

Inflation Targeting: Czech Experience

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TWO INTRODUCTORY NOTES

1. Inflation targeting is not a simplistic strategy, many aspects considered:

- **preconditions**
- **strategy components**
- **internal and external outcomes**

2. Inflation targeting is not a rigid strategy, it is a strategy in motion

1. THE THREE IMPORTANT ASPECTS

- certain **preconditions** should be met to introduce IT successfully (but it is important to note that one learns swimming only by jumping into water)
- several **components** should be designed with care (do not focus only on target or forecasting model)
- certain **outcomes** should be observed relatively soon (others in medium term)

2. STRATEGY IN MOTION

- IT needs modifications to reflect **new theoretical views** and concepts that develop every 3-5 years (think SDGE models)
- IT needs modifications to reflect **new views on best practices** (think transparency)
- IT needs modifications to reflect **new external challenges** (think global low inflation)

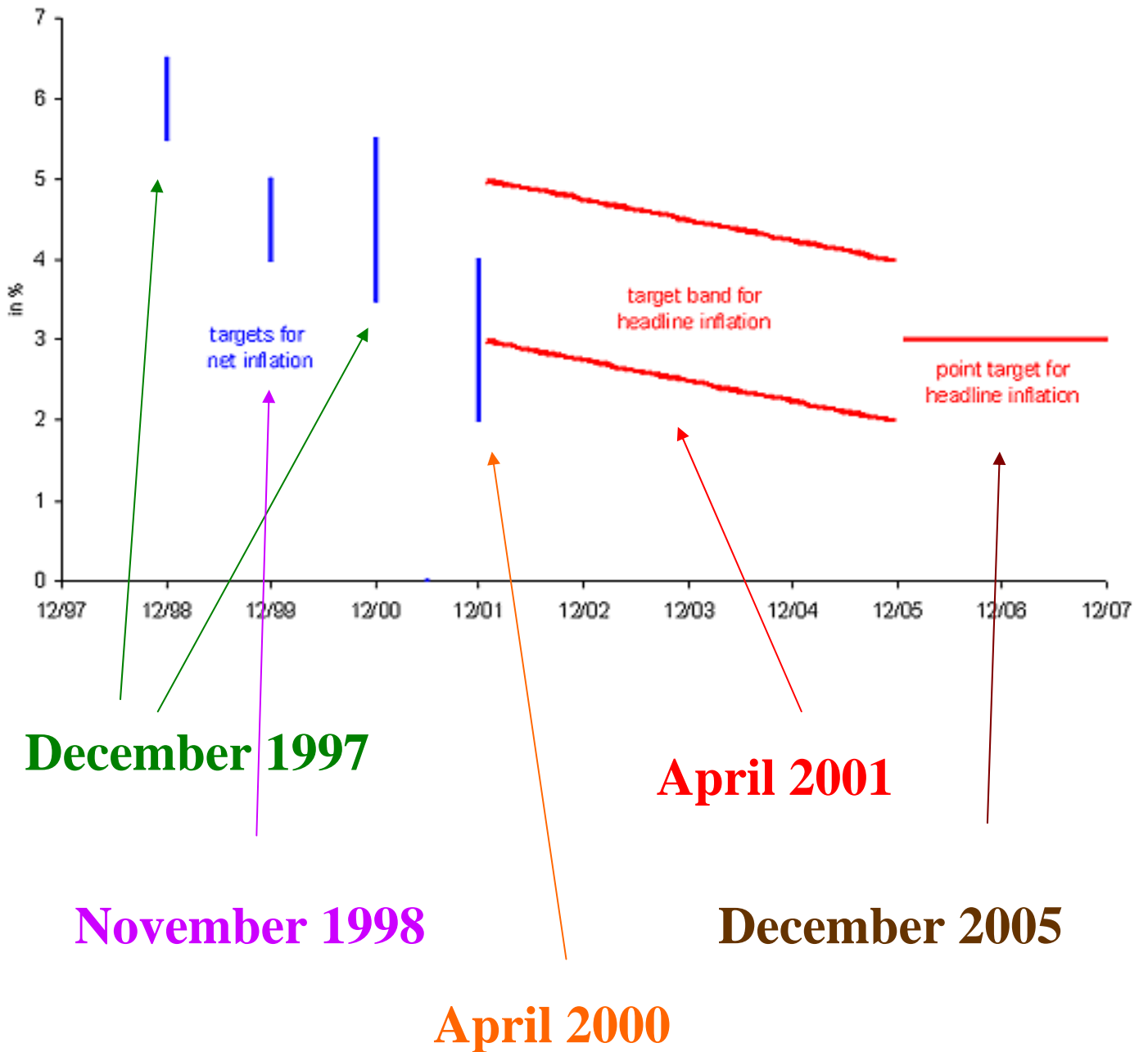
1.1 Preconditions

- **important to have prior to IT**
 - **externally:**
 - institutional set-up (independence, accountability)
 - well-developed financial markets
 - **internally**
 - support of the Board
 - core team of educated experts
- **not so important to have**
 - **externally:**
 - perfect set-up (who owns target may be clarified in the introductory period)
 - deep financial markets (some will develop under IT only)
 - **internally**
 - large team of experts (they will come)
 - sophisticated forecasting model (it will be developed later)

1.2 Components

- **Target specification**
 - time horizon (CNB: 1Y, 3Y, infinite)
 - interval versus point (CNB: points in time, continuous interval, point with bands)
 - which price index (CNB: net inflation, CPI)
- **Caveats**
 - initially no caveats (net inflation)
 - now ex ante caveats
 - no formal explanatory letter
- **Decision-Making Framework**
 - framework for discussion (model forecast by staff)
 - analysis of risks (staff and Board) e.g. alternative scenarios
 - actual decision (Board votes, often different views)
- **Communication (transparency)**
 - decision (press conference)
 - reasons (minutes)
 - details about forecast (Inflation report)
 - details about decision (internal protocol)

1.2.1 Target specifications



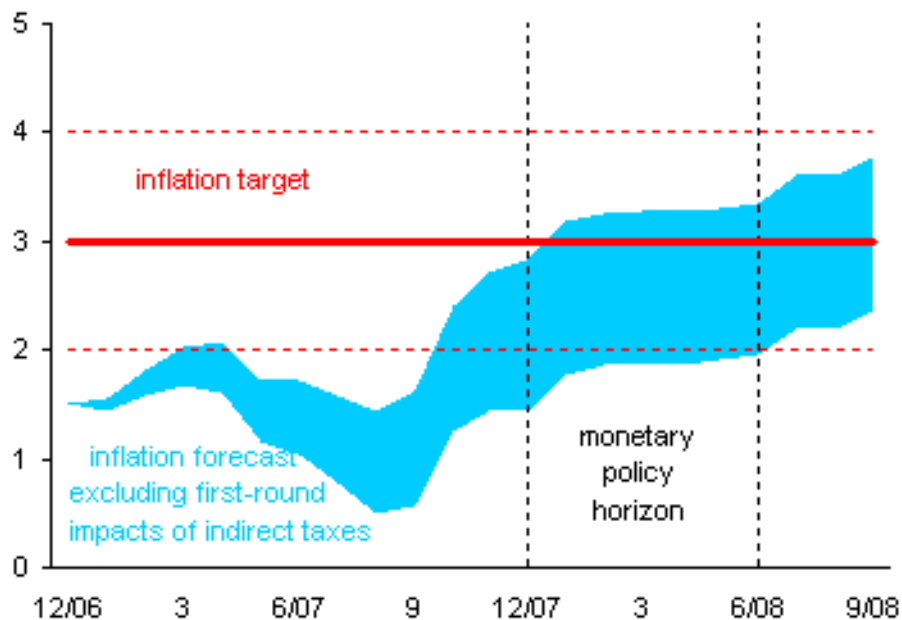
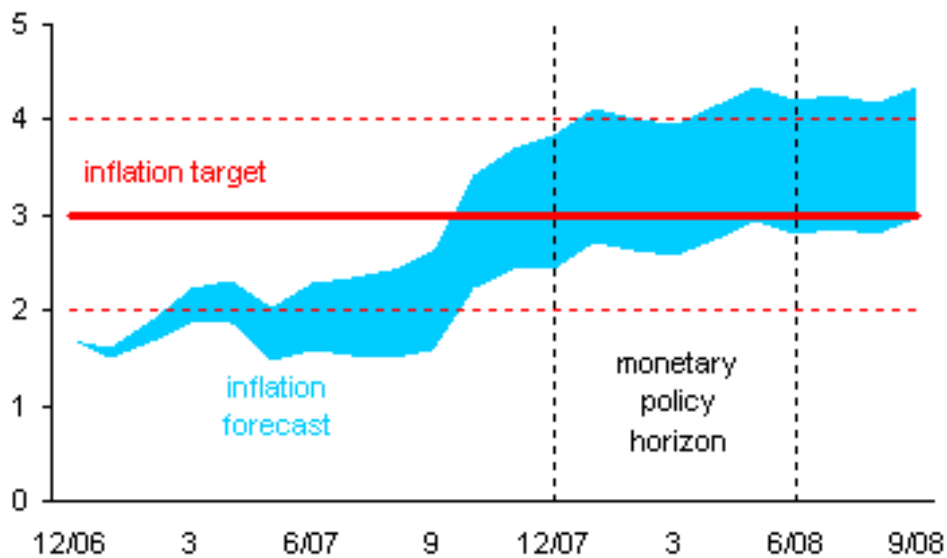
1.2.2 Caveats

The following exceptions ex ante (caveats/escape clauses) from achieving the inflation target are used by the CNB:

- major deviations in world **prices of energy**
- major deviations in **agricultural prices**
- major changes in **indirect taxes**
- major changes in **regulated prices**

In these cases, the CNB does not respond to the primary impacts of the shock.

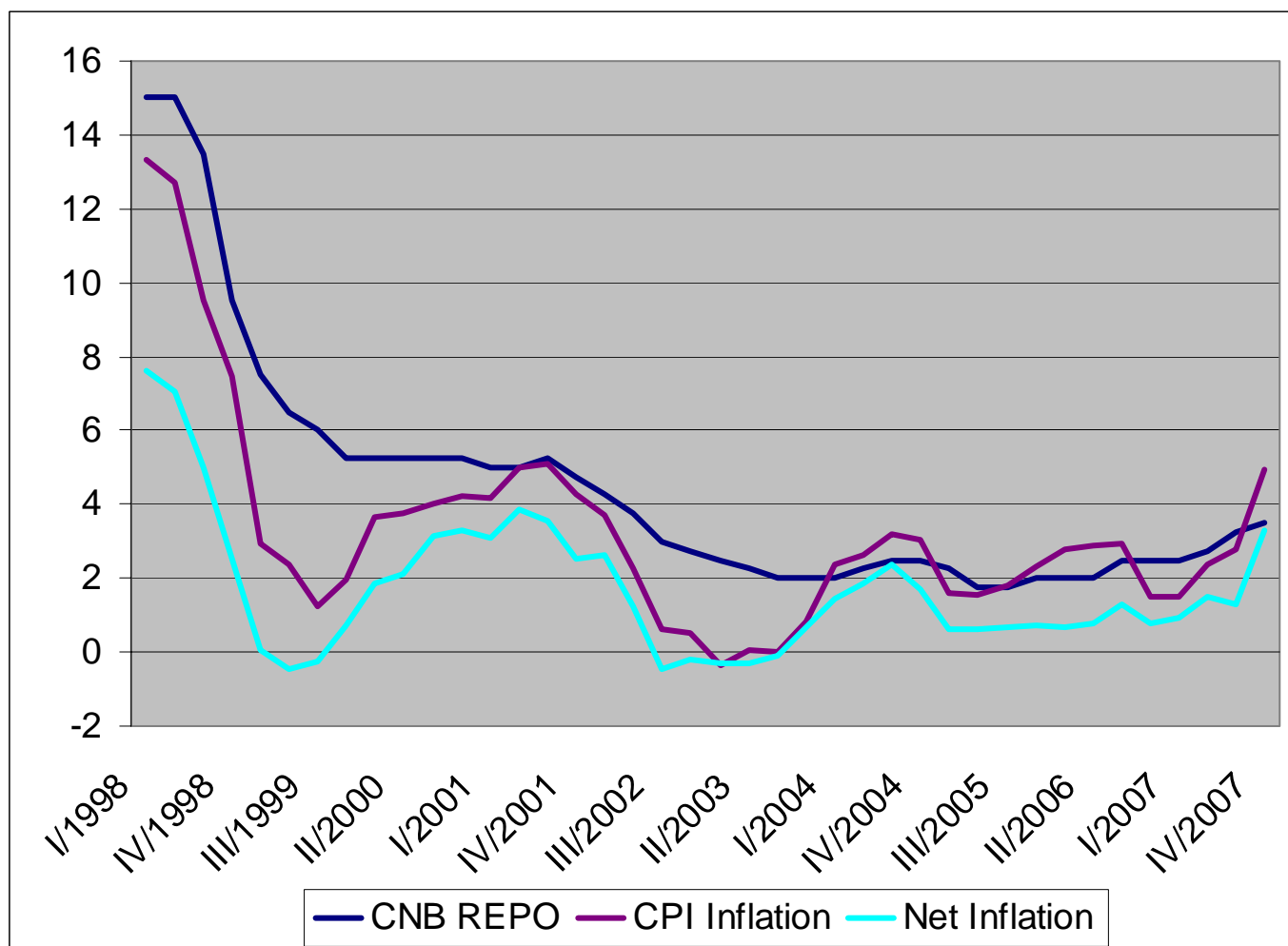
1.2.3 Decision-making Framework



1.3 Outcomes

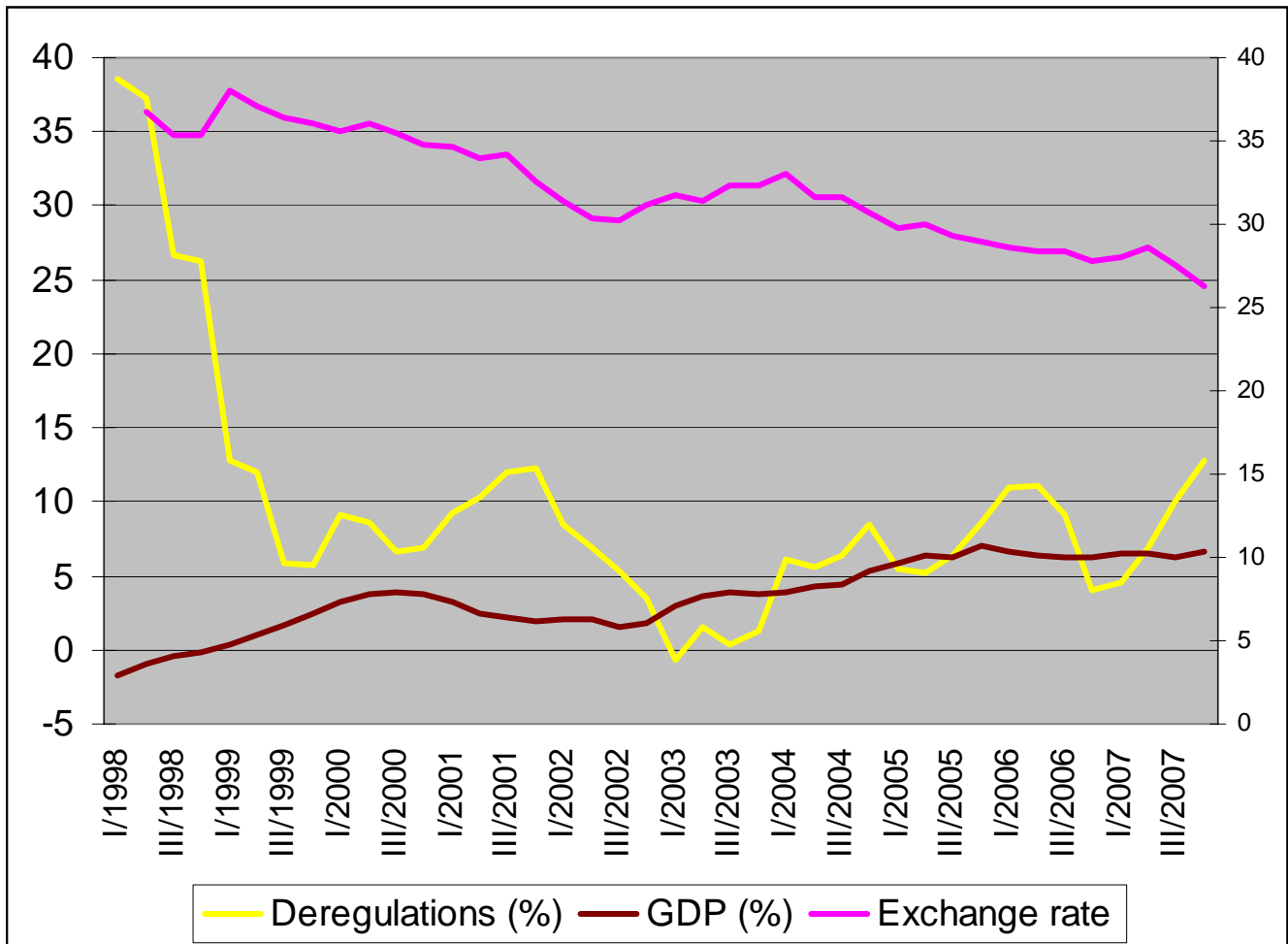
- **primary external outcome: low inflation** (low volatility could be aimed at) **and stable expectations**
- **secondary external outcome: good economic performance**
- **primary internal outcome: institution changes** (staff improves their modeling know-how, Board focuses more on price stability)
- **secondary internal outcome: various processes can change** (pressure on well-maintained web to comply with transparency)

1.3.1 Primary Outcome



Low inflation and nominal interest rates

1.3.2 Secondary Outcome



Output growth recovered, koruna strong

2 STRATEGY IN MOTION (1)

- CNB updates **level of the target** (global low inflation, completed transition)
- CNB is **improving transparency** over time (faster publishing of minutes, publishing of internal protocols)
- CNB is **improving the forecasting model** (from QPM, used since 2002, to SDGE model)

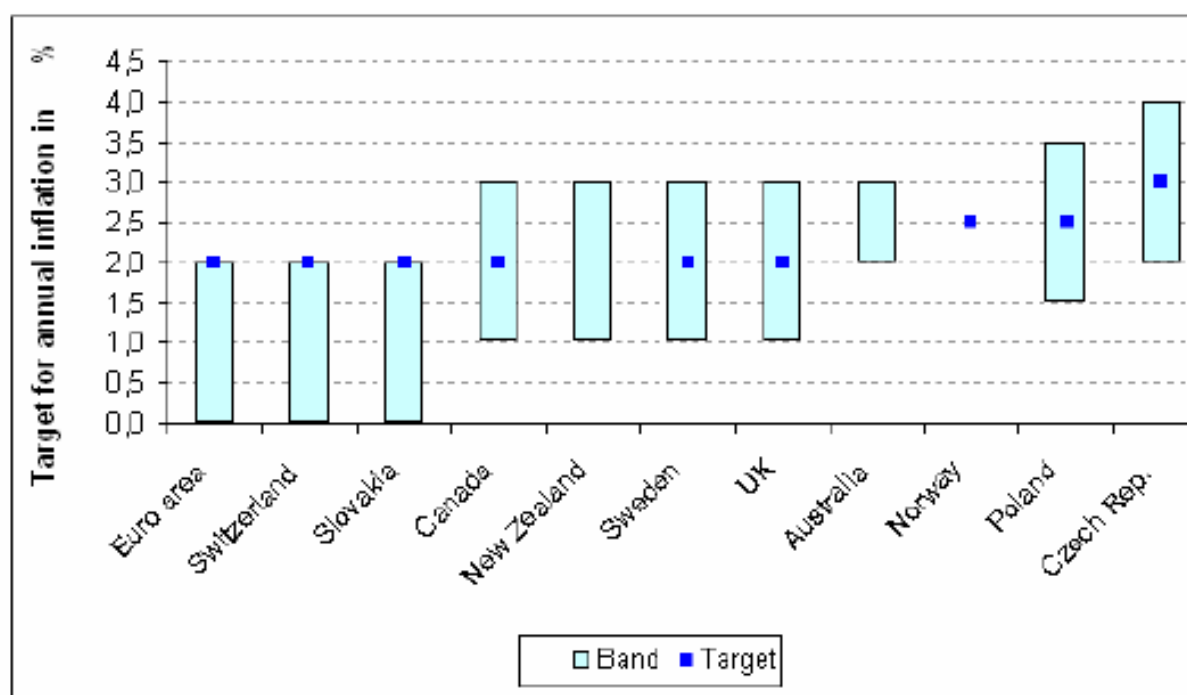
STRATEGY IN MOTION(Cont.):

The 2007 changes

- **New inflation target of 2% (\pm 1%) from January 2010**
- **Publication of votes cast by name from 2008**
- **Publication of interest rate path as fan chart from 2008**
- **Reduction in number of meetings to 8 from 2008**

2.1 New target

- **Current target set at 3% ($\pm 1\%$)**
- **Extension of inflation targeting perspective beyond 2010**
- **Advanced countries mostly have target of 2% or 2.5%**



Source: National Central Banks; Wyplosz (2006)

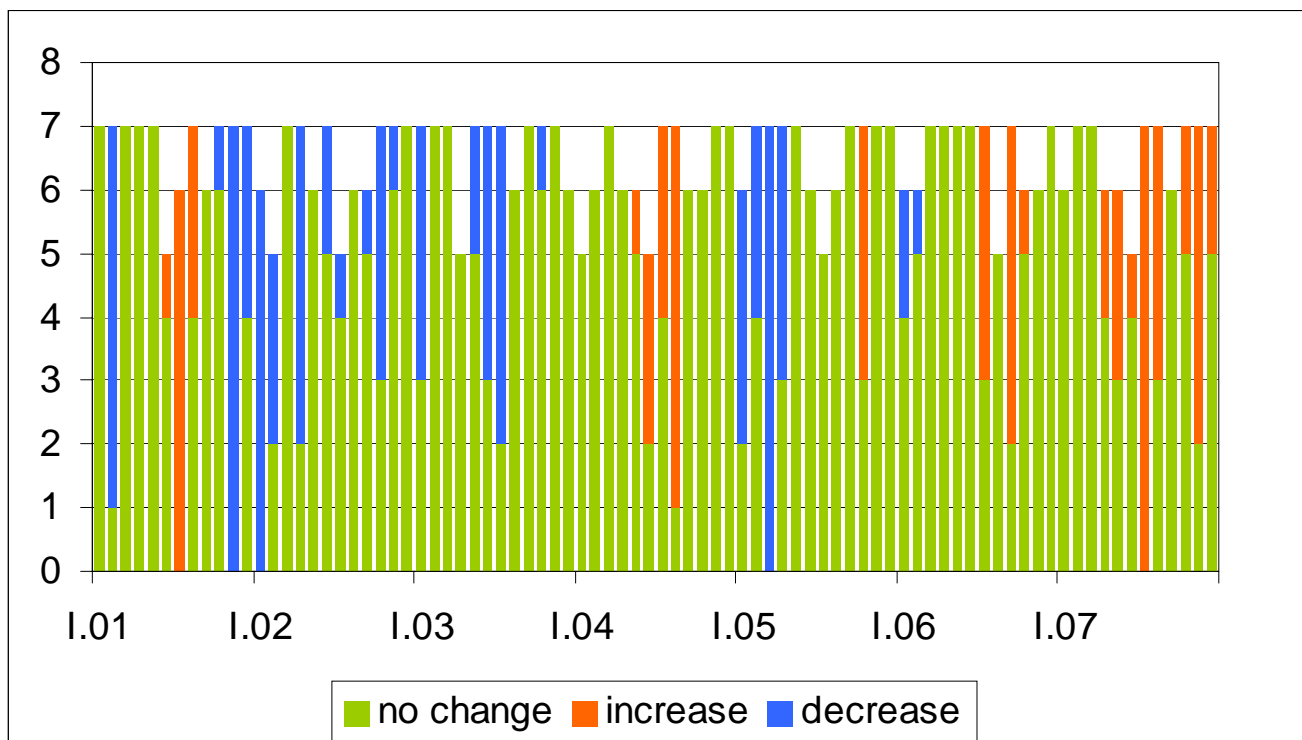
2.2 Publication of votes (1)

- **CNB publishing voting ratios since 2000**
- **Full minutes of BB discussion published after 6 years**
- **Some central banks also publish voting by name**

	Publication of names		Publication of names
Australia	no	Peru	no
Czech Rep.	no	Poland	yes, from 2001
Chile	no	Slovakia	no
Canada	no	Sweden	yes, from 1999
Columbia	no	Switzerland	no
Hungary	yes, from 11/2005	UK	yes, from 1997
Norway	no	Euro area	no
New Zealand	n/a (governor only)	USA	yes, from 1996

2.2 Publication of votes (Cont.)

- **Voting by name will increase transparency**
- **Diversity in views beneficial**



2.3 Publication of path

- **CNB described interest rate path only verbally**
- **Number of central banks publishing in numerical form is rising**

	Publication of rates		Publication of rates
Australia	no (CR)	Peru	no (CR, +ER internally)
Czech Rep.	no (verbally yes, ER)	Poland	no (CR)
Chile	no (ER)	Slovakia	no (ER)
Canada	no (ER)	Sweden	yes (ER)
Columbia	no (formerly yes, ER)	Switzerland	no (CR)
Hungary	no (CR)	UK	no (ME)
Norway	yes (ER)	Euro area	no (ME)
New Zealand	yes (ER)	USA	no (ER)

Source: National Central Banks

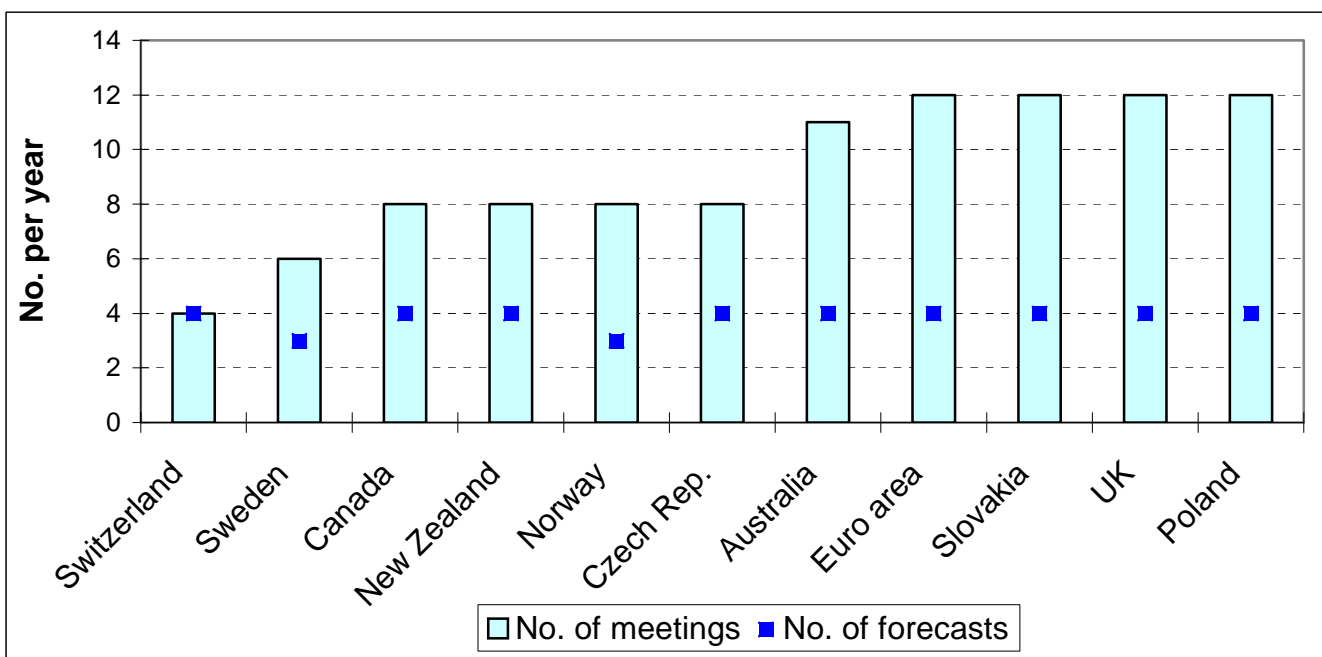
CR = forecast assumes constant rates (\Rightarrow nothing to publish)

ME = forecast assumes rates according to market expectations (\Rightarrow not with endogenous rates)

ER = forecast with endogenous rates

2.4 Board meetings

- **CNB to change to 8 meetings a year in 2008**
- **Reflects stability of Czech economy**
- **Reduces number of meetings with no new forecast**



Source: National Central Banks; Heenan, Peter and Roger (2006)

CLOSING REMARKS: CHALLENGES

- **maintaining stable inflation if/when global inflation higher may not be easy**
- **low interest rates have implications for financial stability**

Thank you for your attention.