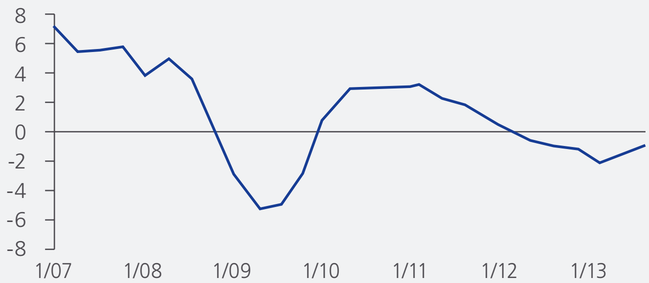
THE EXCHANGE RATE AS A MONETARY POLICY INSTRUMENT

Why the Czech National Bank decided to weaken the exchange rate of the koruna

The global financial and economic crisis caused the Czech economy to slow sharply in 2008 and to contract by more than 4% the following year. After two years of sluggish recovery, the economy weakened again in 2012 and 2013. This was reflected in rising unemployment, falling household income and consumption, and shrinking corporate profits and investment. The Czech National Bank reacted by making full use of its main monetary policy instrument, gradually lowering interest rates to "technical zero" (0.05%). On top of this, it pledged in autumn 2012 to keep interest rates at this level for as long as necessary. However, as it is impossible to lower interest rates into negative territory, the CNB began communicating in autumn 2012 that it was prepared to use other instruments to ease monetary policy further if the need arose. After careful consideration, it opted for the exchange rate. For the Czech Republic, which is a small open economy with a long-term liquidity surplus in its banking sector, this is a more appropriate instrument than, say, government bond purchases.

Figure 1: GDP growth

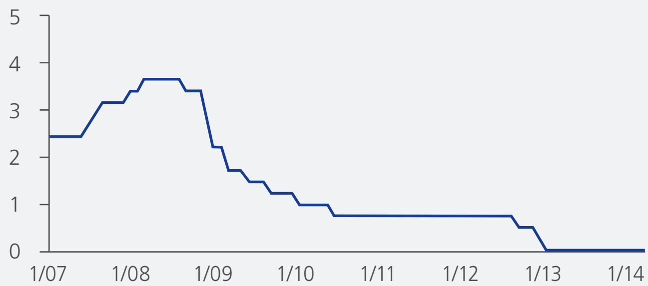


The mere announcement that the CNB was prepared to use the exchange rate to ease monetary policy caused the Czech koruna to weaken in late 2012/early 2013 and then stabilise. This in turn slowed the disinflationary tendencies and gave the economy some breathing space.

In the event, however, the recession and the labour market slump faded only very slowly and their anti-inflationary effects, coupled with falling prices of commodities and energy, led to a further decrease in inflation.

The CNB's short-term outlook at the end of 2013 indicated a growing risk of deflation. Prices of many items in the consumer basket (especially consumer goods) had meanwhile been falling for some time and there was a danger that households and firms would take the falling prices for granted and incorporate them into their expectations and wage-setting. This, however, would have had dire consequences for the Czech economy. The CNB therefore decided in November 2013, in accordance with its statutory mandate to maintain price stability and in line with its previous communications, to start using the exchange rate of the koruna as an additional monetary policy instrument.

Figure 2: The CNB's key interest rate



What might have happened had the CNB not intervened

If the CNB had not eased monetary policy further, the previously relatively stable exchange rate trend might have been interrupted and the koruna might have started appreciating sharply. At the same time, firms, households and financial markets would have gambled even more on a further decline in prices and would thus have been less willing to borrow despite the record low interest rates. The anti-inflationary tendencies would have subsequently gained momentum and the emerging recovery would have faltered or even ground to a complete halt. The economy would have sunk into a further wave of recession or even deflation, i.e. a sustained fall in the price level. This would have led to a further strengthening of the exchange rate and deflation expectations, and the Czech economy could have found itself in a vicious circle that economists call a deflationary/recessionary spiral.

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A decline in prices of goods and services might seem a good thing to individual consumers, but it is extremely harmful and unwelcome at the whole-economy level. Central banks all around the world do all they can to avoid the risk of deflation. Many firms and households defer their purchases in expectation of falling prices. This in turn causes demand to dry up, or at least to shift in time. If there is no demand, there is no need to produce. Firms lay off workers and household income and corporate profits slump, pushing prices down further. And so the whole process keeps repeating itself. The fall in prices and income increases the real value of debt and causes debt repayment problems. It is not easy to escape a deflationary/recessionary spiral. In this regard, the deeply negative experience of deflation in the 1930s is still a strong reminder for all economic policy authorities, and especially for central banks. Japan also has negative experience with deflation over the last two decades. In line with its mandate to maintain price stability, the CNB therefore decided to act to obviate the risk of deflation, i.e. to ensure a faster return of inflation to its 2% target level, a safe distance away from deflationary levels.

Figure 3: Inflation adjusted for the first-round effect of taxes

The decision to ease monetary policy further was based on economic analyses conducted by the CNB. These analyses showed that if no monetary policy action were taken, the Czech economy might in 2014 go into a period of deflation lasting at least two to three quarters. This, however, is a very optimistic prediction. Historical experience tells us that deflation can be very difficult to stop once it gets going. Prevention is therefore better than cure.

Benefits of the weaker exchange rate

After carefully considering all the risks involved, the CNB Bank Board decided in November 2013 to start using the exchange rate as an additional instrument for easing the monetary conditions. The CNB undertook to intervene in the foreign exchange market to weaken the koruna so as to maintain the exchange rate close to CZK 27 to the euro. This exchange rate commitment is asymmetric, i.e. the CNB will stop the koruna appreciating below CZK 27 to the euro but will leave any further depreciation above CZK 27 entirely in the hands of supply and demand on the foreign exchange market.

The weakening of the koruna has averted the threat of a long-term deflation trap, and economic growth will now accelerate. According to the CNB's February 2014 forecast, GDP will rise by 2.2% in 2014. Thanks to the monetary policy easing, the Czech economy will grow more than one percentage point faster in 2014 than it would have done without such intervention. This simultaneously means that there will be around 35,000 more jobs available on the labour market than if the CNB had not intervened.

Figure 4: The CZK/EUR exchange rate

The exchange rate weakening will boost the price competitiveness of Czech exporters, who will also receive more korunas for the same amount of euros earned. The weaker exchange rate will also increase the prices of imported goods, supporting demand for goods of domestic origin on the Czech market. Households and firms will see that it does not pay to wait for prices to fall further, and a proportion of households (especially medium- and high-income ones) and firms will start consuming and investing more. Czech firms will enjoy rising sales, hire more workers and pay their employees better. Higher household income and consumption along with higher corporate profits and investment will mean higher tax revenues for public budgets. The main benefit to the public is greater job security or a greater chance of finding work. These benefits clearly outweigh the direct consequences of the weakening of the koruna, which may be unfavourable in the short term, as commodities, materials and semi-products purchased from abroad will be more expensive for firms and imported goods and energy will be more expensive for households.

The impact of the weaker exchange rate on inflation will not be dramatic, as the import share of household consumption is only around one-quarter. The average inflation rate in 2014 will be approximately 1.2%, the second-lowest figure in ten years. In 2014 and 2015, inflation will be just below the CNB's 2% target on average.

How the interventions are made

The CNB is purchasing foreign currency as needed in accordance with foreign exchange market conditions so as to achieve the desired easing of the monetary conditions as mandated by the Bank Board. The CNB can use infinite amounts of koruna to purchase foreign currency, as it itself issues the Czech currency in both paper and electronic form. The CNB is resolved to intervene in such volumes and for such duration as needed to maintain the chosen exchange rate level, to avert the risk of deflation and to return inflation gradually to the 2% target.

The CNB will continuously monitor the appropriateness of the chosen exchange rate level and may revise it if necessary. However, a change in the target exchange rate would need a much stronger impulse and reassessment of the situation than in the case of a change of interest rates.

The use of the exchange rate as a monetary policy instrument will be discontinued when it becomes necessary to tighten monetary policy significantly as a result of very substantial inflation pressures in order to hit the inflation target. Only then will the CNB discontinue its interventions and raise interest rates above (technical) zero. The need for easy monetary policy can be expected to last a long time. The CNB is therefore likely to continue using the exchange rate as a monetary policy instrument at least until the start of 2015.