

The CNB's inflation target from January 2006

11 March 2004

The current inflation target of the Czech National Bank (CNB) is defined up until December 2005. In line with the *CNB Monetary Strategy* document, the CNB is now setting its inflation target for the period starting January 2006. This means that, sufficiently in advance, a framework is created for monetary policy decision-making with impacts on inflation from the start of 2006, and long-term inflation expectations are anchored.

The CNB hereby announces that the inflation target for the period starting January 2006 is year-on-year consumer price index (CPI) change of 3%. The CNB will at the same time endeavour to ensure that actual inflation outturn does not differ by more than one percentage point in either direction from this target. The inflation target will be in force continuously until the Czech Republic joins the euro area, when the implementation of monetary policy directed at maintaining price stability will pass on to the European Central Bank (ECB).

This target has been set in line with the general principles of the CNB's monetary policy strategy, defined in the *CNB Monetary Strategy* document of April 1999 and updated or supplemented by later documents on the announcement of the inflation targets for 2001 and 2002–2005 and by *The Czech Republic's Euro-area Accession Strategy*. The declared inflation target does not institute any acceleration of targeted inflation and follows smoothly on the end of the previous steadily descending target band. Given the low-inflation environment, the target is set in horizontal form.

The inflation target is at the same time a good starting point for future fulfilment of the convergence criteria, corresponds to the long-term inflation expectations of the financial markets, and also conforms to the limitations stemming from statistical overvaluation in measuring inflation. The target takes into account also the zero nominal interest rate bound and the potential downward inflexibility of wages.

The inflation target has been set slightly above the price stability level declared by the ECB for the euro area in terms of the year-on-year change in the harmonised index of consumer prices (HICP), which is "below but close to 2%". This small inflation differential reflects the long-term real convergence of the Czech economy towards the euro area average, which will continue for some time after the Czech Republic's accession to the euro area.

The CNB continues to regard its inflation targets as medium-term targets from which actual inflation may deviate temporarily. Such a deviation comes into consideration especially if the economy is hit by an "exogenous shock". If such a shock deflects expected inflation from the target, the CNB does not respond to the primary impacts of the shock. It will apply an exemption ("escape clause") from the obligation to hit the inflation target and accept the deviation of the inflation forecast from the target caused in this way. There can be a whole range of shocks which create room for applying such escape clauses. They include, for example, major deviations in world prices of energy raw materials or major deviations in agricultural producer prices. A specific type of exogenous shocks is administrative measures that have strong price impacts, in particular major changes in the structure or rates of indirect taxes and major changes in the segment of regulated prices.