The Euro and the Banking Union: A View from Prague

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Outline of the presentation

- Introduction
- Assessment by the European Union: the Maastricht Convergence Criteria
- Assessment by the Czech Republic: Convergence of the Czech economy with the Euro Area
- Assessment of the Euro Area, in particular of the Banking Union
- Conclusion

Introduction

- EU has 28 Member States (UK*)
- Euro is the currency of the European Union (since the Treaty of Maastricht)
- As of today, 19 member states have adopted the euro as their common currency
- The remaining Member States are „Member States with a derogation“ (Art. 139 TFEU): SE, CZ, PL, HU, RO, BG, HR
- 2 Member States have an „opt-out“ from the Treaty (don‘t have the obligation to adopt the euro): DK, UK*

Regular Assessments: EU

At least **once every two years**, or at the request of a Member State with a derogation, **the Commission and the European Central Bank** shall report on the progress in fulfilling their obligations regarding the achievement of the economic and monetary union (Art. 140 TFEU)

– also known as **Convergence reports**

- Economic convergence: 4 Maastricht criteria + other relevant factors (macroeconomic imbalances)
- Compatibility of national legislation with the Treaties

National strategy from 2007

- Annual assessment
- Fulfilment of the (Maastricht) convergence criteria and of the degree of economic alignment (Ministry of Finance + Czech National Bank): adopted by the government
- Assessment of the degree of economic alignment with the euro area (Czech National Bank)

Pros and Cons of the Euro Adoption

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Pros (benefits)

- Zero exchange rate risk with the main trading partners
- Lower transaction costs (no need for exchange)
- Higher price transparency and more competition
- Deeper economic integration (?)

Cons (costs)

- Loss of an important macroeconomic adjustment variable
- Higher degree of economic sovereignty (?)

The higher the cyclical and structural alignment with the euro area and the more flexible the economy, the more the benefits should be higher then the costs.

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Assessment by the European Union: the Maastricht Convergence Criteria

Convergence Criteria - Summary

What is measured?	How is it measured?	Convergence criteria
Price stability	Harmonised consumer price inflation rate	Not more than 1.5 percentage points above the rate of the three best performing countries (1y)
Sound public finances	Government deficit as % of GDP	Reference value: Not more than 3%
Sustainable public finances	Government debt as % of GDP	Reference value: Not more than 60%
Durability of convergence	Long-term interest rate	Not more than 2 percentage points above the rate of the three best performing countries in terms of price stability (1y)
Exchange rate stability	Deviation from a central rate	Participation in the European Exchange Rate Mechanism (ERM 2) for two years

Fulfilment of the Convergence Criteria in 2016

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Table 2: Convergence criteria as fulfilled by non-euro area Member States with a derogation

	Consumer price inflation rate	Government deficit as % of GDP	Government debt as % of GDP	Long-term interest rate	Deviation from a central rate	Legal convergence
	Reference value: 0.7%	Reference value: Not more than 3%	Reference value: Not more than 60%	Reference value: 4%	Participation in ERM II for at least 2 years without severe tensions	Adaptation to requirements under Article 131 TFEU
Bulgaria	-1.3	0.0	29.5	2.3	NO[1]	NO
Croatia	-0.6	-0.8	84.2	3.5	NO	NO
Czech Republic	0.6	0.6	37.2	0.4	NO	NO
Denmark	0.0	-0.9	37.8	0.3		
Hungary	0.4	-1.8	74.1	3.1	NO	NO
Poland	-0.2	-2.4	54.4	3.0	NO	NO
Romania	-1.1	-3.0	37.6	3.3	NO	NO
Sweden	1.1	0.9	41.6	0.5	NO	NO

Source: Eurostat, ECB Convergence Report 2016

Fulfilment of the Convergence Criteria by CR: Historical Perspective

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017*
Price stability													?
Government financial position													
Interest rate convergence													
Exchange rate													

Compliant

Not compliant

Cannot be evaluated

Assessment by the Czech Republic: Convergence of the Czech economy with the Euro Area

Nominal and Real Convergence (EU-15)

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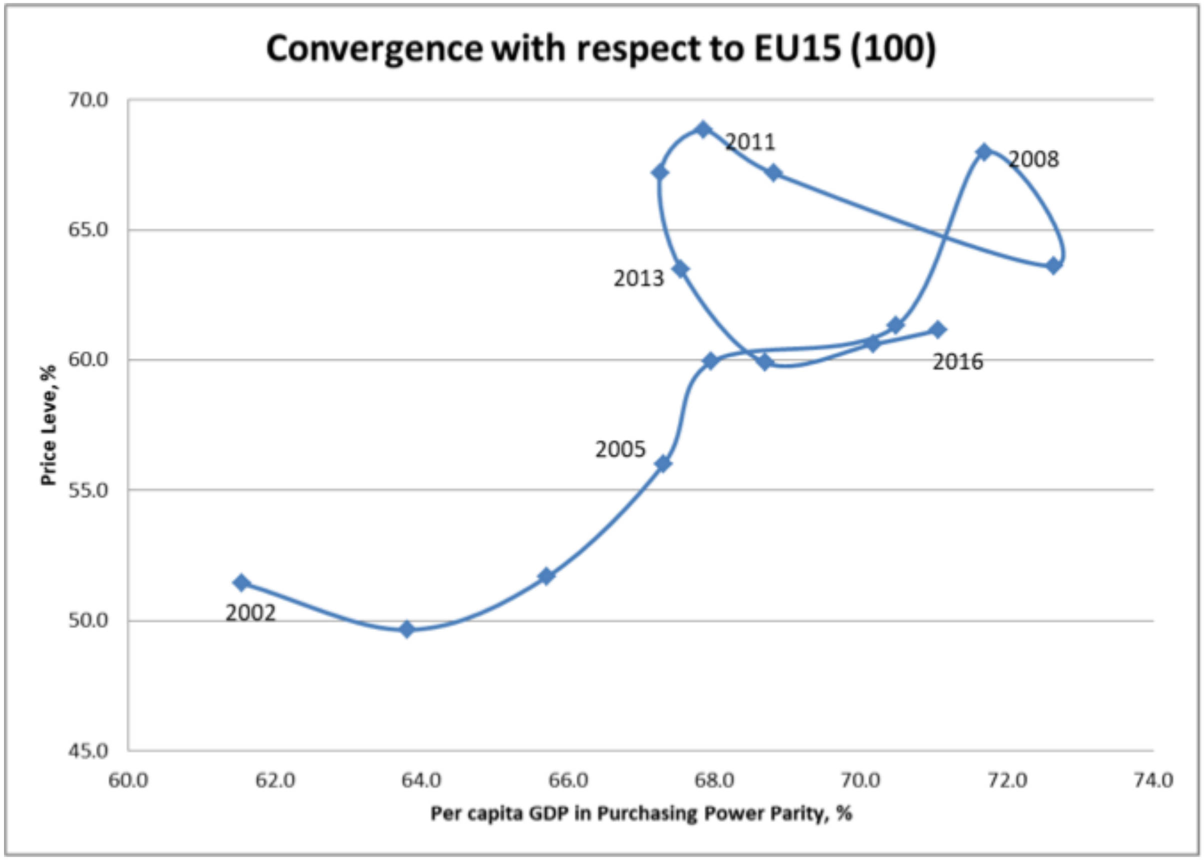
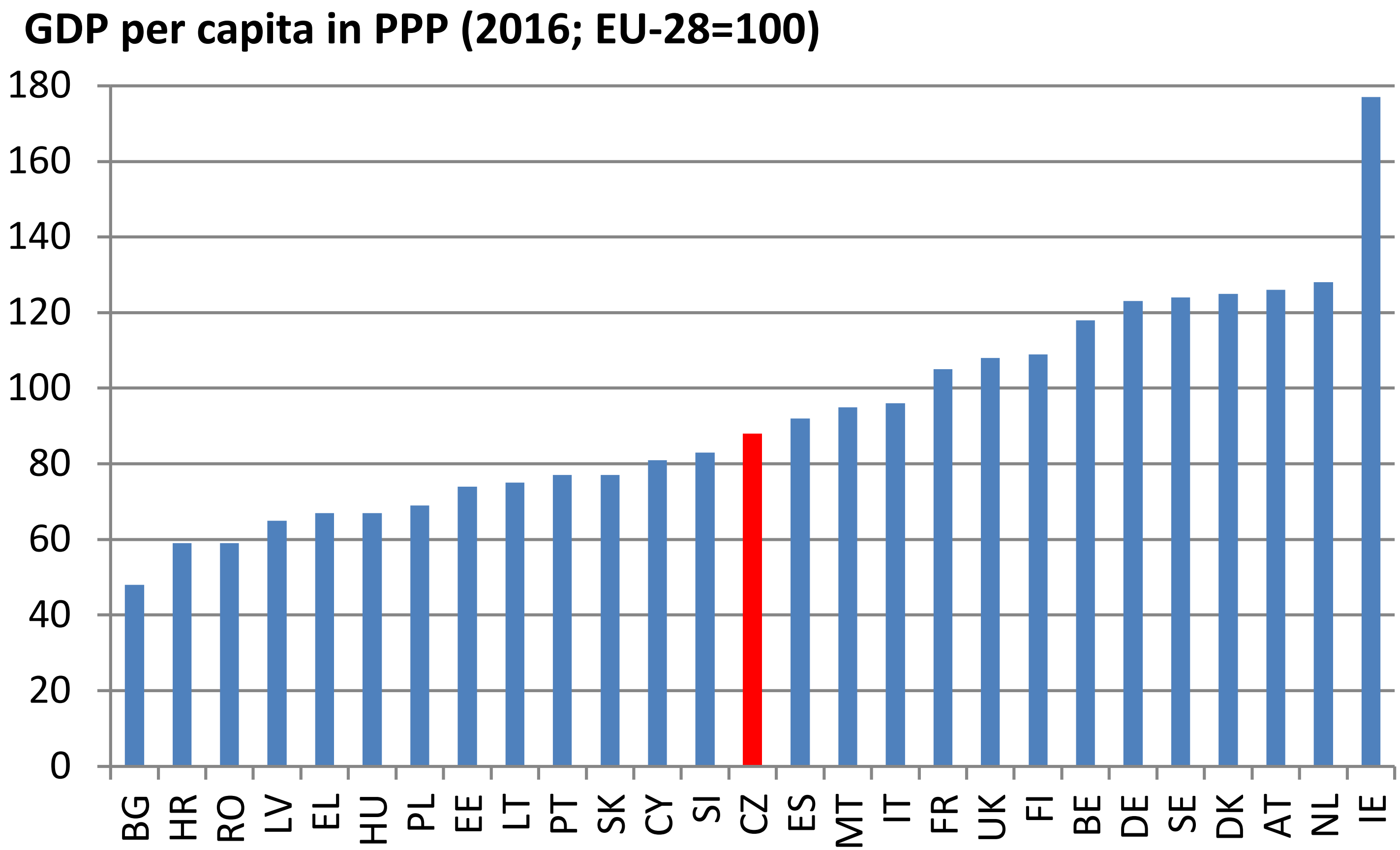
- Convergence until 2008, GDP per capita in PPP declined relative to EU-15 during the world financial crisis
- Real convergence renewed starting in 2013 but price converge still falling behind

Real and nominal convergence still unfinished



Source: Eurostat

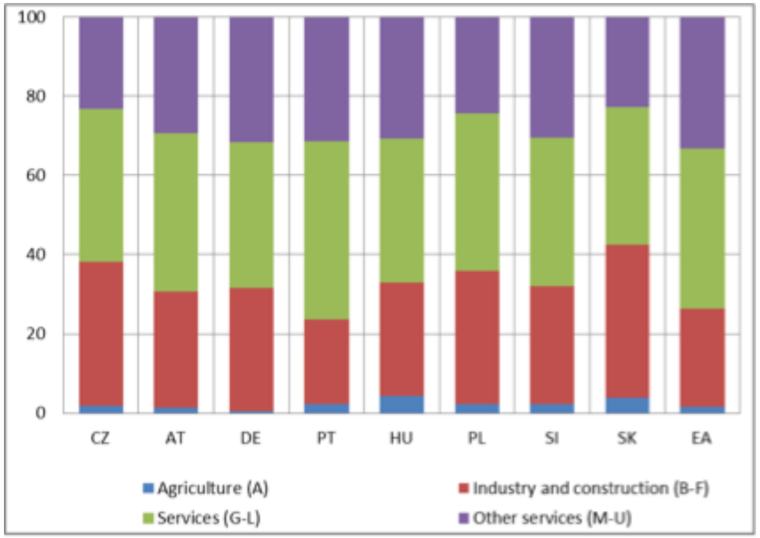
GDP per Capita in PPP (EU-28)



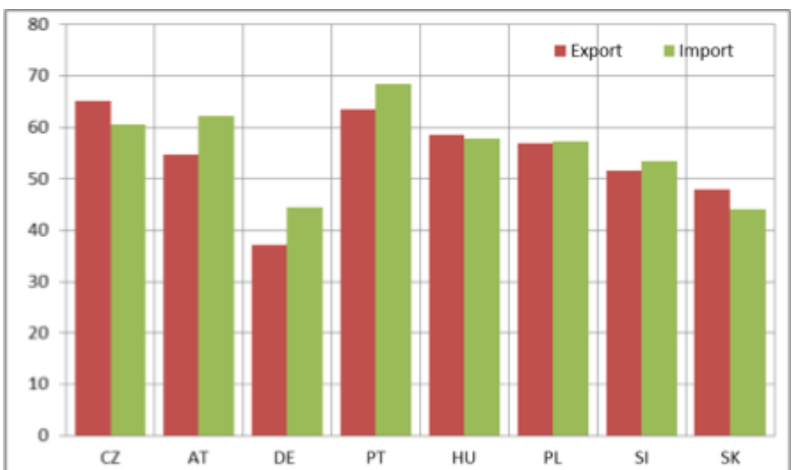
Note: LU not shown (267).
Source: Eurostat

Structural Convergence

Shares of economic sectors in 2016 (%)



Shares of exports and imports to the euro area in 2017H1 (% of total)



Source: Eurostat and CNB's calculations

- Structural similarities reduce risks of asymmetric effects of economic shocks
- Higher share of industry in the Czech economy, lower share of services – both relatively stable in time
- Strong trade and ownership links with the euro area increase the benefits of eliminating potential exchange rate fluctuations

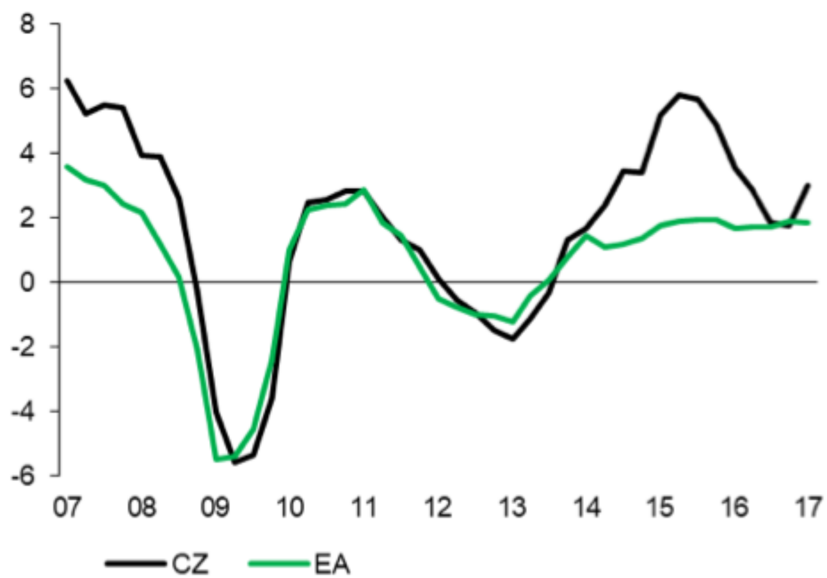
Trade and ownership structure are the main arguments for the euro

Cyclical Convergence

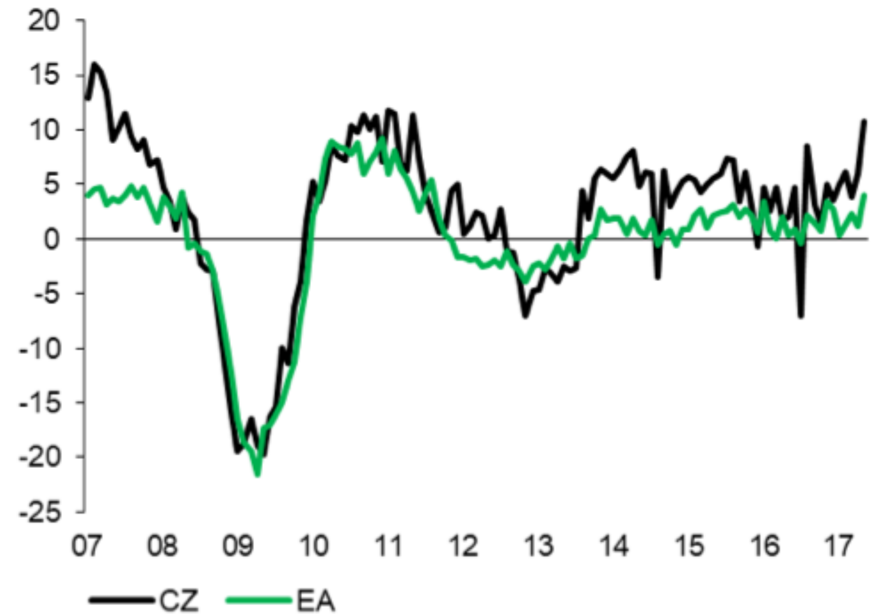
- The cyclical alignment => single monetary policy well configurated for the Czech economy
- Optimum currency area => the loss of independent monetary policy is less costly for a country with a more correlated business cycle

Analyses indicate a high degree of cyclical alignment

Real GDP growth in the Czech Republic and the euro area (% YoY)



Growth rate of industrial production index in the Czech Republic and the euro area (% YoY)



Source: Eurostat and CNB's calculations

Adjustment Mechanisms: Fiscal Policy

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Fiscal policy ideally countercyclical

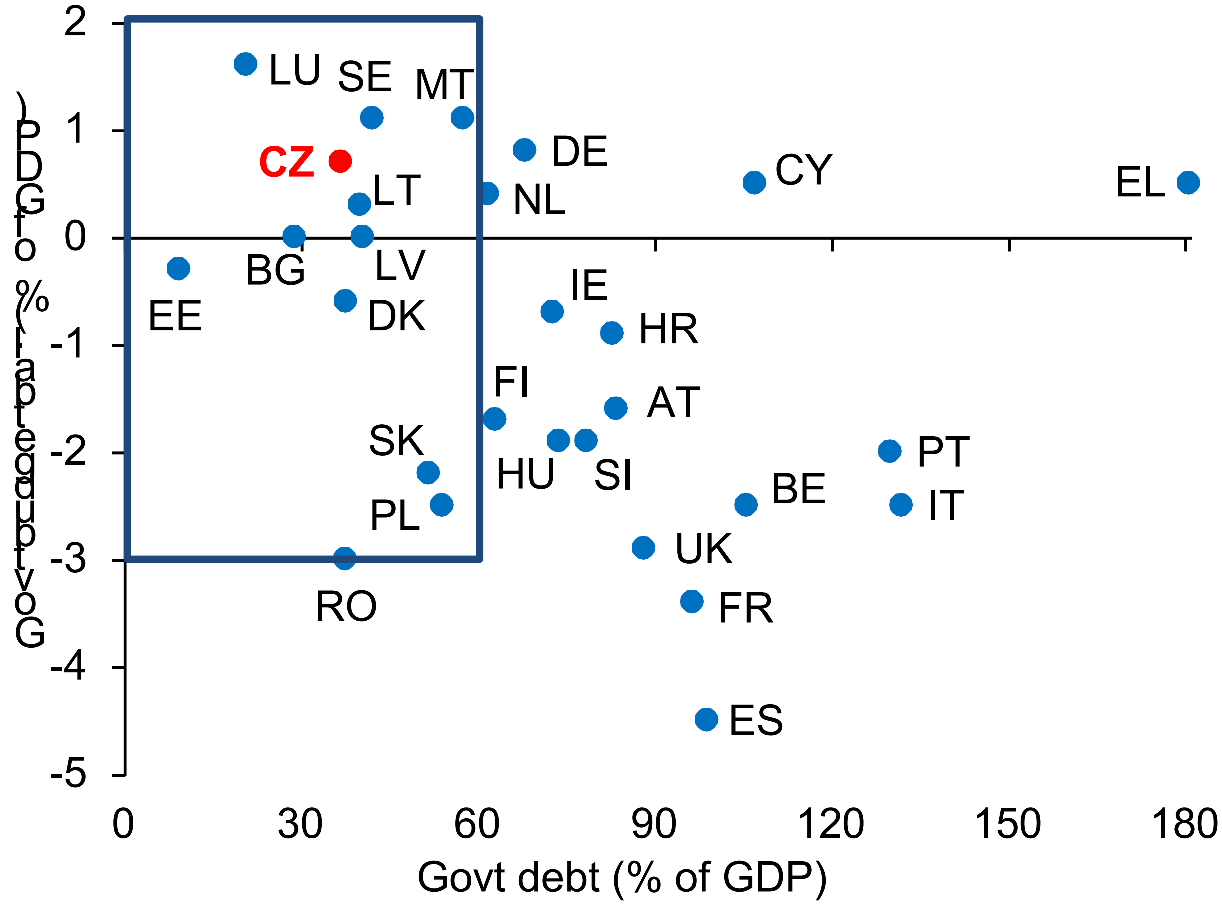
- Lower structural deficits and lower debt => more space to cope with downturns and recessions
- Improvement of the structural balance since 2014 – structural surplus in 2016
- Government debt is low but coping mainly with population ageing (pension and health expenditures)

Sufficient fiscal space nowadays

Fiscal policy might be able to fulfill its role in the future

Fiscal Positions of EU-28 Countries

Fiscal positions of EU-28 countries

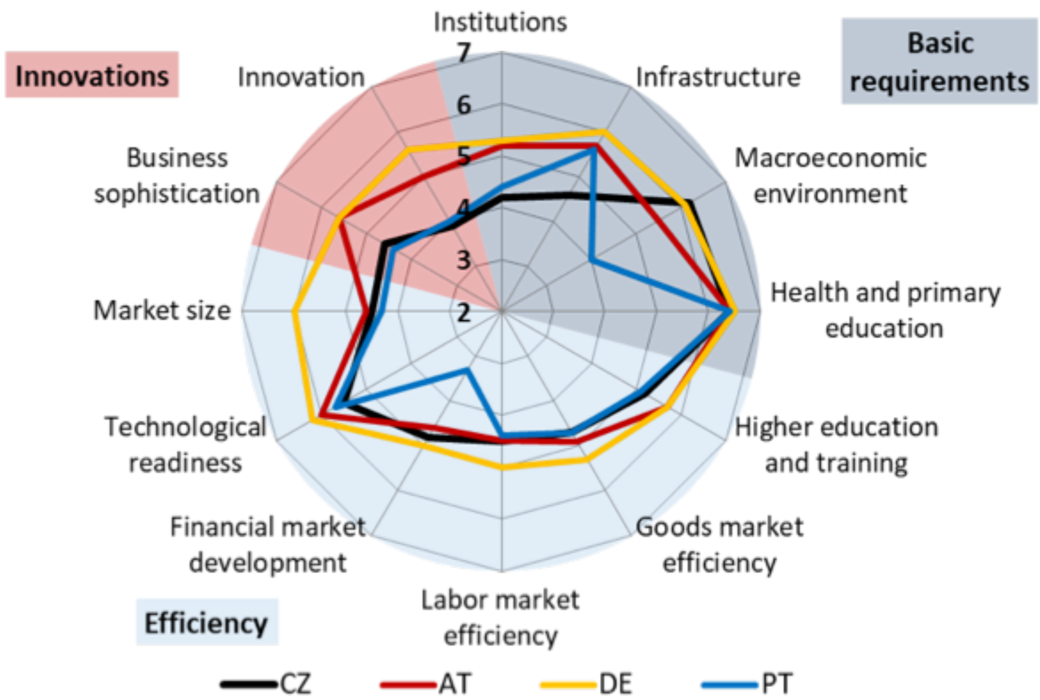


Note: 2016 data. Countries compliant with the Stability and Growth Pact lie in the marked area.
Source: Eurostat.

Business environment is still more burdened by administrative and regulatory barriers than those in the other countries under comparison.

Space to improve and catch up with advanced countries

Barriers to growth and competitiveness (GCI)



Source: World Economic Forum

Reasons for not setting a target date

- Areas showing misalignment
  - Unfinished process of real economic convergence (price level, wage level)
  - Long-term sustainability of public budgets is not fully resolved
  - Differences also persist in the structure of the Czech economy compared to the euro area
- Euro area entry will in reality also be conditional on participation in the new institutions and mechanisms (costs relating to joining the ESM)
- The economic situation in the euro area itself still cannot be assessed as sufficiently stabilised either

Assessment of the Euro Area

New Elements in Economic Management

- Banking Union
- Strengthened fiscal surveillance
  - Tightened SGP rules (Six-Pack, Two-Pack)
  - Minimum requirements for fiscal frameworks
- Fiscal Compact (Treaty on Stability, Coordination and Governance in the Economic and Monetary Union)
- Oversight of macroeconomic imbalances
  - Excessive imbalance procedure
- Crisis management instruments
  - EFSM – European Financial Stabilization Mechanism
  - EFSF – European Financial Stability Facility
  - ESM – European Stability Mechanism
- The European semester – a new framework for policy coordination (country-specific recommendations)
- The Euro Plus Pact

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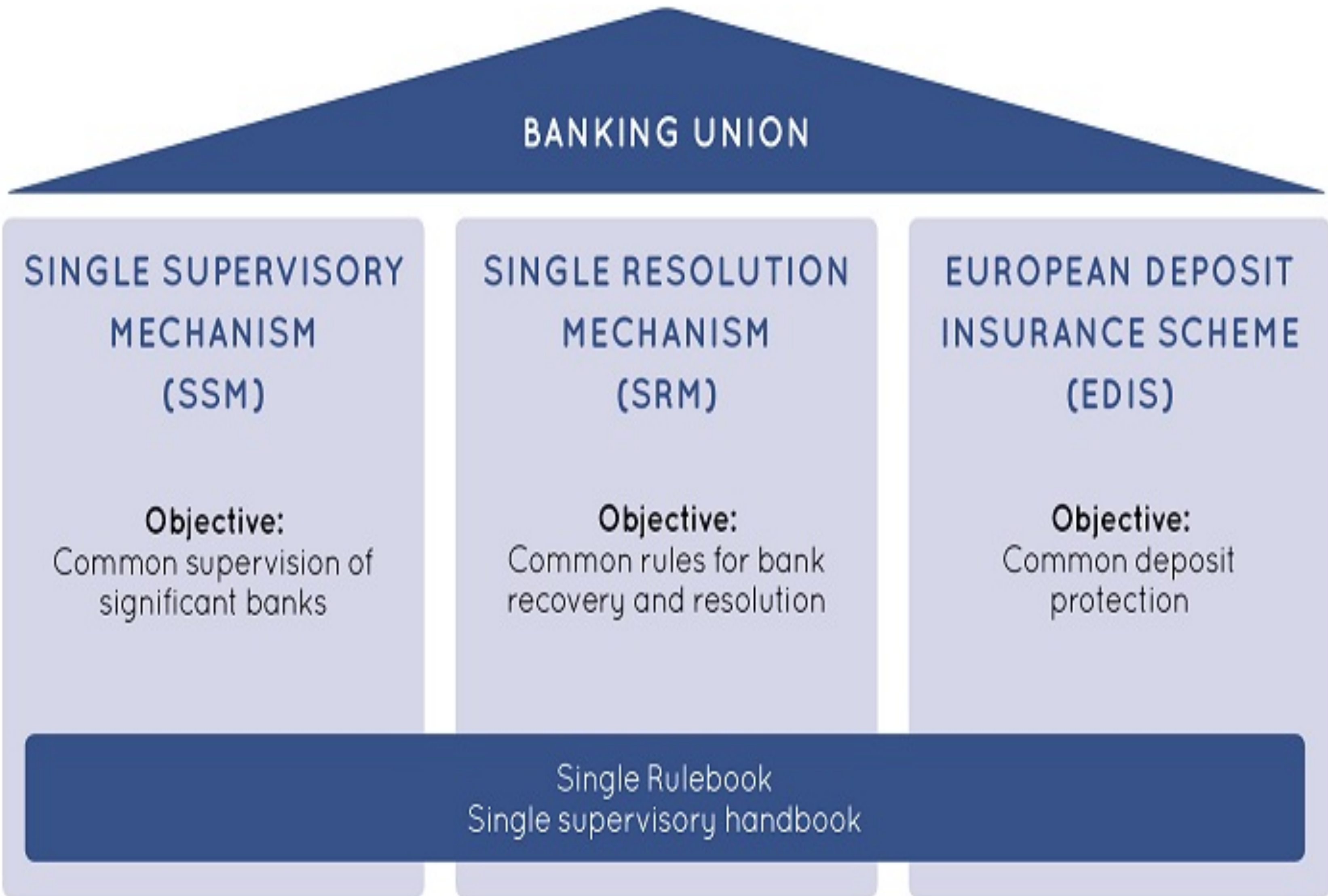
- A key rationale for the banking union was to cut the vicious circle between banks and national public finances

Structure of the Banking Union



The Banking Union Should Help to Break the Link Between Banks and Sovereigns

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- Banks should be stronger and more immune to shocks: Common supervision should ensure effective enforcement of stronger prudential requirements for banks, requiring them to keep sufficient capital reserves and liquidity. This should make EU banks more solid, strengthen their capacity to adequately manage risks linked to their activities and absorb losses they may incur.
- Failing banks should be resolved without taxpayers money, limiting negative effects on governments' fiscal positions: bank resolution should be financed by banks' shareholders and creditors and by a resolution fund financed by industry. Banks should not be bailed out and government fiscal position should not be weakened further.
- Banks should no longer be "European in life but national in death" as they should be supervised by a European mechanism and any failure should also be managed by a European mechanism.

The Banking Union is Incomplete and its Implementation not Convincing

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- **2 main elements of the BU missing**

A) Pillar III (European Deposit Insurance Scheme)

B) The fiscal backstop for Pillar II

- the reason: too much risk-sharing (or redistribution?); the first step into the fiscal union (no control of expenditures by the MS!)

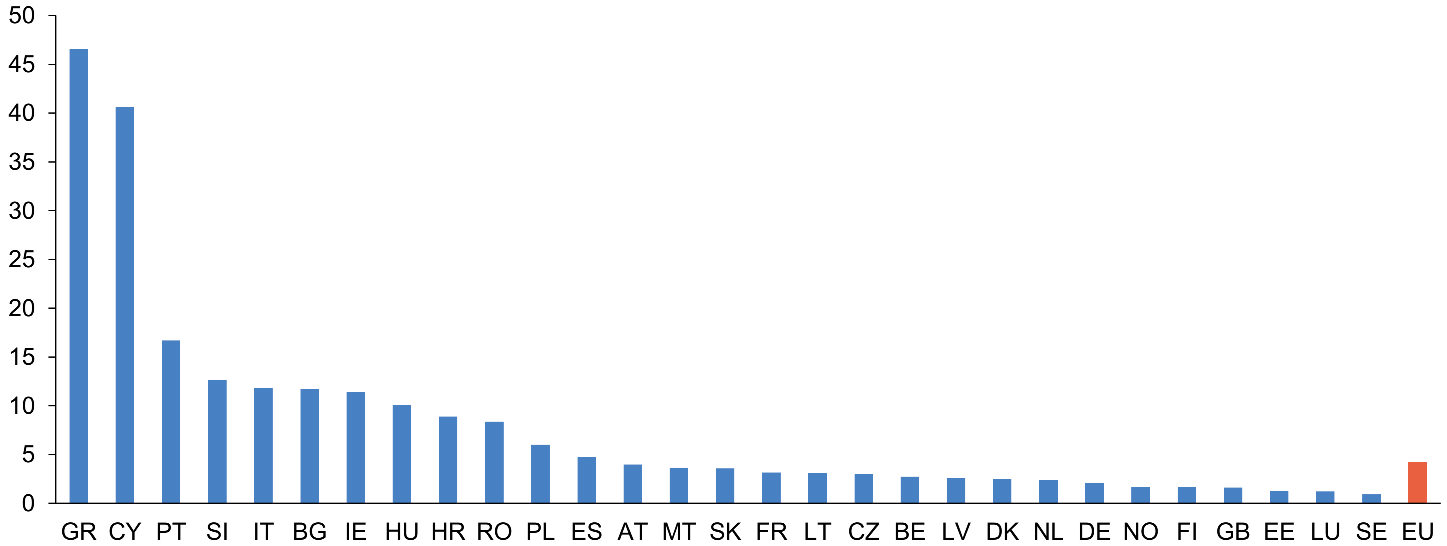
- **The implementation of the resolution mechanism so far not very convincing**

- in line with the letter, but against the spirit of the new resolution system (bail-in; no costs for the tax payers): the case of two Italian banks („*Death in Venice* for the Banking Union“)

Non-Performing Loans (NPL) in the EU

- Gross NPLs amounted to 5.1% of gross loans in the EU at the end of 2016 (7.3% of EU GDP)
  - High figure by historical standards, higher than in other jurisdictions (US, Japan ~ 1.5%)
  - Differs significantly across EU countries (from 1% to almost 50%)

Non-performing loans by country (% of gross loans)



Note: Data refer to September 2017.
Source: EBA Risk Dashboard, December 2017.

High Stock of NPLs – Why Is It a Problem?

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High stock of NPLs negatively affect:

- Resilience of the banking sector to shocks and hence increase the systemic risk
- Bank profitability
- New lending (and monetary transmission)
- Economic growth

Conclusion

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- The Czech economy would manage to join the Euro Area (fiscal sustainability, labour market)
- **Euro Area (and the Banking Union) still incomplete and with many question marks**
- Therefore questionable if the Euro Area becomes the centre of gravity of further EU integration
- Despite the discussions on the euro adoption have recently intensified in CZ, it is not on the agenda in the near future
- Our obligation to adopt the euro is debatable because of new elements linked to this obligation

Thank you for your attention

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Annex

Macroeconomic Environment Index 2017

Value from 1 (low) to 7 (high)

Notes: The macroeconomic environment index is a composite indicator of the Global Competitiveness Index 2017 consisting of single indicators measuring: fiscal, monetary indicators, saving rate and sovereign debt rating.

Source: World Economic Forum

Public Support to the Euro