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Monetary Policy and Fiscal Analyses Division

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In this issue

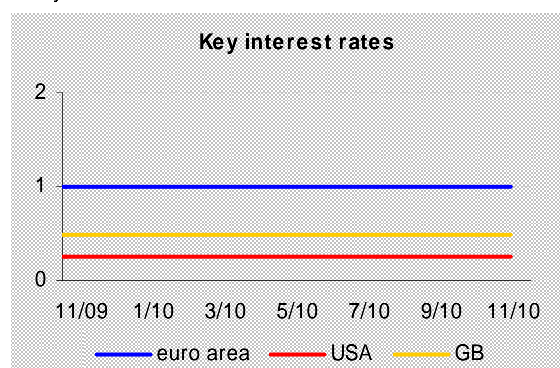
The global economic recovery has slowed and question marks hang over the future. The situation in Europe is being aggravated by a debt crisis and related investor nervousness since Ireland was forced to ask international institutions for financial help. From the monetary policy point of view, most of the central banks under review have "responded" to the nervousness, fiscal consolidation and slower recovery by keeping rates flat. The exceptions are the Riksbank and the Hungarian central bank, which raised key rates, and the Fed, which started a second round of quantitative easing in November. In Spotlight *we take a look at central banks' exchange rate interventions. Our selected speech is an address given by the governor of the Central Bank of Ireland.*

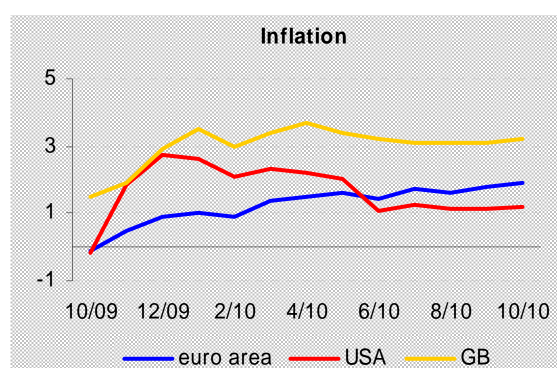
1. Latest monetary policy developments at selected central banks

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 Oct (0.00) 4 Nov (0.00) 2 Dec (0.00)	21 Sep (0.00) 2–3 Nov (0.00) 14 Dec (0.00)	6–7 Oct (0.00) 3–4 Nov (0.00)
Current basic rate	1.00%	0–0.25%	0.50%
Latest inflation	1.9% (Nov 2010)	1.2% (Oct 2010)	3.2% (Oct 2010)
Expected MP meetings	13 Jan 3 Feb 3 Mar	14 Dec 25–26 Jan	8–9 Dec 12–13 Jan 9–10 Feb
Other expected events	3 Mar: publication of forecast	12 Jan: publication of Beige Book	16 Feb: publication of Inflation Report
Expected rate movements[3]	→	→	→

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

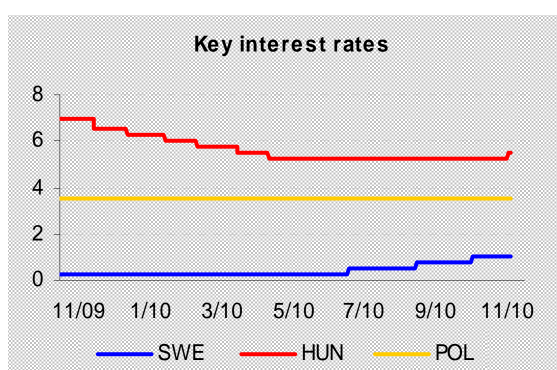


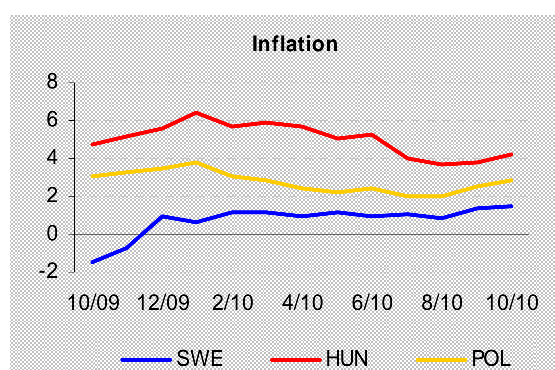


The **ECB** left its interest rates unchanged. Inflation is expected to be subdued at the monetary policy horizon. Economic growth slowed from 1% growth in 2010 Q2 to 0.4% in Q3. The ECB expects real GDP growth of 0.7% – 2.1% for 2010 and 0.6% – 2.8% for 2011. The ECB decided to extend its extraordinary liquidity-providing instruments. This means that additional three-month refinancing tenders will take place in January, February and March 2011. Unlimited one-month liquidity will also continue to be provided. The **Fed** left its key rate unchanged and decided to reintroduce quantitative easing (QE2), i.e. to purchase Treasury bonds amounting to $600 billion (see *News* for more details). This decision is meant to help support the economic recovery while maintaining price stability. The **BoE** kept its key rate unchanged at 0.50%, where it has been since 5 March 2009. A wide range of views on future monetary policy steps was apparent at the November meeting. One MPC member opened a discussion on the re-introduction of securities purchases as part of quantitative easing, but most members did not share this opinion and voted to maintain the current interest rate without increasing the volume of securities purchases.

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)	25 Oct (+0.25)	27 Sep (0.00) 25 Oct (0.00) 29 Nov (+0.25)	28–29 Sep (0.00) 26–27 Oct (0.00) 22–23 Nov (0.00)
Current basic rate	1%	5.50%	3.50%
Latest inflation	1.5% (Oct 2010)	4.2% (Oct 2010)	2.8% (Oct 2010)
Expected MP meetings	14 Dec	20 Dec 24 Jan 21 Feb	21–22 Dec 24–25 Jan 21–22 Feb
Other expected events	15 Dec: publication of Monetary Policy Report	21 Feb: publication of Inflation Report	22 Feb: publication of Inflation Report
Expected rate movements[3]	↑	→	→





The **Riksbank** raised its key interest rate by 0.25 p.p. to 1% in the last quarter. The Swedish economy is growing and the global recovery has boosted Swedish exports. The Riksbank says that a combination of fiscal stability, a high level of household saving and optimism among households is creating the conditions for increasing consumption. Even if current inflationary pressures are low, the Riksbank expects them to increase in tandem with the strengthening of economic activity in Sweden. The repo rate has been increased towards a more "normal" level, according to the Riksbank. The last operation associated with the financing of Swedish banks (a 3-month fixed-interest rate loan) took place in October and no other operation of this type will follow. These steps can also be viewed as being part of the "normalisation" of monetary policy. A speech by Deputy Governor Lars Svensson regarding the current interest rate setting can be found here.

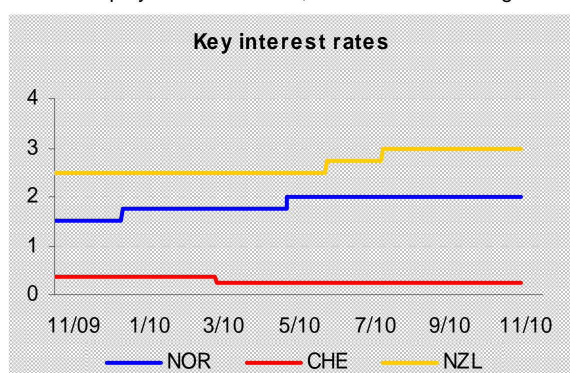
In light of inflation risks and major cost-push shocks the **MNB** raised interest rates by 0.25 p.p. to 5.5%. The MNB expects inflation to rise in the short term, due to significant domestic cost-push shocks (caused by unprocessed food prices and a windfall tax imposed on certain sectors). The MNB justified the increase in rates also by a potential rise in inflation expectations and by the second-round effects of the cost-push shocks. Domestic demand is picking up. Household consumption is expected to rise thanks to a lower direct tax burden and improving employment. Investment is expected to increase as a result of projects undertaken in the manufacturing sector. However, investment activity may be restrained by heightened uncertainty surrounding the current business environment due to the imposition of sector-specific windfall taxes.

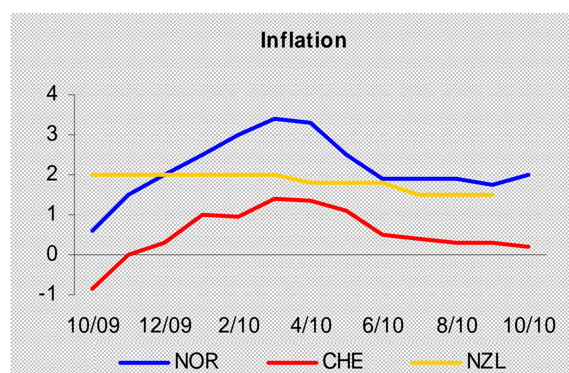
The **NBP** left its key interest rates unchanged in view of the still limited inflationary and wage pressure. Economic growth in Poland accelerated compared to 2010 H1. Inflation rose to 2.8% in October, i.e. above the 2.5% inflation target. The rise in headline inflation was primarily connected with a further increase in food and energy prices. Core inflation (i.e. inflation adjusted for such effects) remained unchanged. A slight rise in inflation is expected in the first months of 2011 due to a change in VAT rates.

Other selected inflation-targeting countries

	Norway (NB)	Switzerland (SNB)	New Zealand (RBNZ)
Inflation target	2.5%	< 2%	2%[6]
MP meetings (rate changes)	22 Sep (0.00) 27 Oct (0.00)	16 Sep (0.00)	16 Sep (0.00) 28 Oct (0.00)
Current basic rate	2.00%	0–0.75%[5]	3.00%
Latest inflation	2.0% (Oct 2010)	0.2% (Oct 2010)	1.5% (Oct 2010)
Expected MP meetings	15 Dec 26 Jan	16 Dec	9 Dec
Other expected events	16 Mar: publication of Monetary Policy Report	16 Dec: publication of Monetary Policy Assessment	9 Dec: Monetary Policy Statement
Expected rate movements[3]	→	→	→

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





The **Norges Bank (NB)** kept its key monetary policy rate at 2% in October. The Norwegian economy is growing at a moderate pace and inflation is lower than the central bank expected. Inflation will remain at around 1.5% until summer 2011. According to the NB, there is a risk that inflation may remain below target over a longer period, due to low consumer price inflation and falling prices for imported goods. In the central bank's opinion this implies low current interest rates. The key rate will therefore be held at the current level over the coming quarters and then gradually raised towards a "more normal" level.

The **SNB** left the target range for the interest rate (LIBOR on CHF-denominated deposits) unchanged and is keeping the LIBOR within the lower part of the target range of 0.00–0.75%, i.e. at 0.18% on average for the quarter. Since mid-2009, the Swiss economy has developed more dynamically than previously expected. For 2010, the SNB expects real GDP to grow by around 2.5% (up by 0.5 p.p. compared to the previous forecast). In 2010 H2 and in 2011, however, the SNB expects a marked slowdown in growth. This reflects the strong appreciation of the Swiss franc and the declining momentum of the global economy. The SNB revised its inflation forecast downwards over the entire horizon and expects inflation to amount to 0.7% in 2010, 0.3% in 2011 and 1.2% in 2012. The SNB also does not rule out the possibility that inflation will temporarily turn slightly negative at the beginning of 2011.

The **RBNZ** left its key rate unchanged at 3%. According to the RBNZ, the global economy is slowing, but New Zealand's exports are being supported by demand from Australia and China. The household sector remains cautious about consumption and domestic firms are less optimistic about their future prospects than in the previous quarter. In the governor's opinion it is appropriate to continue reducing the extraordinary stimuli implemented during the recession (in 2008 and 2009), but the pace and extent of growth in the key rate will be slower than the RBNZ expected in June.

2. News

ECB continues to conduct extraordinary operations

On 2 December the ECB announced an extension of its extraordinary liquidity-providing instruments. This means that additional three-month refinancing tenders will take place on 26 January, 23 February and 30 March 2011. The ECB will also continue to provide unlimited one-month liquidity.

ECB welcomes Irish government's request for financial assistance…

On 21 November, the ECB welcomed the request of the Irish government for financial assistance from the International Monetary Fund, the European Union and euro-area Member States. The financial support will be conditional on the creation of a stabilisation programme and on restrictive actions by the Irish government. The ECB is confident that the assistance will safeguard the stability of Irish banks and their role in the functioning of the economy. For more information please see point 4. EU financial assistance.

…and assesses other steps relating to programme in Greece

A team from the European Commission, European Central Bank and International Monetary Fund visited Athens from 14–23 November for a review of the Greek government's economic programme. The programme consists of a €80 billion loan from euro area countries and a €30 billion stand-by arrangement with the Fund. The objective of the programme is to restore fiscal sustainability, safeguard financial sector stability and boost competitiveness in order to create the conditions for sustained growth and employment.

In the **fiscal area**, the deficit reduction by 6% of GDP in 2010 was more than the initially targeted change. At the same time, data revisions for 2009 and weaker-than-projected revenue collection means that an extra effort will be needed to meet the deficit target of 7.5% of GDP in 2011. New measures will be introduced in tax bases as well as in health spending, state enterprises and tax administration. In the **financial sector**, the activation of a €25 billion expansion of the government programme to guarantee bank bonds will help support the liquidity position of Greek banks. As regards **structural reforms**, while significant progress has been made with pension reform, other reforms – e.g. aligning wages more closely with firm-level productivity – have yet to be implemented. The next programme review is scheduled for February 2011.

Fed to reintroduce quantitative easing

On 3 November, the Fed decided to reintroduce quantitative easing, i.e. to purchase a further $600 billion of longer-term Treasury securities by the end of the second quarter of 2011, a pace of about $75 billion per month. Moreover, the Fed will continue to invest principal payments from agency debt and agency mortgage-backed securities in further purchases of Treasury securities.

Federal Reserve Board establishes Office of Financial Stability Policy and Research

On 4 November, the Federal Reserve Board established the Office of Financial Stability Policy and Research and appointed J. Nellie Liang as its director. The objective of the Office is to support the Board's financial stability responsibilities. The tasks of the Office focus on financial stability issues, in particular the identification and analysis of potential risks to the financial system and the economy, the monitoring of asset prices, leverage, financial flows and other market risk indicators.

Magyar Nemzeti Bank purchases mortgage bonds

The MNB is continuing to offer purchases of forint mortgage bonds in the secondary market. The last auction on 17 December produced no new purchases, as the MNB did not receive any offers. The next purchase will take place on 8 December 2010. A detailed overview of the volumes can be found here.

RBNZ to remove last liquidity facility put in place during financial crisis

On 9 November, the RBNZ announced the removal of the last remaining liquidity facility put in place during the financial crisis. The regular Tuesday Open Market Operation involves repurchase transactions for maturities of up to three months. The change will take effect on 1 December 2010.

3. Spotlight: Exchange rates and central banks in the wake of the crisis, or old diseases with new complications

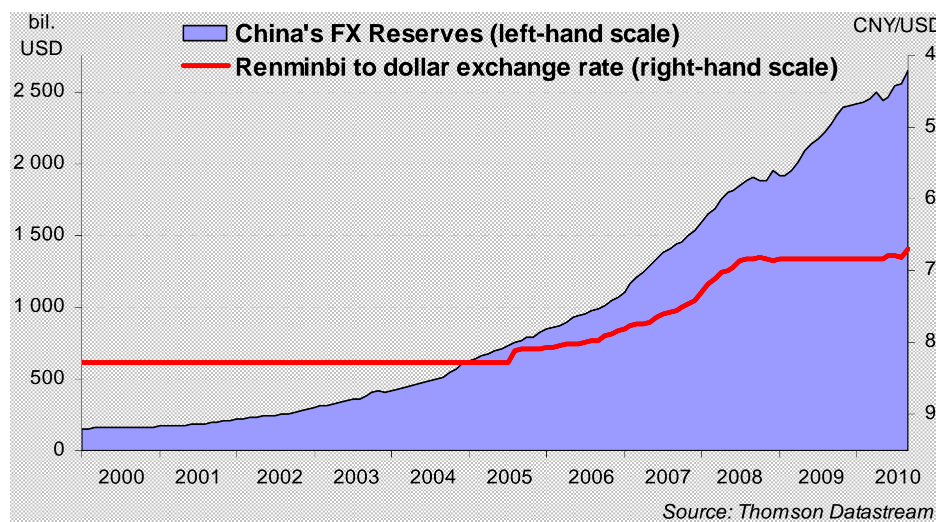
Market adjustments of the exchange rate are one of the traditional adjustment processes in the economy and provide an element of flexibility when asymmetric economic shocks occur. However, unilateral competitive devaluation and maintaining an artificially low exchange rate are instruments for increasing price competitiveness to the detriment of other economies. In Spotlight *we take a look at this long-discussed issue. We describe the evolution and effects of China's exchange rate policy and the consequences of the unconventional monetary policies adopted in reaction to the recent global financial and economic crisis, including externalities affecting emerging economies.*

After the fall of the Bretton-Woods monetary system in the 1970s, the exchange rates of major world currencies started to be determined by the market and became a means of market adjustment of the economy. However, some countries have come to regard the possibility of influencing the exchange rate as a potential economic policy instrument that can be used to affect the price competitiveness of their producers.

By devaluing its currency, a country can attain lower prices in foreign currency and thereby boost its economic growth through growth in net exports. However, this leads to a relative deterioration in the position of other countries, whose producers find themselves at a price disadvantage on the relevant markets. Competitive devaluation and other instruments for bettering a country's position at the expense of others have come to be called "beggar thy neighbour policy". Using such policy can be particularly "tempting" at times of economic recession. Devaluation or undervaluation of the currencies of large countries then becomes a problem for the entire global economy.

Before the crisis, the debate on exchange rate interventions as an instrument of economic policy was fuelled above all by China's exchange rate policy, given its growing importance in global markets. China was criticised by many for supporting its economy's competitiveness by significantly and persistently undervaluing its currency, the renminbi (CNY). Following several years of fixation of the Chinese currency to the US dollar at CNY 8.3 to the dollar, the Chinese central bank allowed its currency to appreciate slightly as from 21 July 2005. However, during the global crisis – more specifically at the end of July 2008 – China again fixed its currency against the US dollar. The renminbi started to appreciate against the dollar again on 19 June 2010, but only very moderately – by less than 3% between June and November (to CNY 6.7 in November). However, this is still regarded as a significant undervaluation compared to the estimates of the fundamental equilibrium exchange rate of the Chinese currency.[1]

[1] It is difficult to estimate the fundamental level of the exchange rate. The estimates of the undervaluation of the renminbi vis-à-vis the dollar usually range between 15% and 30%.



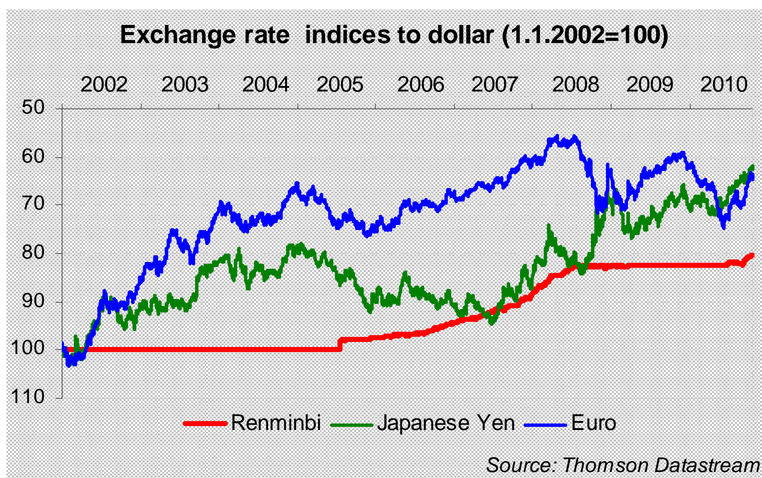
China's exchange rate policy and its interventions to maintain an undervalued exchange rate are reflected in a huge increase in its international reserves, of which roughly 65% is held in assets (mainly bonds) denominated in US dollars (and around 26% in euro) according to official Chinese sources. These now total $2.6 trillion, almost 50% higher than before 2008, making China one of the world's largest US government bond holders.

Moreover, in its attempts to diversify its reserves China is affecting the exchange rates of other currencies. In the first seven months of this year, it purchased bonds issued by South Korea and Japan. The exchange rate of the Japanese yen against the dollar subsequently hit a 15-year high and the Bank of Japan decided in September to intervene for the first time in six years. This intervention totalled JPY 2,124.9 billion (around $25 billion). However, the effects of this intervention were soon reversed by spontaneous market developments, so the bank did not achieve its objective of weakening the yen. In addition, Japan received much criticism from other countries.

In connection with recent global economic developments and the related monetary policy responses, a debate has also emerged regarding the impact of the monetary policy of advanced countries' central banks on the exchange rates of other currencies. Most big players (the Fed, the ECB, the BoE, etc.), along with some smaller central banks (the SNB and Israel), had to resort to unconventional monetary policy instruments during the world financial and economic crisis (see the June 2009 issue of Central Bank Monitoring for details). It now seems that this episode is not quite over yet. The expectations of the financial markets that the Fed would start another round of quantitative easing in the USA recently caused a sharp depreciation of the dollar (although after the step was announced, the dollar surprisingly started to appreciate). The ECB is not considering any further quantitative easing, and any future appreciation of the euro will have the strongest impact on the economies of the southern periphery of the EU, which by contrast would need to weaken their currencies and ease monetary conditions in general. The deliberations about raising the ECB's policy rates are therefore going on in the context of the expected impacts on the ailing European countries.

Moreover, the extremely low interest rates and the huge amount of liquidity that has been provided to the economy, especially in the USA, are motivating investors to seek higher yields abroad (the dollar is becoming a financing currency), and especially in emerging economies. At the onset of the crisis the currencies of emerging economies initially weakened sharply. Later on, however, in an environment of large capital inflows, they started to strengthen, pushing down the price competitiveness of domestic products in international markets. In addition, these financial flows can generate asset market imbalances and disrupt the financial stability of those countries. Brazil has experienced a huge inflow of capital, as its interest rates are particularly high. In October, after the Brazilian real had strengthened by around 35% since the start of 2010, Brazil levied a 2% tax on capital inflows. Although this measure will probably have only a limited and short-term effect, there are concerns that other economies, including some outside South America, might resort to similar instruments. Again, if Brazil "helps itself" like this, it will in fact being doing so at the expense of other countries and

subsequent capital inflows might go to, say, Mexico or other economies attractive to investors who have "cheap" dollars.



Although floating exchange rates are a legitimate element of an economy's short-term flexibility, from the perspective of global competitiveness and cross-border trade the world economic system is a zero-sum game in the longer run (of course we cannot deny the exceedingly positive effect – proven over many centuries – that free foreign trade leads to growth in the wealth of the countries involved thanks to growth in their productivity due to specialisation and the international division of labour). On the global scale, therefore, constant unilateral interventions to weaken a currency vis-à-vis the rest of the world cannot be successful in the long run or beneficial to world trade and sustained economic growth.

Therefore, the International Monetary Fund is planning to draw up analyses of the potential effects of economic policy decisions on other countries and on both regional and global stability. These "spillover reports" will be focused on the systemically most important economies. The first five studies – on China, the euro area, Japan, the USA and the United Kingdom – are planned for next year. The reports will be prepared on the basis of discussions with these countries as well as with countries that might be affected by their actions. However, more radical voices can also be heard, calling for the establishment of a new international currency system to prevent the problems of the USA from spilling over to the world economy via the dollar's role as the global reserve currency ("the dollar is our currency but your problem").

4. Selected speech: On Irish banks and the new borrowing programme

Patrick Honohan, Governor of the Central Bank of Ireland, gave a speech at a financial services seminar on 23 November 2010.

Governor Honohan devoted the first part of his speech to looking back at Ireland's performance and started by recollecting 1958, when Ireland asked the World Bank for help by carrying out a review of the Irish economy with a view to a possible borrowing programme for Ireland from the Bank. Ireland in fact borrowed a total of $150 million between 1969 and 1975 for a variety of development projects. As the Mr Honohan said, the resonances from this 52-year old event were particularly sonorous this week (i.e. on 23 November 2010), as an IMF team scrutinised another Irish plan and mapped out another international programme of borrowing by Ireland in cooperation with European institutions.

The second part of the Governor's address dealt with the banking sector. In his opinion, important aspects of the banking crisis are themselves a part of the globalisation story. By this he means poor loan appraisal practices and the consequences of the bubble mentality. All this would not have added up to anything of great consequence had it not been for the access, through the globalised banking system, to vast sums that could be borrowed from abroad. Irish banks had been internationally integrated for a couple of centuries. They sourced funds in times of need from the Bank of England, but more normally placed very substantial funds on deposit in the London money market, given that Irish land and professional classes were net savers and the banks unenthusiastic in the past about lending too much locally. In 2003, the banks wanted to keep feeding the property bubble. The run-up in net foreign borrowing was spectacular, and its contraction equally sharp (as foreign lenders declined to rule-over into an economy with a property bust and then also a stressed Sovereign). Deleveraging this exposed funding position through structural measures is a key goal of current banking policy. Apart from the pressure on the Sovereign, there is another unfavourable factor, namely that the capital position of the banks has been placed under pressure by prospective loan losses. Naturally, lenders to banks needed assurance that the banks' capital would be increased. This has been done on a large scale over the past two years. However, these investors needed more and better information about the portfolio of the banks. The lengthy process of determining the loan losses, the setting of capital targets and concerns regarding tail risk have tended to muddy communication around the capital adequacy of the Irish banks. This, together with the heightened uncertainty prevailing since the end of April, argues for higher capital requirements.

According to Governor Honohan, discussions about bank capital ratios and stress tests (the Prudential Capital Adequacy Review conducted in September 2010 and planned again for early 2011) will be key elements of the programme being negotiated at present with the European Commission and the IMF. The aim is to restore confidence in Irish banks and the Irish banking system. This can also be achieved by disclosing much more information to investors. Mr Honohan gave the example of the "residential mortgage book", where more detailed information would be available on, for example, the aging and migration of loans and the breakdown of loans into categories. This would allow tail risks to be identified more easily. Mr Honohan believes that if analysts do not have sufficient information they tend to assume the worst, as they feel that if information is not disclosed, it must be bad. Communicating more information would not only enlist the expertise of market credit analysts, but could lower the cost of borrowing as investors regain confidence.

Restoration of market confidence in the banks and in the finances of the Irish state will step by step be rebuilt by these and other measures to be contained in the programme on which negotiations have begun. The Irish authorities will slim down the banking system so that it better serves the needs of the economy. While this process will take some time, we can be reassured by the announcements of recent days that the Irish banking system retains the support not only of the Central Bank of Ireland, but also of the European institutions.

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