

OECD ECONOMIC SURVEY OF THE CZECH REPUBLIC 2004

Excerpt from Chapter 3, Policy for a Smooth Entry to the Euro Area

FULFILLING THE MAASTRICHT CRITERIA

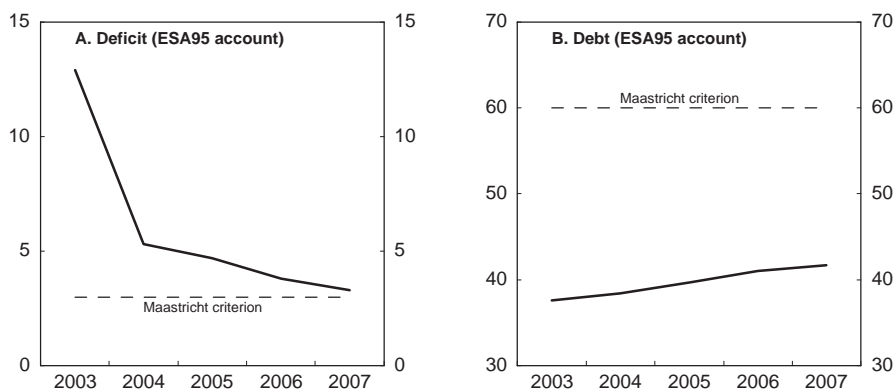
Fulfilling the Maastricht criteria is tricky

The fiscal criteria are tight but necessary anyway

1. High deficits present the most immediate challenge in meeting the Maastricht criteria and tangible progress in fiscal consolidation is needed to have a chance of being assessed positively by the EU authorities. For a strong guarantee of a positive assessment a deficit of 3 per cent of GDP or less has to be reached (**Annex 3.A1**). As described in **Chapter 2**, the authorities are aiming for a 3.3 per cent deficit, by 2007 (ESA95 accounts) (**Figure 3.1**). It would seem likely future plans will be for a deficit of 3 per cent or below in 2008. This fits in with the scenario of euro adoption in 2009 or 2010 mentioned by the Czech authorities, indeed it leaves a margin of one or perhaps two years. However, as **Chapter 2** discusses, a lasting structural consolidation is yet to be seen. Targeted revenue and spending measures aimed to bring the deficit under control have to some extent been delayed or diluted and detailed proposals for deep reforms to expenditure and service provision in the important areas of pensions and health have yet to be agreed on by the government.

2. The debt criterion for euro adoption should easily be fulfilled, unless of course fiscal consolidation is derailed completely. According to the ESA95 accounts used in assessing the fiscal criteria, the debt is currently at 37.6 per cent of GDP and there is therefore some way to go before the 60 per cent benchmark is breached.

Figure 3.1. **Maastricht fiscal criteria and 2004 Convergence Programme ambitions**¹
Per cent GDP



1. Projections for 2004-2007. Data refer to general government.
 Source: Ministry of Finance.

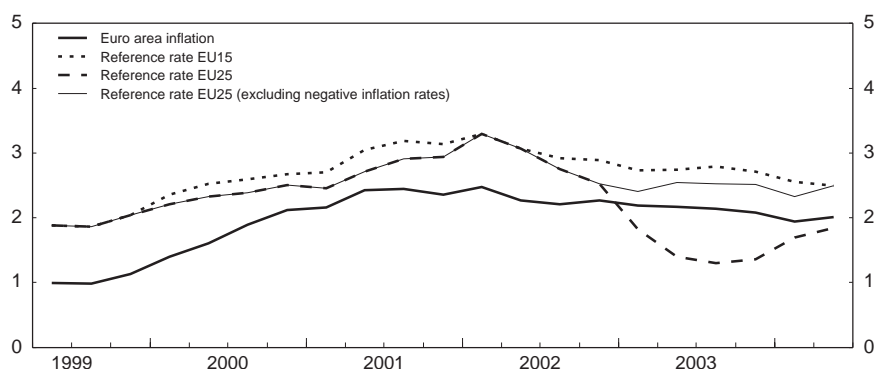
The monetary criteria

3. Achievement of three of the Maastricht criteria depends mainly on successful monetary policy. First, the rate of inflation has to be no greater than a special reference rate over a specified 12-month assessment period. Second, the currency has to not only remain in ERM II for at least two years but also be judged as having a satisfactory performance within ERM II. Finally, there is a long-term interest rate criterion (**Annex 3.A1**). This condition is generally regarded as being less relevant as it would usually be fulfilled along with the inflation criterion.¹

The inflation criterion

4. In spring 2004, the CNB announced that a flat central target of 3 per cent with a ± 1 percentage point tolerance band would apply from January 2006 and that this will be maintained through to entry to the euro area (see **Box 3.3** for more detail on inflation policy). The choice of a 3 per cent inflation target is justifiable on medium-term grounds as, given Balassa-Samuelson effects (see below), a target pitched significantly lower than this would imply a restrictive monetary policy with risks to growth. For instance, a target of 2 per cent, allowing for a Balassa-Samuelson effect of 1 per cent, would be equivalent to a 1 per cent inflation target in more advanced economies.

Figure 3.2. Reference rates for the Maastricht inflation criteria¹
Per cent



1. The reference rate is average inflation of the three EU15 (or three EU25) countries with the lowest inflation PLUS 1.5 percentage points. The calculation is made on four-quarter moving averages of annualised HICP inflation.

Source: Czech National Bank; Eurostat; OECD.

5. However, there may be some difficulty communicating the consistency of the 3 per cent target with the Maastricht inflation criterion and the Czech authorities should pay close attention to how the criterion is interpreted and applied by the European Commission and the European Central Bank and adjust their communication strategy accordingly. The criterion says that inflation must not exceed by more than 1½ percentage points that of the “three best-performing” EU member states. Since May 2004, this has implied a calculation based on all 25 EU member states, not just the EU15 as for previous applicants for euro entry. Until recently, the “three best-performing” were simply identified as the three countries with the lowest inflation and as **Figure 3.2** illustrates this suggested that the reference rate could be volatile and possibly quite low. However, neither the European Commission nor the ECB are strictly committed to this specific formulation and it is possible that a variant of it will be applied when the Czech Republic’s inflation record is assessed. Indeed, the Commission’s Convergence Report issued in October 2004 calculates the references value (2.4 per cent) as described above, except Lithuania is excluded on the basis that “countries with negative inflation are not considered to be best performers in terms of price stability”

(European Commission, 2004, page 3). Based on historical data, it looks as though excluding negative inflation outcomes makes the reference rate considerably smoother and closer to the euro area average inflation and closer to the reference rate used for the first wave of euro-area entrants (**Figure 3.2**). Nevertheless, even using this latest calculation method, the reference rate is typically well below 3 per cent and without good communication on developments in the reference rate in the context of Czech monetary policy, the CNB's target may become a weak signal in forming market expectations because markets may believe that the CNB will in fact have to aim well below target -- at least for the period of assessment for euro entry.

Box 3.3. The Czech National Bank's inflation targeting regime

Monetary policy is conducted by the Czech National Bank using an inflation targeting regime that closely resembles those used in other OECD countries. The regime was introduced in 1998 when conditions made the then policy of targeting money supply and maintaining a fixed exchange rate untenable. As with other inflation targeting regimes, it is accompanied by wide dissemination of the inflation (and output) forecasts that are used as a basis for policy decisions by the CNB Board. The CNB's quarterly *Inflation Report* is the main vehicle for publishing the forecasts and it underscores the forward-looking nature of policy decisions; in particular, it stresses that the period of most effective transmission of policy actions lies between 4 and 6 quarters ahead. In addition, a summary of the monthly meetings of the CNB Board is also made public.

The target was initially couched in terms of headline "net" inflation, defined as headline (*i.e.* CPI) inflation net of changes due to regulated prices and indirect taxes. In 2002 the CNB shifted to targeting headline inflation with a declining inflation band from a range of 3 to 5 per cent in January 2002 to 2 to 4 per cent in December 2005. In spring 2004, a central target of 3 per cent from January 2006 with a ± 1 per cent tolerance band was announced.

The main monetary policy instrument is through repo tenders, *i.e.* short-run deposit facilities tendered out by the Central Bank to commercial banks. 14-day, variable rate tenders are conducted and the declared repo rate is the maximum rate at which banks bids can be satisfied in the tender. Other open market operations include foreign exchange operations and securities operations, though these are rarely used.

Special arrangements have been made to prevent foreign capital inflows due to privatisation from putting undue pressure for currency appreciation and so avoiding unwanted deflationary pressures on prices. A joint agreement between the government and the CNB was first made in 2000 and was revised in 2002. Under the 2002 agreement the government parks 20 per cent of its forex proceeds from privatisation (up to an equivalent of CZK 25 billion) with the CNB in order to pay for outstanding state guarantees to the CNB that are due to be paid in 2007. The remainder of the privatisation proceeds are converted to koruna for the government by the CNB -- *i.e.* not on the open currency market. The CNB charges 3 per cent for the initial CZK 50 billion, 6 per cent for the next 50 billion and 9 per cent thereafter.

6. The CNB's announcement of the new inflation target involved some changes in strategy. First the stress on the central 3 per cent figure signals a shift away from a band-type target towards greater importance for the centre of the band. Second, the Bank's medium-term model is to play a greater role in the inflation forecasts (previously the inflation forecasts relied more heavily on short-term forecasts and expert judgement). Greater use of the medium-term model will mean certain key variables, notably the exchange rate, will be explicitly endogenous to the inflation forecast. This should allow for rather tighter monitoring of the Bank's inflation forecast and performance in reaching inflation targets. As part of this new approach, there has also been a change in communication strategy on exogenous inflationary influences. Previously the Bank explicitly listed events that were not considered within its responsibility in achieving inflation targets. The list of "escape clauses" included price changes in international commodities, major changes in the koruna's exchange rate which were not connected with domestic fundamentals and domestic monetary policy and, changes in regulated prices and indirect taxes.² The Bank has now stopped referring to this list in its communication strategy.

The exchange-rate stability criterion

7. For countries such as the Czech Republic, with an inflation targeting regime and a floating exchange rate, maintaining membership of ERM II, and moreover a positive assessment by the EU authorities of fulfilling the exchange rate criterion, are by no means automatically guaranteed. For a positive assessment the exchange rate has to remain “close to” the central parity without “severe tensions”, this implies remaining a lot closer to central parity than the 15 per cent band that, if breached, under normal circumstances would trigger ECB-assisted intervention.³ In assessing deviation from central parity there is more tolerance of appreciation than depreciation (more on this below). So in effect the exchange rate is narrowly pegged and cannot be used to absorb exogenous shocks. Furthermore, the implicit peg can invite speculative attacks by the markets and this is likely to be the greatest vulnerability during ERM II membership.

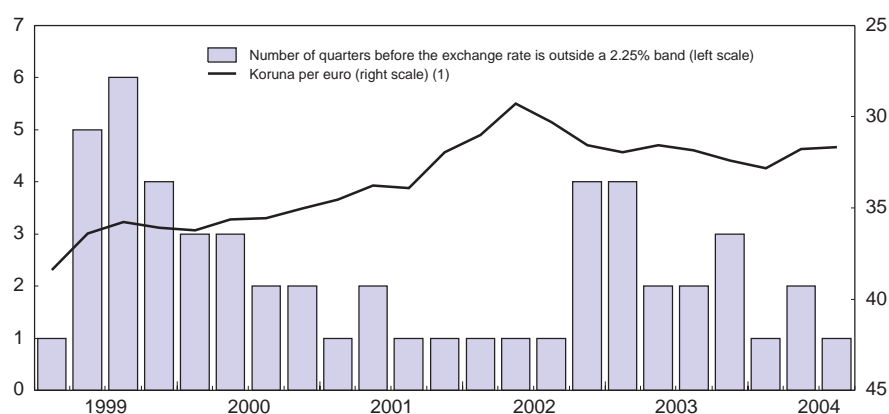
8. Of likely less importance in fulfilling the exchange-rate criterion are issues raised by the Balassa-Samuelson effect. The upward pressure on the real exchange rate from the Balassa-Samuelson effect can make for tricky trade offs in deciding whether to take the real appreciation in the form of higher inflation (and that may have to be damped at the expense of growth) or in the form of faster nominal exchange rate appreciation (potentially threatening fulfilment of the exchange-rate stability criterion). A recent review by Egert *et al.* (2004) calculates the annual inflation due to the Balassa-Samuelson effect from 11 studies covering the Czech Republic and finds a range of 0.2 to 4.3 per cent. However, five of the studies have a value close to 1 per cent, suggesting this is the most likely magnitude of the effect, which -- if realised -- would not pose problems *per se* for the inflation targeting while complying with the exchange rate criterion necessary for a positive evaluation of ERM II membership.

9. The assessment of the exchange-rate criterion is not always understood by markets and analysts, and to clarify the situation the CNB has made an explicit statement of the position of the European authorities and its interpretation of it (CNB, 2003a). The key points of the statement are:

- That no downward realignment of the central parity within the two-year examination period will be possible. The Bank interprets this as implying that upward realignment is implicitly possible.
- That a 2.25 per cent band will serve as the benchmark for assessment. The Bank’s interpretation is that if excessive interventions or non-market measures have to be used to remain in the band, this could jeopardise fulfilment of the criteria. If the band were breached, the Bank’s understanding is that breaches of the upper limit are more admissible than those of the lower limit (see **Annex 3.A2** for the full text of the CNB’s interpretation).

10. A very crude impression of the difficulties in remaining close to central parity is illustrated in the past history of exchange rate movements. **Figure 3.3** shows for each end-of-quarter exchange rate the number of quarters the rate remains within 2.25 per cent of the initial rate. From this it is clear that exchange rate has not remained within any 2.25 per cent band for the past few years for any great length of time, implying that the Central Bank will be unlikely able to conduct “business as usual” in its inflation targeting and be confident that the exchange rate will remain close to the central parity set at the beginning of ERM II entry.

Figure 3.3 A 2.25 per cent band in the context of past exchange rates



1. Rates are for last day of each quarter. A rise (decrease in rate) indicates appreciation.

Source: Eurostat; OECD calculations.

11. However previous exchange-rate movements are of course an inaccurate indicator of the policy challenges for the monetary authorities as the dynamics of inflation and exchange rates will be different in ERM II. In particular, announcement of a central parity can help smooth currency fluctuations. In addition, exchange rate movements in the koruna, at least over the past couple of years, have been lower compared with some of the prospective members of the euro area, notably Hungary and the Poland.⁴ From this perspective it seems likely the Czech authorities will face less of a challenge in meeting the exchange-rate criterion compared with some other countries.

ENDNOTES

1. The Maastricht interest rate criterion is often criticised as an imperfect indicator of a country's commitment to price stability, and possibly more an indication of market expectations about the country's chance of adopting the euro.
2. The inflation influences the CNB, until recently, explicitly listed as being outside its responsibility were:
 - major changes in world prices of raw materials, energy-producing materials and other commodities;
 - major changes in the koruna's exchange rate which are not connected with domestic fundamentals and domestic monetary policy;
 - major changes in the conditions for agricultural production which have an impact on prices;
 - changes in regulated prices whose effects on inflation would exceed 1 to 1½ percentage points;
 - step changes in indirect taxes.
3. The ECB however is in fact not strictly obliged to intervene when an ERM II currency hits the boundary of the 15 per cent band. Interventions are in principle automatic and unlimited unless they, to quote from official ECB sources, "conflict with the primary objective of price stability in the member state or the euro area" (ECB, 2003).
4. The differences in volatility between the Visegrad currencies are illustrated in calculations of the standard deviation of the monthly euro exchange rates over the past 2 years or so. For the Czech koruna and the Slovak koruna, the standard deviation has been equivalent to a little above 2 per cent of the average exchange rate. For the Hungarian forint it is about 3½ per cent and for the Polish zloty, a little over 6 per cent.

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