Inflation Targeting in the Czech Republic

WHY and HOW

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CZECH CNB NATIONAL BANK

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Environment for the monetary policy in the early 90s

- In the 80s, Czechoslovakia - one of the most rigid and most heavily regulated economies in the Eastern bloc
- Level of macroeconomic stability, private savings and credibility of the currency relatively high
- Field for the monetary policy
    - limited number of banks
      (monobank system dissolved in Nov 89)
    - no financial markets
    - koruna not convertible
    - development of the black market
- Nominal inflation low, hidden inflation (demand overhang on market with state controlled prices) present

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1st January 1991

- Liberalization of prices
- Internal convertibility of CSK
- Liberalization of foreign trade
- Start of privatization
- Unification of exchange rates and introduction of **fixed rate** against trade weighted basket

- Due to weak credibility, low capital mobility

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Monetary policy framework

- **Monetary policy:**
  - *ultimate goal* - monetary stability
  - *intermediate targets* - fixed exchange rate + M2
  - *instruments* - newly introduced auction refinancing credit, emergency credit and credit against the pledge of bills, interest rate ceiling 24% introduced, lending limits introduced
- **First year performance (incl. dereg. of prices):**
  - inflation rate only 56.6% (in Jan and Feb)
  - GDP growth declined to -11.6% (measurement problem)

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… Field for monetary policy was gradually changing …

- Reduced uncertainty about future economic course of the country
- A large number of banks emerged
- Financial markets gradually liberalised and developed
- Convertibility of koruna deepened, regulations were slowly lifted

- On Jan 1, 2003, former federation CSFR split and the CNB, central bank of the Czech Republic, replaced the former SBCS
- CZK was introduced

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… Leaving nominal anchor …

- Development of the FX market allowed CNB to reduce its activities there and introduce small band (+/- 0.5 %) since Sept 92
- **Both** *ultimate goal* (monetary stability) and *intermediate target (*M2 + FX rate) unchanged
- Further liberalisation of the FX regime and reduction of the risk premium (e.g. OECD member since 1995) have made the fixed FX rate policy difficult in the environment of higher single digit inflation (and high interest rates) - on February 28, 1996, the band was widened to ±7.5%

May 27, 1997 – CZK is floating

- Spill-over from the Asian crisis was the short term cause
- Low commitment of all other policies (or even discussion about it) to fixed FX rate and weak supply side compared to expanding demand were the real cause. Weak corporate governance in banking sector was an important contributor and obstacle to transmission of monetary policy
- Too long existence of the regime in such an environment put CNB in front of the difficult decision under time pressure

Do not stick to temporary policies for too long!

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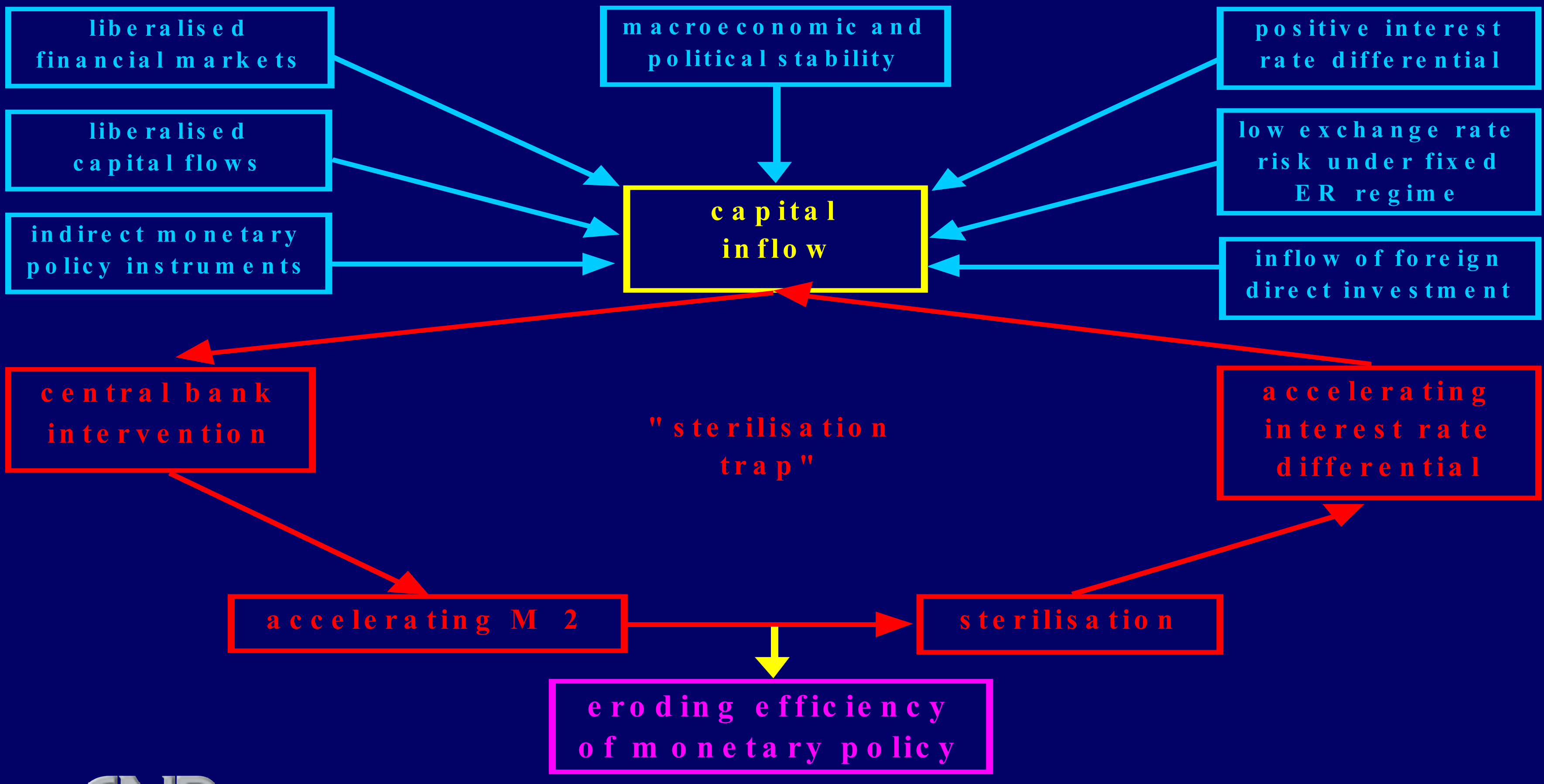
...New monetary policy scheme...

- Is fixed or well managed FX rate an option :



... Other options ...

1. Substantial widening of fluctuation band creating room for more autonomous monetary policy
   - *This solution was partly chosen when the band was widened to ±7.5% . After the crises, any band will suffer from weak credibility.*
   - *Too wide band does not serve the objectives:*
     - *Too large to stabilize*
     - *Exists, so it can be the source of tensions*

2. Monetary targets – do not hurt but do not work well either…
   - *Complications in conducting the policy on a developed and unregulated market*
   - *Do not reflect the actual policy of the CNB*
   - *Are difficult to communicate*

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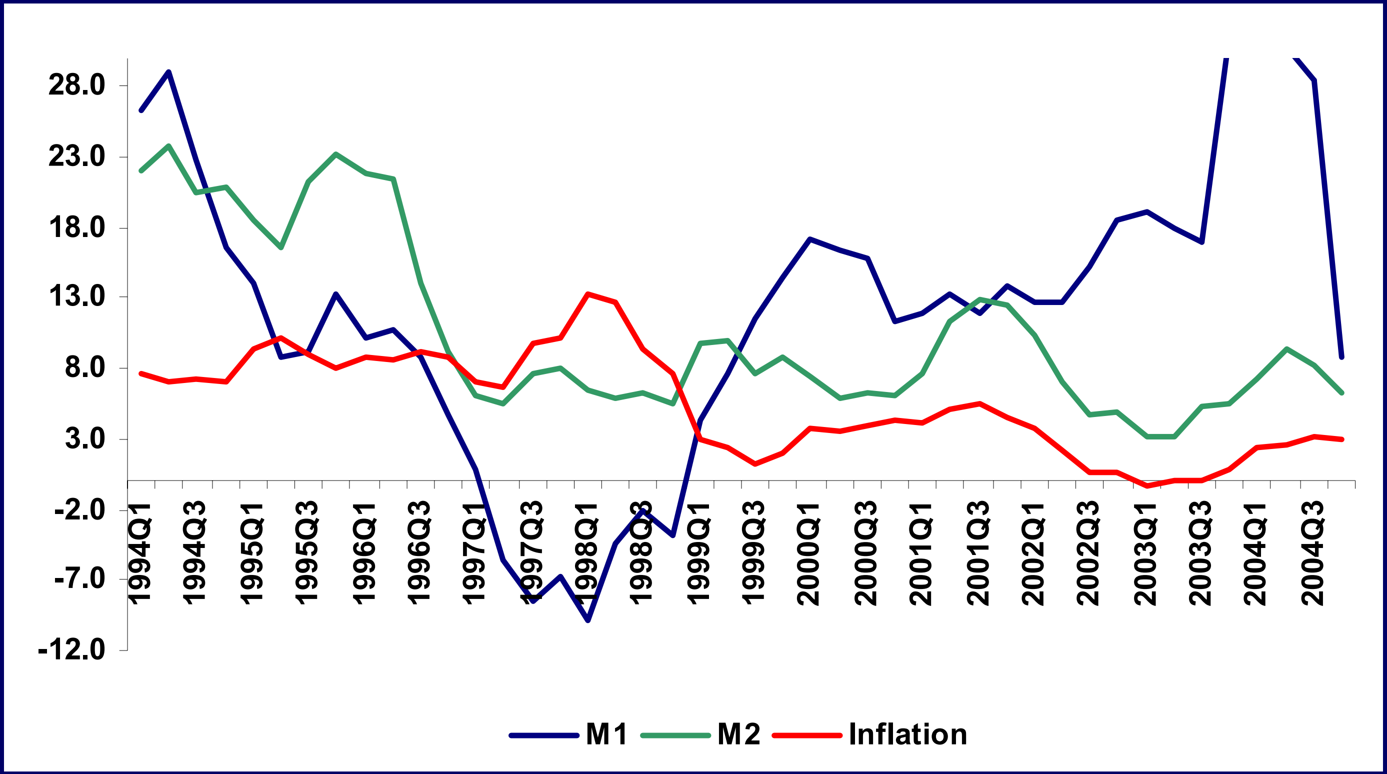
Monetary target transparency



Implementation of the monetary policy

end of 90s

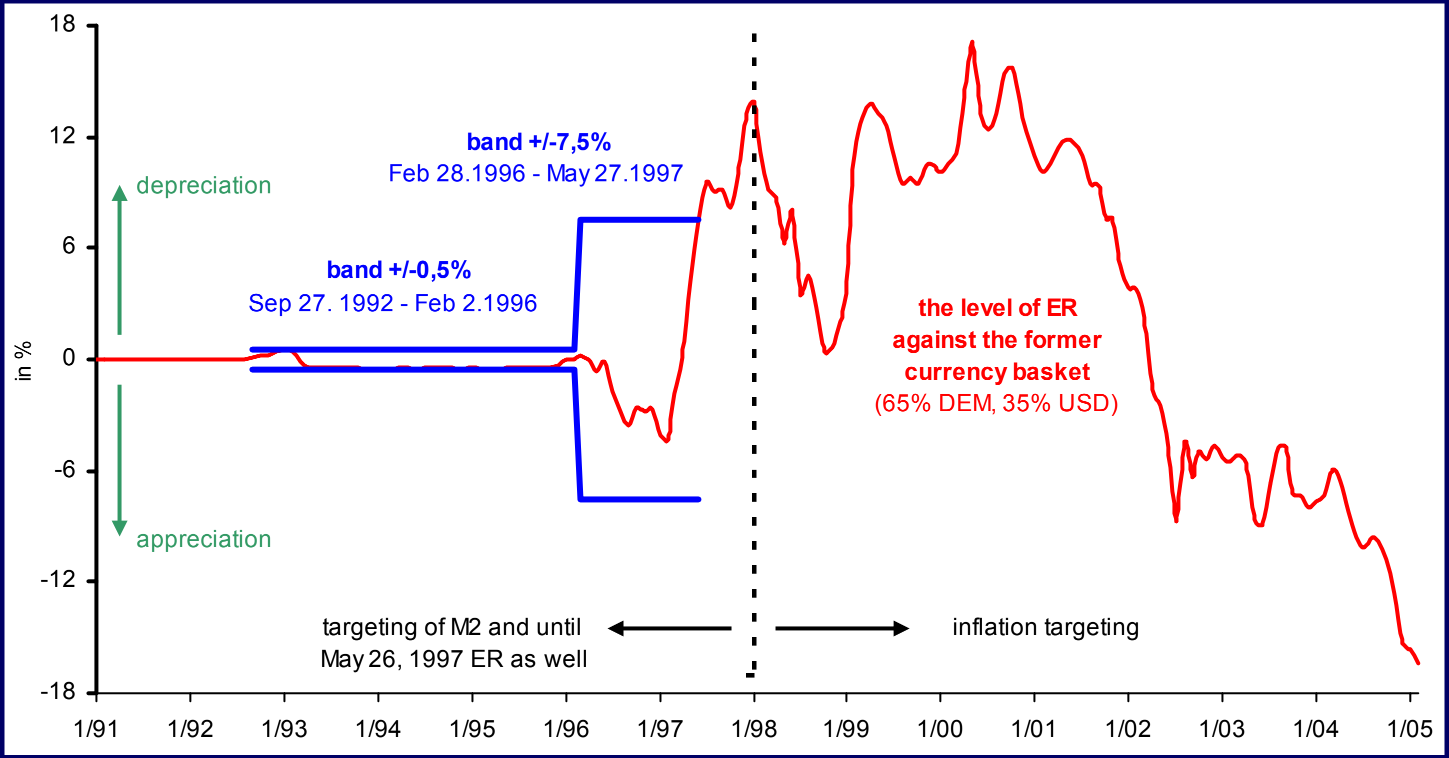
- Internationalization of the market
- Increased transparency of CNB and marketplace
- Removal of most regulations, CZK convertible in practice
- Money market and FX market liquid and efficient
- Main tools of the CNB
  - short term interest rate (2 W, partly 3 M)
  - FX rate - interventions

Inflation Targeting

or

Targeting of the Inflation

... after the fixed FX rate is over ...



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Considering IT pros and cons in CNB

- **Transparency +**
  - commitment to open and transparent policy
  - more interest of market and media in CNB
  - monetary target not transparent
  - call for more transparency to build credibility after crises
  - “say what you do and do what you say“
- **Feasibility -**
  - economy volatile, especially after the crises
  - no or weak forecasting mechanism (risk of either not achieving the target or too restrictive policy)
  - part of CPI highly volatile, part regulated without medium term strategy

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IT c CNB Mk. I and II

- Pros > Cons, target is net inflation (CPI ex. regulated prices and tax changes), specific “escape“ clauses
- Forecast
  - reliance on single equation expert “models“, later from Q4 small macro model
  - monetary policy role very weak
  - creation of the “communication“ scheme

IT c CNB Mk. III and IV

- From NI to CPI (with some assumption on growth of regulated prices), weaker accent on exemptions
- From conditional forecast to unconditional, with reaction function and active role of monetary policy (since 2001)
- Gradual shortening of the short term expert forecast to Q1, more of the importance of the model (since mid 2002)
- Larger, less aggregated model under construction

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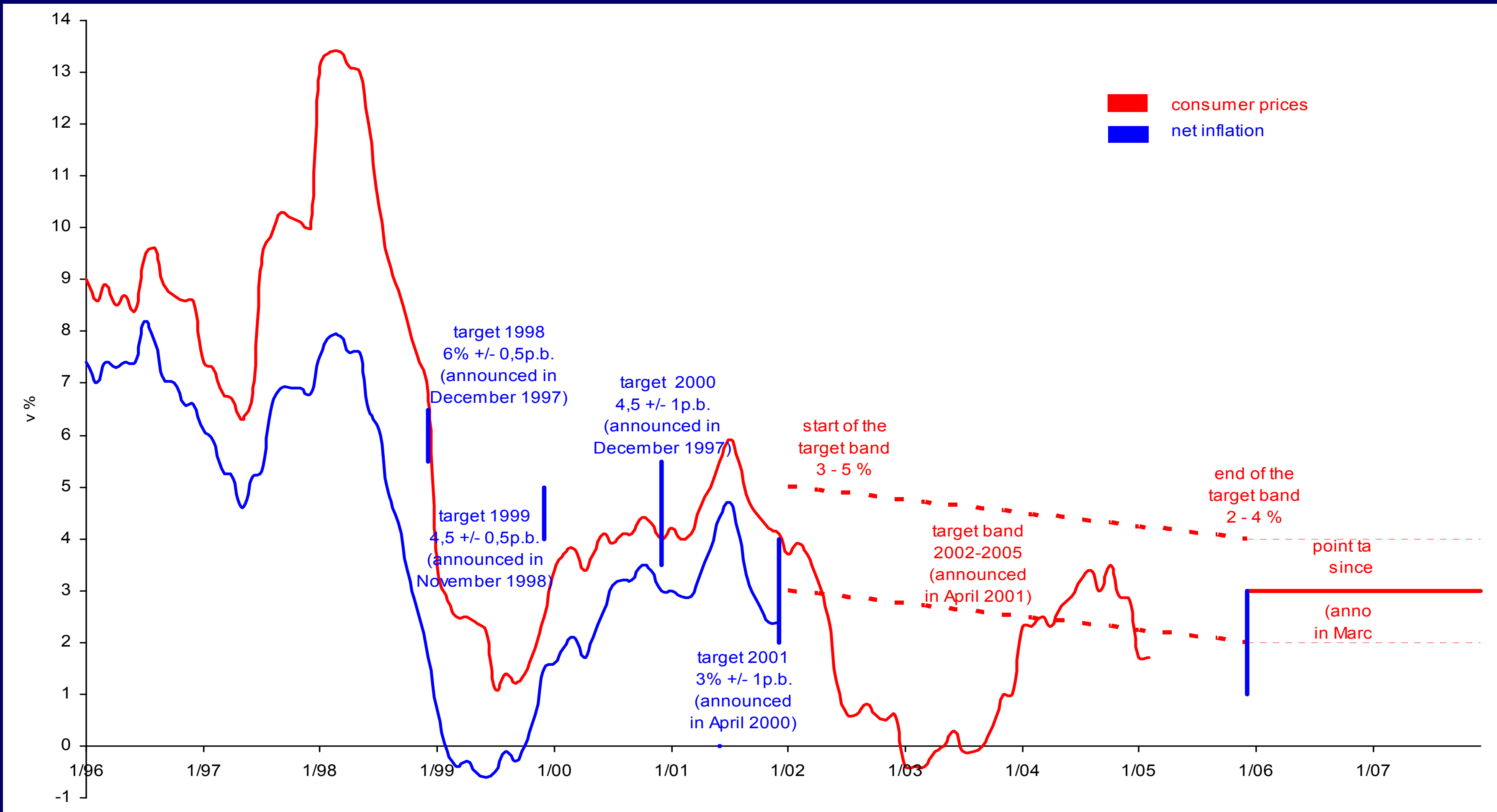
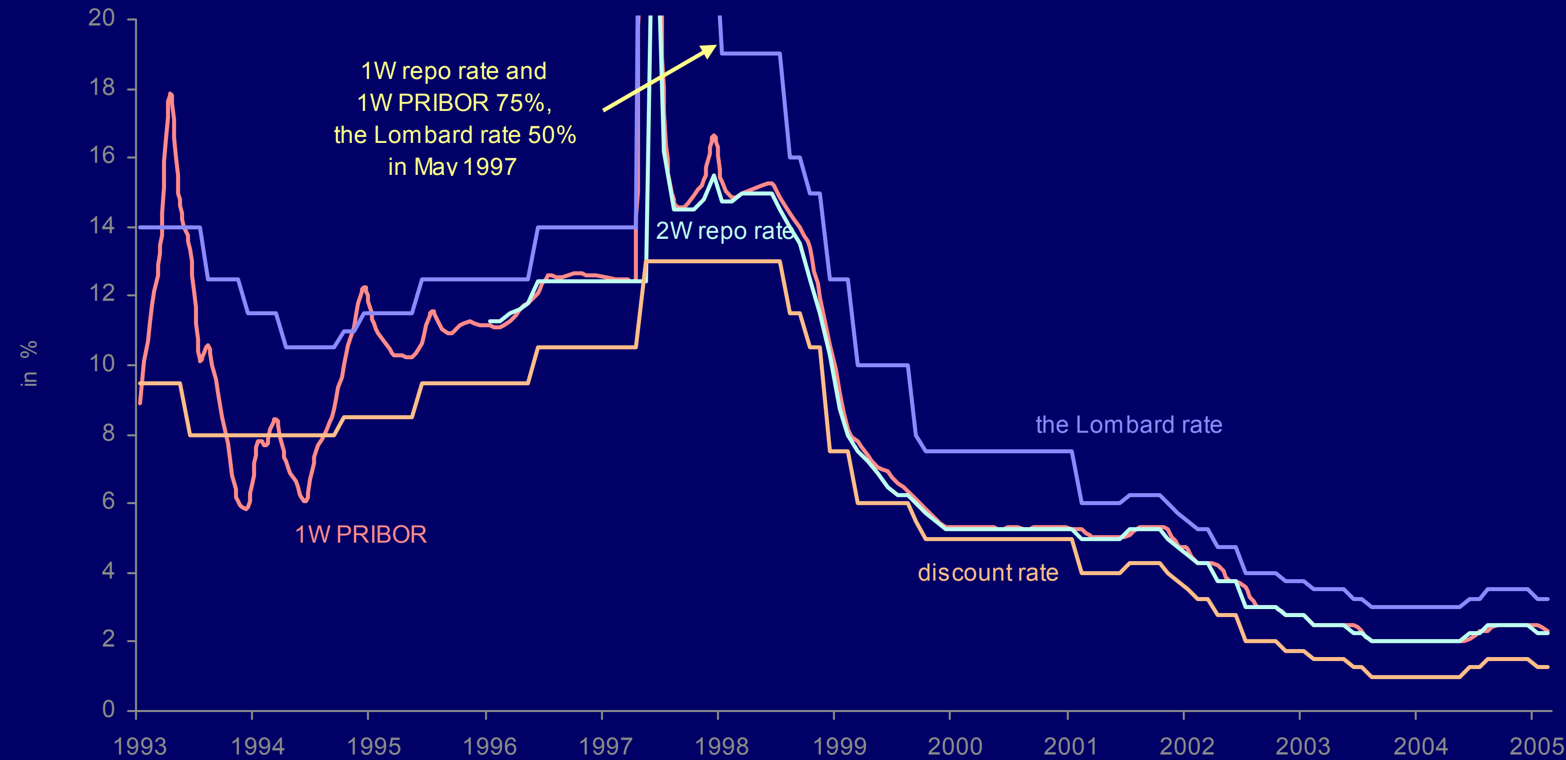
CNB targets



v %
14
13
12
11
10
9
8
7
6
5
4
3
2
1
0
-1
1/96
1/97
1/98
1/99
1/00
1/01
1/02
1/03
1/04
1/05
1/06
1/07
consumer prices
net inflation
target 1998
6% +/- 0,5p.b.
(announced in
December 1997)
target 1999
4,5 +/- 0,5p.b.
(announced in
November 1998)
target 2000
4,5 +/- 1p.b.
(announced in
December 1997)
target 2001
3% +/- 1p.b.
(announced
in April 2000)
start of the
target band
3 - 5 %
target band
2002-2005
(announced
in April 2001)
end of the
target band
2 - 4 %
point ta
since
(anno
in Marc

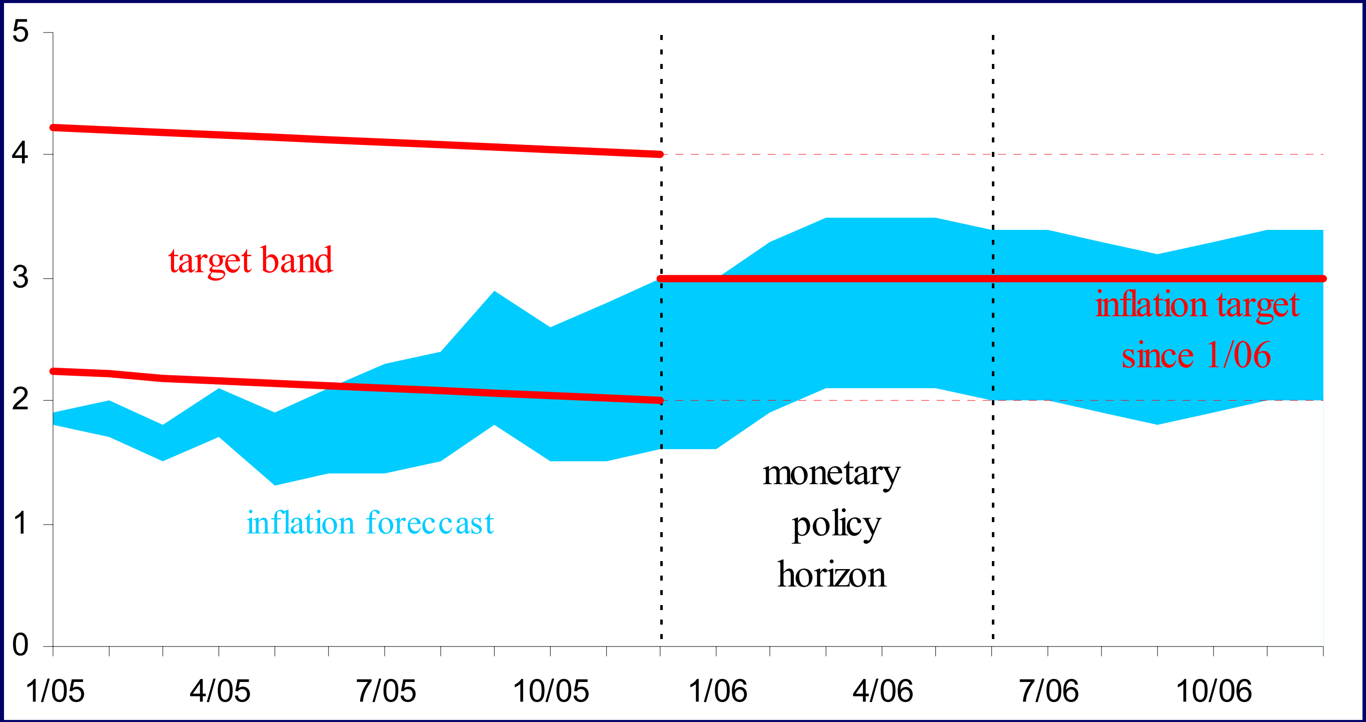
Monetary policy



Framework of IT

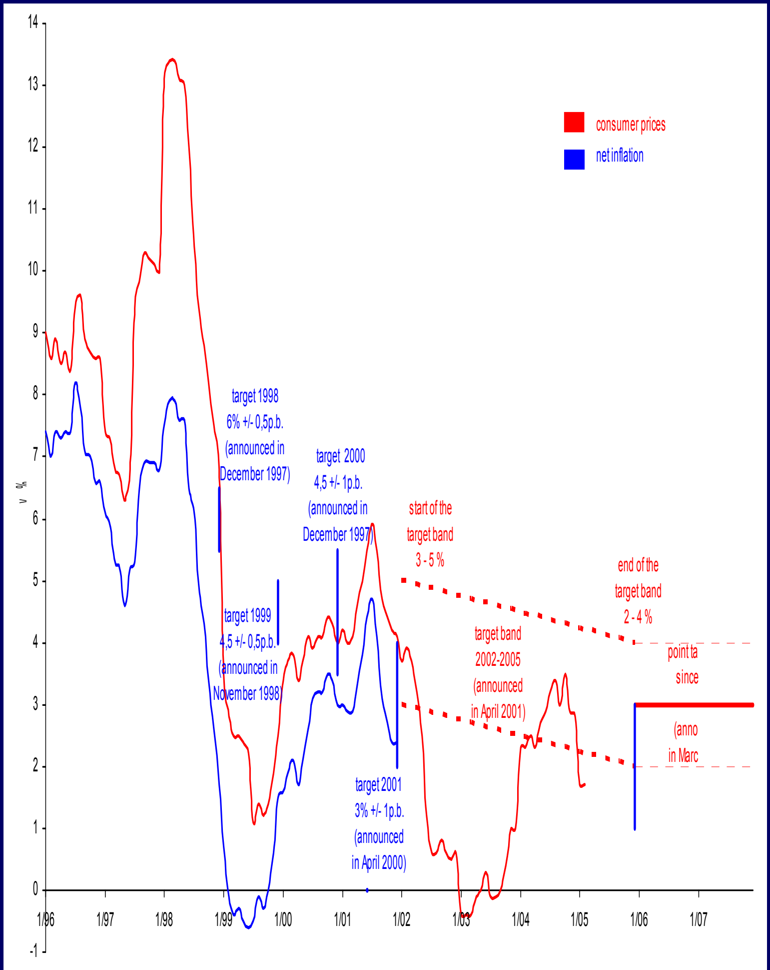
- Target - set by CNB, government is consulted
- Instruments – ECB toolkit, interventions not excluded
- Forecast
  - staff, model based, 4 times a year
  - forecast disclosed (ex. IR and precise FX)
- Transparency
  - press conf., minutes incl. an. votes /<2 W/, Inflation report incl. FC 4/Y
  - reporting 2/Y to parliament, no formal IT accountability

Current forecast



Main experience

- Achieving the target - NOT OFTEN, undershot most of the time, despite “aggressive“ monetary policy. Shocks (mostly FX) are partial cause
- Transparency – pretty high, appreciated by analysts and the public
- Inflation expectations – very good, close to the target
- Better policy scheme – NOT KNOWN



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IT lessons

- Target setting in converging economy:
  - how big is the need for price adjustment, how will it take place and what is the estimated BS effect
  - equilibrium appreciation has an impact on inflation
  - falling risk premium can reduce IR autonomy
  - too low rates in economy can get inflation to the target but has intertemporal impacts (risk of asset price bubbles etc.)

- Incentives for target with some spread against the base economy (EU) is rational. But can you achieve it?

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Main challenges now

- Role of the FX rate in a small open economy with Inflation Targeting
  - has impact on the forecast without a doubt
  - so must have impact on the policy
  - too much of the reaction can get CB into the “FX trap“
- Role of the “volatile items“ in CPI
  - some items with high volatility have higher proportion in CPI

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Challenges ahead

- Going to ERM II
  - too many policy changes
  - too many targets
  - some targets are not even clear

- Need likely some pragmatic policy and shortening of the period for the minimum time