

## **THE SETTING OF THE INFLATION TARGET FOR 2001**

Prague  
April 2000

# THE SETTING OF THE INFLATION TARGET FOR 2001

## 1. Introduction

In its “CNB Monetary Strategy” document, the Czech National Bank committed itself to announcing in April each year the inflation target for the end of the following year. In line with this commitment, the end-2001 inflation target was set in April 2000. This target should be understood as a stepping stone in the implementation of the long-term disinflationary strategy which, after achieving basic consensus with the Government, was anchored in the aforementioned “CNB Monetary Strategy”, a document approved and submitted to the public in April 1999. The principles of this document have become an integral part of the “Medium-term Economic Strategy of the Czech Republic” and of the related joint document of the Czech Government and the EU Commission: “Joint Assessment of the Economic Policy Priorities of the Czech Republic”.

The system of inflation targeting has been applied in the Czech economy since the beginning of 1998. The purpose of the switch to this monetary policy regime was to provide the still transforming economy with a new nominal anchor after the exchange rate peg had to be abandoned owing to the currency turbulence. In contrast to the various types of intermediate targets, monetary policy within the inflation targeting regime is focused directly on its core task: achieving price stability. Inflation targeting is based on a multi-criteria approach to decision-making regarding the setting of monetary policy. It has the advantages of greater transparency, the use of a full set of indicators of the future inflation trend, and of effective influencing of the inflation expectations of market participants. In the conditions of a still transforming economy, announcing progress targets on a trajectory towards a low-inflation economy creates the preconditions for minimising the costs of the disinflationary process.

The first phase of inflation targeting between 1998 and 2000 saw a major reduction in price indices. In contrast to the accelerating inflation in the second half of 1997 and at the beginning of 1998, inflation dropped significantly during a relatively short period. The initial two-digit values for overall inflation (consumer price index growth) fell to levels viewed as representing price stability. This trend outpaced the expected course of the disinflationary process as formulated in the end-1998 and end-1999 targets for year-on-year net inflation. This was due to both internal and exogenous factors. Analyses show that a significant part of the deviation of net inflation from the target interval was caused by a unique trend in food prices and by a major fall in the prices of oil and other commodities, i.e. factors lying outside the reach of monetary policy measures and to which the “exceptions” rules apply. These rules justify no immediate monetary policy response to the exogenous shocks mentioned above and no attempt to return price indices to their target values within the one-year horizon. Such a response would be excessively costly from the point of view of the stability and performance of the real economy. The deviation of net inflation from the target was also due in part to subdued domestic demand.

Given the significant role of exogenous factors, the low price index levels do not in themselves justify the conclusion that the characteristics of a low-inflation economy have prevailed. The Czech economy has not yet entirely resolved its structural defects, high transactions costs and lack of flexibility, the overcoming of which is a precondition for sustained price stability. Moreover, it can be expected – and the current trend already confirms – that the positive supply and price shocks from the past period will be corrected in

the opposite direction. On the other hand, the tendency towards increased low-inflation expectations and the gradual convergence of these expectations among economic agents is a positive signal. In contrast to the situation in 1997 and 1998, the CNB's inflation forecasts for 2000 essentially concur not only with the projections of the Ministry of Finance and the Czech Statistical Office, but also with those of the trade unions and with the expectations of markets, analysts and households. Moreover, unlike in the past, the price movements will take place amid an accelerating economic recovery.

In the context of the above factors and conditions, the setting of the 2001 inflation target opens the next phase in the disinflationary process. This phase should culminate in around 2005 with the achieving of a level of price stability that is sustainable and essentially compatible with EU standards. In contrast to the previous phase, when price indices declined considerably, this largely involves maintaining the already low level of inflation and stabilising the overall price trend in the longer term, while allowing sufficient room for continuing the desired adjustment of relative prices. In this connection the importance of setting a justified and credible target for the year 2001 is clear. This target pre-determines not only the orientation of monetary policy for the 2001 horizon itself, but also the conditions for consistency of subsequent progress targets with the requirements for price stabilisation and with the objectives of the CNB Monetary Strategy document.

## **2. Starting points and principles for setting the inflation target for 2001**

The setting of the inflation target for the year 2001 has two basic dimensions:

- a) the system, or regime, dimension,
- b) the actual level of the target, or a quantitative specification.

The principles of the CNB Monetary Strategy document form the basis for both dimensions. In addition, the 2001 inflation target was based on an assessment of the experience from the previous phase of inflation targeting and in particular on inflation projections in the context of the overall macroeconomic outlook and monetary policy objectives.

### **2.1 Principles for setting inflation targets after 2000 in the CNB Monetary Strategy.**

- The setting of inflation targets following the year 2000 will fulfil the strategic objective of implementing a gradual process of disinflation culminating in or around 2005 in conditions of sustainable price stability. This price stability is defined as year-on-year net inflation of  $2\% \pm 1$  percentage point, i.e. somewhat higher than the European Central Bank's definition of year-on-year harmonised consumer price index growth of below 2%. The slope of the disinflation trajectory has been derived from the room required for considerable adjustment of the "inherited" distortions in relative prices. Within the above horizon, the outturns of net inflation and overall inflation will gradually converge. Nevertheless, because of the nontradable nature of most of the goods and services whose prices are still regulated, the trend of a rather higher level of overall inflation relative to net inflation will persist even after 2005.
- The setting of individual progress targets will respect the general principles for the lower and upper limits of the target interval. The defined level of price stability forms the lower limit of this interval. The setting of the target interval will be based on the principle of non-acceleration, i.e. the principle that monetary policy and the inflation target settings

will not generate an acceleration in inflation in comparison with the previous level, allowing for exogenous and temporary influences. In the event of deviations from the progress targets due to significant exogenous shocks, the adopted exceptions will apply.

- The inflation targeting regime is the more effective, the more it can be supported by a co-operative approach to achieving price stability by all the relevant entities, particularly the Government and the Central Bank, but also the trade unions. Such an approach allows the desired mix of government economic policy and central bank monetary policy to be achieved, as well as enabling joint starting points and the expectations of market participants, employers, trade unions and investors to be shared. If their inflation expectations develop in line with the inflation targets, the preconditions are created for minimising the costs accompanying the disinflationary process.

## **2.2 System characteristics of the inflation target for the year 2001**

A fundamental shift in the setting of the inflation target for the year 2001 was the enhanced co-operative approach between the CNB and the Government (represented by the Ministry of Finance). This followed on from the standard co-operation between the two institutions in the previous phase of inflation targeting. Prior to setting and announcing the inflation target, the macroeconomic starting points and forecasts were jointly assessed, consultations with experts held and relevant information exchanged. On this basis, fundamental agreement was reached on assessing inflation and on the approach to setting the target level. This has created the preconditions for boosting the credibility and effectiveness of the inflation target, as well as for forming the desired monetary and fiscal policy mix.

The above trends in developing a co-operative approach between the CNB and the Ministry of Finance have also given the following “regime changes” in the setting of the inflation target for 2001.

- a) A shift from formulating the target in the form of net inflation only towards parallel announcement of a target for the year-on-year consumer price index.

When the inflation targeting regime was introduced at the beginning of 1998, the net inflation index was chosen as the target indicator. This approach was justified primarily by the non-existence of a specified and firm plan for the adjustment of administratively regulated prices or for changes in indirect taxes and fees. The announcement by the Ministry of Finance in February 2000 of a medium-term scenario for changes in regulated prices, taxes and fees (in the form of the “Outlook for Changes in Regulated Prices up to 2002”) has altered the situation and has paved the way for a gradual transition from net inflation targeting to the more standard regime of overall inflation targeting. On this basis, a parallel overall inflation figure corresponding to the net inflation target value can be calculated.

In connection with the above change, starting with the 2001 horizon the inflation target will continue to be set primarily in the form of net inflation, but a corresponding target value in the form of overall inflation (i.e. year-on-year CPI growth) will be derived in parallel. However, the relevance of this target value is conditioned by adherence to the objectives formulated in the Outlook document mentioned above.

This arrangement on the one hand maintains the continuity of the net inflation targets, including their anchoring in the CNB Monetary Strategy, and on the other simultaneously

brings about a shift towards targeting the standard and wider indicator of overall inflation. The public receives information on what overall inflation it can reckon with when the target for net inflation is met. This enhances the influencing of inflation expectations and establishes a base consistent with budget projections and with wage bargaining, thus making the inflation targeting regime more effective. The arrangement at the same time respects the current restrictions hampering full transition towards targeting overall inflation. For many price items, the Outlook document provides only preliminary estimates of the rate of price change, which may undergo various changes depending on updated cost analyses, world price trends, etc. Besides that, it covers the expected trend only until the election year 2002 and does not include prices regulated by municipalities.

#### b) Standardisation of the date for announcing inflation targets and their time horizon

In the first phase of inflation targeting, the medium-term target for end-2000 co-existed with short-term progress targets with a one-year horizon for 1998 and 1999. Starting with the target for 2001, the objective of the CNB Monetary Strategy document to harmonise the horizon for inflation targets and their announcement date with the commencement of work on the macroeconomic framework for the state budget for the following year has been implemented. This creates the preconditions for bringing together the starting points for monetary and fiscal policies in the relevant period. The standardisation of the setting and announcing of inflation targets according to this rule, i.e. in April of the preceding year, involves a lead time of twenty months, which is consistent with the characteristics of the transmission mechanism in the current phase of the Czech economy.

### **2.3 Starting points for setting the level of the 2001 inflation target**

The setting of the inflation target for 2001 was based on an evaluation of price trends in the wider context of the macroeconomic situation and its outlook.

The main determinants in the price area were:

- the actual inflation level: year-on-year net inflation of 2.1% in March 2000;
- the inflation expectations of economic agents: according to the regular CNB survey in March 2000, selected financial market participants expected net inflation of 3.2% in the one-year horizon;
- the inflation forecast for 2001: the interval for year-on-year net inflation for end-2001 is 2.2%–3.9%;
- the inflation target for 2005 according to the CNB Monetary Strategy: year-on-year net inflation of 2% ± 1 percentage point;
- the rules for the lower and upper limits of the target bandwidth, with the proviso that the inflation target will be specified according to the current macroeconomic and monetary outlook for the period in question.

According to the forecasts of both the CNB and the Ministry of Finance, the overall macroeconomic situation will be favourable in the medium-term horizon of 2000–2003. The current recovery phase is expected to develop into economic growth amid maintained macroeconomic stability and only a modest worsening of the external imbalance.

According to CNB estimates, GDP in the above period will fluctuate between 2% and 3% a year on average, with a tendency to accelerate over time. Economic output will be favourably affected by rising external demand and by an improving domestic supply response and greater competitiveness.

On the supply side, the expected sizeable increase in factor productivity will be of major importance, particularly in industry, where it has already started. The determinants of this include in particular the accelerating inflow of productive foreign direct investment, the continuing restructuring of businesses and the modernisation of production capacities, as well as the increased efficiency of financial intermediation as a result of bank privatisation.

The rise in productivity will raise the competitiveness of domestic production, which in turn will boost domestic supply. On the other hand, given the only sluggish pick-up in economic growth and services output, the higher productivity will curb any expansion in labour demand. For this reason, unemployment is expected to remain fairly high.

On the demand side, foreign direct investment will be an important factor in the expected recovery and growth in investment activity. The rise in household consumption, despite being biggest by weight, will probably be quite slow in the medium-term horizon.

These expectations concerning the nature and structure of macroeconomic developments in the medium term indicate that macroeconomic stability should essentially be preserved and that the inflation pressures generated should be relatively subdued.

### **3. Inflation target for 2001**

Based on the assessment and synthesis of the above starting points, the annual net inflation target for the end of 2001 has been set at  $3\% \pm 1$  percentage point.

Taking into account the expected inflation effects of changes in regulated prices and indirect taxes, the mid-point of this target (3%) corresponds to a target level for the mid-point of overall inflation of 5%.<sup>1</sup>

The target interval of  $3\% \pm 1$  percentage point for net inflation in 2001 preserves continuity with the bandwidth of the targets for 2000 and 2005. This interval, i.e. 2.0%–4.0%, corresponds to an interval of 4.3%–5.8% for overall inflation (for reasons of calculation this interval is narrower than  $\pm 1$  percentage point).

The inflation target for 2001 reflects the low inflation level achieved so far and expresses the monetary policy intention to maintain this low level in the next period. The target level is in line with the predictions for inflation factors in 2001 and conforms with the inflation expectations of economic agents. The forecasts also indicate that this inflation target is consistent with the expected favourable characteristics of the Czech macroeconomic environment.

The monetary policy focused on hitting the 2001 target is expected to have an essentially neutral character. This reduces the risk of an acceleration of inflation and of inflation

---

<sup>1</sup> Starting from 2001, the consumer basket will be updated. According to preliminary data, the impact of this change on net inflation will be in the range of several tenths of a percentage point.

expectations in the future period, which might be strengthened by the choice of an excessively easy monetary policy. Such deviation in inflation would again require a restrictive correction in the future, with negative effects in the form of interest rate instability, a renewed increase in inflation and interest rate differentials, and higher volatility of capital flows affecting the exchange rate and overall macroeconomic stability. From the point of view of the national economy it would be extremely inefficient to allow a renewed major increase in price indices and to bear once again the costs accompanying the entire disinflation process.

The stabilisation of inflation at a low level and the corresponding low level of interest rates create preconditions for dynamic economic growth, for stabilisation on the financial markets, including the exchange rate, and for gradual nominal convergence in the process of preparation for membership of the European Union and later also of the Economic and Monetary Union.

The consensus between the CNB and the Ministry of Finance on the 2001 target is a signal that their assessments of future macroeconomic developments in the Czech economy have converged considerably. The Government's support for the 2001 inflation target means that one of the most important principles of the CNB Monetary Strategy document has been fulfilled. It can be expected that the co-operation in setting inflation targets between the CNB and the Government will improve the targets' credibility and effectiveness and at the same time facilitate better co-ordination between central bank monetary policy and government economic policy.