CZECH REPUBLIC'S ACCESSION TO THE EMU

IMPLICATIONS FOR MONETARY POLICY AND EXCHANGE RATE REGIME

Zdenek Tuma

CEPS, Brussels
24 June 2002
1. OUTLINE

• The present monetary policy regime (Inflation targets currently till 2005; floating ER);

• Real and/vs. (?) nominal convergence
  (Challenges for monetary policy; benefits from EMU-accession perspective);

• Financial integration with the EU;

• Timing of EMU accession
  (Fast versus slower strategy etc.);

• Monetary policy and ER regime before accession (ERM II etc.).
2. CNB’s Monetary Policy

- **Inflation targeting** since 1998;
- **Inflation targets** for headline inflation currently specified till Dec. 2005;
- **Targets** outline convergence of inflation to upper bound of Maastricht criterion;
- **The regime** is rule-based and transparent;
- **Exchange rate regime** = **floating** (only occasional interventions against volatility).
3. Nominal Convergence

- Inflationary pressures currently weak;
- Further disinflation outlined by inflation targets (CZ, HUN, POL);
- Inflation convergence not an obstacle to EMU accession.

<table>
<thead>
<tr>
<th>Country</th>
<th>Inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Rep.</td>
<td>3.2 %</td>
</tr>
<tr>
<td>Hungary</td>
<td>6.1 %</td>
</tr>
<tr>
<td>Poland</td>
<td>3.0 %</td>
</tr>
<tr>
<td>Slovakia</td>
<td>3.6 %</td>
</tr>
<tr>
<td>Slovenia</td>
<td>8.5 %</td>
</tr>
</tbody>
</table>

April 2002; EMU = 2.4 %
4. Nominal Convergence (II)

- Interest rates already close to the EU in CZ;
- Also not a major problem (even though “convergence play” before EMU accession is important for all countries, incl. CZ).

<table>
<thead>
<tr>
<th>Country</th>
<th>10Y gov’t bond yields</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Rep.</td>
<td>5.0 %</td>
</tr>
<tr>
<td>Hungary</td>
<td>7.4 %</td>
</tr>
<tr>
<td>Poland</td>
<td>7.9 %</td>
</tr>
<tr>
<td>Slovakia</td>
<td>8.0 %</td>
</tr>
</tbody>
</table>

June 2002; EMU ≈ 5 %
5. Public Budgets

- Structural problems in public finance;
- Difficult to fulfil Maastricht criterion / G&S Pact soon (debt criterion OK; expected to reach \( \approx 25 \% \) of GDP in 2002);
- Stabilising role of fiscal policy very constrained at present.
6. Real Convergence

- **Convergence**: clear implications for welfare;
- But implications for EMU accession not straightforward (more an issue of structure than size);
- May create some challenges for monetary policy (in EMU or outside).
7. Real Exchange Rate

- Long-run real appreciation trend 3-5 %;
- CZ: B-S effect ≈1-2 %; price deregulations ≈1.5-2.0 %; T-o-T ≈1.0-1.5 %;
- In late-2001 / early-2002 an excessive appreciation.

<table>
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<td>Czech Rep.</td>
<td>3.2</td>
</tr>
<tr>
<td>Hungary</td>
<td>0.6</td>
</tr>
<tr>
<td>Poland</td>
<td>4.1</td>
</tr>
<tr>
<td>Slovakia</td>
<td>1.8</td>
</tr>
<tr>
<td>Slovenia</td>
<td>1.6</td>
</tr>
</tbody>
</table>
8. Challenges for Monet. P.

- No one-off price jumps expected, perhaps except of food;
- After accession, inflation will likely exceed EU-average;
- Before accession, real appreciation can go partly through inflation differential, partly through nominal appreciation;
- Inflation differential (2-3 % in CZ) is anchored by targets, the rest must go through nominal appreciation;
- Nom. appreciation would push tradable prices ↓ (? flexibility), which must be reflected in plans of industrial firms, e.g. in wage bargaining;
- Nominal appreciation within ERM II (problem or not?);
- The relative prices will be changing during this process;
- The convergence play and ER volatility.
9. Structural Convergence and OCA Issues

- While GDP and price convergence creates challenges for monetary policy, structural convergence is good for CBs as it reduces the risks of EMU accession.
- As in the whole transition, the fastest changes can be observed in foreign trade (↑ openness of the economy; ↑ share of EU in exports; ↑ exports of more sophisticated goods and intra-industry trade etc.);
- At highly aggregated level, the economic structure of accession countries broadly similar to that of the EU (except of traditional role of agriculture in some countries);
- At a more disaggregated level, a shift away from traditional industries to modern ones (often cyclically-sensitive).
## 10. Structural Convergence and OCA Issues (II)

<table>
<thead>
<tr>
<th>Country</th>
<th>CZ</th>
<th>HU</th>
<th>PO</th>
<th>SL</th>
<th>SK</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exports of G&amp;S/GDP</td>
<td>71%</td>
<td>60%</td>
<td>30%</td>
<td>60%</td>
<td>76%</td>
</tr>
<tr>
<td>Exports to EU</td>
<td>69%</td>
<td>75%</td>
<td>70%</td>
<td>62%</td>
<td>61%</td>
</tr>
<tr>
<td>Exports of SITC7+8</td>
<td>60%</td>
<td>71%</td>
<td>54%</td>
<td>55%</td>
<td>52%</td>
</tr>
<tr>
<td>FDI stock (USD p.c.)</td>
<td>2610</td>
<td>2280</td>
<td>1050</td>
<td>1630</td>
<td>960</td>
</tr>
<tr>
<td>Agriculture/Employ.</td>
<td>5%</td>
<td>6%</td>
<td>19%</td>
<td>10%</td>
<td>6%</td>
</tr>
<tr>
<td>Industry/Employ.</td>
<td>31%</td>
<td>27%</td>
<td>24%</td>
<td>32%</td>
<td>30%</td>
</tr>
<tr>
<td>Construction/Employ.</td>
<td>9%</td>
<td>7%</td>
<td>7%</td>
<td>6%</td>
<td>8%</td>
</tr>
<tr>
<td>Services/Employ.</td>
<td>55%</td>
<td>60%</td>
<td>50%</td>
<td>52%</td>
<td>56%</td>
</tr>
<tr>
<td>Agriculture/GDP</td>
<td>4%</td>
<td>4%</td>
<td>3.5%</td>
<td>3%</td>
<td>4%</td>
</tr>
<tr>
<td>Industry/GDP</td>
<td>34%</td>
<td>29%</td>
<td>25%</td>
<td>31%</td>
<td>25%</td>
</tr>
<tr>
<td>Construction/GDP</td>
<td>7%</td>
<td>5%</td>
<td>7.5%</td>
<td>5.8%</td>
<td>5%</td>
</tr>
<tr>
<td>Services/GDP</td>
<td>55%</td>
<td>62%</td>
<td>64%</td>
<td>60%</td>
<td>66%</td>
</tr>
</tbody>
</table>

2001
11. Business Cycles

- But cyclical synchronisation far from perfect so far (e.g. at present or in 97-98);
- An impact from EU apparent, though (96, 99, 2001-02).
12. Financial Integration

- Number of banks
- Foreign share in bank equity (%)

- 1990-2001
- Foreign bank branches
- Foreign-controlled banks
- Czech-controlled banks

- 1996-2001
- Foreign share in bank equity (%)
13. Financial Integration (II)

- The bank privatisation has been finished;
- Foreign owners controlled 70% of bank equity and 95% of bank assets at the end of 2001;
- Largest banks have been sold to banks from EU;
- The benefits have started to materialise gradually;
- Foreign banks have been implementing their know-how and procedures, which may increase similarities in the transmission of monetary policy;
- Retail segment has been getting more developed;
- Capital markets still underdeveloped (source of asymmetry); but EMU accession will also allow to participate in EU-wide markets without ER risk.
14. Factors of EMU Accession

- High credibility of domestic monetary authorities ⇒ no need to adopt euro unilaterally to import macro-stability;
- High degree of convergence ⇒ euro a rational choice over a longer-run;
- The accession is thus an issue of timing only (2006-??);
- The structural convergence to the EU proceeds quite fast, the same is true about legal and institutional area (but cycles still not strongly synchronised);
- This convergence should reduce danger of asymmetric shocks and increase the synchronisation of cycles with the EU, thus making the risks of EMU accession lower;
- The main challenges remain in the fiscal sphere and in further institutional and legal convergence.
15. Fast vs. Slower Strategy

<table>
<thead>
<tr>
<th>FAST</th>
<th>SLOWER</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fast fiscal reform (shock for economy)</td>
<td>Slower fiscal reform (but can not avoid it)</td>
</tr>
<tr>
<td>Clear timetable, less uncertainty</td>
<td>Time to adapt to EU-accession challenges</td>
</tr>
<tr>
<td>Convergence play shorter</td>
<td>More time to increase convergence</td>
</tr>
<tr>
<td>Eliminate ER volatility sooner</td>
<td>Accession after restrictions on labour mobility are over</td>
</tr>
</tbody>
</table>

- Both strategies are viable.
- Both have their risks (hard to weight them precisely).
- Eventually it will be a political decision.
16. Accession and ERM2

- The requirement to spend 2 years in ERM2 is a risk common to all strategies ("soft peg" regime);
- The degree of this risk may differ among strategies (but hard to tell how ex ante);
- It seems reasonable to spend in the ERM2 the minimum required period for any strategy;
- The crucial issue is to determine an appropriate central parity for ERM 2 entry (for any strategy);
- Before ERM2 entry, the current monetary policy regime is unlikely to be changed;
- A slower strategy would require to extend the current inflation targets beyond 2005 (in 2003 at latest).