Miroslav Singer: The Czech Republic outside EMU – a success story born from painful lessons. A Czech view on resolving the euro crisis

Speech by Mr Miroslav Singer, Governor of the Czech National Bank, as part of the OMFIF (Official Monetary and Financial Institutions Forum) Golden Series on World Money, Reform Club, London, 28 June 2011.

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A horrible end is better than endless horror.

Lieber ein Ende mit Schrecken als ein Schrecken ohne Ende. Ferdinand Von Schill (1776–1808)

Ladies and Gentlemen,

As we all know, the eurozone is facing serious problems at the present time. It is my opinion that there are important lessons to be learned from the collapse of the Bretton Woods system in the early 1970s. The Czech policy authorities learned these lessons – often the hard way – first of all after the split of Czechoslovakia 1993, and again during the financial and currency crisis that hit the Czech Republic later in the same decade. In my speech today I will recall these lessons and examine how they can be applied in order to minimise the costs of resolving the eurozone debt crisis.

Before going any further, however, I'd like to draw your attention to four basic – and surprising, perhaps even shocking – facts about the Czech Republic. First of all, it may come as a shock to some of you to learn that the Czech Republic is not an Eastern European country. In fact, its capital, Prague, lies more than 90 miles west of Vienna. In the words of a famous Londoner – the actor Michael Caine – "Not a lot of people know that".

What is more, the Czech economy is further west than you might think not just geographically, but also economically. This brings me to shocking fact number two. Despite tepid real growth averaging 3%, the Czech economy has grown by 10% on average in recent years thanks to appreciation of its exchange rate. Therefore, the Czech economy has multiplied in size more than 4.5 times since 1993 in nominal terms in euros. Consequently, it could have bought on average more than 7% p.a. of the core European countries' real GDP over the last 18 years.

And now for shocking fact number three. Despite, or maybe thanks to, our first-hand experience with financial crisis (bad loans exceeded 40% of GDP in the late 1990s), no bailout has been needed and no taxpayers' money has been used to save any Czech financial firm in the latest turmoil.

Finally, and a good deal less shockingly I'm pleased to say, the Czech National Bank has been not only the central bank, but also the integrated supervisor of the Czech financial industry since 2006. This set-up gives us many advantages in terms of dealing with the financial crisis and maintaining financial stability at national level, and it hopefully also enhances our understanding of the current events in the eurozone.

I'd now like to remind you of some important events which, I feel, provide us with important lessons and guidance for dealing with the current crisis. The first of these was the collapse of the Bretton Woods system at the beginning of the 1970s. The key lesson from this event was the so-called Impossible Trinity, namely that it is impossible to have a fixed exchange rate, free capital flows and independent monetary policy all at the same time.

Cracks started to appear in the Bretton Woods system in the 1960s as a result of globalisation of the financial system and enormous growth in cross-border capital flows. This process was accelerated by the expansive fiscal policy of the USA, which fostered monetary expansion, a loss of competitiveness of US producers and growth in the US trade deficit. As

soon as the rising demand for dollars exchangeable for gold encountered the limited stock of US gold reserves, the credibility of the US dollar foundered. This loss of credibility undermined the very foundations on which the global monetary system was built. The fall of the Bretton Woods system teaches us that a fixed exchange rate requires a consistent macroeconomic framework and corresponding coordination of all aspects of monetary policy. Various adjustments to this set-up might reduce some partial imbalances, but if the cause of the problem is not tackled head on, the effects of such adjustments will be short-lived and it will only be a matter of time before the whole system comes crashing down.

Now let's move forward in time some 20 years, to the split of the Czechoslovak currency following the dissolution of Czechoslovakia in 1993. For many years, fiscal transfers had masked the significantly inferior performance of Slovak economy relative to its Czech neighbour to the west. This performance gap was further widened by the closing-off of the Slovak armament industry from the federal centre at the beginning of the 1990s. After the country split in two, the stated goal of keeping a common currency came under market pressures as Czech and Slovak entities transferred their deposits to Czech banks and capital flowed out of both countries. As a result, this goal was abandoned in less than two months and an independent Czech crown – or koruna – was introduced. I should add that the CNB had its plan B and had been running preparations for the currency split since the second half of 1992. Consequently, after it had decided to act, it was able to act fast.

So, what lessons can we learn from this event? The lack of political will to preserve the federal Czechoslovak state had quickly recognisable consequences for the common currency. As a result, the costs of the event were relatively low and order was quickly restored in both new currency markets. Despite the U-turn in decision-makers' communication, the situation had been easy to read by markets, citizens and economic agents in general.

A few years later, the Czech economy was hit by a severe currency and financial crisis. Until 1996, the Czech Republic maintained a fixed exchange rate regime and generally stabilisation-oriented (restrictive) macroeconomic policies. However, entry to the OECD and related capital flow liberalisation created an Impossible Triangle. This led to twin deficits and attempts to "half-free" the exchange rate regime similar to those made in the Bretton Woods case. Additional factors such as data errors and an insufficiently credible first reform package only exacerbated the problems. Serious worries of the Czech National Bank about its credibility and reputation contributed to its mistakes. A change of government made acts of government less predictable.

The defence of the exchange rate was ended by the central bank without the knowledge of the government. This caused a wide rift to open up between these two authorities. A general lack of coordination of macroeconomic policies, and possibly too restrictive monetary policies, culminated in a severe financial crisis. The outcome was a very costly event that could, with the benefit of hindsight, be judged as avoidable to a significant extent. General U-turns made by policy authorities contributed to these high costs. Even for the majority of market players, many of the decisions taken at the time were difficult to predict, read and adjust to. The chief conclusion from these two Czech-made episodes of turmoil is that predictable actions produce lower-cost outcomes than unpredictable ones. This time the CNB had no plan B, so after the fixed regime was abandoned, it took several months to prepare the first coherent monetary policy framework after the end of the fixed exchange regime.

All of which brings me to the current parlous situation of the eurozone. Let me start with a few observations. The eurozone's mechanisms have supported economic divergence rather than convergence. The rules are not only wrong, they are manifestly and idly ignored regardless of their quality. To see this, consider for example that the eurozone's debt exceeds the Maastricht debt criterion by one-half, and its deficit exceeds the deficit criterion by a factor of almost two. Only three eurozone countries – Finland, Luxembourg and

Estonia – fulfil the Maastricht criteria. The belief that eurozone membership has disciplining consequences after joining has been proved unsubstantiated.

As in the case of the Czech crisis of the 1990s, political and economic policy authorities have made numerous U-turns at state and EU level during the crisis. There have been volte-face, for example, on bank bailouts and the necessity for them, on the need to relax monetary policy in Europe, on the state of the EU financial sector, on the no-state-bailout clause, and on the sufficiency of the current Greek package.

In addition, several false myths have been propagated, for example on the consequences of Greek bankruptcy for the German and French banking sectors and on the need for the ECB and central banks to have positive equity. In fact, numerous central banks have negative equity yet have no problems operating if they are credible enough. The real capital of a central bank is its credibility and reputation, not a figure on its balance-sheet. Credibility and reputation are virtues that thrive on consistent and credible policies and communication. Another myth is that the eurozone cannot survive a Greek default. Why not? Is it insolvent? Are there significant trade dimensions between Greece and the eurozone? According to available DTCC data – which is incomplete but very probably covers the majority of cross-border transactions – even CDS that are now so often mentioned should not present a systemic problem for the European financial system. Note that CDS on Greek debt are higher than a year ago, but the euro is stronger than at the peak of last summer's Greek crisis. The markets do not appear to think that Greece is that fundamental to the survival of the eurozone. Finally, it is implied that if we solve the debt problem, Greece and Portugal are saved. They are not. Competitiveness is the real issue for these countries. No economy can survive and thrive unless it is competitive.

The upshot of the recent U-turns is that the markets are completely confused and do not see any predictable outcome to adjust to. They see no will to allow Greece to leave the eurozone and depreciate, but they also see no willingness to support the country sufficiently. The solution to the crisis has already been made unavoidably costly due to past incredible and unclear communication.

There are two possibly costly but credible ways to restore competitiveness. The first is a solution within the framework of the eurozone. This would involve restructuring the debt and imposing and rigorously enforcing fiscal discipline. But the structural reforms are hardly enough to restore competitiveness within a short enough period of time in such a scenario. In addition, tens of billions of euros in aid would have to flow from the strong eurozone economies to the weak ones to restore competitiveness. Such generous aid would very probably have to be conditional on the distribution of the aid not being managed by the Greek authorities. The ECB would provide liquidity support – and assurances of such support – to the Greek banking sector. I believe that given the relatively small size of Greece – and even, if need be, of Greece and Portugal – both those actions are within the realm of the politically feasible.

The second way out of the crisis is the "classic" IMF prescription, that is to say, fiscal discipline, debt restructuring and currency devaluation. Note that to make such a scenario easier some aid is also very desirable at least in the form of support for the drachma from the ECB and/or European authorities (among others) to avoid an overshooting after the exit from the eurozone.

Note that we are currently seeing a rather disorderly effort along the lines of the first scenario of keeping the current eurozone together. In the same spirit we could see an orderly exit from the eurozone, if there is the political will. In short, to minimise the costs, either scenario needs to be carried out in an orderly way, while disorderly implementation results in dramatically increased costs in both cases. Therefore, instead of the current muddling through, one of these two ways should be chosen and clearly communicated to markets, voters and others. Otherwise, we risk a further loss of credibility for everyone involved in Europe and very likely for the IMF as well. Further continuation of the current uncertainty will

continue to cause significant economic costs for the EU and Europe in particular. At present, the risk of an event pushing Greece (and/or others?) into unexpected default is shooting up. That would surely be the most costly outcome, at least in the short term. We need to avoid a repeat of the 1997 Russian default, where Russia received a programme of aid, everyone expected it to work, but the needs turned out to be much bigger two months later.

There is also a very rapidly increasing risk of citizens running on Greek banks as well as a rocketing risk of some other EU/eurozone country's voters producing an outcome that will, in addition to other more likely and more profound consequences, further complicate finding a solution to the technical issues, i.e. how to structure the debt restructuring.

To conclude, this is a crisis whose causes lie in eurozone institutions, which we were assured were created – together with the eurozone itself – to prevent crises. Without further close involvement of eurozone institutions, including the ECB and eurozone member states, it will most probably result in a disorderly meltdown of at least some European economies. On many levels, including the level of European institutions, the crisis was caused by incoherent and/or insincere communication, which increased the uncertainty of market participants in the broad sense. Our country's history tells us that a generally predicted loss of a currency fix has much lower costs (including political ones) than an unexpected one. If eurozone countries and EU institutions opt for "safe" Greek membership in the eurozone, they must present a solution that is broad, generous and general enough to convince the markets of its credibility. This solution had better come fast, though, as muddling through has significant economic costs and increases the risks dramatically. In the meantime, the authorities should at least avoid communication that increases the risk of a run on banks and of angering the voters of fiscally sounder eurozone states. Last but not the least, a plan B would be highly desirable.

Let me end by stressing that any disorderly outcome clearly goes against all the interests of the Czech Republic and its economy. There is now no possibility of a happy (i.e. relatively costless) end. But we should end the uncertainty. After all, muddling through the current crisis is clearly occupying European decision-makers to an extent that is preventing them from solving the issues important for the core and crucial parts of the eurozone and EU – for example, how to change this part of the world, which is currently sliding down the global relative benchmarks quite fast, in a way that will enable Europe to regain its past ability to compete globally.