CENTRAL BANK MONITORING – DECEMBER

2018

Monetary Department
Monetary Policy and Fiscal Analyses Division

CZECH NATIONAL BANK

IN THIS ISSUE

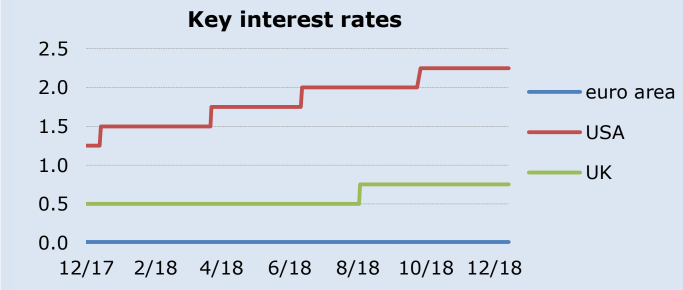
Inflation is currently above the inflation targets in most of the economies we monitor, and economic growth continues to show solid rates. The labour markets of most countries remain fairly tight, as reflected in rapid wage growth rates. With the exception of the Fed, central banks' policy rates are below 2%, still giving their economies a monetary policy stimulus and also opening up significant space for monetary policy normalisation. Only the Federal Reserve, the Bank of Canada and the Norges Bank raised rates. Roughly half of the central banks monitored (the Fed, the Riksbank, the Norges Bank, the Bank of Canada and the MNB) can be expected to increase their key rates in the coming months. The ECB ended its asset purchases but will continue to reinvest the principal payments from maturing securities. Spotlight *focuses on Islamic finance. In our* Selected speech*, ECB President Mario Draghi emphasises the importance of central bank independence.*

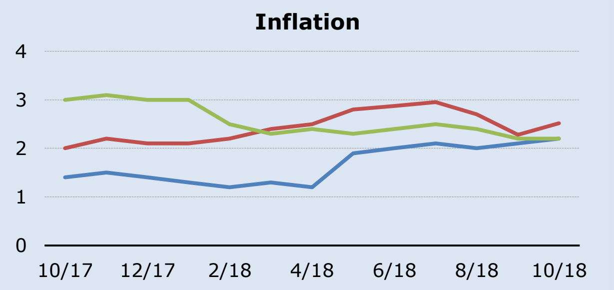
1. LATEST MONETARY POLICY DEVELOPMENTS AT SELECTED CENTRAL BANKS

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)	25 Oct (0.00) 13 Dec (0.00)	25–26 Sep[5] (+0.25) 7–8 Nov (0.00)	1 Nov (0.00)
Current basic rate	0.00%; -0.40%[3]	2.00–2.25%	0.75%
Latest inflation	2.0% (Nov 2018)[4]	2.5% (Oct 2018)	2.4% (Oct 2018)
Expected MP meetings	24 Jan 7 Mar	18–19 Dec[5] 30–31 Jan	20 Dec 7 Feb
Other expected events	7 Mar: publication of Eurosystem staff projections	Feb 2019: publication of Monetary Policy Report	7 Feb: publication of Monetary Policy Summary
Expected rate movements[6]	→	↑	→

[1] ECB definition of price stability "below but close to 2%"; [2] January 2012 definition of inflation target; [3] deposit rate; [4] flash estimate; [5] meeting associated with summary of FOMC economic forecasts; [6] direction of expected change in rates in next three months taken from Consensus Forecasts.





The **ECB** kept its policy rates unchanged and expects them to remain at their present levels until at least the end of summer 2019. In line with its previous rhetoric, the ECB announced that it would stop its net asset purchases at the end of this year. However, it will continue to reinvest the principal payments from maturing securities purchased under the asset purchase programme for an extended period of time past the date when it starts raising the key ECB interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation. The GDP growth outlook was reduced slightly in December compared with the September forecast. The ECB expects GDP to grow by 1.9% this year, 1.7% in 2019 and 2020 and 1.5% in 2021. The latest estimate for inflation in November is 2.0%. ECB staff projections foresee inflation at 1.8% in 2018, 1.6% in 2019, and slightly under 2% in next two years.

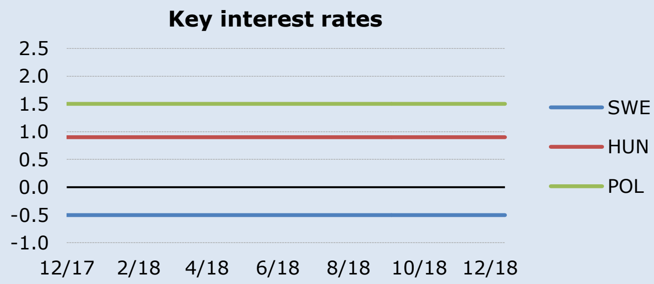
The **Fed** raised its base rate by 0.25 pp to 2.00%–2.25% in September. The rate was left unchanged at the November meeting. According to the FOMC macroeconomic projections, the key rate can be expected to increase by a further 0.25 pp in December 2018 (12 of the 16 FOMC members). A further three rate increases can be expected in 2019. The FOMC expects stronger GDP growth this year and the next than forecasted in June, i.e. 3.1% versus 2.8% in 2018 and 2.5% versus 2.4% in 2019. According to the Fed, the equilibrium interest rate level is around 3% in the long run (up slightly from 2.88%). The unemployment rate outlook for the next three years is below 4%.

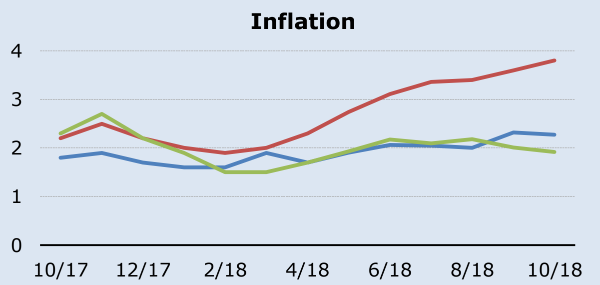
The **BoE** kept its key interest rate unchanged (at 0.75%) in November, so the stock of government and corporate bond purchases remained unchanged at GBP 435 billion and GBP 10 billion respectively. According to the bank, aggregate supply and demand are broadly in balance. The BoE expects GDP to grow by 1.75% per year on average over the coming three years, assuming a gradually rising path of interest rates. The labour market remains tight and the unemployment rate is its lowest since the mid-1970s. Inflation is projected to remain above the target for most of the three-year forecast period and to drop to the target at the end of the third year.

Selected central banks of inflation-targeting EU countries

	Sweden (Riksbank)	Hungary (MNB)	Poland (NBP)
Inflation target	2%[3]	3%	2.5%
MP meetings (rate changes)	23 Oct (0.00)	18 Sep (0.00) 16 Oct (0.00) 20 Nov (0.00)	2–3 Oct (0.00) 6–7 Nov (0.00) 4–5 Dec (0.00)
Current basic rate	-0.50%; -1.25%[2]	0.9%; -0.15%[2]	1.50%
Latest inflation	2.4% (Oct 2018)	3.8% (Oct 2018)	1.2%[4] (Nov 2018)
Expected MP meetings	19 Dec 12 Feb	18 Dec 29 Jan 26 Feb	8–9 Jan 5–6 Feb 5–6 Mar
Other expected events	13 Feb: publication of Monetary Policy Report	17 Dec: publication of Inflation Report	11 Mar: publication of Inflation Report
Expected rate movements[1]	↑	↑	→

[1] Direction of expected change in rates in next three months taken from Consensus Forecast survey; [2] deposit rate; [3] CPIF – consumer price index including fixed interest rate; [4] preliminary estimate.





The **Riksbank** left its policy rate at -0.5% but expects it to be raised by 0.25 pp either in December this year or in February 2019. Two Executive Board members voted for a rate increase of 0.25 pp in October. The Riksbank is continuing to reinvest principal payments and coupon payments in the market. Inflation rose to 2.4%, due mainly to rapidly rising energy prices. In its October forecast, the Riksbank kept its CPIF inflation outlook at 2.2% for 2018, 2.1% for 2019 and 1.9% for 2020. It lowered its GDP growth forecast for this year from 2.9% to 2.3% and expects growth of 1.9% for next year and 2.0% for 2020. It expects unemployment of between 6.3% and 6.5% over the next three years.

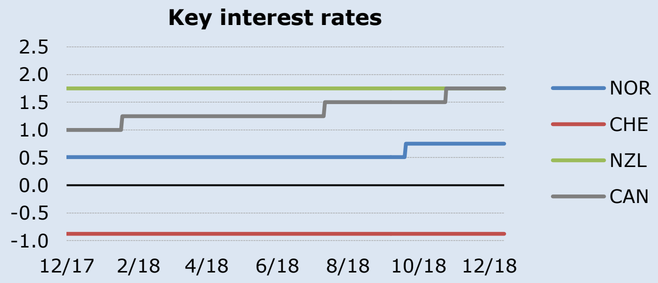
The **MNB** maintained its base rate at 0.9% and its deposit rate at -0.15%. It expects inflation to increase over the medium term due to growth in domestic demand and wages. Inflation rose to 3.8% and core inflation to 2.6%, due mainly to a sharp rise in components such as fuel and food prices. The Hungarian economy grew by 4.8% in the third quarter and is expected to maintain this pace this year. GDP growth will stand at 4.4% in 2018 as a whole and then slow from 2019. Rapid growth in corporate loans continues. The MNB will phase out the three-month deposit facility by the end of the year and required reserves will become the main monetary policy instrument. The MNB will launch the Funding for Growth Scheme Fix at the beginning of 2019 and will sterilise excess liquidity using a preferential deposit facility bearing interest at the base rate (see here for details). The MNB also ended mortgage bond purchases in the secondary market and will also end purchases in the primary market by the end of 2018.

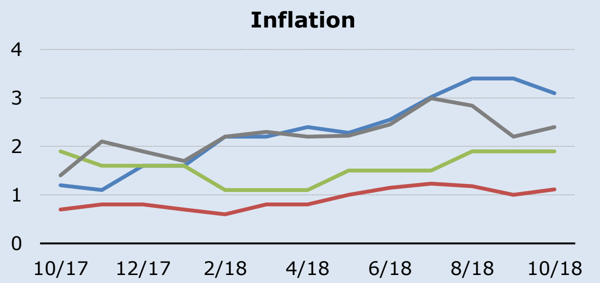
The **NBP** left its interest rate unchanged at 1.5% over the past three months. GDP growth (5.1% in Q3) is being driven mainly by strong consumer demand, fuelled by increasing employment and wages. Despite this, consumer inflation remains moderate. According to the November forecast, the NBP expects GDP growth of 4.8% this year, 3.6% in 2019 and 3.4% in 2020. Assuming a constant 3M WIBOR at 1.7%, the NBP expects inflation of 1.8% in 2018, rising to 3.2% in 2019 and falling to 2.9% in 2020.

Other selected inflation-targeting countries

	Norway (NB)	Switzerland (SNB)	New Zealand (RBNZ)	Canada (BoC)
Inflation target	2%[5]	0-2%	2%	2%
MP meetings (rate changes)	20 Sep (0.25) 25 Oct (0.00) 13 Dec (0.00)	20 Sep (0.00) 13 Dec (0.00)	27 Sep (0.00) 8 Nov (0.00)	24 Oct (+0.25) 5 Dec (0.00)
Current basic rate	0.75% -0.25%[1]	from -1.25% to -0.25%[2]; -0.75%[3]	1.75%	1.75%
Latest inflation	3.5% (Nov 2018)	0.9%[6] (Nov 2018)	1.9% (2018 Q3)	2.4% (Oct 2018)
Expected MP meetings	24 Jan 21 Mar 9 May	21 Mar	13 Feb	9 Jan 6 Mar
Other expected events	21 Mar: publication of Monetary Policy Report	19 Dec: publication of Quarterly Bulletin	13 Feb: publication of Monetary Policy Statement	9 Jan: publication of Monetary Policy Report
Expected rate movements[4]	↑	→	→	↑

[1] Only on reserves exceeding quota ("reserve rate"); [2] chart displays centre of band; [3] negative deposit rate on banks' account balances held at SNB, graded according to balance amounts; [4] direction of expected change in rates in next three months taken from Consensus Forecasts or, in the case of New Zealand, from RBNZ survey; [5] inflation target lowered from 2.5%; [6] preliminary estimate.





As expected, the **NB** increased its policy rate by 0.25 pp to 0.75% in September. It also raised the rate on reserves in excess of banks' individual quotas by 0.25 pp to -0.25%. The rates were left unchanged at the October and December meetings. The NB expects the policy rate to rise gradually to 2% at the end of 2021, with the first interest rate increase of 0.25 pp to 1.00% planned for March 2019. The Norwegian economy will expand by 2.4% in 2018 and 2.3% in 2019. The positive output gap is forecasted to widen until the start of 2020, before gradually narrowing. Inflation is projected to approach the 2% inflation target from below. On 12 December, the NB advised the Norwegian Ministry of Finance to increase the countercyclical capital buffer to 2.5%, effective from 31 December 2019; the buffer will thus attain its highest possible level.

The **SNB** is maintaining the target range for its monetary policy rate (3M LIBOR) in negative territory (at between -1.25% and -0.25%). The rate on banks' account balances with the SNB also remains at -0.75%. The SNB continues to reserve the right to intervene in the foreign exchange market as necessary. It anticipates slightly lower GDP growth of 2.5% for 2018 than in the previous forecast, slowing to 1.5% in 2019. The bank left its inflation forecast for 2018 at 0.9% and revised down its forecast for 2019 from 0.8% to 0.5% and that for 2020 from 1.2% to 1.0%.

The **RBNZ** left its official rate at 1.75% and expects to keep it at this level into 2020. Inflation was 1.9% in 2018 Q3 and will rise above the inflation target in the medium term as capacity pressures build. Employment is around its maximum sustainable level. A further rise in employment will depend on firms' willingness to hire workers at higher wages, which would push up inflation. Economic growth was 2.5% in 2018 Q2. According to the RBNZ forecast, the economy will expand at a rate of around 3% next year.

The **BoC** raised its key rate by a further 0.25 pp to 1.75% in October. Canada's economy is operating close to its potential, and inflation, at 2.4% in October, is above target. GDP growth will be about 2% in the second half of this year and 2.1% in 2019, before slowing to 1.9% in 2020. The BoC expects inflation to return to the target during 2019 after temporary inflationary factors, such as increases in fuel prices and minimum wages, fade out.

2. NEWS OVER THE LAST THREE MONTHS

Federal Reserve to review its monetary policy in 2019…

The Federal Reserve announced that next year it will review the strategies, tools and communication practices it uses to pursue its mandate. Beginning around the middle of 2019, Fed policymakers will discuss the perspectives offered during its outreach events with a broad range of interested stakeholders. On 4–5 June 2019, the Fed will organise a research conference at the Federal Reserve Bank of Chicago, with speakers and panellists from outside the Federal Reserve System. As part of the changes in communication, Fed Chairman Jerome Powell had already announced that from January 2019 the Fed will hold a press conference after every FOMC meeting.

…and considers changing its key interest rate

At their November meeting, the FOMC members discussed the possibility of choosing alternative interest rates in a situation of abundant excess reserves. The Fed's current key interest rate is the federal funds rate (FFR). The rates discussed included in particular the overnight bank funding rate (OBFR), calculated using federal funds transactions and certain Eurodollar transactions. Participants will continue their discussion at upcoming meetings.

Slovak central bank governor resigns

NBS Governor Jozef Makúch announced his resignation with effect from 1 March 2019. He will therefore not conclude his second six-year mandate. He has served as governor since 2010. Current Slovak Minister of Finance Peter Kažimír, who has confirmed his interest in the position, is expected to succeed him.

BoC publishes staff economic projections for first time

The Bank of Canada launched a database with more than 30 years of past staff economic projections of the Canadian economy. These projections serve as a starting point for quarterly Monetary Policy Report forecasts and interest rate decisions. The series are published with a five-year lag, with annual updates to follow.

Amir Yaron appointed Bank of Israel governor

Professor Amir Yaron from the Wharton School of the University of Pennsylvania was appointed to head the Bank of Israel (BoI) from 12 November. As governor he will succeed Karnit Flug, whose five-year term has ended. In honour of the outgoing governor, the BoI organised a farewell conference.

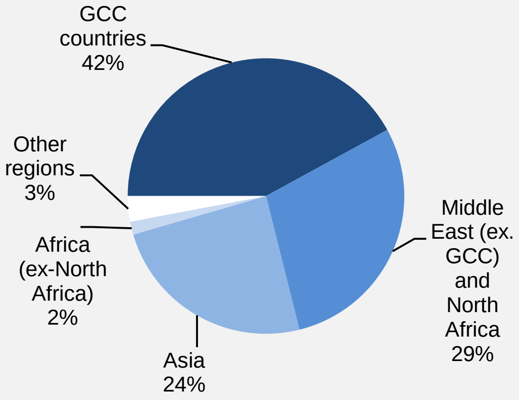
3. SPOTLIGHT: ISLAMIC BANKING

The system of Islamic financial institutions operating in conformity with Islamic law – Islamic finance for short – is currently only a small share of global finance, but it continues to grow in size and significance. Western central banks and other international institutions are therefore beginning to track the status and condition of this until recently marginal part of the financial sector and are trying to avert any problems arising from its specific nature. This edition of Spotlight *briefly presents the issue of the Islamic financial sector and mentions the most acute problems Islamic finance needs to address.*

The size and structure of the Islamic financial sector

Islamic finance is a small but continuously expanding part of the global financial system. At just over USD 2 trillion, it currently accounts for less than 2% of global financial assets. Islamic financial products are offered in more than 60 countries, while Islamic banks are classed as systemically important in 12 countries.[1]

Breakdown of Islamic finance by region (2017)



Source: IFSB

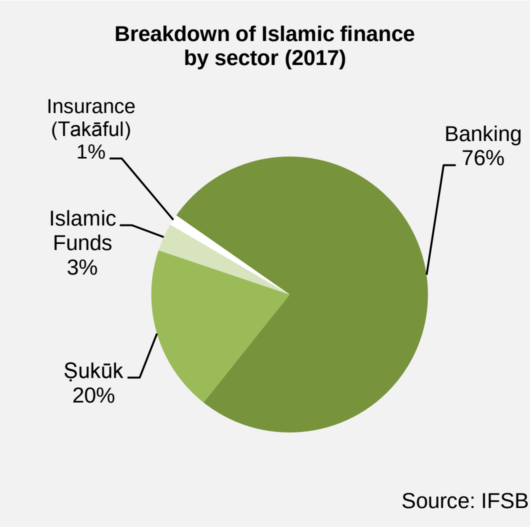
Islamic finance is concentrated mainly in countries of the Middle East and Southeast Asia. Of the total volume, the GCC[2] countries account for more than 40%, the Middle East and North Africa region for almost 30%, Asia for about 25% and other regions for the rest; Europe makes up around 1% of total Islamic finance at present.[3] The largest Islamic financial markets are Iran and Saudi Arabia. Most large global financial centres, among them London, Luxembourg, Singapore and Hong Kong, also allow trading in Islamic products.

The most important international organisation of Islamic financial institutions is the Islamic Financial Services Board (IFSB) headquartered in Malaysia, whose members comprise 78 regulatory and supervisory authorities and over 100 international and national organisations from almost 60 jurisdictions. The main objective of the IFSB is to issue global standards and guiding principles for Islamic financial institutions. The IFSB also conducts research and coordinates initiatives on Islamic finance-related issues, as well as organising seminars and conferences for regulators and other industry stakeholders. In addition, it publishes reports on the condition and stability of Islamic finance every year.

The IMF and the World Bank are also paying attention to Islamic finance. The IMF has published a paper on the financial stability of Islamic banks as a whole and has prepared case studies of some countries.[4] In 2019, it will also start to monitor the condition of Islamic banks and issue recommendations on improving regulation in reports on the financial sectors of selected countries (especially those where Islamic banks are systemically important – see above). In these recommendations, the IMF will apply the IFSB's guiding principles, among other things. The IMF is already trying to push for greater consistency in the application of rules in the Islamic financial sector and warns that some Shari'ah-compliant products are so complex as to be able to slow economic growth and lead to financial instability.

[1] The criterion of systemic importance of the Islamic banking sector, namely a situation where it exceeds 15% of the assets of the domestic banking sector – is currently met in 12 countries: Iran, Sudan, Brunei, Saudi Arabia, Kuwait, Qatar, Malaysia, the United Arab Emirates, Bangladesh, Djibouti and Jordan. Bahrain is just below the 15% threshold; Yemen has been excluded from this group in the past year due to a lack of credible data. Islamic banking accounts for 100% of the banking sectors in Iran and Sudan.
[2] The GCC (Gulf Cooperation Council, the Cooperation Council for the Arab States of the Gulf) consists of Bahrain, Qatar, Kuwait, Oman, Saudi Arabia and the United Arab Emirates.
[3] Islamic banks, or Islamic "windows" of conventional banks, operate mainly in Turkey and the UK. The latter is the main centre and pioneer of Islamic finance in the Western world and in 2014 became the first non-Muslim country to issue government sukuk. The Bank of England joined the international Islamic Financial Services Board (IFSB) in 2015. Spain and Poland are also showing an interest in Islamic finance.
[4] Ensuring Financial Stability in Countries with Islamic Banking (IMF, February 2017) and the follow-up Multi-Country Report: Ensuring Financial Stability in Countries with Islamic Banking (IMF, June 2017).

Islamic finance has been growing again in recent years after several years of sluggish growth caused mainly by low oil prices and the poor condition of some Islamic countries' economies. It increased in size by 7% year on year in 2016 and 8.3% in 2017. All components of Islamic finance (the banking sector, the insurance sector and particularly capital markets) contributed to the growth in 2017.



However, the banking sector remains the biggest component of Islamic finance, accounting for more than three-quarters of the total. Insurance (takaful) accounts for a little over 1% and the rest (about 23%) is made up of Islamic capital markets (trading mainly in Islamic bonds – sukuk[5] and also capital and commodity funds and money market funds). Special Islamic stock indices started to be created for capital markets in the late 1990s. The first Dow Jones Islamic Market index (DJIM World) and the first FTSE Shariah Global index were launched in 1999, and the S&P Shariah indices were introduced in subsequent years.

The specific nature of Islamic finance

The Islamic economic and financial system is specific in combining the conventional financial system with the principles of Islamic law and ethics. The basic principles include a prohibition of giving and taking interest, a prohibition of engaging in speculative behaviour and gambling in general, and a prohibition of financing activities that Islam considers harmful to society (investing in alcohol and tobacco producers, pork processing, gambling and the arms and pornographic industries, for example, is therefore not permitted). Transactions should also be oriented to the real economy and the parties should share the profit or loss.

Given the ban on using interest, Islamic financial companies must structure their financial products differently than conventional financial firms to be able to somehow generate a profit and motivate clients to deposit cash. This mostly involves the use of an underlying asset. A profit may thus be made on trading in assets (such as commodities) or leasing or selling assets (such as property, manufacturing firms and equipment) on a hire-purchase basis, for example (see Box 1 for details). This results in wider activity structures (and different balance sheet structures) than in traditional banks, as Islamic banks are involved as partners in property investments and commodity trades, for example, besides the usual acquisition of deposits and provision of funds to investors.

The first modern Islamic banks were established in Egypt and Malaysia in the 1960s. Commercial Islamic banking began to develop on a large scale in the 1970s as capital flowed into oil-exporting countries during the oil crisis. In recent decades, Islamic finance has also become attractive to traditional Western-style financial institutions, which have started to offer Islamic financial products on the international

Box 1: The most common instruments used in Islamic finance

Murabahah – a deferred payment purchase where the bank, instead of providing a loan to purchase a product, buys the product itself and lets the client use it. However, the bank owns the product until its purchase price and a profit margin is paid.

Mudarabah – a silent partnership where one party (the bank) invests capital in a project and the other party supplies know-how and the project manager. The two parties split the profit at a ratio agreed in advance.

Musharakah – a partnership where two or more parties invest funds in a project and share the profit or loss on the investment proportionately (in relation to the capital invested).

Istisna – a contract to deliver a turn-key project. It is used mostly in construction. The bank finances a development project and hands the property over to the client on completion. The client then pays the bank the price of the investment plus a fee under terms agreed in advance.

Qard Hasan – an interest-free loan, most often for charitable purposes or to clients in financial distress. The bank usually provides the loan against collateral and in some cases charges fees to cover the costs of the loan.

[5] Sukuk are the Islamic equivalent of bonds. They are tradable certificates granting ownership of part of an underlying asset and bearing profit. The economic and risk profiles of individual sukuk differ depending on the underlying assets, so some behave as bonds while others resemble shares, but never with voting rights.

Islamic financial market and, to a lesser extent, on Western markets.

Like the conventional financial system before it, Islamic finance is gradually being penetrated by modern financial technology in the form of, for example, partnerships with electronic payment transaction providers and virtual Islamic branches of conventional commercial banks. However, mobile banking still has a lower take-up than in conventional banking (38% among conventional banking customers versus 26% among Islamic banking customers in the GCC countries according to an EY survey).[6]

Insufficient standardisation

A specific feature of Islamic financial institutions is that they are supervised by a board of experts (a Shari'ah Supervisory Board, SSB), which assesses the acceptability of transactions from the perspective of Islamic law. These boards are not governed by globally harmonised standards yet, and few external experts on Islamic law assess transactions internationally. The need for standardisation generally, and more external experts specifically, was laid bare by the scandal at the United Arab Emirates-based company Dana Gas, which in 2017 announced that its obligations (sukuk totalling USD 700 million) had been declared no longer Shari'ah-compliant by a UAE board of experts and that their redemption was therefore unenforceable. Investors are defending themselves in court in the UK, under whose legislation the sukuk were issued. Moreover, the interpretation of Islamic law can differ in countries where Islamic finance is not governed by law and where there is no centralised board (until 2016, only 12 countries had centralised boards of experts).

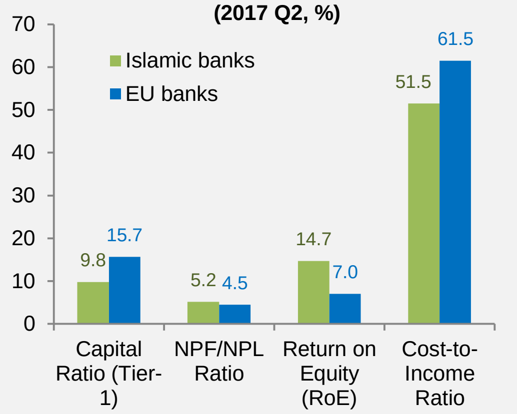
Another weak link of Islamic financial institutions is their low level of transparency and governance in general. Just 55% of these institutions publish financial reports and most are insufficiently transparent.

The institutions seeking global harmonisation of standards across Islamic financial institutions include the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), which sets accounting standards for Islamic products, and the above-mentioned IFSB, which seeks to integrate global standards for insurance companies, banks and securities trading.

Financial condition and capital requirements

As regards the resilience of the Islamic banking sector as a whole, most indicators of the soundness of Islamic banks meet the minimum international regulatory requirements. The global Islamic banking industry in fact fared better than traditional banks during the global financial crisis, because the ban on speculative transactions meant it was not exposed to risky trades. At present, it is no longer outperforming conventional banking in all aspects of stability. Nevertheless, Islamic banks are in increasingly better shape than European banks in terms of return on equity and efficiency ratios. The capitalisation of Islamic banks, though, is weaker than that of EU banks, and their non-performing loans ratio (or rather non-performing financing ratio, NPF) is also higher. Islamic banks are also increasingly exposed to exchange rate volatility in many countries. It should be noted, however that these average indicators of Islamic banks as a whole are a result of very different developments in different markets.

Selected financial soundness indicators for Islamic and European banks (2017 Q2, %)



Source: IFSB, EBA

Like other commercial banks, Islamic banks are subject to liquidity management rules, including the Basel III rules. These rules require banks to hold a certain amount of high quality liquid assets (HQLA). Islamic banks usually hold this HQLA reserve in the form of high-quality tradable sukuk, whose volume on the market, however, is limited. The biggest challenge for Islamic banks as regards compliance with the capital rules is therefore a shortage of well-structured and easily transferable Shari'ah-compliant

[6] World Islamic Banking Competitiveness Report 2016 (EY, 2015).

instruments bearing sufficient returns. In addition, a lack of other suitable assets means that banks often hold sukuk to maturity, resulting in limited liquidity on the secondary market.[7]

Long-term sukuk are (like conventional bonds) issued by governments or corporations. Demand for government sukuk always exceeds supply several times over. Issuance of sukuk by GCC countries, which their governments are using to cover budget deficits caused by low oil prices, has increased in recent years. In addition, nine central banks of mostly Islamic countries in 2010 founded the International Islamic Liquidity Management Corporation (IILMC) to increase the supply of sukuk. The IILMC issues short-term dollar sukuk with maturities of up to one year, which have obtained a high rating from Standard & Poor's and which most regulatory authorities in the IILMC countries consider to be high quality capital for liquidity management purposes. The volume of sukuk issued by the IILMC has been gradually increasing – from USD 490 million in August 2013 to USD 3 billion at the end of 2017.

Another way of complying with the liquidity regulations besides holding sukuk is to use central bank facilities, for instance by depositing reserves on a central bank's account. However, central bank facilities are remunerated and so are inaccessible to Islamic banks.

To maintain Islamic banks' financial soundness and help them comply with liquidity requirements, central banks have therefore started to create specific Shari'ah-compliant products allowing Islamic banks to draw liquidity from central banks if needed. Several countries (Turkey, Indonesia and Pakistan, for example) allow the use of sukuk in open market operations ("Islamic repos"). The Bank of England (BoE) started to consider establishing a deposit facility suitable for Islamic banks back in 2015. Based on a survey of the instruments of nine central banks and subsequent consultation steps, it chose a "wakala fund"[8] as the most suitable instrument. A BoE subsidiary called the Bank of England Alternative Liquidity Facility (BEALF) will be established this year to house the fund.[9]

Conclusion

The growing significance of Islamic finance in the financial sector – both globally and specifically in some countries – is creating an increasing need for single rules and processes. The financial soundness and stability of Islamic banks is of interest not only to their domestic jurisdictions, but also to the Western countries in which Islamic products are offered and to international institutions. It can be expected that, as Islamic financial products become more widely known and widely used, the pressure to align standards across the entire global banking sector will grow further and the responsibility and transparency of Islamic financial institutions will also increase.

[7] However, the Basel III rules take the limited flexibility of Islamic banks into account, allowing them to use a broader range of assets; see paragraph 68 of the BCBS document https://www.bis.org/publ/bcbs238.pdf.
[8] The wakala model will entail the central bank establishing a wakala fund constituted of suitable sukuk, also using cash if necessary, to achieve a rate of return close to the expected profit rate (EPR). The EPR may be the same as, or within a corridor of, the interest rate for conventional commercial banks (or may be entirely different). One example of the use of the wakala model is the situation where an Islamic bank deposits liquidity at a central bank, which then invests it in a wakala fund. The central bank returns the principal and any profit to the Islamic bank on maturity.
[9] https://www.bankofengland.co.uk/-/media/boe/files/markets/funding-for-lending/the-establishment-of-the-boe-alternative-liquidity-facility-bealf

4. SELECTED SPEECH: CENTRAL BANK INDEPENDENCE

In a speech given at the Belgian National Bank in Brussels, the President of the European Central Bank (ECB) Mario Draghi emphasised the importance of central bank independence, which enabled banks to fulfil their price stability mandates in the difficult times of the recent financial crisis.

In the 1970s, central banks had to regain credibility as institutions capable of delivering price stability. At that time, policymakers believed that an increase in the money supply could boost aggregate demand and stimulate employment, while keeping inflation expectations anchored. This policy turned out to be time-inconsistent and led to growth in inflation expectations and inflation. The way out was to delegate monetary policy to independent central banks with a price stability mandate. This rested on three elements: central banks needed a clear mandate to achieve price stability; they needed independence over the instruments they could use; and monetary policy had to be embedded in a strong accountability framework. This guaranteed that independent central banks would not exercise power arbitrarily. Their discretion was limited to *how* they formulated monetary policy. They had no discretion over *whether* to pursue their goals and *what* goal they had to achieve. The ECB's mandate was established on this basis.

At the turn of the millennium, the monetary policy framework went unquestioned. But the financial crisis led to a steep drop in output and inflation, presenting central banks with new challenges to their objectives (deflationary threats) and their instruments (the need for unconventional measures). The new environment of low inflation and unconventional policies has led some observers to query whether the circumstances that justified central bank independence still exist and whether the grounds for delegating monetary policy to independent authorities remain valid.

The first claim is that time inconsistency has become less relevant, as the inflationary pressures have largely disappeared in advanced economies and the social consensus behind price stability is now so well established that elected authorities would not compromise it in the pursuit of other objectives. Mr Draghi disagrees, arguing that the absence of inflationary pressures is well-explained by two factors, neither of which justify a change to the policy framework: the stability of the monetary regime (anchored inflation expectations and reduced inflation volatility) and the depth of the crisis, which created unusually high unemployment and made inflation less responsive as the labour market recovered. Independent central banks, he says, remain the best institutions to anchor inflation expectations. He also disagrees that elected authorities will no longer compromise price stability. The crisis showed that time inconsistency remains a risk. When inflation is rising, political authorities prioritise growth over monetary tightening. And when it is falling, there are incentives to prioritise financial sector concerns over monetary easing.

The second claim – concerning the relationship between monetary and fiscal policy – is that, once central banks buy large volumes of government bonds, they cross the boundary into fiscal policy, thus exceeding their mandates. Such reasoning, says Mr Draghi, ignores key aspects of the institutional framework, which gives central banks independence over their tools, but not their goals. During the crisis, central banks followed this principle to the letter. They would have failed their mandates without instrument independence. The shift was only in form, not function. The ECJ ruled that OMTs are legal and a legitimate tool of monetary policy. This is not to say that monetary policy could not benefit from greater alignment with fiscal policy. However, such policy alignment has to be based on full independence.

The third claim is that the distributional effects of unconventional policies are much larger than those of conventional policies. Mr Draghi notes that the delegation of monetary policy to an independent body rests on the premise that such effects are not first order. Empirical evidence suggests the effects on the distribution of both conventional and unconventional policies are in any case limited. Unconventional measures have barely affected wealth inequality. Asset purchases have at the same time triggered both a sizeable reduction in unemployment and wage increases. The lowest-income households have benefited in particular. The distributional effects of the ECB not defending its mandate would have been severe.

The arguments against central bank independence miss a more fundamental point – the value of an independent central bank that can act decisively. The independent ECB was able to create the required policy space in an extremely difficult context. Coordinated policy responses among governments were difficult to achieve and often turned out to be insufficient. To be credible and fulfil their mandates, central banks therefore need to remain independent.

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