

MANAGING ECONOMIC CONVERGENCE AND FINANCIAL STABILITY IN THE CZECH REPUBLIC

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Abstract:

This article addresses the issue of macroeconomic policies in the pre-accession period. The key theme is an assessment of the relationship between the real and nominal convergence of the candidate countries towards the EU. Support for real convergence cannot proceed on a long-term basis in contradiction to the nominal convergence criteria. Despite a renewal of growth in 1999, a whole range of persisting structural problems, chiefly in the fiscal area, confirm the benefit of voluntary pursuance of the nominal convergence criteria. For the central bank, the inflation criterion is particularly relevant. The issue of catching-up with the EU price level is discussed from this point of view. Neither the theoretical models (the law of one price and the Balassa-Samuelson effect) nor the empirical evidence provide arguments for abandoning the efforts for price stability. The most appropriate monetary policy regime linking the interests of monetary policy and government economic policy is inflation targeting.

Keywords: accession process, policy mix, nominal and real convergence, price level, Balassa-Samuelson effect, one price law, inflation targeting

JEL Classification: E230, E310, E520, E610, F020, F150

1. Copenhagen versus Maastricht

One of the key economic policy issues for countries aspiring to become members of the European Union is that of “real versus nominal convergence”. This is indeed a pivotal issue, as it deals with the identification and sequencing of the key decision-making priorities for the candidate countries to follow. This problem can be rephrased in simple terms as “Copenhagen versus Maastricht”.

Seen from the official point of view, the conclusive and regularly evaluated benchmark for accession to the European Union is the so-called Copenhagen criteria.¹⁾

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1) The progress of the candidate countries in meeting the Copenhagen criteria is mapped out in regular reports of the European Commission. The fact that domestic politicians closely watch the conclusions of these reports is illustrated by the commotion about the report for 2000. This concluded that “the Czech Republic can be regarded as a functioning market economy and should be able to cope with competitive pressure and market forces within the Union in the near term, provided that it keeps up and completes the implementation of structural reforms”. This opinion was interpreted as ranking the Czech Republic as a third-wave country. This produced many critical responses, as well as a positive result in the form of redoubled political efforts to remedy the problems found.

These criteria, together with political requirements such as the rule of law, stability of democratic institutions and respect for human rights and the rights of minorities, also contain a set of relatively general economic criteria – in particular the requirement for the candidate countries to have a functioning market economy and to be able to withstand competitive pressures and market forces within the Union.²⁾ On the macroeconomic level, the economic part of Copenhagen criteria is interpreted in such a way that the top priority must be given to enhancing economic growth and closing the performance gap between the candidate country and the member states of the Union.³⁾ However, no specific numbers are given to indicate the desired speed of economic growth.

Another undeniable fact is that the mandatory focus on fulfilling the Maastricht criteria, which lay down explicit parameters for inflation, long-term interest rates, public budgets and the exchange rate, represents the later stage of preparing for accession to European Monetary Union (EMU). In fact, there is not much freedom for discretion, as, by adopting the *acquis communautaire*, the candidate countries committed themselves to adopting the single currency. They were denied the so-called opt-out clause, which – as a privilege of some current EU Member States – stipulates the right to retain the national currency. By preparing to join the EU, the candidate countries are automatically undertaking to draw up, when they become members, a convergence programme specifying guidelines for the adoption of the euro. The clear progression – “first membership in the EU and then membership in the EMU” – however, creates an obvious sequencing for the official obligations of the Copenhagen and Maastricht criteria.

Many economists believe that this sequencing is right and grounded. They believe that the two sets of criteria – the real convergence of Copenhagen and the nominal convergence of Maastricht – compete with each other to some extent. They are concerned that “exaggerated” ambitions within nominal convergence, i.e. the emphasis on low inflation or low public debt, will hurt real convergence. They argue that a narrow focus on the Maastricht criteria will result in slower growth and more time needed to close the performance gap between the accession countries and the EU Member States.

There exists, however, an alternative view, highlighting the strong elements of complementarity between the processes of real and nominal convergence. This view has been adopted by the European Central Bank, which maintains that the processes should be followed in parallel. In other words, the fact that the Maastricht criteria are not obligatory for accession to the EU should not prevent the macroeconomic policies of the candidate countries being, in the medium run, consistent with the eurozone policies (see European Central Bank, 2000).

How might the desired accord be achieved in practice? And how a large trade-off between real and nominal convergence do policymakers have at hand? Each candidate country will have to choose its own path, taking into account its own historical experience and social preferences. This applies equally to the Czech Republic, which in the previous period of economic transformation gathered a large volume of empirical evidence which should now be put to use.

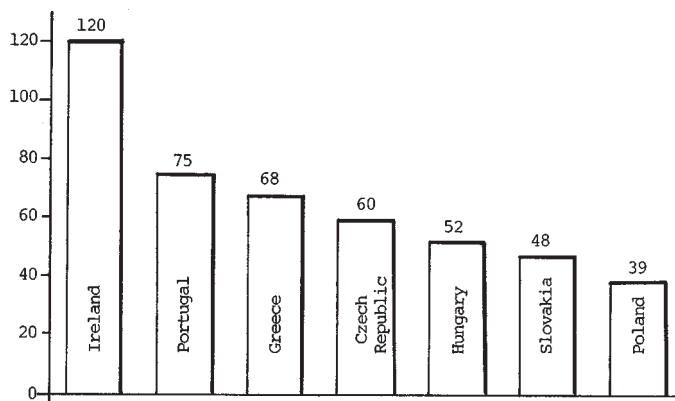
2) These requirements entail a large number of mostly microeconomic tasks – completing structural reform and privatization, improving law enforcement, strengthening the banking sector, developing local financial markets, etc. It is considered a natural consequence that the above tasks, if implemented, will foster economic growth.

3) This is a matter of definition. Given the more or less constant labour force, economic growth is tantamount to an increase in labour productivity.

1. 1 A Case Study of Non-sustainable Growth

The statistics show that in 2000, Czech per capita Gross Domestic Product (GDP) was approximately 60 % of the EU average (see Figure 1). At the same time, the economically weakest EU Members recorded higher values: Greece 68 % and Portugal 75 %. Amongst the candidate countries, the Czech Republic was outperformed by Slovenia (71 % of the EU average), but was ahead of Hungary (52 %) and Poland (39 %).

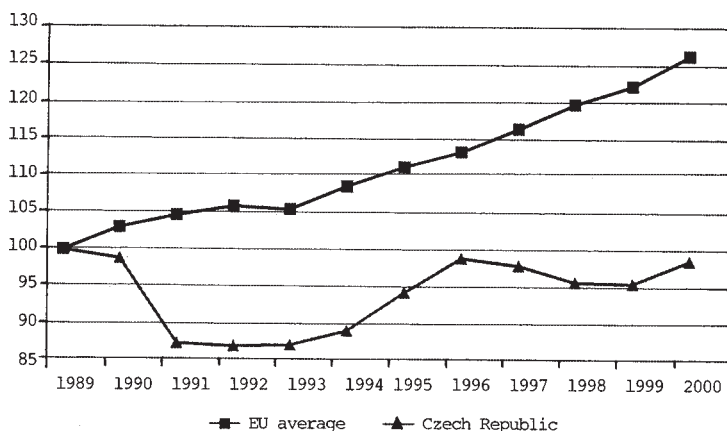
Figure 1
Comparison of Economic Strength of Selected Countries (in %)



Note: GDP per capita in purchasing power parity in 2000; EU average = 100 %.
Source: OECD, 2001.

A more alarming finding than the mere existence of a performance gap at any particular moment is the fact that the gap between the Czech Republic and the EU countries has a widening tendency (see Figure 2).

Figure 2
Widening of the Performance Gap between the EU and the Czech Republic (in %)



Note: Fixed prices; 1989 = 100 %.
Source: Vintrová et al., 2001; Czech National Bank database.

Whereas in 1990 the Czech Republic's GDP per capita was approximately 69 % of the EU average, the following decade of transition saw the gap increasing by almost 10 percentage points. This comparison clearly suffers from many flaws. It ignores the simple truth that the candidate countries have undergone sweeping social changes, accompanied by an inevitable transformation recession. The statistical GDP data are not able to take account of the huge leap from a shortage economy and distorted international trade to market structures where price respects the sovereignty of the consumer and profit is a reflection of business success. However, the fact remains that the Czech Republic has fallen back from the EU economic level, especially with respect to the economic recession of 1998 – 1999.⁴⁾

Under these circumstances, the importance of economic growth cannot be overstated. It is evident that a growing economy has higher financial capacity for completion of transformation objectives and transposition of European legislation. The growth fosters an increase in competitiveness, which in turn is a pre-requisite for prosperity in a club of countries respecting the four fundamental freedoms of free movement of persons, goods, services and capital.

Both parties have a vested interest in accelerating the growth. The EU does not need weak members depleting structural funds, demanding various waivers, and generating fears of destabilization of the common labour market without offering offsetting benefits to the others. So, acceleration of real convergence quite rightly becomes the key priority for the economic policies of candidate countries and an area closely watched by the EU.

In this context one should recall that the Czech economy showed very promising performance just a few years ago. In 1995 and 1996, the growth reached levels of 5.9 % and 4.8 % respectively. In these years, the Czech Republic was dubbed the "Central European tiger" or "the front-runner of the transitive economies". In an atmosphere of transformation achievements and strong macroeconomic figures, the restrictions on free movement of capital were largely abolished and the Czech currency became externally convertible. Seen in retrospect, the rate of opening of the economy may appear too fast, but it mirrored the optimism of the times.

The period of boom came to a sticky end: a speculative attack on the koruna, austerity packages accompanied by tight fiscal and monetary measures, political crisis and later also a protracted period of economic downturn. The economy learned a lesson that economic growth must have another important characteristic – it must be sustainable. From this point of view, the macroeconomic performance prior to the monetary turbulence of 1997 exhibited serious flaws. The rising domestic demand was met largely by imports, as the non-restructured domestic supply suffered from many bottlenecks. Current account deficits were to a large extent financed by short-term capital. Real wage growth outpaced labour productivity growth. The misaligned domestic fundamentals were further shaken by volatile global financial markets (a more detailed explanation can be found in Dědek, 2000).

Czech policymaking thus saw with its own eyes that a boom-bust pattern prolongs the process of catching up with the EU and translates into extra costs. Using the terminology of today we can say that the one-sided preference for real convergence failed.

4) Revisions to the national account statistics in 1997 showed that the transformation recession in the Czech Republic in the 1990 – 1993 period was smaller than in Hungary or Poland. Prior to the revision, the prevailing opinion had been that the Czech Republic had shown the largest transformation decline. Similarly, the loss of output during the second recession in 1997 – 1998 now looks more benign (up to one percentage point more) following statistical revision in 2001.

1. 2 *Shadow Importance of the Maastricht Criteria*

Now the economic recession has been overcome, the prospects of the Czech economy appear more optimistic. The economy showed the first signs of recovery in the second quarter of 1999, and since then the positive growth trend has been strengthening. Furthermore, inflation has stabilised at a relatively low level, close to the price stability required by the Maastricht criteria.⁵⁾ However, it must be admitted that this situation is not fully the result of deliberate policy by the central bank, but of a largely opportunistic exploitation and anchoring of external disinflationary pressures.

The following finding is of even greater significance – although there is no official requirement to meet the Maastricht inflation target, the benefits of low inflation are evident. For example, in the balance-of-payments area the low inflation has translated into a low interest rate differential, which is discouraging inflow of speculative capital. At the same time, a stable low-inflation environment encourages inflow of foreign direct investment. This structure helps to safely finance the current account deficits that are an inherent part of transitive economies. Low inflation also keeps currency appreciation at bay, thus helping to preserve external price competitiveness. Other things being equal, it also puts the state budget under less strain, as it slows down the triggering of various mandatory indexation rules.

Nor is there an obligation to meet the Maastricht interest rate criterion. But nobody has any doubts that the presence of a low and stable interest rate contributes significantly to growth. Banks can evaluate more projects as less risky and worth financing over a longer period of time. The costs of financing for businesses are lower, and households enjoy cheaper mortgages. Interest payments on state debt are less of a burden.

The central banker should continuously emphasise the mutual dependency between the inflation and interest rate criteria. Interest rates can be low only if the inflation rate is low. Pressures on the central bank to follow the reverse trend, i.e. to maintain low interest rates despite high inflation, may lower the credibility of monetary policy and are therefore counterproductive.

As already mentioned, the Czech economy has recovered from the recession and has embarked on a path of growth, with market expectations being rather positive. In parallel, there are concerns, however, about the danger of twin deficits, i.e. an increase in both the current account and public sector deficits.⁶⁾ These risks have been repeatedly pointed out by international institutions – e.g. the conclusions of FSAP mission saw the current trends as contributing to the vulnerability of the economy.⁷⁾ Furthermore, it seems that no radical solution is politically feasible. On the

5) Consumer inflation measured by the year-on-year change in the CPI reached 4.2 % in the first half of 2001. "Net inflation" (which excludes changes in indirect taxes and regulated prices) was 3.0 % as at the end of 2000.

6) The "passive scenario" of the Ministry of Finance, which assumes continuation of the entrenched trends, estimates the public spending deficit in the 2001 – 2003 period at 6 – 7 % of GDP. The dominant course of fiscal consolidation as presented by the government in its Pre-accession Economic Programme is based on a substantial increase in VAT and indirect taxes, which is not likely to be received well in Parliament.

7) The FSAP (Financial Sector Assessment Program) under the auspices of the IMF and WB, an important element of the new financial architecture, strives to improve the quality of financial systems in the member states. The Czech Republic was among the first countries to allow a thorough examination by the project. The Czech Republic is also doing well in the ROSC (Reports on Observance of Standards and Codes), which examine in detail the status of observance of international standards in the financial sector.

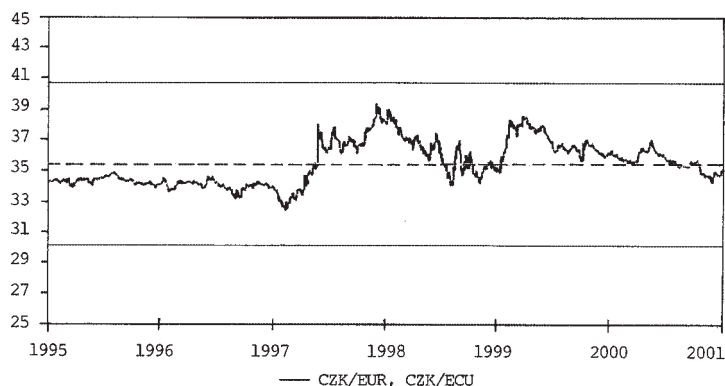
income side, it is difficult to envisage an immediate increase in taxation, not to mention that a significant hike in tax rates could also negatively influence both inflation and economic growth. On the expenditure side, there is a palpable aversion to reducing the current welfare schemes and to taking unpopular steps in the light of the upcoming elections.

Again it is proven that although no external authority is pressing on the Czech Republic to meet the Maastricht fiscal requirement, economic reality and macro-economic prudence are urging this sort of behaviour. A political commitment to Maastricht would perhaps be welcome, as it is likely that public finance consolidation would be easier to achieve if such a commitment did exist.

Last but not least, there is the Maastricht exchange rate requirement. One can doubt the real benefit of this criterion for exchange rate stability if it stipulates keeping fluctuations within a 30 % band. Under these parameters, the CZK would have met the requirement even in times of currency turbulence (see Figure 3).

Figure 3

The Nominal Exchange Rate of the CZK inside the Maastricht Band



Note: Range $\pm 15\%$ from the national central parity.

Source: Czech National Bank database; own calculation.

The exchange rate criterion is a very soft restriction on those candidate countries, which are aware of the benefits of exchange rate stability and would therefore itself strive to contain fluctuations within a much narrower range than the Maastricht one. Therefore, the only real importance of Maastricht type stability is that it sets out a minimum “quarantine period” of two years in the form of membership in ERM II for each candidate country aspiring to adopt the single currency. It may, however, look strange to require the candidate countries to pass a lengthy exam in external price stability which is itself a lot less challenging than the proven ability to maintain a stable exchange rate. But these are rules of the game which the European Union refuses to change with respect to the equal treatment principle.

The Czech currency is now in a regime of managed floating – with a greater accent on floating than on managed. Is this the best arrangement in the pre-accession period, or are there viable alternatives? The answer is that a higher degree of exchange rate flexibility would better suit the specific features of the pre-accession period, but the benefits of the current regime lie largely in negative delimitation. In other words, any other exchange rate regime based to a greater extent on officially declared stability (a fixed rate, currency board or unilateral “euro-isation”), poses

greater risks when one takes into account the degree of openness of the Czech economy with respect to capital flows. This experience was reconfirmed by the series of exchange rate crises in the 1990s, which warn against a combination of pegged rates, liberalised capital flows and inconsistent economic policies.

It is often said in defence of floating that exchange rate flexibility serves as a shock absorber. However, we should not overestimate this role. A number of examples may be found of a liberalised financial account being driven by motives that conflict with concerns regarding the current account where the former usually prevail over the latter. The dominance of capital flows results in a longer-term trend of nominal exchange rate appreciation, which adds to the real appreciation driven by the higher domestic rate of inflation. This contributed to the widening of the external imbalance in the period prior to the Czech currency turbulence of 1997 and became a risk factor in the recent fragile recovery of the economy.⁸⁾ Furthermore, it is evident that the exchange rate fluctuations of the Czech currency are often a result of swings in global currencies. They are not therefore generated by domestic economic affairs. Nevertheless, these externally induced events have significant implications for the domestic economy.⁹⁾

The current regime of managed floating is thus the second-best alternative which should not cloud the benefits for a trade-oriented economy deriving from exchange rate stability. But does a first-best solution exist at all and, if so, what is it? On the general level, the adoption of the single currency could be the answer. This will mean that an irrevocably fixed rate will be introduced with respect to the Czech main trading area, which will undoubtedly enhance trade and strengthen competition. The Czech economy will once and for all escape the threat of a monetary crisis, for where there is no national currency no speculation can be made against it. This will, no doubt, come at the price of new problems, as the winding-up of a national currency is no trivial issue. Notwithstanding these problems, it is still good news for the Czech economy to be able to participate in a joint project responding to the many challenges of worldwide economic globalization.

2. Closing the Price Gap

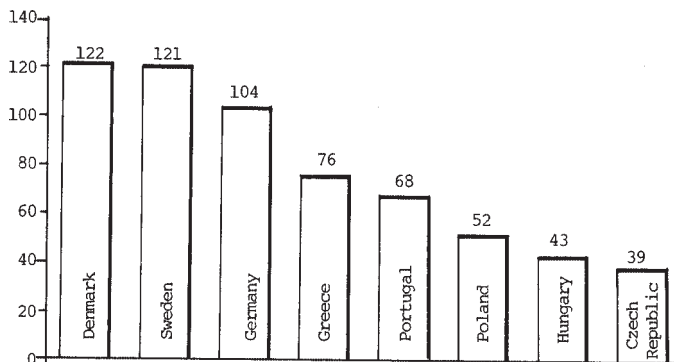
The price level problem has become one of the most hotly debated issues under the umbrella of real versus nominal convergence. The basis for the dispute is the “hard” empirical fact that the price levels in the candidate countries are below those in the EU Member States. This problem is particularly acute for the Czech Republic, as its price level stands at about 40 % of the EU average (see Figure 4).

This observation raises a number of questions. Isn't the Czech economy committing a fatal mistake by having a disinflation strategy that focuses on achieving inflation comparable to the EU average? Isn't such strategy in fact counterproductive, only postponing the necessary hike in prices to bring them to the same level as in the European Union? Isn't the central bank exposing the economy to the danger of a massive price jump upon entry to the EU? There are even doubts about the

8) These cases are symptoms of a more general problem dubbed by some authors as “fear of floating” (see Goldfajn, Olivares, 2001; Krugman, 2001).

9) An illustrative example of the negative impact on the exchange rate caused by global currencies was the period of strengthening of the USD against the EUR. The CZK was falling against the USD and rising against the EUR. As key commodities are purchased in USD, a stronger USD makes imports more expensive. Most exports on the other hand go to EU Member States, so a weaker euro translates into lower export income. The trade balance was thus hampered on both the import and export side.

Figure 4
Comparison of Price Levels (in %)



Note: Price levels in purchasing power parity in 2000; EU average = 100 %.
Source: OECD, 2001.

consistency of the Maastricht criteria per se. How should it be possible to close the price gap, either through higher inflation or through nominal appreciation, when the Maastricht criteria in parallel require price and exchange rate stability?

2. 1 *The Law of One Price*

The discussions about catching up with the EU price level often confuse two theories – the “law of one price” on the one hand and the “Balassa-Samuelson effect” on the other. The law of one price belongs to the family of models accentuating the aspect of disequilibrium thinking. Its driving force is the alleged disparity of values of products at home and abroad. Pricing arbitrage follows to remedy the pricing anomaly: the demand for cheaper domestic goods drives domestic prices up, thus converging them to those abroad. The outstanding gap between domestic prices and those in the European Union seemingly provides empirical grounds for this theory.¹⁰⁾ But is the statistically determined gap really the distance the prices would have to jump?

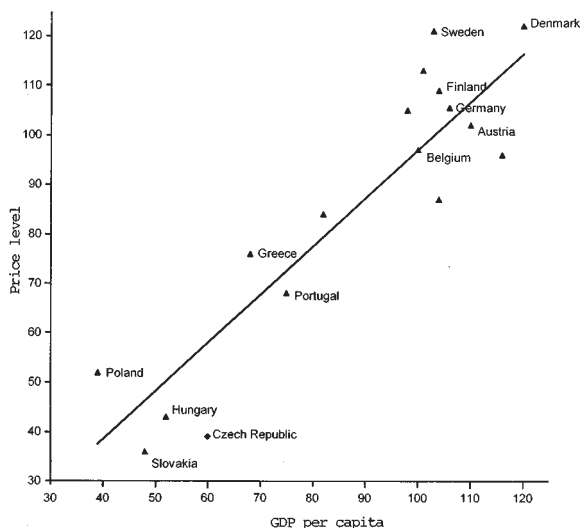
Figure 5 has been frequently used as a demonstration of the strong correlation between GDP per capita and the price level. However, if this is a regular pattern, the only correct method for determining the size of the price anomaly is not to measure the distance to the EU average, but to measure the vertical distance to the estimated regression line. In other words, if the regression line slopes at about 45 degrees, then the Czech Republic with its 60 % of the EU average GDP has a “legitimate right” to about 60 % of EU average prices. The remaining deficit then cannot be linked to the closing of the price gap by way of pricing arbitrage, but to the closing of the average productivity gap with respect to the EU Member States. When the price level is only about 40 % of the EU average, the space for catching up the

10) Figure 5 points to the existence of vast differences in price levels also within the EU. These differences are also changing very slowly. According to the OECD (2001), the difference between Denmark and Portugal reduced by only 11 percentage points during the last decade (in 1990, the two countries stood at 126 % and 61 % respectively vis-à-vis the EU average, whereas in 2000 the corresponding figures were 122 % and 68 %). The difference between Spain and Denmark, on the other hand, widened by 4 percentage points during the same period.

gap is not 60 % (= 100 % – 40 %), but only 20 % (= 60 % – 40 %). This “distance” is then a lot shorter, approaching the measurement error.

Figure 5

Statistical Interdependency between the Price and Economic Level



Note: Measured on the basis of PPP; EU = 100 %.

Source: OECD, 2001; Czech National Bank calculations.

And there is an additional factor. The size of the price gap cannot be inferred simply from a statistical comparison which does not capture “microeconomic details” such as transportation costs, quality and reputation of goods, varying consumer preferences, and so forth. These factors, if they are the root of the price anomaly, do not themselves pose the risk of a price jump, as entry to the European Union will not bring anything new. Pressure to increase prices may be expected in areas where entry to the EU will lead to elimination of trade barriers or implementation of large-scale state aid programs.¹¹⁾ In other words, if no significant trade barriers exist for a given commodity group, the assumption is that the prices in the given commodity group have already been realigned. This should be the case regardless of any comparative statistical analyses which do not take into account the above microeconomic details.

From the viewpoint of putting monetary policy into practice, the following remark is very relevant – the opinion that the price gap problem will be solved by way of stimulating higher inflation is simply not true. Higher inflation means price increases in general. The price gap, on the other hand, reflects certain disproportions in relative prices. Higher inflation means only that the alignment of relative prices will

11) Large potential for a price leap exists in the agricultural commodities sector, where price distortions can be attributed to the Common Agricultural Policy. According to a study by Vintrová, et al. (2001), joining the CAP could translate into prices of food increasing by 35 % – 45 %. The restrictions in place could also be used to explain why the price of arable land is approximately one tenth of the price in the EU countries neighbouring the Czech Republic. Price gaps may also be attributable to lower indirect taxes and unfinished changes in administered prices.

happen at a higher price level, as the general rise in prices does not itself change the price ratios. And if the higher inflation leads to a weakening of the currency, the price gap will be reproduced with this amount of weakening.

2.2 *The Balassa-Samuelson Effect*

While the adjustment mechanism in the law of one price is put into motion by a state of disequilibrium, the Balassa-Samuelson effect is based on equilibrium reasoning. The model envisages transmission of a wage increase in a tradable sector with a higher rate of productivity into a non-tradable sector with a lower rate of productivity. The assumption of equalization of wages in the two sectors drives wages in the non-tradable sector up, causing higher inflation. If we drop the assumption of a fixed exchange rate, the model predicts a real appreciation of the domestic currency against foreign reference currencies.

It should be noted that the logic of the Balassa-Samuelson model does not mention the need to narrow or close the price gap. It only mentions that higher productivity will lead to a real appreciation of the currency or, if the exchange rate is fixed, to a higher inflation rate. So it also works in reverse – a lower productivity rate vis-à-vis a reference country will be the condition for preserving or even broadening the price gap. In any case, the Balassa-Samuelson model is, particularly for candidate countries, topical in its message that higher productivity or faster growth will lead to higher inflation. A too ambitious disinflationary policy may thus be viewed as a hindrance to productivity growth, inhibiting real convergence.

We cannot deny the Balassa-Samuelson effect its logical consistency. However, we should make an assessment of its empirical importance. The estimate of the strength of this effect will determine a lower limit for reducing inflation which – if not respected – may logically damage productivity growth and the speed of real convergence. The strength of this effect also determines whether any inconsistency really exists in the Maastricht criteria. If this effect is not significant, it could be easily absorbed by the slack permitted by the criteria (see Szapary, 2000, for a survey of estimations of this effect from different authors).¹²⁾

Intuitively, we can envisage a gradual reduction in the significance of this effect. It seems that the traditional way of regarding the service sector as non-tradable is losing its relevance owing to the fact that a great number of non-traded activities are now subject to strong international competition. Globalization processes driven by technological innovations are leading to a reduction of transaction costs, and subsequently to a reduction of the relative weight of purely non-traded commodities.

Finally, we have to point out that the paradigm of the Balassa-Samuelson effect shows one fundamental flaw – abstraction from capital flows, as if the exchange rate and inflation rate were to be judged solely on the basis of the current account. This crucial omission may be fatal, particularly for a small open economy with a high degree of capital mobility.

Once we introduce the capital account into the model, we can see a new set of consequences of a high inflation rate. A wider inflation differential, maybe even caused by the Balassa-Samuelson effect, tends to be reflected in a comparable inte-

12) If the inflation criterion tolerates an excess of up to 1.5 percentage point above the reference level and the exchange rate criterion is a 30 % fluctuation range, then a moderate Balassa-Samuelson real appreciation can easily be split into inflation and nominal exchange rate values which still meet the Maastricht criteria. Furthermore, this kind of decomposition will have to be observed only during membership in ERM II, so the binding period may be only two years.

rest rate differential. The inflow of short-term capital stimulated by the higher domestic interest rates triggers an exchange rate strengthening, helping to reduce inflation. A stronger exchange rate, other things being equal, translates into slower economic growth, thereby reducing domestic inflation. Adjustment mechanisms carried by the capital flows may, however, cause "overshooting", becoming a trigger of subsequent economic turbulence. A small open economy should avoid situations in which excessive capital flows are about to cause macroeconomic instability.

Last but not least, a model which, in theory, justifies the positive correlation between growth and inflation, should not be used as an alibi for inflation generated by an overheating economy, driven by real wages growing faster than labour productivity, excessive fiscal expansion and mounting government debt. These are intolerable inflation risks which have nothing to do with the Balassa-Samuelson effect. On the contrary, the model urges an interpretation stressing the strong relationship between convergence of price levels on the one hand and convergence of labour productivity rates and maintenance of macroeconomic stability on the other. The model does not explicitly mention the impact of ignoring this relationship. However, there is a track record of countries stricken by monetary crises.¹³⁾

3. Policy Co-ordination in the Czech Republic

The policy trade-offs involved in the issue of real versus nominal convergence demand co-ordination between the government and the central bank. Both these institutions must have a say, as the implications of their policies are crucial for solving the problem. On the other hand, the implications of the two sets of policies are mutually dependent. However, the law requires the central bank to decide independently of the government. An efficient system of co-ordination is therefore needed, suggesting suitable policy mixes while respecting central bank independence.

At least two reasons exist for why monetary policy within an inflation targeting regime creates a suitable environment for successful co-ordination and communication between the government and the central bank. The first important consideration is that the inflation target may become a bridge between government and monetary policies. While respecting the operational independence of the central bank, the government gets an opportunity to be involved in the process of setting the inflation target. The government will thus participate in setting the key parameters for suppressing inflation, such as the speed of disinflation and the definition of price stability. Simultaneously, it is in the interest of the central bank that the government supports the inflation target, as this adds to the credibility of monetary policy. And higher credibility is widely recognised as a vehicle for reducing the cost of meeting the target. Furthermore, the fact that the government accepts the inflation target means that the target will be made part of government economic policy. In other words, on the one hand the government creates better conditions for hitting the inflation target, and, on the other hand, any measures taken by the central bank aimed at achieving the inflation target cannot be interpreted as an act of hostility towards the government.

In what form have the above features been reflected in the practical policies of the Czech authorities? Although the history of inflation targeting in the Czech Republic is still short, we can already distinguish three stages.

13) A warning example of consequences of price and wage catch-up not backed by catch-up in labour productivity is the reunification of Germany, which was made possible only by huge transfers from the old to the new federal states.

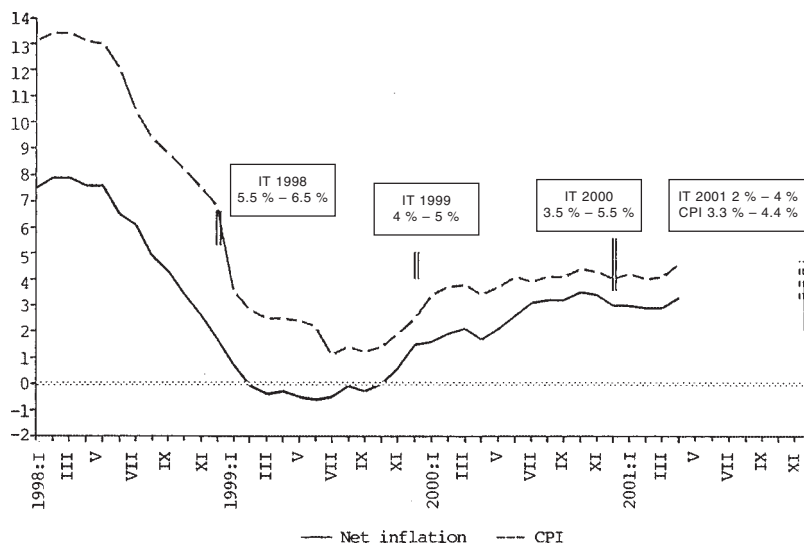
Inflation targeting was launched in December 1997, when a short-term target for the end of 1998 and a medium-term target for year 2000 were announced.¹⁴⁾ The concept of “net inflation”, which is in fact the consumer price index minus changes to regulated prices and indirect taxes, was chosen as the factor for steering monetary policy.

The first inflation targets were declared unilaterally by the Czech National Bank. This “self-targeting” approach was occasionally criticised. It must, however, be remembered that at the end of 1997, a new anchor was being sought for monetary policy, as the exchange rate anchor had been lost in the currency turbulence. The country was experiencing a political crisis, so it was very difficult to spend time discussing conceptual issues of monetary policy with the government. The need for a new anchor was further exacerbated by a dramatic rise in inflation expectations. When comparing the actual inflation figures with the 2000 target, it was obvious that the CNB envisaged a moderate disinflation. But events took a different turn, owing in particular to a strong and unexpected influence from external factors such as an extreme drop in oil prices, imports of subsidised agricultural products and aggressive pricing between retail chains. In conjunction with the upcoming economic recession at home, this resulted in faster-than-expected disinflation. Eventually, it all led to an undershooting of the inflation targets and an only gradual return to the originally planned disinflationary trend.

The second stage started with the approval of a document entitled *CNB Monetary Strategy* in March 1999. In this document, the CNB presented a longer-term vision for gradually embracing the European standards for price stability, quantified in the form of a net inflation target of $2\% \pm 1$ percentage point for the year 2005. However, more importantly, the bank’s strategy was incorporated into a document

Figure 6

Confronting Inflation with Inflation Targets (in %)



Source: Czech National Bank database.

14) In November 1998, an intermediate target was set for the end of 1999.

entitled *Medium-term Economic Strategy of the Government of the Czech Republic* and subsequently into a document entitled *Joint Assessment of the Economic Policy Priorities of the Czech Republic*, which outlined the Czech Republic's path into the EU.

The dealings with the government, and in particular with its economic experts, were no walk in the park. Many edges had to be softened and many positions clarified. The discussions on the practical implications of the price level issue were the most contentious. The result – in the form of consensus on the joint position of the government and the central bank – was achieved not only on the strength of the individual arguments, but also by the desire to present a consensus on economic issues to the European Commission.

If the consensus was reached under the pressure of reputation risk, one must ask whether the *CNB Monetary Strategy* accepted by the government is not getting obsolete. After all, the turbulent period of 1999 – 2000 exposed the Czech economy to a negative oil-price shock and the after-effects of recession. In the light of this test, the central bank's vision still seems to be standing its ground. In principle, the longer-term plans are still being met. The sharp disinflation was followed not by a resurgence of inflation, but by an anchoring of inflation expectations at a lower level. The missing of the medium-term inflation target for 2000 by only a narrow margin should, under the given circumstances, be interpreted as an achievement.

At present, inflation targeting is at the start of its third stage. This had a problematic beginning. In January 2001, a controversial amendment to the Czech National Bank Act entered into force. This imposed an explicit obligation on the central bank to consult and reach agreement with the government on the inflation target. This new feature introduced into inflation targeting has met with criticism from the European Commission as an element compromising the independence of the central bank. In the event, this provision was soon abolished by the Constitutional Court, which found it to be a breach of the independent status of the central bank as guaranteed by the Constitution.

However, this episode opened up a debate on how it is that the central bank can have operational independence, but not the sole authority to set targets. Reconciliation of the principle of target dependence, i.e. a form of government involvement in setting inflation targets, with the European legislation thus requires voluntary and not compulsory co-operation. From this point of view, the law did not have to codify the need for co-operation, as inflation target consultations had already become part of the communication between the central bank and the government.

The current stage has also seen the introduction of some technical changes to inflation targeting, such as description of the inflation target in the form of a continuously descending band and a switch to targeting headline inflation as measured by the overall consumer price index.¹⁵⁾ The new concept was approved by the government in April 2001. This motion reflected not only the consensus of the two main policymaking bodies with respect to continuing the disinflationary trend, but also the willingness of the government to put agreement regarding the inflation target on a more long-term footing.

15) The new inflation target puts annual headline inflation at the level of 2 – 4 % at the end of 2005. When this plan is compared with the ECB's inflation target of 0 – 2 % for the harmonised consumer price index, we can intuitively conclude that the CNB inflation policy hopefully leaves sufficient space for the adjustment of relative prices and for the Balassa-Samuelson effect.

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