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ADOPTION OF THE FX COMMITMENT IN THE CZECH REPUBLIC: SOME REFLECTIONS OF THE INSIDER

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Abstract:

This article discusses the decision of the Czech National Bank from November 2013 to use the exchange rate as an additional monetary policy instrument from the point of view of one the Board members present in the monetary policy meeting under discussion. Even a few years after the end of the intervention regime, it is impossible to objectively assess all the advantages and disadvantages and future risks of this step. The goal of this article is not to provide a systematic analysis of the impact of FX interventions, but to reflect on some of their controversial or risky aspects in view of the global economic development.

Keywords:

GDP, monetary policy; central bank, FX intervention, deflation, inflation target, inflation expectations, exchange rate, macroprudential policy, self-reflection, art of communication

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1 Introduction

At the beginning of November 2013, the Bank Board of the Czech National Bank (CNB) decided to use the exchange rate as another monetary policy instrument and, through massive interventions on the FX market, quickly achieved the announced exchange rate commitment of 27 CZK/EUR. According to the CNB, it was necessary to further ease monetary conditions in a situation where monetary policy rates had been at a technical zero for a year. The CNB sought to meet the 2% inflation target and to prevent deflationary expectations that, in its opinion, could postpone investments and consumption and negatively impact the economy.

This topic was discussed in the media and among economists as soon as the FX interventions started. The economists were divided into zealous supporters and opponents. On the other hand, the general public was almost unanimously very much against these interventions, which, among other things, forced the CNB to significantly increase its media activity. The reaction of general public was largely expected, as the exchange rate commitment was an incomprehensible theoretical monetary policy tool with which the general public had and still has relatively little experience.

The opponents and supporters of the intervention regime are unable to agree on its overall effects even several years after the end of the exchange rate commitment. Their position did not significantly change during the commitment period, but the discussion became focused on three basic areas. First, whether or not it was at all necessary to start the foreign exchange interventions. Secondly, whether or not it was worth taking this risk in view of the subsequent development of the main macroeconomic indicators and how much did the commitment actually affect economic performance. And thirdly, whether or not we are now able to identify and assess all the potential risks associated with the exchange rate commitment. This article deals with all these questions, but instead of providing an exhaustive analysis it points out to selected issues that will require a broad professional discussion in the future, which is important for the further development of monetary policy theory and practice. While doing so it also offers personal views of the author – a CNB board member at the time of the FX commitment adoption.

2 FX intervention as a monetary tool

2.1 An appropriate choice of an economic policy mix

The CNB's decision to adopt the exchange rate commitment must be regarded in a broader international context and assessed as part of the country's overall economic policy. Prior to the global financial crisis, the corporate and household debt had risen sharply in both advanced and developing economies. Many governments also struggled with an unprecedentedly high debt levels (Řežábek, 2015). After the financial crisis of 2008, the accumulated credit risks resulted in the financial sector's high losses that, due to a weakened credit supply, then impacted the real economy and deepened the economic recession. In this situation, highly indebted governments that were exposed to market financing problems did not have sufficient room to implement an effective fiscal policy. Only central banks were able to give the governments the time they vitally needed thus offering a temporary solution. They in fact seized this opportunity and suddenly became an absolute hegemon in terms of economic policy (El-Erian, 2016).[1] On the other hand, the governments did not use the provided room very effectively and failed to show enough decisiveness to implement unpopular measures. The world's leading central

[1] In this context, the following saying became famous: “Central banks are the only game in town.”

banks thus increasingly felt that it was up to them to resolve all economic problems even at the risk of establishing previously unthinkable conditions on financial markets. This feeling then turned into the belief that pro-active, even aggressive, interventions in the economy must be carried out at all costs.

Although this reaction may seem understandable in the short run, the long-term effects of very low interest rates and, to a large extent, the artificial prolongation of the natural economic cycle, come with many systemic risks, the ultimate consequences of which are difficult to estimate now. As a certain barrier against the environment of highly eased monetary conditions and also as a response to the financial crisis, economic policymakers started gradually using instruments that are collectively referred to as macroprudential policy.

In this global mindset, it is not surprising that the CNB also succumbed to the saviour complex of leading central banks, and the Bank Board followed very proactive approach of the central banking community to solving economic problems. Although the Czech governmental sector's debt in the post-crisis period was not as high as the debt of other governments, the Czech fiscal policy has always been rather pro-cyclical. This means that the expansionary policy was implemented during economic growth and fiscal restrictions during a recession (Řežábek, 2019). This was also the case in 2012–2013 during the Nečas government, which during the contraction phase of the economic cycle favored budgetary prudence and fiscal cuts instead of a necessary fiscal stimulus. Regardless of who was responsible for the initial situation, a mixture of a very eased monetary conditions further fueled by the exchange rate commitment and a restrictive fiscal policy is not an ideal situation for the economy. Even though the government and the CNB implement their policies independently from each other by law, a reasonable level of cooperation of these two authorities would be beneficial for the country's economic growth (Řežábek, 2019).

It is clear that if the economic mix is set up incorrectly, the easing of the monetary policy must be more drastic and of long-term nature, which comes with many risks and unpredictable consequences. We can compare this situation to the release of the famous "genie" from a bottle. The fact that the CNB did not have the situation fully under control and that the ability to estimate the future effects of non-standard decisions is rather limited is supported by subsequent economic development. In particular, intervention regime, which was expected to end in a relatively short time, was gradually extended for more than three years and the volume of necessary interventions exceeded the expectations of the vast majority of participants.

Just like the authorities in other countries, the CNB continuously tried and is still proactively trying to mitigate the effects of eased monetary conditions through macroprudential policy tools. The fact is, however, that household loans continued to grow rapidly, the price of many assets is significantly overvalued and real estate is virtually unaffordable for the middle class. This has led to a further tightening of macroprudential instruments in the pre-pandemic years. We can thus also argue that the foreign exchange interventions led to a suboptimal mix between a rather eased monetary policy and an overly strict macroprudential policy. For instance, it is now almost impossible for many young households in large cities to get a loan under existing regulatory measures without taking additional risks (e.g. getting a loan outside the banking market).

Naturally, the Czech economy operates in a certain economic territory. As a small open economy, it is affected by the economic growth and monetary policy of its largest business partners.[2] Considering the size and strength of the Czech economy, it is not quite possible to

[2] In particular, the ECB's current policy is much more eased than that of the CNB.

deviate from global trends. However, it is all the more necessary to have national and international discussions about the risks of an unsuitable economic mix and the impact of a long-term eased monetary policy.

2.2 The art of communication

If the supporters and opponents of the exchange rate commitment (and the CNB as well) agree on one thing concerning the intervention regime, it is quite poor communication following the start of the commitment. At first, the CNB underestimated the level of resistance among professionals and the general public against the interventions and was not prepared to support its decision with sufficiently clear arguments consistent over time. The initial blunders in communication thus affected how the interventions were accepted. The CNB’s subsequent efforts to better explain and discuss its steps did not help much either.

It is never good when such a major step comes as a surprise for the market and the public. The stakeholders did not expect the FX interventions to be implemented after a relatively long period of verbal warnings. Just like any other unfulfilled threat, the warnings gradually became less credible. Moreover, the decision to declare the exchange rate commitment was finally made at a time when some of the subjects were already starting to feel that the acute recession was over. Some lag in the adoption of the exchange rate commitment can naturally be ascribed to lengthy decision-making processes within the CNB, but such a fact is not important for the public in terms of communication.

Communication during the period of the planned termination of the intervention regime and the announcement of the so-called hard commitment cannot be considered very successful either. It consisted of a publicly announced date by which the CNB committed not to terminate the exchange rate floor. This explicit guarantee provided speculative investors with some guideline on how to proceed and resulted in an enormous accumulation of speculative positions just before the end of the interventions. This would probably not have happened if a different communication strategy had been used. The interventions, which led to a massive overboughtness of the Czech Koruna, only contributed to uncertainty about the future trend of the exchange rate. Complications with estimating the future trajectory of the exchange rate make it impossible for companies to correctly choose its optimal values for hedging, which makes investment decisions more difficult and increases financial costs.

Despite all the communication blunders, I consider the CNB's self-reflection in this area to be a positive thing. It allows the CNB to learn from its mistakes and to avoid similar situations in the future. A frequently neglected benefit of the CNB's better communication also includes the fact that the general public would be more interested in how the central bank operates.

2.3 Did the interventions work?

The success/failure of the exchange rate commitment can be assessed based on a number of criteria, and each economic agent is likely to assign a different importance to individual factors. For the sake of objectivity, it is therefore useful to make this assessment based on indicators that are easily quantifiable and that characterize the overall macroeconomic environment. Two basic indicators are naturally: economic activity growth (GDP) and consumer inflation (changes in the CPI). So, what can we say about the success of the exchange rate commitment based on the actual trend and rigorous quantitative methods?

The CNB’s official website presents the foreign exchange interventions as an unequivocal success, which the CNB proves by the outputs of the forecasting model, the favorable economic development and the rising inflation after the declaration of the exchange rate commitment. The statements of the bank's leading representatives on the CNB's official blog adhere to the same line of argumentation. This is of course not surprising and it could be hardly expected to hear something else. It is therefore more interesting to read the research papers that evaluated the effectiveness of the foreign exchange interventions and that, due to their scientific nature, should be a priori impartial. There are not many available sources, but their number is sufficient to get a basic picture. Some of the papers come directly from the CNB's economic research (e.g. Brůha and Tonner, 2015), other papers were written by the IMF's researchers (Caselli, 2017). The effectiveness of the exchange rate commitment is naturally also a subject of interest of academic institutions and a great topic of students' theses (see e.g. Svačina, 2015; Opatrný, 2016).

Despite the authors' diverse backgrounds, their scientific papers are generally more sober and cautious in their assessment of the impact of the interventions than the CNB's official communication. Virtually all papers agree that the available methods are not able to prove a positive impact of the exchange rate commitment on the subsequent growth of the overall economic activity. According to the papers, the impact of the foreign exchange interventions on overall inflation is often very weak or inconclusive. The economic growth and inflation would probably be very similar even without the exchange rate commitment, and other factors played a major role in the economic recovery. Research papers usually identify more clearly the impact on core inflation. However, in this case as well, the obtained results depend on the choice of specific variables in the model, and individual model specifications often show a considerably different effectiveness. Considering the fact that we do not really know the "right" model, certain caution is in order.

It is indeed plausible that the final effects of the interventions may have been slightly positive in terms of GDP growth and inflation. However, as the research papers show, this will always be very difficult to quantify precisely and it may continue to be disputed. It is worth emphasizing that the available objective assessment of the success of the interventions is far from clear and conclusive, and it so far has not taken into account long-term risks (e.g. a drastic increase in money volume, low deposit rates, inflated prices of assets, the role of central banks as major global investors on capital markets) that can very much affect the overall cost-benefit ratio in the long run. The fact that even today we are not able to unequivocally confirm the benefits of the exchange rate commitment proves that the interventions were, a priori, a very risky step with unpredictable consequences, which central banks, as conservative institutions, should perhaps try to avoid.

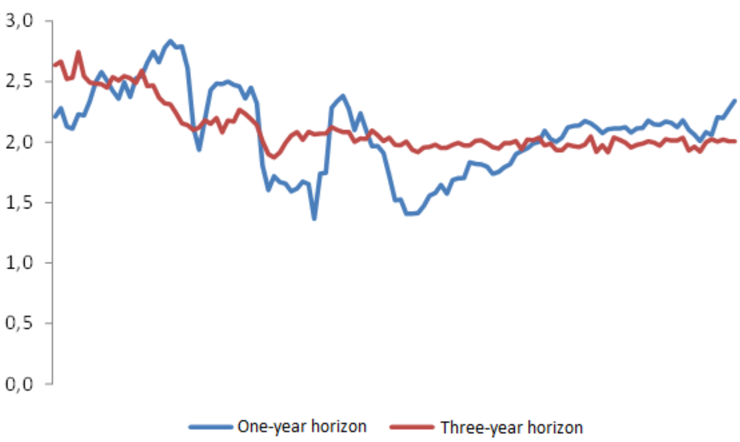
2.4 Is (short-term) deflation dangerous?

This is a key question in the whole dispute over the need for foreign exchange interventions, yet professional discussions surprisingly paid little attention to it. There are no research papers systematically analyzing the harmfulness of deflation in the Czech economy in connection with the declaration of the exchange rate commitment. It is thus necessary to rely on foreign literature that analyzes this issue, but does not necessarily cover Czech specifics or analyzes crises of long ago that cannot be compared to today's situation (e.g. the great economic crisis in the late 1920s). Even this article does not try to provide such a comprehensive analysis and provides only selected comments, the purpose of which is to draw more attention to these aspects and to encourage their more systematic research.

First of all, the question is whether to proceed symmetrically in undershooting and overshooting the inflation target due to extraordinary shocks or whether there is a reason for an asymmetric reaction.[3] The CNB often approached the shocks, which increased inflation above the target once, by applying exceptions and communicated that the impact of these shocks would gradually subside and inflation would return to the target (see, for example, the increase in the VAT rate in 2008). The CNB did not find it necessary to respond to a temporarily higher inflation rate outside the tolerance band and only monitored whether or not one-off shocks had any secondary effects and resulted in market subjects' inflation expectations. During the year 2013, the trend of inflation was influenced, among other things, by lower prices (especially the price of energies, mobile phone tariffs and healthcare fees), which together contributed to a drop in inflation by approximately one percentage point. Personally, I believe that, given the existing risks, the CNB should have had the courage to act just like in the case of one-off inflationary shocks and to simply sit below-target inflation out.

In this context, let us look at the impact of inflation in 2013 on the anchoring of inflation expectations and whether or not there was a threat of their systematic decline. Every monetary policymaker may have different sensitivity to small fluctuations in inflation expectations, and if they are looking for evidence of potential deflation, then even small changes in these expectations will make them worry. However, it is always good to assess trends over a longer horizon. Figure 1 shows inflation expectations in terms of a one-year and three-year horizon with the x-axis intentionally left out so that it would not be clear which time period is covered in the graph. Is it easy to see from the graph the time period just before the interventions? I believe that it is not and that during the time period before the interventions started, there was nothing atypical about expectations that would indicate problems with their long-term anchoring. We can see that inflation expectations in a one-year horizon are fluctuating as usual and tend to oscillate around the inflation target. On the other hand, we can see in the left half of the graph that expectations in a three-year horizon gradually decline. However, this has nothing to do, as one might expect, with the pre-intervention period, but with the change in the inflation target from three to two percent in 2010.

Figure 1: The trend of inflation expectations

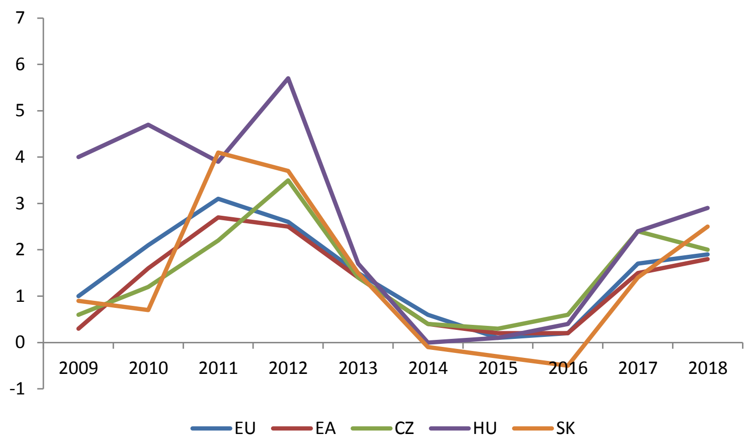


Source: Czech National Bank

[3] The CNB's website www.cnb.cz/cs/menova-politika/cilovani/ shows that, in terms of exceptions, the CNB handles inflation and disinflation shocks symmetrically. However, it is disputable whether this is really true in practice. The analysis of Čečrdlová (2017) suggests that an asymmetric approach is adopted in practice.

It is also interesting to compare the trend of inflation on an international level. Figure 2 shows a similar trend in Central European countries and in the EU as a whole. In 2012, inflation in the CR was the highest among all analyzed countries, with the exception of Hungary; in 2013, it was roughly the same as in other countries. Because of sufficiently high monetary policy rates, the Polish and Hungarian central banks were able to reduce them during this time period, while Slovakia, which is part of the euro area, could not ease its monetary conditions on its own in order to avert deflation. This resulted in a relatively long time period during which inflation was, on average, slightly in the deflationary zone. However, the drop into slight deflation does not seem to have harmed the Slovak economy in any way, and inflation then gradually returned to the normal level, in line with the trend in the entire region.

Figure 2: Average annual inflation in selected countries



Source: Eurostat

The question of why the drop of inflation in the deflationary zone did not result in any long-term problems of the Slovak economy, as was the case in the past in some other countries, is relevant and should be the subject of major impartial research. Obviously, not every slight deflation necessarily results in a deflationary spiral, and I personally did not see it coming in 2013. In this context, it is often argued that households and firms may, in anticipation of future price reductions, postpone their consumption and investments and plan to purchase the same product later at a cheaper price (for expectations, see the previous subchapter).[4] Although these arguments may somewhat make sense, empirical evidence to convincingly prove them is insufficient. Indeed, it is certainly true that an expected significant price increase will accelerate present consumption and investments, but it is not so obvious the other way around. It probably depends, among other things, on the type of products, the purchase of which can be postponed in a certain situation (typically it concerns electronics, cars, selected technologies, etc.). The technological progress of these products has been enormous in the past decades. As a result, their prices permanently and naturally drop or slightly increase if their utility is dramatically higher. There is no indication that this price trend would postpone consumption; on the contrary, the fact that even middle- and low-income households can afford these products encourages consumption at the aggregate level in the long run. Purchase decisions are not primarily made based on short-term price fluctuations, but rather based on potential moral obsolescence. When people wonder whether or not they should buy some electronics, they far more often say "*I will*

[4] The drop in prices due to a lower demand during a crisis is rather an expected reaction.

wait for a new model" or "*It is not worth investing in this technology and it is better to wait for new trends*" rather than "*I will wait until it is cheaper and then I will buy it*."

3 Conclusion

The CNB's decision from November 2013 to use the exchange rate as an additional monetary policy instrument provoked a big debate, and to this day this step has been considered controversial. Even after all this time, it is still difficult to quantify the overall benefits and costs of the interventions. However, we can say that there is time incompliance between potential short-term to medium-term benefits and potential medium-term to long-term risks. The legacy of the exchange rate commitment includes the long-term overboughtness of the Czech Koruna, high risks to financial stability and the threat to economic growth in the long run. This trend may cause a greater economic volatility rather than stability. The question therefore remains whether or not it was necessary to take a relatively risky step in this situation, and whether or not the resulting risks are not ultimately greater than the policy of tolerating a short-term inflation drop to zero or even slightly below zero.

Neither side is likely to back down from its original position in the future. Nevertheless, there are areas where both sides should agree as soon as possible for the sake of the country's long-term prosperity. This includes the need to focus on a deeper understanding of economic processes in a changing world and to pay attention to the further development of economics, which alone can offer clearer answers to the existing controversial questions.

The biggest danger for the future may be the fact that central bankers may get the impression that they are infallible, omnipotent and can solve all economic problems. But there might be a high price to pay in the future…

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