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***Strategy of the Czech Economic Policy to the
Current Enlargement Process of the European
Monetary Union– When We Shall Replace the
Czech Currency with the Euro***

Executive Summary

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Our recommendation on the optimal timing of the entry of the Czech Republic into the European Monetary Union (EMU) is based on the New Theories of Growth and theories of Business Cycles including empirical verification of their conclusions. In the framework of these theories we used mainly the framework of Balassa – Samuelson Approach, theory of Optimal Currency Areas and Political Economy of the European Monetary Integration.

We also showed real possibilities arising from the adoption of Maastricht Criteria, precedents of evaluation of their meeting in 1998 when EMU was created, and limits of speed of joining, which the Czech Republic is interested in because of the current settings of targets of European institution, primarily the European Central Bank (ECB) and the European Commission (EC).

The advantages of as-quickly-as-possible entry are prevailing in our analysis.

- a) If we entered the EMU later than other candidate countries, it could harm our trade with members of the euro-zone. Empirical studies suggest, that euro has already added up to 30% to trade within the euro-zone and that this process continues. Trade creation within the euro-zone has a positive impact on member countries' productivity and therefore raises competitiveness of tradable goods sector.
- b) Any delay in EMU membership can discourage foreign direct investment in the Czech economy and can lead to acceleration of outflow of domestic and foreign capital. This outflow is likely to cause fast growth of unemployment and decline in wages.
- c) The entry itself will have a positive influence on convergence of business cycle and economic structure between the Czech and euro-zone's economies. Staying out of the euro-zone is connected with risk of exchange rate fluctuations, which can – among others – delay the convergence.
- d) Common currency will reduce exchange-rate risks and transaction costs of the Czech exports. Export prices will be more transparent and will lead to further export growth. It will boost economic growth and wage growth. Growth of non-tradable goods will be on the contrary dependent on a wage growth.
- e) The euro changeover will eliminate the danger of harmful deflation in the Czech economy because Balassa – Samuelson effect will be manifested only through selective growth of prices in nontradables sector and not through nominal exchange rate appreciation.
- f) Real appreciation of domestic assets caused by capital inflow will be fully absorbed by growth of domestic assets prices. That is why the capital inflow will not influence consumption, as it would happen in the case of the appreciation of local currency followed by import growth.

- g) There are of course many areas, where the Czech markets are less flexible compared to international standards (namely housing market and labour market). Reforms of these markets are desirable no matter whether or not the Czech Republic joins the EMU. There is definitely no reason to wait until they are more flexible. On the contrary, higher inflation rate after joining the EMU could enlarge space available for reforms than it would be in case of deflation caused by fast convergence through the exchange rate channel while keeping our own currency.

Due to original definition of Maastricht Criteria and putting their interpretation more precisely later it is clear, that joining the EMU will bring short-term costs represented by restrictive fiscal policy.

The period of convergence, which is necessary for entering the European Monetary Union without these costs, would probably take tens of years with very unsure result.

There are many studies of prestige international organizations (UN Economic Commission for Europe, Centre for Analysis and Research of Economic Policy, International Monetary Fund or European Bank for Reconstruction and Development), but also of central banks (National Bank of Hungary), which have doubts about the economic suitability of Maastricht Criteria, especially for new member states. The authors of this study share these doubts. It is not necessary to modify the criteria – just a change of their interpretation would help the new member states to lower the entrance costs.

But if we take into account real political (im)possibility of the change of these criteria, we have to accept them as a political constant. The only chance can be seen in potential change of price stability definition by ECB.

Current legislative and institutional rules in the EU make EC and ECB rather delaying the enlargement of the EMU.

Fiscal policy is the main limiting factor of speed of euro entry in the case of the Czech Republic. We have to meet not only the budget deficit criterion but we also have to achieve flexibility of fiscal policy, which must be high enough to allow regulation of aggregate demand, while we will participate on Exchange Rate Mechanism II (ERM-II) with narrow exchange rate fluctuation zone. Without this regulation of aggregate demand we might not be able to meet inflation and interest rates criteria.

Measures reducing economic costs of the euro adoption can be taken above all in the area of institutional changes in fiscal policy framework. It is also advisable to accept series of structural reforms. Paradoxically, being in the euro-zone can provide wider space for these reforms than staying out.

We answer the question “*What exchange rate strategy shall the Czech Republic choose in the process of joining the EMU?*” as follows: With the current rules of the ERM-II, it means with wide fluctuation zone $\pm 15\%$ combined with restrictive consideration of exchange rate convergence criterion derived from original narrow zone, it is suitable to stay in the ERM-II as short time as possible. Different situation would appear if the ECB and EC decided they would stabilize exchange rate of the Czech Crown in a narrower zone.

Main aim of this study, to answer the question “*When shall the Czech Republic enter the EMU?*”, can be realized by answer “*As quickly as possible*”. The speed of joining depends on three factors:

- a) speed of consolidation of public finance in the Czech Republic (including institutional reform),
- b) willingness of the EU and the EMU institutions to accept candidates countries to enter the euro-zone; this willingness seems to be relatively low in the presence,
- c) candidate countries’ good knowledge of the precedents of evaluation of Maastricht Criteria meeting and their ability to use it during the process of the EMU enlargement negotiations.