CNB Monetary Policy and Developments in the Czech Economy

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Overview

• Unconventional instruments of CBs in advanced economies: overview
• CNB monetary policy since 2012 and weakening of koruna
• Recent developments in Czech economy
• Weakening of koruna: assessment after 18 months
• Current CNB forecast
• Financial regulation, Basel, Solvency II
Unconventional policies of CBs

- Short-term interest rates were primary instrument before crisis; monetary aggregates and exchange rates adjusted to interest rates
- CBs exhausted their ability to influence economy via interest rates quite soon after outbreak of crisis (⇒ ZLB)
- Post-crisis unconventional policies had two main objectives:
  - To restore functioning of financial markets + financial intermediation:
    - liquidity injections
    - private asset purchases
  - To support economic activity at ZLB:
    - government bond purchases
    - forward guidance: CB commitment not to follow old interest rate rule
  - Two objectives closely interlinked; common denominator: safeguarding macroeconomic stability
- Other CB instruments: forex interventions, negative interest rates

The objective of the unconventional policies was to restore the crisis-hit transmission mechanism and, after 2012, to boost demand and increase inflation
Inflation during crisis: stylised facts for advanced economies

- Sharp fall in inflation after financial crisis erupts
- Rising inflation: recovery, fiscal consolidation
- Disinflation: second recession, low demand, positive oil shock

Low inflation started to be a problem after 2012; main reason: low demand pressures
Unconventional policies and exchange rate: three patterns

I. Exch. rate commitment as direct tool: CH, CZ

II. Quant. easing works through exchange rate indirectly: UK, ECB

III. Negative int. rates work through exchange rate indirectly: CH after exit, DK, S

Either the exchange rate was used directly as an unconventional policy tool, or its weakening was a side effect of QE or negative interest rates.
CNB monetary policy since 2012 and weakening of koruna
Monetary policy since end-2012 1/2

• In autumn 2012 CNB announced that if it became necessary to ease monetary conditions further, it would do so by weakening exchange rate of koruna
• In November 2012 CNB:
  ◆ lowered its key interest rates to “technical zero” ⇒ no further easing of monetary conditions was possible via interest rates
  ◆ halted sale of yields on its forex reserves
• During 2013 CNB made verbal interventions to weaken koruna
  ◆ verbal interventions had some effect (tenths of koruna)
  ◆ for roughly one year they delivered unusually stable exchange rate in historical terms
  ◆ but effectiveness of interventions gradually faded
• Forward guidance was introduced in March 2013: “Interest rates will remain at current levels (i.e. at technical zero) over longer horizon until inflation pressures increase significantly”

The CNB completely exhausted its main monetary policy instrument, i.e. interest rates
Disinflation pressures gradually increased during 2013:
- Slowest GDP growth in central Europe, large negative output gap, two-year-long decline in fixed investment
- Slowest-ever wage growth in private firms; 33% increase in household deposits during 2008 Q1–2013 Q3
- Imported disinflation pressures (CPI, PPI); fall in inflation expectations to historical lows; fall in velocity of money; several-year-long general fall in property prices
- Constantly rising disinflation pressures were indicating ever-increasing decline in inflation well below inflation target and risk of deflation
- On 7 Nov 2013, CNB weakened koruna to around CZK 27/euro (roughly equivalent to cutting rates by 1 percentage point) and expressed (one-sided) exchange rate commitment (to prevent koruna appreciating below CZK 27/euro and on weaker side to allow exchange rate to float; move of commitment to weaker level not ruled out)

The exchange rate became a new tool in the IT regime
ER commitment after Nov 2013

- 17/12/2013: “CNB will keep exchange rate close to CZK 27/EUR at least until early 2015”
- 26/6/2014: “Bank Board stated that CNB would not discontinue use of exchange rate as monetary policy instrument before 2015 Q2”
- 31/7/2014: “CNB will not discontinue use of exchange rate as monetary policy instrument before 2016”
- 17/12/2014: “Deflationary pressures from abroad are currently associated largely with positive supply shock, in particular fall in energy commodity prices; only if there were to be long-term increase in deflation pressures capable of causing slump in domestic demand, renewed risks of deflation in Czech economy and systematic decrease in inflation expectations, would it be necessary to consider moving exchange rate commitment to weaker level”
- 5/2/2015: “CNB will not discontinue use of exchange rate as monetary policy instrument before second half of 2016”
- 26/3/2015: “Probability of moving exchange rate commitment has increased compared to previous Bank Board meeting”

The exchange rate commitment has been extended several times since November 2013
The outlook for effective PPI in the euro area has been falling systematically since November 2013.
Recent developments in Czech economy
GDP growth surged in 2015 Q1; seasonally adjusted q-o-q growth was 3.1% (0.4% in 2014 Q4), while y-o-y growth was 4.2% (1.4% in 2014 Q4)
The GDP growth in Q1 was due mainly to rising inventories but was driven by all components of domestic demand; by contrast, net exports slowed GDP growth.
Seasonally adjusted industrial production has been rising quite quickly in recent months: 5% in Jan, 4.5% in Feb, 3.7% in Mar, 4.2% in Apr; industry is the engine of the economy
Seasonally adjusted retail sales have been maintaining high growth rates in recent months: 7.8% in Jan, 7.2% in Feb, 6.6% in Mar, 6.7% in Apr (deferred consumption)

Source: CZSO
After “treading water” for several years, the labour market has been heading north-west for about a year and a half, indicating a recovering economy.
The rising labour demand has not generated significant wage growth so far; the average nominal wage rose by 2.2% and the average real wage by 2.1% in 2015 Q1.
Inflation has accelerated in recent months: annual headline inflation from 0.2% in Mar to 0.5% in Apr and 0.7% in May and monetary policy-relevant inflation from 0% to 0.3% and 0.5%
A decline in fuel prices has been offset by growth in other market prices and by tax changes.
The y-o-y decline in industrial producer prices slowed from -3.6% in Feb to -2.9% in Mar and -2.6% in Apr; oil products were the main factor underlying the negative growth.
Weakening of koruna: assessment after 18 months
The koruna has been on the weaker side of the exchange rate commitment since it was announced, no interventions after initial weakening needed.
Impacts of various factors on change in Czech economic growth

<table>
<thead>
<tr>
<th>Impact of:</th>
<th>2013</th>
<th>2014</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>-0.7%</td>
<td>2.3%</td>
<td>3 p.p.</td>
</tr>
<tr>
<td>Fiscal impulse</td>
<td>-0.95 p.p.</td>
<td>0.24</td>
<td>1.19 p.p.</td>
</tr>
</tbody>
</table>

Source: CNB, CZSO

The weakening of the koruna was one of the reasons for the economic turnaround.
Actual and hypothetical inflation had the koruna not been weakened

Had koruna not be weakened, inflation would have been below -2% at end of 2014

Source: CZSO, CNB
**CNB Forecast (May 2015)**

- GDP: 2.6% in 2015; 3.2% in 2016
- CPI: 0.2% in 2015; 1.7% in 2016
- PPI: -1.8% in 2015; 2.1% in 2016
- 3M PRIBOR: 0.3% in 2015; 0.3% in 2016
- Real wages: 2.3% in 2015; 2.2% in 2016
- Employment: 1% in 2015; 0.9% in 2016
- Unemployment (ILO): 5.4% in 2015; 5% in 2016
- Government deficit (% of GDP): -1.6% in 2015; -1% in 2016
- Government debt (% of GDP): 40.6% in 2015; 40% in 2016
- Trade balance (% of GDP): 6.3% in 2015; 6.8% in 2016
- Current account (% of GDP): 1.1% in 2015; 1.5% in 2016

Risks to forecast were viewed as being on downside in May (low wage growth; stronger CZK/EUR rate)
Summary

• Financial and economic crisis forced CBs in advanced economies to use various unconventional tools; crisis is now over in countries that adopted such policies sooner and more aggressively
• CNB also started to use unconventional tools after Nov 2012: forward guidance, verbal interventions, weakening of koruna (deflation risks), repeated extension of exchange rate commitment (imported disinflation)
• Positive supply shock (slump in oil prices) ⇒ escape clause applied
• Czech economy now recovering quite fast; recovery apparent in all areas, including labour market
• Inflation gradually rising, but demand-pull inflation pressures remain subdued, mainly due to sluggish wage growth
• Inflation will return to 2% inflation target during 2016
• Weakening of koruna prevented deflation and was one of factors of recovery ⇒ we assess it as success
• CNB will not discontinue use of exchange rate as MP instrument before 2016 H2

We are now beyond seeing the light at the end of the tunnel – we are out of the tunnel
Financial regulation

- After financial crisis in 2008: fundamental reconsideration of financial regulation and supervision (under G20 leadership)
- Initial objectives: more resilient and safer financial sector, levelling playing field, improving risk management (specific focus on cross-border resolutions and systematically important institutions)
- Main regulations: Basel III, CRDIV/CRR, BRRD, AIFMD
- However:
  - regulation has become quite extensive and complicated, at more granular level, with frequent changes
  - Harmonised policies are unlikely to work in same way in different historical, economic and institutional environments

The synergistic and long-term effects of regulation are not straightforward and may even be contradictory
Basel framework was intended for large cross-border banks
In EU it was implemented in 2014 via CRDIV/CRR for all institutions (credit institutions + investment firms)
CRDIV/CRR = 500 pages + hundreds of pages of technical standards, guidelines, Q&As
CRDIV/CRR encompasses both micro and macroprudential level
New regulatory elements: several levels of capital ratios, liquidity ratios, leverage ratio, capital buffers, systemic risk
Pros: more stable financial system
Cons: very high administrative burden and implementation costs (e.g. approvals, reporting, IS/IT)
EBA stresses maximum organisation

Banks in the Czech Republic are Basel III compliant
**Solvency II**

- Replaces outdated insurance regulation; promotes financial stability and consumer protection
- Comes into force on 1 January 2016 (transposition process will be completed before end of 2015)
- Preparatory phase: (re)insurance undertakings gradually implementing preparatory guidelines according to CNB roadmap
  - Undertakings submit quarterly progress reports (to CNB) on their compliance with guidelines
  - CNB provides general feedback to industry as a whole (gaps discussed individually)
  - Active approach of CNB to preparations contributes to smooth transition of undertakings to Solvency II
- Implementation costs are likely to be high (excessively detailed regulation; Sol I: approx. 130 pages vs Sol: II 2,100 pages)

According to the latest information, we do not foresee insurance undertakings having any problems meeting the Solvency II capital requirements
Thank you for listening

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