

EA OUTLOOK AND EXPECTED EURO ADOPTION SURVEY OF ANALYSTS' OPINIONS

Financial Markets Department
Operations Analyses Division

2019

Summary

Like last year, seven respondents took part in this year's survey of the views of analysts from leading financial institutions on selected topical EU issues and on euro adoption in the Czech Republic, although there were some minor changes in line-up.

The main topic in the EU this year is undoubtedly Brexit. The analysts consider the current situation in the UK to be complicated and unclear, although a narrow majority believe that the latest events suggest a no-deal Brexit. The possibility of the UK remaining in the EU is seen as unlikely. The analysts are critical of the debt levels of some Southern European countries, especially Italy. In normal circumstances, their falling credibility would probably make remedial measures inevitable, but the market correction mechanism is almost fully suppressed now (at a time of QE by the ECB).

The views on ECB monetary policy, the functioning of the EU and the Czech Republic's entry to the euro area differ diametrically even in our relatively small set of respondents. On the one hand, scepticism prevails regarding the euro area as an optimum monetary area and the effectiveness of ECB monetary policy. At the same time, most of the analysts believe that economic pros of introducing the single currency in the Czech Republic do not currently outweigh the cons. In this context, some of the analysts believe that the Czech Republic should concentrate on making maximum use of the opportunities offered by the current form of EU membership. On the other hand, there are euro-optimistic views according to which it is important for the Czech Republic to be part of the euro area, to contribute to shaping it and to establish closer cooperation with euro area countries. In addition to these economic and political advantages, the euro is expected to reduce transaction costs, eliminate exchange rate risk and increase foreign trade in the Czech Republic.

The Czech Republic has pledged to join the euro area and most of the investors believe the euro will one day become the Czech currency. Although this is not expected to happen in the very near future, it is very important to be well prepared, so a small majority of the respondents believe that the preparations for euro adoption in the Czech Republic should be stepped up. According to the average estimate, the euro can be expected to be introduced around 2027 at the earliest. However, the actual date might be postponed due to external economic factors and low public interest.

The participants in this year's survey were:

Jan Vejmělek, Komerční banka

Luboš Růžička, Raiffeisenbank

Petr Dufek, ČSOB

Petr Sklenář, J&T

Jan Kudláček and Ondřej Kurečka, AXA

Patrik Rožumberský, UniCredit Bank

Shivaan Tandon, The Economist Intelligence Unit

We would like to thank everyone who contributed.

Prague, 2 August 2019

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.

1. BREXIT

The form of future UK-EU relations

According to the analysts, the issue of future relations between the UK and the EU was surrounded by a great degree of uncertainty at the time of the survey. Some of the respondents said the probabilities of a Brexit with a deal and a no-deal Brexit were equal, and some did not even rule out a new referendum with the possibility of the UK staying in the EU. They saw the situation as very unclear and the ability of the UK Parliament to find a unified approach to Brexit as very small. Boris Johnson is expected to re-open negotiations with the EU, but the EU seems unlikely to offer concessions, so UK voters may face a new referendum.

Although an association agreement would be more favourable, a narrow majority of the respondents felt that the latest developments tended to suggest a no-deal Brexit, with Brexit to be followed by lengthy negotiations and bilateral agreements taking the form of a customs union at the very most.

The impacts of the persisting uncertainty regarding the form and implementation of Brexit on the Czech Republic.

No direct negative impacts of the persisting uncertainty regarding the form and implementation of Brexit are apparent as yet. However, the analysts can imagine impacts on the exchange rate, on the UK's demand for Czech products (Czech exports to the UK fell last year after eight years of constant growth, and many exporters are reportedly establishing firms directly in the UK) and on investment by firms whose output is closely linked to the UK. The uncertainty surrounding Brexit may also be associated with worse sentiment in industry. It will undoubtedly be reflected in monetary policy, as central bankers are taking Brexit into account in all their policy rate decisions (in the form of postponed rate increases). However, much bigger negative impacts can be expected on the UK itself.

The probability and circumstances of the UK potentially staying in the EU

Although the option of the UK remaining in the EU is by no means ruled out, especially if no political solution is found and the country has to proceed to early elections, the respondents attach a relatively low probability to it. The UK Parliament would have to agree to call a new referendum (for example under pressure from Scotland threatening to leave the UK), but strong resistance to this is widely apparent. That said, a second referendum might break the political deadlock in Parliament. However, there is also a possibility that Brexit will become watered down in a long series of postponements and negotiations.

2. EU RISKS AND OPPORTUNITIES

Sustainability of the government debts of euro area countries (such as Greece and Italy)

The analysts view the government debts and their growth rates in some Southern European countries, especially Italy, as unsustainable. This could be confirmed in the event of an increase in interest rates, the onset of another recession, the termination of the asset purchase and reinvestment programme, or a combination thereof. In some cases, the level of debt (relative to GDP) has risen in spite of solid economic growth and unusually low returns. Governments are meanwhile seen as highly unwilling to implement structural reforms.

It seems inevitable that the excessive debt burdens will be resolved through some form of restructuring, be it write-offs or monetisation. However, a view was also expressed that in normal conditions investors would get rid of the bonds of such indebted countries en masse, but the fact that the ECB has become the largest creditor of all the euro area countries completely changes the situation. Since the ECB is talking about conducting another round of quantitative easing, the debt levels – and even restructuring – are irrelevant.

The political, economic and fiscal situation in Italy and its impacts on euro area stability.

Italy does not enjoy much confidence among our analysts, who believe that any effort made by the populist government to boost the economy, which is currently on the brink of recession, will – despite the stimulus measures – exacerbate the problem of fiscal indiscipline and the strained relations with Brussels. Moreover, according to some of the analysts, the current developments in Italy are not conducive to the stability of the monetary union as a whole in both economic and (geo)political terms.

For example, if the fragile government coalition were to break up or further budgetary problems were to arise, and if a fall in investor confidence were to lead to a sharp rise in returns, the Italian economy would face the risk of a deeper recession according to the pessimistic scenarios or even a banking crisis in the worst-case scenario (given the increased vulnerability of financial institutions in Italy). On the other hand, one of the respondents expects no major direct impacts on the stability of the euro area.

According to the analysts, Italy, like many other countries, did not think about the future in good times and did/does not have a reliable mechanism to enforce fiscal discipline and prevent high debt. In normal circumstances, the market is the best “enforcer” of sound fiscal policy, but the bond markets have long been deformed by the ECB’s quantitative easing policy. According to some of the respondents, such conditions are therefore not suitable for establishing a banking union.

The analysts believe that if Italy wants to stay in the euro area and avoid a sharp rise in debt costs, it will have to opt for tighter fiscal policy and make more unpopular reforms.

What position should the Czech Republic adopt in the debate about defining the relationships between euro and non-euro countries

Some of the analysts believe that the Czech Republic should maximise its influence (for example by joining the euro area), clearly embrace its commitment to adopt the euro and participate directly in further shaping the monetary union while minimising the related costs. It should also strive to establish closer links with euro area countries, because the benefits of doing so will outweigh any costs. The Czech Republic should also work to get non-euro area countries more closely involved.

Conversely, views were expressed that the Czech Republic should cautiously monitor the euro area experiment, not change its current position (i.e. only assess the situation in the euro area, as the pros of adopting the euro do not currently outweigh the cons) and remain passive.

The Czech Republic's untapped economic opportunities in the EU

Are there any economic opportunities which the Czech Republic should use but does not? One option mentioned is more efficient use of EU subsidies. Another example consists in more robust promotion of the country's interests in the green policy area, especially in decisions on the compulsory introduction of technology that will affect the Czech Republic's prosperity irrespective of whether or not it is truly environmentally friendly. Experience gained in the area of "green" biofuels and solar power stations should inspire the Czech Republic to encourage a debate across EU institutions.

There is also a euro-optimistic view that, after joining the euro area, the Czech Republic should contribute to the future course of the monetary union. On the other hand, the eurosceptic attitude is focused on making maximum use of the free movement of goods, services and persons (as a small export-oriented economy) to attain comparative advantages, on greater diversification of trading partners and on extensive access to export markets.

Potential impacts of some member states (BG, HR, RO) joining ERM II and subsequently the euro area.

There are isolated views among the analysts that the entry of the above states might further amplify the problems in the euro area as a suboptimal monetary area, hence the impact of this integration change on the euro area's stability might be negative. This would probably further strengthen the arguments of the opponents of the Czech Republic's entry to the euro area. The entry of these countries to the euro area might be seen as competition for the Czech Republic, with negative – albeit minor – impacts on Czech exports.

On the other hand, a more neutral opinion avoids criticising other countries' autonomous decision to give up their floating exchange rates with all its pros and cons. However, this is no reason for the Czech Republic to follow them.

The last, least pessimistic, view is that the entry of these countries to the euro area will have no direct economic impact, given their relatively low debt levels and economic power relative to the whole, but will have a political impact in the form of an increase in the significance of the euro area in relation to the non-euro area countries.

3. MONETARY POLICY

How do you think the ECB's monetary policy normalisation will continue?

As long as quantitative easing (QE) or negative interest rates do not start to be viewed as normal monetary policy instruments, the respondents believe the journey from unconventional monetary policy may take a few more years yet, given the worsening situation in the global economy. However, this journey will lead via the discontinuation of QE and a reduction in the ECB's balance sheet to growth in reference interest rates. That said, it now looks like the current unconventional instruments will be stepped up or the asset purchases will be relaunched and interest rates will be cut to more negative levels. The key rate might be reduced by 10 bps at the ECB's meeting in August. Given the current economic situation, some of the respondents do not expect monetary policy to be normalised in the next year or two.

The timing of the end of the ECB's asset purchase programme

The analysts have no unanimous opinion on the timing of tapering. On the one side is the view that the ECB should have ended the asset purchase programme faster and earlier. By doing so, it could have created more space for easing policy following a further economic slowdown (the stock of eligible bonds could have remained larger).

Against this are arguments that such action would have been too risky given the fragile economic recovery in the euro area and the absence of structural changes, and that the current economic situation, with inflation well below the ECB's target, shows that the purchases should not have been ended.

There is also a view that the termination of asset purchases might be only temporary. Given the high risks of lower-than-desirable inflation and economic growth (relating to Brexit and the US-China trade war), purchases might be renewed despite the fact the ECB's monetary policy even now remains highly stimulative given the third wave of long-term refinancing operations (TLTRO III, viewed by some of the respondents as a modified form of QE) and reinvestment of purchased assets.

There are also isolated doubts about the effectiveness of the QE programme, as despite its introduction inflation has not changed course and core inflation has long been flat. The main doubts concern the effectiveness of the credit transmission channel given the large growth in liquidity arising from the ECB's measures.

TLTRO III programme

The TLTRO III programme is seen as a means of providing liquidity and an instrument for boosting banks' lending activity in the current phase of slowing growth in the euro area. It is also regarded as an active and largely necessary step by the ECB to strengthen financial stability and prevent the risk of contagion of the liquidity problems of Mediterranean banks in the EMU, Italian ones in particular, as the previous rounds of TLTRO near maturity. This programme may be viewed as an alternative to cutting key interest rates. A more neutral opinion is that "the euro area could get by without it, but on the other hand it will have no negative effect".

Monetary-policy-neutral level of nominal interest rates in the euro area

The question regarding the monetary policy neutral level of nominal interest rates is viewed as a tough one to answer (due, among other things, to the internal heterogeneity of the euro area and the non-functioning of equilibrating channels), even for ECB experts. The analysts' estimates are very mixed. The rate on the minimum side of the range is zero to slightly negative, while the maximum is around 2.5%. The average is 1.3%, much lower than in last year's survey, when it was 2.3%.

4. INTEGRATION AND REGULATION

The Commission's initiative to strengthen the international role of the euro, and instruments for achieving this.

According to some of the respondents, tendencies towards a more diversified and multipolar system of several global currencies have been observed lately, but the effort to support the international role of the single European currency can be viewed as positive. A stronger international role of the euro would be reflected positively in Europe's ability to promote, for example, smoother trading (such as the use of the euro in energy trading to counterbalance the US dollar) and especially in its ability to promote its geopolitical interests. This is therefore an area where economic and geopolitical issues intersect.

Nevertheless, the main prerequisite for meeting this objective is to stabilise the euro by increasing confidence in the long-term viability of this European project. This could certainly be achieved through closer integration of the euro area, but according to some of the respondents this process is unlikely to see major progress in the near future. At the moment, therefore, Europe can increase the international role of its currency by supporting foreign trade, for example by opposing the growing tendency towards isolation and protection of its market by, say, signing trade agreements with non-European states.

On the other hand, a pessimistic view sees this initiative as a political ambition that is inconsistent with the economic situation. The supporters of this approach believe that currencies gain importance and respect rather differently than through marketing. The euro must build a stronger role for itself naturally. This will be hard to do without a stable and economically strong euro area.

Regulatory support for securities/investment instruments regarded as sustainable finance, i.e. environmentally or socially responsible investments

The respondents are split into two camps on this issue as well. Supporters of regulation believe that "green" or socially-oriented projects often have little chance of being implemented without public support and that properly targeted regulatory support for the instruments used to finance them may be an appropriate parameter for sustainable development and is certainly one way of supporting such projects.

As such instruments are used to promote a particular ideology, the question is whether such interference in market mechanisms is desirable or not. A more liberal, and hence opposing, view, supported by a narrow majority of the respondents, questions the ability of economic policy makers to foresee all the consequences. Moreover, under this approach, banks would be expected to substitute for social, environmental and other state policy, which is not desirable. The experience with housing policy in the USA, the impacts of which are being forgotten, is cited as a negative example. Banks have been playing the role of financial intermediaries for several centuries now because they are able to invest and make returns. If they are meant to look after social welfare or the climate as well, their role will start to change. However, such a tendency is considered risky, as it would undermine the long-term stability of the financial sector (and disturb the relationship between risk and yield) and increase the involvement of the public sector. It might even result in the nationalisation of part of the banking sector.

What impact might the newly declared closer economic cooperation between Germany and France have on economic integration in the EU?

The analysts have a neutral to slightly positive view on the economic impacts but see major risks in the political area. A bloc formed of the two economically most important countries in the EU could limit the power of other, smaller countries. These two powers would have a greater ability to pursue their vision, which in many cases could be contrary to those of smaller states and pose a risk to the integration of the other states in the EU. Disputes within the EU could easily escalate and the idea of a united Europe could be undermined. On the other hand, the threat of being stuck on the periphery of European integration could pressure other states into getting involved in the integration process more intensively than before. However, the influence of the currently strengthening anti-European movements (amplified by the expected economic problems in Europe) is likely to get stronger. The question is how far this declared cooperation will actually go. It may be only a declaratory intent aimed at gradually establishing a fiscal or political union, for example.

5. THE CZECH REPUBLIC'S ACCESSION TO THE EA

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

Most of the analysts believe that the economic cons of the Czech Republic joining still outweigh the pros. The number of respondents with the opposite view increased by one compared with last year, i.e. two analysts now see a preponderance of pros.

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

Unlike last year, a narrow majority of the respondents believe that the Czech Republic should step up its preparations for introducing the single currency. The Czech Republic has pledged to join the euro area and the analysts speak of a need to prepare legislatively for this step properly and in good time. Political preparations will also be important, as euro adoption is largely a political decision and, according to some of the respondents, the Czech Republic is already prepared economically.

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

The benefits for the Czech Republic should naturally include lower transaction costs, the elimination of exchange rate risk, growth in foreign trade, and the ability to participate in decision-making processes.

Will the CNB ultimately become a euro area Member State?

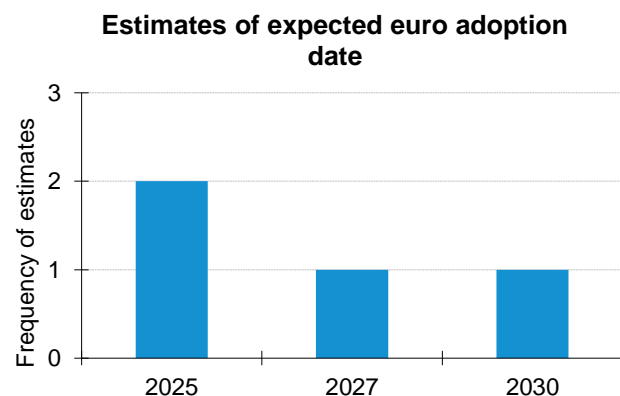
Five of the respondents believe that the euro will ultimately become legal tender in the Czech Republic. One respondent does not (without providing any detailed explanation) and the last respondent does not expect it to happen in the near future, i.e. in the next five to ten years. His argument is the absence of economic and financial advantages, in contrast to unavoidable and clear primary costs. He also does not consider the euro area to be an elite and well-functioning club: the non-euro area countries are faring as well as, or rather better than, the euro area countries. Therefore, even the political arguments boil down to a single slogan: "Being there".

Expected euro adoption date

The estimated euro adoption date has moved back almost two years compared with the previous survey. Last year the analysts predicted 2025 on average, whereas their average estimate this year is around 2027. The longer distance in time from the survey date suggests less optimism among the analysts about the speed of euro adoption. It should also be pointed out that the respondents give these dates as very rough estimates and state that they are the earliest ones they can imagine, i.e. they concede that there is a large risk of the Czech Republic joining the euro area at a later date.

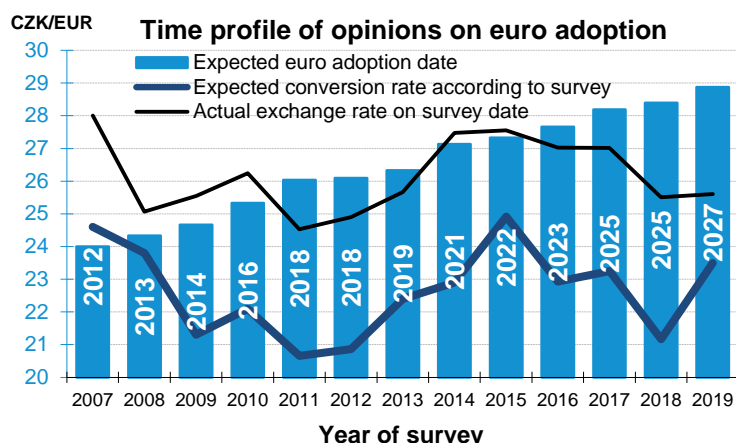
Nearest expected euro adoption date	
min	2025
average	2027
max	2030
Expected conversion rate (EUR/CZK)*	
min	22.00
average	23.50
max	24.50

* min conversion rate = strongest expected EUR/CZK rate



Expected CZK/EUR conversion rate

Only three of the respondents ventured to estimate the extremely hard-to-predict future conversion coefficient upon the Czech Republic's entry to the euro area. This time, their average estimate did not reflect the koruna's rate on the foreign exchange market, which has weakened slightly since last year's survey (by CZK 0.1 to the euro), and returned to the 2017 level. The average estimate was CZK 23.25 to the euro two years ago and CZK 21.17 last year and is currently CZK 23.50.



What factors might jeopardise euro adoption on your expected date?

The main risks which might postpone the Czech Republic's entry to the euro area on the date mentioned by the analysts include the Czech public's persisting negative attitude towards euro adoption, as Czechs generally hold their koruna dear, and the unwillingness of the political representation to oppose the public's sceptical view and start preparing for the country's entry to the EMU.

Alongside that are external effects, namely the problems of the euro relating to the debt levels of some euro area countries. In the extreme case, this could lead to another financial crisis in the euro area, which would also probably move back the expected euro adoption date in the Czech Republic.

Which country will be the first to use the euro: the Czech Republic, Poland or Hungary?

The analysts' views are mixed. In individual cases, they either see no clear lead in any of the countries considered, or see Hungary as the favourite due to the largest public support for the euro there, or tip the Czech Republic due to its best economic preparedness. However, the largest number of analysts believe that Poland will be the first Central European country to adopt the euro after Slovakia. These respondents generally agree that this will have a positive impact on the other states in the region and possibly also foster an increase in the proportion of the population supporting entry to the euro area in the other states in the region, which might in turn be reflected in greater integration efforts by politicians.

However, there are views that this is primarily a political rather than an economic issue. Since opposition to the euro area entry is significant and political support lukewarm in all the said countries, some of the respondents believe that the euro area is unlikely to enlarge into the Central European region in the near future. The challenges faced by the single European currency, which will most likely be amplified further in a period of economic contraction, will not provide much incentive for early euro adoption over the next few years either. Moreover, no deadline has been set for these states to adopt the euro, nor is there any enforcement mechanism.

Do you expect the ERM II entry conditions currently being imposed on Bulgaria will be reflected in the conditions applying to future euro candidates?

The majority of the respondents consider it likely that the entry conditions for Bulgaria will be a precedent that will affect the conditions for further enlargement of the euro area for some time to come. Moreover, there is a view that there will be pressure on each country concerned to be bound as much as possible by the rules and the unification (federal) structure upon joining the EMU and ERM II. On the other hand, a minority expect the opposite, since Bulgaria is a unique case and the same standards should therefore not apply to other candidate countries in the future.

**SELECTED EUROPEAN TOPICS AND EURO ADOPTION IN THE CZECH REPUBLIC
- SURVEY OF ANALYSTS 2019 -**
Date: Name of organisation: **1. BREXIT***What is the most likely form of future UK-EU relations?**What impacts on the Czech Republic caused by the persisting uncertainty regarding the form or implementation of Brexit do you see?**Do you see any probability that the UK will ultimately not leave the EU? Under what circumstances?***2. EU RISKS AND OPPORTUNITIES***Do you consider the government debts of euro area countries (such as Greece and Italy) sustainable?**Do you believe they will have to be restructured?**How do you assess the current situation in Italy (political and economic developments, problems with fiscal discipline, etc.) and its potential impacts on the stability of the euro area and the EU as a whole?**What position should the Czech Republic adopt in the debate about defining the relationships between euro and non-euro countries (greater involvement of non-euro countries, even if it entails some costs)?**Are there economic opportunities for the Czech Republic in the EU which it should use but does not do so? If so, what are they?**How do you assess the potential impacts (economic ones, on the stability of the euro area, strategically for the Czech Republic) of the plan of some EU Member States to join the ERM II, and possibly the euro area, soon (BG, HR, RO)?***3. MONETARY POLICY***How do you think the ECB's monetary policy normalisation will continue?**What's your view of the timing of the end of net asset purchases under the ECB's asset purchase programme?**What do you think about the introduction of the TLTRO-III programme?**What is the monetary-policy-neutral level of nominal interest rates in the EA?***4. INTEGRATION A REGULATION***What do you think about the EC's initiative to strengthen the international role of the euro?**What instruments could the EC use to achieve its objectives?**Do you regard it as desirable to provide regulatory support (including, for example, possible preferential risk treatment) for securities/investment instruments considered to be sustainable, i.e. environmentally or socially responsible?**What impact might the newly declared closer economic cooperation between Germany and France have on economic integration in the EU?***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?**Which of the three Central European countries (Poland, Hungary and the Czech Republic) will in your view be the first to adopt the euro? Will this potential EA entry affect the decision-making of the remaining two countries?**Do you expect the ERM II entry conditions currently being imposed on Bulgaria (simultaneous banking union entry, among other things) will be reflected in the conditions applying to future euro candidates?*

Note:

Please return this form by e-mail to:

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