

In the past three months the Fed and the ECB continued tightening monetary policy. Growing inflation risks are visible primarily in the euro area, where inflation rose to 2.5% in May. Slovakia saw an even more pronounced rise in inflation, which the NBS responded to with a 50 basis-point rate hike. The other monitored banks left their rates unchanged. In Spotlight we take a look at the European Commission and ECB Convergence Reports, which led to a recommendation to admit Slovenia, but not Lithuania, into the euro area. Our selected speech is Axel A. Weber's address on oil price shocks and monetary policy.

1. Developments since the last issue of Monitoring (March 2006) 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%	2.5% (May 2006) ⁴	2.75%	6 Apr/0.00 4 May/0.00 8 Jun/+0.25 ↗	6 Jul 31 Aug ↗	31 Aug: publication of new forecast
Sweden (Sveriges Riksbank)	2.0%	1.5% (Apr 2006)	2.00%	27 Apr/0.00 ↗	19 Jun 29 Aug ↗	20 Jun: publication of IR ⁵
United Kingdom (Bank of England, BoE)	2.0%	2.0% (Apr 2006)	4.50%	5–6 Apr/0.00 3–4 May/0.00 7–8 Jun/0.00 →	5–6 Jul 2–3 Aug 6–7 Sep →	9 Aug: publication of IR ⁵
Hungary (Magyar Nemzeti Bank, MNB)	3.5%	2.3% (Apr 2006)	6.00%	20 Mar/0.00 24 Apr/0.00 22 May/0.00 →	19 Jun 24 Jul 28 Aug →	28 Aug: publication of IR ⁵
Poland (Narodowy Bank Polski, NBP)	2.5%	0.7% (Apr 2006)	4.00%	28–29 Mar/0.00 25–26 Apr/0.00 30–31 May/0.00 →	27–28 Jun 25–26 Jul 29–30 Aug →	30 Aug: publication of IR ⁵
Slovakia (Národná banka Slovenska, NBS)	< 2.5%	4.4% (Apr 2006)	4.00%	27 Mar/0.00 25 Apr/0.00 30 May/+0.50 ↗	27 Jun ⁶ 25 Jul ⁶ 29 Aug ⁶ →	Monetary survey issued on given MP meeting dates
USA (Federal Reserve System, Fed)	n/a	3.5% (Apr 2006)	5.00%	27–28 Mar/+0.25 10 May/+0.25 ↗	28–29 Jun 8 Aug ↗	14 Jun, 26 Jul and 6 Sep: publication of Beige Book
New Zealand (Reserve Bank of New Zealand, RBNZ)	2.0%	3.3% (1Q2006)	7.25%	27 Apr/0.00 8 Jun/0.00 →	27 Jul →	

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 decides on rates once a week; the given dates correspond to the discussion of the Situation Report.

2. News

[ECB and European Commission assess readiness of Lithuania and Slovenia to adopt euro](#)

In mid-May, the [European Central Bank](#) and the [European Commission](#) published their Convergence Reports assessing the preparedness of Lithuania and Slovenia for adopting the single currency. According to these reports, Slovenia has met all the conditions set in the Maastricht Treaty and Lithuania has fulfilled all the criteria except the inflation criterion. The details of this assessment and the causes of Lithuania's non-fulfilment of the inflation criterion are addressed in *Spotlight*.

[ECB changes forecast assumptions...](#)

Starting in June, the ECB's macroeconomic projections will be based on the assumption that short-term interest rates will move in line with market expectations. Until March, the ECB's projections had assumed constant short-term interest rates. This technical change should improve the quality and internal consistency of the projections. The ECB's projections will continue to be compiled by ECB staff and hence will not necessarily concur with the opinions of members of the Governing Council, who use the projections as one of the inputs for their decision-making.

[...specifies responsibilities of Executive Board members...](#)

At the start of June, the ECB Executive Board decided to distribute the responsibilities for individual ECB management areas among its members. For example, President Jean-Claude Trichet has been made responsible for communications and internal audit, Vice-President Lucas D. Papademos for financial stability and supervision and research, and new Executive Board member Jürgen Stark for economics and information systems.

[...and will stop selling gold](#)

At the end of March, the ECB announced that it had completed a project of gold reserve sales amounting to 57 tons of gold. These sales were in conformity with the Central Banks' Gold Agreement, dated September 2004 and signed by 15 European central banks. The ECB also said that it does not intend to sell gold for the second year of the agreement, starting on 27 September 2005 and ending on 26 September 2006.

[Riksbank to publish only three reports a year...](#)

The Riksbank's Executive Board decided in March that starting this year it will publish only three inflation reports a year. Its two autumn reports, which were published quite close together (at the end of October and the end of December) will be replaced by one report. The inflation reports will thus be better spread across the year and the Riksbank's forecasting resources will be used more efficiently.

[...and changes its foreign currency reserve structure](#)

In April, the Riksbank announced that it had changed its foreign currency reserve structure in favour of the euro (from 37% to 50%). The Riksbank's portfolio now also includes the Norwegian krona (10%), and the shares of the Australian and Canadian dollars in the portfolio have increased slightly (from 3% to 5% and from 4% to 5% respectively). Conversely, the share of the US dollar has decreased and the Japanese yen has disappeared altogether. The purpose of the reallocation is to reduce the effect of exchange rate fluctuations on the value of the reserves measured in Swedish kronor. The Riksbank stressed that the choice of allocation was based on the currencies' volatility in relation to one another and not on expectations of future appreciation/depreciation.

BoE changes monetary policy implementation framework

As from mid-May, the BoE will pay interest on reserve balances held by banks and building societies. The reserves will now be calculated on the basis of average balances over the month. The BoE will execute open market operations on a weekly basis (compared to a daily basis until May). According to the BoE, these changes are aimed at bringing short-term interest rates into line with the reference rate, reducing their volatility and generally improving the liquidity management system.

NBS to sell income on its forex reserves...

The NBS Board decided at its April meeting to sell off the income earned on its foreign exchange reserves. Its stated reason for doing so is that the reserves represent five times the average monthly imports into the Slovak Republic. The NBS will perform the conversions outside the domestic foreign exchange market so as to minimise the effect on the Slovak koruna. The expected volume of these transactions on average will be 1% of the daily turnover on the Slovak koruna market and should not exceed 3% of this turnover. The NBS will disclose the volumes of these transactions in its situation reports on monetary developments.

...and publishes cost-benefit analysis for euro adoption...

At the end of March, the NBS published an analysis quantifying the benefits and costs of adopting the euro. For example, the effect of the loss of autonomous monetary policy was quantified at roughly 0.04% of GDP. According to this analysis, the benefits of adopting the euro in Slovakia outweigh the costs overall. However, the document states that to take full advantage of the benefits of the euro in Slovakia, the flexibility of the Slovak economy needs to be increased.

...and code of ethics for businesses for introduction of euro

In April, the NBS published on its website a code of ethics for businesses for the introduction of the euro, prepared in partnership with the Slovak Government's authorised representative for the introduction of the euro and the Business Alliance of the Slovak Republic. Among other things, the Code obliges businesses not to use euro adoption as an excuse to make unjustified price movements, to introduce dual prices for goods and services as soon as possible after the koruna-euro conversion rate is published, and to frontload with sufficient euro banknotes and coins.

Fed launches monetary policy website for public

This website is intended to be a fun way of teaching high school students about the Fed's Board of Governors. Basic information on the Fed's monetary policy is provided in the form of simple questions and answers. The site also features a quiz.

3. Spotlight: Convergence Reports assess preparedness of Lithuania and Slovenia for the euro

In mid-May, the ECB and the European Commission published their Convergence Reports assessing the preparedness of Lithuania and Slovenia for adopting the single currency. According to these Reports, Slovenia has met all the conditions set in the Maastricht Treaty and Lithuania has fulfilled all the criteria except the inflation criterion.

The Baltic States have higher inflation

In March, Lithuania and Slovenia asked the ECB and the Commission to draw up an extraordinary Convergence Report so that they can adopt the euro at the start of next year. Estonia, the third candidate country which would this year have met the condition of a two-year stay in the ERM II, did not submit an application. This was due to its high rate of inflation, which at the beginning of the year significantly exceeded 4%, i.e. a level incompatible with fulfilment of the inflation criterion.

All the Baltic States face the problem of high inflation. With an inflation rate of over 7% at the beginning of the year, Latvia is showing even higher inflation than Estonia. The lowest inflation is in Lithuania, which had been relying on early elaboration of its Convergence Report and narrow fulfilment of the inflation criterion. However, its 12-month average rate of inflation in March, included in the examination (2.7%), exceeded the reference value (2.6%) by 0.1 percentage point. The Commission's Convergence Report found that Lithuania had not satisfied the inflation criterion.

The high inflation in the Baltic States is linked with fixed exchange rates

The high inflation in the Baltic States is attributable to the fixed exchange rate regimes in these countries, which prevent inflationary pressures from being absorbed through exchange rate appreciation. Estonia and Lithuania maintain currency boards (Estonia since 1992, Lithuania since 1994), which imply a completely fixed rate, while Latvia maintains its exchange rate within a very narrow band of $\pm 1\%$ against the euro. These fixed exchange rate regimes imply a need to keep interest rates close to those of the ECB, i.e. at relatively low levels. Meanwhile, however, the Baltic States – like the other Central and Eastern European economies – face long-term real exchange rate appreciation, which, under a fixed exchange rate, leads to higher inflation. In conditions of higher inflation and low nominal interest rates, a situation is arising where real interest rates are too low or even negative (see Chart 1). These easy interest rates act further towards higher inflation (by fostering economic growth).

These demand-pull inflationary factors have been joined recently by cost factors in the form of changes to indirect taxes and administered prices (the contribution of these prices in Lithuania in 2005 is estimated at 0.8 percentage point) and growth in world energy prices. Moreover, these cost factors will continue to act in the years ahead owing to further harmonisation of excise duties and rising import prices of energy-producing materials from Russia, which currently supplies these commodities to the Baltic States at below world prices.

Ecofin will have the final say

The final decision on whether to accept new countries into the euro area will be taken by Ecofin (the council of finance ministers of the EU member states) in July. However, Lithuania is unlikely to be admitted for the simple reason that Ecofin can only decide to admit a country on the basis of a formal proposal made by the Commission. The Commission has submitted such a proposal in the case of Slovenia, but not in the case of Lithuania, so Ecofin has nothing to decide on in Lithuania's case.

But Lithuania remains intent on joining the euro area as soon as possible. The Governor of the Lithuanian central bank has said that if euro adoption is postponed the central bank will formulate a new economic forecast and will set a realistic new euro adoption date based on that forecast. However, if the Commission’s spring forecast turns out to be right, Lithuania will not realistically be able to adopt the euro before 2009.

Other ERM II countries also face problems with inflation

It is not only the Baltic States that are having problems with meeting the inflation criterion. So are many other countries attempting to join the euro area soon (see Chart 2). At present, Latvia has the highest inflation in the European Union (6.1% in April), followed by Slovakia (4.4%) and Estonia (4.3%). If these countries are to satisfy the inflation criterion next year (Latvia and Estonia are planning to join the euro area at the beginning of 2008) or in 2008 (Slovakia is planning to enter at the start of 2009), inflation will have to be reduced significantly. However, even Malta (with inflation of 3.5% in April) is far from sure of meeting the inflation criterion next year.

Chart 1: Real interest rates (1-year money market rates-annual HICP inflation)

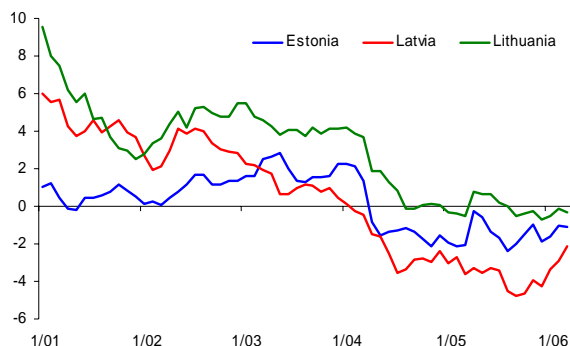
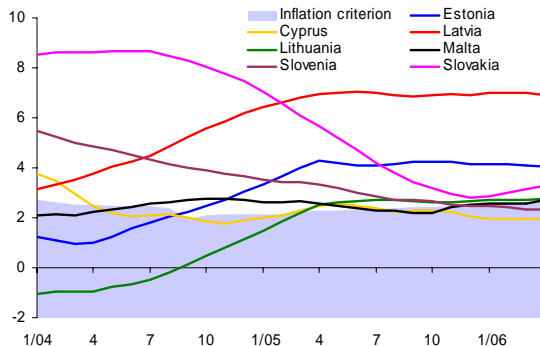


Chart 2: Inflation in selected countries (1-year moving average rate of annual HICP inflation)



Sources: Eurostat, CNB calculations

4. Axel A. Weber on oil price shocks and monetary policy in the euro area

In this part, we summarise the speech given by Axel A. Weber, President of the Deutsche Bundesbank, at [the Central Bank and Financial Services Authority of Ireland in Dublin on 11 May 2006](#).

Axel Weber gave this year's Whitaker Lecture, named after the leading Irish economist and former governor of the Irish central bank, Kenneth Whitaker.

The first part of the lecture was devoted to a comparison of the current rise in oil prices with previous oil price shocks. This comparison revealed that the developments on the oil market since mid-2003 are comparable with the first oil price shock (1973–1974) – a “textbook” example of a supply shock, which caused serious stagflation in the oil-importing countries – as well as with the second oil price shock (1978–1979) and with the period following the invasion of Kuwait (1990). However, Mr Weber emphasised that the previous oil price shocks were, in contrast to the current one, accompanied by a severe slowdown in global economic growth in the oil-importing countries. The comparison of the behaviour of inflation seems analogous: the first and second oil price shocks went hand in hand with a doubling of inflation, whereas the present global inflation rates are the lowest for 35 years.

Weber went on to say that the current oil price shock has been driven primarily by demand (particularly in the USA and China), which is coming up against limited spare capacities in oil refining and production. At the same time, however, the latest hike in oil prices is also due to a slow response from oil producers to the growing demand. Growth in oil prices dampens economic activity in oil-importing countries, but the impacts of the oil price shock are offset somewhat as oil producers spend their income on imported capital goods or invest in oil importers' financial markets. Other reasons for the limited impact of oil prices on the current economies of advanced countries include a decline in the share of energy-intensive industries in GDP, growth in global competition, weaker bargaining power of trade unions and higher credibility of central banks.

The second part of the lecture was devoted to the question of whether the current benign environment in the world economy means that oil price shocks have lost their potentially damaging effects and are no longer a challenge for monetary policy. Weber stressed that, in his view, this is not the case, hence monetary policy still cannot afford to treat oil price shocks with benign neglect. The possible trade-off between inflation and output stabilisation is influenced by the functionality of the monetary policy transmission channels and by the existence of real rigidities. As regards real rigidities on the labour market, the more flexible real wages are, the faster the economy can cope with an oil price shock and hence the faster the output gap can be closed. Moreover, the better inflation expectations are anchored, the smaller the impacts of an oil price shock are on inflation. Weber also pointed out that this type of shock affects not only current output, but also potential output. To sum up, Weber recommends that in response to an oil price shock, monetary policy should focus on price stability, anchoring inflation expectations and not trying to implement a policy of fine-tuning.

In the euro area, according to Weber, the growth in oil prices has so far been reflected only in higher prices of energy and not in prices of other goods and services. However, oil prices are only one, albeit important, factor contributing to the current inflation risks in the euro area.

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