

# *Inflation Targeting and Use of the Exchange Rate as a Monetary Policy Instrument: CNB Experience*

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# 17 Years of Experience with IT

- Adoption of IT: 1998; IT framework has undergone enormous changes (evolution of inflation targets; adoption of escape clauses and switch to flexible IT; forecasting techniques; switch from conditional to unconditional forecasts; increasing transparency)
- Positive:
  - ◆ Successful disinflation, anchoring of inflation expectations
  - ◆ Contributed to macroeconomic stabilisation of Czech economy
  - ◆ Facilitated long-term real and nominal convergence of Czech economy to developed economies
  - ◆ Flexible IT framework allowed us to add exchange rate to list of instruments used to ease monetary conditions
- Negative:
  - ◆ Frequent undershooting of targets (in 2007–2008 and 2011–2014)
  - ◆ Relatively high volatility of exchange rate

The IT regime has functioned as a consistent decision-making framework, proving effective even at the height of the financial and economic crisis

# *Weakening of koruna in November 2013*

- CNB weakened koruna to around CZK 27/euro (roughly equivalent to cutting rates by 1 percentage point)
- Expressed (one-sided) exchange rate commitment:
  - to prevent excessive appreciation of koruna below CZK 27/euro
  - on weaker side of CZK 27 level to allow exchange rate to float according to supply and demand on foreign exchange market
- Weakening of koruna was aimed at:
  - averting real threat of deflation
  - attaining inflation target earlier
  - helping economy to recover faster
  - exiting zero interest rate level earlier (and returning to use of main monetary policy instrument sooner)

**The exchange rate became a new tool in the IT regime**

# Koruna-euro exchange rate (3 January 2000 – 17 November 2014)



Source:  
Eurostat

The November weakening of the koruna was not at all unusual by historical standards

# Key macroeconomic indicators

	y-o-y change in %			
	Available on 7 Nov 2013		Available on 6 Nov 2014	
GDP (s.adj.)	II/13	-1,3	II/14	2,5
Household consumption (s.adj.)	II/13	0,0	II/14	1,9
Gross capital consumption (s.adj.)	II/13	-14,0	II/14	6,3
CPI	9/13	1,0	9/14	0,7
Monetary-policy relevant inflation (without taxes)	9/13	0,2	9/14	0,6
Unemployment - age 15-64 years (s.adj., in %)	III/13	7,0	III/14	6,0
Average nominal wage in business sector	II/13	1,1	II/14	2,5
Number of vacancies	9/13	39 040	9/14	56 600
Gross operating surplus of non-financial enterprises	II/13	1,3	II/14	14,5
Composite confidence indicator	10/13	88,9	10/14	94,1
Retail sales incl. cars (s.adj.)	9/13	0,3	9/14	4,5
Industrial production (s.adj.)	9/13	1,8	9/14	5,6
Construction output (s.adj.)	9/13	-12,7	9/14	8,4

Source: CZSO

The key macroeconomic indicators are developing much more favourably this year than they were before November 2013

# *Assessment of weakening of koruna*

- Czech economy avoided deflation and emerged from recession
- Growth fostered by: 1) weakening of koruna, 2) end of budgetary restrictions, and 3) recovery abroad (albeit weaker than expected)
- Developments (except for lower inflation) in line with what we envisaged when we weakened koruna
- Low (but non-negative) inflation fostered by more deflationary (than expected) producer price developments in euro area and deeper decline in domestic administered prices
- CNB will not discontinue use of exchange rate as MP instrument before 2016; we do not expect koruna to appreciate significantly after exit
- Monetary policy faced no adverse trade-offs during crisis; weakening of koruna stimulated economic activity, which in turn helped lift inflation towards CNB's inflation target

**The weakening of the koruna turned out to be beneficial and even more necessary than it seemed in Nov 2013**