Inflation Targeting: Czech Experience

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Paris, February 2007

1998-2007

After nearly ten years of targeting inflation in the CNB,
there are certainly lessons to share

What to Learn from the Czech Experience?

- **One should think about IT in three steps**
  - 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)
- **One should view IT as a 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)

# IT in Three Steps: 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)
    - fashionable complicated forecasting model (it will be developed later)

IT in Three Steps: 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)

Target specification

December 1997

November 1998

April 2000

April 2001

December 2005
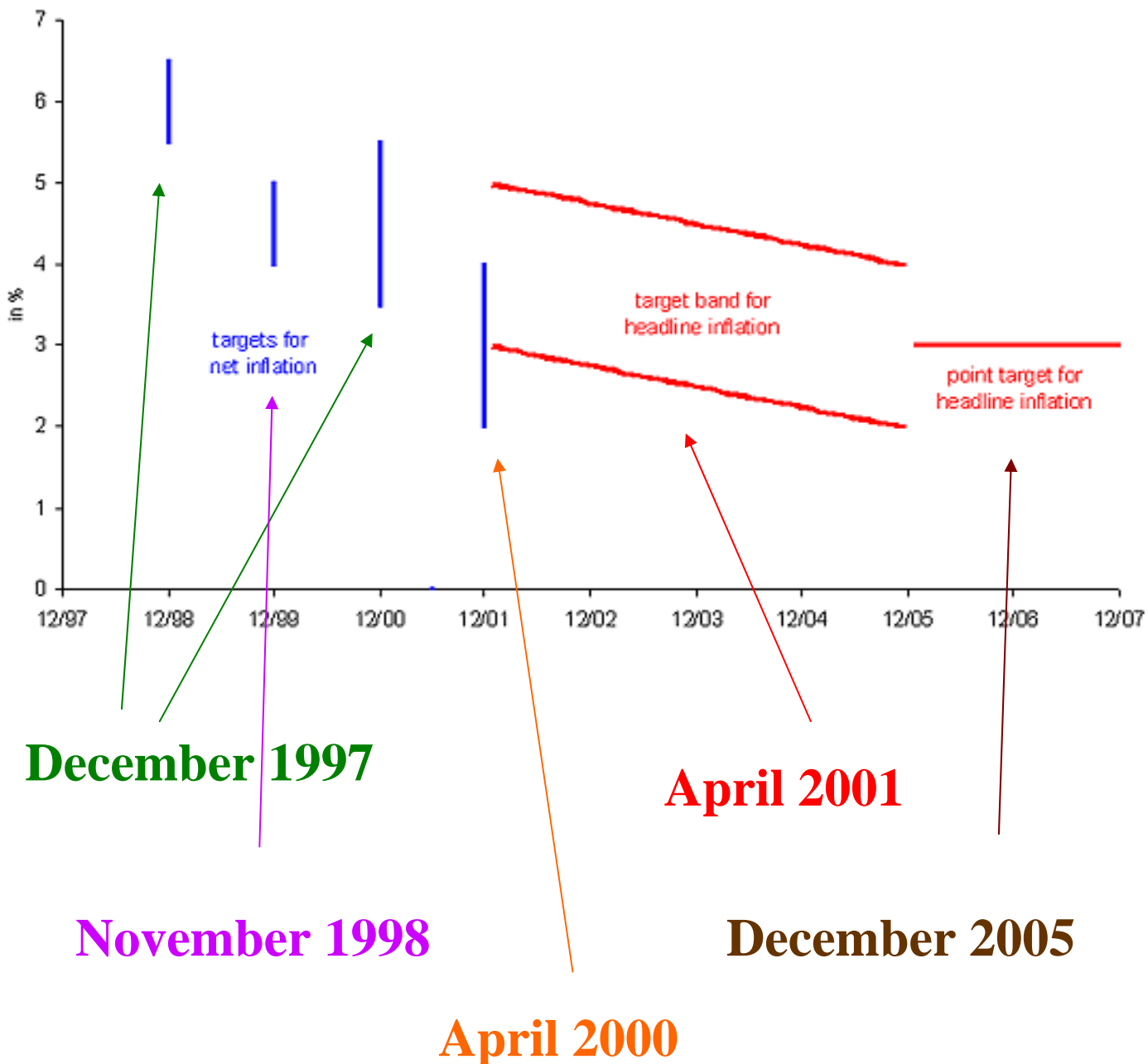
Caveats

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.

Decision-making Framework
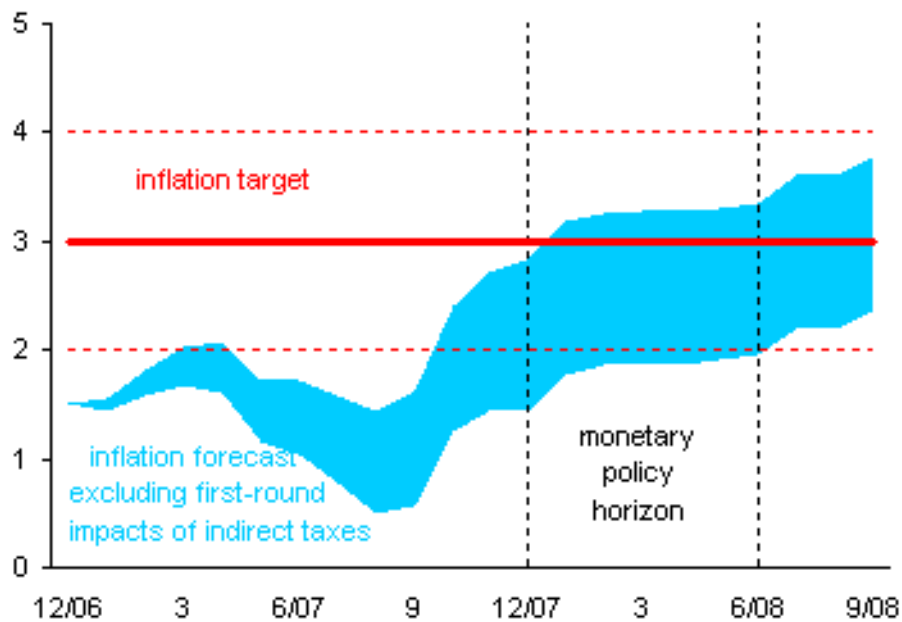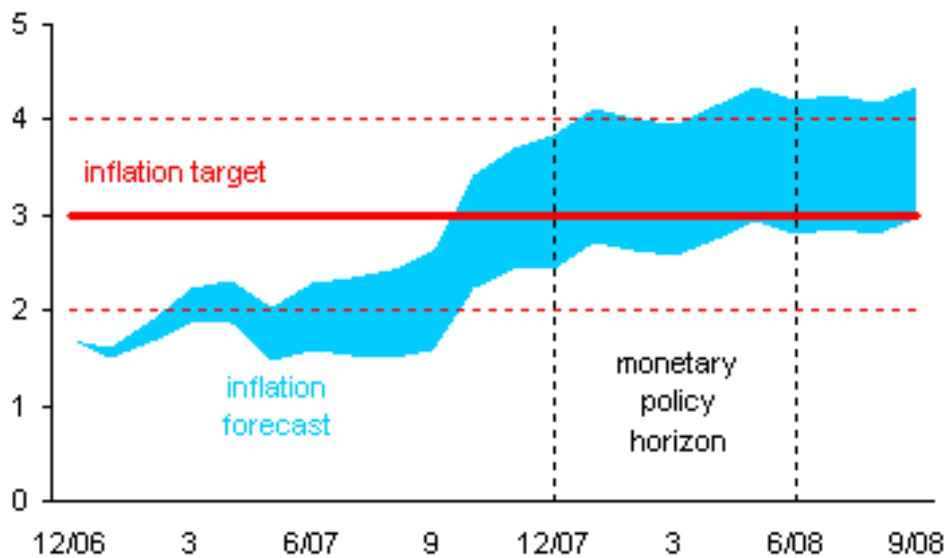
IT in Three Steps: Outcomes

- **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 transparence**
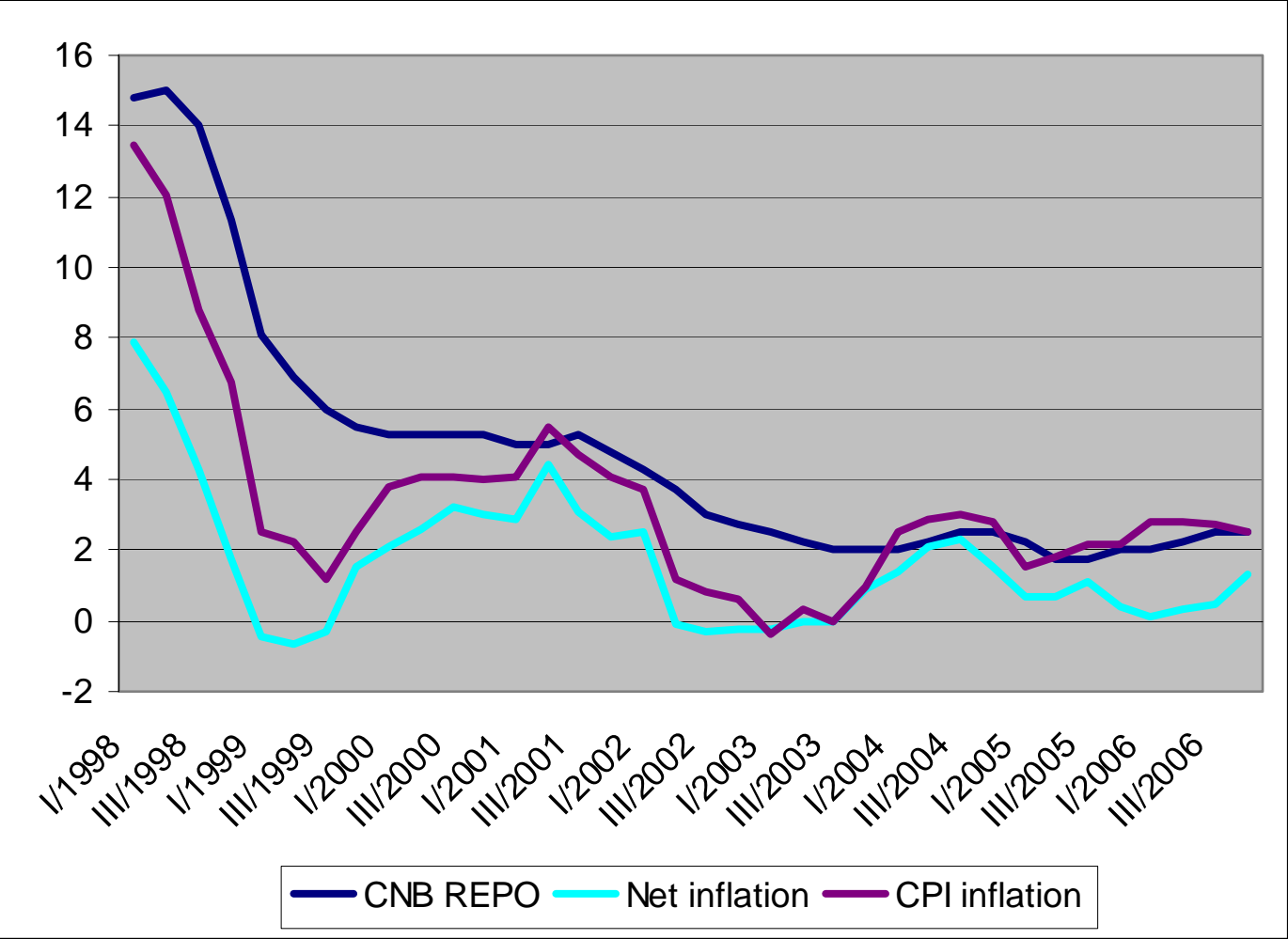
Primary Outcome

Secondary Outcome
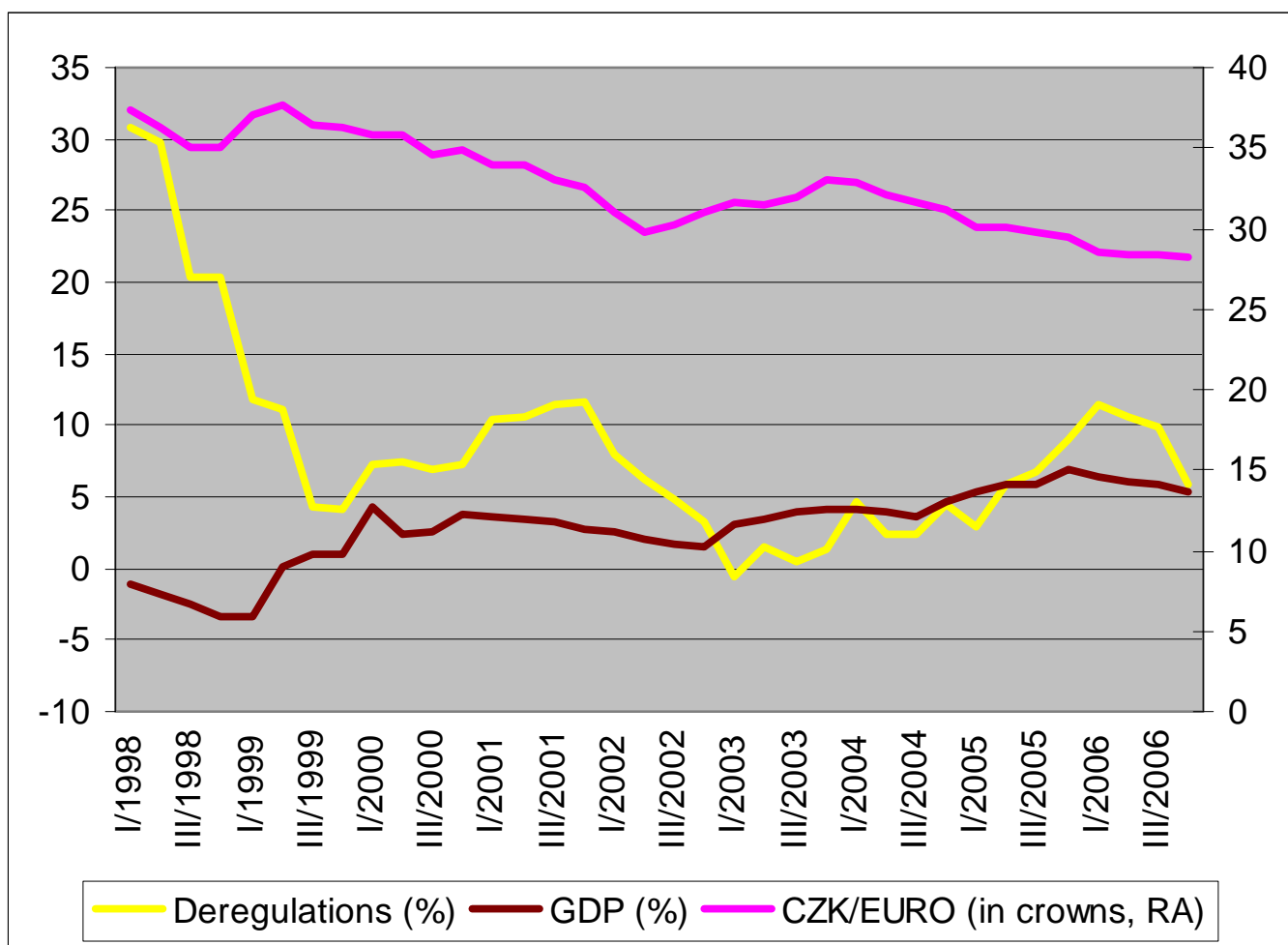
IT in Motion:
Current Challenges

- CNB is **improving the forecasting model** (from QPM, used since 2002, to SDGE model)

- CNB is **improving transparency** over time (faster publishing of minutes, new publishing of description of interest rate path)

- CNB considers **level of the target** (global low inflation, and also due to the expected euro adoption after 2010)