

## LEGAL ASPECTS OF DECISION MAKING ON THE CENTRAL BANK'S PRIMARY OBJECTIVE

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### ABSTRACT

*The Czech National Bank started to intervene in the foreign exchange market to weaken the Czech currency in 2013. The purpose of the article is to analyze the way of deciding on monetary policy of Czech National Bank foreign exchange interventions according with the Czech and European legislation. Another objective of the article is to compare the main monetary policy objectives in the Czech and Slovak legislation. Last but not least, the aim is to evaluate the success of the Odysseus form of the Forward guidance communication strategy and to assess the responsibility of the Czech National Bank for its implementation of monetary policy. Legal regulation of the principal objective of the Czech National Bank has been changed from monetary stability to price stability in the Czech Constitution. The Slovak Constitution has never included the main objective of the Slovak National Bank, to which is directed its activity. Neither of the legal regulations, however, specify what is meant by price stability or instability of prices. Legislation should establish the central bank's focus on financial stability. The Czech legislation should specify how the Czech National bank and the government will inform each other about individual measures, including deadlines. The government should be informed about the planned monetary policy measures in advance. For the decision of the CNB Bank Board on major monetary policy measures, a higher quorum should be achieved.*

**KEYWORDS:** *Communication strategy, Foreign exchange interventions, National Bank of Slovakia, The independence of the Czech National Bank, Price stability.*

**JEL CLASSIFICATION:** *G32, E58, K20*

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### 1. INTRODUCTION

At the beginning of November 2013, the Czech National Bank, from here on referred to as the "CNB", began to intervene in the foreign exchange market in order to weaken the domestic currency so that its value was close to the level of CZK 27 to € 1. The purpose of this measure was to contribute towards meeting the 2% inflation target and to avoid the risk of deflation. This step was preceded by the use of a number of standard monetary policy instruments, one of which in particular was the marked drop in interest rates during 2012. The two-week repo rate and the discount rate reached 0.05%, the Lombard rate reached 0.25% (Czech National Bank, 2017). CNB interest rates thus reached the "technical zero" (zero lower bound). It was therefore necessary to apply unconventional instruments of monetary policy, including foreign exchange interventions (Svensson, 2003). Prior to the implementation of these instruments, the CNB used a communication strategy based on publishing information on the forthcoming monetary policy measures called Forward guidance (Filardo and Hofmann, 2014). After the first implementation of the foreign exchange interventions, the CNB faced a wave of criticism. It was accused of insufficient communication during the implementation of monetary policy. Some economists and businessmen judged the CNB's decision to weaken the currency and claimed it to be a poor managerial decision that threatened Czech households and non-exporting firms. Economist Pavel Kohout assessed the

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impact of CNB's foreign exchange interventions as follows: *"The intervention of the Czech National Bank had an immediate result. Czech households lost about 76 billion crowns in a single day, if we consider the volume of bank deposits and changes in their value in Czech crown to the euro. If we also included securities in the domestic currency, including pension funds, mutual funds and other instruments, the total would go up to hundreds of billions"* (Kohout, 2013).

## 2. SCIENTIFIC AIM AND METHODS

The aim of this article is to analyze the compatibility of Czech National Bank foreign exchange interventions with the Constitution of the Czech Republic, the Czech National Bank Act and the Treaty on the Functioning of the European Union by analyzing the development of legal regulation of the Czech National Bank's main objective and comparison with the development of legal regulation of the main objective of the Slovak National Bank. On this basis, I wish to evaluate the success of the Odysseus form of the Forward guidance communication strategy used by the Czech National Bank in the preparation and enforcement of its monetary policy measures. Last but not least, the aim is to assess the responsibility of the Czech National Bank for its implementation of monetary policy.

For the purpose of evaluating the main objective of the Czech National Bank and the National Bank of Slovakia, an analysis of Czech and Slovak legislation as well as legislation of the European Union was carried out. The evaluation of the main objective of the central banks was conducted through key foreign studies on monetary policy. Logical methods are used to process the paper, in particular, induction and deduction, analysis, synthesis, and comparison. The article was prepared using data from the ARAD data series system of the Czech National Bank's information service as well as from the ASPI legal information system.

I wrote this article based on the fact that the economy and politics are interrelated. This relationship is given by the social form of production and the power and state form of the given society. The economy is both the starting and determining point in this relationship. Politics should be seen as a framework for trade. Efficiency in the public sector can be ensured only by enforcing the unanimity rule in collective decisions. Trade and negotiations should be the basis of economic exploration, not an issue of maximization. It is the very existence of rules that makes it impossible to study economics without relation to politics. Politics has become an endogenous variable for each relevant model of economic policy.

## 3. THE OBJECTIVE OF THE CENTRAL BANK

### 3.1 The main objective of the Czech National Bank

The status and activities of the CNB are governed by two laws in particular, Constitutional Act No. 1/1993 Coll., The Constitution of the Czech Republic as amended, and Act No. 6/1993 Coll., on the Czech National Bank, as amended. Both laws have been amended many times. Pursuant to Article 98 (1) of the Constitutional Act No. 1/1993 Coll., The Constitution of the Czech Republic, as amended, the CNB's main objective is to maintain price stability. This objective is also stated in Section 2 (1) of Act No. 6/1993 Coll., on the Czech National Bank, as amended. However, none of the legislation stipulates what is meant by price stability or price instability, i.e. price changes, and fails to state the conditions under which prices can still be considered stable. A definition is offered by the European Central Bank, which has established the *"quantitative definition of price stability"* as follows: *"Price stability is defined as a year-on-year increase in the Harmonized Index of Consumer Prices (HICP) below 2%."* According to the ECB, deflation is, of course, inconsistent with the objective of price stability thus defined: *"By referring to 'an increase in the HICP of below 2%' the definition makes clear that not only inflation above 2% but also deflation (i.e. price level declines) is inconsistent with price stability"* (European Central Bank, 2017). The initiation of the CNB's foreign exchange interventions in November 2013 does not, in this respect, conflict with the

framework provided by the Czech National Bank by Constitutional Act No. 1/1993 Coll., The Constitution of the Czech Republic and Act No. 6/1993 Coll., on the Czech National Bank as amended, as Czech legislation does not directly characterize price stability. The CNB has not yet exceeded "the CNB's inflation target of 2%" during foreign exchange interventions in accordance with the definition of price stability given by the European Central Bank.

### **3.2 Development of the legal definition of the main objective of the Czech National Bank**

In the wording of Constitutional Act No. 1/1993 Coll., The Constitution of the Czech Republic in force as of 28 December 1992 and effective as of 1 January 1993, the CNB's main objective was defined in Article 98 (1) as follows: *"The Czech National Bank is the central bank of the state. The main objective of its activities is to ensure the stability of the currency."* The main objective of the CNB's activities was also defined in § 2 of Act No. 6/1993 Coll. valid from 31 December 1992 and effective as of 1 January 1993. The CNB's stated objective remained in both laws until the preparations for the Czech Republic's accession to the European Union, that is to say, until 2001. At that time, legislation was harmonized with European Community law, respectively the European Union. In Article 105 (1) of the Treaty establishing the European Communities of 25 March 1957, the monetary policy objective of the European System of Central Banks, the ESCB, was formulated as follows: *"The primary objective of the ESCB is to maintain price stability."* This objective remained untouched even by later contracts such as the Nice Treaty or the Treaty on the Functioning of the European Union, in which the objective of price stability is included in Article 127.

On 1 January 2002, Constitutional Act No. 1/1993 Coll. in the wording of Act No. 448/2001 Coll., where the main objective of the CNB was defined in Article 98 (1) as follows: *"The Czech National Bank is the central bank of the state. The main objective of its activities is to maintain price stability."* As early as in 2000, Act No. 6/1993 Coll., on the CNB was amended by Act No. 442/2000 Coll. with effect from 1 January 2001. The main objective of the CNB referred to in Section 2 (1) was thus amended: *"The primary objective of the Czech National Bank is to ensure price stability."* This change to the CNB's main objective should have, however, first appeared in the amended version of Constitutional Act No. 1/1993 Coll., The Constitution of the Czech Republic and only subsequently in Act No. 6/1993 Coll. on the Czech National Bank.

As of 1 January 2001, a contradiction in the definition of the main objective between Constitutional Act No. 1/1993 Coll. and the Act on the CNB was therefore apparent, which resulted in the annulment of the disputed parts of the amendment to the Act on the CNB by the finding of the Constitutional Court dated 20 June 2001, sp. Pl. ÚS 59/2000, for their unconstitutionality. The finding declares the following, among other things: *"The Constitutional Court has found a substantive motion for the annulment of the first sentence of Section 2 (1) of the First Act on the CNB, which states that 'the primary objective of the Czech National Bank is to ensure price stability.' However, Article 98 (1) of the second sentence of the Constitution defines the main objective of its activities differently and as maintaining the stability of the currency. The latter offers a broader concept, resulting in the common law limiting the scope of the main activities of the central bank of the state."*

### **3.3 Monetary and price stability**

What is interesting is the justification of the finding of the Constitutional Court, sp. Pl. ÚS 59/2000, in which the concept of stability of the currency is commented on in the following manner: *"... it is broader, resulting in the common law limiting the scope of the main activities of the central bank of the state."*

While the notion of price stability (note not stability of prices, i.e., constant prices) is legislatively well defined, there is no precise legislative definition for monetary stability. Some economists even confuse these terms. An example is the contribution *"Monetary and Financial Stability: Is There a*

*Trade-off?*" by Otmara Issinga, who stated: "*Monetary stability is a synonym for price stability.*" The concept of price stability was characterized as follows: "*Price stability refers to a stable price level or a low level of inflation and not to stable individual prices*" (Issing, 2003).

Similarly, Wim Duisenberg also describes the concept of monetary stability: "... *monetary stability is defined as stability in the general level of prices, or as an absence of inflation or deflation.*" (Duisenberg, 2001)

On the other hand, Michael Foot sees monetary stability as one of the four components of financial stability: "... *we have financial stability where there is: (a) monetary stability; (b) employment rates close to the economy's natural rate; (c) confidence in the operation of the general economy of key financial institutions and markets; and (d) where there is no relative price movements of either real or financial assets in the economy that will undermine (a) or (b).*" (Foot, 2003)

In my view, monetary stability and price stability should not be confused. Both are however closely related, and the higher the interconnection, the closer the relation, or more precisely, the dependence of the economy of one state on the economies of other states in terms of imports and exports. If there is a significant volatility in the domestic currency exchange rate against a foreign currency, and the domestic economy is dependent on imports of energy, raw materials and goods, it will adversely affect price stability. An example is the development of the domestic currency exchange rate from 1996 and 1997, the end of the CNB's interventions to support the exchange rate of the crown against foreign currencies and the subsequent transition to a floating exchange rate.

Contrary to the finding of the Constitutional Court, Pl. ÚS 59/2000, it is not possible, in my opinion, to state that the main objective of the CNB was narrowed and that there was "*a limitation in the scope of the main activities of the central bank of the state*". In the background of the legislative adjustment of the CNB's core objective, it is necessary to see, in addition to adopting the legal standards in force in the European Union, the effort to clearly define the CNB's main objective to be as objective and measurable as possible and for its performance to be easily evaluated.

Focusing on price stability - a low inflation rate also has an undeniable advantage in that the rate of meeting this target can be easily compared to other countries. The effects of, for example, higher inflation rates on the country's economy, household and business behavior can be pretty easily predicted and, depending on this, the central bank's monetary policy and the government's fiscal policy can be adjusted to minimize the negative effects caused by high inflation rates. The objective of achieving monetary stability, more precisely, the stability of the currency, which are the terms that the Constitutional Court in its judgment of 20 June 2001, Pl. ÚS 59/2000 confuses, is less graspable.

### **3.4 Legal regulation of the status of the Slovak National Bank**

The Constitution of the Slovak National Bank first appeared in Constitutional Act No. 460/1992 Coll. of The Constitution of the Slovak Republic as amended on 1 December 1992, in Article 56, where only the following was stated: "*The Slovak Republic has established a bank of issue. The details are set by the law.*" Article 56 remained in this form unchanged until the year 2001. In 2001, amendment No. 90/2001 Coll. of the Constitutions of the Slovak Republic was approved, in which Article 56 was supplemented by other provisions. Article 56 paragraph 1 newly guaranteed the independence of the National Bank of Slovakia directly by the Constitutional Act, as well as the possibility for the central bank to issue generally binding legal regulations if authorized by law. Article 56 paragraph 2 redefined the position of the supreme governing body of the National Bank of Slovakia - the Bank Board of the National Bank of Slovakia. The legal regulation of the position of the central bank of Slovakia given by the Constitution of the Slovak Republic thus comes close to the Czech legal framework. No changes were made in the Constitution of the Slovak Republic during the years 2001 - 2016, the legal regulations of the National Bank of Slovakia remained therefore unchanged.

Contrary to the Czech Constitution, the Slovak Constitution has never defined the main objective to which the central bank's activities should be directed. The main objective of the National Bank of Slovakia was legislatively defined upon the establishment of an independent Slovakia by Act No. 566/1992 Coll., of the National Bank of Slovakia as amended on 18 November 1992 in § 2 as follows: "*The primary task of the National Bank of Slovakia is to ensure currency stability.*"

This appointed main objective of the Slovak central bank's activity is practically in line with the main objective defined by the Czech National Bank Act, in force until 2000.

Adjustment of the main objective of the Slovak central bank in Act No. 566/1992 Coll. was made by amendment Act No. 149/2001 Coll., in which the main objective of the National Bank of Slovakia in § 2 was introduced for the first time - maintaining price stability. This change took place several months later in comparison with the same change made in the Czech Act on the Czech National Bank. Other major amendments to the Act on the National Bank of Slovakia were made in connection with the preparation for the introduction of the single European currency. However, price stability as the main objective has remained untouched.

### **3.5 Independence of the Czech National Bank**

Independence of the central bank according to Revenda includes institutional, functional, personal and financial independence (Revenda, 2012).

The relationship between the CNB and the government is governed by Part Three of Act No. 6/1993 Coll., on the CNB, as amended. However, the institutional definition of independence of the central bank is based on Article 130 of the Treaty on the Functioning of the European Union and is much broader than the definition of the independence of the CNB by Act No. 6/1993 Coll. in the first wording published on 31 December 1992, where it was stated in § 9 paragraph 1: "*The Czech National Bank is independent from the instructions of the government in securing its main objective (§ 2).*"

The functional independence of the CNB is an autonomous formulation of the partial objectives of monetary policy and ways of achieving them. The only limitation of the CNB's functional independence is, according to § 35 (a) of the Act on the CNB, the obligation to set the exchange rate regime to foreign currencies only after discussion with the government.

The CNB's personal independence lies in the method of appointing members of the CNB's supreme body, the CNB Bank Board, with limited options for their appeal. Under Article 62 (k) of the Constitutional Act No. 1/1993 Coll. as amended, it is the President of the Czech Republic who appoints the members of the Czech National Bank Board of Directors. This power of the President of the Czech Republic is exclusive. The terms of membership of the CNB Bank Board are governed by Section 6 of Act No. 6/1993 Coll., on the CNB, as amended.

The last aspect of the independence of the CNB is financial independence. The CNB operates according to Section 47 of Act No. 6/1993 Coll. on the Czech National Bank in accordance with the budget, which according to Section 5 (2) (b) is approved by the CNB Bank Board. The CNB's management of expenditure on the acquisition of property and operating expenses of the Czech National Bank is monitored by, pursuant to Section 3 (3) of Act No. 166/1993 Coll., on the Supreme Audit Office, as amended, the Supreme Audit Office. Under Section 47 (3) of Act No. 6/1993 Coll. on the Czech National Bank, as amended; the CNB shall submit an annual report on the results of its operations no later than three months after the end of the calendar year for the consideration of the Chamber of Deputies of the Parliament of the Czech Republic.

### **3.6 Transparency of the Czech National Bank and Forward Guidance**

Forward guidance (FG) is the communication strategy of the central bank, which lies in disclosing information on planned monetary policy measures. The possibility of influencing the Czech crown's exchange rate in the situation of the ZLB appears for the first time in records of the CNB Bank Board meeting of 19 December 2012 (CNB, 2012). The CNB's determination to influence the exchange rate of the Czech currency is evident also from further records of the CNB Bank Board

meeting of 28 March 2013, 2 May 2013 and 27 June 2013. The minutes of the CNB Bank Board meeting of 1 August 2013 show that the CNB Bank Board voted on the launch of foreign exchange interventions as another instrument for the loosening of monetary conditions and decided not to use this instrument (CNB, 2013). The immediate launch of foreign exchange interventions right after the vote on the announcement of the commitment to maintain the exchange rate at the level of CZK 27 /€ 1 on 7 November 2013 shocked politicians, entrepreneurs and the public.

Raiffeisenbank analyst Michal Brožek said: "*Neither we nor the market expected the launch of interventions in view of the ongoing revival of the Czech economy*" (Brožka, 2013). The CNB did not manage the forward guidance when introducing the intervention regime.

### **3.7 Responsibility of the Czech National Bank for the implementation of monetary policy**

Based on the above-mentioned, the central bank of the Czech Republic has a considerable degree of independence from the state, more specifically from the government. Discussions on the determination of the optimal degree of independence of the CNB emerged in its early beginnings in 1993. It is most often the case with regard to the application of measures in the implementation of a monetary policy that does not have broad consensus across the professional public, politicians, entrepreneurs and the general public. An example is the already mentioned monetary policy enforced by the CNB in 1996 and 1997 or the decision to conduct foreign exchange interventions on 7 November 2013 in order to keep the domestic currency exchange rate at CZK 27 / EUR.

In response to these steps, there were various suggestions on how to restrict the CNB's autonomy guaranteed by law in the implementation of monetary policy. An example is Professor Vostatka's suggestion, published on 22 July 2015 for "Týden" (Week) magazine, when he stated: "*The law should no longer allow the CNB Bank Board to fight against deflation by using devaluation of the crown*" (Vostatek, 2013).

The CNB is able to conduct a number of administrative proceedings, e.g. bank licensing procedures, which is a prerequisite for the provision of banking services in accordance with Act No. 21/1992 Coll., on Banks in the Czech Republic. It is therefore legally possible to review administrative acts issued by the CNB as an administrative body. It is, however, difficult to imagine a judicial review of the monetary policy of the CNB.

The issue of liability and possible sanction of the members of the CNB Bank Board itself is also problematic. Under Section 6 (10), a member of the Bank Board may be revoked only if he has ceased to fulfil the conditions required for the performance of his duties, or if he has committed serious misconduct. The CNB Act, however, does not indicate what is considered as "serious misconduct". Yet it would be sufficient simply to provide a list of examples of serious misconduct. Any decision regarding the monetary policy of the Czech National Bank is not a decision of the individual members of the Bank Board of the Czech National Bank, but a decision of the collective body as such. Wanting to withdraw a member of the Bank Board for voting in the Bank Board is not an option, just as it is not possible to dismiss a member of parliament for voting.

## **4. DISCUSSION**

The Czech National Bank has a considerable degree of independence. If I compare the position of members of the CNB Bank Board, for example, to elected representatives of the Parliament of the Czech Republic, members and senators who are also not responsible for voting under Article 27 of Constitutional Act No. 1/1993 Coll. as subsequently amended, none of the members of the CNB Bank Board have political responsibility.

If I compare the independence of CNB Bank Board members to *judicial independence*, which is exercised by independent courts through independent judges who, for example, issue a decision in civil proceedings that must be duly justified, i.e. it must be stated what, and for what reasons, the plaintiff sought, how the defendant expressed the facts, the facts the court considers to be proven, the evidence that was evaluated, the conclusions reached on the facts, and the manner in which the

matter was legally judged. On this basis, the party to the proceedings, which has not been fully or partially satisfied, may file an appeal (exercise proper appeal).

It is not possible to appeal against the decision of the CNB Bank Board, for example, on a specific step in the implementation of monetary policy. There is no body or authority that is able to annul or alter the contested decision.

The Act on the CNB, as amended, imposes the obligation on the Czech National Bank and the government to inform each other about the principles and measures of monetary, macro prudential and economic policy (Section 9 (2)), but does not specify how the CNB and the government are to fulfil this obligation.

The exact information, level of detail and time frames in which they are to mutually provide information, is not specified. Under the Act on the CNB, Section 35 (a), the CNB sets the regime of the Czech currency exchange rate for foreign currencies only after discussion with the government. From the above, it can be inferred by law that the Bank Board should first discuss and approve this part of the monetary policy itself, including the deadlines for launching its enforcement, then inform the government and only then proceed to enforcing the policy.

However, there are no sanctions for the CNB's breach of this duty. Most of the government's policy measures in the area of fiscal policy, unlike the CNB's monetary policy, are known for a long time in advance and are passed in the form of laws through the entire legislative process.

The general government plan for its fiscal policy mandate is already included in a coalition agreement.

Long-term goals of the government's general economic policy include even balance of payments, economic growth and low inflation while maintaining high employment. These goals should be pursued by both the government and the central bank.

Both the Constitution of the Czech Republic and the Act on the Czech National Bank now define the main objective of the Czech National Bank as maintaining "price stability". However, the concept of price stability or price instability is not further explained by the legislation, and the time limits and conditions under which the objective is to be achieved also remain undefined. The European Central Bank defines price stability as annual growth of the harmonized index of consumer prices for the Eurozone by less than 2 %.

The meaning of price stability is not identical to the concept of stability of prices. Stability of prices can be understood as the stability, immutability of prices. Replacing the objective of achieving monetary stability with the goal of achieving price stability gradually in both laws is in line with the definition of the core objective of the European System of Central Banks already under the Treaty establishing the European Community.

The high level of independence of the Czech National Bank goes hand in hand with the factual impossibility of legally assessing the implementation of monetary policy, or of assuming responsibility for the manner in which it is implemented. Decisions in this area are legally non-reviewable. It is not possible to appeal against decisions of the CNB Bank Board, for example, on a specific step in the implementation of monetary policy. There is no body or authority that is able to annul or alter the contested decision.

## **5. CONCLUSIONS**

The Czech National Bank artificially weakened the exchange rate of the Czech currency for approximately three and a half years. The people and companies was not well justified by the need to weaken the Czech crown.

The start of the interventions was, in my opinion, wrongly timed. When the interventions started, the Czech economy was already behind the recession. Decisions on foreign exchange interventions have come too late. Another problem, in my opinion, is the fact that the Czech National Bank did not manage the Forward Guidance communication strategy. For the decision about interventions

was no support from the Bank Board for a long time. This triggered the expectation that the central bank did not start foreign exchange intervention. However, a part of the Forward Guidance communication strategy is not just the right timing of a specific monetary policy measure but also its explanation for ordinary people. The Czech National Bank has not defended monetary policy against ordinary people. Households and companies have taken the currency weakening with great dislike and interpreted it as raising prices.

The central bank failed to meet the inflation target of 2 % set by itself until the beginning of 2017. In my opinion, the monetary policy objective should not only be price stability. The objective of monetary policy should be financial stability, which includes, in particular, price stability, monetary stability, stability in financial markets etc. Law should regulate these goals and the policy of their achievement.

The Czech National Bank and the Czech government inform each other about the principles and measures of monetary, macro prudential and economic policy.

In the author's view, legislation should specify how the central bank and the government will be informed about individual measures, including deadlines. The decision-making and implementation of the central bank's monetary policy measures are swift, unlike the government's fiscal policy measures, which mostly have to go through the entire legislative process. The government should, in my view, be informed of the planned monetary policy measures in advance. The central bank and the government should coordinate economic policy. Law should regulate the relevant deadlines in which the central bank will inform the government and the manner of communication between the central bank and the government. The decision of the CNB Bank Board on unconventional measures in the area of monetary policy should be better regulated in the Czech legislation (increase of the quorum in voting).

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