

The Czech Republic's Euro-area Accession Strategy

(Joint Document of the Czech Government and the Czech National Bank)

1. The Czech Republic's process of accession to the European Union is drawing to a successful completion. The negotiations on the financial conditions for accession were completed at the Copenhagen summit in December 2002, and in Athens in April 2003 the Czech Republic's Treaty of Accession was officially signed. Following the referendum on accession held in June 2003, the accession process is to be closed with the ratification of the Treaty of Accession by the parliaments of the EU Member States. The Czech Republic is set to become a Member State of the EU in May 2004.
2. An integral part of the Czech Republic's accession to the EU is the obligation of subsequently joining the euro area. Given the inevitable policy implementation lags, a credible strategy needs to be established for the Czech Republic's integration into European monetary structures. This strategy will then serve as the basis for each particular economic policy, and in particular for monetary policy. For this reason, the Government in its Policy Statement set itself the task of preparing a euro-area accession strategy in co-operation with the Czech National Bank (CNB).
3. This document presents the joint and co-ordinated approach of the Ministry of Finance, the Ministry of Industry and Trade and the CNB to the basic issues associated with the Czech Republic's entry into the Economic and Monetary Union. It 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 euro area. The document recommends that the Czech Republic join the euro area as soon as economic conditions allow for doing so. The timing therefore depends to a large extent on the speed of the real convergence process, achieved by means of structural reforms, and on the nominal convergence process, especially on a rigorous fiscal consolidation.

The Starting Points for Joining the Euro Area

4. The 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 (ECB), which sets a single interest rate for the entire euro area. 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 euro and on co-ordination of economic and budgetary policies both mutually and among the Member States. This co-ordination is achieved by means of multilateral surveillance of such policies. The formation of excessive budget deficits is prevented by the *Treaty establishing the European Community* and the *Stability and Growth Pact* (see Box 1). Within these relatively narrow confines, fiscal policy is left to the discretion of the individual EMU Member States.

BOX 1: 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 declared, 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 euro-area 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 euro and consequently established the euro area. 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 euro area. Despite not having an opt-out clause, Sweden also currently remains outside the euro area for domestic political reasons.

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 euro area in this stage. Upon EU accession, the CNB 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 euro-area Member States.

8. Under the EU legislation, prior to adopting the euro the Czech Republic must therefore be an EU Member State and must have fulfilled the Maastricht convergence criteria (see Box 2), 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 its *Convergence Programme*.

BOX 2: 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 *exchange rate convergence criterion* requires participation for at least two years in the ERM II and observance of the normal fluctuation margins close to central parity provided for by the mechanism for at least two years.

9. The convergence required for entering the euro area is formally assessed according to the procedure laid down in the *EU Treaty*. 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 euro area will not be able to join the monetary union and will retain the status of Member States with a derogation. These countries will have to wait before they can benefit from euro-area membership and will be at a comparative disadvantage relative to the new euro-area members.

10. The exchange rate convergence criterion requires two-year participation in the ERM II and at the same time movement of the exchange rate close to its central parity. The central parity and fluctuation band within the ERM II 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. In July 2003, the CNB prepared a document entitled *ERM II and the Exchange-rate Convergence Criterion* containing a detailed argumentation of the current position as information for the Czech Government and the public. Given that participation in the ERM II – 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 euro area. The Government and the CNB agree that staying in the ERM II for longer than the minimum required period of two years does not seem desirable.

The Positive Effects and Risks of Euro-area Participation

Expected Positive Effects

11. The Czech Republic's entry into the euro area will complete the Czech economy's process of 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 euro area should have positive impacts on *domestic economic policy*, since the key elements of the system are requirements to achieve balanced public budgets in the medium term and undertake structural reforms supporting long-term sustainable economic growth.

13. Fiscal policy implemented in accordance with the Stability and Growth Pact will reduce the costs of financing public budgets and lead to stabilisation of *long-term interest rates* at a low level. Corporations and households will profit not only from low interest rates, but also from access to the deeper, more liquid and more transparent capital markets of the euro area.

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 risk* vis-à-vis the euro-area 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. Euro-area membership may thus further speed up the Czech economy's real convergence towards the EU average.

Potential Risks

17. The Czech Republic's entry into the euro area 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 euro area. In the event of insufficient cyclical and structural alignment of the Czech economy and its financial sector with the euro-area economies, economic shocks may have unequal and asymmetric impacts.

18. For the economic policy of the Czech Republic, the loss of independent monetary policy will mean a loss of important instruments that could help to mitigate the negative effects of distinct economic developments at home and abroad and thus facilitate economic convergence. In the run-up to euro-area entry, economic policy will, already in this phase, have to be targeted at achieving rapid economic convergence and at improving the Czech economy's ability to respond, so as to lower the risk of a slowdown in economic growth brought about by asymmetric shocks and their impacts. Although the characteristics of the Czech economy have since the beginning of the transformation converged towards those of the EU Member States, some misalignment of economic cycles and structural discrepancies will remain even after it joins the euro area. Of key importance for ensuring the Czech economy's ability to respond are a stabilising fiscal policy, flexibility on the labour and products markets, and well-functioning financial markets.

19. On the other hand, fulfilment of the conditions and full applicability of the Stability and Growth Pact will require, in addition to a strengthening of the automatic stabilisation effect of fiscal policy, a tightening of fiscal policy in order to ensure the long-term sustainability of balanced public finances. Public finances are a potential barrier to the entry into the euro area not only because of the excessive deficits, but also because of inadequate structural adjustment, especially on the expenditure side. Fiscal policy must not only be ready to fulfil its macroeconomic stabilisation function, but also be consistent with other structural policies supporting the competitiveness of the Czech economy within the single market.

20. The decision to fix the exchange rate irrevocably and adopt the single monetary policy can only be made when sustainable convergence of the economy and of macroeconomic and microeconomic policies have been achieved (opening of markets, competitiveness within the single market, and increasing economic integration and functioning of institutions on the products, services and capital markets).

Economic alignment

21. The characteristics of the Czech economy have been 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 Czech economic cycle is less aligned with the cycle in the euro area than is that of the average euro-area Member State. In the area of alignment of the real economy and financial sector structures, too, there is room for further improvement.

22. 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 euro-area countries, by analysing the correlation of demand and supply shocks between the Czech economy and the euro-area 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 related to the Czech Republic's international trade and financial sector linkages with the euro-area countries.

Fiscal consolidation

23. The Czech Republic's large public budgets 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 balanced public budgets 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 euro area – be the key instrument of macroeconomic stabilisation.

24. An insufficiently consolidated public finance system could have particularly adverse effects during the Czech Republic's participation in the ERM II and in the first few years after it enters the euro area. During this period, the probability of the Czech economic cycle diverging from that elsewhere in the euro area will be higher than in later years. The cyclical misalignment may be reinforced by progress with structural reforms, manifesting themselves as supply shocks with effects on potential output. Moreover, given unified nominal interest rates, the expected positive inflation differential between the Czech Republic and the euro-area 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 euro area, prudent fiscal policy will be a key condition for maintaining sustainable economic growth.

25. In response to the long-running unfavourable fiscal situation, the Government has in the course of 2003 prepared and approved a three-year consolidation programme aimed at reducing the public budgets deficit to no more than 4% of GDP by 2006. The consolidation hinges on reductions in public expenditure and a modest rise in the overall tax quota. Together with the proposed series of expenditure and revenue measures, some changes have also been made to the framework within which fiscal processes take place. The principle of medium-term fiscal targeting – implemented by means of binding aggregate three-year expenditure frameworks – has been introduced.

26. The launch of the fiscal balance renewal process will help the Czech economy to move towards a position in which it will be able to aspire to adopt the euro. This is, however, only the first stage and must be followed by another stage of further reductions in public budget deficits resulting from the implementation of more profound structural reforms. To realise all the benefits of the single currency, eliminate the potential risks and ensure the sound operation of the economy before and after the euro is adopted, it is thus vital to continue with the work already commenced and to steer the fiscal system toward balanced positions.

27. Fulfilling the Maastricht budget criterion alone is not enough. This is clearly documented by the economic difficulties currently being experienced by certain EU Member States who in the past failed to take full advantage of the opportunity to achieve fiscal balance. The need to establish sufficient room for manoeuvre in the fiscal system is underlined by the fact that, as early as in the second half of this decade, the public budgets will start feeling the effects of adverse demographic pressures. Furthermore, radical consolidation is necessary because the budget system will, particularly in the first years after accession, have to find sufficient

resources to finance necessary infrastructure investments, which will in turn facilitate the process of real economic convergence.

28. A crucial factor for fiscal policymaking, as well as from the point of view of fulfilling the future EU membership obligations in the area of co-ordination and surveillance procedures, will be the quality of all the national economic statistical data. If these data are not of a high enough standard (with respect to timeliness, reliability, stability and transparency) it will be difficult to correctly understand and evaluate the economic situation and prepare corrective measures. The statistical data are moreover the cornerstone of all the co-ordination and surveillance procedures. Inadequate national economic statistics and government financial statistics are another potential (“technical”) barrier to entry into the euro area.

29. The appropriate methods for assessing progress with public finance consolidation 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 international comparisons of the public budget deficits and the cyclical position of the economy.

The labour market

30. Like the labour market in the EU, 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 the new member states 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.

31. 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, by evaluating the share of the long-term unemployed in the total number of people unemployed, or by evaluating the structure of employment.

Euro-area Accession Strategy

32. Under the European legislation, the Czech Republic’s entry into the euro area is tied to its accession to the EU. Membership of the euro area will enable the Czech Republic to participate fully in formulating and implementing the single European monetary and exchange rate policy and will lead to a strengthening of the macroeconomic stability of the Czech economy.

33. From the procedural point of view, assuming that the Czech Republic enters the EU in 2004 and fulfils the Maastricht convergence criteria, the first theoretically possible year for joining the euro area is 2007. Given that the ERM II is to be regarded merely as the gateway to joining the euro area, with a maximum participation period of two years, the decision on the timing of the euro’s introduction hinges on the outlook for the fulfilment of the other convergence criteria and on the evaluation of the Czech economy’s degree of alignment with the euro-area economies. In other words, the Czech Republic should enter the ERM II only after conditions have been established which enable it to introduce the euro at the time of the assessment of the exchange-rate criterion (two years after joining the ERM II) and to then benefit from its introduction without experiencing any problems.

34. The preparedness of the Czech Republic for ERM II participation and euro-area accession will be assessed each year not only with respect to fulfilment of the formal entry criteria, but also by means of detailed economic analyses. Specifically, during the drafting and discussing of the *Convergence Programmes*, the Government will each autumn receive an assessment of the Czech economy's current and expected fulfilment of the Maastricht convergence criteria and an assessment of the degree of the Czech economy's alignment with the euro area. On the basis of this assessment, the CNB and the Ministry of Finance will propose to the Government a decision on whether to initiate the procedure that will take the koruna into the ERM II. Given the intention to participate in the ERM II for the obligatory two years only, the decision to join the ERM II will also imply the date for euro-area entry, i.e. the introduction of the euro in the Czech Republic.

35. This year's assessment was made during the summer months as part of the preparation of the *Pre-accession Economic Programme* for 2003. Under the EU legislation, and given the Czech Republic's position with respect to the ERM II mechanism, the country's potential participation in ERM II as from May 2004, i.e. its expected date of accession to the EU (the earliest possible date), would imply the assessment of the exchange-rate convergence criterion taking place sometime around June 2006. However, the current outlook for the fulfilment of Maastricht convergence criteria, which takes into account the approved plan to reform public finances, does not indicate that the public budget deficit criterion will be fulfilled by this date. This means that the Czech Republic will not be able to join the euro area at the turn of 2007 and that the Czech koruna will stay outside the ERM II after the Czech Republic's expected accession to the EU in May 2004.

36. The strategic goal of the Government and the CNB is to lay the groundwork for introducing the euro in the Czech Republic. The Government's economic strategy will be to support economic growth, maintain macroeconomic stability, ensure long-term corporate competitiveness and raise employment while reducing the high long-term unemployment rate. In the fiscal area, the Government will, during the current electoral term, prepare the next stage of the fiscal reform in such a way that fulfilment of the Maastricht fiscal criteria is not based on one-off revenues or cuts but is the result of gradual reform steps and far-reaching structural reforms.

37. Until the monetary integration process has been completed, independent Czech monetary policy will continue to be implemented by means of the inflation targeting strategy. Within this system, the inflation targets will be directed at fulfilling the Maastricht convergence criteria on price stability and long-term interest rates.

38. Sufficient alignment of the Czech economy with the euro-area economies in the real and financial spheres, flexible fiscal policy and a well-functioning labour market will be of key importance for the future smooth functioning of the economy within the ERM II and after the subsequent introduction of the euro, when the Czech Republic will give up its autonomous monetary policy. To achieve further progress in these areas, the Czech Republic needs to further deepen the structural reforms directed at increasing the flexibility of the Czech economy and to implement the second stage of the consolidation of its public finance system based on structural reforms of public finances.

39. Provided that the Maastricht criteria are fulfilled, including a successful consolidation of public finances, a sufficient level of real convergence is achieved and adequate progress is made with structural reforms guaranteeing sufficient economic alignment with the EU Member States, the Czech Republic can be expected to join the euro area around 2009–2010.