

Monetary and Statistics Department
Monetary Policy and Strategy Division

The latest measures taken by the leading central banks (the European Central Bank and the Fed) came as no surprise. The same cannot be said for the other central banks, most of which (except the RBNZ) took an easier stance than predicted by the market. Rates were reduced in Hungary in response to a faster-than-expected fall in inflation. A similar cut in Slovakia was motivated by appreciation of the Slovak koruna. In Spotlight we look at Slovakia and specifically at the NBS's Monetary Programme until 2008, in which the NBS explicitly adopts inflation targeting.

1. Developments since the last issue of Monitoring (December 2004) and expected future information

	Inflation target ¹	Latest inflation	Current basic rate	MP meeting date/rate change/ expectation ²	Next MP meeting/ expectation ³	Other expected events
Euro area (European Central Bank, ECB)	<2.0%	2.0% (Feb 2005) ⁴	2.00%	13 Jan/0.00 3 Feb/0.00 3 Mar/0.00 →	7 Apr 4 May 2 Jun →	2 Jun: new interim forecast to be published
Sweden (Sveriges Riksbank)	2.0%	0.0% (Jan 2005)	2.00%	27 Jan/0.00 ↗	14 Mar 28 Apr →	15 Mar: publication of IR ⁵
United Kingdom (Bank of England, BoE)	2.0%	1.6% (Jun 2005)	4.75%	12–13 Jan/0.00 9–10 Feb/0.00 9–10 Mar/0.00 ↗	6–7 Apr 4–5 May 8–9 Jun →	11 May: publication of IR, including new forecast
Hungary (Magyar Nemzeti Bank, MNB)	4.0%	4.1% (Jan 2005)	8.25%	20 Dec/-0.50 24 Jan/-0.50 21 Feb/-0.75 ↘	29 Mar 25 Apr 23 May ↘	23 May: publication of IR, including new forecast
Poland (National Bank of Poland, NBP)	2.5%	4.0% ⁴ (Jan 2005)	6.50%	21–22 Dec/0.00 25–26 Jan/0.00 24–25 Feb/0.00 ↗	29–30 Mar 26–27 Apr 24–25 May →	
Slovakia (National Bank of Slovakia, NBS)	3.5%	3.1% (Jan 2005)	3.00%	21 Dec/0.00 28 Jan/0.00 25 Feb/-1.00 →	24 Mar ⁶ 29 Apr ⁶ 24 May ⁶ ↘	Monetary survey issued on given MP meeting dates
USA (Federal Reserve System, Fed)	n/a	3.0% (Jan 2005)	2.50%	14 Dec/+0.25 1–2 Feb/+0.25 ↗	22 Mar 3 May ↗	
New Zealand (Reserve Bank of New Zealand, RBNZ)	2.0%	2.7% (4Q2004)	6.75%	27 Jan/0.00 10 Mar/+0.25 →	28 Apr 9 Jun →	9 Jun: new interim forecast to be published

¹ inflation target valid for the current period; in the cases of Hungary and Slovakia the year-end target

² the direction of the expected change in rates in the past quarter is taken from the Consensus Forecasts survey (or, in the case of New Zealand, from the RBNZ's own survey)

³ provisional meeting dates. The direction of the expected change in rates in the coming quarter is taken from the Consensus Forecasts survey (or, in the case of New Zealand, from the RBNZ's own survey)

⁴ preliminary estimate

⁵ Inflation Report

⁶ The NBS Bank Board decides on rates once a week; the given dates correspond to the discussion of the Situation Report on Monetary Development

2. News

[ECB assesses euro area financial stability ...](#)

In December, the ECB published its first ever Financial Stability Review, prepared by the Banking Supervision Committee (BSC). The Review brings together for the first time the financial stability reports drawn up at the level of euro area member states (currently 7 out of the 12 member states). The Review states that financial stability improved last year, but also points out several potential threats to stability, for example the high price of oil, imbalances in the US economy, high property prices and the related high level of debt of European households, and the efforts of financial institutions to invest in high-yield assets even at the cost of higher risk.

[... and launches live press conference webcasting](#)

Starting on 3 March 2005, the ECB's press conference following the Governing Council's meeting will be webcast live on the ECB's website. A TV signal will also be available with a slight delay. The press conference is simultaneously interpreted into three languages: English, French and German.

[Riksbank to start publishing forecast based on market rates ...](#)

In a speech given in February, Riksbank Governor Lars Heikensten outlined changes which are expected to appear as early as the March Inflation Report. The main change is a switch to publishing forecasts based on predicted market interest rates (the Riksbank previously assumed constant interest rates). Heikensten says that the main advantages of the change include better material underpinning the bank's decisions, the opportunity to discuss future rates and more transparent decision-making. The change will also allow the bank to produce a longer-term forecast.

[... and sells off its gold](#)

The Riksbank also announced in February that it had sold 15 tonnes of gold under the renewed Central Bank Gold Agreement (CBGA), between 15 European central banks, which came into force in September 2004. The agreement allows it to sell up to 60 tonnes of gold over a five-year period. The gold holdings at the Riksbank currently amount to approximately 170 tonnes.

[BoE publishes equations for its new model ...](#)

Since 2003 the BoE has been using the Bank of England Quarterly Model (BEQM) to produce its macroeconomic projections. Last summer the BoE published the core attributes of the model, and this January it also disclosed the individual equations of the model complete with parameterisation. The BEQM is based on assumptions of agents' behaviour at the microeconomic level, i.e. it implicitly contains a production and consumption function. It contains, among other things, equations disaggregating GDP and describing the labour market, property market and government performance. The model's outputs are used by the Monetary Policy Committee, but the published projection is also based on the MPC members' expert judgment and on the technical assumption of constant rates.

[... and reforms its money market operations](#)

The BoE in February introduced the first of a series of planned changes to its money market operations aimed at making monetary policy implementation more flexible, efficient and transparent. With effect from 11 March the overnight repo rate will be the basic repo rate plus 25 b.p. and the rate on the overnight deposit facility will be the basic repo rate minus 25 b.p. The reverse repo rate is now also indexed to the basic repo rate.

[Magyar Nemzeti Bank Council has new members ...](#)

At the start of February, Prime Minister Ferenc Gyurcsány appointed four new Monetary Council members. They are: Judit Neményi, former Director of Research at the MNB, Tamás Bánfi and Csaba Csáki from Corvinus University, and Péter Bihari, former Chief Economist at Budapest Bank. Gyurcsány notified MNB Governor Zsigmond Járαι of these names just one hour before they were made public, prompting the MNB to issue a press release expressing disagreement with the one-step expansion of the number of Council members and with some of the nominees. The nominations have still to be formally approved by President Ferenc Mádl.

[... and starts to publish minutes of its meetings](#)

The MNB began publishing minutes of the Council's meetings as from December. The minutes are published prior to the next Council meeting and are divided into two sections. The first discusses economic and financial developments based on analyses submitted by staff of the bank. The second contains an evaluation of current economic conditions by the Council members and the monetary policy decision actually taken. The minutes state the numerical division of the votes cast, but do not put names to those votes. The publication of the minutes is not directly linked with the appointment of the new Council members, as the former has been in trial operation since last June.

[National Bank of Poland agrees euro area membership strategy with government](#)

At a meeting held at the start of February, representatives of the MPC and the Polish government agreed that Poland's membership of the euro area will foster an upturn in economic growth. An appropriate fiscal-monetary policy mix, as defined in the government's Convergence Programme, was given as a condition for successful fulfilment of the Maastricht criteria. The government and the NBP also agreed that Poland's stay in ERM II should be as short as possible, that it would be desirable to exclude pension reform costs from the assessed public finance deficit, and that the exchange rate criterion should be interpreted in a way that eliminates unnecessary macroeconomic risk.

[National Bank of Slovakia adopts inflation targeting, ...](#)

At the end of December the NBS published its Monetary Programme until 2008, when Slovakia plans to join the euro area. The document defines the NBS's monetary policy as "inflation targeting in the conditions of ERM II". See *Spotlight* for more details of the NBS's new monetary policy system.

[... introduces weekly meetings ...](#)

The NBS Bank Board announced at the end of January that it will meet once a week (rather than once a month as previously). These meetings, at which the regular Situation Reports will not be discussed (these will remain monthly), will "consider the current situation on the financial market and confirm the results of the regular sterilisation repo tenders". This step should give the Board scope for more flexible and operative decision-making. The only change in NBS rates (-1.0 percentage point) made so far in this weekly system coincided with the discussion of the February Situation Report.

[... and combats exchange rate appreciation.](#)

The continuing appreciation pressure on the Slovak koruna has forced the NBS to intervene in the forex market several times this year. Given the limited effect of these interventions, the NBS in February took the unusual measure of stopping the withdrawal of liquidity in repo tenders. This way it wants to deter short-term speculative capital, much of which has been invested in repo tenders. The result is that money market rates are now some 100 b.p. below the NBS reference rate (currently 3.0%) at all maturities.

3. Spotlight: National Bank of Slovakia introduces inflation targeting

At the end of December, the NBS published its Monetary Programme until 2008, when Slovakia plans to join the euro area. The document defines the NBS's monetary policy as "inflation targeting in the conditions of ERM II". The NBS's inflation targets envisage inflation falling steadily to a level guaranteeing compliance with the Maastricht inflation criterion.

Reasons for adopting inflation targeting

The main reason for the explicit adoption of inflation targeting is Slovakia's ambition to enter the euro area in the near future (2008–2009). This ambition was formulated in July 2003 in the "Joint Declaration of the Government of the Slovak Republic and the NBS on the Procedure of Entry to the Euro Area" approved during discussions of the "Strategy for Adopting the Euro". The Slovak strategy was updated last September, when the government approved a document entitled "Specification of the Strategy for Adopting the Euro in the Slovak Republic". Referring to the results of analyses and the advanced phase of reforms, this document states that introduction of the euro is realistic in 2009.

The specification of the timing of Slovakia's euro area entry allowed the NBS to set a time scale during which it will be responsible for meeting the inflation and exchange rate criteria. The NBS's plan is to enter ERM II in the first half of 2006 and satisfy the inflation criterion at the start of 2008. The declared target trajectory is consistent with this plan, envisaging average 12-month inflation below 2% at the time of the assessment of the inflation criterion. Membership of ERM II is not viewed as an obstacle. On the contrary, the NBS declares that ERM II should create an appropriate framework for nominal and real convergence and that it leaves sufficient room for adjustments to shocks.

The NBS regards the explicit setting of inflation targets as an instrument that will help it to satisfy the inflation criterion. The NBS will thus focus to a greater extent on shaping the public's inflation expectations and expects that the targets will provide economic agents with a more transparent and clearer framework for their saving and investment decisions and their wage bargaining.

Main attributes and specific features of the NBS's inflation targets

The targets have been set in terms of annual consumer price inflation measured by the HICP index as of the year-end, i.e. in December 2006, 2007 and 2008. The targets are asymmetric – lower inflation is regarded as meeting the target. The NBS has also determined a predicted inflation outturn (again for the HICP) in December 2005 of 3.5% ± 0.5 p.p., which also has the character of a target (see Chart 1). Slovak HICP inflation is almost 0.2 p.p. lower on average than CPI inflation (see Chart 2), the index previously implicitly targeted by the NBS.

The inflation target is defined in the Programme as an unambiguous commitment to which the NBS will subordinate the conduct of monetary policy. This notwithstanding, the NBS leaves itself room for potential non-fulfilment of the target and defines a set of escape clauses, i.e. unexpected situations that are beyond the scope of monetary policy:

- non-fulfilment of the trajectory for fiscal deficits, which are meant to fall below 3% in 2007,
- administrative measures having an impact on the price level exceeding 1 p.p. in 2005, 0.6 p.p. in 2006, 0.8 p.p. in 2007 and 1.1 p.p. in 2008,
- significant fluctuations in energy prices,
- significant movements in the exchange rate (particularly vis-à-vis the USD) not associated with monetary policy measures and the development of economic fundamentals,
- food prices,
- extensive natural disasters.

The exchange rate regime of the Slovak koruna – managed floating – remains unchanged.

Forecast for the Slovak economy up to 2008

The Monetary Survey as usual contains a four-year forecast for the economy. The forecast for inflation is at the same level as the targets. GDP growth of around 5% is predicted in 2005 and 2006. Growth is expected to peak at 6.6% in 2007 then slow to “just” 4.6% in 2008. The forecast also predicts subdued nominal wage growth at a level broadly in line with labour productivity growth, average unemployment growth of 0.7% and a gradual fall in the current account deficit following a widening this year. The forecast is based on the assumption of unchanged interest rates and appreciation of the real equilibrium exchange rate.

By comparison with the previous forecast (published in the monetary programme for 2004 updated in May 2004), the latest forecast is for lower inflation (despite taking into consideration the aforementioned difference between the CPI and the HICP) coupled with higher GDP growth.

Chart 1: The NBS's inflation targets

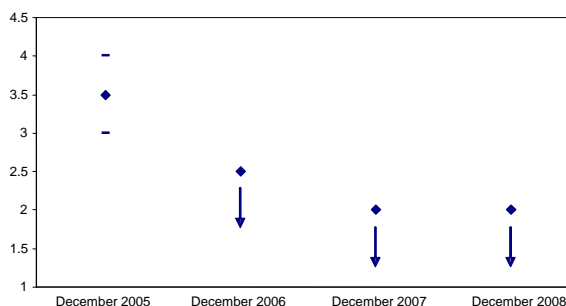
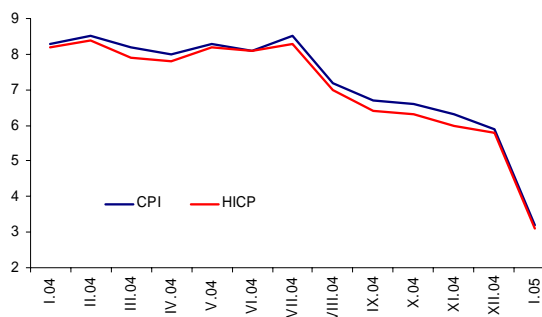


Chart 2: CPI and HICP inflation



Source: NBS and Statistical Office of the Slovak Republic; arrows denote target asymmetry

This document is published by the Czech National Bank and is freely distributable. Closing date: 10 March 2005. Current and past issues can be downloaded free from the *Monetary Policy* section of the CNB website. Contact: <http://www.cnb.cz>
info@cnb.cz