Low inflation and its effects on the economy: the Czech experience

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27th International Financial Congress
Saint Petersburg, Russia
6-8 June 2018

Some facts about the Czech economy

- In 1993-2017, cumulated real GDP growth was 88% or 2.7% p.a.
- In 2017, GDP per capita at purchasing power parity reached well above 80% of the euro area average
- Rate of unemployment is the lowest in the EU (2.3% in April 2018)
- The level of public debt was 34.6% of GDP in 2017
- Current account of balance of payments has been in surplus since 2014 (1.1% of GDP in 2017)
- Among the EU countries with one of highest levels of social cohesion
- The second biggest car producer per capita in the world (after Slovakia)

Monetary policy contributes to overall macroeconomic developments.

Outline

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- 2018: 20 years of inflation targeting in the Czech Republic
- First decade (1998-2008): disinflation and inflation stabilisation
- Second decade (since 2009): effects of the financial crisis – unconventional monetary policy and back to normal
- Summary and lessons learned

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- **2018: 20 years of inflation targeting in the Czech Republic**
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2018: 20 years of inflation targeting

- Before 1998, CNB‛s policy was based on a mix of money targeting and exchange rate peg
- This regime was abandoned in 1997 due to a currency crisis
- The Czech Republic introduced inflation targeting (IT) in 1998 as the first emerging market economy at that time
- Reasons for introducing IT
  - Inconsistency of previous regime with liberalised capital flows
  - Inability of money targeting to anchor inflation expectations
  - Experience of other central banks (RBNZ, BoC, BoE, BoA etc.)

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First decade (1998-2008): disinflation and inflation stabilisation

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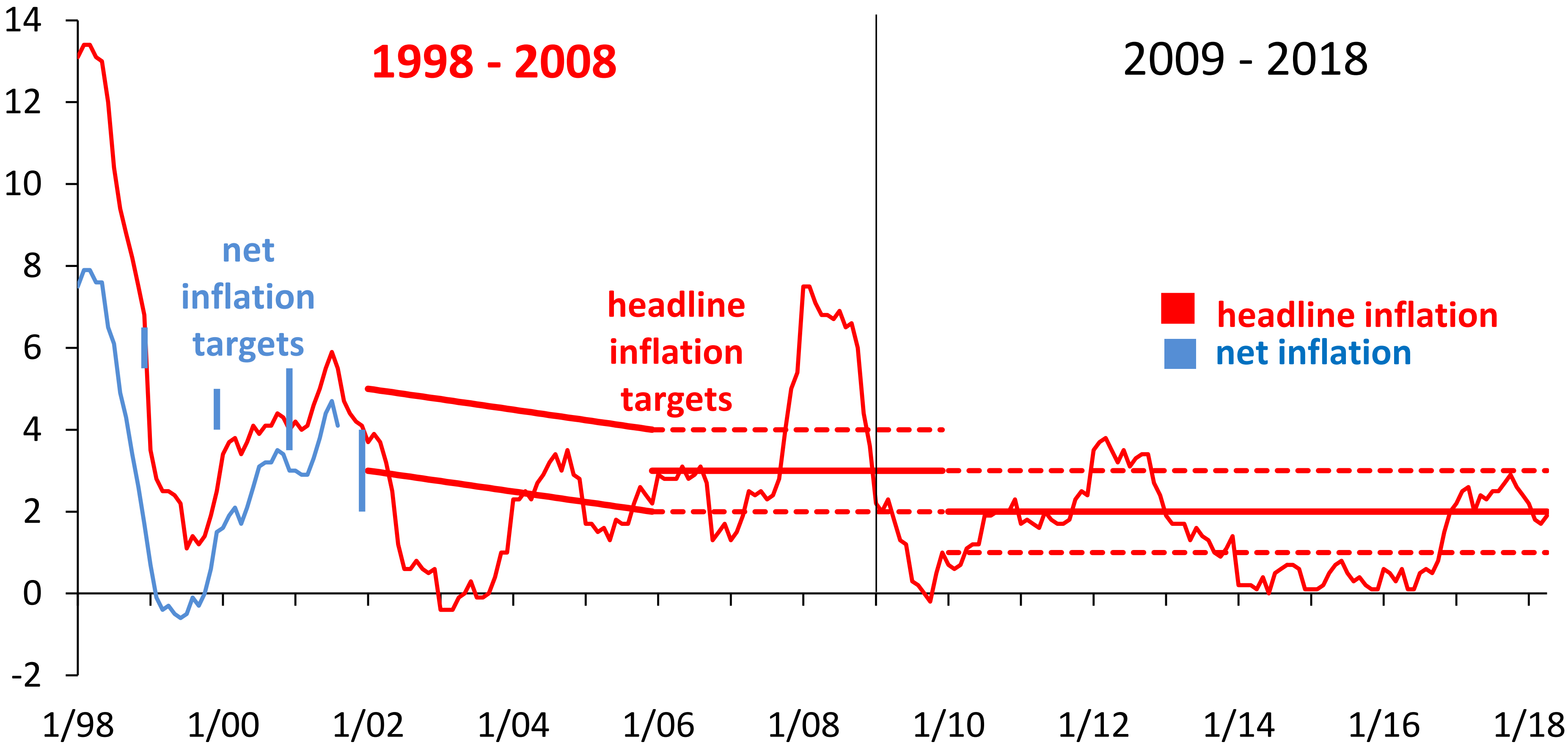

First decade (1998-2009): disinflation and inflation stabilisation

- Initial stage (1998-2001): end-of-the-year targets for net inflation
- 2002-2005: a continuous declining corridor for headline inflation; gradual approach
- 2006-2008: a permanent/continuous point target of 3% with a tolerance band of +/-1 p.p.

- Inflation rapidly reduced to values observed in developed countries
- However, there were significant temporary deviations from the target due to several (mainly external) shocks

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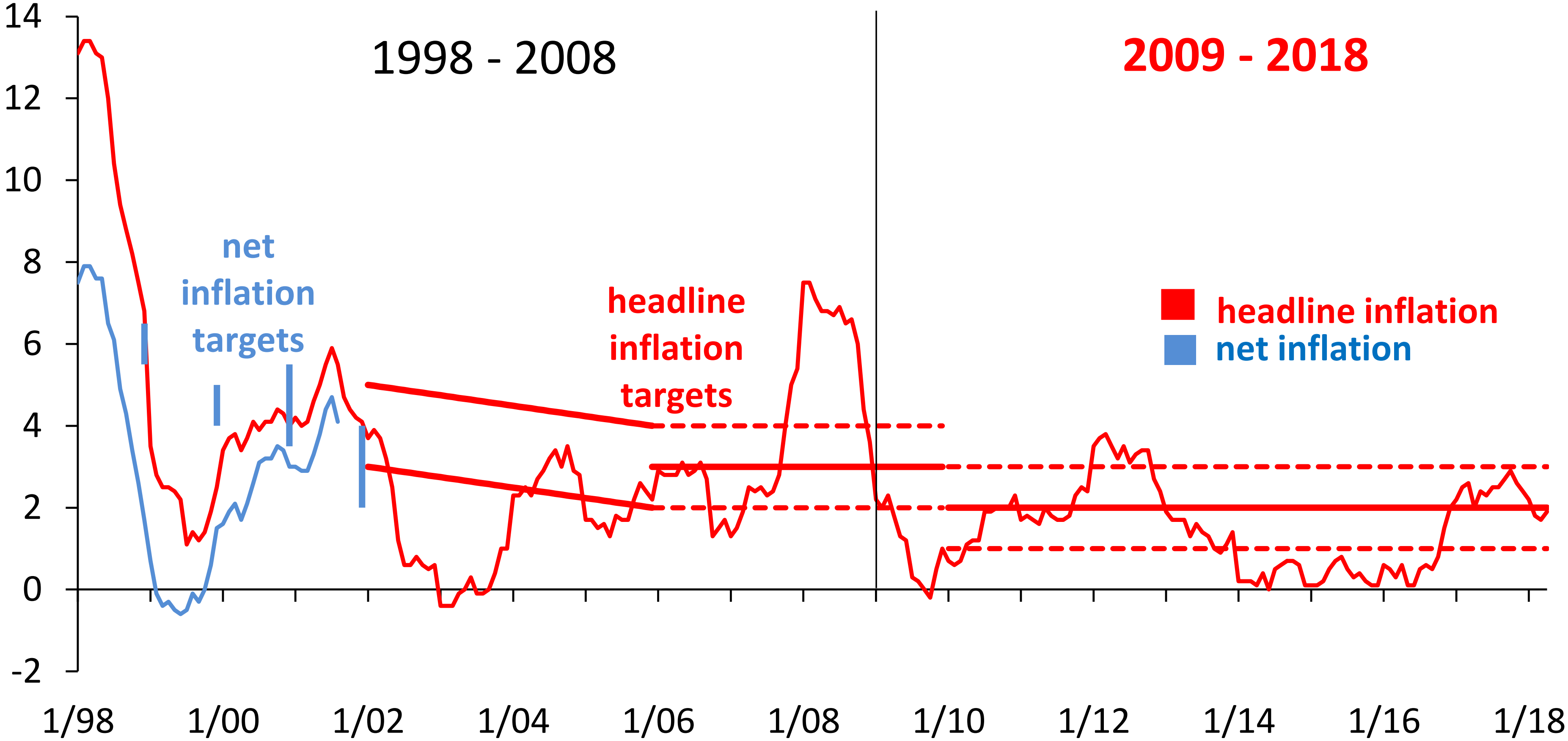
Second decade (since 2009)



Second decade (since 2009): effects of the financial crisis

- Lowering the inflation target as of 2010 by 1 percentage point (to 2% with a tolerance band of +/- 1 p.p.)

- Lowering interest rates in response to the deep recession caused by the global financial and economic crisis (starting to as early as summer 2008)
- Due to a renewed lengthy recession (a consequence of the euro area debt crisis), rates started to near the zero lower bound in 2012
- Introduction of the exchange rate floor at 27 CZK/EUR in November 2013 to avoid a deflation-recession spiral or long-term undershooting of the inflation target

Second decade (since 2009): exchange rate floor and back to normal

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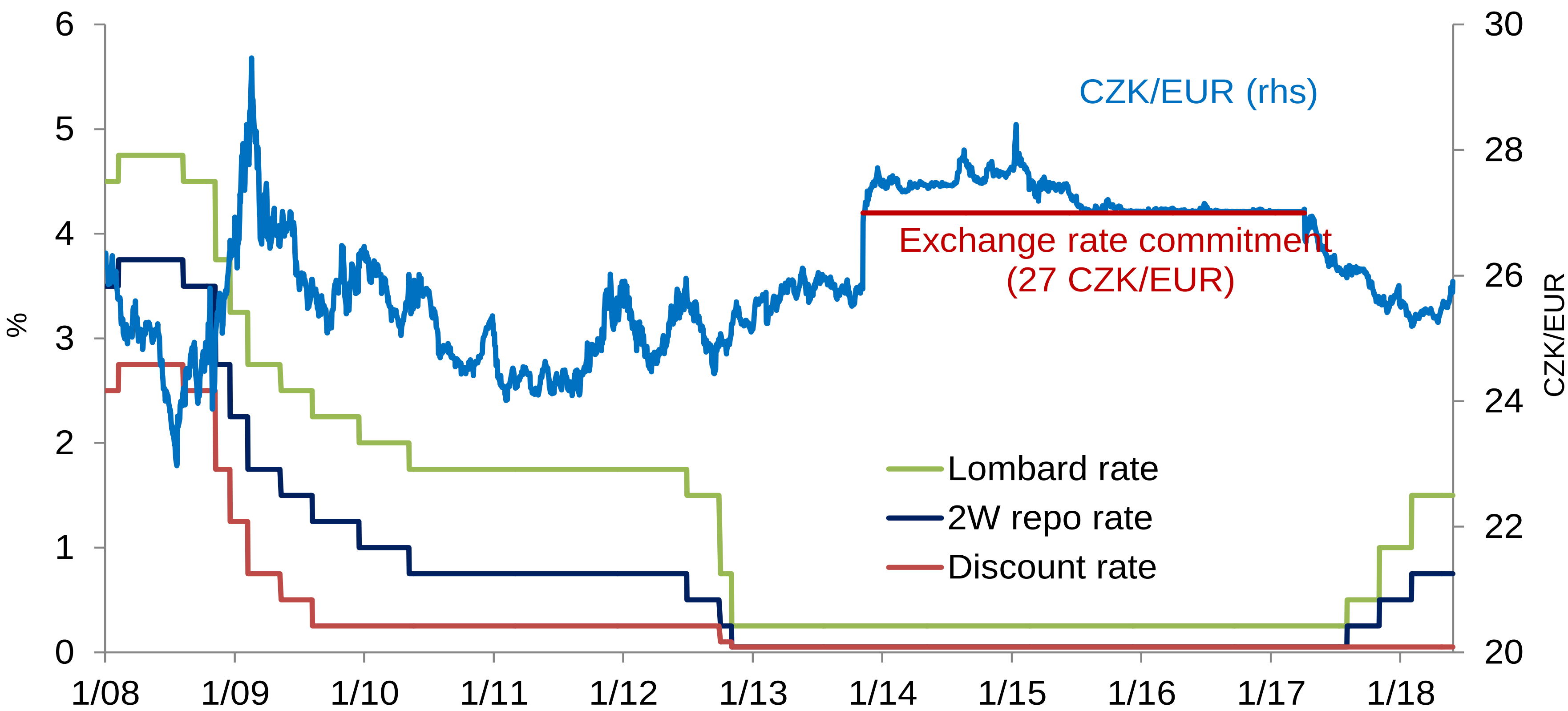

- The FX floor was abandoned on 6 April 2017 as conditions for sustainable fulfilment of the 2% inflation target had been met
- The exit was smooth, followed by three interest rate hikes in 8/2017, 11/2018 and 2/2018. The Czech koruna appreciated gradually and moderately.

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Summary

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- The successful conduct of monetary policy under inflation targeting brought inflation down from high values to the level usual in advanced countries
- Subsequently, this regime was able to cope with the threat of harmful deflation during a lengthy domestic recession thanks to the use of the exchange rate as an additional monetary policy instrument

Lessons learned (1)

- The process of disinflation takes time and depends on several factors (regulatory prices, tax changes, indexation, cyclicality of fiscal policy,…)
- The long-term benefits of low inflation have to be communicated (as counter-argument to the short-term costs)
- There should be only ONE SINGLE target: no other nominal objectives for the central bank than inflation (no exchange rate or money supply)
- The monetary policy framework has to be well defined
  - for instance publicly announced numerical inflation target
  - strong commitment and ownership by both staff and the Board

Lessons learned (2)

- The central bank has to be professional, transparent, independent, accountable, and therefore credible – ready for unpopular steps in the short run and if necessary ready to use all the means it has to achieve its objective

- The IT is based on forward-looking monetary policy decisions
  - credible forecasting tool (modelling)
  - transparent communication (say what you do, do what you say)

- The IT is a never ending process (continuous improvements of forecasting tools and communication; macroprudential issues…)

Thank you for your attention

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