

The Bank of England lowered rates in August for the first time since July 2003. The BoE's rate cut had been expected, but the Riksbank's big reduction took the market by surprise. The central banks of Hungary (MNB) and Poland (NBP) also continued lowering their rates, both cutting their key rates by 1 percentage point. The Fed maintained the opposite trend, carrying on with its policy of regularly raising rates. In Spotlight we take a look at the MNB's new inflation target. For the first time we feature a speech by a central banker, namely Donald L. Kohn's remarks on the risk premium.

1. Developments since the last issue of Monitoring (June 2005) and expected future information

	Inflation target ¹	Latest inflation	Current basic rate	MP meeting date/rate change/expectation ²	Next MP meeting/expectation ³	Other expected events
Euro area (European Central Bank, ECB)	<2.0%	2.1 (Aug 2005) ⁴	2.00%	7 Jul/0.00 1 Sep/0.00 →	6 Oct 3 Nov 1 Dec →	1 Dec: publication of new forecast
Sweden (Sveriges Riksbank)	2.0%	0.3% (Jul 2005)	1.50%	20 Jun/-0.50 23 Aug/0.00 →	19 Oct 1 Dec →	20 Oct: publication of IR ⁵
United Kingdom (Bank of England, BoE)	2.0%	2.3% (Jul 2005)	4.50%	6–7 Jul/0.00 3–4 Aug/-0.25 7–8 Sep/0.00 →	5–6 Oct 9–10 Nov 7–8 Dec →	16 Nov: publication of IR ⁵ , including new forecast
Hungary (Magyar Nemzeti Bank, MNB)	4.0%	3.7% (Jul 2005)	6.25%	20 Jun/-0.25 18 Jul/-0.25 22 Aug/-0.50 ↘	19 Sep 24 Oct 28 Nov ↘	28 Nov: publication of IR ⁵ , including new forecast
Poland (National Bank of Poland, NBP)	2.5%	1.3% (Jul 2005)	4.50%	28–29 Jun/-0.50 26–27 Jul/-0.25 30–31 Aug/-0.25 ↘	27–28 Sep 25–26 Oct 29–30 Nov ↘	30 Nov: publication of new IR ⁵
Slovakia (National Bank of Slovakia, NBS)	3.5%	2.0% (Jul 2005)	3.00%	23 Jun/0.00 29 Jul/0.00 26 Aug/0.00 →	30 Sep ⁶ 25 Oct ⁶ 29 Nov ⁶ ↘	Monetary survey issued on given board meeting days
USA (Federal Reserve System, Fed)	n/a	3.2% (Jul 2005)	3.50%	29–30 Jun/+0.25 9 Aug//+0.25 ↗	20 Sep 1 Nov ↗	19 Oct and 30 Nov: publication of Beige Book
New Zealand (Reserve Bank of New Zealand, RBNZ)	2.0%	2.8% (2Q2005)	6.75%	28 Jul/0.00 →	27 Oct →	15 Sep and 8 Dec: publication of Monetary Policy Statement

¹ inflation target valid for the current period (or, in the cases of Hungary and Slovakia, the year-end target)

² the direction of the expected change in rates in the past quarter is taken from the Consensus Forecasts survey (or, in the case of New Zealand, from the RBNZ's own survey)

³ provisional meeting dates. The direction of the expected change in rates in the coming quarter is taken from the Consensus Forecasts survey (or, in the case of New Zealand, from the RBNZ's own survey)

⁴ preliminary estimate

⁵ Inflation Report

⁶ The NBS Bank Board decides on rates once a week; the given dates correspond to the discussion of the Situation Report

2. News

[ECB General Council meets in wider composition ...](#)

Since June, following the signing of the Accession Treaties with Bulgaria and Romania, the governors of the Bulgarian and Romanian central banks have been attending the General Council's meetings. Their role, however, is limited to observer status. The same status has been accorded to experts of the Bulgarian and Romanian central banks, who may now attend ESCB committee meetings.

[... and ECB faces lawsuit over security features on euro banknotes](#)

US company Document Security Systems Inc. (DSS) lodged a lawsuit against the ECB at the start of August. DSS alleges that the ECB is using anti-counterfeit technology on which the company has held a patent since 2004 on all euro banknotes without a proper licence. The DSS is claiming "damages at the rate of a reasonable royalty" from the ECB. The ECB has not yet commented on the action.

Banca d'Italia approves new statute

In response to the case of Banca d'Italia Governor Antonio Fazio, the Italian government has approved several changes to the functioning of this institution. The main revisions are the introduction of a seven-year term of office for the governor and the transfer of key decision-making powers from the governor to the Board. However, these changes will not affect the present governor, who has a life mandate.

[MNB sets new target](#)

In August, the MNB and the Hungarian government set a new medium-term inflation target, expressed as annual CPI growth of 3%. Unlike the previous targets, which were set for the year-end, the new target is continuous. The MNB's new target is thus identical to that of the CNB. For this reason, and given that in the near future the MNB's monetary policy will face the same challenges relating to euro-area entry as the CNB's monetary policy, we take a closer look at this event in *Spotlight*.

[Poland publishes euro adoption plan](#)

The Polish Ministry of Finance has published a document entitled *Process of Poland's integration with the Euro Area: Membership Conditions and Process Management Strategy*. The document identifies four stages of the integration process: prior to ERM II entry; from ERM II entry to Ecofin's decision on Poland's entry into the euro area; from this decision to euro-area entry; and from euro-area entry to the termination of circulation of the domestic currency. For each stage it outlines the necessary economic and administrative steps and their potential risks. A more detailed procedure for the individual stages will be published soon in a document *National Strategy of Euro Introduction*.

[NBS publishes analysis of Slovakia's economic convergence to EU ...](#)

This NBS analysis assesses the present state of convergence of the Slovak economy within the EU, identifies the main conditions and implications of meeting the criteria for euro-area entry, and compares the results achieved in Slovakia and the prospects for future fulfilment of these criteria with the other countries of the Vysegrad Four. The analysis concludes that Slovakia will satisfy all the Maastricht criteria in 2007 and will be able to adopt the single currency on 1 January 2009.

[...and Slovak government approves euro adoption plan](#)

At its July meeting, the Slovak government approved the *National Euro Changeover Plan*. The Plan envisages Slovakia entering ERM II in the first half of next year, satisfying the other Maastricht criteria in 2007 and adopting the euro on 1 January 2009.

[Fed likely to continue raising rates even after Hurricane Katrina](#)

According to Anthony Santomero, President of the Reserve Bank of Philadelphia, the economic aftermath of Hurricane Katrina will only be short term and will not endanger the expansion of the US economy. The Fed will thus be able to continue with its policy of steadily increasing rates. The former President of the Reserve Bank of Dallas, Robert McTeer, expressed the opposite view, saying that the Fed might reduce rates in reaction to Katrina. The market currently expects one or two rate increases by the end of the year.

[People's Bank of China revalues yuan slightly](#)

At the end of July, the Chinese central bank symbolically revalued the yuan against the US dollar by two per cent following substantial international pressure to make its exchange rate policy more flexible. At the same time it stopped pegging the yuan exclusively to the dollar and started pegging it to a basket of currencies containing the US dollar, the Japanese yen, the Korean won, the Singapore dollar, the British pound, the Malaysian ringgit, the Russian rouble, the Australian dollar, the Thai baht and the Canadian dollar.

[Romanian central bank starts targeting inflation](#)

The Romanian central bank (NBR) published its first [Inflation Report](#) in August. This document presents the new inflation target, which takes the form of a band descending from 7.5% \pm 1 percentage point at the end of this year to 5% \pm 1 percentage point at the end of 2006. The announcement of an explicit target means that the NBR has completed the gradual transition from a crawling peg to inflation targeting.

3. Spotlight: The MNB's new target

In August, the MNB and the Hungarian government set a new medium-term inflation target, expressed as annual CPI inflation of 3%. Unlike the previous targets, which were set for the year-end, the new target is continuous. The MNB's new target is thus identical to that of the CNB. For this reason, and given that in the near future the MNB's monetary policy will face the same challenges relating to euro-area entry as the CNB's monetary policy, we take a closer look at this event in Spotlight.

Previous inflation targets

The Magyar Nemzeti Bank adopted inflation targeting in 2001. In line with its primary objective, which, according to the MNB Act, is to achieve and maintain price stability, the MNB and the government initially set the inflation targets so as to lower inflation quickly, thus facilitating early fulfilment of the Maastricht convergence criteria and Hungary's entry into the euro area. The targets were set at $4.5\% \pm 1$ percentage point for the end of 2002, $3.5\% \pm 1$ percentage point for the end of 2003 and below 3% for 2005 in order to meet the Maastricht inflation criterion.

The MNB managed to hit the end-2002 inflation target, as inflation fell to just under 4% in spring 2003 from around 10% at the time the targets were set. However, in summer 2003 inflation started rising again. The MNB's new medium-term inflation target announced in October 2003 set inflation at $4\% \pm 1$ percentage point for the end of 2005. In November 2004, the medium-term inflation target was updated to $3.5\% \pm 1$ percentage point for the end of 2006. Chart 1 shows the inflation path and the fulfilment of the MNB's inflation targets in previous years.

The new inflation target

The new inflation target of $3\% \pm 1$ percentage point follows on smoothly from the previous targets. Unlike the previous targets, which were set for the year end, the new target is continuous. It will thus be possible to assess its fulfilment on an ongoing basis. The MNB will do so regularly in its quarterly Inflation Report and Annual Report. There are no explicit time limits on the new target, but it will be reviewed at the time of Hungary's entry into ERM II, and in three years' time at the latest.

The MNB's inflation target of 3% implies an inflation differential against the euro area countries of roughly one percentage point. This differential is justified by the nominal convergence of the Hungarian economy, especially in the domestic service sector. Taking into account the declared 5–8 quarter lag in the transmission of MNB monetary policy to the economy, the MNB Monetary Council made decisions based on the new target at its August meeting. Although the mid-point of the MNB's August forecast, conditional on interest rate stability, was 3% as from 2007 (see Chart 2), the Monetary Council lowered its reference rate by one half of a percentage point in August. The Monetary Board's statement indicates that the August decision was due to a forecasted undershooting of the target in 2006 and considerable uncertainty regarding inflation in the longer term.

The target's consistency with meeting the Maastricht criteria

The MNB described the new inflation target as an appropriate starting point for meeting the Maastricht criteria. However, it also stated that the target would be reviewed and, if need be, changed when Hungary enters ERM II. Given the 5–8 quarter lag in the transmission of monetary policy to inflation, and given that the inflation criterion is calculated as a twelve-month moving average, any change to the inflation target would affect the inflation criterion only after three years. However, the question arises whether Hungary will want to stay in ERM II for such a long time.

Escape clauses

The new inflation target allows the MNB not to respond to the primary effects of previous external shocks and government measures (a document describing the new target explicitly names regulated prices, prices of unprocessed food and fuel prices). The MNB will, however, respond to the second-round effects of these one-off shocks in order to prevent inflation rising over the long term. However, the MNB’s option of making exceptions for short-term shocks is limited to a ± 1 percentage point deviation from the 3% inflation target, as the MNB and the government have agreed that only inflation moving within this range is compatible with price stability.

Chart 1: Fulfilment of the MNB’s medium-term targets

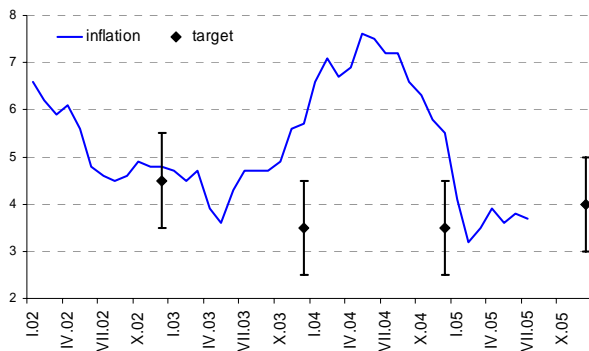
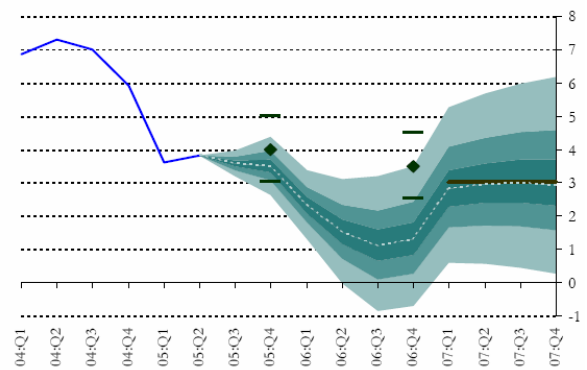


Chart 2: The MNB’s August forecast



Source: MNB, Hungarian Central Statistical Office

4. Selected speech: Donald L. Kohn on the risk premium

In this section we summarise a speech given by Donald L. Kohn, Member of the Board of Governors of the US Federal Reserve System, at the [Financial Market Risk Premiums Conference in Washington on 21 July 2005](#).

Donald L. Kohn draws attention to how estimates of risk premiums may influence the monetary policy decisions of central bankers, and, conversely, how policymakers may affect the level and path of risk premiums. The author defines the risk premium as: "... the additional compensation required by investors for holding a risky security – that is, one with uncertain returns – above the compensation that would be demanded by risk-neutral investors who care only about expected returns".

The Federal Reserve regularly monitors the risk premiums on equities, corporate bonds and Treasury securities. Nevertheless, as Kohn states, it is quite difficult to differentiate between the risk premium and the expected yield on the market price of an asset, since each separation is based on specific modelling assumptions. He gives the example of a long-term corporate bond yield, which consists of partial compensations and separate risk premiums for uncertainty about each of the underlying factors. An ideal model would account for each of these two components separately. In practice, however, we encounter interdependence of the compensations and the risk premiums linked to them. Central bankers should therefore be aware of the theoretical and empirical limitations when interpreting market price movements. However, this is not to deny that risk premiums are relevant for the conduct of monetary policy. One reason is that central bankers simultaneously influence the level and path of the risk premium. Making the monetary policymaking process more transparent reduces uncertainty and thus compresses risk premiums.

Kohn also emphasises that policymakers should in their decision making take into account the level and path of the risk premium in its entire economic context and not to look at it in isolation. Risk premiums can be viewed in three ways: (i) as indicators of uncertainty, (ii) as indicators of economic conditions, or (iii) as tools for monitoring financial stability. Using estimates of risk premiums on equity and bond markets as an example, he shows that divergences in risk premiums on these markets are not unusual from the historical perspective. He goes on to discuss the hypothesis that the fall in the volatility of economic growth along with the decline in inflation and its stabilisation around low values since the 1980s has reduced the deviations of economic and financial variables from expectations, thus leading to a decline in risk premiums.

Towards the end of his speech, Mr Kohn draws attention to another challenge faced by central bankers. To formulate monetary policy we need to determine whether a change in the risk premium is a change in trend or a mere blip. Central bankers should focus on distinguishing between risk premium trends and blips, including their correlation across markets.

This document is produced by the Monetary and Statistics Department of the Czech National Bank and is freely distributable. Closing date: 8 Sep 2005. 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