Selected European topics and euro adoption in the Czech Republic 2024

Czech National Bank —— Euro Survey —— 2024

CZECH NATIONAL BANK

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I. INTRODUCTION

This year, we again conducted a survey of analysts on current economic issues related to the EU and the expected entry of the Czech Republic into the euro area. Following an initiative of the president of the Czech Republic, the topic of the introduction of the euro in the Czech Republic has come to the fore and is being discussed more often, meaning that – unlike in other years – the survey itself is highly topical. The results show a significant diversity of opinions, even within the relatively small sample of respondents, and therefore it is very difficult to establish the mainstream. At the same time, this confirms that the topics discussed are complicated and often do not present any easy solution. Therefore, rather than looking for clear directions, it is useful to accept that there is a wide range of arguments that should be addressed, or at least taken into account, in the debate on the EU and the adoption of the euro in the Czech Republic. However, it is clear from the responses that the EU faces a number of difficult challenges that will have to be dealt with in some way. Also, the earliest realistic date on which the analysts on average expect the Czech Republic to be able to meet its commitment to join the euro area has not changed since last year. This time, unlike the usual situation in the past, the Czech Republic's expected date for joining the euro area has therefore not been postponed.

We thank all those who provided contributions to the survey – they are much appreciated. However, it should be noted that the opinions expressed in this survey are those of the participating respondents and do not necessarily reflect the official views of the CNB.

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II. CURRENT ISSUES FACING THE EU

What do you consider the most important challenges for the EU and how do you think they should be resolved?

Given the current situation in Ukraine, the key challenges for the EU are naturally security, the future geopolitical order and the general global geopolitical situation. Although the EU's defence policy is being strengthened, it is still not sufficient and the analysts indicate that defence spending should be further increased. The ongoing war in Ukraine may mean the EU is acting much more in unison, and the necessary structural changes, mostly in energy, are accelerating. However, security should also be supported through efforts to bring the bloc's members closer together, especially as regards their stance on the war in Ukraine. In this context, it is important to continue to support the attacked country and to cooperate with NATO.

An excessive administrative and regulatory burden is considered another major challenge that the EU currently faces. Regulation and innovation are considered to be at odds in many respects. This is largely related to the current form of ESG policy and the Green Deal. The result has been a significant increase in energy prices, as the energy transition is not going according to plan and the costs for companies and households are huge. This, together with the unavailability of raw materials, unfavourable productivity developments and the appreciation of the real effective exchange rate, has had a very negative impact on the competitiveness of European firms on the domestic and international markets (energy prices for companies in the EU have risen by around 220% on average since 2015, by 17% in the US and by 4% in China). Expensive energy also negatively burdens household budgets and erodes real purchasing power. From this point of view, the shutdown of nuclear energy can be perceived as an irresponsible step. The energy situation is thus a call for transformation, which should include the further reduction of energy dependence on Russia.

In addition to climate policy, however, similar regulatory problems are emerging elsewhere, for example with the GDPR, as scientific studies (and thus education) are being moved abroad due to formal restrictions. Some think that this ongoing process is already having devastating effects on research and development, whether in healthcare or artificial intelligence research. Another problem is associated with the absence of funding and research concepts for artificial intelligence and microchip production. The EU's support in this area compared to that in the US is considered ridiculously low. Shortcomings are also seen in the preparation of credible concepts for the EU as a whole. Relaxing a number of rigid rules, removing (at least partially) bureaucratic burdens (with the aim of promoting entrepreneurship), rethinking ESG policies and maintaining competitiveness should therefore be among the EU's key goals. It is therefore important to rethink priorities and set long-term, rational goals that correspond to the real world, taking into account economic growth, politics, security, energy policy and conflicting climate policy interests. It would certainly be beneficial to improve the attractiveness of Europe for innovative companies whose products have higher added value, either by reducing the administrative burden or by making the tax environment more attractive.

Another significant challenge that the analysts see is the preparations for the enlargement of the EU to include more countries such as Ukraine, Moldova and Georgia. The EU should provide the necessary assistance for reforms in these countries. Another long-term weakness that the EU faces is slow decision-making. In this context, and also with the anti-EU attitudes of the governments of some Member States, the question arises of whether the voting system should be changed and whether the veto principle should be maintained. And last but not least, there are also difficulties in demographic development and the ageing of the European population.

What is your current opinion on ESG policy and the European Green Deal?

The views on ESG policy and the Green Deal are mixed. On the one hand, they are seen as a necessity due to climate change, as global warming is very likely to occur as a result of human activity. ESG and the Green Deal then provide frameworks for putting this phenomenon on the agenda of important tasks. As this is an irreversible process, it is necessary to accept the Green Deal and not stay outside the mainstream. The agenda naturally brings risks but also opportunities.

However, ESG arouses scepticism among a significant part of the public, so it is necessary to spread the necessary awareness. In particular, it is important to emphasise that this is not a measure aimed against economic prosperity and that the differing initial positions of the individual states are taken into account, i.e. the targets for the Czech Republic are less ambitious than those for more developed countries, and that the affected regions or households have support available, for example from EU funds.

On the other hand, critics see ESG as a very expensive sum of ideas that will lead to formalism yet will not help the matter. The Green Deal is, from this perspective, based on ideals and faith in technological progress that has not yet taken place. It brings a lot of rules and plans without feasibility and impact studies. Although these are commendable environmental-protection ideas, the implementation itself is leading to increased costs for European companies (whether through the increase in the price of production inputs or the need to create additional "unproductive" jobs for reporting and compliance tasks due to the further increase in the complexity of regulatory measures). This is only making the already weak competitiveness of the European economy fall further behind.

Another common problem, at least as regards finance, is "greenwashing", where the real change is small but the output is "painted green". Many steps are being taken because they must be done, even if the environmental benefits are questionable. The approach then preferred is to comply with the regulatory minimum and not to be a leader of change. The situation is similar with some of the objectives of the originally approved regulation, which are now being relaxed and changed. Therefore, it is important to strictly distinguish between environmental protection and some would-be green policies or approaches.

A more conciliatory approach would be to link sustainability and prosperity more strongly. Promoting sustainable-growth parameters and ideas does not have to be in conflict with the growth of wealth and quality of life, as long as ESG decision-making goes through a critical assessment of costs and benefits. In other words, it needs to be ensured that ESG does not become a bureaucratic goal in and of itself. If the administrative burden exceeds a reasonable limit, it will not serve its original purpose and will lead to an outflow of companies and their operations abroad. The Green Deal is also ripe for revision in terms of its goals and the timeframe for achieving them, because if there is no feasible and credible plan, even a good goal will eventually be discredited. In general, it would also be sensible to focus more (as in the US) on a "business support" system during the energy transition.

Will the December 2023 reform improve the enforceability of the fiscal rules? Will the debt of European countries be reduced, or will the configuration of the system as a whole encourage free riding?

Optimistic and pessimistic opinions clash again here. The optimistic ones see the 2023 reform as a significant contribution to increasing fiscal discipline and setting a trend towards improving fiscal positions, as any agreement on the sustainability of public finances is positive in the context of high European debt. Moreover, in the current environment of higher interest rates and more expensive financing, it will be necessary to build up the necessary reserves when implementing fiscal policy. According to some of the respondents, this is the right direction if only because the enforceability of fiscal rules has become more realistic. A more differentiated approach for individual states can also be highlighted, i.e. the possibility of gradually reducing debt while maintaining sustainable growth.

However, for the new system to work, it will be essential to insist on compliance with obligations, meaning to enforce fines for failure to fulfil obligations. Hence the scepticism of some of the analysts, who do not expect a significant change or shift. If the rules are not enforced, which is something that happens in the euro area not only when crises occur, it will be difficult to change anything substantial. It will always be about political preferences and the will of politicians. The higher deficits of Italy and France will likely be handled differently than they would otherwise be. Similarly, there are other phenomena, such as when the behaviour of some members (e.g. Slovakia) is more akin to free-riding (fiscally irresponsible behaviour at the expense of others). And some are of the opinion that the free-rider principle has actually been strengthened by the ECB, so compliance with the rules will be significantly influenced by its stance. However, in general, public budgets in the EU are still in better shape on average than in the US, for example.

How do you assess the common European bonds under NGEU? Is this a step towards a fiscal union? Should the EU or the euro area become a fiscal union? Why?

The NGEU, or any common European bonds, can be seen as an example of the Salami Method, moving the EU towards a fiscal union but without a clear and transparent decision. The question is whether this is a step in the wrong or right direction. On the one hand, the money from these bonds is often understood as free money or a gift, and the fact that it will have to be repaid one day is forgotten. Probably also by increased contributions by individual states to the common budget. However, a shift to a fiscal union could help the euro area, among other things, to finance common European goals (let's leave aside the question of the adequacy and choice of these goals, whether in sustainability or the development of modern technologies).

It also turns out that it is difficult to have a monetary union without a fiscal union. This also supports the theoretical view that in order for the euro area to move closer to an optimal currency area, it needs to balance the single monetary policy with a strong fiscal policy. For example, fiscal integration of the Union may also be necessary to suppress or eliminate the recurrent euro crises. For the time being, however, the shift to a fiscal union is not seen as a priority, while according to some opinions, the public is not in favour of it either. The fact that this is a sensitive topic is evidenced, for example, by the discussion on single deposit insurance.

According to the analysts, the threat of free-rider behaviour is a significant risk for a fiscal union or common bonds. It will be difficult to avoid free-rider abuse until the Member States have their public budgets in order. Instead, a more politically feasible, though still very unpopular, move is stronger and firmer coordination of fiscal policy and budget transfers. So, while this is a desirable direction for Europe in the long term, it is unrealistic in the short term. In the short term, it is also very difficult to establish political consensus on the unification of large expenditure policies, especially in the social area.

There are alternative views that NGEU bonds may not represent a major step towards a fiscal union, the operation of which is difficult to imagine. However, the NGEU can be considered an important source of funding from some perspectives. For example, the EC recently stated that investments financed under the Recovery and Development Fund have contributed to tangible results with the potential to increase the EU's real GDP by up to 1.4% in 2026. At the same time, the NGEU could be a financial source of support not only for the EU itself, but also for Ukraine.

What is your opinion on the possibility of limiting or abolishing the right of veto in the EU? Would this streamline or enhance the decision-making process in the EU?

Even within our relatively small group of analysts, there is a wide range of answers to this question, ranging practically across the entire scale and distributed almost evenly. There are three clear opinions that limiting the right of veto would make the decision-making process more efficient.

There is one compromise approach, according to which the limitation of the right of veto makes sense in some areas and not in others. Another conciliatory opinion is that limiting the unanimity principle and the right of veto of individual states is a step towards improving the Union's ability to act, but on the other hand may lead to a reduction in the level of identification of smaller EU Member States with this institution.

The remaining three respondents are unequivocally opposed to restricting the right of veto. In their view, it would not lead to better and higher-quality decision-making, but would primarily lead to a strengthening of the position of several larger states, such as France and Germany. In many economic respects, the impact of large states is already so fundamental that they influence decision-making and voting more than proportionally. They do not see any greater benefit for the functioning of the EU here. In addition, it is not a good idea to remove safeguards that protect smaller and weaker states. Even if the right of veto is exercised, there is no guarantee that the demands of the state that exercised the right will be met. Finally, without the right of veto, the incentive to compromise in negotiations could be weakened. In the opinion of one respondent, the abolition of the right of veto is also not appropriate because decisions in the EU are made without proper analysis. Including in foreign policy. The attitude of the large EU Member States at the beginning of the war in Ukraine may serve as a warning.

III. MONETARY POLICY

Did the Czech Republic benefit from having independent monetary policy when dealing with the pandemic and energy crises (or the subsequent high inflation)?

Only one respondent does not see any tangible benefits of independent monetary policy in the Czech Republic during the recent crises. For comparison, the example of Slovakia is presented, where without independent monetary policy and with a similar economic structure, higher real economic output has been achieved since 2020 with lower accumulated inflation than in the Czech Republic.

As last year, the vast majority of respondents are convinced that independent monetary policy has been beneficial in overcoming the pandemic and energy crisis. From a theoretical perspective, the EU is not an optimal currency area, mainly due to significant structural differences between the individual states. Independent monetary policy is therefore beneficial for the Czech Republic at the moment and helps it better cope with various economic challenges. In addition, one respondent said that independent monetary policy is also useful when dealing with the consequences of economic crises.

Earlier and more aggressive monetary-policy tightening in recent years can be seen as a noticeable benefit, as it helped cool inflation more effectively. With higher inflation, the Czech economy would hardly benefit from the ECB's relatively relaxed monetary policy. In addition to the different nature of inflation in the Czech Republic and the euro area, the domestic property market was also overheated. The labour market was also very tight, with labour shortage problems persisting even during the pandemic and the energy crisis. The influx of Ukrainian immigrants has not helped much in this regard.

In the context of monetary policy conduct during crises, the ECB, which would take over responsibility for monetary policy in the Czech Republic after euro adoption, has been criticised to some extent. This is because unlike the CNB, the ECB underestimated and relativised inflation at the beginning, according to some opinions. In addition, the CNB is a standard central bank, while the ECB has entered a territory where a central bank is not supposed to operate. It has become the financier of the irresponsible budgetary policy of euro area Member States and an agile promoter of green policy, while a central bank's goal should be to ensure low inflation and financial stability.

By contrast, a significant disadvantage of independent monetary policy compared to a single monetary policy is seen in its higher susceptibility to local political influences and other interests.

Do you consider the current level of interest rates in the Czech Republic and the EUR/CZK exchange rate to be appropriate?

Most of the analysts share the view that the current level of interest rates has been set adequately in view of the state of the economy. The CNB's optimal rate settings are of course changing with new economic developments – the decision to gradually reduce interest rates as inflation fades towards a neutral level is considered correct. However, the CNB should not forget that the koruna now rests on the interest rate differential, so it should proceed carefully and predictably when lowering interest rates.

Again, however, there is a group of analysts with the opposite opinion. Given that real economic performance is anaemic, the current monetary policy stance can be regarded as highly restrictive despite the fact that inflation is close to the CNB's target. Given the state of the economy, some advocates of a more activist monetary policy say that key interest rates should have risen faster, and should now come down faster. Rates should therefore be lower, but against the background of persistent pressures in the services sector should not fall as low as in previous interest rate cycles. The 2W repo rate is expected to gradually fall to 3.5%-4% at the end of this year and to 3.5% at the end of next year, or lower.

The koruna exchange rate, which was CZK 25.17 to the euro at the cut-off date, was considered by the analysts to be reasonable or slightly undervalued. However, the slight defensiveness of the koruna in recent quarters (also as a result of the fall in domestic rates) is currently not harming anything. The development of the CZK is now also significantly affected by the USD/EUR exchange rate. Market pressure for a possible weakening (in an environment of rapid CNB rate cuts) is likely to be dampened by the start of the ECB's and later the Fed's rate-cutting cycle. A trend of appreciation of the koruna is expected in the coming years. In the long run, the exchange rate reflects the good structural position of the economy and therefore a potential weakening should be prevented by the CNB.

What is the monetary policy-neutral level of nominal interest rates in the Czech Republic?

According to the analysts, the nominal neutral interest rate in the Czech Republic is slightly higher than in the past. They currently estimate it to be in the range of 3% to 4%, assuming that the CNB's 2% inflation target is met. This thus represents between 1% and 2% in real terms. One reason for the increase in the neutral interest rate may be the higher demand for capital and investment related to the energy transition. Another aspect is the positive net migration to the Czech Republic. Persistent pressure from the labour market and property prices may also contribute to the rise in the neutral interest rate, which leads to nominal convergence, which has also started through the price channel. This, together with geopolitical factors and deglobalisation tendencies, may, according to some opinions, lead to inflation staying close to the upper boundary of the tolerance band. With the real component staying at a constant level, the nominal monetary policy-neutral interest rate moved up accordingly along with the higher inflation.

How do you see the future of central bank digital currency, for example, the digital euro?

The analysts do not agree on the answer to this question either. Their sceptical group sees nothing in central bank digital currency that could not be done without it. The more critical of them believe that central banks should not take this path, as there is a significant risk of abuse of control over a digital currency. If institutions could fully control citizens' access to money and transactions, the danger of introducing sanctions for "undesirable individual conduct" would be very high. This increases the likelihood of abuse in restricting personal freedoms. Similar attempts can be seen in China in the area of social scoring. If there is a possibility of abuse, it will probably be used in some form one day.

On the other hand, the optimistic group of analysts considers that the central bank's digital currency has a future in the euro area as payments are moving online. This method suits more and more people and the proportion of such people is likely to continue to increase. The conservative view is that the digital euro will be introduced after a trial phase, but will only be a complementary payment instrument to the cash euro. In any case, for the central bank, the digital currency could be another tool it can use to conduct monetary policy.

IV. THE CZECH REPUBLIC'S ACCESSION TO THE EURO AREA

What are the main pros and cons (risks) of the Czech Republic joining the euro area?

The **advantages** mentioned by the analysts if the Czech Republic, with its small open economy, enters the euro area include direct savings for business and tourists – i.e. transaction costs, or the elimination of exchange rate risks, which are, however, already relatively manageable for exporters and importers through hedging. At the same time, a common currency increases pricing transparency for tradable commodities and the comparability of income (salaries). At the same time, the Czech Republic would become a member of the EU core, which may improve its credit and strengthen its negotiating position. However, progress in digitalisation may reduce the savings from transaction costs or other costs.

One risk associated with the introduction of the euro may lie in overly high expectations. The euro alone will not guarantee prosperity for the domestic economy. One example of this is Slovakia.

On the other hand, the loss of the state's own monetary policy (both the possibility to set key interest rates and the movement of the independent currency) is a clear **disadvantage**. In addition, the euro area is a very heterogeneous and sub-optimal monetary union, and this entails a sub-optimal monetary policy stance and can be painful, especially in times of crisis. At present, ECB policy would probably bring a more inflationary environment and a likely gradual loss of competitiveness. The opposite result would require more fiscal policy activity.

The koruna exchange rate acts as something of a buffer that dampens or partially absorbs external shocks, thereby preventing them from fully passing through to the real economy. At least temporarily, therefore, an increase in fluctuations in economic activity cannot be ruled out if the euro is introduced. The fixing of the exchange rate, which will affect the wealth of the population once and for all, can be considered another disadvantage.

Last but not least, effective supervision of the domestic financial market may be lost.

Given the state of the financial sector in the Czech Republic (the condition of banks, the functioning of regulation, etc.), macroeconomic developments in the Czech Republic and the euro area (heterogeneity), and developments over the last 10 to 20 years, some believe that there is no significant and concrete positive benefit from adopting the euro (e.g. the elimination of exchange rate fluctuations applies only to certain groups and is not a universal benefit).

Do the economic pros of the Czech Republic joining the euro area currently outweigh the cons?

We did not receive a unanimous answer to the question of whether the economic pros of the Czech Republic joining the euro area would currently outweigh the cons. While five respondents believe that the pros are not large enough to outweigh the cons, the remaining three analysts see it the other way around and, in their eyes, the pros do outweigh the cons.

How would you assess the current economic and political preparedness of the Czech Republic to enter the euro area?

The analysts believe that although the Czech Republic does not currently fulfil the Maastricht criteria, it could be economically and technically ready to join the euro area relatively quickly and could meet the essential admission conditions within the necessary technical deadlines. There is even one estimate that three years would be sufficient. In this respect, the changeover to the single currency should not be too burdensome for the Czech economy under normal conditions. In addition, a significant part of business is already beginning to be euroised.[1] This is also being fostered by the gradual introduction of the functional currency in the accounts of many export-oriented firms. Difficulties may arise in the event of greater frequencies of asymmetric shocks in the coming years, such as due to decarbonisation and deglobalisation, or the onset of a traditional crisis, which may increase the importance and benefits of independent monetary policy.

The main problem for entry is, however, low political preparedness. The euro is rejected by the majority of society and there is no clear political consensus. In the Czech Republic, the negatives associated with the EU, such as excessive regulation of everything, are perceived much more than the positives, such as the influence of the EU cohesion funds. Czech society is highly polarised on this topic, as demagoguery and emotions prevail on the part of both supporters and opponents.

According to one analyst, comparing the pros and cons is a bit like comparing apples (microeconomic benefits) and pears (macroeconomic risks). The Czech Republic can exist just as well both inside and outside the euro area.

Should the Czech Republic step up its preparations for euro adoption? What initial steps should the government take in this area?

The group of respondents who believe that the Czech Republic should be more active with regard to the possible adoption of the euro in the Czech Republic is slightly predominant as regards this question. It is essential to choose a unified strategy through agreement across the governing parties. After that, it will be crucial to determine the date of entry into the euro area as the necessary steps to achieve this goal will depend on this. First and foremost, the consolidation of public finances and the initiation of reform steps – in pensions and taxes. Preparations for euro adoption in the Czech Republic must be carried out in such a way as to limit the stay in ERM II to the shortest possible time. In addition, before adopting the euro, politicians should start negotiating the conditions, including issues related to joining the banking union. It will also be necessary to increase public perception of the attractiveness of being part of the core of the EU.

In the group of analysts who believe that there is no need to intensify preparations for joining the euro area, there are opinions, for example, that there is actually no reason for this from an economic or financial perspective, as it is a purely political step. However, this does not mean that the Czech Republic should not meet the conditions for adoption, such as reducing deficits and ensuring the sustainability of public finances. The Czech Republic should put its public finances in order in its own interest, not because of the euro.

What factor (what potential trigger) will ultimately decide the Czech Republic's entry into the euro area?

Virtually every analyst considers something different as a potential trigger for the Czech Republic's entry into the euro area. For example, if it becomes clear that the Czech Republic is missing the boat and that the pros outweigh the cons.

Another reason may be the gradual euroisation of the economy, which would lead to a reduction in the effectiveness of CNB policies. Similarly, the adoption of the euro may be accelerated if the CNB fails to manage a crisis. Such a scenario could be, for example, support for rapid public debt growth through excessively low real rates. Any excesses, or the CNB's inability to prevent them, could then undermine the argument about the benefits of the Czech Republic having its own monetary policy.

If the Czech economy is overtaken by Poland in terms of prosperity and medium-term growth, or if other states, such as Poland, adopt the euro, may also be triggers for the Czech Republic's entry into the euro area.

[1] However, euroisation in the Czech economy is very asymmetrical – with households it is at a minimum level, and with firms mainly on the liabilities side.

In the political sphere, a strong leader ("opinion maker") may emerge who is able to reverse public opinion or mitigate the Czech public's negative stance towards adoption of the euro (for example, the current president of the Czech Republic). This could then induce a change in the positions taken by other politicians.

One turning point could be the result of parliamentary elections if they are won by a coalition that has the adoption of the euro on its programme. However, some form of shift in society's approach to the euro will be necessary as there is still a lot of resistance. In the best case, the economic interest of the majority of the Czech population will prevail – for example, when companies become able to explain to their employees why the euro is good for them. Or, in the extreme case, the process of adopting the euro will be triggered by a political decision regardless of the consequences.

When do you expect the Czech Republic to enter the euro area?

Naturally, the answer to this question is very complex and practically is akin to crystal ball divination. However, the analysts found the courage to provide us with some rough estimates. There were however major differences in the responses. Yet compared to last year's survey, the overall message is somewhat less sceptical. It is worth remembering, for example, last year's statement that "it would be better to stay outside the euro area for at least 30 years and then reconsider the situation." Now the most pessimistic voice says, "Answers are usually NEVER correct, but I see the chance of the Czech Republic adopting the euro in the foreseeable future (5-10 years) to be minimal." All the other respondents could imagine the introduction of the single European currency in the Czech Republic by 2040 at the latest. If we calculate a rough average from the answers received, we get the first third of 2031. As in the previous survey, this must be taken with extreme caution, as the analysts often added a note to their estimates stating that in their view this is the first possible realistic date, and admit it is very likely that the euro adoption date will be later than this.

As indicated in the chart below, the expected time until euro adoption in the Czech Republic has had a gradually increasing trend over the course of our survey history. This year's result goes against this trend and, on average, the expected euro adoption date is less distant from the survey date than in the past two years.