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Three Deflations in the Czech(-oslovak) History:

„Two that did happen, and one that did not…“

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Outline

- 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

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CNB‘s November 2013 decision

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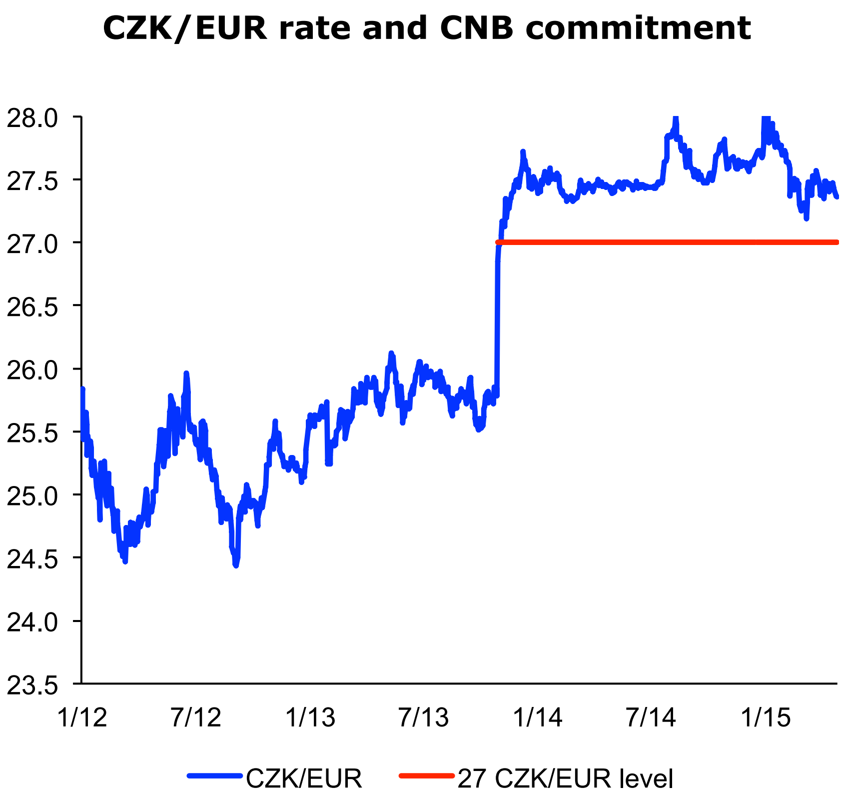
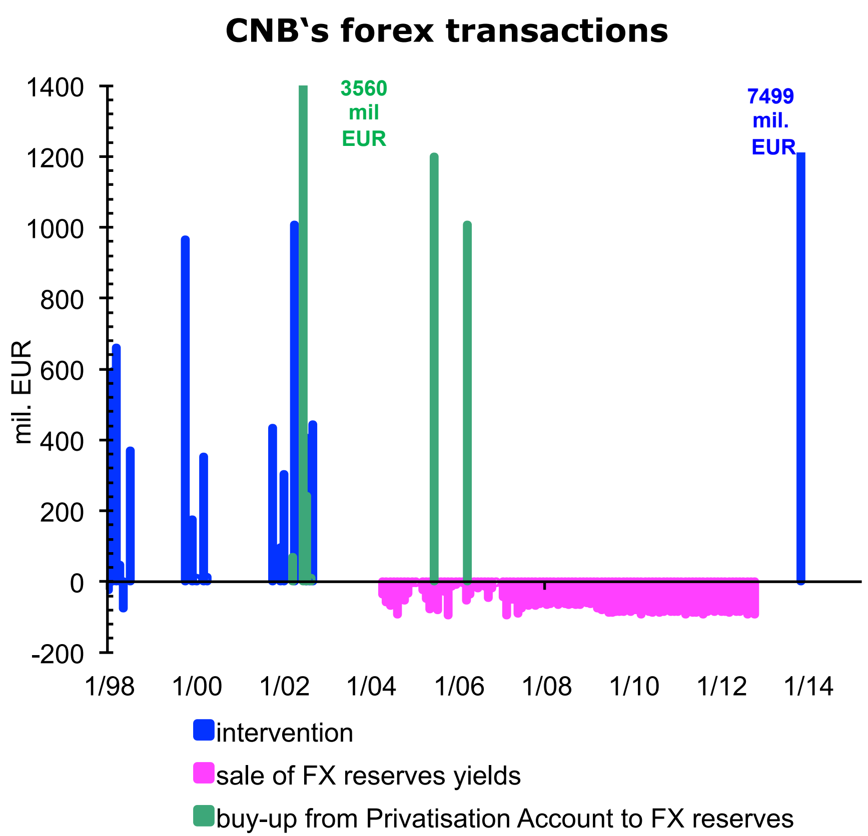
- The Board decided to start using the exchange rate as an additional instrument for easing the monetary conditions, stating that: ”The CNB will intervene on the FX market to weaken the koruna so that the exchange rate is close to CZK 27/EUR.“
- The exchange rate level was chosen to avoid deflation or 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 since the decision





- 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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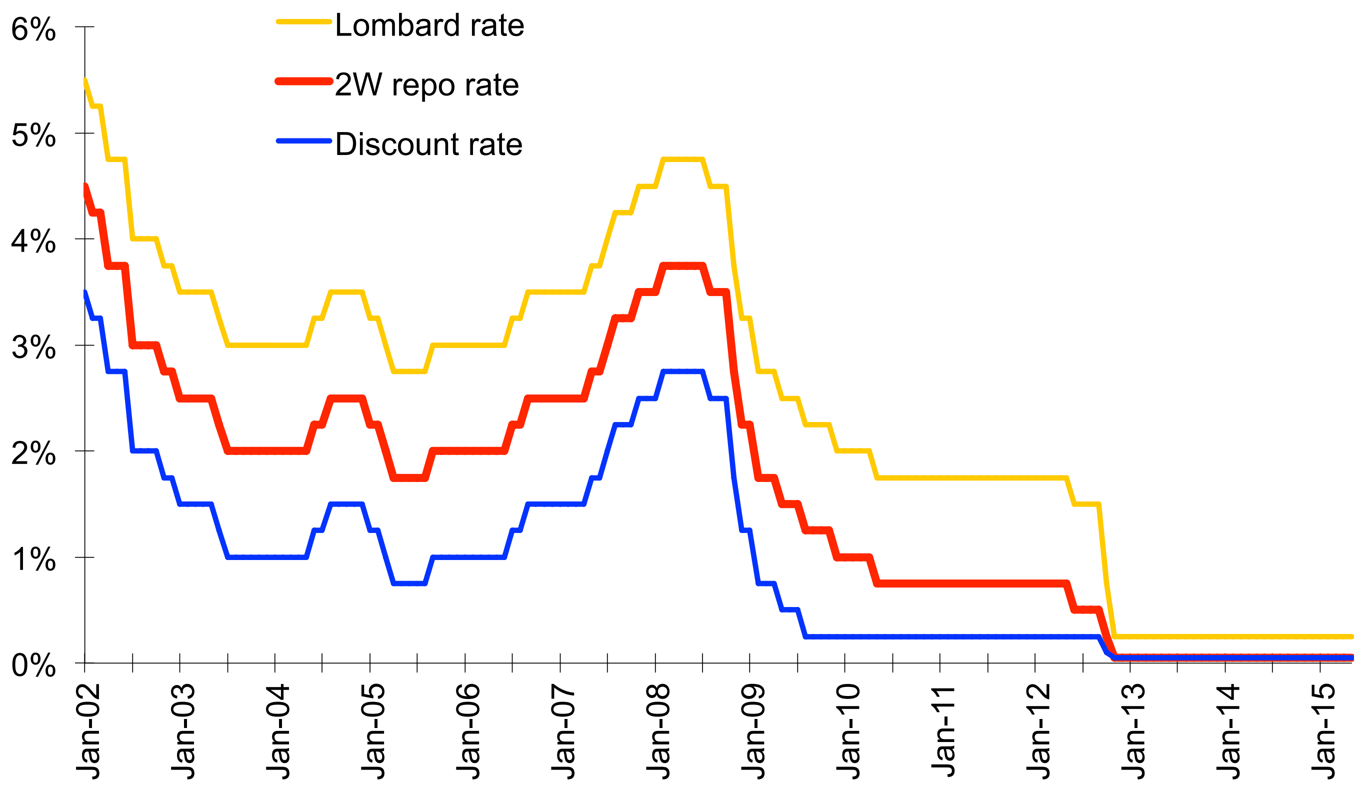
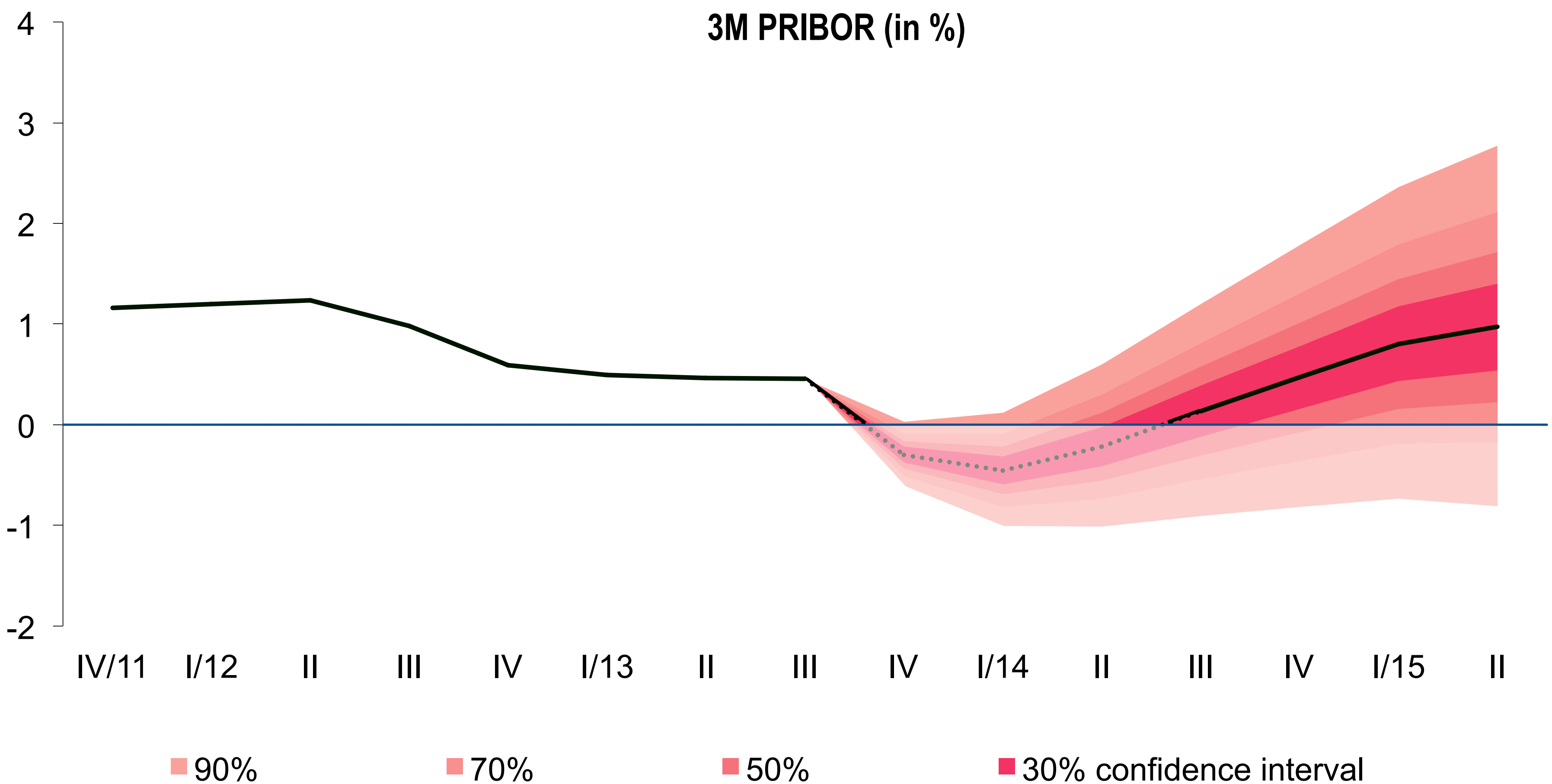
Main policy interest rates



- 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

The need for MP easing in November 2013



- 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.

Inflation – actual vs. targets

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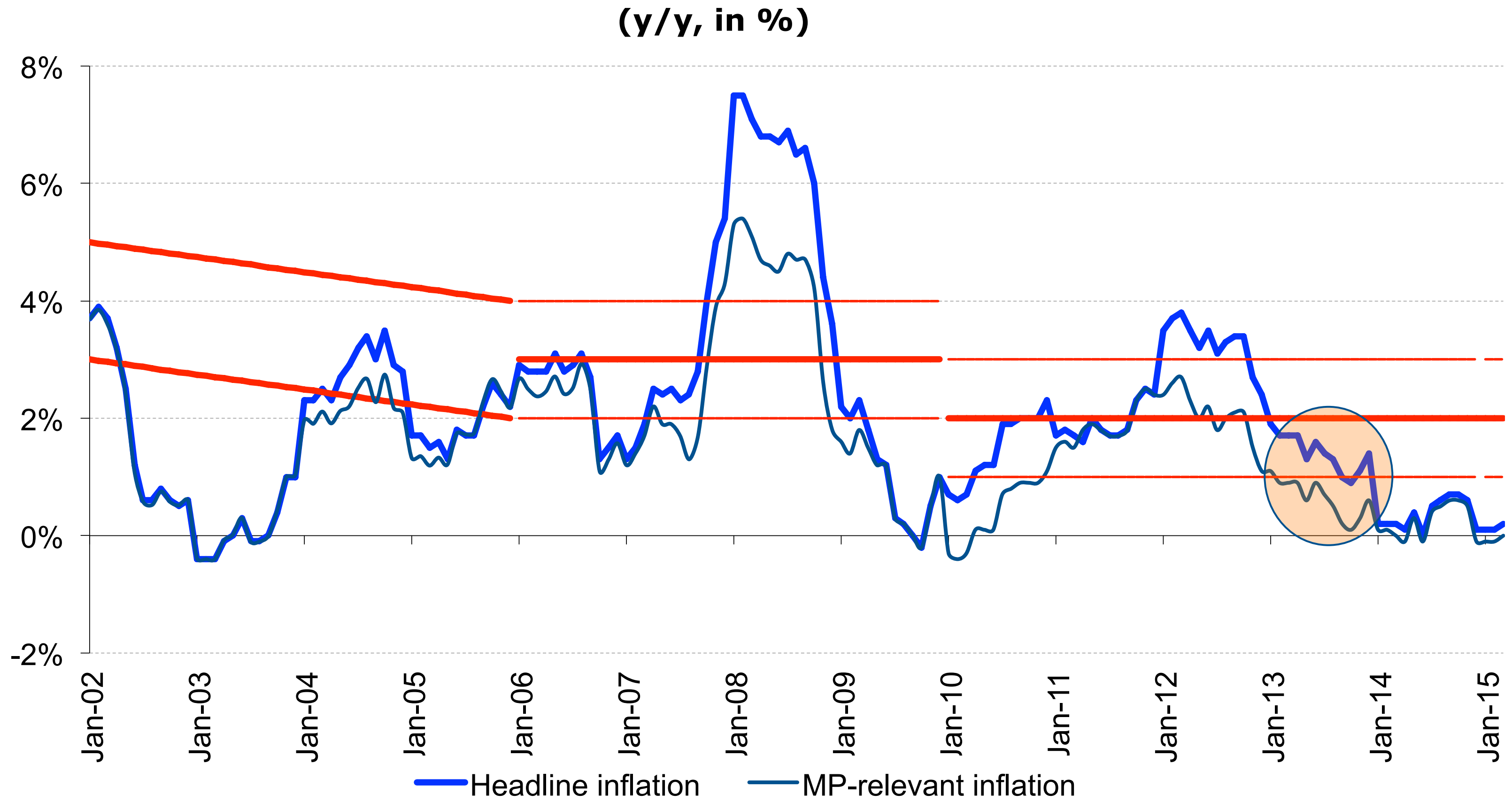
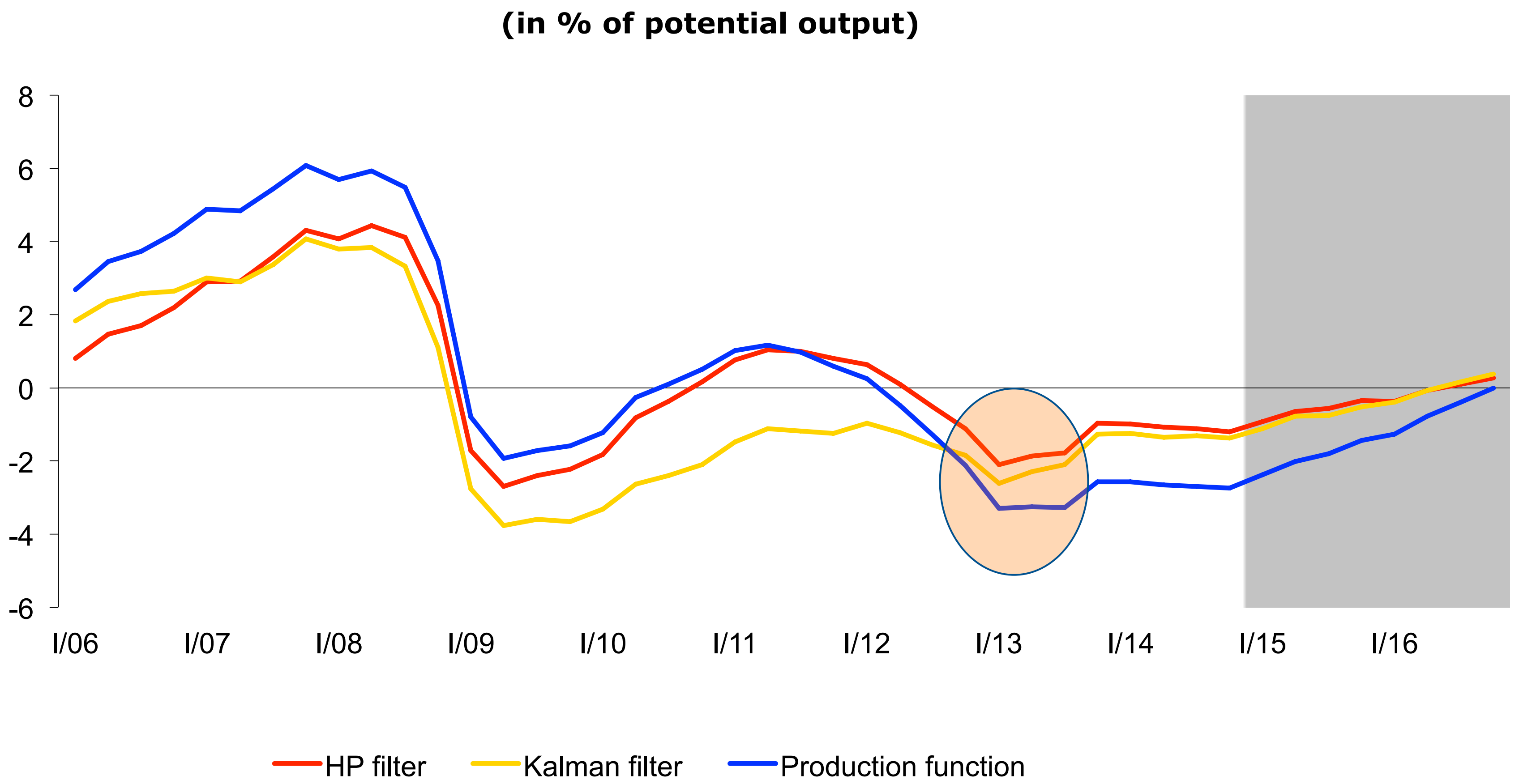


- Headline inflation was close to 1 % in 2013 (i.e. well below the target, but seemingly far from deflation) only due to indirect tax increases.
- MP-relevant inflation had been below the target from November 2012, and it was falling toward zero during 2013.

Output gap



- 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

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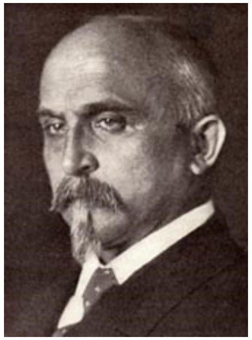
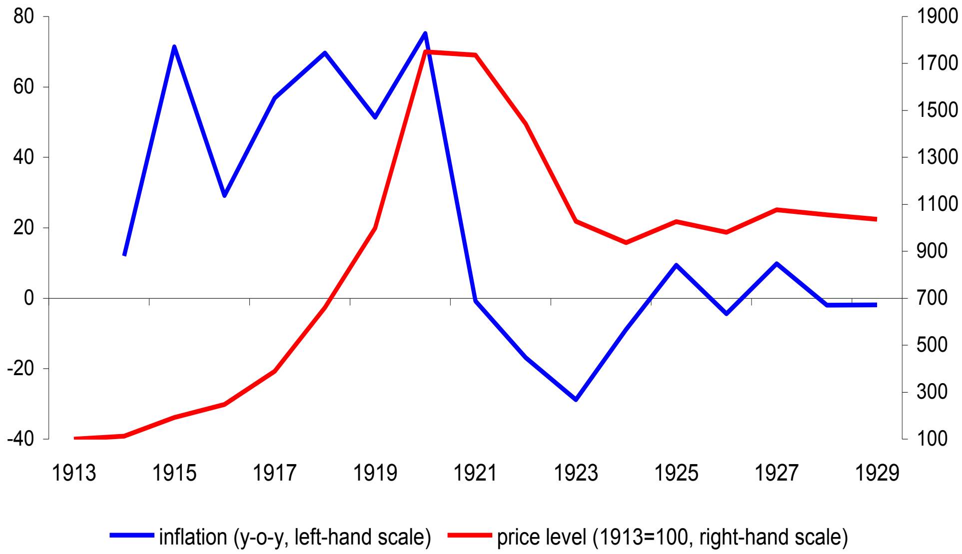
- The <u>deflationary policy in the post-WWI period</u> helped to <u>establish the culture of price stability</u> in Czechoslovakia, but at a <u>high cost</u> (both economically, and for Alois Rašín himself).

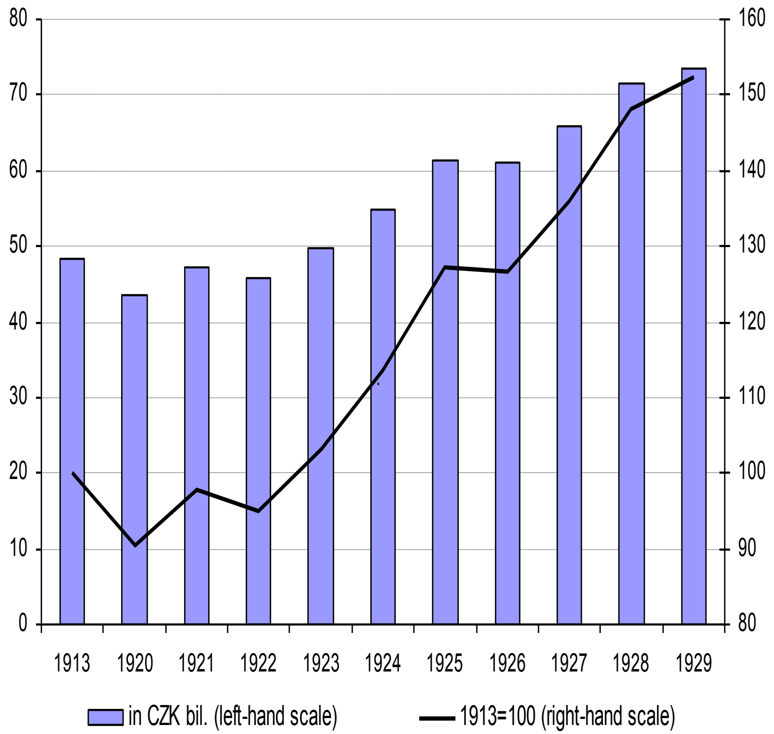


Inflation and Price Level



Note: from 1913 to 1920 unweighted index of adminstrated prices of 38 items, between 1921-1923 prices of food, fuels, petrol and soap, from 1924 food prices. Source: Ministry of Finance Report on Supplying People in Czechoslovakia, 1920, Statistical Handbook of Czechoslovakia, 1925, Price Reports of Statistical Office 1921-1929, Matoušková (2008).

GDP



The Great Depression policy debate

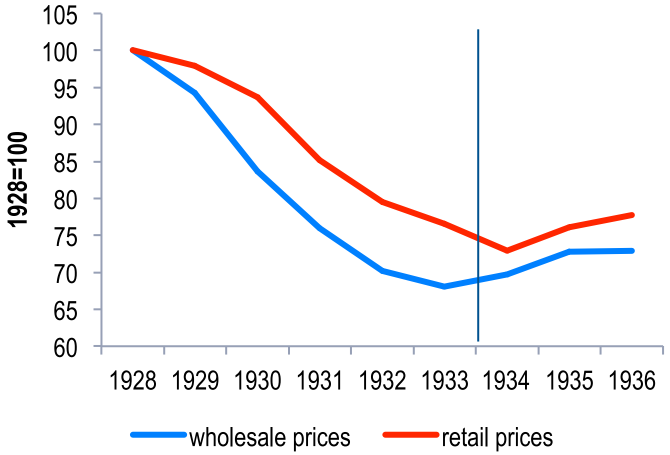
- There was a similar policy debate to the current one in Czechoslovakia 80 years ago.
- Vilém Pospíšil (proponent of Gold Standard, follower of Alois Rašín)

versus

Karel Engliš (proponent of price stability, closer to the modern view)

Pospíšil

Engliš



- 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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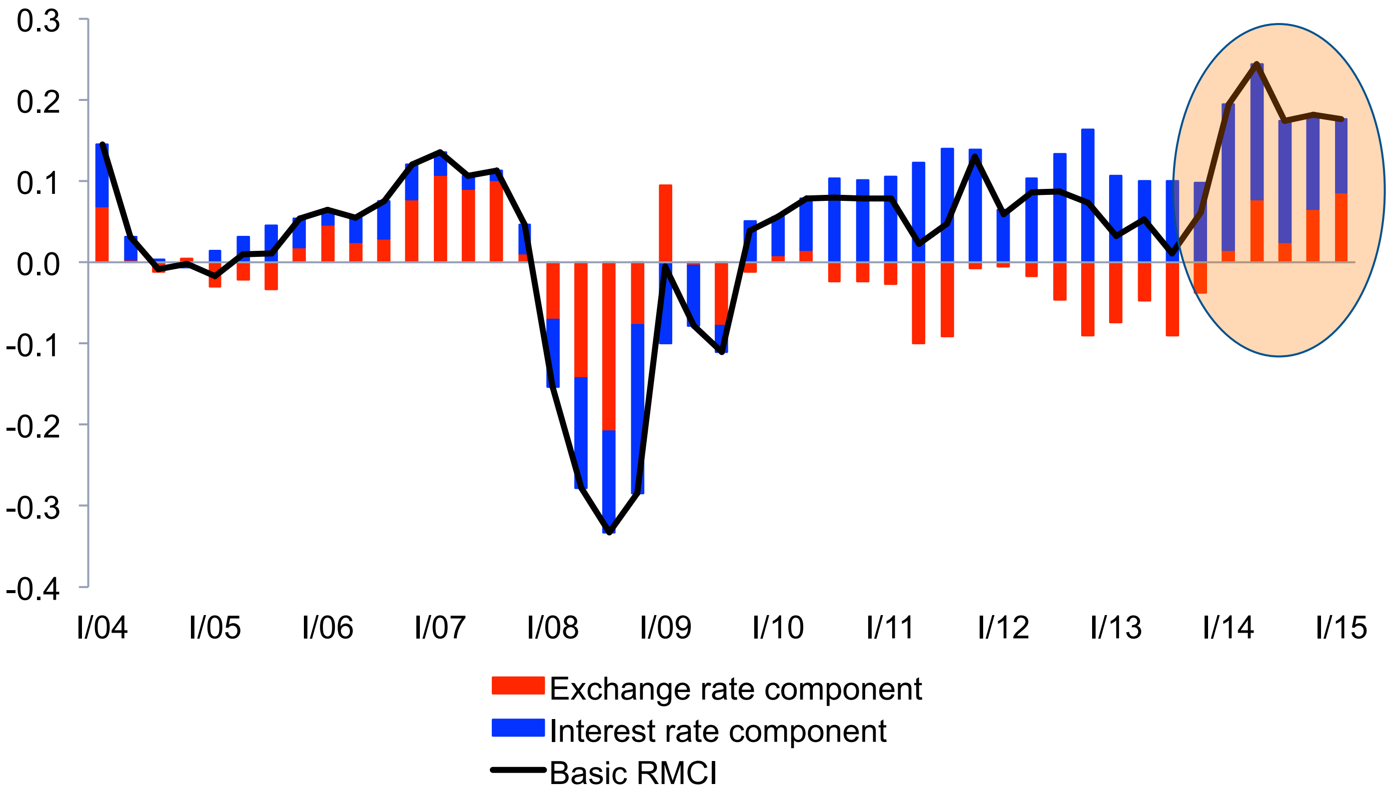
Overall monetary conditions



- The CNB's policy measure has <u>significantly eased the overall monetary conditions</u>, both in their interest rate (via higher inflation expectations) and exchange rate components.

Comparison of the data available then and now

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

- 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.

Inflation forecast

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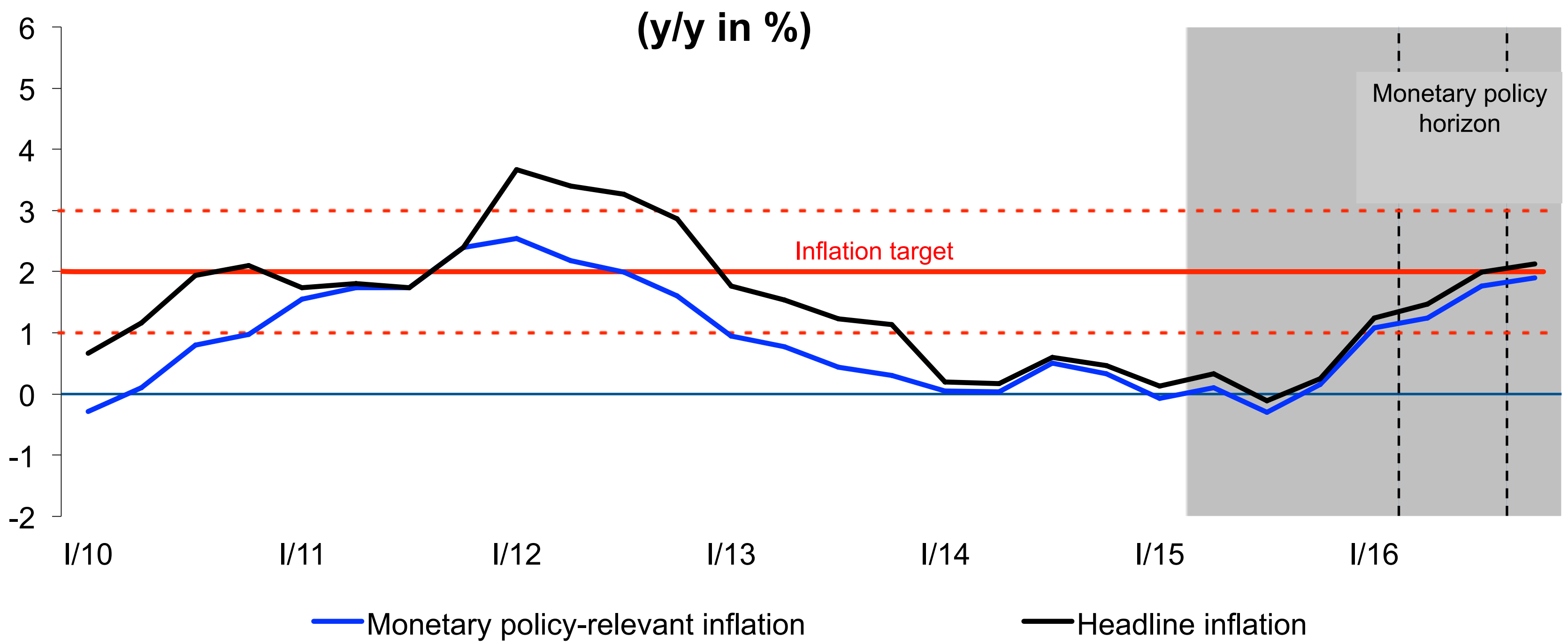

- Once the current anti-inflationary supply-side shocks fade away, inflation will start increasing toward the CNB's 2 % target.
- This will be fostered by a continued growth of the domestic GDP and accelerating nominal wage growth in the business sector.
- It is important to make sure that inflation expectations remain well anchored.

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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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www.cnb.cz

http://www.cnb.cz/en/monetary_policy/weakening_koruna/index.html

http://www.cnb.cz/en/research/research_publications/irpn/2014/rpn_03_2014.html

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