Stability of the Czech Koruna and Convergence towards the Euro

Jan Frait – Czech National Bank

Investment Forum Ostrava – October 2, 2003

Introduction
My presentation is entitled “Stability of the Czech Koruna and Convergence towards the Euro”. These are exactly the things I was promising here during the Investment Forum only two years ago. Today I feel quite at ease, because the Czech currency is stable and convergence is on the way. My goal is thus to say a few words about what has been achieved and also about the monetary and macroeconomic outlook.

The Czech National Bank (CNB) and the other central banks of the EU accession countries have stepped up their efforts to prepare for becoming members of the European System of Central Banks in May 2004. These efforts have been focused primarily on making further progress with nominal convergence and stability of the financial system so as to enable smooth economic – and later on also monetary – integration within the eurozone. In my presentation, I will comment on the monetary policy of the CNB, developments in the domestic banking sector and on the Czech strategy towards the future adoption of the euro.

1. Current monetary policy and the macroeconomic outlook
According to the Czech Constitution, the CNB’s primary objective is “to maintain price stability”. Without prejudice to this primary objective, the Czech National Bank is also tasked with supporting the “general economic policies of the Government leading to sustainable economic growth”. This means that the CNB should set its main policy instrument, namely interest rates, at a level that will maintain inflation at a low and stable level without needlessly slowing, or excessively accelerating, the economic growth rate.

Since January 1998, the CNB has conducted its monetary policy within an inflation targeting (IT) system. Putting it simply, the CNB has undertaken to maintain inflation under normal external economic conditions on course for an announced inflation target. As far as the choice of the IT system is concerned, it was definitely a case of jumping on a long-run trend. The CNB was the first post-socialist central bank and one of the first central banks outside the industrially developed countries to opt for this particular regime. Today, we can see more and more countries operating such a system. Even the European Central Bank (ECB) is slowly moving towards an IT framework. It is fair to admit that the early introduction of IT in the Czech Republic generated some controversial results, and later the whole framework was significantly redesigned. Nevertheless, taking a long-run view, the switch to this modern way of making monetary policy was definitely a success.

1 Jan Frait – Board Member and Chief Executive Director, Czech National Bank, Na Příkopě 28, 115 03 Praha 1, Czech Republic, e-mail: jan.frait@cnb.cz
The design of the inflation targets is documented in Figure 1. Up to 2002, the target was set in terms of “net inflation”, which excluded the 18 per cent of the Consumer Price Index (CPI) basket items regulated by the government (e.g. energy prices and rents). In 2002 the CNB moved towards a “full-fledged” form of IT regime based more on the medium-term perspective, under which the target is set in terms of CPI (headline) inflation. At present, the CNB’s inflation target takes the form of a continuous band for annual consumer price inflation descending evenly from 3%–5% in January 2002 to 2%–4% in December 2005. This indicates that the disinflationary process in the Czech economy is drawing to an end.
During the five years of IT, the Czech Republic has become a low-inflation economy. Figure 2 shows that inflation went down sharply to a very low level during 1998 and has stayed there up to the present. However, the inflation rate itself has frequently ventured outside the target range. This applies primarily to the 1998–1999 period of net inflation targeting. Also, the current period reveals a significant undershooting of the headline inflation target. This year, we have even experienced a mild decline in consumer and producer prices. To sum up, the volatility of inflation is still relatively large and biased asymmetrically downwards.

*Figure 3: The recent decline in inflation*

![Graph showing recent decline in inflation](image)

*Source: CNB and Czech Statistical Office*

The factors behind the inflation volatility are typical for a small open economy – namely volatility of import prices caused by changes in natural resources prices and nominal exchange rate swings. The specific domestic factors are the volatility of agricultural and food prices, and also of administered prices during the period of deregulation. The current decline in inflation is to a large extent linked to the expectations-driven appreciation of the Czech koruna against the euro and its subsequent appreciation also against the dollar, a side effect of the euro/dollar exchange rate changes. As Figure 4 shows, the koruna was appreciating against the euro on a year-on-year basis throughout 2000–2002. Only this year has the trend been reversed to some extent. The swings against the dollar were even more pronounced. The trend in the CZK/EUR exchange rate was identified by the CNB as a bubble threatening industrial performance and the external balance, and the subsequent policy actions against it were relatively successful. This year we have witnessed remarkable stability of the koruna as far as its value against euro is concerned.
The currency appreciation, the unexpected decline in food prices and the low increases in administered prices have caused inflation to undershoot the target significantly and for a rather long period. According to the CNB’s current forecast, inflation will move back to the target band during 2004, although thanks partially to increases in indirect taxes. The overall inflation pressures should be rather low even during the following years. The CNB will soon start discussions on setting the inflation target for the period starting in 2006. Today, bearing in mind the ECB target, the Maastricht criteria and the convergence trends, I can only estimate that the midpoint of the future CNB target for headline inflation will probably be set between 3 and 4 per cent.
Estimating the negative combined impact of the exchange rate appreciation and the worsening output growth in the world economy, the CNB has used its instruments to stimulate domestic demand in the last two years. The central bank repo rate has been reduced to an unusually low level (currently 2%) and large intervention purchases of foreign exchange have been made, too. The low interest rates and the stabilised exchange rate have helped to keep the growth rates of domestic demand and household consumption at a stable and relatively high level. It would make no sense to pretend that the slowdown in the EU economies has not created a very difficult environment for exporters. Nevertheless, sound corporate performance – occurring despite the negative external shocks – is also contributing to the current output growth. We expect that once the eurozone economy recovers, the Czech economy will again grow at a rate of 3.0 to 3.5 per cent during 2004–2006. This growth should be driven more by net exports and less by domestic demand of households and the government.

*Figure 6: Growth in domestic demand and GDP*

![Chart showing growth in domestic demand and GDP](chart.png)

*Source: Czech Statistical Office*

2. Macroeconomic convergence and strategy towards the euro

Besides the traditional goals, there has been one additional major factor leading our policy in the last few years – EU and EMU accession. During the last three years, the CNB has endeavoured to conduct policy so as to achieve results compatible with the Maastricht criteria for nominal convergence. To the great surprise of some of our colleagues from the EU institutions, the criteria relevant for central banks, namely inflation rates and interest rates, now behave in a way that is fully in line with these criteria. The nominal exchange rate against the euro exhibits higher volatility than expected, but the trend towards appreciation is also compatible with the Maastricht criteria. If we look at Table 1, describing the compliance of the accession countries with the criteria in 2002, the Czech Republic’s meeting three of the criteria is the most successful among the economies of Central Europe. The overall picture is that even before EU entry the convergence required for EMU entry is at a very advanced stage in all the countries under consideration. The main problem that is still to be addressed is the level of fiscal deficits.
Table 1: Accession countries and the Maastricht criteria (2002 figures)

<table>
<thead>
<tr>
<th></th>
<th>HICP inflation¹</th>
<th>Fiscal deficit (% of GDP)</th>
<th>Public debt (% of GDP)</th>
<th>Long-term yields²</th>
<th>Exchange rate regime³</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cyprus</td>
<td>2.8</td>
<td>-3.5</td>
<td>58.6</td>
<td>5.4</td>
<td>10-y</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>1.4</td>
<td>-6.7</td>
<td>26.9</td>
<td>4.6</td>
<td>10-y ERMII shadow</td>
</tr>
<tr>
<td>Estonia</td>
<td>3.6</td>
<td>1.3</td>
<td>5.8</td>
<td>--</td>
<td>-- CBA (euro)</td>
</tr>
<tr>
<td>Hungary</td>
<td>5.3</td>
<td>-9.2</td>
<td>56.3</td>
<td>7.1</td>
<td>10-y ERMII shadow</td>
</tr>
<tr>
<td>Latvia</td>
<td>2.0</td>
<td>-3.0</td>
<td>15.2</td>
<td>5.3</td>
<td>5-y Peg to SDR</td>
</tr>
<tr>
<td>Lithuania</td>
<td>0.4</td>
<td>-2.0</td>
<td>22.7</td>
<td>6.0</td>
<td>10-y CBA (euro)</td>
</tr>
<tr>
<td>Malta</td>
<td>2.2</td>
<td>-6.2</td>
<td>66.4</td>
<td>5.7</td>
<td>10-y peg to basket</td>
</tr>
<tr>
<td>Poland</td>
<td>1.9</td>
<td>-4.1</td>
<td>41.8</td>
<td>7.3</td>
<td>10-y float</td>
</tr>
<tr>
<td>Slovakia</td>
<td>3.3</td>
<td>-7.2</td>
<td>42.6</td>
<td>6.9</td>
<td>10-y managed float</td>
</tr>
<tr>
<td>Slovenia</td>
<td>7.5</td>
<td>-2.6</td>
<td>28.3</td>
<td>3.4</td>
<td>5-y managed float</td>
</tr>
<tr>
<td>AC-10⁴</td>
<td>2.8</td>
<td>-4.8</td>
<td>39.9</td>
<td>6.4</td>
<td></td>
</tr>
<tr>
<td>Reference value</td>
<td>2.9</td>
<td>-3.0</td>
<td>60.0</td>
<td>6.9</td>
<td></td>
</tr>
</tbody>
</table>

Shaded areas indicate compliance. 1) Period average. 2) Period average; some countries still lack a liquid market for long-term government bonds. 3) IMF classification. 4) Weighted by nominal GDP.


The parameters and structure of the CNB’s instruments are also almost fully harmonised with those of the ECB. Many central banks – particularly in past decades – have also employed “required reserves” as an instrument of monetary policy. This instrument requires banks to hold a specified percentage of the deposits they accept on zero-notice accounts at the central bank. However, the CNB – in keeping with the worldwide trend – no longer uses required reserves for monetary policy purposes. Although banks are still required to hold a small percentage of their deposits at the CNB, these funds – remunerated at the repo rate – serve as a cushion for the smooth running of the interbank payment system operated by the CNB.

Figure 7: Convergence in central bank interest rates

The main instrument is the two-week repo rate. Banks have the option of depositing their excess liquidity at the CNB for a two-week period on the basis of repurchase agreements (“repos”) at a rate not exceeding the two-week repo rate. By changing the repo rate, the CNB influences short-term interest rates on the interbank market. This signal then spreads to interest rates throughout the economy, to economic activity and ultimately to inflation. Figure 7 shows that the low-inflation environment has enabled the repo rate to be cut to the level prevailing in the eurozone. Figure 8 illustrates that it is not only short-term interest rates that have converged to the low levels typical of industrially developed economies. Long-term interest rates on koruna assets have even moved below the German and U.S. levels recently.

Figure 8: The interest-rate differential has disappeared

Source: CNB

3. The Czech Republic and the euro

Given the success with nominal convergence, the Czech Republic and the other accession countries last year published strategies towards the euro. These are rather ambitious, since there are hopes that participation in EMU will strengthen macroeconomic stability and speed up the real convergence process. The strategies usually talk about 2007 as the first possible year for joining the eurozone.

Our strategy understands that certain preconditions have to be fulfilled to ensure that the positive effects really materialise and that the potential risks of eurozone membership are minimised. Sufficient alignment of the Czech economy with the eurozone economies in the real and financial spheres, flexible fiscal policy and a well-functioning labour market will be of key importance for the smooth functioning of the economy within EMU. To achieve further progress in these areas, the Czech Republic needs to further deepen structural reforms directed at increasing the flexibility of the Czech economy and to consolidate its public finance system.

The CNB believes that the evaluation of the positive effects and possible risks speaks in
favour of the Czech Republic’s fast entry into the eurozone. Our key arguments include the intensive integration of local manufacturing production with the eurozone manufacturers. Looking at the scope of intra-industry trade (Figure 9), we can see that the level is much higher than the EU average and the highest within the accession countries. The CNB has thus recommended that the above measures must be implemented in such a way as not to rule out the possibility of joining the eurozone sometime around 2007. However, the current outlook in the fiscal policy area is not fully consistent with this scenario. The fiscal consolidation measures seem to be the least ambitious if we compare the difference between deficit levels in 2002 and 2006 announced by the individual countries in their Pre-accession Economic Programmes. The Czech Republic will thus join the eurozone later – probably during 2009–2010 only after the second stage of fiscal consolidation, which is not yet being designed.

Figure 9: Foreign trade integration is very deep

![Figure 9: Foreign trade integration is very deep](source: ECB (2003))

4. Exchange rate trends and exchange rate policy
One of the key decisions on the way towards the euro is the one on ERM2 membership and the properties of the exchange rate system within this regime prior to adopting the euro. Under the current conditions, the candidate countries are required to participate successfully in the ERM2 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%) to be used for evaluating exchange rate stability compatible with the Maastricht criteria.

The position of the candidate countries towards the ERM2 differs from that of the European Commission and the European Central Bank. Personally, I cannot see any value added in using the ERM2 regime. The Czech Republic stabilises inflation by means of inflation targeting, and the ERM2 can hardly be a tool for stabilising the nominal exchange rate. The width of the band (±15%) is too large, intra-marginal interventions by the ECB are unlikely,
and marginal intervention by the ECB cannot be guaranteed. Under such circumstances the agreed central parity in the narrower range of ±2.25% would be prone to destabilising testing by the foreign exchange markets. In addition, a double-shift from inflation targeting, which is close to the current monetary policy system in the eurozone, to a very different system and then back again does not make much sense.

To sum up, the CNB views the ERM2 as the gateway to adoption of the euro. We strongly recommend participation in the system for only the minimum required period of two years and joining it only when the preconditions for adopting the euro within a two-year horizon have been established. Given that, the CNB recommends to the government that the koruna should be kept outside the ERM2 after the Czech Republic joins the EU in 2004 and that our preparedness for adopting the euro should be evaluated each year.

*Figure 10: Is there value added in ERM2?*

![Graph](chart.png)

*Source: CNB*

I can understand the fears that the accession countries will use the nominal exchange rate to improve their external competitiveness at the expense of their EU partners prior to EMU membership. However, if you look at the following chart, 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. All this means that introduction of the euro would not change things much – we have an economy with open goods and financial markets, a strong trade orientation towards the EU and nearly the same nominal exchange rate for more than 12 years. Euro adoption would merely fix this exchange rate permanently.

As to the movements of the nominal exchange rate prior to EMU membership, the CNB expects that stability of the nominal exchange rate at the current levels would be consistent with the underlying trends and policy targets. Only a minor exchange rate appreciation in the range of 1 or 2 per cent per year would be justified and understood as a sound and equilibrium phenomenon.
5. Stabilisation and development of the banking sector

I would like to conclude my presentation with a few words on the developments in the local banking sector. The sector went through a widespread crisis between 1997 and 2000. A lot of money was lost and a vast amount of public money was spent in an effort to make the banking sector healthy and stable. The state-owned banks were privatised and now they have foreign owners with a good reputation and considerable experience. The stabilisation and restructuring process is now practically finished. We can see positive things happening in the banks in the rising figures, and it is clear that the public has regained its confidence in the sector. The Czech banking sector is set to become an integral part of the European financial market. It is one of the largest among the accession countries.

Figure 12: Size of the banking sector

If we look at the indicators of the banks’ health (Table 2), we can see high capital adequacy, strong liquidity, a sharp drop in the ratios of classified credits and non-performing loans, and more than satisfactory coverage of the weighted classification with reserves and provisions. The banks thus enjoy favourable conditions for further development.

Table 2: Czech banking sector has been stabilised

<table>
<thead>
<tr>
<th></th>
<th>End 1999</th>
<th>End 2000</th>
<th>End 2001</th>
<th>End 2002</th>
<th>2003 H1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital adequacy (%)</td>
<td>13.6</td>
<td>14.9</td>
<td>15.4</td>
<td>14.2</td>
<td>15.7</td>
</tr>
<tr>
<td>Quick assets/total assets (%)</td>
<td>19.5</td>
<td>19.4</td>
<td>20.8</td>
<td>32.7</td>
<td>55.9</td>
</tr>
<tr>
<td>Classified credits (% of total credits)</td>
<td>32.2</td>
<td>29.9</td>
<td>21.5</td>
<td>15.8</td>
<td>13.3</td>
</tr>
<tr>
<td>Non-performing loans/total loans (%)</td>
<td>21.9</td>
<td>19.90</td>
<td>13.7</td>
<td>8.1</td>
<td>6.3</td>
</tr>
<tr>
<td>Weighted classification (% of total credits)</td>
<td>16.9</td>
<td>12.9</td>
<td>9.5</td>
<td>5.5</td>
<td>4.1</td>
</tr>
<tr>
<td>Coverage of weighted classification with reserves and provisions (%)</td>
<td>67.9</td>
<td>65.0</td>
<td>84.7</td>
<td>113.9</td>
<td>136.9</td>
</tr>
</tbody>
</table>

Source: CNB

This year we can see renewed growth in credit creation (Figure 13). This is concentrated primarily in lending to households. In the years ahead, we also hope for a rise in lending to non-financial corporations.

Figure 13: Renewed growth in credit creation

Source: CNB
Conclusion
The CNB and the Czech financial sector are fully ready for joining the EU next year. The CNB also expects that adopting the euro later on will strengthen the macroeconomic stability of the Czech economy and speed up the real convergence of the Czech economy towards the EU economies. The CNB is therefore convinced that the Czech Republic should join the eurozone as soon as economic conditions allow for doing so. A necessary condition for this is a reform of the public finance system and more profound structural reforms leading to greater flexibility, such as improvements to the functioning of the labour market and government administration.

References
ECB (2003): The acceding countries’ strategies towards ERM II and the adoption of the euro: An analytical review. European Central Bank, Mimeo, September