Stability as a key factor of the success of the Czech financial system and economy

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Introduction

• Czech economy has experienced four shocks since beginning of transformation:
  ♦ 1990–1991: transformation recession
  ♦ 2001–2002: appreciation bubble and economic slowdown


• Content of presentation:
  ♦ Causes of instability before and during twin crisis
  ♦ Regaining macroeconomic and financial stability
  ♦ Lessons
Causes of twin crisis I: Macroeconomic developments

- Strong demand
  - High wage growth (much higher than productivity growth)
  - High growth of private and public investment (infrastructure)
  - Strong credit growth
  - Strong capital inflow (high interest rate differential)
- Weak supply side (underdeveloped markets, badly defined property rights, malfunctioning legal and institutional framework, etc.)
  ⇒ Emergence of external imbalance
- Situation also complicated by errors in main statistical series (GDP, foreign trade, current account) preventing correct assessment of state of Czech economy

In 1996 the overheating proved to be unsustainable: the situation required adjustment and appropriate policy responses
Inflation in Czech Republic

Inflation during 1994–1997 was relatively stable (though a bit higher) and slightly decelerating.

Source: CZSO
“Impossible Trinity”

• Fixed exchange rate regime
• Money targeting
• Capital account liberalisation (managed and spontaneous); basically ended by entry into OECD in October 1995

↓

• “Impossible Trinity”: (problematic) coexistence of:
  ◆ Free capital flows
  ◆ Fixed exchange rate
  ◆ Independent monetary policy

Capital account liberalisation undermined cohesion of monetary policy framework ⇒ necessitated change of exchange rate regime
**Efforts to rectify imbalances**

- Increase in interest rates (beginning of 1996)
- Widening of fluctuation band (end of February 1996, to ±7.5%)
- 1st stabilisation package in April 1997 (but not credible)

  This was not enough to persuade markets!

  → speculative attack (in May 1997) → abandonment of peg
  → managed float → depreciation of koruna → inflationary expectations → inflation

- 2nd stabilisation package in June:
  - Macro measures: fiscal tightening, wage freeze, import deposits
  - Micro measures: legal and institutional reforms

- Introduction of inflation targeting (since January 1998)

  **The price for rectifying the imbalances was the crisis of 1997–1998**
Rapid growth in bad loans became the main source of difficulties in the banking sector.
Twin crisis: causes

- Until first third of 1997, macroeconomic imbalances and banks’ problems developed more or less in parallel
- Outbreak of currency crisis and slide into recession caused two crises to merge into one
- Sharp depreciation + dramatic interest rate increase + fiscal restrictions ⇒ shock to banking sector of magnitude not usually simulated in bank stress tests
- Twin crisis was caused solely by inappropriate policies:
  - a) underestimation of symptoms of overheating and external imbalances; b) underestimation of Impossible Trinity and c) late exit from fixed exchange rate regime
  - deferral of privatisation of large banks in 1994–1995

The twin crisis was an unforced crisis of domestic origin
Towards overall stability
Liquidity ratios in the banking sector

Key ratios have not changed much over recent years and remain high

Source: CNB
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The ratio of deposit to loans is very favourable in the Czech Republic

Ratios of deposits to loans in selected countries

(%; end of 2011; deposits/loans to residents)

Source: ECB
Note: EA = euro area; EU = average for all EU countries.
The Czech banking sector remains profitable despite the adverse economic conditions.

Source: CNB

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As of July 2012, capital adequacy was 16.4% (Tier 1 ratio 15.6%)
Banking sector now

- Banking sector underwent fundamental restructuring over several years
- Range of financial services offered has expanded greatly
- Banking sector is currently well capitalised, highly profitable and resilient to shocks
- Its resilience is regularly tested in tough stress tests conducted by CNB

In the second half of the 1990s the banking sector was a source of disturbances and a cause of twin crisis, whereas now it is a buffer against external shocks
First phase of integration of supervision: 1 April 2006

Office for Supervision of Credit Unions

Capital Market Supervision

Insurance and Pension Funds Supervision

Banking Supervision
Second phase of integration of supervision

Sectoral model

Banking Regulation and Supervision Department
Capital Market Regulation and Supervision Department
Insurance Companies Regulation and Supervision Department

Functional model

Financial Market Supervision Department
Financial Market Regulation and Analyses Department
Licensing and Sanctions Procedures Department

1 January 2008
**Role of supervision: 1990s and now**

- Factors formerly weakening role of banking supervision:
  - Limited circle of people, who inevitably knew each other
  - State representatives sitting “on other side of table” (in banks)
  - “No time” for standard supervisory procedures (only choice available in some phases: *bail it out or close it down*)

- Role of supervision now:
  - No major or systemic sources of risk in banking sector
  - Integration of supervision (2006) was big step forward in safeguarding financial sector stability (closer relationship with monetary policy)
  - Foreign ownership of sector reduces conflict of interests of supervisory staff

- Main risk: shift of supervision to supranational level

  *Domestic financial market supervision conditions are better now than they were in the 1990s*
Macroeconomic stability

• Macroeconomic stabilisation fostered by:
  ♦ Macroeconomic restrictions (monetary and fiscal) in 1998
  ♦ Introduction of consistent framework in 1998 (inflation targeting + floating exchange rate)
• Switch from peg to float turned real appreciation process into combination of low inflation and nominal appreciation of koruna
• After two decades of disinflation, inflation targeting and float allowed CZ to achieve price stability comparable with advanced economies (inflation target 2% for CPI as from start of 2010)

The present flexible and stable microeconomic framework is an effective shock adjustment mechanism
After the switch to inflation targeting (1998) inflation fell from 9–10% to a level regarded as price stability; the volatility was due mostly to exogenous shocks (VAT, crude oil, food, etc.) and the exchange rate
Equilibrium and nominal exchange rate of koruna (CZK/EUR)

The exchange rate of the koruna has been close to its equilibrium values since 1997.

Source: Komárek L., Motl M. (2012)
Refining inflation targeting regime

- Switch from net inflation targeting to headline inflation targeting (2002)
- Switch from conditional to unconditional forecasts (2002)
- Gradual introduction of model-based forecasts
- Gradual incorporation of BB members into forecast creation process
- Number of monetary policy meetings reduced from 12 to 8 per year
- Transparency of inflation targeting regime systematically increased: publication of interest rate path (2008) and exchange rate path (2009), publication of BB voting by name (2008), publication of graph of risks to inflation projection (2011)
- CNB is now one of the most transparent banks in the world

The CNB strives to ensure that its monetary policy is credible and provides the best possible anchor for inflation expectations
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Monetary policy transmission mechanism: New approach

Macroprudential policies are being implemented to change the behaviour of the financial sector in a way which will enhance the efficiency of monetary policy and prevent financial instability.
Summary and lessons 1/2

• Sound and stable currency is result of:
  1) appropriate monetary policy framework
  2) correctly implemented macroeconomic policies
  3) appropriate regulation and careful supervision of financial sector

• Fixed exchange rate was very useful and stabilising for initial phase of economic transformation (it provided economy with one of few anchors available at that time)

• Twin crisis (1997–1998) was caused by domestic factors and inappropriate domestic policies (too long-lasting fixed exchange rate strategy and deferred privatisation of banks)

• Clean-up and fundamental restructuring of banking sector were condition for economic growth

• Lesson from 2002: Monetary policy must be aware of risk of float and cannot behave as if exchange rate does not exist
Summary and lessons 2/2

- 2009: depreciation of koruna – shock absorber
- Despite some volatility, flexible exchange rate of koruna was key intermediation mechanism of real and nominal convergence
- Former sources of shocks (monetary policy framework and financial sector) turned into absorbers of external shocks
- Unification of supervision into CNB was effective tool for absorbing impacts of financial crisis
- Transfer of financial market supervision to supranational level will pose risk to financial stability

In the 1990s the risks of instability were mostly of a domestic nature, whereas external risks now predominate and will continue to do so
Thank you

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