

The CNB's new inflation target and changes in monetary policy communication

8 March 2007

At its meeting today, the CNB Bank Board approved the CNB's new inflation target, a reduction in the number of monetary policy meetings of the Board, and several changes in monetary policy communication.

The CNB announces the new inflation target as annual consumer price index growth of 2% (with a tolerance band of $\pm 1\%$), effective from January 2010.

Starting from 2008 the CNB will publish the following new information:

- **the forecast-consistent interest rate path in numerical form, as a fan chart;**
- **the votes cast by the board members on interest rate changes by name.**

In 2008 the CNB will change the frequency of the Bank Board's regular monetary policy meetings from monthly to eight meetings a year.

The CNB's inflation target as from January 2010

The current target of the Czech National Bank (CNB) of 3% was announced in March 2004 and took effect in January 2006. It was set marginally above the price stability level declared by the European Central Bank (ECB) for the euro area and also above the inflation target levels of most central banks in advanced countries (mostly 2.0% or 2.5%). This target level reflected some specific features of a transforming economy converging towards the advanced countries. On declaring the target, the CNB announced that it would remain in effect until the Czech Republic enters the euro area, at which point monetary policy decision-making will transfer to the ECB.

However, the postponement – towards the end of last year – of the euro adoption date beyond the originally considered horizon of 2010 established a longer-term perspective for the operation of the inflation targeting system in the Czech Republic. It offers space for considerations about whether the current inflation target corresponds ideally to the understanding of price stability and the expected evolution of the Czech economy beyond 2010.

The process of equilibrium real appreciation of the Czech koruna can be expected to continue gradually slowing as some of its underlying factors unwind. By 2010 the process of deregulation of most prices and the harmonisation of indirect taxes should have been completed, so these administrative effects will not be exerting significant upward pressures on inflation in the Czech Republic. The improvement in the terms of trade and changes in the structure of relative prices are also likely to slow compared to the current trend; these factors are also fostering real appreciation of the koruna. Correspondingly, the need to keep open a positive inflation differential as one of the channels for raising the Czech price level to the level of the advanced countries will gradually subside. The existing trend moreover confirms that the Czech economy

is capable of achieving high rates of growth while maintaining a low level of inflation and a moderate trend of appreciation of the nominal exchange rate of the koruna. Prices of tradable commodities are showing downward flexibility thanks to a combination of subdued wage growth and high labour productivity growth in industry. The change in the structure of relative prices, which is usual for a converging economy, can thus proceed with no problem even amid low overall inflation.

Given the gradual stabilisation of the structure of consumption and the completion of the main “transformation” changes in the quality of consumer goods, the extent of statistical over-estimation in the measurement of inflation can also be expected to decrease gradually. Lower measured inflation should also be fostered by the fact that the new consumer basket in use since January this year increases the weight of tradable unregulated commodities, i.e. goods whose prices are, in the long term, rising only slowly or even falling in the Czech Republic and on world markets.

The inflation expectations of financial market participants are anchored at low levels and at the three-year horizon are just below the CNB’s current target. In this situation it is appropriate to move the inflation target to a lower level in line with the practice in advanced countries. The inflation targeting regime has accrued sufficient credibility for the new target to anchor inflation expectations effectively; this, in turn, will make the target easier to achieve. The CNB will allow inflation to gradually decline to the new inflation target level sufficiently in advance (roughly one year) in order for inflation to be close to the target as of its effective date. Analyses suggest that lowering the target sufficiently in advance will have very low real economic costs and does not necessitate a higher nominal interest rate level in the short run; in the longer run, by contrast, nominal rates will on average be lower thanks to the lower targeted inflation.

After considering all the above facts, the CNB announces the new inflation target as annual consumer price index growth of 2%, effective from January 2010. As before, the CNB will strive to ensure that actual inflation does not differ from the target by more than one percentage point on either side.

The CNB continues to view its inflation targets as a medium-term ones which actual inflation may deviate from temporarily as a result of exogenous shocks. Changes to indirect taxes are one such shock; monetary policy does not react to the first-round effects of such changes and concentrates only on their second-round effects.

Publication of the forecast-consistent interest rate path

One of the key materials for monetary policy decision-making is the CNB's regular macroeconomic forecast. The forecast is drawn up by the CNB's Monetary and Statistics Department after consultations with the Bank Board, and its message is described in detail in the Inflation Report. The CNB forecast is based on the assumption of an active central bank which steers inflation towards the inflation target by means of changes in interest rates. Up to now this part of the forecast – the “forecast-consistent interest rate path” – has been described only verbally, and not numerically.

Starting from 2008 the CNB will publish the forecast-consistent interest rate path in numerical form, as a fan chart. This step will further enhance the transparency of the CNB forecast and the Bank Board's monetary-policy considerations, and will give external observers a better understanding of the inflation forecast and CNB monetary policy.

In no event, however, should this path be understood as a commitment of the CNB regarding the future evolution of rates. Owing to the arrival of new information after the preparation of the forecast, and to board members' different views of economic developments than as outlined in the Monetary and Statistics Department's forecast, the actual interest rate path can deviate from the forecasted path. As with the forecast of the other main variables, this uncertainty surrounding the future interest rate path will be illustrated in a fan chart.

Publication of the votes cast by the board members by name

Since the very start of inflation targeting, the CNB has been gradually increasing the level of transparency and accountability associated with the Bank Board's monetary policy decision-making. Since 1998, the minutes of the Board's monetary policy meetings have been published on the CNB website and in the Inflation Report. Since mid-2000 the minutes have included a record of the ratio of the votes cast, and for over a year now this voting ratio has also been disclosed straight after the monetary policy meeting at a news conference. In 2001 the Board also decided to publish the Situation Reports on Economic and Monetary Developments – the main reference material for the Board's monetary policy discussions – together with the full minutes of these discussions, with a six-year time delay. The first set of these documents will be published in January 2008.

The disclosure, as from the start of 2008, of the votes cast by the board members on interest rate changes by name will represent a further move towards increased transparency in monetary policy-making. This step towards the model used by a number of central banks in other countries will allow experts and the general public to better identify the opinions of each board member and thus better understand the decisions of the Board as a whole. It will give the board members more freedom to express their views in public. Increasing the board members' individual accountability for their own voting will enhance the principle of majority decision-making at board level. This collective decision-making will continue to reflect the natural diversity of the board members' expert opinions on economic and monetary developments.

Reduction of the number of regular monetary policy meetings to eight a year

In recent years the Czech economy has stabilised close to its equilibrium level. Inflation, too, has stabilised at low values and inflation expectations are firmly anchored. Consequently, the situation does not require such frequent changes in interest rates as in the early stages of inflation targeting. **In 2008 the CNB will change the frequency of the Bank Board's regular monetary policy meetings from monthly to eight meetings a year.** Numerous major central banks around the world apply a similar system.

The CNB still reserves the right to decide on monetary policy issues outside the framework of the regular monetary policy meetings. As before, however, it will only exercise that right in exceptional cases.

The regular monetary policy meetings will be timed to optimally reflect the schedule for the publication of key macroeconomic indicators and inputs to the CNB forecast. The CNB will publish the specific calendar of monetary policy meetings for 2008 this autumn.