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Interview: Zdeněk Tůma Governor, Czech National Bank

With

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Interview: Zdeněk Tůma

Martina Horáková speaks to the Czech governor about the crisis, calls for cross-border supervision and the process for adopting the euro.

The Czech National Bank's legal mandate is to maintain price stability and, if this is achieved, to support the economic policy of the government. How much weight do you place on the second part of that objective?

For me the second part was always something included to please politicians. We didn't originally define the objective in this way, but it was added when we entered the European Union. I have always regarded it as nonsensical and immaterial from an economic point of view, but in practice it doesn't compromise the achievement of the primary objective of price stability. Price stability is the central bank's primary objective. If this is accomplished, one has no reason to go against the goals of the government.

In February this year the Czech National Bank became the first central bank in the world to publish its forecast of a bilateral exchange rate. What is the reason for this move?



Zdeněk Tůma

I would add that in addition to the exchange-rate forecast, we also belong to a small group of central banks that publish the expected interest-rate path. While the academic support for doing this is quite strong, central bankers have expressed concerns over whether the public is able to understand that the projections are not a guarantee of some kind, or equal to the central bank's target; but rather a conditional forecast. The conditional nature of the forecast should be clear from current events: today there significant uncertainties, which means that the central bank's forecasts can often change sharply as the risks evolve and materialise differently from what was

expected. That said, I have sympathy for a gradual approach to this kind of transparency. If we were just introducing our inflation-targeting framework, in the current volatile environment, I would be scared to publish even the interest-rate forecast, because it would be something new for the public to get used to and fully understand. I recall that some countries had already introduced an inflation-targeting framework, but were unwilling to even publish their forecasts for GDP. For me it was always an important part of the transparency that should accompany inflation targeting. We therefore published GDP and inflation forecasts right from the start when we introduced inflation targeting eleven years ago. And I would say that this, along with the experience we have had since the decision to publish the interest-rate forecast a year ago, has been positive.

Would you say that the public's understanding of the forecasts has improved over time? What has been the central bank's role in communicating with the public and improving understanding?

We have learned how to communicate and explain what we are in fact showing when we publish a forecast and the public has learned how to absorb this form of communication. This is why we had the courage to publish our exchange-rate forecast, which many may view as a risky decision, but I see it as fine tuning of our communications and transparency measures. In the past, although the public knew that we were reluctant to comment much on the exchange rate, we were always asked about this anyway after our rate-setting meetings and public speeches. The more formal process for publishing our forecast makes it easier to communicate our forecast as a complex story about the economy.

In dealing with the crisis, a number of central banks have found lowering interest rates and changing the rules for monetary operations to be rather ineffective in removing tensions in the money markets. Have you had a similar experience and what other tools would you emphasise?

We haven't had such severe problems in the money markets. But in other countries, once the interest rate option has been exhausted, it is natural that quantitative easing follows. And we'll have to wait for some time to see how effective this is. But we are not in this position in the Czech Republic, so I don't want to judge the situation in other countries. We still have ammunition and room for maneuver in terms of monetary policy. If we do get to a situation where the transmission mechanism is only partly functioning, there's only so much you can do. If institutions don't trust each other it is due to wide-ranging problems in the financial markets, but that doesn't mean the central bank should come in and take complete responsibility for the markets, providing blanket guarantees of all transaction. Such a situation would be difficult to exit from. It's one thing to assist a market that isn't functioning perfectly and another thing to replace the market

entirely. Thus far, the mistrust in the Czech banking sector has been quite limited and banks have enough liquidity, so the market for short-term instruments is functioning quite well. We have taken some steps to assure that there is sufficient liquidity. In particular, we offered liquidity against governmental bonds, but it has not been used much, which suggests that banks either have sufficient liquidity or are able to link with their parent institution. We also offer foreign-exchange swaps and it seems that this is enough at the moment.

Are you worried about capital flight, which could perhaps be associated with general perceptions about emerging markets and heightened risk aversion, rather than conditions specific to the Czech Republic?

No, it's not a problem for me or the government. It is not a political problem; if it was the government would not have opened the banks up to foreign ownership. It became apparent in the beginning of the 1990s that although we tried to develop Czech banks, there was not enough capital and know-how here and finally it all ended in foreign hands. This was a ten-year long process and we're comfortable with the present situation. Our banks are almost exclusively owned by foreigners, but mostly they don't operate as branches of foreign parents. They are incorporated here and subject to Czech law and regulation. We are, therefore, confident that we have a framework that doesn't encourage capital flight.

What is your position on whether Europe needs a unified cross-border regulatory authority?

There is lot of debate and discussion about better cross-border cooperation. Of course, we should talk about the balance between national and cross-border authority, but host countries must retain responsibility for the health of their financial institutions and should have the powers required to do this. That is the starting point. But it is also clear that there must be cross-border cooperation and that information must be shared given the increasing importance and size of cross-border financial institutions. So the key is to find the balance. We have cautioned against a big revolution, which could be counterproductive. A sudden jump towards a pan-European regulator is not advisable. I maintain that while effective oversight must be anchored at the domestic level due to the fact that local knowledge will always be superior, it is clear that directives and principles for regulation and supervision can and should be unified. We are currently moving towards such unified regulatory principles, but the degree of discretion at the national level in implementing these remains significant. So one thing that could be done is to possibly reduce discretion at the national level. The same applies to rules – I have sympathy for the industry's complaint that there are 68 regulatory institutions in Europe, all with different reporting rules and standards.

What about unifying regulation within borders?

This goes hand in hand with the issue of cross-border regulation. After all, regulation imposes a cost on financial institutions and we need to think about how we can reduce this cost. Unifying cross-border principles, rules and standards can play its part, and unifying regulation at the national level will too, as the reduction in the number of regulators involved will make communication between firms and supervisors easier and less costly. Similarly, cross-border cooperation and information sharing becomes easier if there are less national regulators around the table. This is an organisational point, but the experience is also very positive in terms of the effectiveness of unified national regulation. Risks do not only spread quickly and easily across borders, but also between different sectors of the domestic financial sector, so it helps if a single regulator can take a holistic view of how the risks are spreading. This is why encouraging national regulatory consolidation, with an appreciation that it will also make the challenge of finding the balance between cross-border and national supervision so much easier, is high on the agenda of the Czech Republic's presidency of the European Union for the first six months of the year.

Jean-Claude Trichet has said that the European Central Bank should have more supervisory powers. What is your opinion of this proposal?

It is certainly one of the options, although we should realise that it could take some time to achieve, because supervision has been taken away from the central bank in many countries. If the ECB were to get this supervisory role, it would be natural for the national central banks within the European System of Central Banks to take the lead at the national level. I would see the European System of Central Banks as being the leading authority. This also means that that you can forget about the Committee of European Banking Supervisors and other coordinating bodies, because you would already have a clearly defined platform. This idea would not require significant organisational changes and is quite close to what President Trichet has proposed.

What is your opinion of current exchange of information between European regulators?

Sometimes it works very well, sometimes not so well. It also varies from national regulator to national regulator, some have a very open attitude and some create complications. But we have moved forward a great deal. I was annoyed by the recent calls from politicians, who said regulators must cooperate internationally and work towards cross-border regulation. We have had Basel since the 1980s. Over the last five years, hundreds of people have worked incredibly hard on the design and implementation of Basel II. Given the politics involved with the regulation of the financial sector, I am concerned that there might be demand for revolutionary changes, when in fact

the improvement in international cooperation has been incredible over the past decade.

What lessons for the Czech Republic stem from the adoption of the euro by Slovakia on 1 January this year?

I view Slovakia's adoption of the euro as a great success. It was even better received by the public than originally expected. There are two crucial differences between the Czech Republic and Slovakia. The first difference is an economic one relating to monetary policy and exchange rate, and the second one is political. Taking the second one first, there was, and still is, a much greater political consensus in Slovakia that the adoption of the euro was a good thing than there is in the Czech Republic. As far as the economic differences are concerned, Slovakia has always taken a different view on the relationship between monetary policy and the exchange rate. Although they also switched to inflation targeting, they did so at a time when they were already in the euro-adoption process and were watching the exchange rate closely. The Slovak authorities were always worried that their economy is even smaller than that of the Czech Republic and that the market for Slovak koruna was even thinner than that for the Czech koruna. Therefore, they were more worried about the volatility of the exchange rate and their ability to cope with it. So even with the adoption of inflation targeting, the emphasis on the exchange rate was always stronger in Slovakia than in the Czech Republic. The case for having a fixed exchange rate was, therefore, stronger and easier to make in the case of Slovakia.

Does the global financial and economic crisis take the Czech Republic closer or further away from adopting euro?

The trouble with the euro debate is that you find qualitative advantages on both sides of the argument, while empirical evidence either way is hard to find and inconclusive. We have always stressed that the monetary-policy regime plays some part in dealing with shocks, but neither independent monetary policy nor a fixed exchange-rate regime can be a panacea. The important thing is to ensure consistency in economic policy over the long term. I have personally argued that it makes sense for the Czech Republic to be part of the euro area when the time comes, with all its pluses and minuses. But if the economic advantages only marginally outweigh the disadvantages, it is clear that the political dimension will be the key to the adoption of the euro. And here the picture is not always black and white either. We are part of a political integration process, where a key consideration is whether we will really have a seat around the decision-making table and will be able to influence the outcome of the meeting. It's clear, therefore, that the political arguments, as with the economic ones, are not always clear-cut. So it really is up to the government to decide about the merits of adopting the euro and to set a date for doing so. □