Prospects of Adopting the Euro in the Czech Republic

Perspektivy přijetí eura v České republice

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Abstract

The article explores prospects of adopting the euro in the Czech Republic. Interests and arguments of important stakeholders are discussed, concluding that reasons for diverging attitudes result from conflicting particular economic interests and political preferences on the future course of European integration. Special attention is given to inflationary and distributional consequences of adopting the euro while the Czech Koruna is still appreciating. The article explains why the Czech Republic ceased aiming at the Euro area accession and concludes that the process of the euro adoption may be eventually launched only if political power shifts to eurooptimistic political parties.

Keywords

European Monetary Union, euro, inflation, monetary policy, exchange rate

JEL Classification E52, F33

Abstrakt

Článek se zabývá sporem o zavedení eura v České republice. Diskutovány jsou zájmy a argumenty významných aktérů tohoto sporu, se závěrem, že rozcházející se názory pramení z rozdílných partikulárních ekonomických zájmů a politických preferencí ohledně budoucího kurzu evropské integrace. Zvláštní pozornost je věnována inflačním a distribučním důsledkům přijetí eura v době, kdy má česká koruna stale ještě prostor k apreciaci. Článek se zabývá důvody, proč Česká republika přestala usilovat o začlenění do eurozóny, a uzavírá, že proces eventuálního přijetí eura může být spuštěn v případě posunu těžiště politické moci ve prospěch eurooptimistické politické strany.

Klíčová slova

Evropská měnová unie, euro, inflace, monetární politika, směnný kurz

Introduction

In November 2010, Czech President Václav Klaus expressed his wish that the cabinet should negotiate an opt-out from the obligation to eventually adopt the euro[1]. This article traces the history of euro-critical agenda of Václav Klaus and Civic Democratic Party and shows that the

1 *http://www.eubusiness.com/news-eu/czech-economy.78l*

euro area accession is perceived by all relevant stakeholders as a decision based on political rather than economic considerations. It is practically impossible to evaluate such issue ripe with trade-offs on economic grounds in a universally acceptable manner. Economic arguments are used in the context of the debate rather as useful rhetorical devices supporting positions motivated by politics. It follows that the eventual adoption of the euro in the Czech Republic is ruled out as long as eurosceptic Civic Democrats remain in power.

The article first traces the development of the official stance of different stakeholders (sections 2 – 4): the government, Czech National Bank, major export business and European Commission. Sections 5 – 7 provide an overview of the conflicting economic arguments for and against the euro area accession, section 8 discusses the impact of the financial and economic crisis.

1 Development of the Government's and Czech National Bank's Official Stance

The Czech Republic was formally bound to eventually adopting the euro by the European Union (EU) accession agreements. The debate as to whether the euro should be introduced sooner rather than later has been going on ever since. During the time of the Social Democratic (ČSSD) government, the official stance was in favor of adopting the euro as soon as possible.[2] This was reflected in the Czech Republic's Euro-area Accession Strategy, a joint document by the Czech government and the Czech National Bank, approved in 2003. They recommended that the Czech Republic should join the Euro area "... as soon as economic conditions allow for doing so", which they expected to be around 2009–2010. This date was later postponed to 2012 because of general unwillingness to cut the budget deficit in line with the annual government deficit criterion before the elections in 2006.

The official attitude towards adopting the euro changed after a government, led by the eurosceptical Civic Democratic Party (ODS), was formed in 2007. An updated Euro-area Accession Strategy was approved by the new government on August 29., 2007 (Czech National Bank, 2007). In this document, the "as soon as" stipulation was dropped, and no target date was set. When Prime Minister Topolánek was asked whether he personally thought a euro adoption target date should be set, he replied through his spokeswoman: "No. No responsible government gives a date which it cannot influence. Setting a date would be a pure formality." (Petrus, 2007). The dropping of the "as soon as" stipulation is even more significant than the omission to set a prospective entry date. The updated strategy implies that the fulfillment of the Maastricht criteria is not a sufficient condition for a political decision to join the euro. It insists on removing all obstacles to adopting the euro by 2010 but refuses to set a date for actually joining the euro. ODS clearly prefers that the adoption of the euro be postponed ad infinitum, in line with its honorary chairman Václav Klaus' ongoing critique of European integration.[3] The reason for continuing rhetorical insistence on the eventual adoption of the euro is twofold:

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2 *After 1989, Social Democrats used the rhetoric of "a return to Europe" as a legitimization device in an environment of widespread media-bashing of the Left.*

3 *Václav Klaus views the single currency as a predominantly political project with the objective of furthering political integration of Europe. See also Klaus 2008.*

- lip service to the legal (albeit derogated) commitment to adopt the euro
- and utilization of the Maastricht criteria as an argumentation vehicle for furthering unpopular changes in economic policy.

To legitimize budgetary cuts in social spending, the Updated Accession Strategy goes far beyond the Maastricht criteria, as can be seen from the following paragraph:

> *"35. However, fulfillment of the Maastricht fiscal criteria should in no way be regarded as a sufficiently ambitious goal for the fiscal reforms in the medium term. The only sufficiently ambitious goal is to provably target the public finance deficit – at a rate of at least 0.5% of GDP a year – well below the value of the Maastricht convergence criterion towards fulfillment of the obligation arising under the revised Stability and Growth Pact. In the Czech Republic's case, this means heading in the medium term towards a structural (cyclically adjusted) public budget deficit of no more than 1% of GDP. Only in this situation will it be possible to consider state fiscal policy as sufficiently able to effectively perform its macroeconomic stabilising role following the loss of independent monetary policy." (Czech National Bank, 2007: 7)*

Another agenda outside the scope of the Maastricht criteria is an insistence on the reduction of workers' legal protection:

> *"38. Increasing the flexibility of the Czech economy remains another challenge for economic policy and for the future sustainability of the benefits of adopting the euro in the Czech Republic. [...] In addition to the insufficient stabilising role of public finances, the Czech economy's main problem in this area is its still limited ability to adjust flexibly in the labour market. [...]*
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> *"39. As in numerous Eurozone countries, the Czech labour market suffers from insufficient flexibility, reflecting strict employment protection regulations, a rising minimum wage [currently 8000 CZK, PG] and high labour taxation. Its insufficiently aligned tax and benefit system creates a demotivating environment, especially for the long-term unemployed in low-income families with children. A high ratio of social benefits to incomes in low-income households is also having a negative impact on the stabilising ability of fiscal policy. Enhancing the flexibility of the labour market by increasing the mobility of the Czech labour force also remains a challenge." (Czech National Bank, 2007: 8)*

The willingness of the Czech National Bank to bend its approach regarding the euro in whatever direction is required by the government shows that the decision to join the Euro area is generally regarded as properly political decision (unlike setting interest rates).

2 Business Demands

The demand for a quick adoption of the euro can be heard from companies in the Czech Republic which trade with the EU, but until recently, this was not an important issue. In 2003 Vratislav Kulhánek (head of the managing board of Škoda Auto) argued that, from the perspective of his company, the Euro area accession was an issue of marginal importance since they can hedge against the exchange rate risk and the majority of their business transactions are done in euros anyway.[4] Spikes in the exchange rate appreciation of CZK propelled some corporate demand for adopting the euro, however this was countered with an argument that adopting the euro, albeit ruling out the nominal appreciation, would produce the same reduction of profit margins via correspondingly higher inflation rate in the Czech Republic (Tůma, 2007). However, Tůma´s argument hinges on an implicit assumption that the higher inflation would not result in reduction (or deceleration) of real wages, while employers may be hoping to utilize an increased inflation rate as a (at least short-term) buffer against the real wage appreciation (see ČSÚ, 2008).

3 Changed Position of the European Commission

Even the European authorities seem to be reluctant to invite new members to the Euro area, as was indicated by the refusal to accept Lithuania's accession that was planned for January 1, 2007. The official reason for this refusal was the fact that Lithuania failed to meet the price stability criterion by a meager 0.1 %. This selective stringency contrasts to the benevolent approach of the European Commission in response to extensive violations of the Maastricht criteria by countries such as Germany and France. It would be hard to punish new Euro area members for failing to meet the Maastricht criteria in the future, whilst at the same time exculpating old members. This development could be seen to be a sign that the original *Stability and Growth Pact* de facto passed out.

4 Debate among Economists

Economists in the Czech Republic are divided on their opinion as to whether the euro should be adopted sooner (Dědek, 2003) or later (Janáčková, 2002; Janáček; Janáčková, 2004) (or never), leaning towards a later adoption. Economists associated with commercial banks tend to support postponement. Commercial banks would lose out from joining the euro as their profit from exchange operations would be substantially reduced, whilst competitive pressure would increase. Economists at the Czech National Bank are divided into two groups. Both groups use the same arguments for and against quick or postponed euro adoption, but ascribe them different importance to reach opposite conclusions. That may be seen as a reason why the Czech National Bank did not produce an official cost/benefit analysis for adopting the euro, unlike the Slovak National Bank (2006) which supported a quick Euro area accession. An assessment of the preparedness of the Czech Republic towards adopting the euro is provided in Helísek 2009, which concludes that the reasons for postponing the adoption are political rather than economic.

5 Arguments in Support of the Euro Adoption

Frequently used arguments in favor of euro adoption are as follows:

- *Elimination of exchange rate risk with Euro area countries*. This is an issue especially for smaller companies, as the costs of hedging, using financial derivatives, are prohibitive for relatively small transactions. Therefore, both small and medium-sized companies

4 *The interview is available at http://www.bbc.co.uk/czech/indepth/story/2003/10/031008_kulhanek.shtml.*

usually "hedge" against the exchange rate risk by requiring higher margins in the case of crossborder operations. It can be justly argued that the adoption of the euro would produce an increase of trade and specialization within Euro area countries by eliminating both this excess risk margin and costs of hedging, however the extent of such an increase is far from clear (see below).

- *Reduction of transaction costs.* Both households and firms would reduce their costs associated with exchange transactions. In addition, companies would reduce costs related to multiple currency accounting and costs associated with the need to hold liquidity reserves in different currencies.
- *Increased price transparency*. Increased price transparency may increase allocation efficiency.

According to some older studies, an increase in trade caused by a currency union is insignificant (Brada; Mendez, 1988). Therefore, considerable attention was given to a historical analysis by Andrew Rose (2000), who came to the conclusion that establishing a monetary union would cause an increase in trade of 60 to 200 %. Against an attempt to employ this result in advocating the European Monetary Union (EMU), it was argued that the majority of samples in Rose's statistical model were monetary unions between a colony and its former colonial power. Rose himself later modified his model and yielded a moderated result of trade increases in a range of tens of percents. An analysis from 2003, measuring the trade increase attributable to the EMU, reached even lower values between 2.3 and 6.3 %. (Vicerelli; de Nardis, 2003)

It should be noted that a possible monetary crisis does not play any substantial role in the arguments of supporters of a quick euro adoption. However, supporters of a postponed adoption have been accused of ignoring the globalization risks, and neglecting the impossibility of maintaining independent monetary policy, fixed exchange rate and liberalized capital flows all at the same time.

6 Arguments for the Postponement of Euro Adoption

6.1 Implications of the Lack of Independent Monetary Policy

Although the monetary policy of the Czech National Bank is practically limited to setting the key interest rates for the Czech Koruna, the loss of this power may have serious consequences. The inability to maintain different nominal interest rates in different EU countries will cause problems as long as these countries are experiencing different phases of the business cycle and/or different rates of inflation. In 2002, there was a higher rate of inflation in Spain than in Germany. Spain needed to reduce its rate of inflation by restricting the money supply (by setting a higher interest rate), while Germany needed to increase the money supply (by setting a lower interest rate). But the effect of a constant nominal "one size fits all" ECB interest rate is always exactly the opposite: the real interest rate in Spain was 0.15 %, while in Germany it was 2.15 %. The only solution to this problem would be an alignment of the business cycles and a substantial reduction of inflation rate differentials within the Euro area countries. But in a monetary union this is only possible after price level gaps have been substantially reduced, which in turn requires a higher level of real convergence among EU countries to be achieved.

6.2 Effects of Adopting the Euro on the Official and Perceived Rate of Inflation

It is a generally accepted fact that th e introduction of the euro will cause an "inflationary jump" as a consequence of price rounding-up and the transferal of transition costs[5] to customers. According to the European Central Bank, this inflationary jump was quite negligible in individual countries, in ranging between 0.12 to 0.29 %. This finding is a sharp contrast to the substantial increase of perceived inflation (see Table 1).

Table 1: Mean difference between standardized perceived and actual inflation and perceived inflation before and after the euro changeover

	Perceived-actual inflation		Perceived inflation	
	pre	post	pre	post
Austria	-0.15	0.85	-5.77	33.11
Belgium	-0.09	0.62	22.42	40.94
Denmark	0.31	-0.02	-19.63	-16.28
Finland	-0.09	1.12	-14.40	-2.17
France	-0.09	0.67	-0.38	43.61
Germany	-0.31	1.23	19.63	63.83
Greece	-0.43	0.89	23.70	43.94
Ireland	0.27	0.32	28.35	55.33
Italy	0.11	0.36	17.40	48.06
Luxembourg	.	-0.56	.	35.11
Netherlands	-0.29	1.18	23.07	74.44
Portugal	0.15	0.50	23.38	46.44
Spain	0.04	0.40	13.00	49.39
Sweden	-0.16	0.75	-28.05	-15.33
United Kingdom	0.41	-1.44	2.65	-8.44

Source: Mastrobuoni (2004), p. 30.

Various hypotheses explaining the wide discrepancy between the official inflation rate as measured by the Eurostat methodology and the inflation rate perceived by the public have been suggested. Leaving aside the possibility that the ECB is intentionally playing with the CPI weights to artificially undervalue the inflation rate (see Kohout, 2007; ČSÚ, 2007), some authors argue that the higher rates of perceived inflation should be attributed to an inflationary illusion or even an "inflationary masochism": Wolfgang Brachinger (2005) argued that the higher rate of perceived inflation is caused by the fact that the inflation rate was relatively higher for goods and services purchased with a relatively high frequency. This is an explanation of how inflationary illusion may occur. Price increases for goods and services purchased with relatively high frequency have higher subjective weight in the formation of inflationary perceptions, while their effect on real income is in line with the official rate of Consumer Price Index change.

While the psychological effects partially explain the discrepancy between the official and the perceived rate of inflation, I believe it is vital to focus on the "real" effects hypotheses:

5 *Staff training, accounting software upgrades, dual pricing, dual cash reserves and so on.*

the official rate of inflation measures the rate of inflation for an average household. However, adopting the euro caused higher price increases for goods and services which are, to a greater extent, to be found in the consumption baskets of households with lower than average income. And, because at least 2/3 of households have a lower than average income, it follows that the inflation rate for a median income household (measured by the perceived inflation surveys) is higher than the official rate of inflation for an average income household (measured by Eurostat).

As early as 1958, Kenneth Arrow noted that, "there should be a separate cost-of-living index number for each income level," (Arrow, 1958) because lower income households are likely to have consumption patterns that differ from those of higher income households.

The United States Congress discussed a proposal to construct a special CPI for the elderly, for the purpose of adjusting Social Security benefits. Several research projects (Garner; Johnson; Kokoski, 1996; Hobijn; Lagakos, 2005) were undertaken, leading to a conclusion that, although there were differences between inflation rates for different types of households, these differences were not substantial and/or persisting. Therefore, these papers concluded, it is possible to continue using the Consumer Price Index for All Urban Consumers as a proxy for inflation rate for all types of households.

In the Czech Republic, the situation is different than in the United States. Here, the CPI rates of change are consistently higher for poorer households and households of the elderly. This is a consequence of relatively higher inflation rates for categories like apartment rental, public transport, energy, health care and so on, which were heavily subsidized during the previous regime and since then have experienced a continuing process of "price narrowing". Needless to say, these groups of services have a lion's share in the consumption baskets of the poorer households. It follows that inflation results in a deterioration of the poorer and elderly households' real income as long as the average inflation rate is used for valorization purposes, making these types of households especially sensitive to the euro accession inflationary jump.

In the specific situation of the Czech Republic, the "inflationary jump" will be accentuated due to the fact that the current price level in the Czech Republic is slightly over 60 % of the euro area average. Convergence of the Czech Republic price level to the average price level in the EU is currently mediated through the ongoing appreciation of the Czech Koruna to the euro. The Czech National Bank´s aim to keep the rate of this appreciation at approximately 3% p. a. was dwarfed by rates of appreciation exceeding 10% yoy. In the case of an immediate adoption of the euro, the appreciation channel would be ruled out and the whole rate of appreciation would transform into an increase in the rate of inflation. However, the potential for such an extensive inflationary jump is decreasing by the progress of the real convergence, as the ongoing appreciation of the Czech Koruna is exhausting the scope for future appreciation.

7 Impact of the Financial and Economic Crisis of 2007

Another reason for postponed Euro area expansion on part of both the ECB and prospective Euro area admitees is the unfolding financial and economic crisis. It should be remembered that the mood of financial markets shifts often. While currently the doom and gloom is raised concerning the future prospects of the euro with respect to possible sovereign debt crisis in Greece, Ireland, Spain, Italy, Belgium or Portugal, the EUR/USD exchange rate is not much different than it was before the financial crisis unfolded.

And again the principal matter of costs and benefits of a monetary union in the light of financial and economic crisis is a subject of debate and ideologically motivated interpretation. While euro may be more stable against speculative attacks than local currencies, the ability to better synchronize the exchange rate with local economic conditions may be valuable in turbulent and uncertain times. However, given that especially private debt of many highly indebted countries is denominated in foreign currency without an exchange rate risk hedge, devaluation of the local currency constitutes a rather costly option. The ability to increase the money supply to prevent the default of a debt denominated in local currency is even less important, as the possibility of inflationary alternative to the default should be perceived by the financial markets as an equal risk. While the current experience of highly indebted European countries fails to provide a clear-cut case against the eventual euro adoption, it certainly warrants caution.

Conclusions

Accession to the Euro area in any foreseeable future is unlikely, as currently there is no sufficiently influential interest group willing to push for quick adoption of the euro in the Czech Republic. While exporters may have reasons to prefer the inflationary scenario (adopting euro soon) over the appreciation scenario (adopting euro later) only when it results in deceleration of real wages, for the same reason politicians together with voters and labour unions tend to prefer the opposite.

Lacking political backing and decisive economic arguments, adoption of the euro in the Czech Republic is ruled out unless political power shifts. While other reasons for maintaining an independent monetary policy may continue to weight against advantages of adopting the euro, their performative importance pales in comparison with that of the future ruling party's political preference on the course of the European integration, these being determined ideologically.

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