Central Banks,Monetary Policies and Banks

HP 381

10th April 2017

Central bank mandates (most) often include

- maintaining price stability – monetary policy
- maintaining financial stability and see to the sound operation of the financial system in the Czech Republic,
- issuing banknotes and coins, manage the circulation of currency and administer clearing between banks,
- supervising the entities operating on the financial market.

Objective (-s) of monetary policy

- The main objective is to preserve price stability, i.e. low and stable inflation
- However, if price stability conditions are met and without prejudice to the main objective, the central bank can also support the general economic policies of the Government
- In practice, price stability does not literally mean unchanging prices, it means moderate growth in prices – **this is where the story becomes complicated**
- Two essential questions:
    1. Why stability of prices?
    2. What is it? Is it only inflation at **0%**?

Why „stability of prices?"

- It is the most comprehensive indicator reflecting the overall balance and stability (internal, external) of economy …
- If prices are not stable, this may become most detrimental to economic performance and prosperity …

Examples:

- **Will you buy a house if you don´t know how much you will actually pay for it?**
- **Similarly, will investors invest (for instance in machinery and equipment), if they don´t how much they will actually pay?**
- Moreover, **inflation is a simple indicator**, comprehensible to a wide audience … and thus makes it easier to explain **(and trust)** what central bank's are doing in monetary policy

Trust is essential – but why?

Trust influences your behaviour everywhere. Without it, you would not:

- Board a plane
- Jump in the swimming pool
- Get married
- Lend money to your friend
- Take a mortgage and invest in real estate …

If you don´t trust the central bank, you will not trust what they say and what they do about inflation …

This is where the concept of **inflationary expectations** comes into our attention

How powerful the central bank actually is?

- It is – indeed – very powerful, because it influences the price of one commodity, that is present everywhere in our lives – that is **money**
- (By setting the price of money, it influences the size of inflation)
- And the price of money matters in our lives
- **However**, the powerful central bank may not be powerful enough if people do not trust it
- **Example:** if annual inflation has been for many years at 10%, you will likely ask your employer for a 10% increase of your salary
- If everyone does the same – as they probably would – there will be all the sudden 10% more money on the market available for spending **– pushing inflation upwards**
- **Due to inflationary expectations, inflation is feeding itself: this is not only theory, we have lived through that in this country**

Economic growth and inflation … how are they linked?

- Sometimes, politicians argue that by maintaining low inflation, central banks are killing economic growth
- Why do they say so? … Because to keep inflation low, the central bank may (in some circumstances) set the price of money high – making investment more expensive, thus reducing the possible profit on such investment and consequently the appetite for any such investment

This suggests that between inflation and growth there may be a link – lets´ explore it

Economic growth and price stability are not antagonistic features …

- … on the contrary, both theory and the practical policy demonstrate that these features are complementary and support each other:

- If growth is not balanced, then it will not be sustainable …
- The Czech lesson 1995-1998: dynamic growth, but fuelled by excess domestic demand and capital inflows …
- … this has provoked a sudden correction, driven by the market: fluctuations of exchange and inflation rates, interest rates, government and household spending
- Output (and welfare) losses were the unavoidable consequence

Lessons learned

- A stable currency and a low inflation are fundamental to a sustainable, optimal economic growth…
- Experience suggests that low inflation is less volatile
- that inspires confidence and …
- It allows for planning and strategizing

Important consequence

- It is not true that central banks are pursuing their main objective (of price stability) no matter how much it would cost (to the economy …)
- Central banks are <u>of course</u> interested in economic prosperity and a sound (= balanced) economic environment/growth …
- … However, the price stability needs to come first
- The trouble is, that there is no single view as to what price stability actually means (we will discuss this in a moment …)

So, can price stability be quantified?

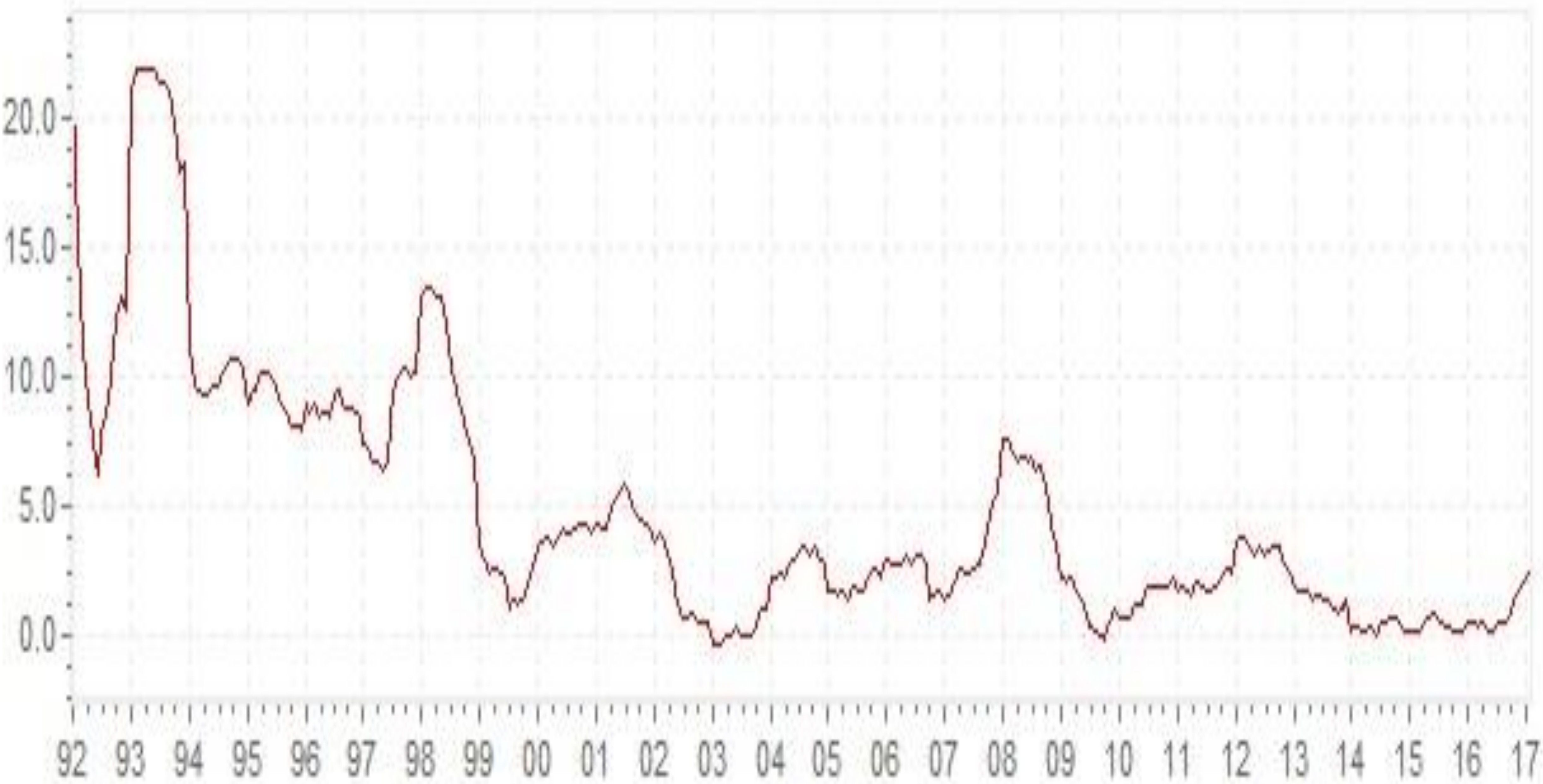
- Let´s try a vote in the class …

- It all depends on WHO articulates the opinion on price stability … politicians, central bank, trade-unions, employers, independent consultants and experts, external institutions etc …
- It also depends in WHICH specific economic context (economic recession, structural parameters of the economy …) we are

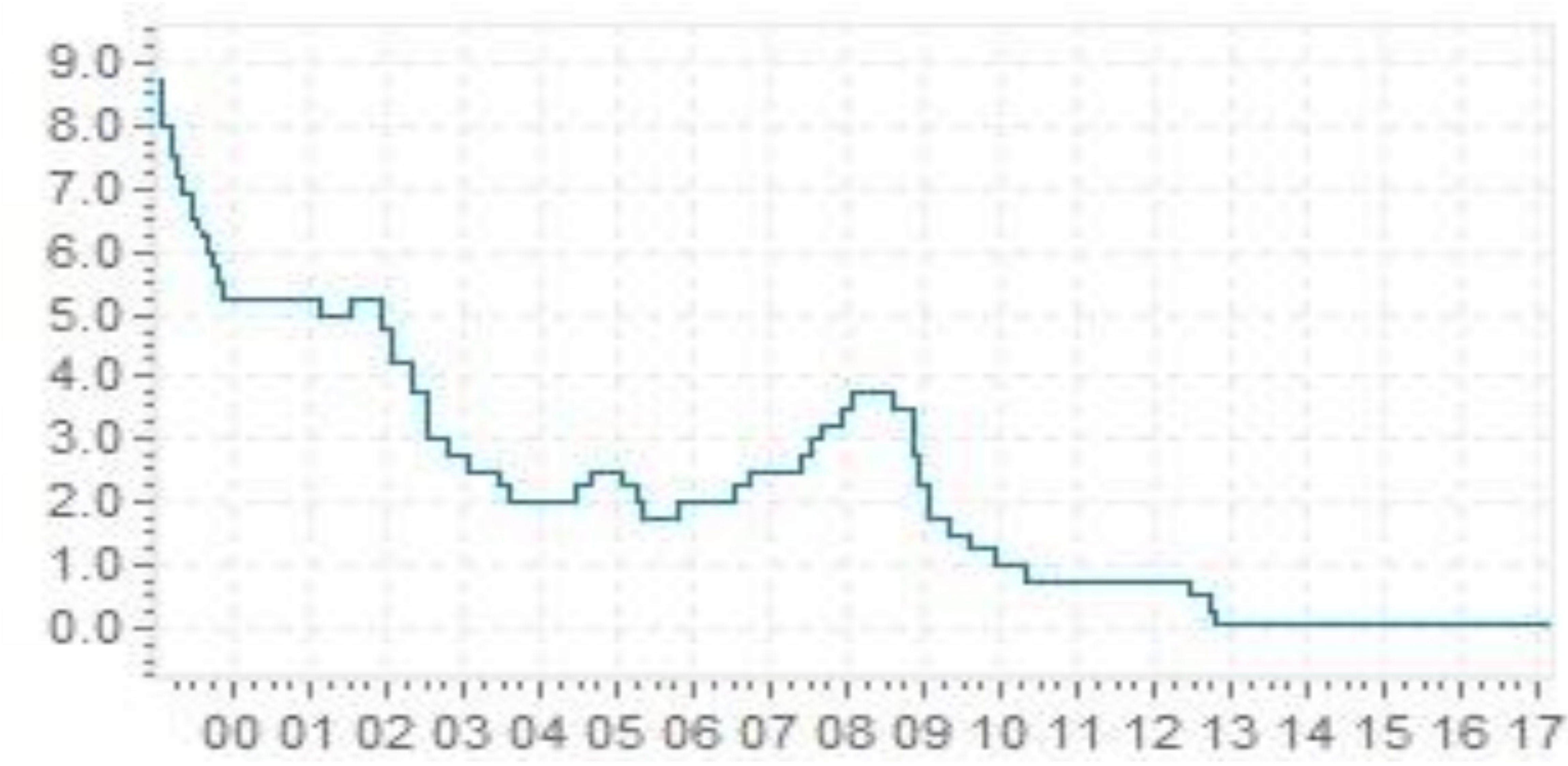
In all these aspects, the central bank has the best prerequisites and qualifications to be the most neutral:

1. It is not political
2. It has a different time horizon
3. It has a different mandate

Czech inflation 1992-2017



Czech monetary policy rate 1999-2017



Discussion: and what if inflation felt below 0 to negative values?

- Why are central banks so scared about negative inflation (=deflation)?
  - impact on consumer behaviour (spending)
  - Impact on bank lending
  - Impact on corporate profits
  - Impact on economic growth
  - Impact on unemployment

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Danger of deflationary spiral

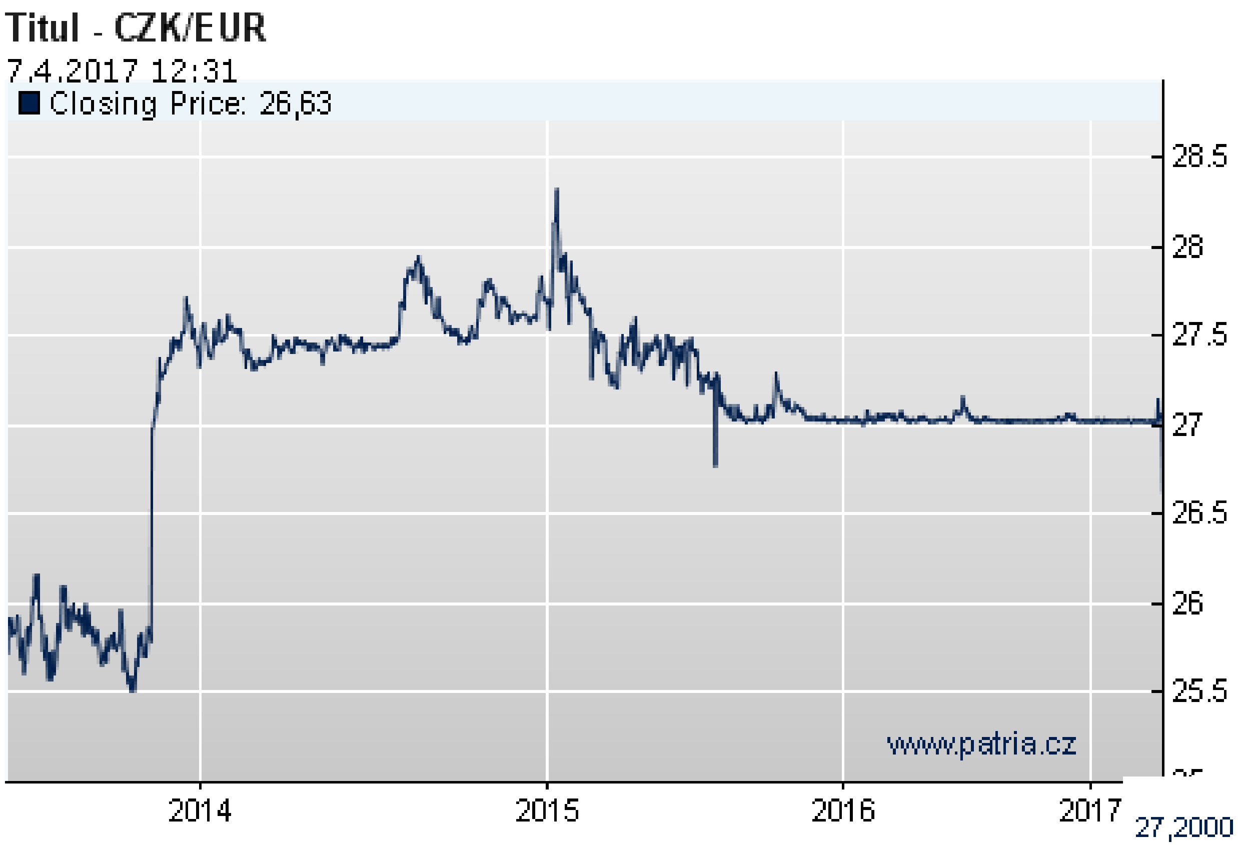
For many, it is not **that** simple (or, more precisely, deflation is not that simple)

Would it help to enter the eurozone and get the euro? The euro as an alternative?

- A monetary zone, such as the eurozone, cannot be (and is not) as such providing protection against deflation … it is just another setup for monetary policies
- Indeed, the eurozone was struggling with lots of similar problems as the Czech central bank
- They were even using unconventional tools, such as negative policy rates
- A specific issue is the prevailing heterogeneity of the eurozone – thus, the one size policy form Frankfurt does not necessarily fit all
- **Example:** Slovakia lived through a deflationary episode – this should be carefully analysed to draw lessons about the relationships between deflation and economic performance

Special item

FEX intervention – November 2013 – April 2017


Titul - CZK/EUR
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Closing Price: 26,63
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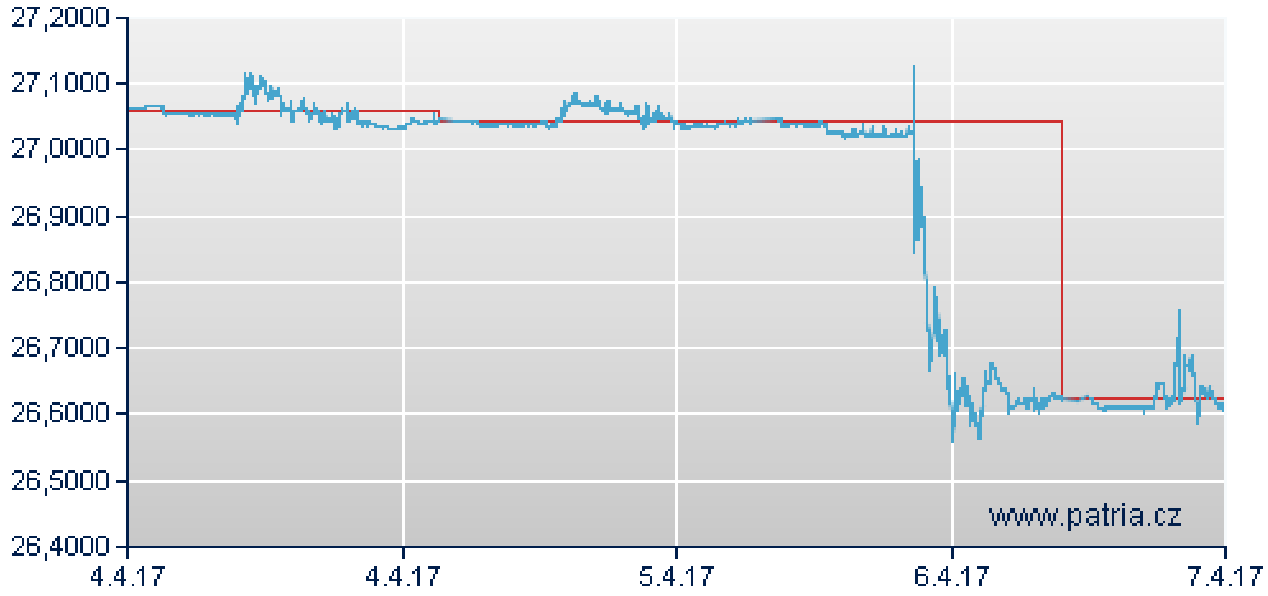
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Where did the issue of interventions come from?

Lets go back to 2010-2013:

- Inflation very low, approaching the 0 bound
- Economy struggling to escape from recession

Do you remember what we said earlier? If price stability conditions are met and without prejudice to the main objective, the central bank can also support the general economic policies of the Government.

Observations

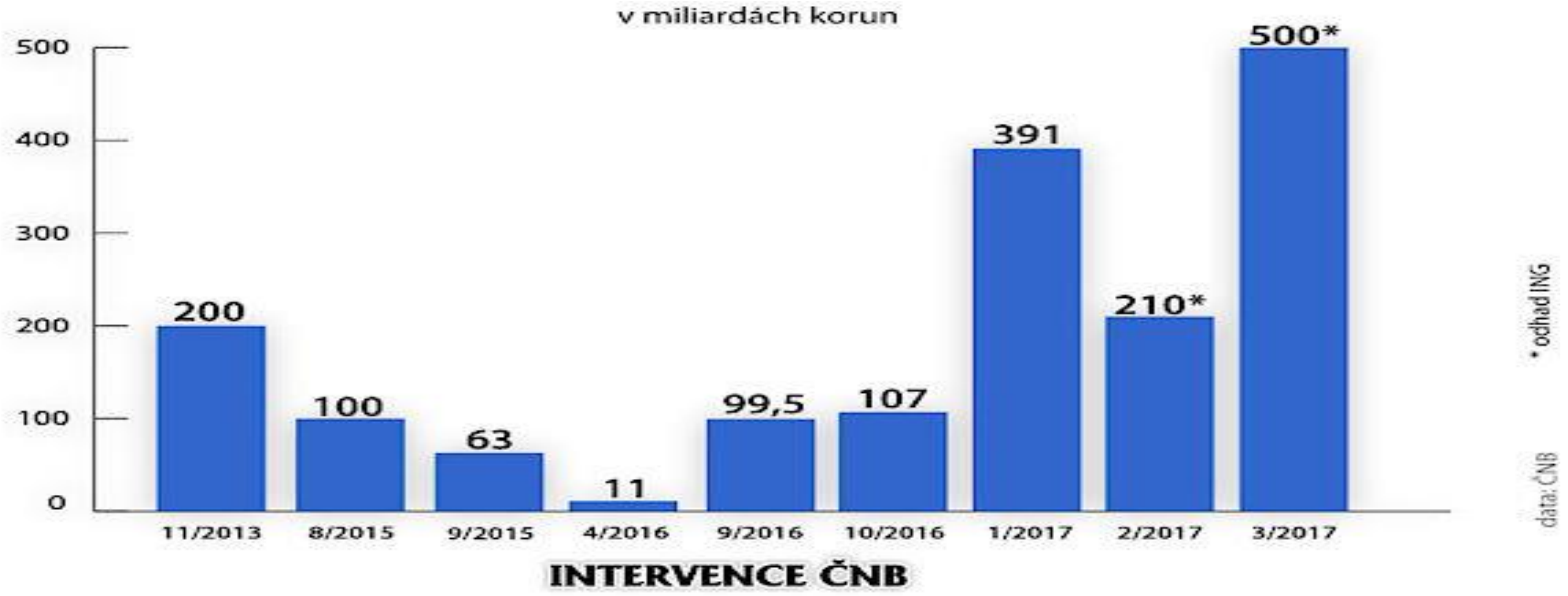
- The CNB lowered its key interest rates to zero in November 2012 = they could no longer use interest rate as an instrument to adjust further their policy (using their language „no further easing of the monetary conditions was possible via interest rates“)
- What else could they do???? … The decided to focus on the Exchange Rate
- Why the Exchange rate? … because by manipulating the exchange rate, they can „create“ more inflation
- Example: an imported bake roll, worth 1 euro will cost no longer 26 crowns, but 27 …

And so …

- … in November 2013, the central banks has decided:
  - To set a floor for the Exchange rate at 27 CZK per euro and …
  - In order to fulfil this commitment to be active on the foreign exchange market (the FEX market)

- Remember – the FEX market is precisely what it is called: a market, where the price of one commodity – in this case the euro – is set by the law of demand and supply … this is why and how the central bank can make happen its decisions

Yes they can … but it is not for free … (data in billions of CZK)

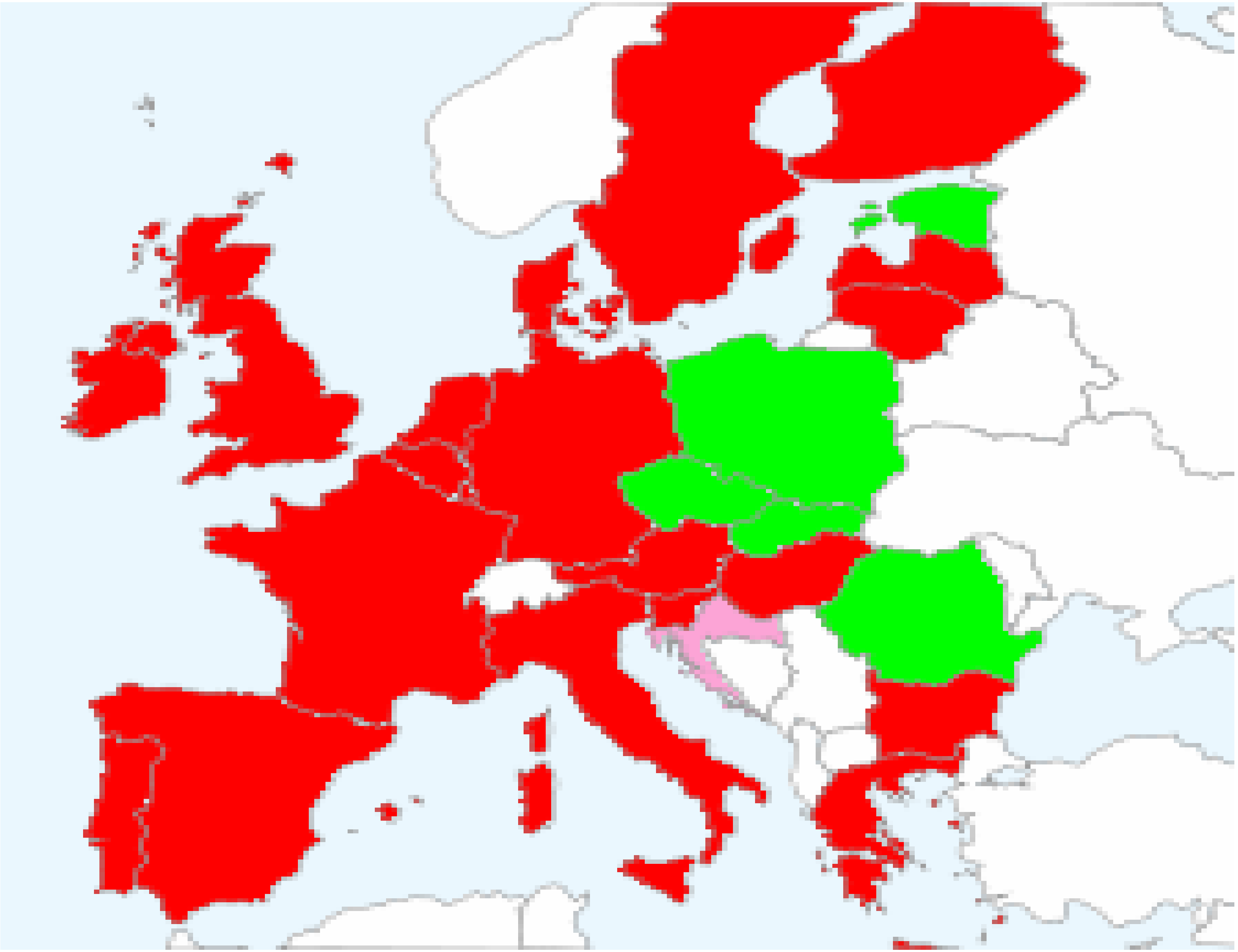


(The overall equivalent is 75 bill. Euro)

Monetary policy, banks and the Banking Union

- The challenges to banks are quite similar almost everywhere across Europe: low interest rates environment, excessive regulation, cybersecurity etc.
- So the low inflation, implying low interest rates is just one of the factors, pushing the profitability of banks downwards
- Our banks are well positioned to sustain this situation …
- However and overall, the current monetary environment is systemically not sound to the economic performance of countries and banks
- The Banking union has been designed to make the European financial industry more resilient – however the question is, whether (or to what extent) this has been a sucessful operation
- And the Czech banks are in an excellent condition, so what would be the point of joining the Banking union?

Map of EU states, where state aid was provided to the banking sector between 2008-2016 (in red)



Performance indicators at sector level and trends

- Strong capital (practically all high quality Tier 1 capital) and liquidity position (around 18%)
- Profitability above EU average (ROE over years close to 20%)
- *(The net interest rate income contributes almost 3 time as much as fees to the financial and operating income of the banking industry)*
- Assets to GDP at modest cca 125 %
- Loans: moderate but permanent growth (despite recession 2008-2013)
- NPLs: quantitatively not a big issue, however source of risk in banking sector

Client bank deposits to loans ratio in 2015 in EU member states