Central Bank Monitoring

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Monetary and Statistics Department
Monetary Policy and Strategy Division

While the US Fed carried on with its policy of gradually raising rates, ECB rates stayed flat at 2%. The Hungarian central bank continued lowering its rates fairly sharply, albeit at a rather slower pace than at the start of the year. The National Bank of Poland responded to falling inflation by cutting its rates. In* Spotlight *we take a look at the entry of Cyprus, Latvia and Malta into ERM II.

1. Developments since the last issue of Monitoring (March 2005) 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% (May 2005)[4]	2.00%	7 Apr/0.00 4 May/0.00 2 Jun/0.00 →	7 Jul 1 Sep →	1 Sep: new interim forecast to be published
Sweden (Sveriges Riksbank)	2.0%	0.3% (Apr 2005)	2.00%	14 Mar/0.00 28 Apr/0.00 →	20 Jun 23 Aug →	21 Jun: publication of IR[5]
United Kingdom (Bank of England, BoE)	2.0%	1.9% (Apr 2005)	4.75%	6–7 Apr/0.00 4–5 May/0.00 8–9 Jun/0.00 →	6–7 Jul 3–4 Aug 7–8 Sep →	10 Aug: publication of IR, including new forecast
Hungary (Magyar Nemzeti Bank, MNB)	4.0%	3.9% (Apr 2005)	7.25%	29 Mar/-0.50 25 Apr/-0.25 23 May/-0.25 ↘	20 Jun 18 Jul 22 Aug ↘	22 Aug: publication of IR, including new forecast
Poland (National Bank of Poland, NBP)	2.5%	3.0% (Apr 2005)	5.50%	29–30 Mar/-0.50 26–27 Apr/-0.50 24–25 May/0.00 →	28–29 Jun 26–27 Jul 30–31 Aug ↘	
Slovakia (National Bank of Slovakia, NBS)	3.5%	2.5% (Apr 2005)	3.00%	24 Mar/0.00[6] 29 Apr/0.00[6] 24 May/0.00[6] ↘	23 Jun[6] 29 Jul[6] 26 Aug[6] →	Monetary survey issued on given board meeting dates
USA (Federal Reserve System, Fed)	n/a	3.5% (Apr 2005)	3.00%	22 Mar/+0.25 3 May/+0.25 ↗	29–30 Jun 9 Aug ↗	
New Zealand (Reserve Bank of New Zealand, RBNZ)	2.0%	2.8% (1Q2005)	6.75%	28 Apr/0.00 9 Jun/0.00 →	28 Jul →	

[1] inflation target valid for the current period (or, in the cases of Hungary and Slovakia, the year-end target)
[2] the direction of the expected change in rates in the past quarter is taken from the Consensus Forecasts survey (or, in the case of New Zealand, from the RBNZ's own survey)
[3] provisional meeting dates. The direction of the expected change in rates in the coming quarter is taken from the Consensus Forecasts survey (or, in the case of New Zealand, from the RBNZ's own survey)
[4] preliminary estimate
[5] Inflation Report
[6] The NBS Bank Board decides on rates once a week; the given dates correspond to the discussion of the Situation Report on Monetary Development

2. News

Three more countries join ERM II

Another three countries – Cyprus, Latvia and Malta – joined ERM II at the start of May. In *Spotlight* we take a closer look at the circumstances surrounding their accession and their prospects of successfully meeting the exchange rate criterion.

ECB criticises revision of Stability and Growth Pact ...

Responding to the changes to the Stability and Growth Pact proposed in March (and later approved) the ECB said: "The Governing Council of the ECB is seriously concerned about the proposed changes to the Stability and Growth Pact. It must be avoided that changes in the corrective arm undermine confidence in the fiscal framework of the European Union and the sustainability of public finances in the euro area Member States." The ECB also assured the public and the markets that it remained firmly committed to maintaining price stability.

... sells its gold ...

In conformity with the Central Banks' Gold Agreement, the ECB sold 47 tons of gold from its reserves in the first year of the agreement. It also announced that it was not intending to sell more gold before the end of the first year of the agreement.

... and jointly publishes new journal

The ECB, along with other sponsoring organisations, in May launched the publication of a new quarterly publication, the *International Journal of Central Banking* (IJCB), available free of charge and in full at www.ijcb.org. The IJCB features articles on central bank theory and practice, with a special emphasis on monetary and financial stability. Its Managing Editor is Ben S. Bernanke, currently a Federal Reserve Board Governor and an economic adviser to President Bush.

Riksbank appoints Kenneth Rogoff as adviser

Kenneth Rogoff is a Harvard professor and one of the world's leading researchers in the field of monetary policy, exchange rates and international capital flows. He also has experience of practical policy implementation from the Fed and the IMF. The Riksbank's external advisers assist its Executive Board with economic assessments, provide concrete advice and facilitate its contacts with the international research community.

BoE: Paul Tucker reappointed to MPC

Paul Tucker, Executive Director for Markets, has been reappointed by Bank of England Governor Mervyn King, after consultation with Chancellor of the Exchequer Gordon Brown, for a further three-year term as a member of the Monetary Policy Committee (MPC). Another MPC member, Marian Bell, whose term of office ended in June, is to be replaced by David Walton, Chief European Economist for investment bank Goldman Sachs.

National Bank of Poland launches new forecasting model

As from May the NBP's forecast is based on a new model called ECMOD. The model consists of five interlinked modules – the real economy (demand and supply sides), nominal variables, external developments, fiscal developments and policy-making rules. It contains 100 equations, 15 of them behavioural. Simultaneously with the switch to the new model the NPB started publishing its GDP forecast in fan chart form. The published forecasts are still based on the assumption of constant interest rates.

National Bank of Slovakia starts publishing fan charts ...

According to an article published in the journal *BIATEC* issued by the NBS, the Slovak central bank is to start publishing its medium-term inflation forecast in fan chart form this year. The chart was presented together with the NBS's April forecast, which indicates an undershooting of this year's target and approximate fulfilment of the target in 2006. According to this chart, annual inflation at the end of 2006 will, with 90% probability, lie within the range 0.2% to 4.0%.

... based on a new model ...

The preceding issue of the same journal carried a related article describing a new medium-term NBS model, produced with the technical assistance of the IMF and the CNB. It is a "gap model" and is based on estimating the deviations of economic indicators from their equilibrium trend. The model comprises around 100 equations, eight of them behavioural, including the central bank's reaction function. However, it is not yet clear whether the NBS's forecasts will contain the model-forecasted evolution of monetary policy.

... and publishes national euro adoption plan together with Slovak Finance Ministry

The plan has been published on the Slovak Finance Ministry website for comments from other government departments. The envisaged euro introduction date – for both cash and non-cash payments – is 1 January 2009. ERM II entry is expected in the first half of next year, and fulfilment of the other Maastricht criteria in 2007.

3. Spotlight: Cyprus, Latvia and Malta join ERM II

Another three countries – Cyprus, Latvia and Malta – joined ERM II at the start of May. The "new recruits" have much in common with the three countries that entered ERM II a year earlier – they are all small open economies with a fixed exchange rate system and intend to stay in ERM II only for as long as is necessary. In the cases of Cyprus and Latvia, the parity was set at the existing central rate. Malta fixed its parity at its last exchange rate level.

Predecessors' experience

It is a year since the first three countries from the group of new EU member states – Estonia, Lithuania and Slovenia – joined ERM II. Their stay in the mechanism has been a successful and their currencies have not been exposed to major speculative attacks. As regards Estonia's economy and prospects of satisfying the Maastricht criteria, there has been a slight fall in its current account deficit (12.7% in 2004), but a simultaneous sharp rise in inflation (4.7% in April 2005). Lithuania has seen a similar rise in inflation (3.2% in April 2005), coupled with a widening of its current account deficit (7.1% of GDP in 2004). Slovenia, by contrast, has recorded a modest decrease in inflation (2.7% in April) and its current account deficit remains very small (0.4% in 2004).

Parity settings came as no surprise

More EU member states joined ERM II with effect from 2 May 2005. The key decision as regards joining ERM II is the setting of the central parity rate. In the case of Cyprus, it was set at the existing parity rate (see Table 1), and the wide fluctuation band (±15%) was also retained. Similarly, Latvia kept its previous fixed exchange rate regime, adopting a parity equal to the previous anchor along with a unilateral commitment to maintain its exchange rate within a narrow band of ±1%. Prior to ERM II entry, the Maltese lira had been fixed to a basket of three currencies (euro, dollar, pound), so its ERM II central parity was set at the lira's last exchange rate against the euro. Malta decided unilaterally to continue its practice of maintaining its rate at this parity.

Potential conflict between fixed exchange rate and other criteria

Fixing currencies against the euro can potentially conflict with the inflation criterion. In the case of the new members of the ERM II club, however, one can argue that this risk is low. First of all, these countries have highly open economies with close links to the euro area nations, so fixing the exchange rate helps to stabilise the domestic price level. Second, all of them have a relatively long experience with a fixed rate, and this experience demonstrates their ability to reduce inflation within such a system. Third, all of them are maintaining a positive interest rate differential vis-à-vis the euro (Cyprus at 1.75%, Latvia at 2.00% and Malta at 1.25%), which is tightening domestic monetary conditions and curbing excessive price growth. The only country in any real danger of failing to satisfy the inflation criterion is Latvia, which has the lowest price level (55% of the EU average in 2003) and which posted the highest inflation rate in 2004 (6.2% on average).

The fiscal criteria could pose a much bigger hurdle. Cyprus and Malta both had a deficit of 5.2% of GDP in 2004 and their government debt significantly exceeds 60% of GDP (Cyprus 74.9% and Malta 73.2% in 2004). The entry agreement therefore explicitly commits Malta and Cyprus to implementing sound fiscal policy and lowering their debt.

In Latvia's case, an over-high current account deficit could be a barrier to eurozone entry, as it could be interpreted as a major tension endangering successful participation in the euro area. According to an ECB estimate, Latvia's current account deficit was more than 12% in 2004 (the ECB estimated the sustainable deficit at no more than 9.7%). Cyprus and Malta currently have much lower deficits, thanks mainly to surpluses on services.

Interesting circumstances

Despite the tight secrecy surrounding all preparatory documents for ERM II entry, the Cypriot weekly *Financial Mirror* reported on 27 April that Cyprus and two other member states were to join ERM II on 2 May, quoting a senior central banker as its source. The Central Bank of Cyprus responded by announcing that it had no information on the issue.

According to a subsequent Dow Jones report, this leak led to considerations of delaying Cyprus's ERM II entry. The report quoted a senior diplomat in Brussels as saying that Cyprus would join ERM II as late as August. In the end, though, Cyprus joined the ERM II on 2 May. The official announcement was made on 29 April.

Premature disclosure of ERM II entry data can adversely affect exchange rate stability. If the rate is floating and if the central parity is based on the final exchange rate, there can be speculative pressure on a strengthening of the current exchange rate from investors with open long positions in the domestic currency (or for a weakening in the case of short positions). In Latvia and Malta, however, the condition of a floating rate did not apply and the fixing of their rates within a very narrow (Latvia) or zero (Malta) band thwarted any speculation on a parity shift. The above scenario could thus have materialised only in Cyprus, which had a wide enough fluctuation band. However, given general expectations that the central rate of the Cyprus pound would be fixed in ERM II at the previous parity level, the early disclosure of the entry data had a negligible impact (see Chart 1). The publication of the data led to a slight depreciation of the pound, and Friday's jitters over delayed entry generated considerable exchange rate volatility. After the announcement of Cyprus's ERM II entry on 2 May 2005 the rate returned to roughly its initial position. During May the Cyprus pound strengthened by 0.7% and is thus 1.6% from its central parity (see Chart 2).

Table 1: Central parities

Country	Currency	Central parity
Cyprus	CYP	0.585274
Latvia	LVL	0.702804
Malta	MTL	0.429300

Chart 1: EUR/CYP rate before entry

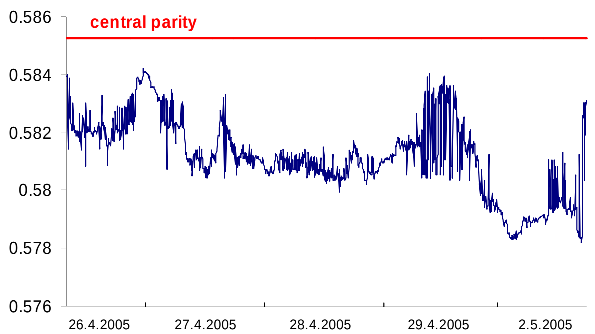
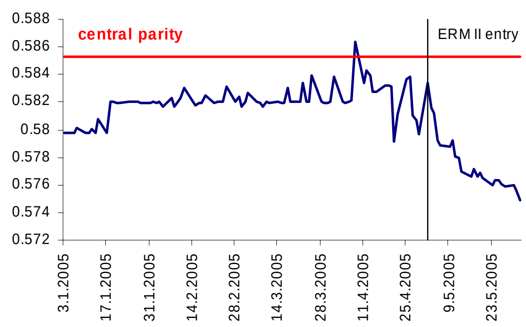


Chart 2: EUR/CYP rate after entry



Source: ECB, Bloomberg

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