The Czech Republic and the Euro – Draft Accession Strategy

1. The negotiations on the Czech Republic's accession to the European Union are drawing to a close. As stated at the EU summit in Nice in 2000, the assumed time horizon for EU enlargement is the year 2004. According to the European Commission's *Regular Report* of October 2002, the Czech Republic has made considerable progress in fulfilling the political and economic criteria for EU accession. The negotiations on the financial conditions for accession were completed in December 2002 at the Copenhagen summit.

2. An integral part of the Czech Republic's accession to the EU is the obligation of subsequently joining the eurozone. Given the inevitable policy implementation lags, a credible timetable needs to be established for the Czech Republic's integration into European monetary structures. This timetable will then serve as the basis for each particular economic policy.

3. This document summarises the starting points for the Czech Republic's integration into European monetary structures and discusses the positive effects and potential risks associated with joining the eurozone. The Czech National Bank recommends that the Czech Republic join the eurozone as soon as economic conditions allow for doing so. In the same time it recommends that the process of structural reform and fiscal consolidation be accelerated.

1. The Starting Points for Joining the Eurozone

4. Economic and monetary union (EMU) was implemented in three stages on the basis of the Maastricht Treaty. During the first stage, starting in 1990, the liberalisation of capital flows was completed and a single internal market was created. The second stage, starting in 1994, focused on making progress on convergence of the Member States' economies. The third stage involved introducing the non-cash euro and launching the single monetary policy of the European Central Bank, which sets a single interest rate for the entire eurozone. The process of monetary integration was completed by the introduction of euro banknotes and coins into circulation in January 2002.

5. Economic integration within EMU is founded on the single currency and on co-ordination of economic policies. Fiscal policy is left partly to the discretion of the individual EMU Member States. The formation of excessive budget deficits is prevented by the *Treaty establishing the European Community* and the *Stability and Growth Pact* (see the Box).

Box: Budget Deficits of the EU Member States

Article 104 of the *Treaty establishing the European Community* sets forth that Member States must avoid excessive government deficits. The decision on whether an excessive deficit exists is made by the European Council based on a report presented by the Commission. Where the existence of an excessive deficit is decided, the Council makes recommendations to the Member State concerned with a view to bringing that situation to an end. The recommendations of the Council are not made public unless the Member State fails to respond to the recommendations within the period laid down. In addition, under the *Stability and Growth Pact* financial sanctions may be imposed on eurozone Member States in the form of either a non-interest-bearing deposit requirement or – after two years of the decision to impose sanctions, unless the excessive deficit has in the view of the Council been corrected – a fine.

6. In 1999, eleven countries satisfied the conditions for adopting the single currency and consequently established the eurozone. They were joined by Greece in 2001. The United Kingdom and Denmark, which at the start of the Maastricht process insisted on an *opt-out clause*, are not currently part of the eurozone. Despite not having an opt-out clause, Sweden also remains outside the eurozone for the time being, for domestic political reasons, and will decide on its future course of action in a referendum.

7. When it joins the EU, the Czech Republic will automatically participate in the third stage of EMU. It will acquire the status of "Member State with a derogation" regarding the adoption of the euro, i.e. it will not be a member of the eurozone in this stage. Upon EU accession, the Czech National Bank will become a member of the European System of Central Banks (ESCB). After the Czech Republic adopts the euro, the CNB will become part of the *Eurosystem,* which consists of the ECB and the national central banks of the eurozone Member States.

8. Under the EU legislation, prior to adopting the euro the Czech Republic must be an EU Member State and must have fulfilled the Maastricht convergence criteria (see the Box), including compatibility between its legal rules and EU law on EMU. The European legislation does not explicitly stipulate a date for adopting the euro or for fulfilling the convergence criteria. Nonetheless, the Czech Republic will have to document periodically the progress of its economy towards fulfilment of the Maastricht criteria in the so-called *Convergence programme.*

Box: The Convergence Criteria

The *criterion on price stability* requires that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best performing Member States in terms of price stability.

The *criterion on long-term interest rates* requires that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability.

The *criterion on the government budgetary position* means that a Member State has a ratio of planned or actual government deficit to GDP that does not exceed 3%, unless:

- either the ratio has declined substantially and continuously and reached a level that comes close to the reference value,
- or, alternatively, the excess of the reference value is only exceptional and temporary and the ratio remains close to the reference value.

The *criterion on government debt* means that a Member State has a ratio of government debt to GDP that does not exceed 60%, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The *criterion on exchange rate stability and participation in the Exchange Rate Mechanism* (at present the ERMII) means that a Member State's currency has respected the normal fluctuation margins provided for by the exchange rate mechanism for at least two years.

9. The convergence required for entering the eurozone is assessed according to the procedure laid down in the *Treaty establishing the European Community.* The final decision is subsequently made by a summit of EU Member States acting on the recommendation of the ECOFIN Council. Those Member States whose economic conditions are assessed as a potential threat to the maintenance of price stability in the eurozone will not join the monetary union and will retain the status of Member States with a derogation. These

countries will thus have to wait before they can benefit from eurozone membership and will be at a comparative disadvantage relative to the new eurozone members.

10. The criterion on exchange rate stability requires two-year participation in the ERMII. The central parity and fluctuation band of the exchange rate regime within the ERMII will – after being agreed upon between the CNB and the government – be discussed with the ECB and the Commission and subsequently approved by the ECOFIN Council. Given that participation in the ERMII – unlike the irrevocable fixing of the exchange rate within a monetary union – does not in itself eliminate the risk of currency turbulence, it is regarded merely as the gateway into the eurozone. Staying in the ERMII for longer than the minimum required period is not deemed desirable.

2. The Positive Effects of, and Possible Barriers to, Eurozone Participation

Positive Effects

11. The Czech Republic's entry into the eurozone will represent the completion of the Czech economy's integration into European monetary structures. The Czech Republic will be able to participate fully in formulating and implementing the single European monetary and exchange rate policy, which aims to strengthen macroeconomic stability in Europe.

12. Membership of the eurozone should have positive impacts on *domestic economic policy*, since the key elements of the system are a requirement for balanced public budgets in the medium term and a requirement to undertake structural reforms supporting sustainable economic growth.

13. Fiscal policy implemented in accordance with the Stability and Growth Pact, coupled with a decline in the risk premium, will lead to stabilisation of *long-term interest rates* at a low level. Corporations and households will profit not only from the low interest rates, but also from access to the deeper, more liquid and more transparent eurozone capital markets.

14. The irrevocable fixing of the currency within EMU will increase the stability of the financial sector and reduce the risks of *monetary turbulence*. Sharp fluctuations in the exchange rate present a significant threat to a small open economy in an environment of liberalised capital flows.

15. The domestic enterprise sector in particular will profit from the elimination of *exchange rate risks* vis-à-vis the eurozone countries, which are the Czech Republic's most important trading partners. These benefits will show up as a decline in transaction and hedging costs and a reduction in investment uncertainty. The household sector will profit from greater *price transparency*, which stimulates competition.

16. These positive effects will foster a more stable environment for entrepreneurship, more efficient allocation of resources and subsequently higher economic growth. Eurozone membership will thus further speed up the real convergence of the Czech economy towards the EU average.

Possible Barriers

17. The Czech Republic's entry into the eurozone is associated not only with numerous advantages, but also with some risks, the intensity of which will change over time. These risks are connected primarily with the response of the economy to economic disturbances under the irrevocably fixed exchange rate within the eurozone. In the event of insufficient cyclical and structural alignment of the Czech economy and its financial sector with the eurozone economies, economic shocks may have unequal and asymmetric impacts in different regions. The cessation of an independent monetary policy able to respond flexibly to such shocks constitutes a challenge for fiscal policy and for the functionality of natural adjustment mechanisms, especially on the labour market. The barriers to fast entry into the eurozone may thus be as follows: (i) insufficient alignment of the Czech economy with the eurozone economies in the real and financial spheres, (ii) low fiscal policy flexibility, and (iii) an insufficiently flexible labour market.

Economic alignment

18. The characteristics of the Czech economy are gradually converging towards those of the EU Member States. Trade with the EU accounts for about two-thirds of the total foreign trade of the Czech economy, and the inflow of foreign direct investment from the EU accounts for as much as four-fifths of all the investment flowing into the Czech economy. Nevertheless, the cyclical development of the Czech economy is less aligned with the cyclical trend in the eurozone than is that of the average eurozone Member State. In the area of alignment of the real economy and financial sector structures, too, there is room for further improvement.

19. The sufficiency of economic alignment over time and in international comparison can be assessed, for example, by analysing the correlation of the economic cycle with the eurozone countries, by analysing the correlation of demand and supply shocks between the Czech economy and the eurozone economies, or by evaluating structural similarity on the basis of the shares of individual sectors in total value added or on the basis of a set of criteria relating to the Czech Republic's international trade and financial sector linkages with the eurozone countries.

Fiscal consolidation

20. The Czech Republic's large public budget deficits, together with the built-in trends towards a further structural widening of those deficits and inadequate conditions for the symmetrical functioning of automatic stabilisers, represent a serious barrier to effective fiscal stabilisation policy. The aim of fiscal consolidation must be not only to fulfil the Maastricht criteria, but also – in compliance with the Stability and Growth Pact – to achieve in the medium term a balanced public finance budget facilitating the effective action of automatic stabilisers and flexibility of discretionary expenditure. In the absence of an autonomous monetary policy, fiscal policy will – given the irrevocably fixed exchange rate within the eurozone – be the key instrument of macroeconomic stabilisation.

21. An insufficiently consolidated public finance system could have exceptionally adverse effects during the Czech Republic's participation in the ERMII and during the first few years after it joins the eurozone. During this period, the probability of the Czech economic

cycle diverging from that elsewhere in the eurozone will be higher than in the later stage of integration. Moreover, given the unified nominal interest rates, the expected positive inflation differential between the Czech Republic and the eurozone average in this period will result in lower real interest rates, which could trigger excessive growth in domestic demand. Therefore, in the years immediately following the Czech Republic's entry into the eurozone, prudent fiscal policy will be a key condition for maintaining stable economic growth.

22. The appropriate methods for assessing progress in the area of consolidation of public finances include, for example, analysis of the sensitivity of built-in stabilisers by assessing the impacts of GDP fluctuations on the public budgets, analysis of the public budgets' room for manoeuvre for discretionary policy based on the budget structure or an international comparison of the public budget deficits and the cyclical position of the economy.

The labour market

23. Like the EU labour market, the Czech labour market is characterised by relatively low mobility and flexibility of the labour force. Moreover, for several years following accession, restrictions on the free movement of labour from new member states will have to be reckoned with. To strengthen the adjustment mechanisms on the labour market, steps must be taken to increase the flexibility of the labour market and real wages not only in the institutional area, but also in areas such as transport infrastructure and the housing market.

24. The degree of labour market flexibility can be assessed, for example, by evaluating the inter-regional mobility of the population, by analysing the variance in regional unemployment rates, by analysing wage flexibility or by evaluating the share of the long-term unemployed in the total number of people unemployed.

3. Draft Strategy for Eurozone accession

25. Under the European legislation, the Czech Republic's entry into the eurozone is tied to its accession to the EU. From the procedural point of view, assuming that the Czech Republic enters the EU in 2004 and fulfils the Maastricht convergence criteria, the first possible year for joining the eurozone is 2007. Membership of the eurozone will enable the Czech Republic to participate fully in formulating and implementing the single European monetary and exchange rate policy and will strengthen the macroeconomic stability of the Czech economy. Participation in the eurozone will speed up the real convergence of the Czech economy towards the EU economies.

26. On the other hand, certain preconditions have to be fulfilled to ensure that the aforementioned positive effects really materialise and that the potential risks of eurozone membership are minimised. In the ERMII exchange rate regime and after the subsequent adoption of the euro, when the Czech Republic will give up its autonomous monetary policy, sufficient alignment of the Czech economy with the eurozone economies in the real and financial spheres, flexible fiscal policy and a well-functioning labour market will be of key importance for the smooth functioning of the economy. To achieve further progress in these areas, the Czech Republic needs to further deepen structural reforms

directed at increasing the flexibility of the Czech economy and to consolidate its public finance system.

27. The evaluation of the positive effects and possible risks speaks in support of the Czech Republic's fast entry into the eurozone. However, the current outlook in the fiscal policy area is not fully consistent with this scenario. Accordingly, the aforementioned economic and political measures must be implemented in such a way as not to rule out the possibility of joining the eurozone sometime around 2007.

28. Until the monetary integration process has been completed, independent Czech monetary policy will continue to be implemented by means of the inflation targeting strategy. Continuing participation of the koruna in the EMRII is consistent with this strategy. ERMII is regarded merely as the gateway to eurozone participation and not as an alternative to the existing monetary policy regime.