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"The Basic Features of the Proceeding Discussion about the Czech Republic Preparation for Joining the Eurozone"

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Abstract:

Paper summarised the current stage of the Czech Republic preparation for accession to EU and its adherence to the aims of EMU with accent on basic features of

- macroeconomic policy orientation
- adoption and implementation of the EMU related acquis communautaire
- assessment of the Copenhagen and Maastricht criteria fulfilment
- possible period for adoption of the euro.

Meeting the Copenhagen convergence criteria constitute a prerequisite for the Czech Republic accession to EU (in year 2004). But the fulfilment of the Copenhagen criteria (real convergence) support the ability to adhere to the aims of EMU at the time of the Czech Republic accession to EU. As is mentioned (/1/; /2/; /3/) there exists the strong elements of complementarity between the processes of real (Copenhagen criteria) and nominal convergence (Maastricht criteria). This view has been adopted by the European Central Bank (ECB) (/4/).

The fulfilment of the "Maastricht convergence criteria" (including price stability, the sustainability of public finance, exchange rate stability in the framework of participation in the Exchange rate mechanism and the convergence of interest rates) is not mandatory for the Czech Republic accession to EU. But creating the macroeconomic conditions for their realisation is important part of economic strategy and policy for the accession to EU (/5/; /6/) and in particular of the adoption and the implementation of the EMU- related acquis communautaire which will provide the necessary background to pursue stability - oriented policies in preparation period for the final adoption of the euro in the Czech Republic (during the period 2006-2010).

1. Macroeconomic policy orientation towards meeting the Maastricht convergence criteria

The **primary objective of economic policy** is to meet the Copenhagen criteria, whilst closing the gap in income levels between the Czech Republic and the EU (/6/). In this context the Czech economic strategy is oriented to the improvements of competitiveness in the broadest sense in medium- term. The integration of the Czech economy into EU single market environment (and later into EMU environment) is crucial steps in coping with the challenge of globalisation.

The medium-term framework of Czech macroeconomic policy is based on co-ordination of national monetary and fiscal policies (/7/).

The main objective of the Czech National Bank (CNB) **monetary policy** is price stability. Monetary policies are conducted under **inflation targeting** on the basis of the CNB´s long-term monetary strategy. Inflation target for the next four-year period has been announced in the form of range for year-on-year growth of headline consumer price index, descending evenly from the level of 3-5 per cent in January 2002 to the level of 2-4 per cent in December 2005. Favourable inflationary development, economic growth without any visible imbalance tendencies and halting of interest rate cuts abroad are the main factors influencing CNB´s monetary policy regime in the forthcoming period.

The main objective of **fiscal policy** in the medium run is to consolidate public finance and to create a room for manoeuvre so that fiscal policy can make use of its stabilising properties. The public finance consolidation will be focused on the medium-term consolidation of the tax quota and a gradual reduction in the expenditures quota in order to mitigate and subsequently eliminate public finance's deficit tendencies without negatively effecting the performance of the Czech economy and its real convergence. A gradual reduction in structural deficits will require adaptation of the expenditure and revenue side of the general government budgets. This primarily involves a revision and revaluation of the volume and structure of mandatory expenditures and improving budgetary allocation. This task is essential for preparing the Czech Republic for EU accession as well as for becoming a full-pledge member of the EMU in the future.

Main medium-term economic challenges for the Czech Republic are **public finances.** The sources of **fiscal risk** (or challenges) are identified as

- the implicit indirect government liabilities that developed at institutions managing non-performing assets
- the indirect government liabilities stemming from state guarantees
- future expenditure for pension and health care stemming from changes in demographic developments.

In 1999, the CNB announced the **Long-term Monetary Strategy**, with the approval of the Government. The CNB set the target to approximate price growth to the EU and to create conditions for reaching the long-term objective of price stability defined in the Long-term Monetary Strategy anticipated for around 2005. In April 2001, there was a shift to a continuously targeted band for total year-on-year inflation that will steadily fall from 3-5 per cent in January 2002 to 2- 4 per cent in December 2005. This target was set on the basis of an agreement with the Government. If inflation is affected by excessive unbalanced tendencies in regulated prices or the unexpected administrative measures, the institution of exceptions shall be applied to reach the inflation target.

A new quality of a dialogue between the Central Bank and the Government has **improved the conditions for forming a desirable mix of monetary and fiscal policy**. Consensus of the Government, the Central Bank and other entities, including trade unions, increases the credibility of announced inflation targets. This also has a favourable effect on inflation expectations and reduces the costs of anti-inflationary policy.

The task of fiscal policy in the medium run is to consolidate public finances and to create a room for manoeuvre so that fiscal policy will limit the danger of the pro-inflationary risk.

The consensus of the government and CNB on the medium-term tasks of both monetary and fiscal policy should pursue both goals in co-operation, i.e. the goals of price stability and balancing the economic cycle.

Important measure for increasing sustainability of the fiscal stance of the Czech economy in medium-term is **the conception of increasing the efficiency of public finances** prepared by Ministry of Finance CR. It is supposed of **five principles forming the basis of budgetary reform** needed for the future meeting the nominal (Maastricht) convergence criteria as a prerequisite for joining EMU**:**

- **Principles of transparency**: the direction for continuing strengthening of fiscal transparency is based on prior analyses and the identified sources of fiscal risk as well as international codes and recommendations for fiscal transparency related to:
  - clearly defining the Government sector based on the principles of the integrity of the budget and its financing
  - the accessibility of reliable, systematic, complete, timely and comparable information for budgetary participants and the general public
  - the openness of budgetary preparations and implementation, strengthening of the system of financial controls over all the procedural levels of public finance including verification by an independent entity.

- **Principles of budgetary stability**: this mainly concerns improving the management of budgetary expenditures by a complex system of preparation and establishing medium-term expenditure targets according to Government priorities and integrating them into the medium-term expenditure framework:
  - efficiency from the standpoint of operations as well as allocation by introducing Government expenditure budgeting on the basis of performance and results
  - decentralizing budgetary authorities and responsibilities to strengthen the subsidiary principles, while integrating the functions of financial management (implementation of the budget, budget and debt financing, accounting, bookkeeping and financial statistics and financial planning).

2. Adoption and implementation of the EMU related acquis communautaire

According to the opinion of the ECB (/4/) the adoption and the implementation of the EMU- related acquis provide the candidates for accession to EU with the necessary background to pursue stability - oriented policies. From the perspective of the Eurosystem for establishing the appropriate conditions for stability – oriented monetary policies, sound banking systems and smoothly functioning market economies are important in particular legislation

• on central banks
• capital movements
• relating to the creation of conditions for sound banking systems and financial stability.

According to 2002 Regular Report (/8/, p.78) "the Czech Republic has made significant progress in the adoption of EMU- related acquis".

In March 2002, Parliament amended **the Law on the Czech National Bank (CNB)** with a view to aligning it fully with the acquis. The amendment entered into force on 1 May 2002.

As regards the independence of the CNB, the amendment to the act on the CNB has ensured compatibility with the acquis with changes in the area of financial, personal and institutional independence. Additionally, an amendment to the Constitution of the Czech Republic has ensured that the primary objective of the CNB is defined as price stability.

In the field of **capital movements**, liberalisation in line with the acquis is almost completed. In the field of capital movements and payments, an amendment to the Foreign Exchange Act has been adopted. As of January 2002 it abolishes restriction on acquisition of real estate by branches and agencies established in the Czech Republic.

In terms of **payment system**, the amendment to the Act on Banks, which entered into force on 1 May 2002 has abolished the CNB´s monopoly on clearing domestic inter-bank currency payments. It has also aligned Czech legislation with the acquis concerning the single licence for institutions authorised to issue electronic payment instruments.

As regards **money laundering**, the amendment to the Act on Banks prohibits any new deposit or payment of interest on existing anonymous account from 1 January 2003.

In the field of financial services, transposition of **banking sector acquis** has been largely completed. The harmonisation amendment to the Act on Banks (dealing with regulation and banking supervision) entered into force in May 2002. This act with the new Act on Payments has helped ensure a comprehensive transposition of the relevant acquis.

According to overall assessment of those aspects of the Economic and Monetary Union acquis which candidate countries should implement before accession, **the Czech Republic have completed the process of legislative alignment with the EMU acquis.**

3. Assessment of the Copenhagen criteria (with adherence to EMU) fulfilment

There is the mutual relationship between real and nominal convergence in the process of the Czech Republic preparation to accession for EU and consequently to EMU. In particular price stability has a positive impact on real economic performance and sufficient fulfilment of the Copenhagen criteria support the ability to adhere to the aims of EMU already in the period of preparation for accession to EU.

In its 2002 Regular Report (/8/), the Commission concluded that **the Czech Republic is a functioning market economy.** The continuation of its current reform path should enable the Czech Republic to cope with competitive pressure and market forces within the Union. Against a challenging international economic environment, economic performance has improved. Macroeconomic stability has achieved, reforms have deepened while the Czech authorities´ commitment to the economic requirements of EU accession has been sustained.

The Czech Economy has returned to solid **growth rates** following a recession in 1997 and 1998 and macroeconomic stability has been regained (see figure in table 1). But the progress in terms of real income convergence is slow. In 2001 the average per capita GDP in purchasing power standards (PPP) amounted to 57% of the EU-15 average (/8/).

The economy as a whole has achieved a satisfactory level of competitiveness. Gains in **labour productivity** over the last five years have enhanced the external competitiveness of the Czech economy (/11/).

Table 1

Main trends of basic real convergence indicators in the Czech Republic

	1997	**1998**	**1999**	**2000**	**2001**
Real GDP growth rate, per cent a)	-0.8	-1.0	0.5	3.3	3.3
Labour productivity growth, per cent b)	0.1	0.4	2.6	4.0	2.9
GDP per capita in ECU/euro PPP	12100	12200	12500	12600	13300
Gross value added structure, in per cent c)					
Agriculture and forestry	4.4	4.6	4.2	4.3	4.2
Industry	34.1	32.5	31.8	32.3	32.9
Construction	8.0	7.2	7.2	7.1	7.2
Services	53.4	55.7	56.8	56.3	55.8
As % of GDP c)					
Gross fixed capital formation	30.6	29.1	27.8	28.3	28.3
Exports of goods and services	56.5	58.8	60.6	69.8	71.3
Imports of goods and services	62.5	60.0	61.9	73.2	74.1
Share of EU-15 as % of total external trade					
Exports	59.8	64.0	69.2	68.6	68.9
Imports	61.8	63.5	64.2	62.0	61.8
As % of population					
Economic activity (15-64)	71.7	71.7	71.8	71.2	70.7
Employment rate					
(15-64)	68.6	67.5	65.6	64.9	65.0
Average employment structure, in per cent					
Agriculture and forestry	5.8	5.6	5.3	5.2	4.6
Industry	32.0	31.5	31.1	31.0	31.4
Construction	9.6	10.0	9.4	9.4	9.1
Services	52.6	52.9	54.1	54.8	54.6
Unemployment rate as % of labour force, total	4.3	5.9	8.5	8.8	8.0
Lon-term unemployment share, as % of all unemployed	32.3	31.5	36.7	50.0	52.9

a) In constant prices

b) GDP in constant prices per employed person

c) In current prices

Source: /8/

The sectoral structure of the economy, which is characterised by a relatively large manufacutring sector, has altered only marginally. The share of the manufacturing sector in the economy has altered with the economic cycle. Its decline, both in terms of gross value added and of employment, came to a halt in 1999, and it has been rising again since then. In 2001, industry (without construction) produced 34% of gross value added, the same share as in 1997. The development of the services sector in terms of GDP shows just the reverse trend, though its share in total employment has been on the rise over the whole period. In particular, financial intermediation and the tourist sector posted gains. The gross value added of construction fell from 8% in 1997 to 7% in 2001 with a smaller drop in the share of total employment. The agricultural sector has never posed a severe challenge in terms of structural adjustment because of its small size.

High level of **gross fixed capital formation** have significantly improved the supply side of the economy. Over last five years, fixed investment has average 28.8% of GDP. Private investment has reached 23.5% of GDP on average, thus leaving about 5% for public investment which compares favourably to the EU average. This strong investment performance has helped to replace the old capital stock and has upgraded production capacities. As a result productivity increases of about 3.2% on average over the last three years pushed up output growth and improved competitiveness. Physical infrastructure as a prerequisite for smooth economic development has got closer to international standards.

Employment policy is focused on fighting unemployment and on fostering flexibility. Progress in this policy area has been rather limited, though there seems to be a policy consensus on the most pressing deficiencies on the labour market: increasing regional disparities in unemployment, rising unemployment levels within what are considered high-risk groups and a declining employment rate in the older age groups. Labour force mobility will remain limited as long as adequate housing cannot be provided due to the highly regulated rent market. Active employment policy measures need to be focused on target groups with a clear linkage to market requirements.

The **well-skilled labour force has been an asset for coping with economic restructuring and making the Czech economy more competitive**. The high quality of professional education and the short time required to obtain qualification together with relatively low wage costs have been an advantage in competition for foreign investments. While the majority of the labour force have completed secondary education (about 66%), the percentage of the people with tertiary education has remained at a level of about 12%. Considering the trend towards increasingly advanced production technologies, a more sophisticated services sector and deeper integration into the world economy, education must be able and willing to meet higher demands. The education system faced the challenge of expanding tertiary education and providing the workforce with tools to adapt to life-long learning in order to continuously meet labour market requirement.

Unemployment remains high due to restructuring and structural mismatches on the labour market.

The unemployment rate (labour force survey data) has more doubled, from 4.3% in 1997 to 8.8% in 2000. Its decreases to 8% in 2001 appears to be in particular the result of an amendment to the Labour Code limiting overtime work. The unemployment rate reflects the impact of the 1997 crisis and subsequently economic restructuring which only starts at late stage in the transition process. Employment fell in each year between 1997 and 2000, amounting to a cumulative loss of employment of 3.0% registered. Though the adjustment process has been accompanied by accelerating investments and new employment opportunities, these have not been able to compensate for the job losses. The composition of unemployment reveals the structural shortcomings in the labour markets. Workers in sectors undergoing restructuring find it difficult to move to the other sectors or regions with a higher growth potential since flexibility and mobility are hampered by deficiencies in re-qualification and the scarcity of affordable housing in more prosperous regions. In certain circumstances, the social benefit system may work as an disincentive to take up work. Hence, while some regions and sectors suffer from high and even increasing unemployment, others are reporting the first signs of shortage in the skilled labour force.

The Czech economy is very open and **trade integration with the EU has reached high levels.** While in 1997 exports and imports of goods and services amounted to 119% of GDP, this ratio rose to more than 145% in 2001. Exports to the EU also showed a clear upward trend, from roughly 60% of total exports in 1997 to about 69% in 2001. Imports from the EU as a percentage share of the total, by contrast, have hovered around the five- year average of 62%. In general, trade with developed market economies has intensified, but trade relations with other transitional economies have been extended as well. External trade is concentrated to a very high degree on technology and capital- intensive manufactured goods, with an emphasis, on the export side, on road vehicles and electrical machinery (/12/).

The Czech economy has emerged as an **attractive market for foreign investment.** From 1997 to 2000, inflows of foreign direct investment (FDI) reached an average of 7.8% of GDP, peaking at 11.6% in 1999 and then decreasing to 8.7% in 2001. In the first quarter of 2002, FDI reached EUR 3.1 billion. FDI inflows originated mainly from the EU and other OECD countries and were concentrated in the machinery and equipment sector and in the financial services sector. Privatisation- related FDI has accounted for a large share of total FDI, but greenfield and brownfield investment has gained increasing importance. This development has been supported by offering attractive incentive packages to foreign investors. The Czech Investment Incentive Act provides a large number of investment incentives that can be combined. The Office for Protection of Economic Competition ensures the compliance of the investment grants with the acquis.

Good progress in real convergence has been influenced by **the macroeconomic policy mix** (which has been broadly adequate) and also by the process of privatisation. **The private sector** is firmly established and accounts for the overwhelming part of the Czech economy. Private ownership has become the dominant form of ownership. In 2001, 79.8% of GDP was produced in private companies, in contrast to 74.7% of GDP in 1997. The land market has been liberalised and land registers, broadly speaking, work properly. The supply of industrial and commercial land has continued to exceed demand, although the market in economically booming regions like Prague is tighter. Overall, the state still owns a significant share of land.

The conclusion from real convergence of the Czech economy development during last five years has supported the opinion that it created conditions for relatively quicker admission into the Eurozone where the single currency- the euro- is used.

4. Assessment of the Maastricht criteria fulfilment

Assessment in terms of main trends of the basic nominal convergence indicators in the period of last five years support the faster adoption of the euro in the Czech economy (see figures in table 2).

Inflation remained at relatively low levels. After peaking at 9.7% in 1998, the inflation rate dropped to a very low 1.8% in following year. However, since the beginning of the economic pick-up, as price deregulation measures have also been taken up again and pushed by the increase in international commodity prices, the inflation rate edged up to 3.9% in 2000 and 4.5% in 2001. Throughout the first half of 2002, inflationary pressures were subdued. Slackening economic activity, low international commodity prices but also the strong Czech crown has contributed to this development. In the first half of 2002, consumer price inflation was 3% higher than in the corresponding period of the previous year.

The current monetary and exchange rate policy framework of direct inflation targeting and a managed exchange rate float have served the economy well. Inflation targeting was introduced in 1998, with net inflation serving as the reference until 2001. In the first years, the inflation targets of the CNB were undershot. With its "Setting of the Inflation Target for the Period 2002 to 2005", the CNB has embarked upon headline inflation targeting which helps ensure that the public accepts the targets. The inflation target is set as a band which should fall continuously from 3% to 5% in January 2002 to 2% to 4% in December 2005.

Monetary policy has been accommodating since 1998. Interest rates been cut back several times, recently reaching 3% for the main **interest rate**, the two-week repo rate. The real short-term interest rate (day-to-day money market rate, corected for by consumer price inflation) has equally been falling from around 11% in 1997 to 0.5% in 2001. Monetary conditions reflect the low inflationary environment and the strong exchange rate of the Czech currency.

Reluctance too undertake comprehensive expenditure reforms has led to **a deterioration in public finances**. The previous government pursued only modest fiscal consolidation, but the fiscal programme of the newly-elected government is not very ambitious in this respect, either. On the basis of harmonised EU standards (ESA 95), the **general government deficit** has averaged 3.8% of GDP from 1997 to 2001. In 2001, the deficit reached 5.5% of GDP and it is anticipated that it will surge to 6.6% of GDP in 2002. Public budgets have to swallow the costs resulting from the delayed implementation of structural reforms, in particular the clean-up of the banking sector and the restructuring of the corporate sector.

Table 2
Main trends of basic nominal convergence indicators in the Czech Republic

	1997	1998	1999	2000	2001
Inflation rate					
Consumer price index a)	8.0	9.7	1.8	3.9	4.5
Average interest rates, % per annun					
Long-term b)	10.5	12.1	7.6	6.8	6.0
Credit rate	13.2	12.9	8.7	7.2	7.0
Deposite rate	7.7	8.1	4.5	3.4	3.0
Public finance, as % of GDP					
General Government deficit surplus	-2.7	-4.5	-3.2	-3.3	-5.1
General government debt of the whole economy c)	44.6	39.5	43.2	41.2	36.5
Gross foreign debt of the whole economy as % of exports c)	42.5	45.2	46.8	38.1	.
FDI (net) inflow, in Mio ECU/ euro	1148	3303	5932	5405	5489
FDI (net) inflow, per cent of GDP	2.5	6.6	11.6	9.8	8.7
Current account balance, percent of GDP	-6.1	-2.3	-2.7	-5.3	-4.6

a) Annual average
b) 5 year government bonds yield to mat.
c) In CZK
Source: /8/; /10/

General government debt has been moderate but this does not completely reflect government´s financial exposure. General government debt reached 23.6% of GDP at the end of 2001, up from 13.7% in 1998. Past and current levels of government debt do not fully reflect the actual picture of indebtedness as they include only part of the debt of the transformation institutions and guarantees of the government and the National Property Fund. The government has started to gradually internalise these liabilities in the general government debt. That adds substantially to the statistically reported stock of government debt over time.

The **current account deficit** averaged 4.1% of GDP between 1997-2001. Since 1998, the deficits have been financed by **high inflows of foreign direct investment**. In 1996/1997, the economy was confronted with unsustainable current deficits due to soaring deficits in foreign trade. The implementation of the austerity measures in 1997 led to a temporary sharp deceleration of imports. With the economy recovering since 1999, the trade and current account deficits have widened again. However, the trade deficits have been dominated by investment good imports and there is no indication so far that consumer goods imports are getting out of hand. In 2001, the trade balance recorded a deficit of 5.5% of GDP and the current account surplus. In the first quarter of 2002, the trade balance posted an estimated deficit of 4.6% of GDP and current account deficit reached 4.2% of GDP.

5. The benefits and risks of the accelerated adoption of the euro

In discussions on the **possible time the Czech Republic should adopt the euro**, there are two flows of opinion. The first is "the sooner the better" (/2/), and the second is "be careful, no need to hurry" (/1/). Going by the Regular Reports of recent years, the European Commission is more inclined to the latter view. The outcome of this debate necessarily entails a detailed examination of the other theoretical observations and an evaluation of the practical experience of countries (e.g. Ireland, Portugal and Spain) (/2/) when the exchange rate mechanism disintegrated in 1993, or the recent experience of Argentina. Some of the Czech Republic´s basic macroeconomic parameters (economic level and comparative price level) will not come close to the standards enjoyed by the least economically developed countries (Greece and Portugal, when they entered the Eurozone) until 2008-2010. Therefore their results could play a key role in future decision.

According to the results of study prepared for the Czech government (/1/) **the benefits of joining the Eurozone** rest primarily in:

- **the elimination of the risk of currency crises**. World-wide experience of repeated financial and currency crises, which can be sparked or augmented also by the "international infection" effect, is a powerful argument in favour of the fast adoption of the euro
- **the reduction in transaction costs**, i.e. the cost of converting currency
- the anticipated **cut in interest rates**, even though this change would only affect the Czech Republic to a lesser extent (considering the low interest rate differential).

The volatility of the **exchange rate will also fall and exchange rate fluctuations would be eliminated completely** in relations with the Czech Republic´s main trading partners- members of the Eurozone. **The absence of the exchange rate is undoubtedly a factor simplifying real convergence**. However, the exchange rate is also a significant factor of the economy allowing for adaptation to changes in the economic situation. Experience has confirmed that where the exchange rate fails to adapt, the external imbalance tends to be corrected by a slowdown or decline economic growth.

There are general and specific risks of the accelerated adoption of the euro.

General risks are connected with the fact that yet, there is no synchronisation between the Czech economic cycle and the Eurozone cycle, nor can we assume that the impacts of economic shocks on the Czech economy and on the other members of the Monetary Union will be symmetrical. Substitute adaptation mechanism could be high price and wage flexibility (up or down) and high cross-border mobility of the workforce and of business activities (in both directions). However, these mechanisms are still weak. It is well known that European Union is working in the interest of current Member States to slap administrative restriction on the free movement of the workforce and business activities (especially services) for a long period of time. Fiscal policy, as another adaptation instrument, will also be limited by the fiscal stability pact.

Specific risks are attached to transition economies. **These risks relate to loss of the adaptation mechanisms** of the economy, which is at a much lower economic level than the economies of other Eurozone members. Differences in economic level lead to major divergences in structural characteristics and in resistance of economies to external shocks, as well as in the inflation rate which is optimal for their economic growth. The process of real convergence will give rise, in the Czech economy, to the tendency of real appreciation of the currency, which will be expressed after Eurozone accession as a real appreciation of domestic assets, resulting in an increase on general price levels. This is set to be a long-term process.

Real appreciation will on the one hand bring the danger of loss of competitiveness, and on the other hand the problem will emerge as to whether the economy will be able to achieve optimum growth at an inflation rate low enough not to interfere with the European Central Bank´s monetary goals.

An anti-inflation policy that is too tight could slow down the necessary correction of relative prices, which must be a lot deeper in the Czech economy than stabilised Member States because of the persistent price deformations. Price levels in the Czech Republic are among the lowest in Central-Eastern European (CEE) countries, and therefore we can expect them to balance out at a much more forceful pace. A very important long-term source of real appreciation will be the tradable and non-tradable sectors of the economy, in a situation where there is "wage contagion". There will be several reasons for real appreciation- as the Czech economy catch up technically and economically, price growth will be faster, which will be reflected in part as "fictitious inflation", because product innovation and enhanced quality will be registered statistically as a price rise.

ECB efforts to maintain a low inflation rate in the Eurozone as a whole could check the economic growth of new members and reduce their inflation under the level required for the smooth progress of swift real convergence. If the ECB were to put its inflation targets up, this would interrupt efforts to establish the euro world-wide as a strong currency with a low inflation rate which will be able to compete with the dollar in the future as the world´s main transaction and reserve currency. Recent experience in transition economies (e.g. the abrupt halt of economic growth in Poland due to attempts at implementing rapid disinflation) are steering the European Central Bank towards a policy of greater prudence, and its opinions are generally being **channelled into recommendations that candidate countries do not hurry along their entry to the Eurozone at an unnecessarily fast pace.**

Once the Czech Republic becomes a member of the European Union, we can expect several years of numerous changes in relative prices and faster movements in prices levels towards the average EU level. This faster progression will continue until the integration impacts of the new environment the Czech Republic will find itself in as an EU Member state have been absorbed. The higher inflation rate this will entail should be incorporated in advance into the Czech National Bank´s inflation targets for the post-accession period. It will be essential for the central bank to take objective price impacts into account. It would be inexpedient to combat a temporary rise in the inflation rate with monetary policy because this could artificially induce a recession in the economy.

After absorbing initial integration influences, the economy should be given a certain time to adapt, during which there would be no point in attempting premature approximation of the inflation rate with the Maastricht Criteria. A key element will be support for a **rise in productivity and the preservation of competitiveness**. When a consensus is reached between the Czech Republic and Eurozone countries that the Czech Republic is ready for admission to the Eurozone, it will be necessary to make a decisive cut in inflation, the public deficit, and the state debt to the level required under the Maastricht Criteria. This should not be a major problem in the case of state debt, as, in relation to GDP, this is still one of the lowest among EU Member candidate countries and even Member States (second to Luxembourg). However, another reduction in inflation and achieving a 3% public finance deficit could endanger economic growth in the medium term.

At least two years prior to the estimated adoption of the euro, the Czech Republic will have to join ERM 2. If it manages to enter with an appropriate initial exchange rate, then the two-year abidance to the fluctuation band of ± 15% set for ERM 2 should not pose any great problem.

Although large-scale exchange-rate fluctuations cannot be ruled out, the koruna has reported a remarkable degree of short-term and long-term stability against European currencies right from the beginning of transformation. The Czech economy, unlike Poland and Hungary, for example, is not accustomed to using the exchange rate as a permanent instrument to support competitiveness for years on end. Therefore it will not take long in ERM 2 to find out whether the Czech economy is able to function without permanent competitive devaluation. Nevertheless, throughout the time the Czech Republic remains an ERM2 member, a considerable amount of attention will have to be devoted to financial markets, which could exploit a fixed fluctuation band for speculation against the Czech currency. Therefore this is a risk period and ERM 2 membership should be kept to the minimum possible period (preferably the prerequisite two years).

6. Concluding remarks

Comparison of forecasted trends of basic real and nominal convergence indicators (according to the macroeconomic forecast prepared by the Ministry of Finance CR, October 2002) for the period 2002-2005 (see figures in Table 3), together with expected combination of needed legal framework fasten up the attributes of functioning market economy and with conclusion of the adoption and the implementation of the EMU- related acquis, create the condition for the adoption of the euro in near future in the Czech Republic.

Table 3

Forecasted trends of basic real and nominal convergence indicators in the Czech Republic

	2002a)	**2003a)**	**2004b)**	**2005b)**	**2002-2005c)**	**1997-2001d)**
Real convergence indicators						
Real GDP growth rate, per cent	2.7	3.3	3.8	4.2	3.5	1.1
Labour productivity growth, per cent e)	2.3	3.2	3.8	3.8	3.3	2.0
As % of GDPf)						
Gross fixed capital formation	27.8	27.7	27.6	27.4	27.6	28.8
Exports of goods and services	65.7	64.1	65.0	66.7	65.2	63.3
Imports of goods and services	66.7	65.1	65.3	66.3	65.8	66.3
Unemployment rate as % of labour forces (average)	9.2	9.9	9.9	.	9.7	7.1
Nominal convergence indicators						
Average inflation rate, per cent	2.0	2.0	3.2	.	2.4	5.6
Average interest rate, percent per annum						
Credit rate	6.3	6.3	6.7	.	6.4	9.8
Deposite rate	2.3	2.4	2.7	.	2.5	5.3
Public Finance, as % of GDP						
General Government deficit/surplus g)	-9.0	-7.8	.	.	-8.4	-3.8
General Government debt	20.3	24.0	.	.	22.2	15.3
Current account balance, per cent of GDP	-4.2	-4.1	.	.	-4.1	-4.3
Gross foreign debts	29.0	28.0	.	.	28.5	41.0

a) Forecast
b) Outlook
c) Average of forecasted figures
d) Average of real development figures
e) GDP of constant prices per employed person
f) In current prices
g) Excluding net lending

Sources:/8/;/10/

In conclusion it is interesting to mention the discussion remark of Mr Zdeněk Tůma, CNB Governor, that the Czech Republic will not be able to fulfil the Maastricht Criteria before 2006. According to his opinion, the Czech Republic will adopt the euro around the year 2008 (/9/).

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