Three Deflations in the Czech(-oslovak) History:
„Two that did happen, and one that did not…”

Vladimír Tomšík
Vice-Governor
Czech National Bank

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• CNB‘s policy decision in November 2013
• Why was the policy action needed?
• Our historical experience with two deflation episodes
• Outcomes so far – the story of averted deflation
• Conclusions
CNB’s policy decision in November 2013

Why was the policy action needed?

Our historical experience with two deflation episodes

Outcomes so far – the story of averted deflation

Conclusions
The Board decided to start using the exchange rate as an additional instrument for easing the monetary conditions, stating that: "The CNB will intervene on the FX market to weaken the koruna so that the exchange rate is close to CZK 27/EUR."

The exchange rate level was chosen to avoid deflation or long-term undershooting of the inflation target and to speed up the return to the situation in which the CNB will be able to use its standard instrument, i.e. interest rates.

The exchange rate commitment is one-sided. This means that the CNB stands ready to prevent excessive appreciation of the koruna exchange rate below CZK 27/EUR. On the weaker side of the CZK 27/EUR level, the CNB is allowing the exchange rate to move according to supply and demand on the FX market.
The exchange rate weakened immediately and has moved with relatively low volatility above the level of CNB‘s commitment.

Actual interventions were quite massive, but took place only for a few days after the policy decision of the CNB.
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• In November 2012, the CNB hit the zero lower bound (ZLB).

• Since then, the policy rates have been set at “technically” zero level: 0.05 % for the 2W repo rate and O/N deposit (i.e. discount) rate, and 0.25% for the O/N lending (i.e. Lombard) rate.
Consistent with the forecast in November 2013 was a significant decline in market interest rates well below zero, which would have required 4 further policy rate cuts.
• Headline inflation was close to 1 % in 2013 (i.e. well below the target, but seemingly far from deflation) only due to indirect tax increases.

• MP-relevant inflation had been below the target from November 2012, and it was falling toward zero during 2013.
• The output gap was estimated at -2 to -4 %, i.e. according to some methods even deeper than in previous post-Lehman recession.
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Rašín’s deflationary policy in 1919–1923

- The deflationary policy in the post-WWI period helped to establish the culture of price stability in Czechoslovakia, but at a high cost (both economically, and for Alois Rašín himself).

Inflation and Price Level

GDP

The Great Depression policy debate

- There was a similar policy debate to the current one in Czechoslovakia 80 years ago.
- Vilém Pospíšil (proponent of Gold Standard, follower of Alois Rašín) versus Karel Engliš (proponent of price stability, closer to the modern view)

- February 1934: Pospíšil steps down as the Governor of NBČS, is succeeded by Engliš and koruna is devalued by 1/6. As a result, the five years of economic recession and deflation in Czechoslovakia end (later than in many other countries that have eased their MP sooner).
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The CNB’s policy measure has significantly eased the overall monetary conditions, both in their interest rate (via higher inflation expectations) and exchange rate components.
### Comparison of the data available then and now

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Data available on 7 Nov 2013</th>
<th>Data available now</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP (s.a.)</td>
<td>II/13 -1.3</td>
<td>IV/14 1.4</td>
</tr>
<tr>
<td>Household consumption (s.a.)</td>
<td>II/13 0.0</td>
<td>IV/14 2.0</td>
</tr>
<tr>
<td>Gross fixed capital formation (s.o.)</td>
<td>II/13 -5.2</td>
<td>IV/14 4.3</td>
</tr>
<tr>
<td>CPI</td>
<td>9/13 1.0</td>
<td>4/15 0.3</td>
</tr>
<tr>
<td>Unemployment rate (ILO definition, s.a.)</td>
<td>9/13 7.1</td>
<td>3/15 5.9</td>
</tr>
<tr>
<td>Average nominal wage</td>
<td>II/13 1.2</td>
<td>IV/14 2.3</td>
</tr>
<tr>
<td>Average nominal wage in business sector</td>
<td>II/13 1.1</td>
<td>IV/14 1.9</td>
</tr>
<tr>
<td>Number of vacancies (s.a.)</td>
<td>9/13 39 040</td>
<td>3/15 77 497</td>
</tr>
<tr>
<td>Overall confidence indicator (index)</td>
<td>10/13 88.9</td>
<td>4/15 95.1</td>
</tr>
<tr>
<td>Retail sales without automobile segment (s.a.)</td>
<td>9/13 -0.6</td>
<td>2/15 6.3</td>
</tr>
</tbody>
</table>

- Key indicators of the real economy look much better now than in November 2013. GDP is growing, which is having a favourable impact in the labour market and on the confidence of households and enterprises.
- Inflation remains very low, but this mainly reflects the foreign environment.
- The data thus show that the weaker exchange rate has fulfilled its purpose, averting the risk of deflation driven by insufficient demand.
• Once the current anti-inflationary supply-side shocks fade away, inflation will start increasing toward the CNB‘s 2 % target.
• This will be fostered by a continued growth of the domestic GDP and accelerating nominal wage growth in the business sector.
• It is important to make sure that inflation expectations remain well anchored.
Outline

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• On November 2013, the CNB took a decisive action to avert the risk of deflation driven by insufficient aggregate demand.

• Two episodes from Czechoslovak inter-war history clearly show that a deflation is not to be regarded as price stability, and it may have significant welfare costs.

• The CNB’s exchange rate commitment has significantly contributed to the economic recovery and improved labour market situation.

• But once the direct effects of low oil prices fade away, inflation will start returning to the CNB’s 2% target. The CNB’s role is to make sure that inflation expectations remain well anchored.
Thank you for your attention

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Vladimír Tomšík
vladimir.tomsik@cnb.cz