CENTRAL BANK MONITORING – DECEMBER

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Monetary and Statistics Department
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CZECH NATIONAL BANK

In this issue

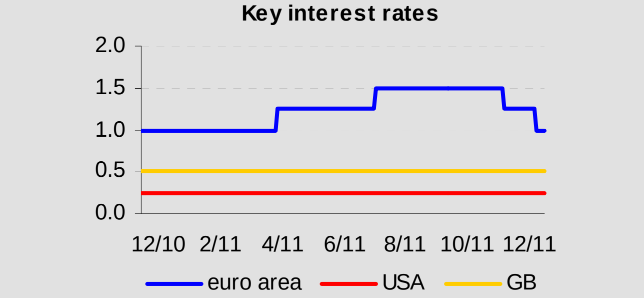
The debt crisis in the euro area is negatively affecting the perceptions of economic agents in Europe and beyond and is fostering uncertainty in financial markets. This is increasing bank funding costs and giving rise to heightened volatility on world stock markets. The ECB cut its key interest rate twice and began using unconventional monetary policy instruments again (among other things it entered the covered bond market and is supporting liquidity in the euro and other currencies; in addition, it is going to lower the reserve requirements in January). The Bank of England also started buying debt securities again. The Swiss central bank is maintaining a minimum exchange rate of CHF 1.20 to the euro. Only Hungary recorded monetary policy tightening. The remaining central banks under review left their key interest rates unchanged. In Spotlight *we describe the current monetary policy of the Swiss central bank. Our selected speech presents the vision of the (now former) ECB President Jean-Claude Trichet on the future functioning of the euro area.*

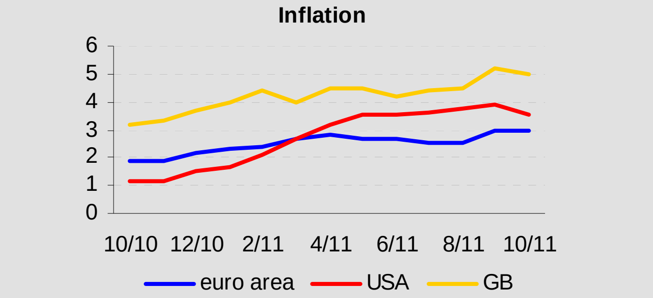
1. LATEST MONETARY POLICY DEVELOPMENTS AT SELECTED CENTRAL BANKS

Key central banks of the Euro-Atlantic area

	Euro area (ECB)	USA (Fed)	United Kingdom (BoE)
Inflation target	< 2%[1]	n.a.	2%
MP meetings (rate changes)	6 Oct (0.00) 3 Nov (-0.25) 8 Dec (-0.25)	20 Sep (0.00) 1–2 Nov (0.00)	5–6 Oct (0.00) 9–10 Nov (0.00) 7–8 Dec (0.00)
Current basic rate	1.00%	0–0.25%	0.50%
Latest inflation	3.0% (Nov 2011)[2]	3.5% (Oct 2011)	5.0% (Oct 2011)
Expected MP meetings	12 Jan 9 Feb 8 Mar	13 Dec 24–25 Jan	11–12 Jan 8–9 Feb 7–8 Mar
Other expected events	8 Mar: publication of forecast	Second half of Jan: publication of Beige Book	15 Feb: 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.





At its October meeting, the **ECB** decided to renew its covered bond purchase programme and continue conducting 3-month and 1-year liquidity-providing operations. At its November and December meetings it lowered interest rates each time by 0.25 p.p., to 1.00%. At the December meeting it approved a set of measures to support bank funding, in particular two refinancing operations with a maturity of 36 months and full allotment (see *News*). These decisions were fostered by uncertainty in financial markets and a worsening economic outlook. Real GDP growth of -0.4–1.0% is expected in 2012, while inflation should fall to 1.5–2.5%.

The **Fed** left its key interest rate unchanged. In September, it declared its intention to sell short-term Treasury bonds and finance purchases of long-term bonds from these sales, as well as to reinvest principal payments from expiring agency debt securities (see *News* for details). According to the latest forecast, economic growth will pick up slightly in Q3, but labour market conditions are still weak. The unemployment rate stopped rising but remained high at 9.1% in September. Industrial production rose in September, but is likely to show only modest growth for Q3. The Fed remains committed to holding rates low until mid-2013. The effect of the previous growth in commodity and import prices is gradually disappearing from inflation. The FOMC decided to continue to reinvest payments from expiring agency debt securities.

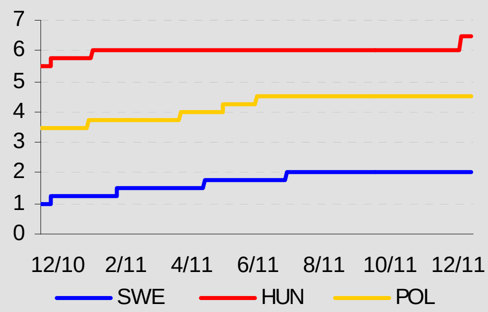
The **BoE** is maintaining its interest rate at 0.50%. In October it increased the size of its asset purchase programme to £75 billion. The purchases take place at weekly intervals. The renewal of this programme should ease the strains in bank funding caused by the debt crisis in the euro area. Inflation reached 5.0%, but should fall in the medium term as temporary factors such as the recent growth in energy prices and the effects of the January VAT increase unwind.

Selected central banks of inflation-targeting EU countries

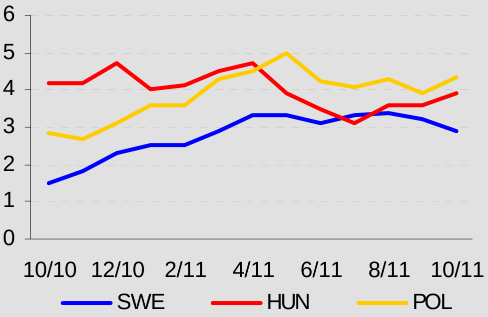
	[Sweden (Riksbank)]	[Hungary (MNB)]	[Poland (NBP)]
Inflation target	2%	3%	2.5%
MP meetings (rate changes)	27 Oct (0.00)	20 Sep (0.00) 25 Oct (0.00) 29 Nov (+0.50)	4–5 Oct (0.00) 8–9 Nov (0.00) 6–7 Dec (0.00)
Current basic rate	2.00%	6.50%	4.50%
Latest inflation	2.9% (Oct 2011)	3.9% (Oct 2011)	4.3% (Oct 2011)
Expected MP meetings	19–20 Dec	20 Dec 23 Jan 20 Feb	10–11 Jan 7–8 Feb 6–7 Mar
Other expected events	16 Feb: publication of Monetary Policy Report	22 Feb: publication of Quarterly Report on Inflation	Mid-March: publication of Inflation Report
Expected rate movements[1]	→	↓[2]	→

[1] Direction of expected change in rates in coming quarter taken from Consensus Forecast survey. [2] Estimate of future rate cuts is based on November CF, but MNB subsequently raised rates. December CF not yet available.

Key interest rates



Inflation



The **Riksbank** held its key interest rate unchanged at 2%. The Swedish central bank expects slightly weaker economic growth compared to the previous forecast owing to worsening global economic conditions. Domestic inflationary pressure is also currently weak, according to the Riksbank, even though inflation is above the inflation target. Two members of the Riksbank Board (Karolina Ekholm and Lars E.O. Svensson) disagreed with the repo rate setting and with the future interest rate path. They preferred to lower the rate to 1.75% for the current period. More details are available here.

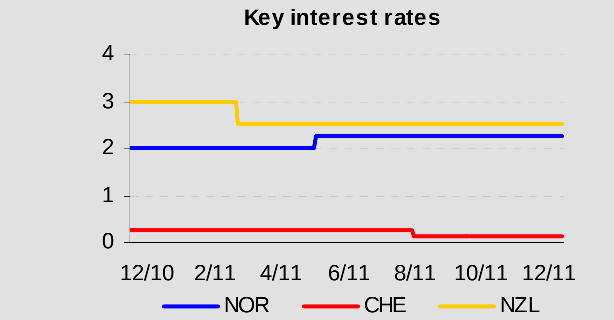
The **MNB** raised its base rate by 0.50 percentage point to 6.50% in November. This was due to the weak exchange rate of the forint and a rise in the country's risk premium, which is a threat to meeting the inflation target. For the MNB, the weak forint is also a potential source of vulnerability of the financial system and the economy as a whole, since a substantial proportion of private debt is still denominated in foreign currency. The MNB expects output to remain below its potential over the next two years. Export growth will decrease owing to unfavourable economic developments abroad. Domestic demand remains low and corporate profitability is expected to decline.

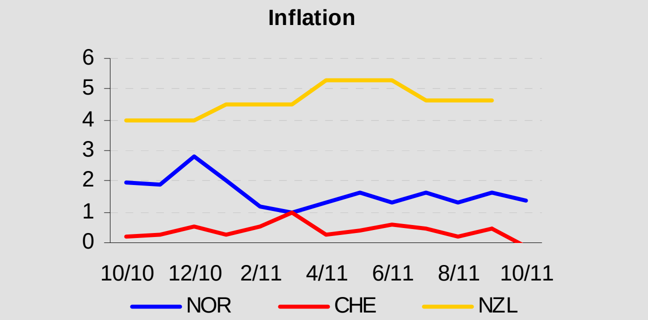
The **NBP** kept its key rates unchanged at 4.50%. Economic growth remained relatively high in 2011 Q3 and was driven by rising private consumption and accelerated investment growth. The inflation rate remained above the inflation target, reaching 4.3%. Inflation will persist at a heightened level in the coming months, primarily due to the previous sharp rise in commodity prices and the zloty depreciation of recent months. According to the NBP, in the medium term inflation will be curbed by decelerating domestic demand due to fiscal tightening implemented in 2011 H1 as well as the global economic slowdown.

Other selected inflation-targeting countries

	Norway (NB)	Switzerland (SNB)	New Zealand (RBNZ)
Inflation target	2.5%	< 2%	< 2%[1]
MP meetings (rate changes)	21 Sep (0.00) 19 Oct (0.00)	15 Sep (0.00)	15 Sep (0.00) 27 Oct (0.00) 8 Dec (0.00)
Current basic rate	2.25%	0–0.25% [2]	2.50%
Latest inflation	1.4% (Oct 2011)	-0.1% (Oct 2011)	4.6% (Oct 2011)
Expected MP meetings	14 Dec 14 Mar	15 Dec	26 Jan 8 Mar
Other expected events	14 Mar: publication of Monetary Policy Report	15 Dec: publication of Monetary Policy Report	8 Mar: publication of Monetary Policy Statement
Expected rate movements[3]	↓	→	→

[1] Centre of 1–3% target band; [2] chart displays centre of band; [3] direction of expected change in rates in coming quarter taken from Consensus Forecast survey or, in the case of New Zealand, from RBNZ survey.





The **Norges bank (NB)** kept its monetary policy rate unchanged at 2.25% in the period under review. Economic growth remains robust, but signals from the business sector suggest declining profits. Private consumption is low. The expected downturn in global economic growth and the debt problems in the euro area are viewed as adverse factors for the Norwegian economy. Inflation is low. The NB expects the inflation rate to be between 1.25% and 1.50% in summer 2012 (i.e. at the forecast horizon). For the next period, ending on 14 March 2012, the NB expects the interest rate to be in the interval 1.75–2.75% unless the Norwegian economy is exposed to major shocks.

The **SNB** is maintaining rates in the lower part of the 0–0.25% corridor. It is also continuing to enforce the minimum exchange rate of CHF 1.20/EUR and still prepared to buy foreign currency in unlimited quantities if this limit is exceeded. The Swiss economy is suffering from both the previous appreciation of the franc and the softening in international demand. The SNB expects real GDP growth at 1.5–2% in 2011. Its inflation forecast for 2011 is 0.4%. For 2012 and 2013 it expects average inflation rates of -0.3% and 0.5% respectively, assuming a zero interest rate and a further weakening of the franc.

The **RBNZ** left its key rate at 2.50%, commenting that domestic economic activity was continuing to expand modestly despite elevated commodity prices. The European debt crisis could cause a further slowdown in global economic growth, which in turn could restrain the prices of New Zealand's export commodities. In addition, tightness in international financial markets means funding costs for New Zealand banks will increase.

2. NEWS

Central banks take coordinated actions to ease strains in financial markets

Six central banks – the Fed, the ECB, the Bank of Canada, the Bank of England, the Bank of Japan and the Swiss National Bank – agreed at the start of December to lower interest rates on US dollar liquidity swaps by 0.50 percentage point and to extend the existing swap arrangements to February 2013. As a contingency measure, these central banks have also agreed to establish bilateral liquidity swap arrangements so that liquidity can be provided in any of their currencies where needed. The ECB, BoE, SNB and BoJ had already introduced 3-month dollar liquidity tenders in previous months. The short-term operations commenced in May 2010 are also continuing.

ECB announces new covered bond purchase programme in October…

The ECB decided at its October meeting to launch a new covered bond purchase programme (CBPP2). The purchases will be conducted between November 2011 and October 2012 in both the primary and the secondary markets for a total intended amount of EUR 40 billion. The first covered bond purchase programme (of EUR 60 billion) was announced in May 2009 and ended in June.

…and adopts further measures to support financial markets in December

The ECB decided in December to conduct two longer-term refinancing operations (LTROs) with a maturity of 36 months and the option of early repayment after one year. The operations will be conducted as fixed rate tender procedures with full allotment. The rate will be fixed at the average rate of the main refinancing operations over the life of the respective operation. The first operation will take place in December 2011 and the second in February 2012. The ECB also reduced the reserve ratio from 2% to 1% as from 18 January 2012. Collateral availability was also increased.

New Fed measures to improve financial market conditions

After its September meeting, the Fed announced its intention to purchase, by the end of June 2012, USD 400 billion in Treasury securities with maturities of 6–30 years and to sell an equal par value of bonds with maturities of three years or less. The Fed believes that this programme (also known as "Operation Twist") will bring down long-term interest rates and make financial market conditions more accommodative. The Fed will also reinvest principal payments from expiring agency securities to improve the conditions on mortgage markets.

Central banks of Hungary, Poland and Switzerland dissatisfied with exchange rate developments

The Hungarian economy is suffering from a weakening forint. The November downgrading of Hungary's rating to the speculative grade Ba1 with a negative outlook by Moody's fostered further depreciation. The Polish central bank is also facing domestic currency depreciation and intervening repeatedly in the foreign exchange market in favour of the zloty. While Hungary and Poland are fighting the effects of a too weak exchange rate (with the risk of higher inflation and problems arising from large foreign currency debt), the Swiss National Bank (SNB) is grappling with an excessively strong currency. The SNB's monetary policy and its fight against the strong franc recently is analysed in more detail in *Spotlight*.

Review missions to Greece, Ireland and Portugal

Another round of review missions by the "Troika", consisting of staff teams from the European Commission, the ECB and the IMF, took place in Greece (fifth review), Ireland (fourth review) and Portugal (second review) in the last quarter. Payment of the next tranche of financial assistance was then approved for all three countries.

Six-member committee starts to make monetary policy decisions in Israel

Since October, Israeli monetary policy has been set by a six-member committee. In addition to the governor, the deputy governor and a special advisor, the committee consists of three external members. The decision on the interest rate is reached by majority decision of the committee members. If the vote is tied, the governor has an additional vote. The ratio of votes is disclosed in the minutes of the meeting. The committee was established in accordance with the Bank of Israel Law of 2010. Until October, monetary policy interest rate decisions were made solely by the governor.

Changes in ECB management

On 1 November, Mario Draghi, the former governor of the Italian central bank, replaced Jean-Claude Trichet (see also the speech in section 4) as ECB president. Two other members of the ECB's Executive Board will be replaced as well. Jürgen Stark resigned in September and will leave the ECB at the end of this year. Lorenzo Bini Smaghi will leave his post on the same date.

3. SPOTLIGHT: MONETARY POLICY OF THE SWISS NATIONAL BANK

A freely floating exchange rate is a tool for correcting economic imbalances or for absorbing economic shocks. Targeted intervention to weaken a national currency is often viewed by neighbouring economies as a way of increasing the price competitiveness of that country at the expense of others ("competitive devaluation"). The debate is complicated by the difficulty of estimating the equilibrium exchange rate level. In a freely floating exchange rate regime, however, extreme events can lead to excessive, "fundamentally unjustified" appreciation with the potential to cause severe problems for the economy. This is what happened, for instance, to Japan after the tsunami in March. Switzerland has also faced a sharp appreciation of its currency this year due to the financial market turbulence. The following article looks at the monetary policy of the Swiss central bank and its fight against the appreciating franc.

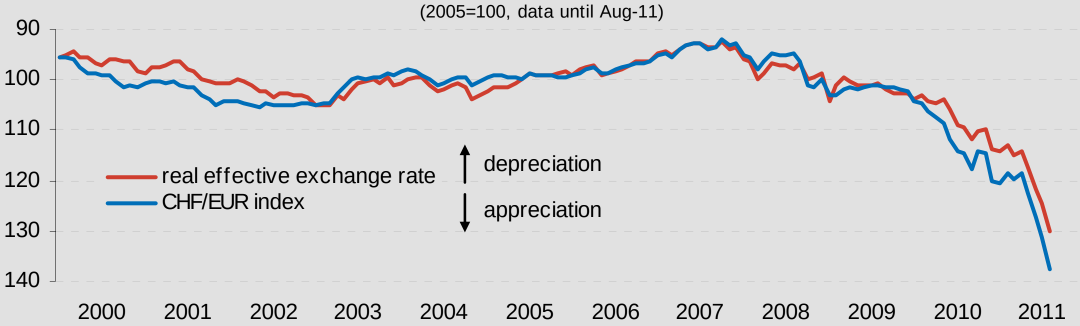
The Swiss National Bank (SNB) equates price stability – the primary objective of its monetary policy – with a rise in the national consumer price index of less than 2% per annum. The SNB's forecast for inflation over the next three years, based on the assumption of a constant monetary policy rate (the "conditional forecast"), is compiled quarterly. The interest rate decision is made at the same time. Monetary policy is implemented by fixing a target range for the three-month Swiss franc Libor, which is the reference interest rate in the interbank market for unsecured loans. As a rule, this target range extends over 1 percentage point, and the SNB generally aims to keep the Libor in the middle of the range. Repo transactions are the main monetary policy instrument.

During the global financial and economic crisis, the SNB significantly eased its monetary policy. The targeted rates gradually declined to a minimum – de facto to zero. Monetary swaps were also used. Unconventional instruments – interventions in the foreign exchange market and purchases of Swiss private bonds – were introduced in March 2009. Moreover, the maturity of repo transactions was extended to 12 months. In 2010, the SNB opened the repo market to non-bank financial market participants, which, unlike the unsecured money market, had proved resilient to the crisis (for details see the speech by Thomas Jordan, Member of the Governing Board, covered in the March 2010 issue of *Monitoring*).

At that time, problems relating to the exchange rate of the Swiss franc – in addition to the other impacts of the crisis – started to be felt more than before. The Swiss franc had been relatively stable since the start of the new millennium, but in mid-2009 it began to appreciate significantly. By the end of June 2011 it had risen in value by 26%. Between the start of July and 10 August it appreciated by further 17%, reaching a record high of CHF 1.05/EUR. This rapid appreciation in such a short period of time was probably not due to macroeconomic fundamentals. The appreciation of the franc was driven by the debt problems of advanced economies, the euro area in particular, and the related search for a safe haven.

Real effective and nominal exchange rate

(2005=100, data until Aug-11)



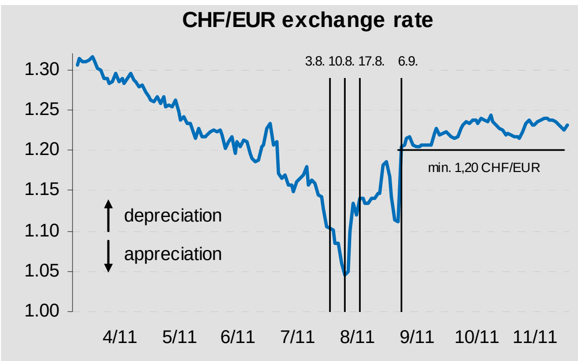
Source: IMF IFS, CNB

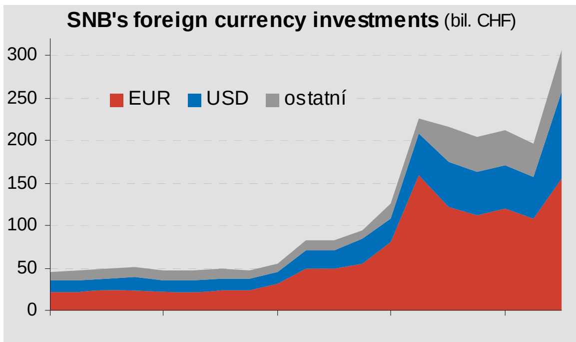
SNB's repo operations (bil. CHF)

	2010												2011									
	1	2	3	4	5	6	7	8	9	10	11	12	1	2	3	4	5	6	7	8	9	10
providing	28	15	11	2	–	–	–	1	–	–	–	–	–	–	–	–	–	–	–	18	7	25
absorbing	–	–	–	–	–	–	20	22	19	20	26	13	27	27	21	26	20	25	26	–	–	–

The SNB's interventions in the foreign exchange market were no longer effective in fighting further appreciation. In August 2011, the SNB decided to intervene indirectly by narrowing the key interest rate range from 0.00–0.75 p.p. to 0.00–0.25 p.p. and sharply increasing the supply of liquidity to the money market, at first from the initial level of around CHF 30 billion to CHF 80 billion, later to CHF 120 billion, and subsequently to CHF 200 billion. The rise in the supply of Swiss francs was achieved by not renewing reverse (liquidity-absorbing) repo transactions and by purchasing SNB Bills, and later also by conducting foreign exchange swaps and liquidity-providing repo transactions. These operations exerted downward pressure on money market rates and also significantly weakened the Swiss currency, albeit only temporarily.

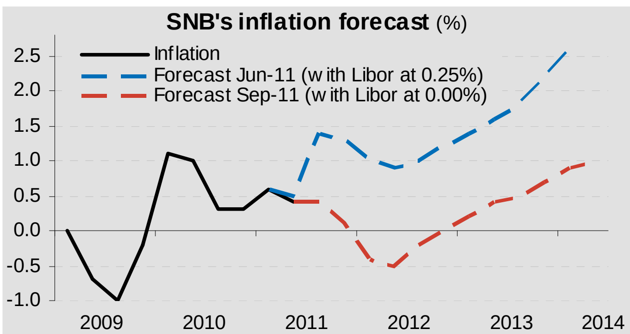
At the start of September, when all its measures to stop the franc appreciating had proved ineffective, the SNB set a minimum exchange rate of 1.20 CHF/EUR, stating that it would buy foreign currency in unlimited quantities if the rate fell below this level. The morning before this step was announced the exchange rate had been 1.10 CHF/EUR. After the announcement it quickly rose above the set minimum.





Source: SNB

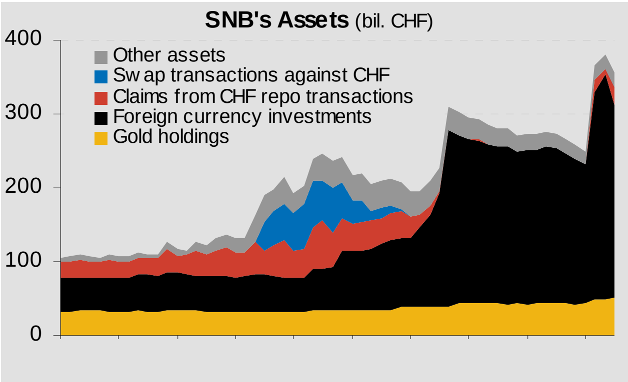
The SNB took this action because the extremely fast appreciation threatened to cause a recession and challenge price stability. In the SNB's July/August 2011 survey, 84% of manufacturing firms said that they were experiencing negative effects due to the franc's appreciation. Exporters have responded to the nominal appreciation of the franc by cutting their margins, but this increases their vulnerability in the event of further demand shocks. Moreover, demand for labour and investment decisions are being affected by uncertainty regarding future developments, the worse outlook for the global economy and further negative repercussions of the debt crisis in Europe.

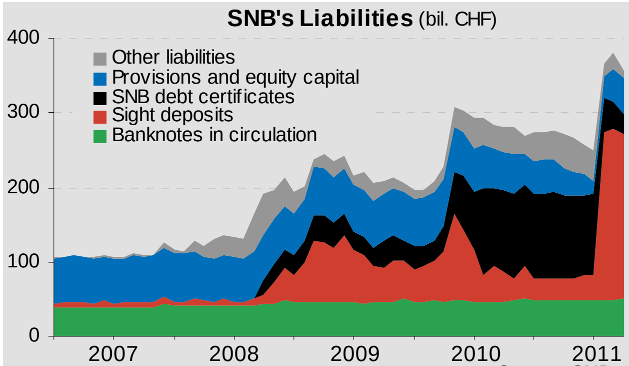


Source: SNB

The appreciating franc has also substantially affected the latest inflation forecast, which shows an inflation rate of 0.4% for 2011, a rate of -0.3% for 2012 and a rate of 0.5% for 2013. This forecast is based on the assumption of a three-month LIBOR of 0.0% and a slight weakening of the Swiss franc. However, there is a risk of even lower inflation or long-term deflation should the franc not weaken. The current forecast for low inflation, the still relatively strong franc and the uncertain external demand imply a need for easy monetary policy in future, too, but this may create conditions for a further rise in property prices, which are already relatively dynamic.

The SNB's unconventional monetary policy and fight against the strong franc are reflected in its balance sheet total. This has increased from a pre-crisis level of CHF 110 billion to CHF 245 billion in April 2009, broke through CHF 300 billion for the first time in May 2010, and in September this year exceeded CHF 380 billion (almost four times the 2007 level). The appreciating franc also resulted in the central bank suffering a loss in 2010. The foreign exchange losses are due to a different currency structure for assets and liabilities. For this reason, a new agreement on the distribution of the central bank's otherwise normal profit to the Confederation and the cantons has been concluded this year. From this year on, the profit will be distributed only if the SNB's distribution reserve turns positive again.





Source: SNB

4. SELECTED SPEECH: TOMORROW AND THE DAY AFTER TOMORROW: A VISION FOR EUROPE

On 24 October 2011, Jean-Claude Trichet, whose eight-year term as President of the European Central Bank (ECB) expired at the end of October 2011, presented to an audience at the Humboldt University in Berlin his vision for the future functioning of the European Union in the context of the past developments and current problems in the euro area.

The (now former) ECB President started by discussing the relationship between Germany and the European Union. He reminisced about his work with German colleagues on the legislative foundations of the euro in the Maastricht Treaty. He stressed that their goal had been to ensure that, among other things, the ECB would be based on the principles of independence and the pursuit of price stability. He recalled that ten years ago Germany, which is now thought of as the engine of the European economy, had been seen by some observers as the sick man of Europe. Since mid-2009, however, German GDP had grown by 6.9%, employment by 2.1% and exports by 25.6%. According to Mr Trichet, this performance is no accident. It is the result of sound fiscal policies and rigorously implemented structural policies. Germany is an example of a country that, in the environment of the single currency, has regained competitiveness after unification. During its economic recovery, it has benefited from the single European market and a stable monetary environment (the average inflation rate in Germany since 1999 has been 1.6%). It now sets a positive example to those euro area countries which are trying to regain their competitiveness.

In the second part of his speech, devoted to monetary policy, Mr Trichet emphasised that the ECB's objectives – stability, responsibility and independence – do not change. However, the policies used to achieve them have to adapt in an economic crisis. If financial institutions get into trouble and are unable to play their role in the transmission mechanism, Mr Trichet considers it right to use non-standard measures, i.e. unlimited refinancing operations at fixed rates and with full allotment, and bond market interventions. According to Mr Trichet, the latter are not inflationary, as the aim was not to inject additional liquidity, but to support monetary policy transmission in the euro area. This is because the bond market largely determines interest rates on loans and mortgages. Owing to these instruments, the ECB's balance sheet has expanded by 80% since the beginning of the crisis. This is much less compared to some other central banks (the balance sheet of the Fed has increased by 230%, that of the Bank of England by 205%, and that of the Swiss National Bank by 235%). Mr Trichet concludes by adding that the use of these instruments during the crisis was fully in line with the mandate to maintain price stability. The ECB also demonstrated its independence of politicians.

Mr Trichet believes that the future of the European Union lies in closer political integration based on a new institutional framework. He envisages the establishment of a European finance ministry and the transformation of the EU Council into the upper house (Senate) and the current European Parliament into the lower house of a new EU parliament. These new institutions with broader powers would be responsible for forming common fiscal and economic policies supporting competitiveness while continuing to respect the subsidiarity principle.

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