The Czech Republic: 20 Years of Inflation Targeting and the Way Forward

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I. The economic situation in the Czech Republic
II. 20 years of inflation targeting
III. The way forward and the question of euro adoption
I. The economic situation in the Czech Republic
Economic prosperity

GDP per capita in PPP (2018; EU-28=100)

- In 1993–2018, cumulative real GDP growth was 94%, or 2.7% p.a.
- In 2018, GDP per capita at purchasing power parity reached 90% of EU-28 average

Second biggest car producer per capita in world (behind Slovakia)

Note: Luxembourg not shown (254).
Source: Eurostat.
Public debt level was 32.7% of GDP in 2018
Unemployment rate is lowest in EU (2.1% in September 2019)

Employment rate has increased since 2005

Among EU countries with highest levels of social cohesion
II. 20 years of inflation targeting
Czech Republic was first emerging economy to introduce inflation targeting in 1998, with aim to achieve low inflation

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

- Inflation rapidly reduced to values observed in developed countries
- However, significant temporary deviations from target due to several (mainly external) shocks
• Inflation target lowered by 1 percentage point (to 2% with tolerance band of ±1 p.p.) as from 2010
• Lowering of interest rates starting in summer 2008
Due to renewed lengthy recession, rates started approaching zero lower bound in 2012.
1998–2008

Since 2009

Monetary policy reaction to euro area debt crisis (2)
• Introduction of exchange rate floor at 27 CZK/EUR in November 2013
Exchange rate floor as monetary policy instrument (2)

1998–2008

Since 2009

headline inflation
net inflation targets
headline inflation targets

net inflation
headline inflation targets

Exchange rate floor as monetary policy instrument (2)
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 eight interest rate hikes between 8/2017 and 5/2019. Czech koruna appreciated gradually and moderately.
Summary

- 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.

- The Czech Republic has successfully moved towards normalisation of monetary policy.
III. The way forward and the question of euro adoption
Pros and cons of euro adoption

Pros (benefits)
- Zero exchange rate risk with main trading partners
- Lower transaction costs (no need for exchange)
- Higher price transparency and more competition
- Deeper economic integration (?)

Cons (costs)
- Loss of important macroeconomic adjustment variable
- Higher degree of economic sovereignty (?)

The higher the cyclical and structural alignment with the euro area and the more flexible the economy, the more the benefits should be higher than the costs
Czech Republic’s assessment of euro adoption preparedness

- High degree of openness of Czech economy
- Persisting strong trade and ownership links
- Gradually rising use of euro by non-financial corporations
- Signs of increasing labour market flexibility
- Stable banking sector resilient to economic shocks

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- Still unfinished process of real economic convergence
- Persisting lower structural similarity of economies
- Misalignment of financial cycles
- Czech public finance sustainability yet to be resolved
• Regardless of the costs and benefits, the Czech Republic has been obliged to adopt the euro since joining the EU

• The Czech economy would manage to join the euro area, as it is converging to the euro area core and to the EU average

• The euro area faces many problems: some (large) economies are not converging; still incomplete and with many question marks

• Our obligation to adopt the euro is debatable because of new elements/duties linked to this obligation (e.g. additional costs related to joining the ESM)

• Euro adoption is not on the agenda in the near future
Thank you for your attention

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Additional slides
Activities of the Czech National Bank

- Conducting monetary policy to maintain price stability (flexible inflation targeting)
- Issuing banknotes and coins
- Managing payments and currency in circulation
- Financial stability
- Financial market supervision
- Resolution
- Consumer protection
Setting of countercyclical capital buffer rate

- Rise in CCyB rate to 2.0% with effect from July 2020 is based on assessment of position of economy in financial cycle and of banking sector vulnerability indicators.
- Fifteen European countries have set non-zero CCyB rates; in eleven non-zero rate already effective. Eleven have announced rate increase (including CZ).

Source: CNB
Regulation of mortgage loans

**Estimated overvaluation of apartment prices**

Source: CNB


- **Upper LTV limit of 80%; max. 15% of loans for LTV of 80%–90%; no loans for LTV above 90%**
- **Upper DTI limit of 9 times applicant’s net annual income and DSTI limit of 45% of applicant’s net regular income**
- Cap on maturity of 30 years, requirement for regular amortisation.
Public support for euro

Source: Eurobarometer, Spring 2019
• FX interventions amounted to EUR 75.9 billion during exchange rate commitment period from 7 Nov 2013 to 6 Apr 2017 (of which EUR 42.5 billion in 2017)
Total central bank assets to nominal GDP in national currency (in %)

- Federal Reserve System
- European Central Bank
- Bank of England
- Bank of Japan
- Swiss National Bank
- Czech National Bank

Source: Bloomberg, central bank websites
• According to monetary policy transparency index, CNB ranked second among most transparent central banks in 2015

• As of January 2020, CNB will further increase transparency by introducing attributed minutes

Note: Top 6 countries ranked by monetary policy transparency index.
Source: Dincer, Eichengreen and Geraats (2019).
CZK/EUR exchange rate

Note: The confidence intervals of the CZK/EUR exchange rate forecast reflect the predictive power of past forecasts (with the exception of the exchange rate commitment period). They are symmetric and linearly widening.
Source: CNB Inflation Report, November 2019
Interest rates (in %)

Client interest rates (in %)

- 3M PRIBOR
- 3M EURIBOR
- Czech Republic: loans to non-financial corporations
- Euro area: loans to non-financial corporations