

**Monetary and Statistics Department
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Monetary policy tightening remained the main trait of the last three months. Of the eight central banks monitored, those of Poland and New Zealand again left their rates unchanged; this time they were joined by the Fed. Hungary's MNB took the record again, raising its rates in two steps by a total of 0.75 percentage points. The other central banks all raised their rates by 0.25 percentage points. In Spotlight we take a look at an ECB conference on the current role of money in monetary policy. Our selected speech is Erkki Liikanen's address on Finland's euro area experience.

1. Developments since the last issue of Monitoring (September 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%	1.6% (Oct 2006) ⁴	3.50%	5 Oct/+0.25 2 Nov/0.00 7 Dec/+0.25 ↗	11 Jan 8 Feb 8 Mar ↗	8 Mar: publication of new forecast
Sweden (Sveriges Riksbank)	2.0%	1.3% (Oct 2006)	2.75%	25 Oct/+0.25 ↗	14 Dec 14 Feb ↗	15 Feb: publication of IR ⁵
United Kingdom (Bank of England, BoE)	2.0%	2.4% (Oct 2006)	5.00%	4–5 Oct/0.00 8–9 Nov/+0.25 6–7 Dec/0.00 →	10–11 Jan 7–8 Feb 7–8 Mar ↗	14 Feb: publication of IR ⁵
Hungary (Magyar Nemzeti Bank, MNB)	3.5%	6.3% (Oct 2006)	8.00%	25 Sep/+0.50 24 Oct/+0.25 20 Nov/+0.00 →	18 Dec 22 Jan 26 Feb →	26 Feb: publication of IR ⁵
Poland (Narodowy Bank Polski, NBP)	2.5%	1.2% (Oct 2006)	4.00%	26–27 Sep/0.00 24–25 Oct/0.00 28–29 Nov/0.00 →	19–20 Dec 30–31 Jan 27–28 Feb →	29 Jan: publication of IR ⁵
Slovakia (Národná banka Slovenska, NBS)	< 2.5%	3.1% (Oct 2006)	4.75%	26 Sep/+0.25 31 Oct/0.00 28 Nov/0.00 →	19 Dec ⁶ 30 Jan 27 Feb →	Monetary survey issued on given MP meeting dates
USA (Federal Reserve System, Fed)	n/a	1.3% (Oct 2006)	5.25%	20 Sep/0.00 24–25 Oct/0.00 ↗	12 Dec 30–31 Jan ↘	17 Jan: publication of Beige Book
New Zealand (Reserve Bank of New Zealand, RBNZ)	2.0%	3.5% (3Q 2006)	7.25%	14 Sep/0.00 26 Oct/0.00 7 Dec →	25 Jan 8 Mar →	

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 publishes 2006 Convergence Report...](#)

On 5 December, the ECB and the European Commission published a Convergence Report assessing economic and legal convergence in nine EU Member States: the Czech Republic, Estonia, Cyprus, Latvia, Hungary, Malta, Poland, Slovakia and Sweden. In producing this report, the ECB fulfils the requirement of Articles 122(2) and 121(1) of the Treaty establishing the European Community to report to the Council of the European Union (EU Council) at least once every two years or at the request of a Member State “on the progress made in the fulfilment by the Member States of their obligations regarding the achievement of economic and monetary union”. At present, 13 Member States are not full participants in the Economic and Monetary Union. Two of these states, Denmark and the United Kingdom, have a special status under the relevant Protocols attached to the Treaty. As a consequence, Convergence Reports for these two Member States only have to be provided if they so request. Another two Member States, Lithuania and Slovenia, were assessed in Convergence Reports issued in May 2006, following their requests for an examination. Taking into account these reports, Slovenia was given the go-ahead to join the euro area on 1 January 2007, whereas Lithuania’s entry was not approved. The December report states that of the nine countries examined, the Czech Republic, Cyprus, Poland and Sweden meet the inflation criterion; Estonia, Cyprus, Latvia and Sweden satisfy the public finance criterion; only Estonia meets the exchange rate criterion; and all the countries except Hungary are compliant with the long-term interest rate criterion.

[...and study on differences in interest rates...](#)

On 20 September the ECB published a report entitled “Differences in MFI interest rates across euro area countries”. This publication was prepared by a group of experts at the ECB and at national central banks under the joint mandate of the Monetary Policy Committee and the Statistics Committee. The report presents the first comprehensive assessment of cross-country differences in various types of deposit and lending interest rates that are offered and charged by euro area monetary financial institutions to households and non-financial corporations. The report states that despite the remarkable convergence that has taken place in the euro area in recent years, similar types of interest rate still vary considerably across countries. Only a small part of these differences can be attributed to statistics. The main factor is remaining product heterogeneity, which makes it methodologically difficult to unify categories at the euro area level. Other factors such as the data aggregation method and differences in credit risk and market structure also contribute.

[...launches a new Statistical Data Warehouse...](#)

A new Statistical Data Warehouse was launched on 21 September. It is intended for a wide range of users, ranging from one-time visitors to market participants, journalists, analysts and researchers. It is simple to use and allows users to quickly find, display, chart and download data. The Warehouse is available at <http://sdw.ecb.int>.

[...and organises 4th Central Banking Conference](#)

The 4th Central Banking Conference took place on 9–10 November 2006 under the patronage of the ECB, this time on the theme of “The role of money: money and monetary policy in the twenty-first century”. The conference and its conclusions are covered in more detail in *Spotlight*.

[Swedish parliament commissions independent report on monetary policy](#)

The Swedish parliament's Committee on Finance on 28 November published "An assessment of Swedish monetary policy 1995–2005" by Frederic S. Mishkin and Francesco Giavazzi. The Committee commissioned the independent assessment in spring 2005. According to the authors the Swedish central bank comes out of the evaluation very favourably. Monetary policy making has greatly improved from what occurred prior to the adoption of inflation targeting under an independent central bank. However, in recent years the Riksbank has persistently undershot its inflation target, leading to a loss in output and higher unemployment. The Riksbank has also not been effective enough in clearly communicating its strategy. The authors therefore make nine recommendations in the areas of the governance, conduct and communication of monetary policy.

[Adam Smith to feature on banknotes](#)

The world-renowned philosopher and economist, Adam Smith, is to be portrayed on a new £20 banknote the Bank of England is to introduce into circulation next spring. The note will start a new series of new-design Bank of England banknotes. The new note will incorporate enhanced security features and will initially circulate in tandem with the older £20 note.

[NBS approves Communication Strategy until 2009](#)

The Bank Board of the National Bank of Slovakia (NBS) has approved the NBS Communication Strategy until 2009, defining the main objectives and target groups and proposing communication instruments to achieve the set objectives. The Strategy pays special attention to communication with experts and the public in the field of monetary policy in connection with the fulfilment of the NBS Monetary Programme. All communication with the public will be guided by the principles of transparency, predictability and comprehensibility. Explaining the Maastricht criteria for inflation and the exchange rate will be a main monetary policy objective, while achieving the target inflation level will be the overriding objective.

[Fed discusses possibility of targeting inflation](#)

At its meeting on 24–25 October, the FOMC discussed the advantages and disadvantages of setting a quantitative inflation target. It was stated that this was a complex issue that required further discussion. The debate on this issue will continue at the FOMC's meeting in January 2007.

[RBNZ releases another fascinating book](#)

The RBNZ and the New Zealand Treasury in October released a book entitled "[Testing stabilisation policy limits in a small open economy](#)". The book contains the proceedings of a conference held in Wellington on 12 June 2006. Although macroeconomic policies in New Zealand have achieved considerable success over the past decade, there have at times been periods of significant external imbalance and variability in the NZ dollar. The conference examined the possibility of employing alternative stabilisation policies. In this respect some of the papers will be of interest to Czech readers. Representatives of the OECD, the IMF, central banks and universities presented papers at the conference.

3. Spotlight: The ECB's "Role of Money" conference

On 9–10 November 2006 the ECB held a conference entitled "[The role of money: money and monetary policy in the twenty-first century](#)", part of a cycle of central banking conferences organised by the ECB every two years. It is presumably no accident that this topic was chosen in the year that Otmar Issing, regarded as the founding father of the ECB's two-pillar monetary policy strategy, left the ECB's management after a tenure of eight years. Mr Issing gave an honorary address at the conference in which he defended the ECB's choice of monetary policy strategy. The conference was attended by senior representatives of numerous central banks, leading world economists, financiers and journalists.

In their speeches, the ECB's top managers mostly praised the successes achieved by the ECB since its foundation in maintaining price stability, despite this being no easy task for a newly established monetary authority. In this context it was mentioned several times that the monetary pillar of ECB policy had helped anchor inflation expectations. The argument that *monetary* policy must by definition take an interest in *money* and that "inflation is ultimately a *monetary* phenomenon" was also used quite often.

Jürgen Stark ended his opening address with a challenge that monetary policy should always be prepared to learn from modern economic theory, but at the same time that economic theory should respect truths that have survived the test of time (see above). Christian Noyer noted that even if money does not have a direct relationship to inflation, it can be a useful leading indicator for longer time horizons than those that central bank forecasts usually focus on. It can also help identify the emergence of future financial imbalances in good time. In his address, the President of the ECB, Jean-Claude Trichet, took issue with the widespread view that in practice the ECB has never been guided by the monetary pillar if the economic analysis pillar has not been pointing in the same direction. He also expressed the belief that the ECB had succeeded in explaining its strategy well to the public. This unanimity of views among the members of the Executive Board of the ECB was upset slightly by a visionary remark in which Lucas Papademos admitted that it might be possible to merge the two pillars into one. However, this step, he said, was conditional on constructing a macroeconomic model incorporating dynamic stochastic general equilibrium models as well as imperfections in the financial system and the information content of monetary aggregates.

Another major ECB contribution to the conference programme was a study attempting to assess the ECB's 1999–2006 experience, authored by a team led by Lucrezia Reichlin. It emphasised that the ECB's strategy had evolved over time and had responded to the challenges faced by the ECB in practice. Among other things, the importance of expert judgement in the ECB's monetary analyses had been increased in an effort to take portfolio shifts into account and provide a behavioural explanation of monetary developments. Reduced form money-based inflation forecasts had also come to play a more prominent role. It was demonstrated that the forecasts based on money and those based on economic analysis had mean errors of opposite sign, hence the two types of forecast were complementary. Moreover, monetary aggregates corrected for portfolio shifts gave unbiased forecasts of inflation, although the correlation with inflation was negative. Conversely, the importance attached to estimates of money demand had fallen significantly and the ECB now relied far less on the stability of money demand over time. By way of conclusion, the extent to which the monetary pillar had been reflected in the ECB's actual monetary policy decisions was evaluated. In most cases, the recommendations stemming from the two pillars had pointed in the same direction and no dilemma had arisen. It appeared, however, that when the signals had been blurred, the ECB had favoured its economic analysis.

The representatives of the academic community were far less united than the ECB staff in their

appraisal of the usefulness of monetary analyses for monetary policy. This split was symbolised on one side by the address given by Michael Woodford from Columbia University, whose message was given further weight by comments made by Harald Uhlig from Humboldt University in Berlin, and on the other side by Lawrence J. Christiano from Northwestern University. As expected, Professor Woodford presented the standard model of new Keynesian economics, in which money is an endogenous variable and has zero added information value. These conclusions were criticised by several ECB representatives in their speeches. Professor Christiano, by contrast, presented a model with sticky wages and financial market imperfections in which inflation targeting may destabilise the economy. In some circumstances, then, it is appropriate to apply exemptions and start reacting to credit or money growth. The prevailing view from the floor seemed to lie somewhere between these two poles, i.e. monetary aggregates should be assigned a weight in monetary policy to the extent that they are useful in forecasting inflation. It was also mentioned several times in the debate that money analyses can be useful in identifying risks to financial stability, although the point was also made that there is no reason to focus such analyses solely on financial instruments that enter the monetary aggregates and that other financial assets and liabilities should also be taken into consideration.

The conference ended with a panel discussion featuring top representatives of the most important central banks – ECB President Jean-Claude Trichet (see above), US Fed Chairman Ben Bernanke, Governor of the People's Bank of China Zhou Xiaochuan and Deputy Governor of the Bank of Japan Kazumasa Iwata. Mr Bernanke focused on the Fed's historical experience with the use of monetary aggregates. He emphasised that money demand stability had collapsed several times in the USA, hence the Fed at present carefully analyses monetary developments but attaches quite a small weight to them in its decisions. Mr Zhou described the gradual establishment of standard central banking in China since 1985, including the current challenges (gradual reform of the forex market etc.). Mr Iwata discussed the Japanese experience with the quantitative easing policy at a time of deflation.

Overall the conference can be assessed as a useful exchange of views on a theme that remains a subject of dispute between theoreticians and monetary policy practitioners.

4. Selected speech: Erkki Liikanen on Finland's euro area experience

In this part we summarise the speech entitled "[Finland, the EMU and the introduction of the euro](#)" given by Erkki Liikanen, Governor of the Bank of Finland, at the Economic Forum of Hospodarske Noviny Club in Bratislava on 20 October 2006.

Erkki Liikanen divided his speech into three interlinked parts whose common thread was a retrospective look at Finland's almost eight-year participation in the euro area. He discussed the following issues: (i) perceptions of the suitability of the single monetary policy of the euro area for Finland given the country's specific features; (ii) practical experience with introducing the euro; and (iii) a brief assessment of the functioning of the Finnish economy with the euro.

Before Finland joined the euro area, there had been an intensive debate about the pros and cons of this step. Much attention had been devoted to the strong asymmetry of the Finnish economy (with regard to both the timing and amplitude of economic cycles) vis-à-vis the economies of Germany, France and the Benelux countries, and to related fears that the single monetary policy could be inappropriate for the Finnish economy. This asymmetry was due mainly to a different structure of production (a disproportionately high share of the forestry industry and, since the early 1990s, the technology-intensive mobile phone and network industry) and a foreign trade orientation towards non-members of the euro area (Sweden, the UK and Russia). Before it entered the ERM, the Finnish economy had been hit harder by the economic crisis than the other euro-candidates. It had been forced to change its exchange rate regime and interest rates had increased.

The introduction of the euro as an account currency (at the start of 1999) and euro cash (at the start of 2002) was accompanied by a gradual rise in confidence as knowledge of the single European currency project rose. Mr Liikanen described the use of a "decentralised approach" to the management of the campaign in Finland. This had consisted of a national campaign (conducted by government authorities and the European Commission) a euro area-wide campaign (conducted by the European Central Bank and the national central banks of the Eurosystem) and the Bank of Finland's own campaign. The advantages of such a campaign, said Mr Liikanen, were that it had been aimed at several different target groups simultaneously and that the tone of the campaigns had varied. However, it was vital that the campaigns had been understandable and well coordinated.

The introduction of euro cash in Finland had generated no notable change in consumer price inflation, although some product prices had been rounded upward. At the time of the changeover to euro banknotes there had also been bigger differences between perceived and actual inflation, as in many other euro area countries. Mr Liikanen said that this may have stemmed from the monitoring of only some items of the consumer basket; imprecise following of price developments given in euro prices; inconsistent euro-to-markka conversions (the use of a rounded-up conversion coefficient); and changes in sellers' pricing practices (the use of "psychological prices" ending in the digits 5–9).

In the final part of his address, Mr Liikanen assessed Finland's euro area experience to date. He stated that although the Finnish economy had experienced many of the possible asymmetric shocks after joining the euro area (a strong boom-bust cycle in the telecom industry, a strong depreciation and subsequent appreciation of the euro against the dollar, oil price growth), it could be said that it had coped with all of these shocks. The data on inflation, GDP, employment and the profitability of Finland's industry indicated that the single monetary policy in fact suited Finland rather well.

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