Ministry of Finance of the Czech Republic
and the Czech National Bank

Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area

December 2023

Assessment of the Fulfilment of the Maastricht Convergence Criteria
and the Degree of Economic Alignment of the Czech Republic with the Euro Area
December 2023

Ministry of Finance of the Czech Republic
Letenská 15, 118 10 Prague 1

Czech National Bank
Na Příkopě 28, 115 03 Prague 1

E-mail: informace@mfcr.cz

ISSN 2336-5110 (on-line)

Free distribution

Electronic archive:
www.mfcr.cz/maastricht
www.cnb.cz/euro-area-accession

Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area

December 2023

Contents

The Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area provides the Czech Government with a basis for appropriately timing entry into the exchange rate mechanism and subsequent adoption of the euro by the Czech Republic. It is available on the Ministry of Finance website at:

www.mfcr.cz/maastricht

We welcome any relevant suggestions for improving the quality of the publication. Please send any comments to:

informace@mfcr.cz

List of tables

List of charts

Abbreviations

CNB .... Czech National Bank
CZ .... Czech Republic
CZK .... Czech koruna
CZSO .... Czech Statistical Office
EC .... European Commission
ECB .... European Central Bank
ERM II .... Exchange Rate Mechanism II
ESM .... European Stability Mechanism
EU .... European Union (covering all 27 countries)
EUR .... euro
GDP .... gross domestic product
IMF .... International Monetary Fund
MF CR .... Ministry of Finance of the Czech Republic

Country codes

AT – Austria, BE – Belgium, BG – Bulgaria, CY – Cyprus, CZ – Czech Republic, DE – Germany, DK – Denmark, EE – Estonia, ES – Spain, FI – Finland, FR – France, GR – Greece, HR – Croatia, HU – Hungary, IE – Ireland, IT – Italy, LT – Lithuania, LU – Luxembourg, LV – Latvia, MT – Malta, NL – Netherlands, PL – Poland, PT – Portugal, RO – Romania, SE – Sweden, SI – Slovenia, SK – Slovakia

Symbols used in tables

A dash (–) in place of a number indicates that the phenomenon did not occur.

Cut-off dates for data sources

The document was prepared using the data available as of 16 November 2023.

Note

Sum totals published in tables may be subject to inaccuracy in the last decimal place in some cases due to rounding.

Summary and Recommendations

The Czech Republic undertook to adopt the euro by signing the Act concerning the conditions of accession of the Czech Republic to the European Union. One of the conditions that must be fulfilled by each Member State in the process of joining the euro area is the achievement of a high degree of sustainable convergence, which is assessed according to compliance with the **Maastricht convergence criteria**. This document assesses the Czech Republic's compliance with these criteria.

Setting a specific date for joining the euro area is fully within the competence of each Member State, but it should ideally depend on its degree of preparedness. Besides undoubted benefits, such as a reduction in transaction costs and the elimination of exchange rate risk, adopting the euro entails giving up independent monetary policy and the exchange rate of the koruna as stabilising macroeconomic instruments. The preparedness of the economy to join the euro area must therefore be assessed from the perspective of its economic alignment and structural similarity with the monetary union, and also from the point of view of its ability to absorb asymmetric shocks using other mechanisms, in particular via fiscal policy, the labour market and the banking sector, after the loss of independent monetary policy.

This year marks the 20th anniversary of the signing of the Accession Treaty. Since then, the euro area and the European Union as a whole have experienced the economic recession of 2008 and 2009, followed by the euro area debt crisis in some euro area countries. In 2020 and 2021, the world was paralysed by the Covid-19 pandemic, and last year the energy crisis and Russia's aggression in Ukraine accelerated growth in the price level. These and other events affect other processes of European integration aimed at strengthening economic and fiscal coordination and completing the banking union and the capital markets union. The new institutions and rules are thus changing the shape of the euro area and the content of the obligation to adopt the euro. These facts also need to be properly assessed and considered in decisions about the timing of monetary union entry.

In addition to assessing **legal compatibility**, the **assessment of a country's preparedness** for euro adoption and the related rights, obligations, privileges and commitments includes an assessment of compliance with the **convergence criteria**: the achievement of a high degree of price stability, the sustainability of the government financial position, the observance of the normal fluctuation margins of the exchange rate, and the durability of convergence being reflected in the long-term interest-rate levels.

The analysis contained in this document reveals that the Czech Republic will very probably not fulfil the criterion on price stability in 2023. The Czech economy – despite a significant slowdown in price growth – is still among the EU countries with the highest inflation, which has, until recently, been intensified by strong supply and demand pressures, and increased inflation expectations. **The criterion on the convergence of interest rates is likely to be fulfilled both this year and the next** due to the decreasing difference in the monetary policy stance of the Czech National Bank and the European Central Bank. Public finance consolidation has been slowed by measures aimed at reducing the impact of the energy crisis on households and businesses. Therefore, the Czech Republic does not fulfil the reference value for the general government deficit. However, given the persisting uncertainty about macroeconomic developments, the European Commission did not propose the opening of an excessive deficit procedure during the activation of the general escape clause, which is part of the European Union's common fiscal rules. **The Czech Republic is thus still formally compliant with the criterion on the government financial position.**

In 2024, the Czech Republic **will probably fulfil the reference values for the criterion on the government financial position, the convergence of interest rates and price stability**. Inflation should fluctuate close to the upper boundary of the tolerance band around the CNB's inflation target next year due to the fading of adverse supply-side factors and the effects of the previous monetary policy tightening. A recovery package and the expected economic recovery will foster a drop in the general government deficit. The Czech Republic is formally non-compliant with **the exchange rate fluctuation criterion**, as it does not participate in the relevant exchange rate mechanism.

As regards the Czech economy's alignment with the euro area and its ability to adjust to possible asymmetric shocks without its own monetary and exchange rate policy, the characteristics of the Czech economy can be divided into three groups.

The first group consists of **economic indicators suggesting a relatively low level of risk associated with potential euro adoption** in the area analysed. This group has long included the Czech economy's close trade and ownership links with the euro area. These factors represent preconditions for the realisation of the benefits of euro adoption and also foster alignment between the Czech and euro area business cycles. The latter is currently very high. However, it is not clear to what extent its increase is only a temporary consequence of the similar impacts of strong global economic shocks. The close trade links are also reflected in an increasing share of euro-denominated financing of Czech corporations. This was fostered last year by a high interest rate differential between koruna and euro interest rates as well. The koruna remains aligned with the euro vis-à-vis the dollar and is thus not a barrier to joining the euro area either. As regards the adjustment mechanisms of the Czech economy, the low long-term unemployment rate, which is still among the lowest in Europe, can be positively assessed. The development of the domestic banking sector is also favourable. The sector is characterised by a robust capital and liquidity position, high profitability and a low ratio of non-performing loans. Its resilience to potential negative shocks thus remains high.

The **category of indicators with a neutral message** primarily includes the similarity of monetary policy transmission in the Czech Republic and the euro area. Although the Czech Republic differs from the monetary union average in some financial indicators such as the structure of households' financial assets and the structure of loans for house purchase by fixation period, this cannot be considered a fundamental barrier to euro adoption. The depth of financial intermediation and the level of private sector debt in the Czech Republic are relatively low and thus do not represent a potential source of systemic risk. The alignment of the Czech and euro area financial cycles, which was little changed last year, and, in the longer run, the convergence of interest rates are also assessed as neutral. The latter has increased again since the second half of 2022 amid flat domestic interest rates and a tightening of ECB monetary policy. The volatility of the koruna exchange rate, which fell back to pre-crisis level as the energy crisis subsided and uncertainty on financial markets calmed, does not pose a risk either. The alignment of the Czech and euro area financial markets is also returning to the levels of the previous decade. Most labour market indicators are also neutral. The geographical mobility of the labour force is rising further due to an increase in the share of foreigners in the population, while labour efficiency indicators are little changed. The participation rate of early-middle aged women in the labour market also remains low, which is linked with long parental leave and the low share of part-time jobs. As regards the risks associated with potential euro adoption, the assessment of general government debt is also neutral. However, the debt increased again last year.

The third group consists of **indicators suggesting economic risks associated with euro adoption** in the area analysed. These indicators include the unfinished process of economic convergence of the Czech Republic towards the euro area, especially as regards the convergence of the price and wage levels. Their lag behind the euro area average remains significant despite faster convergence last year, most notably in the case of wages and prices of some services. The relatively low structural similarity of the Czech economy with the euro area consisting in an above-average share of industry in domestic GDP would also be a risk in the event of euro adoption. The persisting structural imbalance of Czech public finances is a problem as regards the adjustment mechanisms of the Czech economy. Several measures have been taken in recent years which have had a negative impact on public finance long-term sustainability. At present, however, the government is seeking to improve fiscal indicators, either as a result of public finance consolidation via a recovery package or changes to the pension system. Czech legislation expects a gradual return to the medium-term objective, which corresponds to a structural deficit of 0.75% of GDP (in this context, a structural deficit of no more than 0.5% of GDP usually applies to euro area countries).

The design and functioning of the economic and monetary union are evolving over time, so these processes continue to require monitoring and assessment. Apart from the benefits, the adoption of the single currency also entails institutional and financial **obligations**, which must be taken into account when deciding on the timing of euro area entry. The total financial costs that will be associated with euro adoption in the future may change. The currently estimated financial obligations for the Czech economy, which were not known when the Czech Republic joined the European Union, mainly include a subscription of capital of the European Stability Mechanism and a transfer of contributions from banks registered in the Czech Republic to the Single Resolution Fund. Although any precise quantification of financial obligations would only be possible at the time of the Czech Republic's hypothetical entry into the euro area, these obligations – together with the payment of the rest of the share in the subscribed capital of the ECB and a contribution to the ECB's reserve funds – can be estimated at around CZK 118 billion overall (more details and the assumptions for this estimate are given in Appendix B).

To sum up, the Czech Republic **will not meet** two of the Maastricht convergence criteria **in 2023**. Specifically, it will not fulfil the price criterion and the exchange rate fluctuation criterion. No substantial progress has been made as regards the Czech Republic's economic preparedness for euro adoption. The economic level has even diverged slightly from the euro area average over the last two years, while there was only partial convergence in the price level and especially the wage level. There are still large differences in the structure of economies. The issue of Czech public finance long-term sustainability is also yet to be resolved. The impacts of the energy crisis further highlighted the euro area's economic heterogeneity. The fiscal positions of most euro area Member States also remain unfavourable.

In view of all the above facts, **the Ministry of Finance and the Czech National Bank recommend that the Czech government should not set a target date for euro area entry for the time being**. This recommendation implies that the government should not aim for the Czech Republic to join the exchange rate mechanism either.

1 Fulfilment of the Maastricht Convergence Criteria

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, European Union (EU) Member States are required to **achieve a high degree of sustainable convergence** in order to join the euro area. This is determined according to the criteria (also referred to as the Maastricht criteria) for the achievement of a high degree of price stability, the sustainability of the government financial position, the observance of the normal fluctuation margins of the national currency against the euro and the durability of convergence being reflected in the long-term interest-rate levels. The criteria are enshrined in Article 140 of the Treaty and detailed in Protocol No. 13 on the convergence criteria. This section briefly describes the individual criteria (a more precise definition is given in Appendix A) and analyses their fulfilment. Although the actual assessment of compliance with all the convergence criteria would take place several quarters ahead of the planned changeover date, the Czech Republic will not fulfil the reference value of the price criterion in 2023.

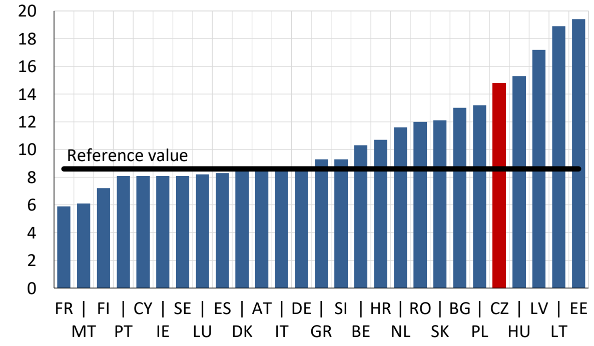
The reference value of the price stability criterion is very unlikely to be met due to only slowly easing supply and demand inflation pressures in the domestic economy. The criterion on the convergence of interest rates should be fulfilled again due to convergence of CNB and ECB monetary policies. The Czech Republic is still formally compliant with the criterion on the government financial position, as the European Commission did not open an excessive deficit procedure, citing the persisting uncertainties regarding macroeconomic developments while the general escape clause was in place. However, the poor condition of Czech public finances calls for consolidation. Last but not least, the Czech Republic has not yet joined the relevant exchange rate mechanism which forms the basis for assessing compliance with the fluctuation band for the national currency's exchange rate against the euro, and thus does not fulfil the relevant criterion.

1.1 Criterion on Price Stability

The price stability criterion assesses the rate of consumer inflation, which must not be more than 1.5 percentage point higher than the average of the three best performing EU countries in terms of price stability.

The Czech Republic was not compliant with this criterion in 2022. High inflation was fostered by both supply and demand factors. The main role was played by high prices of energy, food, oil and many materials, which were caused largely by supply frictions and global uncertainty. This was further supported by the previous accommodative monetary and fiscal policy in the Czech Republic leading to a significant increase of price growth in the core component of inflation. The Czech Republic ranked among the EU countries with the highest inflation in 2022 (see Chart 1.1).

Chart 1.1: Average inflation rate in 2022
harmonised index of consumer prices; in %



Source: Eurostat (2023a).

The period of significantly increased inflation continues this year as well, although annual inflation has been slowing so far this year.[1] Energy prices have broadly stabilised due to the government's measures and the situation on the wholesale market and can be expected to start to decline gradually. According to the MF CR, the price of oil will have an anti-inflationary effect in whole-year terms, as will the koruna's exchange rate against major world currencies. Supply chains already operate without major problems, so the inflation pressures stemming from supply-side frictions should not be significant. Owing to a decline in private consumption as a result of a sharp drop in real income, the effect of the position of the economy in the business cycle is anti-inflationary. However, a tight labour market is increasing the pressure on nominal wages and is thus having an inflationary effect. This year, inflation is already being dampened more markedly by the restrictive effect of the previous significant increase in monetary policy interest rates by the CNB. Despite that, the Czech Republic has ranked among the EU countries with the highest inflation so far in 2023. **The Czech Republic is very unlikely to meet the criterion on price stability in 2023** (see Table 1.1).

In 2024, inflation pressures will be affected mostly by market factors. Gas prices should fall further, while lower electricity prices will be offset by a sharp rise in the administered component. Changes to indirect taxes after taking into account second-round effects and the price of an annual road toll vignette as part of the fiscal

[1] The temporary increase in annual inflation in 2023 Q4 is due to the previous year's base effects, when the introduction of the government's temporary energy savings tariff lowered the prices of electricity for households reported in statistics.

consolidation package should slightly increase inflation. The persisting restrictive impacts of the previous monetary policy tightening will be supported by the negative income effect of the above fiscal measures and will thus together ease inflation pressures. These factors will outweigh only gradually slowing and hence still relatively brisk growth in nominal wages and slight depreciation of the koruna against the euro. Next year, annual inflation might fluctuate close to the upper boundary of the tolerance band around the CNB's inflation target. **The Czech Republic will probably meet the criterion on price stability in 2024**.

Table 1.1: Consumer prices

harmonised index of consumer prices; average for last 12 months vs. average for previous 12 months as of end of period; growth in %

	2015	2016	2017	2018	2019	2020	2021	2022	2023 *Forecast*	2024 *Forecast*
Average for 3 EU countries with lowest inflation*	-0.9	-0.8	0.6	0.7	0.4	-1.0	0.7	7.1	3.1	2.0
Reference value	0.6	0.7	2.1	2.2	1.9	0.5	2.2	8.6	4.6	3.5
Czech Republic	0.3	0.6	2.4	2.0	2.6	3.3	3.3	14.8	12.1	3.5

*Note: * More precisely, the three best performing Member States in terms of price stability (see Appendix A). These are Belgium, Luxembourg and Denmark for 2023 and Sweden, Finland and Denmark for 2024.*

Source: Eurostat (2023a). Forecasts for 2023 and 2024 according to the EC (2023a) and the MF CR (2023a). MF CR calculations.

1.2 Criterion on the Government Financial Position

The criterion on the government financial position requires the long-term sustainability of the government financial position. Formally, it is fulfilled if an excessive deficit procedure is not ongoing for the country in question. This procedure is usually opened if the country does not fulfil one of the components of the fiscal criterion, i.e. (in simple terms) a general government deficit of no more than 3% of GDP and general government debt of no more than 60% of GDP, unless the government debt ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

The Czech Republic does not fulfil the reference value for the deficit. However, the EC did not propose the opening of an excessive deficit procedure due to the persisting macroeconomic uncertainties, which it referred to during the application of the general escape clause. The Czech Republic is thus still formally compliant with the criterion on the government financial position.[2]

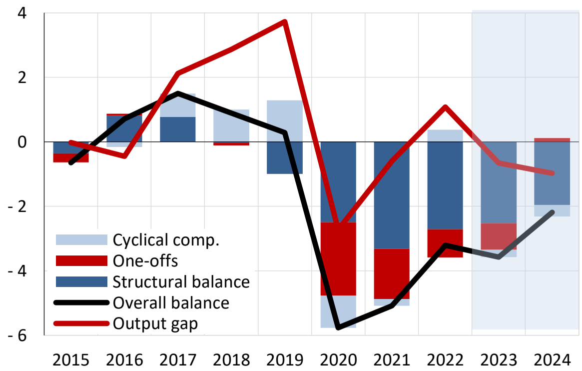
The previously positive balance turned negative (below -5% of GDP) in 2020 and 2021. The sharp deterioration in general government finances was due to a decline in economic activity during the Covid-19 pandemic and the related government fiscal stabilisation, support and redistribution policies. The phase-out of these measures and faster growth in tax revenues **in 2022** supported an improvement in the balance to **−3.2% of GDP.**

The Ministry of Finance expects a balance of **-3.6% of GDP** in **2023**. The widening of the deficit is due mainly to an increase in one-off expenses reducing the impact of high energy prices on economic agents and growing mandatory expenditures in the social area. In addition to the fiscal consolidation package, renewed economic growth and almost balanced one-off income and expenditure should help to improve the balance **in 2024** (a change of 1.0 pp of GDP). The Ministry of Finance therefore estimates the overall general government deficit at **2.2% of GDP**.

From the perspective of fiscal policy and budgetary surveillance, the balance under review is adjusted for the business cycle and one-off and other temporary measures (the "**structural balance**"). Chart 1.2 captures the structural components of the general government balance quantified by the OECD method, which is also used in modified form by the European Commission. Under this methodology, the Czech Ministry of Finance expects a moderate improvement in the structural balance.

Chart 1.2: General government balance

general government balance in % of GDP; output gap in % of potential output



Source: MF CR (2023a).

The structural balance is compared with the MTO of each EU member State. The MTO for the Czech Republic is currently a structural deficit of 0.75% of GDP. **After the Czech Republic joins the euro area, the MTO could be tightened to -0.5% of GDP** as the Treaty on Stability,

[2] The criterion will be fulfilled in 2024 provided that an excessive deficit procedure (EDP) is not opened against the Czech Republic in spring 2024 based on the result of general government finances in 2023, as the result should exceed the reference value only temporarily.

Coordination and Governance in the Economic and Monetary Union allows a more benevolent structural balance of -1.0% of GDP only if general government debt is well below 60% of GDP and risks to long-term sustainability are low.

Public deficits are reflected in **growth in debt**. Given the current fiscal policy stance,[3] the debt-to-GDP ratio should continue to rise despite an economic recovery, but the **debt level** should remain **below the reference debt level in the convergence criterion** with a predicted value of 45.9% of GDP in 2024.

Table 1.2: General government balance
general government balance and debt; in % of GDP

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
									Forecast	*Forecast*
Reference value of government balance	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0	-3.0
Czech Republic	-0.6	0.7	1.5	0.9	0.3	-5.8	-5.1	-3.2	-3.6	-2.2
Reference value of general government debt	60.0	60.0	60.0	60.0	60.0	60.0	60.0	60.0	60.0	60.0
Czech Republic	39.7	36.6	34.2	32.1	30.0	37.7	42.0	44.2	44.7	45.9

Note: A precise definition of this criterion is given in Appendix A.
Source: MF CR (2023a).

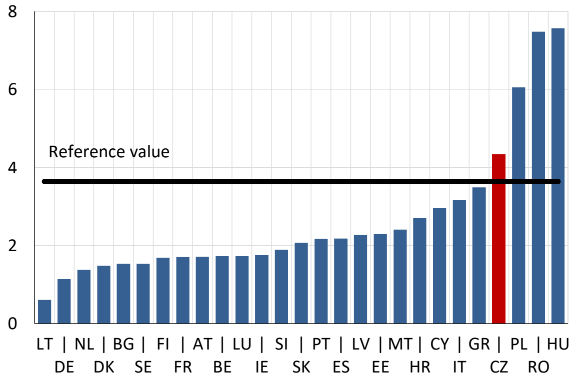
1.3 Criterion on the Convergence of Interest Rates

Under the criterion, convergence of interest rates is achieved if yields of government bonds with an average residual maturity of 10 years do not exceed by more than 2 percentage points the average of the yields on government bonds in the three best performing EU countries in terms of price stability.

This criterion **was not fulfilled in 2022** (see Chart 1.3, Table 1.3). In mid-2021, the CNB started to respond to sharply rising inflation pressures by markedly raising key interest rates. This subsequently fostered a rise in government bond yields. By contrast, the ECB kept key interest rates at zero until July 2022 and only then started to increase them significantly too. A decline in the differential between CNB and ECB interest rates will contribute to the likely fulfilment of this criterion in the coming years.

The forecasts in the Convergence Programmes and Stability Programmes (EC, 2023b) of the reference countries expect **the estimated interest rate levels for the Czech Republic to be below the Maastricht criterion again in 2023 and 2024.**

Chart 1.3: Long-term interest rates in 2022
yields on government bonds with average residual maturity of 10 years; in %



Source: Eurostat (2023b).

Table 1.3: Long-term interest rates on government bonds
yields on government bonds with residual maturity of 10 years; 12 month average; in %

	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
									Forecast	*Forecast*
Average for 3 EU countries with lowest inflation*	1.8	2.1	1.3	2.1	1.3	0.7	0.6	1.6	2.7	2.8
Reference value	3.8	4.1	3.3	4.1	3.3	2.7	2.6	3.6	4.7	4.8
Czech Republic	0.6	0.4	1.0	2.0	1.5	1.1	1.9	4.3	4.4	3.6

*Note: * More precisely, the three best performing Member States in terms of price stability (see Appendix A). The reference value of the criterion was calculated from the outlooks for long-term interest rates for Belgium, Luxembourg and Denmark for 2023 and from the rates for Sweden, Finland and Denmark for 2024.*
Source: Eurostat (2023b), EC (2023a, 2023b). MF CR (2023a) calculations and forecasts.

[3] The fiscal stance described includes the effect of the recovery package.

1.4 Criterion on Participation in the Exchange Rate Mechanism

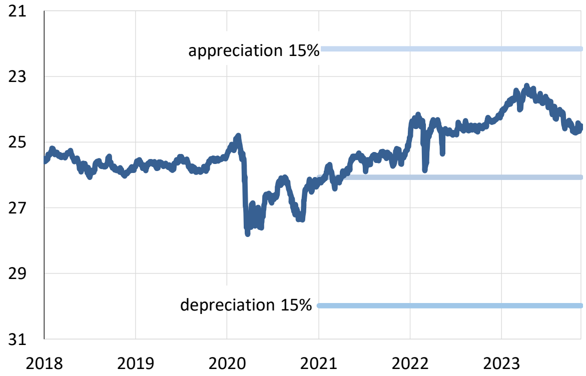
The admission of a state into the euro area is conditional on a successful, at least two-year stay of the national currency in the exchange rate mechanism (ERM II). The exchange rate is expected to move within the fluctuation band of ±15% without devaluation of the central rate and excessive pressures on the exchange rate. Formal fulfilment of the criterion on exchange rate stability will only be possible after the Czech Republic joins ERM II. Until then, the **assessment** can be made **only at a hypothetical level**.

The central rate of the koruna against the euro, against which exchange rate fluctuations would be monitored, would be set before entry into ERM II. The length of stay in the mechanism is set at a minimum of two years before the assessment of preparedness to adopt the euro. The Czech Republic's Euro-area Accession Strategy (CNB, Czech Government, 2003), its update (MF CR, 2007) and the December 2022 Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area (MF CR, CNB, 2022) imply that the Czech Republic should stay in ERM II for the minimum required period only.

For the purposes of this document, the hypothetical CZK/EUR central rate is set as the average exchange rate in 2021 Q1, i.e. the quarter preceding hypothetical ERM II entry at the start of 2021 Q2, which would have allowed euro adoption on 01 January 2024. Chart 1.4 shows that the **exchange rate was at stronger levels than the hypothetical central rate for most of the period under review**. The CNB's foreign exchange market interventions during 2022 also helped stabilise the exchange rate. Despite appreciating in the first half of 2023 due to the calming of the energy market situation (leading to a reduction in risk mark-ups), the koruna exchange rate fluctuated comfortably within the ±15% band over the entire two-year period.

According to the MF CR forecast (2023a), the koruna will depreciate slightly in 2024, which is due mainly to its very strong exchange rate in the first half of 2023 and the convergence of interest rates in the Czech Republic and the euro area. The subsequent reversal towards the trend of moderate appreciation of the domestic currency connected with renewed real convergence in the next years of the outlook should not be inconsistent with fulfilment of the exchange rate criterion. This conclusion is supported by the fact that the assessment of this criterion has historically been more lenient on the appreciation side and shifts of the central rate towards revaluation have been tolerated.

Chart 1.4: Nominal CZK/EUR exchange rate



Note: The hypothetical central rate is simulated by the average exchange rate in 2021 Q1. Data up to 16 November 2023.
Source: CNB (2023b). MF CR calculations.

2 Assessment of the Degree of Economic Alignment

Future adoption of the single European currency should increase the benefits accruing to the Czech Republic from its intense involvement in international economic relations. Euro adoption will lead to the elimination of exchange rate risk and part of transaction costs in relation to the euro area. Foreign trade and investment will thus become more effective. Besides these benefits, however, euro adoption simultaneously entails risks arising from the loss of independent monetary policy and the stabilising role of a flexible exchange rate. The key factors for a successful functioning of the Czech Republic in the monetary union will therefore be its economic alignment with the euro area and the economy's ability to absorb potential asymmetric shocks using other mechanisms (CNB, 2023a).

This section is thus divided into two basic areas. The first part assesses the similarity of the long-term trends, medium-term developments and the structure of the Czech economy compared to that of the euro area, including the similarity of monetary policy transmission. It thus captures the risk that the euro area single monetary policy may be inadequate for the Czech economy. The second part answers the question of to what extent the Czech economy is capable of absorbing the impacts of asymmetric shocks using its own adjustment mechanisms, namely autonomous fiscal policy, labour market flexibility, the product market and the banking sector.

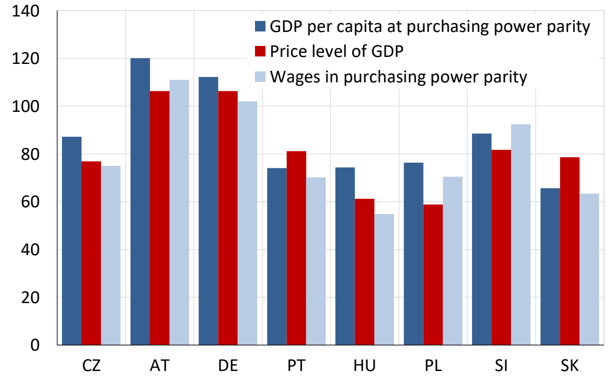
2.1 Cyclical and structural alignment

A high degree of alignment of the Czech economy with the euro area economy is a necessary condition for the euro adoption costs arising from the loss of the Czech Republic's own monetary policy to be relatively small.

The economic level of the Czech Republic (as measured by GDP per capita at purchasing power parity) diverged slightly from the euro area average in 2022, while convergence of the price and wage levels accelerated. However, the lag behind the euro area average remains significant, especially for the price level and to an even greater extent for the wage level. The unfinished process of convergence thus remains a factor arguing against early euro adoption. If the euro was adopted, there could be sustained pressure on the slight overshooting of the current 2% inflation target due to appreciation of the equilibrium real exchange rate and convergence of the wage level.

Chart 2.1: Degree of economic convergence in 2022

euro area = 100

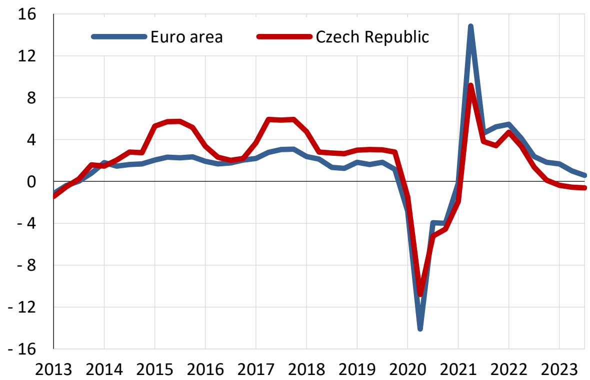


Source: Eurostat (2023c). CNB calculations.

The correlation of economic activity in the Czech Republic and the euro area has long been high, as business cycles in the last fifteen years have been largely determined by common external shocks. In recent years, these economies have become even more cyclically aligned as a result of the pandemic and the war in Ukraine. This has been reflected in a high correlation of GDP growth in the Czech Republic and the euro area and a strong correlation of Czech exports with economic developments in the euro area. However, this increase in cyclical alignment is to a large extent likely to be only a temporary consequence of the combined effect of strong global economic shocks.

Chart 2.2: Real GDP growth in the Czech Republic and the euro area

year-on-year; seasonally adjusted; in %

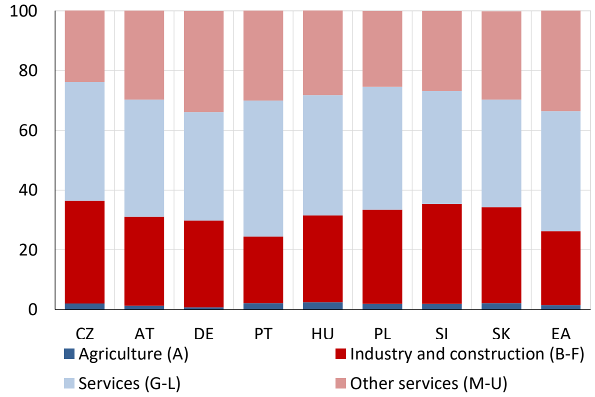


Source: Eurostat (2023c). CNB calculations.

The persisting **differences in the structure of the Czech and euro area economies** consist mainly in an above-average share of industry in Czech GDP. As regards euro adoption, the structural differences pose a risk of asymmetric effects of economic shocks, to which the single monetary policy would not be able to respond in full. There have been no major changes in the structural similarity of economies in recent years. For example, the rapidly growing electromobility remains a challenge for the domestic economy, as the automotive sector is well above average in domestic industry by European comparison.

Chart 2.3: Sectoral structure of the economy in 2022

in % of gross value added

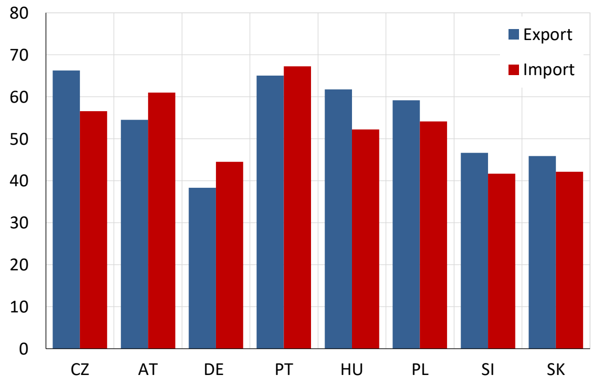


Note: The sectors are broken down by NACE classification.
Source: Eurostat (2023c). CNB calculations.

The Czech Republic's close **trade and ownership links** have long been one of the strongest arguments for it joining the euro area. The Czech Republic's transition to the euro would eliminate exchange rate risk and reduce transaction costs for all trade with euro area countries. At the same time, the high intensity of international economic relations, including the high intensity of intra-industry trade, leads to greater synchronisation of economic shocks and cyclical alignment and hence to lower costs associated with the loss of independent monetary policy. Alignment is also being supported by a high level of ownership links with the euro area in terms of investment from euro area countries in the Czech Republic.

Chart 2.4: Exports to the euro area and imports from the euro area

in % of total exports and imports, annual moving total of the monthly data as of July 2023



Source: Eurostat (2023c). CNB calculations.

According to the CNB's calculations, **the alignment of the Czech and euro area financial cycles** was broadly unchanged in 2022 and thus remains only partial.

The tightening of monetary policy in the euro area from the second half of 2022 onwards, amid flat domestic rates, was reflected in a decline in **the interest rate spread**. The ECB's rate increases were gradually catching up with the previous tightening of the CNB's monetary policy, which led to a marked decline in the interest rate differential in short-term rates. The response in long-term rates was also significant and the spread between Czech and German government bond yields dropped to the pre-pandemic level.

The Czech currency reacts to changes in the environment outside the euro area similarly to the euro. The correlation of the koruna-dollar exchange rate with the euro-dollar exchange rate remains high, although it has decreased slightly compared to the second half of last year. The volatility of the exchange rate of the Czech currency against the euro has been falling since mid-2022. A relatively mild recession during the energy crisis and an improvement in financial market sentiment (following the panic in the first half of 2022), among other things, has helped stabilise the exchange rate. The CNB's foreign exchange interventions against the depreciation of the koruna vis-à-vis the euro and its declared readiness to prevent excessive fluctuations of the koruna last year also had an effect.

The results of analyses of **financial market convergence** show a return to the pre-pandemic situation due to the fading impacts of the Covid-19 and energy crises and the ongoing decline in inflation in the context of global monetary policy tightening. The deterioration in the alignment of the Czech and German government bond markets in previous years reversed, as did that of the alignment of the Czech money and foreign exchange markets with the euro area market. The rate of transmission of global news to the Czech government bond market has increased significantly. By contrast, it decreased slightly in the money market and remained elevated on the foreign exchange market. Financial market alignment has thus increased overall.

The depth of financial intermediation and the level of private sector debt in the Czech Republic are relatively low and thus do not pose a systemic risk. As in the other countries under review, their levels fell year on year in 2022 and remain well below the euro area average. However, the relatively high euro area levels do not represent levels to which the Czech financial sector should converge, as an excessively large financial sector and overleveraged private sector could pose a risk of exacerbating the cyclical decline in the real economy due to a possible negative shock in certain circumstances. At the same time, in an environment of elevated inflation and high interest rates, more indebted economic agents may be exposed to risks associated with growth in debt service. This applies especially to non-financial corporations, but the risks may also be elevated for overindebted households, mostly in countries where loans with a variable interest rate predominate. Household debt is relatively low in the Czech Republic, with a preference for five-year interest rate fixations prevailing for housing loans.

The similarity of the structure of the financial liabilities of Czech and euro area corporations has remained relatively high compared to the countries under review. It declined temporarily in the last year as a result of a marked swing in financial derivatives purchased by energy companies. However, this swing was caused by the exceptional energy situation and had no permanent impact on the structural similarity of Czech firms with those in the euro area. A decrease in the structural mismatch in the last year has been fostered by growth in the proportions of shares and other equity in the total liabilities of Czech firms. A decrease in the structural mismatch has long been fostered by a gradual decline in other accounts payable (especially trade credits and advances) of Czech firms, whose share in the total liabilities of the domestic business sector used to be much higher than in euro area countries.

Despite a continued increase, **the similarity of the structure of the financial assets** of Czech households and households in the euro area remains rather low. The persisting dissimilarity is due mainly to Czech households' preference for cash and deposit holdings, together with holdings of investment fund units and shares, while households in the euro area hold a large part of their balance sheets also in insurance and pension schemes. These categories have converged in the last year, leading to a decrease in the mismatch in the asset structure. Differences in the asset structure of households in the Czech Republic and in the euro area may imply their different sensitivities to changes in interest rates and hence the different impacts of a possible single monetary policy.

The interest rate fixation **structure of loans to non-financial corporations** in the Czech Republic and the euro area remains similar. More than 86% of loans to non-financial corporations have floating rates or rates fixed for up to one year in the Czech Republic and in most of the euro area countries under review. Such a high share of loans with short fixation periods implies fast transmission of changes in monetary policy rates and, in turn, market rates to rates on loans provided to non-financial corporations.

Changes in monetary policy rates are most often transmitted to client rates on loans to non-financial corporations through the three-month PRIBOR. The transmission of the increase in monetary policy rates to client rates is thus substantial and with a minimal lag. The same applies to the euro area. The spread between client rates on loans to non-financial corporations and the three-month interbank rate (the risk premium) in the Czech Republic fluctuated around its long-term average (1.5 pp) in the first half of this year. The spread in the Czech Republic is currently slightly higher than in the euro area, reflecting an increase in banks' perceived riskiness of corporations in the Czech Republic and banks' view of future economic developments.

As regards **loans for house purchase**, the trend of choosing longer-term fixations reversed in most countries under review. Households more often opted for shorter fixations than in previous years due to higher market interest rates. In the Czech Republic this meant a shift back to five-year fixations, which are now predominant. In the euro area, there was a move away from fixation periods of over ten years and a rise in the share of floating rates or fixations of up to one year. Loans to households were provided at significantly higher interest rates. In addition to a shift towards shorter or flexible fixation periods, this naturally led to a decrease in total loans in the Czech Republic and the euro area. The main difference between the fixation structure in the Czech Republic and that the euro area still consists in the share of fixations of over ten years. This is negligible in the Czech Republic, while it is 50% in the euro area, despite having declined. The other main difference is that the share of variable fixations or fixations of up to one year in the euro area as a whole is almost 25% compared to their negligible share in the Czech Republic. In addition, euro area households with long interest rate fixations are less sensitive to fluctuations in interest rates on loans for house purchase.

Companies have increased their **financing in foreign currency** (especially in euro), albeit at a slower pace than in the previous period, while the share of foreign currency loans and deposits of Czech households has long remained very low. The share of foreign currency in the financing of Czech companies from domestic banks and from abroad via multinationals within foreign direct investment or directly by domestic corporations abroad exceeded 60%. Monetary policy thus affects a smaller proportion of corporate debt financing through the interest rate channel of the transmission mechanism than in the past. The share of foreign currency loans from domestic banks remains above the long-term trend due to a previous sharp increase associated with the high interest rate differential between domestic and foreign interest rates, reaching a new historical high in the last year (48% in June). However, its growth has lessened in intensity over the last year due to a narrowing interest rate differential. Some sectors are already showing stabilisation of the share of euro-denominated loans. In manufacturing, however, this share has increased further, albeit at a slower pace than in the previous period. The gradual euroisation of Czech companies can be expected to initially slow due to a further narrowing of the interest rate differential and then continue in line with the long-term trend, i.e. not as fast as in the previous period. In addition to the cyclical component affected by the interest rate differential, the upward trend in euroisation has long been due mainly to high trade integration with the euro area and corporations' efforts to naturally hedge against exchange rate risk. The slowdown in the dynamics of euroisation will also be fostered by an expected weakening of the koruna against the euro, which will increase the koruna value of the debt. The currently high share of euro-denominated loans may represent an increase in exchange rate risk in some corporations in the event of more significant depreciation of the koruna. The degree of euroisation in Czech companies may increase further due to the government's intention to allow firms to keep accounts and tax records in euro.

2.2 Adjustment mechanisms

If set correctly, **fiscal policy** – like monetary policy – should have a countercyclical effect and thus be a stabilising element for the economy. Otherwise it becomes a source of shocks and deepening macroeconomic imbalances.

Unfavourable economic developments along with fiscal stabilisation policy focusing on supporting households and firms led to sizeable general government deficits in the Czech Republic in 2020–2022. Although the deficit decreased in 2022 due to the fade-out of many temporary measures adopted during the Covid-19 pandemic, it remained above the 3% reference level for the general government deficit for the third consecutive year due to the adoption of new measures in response to the refugee and energy crisis. The medium-term objective for the Czech Republic (a structural balance of -0.75% of GDP) was also significantly exceeded. Given the application of the general escape clause of the Stability and Growth Pact, these developments remained in line with European legislation.

However, the structural imbalance of Czech public finances is not related solely to the implementation of temporary fiscal measures adopted to stabilise the Czech economy during the recent crisis. A number of measures which were adopted especially during the Covid-19 pandemic, were not directly linked to the pandemic and had significant lasting fiscal impacts. These measures thus exerted additional pressure on Czech public finance. However, given the relatively favourable initial level of general government debt, the fulfilment of the Maastricht debt criterion has not been jeopardised, and the national debt limit (the "debt brake") has not been exceeded.

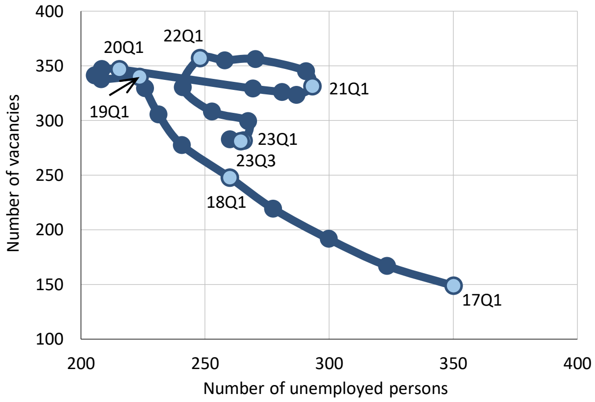
Given the national and European commitments in the area of budget responsibility, the Czech government will start consolidating Czech public finances in 2024. In May this year, it introduced a set of measures representing the first step towards correcting imbalances, to be followed by further measures to ensure sustainable public finances in the long term. Fiscal discipline and a reduction in excessive deficits will broaden the room for reducing the cyclical fluctuations of the economy, which is particularly necessary if a country loses its domestic monetary policy after euro adoption. Public finance consolidation is also necessary due to population ageing, which will adversely affect, among other things, the performance of the public pension and health care systems.

The labour market is another important mechanism through which the economy can cope with asymmetric shocks in the absence of independent monetary policy.

Following a temporary deterioration, Czech labour market indicators are gradually improving overall and are now close to the pre-pandemic levels. Employment is rising steadily, while the rate of economic activity among the population has reached historical highs. The long-term unemployment rate, which is among the lowest in Europe, also remains a positive factor. The growing labour market flexibility is being fostered by an increasing share of foreign nationals in the population, significantly affected by the arrival of refugees fleeing the war in Ukraine last year. However, some long-running problems persist in the labour market. The number of vacancies is still higher than the number of unemployed persons. The share of part-time jobs remains low, with the Czech Republic lagging well behind Germany and Austria in this area.

Chart 2.5: Job vacancies and unemployed persons

in thousands of persons/vacancies; seasonally adjusted



Source: Ministry of Labour and Social Affairs (2023). CNB calculations.

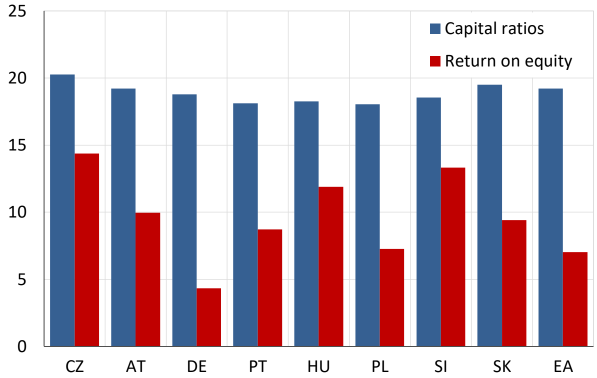
Tax changes in 2021 helped reduce overall labour taxation. This was reflected in a decline in the risk of a "low wage trap", which reduces the incentive to seek better-paid work. The risk of an "unemployment trap", which reduces the incentive to return to employment, also fell slightly.

The condition of the **financial sector** plays an important role in the economy's ability to absorb economic shocks.

The Czech banking sector developed favourably in 2022 and maintained its high resilience to potential adverse shocks. Its capitalisation remained robust and high by international comparison thanks in part to capital buffers and capital surpluses in excess of the regulatory requirements. Capital buffers create favourable conditions for smooth lending to the real economy and absorption of any increased credit losses. The banking sector's resilience to a crisis is also being enhanced by gradual compliance with a minimum requirement for own funds and eligible liabilities. The profitability of the banking sector is high by international comparison. It has developed favourably mainly due to slower transmission of tightened monetary policy to client interest rates on current and time accounts and relatively low loan impairment losses. The liquidity position remains robust due to a persistently high proportion of liquid assets and stable funding. The default rate decreased in almost all the countries under review despite an environment of elevated inflation and relatively high interest rates. In the Czech Republic, it remained at historical lows for both loans to households and loans to non-financial corporations. However, a potential deterioration in loan portfolio quality, caused by sustained elevated inflation or a potential economic recession, remains a key risk.

Chart 2.6: Banking sector indicators in 2022

in %



Note: The capital ratio is the ratio of a bank's capital to its risk-weighted assets. It thus expresses the bank's financial strength and measures its ability to cover any future losses with capital.
Source: ECB (2023).

3 Situation and Institutional Developments in the Euro Area

This year marks the 20th anniversary of signing the Czech Republic's obligation to adopt the euro. During that period, the EU has been through a major economic recession which – in some euro area countries – subsequently transformed into a debt crisis, followed by a pandemic crisis and an energy crisis triggered by Russia's military aggression against Ukraine. These and other events have shaped and will continue to affect euro area integration aimed at strengthening economic and fiscal coordination and completing the banking union and the capital markets union. Over the years, the euro area has also expanded to include new members – most recently on 1 January 2023, when Croatia became its 20th member. Bulgaria is also seeking to join the monetary union. Its ambition was to become a member at the same time as Croatia. However, it failed to achieve this goal, and the target date for Bulgaria's entry has been repeatedly postponed (it is currently 1 January 2025).

Euro adoption is associated with costs arising from new institutional commitments due to developments in the euro area, including the obligation to join the banking union or the European Stabilisation Mechanism. New institutions and regulations are thus changing the form of the euro area and hence also the content of the obligation to adopt the euro, which will have to be properly assessed and considered in decisions on the timing of monetary union entry.

3.1 Situation in the Euro Area

Economic alignment of euro area countries is essential to the smooth functioning of the monetary union. However, the series of events faced by the global economy after 2019 exacerbated the macroeconomic imbalances of the euro area countries, amplifying the already fundamental **structural and economic differences**.

The year 2022 was characterised by an energy crisis, high inflation, the start of monetary policy tightening and persisting problems in supply chains against the backdrop of the ongoing war in Ukraine. However, the European economy proved highly resilient to these negative factors, although the intensity of the impacts differed from country to country. This may have been related to the different structure of the economies and the heavy reliance of some countries on imports of energy commodities. The hardest-hit countries in the monetary union included the Baltic states, Germany and Slovakia, while the impacts on the economic growth of southern European countries were dampened significantly by a post-pandemic recovery in activity in the services sector. The trends in the relative economic levels of the Member States remain very uneven.

Strong demand for labour and firms' efforts to retain highly qualified staff resulted in **labour market** tightness and a drop in the unemployment rate in all euro area countries last year. However, significant differences persist across countries. In 2022, the unemployment rate exceeded 12% in Greece and in Spain, while in Italy it was above 8%. By contrast, the unemployment rate in Germany and Malta fluctuated around 3% in the same year. In the first half of 2023, the unemployment rate showed a downward trend in the euro area, reaching 6.5% in September. However, given the expected economic slowdown this year, employment growth could slow slightly next year.

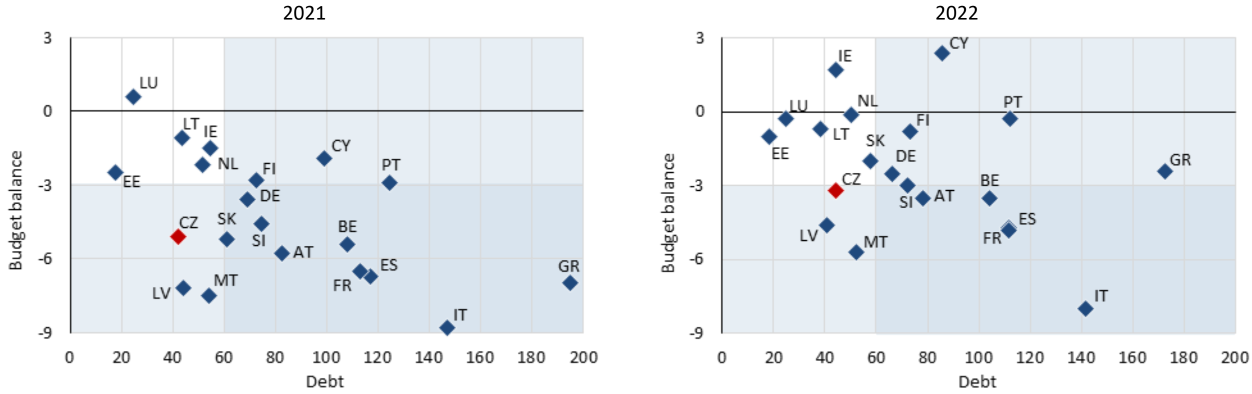
After peaking at double digits in October 2022, **inflation** in the euro area has been slowing significantly due to a sharp drop in energy commodity prices. However, the pace differs across the countries of the monetary union. In September, the highest annual inflation (exceeding 7%) was in Slovakia, Croatia and Slovenia. By contrast, the lowest (below 1%) was recorded in Belgium and Denmark. The Netherlands even recorded slight deflation. Expecting inflation to remain above the 2% target for a longer period, the European Central Bank continued to raise interest rates until September to 4.5% but in October opted to keep them stable.

Public finance performance in euro area countries has improved markedly due to consolidation of public budgets (see Chart 3.1). However, most countries' debt remains high and exceeds the limit. The planned tightening in 2022 was dampened by government measures to soften the impacts of high energy prices and higher defence spending. The economic recovery and consolidation helped to reduce the euro area general government **deficit** to 3.6% of GDP on average last year. The average debt fell to 91.0% of GDP. **General government debt** exceeded 60% of GDP in 11 countries, with debt-to-GDP ratios exceeding 100% in six countries (Belgium, France, Italy, Portugal, Greece and Spain). In 2022, only six of the 19 euro area countries were compliant with both the deficit and debt benchmarks (Estonia, Ireland, Lithuania, Luxembourg, the Netherlands and Slovakia).

The lifting of the temporary extraordinary measures related to the Covid-19 pandemic and the almost complete discontinuation of energy measures are likely to lead to a further decline in the general government debt-to-GDP ratio in 2023 and 2024.

The economic recovery supported by the positive impacts of the relatively resilient labour market, growth in households' disposable income and falling prices of energy commodities and food will be probably dampened by elevated headline inflation and tighter monetary and fiscal policy.

Chart 3.1: Fiscal positions in the euro area and the Czech Republic
in % of GDP



Note: The Czech Republic is not a euro area country and is only listed here for comparison. Data as of 23 October 2023.
Source: Notification tables of the various countries, Eurostat (2023d).

3.2 Institutional Developments in the EU and Related Obligations

Since the Czech Republic joined the EU, many reforms have been implemented to **enhance the stability and deepen the integration of the union**. Nonetheless, the institutional framework of the EU and the euro area is continuing to evolve. The Czech Republic faces further institutional or financial changes and obligations arising from the previously submitted and expected future proposals. These must be taken into account when debating the timing of euro area entry.

A Strategic Agenda for 2019–2024 was adopted at the European Council meeting in June 2019 (Council of the EU, 2019a). This set out priorities for the direction of the EU and, among other things, confirmed that deeper economic and monetary union is a priority for the EU to strengthen its economic stability, resilience and growth potential.

In June 2019, the euro area member states took another minor step towards achieving this goal by agreeing on the main elements of the budgetary instrument for euro area and non-euro area countries. However, the debate on these proposals was suspended as a result of the approval of the Next Generation EU instrument, which was prepared in response to the effects of the Covid-19 pandemic.

Completing the **banking union** is part of the deepening of the economic and monetary union. This project was created in response to the rise in market distrust in the euro area banking systems and the collapse of major banks and cross-border banking groups located in the euro area, whose bail-out required high public spending during the financial and debt crisis after 2008. Its aim is to ensure the safety and soundness of the euro area banking sector, which affects the stability of the EU as a whole, and to ensure that the failure of non-viable banks is addressed without the need to use taxpayers' money and with minimal impact on the real economy.

Partial progress in creating the banking union was achieved in 2019 (i.e. before the pandemic), when a banking package was adopted to strengthen the resilience and resolvability of EU banks (Council of the EU, 2019b). The package enshrined a set of reforms aimed at improving the situation in those areas. It also implements important international standards and aims to contribute to the completion of the implementation of "post-crisis" international regulation. In the context of strengthening bank resilience, it is worth mentioning the publication of another banking package of legislative proposals in 2021 (EC, 2021a), which is focused primarily on completing the implementation of the rest of the Basel III standards. The package contains proposals to review the Capital Requirements Directive and the Capital Requirements Regulation. In June 2023, the Council and the European Parliament reached a preliminary agreement on changes to these legislative acts (see Council of the EU, 2023).

During 2020, efforts were focused primarily on measures directly connected with containing the Covid-19 pandemic, and, as a result, activities related to the completion of the banking union were set aside. In December 2020, the Euro Summit mandated the Eurogroup to develop, by consensus, a roadmap for the completion of the banking union, focusing on setting the course of action in four defined areas (Council of the EU, 2020a). Despite considerable efforts to find consensus, this objective has not been achieved. As a follow-up, the Eurogroup adopted a statement in June 2022 (Council of the EU, 2022) declaring that work on completing the banking union should focus directly on strengthening the crisis management framework for banks and national deposit insurance schemes. In April 2023, the Eurogroup followed up on the aforementioned statement of June 2022, with the Commission presenting the main objectives of its legislative package on the crisis management and deposit insurance framework (EC, 2023c). The other three topics – the introduction of an European Deposit

Insurance Scheme (EDIS), the strengthening of cross-border integration of banking groups and the regulation of holdings of sovereign exposures (government bonds) by domestic banks – were set aside for the time being.

The Commission has worked continuously with the Member States concerned to reduce the level of non-performing loans (NPLs) in the European Semester and elsewhere. Banks generally managed to reduce the ratio of these loans, even during the pandemic and the war in Ukraine (to 1.9% in 2022 Q4 compared to 2.8% in 2019 Q4). However, it is still important to monitor the ratio, improve insolvency frameworks and, among other things, develop secondary markets for these loans. To prevent a further increase in the NPL ratio, the European Commission issued an Action Plan in December 2020 to tackle non-performing loans in the aftermath of the Covid-19 pandemic (EC, 2020a). At the same time, the Council underlined the intention to proceed swiftly with legislative proposals on secondary markets for these loans and accelerated extrajudicial collateral enforcement (see Council of the EU, 2021). However, the directive on accelerated extrajudicial collateral enforcement (European Parliament and Council of the EU, 2018) is still awaiting the adoption of the European Parliament's mandate. By contrast, substantial progress has been made in developing the aforementioned secondary market for NPLs, in particular the adoption of Directive (EU) 2021/2167 of the European Parliament and of the Council on credit servicers and credit purchasers (European Parliament and EU Council, 2021a). The transposition of this directive is currently in the legislative process, where the draft law on the market for non-performing loans was approved by the Czech government at its meeting on 14 June 2023. The bill was submitted to the Chamber of Deputies of the Czech Parliament as Parliamentary Print 472.

In the context of the negotiations on deeper economic and monetary union, meetings were held from the end of 2017 to March 2020 on reforming the **European Stability Mechanism**. This reform also concerned the introduction of a new instrument called the common backstop to the **Single Resolution Fund**. This is a last resort instrument to be used if the Single Resolution Fund becomes depleted. As non-euro area banking union countries are not members of the European Stability Mechanism, they are to provide parallel credit lines under similar conditions to ensure equal treatment. The sum total of all the credit lines should equal the target level of the Single Resolution Fund, i.e. about EUR 78 billion. The backstop will be fiscally neutral in the medium term because the funds used in individual cases will always be repaid within three to five years out of contributions collected from the banks in the banking union.

In 2021 Q1, euro area member states as the shareholders of the European Stability Mechanism (ESM) signed an agreement (ESM, 2021) providing the legal basis for a set of new competences for the European Stability Mechanism. The reformed treaty will enter into force after ratification by the parliaments of the countries concerned. Italy is the last signatory Member State that has yet to ratify the reformed Treaty.

Since 2015, the EU has been developing the concept of a **capital markets union**. Building on a 2017 Mid-Term Review of the implementation of legislative and non-legislative measures, and following calls from the Council (Council of the EU, 2019c) and the European Parliament (EP, 2020), the European Commission in September 2020 published a new Action Plan to boost the EU's capital markets union over the coming years (EC, 2020b), which should ensure access to market funding. In the Action Plan, the Commission introduced 16 legislative and non-legislative proposals which focus on simplifying access to company information, making it easier for SMEs to access non-bank finance, strengthening investor protection, harmonising national insolvency legislation and creating a single rulebook for EU capital market supervision.

In light of the Action Plan, the Commission presented another package of legislative proposals (EC, 2021b) aimed at integrating capital markets in November 2021. An agreement on some of the proposals has already been reached between the Council and the European Parliament. The Commission supplemented this package with additional proposals for legislative acts in December 2022 (EC, 2022). The Council has already reached a common position on some of these proposals. In April 2023, representatives of the Council, the Commission and the European Parliament undertook in a joint statement to complete the legislative work concerning the capital markets union before elections to the European Parliament in 2024 (EC, 2023d). The capital markets union project is politically exposed and focuses mainly on post-pandemic economic growth, sustainable finance, digitalisation, and also puts greater emphasis on EU autonomy in some areas (and, after the UK's exit from the EU, on reducing the dependence of EU capital market participants on the City of London).

The **response** at the European level **to the economic situation caused by the Covid-19 pandemic** has supported the EU's economic resilience, even in the current geopolitical and economic context. The elements of the joint response included a **European Stability Mechanism credit line**, an EU budget instrument (especially **SURE**, an instrument for support to mitigate unemployment risks in an emergency) and a **guarantee fund provided by the European Investment Bank**.

In addition, the European Commission published a communication on the plan to support economic recovery in the EU (EC, 2020c). The aim of the proposal was to harness the full potential of the EU budget to mobilise investment and frontload financial support in the first crucial years of recovery. The proposals were endorsed politically at the July 2020 European Council

(Council of the EU, 2020b), followed by approval of the related legislation in the Council and the European Parliament.

The main pillar of the recovery plan is the **multiannual financial framework** for 2021–2027, approved at EUR 1,074 billion (at 2018 prices). New tools will be created and key programmes strengthened so that investment can be directed quickly to where it is most needed. In response to global developments and their impacts on the EU, and the new challenges the EU is facing, the Commission put forward a proposal for the medium-term review of the framework in June 2023. The proposal focuses on three political priorities: assisting Ukraine, supporting Member States in their fight against migration and establishing the Strategic Technologies for Europe Platform. The other pillar is the EUR 750 billion **Recovery plan for Europe** – **"Next Generation EU"** – aimed at temporarily boosting the EU budget with financing raised on the financial markets. The centrepiece of the recovery plan is a **Recovery and Resilience Facility** (European Parliament and EU Council, 2021b). The aim of the facility is to provide large-scale financial support for reforms in the Member States and for public investment projects that will strengthen the cohesion and resilience of the Member States. The approved maximum allocation of EUR 672.5 billion (at 2018 prices) is a combination of grants (EUR 312.5 billion) and supplementary voluntary preferential loans (EUR 360 billion). To some extent, the Facility builds on the work on the above-mentioned budgetary instrument for the EU and finances part of the targeted reforms and investments undertaken by Member States by the end of 2026. Unlike the previous plans, this has been declared a one-off instrument aimed at addressing the impacts of the pandemic, although there are voices calling for it to be established on a permanent basis. The Commission had already disbursed EUR 153.4 billion by the cut-off date for this assessment.

On the revenue side of the EU budget, the Commission presented two packages of proposals for new own resources, which should primarily be used to repay loans under the Recovery plan for Europe. The first package put forward in December 2021 proposes a new source based on revenues from emission allowances, revenues from the carbon border adjustment mechanism and a source based on the profits of multinational companies. In the second package presented in June 2023, the Commission updated the first two aforementioned sources and complemented them with a proposal for a new temporary statistical own resource based on company profits.

Following the **REPowerEU** initiative, which aims to end the EU's dependence on imports of fossil fuels from Russia, the financial envelope of the Recovery and Resilience Facility was increased by EUR 20 billion.

The general escape clause of the Stability and Growth Pact is to be deactivated at the end of 2023 for the first time since the outbreak of the Covid-19 pandemic in the EU in March 2020. As a result, under the current legislation (in particular Council Regulation No 1466/97), Member States will be required to comply with the medium-term budgetary objective or the adjustment path towards its fulfilment (in terms of the structural balance). The European Commission also called on Member States to ensure compliance with the reference value for the deficit of 3% of GDP and credible and continuous debt reduction or debt sustainability at prudent levels over the medium term (EC, 2023e). Although these requirements are inspired by the package of legislative proposals to reform the EU economic governance framework, they are still based on the current legislation. In view of the persisting macroeconomic uncertainties, the Commission has so far concluded that while the general escape clause is in place, it is inappropriate to propose the opening of an excessive deficit procedure vis-à-vis individual Member States. Where relevant, the Commission will propose the opening of this procedure in spring 2024. This is important, among other things, for the assessment of the criterion on the government financial position. However, the question is how the Commission's procedure will be perceived by the countries affected (and whether it will be enforceable in practice) in a situation where a set of new economic governance rules is in an advanced stage of discussion (see below).

In addition, the European Commission followed up on its pre-pandemic initiative to reform the EU's existing fiscal rules. To this end, the Commission published the aforementioned package of legislative proposals to reform the EU economic governance framework (EC, 2023f) in April 2023. The primary aim of these proposals is to strengthen debt sustainability and support economic growth in all Member States through reforms and investment. The reform proposes to simplify economic governance, increase Member States' responsibility for defining their commitments and strengthen the emphasis on the medium-term horizon. Specifically, the proposed changes would be reflected under the European Semester in the replacement of National Reform Plans and Convergence Programmes (or Stability Programmes) with medium-term fiscal-structural plans, which are the cornerstone of the proposed reform. The plans should integrate fiscal and structural aspects and the reform and investment commitments of the individual Member States. In addition to the fiscal level, the plans should also focus on a description of the implementation of these reforms and investments that would respond to the challenges identified under the European semester and to the EU's common priorities. A key element of the plan is a net spending path which represents the multi-year spending plan of Member States for a period of at least four years.

On 1 January 2023, the monetary union was expanded to include Croatia, which became its 20th member. **The entry of Croatia and Bulgaria into the ERM II exchange rate mechanism** in July 2020 as part of the process of adopting the single currency was accompanied for the first time by their **simultaneous entry into the banking union**. Although formally the entry of the two countries into the banking union was their voluntary commitment, it was actually a condition for joining ERM II. In addition, such an approach was identified by the ERM II parties as a precedent for other ERM II candidates, and it can be assumed that it will be required of all future applicants for ERM II entry. However, EU law does not make accession to the banking union a condition for joining ERM II. **The Czech Republic does not feel legally obliged to adopt Bulgaria's and Croatia's approach** and does not regard participation in the banking union as a necessary condition for ERM II entry.

Given the ongoing discussions in the EU about the future institutional arrangement of the euro area, the obligations that would arise for the Czech Republic on accession to the euro area cannot be fully assessed at present. The estimated financial costs associated with the Czech Republic's hypothetical entry into the euro area, which arise mainly from participation in the banking union and the ESM and payment of the rest of the share in the subscribed capital of the ECB, are quantified in Appendix B.

References

Act concerning the conditions of accession of the Czech Republic, the Republic of Estonia, the Republic of Cyprus, the Republic of Latvia, the Republic of Lithuania, the Republic of Hungary, the Republic of Malta, the Republic of Poland, the Republic of Slovenia and the Slovak Republic and the adjustments to the Treaties on which the European Union is founded. Official Journal L 236, pp. 33, 23 September 2003, [cited 16/11/2023], <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A12003T%2FAFI>.

Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund [cited 16/11/2023], <http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%208457%202014%20INIT>.

CNB (2023a): Alignment Analyses. Prague, Czech National Bank, December 2023, <https://www.cnb.cz/en/monetary-policy/euro-adoption/>.

CNB (2023b): Exchange rates. Prague, Czech National Bank, November 2023 [cited 16/11/2023], <https://www.cnb.cz/en/financial-markets/foreign-exchange-market/central-bank-exchange-rate-fixing/central-bank-exchange-rate-fixing/>.

CNB, Czech Government (2003): The Czech Republic's Euro-area Accession Strategy. Prague, Czech National Bank and Czech Government, April 2003 [cited 16/11/2023], <https://www.cnb.cz/en/monetary-policy/inflation-reports/boxes-and-annexes-contained-in-inflation-reports/The-Czech-Republics-euro-area-accession-strategy-00001/>.

Council of the EU (2011): Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies. Brussels, Council of the EU, November 2011 [cited 16/11/2023], <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:01997R1466-20111213>.

Council of the EU (2019a): A new strategic agenda 2019−2024. Brussels, Council of the EU, June 2019 [cited 16/11/2023], <https://www.consilium.europa.eu/en/press/press-releases/2019/06/20/a-new-strategic-agenda-2019-2024/>.

Council of the EU (2019b). Banking union: Council adopts measures to reduce risk in the banking system. Brussels, Council of the EU, May 2019 [cited 16/11/2023], <https://www.consilium.europa.eu/en/press/press-releases/2019/05/14/banking-union-council-adopts-measures-to-reduce-risk-in-the-banking-system/>.

Council of the EU (2019c): Council conclusions on the deepening of the capital markets union. Brussels, Council of the EU, December 2019 [cited 16/11/2023], <https://data.consilium.europa.eu/doc/document/ST-14815-2019-INIT/en/pdf>.

Council of the EU (2020a): Statement of the Euro Summit in inclusive format. Brussels, Council of the EU, December 2020 [cited 16/11/2023], <https://www.consilium.europa.eu/media/47298/11-12-20-euro-summit-statement-en.pdf>.

Council of the EU (2020b): European Council conclusions, 17−21 July 2020. Brussels, Council of the EU, July 2020, [cited 16/11/2023], <https://www.consilium.europa.eu/media/45109/210720-euco-final-conclusions-en.pdf>.

Council of the EU (2020c): Council Regulation (EU) 2020/2094 of 14 December 2020 establishing a European Union Recovery Instrument to support the recovery in the aftermath of the COVID-19 crisis. Brussels, Council of the EU, December 2020 [cited 12/10/2023], <https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32020R2094>.

Council of the EU (2021): Informal video conference of economic and finance ministers, 19 January 2021. Brussels, Council of the EU, January 2021, [cited 16/11/2023], <https://www.consilium.europa.eu/en/meetings/ecofin/2021/01/19/>.

Council of the EU (2022): Eurogroup statement on the future of the Banking Union of 16 June 2022. Brussels, Council of the EU, June 2022, [cited 16/11/2023], <https://www.consilium.europa.eu/en/press/press-releases/2022/06/16/eurogroup-statement-on-the-future-of-the-banking-union-of-16-june-2022/>.

Council of the EU (2023): Banking sector: Provisional agreement reached on the implementation of Basel III reforms. Brussels, Council of the EU, June 2023 [cited 16/11/2023], <https://www.consilium.europa.eu/en/press/press-releases/2023/06/27/banking-sector-provisional-agreement-reached-on-the-implementation-of-basel-iii-reforms/>.

EC (2020a): Action plan: Tackling non-performing loans (NPLs) in the aftermath of the COVID-19 pandemic. Brussels, European Commission, December 2020 [cited 16/11/2023], < https://finance.ec.europa.eu/publications/action-plan-tackling-non-performing-loans-npls-aftermath-covid-19-pandemic_en>.

EC (2020b): A Capital Markets Union for people and businesses − new action plan. Brussels, European Commission, September 2020 [cited 16/11/2023], <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2020:590:FIN>.

EC (2020c): Recovery plan for Europe. Brussels, European Commission, July 2020 [cited 16/11/2023], <https://ec.europa.eu/info/strategy/recovery-plan-europe_en>.

EC (2021a): Banking package. Brussels, European Commission, October 2021 [cited 1611/2023], <https://finance.ec.europa.eu/publications/banking-package_en#documents>.

EC (2021b): Capital markets union: Commission adopts package to ensure better data access and revamped investment rules. Brussels, European Commission, November 2021 [cited 16/11/2023], <https://finance.ec.europa.eu/publications/capital-markets-union-commission-adopts-package-ensure-better-data-access-and-revamped-investment_en>.

EC (2022): Capital markets union: clearing, insolvency and listing package. Brussels, European Commission, December 2022 [cited 16/11/2023], <https://finance.ec.europa.eu/publications/capital-markets-union-clearing-insolvency-and-listing-package_en>.

EC (2023a): Autumn 2023 Economic Forecast. Brussels, European Commission, November 2023 [cited 16/11/2023], <https://economy-finance.ec.europa.eu/economic-forecast-and-surveys/economic-forecasts/spring-2023-economic-forecast-improved-outlook-amid-persistent-challenges_en>.

EC (2023b): Stability/Convergence Programmes 2023. Brussels, European Commission, June 2023 [cited 16/11/2023], <https://commission.europa.eu/content/2023-european-semester-national-reform-programmes-and-stabilityconvergence-programmes_en>.

EC (2023c): Reform of bank crisis management and deposit insurance framework. Brussels, European Commission, April 2023 [cited 6/9/2023], <https://economy-finance.ec.europa.eu/economic-forecast-and-surveys/economic-forecasts/autumn-2023-economic-forecast-modest-recovery-ahead-after-challenging-year_en>.

EC (2023d): Capital Markets Union: EU renews commitment to integration and development of capital markets. Brussels, European Commission, April 2023 [cited 2/8/2023], <https://ec.europa.eu/commission/presscorner/detail/en/statement_23_2482>.

EC (2023e): Fiscal Policy Guidance for 2024. Brussels, European Commission, March 2023 [cited 6/9/2023], <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM%3A2023%3A141%3AFIN>.

EC (2023e): New economic governance rules fit for the future. Brussels, European Commission, April 2023 [cited 2/8/2023], <https://economy-finance.ec.europa.eu/publications/new-economic-governance-rules-fit-future_en>.

ECB (2020): Decision of the European Central Bank of 22 January 2020 on the paying-up of the European Central Bank's capital by the non-euro area national central banks (ECB/2020/2). Official Journal L 27 I/1, pp. 1–3, 1 February 2020 [cited 16/11/2023], <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32020D0136&qid=1694072063461>.

ECB (2023): Supervisory and Prudential Statistics. Frankfurt am Main, European Central Bank, August 2023 [cited 21/8/2023], <https://sdw.ecb.europa.eu/browse.do?node=9691103>.

ESM (2021): ESM Treaty – Amending Agreement. Luxembourg, European Stability Mechanism, February 2021 [cited 16/11/2023], <https://www.esm.europa.eu/system/files/document/2023-05/05-TESM-AMD-HR.en21.pdf>.

European Parliament (2020): Further development of the Capital Markets Union: improving access to capital market finance, in particular by SMEs, and further enabling retail investor participation. Brussels, European Parliament, September 2020 [cited 16/11/2023], <https://www.europarl.europa.eu/doceo/document/A-9-2020-0155_EN.html>.

European Parliament and EU Council (2013): Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area. Brussels, European Parliament and EU

Council, May 2013 [cited 16/11/2023], <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0473&from=EN>.

European Parliament and EU Council (2018): Draft directive of the European Parliament and of the Council on credit servicers, credit purchasers and the recovery of collateral. Brussels, European Parliament and EU Council, March 2018 [cited 16/11/2023], <https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52018PC0135>.

European Parliament and EU Council (2021a): Directive 2021/2167/EU of the European Parliament and of the Council of 24 November 2021 on credit servicers and credit purchasers and amending Directives 2008/48/EC and 2014/17/EU (Text with EEA relevance), 24 November 2021, [cited 16//11/2023], <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32021L2167>.

European Parliament and EU Council (2021b): Regulation (EU) No 2021/241 of the European Parliament and of the Council of 12 February 2021 establishing the Recovery and Resilience Facility, 12 February 2021 [cited 16/11/2023], <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32021R0241>.

Eurostat (2023a): EMU Harmonised Index of Consumer Prices. Luxembourg, Eurostat, September 2023 [cited 16/11/2023], <http://appsso.eurostat.ec.europa.eu/nui/show.do?dataset=prc_hicp_mv12r&lang=en>.

Eurostat (2023b): EMU Convergence Criterion Series – Monthly Data (convergence criterion bond yields). Luxembourg, Eurostat, September 2023 [cited 16/11/2023], <https://ec.europa.eu/eurostat/databrowser/view/IRT_LT_MCBY_A/default/table?lang=en>.

Eurostat (2023c): Database. Luxembourg, Eurostat, November 2023 [cited 16/11/2023], <https://ec.europa.eu/eurostat/data/database>.

Eurostat (2023d): Government Deficit and Debt. Luxembourg, Eurostat, April 2023 [cited 21/4/2023], <https://ec.europa.eu/eurostat/databrowser/view/gov_10dd_edpt1/default/table?lang=en>.

Government proposal for an Act on the Market for Non-Performing Loans. Parliamentary Print No. 472/0, Chamber of Deputies, 9th parliamentary term, pp. 2–22 [cited 2/8/2023], <https://www.psp.cz/sqw/text/orig2.sqw?idd=228431>.

MF CR (2007): The Czech Republic's Updated Euro-area Accession Strategy. Prague, Ministry of Finance of the Czech Republic, December 2007 [cited 16/11/2023], <https://www.zavedenieura.cz/assets/en/media/The-Czech-Republics-Updated-Euro-area-Accession-Strategy-2007.pdf>.

MF CR, CNB (2022): Assessment of the Fulfilment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area. Prague, Ministry of Finance of the Czech Republic, Czech National Bank, December 2022 [cited 16/11/2023], <https://www.mfcr.cz/en/eu-and-international-affairs/euro-area-accession-strategy/fulfilment-of-the-maastricht-criteria/2022/assessment-of-the-fulfilment-of-the-maas-49586>.

MF CR (2023a): Macroeconomic Forecast of the Czech Republic. Prague, Ministry of Finance of the Czech Republic, November 2023 [cited 16/11/2023], <https://www.mfcr.cz/en/fiscal-policy/macroeconomic-analysis/macroeconomic-forecast/2023/macroeconomic-forecast-november-2023-53578>.

MF CR (2023b): Convergence Programme of the Czech Republic. Prague, Ministry of Finance of the Czech Republic, April 2023 [cited 16/11/2023], <https://www.mfcr.cz/en/eu-and-international-affairs/euro-area-accession-strategy/convergence-programme/2023/convergence-programme-of-the-czech-repub-51091>.

Ministry of Labour and Social Affairs (2023): Unemployment – monthly. Prague, Ministry of Labour and Social Affairs, November 2023 [cited 16/11/2023], <https://www.mpsv.cz/web/en/information-on-unemployment>.

Protocol (No 4) annexed to the Treaty on European Union and the Treaty on the Functioning of the European Union: on the Statute of the European System of Central Banks and of the European Central Bank. Official Journal C 326, 26/10/2012, pp. 30−50, [cited 6/9/2023], <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:C:2012:326:FULL&from=EN>.

Protocol (No 12) annexed to the Treaty on European Union and the Treaty on the Functioning of the European Union: on the excessive deficit procedure. Official Journal C 326, 26/10/2012, pp. 79−80 [cited 6/9/2023], <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:C:2012:326:FULL&from=EN>.

Protocol (No 13) annexed to the Treaty on European Union and the Treaty on the Functioning of the European Union: on the convergence criteria. Official Journal C 326, 26/10/2012, pp. 81−82 [cited 6/9/2023], <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:C:2012:326:FULL&from=EN>.

A Appendix – Maastricht Convergence Criteria

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 Protocol No. 13 on the Convergence Criteria also 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 in their Convergence Reports (the European Commission and ECB). Therefore, when assessing the fulfilment of the criteria one should also take into account the specific way in which these institutions implement the criterion. Previous practice shows that countries with low or negative inflation rates are not automatically excluded as reference countries. Only countries that record significant deviations in inflation from the other EU countries owing to extraordinary or specific factors are excluded.

Criterion on 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 Protocol No. 13 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 shall prepare a report assessing whether an excessive deficit exists on the basis of the following two criteria if a Member State does not fulfil the requirements for budgetary discipline.

1. whether the ratio of the planned or actual government deficit to GDP exceeds a reference value (defined in Protocol No. 12 on the excessive deficit procedure as 3% of GDP), unless:
   a. either the ratio has declined substantially and continuously and reached a level that comes close to the reference value;
   b. or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value.
2. whether 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.

However, several other steps need to be taken between the European Commission’s report and the start of the excessive deficit procedure. The excessive deficit procedure is opened by the EU Council, acting on a proposal from the European Commission. The EU Council also closes the procedure, acting on a recommendation from the Commission.

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 being reflected in the long-term interest-rate levels".

Article 4 of Protocol No. 13 on the Convergence Criteria specifies that: "The criterion on the convergence of interest rates…shall mean 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

As in the case of the price stability criterion, the Treaty and the Protocol provide scope for a looser interpretation of the specific value of the criterion. It is within the competence of the assessing institutions to decide whether the calculation of the interest rate criterion will include all three countries used for the calculation of the price stability criterion or whether certain countries will be excluded from the calculation of the interest rate criterion.

Interest rates measured on the basis of long-term government bonds or comparable securities are regarded as long-term interest rates. These interest rate statistics are based on monthly average interest rates on long-term government bonds in per cent per annum. Bonds with residual maturities ranging from 8 to 12 years are classified as benchmark bonds (this range is fully in line with the conditions on the Czech government bond market and is based on the Czech government bond issue frequency). A combination of bonds whose average residual maturity is as close to 10 years as possible is then generated from this set.

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 euro".

Article 3 of Protocol No. 13 on the Convergence Criteria stipulates that: "The criterion on participation in the exchange-rate mechanism of the European Monetary System referred to in the third indent of Article 140(1) of the Treaty shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against the euro 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 European Monetary Institute Council in October 1994 and its statements in the November 1995 report entitled "Progress towards Convergence".

The European Monetary Institute 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 it "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 "Progress towards Convergence" report it was stated that "when the Treaty was conceived, the 'normal fluctuation margins' were ±2.25% around bilateral central parities, whereas a ±6% band was a derogation from the rule. In August 1993 the decision was taken to widen the fluctuation margins to ±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.

B Appendix – Financial Obligations for the Czech Republic of Euro Area Entry

This Appendix lists the estimated direct financial costs in the hypothetical case of the Czech Republic entering the euro area, and the financial obligations closely linked with entry. These are the financial costs and obligations for the Czech Republic (general government) or economic entities established in the Czech Republic. With the exception of the obligation vis-à-vis the ECB, these obligations arose after the Czech Republic's EU entry as a result of the further development of the EU, and therefore were not known at the time the Czech Republic committed to adopt the euro. Besides the current legislation, the calculations are based on a number of assumptions. An exchange rate of CZK 24.0 to the euro, the expected exchange rate in 2023 Q4, was always used to convert the obligations and costs expressed in euro into Czech koruna.

Payment of the rest of the Czech Republic's share in the subscribed capital of the ECB	**Estimate**[1)]
− Following euro area entry, the CNB would have to pay up the outstanding amount of the subscribed capital of the ECB (Article 48 of the Protocol (No. 4) on the Statute of the European System of Central Banks and of the ECB). − Only a minimal percentage (3.75%) of the subscribed capital of the ECB has been paid up to date, as a contribution to the operational costs of the ECB (Decision ECB/2020/2).	EUR 0.2 billion CZK 4.9 billion
Obligations associated with the Czech Republic's participation in the European Stability Mechanism	**Estimate**[2)]
− The total obligation is CZK 391.0 billion, of which CZK 346.3 billion is a contingent liability payable in the event of full use of the European Stability Mechanism's lending capacity and in the extreme scenario. − The Czech Republic would then have to pay up capital totalling around CZK 44.7 billion within four years. These funds will remain the property of the Czech Republic, which in exchange will receive shares of the European Stability Mechanism of the same total nominal value. The Czech Republic will also acquire the relevant shareholder's rights and obligations. − The Czech Republic may theoretically adopt the euro without becoming a contracting party to the European Stability Mechanism, but euro area members can de facto make their consent to euro adoption in the Czech Republic conditional on European Stability Mechanism entry.	EUR 1.9 billion CZK 44.7 billion
Liabilities to the Single Resolution Fund	**Estimate**[3)]
− The Czech Republic is obliged to join the banking union no later than upon euro adoption. − The intergovernmental Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund requires that funds from the national resolution tool – the Resolution Fund in the case of the Czech Republic – be transferred to the Single Resolution Fund.	up to EUR 1.5 billion up to CZK 36.6 billion
− The annual fees that Czech banks would pay for the operation of the Single Resolution Board. − The provisions of the Agreement will start to apply to the Czech Republic upon euro area entry (or banking union entry, should the Czech Republic join the banking union before adopting the euro).	direct: a few hundred thous. EUR; indirect: a few mil. EUR[4)]
Costs associated with the Czech Republic's participation in the Single Supervisory Mechanism (an obligation since 2014)	**Estimate**[4)]
− The annual fees that Czech banks would pay the ECB for supervision.	direct: a few hundred thous. EUR; indirect: several mil. EUR[4)]

Note: 1) *Moreover, euro adoption is connected with an obligation to transfer to the ECB a part of the international reserves (and contribute to the ECB's reserve funds). In accordance with the Statute of the ESCB, the ECB specifies the details in its decision on the country's euro area entry. This obligation would be approximately more than EUR 900 million.*
2) *Paid-up capital represents CZK 44.7 billion of the Czech Republic's share in the subscribed capital of the European Stability Mechanism; the rest is contingent liabilities. The Czech Republic's share in the subscribed capital does not take into account a temporary correction of the European Stability Mechanism capital subscription key, to which economically weaker European Stability Mechanism members are entitled (and to which the Czech Republic would also be entitled in the current situation).*
3) *An estimated amount representing the target level of the Resolution Fund to be reached by 31 December 2024. However, the amount of funds transferred will depend on the risk profile of Czech banks and on the specific number of Member States that join the banking union. In the case of the Czech Republic, with its generally less risky banking sector, the amount transferred would probably be lower than stated here.*
4) *Direct costs only include fees to be paid directly by small and some medium-sized Czech banks. Moreover, indirect costs also include fees for large and some medium-sized Czech banks that would, however, be covered by their parent institutions.*

The Appendix does not capture other factors that would have an impact on the Czech Republic's budget or, more broadly, on the conduct of budgetary and fiscal policy in the event of euro area entry. Budgetary impacts would stem from any financial penalties that might be imposed on euro area countries under EU surveillance of members' budgetary policies or surveillance of macroeconomic imbalances. The implementation of budgetary and fiscal policy in the Czech Republic would be affected, among other things, by Regulation (EU) No. 473/2013 of the European Parliament and of the Council, which deepens EU surveillance of euro area members' budgetary policies.

Glossary

An **asymmetric shock** is a macroeconomic shock with an uneven impact on the individual countries of the monetary union.

Convergence means the tendency of less advanced economies to catch up with the more advanced ones. As a rule, the level of gross domestic product per capita at purchasing power parity is compared.

Correlation is the statistical expression of the relationship between two variables. Correlation does not imply that the evolution of one variable is a cause and that of the other a consequence.

The **cyclically adjusted balance** of the general government sector is used to identify the fiscal policy stance, as it does not include revenues and expenditures generated by the position of the economy in the business cycle.

Discretionary measures are direct interventions by executive or legislative authorities in the revenues and expenditures of the general government sector.

The **euro area** comprises the EU Member States that have adopted the euro under the Treaty. As of 1 January 1999, the euro area consisted of eleven countries – Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. Greece joined the euro area in 2001, followed by Slovenia in 2007, Cyprus and Malta in 2008, Slovakia in 2009, Estonia in 2011, Latvia in 2014, Lithuania in 2015 and Croatia in 2023.

The **European Stability Mechanism** is a financial assistance fund for EU Member States that use the euro as their currency. It was established in 2012 by an international treaty outside EU law, so it is an independent international financial institution. However, its operations are closely linked with EU law as well as EU and euro area institutions.

The **general government sector** is defined using internationally harmonised rules at EU level. In the Czech Republic, it consists of three main subsectors under ESA 2010 methodology: central government, local government and social security funds.

The **Harmonised Index of Consumer Prices** is an index measuring the price level. It is constructed on the basis of regular monitoring of prices of selected goods and services, which have certain weights in the consumer basket. Its calculation in EU countries is governed by unified and legally binding procedures, which enables cross-country comparisons. It is therefore used to assess the criterion on price stability.

Inflation is growth in the general price level, i.e. internal depreciation of a currency. The price level is measured using price indices such as the Harmonised Index of Consumer Prices.

Long-term interest rates are measured on the basis of long-term government bonds or comparable securities. These interest rate statistics are based on monthly average interest rates on long-term government bonds in per cent per annum. Bonds with residual maturities ranging from 8 to 12 years are classified as benchmark bonds (this range is fully in line with the conditions on the Czech government bond market and is based on the Czech government bond issue frequency). A combination of bonds whose average residual maturity is as close to 10 years as possible is then generated from this set.

The **medium-term objective** is expressed in terms of the structural balance and implies public finance sustainability in the country concerned. For the Czech Republic, it currently equates to a structural balance of -0.75% of GDP.

One-off and other temporary operations are measures on the revenue or expenditure side that have only a temporary effect on the general government balance and often stem from events beyond the direct control of executive or legislative authorities (e.g. expenditure on flood damage repairs).

The **Single Resolution Fund** is a fund financed by contributions from banks, collected by the participating countries. Lending between national compartments will be allowed. To prevent a shortage of funds in the Single Resolution Fund during a transitional period (until the end of 2023), the states of the banking union have agreed on temporary public funding in the form of individual (not mutualised) credit lines. A permanent mechanism of financial backstops should be fully operational by the end of the transitional period.

The **Single Resolution Mechanism** is a mechanism comprising a centralised board, which will prepare proposals for bank resolution procedures, and a fund for bank resolution in the banking union. Its objective is to ensure proper bank resolution with a minimal impact on public budgets, as the bank's shareholders and creditors, as well as a dedicated fund financed by banks themselves, will bear primary responsibility for covering any losses.

The **Single Supervisory Mechanism** is a new system of banking supervision in the EU. It falls within the competence of the ECB and the national competent authorities of the participating countries.

The **Stability and Growth Pact** is a binding framework for the coordination of national fiscal policies in the European Union. If an EU Member State has a general government deficit exceeding 3% of GDP, or does not reduce its debt exceeding 60% of GDP at a sufficient pace, an **excessive deficit procedure** is usually opened against it. This procedure is opened on the basis of a comprehensive assessment of the country's economic and budgetary situation. For example, if the excessive deficit (or debt) is only temporary, caused by adverse (cyclical) economic developments, an excessive deficit procedure may not be launched. The penalties imposed differ according to whether or not the country is a member of the euro area.

The **structural balance** is the difference between the cyclically adjusted balance and one-off and temporary operations (see above).

Ministry of Finance of the Czech Republic
Letenská 15
118 10 Prague 1

www.mfcr.cz

Czech National Bank
Na Příkopě 28
115 03 Prague 1

www.cnb.cz

ISSN 2336-5110