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Criteria Beyond Maastricht

The Czech Republic and the Euro

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- The Czech Republic promised to join the Eurozone upon its entry to the EU in 2004. The Czech economy has already met the Maastricht criteria on several occasions. However, there is still no definite date set for Euro adoption.

- The majority of the Czech public oppose the common currency, and this is reflected in the attitudes of Czech politicians.

- The Czech development strategy has so far rested on two main pillars – an undervalued currency and disproportionately low labor costs. Adopting the Euro means that the exchange rate channel for convergence would be abandoned and convergence would have to be facilitated by other means.

- There are few effects related to entry to the Eurozone that can be determined with any level of accuracy, and these are not very significant.

- On the other hand, there are some quite uncertain but potentially very significant consequences. Among the expected effects are lower transaction costs, higher wages, higher outflow of labor and higher inflation, all of which could generate serious economic imbalances.

- However, not joining the Eurozone would mean free riding on the system, with potentially very detrimental effects on the national interest of the Czech Republic.

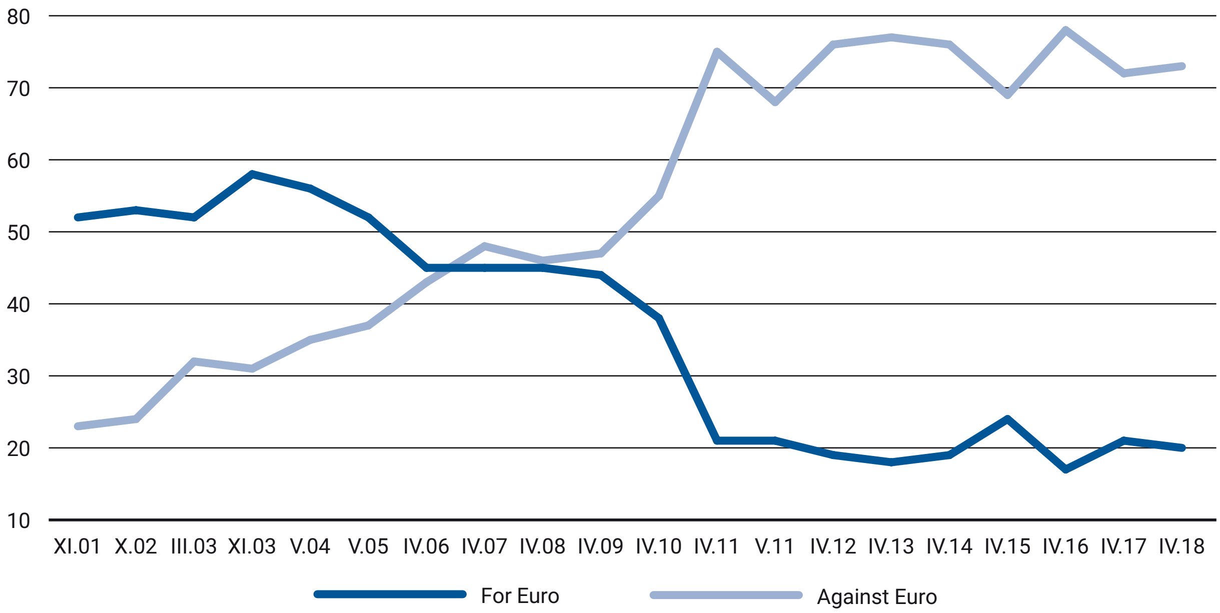
Introduction

The Czech Republic joined the EU in 2004 and upon its entrance promised, like every other country joining the community after 1992, that it would adopt the single European currency as soon as the economic and political conditions so allowed. The government and the Czech National Bank had already started with preliminary preparations for this process before the country joined the EU. In 2003 they released the Joint plan for the adoption of the Euro in the Czech Republic (Vláda ČR, ČNB 2003). The first plan envisioned the entry to the Eurozone in 2010, but the Czech government failed to join the ERM II (one of the entry conditions) and the exact date had to be postponed (Vláda ČR, ČNB 2007). Initially it was set at 2012, but with the unfolding of the Eurozone crisis the date was postponed again. The Czech government has not yet announced any new definite date for its adoption of the single European currency.

The Czech Republic could theoretically have already joined the eurozone on several occasions. The Czech economy met the Maastricht criteria even before the Eurozone crisis, and has no substantial problems in fulfilling them now (European Commission, Directorate-General for Economic and Financial Affairs 2018). Nonetheless, the Czech government has been deliberately postponing its entry to the ERM II, and for this reason it does not formally meet one of the official requirements for entry to the Eurozone. This is a very similar approach to that which Sweden has employed ever since it joined the EU in 1995, and the Swedish precedent together with the turmoil in the Eurozone has allowed the Czech Republic to evade its official promise to adopt the common currency without much pressure from the European Commission and other member states, at least for now.

Officially, the Czech Republic follows the (quite elaborate) National plan for Euro Adoption, which was adopted by the Government of the Czech Republic in 2007 (Vláda ČR 2007). The whole process has been supervised by the Ministry of Finance, which established the National Coordination Group for the Euro Adoption in the Czech Republic led by Oldřich Dědek (Ministerstvo financí 2013). However, in reality there has been very little progress owing to the fact that the government has yet to decide on the exact date for Euro adoption. There are doubts as to whether there is sufficient political consensus to undertake such a decision in the foreseeable future whatsoever.

Chart 1: Opinions on the adoption of the Euro in the Czech Republic over time (in %).



Source: Hanzlová (2018), Občané ČR o budoucnosti EU a přijetí eura – duben 2018.

These doubts stem from the persistently negative opinions towards Euro adoption that prevail among both the Czech political representation and the general public. Both groups have mutually hardened their views over the years. Leading Czech politicians had expressed their doubts about the functioning of the Eurozone even before the global financial crisis. One of the main voices against Euro adoption was the then President of the Czech Republic Václav Klaus. Public opinion on the matter was unequivocally positive only for a short period after the country joined the EU. The number of supporters and opponents had evened out by 2006, by 2010 public opinion had moved strongly against the adoption of the single currency, and this unambiguously negative stance has entrenched itself among the Czech public ever since (Chart 1).

The recent Czech political representation has displayed predominantly negative attitudes toward the introduction of the Euro into the national economy in the foreseeable future. The Czech Prime Minister and leader of by far the strongest political party in the Czech Chamber of Deputies (29.64%) Andrej Babiš claims to be satisfied with the national currency, and in his view the adoption of the Euro is a low priority issue (ČTK 2018). His coalition partners, the Czech Social Democrats (7.27%), are in favor of adoption, but their position has been seriously weakened over the last few years, and they did not move far in that direction when they had the opportunity to do so as the strongest party in the previous government. The Czech Communists (7.76%), who passively support the present government, are against adoption. The Civic Democrats (11.32%), currently the largest opposition party, are strongly against entry to the Eurozone in its present form. The extreme-right SPD (10.64%) are vigorously against the Euro and would like to emulate the UK and leave the EU completely. There are three political parties that are for the Euro in principle but would prefer to wait for the most suitable moment; these are the Pirates (10.79%), the Christian Democrats (5.80%) and STAN (5.18%). The only party that has consistently declared itself in favor of the earliest possible adoption of the common European currency is the liberal TOP09 (5.31%).

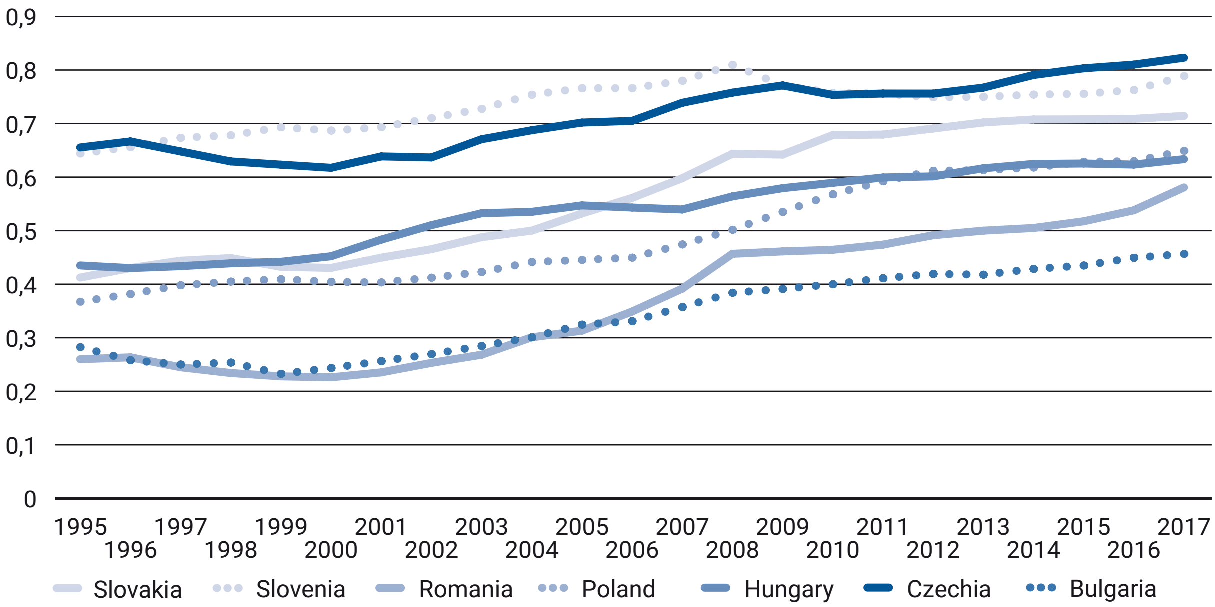
The issue has not been at the forefront of public discussions in the last several years, and there seems to be a tacit understanding among the population that the Czech Republic will not adopt the Euro at least in the next 5-10 years, if ever. Opponents of the move have claimed that the current Eurozone is very different from the original one and that the validity of the original Czech commitment is therefore questionable (Krutílek 2013). Supporters of adoption of the single currency warn that the Czech Republic will become isolated within the EU and therefore lose its influence over the future development of the community (Niedermeyer 2017). The main economic interest groups support the Eurozone membership in principle, but there are some differences. The Confederation of Industry of the Czech Republic is pressurising the government to declare the official date for Euro adoption, and warns against too many delays, which could move the Czech economy to the economic periphery of Europe (Svaz průmyslu a dopravy ČR 2017). The Czech-Moravian Confederation of Trade Unions is not against joining the Euro per se, but claims that real economic convergence to the level of the core EU countries is a much more important goal and that this goal can be more readily achieved outside the Eurozone, at least for the time being (Fassmann, Ungermann 2018).

The effects of Euro introduction in the Czech Republic.

The Czech Republic is a small, open economy, highly dependent on its trade with the EU, particularly with the Eurozone. Since 1990 the economy has undergone a very slow process of real economic convergence that has somewhat accelerated in recent years but in general has been very unsatisfactory (Chart 2). In reality, other central and eastern European (CEE) countries have converged toward the Czech Republic (and Slovenia) more than the Czech Republic toward the European core.

Upon first glance, the Czech economy has solid macroeconomic fundamentals. Recently GDP growth has accelerated (4.5% in 2017), the level of unemployment is one of the lowest (if not the lowest – around 3%) in Europe and inflation has

Chart 2: GDP per capita, real expenditures in PPS EU 28 (EU 15=1)

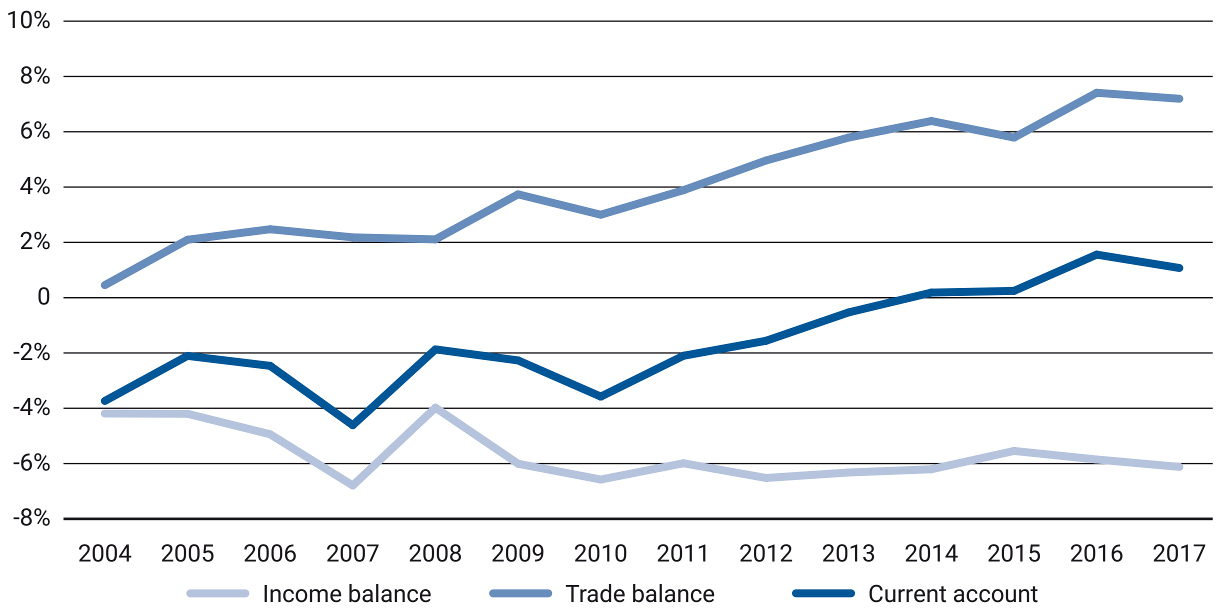


Source: Eurostat (2018a). Purchasing power parities (PPPs), price level indices and real expenditures for ESA 2010 aggregates. Own calculations.

been very low for a decade (0.3–3.3% per year). However, there have been some worrying underlying trends. The Czech Republic experiences huge income outflows (Chart 3) and the productive structure of the economy suggests that it has been locked in a very precarious position within the global value chain (Krpec a Hodulak 2018).

The following text will attempt to analyze the potential costs and benefits of Czech entry to the

Chart 3: The Czech current account and its components (% of GPD, current prices)



Source: Czech National Bank (2018), ARAD data series system, own calculations.

Eurozone over several dimensions of the Czech economy. However, a warning is in place here, as there are very few known definite costs and benefits, and the total value of those that are known with some accuracy is not very significant. Many potentially much more important aspects depend either on the actual CZK/EUR exchange rate upon entry, which is as yet completely unknown, or are of a structural and institutional nature and their impacts are only possible, not certain. The structural and institutional effects cannot be calculated with any reasonable degree of certainty at the moment, but I will provide some broad guidelines for their assessment.

In general, some of the usual expected effects of adoption of the common currency that were predicted by earlier studies (Lacina et al. 2007), such as increased inflow of investment and reorientation of trade flows towards the euro area member states, have already materialized to a significant degree, and further substantial increases in these effects are highly unlikely. For example, the Czech Republic already conducts most of its trade with other EU countries (83%) and more specifically the Eurozone (66%). For this reason, the analysis will not delve much further into these effects.

Employment, labor costs and wages

Within the international context, the Czech development strategy has so far rested upon two main pillars – undervalued currency and disproportionately low labor costs that do not reflect the real productivity of the workforce. This strategy has been in place since the early 1990s and was reinforced by the devaluation of the CZK and the fixed exchange rate that the Czech National Bank maintained between 2014 and 2017. In this respect the Czech economy does not differ much from the other CEE countries in its basic philosophy, but as the devaluation demonstrates, it has definitely been more consistent in pursuing it in practice. The lower price level and comparatively very low labor costs have been one of the main components that have ensured the high competitiveness of the country, which have been materialized in massive trade surpluses in recent years (over 7% of GDP, Chart 3). It is also one of the decisive factors behind the recently extremely low level of unemployment.[1]

The Czech labor unions made calculations for 2013 which compared the average unit labor costs and productivity in Germany and the Czech Republic. They concluded that labor purchased in the Czech Republic produced approximately 1.5 more output for the same costs than in Germany (Fassmann, Ungerman 2015).[2] Therefore, the Czech Republic still enjoys strong price competitiveness, although the situation has been gradually changing in the last few years.

There are two channels that facilitate real economic convergence, one is the increase in price levels and the other is the appreciation of the national currency. Adopting the Euro means that the exchange rate channel for convergence would be abandoned and convergence would have to be facilitated by other means. This is not impossible, but the recent empirical findings suggest that it is more difficult to converge once a country has joined the Eurozone (Fassmann, Ungerman 2018). Therefore, the level of achieved real convergence and the nominal exchange rate upon entry to the Eurozone is of paramount importance. The following table depicts three possible scenarios for the development of Czech labor costs presented by the economic experts of the Czech labor unions.

All these scenarios have to be taken with a grain of salt, but they point to some very disturbing facts. The table draws a bleak picture for Czech economic convergence in the case of fixing the exchange rate, i.e. adopting the Euro too soon. Therefore, the question boils down to this: would joining the Eurozone stimulate economic growth enough to compensate for the loss of the exchange rate channel of convergence in labor costs (and wages)? This is a very difficult question to answer since there

1. The Czech Republic has always had one of the lowest levels of unemployment among CEE countries since 1989.

2. Obviously the productivity level is much higher in Germany, but so are labor costs. The resulting number is arrived at by comparing the relative costs and productivities in the respective countries.

Table 1. When will Czech labor costs converge with the labor costs of the most developed European countries?

Country	Number of years needed to fully converge (2004–2014 benchmark)		
	At 27 CZK per EUR and the pace of convergence of the last 10 years	**At 10% stronger exchange rate and the pace of convergence of the last 10 years**	**At 20% stronger exchange rate and the pace of convergence of the last 10 years**
Norway	never	never	495
Denmark	207	122	86
Belgium	185	113	80
Sweden	147	95	68
France	112	76	56
The Netherlands	113	76	55
Finland	134	83	58
Austria	103	69	50
Germany	84	59	45
Czechia	0	0	0

Source: Fassman, Urgeman (2018), pp. 19.

are too many uncertainties. On one hand, there will definitely be some reduction of transaction costs for firms as a result of using a single currency. This should lead to some productivity gains, but estimates of these are only between 0.28% and 0.5% of GDP (Helísek et al. 2009, Pečinková 2008). The other positive influence might be an increase in price transparency, since all prices would be listed in Euros. This could also lead to an increase in competitive pressures and more productivity gains. However, most of these as well as other benefits originally ascribed to the single currency (increase in trade and investment) have probably already materialized, and further increases might be rather insignificant. On the other hand, once inside the Eurozone, the Czech Republic would not be able to use its monetary policy according to its needs, and fiscal policy would be seriously restricted. This can seriously diminish prospects for future economic growth. These points will be elaborated upon further in the text.

Migration and labor mobility

The Czech Republic has one of the lowest percentages of foreign-born population in Europe. The latest available data published by OECD are for 2013, and the figure for the Czech Republic is only 7.1% (OECD 2018). This number is even more striking if one considers the fact that most of these foreign-born inhabitants are Slovaks. Nevertheless, at the same time this number has increased significantly since 2004 and the country has experienced a substantial increase in the inflow of foreign labor since 2009. Apart from Slovaks, the main EU nationals that have been migrating to the Czech Republic are Bulgarians, Romanians, Hungarians, Poles and Germans.[3] The Czech Republic has experienced a net increase in its workforce through migration because the Czechs have been very reluctant to move permanently abroad in search for work (second only to the Slovaks) (Fries-Tersch, Tugran, Rossi, Bradley 2018: 42). At the same time, due to the geographical position of the Czech Republic, there is a noticeable number of people commuting to work abroad but living in their home country. The number of Czech commuters has risen continuously. The overall figure has more than doubled between 2010 and 2017 and now stands at approximately 62,500 people (Eurostat 2018b).

There are two ways in which adopting the single European currency can influence migration and labor mobility from the Czech economy. Firstly, workers won't have to exchange their currencies any longer, which will reduce the costs of working abroad for both Czechs working outside the country and for foreigners willing to work in the Czech Republic. However, this won't probably play any significant role in the overall assessment of the costs and benefits and would therefore not have much real effect. Secondly, a potentially much more pronounced effect could result from increased price transparency. Due to the depressed price levels in the CEE countries, their average real wages are much higher than their nominal equivalents. This makes working abroad very attractive, since the nominal wage differentials are still very high. The size of these differentials is currently still distorted to some degree by the exchange rate. The convergence of both wages and prices would reveal the full extent of the differences and could lead to a significant increase in the number of Czech cross-border commuters. This would create pressure on domestic employers to increase wages, which in turn could attract more foreign laborers to the Czech Republic. However, it is extremely difficult to make any serious predictions since, according to the 2017 annual report on intra-EU labor mobility, the similarity of languages and common cultural heritage continue to be an important determinant of labor mobility even in comparison with purely economic incentives (Fries-Tersch, Tugran, Rossi, Bradley 2018: 109).

3. Apart from these, the Czech Republic harbors a significant number of laborers from Ukraine and Vietnam.

Prices

As a result of its preferred economic strategy, the Czech Republic currently has much lower price levels than those typical for Western Europe. I have already mentioned the two convergence channels that have so far been available to the Czech economy. Joining the Eurozone would create a regime of a de facto fixed exchange rate which would preclude any further appreciation of the Czech currency. The convergence would have to work solely through the price channel. The earlier studies predicted a possibly substantial risk of higher inflation after the adoption of the single currency in the Czech Republic (Lacina et al. 2007). A more recent paper published by the ECB finds some significant evidence for the long run relationship between real convergence and inflation, which can be measured as the link between GDP per capita levels and price levels (Diaz del Hoyo, Dorrucci, Heinz, Muzikarova 2017).

There are two most relevant explanations for rising prices after Czech entry to the Eurozone. The first theoretical explanation is based on the so-called Balassa-Samuelson effect. According to this theory, countries converge in GDP per capita levels mainly through productivity increases in the tradable sector of the economy (sectors engaged in international trade), which are followed by increases in prices of non-tradables (sectors producing for domestic consumption). The effect should be higher the larger the relative productivity growth differential in the tradable to non-tradable sector of the Czech Republic in comparison with the rest of the Eurozone, and the larger the share of non-tradables in consumption. However, there are both theoretical and empirical problems that make an exact prediction of the relative importance of this effect difficult. Firstly, it is extremely difficult to distinguish tradables from non-tradables with precision in reality. And secondly, it is difficult to isolate the effects of the Balassa-Samuelson effect from other historical influences on inflation. With this in mind, we can make some comparisons that can give us an idea about the effects on the price level in the Czech Republic. On one hand, there is a sizeable productivity differential between the Czech tradable and non-tradable sectors which should intensify the effect. On the other hand, the Czech Republic is already highly export-dependent, and its non-tradable sector is comparatively smaller, which should mitigate the intensity of the effect. The usual contribution of the Balassa-Samuelson effect to the country's inflation is between 1–2%, with the number for the Czech Republic at 1.6% (Lacina et al. 2007: 40).

The second reason for expected higher domestic inflation in the Czech economy stems from the nominal wage differentials between the Czech Republic and its more developed neighbors that are already members of the Eurozone. The effects of these differences on labor mobility have already been mentioned in the previous text. The increasing number of commuters/long term laborers leaving the Czech Republic for Germany and Austria will, in combination with the already low level of unemployment, lead to intensive upward pressure on wages, which could result in either decreasing profits of Czech companies or increasing prices. Overall, one should definitely expect some increase in inflation in the first years after the Czech Republic joins the Eurozone. The extent of this increase is uncertain but should not be unbearably high.

Public debt and budget balance

There are two types of costs related to the future development of the Czech budget balance and public debt in relation to entry to the Eurozone. The first can be estimated with reasonable accuracy. These are the costs that are incurred automatically upon the entry of any country, and are related to the institutional structure of Eurozone. The Czech Republic will have to pay substantial contributions to the European Stability Mechanism. This is a permanent intergovernmental organization set up by the Eurozone for member countries that need financial assistance. The current estimates of the Czech contribution are around 50 billion CZK that the Czech government would have to pay outright from the national budget, and another up to 380 billion CZK that the country has to be prepared to provide in time of emergency. Some further 9–21 billion CZK will have to be paid as an obligatory contribution to the Single Resolution Fund (Fassmann, Ungerman 2018: 56, 67). This fund is one of the pillars of the newly established Banking Union, and is meant to provide financial assistance to the largest European banks during banking crises.[4] However, these costs can only be roughly estimated, the final size of the Czech contributions will be determined before entry and will depend on the condition of the Czech economy and the prevailing exchange rate at the time.

The second type of cost is only hypothetical, highly controversial, but could be enormous and is therefore worth mentioning. Among the often-claimed benefits of the common currency are fiscal discipline and prevention of currency crises. But these claims are implausible, especially after the 2010 Eurozone crisis, and are based on very problematic assumptions about the relationship between states and their currencies. A monetary sovereign country (a country issuing its own currency) cannot in any meaningful sense be "forced" into insolvency in the currency it issues by the financial markets, since it can always monetize its debt (Goodhart 1998). This can, though need not be inflationary, but that is another issue.

Joining the Eurozone means giving up national monetary sovereignty and joining a club that as of now does not have any plausible mechanism for resolving long-term macroeconomic imbalances without imposing disproportionate costs on the affected countries. Since its establishment, the Eurozone has attempted to enforce rules that would deter countries from pursuing policies leading to macroeconomic imbalances. The Eurozone crisis is definite proof that this strategy had failed spectacularly. The Eurozone has been trying to prevent another failure by imposing even more and stricter rules, hence the Fiscal Compact and Banking Union.

4. This contribution is supposed to be temporary. Most of the capital should be provided later by the largest commercial banks in the Eurozone.

However, there is no guarantee that this will work in future.[5] Once in the Eurozone, the member countries cannot choose their own policies in time of crisis. They have to abide by the rules imposed upon them by the European Commission and the ECB, and the track record of these institutions has so far been unimpressive, to say at least. The austerity measures that the affected countries were forced to implement not only created dismal economic growth, but effectively further increased their debt to GDP ratio. A monetary sovereign country that has only an insignificant portion of its debt denominated in foreign currencies can always use its fiscal and monetary policy at will, and reflate the economy in order to overcome the crisis sooner (Mitchell 2015). The Czech Republic not only has very low levels of public debt, but only about 11% of that debt bears a foreign exchange risk (Ministerstvo financí ČR 2018: 15).

The present economic fundamentals of the Czech economy and its strong integration into (primarily German-controlled) European production chains suggest that it is unlikely that the country would go through a similar type of crisis that decimated the southern wing of the EU. However, this could easily change once the Czech Republic has accepted the Euro. Rising prices and wages dissociated from the real productivity growth could lead to increases in demand and shift the Czech current account into deficit. This would be accompanied by rising foreign debt and could lead to a crisis of a very similar nature to that which we saw in the European south.

Regional cooperation and trade integration

Whereas the previous paragraphs pointed to the disadvantages and potentially massive costs related to entry to the Eurozone, here we will mention two potentially high costs that could materialize in the case that the Czech Republic decides to stay outside the club.

5. Indeed, the whole approach might be seriously misguided. Spain went through a serious crisis that was primarily caused by the private, not the public sector of the economy. For a detailed analysis of this issue see Mitchell 2015.

Firstly, the Eurozone crisis has prompted the member countries to deepen their integration in several important aspects (e.g. the Banking Union). The countries outside of the Eurozone do not fully participate in this development and cannot fully influence its final outcomes. This is a serious problem, since the number of conditions and regulations that the Czech Republic will be expected to adopt upon its entry to the Eurozone has been rising without the Czech government having any say about it. Furthermore, this development could create a situation where the Czech Republic would be left out of future decisions on deepening European integration in areas that relate to economic and monetary union.

Secondly, of course, there is always a possibility that the Czech Republic could postpone its membership indefinitely. However, there are several problems also with this proposition. Firstly, this is effectively free riding on the system, and could result in retaliatory measures in future. Secondly, if this uncooperative stance were to be adopted by every country, the European Union could disintegrate rapidly. A stable European political environment and stable European economy is a vital Czech national interest. The Czech economy is extremely dependent on the EU, particularly on Germany. Free riding on the system could backfire. By joining the Eurozone, the Czech Republic would demonstrate that it accepts the moral responsibility for the future development in Europe. Furthermore, the country could then actively try to influence the future reforms in a desirable direction.

Conclusion: What can be done to minimize the risk of Euro introduction

There are very few costs and benefits of entry to the Eurozone that can be determined with any reasonable certainty, and these are not very significant. There are also some potentially huge costs and benefits that could materialize both if the Czech Republic joins the Eurozone and if it decides to stay outside. However, these are virtually impossible to quantify.

Nonetheless, there are things that could be done to mitigate the cost of Euro adoption. Firstly, the Maastricht criteria should not be the main indicator of readiness, at least not for the Czech government. The Czech economy should achieve a reasonable level of real economic convergence with the Eurozone in order to curb the build-up of macroeconomic imbalances after entry. The EU could help with this process, e.g. through cohesion funds. Secondly, the Eurozone should address the problems of intra-Eurozone imbalances more vigorously. This would, however, have to entail some form of fiscal union, which does not seem very likely, at least in the foreseeable future.

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About »Dialogue on Globalization«

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On the other hand, there are some quite uncertain but potentially very significant consequences. Among the expected effects are lower transaction costs, higher wages, higher outflow of labor and higher inflation, all of which could generate serious economic imbalances.

However, not joining the Eurozone would mean free riding on the system, with potentially very detrimental effects on the national interest of the Czech Republic.

The Friedrich-Ebert-Stiftung (FES) has been represented in the Czech Republic by its Prague office since 1990. Through its activity in the Czech Republic it contributes to strengthening of democracy, development of a legal state and social justice, both within the state and society. It supports the Czech-German understanding within a United Europe. The vocal point of the activity of the FES, Representation in the Czech Republic is European Integration, social-political dialogue, co-operation with the trade unions and support for a democratic and socially inclusive society. Important partners of FES in the Czech Republic are scientific and educational institutions, government bodies, the Parliament of the Czech Republic, trade unions, cities and municipalities, non-governmental organisations, universities, schools and colleges and the media.

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