Zdenek Tuma: Present and future challenges for the Czech National Bank

Introductory remarks by Mr Zdenek Tuma, Governor of the Czech National Bank, at the CNB Conference: ”Challenges of EU Accession”, Prague, 1 April 2003.

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Ladies and gentlemen, dear colleagues,

It is my pleasure and honour to welcome you here to the Czech National Bank for what I believe will be a very interesting policy-oriented conference.

The Czech National Bank is this year celebrating a decade of its existence as the central bank of the Czech Republic. When we look back at that period, we can see many difficult challenges that we had to face in order to facilitate the economic transition and later on to bring our operations into line with best international practices. This experience is similar for all other central banks in the post-communist EU-accession countries. But I do not want to speak about those past challenges today. They are mostly behind us, and our situation is now very different. Therefore, I would like to be forward-looking - as any modern central banker should - and to speak about the challenges that we all share at present and, most importantly, about those that lie ahead.

As you all know, the accession treaties will be signed in two weeks. This will be a symbolic milestone in the EU integration process, which has been going on in the economic and political sphere for many years. The implications of this process for monetary policy - and economic policies in general - have been debated extensively on many occasions. These academic discussions have covered the pros and cons of EU and EMU accession, its optimal timing, the associated risks and so on. Not surprisingly, they have often been inconclusive and could continue for many years to come. However, time presses us, as monetary policy-makers, to cope with these fundamental uncertainties and to make decisions, designing clear steps to be taken to meet the EU accession challenges.

Therefore, I am glad that we have gathered here to discuss our future policies. The topics are the same for all of us, and we thus have many ideas to share. But even before we get to the discussion, I would like to stress that in many areas we are unlikely to find universal solutions for all countries. Policies need to take into account the particular circumstances of each accession country, such as its current economic situation, monetary policy regime and fiscal stance. For example, the way towards the eurozone in an accession country with a currency board will be completely different from that of an inflation targeting country with a floating exchange rate. But there may be important differences within these two broad groups, too. So it should come as no surprise that a number of countries have indicated a clear preference for the “fast-track” approach, whilst others have adopted a more cautious approach. I hope that our debate today will cast more light on these country differences.

EU accession per se will probably have relatively little effect on the way monetary policies are conducted in the new member states. It may, however, create some challenges, for example by affecting inflation rates. Given that the harmonisation and integration processes in the economic field have been under way for a long time, I personally do not expect accession itself to be a pronounced shock. Nonetheless, there are still some remaining factors, such as the final steps in the harmonisation of indirect taxes, the introduction of EU customs policies and the adoption of the common agricultural policies, which may have a non-negligible one-off impact on inflation. It is certainly useful to debate this impact in terms of its likely size and the appropriate responses by the central banks.

EU accession is also likely to influence the real convergence process in the medium run. In fact, it has been influencing it long before the accession date itself, through FDI inflows, declining risk premia, pressure for structural and legal reforms, and so on. Related to that, there have been many discussions on the potential trade-offs between the real and nominal convergence processes. It has been questioned whether the accession countries can simultaneously achieve low inflation, nominal exchange rate stability, consolidated public budgets and sufficiently fast economic growth. It has often been argued that economic growth should be given priority at the current stage, and only later on should the nominal convergence goals be pursued more vigorously. As a result, we have heard many warnings against fast EMU entry.

In reality, however, most of the accession countries have already achieved impressive results in the nominal convergence process. They are now among the countries with moderate or even very low inflation rates, and their nominal interest rates have converged to the EU levels. In the majority of cases, no practical problems with achieving the Maastricht criteria on inflation and long-term interest rates are thus envisaged. Moreover, this progress has often been achieved simultaneously with satisfactory growth performance, even though some countries have gone through periods of growth slowdown correcting previous imbalances in their economies.

Therefore, I think that the potential conflict between real and nominal convergence has often been exaggerated. The two processes have different time horizons, nominal convergence being achievable in the medium-run, whilst real convergence remains a long-run matter. There is, however, one particular link between the two processes that needs to be taken into account when we design our policies towards EMU accession.

Faster GDP growth is likely to lead to a real exchange rate appreciation, making it impossible to have both very low inflation and a completely stable nominal exchange rate. This issue is well known and has received much attention. At the current stage of development, however, we need to shift from purely qualitative judgements to quantitative analyses of what has caused the real exchange rate appreciation trends in many accession countries. For example, the majority of empirical studies of the well-known Balassa-Samuelson effect have concluded that this hypotheses explains only 1-2 percentage points (or even less) a year of the observed real appreciation in Central European countries. This necessitates searching for other influential factors and forecasting their development for the future.

The implications of the real appreciation process are probably different for those countries with hard pegs against the euro compared with countries that have floating exchange rates. In the case of currency boards, the only channel of real appreciation is an inflation differential. As the Maastricht inflation criterion is relatively strict, even a relatively modest pace of real appreciation might lead to complications. It will be certainly interesting to hear today if these countries really perceive this challenge as serious and what alternative policies - such as fiscal policies and/or income policies - they can use to overcome the problem successfully. For countries with more flexible exchange rates, the Maastricht exchange rate criterion is less binding, and a modest nominal appreciation trend can be accommodated within its fluctuation bands. It will be interesting to hear whether we all share this view. Another question is whether we see any implications of the real appreciation process for designing the details of our ERM2 membership, such as its duration or the chosen central parity.

This brings me to the issue of ERM2 membership and its consistency with our current monetary policy regimes. The proponents of the ERM2 regime argue that it is a useful monetary policy framework which can have a disciplining impact on domestic policies, limit exchange rate volatility, and help determine the conversion rate for EMU entry, but at the same time provides enough flexibility. Even though there is no doubt a valid point in all these arguments, some of the accession countries' central banks have expressed much less enthusiasm about the ERM2. I wonder whether we are able to reach a consensus on this subject today. On the practical level, we all have to define our policy positions as regards the appropriate timing of ERM2 membership, choice of central parity, supportive policy mix and so on. Our debate should pay attention to the differences among the individual accession countries in addressing these policy issues.

So far, I have focused on the monetary aspect of EMU entry only. In many cases, though, monetary policy is unlikely to be the major bottleneck in the accession process. For many countries, the key practical constraint seems to be their public budgets. Notable exceptions are the Baltic States and a few other candidate countries, for which there seem to be few obstacles to early eurozone entry in this respect. But many other countries run large public deficits, even after subtracting one-off transition costs. The necessary reforms would have to include changing the public finance structure to address the ageing problem, overly generous social security systems, etc. These are problems shared by all European countries, and are politically quite hard to resolve. The consolidation of public budgets to a sustainable position is thus one of the key challenges for some accession countries (as well as for the present EU members). This is all the more true because upon EU accession the Stability and Growth Pact will also become relevant to the new member states. This is something that has not been fully realised and appreciated yet, at least in the Czech Republic. It will be very interesting to hear the experience of the other accession countries.

There are many more aspects to the accession debate. These include balance-of-payments developments and exchange rate issues; the role of structural policies in achieving the optimum-currency-area criteria; the role of fiscal and income policies in fulfilling the Maastricht criteria both on inflation and on exchange rate stability; financial sector reforms and developments, including their implications for monetary transmission; and so on.

I could spend much longer discussing these matters, as well as focusing more deeply on the issues that I have already mentioned. Nonetheless, I do not want to prejudice our debate by volunteering my own opinions at the very beginning of this conference. Therefore, let me stop at this point and pass the floor to the chairman of our first panel debate, Mr Jakob A. Frenkel (from Merrill Lynch International). Before I do that, though, I would like to welcome you once again and thank all of you for accepting our invitation to this event.