark this anniversary, the ECB issued a special issue of its Monthly Bulletin looking back at the economic developments over the past ten years.

Central rate of Slovak koruna revalued

On 28 May, the finance ministers of the euro-area Member States, the President of the ECB and the finance ministers and the central bank governors of Denmark, Estonia, Latvia, Lithuania and Slovakia decided, by mutual agreement, to revalue the central rate of the Slovak koruna in ERM II by 17.6472% with effect from 29 May 2008. The central rate of the koruna was set at 1 euro = 30.1260 koruna. The standard fluctuation band of ±15% will continue to be observed around the central rate. The upper and lower limits of the band are 34.6449 and 25.6071. According to an official ECB communiqué, the revaluation of the central rate is justified by ongoing improvements in underlying fundamentals.

Nordic central banks enter into swap agreements

The central banks of Sweden, Norway, Denmark and Iceland have entered into swap facility agreements allowing Iceland to acquire euro against Icelandic krona if the need arises. The Central Bank of Iceland can obtain up to EUR 500 million from each central bank. Riksbank Governor Stefan Ingves says that the agreement is aimed at safeguarding Iceland's macroeconomic and financial stability. The swap lines are not currently being drawn upon, but are ready for immediate use to cover the acute needs of the Icelandic economy and are therefore a precautionary measure.

More open Riksbank communication

The Executive Board of the Swedish central bank has adopted an integrated document that describes the bank's internal and external communication policy. The document summarises the principal changes in communication that have taken place in recent years. Riksbank representatives will be more generous in providing information, which means, for example, we can expect comments on recent economic data in relation to the current forecast. However, the members of the Executive Board are still barred from revealing how they intend to vote on interest rates.

Mishkin to resume teaching at Columbia University

Frederic S. Mishkin on 28 May submitted his resignation as a member of the Board of Governors of the Federal Reserve System, effective 31 August 2008. The next Federal Open Market Committee meeting on August 5 will thus be his last. Mishkin is seen as one of the protagonists of the recent aggressive cuts in monetary policy interest rates in the USA.

3. Spotlight: Convergence Reports assess Slovakia's preparedness for the euro

The European Commission and the European Central Bank in early May published their regular Convergence Reports for 2008, in which they assess the economic and legal convergence of ten EU Member States (Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia and Sweden). As a hot candidate for adopting the euro in 2009, Slovakia is assessed in particular depth in these reports, and for the same reason we examine its assessment in the Convergence Reports in this Spotlight. *While the Commission assessed the fulfilment of the Maastricht criteria in Slovakia as relatively problem-free, the ECB is more critical of Slovakia. The definitive decision on the adoption of the euro in Slovakia and on the conversion rate between the Slovak koruna and the euro will be made by the EU Council in the composition of the ministers of finance and economics (Ecofin) at its July meeting. It is likely that Ecofin will approve the adoption of the euro in Slovakia as from 2009.*

Slovakia meets price stability criterion, but ECB Convergence Report expresses considerable concerns regarding sustainability of fulfilment of price stability criterion
At 2.2%, the rate of inflation measured by the Harmonised Index and Consumer Prices (HICP) was 1.0 p.p. below the reference value of 3.2% as of March 2008. The Commission expects it to remain below the reference value in the months ahead, albeit with a narrowing margin. The koruna's trend exchange rate appreciation has exerted a moderating effect on inflation, in particular in 2007 and early 2008. The stronger exchange rate of the koruna combined with low increases in regulated energy prices and fuel prices contributed to a decrease in annual HICP inflation to 1.2% in summer 2007. Inflation subsequently increased to 3.4% in the first quarter of 2008, mostly as a result of the global shocks affecting food and fuel prices, but also due to some acceleration in prices of non-regulated services. These factors are expected to continue affecting inflation in 2008. The ECB expects average inflation of around 3.8% in 2008, declining to some 3.3% in 2009. However, according to the ECB's Convergence Report there are numerous upside risks to inflation in Slovakia and the ECB expresses considerable concerns regarding the sustainability of fulfilment of the price stability criterion. The ECB says that the risks relate to the tightening labour market conditions, the fading of the dampening effects on inflation of the appreciation of the koruna, and to the increase in global energy prices, which has not yet been fully reflected in consumer prices. From the long-term perspective, the ECB believes that the process of catching-up with the economic and price level of the advanced countries is also likely to have a bearing on inflation.

Long-term interest rate criterion fulfilled comfortably
At 4.5%, the average level of long-term interest rates in Slovakia in the year to March 2008 was 2 p.p. below the 6.5% reference value. The factors behind the decline in interest rates in Slovakia are decreasing country-risk premia and favourable inflation. The spread vis-à-vis euro-area long-term interest rates had been declining markedly since 2002 to practically disappear in April 2007. Since mid-2007, a slight positive spread of around 30 basis points opened again, reflecting the significant drop in long-term interest rates in the euro area.

Koruna's stay in ERM II characterised by trend appreciation
At the time the 2008 Convergence Reports were drawn up, the Slovak koruna had been participating in ERM II for more than the required two years. The pre-ERM II appreciation trend had continued after ERM II entry, leading to a revaluation of the central parity by 8.5% with effect from 19 March 2007. The koruna continued appreciating in spring 2008, fluctuating 8–9% above the central parity. During the two-year assessment period, the koruna traded almost always in the stronger part of the fluctuation band, with an average deviation of 5.4% from the central parity. The Commission nonetheless asserts that the observed appreciation was consistent with underlying fundamentals, the koruna did not experience severe tensions and so Slovakia fulfils the exchange rate stability criterion. The ECB report states that the trend appreciation of the Slovak koruna makes it more difficult to analyse how the Slovak economy might operate under conditions of irrevocably fixed nominal exchange rates (following the adoption of the euro).

Government budgetary position criterion will be fulfilled after expected abrogation of excessive deficit procedure by Ecofin

An excessive deficit procedure was imposed on Slovakia in 2004 as a means of reducing its fiscal deficit below 3% of GDP by 2008. In the period under review, Slovakia succeeded in cutting the deficit significantly (to 2.2% of GDP in 2007), mainly by reducing government budget expenditure. According to the Commission services' spring 2008 forecast, the general government deficit will first decline and then widen moderately (to 2.0% of GDP in 2008 and to 2.3% in 2009), but will remain constantly below 3% of GDP. General government debt declined significantly since the beginning of the decade to reach 29.4% of GDP in 2007. The Commission services' forecast projects a broadly stable general government debt ratio. The Commission thus assesses public finance developments in Slovakia as favourable. At the time this year's Convergence Reports were drawn up, Slovakia was still the subject of an excessive deficit procedure, but it is very likely that Ecofin will decide to abrogate this in June.

Overall assessment and Slovakia's next steps on road to euro

According to the Commission's Convergence Report, Slovakia had fulfilled all the economic and legislative criteria for the adoption of the euro. Despite the concerns raised by the ECB, it is likely that Slovakia will introduce the euro as its legal tender at the start of 2009. This will make Slovakia the 16th member of the euro area and the National Bank of Slovakia a member of the Eurosystem. The definitive decision on the adoption of the euro in Slovakia and on the conversion rate between the Slovak koruna and the euro will be made by Ecofin at its July meeting, after consultation with the European Parliament and the EU Council.

4. Selected speech: Irma Rosenberg on the monetary policy impacts of rising commodity prices

In this part we summarise the speech entitled [“Rising Commodity Prices”] given by Irma Rosenberg, First Deputy Governor of Sveriges Riksbank, at Skandinaviska Enskilda Banken in Stockholm on 9 May 2008.

Irma Rosenberg discussed the monetary policy impacts of rising commodity prices on global markets. She began by expressing the current monetary policy challenge: *“How will commodity prices develop, and what contagion effects will there be for other prices?”* She went on to analyse the factors behind the current rise in commodity prices. Among them she included: (i) increased commodity demand from emerging markets; (ii) supply effects (poor harvests, higher mining costs, political uncertainty in some exporting countries and alternative areas of use of some commodities); (iii) the weakening dollar; (iv) the global low interest rate environment; and (v) greater investor interest in commodities as a safe haven and a means of diversifying risks.

Irma Rosenberg began the next part of her speech with a general discussion of an important effect ensuing from the rising energy and commodity prices in recent years, namely the change in their relative prices in relation to manufactured products. But what is fundamental from a monetary policy perspective is that changes in relative prices do not in themselves constitute inflation. Inflation refers to the general price level, which is measured with some broader measure, such as the consumer price index. Dr Rosenberg emphasised that monetary policy cannot and should not counteract changes in relative prices. But what central banks can govern in the long term is the way inflation develops. The same relative price changes can occur with low inflation as with high inflation. If commodity prices soar, this means implicitly that producers’ costs will rise and inflation will be pushed up. For a central bank with an inflation target the task is then to use monetary policy to avoid secondary effects on wages and other prices and to counteract a rise in inflation expectations. If prices rise more quickly abroad then a credible monetary policy should also lead to a stronger domestic currency, which contributes to limiting the impact on domestic prices. Managing price increases in a long-term perspective is actually a question of making well-balanced interest rate decisions at each individual monetary policy meeting.

Dr Rosenberg then said that the principles of monetary policy-making at a time of rising commodity prices are simple. Given the conditions and attributes of the inflation targeting system applied by the Riksbank, they involve finding a path for interest rates that ensures inflation is close to the target while the real economy is in balance. However, the practical implementation of the principles is far from simple. The first reason is that the model set-up cannot capture all of the effects that lead or might lead to rising commodity prices in the future. The second reason is that the central bank cannot immediately influence price impulses, because of the monetary policy transmission lag. A further complication is that the effects of rising commodity prices on inflation and the real economy move in different directions. Inflation rises while production and employment slow down. Finding the optimum weights of response to these effects is no simple task, but this is something that must be achieved in monetary policy.

In conclusion, Dr Rosenberg said among other things that it is not impossible that the commodity price rises will instead be lower than expected. Possible reasons for this would be if international economic activity slows down more quickly than anticipated and if interest in portfolio investment in commodities declines as a result of falling expectations of future return on such investments. Both these scenarios would gradually lead to decreasing consumer price inflation.

This document is produced by the Monetary and Statistics Department of the Czech National Bank and is freely distributable. Closing date: 5 June 2008. Current and past issues can be downloaded free from the Monetary Policy section of the CNB website. Contact: http://www.cnb.cz or info@cnb.cz