Two Decades of Inflation Targeting in the Czech Republic

(Introduction)

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The start of 2018 marked the twentieth anniversary of inflation targeting in the Czech Republic. This monetary policy regime has been evolving over time and has refined considerably. Forecasting tools have become much more sophisticated, as has the framework within which the Bank Board applies them in its deliberations. The Czech National Bank (CNB) has also become substantially more open and transparent in its communications. The biggest challenge to inflation targeting as a policy regime was the global financial and economic crisis, which hit the Czech economy hard and led the CNB to decide to introduce an exchange rate commitment in 2013.

The Early Years of Inflation Targeting

The Czech National Bank opted for inflation targeting as its new monetary policy regime after the fixed exchange rate combined with money targeting collapsed in May 1997. The exchange rate peg, which had served as a nominal anchor for the transformation economy since 1991, became undermined by the liberalization of financial flows in the mid-1990s and constituted a classical case of the Impossible Trinity. The ensuing currency turbulence and economic and monetary disorder throughout 1997 paved the way for a policy framework which would be consistent with a more advanced stage of economic transformation. At the time, inflation targeting was being applied by just a few central banks in advanced economies, and even they had not been using it very long. The Czech Republic was the first post-socialist economy to adopt this regime with a view to reducing the consistently high (though still single digit) inflation recorded in previous years and stabilising it at the low levels comparable to those witnessed in advanced countries.

The new monetary policy framework provided the economy with a nominal anchor in the form of a clearly set target for inflation – or, more precisely, for the pace of disinflation – and thus helped anchor inflation expectations. Inflation targeting is characterised by forward-looking monetary policy decisions. This means that the setting of monetary policy instruments is derived from a forecast of the future path of inflation and other variables. The fact that the macroeconomic forecast is built on internally consistent variables is perceived to increase the credibility, transparency and predictability of monetary policy.

The regime of inflation targeting was modified at the start of 2002, when net inflation[1] targets were replaced by targets for headline consumer inflation. Since headline inflation is easier for the public to understand, headline inflation targets have greater potential to anchor inflation expectations. Another change was that the inflation targets were set as a gradually declining band rather than year-end targets.

[1] Net inflation is defined as headline consumer inflation excluding administrative effects, i.e. administered prices and the first-round effects of changes to indirect taxes.

The quite moderate slope of this band (from 3%–5% in 2002 to 2%–4% in 2005) indicated a preference for only gradual disinflation.

Right from the outset, the CNB regarded its inflation targeting as "flexible". This meant that under certain circumstances the inflation target might temporarily not be fulfilled. This might be due to selected economic shocks where attempting to return inflation to the target too quickly would result in undesirable volatility in GDP and employment. Such situations were characterized by pre-announced exemptions, or escape clauses. If an economic shock subject to an escape clause deflected inflation from the target, the CNB did not respond to its first-round effects and tolerated a temporary deviation from the forecast and, subsequently, future inflation from the target. Theoretically, the whole range of shocks creates room for applying such escape clauses. Over the last 20 years, however, the CNB has applied them in a limited way, mostly in connection with changes to indirect taxes and in some cases also in connection with sharp swings in global oil and food prices.

Advanced Inflation Targeting

In 2006, the CNB started to target stable inflation, expressed as a 3% annual consumer price increase with a tolerance band of ± 1 percentage point. The advantage of a point target over a target band is that it provides a better anchor of inflation expectations for all economic agents. For economic agents, a point inflation target is thus a good inflation anchor in the medium term. This does not mean, however, that inflation has been close to the target for most of the time. In 2010, the point inflation target was lowered to 2% ± 1 p.p. This brought the CNB's inflation target into line with the usual level of targets in advanced countries.

The forecasting system was further improved as the target was lowered. In 2008, the CNB became one of the first central banks to introduce a "core", dynamic stochastic general equilibrium model into a regular forecasting practice. The forecast preparation process, including the discussions with the Bank Board about the assumptions, message and risks of the forecast, became well structured and standardised over time. This strengthened the key role played by the forecasting process in supporting the Bank Board's monetary policy decision-making.

The transparency of the CNB's monetary policy has been steadily increasing over years. The CNB started to publish audio recordings on its website about an hour after each press conference in May 2007 and video recordings of the press conference in December 2009. The CNB has published the votes cast by the Bank Board members and fan charts of the forecast-consistent interest rate path since 2008. The CNB also started to publish the forecasted path of the koruna-euro exchange rate, consistent with other parts of the forecast, in 2009. These changes have made the CNB one of the most open inflation-targeting central banks, thus enhancing the credibility, transparency and predictability of its monetary policy.

Generally, the CNB uses its instruments to steer future inflation close to the target at the monetary policy horizon (unless the situation necessitates the application of a temporary escape clause). Frequent unexpected events cause inflation to deviate to a greater or lesser extent from the point target. Although monetary policy can respond to these shocks and try to hit the point inflation target in the future, it is not capable of returning inflation to the target immediately. In addition to the new point target, the CNB therefore defined a tolerance band of one percentage point in either direction to reflect this uncertainty in hitting the inflation target.

Unconventional Monetary Policy

The limited room to ease monetary policy almost ran out in early November 2012, when the CNB Bank Board lowered its policy rate to 0.05%, or "technical zero". At the same time, the CNB pledged to leave interest rates at this level for as long as needed. Unable to loosen monetary policy further by means of interest rates, the CNB started to communicate in autumn 2012 that it was ready to use additional instruments should further easing become necessary. After careful consideration and after publicly hinting at its readiness to use it, the board opted for the exchange rate. For the Czech Republic, which is a small open economy, the exchange rate seemed to be a more suitable unconventional instrument for further easing of monetary conditions than, say, government bond purchases.

By the autumn of 2013, our forecasts were signalling that the recession and the labour market downturn were subsiding only very slowly, and their anti-inflationary effects, coupled with falling prices of commodities and energy, were leading to a further decrease in inflation to negative levels. According to analyses, monetary policy inaction would lead to the appreciation of the koruna. Firms and households would further postpone consumption and investment, and so the incipient recovery would slow or halt completely. The Czech economy might get into a vicious circle known as a deflation-recession spiral, which would be very difficult to break. According to the forecast, monetary policy needed to be eased significantly to avert this risk. In November 2013, the CNB decided to use the exchange rate as an additional instrument for easing monetary policy as necessary and made a commitment to keep the exchange rate of the koruna close to CZK 27 to the euro.

After the exchange rate commitment was announced, the koruna weakened above the floor with the aid of foreign exchange interventions by the CNB. The CNB clearly declared that it stood ready to intervene without any time or volume limits. Owing to this, the exchange rate commitment quickly earned high credibility. Until summer 2015, the koruna was above the floor of CZK 27 to the euro without the need for CNB interventions. In mid- 2015, however, quantitative easing by the ECB and continued favourable developments in the domestic economy pushed the koruna to the commitment level. From July 2015 onwards, when needed, the CNB intervened to avoid appreciation below the floor. Although it had been initially intended to maintain the commitment for about one and half years, unexpected disinflationary pressures stemming mainly from abroad forced the CNB to extend it several times. Only in late 2016 and early 2017 did domestic inflation pressures (core inflation) and food and fuel prices start to rise quickly, which implied that the condition of sustainable fulfilment of inflation target had been met. Continuation of the commitment was thus no longer necessary to fulfil the CNB's primary objective of maintaining price stability. The exchange rate commitment was abandoned in April 2017 and the monetary policy has been gradually normalizing since then.

An Overall Assessment of 20 Years of Inflation Targeting

The twentieth anniversary of inflation targeting offers a perspective to assess the substantial Czech experience with the monetary policy framework. It has not always been possible to consider the monetary policy of the CNB as flawless. In the first decade of our inflation targeting there were examples of inflation deviating from the target, mainly in the downward direction. The main causes of this tendency were, above all, exogenous inflation dampening shocks, specific features of the CNB's forecasting model, asymmetry in the decision-making process, and declining inflation expectations. Likewise, during the long term exchange rate commitment, inflation fluctuated for almost three years below the lower limit of the target tolerance zone. The benefit of hindsight shows that exchange rate conditions in the period concerned could have been dramatically more relaxed than in fact they were. These partial inadequacies, however, do not diminish the fact that inflation targeting was highly beneficial for CNB policy making and yielded fundamental system advantages. These may be summarized as follows:

- Inflation targeting provides consistent and structured thinking for the decision making framework.
- The methodology of the whole framework over 20 years has fundamentally changed in style: it started from a rather primitive and intuitive approach and matured into a sophisticated, formalised, state-of-the-art model, highly rated even on the international level.
- Inflation targeting is nowadays carried out through a thoroughly standardised and structured process, shaping new prognoses and incorporating evaluation of the success of previous prognoses.
- Inflation targeting has proved to be a very effective way of forming and anchoring inflation expectations.
- The targeting of inflation has demonstrated the ability to face the consequences of the financial crisis by exploiting the exchange rate as an unconventional instrument of monetary policy.
- Today's inflation targeting setting is highly transparent, reliable and predictable.
- Inflation targeting constitutes an important element of the macroeconomic stability framework of the Czech Republic.

Personally, I judge that for the CNB, but clearly also for tens of other national central banks, there is no viable alternative which compares with applying an inflation targeting regime. Therefore, it can be anticipated that as long as the Czech National Bank continues to conduct its own independent monetary policy, over the next decade or so it will continue to pursue a monetary policy regime which naturally further refines on its inflation targeting.