



Does the Monetary Policy Department's name need to be reviewed, or its existence justified, following Slovakia's entry into euro area?

Ing. Renáta Konečná
Národná banka Slovenska

The answer to this question is not as clear as it may appear at first sight. In the area of monetary policy, the introduction of the euro automatically means that the national central bank loses the capacity to influence the domestic economy by applying standard tools, such as the level of interest rates or the exchange rate. At the same time, it means relinquishing the original, independent (or national) monetary policy and therefore also giving up certain activities related to the conduct of monetary policy.

In practice, the loss of national monetary policy meant that the Monetary Policy Department ceased drafting proposals for the NBS Bank Board as the basis for interest rate decisions, and also stopped providing a commentary on the set level of NBS rates (known as "Rationale behind the decision of the Bank Board of the NBS on the set levels of the NBS interest rates"). Therefore, current (and also expected) macroeconomic developments, especially the trajectory of inflation, are no longer evaluated in relation to a predetermined target. It was also necessary to change the cyclical ("gap") model that had hitherto been used and was focused on an active monetary policy in an inflation targeting regime.¹ With a dimension of national monetary policy having been relinquished, the scope of the NBS Monthly Bulletin was reduced.

Another activity rendered redundant was monitoring of the exchange rate, which included analyzing of its macroeconomic impacts and proposing possible responses from the central bank. As regards the nominal exchange rate, Slovakia is no longer in the position of being a small open economy, since approximately 90% of its exports and 70% of its imports are now denominated in euros, i.e. in the domestic currency.

Although these activities ceased after euro area entry, they represented only a tiny part of the overall activities of the Monetary Policy Department ("MPD"). Just like many uninvolved laymen and professionals, we expected that after the several years of intensive preparations for the introduction of the single currency, focused on producing various analyses, questionnaires and documents for the missions from the European Commission and the ECB, the pace of work would

ease up considerably and some duties would become obsolete. But during 2008, and especially the second half of the year, our colleagues from euro area central banks gradually disabused us of this notion.

After a year of working within the "club" of countries that use the single currency, we have to say those colleagues were right. The few activities that the MPD was relieved of have more than been made up by supplementary activities that were and are related to the country's full membership of the euro area. They concern a number of areas, namely: monetary policy, analysis, forecasting and statistics.

MONETARY POLICY AND ANALYSIS

The NBS Governor began participating in the twice a month meetings of the ECB's Governing Council (its purpose being to discuss and decide on monetary policy and other ECB matters in relation to the euro area), in addition to his established attendance at meetings of the ECB's General Council (which meets four times a year and serves as a forum for the exchange of opinions between the central bank governors of the 27 EU Member States). This required the MPD to carry out more in-depth monitoring and analysis of developments in the international economic environment, especially the euro area, which serve for the drafting of the NBS Governor's opinion on materials discussed by the Governing Council (which for a single meeting range in length from around 50 to 300 pages), including presentation proposals.

In addition, the objective of ensuring that NBS is fully represented in monetary-policy matters of

¹ Gavura, M. and Reľovský, B.: A simple model of the transmission mechanism of Slovakia's economy, its structure and properties. *Biatic*, Volume 13, no. 4/2005, Národná banka Slovenska.



2 The process of creating a medium-term forecast at the NBS and the basic features of the current forecast MTF – 2009Q2. *Biatec*, Volume 17, no. 7/2009, Národná banka Slovenska.

3 Reľovský, B. and Široká, J.: A structural model of the Slovak economy. *Biatec*, Volume 17, no. 7/2009, Národná banka Slovenska.

4 AWM – Area-wide model; see Fagan, G., Henry, G. and Mestre, R.: An area-wide model (AWM) for the euro area. ECB Working Paper No 42, January 2001, European Central Bank.

the Eurosystem requires that the level of monitoring and analysis previously applied to the domestic economy now be applied to the euro area economy. A detailed analysis of the global economy is produced on a quarterly basis, and reports and analyses of current developments in the external macroeconomic environment are included in macroeconomic monthly reports. The scope of analyses of the international economy may today be divided into three areas: global economic developments along with commodity markets, the economic situation in the region (the Czech Republic, Poland, Hungary), and economic developments in the euro area. In the case of the euro area, emphasis is also placed on the monitoring of major economies (e.g. Germany).

For this purpose, it was necessary to establish a comprehensive monitoring and analytical system and to specify key activities in regard to the international economy.

Thus, following the euro area entry, analyses of the international environment and of both current and expected economic developments in euro area became a key basis for the NBS Governor's regular involvement and presentations in respect of all economic and monetary policy matters of the euro area. Monetary policy therefore continued to be covered by Národná banka Slovenska, the difference being that its focus was not any more Slovakia's economy, but the broader setting of effective monetary policy for the euro area. In addition to monetary policy commentaries, the MPD participates through its work (whether proactively or in the context of comment proceedings and professional discussions) in the preparation of a full range of analytical materials within the Eurosystem. In the area of teaching activities, we contribute within the remit of our competence to the training of Eurosystem staff.

FORECASTING

As a result of Slovakia joining the euro area, Národná banka Slovenska participates in all Eurosystem activities and processes. This includes its involvement in the preparation of the joint euro area forecast. Twice a year, all Eurosystem central bank contribute to the production of the "Eurosystem staff macroeconomic projections for the euro area". Before euro area entry, the MPD produced a medium-term forecast on a quarterly basis. After entry, it was necessary in the case of the June and December forecasts to adjust to the ECB's forecasting process by making organizational and technical changes. This meant in practice that over the course of six weeks it was necessary to update the medium-term forecast three times on average, i.e. to attend three times the full number of internal meetings for the baseline forecast and for the short-term and medium-term versions. During this period the national central banks communicate with the ECB and an intensive exchange of information takes place. Staff of the national central banks also meet at the ECB headquarters (in so-called working groups) in or-

der to discuss common assumptions, present national forecasts, compare their forecasts with the ECB's projection, consult over various problematic issues, and seek solutions. This change meant the MPD had to alter its internal forecasting process by making it longer, broader (within the scope of the projected variables) and more intensive, in order to formulate the text or "story" of the forecast and to seek arguments for comparison within the Eurosystem forecasting process. Our success in handling this task is confirmed by the interest shown by certain central banks, both inside and outside the euro area, in seeing a presentation of our prediction process and the internal arrangement of relations within the MPD.

As regards analytical tools, in the area of macroeconomic forecasting it was necessary to construct econometric tools that make possible full compliance with requirements under the Eurosystem's common projection process. That is why NBS has since the euro adoption date been using a new model apparatus – a structural model³ of a small open economy, which replaced the gap model that had been used up to then and had been focused on an active monetary policy in an inflation targeting regime. The new NBS model may be summed up as a standard econometric model of medium size, based on a synthesis of the AWM⁴ model used by the ECB. The new model is used to cover two basic groups of needs arising from this membership, but also domestic requirements. It is used for *forecasting purposes* (twice a year the process of producing the medium-term forecast for the Slovak economy is included in the Eurosystem forecasting process, and twice a year the model is used to prepare the central bank's internal forecast), and it covers *analytical needs* (the model is used for simulations of monetary-policy, fiscal, price or demand shocks, whether in the scope of ECB analyses focused on the whole euro area or analyses concerning only the domestic economy).

As for current trends in macroeconomic modeling, it should be noted that, taking the forward-looking view, the new model represents a stepping stone on the way to the construction of comprehensive model of the Slovak economy based on macroeconomic fundamentals. In future, the central bank's model apparatus used for the above-mentioned purposes is expected to be extended by the inclusion of the so-called Dynamic Stochastic General Equilibrium (DSGE) model.

In the area of econometric modeling and economic research, Národná banka Slovenska, through members of its MPD staff, engages in active cooperation within the ECB's Working Group on Econometric Modelling (WGEM). This cooperation supports the sharing of knowledge in this area, work on common projects, and the more effective construction of internal analytical tools. It is the central banks of small economies that benefit most from this cooperation, since it allows them to draw on the know-how in this area



and more efficiently keep pace with economic research. Another example of cooperation was the consultation with ECB analysts during the design of the above-mentioned structural model.

In addition to these changes in the model forecasting apparatus, directed and used mainly for the medium-term horizon, it was necessary to adjust, establish or amend the forecasting tools used also for the short-term forecast. The original tools were modified for the use of seasonally-adjusted data, and several new models were created, including simple single-equation models and multi-equation models that used both quarterly and monthly indicators for forecasting. Apart from that, there was an increase in requirements not only for the scope of projected variables, but also for the coordination of the forecasting process (harmonization of the data publishing schedule, ESCB forecasting deadlines, and forecasting processes) and the process became more time consuming.

As regards changes in individual projected and analysed variables, the MPD switched to the forecasting of seasonally adjusted time series and changed the focus from year-on-year to quarter-on-quarter. This resulted in the creation of entirely new short-term models and relations and a need to become familiar with the reading of the forecast in regard to the development of individual components from quarter to quarter.

STATISTICS

After Slovakia joined the euro area, it was necessary to extend the scope of the statistical data that are transmitted and fall within the competence of the MPD, and particularly in the area of balance of payments. The ECB uses Slovakia's balance of payments data when compiling the euro area's balance of payments, which is used for regular monitoring of monetary conditions across the euro area, for analyzing factors affecting financial markets, and for analyzing the development of the M3 monetary aggregate, which is an important indicator in respect of the ECB's monetary policy. It was for these reasons that, after euro area entry, Národná banka Slovenska through the MPD started to transmit (in addition to the „national“ balance of payments that it was already sending) a monthly balance of payments and quarterly statistics for the international investment position vis-à-vis non-euro area countries – in accordance with the change in how non-residents are viewed, and their breakdown into “intra-euro area” and “extra-euro area”, which for the ECB is an important distinction with regard to the relationship between the euro area and the rest of the world. Furthermore, NBS also began transmitting

the quarterly balance of payments and the annual international investment position vis-à-vis selected non-euro area countries representing the euro area's most significant economic partners (16 countries in total), as well as stock and transaction data on the currency structure of debt securities. Satisfying these new ECB requirements necessitated substantial changes in the compilation system for the balance of payments statistics and represented a sharp increase in activities related to the collection and processing of data and to the checking of the required statistics.

SUMMARY

In general, it may be said that monetary policy (and the functioning of the MPD) need to be viewed in terms of extending monitoring and producing analyses for the whole euro area, so as to adopt appropriate standpoints and present opinions regarding the conduct of the common monetary policy through the ECB. Also no less significant than it was before the euro area entry is the detailed monitoring, analyzing and forecasting of the Slovak economy's development, including supplementary statistical requirements. In all these areas, joining the euro area increased demands on both the scope and quality of activities performed by the MPD.

Amid the loss of the autonomous monetary policy and the exchange rate, the MPD will continue to monitor real variables, i.e. real effective exchange rate as well as interest rates and they impact on the domestic economy, and to extend to a relatively considerable degree the focus on structural policies analysis, above all in the area of labour market and competitiveness of the Slovak economy in the context of the single currency, as well as fiscal development and its sustainability. It is such analyses of these areas, in a country without an autonomous monetary policy, that will be most important, since fiscal policy (in the broadest sense) will represent the most significant and sole channel for preventing the emergence of disequilibria and supporting long-term and sound growth.

In conclusion, it should be noted that the primary aim of this article was to give a broad overview of what joining the euro area meant for one NBS department in terms of reducing or extending its duties. Clearly there has been an intensification of many activities that must be taken in all euro area countries. In this regard, our task, and at the same time objective, is to provide an independent view of current and expected developments in the euro area under the monetary policy decision-making process of the ECB's Governing Council.