Monetary policy lessons from the financial crisis: The case of the Czech Republic

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Some facts about the Czech economy

- In 1993–2017, cumulative real GDP growth was 88%, or 2.7% p.a.
- In 2017, GDP per capita at purchasing power parity reached well above 80% of euro area average
- Unemployment rate is lowest in EU (2.3% in May 2018)
- Public debt level was 34.6% of GDP in 2017
- Current account has been in surplus since 2014 (1.1% of GDP in 2017)
- Among EU countries with highest levels of social cohesion
- Second biggest car producer per capita in world (behind Slovakia)

**Monetary policy contributes to overall macroeconomic developments**
• Inflation targeting: the Czech monetary policy framework for the last 20 years

• Effects of the financial crisis and unconventional monetary policy

• Back to normal and new challenges

• Conclusions
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• CZ introduced inflation targeting in 1998 – first emerging market economy to do so
• Before 1998, CNB policy was based on mix of money targeting and exchange rate peg (abandoned in 1997 due to currency crisis)
• 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.)
2018: 20 years of inflation targeting (2)
Reasons for the 2% inflation target

- 2% targets since 2010
- Represents best international practice, reflecting:
  - upward measurement biases in CPI inflation;
  - need to maintain buffer above ZLB and deflation risk.
- CNB’s track record and future fulfilment of Maastricht price stability criterion were also taken into account
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Monetary policy challenges after 2008/2009 (1)

- Lowering of interest rates starting in summer 2008
- Due to renewed lengthy recession, rates started approaching zero lower bound in 2012
- Introduction of exchange rate floor at 27 CZK/EUR in November 2013
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The choice of unconventional instrument

- First round of contingency planning took place already in 2009
- Debate intensified and became more specific in 2012
- CNB discussed full menu of available options; choice reflected specific Czech conditions:
  - **Forward guidance**: used from November 2012 (“Rates will remain at zero level over a longer horizon until inflation pressures increase significantly.”)
  - **Negative rates**: besides general doubts, there were legal issues in CZ related to penalty interest rates.
  - **QE**: banking sector saturated with liquidity; LT Czech govt bond yields already low; shallow private bond markets (and absence of visible market disruptions in 2012–2013).
  - **Helicopter drop of money**: discussed as theoretical concept, but infeasible in practice.
  - **FX interventions/exchange rate**: seen as clearly most effective tool in small open economy with no FX balance sheet mismatches.
Outline

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• FX floor was abandoned on 6 April 2017, as conditions for sustainable fulfilment of 2% inflation target had been met

• Exit was smooth and was followed by four interest rate hikes in 8/2017, 11/2017, 2/2018 and 6/2018. Czech koruna appreciated gradually and moderately.
Monetary policy is primarily focused on price stability, using interest rate instrument (more weight on residential real estate prices as part of CPI inflation)

Macroprudential policy focuses on financial stability
Rise in CCyB rate to 1.5% with effect from July 2019 is based on assessment of position of economy in financial cycle and of banking sector vulnerability indicators.

Eight European countries have set non-zero CCyB rates; in five non-zero rate is in effect and five have announced rise (including CZ).
• Upper LTV limit of 80%; max. 15% of loans for LTV of 80%–90%; no loans for LTV above 90%

• New recommendation as of 1 October 2018:
  • upper DTI limit of 9 times applicant’s net annual income,
  • upper DSTI limit of 45% of applicant’s net income.
  • warning to banks regarding risky DTI (>8) and DSTI (>40%) levels remains in effect.

Source: CNB

Note: Net new loans also include increases in existing loans.
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Conclusions

• Three periods of monetary policy easing since 2008, including unconventional measure (FX commitment)

• Since April 2017 return to normal: four interest rate hikes since then (inflation on target since end of 2016)

• IT continues to be effective monetary policy framework

• Key dilemma: interplay between monetary policy and financial stability: interest rates for inflation targeting, macroprudential measures for financial stability
Thank you for your attention

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