Role of the Central Bank in Economic Transformation

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Czech economy – heritage from communist times

- In 80s, Czechoslovakia one of the most rigid and most heavily regulated economies in the East bloc;
- Level of macroeconomic stability, private savings and credibility of the currency relatively high;
- Nominal inflation low, hidden inflation high (demand overhang on market with state controlled prices);
- Field for the monetary policy;
  - limited number of banks (monobank dissolved on Nov 89);
  - no financial markets;
  - koruna not convertible, existence of limited black market.
Design of economic reform „1st January 1991“

- Liberalization of prices;
- Liberalization of foreign trade;
- Internal convertibility of Koruna (for CA transactions);
- Start of privatization;
- Unification of exchange rates and introduction of fixed rate against trade weighted basket.

- Due to weak credibility, low capital inflows, financing through official resources at the beginning.
Monetary policy framework

- **Monetary policy:**
  - *ultimate goal* - monetary stability;
  - *intermediate targets* - fixed exchange rate + M2;
  - *Instruments:*
    - auctions refinancial credits (+ emergency credits and credits against the pledge of bills);
    - interest rate ceiling 24%, lending limits;
    - FX transactions for balancing of positions of the banks.

- **First year performance (incl. dereg. of prices):**
  - inflation rate 56.6% (took place in Jan and Feb);
  - GDP growth declined to -11.6% (internal and external reasons).
Other tasks of central bank

- Banker for the government;
- Advisor of the government.

- Banking sector supervisor:
  - Licencing of new banks;
  - Regulation;
  - Supervision.

- Financial market development:
  - Infrastructure;
  - Execution of the transaction.
Economy is changing ...

- Reduced uncertainty regarding future economic course of the country;
- A large number of banks emerged;
- Financial markets gradually liberalised and developed;
- Convertibility of koruna deepened, regulations are gradually lifted.

On Jan 1, 1993, former federation CSFR was split, the CNB replaced SBCS - former central bank of CSFR, CZK was introduced
Since Sept 92 CNB has reduced its FX activities and introduced band (+/- 0.5%);

**Both ultimate goal (monetary stability) and intermediate target (M2 + implicit assumption of FX stability) unchanged;**

Further liberalisation of the FX regime and reduction of the risk premium (OECD member since 95) made fixed FX rate policy difficult and costly - CPI was at high single digit and nominal IR were high), since February 28, 1996, band widened to ±7.5%.
**Czech economy – end of 90s**

- **Real economy**
  - High growth in mid 90s (6.9% in 95) followed soon by decline (-0.7% in 97);
  - Growing inbalances, especially BoP (CA more than 6% in 96);
  - Inflation „sticky“ (high single digits).

- **Banking sector**
  - Cummulation of bad loans in portfolios of the banks (20% +);
  - Sometimes incorrect reporting;
  - Missalocation of credits, related party loans, frauds.

- **Monetary policy**
  - After introduction of the 15% band, monetary policy in theory „independent“;
  - In practice, still focused on exchange rate.
May 27, 1997 – CZK is floating

- Spill over from the Asian crises was the short term cause of crises;
- 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 important contributor to the crises and obstacle for 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!*
Changes in the Czech economy

- Financial sector
  - Privatisation of the large state owned banks;
  - Focus on fast adoption of standard regulation (including independent SEC);
  - Focus on law enforcement.

- Monetary policy
  - Effort to stabilize currency after the crises;
  - Changing position of the central bank.

- Real economy
  - Gradual effort to improve environment for enterprises / structural reforms;
  - Support of FDI;
  - Deterioration of fiscal policy;
  - Only slow other important reforms (fiscal, pension, medical, labour).
After crises monetary policy

- „Real“ floating of the currency after may 97 reality;
- Monetary targeting neither credible or transparent, targeting of inflation is the natural choice;
- Setting proper „disinflationary target“ under big uncertainty is very difficult;
- When real appreciation „natural“, nominal rates must go down.
Inflation vs. targets

- Actual disinflation faster than intended;
- Two episodes of sharp target undershooting related to exchange rate appreciation;
- FX interventions against the appreciation in 1998 and 2001-02, but no interventions since then.
Outcome - Czech economy in new millennium

- Speed up of economic growth;
- Improvement of CA situation, but at the same time change of the structure of the deficit;
- Improvement of banking and financial sector (fast credit growth, profitability high).
Central bank tasks

- Monetary policy is the key task
  - Transparency;
  - Know how improvement.

- Other key areas
  - EU cooperation, ESCB membership;
  - Financial stability (it is .....);
  - Since 2006, overall financial market supervision;
  - Banking functions for government;
  - Advisory role very limited;
  - How to preserve independence?

- Future – CR in Eurozone, CNB delegates monetary policy to ECB.
Some challenges of the Czech economy

- In future, CA BoP will be influenced a lot by deficit of balance of income;
- Sometimes, currency volatility high, not dominated by „domestic factors“. Forecasting very difficult, credibility in risk;
- Decision of Eurozone entry is „tricky“.
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