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Central bankers' views on monetary policy implications of GVC integration: Czech case

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What are the channels through which GVCs affect macroeconomic outcomes in Czech Republic?

- The Czech economy is one of the most industrialised in the world
- Its GVC integration is high, mainly due to an exceptionally large weight of the auto industry in GDP
- The current GVC disruptions are having a double impact on the Czech economy:
  - they are hindering the supply side (delayed supplies of intermediate products are leading to lower production) and thereby slowing economic growth
  - elevated prices of commodities, energy and components are stimulating cost-push inflation (this, hand in hand with domestic demand-pull inflation, is creating a need to tighten monetary policy, which the CNB has been doing since June)
- Conclusion: GVC integration increases cost and price competitiveness, because the economy benefits from the comparative advantages of international specialisation, but it simultaneously makes the economy more vulnerable to disruptions originating in GVCs

How has the role of the exchange rate pass-through (ERPT) evolved over time on the back of stronger integration of the Czech economy into GVCs?

- The position of the Czech economy in the international division of labour has changed greatly over the last three decades
- In the 1990s “hired labour” was widespread (domestic firms carried out low value added operations for foreign business partners), whereas today there are many independent medium-sized (“Mittelstand”) firms with their own R&D, design and sales; these firms create higher value added and have higher profit margins
- This economic profile should *ceteris paribus* reduce the ERPT to inflation: the higher up the value chain a country is, the lower is the ERPT to inflation
- The Czech Republic has moved distinctly higher up the value chain over the last three decades, and its ERPT to inflation is gradually reaching levels typical of advanced economies

If the role of the ERPT has changed, does this affect the efficacy of monetary policy and/or of your current exchange rate regime?

- Since 1998 the Czech Republic has been using IT combined with a managed float
- The flexible exchange rate has been a source of shocks several times over the past almost 25 years but was an absorber of exogenous shocks during the two global crises
- The CNB is confident in its ability to pursue a sufficiently competent independent monetary policy that benefits the Czech economy and aids its long-term convergence
- The long-term decline in the ERPT to inflation is *ceteris paribus* reducing the room for the exchange rate to be a source of shocks and increasing the effectiveness of interest rates as the primary MP instrument
- Spontaneous euroisation is reducing MP efficacy (loans are cheaper in EUR than CZK)
- However, the intensive integration of the Czech economy into GVCs is increasing its vulnerability to disruptions that may stem from GVCs (see above)
- The present situation is posing MP challenges but does not constitute grounds for considering changing our current MP or ER framework

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How can price hikes that may directly or indirectly result from climate change policies be reconciled with central banks' inflation targets?

- Research at the CNB has not paid systematic attention to this issue so far
- Although we concede that climate change policies may be having recognisable impacts on inflation, the overheating of the Czech economy seen in recent years has significantly greater implications for our monetary policy
- The domestic demand pressures have recently been exacerbated by an external cost shock, which is increasing the risk of a wage-price spiral
- Given the present situation and future trends (over the next two years), the impacts of climate change on inflation therefore play a marginal role and our monetary policy does not address them explicitly

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Should monetary policy react to such price hikes at all? Or should policymakers only react to second-round effects, and thereby reduce the effectiveness of climate change policies and risk stagflation?

- Central banks should always react to second-round price pressures – it's in their "job description"
- If the first-round price pressures appear to be temporary, we regard it as normal to make them the subject of exemptions under inflation targeting
- If, conversely, they turn out to be long-lasting, it is legitimate to consider changing the inflation target
- However, any change to the inflation target should be preceded by thorough analyses in the MP reviews conducted by central banks from time to time

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Or, alternatively, do we need to change the definition of inflation targets, inflation measures or the mandate of central banks?

- We do not believe anything should be changed in the price stability focus of central banks' mandates
- However, it is legitimate to consider changing inflation targets or using different measures of inflation where appropriate/necessary

- The CNB believes that environmental protection should be the sole domain of governments/politicians and that central banks should be entirely exempted from it, or at most have only a complementary role (but even this should first be debated and only then enacted into law)

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Thank you