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SHOULD THE CZECH REPUBLIC ENTRY INTO THE EURO AREA?

Abstract:

The paper deals with the question whether the Czech Republic should adopt euro. The aim of the paper is to evaluate potential advantages and disadvantages of euro adoption. The implemented methodological framework combines the use of logical arguments with an analysis and comparison of statistical data. The analysis showed that entry into the eurozone would currently be disadvantageous for the Czech Republic and would bring a large number of risks. The loss of own monetary policy, which currently plays an important role in taming high inflation, was assessed as the main risk. In addition, the Czech Republic did not meet any of the Maastricht criteria in 2022; thus, the Czech Republic does not even meet the conditions necessary for adoption of euro.

Keywords:

European Union, eurozone, Czech Republic, inflation, economic growth

JEL Classification: F15, E52, F41

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1 Introduction

Recently, the issue of the Czech Republic's entry into the European Monetary Union (EMU) has been discussed again. However, this topic still does not receive as much attention as it deserves in view of its importance. It is clear that a broader expert discussion would not be detrimental. This is despite the fact that the issue is not entirely topical, as the government of Petro Fiala has announced that it will not decide on the adoption of the euro during its term in office. Since a new cabinet that could potentially decide on adoption will not emerge until the 2025 elections, the koruna must remain in the ERM II exchange rate system for at least two years, and it would take another year to assess the Czech Republic's eligibility for entry, the most optimistic date for euro adoption is 2028. It is worth mentioning that the public's attitude towards euro adoption is clearly negative - 64% of citizens are against joining EMU (europa, 2021).

The adoption of the euro in the Czech Republic and other EU Member States has been the subject of a number of studies. For example, immediately after the major EU enlargement in 2004, the issue of the new Member States joining the euro area was addressed by Šaroch et al.(2005), when they concluded that the main risk of EMU entry for the newly acceding countries was the need to comply with the Maastricht criteria concerning fiscal rules. Newly entering economies were in the process of catching up, and it was the need to comply with fiscal rules that would have a negative impact on economic growth.

The issue of euro adoption is of course also relevant for other post-communist countries in the EU. (2012)who, among other things, stated that Hungary should meet the Maastricht criteria regardless of its entry into ERM II. Poland's entry into the euro area has been discussed by Visvizi and Tokarski (2014)who concluded that the main obstacle to Poland's entry into EMU is the fact that Poland is in the process of catching up and adopting the euro would slow down the convergence process. The study by Cieslik and Turgut (2021) on the other hand, found that a significant obstacle to Poland's adoption of the euro is its divergent fiscal policies, and they consider fiscal harmonisation within the EU to be problematic.

The Dandashly and Verdun study (2018), which examined the euro adoption process in the Czech Republic, Hungary and Poland, again showed that the euro adoption process in these countries is largely political and depends on the political ideology of the ruling parties.

The article by Cavallo et al. is very useful.(2015)which analyses the price impact of the introduction of the euro in Latvia. The paper examined price changes for thousands of different types of goods from Zara, the largest clothing chain. The authors found that the prices of the chain's goods in Latvia increased from 6 to 89% after the country joined the EMU. The goods were almost identical to those sold in, for example, Germany

The impact of the introduction of the euro in Estonia was discussed by Brixiova et al. (2009), where their study showed that the effects of exogenous shocks on Estonia and the euro area are not synchronous.

This article aims to assess whether the Czech Republic should adopt the euro. All potential benefits and risks of joining the EMU will be assessed.

The benefits of the Czech Republic's rapid accession to EMU include:

- Reducing transaction costs
- Reducing the risk of currency and financial turbulence
- Stabilisation of long-term interest rates
- Completing the integration process
- Greater price transparency and international comparability

Risks include:

- The loss of monetary and exchange rate policy as tools against asynchronous cycles and asymmetric shocks
- The need to contribute to the rescue fund
- Possible asymmetry of monetary transmission
- Loss of mining royalties (offset by share of ECB mining royalty income)

2 Methodology and data

The research part of the paper is based, among other things, on the analysis of secondary data that are publicly available (Eurostat Database, CNB and ECB databases). In some cases, data from previous years are used to meet the objective of the thesis in order to perform time series and comparative analysis. At the time of writing (January 2023), complete data for 2022 was available.

Logical methods, i.e. abstraction and concretization, analysis and synthesis, are used in the analysis of empirical data. The methods of induction and deduction are also used. It should be noted here that the conclusions drawn from the process of induction are always influenced by subjective approach (level of knowledge, experience, etc.), so their validity is limited.

The main method is a logical argumentation and comparison of statistical data, through which the author managed to achieve the stated goal of the thesis.

3 Results

3.1 Benefits of joining EMU

The benefits of joining the euro area certainly include a reduction in transaction costs, especially for businesses. This saves both the financial costs of exchange fees or foreign currency account fees and administrative costs. Previously, the reduction in the cost of managing accounting systems was also cited as a key argument for adopting the euro, as many companies had to keep dual accounting records - in the domestic currency and in euros. However, this is no longer the case as the current government has decided that companies will be allowed to keep all their accounts in euros. As a result, the most important argument of businesses nowadays is the need to pay their employees in local currency and the associated transaction costs. This is particularly relevant for businesses that have most of their revenues in euros.

Transaction costs will also be reduced for households who, when travelling to euro area countries, do not have to waste time exchanging crowns for euros and searching for the exchange office with the best exchange rate. They also do not have to pay exchange fees for this service. However, in these days of high technological sophistication, this argument for adopting the euro is beginning to lose its relevance. A significant number of households already have bank accounts in several currencies and can thus carry out payment transactions by card without the exchange rate being converted according to the bank. In addition, there are also many companies that offer low-fee currency conversion, such as Revolut. At the same time, it should be mentioned that this will limit the income of financial institutions that are engaged in currency exchange activities.

The benefit is the elimination of exchange rate risks. This will be particularly beneficial for Czech companies trading with euro area countries. They will not have to worry about estimating exchange rate developments and will save the cost of exchange rate risk insurance. However, it will also harm currency speculators, who make high profits from correct exchange rate estimates.

Increased price transparency and international comparability are also positive. Thanks to this, Czech households will not have to waste time converting prices into crowns when buying goods in euro area countries. Again, however, this is essentially a marginal cost.

The completion of the integration process is often cited as a plus. However, this is more of a psychological advantage and it is hard to say whether it is a real advantage for the Czech Republic at all. It also entails the loss of one of the attributes of state sovereignty.

Another advantage is that the Czech Republic will be able to participate in the development of the common monetary policy. However, according to the author of the article, the weight of our state will be negligible. As is the case in the European Union (EU), decisions in the eurozone are usually made according to the needs of the strongest economies, i.e. Germany and France. It does not seem very likely that we will have a major voice in monetary policy making.

Greater discipline imposed on domestic economic policies is also mentioned. However, this seems highly unrealistic when looking at the "southern" wing of the euro area - but also, for example, at France or Germany. In EMU, there has been a clear violation of the Stability and Growth Pact in the past, i.e. a change in the rules of the game by abandoning the principle that each country is responsible for its own debts (Pečinková, 2008). It is also important to mention that the implementation of the Maastricht criteria was suspended as a result of the Covid-19 pandemic and budgetary responsibility became very loose in EMU countries.

According to the author, the recovery of public finances is inevitable regardless of the Czech Republic's entry into EMU. An overly generous social system that does not motivate people to work will inevitably lead to unfortunate consequences. Reforms in the social system - especially in the area of pensions - are inevitable. However, the main reason for reforming public finances is not compliance with the Maastricht criteria - we should comply with their principles regardless of formalised criteria. The idea that joining EMU will lead to greater fiscal responsibility of governments is highly unlikely.

The reasons sometimes given in favour of joining the eurozone include a reduction in interest rates and increased trade with EMU countries. However, the Czech Republic already trades significantly with EMU countries and a significant increase in foreign trade with these countries does not seem very likely. A reduction in interest rates appears to be a disadvantage at the present time, when we are facing high inflation.

3.2 Disadvantages of joining the EMU

The most important argument against adopting the euro is the loss of monetary policy. This argument is particularly relevant at the present time. Different countries in the euro area have significantly different levels of inflation. While some economies suffer from inflation approaching 20% (Eurostat, 2023), other economies do not experience such high inflation. This again shows the differences between economies. According to the author, there are several reasons for the different price levels. One of them is different energy policies, where countries use different energy mixes. Thus, some countries have been hit very hard by the impact of the energy crisis, which has caused a significant cost shock leading to higher prices. Some economies, on the other hand, have hardly been affected. On this topic, see for example Zhou et al. (2022), Ninomiya et al. (2022) or Zhunussova et al. (2022). Another reason for different price levels is, for example, the different approach to pandemic restrictions, with countries with tighter lockdowns also experiencing higher inflation (Eurostat, 2022; IMF, 2022). Of course, the fiscal policies of national governments also play a role. This topic is discussed in more detail by, for example, Strasky et al. (2022) or Ladi et al. (2020).

A major disadvantage for the Czech Republic is the loss of the possibility to apply an exchange rate policy. The exchange rate mechanism is currently the CNB's most effective tool in the fight against high inflation. The current level of the CNB base rate is significantly higher - the repo rate is at 7% (CNB, 2023a) - than the level of the European Central Bank base rate, which has a base rate set at 2.5% (ECB, 2022). The interest rate differential is also written into general interest rates in economies. A higher interest rate in the Czech Republic means a higher rate of return on Czech financial assets. This causes increased demand from foreign investors for assets issued in the Czech currency, which leads to increased demand for Czech crowns. The increased demand for the koruna causes its appreciation. A stronger koruna means that Czech goods and services are relatively more expensive relative to foreign goods and services. Czech exports are thus falling and imports are rising. As a result, net exports, which are part of aggregate demand, fall. The fall in aggregate demand leads to a cooling of the economy and contributes to lower price growth. In the case of EMU membership, we would not be able to use this instrument to reduce the inflation rate.

Another significant risk of adopting the euro is the possible increase in inflation that could affect the Czech Republic. As a catching-up economy, the Czech Republic has a lower price level. By giving up the koruna, we would lose the possibility of the price level being offset by an appreciation of the exchange rate. It would only be offset by the inflation channel. An increase in inflation would of course mean a reduction in our competitiveness (Janáčková, 2007). This phenomenon can also be observed in the case of Croatia, where there was a sharp increase in prices immediately after the announcement that it would join the Eurozone (Eurostat, 2023). However, the relationship between inflation rates and EMU membership is not clear-cut, e.g. the study by Dreyer and Schmid (2020) argue that there is no short- or long-term impact of EMU membership on inflation rates. In contrast, however, studies such as Cavallo et al. (2015) found that EMU entry caused a dramatic increase in inflation rates for some countries.

It is also important to mention that if we join EMU, we will be forced to contribute significant funds to the rescue fund. (Janáčková, 2015). This, especially with the loosening of the rules due to the Covid -19 pandemic, appears to be a significant risk.

The evaluation of EMU in the context of the theory of optimal currency areas is also crucial for the assessment of EMU entry .

According to the theory of optimal currency zones, formulated by economist Robert Mundell (1961) and later developed by economists Ronald McKinnon and Peter Kenen (2002) , an optimal currency area should satisfy the following conditions:

1. a high degree of mobility of labour, capital, goods and services
2. high degree of business cycle synchronisation
3. the symmetry of exogenous shocks, or the response to them
4. high degree of diversification of foreign trade and homogeneous production structure
5. bilateral price and wage flexibility
6. the existence of a sufficiently strong fiscal smoothing mechanism or common fiscal policy

As for the first point, according to the author, it is only partially fulfilled. The free movement of goods is guaranteed, but there are significant obstacles to the free movement of services and labour. Some areas in particular are quite restrictive with regard to the free movement of services. The movement of labour is also still heavily regulated.

The economic cycles of individual countries are also not entirely synchronous. The degree of convergence is most easily determined by comparing GDP trends across countries using the correlation coefficient. This shows that the Belgian and French economies, for example, are quite interconnected. But the correlation coefficient for the UK and German economies, for example, is low and negative (Eurostat, 2022b). This means that when the German economy declines, the British economy tends to grow. It is this fact that can be identified as one of the main reasons why the UK has rejected the introduction of the euro. The UK's economic cycle is much more aligned with that of the US. The UK would thus already find it more profitable to adopt the dollar than the euro (Janacek, 2007).

External shocks hit Member States at different intensities and need to be responded to differently in each country (see, for example, the different impact of the energy shock on different EMU countries mentioned above).

The production structure is largely heterogeneous.

The price and wage flexibility condition does not apply either.

A common monetary policy is not supported by a common fiscal policy.

It is thus clear that the current EMU is far from being an optimal monetary union. It is also fundamental that the idea of a common currency, the euro, was primarily a political decision and not an economic one. The economic implications did not play a major role in the creation of the eurozone (Parsons, 2002).

The condition for an EU country to join the euro area is the achievement of a high degree of sustainable convergence, which is determined by the Maastricht criteria. These criteria include (CNB, 2023b):

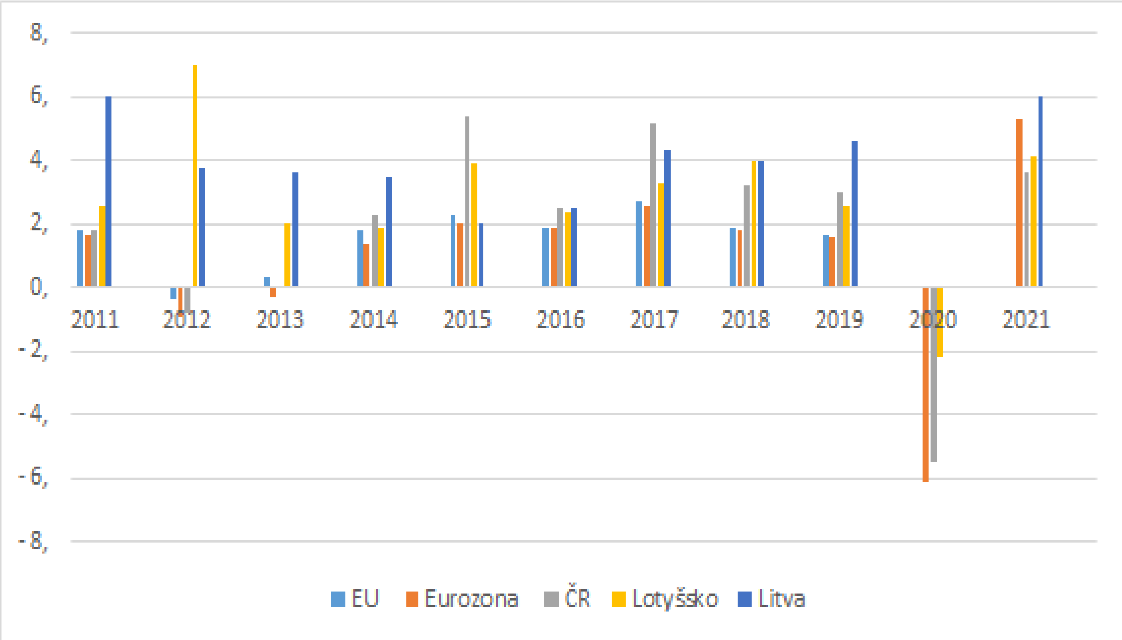
- the price stability criterion - average annual inflation must not exceed by more than 1.5 percentage points the average annual inflation of the three best performing Member States,
- the government finances criterion - the government debt-to-GDP ratio must not exceed 60% and the government deficit-to-GDP ratio must be less than 3%,
- the interest rate convergence criterion - the long-term nominal interest rate must not exceed by more than 2 percentage points the average of the three best performing countries in terms of price stability,
- the criterion for participation in the exchange rate mechanism - at least two years before joining EMU, the candidate country should have joined ERM II and there should be no devaluation during this period

The Czech Republic is unlikely to meet the benchmarks for any of the criteria in 2022 (CNB, 2023b). Thus, the Czech Republic does not currently meet the conditions for EMU accession and rapid adoption of the euro seems unrealistic.

The Maastricht criteria are primarily used by euro area members to assess whether it is appropriate to admit a country and whether its possible entry would jeopardise the stability of the euro. It is understandable that Member States want to have certain guarantees from new entrants. However, for the Czech Republic, its own criteria for deciding whether or not to adopt the euro are far more important. Just as the UK created its own criteria in 1997. These criteria were defined by former President Václav Klaus. They are, of course, different from the British ones, given the differences between the economies of the Czech Republic and the UK, and also given the date of their publication. The first point is whether the common European currency has succeeded and whether the Member States have benefited economically. The second point is whether the convergence of the Czech economy with the euro area countries has been sufficient, in terms of a number of economic parameters, primarily price and wage levels. The third point is whether we want monetary union to accelerate further integration processes (Klaus, 2006).

The question of whether the euro has succeeded in helping Member States is a complex one that would require a separate analysis for each euro area Member State. It would be necessary to net out the impact of other factors affecting the macroeconomic aggregates of these economies. Figures 1 and 2 offer an interesting perspective, showing, among other things, the evolution of economic growth and inflation in Latvia and Lithuania. The chart also shows the average real output growth and the average level of inflation in the euro area, the EU and the Czech Republic.

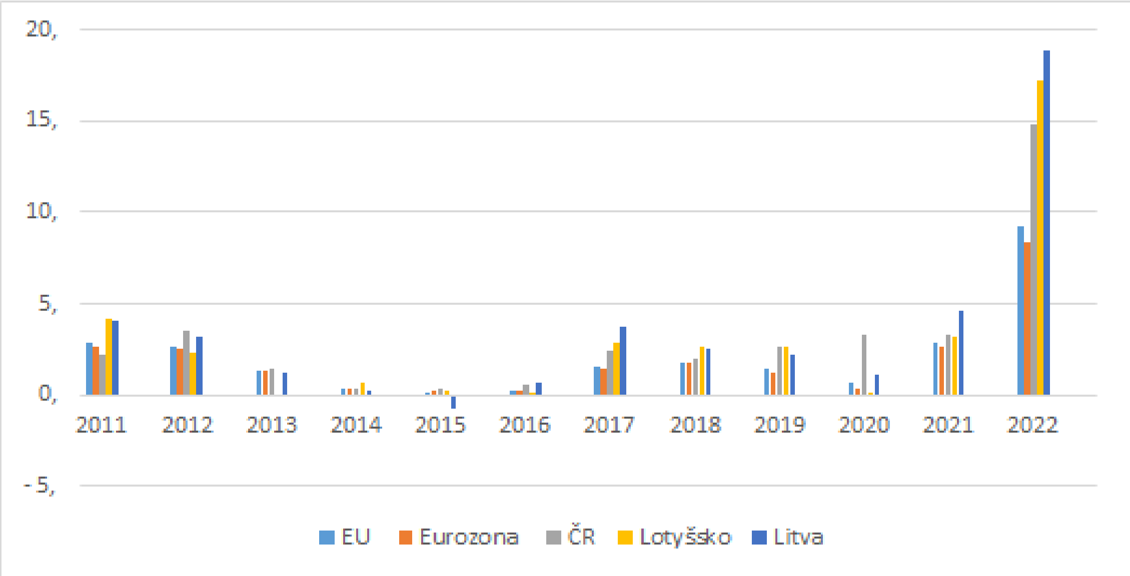
Chart 1: Real GDP growth in the EU, euro area, Czech Republic, Latvia and Lithuania



Data source: own processing (Eurostat, 2022)

The chart shows that both Lithuania and Latvia have achieved lower output growth rates since joining EMU. The decline in the growth rate is particularly pronounced in Lithuania. Over time, however, we can observe that both countries have been growing faster over a longer period of time, until the outbreak of the Covid-19 crisis. The graph also shows that the economic cycles of the Czech Republic and the euro area are not synchronous.

Chart 2: Inflation developments in the EU, the euro area, the Czech Republic, Latvia and Lithuania



Data source: own processing (Eurostat, 2023)

In Chart 2, we can observe that neither Lithuania nor Latvia showed a higher increase in the price level after joining EMU. This was due to the global trend, with inflation rates reaching almost zero in most economies. However, the situation changed with the outbreak of recent cost shocks, which triggered unprecedented rates of inflation growth in both countries. Moreover, as a result of the single monetary policy, these Baltic economies cannot effectively fight inflation. EMU countries experiencing enormously high inflation would need a very restrictive monetary policy. However, they do not have the option of proceeding with monetary tightening. On the other hand, some economies are not experiencing such high inflation and are more worried about an economic recession in 2023. Therefore, it is more beneficial for them to keep rates at lower levels. These facts are indicative of the great heterogeneity of euro area countries.

Average inflation rates in the euro area and the EU were similar. In particular, the Czech Republic had a higher inflation rate than the EU and euro area average in the last year of the period under review. The author of the paper attributes the reasons for the higher inflation in the Czech Republic to the overheated labour market, the looser fiscal policy of the Andrej Babiš government and the tighter restrictions introduced during the Covid-19 pandemic.

A key criterion in the assessment of the Czech Republic's entry into the euro area is the alignment analysis prepared annually by the CNB, which should serve as a basis for the government's assessment of whether to adopt the euro. The analysis has shown that the decision on the timing of EMU entry is accompanied by significant uncertainties, as not all potential future obligations for the Czech Republic arising from euro adoption are currently known. The uncertainties are linked to the incompleteness of some key projects that will have a significant impact on the functioning of the euro area and to some of the persistent problems of the EMU (CNB, 2023b).

4 Discussion and conclusion

After weighing all the potential benefits and risks of adopting the euro, it is clear that there is no need to rush its adoption. At first glance, the impression may be that the advantages outweigh the disadvantages, but on deeper analysis the opposite is true. After all, the same view should be taken by the EMU, which should first resolve its current problems and then accept other members (although this is unfortunately not actually happening). The Czech Republic does not even meet any of the Maastricht criteria at present, so its entry into ERM II would be difficult to justify.

The most important argument against adopting the euro is the loss of monetary policy and the impossibility of influencing the inflation rate through a strong koruna. A strong koruna has been defined by the current CNB Governor as the CNB's objective (Michl, 2022). A fundamental argument against adopting the euro is the different economic cycles of the individual euro area countries and therefore the need to implement different monetary policies. Another risk is that joining the European Banking Union, which is associated with eurozone entry and would entail an obligation to guarantee the liabilities of other countries. Last but not least, the loss of national sovereignty, which is undoubtedly also associated with EMU entry, should also be mentioned.

The benefits of adopting the euro are mainly linked to the microeconomic effects on businesses and households in terms of reduced transaction costs. For companies, these are mainly the elimination of exchange rate risks and the possibility to pay employees in euro. For households, it concerns the costs associated with travelling abroad. However, these costs were assessed as rather marginal compared to the macroeconomic effects of euro adoption.

In the context of the adoption of the euro, it is also worth considering whether we are really forced to adopt the euro. Only the UK and Denmark have negotiated a permanent exemption. The UK has even left the EU itself, and in the case of Denmark, it is a specific case where, although the country has a permanent derogation that it does not have to adopt the euro, the Danish currency is fixed to the euro at a fixed exchange rate, and so Denmark de facto has the euro (it cannot influence the exchange rate), even though the Danish krone is the official currency in the country. Although the Czech Republic has committed to adopting the euro, on the other hand, the rules of the game have not been followed in the past, even by eurozone countries, for example when the Stability and Growth Pact, which was supposed to ensure budgetary discipline of countries after adopting the euro, was violated.

It would be worth considering whether we are really forced to adopt the euro. In this respect, the example of Sweden, which is also committed to adopting the euro but has already rejected it twice in referendums, is interesting. Supporters of deeper European integration and the rapid adoption of the euro should also ask themselves whether they are really willing to contribute indirectly to the pension of, for example, a Greek pensioner who took an inadequately high salary in the public sector and retired at a much earlier age than a Czech citizen.

5 Resources

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