Press conference of the CNB Bank Board

7th Situation Report on Economic and Monetary Developments

7 November 2013

CZECH NATIONAL BANK

The monetary policy decision and the stance of the CNB

- At the close of the meeting the Board decided unanimously to leave the two-week repo rate unchanged at 0.05%.
- Interest rates will remain at current levels (i.e. at technical zero) over a longer horizon until inflation pressures increase significantly. The existing forecast does not predict such an increase in inflation pressures and no tangible risk in this direction can be identified either.
- The Board also decided to start using the exchange rate as an additional instrument for easing the monetary conditions. The CNB will intervene on the FX market to weaken the koruna so that the exchange rate of the koruna against the euro is close to CZK 27/EUR.

Reasons for the decision within the context of the forecast

- Consistent with the forecast is a significant decline in market interest rates well below zero, followed by a rise in rates above the current levels only at the end of 2014.
- Given the zero lower bound on interest rates, this points to a significant need to ease monetary policy using other instruments.
- An alternative scenario quantifying the use of the exchange rate of the koruna confirms that a sustained weakening of the exchange rate is an effective instrument for accelerating the return of inflation towards the target.

The exchange rate as an additional monetary policy instrument

- So far the CNB has used its standard instruments to ease the monetary conditions. The key monetary policy rate was lowered gradually, reaching the technical zero bound in autumn 2012.
- In order to avoid long-term undershooting of the inflation target and to speed up the return to the situation in which it will be able to use its standard instrument, i.e. interest rates, the CNB has started to use the exchange rate as an additional monetary policy instrument.
- The CNB is resolved to intervene on the FX market in such volumes and for such duration as needed to reach the desired exchange rate level with the aim of hitting its inflation target in the future.

The baseline versus alternative scenario of the forecast

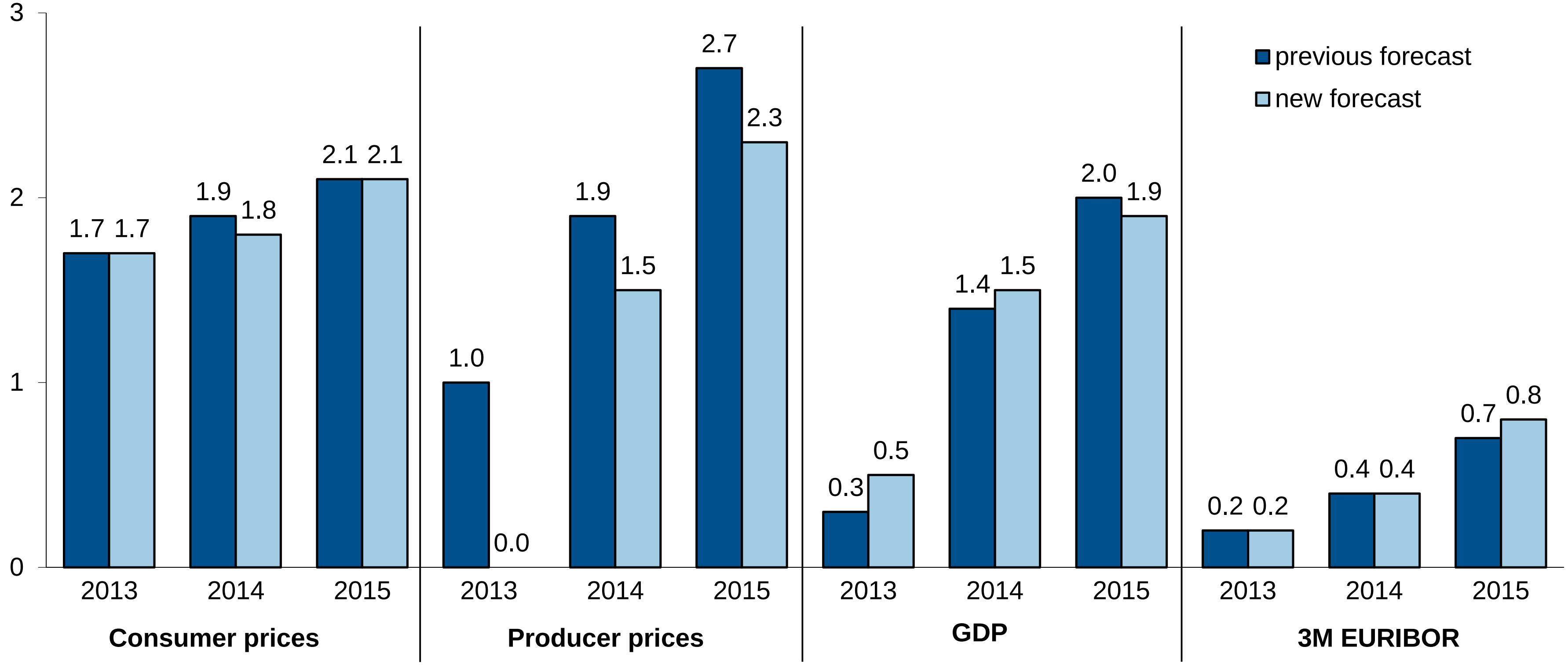
- Consistent with the baseline scenario of the forecast is a decline in market interest rates, which cannot occur in practice, pointing to a need to use a different monetary policy instrument.
- As a result of the Bank Board's decision to start using the exchange rate, the alternative scenario becomes the most probable description of expected future economic developments.
- The following slides describe first the baseline scenario and then the alternative scenario.

The message of the forecast
(baseline scenario with negative rates)

- Food prices and administered prices together with tax changes continue to be the source of current inflation, but their contribution is decreasing. The domestic economy continues to dampen inflation significantly.
- At the beginning of 2014 inflation will fall to zero due to an unwinding of the effects of VAT changes and a drop in administered prices. In the following period inflation will grow again towards the target.
- This year, GDP will drop by 0.9% overall. However, a gradual recovery has already been observed since 2013 Q2. Next year, the economy will grow by 1.5% and the growth will accelerate to 3% in 2015.
- The koruna exchange rate will be broadly flat in the near future. At the longer end of the forecast it will appreciate only very slowly.
- Consistent with the forecast is a significant decline in market interest rates well below zero, followed by a rise in rates above the current levels only at the end of 2014.

The external environment (i)

Comparison between the assumptions of the new and previous forecasts for the effective euro area



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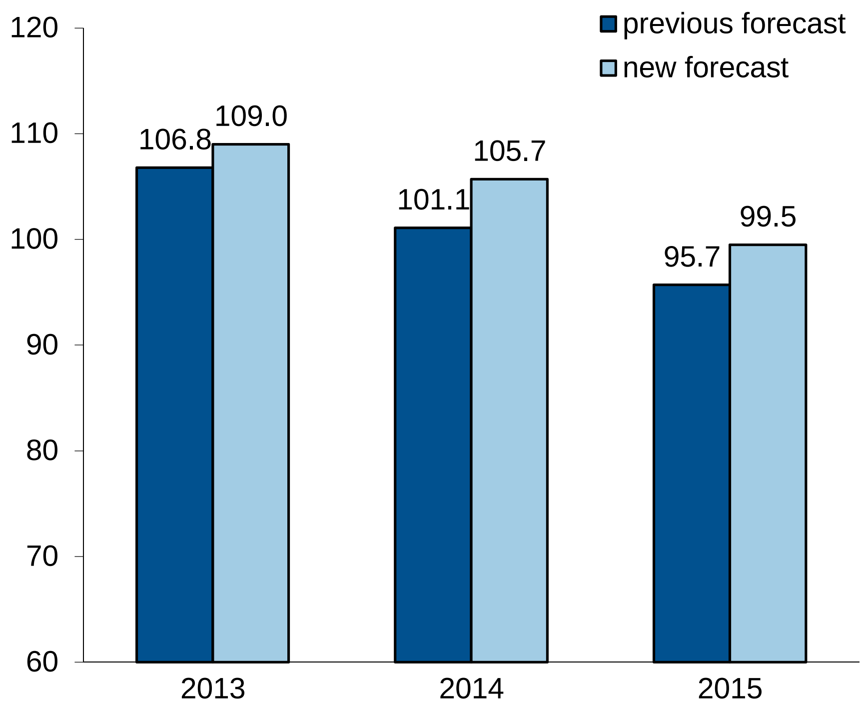
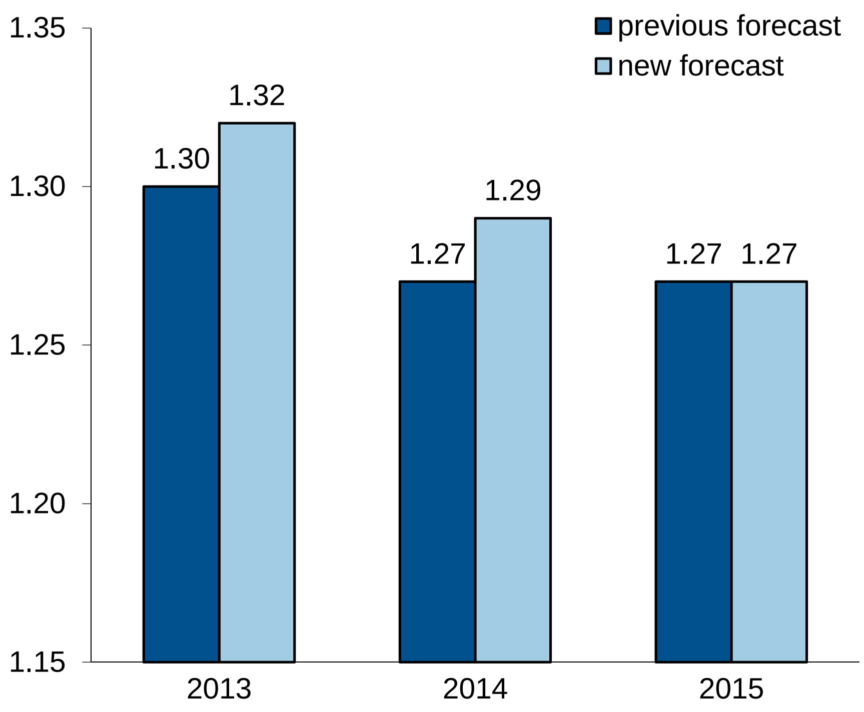
The external environment (ii)

Comparison between the assumptions of the new and previous forecasts



Brent oil (USD/barrel)



USD/EUR

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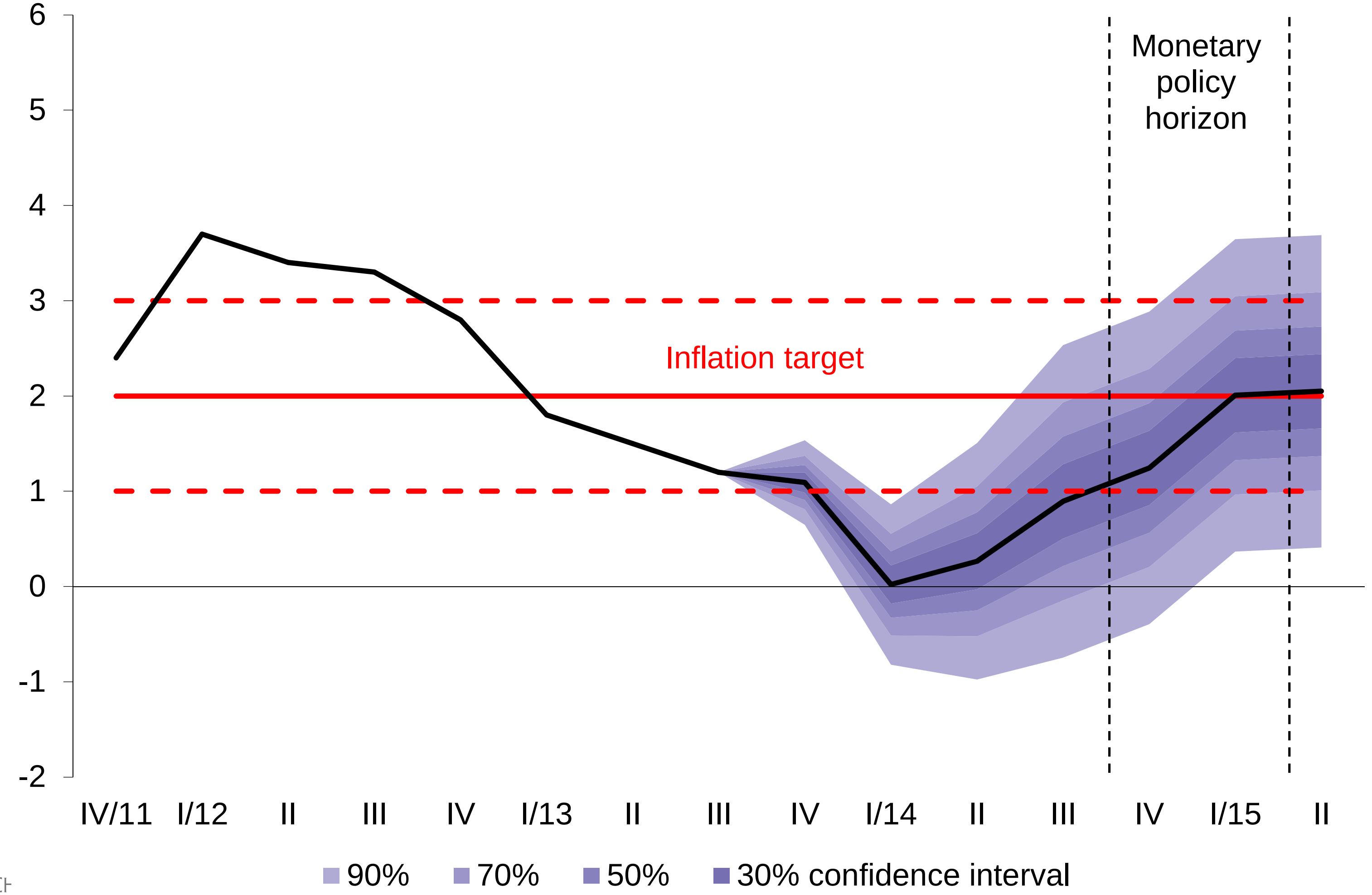
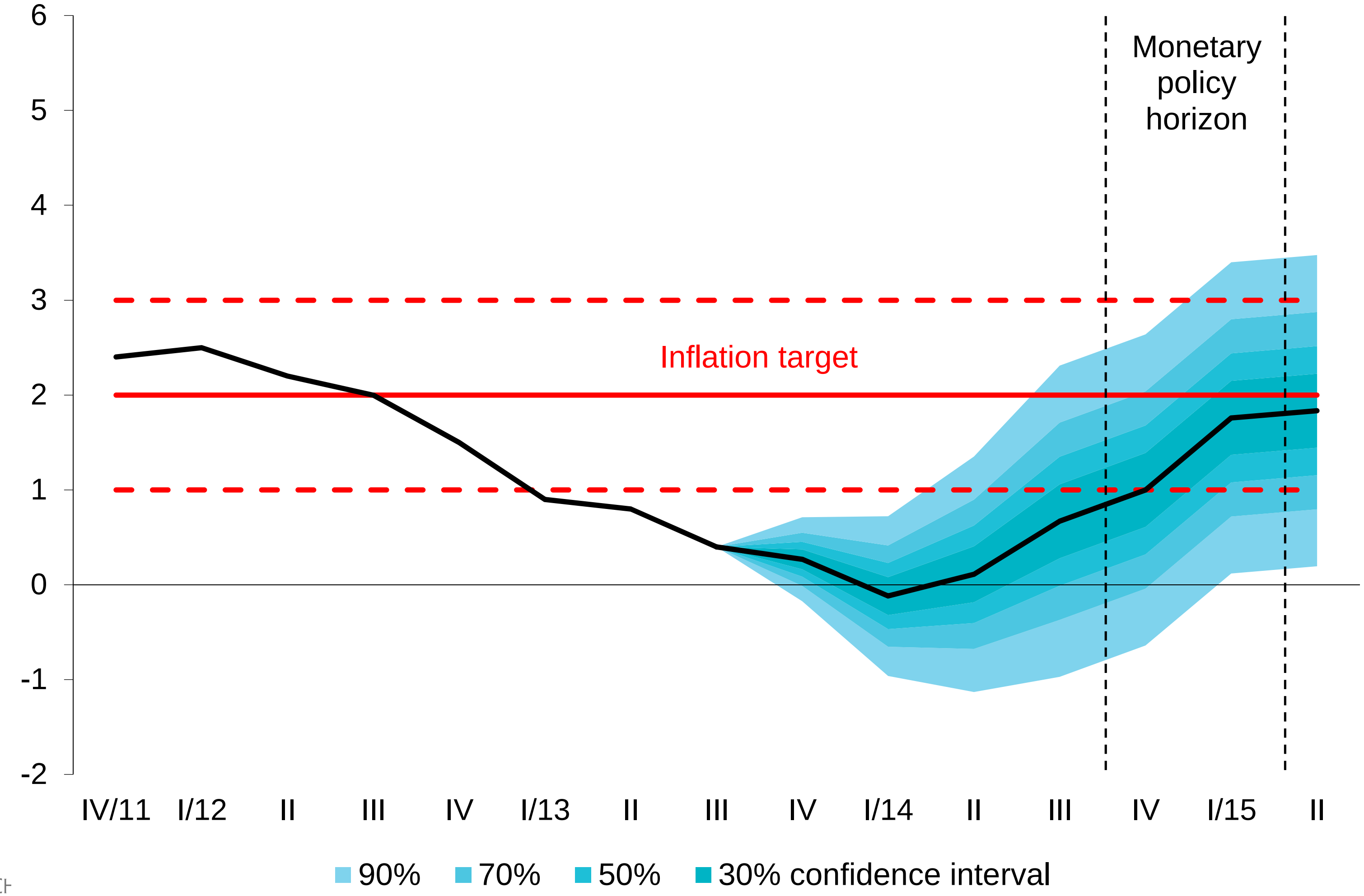
The forecast for headline inflation
(baseline scenario with negative rates)



The forecast for monetary-policy relevant inflation

(baseline scenario with negative rates)



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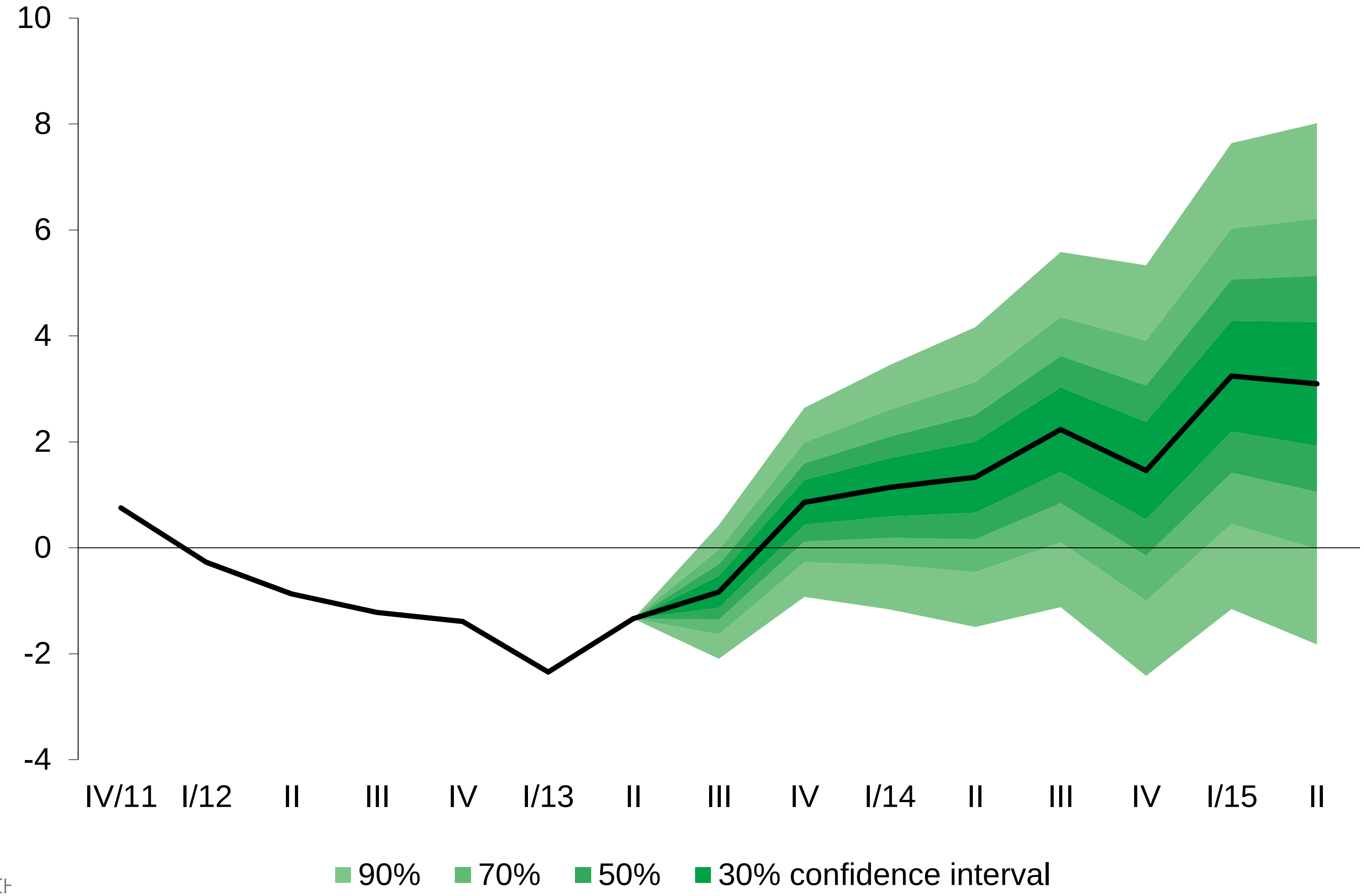
The forecast for GDP
(baseline scenario with negative rates)



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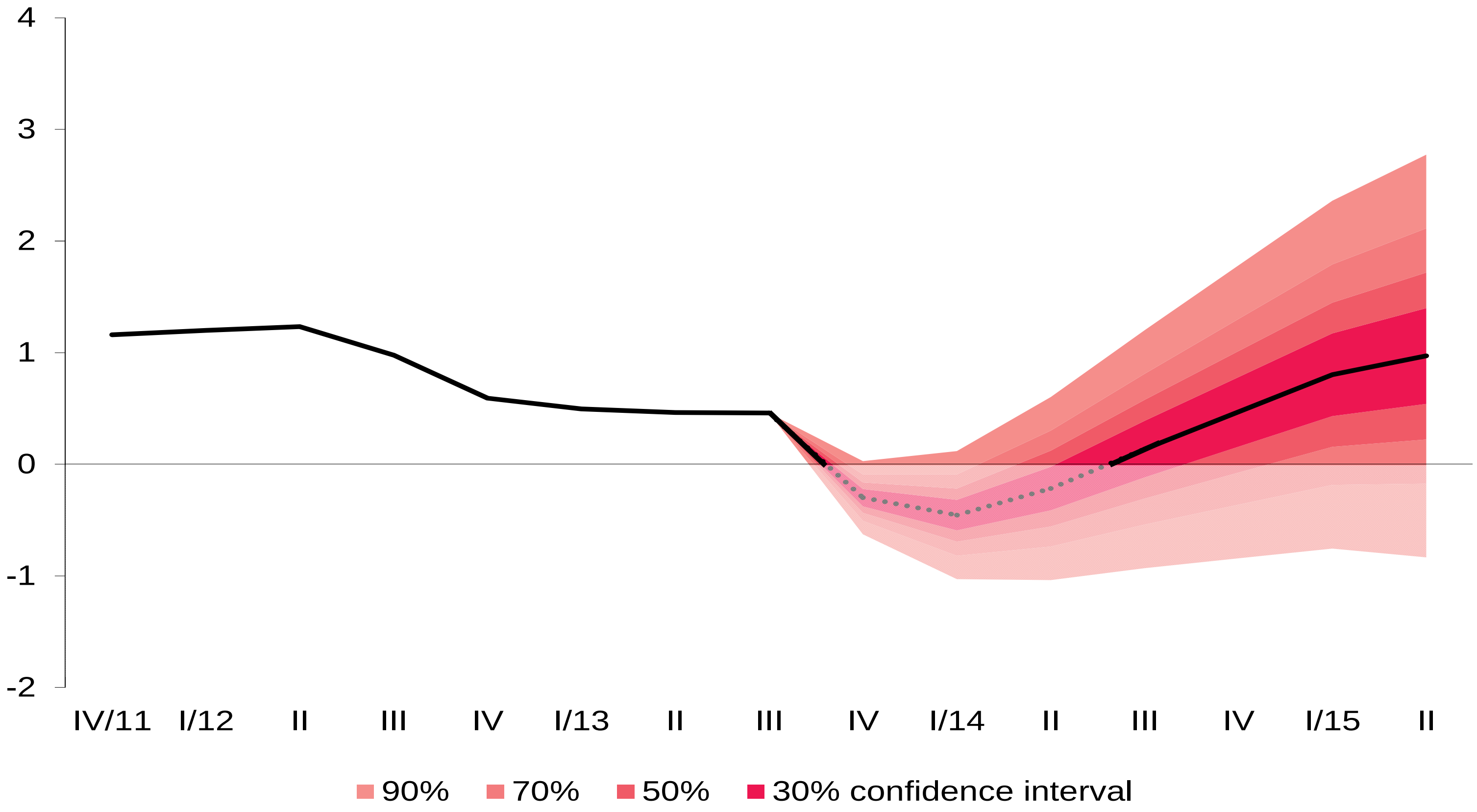
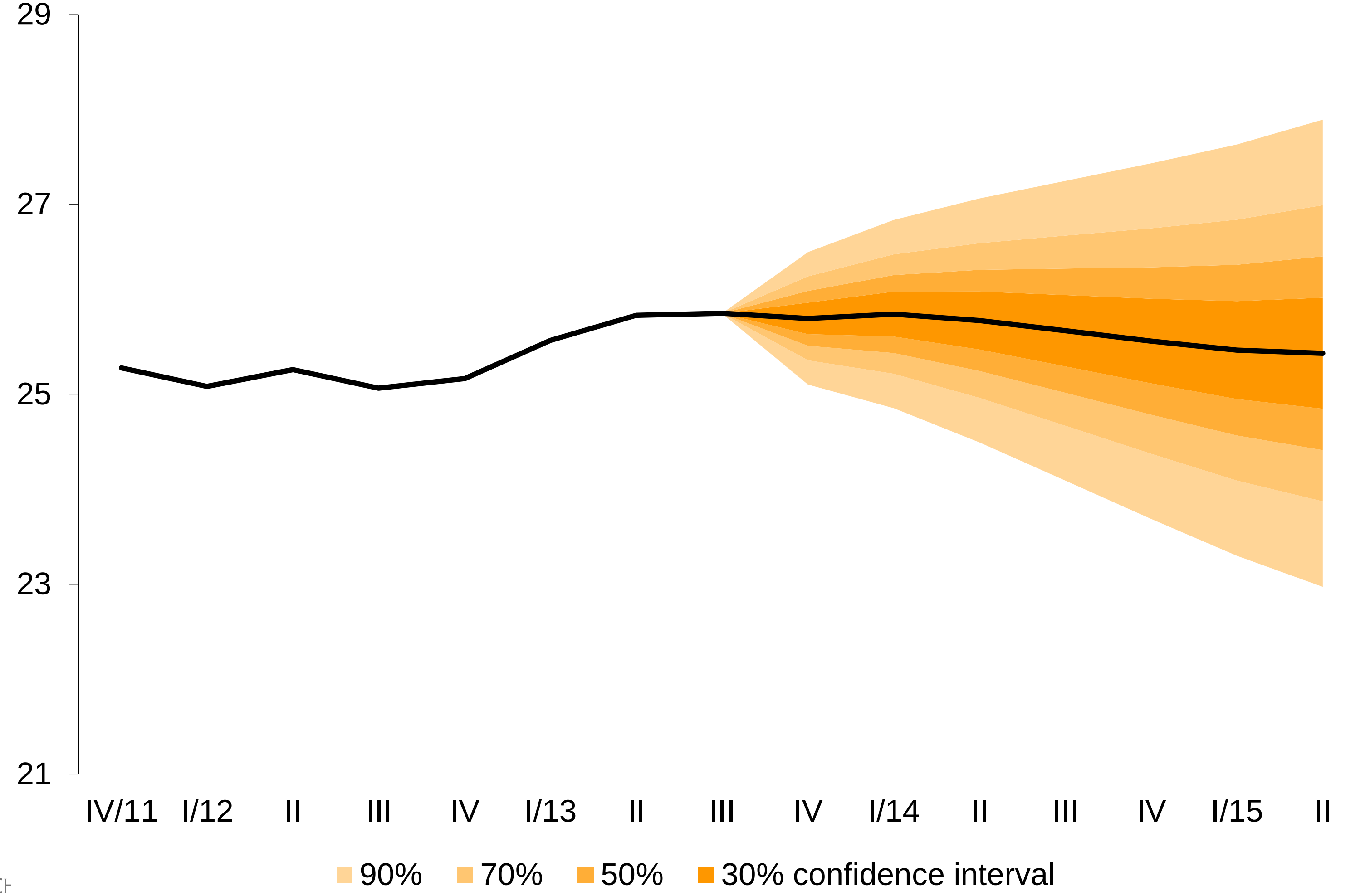
The forecast for interest rates (3M PRIBOR)
(baseline scenario with negative rates)

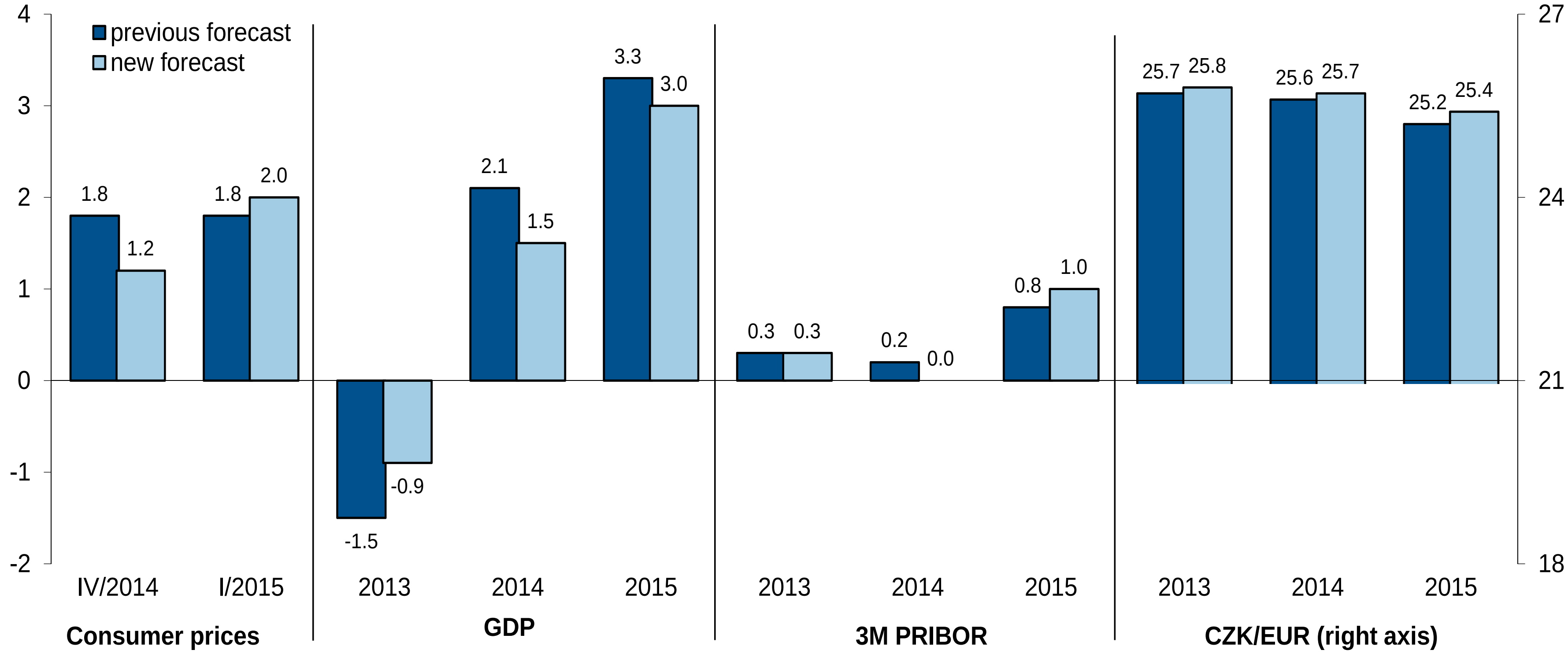


- Market rates turn negative in the forecast for the first time.

The forecast for the CZK/EUR exchange rate (quarterly averages) (baseline scenario with negative rates)



Comparison with the previous forecast
(baseline scenario with negative rates)

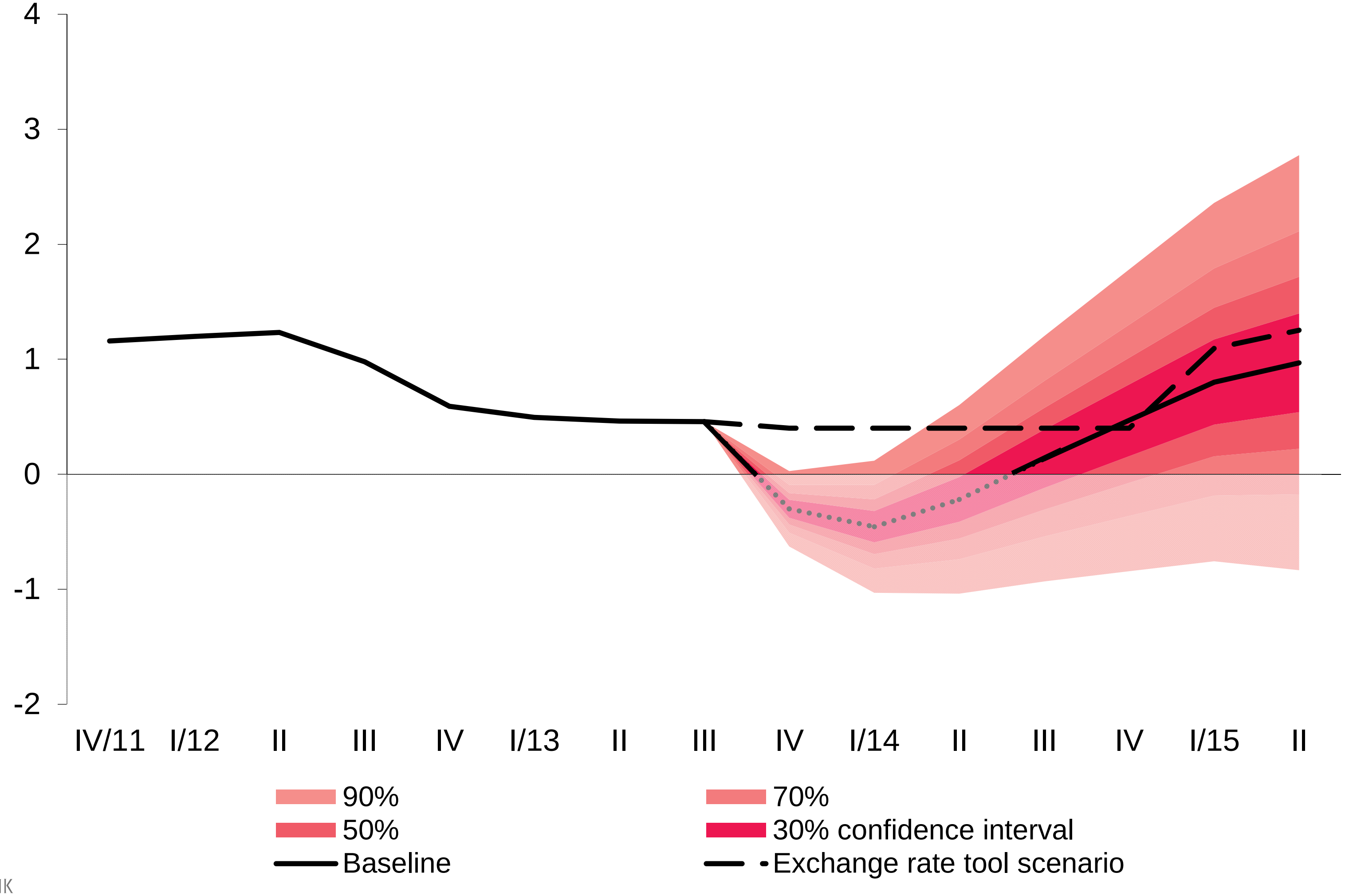


Alternative scenario of using the exchange rate as an additional instrument

- The alternative scenario takes into consideration that room for further lowering of monetary policy interest rates has been exhausted.
- In the alternative scenario, the exchange rate takes over the stabilising role of monetary policy. The CNB will intervene on the foreign exchange market to weaken the koruna so that the exchange rate of the koruna against the euro is close to CZK 27/EUR.
- This facilitates an earlier return of headline and monetary-policy relevant inflation to the 2% target compared to the baseline scenario even with interest rates being at the zero lower bound.
- At a shorter horizon, GDP growth recovers more quickly compared to the baseline scenario.

The forecast for interest rates (3M PRIBOR)

(alternative scenario of using the exchange rate)



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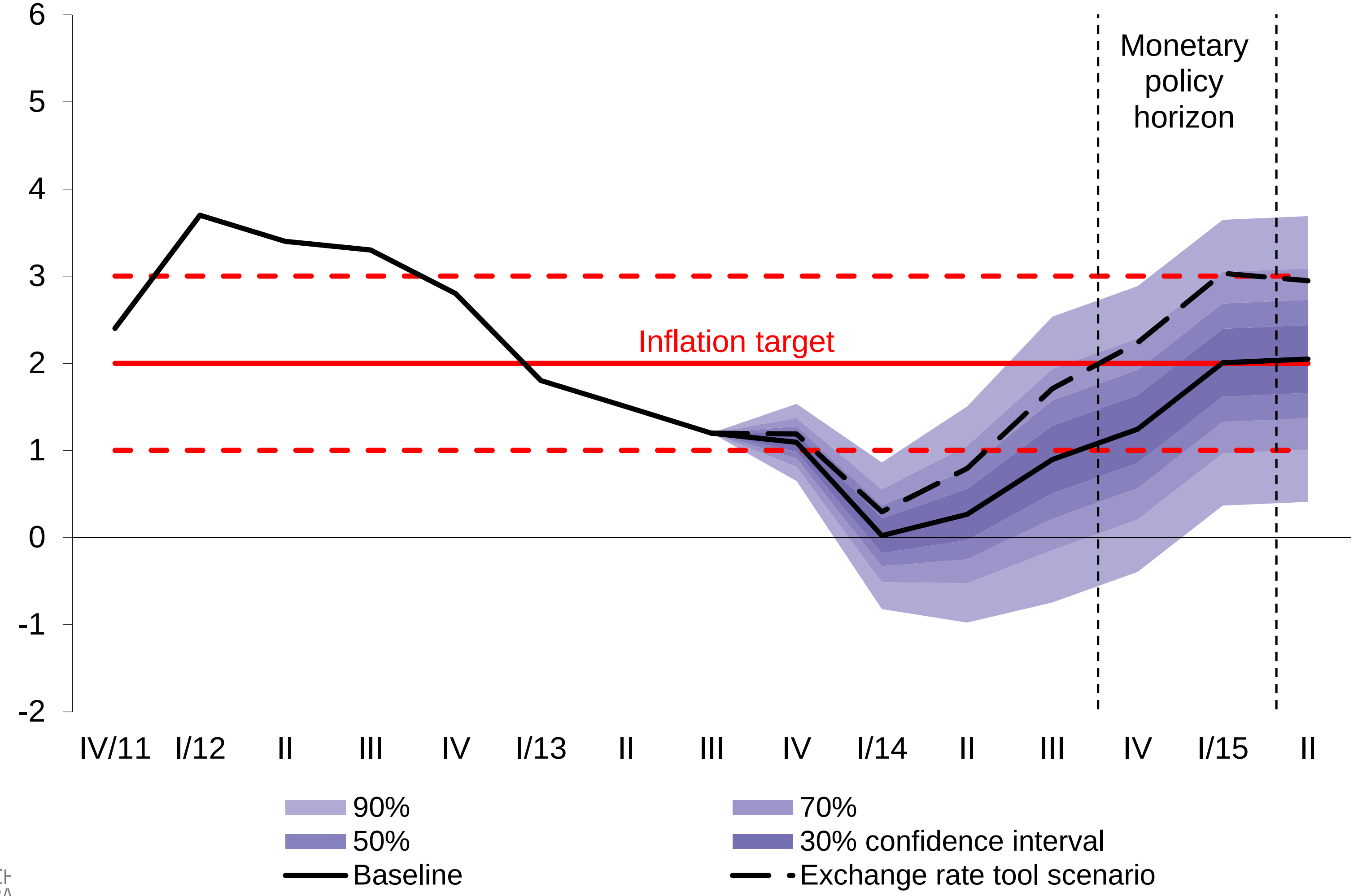
The forecast for headline inflation
(alternative scenario of using the exchange rate)



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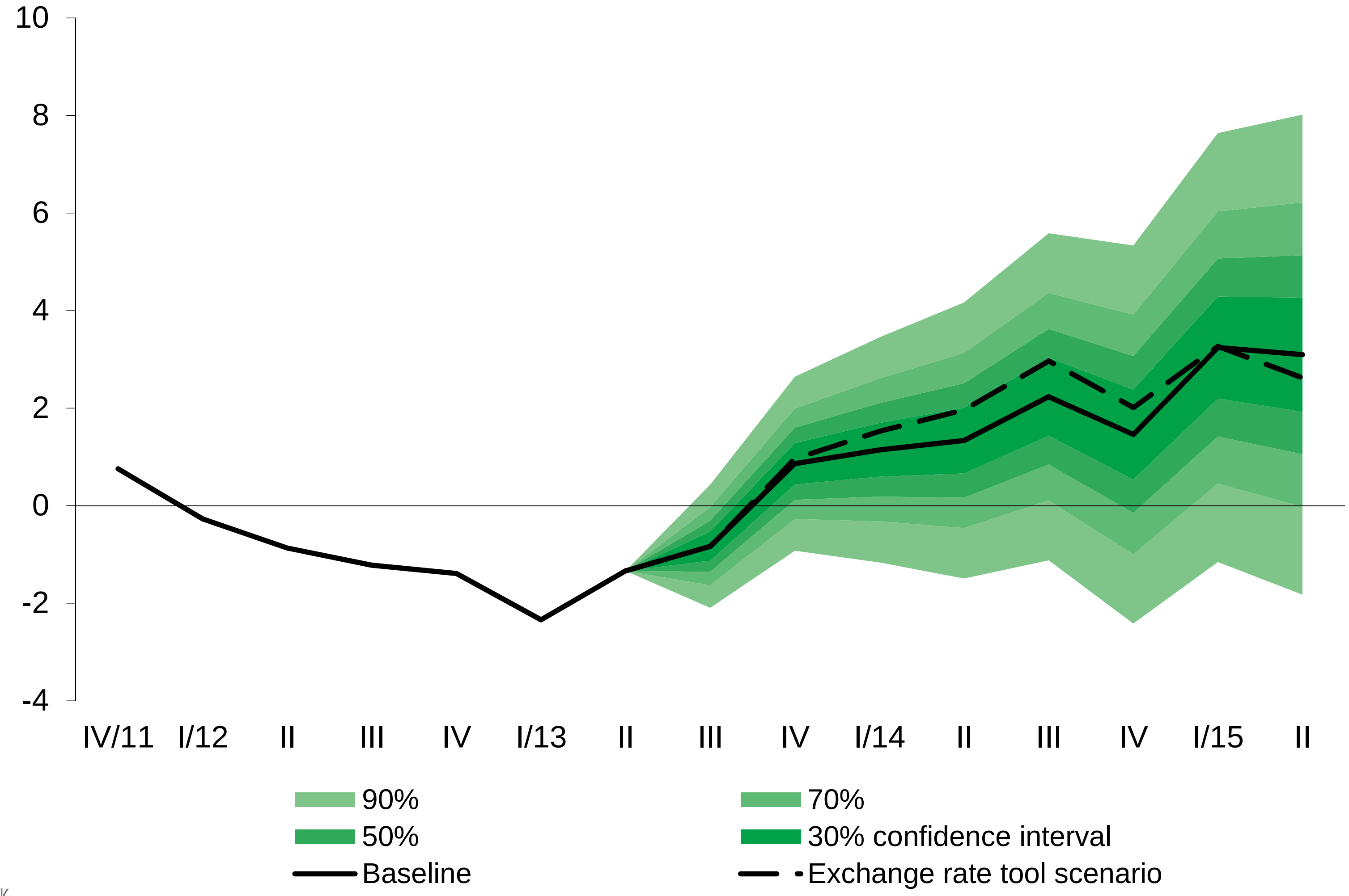
The forecast for GDP
(alternative scenario of using the exchange rate)



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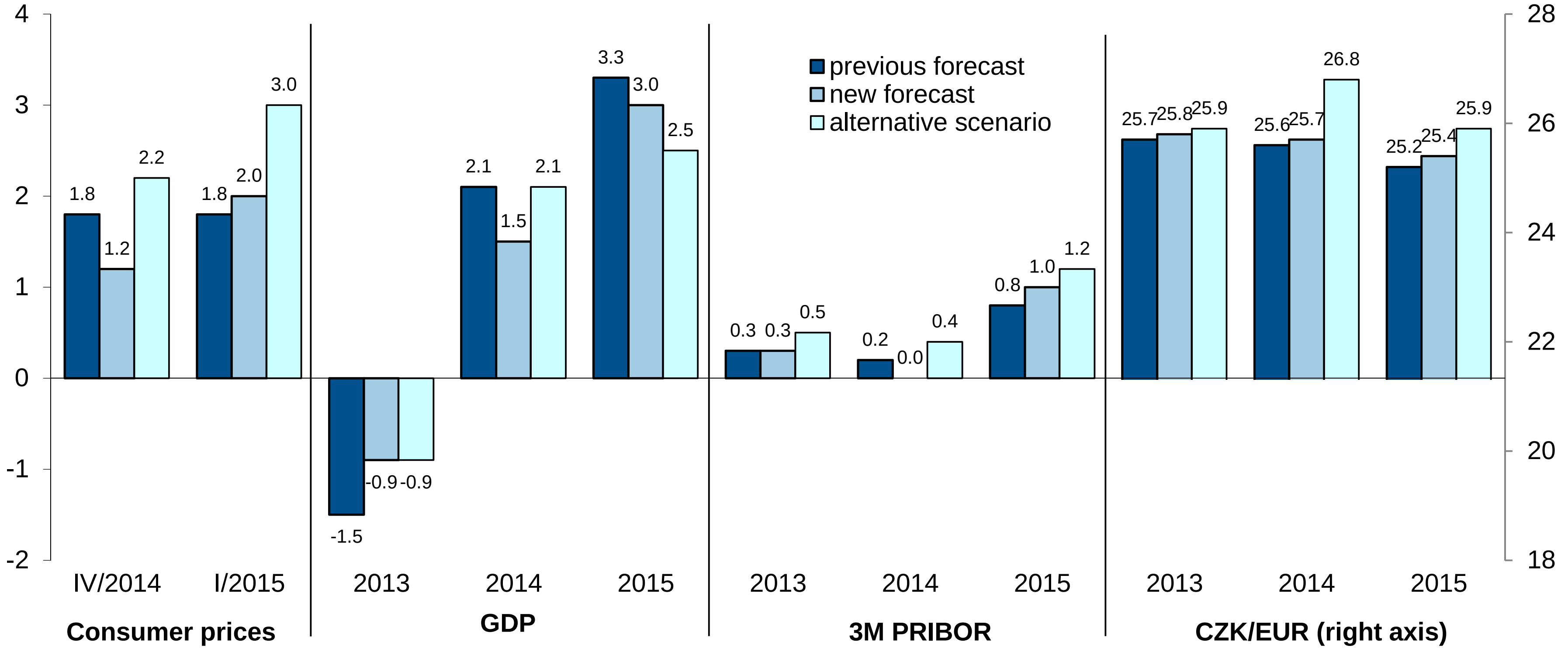
Comparison of the alternative scenario with the baseline scenario and with the previous forecast



Thank you for your attention

More information about the forecast
can be found at

http://www.cnb.cz/en/monetary_policy/forecast/

and in Inflation Report IV/2013,
to be published 15 November 2013.