“Recent developments in the European Union: a look to the East”

Speech by Professor John (Iannis) Mourmouras

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at the University of New York in Prague

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Dear Prime Minister Jan Fischer,
Your Excellencies,
Ladies and Gentlemen,

Introduction

It is a great pleasure for me to be with you today in beautiful Prague and I would like to thank the University of New York in Prague (UNYP) for inviting me to address fellow professors and high-flyer students, who may one day be among Europe's top businessmen and policymakers. This is why it is important for me to share with you my thoughts as an economist and an official on some of the key issues on the political and economic agenda at this very significant time for our continent and the world.

In terms of the structure, I will start my speech with a look into the major risks for the global economy and then turn to our continent, Europe, to discuss the current state of the eurozone economy and architecture as the euro turns 20 this year. Finally, I would like to focus on Central and Eastern European (CEE) states, 15 years after their entry into the European Union, and of course our host country today, the Czech Republic, its macroeconomic situation and potential entry in the euro area sometime in the future.

1. Risks to global growth in 2019

As global growth is starting to lose momentum, there are two major short-term risks to the global growth outlook. The first concerns the escalating trade conflict threatening the world's economy and, more particularly, the question of how the US President Trump's trade war against China will pan out and whether steps will be taken to solve existing trade tensions. The second is the uncertainty over global monetary policies and tightening financial conditions.

1.1 Global trade tensions

Let me begin with the US-China trade war, which many consider to be the key risk this year (see Table 1). Even though this has not led to a significant slowdown in world trade, thanks in particular to the robustness of US demand, the negotiations are expected to remain a key topic in 2019. The latest round

of actions (10% tariffs on US$200 billion of US imports from China and 5-10% tariffs on US$ 60 billion of China's imports from the US) are set to make a more material economic impact than previous ones (see Table 1).

Table 1 Timeline of trade tensions since January 2018

Date	Event
22 Jan. 2018	Announcement by the US administration of the introduction of customs tariffs of 30% on solar panels and 20% on washing machines.
23 March 2018	Customs tariffs on US imports of steel (25%) and aluminium (10%) take effect (Section 232 of the Trade Expansion Act). The exemptions initially granted to Canada, Mexico and the European Union ended on 1 June 2018. South Korea, Australia, Argentina and Brazil will be exempt from these tariffs but will have to limit their export volumes. According to data published by the Peterson Institute, USD40.9 billion worth of goods would be affected by the tariffs, i.e. 1.7% of total US imports in 2017.
23 May 2018	The Trump administration asks Commerce Secretary Wilbur Ross to lead an investigation into the impact of imports of automobiles and parts on national security (Section 232 of the Trade Expansion Act). The United States imported USD359 billion in cars, car parts and engines in 2017 according to the Census Bureau, i.e. 15.3% of the country's total imports. On 22 June 2018, President Trump threatened the European Union with the application of 20% tariffs on US imports of European cars and car parts. On 25 July 2018, D. Trump and JC. Juncker agreed to a gradual phase-out of tariff and non-tariff barriers on non-automotive industrial goods.
22 June 2018	In reaction to the application of US tariffs on steel and aluminium, of 10% and 25%, respectively, representing EUR6.4 billion in European exports, the European Commission voted in favour of increasing customs duties to 25% on imports worth 2.8 billion euros coming from the US. The list of products targeted breaks down into steel products for one-third, agricultural products for one-third (corn, rice, peanut butter, bourbons) and industrial products for one-third (boats, leather shoes, cosmetics, jeans), all exported from states that are politically strategic for Donald Trump.
6 July 2018	Additional tariffs of 25% on the first tranche of USD34 billion of goods from China were applied (Section 301 of the Trade Act of 1974). On 23 August, customs tariffs were applied to the second tranche worth USD16 billion. Based on the accusation of unfair practices by Beijing with respect to intellectual property, technology transfers and innovation, the Trump administration announced that it was imposing customs tariffs on 1,102 technology products coming from China. The US Trade Representative specified that the list of goods specifically targets products related to China's 'Made in China 2025' industrial policy. The Americans thus targeted the aerospace, IT and communications, robotics, industrial equipment, new metals and automobile sectors. The USD50 billion of goods represent 2.1% of total goods imported to the US, 9.9% of Chinese exports to the US, and 2.2% of total Chinese exports.
6 July 2018	In response to the trade measures imposed by the US, China also imposed customs tariffs on goods imported from the US for a total of USD50 billion. Like the United States, Beijing imposed tariffs on an initial amount of USD34 billion on 6 July – primarily for agricultural products such as soya and seafood imports and the automotive segment – and on the remaining balance of USD16 billion on 23 August.
17 July 2018	The European Union and Japan signed a free trade agreement (the Economic Partnership Agreement – EPA) representing 30% of world GDP and 600 million consumers – the largest free-trade zone in the world – to counterbalance the US protectionist attempts. This agreement notably includes free access to the Japanese markets for 85% of European agri-food products as well as free access to the European market for Japanese automobile exports – at the end of a seven-year transition period. This agreement is expected to be implemented in 2019.
24 Sept. 2018	Additional tariffs of 10% imposed by the US take effect on USD200 billion of Chinese imports. Tariffs of between 5% and 10% imposed by Beijing on USD60 billion of goods from the United States. US tariffs were supposed to be increased to 25% on 1 January 2019. However, on 30 November, the presidents of the US and China reached a 90-day truce on raising tariffs, postponing the decision to increase tariffs to 25% to 1 March 2019.
16 Oct. 2018	The Trump administration announced its intention to negotiate three separate trade agreements with Japan, the European Union, and the United Kingdom.
30 Nov. 2018	The presidents of the US and China reached a 90-day truce on raising tariffs, postponing the decision to increase tariffs to 25% to 1 March 2019.
1 March 2019	End of the trade truce. The United States will decide whether to raise customs tariffs on USD200 billion of imports from China to 25%.

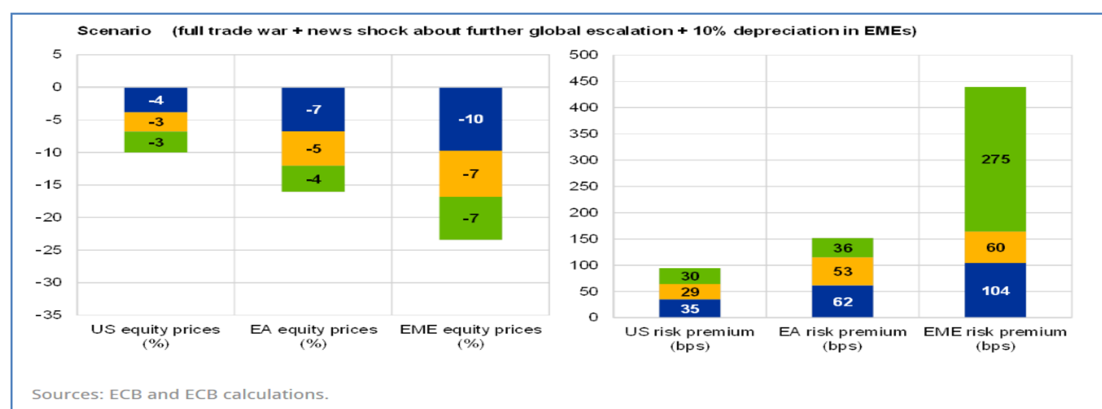
Source: Bloomberg.

The Presidents of the US and China reached a truce on the raising of tariffs, conditional on efforts made by Beijing with regard to demands from the US, which expires end of the month. If no significant progress is made, the increase of 10% to 25% on US $200 billion of imports from China would take effect on 1 March 2019. Estimates from the Peterson Institute in Washington DC suggest that the US now has tariffs on 12% of its total imports, while the combined trading partner retaliation covers 8% of total US exports, with the latest round having a bigger impact on households as more consumer goods have become subject to tariffs. A further increase in the tariffs that the US

applies to Chinese imports – from 10% to 25% in early 2019 – could negatively affect business and financial market sentiment.

As a recent ECB publication[1] shows, an escalation to a more generalised trade war could lead to a significant drop in asset prices (see Figure 1).

Figure 1 Full trade war impact on asset prices across the globe



Sources: ECB and ECB calculations.

In this scenario, US equity prices would fall by about 10% and US corporate bond spreads would increase by up to 100bps in the first year. In the euro area, equity prices would fall by 15% and corporate bond spreads would increase by 150bps in the first year.

1.2 Uncertainty over global monetary policies

Last year global monetary policy stances diverged. At one end of the spectrum was the US Federal Reserve which raised its key interest rates 4 times from 1.50% to 2.50%, confirming its gradual approach to monetary tightening. At the other end, the People's Bank of China, and the Bank of Japan continued their ultra-loose monetary policies, while European Central Bank concluded its quantitative easing via PSPP. 2019 seems to be a different story from a central bank perspective as a "risk management" approach seems to prevail. Let me give you briefly my own insights on the global policy outlook:

Starting with the Fed: After the dovish speech by the Fed Chair Jerome Powell at the Economic Club of Washington, D.C. last month, which set the record for a data-dependent monetary policy, following the Fed's projection for a GDP growth rate of 2.3% in 2019 from 2.9 in 2018, the market participants no longer price in any hike in the Fed Funds rate this year. Chair Powell made it clear there would have to be a "reason" to hike rates and that reason would have to be inflation.

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[1] European Central Bank, *The resurgence of protectionism: potential implications for global financial stability,* 27/11/2018.

Turning to the ECB, the ECB will continue reinvesting the principal payments from maturing securities purchased for an extended period of time, contributing to accommodative monetary policy and favourable liquidity conditions. Moreover, markets expect the ECB to extend its long-term loan programme to the banking sector (TLTRO). At the last GC meeting, the ECB left its key interest rates unchanged and also left its forward guidance unchanged, but moved to describing growth risks “on the downside” and did not take any decision on TLTROs.

Regarding **the Bank of England,** monetary policy remains subject to the outcome of Brexit. The high level of uncertainty forces the *status quo* to prevail in the short run. Hence, the basis for the Bank’s ‘hawkish’ policy signalling seems more doubtful.

In Japan, **the Bank of Japan** maintained its deposit rate at -0.10% and its 10-year target yield close to 0.00%. It also announced that it would extend this policy on a long-term basis due to low inflation, so there is no monetary tightening in sight.

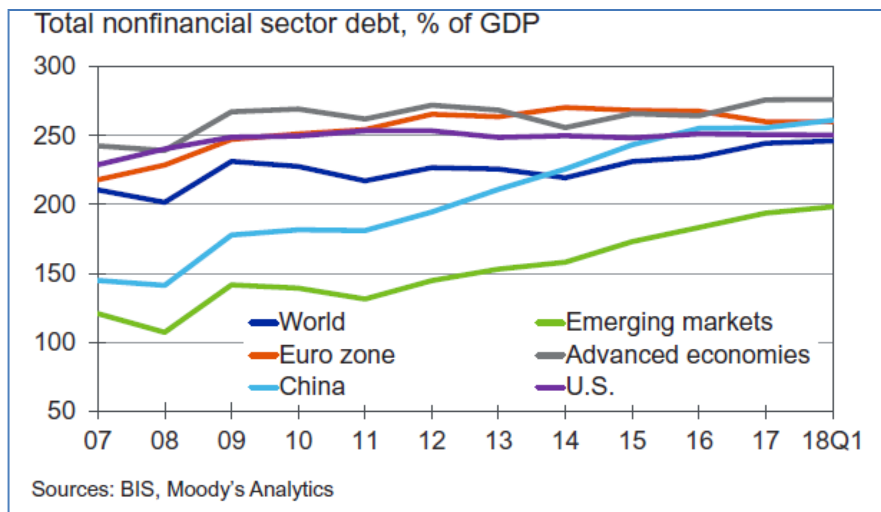
Last but not least, **the People’s Bank of China (PBoC),** continues its accommodative monetary policy expanding the liquidity offered to the banking system in 2019 by strengthening the measures put in place in 2018. Furthermore, earlier this month, PBoC decreased by 100 basis points in its reserve requirement rate, bringing it to 13.5% for big banks.

1.3 Other risks

1.3.1 The US $247 trillion global debt mountain

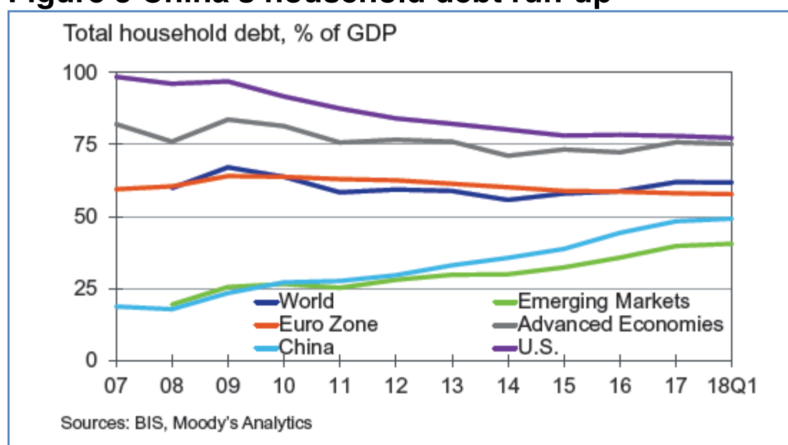
Another alarming feature for the global growth outlook is the global debt levels which have reached new records both in dollar terms and in relation to GDP. Total global debt owed by households, governments, non-financial corporates and the financial sector - reached 318% of gross domestic product, while excluding the debt of financial companies like banks, total gross world public and private debt reached a record 246% of GDP exceeding the previous record of 213% in 2009 (see Figure 2).

Figure 2 Debt rises across the globe



A higher proportion of the debt has accumulated in China and other emerging markets. Indeed, China's total non-financial debt has risen over the past 10 years from 141% of GDP in 2008 to 261% in the first quarter of 2018. It has risen above the ranks of other emerging markets to exceed that of the US and match the eurozone's. Moreover, China's household debt hit a record high at almost 50% of GDP in the March quarter of 2018, according to the BIS (see Figure 3).

Figure 3 China's household debt run-up



Elsewhere, Japan and the US account for more than half of that global debt, while in the euro area, government debt remains at very high levels, around 85%. Finally, public debt in the emerging markets has increased by 11% of GDP over the past five years, reaching 51% in 2018, approaching levels last seen during the 1980s debt crisis driven mainly by sizeable fiscal deficits and the domestic currency depreciations vis-à-vis the US.

1.3.2 Brexit

Four pending outcomes

Following the heavy defeat of PM May's EU Withdrawal Agreement at the House of Commons mid-January, there are now four possible Brexit scenarios: 1. A delayed Brexit 2. A hard Brexit 3. A second referendum and 4. A general election. We are only weeks away from the 29 March deadline and PM May's attempts to renegotiate the withdrawal agreement do not seem to be successful. So there is a real possibility of the UK exiting the EU without a specific legal framework and even without a transition period. Whatever the outcome, there is now justified heightened uncertainty about what the future holds for the relationship between the UK and the EU. With the deadline approaching, pressure rises on firms to make contingency plans for an abrupt and disorderly exit. As a result, financial services firms have no choice, but to continue preparing for the worst outcome ("no deal"), hoping for the best.

I expect that we will have a delayed Brexit. I hope common sense will prevails that we will avoid a hard Brexit.

2. The euro at 20

This year we celebrate the 20th anniversary of the European single currency and the eurozone. In 1999, stage III of the Economic and Monetary Union (EMU) irrevocably fixed exchange rates among eurozone member states and transferred authority over monetary policy to a pan-European, centralised institution, the European Central Bank. The first decade of a prolonged cycle of economic expansion and prosperity was followed by the 2010-12 sovereign debt crisis, resulting in high levels of unemployment and poor growth performance. This very severe debt crisis, which hit countries on the europeriphery the hardest. Four of them (Greece, Ireland, Portugal and Cyprus) had to follow adjustment programmes to bring their economies back on track, including my own, Greece. Despite the continuing divergence between the North and the South with regard to real wages and productivity, overall the single currency has been a success. Nevertheless, it would be naïve to attribute the debt crisis solely to the failings of some European Union member states without recognising the shortcomings of monetary union's architecture.

2.1 Adjustment programmes in the eurozone

I will very briefly look into these four countries' experiences with adjustment programmes. Table 2 below summarises a number of characteristics of these programmes in the europeriphery.

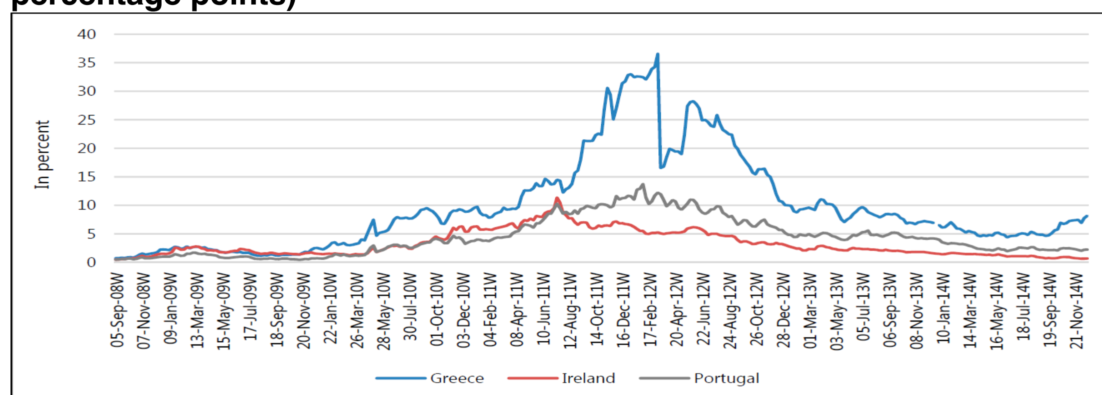
Table 2 Overview of the Financial Assistance Programmes in Greece, Ireland, Portugal and Cyprus

Overview of the Financial Assistance Programmes in Greece, Ireland, Portugal and Cyprus									
Country	Type of Crisis	Date of approval	Date of expiration	Amount in € (bn)	EFSF/ESM LoansWeighted Average maturity	Review Average Duration	Number of governments	Capital Controls	Type of Exit
Greece	Sovereign Debt/Competitiveness	May 2010	August 2018	110 (52,9+20,7)+ 172,6 (141,8+11,6) +86(40,2)	30,2	6,7	5	From June 2015	
Ireland	Banking/Real Estate Bubble	December 2010	December 2013	67,5	20,8	3,0	2	No	"Clean" (Post-programme surveillance without precautionary credit line)
Portugal	Sovereign Debt/Competitiveness	May 2011	June 2014	78 (50,3+26,5)	20,8	3,4	2	No	"Clean" (Post-programme surveillance without precautionary credit line)
Cyprus	Banking	April 2013	March 2016	10 (6,3+1)	14,9	4,9	1	From April 2013 to April 2015	"Clean" (Post-programme surveillance without precautionary credit line)

Source: Bank of Greece.

One can see in the above table that Greece has received about €240 billion from all three programmes, while the other countries have received much lower amounts, Ireland €67.5 billion, Portugal €76.8 billion and Cyprus €7.3 billion. While it is widely believed that the euro area crisis started from Greece, incidentally the first sign of crisis within the euro area appeared in Ireland after Bear Sterns was rescued in March 2008, whereby Irish sovereign spreads started to diverge noticeably. Nine months later, in December 2009, there was heightened pressure on GGBs. Greece was the first country though within the euro area to sign a financial assistance programme, and unfortunately the last one to exit from such a programme.

Figure 4 Ten-year government bond yields in euro area crisis countries vis-à-vis German Bund yields (September 2008-December 2014, in percentage points)



Source: Haver Analytics.

During this period, Greece experienced a dramatic fall in output (more than 25%), the unemployment ratio almost tripled from 9% in 208 to 26% in 2015, a huge fall in the standards of living and valuations of assets (real and financial) and another mountain of private debt had been built up (around €220 billion in 7 years). So, what went wrong in Greece? There are several reasons for this, let me name just a few: the starting-point argument (a huge deficit that required a bold adjustment effort); errors in the design of the programme that include the mix of adjustment measures (a greater reliance on tax increases than public spending cuts), the value of fiscal multipliers that we show above, etc., the slow pace of implementation of structural reforms (due to a lack of programme ownership on behalf of Greek authorities); the fact that Greece is a relatively closed economy and, hence, internal devaluation may contribute negatively, in net terms, to economic activity, the fact that debt restructuring in 2012 should have occurred much sooner, i.e. at the beginning of the first MoU in 2010, a directionless economic governance in the first half of 2015 and the ensuing huge cost of the economy's backtracking, we lost valuable time then, which led to the imposition of capital controls, a severe distortion upon the economy; the wrong sequencing of reforms: product market reforms should come first, followed by labour market reforms, the exact opposite took place in Greece.

On top of the above reasons which are more or less commonly accepted, I would add a couple of other - rather technical and more subtle - reasons and this is my contribution to the relevant debate, my own two articles published in the FT and WSJ in 2012. In the first one I argue that the structural deficit should be the appropriate target variable and not the nominal deficit, since the cyclical deficit would correct itself through the economy's automatic fiscal stabilisers, provided that growth-enhancing measures supplement fiscal consolidation. In the second one, I argue that structural reforms work better and quicker when there is investment to capitalise on them and, more generally, demand in the economy because the more the recession lingers on, the harder it is to achieve positive results by implementing structural reforms. Such a demand element can be incorporated into an adjustment programme in monetary unions through the adoption of a broader concept of

conditionality, namely that of investment conditionality, along with fiscal and structural conditionalities.

These are important lessons to be drawn from the Greek experience, and hopefully this will be taken into account in the design and implementation of future adjustment programmes in monetary unions and will also be taken seriously into account in the decisions to be made by prospective members of the euro area, such as the Czech Republic.

Talking about Greece, the Greek bail-out programme ended successfully in August 2018. There should be no complacency or slackening of effort on behalf of the national authorities, especially in 2019, an election year in Greece. The government must commit to the implementation of growth-enhancing reforms, particularly in the public sector (including administrative reform and speeding up of judicial procedures). This will enhance the country's credibility in the eyes of international capital markets and credit rating agencies. Following a period of prolonged fiscal consolidation and private investment, the country needs an investment shock. In 2014, I suggested reducing primary surplus targets, along with slashing corporate tax rates drastically and gradually, in line with the fiercely competitive corporate tax rates applied by Greece's neighbours in the Balkans.

2.2 What the ECB did for the crisis

Amidst the crisis, the ECB used all the appropriate instruments at its disposal in order to ensure its primary priorities: price and financial stability. On the one hand, it contributed to price stability by reducing base rates, by cutting refinancing costs for countries in distress through the Securities Markets Programme (SMP), providing liquidity to banks through LTROs and TLTROs, announcing the Outright Monetary Transactions (OMT) programme, Emergency Liquidity Assistance (ELA) by national central banks to banks facing liquidity shortages, and of course its asset purchases as part of Quantitative Easing (QE). On the other hand, it has also been assigned specific tasks to be carried out through the Single Supervisory Mechanism (SSM) to ensure the safety and soundness of the European banking system, increase financial integration and stability and ensure consistent banking supervision. Currently, the ECB is directly supervising 118 "systemically significant banks", representing almost 82% of total banking assets in the euro area. The ECB's stress test results were made public last Monday, indicating that all banks improved capital basis with higher capital buffers than in 2016.

2.3 What the ECB is doing now

2.3.1 ECB reinvestments

The ECB will continue reinvesting the principal payments from maturing securities purchased for an extended period of time, contributing to accommodative monetary policy and favourable liquidity conditions.

The ECB has clarified that during the period of net asset purchases, principal redemptions of public sector securities will be reinvested in the jurisdiction in which the maturing bond was issued. An open issue remains – and this is my own personal view – that is, whether the ECB would reinvest maturing bonds introducing a new twist while respecting the capital key.

2.3.2 Balance sheet size

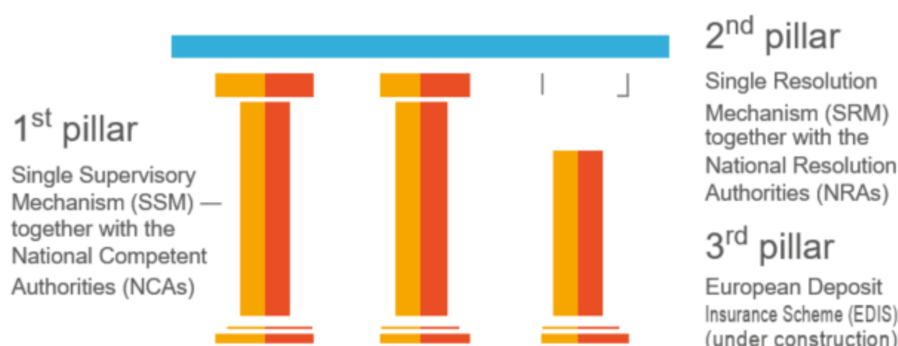
In terms of challenges ahead, beyond the reinvestment period i.e. beyond 2020, let me focus on a second, pivotal issue in the medium-term: this is the question of how long it will take the ECB to reduce the size of its balance sheet to its original – or another predetermined – level. My personal view is that there is no need for the ECB to rush to reduce the size of its balance sheet, as it is important to take into account the uncertainty created among market participants and avoid any potential market disruptions. There are other – conventional – tools to use if tightening is deemed necessary, including raising interest rates, increasing reserve requirements and using reverse repurchase operations to drain excess liquidity. What is important is to make sure predictability is safeguarded by presenting a normalisation sequencing roadmap, which would allow the balance sheet to shrink passively, by holding the assets purchased to maturity. In the case of the euro area, it would take 30 years to clear all the assets from its balance sheet after the purchases end and approximately five years to reduce asset holdings by half.

3. EMU reform

Turning now to the EMU, it would be naïve to attribute the debt crisis solely to the failings of some European Union member states without recognising the shortcomings of the monetary union's architecture. To address the next global downturn and ensure a stable euro, economic and monetary union must be deepened. The agreement, at last December's euro summit, on developing a budget instrument for the euro area and setting the terms of reference for the common backstop to the single resolution fund, was a welcome step. But progress is needed on the capital markets union and the banking union's third pillar, the European deposit insurance scheme (see Figure 5), consisting of a European Deposit Insurance Scheme (EDIS). It was scheduled to be introduced by 2025 to provide stronger and more uniform insurance cover for all retail depositors in the euro area, but has now been abandoned. There is now a discussion on creating a "high-level working group" to come up with the initial stages for its creation.

As we celebrate the euro's 20th anniversary, we need to stress that despite its imperfections, the euro is an integral part of European integration that is recognised by the public. The latest Eurobarometer survey (November 2018) showed that popular support for the single currency is at its highest (at 74%) since surveys began in 2002.

Figure 5 The three pillars of the Banking Union



Source: Single Resolution Board.

There are many initiatives on the table in the debate about deepening the EMU. Proposals such as a European safe bond and a European monetary fund will help mitigate the divergence between core and periphery countries and break the vicious cycle between banks and sovereigns.

According to the Commission's proposal on a **European safe bond**, investors can buy government debt into the euro area as a whole, rather than into one particular member state. This is different from a pooling of national government debt issuance, known as common Eurobond, which remains a political taboo in Germany. Sovereign debt across the eurozone could be bundled into a new financial instrument (ESB) and sold, if you like as a European brand, to investors.

The Commission also proposed turning the ESM into a **European Monetary Fund**, anchored in the Union legal framework. The tasks and the financial means of the ESM would be transferred to the EMF and should also be in charge of future sovereign debt restructurings.

4. Central and Eastern European (CEE) countries

Coming to Central and Eastern European countries now, they are expected to continue for the most part to record solid growth rates in 2019 (in the area of 3% or higher in some cases). In the case of the **Czech Republic**, the real GDP growth rate is projected by the IMF at 3% in 2019 [European Commission Winter 2019 Interim Forecast: 2.9%] and 2.5% in 2020.

4.1 Benefits from EU membership

After EU accession, the CEE region has been recording rapidly improving economic growth rates offering an attractive environment for foreign investment, stronger demand, easy financing conditions and of course making the most of available EU funding, mainly through the EU's structural and

cohesion funds. Under the current EU budget (formally known as the Multiannual Financial Framework or MFF) for the period 2014-2020, the 6 CEE EU Member States (that are not members of the euro area) are allocated €157 billion or 45.4% of the total amount earmarked for the EU's two structural funds (European Regional Development Fund - ERDF and the European Social Fund - ESF), and the Cohesion Fund. Among 6 CEE Member States, Poland is by far the largest recipient of EU structural and cohesion funds (22% of total allocations), followed by Romania (6.4% of total allocations) and the Czech Republic (6.2% of total allocations). By way of comparison, Greece has been allocated €15.8 billion, which represent 4.6% of total allocations. The CEE economies enjoy around 4% of GDP gross inflows from the cohesion and CAP funds on average during the current 2014-2020 EU budget cycle (see Table 3).

Table 3 EU funds allocated to CEE Member States and Greece under the Multiannual Financial Framework (MFF) 2014-2020

Country	In €	As % of total allocations
Greece	15,774,066,781	4.6
Bulgaria	7,312,413,787	2.1
Croatia	8,245,993,253	2.4
Czech Republic	21,501,038,980	6.2
Hungary	21,444,582,271	6.2
Poland	76,345,205,832	22.0
Romania	22,283,994,996	6.4
Total	**346,289,772,498**	**100**
Note 1: The figures refer to the two structural funds, namely the European Regional Development Fund (ERDF) and the European Social Fund (ESF), as well as the Cohesion Fund (CF).		
Note 2: EU funds allocated to other countries are estimated at about €160 billion.		
Source: European Commission.		

This may drop by 0.2%-0.7% of GDP during the next seven-year period. Under the new MFF 2021-2027, for which the European Commission presented its proposal to the Council of Ministers last May. The total budget is worth €1.28 trillion and amounts to 1.11% of EU gross national income, which is about 1/50th of most EU Member State government spending. The aim is for the new budget to be approved this spring, but the proposal has several contentious parts and difficult and long-drawn negotiations are expected between the Member States especially given the large budget gap to be left by the UK's exit from the EU which may be addressed through additional

funding from the EU-27, on which there is already strong opposition. A hard Brexit cannot be ruled out given the state of negotiations between the EU and the UK as the 29 March deadline approaches. Such a scenario could have a negative effect on CEE exports and investments and also be a factor influencing the discussion on euro adoption and I know that the Czech Republic is particularly interested in the outcome of the Brexit process.

4.2 The situation of the Czech economy

The Czech economy has close trade and ownership links with the euro area. The business cycle of the Czech economy is highly aligned with the one of the euro area, albeit over the past years decreased, and also the exchange rate developments of the koruna against the dollar is close to the fluctuation of the euro with respect to the dollar. The current situation of public finances is favourable (with a fiscal surplus of around 1% and one of the lowest debt-to-GDP ratios (32%) in the EU) and would allow fiscal policy interventions if needed and the labour market is flexible. The banking sector is deemed to be resilient, however, rising residential property prices and associated loans remain a risk.

The Czech economy has a high degree of openness and continues its shift towards more knowledge-intensive activities. Although it slowed down in 2018 compared to the previous year, it continues to operate above its potential with a GDP growth rate expected to reach 3.0% y-o-y (from 4.3% in 2017). The main driving force is domestic demand and specifically the growth of private consumption which has positive contribution to GDP growth in contrast with inventories and net exports which have a negative one.

The inflation rate is expected to reach 2.3% year-on-year in 2019, according to the IMF. Labour market conditions coupled with demographic constraints may be seen as potential downside risks for the country. Employment growth remained low (1.6%) in 2018 and it is estimated to further decease in following years, whereas population is further ageing and there is a shortage of skilled employees.

Macroeconomic risks remain primarily associated to the global factors that may affect sentiment on global markets. In addition, further protectionist measures in global trade and the actual conditions under which “Brexit” will take place remain major sources of external uncertainty. On the domestic front, some uncertainty is related to the potential effects of administrative measures in the coming years, including the third and fourth phase of the electronic sales registration and proposed VAT changes.

Strong export performance and participation in global value chains (primarily with respect to manufacturing) contributed the most in the overall remarkable growth performance of the Czech Republic. The Czech Republic’s economy relies strongly on the car industry sector. With a share of about 6 % on gross value added in 2017, manufacturing of motor vehicle ranks high in the EU. When taking into account also supply chains, the industry accounts for around 10% of the economic output. Foreign-owned companies have a strong focus on exports. Despite representing only around 13% of trading firms, foreign-

owned firms account for more than 80 % of total exports by value. FDI supports over 1/4 of all private sector jobs and 42% of the private sector's value added.

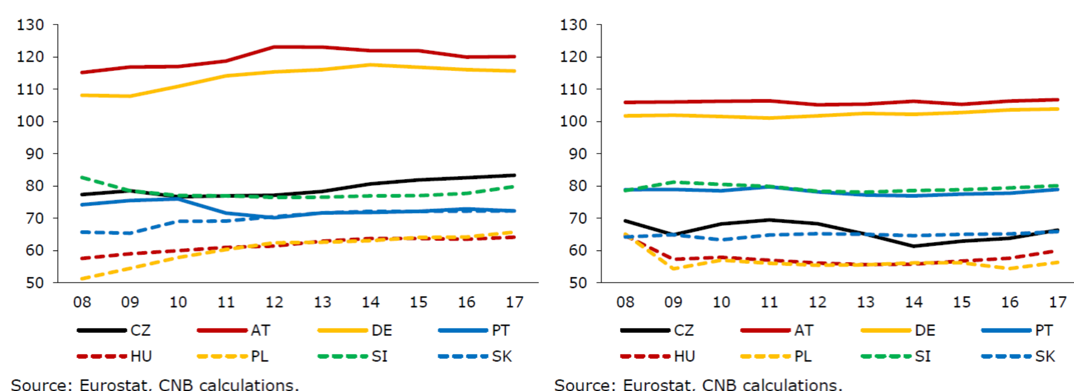
Monetary policy

Last Thursday, the Czech National Bank kept its main policy rate unchanged at 1.75%, after it had increased it by 125 basis points in 2018. The CNB´s rate hikes in 2018 mainly reflected the ongoing inflationary pressures against the backdrop of a weaker-than-expected koruna. The exchange rate defied the central bank's projections for appreciation in 2018 amid increasing uncertainty about the foreign demand development (weaker German and Chinese data, risk of trade wars and a potential hard Brexit, Italian budget plans, and an economic slowdown in China). While many of these risks may not materialize, a quick improvement of global sentiment that could trigger sharp koruna appreciation is unlikely, according to the CNB. The negative impact of the hard Brexit scenario on the Czech economy is likely to be partly offset by assuming a weaker koruna.

One last remark about CNB policies and the countercyclical buffer. The countercyclical capital buffer (CCyB) is part of a set of macroprudential instruments, designed to help counter pro-cyclicality in the financial system. Currently, in the Czech Republic, the countercyclical capital buffer is 1.25% and will reach 1.75% by 2020. Today, the highest countercyclical capital buffers (at 2%) are applied in Sweden and Norway. Its aim is higher resilience of the financial system to risks associated with the behavior of the banking sector over the financial cycle and especially with large fluctuations in lending, which amplify cyclical swings in economic activity. Therefore, by increasing the CCyB rate at this stage, the CNB is looking to protect the banking sector against potential losses associated with a build-up of cyclical systemic risk and thereby support a sustainable provision of credit to the real economy through the financial cycle. Moreover, the setting of the rate at 1.75% acknowledges the exposure and susceptibility of the Czech Republic economy to a downturn or the materialization of cyclical systemic risk, potentially arising from an external shock. The decision also reflects the expected limited impact on the credit environment and real economy at this stage.

4.3 The debate in the Czech Republic on euro area entry

Figure 6A GDP per capita at PPP and 6B Price level of GDP (euro area = 100)

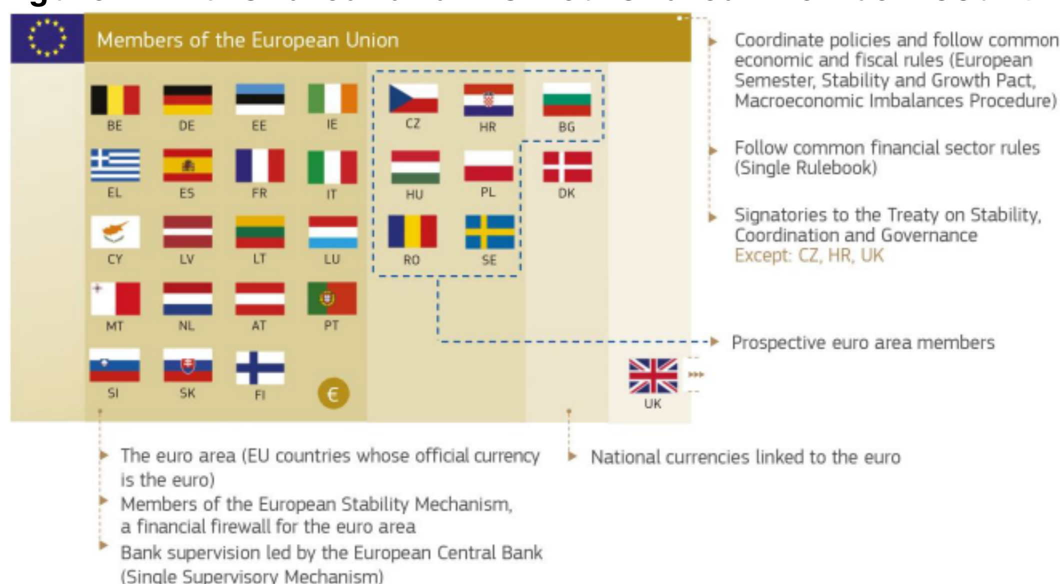


The unfinished process of long - term convergence towards the advanced euro area countries remains a barrier to early euro adoption. Although this process has resumed in all key indicators in recent years, the distance of the Czech Republic from the euro area average remains significant in most indicators. If the euro was adopted, domestic inflation could rise above the CNB's current 2% target due to equilibrium appreciation of the real exchange rate and convergence of the wage level. Czech GDP at purchasing power parity per capita has been converging towards the euro area average again since 2013, but is still lagging visibly behind it. This level only slightly exceeded 83% in 2017.

Among the countries under comparison, the Czech Republic is more advanced than other Central European non-euro area countries, but still lags well behind core euro area countries such as Austria and Germany (see Figure 6A and 6B below).

Following the accession of Lithuania on 1 January 2015, the process of euro area enlargement has stalled. Out of the 8 EU non-euro area Member States, two Member States have national currencies linked to the euro (see Figure 7 below). Bulgaria has stated its intent to join the interim Exchange Rate Mechanism (ERM2) and Denmark has opted out of euro area accession.

Figure 7 Euro area and non-euro area member countries



Source: European Commission, COM (2017) 821 final, “Further steps towards completing Europe’s Economic and Monetary Union: a roadmap”, p. 2.

Upon EU entry, the Czech Republic obtained the status of a Member State with a derogation from the euro. But it is up to the Member State to fix the date for euro entry, depending on how prepared it is to join EMU. This should be assessed not only from the perspective of legal compatibility and compliance with the Maastricht criteria (see below).

In order to function successfully in the EMU, it is important for the Czech economy to be able to operate without a flexible exchange rate of its currency and without an independent monetary policy as effective stabilising macroeconomic instruments. Of equal importance are the euro area’s economic and institutional situation and convergence of economic levels across countries. The current state of alignment of the Czech economy with the euro area economy with regard to potential euro adoption is assessed every year by the Czech Central Bank (CNB).

According to the CNB, the timing of monetary union entry depends on the impact of the EMU – banking union configuration, i.e. whether the reform aimed at safeguarding the stability of the euro area in the event of another crisis in future, will be completed. The CNB also weighs the impact of the exact content of the euro adoption obligation, since it is has recently been tied to participation in the Banking Union and ESM by other EU countries, for instance in the case of Bulgaria. This implies an obligation to contribute to the ESM’s capital and assume all the rights and duties of membership, including the ESM’s claims on Greece which will not start to mature until 2034. The sustainability of the Greek debt is therefore also deemed an important fact for the Czech Republic’s decision to enter the EMU. Of course, the Czech Republic could adopt the euro without becoming a contracting party to the

ESM, but the CNB fears that the euro area members can make their consent to euro adoption in the Czech Republic conditional on ESM entry.

The balance of the costs and benefits of introducing the euro will depend mainly on the timing of euro area entry. And a hard Brexit will weigh on that decision. The undoubted benefits in the form of a reduction in transaction costs and the elimination of exchange rate risk which will arise from euro adoption given the Czech economy's strong links with the euro area economy have remained broadly unchanged. But the costs and potential risks depend on several parameters, including economic convergence with the euro area in the economic and price level, which affects the long-term outlook of the Czech economy. The degree of alignment with the euro area over the business cycle is also a crucial factor, since it is the one that determines the appropriateness of the single monetary conditions for the Czech economy. In addition, an important parameter is the economy's ability to absorb potential asymmetric economic shocks using other adjustment mechanisms, lacking its own monetary policy. The Czech Republic would join the banking union upon entry into the EMU. As a result, a large proportion of the current powers of the national supervisory and resolution authorities would be transferred to EU authorities and supervision of systemically important banks would be performed by the ECB. A final factor that should be factored in are the direct financial costs and obligations of EMU entry and integration into the stabilisation mechanisms – both existing ones and those in the making as part of the deepening of the EMU.

The Czech Republic is today compliant with all but one of the "Maastricht criteria", designed to ensure nominal economic convergence between interested non-euro area countries with the Member States of the euro area (see Table 4 below).

Table 4 Maastricht convergence criteria

What is measured?	How it is 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
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
Exchange rate stability	Deviation from a central rate	Participation in the European Exchange Rate Mechanism for two years

Source: European Commission.

The Czech Republic is compliant with the first criterion of price stability, however, inflation is currently in the upper half of the tolerance band with respect to the central bank's target. Furthermore, the second criterion of the government fiscal position is met in both the budget balance and the debt components; but sustainability has to be resolved (see Table 5).

Table 5 Government finance indicators for euro area and non-euro area EU CEE Member States, EU and euro area

Country	General government net lending/borrowing (as a % of GDP)				General government gross debt (as a % of GDP)			
	2017	**2018**	**2019**	**2020**	**2017**	**2018**	**2019**	**2020**
Bulgaria	0.9	-0.9	-0.5	0	23.9	23.3	22.6	21.5
Croatia	0.8	-0.5	0.2	0.5	77.8	74.2	70.8	67.6
Czech	1.6	1.5	1.1	0.8	34.7	33.2	31.9	31.1
Hungary	-2	-2.4	-2	-1.9	73.6	71.3	69.1	67.4
Poland	-1.7	-1.5	-1.5	-1.4	50.6	50	48.5	47.2
Romania	-2.8	-3.6	-3.5	-3.5	36.8	37.2	38.8	39.8
Slovak	-1	-0.7	-0.5	0	50.9	49.2	46.7	45
Slovenia	-0.8	0.2	-0.1	-0.2	73.6	69.7	67.5	65.5
EU-28	-1	-0.9	-0.8	-0.7	83.2	81.4	79.3	77.4
Euro area	-0.9	-0.6	-0.6	-0.5	86.6	84.4	82	79.8

Source: IMF World Economic Outlook (October 2018).

Thirdly, the Czech Republic is compliant with the criterion of convergence of its interest rates and is likely to remain so until 2021. Only the fourth criterion has not been met yet. Here, I need to point out that an assessment of the exchange rate criterion would be possible only after the country joins the mechanism Exchange Rate Mechanism (ERM II) and the exchange rate fluctuations of the central rate of the koruna against the euro are monitored for a minimum of two years before assessment to adopt the euro. A parameter favouring euro entry is that the exchange rate developments of the koruna against the dollar is close to the fluctuation of the euro with respect to the dollar. Furthermore, the level of interest rates shows small differences with the euro area. However, Czech law does not fully comply with the requirements for central bank independence, the monetary financing prohibition and legal integration into the Eurosystem. In light of the above, the Czech Republic has not set a target date to adopt the Euro. In fact, the Ministry of Finance and the Czech National Bank issued a joint recommendation not to set a target date in the annual analytical report that evaluates the country's readiness to join the approved by the government.

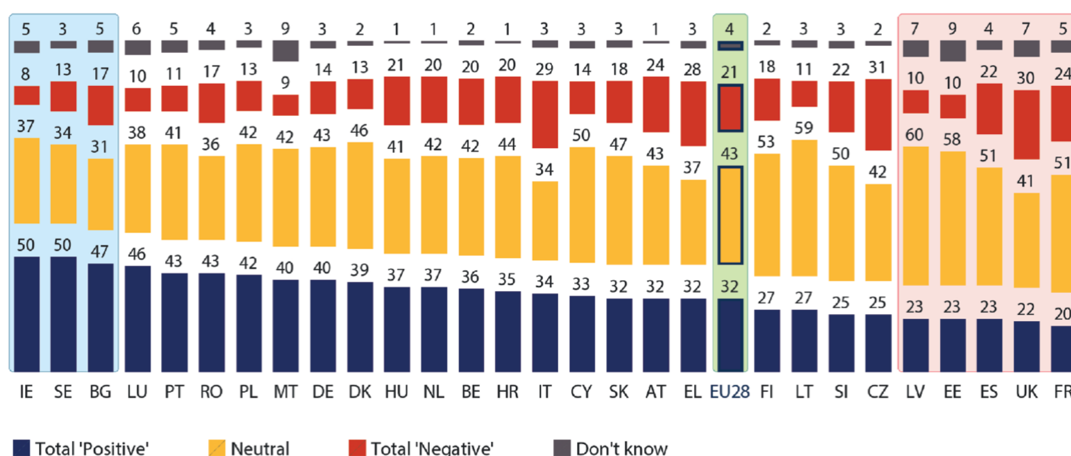
Public opinion

According to the Eurobarometer survey of April 2018 only 33% of the citizens support the adoption of the Euro. I understand that clearly the public in this country is quite sceptical about entry into the euro and more generally about European integration, the EU and its institutions, despite the recent rise in popular support for the EU in most other countries. In the Eurobarometer of October 2018, almost 60% of Czechs stated they would not vote in the upcoming European Parliament elections (compared with an EU average of 33%). Also, as you can see in the following Figure in the Czech Republic is one of only three countries out of 25 EU Member States, where citizens have a more negative than positive image of the European Parliament, along with France and the UK (see Figure 8)!

I fear that the Greek tragedy has influenced your opinion to enter the eurozone, just like my British friends are telling me that it had affected their decision at the referendum on the UK's exit in June 2016. Indeed, the Greek people have suffered a lot as a result of the unprecedented crisis.

Figure 8

Q In general, do you have a very positive, fairly positive, neutral, fairly negative or very negative image of the European Parliament? (%)



Source: Parlemeter 2018, QA1

Concluding remarks

In closing, I am certain, however, that we will all agree on the following. It is one thing being a member of the EU and another thing being a member of the eurozone.

Only two weeks ago, I was visiting Singapore in Southeast Asia, a very dynamic and increasingly competitive regional block, led by China, to give a speech at an international conference on global risks. It is true that we have been witnessing a global shift since the financial crisis in 2008-2009 with the slowing of the globalisation trend (what the Economist last month referred to as the catch word "slowbalisation") and the subsequent gradual rise of regional poles. In my view, whatever the outcome of the current trade conflicts

triggered by the US's protectionist turn for the past two years, the bottom line is that regional poles will continue to thrive. The European Union is a major regional trade block. In fact, it is the world's largest trading block, a single market of 500 million consumers and 21 million small and medium-sized enterprises (SMEs). Therefore, it is important to ensure that we are able to compete as a united European entity against other regional poles. Unity is our force.

However, entry in the euro and its timing will ultimately be a democratic choice of the Czech people, which will be fully respected by all of us in the eurozone, no matter what. You are fortunate to have in this country very good macroeconomists, but also a credible institution, your central bank, which enjoys a high reputation in the central banking world, so you can take their advice. As a matter of fact, both your Governor, Jiri Rusnok, and your former Governor, Miroslav Singer, are good friends of mine. Miroslav paid a tribute to me and he travelled to London for the launch of my latest book on monetary policy and global markets in the City of London in December 2017, along with Charles Goodhart and Chris Pissarides, the Nobel winner from the LSE, and former Bundesbank President, Ernst Welteke.

On the eve of the upcoming European Parliament elections, we should bear in mind not to let the populists set the agenda, despite the reasonable fears on migration. It is our duty to protect the legacy of democracy and European values against totalitarianism. This battle for the minds of Europeans is not only to be fought in this country. From all sides of our continent come signs of nationalism, threatening the European construction. On the eve of this key European election, we need to fight for the vision of Europe as a soft power and demonstrate to European citizens that the EU contributes to their well-being and safety in many ways, it has made our societies peaceful, more powerful and prosperous.

Thank you very much for your attention.