ASSESSMENT OF THE FULFILMENT OF THE MAASTRICHT CONVERGENCE CRITERIA AND THE DEGREE OF ECONOMIC ALIGNMENT OF THE CZECH REPUBLIC WITH THE EURO AREA

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1 SUMMARY AND RECOMMENDATIONS REGARDING THE CZECH REPUBLIC'S PREPAREDNESS FOR JOINING ERM II AND THE EURO AREA

Besides being required to harmonise their legislation with Articles 130 and 131 of the Treaty on the Functioning of the European Union (the Treaty) and the Statute of the European System of Central Banks and the European Central Bank (ECB), EU Member States are required to achieve a high degree of sustainable convergence in order to join the euro area.

The degree of sustainable convergence is assessed according to the Maastricht convergence criteria. These comprise a criterion on price stability, a criterion on the government financial position, a criterion on participation in the exchange rate mechanism and a criterion on the convergence of interest rates. These criteria are set out in Article 140 of the Treaty and detailed in Protocol No. 13 on the Convergence Criteria annexed to the Treaty.

The Czech Republic is obliged (the Act concerning the conditions of accession of the Czech Republic to the EU forms an integral part of the Treaty concerning the accession of the Czech Republic to the EU) to take steps to be prepared to join the euro area as soon as possible. However, setting the date for joining the euro area is within the competence of the Member State and depends on its preparedness. This preparedness can be assessed from the perspective of the economic alignment and structural similarity of the Czech economy and the euro area economy, and from the point of view of the economy's ability to absorb shocks and adjust adequately to them, for example via effective fiscal policy, a flexible labour market and a sound financial sector.

European institutions have recently been increasing the level of integration and taking steps towards a genuine economic and monetary union. A banking union is being established, and an extensive reform of the rules for fiscal supervision and economic policy coordination has been carried out in order to increase financial solidarity. The changes in the economic and political framework of the EMU and in the functioning of rescue mechanisms imply new and unforeseen institutional and financial obligations for countries acceding to the single currency.

1.1 Assessment of Fulfilment of the Convergence Criteria

The Czech Republic is currently compliant with the **criterion on price stability**. It is also expected to record only modest inflation in 2015–2017, which means it should fulfil this criterion. The inflation target of the Czech National Bank (CNB) has been set at 2% (for the consumer price index) since 1 January 2010. The CNB seeks to ensure that actual inflation does not deviate from the target by more than one percentage point. Given the ECB's definition of price stability and the inflation targets of the non-euro area EU Member States, this target creates good conditions for future fulfilment of the price stability criterion.

The **criterion on the government financial position** sets conditions for the levels of the government deficit and government debt. The Czech Republic is currently compliant with this criterion. For all EU countries, failure to fulfil this criterion is accompanied by an excessive deficit procedure (EDP). The Czech Republic was in an EDP from December 2009 to June 2014. The government's current fiscal policy plan (see the government's Programme Declaration) is to continue satisfying this Maastricht criterion in the future. Specifically, the government fiscal strategy aims to reach the deficit to 2.2% of GDP in 2015, 1.4% of GDP in

2016 and 1.1% of GDP in 2017. The still not entirely stable situation in the euro area and its possible impacts on the Czech economy represent the main risk to this plan.

The government debt-to-GDP ratio has always been below the 60% level in the Czech Republic. Given its relatively low level of government debt in the past, the Czech Republic has had no problems fulfilling this criterion so far, although the debt rose sharply in 2009–2012. A debt of 43.8% of GDP is expected for 2014, i.e. 2.0 percentage points lower than in 2013. The decline in the relative level of debt is due to the release of a financial reserve created in the past and to sharing of the liquidity of public bodies. The relative government debt level is expected to fall slightly further over the medium term, amounting to 41.7% of GDP in 2017. A major long-term risk going forward is the expected adverse effect of population ageing. Unless structural changes are made to the pension and health care systems, a further increase in the debt-to-GDP ratio can be expected in the long run (other things being equal).

The admission of an EU Member State into the euro area is conditional on a successful, at least two-year stay of the national currency in ERM II. Assessment of the fulfilment of the **criterion on participation in the exchange rate mechanism** will only be possible after the Czech Republic joins ERM II and the central rate of the koruna against the euro, against which exchange rate fluctuations would be monitored, has been set.

The koruna's exchange rate against the euro had shown a long-term appreciation trend in the pre-crisis period. However, this trend came to a halt in 2008. Since then, the exchange rate has recorded fluctuations reflecting the various phases of the economic and debt crisis, generally with a stabilising effect on domestic economic activity. Owing to the need to ease the monetary conditions after reaching the zero lower bound on interest rates, the CNB decided in November 2013 to start using the exchange rate as an additional monetary policy instrument. On the day the exchange rate commitment was announced, the koruna weakened abruptly to close to CZK 27 to the euro. Subsequently, the exchange rate stabilised close to CZK 27.5 to the euro without any further foreign exchange interventions. The CNB's foreign exchange commitment will apply until the CNB is certain that the risk of undershooting the inflation target of 2% has fallen significantly. The return to conventional monetary policy should not imply a sharp appreciation of the exchange rate to the level recorded before the CNB started intervening. The exchange rate can be expected to start appreciating again, albeit at a more modest pace, amid renewed real convergence.

Overall, it can be seen that exchange rate deviations can approach or even exceed the set fluctuation band in turbulent times. The appropriate timing of ERM II entry will therefore be of key importance for successful fulfilment of the exchange rate stability criterion going forward. The Czech Republic should enter ERM II amid a stable situation in the domestic economy and stable global financial markets.

The Czech Republic is currently comfortably compliant with the **criterion on the convergence of interest rates** (long-term interest rates in the Czech Republic were the sixth lowest in the EU in September 2014). Given, among other things, the construction of this criterion (the reference states often include countries with high interest rates), compliance with this criterion can be regarded as highly probable in the medium term. However, it is important to maintain the confidence of the financial markets in the long-term sustainability of Czech public finance.

1.2 Assessment of Economic Alignment Analyses

The situation in recent years has been strongly affected by the impacts of the global financial, economic and subsequently European debt crisis. At the same time, the Czech economy has stopped catching up with the euro area economic level, although the latest data suggest that convergence may have been restored. On the other hand, it is now showing increased business cycle alignment with the euro area.

The characteristics of the Czech economy as regards its preparedness to adopt the euro can be divided into four groups.

The first group consists of **economic indicators that speak in the long run in favour of the Czech Republic adopting the euro**. These include the high degree of openness of the Czech economy and its close trade and ownership links with the euro area. These factors provide for the existence of microeconomic benefits of euro adoption, such as a reduction in transaction costs and the elimination of exchange rate risk. Strong trade links with the euro area are also reflected in a high correlation between the exchange rates of the koruna and euro against the dollar and are also fostering alignment of the business cycle with the euro area. Another favourable factor is the achievement of long-term convergence in the rate and persistence of inflation and in nominal interest rates, as this reduces the macrofinancial risks associated with euro adoption. The Czech banking sector is not a barrier to joining the euro area either. Its sufficient capitalisation and high profitability make it capable of helping to absorb economic shocks, and it ensures that monetary policy is transmitted to the economy in a manner that does not differ fundamentally from that in the euro area.

The second group contains **areas where convergence was disrupted by the crisis but where an improvement has been recorded again in recent years**. The increased volatility of the koruna's exchange rate against the euro has been replaced by gradual stabilisation. The use of the exchange rate as a monetary policy instrument at the zero lower bound on interest rates has recently led to high exchange rate stability. After rising substantially because of the global financial crisis, risk premia have decreased again and the standard transmission of monetary policy rates to client rates has thus been renewed. The alignment of financial markets has also resumed in recent years. This group also includes fiscal policy, where the general government structural deficit decreased markedly in 2010–2013. However, this deficit is expected to increase slightly again, representing a risk of procyclical fiscal policy and temporary divergence from the medium-term objective (MTO).

The third group consists of **areas where positive trends were disrupted by the global crisis, and a return to the convergence path has yet to occur**. The real economic convergence of the Czech Republic to the euro area observed until 2008 has halted since then, although the current data are indicating the possibility of renewed convergence. As measured by GDP per capita (converted using purchasing power parity), the Czech Republic is at a higher absolute level than the least developed euro area countries, but this is evidently no guarantee of future smooth functioning of the economy in the EMU. The long-term price level convergence trend has also been interrupted. The previous convergence of the price level to the euro area halted in 2008. Since then, the Czech price level has been flat on average relative to that in the euro area.

The fourth group contains **areas which are showing long-term problems or misalignment and which, moreover, are not showing any significant improvement**. This group includes population ageing, which poses a risk to the long-term sustainability and stabilisation function of public finances. There has been no significant – and, from the perspective of euro adoption, desirable – improvement in the flexibility of the Czech labour market since the Czech

Republic joined the EU. The flexibility of the labour market thus remains average overall by comparison with the other European economies. Its weak points continue to include relatively low labour mobility and relatively high implicit labour taxation. On the other hand, the labour market is also showing signs of greater flexibility, particularly in the form of rising countercyclical use of the number of hours worked. Persisting administrative barriers to starting a business have long hampered the flexibility of the Czech product market. Significant differences vis-à-vis the euro area still exist in the structure of the Czech economy, which is characterised by a high share of industry and a low share of services. Differences also persist in the financial sector and in the structure of financial assets. These factors may be a source of asymmetric shocks and cause the single monetary policy to have different effects.

1.3 Situation in the Euro Area

Developments in the **euro area** in recent years are pointing to misalignment within the monetary union itself and, for some countries, even to continuing divergence. Exchange rate fixing, sharp interest rate cuts on the periphery of the euro area and the absence of fiscal integration have resulted in a systematic accumulation of major imbalances in the euro area. With no option of exchange rate depreciation, the current single monetary policy seems too restrictive for the less competitive countries, which are often showing negative consumer price inflation and high debt ratios. Conversely, the single monetary conditions may be too easy for the countries with high competitiveness and rising prices of assets, for example property prices. These factors, combined with some other effects, have been reflected in rising misalignment in a whole range of indicators, for example long-term interest rates, unemployment and partly also GDP growth. Although the situation in the euro area has improved recently, the economic and debt crisis still cannot be said to be definitively over.

Major changes are being made to economic policy and the **institutional framework** in response to the euro area's problems. In November 2014, the Single Supervisory Mechanism (SSM) will be launched as part of the formation of the banking union. The SSM will assume supervisory powers over systemically important financial institutions in the euro area. A Single Resolution Mechanism (SRM) is being created at the same time. It will consist of a bank resolution fund financed by contributions from banks, and "backstops" at the national and European levels. These will take over the main role in bank crisis resolution from the European Stability Mechanism (ESM), whose financial capacity has so far been available for recapitalisation of problem banks and for the provision of assistance to overindebted countries. If it adopted the euro, the Czech Republic would – according to updated Czech Finance Ministry calculations – have to pay about CZK 51 billion[1] into the ESM and undertake to supply a further amount of up to around CZK 391 billion in the event of non-repayment of certain loans or a large decrease in the contracting parties' solvency. Were the Czech Republic to join the SSM, the obligation to pay the ECB a fee for performing supervision would apply to virtually all credit institutions in the Czech Republic. In such case, the total fee payable to the ECB by liable domestic credit institutions can be estimated at EUR 1.8 million. If the Czech Republic were to enter the SRM, it would – under the relevant intergovernmental agreement – have to deposit a total of around CZK 17.3 billion in the SRM by the end of the transition period. Further institutional changes also apply to non-euro area countries (changes to the Stability and Growth Pact and the introduction of the European semester and the macroeconomic imbalance procedure). It is apparent that the euro area is

[1] Based on current macroeconomic indicator levels, ESM entry would increase the general government debt by 1.2 percentage points. However, this impact would not occur until after ESM entry, i.e. after the assessment of fulfilment of the Maastricht criteria connected with entry into the euro area.

undergoing substantial institutional change. The major shifts include the budget costs of joining the euro area rescue mechanisms and a reduction in national autonomy in the banking supervision area in an effort to strengthen the robustness of the monetary union to fiscal problems in individual countries and to shocks emanating from their banking systems.

1.4 Conclusions and Recommendations

Significant institutional changes in the functioning of the monetary union have gradually been implemented in recent years. These changes are fundamentally changing the conditions and obligations arising from the Czech Republic's potential membership of the euro area. Owing to the ongoing changes, the shape of the framework for the functioning of the euro area has moved away from the situation that existed when the Czech Republic entered the EU. On the other hand, the Czech Republic – as a state that is committed to adopting the euro in the future – has been involved in preparing the legislation connected with these changes. The main elements of the new architecture in the euro area, which will take the form of a banking union, are now defined more clearly than in previous years. The uncertainty surrounding the future form of the basic economic, political and institutional architecture of the euro area, which in past years has been a major obstacle to reliably assessing the costs and benefits to the Czech Republic of joining the euro area, has decreased compared to previous years. As regards economic developments, the economic recovery in the euro area is still fragile and the risk of the economy falling into deflation and slipping back into recession persists.

The preparedness of the Czech Republic itself to adopt the euro has improved compared to previous years. All the Maastricht criteria except for ERM II participation are likely to be fulfilled in the medium term. In order to make their fulfilment sustainable, it is necessary to strengthen the fiscal framework and concentrate on compliance with the medium-term objective beyond 2015. At the same time, reforms to ensure public finance long-term sustainability in connection with population ageing must be adopted and permanently implemented. It is also appropriate to take measures to increase the flexibility of the labour market and reduce administrative barriers to entrepreneurship. Last but not least, it is also desirable to continue taking steps towards achieving a greater degree of economic alignment and real convergence, primarily through structural reforms.

In view of the above facts, the Ministry of Finance and the Czech National Bank, in line with the Czech Republic's Updated Euro-area Accession Strategy, recommend that the Czech government should not set a target date for euro area entry for the time being. The recommendation not to set a target date for euro area entry for the time being implies a recommendation that the Czech Republic should not attempt to enter ERM II during 2015.

2 Assessment of the Current and Expected Fulfilment of the Maastricht Convergence Criteria

2.1 The Criterion on Price Stability

Box 2.1: Definition of the criterion on price stability

Treaty provisions

The first indent of Article 140(1) of the Treaty requires: "the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability".

Article 1 of Protocol No. 13 on the Convergence Criteria also stipulates that: "the criterion on price stability shall mean 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. Inflation shall be measured by means of the consumer price index on a comparable basis taking into account differences in national definitions."

Application of Treaty provisions in ECB and EC Convergence Reports

With regard to "an average rate of inflation, observed over a period of one year before the examination", the inflation rate is calculated using the increase in the latest available 12-month average of the Harmonised Index of Consumer Prices (HICP) over the previous 12-month average.

The reference value of the price criterion is calculated as 1.5 percentage points plus the simple arithmetic average of the rate of inflation in the three countries with the lowest inflation rates, provided that this rate is compatible with price stability.

Implementation of the price stability criterion – current practice

Both the Treaty and the Protocol in some areas leave scope for interpretation by the institutions that assess the fulfilment of the criteria (the European Commission and European Central Bank). Therefore, when assessing the fulfilment of the criteria one should also take into account the specific way in which these institutions implement the criterion. Previous practice shows that countries with low or negative inflation rates are not automatically excluded as reference countries. Only countries that record significant deviations in inflation from the other EU countries owing to extraordinary or specific factors are excluded. Examples include the exclusion of Ireland from the calculation of the criterion in Convergence Report 2010, that of Greece in 2013, and that of Greece, Bulgaria and Cyprus this year. The resulting reference value may thus be very low even when extraordinary observations are excluded, especially in the current context of very subdued inflation.

The Czech Republic was compliant with the criterion on price stability in 2011. It temporarily failed to fulfil the price stability criterion in 2012 due to an increase in indirect taxes and adverse supply shocks, but since 2013 it has been compliant with it again.

Inflation pressures from the domestic economy were not apparent in 2012 and 2013 owing to the size of the negative output gap. The average inflation rate was only 1.4% in 2013 despite an increase of 1 percentage point in the two VAT rates to 15% and 21% on 1 January 2013. Although the CNB decided in November 2013 to use the exchange rate as an additional monetary policy instrument in order to maintain price stability in line with its inflation target, the average inflation rate was only 0.6% in September 2014. However, this low figure should be seen in the broader context of very low inflation in the EU. The Czech Republic is approximately in the middle of the set of EU countries.

Table 2.1: Harmonised index of consumer prices
(average for last 12 months vs. average for previous 12 months as of end of period, growth in %)

	2011	2012	2013	9/2014	2014	2015	2016	2017
Average for 3 EU countries with lowest inflation*	1.6	1.6	0.3	0.0	0.4	1.0	1.4	1.5
Reference value	3.1	3.1	1.8	1.5	1.9	2.5	2.9	3.0
Czech Republic	2.1	3.5	1.4	0.6	1.0	2.3	2.1	2.0

* More precisely, the three best performing member countries in terms of price stability (see Box 2.1).

Note: The outlook for 2014–2017 was taken from the Convergence Programmes and Stability Programmes of the individual Member States except Greece, Cyprus and Portugal, whose Stability Programmes are not available. Owing to the unavailability of average HICP inflation rates, private consumption deflators were used for Germany and Spain and average national CPI inflation rates were used for Croatia and Slovenia. In the assessment of inflation for 2012 and 2013 we excluded Greece from the calculation of the criteria, in the assessment of inflation in September 2014 we excluded Greece, Bulgaria and Cyprus, and in the assessment of inflation in December 2014 (whole year) we excluded Bulgaria. We thus adopted an approach similar to that used by the European Commission and the European Central Bank in their June 2013 and June 2014 Convergence Reports.

Source: Eurostat, Convergence Programmes and Stability Programmes of EU Member States, Czech MoF calculations (which may differ from the CNB's forecast).

In 2014, inflation will be very low due to a decline in administered prices, very low inflation in trading partner countries and a still negative output gap, which is preventing any major pass-through of rising demand to prices. The Czech Republic should thus be comfortably compliant with the price stability criterion. In 2015–2017, prices in the Czech Republic will still be affected, in addition to standard factors, by administrative measures, although their contribution should be smaller than in the past. The criterion should also be fulfilled in 2015–2017. However, fulfilment of the criterion is conditional on no other changes except those planned being made to indirect taxes and no other significantly inflationary administrative measures being taken in the consumer price area during the reference period for the assessment of this criterion.

2.2 Criterion on the Government Financial Position

The criterion on the government financial position is satisfied only when both components of the fiscal criterion, i.e. the general government deficit and debt, are fulfilled in a sustainable manner.

2.2.1 General government deficit

Box 2.2: Definition of the criterion on the government financial position

Treaty provisions

The second indent of Article 140(2) of the Treaty requires "the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6) of the Treaty".

Article 2 of Protocol No. 13 on the Convergence Criteria stipulates that this criterion "shall mean that at the time of the examination the Member State is not the subject of a Council decision under Article 126(6) of this Treaty that an excessive deficit exists".

Article 126 of the Treaty sets out the excessive deficit procedure, which is specified in more detail in the Stability and Growth Pact. According to Article 126(3) of the Treaty, the European Commission prepares a report if a Member State does not fulfil the requirements for fiscal discipline, in particular if:

1. the ratio of the planned or actual government deficit to GDP exceeds a reference value (defined in Protocol No. 12 on the excessive deficit procedure as 3% of GDP), unless:

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

2. the ratio of government debt to GDP exceeds a reference value (defined in the Protocol on the Excessive Deficit Procedure as 60% of GDP), unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The criterion on the government financial position was not fulfilled in 2009–2013. The excessive deficit procedure was opened against the Czech Republic at the end of 2009 for the second time (the first time having been in 2004–2008) based on an expected exceeding of the reference value for the general government deficit-to-GDP ratio. As a result of a recession in late 2008 and early 2009, the general government balance saw a marked deterioration. In addition to unresolved structural problems, the general government sector faced an unprecedented shortfall in tax revenues owing to the highly unfavourable economic situation and to legislative changes (reductions in the social security contributions and the corporate income tax rate). Expenditure on mitigating the effects of the recession was increased at the same time.

In 2010–2013, the government implemented a programme to consolidate public budgets and the general government deficit fell gradually. The only exception was a widening of the deficit in 2012, which reflected strong one-off effects, particularly financial compensation relating to property settlement between the state and churches. In 2013, measures on the revenue side of the public budgets (primarily an increase in both VAT rates and temporary adjustments to personal income tax) led to an improvement in the deficit to 1.3% of GDP. The excessive deficit procedure against the Czech Republic was discontinued in June 2014.

According to the autumn notifications, the Czech Ministry of Finance expects a deficit of 1.5% of GDP for 2014. On the revenue side, direct tax and VAT revenues should rise slightly compared to 2013, whereas excise duty revenues are expected to decline owing to frontloading by cigarette manufacturers and retailers. The impact of discretionary tax measures is expected to be modest. On the expenditure side, budgeted government debt servicing expenditure can be expected to decline thanks to stable debt developments and relatively favourable financial market developments. Growth in government investment is expected to be financed mostly from EU funds and have no major effect on the deficit.

According to current estimates, the Czech Ministry of Finance expects the general government balance to deteriorate to -2.2% of GDP in 2015 and then improve to -1.4% of GDP in 2016 and -1.1% in 2017. Based on this outlook, the deficit part of the public finance criterion is expected to be fulfilled in the future as well.

Table 2.2: General government balance
(ESA 2010 methodology, in % of GDP)

	2011	2012	2013	2014	2015	2016	2017
Reference value	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0
Czech Republic	-2.9	-4.0	-1.3	-1.5	-2.2	-1.4	-1.1

Source: 2011–2013: CZSO: Autumn Notifications. 2014–2017: Czech MoF: Fiscal Outlook (November 2014).

As regards the smooth functioning of the Czech economy, it is also necessary to endeavour to meet the medium-term objective (MTO) of achieving a structural general government deficit of 1.0% of GDP. Temporary achievement of this objective in 2013 completed the government's consolidation policy. The new government is pursuing a stimulus policy intended to support the economic recovery. Given this fiscal policy, the MTO will not be fulfilled in 2015–2017. The Ministry of Finance estimates the structural deficit at 1.1% of GDP in 2014, 1.8% of GDP in 2015, 1.6% of GDP in 2016 and 1.4% of GDP in 2017.

The risk of a fragile recovery of the Czech economy and a deterioration in the economic outlook for euro area countries persists. A slowdown in economic growth would in turn affect tax revenues in particular, as well as some social benefits, and consequently the general government balance.

2.2.2 General government debt

Given its low initial level of government debt, the Czech Republic has had no problem fulfilling this item of the criterion so far. The debt increased significantly from about 30% of GDP to more than 40% of GDP in 2009–2012 owing to the global financial and economic crisis. This was a result of higher general government deficits on the one hand and low nominal GDP growth on the other. The marked increase in the debt in 2012 was due to the creation of a government debt financing reserve, whose gradual dissolution led to a decline in the debt quota in 2013 and 2014. Given the fiscal policy stance, the debt ratio is expected to fall slightly over the outlook period owing to the economic recovery, and is likely to reach 41.7% of GDP in 2017.

Total general government debt is still low relative to the EU average and the criterion will very probably be fulfilled in the years ahead. However, the margin of fulfilment of this criterion shrank significantly following the outbreak of the crisis.

Table 2.3: General government debt
(ESA 2010 methodology, in % of GDP)

	2011	2012	2013	2014	2015	2016	2017
Reference value	60.0	60.0	60.0	60.0	60.0	60.0	60.0
Czech Republic	41.0	45.5	45.7	43.8	42.3	42.1	41.7

Source: 2011–2013: CZSO: Autumn Notifications. 2014–2017: Czech MoF: Fiscal Outlook (November 2014).

The adverse effects of population ageing pose a risk to the long-term evolution of general government finance. Although quite significant measures have been taken in the area of public pensions (parametric changes to the current pay-as-you-go system), long-term projections suggest that it is appropriate to continue with reforms.

2.3 Criterion on Participation in the Exchange Rate Mechanism

Box 2.3: Definition of the criterion on participation in the exchange rate mechanism

Treaty provisions

The third indent of Article 140(1) of the Treaty requires: “the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the euro”.

Article 3 of Protocol No. 13 on the Convergence Criteria stipulates that: “the criterion on participation in the exchange-rate mechanism of the European Monetary System referred to in the third indent of Article 140(1) of the Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency’s bilateral central rate against the euro on its own initiative for the same period.”

Application of Treaty provisions in ECB and EC Convergence Reports

The Treaty refers to the criterion of participation in the European exchange-rate mechanism (ERM until December 1998 and ERM II since January 1999).

First, the ECB and the EC assess whether the country has participated in ERM II “for at least the last two years before the examination”, as stated in the Treaty.

Second, as regards the definition of “normal fluctuation margins”, the ECB recalls the formal opinion that was put forward by the EMI Council in October 1994 and its statements in the November 1995 report entitled “*Progress towards Convergence*”.

The EMI Council's opinion of October 1994 stated that "the wider band has helped to achieve a sustainable degree of exchange rate stability in the ERM", that "the EMI Council considers it advisable to maintain the present arrangements", and that "member countries should continue to aim at avoiding significant exchange rate fluctuations by gearing their policies to the achievement of price stability and the reduction of fiscal deficits, thereby contributing to the fulfilment of the requirements set out in Article 140(1) of the Treaty and the relevant protocol".

In the "*Progress towards Convergence*" report it was stated that "when the Treaty was conceived, the 'normal fluctuation margins' were ±2.25% around bilateral central parities, whereas a ±6% band was a derogation from the rule. In August 1993 the decision was taken to widen the fluctuation margins to ±15%. The interpretation of the criterion, in particular of the concept of "normal fluctuation margins", became less straightforward. It was then also proposed that account would need to be taken of "the particular evolution of exchange rates in the European Monetary System (EMS) since 1993 in forming an ex post judgement".

Against this background, in the assessment of exchange rate developments the emphasis is placed on exchange rates being close to the ERM II central rates.

Third, the issue of the presence of "severe tensions" or "strong pressures" on the exchange rate is addressed by examining the degree of deviation of exchange rates from the ERM II central rates against the euro. Other indicators, such as short-term interest rate differentials vis-à-vis the euro area and their evolution, are used as well. The role played by foreign exchange interventions is also considered.

Formal fulfilment of the criterion on exchange rate stability will only be possible after the Czech Republic joins ERM II, so the assessment of fulfilment of this criterion can be made only at an analytical level. For the purposes of such assessment, the hypothetical CZK/EUR central parity is set as the average exchange rate in 2012 Q1, i.e. the quarter preceding hypothetical ERM II entry at the start of 2012 Q2, which would have allowed euro adoption on 1 January 2015.[2] With the aid of this parity it is theoretically possible to monitor whether the Czech Republic would have fulfilled the exchange rate stability criterion in the given time period. Chart 2.1 shows that the exchange rate did not leave the band of ±15% around the hypothetical central parity in the period under review despite the fact that the CNB decided in November 2013 to start using the exchange rate as an additional monetary policy instrument because of the need to further ease the monetary conditions after the lower bound on interest rates had been reached. The koruna weakened sharply to close to CZK 27 to the euro on the day when the exchange rate commitment was announced.[3] The exchange rate then stabilised at close to CZK 27.5 to the euro without further interventions (see Chart 2.1). The CNB's foreign exchange commitment will apply until the CNB is certain that the risk of undershooting the 2% inflation target has fallen significantly.[4] The return to conventional monetary policy should not imply a sharp appreciation of the exchange rate to the level recorded before the CNB started intervening, as the weaker exchange rate of the koruna is in the meantime passing through to prices and other nominal variables. Any exchange rate appreciation in the longer run owing to the renewal of real convergence should not be inconsistent with fulfilment of the exchange rate criterion, as the assessment of this criterion

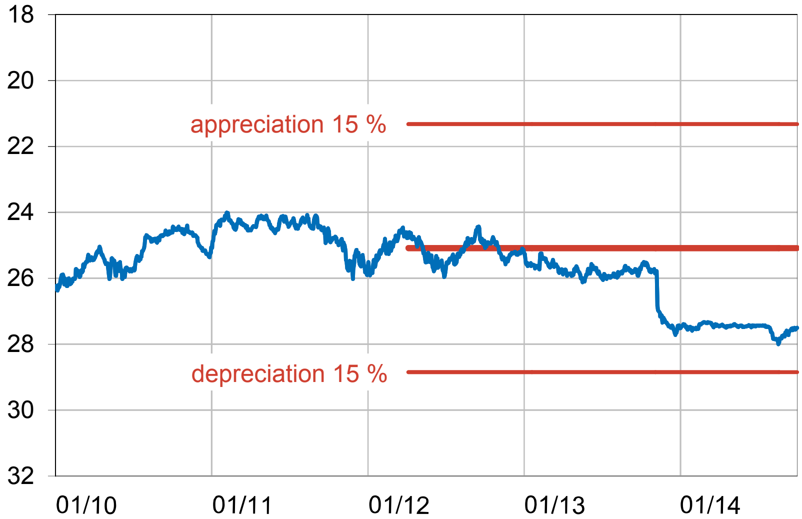
[2] The hypothetical adoption of the euro in 2015 would have been preceded by an assessment of all the convergence criteria in 2014 Q2.

[3] The CNB regards the commitment as asymmetric, i.e. one-sided in the sense that it will not allow the koruna to appreciate to levels it would no longer be possible to interpret as "close to 27 CZK/EUR". On the stronger side of the 27 CZK/EUR level, the CNB is preventing the koruna from appreciating further by intervening on the foreign exchange market, i.e. by selling koruna and buying euro. On the weaker side of the 27 CZK/EUR level, the CNB is allowing the koruna exchange rate to float.

[4] The Bank Board has stated repeatedly at its monetary policy meetings this year that the CNB will not discontinue the use of the exchange rate as a monetary policy instrument before 2016. This year's developments show that the weakening of the exchange rate has averted the threat of deflation and fostered a switch of the economy to growth and hence a return to the long-term convergence path. Inflation nonetheless remains low, due among other things to very subdued inflation in the euro area and an annual decline in administered prices.

has historically been more lenient on the appreciation side and shifts of the central parity towards a stronger exchange rate have commonly been tolerated.

Chart 2.1: Nominal CZK/EUR exchange rate



Note: The hypothetical central parity is simulated by the average exchange rate for 2012 Q1. Data up to 30 September 2014.
Source: CNB, MF calculations.

The length of stay of an EU Member State in ERM II is set by the Treaty at a minimum of two years before the assessment of preparedness to adopt the euro. The Czech Republic's September 2003 Euro-area Accession Strategy and its August 2007 update state that the Government and the CNB agree on staying in ERM II for the minimum required period only. This implies that the Czech Republic should enter the ERM II only after it has achieved a high degree of economic alignment and after conditions have been established which enable it to introduce the euro shortly after the assessment of the exchange rate criterion. In addition, the Czech Republic should enter ERM II amid a stable situation in the domestic economy and stable global financial markets.

2.4 Criterion on the Convergence of Interest Rates

Box 2.4: Definition of the criterion on the convergence of interest rates

Treaty provisions

The fourth indent of Article 140(1) of the Treaty requires: "the durability of convergence achieved by the Member State and of its participation in the exchange-rate mechanism of the European Monetary System being reflected in the long-term interest-rate levels".

Article 4 of Protocol No. 13 on the Convergence Criteria specifies that: "the criterion on the convergence of interest rates means 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 two percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions."

Implementation of the criterion on the convergence of interest rates

As in the case of the price stability criterion, the Treaty and the Protocol provide scope for a looser interpretation of the specific value of the criterion. It is within the competence of the assessing institutions to decide whether the calculation of the interest rate criterion will include all three countries used for the calculation of the price stability criterion or whether certain countries will be excluded for the calculation of the interest rate criterion. One example is the exclusion of the high value of Irish interest rates from the calculation of the relevant criterion in Convergence Report 2012.

The annual average long-term interest rates in the Czech Republic for convergence purposes showed a downward trend during 2011–2014. At present they are at historical lows. The Czech Republic constantly fulfilled the interest rate criterion by a considerable margin in the period under review.

Table 2.4: Long-term interest rates for convergence purposes
(average for the last 12 months, in %)

	2011	2012	2013	9/2014	2014	2015	2016	2017
Average for 3 EU countries with lowest inflation*	3.3	3.1	4.4	3.4	3.9	4.3	3.2	3.1
Reference value	5.3	5.1	6.4	5.4	5.9	6.3	5.2	5.1
Czech Republic	3.7	2.8	2.1	1.9	2.4	2.6	2.8	3.0

* More precisely, the three best performing countries in terms of price stability (see Box 2.1, Box 2.4)

Note: The outlook for EU countries for 2014–2017 was taken from the Convergence Programmes and Stability Programmes of the individual Member States except Greece, Cyprus and Portugal, whose Stability Programmes are not available. Owing to the unavailability of data for some reference countries, the value of the criterion was calculated by fixing the current real interest rates and adding the inflation outlooks for these countries.

Source: Eurostat, Convergence Programmes and Stability Programmes of EU Member States, Czech MoF calculations.

The Czech Republic's fiscal policy credibility is reflected in its stable and high sovereign rating and in the smooth subscription of Czech government bonds, which is fostering stability of Czech government bond yields.

Given the still not fully resolved problems in the euro area and new geopolitical risks (the Ukrainian crisis and the Middle East), the prediction for 2015–2017 is surrounded by some degree of uncertainty. Based on developments to date and also on the construction of this criterion, however, one can say that the Czech Republic should have no problems fulfilling it in the future. However, this is conditional on maintaining the confidence of the financial markets in the long-term sustainability of Czech public finance, which, given its current and expected situation, should not be a problem.

3 ASSESSMENT OF THE CZECH REPUBLIC'S CURRENT ECONOMIC ALIGNMENT WITH THE EURO AREA

This part summarises the results of a set of analyses directed at assessing the Czech economy's alignment with the euro area over and above the formal criteria, the fulfilment of which is assessed in the previous part.[5]

The Czech Republic's future entry into the euro area ensues from the commitments associated with EU membership. Adoption of the single European currency should lead to the elimination of exchange rate risk in relation to the euro area and to a related reduction in the costs of foreign trade and investment. This should further increase the benefits accruing to the Czech Republic from its intense involvement in international economic relations. Besides the aforementioned benefits, however, adoption of the euro will simultaneously imply costs and risks arising from the loss of independent monetary policy and exchange rate flexibility vis-à-vis major trading partners. The costs and benefits stemming from euro adoption will be affected by the characteristics and situation in both the Czech economy and the euro area economy. These factors will influence whether adoption of the euro by the Czech Republic will lead to an increase in the country's economic stability and performance.

The analyses are divided into two basic groups according to the type of question they try to answer. The section entitled "Cyclical and Structural Alignment" indicates the size of the risk of economic developments being different in the Czech Republic compared to the euro area and hence the risk of the single monetary policy being highly suboptimal for the Czech economy. The section entitled "Adjustment Mechanisms" answers the question of to what extent the Czech economy is capable of absorbing the impacts of potential asymmetric shocks using its own adjustment mechanisms. The basic theoretical starting point for the underlying analyses is the theory of optimum currency areas. These analyses are aimed at assessing the evolution of the alignment indicators over time and in comparison with selected countries.

3.1 Cyclical and Structural Alignment

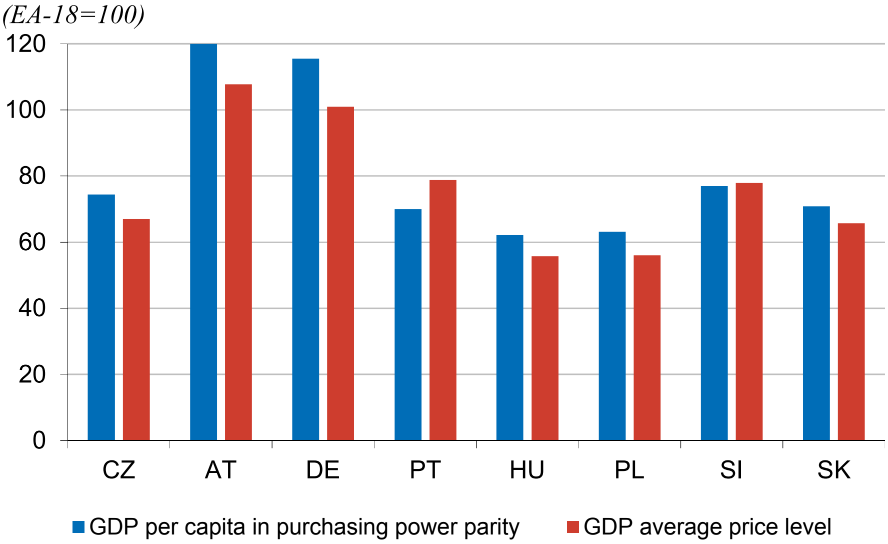
Greater alignment of the Czech economy with the euro area economy is a necessary condition for the euro adoption costs arising from the loss of the Czech Republic's own monetary policy to be relatively small.

The **degree of real economic convergence** is an important indicator of the Czech economy's similarity to the euro area. A higher level of such convergence fosters greater similarity of long-run equilibrium development. It can also foster a lower likelihood of misalignment in the shorter run. A higher degree of convergence in the economic level prior to ERM II entry and prior to euro adoption should further increase the relative price level, which will reduce the potential future pressures for growth of the price level and equilibrium appreciation of the real exchange rate after joining the euro area. The Czech economy had been gradually converging towards the euro area in real terms before the crisis broke out. However, this trend halted in 2009, and the Czech Republic's economic level relative to that of the euro area has been flat since then. In recent years, GDP per capita has been about three-quarters of the euro area

[5] These analyses are presented in detail in a document entitled "*Analyses of the Czech Republic's Current Economic Alignment with the Euro Area in 2014*", which was prepared by the CNB and will be published on its website. The above document compares developments in the Czech Republic with those in Austria, Germany, Portugal, Hungary, Poland, Slovenia and Slovakia (the "countries under comparison").

average. Owing to the crisis, the convergence process was also interrupted in the case of the price level of GDP, which has halted at around 70% of the euro area average. The wage level in the Czech Republic in 2013 was just under 40% of the average euro area level when converted using the exchange rate and about 60% when converted using purchasing power parity. The price level thus remains slightly below the level corresponding to the performance of the economy. This has its long-term structural cause and is also linked with the aforementioned halt in the real equilibrium appreciation of the koruna (on an HICP basis), as the weakened real exchange rate in the period following the onset of the global financial and economic crisis helped to absorb macroeconomic shocks (including, in November 2013, the commencement of use by the Czech National Bank of the nominal exchange rate as an additional instrument for easing monetary policy to avert the threat of deflation and facilitate a faster return of inflation to the 2% target and to support the economic recovery). According to the analyses, equilibrium real appreciation of the koruna against the euro, albeit at a lower rate than before the crisis, can be expected over the next five years provided that real GDP convergence is renewed. Continuing real appreciation of the exchange rate following euro area entry would mean a positive inflation differential vis-à-vis the euro area and related low (negative) real interest rates.

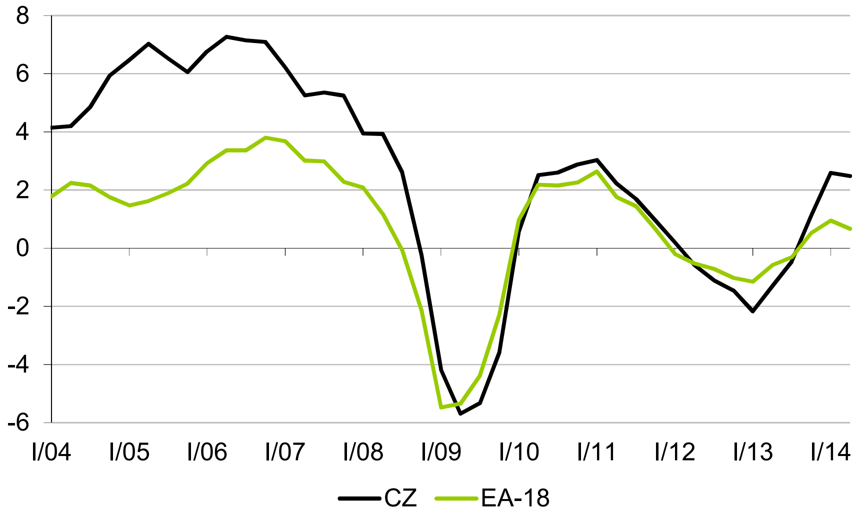
Chart 3.1: Real economic convergence of selected states towards the euro area in 2013
(EA-18=100)



Source: Eurostat, CNB calculations.

Sufficient **cyclical alignment of economic activity** increases the likelihood that the single monetary policy in the monetary union will be appropriately configured from the perspective of the Czech economy. The analyses indicate increased correlation of overall economic activity between the Czech Republic and the euro area in recent years; the same goes for activity in industry and export activity. The increase in the correlations monitored can be attributed partly to a greater significance of common extraordinary shocks in the form of the global financial and economic crisis and the subsequent gradual recovery. The domestic economy's strong trade links with the euro area suggest, however, that the high degree of alignment will persist in conditions of normal development.

Chart 3.2: Real GDP growth in the Czech Republic and the euro area
(in %, year-on-year, seasonally adjusted)



Source: Eurostat, CNB calculations.

Similarity of the **structure of economic activity** with the euro area should reduce the risk of asymmetric economic shocks. The persisting relatively high share of industry (moreover with an exceptionally significant share of the procyclical car industry) and a smaller share of services compared to the euro area may mean a higher risk of asymmetric shocks for the Czech economy, to which a potential single monetary policy will evidently not respond in full. In addition, the differences in the structure of the Czech economy vis-à-vis the euro area economy are widening gradually, so structural misalignment is becoming one of the risks of adopting the single currency.

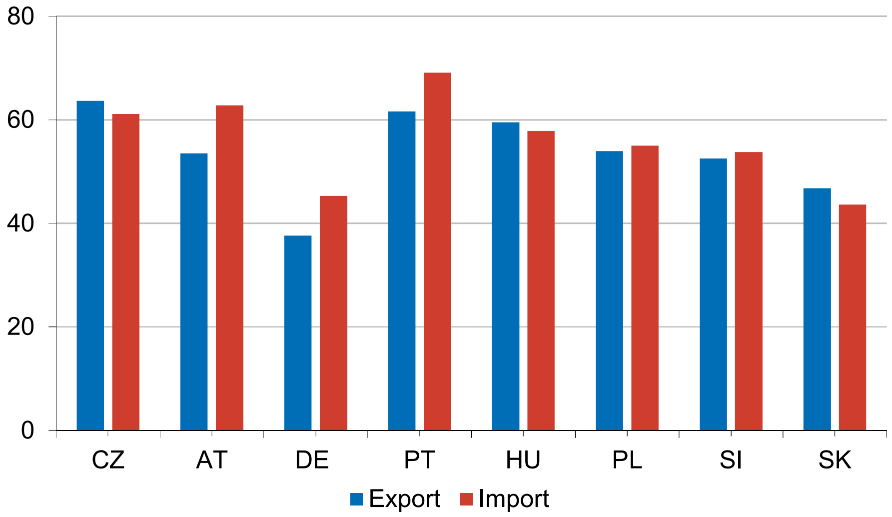
Fast convergence of **nominal interest rates** in connection with joining the euro area acted as an asymmetric shock in some economies in the past, generating macroeconomic imbalances and risks to financial stability. For a country planning to enter the monetary union, earlier gradual interest rate convergence is therefore an advantage. The fact that the difference between Czech and euro area interest rates has long been very low is favourable from this perspective. Three-month interbank market rates showed a slightly positive interest rate differential in 2009 and 2010, but this closed gradually and is now very close to zero. Government bond yield differentials against Germany also grew temporarily in early 2009 and again in 2012 H1, also due to increased financial market tensions linked with the escalation of the euro area debt crisis. However, the interest rate differential between Czech and German long-term interest rates has long been much lower than in the other non-euro area countries under review.

Another indicator of the possibility of sharing a single currency is long-term co-movement in the **exchange rate** of the national currency and the single currency against a reference third currency. This area has been strongly affected over the last year by a regime change in the form of the adoption of an exchange rate commitment by the Czech National Bank. After this commitment was announced in November 2013, the exchange rate stabilised just above CZK 27 to the euro. This led to an increase in the correlation between the exchange rate of the koruna against the dollar and the exchange rate of the euro against the dollar. However, this correlation had long been the highest and most stable of the Central European currencies and fell only temporarily during the global crisis and the subsequent European debt crisis.

The Czech economy's strong **trade and ownership links** with the euro area increase the benefits arising from the elimination of potential fluctuations in the exchange rate and the reduction in transaction costs. The euro area is the partner for 64% of Czech exports and 61% of Czech imports, a level comparable to, or even higher than, that in the other non-euro area countries under review. The share of intra-industry trade is relatively high as well (see Chart 3.3). After declining modestly in 2011, the degree of ownership links in the Czech economy, as measured by direct investment from the euro area, has returned to growth and is the highest of all the countries under review.

Chart 3.3: Share of exports to the euro area in total exports and share of imports from the euro area in total imports in 2014 H1

(in % of total exports and imports)



Source: Eurostat, IMF, CNB calculations.

The **financial sector** in the Czech Republic is still much smaller than that in the euro area. The depth of financial intermediation, as measured by the ratio of financial institutions' assets to GDP, is roughly one-quarter of the value for the euro area. In 2013, the share of bank loans to the private sector to GDP in the Czech Republic was 58%, less than half that in the euro area. However, the current level of the aforementioned indicators in the euro area is not necessarily optimal. On the contrary, in many countries it may reflect private and public sector overleveraging.

The **structure of the financial assets and liabilities of Czech non-financial corporations and households** is gradually converging to that of euro area entities, but still shows differences. For corporations, the difference is particularly visible in a higher weight of ownership shares (such as equities) at the expense of loans in their net debtor position, due to frequent foreign ownership. Corporations in the Czech Republic are showing the highest liquidity, although liquidity growth has also been visible in the euro area in recent years. The Czech corporate debt to equity ratio has been rising over time and is now higher than that in the core euro area countries under review. In response to tighter lending conditions, corporations in both the euro area and the Czech Republic have started to make greater use of bond financing. The structure of the financial assets and liabilities of Czech households converged to that of euro area households in the period under review, as the share of short-term liabilities decreased and total debt increased. The solvency of Czech households is close to the euro area average.

In the past, the **effect of monetary policy rates on client rates** in the Czech Republic was roughly the same as in the euro area. Rate transmission is fast, taking place within one month for most types of loans. The global financial and economic crisis led to a temporary slowdown and weakening of the transmission of monetary policy interest rates in the Czech economy as a result of rising client risk premia. However, this increase was comparable with that in the euro area core countries. The structure of interest rate fixations on new loans to non-financial corporations is similar to that in the euro area. The same basically goes for mortgage loans, although mortgages in the Czech Republic are dominated by loans with fixations of up to five years, while in the euro area longer fixations are more common.

Differences in **inflation persistence** in the monetary union countries could lead to the single monetary policy having different impacts. However, inflation persistence in the Czech Republic has long been average among the countries under comparison. The difference is not significant even compared to the euro area core countries. Inflation persistence thus does not pose a significant risk to the symmetric effect of the single monetary policy in the Czech Republic.

The analysis of **alignment of financial markets** (the money, foreign exchange, bond and stock markets) with the euro area reveals that synchronisation in the individual segments of the Czech financial market has long been mostly high and comparable with the euro area countries. After a sharp increase in fragmentation following the outbreak of the global financial crisis, the situation in the Czech financial markets started to improve in 2009 and then returned gradually to the pre-crisis degree of alignment on all markets under review. However, this trend continues to be conditional on active central bank policy-making focused on mitigating the impacts of the crisis, including unconventional measures.

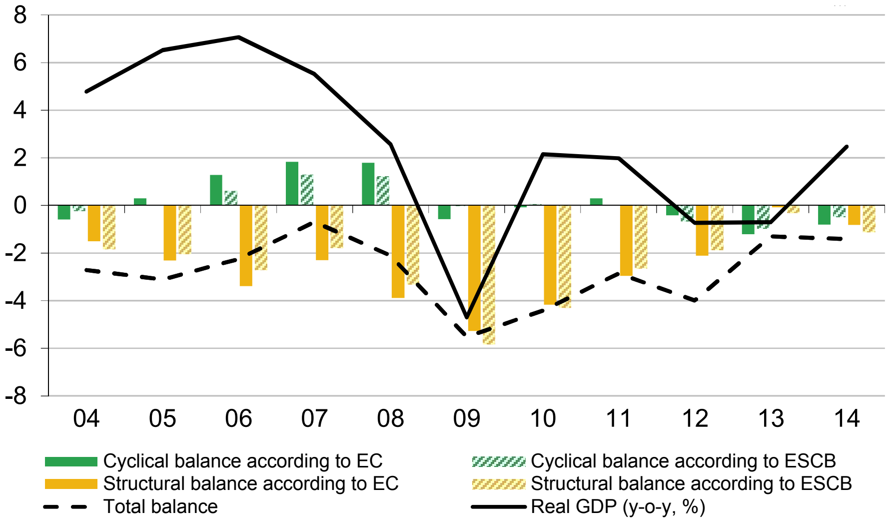
Despite a modest increase in the recent period, the degree of **euroisation** in the Czech Republic has long been low and is due to economic agents' high trust in the domestic currency amid sustained low and stable inflation and low interest rates. The use of foreign currency is thus concentrated primarily in the sector of corporations involved in foreign trade and in the commercial property sector. Unlike in the other countries in the region, Czech households' foreign currency debt is negligible.

3.2 Adjustment Mechanisms

If set correctly, **fiscal policy** – like monetary policy – should have a countercyclical effect and thus be a stabilising element for the economy. Otherwise it becomes a source of deepening macroeconomic imbalances and economic shocks itself. The closer the structural part of the public budget deficit is to zero and the lower is the accumulated public finance debt, the more room there will be at a time of economic downturn for automatic stabilisers to function and countercyclical discretionary measures to be implemented. Czech budget policy was characterised by chronic deficits and a procyclical effect for a major part of the period under review. Windfall tax revenues in 2006–2008 were not employed to reduce the fiscal deficit, but instead tended to be used to generate new public expenditures. Similarly, tax cuts in the period of rapid economic growth were not accompanied by corresponding austerity measures on the public expenditure side. Fiscal policy had the desirable countercyclical nature particularly in 2009, when government anti-crisis and other measures were adopted. In 2010, fiscal consolidation was commenced and budget deficits shrank markedly, albeit at the cost of a strong procyclical restrictive effect of fiscal policy in 2010–2013. In addition, the fall of the economy into recession in 2012–2013 made the government abandon its originally declared intention to comply with the medium-term objective (MTO) in 2015. Meeting this objective is a precondition for fiscal policy to be ready to fulfil its macroeconomic stabilisation role effectively after the loss of independent monetary policy associated with euro adoption. By contrast, the structural component of the government deficit is expected to increase again. Although the Czech Republic's total general government debt is lower than that of many EU countries, it has been showing very fast growth in recent years. The high and rising share of mandatory expenditure combined with the expected effect of demographic changes on pension system expenditure (this effect is mitigated by an increase in the retirement age adopted as part of parametric reforms of the pension system) and health care system expenditure also poses a risk to public finance sustainability. The preparedness to enter the euro area has thus improved overall from the fiscal policy perspective, but is still a limiting area.

Chart 3.4: The fiscal balance and its cyclical and structural components

(as % of GDP)



Note: The structural and cyclical balances are estimated using the methods of the European Commission and the European System of Central Banks. GDP and the total balances for 2014 and 2015 are the CNB's forecasts published in Inflation Report IV/2014. Positive values represent a public budget surplus and negative values a public budget deficit. The sum of the cyclical and structural balances does not equal the total balance since the structural balance is adjusted for extraordinary one-off fiscal measures in addition to the effect of the cycle.

Source: CZSO, CNB calculations.

The **labour market** is another important mechanism through which the economy can cope with asymmetric shocks in the absence of an independent monetary policy. There has been no significant – and, from the perspective of euro adoption, desirable – improvement in the flexibility of the Czech labour market since the Czech Republic joined the EU. The flexibility of the Czech labour market thus remains average overall by comparison with the other European economies. Both long-term unemployment and structural unemployment were rising slightly until 2013 owing to subdued economic activity, but are still among the lowest in the countries under comparison. The weak points in the labour market still include persisting relatively high implicit labour taxation and relatively low labour mobility. The total share of foreign nationals in the population was increasing until 2008 but then halted at lower levels than those typical of the advanced euro area countries owing to lower demand for foreign labour at a time of subdued economic activity. The Czech Republic still has large differences in unemployment across regions, despite the fact that they have shrunk by comparison with the pre-crisis period. On the other hand, the labour market is showing signs of greater flexibility, particularly in the form of rising countercyclical use of the number of hours worked.

The **institutional rules on the labour market** have a strong effect on its flexibility. The ratio of the minimum wage to the average wage was falling until mid-2013, when the minimum wage was increased. This has an effect mainly on low-skilled jobs, where a high minimum wage can greatly reduce wage flexibility and increase long-term unemployment. By contrast, overall labour taxation in the Czech Republic is relatively high, and has increased slightly further in recent years. The implicit taxation rate, expressing the average effective tax burden, is the second highest among the countries under comparison. The financial incentives for childless unemployed people to seek and accept a job are still low relative to the countries under comparison. Employment protection remains relatively strong for regular employment, but is lower for temporary jobs.

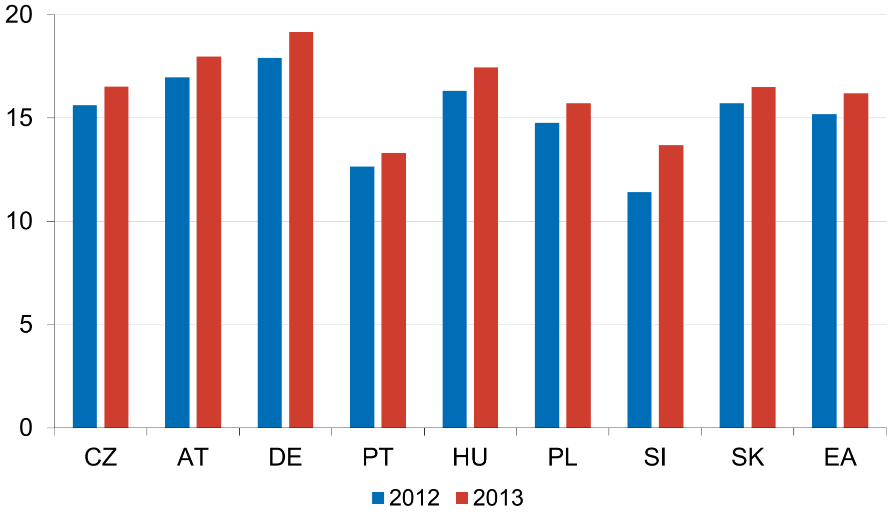
The **response of wages to the business cycle** can enhance the economy's ability to absorb shocks to which the single monetary policy cannot respond sufficiently. From the longer-term perspective, the Czech Republic shows a strong response of unemployment to the phase of the business cycle, although a slightly lower one compared to the euro area average. At the same time, a weaker, albeit positive, response to the business cycle is recorded for real wages, while in the euro area this relationship is not observed robustly. This suggests that in both the domestic and euro area economy the labour market absorbed negative shocks through higher unemployment rather than through wage cuts. In recent years, however, the Czech Republic has seen labour market adjustment through the aforementioned use of part-time work, and a decline in real wages has been recorded as well.

In the area of **product market flexibility** the Czech Republic is at a similar level in 2014 as in the previous year. However, the domestic business environment remains in some respects (starting a business in particular) more burdened with administrative obstacles than in the other countries under comparison. As far as the conditions for closing a business are concerned, the Czech Republic, along with the other countries under comparison except Hungary, is at a relatively good level in global terms. Although the Czech corporate tax rate, as measured by the statutory tax rate, is one of the lowest among the countries monitored, the overall tax burden as measured by implicit taxation of corporations in the Czech Republic is one of the highest.

Stability and effectiveness of the **banking sector** is a necessary condition for the sector to be able to absorb shocks. By contrast, an unsound banking sector can create shocks and propagate them to the real economy. It can also cause problems in the fiscal area, especially in the absence of an effective bail-in mechanism for involving shareholders and junior bond holders in resolving problems in banks. The Czech banking sector continues to display very good macroprudential indicators. Its high profitability, sufficient capital adequacy, relatively low NPL ratio and limited dependence on other countries rank it among the most stable sectors in the sample of countries under review. The domestic banking sector is therefore not a source of shocks and should be able to absorb fluctuations emanating from the domestic economy or from abroad.

Chart 3.5: Capital adequacy ratio

(in %)



Note: The capital adequacy ratio is the ratio of a bank's capital to its risk-weighted assets. It thus expresses the bank's financial strength and measures its ability to cover any future losses with capital.

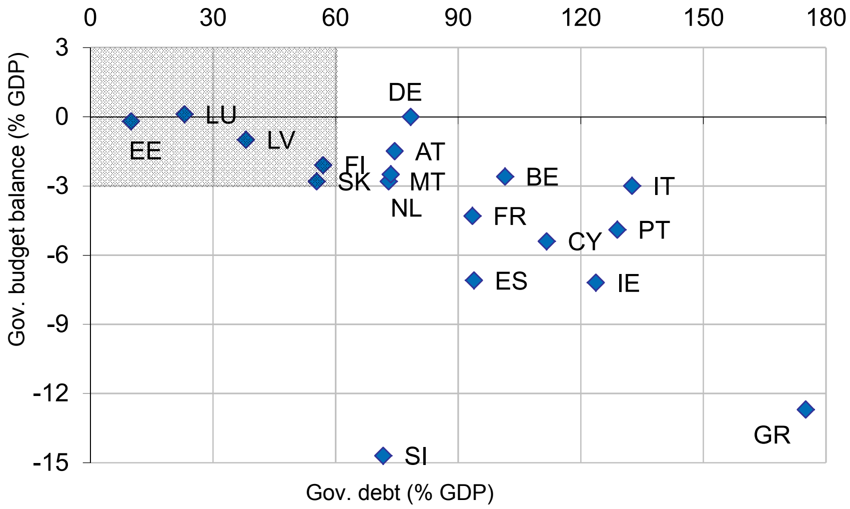
Source: IMF FSI.

4 Situation in the Euro Area and New Obligations for Accession Countries

Developments in the euro area in recent years deserve increased attention. On the one hand they are pointing to differences between the countries of the EMU, and on the other hand they are leading to a change in its institutional architecture and therefore significantly altering the costs and benefits of euro adoption.

Economic alignment of euro area countries is a basic prerequisite for the EMU to function smoothly. However, developments in recent years point to persisting shortcomings in this area. The southern periphery countries hit hardest by the debt crisis continue to record high unemployment, relatively high interest rates and low inflation (or even deflation) compared to the "core" EMU countries. The differences in GDP growth widened the most in 2008–2009 and again in late 2012 and early 2013 as the economies were hit by recession in different periods and to different extents. By contrast, the unemployment rate was initially converging, but since 2009 has been rising much more strongly in some countries. The financial and economic crisis was also accompanied by rising misalignment in the inflation rate. This misalignment has decreased again in recent years, but inflation convergence in euro area countries at very low average levels cannot be regarded as a positive trend, as it represents a risk to the still fragile economic recovery and complicates the resolution of the debt problems of the southern periphery countries. The risk of the euro area countries falling into deflation and slipping back into recession has meanwhile increased further. In 2010–2012, very large divergence could be seen for long-term interest rates, which reflect the different magnitudes of the debt problems across euro area countries. This misalignment has decreased since 2012 thanks to a calming of the market situation and to measures adopted by the ECB. The fiscal criteria laid down in the Treaty on the Functioning of the EU are at present met only by five of the eighteen countries (see Chart 4.1).

Chart 4.1: Euro area fiscal positions in 2013



Source: Eurostat.

Besides Latvia's accession to the euro area and the approval of Lithuania's accession, developments in the institutional framework of the euro area in 2014 were dominated by steps taken towards the successful launch of the banking union as set out by the European Council in December 2012.[6] Preparations continued for the launch of the Single Supervisory Mechanism (SSM) in November 2014. The shape of the Single Resolution Mechanism (SRM) was also agreed. Both mechanisms are meant primarily for euro area member countries, which have to participate under EU law. However, non-euro area Member States may also join the banking union by entering into "close cooperation" with the ECB.

Also related to the banking union is the direct bank recapitalisation instrument in the European Stability Mechanism (ESM), the form of which was preliminarily agreed on by euro area member countries[7] in June 2014. The agreement still has to be endorsed by the national parliaments of the contracting parties whose legal systems require such approval, and by a unanimous decision of the ESM Board of Governors (i.e. the euro area ministers of finance).

The ESM is a permanent mechanism designed to safeguard financial stability within the euro area. It has been operating since autumn 2012. Although the Czech Republic may theoretically adopt the euro without becoming a contracting party to the ESM, euro area members can make their consent to euro adoption in the Czech Republic conditional on ESM entry. If it joined the ESM, the Czech Republic would have to pay about CZK 51 billion[8] into the capital of the ESM within four years of entry. This estimate was calculated by the Czech Ministry of Finance on the basis of the ECB's capital subscription key, which is applied in this case. In addition, in the event of non-repayment of loans provided by the ESM or a large decrease in the contracting parties' solvency, the Czech Republic could be obliged to provide additional capital to the ESM. Should the ESM's lending capacity be used in full in the future, this contingent liability of the Czech Republic could climb to around CZK 391 billion.[9] In view of the current stabilisation/recovery of the euro area economies, the ESM's capacity is unlikely to be used in full in the near future (around EUR 49 billion of the ESM's total lending capacity of EUR 500 billion is currently lent or pledged).

Obligations relating to SSM membership: supervisory fees payable by banks

As from 2015, the ECB will levy supervisory fees on banks in all countries joining the SSM. It will not charge such fees to banks from countries outside the SSM.[10] The total amount of the fees[11] will be equal to the ECB's costs of supervision.

In the event of accession to the SSM and the banking union, the total amount of fees paid to the ECB by liable domestic credit institutions can be estimated at EUR 1.8 million. Therefore, the impact on the banks concerned should not be significant.

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[6] Source: European Council (2012).

[7] All euro area member countries also became contracting parties to the ESM at the same time. See also below.

[8] The change in the amount compared to the previous Assessment is due chiefly to a different exchange rate (CZK 27.4 to the euro, as against CZK 25), to the inclusion of the effect of Latvia's accession and Lithuania's expected accession to the ESM, and to revised assumptions regarding the specific form of accession (it is now assumed that the ESM's capital will be increased by the Czech Republic's full share of the instead of the capital being reallocated among the existing shareholders as previously assumed).

[9] See the previous footnote.

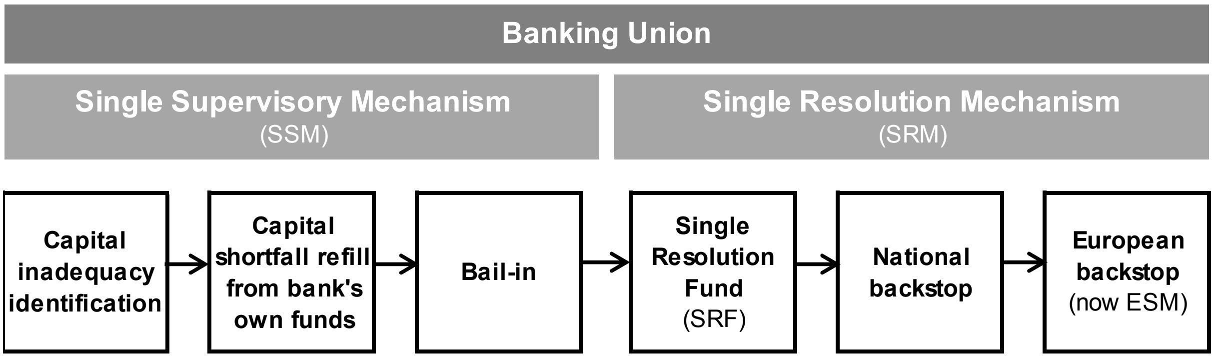
[10] The calculation of the annual supervisory fee does not take into account subsidiaries established in non-participating Member States. In this regard, and in order to determine the relevant fee factors for a fee-paying group of entities, the group should provide sub-consolidated data for all subsidiaries and operations controlled by the parent undertaking in participating Member States. See Article 10(3)(c) of the ECB regulation on supervisory fees of 22 October 2014.

[11] For 2015, these costs are estimated at EUR 260 million. The fee should have two components: a fixed (minimum) component equal to 10% of the ECB's costs of supervision, i.e. around EUR 26 million in 2015, and a variable component, totalling roughly EUR 234 million in 2015, allocated to banks according to their total assets and total risk exposure.

Obligations relating to SRM membership: transfer and mutualisation of SRF contributions

Probably the most important obligation relating to SRM participation is the transfer of contributions collected by participating Member States from their banks for the purposes of bank resolution[12] to the Single Resolution Fund (SRF). These contributions will be made available – at first only in part, but later fully – for bank resolution in other participating Member States by being transferred from the "national compartments". However, the other participating Member States will only be able to use these contributions once the troubled bank has been recapitalised from internal sources (by involving shareholders and creditors in a bail-in) and those Member States have used up a specified proportion of the contributions collected from banks in their territories. At the same time, it must be stressed that a participating Member State that makes the contributions collected in its territory available will reciprocally gain access to the contributions collected from banks in other participating Member States.

Chart 4.2: Scheme of the banking union



At the end of a transitional period the national compartments will cease to exist and the SRF funds will become indivisible. At that moment, the total SRF funds should correspond to 1% of the insured deposits of the participating Member States. The transitional period for euro area countries and other EU Member States that decide to join the banking union by 2015 should start on 1 January 2016 and last eight years (or a maximum of twelve years).

The commitment to transfer contributions collected from banks to the SRF and make them available to other participating Member States is laid down not in EU law, but in an Intergovernmental Agreement (IGA). The IGA stands outside EU law but is materially linked to it and may only be interpreted in a manner compatible with it.[13] The Czech Republic signed the *Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund* in May 2014. If the Czech Republic ratifies it, its provisions will start to apply to the Czech Republic from the moment of euro area entry, or banking union entry should the Czech Republic decide to enter the banking union before adopting the euro.

Under the IGA, the Czech Republic would have to pay about CZK 17.3 billion at the end of the transitional period in the event of joining the SRM. This estimate is derived from the current amount of insured deposits at the national level. Taking into the expected increase in such deposits over ten years (the period required to reach the target level of the national resolution fund), the amount would be CZK 25 billion. However, the actual level of the Czech

[12] The obligation of all EU Member States to collect similar contributions is stipulated in a directive of the European Parliament and of the Council on "recovery and resolution" in the financial sector (2014/59/EU).
[13] In addition, the parties to the IGA agreed that the necessary steps will be taken to incorporate the content of the IGA into the EU legal framework within ten years of the date of entry into force of the IGA.

Republic's SRF contribution would differ from these amounts, because the amount of insured deposits at the European level, or more precisely at the level of the participating Member States, will be decisive for the SRF target level. In line with the above, and on equal terms, the Czech Republic would also have access to the contributions of the other participating Member States upon the payment of its contribution. If only euro area countries were to participate, the target capacity of the SRF would total around EUR 55 billion.

Given the total assets of the euro area banking sector (EUR 30 trillion in 2013), however, even the aggregate financial capacity of the SRF together with the planned instrument of direct recapitalisation of banks from the ESM would not necessarily be enough to solve any major problems in the banking sector. On the other hand, the bail-in tool should help significantly reduce the potential demand for funds from the SRF and the ESM.

Potential costs relating to the Macroeconomic Imbalance Procedure

Further expenses in the form of financial penalties could apply to the Czech Republic after it joins the euro area if a macroeconomic imbalance[14] is identified and the Czech Republic fails to prove that it has made sufficient efforts to eliminate it. The 2014 Alert Mechanism Report (AMR) stated that the indicative threshold for the net international investment position had been exceeded in 2013. In line with the AMR 2012–2014 conclusions, however, the Czech Republic was not subjected to an in-depth review as part of the surveillance of macroeconomic imbalances.

Outlook

The uncertainty regarding the future economic policy and institutional architecture of the euro area has decreased in recent years, but some questions remain. At its June 2014 summit, the European Council approved strategic priorities for the next five years. These include stronger euro area governance and stronger economic policy coordination, convergence and solidarity. In addition to the standpoints of the Member States, much will naturally depend on the positions of the newly elected European Parliament and the new European Commission. The new President of the European Council and of the Euro Summit will undoubtedly also attempt to influence the future course of economic integration.

[14] The Macroeconomic Imbalance Procedure (MIP) was introduced in 2011 as part of the "Sixpack". Since 2012 the MIP has been part of the European semester and has also been included in the Convergence Reports prepared by the European Commission and the European Central Bank.