

EA OUTLOOK AND EXPECTED EURO ADOPTION SURVEY OF ANALYSTS' OPINIONS

Financial Markets Department
Operations Analyses Division

2017

Summary

Nine respondents, including one from abroad, took part in this year's survey to obtain the views of analysts from leading financial institutions on selected topical EU issues and on euro adoption in the Czech Republic. According to the respondents, the EU is facing substantial risks at the political, economic, and economic policy levels. One example is Greece, where the fiscal situation is not considered sustainable. Nevertheless, despite persisting difficulties in the financial sector (especially in Southern European countries), an escalation of the problems – which could lead to a systemic banking crisis – is not expected in the near future. The analysts are also highly critical of the increasing bank regulation. The EU financial sector not only will have to cope with its existing problems and stricter regulation, but will also face new challenges (e.g. FinTech).

Although the analysts expect that the UK will indeed leave the EU within two years, their views on mutual trade arrangements differ widely. However, Brexit is not expected not trigger a wave of exits by other countries in the immediate future.

Euro area inflation is expected to remain close to 2% in the coming years. The ECB will gradually move away from unconventional monetary instruments. QE could be ended during 2018, the most frequently mentioned form being a tapering of purchases. The current divergence between Fed and ECB monetary policies could result in a weaker and more volatile exchange rate of the euro against the dollar.

Most of the respondents believe that economic pros of the Czech Republic joining the euro area do not yet outweigh the cons (although the number of analysts holding the opposite view has increased since last year), although they do admit that the euro will one day become legal tender in the Czech Republic. However, the average expected entry date is eight years away and, moreover, is subject to considerable risks – on the side of both the Czech Republic and the euro area – which might cause it to move further into the future. The analysts are also highly sceptical about the Czech Republic participating voluntarily in the banking union.

The participants in this year's survey of expected euro adoption in the Czech Republic were:

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Michal Brožka, Raiffeisenbank
Petr Dufek, ČSOB
Petr Sklenář, J&T
Jan Kudláček and Ondřej Kurečka, AXA investiční společnost
Emily Mansfield, The Economist Intelligence Unit
Michal Šoltés, Roklen
Patrik Rožumberský, UniCredit Bank
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The views expressed in this document are based on a survey among the participating analysts and do not necessarily reflect the official views of the CNB.

SELECTED EUROPEAN QUESTIONS

1. EU RISKS AND OPPORTUNITIES

The biggest risks to the functioning of the EU?

Given the large number of potential problems identified, **the analysts' confidence in the efficient functioning of the EU** is relatively **weak**. The wide range of risks to the smooth functioning of the EU can be divided into three key and overlapping areas: economic, economic policy and political.

The persisting difference in the Member States' economic levels is considered a major **economic risk**. This difference is tending to widen. The financial problems of Southern European banks, especially in Italy, were also mentioned.

According to some of the analysts, the very existence of a monetary union without a fiscal and political union is a major complication in the **economic policy area**, as fiscal policy stances are not sufficiently coordinated across countries. Even in the case of monetary policy, where integration is the deepest, there are repeated signs of different views on ECB policy. According to the analysts, overregulation, structural imbalances and inconsistent enforcement of rules, resulting in greater moral hazard, are another pressing problem. Also criticised were the efforts to unify the tax system, which could cause slower economies to lose the option of tax competition with economically stronger countries.

The **political risks** include deeper integration without explicit public consent,¹ the absence of a conceptual strategy for the future development of the EU, differences of opinion, and an insufficiently functional decision-making mechanism in an overly heterogeneous group such as the EU. This may be further complicated by negotiations about the conditions of exit from the EU, with individual states putting their own interests ahead of a unified approach. In addition to a lack of political will to implement reforms to safeguard a solid rate of economic growth coupled with the need to consolidate public finances, the growth in the popularity of Eurosceptic and populist parties pushing for the dissolution of the EU is also a very current threat.

Might the problems in Southern European banks result in a banking crisis?

A clearly prevailing view among the respondents is that the current poor condition of the banking systems in Italy, Greece and Cyprus will most likely not result in a systemic banking crisis at the national or regional level. However, this does not rule out persisting financial problems in individual financial institutions, problems which may, in the extreme case, lead to individual collapses, albeit with smaller repercussions for society as a whole. The banking sector as a whole is considered to be stabilised and in a better condition than during the recent debt crisis. The establishment of a stabilisation fund and a mechanism to cover losses was a major undertaking by Brussels in this area.² The tolerance of the ECB as a regulator and, simultaneously, a lender (through the Eurosystem) is also very high.

¹ The democratic deficit, as one of the respondents calls the absence of explicit consent of EU citizens to deeper EU integration, might give rise to protests and, in the extreme case, the exit of some Member States from the euro area.

² The example of Italian banks shows that the state will always be the end creditor.

Do you consider Greece's current fiscal policy stance to be sustainable and its debt situation to be stabilised?

All the respondents believe that the **fiscal situation in Greece is not stabilised and will not be stabilised without assistance from third parties** (e.g. multilateral institutions or the EU). Government debt is the biggest problem. According to some of the analysts, it is unsustainably large in the absence of at least partial write-offs or maturity extension (as proposed by the IMF). However, the negotiations about a debt write-off between the IMF and Europe will be largely paralysed by this year's elections in Germany, as it is a major lender and an opponent of any further adjustment of the assistance parameters and it fears a precedent being set for other indebted euro area countries. Moreover, given the projection of **low GDP growth and the current Greek government's refusal to implement austerity measures**, no marked decline in the debt-to-GDP ratio is expected.

Another big problem is a **lack of will to implement structural reforms** to transform Greece into a competitive economy. One analyst even estimates that developments in Greece will, with 60% probability, result in Grexit within five years due to problems with implementing and financing the bail-out programme, failure of which would lead to weaker/undermined political will to keep Greece in the euro area.

Do you expect the new US president to have any impacts on the euro area? If so, what?

The analysts' answers to this question carry a wide range of messages – from **expectations of negligible changes, through growing uncertainty and protectionism on both sides of the Atlantic** (including related changes in export destinations and export structure), **to the threat of an outbreak of currency wars**. Such wars could hamper the already low growth rate of euro area exports and negatively affect euro area economic growth. Their negative impacts would probably outweigh the short-term benefits that the possible fiscal expansion in the USA might have on export performance in the euro area.

On the other hand, there were thoughts that the US sanctions against Russia might be relaxed, which, in turn, would exert pressure for an easing of anti-Russian sanctions in Europe. The USA's new attitude to NATO, which could be reflected in higher defence spending, was considered as well. Also mentioned was a purely political aspect, namely the rise of populist candidates in elections. Conversely, failure of the Trump administration might stop a massive wave of populism sweeping through Europe.

What FinTech opportunities and risks do you see for the development and stability of the EA/EU financial market?

FinTech is a challenge for the financial sector, as it may gradually create competitive pressures in the areas of prices and new technology, disrupt the hegemony of traditional financial institutions and reduce their profitability. Coupled with the problems of the Italian banking sector, for instance, this could pose a major risk. However, **FinTech will also be a regulatory challenge**, as there are concerns about the emergence of an overregulated banking sector living side by side with another, unrestrained one. On the other hand, FinTech contains a large number of RegTech solutions, i.e. automation and increased efficiency in the areas of compliance and fraud detection, and better analysis of large datasets. This **could** eliminate many risks, **strengthen financial stability** and **actively help develop financial markets**. Regulatory and government (tax and investment) support will be essential, though.

2. BREXIT

When and in what form do you expect the future post-Brexit relationship between the EU and the UK to be clarified?

Most of the analysts believe that the UK will leave the EU within two years. However, their views on mutual trade arrangements are mixed. While some of the analysts are convinced that the gradual fine-tuning of trade relations between the EU and the UK will not meet the two-year deadline and will take a few more years, others believe that mutual trade arrangements will be negotiated before the UK exits the EU in 2019 (albeit under immense pressure and at the last minute). Nevertheless, the respondents admit a large risk of the negotiations failing and, if deals are not signed, the UK being forced to revert to the WTO's terms and conditions.

What do you think the trade and economic-policy agreements between the UK and the EU will look like?

It is generally believed that a trend toward continued close trade links between the UK and the EU will prevail. One option is that the UK will remain in the single European market with minor concessions on both sides. Another possibility is the creation of a free trade zone based on a bilateral agreement (as in the case of Switzerland or Norway) or a customs union for smooth trade in goods but with greater or lesser barriers to the movement of services and persons. However, customs union membership would imply joint access to third parties, which would prevent the UK from negotiating specific conditions with trading partners. Another option mentioned was "paid" access of the UK to the single European market without a requirement to observe all four freedoms.

What impact will Brexit have on the euro area and on non-euro area states?

Given the expected decline in economic growth in the UK and depreciation of sterling, a **slight negative effect on foreign trade** can be expected in individual states (e.g. Germany) regardless of whether or not they are euro area members. **The analysts therefore do not expect major differences in the impacts on euro area and non-euro area member states.** However, such differences may arise indirectly when firms decide to quit the UK, as they will probably opt for euro area countries. From the long-term perspective, though, the key factor will be the trade conditions countries negotiate for themselves.

No major impacts are expected on the EU as a whole and its architecture, as long as at least a minimum degree of pragmatism prevails on both sides and the rather irrational emotive positions on the EU side fade away. However, **Brexit will undoubtedly have an effect on the EU budget** (the structural and cohesion funds), to which the UK was a net contributor. Last but not least, uncertainty is increasing, and that is never a good sign for smooth economic development.

Do you think any of the EU Member States will follow the UK?

The prevailing view is that other Member States will most probably not leave the EU in the next two years. Probably the biggest risk is the presidential election in France, but even if Marine Le Pen wins, she will probably not gain enough support for

this step. By contrast, one analyst thinks that a similar situation may arise in the coming five years as a result of the EU's efforts to absorb power (including through regulations) without responsibility and practical knowledge, or because the EU is moving away from its citizens.

3. MONETARY POLICY

What price and financial stability developments do you expect to see in the EU and the euro area in the next few years?

Inflation could remain below the 2% inflation target in the coming two years, but it will be more robust than in recent years. However, two analysts do not rule out a rise above the inflation target with a risk of price bubbles, especially on the property market.

Central banks are expected to gradually move away from unconventional instruments (one analyst estimated that QE will not be ended before the second half of next year) and monetary policy rates are expected to become the main instrument again. However, they will tend to go up only gradually.

Financial stability, which is not considered to be at risk according to some of the analysts, is being pushed into the background, as the prime concern is inflation and funding for overindebted countries. The outcome of the negotiations on banking sector regulation (Basel) and the political will to resolve the banking crisis in the southern periphery, including the talks with Greece on the conditions of further assistance, will be crucial for the further development and formation of financial stability. The rate of introduction of new regulatory measures is expected to stabilise and some outdated measures might be abolished, but the planned easing of the regulation of the US banking sector is unlikely to carry over to Europe.

How will the euro area be affected by the divergence between ECB and Fed monetary policies?

Divergence of monetary policies, described by some as the ECB's policy lagging behind the Fed's, **might lead to a weaker exchange rate of the euro against the dollar** (below parity according to one analyst). This would probably affect euro area foreign trade, with a potential impact on economic growth, or partly create conditions for a monetary policy tightening by the ECB. There would also be a danger of an outflow of interest rate-sensitive capital. One of the analysts also admits that the volatility of the EUR/USD currency pair could increase.

When do you think the ECB's asset purchase programme will end?

The analysts mostly think that **the current asset purchase programme will end during 2018**, but a minority admit that the process of tapering the purchases might start this year. One analyst also expressed the view that the ECB might take into account the parliamentary elections in Germany when deciding on the timing.

What form do you think the ECB will choose for ending its asset purchase programme and normalising its monetary policy?

The ECB might be inspired by the Fed's experience. It is generally expected that the purchases will be tapered rather than halted all at once. **The analysts most often mention EUR 10 billion a month.** The income on maturing assets is expected to be reinvested for some time (so the ECB's balance sheet should not shrink) to prevent any rise in volatility and nervousness in the financial market. The prevailing view is also that interest rates will be kept at very low levels. The ECB is expected to return to conventional monetary policy after the asset purchase programme ends – in late 2018/early 2019 according to one estimate and not before 2021 according to another.

What is the monetary-policy-neutral level of nominal interest rates in the euro area?

The estimates lie in a range of 1%–3%. The average is 2.2% and the median 2.5%. However, four analysts did not provide estimates and one even questioned the existence of a single policy-neutral interest rate for the euro area as a whole, referring to excessive heterogeneity of the member states' economies. Moreover, he said it was very hard to determine the neutral rate after the financial crisis.

4. INTEGRATION AND REGULATION

Do you expect a stronger impetus for a further deepening of the economic/fiscal integration of the EMU this year? In what areas?

Most of the respondents do not expect any deepening of economic/fiscal integration in the near future. On the contrary, some even believe that the pace will slow, largely due to elections in key euro area states or the UK's negotiations with the EU about the terms of Brexit, which will divert top officials' attention from reform efforts (the need to unify the tax system was cited as an example of a major challenge to further integration).

Only one analyst felt there would be progress in the area of integration. He believes that the problems of the Italian banking sector could lead to deepening integration in the "banking union" area.

Do you see any potential in joint issues of European government bonds or similar instruments?

Except for the EFSF, whose bonds can essentially be considered joint European bonds, **the analysts do not see much room for an issue of joint government bonds or similar instruments in the near future.** Moreover, the ECB's current policy has led to a drop in credit spreads on riskier government bonds compared to safer ones, which is reducing the urgency to issue joint government bonds.

In addition, joint European bonds attract criticism. They are viewed as a way for less disciplined countries to take advantage of the credit of fiscally responsible states. This would give rise to free rider and moral hazard problems. Ultimately, it would mean developed countries subsidising less developed ones, i.e. wealth redistribution among countries. This currently lacks political support. In the more distant future, however, a change in approach cannot be ruled out altogether.

What are/will be the impacts of increasing banking regulation? What do you expect of the new proposals to mitigate risks in the banking sector?

The increasing banking regulation was also a target of much criticism for its theoretical approach, which creates more problems than positive effects. The growing regulatory intensity is mitigating risks, pushing down costs of banking services and fostering the implementation of modern technology. On the other hand, it may not only adversely affect banking sector profitability and the range of services offered, but also hinder growth by weakening the credit channel. Moral hazard, i.e. the danger that clients will be motivated to consider only the prices and not the quality of institutions, cannot be ignored either. According to the analysts, some banking services are moving outside regulated banks (e.g. shadow banking, peer-to-peer lending).

THE CZECH REPUBLIC'S ENTRY INTO THE EA

Do the economic pros of the Czech Republic joining the EA currently outweigh the cons? Should the Czech Republic step up its preparations for euro adoption?

Most of the analysts believe that the economic cons of the Czech Republic joining still outweigh the pros. The number of the respondents holding the opposite opinion has risen by one to two. At the same time, the number of analysts who are convinced that the Czech Republic should step up its preparations for euro adoption has increased. While there was also only one analyst holding this opinion in last year's survey, three analysts favour faster preparations this year.

What do you see as the main benefits of fast euro adoption?

The smaller group of supporters of faster euro adoption believe that, in addition to **eliminating exchange rate risks**, it could have a **positive geopolitical benefit**. Moreover, given the length of the approval processes in the Czech Republic, the country's legislation must be prepared in good time for the moment when conditions become suitable for euro adoption. The required goals for joining the euro area can be essentially considered positive in themselves.

Do you believe the Czech Republic will ultimately become an EA member?

Most of the respondents believe that the Czech Republic will ultimately adopt the euro. Three analysts believe the opposite, but only for the near future (four years in one case, five to ten years in the second and the following ten years in the third) due to disagreements on the domestic political scene, general anti-European sentiment among the public, the benefits of the floating exchange rate of the koruna and concerns about the costs of entry to the ESM. Developments in the euro area, which is showing centrifugal tendencies at the economical and financial level (e.g. non-converging economies), are not without problems either. According to one analyst, the euro area is not "an attractive club for a select few".

Although the sceptical respondents take into account the benefits of the single currency (e.g. transaction cost savings, potential growth in trade with other euro area countries and a more stable price environment), their overall contribution can nowhere near offset the costs associated with euro area entry. In addition, according to one analyst, the Czech economy is prone to demand shocks, for which the floating exchange rate acts as an automatic stabiliser.

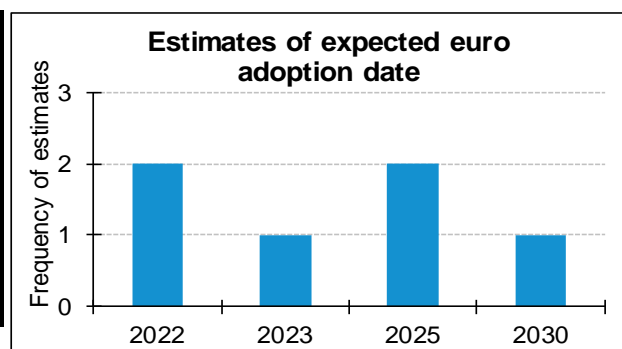
Although, according to one of the sceptical analysts, it is hard to find political arguments for joining the euro area and the political scene is dominated by tendencies towards a single argument: "being there", the Czech Republic will in his view ultimately adopt the euro in the more distant future.

Expected euro adoption date

The most optimistic date for euro adoption in the Czech Republic has shifted one year further into the future, this time to 2022. **The average date is encumbered by slightly more pessimism and has shifted by two years (to 2025).** The previous seven-year gap between the survey date and the expected average date of EA entry has thus increased to eight years. Moreover, it is important to always bear in mind that many respondents view their estimates as "the earliest possible", so the realistic average would probably be in the more distant future.

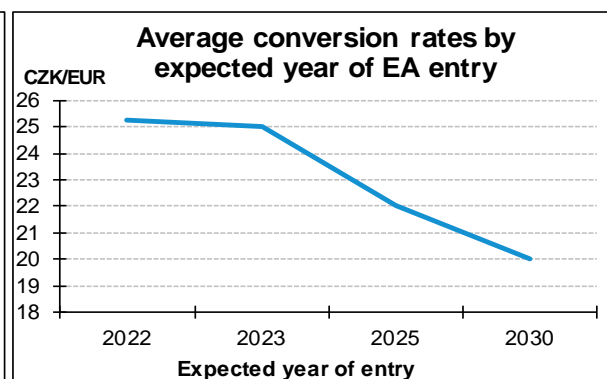
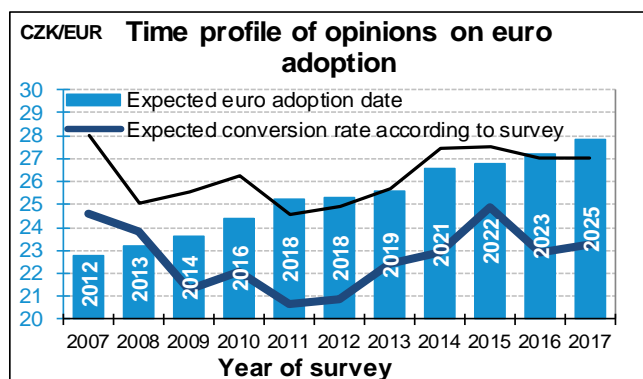
Expected euro adoption date	
min	2022
average	2024
max	2025
Expected conversion rate (EUR/CZK)*	
min	22.00
average	23.50
max	25.00

* min conversion rate = strongest expected EUR/CZK rate



What exchange rate do you expect for the conversion of koruna into euro?

Although the market exchange rate of the koruna against the euro is virtually unchanged from the previous survey, **the estimated rate for the conversion of koruna prices into euro prices has shifted to a slightly weaker level on average.** Last year it was **CZK 22.93 to the euro**, whereas now it is **CZK 23.25**. As the left-hand figure below shows, the expected dates for the Czech Republic's euro area entry have progressively moved into the future in the surveys and the estimated conversion coefficients have trended towards weaker levels in line with the current exchange rate. However, as indicated by the right-hand chart below, the analysts expect the appreciation trend to predominate again in the future; the later the Czech Republic is expected to join the euro area, the stronger is the estimated conversion coefficient.



What factors might jeopardise euro adoption on your expected date?

The factors which, according to the analysts, are complicating euro adoption lie not only on the side of the Czech Republic, but also on the side of the EU. The **domestic** ones have long included little interest from politicians, which is largely related to strong public aversion to adoption of the euro. It would thus be necessary to “overcome the resistance of most voters to giving up their popular and trustworthy crown”. According to the analysts, this would be a serious political decision, and unless it becomes an election issue the government can hardly be expected to make it.

A risk on the euro area side representing a fundamental barrier to adopting the euro on the expected date is the worst-case scenario of a break-up of the euro area. In a less serious scenario, some other kind of political instability is considered. The operation and management of the EU itself and, last but not least, unfavourable economic developments may also be disincentives.

Would it be beneficial for the Czech Republic to join the banking union before EA entry? Why?

Although there are opposing views, most of the analysts are still convinced that it would not be beneficial for the Czech Republic to join the banking union before it becomes an EA member.

Joining the banking union could enhance the reputation and credibility not only of the domestic banking system, but of the Czech Republic in general. The potential benefits also include more comprehensive supervision, greater stability of the financial sector and access to EU money if the need to bail out a domestic bank arose. Nevertheless, there are numerous opposing views, according to which membership of the banking union before joining the euro area is pointless and offers no benefits. The domestic banking sector is not showing any major problems and supervision by the CNB is sufficiently effective. Moreover, it is not clear how strong the final form of regulation in the banking union will be, so it would not be rational to bear any additional costs in the absence of obvious and specific benefits. However, if it became clear that the Czech Republic would join the euro area within several years, the opposition to joining the banking union would probably not be as strong either.

**SELECTED EUROPEAN TOPICS AND EURO ADOPTION IN THE CZECH REPUBLIC
- SURVEY OF ANALYSTS -**

Date:

Name of organisation:

1. EU RISKS AND OPPORTUNITIES

What do you see as the greatest risks to the functioning of the euro area?

Might the problems in Southern European banks result in a banking crisis?

Do you consider Greece's current fiscal policy stance to be sustainable and its debt situation to be stabilised?

Do you expect the new US president to have any impacts on the euro area? If so, what impacts?

What FinTech opportunities and risks do you see for the development and stability of the euro area/EU financial market?

2. BREXIT

When and in what form do you expect the future post-Brexit relationship between the EU and the United Kingdom to be clarified?

What do you think the trade and economic-policy agreements between the UK and the EU will look like?

What impact will Brexit have on the euro area and on the non-euro area states?

Do you think that any other EU member states will follow the UK?

3. MONETARY POLICY

What price and financial stability developments do you expect to see in the EU and the euro area in the next few years?

How will the euro area be affected by the divergence between the ECB's and Fed's monetary policies?

When do you think the ECB's asset purchase programme will end?

What form do you think the ECB will choose for ending its asset purchase programme and returning to the normalisation of its monetary policy?

What do you think the monetary-policy neutral level of euro area nominal interest rates is?

4. INTEGRATION AND REGULATION

Do you expect a stronger impetus for further deepening the economic/fiscal integration of the EMU this year? In what area?

Do you see any potential in joint issues of European government bonds or similar instruments?

What are/will be the impacts of strengthening banking regulation? What do you expect from the new proposals for mitigating risks in the banking sector?

5. THE CZECH REPUBLIC'S ACCESSION TO THE EA

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

Yes No

Should the Czech Republic step up its preparations for euro adoption?

Yes No

If yes, what do you see as the main benefits of fast euro adoption?

Do you believe that the Czech Republic will ultimately become an EA member?

Yes No

If NO, why not?

If YES, when do you expect the Czech Republic to adopt the euro?

What exchange rate do you expect for the conversion of koruna into euro?

What factors might jeopardise adoption of the euro on your expected date?

Would it be beneficial for the Czech Republic to join the banking union before EA entry? Why?