Adopting the euro in The Czech Republic

For corporate treasuries in The Czech Republic, membership in the European Union and adoption of the euro will bring substantial and, for the most part, positive changes.

by Petr Polak

As of 1 May 2004 The Czech Republic, along with Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia, became a member of the European Union (EU). Since joining the EU, these countries have been granted the status of Member State with a derogation, which means they will not immediately adopt the euro. Upon accession, the central banks of new members became a part of the European System of Central Banks (ESCB). However, they will not participate in monetary-policy decision-making on a European scale until they adopt the euro.

The Maastricht convergence criteria fulfilment: The Economic and Monetary Union (EMU) was implemented in three stages on the basis of the Maastricht Treaty. During the first stage, starting in 1990, the liberalisation of capital flows was completed and a single internal market was created. The second stage, starting in 1994, focused on convergence of the Member States' economies. In the third stage, the non-cash euro was introduced and the single monetary policy of the European Central Bank (ECB) was launched, with a single interest rate set for the entire euro area. The process of monetary integration was completed with the circulation of euro banknotes and coins in January 2002.

The Czech Republic and the other new member countries automatically participate in the 3rd stage of EMU. Under EU legislation, prior to adopting the euro the country must have fulfilled the Maastricht convergence criteria in addition to its membership in the EU (see sidebar).

The convergence required for entering the euro area is formally assessed according to the procedure laid down in the EU Treaty. The final decision is subsequently made by a summit of EU Member States. Member States whose economic conditions are a potential threat to the maintenance of price stability in the Eurozone cannot join the monetary union and retain the status of Member States with a derogation.

Membership of the euro area should have positive impacts on Czech economic policy, since the key elements of

Figure One: Observance of the Maastricht criteria by New-10 EU member states

	Inflation y-t-y CPI in % p.a., 2003	**Interest rates** 10Y bonds yield in % p.a. 2003	**Budget deficit** in % of GDP, 2003	**Govt. debt** in % of GDP, 2003	**F/X rate** Dispersion from the average rate during last two years
Required criterion	**2.1**	**6.1**	**-3.0**	**60.0**	**+/- 15%**
1 Estonia	1.2	2.8	2.6	5.8	0
2-4 Czech Republic	1.0	4.5	**-12.9**	37.6	+8.9
2-4 Lithuania	-1.3	**6.4**	-1.7	21.9	0
2-4 Slovenia	**4.7**	5.5	-1.8	27.1	+3.4
5-7 Latvia	**3.5**	**7.4**	-1.8	15.6	+11.0
5-7 Slovakia	**9.3**	5.0	**-3.6**	42.8	-6.8
5-7 Malta	0.7	4.7	**-9.7**	**72.0**	+4.6
8-10 Cyprus	**2.2**	4.8	**-6.3**	**72.2**	+1.8
8-10 Hungary	**5.6**	**7.6**	**-5.9**	59.0	-8.5
8-10 Poland	1.6	**6.7**	**-4.1**	45.4	**+20.0**

Bold text = criterion not met

Source: *HN, Eurostat, Deutsche Bank*

The Maastricht Convergence Criteria

1. The criterion on price stability requires 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.

2. The criterion on long-term interest rates requires that, observed over a period of one year before the examination, a Member State has an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability.

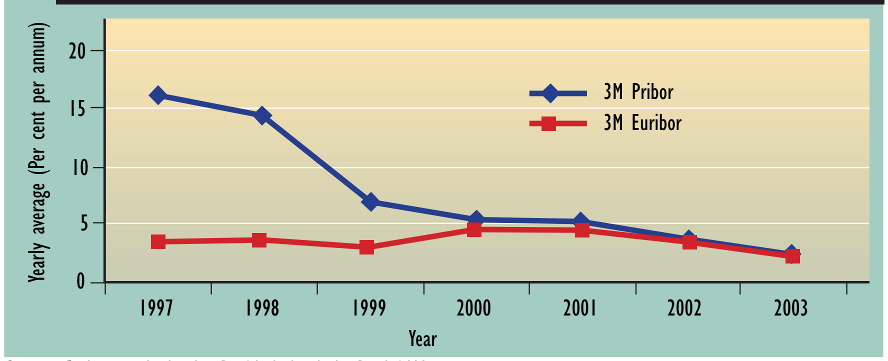
3. The criterion on the government budgetary position means that a Member State has a ratio of planned or actual government deficit to GDP that does not exceed 3%.

4. The criterion on government debt means that a Member State has a ratio of government debt to GDPthat does not exceed 60%, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

5. The exchange rate convergence criterion requires participation for at least two years in the ERMII and observance of the normal fluctuation margins close to central parity provided for by the mechanism for at least two years.

the system are requirements to achieve balanced public budgets in the medium term and structural reforms supporting long-term sustainable economic growth. It is likely that fiscal policy implemented in accordance with the Stability and Growth Pact will reduce the costs of financing public budgets and lead to stabilization of interest rates at a low level. Corporate treasury will profit not only from low interest rates, but also from access to the deeper and more liquid money and capital markets of the euro area.

Figure Two: Comparison of the development of the 3M reference interest rates for Czech and Dutch (since 1999) markets



Source: Ceska narodni banka, De Nederlandsche Bank N.V.

The importance of interest-rate stability for treasurers in the Czech Republic can be seen from Figure Two, which compares development of the 3M interest rates in the Czech Republic and the Netherlands (after 1999 in the Eurozone, because of Dutch EMU participation) in the period of 1997-2003. A major fall in interest rates after 1997 led to the widespread use of IR hedging tools in the Czech financial market, such as FRA, IRS, and IR options.

Since the Czech economy depends heavily on foreign trade (exports in 2002 accounted for 55% of GDP, with almost 60% of these exports to Eurozone countries), the domestic corporate sector in particular will profit from the elimination of exchange-rate risk for trading with Eurozone countries. Such benefits will show up as a decline in hedging costs and bank fees and a reduction of investment uncertainty.

Figure Three shows developments in the exchange rates of the main CEE currencies. The biggest strengthening has been achieved by the Czech currency, at 19.7 %, between the years 1999 and 2002. Other currencies in the region have shown a similar trend, although not to the same degree as the Czech koruna. Such developments made life difficult for Central European exporters and led to an increase in the use of FX hedging tools such as forwards and options in daily treasury activities as well as in corporate financial planning in the region.

Figure Three: FX rate development in CEE countries, year averages against 1 EUR

	1999	2000	2001	2002
CZK	36.88	35.61	34.08	30.81
SKK	44.12	42.59	43.31	42.70
HUF	252.80	260.04	256.68	244.50
PLN	4.23	4.01	3.67	3.76

Source: central banks of respective countries

Potential risks: In the event of insufficient cyclical and structural alignment of the Czech economy and its financial sector with the euro-area economies, economic shocks may have unequal and asymmetric impacts. The decision to fix the exchange rate irrevocably and adopt a single monetary policy can be made only when sustainable convergence of economic policies has been achieved. This includes opening of markets, competitiveness within the single European market, and increasing economic integration and functioning of institutions involved in manufacturing, services, and financial markets.

The strategic goal of the Government and the Czech National Bank is to lay the groundwork for introducing the euro in the Czech Republic. Provided that the Maastricht criteria are fulfilled, including a successful consolidation of public finances; a sufficient level of real convergence is achieved, and adequate progress is made with structural reforms guaranteeing sufficient economic alignment with the EU Member States, the Czech Republic can be expected to join the euro area around 2009-2010.

Corporate treasury will adopt the euro as an official currency, with the following results:

- a reduction of prices of bank and financial services;
- higher liquidity and new financial tools denominated in euros;
- an increase in the number and volume of corporate bond issues;
- pan-European offerings of Czech corporate bonds and commercial paper (after the introduction of new EU legislation creating a single market in financial services in 2005).

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