MONETARY POLICY OF THE CZECH NATIONAL BANK

CZECH NATIONAL BANK

PRINCIPLES, PROCEDURES, INSTRUMENTS

Would you like to know a bit more about the Czech National Bank than what you can find in the newspapers? The following fact sheet will guide you around the world of the CNB. It's a world that may seem unremarkable, but the CNB's work is in many respects crucial to the Czech economy.

Under the Czech Constitution, the CNB's primary objective is to maintain price stability. In addition, the CNB is tasked with maintaining financial stability and seeing to the sound operation of the financial system. Without prejudice to the primary objective, the CNB also aims to support the general economic policies of the Government leading to sustainable economic growth. Price stability is achieved by steering interest rates in the Czech economy so as to maintain inflation at a low and stable level without needlessly slowing, or excessively accelerating, the economic growth rate.

HIGH INFLATION DAMAGES THE ECONOMY

The objective of achieving and maintaining low and stable inflation is based on international experience that high and volatile inflation damages the economy. It causes this damage by creating uncertainty and forcing money holders to focus on short-term projects. Economic growth, meanwhile, is founded primarily on longer-term investment.

High inflation also hampers inflation forecasting and thus introduces various distortions into the economy: it changes the real value of debtors' liabilities to their creditors, creates distortions in the tax system, causes interest rates to be volatile (leading in turn to swings in the inflow and outflow of short-term risk capital and hence to exchange rate fluctuations) and so on. High inflation also erodes the value of savings.

The economic value of low inflation is also demonstrated by the fact that maintaining inflation at low levels is currently the primary objective of central banks in the majority of the advanced nations, including the European Central Bank.

THE CNB IS AN INDEPENDENT AND OPEN INSTITUTION

In the pursuit of its statutory objective, the CNB has a high degree of independence from political influence. Above all, it is independent in making decisions on the settings of monetary policy instruments. Its independence is also reflected in the manner in which its senior officers are elected and dismissed (they are appointed and – under very strict conditions – dismissed by the Czech President).

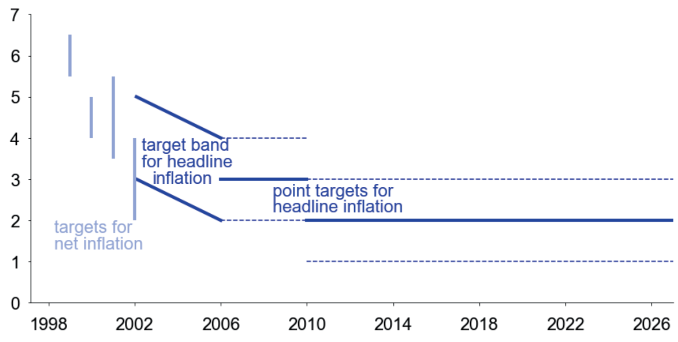
The CNB's independence protects it primarily from any political pressure to adopt measures to boost short-term economic growth, for instance in the run-up to a general election. Such measures would in the longer term cause an undesirable rise in inflation, while growth in economic activity would soon return to its original level, or even fall below it (as a result of the increased inflation).

The CNB's high degree of independence is counterbalanced by openness with respect to disclosure of information. The CNB uses various channels to inform the public about its monetary policy system, its inflation target, its inflation forecasts and the attendant risks, and about its monetary policy measures and its reasons for adopting them. To inform the public, the CNB not only issues quarterly Monetary Policy Reports, which are submitted to the Chamber of Deputies (the lower house of the Czech Parliament) and published on the CNB's website, but also releases minutes of the CNB Bank Board's monetary policy meetings, holds news conferences, publishes articles and gives interviews in the press and other media, arranges presentations and speeches by Bank Board members, and so on.

THE CNB STEERS INFLATION TOWARDS THE OFFICIAL INFLATION TARGET

Since January 1998, the CNB has conducted its monetary policy within an inflation targeting system. Putting it simply, the CNB has undertaken to try to maintain inflation under normal external economic conditions close to an announced inflation target. This system has several advantages over other monetary policy regimes (such as money targeting and exchange rate targeting). First of all, it focuses directly on controlling inflation, a variable that directly affects the decision-making and behaviour of most of us in the areas of consumption, investment and saving, even though we may not realise it. This central bank commitment in the form of an inflation target is well understood by the public and provides an anchor for inflation expectations.

The CNB's inflation targets



MONETARY POLICY NEEDS TO BE FORWARD-LOOKING

Owing to the lag that arises between the implementation of a monetary policy measure and its greatest impact on inflation, the CNB's monetary policy decision-making is guided not by the present situation but by the forecast for the future – rather like someone deciding what to put on when leaving home in the morning not according to the weather outside but according to the forecast for the whole day. By the CNB's estimates, interest rate changes have their greatest impact on inflation some 12 to 18 months further down the line. Consequently, the CNB concentrates on this horizon in its monetary policy deliberations, although of course it also takes into account developments before and after this period.

The forecasts for inflation and the economy as a whole are based on past and present developments, on assumptions regarding several key variables. The forecast is created using a sophisticated model of the workings of the Czech economy. However, it is also significantly affected by the professional discussions and expert opinions of CNB economists.

The prediction model is based on the CNB's knowledge of how strongly – and with what kind of lag – developments in the external environment (such as changes in inflation or economic growth in other countries and world prices of raw materials), price-related administrative decisions made by Czech national and local authorities, and, in particular, changes to the CNB's interest rates, pass through into various areas of the economy and ultimately into inflation. The two most important channels whereby changes to the CNB's rates affect the economy run via client interest rates and via the exchange rate. Client interest rates, i.e. the lending and deposit rates that commercial banks offer to households and firms, move in step with changes in the CNB's rates. Client interest rates in turn affect demand – i.e. how much households consume and firms invest and, conversely, how much both groups save. The exchange rate also usually reacts to changes in the CNB's rates, especially if such changes are sizeable and are perceived as long-term. The exchange rate in turn strongly affects prices of imported goods and hence inflation. With a longer lag it also affects exports and imports, aggregate demand and, again, inflation.

The model also takes on board – in a simplified, model way – the behaviour of the central bank itself which is consistent with its statutory objectives. The overall forecast therefore includes the projected path of interest rates. In its materials for the public, the CNB calls this projection the "interest rate trajectory consistent with the overall forecast". The interest rate projection indicates the central bank interest rate policy that is consistent with the economic outlook and the fulfilment of the 2% inflation target. However, it should not be understood as a binding commitment by the CNB as regards the current and future level of interest rates. The arrival of new information since the forecast was drawn up and different views of the board members of economic developments than those outlined in the CNB forecast mean that the actual interest rate path may deviate from the forecasted path. The same applies to the forecast for the exchange rate of the koruna to the euro. The CNB is the only central bank in the world to publish a forecast for the nominal exchange rate vis-à-vis a specific currency.

WHY IS THE INFLATION TARGET SOMETIMES NOT HIT?

Despite carefully considered monetary policy decisions, inflation can sometimes diverge from the target. This happens mainly when such decisions are based on predictions and assumptions that fail to materialise. Economic forecasting is a very difficult business, and all macroeconomic forecasts – not just those drawn up by the CNB – can turn out to be wide of the mark to a greater or lesser extent. The most frequent – although by no means only – cause of failures of macroeconomic forecasts is a sharp change in the value of some external variable of relevance to Czech inflation. Such variables, which include world prices of raw materials and food, global sentiment (which significantly affects the koruna exchange rate) and external demand for Czech exports, can be predicted with some uncertainty. But they have regular and discernible impacts on Czech inflation, as evidenced by the nation's relatively volatile inflation history. Difficult-to-predict changes to administered prices, fees and indirect taxes also play a major role in determining inflation.

Inflation in the Czech Republic
(annual consumer price inflation)

Imagine that an external shock has caused inflation to move outside the target band over the coming quarters. The CNB could, of course, respond by dramatically changing its monetary policy instruments to force inflation back on target. However, such a response could result in an undesirable destabilisation of the economy. Moreover, we need to consider whether the manifestations of the shock in the first few quarters – known as its first-round effects – are in fact essential changes in relative prices which ought not to be suppressed, i.e. the economic and price system is adjusting to the new situation by means of such changes, meaning that strictly speaking they are not changes in inflation at all.

If such first-round effects are very strong, the official inflation rate can depart from the inflation target band. For these reasons the CNB – like other inflation-targeting central banks – repeatedly tells the public in its publications that there may be situations where it is economically right to accept temporary non-fulfilment of the inflation target. The CNB's monetary policy is focused on suppressing the secondary effects of the shock, which can emerge later as unwanted and genuinely inflationary "echoes" of the primary effects. This was the case in early 2022, when the CNB intentionally did not respond to the first-round price effects of the war in Ukraine, which led to a surge in world prices of energy, raw materials and food.

THE INFLATION FORECAST TAKES SEVERAL WEEKS TO DRAW UP

The key source material for the CNB Bank Board's decisions is the macroeconomic forecast. The forecast is drawn up four times a year by the Monetary Department. It takes a large team of economists about a month to prepare each forecast. At their initial meetings, they identify the core topics and discuss the current position of the domestic economy in the business cycle, domestic economic developments in the near future and the assumptions of the forecast, in particular the outlook for external variables. The forecast for the external environment is based on the CNB's own forecasting models and on market outlooks and forecasts made by foreign analysts. The interpretation of the current state of the economy and the assumptions of the forecast largely determine the message of the forecast. For this reason, the Bank Board is also involved in this discussion.

An important part of the projection is a short-term forecast drawn up on the basis of an analysis of new data using special models and expert judgement. The short-term forecast for the next quarter is then entered into the core prediction model, which is made up of dozens of equations. The equations describe the key relationships in the Czech economy and between the Czech economy and the rest of the world over the medium term. The forecast generated by the core prediction model is again subject to expert debate among economists in the Monetary Department and to other potential expert adjustments. The process of integration of the model-based and expert views of future economic developments is the most demanding and time-consuming part of the forecasting process. At the end of this process we obtain the final version of the baseline scenario of the CNB's macroeconomic forecast.

The baseline scenario of the forecast is the most likely future path of the Czech economy as seen by the Monetary Department's economists on the basis of previous interactions with the Bank Board. One particular interest rate path leading future inflation to stay close to the 2% inflation target is consistent with the baseline scenario. Besides the baseline scenario, the Monetary Department draws up additional scenarios based, among other things, on previous communication with the Bank Board. They capture the main risks and uncertainties of the forecast, offering an alternative view of possible future developments. The baseline and additional scenarios are then presented to the Bank Board at the monetary policy meeting and subsequently to the public in the Monetary Policy Report.

Roughly the same description of the forecast – supplemented with technical passages that are of little interest to external readers – is then given in the Situation Report, which is an internal document intended for the Bank Board's decision-making and which is published six years later.

THE CNB BANK BOARD HOLDS A MONETARY POLICY MEETING EIGHT TIMES A YEAR

The situation in the Czech economy does not usually change fast enough to warrant this very time-consuming forecasting process each and every month. The forecast is thus prepared by the Monetary Department once a quarter, so that important statistical data published quarterly can also be incorporated. The forecast is submitted to the supreme governing body of the CNB, the seven-member Bank Board, in an internal document entitled the Situation Report on Economic and Monetary Developments as a key material for its monetary policy decision making at the beginning of February, May, August and November. With the exception of technical passages that are of little interest to external readers, the Situation Report is identical to the Monetary Policy Report and is published six years later.

The Bank Board, however, holds a meeting eight times a year – at the end of March, June, September and December besides the months mentioned above. In these months, the Situation Report does not contain a new forecast but provides a comparison of the latest key macroeconomic figures with their forecast values, evaluates the situation with respect to the possible future course of inflation, and updates the uncertainties and risks attaching to the most recent forecast.

The monetary policy meeting of the Bank Board usually begins with a presentation and a discussion of the Situation Report, which is always presented to the Bank Board by the Monetary Department several days in advance. The presentation ends with the formulation of the Monetary Department's own recommendation for the Bank Board in the area of the immediate interest rate settings and communication. The Board members are also provided with an opinion on the Situation Report under discussion, drawn up by one of their advisers and the Financial Stability Department.

Once the presentation is over, the members of the Bank Board are free to ask questions. In the final phase of the meeting, the Board goes into closed session to discuss the risks and uncertainties of the current forecast and the overall monetary policy context and to subsequently vote on the monetary policy action. This vote is not necessarily always unanimous and the final decision can differ from the message of the current forecast and from the Monetary Department's recommendation.

The measures adopted are immediately disclosed in a press release and explained and expanded upon at an afternoon news conference, at which the ratio of the votes cast is also released. The press conference is made available to the public on-line on the CNB website. A more detailed account of the discussion leading up to the Bank Board's decision, including names attached to arguments and the votes cast by the individual Bank Board members, is published eight days later in the minutes of the meeting. On the release of the CNB's new quarterly forecast (in February, May, August and November), a forecast of the future development of the key economic variables (headline inflation, monetary policy-relevant inflation, GDP, the CZK/EUR exchange rate and the path of interest rates consistent with the forecast) is also disclosed at the press conference held on the day the decision is made and on the CNB website. The full minutes of the Board meeting and the Situation Report are published six years later.

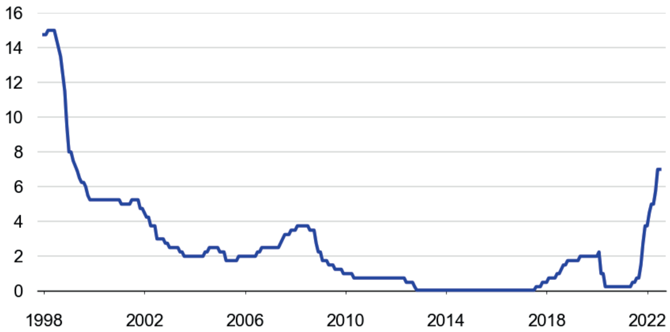
THE CNB EMPLOYS MARKET INSTRUMENTS IN ITS MONETARY POLICYMAKING

To implement its monetary policy decisions the CNB makes use of “indirect”, non-administrative market instruments. In other words, the CNB makes monetary policy not by means of orders, prohibitions, limits and suchlike, but by offering banks business transactions and commercial terms formulated in such a way that those banks in turn offer their partners transactions under terms the CNB views as desirable at that particular moment. Through this basic mechanism, and via the channels described earlier (i.e. via client interest rates, the exchange rate, etc.), the CNB’s monetary policy aims gradually spread through more and more markets and transactions into the entire economy.

The main CNB instrument is the two-week repo rate. Banks have the option of depositing their excess liquidity at the CNB for a two-week period on the basis of repurchase agreements (“repos”) at a rate not exceeding the two-week repo rate. By changing the repo rate, the CNB influences short-term interest rates on the interbank market. This signal then spreads to interest rates throughout the economy, to economic activity and ultimately to inflation.

In some situations the CNB may use other instruments at its disposal. For instance, it may conduct FX interventions to influence the koruna exchange rate and moderate excessive exchange rate volatility. The CNB used FX interventions from November 2013 until April 2017 as part of its exchange rate commitment with the aim of providing the required monetary policy easing in a situation where monetary-policy interest rates had reached “technical zero”.

The CNB’s two-week repo rate



THE CZECH REPUBLIC’S ACCESSION TO THE EURO AREA

On joining the European Union, the Czech Republic undertook to join the euro area, i.e. adopt the single European currency (the euro), in the future. Like the other new EU members, the Czech Republic acquired the status of Member State with a derogation from introducing the euro. For EU Member States, joining the euro area is conditional, among other things, on fulfilling the “Maastricht convergence criteria”. This is a set of requirements applied to assess the extent to which the candidate countries have converged towards the euro area economies.

The CNB is convinced that the Czech Republic should not join the euro area before economic conditions allow for doing so. The Czech economy’s preparedness to adopt the euro is gradually improving. However, some bottlenecks, such as an unfinished process of real economic convergence and low structural similarity of the Czech economy with the euro area, persist.

In addition to the state of the Czech economy, it is essential to assess the economic and institutional situation in the euro area itself. Since the establishment of the euro area, new institutions and regulations have fundamentally changed its form and hence also the content of the euro adoption obligation assumed by the Czech Republic on joining the EU.

CNB CZECH NATIONAL BANK