

## **The Setting of the Inflation Target for 2002–2005**

### **1. The main features of the *CNB Monetary Strategy* document**

At the start of 1998 the CNB switched to inflation targeting. The purpose of this step was to put monetary policy into an effective framework and to provide the economy with an anchor, which, in the form of the exchange rate peg, it had lost in the exchange rate turbulence in May 1997. Over the following years, the inflation targeting regime has been developed and refined. The announcement in April 1999 of the *CNB Monetary Strategy*, setting out the main features of the disinflationary trajectory in the long term, became an important milestone. This document became one of the key starting points of the *Medium-Term Economic Strategy of the Government of the Czech Republic* and of the joint Czech Government–European Commission document *Joint Assessment of the Economic Policy Priorities of the Czech Republic*, which defined the main outlines of the Czech Republic's policy orientation in the run-up to EU accession.

The *CNB Monetary Strategy* contains the objective to achieve sustainable price stability within the 2005 horizon. It also formulates principles for setting the inflation targets between 2000 and 2005. Price stability was specified in terms of annual net inflation within the 1%–3% range. The disinflationary trajectory and the price stability level together create the room required for the correction of distortions in relative prices and the price adjustment linked with the EU convergence process.

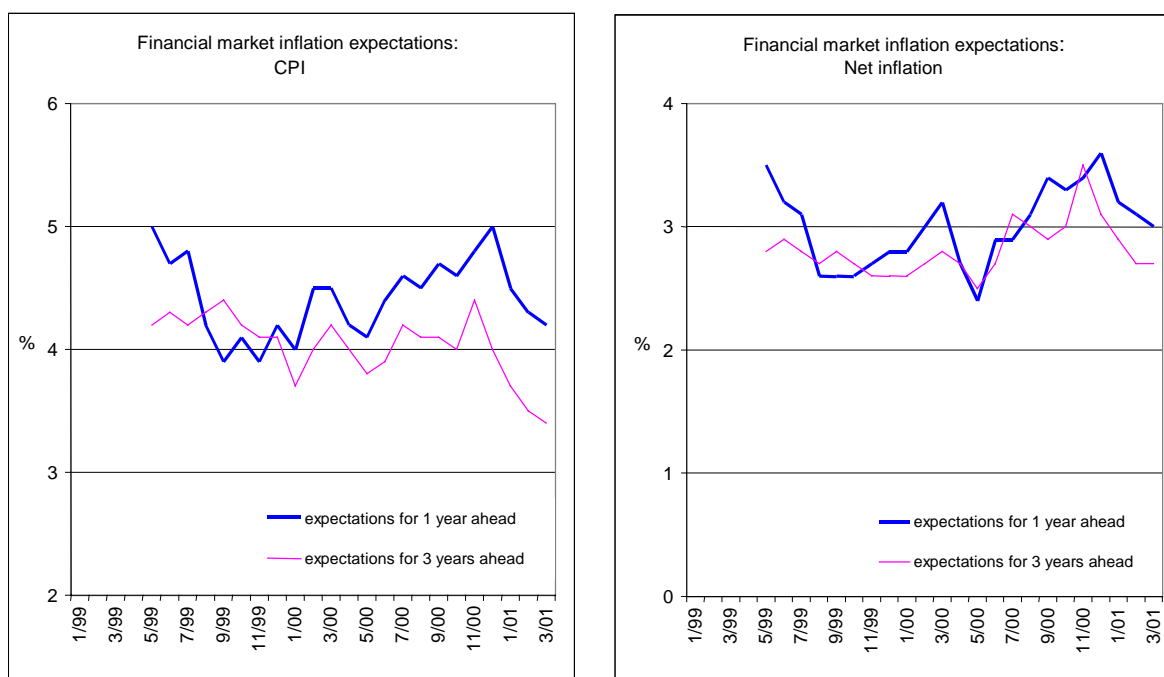
A major element of the *CNB Monetary Strategy* document is the explicit interest of the CNB in announcing inflation targets in co-operation with the Government. This principle is based on the conviction that the inflation targeting regime is the more effective the more it can rely on the co-operation of all relevant economic agents. Uniform and low inflation expectations among economic agents create the prerequisites for minimising the costs of the disinflationary process and for achieving a relatively low interest rate level and sustainable economic growth. The requirement to set the inflation target following consultations, or by agreement, with the Government has been incorporated into the recent amendment to the Act on the CNB.

Following more than three years of experience with the inflation targeting regime, we can say that this regime has heightened the transparency and comprehensibility of monetary policy, strengthened the CNB's credibility both in the Czech Republic and abroad, and, by anchoring inflation expectations, has significantly contributed to the macroeconomic stabilisation of the Czech economy. The strengthening of the low-inflation environment has helped the Government to create the necessary conditions for fast and sustainable economic growth facilitating real convergence towards the EU and further engagement in the European integration process.

### **2. Strengthening the low-inflation environment**

The previous phase of inflation targeting, demarcated by the year 1998 and the medium-term inflation target for 2000, saw a significant decline in the annual price indices and a slowdown

in inflation to a substantially lower level. Despite intense price pressures caused in 2000 by an external price shock and uncertainties about its secondary effects, both inflation and inflation expectations were maintained at a low level (see the chart). During the second half of 2000 and at the start of 2001, headline consumer price inflation moved around 4% and net inflation fluctuated around 3%. The net inflation forecast for the end of this year indicates outturns in the lower half of the inflation target range of 2%–4%. This forecast is not at odds with the Ministry of Finance’s macroeconomic outlook, which also predicts macroeconomic stability and a continuing low-inflation environment.



The stabilised macroeconomic and price trend is creating favourable conditions for continuing restructuring of the business sector, consolidation of the banking sector and rising efficiency of allocation of limited production factors. This is leading to a strengthening of the supply side and growth in the competitiveness of the economy. The low-inflation environment means increased social security for the population.

In the period ahead it is desirable to further strengthen the macroeconomic stability achieved and to maintain the low-inflation trend. These medium-term objectives are reflected in the proposed form and level of the inflation target, which involves a switch to a continuous targeting range starting in January 2002 and which in 2005 will culminate in the long-term objective of price stability as contained in the *CNB Monetary Strategy* document. The setting of a target trajectory for the longer term conforms to the medium-term nature of monetary policy and the practice of the majority of the countries targeting inflation.

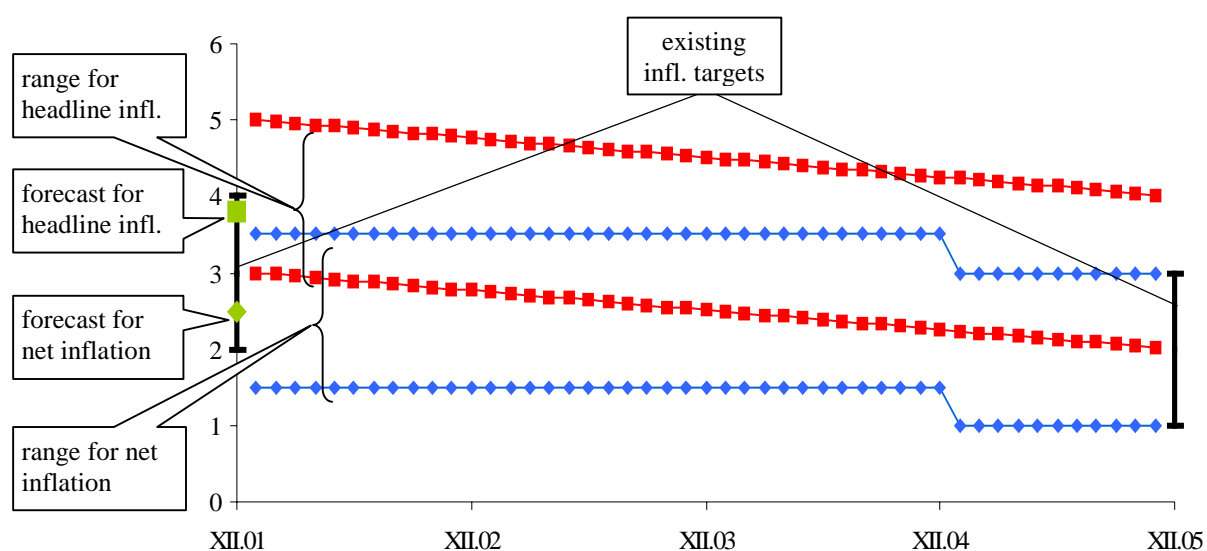
The continuous target range can be set in two ways: for net inflation or for headline inflation. As mentioned above, the *CNB Monetary Strategy* document defined price stability in terms of net inflation, taking into account that the headline inflation outturns would gradually approach the net inflation level in the longer term. The inflation target for 2001 announced in April 2000 was set in terms of net inflation. However, the possibilities of switching to targeting headline inflation, i.e. annual growth in the consumer price index, had been considered as early as last year. Consequently, in parallel with the net inflation target, a corresponding headline inflation figure was announced. The CNB is well aware that this price index is a more comprehensive

indicator of price developments in the economy than is net inflation, and that it is the key indicator for the decision-making of economic agents, particularly households. In comparison with a target defined in terms of net inflation, a headline inflation target is more comprehensible to the public and has greater potential to influence inflation expectations.

However, the switch to targeting headline inflation presents some hazards, the main one being uncertainty over changes in regulated prices and the impact of other administrative measures on inflation. Erratic year-on-year changes in regulated prices or changes differing from the originally announced scenarios may lead to significant price fluctuations in individual years. This uncertainty is heightened by the need to consolidate public finances, which may require one-off administrative measures affecting inflation. The completion of harmonisation of the tax system, particularly in the area of indirect taxes, may have difficult to predict implications for prices. The benefits of switching to targeting headline inflation will thus be felt primarily if the extent and timing of the administrative measures in the price area are easily predictable, if there exist reliable longer-term scenarios for these measures and if these measures are spread evenly over time so as to reduce the risk of one-off price fluctuations. In the event of erratic changes in regulated prices and unforeseen changes in administrative measures affecting inflation, the mechanism of exemptions from hitting the inflation target (known as caveats) would apply.

Were net inflation targeting to continue, the appropriate way to fulfil the *CNB Monetary Strategy* would be to set a horizontal target range reflecting the low level of inflation achieved and approaching the price stability level. This range would be located symmetrically between the existing net inflation target for 2001 (2%–4%) and the long-term net inflation target for 2005 (1%–3%). The corresponding horizontal target would then be 1.5%–3.5% for 2002–2004 and 1%–3% for 2005.

For the above reasons of greater transparency and influencing inflation expectations, the CNB is proposing to set the inflation target up to 2005 in the form of the consumer price index. This involves a descending target range starting in January 2002 at the values which can be expected for headline inflation at end-2001. This range will then gradually drop during 2002–2005 to the headline inflation level consistent with price stability as defined for net inflation in the *CNB Monetary Strategy* document. The target values for headline inflation are thus derived from the trajectory for net inflation described in the *CNB Monetary Strategy* document by incorporating the expected changes in regulated prices and other administrative measures. The proposed range is headline inflation of 3%–5% in January 2002 and 2%–4% in December 2005. This range for the consumer price index corresponds to the aforementioned horizontal range for net inflation. The moderately declining – rather than horizontal – target range is based on the assumption of diminishing changes to regulated prices, which, in addition to net inflation, comprise the other component of headline inflation.



The suggested headline inflation target is in line with the *CNB Monetary Strategy*. It should help stabilise inflation and inflation expectations at a low level and facilitate the transition to the long-term inflation target. The proposed trajectory for the inflation target can meanwhile be expected to leave sufficient room for price adjustment in connection with EU convergence.

Setting the target in the form of a continuous range further increases the transparency of the monetary policy, enhances its continuous character and allows continuous evaluation of price developments.

### **3. Conclusion**

The Czech National Bank, by agreement with the Government, is hereby announcing the inflation target for annual headline consumer price inflation in January 2002–December 2005. The inflation target takes the form of a continuous range descending evenly from 3%–5% in January 2002 to 2%–4% in December 2005. In the event of erratic changes in regulated prices or unforeseen administrative measures affecting inflation, the mechanism of caveats will apply.