CENTRAL BANK MONITORING – MARCH

2011

Monetary and Statistics Department
Monetary Policy and Fiscal Analyses Division

CZECH NATIONAL BANK

In this issue

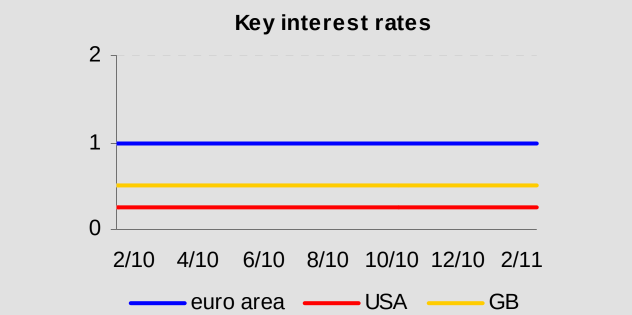
The global economic recovery slowed and is expected to accelerate again in the second half of 2011. The debt crisis in Europe is continuing with varying intensity and investors remain nervous. Rising prices of commodities and energy have become a common, but not the only, cause of inflation in the economies under review. From the monetary policy point of view, most of the central banks we monitor "responded" to the ongoing/planned fiscal consolidation and slower recovery by keeping rates unchanged. The exceptions were the Swedish, Hungarian and Polish central banks, which raised their key rates. However, as economic activity gradually recovers and inflation is pushed upwards by commodity prices, the ECB, the Fed and the Bank of England can be expected to start a cycle of monetary policy tightening in the second half or at the end of 2011. In Spotlight *we take a look at the changeover to the euro in Estonia. Our selected speech is an address given by the Deputy Governor of Sveriges Riksbank.*

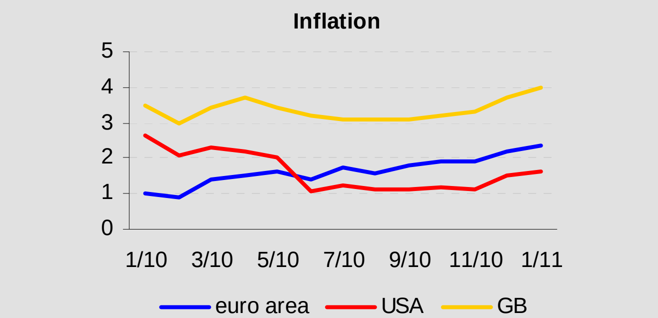
1. LATEST MONETARY POLICY DEVELOPMENTS AT SELECTED CENTRAL BANKS

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)	13 Jan (0.00) 3 Feb (0.00) 3 Mar (0.00)	14 Dec (0.00) 25–26 Jan (0.00)	8–9 Oct (0.00) 12–13 Jan (0.00) 9–10 Feb (0.00)
Current basic rate	1.00%	0–0.25%	0.50%
Latest inflation	2.4% (Feb 2011)[2]	1.6% (Jan 2011)	4.0% (Jan 2011)
Expected MP meetings	7 Apr 5 May 9 Jun	15 Mar 26–27 Apr	9–10 Mar 6–7 Apr 4–5 May 8–9 Jun
Other expected events	9 Jun: publication of forecast	13 Apr: publication of Beige Book	11 May: 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** left interest rates unchanged, pointing out upside risks regarding price developments and even signalling the possibility of an interest rate hike at the next meeting. The ECB's new macroeconomic projections foresee real GDP growth between 1.3% and 2.1% in 2011 and between 0.8% and 2.8% in 2012. The ECB expects inflation in a range of 2.0%–2.6% in 2011 and 1.0%–2.4% in 2012. The projections are based on oil price futures as of mid-February 2011, i.e. they exclude the most recent oil price increases. Refinancing operations will continue to be conducted as fixed rate tender procedures with full allotment in the quarter ahead.

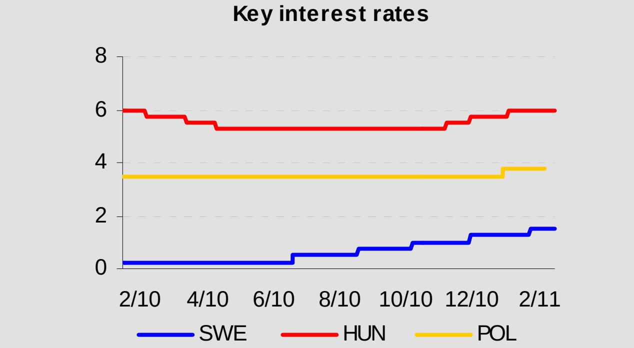
The **Fed** left its key rate unchanged and continued its quantitative easing (QE2), i.e. Treasury bond purchases of $600 billion. The economic recovery is continuing, though at a rate that has been insufficient to bring about a significant improvement in labour market conditions. Growth in household spending picked up late last year, but remains constrained by high unemployment, modest income growth, lower housing wealth and tight credit. Longer-term inflation expectations remain stable.

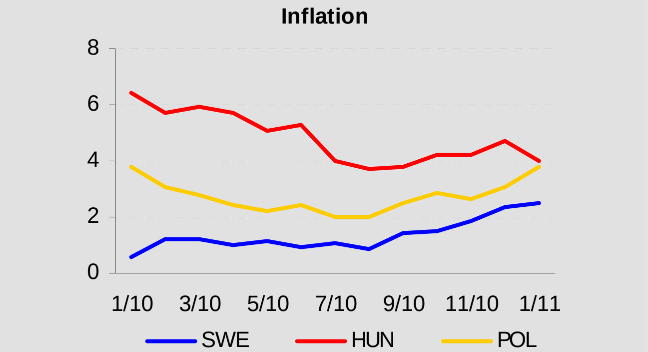
The **BoE** kept its key rate unchanged at 0.50%, where it has been since 5 March 2009. A wide range of views on future monetary policy steps was apparent at the February meeting. The recent increase in inflation was due to rising import prices and commodity prices and to a VAT increase. The BoE expects inflation to pick up to between 4% and 5% in 2011 and then fall back towards the 2% target in 2012 as the effects of the VAT increase and other factors wane. Three MPC members out of nine voted to increase the key interest rate by either 0.25 or 0.50 percentage point. One member voted to increase the size of the asset purchase programme.

Selected central banks of inflation-targeting EU countries

	Sweden (Riksbank)	Hungary (MNB)	Poland (NBP)
Inflation target	2%	3%	2.5%
MP meetings (rate changes)	14 Dec (+0.25) 14 Feb (+0.25)	20 Dec (+0.25) 24 Jan (+0.25) 21 Feb (0.00)	21–22 Dec (0.00) 18–19 Jan (+0.25) 1–2 Mar (0.00)
Current basic rate	1.50%	6.00%	3.75%
Latest inflation	2.5% (Jan 2011)	4.0% (Jan 2011)	3.8% (Jan 2011)
Expected MP meetings	19 Apr	28 Mar 18 Apr 16 May	4–5 Apr 10–11 May 7–8 Jun
Other expected events	20 Apr: publication of Monetary Policy Report	28 Mar: publication of Quarterly Report on Inflation	8 Jun: 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** twice raised its key interest rate by 0.25 percentage point last quarter, to 1.5%. The Swedish economy is continuing to grow strongly, supported by exports, investment and household consumption. Although current inflationary pressures are low, the Riksbank expects them to increase as economic activity in Sweden strengthens. Rising commodity and energy prices are contributing to a higher inflation rate. To stabilise inflation close to the target and to avoid resource utilisation being too high, the Riksbank decided to raise the repo rate.

In light of inflation risks and major cost-push shocks, the **MNB** twice raised interest rates by 0.25 percentage point, to 6.0%. At its latest monetary policy meeting it left key rates unchanged. The MNB expects inflation to rise in the near future, due to significant domestic cost-push shocks (caused by unprocessed food prices and the introduction of sector-specific taxes). The MNB justified the increase in rates also by a potential rise in inflation expectations and by possible second-round effects of the cost-push shocks. External demand is the main driver of Hungarian economic growth. Domestic demand is recovering only gradually. Household consumption is likely to pick up further, due to the easing of direct tax burdens and improvements in employment.

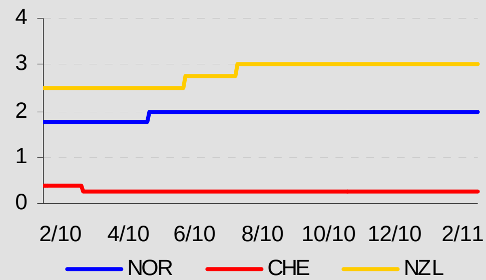
At its January meeting, the **NBP** increased its key interest rates owing to an expected gradual rise in wage and inflation pressures caused by relatively high economic growth. Rates were left unchanged at the March meeting. The main reasons for this decision were persisting uncertainty regarding consumer demand, very moderate wage growth and rising unemployment. Inflation rose to 3.8% as a result of faster growth in food and energy prices and VAT changes. The NBP expects the impact of global commodity prices to abate in the second half of the year, but it is aware of the risk of second-round effects in the short run.

Other selected inflation-targeting countries

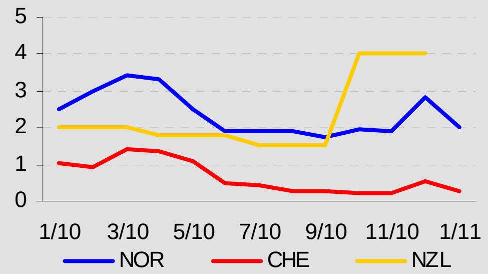
	Norway (NB)	Switzerland (SNB)	New Zealand (RBNZ)
Inflation target	2.5%	< 2%	2%[1]
MP meetings (rate changes)	15 Dec (0.00) 26 Jan (0.00)	16 Dec (0.00)	9 Dec (0.00) 27 Jan (0.00)
Current basic rate	2.00%	0–0.75%[2]	3.00%
Latest inflation	2% (Jan 2011)	0.3% (Jan 2011)	4% (Dec 2010)
Expected MP meetings	16 Mar	17 Mar	10 Mar 28 Apr 9 Jun
Other expected events	16 Mar: publication of Monetary Policy Report	25 Mar: publication of Monetary Policy Report	10 Mar and 9 Jun: 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 the RBNZ's survey.

Key interest rates



Inflation



The **Norges Bank (NB)** kept its key monetary policy rate at 2% in December and January. The Norwegian economy is benefiting from rising economic activity in its trading partner countries, especially Germany. As in other advanced economies recently, consumer price inflation has risen mainly because of energy and commodity price increases. The low interest rate level has not triggered a substantial increase in household borrowing so far, but the rise in house prices and consumer spending has picked up. The labour market is stable and employment is expected to rise in the quarters ahead.

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 0.25% on average for the quarter. The Swiss economy continued to record robust growth in 2010 Q3, but the SNB expects economic growth to slow in the quarters ahead, mainly because of weaker exports. Compared to September, the SNB revised its latest (December) inflation forecast slightly downwards over the entire horizon. If a deflation threat emerges, the SNB intends to take the measures necessary to ensure price stability (as mentioned in connection with the appreciating Swiss franc).

The **RBNZ** left its key rate unchanged at 3%, explaining that it seemed prudent to keep the rate low until the recovery becomes more robust and underlying inflationary pressures show more obvious signs of increasing. According to the RBNZ, economic activity in New Zealand slowed in 2010 H2. Trading partner activity, however, continues to expand and New Zealand's export commodity prices have increased further. Business confidence, across a range of industries, has picked up and imports of capital equipment have grown. The property market is also showing signs of stabilisation. After the January meeting, the governor said that interest rates were likely to increase modestly over the next two years. However, the recent earthquake can be regarded as a new factor in interest rate decision-making.

2. NEWS

Estonia joins euro area

On 1 January, Estonia became the seventeenth member of the euro area. Eesti Pank paid up the remainder of its contribution to the capital of the ECB, transferred its contribution to the foreign reserve assets of the ECB and became a member of the Eurosystem. Estonian monetary financial institutions have been integrated into the euro area banking system and Estonian counterparties are thus able to participate in ECB open market operations. The changeover to the euro in Estonia is covered in more detail in *Spotlight*.

ECB increases its capital by €5 billion...

The ECB decided to increase its subscribed capital from €5.76 billion to €10.76 billion with effect from 29 December 2010 owing to increased volatility in foreign exchange rates, interest rates and gold prices as well as credit risk. The euro area national central banks will pay their additional capital contributions in three annual instalments, the first of which took place at the end of 2010. This decision resulted from an assessment of the adequacy of statutory capital and will allow the ECB's provisions and reserves to be augmented. This is the first increase in ECB capital in 12 years.

...extends requirements in Eurosystem collateral framework...

Asset-backed securities (ABSs) used as collateral in Eurosystem credit operations will have to be supplemented with loan-by-loan information. The ECB plans to introduce these requirements by mid-2012, first for mortgage-backed securities. The new requirements are expected to contribute to further developing transparency in the ABS market.

...and signs swap facility agreement with Bank of England

The ECB and the BoE have agreed a temporary liquidity swap facility of up to £10 billion. The liquidity is to be made available to the Central Bank of Ireland for the purpose of meeting any needs of the Irish banking system. The agreement expires at the end of September 2011.

Central banks extend swap arrangements with Fed

The Bank of Canada, the Bank of England, the European Central Bank, the Bank of Japan and the Swiss National Bank have extended their swap arrangements with the Fed to 1 August 2011. The provision of US dollar liquidity, designed to prevent stresses in short-term funding markets and to improve liquidity conditions in global money markets, will thus continue. The original arrangements were agreed in May 2010.

European Systemic Risk Board (ESRB) established

The representatives of the ESRB – the institution which will oversee and assess risks to financial stability in the EU – met for the first time in January in Frankfurt am Main. The ESRB will be headed by the President and Vice-President of the ECB, the governors of the national central banks of the EU Member States and representatives of other institutions. Three financial market supervision authorities were established at the same time: EBA (bank regulation), ESMA (capital market regulation) and EIOPA (regulation of insurance companies and pension funds), which, together with the ESRB, make up the European System of Financial Supervisors (ESFS).

BoE Governor sends open letter to Chancellor

The UK inflation rate in January reached 4.0%, i.e. two percentage points above the central bank's target. BoE Governor Mervyn King therefore sent an open letter to the Chancellor of the Exchequer as he is required to do by law. In his letter the Governor gives the main reasons for the deviation of inflation from the target: the rise in VAT, the continuing consequences of the fall in sterling in late 2007 and 2008, and recent increases in commodity prices, particularly energy prices.

Third ECB, EC and IMF review mission takes place in Greece

Representatives of the European Commission, European Central Bank and International Monetary Fund visited the Greek capital in late January and early February to assess the progress made by the government's economic programme, which is being supported by loans from euro area countries and the IMF. According to the mission's experts, the programme has made further progress towards achieving its objectives despite delays in some areas. Greece should thus receive another €15 billion in financial assistance. The next review of the situation in Greece is scheduled for May 2011.

Norges Bank has new Governor

Øystein Olsen became the new governor of the Norwegian central bank on 1 January. He replaced Svein Gjedrem, who headed Norges Bank from 1999. Mr Olsen was appointed for a six-year term. His previous post was that of Director General of Statistics Norway. In his introductory speech he stated that the central bank would continue along the same path, but that he was aware of challenges in the form of imbalances and problems in the international economy.

Kevin Warsh announces intent to resign as member of Fed Board of Governors

Kevin Warsh announced his intent to resign from his post in the Fed's Board of Governors. The youngest Board member, appointed in 2006, submitted his letter of resignation to President Obama without giving any reasons for his decision.

Hungary changes rules of appointment to central bank management

The Hungarian parliament approved a change to the rules of appointment of members of the Magyar Nemzeti Bank's rate-setting Monetary Council. The Hungarian president signed the relevant amendment to the Act on the Magyar Nemzeti Bank into law. The parliament now has the right to appoint four of the seven council members. Under the previous legislation, the these four members had been appointed by the president of Hungary – two at the proposal of the MNB governor and two at the proposal of the prime minister. The terms of office of four council members expire at the start of March. In an opinion, the ECB noted the importance of central bank independence and criticised the frequent changes to the Hungarian central bank law, which had undermined the stable basis needed for the central bank's functioning. The ECB also noted that the combination of the changes to the remuneration of the decision-making body of the MNB and to the competences of the governor with the repeated criticism expressed by the government concerning interest rate decisions taken by the MNB could be seen as the government trying to influence the governor in the performance of his tasks.

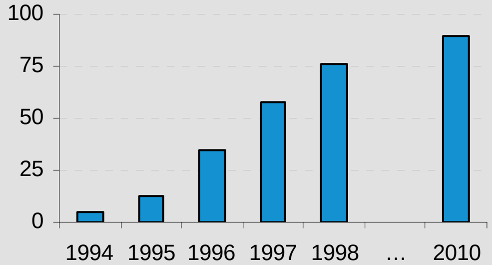
3. SPOTLIGHT: INTRODUCTION OF THE EURO IN ESTONIA

On 1 January 2011 Estonia became the seventeenth country of the euro area and its central bank (Eesti Pank) became a member of the Eurosystem. Estonia adopted the euro at a time when the global financial and economic crisis was causing the euro area difficulties and exposing its weak points. Paradoxically, however, the oppressive domestic impacts of the crisis "helped" Estonia satisfy the price stability criterion, which until that point had been the main barrier to its joining the monetary union. As Estonia had had its currency fixed to the euro ever since the single European currency came into being and had not been pursuing its own independent monetary policy, adoption of the euro was a natural end point of the process of integration into European structures. In the monetary policy area, Estonia can now participate in decision-making. Joining the euro area brings also some benefits in the form of the definitive elimination of exchange rate risk and transaction costs. A probably less welcome fact is that Estonia will now have to contribute financial assistance to ailing euro area countries. The changeover itself was well prepared and proceeded smoothly.

The road to the euro

Estonia entered the EU on 1 May 2004 along with another nine new member states. The decision to join the EU had been confirmed in a referendum held the previous November. The referendum result also revealed public support for further progress with the country's integration into European structures. At that time the Estonian kroon was already fixed to the European currency within a currency board framework. Before that – since 1992 – it had been pegged to the Deutsche Mark. The fixed exchange rate regime caused, among other things, a massive rise in private sector foreign currency borrowing, which as early as 1998 accounted for three-quarters of total credit. For Estonia, the planned changeover to the euro therefore represented a natural exit from the fixed exchange rate regime and the completion of integration into European currency structures, something that seemed particularly attractive during the crisis.

Foreign currency loans (% of total loans)



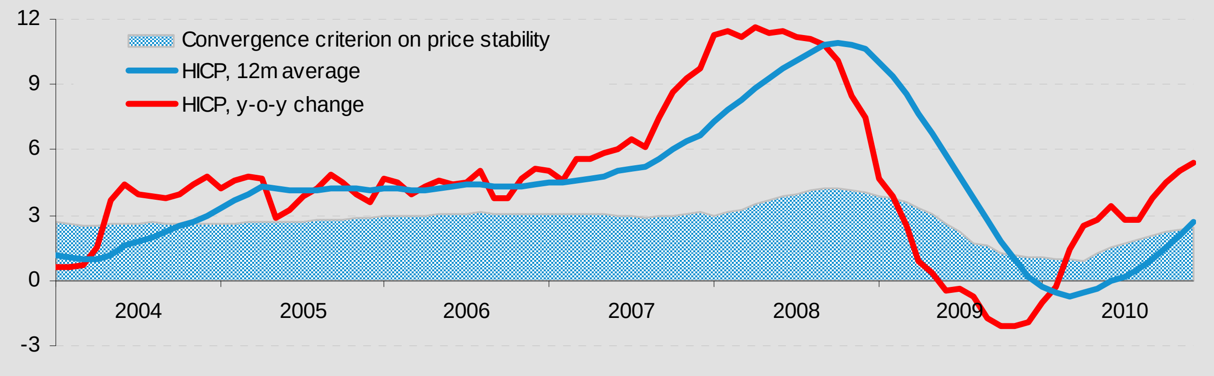
Source: Eesti Pank

The practical preparations for euro adoption started prior to EU entry. In January 2004, the Estonian government set a target of being technically ready by January 2007. In June 2004, Estonia joined the ERM II exchange rate mechanism. The Estonian government and the Eesti Pank agreed on a target of adopting the euro at the earliest possible time. In December 2004, the government set up a *National Changeover Committee*, and at the start of 2005 six task forces were formed to identify and resolve potential problems relating to the changeover. One of them was a joint task force of Eesti Pank and credit institutions, which dealt with card payments, ATMs and currency in circulation. The other task forces addressed such issues as the business environment, technical preparation of state institutions, consumer protection, legislation and communication. Later on, a seventh task force was established to monitor the fulfilment of the convergence criteria. The task force members were drawn from both the public and private sectors. A *National Changeover Plan* was compiled based on the documents prepared by the task forces.

The European Commission's autumn 2006 and spring 2008 assessments of technical preparedness were very favourable. Some of the economic criteria, however, were not fulfilled until last year. These "Maastricht criteria" were assessed four times in the Convergence

Reports of the Commission and the European Central Bank, namely in 2004, 2006, 2008 and 2010. Most of the convergence criteria had long been satisfied. Public finances were in surplus in 2001–2007. Even during the global crisis Estonia managed to keep its deficit very low and compliant with the budget criterion (i.e. below 3% of GDP). Estonia's total government debt is the lowest of all the EU countries. The low government debt means it is not possible to assess the interest rate convergence criterion directly, as Estonia does not issue ten-year government bonds. The convergence reports reveal, however, that Estonia had no problem complying with this criterion. Estonia had spent more than five years in the ERM II and the kroon was fixed at EEK 15.6466 to the euro, so the exchange rate stability criterion was also fulfilled.

Inflation in Estonia



Source: Eurostat, own calculations

Until last year, however, euro adoption in Estonia had been hindered by a high inflation rate, which was not compliant with the price stability criterion. In the context of economic convergence, the fixed exchange rate had led to a rise in inflation in the pre-crisis period. The monetary policy imported *de facto* from the ECB had been too loose for Estonia's needs and real interest rates had been excessively low and often negative. In 2007–2008, inflation had been fuelled, in addition to the overheated domestic economy, by external factors, for example high commodity prices. A change occurred thanks only to the global financial and economic crisis, which "helped" Estonia to meet the last criterion, albeit at the cost of a sharp economic contraction and a rise in unemployment. (The final convergence reports of the European authorities and the assessment of fulfilment of the Maastricht criteria in Estonia were addressed in more detail in the Spotlight section of the June 2010 issue of Monitoring.)

The changeover

The final phase of preparations for adoption of the euro as the Estonian legal tender could begin in earnest last summer after the relevant EU authorities approved Estonia's accession to the euro area on 1 January 2011. Like its predecessors Slovakia, Cyprus, Malta and Slovenia, Estonia decided to introduce the euro without a transition period (the "big bang" scenario).

The design for the national side of Estonia's euro coins arose from a public competition. The winning design features a geographical image of Estonia and the word "Eesti". Estonian euro coins started to be minted at the Finnish Mint in July. The country also borrowed most of its euro banknotes from Helsinki. To introduce the cash euro, roughly 194 million coins and 45 million banknotes were needed.

The communication strategy – with its euro-welcoming "Tere euro" logo – was focused primarily on the general public and on businesses. The information for the public mostly concerned the schedule for the exchange of money, issues related to the exchange rate of the euro against the existing national currency, and information about the visual appearance and security features of euro banknotes, consumer prices, etc. Businesses were informed mainly about changes in legislation, accounting regulations and IT applications. Rules for rounding, dual circulation of banknotes and coins, and dual display of prices were also an important part of the communication process. Important and potentially vulnerable groups of the population were addressed using various information materials and channels.

Three main channels were used to put the euro into circulation: banks, ATMs and retailers. Post offices were an important distribution channel in rural areas. Retailers were required to display their prices in both the kroon and the euro as from July 2010, and the dual display of prices will continue until June 2011. Frontloading of banks with coins started in September. Three months before "D-day" banks started frontloading their main clients, but not the general public. In contrast to the changeover process in previous countries, there was an option of frontloading small businesses in the last five days of 2010. Besides ensuring a smooth supply of the new single currency, it was also important to withdraw the kroon from circulation. This process started with a coin collection campaign in October. Banks also tried to persuade the public to deposit as much free cash with them as possible.

The changeover itself took place on 1 January 2011 at the rate of EUR 1 = EEK 15.6466. In the first two weeks of January there was a dual circulation period when both the euro and the kroon were legal tender. At the end of this period, the euro became the only legal tender. Banks are obliged to exchange kroons for euros at the set rate free of charge in the first half of 2011. In the second half of the year, exchange will be possible only in a limited number of bank branches. After that it will be possible to exchange the kroon for an unlimited period of time free of charge at the Eesti Pank.

To set a good example for the private sector, kroon tax rates and state fees and contributions in euro have been rounded in a direction that is favourable for the public. In line with a European Council Regulation, the euro was not allowed to affect the continuity of contracts or other legal documents.

Impacts of euro adoption in Estonia

Estonia is a small and very open economy with very close trade links with the EU economy. The main benefits of introducing the euro will therefore be the removal of transaction costs, better price comparability and the definitive elimination of exchange risk in relation to the euro area. These factors are conducive to the further development of trade and financial integration. Euro area membership may foster greater credibility and confidence in Estonia's economic and financial stability and hence lower risk margins and long-term interest rates.

As Estonia was maintaining a fixed exchange rate and the Estonian economy was thus under the direct influence of ECB monetary policy, euro adoption does not mean a loss of Estonia's own monetary policy, as it de facto had none. The Eesti Pank will become part of the Eurosystem and will participate in the decision-making on euro area monetary policy through its representative in the Governing Council of the ECB. On the other hand, membership in the euro area will imply a less welcome duty for Estonia to contribute potential financial assistance to ailing euro area countries in the future.

The Estonian public was worried that prices would rise in connection with the changeover. According to an Eesti Pank report, however, euro adoption did not affect the price level. In January 2011 annual inflation was 5.3% and the price level was unchanged from the previous month. According to Statistics Estonia, the changes due to rounding during the changeover were mostly in the range of ±0.2%. Referring to the Estonian Consumer Protection Board's observations and Statistics Estonia's data, the Eesti Pank says that the introduction of the euro did not cause any serious price distortions and price trends did not change much in the first month of the year. The Consumer Protection Board's price observations showed that January price change patterns were not different from those of previous months, but the transition to psychologically convenient prices may continue in some sectors. The share of prices that end in zero or nine euro cents has increased somewhat since summer among the most popular goods and services. The rise in consumer prices in January was largely due to global food price growth, which was not related to the changeover. According to the official position, therefore, the increased inflation is not a result of the introduction of the euro.

4. SELECTED SPEECH: MANY DIMENSIONS TO WELL-BALANCED MONETARY POLICY

Barbro Wickman-Parak, Deputy Governor of Sveriges Riksbank, gave a speech at commercial bank Swedbank on 26 January 2011 concerning the Riksbank Executive Board's January vote on interest rates.

Deputy Governor Wickman-Parak opened her speech by explaining why she voted to increase the interest rate at the monetary policy meeting in December.[1] She emphasised that her decision was influenced by the risks towards the end of, or beyond, the forecast horizon. In her decision-making she weighed two opposite tendencies in the expected evolution of the Swedish economy. On the one hand, it was clear from the current economic situation that both resource utilisation and inflation would remain low in the medium term. On the other hand, there was a risk of strained resource utilisation leading to excessively high inflation in the long term. In her opinion, a current slight increase in interest rates would prevent more drastic increases in the future.

Later in her speech Deputy Governor Wickman-Parak dealt with the interpretation of, and links between, economic indicators. The factors underlying these indicators, such as investors' expectations of future interest rates, are very difficult to assess in many cases.

Another topic covered in the speech was the exchange rate of the Swedish krona. Economic theory assumes a positive relationship between the interest rate differential and the exchange rate. Data since 1995 confirm this positive link, with some exceptions. The interest rate differential has increased in recent years, probably reflecting investors' expectations that economic growth will be higher in Sweden than in the euro area. The Deputy Governor believes that the sharp appreciation of the krona in recent months was due not only to the difference between interest rates on Swedish and German bonds, but also probably to investors' willingness to purchase the krona more than the euro after the publication of favourable economic results for the Swedish economy.[2] Another major contributing factor was the fact the krona weakened significantly at the start of 2009, and so the room for appreciation was larger.

Another important and difficult-to-assess factor is Sweden's rising household indebtedness. It is very complicated to determine the critical point for household borrowing in the economy. Excessive household borrowing is a risk because households may, in the event of a future recession combined with uncertainty on the labour market, begin to consolidate their debt and reduce their consumption, which would reinforce the downward tendencies in the economy. Deputy Governor Wickman-Parak does not consider the current debt level of Swedish households to be alarming, but is concerned that it will prevent monetary policy from functioning effectively in the long run if the current trend (growth of around 8%) continues. This concern had a major influence on her decision to vote for an increase in interest rates.

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[1] The majority of the members of the Executive Board voted to increase the repo rate to 1.25%.
[2] Swedish GDP rose by 6% in 2010 and thus returned to its usual, pre-crisis level a year earlier than forecasted by the central bank in autumn 2009.