Low inflation and its effects on the economy: the Czech experience

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Some facts about the Czech economy

- In 1993-2017, cumulated real GDP growth was 88% or 2.7% p.a.
- In 2017, GDP per capita at purchasing power parity reached well above 80% of the euro area average
- Rate of unemployment is the lowest in the EU (2.3% in April 2018)
- The level of public debt was 34.6% of GDP in 2017
- Current account of balance of payments has been in surplus since 2014 (1.1% of GDP in 2017)
- Among the EU countries with one of highest levels of social cohesion
- The second biggest car producer per capita in the world (after Slovakia)

Monetary policy contributes to overall macroeconomic developments.
• 2018: 20 years of inflation targeting in the Czech Republic

• First decade (1998-2008): disinflation and inflation stabilisation

• Second decade (since 2009): effects of the financial crisis – unconventional monetary policy and back to normal

• Summary and lessons learned
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• Summary and lessons learned
• Before 1998, CNB’s policy was based on a mix of money targeting and exchange rate peg
• This regime was abandoned in 1997 due to a currency crisis
• The Czech Republic introduced inflation targeting (IT) in 1998 as the first emerging market economy at that time
• Reasons for introducing IT
  – Inconsistency of previous regime with liberalised capital flows
  – Inability of money targeting to anchor inflation expectations
  – Experience of other central banks (RBNZ, BoC, BoE, BoA etc.)
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First decade (1998-2008): disinflation and inflation stabilisation

1998 - 2008

2009 - 2018

headline inflation
net inflation
headline inflation targets
net inflation targets

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- Initial stage (1998-2001): end-of-the-year targets for net inflation
- 2002-2005: a continuous declining corridor for headline inflation; gradual approach

- Inflation rapidly reduced to values observed in developed countries
- However, there were significant temporary deviations from the target due to several (mainly external) shocks
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Second decade (since 2009)

1998 - 2008
- Headline inflation targets
- Net inflation targets

2009 - 2018
- Headline inflation
- Net inflation
Second decade (since 2009): effects of the financial crisis

- Lowering the inflation target as of 2010 by 1 percentage point (to 2% with a tolerance band of +/- 1 p.p.)

- Lowering interest rates in response to the deep recession caused by the global financial and economic crisis (starting to as early as summer 2008)
- Due to a renewed lengthy recession (a consequence of the euro area debt crisis), rates started to near the zero lower bound in 2012
- Introduction of the exchange rate floor at 27 CZK/EUR in November 2013 to avoid a deflation-recession spiral or long-term undershooting of the inflation target
• The FX floor was abandoned on 6 April 2017 as conditions for sustainable fulfilment of the 2% inflation target had been met.

• The exit was smooth, followed by three interest rate hikes in 8/2017, 11/2018 and 2/2018. The Czech koruna appreciated gradually and moderately.
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• Summary and lessons learned
The successful conduct of monetary policy under inflation targeting brought inflation down from high values to the level usual in advanced countries.

Subsequently, this regime was able to cope with the threat of harmful deflation during a lengthy domestic recession thanks to the use of the exchange rate as an additional monetary policy instrument.
Lessons learned (1)

- The process of disinflation takes time and depends on several factors (regulatory prices, tax changes, indexation, cyclicality of fiscal policy,...)

- The long-term benefits of low inflation have to be communicated (as counter-argument to the short-term costs)

- There should be only ONE SINGLE target: no other nominal objectives for the central bank than inflation (no exchange rate or money supply)

- The monetary policy framework has to be well defined
  - for instance publicly announced numerical inflation target
  - strong commitment and ownership by both staff and the Board
Lessons learned (2)

- The central bank has to be professional, transparent, independent, accountable, and therefore credible – ready for unpopular steps in the short run and if necessary ready to use all the means it has to achieve its objective.

- The IT is based on forward-looking monetary policy decisions:
  - credible forecasting tool (modelling)
  - transparent communication (say what you do, do what you say)

- The IT is a never ending process (continuous improvements of forecasting tools and communication; macroprudential issues...).
Thank you for your attention

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