EU Accession, EU Membership and Challenges for Central Bank

Jan Frait – The Czech National Bank1

Introduction

It is rather a special moment for the central banker from an acceding country to be in one of the ESCB central banks today, just at the end of the last year of the existence of his country as the EU non-member. I recalled the importance of this moment when I faced the first question suggested for this panel: What is behind the relative success of the acceding CEES? My answer is “to a large extent the accession process itself”. Of course, there are other factors at consideration, but these were the clearly defined criteria and requirements to be met to become the EU member that constrained and directed the steps of the politicians and policymakers. I assume that there were so many problems and challenges not only at the outset, but also during the advanced phase of transition, it would be practically difficult to overcome without being given the benchmark and then the pressure to reach externally.

I remember that in 1996 I wrote the paper labelled “Economic Transition in the Czech Republic: a Real Success?” evaluating the results of the Czech economic transition (see Frait, 2000). I concluded the paper with “Was the Czech transition a real success? The initial period may be considered as a success, though some promising opportunities were missed later. The transition to a modern capitalist economy in the Czech Republic got stuck somewhere in the middle of the road and additional painful steps are necessary. The results of the transitional process suggest that the key to the success depend upon the ability of the authorities to create an institutional framework compatible with a market economy. The transition itself is a long-term and complicated process even in countries with a history of market based economies (like the Czech Republic, Slovakia, Poland or Hungary). It is quite easy to create institutions like a two-tier banking system, a stock exchange or mutual funds. It is however quite difficult to make them work as they do in traditional market economies. This has been confirmed above by the Czech Republic’s failure to create an efficient and well functioning banking system, capital market and corporate governance mechanism.”

In the period of 1996 to 1998, the prospects regarding the early EU membership seemed to be a bit distant. Only after the politicians and policy-makers took the EU accession process seriously, the crucially needed reforms aimed at creating the European-like legal framework and moving towards the European standards were initialized. And these reforms brought the Czech economy much closer to the market-oriented economy of the European kind. Some of my colleagues even argue that these were the key benefits of the EU membership and once the pressure from the accession requirements ceases in May 2004, the EU membership will not be much helpful in modernizing and restructuring the Czech economy any more.

The second question was: “Is economic transition in acceding countries over?” My answer is “not absolutely”. The transition has to continue especially in the institutional sphere.

1 Jan Frait is the Board Member of the Czech National Bank (jan.frait@cnb.cz). The paper is an enlarged version of the speech given during the 50th East Jour Fixe „Transition: Past, Present, Future“, Vienna, Oesterreichische Nationalbank, 15.12.2003.
Of course, due to the EU accession efforts, the laws and regulations have been written but they are not always enforced and built into the behaviour of the economic agents. Partially it can be explained by the much stronger path dependency than we originally expected. But to a large extent, it is a reflection of the new structures and patterns of behaviour that emerged during the transition itself. These constitute barriers to future growth and the future stage of transition has to focus primarily on them. In this sense, the words from my paper cited above still apply: “The future of the Czech economy, as well as other transitional economies, depends to a large extent on the ability to create legal and regulatory frameworks which can secure property rights, guarantee equal conditions for competing economic agents, protects investors, provides incentives for making information publicly available and limits the opportunities for economic crime and corruption.”

The next question was “Is there a scope for transition economics after EU enlargement?”. I have already said that there is a huge scope for the institutional economics dealing with transitional issues. In addition to that there are numerous questions related to microeconomics as well as macroeconomics. Some may view them as questions belonging to transitional economics while the others as new challenges for the standard economics. I have no ambition to decide on that. It is much more important to look at the questions themselves. They stem from a very specific situation of some of the current acceding countries. This can be described as follows: the industrially oriented economies with the large scope of “old” sectors producing relatively non-sophisticated production and with the need for further restructuring; economies exposed to globalization, owned to a large extent by foreigners and facing a fierce competition from the East; next year the EU economies with generous social system, population getting older and relatively low level of GDP per capita; economies with huge potential but with relatively low wage and price levels and thus different relative prices compared to the current EU standards, constrained by Maastrich criteria and forced to switch to semi-fixed exchange rate regime.

Figure 1: Inflation in the Czech Republic and the EU

Source: CNB and Eurostat

A situation like this is really specific and creates conditions for a very complicated dynamics with the multiple-equilibria solutions. It also creates many challenges for the designers of economic strategies and policy-makers. I believe that it altogether offers fascinating material for the academic profession. I do not have an ambition to submit a
complex view of the future developments. After the introductory chapter describing the current macroeconomic situation of the Czech economy, I will point to some challenges faced by central bankers.

1. Where Do We Stand?

It is almost a stylized fact that the basic macroeconomic convergence in the Czech Republic has been fully achieved. Inflation went down to the levels compatible with price stability definition.

The short-term as well as long-term interest rates stay on the levels of the industrially developed countries. In other words, the interest rate differentials converged to zero levels some time ago.

Figure 2: Interest rate differentials disappeared

![Figure 2: Interest rate differentials disappeared](image)

Source: CNB and IMF IFS

Nominal exchange rates are relatively stable and even approximately 10 per cent stronger in nominal terms than 13 years ago.

Figure 3: Long-run stability of the Czech Koruna

![Figure 3: Long-run stability of the Czech Koruna](image)

Source: CNB
Even the current fiscal situation is relatively stabilized despite the need for the further reforms. The deficits are historically not much larger than in the EU-15; and the level of debt is still relatively low though with a risky trend.

**Figure 4: Public finances: deficit and debt**

![Graph showing public finances deficit and debt](image)

*Source: CSU and Eurostat*

We can also see major achievements in re-establishing financial stability, especially the stability of the banking sector. We can see high capital adequacy, sharp drop in ratios of classified credits and non-performing loans, strong liquidity, and more than satisfactory coverage of weighted classification with reserves and provisions. The banks thus face favourable conditions for further development.

**Figure 5: Soundness of banking sector**

![Graph showing soundness of banking sector](image)

*Source: CNB*

The task for the policy-makers is therefore to switch the attention towards the real and structural convergence. The key question for the central bankers is whether pursuing the policy of the early euro adoption has a potential to promote the real and structural convergence or whether the continuation with a national currency for some time will do a better job.

### 2. Exchange Rate Dynamics

The specific economic situation outlined above is translated to the number of difficult questions regarding the exchange rate dynamics and exchange rate policies. I would say that these are the exchange rate issues that perfectly reflect the tough challenges faced by the policy-makers in the acceding countries. I will start the discussion by providing some
background information on the developments in the Czech Republic.

The exchange rate developments during 2003 were entirely different from 2002 and 2001. During the previous two years, we witnessed dramatic changes in the EUR/CZK rate, massive operations of the central bank in the foreign exchange market and the major decline in the short-term interest rates. On the contrary, the EUR/CZK exchange rate was remarkably stable during 2003, the CNB moved out of the market and returned back to the normal flexible inflation targeting procedures and measures. The exchange rate has been moving in a 7 percent range this year compared to 12 percent in 2002 and even 13 percent in 2001. Also the maximum value of this year (30.77) is far from the maximum value of 2002 (28.86).

The exchange rate swings have major impact on the price competitiveness of the local producers. In 2002 the average unit labour cost of industrial production (measured in the euro by average yearly exchange rate) went up on a year-on-year basis by roughly 10 percent, in 2003 they decreased at least by 5 percent. While the productivity and wage components were relatively stable, the exchange rate component changed abruptly. Still, we do not feel that the developments described above could be labelled as “severe tensions”.

Figure 6: Nominal and real CZK/EUR exchange rate developments

![Graph showing nominal and real CZK/EUR exchange rate developments from 1994 to 2003.](image)

Source: CNB

On the background of the EUR/CZK stability we experienced a significant shift in the EUR/USD rate and consequently the USD/CZK rate. The appreciation of the koruna against the dollar has been rather profound. The average rate was 28.30 in 2003 compared to 32.68 in 2002 and 38.03 in 2001. It would not be surprising to see a few years of the strong euro after living for a few years with a strong dollar since this was a typical pattern in the last few decades. The picture shows that volatility measured by the year-on-year percentage changes was rather unusual. Especially the appreciation of the koruna against the dollar by 30 percent during the summer 2002 was extraordinary.
Generally speaking, the „cheap“ dollar and „dear“ euro combination that emerged at the end of the last year is viewed as positive news for the Czech economy given the patterns of foreign trade and payments. In particular, cheap dollars means lower cost of many technologies important for the modernization of the economy. However, strong euro against the dollar can also mean drop in the competitiveness of the European production in the world markets that is also being manufactured more and more by the local firms. If strong euro prevails for a longer time period, the real impact of this on the local exports and the industrial production will be only seen with some delay. There is a certain probability, given the dependence of the Czech exports on the EU exports, that the strong euro will have some significant negative impact on the local manufactures.

As to the following years, we now believe that it is desirable for the nominal exchange rate of the koruna against the euro to stay close to the current levels. Sustainable and fundamentally driven real exchange rate appreciation that is now estimated to decline in the years ahead to rather a low level should be materialized primarily via the inflation differential. There is a very limited scope for nominal exchange rate appreciation. As I will explain below, the stability of the nominal exchange rate would secure competitiveness, accommodate moderate inflation targets while creating favourable climate for technological investments.

When discussing the policy co-ordination with the government, we stress that the stability of exchange rate requires also the decisive fiscal stabilization. Without it, the growing needs for external borrowings could initially cause exchange rate appreciation (when the foreign capital is attracted), and later on subsequent depreciation (when the debts have to be repaid). Volatility like this can hardly be supportive for long-run economic growth. These are the exchange rates swings in the last three years and the fear of instability in the future that stand behind the desire of manufacturers to have the euro as a domestic currency as early as possible.

Source: CNB
3. Eurozone Accession and Exchange Rate Policy

At the outset of 2004, with the eurozone accession in mind, it is more and more important for the central banks in the acceding countries to focus on the future exchange rate developments and trends in real exchange rates. The understanding of determinants of the past and the future trends and the view of the optimal, sustainable or equilibrium real exchange rate will be also one the biggest challenges for the CNB since the implications are numerous.

Figure 8 documents that in the Czech Republic, despite the volatility, real exchange rate vis-à-vis EUR (DEM) was most of the time moving in the appreciation zone during the last 10 years. After the period of fast real appreciation at the beginning of the transition, further appreciation should be much milder. The picture shows that after the appreciation episode in the and of 2001 and the first half of 2002 the real exchange rate returned back to the long-run trend for a mild appreciation.

\[Figure\ 8: \  Trend\ in\ real\ exchange\ rate\]

\[\begin{array}{|c|c|}
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\text{Source: CNB} \\
\text{real CZK/EUR} & \text{Y-O-Y real CZK/EUR} \\
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\end{array}\]

It is also true that the CNB straggled over years to prevent from a faster real appreciation buying large amount of the foreign exchange reserves (see Figure 9). This amount seems to be excessive and leads to the question whether or not the central bank has been constantly attempting to prevent from fundamentally driven adjustments in real exchange rate. I will explain below that there are strong reasons to believe that this was not the case and that the policy aimed at slowing down the appreciation was badly needed.

For years, there have been serious discussions among the analysts and policy-makers on the implications of the policy of low inflation on the background of the natural trends for the real appreciation. The general assumption in the market is still that the very limited scope for the real appreciation via inflation differential requires some nominal appreciation. Since the policy of low inflation is required by the Maastricht criterion for the inflation, it is generally believed that the Czech Republic and some other acceding countries will join the eurozone with the euro cheaper in nominal terms. Our experience challenges this particular belief in a way. At the same time, we are a bit concerned that despite the large uncertainty about the
scope and timing of the appreciation movements, the belief like that has a potential to create non-linear dynamics in the nominal exchange rate with potentially adverse effects on the economic activity and the process of the real convergence.

**Figure 9: Trend in real exchange rate**

![Trend in real exchange rate](image)

*Source: CNB*

The CNB was facing the effect of “convergence game” especially in the 2001-2002 period. Fortunately, the appreciation bubble burst relatively soon and the exchange rate returned to the more realistic levels. Recently, we concluded that after some adjustment in the nominal exchange rate in the previous years, and after completing the major steps in deregulation of administered prices, the scope for the further sustainable real appreciation will be limited in the years ahead to roughly to 2 or 3 percent a year. Given the scope for inflation differential, hardly any nominal appreciation will thus be needed. In other words, the fundamentally-driven real appreciation might be slow enough not to imply a serious conflict between low inflation and reasonable economic growth. The factors behind this conclusion are the relatively pessimistic view of real convergence potential of the Czech economy and some recent estimates of the Balassa-Samuelson effect.

However, relying on these two factors (relatively slow growth and low value of the Balassa-Samuelson effect) creates the “fear of success”. The fear is based on the assumption that if for some reasons the Czech economy switches to GDP growth rates much higher compared to the current ones, the conflicts between the eurozone accession/membership and convergence may emerge. A huge success would stimulate credit creation and domestic demand to such an extent that overheating of the economy would be hardly avoidable. In addition, the attempts to front-load the expected success may have a potential to initiate the asset markets bubbles and potentially threaten the stability of the financial sector.

Of course, there is certain logic in the “fear of success” considerations. However, the logic is a bit flawed and the fear itself is exaggerated. First, there is no inherent conflict between nominal and real convergence associated with the eurozone accession requirements *per se*. As I have already expressed, the existence of a conflict is strongly conditioned upon the strength...
of the potential growth in the acceding countries. The conflict would emerge only if the growth in the acceding countries picked up to the very high and persistent levels compared to the current eurozone members. And second, the Balassa-Samuelson effect, that dominates thinking about convergence dynamics, does not constitute a valid argument since it is a rather poor description of the current state of affairs in transitional economies. Turek (2002) questions the validity of the Balassa-Samuelson logic based on comparative advantages, homogeneity of tradeables, clear frontiers between tradeables and non-tradeables, dominance of non-tradeables by services and other features of traditional international trade theory. The link between productivity and price level may be rather weak due to the high transaction cost of producers in transitional countries that try to sell their production in foreign mature markets dominated by well established companies and global multinationals. Producers from transitional countries are often forced to sell products with a low level of sophistication for low prices close to their low costs or to engage in low-income outward processing traffic. That is translated to low wages and prices in transitional economies, no matter whether or not the producers have low or high productivity in their production leagues. Under these assumptions, the growth in productivity itself does not guarantee increase in incomes, wages and prices (and thus in real value of domestic currencies). This can be delivered only via more sophisticated, specialised and diversified production sold for the higher prices in the international markets. And there is no easy way to achieve that. It is necessary to create a business-supportive environment with a modern institutional and operational framework.

The link between the real exchange rate and external competitiveness is also very important\(^2\) and traditional analysis is not sufficient. When thinking about the acceding countries, it is necessary to take into account a typical problem faced by an emerging market economy that is linked to the move towards the more sophisticated production with tougher competition in the world markets. Under this process, higher productivity may not simply lead to higher external competitiveness and a stronger real exchange rate may not be justified because the producers are forced to compete on a much higher level than before. In other words, it is much easier to penetrate the higher product leagues with a relatively weak currency than with a relatively strong one.

The additional complicating factor is the phenomenon of the so-called double-speed economy. This term describes the situation when there are two different sectors in the economy. The first one is the sector comprised of well-performing companies usually with foreign ownership ("new" sector henceforth) and the second sector is the one comprised of the traditional companies owned often by the local investors and government ("old" sector henceforth). The trend for the real appreciation is in line with the performance of the foreign sector and we may say that it is caused by it (through the capital inflows to the sector and its export capability). In theory, the old sector firms should adjust to the new sector ones by

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\(^2\) Real exchange rate is often viewed as a key indicator of external competitiveness, and real appreciation is frequently understood as a loss of external competitiveness. However, the link between real exchange rate and external competitiveness is rather a complex one. On one hand, real appreciation may really lead to loss of external competitiveness when actual real exchange rate becomes overvalued compared to the long run fundamental value. On the other hand, real appreciation may reflect growing external competitiveness implied by the improvements in efficiency and productivity in tradeables.
increasing the productivity, and those that are not able to do so should leave the market. In reality, it is extremely difficult for many “old” sector firms to increase productivity and lower costs. Initially, they were not forced to leave the market, and through the bank system and government bailouts they burdened with extra costs the relatively efficient sector. But now, they are step by step forced out of the market or in some cases towards the new sector. This creates questions like “Should it lead to faster real appreciation?” or “Should even central bank promote faster real appreciation to foster further restructuring?”. There is no single answer since there is also no single optimal trend in real exchange rate. We can find reasonable equilibrium solutions for the slower as well as the faster real appreciation. The problem is that the latter solution, which may be more suitable from the long-run perspective (since it should lead to the economy with more technologically advanced production), may be practically difficult to achieve without exposing the economy to significant risks. Given the complexity of the economy-wide restructuring, the risks seem to be so high that a cautious approach by the central banks to the real exchange rate appreciation can only be recommended.

4. The Czech Republic and the Euro

The CNB strategy towards the euro was published after an intensive discussion in the Bank at the end of 2002. The strategy concludes that the evaluation of the positive effects and possible risks speaks in favour of the Czech Republic’s fast entry into the eurozone. The CNB thus recommended that some necessary measures must be implemented in such a way as not to rule out the possibility of joining the eurozone sometime around 2007 after spending a minimum required period of 2 years in the ERM2 exchange rate regime. The strategy of the CNB has been generally supported by the corporate sector. This is the reflection of the strong trade orientation towards the EU and the deep integration of the local manufacturers with the eurozone (see Figure 10 showing one of the key indicators – the level of intra-industrial trade).

During the subsequent negotiations with the government, it became clear that the outlook in the fiscal policy area based on the now implemented reform package was not fully consistent with the fast-track approach towards the euro. The country will thus have an option to join the eurozone later - probably during 2009-2010 only after implementing the 2nd stage of fiscal consolidation, which is not yet being designed. This can still be viewed as relatively early adoption of the euro. However, I have to emphasise that the arguments speaking in favour of having the euro even sooner listed in the CNB strategy were not challenged in a fundamental way. The less ambitious approach is determined by the preferences concerning the speed of measures aimed at reductions of the public finance deficit, not by a decision on the optimal timing of the eurozone entry. Nevertheless, it would not be appropriate to narrow the debate on the optimal timing on the ability to meet the Maastricht criterion for the budget

3 Relatively fast real appreciation would lead to faster restructuring with some traditional productions quickly dying. If the new productive capacities were not establish quickly enough, it would result in slow economic growth. Slow growth would worsen fiscal situation and at the end, the reputation of the economy could become basically undermined. In a situation like this, the crisis of the confidence can easily be transformed to a severe financial crisis.
deficit.

**Figure 10: Integration of the Czech economy is large**

Share of intra-industrial trade in accession countries
(in % of total EU trade, 2000)

Source: ECB (2003a)

This point gives me a chance to switch smoothly to some general fiscal issues. As I said, the key reason behind the decision of the Czech government not to struggle for the earliest adoption of the euro was the desire to have a few years more for using fiscal measures to promote growth and convergence. The opinion of the CNB is nevertheless different. We understand deep structural reforms in public finances as a way of promoting growth and convergence. If the needed reforms are instituted, there will be more scope for the stabilization role as well as the growth-stimulating role of the fiscal policy. These are exactly the roles that we are missing now even though we experience a 5-or even a 6-percent fiscal deficits year by year. It is clear that the current levels of public deficits will not be tolerable in the future, since the deficits are largely structural in their nature and related to the long-run unsustainability of some socially-oriented public spending programmes.

Against this background, the Stability and Growth Pact cannot be viewed as an obstacle, but as a reasonable framework for constraining fiscal policies in the monetary union. The fact that upon EU accession, the Stability and Growth Pact will become relevant to the new member states has not been fully realised and appreciated yet. Even though the member countries will not be subjected to sanctions before joining the eurozone, as the EU members they should have in place at least a credible programme towards achieving its objectives anyway. Despite the uncertainty on how the Stability and Growth Pact will work in the future, it is clear that rules like this will always have to be in place in the eurozone. It is natural to think about modifying somehow the existing rules. Especially the debate on details concerning the flexibility of the rules of the game should not be blocked. They can be for example defined in terms of the structural budget deficit and they can also emphasize sustainability issues (like the level of the debt). For the acceding countries, the rules should also be flexible enough so as not to conflict with necessary deep reforms in pension schemes.

The CNB strategy warns that important preconditions have to be fulfilled to ensure that
the potential positive effects really materialise and that the existing risks of the eurozone membership are minimised. First, sufficient alignment of the Czech economy with the eurozone economies in the real and financial spheres is required. Second and maybe more important, the economy must be flexible and adaptable enough. The flexibility and adaptability applies to the fiscal policy stabilization role, the labour market features as well as the framework for conducting business. To achieve further progress in these areas, the Czech Republic needs not only to consolidate its public finance system, but to further deepen structural reforms, too.

As I indicated above, the arguments for the early euro adoption are rather strong, but there still is one important aspect. It is natural for the faster-growing converging economy in a monetary union to have a higher inflation rate compared to a mature economy. If these two economies share the same interest rate, the real interest rate in the converging one will naturally be lower. This may have some implications. Of course, the converging economy will also have a currency that appreciates in real terms. The potential for overheating given by the low level of the real interest rates in the economy with the fast growth would thus be limited by current account implications of real exchange rate appreciation. The offsetting properties may nevertheless be far from perfect creating the risk of boom in the domestic demand at the expense of external deficit. The risk of macroeconomic and financial stability may thus emerge. The question is how to establish policy instruments that have the potential to manage risks linked to the situation like this. The scope of the problem is again linked to the scope of the underlying real exchange rate appreciation.

On macroeconomic level, after losing monetary policy tools, there will be a critical need for alternative tools for the effective stabilization. Some may be based on the flexibility of markets themselves. Some additional have to be available for the government and utilised not only during the downturns of economic activity, but even more in the upturns. Especially the high economic growth based on the foreign capital inflow may call for the measures aimed at reducing the growth in the domestic expenditures and preventing the asset market bubbles. Nevertheless, the belief in the major role of macroeconomic policies in securing growth and stability is excessive. The loss of independent monetary policy and the clear limits on using fiscal policy do not create the barriers to achieving macroeconomic stability. The Czech Republic as well as the other acceding countries has enough scope for making the economy more efficient, flexible and modern via institutional, structural and other microeconomic reform steps and improvements. Following this way, the risks associated with rather constrained macroeconomic policies can be limited. These are the challenges for the policy makers that have to be addressed in a few years following May 2004.

5. Exchange Rate Policy and ERM2

One of the key decisions on the way towards the euro is the one on the ERM2 membership and the exchange rate regime properties within this regime prior to the euro adoption. Under the current conditions, the candidate countries are required to participate successfully in the ERM2 exchange rate mechanism for at least two years. Successful participation means announcing a central exchange rate ("central parity") and then maintaining the actual exchange rate within a standard fluctuation band around the central parity without severe
tensions for the entire examination period. One of the features of the ERM2 is the difference between its fluctuation band ± 15 % and the narrower range ± 2,25 % that is to be used for evaluation of exchange rate stability compatible with the Maastricht criteria. Given the positive approach of the EU institutions to the exchange rate appreciation of the acceding countries’ currencies, the actual evaluation range will be basically defined as +15/-2,25 and even the less strict interpretations should be officially available that is based on “without severe tensions” clause (ECB, 2003b). For conducting the central bank policies, a definition like that is a bit vague. One can only tell ex post, whether or not the tensions were severe. Our experience with 2001-2002 appreciation pressures provides evidence that properly addressing pressures in the foreign exchange market (especially non-fundamental and expectations-driven ones) can mean allowing the exchange rate to change sharply and then adjust back with the support of accommodating and offsetting interest rate policy.

The position of the acceding countries toward the ERM2 differs from the one of the European Commission and the ECB. Personally, I cannot see any value added in using the ERM2 regime. The Czech Republic stabilises inflation by means of the inflation targeting and the ERM2 can hardly constitute the tool for stabilising nominal exchange rate. The width of the band ± 15 % is too large, intra-marginal intervention of the ECB are unlikely, and marginal intervention of the ECB cannot be guaranteed. Under such circumstances the agreed central parity in the narrow range could be prone to testing by foreign exchange markets. The probability of this is increased by uncertainty of the market participant as to the “fair” value of currency due to the multiple-equilibria phenomenon, and potential conflict between exchange rate targets and inflation criterion. Paradoxically enough, the stabilising properties promised by the ERM2 proponents could easily be overcome by non-fundamental destabilising forces.

In addition, a double-shift from inflation targeting that is close to the now prevailing monetary policy system in the eurozone to a very different system and then back does not make a big sense. One of the key successes of the CNB policies based on flexible inflation targeting and floating exchange rate regime was the stabilization of the inflation as well as nominal interest rates on very low levels. It would be extremely difficult to achieve with the fixed exchange rate in the environment of convergence trends, free movement of capital and unstable conditions in the world economy.

To sum up, the CNB views the ERM2 as an entry gate to adoption of the euro. We strongly recommend participation in the system only for a minimum required period of two years and joining it only when preconditions for adoption of the euro within a 2-year horizon have been met. The experience of Hungary with an ERM2-like regime obtained so far provides the rationale for the approach like this. To sum up, the CNB recommends the government to keep the koruna outside the ERM2 after joining the EU in 2004 and evaluate the perspective preparedness for adoption of the euro regularly each year. The CNB also strongly prefers to continue with the policy of inflation targeting in the period before joining the eurozone. A 2-year period of joint operation under inflation targeting and ERM2 will surely be a challenge for the central bank, though for a limited period of time it should be manageable.
There are some popular questions concerning macroeconomic dynamics associated with the ERM2 and the euro adoption issues. Will adopting the euro lock in the appreciation in local currencies and result in inflation? Will the acceding countries join the eurozone with the euro much cheaper in nominal terms given the very limited scope for the real appreciation via inflation differential? And especially, would fixing nominal exchange rate close to the current „undervalued“ values conflict with price level convergence, relative price adjustments and structural changes? With some simplification, I would say if countries like the Czech Republic were able to maintain practically the same exchange rate for 13 years (see Figure 3) while pushing gradually inflation to very low levels, it should be possible to continue with exchange rate locked in by the euro after joining the eurozone. After the whole transitional period, a major part of convergence in price levels and price structures should be completed. Only gradual adjustments should follow then. In addition, as I said, the scope for further sustainable real appreciation would be rather limited. Against this background, with some scope for the inflation differential available, hardly any nominal appreciation will be needed. It does not appear that keeping nominal exchange rate close to levels prevailing now may cause major difficulties and conflicts providing the flexibility of the economy is increased. After all, the undervaluation is surely much lower than 13 years ago.

I can even understand the fears of that the acceding countries will use nominal exchange rate to improve external competitiveness at the expense of EU partners prior to the eurozone membership. However, if you again look at the Figure 3, there is clear evidence that this has never been the case in the Czech Republic. The koruna is nominally stronger than in 1991 when the economic transition began. In this respect, joining the EU and later on introducing the euro will not change things so dramatically. The economy has fully open goods and financial markets and nearly the same nominal exchange rate for many years. Euro adoption would only fix this exchange rate permanently. This is confirmed by the fact that the CNB strategy has been generally supported by the corporate sector. This is the reflection of the strong trade orientation towards the EU and the deep integration of the local
manufacturers with the eurozone. Though the level of the traditionally measured euroization of the economy is very low, many Czech-based companies invoice each other in the euro even within domestic trade relations. The adoption of the euro thus would not change much the environment the companies operate in.

Fixed exchange rates are conditioned upon sound policies. Introduction of the euro can be viewed as a permanent fixing of the nominal exchange rate. Though the fixed exchange rates are not rather popular today, we can find number of countries operating with them with superb results (for example Austria before joining the eurozone, Denmark still now and the Baltic States within the acceding countries). The fixed exchange rate can deliver excellent performance when the two conditions are met. First, the government runs sound fiscal policy that supports the selected parity. And second, the economy is flexible enough to withstand various shocks. This requires the existence of the adjustment channels alternative to the exchange rate changes. We can even find that some eurozone countries (Austria is a nice example) do feel rather comfortably in the monetary union, because the decades of the strictly fixed exchange rates were used to create sufficient flexibility. On the contrary, some countries that were relying on the exchange rate adjustments, now lack these alternative channels. Against this background, the real obstacle to the early introduction of euro in the Czech Republic is the insufficient flexibility of the economy. This is why this particular problem has been so widely addressed in the CNB strategy.

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