Chapter 30

Czech Republic: Czech National Bank's Role in the Monetary Policy

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Abstract

This chapter deals with monetary policy in the Czech Republic, in which the Czech National Bank plays a crucial role. Broadly, the objective of monetary policy is to ensure price stability. Notably, Czech Republic has not joined the Eurozone – it is a member of the European System of Financial Supervision and cooperates with the European Systemic Risk Board and European Supervisory Authorities. While, prior to the COVID-19 pandemic, the Czech Republic met most of the Maastricht criteria for the euro, with the exception of compliance with normal exchange rate fluctuation margins, the situation has changed with the pandemic: currently, it only meets the criterion of the total general government debt-to-GDP ratio. Meanwhile, the most important factor for decision-making is the degree of alignment of the Czech economy with the Eurozone, which is key to outweighing the gains from the introduction of the euro over the losses from its own monetary policy. Presently, it is not possible to state that the Czech economy is significantly aligned with the euro area. As a non-member of the euro area, the Czech Republic is not obliged to join the European Banking Union. Important to note is that the Czech Republic regularly prepares a study that analyses all relevant aspects of its possible participation in the European Banking Union to help it make an informed decision on whether to join the European Banking Union before adopting the euro. These studies show that the banking sector in the Czech Republic is highly stable; therefore, it is increasingly advantageous for the Czech Republic to remain outside the European Banking Union. Notably, the Czech Republic used interest rates and foreign exchange interventions

Eva Tomášková – Michal Radvan (2024) 'Czech Republic: Czech National Bank's Role in the Monetary Policy'. In: Zoltán Nagy (ed.) *Economic Governance. The Impact of the European Union on the Regulation of Fiscal and Monetary Policy in Central European Countries,* pp. 695–715. Miskolc–Budapest, Central European Academic Publishing.

https://doi.org/10.54237/profnet.2024.znecogov_30

to ensure the stability of the economy during the pandemic and, subsequently, the Russo-Ukrainian war.

Keywords: *Czech monetary policy, Czech National Bank, euro, banking, monetary policy, COVID-19 pandemic, Russo-Ukrainian war*

1. The Czech National Bank as the leading monetary policy institution

In the area of monetary policy in the Czech Republic, the Czech National Bank is entrusted with a crucial role. The basic legal regulation of the bank is included in the Constitution,[1] which states that the Czech National Bank is the central bank of the state. In line with EU primary law, the same article defines the main objective of the Bank's activities as ensuring price stability.[2] The activities of the Czech National Bank may only be interfered with by law.[3]

Notably, the Czech National Bank is a part of the European System of Central Banks and contributes to fulfilling its objectives and tasks. It is also part of the European System of Financial Supervision and cooperates with the European Systemic Risk Board and European Supervisory Authorities. The supreme governing body of the Bank is the Bank Board, which consists of a governor, two Deputy Governors, and four other Bank Board members. All Bank Board members are appointed by the President of the Czech Republic for a maximum of two six-year terms.[4]

The Bank carries out its specific activities in compliance with the Act on the Czech National Bank.[5] In addition to creating a low-inflation environment in the economy, the Bank fosters financial stability and supervises the operation of the financial system in the Czech Republic (e.g. the banking sector, capital market, insurance industry, pension funds, credit unions, electronic money institutions, bureaux de change). Its specific tasks are to issue banknotes and coins and manage and oversee currency circulation, payment systems, and settlements between banks.[6]

The independence of the Czech National Bank is guaranteed by the Constitution as its autonomy is conditio sine qua non and a prerequisite for effective monetary instruments conducive to price stability.

1 Act no. 1/1993 Sb., the Constitution of the Czech Republic, as amended.
2 Art. 98 of the Constitution of the Czech Republic.
3 Hulkó and Radvan, 2022, p. 62.
4 *About the CNB* [Online]. Available at: https://www.cnb.cz/en/about_cnb/ (Accessed: 24 August 2023).
5 Act no. 6/1993 Sb., on the Czech National Bank, as amended.
6 *About the CNB* [Online]. Available at: https://www.cnb.cz/en/about_cnb/ (Accessed: 24 August 2023).

The Bank's activities can be summarized as follows: (i) Broadly, in monetary policy, banks endeavour to keep inflation low, stable, and predictable; the Czech National Bank achieved its 2% inflation target by setting interest rates and using other monetary policy instruments. The Bank Board decides on which instruments to use and how to use them based on a macroeconomic forecast and an assessment of risks and uncertainties conducted eight times a year.[7] (ii) The Bank sets a macroprudential policy by identifying, monitoring, and assessing risks to the stability of the financial system and, by preventing or mitigating these risks, contributes using its powers to the resilience of the financial system and the maintenance of financial stability.[8] Banks define financial stability as a situation in which the financial system operates with no serious failures or undesirable impacts on the present and future development of the economy while showing a high degree of resilience to shocks.[9] (iii) The Bank is the supervisory authority of the Czech Republic's financial market. It lays down rules that safeguard the stability of the banking sector, capital market, insurance industry, and pension scheme industry. It regulates, supervises, and, where appropriate, issues penalties for noncompliance with these rules.[10] (iv) The Bank is the exclusive issuer of Czech banknotes and coins. Circulating banknotes and coins are intended for cash payments. Commemorative banknotes and coins are designed for collection and investment purposes, and banks sell them through their contractual partners at prices different from their nominal values.[11] (v) The Bank contributes to preparing draft legislation regarding payments and clearing between banks, foreign bank branches, and credit unions. It promotes smooth and efficient payments, and contributes to the safety, soundness, efficiency, and development of payment systems.[12] (vi) The Bank declares the exchange rate of the Czech koruna against other currencies in the financial market in the form of foreign exchange market rates and the exchange rates of other currencies. (vii) The Bank is the resolution authority for banks, credit unions, and certain investment firms in the Czech Republic. 'Resolution' refers to the restructuring of an institution to ensure the continuity of its critical functions, minimise impacts on the economy and financial system, and restore the viability of all or part of that institution.[13] (viii) In its area of competence, the Bank compiles and publishes statistics, particularly monetary and financial statistics, balance of payments statistics, supervisory statistics, financial accounts statistics, general economic statistics, and government finance statistics. The statistics are compiled in

7 *The Mandate of the Czech National Bank* [Online]. Available at: https://www.cnb.cz/en/about_cnb/mission/ (Accessed: 24 August 2023).

8 Ibid.

9 *Financial Stability* [Online]. Available at: https://www.cnb.cz/en/financial-stability/ (Accessed: 24 August 2023).

10 *The Mandate of the Czech National Bank* [Online]. Available at: https://www.cnb.cz/en/about_cnb/mission/ (Accessed: 24 August 2023).

11 Ibid.

12 Ibid.

13 Ibid.

accordance with the international standards of the European Union (EU) and the relevant requirements of European supervisory authorities.[14] (ix) The objective of the Bank's economic and financial research is to provide outputs that expand its knowledge base for its core activities.[15]

2. Introduction of the Euro: The Czech experience

Through the Act of Accession of the Czech Republic to the European Union, the Czech Republic committed to joining not only the EU, but also the euro area. The Treaty of Accession was signed over 20 years ago in 2003 and accession took place in 2004. Since the Czech Republic has not yet joined the euro area, its monetary policy is governed by Art. 130 and 131 of the Treaty on the Functioning of the European Union (TFEU) and the Statute of the European System of Central Banks and the European Central Bank. Art. 130 provides for the independence of the national central bank (NCB) in relation to the exercise of the powers and performance of the tasks and duties conferred on the NCB by the Treaties and the Statute of the European System of Central Banks and the European Central Bank. It also suggests that neither the European Central Bank (ECB) nor any NCB or member of its decision-making bodies may seek or take instructions from the institutions, bodies, offices, or other entities of the EU; from any government of a Member State; or from any other entity. Art. 131 requires each Member State to ensure that its national legislation, including the Statute of the National Central Bank, complies with the Treaties and with the Statute of the European System of Central Banks and of the European Central Bank.

2.1. The Maastricht convergence criteria

As mentioned above, the entry of a Member State of the EU into the Eurozone is subject to the achievement of a high degree of sustainable convergence, in addition to the compatibility of its legislation with Arts. 130 and 131 of the TFEU and the Statute of the European System of Central Banks and the European Central Bank. The convergence criteria were established in Art. 140 of the TFEU and elaborated in Protocol No. 13 of the Treaties.

Specifically, the convergence criteria are as follows: (i) Achieve a high degree of price stability; (ii) A sustainable government finance position in the long term; (iii) Compliance with the normal fluctuation margins of the exchange rate; (iv) Durability of convergence, as reflected in long-term interest rates.[16]

14 Ibid.
15 Ibid.
16 European Central Bank, 2023.

The price stability criterion measures the rate of consumer price inflation, which must not exceed 1.5 percentage points of the average price stability of the three best-performing EU countries. The Czech Republic will not meet this criterion by 2020, partly due to the low benchmark. High inflation in the Czech Republic in 2021 is driven by supply side factors, amplified by loose fiscal and monetary policies and a tight labour market. This is reflected in accelerated wage growth and input and energy prices. At the same time, the relaxation of anti-pandemic measures led to rapid growth in household consumption. In 2022, expansionary fiscal policy, previously loose monetary policy, and pandemic-induced low output began to take effect. Meanwhile, the economic consequences of Ukraine's invasion by Russian troops, which led to an energy and food crisis, were also negative. In 2023, price increases occurred – particularly in the energy and food sectors. In addition to supply side inflation, demand-side inflation also increased due to a tight labour market and high lending volumes, particularly housing-related lending, which, in turn, contributed to rising housing prices and the high contribution of imputed rents to inflation. In both years, the Czech Republic had one of the highest inflation rates in the EU.

In 2023, inflationary pressures gradually eased, both through a reduction in supply side factors causing inflation (problems with the supply of production inputs and oil prices) and through the effect of the Czech National Bank's interest rate hikes. The exchange rate of the CZK against the main world currencies, which is neutral, does not have an impact. Highly mandated expenditures are expected to contribute to an increase in inflation. Thus, the Czech Republic does not fulfil the criterion in 2023 and most likely will not fulfil the price stability criterion in 2024.

The public finance position criterion requires an EU country to maintain a sustainable public finance position in the long term. This criterion is formally met if a country does not have an excessive deficit. An excessive deficit procedure (EDP) is triggered if a country fails to meet one of its fiscal criteria. The first requirement is a deficit ceiling of 3% of GDP. The second requirement is a government debt ceiling of 60% of GDP. In these cases, an exception can be made in the event of an overshoot if the government debt ratio declines sufficiently towards this value. The Czech Republic has been in breach of the deficit maximum value since 2020, as the balance fell below -5% of GDP in 2020 and 2021 (a 2020 deficit of 5.8%, a 2021 deficit of 5.1%). The reason for this decrease was the decline in economic activity during the COVID-19 pandemic and the related government stabilisation, support, and redistribution policies. By 2022, the deficit was 3.6% of GDP. Thus, the deficit was reduced, but remained above the maximum value.

Owing to the application of the general escape clause, which allowed Member States to temporarily depart from common fiscal rules, the European Commission did not initiate the Excessive Deficit Procedure. Therefore, the Czech Republic still formally fulfils the criteria for government financing. The structural balance was measured against the medium-term budgetary objective of each EU Member State. The Czech Republic has so far set a target of -0.75% of GDP. However, the medium-term budgetary objective could be tightened to -0.5% of the GDP after joining the Eurozone. According to the Treaty on Stability, Coordination, and Governance in the Economic and Monetary Union, a structural balance threshold of -1.0% of GDP is only allowed if general government debt is well below 60% of GDP and long-term sustainability risks are low.

By 2023, the total general government debt is projected to increase to 44.1% and the level of total debt should remain below the reference value of the convergence criterion. An important factor behind the increase in debt is the rise in the general government deficit relative to GDP. However, under the current fiscal policy settings, despite economic recovery, the debt-to-GDP ratio is expected to continue to rise. Unfortunately, there is no deadline set for when the general government budget would stop falling against GDP; this will be marked by the generation of a budget surplus.

The interest rate convergence criterion requires yields on bonds with an average residual maturity of 10 years to be no more than two percentage points above the average bond yields in the three best-performing EU countries in terms of price stability.

This criterion has always been met, but since mid-2021, the Czech National Bank has sought to mitigate rising inflationary pressure by substantially increasing base interest rates. In contrast, the ECB maintained base interest rates at zero until July 2022, before gradually increasing them more significantly. Furthermore, the ECB's negative differential *vis-à-vis* the Czech National Bank is expected to remain this year, so it will not be met in 2023 either. A similar outlook has been assumed for the next few years.

Maintaining the national currency in the exchange rate mechanism (ERM; specifically, here, the ERM II) for at least two years is the fourth and final criterion. In the ERM, the exchange rate is assumed to move within a fluctuation band of ±15% without devaluing the central parity and without putting excessive pressures on the exchange rate. The fulfilment of this criterion can only be assessed after the entry of the Czech Republic into the ERM II. However, if one were to assess whether the Czech Republic would be able to fulfil this criterion at present, it can be concluded that meeting this criterion should not be problematic. The achievement of a stable exchange rate was supported by the Czech National Bank's intervention in the foreign exchange market in 2022. From 2021 onwards, an appreciating trend in the exchange rate can be observed, with the CZK exchange rate moving within a fluctuation band of ±15% over this two-year period. It is also possible to take into account the fact that even if the exchange rate were to appreciate more strongly and the fluctuation bands were to be slightly exceeded, there would be no immediate rejection of the country's entry into the Eurozone, as shifts of the central parity towards a stronger exchange rate have been tolerated in the past.

Based on the assessment of the above criteria, it can be concluded that the Czech Republic does not currently fulfil any convergence criteria. As noted above, the Czech Republic has one of the highest inflation rates in the EU, which is caused by both demand and supply side factors and fed by elevated inflation expectations. High inflation is subsequently reflected in the diverging monetary policies of the ECB and the Czech National Bank, which negatively affect interest rates, and is therefore a consequence of the non-fulfilment of the next convergence criterion.

Specifically, the criterion for the state of public finances was also not fulfilled, except that the European Commission did not initiate an excessive deficit procedure against any country because of the COVID-19 pandemic. However, the European Commission's approach cannot be relied on to remain benevolent in future periods. Public finances in the Czech Republic are burdened by high structural deficits, and leading economists currently consider the impulses to reduce them insufficient. Although the Czech Republic technically meets the exchange rate fluctuation criterion, it does not truly fulfil it because it has not yet joined the ERM II.[17]

2.2. Pros and cons of being a part of the Eurozone: A Czech perspective

Over the past 20 years, the Czech Republic has taken the position of aligning its economic development with the Eurozone and trying to ensure that the economy itself minimises possible asymmetric shocks through other mechanisms. According to the Czech National Bank in 2023,[18] the degree of alignment of the Czech economy with the Eurozone is key to outweighing the gains from the introduction of the euro over the losses from its own monetary policy. As reported by the Czech National Bank, the Czech economic level moved slightly away from the Eurozone average in 2021; however, compared to the situation associated with the onset of the external shocks listed above, price and wage levels have recovered. The absolute value, reflecting the distance from the Eurozone average, is still significant, discouraging the early adoption of the euro. In such a case, if the euro were to be adopted, inflationary pressures would increase significantly, and inflation above 2% would be expected with a high degree of probability. Examining the correlation between economic activity in the Czech Republic and the Eurozone reveals that the cyclical development of these economies is primarily aligned; this is again due to the economies' response to external shocks, which makes it impossible to conclude that there is a long-term alignment in terms of economic development. There are also significant differences in economic structure, with industry comprising a large share of GDP in the Czech Republic thanks to its automotive sector.

On the contrary, a high level of trade and ownership interdependence encourage the Czech Republic to join the Eurozone. Adopting the euro would remove exchange rate risk and reduce transaction costs in trade with Eurozone countries. The Czech Republic's position as an open economy leads to the synchronisation of economic shocks and cyclical alignment, which should lead to lower costs associated with the loss of an independent monetary policy. Meanwhile, 'ownership interdependence'

17 Ministry of Finance, Czech National Bank, 2022.

18 *Devizové rezervy a devizové intervence* [Online]. Available at: https://www.cnb.cz/cs/menova-politika/vzdelavani/12-devizove-rezervy-a-devizove-intervence/index.html (Accessed: 30 August 2023).

refers to investment by Eurozone countries in the Czech Republic. According to the Czech National Bank, financial cycle alignment between the Eurozone and the Czech Republic is gradually increasing. However, the Czech National Bank tightened its monetary policy in 2022, which increased the interest rate differential, particularly for short-term rates.

Although the Czech Republic is not in the Eurozone, its currency reacts to environmental changes in a similar manner to the euro. The correlation between the CZK and the dollar was similar to that between the CZK and the euro. Initially, the Russian invasion caused deterioration; next, owing to foreign exchange interventions to weaken the CZK against the euro, the correlation increased. Therefore, the exchange rate of the CZK against the Euro was the same as that of the other Central European currencies. According to the Czech National Bank, the alignment of individual segments of the Czech financial market with the Eurozone is moving away from the pre-pandemic levels. The level of private sector indebtedness and the depth of financial intermediation are relatively low in the Czech Republic and, according to the Czech National Bank's assessment, remain below the Eurozone level. However, it would be inappropriate to follow other Eurozone countries in this respect because the significant size of the financial sector and high private sector indebtedness may negatively impact cyclical fluctuations in the real economy. If private sector indebtedness increases, the scope of monetary or fiscal economic policies is reduced.

The structure of financial liabilities of Czech non-financial corporations with Eurozone corporations is still high, in contrast to the similarity in the structure of financial assets of Czech households with Eurozone households. The decline in other liabilities of Czech corporations (e.g. financing through bridge loans) contributes to the reduction of structural mismatch, as their share in total corporate liabilities is higher than that in Eurozone countries. Meanwhile, the structural similarity in financial assets between Czech and Eurozone households remains low; this is because Czech households prefer to hold cash, deposits, units, and shares while Eurozone households prefer insurance and social programmes. Thus, households' responses to interest rate changes and, hence, the use of interest rates as a monetary policy tool, may differ. Regarding the structure of loans according to the length of interest rate fixation, the trend is similar in the Czech Republic and Eurozone, with an increase in loans with longer fixations over the last decade. The largest volume of new loans to non-financial corporations (88%) has floating rates or rates with a fixation of up to one year.

Regarding nonfinancial corporate loans and overnight interbank market rates, client spreads remain lower than those in the Eurozone. The structure of client rate spreads is markedly different, as they have shown a significant increase in recent months due to monetary policy, and have emerged gradually and to varying degrees across interest rate segments. The evolution of the 10-year government bond yield in the Czech Republic only partially illustrates the evolution of monetary policy rates, as it is also influenced by factors unrelated to the evolution of monetary policy rates (e.g. fiscal policy and market expectations in the long term). The spread of the 10-year bond yield to the overnight interbank rate is negative; that is, short-term money market rates are higher than the 10-year government bond yield. However, if we compare the client rate for loans to nonfinancial corporations with the yield on 10-year government bonds, the spread is positive. The most common fixation in the Eurozone is ten years, whereas in the Czech Republic, the most common fixation is five years. Different fixation lengths may imply varying degrees of sensitivity to changes in market or monetary policy rates.

Longer fixed periods may reduce the sensitivity of client interest rates to changes in financial market rates. Czech households are very conservative and the share of foreign currency loans and deposits is still very low, whereas the share of euro-denominated credit financing is increasing among businesses. This is because of the high degree of trade interdependence with the Eurozone and the desire to naturally hedge exchange rate risk. Notably, the high interest rate differential between the CZK and euro interest rates has exacerbated this increase, with the share of euro-denominated loans in total corporate loans now exceeding 40%. In this respect, there are no differences across enterprise sectors and sizes, and the share of euro-denominated loans in total loans is similar. This may increase further in the context of forthcoming changes to the Accounting Act,[19] which would allow businesses to keep their accounts and pay taxes in euros. For this reason, however, the Czech National Bank's monetary policy can be expected to be less effective.[20]

Based on the above, the Czech Republic's monetary policy stance is, in many respects, similar to that of the Eurozone. This conclusion is best supported by the fact that the CZK reacts to changes in a similar way to the euro. However, there are a number of areas in which the Czech Republic's situation differs from that of the Eurozone, such as the potential of monetary policy instruments, including the different impacts of these instruments on the business and household sectors and the profitability of the banking sector.

If the Czech Republic is committed to adopting the euro, its primary aim should be to align its economic development with that of the Eurozone and stimulate the economy so that it can respond independently to external influences without major government intervention. Although this has been declared, instruments are not always used, particularly in fiscal policy, to realize this objective. Currently, monetary policy efforts are focused on reducing inflation. The attitude of the Czech Republic towards the Eurozone could be appropriately expressed in the words of the current Minister of Finance, Zbyněk Stanjura: 'We are to adopt the euro when it is advantageous for the Czech Republic, and so far it is not.'[21]

19 Act no. 563/1991 Sb., as amended.

20 Ministry of Finance, Czech National Bank, 2022.

21 *Přijetí eura se na čtyři roky odkládá. Podle vznikající vlády by to „nebylo výhodné“*, 2021.

3. The European Banking Union

The European Banking Union (EBU) was created in response to the 2008 financial and debt crises. Its aim was to increase the safety and soundness of the banking sector within the euro area and minimise the impact on the real economy in the event of bank failure. Put differently, this banking union is designed to strengthen economic and monetary unions. In general, joining a banking union involves cross-border risk and loss sharing and is clearly more beneficial for countries with relatively unstable banking sectors[22] while likely disadvantageous for countries with relatively stable ones.

All Eurozone countries automatically participate in the EBU, but countries outside the Eurozone can also cooperate closely. The Czech Republic, which is not a member of the euro area, is not obliged to be a member of the EBU; however, it does have the option to do so. The Czech Republic regularly prepares a study containing all relevant aspects of its possible participation in the EBU in order to be able to make an informed decision on whether to join the EBU before adopting the euro or to wait. Specifically, these studies assessed the impact of the country's entry into the EBU according to several criteria.

The first criterion is the situation of the national banking sector; that is, its resilience, structure, size, extent of cross-border activities, intensity of ownership, and credit interconnectedness with banks in the Eurozone. The 2021 study confirms the conclusions of the 2015 Study and the 2016 Update, characterizing the Czech banking sector as follows: (i) Relatively high levels of capitalisation and profitability; (ii) Low levels of non-performing loans; (iii) High levels of bank funding through customer deposits; (iv) Low use of bank assets as collateral; (v) Very low importance of central bank funding; (vi) Low levels of household and nonfinancial corporate debt; (vii) Low levels of household foreign currency debt; (viii) Lower banking sector balance sheet relative to GDP; (ix) Dominant role of banking entities owned by parent banks in the Eurozone; (x) The banking sector is a significant owner of Czech government bonds.[23]

These banking sector characteristics place the Czech Republic among countries with a more resilient and stable banking sector than many other EU Member States. From the analysis of these ten indicators, joining a banking union is not yet beneficial for the Czech Republic.

The EBU is based on a Single Supervisory Mechanism (SSM), which refers to the transfer of supervisory powers to the ECB. By joining the EBU, some supervisory and regulatory activities are transferred to the ECB; in the case of euro-area Member States, this transfer has already been made; in the case of countries not yet in the euro area, the central bank of that country would lose some of its activities. The Czech Republic's entry into the EBU would mean a significant reduction in the Czech National Bank's supervisory powers over major institutions and a weakening of the voting power of the

22 European Council, 2023.
23 Ministry of Finance, 2020.

European Banking Authority and colleges of supervisors. These steps would mean that, in the event of the failure of a foreign bank, Czech subsidiaries could be at risk and the Czech National Bank would not be able to determine its own measures, which may be most effective given its knowledge of the Czech environment.

In the context of supervision and the general functioning of the SSM, assessments by the European Commission and the European Court of Auditors took place in 2016 and 2017. In its 2017 report, the European Commission positively assessed the first years of the ECB's functioning as a supervisory authority, but also identified areas for improvement. The European Court was more critical of the 2016 report; in particular, it was concerned with the supervisory structure, which is highly complex and requires a high degree of coordination and communication between ECB staff and Member States. There were also shortcomings in the IT and skills of the competent national authorities carrying out on-site inspections, which may affect the efficiency and effectiveness of decision-making. This factor also supports the Czech Republic's wait-and-see attitude, with the view that it should monitor the activities of the SSM, and, when more knowledge is available, re-evaluate its decision.

To make an informed decision on whether to join the EBU, the study published in 2021 provides a table containing individual criteria focusing on supervisory performance and financial costs, as assessed by the Ministry of Finance, the Ministry of Foreign Affairs, the Office of the Government, and the Czech National Bank. Consequently, the criteria relevant to informed decision making were divided into three areas. The first area contains factors in favour of the Czech Republic joining the SSM under current conditions; the second contains neutral factors or factors not assessable under current conditions; and the last contains factors against the Czech Republic joining the SSM under current conditions (see Table 1).[24]

Table 1: Banking supervision, regulation, and financial stability (abridged)[25]

	Factors for entry	**Neutral factors**	**Factors against entry**
THE EXERCISE OF SUPERVISION IN TIMES OF FINANCIAL STABILITY			
Supervision of significant institutions and their subsidiaries in significant groups			x
Supervision of minor institutions and their subsidiaries in major groups			x
Supervision of bank branches		x	

24 Ibid.
25 Ministry of Finance, 2020.

	Factors for entry	Neutral factors	Factors against entry
Prudential requirements (transfer of competencies from the Czech National Bank to the ECB, liquidity, limits on large exposures)			x
ECB approach to capital requirements		x	
Macro-prudential supervision and requirements		x	Czech National Bank
Licensing (from the perspective of the Czech market)			x
Assessment of acquisition of qualifying holdings (from the perspective of the Czech market)			x
Role of the EBA and dispute resolution between supervisors			x
The ECB as an active member of the college representing the Czech National Bank			x
The Czech National Bank and participation in the ECB Supervisory Board[26]	x	Czech National Bank	
Safeguard mechanisms for the participating countries of the Banking Union whose currency is not the euro[27]		x	x, Czech National Bank
The Czech National Bank's non-participation in the Governing Council of the ECB			x
Responsibility for supervision (ECB and Czech National Bank in relation to the Czech Republic)			x
Democratic control		x	
SSM regulatory supervisory framework			x
Rating		x	Czech National Bank

26 The Ministry of Finance, Ministry of Foreign Affairs, and Office of the Government took a neutral position regarding access to timely information and co-decisions on the supervision of institutions in the EBU.

27 Regarding membership in the European Banking Authority, the CNB was opposed to accession; regarding ending the close cooperation between the ECB and participating countries that do not use the euro as their official currencies, all interviewees were opposed to accession.

	Factors for entry	**Neutral factors**	**Factors against entry**
SUPERVISORY PERFORMANCE IN TIMES OF FINANCIAL INSTABILITY			
Prudential supervision			x
Macroprudential supervision		x	
Group supervisory performance		x	
Possibility of providing financial assistance to the parent institution		x	
Easier transmission of financial distress due to stronger links with the parent institution and group members			x
Lender of last resort		x	Czech National Bank
FINANCIAL COSTS ASSOCIATED WITH PARTICIPATION IN THE SSM			
Operating and other costs of the institution		x	
Financial contributions to ECB activities			x
Supervisory authorities			x

As stated in the 2021 study, based on the experience of the members of the EBU, the Czech Republic would have to increase its budget if it joined the EBU, mainly because of the increased administrative burden. Furthermore, the Bank's supervisory competencies would be transferred to the ECB, and the Czech National Bank would have to participate in the colleges but without voting rights. A shortcoming in the functioning of the SSM is the lack of differentiation of supervisory responsibilities within the SSM. Moreover, different legal frameworks are reflected in the ECB's supervisory activities, which negatively affect the performance of supervision. Additionally, the extent to which the ECB can influence the supervision of less significant institutions is not clearly predictable. Overall, in the context of supervision and regulation, it has been argued that it would be preferable for countries outside the euro area to join the banking union only when they decide to adopt the euro.

Crisis resolution in the banking sector was carried out under the Single Resolution Mechanism (SRM) regulation, which became effective on 1 January 2016 and applies to all countries with banking unions. According to previous studies, the measures set out in the SRM would be disadvantageous for a non-euro country. The primary concerns are the transfer of competencies to the ECB and the obligation to participate in financing future bank crises in other Member States. According to a 2021 study, the total amount of contributions paid by Czech-based banks to the

Single Resolution Fund (SRF) would be between CZK 17 billion and CZK 26 billion if they joined the banking union. Therefore, the Czech banking sector would contribute between CZK 7 billion and CZK 17 billion less than the current Resolution Fund; however, these funds would be used to finance the resolution of any entity in the banking union. If funds continue to be paid to the resolution funds, they will only be used to resolve domestic institutions. If the SRF were to be drawn down, the collection of contributions would resume, and it would be difficult to estimate the amount of this contingent liability. On the positive side, the number of entities contributing to the SRF is higher[28] than that contributing to the Resolution Fund. Given the good health of the banking sector in the Czech Republic, it can be assumed that additional contributions to the Resolution Fund were less frequent than those to the SRF.

In the wake of the COVID-19 pandemic, the EU has called on supervisory authorities to take measures to support the financing of households and businesses facing difficulties and that have had to temporarily reduce or minimize their activities; notably, it has been recommended that these measures be temporary. Under the SSM, the ECB reduced certain reserve ratios and liquidity coverage requirements. The Czech National Bank also took this recommendation into account, with the proviso that, in view of the greater resilience and stability of the banking sector, these were rather partial steps. For example, the countercyclical capital buffer for banks at the Czech National Bank was reduced from 1.75% to 1% and then to 0.5%, repo delivery operations were announced three times instead of once a week, and mortgage bonds could be included among the loans to be secured. Thus, the Czech National Bank was able, during the COVID-19 pandemic, to opt for measures that specifically helped the domestic market because it was not a member of the banking union. This also impacted the Czech Republic's attitude towards the banking union.[29]

The EDIS is based on the harmonisation of deposit insurance rules and the creation of a common fund. Its aim is to: (i) Create a common deposit insurance mechanism separate from public budgets; (ii) Strengthen financial stability; (iii) Ensure citizens' confidence in protecting their deposits; (iv) Weaken the links between countries and banks within their territories, thus reducing the risk of contagion.

The EDIS is primarily based on a policy debate on whether progress in risk reduction has been sufficient, with some banking union Member States leaning towards the view that progress in risk reduction has been sufficient and others arguing the opposite; however, the COVID-19 pandemic has disrupted this discussion. In April 2023, the European Commission adopted a proposal that enabled authorities to organise an orderly market exit for failing banks. This process is not dependent on the firm's size or business model; therefore, it includes smaller players.

28 There are approximately 4.300 banking institutions operating in the euro area and only 34 insured banking institutions in the Czech Republic.

29 Ministry of Finance, 2020.

Under the 2023 reform, protection for owners and borrowers has increased and a deposit insurance scheme has been set up (before the reform, bank losses would have been paid by depositors). In banking unions, safety nets are financed by the SRF (EUR 80 billion) and Deposit Guarantee Schemes (EUR 55 billion). The reform should bring about higher incentives for smaller and mid-sized banks to choose a resolution, such as facilitating the transfer of deposits to another bank. However, because too little time has passed to effectively analyse the impact of this reform, it is not entirely relevant to the analysis of the potential effects of the Czech Republic's entry into banking unions.[30]

4. Monetary aspects of crisis management

4.1. Eurocrisis

As suggested above, the primary goal of the Czech National Bank – enshrined directly in Art. 98 of the constitution – is price stability. In 1997, the Czech National Bank Board decided to change its monetary policy regime and, in 1998, opted to engage in inflation targeting, that is, to maintain inflation within predetermined bands. From 2002 to 2005, the target was set in the form of a linearly declining band, with a bandwidth of 3–5% in 2002 and a gradual reduction to 2–4%, to be reached in December 2005. In 2006, the Czech National Bank set an inflation target of 3%, with a further change in 2010. The inflation target has remained unchanged since 2010, with an annual increase in the consumer price index of 2%. The Czech National Bank expects this target to remain at the same level until the Czech Republic's accession to the Eurozone, in line with the targets of other central banks operating in advanced economies. The Czech National Bank regularly assesses whether its inflation target has been met.

As also noted above, monetary policy, which is intended to achieve and maintain price stability, is regulated by the Czech National Bank Act. Art. 5 lists the instruments of monetary regulation of the Czech National Bank; specifically, Art. 23 states that the Czech National Bank sets interest rates, frames, maturities, and other terms of transactions and determines the types of such transactions and its counterparties.

Therefore, interest rates are the primary monetary policy instruments. The board decides on where to set interest rates at regular meetings, and the rates applicable for the following period are published after each meeting. The most important interest rate is the two-week repo rate, which represents the marginal interest rate for repo operations (i.e. the withdrawal of excess liquidity from commercial banks against securities). Repo operations are usually executed thrice a week in the form

30 European Commission, 2023.

of variable-rate tenders with a base duration of 14 days. Commercial banks tender their cash, with the Czech National Bank preferentially accepting bids requesting the lowest interest rate up to the amount of the estimated liquidity surplus for the day. The two-week repo rate influences short-term market interest rates. The Czech National Bank also announces the Lombard rate, which is the rate at which commercial banks can borrow liquidity from the Czech National Bank overnight against the collateral provided by the lending facility. The third rate announced by the Czech National Bank is the discount rate; this rate is the opposite of the Lombard rate, in which commercial banks deposit liquidity overnight with the central bank under the deposit facility.

The Czech National Bank has the option of using other monetary policy instruments; however, these are only used in specific situations when interest rates reach the effective lower bound and a more significant monetary policy instrument is needed. These monetary policy instruments include foreign exchange interventions. Foreign exchange interventions were used between 2013 and 2017, and their effect was notably greater than that of interest rate changes. The Czech Republic is characterised by a banking sector with a long-term liquidity surplus, and because of the zero lower bound on interest rates, the Bank Board decided in 2012 to use a more effective instrument. Between 2012 and 2013, the Czech economy was in a downturn, reflected in rising unemployment and declines in profits, business investment, and household income and consumption, and threatened to fall into a deflationary spiral. The Czech National Bank sought to reverse this development by lowering interest rates to near zero (0.05%) based on the understanding that interest rates would be kept at this low level for the necessary period. If a traditional monetary policy instrument was ineffective, another instrument was used. The anti-inflationary effects associated with the rise in unemployment and the cooling of investment and consumption were slow, and there was a further decline in commodity and energy prices. Inflation was forecasted to fall to zero in 2014; therefore, the Czech National Bank decided to implement its intention in 2013. Notably, the IMF also recommends the use of foreign exchange interventions.[31]

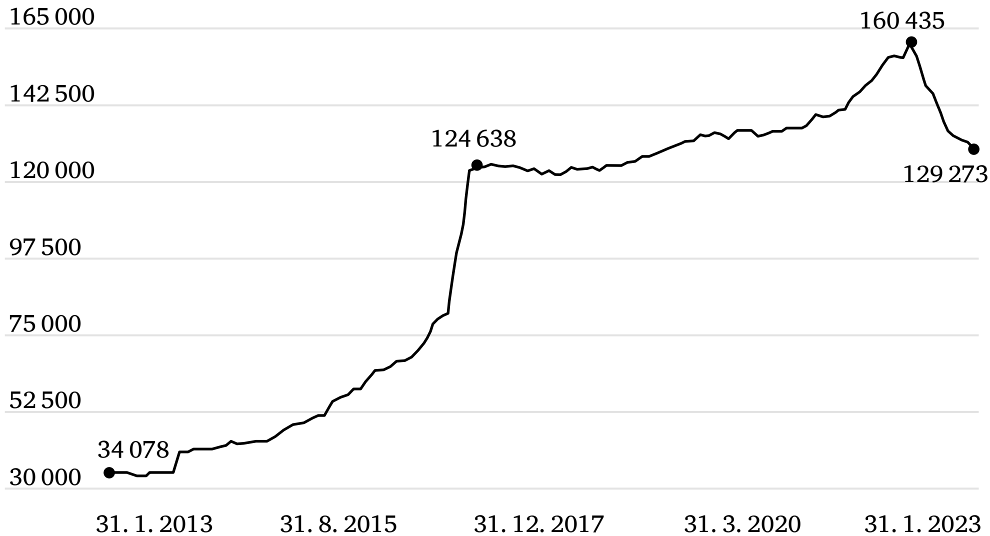
From November 2013 to April 2017, the Bank kept the exchange rate less than or equal to CZK 27 to the euro and spent over CZK 2 trillion on interventions. At the beginning of 2013, total foreign exchange reserves were approximately EUR 34 billion; in March 2017, they were four times higher. According to the Czech National Bank, the use of foreign exchange interventions was successful, as it not only prevented deflation but also contributed to overcoming the economic crisis. According to some economists, foreign exchange interventions lasted for too long and resulted in high exchange rate losses. However, the Czech National Bank defended itself, stating that these losses will be covered by future profits and will not burden the Czech state.

31 *Devizové rezervy a devizové intervence* [Online]. Available at: https://www.cnb.cz/cs/menova-politika/vzdelavani/12-devizove-rezervy-a-devizove-intervence/index.html (Accessed: 30 August 2023).

4.2. The COVID-19 Crisis

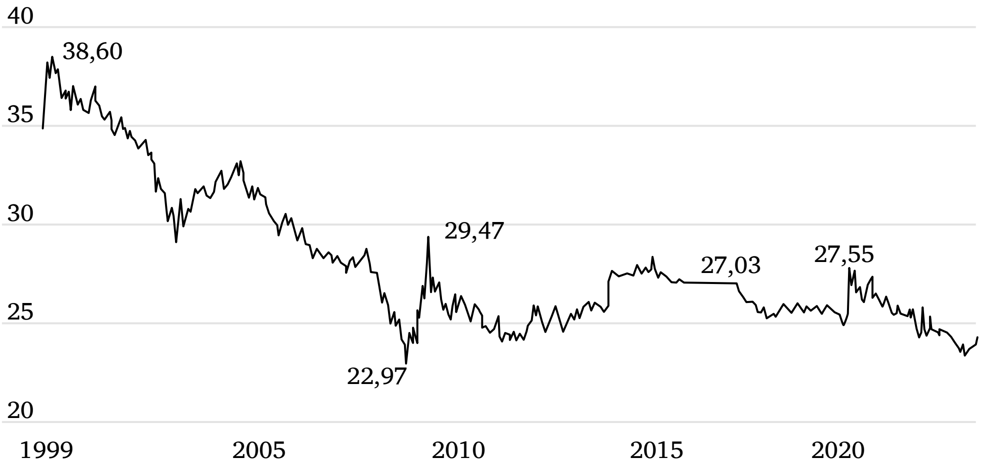
Further foreign exchange interventions began in March 2022 due to the significant weakening of the CZK and high inflation; specifically, the Czech National Bank began to sell off its euro reserves and buy domestic currency to strengthen the CZK (see Figure 1).

Figure 1: Foreign exchange reserves of the Czech National Bank (in billions of EUR)



Thanks to high inflation, in 12 months, the Bank spent approximately EUR 26 billion – approximately 16% of its foreign exchange reserves. The CZK appreciated more than 6% against the euro for the entire year. Many economists view this step positively, arguing that interest rate operations in which higher rates lead to a decline in investment and consumption are relatively ineffective. However, because companies have started to demand loans in euros, they are not affected by the higher interest rates set by the Czech National Bank. A strong CZK has a negative impact on inflation, as Czech entrepreneurs cannot increase prices significantly because households would prefer goods from abroad. Furthermore, exports decline as they become more expensive abroad, which negatively affects employment, wages, and, ultimately, household demand. At present, foreign exchange interventions have not been terminated because the continuation of commitment acts has a psychological effect on markets; however, the Czech National Bank is not using these interventions because the CZK has strengthened. Economists believe that the Czech National Bank would intervene again if the CZK entered the range of CZK 24.50 to 25.00 CZK/EUR.[32]

Figure 2: CZK to EUR exchange rate[33]



In addition to Art. 23, three other articles on monetary policy are listed in the Act on the Czech National Bank (the fifth section is devoted to monetary policy instruments). Art. 24 stipulates that banks, foreign bank branches, and credit unions must maintain mandatory minimum reserves in their accounts with the Czech National Bank; these reserves are kept in CZK and may or may bear interest. The minimum reserves may amount to a maximum of 30% of the total liabilities of the person required to maintain minimum reserves, less the liabilities of that obliged entity *vis-à-vis* other persons. The Czech National Bank also stipulates the possibility of setting minimum reserve requirements differently for individual obliged entities.

Mandatory minimum reserves were very important in the Czech Republic during the 1990s, when the money market was not yet fully developed. The level of minimum reserves and other conditions attached to them have since been adapted to contemporary needs. With the introduction of inflation targeting in 1998, their levels gradually decreased. Since October 1999, the reserve requirement rate has been 2% of banks' liabilities to non-banks, with a maturity of up to two years. In 2001, remuneration of reserve requirements at a two-week repo rate was introduced.[34]

Art. 25 imposes sanctions when the debtor fails to maintain the required minimum reserves. In this case, the Czech National Bank is entitled to charge interest on the amount by which the minimum reserve requirements are not met. This

32 Voženílek, 2023.
33 Ibid.
34 Czech National Bank, 2021.

interest corresponds to the average Lombard rate for the period for which it should have maintained the minimum reserves, increased by five percentage points and at least 5%. Art. 26 sets out what the Czech National Bank establishes in its decree.

As mentioned, the Czech National Bank is trying to further stabilise the situation using interest rates; specifically, it increased interest rates to 6% during the COVID-19 pandemic (see Table 2).

Table 2: Discount rate of the Czech National Bank[35]

Date	Discount rate
27 March 2020	0.05
1 October 2021	0.50
5 November 2021	1.75
23 December 2021	2.75
4 February 2022	3.50
1 April 2022	4.00
6 May 2022	4.75
23 June 2022	6.00

4.3. Russo-Ukrainian War

After the COVID-19 pandemic, the Russia–Ukraine conflict escalated, resulting in a substantial increase in energy prices. These inflationary pressures had to be solved by the Czech National Bank, which therefore continues to maintain high interest rates. The current situation shows that prices are decreasing very slowly; thus, it is expected that there will be no change in the Czech National Bank in the near future.

35 *Devizové rezervy a devizové intervence* [Online]. Available at: https://www.cnb.cz/cs/menova-politika/vzdelavani/12-devizove-rezervy-a-devizove-intervence/index.html (Accessed: 30 August 2023).

5. Conclusions and Recommendations

Generally, the financial sector plays an important role in the economy's ability to absorb economic shocks. The banking sector in the Czech Republic is developing favourably and is highly resilient to potential negative shocks. The profitability of the banking sector in the Czech Republic has been high for a long time, and this was also the case in 2021, when it increased from pandemic levels. In 2022, the profits in the banking sector continued to grow owing to the higher margins associated with the Czech National Bank's policy rate hikes and increasing demand for loans. The banking sector is building a countercyclical capital structure that continues to increase its resilience; in particular, capital buffers ensure smooth lending to the economy and the stability of the banking sector in the event of negative external factors (e.g. economic downturns, geopolitical tensions). Moreover, the banking sector has a high proportion of liquid assets; thus, its liquidity should be high.[36]

These aspects align with the conclusions of the Czech Republic's previous studies, which suggest that it should maintain a wait-and-see approach and not join the EBU or Eurozone. By not being a member of the euro area, the Czech Republic can effectively address the monetary policy situation according to the specifics of its domestic market. Further, in addition its relatively resilient and stable banking sector, the Czech Republic would have to consider the loss of its supervisory authority, especially over 'significant' banking institutions, their subsidiaries, and significant foreign banks with headquarters in its territory. Conversely, less significant entities (medium and small entities) would continue to be supervised by the Czech National Bank. The next study on the factors for or against entry into a banking union is expected to be published in 2024. The Czech Republic's entry into the banking union may indicate that it will seek to deepen integration with the EU, which may be reflected in its perception of future negotiations.

The actual determination of a specific date of entry is entirely within the competence of each EU Member State, although it should ideally be based on the State's level of preparedness. In addition to the undeniable positive benefits of being in the Eurozone, such as lower transaction costs and the elimination of exchange rate risk, adopting the euro means giving up an independent monetary policy and the exchange rate of the koruna as stabilising macroeconomic instruments. Therefore, an economy's readiness to join the euro area should be assessed in terms of its economic alignment and structural similarity with the monetary union, as well as its ability to absorb asymmetric shocks through other mechanisms, notably fiscal and labour market policies, after the loss of a separate monetary policy. Therefore, joining the EBU and Eurozone is primarily a strategic and political decision – one that is entirely up to the Czech Republic.

36 Ministry of Finance, Czech National Bank, 2022.

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