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

Marek Mora
Board Member
Czech National Bank

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Some facts about the Czech economy

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- 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

Outline

- 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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2018: 20 years of inflation targeting (1)

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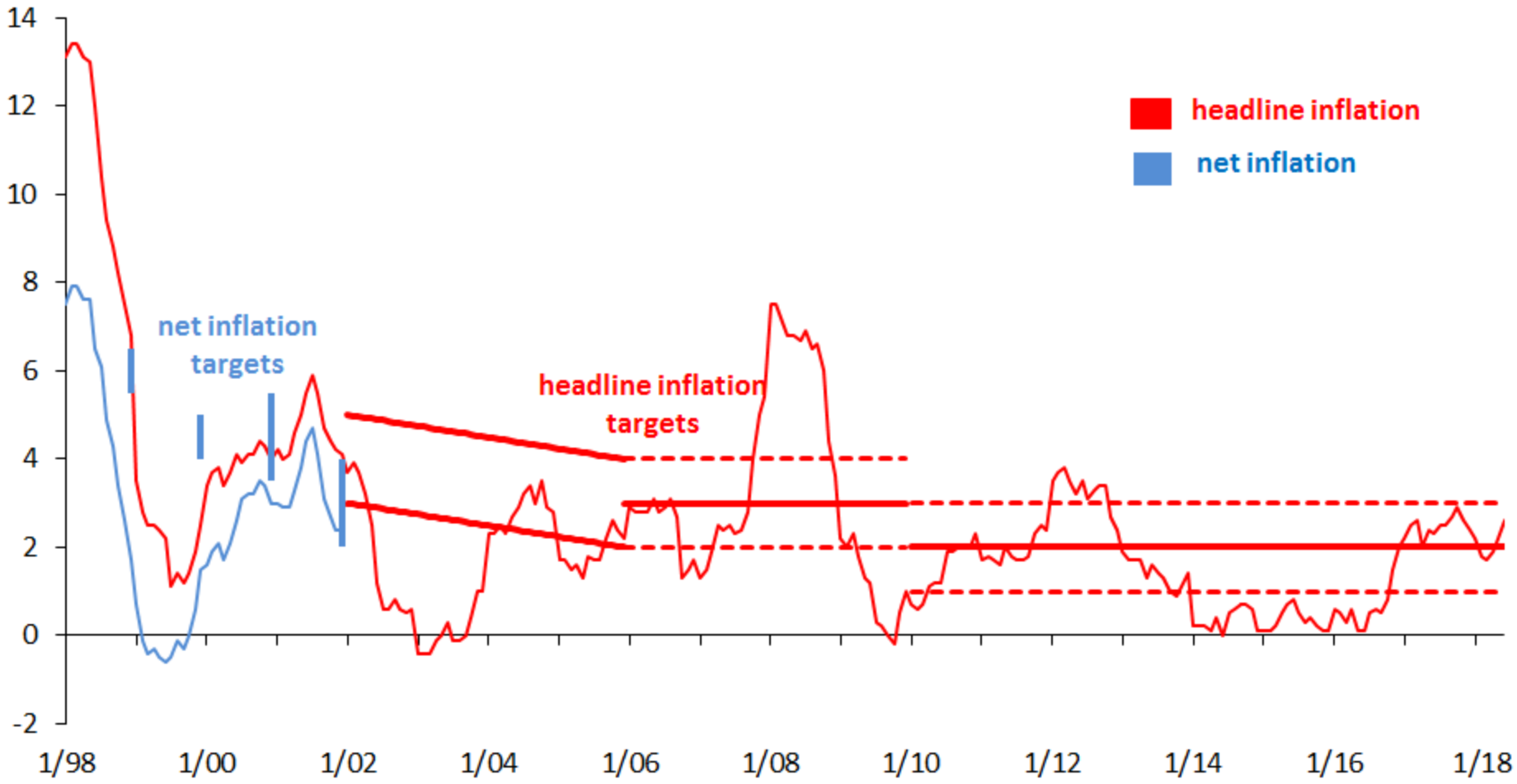
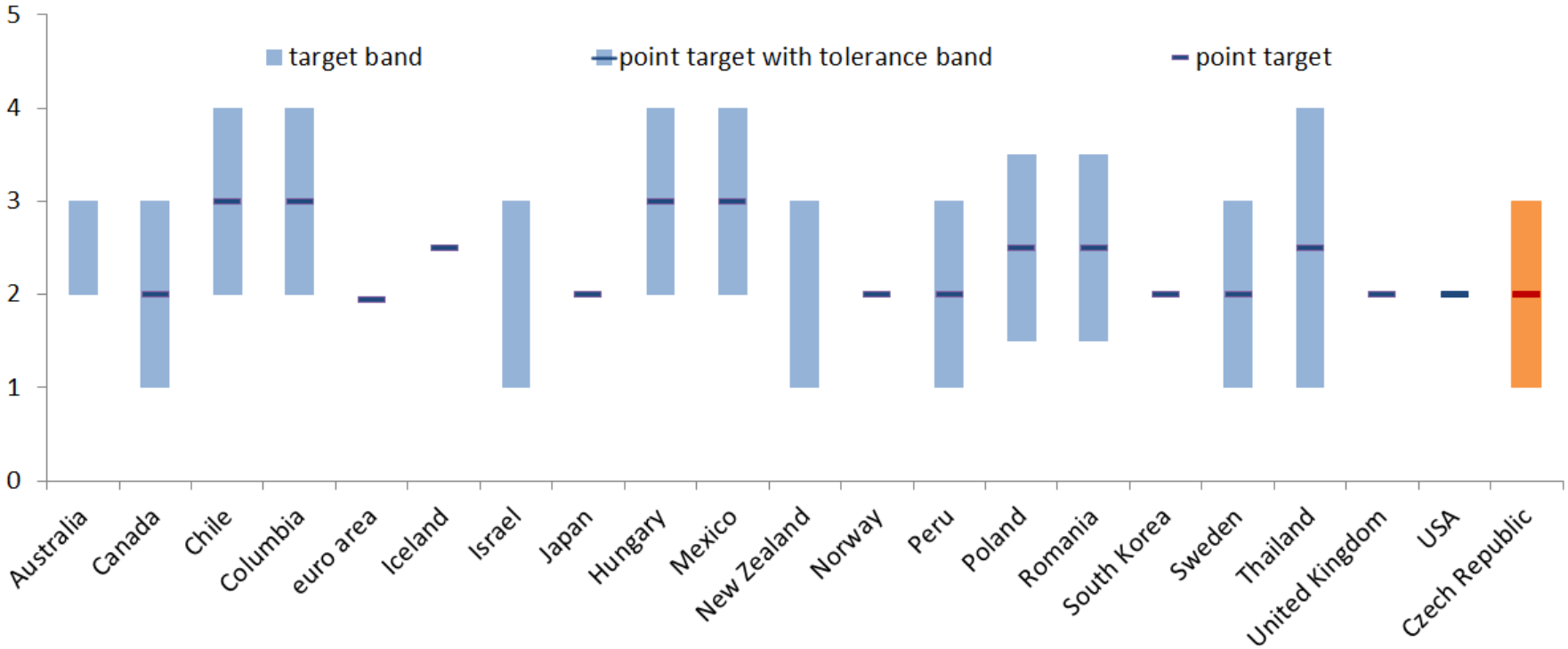
- CZ introduced inflation targeting in 1998 – first emerging market economy to do so
- Before 1998, CNB policy was based on mix of money targeting and exchange rate peg (abandoned in 1997 due to currency crisis)
- Reasons for introducing IT
  - Inconsistency of previous regime with liberalised capital 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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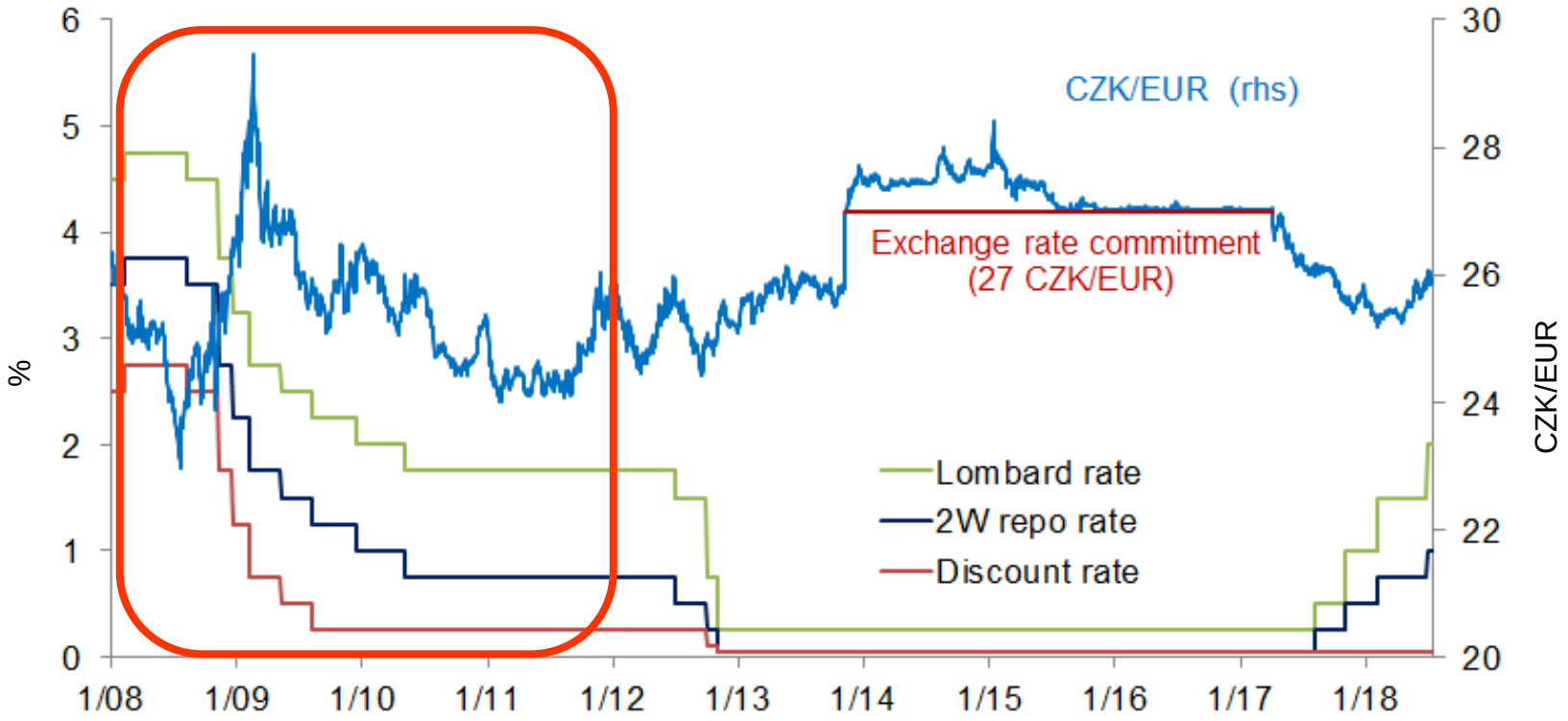
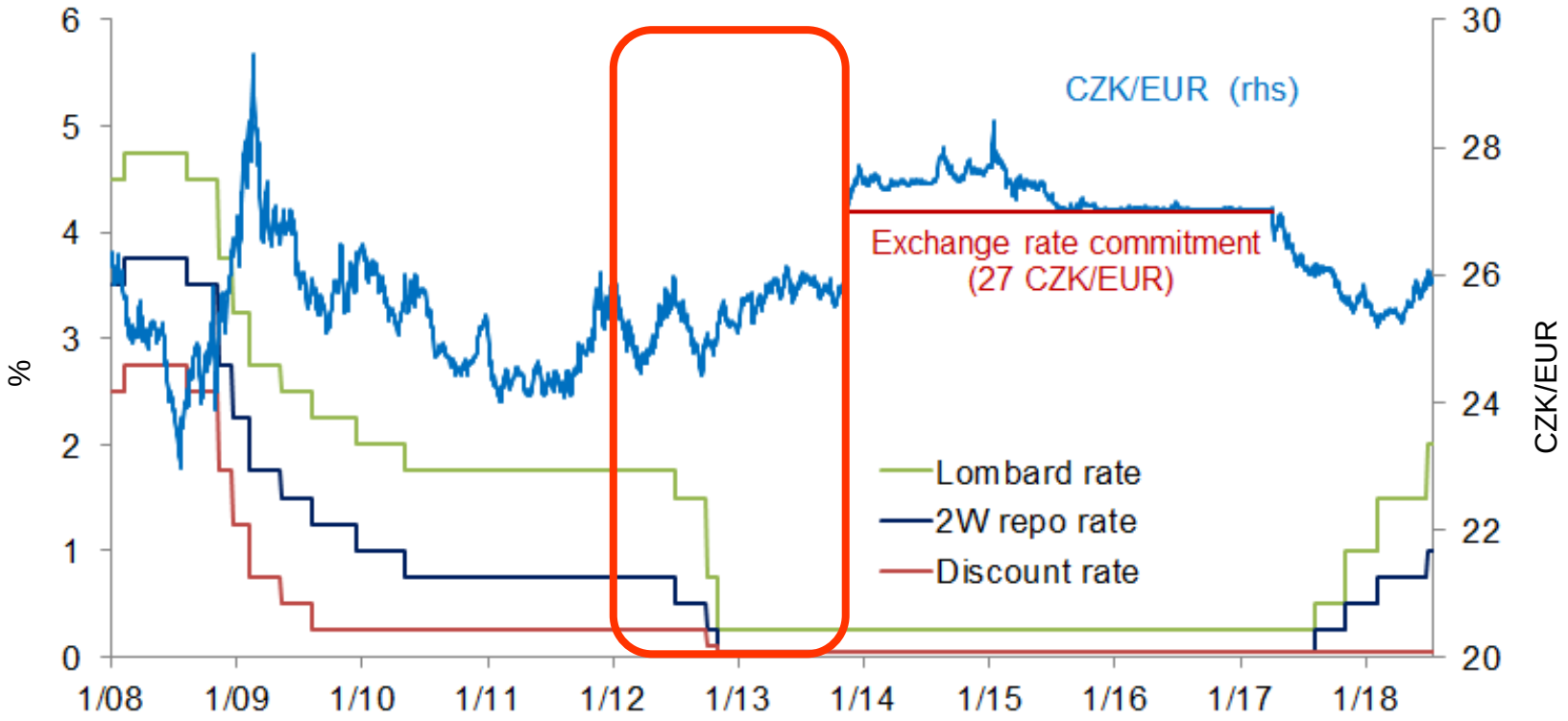
Monetary policy challenges after 2008/2009 (1)



- 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

Monetary policy challenges after 2008/2009 (2)



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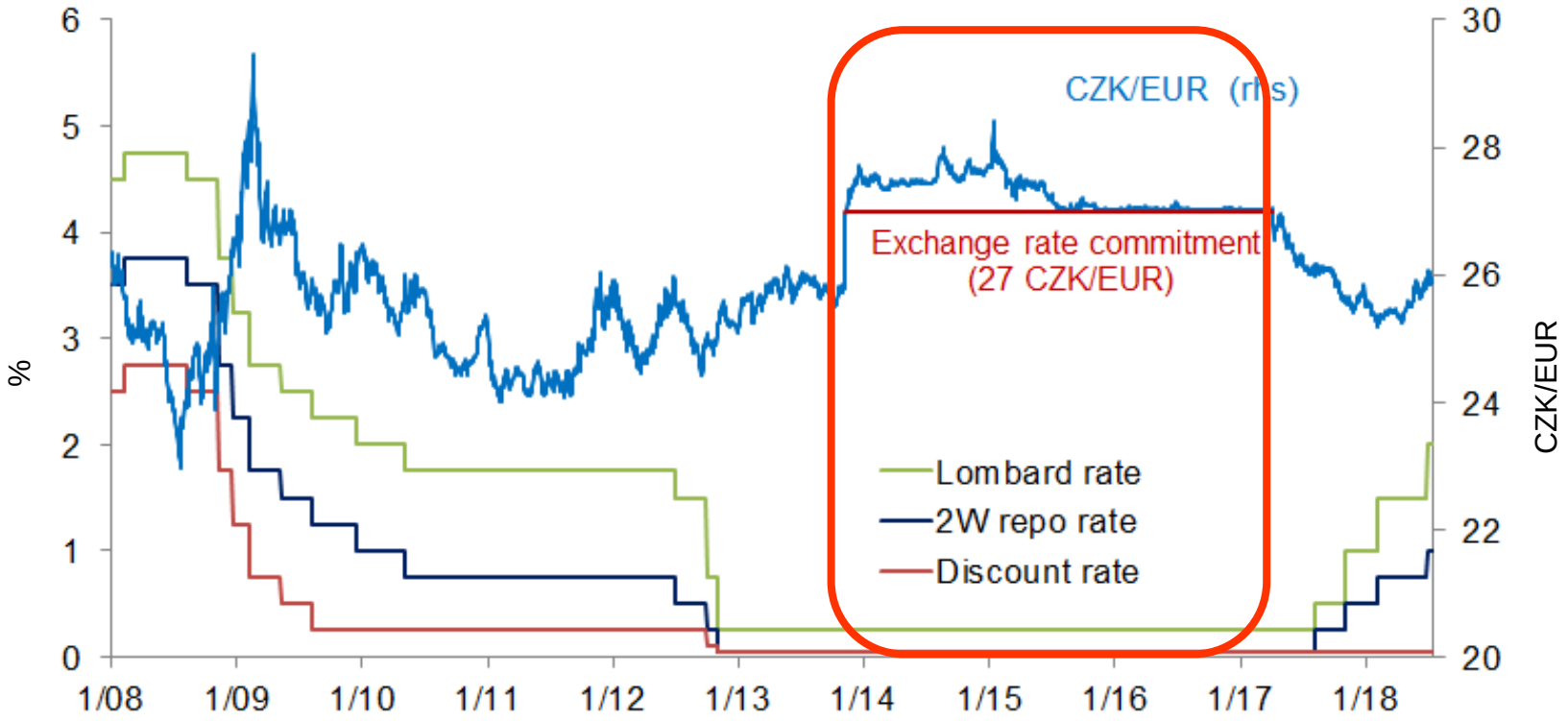
Monetary policy challenges after 2008/2009 (3)



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The choice of unconventional instrument

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- 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.

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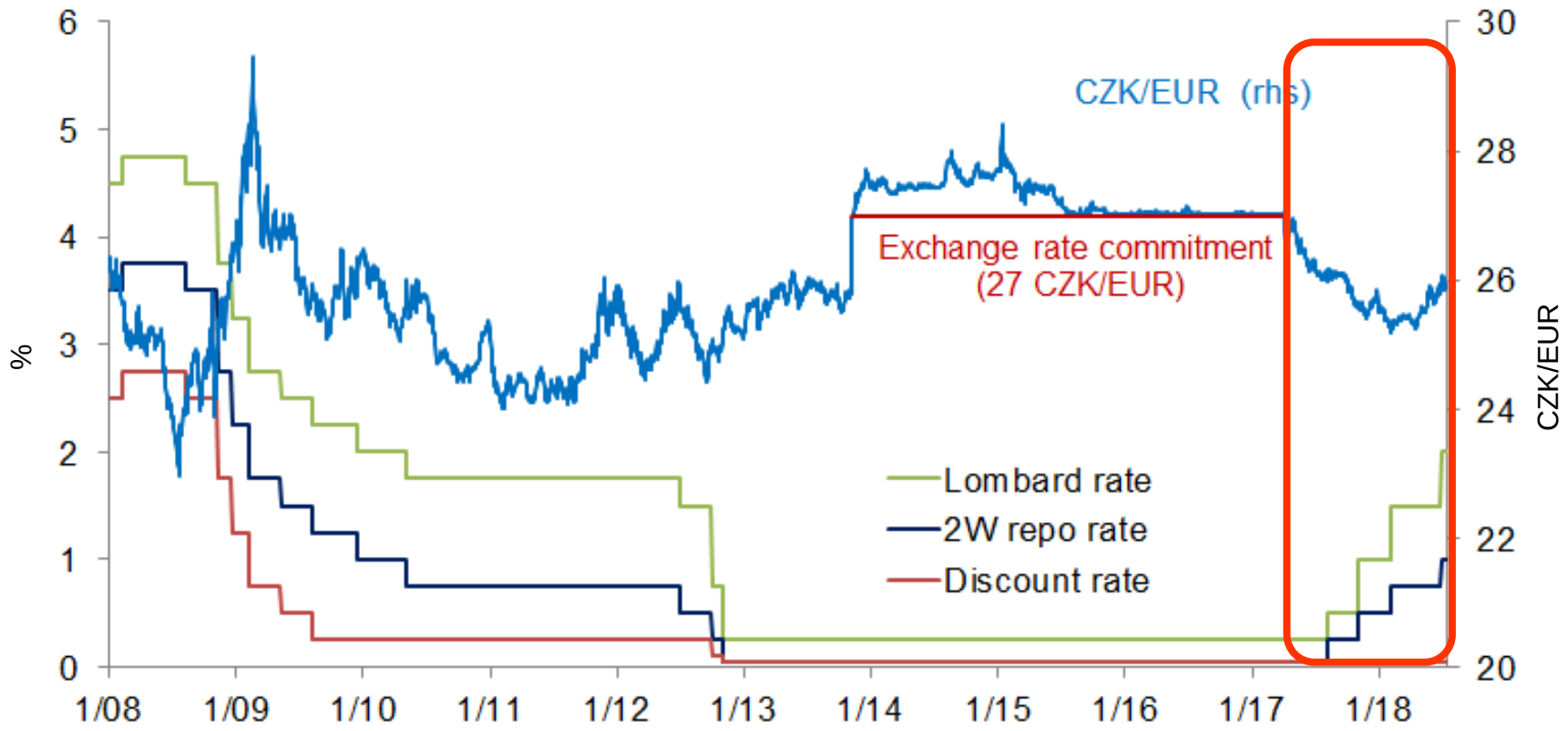
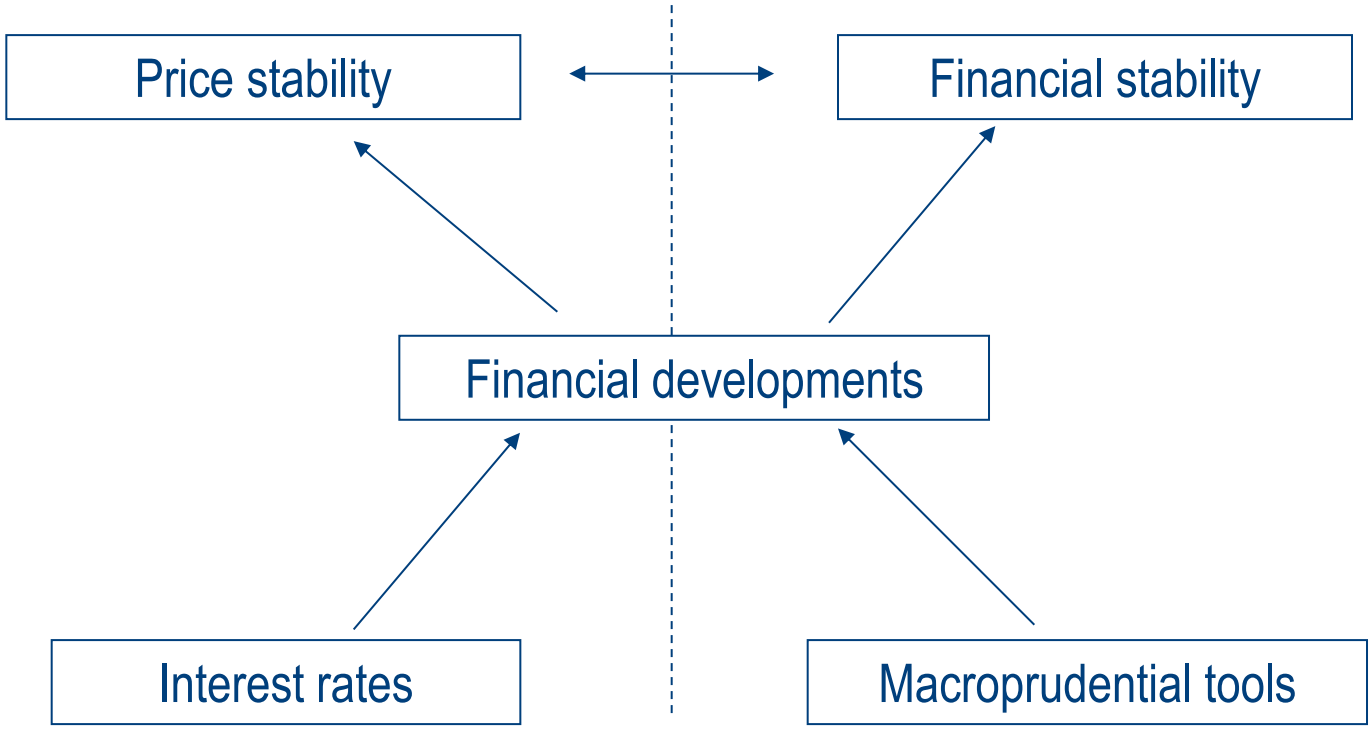
Normalisation of monetary policy since April 2017



- 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.

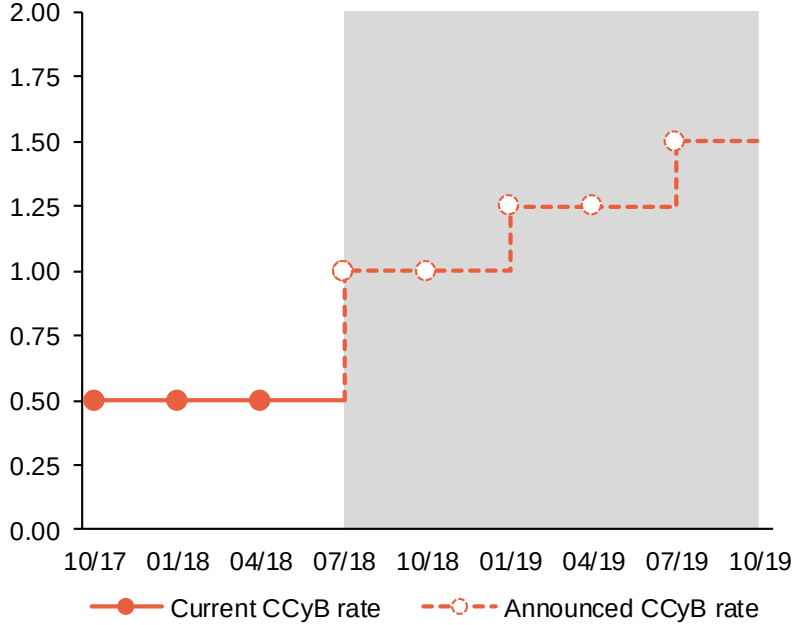
Interactions with macroprudential policy



- 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

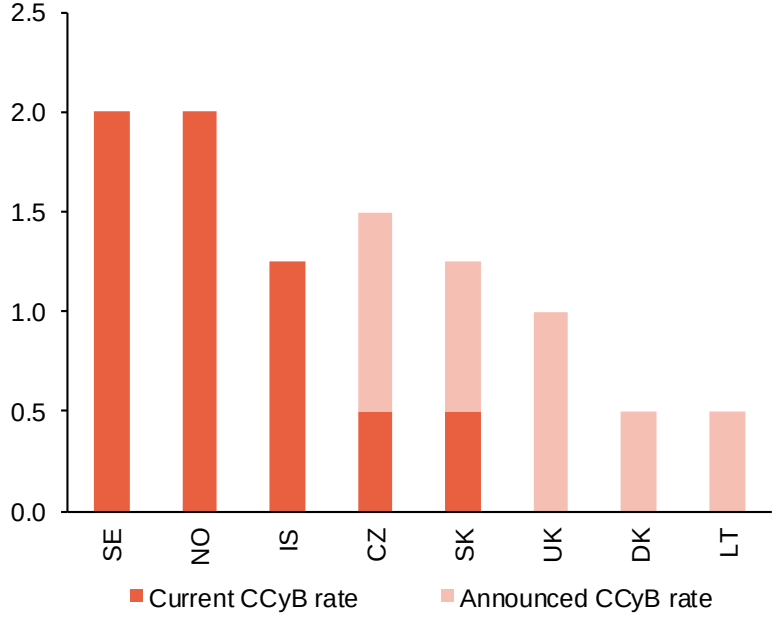
Setting of countercyclical capital buffer rate

Current and announced CCyB rate in the Czech Republic
(% of total risk exposure)



Source: CNB

CCyB rates in selected European countries
(% of total risk exposure)

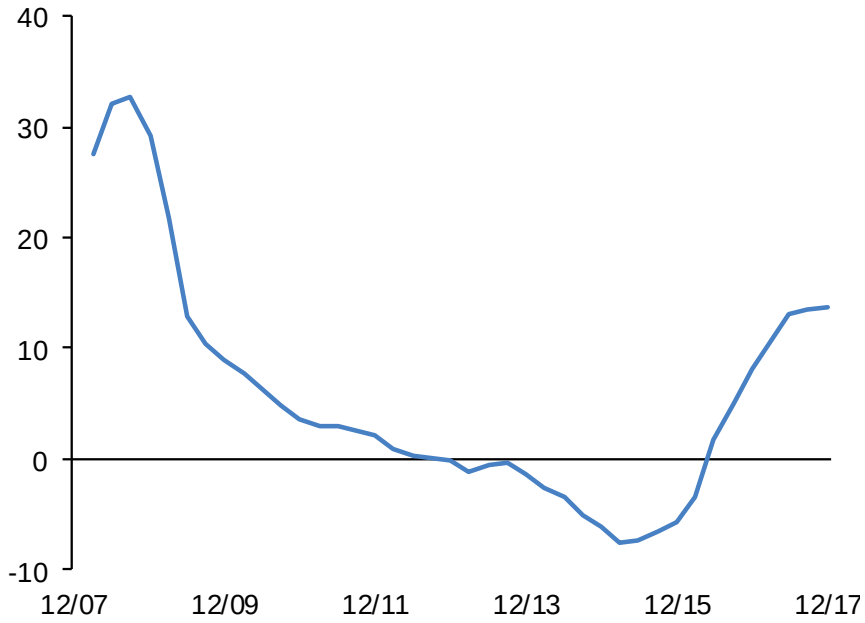


Source: ESRB

- 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)

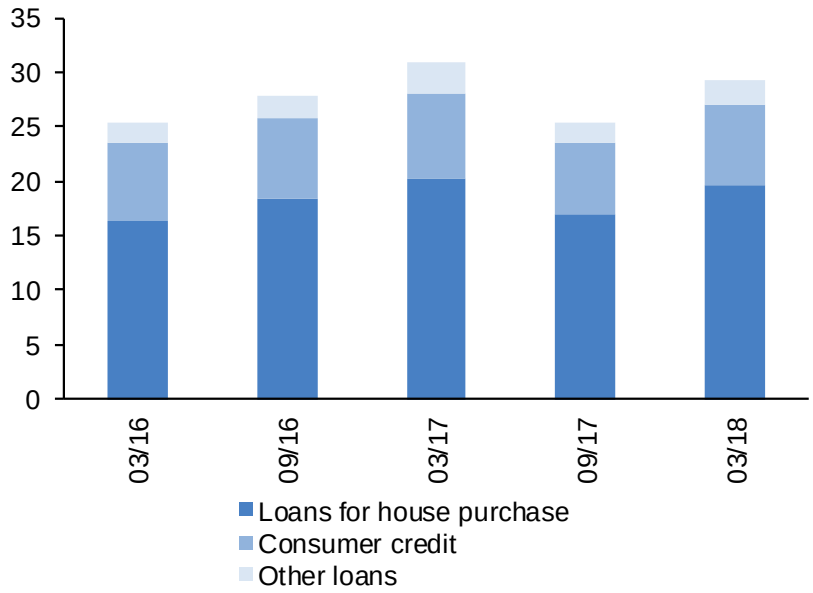
Regulation of mortgage loans

Estimated overvaluation of apartment prices (%)



Source: CNB

Amounts of net new loans to households (CZK billions)



Source: CCR, CNB

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

- 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.

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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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Marek Mora
marek.mora@cnb.cz