

Chapter 6

**CZECH REPUBLIC - THE PRESENT SITUATION OF
A PROSPECTIVE EUROZONE MEMBER:
CURRENT CHALLENGES DURING TIME OF
CREATIVE DESTRUCTION (A COMPARISON WITH
SLOVAKIA AS A EUROZONE MEMBER)**

*Michal Mejstrik**

Professor at Charles University, Praha, Czech Republic

1. INTRODUCTION

The Czech Republic was admitted to access the EU in May 2004, following the European Union membership referendum in 2003. The referendum approved the country's accession with a significant majority of 77.3% in favor and implicitly also approved the future adoption of the euro as required by the 2003 Treaty of Accession to the European Union (subject to compliance with the euro convergence criteria). Since then, the date for euro adoption has not been fixed by either the left-center coalition governments (led by Mr. Paroubek in 2005-6 and Mr. Sobotka since January 2014) nor by the right-center coalition governments (led by Mr. Topolanek in 2006-9 and Mr. Necas in 2010-2013) and not without reason. According to a Eurobarometer poll in April 2015, only 29% of Czechs supported euro adoption, while 70% were opposed.

In fact, the pendulum of sentiment of most constituencies has swung against rapid euro introduction, mostly due to the Euro-American financial crisis and the cumbersome solution to the problems of Greece. The Czech historical "fiscal innocence" feature has resulted in relatively tight fiscal and monetary policies that complied with the European Union strategy. A temporary budgetary deficit expansion was replaced by an austerity policy that allowed a halt to the excess deficit procedure in June 2014. The Czech koruna, with a floating exchange

*Corresponding author: Michal Mejstrik, PhD. E-mail: michal.mejstrik@gmail.com. This research was supported by the Czech Science Foundation (project GACR No. 14-02108S - The nexus between sovereign and bank crises). This research was supported also by the Czech Science Foundation (project GACR No. 16-02392S) Competitiveness and Exchange Rates: Institutions and Innovations.

rate, had not yet participated in the European Exchange Rate Mechanism II. Exchange rate flexibility, however, provided some additional room for economic adaptation during the financial crisis.

In early 2013 President of the Republic changed from Eurosceptic Vaclav Klaus to pro-Euro Milos Zeman. With this change the prospect of the Euro adoption has become more positive. In this chapter I would like to discuss the present political and economic situation in my country and challenges facing the country regarding the Euro adoption from perspective of creative destruction.

This chapter is structured as follows: Section 2 provides a short chronological review of political changes regarding the Euro adoption. Section 3 discusses how the Czech Republic complies with nominal convergence criteria. Section 4 explains the country's progress after the system change and the EU accession. Section 5 explains the country's characteristics of foreign trade and its international competitiveness. Finally, Section 6 reaches some conclusion.

2. POLITICAL CHANGES REGARDING THE EURO ADOPTION

For a complete picture, we must also consider the role of the governor of the Czech National Bank (central bank), who has an advisory role in the government about the timing of euro adoption. By the Czech Constitution, any Czech President has an important power channel – the discretionary appointment of his nominees to the central Bank Board, the supreme governing body of the Czech National Bank (CNB), for a maximum of two six-year terms. During his two five-year terms (2003-2013), Eurosceptic president Klaus, who served as the second Czech president, appointed a Bank Board consisting of the CNB Governor, two Vice-Governors and four other Bank Board members, nearly two times by experts to whom he believed. Eurosceptic Singer will serve as CNB Governor until June 2016.

In 2010, in the midst of a volatile economic environment, President Vaclav Klaus also initiated negotiations to opt-out of euro adoption. On behalf of the government, Prime Minister Petr Necas responded with a declaration: there was no need for an opt-out because there was no target day on which euro adoption must be set external to a decision by the Czech government, which has sufficient discretion. Because the financial crisis lowered Czech appetite for euro adoption, in November 2011, Necas stated the results of his ODS party congress: the conditions under which the Czech citizens decided in referendum in 2003 on Czech accession to the EU and committed to adopt the euro had changed. Therefore, the ODS in its resolution demanded that the possible adoption of the single currency and entry into the European stabilization mechanism be determined by Czech citizens through another referendum. The government's junior coalition party, TOP 09, was opposed to a euro referendum, but this coalition government then resigned in June 2013.

Milos Zeman, who was elected third President of the Czech Republic in early 2013, supports euro adoption by the Czech Republic, although he also considered a referendum on the decision. Shortly after taking office in March 2013, Zeman suggested that the Czech Republic would not be ready for the switch for at least five years. Prime Minister Bohuslav Sobotka, from the Social Democrats, stated on 25 April 2013, prior to his party's election victory in October 2013, that he was "convinced that the government that will be formed after next year's election should set the euro entry date" and that "1 January 2020 could be a date

to look at.” Shortly after being sworn into the new cabinet in January 2014, Czech Foreign Minister Lubomír Zaorálek stated that the country should join the eurozone as soon as possible. The opposition TOP 09 also ran on a platform in the 2013 parliamentary election that called for the Czech Republic to adopt the euro between 2018-2020. On 29 May 2013, Miroslav Singer, the Governor of the CNB stated that in his professional opinion, the Czech Republic would not be able to adopt the euro before 2019.¹

In April 2014, the Czech Ministry of Finance clarified in its Convergence Program delivered to the European Commission that the country had not yet set a target date for euro adoption and would not apply for ERM-II membership in 2014. Zeman stated in June 2014 that he hoped his country would adopt the euro as soon as 2017, arguing that adoption would be beneficial for the Czech economy overall. The opposition ODS party responded by running a campaign encouraging Czechs to sign an anti-euro petition. This was handed over to the Czech Senate in November 2014 but is viewed by political commentators as having no impact on the government’s policy to adopt the euro in the medium-term without holding a referendum. The joint document of Ministry of Finance Czech Republic (MF CR) and CNB “Assessment of the Fulfillment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area” (MF CR, CNB, 2014), approved by the government on 15 December 2014, states that important institutional changes in the functioning of the monetary union and related additional conditions and commitments stemming from the Czech Republic’s possible membership in the euro area have been implemented in recent years.

In March 2015, the ruling Czech Social Democratic Party adopted a policy of gathering political support to adopt the euro by 2020.

In April 2015 in its Czech Republic Convergence Program 2015, the coalition government considered the country’s level of preparedness to adopt the euro. At that point, it announced that it is necessary, despite certain improvements, to ensure the long-term sustainability of public finances, in particular in connection with the ageing population (see Chapter 5 of Czech Convergence Program 2015), and also advisable to adopt institutional measures that would reduce administrative barriers to business and increase labor market flexibility. Considering these facts, and in accordance with the Updated Accession Strategy of the Czech Republic to the Euro Area, the government has not yet established a target date for joining the Euro Area and will not endeavor to enter ERM II during 2015 (in accordance with the Updated Accession Strategy of the Czech Republic to the Euro Area, the length of stay there should be minimal). Hence, the coalition government agreed to not set a euro adoption target and not to enter ERM-2 until after the next legislative election scheduled for 2017, making it unlikely that the Czech Republic will adopt the euro before 2020. In addition, the coalition government agreed that if it wins re-election, it would set a deadline of 2020 to agree on a specific euro adoption roadmap.

3. COMPLIANCE WITH THE NOMINAL CONVERGENCE CRITERIA

Currently, the Czech Republic complies with most of the Maastricht (nominal) convergence criteria except for the criterion on the exchange rate, as it has not yet joined

¹ Here, the statements are followed with detailed references summarized and regularly updated in Wikipedia (2015).

ERM II. As mentioned earlier, the joint document of MF CR and CNB, “Assessment of the Fulfillment of the Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area” (MF CR, CNB, 2014), approved by the government on 15 December 2014, states that important institutional changes in the functioning of the monetary union and related additional conditions and commitments for the Czech Republic stemming from its possible membership in the Euro Area have been implemented in recent years. Let us discuss this statement now in more detail.

3.1. The Czech Republic Is Compliant with the Criterion on Price Stability

The Czech Republic has been compliant with the criterion on price stability since 2002, with the only exception being in 2004, when inflation increased temporarily due to changes to indirect taxes and a simultaneous decrease in the reference value resulting from exceptionally low inflation in some EU countries. Nath, Tochkov (2011) focus on the ten new member countries from Central and Eastern Europe (CEE) and the role of price stability as one of the pre-conditions for joining the Economic and Monetary Union (EMU) and adopting the euro. They examined the dynamics of inflation rates in those ten CEE countries relative to the EMU accession benchmark inflation over the 20 year period 1990-2009; the 150% Czech koruna inflation was the lowest among all (e.g., inflation of the Polish zloty was 450%).

According to the current forecast, on which the Czech Republic’s Convergence Program 2015 is based (inflation stepwise increasing to 2% not before 2017), and to the inflation outlook for EU Member States, there should be no danger of non-fulfillment of this criterion in the future. Target conditions for the fulfillment of the criterion near its reference value are currently met, provided that inflation in the EU Member States does not deviate too far downwards from the ECB’s definition of price stability and the reference value.

3.2. The Czech Republic Is Compliant with the Criterion on the Sustainability of the Government’s Financial Position

The criterion on the government’s financial position was not fulfilled in 2009-2013. The excessive deficit procedure was opened against the Czech Republic at the end of 2009 for the second time (the first time having been in 2004-2008), as it was expected to exceed the reference value for the general government deficit-to-GDP ratio.

Table 6.1. Harmonized Index of Consumer Prices (average for last 12 months vs. average for previous 12 months as of end of period, growth in %)

	2011	2012	2013	9.14	2014	2015	2016	2017
Average rage for 3 EU countries with lowest inflation	1.6	1.6	0.3	0.0	0.0	0.4	1.0	1.4
Reference Value	3.1	3.1	1.8	1.5	1.9	2.5	2.9	3.0
Czech Republic	2.1	3.5	1.4	0.6	1.0	2.3	2.1	2.0

Source: MF CR, CNB, (2014).

As a result of a recession in late 2008 and early 2009, the general government balance saw a marked deterioration. In addition to unresolved structural problems, the general government sector faced an unprecedented shortfall in tax revenues owing to a highly unfavorable economic situation and to legislative changes (reductions in social security contributions and in the corporate income tax rate). Expenditures to mitigate the effects of the recession were simultaneously being increased. In 2010-2013, the government implemented a program to consolidate public budgets, and the general government deficit fell gradually. The only exception was a widening of the deficit in 2012, which reflected strong one-off effects, in particular, financial compensation relating to a property settlement between the state and churches. In 2013, measures on the revenue side of the public budgets (primarily an increase in both VAT rates and temporary adjustments to personal income tax) led to an improvement in the deficit to 1.3% of GDP. The excessive deficit procedure against the Czech Republic was retracted in June 2014.

In comparison to the December report “Assessment of the Fulfillment of the Maastricht Convergence Criteria...” MF CR, CNB, (2014), the April Czech Convergence Program (2015) expects a further sustainable decrease in the public budget deficit from 2015 onwards. For 2014, a government sector deficit of 2.0% of GDP and government debt of 42.6% of GDP were reported.

The forecast estimates a government sector deficit of 1.9% of GDP in 2015, with a subsequent gradual decrease to 0.6% in 2018, which is well below the reference value of 3% of GDP. The structural balance should develop positively in the same period, from -1.7% of GDP in 2015 to -1.1% of GDP in 2018, i.e., to a level close to the medium-term budgetary objective of the Czech Republic. General government debt as a percentage of GDP reached a peak in 2013; for 2015, the government expects it to decrease to 40.9% of GDP, i.e., by more than 4 pp compared to 2013. The primary cause of this decrease is the integration of liquidity from the state treasury system. In 2018, government debt should fluctuate around 40% of GDP, a level that is relatively low in comparison with the reference value of 60%.

**Table 6.2. General Government Balance
(ESA 2010 methodology, in % of GDP)**

	2011	2012	2013	2014	2015	2016	2017
Reference Value	- 3	- 3	- 3	- 3	- 3	- 3	- 3
Czech Republic	- 2.9	- 4	- 1.3	- 1.5	- 2.2	- 1.4	- 1.1

Source: MF CR, CNB, (2014).

**Table 6.3. General Government Debt
(ESA 2010 methodology, in % of GDP)**

	2011	2012	2013	2014	2015	2016	2017
Reference Value	60.0	60.0	60.0	60.0	60.0	60.0	60.0
Czech Republic	41.0	45.5	45.7	43.8	42.3	42.1	41.7

Source: MF CR, CNB, (2014).

3.3. The CR Is Fully Compliant with the Long-Term Interest Rate Criterion

The annual average long-term interest rates in the Czech Republic for convergence purposes showed a downward trend during 2011-2014.

At present, they are at historical lows. The Czech Republic consistently fulfilled the interest rate criterion by a considerable margin in the period under review. The Czech Republic's fiscal policy credibility is reflected in its stable and high sovereign rating and in the smooth subscription of Czech government bonds, which is fostering stability in Czech government bond yields. Given the still not fully resolved problems in the Euro Area and new geopolitical risks (the Ukrainian crisis and the Middle East), the prediction for 2015-2017 holds some degree of uncertainty. Based on developments to date and also on the construction of this criterion, however, one can say that the Czech Republic should have no problems fulfilling it in the future. This is conditional on maintaining financial market confidence in the long-term sustainability of Czech public finance, which, given its current and expected situation, should not be a problem.

3.4. Criterion on Participation in the Exchange Rate Mechanism

The Czech Republic operates under a managed floating exchange rate regime. It will only be possible to fulfill the exchange rate stability criterion after the Czech Republic joins ERM II and announces central parity for the CZK/ EUR exchange rate within this mechanism. A pre-assessment of the fulfillment of this criterion can only be made at an analytical level.

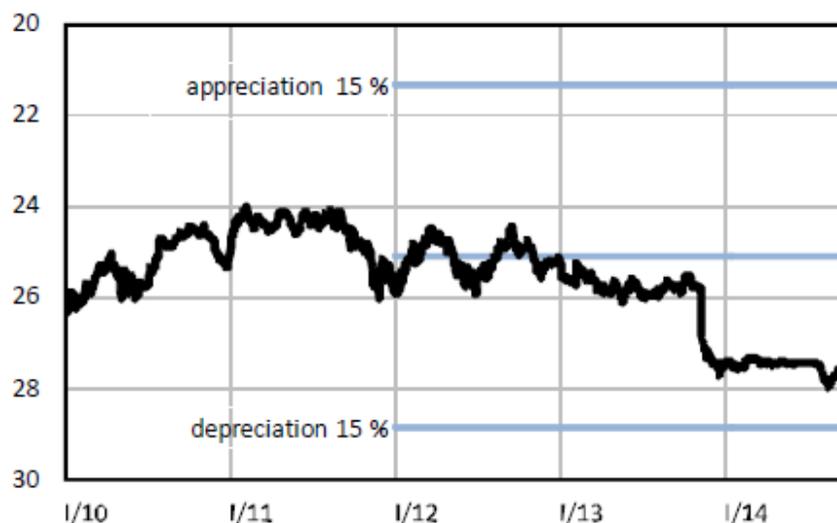
Figure 6.1 shows that the fluctuations in the CZK/EUR exchange rate over the last few years have been distinctly smaller than the hypothetical band of $\pm 15\%$ around the hypothetical central parity in the period under review. This was achieved despite the fact that the CNB decided in November 2013 to start using the exchange rate as an additional monetary policy instrument because of the need to further ease monetary conditions after the lower bound on interest rates had been reached.

Table 6.4. Long Term Interest Rates for Convergence Purposes
(average for the last 12 months, in %)

	2011	2012	2013	Sep-14	2014	2015	2016	2017
Average for 3 EU countries with lowest inflation	3.1	3.1	4.4	3.4	3.9	4.3	3.2	3.1
Reference Value	5.1	5.1	6.1	5.1	5.1	6.1	5.1	5.1
Czech Republic	3.1	2.1	2.1	1.9	2.4	2.1	2.1	3.0

	2011	2012	2013	Sep-14	2014	2015	2016	2017
Average for 3 EU countries with lowest inflation	3.3	3.1	4.4	3.4	3.9	4.3	3.2	3.1
Reference Value	5.3	5.1	6.4	5.4	5.9	6.3	5.2	5.1
Czech Republic	3.7	2.8	2.1	1.9	2.4	2.6	2.8	3

Source: MF CR, CNB, (2014).



Source: MF CR, CNB, (2014).

Note: In the chart, an upward movement of the exchange rate means appreciation of the koruna vis-à-vis the euro. The hypothetical central parity was simulated by the average exchange rate for 2012 Q1. Data up to 30 September 2014.

Figure 6.1. Nominal CZK/EUR Exchange Rate.

With respect to the fact that disinflation continued even after the reduction of interest rates to the technical minimum in November 2012, the CNB began to further relax the monetary conditions in November 2013.

To prevent the long-term undershooting of the inflation target, the Bank Board CNB controversially voted to start using the exchange rate as an additional monetary policy instrument for the first time in its modern history. Intervention on the foreign exchange market (at a volume of approximately EUR 7.5 billion) was carried out in November 2013. The koruna weakened sharply to close to CZK 27 to the euro on the day that the exchange rate commitment was announced. The exchange rate then stabilized at close to CZK 27.5 to the euro without regular interventions.² The mere existence of the exchange rate commitment and the declared resolution of the CNB to meet this commitment have mostly been sufficient to maintain an exchange rate above the level of 27 CZK/EUR. As recently estimated by Czech analysts, foreign reserves from occasional interventions might accumulate within the next year—up to 50% of GDP—but Jiri Rusnok (a new pro-European Board member appointed in 2014 by president Zeman as a new Bank Governor nominee) does not find this to be a current threat (from Rusnok interview with Fiserova, M., Bednarik R. (2015)).

The return to conventional monetary policy (not earlier than in the second half of 2016) might not imply a sharp appreciation of the exchange rate to the level recorded before the CNB began intervening; in the meantime, the weaker exchange rate of the koruna should pass through to prices and other nominal variables.

² According to MF CR, CNB (2014), the CNB regards the commitment as asymmetric, i.e., one-sided in the sense that it will not allow the koruna to appreciate to levels that could not be considered “close to 27 CZK/EUR.” On the stronger side of the 27 CZK/EUR level, the CNB is preventing the koruna from appreciating further by intervening on the foreign exchange market, i.e., by selling koruna and buying euro. On the weaker side of the 27 CZK/EUR level, the CNB is allowing the koruna exchange rate to float.

This point is often subject to criticism from many analysts. Paradoxically, the former president Klaus has criticized the majority of his appointees as Bank Board members, who surprisingly diverged in opinion and voted for intervention on the foreign exchange market in November 2013 (after Klaus' second term expired). While President Zeman joined in criticizing the interventions, his appointee Jiri Rusnok accepted it as the current reality.

Another interesting point can be provided by comparing the dynamics of exchange rates for Czech currency (CZK) and Slovak currency (SKK) in Chart 2.2 prior to Slovakia adopting the euro in 2009. One should keep in mind that both currencies were created after the peaceful 1993 split of the joint state the Czech and Slovak Federative Republic ("Czechoslovakia"). On February 8, 1993, the joint Czechoslovak currency (CSK koruna) was replaced by two separate currencies (by the Czech koruna and the Slovak koruna), both at par. Czech currency has been appreciating ahead of Slovak currency, which was later fixed to the Euro. Figure 6.2 shows again that the fluctuations in the CZK/EUR exchange rate over the last few years have been rather small.

The Czech Republic's September 2003 Euro Area Accession Strategy and its August 2007 update state that the Government and the CNB agree on remaining in ERM II only for the minimum required period. This implies that the Czech Republic would enter the ERM II only after it has achieved a high degree of economic alignment and after conditions have been established that enable it to introduce the euro shortly after the assessment of the exchange rate criterion. In addition, the Czech Republic should enter ERM II based on a stable situation in the domestic economy and stable global financial markets.



Source: Prepared by the author based on data of Eurostat 2015.

Figure 6.2. Nominal CZK/EUR and SKK/EUR Exchange Rates.

3.5. Assessment of the Czech Republic's Current Alignment with the Euro Area

The analyses in MF CR, CNB, (2014) are divided into two basic groups: i) "Cyclical and Structural Alignment" and ii) "Adjustment Mechanisms." The basic theoretical starting point for the underlying analyses is the theory of optimum currency areas and its institutional underpinnings. These points are discussed in more detail in Chapter 5 and Chapter 9 respectively and Chytilova, Mejstrik (2010). We will only add the evolution of some alignment indicators over time and in comparison with Slovakia.

4. CZECH REPUBLIC PROGRESS AFTER THE SYSTEM CHANGE AND THE EU ACCESSION

4.1. A Historical Overview

The end of 1989 significantly changed the political orientation of the country. This was soon followed by the transition from a centrally planned economy to a market economy. The author shares a Schumpeterian view that in any dynamic society, evolution is a permanent process that includes society's comprehensive restructuring, encompassing both the real and the financial sectors of the economy. Typically, the relatively stable elements and structural relationships in both sectors are sporadically subject to change during times with particularly numerous innovations. A characteristic feature of quickly transforming post-Communist economies in their transition to a market economy is an imbalance in their economic development combined with a complete restructuring, which can be likened to the process of "creative destruction" (if we paraphrase the concept introduced by J. Schumpeter).

Among the most important economic changes are the foundation of a legal environment and of a market economy and its institutions, price liberalization and deregulation, liberalization of foreign trade, currency and macroeconomic stabilization, restitution, establishment of a two-tier banking system instead of a state monobank, establishment of a new social network, and, of course, privatization.

Major privatization steps were described in Mejstrik (1997, 2012) and Mejstrik (2004):

1991	start of small-scale privatization
1992	start of large-scale (coupon) privatization to domestic investors, including minority stakes in some state-owned banks start of privatization of companies to domestic and foreign owners (usually through tenders)
1997-2001	privatization of remaining state shareholdings in banks to foreign investors

The extraordinary 1993 peaceful dissolution of the joint state Czech and Slovak Federative Republic ("Czechoslovakia") followed by the creation of two separate currencies (the Czech koruna and the Slovak koruna, as already mentioned above) affected economic

development. Although the political and economic split was rather smooth, it nonetheless affected business relations and economic policy.

Typical macroeconomic features of an economic transition appeared in the Czech (and also Slovak) Republic in the early 1990s: a drop in GDP; double-digit inflation; rising unemployment; increasing state indebtedness; significant changes in the money supply, forms of money and the speed of money circulation; and the establishment of new currency regimes often linked to a single foreign currency or a basket of foreign currencies. However, the impacts were, in general terms, not as strong as in other transforming countries in the Central and Eastern European region (Unemployment remained low for several years and has never significantly exceeded 10%; inflation almost immediately fell below 20% after the shock of liberalization and subsequently decreased further; increased state costs were often covered by revenues from privatization, etc.). GDP growth accelerated until 2008 but was interrupted by the impact of two dips stemming from the financial crisis. The austerity policy kept public debt and its financing costs quite low but pushed capital formation and private consumption into negative territory. This primarily affected the construction sector. The positive changes in both the international and domestic environment and sentiment (e.g., postponed investment and private consumption) combined with one-off factors such as delayed utilization and refunds from remaining EU structural and cohesion funds programs (for the programming period 2007-2013) triggered renewed growth in the GDP in 2014 and especially in the first half of 2015. The relatively low base from the recession years have currently lifted the Czech Republic into the group of EU countries with the strongest economic performance. Low unemployment, sizable labor vacancies, etc., indicate that the GDP 1H 2015 growth of 4.2% is probably close to the potential product. The development of key macroeconomic indicators can be seen in Table 6.5 below.

Table 6.5. Macro Economic Indicators of Czech Republic, 2008-2014

	2008	2009	2010	2011	2012	2013	2014
GDP growth rate (real)	2,7%	- 4,8%	2,3%	2,0%	- 0,9%	- 0,5%	2,0%
Consumption of households, annual change in % GDP (real)	1,3%	- 0,3%	0,5%	0,1%	- 0,7%	0,3%	0,7%
Gross fixed capital form, annual change in % (real)	2,5%	- 10,1%	1,3%	1,1%	- 3,2%	- 2,7%	2,0%
Gross industrial production annual change in % (real)	7,8%	- 11,2%	6,0%	6,6%	- 2,2%	- 4,3%	4,7%
construction output annual change in % (real)	- 0,4%	- 3,3%	3,7%	- 6,6%	- 3,0%	1,1%	3,4%
Unemployment rate in %	4,4%	6,7%	7,3%	6,7%	7,0%	7,0%	6,1%
Consumer prices, % change p.a.	6,4%	1,1%	1,4%	1,9%	3,3%	1,4%	0,4%
Central bank policy rate, % p.a. end of period	2,25%	1,0%	0,75%	0,75%	0,05%	0,05%	0,05%
General gov. budget balance, in % of GDP	- 2,1%	- 5,5%	- 4,4%	- 2,7%	- 3,9%	- 1,2%	- 2,0%
Public debt in % of GDP	28,7%	34,1%	38,2%	39,9%	44,6%	45,0%	42,6%
Gross external debt in % of GDP	46,4%	49,9%	54,7%	57,5%	60,3%	63,5%	66,6%

Source: Prepared by the author based on data of Czech statistical office CZSO, CNB data.

At the same time, international rating agencies have not downgraded the stable Czech Republic sovereign rating, which is better than that of Slovakia and other new EU member states and well ahead of the eurozone Southern wing members. The investment rating by Moody's is A1 for the Czech republic and A2 for Slovakia, while Standard and Poor's gives a stronger AA- grade for the Czech Republic and A for Slovakia.

4.2. An Economic Convergence

While we discussed mostly the Maastricht nominal convergence criteria in the second section of this chapter, here we should add the real convergence issues that reflect the catching-up of per capita income levels and institutional structures. One should also keep in mind the Copenhagen criteria: economic – a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the EU; political – the stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities; adoption of the *acquis* – ability to assume the obligations related to membership, including adherence to the aims of political, economic and monetary union.

However, here one should recall the older discussion by former vicegovernor CNB Dedek (2004) that “the key question is to what extent the two sets of criteria, the real convergence of Copenhagen and the nominal convergence of Maastricht, compete with each other or rather whether they share the strong elements of complementarity. There are a number of proponents who would argue that the so-called exaggerated ambitions of nominal convergence, i.e., placing emphasis on low inflation or low public debt, will hurt economic growth, and thus more time will be needed to close the performance gap between the accession countries and the EU member states. An alternative view adopted, e.g., by the ECB suggests that the two processes should be followed in parallel... In the context of this debate, one should recall that the Czech economy showed very promising growth rates in 1995-96... However, this growth period also witnessed widening imbalances and ended with a speculative attack on the koruna, austerity packages, political crisis and a protracted period of economic downturn... Therefore, a lesson should be learnt that the one sided preference of the real convergence poses risks of a boom-bust pattern that may prolong the process of catching up with the EU and may translate itself into extra social costs. Under the umbrella of the real and the nominal convergence, one can also debate the contentious issue of the process of catching up with the EU price level. The basis for the dispute is an empirical fact that the price levels in the candidate countries lag behind those of the EU member states. This observation then tends to promote concerns whether the disinflation strategy only postpones the necessary hike in prices to bring them to the same level as that prevailing in the EU. Or is this strategy counterproductive by exposing the economy to the danger of a massive price jump upon entry to the EU? There are even doubts about the consistency of the Maastricht criteria, which require price and exchange rate stability in parallel, while the candidate country supposedly needs to close the price gap either by way of higher inflation or by way of nominal appreciation... Particular attention is paid to the so-called Balassa-Samuelson effect, which is topical in its message that higher productivity or a faster growth will inevitably lead to higher inflation. A too ambitious disinflation may thus be viewed as a hindrance to productivity growth, inhibiting real convergence ...”

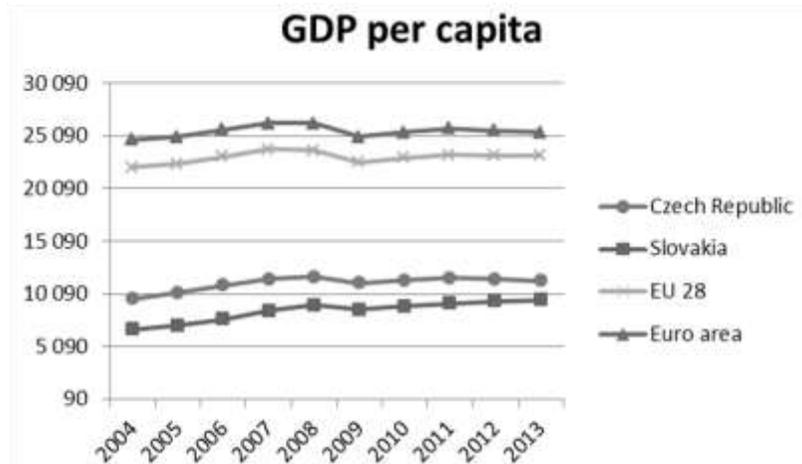
Economic convergence may be interpreted and measured in many ways, as discussed by Dambrowski (2014) and Balazs Forgo, Anton Jevcak (2015) and applied to CEE countries as well. As the latter authors summarized, “a majority of Central and Eastern European CEE10 countries achieved significant real convergence vis-à-vis the Euro Area EA12 countries between 2004 and 2014. However, compared to the period preceding the 2008/09 global financial crisis, real GDP growth weakened considerably in the post-crisis period. Moreover, a substantial real convergence gap, in terms of average GDP per capita in purchasing power standards, remains between the CEE10 and the EA12. The rapid pace of economic convergence in the pre-crisis period partly reflected an investment boom that was not sustained in the post-crisis period...

Most CEE10 countries also recorded substantial progress in terms of nominal convergence. Over the last decade, five out of ten CEE countries fulfilled the accession criteria and subsequently joined the Euro Area. Inflationary pressures moderated in the post-crisis period, thanks to more favorable global commodity price developments as well as more subdued growth performance. Despite considerable convergence, there still remains a sizable price-level gap vis-à-vis the EA12, which is larger for non-traded goods. One of the key challenges for the CEE10 will thus be to preserve low inflation rates while succeeding in reinvigorating the pace of real convergence in the coming years.” Their general conclusion is valid also in our case. In 2005, after the EU accession, the Czech government adopted the first long-term “Strategy of Economic Growth for 2005-2013,” which focused the country on a “knowledge and technology EU center with a growing living standard and high employment.” The strategic objective was to “approach the economic level of economically advanced EU countries subject to sustainable principles.” The indicator GDP per capita “should have achieved the EU average in 2013.” That ambitious objective has not been achieved.

To assess the process of recent real convergence, we use a simple approach both by comparing Real Gross Domestic Product GDP per capita and its growth rates and examining relative levels of GDP per capita in purchasing power standards (PPP terms). The degree of trade openness and, in particular, goods exports to the Euro Area will also be considered in the next section. Regardless of which indicator we use, the catching-up process is somewhat slow. Czech real GDP per capita in current euros in Figure 6.3 has grown from 9.6 thousand euro in 2004 to 11.5 thousand euro in 2008 and then more or less stagnated until 2014. The relevant figures for Slovakia were 6.7 thousand euro in 2004, gradually approximately growing to 9.5 thousand euro in 2013. This is still a fraction of the level of indicators both for the EU28 and the Euro Area.

The picture in Figure 6.4 looks better as a more adequate indicator of Real GDP per capita in PPP in terms of the respective countries. Czech real GDP per capita in PPP terms has grown from 77% of the EU28 average in 2003 to 84% of the EU average in 2014 (now the highest among new EU member states), and the recent figures for the second quarter 2015 indicate further catching up. The relevant figures for Slovakia were 55% in 2004, quickly growing up to 75% in 2014.

Figures 6.3 and 6.4 demonstrate growth volatilities that have visible similarities despite Slovak membership in this Euro Area, which might have strengthened the cyclical movement. The part of fluctuations in nominal terms has been modified by different deflators of real GDP.



Source: Prepared by the author based on data of Eurostat 2015.

Figure 6.3. Real GDP per capita in current Euros.

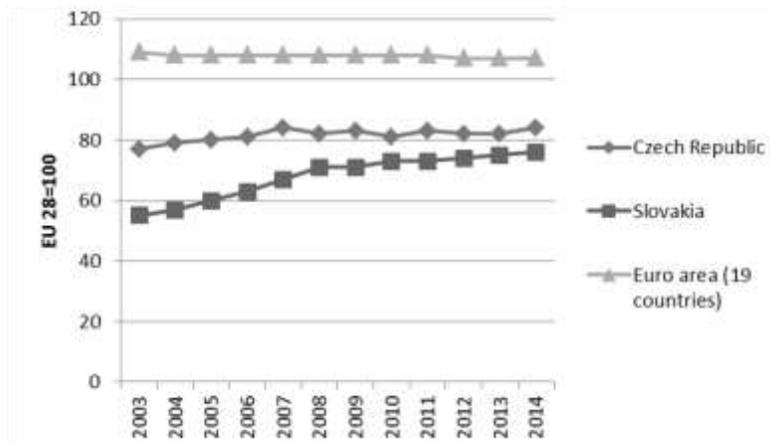


Figure 6.4. Real GDP per capita in PPP terms of respective country.

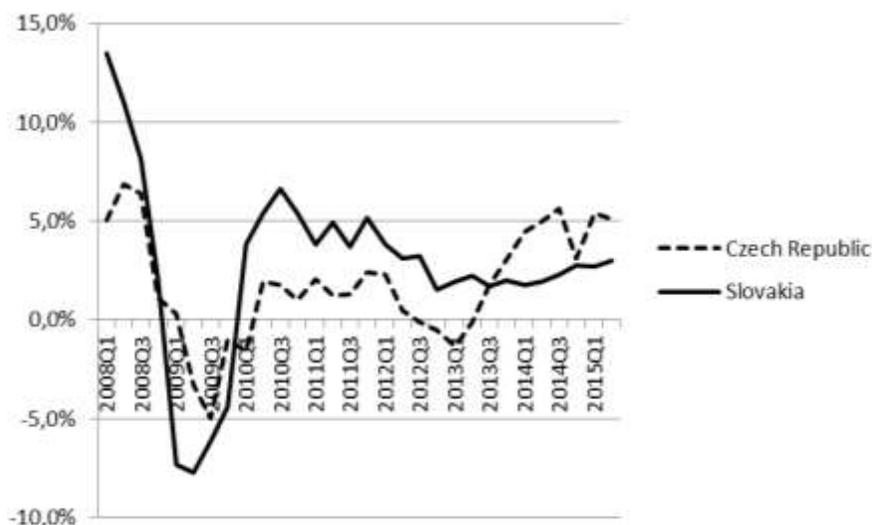
The catching-up process and its enormous volatility can be seen across all industries (except construction) that have renewed refurbishments and investments into production facilities to allow Czech industrial companies to become an efficient part of global value chains. Industry successfully contributes more than one third to GDP, following the important historical path of the Czech economy, which is driven by its outward looking manufacturing and industry as a whole. We will address competitiveness later.

Let us now turn our attention towards the financial sector. Western European major banking groups advanced to the emerging market of Central and Eastern Europe, including the Czech Republic and Slovakia as analyzed in detail by Mejstrik (2004).

While the share of foreign-owned banks quickly became dominant in the Czech banking sector,³ the monetary authorities have not lost their grip on the banking sector.

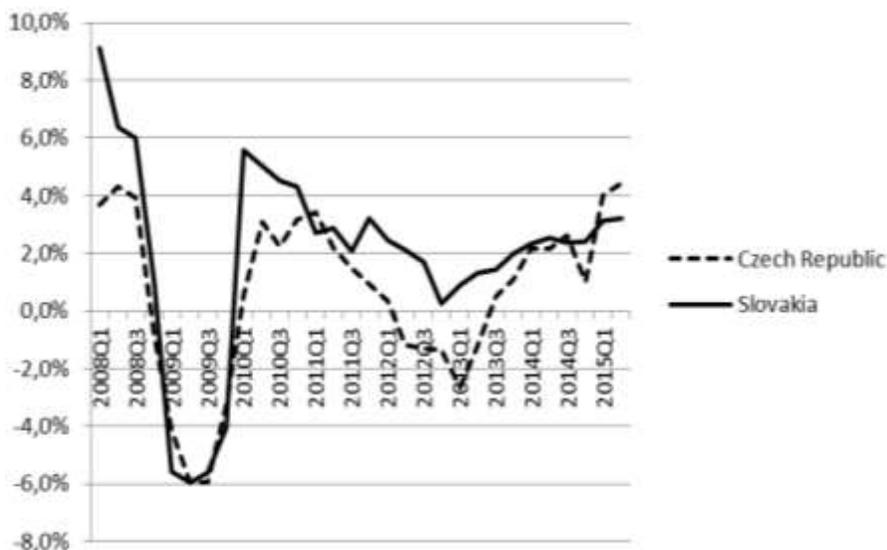
³ Since 2003, the share of foreign-owned banks in total assets in the banking sector has been over 95%. Most non-performing loans in privatized banks had been restructured and/or sold at a discount to state-owned Konsolidacni banka. Czech subsidiaries of foreign banks have been very risk averse since that time.

In contrast to many neighbors (such as Hungary and Poland), the floating exchange rate régime (Czech currency either appreciated or fluctuated around hypothetical central parity; see Figures 6.1 and 6.2 above), relatively low inflation and comparatively low interest rates generated a negligible propensity for demand for foreign exchange loans except for global financial and industrial groups active in the CR.



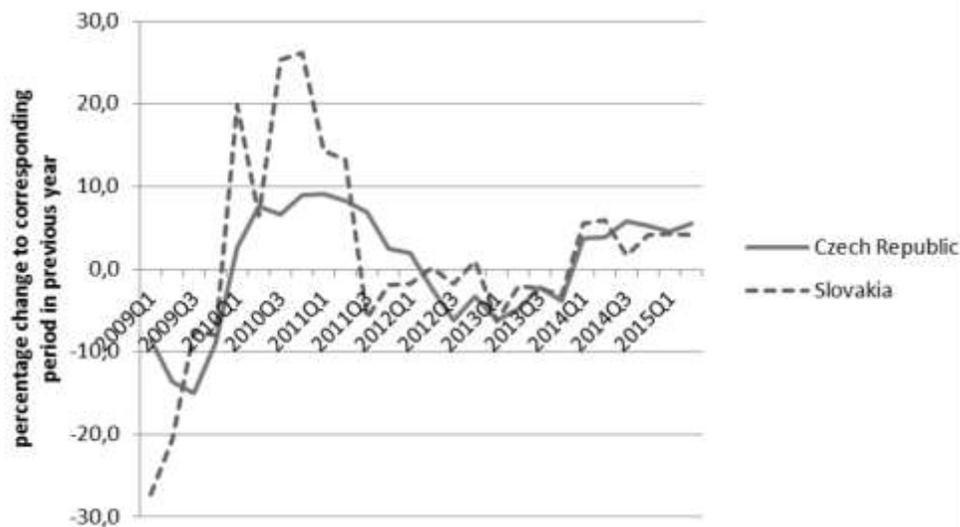
Source: Prepared by the author based on data of Czech Statistical Office, Slovak Statistical Office. CR for Czech Republic, SR for Slovakia.

Figure 6.5. GDP Quarterly Growth percentage change over quarter of previous year in nominal and real terms in respective currencies.



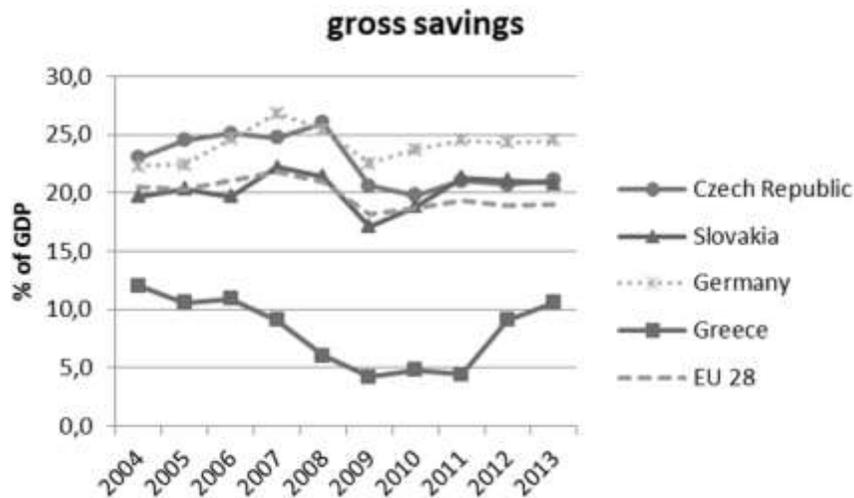
Source: Prepared by the author based on data of Czech Statistical Office, Slovak Statistical Office. CR for Czech Republic, SR for Slovakia.

Figure 6.6. Real GDP Growth.



Source: Prepared by the author based on data of Eurostat 2015.

Figure 6.7. Industry (except construction) gross value added, Quarterly Growth, percentage change to corresponding period in previous year.



Source: Prepared by the author based on data of Eurostat 2015.

Figure 6.8. Gross Savings as percentage of GDP.

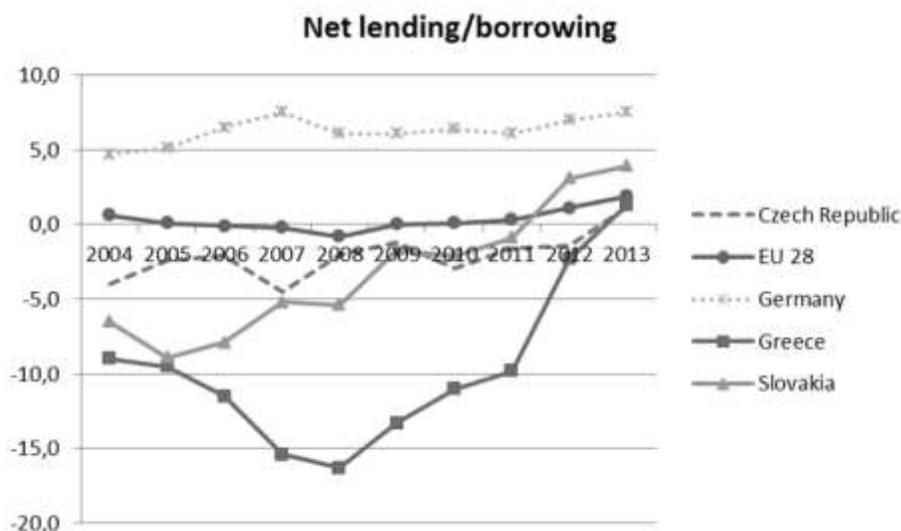
Czech and Slovak risk-averse banks gradually accumulated excess deposits over loans due to the propensity of their citizens to save money through banks, a behavioral feature shared with German citizens, thereby exceeding the EU-28 average savings rate (see Figure 6.8). In this environment, it was much easier and cheaper for the biggest banks to collect domestic deposits through their own deposit networks rather than obtaining funding through the international capital market, where prevailing interest rates are higher. The same was true for risk-averse borrowers, who were offered cheap domestic loans with natural hedging. After the crisis, the interest rates received by depositors further declined and somewhat lowered their propensity to save.

The issues of real convergence can be well demonstrated by the Greek case. Recent problems in Greece indicate low quality growth based upon decades of expansionary public budgets and very low savings. The superficial assessment by traditional macroeconomic statistical measures (GDP growth per capita, public finance deficits or government spending share) was misleading. A careful look at the gross national savings development (see Figure 6.8) indicates that both private and public savings in Greece were well below the EU average during the quick real convergence, although Greece reached up to 93% of EU 28 average GDP per capita in 2011. The growth and convergence were, however, artificially based upon heavy borrowing and not on savings.

When a country's own savings are missing, then both the private and the public sector must borrow foreign money for economic growth (see Figure 6.9). Statistics of real convergence, such as Figure 6.4, are significantly biased in such an environment and should be accompanied by other indicators.

As we can see from Figure 6.9, in contrast to Greece, Czechs have behaved better with respect to net savings/borrowing and sustainable development. Germans represent a special category, with extraordinarily large gross savings and significant net lending.

The balance of payments in Table 6.6 looks reasonable, with a 0.6% surplus in 2014 after a series of current account deficits that fluctuated mostly within $\pm 2\%$ of GDP. Exports have been growing along with imports and the trade balance in goods; the 5.6% surplus in 2014 looks healthy and contributed to GDP growth. Foreign direct investments were influenced by a dividend withdrawal by number of FDI investors, who are repaying their debt abroad. The services balance, driven by tourism and high-tech services, has been in surplus for many years. The volume of international foreign exchange reserves has increased, especially after the CNB interventions, but it is still well below the critical level expressed by the percentage of GDP.



Source: Prepared by the author based on data of Eurostat 2015.

Figure 6.9. Net national savings/lending(+)/Borrowing(-) as percentage of GDP.

Table 6.6. Czech Republic Balance of Payment 2008-2014 in CZK millions

	2008	2009	2010	2011	2012	2013	2014
A Current account (in % GDP)	- 75 255	- 89 203	- 141 777	- 84 801	- 63 313	- 21 784	26 100
	- 1,9%	- 2,3%	- 3,6%	- 2,1%	- 1,6%	- 0,5%	0,6%
Trade balance in goods (in % GDP)	84 845	146 877	118 865	156 759	201 424	166 973	238 894
	2,1%	3,7%	3,0%	3,9%	5,0%	4,1%	5,6%
Export	2 250 376	1 914 479	2 226 072	2 421 535	2 542 471	2 681 419	3 043 200
Import	2 143 254	1 846 169	2 153 658	2 362 118	2 500 318	2 514 446	2 804 306
Services	89 274	81 917	78 476	81 282	77 626	70 359	55 877
Income	- 147 688	- 216 659	- 249 930	- 223 345	- 237 528	- 249 019	- 258 963
Current transfer	- 12 412	- 19 421	- 10 712	- 18 215	- 27 209	- 10 098	- 9 709
B Capital and Financial Account	- 17 205	- 21 072	- 84 742	- 62 054	64 700	150 744	80 133
B1 Capital account	26 024	51 275	37 597	12 710	53 011	82 437	32 170
B2 Financial account (excl. reserves)	- 43 229	- 72 347	- 122 339	- 74 764	11 689	68 308	47 963
Direct investment (in % GDP)	- 36 327	- 37 694	- 94 991	- 46 805	- 121 261	7 438	- 133 633
	- 0,9%	- 1,0%	- 2,4%	- 1,2%	- 3,0%	0,2%	- 3,1%
Portfolio investment	9 146	- 158 688	- 150 353	- 5 781	- 54 848	- 92 838	90 269
Financial derivatives	2 607	1 288	4 748	3 674	- 8 618	- 4 737	- 6 046
Other investment	- 58 766	62 101	76 832	- 8 622	115 942	- 29 747	24 250
B3 Reserves assets	40 111	60 647	41 425	- 17 230	80 474	188 191	73 123
C Net errors and omissions	6 001	- 34 419	- 18 159	- 2 673	21 991	7 655	- 10 306
International reserve	716 044	764 312	796 779	803 393	855 251	1 118 380	1 244 288
Change in int. reserves		48 268	32 467	6 615	51 858	263 129	125 909

Source: Prepared by the author based on data of CNB, Czech Statistical Office CZSO.

The strong growth of the Czech economy in the first two quarters of 2015 was followed by further improvement in its foreign balance – there is a record surplus in the current account of the balance of payments in the amount of 95.8 billion CZK or 4.4% of the nominal 1H 2015 GDP. Surpluses in the current account and capital account make it possible to finance deficits in the financial account generated by foreign reserves growth.

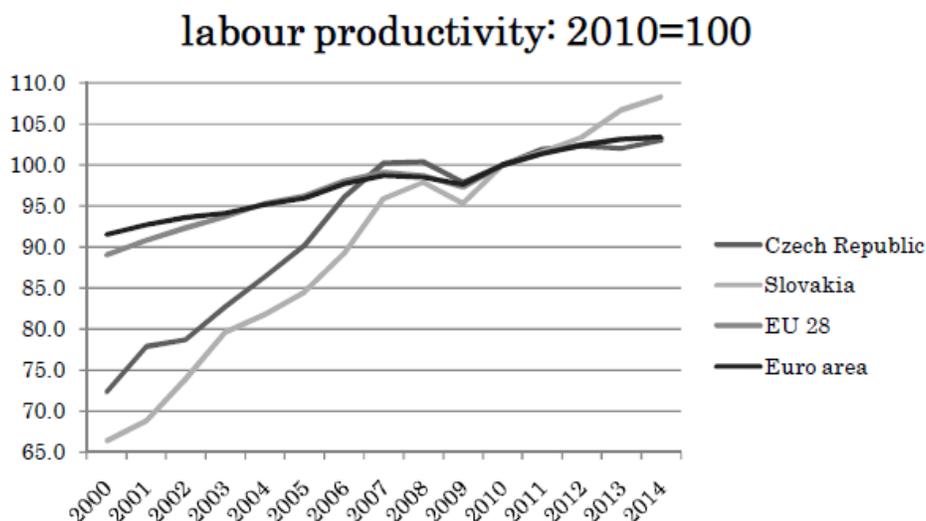
One note should be added. Whenever the private sector was exposed to competition in the Czech economy, then the subsequent adaptation to the economic cycle and international demand was smooth via both supply response and cost savings. Reliance upon public procurement tenders created less effort and motivation and more corruption cases, etc.

It is somewhat surprising that the originally very low levels of wages and salaries have been catching-up to the EU28 level sooner than labor productivity, which also reflects the value added of innovated goods and services responding to demand. According to the OECD, real labor productivity per hour worked has achieved half of the average of the advanced eurozone countries but was lower than in Slovakia. The comparative dynamics in Chart 3.2b confirm that Slovakia accelerated the most. The residuals of old-fashioned Slovak industry were replaced by highly productive car manufacturers, which represent the dynamic core of more diversified Czech manufacturing as well.

5. THE CHARACTERISTICS OF FOREIGN TRADE AND INTERNATIONAL COMPETITIVENESS

5.1. Foreign Trade

The Czech Republic is a small open economy for which exports constitute an essential prerequisite for long-lasting and sustainable prosperity and economic growth. The very high ratio of openness (export volume to GDP) is over 67%.



Source: Prepared by the author based on data of Eurostat 2015.

Figure 6.10. Real labor productivity per hour worked (Index 100 for year 2010).

Due to the country's size, Czech exports represent only a small fraction of world exports, and it can be regarded as niche exporter.

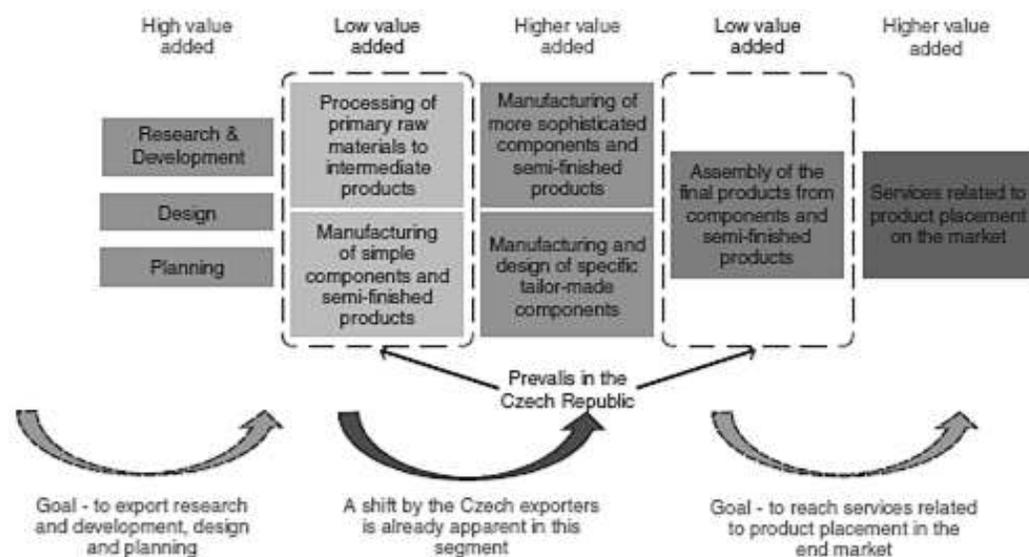
As implied by a range of analyses⁴, the export sectors in the Czech Republic are the driving force behind the increasing productivity and competitiveness of the Czech economy (unlike those sectors that focus primarily on the domestic market). Exports have a positive relation to both GDP growth and employment growth for the low-skilled as well as the high-skilled labor force. As stated by Mejstrik (2011) and then repeated in the 2012-2020 International Competitiveness Strategy for the Czech Republic, the existing export success of the Czech Republic benefitted particularly from two key factors: the maximum utilization of its position rent⁵ and a relatively cheap but qualified labor force. International comparisons⁶ show that Czech businesses are successful and valued as medium-tech subcontractors, particularly by companies from EU-15 countries, which are the final destination for more than 64% of Czech exports.

These two unquestionable qualities of the Czech Republic and Czech businesses attracted a wide range of major foreign investments in the 1990s and very shortly after 2000 to become an important engine of Czech economic growth. Deep structural reforms studied by Chytilová, J., Mejstrik, M. (2010) positively changed the Czech economic and social model. At present, however, it is obvious and provable with data that the aforesaid advantages of the Czech Republic are becoming gradually exhausted and are being renewed on the basis of investment and labor productivity growth, as discussed in section 5.2 below.

Furthermore, it is essential to bear in mind that foreign direct investment, which helped the Czech Republic to overcome both its period of transformation from a centrally planned economy and the turbulence during the 1990s, can change very quickly from being a comparative advantage of the Czech Republic into a threat to the stability of the Czech economy until international competitiveness is further increased. The Czech Republic has a significant concentration of exports in a few industries linked to foreign manufacturing plants in the Czech Republic (car making industry, electronics and, to a certain extent, tourism). The high sectoral concentration of Czech exports together with the even more significant territorial export orientation to EU countries (exports to the EU28 represent approximately 80% of all Czech but also Slovak exports) make the Czech Republic vulnerable to fluctuations on international markets. The recent troubles of the Russian economy led to a direct export decrease to Russia of one third in the first half of 2015 alone.

The eurozone, which is – as mentioned above – the leading export territory for the Czech Republic, suffered from an intensive debt crisis in 2010, and European countries did not fully recover until 2013. In addition, the banking sector experienced a shock, as did entrepreneurs, which temporarily drove confidence in the stability of the eurozone sharply downwards. Fortunately, Germany is a neighbor of the Czech Republic and the target of one third of Czech exports. A deep integration with Germany within global value chains makes both the Czech and the Slovak economies vulnerable to German exporters, as 60% of Czech exports to Germany are subsequently re-exported.

The vision of the implemented Czech Government Export Strategy is to make maximum use of synergies arising from pro-export, as well as other, activities of the state to develop export-relevant services to facilitate the success of Czech exporters in foreign markets. In this manner, the Strategy contributes to the wider vision established by the 2012-2020 International Competitiveness Strategy for the Czech Republic, which wants to shift the Czech Republic closer to the 20 most competitive countries in the world by 2020.



Source: Mejstrik (2011).
EEIP, a.s.

Figure 6.11. Strategic steps to increase the value added for Czech exporters.

The Export Strategy is intended to support exporters in their diversification and in their shift along the value chain towards the production of goods and services with higher value added (see Figure 6.11).

5.2. Increasing Price and Nonprice International Competitiveness

The widely shared analysis of Czech international competitiveness by Mejstrik (2011) noted that the existing export success of the Czech Republic benefitted particularly from two key factors: the maximum utilization of the Czech position rent⁵ and the relatively cheap but qualified labor force. The wages grew and the real unit costs of the labor force in the Czech Republic temporarily increased, which resulted in a decrease in the price competitiveness of the Czech Republic and its comparative advantage in the European market (see Figure 6.12). Renewed labor productivity growth (Figure 6.10) allowed further wage increases but again squeezed the ratio indicator. The total Czech Unit Labor cost index is only 2% above its 2005 value. Slovakia experienced even more volatile increases in wages and labor productivity, which brought the Slovak ULC index close to its 2005 level.

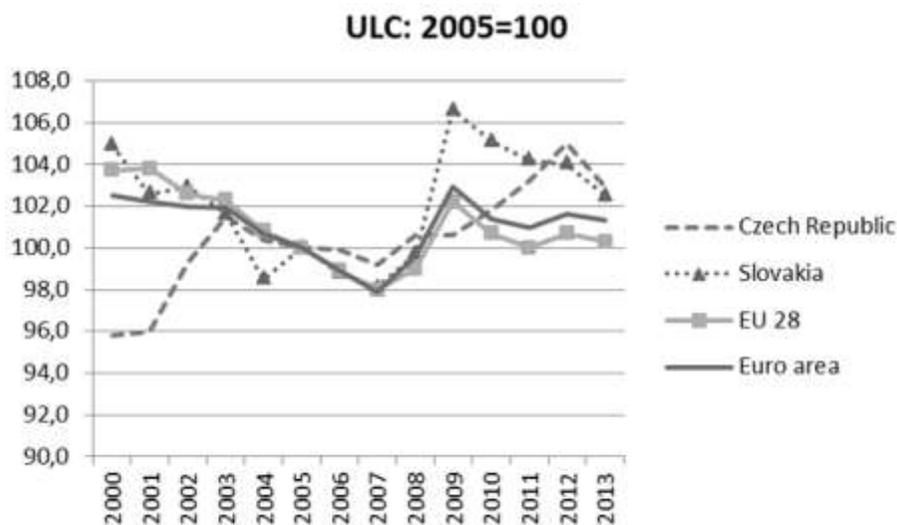
Figures for the first half of 2015 (not included in Figure 6.12) might indicate further improvement in Czech indices.

The exchange rate developments described in section 3.4 (in combination with ULC developments) contributed to the favorable evolution of the Real Effective Exchange Rate/REER, which is a crucial international price competitiveness indicator.

A more detailed look into sectoral unit labor costs discloses deep differences among sectors in terms of international price competitiveness. While the dynamic manufacturing sector, which has the highest productivity growth, demonstrates Czech manufacturing

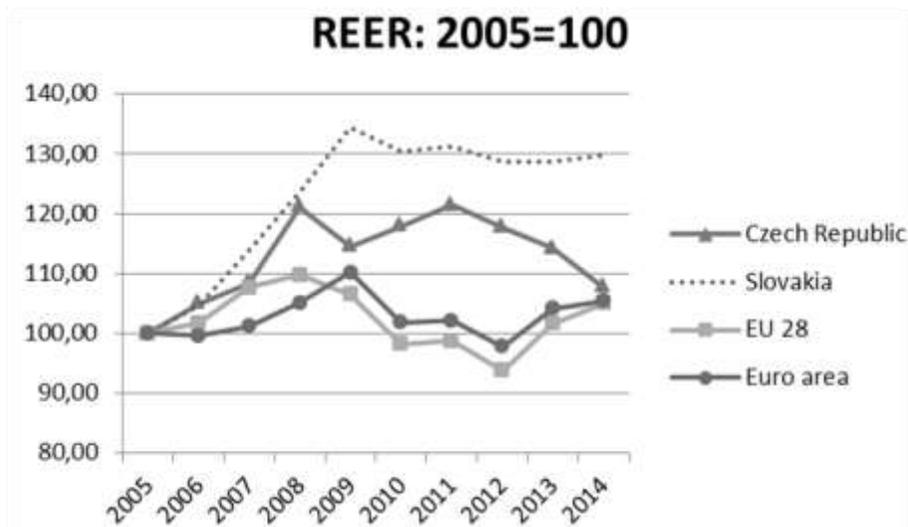
strength, a stagnating construction sector is somewhat lagging; however, the indices of the industry as a whole are satisfactory. The Slovak situation, driven by its originally lower wage growth in euros, also maintains price competitiveness. Czech and Slovak price competitiveness has, however, placed their industries well in comparison to EU28 countries average figures, which have deteriorated, particularly in the construction sector.

International comparisons of the Global Competitive Indices by the World Economic Forum reflected in Mejstrik (2011) showed that the Czech Republic still lags behind developed countries also as regards non-price competitive advantages.



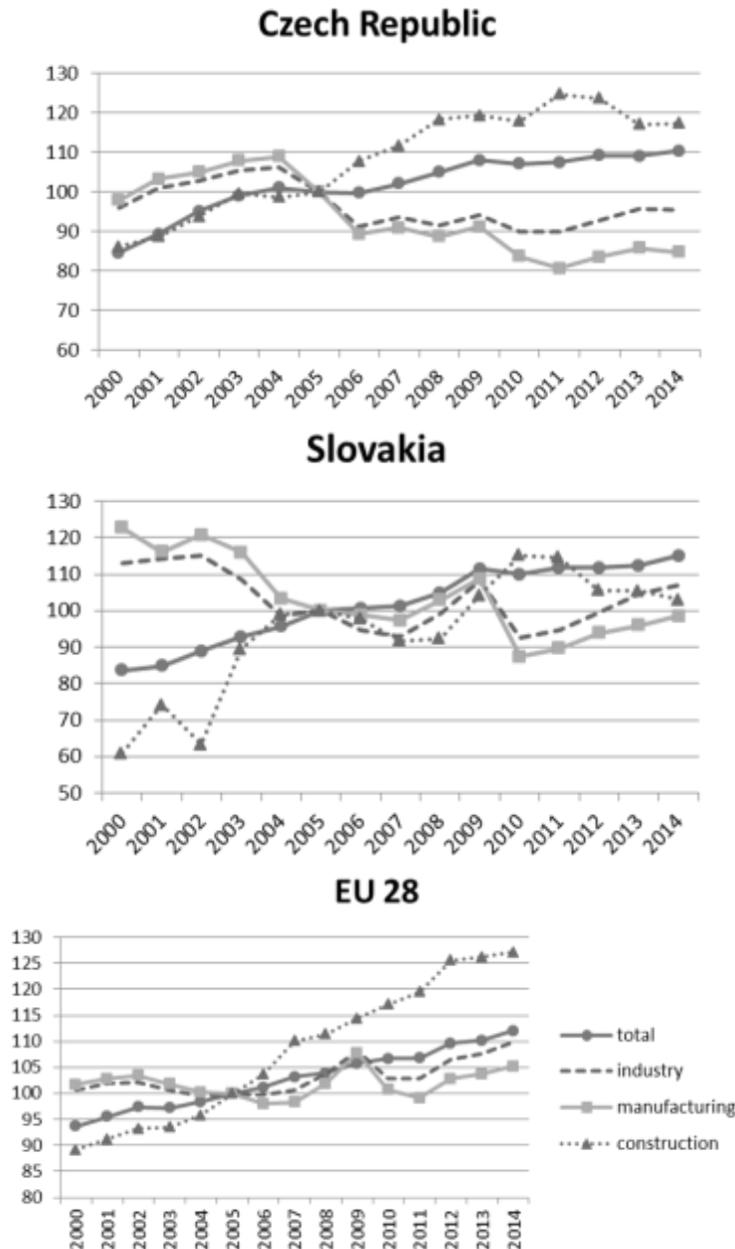
Source: Prepared by the author based on data of Eurostat 2015.

Chart 6.12. Real unit labor costs in the total economy.



Source: Prepared by the author based on data of Eurostat 2015.

Figure 6.13. Real Effective Exchange Rate (deflator: unit labor costs in the total economy - 37 trading partners).



Source: Prepared by the author based on data of Eurostat 2015.

Figure 6.14. Sectoral Unit Labor Costs – productivity vs. wage unit labor costs decreased in CZ manufacturing (2005 = 100).

Unfriendly public institutions, corruption, a gradually developing infrastructure, unsatisfactory improvement in education levels and insufficient innovation development have rapidly shifted the Czech Republic down into the category of less attractive and non-perspective countries given fierce international competition; it can no longer be redeemed in any way by its favorable position in the center of Europe.

To benefit from the maximum utilization of the Czech position rent and its improvement potential in Infrastructure, Institutions and Innovation (the 3 Is), the widely accepted analysis of Mejstrik (2011) and his colleagues in the National Economic Council of Czech Government (NERV) led to the creation of the 2012-2020 International Competitiveness Strategy for the Czech Republic, which is named “3 I.” This strategy has been appraised by the OECD and is a building block of the EU structural and cohesion funds program for the programming period 2014–2020 as well as for the Czech program of national reforms; it was also reflected in the Convergence program of the Czech Republic (Ministry of Finance CR (2015)).

CONCLUSION

In April 2015, in its Czech Republic Convergence Program 2015, the coalition government reflected on the country’s level of preparedness to adopt the euro and announced that it is necessary, despite certain improvement, to ensure the long-term sustainability of public finances, in particular in connection with the ageing population.

The discussion on euro adoption has been affected by the recent discussion on how to implement EU loan programs for Greece, including the use of the silent EFSM guaranteed by all EU members. This has reopened the issue of exposure and the collateral requirements for refinancing credit, as the smaller eurozone countries might be significantly exposed although their living standard (including that of Slovakia) is lower than the standard being subsidized in Greece (Nardelli Alberto and Merler Silvia (2015)).

Hence, the coalition government agreed to not set a euro adoption target and to not enter ERM-2 until after the next legislative election in 2017, making it unlikely that the Czech Republic will adopt the euro before 2020. In addition, the coalition government agreed that if it wins re-election, it would set a deadline of 2020 to agree on a specific euro adoption roadmap. Jiri Rusnok, under consideration by president Zeman as his nominee for the new CNB governor in 2016, might support euro adoption in his advisory role at that time.

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