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Monetary and Statistics Department
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CZECH NATIONAL BANK

In this issue

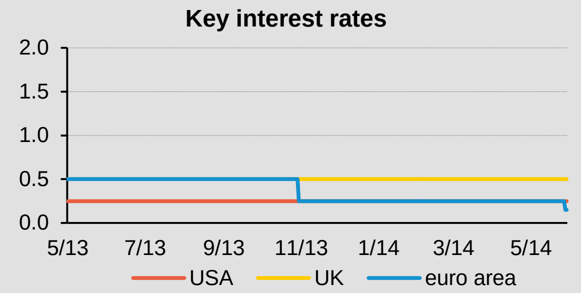
The US Federal Reserve decided to reduce its asset purchases in March and April, but according to the May estimate, US GDP declined by 1% in Q1 (in quarterly annualised terms). In early June, the European Central Bank lowered its monetary policy rates further, even cutting the deposit rate to a negative level, and introduced other measures to ease the monetary conditions and to support lending. The Bank of England left both its interest rate and the size of its asset purchase programme unchanged, but published a strategic plan for the next three years and prepared major organisational changes focusing on joint decision-making in the areas of monetary and financial stability. The Hungarian central bank is continuing with its series of policy interest rate cuts, albeit at a lower pace than before. The central bank rate in Hungary is currently slightly lower than that in Poland, while inflation is well below the target in both countries. By contrast, the central bank in New Zealand, where the economy is growing and inflation pressures are gradually gaining in strength, started to tighten its monetary policy. The current Spotlight *focuses on the Baltic economies and their relationship to the euro, and especially on Lithuania, which is planning to join the euro area at the start of 2015. Our* Selected Speech *is by Bank of England Deputy Governor Charlie Bean, who reflects on the exit from unconventional monetary policy instruments.*

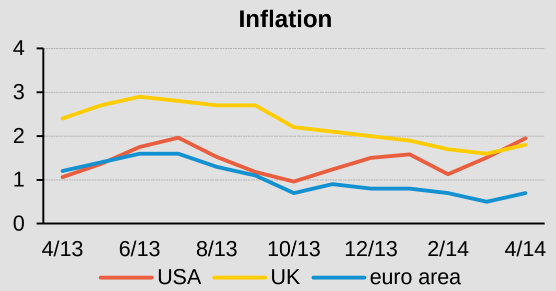
1. LATEST MONETARY POLICY DEVELOPMENTS AT SELECTED CENTRAL BANKS

Key central banks of the Euro-Atlantic area

	Euro area (ECB)	USA (Fed)	United Kingdom (BoE)
Inflation target	< 2%[1]	< 2%[2]	2%
MP meetings (rate changes)	3 Apr (0.00) 8 May (0.00) 5 Jun (-0.10)	18–19 Mar (0.00) 29–30 Apr (0.00)	9–10 Apr (0.00) 7–8 May (0.00) 4–5 Jun (0.00)
Current basic rate	0.15%	0–0.25%	0.50%
Latest inflation	0.5% (May 2014)[3]	2.0% (Apr 2014)	1.8% (Apr 2014)
Expected MP meetings	3 Jul 7 Aug 4 Sep	17–18 Jun 29–30 Jul	9–10 Jul 6–7 Aug 3–4 Sep
Other expected events	4 Sep: publication of forecast	16 Jul: Beige Book	13 Aug: publication of Inflation Report
Expected rate movements[4]	→	→	→

[1] ECB definition of price stability; [2] January 2012 definition of inflation target; [3] flash estimate; [4] direction of expected change in rates in coming quarter taken from Consensus Forecast survey.





The **ECB** decided on a combination of measures to provide additional monetary policy accommodation and to support lending to the real economy. The ECB lowered its monetary policy rates, even cutting the deposit rate to -0.10%. It introduced new longer-term refinancing operations, extended fixed rate lending with full allotment and decided to intensify preparatory work related to outright purchases in the ABS market (for more details see *News*). The inflation forecast fell further. The ECB foresees inflation of 0.7% in 2014, 1.1% in 2015 and 1.4% in 2014. It expects GDP to increase by 1.0% this year.

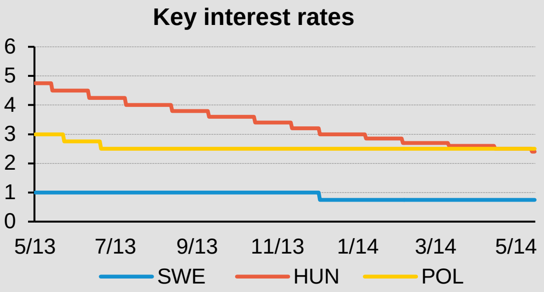
With the unemployment rate continuing to fall and even dropping below 6.5%, the **Fed** updated its forward guidance. It had previously announced that an unemployment rate above this level was a condition for maintaining low rates. In April the Fed announced that it expected the very low interest rates to be maintained for a considerable time after the asset purchase programme ends, especially if inflation remains below the 2% goal, and provided that inflation expectations remain well anchored. Purchases by the Fed continued to decline – the monthly amount fell from USD 65 billion to USD 55 billion in April and USD 45 billion in May. The Fed foresees a further gradual reduction in the pace of asset purchases, but noted at the same time that this reduction was not on a preset course and would remain contingent on current outlooks and assessments. GDP increased by 2.6% in 2013 Q4 (quarterly annualised change) but declined by 1% in 2014 Q1, mainly because of a negative contribution of investment in inventories.

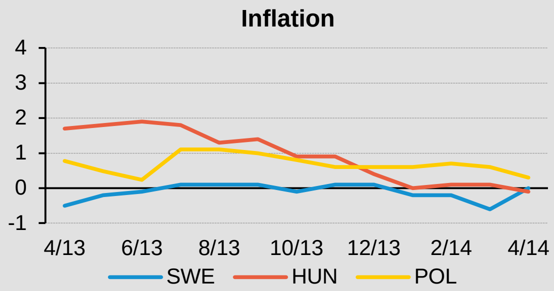
The **BoE** left its key interest rate at 0.50% and also maintained the size of its asset purchase programme. Inflation was 1.8% in April, close to the BoE's target. Economic activity continues to recover in the UK. GDP growth was 3.1% year on year and 0.8% quarter on quarter in 2014 Q1. Unemployment fell by 0.4 pp compared to 2013 Q4, to 6.8%.

Selected central banks of inflation-targeting EU countries

	Sweden (Riksbank)	Hungary (MNB)	Poland (NBP)
Inflation target	2%	3%	2.5%
MP meetings (rate changes)	9 Apr (0.0)	25 Mar (-0.10) 29 Apr (-0.10) 27 May (-0.10)	8–9 Apr (0.0) 6–7 May (0.0) 2-3 Jun (0.0)
Current basic rate	0.75%	2.4%	2.50%
Latest inflation	0.0% (Apr 2014)	-0.1% (Apr 2014)	0.3% (Apr 2014)
Expected MP meetings	2 Jul	24 Jun 22 Jul 26 Aug	1–2 Jul 19 Aug 2–3 Sep
Other expected events	3 Jul: publication of Monetary Policy Report	24 Jun: publication of Quarterly Report on Inflation	1/2 Jul: publication of Inflation Report
Expected rate movements[1]	→	↓	→

[1] Direction of expected change in rates in coming quarter taken from Consensus Forecast survey.





The **Riksbank** left its monetary policy interest rate at 0.75%. According to the Riksbank, the repo rate will remain at this low level for around a year. The Riksbank considers it appropriate to wait until inflation picks up before beginning to raise the repo rate. Domestic economic activity is clearly strengthening, but inflation will remain low until the year-end. Compared to February the inflation forecast has been revised downwards, primarily for the coming months. Price increases have been low relative to companies' costs. However, as economic activity strengthens, companies are expected to raise their prices to a greater extent.

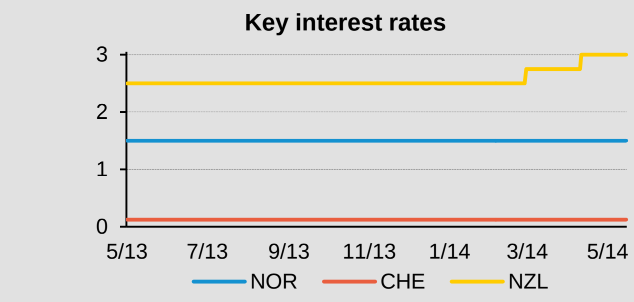
The **MNB** lowered its monetary policy rate by 0.10 pp rate three times in the last quarter, i.e. by a total of 0.30 pp to the current level of 2.4%. Inflation in April was negative for the first time, at -0.1% year on year. Although unemployment is falling in Hungary, it still exceeds the level implied by structural factors. The MNB expects the negative output gap to close gradually at the policy horizon. However, achieving and maintaining price stability in the medium term points in the direction of monetary easing. The MNB thus still expects the key interest rate to decline gradually.

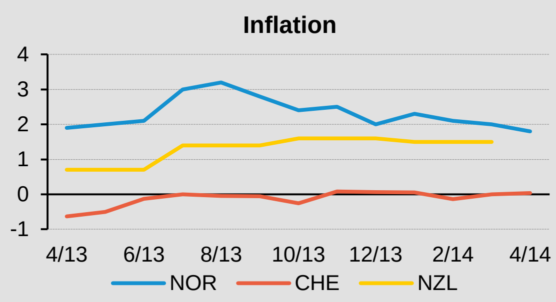
The **NBP** left its monetary policy rate unchanged at 2.50%. Inflation fell to 0.3% in April, thus diverging even more markedly from the 2.5% inflation target. NBP Governor Marek Belka noted that inflation was low due mainly to import prices and that it could turn negative in the summer months. Although the NBP expects the current rate level to be maintained until the end of 2014 Q3, Belka does not rule out a further reduction. On the other hand, the Polish economy is developing favourably. GDP growth rose to 3.4% in Q4, driven by faster investment growth and a slight acceleration in consumer demand. The unemployment rate declined but remains fairly high and is restricting wage growth.

Other selected inflation-targeting countries

	Norway (NB)	Switzerland (SNB)	New Zealand (RBNZ)
Inflation target	2.5%	0–2%	2%
MP meetings (rate changes)	27 Mar (0.00) 8 May (0.00)	20 Mar (0.00)	13 Mar (+0.25) 24 Apr (+0.25)
Current basic rate	1.50%	0–0.25%[1]	3.00%
Latest inflation	1.8% (Apr 2014)	0.0% (Apr 2014)	1.5% (2014 Q1)
Expected MP meetings	19 Jun 18 Sep	19 Jun	12 Jun 24 Jul
Other expected events	19 Jun: publication of Monetary Policy Report	25 Jun: publication of Monetary Policy Report	12 Jun: publication of Monetary Policy Statement
Expected rate movements[2]	→	→	↑

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





Norges Bank left its key interest rate unchanged at 1.50%. The Norwegian economy grew by almost 2% year on year in 2014 Q1 and economic growth should pick up further to 3% according to the NB's forecast. Inflation has fallen over the last three months and was below the NB's target in April. Bank lending and deposit rates have gone down somewhat and the survey of bank lending reported slightly higher household credit demand. House price inflation has picked up in recent months.

The **SNB** left rates in the lower part of the 0–0.25% target range and is sticking to its commitment to enforce a minimum exchange rate of CHF 1.20 to the euro. In its statement, it confirmed that it stands ready to enforce the minimum exchange rate, if necessary, by buying foreign currency in unlimited quantities, and to take further measures as required. The inflation forecast was adjusted downwards once again. According to the new SNB forecast, inflation will be zero in 2014, 0.4% in 2014 and 1.0% in 2016. The SNB expects GDP growth of 2% for 2014 as a whole. The SNB continues to monitor the risks of imbalances on the mortgage and property markets. As of the end of June it will increase the countercyclical capital buffer required of banks.

The **RBNZ** increased its key interest rate by 0.25 pp in both March and April, i.e. by a total of 0.50 pp, to the current level of 3%. The increase in interest rates is due mainly to an expected strengthening of inflationary pressures, especially in construction and other non-tradable sectors. Prices of export commodities are also high. GDP recorded a year-on-year increase of 3.1% in 2013 Q4, due mainly to exports. Economic growth in 2014 Q1 is estimated at 3.5%. Property price inflation has moderated in recent months, partly because of the RBNZ's restrictions on the loan-to-value ratio, and gradually rising interest rates will have a further moderating influence.

2. NEWS

ECB announces new measures to provide additional monetary policy accommodation

At the beginning of June, the European Central Bank decided on several measures to provide further monetary policy accommodation and to support lending to the real economy.

The ECB lowered the interest rate on the main refinancing operations by 10 bp to 0.15%, the rate on the marginal lending facility by 35 bp to 0.40% and the rate on the deposit facility by 10 bp to -0.10%. Apart from the deposit facility, the negative deposit rate will also apply to average reserve holdings in excess of the minimum reserve requirements and other deposits held with the Eurosystem.

To enhance the functioning of the monetary policy transmission mechanism, the ECB aims to support lending in the real economy and will also intensify preparatory work related to outright purchases of asset-backed securities (ABS). To support lending to the non-financial private sector, the ECB will conduct a series of targeted longer-term refinancing operations (TLTROs). The first operations will be conducted in September and December and the counterparties will be entitled to an initial borrowing allowance equal to 7% of the total amount of their loans to the non-financial private sector, excluding loans to households for house purchase. During the period from March 2015 to June 2016, additional TLTROs will be conducted quarterly and the additional amounts will depend on the counterparty’s new net lending to the private sector. All TLTROs will mature in September 2018 and the interest rate will be fixed over the life of each operation at the rate on the main refinancing operations, plus a fixed spread of 10 bp.

As regards the features of the main refinancing operations, the ECB will continue conducting them as fixed rate tender procedures with full allotment at least until December 2016. The three-month longer-term refinancing operations (LTROs) will be allotted in the same way. The Eurosystem’s special-term refinancing operations with a maturity of one maintenance period will be discontinued and the weekly fine-tuning operation sterilising the liquidity injected under the Securities Markets Programme will be suspended.

BoE launches Strategic Plan

The Bank of England published a strategic plan to transform the institution over the next three years, with the focus placed on its two core functions – monetary and financial stability – unified in a new mission: promoting the good of the people of the United Kingdom. The plan to transform the BoE into “One Bank”, or a “central bank for the 21st century”, outlines fifteen core initiatives emphasising joint policy decision-making across different areas of the Bank, greater openness and transparency, opening up the research agenda and key policy questions to external contributors (e.g. universities), opening data sets to the public, and building public understanding.

The BoE’s fifteen core initiatives			
One Mission, One Bank			
(1) Open, transparent and agile culture (2) Forefront of joint policy decision-making (connectivity across MPC, FPC and PRA)			
Diverse and Talented	***Analytic Excellence***	***Outstanding Execution***	***Open and Accountable***
(3) One Bank, your reward (to support internal mobility) (4) Rewarding excellence and teamwork (5) Compelling talent strategy	(6) One Bank research agenda (7) New approach to data and analysis (8) One Bank data architecture	(9) One credible voice in international policy (10) Delivering supervision as One Bank (11) Execution in core markets (12) A safer Bank	(13) Enhanced central bank transparency (14) Accountable (15) Engaged and approachable

As of 1 June, a number of changes will be made to the organisation structure to align it better with the Bank’s mission. A new deputy governor-level position for markets and banking will be created (in the current organisation structure there are deputy governors for three areas: prudential regulation, monetary policy and financial stability). Spencer Dale, currently Director of Monetary Analysis and Chief Economist, will head a new Financial Stability Strategy and Risk Directorate. Andy Haldane, to date responsible for financial stability, will take the position of Chief Economist and his role will be expanded to build research, analysis and data capability. The current Director for Markets, Paul Fisher, will become Executive Director for Specialist Supervision and Regulatory Operations in the Prudential Regulatory Authority. Among other changes, new directorates will be created to bring together relevant policy divisions.

MNB celebrates 90th anniversary by adopting statute…

To commemorate the 90th anniversary of its foundation, the MNB published a Statute formulating its mission, vision and fundamental values in different areas of activity. The Statute identifies independence and responsibility as the two main pillars.

…and aims to reduce country's foreign currency debt

Magyar Nemzeti Bank would like to see a reduction in foreign currency-denominated debt in the economy. This would reduce the risk of negative effects of exchange rate volatility and may also reduce the country's risk premium. The MNB is focusing on government debt and stands ready to provide the necessary amount of foreign currency from foreign exchange reserves if the state in turn increases the size of forint-denominated debt issues. The Hungarian banking system is supposed to contribute materially to the achievement of the self-financing concept, as the MNB sees scope for banks to hold more HUF government securities in their balance sheets (banks currently represent nearly one-fifth of government financing). The MNB expects Hungarian bonds to replace central bank two-week bills in banks' portfolios. The MNB will encourage the shift by introducing the following monetary policy instruments:

(1) a forint **interest rate swap facility** to mitigate the interest rate risk of long-term foreign-denominated assets;

(2) a floating-rate **long-term collateralised forint loan facility** to improve access to forint liquidity;

(3) an **asset swap facility** to enable the MNB's counterparties to obtain foreign currency-denominated securities in exchange for long-term forint-denominated securities, which will improve access to foreign exchange liquidity;

(4) as from August, the MNB's main policy instrument will change: the two-week MNB bill will be replaced by a **two-week deposit facility**.

New data on Swedish household debt

Swedish households' debts are a big issue for the Riksbank and are deterring the Swedish central bank from easing monetary policy even though inflation has been fluctuating around zero for a year and a half now. Although Swedish central bankers realise the risks of inflation deviating from the target for a prolonged period of time, their decision-making suggests that they are not worried about deflation (as confirmed by a speech given in May by Deputy Governor Martin Flodén, who nevertheless voted for a repo rate cut). A prominent opponent of this attitude is Lars Svensson, who left the central bank last year. His continued criticism sparked further discussion of this issue.

A new data set has been collected from the eight largest Swedish banks. It covers about 80% of household loans from financial institutions and 94% of all mortgages. The new figures provide a detailed picture of households' loans with respect to income, geographical area and age group and over time, although data on wealth and the value of housing is unavailable. The Riksbank's primary concern is households' reaction in the event of a crisis – they may drastically reduce their consumption and this could affect profitability of companies and the whole macroeconomy. An additional problem is that mortgage lending forms an important part of Swedish banks' assets, which makes the financial system sensitive to risks linked with households' indebtedness.

- 52% of Sweden's total adult population is indebted (almost four million individuals)
- 95% of the total amount of household debt consisted of mortgages
- the average indebted individual has three loans, is 50 years of age, and has a debt ratio of 296%
- four out of ten borrowers are not reducing their debts and those who are reducing them are doing so very slowly
- if the borrowers who reduce their debts continue to reduce these debts at the same rate, on average they will be free of debt in about 100 years

The Riksbank finds the conclusions worrying and recommends therefore new measures to reduce risks in the financial system, among others the countercyclical capital buffer set at 2.5%.

Valuation loss means SNB will not pay dividends this year

The Swiss National Bank will not pay any dividends this year. The Confederation and the cantons are also left without their usual part of the profit. This is due to a large loss for the financial year 2013 (CHF 9.1 billion), primarily because of valuation losses on gold holdings (CHF 15.2 billion), which could not be offset by other earnings (profit on foreign currency positions amounted to CHF 3.1 billion and the net result from the sale of the stabilisation fund was CHF 3.4 billion).

EC and ECB publish convergence reports

The European Commission and the ECB published their regular assessments of the fulfilment of the Maastricht convergence criteria. The convergence reports concern the eight non-euro Member States without a permanent opt-out (i.e. excluding the UK and Denmark). Croatia was under review for the first time, as it joined the EU last year. The reports, which usually come out once every two years, have the standard format. As regards the price stability criterion, the inflation rates of Greece (12-month average HICP inflation in the reference period of -1.2%), Bulgaria (-0.8%) and Cyprus (-0.4%) were excluded from the calculation of the reference value. This year's convergence reports are especially significant for Lithuania, which is the last Baltic economy with its own currency and plans to introduce the euro in January 2015. The Baltic states and their path towards the euro are discussed in *Spotlight*.

	Bulgaria	Czech Rep.	Croatia	Lithuania	Hungary	Poland	Romania	Sweden
price stability criterion: 1.7%	-0.8%	0.9%	1.1%	0.6%	1.0%	0.6%	2.1%	0.3%
public debt criterion: 60% of GDP	18.9%	46.0%	67.1%	39.4%	79.2%	57.0%	38.4%	40.6%
public budget criterion: -3% of GDP	-1.5%	-1.5%	-4.9%	-2.1%	-2.2%	-4.3%	-2.3%	-1.1%
interest rate criterion: 6.2%	3.5%	2.2%	4.8%	3.6%	5.8%	4.2%	5.3%	2.2%
exchange rate criterion: ERM II	no	no	no	yes	no	no	no	no

Stanley Fischer appointed new member of Fed Board

The former governor of the Bank of Israel Stanley Fischer became a member of the Board of Governors of the Federal Reserve System (and thus a member of the FOMC) in May, after the Senate approved his nomination by President Obama. Fischer is simultaneously nominated as Vice Chair of the Board.

3. SPOTLIGHT: THE BALTIC STATES AND THE EURO DURING THE ECONOMIC CRISIS

Following the collapse of the Soviet Union, the Baltic states regained their independence and soon started working towards joining Western organisations. After experiencing a boom at the start of the millennium, they were hit hard by the global economic crisis, with Latvia particularly badly affected. Despite this, they decided to keep their fixed exchange rate regimes and opted for severe austerity measures. Following a double-digit plunge in economic activity, they made a surprisingly rapid recovery and eliminated their massive current account deficits. However, the Baltic states still face many structural problems, most notably persisting high unemployment. At the height of the euro area crisis, when the suitability of the single currency was being questioned in many other countries, Estonia, Latvia and Lithuania remained eager to adopt the euro. Estonia joined the euro area in 2011 and Latvia followed suit this year. Lithuania, which was first rejected eight years ago, was re-assessed this year along with the other non-euro Member States in the regular convergence reports of the European Commission and the ECB. It is expected to adopt the euro next January.

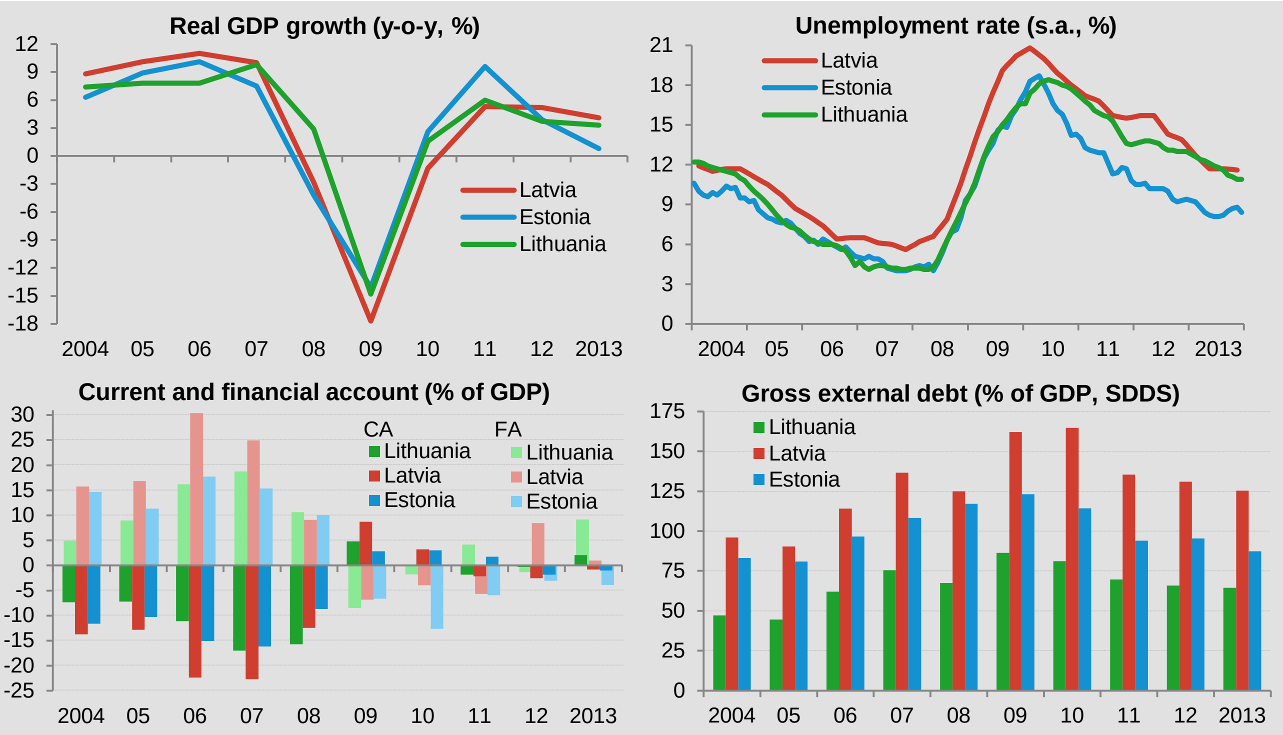
Estonia, Latvia and Lithuania regained their independence at the start of the 1990s and for geopolitical reasons soon started working towards joining the Euro-Atlantic organisations. At the beginning of the transformation process, the rouble was replaced by national currencies, which were intended as a nominal anchor and therefore had fixed exchange rates from the outset: the Estonian kroon was pegged to the German mark, the Lithuanian litas to the US dollar and the Latvian lats to a basket of currencies defined by the IMF currency unit (SDR). The push to join Western organisations culminated in 2004, when all three countries became members of NATO and the EU. All three currencies were gradually pegged to the euro.

The three small Baltic states, which have a total population of just 6.3 million, account for only 1% of the EU population. In addition, they face a persistent and significant population decline due to emigration and low birth rates. The population has shrunk by 11% in Latvia and almost 13% in Lithuania since 2004. The decline in Estonia, which is the smallest of these countries (population 1.3 million), has been less pronounced. These countries have very open economies influenced mainly by conditions abroad and less so by domestic economic policy.

The Baltic economies started booming at the beginning of the millennium. The boom further intensified after they joined the EU. Massive capital inflows caused extremely rapid growth in lending, domestic demand soared and wide current account deficits opened up (almost 23% of GDP in Latvia). Foreign debt also surged as a result. Inflation increased sharply and property prices doubled in just a few years. Marked real appreciation of all three currencies coupled with lacklustre productivity growth eroded the Baltic states' competitiveness.

Having accumulated large imbalances, the Baltic economies were hit hard by the global financial and economic crisis. Capital inflows halted abruptly. On the other hand, their current accounts recorded a swift correction owing to a drop in domestic demand. Lithuania and Latvia had problems with government financing as yields on their bonds jumped upwards. By contrast, the Estonian government was free of debt when the crisis started. Consequently, at a time when other countries were being forced to adopt austerity measures, Estonia had room to stimulate its economy using fiscal policy. Property prices slumped throughout the Baltic region. In 2009 GDP fell by more than 14% in all three economies. Unemployment continued to soar despite mass emigration. Roughly 20% of the population found themselves out of work.

Latvia was hit hardest, as its situation was exacerbated by problems in banks. There was a run on the country's second-largest bank and the financial system faced a shortage of liquidity. Concerns about the sustainability of the fixed exchange rate and speculation that it would be abandoned started to appear. Latvia's rating was downgraded in October and interbank market interest rates doubled. There was a need to stabilise the financial sector and restore confidence in banks, increase the international reserves and stop the outflow of capital. Latvia eventually received financial assistance from the IMF, the EU and several other countries.



During the crisis, all three Baltic economies decided to maintain their fixed exchange rates at any cost, refusing the option of nominal depreciation of their currencies, which would have helped to dampen the economic shock. Instead, they adopted strong austerity measures in many areas, cutting pensions and public employees' salaries and reining in spending on education and health care. Between the end of 2008 and the start of 2010, wages in the public sector in Latvia fell by 27%, while private sector wages went down by 6%. The austerity measures met with an unusual level of public understanding and were not accompanied by large-scale protests or strikes. Voters in Estonia and Latvia even re-elected their austerity governments, although Lithuanian voters expressed their dissatisfaction with this policy in 2012.

Economic activity recovered surprisingly quickly in all three economies, driven mainly by exports. Latvia repaid its rescue package in September 2012 even though the final repayment had originally been scheduled for 2015. Despite the rapid economic recovery, however, GDP is still well below the pre-crisis trend. The unemployment rate is falling sharply but remains very high. Very limited lending is also a persisting problem.

Estonia
1/1/2011

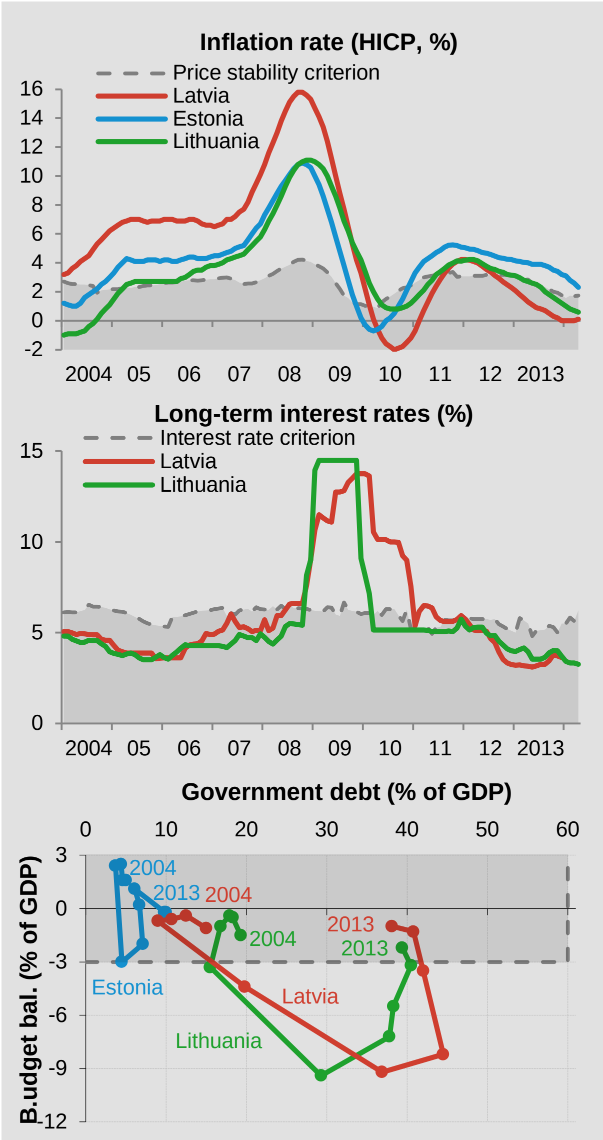
Latvia
1/1/2014

Lithuania
1/1/2015?

Euro area accession

The continuing eagerness to adopt the euro shown by the Baltic states at the height of the euro area crisis was unusual by comparison with other countries. The reasons, however, are understandable. The fixed exchange rate meant that they would experience no major economic policy change on euro area accession yet they would be able to participate in the negotiations on the euro area's monetary policy settings. On switching to the euro, moreover, the risk of a speculative attack and forced devaluation of the domestic currency, which would have been very painful for many economic agents expecting a fixed exchange rate (especially with regard to their foreign currency debt), would disappear for good.

Fulfilment of the Maastricht economic and legislative criteria, which is regularly evaluated in the convergence reports of the European Commission and the ECB, is a precondition for euro area entry. The government debt ratios of the three economies are well below the limit of 60% of GDP. During the crisis, Latvia and Lithuania significantly exceeded the 3% limit for the government deficit to GDP ratio. Long-term interest rates were also affected, but both countries returned to values within the stipulated limits. Estonia is unique in this regard, as its debt only edged up to 10% of GDP (the interest rate criterion cannot be calculated for this country, as it has no long-term government bond market owing to the government's very low debt level). Given the fixed exchange rate, no problems were encountered with regard to the exchange rate criterion for most of the period under review, although the Latvian lats did come under strong pressure during the crisis.



However, the price stability criterion was an issue for the Baltic states. As their economies are small and very open, they are strongly exposed to foreign influences and economic shocks. In the long term, these countries are converging to the more advanced part of the EU in terms of economic performance and, as a result, price level. Given their fixed exchange rates, this generally led to higher inflation rates compared to the EU average, causing real equilibrium appreciation of the Baltic currencies. Without their own monetary policies the national central banks were largely powerless to influence inflation. The Baltic states therefore fulfilled the price stability criterion for only a very short time, paradoxically aided by the economic crisis. In Latvia the fulfilment of this criterion was also due to slower growth in administered prices and a decrease in VAT.

Lithuania, which attempted to become the first Baltic state to join the euro area back in 2006, was refused on account of non-fulfilment of the price stability criterion, as its inflation rate of 2.7% was slightly above the reference value and the assessing institutions expected it to accelerate further in the future. However, Lithuania has a very realistic chance of joining this year, as the convergence reports have favourably assessed its fulfilment of the entry criteria. Although its accession to the euro area will have to be approved by European representatives, preparations in the last Baltic country with an independent currency are already in full flow.

Sources of data and figures: Eurostat (GDP, unemployment, Maastricht criteria), IMF IFS (balance of payments, external debt), ECB and Lietuvos Bankas (figures).

4. SELECTED SPEECH: THE FUTURE OF MONETARY POLICY

During a visit to the London School of Economics, Charlie Bean, Deputy Governor of the BoE delivered a speech reflecting on some of the innovations in monetary policy that took place as a result of the crisis and considering the timing and impacts of the exit from unconventional monetary policy.

In his speech, Charlie Bean addresses the question of forward guidance. Although the central bank can implement an optimal path for rates that boosts demand today by holding rates "lower for longer", this policy might be time inconsistent. When the future comes, current commitments may no longer seem appropriate. From this perspective, such time-inconsistent strategies can be credibly implemented only over rather short horizons.

Bean also makes interesting remarks about the effectiveness of unconventional policies and considers the future exit from the current monetary policy regime. After interest rates reached their effective lower bound, quantitative easing took place in the UK in two rounds. Under this programme, the BoE acquired £375 billion of longer-term UK government debt – equivalent to around 25% of annual GDP – comprising £200 billion purchased between March 2009 and February 2010 and another £175 billion acquired between October 2011 and November 2012. Such purchases led to lower long-term rates and added extra liquidity to the banking system, which helped boost credit supply. These purchases may have reinforced market perceptions that policy would remain loose for an extended period. Analysis by the BoE suggests that the first phase of asset purchases lowered long rates by around 1 pp; other studies find a similar impact from the Federal Reserve's asset purchases. The impact of the second round is harder to isolate, as the purchases were carried out in the phase when financial markets were less dysfunctional and when rates were affected by other market factors.

Since the evidence suggests that asset purchases lower longer-term rates and stimulate demand, they should not be set as a permanent part of the central bank's armoury. It has been shown that the central bank has less of a handle on their impact when markets are functioning normally. Besides, if the central bank routinely deals in large quantities of government debt, the fear of monetisation of debt may rise in line with the risk of loss of independence of the fiscal authorities.

Bean argues that when the era of unconventional policy does come to an end, rates are likely to rise only gradually and to a level that is likely to remain below its pre-crisis average. The large stock of asset purchases will need to be unwound. An issue is the timing and speed of the exit strategy. In principle, the BoE could just let the gilts mature. However, this would take a long time, as the average maturity of the portfolio is more than 12 years. So, active sales seem more appropriate. Such sales will put upward pressure on yields, though by much less than the purchases pushed down on yields. A change in the preferences of commercial banks, which are now demanding more high-quality liquid assets, should also attenuate the upward pressure on yields. Nevertheless, it is evident that sales of gilts will increase the volatility of market rates. We have already seen the sensitivity of markets to changes in the expected path of US monetary policy during the "taper tantrum" last spring and its attendant consequences for other countries – especially the emerging economies. Movements in yield curves have been strongly correlated across countries, not only at the long end, but also at the short end of the curve, where domestic monetary policy considerations ought to dominate.

Even though Bean is aware of the risks associated with the speed and timing of the exit, he is optimistic about the situation, mainly due to the better functioning financial system. However, he concedes that the impacts on emerging markets might be less favourable.

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