# The Czech Economy and Monetary Policy: Deflationary Risks and the Exchange Rate as a Monetary Policy Instrument

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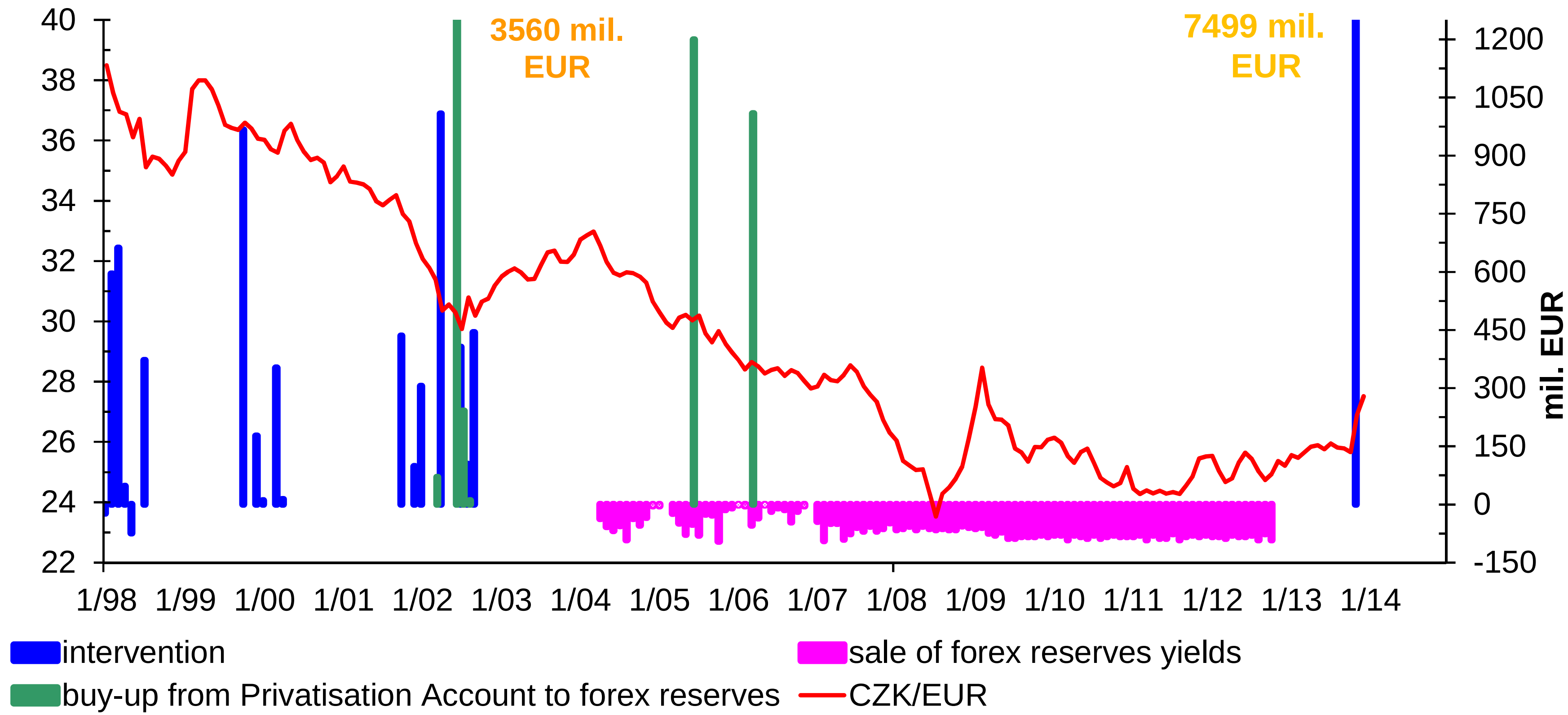
*I. Did the flexible exchange rate regime help to keep the economy competitive in the boom years?*

1. A small open economy with a flexible exchange rate regime like the Czech Republic must always bear in mind that:
   - the exchange rate could behave either as a shock absorber or as a shocks generator (source of shocks).
   - a flexible exchange rate in a (post)-transition economy can also serve as a channel of nominal convergence towards the advance economies.
2. The Czech Republic introduced the flexible exchange rate in May 1997 as a reaction on exchange rate turbulences. Since then we observed an appreciation trend until the financial crisis of 2008.
   - The appreciation trend was in line with the nominal convergence of the Czech economy when domestic inflation remained at low levels and well anchored. The exchange rate thus served as a tool against overheating of the booming economy.
3. Overall, the flexible exchange rate regime had stabilizing effect on the economy and minor fluctuations were absorbed in exporters' profit margins. However, in 2002 and in 2007, we saw abrupt appreciation of the Czech Koruna. Because these swings could endanger the competitiveness of the economy, the CNB reacted.

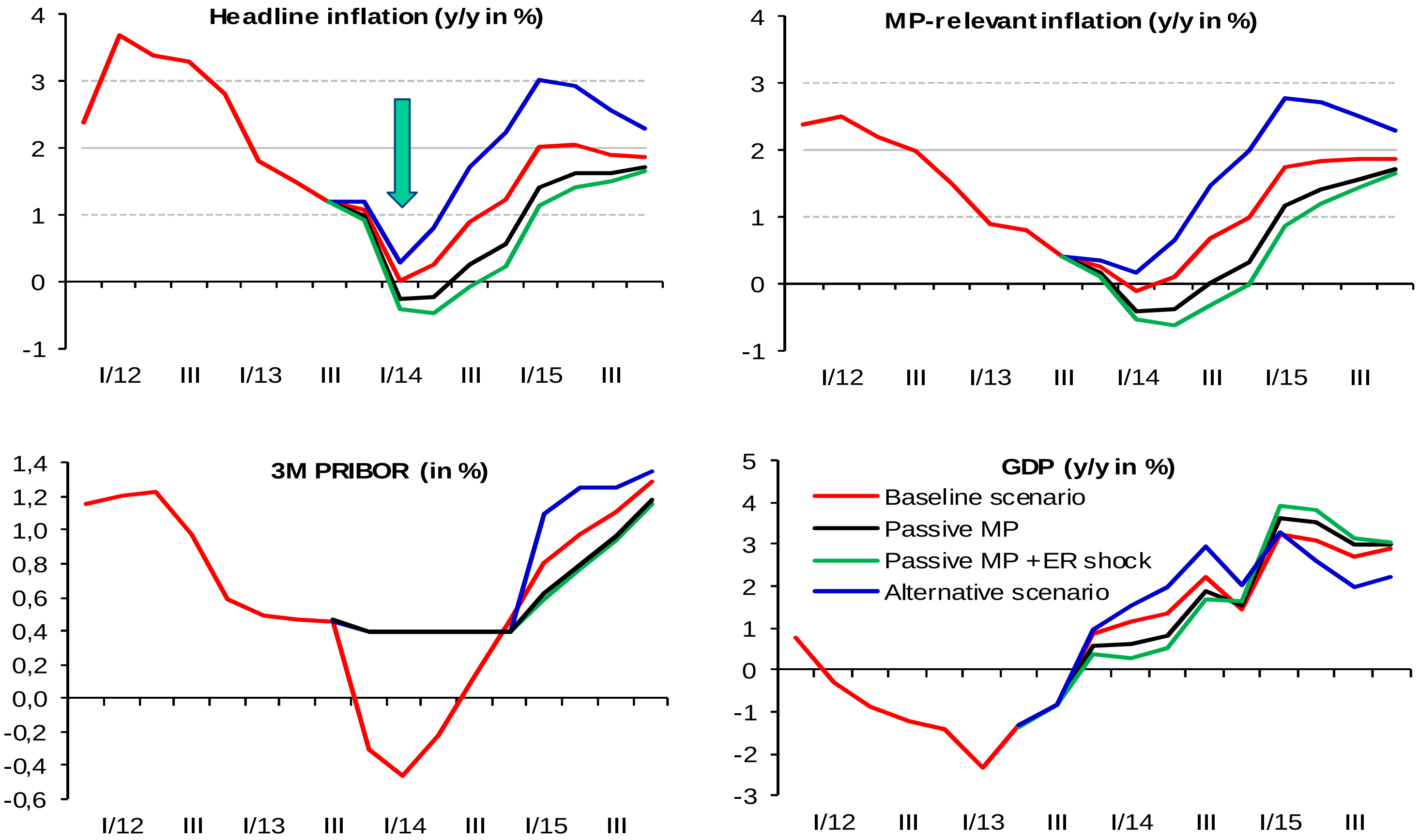
- In 2002, appreciation was caused by huge capital inflow (seen as an external factor, i.e. shock to the economy). The CNB lowered the interest rates and additional measures were also implemented (e.g. sterilization of privatization FDI). This helped to ease monetary conditions.
- In 2007, possible carry trade operations were probably behind the Koruna depreciation in the first half of the year. In these times the Czech Republic had lower interest rates compared to the euro area. Beginning of the global financial crisis led to selling out of risk assets and subsequently to repayments of loans in Koruna which served as a financing currency. This caused an abrupt appreciation of the Koruna.
- <u>When the Czech economy was hit by the global financial crises in 2009, the Koruna weakened and helped thus to ease monetary conditions while the external demand slumped.</u>
- Since the global financial crises the Koruna has been moreover flat until the CNB used the exchange rate as the tool of monetary policy from 7th November 2013.
- <u>Later, the experience of the Czech Republic shows the advantage of having additional monetary instrument in ZLB constraint situation, which the CNB reached in November 2012.</u>

# CNB interventions / ER as the tool of monetary policy




- Sales of FX reserves yields were halted in November 2012 in order to avoid the possible conflict of monetary policy implementation in case of commencement of FX intervention to weaken the CZK/EUR exchange rate.
- 7th November 2013: the CNB decided to switch to an alternative scenario and start using the exchange rate as an instrument for further monetary easing ⇒ CNB´s commitment to hold the exchange rate close to 27 CZK/EUR level (at least to beginning 2015)

# Comparison of model scenarios (Board meeting on 7th November 2013)




- The relevant policy comparison was between <u>the alternative scenario with exchange rate instrument and the passive MP scenario(s)</u> – here the difference clearly favours the former in all major variables (plus recall the uncertainty as regards the return to the target with passive MP).

# 2W repo rate path – Comparison of all scenarios (Board meeting on 7th November 2013)

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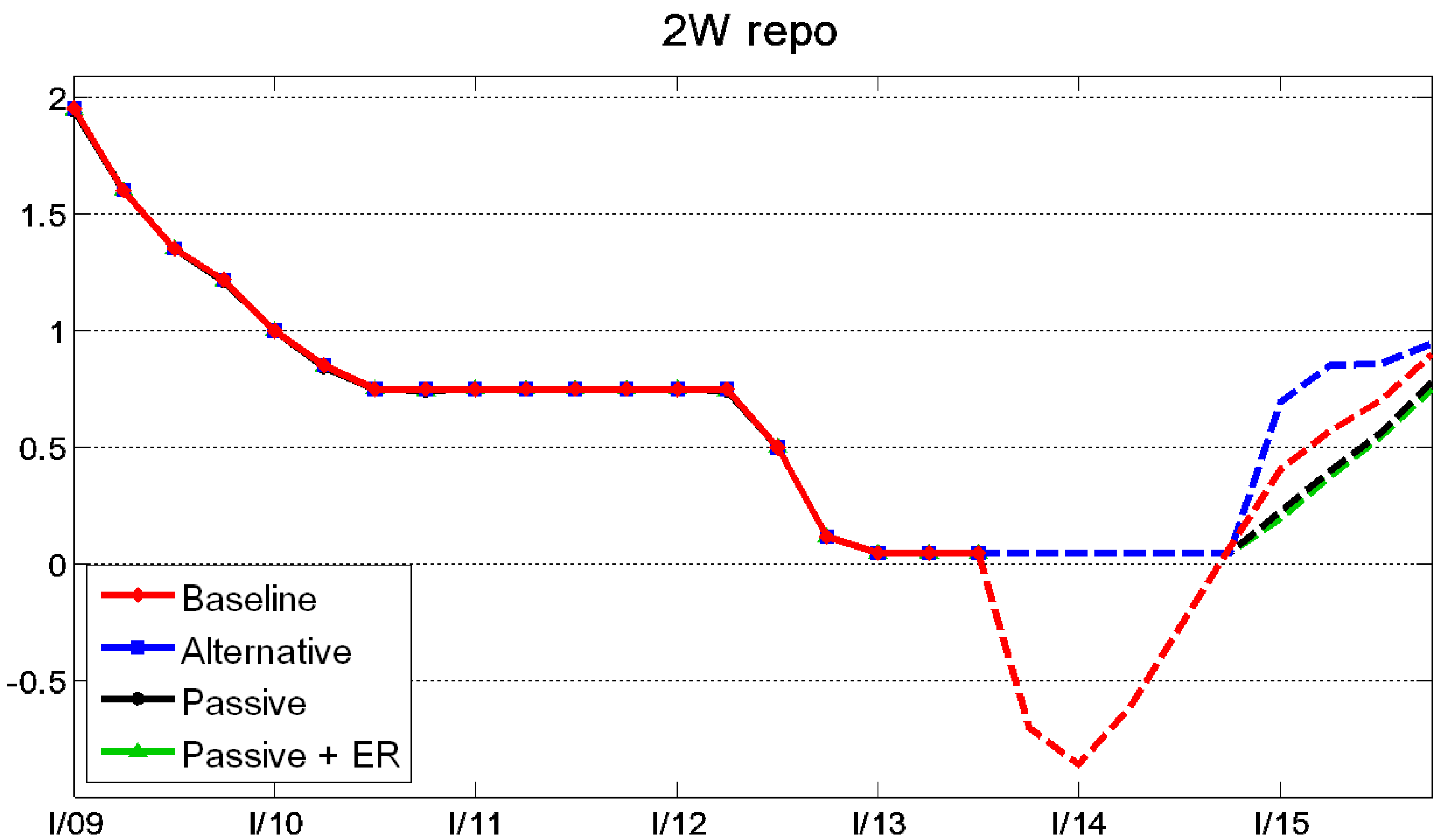


- The alternative scenario assumes exit in 1.Q 2015, but it might come later in reality (the Board may take a different view, premature exit must be avoided, the ER pass through might prove weaker, economic situation may change etc.).

## *II. Currently, the Czech Republic experiences very low inflation. How do you deal with this situation?*

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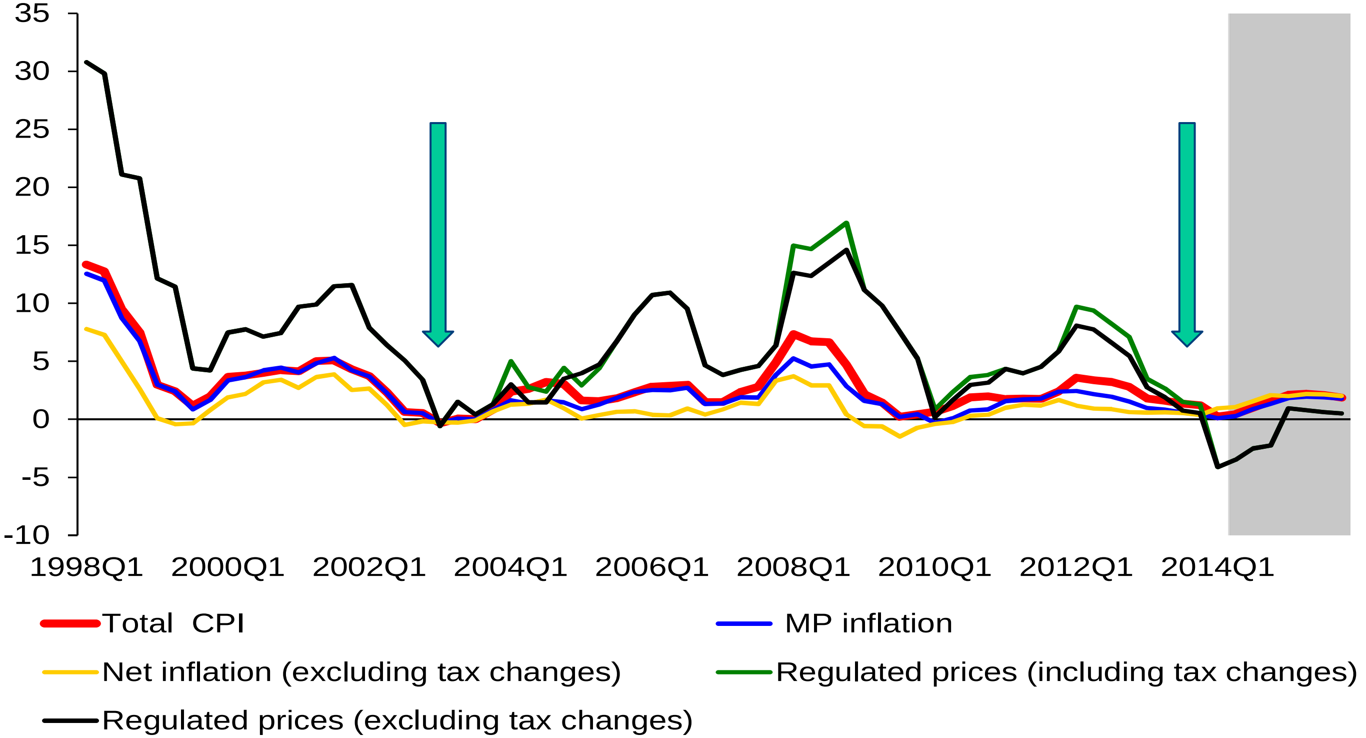



- Historically, inflation in 2013 was at very low levels. In the last fifteen years, a similar reduction in inflation occurred at the turn of 2002/2003.
- 2013: (i) clear decline in wage growth in the business sector, (ii) weak effective foreign demand, (iii) effect of domestic restrictive fiscal policy and (iv) stronger exchange rate.
- The only Inflation component with a growth outlook was food prices, mainly due to the trend growth of agricultural commodity prices on world markets in recent years, but with a distinct slowdown in prices expected in late 2013 and 2014 also.

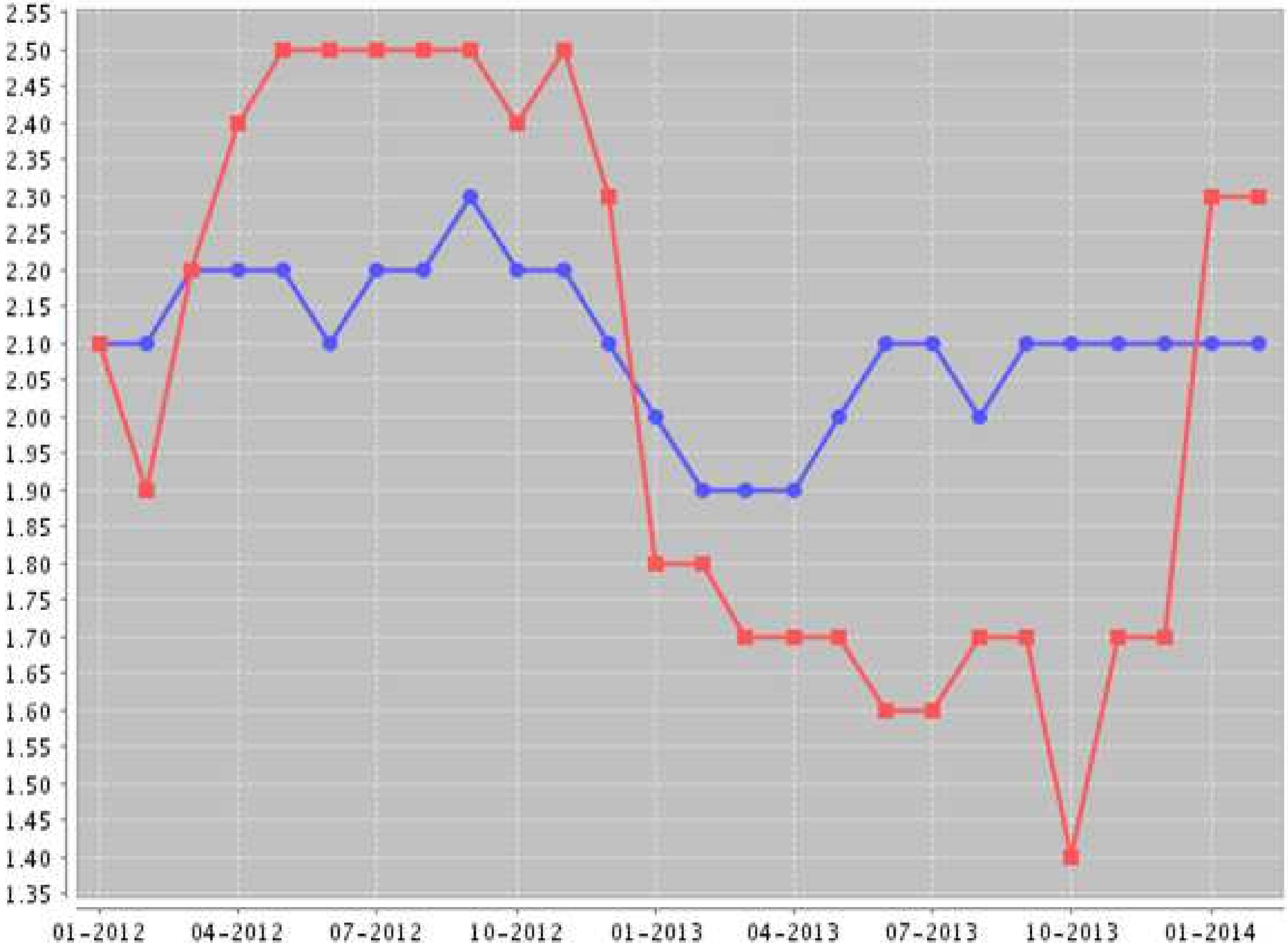
- The CNB restricting monetary policy given by the lower limit of zero policy rates (base rate 2W repo was set since late 2012 on the technical zero). $\Rightarrow$ Risk of deflation at least in the first half of 2014.
- The deflationary risk was also amplified the potential appreciation of the koruna due to higher domestic real interest rates coupled with the expected recovery of the economy 's main trading partners in a situation of relaxed monetary policy in the world and the gradual unwinding of domestic government measures in the fiscal area.
- The published data thus confirm the CNB's view that the November decision to start using the exchange rate as an additional instrument of monetary policy contributed significantly to ward off the threat of deflation.
- Outcomes of the weakening of the exchange rate (up to now):

(i) higher import prices $\Rightarrow$ higher consumer prices

(ii) higher net nominal exports $\Rightarrow$ higher GDP growth

(iii) higher inflation expectation $\Rightarrow$ higher domestic consumption

# Inflation expectations




Outlook for **12** and **36** months

# Headline inflation forecast (Inflation Report I/2014)

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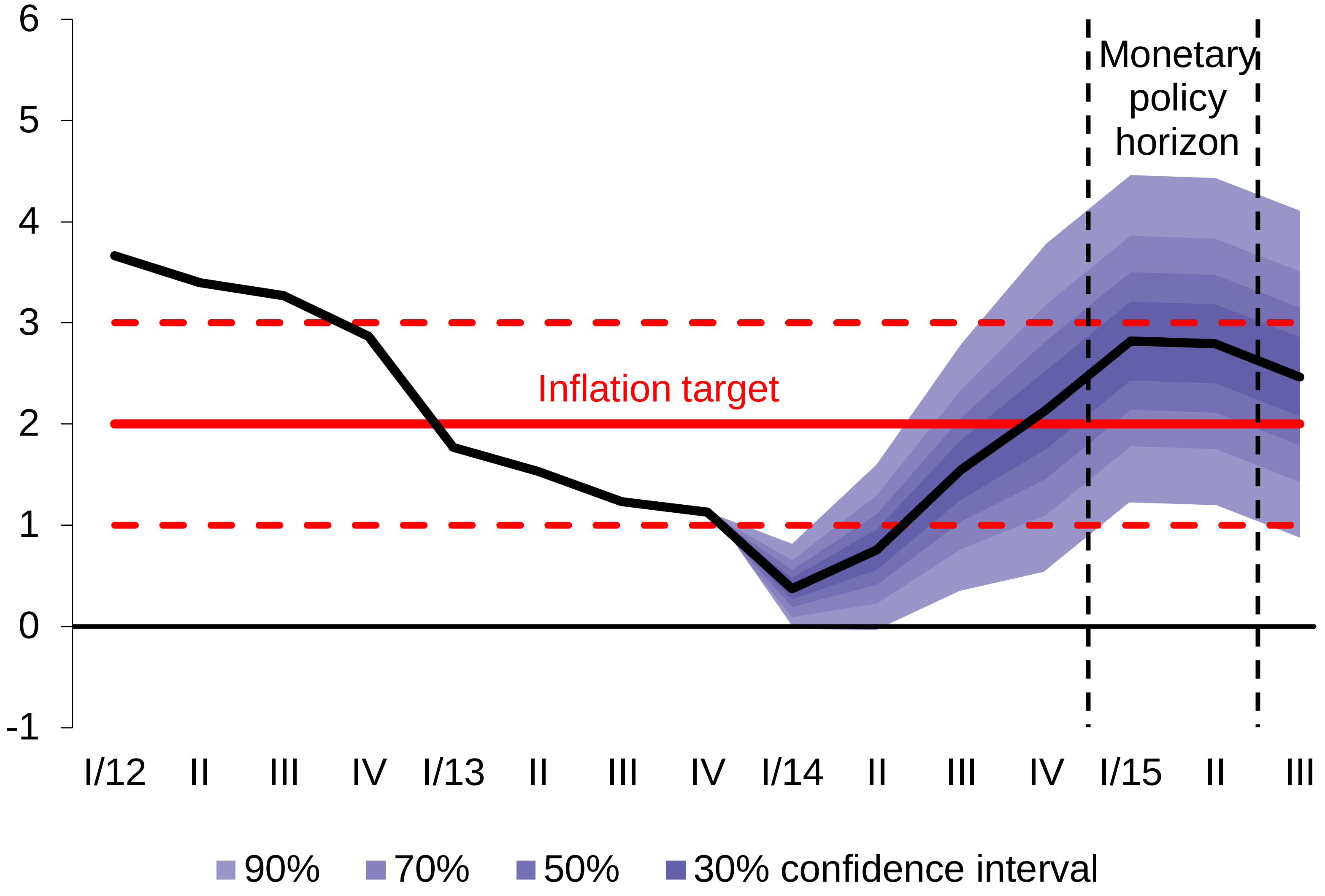
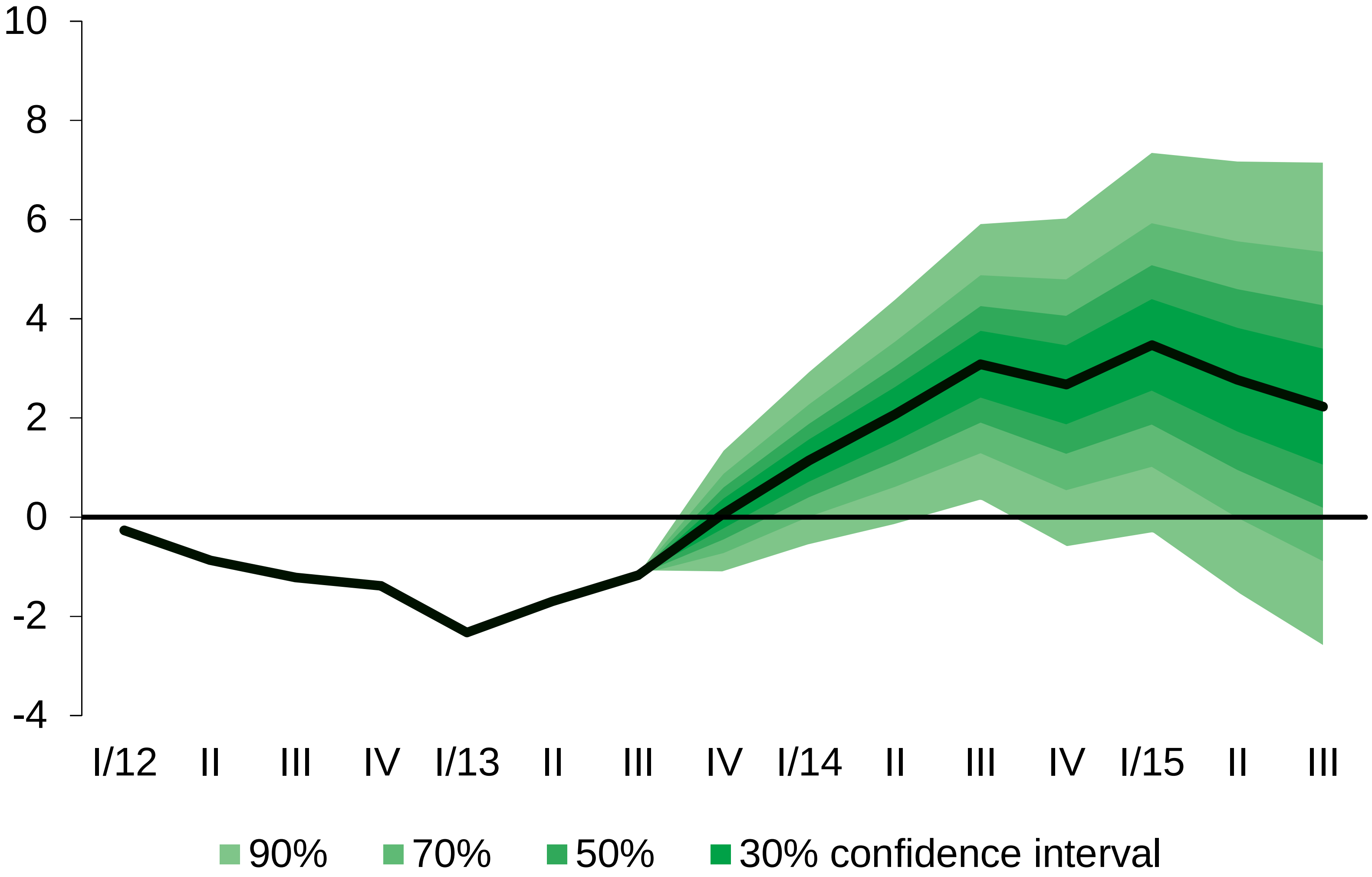


# GDP growt forecast (Inflation Report I/2014)



# Conclusion

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- Before November 2013 the Czech National Bank (CNB) used its standard instruments to ease the monetary conditions. The key monetary policy rate was lowered gradually and reached the technical zero bound in autumn 2012.
- In order to avoid long-term undershooting of the inflation target and to speed up the return to the situation in which it will be able to use its standard instrument, i.e. interest rates, the CNB has started to use the exchange rate as an additional monetary policy instrument.
- The CNB is resolved to intervene on the FX market in such volumes and for such duration as needed to reach the desired exchange rate level with the aim of hitting its inflation target in the future.

## IMF and OECD statements about interventions

- *"Fund advice, at the last Article IV Consultation, was that if a persistent and large undershooting of the inflation target is in prospect, <u>FX interventions should be employed</u>. The current situation justifies the CNB's action from that perspective."* - Mr. Masanori Yoshida, Mission Chief for Czech Republic, **International Monetary Fund**.

- *'If a persistent and large undershooting of the inflation target is in prospect, additional tools should be employed. <u>Foreign exchange (FX) interventions would be an effective and appropriate tool to address deflationary risks in the context of inflation targeting framework</u>. …..'* Mr. Johann Prader, the Executive Director representing Czech Republic in the Executive Board of the **International Monetary Fund**.

- *„Low demandside pressures and decelerating food prices are containing inflation pressures in the near term. With interest rates technically at zero and excess liquidity in the banking sector, the National Bank has started foreign exchange interventions to prevent a long-term undershooting of the inflation target. <u>Foreign exchange interventions should continue until inflation rises into the boundaries of the inflation target range and conventional monetary policy tools become effective again</u>,"* - **Organisation for Economic Co-operation and Development.**

# Thank you for your attention!

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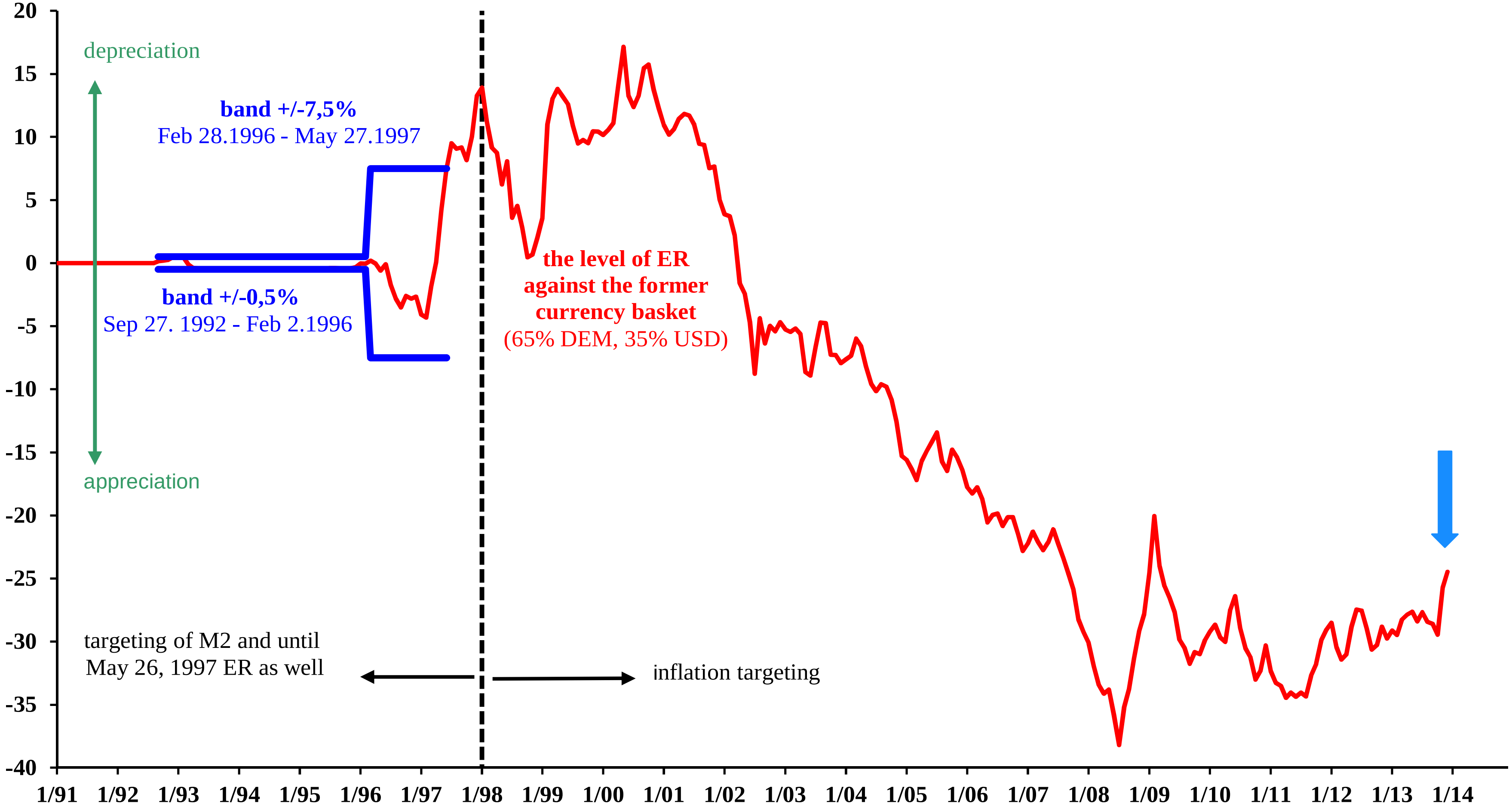
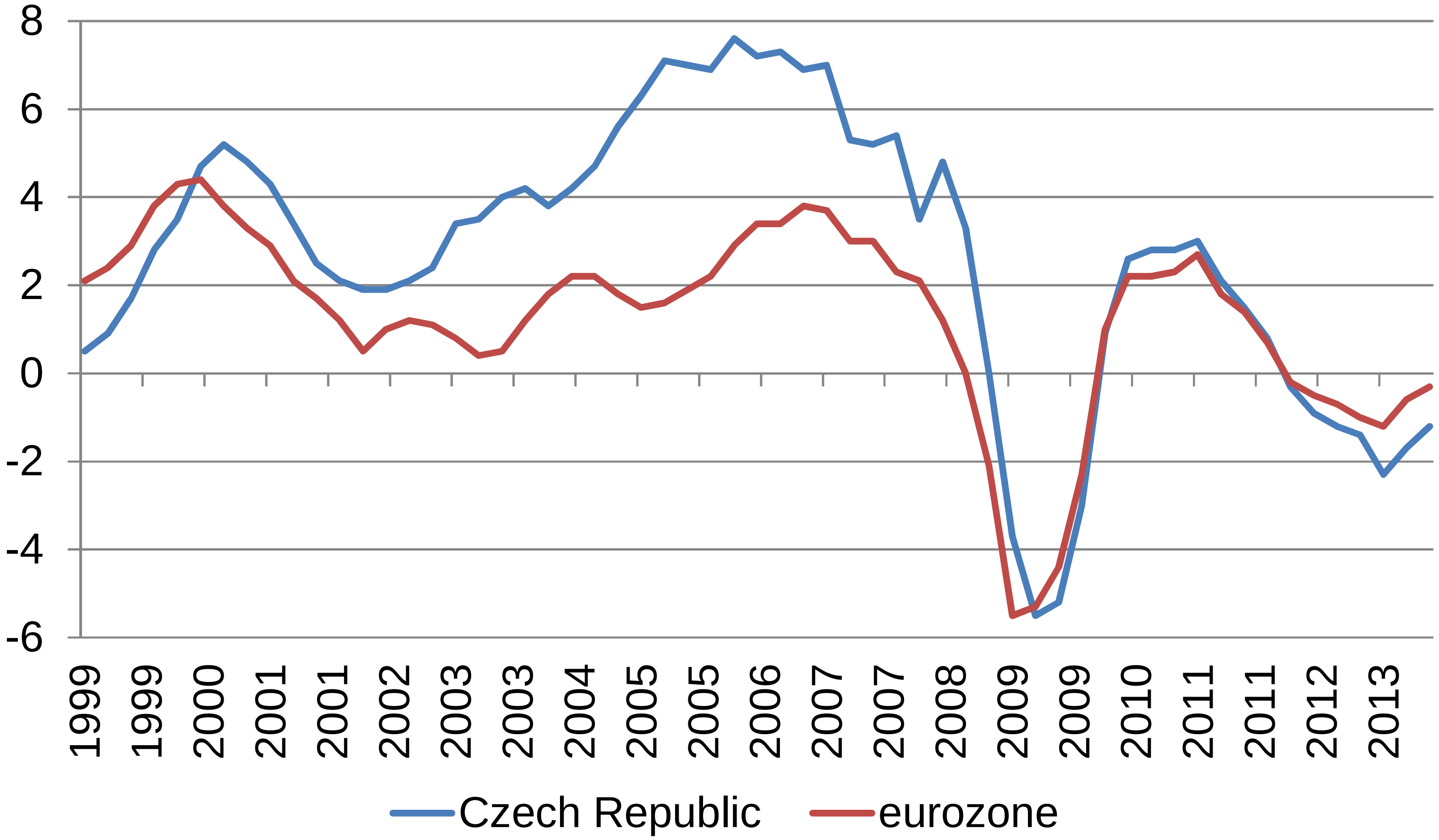
# The exchange rate development (1991-2014)



Real GDP growth (s.a., y/y in %)




- The Czech economic cycle has become synchronized with the euro area, with a double-dip pattern

# CZK/EUR Nominal exchange rate development

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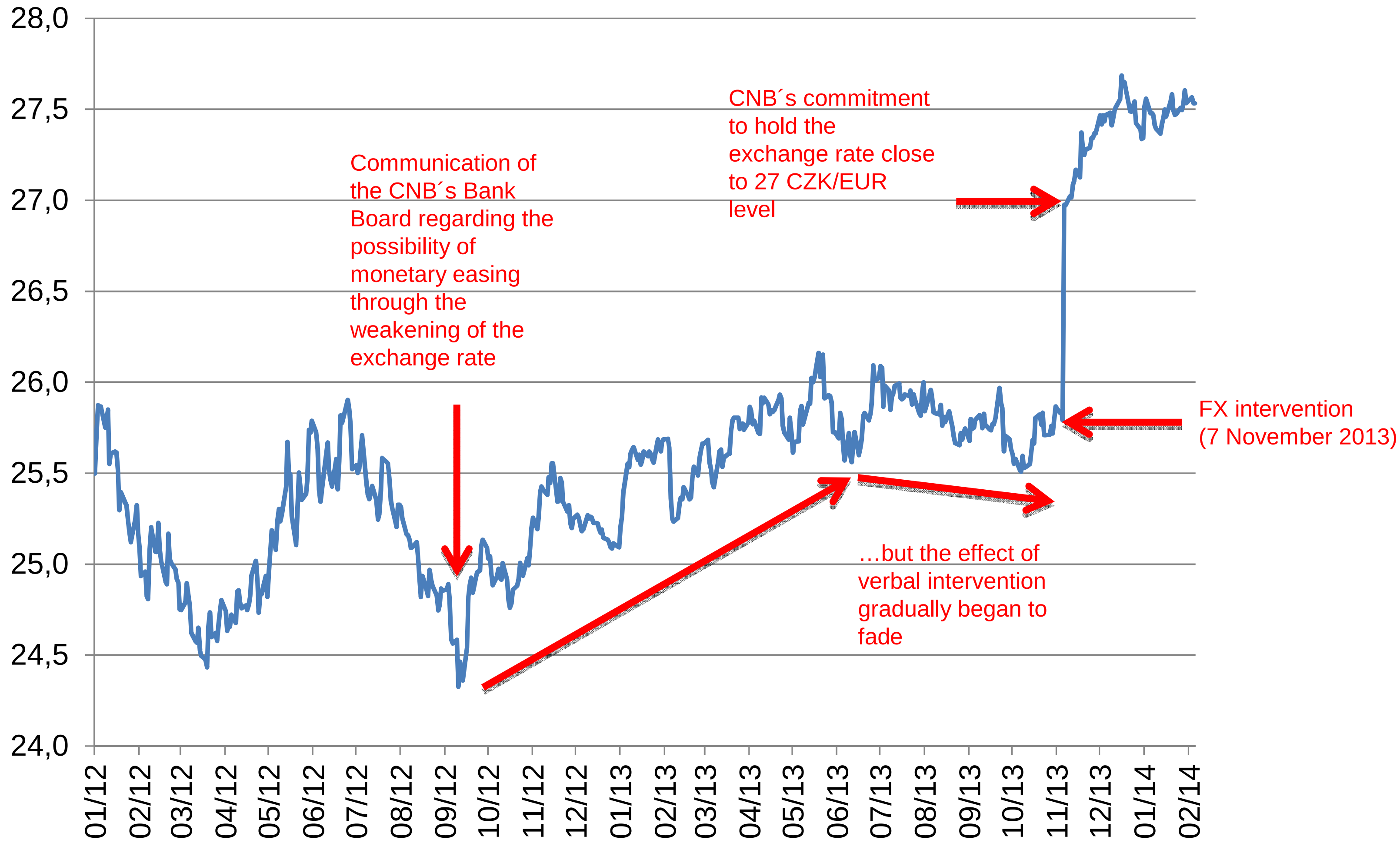


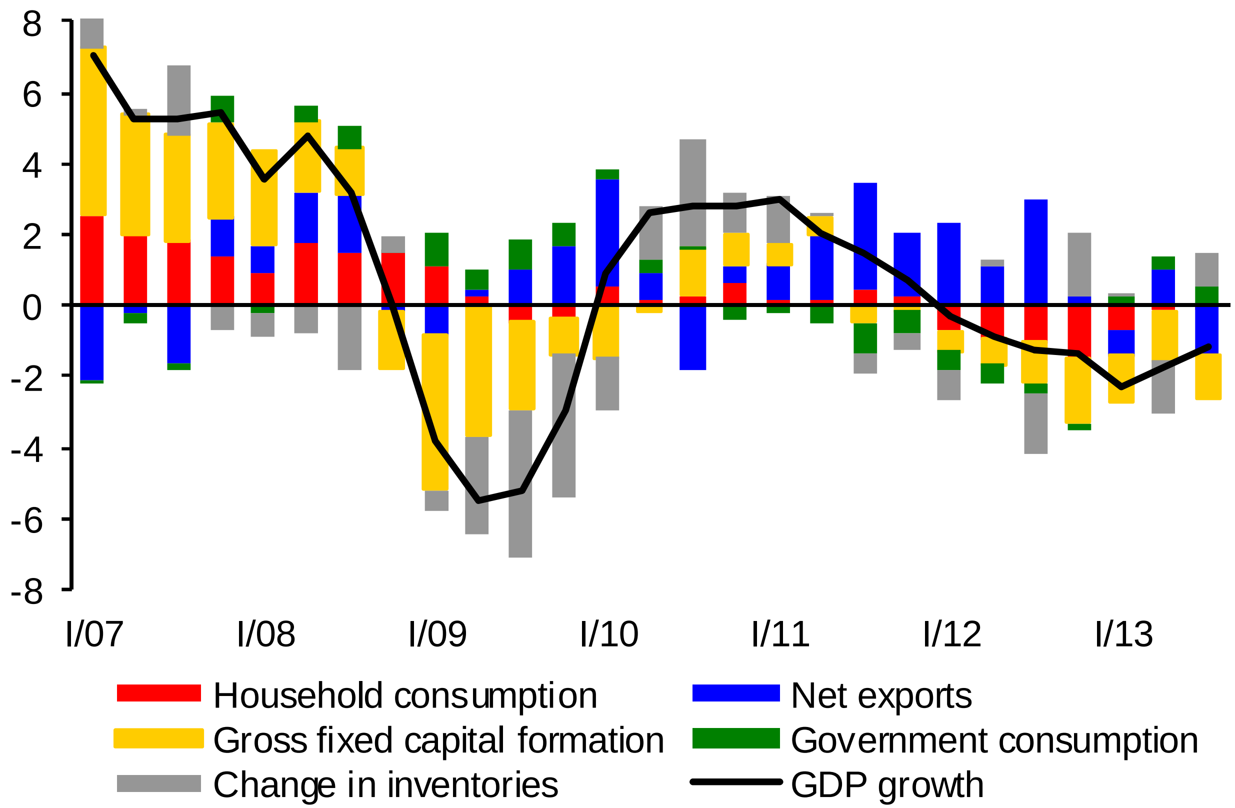

- After the notification of the CNB´s Bank Board at a press conference on 7th November 2013 to initiate FX interventions and to use the exchange rate for the further easing of monetary policy, the exchange rate immediately depreciated to the desired level of 27 CZK/EUR

# Structure of the Czech GDP growth



**Annual GDP growth structure**

(annual percentage changes; contributions in percentage points; seasonally adjusted)




- Post-Lehman decline mainly due to falling inventories and fixed investments, recently private consumption as well
- The main driver of Czech GDP growth has been net exports

# Foreign trade of goods and services in 2012 (% of GDP)

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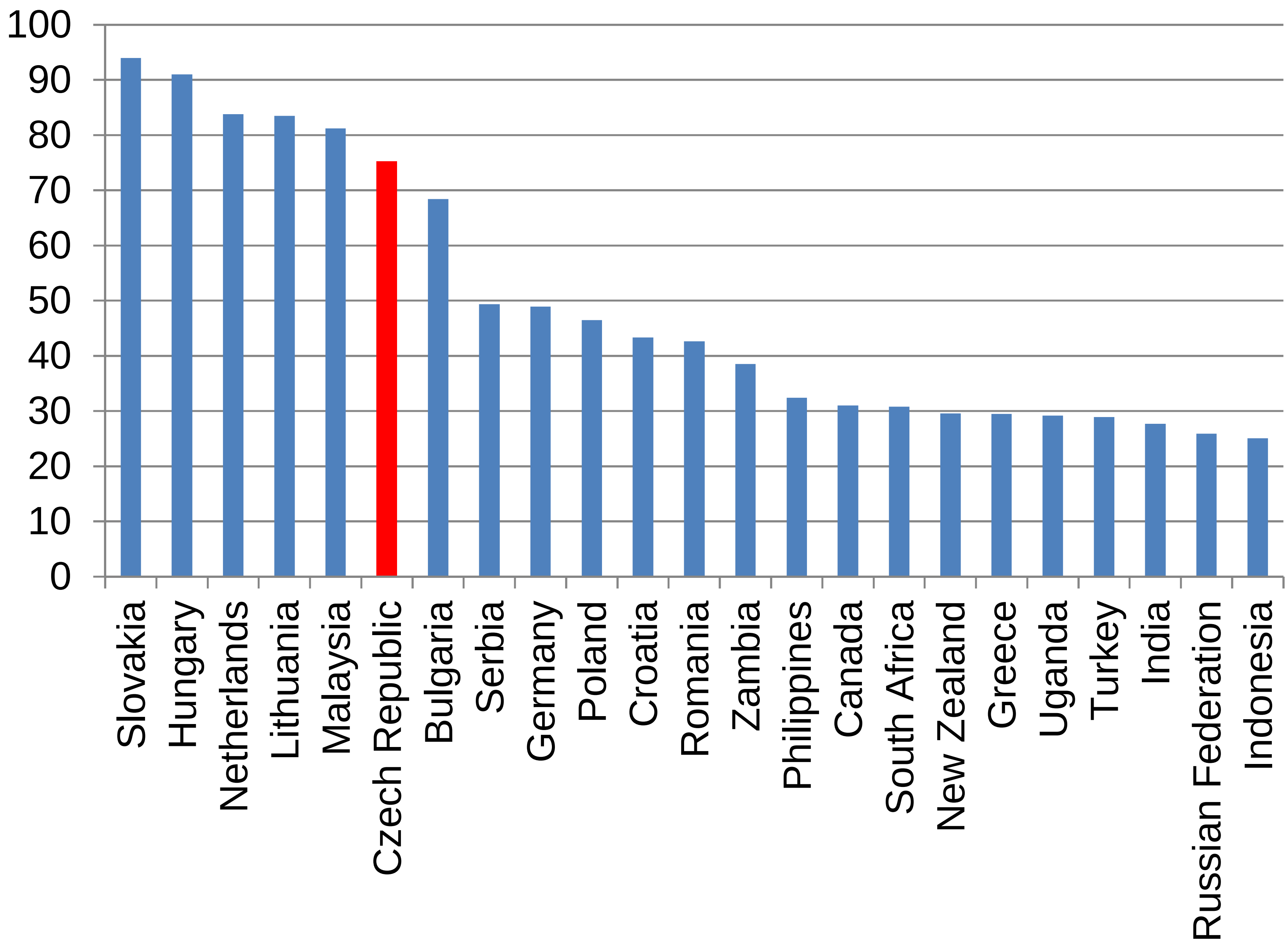
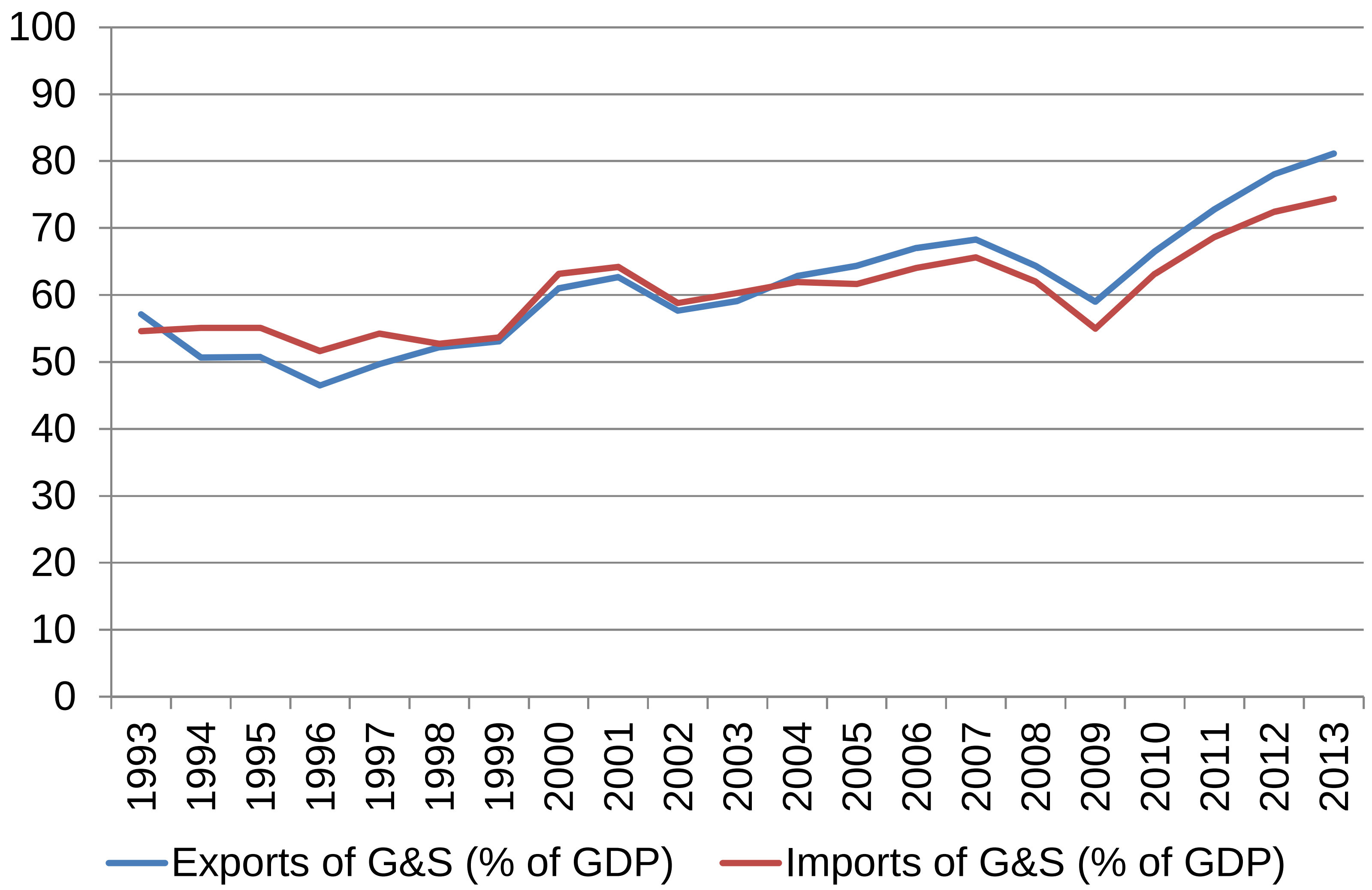


# Economic openness of the Czech Republic




- High and increasing openness to foreign trade
- The level of exports is very closely linked to imports

# Foreign trade (y/y in %, s.a.)

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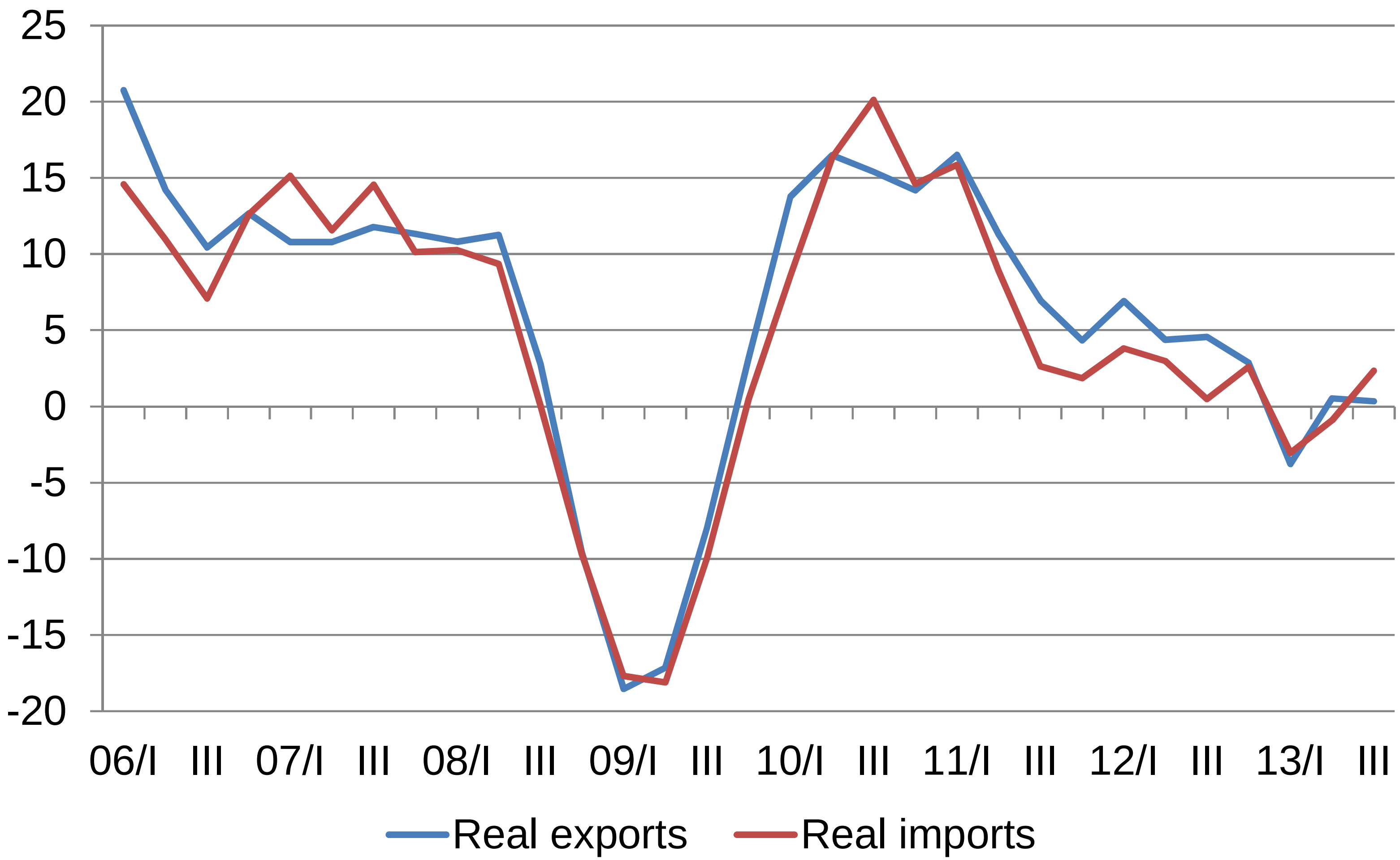
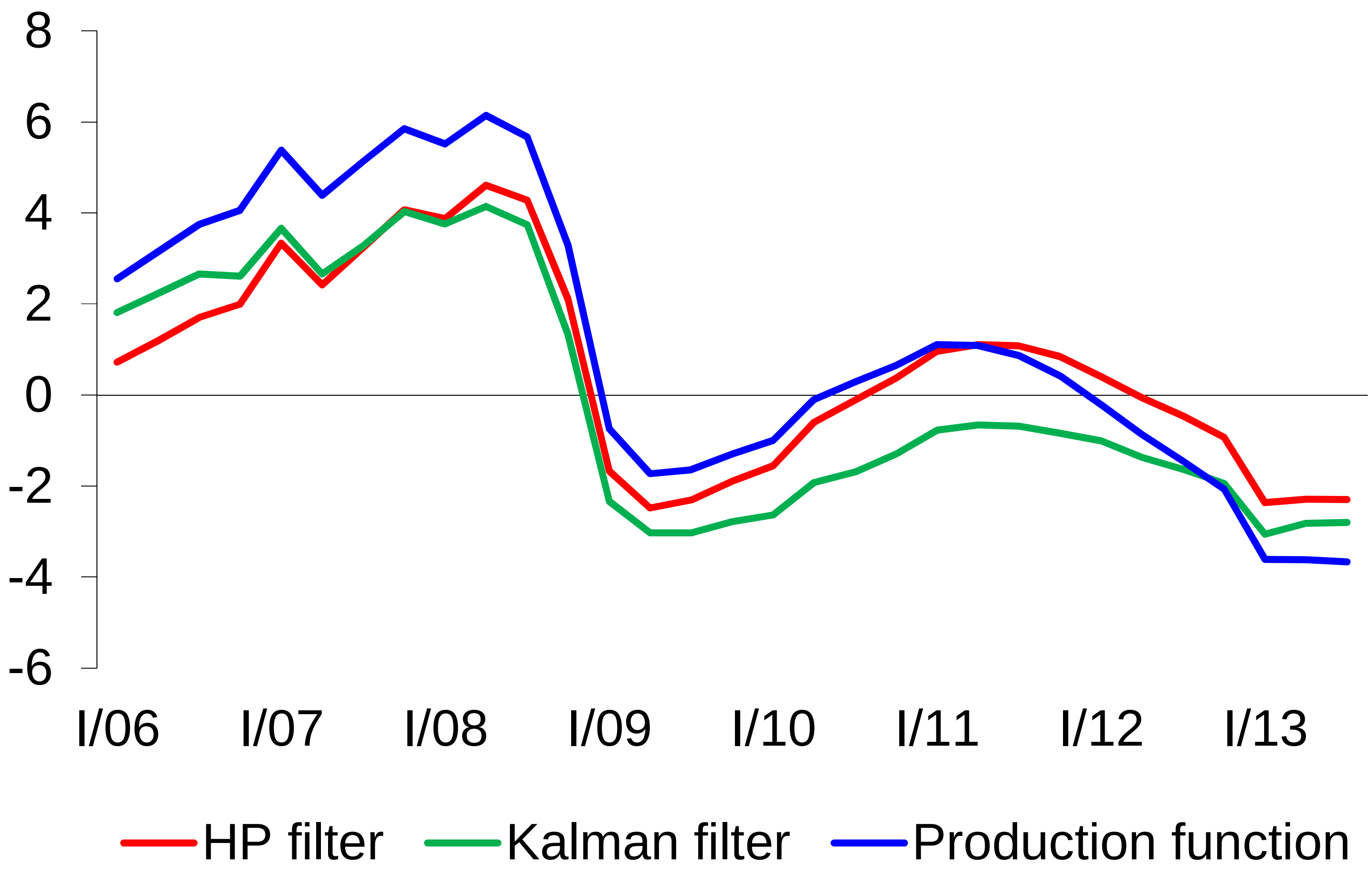


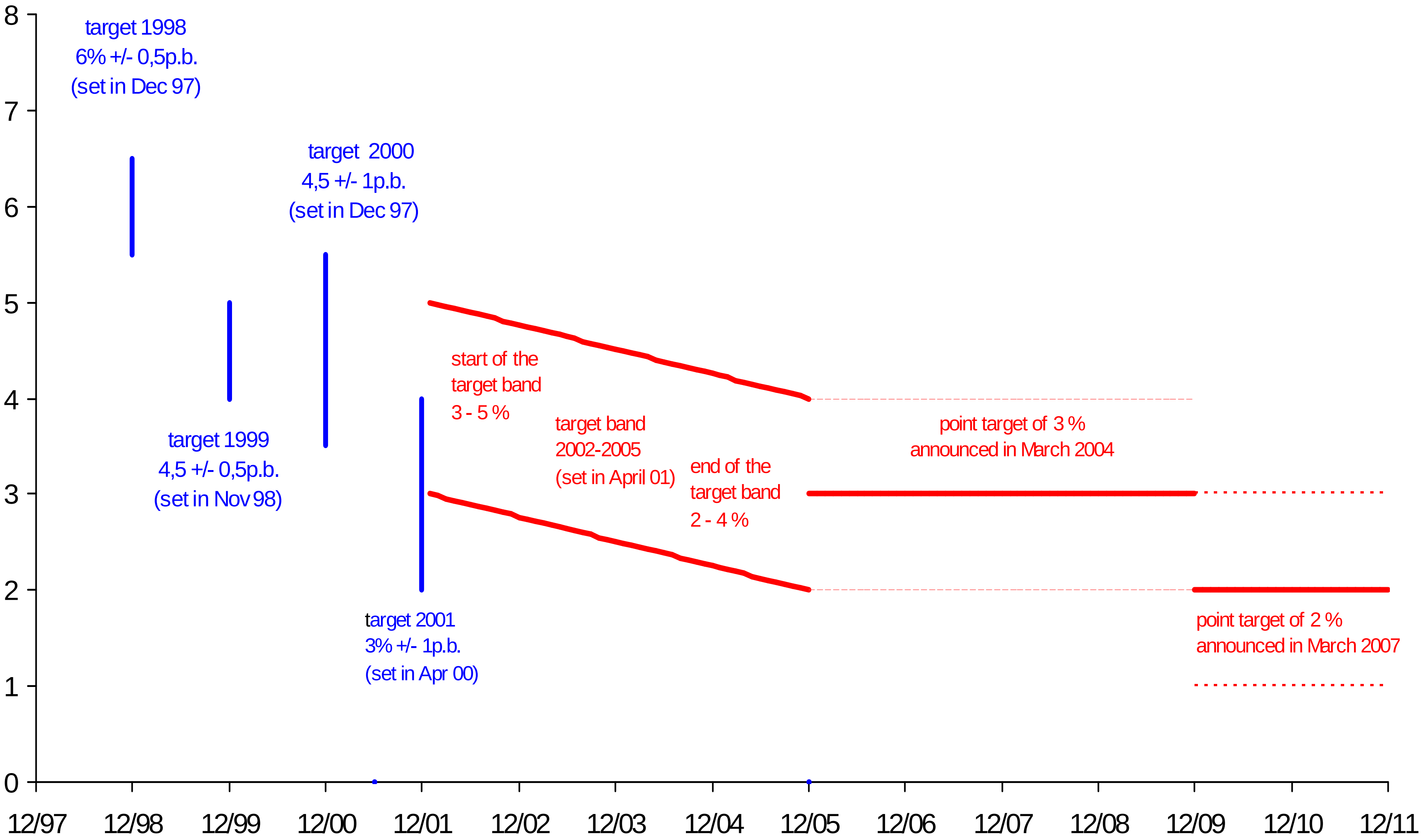

- Sharp drop in foreign demand in post-Lehman period
- After the financial crisis export growth has slowed down gradually, exports mainly directed to the core euro area

# Output gap (in % of potential output)



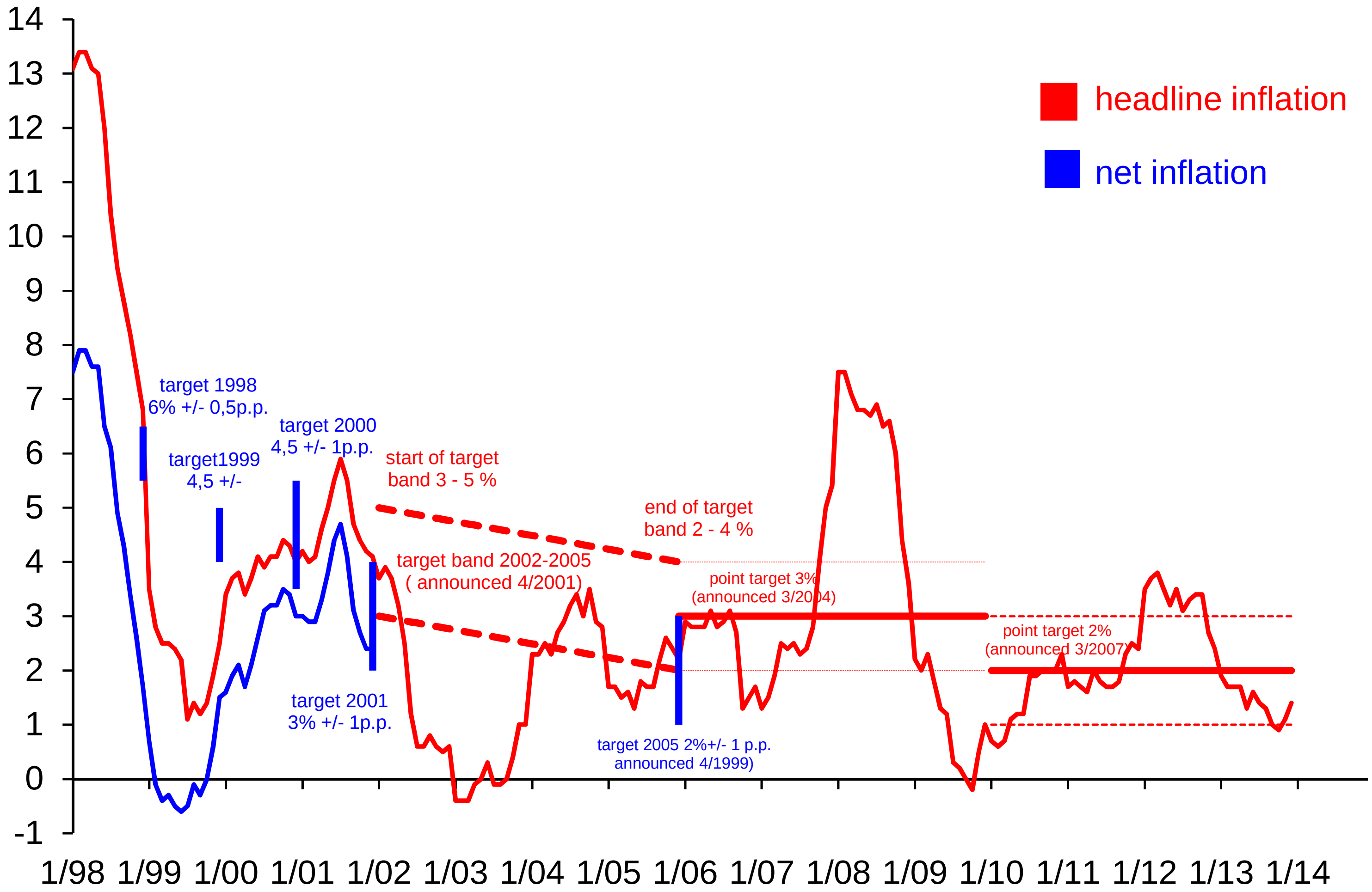

- Some overheating before the crisis
- Negative output gap since early-2009 (Kalman filter), currently remains significantly negative

# Inflation targets




- Currently a 2% target (since January 2010)

# Achievement of targets




- Since 1997-1998 (CZK depreciation, deregulations) gradual disinflation process, low inflation since 1999
- Inflation has been volatile due to commodity price shocks and changes in indirect taxes and administered prices

# CNB key interest rates (percentages)

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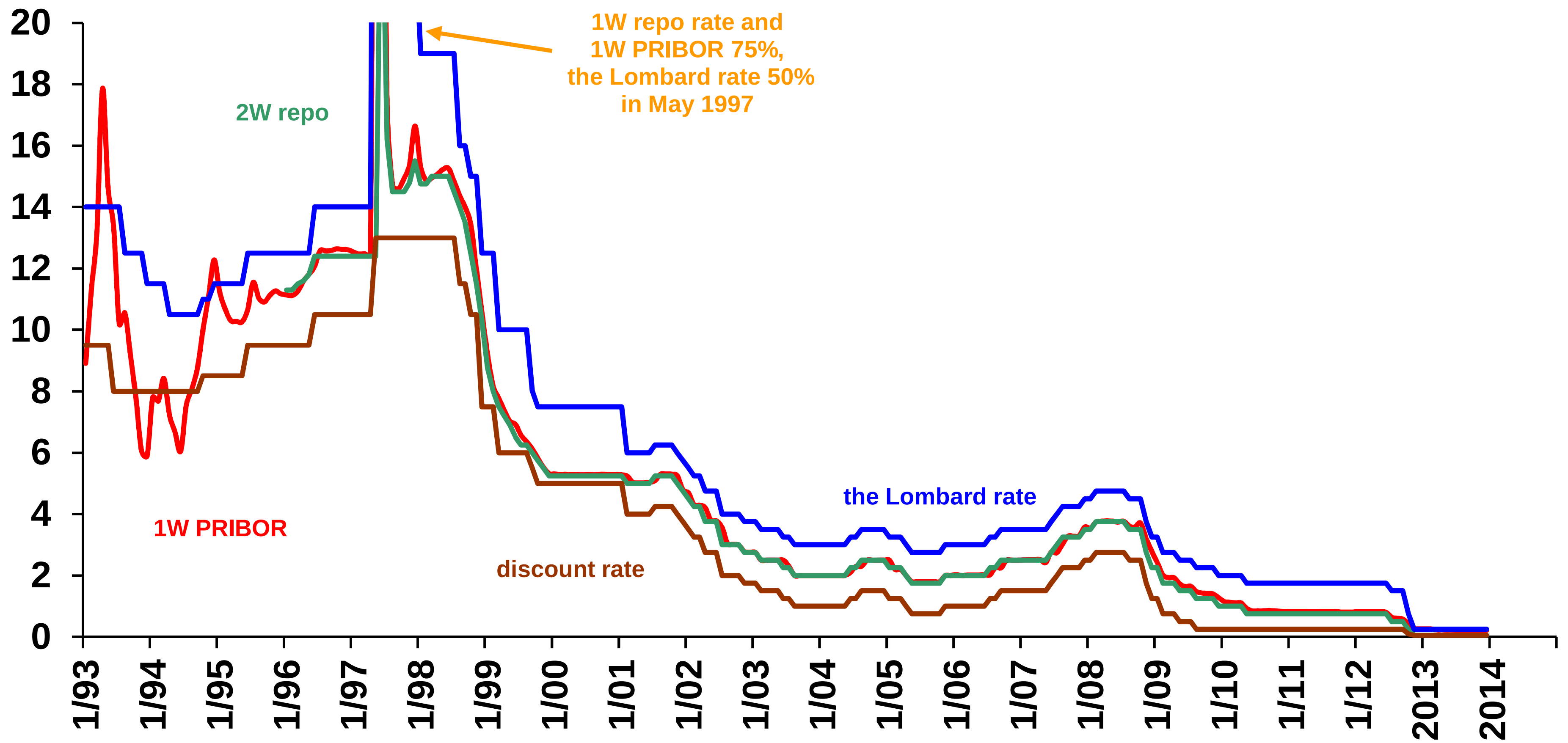


- Process of disinflation led to their fall to historically low levels

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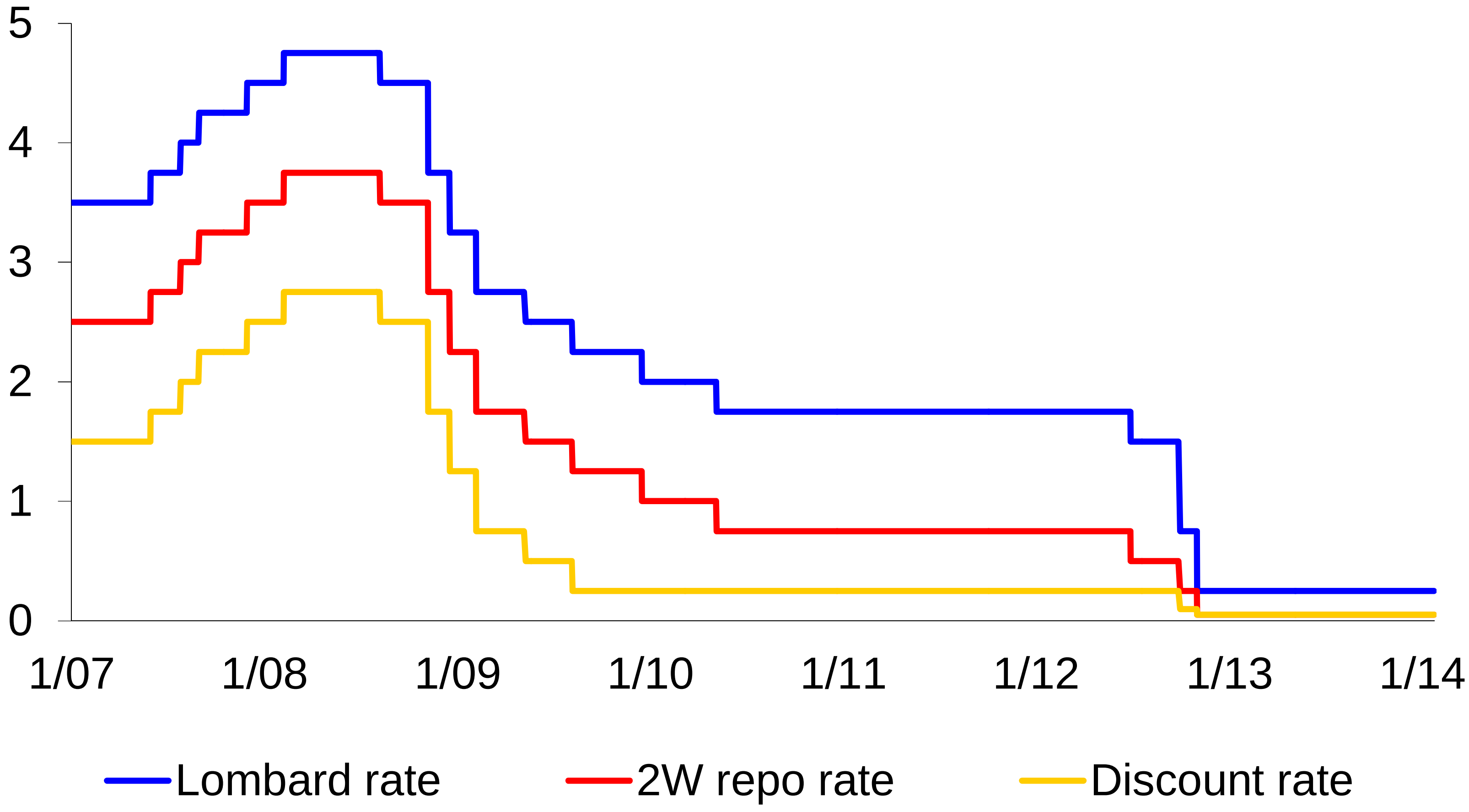


- Monetary policy easing in 2008-2010, 2W Repo rate cut from 3.75% to 0.75%, three further rate cuts in 2012
- Main policy rate currently at the „technical" zero lower bound level 0.05%