

Central Bank Monitoring

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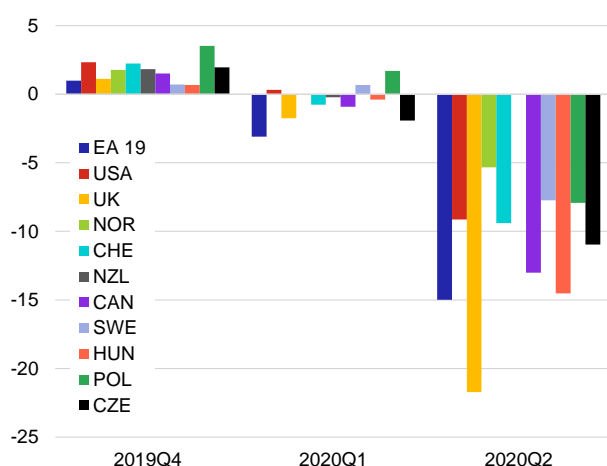
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In this issue

Economies are assessing the full extent of the damage caused by the coronavirus pandemic. Governments and central banks have adopted numerous supporting economic and social measures. The monitored economies, which recorded a sharp decline in GDP in the first half of the year (see the chart below), are now seeing a partial recovery enabled by the easing of quarantine measures and a return of firms and households to normal life. Unemployment has increased in the individual countries and is expected to keep rising for the rest of this year. The room for conventional monetary policy has almost been used up, so central banks are providing additional stimulus to their economies using unconventional monetary policy measures, mainly focused on credit flow support and financing costs. Unconventional programmes are still in place in most of the economies monitored and have even been expanded and extended recently in some of them.

In *Spotlight*, we discuss this year's Convergence Reports of the ECB and the European Commission, mainly from the perspective of the recent entry of Bulgaria and Croatia into ERM II. In our *Selected Speech*, US Fed Chair Jerome H. Powell clarifies the revised monetary policy strategy of the US central bank.

All the countries monitored saw a sizeable drop in real GDP in 2020 Q2 (year on year in %)



Note: Data are not available for New Zealand for 2020 Q2.
Data source: OECD

This publication aims to provide economists and other specialists with information on the latest monetary policy developments, strategies and communications at selected central banks.

Current and past issues can be downloaded free from the Monetary Policy section of the CNB website: <https://www.cnb.cz/en/monetary-policy/monitoring/>, where you can also download a file containing a list of all the thematic articles and speeches.

The publication is produced by the Monetary Policy and Fiscal Analyses Division of the Czech National Bank's Monetary Department and is freely distributable. Authors: Lucie Matějková (editor), Kateřina Arnoštová and Ivana Kubicová.

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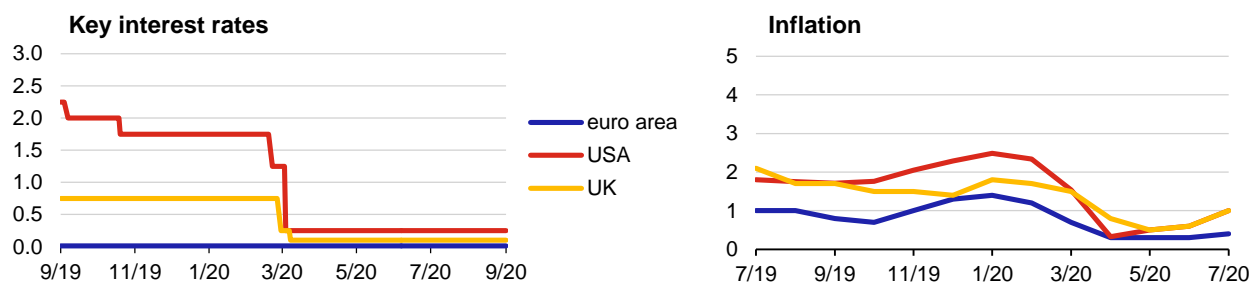
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I. LATEST MONETARY POLICY DEVELOPMENTS AT SELECTED CENTRAL BANKS

I.1 KEY CENTRAL BANKS OF THE EURO-ATLANTIC AREA

	Euro area (ECB)	USA (Fed)	United Kingdom (BoE)
Inflation target	<2 % ¹	2% ²	2%
MP meetings (rate changes)	16 Jul (0.0);(0.0) ³ 10 Sep (0.0);(0.0) ³	9–10 Jun (0.00) 28–29 Jul (0.00)	18 Jun (0.00) 6 Aug (0.00)
Current basic rate	0.00%; -0.50% ³	0–0.25% ⁴	0.1%
Latest inflation	-0.2% (Aug 2020) ⁵	1% (Jul 2020)	1% (Jul 2020)
Expected MP meetings	29 Oct 10 Dec	15–16 Sep ⁶ 4–5 Nov 15–16 Dec ⁶	17 Sep 5 Nov 17 Dec
Other expected events	29 Oct: publication of forecast	Feb 2021: publication of Monetary Policy Report	17 Sep: publication of Monetary Policy Report
Expected rate movements⁷	→	→	→

Note: ¹ ECB definition of price stability “below but close to 2%”; ² long-term average, according to August 2020 definition; ³ deposit rate; ⁴ chart shows upper boundary of band; ⁵ flash estimate; ⁶ meeting associated with summary of FOMC economic forecasts; ⁷ direction of expected change in rates in next three months taken from Consensus Forecasts.



The **ECB** kept rates unchanged and will keep them at the present level (or lower) until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2%. It continues to implement measures adding monetary policy stimulus in response to the economic impacts of the pandemic. The size of the PEPP emergency asset purchase programme remains at EUR 1,350 billion as approved in June; net purchases will take place until at least the end of June 2021 and, in any case, until the ECB judges that the coronavirus crisis phase is over. Net asset purchases under the APP will also continue at a monthly pace of EUR 20 billion, together with the purchases under the additional EUR 120 billion temporary envelope until the end of the year. TLTRO III has registered a high take-up of funds and the ECB will continue this form of funding support. Real GDP fell by 15% in Q2. The ECB expects a slightly smaller decline in GDP this year (8.0%) compared with the June forecast (8.7%). Its growth forecast for the subsequent years is largely unchanged at 5.0% in 2021 (formerly 5.2%) and 3.2% in 2022 (formerly 3.3%). The August flash estimate for inflation was -0.2%. The ECB predicts inflation of 0.3% in 2020 (unchanged from the June forecast), 1.0% in 2021 (formerly 0.8%) and 1.3% in 2022 (1.3%).

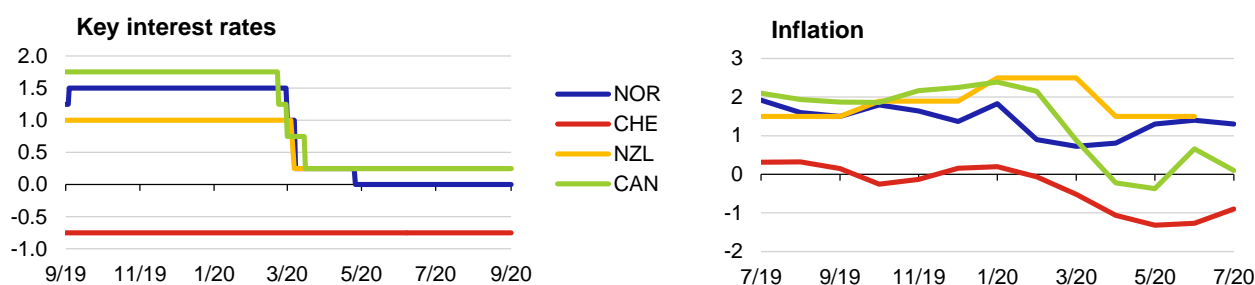
In August, the **Fed** announced a review of its monetary policy strategy. It will now target average inflation at 2% (see *News* for details). It left its key federal funds rate unchanged over the last three months. According to the FOMC, interest rates will remain at their current level or lower until the FOMC is confident that the economy has weathered the impacts of the coronavirus pandemic; in the opposite case, the Fed is ready to use all the tools at its disposal. The FOMC undertook to continue its asset purchases “at least at the current pace”. At the same time, it extended the existing rescue facilities until the end of this year. In its forecast, the FOMC expects only a modest economic recovery. This caused concerns on financial markets. In the minutes of its July monetary policy meeting, the FOMC shared concerns regarding the termination of government support programmes, which are having a favourable impact on consumers and consumer demand. It sees this as a risk to the pace of the economic recovery.

The **BoE** kept its key rate unchanged at 0.1%. The UK economy contracted by 20.4% quarter on quarter and 21.7% year on year in Q2. This is slightly less than the BoE had expected (25%). The BoE continues to purchase government and corporate bonds and support the funding of SMEs via the TFSME programme. Inflation was 1% in July. The BoE expects it to remain well below the inflation target in the period ahead (0.3% at the year-end) and reach 2% in two years' time.

I.2 SELECTED INFLATION-TARGETING NON-EU COUNTRIES

	<u>Norway (NB)</u>	<u>Switzerland (SNB)</u>	<u>New Zealand (RBNZ)</u>	<u>Canada (BoC)</u>
Inflation target	2%	0–2%	2%	2%
MP meetings (rate changes)	18 Jun (0.00) 19 Aug (0.00)	18 Jun (0.00)	24 Jun (0.00) 12 Aug (0.00)	15 Jul (0.00) 9 Sep (0.00)
Current basic rate	0%	-0.75%	0.25%	0.25%
Latest inflation	1.3% (Jul 2020)	-0.9% (Jul 2020)	1.5% (2020 Q2)	0.1% (Jul 2020)
Expected MP meetings	24 Sep 5 Nov 17 Dec	24 Sep 17 Dec	23 Sep 11 Nov	28 Oct 9 Dec
Other expected events	24 Sep: publication of Monetary Policy Report	30 Sep: publication of Quarterly Bulletin	11 Nov: publication of Monetary Policy Statement	28 Oct: publication of Monetary Policy Report
Expected rate movements²	→	→	→	→

Note: ¹ direction of expected change in rates in next three months is taken from Consensus Forecast survey or, in the case of New Zealand, from RBNZ survey).



The **NB** kept its policy rate unchanged at zero and expects it to remain at this level for some time, probably beyond the end of 2023. In Q2, annual Norwegian GDP fell by 5.3%, the smallest drop among the economies monitored. Recent (quarter-on-quarter) data from July signal a shift of GDP growth back to positive territory. Inflation is low (1.3% in July) but will be above the target next year according to the July forecast (no forecast is drawn up in August). The NB continues to provide banks with additional liquidity in the form of “F-loans” (with one-week to 12-month maturity).

The **SNB** kept its base rate at -0.75% and continues to use its refinancing facility (the SNB COVID-19 CRF) to provide the banking system with additional liquidity. The SNB’s June forecast predicts negative inflation of -0.7% in 2020 and -0.2% in 2021 (the March forecast had expected 0.3% in 2021) and expects inflation to reach 0.2% in 2022 (0.7% in the March forecast). The SNB’s GDP outlook for this year expects a contraction of around 6%. A new forecast is to be published in late September.

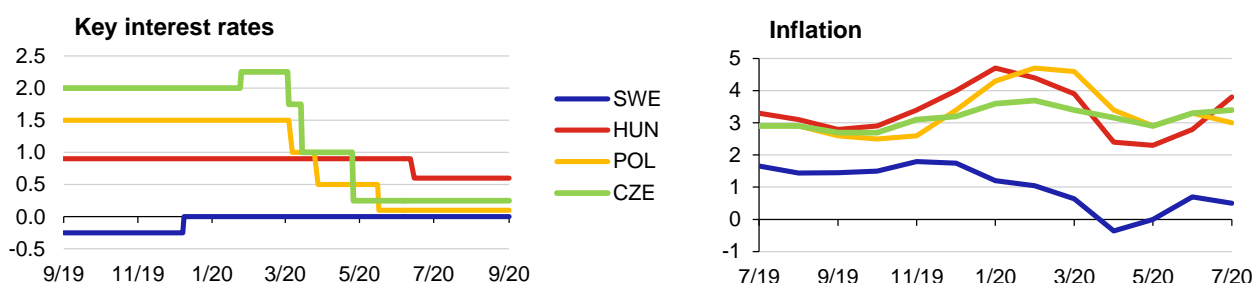
The **RBNZ** left its key rate unchanged at 0.25%. In August, it decided to expand the LSAP asset purchase programme from NZD 40 billion to NZD 100 billion by June 2022. The LSAP has helped to reduce bond yields by around 0.6–1.0 pp along the entire yield curve. The RBNZ continues to provide banks with secured 12-month loans and is now providing loans for up to three years to support the government programme to fund small enterprises (TLF). The RBNZ is preparing a package of additional extraordinary measures to further ease monetary conditions should that become necessary. The measures include a negative OCR rate supported by funding banks at near-OCR (a funding for lending programme) and by purchases of foreign assets.

The **BoC** left its key rate unchanged at 0.25% and continues to purchase government bonds at a weekly pace of at least CAD 5 billion. This quantitative easing will continue until the recovery is well underway. Term repo operations are continuing and the BoC is supplying liquidity to the market using its CTRF and SLTF facilities; however, take-up of short-term liquidity has decreased thanks to the money markets operating smoothly. Canada’s GDP fell by 11.5% year on year in 2020 Q2, largely in line with the BoC’s July forecast. In this forecast, the BoC expects GDP to decline by 7.8% this year and grow by 5.1% in 2021 and 3.7% in 2022. Inflation is close to zero and is expected to remain below the target in the near term (0.6% in 2020, 1.2% in 2021 and 1.7% in 2022). Measures of core inflation are between 1.3% and 1.9%, reflecting the large degree of economic slack.

I.3 SELECTED CENTRAL BANKS OF INFLATION-TARGETING EU COUNTRIES

	Sweden (Riksbank)	Hungary (MNB)	Poland (NBP)	Czech Republic (CNB)
Inflation target	2% ¹	3%	2.5%	2%
MP meetings (rate changes)	30 Jun (0.00)	23 Jun (-0.15) 21 Jul (-0.15) 25 Aug (0.00)	16 Jun (0.00) 14 Jul (0.00)	24 Jun (0.00) 6 Aug ³ (0.00)
Current basic rate	0%; -0.1% ²	0.6%; -0.05% ²	0.10%	0.25%
Latest inflation	0.5% (Jul 2020)	3.8% (Jul 2020)	3% (Jul 2020)	3.4% (Jul 2020)
Expected MP meetings	21 Sep 25 Nov	22 Sep, 20 Oct 17 Nov 15 Dec	15 Sep, 7 Oct 4 Nov 2 Dec	23 Sep 5 Nov 17 Dec
Other expected events	22 Sep: publication of Monetary Policy Report	24 Sep: publication of Inflation Report	9 Nov: publication of Inflation Report	12 Nov: publication of Inflation Report
Expected rate movements⁴	→	→	→	→

Note: ¹ CPIF – consumer price index including fixed interest rate; ² deposit rate; ³ publication of new forecast; ⁴ direction of expected change in rates in next three months taken from Consensus Forecast survey.



The **Riksbank** left its key rate unchanged at 0%. The deposit rate is slightly negative (-0.1%). The July forecast expects the key rate to be kept unchanged at 0% until 2023. Since the start of the pandemic, the Riksbank has introduced a series of programmes to support the economy and is purchasing government, covered, corporate and municipal bonds in a total planned amount of SEK 500 billion (an increase on the SEK 300 billion approved in March), extended to the end of June 2021. In July, the Riksbank cut by 0.1 pp the interest supplement that applies if a bank does not meet the requirement for onward lending (formerly the repo rate plus 0.2 pp) and extended the loan maturity from two to four years. The CPIF inflation outlook is 0.4% for this year and 1.4% for the subsequent two years. The GDP growth outlook for this year is more favourable overall than the previous forecast, although it still expects a sizeable decline (4.5%); economic activity is forecasted to grow by 3.6% in 2021 and 4.1% in 2022.

The **MNB** lowered its base rate in two consecutive steps of 0.15 pp to 0.6%. The deposit rate is negative at -0.05%. The MNB continues to support liquidity and access of economic agents to funding using specific programmes. The corporate sector is being supported by the Funding for Growth Scheme Go! to foster lending to SMEs and by the Bond Funding for Growth Scheme. At the same time, the MNB is purchasing government bonds with maturities of over 15 years (to lower yields at the longer end of the yield curve). Hungary's GDP fell by 13.6% year on year in Q2 and inflation reached 3.8% in July. The [June forecast](#) expects economic growth of 0.3–2.0% this year, 3.8–5.1% in 2021 and 3.5–3.7% in 2022. According to the forecast, inflation will be between 3.2% and 3.3% this year and the next and at 3% in 2022.

The **NBP** kept its interest rate at 0.1% and is buying government bonds and government-guaranteed debt securities. A programme to refinance loans granted to firms is also in place. Polish GDP fell by 7.9% year on year in Q2. The July forecast expects inflation of 3.3% in 2020, 1.5% in 2021 and 2.1% in 2022. According to the forecast, GDP will drop by 5.4% this year and grow by 4.9% and 3.7% in the following two years.

The **CNB** left its key (2W repo) rate at 0.25% in June and August. Its summer forecast expects rates to rise gradually from mid-2021 onwards. Reduced external demand, a marked rise in unemployment and worse overall perceptions of the economic situation among Czech firms and households will have an adverse effect on the economy in the months ahead. According to the CNB's forecast, GDP will drop by around 8% this year. Inflation will stay above the upper boundary of the tolerance band for the rest of this year, owing mainly to high core inflation and growth in food prices. In mid-2021, inflation will decrease towards the 2% target.

II. NEWS OVER THE LAST THREE MONTHS

Fed revises monetary policy strategy and will target average inflation

The head of the US Fed, Jerome H. Powell, announced that the Fed is [moving towards](#) targeting average 2% inflation. After the current period of inflation below 2% ends, the Fed will thus tolerate a period of inflation slightly above 2%. In practice, this means that the Fed could keep its interest rates close to zero for a longer period of time to compensate for the recent systemic undershooting of its inflation target. At the same time, the Fed's approach to employment is changing, focusing on achieving maximum broad and inclusive employment and taking into account its shortfalls from its maximum level rather than its deviations (both positive and negative) from its maximum level as applied so far.

This change in the approach to inflation targeting is a result of the Fed's monetary policy review, which has been under way since the end of 2018 (see the [December 2018](#) and [March 2020](#) issues of CBM; central banks' monetary policy reviews were described in the [March Spotlight](#)). Powell [explained](#) the change in Fed's monetary policy in a speech at the Jackson Hole Central Bankers Symposium (see below and the speech in the final section of this CBM). The FOMC [announced](#) the change in a press release and also published a [new Statement of Long-Term Goals and Monetary Policy Strategy](#). Public reviews of the Fed's monetary policy will now take place at regular intervals roughly every five years.

Fed to ease Volcker rule in October

In October, the Fed will [ease the Volcker rule](#), which restricts investment in speculative assets. At the end of June, it also [published](#) the results of its stress tests, which this time also reflected the possible effects of the coronavirus crisis on the economy and the financial system. The risk that some banks' capital could get close to the minimum capital requirements led the US Federal Reserve to limit the amount of dividends paid by banks and to ban the repurchase of bank shares until the end of the third quarter of this year.

Theme of this year's virtual conference in Jackson Hole: monetary policy vision for the coming years

The annual August meeting of central bankers and academics in Wyoming took place virtually this year due to the coronavirus pandemic. The theme of the symposium was [monetary policy in the decade ahead](#). The keynote address was delivered by the head of the US Fed, Jerome H. Powell, who announced a change in the Fed's monetary policy strategy (see above). Other speeches and remarks were given by, for example, ECB Chief Economist Philip Lane, who [expressed](#) the ECB's willingness to adjust its monetary policy instruments to achieve its inflation target, Governor of the Bank of Canada Tiff Macklem, who [emphasised](#) the importance of concise central bank communication, and Governor of the Bank of England Andrew Bailey, who [reflected](#) on the countercyclical role of central banks' balance sheets.¹

Bulgaria and Croatia join ERM II

In July, Bulgaria and Croatia became part of ERM II, successful participation in which is a condition for adopting the euro. The ECB [announced the central parity](#) of the Bulgarian lev and the Croatian kuna against the euro and the standard fluctuation band of $\pm 15\%$. Euro adoption will be conditional on a successful assessment of the readiness of these countries in the convergence reports of the ECB and the European Commission (see also the current Spotlight). The nearest possible date for the adoption of the euro by Bulgaria and Croatia is thus 1 January 2023.

ECB introduces euro repo facility for non-euro area central banks

The ECB [introduced](#) a new EUREP programme to provide euro liquidity to non-euro area central banks through repo operations. This new facility was introduced as a precaution to address the euro liquidity needs of non-euro area central banks in the context of the coronavirus pandemic. The facility will be operational until June 2021.

¹ The virtual meeting in Jackson Hole was also the subject of a [cnBlog article by CNB Deputy Governor Marek Mora](#) (in Czech), who represented the CNB at this symposium.

III. SPOTLIGHT: THIS YEAR'S CONVERGENCE REPORTS AND THE ENTRY OF BULGARIA AND CROATIA INTO ERM II

In June this year, the European Commission (EC) and the European Central Bank (ECB) published their regular reports assessing the progress made by EU Member States that have not yet adopted the euro in fulfilling the obligations related to their future accession to the single currency. This year's convergence reports were of particular importance for Bulgaria and Croatia, which had earlier expressed their interest in early euro adoption and in July entered ERM II.

With the exception of Denmark, which negotiated a permanent opt-out from the final phase of the Economic and Monetary Union (EMU) in the Maastricht Treaty,² EU Member States are legally bound to join the euro area and adopt the euro in the future. Member States which do not yet fulfil the necessary conditions for euro adoption are referred to as countries with a derogation. However, no binding timetable has been set for these countries (there are currently seven of them: Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania and Sweden), and the timing of their euro area entry (after they meet the entry conditions) is within these countries' competence.

The progress made by the Member States with a derogation in fulfilling their obligations relating to their EMU entry is regularly assessed by the European Commission (EC) and the European Central Bank (ECB) in [convergence reports](#). Pursuant to the Treaty on the Functioning of the European Union (Article 140), the EC and the ECB submit these reports to the EU Council at least once every two years, or at the request of a particular Member State.³ Their task is to assess the compatibility of the legislation of each of these Member States, including the statutes of their national central banks, with the Statute of the European System of Central Banks (ESCB) and of the ECB, and to examine whether the countries concerned have achieved a high degree of sustainable convergence by reference to the fulfilment of the Maastricht convergence criteria of price stability, sustainable public finances, exchange rate stability while participating in ERM II, and convergence of long-term interest rates. The reports must also take account of the results of the integration of markets, the situation and development of the balances of payments on the current account and an examination of the development of unit labour costs and other price indices.

Table 1: Fulfilment of the criteria according to the three latest EC convergence reports

Convergence criteria:	Bulgaria			Czech Republic			Croatia			Hungary			Poland			Romania			Sweden			
	2016	2018	2020	2016	2018	2020	2016	2018	2020	2016	2018	2020	2016	2018	2020	2016	2018	2020	2016	2018	2020	
Compatibility of legislation	x	x	x	x	x	x	✓	✓	✓	x	x	x	x	x	x	x	x	x	x	x	x	x
Price stability	✓	✓	x	✓	x	x	✓	✓	✓	✓	x	x	✓	✓	x	✓	x	x	x	x	✓	✓
Govt. financial position	✓	✓	✓	✓	✓	✓	x	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	x	✓	✓	✓	✓
FX rate stability in ERM II	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x	x
Long-term int. rates	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	x	✓	✓	x	x	✓	✓	✓	✓

The EC and ECB convergence reports are published simultaneously. However, they are separate documents – during the preparation of which the EC and the ECB consult each other (especially on the alignment of reference values) – and their assessments of the individual countries' convergence may differ. The ECB report, which is traditionally more comprehensive, provides a detailed evaluation of developments in the areas relating to the individual criteria; however, only the EC report contains a clear assessment of whether the criteria have been met. A positive assessment opens the way for EU Member States to join the euro area, as it is used – on a proposal from the Commission (and after consultation with the European Parliament and discussion in the European Council) – by the EU Council as the basis for its decision on the fulfilment of the necessary conditions for adopting the euro and the abrogation of the derogation. The Council subsequently fixes the conversion rate at which the euro will be substituted for the currency of the Member State

² The United Kingdom used to have the same permanent opt-out but left the EU on 31 January 2020.

³ The regular convergence reports assess all countries with a derogation (Denmark would be included if it were to express an interest in adopting the euro). Reports prepared at the request of a particular country focus solely on assessing that country. They are produced if the country applies to join the euro area between two regular convergence reports.

concerned, and takes the other measures necessary for the introduction of the euro as the single currency in the Member State concerned.

2020 convergence reports

The latest convergence reports were published in June 2020. None of the countries under examination were participating in ERM II in the period under review, so none of them could meet all the necessary euro adoption criteria.

The COVID-19 pandemic, which has fundamentally disrupted the economy of the EU and of its Member States and could have a significant impact on economic convergence indicators, is captured to only a limited extent in this year's convergence reports, as the data used (up to April/May 2020) and the reference values set on the basis of the data for April 2019–March 2020 largely reflect the pre-pandemic situation. In addition, it is not clear yet how the anti-pandemic measures introduced by the individual countries and their measures to support the economy will affect the statistical data. The forward-looking sections of the convergence reports draw on various relevant forecasts (such as the Commission's spring 2020 forecast) which try to estimate the likely economic effects of the coronavirus crisis. However, such forecasts are surrounded by much higher than usual uncertainty. The ECB expects the next convergence reports to provide a detailed analysis of the economic impacts of the COVID-19 pandemic.

According to the ECB convergence report, the countries under examination have made little progress overall since the 2018 convergence reports were published. Nonetheless, the economic situation in most of them was good until the pandemic broke out and all have made progress towards correcting external and internal imbalances and reducing dependence on external funding. However, significant vulnerabilities of various kinds still persist in the individual countries. Moreover, the deterioration in the economic environment after the pandemic outbreak has caused economic activity to slow down and even contract in all of them. The national authorities have responded with fiscal, macroprudential, supervisory and monetary policy measures.

Compatibility of legislation

The review of the compatibility of national legislation, including the statutes of the national banks of the Member States with a derogation, with EU law (the Treaty on the Functioning of the European Union and the ESCB/ECB Statute) includes an assessment of compliance with the prohibition of monetary financing and the prohibition of privileged access to financial institutions.

According to the EC convergence report, only the legislation in Croatia is fully compatible with EU law. In the other countries, there are incompatible elements and shortcomings in the areas of central bank independence, the prohibition of monetary financing and the integration of the central bank into the ESCB at the time of euro adoption.

The ECB provides a much more detailed assessment of legislative compatibility in its convergence report. As regards independence, it assesses the functional, institutional and financial independence of central banks, and also evaluates confidentiality, the prohibition on monetary financing and on privileged access to financial institutions, the use of a unified name for the euro, and the future integration of the national central banks into the Eurosystem. The ECB is not limited to making a formal evaluation of the letter of national legislation, but also considers whether the implementation of the legislation complies with the spirit of the Treaty on the Functioning of the EU, especially as regards the independence of the national central bank. Unlike the EC, the ECB finds shortcomings in all the countries under examination.

Economic criteria

The criterion on price stability requires a Member State to have a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best performing Member States in terms of price stability.⁴

Five out of the seven countries under examination exceeded the reference value of inflation, which was 1.8% in March 2020.⁵ Only Croatia and Sweden met the criterion. Inflation in these two countries is expected to remain below the reference value in the months ahead. Bulgaria did not fulfil the criterion on price stability (2.6%). However, according to the EC forecast, the Bulgarian inflation rate will approach the reference value in the months ahead. The remaining countries (the Czech Republic, Hungary, Poland and Romania) did not fulfil the criterion. According to the forecasts, their inflation rates will remain well above the reference value in the months ahead.

⁴ For the purposes of this criterion, inflation is measured using the harmonised index of consumer prices (HICP). Previous practice shows that countries with low or negative inflation rates are not automatically excluded as reference countries. Only countries that record significant deviations in inflation from the other EU countries owing to extraordinary or specific factors are excluded.

⁵ The criterion was set using the results of Portugal, Italy and Cyprus, whose respective 12-month inflation averages (for April 2019–March 2020) were 0.2%, 0.4% and 0.4%.

The criterion on the government financial position is defined as sustainability of the government financial position. Specifically, the country under examination must not be subject to an EU Council decision on the existence of an excessive deficit. The requirements for fiscal discipline are not fulfilled if the ratio of the planned or actual government deficit to GDP exceeds 3% and if the ratio of government debt to GDP exceeds 60%. However, a number of other relevant factors are taken into account in the assessment.

Romania has been the subject of a Council decision on the existence of an excessive deficit since April 2020. Its deficit has worsened considerably since 2018, and with unchanged policy (and taking into account the economic and fiscal impact of the coronavirus crisis) it would increasingly exceed the threshold. A deadline of 2022 has been set for Romania to correct the excessive deficit. The other countries were not subject to a Council decision on the existence of an excessive deficit and, according to the EC's assessment, fulfilled the criterion. In 2020, however, the EC expects public finance deficits to increase above 3% due to the coronavirus crisis in all the countries under examination except Bulgaria, where the deficit will probably remain close to the reference value. Nevertheless, the EC stated that it is not necessary at the moment to adopt a decision on the excessive deficit procedure in these countries due to the current situation.

The criterion on the exchange rate is defined as observance of the exchange rate fluctuation margins provided for by ERM II, for at least two years, without devaluing against the euro. None of the countries under examination were participating in ERM II during the preparation of this year's reports, so none of them could fulfil this criterion.

According to the ECB report, the countries under examination had different exchange rate regimes. The Bulgarian lev was fixed to the euro within the framework of a currency board arrangement, while the Croatian kuna and the Romania leu operated under a managed float (with very low volatility in the case of the kuna). The other countries had floating exchange rate regimes.

The criterion on long-term interest rates requires that a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability.

Romania exceeded the reference value of 2.9%,⁶ while the other countries under examination fulfilled the criterion. The average long-term interest rate was slightly negative in Sweden and positive in the other countries. The heterogeneity of long-term interest rates across the countries reflected differences in their cyclical positions and financial markets' assessment of their internal and external vulnerabilities. At the end of the period under review, the central banks of Croatia, Hungary, Poland and Romania announced (and in some cases also launched) government bond purchase programmes in response to increasing financial market pressures linked with the COVID-19 pandemic. The Swedish central bank announced an expansion of its bond purchase scheme.

Table 2: Economic convergence indicators

	Reference value	Bulgaria	Czech Republic	Croatia	Hungary	Poland	Romania	Sweden
Price stability	< 1.8%	2.6%	2.9%	0.9%	3.7%	2.8%	3.7%	1.6%
Govt. financial position								
deficit to GDP	> -3%	2.1%	0.3%	0.4%	-2.0%	-0.7%	-4.3%	0.5%
debt to GDP	< 60%	20.4%	30.8%	73.2%	66.3%	46.0%	35.2%	35.1%
FX rate stability in ERM II	-	-	-	-	-	-	-	-
Long-term int. rates	< 2.9%	0.3%	1.5%	0.9%	2.3%	2.2%	4.4%	-0.1%

Note: The data on inflation and interest rates are for April 2019–March 2020 and the data for the government financial position are for 2019. The green-shaded areas denote fulfilment of the criterion, while the red-shaded areas indicate non-fulfilment.

The convergence reports also assess **other relevant factors**, in particular balance of payments developments and integration of markets. According to the EC, most of the countries under examination had made varying degrees of progress in addressing imbalances in their economies. The EC's in-depth review published in February 2020 concluded that Croatia, Romania and Sweden suffer from macroeconomic imbalances.⁷ The economies of all the countries under examination except Romania are well integrated with the euro area through trade and investment linkages, and the financial sectors of all of them are well integrated into the EU financial sector. Sweden performs better than most of the

⁶ The criterion was set using the results of Portugal, Italy and Cyprus, whose respective average long-term interest rates for April 2019–March 2020 were 0.5%, 1.6% and 0.8%.

⁷ The imbalances are connected with a high level of external debt in Croatia, loss of competitiveness and growth in the current account deficit in the context of expansionary fiscal policy in Romania, and high house prices and growth in household debt in Sweden.

other euro area Member States in the assessment of the business environment. The scores of the Czech Republic and Poland in this assessment are similar to the average of the euro area members, while Bulgaria, Croatia, Hungary and Romania perform worse. The external positions of most of the countries under examination have stabilised in recent years, and the current account recorded a surplus in all of them except Romania, where it switched to a deficit. The net international investment position remains strongly negative in most of the countries, with only Sweden reporting a positive net position. Sweden is also the exception in the assessment of price and cost competitiveness, as it is the only country whose real effective exchange rate has not appreciated in recent years. House prices in Sweden also developed differently and slightly reversed the strong growth recorded in previous years, while in the other countries under examination they continued to increase.

Overall, none of the countries under examination was assessed by the EC in June 2020 as having met the conditions for euro adoption. The best performer was Croatia, which fulfilled all the criteria except the exchange rate one. Sweden met all the economic criteria but displays shortcomings in its legislative compatibility. Bulgaria, the Czech Republic, Hungary and Poland only fulfilled the criteria on the government financial position and long-term interest rates. Romania satisfied none of the criteria and received the worst assessment.

The entry of Bulgaria and Croatia into ERM II

Although the convergence reports do not assess the Member States' ability to enter ERM II, this year's reports were important for Bulgaria and Croatia, which had earlier announced their intention to join the euro area soon and had applied to enter ERM II.⁸

According to the reports, the two countries had committed to implement a number of measures (prior commitments) to ensure a smooth transition to, and participation in, ERM II. As regards Bulgaria, the measures cover six policy areas: banking supervision, macroprudential framework, supervision of the non-banking financial sector, insolvency framework, anti-money laundering framework and governance of state-owned enterprises. Croatia had undertaken to implement measures in the following six areas: banking supervision, macroprudential framework, anti-money laundering framework, statistics, public sector governance and business environment. According to the convergence reports, both countries were working towards the completion of these prior commitments at the time of preparation of the reports, doing so in close liaison with the Commission and the ECB, which are monitoring their progress.

Both Bulgaria and Croatia had also committed to enter the Banking Union, i.e. to join the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), simultaneously with entry into ERM II. Whereas the ECB report mentions the obligation to join the SSM at the latest on the date of euro adoption, the Commission regards SSM entry as a new condition for ERM II entry and speaks of an "enhanced approach" to the accession process, one which should also be applied to all other countries wishing to enter ERM II.⁹

For years now, the Bulgarian and Croatian central banks have been using the exchange rate as the main nominal anchor to achieve their objective of price stability. The Bulgarian lev is fixed to the euro within the framework of a currency board, while the Croatian kuna is traded under a tightly managed float. Both these currencies have therefore been mostly stable against the euro in recent years.

Bulgaria's and Croatia's entry into ERM II was approved by the relevant European authorities in July 2020.¹⁰ The two countries will thus seek to fulfil all the Maastricht convergence criteria in the years ahead.

To fulfil the exchange rate criterion, they must each maintain a fluctuation band of $\pm 15\%$ around the central exchange rate of their currency against the euro,¹¹ without devaluing against the euro.

⁸ Bulgaria and Croatia applied to join ERM II in July 2018 and July 2019 respectively. Developments in these countries were the subject of Spotlight articles in the [March 2018](#) (Bulgaria) and [December 2019](#) (Croatia) issues of CBM.

⁹ The CNB has disagreed with this interpretation from the beginning, as it is of the opinion that entering the banking union before joining the euro area would put the Czech Republic in an unequal position with respect to the euro area countries and is not required by EU law. To avoid a precedent for the Czech Republic's future ERM II entry, the CNB objected to this approach in the EU1 Economic and Financial Committee in September 2019 and expressed reservations about the application of the new ERM II entry conditions to the Czech Republic.

¹⁰ See <<https://www.consilium.europa.eu/en/press/press-releases/2020/07/10/communiqués-by-the-erm-ii-parties-on-bulgaria-and-croatia/>>.

¹¹ Under the agreements on the entry of Bulgaria and Croatia into ERM II, the central exchange rates were set at EUR 1.95583 for the Bulgarian lev and EUR 7.53450 for the Croatian kuna. The currencies stood at these levels at the time of ERM II entry (10 July 2020).

IV. SELECTED SPEECH: Jerome H. Powell: The Fed's Monetary Policy Review

Since the end of 2018, the US Fed has been conducting the first-ever public review of its monetary policy framework. Its motivation, course and outcomes were described by US Fed Chair Jerome H. Powell in his [speech](#) at an August video conference replacing the annual central bankers' conference in Jackson Hole.

According to Powell, the key aim of this review was to use the Fed's new understanding of economic developments to make changes to its monetary policy framework that would best foster its ability to achieve its dual mandate of maximum employment and price stability. The review was motivated by new findings in four key areas of economic development. First, the potential growth rate of the economy has declined in recent years. Some slowing in growth was to be expected, reflecting slowing population growth and the aging of the population. More troubling has been the unexpected decline in productivity growth, which is the primary driver of improving living standards.

Second, the general level of interest rates has fallen both in the USA and around the world. Estimates of the neutral federal funds rate, which is the rate consistent with the economy operating at full strength and with stable inflation, have fallen substantially, in large part reflecting a fall in the equilibrium real interest rate. This rate is not affected by monetary policy but instead is driven by fundamental factors, including demographics and productivity growth – the same factors that drive potential economic growth. Nonetheless, this decline in the neutral rate has profound implications for monetary policy, as the Fed has less scope to support the economy during an economic downturn.

Third, and on a happier note, the record-long expansion that ended this year led to the best labour market seen in some time. For roughly two years, the unemployment rate hovered well below most estimates of its sustainable level, and despite the aging of the population, the participation rate rose. The gains began to be shared more widely across society, particularly at the lower end of the income spectrum. But for the pandemic, these gains would probably have continued.

Fourth, the tight labour market did not trigger a significant rise in inflation. Over the years, forecasts showing a return to 2% inflation were never realised. These forecasts are predicated on estimates of how much upward pressure on inflation arises when the unemployment rate falls relative to its estimated natural rate. As the unemployment rate moved lower and inflation remained muted, estimates of the natural rate of unemployment were revised down. The muted responsiveness of inflation to labour market tightness (referred to as the flattening of the Phillips curve), low longer-term inflation expectations and global disinflationary pressures may have been holding down inflation more than was generally anticipated. The persistent undershoot of inflation from the Fed's 2% longer-run objective is a cause for concern. Although the efforts of central banks for non-zero inflation may seem counterintuitive to many, low and stable inflation is essential for a well-functioning economy. Inflation that is persistently too low can pose serious risks to the economy.

The Fed's review had three pillars. The first was a series of *Fed Listens* events, which yielded a clear message about the importance of a strong labour market. A subsequent research conference brought together some of the world's leading academics to address topics central to the review. Finally, five FOMC meetings were held. The result is a revised *Statement on Longer-Run Goals and Monetary Policy Strategy*. This statement, adopted with the unanimous support of FOMC participants, explains how the FOMC interprets its mandate and describes the framework through which it wishes to achieve its maximum-employment and price-stability goals. In line with its previous statement, the FOMC believes that specifying a numerical goal for employment is unwise, that a longer-run inflation rate of 2% is most consistent with its mandate to promote both maximum employment and price stability, and that monetary policy must be forward looking, taking into account the expectations of households and firms and the lags in monetary policy's effect on the economy.

The key innovations in the new statement reflect the above changes in the economy, particularly the low level of interest rates. The revised strategy emphasises that maximum employment is a broad-based and inclusive goal which primarily benefits low-income groups. The FOMC will thus be informed by its "assessments of the *shortfalls* of employment from its maximum level" rather than by "*deviations* from its maximum level", as in its previous strategy. This change reflects the view that a robust job market can be sustained without causing an outbreak of inflation. Important changes were made to the price-stability side of the mandate. The longer-run goal continues to be an inflation rate of 2%, with an emphasis on anchoring inflation expectations at this level. However, if inflation falls below 2% and never moves back above it, then it will average less than 2%. This means that inflation expectations would fall and pull realised inflation down. The FOMC wants to prevent this in its new strategy by seeking to achieve inflation that averages 2% over time. Therefore, following periods when inflation has been running below 2%, monetary policy will likely aim to achieve inflation moderately above 2%. The FOMC is not tying itself to a particular mathematical formula that defines the average.

At the end of his speech, Powell expressed his belief that conducting a review at regular intervals is a good institutional practice, providing valuable feedback and enhancing transparency and accountability. The Fed thus plans to undertake a thorough public review of its monetary policy strategy, tools and communication practices roughly every five years.

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