CNB monetary policy since 2012

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Monetary policy before November 2013

- 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 0.05% ("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 aimed at weakening 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

In November 2012 the CNB exhausted its main monetary policy instrument, i.e. interest rates

2013: strengthening disinflation

- Czech economy was more subdued than its neighbours
- Estimates of output gap were strongly negative in mid-2013
- Decline in fixed investment lasting more than two years
- Lowest-ever wage growth in private firms
- Falling inflation in euro area ⇨ further ECB interest rate cuts
- Price declines: PPI in manufacturing, construction, services, agriculture
- Inflation expectations had fallen to historical lows
- Falling growth of monetary aggregates and velocity of money
- Several-year-long fall in property prices (except in Prague)

The constantly rising disinflation risks were indicating an ever-increasing decline in inflation well below the inflation target and increasing risks of negative inflation

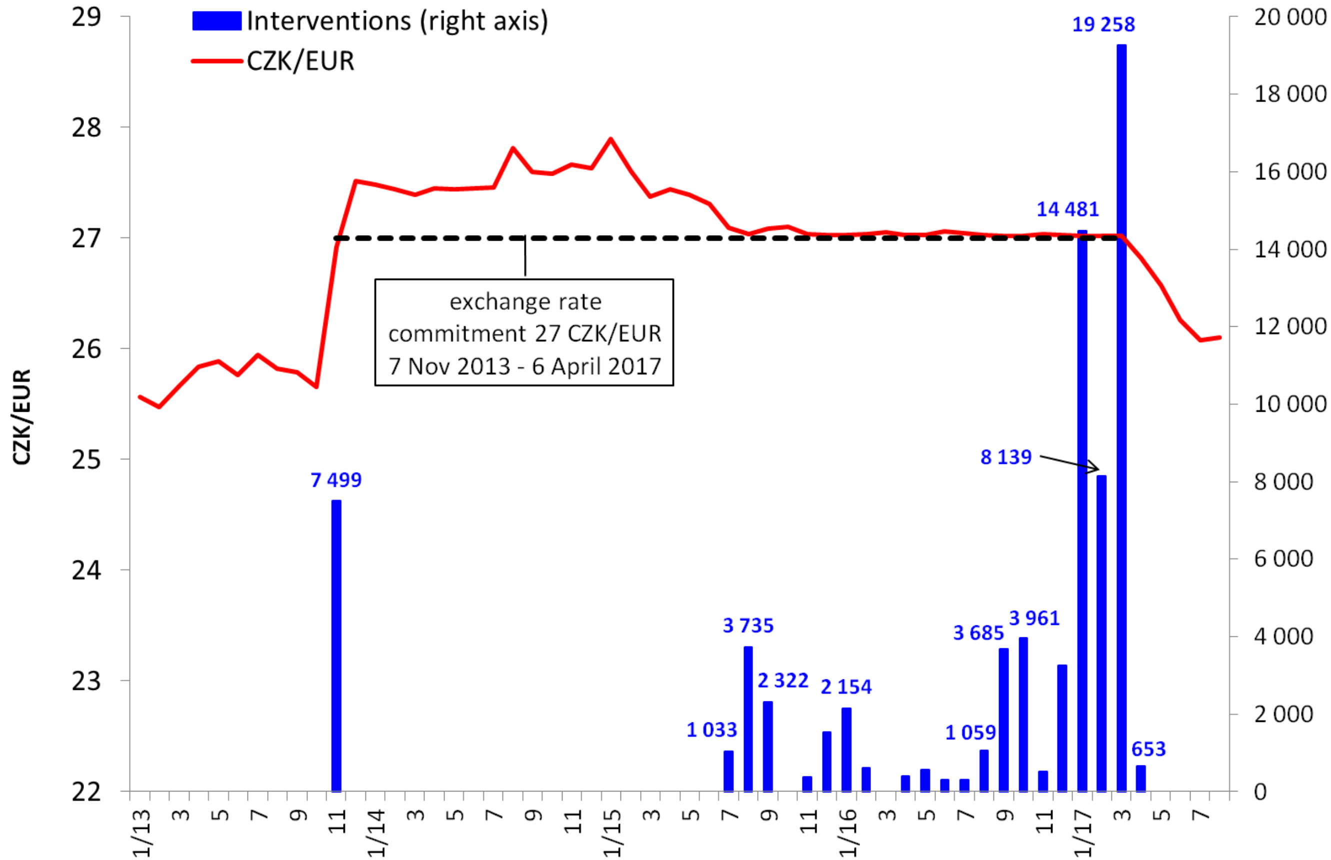
Exchange rate commitment: adoption

- On 7 Nov 2013 exchange rate commitment announced:
  - koruna would not appreciate below CZK 27/euro
  - on weaker side of CZK 27 koruna was allowed to float
  - CNB was prepared to make unlimited FX interventions
  - commitment was roughly equivalent to cutting rates by 1 p.p.
- Aim of commitment:
  - to further ease monetary conditions at zero lower bound
  - to tackle disinflationary/deflationary pressures
  - to revive economy and achieve inflation target more quickly
- Commitment was prolonged several times due to:
  - strong and longer-lasting (mainly external) disinflationary pressures
  - more (and longer-lasting) accommodative ECB monetary policy
- Final "hard" commitment lasted until end of 2017 Q1

The commitment became an unconventional MP instrument; the CNB joined other CBs using unconventional instruments (albeit in different forms) in a disinflationary environment

Exchange rate commitment and FX interventions

(January 2013 – August 2017)



Source: CNB, Eurostat

In mid-2015 the CNB started intervening (buying euro for koruna) to maintain the commitment; interventions in each month of 2017 Q1 were larger than in Nov 2013

Exchange rate commitment: exit

- Weakening of koruna contributed to economic recovery and gradual rise in inflation in 2014
- Other factors that aided recovery:
  - growth in external demand
  - end of restrictive domestic fiscal policy
- In late 2016/early 2017 domestic inflation pressures (core inflation) and food and fuel prices started to rise quickly:
  - condition of sustainable fulfilment of inflation target was met
  - continuation of commitment was no longer necessary to fulfil CNB's primary objective of maintaining price stability
- Exchange rate commitment was ended on 6 April 2017

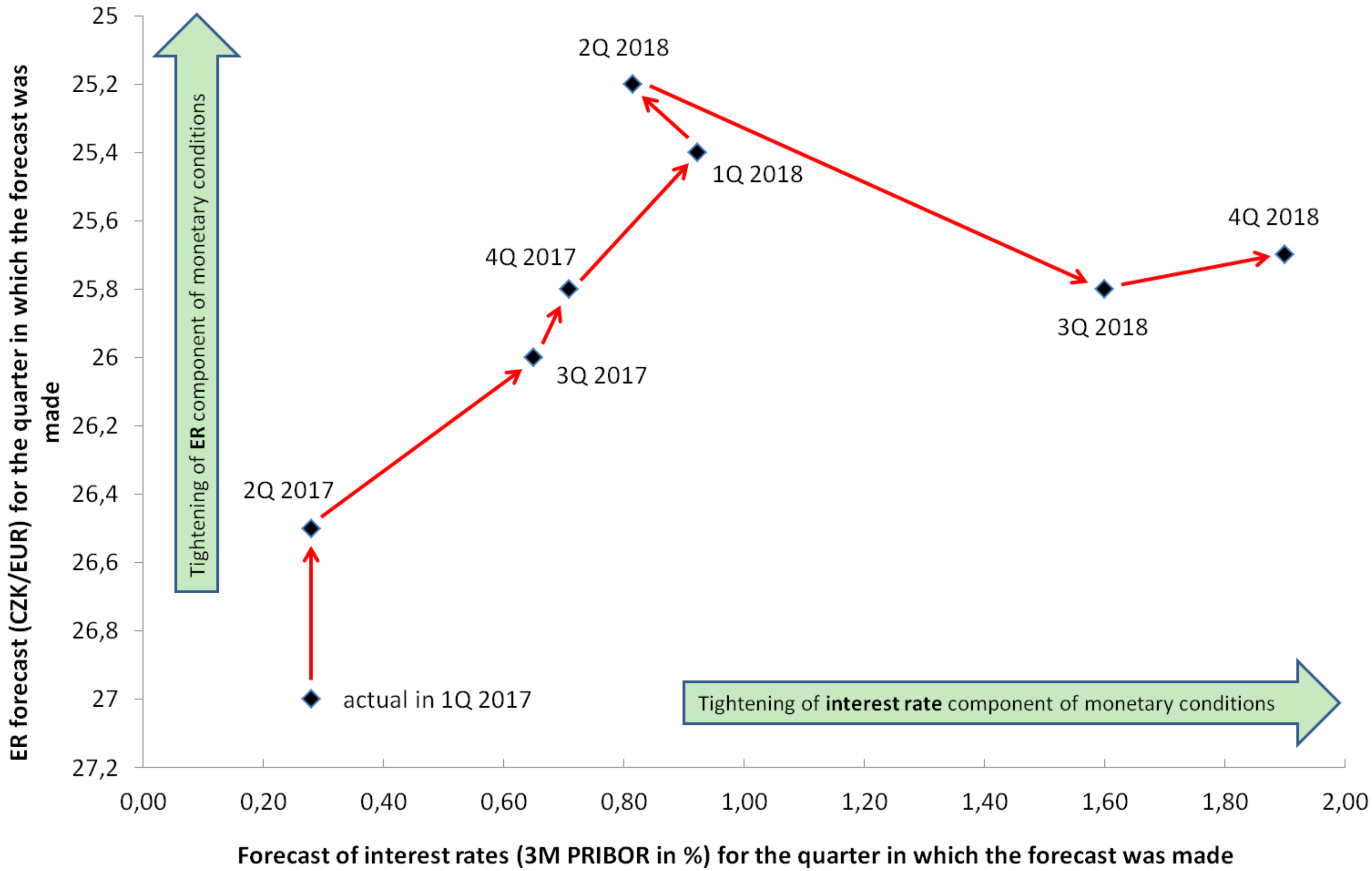
The exit from the commitment was the first step towards normalising monetary policy, i.e. towards using interest rates as the main instrument again

Normalisation of CNB monetary policy

- Return to managed float
- CNB has raised 2W repo rate seven times since April 2017:
  - **August 2017**: from 0.05% to 0.25%
    (first central bank in advanced Europe to increase rates)
  - **November 2017:** from 0.25% to 0.50%
  - **February 2018:** from 0.50% to 0.75%
  - **June 2018:** from 0.75% to 1.00%
  - **August 2018:** from 1.00% to 1.25%
  - **September 2018:** from 1.25% to 1.50%
  - **November 2018:** from 1.50% to 1.75%
- Rate hikes were facilitated by relatively depreciated koruna
- Starting with February Inflation Report, CNB returned to publishing projected exchange rate path
- Monetary policy tightening goes hand in hand with macro-prudential policy tightening, which CNB embarked on earlier

The gradual return of monetary policy to normal is a sign that the economy has overcome the 2008–2013 crisis

Forecasts: interest rates and exchange rates



Source: CNB

The somewhat weaker koruna in 2018 Q3 and Q4 implies a faster increase in interest rates

ER commitment: economic outcomes

(percentage points)

		Model-based approach		Empirical approach	
		I	II	I	II
Inflation (CPI)	2014	1.2	1.2	0.1	0.2
	2015	1.8	1.5	0.6	0.8
GDP growth	2014	1.2	0.8	0.3	0.4
	2015	0.6	1.2	1.7	1.8
Household consumption growth	2014	1.4	0.3	0.4	0.4
	2015	0.9	1.0	1.5	1.7
Unemployment	2014	-	-0.3	-0.2	-0.1
	2015	-	-1.2	-0.6	-0.5

Note: Model-based approach I: simulation with core prediction model used at CNB
Model-based approach II: simulation with core prediction model explicitly including labour market
Empirical approaches I and II: based, respectively, on synthetic control method and its generalised variant

Source: Brůha, Jan and Jaromír Tonner, An Exchange Rate Floor as an Instrument of Monetary Policy: An Ex-post Assessment of the Czech Experience, CNB WP 4/2017

Model-based and empirical approaches confirm that the commitment had positive effects on inflation and the real economy

Concluding remarks

- CNB opted for ER commitment due to following features:
  - Czech economy is very open
  - has positive net exports and high share of manufacturing
  - exchange rate pass-through to inflation is strong and fast
- After adoption of ER commitment CNB was exposed to heavy criticism; public generally did not understand that:
  - weakening of CZK relaxes (not tightens!) monet. conditions
  - weakening of koruna by 5% is not "end of the world"
  - there is difference between short and long run (J-curve)

  ⇨ Adoption of ER commitment was not costless in terms of central bank credibility
- ER commitment proved to be beneficial as envisaged: delivered faster recovery and higher inflation
- Exit from ER commitment was (surprisingly) smooth
- Despite ongoing normalisation of monetary policy we are not in normal situation yet

CNB experience with ER commitment is positive

Thank you

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