

# The Czech Republic's Updated Euro-area Accession Strategy

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

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## Introduction

1. The Czech Republic has participated in the third stage of economic and monetary union (EMU) since its accession to the European Union (EU), when it acquired the status of a Member State with a derogation regarding the adoption of the euro. Consequently, it is not yet a member of the euro area, but has committed itself to introducing the euro and joining the euro area in the future. It is, therefore, vital to have in place a euro adoption strategy serving as a basis for each particular economic policy.
2. Accordingly, the Government approved *The Czech Republic's Euro-area Accession Strategy* in 2003, a document drawn up in cooperation with the Czech National Bank (CNB). As the original Strategy has not been fulfilled, the Government of the Czech Republic and the CNB are presenting an update of the document. This update takes into account domestic and external developments since the original text was approved. Like the original document, it presents the joint and coordinated approach of the Government of the Czech Republic and the CNB to the future adoption of the euro.

## Assessment of the Czech Republic's 2003 Euro-area Accession Strategy and past fulfilment of the convergence criteria

3. The Czech Republic's 2003 Euro-area Accession Strategy (hereinafter the "Strategy") summarised the starting points of the nation's integration into the euro area and discussed the expected benefits and risks. The document recommended that the Czech Republic join the euro area "... as soon as economic conditions allow for doing so". The timing of entry depended on the speed of real and nominal convergence of the Czech economy to the euro area economies. Provided that the Maastricht criteria were fulfilled (including a successful consolidation of public finances), a sufficient level of real convergence was achieved and adequate progress was made with structural reforms guaranteeing sufficient economic alignment with the euro area countries, the document expected the Czech Republic to join the euro area around 2009–2010.
4. The Strategy also defined the conditions of entry and the approximate length of stay in ERM II, subject to fulfilment of the exchange rate convergence criterion in the Czech economy.<sup>1</sup> The Strategy stated that the Czech Republic would stay in ERM II for the minimum possible period.<sup>2</sup> It would enter ERM II only after conditions had been established enabling it to adopt the single currency and then benefit from its introduction without experiencing any problems, i.e. only after progress had been achieved in preparing and implementing reforms of public finances and after other reforms had been adopted to increase

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<sup>1</sup> The exchange rate convergence criterion requires participation in ERM II for at least two years without devaluation of the central rate.

<sup>2</sup> The idea of the Czech Republic staying in ERM II for the minimum required period was adopted by the CNB and published as early as July 2003 in a document entitled *ERM II and the Exchange-rate Convergence Criterion*.

the flexibility of the Czech economy, and especially the labour market. Such reforms were vital not only because of the adoption of the euro, but also for their own sake, as they were a precondition for the further sound development of the Czech economy.

5. In the Strategy, the Government and the CNB committed themselves to annually assessing the preparedness of the Czech Republic for euro-area accession, with reference to the current and expected fulfilment of the Maastricht convergence criteria and economic alignment with the euro area. The assessment would result in a recommendation to the Government on whether to initiate the procedure that will take the koruna into ERM II in the year following the assessment. All three assessments conducted since the approval of the Strategy have resulted in a recommendation for the Government not to attempt to enter ERM II the following year. The negative recommendation contained in the most recent assessment, conducted in October 2006, means that the Czech Republic's future accession to the euro area has been postponed beyond the horizon of 2009–2010 envisaged in the original Strategy.

6. The excessive deficit procedure was opened against the Czech Republic on its accession to the EU, owing to its high public budget deficits. This was aimed at reducing the public finance deficit in a sustainable and credible manner below 3% of GDP before 2008. The plan for a gradual reduction in the deficit was endorsed by the EU authorities on the basis of the Convergence Programme submitted by the Government in May 2004. The plan was built on the fiscal targets of the public finance reform approved by the Government in 2003.

7. This fiscal reform, or consolidation programme, was based on cutting public expenditure and modestly increasing the overall tax quota. This was complemented by a change to the institutional setup introducing medium-term fiscal targeting anchored by medium-term spending frameworks. The reform successfully started a restructuring of the revenue side of public budgets. However, the original aims on the expenditure side were abandoned and the measures taken had only a short-term impact. Moreover, the new medium-term expenditure ceilings have been exceeded several times since 2005. The additional income stemming from rapid economic growth was used to increase expenditure rather than to reduce the deficit. The Government thus failed to take advantage of the rapid economic growth to consolidate expenditure in a sustainable manner. Nevertheless, thanks to the good economic situation and to overestimation of the spending plans of individual ministries (manifesting itself in transfers to reserve funds), the original – albeit none-too-ambitious – deficit reduction strategy was fulfilled.

8. However, this trend was interrupted in 2007 owing to a large increase in social expenditure resulting from the 2006 pre-election measures, leading to procyclical fiscal policy. The 2007 consolidation programme's original target of 3.3% of GDP is thus not likely to be met and the Czech Republic is thus unable to end the excessive deficit procedure within the stipulated deadline. The existence of the excessive deficit procedure creates a legal impediment to entry into the euro area, as it implies non-fulfilment of the fiscal convergence criterion. Moreover, the current state of public finances is hampering their stabilising effect over the economic cycle.

9. Unlike the criterion on the general government position, the Czech Republic is compliant with the Maastricht criterion on government debt. Although the government debt recorded significant growth up until 2003, its ratio to GDP was only 30.1% in 2006, as compared to the reference value of 60%, thanks to its relatively low starting level. It has stabilised roughly at this level since then and is not expected to rise substantially in the near future. Fulfilment of the criterion should thus not be in jeopardy at the expected euro adoption horizon. From the long-term perspective, though, significant upward pressure might be exerted on the

government debt if fundamental reforms of the pension and health care systems fail to be delivered.

10. The Czech Republic has been compliant with the Maastricht price stability criterion in recent years. Domestic inflation has long been low, reflecting among other things the successful anchoring of inflation expectations by CNB monetary policy. However, the current outlook for inflation suggests that the reference value for the price stability criterion is likely to be exceeded in 2007 and 2008, mainly because of changes to indirect taxes. Once this one-off shock arising from administrative measures has unwound, inflation will return to lower levels.

11. The Czech Republic has also long been compliant with the criterion on long-term interest rates. Since 2006, domestic long-term interest rates have even been below those in the euro area countries. This mainly reflects the long-standing low-inflation environment in the Czech economy. The long-term interest rate criterion should be fulfilled in the future with no problem, provided that the Czech Republic succeeds in fulfilling the other convergence criteria.

12. Since the adoption of the Strategy, the Czech Republic has continued to apply a floating exchange rate under a monetary policy regime of inflation targeting. Under this regime, the koruna exchange rate is determined by market supply and demand and the CNB intervenes on the foreign exchange market only in exceptional situations.<sup>3</sup> The exchange rate has continued to show a gradual nominal appreciation tendency since the Strategy was adopted. The previous process of catching-up with the price level of the advanced EU countries through the exchange rate and inflation channels has created conditions for balanced fulfilment of the convergence criteria for inflation and interest rates.

13. The stabilisation of inflation at a low level amid low interest rates and strong economic growth can thus be considered positive in terms of fulfilling the Strategy, as can the increasing openness and competitiveness of the Czech economy. By contrast, the evolution of public finances and the lack of reforms aimed at delivering balanced public sector accounts in the long run and making the Czech economy, and especially the labour market, more flexible, can be viewed as unfavourable. This is reflected in failure to fulfil the original ambitions of the Strategy regarding the date of adoption of the euro in the Czech Republic.

14. The original time frame for introducing the euro around 2009–2010 required that attention be given to the practical preparations for the changeover. In November 2005, the Government of the Czech Republic established the office of National Coordinator of the Introduction of the euro. Subsequently, a National Coordination Group for the Introduction of the euro was set up. This body prepared a draft scenario for a single-step transition to the euro (approved by the Government in October 2006) and a National Euro Changeover Plan for the Czech Republic (approved by the Government in April 2007). The National Plan covers the technical, organisational, legal and communication aspects of the preparedness of the Czech economy for the introduction and use of the euro for businesses, the public and the state administration.

15. At this stage, the actions of the National Plan are structured independently of the specific changeover date and are thus conceived as a set of tasks to be implemented within a specific time limit before €day (the euro adoption date). The tasks, arranged in terms of time sequence, show that it is necessary to allow at least three years for the technical preparations from the logistical perspective. These preparations thus need to start virtually as soon as the decision is made to join ERM II. The costs associated with the changeover will not be

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<sup>3</sup> The CNB has never intervened in the foreign exchange market since the adoption of the Strategy.

covered from the public funds and will be borne by each private entity itself. For that reason, the target date must be set in such a way that it is sufficiently credible and gives all those involved the chance to plan their expenses efficiently.

## **Developments in the EU since the Strategy was adopted**

16. The introduction of the euro in 1999 was connected with expectations of strong pro-growth impulses, although these were conditional on the implementation of structural reforms. However, many euro area countries failed to make sufficient efforts to implement the necessary reforms. This, coupled with an adverse phase of the business cycle, led to a slowdown in euro area economic growth. The economic stagnation in the euro area chiefly reflected problems in its main national economies, as some smaller countries achieved favourable economic results even in this environment. At present, the euro area is in an upward phase of the business cycle, which is also being reflected in a marked increase in job creation. The experience with the adjustment mechanisms under the single monetary policy thus shows that the economic success of the euro area countries depends primarily on their domestic economic policies. In order for the euro area to operate successfully, these policies should focus on enhancing market flexibility and efficiency. This is an important message for Czech economic policy.

17. The euro has been reinforcing its position as a credible global currency. It has gradually appreciated in recent years following an initial depreciation linked with uncertainty regarding the efficiency of the institutional setup in the euro area and rapid economic growth in the United States. In addition to economic factors, the ongoing appreciation of the euro against the dollar is underpinned by rising confidence in the ECB, the euro and the potential of the euro area economy. Owing to EU enlargement and the growing credibility of the euro, the share of the euro in the foreign trade transactions of many countries and in the international reserves of many central banks is increasing.

18. A revision of the Stability and Growth Pact was approved in 2005, setting different medium-term fiscal objectives for individual countries and putting an emphasis on fiscal consolidation in good times. The Czech Republic set itself this fiscal objective as a public budget deficit of 1% of GDP, to be achieved in 2012 according to the Convergence Programme. Most of the EU Member States, which have faced widening fiscal imbalances in recent years, have adopted a series of measures leading to a gradual improvement in their public budgets. Of the new EU Member States, only the Czech Republic and Hungary expect their fiscal development to fall short of their obligations under the Stability and Growth Pact in the near future.

19. The approaches of the new EU Member States, which have not adopted the euro so far but are obliged to do so in the future, remain mixed. Seven out of the ten new Member States that joined the EU on 1 May 2004 opted for a strategy of adopting the euro as soon as possible (Latvia, Lithuania, Estonia, Malta, Cyprus, Slovakia and Slovenia). Consequently, these countries (including Slovenia, which joined the euro area in 2007) joined ERM II as early as 2004 and 2005. However, Lithuania, Latvia and Estonia were forced to delay their plans for euro area entry and have not set new official dates so far. Malta and Cyprus are planning to adopt the euro at the beginning of 2008 and have already received the approval of European institutions. Slovakia is intending to join the euro area at the beginning of 2009. Like the Czech Republic, Hungary and Poland opted to participate in ERM II only for the shortest period necessary to fulfil the exchange rate criterion and make technical preparations for the euro. As in the case of the Czech Republic, the entry of these two countries into

ERM II will depend on their expected euro adoption date. However, neither country has set such a date so far. Poland and Hungary are not expected to adopt the euro until 2012 and 2014 respectively. Bulgaria and Romania, which joined the EU in the most recent wave of enlargement, have relatively ambitious plans regarding euro area entry. Bulgaria intends to enter ERM II as soon as possible, and Romania has set 2014 as its target date for euro adoption.

20. Slovenia's changeover to the euro in January 2007 went smoothly from the technical point of view. Slovenia also experienced a temporary rise in perceived inflation, which deviated from actually measured inflation, but this deviation was smaller in scale than that recorded during the cash changeover in the countries of the "first wave". According to preliminary analyses, the transition to euro cash in Slovenia can be assessed as a successful policy, based on active and thorough preparation from the technical and organisational points of view.

21. By contrast, the "old" Member States standing outside the euro area – Denmark and the United Kingdom, which have an opt-out clause, and Sweden, which rejected the euro in a referendum – are not planning to adopt the euro any time soon and are insisting that the euro must be approved in a referendum (and – in the UK – also by the government and parliament). Nevertheless, Denmark has participated in ERM II since 1999, maintaining a fluctuation band of  $\pm 2.25\%$  around the central rate on a voluntary basis without experiencing any significant problems.

22. Lithuania's application to join the euro area, submitted in 2006, was turned down owing to its narrow failure to meet the inflation criterion and its adverse outlook for inflation. This example shows that the European authorities (the European Commission, Ecofin and the ECB) apply a strict interpretation of the Maastricht convergence criteria and the other conditions for euro adoption when assessing applicant countries. Besides the strictly legal viewpoint, this interpretation places an emphasis on sustainable fulfilment of the economic criteria after euro adoption.

### **The ability of the Czech economy to operate in the euro area**

23. To benefit from the introduction of the euro, the Czech economy must show a high degree of economic convergence, integration and alignment with the euro area. After the loss of independent monetary policy, flexibility and the ability to adjust quickly to economic shocks will be crucial for maintaining the good performance of the Czech economy. This was already pointed out in the 2003 Strategy. While some of these required features of the Czech economy have been in place for a long time, a need for further improvement is clearly visible in other areas.

24. The factors supporting the introduction of the euro include the high and increasing openness of the Czech economy and its close trade links with the euro area. The euro area accounts for 60% of Czech exports and 50% of Czech imports, while the EU as a whole accounts for more than 85% of Czech exports and 70% of Czech imports. The Czech economy is also characterised by high direct investment inflows from the euro area. The Czech economy's strong economic integration with the euro area creates preconditions for increased cyclical alignment with this area.

25. The Czech financial sector remains considerably smaller in relation to GDP than the euro area average, but the two sectors are now relatively similar in terms of structure. In the Czech Republic, the ratio of loans to GDP has been rising recently as a result of strong growth in loans to households and corporations. Loan portfolio quality and profitability in the banking

sector have increased in recent years. Capital adequacy is falling slightly but remains sufficient for now. The Czech banking sector is currently stable and resilient to external shocks, although this resilience has not yet been tested by adverse economic conditions.

26. Another important step forward by comparison with 2003 is the significant convergence of the Czech Republic's economic level towards the euro area average. GDP per capita at purchasing power parity remains higher in the Czech Republic than in most new EU Member States, slightly exceeding 70% of the euro area average in 2006. The economic level of the Czech Republic can be expected to rise further in the coming years, thereby reducing the difference from the euro area average. The higher degree of real convergence is fostering convergence of the price level, thus reducing the future pressures for equilibrium appreciation of the real exchange rate, which would result in an inflation differential against the euro area average after euro adoption and thereby lower domestic real interest rates.

27. Despite the observed convergence, the difference in the price level compared to the euro area remains relatively sizeable. In 2005, the Czech price level was roughly 56% of the euro area average and 58% of the EU average. Hourly labour costs were about 27% of the euro area average and 31% of the EU average. The process of real convergence and the growth in the relative price and wage levels are likely to continue.

28. As regards aggregate economic activity, a significant difference can still be seen between the business cycle in the Czech Republic and that in the euro area, with no significant alignment taking place. Alignment with the euro area also remains low as regards macroeconomic shocks on the demand and supply sides. The difference in the evolution of the two economies in recent years has been due partly to the pick-up in economic growth in the Czech Republic, which chiefly reflects changes on the supply side of the economy.

29. From the structural point of view, the Czech economy also still differs from the euro area average in having a higher share of industry, which has continued to grow moderately in recent years, and a smaller share of services in GDP. However, a relatively high degree of cyclical alignment can be observed for industrial activity.

30. The current state of public finances in the Czech Republic still greatly limits the room for their macroeconomic stabilising effect. Although the public budget deficits have decreased since 2003, they have remained relatively high despite the rapid economic growth, and the outlook for the near future is rather unfavourable. The deficits are largely structural in nature, reducing the scope for the functioning of automatic stabilisers and, in the extreme case, for the implementation of discretionary measures during economic downturns.

31. The employment rate is rising and total unemployment is falling, chiefly as a consequence of the buoyant economic growth in 2005 and 2006. These indicators are better than both the EU and euro area averages. However, relatively high long-term and structural unemployment remains a serious problem. To a large extent, the growing demand for labour is thus being satisfied due only to a rising number of foreigners. This flexible feature of the Czech labour market is only partly compensating for its overall rigidity. The mobility of the domestic labour force is generally low and the full liberalisation of labour movement between the Czech Republic and all the old EU Member States in 2011 can be expected to generate only a partial improvement in this area. The rather low flexibility of real wages is also a problem; no significant changes have taken place in this area recently. The overall ability of the Czech labour market to absorb shocks thus remains limited and efforts must be made to enhance it.

32. As regards the institutional setup of the labour market, some favourable and unfavourable changes have occurred since the Strategy was prepared. Increases in the minimum wage have led to a rise in its share in the average wage in recent years. On the one hand, this is reducing

the demand for people with low skills. On the other hand, together with certain other factors, especially a tightening of the conditions for claiming benefits, it has resulted in a moderate positive shift in the motivation of the unemployed to seek work since 2005. However, insufficient alignment of the tax and benefit systems remains a serious structural problem. There is a relatively large number of inactive persons who are insufficiently motivated to accept low-paid work. As regards labour law, the conditions for temporary and secondary employment have been tightened somewhat and the conditions for fixed-term employment contracts have been relaxed slightly since 2003. However, the institutional rules are still failing to create good conditions for the employment of people with low skills and for the entry of young people onto the labour market. There has been a partial improvement in the regulatory environment for doing business, but by international comparison it remains hampered by major administrative obstacles.

## **Economic policy challenges and euro adoption prospects in the Czech Republic**

33. The economic policy priority associated with the adoption of the euro in the Czech Republic is fulfilment of the Maastricht criteria. In this area, fiscal policy and the state of public finances are absolutely key areas where fundamental measures need to be taken towards sustainable fulfilment of the convergence criteria. The excessive deficit procedure needs to be ended without delay so that the Czech Republic can restore its credibility as soon as possible and prove that the consolidation process under way is capable of keeping the public finance deficit below 3% of GDP. Conditions for achieving this objective must be created in the state budget for 2008.

34. In this context, the Government and the CNB are aware of the need for further fiscal reforms going beyond those previously approved by the Government for the first phase of fiscal consolidation. That phase represents merely the first step towards sustainable public finances. There is a need to implement further and much deeper changes, especially on the expenditure side of the public budgets. Those changes must reflect the challenges arising in particular from demographic changes (reform of the pension and health care systems), from growth in social benefit expenditure and from the generally high proportion of legally prescribed (mandatory) expenditures.

35. However, fulfilment of the Maastricht fiscal criteria should in no way be regarded as a sufficiently ambitious goal for the fiscal reforms in the medium term. The only sufficiently ambitious goal is to provably target the public finance deficit – at a rate of at least 0.5% of GDP a year – well below the value of the Maastricht convergence criterion towards fulfilment of the obligation arising under the revised Stability and Growth Pact. In the Czech Republic's case, this means heading in the medium term towards a structural (cyclically adjusted) public budget deficit of no more than 1% of GDP. Only in this situation will it be possible to consider state fiscal policy as sufficiently able to effectively perform its macroeconomic stabilising role following the loss of independent monetary policy.

36. In the monetary policy area, the preconditions for achieving the relevant Maastricht convergence criteria have largely been put in place. In March 2007, the CNB announced a new inflation target of 2% for annual CPI inflation (with a tolerance band of  $\pm 1$  percentage point), effective from January 2010. At the same time, it announced that it would allow inflation to descend gradually to the new inflation target far enough in advance so that inflation is close to the target by the date it takes effect. The lowering of the inflation target primarily reflected the longer-term perspective for the operation of the inflation targeting

regime in the Czech Republic due to the postponement of the euro adoption date beyond the originally envisaged horizon of 2010 and the currently low inflation in the Czech economy, manifesting itself in inflation expectations anchored at low levels. The new inflation target is simultaneously consistent with the practice of advanced countries and its level corresponds to the rate of inflation that the ECB views as the threshold with regard to the maintenance of price stability. Lower inflation in the Czech Republic in line with the new target furthermore increases the chances of satisfying the Maastricht price stability criterion in the future and will be accompanied in the long run by lower nominal interest rates, thereby also increasing the probability of future fulfilment of the interest rate criteria while not endangering the fulfilment of the exchange rate criteria.

37. The CNB will continue to apply ex ante exemptions to the impacts of changes to indirect taxes, i.e. it will focus its monetary policy decision-making on hitting the target for inflation adjusted for the first-round effects of such tax changes (referred to as “monetary policy-relevant inflation”). However, during the ERM II participation period, which is simultaneously the reference period for the price stability criterion, this system of escape clauses should preferably be no longer necessary and headline inflation ought to gradually merge with monetary policy-relevant inflation. This will be the case only if no major changes are made to indirect taxes during this period. In the event of major tax changes, the CNB would not be able to ensure fulfilment of the price stability criterion by means of monetary policy.

38. Increasing the flexibility of the Czech economy remains another challenge for economic policy and for the future sustainability of the benefits of adopting the euro in the Czech Republic. Some degree of difference in the structural and cyclical properties of the economy will persist even after the single European currency is adopted. Given the non-existence of independent interest-rate and exchange-rate policy instruments, the effectiveness of the economy’s internal adjustment mechanisms will thus play a key role in mitigating asymmetric shocks. In addition to the insufficient stabilising role of public finances, the Czech economy’s main bottleneck in this area is its still limited ability to adjust flexibly in the labour market and partially also in the product market.

39. As in numerous euro area countries, the Czech labour market suffers from insufficient flexibility, reflecting strict employment protection regulations, a rising minimum wage and high labour taxation. Its insufficiently aligned tax and benefit system creates a demotivating environment, especially for the long-term unemployed in low-income families with children. A high ratio of social benefits to incomes in low-income households is also having a negative impact on the stabilising ability of fiscal policy. Enhancing the flexibility of the labour market by increasing the mobility of the Czech labour force also remains a challenge.

40. The entrepreneurial environment in the Czech Republic is still being hampered by administrative obstacles, which are high by international comparison. The main problems are the high administrative costs of starting up a business and generally complicated regulatory and bureaucratic processes, which are reducing the competitive pressures on product markets and in the long run adversely affecting job creation and employment. The flexibility of the economy is also being compromised by deficiencies in the legislation and the long time it takes to resolve legal disputes. These reservations, although they affect the introduction of the euro, also relate generally to the Czech Republic’s activities in the EU and the international community as a whole.

41. ERM II entry is still viewed as only a necessary condition for adoption of the euro, hence the Czech Republic’s stay in ERM II should be kept to the minimum required length of time. In line with the previous Strategy, the decision to join this system must be based on an



assessment of the outlook for the fulfilment of the Maastricht criteria as well as an assessment of the degree of economic alignment with the euro area. To retain the option of deciding flexibly on the adoption of the euro, it would be appropriate to continue conducting these evaluations at yearly intervals using the existing analytical tools.

42. However, given the interrelated nature of the factors affecting the Czech economy's ability to operate in the environment of the single European currency, and given the other restrictions of the assessment criteria, it is impossible to identify specific "sufficient" values or to draw up an overall indicator of economic preparedness for adopting the euro. Naturally, such a measure would not be very credible and might overlook certain important economic factors. The assessment of economic alignment should therefore focus on analysing developments in areas that pose risks – as discussed here – to the smooth running of the economy after the euro changeover and in the context of overall economic developments.

43. As the Czech Republic's decision to join ERM II should be made approximately three years ahead of euro area entry, it will be necessary to start making technical, institutional and organisational provision for the euro changeover at roughly the same time, in line with the approved National Changeover Plan.

44. Based on an overall assessment of the Czech economy's ability to operate in the euro area, one can say that some of the preconditions for benefiting from the adoption of the single currency have already been met, but others, by contrast, have yet to achieve satisfactory parameters. The main obstacle to the fulfilment of the Maastricht criteria remains the unconsolidated state of public finances. This, coupled with the low flexibility of the economy, and especially the labour market, simultaneously presents a risk to the operation of the Czech economy in the euro area and prevents it from reaping the benefits associated with adopting the euro.

The euro adoption date will therefore depend on resolving these problem areas in a fundamental reform of public finances and on enhancing the flexibility of the Czech economy. The Government therefore sets itself the task of making maximum reform efforts to remove these obstacles by the end of its term of office.