Slovakia and the Euro: How Slovakia has out-paced its Visegrád neighbors on the path to Economic and Monetary Union

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Adoption of the European common currency, the euro, is a requirement for the twelve New Member States which joined the European Union in 2004 and 2007. The Maastricht Treaty imposes macroeconomic requirements on New Member States before they can replace their national currencies with the euro. The aim of this paper is to examine the political environment of the Visegrád states and to explain why Slovakia is the only country among the four Central European states to have adopted the euro. This paper argues that the political will to cut welfare spending and a country’s economic size have been the most important factors in determining when a Central European state will adopt the euro.

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INTRODUCTION

The Maastricht Treaty, adopted in 1993, officially established the European Union (EU) and laid the foundations for the creation of the euro as the common currency among its member states. Adoption of the euro is a requirement of EU accession for the twelve countries that joined the union in May 2004 and January 2007. There are no special opt-outs as there were for the UK and Denmark, although as Sweden has demonstrated, there is also no effective deadline to join the eurozone, the region comprised of EU members that use the euro as their national currency. To qualify for eurozone entry and participation in the Economic and Monetary Union (EMU), New Member States (NMS) must meet the Maastricht convergence criteria and participate in the Exchange Rate Mechanism (ERM II) for at least two years. The timing of euro adoption depends on how fast each member state achieves “a sufficient degree of sustainable nominal convergence” (Issing 2005:1) as measured by the Maastricht criteria. Officially, the NMS are expected to take the necessary steps to comply with the criteria and to join the eurozone, although there is no official timeline or penalty for failure to do so.

Aside from meeting the criteria, however, a country must have the political will to adopt the euro. Interestingly, of the four Visegrád states (Hungary, Poland, Slovakia and the Czech Republic), Slovakia is the only one to have joined the eurozone thus far. Meanwhile, the three larger Central European countries remain the only NMS which have not even entered the Exchange Rate Mechanism. While Poland and Hungary may express some ambivalence about EMU, the Czech Republic is the only country actively eschewing a target date for euro adoption—despite relative success in meeting the criteria. In this paper I will address why Slovakia, which had a much less developed economy than the other Visegrád states and also endured several years of backwards politics, has defied expectations and leapt ahead of its neighbors to become only the fourth NMS to adopt the common currency.

I begin this paper with a brief description of the Maastricht convergence criteria and the Exchange Rate Mechanism (ERM II), an outline the official economic requirements to join the eurozone, and a discussion regarding the implications of exchange rate stabilization. In the following section I describe the political context in each Visegrád country in the years immediately prior to and following EU accession and explain how the differences among the four governments have largely determined each country’s path towards euro adoption. Next, I discuss the costs and benefits associated with euro adoption within the theoretical framework of Optimum Currency Areas (OCA) and as a function of economic size. I find that most of the economic factors typically expected to either encourage or discourage euro adoption do very little to explain the different outcomes in Central Europe, partially due to the fact that the European Union does not constitute an optimum currency area. I identify political will as the most important factor in determining a country’s push for euro adoption and economic size as a significant secondary factor.
THE MAASTRICHT CRITERIA AND EXCHANGE RATE MECHANISM

According to the Treaty of Accession 2003, which concerns EU accession for the ten countries which joined in 2004, in order to participate in EMU, all NMS must meet the following criteria:

- An inflation rate no more than 1.5 percent above the average of the three best-performing EU members
- Long-term interest rates that do not exceed the average rates of these three best-performing states by more than 2 percent for the preceding twelve months
- Public debt that does not exceed 60 percent of a country’s GDP
- A maximum budget deficit of 3 percent of GDP

Once a country demonstrates adherence with the Maastricht prescriptions for public finances, interest and inflation rates, it must participate in the Exchange Rate Mechanism II (ERM II) for at least two consecutive years before adopting the euro. ERM II was designed to reduce exchange rate variability and achieve monetary stability in preparation for EMU. It also serves as a tool for evaluating potential EMU membership. The European Central Bank (ECB) uses ERM II to test the fiscal discipline of new members, enhance exchange rate credibility and provide multilateral support for the exchange rate regime (Beblavý 2007:287).

Participation in ERM II requires a fixed central parity with the euro whereby the participating member state’s currency may only fluctuate within a 15 percent margin around that rate. Both the Member States and the ECB are, in principle, expected to intervene as many times as is necessary to maintain parity between the two currencies, although the ECB may refuse if such an intervention could threaten price stability. Member States are also prohibited from bilateral devaluations during this two-year period unless approved by the ECB (Beblavý 2007:286).

The rigidity of ERM II entails potentially high risks for participant countries that do not already maintain exchange rate parity with the euro through soft pegs or currency boards. A country’s options for exchange rate regimes range from very strict to very loose. Pegs and currency boards entail fixed bilateral exchange rates whereas “floats” allow the exchange rate to be determined by market forces (Klein & Shambaugh 2010, pp.14-15). Compliance with ERM II therefore requires a fundamental shift in currency regime for countries that use inflation targeting or a floating currency. Policies to maintain the exchange rate peg may not be compatible with policies geared towards Maastricht convergence or price stability objectives: The Czech Republic and Poland, for example, use a combination of direct inflation targeting and managed floats which means they face greater difficulties complying with ERM II. Alternatively, for the smaller Baltic countries (Estonia, Latvia and Lithuania), whose currencies have been closely aligned with the euro for several years, participation in ERM II is practically irrelevant as they have already ceded control over their monetary policies to a large extent (Beblavý 2007:286).
Although the criteria allow for some latitude such as a temporarily excessive deficit under certain circumstances and a higher ratio of government debt to GDP if it is deemed to be “sufficiently diminishing,” they have been quite rigidly applied to the NMS. Lithuania, for example, was denied entry to the eurozone in 2006 for having an inflation rate of 2.7 percent which was just fractionally outside the 2.6 percent benchmark rate of ERM II. This was despite the fact that Lithuania had had the lowest average annual inflation rate of any EU member state since 1999, plus a budget deficit and public debt well below the Maastricht limits at 0.5 percent and 18.7 percent respectively (Johnson 2008:835). It has been made clear that a country which fails to comply with the criteria will not be allowed to join the eurozone.

Although New Member States are obliged to seek entry to ERM II, there is no treaty requirement to join by a particular date. The timing of entry to ERM II involves a political judgment about the appropriate balance in priorities between macroeconomic stability, investment in industrial upgrading, and welfare spending to strengthen social cohesion. This decision is further complicated in that it is bound up with the ideological preferences and electoral incentives of governments, the nature of the country’s economic structure, administrative legacies and geopolitics among other factors (Dyson 2007). The NMS are thus individually responsible for their own euro entry strategies, which are not a matter for negotiation with the EU or the eurozone participant states.

**DIVERGENCE IN EURO ADOPTION STRATEGIES**

Since obtaining EU membership, the NMS have diverged significantly in their strategies for euro adoption, despite several macroeconomic and structural similarities. This development has contrasted sharply with the enthusiastic push for EU membership in which the applicant countries were willing to go to great lengths to qualify for European Union accession (Johnson 2008). In order to meet the Copenhagen criteria for EU membership the New Members had to make numerous political, legislative, and economic adjustments, many of which were far-reaching and rather intrusive. Many of the rules required fundamental changes to the existing institutional architecture and applicant countries had to demonstrate considerable achievements in terms of democratic openness, human rights and market reforms. Despite such an aggressive reform agenda, all ten of the 2004 NMS arduously strived to comply.

Kenneth Dyson (2007) has identified broad clusters of euro area accession strategies that can be grouped according to their economic structures, geo-strategic contexts and post-communist legacies. The Visegrad states share common features in their economic structures and exhibit a greater continuity in post-communist state and administrative legacies. All four of the Visegrad states have inherited large welfare states and, compared to the Baltic states and Slovenia, have been much less successful in executing fiscal discipline. The Visegrad states also have a higher degree of business cycle convergence with the other EMU countries, but because of domestic economic and social policy are not incentivized to push for rapid euro adoption (Dyson 2007).
In the run up to EU entry, almost all the New Member States expressed their commitment to pursuing EMU and the standard target date for euro adoption was set at 2008. Just one year later, however, the Visegrád states pushed their official target dates back to 2010 at the earliest, while unofficial briefings suggested dates as late as 2012 or 2015 (Country Monitor 2005; Dyson 2007). Hungary stood out by consistently failing to meet any of the Maastricht criteria. In Poland, the government has demonstrated a persistent lack of expenditure discipline and has therefore failed to bring its budget deficit to within the 3 percent upper limit. Although fulfilling the criteria was less challenging for the Czech Republic, the reluctance of elected officials to pursue membership has postponed setting a target date for entry. Meanwhile, Slovakia became an unlikely outlier in the group by reiterating its commitment to join ERM II and adopt the euro as soon as possible. Why did the Czech Republic, Poland and Hungary opt to lag behind while Slovakia forged ahead?

THE LEFT, THE RIGHT AND THE EURO

The most important determining factor in any country’s decision to adopt the euro is the political will to meet the Maastricht criteria and join ERM II. Governments are expected to actively pursue eurozone accession, which means taking the measures necessary to keep the public debt, budget deficit, and interest and inflation rates within the specified limits to comply with the Maastricht criteria. There is no entity with the authority to compel a country to enter ERM II, therefore an unwilling government can certainly impede euro adoption.

For the Visegrád countries, the fiscal deficit has been the largest constraining factor in Maastricht criteria compliance. The failure to bring deficits below the 3 percent limit is not due to an inability to meet the benchmark, however, but rather a lack of political will and fiscal discipline, particularly with regards to social spending. For example, the Czech Republic, Hungary, and Poland do not have difficulties raising revenue to fund their welfare states. They have also experienced several years of strong economic growth, which means their deficits are not merely cyclical (Beblavý 2007:284). Although employment levels have been consistently lower than the eurozone average in all four countries with the exception of the Czech Republic, it is expenditure which has been the Achilles heel for the three larger Visegrád states (Beblavý 2007:285). All three countries have expenditure-to-GDP ratios much higher than those of the Baltic countries and Slovakia. The most important thing to note, however, is Slovakia’s progress over this period. In 2000 the country had the highest expenditure to GDP ratio but gradually decreased spending to levels consistent with its neighbors’ and then even further to levels similar to those in the Baltic countries. In fact, Slovakia went from the having the highest expenditure among all eurozone and Central and Eastern European (CEE) countries in 2000, to the lowest level in 2007 and 2008. Only Bulgaria and Romania had lower spending in 2009 (IMF 2010).

Where there are large fiscal problems, political elites worry that negative public reactions to cuts in social spending will prevent the structural reforms necessary to fulfill the Maastricht deficit criteria (Beblavý 2007:278). Concern over the effects that EMU could have on a country’s social model has proven to be a primary consideration for many countries in deciding when to adopt the euro (Dyson 2007) and is one of the reasons why Denmark has opted out of the eurozone altogether and why Sweden continues to delay its entry into ERM II. The size of the welfare state is typically one of the most prominent differences in policy preference between
the left and the right and also a large determinant of the fiscal deficit. Therefore, it is not surprising that in the three countries where the left was in power after 2002, Maastricht deficit compliance was eschewed in favor of more generous public spending.

An analysis of the political leanings of the governing parties in the years immediately preceding and following EU accession help explain why Slovakia is the only country to have enacted measures to meet the criteria and join ERM II. Data collected in 2002 and 2006 Hooghe et al (2010) examines a number of characteristics regarding each party that won votes in the elections most prior to those years in over twenty countries across Europe. The results reflect an average of the survey responses of academics that who specialize in political parties and European integration in each country. The survey’s placement of the Central European parties on the left or the right regarding economic issues correspond to traditional expectations in terms of welfare spending and, subsequently, whether or not each government was able and/or willing to bring down spending and pursue euro adoption.

According to the 2002 data, all parties in power in the Visegrád states between 2002 and 2006 (2005 for Poland) were strongly if not overwhelmingly in favor of EU membership. They were all largely in favor of the major EU policy areas surveyed, including the internal market, and the party leadership of all parties in government during this period also publicly supported major domestic reforms to qualify for EU membership. An interesting divergence is seen when we compare the broad ideological stances of the ruling parties in each country, however. For the Czech Republic, Hungary and Poland, all parties were center-left with the exception of the Czech Freedom Union-Democratic Union which played a minor role in the governing coalition and only controlled 4 percent of the seats in parliament. In a striking contrast, the four parties that formed the coalition government in Slovakia during this period were considered to be center-right. Unsurprisingly, the survey paints a similar picture regarding left-right alignment of the parties on economic issues. When asked where each party stood ideologically on whether the government should play an active role in society, all of the Slovak parties were firmly positioned on the right while the dominant parties in the other three countries were in the center or on the center-left (Hooghe et al 2010). These data provide a comprehensive reference point for comparing the governments in power between 2002 and 2010 and help explain why the three larger countries have opted to maintain high deficits at the expense of failing to meet the Maastricht criteria and postponing euro adoption.

As mentioned above, all four Visegrád countries inherited large Communist-era welfare states and have been less successful with fiscal management than other post-Communist countries (Beblavý 2007; Dyson 2007). Although this factor has played a smaller role in postponing euro adoption in the Czech Republic, concerns over social spending have hindered Polish and especially Hungarian efforts to bring their budgets deficits within the 3-percent upper limit set by Maastricht—despite public avowals by political leaders in both countries that they were committed to meeting the criteria and planned to adopt the euro as soon as possible. Slovakia, on the other hand, emulated the more fiscally prudent Baltic countries and enacted harsh austerity measures to rapidly meet the Maastricht criteria (Beblavý 2007: 285).

Another dimension to consider when examining political parties in Central and Eastern Europe is the different way in which Euroscepticism is aligned with left-right dichotomies. Support or opposition to European integration is guided by socioeconomic issues in both Eastern and Western Europe: those who believe they will benefit from globalization and Europeanization
are open to change and support deeper integration, and those who fear they will be the economic losers from these international processes are reluctant to change the status quo. The difference is that in Eastern Europe, Euroscepticism has been comfortably absorbed into the existing party systems because it aligns with the existing set of values on the hard left. In Western Europe, on the other hand, the values that correspond with Euroscepticism are dispersed on both the extreme right and the extreme left which makes it politically awkward for parties to take a position (Marks et al 2006).

**POLITICS BY COUNTRY**

The different preferences for social spending between left- and right-leaning parties explain much of the divergence in euro adoption strategies in the Visegrád Four. That Euroscepticism has been easily incorporated into the existing cleavages of CEE party systems, which also explains why parties on the left are even less inclined to push for eurozone entry. Despite these connections, euro adoption has not been a direct function of left vs. right in any country. In this section I will briefly describe the political motivations surrounding euro adoption in each of the Central European countries.

**Hungary**

In 2006, the Hungarian Socialist Party (MSzP) won an even larger share of parliamentary seats than it had in 2002 and became the first government in a post-Communist NMS to be reelected. Although the party was nominally committed to fiscal consolidation and eventual euro adoption, there was strong political resistance to spending cuts from within the party, especially in the face of an uphill battle to retain power in 2006 (Country Monitor 2005). In fact, given its failure to meet any of the Maastricht criteria, the Hungarian government’s continued enthusiasm for joining the eurozone—even nominally—after EU accession was rather surprising. Hungary’s announcement in 2003 that it planned to adopt the euro on January 1, 2008 and join ERM II as soon as possible were based on optimistic projections of economic growth that would help bring the deficit of 9.7 percent to within the 3 percent upper limit by 2006 (Country Monitor 2003). By that time, the country was already projected to miss its budget reduction targets for both 2004 and 2005 and inflation had reached the highest level in the region (Sherwood 2004). In December 2004, the European Commission and the European Central Bank (ECB) singled out Hungary and Poland as the only prospective eurozone members that satisfied none of the prescribed criteria for entering monetary union.

In October 2005, the Hungarian Prime Minister, Ferenc Gyurcsány, stated the country should not adopt the euro if it required the government to compromise its social goals. This made him the first prime minister to openly question the value of joining the single currency and reflected the diminishing enthusiasm for the euro in Hungary, Poland and the Czech Republic (Country Monitor 2005). In the years since, Hungary has consistently failed to meet the fiscal criteria (its deficit has hovered around three times the limit), while it has continued to press for rapid adoption of the common currency. During the economic downturn the euro was seen as a safe haven, and in 2009 Hungary floated the idea of shortening the time candidate states must spend in ERM II (Perry 2009).
Czech Republic

In the Czech Republic, the right-wing Civic Democratic Party (ODS) came to power and won enough seats to be able to rule alone as a minority government. The party is led by the notoriously Eurosceptic Václav Klaus, who fiercely opposes deeper European integration and EMU in particular. He has repeatedly cited the euro as a perfect example of misguided European policy and derides the fact that it was first and foremost a political project and not based on purely economic underpinnings. Despite having already fulfilled most of the Maastricht criteria and being forecast to bring its budget deficit within the 3 percent upper limit by 2012, the Czech Republic’s date for euro adoption was unlikely to be a policy priority with the ODS at the helm.

The Civic Democrats’ stance on EU integration is rather surprising given its right-wing stance on economic issues. In fact, according to Hooghe et al, the ODS was the sole outlier in terms of its position on EU integration. While all other Eurosceptic or neutral parties in CEE countries were considered to be economically left-wing, the ODS was the only Eurosceptic right-wing party (Marks et al 2006). An interesting caveat to this observation, however, is that of all the Visegrád parties surveyed in 2002, ODS registered the highest level of dissent within the party regarding EU integration (Hooghe et al 2010).

Poland

Despite Poland’s initial proclaimed enthusiasm for the euro, the center-left minority government led by the Alliance of the Democratic Left (SLD) in power at the time of EU accession was forced to shelve the austerity measures necessary for eurozone convergence in order to consolidate popularity and remain in office (Report 2005). In spite of the party’s efforts, the conservative Law and Justice party (PiS) won a narrow victory in the 2005 elections and formed a coalition with a right-wing League of Polish Families (LPR) and the agrarian Self-Defense Party (RP) the following year (Pasek 2005; World Briefing 2006; Chapel Hill expert surveys 2006). According to the 2006 survey data (Hooghe et al 2010), the PiS is considered a radical right party, the Roman Catholic LPR is ideologically on the far right while the RP is slightly left of center. However, all three parties were far left in economic terms.

The 2005 election results were significant for Poland’s path to the euro. The PiS bills itself as the defender of the welfare state and strongly opposes cut in social spending in order to reduce the fiscal deficit. The party had never been committed to rapid EMU entry and had demanded a detailed cost-benefit assessment before pursuing accession (Pasek 2005). Cezary Mech, a PiS politician who had advised against early euro entry, was appointed economy minister and, perhaps more significantly, both coalition partners had been vehemently opposed to EU accession and adoption of the euro (Pasek 2005; World Briefing 2006). These two parties also became an important driving force behind the increased fiscal spending at this time (Risk Summary 2007).

The radical coalition led by the Law and Justice Party only lasted for two years, however. In 2007 the Sejm (lower house of the Polish Parliament) voted for its own dissolution and the elections held in October of that year delivered a decisive victory to the Civic Platform (PO) which then formed a coalition with the Polish People’s Party (PSL). The new government saw a
near-complete turnaround in terms of its support for EU integration, perceptions of benefits from EU membership and its stance on the role of the government in economic matters. The broad ideological position of the government since 2007 is firmly in the center and its position on economic matters a near polar opposite of the government it replaced. Furthermore, the PO was strongly in favor of reducing taxes over improving public services. The PSL favored improving public services but not nearly as strongly as any of the parties which had formed the previous administration (Hooghe et al 2010).

Despite the party’s free-market orientation and the apparent eagerness with which the Prime Minister, Donald Tusk, has pursued euro adoption, Poland has yet to enter ERM II and its current prospects are negative. The new administration had originally planned to adopt the euro in 2012, but in the wake of the global financial crisis the country no longer meets most of the criteria. Moreover, ERM II entails higher risks for Poland than for any of the other new member states because the Polish zloty is a volatile currency that offers sizeable scope for speculators to bet against (Commission 2009). The National Bank of Poland is not convinced of the stabilizing virtues of an early euro adoption (Cover Story 2009) and the ECB has discouraged a hasty entrance over concerns that a currency linked prematurely to the euro could suffer a speculative attack by traders and destabilize the eurozone (Perry 2009).

Furthermore, Poland is in the unique position of having to overcome legal hurdles before being able to adopt the euro. The country’s constitution states that the zloty is the national currency and that only Poland’s central bank has the right to set monetary policy. Euro adoption entails shifting monetary policy to the European Central Bank so the constitution will have to be changed before Poland can enter the eurozone. Currently, the PO lacks the two-thirds parliamentary majority it would need to pass the constitutional amendments and will need the cooperation of the PiS since a qualified majority cannot be reached without their support. The Eurosceptic PiS, however, is opposed to euro adoption without a referendum and has stated that Poland shouldn’t adopt the euro until its economy strengthens to more closely resemble those of the largest eurozone members.

Slovakia

The Slovak case also clearly demonstrates the importance of politics in joining the eurozone although for different reasons. Under the corrupt Prime Minister Vladimir Mečiar, Slovakia spent most of the 1990s regarded as a veritable pariah state (Johnson 2008). In the West he was constantly criticized for his autocratic style of governance, disregard for democracy and the shady privatizations that took place during his rule. Mečiar was not even afforded diplomatic visits by nearly all Western European leaders during his tenure and Slovakia was famously called “a black hole in the heart of Europe” by the then US Secretary of State, Madeleine Albright (Kacer & Tupy 2005). Although the public was strongly in favor of joining the EU, Slovakia was rejected from the first round of EU membership, as the country under Mečiar could not meet the Copenhagen political requirements.

Slovakia did not pursue EU membership until the center-right coalition led by Prime Minister Mikula Dzurinda came to power in 1998. Re-elected in 2002, the Dzurinda administration used its mandate to carry out extensive fiscal and structural reforms, pursue EU membership and meet the Maastricht criteria. As the public increasingly felt the effects of
Dzurinda’s austere economic policies, it became clear that he stood to lose the 2006 elections. In order to ensure continued fiscal discipline and entrench Slovakia in its path to the euro, the Dzurinda government moved the country into ERM II in November of 2005 (Johnson 2008; Rosenberg 2008). This decision effectively tied the hands of future administrations and locked the country into an EMU-bound trajectory. ERM II commits a country to fiscal rectitude by immediately becoming the country’s foremost symbol of credibility. This component of the Maastricht criteria is effective not because of EU enforcement, but because a withdrawal from the process is likely to instigate dramatic ramifications in the financial markets (Johnson 2008). This is exactly what happened in Slovakia.

Public discontent with the Dzurinda government’s austere Maastricht-driven economic policies brought Robert Fico to power in the 2006 elections. His victory was largely attributable to his criticism of and promises to reverse a majority of Dzurinda’s tax, social, pension and legislative reforms. The moment Fico implied that Slovakia might consider postponing its planned 2009 euro adoption for fiscal reasons, however, currency speculators began attacking the Slovak koruna (Johnson 2008; Rosenberg 2008), causing it to rapidly appreciate and threatening to overheat the economy (Zhou 2007). He soon realized that he would have to adhere to ERM II which forced him to abandon his more expensive campaign promises and reiterate Slovakia’s commitment to the original target date (Johnson 2008; Rosenberg 2008).

As our four case study countries demonstrate, political will is the most important determinant as to when a country will adopt the euro. The problem is not the ability to cut spending and meet the criteria, however, but rather the political will to do so. In the critical years leading up to and immediately following EU accession, the left was in power in the Czech Republic, Hungary and Poland, and social spending continued to inhibit reducing the deficit. The Czech Republic’s failure to adopt the euro is less a factor of fiscal irresponsibility and largely a result of the ODS’s hardcore Euroscepticism, but in any case reiterates that politics is the crucial factor. In Slovakia, where the right was in power, the government reigned in spending and the deficit was drastically reduced to a level consistent with Maastricht. Slovakia’s near-complete turnaround from corrupt politics and fiscal mismanagement was due to Dzurinda’s determination for the country to join the club of Western democracies and enter the eurozone.

**Costs and Benefits According to Optimum Currency Areas**

The costs and benefits of an early EMU membership have been widely discussed within the theoretical framework of Optimum Currency Areas (OCA) (De Grauwe and Schnabl 2004). In order for a currency union to be successful, the region must have:

- labor mobility
- openness with capital mobility and price and wage flexibility
- similar business cycles
a risk-sharing system such as a redistribution mechanism to transfer money to areas which have been adversely affected by the first two characteristics. (Optimum Currency Area 2010)

The Stability and Growth Pact, promulgated to maintain economic stability by monitoring adherence to the Maastricht fiscal criteria after Member States have joined the eurozone, (theoretically) prevents fiscal transfers. Since labor and capital are mobile as a result of the original rules which established the EU in 1993, we can examine two other benchmarks of a successful monetary union—labor market rigidity and business cycle correlation—to determine whether these may help explain the divergent paths to the euro among the four Visegrád states.

Labor Market Rigidity and Wages

A common misconception about the economies of the NMS is that their labor markets are too rigid and the fiscal consolidation required by Maastricht would only aggravate this problem. Disappointing levels of job growth in the region has been taken as further evidence that CEE labor markets are ill-equipped to deal with the constraints of a monetary union (Boeri and Garibaldi 2006). Once a country has pegged its currency or joined a currency union, it automatically loses certain measures of labor market flexibility. For example, a country within a currency union must be careful not to overshoot in its wage agreements as it cannot devalue its currency to lower them once they are in place. The concern is that integration with EMU countries may put upward pressure on real wages and outpace productivity growth.

Boeri and Garibaldi (2006) refute such claims. They note that in the five years prior to the 2004 EU enlargement productivity gains had outstripped wage increases in the NMS while the business sector in EMU countries during this same period experienced a cumulative growth in wages which exceeded productivity growth (Boeri and Garibaldi 2006). In their study they compared the institutional features of the existing EMU members to those of the NMS and found that labor markets were no more rigid in the NMS at that time than in the twelve eurozone members. They point out, for example, that minimum wages were kept very low throughout the transition to a market economy, employment protection legislations (EPL) were actually less restrictive in the NMS, and union density and coverage rates were much lower than in the comparison countries. The authors contend that the persistence of high unemployment in these countries was related to productivity enhancing job destruction in the aftermath of prolonged labor hoarding rather than a by-product of structural rigidities.

Interestingly, Slovakia had the strictest EPL of all the NMS (although it later increased flexibility through the expansion of temporary contracts) and the highest union density and coverage rates of the four Visegrád states. According to OCA theory, one would expect Slovakia to have been the least inclined to push for early euro adoption. Flexibility in labor market institutions, however, does not necessarily indicate that labor markets are flexible enough to participate in a monetary union. The same institutional features may function very differently in different environments and there is no doubt that NMS still differ in many ways from the average EMU country.

Business Cycle Correlation
According to OCA theory, business cycle synchronization as a measure of convergence is important because the closer the correlation of business cycles between NMS and the eurozone, the lower the risk of asymmetric shocks and the easier it is to adapt to a single monetary policy. In particular, the loss of an independent monetary policy and of a flexible exchange rate is less painful for the member country. Moreover, in the case of high business cycle correlation, it becomes more plausible to expect the ECB to respond to aggregate shocks and to implement these interventions with greater ease (Furceri 2006; Dyson 2007; Nabil 2009). Afonso and Furceri (2008) analyzed business cycle synchronization as a determinant of cost according to OCA theory and evaluated how important this is for the NMS compared to the EMU members. Their research showed that the business cycles of some NMS were already well synchronized with the EMU as a whole and some had correlations comparable to, or even higher than, those of some of the old member states which implies that these states faced lower adjustment costs in EMU convergence.

Evidence suggests that since 1993, there is a Visegrád (plus Slovenia) cluster that reveals an increasing correlation of the manufacturing cycle with the Euro Area. Within this cluster Hungary exhibits the highest correlation, whereas the Czech Republic lagged much further behind (Dyson 2007). In fact, in Afonso and Furceri’s research of the 2004 NMS, Hungary’s high business cycle correlation suggests that, along with other countries such as Cyprus and Malta, the costs of stabilization would be relatively low. On the other hand, the Czech Republic and Poland had very low levels of correlation in their business cycles and Slovakia, along with Estonia and Lithuania exhibited negative correlations. From their research it appears that Slovakia’s stabilization costs of entry to the eurozone would have been higher in the short to medium term than for any of the other Visegrád countries.

**Costs and Benefits as a Function of Economic Size**

In terms of the costs and benefits of EMU, the most compelling argument for why Slovakia has surpassed its Visegrád peers is that economic size largely determines the pros and cons of euro adoption. The most oft-cited benefit of a currency union is reduced transaction costs. Thus, for small countries which are more dependent on foreign trade, the benefits are more substantial. The external market has a larger effect on their prices, growth, and government revenue which also means stable exchange rates vis-à-vis their main trading partners are extremely important to monetary policy. The opposite is true for economically larger countries like Hungary, Poland and the Czech Republic. Less dependence on trade means their economies are more stratified and their currencies provide wider scope for financial speculation. The rigidity of ERM II thus entails much higher risks as monetary intervention is necessarily curtailed and independent devaluations are prohibited.

Juliet Johnson (2008) compared the ten NMS of the 2004 enlargement and points out that after 2005 the group separated into “pacesetters” and “laggards” when it came to meeting the Maastricht criteria. Johnson attributes this split to the costs and benefits associated with adopting the common currency and notes that the group of “pacesetters” which included Slovakia (plus the Baltic states and Slovenia) all had far lower GDPs than the “laggards”—Poland, Hungary and the Czech Republic. In fact, the pacesetters had met both of the fiscal criteria for Maastricht
well before joining the EU and all petitioned for more rapid adoption of the euro and entered ERM II as soon as they could.

Furthermore, the post-communist states needed to establish credibility in their monetary policies during the transition to a market economy. For smaller states with inexperienced central bankers and less economic certainty, one way to do this was to establish exchange-rate pegs or currency boards to closely align their currencies with stronger, more established ones. This demonstrated to domestic and international actors that a government was committed to responsible monetary and fiscal management and had the simultaneous side effects of stabilizing the economy and converging with the EU market (Tuma 2003; Smidkova 2004; Johnson 2008). As a fragile new state in the wake of a problematic divorce from the Czech Republic, a credible currency and macroeconomic stability were especially symbolic issues for Slovakia (Dyson 2007). The Czech Republic, by contrast, was exceptional in that it had already established one of the most credible economies of the NMS. In 1997 it became the first post-transition economy to introduce inflation targeting and had successfully kept its inflation rates consistent with European levels (Gomez and Lytle 2009) thereby garnering investor confidence. Since the danger of macroeconomic instability is even greater for small and open economies with international capital mobility, the benefits of EMU accession seem to be significant (De Grauwe and Schnabl 2004).

Poland, Hungary and the Czech Republic were not incentivized to adopt the euro in the same way that Slovakia and the other small NMS were. Although the governments recognized the long-term benefits of adopting the euro, the economic benefits in the short and medium term were less evident. Both academics and policy-makers warned that joining the eurozone too soon could hinder economic growth as there were significant investment needs and productivity and price levels were well below the EU average. Additionally, the costs of entering ERM II too quickly were potentially very high. For the larger economies, entrance to ERM II represented a loss of useful monetary policy flexibility with no guarantee of a timely entrance to the eurozone. The smaller states had already given up this autonomy which meant entering ERM II did not represent a significant or particularly controversial change for them. (Smidkova 2004; Johnson 2008).

For the larger Visegrád states, there was also a heightened risk of misalignment between their domestic economies and the eurozone. Adopting the euro too quickly could lead to an overvalued exchange rate, and the complexity of larger states’ internal economies meant that inflation could stubbornly persist under exchange-rate pegs, especially as rapid economic development put upward pressure on prices. So, unlike the smaller states which needed to add credibility to their currencies, the “laggards” preferred to maintain flexibility in monetary policy to offset inflationary pressures from government spending. They felt that more time was needed to coordinate their financial system components in order to more effectively implement the ECB’s monetary policies (Johnson 2008).
CONCLUSION

All New Member States are obligated to eventually replace their national currencies with the euro. They are expected to take the necessary steps to fulfill the Maastricht convergence criteria and seek entry to ERM II. However, as there is no treaty requirement to join by a particular date, the timing is essentially left up to the politicians. The decision to join the eurozone therefore involves a political judgment about the appropriate balance between domestic concerns, macroeconomic stability, and the degree of sustainable convergence with the existing eurozone economies. It is also bound by the nature of a country’s economic structure, administrative legacies, and the electoral incentives of politicians (Dyson 2007). The NMS are thus individually responsible for their own euro entry strategies, which are not a matter for negotiation with the EU or eurozone member states.

The most significant determinant of the timing of euro adoption is the political disposition of a member state’s government. The divergent trajectories of the Czech Republic, Hungary, Poland and Slovakia towards EMU exemplify the importance of political will for euro adoption. When the economic left was in power in the years immediately preceding and just after EU accession, the budget deficit could not be brought within the 3-percent Maastricht limit because of political commitments to social spending. Meeting the economic criteria has been less problematic for the Czech Republic, and although the right took over in 2006, the country has continued to postpone euro adoption primarily because of the Eurosceptic nature of the ODS. The main reason why Slovakia was able to come from behind and surpass its larger, more economically advanced neighbors on the path to the euro was the determination of its political leaders. Furthermore, without the political consensus necessary for a Constitutional amendment in Poland, eurozone accession will remain a legal impossibility.

Political will is certainly not the only relevant factor for euro adoption, however. Both Poland and Hungary have expressed their commitment to euro adoption but have been unable to meet the economic benchmarks. The economic measures pertinent to optimum currency areas do little to explain the attractiveness of the eurozone for any of the Central European countries, but the implications of economic size provide a compelling argument for why Slovakia is the only Visegrád country to have pushed for faster monetary convergence. In particular, economic size largely determines exchange rate regime choice and dependence on exports. Small countries tend to be more dependent on external trade which means it is more practical for their currencies to maintain a close parity with their largest trading partners. This, in effect, diminishes the costs associated with ERM II as smaller economies will have already sacrificed their national monetary policy to a large extent.

The global financial crisis that began in 2008 led to substantial setbacks with regards to meeting the convergence criteria, especially for the fiscal deficit and public debt benchmarks. The 2010 euro crisis initiated by Greek admissions of public profligacy, and which has since led to the creation of a massive “stability fund” to prevent a potential collapse of the entire eurozone, was perhaps even more discouraging for the NMS. Václav Klaus, the Czech President, was quick to argue that the euro was the real cause of the Greek default. He pointed out that Greece might have been spared some pain if it had still had the drachma and simply been able to devalue its currency (Cameron 2010; La Rouche 2010). Moreover, the crisis consequently made euro deferral by prospective members a positive move (Webb et al 2011). Only time will tell if the
Czech Republic, Poland and Hungary will be able to achieve the right combination of political will and fiscal management necessary to adopt the common currency.
REFERENCES


