Monetary Policy in a Small Open and Converging Economy: the Czech Case in the CEE Perspective

Czech National Bank

Mojmír Hampl

Vicegovernor

Prague, September 2, 2013

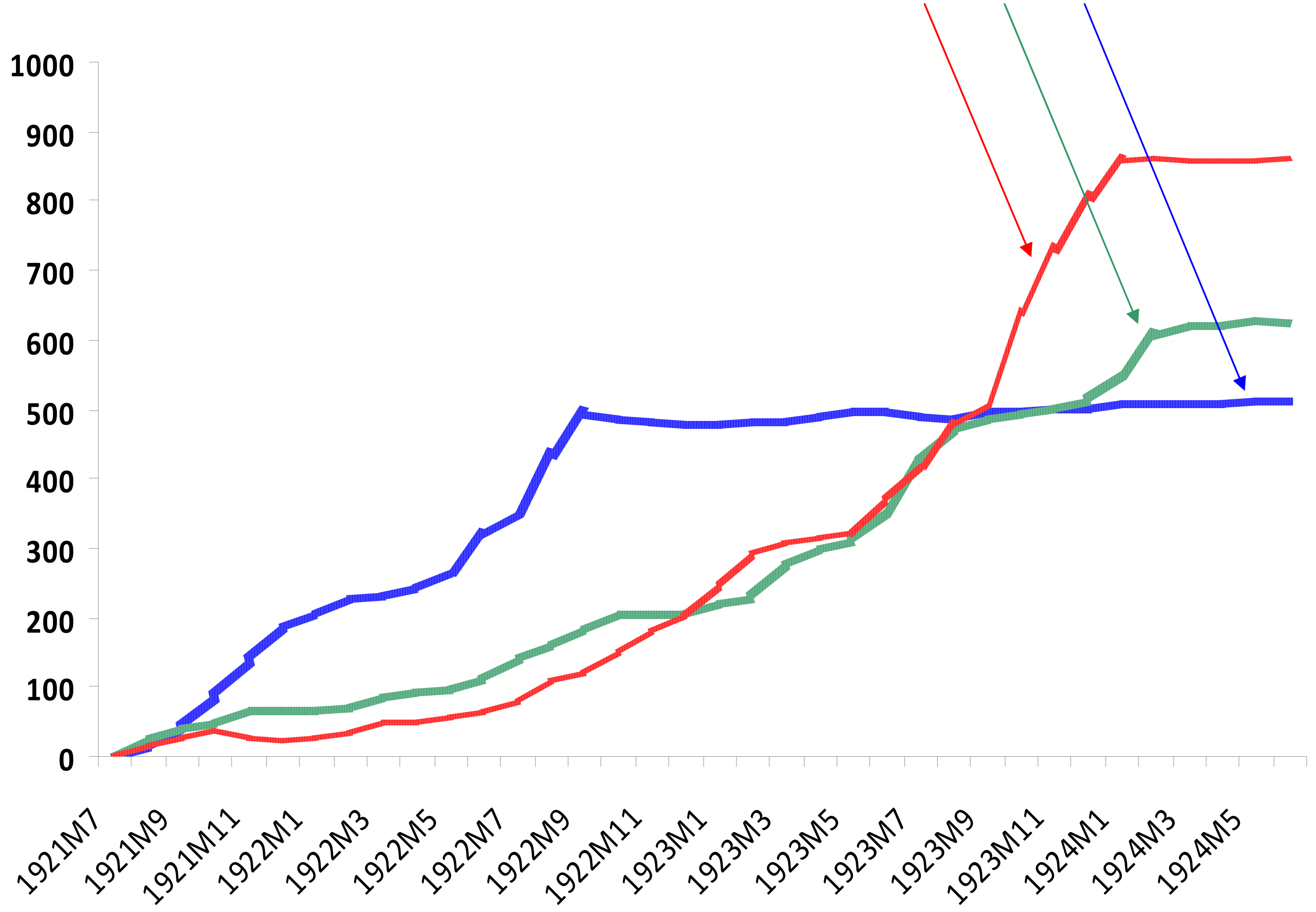
“A nice art collection and quiet surroundings do not make a First World central bank” (Calvo, 2006)

Outline

- A bit of ancient history
- Disinflation strategies in 1990s
- Economic convergence and the real exchange rate
- Implied systematic nominal appreciation and its implication for the balance sheets of households and firms
- ‘Original sin’ and monetary policy after the Lehman collapse and later
- Summary

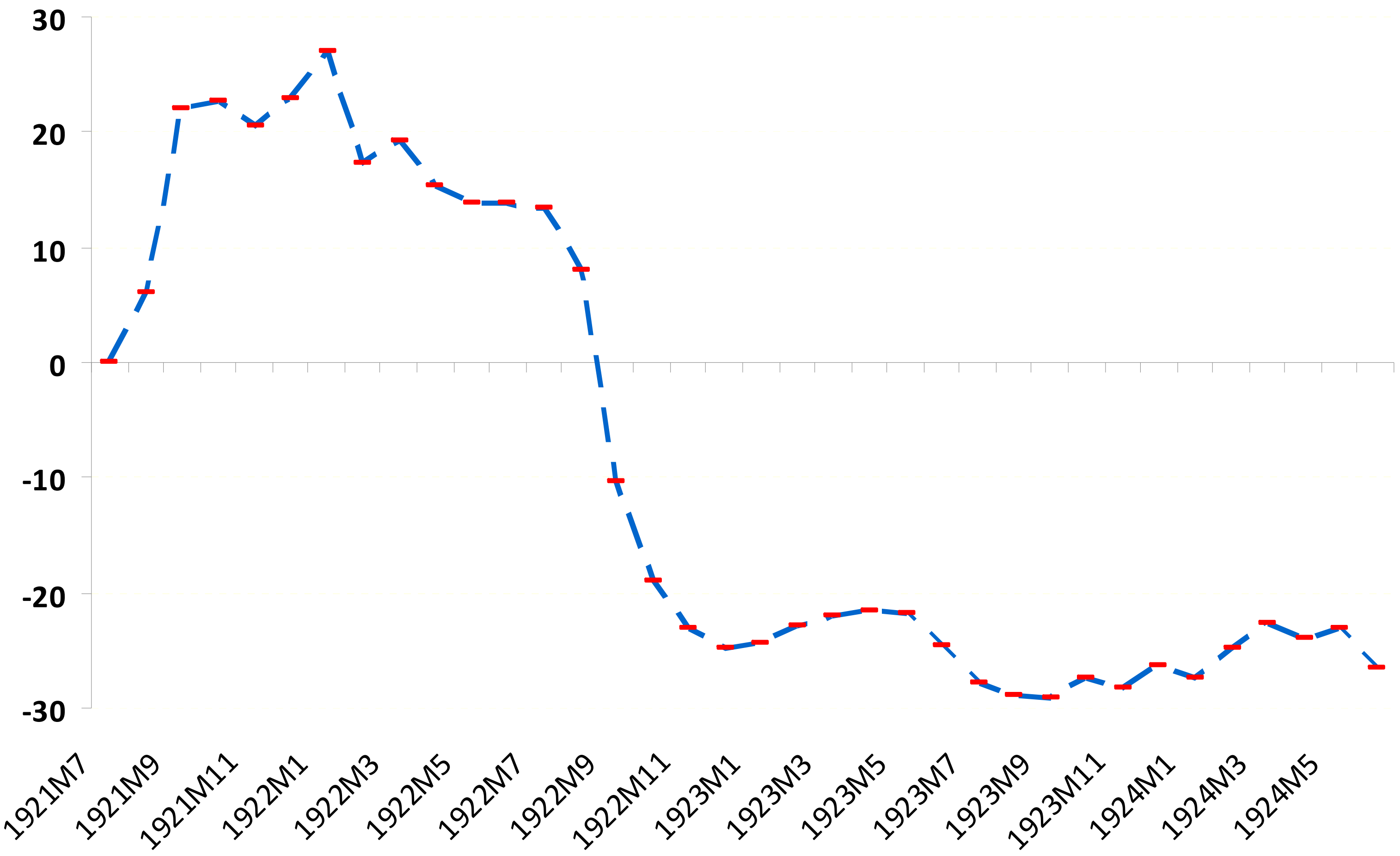
A bit of ancient history

Inflation (Jul 1921 – May 1924, in %) PL, HU, A



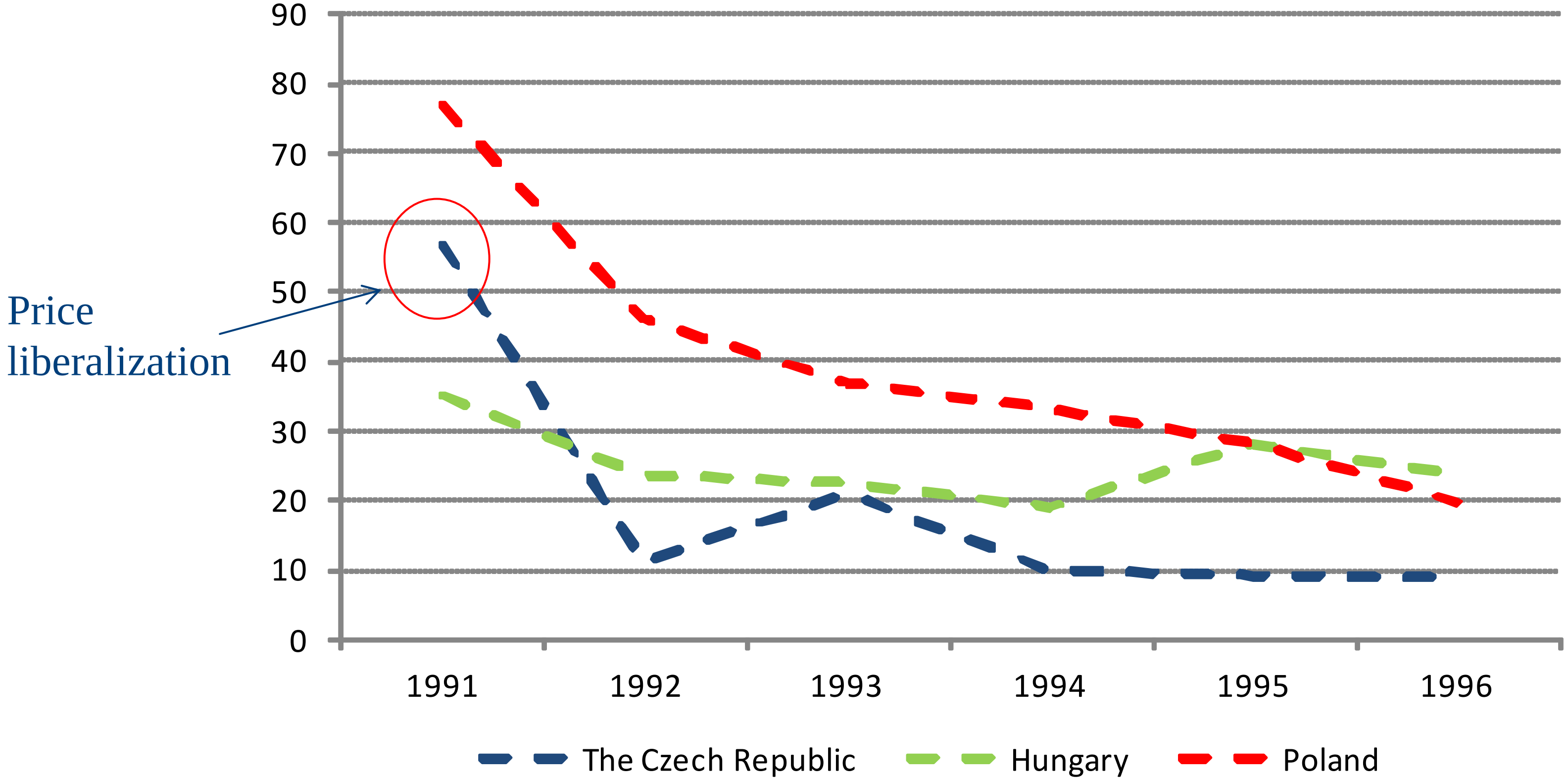
A bit of ancient history

Inflation (Jul 1921 – May 1924, in %) - Czechoslovakia



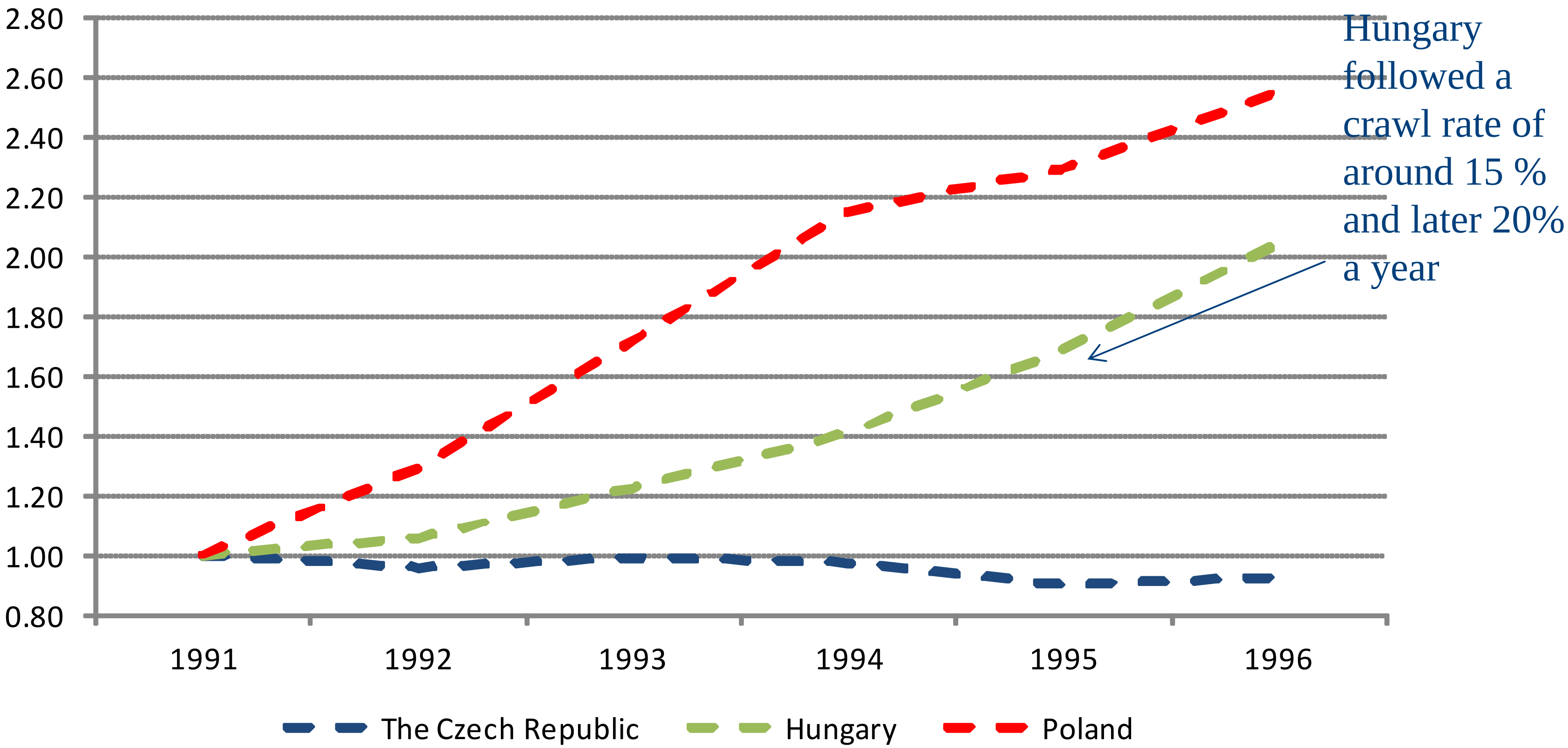
After the price liberalization Czechs disinflated below 10% threshold relatively quickly

Inflation (1991-1996, CPI, in %)



Behind was an implicit peg against DM&USD basket, while Hungary and Poland used a crawling peg

Exchange rate against USD (1991-1996, index, 1991 = 1)

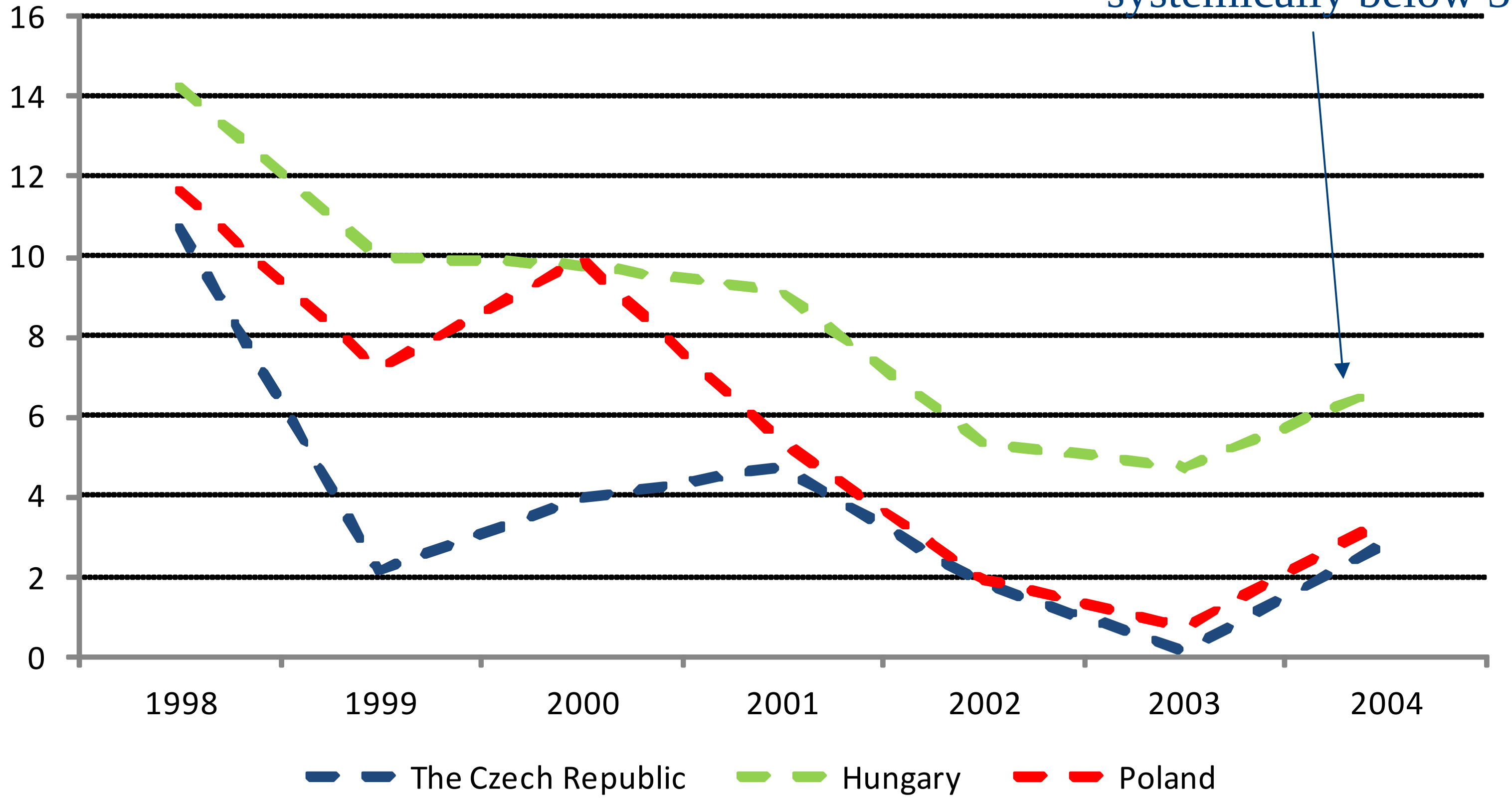


CNB CZECH NATIONAL BANK

Later, after the turmoil in 1997, Czechs adopted inflation targeting and disinflated rapidly, followed by Poland in 2001

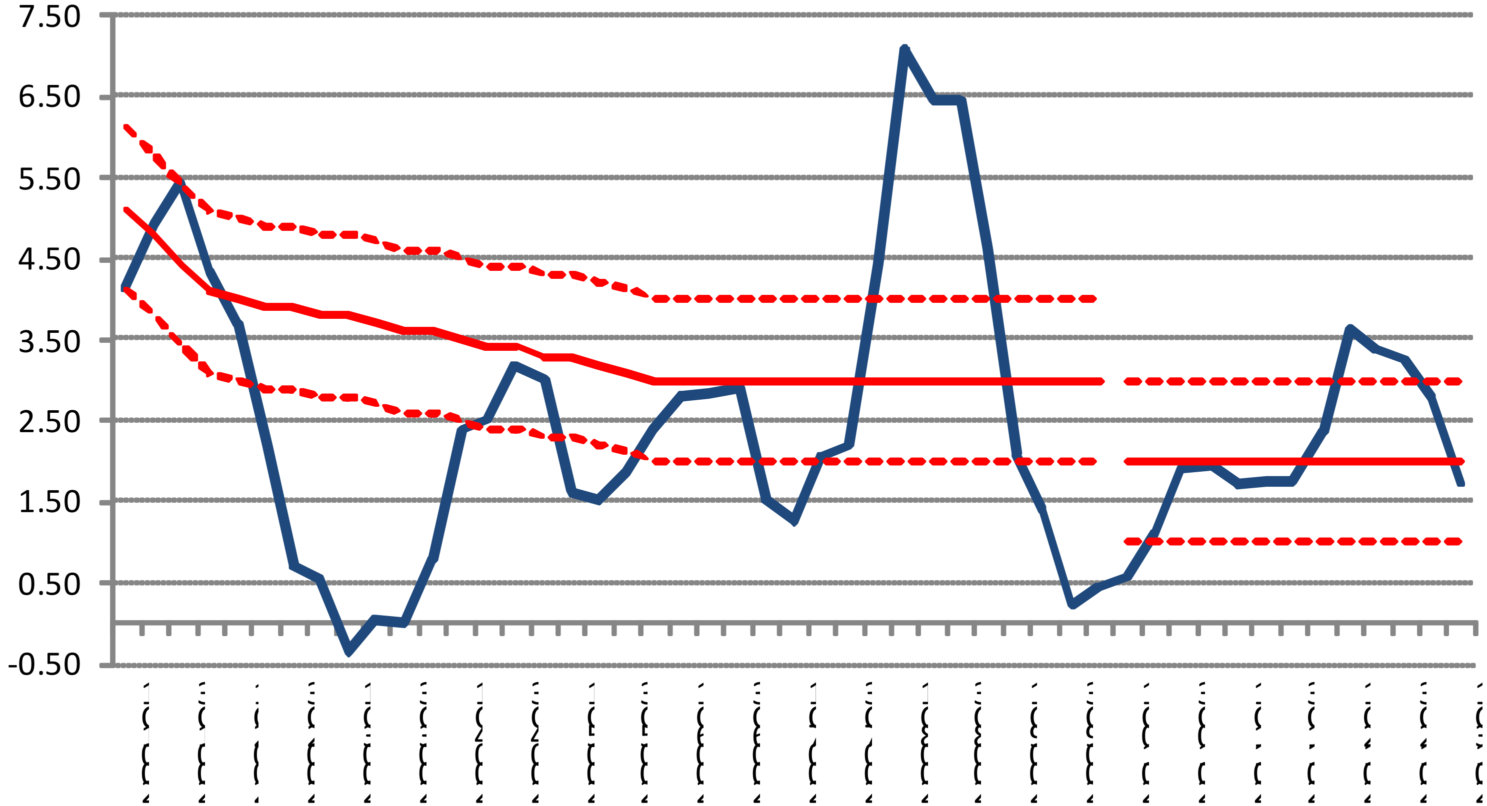
In contrary, Hungary did not manage to disinflate systemically below 5%

Inflation (1998-2004, y-o-y, in %)



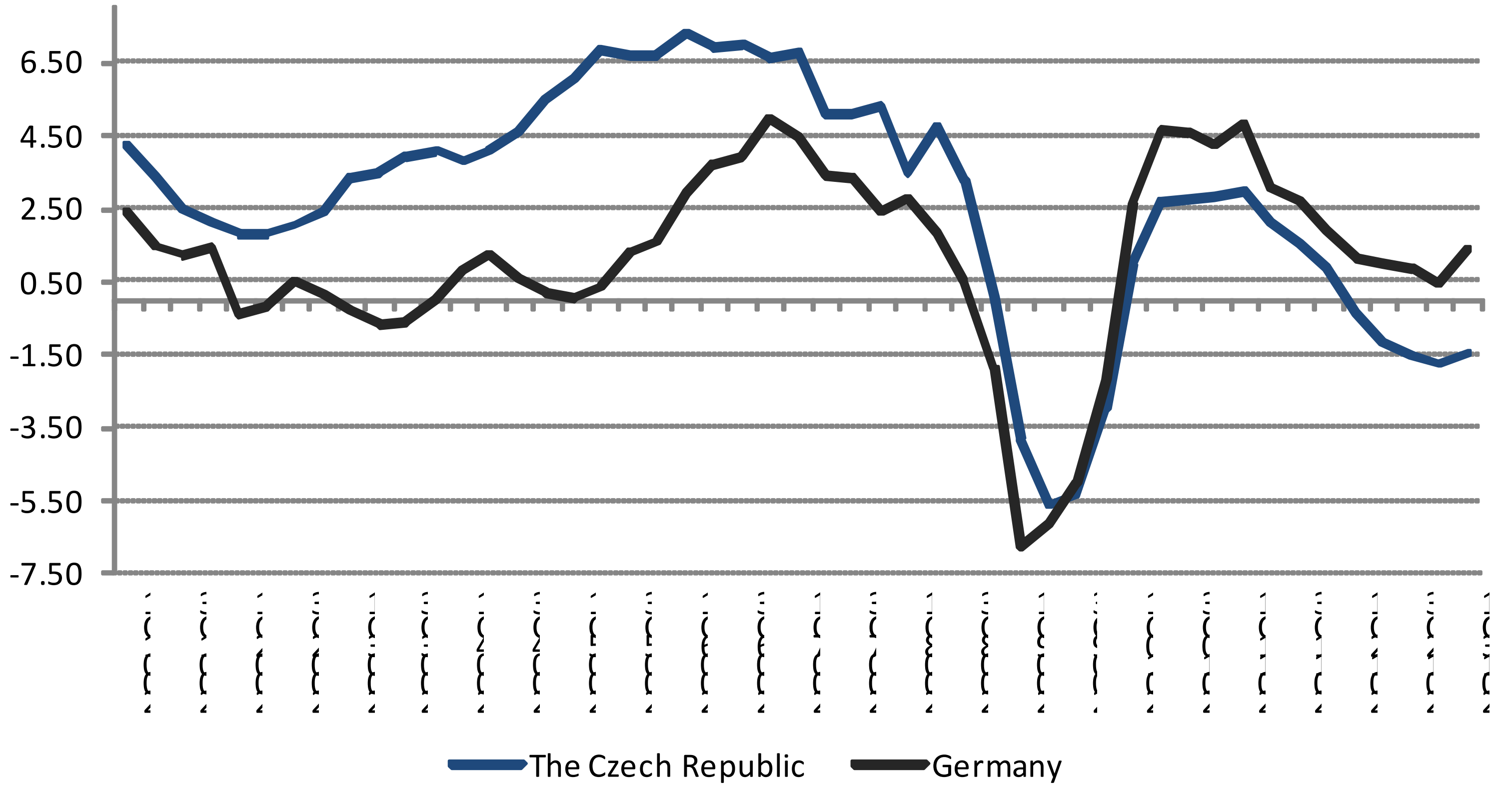
On average Czech inflation has been around 2% after 2001

Inflation (2001Q1-2013Q1, CPI, y-o-y, in %)



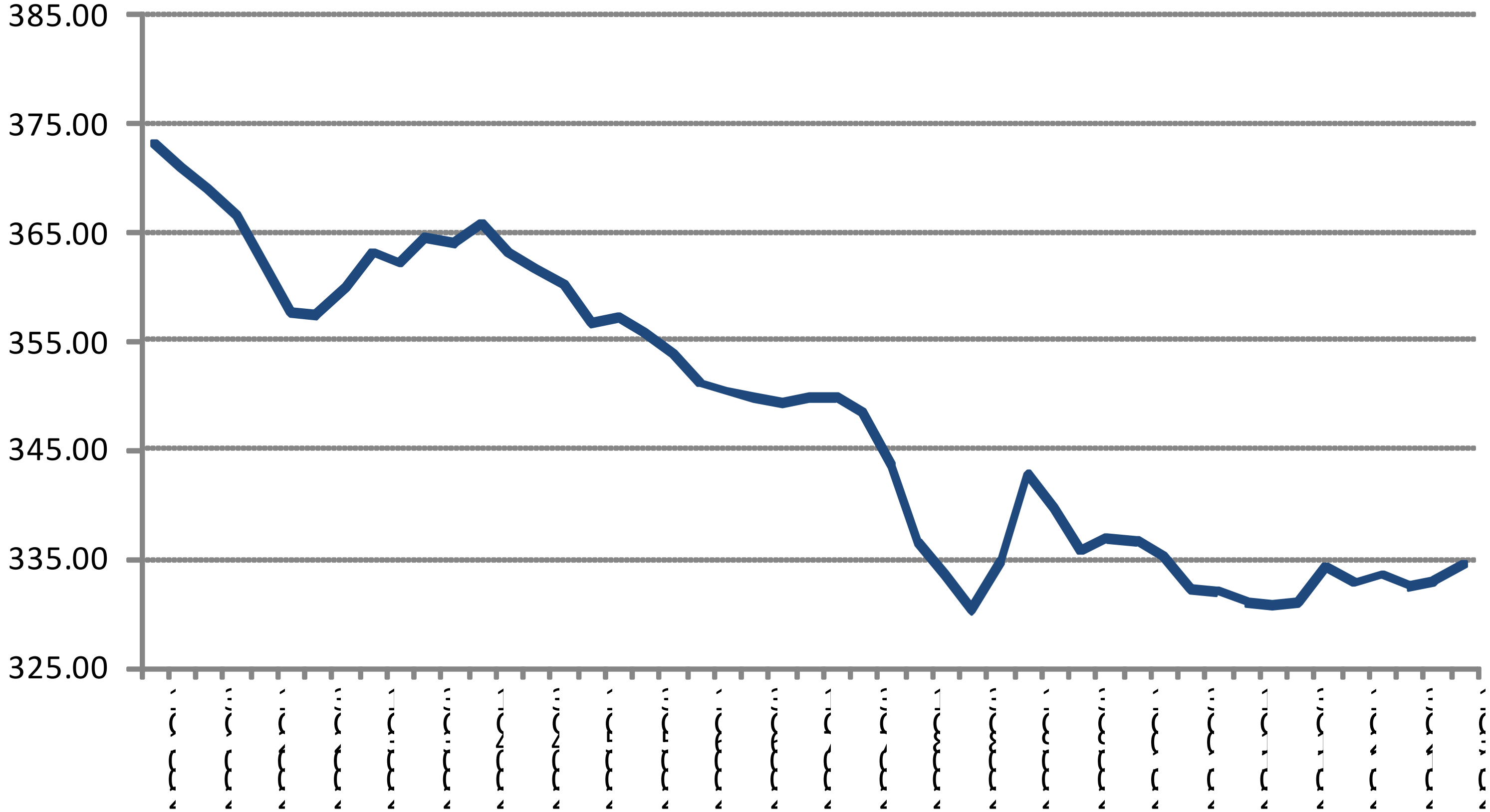
While the economy converged until 2010

Real GDP (2001Q1-2013Q1, y-o-y, in %)



That drew an appreciation of the real exchange rate

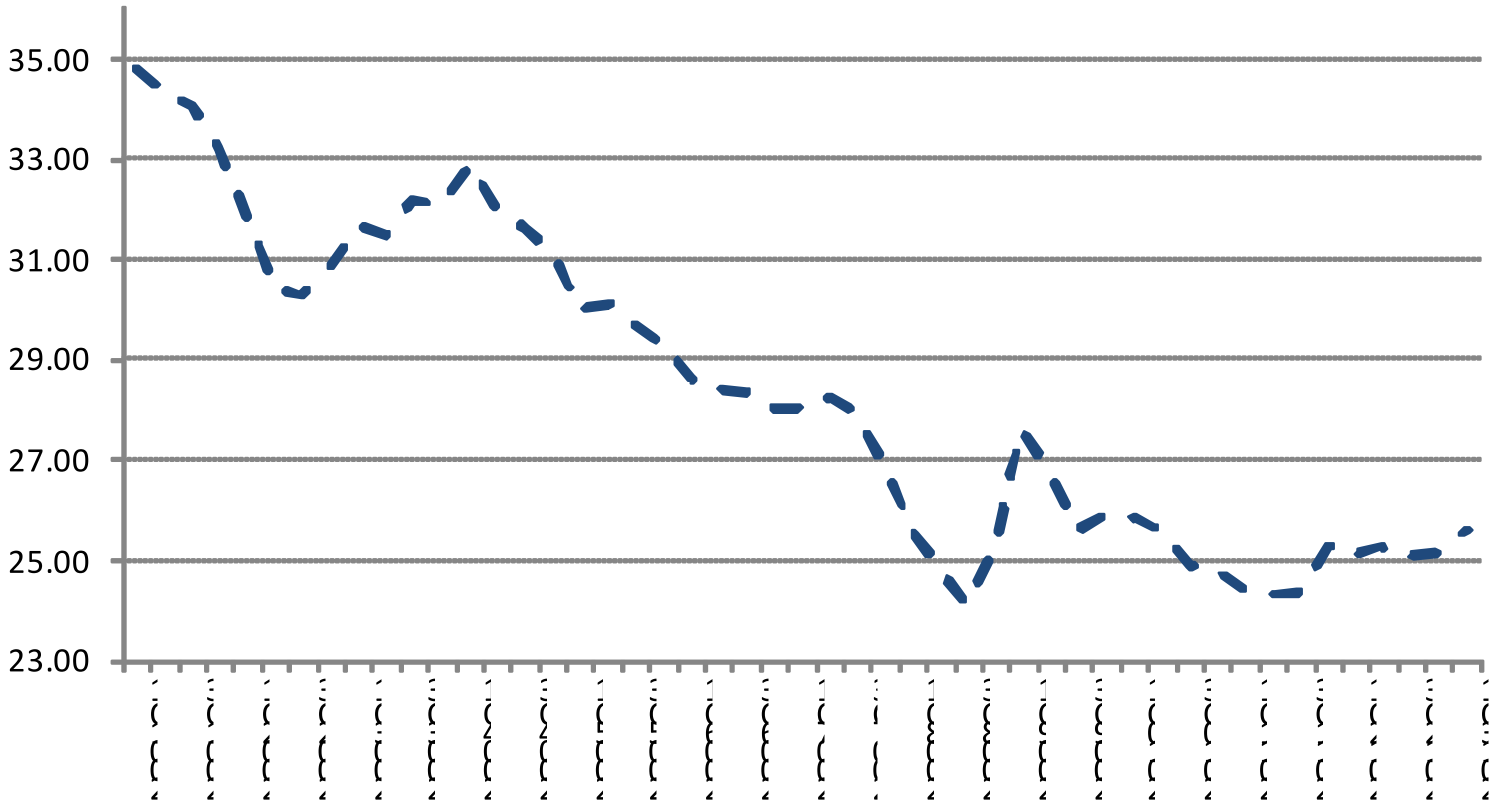
Real Exchange Rate (2001Q1-2013Q1, EUR, 100*ln)



Which, thanks to the zero inflation differential, went fully through the nominal one *(conv. trilemma – ER vs. growth vs. imbalances)*

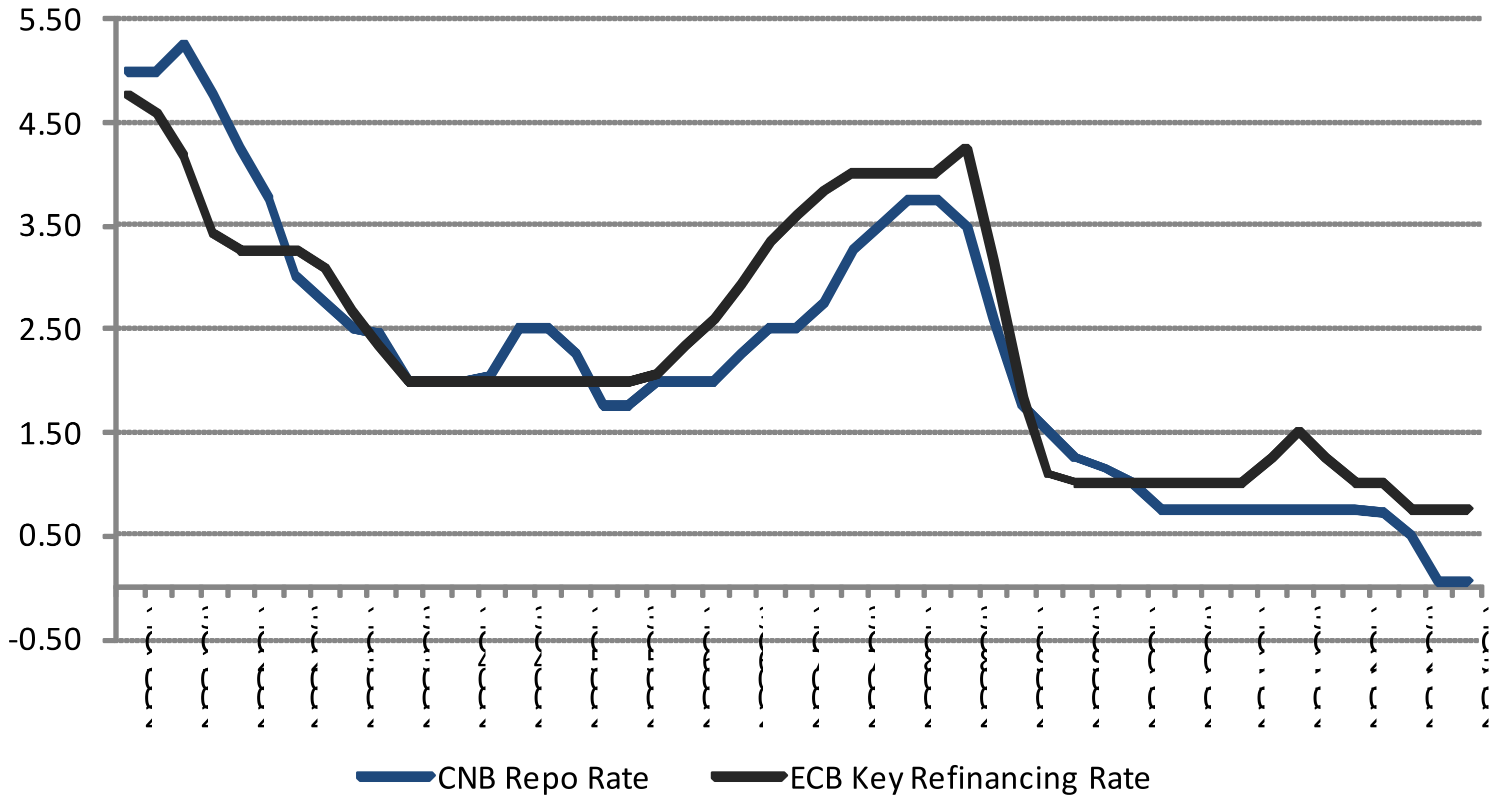
Average annual nominal appreciation reached 2.3% in 2000Q1-2012Q4

Nominal Exchange Rate (2001Q1-2013Q1, CZK/EUR)



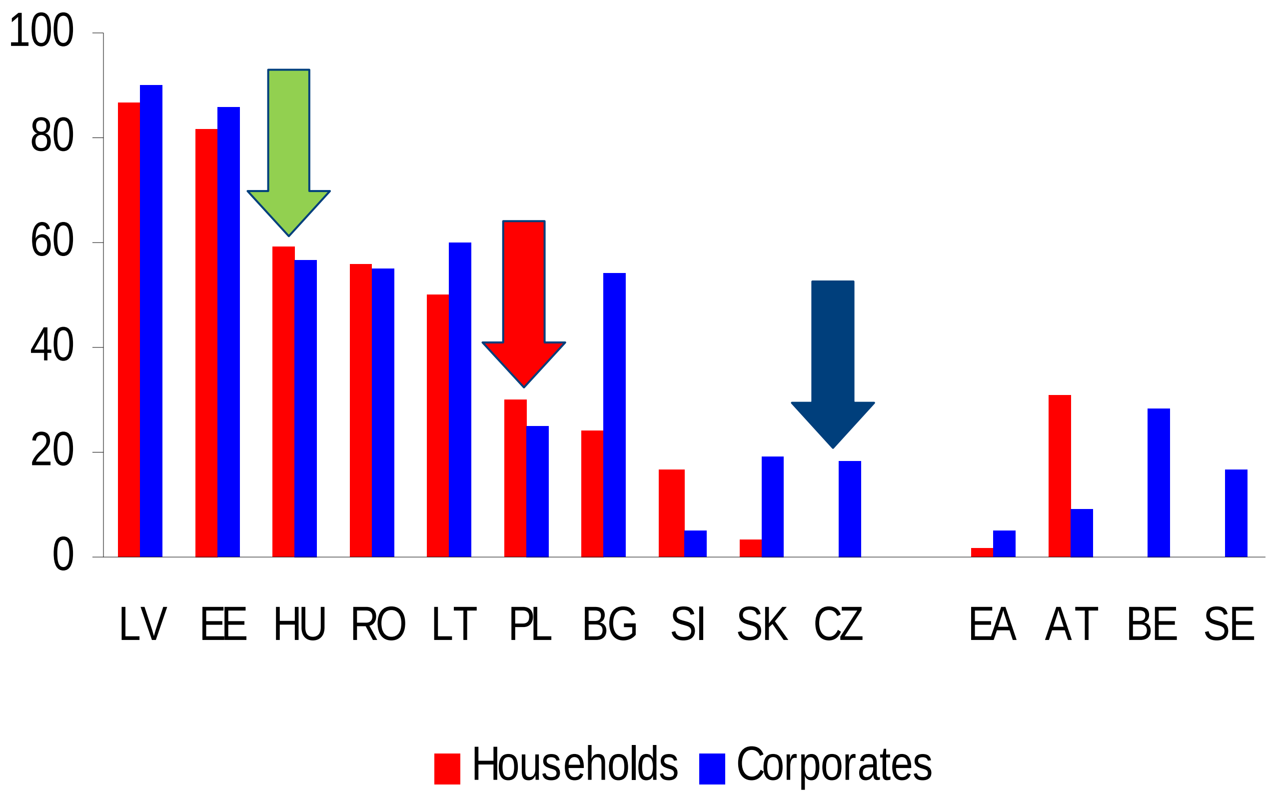
EMU comparable average inflation together with the trend real appreciation moved the policy rate (and interest rates in general) close or even below the ECB rates

Policy Rate (2001Q1-2013Q1, in %)



Combination of all these led to practical non-existence of foreign currency loans for households and only limited amount for firms

Foreign currency loans (2008, in % of total loans)



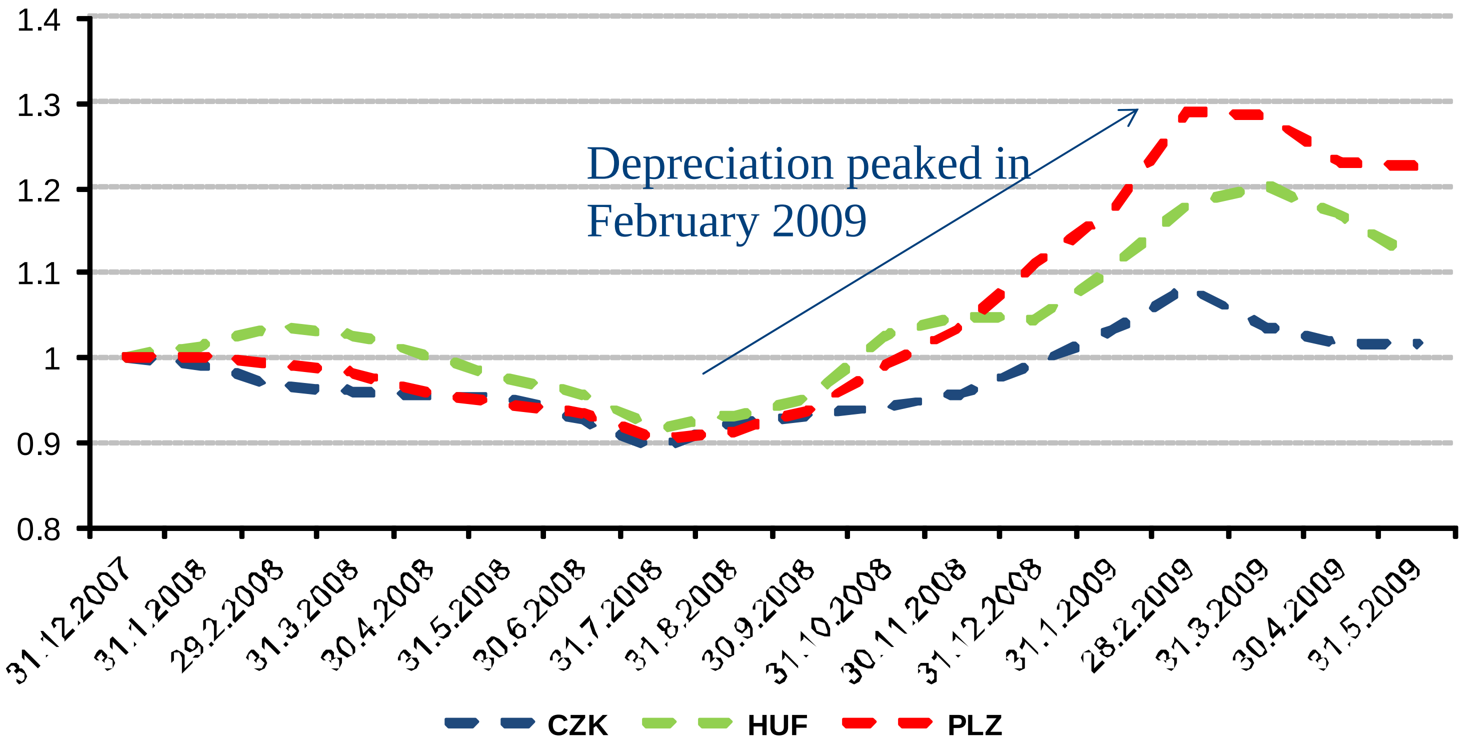
Source: CNB, IFS, IMF

Exchange Rate after the Lehman Collapse

This proved to be of critical importance after the collapse of Lehman brothers

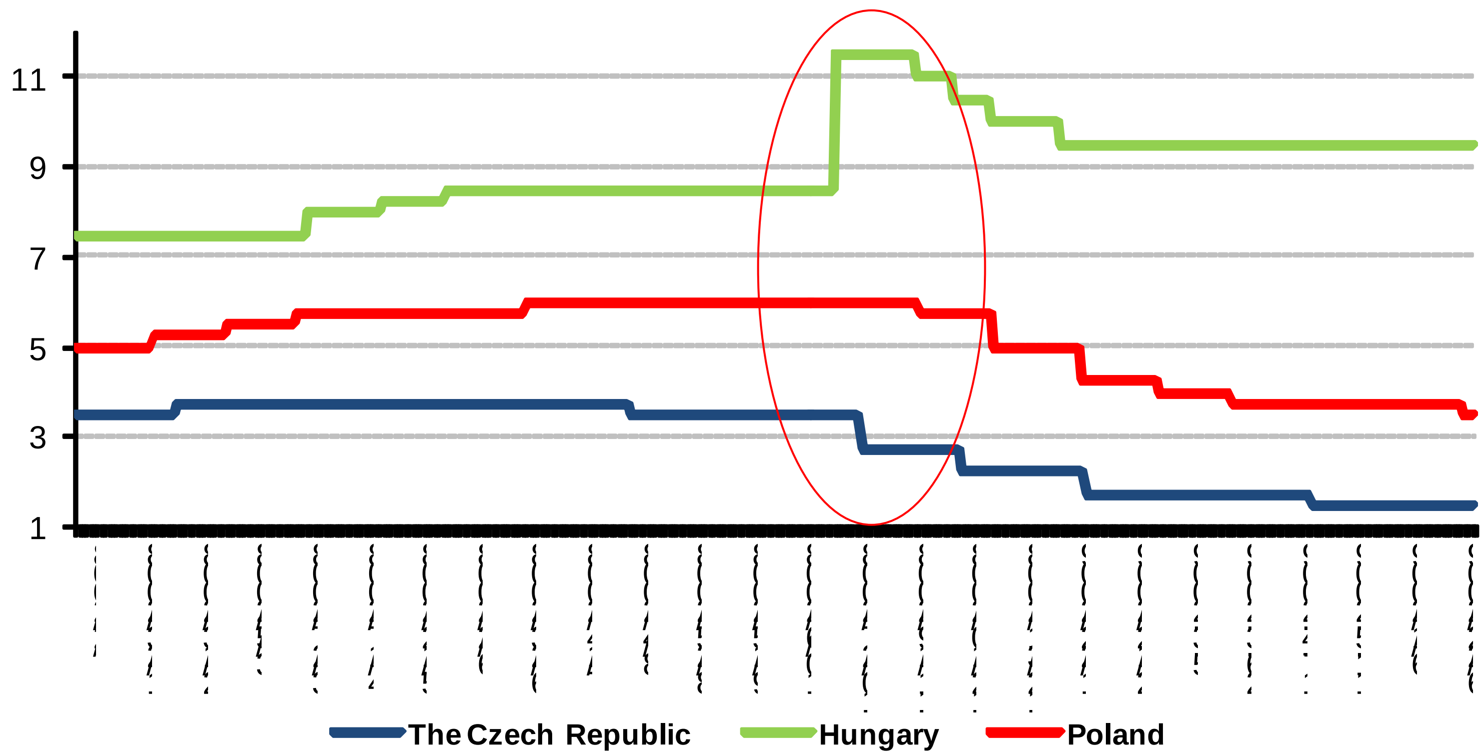
Exchange rate depreciated in all three countries, but with no foreign currency loans one sees it as a welcome adjustment, while …

Exchange rate against EUR (index, 31.12.2007 = 1)



Czechs started to cut the interest rates already in August 2008, but Hungarians, and to less extent Poles, had to defend the exchange rate

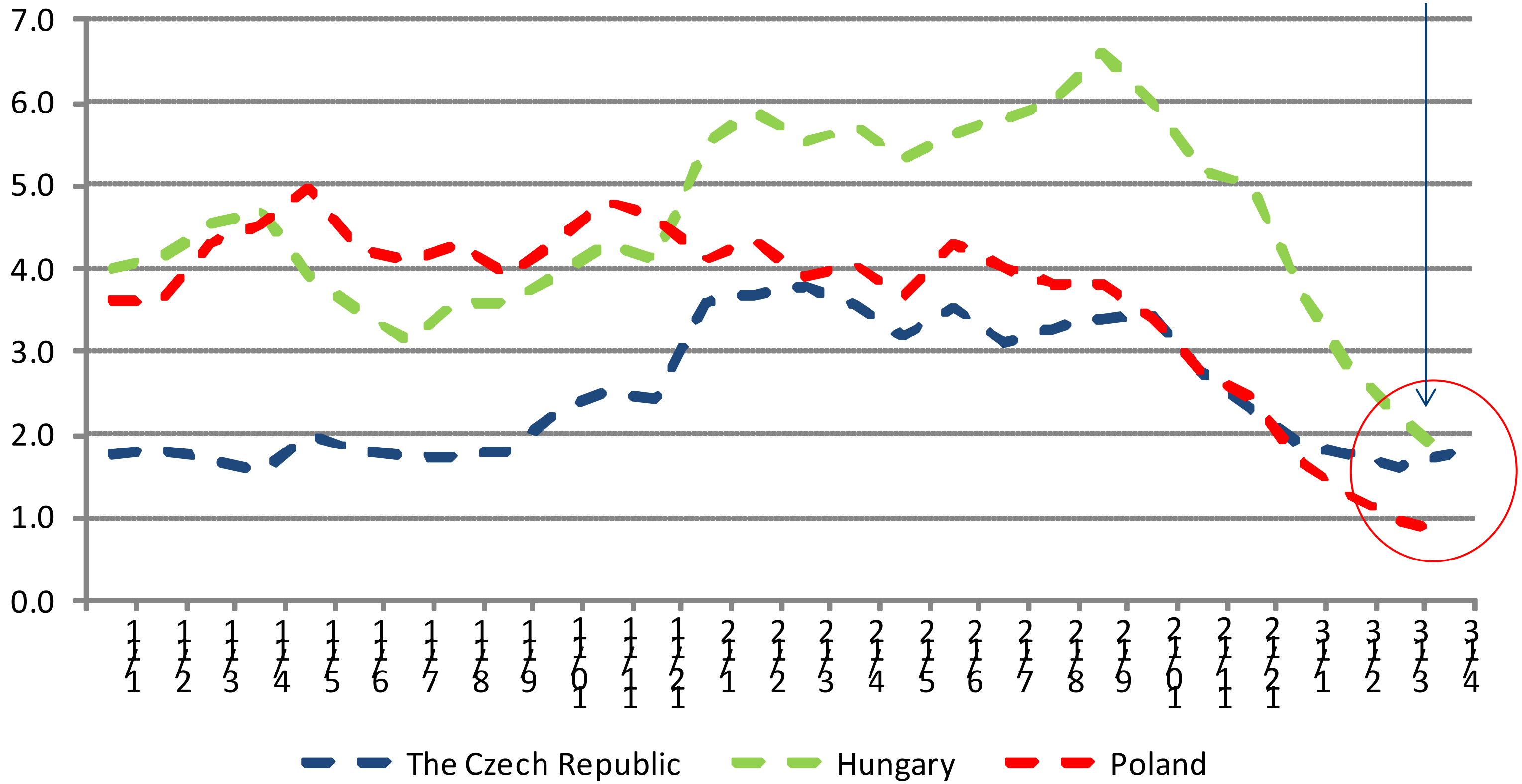
Policy rates (2.1.2008 – 30.6.2009, in %)



After short recovery in 2010-2011 worsening economic situation declined inflation to very low level nowadays

For Hungary it is the lowest inflation ever

Inflation (11/2011-04/2013, CPI, y-o-y, in %)

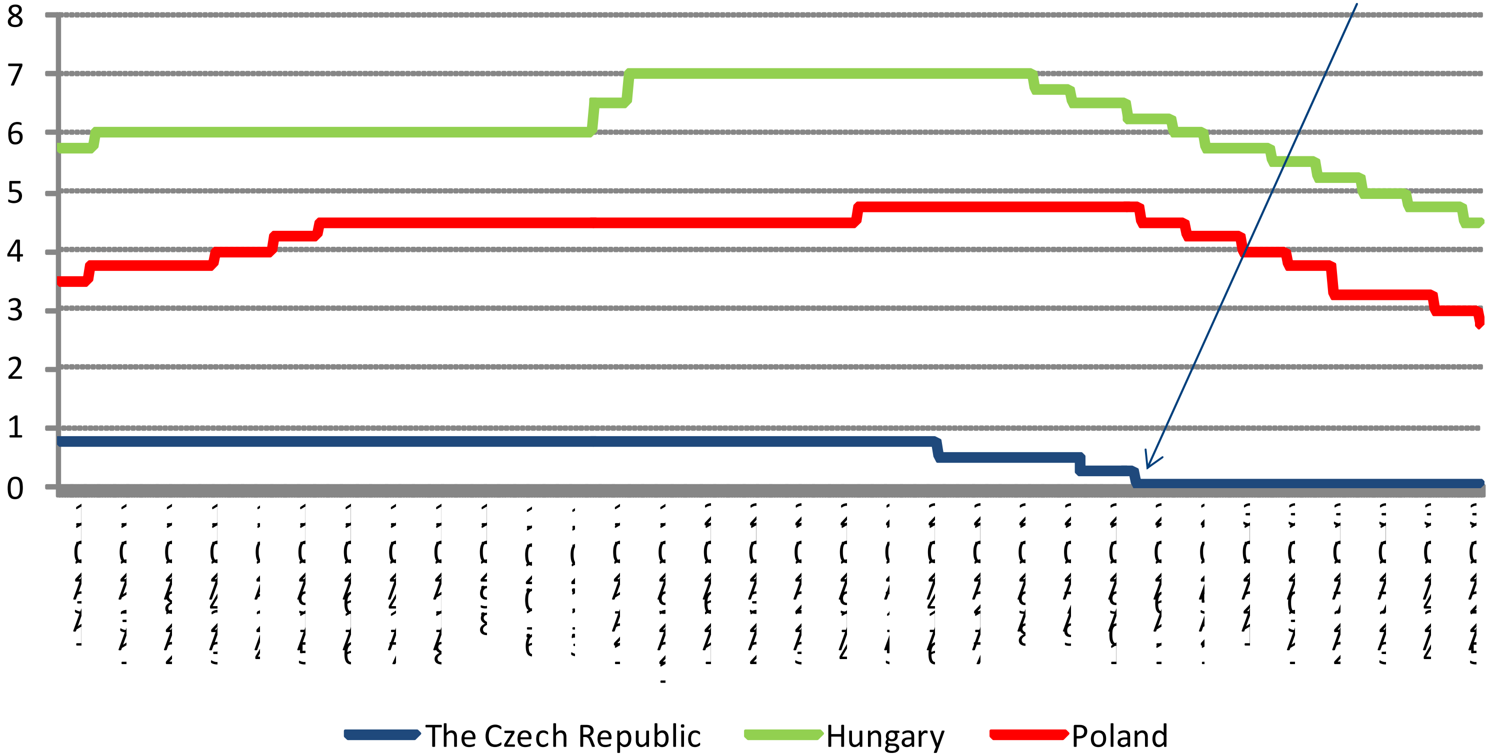


CNB CZECH NATIONAL BANK

But yet central banks keep very different level of policy rates, as the term premium and exchange rate matter

Policy rates (3.1.2011 – 7.6.2013, in %)

CNB lowered its policy rate to zero on November 2, 2012



Summary

- Strategy of low inflation pays off
- Combination of low inflation a trend real appreciation leads to a systematic nominal appreciation and ‘below EMU level’ of nominal interest rates
- While this is a zero game for exporters (real appreciation would happen anyway) it helps to avoid the Calvo’s ‘Original Sin’, i.e. the problem of *foreign currency loans*
- Leaves monetary policy focused on price stability

Thank you for your attention.