

# **ASSESSMENT OF THE FULFILMENT OF THE MAASTRICHT CONVERGENCE CRITERIA AND THE DEGREE OF ECONOMIC ALIGNMENT OF THE CZECH REPUBLIC WITH THE EURO AREA**

A joint document of the Ministry of Finance of the Czech Republic and the Czech National Bank approved by the Government of the Czech Republic on 20 December 2012.

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# 1 SUMMARY AND RECOMMENDATIONS REGARDING THE CZECH REPUBLIC'S PREPAREDNESS FOR JOINING ERM II AND THE EURO AREA

Besides being required to harmonise their legislation with Articles 130 and 131 of the Treaty on the Functioning of the European Union (the Treaty) and the Statute of the European System of Central Banks and the European Central Bank (ECB), EU Member States are required to achieve a high degree of sustainable convergence in order to join the euro area.

The degree of sustainable convergence is assessed according to the Maastricht convergence criteria. These comprise a criterion on price stability, a criterion on the government financial position, a criterion on participation in the exchange rate mechanism and a criterion on the convergence of interest rates. The criteria are set out in Article 140 of the Treaty and detailed in the Protocol on the Convergence Criteria annexed to the Treaty. The related excessive deficit procedure is referred to in Article 126 of the Treaty, in Protocol No. 12 on the Excessive Deficit Procedure annexed to it, and in Council Regulation (EC) No. 1467/97.

The Czech Republic is obliged to take steps to be prepared to join the euro area as soon as possible. However, setting the date for joining the euro area is within the competence of the Member State and depends on its preparedness. This preparedness can be assessed from the perspective of the economic alignment and structural similarity of the Czech economy and the euro area economy, and from the point of view of the economy's ability to absorb shocks and adjust flexibly to them, for example via effective fiscal policy, a flexible labour market and a sound financial sector.

The view on the economic benefits and costs of joining the euro area has also changed in recent years as a result of ongoing fundamental changes in the institutional architecture of the EMU in response to the debt problems of some of its member countries. Changes in the economic and political framework of the EMU and in the functioning of rescue mechanisms may imply new and unforeseen obligations for accession countries.

## 1.1 Assessment of Fulfilment of the Convergence Criteria

The Czech Republic is not currently compliant with the **criterion on price stability**, mainly because of administrative measures (particularly an increase in the reduced VAT rate at the start of 2012). Nevertheless, the Czech Republic is expected to record modest inflation in 2013–2015, which means it should fulfil the price stability criterion. This will be true if no other changes except those planned are made to indirect taxes and no other significantly inflationary administrative measures are taken in the consumer price area. In addition, the calculation of the reference value, from which some countries with very low inflation may, but need not, be excluded, is a source of uncertainty. The resulting reference value may thus be unexpectedly shifted in either direction.

The CNB's inflation target (for the national consumer price index) has been set at 2% since the start of 2010. The CNB seeks to ensure that actual inflation stays no more than one percentage point higher or lower than the target. Given the ECB's definition of price stability and the inflation targets of the non-euro area EU Member States, this target creates relatively good conditions for future fulfilment of the price stability criterion.

The Czech Republic is not currently compliant with the **criterion on the government financial position**, which sets conditions for the levels of the government deficit and

government debt. Due to non-compliance with this criterion, the Czech Republic is still subject to the excessive deficit procedure (EDP) opened against it in 2009.

The government deficit is expected to reach 5.0% of GDP in 2012 (including correction of reimbursable assets from EU funds and the inclusion of the total accrual coverage of financial compensation to churches, which amounts to CZK 59 billion, i.e. 1.5% of GDP, in 2012 in accordance with the ESA 95 methodology). Given the expected macroeconomic developments, however, the current fiscal policy plans should lead to a general government deficit below the Maastricht criterion as from 2013. Specifically, the government fiscal strategy aims to reduce the deficit to 2.9% of GDP in 2013, 2.7% of GDP in 2014 and 2.4% of GDP in 2015. The continuing euro area debt crisis and its subsequent macroeconomic and fiscal effects in the Czech Republic represent risks to this plan.

The Czech Republic has long been compliant with the government debt-to-GDP ratio criterion. Given its relatively low level of government debt on entering the EU, the Czech Republic currently has no problems fulfilling this criterion, although the rate of growth of the debt started rising sharply in 2009. According to the November 2012 Fiscal Outlook of the Czech Republic, a debt of 45.5% of GDP<sup>1</sup> is expected for 2012, i.e. 4.6 percentage points higher than in 2011. Owing to the expected annual government sector deficits, the government debt level will further increase in the medium term, reaching 49.2% of GDP in 2015. A risk going forward is the expected adverse effect of population ageing. Unless the necessary reforms of the pension and health care systems – which are being prepared by the current government – are implemented, a further marked increase in the debt-to-GDP ratio is to be expected in the long run.

A further strengthening of fiscal discipline should be fostered by a constitutional act currently under preparation – the Budget Responsibility Act, which applies fiscal rules – including a new “debt brake” rule – not only to central government, but also to other general government subsectors. The proposed constitutional act significantly improves the current expenditure framework rule in accordance with the Council directive on requirements for budgetary frameworks of the EU Member States.

The admission of an EU Member State into the euro area is conditional on a successful, at least two-year stay of the national currency in ERM II. Assessment of the fulfilment of the **criterion on participation in the exchange rate mechanism** will only be possible after the Czech Republic joins ERM II and the central rate of the koruna against the euro is set. The Czech currency has not entered this system yet, hence it does not have a fixed central parity vis-à-vis the euro against which exchange rate fluctuations and thus also the fulfilment of this criterion can be monitored.

The koruna’s exchange rate against the euro has fluctuated within a relatively narrow range in the last two years, showing no clear trend. The experience of previous years suggests, however, that exchange rate deviations can exceed the set fluctuation band in turbulent times. The appropriate timing of ERM II entry will thus be of key importance for successful fulfilment of the exchange rate stability criterion going forward. The Czech Republic should enter ERM II amid a stable situation in the domestic economy, in global financial markets and in investment sentiment towards the Czech Republic and the whole region.

The Czech Republic is currently comfortably compliant with the **criterion on the convergence of interest rates**, and, in spite of the difficulty in predicting financial market developments, the pressures are not expected to be significant enough to prevent fulfilment of

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<sup>1</sup> Due to regular revisions of the estimates contained in the Macroeconomic Forecast of the Czech Republic, the ratios to GDP at the time the government discusses this document may differ slightly from the values given here.

this convergence criterion in the coming years. It can also be said that the euro area debt crisis is not a risk factor in this respect (as long-term interest rates have not gone up much during the crisis). However, it is essential to maintain the confidence of the financial markets in the medium-term consolidation and long-term sustainability of Czech public finance.

## 1.2 Assessment of Economic Alignment Analyses

The situation in recent years has been strongly affected by the impacts of the global financial, economic and subsequently European debt crisis. At the same time, the Czech economy has stopped catching up with the euro area economic level. On the other hand, though, it is now showing increased business cycle alignment with the euro area. As a consequence of the global crisis, the economies of the euro area and other EU countries, including the Czech Republic, have gone into recession and recorded a considerable deterioration in the government financial position followed by a phase of consolidation of public budgets. Fiscal restrictions are slowing the economic recovery in both the euro area and the Czech Republic. In addition to budget consolidation, the conservative behaviour of consumers is fostering a deeper contraction in domestic economic activity.

The characteristics of the Czech economy as regards its preparedness to adopt the euro can be divided into four groups.

The first group consists of **economic indicators that speak in the long run in favour of the Czech Republic adopting the euro**. These include the high degree of openness of the Czech economy and its close trade and ownership links with the euro area. These factors provide for the existence of microeconomic benefits of euro adoption. Another favourable factor is the achievement of long-term convergence of the inflation rate and nominal interest rates, as this reduces the macrofinancial risks associated with euro adoption. The Czech financial sector is not a barrier to joining the euro area either, as it can help absorb economic shocks and – despite a temporary deterioration during the recent crisis – is strongly integrated with the euro area.

The second group includes **areas which, in terms of euro adoption in the Czech Republic, pose a risk of macroeconomic costs, but which have shown some improvement in recent years**. The cyclical alignment of economic activity in the Czech Republic and the euro area has recently increased significantly according to all the analytical methods used. This, however, is largely due to the extreme global developments, so only in future years will it be possible to prove or disprove the hypothesis that greater business cycle alignment has been achieved in normal global economic conditions. As regards labour market flexibility the favourable developments also include a decrease in the ratio of the minimum wage to the average wage in past years and reforms made in 2011 and 2012. The ability to adjust nominal wages has manifested itself through frequent use of base wage freezes and bonus cuts by corporations in response to the fall in demand in 2009. In terms of labour market flexibility, the positive factors also include an ability to make use of inflows of foreign labour at times of economic growth and, conversely, to reduce the number of foreign workers during economic downturns. The business climate is gradually improving, but some administrative barriers persist and are still more significant than in the other countries under comparison.

The third group consists of **areas where long-term positive trends were disrupted by the global crisis and its repercussions remain evident**. The real economic convergence of the Czech Republic to the euro area observed until 2008 has halted in recent years. As measured by GDP per capita (converted using purchasing power parity), the Czech Republic is at a higher absolute level than the least developed euro area countries, but this is evidently no guarantee of future smooth functioning of the economy in the EMU. Compared to the euro

area average, moreover, a clear difference in the price level persists. The previous price level convergence trend was temporarily interrupted in 2009 as a result of a sharp depreciation of the koruna, but was renewed in 2010 and 2011. The public finance deficit has deteriorated markedly as a result of the economic slump and the anti-crisis fiscal measures adopted. A public finance consolidation process has been under way since 2010, but in 2011 the deficit was 3.3% of GDP and total government debt grew to 40.8% of GDP. The implemented and planned austerity measures will result in a reduction in the public budget deficit in the near future. Fundamental reforms focused on the long-term challenges relating to population ageing have yet to be completed. The impacts of the previous economic downturn are also being reflected in a persisting elevated level of long-term unemployment.

The fourth group contains **areas which are showing long-term problems in terms of the Czech economy's flexibility and ability to adjust to shocks and which are not showing any significant improvement.** This group includes the flexibility of the Czech labour market. Its weak spots include persisting large regional differences and high overall labour taxation.

### 1.3 Situation in the Euro Area and New Obligations for Accession Countries

In its initial years, the euro area showed convergence in unemployment and the inflation rate, but this trend was interrupted during the crisis. By contrast, the differences in economic level (expressed as the variability of real GDP per capita) were widening until the start of the financial crisis and then decreased slightly. The differences in the annual growth rates of euro area economies suggest that their business cycles are not moving significantly into alignment. On the contrary, the differences have generally been widening in recent years owing to different timing and intensity of the onset of the recession during the global financial and economic crisis. The impacts of the escalating debt crisis in the euro area in 2012 offer little hope of improvement in the near future either. Long-term interest rates were gradually converging before the crisis, but the debt problems of some member countries have led to a sharp rise in misalignment in recent years. However, insufficient financial discipline is apparent in most EMU countries. Only three euro area countries are currently compliant with the Stability and Growth Pact criteria.

In response to the problems, euro area countries' governments continued to tighten macroeconomic and budgetary supervision. Rescue mechanisms for the euro area countries have also been bolstered. The changes in the economic and political framework will probably imply that sustainable fulfilment of the Maastricht criteria and sufficient alignment of the Czech economy with the euro area economy will not be sufficient conditions for adopting the single currency. Euro area entry will probably also be conditional on participation in the new institutions and mechanisms. Based on the current information, the costs relating to joining the European Stability Mechanism (ESM) would be particularly substantial upon the Czech Republic's entry into the euro area. After the 12-year period of temporarily lower financial involvement by the Czech Republic elapses, these costs could reach CZK 350 billion, taking the form of gradually paid-in capital in cash and committed callable capital. This is increasing the costs to the Czech Republic of joining the euro area. In addition, other initiatives are under preparation at the European level whose specific impacts cannot be estimated yet (for example the banking union), but which are significantly adding to the uncertainty regarding the future conditions for euro area entry.

### 1.4 Conclusions and Recommendations

The fiscal problems in the euro area have led to proposals for significant institutional changes in the functioning of the monetary union. These changes are fundamentally changing the

conditions and obligations arising from the Czech Republic's potential membership of the euro area. This is increasing the costs of joining the euro area. In light of these facts, amid continuing financial market instability and uncertainty about the future direction of the economy, and given the no less important questions regarding the future institutional set-up of the EU, the current situation does not seem conducive to euro adoption in the Czech Republic.

As regards the preparedness of the Czech Republic itself to adopt the euro, it is necessary in particular to continue the public budget consolidation process and increase the flexibility of the labour market. **In view of these facts, the Ministry of Finance and the Czech National Bank, in line with the Czech Republic's Updated Euro-area Accession Strategy, recommend that the Czech government should not set a target date for euro area entry for the time being.** The recommendation not to set a target date for euro area entry for the time being simultaneously implies a recommendation that the Czech Republic should not attempt to enter ERM II during 2013.

## 2 ASSESSMENT OF THE CURRENT AND EXPECTED FULFILMENT OF THE MAASTRICHT CONVERGENCE CRITERIA

The degree of sustainable convergence is assessed according to the Maastricht convergence criteria, i.e. the criterion on price stability, the criterion on sustainability of the government financial position, the criterion on exchange rate stability and the criterion on long-term interest rates.<sup>2</sup>

### 2.1 Criterion on Price Stability

#### Box 2.1: Definition of the criterion on price stability

##### Treaty provisions

The first indent of Article 140(1) of the Treaty requires: “the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability”.

Article 1 of the Protocol on the Convergence Criteria stipulates that: “the criterion on price stability shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis taking into account differences in national definitions.”

##### Application of Treaty provisions in ECB and EC Convergence Reports

With regard to “an average rate of inflation, observed over a period of one year before the examination”, the inflation rate is calculated using the increase in the latest available 12-month average of the Harmonised Index of Consumer Prices (HICP) over the previous 12-month average.

The reference value of the price criterion is calculated as 1.5 percentage points plus the simple arithmetic average of the rate of inflation in the three countries with the lowest inflation rates, provided that this rate is compatible with price stability.

##### Implementation of the price stability criterion – current practice

Both the Treaty and the Protocol in some areas leave scope for interpretation by the institutions that assess the fulfilment of the criteria (the European Commission and European Central Bank). Therefore, when assessing the fulfilment of the criteria one should also take into account the specific way in which these institutions apply the criterion. In Convergence Report 2010, for example, owing to the general economic situation, countries with negative rates of inflation were chosen as the best performing countries in terms of price stability, in contrast to the practice in previous years, when the three countries with the lowest positive inflation had been selected. The choice of countries to be included in the calculation of the price criterion therefore depends in part on the arbitrary decision of the assessing institutions. In this context, it is necessary to bear in mind that the current stagnation may lead to a negative rate of inflation in some countries.

According to the calculation of the reference value for the three best performing countries in terms of price stability, within the period under review the Czech Republic was compliant with this criterion in 2009–2011. In August 2012, however, the price stability criterion was no longer fulfilled. 2009 saw much lower energy and food prices compared to the previous year amid a global recession which, together with a fall in the domestic economy, manifested itself in sharp disinflation which peaked in 2010 Q2. Since then, prices have been gradually increasing. This growth, which accelerated in 2012, has been due to administrative measures and oil and food prices. The administrative measures have included two VAT increases (increases in both rates of 1 percentage point in 2010 and an increase in the reduced VAT rate of 4 percentage points in 2012) and increases in excise duties in the same years. Inflation

<sup>2</sup> Prepared on the basis of macroeconomic data known until August 2012 and the autumn government deficit and debt notifications.



pressures from the domestic economy, by contrast, have not been apparent. In 2011, annual consumer price inflation was fluctuating close to the CNB's inflation target of 2%. The higher inflation rate and non-compliance with the price stability criterion in August 2012 were thus due to the above adverse supply shocks (oil and food prices) and particularly to administrative measures.

**Table 2.1: Harmonised index of consumer prices**

(average for last 12 months vs. average for previous 12 months as of end of period, growth in %)

	2009	2010	2011	8/2012	2012	2013	2014	2015
Average for 3 EU countries with lowest inflation *	0.0	0.9	1.6	1.5	1.2	1.2	1.3	1.4
Reference value	1.5	2.4	3.1	3.0	2.7	2.7	2.8	2.9
Czech Republic	0.6	1.2	2.1	3.4	3.5	2.3	1.9	2.1

\* More precisely, the three best performing Member States in terms of price stability (see Box 2.1).

Note: The outlook for EU countries for 2012–2015 was taken from the Convergence Programmes and Stability and Growth Programmes of the individual countries except Greece, whose Stability and Growth Programme is not available. Owing to the unavailability of average HICP inflation rates, the private consumption deflator was used for Germany and average CPI inflation rates were used for France and Slovenia at the forecast horizon.

Source: Eurostat, Convergence Programmes and Stability Programmes of individual Member States.

In 2013–2015, prices in the Czech Republic will still be affected, in addition to standard factors, by a significant contribution of administrative measures. This contribution should be strongest in 2013, when, among other things, the two VAT rates are expected to be increased by 1 percentage point. Despite this, the Czech Republic should be compliant with the price stability criterion in 2013–2015. However, this is conditional on no other changes except those planned being made to indirect taxes and no other administrative measures being taken in the consumer price area during the reference period for the assessment of this criterion.

## 2.2 Criterion on the Government Financial Position

The criterion on the government budgetary position is satisfied only when both components of the fiscal criterion, i.e. the general government deficit and government debt, are fulfilled in a sustainable manner.

### 2.2.1 General government deficit criterion

#### Box 2.2: Definition of the criterion on the sustainability of the government financial position

##### Treaty provisions

The second indent of Article 140(1) of the Treaty requires “the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 126(6) of the Treaty”.

Article 2 of the Protocol on the Convergence Criteria stipulates that this criterion “shall mean that at the time of the examination the Member State is not the subject of a Council decision under Article 126(6) of this Treaty that an excessive deficit exists”.

Article 126 of the Treaty sets out the excessive deficit procedure, which is specified in more detail in the Stability and Growth Pact. According to Article 126(3) of the Treaty, the European Commission prepares a report if a Member State does not fulfil the requirements for fiscal discipline, in particular if:

1. the ratio of the planned or actual government deficit to GDP exceeds a reference value (defined in the Protocol on the excessive deficit procedure as 3% of GDP), unless:

- either the ratio has declined substantially and continuously and reached a level that comes close to the reference value, or

- the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value.

2. the ratio of government debt to GDP exceeds a reference value (defined in the Protocol on the Excessive Deficit Procedure as 60% of GDP), unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The criterion on the government financial position was not and is again not being fulfilled, as the excessive deficit procedure was opened for the second time against the Czech Republic at the end of 2009 based on an expected exceeding of the reference value for the government deficit-to-GDP ratio (the Czech Republic was subject to the EDP for the first time in 2004–2008). As a result of a sharp slowdown in economic growth and recession in late 2008 and early 2009, the general government balance saw a marked deterioration. In addition to the unresolved structural problems of Czech public finance, the government sector was facing an unprecedented shortfall in tax revenues owing to the extraordinarily unfavourable economic situation and to legislative changes approved mainly on the revenue side of the public budgets. Expenditure on mitigating the effects of the recession on economic agents was increased at the same time.

The government has been taking consolidation measures since 2010. In 2010, the measures were focused on raising VAT revenues and cutting wage expenditure. The measures for 2011 included, on the revenue side, changes in personal income tax and social security contributions, taxation of donated emission allowances and the introduction of taxes on photovoltaic power stations. On the expenditure side they included a continued reduction in wages in the general government sector, and social benefit cuts. In 2012, on the revenue side there was a one-off increase in the reduced VAT rate, and taxation of lottery income was introduced. On the expenditure side, the state contribution to building savings schemes was reduced and austerity measures were introduced in the health care system. Another significant expenditure-reducing factor in 2012 was a government resolution to cut in expenditure in individual budget chapters. The government sector deficit in 2012 has been substantially increased on a one-off basis by the passing of the government proposal of a law on rectifying some property injustices against churches. The whole sum of the financial compensation, which amounts to CZK 59 billion, i.e. 1.5% of GDP, is taken into account in 2012. This is therefore a methodological issue of the accrual system of accounting and not an actual payment in cash.

The deficit is expected to decrease below 3% of GDP in 2013.

**Table 2.2: General government balance**

*(ESA 1995 methodology, in % of GDP)*

	2009	2010	2011	2012	2013	2014	2015
Reference value	-3,0	-3,0	-3,0	-3,0	-3,0	-3,0	-3,0
Czech Republic	-5,8	-4,8	-3,3	-5,0	-2,9	-2,7	-2,4

Source: 2009–2011: CZSO: Government Deficit and Debt Notifications. 2012–2015: Fiscal Outlook (November 2012).

The medium-term outlook for the state budget in 2013–2015 assumes a gradual improvement in the general government balance to -2.4% of GDP in 2015, in line with the requirements of the Stability and Growth Pact and government's Programme Declaration.

As regards the alignment of the Czech economy with the euro area economy and the sustainability of public finance, it remains essential to address the structural problems of public finance. Under the Stability and Growth Pact, the Czech Republic has been set a medium-term objective (MTO) of achieving a structural general government deficit of 1% of

GDP. Given the current fiscal policy settings, this objective will probably not be fulfilled during the outlook period. The structural deficit is expected to be 2.1% of GDP in 2012. In the following years the deficit is predicted to stabilize around 2% of GDP.

The risk of deterioration of the euro area economic outlook remains at the moment, owing to the persisting debt crisis in Greece and the problematic situation in Spain and some other euro area countries, which is jeopardising the economic growth of all EU countries, including the Czech Republic. A sharp slowdown in economic growth would in turn affect tax revenues in particular, as well as some social benefits, and consequently the general government balance.

## 2.2.2 Government debt criterion

Given the low initial level of government debt, the Czech Republic has had no problem fulfilling this criterion so far. In 2007–2008, the government debt stabilised around 30% of GDP, following a substantial increase (due mainly to government guarantees) in 2001–2003. Since 2009, however, owing to the economic crisis the debt has increased sharply, as the amount of debt is being affected to a large extent by the public budget deficit, the largest component of which is the greatly elevated state budget deficit. Compared to the EU and euro area average, however, the overall debt is not high.

Given the fiscal policy settings, the debt ratio is expected to increase throughout the outlook period, reaching 49.2% of GDP in 2015. It is clear that the period of comfortable fulfilment of the government debt criterion has ended and that increased attention will have to be paid to the sustainability of fulfilment of this criterion in the future.

**Table 2.3: Government debt**  
(ESA 1995 methodology, in % of GDP)

	2009	2010	2011	2012	2013	2014	2015
Reference value	60,0	60,0	60,0	60,0	60,0	60,0	60,0
Czech Republic	34,2	37,8	40,8	45,5	47,6	48,6	49,2

Source: 2009–2011: CZSO: Government Deficit and Debt Notifications. 2012–2015: Fiscal Outlook (November 2012).

The adverse effects of population ageing pose a risk to the long-term public finance trend, even though quite significant measures have been taken, for example, in area of public pensions (parametric changes to the current pay-as-you-go system). However, there is still room to reduce the pressure on public finances. The systemic reforms also include a change to the health care and long-term care systems.

## 2.3 Criterion on Participation in the Exchange Rate Mechanism

### Box 2.3: Definition of the criterion on participation in the exchange rate mechanism

#### Treaty provisions

The third indent of Article 140(1) of the Treaty requires: “the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State”.

Article 3 of the Protocol on the Convergence Criteria stipulates that: “the criterion on participation in the exchange rate mechanism of the European Monetary System shall mean that a Member State has respected the fluctuation margins provided for by the exchange rate mechanism of the European Monetary System without severe tensions for at least two years before the examination. In particular, the Member State shall not have devalued its currency’s bilateral central rate against any other Member State’s currency on its own initiative for the same period.”

#### Application of Treaty provisions in ECB and EC Convergence Reports

The Treaty refers to the criterion of participation in the European exchange-rate mechanism (ERM until December 1998 and ERM II since January 1999).

First, the ECB and the EC assess whether the country has participated in ERM II “for at least the last two years before the examination”, as stated in the Treaty.

Second, as regards the definition of “normal fluctuation margins”, the ECB recalls the formal opinion that was put forward by the EMI Council in October 1994 and its statements in the November 1995 report entitled “Progress towards Convergence”.

The EMI Council’s opinion of October 1994 stated that “the wider band has helped to achieve a sustainable degree of exchange rate stability in the ERM”, that “the EMI Council considers it advisable to maintain the present arrangements”, and that “member countries should continue to aim at avoiding significant exchange rate fluctuations by gearing their policies to the achievement of price stability and the reduction of fiscal deficits, thereby contributing to the fulfilment of the requirements set out in Article 140(1) of the Treaty and the relevant protocol”.

In the November 1995 report entitled “Progress towards Convergence” it was stated that “when the Treaty was conceived, the ‘normal fluctuation margins’ were  $\pm 2.25\%$  around bilateral central parities, whereas a  $\pm 6\%$  band was a derogation from the rule. In August 1993 the decision was taken to widen the fluctuation margins to  $\pm 15\%$ . The interpretation of the criterion, in particular of the concept of ‘normal fluctuation margins’, became less straightforward”. It was then also proposed that account would need to be taken of “the particular evolution of exchange rates in the European Monetary System (EMS) since 1993 in forming an ex post judgement”.

Against this background, in the assessment of exchange rate developments the emphasis is placed on exchange rates being close to the ERM II central rates.

Third, the issue of the presence of “severe tensions” or “strong pressures” on the exchange rate is addressed by examining the degree of deviation of exchange rates from the ERM II central rates against the euro. Other indicators, such as short-term interest rate differentials vis-à-vis the euro area and their evolution, are used as well. The role played by foreign exchange interventions is also considered.

The example of the assessment of sustainability of fulfilment of the exchange rate stability criterion for Slovakia in the 2008 ECB Convergence Report recalls that some European authorities currently tend to take a stricter view in the interpretation of the convergence criteria and their fulfilment.

For the purposes of this assessment of exchange rate stability, the hypothetical CZK/EUR central parity is set as the average exchange rate in 2010 Q1, i.e. the quarter preceding hypothetical ERM II entry at the start of 2010 Q2, which would allow euro adoption on 1 January 2013. With the aid of this parity it is theoretically possible to monitor whether the Czech Republic would have fulfilled the exchange rate stability criterion in the given time period.

Over the past two years, the exchange rate of the koruna against the euro has been on the stronger side of the hypothetical parity with no apparent trend. This might be interpreted as fulfilment of the exchange rate stability criterion. The experience of previous years, however, indicates less exchange rate stability. The koruna’s previous long-term appreciation trend was interrupted in the second half of 2008. The subsequent sizeable depreciation was due to deteriorating foreign investor sentiment about the Central European region, including the Czech Republic, during the global financial crisis. The large magnitude of the depreciation between July 2008 and February 2009 (23%) indicates potential risks to the fulfilment of the exchange rate criterion. After the financial crisis passed, there was a period of a slight appreciation of the koruna. However, the euro area’s problems with the expanding debt crisis in 2011 Q3 caused nervousness return to the financial markets. This was also reflected in increased volatility of the koruna’s exchange rate in both directions. Overall, therefore, it can be seen that exchange rate deviations can exceed the set fluctuation band in turbulent times. The appropriate timing of ERM II entry will therefore be of key importance for successful fulfilment of the exchange rate stability criterion going forward. The Czech Republic should enter ERM II amid a stable situation, both currently and going forward, in the domestic

economy, in global financial markets and in investment sentiment towards the Czech Republic and the whole region.

**Chart 2.1: Nominal CZK/EUR exchange rate**



Note: In the chart, an upward movement of the exchange rate means appreciation of the koruna vis-à-vis the euro. The hypothetical central parity is simulated by the average exchange rate for 2010 Q1.

Source: CNB, Czech MoF calculations. Data up to 30 September 2011.

The length of stay of an EU Member State in ERM II is set by the Treaty at a minimum of two years before the assessment of preparedness to adopt the euro. The Czech Republic's September 2003 Euro-area Accession Strategy and its August 2007 update state that the Government and the CNB agree on a stay in ERM II for the minimum required period only. This implies that the Czech Republic should enter the ERM II only after it has achieved a high degree of economic alignment and after conditions have been established which enable it to introduce the euro shortly after the assessment of the exchange rate criterion.<sup>3</sup>

The Czech economy is highly open and therefore vulnerable to external shocks such as the surge in commodity prices in 2008 (in the context of the high energy intensity of the Czech economy) and the subsequent recession. The freely floating exchange rate has the potential to absorb adverse external shocks impacting on the Czech economy. For instance, a decrease in external demand usually causes the Czech koruna to weaken. This moderates the decrease in net exports and therefore dampens the effects of lower external demand on the Czech economy (the weakening of the Czech koruna at the start of recession serves as an example). The freely floating rate thus also places lower demands on the response of fiscal and monetary policies to adverse external shocks.

## 2.4 Criterion on the Convergence of Interest Rates

### Box 2.4: Definition of the criterion on the convergence of interest rates

#### Treaty provisions

The fourth indent of Article 140(1) of the Treaty requires: "the durability of convergence achieved by the Member State and of its participation in the exchange-rate mechanism of the European Monetary System being reflected in the long-term interest-rate levels".

<sup>3</sup> For details, see the joint documents of the Czech Government and the CNB: "The Czech Republic's Euro-area Accession Strategy" and "The Czech Republic's Updated Euro-area Accession Strategy" at [http://www.mfcr.cz/cps/rde/xchg/mfcr/xsl/eu\\_acc\\_stra\\_13438.html](http://www.mfcr.cz/cps/rde/xchg/mfcr/xsl/eu_acc_stra_13438.html) and [http://www.mfcr.cz/cps/rde/xchg/mfcr/xsl/eu\\_acc\\_stra\\_33780.html](http://www.mfcr.cz/cps/rde/xchg/mfcr/xsl/eu_acc_stra_33780.html)

Article 4 of the Protocol on the Convergence Criteria specifies that: “the criterion on the convergence of interest rates means that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions.”

#### **Implementation of the criterion on the convergence of interest rates – current practice**

As in the case of the price stability criterion, there is room for interpretation by the assessing institutions. In the 2012 Convergence Report, the European Commission and the European Central Bank excluded the interest rate of Ireland from the calculation of the criterion on long-term interest rates, as the country had had restricted access to financial markets in the reference period and its rate had been far above the euro area average and could not be considered an appropriate benchmark. The Irish value was not excluded from the calculation of the price stability criterion in the same period. The reference value for the criterion on interest rate convergence was calculated using the data of two countries (Slovenia and Sweden).

The annual average long-term interest rates in the Czech Republic for convergence purposes showed a downward trend during 2009–2012. The Czech Republic constantly fulfilled the interest rate criterion by a sufficient margin in the period under review.

**Table 2.4: Long-term interest rates for convergence purposes**

*(average for the last 12 months, in %)*

	2009	2010	2011	8/2012	2012	2013	2014	2015
Average for 3 EU countries with lowest inflation *	3.9	4.0	3.3	2.1	1.8	2.5	3.3	4.2
Reference value	5.9	6.0	5.3	4.1	3.8	4.5	5.3	6.2
Czech Republic	4.8	4.2	3.7	3.2	3.4	3.5	3.8	4.0

\* More precisely, the three best performing countries in terms of price stability (see Box 2.1).

Note: Countries facing debt problems were excluded from the forecast for 2012–2015 (Spain over the entire forecast horizon, Ireland in 2013 and Portugal in 2014–2015). Not all the necessary data were available for 2012; the reference value for the criterion was calculated by fixing the current real interest rates of the reference countries.

Source: Eurostat, Convergence Programmes and Stability Programmes of individual Member States.

The Czech Republic’s adherence to fiscal consolidation is reflected in its high sovereign rating and in the strong interest of both residents and non-residents in Czech government bonds, which is fostering stability of Czech government bond yields.

Given the above-mentioned problems in the euro area, the forecast for 2013–2015 is subject to certain risks. Previous developments, however, indicate that the Czech Republic should have no problems fulfilling this convergence criterion, even though the interest rates of the reference countries (e.g. Germany) can be expected to be extremely low. However, maintaining the confidence of the financial markets in the medium-term consolidation and long-term sustainability of Czech public finance is an important condition.



### 3 ASSESSMENT OF THE CZECH REPUBLIC'S CURRENT ECONOMIC ALIGNMENT WITH THE EURO AREA

This part summarises the results of a set of analyses directed at assessing the Czech economy's alignment with the euro area over and above the formal criteria, the fulfilment of which is assessed in the previous part. The Czech Republic's future entry into the euro area ensues from the commitments associated with EU membership. Adoption of the single European currency should lead to the elimination of exchange rate risk in relation to the euro area and to a related reduction in the costs of foreign trade and investment. This should further increase the benefits accruing to the Czech Republic from its intense involvement in the international economic relations. Besides the aforementioned benefits, however, adoption of the euro will simultaneously imply costs and risks arising from the loss of independent monetary policy and exchange rate flexibility vis-à-vis major trading partners. The benefits and costs stemming from euro adoption will be affected by the characteristics and situation of both the Czech economy and the euro area economy. These factors will influence whether adoption of the euro by the Czech Republic will lead to an increase in the country's economic stability and performance.

The analyses are divided into two basic groups according to the type of question they try to answer. The section entitled "Cyclical and Structural Alignment" indicates the size of the risk of different economic developments in the Czech Republic compared to the euro area and hence the risk of the single monetary policy being highly suboptimal for the Czech economy. The section entitled "Adjustment Mechanisms" answers the question of to what extent the Czech economy is capable of absorbing the impacts of potential asymmetric shocks using its own adjustment mechanisms. The basic theoretical starting point for the underlying analyses is the theory of optimum currency areas. These analyses are aimed at assessing the evolution of the alignment indicators over time and in comparison with selected countries. The conclusion as to whether adopting the euro will have economic benefits for the Czech economy and whether the economy is sufficiently prepared for adopting the single currency cannot be made in absolute terms, but the aforementioned comparison with other countries and the assessment of developments over time can be carried out in the context of economic developments in the euro area. In general, the benefits of adopting the euro can be expected to depend on the economic situation in the domestic economy and in the euro area and to increase with greater economic alignment and stronger adjustment mechanisms other than monetary policy and the exchange rate adjustment mechanism.

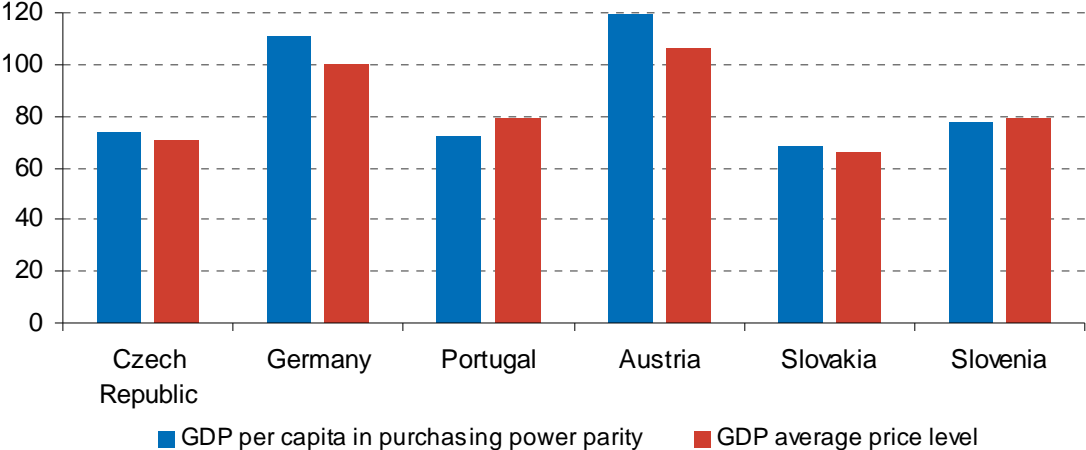
#### 3.1 Cyclical and Structural Alignment

Assuming a stable and sustainable economic situation in the euro area, the costs arising from the loss of the Czech Republic's own monetary policy will be particularly pronounced if the Czech economy is not aligned with the euro area economy. The risks arising from the Czech Republic's accession to the euro area will decrease as the degree of alignment increases.

The **degree of real economic convergence** is an important indicator of the Czech economy's similarity to the euro area. A higher level of such convergence fosters greater similarity of long-run equilibrium development. Indirectly it can also foster a lower likelihood of misalignment in the shorter run. A higher degree of convergence in the economic level prior to ERM II entry and euro adoption should further increase the relative price level, which will reduce the potential future pressures for growth of the price level and equilibrium appreciation of the real exchange rate. From the long-term perspective, the Czech economy is converging

towards the euro area in real terms. However, this trend halted in 2009 as a result of the financial and economic crisis. In recent years, GDP per capita has been about three-quarters of the euro area average. Owing to the crisis, the convergence process was also interrupted in the case of the price level of GDP. In the last two years, however, this level has increased again, reaching 70% of the euro area price level in 2011, although it remains below the level corresponding to the performance of the economy. The wage level in the Czech Republic in 2011 was roughly 40% of the average euro area level when converted using the exchange rate and about 60% when converted using purchasing power parity. The real exchange rate of the koruna (on an HICP basis) appreciated on average by 2.6% a year between 2002 and 2011, but is displaying significant fluctuations around its long-run trend. Some of these fluctuations can be sources of macroeconomic shocks, while others can help to absorb them. The koruna's appreciation in 2007 and the first half of 2008 (i.e. in a situation of high inflation and fast economic growth) had a stabilising effect on the Czech economy, as did the subsequent weakening of the Czech currency during the recession. According to the analyses, equilibrium real appreciation of the koruna against the euro at an average rate of 1.6–2.1% a year can be expected over the next five years. Continuing real appreciation of the exchange rate following euro area entry would therefore mean an inflation differential vis-à-vis the euro area and related lower (or even negative) real interest rates.

**Chart 3.1: Real economic convergence of selected states towards the euro area in 2011**  
(EA-17=100)

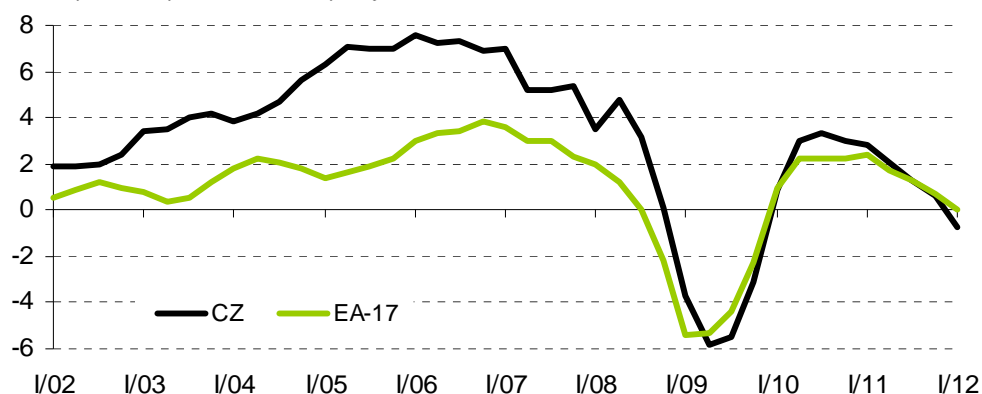


Source: Eurostat, CNB calculations.

**Alignment of economic activity and similarity of economic shocks** will increase the likelihood that the single monetary policy in the monetary union will be appropriately configured from the perspective of the Czech economy. The analyses indicate increased correlation of overall economic activity between the Czech Republic and the euro area in recent years; the same goes for activity in industry and export activity. However, the rise in the monitored correlations, including supply shock correlation, should be assessed in the context of the global economic crisis, the subsequent gradual recovery in economic activity, and later also the impacts of the deepening debt crisis proceeding in parallel in the Czech Republic and the euro area. For this reason, only in future years will it be possible to prove or disprove the hypothesis that greater business cycle alignment has been achieved in normal global economic conditions.



**Chart 3.2: GDP growth in the Czech Republic and the euro area**  
(in %, year-on-year, seasonally adjusted)



Source: Eurostat, CNB calculations.

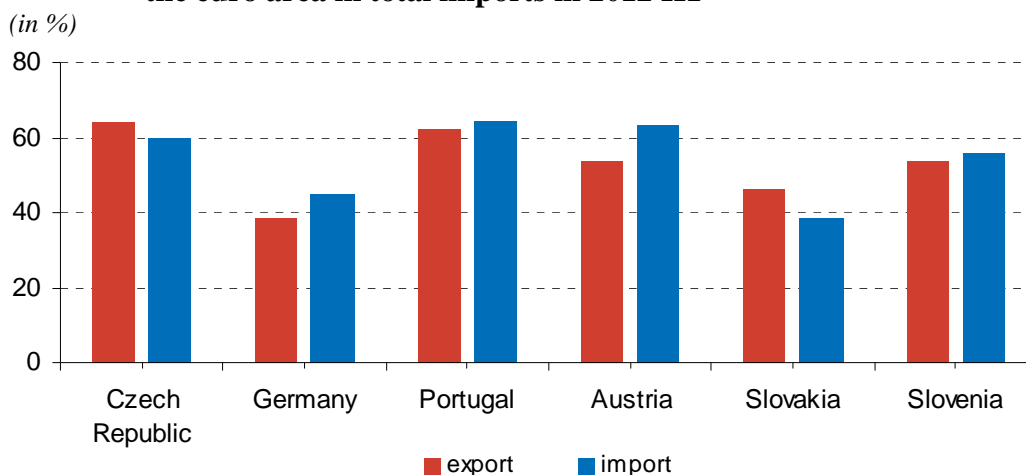
Similarity of the **structure of economic activity** with the euro area should decrease the risk of asymmetric economic shocks. In terms of production structure, the Czech economy retains a specific feature in the form of a higher share of industry and a smaller share of services, particularly financial intermediation, compared to the euro area. In addition, the differences in structure are widening further. The above-average share of the car industry in the total output and value added of the Czech economy compared to the euro area is (as in Germany) a possible source of asymmetric developments.

Fast convergence of **nominal interest rates** in the immediate run-up to joining the euro area acted as an asymmetric shock in some economies in the past, generating macroeconomic imbalances and risks to financial stability. For a country planning to enter the monetary union, earlier gradual interest rate convergence is therefore an advantage. The fact that the difference between Czech and euro area interest rates was close to zero for a long time is favourable from this perspective. Short-term interest rates showed a slightly positive interest rate differential in 2009–2010, but this closed gradually, temporarily turning negative in 2011 H2. Government bond yield differentials against Germany peaked at the start of 2009 and also showed a slight and temporary increase in late 2011 and 2012 H1 due to the euro area debt crisis. However, Czech long-term interest rates have long been much lower than those in the other countries under review.

Another indicator of the appropriateness of sharing a single currency is long-term comovement in the **exchange rates** of two currencies against a reference currency. Compared to the other currencies under review, the correlation between the rates of the Czech koruna and the euro against the dollar was relatively high. It always decreased only temporarily: during the fast appreciation of the koruna in 2001–2002 and later on in connection with the general surge in global financial market volatility after the fall of Lehman Brothers in 2008 H2 and 2009 Q1, when the Czech koruna – like the Hungarian forint and the Polish zloty – came under significant depreciation pressure. A temporary modest decline in correlation was also observed in 2012 H1.

The Czech economy's strong **trade and ownership links** with the euro area magnify the benefits arising from the elimination of potential fluctuations in the exchange rate and the reduction in transaction costs. The euro area is the partner for 64% of Czech exports and 60% of Czech imports, a level comparable to, or even higher than, that in the other non-euro area countries under review. The share of intra-industry trade is relatively high. The Czech economy's ownership links with the euro area on the direct investment inflow side are relatively strong and showing an upward trend. In 2010, foreign direct investment from the euro area was 53% of Czech GDP.

**Chart 3.3: Share of exports to the euro area in total exports and share of imports from the euro area in total imports in 2012 H1**



Source: Eurostat, IMF, CNB calculations.

Despite the smaller size of the Czech **financial sector** and its smaller depth of financial intermediation relative to the euro area, it can be expected to have a similar effect on the economy in normal economic conditions. The depth of financial intermediation in the Czech Republic, as measured by the ratio of financial system assets to GDP, is roughly one-quarter of the value for the euro area. The share of bank loans to the private sector is 56% of GDP in the Czech Republic, i.e. roughly two-fifths of that in the euro area. However, the current level of the aforementioned indicators in the euro area is not necessarily optimal, since in many countries it is more a reflection of private sector overleveraging.

The **structure of the financial assets and liabilities of Czech non-financial corporations and households** is gradually converging to that of euro area entities, but still shows differences. For corporations, the difference is particularly visible in a higher weight of shares in the net debtor position, due to lower ownership links. By contrast, the share of debt is lower than in the euro area. Corporations in the Czech Republic are showing higher liquidity, although liquidity growth has also been visible in the other countries under review in recent years. The maturity of corporate liabilities is longer and debt financing is lower and more stable. Czech households have a higher share of currency and deposits in their assets and a lower debt ratio than euro area households. The household sector's net creditor position is still about half that in the euro area.

In the past, the **effect of money and financial market rates on client rates** in the Czech Republic was roughly the same as in the euro area. The global financial and economic crisis has led to a temporary slowdown in transmission of monetary policy interest rates to the Czech economy owing to some client risk premia. The structure of interest rate fixation on new loans to non-financial corporations is similar to that in the euro area. The degree of **spontaneous euroisation** in the Czech Republic is low and is due to economic agents' high trust in the domestic currency and to sustained low inflation and low interest rates. The use of foreign currency is concentrated primarily in the sector of corporations involved in foreign trade.

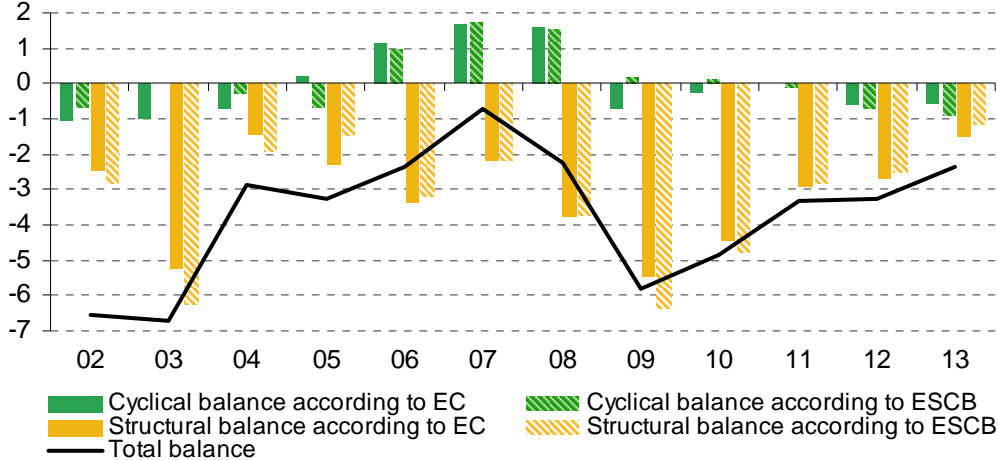
The analysis of **integration of financial markets** (the money, foreign exchange, bond and stock markets) reveals that the speed of elimination of shocks in the individual segments of the Czech financial market was increasing in the pre-crisis period and the level of convergence towards the euro area did not differ much from that of the other countries under review. The only exception was the money market, which was already showing a lower degree and speed of integration in the pre-crisis period, mainly due to different monetary

policy in the Czech Republic compared to other countries. The global crisis and its impacts led to a decline in the speed of adjustment and to loosening financial market integration in all the countries under comparison. The financial market situation started to improve in 2009 H2, and in 2010 the Czech Republic saw a return to pre-crisis values on all markets under review except the government bond market. However, slight divergence was apparent at the start of 2012, due to the escalation of the euro area debt crisis.

### 3.2 Adjustment Mechanisms

Fiscal policy can be a stabilising element for the economy, but it can itself be a source of economic shocks if it is set inappropriately. The closer the structural part of the public budget deficit is to zero and the lower is the accumulated public finance debt, the more room there will be at a time of economic downturn for automatic stabilisers to function and discretionary measures to be implemented. The assessment of the **roles of the structural and cyclical components of the budget balance** shows that the Czech general government deficits in past years were due mainly to non-cyclical effects – until recently, the total deficit was almost identical to the structural component. Fiscal policy was pro-cyclical for most of the period under review. Windfall tax revenues in 2006–2008 were not employed to reduce the fiscal deficit, but instead tended to be used to generate new public expenditures. Similarly, tax cuts affecting the revenue side were not ultimately accompanied by corresponding austerity measures on the public expenditure side, even during years of solid economic growth. Fiscal policy had the desirable counter-cyclical nature in 2009, when government anti-crisis and other measures were adopted. This led to a significant widening of the structural deficit. The public finance situation improved somewhat in 2010 and 2011, when a fiscal consolidation process was commenced and the structural deficit was considerably reduced, albeit at the cost of pro-cyclical fiscal policy. According to the current estimate, the structural deficit should narrow further in 2011 and 2013 thanks to continuing fiscal consolidation. Although the Czech Republic’s **total government debt** is lower than that of many EU countries, it has been growing significantly in recent years. The high share of mandatory expenditure combined with the expected effect of demographic changes on pension system expenditures (this effect is moderated by the increase in the retirement age within the “small” pension reform) and health care system expenditures also poses a risk to public finance sustainability.

**Chart 3.4: The fiscal balance and its cyclical and structural components**  
(as % of GDP)



Note: Positive values represent a public budget surplus and negative values a public budget deficit. The sum of the cyclical and structural balance does not equal the total balance since the structural balance is adjusted for extraordinary one-off fiscal measures in addition to the effect of the cycle.

The overall balance in 2012 does not include the financial compensation for churches of 1.5% of GDP.

Source: CZSO, CNB calculations.

The **labour market** is another important mechanism through which the economy can cope with shocks within the euro area. The Czech labour market is not significantly less flexible compared to other European economies, but its weak spots include persisting large regional differences, high overall labour taxation and low financial incentives to seek a job, particularly for the short-term unemployed and low-income households with children.

The Czech labour market situation reflects the impacts of the previous economic downturn. Long-term unemployment started rising in 2009 H2, although in 2011 it fell slightly. Structural unemployment is hovering around 6%. This is one of the lower figures among the countries under comparison. The Czech Republic still has relatively large differences in unemployment across regions.

**Wage flexibility** can enhance the economy's ability to absorb shocks to which the single monetary policy cannot respond. Nominal wages in the Czech Republic responded to the buoyant economic growth and subsequent sharp downturn in the appropriate direction, dampening the impact of the recession on the Czech labour market. In addition to base wage freezes and indexation, firms often adjusted bonuses and also used other alternative labour cost adjustment channels. According to the results of econometric analyses, however, real wage flexibility is not statistically significant. Differences in **inflation persistence** in the monetary union countries could also lead to the single monetary policy having different impacts. However, inflation persistence in the Czech Republic is average among the countries under comparison.

Although the **international mobility** of Czech workers is not very high, the increase in foreign employment in the Czech Republic until 2008 H1 and its subsequent decline as a result of the economic slump can be regarded as economic adjustment ability. On the other hand, the use of foreign labour in the pre-crisis period indicated the persistence of some serious rigidities in the Czech labour market, as demand for low-skilled labour was not satisfied from domestic sources.

Labour market flexibility is determined to a great extent by the **institutional rules**. The effect of collective bargaining on wage setting in the Czech Republic is no higher than in the current euro area members. The ratio of the minimum wage to the average wage was rising until 2006. Since then it has been decreasing, however. This is important above all in low-skilled jobs, for which the negative impact of a high minimum wage on wage flexibility can be greater. A reduction in the cost of dismissing an employee during the period shortly after the employment contract is signed or after the probationary period has ended can be considered a positive change as from 2012, which should result in higher job creation, especially for graduates and young people. Overall labour taxation in the Czech Republic is relatively high, and has increased slightly further in recent years. The implicit taxation rate, expressing the average effective tax burden, decreased in 2008 and 2009, but increased slightly in 2010. The financial incentives to seek and accept a job are weak in the Czech Republic, particularly for the short-term unemployed and low-income households with children.

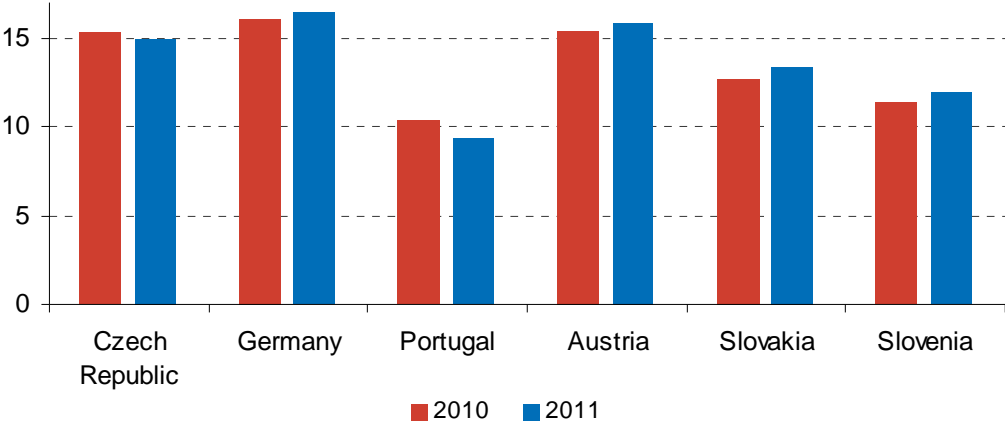
In the area of **product market flexibility** the situation is showing some positive changes. The conditions for doing business have improved compared to the other countries. However, the domestic business environment remains in some respects (e.g. starting a business) more burdened with administrative obstacles than in most of the countries under comparison. The rate of taxation of Czech corporations is one of the lowest among the countries under review.

**Stability and effectiveness of the financial sector** is a precondition for the sector to be able to assist in absorbing economic shocks. By contrast, an unsound financial sector can create

shocks and propagate them to the real economy. It can also cause problems in the fiscal area, as recent experience of some euro area countries shows. The Czech banking sector displays very good macroprudential indicators such as profitability, capitalisation and liquidity and limited dependence on other countries. It is therefore not a source of shocks and should be able to absorb fluctuations emanating from the domestic economy or from abroad. The results of stress tests conducted on portfolios as of 31 March 2012 indicate that the Czech banking sector is also sufficiently resilient to extremely adverse macroeconomic and financial developments.

**Chart 3.5: Capital adequacy ratio**

*(in %)*



Source: IMF FSI.

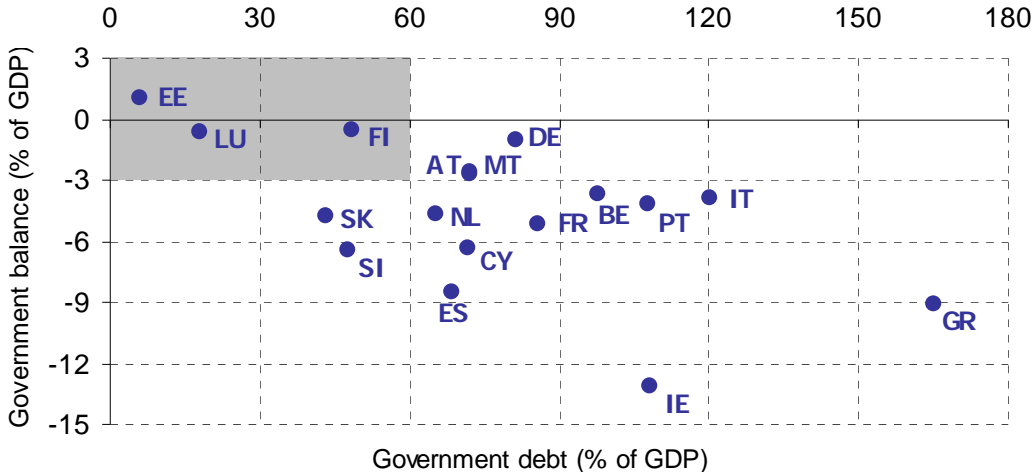
## 4 SITUATION IN THE EURO AREA AND NEW OBLIGATIONS FOR ACCESSION COUNTRIES

Developments in the euro area in recent years deserve increased attention. On the one hand they are pointing to differences between the countries of the EMU, and on the other hand they are leading to a change in its institutional architecture and may therefore significantly alter the benefits and costs of euro adoption.

**Economic alignment of euro area countries** is a basic prerequisite for the EMU to function smoothly. However, recent developments point to shortcomings in this area. The differences in economic level between member countries were widening until the start of the financial crisis. The subsequent decrease in differences is due to a larger fall in real GDP in wealthier countries. The differences in year-on-year growth rates across euro area economies indicate that their business cycles are displaying no major change in alignment. However, these differences widened in 2008–2010 and slightly also in late 2011, as the economies were hit by recession in different quarters and to different extents. By contrast, the unemployment rate was initially converging, but in recent years unemployment has risen much more strongly in some countries. Inflation showed a trend towards relative alignment after euro adoption, but the crisis years saw a temporary increase in misalignment. In recent years, the biggest and fastest-growing gap can be seen for long-term interest rates, which most of all reflect the different magnitudes of the debt problems across euro area countries.

The **public finance situation** in many euro area members is currently putting the functioning of the euro area under the biggest pressure. At present, only three countries (Estonia, Finland and Luxembourg) meet the fiscal criteria laid down in the Treaty on the Functioning of the EU and detailed in the protocols annexed to it. In 2011, eleven countries exceeded the budget deficit criterion (3% of GDP) and twelve were non-compliant with the debt criterion (60% of GDP). Although compliance with the Stability and Growth Pact had been patchy right from the establishment of the euro area, the problems escalated after the outbreak of the global financial and economic crisis.

Chart 4.1: Euro area fiscal positions in 2011



Source: Eurostat.

Major changes are being made to the **institutional framework** in response to the euro area’s problems. The future form of the economic and political organisation of the EMU is changing the view of the economic benefits and costs of joining. In addition to the primary objective of

fiscal consolidation, EU countries' economic policies have recently been aimed at fostering a recovery in economic growth. The process of assessing macroeconomic imbalances has started, and plans are being prepared to create a banking union covering financial market supervision at the European level. The lending capacity of the rescue mechanisms has been further increased, with funds expected to go mainly to Greece and Spain. The EFSF and the ESM are, in addition, supposed to purchase bonds of problem countries on primary and secondary markets. The European Central Bank will potentially also buy bonds under a new programme (OMT). However, these bond purchases may strongly affect the quality of the ECB's balance sheet and exert pressure to increase its capital in the future.

From the perspective of the potential costs to an accession country, the set-up of the rescue mechanisms is of particular importance. Although entering the euro area and joining the ESM are separate actions from the legal point of view, political pressure to perform them simultaneously can be expected. If – purely hypothetically – the Czech Republic became an ESM member this year, according to current rough estimates it would have to pay in cash capital totalling around CZK 32 billion in the first five years after ESM entry and undertake to provide further callable capital of around CZK 250 billion. Twelve years after ESM entry, the Czech Republic's final commitment (i.e. paid-up capital in cash plus callable capital) could total as much as CZK 350 billion (i.e. around 9% of GDP as estimated by the Ministry of Finance for 2012). Moreover, the Czech Republic's obligation to provide callable capital up to the aforementioned amount would not necessarily be purely theoretical if the Czech Republic was co-liaible for all the existing obligations of this institution upon joining the ESM. This is because the ESM may in the future assume the EFSF's obligations – at least any approved undisbursed and unfunded loans – and because the ESM may start to provide assistance on its own account after its establishment. In addition, other initiatives are under preparation at the European level whose specific impacts cannot be estimated yet, but which are significantly adding to the uncertainty regarding the future conditions for euro area entry. These include above all the banking union and the shift towards a fiscal union and closer integration of economic policies. Only future developments in this area will reveal the potential further costs associated with entering the euro area.