Zdeněk Tůma: EU enlargement and monetary integration

Remarks by Mr Zdeněk Tůma, Governor of the Czech National Bank, at the 3rd ECB Central Banking Conference "The New EU Member States: Convergence and Stability", Frankfurt, 21-22 October 2004.

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Ladies and gentlemen,

It has been only recently since we had become members of the European Union. It is only natural that, once the immediate effects of the enlargement have subsided, policy-makers´ attention should shift towards the next step - monetary integration of the twenty-five current EU member states.

The first thing to be considered when discussing European monetary integration is how the different countries will go about adopting the euro. There is no universal strategy that can be used by all new EU member states. The euro may either be adopted rapidly, or after a longer interim period. In the pre-EMU period, the emphasis can be put either on ensuring the low inflation required by the Maastricht Treaty domestically, or on importing it by fixing the exchange rate. The key factors that determine which strategy to adopt are, in my opinion, the size and flexibility of the domestic economy, the current monetary-policy regime and its credibility as well as the state of public finances.

Specifically, small countries that have lived with fixed exchange-rate regimes for the last ten years, and have thus developed economies flexible enough to compensate for fixed exchange rates will most likely benefit from faster adoption of the euro. They are also likely to rely on importing price stability from abroad during the interim period. Larger countries that have invested heavily in developing a credible independent monetary policy but still have more to do in the area of fiscal policy reforms and flexibility of domestic economies, will probably opt for a more cautious approach. They are likely to prefer avoiding double regime switches, opting instead for a smooth and fast transition from the current regime to euro adoption.

The Czech Republic belongs to the latter group. The Czech strategy for euro adoption is based on a cautious timescale. In the pre-EMU period, we want to ensure low inflation domestically, not by importing it. In the strategy, we have pointed to the years 2009-10 as the most likely entry date. In comparison to other new EU member states, this timescale had been viewed as relatively cautious. However, it should be said that other countries in the region have recently pushed back their initially more optimistic estimates. The primary reasons for this more cautious timescale are - in all cases - fiscal developments.

In the pre-EMU period, we will continue targeting inflation. This strategy has gained a substantial degree of credibility in the Czech Republic since its introduction in 1997. Our inflation target for the period beyond January 2006 is set at 3% (for CPI), which should allow us to fulfil the monetary side of Maastricht convergence criteria, and at the same time to reflect the long-term real convergence needs of the Czech economy. In our experience, inflation targeting is capable of producing a sufficiently strong nominal anchor for the economy, and consequently also of stabilising the exchange rate, obviously in the absence of large external shocks.

Hence, in favourable circumstances, inflation targeting will allow us to achieve price and exchange-rate stability simultaneously. Should circumstances become less favourable, the simultaneous achievement of both will be difficult no matter which monetary strategy is adopted. That is why we do not consider ERM2 to be a policy regime superior to the current regime. In line with this stance, we have agreed with the government to stay out of the ERM2 mechanism for the time being. We plan to introduce ERM2 after conditions for meeting all Maastricht criteria within a two-year timeframe have been established.

There is still a number of issues to be discussed, let me address two of them. First, is inflation targeting compatible with ERM2? Second, what is the impact of policy debate about the modifications to the SGP on our forthcoming effort to meet the Maastricht criteria? As far as the compatibility of the two regimes is concerned, namely inflation targeting and ERM2, the specific arrangements have not yet emerged from our ongoing debate. We believe that relying on the economic analysis and intuition rather than on background legal documents as a guide, there is no need to modify the current strategy significantly. It will be able to deliver both price and exchange-rate stability. However, monetary policy alone cannot guarantee the smooth progress of adopting the euro. It is of crucial importance that the whole policy mix is supportive of this goal. The recent failure to enforce SGP rules in the existing euro area should not be taken as an excuse for postponing fiscal reforms in the new EU member states. On the contrary, it should be interpreted as a warning signal that the Maastricht criteria should be met by a sufficient margin prior to euro adoption in order to create an adequate buffer for difficult periods.

Having said that, I would like to emphasise that monetary integration is not only about the adoption of the euro by the new EU members; it is a more general process - a continuous improvement of our common institutional framework, monetary strategy and analytical techniques. There is a very solid foundation upon which to build a common future for our twenty-five countries. This year the euro celebrates its fifth anniversary. Let me take this opportunity to congratulate the ECB for the successes achieved so far. The currency changeover, the lack of historical euro-data, the need to build the credibility of the newly established central bank - these were all challenges that were successfully overcome. The euro has emerged as a stable, highly credible, and important international currency. As a result, we can now discuss the monetary integration of all current EU member states with confidence.

The word “integration” can mean different things in different circumstances. For me today, it means that all current EU member states will contribute as much as they can to these improvements with their own ideas, knowledge and experience. The new ESCB members are prepared to contribute their share. They have gained a wealth of experience from a decade of economic transformation, a decade during which they used a wide variety of monetary policy strategies, from inflation targeting to currency boards, in order to deliver low inflation. Let me mention just a couple of lessons that were learnt:

- how to make decisions and produce good-quality economic forecasts when faced with large uncertainty (eg. about available data)
- how to bring the economy back to low inflation after a series of supply-side shocks and how efficient communication is crucial in such circumstances
- and that maintaining low inflation is much easier providing fiscal discipline and policy co-ordination can contribute to the task.

These issues will surely be familiar to others. The knowledge gained during the transformation period will enrich the policy debates of the ESCB´s councils and working groups. This is how monetary integration will happen on a day-to-day basis both in countries that already use the euro and in those that will introduce it in the future.