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EUROZONE ENLARGEMENT IN TIMES OF CRISIS: CHALLENGES FOR THE V4 COUNTRIES

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INTRODUCTION

The eurozone's eastward enlargement has become one of the most challenging questions for Central and Eastern European (CEE) countries and for euro area members. Different approaches concerning membership at the third stage of the Economic and Monetary Union (EMU) does not make it any easier to work out a coherent strategy underpinning integration with the euro area. Slovenia, Slovakia and the Baltic States undertook a quick path towards the euro, whereas the other CEE countries, especially after the outbreak of the eurozone crisis, have taken a more moderate approach. As a result, Slovenia became the first country from the Eastern enlargement to be granted full EMU membership, in 2007. It was subsequently followed by Slovakia (2009), Estonia (2011) and Latvia (2014). Lithuania aims at adopt the common currency in 2015. In Hungary, the Czech Republic and Poland, the euro has become an issue in national politics. Yet, further consolidation of the euro area affects eurozone outsiders and poses a risk of the CEE countries' becoming marginalised in the decision-making process. Therefore, the metaphor of a departing train is commonly used to underline the political necessity of full EMU membership.

Yet, one may ask whether euro adoption creates risks for these countries? The situation at present in the euro area seems much calmer than it was several months ago when numerous media and politicians were openly expressing concerns about the future of the currency union. Currently, the risk of disintegration seems to have been rather defused, mostly thanks to activities undertaken by the European Central Bank and the declarations by its president, Mario Draghi. The short-term economic outlook reveals that some foundations remain weak, but project economic growth for 2014 in the euro area. Ireland was the first country to return to the financial markets after having applied draconian austerity measures. The unstable and unpredictable situation in the southern eurozone states sheds light on the condition of the rest of the currency union's members, as well as on the candidates themselves. The problems in the eurozone's banking sector are far from being resolved. However, the key components of the banking union - Single Supervisory Mechanism and Single Resolution Mechanism - have been agreed. The crisis proved the readiness of Member States to create instruments and mechanisms once unthinkable to save the common currency. Looking into the future, it is clear that further turbulence in the euro area is in no EU members' interest. There are numerous channels through which the instability is transferred to non-eurozone members, including the Czech Republic, Hungary and Poland.

The aim of this publication is to provide some new insights into the discussion about eastward eurozone enlargement, and is divided into three parts. It seems necessary at the beginning to point out selected problems in the euro area that affect the situation for the entire bloc. Thus, we found extremely useful for the sake of the debate on the sovereign debt crisis to offer the authors a platform to wax polemic on general opinions frequently expressed in public discussions.

Ognian Hishow discusses the common claims that Germany "should do more" to counteract macroeconomic imbalances. In his contribution, Hishow reveals that internal debates in Germany on its role in walking the eurozone out of the woods have found no easy solutions that would find domestic backing or that can be offered to its partners. He dampens expectations that the new governing coalition in Germany will contribute to a breakthrough crisis resolution.

Any analysis of the eurozone's current condition should also include the view of the country where the sovereign debt crisis began and its effects on the CEE. Therefore we asked Anna Visvizi to elaborate on the real origins of the complex structural problems of Greece, and Zoltán Gál on the implication of the financial crisis on the FDIs. The author draws readers' attention to the role of FDI in the CEE banking sector in the post-transition period. In his paper, Gál shows that the CEE banking sector represents a "dual-banking" model that can be characterised by weak local banking structures and dependence on foreign institutions and their resources. He finds that this model can potentially transmit cross-border exogenous shocks to the region.

Having presented the genesis of the crisis in the euro area, we move in the second part of the volume in the maladies afflicting eurozone members and non-euro members' dilemmas about how to reconcile domestic politics with the pressing need to enlarge EMU.

Ettore Dorrucci indicates in his contribution to this section that each candidate country should focus on all aspects of convergence, and not just on selected portions. Dorrucci considers euro adoption to be an opportunity that does not deliver benefits automatically, and depends in large measure on the macroeconomic/structural policy and governance of the acceding country as well as the situation in the euro area. The Slovak Republic, the member in the euroclub, can serve as useful case study. Thus, we asked Martin Šuster to present lessons for other CEE countries from the first-hand experience of Slovakia's eurozone accession. Patryk Toporowski surveys the effects of the eurozone enlargement on the intra-euro area and on intra-EU trade.

Closing this chapter are analyses by Julius Horvath and David Král, who focus on the political debates surrounding euro adoption in Hungary and Czech Republic, respectively. After all, it is politics and not economics set to determine the remaining Member States' strategies on euro area accession.

The last chapter of this joint publication is devoted to Poland's perspective for eurozone accession. Poland, as the most pro-European country of the Visegrad Group, naturally attracts the attention of both financial markets and euro area members, alarmed by the relatively high scepticism among Polish society to adopt the euro.[1] First, Paweł Tokarski briefly elaborates the economic convergence process in Poland, focusing on the challenges of real convergence. This contribution has been complemented by analysis of Agata Gostyńska on the necessary legal adjustments to conform with EU law arising from Poland's status as a member with a treaty derogation. It centres around the necessary constitutional amendments and also discusses the question of the legal feasibility of a referendum on the euro. The latter appears in domestic political discourse and constitutes a tough nut to crack for Poland's decision-makers. Their approach to euro introduction is presented on a time axis built around subsequent Polish governments' programmes, and has been elaborated in a piece by Damian Wnukowski, which closes the volume.

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This volume is a result of the scientific research delivered as part of the Rastanews project "Macro-Risk Assessment and Stabilisation Policies with New Early Warning Signals." The first thematic event of the project, a closed-door scientific seminar, took place in June

[1] The pro-European stance of Polish society is backed by CBOS polls referring to the satisfaction in the V4 countries with EU integration: 78% of Poles, 60% of Slovaks, 44% of Hungarians, and 43% of Czechs agree (individually) that their country has benefitted from EU integration, according to a public opinion poll released in October 2013. For more, see: www.cbos.pl.

2013 at the Polish Institute of International Affairs (PISM). The discussions were subsequently included in a special report published by PISM in September 2013.[2] This book contains more detailed contributions by selected seminar speakers and PISM experts involved in the research. The aim was to collect short texts from experts with various backgrounds, including think tanks and academia as well as the banking sector. The experts were given full liberty concerning the content and structure of their contributions, which resulted in a publication offering a complex approach towards eastward eurozone enlargement. The texts express the personal opinions of the authors and do not necessarily represent that of their institutions. We do hope that the volume will bring added value to the discussion on eurozone enlargement and the future of monetary integration in Europe.

We would like to express our gratitude to all of the authors for their efforts in putting this volume together, and to dr Roderick Parkes, the head of the EU Programme at the Polish Institute of International Affairs, for his valuable assistance and advice.

[2] Membership in the Reforming Euro Area: A Central and Eastern European Perspective, Post-seminar Report, The Polish Institute of International Affairs, Warsaw 2013.

PART I

EUROZONE CRISIS: SELECTED ISSUES

OVERCOMING THE INTRA-EUROPEAN IMBALANCE: HOW MUCH WOULD GERMANY HAVE TO ADJUST?

OGNIAN HISHOW[1]

The euro crisis made clear some euro area member states must regain competitiveness to reduce their trade deficits and resume economic growth. Since the euro area member states cannot adjust by nominal devaluation of their currencies vis-à-vis the currency of the surplus trading partner, the latter have been advised to become "less competitive." However, Germany and other surplus economies cannot provide help at reasonable economic costs.

MAKING THE SOUTH COMPETITIVE

The debate about how the GIIPS countries, and more worrying of late, France, can regain competitiveness has so far revolved around the idea that those nations need to rebalance their budgets and reduce their labour cost by cutting spending and, for instance, payroll taxes. Structural reforms have been suggested and initiated as well.

But the GIIPS are still trapped in debt and economic difficulties: neither sound budgets nor output growth have been achieved after years of effort. There are many reasons why austerity—defined as a real cut in wages and prices—cannot come about easily. One is the unions, which compete with each other to offer the best conditions to their members. No trade union wants to take the lead to accept lower incomes or longer working hours. Another reason is the balance sheet of companies: once prices start falling, the discounted future revenue stream of a particular company no longer matches its debt, thus making it a potential candidate for bankruptcy or hostile takeover, which is in many ways worse.[2] Critics of austerity policies vociferously call for a two-pronged approach as the GIPS economies cannot rebalance successfully because cutting spending and reducing wages amidst a crisis is pro-cyclical. The surplus countries also must rebalance in order to reduce their trade positions. More precisely,

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[1] Ognian N. Hishow, PhD, works as senior expert in German Institute for International and Security Affairs (SWP), Berlin; visiting professor, University of Rochester, New York.

[2] H.-W. Sinn, *Austerity, Growth and Inflation. Remarks on the Eurozone's Unresolved Competitiveness Problem*, CES-IFO WP 4086, January 2013.

Germany, the Netherlands, Finland and others should cut their current account surpluses through various policies.

Germany as of the mid-2000s was running current account surpluses of up to 6% of GDP, most of it with its EMU partners. On average, its current account surplus within the EMU matches the combined current account deficits of Spain, France and Italy (Table 1). Even before the current crisis, then French Finance Minister Christine Lagarde counselled Germany to raise the wage level of the country to increase unit labour costs at a higher pace than its EMU partners. Other proposals followed, all of them urging Germany to boost domestic demand and to invest more in domestically consumed goods and services.

Table 1.
Current account positions in the EU/EMU, average since the year 2000, € bn

Spain	–106
UK	–78
France	–53
Italy	–26
Sweden	28
Netherlands	56
Germany	184

Source: European Commission.

CUTTING THE SAVING RATE

In terms of economics, and when boiled down to the basics, the surplus-deficit problem can be seen as an issue of savings and consumption. Germany's saving rate is outperforming its investment rate, yielding a current account surplus. The opposite occurred (and is still the case) in Spain and the other countries in trouble. Therefore, a reduction of the saving rate of Germany and other northern Member States appears a promising way to fix the crisis.

The national saving rate is composed of the saving rate of the private and public sectors. Private sector savings are the savings of the household and business sectors. It is hard for democracies to force the private sector to save less. What looks rather appealing and easier to try in a democratic society is to cut the saving rate of the government.

Currently, Germany's government does not save at all; rather the fiscal position of the General Government (all levels of the state) is negative since the country is running a budget deficit. The implementation of the idea of reducing Germany's (and Netherlands', and so on) current account surplus would therefore require the federal government to expand and run even larger budget deficits for a while. The estimated additional spending, based on data in Table 1, i.e., roughly 200 bn, would require the deficit to be in the vicinity of 6–7% of GDP. This compared to the current 1–2%.

Given the German penchant for "rainy day" money, this may trigger Ricardian equivalence. High deficits would likely drive up the interest rate, cause a crowding out effect, and in the medium-run a recession. Higher public debt combined with slow growth would make it harder to fund the deficit. Moreover, the EU Commission would launch an excessive deficit procedure within the tightened Stability and Growth Pact, with painful fines; and Germany would prove not to be as credible as it was Berlin that pushed hard for the fiscal compact, "six-pack," "two-pack" and the "debt brake."[3] Most likely, the hoped for result would never show up.

HIGHER INFLATION IN GERMANY AND THE NORTH

Other proposals centre on changing policies between the core and the periphery: because the periphery cannot deflate successfully in a recession, the core should inflate to make it easier for the crisis-ridden economies to resume growth. But what is Germany supposed to deliver in terms of inflation? A few calculations make clear that that option is next to impossible.

We start with the assumption that the German headway in competitiveness vis-à-vis France, Italy and Spain should be eliminated within five years (to be politically acceptable). A German inflation rate of just enough to eliminate the real exchange rate appreciation in the three countries since the inception of the common currency is envisaged. Next, as in the long run the exchange rate reflects price

[3] A German-style debt brake was first raised at the 2011 EU Summit then agreed by several Member States (see: O. Hishow, "Curing Europe's Addiction to Borrowing: Germany's Debt Brake as a Panacea?," *SWP Working Papers*, 2011/07, December 2011).

changes in the sector of tradables and nontradables, the shift of the exchange rate at purchasing power parities (ppp) is calculated.[4] In the EMU, with its free capital movement and price arbitrage, the ppp exchange rate is a function of several variables:

- the inflation differential between the countries
- the price increase in the tradables sector
- the price increase in the nontradables sector.

When perfect competition is also assumed, the goods price level is determined in the market and gains/losses in competitiveness in the goods sector are due to real wage increases/decreases. Between 2001 and 2010, inflation rates, export prices and unit labour cost in the observed economies have moved in different directions, with the effect that Germany has gained competitiveness against Spanish, Italian and French producers.

MODELLING THE ADJUSTMENT

In simple form, the ppp exchange rate is calculated as

$$e = {}^{P_t}\!/_{P_t^*} \qquad (1)$$

where P_t is the price level of tradables in *Home* and * denominates *Foreign*. In the model, *Home* will apply to Spain, Italy and France; *Foreign* stands for Germany. Because of open markets, perfect competition in the EMU makes sure that the real wage w is reflecting productivity q_t in the tradable sector and q_n in the sector of nontradables:

$$ {}^{w}\!/_{P_t} = q_t \quad \text{and} \quad {}^{w}\!/_{P_n} = q_n \qquad (2).$$

Solved for P yields

$$P_t = {}^{w}\!/_{q_t} \quad \text{and} \quad P_n = {}^{w}\!/_{q_n} \qquad (3)$$

and

$$P_t^* = {}^{w^*}\!/_{q_t^*} \quad \text{and} \quad P_n^* = {}^{w^*}\!/_{q_n^*} \qquad (3a).$$

[4] The following calculation of the necessary adjustment is by Paul De Grauwe, in: P. De Grauwe, *International Money: Post-War Trends and Theories*, Clarendon Press, Oxford, 1989.

The term $P_t = {w}/{q_t}$ and $P_t^* = {w^*}/{q_t^*}$ is then solved for *w*:

$$w_t = P_t q_t \quad \text{and} \quad w_t^* = P_t^* q_t^* \tag{4}$$

and inserted in the right hand side of (3) and (3a):

$$P_n = P_t \, {q_t}/{q_n} \qquad (5);$$

$$P_n^* = P_t^* \, {q_t^*}/{q_n^*} \qquad (5a).$$

The price level *P* in a country is made up of the price level of the sector of tradables and the price level of the nontradables sector. Once the share of the tradable sector in all prices is α, the share of the nontradables prices is 1-α, i.e.,

$$P = \alpha P_t + (1-\alpha) P_n \tag{6}$$

$$P^* = \alpha P_t^* + (1-\alpha) P_n^* \qquad (6a).$$

Replacing P_n and P^*_n by the right-hand side of (5) and (5a) leads to

$$P = \alpha P_t + (1-\alpha)(P_t \, {q_t}/{q_n}) \qquad (7),$$

and

$$P^* = \alpha^* P_t^* + (1-\alpha^*)(P_t^* \, {q_t^*}/{q_n^*}) \tag{7a}$$

Returning to (1), the ppp exchange rate can be rewritten as

$$e = {P_t}/{P_t^*} = \frac{P(\alpha^* + (1-\alpha^*)\, {q_t^*}/{q_n^*})}{P^*(\alpha + (1-\alpha)\, {q_t}/{q_n})} \qquad (8).$$

Because the exchange rate appreciation is sought, (8) is differentiated to obtain

$$\varepsilon = \pi - \pi^* - (1-\alpha)[(\kappa_t - \kappa_t^*) - (\kappa_n - \kappa_n^*)] \qquad (9).$$

Here κ_t and κ_n is the change in competitiveness in the sector of tradables and nontradables. In formula (9), α is assumed to be 27%

of GDP. Therefore, in order to keep the calculation of (9) simple, it is assumed that the share of the tradables sector in Germany (in the model *Foreign*, denominated with *) and in the respective *Home* country is constant and of the same percentage. This is not quite the case: Germany's export sector became bigger than it used to be up to the early 2000s and also bigger than the export sector of the other investigated countries. Therefore, the result is skewed somewhat, albeit not significantly.

To capture κ_t and κ_n in Germany and the three other countries, the change in the unit labour cost (ULC) in the export sector, and of the ULC in the whole economy have been used. The change of the variables is over the period 2001–2010; only the ULC of the export sector is based on the period 2005–2010 due to the respective data by Eurostat (Table 2).

Table 2.
Main economic variables in selected EMU member states and associated exchange rate appreciations/required depreciation (for Germany)

2001–2010	Germany	Spain	Italy	France
Inflation	0.11	0.33	0.24	0.21
ULC exp	–0.06	0.05	0.04	0.03
ULC	0.04	0.24	0.25	0.19
α	0.27	0.27	0.27	0.27
Exchange rate shift	–0.21	0.29	0.21	0.15

Source: European Commission.

Table 2 shows how much the exchange rate of the periphery appreciated in real terms in the 2000s against the "German euro" and how much the latter has depreciated against the weighted average of the three. Using formula (8), the result is real appreciation of some 29, 21 and 15% against Germany in Spain, Italy and France, respectively. Then, given a preferred inflation rate of zero (or close to zero) in the latter countries within the next five years, the German inflation rate should be 6.6 percent per year—and for the next five years. This is because the 21% is to be brought down by the end of the fifth year and given the combined relative economic weight of

France, Italy and Spain over Germany of 1.66.[5] Because individual member states of the EMU can push up inflation only by raising wages that is, the major national price) the nominal wage increase has to be in the neighbourhood of 7–8% and above, bearing in mind that the wage sum is not less than 66% of a Western country's national income. In other words, the overall wage increase in Germany would be around 40% in five years to help the three other big economies out of their competitiveness woes.

This troublesome figure would be softened somewhat if the other competitive northern EMU member states—Netherlands, Austria, Finland, Luxembourg—and the nominally non-EMU member Denmark would get along. The combined GDP of those countries plus Germany would match the three southern member states' GDP, making it for Germany one-third cheaper to inflate the North.

However, even this result is not the whole story, bearing in mind that the government cannot force its civic partners to agree on wage increases for the sake of other nations. Then, the solution of last resort would be to allow for an increase in the compensation of civil service employees, a variable the government controls. Yet, that would be another blind alley: in Germany, the share of the civil servants in the labour force is some 18%, or at most 20%. Applying the previous calculation, a wage increase in the neighbourhood of 40% a year in the government sector over five consecutive years would be required—another "mission impossible."

CONCLUSIONS

Because in the EMU most member states trade predominantly with their EMU partners, the competitiveness gained by one member is reflected by the loss of competitiveness in another member. Therefore, shifts in the current account position by county would be the result. This is exactly what happened—for example, Germany expanded its trade surplus and Spain expanded its trade deficit.

In order to regain competitiveness, austerity has been imposed on the GIPS countries. This is not because of a lack of solidarity but because reducing budget deficits is the flip side of increasing savings and thus dealing with the intra-EMU imbalances. The opposite approach—having the North reduce its saving rate—is ruled out

5 The per year discount of 21% over five years gives some 4% per year. This is multiplied by 1.66 to make up for the difference in output.

as economically unrealistic. Also, the North cannot inflate enough to make the South more competitive. Reducing wages in the GIPS countries, i.e., by going through internal devaluation, is most realistic. For instance, research results prove a German effort to support growth in the GIPS states via aggregate demand expansion would translate into only marginal GDP gains there.[6] The bulk of the adjustment cost has to be borne by the deficit partners.

[6] B. Graef, H. Peters, *Ausblick Deutschland*, DB Research Briefing, 18 February 2013.

GREECE: EUROZONE'S WEAK LINK

ANNA VISVIZI[1]

INTRODUCTION

Stereotypically, i.e., the dominant narrative on the eurozone crisis, the "Greece as the eurozone's weak link" argument tends to be linked to a variety of qualitatively diverse and not always accurate claims pointing nevertheless in one way or another to Greece as the trigger of the eurozone crisis. This is allegedly due to the following: (i) the decision to admit Greece to the eurozone was politically-driven and thus premature; (ii) Greece represents a case-study of failed convergence and deficiencies in cohesion policy; (iii) Greece enjoyed (overly) favourable terms of lending following the introduction of the euro in 2001, which resulted in fiscal imbalances; and, (iv) the questionable reliability of macroeconomic data provided by the Greek authorities to the EU monitoring bodies put everyone in the eurozone at risk. For the sake of being precise, it is useful to remember that the "Greece as the eurozone's weak link" argument originates from a statement by former Greek PM George Papandreou.

Commenting on the uncontrolled hysteric rise in spreads for Greek bonds in late 2009 and early 2010 that led Greece to the verge of insolvency, Papandreou—rather than admitting that his government was solely responsible for the hysteric behaviour of the financial markets toward Greece—claimed that: "This is an attack on the eurozone by certain other interests, political or financial, and often countries are being used as the weak link, if you like, of the eurozone."[2] By "shifting the blame" for the dramatic developments in the country in late 2009/2010 from the socialist government to the speculative pressures of the capital markets, to a large extent Papandreou succeeded in transforming the faulty political decisions of his government into a qualitatively different challenge that needed an EU-level solution. While these claims fit squarely in the, at that

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[1] Anna Visvizi, Ph.D., Associate Professor, DEREE—The American College of Greece, Athens, Greece; post-doctoral research fellow, Institute of East-Central Europe, Lublin, Poland.

[2] "Greece says being targeted as euro zone 'weak link'," *Reuters*, 28 January 2010, www.reuters.com.

time still nascent debate on improving EU economic governance, they have also obscured the complex domestic causes of the Greek sovereign-debt crisis. This in turn led to a misguided and, as the Greek reality proves, counterproductive approach to managing the crisis in Greece by the troika of international creditors—the European Commission (EC), the European Central Bank (ECB), and the International Monetary Fund (IMF).

Against this backdrop, the objective of this contribution is to demonstrate that whereas in some aspects Greece may have been the eurozone's weak link, some of the arguments typically associated with this claim are unfair toward Greece and some of them simply do not stand. The argument is structured as follows. In the first step, the causes of the sovereign-debt crisis in Greece are discussed briefly against the background of Greece's membership in the eurozone. In the following move, the question of early warning mechanisms vis-à-vis the crisis in Greece is upheld. A discussion on the ambivalent relationship between Greece, the troika and the EU Member States concludes the discussion.

GREECE, STRUCTURAL PROBLEMS, THE EURO, AND THE SOVEREIGN-DEBT CRISIS

The mechanisms behind the emergence and escalation of the sovereign-debt crisis in Greece are complex. Notably, political rather than economic factors have had a profound impact in leading Greece to the verge of insolvency in early 2010. In other words, the 2007 global financial crisis and the unfolding economic downturn worldwide, rather than affecting Greece directly, exposed the pre-existing long-term structural vulnerabilities of the Greek economy. The most important of these included *unsustainable fiscal policies* and *excessive public expenditures* leading to persistent deficits and a high debt to GDP ratio. These were made possible in the period prior to 2007 because of (overly) favourable lending terms that Greece enjoyed as a member of the eurozone. Although partly hidden by high revenues in the period preceding the global financial crisis, Greece's fiscal weakness was disclosed by the rising cost of financing deficits and government debt after 2007. The public sector has had a fundamental negative role to play in this regard. In turn, *rigid labour and product markets and the overall abusive role of the state in the economy* forestall the possibility for the private sector to swiftly adjust to the changing dynamics of the domestic and international economy following the global financial crisis. This situation was aggravated by a *progressive loss in competitiveness*, related to labour productivity, prices, labour market rigidity and an unhelpful business environment.

Irrespective of the economic weaknesses of Greece, in mid-2009 the country still enjoyed affordable access to capital markets. This situation changed dramatically following an unexpected announcement by the newly elected socialist government (PASOK) that the fiscal deficit in 2009 would reach about 11–12% of GDP,[3] i.e., about three percentage points more than the previous establishment estimated. What was initially thought of as a domestic strategy of discrediting the previous conservative government and establishing a convenient benchmark for assessing the political efficiency of the new cabinet brought about uncontrolled hysterical responses from a number of third actors internationally (markets, investors, rating agencies, governments), which then started questioning the credit-worthiness of Greece. The markets in particular were taken by surprise, which led to a dramatic deterioration of Greece's terms of lending in late October 2009, with yields for Greek bonds rising sharply. The new administration's response to this emergency situation was delayed. Rather than tackling the roots of the problem, Greek Prime Minister Papandreou initiated a strategy aimed at convincing the political establishment in the EU and the U.S. that Greece had fallen prey to massive speculative attacks, and thus that financial regulation should be strengthened to prevent market manipulation.[4]

[3] Eventually, i.e., in November 2010, the size of the deficit for 2009 was calculated at 15.4% GDP. Note that several sources suggest that the initial estimates of a budget deficit for 2009 reaching ca. 9% of GDP, as announced around June 2009, were accurate. However, these estimates have been affected by two issues. First, due to the prolonged political stalemate in Greece that led to early parliamentary elections in October 2009, accompanied by a climate of uncertainty in the Greek economy prior to the elections and further affected by developments right after the elections, public revenue declined substantially in the third and fourth quarters of 2009, thus affecting estimates from June. Second, the size of the budget deficit for 2009 was revised twice, i.e., first in April 2010 to a level of 13.6% GDP and then in November 2010 to 15.4% GDP. This was achieved by including in relevant calculations debts and deficits of the major deficit-generating state-owned enterprises as well as negative values of currency swap transactions that the government of Kostas Simitis was engaged with in 2001 on the eve of the adoption of the euro. These "creative re-calculations" were objected by the ELSTAT Board as contradicting the standard methodology employed by other EU Member States.

[4] A. Visvizi, "The Crisis in Greece and the EU–IMF Rescue Package: Determinants and Pitfalls," *Acta Oeconomica*, vol. 62, no. 1, March 2012, pp. 15–39.

Summing up, structural reforms had been long-overdue in Greece. Attempts by the conservative government of Nea Democratia (ND) to introduce deep structural reforms and austerity measures in the years prior to the crisis were persistently blocked by PASOK, even by means of political blackmail. The same pleas for reforms were ridiculed by PASOK during the electoral campaign of 2009. With Papandreou promising more of a welfare-state, PASOK gained 43.94% of votes; the establishment of a socialist government in October 2009 followed. As the global financial crisis and its consequences rendered the Greek economic system particularly fragile, the surprising (and even today, questionable as to its accuracy) announcement by PASOK casting a shadow on Greece's public finance set the country on a path toward insolvency. The delayed and inappropriate response of the socialist government accelerated the course of events.

THE QUESTION OF EARLY WARNING MECHANISMS VIS-À-VIS THE CRISIS IN GREECE

In context of the "Greece as the eurozone's weak link" thesis, the issue of the reliability of data is frequently and inaccurately held up to suggest deliberate action on the part of the Greek governments to mislead the EU monitoring bodies, thus obscuring the functioning of the early warning mechanisms. For clarification, several other EU members had also been requested to revise their fiscal data over the years, and their revisions "have been reported as being sizeable."[5] It is wrong, however, to claim that "creative statistics" was at play in those cases. Rather, insufficient harmonisation of reporting methodology at the EU level should be blamed for that. For instance, substantial delays were observed in the implementation of the ESA 95 reporting standard. Eurostat's methodology of data aggregation remains questionable up to this day. Indeed, the Commission was repeatedly requested by the European Court of Auditors "to increase its direct verification activities regarding the underlying national accounts data."[6]

It should be noted that the weak fiscal position of Greece was a frequently debated topic, particularly in the context of Greece's

[5] F. de Castro, J.J. Pérez, M. Rodríguez-Vives, *Fiscal Data Revisions in Europe*, ECB Working Paper, no. 1342, European Central Bank, Frankfurt, May 2011, p. 5.

[6] *Annual report concerning the financial year 2003*, European Court of Auditors, OJ C 293, vol. 47, 30 November 2004, p. 87, § 3.62.

last-minute adoption of the euro in 2001. Greece, similar to other countries, was subject to monitoring by both the IMF and the European Commission, and the worsening economic outlook of Greece did not pass unnoticed. For example, in 2009 the IMF warned between the lines of an emerging debt problem in Greece and "the possible loss of market access."[7] As far as the European Commission is concerned, during the period 2001–2009 Greece was subjected twice to the Excessive Deficit Procedure (EDP), described in the treaty and defined in the provisions of the Stability and Growth Pact (SGP), i.e., in 2004 (abrogated in 2007) and in 2009 (ongoing).

Overall, the Commission and the Council were aware of Greece's mounting fiscal problems. Yet, given the irregularity (related to lax reporting standards) of data employed to justify the launch (and for that matter also the abrogation) of the EDP, the corrective measures requested by the Commission and the timeframe for their implementation were misguided. For example, on 5 June 2007, the Council abrogated its earlier decision on the existence of an excessive deficit in Greece.[8] At the same time, the Commission stated that "The Greek statistical authorities improved their procedures, which led to a significant reduction in the statistical discrepancies and an overall higher quality of the data."[9] Accordingly, Eurostat withdrew its reservations concerning the quality of data. Interestingly, in March 2009, in its opinion on the existence of an excessive deficit in Greece, the Commission employed a newly revised set of data submitted by the Greek authorities and approved by Eurostat in 2008. The new data set cast a shadow on the 2007 Council's decision to abrogate the EDP 2004 for Greece.

Overall, Greece's case suggests that although early warning mechanisms were in place and the weak fiscal position of Greece was not a secret, the Commission did not manage to employ the instruments at its disposal in an efficient manner. This was due to weaknesses in the data-aggregation and data-verification processes as well as in the data-reporting methodology employed by Eurostat

[7] *World Economic Outlook*, International Monetary Fund, Washington, D.C., April 2009, p. 23.

[8] Council of the European Union, *Council Decision of 5 June 2007 abrogating Decision 2004/917/EC on the existence of an excessive deficit in Greece* (2007/465/EC), OJ L 176/21.

[9] European Commission, *Recommendation for a Council Decision abrogating Decision 2004/917/EC on the existence of an excessive deficit in Greece*, SEC (2007) 620 final, Commission of the European Communities, Brussels, 16 May 2007, p. 10.

and the Commission. Accordingly, it is unfair to accuse Greece of deliberately engaging with "creative statistics." A brief remark at this point would be that whereas—and incorrectly so—the argument that Greece fiddled with fiscal data is common, nobody questioned the accuracy of the surprising 2009 announcement of the PASOK government about the size of the budget deficit. It is particularly surprising given the fact that the set of fiscal data submitted by the previous conservative government was approved by Eurostat.

THE AMBIVALENT RELATIONSHIP BETWEEN GREECE, THE TROIKA AND THE EU MEMBER STATES

The "Greece as the eurozone's weak link" thesis acquires additional purchase given the fact that the economic situation in the country has not improved irrespective of the generous financial assistance it has received. As the disbursement of each tranche of assistance to Greece is the subject of domestic political debate in several eurozone members, media emphasis on the respective debate reproduces the biased "Greece as the eurozone's weak link" argument. The problem is that the economic situation in Greece is not likely to improve as long as the government of Antonis Samaras is forced by the troika to implement an essentially misguided fiscal adjustment programme. That is, although Samaras has been amazingly successful in restoring the image of Greece as a serious, committed and reliable partner in the EU, the troika keeps the current government hostage to the politically driven commitments of the PASOK government and the Memorandum of Understanding signed in 2010. At the economic policymaking level, this means that the Samaras government remains hostage to a policy-mix that is blind to the culprit of the current crisis, i.e., a bloated, inefficient, highly unionised public sector; overregulation; and excessive taxation. Supervised by a troika preoccupied with unfeasible fiscal targets, the Greek government is effectively blocked from introducing structural reforms and restoring the prospects for growth in Greece.

As the troika proves unwilling to turn away from the apparently counterproductive policy mix, judging from the exorbitant unemployment level of 28% in May 2013 and continuous recession, the Greece case reveals some very serious weaknesses in the informal, possibly idealistic structures of governance underpinning the EU. These weaknesses include: a lack of critical consideration of country-specific economic and political circumstances; the resulting tendency to generalise and resort to stereotypes; an overreliance on insights produced by the troika without confronting them with critical examination; a myopic preoccupation with (the largely constructed notion of) tax evasion rather than with creating incentives for growth and with tax reduction; and the most troubling of all, a tendency to increase state intervention in the economy, mainly through re-regulation and taxation. As the single market used to offer the most tangible benefits of European integration and the market economy[10] became a defining feature of the EU, these weaknesses that contradict the ideas behind the single market and market economy, are deeply disturbing.

[10] As indicated in the 1993 Copenhagen criteria defining the EU membership conditions.

ROLE OF FINANCIAL SECTOR FDI IN REGIONAL IMBALANCES IN CENTRAL AND EASTERN EUROPE

ZOLTÁN GÁL[1]

INTRODUCTION

Foreign direct investment (FDI), foreign ownership and the transformation of the financial sector in Central and Eastern Europe (CEE) have received considerable attention during the transition, from both a theoretical and empirical perspective.[2] Much less attention has been devoted to the post-transition period and the impact of the crisis, which has become the most serious challenge to transition models in the CEE banking sectors.

This research argues that the FDI development path in the CEE followed the pattern of a dependent market economy (DME) type of capitalism.[3] It shows that there was a shift of ownership of the banking

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[2] See: J. Bonin *et al.*, *Banking in Transition Economies: Developing Market-Oriented Banking Sectors in Eastern Europe*, Edward Elgar, Cheltenham–Northampton, 1998; P. Wachtel, "A külföldi bankok szerepe a közép-európai átmeneti gazdaságokban I–II" ('Role of foreign banks in transitional countries of East-Central Europe, I–II'), *Közgazdasági Szemle* ('Journal of Economics'), 1997, pp. 13–30, 124–141; S. Claessens, A. Demirguc-Kunt, H. Huizinga, "How Does Foreign Entry Affect Domestic Banking Markets?," *Journal of Banking & Finance*, vol. 25, no. 5, May 2001, pp. 891–911; C. Buch, S. Golder, "Foreign versus Domestic Banks in Germany and the U.S.: A Tale of Two Markets?," *Journal of Multinational Financial Management,* vol. 11, iss. 4–5, December 2001, pp. 341–361; C. Buch, R. Heinrich, A. Schertler, *External and Internal Financial Structures in Europe: A Corporate Finance Perspective*, *EIFC* Technology and Finance Working Papers, no. 19, 2003, p. 25; A. Berger, Q. Dai, S. Ongena, D. Smith, "To What Extent Will the Banking Industry Be Globalized? A Study of Bank Nationality and Reach in 20 European Nations," *Journal of Banking & Finance*, vol. 27, no. 3, March 2003, pp. 383–415; Z. Gál, "Spatial Development and the Expanding European Integration of the Hungarian Banking System," *Pécs Centre for Regional Studies Discussion Papers*, no. 45, 2004, p. 75, www.researchgate.net.

[3] See: O. Raviv, "Chasing the Dragon. East: Exploring the Frontiers of Western European Finance," *Contemporary Politics*, vol. 14, no. 3, September 2008, pp. 297–314; A. Nölke, A. Vliegenthart, "Enlarging the Varieties of Capitalism: The Emergence of Dependent Market Economies in East Central Europe," *World Politics*, vol. 61, no. 4, October 2009, pp. 670–702; M. Myant, J. Drahokoupil, *Transition Economies: Political Economy in Russia, Eastern Europe, and Central Asia*, Wiley-Blackwell, Hoboken, 2010.

sector from public to private and at the same time from domestic to foreign owners through privatisation.

ROLE OF FINANCIAL SECTOR FDI IN THE CEE

FDI inflows have increased in the CEE in the past 20 years to become the most common type of capital flow. FDI inflow into CEE economies has been a vital factor in the first stage of privatisation, and FDI became the predominant type of incoming capital investment in the first stage of the economic transition. This process not only facilitated the restructuring of the formerly centrally planned economies but privatisation as well. The banking and insurance sector became the primary target of strategic foreign investors. Similar to global processes, the entry of foreign banks was geographically or regionally concentrated, and the main investor banks came from traditional or strong economies and trading partners (mainly from eurozone countries).

Foreign financial inflows have resulted in dramatic changes of ownership structures. In 1994, in the wake of the early transition crises, an overwhelming majority of financial intermediaries in the post-communist countries were still publicly owned. By contrast, in 2007, more than a decade later, private foreign ownership already accounted for about 80% of financial intermediaries' assets in the CEE region. These figures are especially striking when compared to the just under a quarter of foreign-owned banking assets across the European Union (EU), 15.5% in the euro area, and 50% outside the OECD.[4] This share of foreign banks was relatively large compared, for example, to the level of economic development in the region.

The results show that FDI has been substantial in the financial services sector of the Visegrad countries (Czech Republic, Hungary, Poland, Slovakia) and in Slovenia. This analysis covers all sectors, but the focus is on banking. In the Visegrad countries, though with different timing, FDI inflow in the analysed sector had been substantial, resulting in a dominant share of foreign capital (predominantly from traditional partner countries from Western Europe) and a large share of the sector in the stock of FDI already in the pre-crisis era. On the other hand, in Slovenia the role of foreign investors is comparatively much lower, resulting in a predominantly

[4] S. Claessens, N. van Horen, *Foreign Banks: Trends, Impact and Financial Stability*, IMF Working Papers, WP/12/10, January 2012.

domestically owned financial services sector. There is only one regional player, the Hungarian OTP bank.[5]

ASYMMETRIC POWER RELATIONS AND REGIONAL IMBALANCES IN THE DUAL-BANKING SYSTEMS IN CENTRAL AND EASTERN EUROPE

Foreign banks (understandably) followed commercial market principles rather than economic development and were never geared for or "diverted" by regulatory elements towards addressing the development needs of the host CEE. Rather, they were always aimed at redressing the declining profitability of financial institutions operating in the already financialised economies of Western Europe. As a result, foreign financiers emerged as a powerful rentier class in Central Europe, able to extract rent incomes far in excess of their profits in the West.[6] This led not only to an unprecedented transfer of property rights from local society to foreign investors but also to increased imbalances in the financial sector through indebtedness and risk.

If we try to place the CEE in the comparative typologies of capitalism following Nölke and Vliegenthart's[7] argument, the primary source of investment in the CEE is foreign direct investment, not the stock market as in Liberal Market Economies (LMEs) or domestic credit as in Coordinated Market Economies (CMEs). Although FDI does play a role in the CME and LME models, the degree of external dependency is much more extreme in the CEE. As DMEs are heavy importers of capital, the ratio of inward and outward FDI stock is much higher than in the old EU Member States due to the low level of capital exports (OFDI) from these countries.[8]

Due to the extremely huge volumes of FDI, foreign banks prefer to hierarchically control local subsidiaries from their headquarters.[9] This is an alternative mode of finance and governance rather than to accept financing by international capital markets and outsider control by dispersed

[5] Z. Gál, M. Sass, "Financial FDI in CEECs revisited—in the context of the dependent market economies model," paper presented at the RSA Network Seminar "Finance in Transition: Lessons for the Future," Bratislava, 16–17 May 2013.

[6] O. Raviv, *op. cit.,* pp. 297–314.

[7] A. Nölke, A. Vliegenthart, *op. cit.,* pp. 670–702.

[8] *Ibidem*, pp. 670–702.

[9] M. Myant, J. Drahokoupil, *op. cit.*

shareholders in LME, or to accept financing by domestic bank lending as well as retained earnings and insider control by networks of concentrated shareholders in CME. The hierarchy between the headquarters of transnational corporations (TNCs) and local subsidiaries replaces markets (LME) and associations (CME) as a typical coordination mechanism within these economies.[10]

Financial TNCs in international financial centres have a massive concentration of resources that allow them to maximise the benefits of information and connectivity with other centres and generate asymmetric power relations executed through their affiliates. These power relations mediate strong controlling functions and assess the concentration of controlling functions over the CEE within the international financial centre network, from where these investments are controlled.

The research evaluates the inter-linkages within the international financial centre networks through the geographical distribution of subsidiaries and their parent bank locations. It explores the international financial centre function of Budapest, Warsaw and Prague in assessing the preconditions of international financial centre formation. Asymmetric power relations are outcomes of previous FDI transactions and are created between the home and host countries through parent-subsidiary networks of big financial investors.[11] In the financial sector, the eastward market expansion has mainly been to the benefit of West European banks and insurance companies, which control the financial sector in Eastern Europe. They set up their subsidiary networks in parallel in the CEE and it is no coincidence that none of the new Member States hosts a financial centre with full-fledged international functions, partially because Central and Eastern European financial centres are subordinated by Western international financial centres.

As Central and Eastern European countries are largely dependent on foreign investors in finance, explicit attention is directed at determining which CEE financial centres attract multinational financial firms, and

[10] A. Nölke, A. Vliegenthart, *op. cit.,* pp. 670–702.

[11] See: B. Kareman, "Financial Geographies and Emerging Markets in Europe," *Tijdschrift voor Economische en Sociale Geografie*, 2009, vol. 100, iss. 2, pp. 260–266; D. Wójcik, "Geography and the Future of Stock Exchanges: Between Real and Virtual Space," *Growth and Change*, vol. 38, iss. 2, 2007, pp. 200–223; Z. Gál, *Pénzügyi piacok a globális térben: A válság szabdalta pénzügyi tér* ('Financial Markets in the Global Space—the Crisis Distorted Financial Landscapes'), Akadémiai Kiadó, Budapest, 2010, p. 780.

it is empirically assessed from which international financial centres these investments are controlled.[12] The banking sector in the CEE is predominantly commanded from the financial hubs of the neighbouring "old" EU Member States. Vienna, Stockholm and Athens, among others, became gateways to the East and host the headquarters of large investors in the CEE, Baltics and Southeastern Europe, respectively. The largest concentration of parent-subsidiary connections forms bridgehead centres (Moscow, Warsaw, Budapest) in the CEE.[13]

The purpose of the future research is to examine the transformation and post-crisis restructuring of the financial/banking sector in the Central and Eastern European countries, not only in the context of the DME approach but also as part of an attempt to develop and verify the existence of a "dual financial/banking system" model.[14] FDI generates typical core-periphery disparities, not only inside the old EU member countries but also between old and new Member States, which suffer from a "de-nationalised dual-banking system." That model, consisting of large foreign banks and small local/indigenous banks, displays strong dependence on foreign banks and their resources (external liabilities vs. local savings). There is a strong impact of foreign banks on credit creation, cross-border and domestic financial transfers, and financial stability, particularly during a crisis.[15] The general aim is to study the role of the "dual-banking system" in the creation of regional imbalances and in the transmission of adverse shocks in the CEE.

The dependency approach related to financial sector FDI is contrasted by the traditional "modernisation theory," which highlights the key role of foreign banks in institutional development, stability and the increase of financial depth of the banking sectors.[16]

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[12] B. Kareman, *op. cit.,* pp. 260–266.

[13] Z. Gál, "Impacts of the Global Financial Crisis on CEE: A Post-crisis Banking Reconstruction: The Case of Hungary," in: A. Beauclair, E. Mitchell (eds.), *Regional Development and Policy—Challenges, Choices and Recipients: Annual International Conference 18th April–20th April 2011*, Regional Studies Association, Newcastle, 2011, pp. 52–53.

[14] See: P. Alessandrini, A. Zazzaro, "A Possibilist Approach to Local Financial Systems and Regional Development: The Italian Experience," in: R. Martin (ed.), *Money and the Space Economy*, John Wiley & Sons, Chichester, 1999, pp. 71–92; Z. Gál, "The Development and the Polarized Spatial Structure of the Hungarian Banking System in a Transforming Economy," in: G. Barta, É.G. Fekete, I. Kukorelli Szörényiné, J. Tímár (eds.), *Hungarian Spaces and Places: Patterns of Transition*, CRS, Pécs, 2005, pp. 197–219.

[15] *Ibidem.*

[16] See: É. Várhegyi, "Hungary's Banking Sector: Achievements and Challenges," in: A. Riess (ed.), *The Financial Integration of an Enlarged EU: Banking and*

This latter literature highlights that financial sector FDI increased the host country integration into the global economy through improved general and allocative efficiency and technology transfers. Financial sector FDI can also strengthen the institutional development in the host country through improved regulation and supervision, therefore foreign bank entry into emerging markets reduces the incidence of crisis and contagion, particularly when foreign banks have a stronger subsidiary presence.[17]

Current FDI literature[18] focusing on the impact of foreign bank presence on credit creation and financial stability during a crisis confronts the once dominant approach of the "supporting effect" of foreign banks.[19] Rajan[20] found that non-industrial countries that relied more on foreign finance have not grown faster in the long run and typically have grown slowly.

Cetorelli and Goldberg[21] argue that the adverse liquidity shocks that occurred in the developed countries in 2008 and 2009 have reduced lending in local markets through contractions in cross-border lending to banks and through contractions in parent banks' support of foreign subsidiaries as a result of a shortage of liquidity in developed countries, which spread to the CEE.[22]

Capital Markets, EIB Papers, vol. 7, no. 1, Luxembourg, 2002, pp. 75–91; L. Csaba, "Financial Institutions in Transition—The Long View," *Post-Communist Economies*, vol. 23, no. 1, 2011, pp. 1–14.

17 L. Goldberg, "Financial Sector FDI and Host Countries: New and Old Lessons," *FRBNY Economic Policy Review*, March 2007, pp. 1–17.

18 See: R. Rajan, E. Prasad, A. Subramanian, "Patterns of International Capital Flows and Their Implications for Economic Development," a paper presented at the symposium "The New Economic Geography: Effects and Policy Implications," Federal Reserve Bank of Kansas City meeting, Jackson Hole, 24–26 August 2006; N. Cetorelli, L. Goldberg, *op. cit.*, p. 33; S. Claessens, N. van Horen, *op. cit.*, p. 22.

19 R. De Haas, I. Van Lelyveld, *Internal Capital Markets and Lending by Multinational Bank Subsidiaries*, MPRA Paper, no. 13164, February 2009, www.mpra.ub.uni-muenchen.de.

20 See: R. Rajan, E. Prasad, A. Subramanian, *op. cit.* The net assets position and current account balance is more positively correlated with growth. This is due to the limited ability to absorb foreign capital in developing countries. There is now evidence that emerging countries grow fast and run large current account deficits. This was the case in much of the CEE, where inflow of foreign capital was accompanied by large current account deficits, which had an effect on the exchange rate, resulting in a decrease in competitiveness.

21 N. Cetorelli, L. Goldberg, *op. cit.*, p. 33.

22 *Ibidem*.

Claessens and van Horen[23] argue that foreign bank presence in developing countries is negatively related with domestic credit creation.[24] During the global crisis, foreign banks reduced credit more than domestic banks, except when they dominated the host banking systems. The authors also argue that the impact of foreign banks on financial sector development and financial stability depend importantly on the host country, home country and bank characteristics. In the case of the CEE, the presence of foreign banks highlighted the cross-border risks and contagion as they generally reduced domestic credit temporarily in 2009 to a greater extent than did domestic banks (for example, Hungarian cooperative banks). The research also examines the stages and direction of transmission of these shocks and potential contagion. However, the region is not homogeneous in all these respects and comparisons across countries are needed.

Concerning the crisis years, the findings are more consistent with the findings of the current literature,[25] which focus on the impact of foreign bank presence during the current crisis. Foreign banks (parent to subsidiary) played a significant role in the transmission of contagion to emerging market economies during the current crisis. Due to cross-border financial exposures, the related risks of contagion channelled between West European and CEE international financial centres are resulting in an asymmetric shift in capital flows and contributing to further regional polarisation.

The crisis has modified the incentives for EU countries that are not part of the EMU—such as many of the CEE countries—to access the eurozone. Foreign currency indebtedness[26] channelled through the interlinkages of West European parent banks and their local subsidiaries has an implication for internal and external imbalances within the EU banking system.[27] The "dual-banking systems" in

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[23] S. Claessens, N. van Horen, *op. cit.*, p. 2.

[24] *Ibidem*, p. 21–22.

[25] See: R. Rajan, E. Prasad, A. Subramanian, *op. cit.*; N. Cetorelli, L. Goldberg, "Globalized Banks: Lending to Emerging Markets in the Crisis," *Federal Reserve Bank of New York Staff Report*, no. 377, June 2009, p. 33; S. Claessens, N. van Horen, *Foreign Banks: Trends, Impact and Financial Stability*, IMF Working Papers, WP/12/10, January 2012.

[26] In a few CEE countries, catching up in the first half of the 2000s was generally accompanied by macroeconomic stability, but most countries in the region became increasingly vulnerable due to the unsustainable trajectories of huge credit, housing and consumption booms, high current-account deficits and quickly rising external debt (a large proportion of it denominated in foreign currencies).

[27] G. Gorzelak, C. Goh (eds.), *Financial Crisis in Central and Eastern Europe: From Similarity to Diversity*, Scholar, Warsaw, 2010.

the CEE are more prone to transmit adverse shocks across borders and serve as a propagation channel for potential regional shocks that might be transmitted throughout the CEE.

In the run-up to the global crisis, the countries in Central Eastern and Southeastern Europe attracted large capital inflows and some of them built up large external imbalances. Previous studies on external imbalance in the CEE show the positive and significant impact of foreign capital on the investment rate in the CEE and on growth. However, the crisis years caused not only a deterioration of capital inflows but also a deterioration of domestic and foreign demand, which led to a deep economic depression in much of the region. Śliwiński[28] argues that there is no positive correlation between increased domestic savings and domestic investment in crisis-hit countries (Estonia, Latvia, Hungary) and thus this lack of correlation follows the expectation set by the Feldstein-Horioka puzzle. Increased domestic savings (dramatic fall in consumption) were spent for debt repayment rather than investment and consumption. This was the case in some countries that experienced negative or zero growth in 2008 and 2009 (Latvia, Hungary, Romania). In Hungary, accumulated imbalances required huge external adjustment as all indebted economic players were deleveraging. In 2012, the global banking sector reduced its external position in Hungary by about $18 bln, or 14.2% of Hungarian GDP compared to Spain, with 14.3% of GDP. In some countries in the region, funding availability and cost remain a constraint for CEE banking, and the accelerated deleveraging in the banking system led to a more severe decline in bank lending in Baltic states and in Hungary than the eurozone average (measured by loans to the nonfinancial corporate sector).

Summing up, I argue that the role of foreign savings in promoting economic growth in the CEE-10 countries *was* undoubted in the short run and in a growth environment but challenged in the long run, particularly during crisis times. Since the outbreak of the crisis, not only have FDI inflows decreased but also the role of foreign capital in promoting economic growth has been revised.

[28] P. Śliwiński, *External Imbalances in CEE-10 Countries and Feldstein-Horioka Puzzle in 1994–2008*, Poznan University of Economics, 2009, p. 22, http://management6.com.

RESEARCH OUTLOOK

The research aim is on one hand to develop and verify the existence of the "dual-financial/banking system" model[29] in the analysed countries in terms of weak or missing local banking structures and strong dependence on foreign banks and their resources (external liabilities vs. local savings). On the other hand, it examines how foreign ownership and the related evolution of a dual financial and banking system impacted the economies in question during the crisis years in terms of financial stability. The research identifies to what extent the banking system integration of the CEE contributed to the regional imbalances within the European Union and the eurozone. The research relies on various indicators of the financial services and banking sectors of the analysed countries (macro data) and on information from the balance sheets of dominant banks (microdata). It compares the pre- and post-crisis periods. The paper argues that the role of foreign savings in promoting economic growth in the CEE-10 countries was undoubted in the short run and in a growth environment but this is rather not true in the long run and in crisis times. Financialised growth escalated in the years up to 2008 in those countries that lacked domestic deposit bases. This was a transient phase that ended with the world financial crisis, leaving a number of countries, and among them the analysed ones, with uncertain futures.

[29] P. Alessandrini, A. Zazzaro, *op. cit.*, pp. 71–92; Z. Gál, "The Development and the Polarized ...," *op. cit.*

PART II

EUROZONE ENLARGEMENT: ECONOMIC AND POLITICAL CHALLENGES FOR V4 COUNTRIES

ENLARGING THE EURO AREA: FOUR LESSONS FOR CEE COUNTRIES

ETTORE DORRUCCI[1]

The issue of further enlargement of the euro area is back on the stage, and Latvia will indeed adopt the euro on 1 January 2014. Exactly for this reason it is crucial not to repeat certain mistakes made in the past. Insufficient economic, fiscal and financial surveillance in the EU and euro area and wrong decisions on enlargement have been integral to the series of crises that started in Central and Eastern Europe (CEE) in 2008 and in the euro area in 2010. These crises have in turn imparted four major, intertwined lessons on how best to pursue a strategy of enlargement. We should take due account of these lessons, in the ultimate interest of both the "pre-in" countries citizens and those of the euro area at large.

THE FIRST LESSON

The adoption of the euro should be sustainable over the longer run.

The Treaty on the Functioning of the European Union (TFEU) was unambiguous: before adopting the euro, a country should achieve "a high degree of sustainable convergence" with the euro area (Article 140). Yet this has not always been the case. By now, we all agree that "the temporary fulfilment of the numerical convergence criteria is, by itself, not a guarantee to smooth membership in the euro area."[2] Accordingly, the assessment of sustainable convergence should be conducted on the basis of a coherent and integrated approach. As experience with the crisis has corroborated, this assessment should be based on four, interconnected dimensions:

1. *Nominal convergence*, i.e., achieving price stability; ensuring the sustainability of the government's financial position; achieving sustainable convergence of long-term nominal interest rates; and maintaining a stable exchange rate between the national currency and the euro;

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[2] European Central Bank, *Convergence Report on Latvia*, 5 June 2013.

2. *Legal convergence.* It requires national legislation to be compatible with the treaties and the Statute of the European System of Central Banks (ESCB) in areas such as, for instance, the independence of national central banks (NCBs) and compatibility with the prohibitions on monetary financing;

3. *Broader economic convergence*. Adopting the euro makes sense only if the economic structure of a prospective member has converged sufficiently towards the prevailing structures in the euro area. This involves, for instance: (i) a flexible economy, capable of regaining competitiveness via internal devaluation when needed (as it happened, for instance, in Latvia after 2008); and (ii) the absence of unsustainable economic and financial imbalances, which have been one of the main reasons for the crisis.

Institutional convergence. Experience, for example that accumulated during the implementation of the Greek programme since 2010, has also clearly shown how important a strong national institutional environment is for the sustainability of economic integration, convergence and economic adjustment in the euro area. Improvements in the institutional environment entail, among other things, better regulations, better governance, better quality of statistics, a low degree of corruption and a more business-friendly environment.

What we have learned the hard way in recent years is that, while convergence cannot be sustainable over time without a good performance in *all* these dimensions, prior to the euro area crisis we were paying insufficient attention to the third and the fourth dimension.

To be sustainable, nominal convergence should be underpinned by broader economic convergence, which in turn depends on the sustainability of the relevant monetary, fiscal, structural and financial policies before and after euro adoption.[3] The challenges that we have faced since the onset of the crisis highlight the dangers that large and persistent macroeconomic imbalances pose, not only for the stability of domestic economies but also for the smooth functioning of the euro area as a whole. We all know the dire implications of prolonged losses of competitiveness, excessive indebtedness or housing market bubbles. Recognising this fact, the EU has moved towards stronger surveillance and coordination of its members' domestic policies. Two

[3] M. Draghi, "A Central Banker's Perspective on European Economic Convergence," speech at the Anchor 2013 Conference organised by Magyar Nemzeti Bank, Budapest, 7 December 2012.

examples are the new Macroeconomic Imbalance Procedure (MIP) and the intergovernmental Treaty on the Stability, Coordination and Governance in the Economic and Monetary Union, known as the fiscal compact. The MIP aims to prevent a build-up of new macroeconomic imbalances and enforce the correction of major existing imbalances through the Excessive Imbalance Procedure (EIP). In its 2012 and 2013 Convergence Reports, the ECB noted that "EU Member States with a derogation that are subject to an Excessive Imbalance Procedure can hardly be considered as having achieved a high degree of sustainable convergence as stipulated by Article 140(1) of the Treaty." The fiscal compact was signed by all EU members except the UK and the Czech Republic in March 2012, in order to strengthen the sustainability and credibility of fiscal policies.

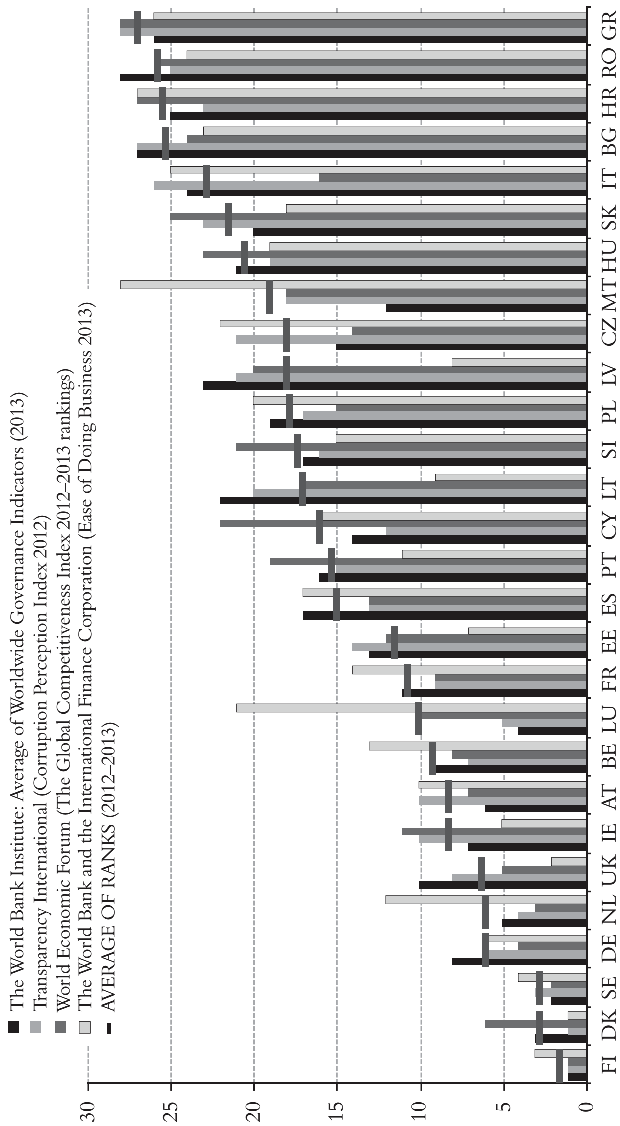
Turning to *institutional* convergence, its importance for the sustainability of economic convergence is undeniable. In certain CEE countries, in particular, removing the existing institutional rigidities and impediments to the efficient use and allocation of production factors would help enhance their economic potential. This would also improve a country's debt-servicing ability and make economic adjustment easier to implement.[4] Giannone *et al.* have indeed shown that the quality of governance had a positive effect on economic resilience during the 2008–2009 recession.[5] Arbia *et al*. have also found that governance indicators are an important explanatory variable for regional growth differences across the EU.[6] Chart 1 shows the current ranking of the 28 Member States of the EU, as reported by various international organisations in the following reports: the Worldwide Governance Indicators (World Bank Institute), the Global Competitiveness Index (World Economic Forum), the Corruption Perception Index (Transparency International) and the Ease of Doing Business Report (International Finance Corporation and World Bank). These indicators provide mostly qualitative information and, in some cases, they reflect perceptions rather than observed facts. Nevertheless, taken as a whole, they summarise a broad set of highly relevant information on the quality of the institutional environment.

[4] European Central Bank, *Convergence Report*, 31 May 2012.

[5] D. Giannone, M. Lenza, L. Reichlin, "Market Freedom and the Global Recession," *IMF Economic Review*, vol. 59, iss. 1, 2011, pp. 111–135.

[6] G. Arbia, M. Battisti, G. Di Vaio, "Institutions and Geography: Empirical Test of Spatial Growth Models for European Regions," *Economic Modelling*, vol. 27, iss. 1, January 2010, pp. 12–21.

Chart 1.
Ranking of EU Member States according to four indicators of institutional strength



Sources: The World Bank Institute (Worldwide Governance Indicators 2013), World Economic Forum (The Global Competitiveness Index 2012–2013 rankings), Transparency International (Corruption Perception Index 2012), and the World Bank and the International Finance Corporation (Ease of Doing Business 2013). See also, ECB (2012) and (2013). Notes: Countries are ranked from one (best performer in the EU) to 28 (worst performer in the EU). Latvia joined the euro area on 1 January 2014.

SECOND LESSON

There is no automatism in the convergence process, which should rather be seen as a byproduct of relentless policy efforts before and after the adoption of the euro, i.e., as a continuum.

As the experiences with convergence in Europe have made clear in recent years, this process does not end with a country's adoption of the euro, nor does participation in single monetary policy provide automatic delivery of convergence.

An illustration of this point is provided in Table 1, which focuses on the "impetus" from EU accession and euro adoption on relative incomes in Spain and Portugal. These two countries joined the EU in 1986 and the euro area in 1999. The table compares them with the group of 10 CEE Member States that entered the EU between 2004 and 2007 (EU-10), some of which have in the meantime also become members of the euro area.

In absolute terms, GDP per capita (expressed in purchasing power parity, or PPP) tripled in Spain and Portugal between 1986 and 2012. It is striking, however, that in *relative* terms, i.e., compared with the euro area average, their GDP per capita remain quite unchanged. This result also holds for per capita income levels in real (constant euro) terms.

The experiences of Portugal and EU-10 countries in the initial years after EU accession appear broadly comparable. Both entered the EU with per capita income levels of around half (or just over) the euro area average and experienced an increase of about ten percentage points (or just under) during the first eight years of EU membership. Portugal, however, did not experience any relative income gains vis-à-vis its euro area peers in the subsequent eight years of EU membership (1994–2002), whereas the recent crisis contributed to even unravel most of the progress previously made. In 2012, the income per capita of Portugal relative to the euro area average was only three percentage points higher than in 1986. This sets an important warning for CEE economies, which should not rely on overly optimistic expectations about convergence in their relative incomes. The latter have indeed increased by one percentage point only in the EU-10 group since the 2008 crisis (Table 1), although this figure conceals strong cross-country differences.

All in all, the convergence record of Spain and Portugal points to the following issues. First, neither EU nor euro area accession guarantees some degree of automatism in economic convergence, at least on a relative basis. It is up to proper policies, both at the national and EU levels, to pursue this objective. Second, the initial conditions upon EU accession seem to matter, for instance in terms of starting income per capita levels. Countries may well experience increased convergence, but it seems more questionable whether full catching-up (understood as achieving income levels comparable to peers) is attainable, although we have witnessed a number of success stories (e.g., Ireland). Third, the relative gains in the convergence process are hard to earn and maintain over many years, but easy to lose over a single crisis episode. Instructive here is the case of Spain, where relative per capita income as a ratio of the euro area average quickly rose to around 80% within a few years after EU accession and remained constant until the recent crisis pushed it back down to its starting level of 1986.

Table 1.
Relative per capita GDP (based on PPP) (in current international dollars)

	2000	2004	2008	2012
EU-10	43	51	60	61
	1986	1994	2000	2012
Spain	77	78	79	77
Portugal	56	65	65	59

Source: IMF World Economic Outlook, ECB staff calculations.

Notes: EU-10 includes the EU Member States that joined between 2004 and 2007, except Cyprus and Malta. The euro area average benchmark refers to the 11 countries that adopted the euro in 1999.

THIRD LESSON

For euro adoption to be successful, the house has to be put in order not only in "pre-in" countries, but also in the euro area itself.

The adoption of the euro should by now be understood as a two-way process. Not only euro area members should expect the fulfilment of sustainable convergence in "pre-in" countries, but "pre-in" countries should in turn expect euro area members to be up to the economic and institutional challenges evidenced by the crisis.

In particular, there is widespread agreement that the construction of the Economic and Monetary Union (EMU) has not yet reached its institutional steady state, despite the progress recently made. This is ultimately because EMU implied a moment of major *discontinuity* in the process of European integration. The break was given by the shift from the "Common Market Era" (1957–1993) to what one may today call the "Union Era," which started materialising in 1994 with Stage 2 of EMU. According to this interpretation, the introduction of the euro in 1999 was not just, as some believed, the "cherry on the pie" (with the pie being the EU internal market), but it rather implied a new, big pie on the cherry. Such a new pie is now understood as the need to complement the monetary union with an effective economic union, fiscal union and financial union. This more advanced institutional architecture will in turn need to be embedded in some form of political union that engages citizens more deeply in European decision-making. As a result, joining the euro area in the future will imply greater sharing of sovereignty and deeper European accountability than it did ten years ago.[7]

Chart 2 provides an illustration of the challenge we are confronted with by developing an index of regional institutional integration in the EU, which evolved from 1957 (Treaty of Rome) till today.[8] Up to 1993, the final goal of the process of integration was the set-up of a common market. This implied the gradual creation of a free trade area and a customs union (which the six founding members accomplished by 1968), and then of a common market which, to a significant—though still insufficient—extent had been attained by 1993. In the meantime, supranational institutions and decision-making processes had been established alongside some degree of coordination of, for instance, monetary and exchange rate policies. In Chart 2 we see that, *given* the final goal of a fully-fledged common market (which receives a score of 50 in the index), this process was not too far from being completed in the early 1990s. The introduction of the single currency, however, implied a dramatic change in the final goal of the integration process. This is because EMU, despite including some mechanisms for coordination of national economic policies, proved unable to cope with the shocks emanating from the global financial crisis and, it may be argued, even contributed to endogenously creating some preconditions for the euro area crisis. In the current setting, the new final goal of the process of European integration can be identified in the Four Presidents' Report of December 2012.[9] This

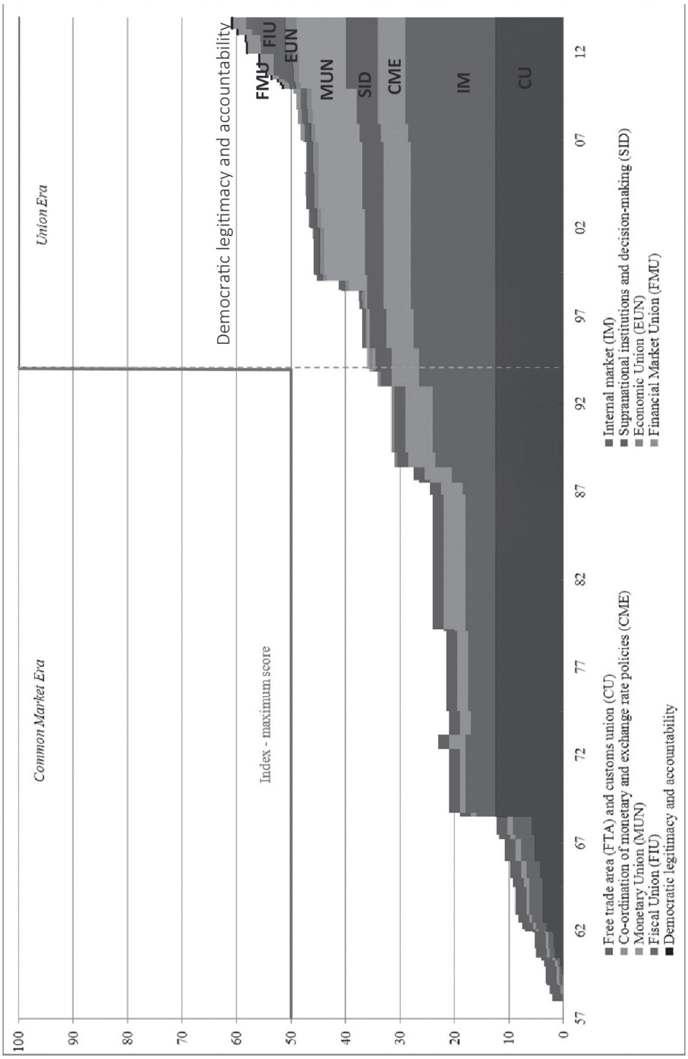
[7] M. Draghi, *op. cit.*

[8] E. Dorrucci, D. Ioannou, F.P. Mongelli, A. Terzi, "After the Earthquake: (Re-)Measuring Euro Area Institutional Integration," presentation at the XXV Villa Mondragone International Economic Seminar, 26 June 2013.

[9] H. Van Rompuy in collaboration with J.M. Barroso, M. Draghi, J.-C. Juncker, "Towards a Genuine Economic and Monetary Union" (also referred to as

implies a major institutional quantum leap. As a result, in Chart 2, the maximum score that the European index of regional institutional integration may achieve one day has doubled to 100. Accordingly, the institutional integration gap to be filled out in the Union Era has widened again—and quite a lot in comparison with the concluding years of the Common Market Era (Chart 2).

Chart 2.
The shift from the "Common Market Era" to the "Union Era"



Source: Dorrucci et al. (2013).

the "Four Presidents Report"), 5 December 2012.

Against this backdrop, it is well understandable that "pre-in" countries want to gain confidence about the likelihood that a new institutional steady state can be eventually achieved in the process of European integration. To be sure, Europe has already made a lot of progress in addressing the challenge. A major additional step will in the near future be the start of the banking union. But substantial work remains to be done, as discussed in the Four Presidents' Report of December 2012.[10]

FOURTH LESSON

The adoption of the euro should be seen as an "opportunity."

The final lesson, which embeds the previous ones, is that the adoption of the euro should be understood as an "opportunity." It is well known that one can not only take advantage of, but also waste an opportunity. We have indeed good examples of both among euro area member states.

It is in the hands of individual countries and the EU collectively whether the euro opportunity will be cashed in (as was the case, for instance, with Slovakia) or dissipated. Several potential benefits of euro adoption, for instance those related to lower real interest rates and importing ECB monetary policy credibility, can turn into weaknesses if they are abused.

A relevant example of a benefit for CEE countries that may turn into a weakness is given by the so called hard currency benefit.[11] Joining the euro area means adopting a hard currency that can stand on its own against the currencies of global powers. A large amount of evidence shows that this is particularly relevant for small, open economies such as those in the CEE, for which it is difficult to shield the exchange rate from the impact of monetary policies pursued by the largest world economies. However, while this benefit is difficult to deny in itself, it can also become a weakness if adopting a hard currency induces a given country to complacency, thereby losing the right incentives to pursue sustainable policies. Fernández-Villaverde *et al*. show, for instance, that steep financial booms have often been

[10] *Ibidem*.

[11] T. Mayer, *Europe's Unfinished Currency*, Anthem Press, London–New York, 2012.

associated with the disappearance of exchange rate risk.[12] In the euro area, several countries delayed reforms because they could borrow much more cheaply than before and loosened budget constraints in a context where regional surveillance had insufficient traction. Accountability, moreover, tends to be lost in the "good" times as bad policymaking has no negative short-run consequences. In such a context, rising asset prices hide all policy mistakes for some time, with a financial bubble going hand in hand with the deterioration of governance and institutions until a crisis erupts.

CONCLUSIONS

The net benefits of euro adoption will increasingly materialise over time and become significant *only if* both individual Member States and the euro area as a whole manage to take advantage of the opportunities offered by the single currency. The bad news is that euro adoption does not necessarily bring net benefits; the good news is that "it is in our hands." A number of success stories confirm that this is indeed the case (Lesson 4).

The successful enlargement of the euro area depends, in particular, on three key preconditions: (i) sound domestic policies should be in place so as to achieve a high degree of sustainable convergence (Lesson 1); (ii) countries should not become complacent after entering the euro area, but rather see the convergence process as a continuum (Lesson 2); and (iii) further progress in the governance of the euro area should in the meantime be made through consolidation of the four unions (Lesson 3).

[12] J. Fernández-Villaverde, L. Garicano, T. Santos, "Political Credit Cycles: The Case of the Eurozone," *Journal of Economic Perspectives*, vol. 27, no. 3, Summer 2013, pp. 145–166.

THE IMPACT OF MONETARY INTEGRATION ON TRADE WITHIN THE EURO AREA: THE EVIDENCE, REVISITED

PATRYK TOPOROWSKI[1]

INTRODUCTION

There is a large consensus by the public that eurozone membership has had a positive influence on trade. However the topic is contentious among researchers: some perceive this impact as moderate or insignificant. Currently, there is new evidence on the eurozone's impact on trade from the newly joined countries to the eurozone that needs to be analysed. This would bring some insight into assessments of the eurozone's overall effects on trade.

The aim of this short analysis is to present the trends in the intra-euro area and EU trade. Because of the complexity of the subject, only several aspects could be examined, as the issue requires further research, including the use of econometric tools. Nevertheless, the analysis provides insightful results on the "euro effect" on trade in recent years. Section One is devoted to a brief literature review, in which the contradictory opinions of researchers are presented in summary. Section Two is further divided into two parts, one comparing trade within the euro area and within the EU, and the other comparing the trade of the new eurozone members (in the period since their accession year up to 2012) with other reference EU non-eurozone countries.

LITERATURE REVIEW

The literature presents rich theoretical arguments and empirical evidence of a positive impact of economic integration on trade.[2] Economic integration enables more effective labour division and product fragmentation, leading to the emergence of global supply

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[2] This is the so called trade creation effect (see: E. Caves, J.A. Frankel, R.W. Jones, *World Trade and Payments: An Introduction*, 10th edition, Pearson Addison Wesley, Boston, 2007, pp. 245–267). Trade barriers work in the opposite direction and, intuitively, have a negative impact on trade.

chains, which induce additional trade. The impact of the currency union, or notably of integration within the eurozone on trade is highly contentious.

The most notable contribution from those that see such an impact is by Rose,[3] who proved that the currency boards and currency unions incentivise trade (that is, the outstanding 200% increase in trade,[4] thus named by several economists as the "Rose effect").[5] In line with this study, several papers provide similar conclusions—common currency enhances trade.[6] However, according to some other studies, the "euro effect" produces regionally concentrated trade effects in more open regions.[7]

The contributions from the other side question the results of the positive and substantial impact of the currency union on trade. Some of them (e.g., Bun and Klaassen[8]) say that, not all factors (such as heterogeneity of the countries) were taken into the account when estimating the impact of the currency union (or euro area membership in this paper) on bilateral trade, thus the results were upwardly biased.

[3] See: A.K. Rose, "One Money, One Market: The Effect of Common Currencies on Trade," *Economic Policy*, vol. 15, no. 30, April 2000, pp. 7–46, and A.K. Rose, "Currency Unions and Trade: The Effect Is Large," *Economic Policy*, vol. 16, no. 33, October 2001, pp. 449–461. These were followed by many contributions, such as: A. Frankel, A.K. Rose, "An Estimate of the Effect of Common Currencies on Trade and Income," *The Quarterly Journal of Economics*, vol. 117, no. 2, 2001. Frankel and Rose based their estimate on a comprehensive dataset covering 186 trading partners at five intervals between 1970 and 1990, and built a so called econometric "naïve gravity model of trade." However, an earlier study was prepared by the European Commission (European Commission, Directorate-General for Economic and Financial Affairs, "One Market, One Money—An Evaluation of the Potential Benefits and Costs of Forming an Economic and Monetary Union," *European Economy*, no. 44, 1990.), in which the positive effects due to a lowering of transaction costs translated into higher trade.

[4] In fact, the early estimates (see: A. Micco, E. Stein, G. Ordonez, "The Currency Union Effect on Trade: Early Evidence from EMU," *Economic Policy*, vol. 18, no. 37, October 2003, pp. 316–356) showed a eurozone membership effect of up to 20% of additional trade compared to trade outside the eurozone.

[5] See, e.g.: T. Havranek, "Rose Effect and the Euro: The Magic Is Gone," Technical Report, *Review of World Economics*, vol. 146, no. 2, June 2010, pp. 241–261.

[6] See, e.g.: J.A. Frankel, S.-J. Wei, *European Integration and the Regionalization of World Trade and Currencies: The Economics and the Politics*, Center for International and Development Economics Research (CIDER) Working Papers C95-053, University of California at Berkeley, 1995; or, R. Glick, A.K. Rose, "Does a Currency Union Affect Trade? The Time Series Evidence," *European Economic Review*, vol. 46, no. 6, June 2002, pp. 6–46 and 1125–1151.

[7] See: J. Costa-i-Font, *Regional Single Currency Effects on Bilateral Trade with the European Union*, LSE "Europe in Question" Discussion Paper Series, London, 2010.

[8] See: M.J.G. Bun, F.J.G.M. Klaassen, "The Euro Effect on Trade Is Not as Large as Commonly Thought," *Oxford Bulletin of Economics and Statistics*, vol. 69, no. 4, 2007, pp. 473–496.

Pakko and Wall[9] doubt Rose's findings by describing his estimates as "provocative." According to their calculations, the impact is weaker and Rose's results are not robust. A similar negative verification was made by several other authors.[10]

NEW EVIDENCE OF THE "EURO EFFECT"

To examine the eurozone's impact on trade, several comparisons of the changing trade patterns should be conducted. The first comparison covers 1996–2002 and 2002–2005—the years around the date of the foundation of the euro area. In parallel with recent eurozone enlargements there are new exogenous impacts. The most important is the emergence of the global economic and financial crisis, when trade, instead of increasing, decreased in 2009. Moreover, domestic demand for foreign commodities fell particularly rapidly in several euro area member countries due to a sovereign debt crisis.[11]

Concerning 1996–2005, trade changes are analysed within the euro area.[12] These intra-euro area trade changes are compared with euro area-EU and intra-EU trade changes. The comparisons of these three groups of countries enables us to draw some conclusions about the differences in trade patterns between the euro and non-euro EU Member States in the beginning of the 21st century.

[9] M.R. Pakko, H.J. Wall, "Reconsidering the Trade-Creating Effects of a Currency Union," *Federal Reserve Bank of St. Louis Review*, 2001, pp. 37–46.

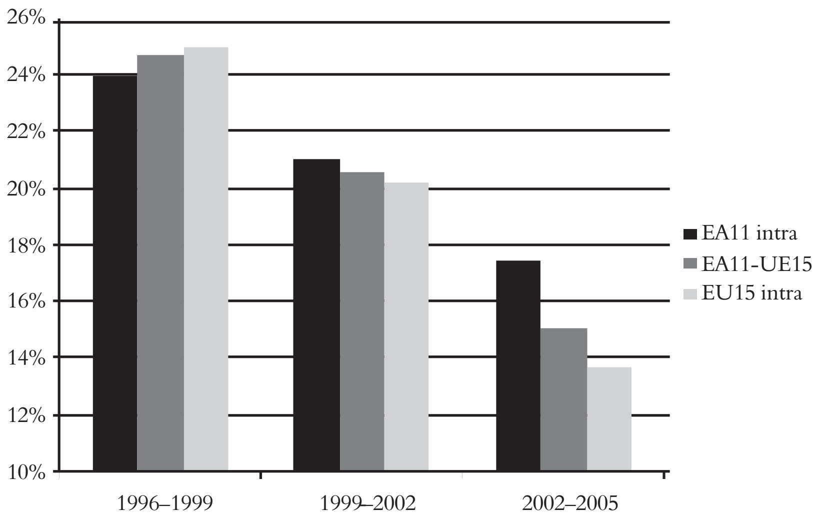
[10] See: V. Nitsch, "Honey, I Shrunk the Currency Union Effect on Trade," *The World Economy*, vol. 25, no. 4, pp. 457–474, 2002; H. Berger, V. Nitsch, "Zooming Out: The Trade Effect of the Euro in Historical Perspective," *Journal of International Money and Finance*, vol. 27, no. 8, December 2008, pp. 1244–1260; R. Baldwin, *The Euro's Trade Effect*, European Central Bank Working Paper no. 594, 2006, C.R. Tamarit, E. Gómez-Herrera, *The Euro Effect on Trade: Evidence in Gravity Equations Using Panel Cointegration Techniques*, Working Papers Serie EC 2011-07, Instituto Valenciano de Investigaciones Económicas, Valencia, 2011; M. Camarero, E. Gómez, C. Tamarit, *EMU and Intra-European Trade: Long-run Evidence Using Gravity Equations*, ThE Papers 10/25, Department of Economic Theory and Economic History of the University of Granada, Granada, 2012.

[11] The data come from Eurostat, however, they are not fully consistent (the trade between two countries and groups differ depending on which country or group is the "reporter" country and which is the trading partner), which biases the results of the study. For the purposes of this study, I decided to show data from the "perspective" of each of the presented countries. This means, that the mentioned countries or groups are "reporters."

[12] For the periods: 1996–1999, 1999–2002 and 2002–2005, I adopted the EA-11 (that included Austria, Belgium, Germany, France, Finland, Ireland, Italy, Luxembourg, Netherlands, Spain, and Portugal). This is without Greece, which joined the eurozone in 2001.

In the case of the period 2007–2012, several other modifications need to be made. Within the euro area, new members emerged, and the number of euro area countries increased. Up to 2009, when the crisis started, the euro area enlarged eastward and southwards and additionally included Slovenia, Cyprus, Malta, and Slovakia. In 2011, it enlarged to include Estonia. In the case of these "late" years, apart from comparing the eurozone bloc, a comparison of the countries joining alone to other like countries outside the eurozone was conducted. Although Slovenia may be compared to Hungary or the Czech Republic in context of welfare (though the size of the countries is relatively different)[13] and its openness, there is no evident match country for Cyprus and Malta. But if we adopt the criterion of the size of the economy, the most similar countries are Latvia and Lithuania. However, the problem is that these countries have fixed exchange regimes, which could generate somewhat of a similar effect as euro membership.

Graph 1.
Trade growth within the EA-11, the EU-15 and between the eurozone and non-eurozone EU-15 Member States



Source: author's own calculations, Eurostat.

In the first time period examined (1996 to 1999), trade within the 11 countries, future eurozone members, grew slower than trade with the EU-15. Additionally, intra EU-15 trade grew the fastest in this

[13] In the case of the economic size of the country, Bulgaria would be more appropriate, but this country just entered the EU, which biases the results.

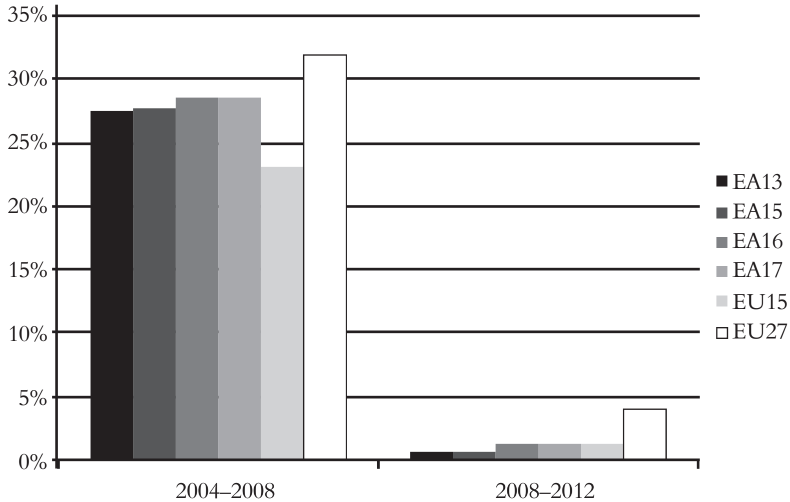
period. Nevertheless, the differences in the trade growth pace were not substantial: between intra-eurozone and intra-EU-15 trade, these discrepancies reached 1.11 p.p. during that period.

Since the time the euro area was officially founded (1999), trade growth decreased in all of the above-mentioned cases. This was visible in the period from 1999 to 2002 (when the currency was put into circulation). However, a further reduction in trade growth was also visible in the next four analysed years (2002–2005). That is interesting as since 1999 the growth rate has slowed the strongest in the case of intra EU-15 trade, whereas in the case of the EA-11 the slowdown was the weakest. As a consequence, the highest level of trade growth in 1999–2002 was observed in the EA-11, and the smallest for the EU-15. A continuation of this trend is visible in the next four years: the slowdown of the trade growth rate is maintained and the greatest contraction in the growth pace took place in intra-EU-15 trade. The trade growth inside the euro area was higher, by 3.8 p.p., than inside the EU-15. This snapshot thus suggests a positive impact of the establishment of the eurozone and a positive impact on intra-euro area trade of putting the euro into circulation. Since the accession of Greece to the euro area group, little has changed. The original situation and trends have remained the same.

But, what happened with trade after the EU enlargement in 2004 and 2007, and since the beginning of the financial and economic crisis? How has the euro affected trade since then? This impact is surveyed by analysing trade growth in the enlarged euro area (up to the EA-17) and by comparing it to trade growth in the enlarged EU (EU-27) in two periods: 2004–2008 (up to the beginning of the crisis) and 2008–2012 (the crisis period, up to the latest available data). Next, the trade of selected new eurozone members is compared to other, similar non-eurozone countries.

After the EU enlargement in 2004 and 2007, the picture of the "euro effect" on trade blurred. Trade growth inside the euro area was slower than in the EU-27 between 2004 and 2008. This is interesting, as trade within the EU-15 is characterised as the weakest trade growth. In the following years, the crisis had begun, which resulted in a contraction of trade. Thus, trade growth through 2008–2012 was highly reduced. But still, the EU-27 remained the group within which trade grew the most rapidly. At the same time, trade growth within the euro area was similar to trade growth within the EU-15, fluctuating around 1%. Thus it is difficult to formulate a thesis that the euro helped to increase trade. These two periods are difficult to assess in this respect. The most important “blurring” factor is that new Member States were in the catching-up process and still were building economic relations with the old Member States, which translated into their much higher trade growth. A second explanation is that since the beginning of the crisis, the southern eurozone Member States experienced a grave downturn, which negatively affected their trade.

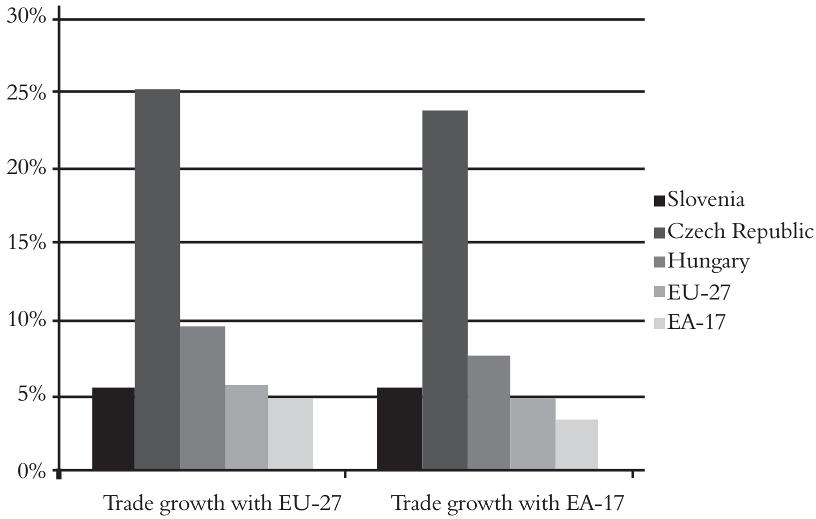
Graph 2.
Trade growth within the euro area and the EU in 2004–2008 and 2008–2012



Source: author’s own calculations, Eurostat.

It is interesting to analyse the trade growth rates of the new eurozone Member States to determine whether joining improved their trade or not. Because I intended to examine the euro effect on trade, which concentrates most within the euro area, I did not analyse the total global trade of the selected new euro Member States but the total trade with the EA-17 and with the EU-27. I analysed each of the countries since the year they joined the eurozone and for an additional four years (in the case of Estonia, an additional two years).

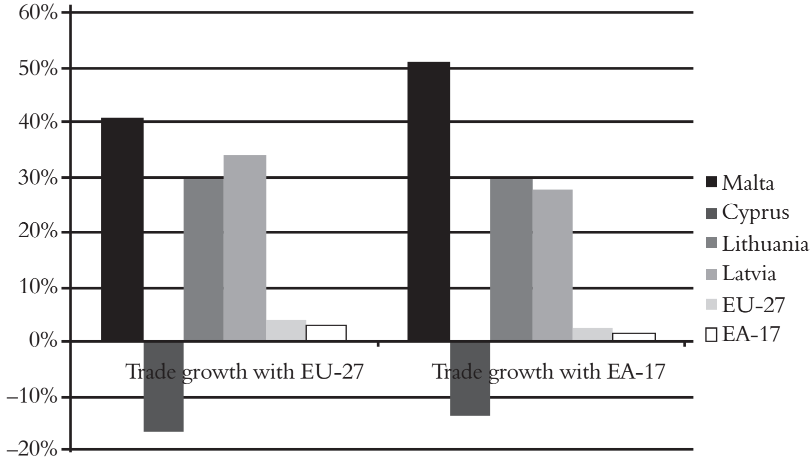
Graph 3.
Trade growth of Slovenia, Czech Republic, Hungary, intra-EU-27 and intra EA-17 since 2007 (first eurozone enlargement with new EU Member States)



Source: author's own calculations, Eurostat.

The case of Slovenian trade also does no favour for the thesis, since euro membership has positively affected its trade since it joined the euro area. Its trade with the euro area or with the EU grew more slowly than Hungary's despite the economic crisis in the latter. Additionally, Slovenian trade growth is much weaker than the Czech's. Nevertheless, Slovenian trade with the euro area or EU increased more strongly than did intra-EU or intra-euro area trade. Moreover, the trade of each of the selected countries and group grew faster in with the whole EU-27 than with the EA-17. This rather points to the bad economic conditions in the euro area, which overwhelmed the positive impact of the euro area itself on trade.

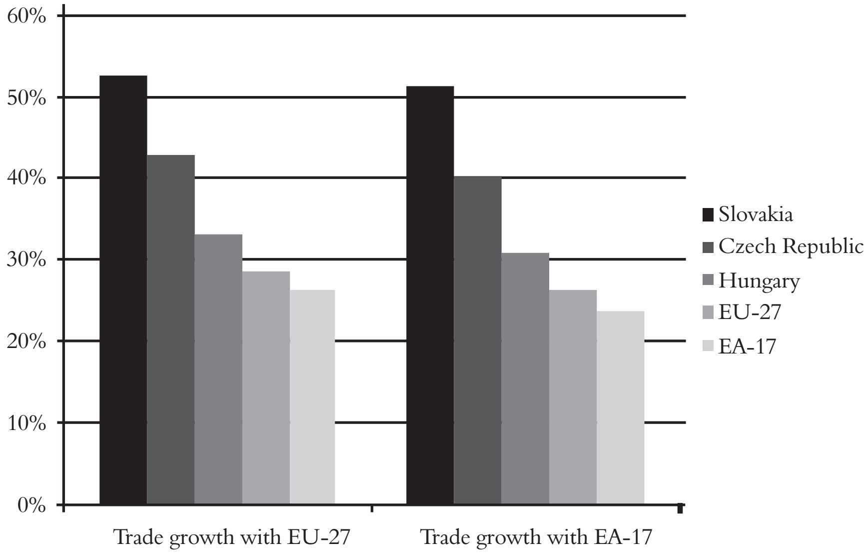
Graph 4.
Trade growth of Malta, Cyprus, Lithuania and Latvia, intra-EU-27 and intra EA-17 since 2008 (second eurozone enlargement with new EU Member States)



Source: author's own calculations, Eurostat.

Graph 4 is difficult to interpret because all of the countries have fixed-rate regimes or belong to the EU. Additionally, the financial crisis in Cyprus decreased its trade, thus disabling the euro effect on its trade. But if we only compare Malta to the two non-euro Member States, we can see it benefitted from euro membership. However, even in this case it is difficult to assess the effect basing on this comparison alone, as both non-eurozone countries experienced a substantial economic downturn in 2009.

Graph 5.
Trade growth of Slovakia, Czech Republic, Hungary, intra-EU-27 and intra EA-17 since 2009 (third eurozone enlargement with new EU Member States)

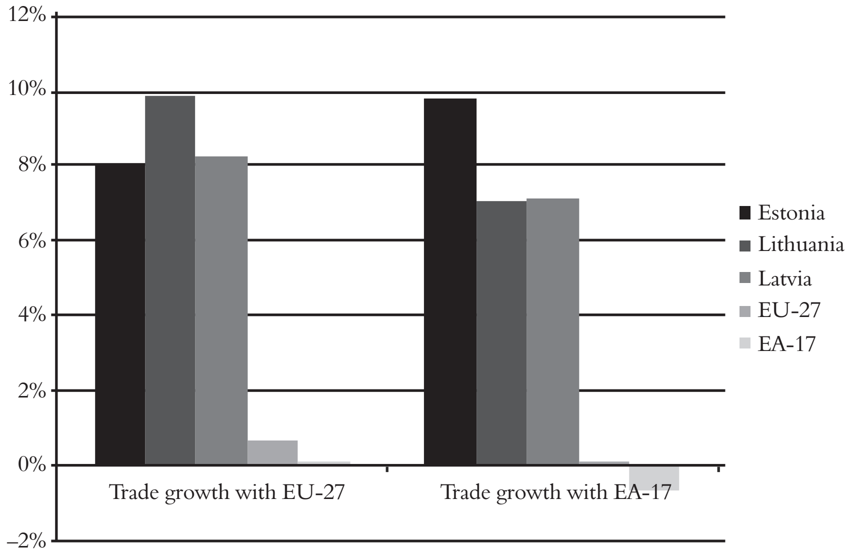


Source: author's own calculations, Eurostat.

A more rosy picture emerges when Slovakia's trade is presented. Its trade growth with the euro area or EU was higher than its neighbours' trade since 2009. This is also truth if the time series is extended to the preceding years. Thus, this is a first certain winner of eurozone accession.

This success story is not fully repeated in the case of Estonia. On one hand, the country's trade growth with the EA-17 was bigger than that of Lithuania and Latvia, but when examining trade with the EU-27, growth was weaker than for those two non-eurozone countries.

Graph 6.
Trade growth of Estonia, Lithuania and Latvia, intra-EU-27 and intra EA-17 trade since 2011 (fourth eurozone enlargement with new EU Member States)



Source: author's own calculations, Eurostat.

CONCLUSIONS

This short study offers new evidence that sheds light on the discussion concerning monetary integration effects on trade. As shown above, the outcome of the discussion is not conclusive, however, the voice of critics of the effect is being heard more often lately. Additional, detailed research is necessary in this area.

The comparisons between similar new eurozone and non-eurozone members as reference countries show that the differences between the eurozone members and the reference non-eurozone member in their intra-EU and intra-EA trade changes do not particularly favour eurozone membership. Only in the case of Slovakia does the euro effect seem to be very substantial. In other cases, the various factors seem to have more of an effect on trade—among them is the economic performance of the trading partners. Cyprus (as a euro member) and Hungary (as a non-euro member) are examples of these other factors' impact on trade. Both countries experienced serious economic downturns, which made trade lower than in other similar countries. This insight—that the other factors have more impact than the "eurozone effect"—should be taken into account in the further research.

POLITICAL ECONOMY OF ACCESSION TO THE EURO: THE CASE OF HUNGARY

JULIUS HORVATH[1]

This paper deals with choosing an exchange rate regime in the Central and Eastern European (CEE) countries, with an emphasis on Hungary. It begins with a short theoretical survey, then presents a general overview of the CEE countries' exchange rate regime choices. Finally, a short case-study of Hungary is presented, then conclusions.

SHORT THEORETICAL SURVEY

There is vast literature concerning the theoretical aspects of choosing an optimal exchange rate regime. For example, in an influential paper, Helpman (1981) shows that in an environment where markets are complete, money is neutral, and there are no rigidities, there is no welfare impact of an exchange rate regime: the exchange rate regime does not really matter.[2] However, if one leaves this frictionless world, then the question appears of which exchange rate regime is preferable under different types of friction and different macro-economic stabilisation policies.

Also, one can discuss exchange rate regimes under the so called Impossible Trinity conditions. If high capital mobility is given, then a country needs to choose from two options: either it opts for a float regime with independent monetary policy, or it opts for a fixed exchange rate regime, and gives up its monetary policy independence. In addition, the recent currency crisis experience showed that countries are more and more vulnerable to adverse shifts in market sentiment. Such shifts, though generally related to concern about economic fundamentals, can often be destabilising.

Finally, the most widespread approach originates from considerations of the optimum currency area theory. Mundell (1961) suggests labour mobility as an important criterion of optimum

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[2] E. Helpman, "An Exploration in the Theory of Exchange-Rate Regimes," *Journal of Political Economy*, vol. 89, no. 5, 1981, pp. 865–890.

currency areas,[3] and subsequent research puts forward additional criteria. McKinnon (1963) considers the openness of an economy as the crucial criterion: the more open an economy, the more it should be inclined to use fixed exchange rates.[4] Kenen (1969) suggests production diversification as a criterion: in well-diversified economies, the importance of asymmetric shocks would be of lesser significance than in less-diversified economies. Thus, fixed rates are the most appropriate for well-diversified economies.[5] Other authors presented other criteria of optimality based on various structural economic characteristics as similarity of rates of inflation, the degree of policy integration, degree of price and wage flexibility, real exchange rate variability, and others.

Yet, some authors such as Machlup (1977), raise the point that when choosing exchange rate arrangements, economic considerations are not of foremost importance. Machlup, for example, argues: "what ultimately counts, however, is that all members are willing to give up their independence in matters of money, credit, and interest. Pragmatically, therefore, an optimum currency area is a region no part of which insists on creating money and having a monetary policy of its own."[6] This helps us to understand why in the CEE countries we observe an interesting situation: countries with similar structural economic characteristics opted for different exchange rate regimes. For example, the Czech Republic opted for managed float while Slovakia joined the eurozone; Romania introduced float and Bulgaria a currency board; Serbia and Albania have float while other western Balkan countries introduced various fixed exchange rate regimes. However, in conjunction with entering the European Exchange Rate Mechanism (ERM II) at some point in the future, which is required before a Member State adopts the common currency, a country's exchange rate will have to be fixed in reference to the common currency.

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[3] R. Mundell, "A Theory of Optimum Currency Areas," *American Economic Review*, vol. 15, no. 4, 1961, pp. 657–665.

[4] R. McKinnon, "Optimum Currency Area, 4," *American Economic Review*, September, 1963, pp. 717–725.

[5] P. Kenen, "The Theory of Optimum Currency Areas: An Eclectic View," in: R. Mundel, A. Swoboda (eds.), *Monetary Problems in the International Economy*, University of Chicago Press, Chicago, 1969, pp. 41–60.

[6] F. Machlup, *A History of Thought on Economic Integration*, Columbia University Press, New York, 1977, p. 71.

CEE AND THE EURO

Eight—former socialist—members of the European Union have not yet adopted the euro.[7] Joining the European Union is bound to the obligation to join—at an unspecified time period—the eurozone. However, there seem to be two types of reasons for policies supporting staying out of the eurozone.

First, potential eurozone member countries need to fulfil nominal macro-economic conditions before joining. Thus, one can divide the set of these countries between those able to fulfill the criteria and subordinate other aims of economic policy to the goal of joining the euro (Slovenia in 2007, Slovakia in 2009, Estonia in 2011) and those countries that have not succeeded so far.

However, there is a second reason why most of the CEE countries did not join the eurozone. The recent financial crisis and the resulting sovereign debt crisis in Europe led to increased scepticism in some of these countries about the usefulness of the euro area accession. As a result, one may observe conscious policies to postpone or possibly even avoid joining the eurozone.

After the CEE countries joined the EU, increased importance was assigned to maintaining as many competences as possible on the national level. This strategy concerns also monetary policy, which is to become an exclusive competence of the European Central Bank in case of eurozone accession. This trend is fuelled by the fact that joining the EU did not bring CEE states substantial increases in living standards, and thus scepticism about the correctness of this decision emerged. In addition, the recent sovereign debt crisis in Europe sent a signal to these countries that being a member of the eurozone is not a guarantee of avoiding deep domestic crisis.

Recent data show that average growth of the seven non-euro CEE countries in 2012 was around 1% compared with a contraction of more than 0.5% in the euro area.[8] Similarly, in 2011 the growth of the non-euro CEE EU members was faster than the growth in

[7] These countries are Poland, the Czech Republic, Hungary, Bulgaria, Romania, Croatia, Latvia and Lithuania. Only Slovenia, Slovakia and Estonia—former socialist states—have both become EU member countries and adopted the euro. Latvia plans to join the eurozone in 2014.

[8] J. Asmussen, a speech given at IIF Central and Eastern Europe CEO Conference in Berlin, 29 April 2013, www.ecb.europa.eu (note: data excludes Croatia, which joined the EU after the speech).

the eurozone. These growth-rate results strengthen those who oppose joining the eurozone. Evidently, this is not a fully persuasive argument as it is not clear whether the sovereign debt crisis is a result of the euro introduction or a result of policy failures.

CASE STUDY: HUNGARIAN POLICY MAKERS AND THE EURO

Hungary has already missed several self-imposed target deadlines and as a result, despite joining the EU in 2004, in 2013 it still does not have a target date for adoption of the euro.

Historically, there seem to be good reasons to join a currency union. Hungary for the last approximately one hundred years went through a very turbulent financial history. If the history of one's own currency stability should matter in considerations of whether to join a currency union, it seems that Hungary should be a country that should opt to do so. When comparing the historical record of the four Visegrad economies, one may observe the stability of the Czechoslovak (later Czech and Slovak) koruna compared to the Hungarian currencies. After large exogenous shocks affected the Visegrad region, Hungarian policymakers typically were not able to keep the value of their currency stable. This was the situation after the First and Second World Wars.[9] In this sense, one might expect a country with a relatively volatile currency and history of high and galloping inflation to opt for joining a monetary union. But actually, I see the opposite.

One sees not only that Hungary—after joining the EU—did not meet the Maastricht criteria but also that consensus has not been built across the political spectrum for euro introduction. Prime Minister Viktor Orbán in 2002 was promising to introduce the euro in the period 2007–2008, but Fidesz's loss in the 2002 parliamentary elections stopped those plans. The Socialist government that ruled Hungary from 2002 till 2010 had issued official dates for the euro's adoption, e.g., Prime Minister Péter Medgyessy claimed that 2008 was a feasible goal, and Finance Minister Tibor Draskovics was already in 2005 favouring a target date of 2010. Support for 2010 as the euro-adoption date was later stated also by Prime Minister Ferenc

[9] M.C. Kaser, A. Radice (eds.), *The Economic History of Eastern Europe 1919–1975*, Clarendon Press, Oxford, 1985, p. xii.

Gyurcsány and Finance Minister János Veres.[10] As we see, the general rule was the constant postponement of dates of entry to the eurozone. But these target dates were never at the centre of the discussion, as there was never sufficient political will to push towards joining the eurozone.

Moreover, one of the largest obstacles to euro introduction was the historically high debt and growing fiscal deficit. In the period of the Socialist's rule, the excessively high budget deficit and higher-than-required inflation led to the abandonment of target dates. After the 2006 election and a second straight Socialist victory, the first internal austerity package was implemented. This austerity package somewhat improved the macroeconomic data. It led the finance minister to announce a draft of a euro-adoption plan. But that was abandoned shortly afterwards, as it seemed that the ruling coalition could not obtain sufficient support in parliament.

The willingness to implement the euro in Hungary weakened after the new Fidesz government came to power in 2010. Although initially the national economy minister, György Matolcsy, spoke about euro adoption in 2012, in February 2011 Prime Minister Orbán made it clear that he does not expect the euro to be adopted before 2020.[11] Later, Matolcsy also confirmed a target date of around 2020.[12] Yet, there were also voices that called for more intensive efforts to join the euro. For example, Governor of the Central Bank András Simor, who was nominated by the previous government, called in September 2010 for the more speedy introduction of the euro in Hungary: "Euro has [a] future, [and] its introduction should receive absolute priority by Hungarian politicians."[13]

[10] M. Jenei, "Will There Be a Hungarian Euro? (Lesz-e magyar euró 2014-re?)," *Index* (Hungarian web portal), 25 October 2010, http://index.hu.

[11] MTI, "Orbán: 2020-ig nem lesz eurónk" ('Orbán: We will not have euro till 2020'), *Index*, 5 February 2011, http://index.hu. The Hungarian prime minister also said that the conditions for joining the eurozone will change as the Member States move towards harmonisation of their fiscal policies, which might endanger the competitiveness of Hungary. However, he emphasised that the government will do everything it can to achieve a 3% deficit-to-GDP ratio.

[12] In *Vilaggazdasag* (a Hungarian economic daily, 4 March 2011, www.vg.hu), Minister of National Economy Matolcsy in an interview with the Austrian publication *Der Standard* stated that first the Maastrich conditions need to be met. He also emphasised the importance of real convergence. Matolcsy also said that "if economic performance allows to achieve debt level to GDP at 50%, we will enter (the eurozone)."

[13] M. Jenei, *op. cit.*

Currently, the Hungarian government is making efforts to decrease the deficit to below the 3% criterion. The overall debt-to-GDP ratio is just under 80%; inflation and the long-term interest rate are still above the reference ratio. Hungary's convergence plan predicts faster growth and a decreasing budget deficit between 2013 and 2016, according to the Ministry for National Economy. The National Economy Minister stated it would be a long time before Hungary would be able to meet the criteria for joining the eurozone. According to the plan, the structural budget deficit will be 2.7% in 2013 before dropping to 2.2% in 2015 and to 1.3% in 2016. Hungary's public debt is expected to fall from 79.2% of GDP late last year to 73.4% in the following two years, according to the government's plan.[14]

In April 2013, the Hungarian prime minister stated that the country cannot seriously consider joining the eurozone until its average economic development reaches 90% of the level of the euro states.[15] "Hungary is aware that we live in Europe and we participate in the European market. At the same time, we have our own currency and our own national economy, but we cannot detach ourselves from what is happening around us," the prime minister said.[16]

Matolcsy, currently the Governor of the Central Bank, stated that it could take 20 years before Hungary joins the eurozone. Matolcsy believes that Brussels' present direction is counter-productive to Hungary's interests. He also stated that the EU should change its policy of forcing members to join the eurozone.[17]

Surprisingly, early in 2013, Hungarian opposition leader Attila Mesterhazy claimed that preparations to join the euro could start in less than two years. His statement was harshly criticised by the government.[18] Meeting the euro entry conditions would help

[14] MTI, "Hungary's new euro convergence plan projects faster growth, smaller deficit—but slower euro adoption," *Realdeal.hu*, 17 April 2013, www.realdeal.hu.

[15] MTI, "Orbán: Hungary will keep forint until its GDP reaches 90% of eurozone average," *Politics.hu*, 26 April 2013, www.politics.hu.

[16] *Ibidem*.

[17] J. Stanford, "Matolcsy: 20 Years until Hungary Joins Euro," *The Daily Hungary*, August 2012, www.thedaily.hu.

[18] M. Feher, "Hungarians Want Euro Later Rather than Sooner," *The Wall Street Journal*, 4 February 2013, http://blogs.wsj.com. Mesterhazy told *The Wall Street Journal* that Hungary could join ERM II in 2015. He also stated that Hungary should take a flexible position concerning the actual date of eurozone entry.

Hungary "win more with its predictability and credibility … than what we lose by it," Mesterhazy said.[19]

Mesterhazy cited a poll in which 500 Hungarians were asked one question: "Some reckon the preparation for the eurozone entry should start during the next government cycle of 2014–2018, others say the process to introduce the euro should rather start after 2018—what do you think?" Citing fears of austerity and high inflation, almost 60% said that Hungary should opt to start eurozone entry preparations after 2018. Slightly fewer than 30% wanted it to take place between 2014 and 2018.[20]

Cohen argues that there are three basic reasons that lead sovereign countries to use their own currencies as legal tender: political symbolism, seigniorage and the ability of one's own currency to have real macroeconomic effects.[21] It is difficult to evaluate the importance of the nation's bond to the forint,[22] and seigniorage does not seem of primary importance when deciding whether to join the eurozone. National currency provides the government with the possibility to decrease dependence on other countries. It seems that for the current governing coalition in Hungary, this type of reasoning is important and a substanial part of society supports it.

CONCLUSION

The euro is and will stay attractive for the CEE states as these countries are deeply inter-connected with the eurozone through trade and investment. This means large benefits from sharing a currency. Seeing the individual developments in the CEE countries, it seems also that the European Union is still the surest path to further development.

Indispensible to Hungary's euro adoption is the need to show a willingness to be a part of the EMU. The Hungarian public should be more aware of not only the drawbacks but also the benefits arising

[19] *Ibidem.*

[20] *Ibidem*; those who did not know or did not want to respond accounted for 15%.

[21] B. Cohen, *The Geography of Money,* Cornell University Press, Ithaca, 1998, pp. 34–46.

[22] One could expect this bond to be low as the forint is not a regional currency, and demand by foreign residents for the forint is relatively low. In addition, Hungary has a tradition of abandoning its own currency as a result of stabilisation policies. In 1925, the Hungarian korona was replaced by the pengő, which was in 1946 replaced by the forint.

from euro area membership, and especially of the fact that it requires a further shift of competences, which should not be perceived, however, as an attack on the country's sovereignty. In other words, as Jörg Asmussen, a member of the ECB Executive Board, once put it "countries cannot join the euro area but continue with the same economic policies based exclusively on national considerations."[23]

[23] J. Asmussen, *op. cit*.

SLOVAK EXPERIENCE WITH THE EURO

MARTIN ŠUSTER[1]

The new Member States entered the EU and thus the Economic and Monetary Union as members with a derogation, which meant they were obliged to adopt the euro when they met the Maastricht criteria. Only the UK and Denmark have a permanent opt-out from adopting the common currency. However, in practical terms—as opposed to purely legal terms—the "outs" can more or less opt-out from the third stage of EMU by deliberately not meeting some of the convergence criteria. Sweden, for example, never entered the Exchange Rate Mechanism (ERM), and so does not meet the exchange rate stability criterion. An individual country can delay some of its nominal convergence indefinitely without ever officially declaring that it does not wish to join the eurozone. Euro adoption is thus a choice, and ideally this choice would be based on rational economic grounds.

Euro adoption is a political question at heart. The transition to the euro is costly and irreversible, therefore it should not be decided by a small parliamentary majority; otherwise the transition process becomes much more expensive and risky. Back in 2004, Slovakia did not want to fall behind again, as it was the last of the ten new member states to complete the accession process. There was thus a lot of motivation to continue with integration. A lot of the political motivation for Slovakia to join was not measurable by economists, but the fact is there was both very broad political support and also popular support for rapid euro adoption. Yet, the decision to join the euro should be determined by a detailed economic cost-benefit analysis.

COST-BENEFIT ANALYSIS

When looking for adequate theories concerning currency unions, the first to recall is the standard Optimum Currency Area. It states that a monetary union would be more beneficial and less likely to be adversely affected by asymmetric shocks if labour and capital are mobile across borders and if wages and prices are flexible. The theory

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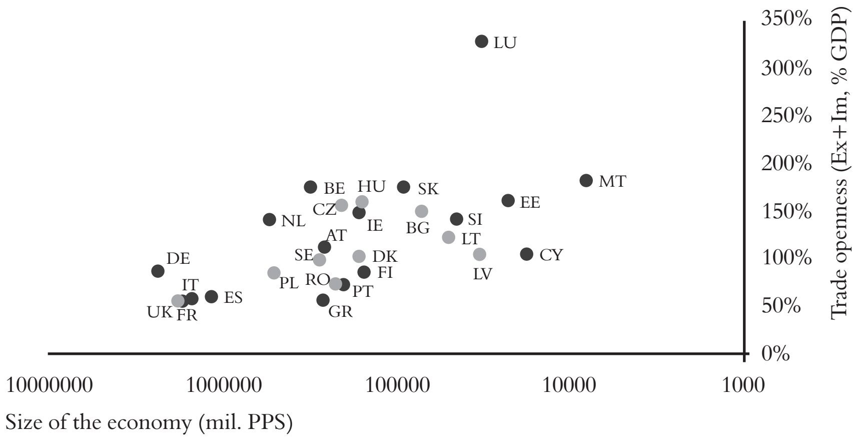
and experience demonstrate that small, flexible and open economies, with flexible prices and wages and labour mobility, along with synchronised business cycles, tend to benefit more from a common currency. Another important factor is the correlation of the business cycles. The more synchronised the cycles, the less likely there are to be asymmetric shocks. Looking at Figure 1, countries in the top right corner should benefit relatively more from the euro. In fact, most countries in this corner either already use the euro, or are actively trying to meet the criteria for euro adoption. However, the practical outcome is much less aligned with the theory in the bottom left corner of the picture, where of the five relatively large and closed EU countries, four were in the original group that formed the euro area.

Figure 1.
Size and openness of EU countries



Source: Eurostat, 2009.

Concerning labour flexibility and the correlation of business cycles, Greece and Hungary are outstanding in the most visible way (Figure 2). The paradox is that the countries that have the most flexible labour markets, the UK and Denmark, are not in the euro area, while the ones that have the least flexible markets have already adopted the common currency.

Figure 2.
Labour market flexibility vs. synchronisation of cycles in EU countries

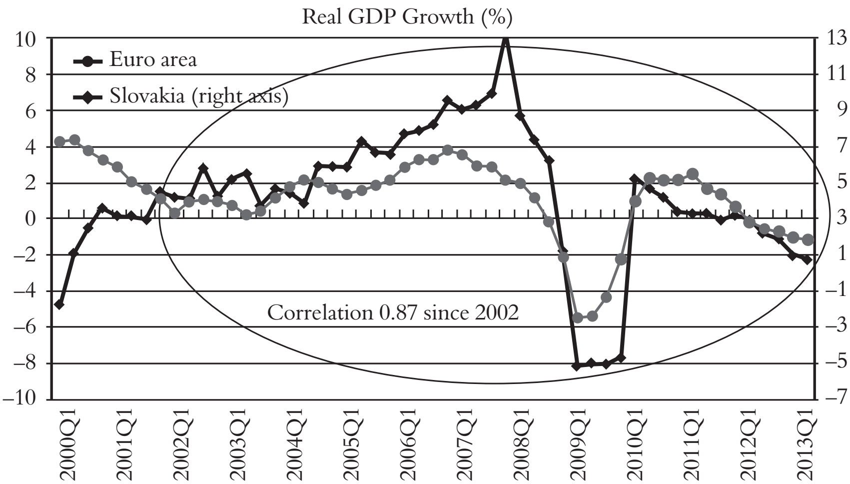
Sources: World Bank, Eurostat, own calculations, 2009.

The Optimum Currency Area theory says nothing about the breaking point at which the cost and benefits of joining the euro area are equal. In fact, since euro area accession is irreversible, there should be some safe margin of benefits before a country decides to join. In the case of Slovakia, according to our estimates, the euro area membership benefits clearly prevailed. The major costs of euro adoption were linked with the technical currency changeover and the loss of independent monetary policy—an important instrument to stabilise the economy. We have estimated that these costs amounted to 0.1% of Slovak GDP.[2] Giving up monetary policy was not that costly since monetary policy in Slovakia could not be used extensively to stabilise the economy. The price level or inflation was relatively stable, but monetary policy was much less successful in stabilising business cycles or the unemployment rate. In addition, the Slovak business cycle is largely synchronised with the rest of the euro area, as the correlation of the Slovak economy with the EU-17 has been 0.87% since 2002. Another issue was the likelihood of slightly higher inflation. The increase in inflation due to currency exchange and price redenomination after the euro adoption is difficult to measure, since it is hard to identify the causes of individual price increases. The National Bank of Slovakia studied the "changeover inflation

[2] M. Šuster *et al.*, *The Effects of Euro Adoption on the Slovak Economy*, National Bank of Slovakia Policy Paper, 2006.

effect" in January 2009 using five different methods. The inflation estimates ranged between 0.12% and 0.19%, which is comparable to the inflation rate within one month. But if price decreases (as a result of rounding prices to attractive values) were also allowed, then the average changeover effect is 0.0%.[3] Similar studies of the Eurostat and of the Slovak Ministry of Finance also proved that the inflation effect of euro adoption was insignificant. In fact, Slovakia was the only euro area country where the population did not have a feeling of a *teuro* effect.[4] The country was probably lucky to adopt the euro in 2009, when the global depression was starting and inflation was falling, even turning to deflation for some time.

Figure 3.
Synchronisation of Slovak business cycles with the euro area



Sources: Eurostat seasonally adjusted data, own calculations, May 2013.

Currently, the sovereign debt crisis is the issue that changes considerably the cost-benefit calculations. With hindsight, we should add to the euro accession costs also participation in financial assistance programmes (as well as the implicit insurance on the benefits side). The first, political, cost of the crisis was the collapse of the Slovak government over the issue of European Financial Stability Facility

[3] M. Doliak, B. Karmažin, "Impact of the Euro Introduction in Slovak Republic on Inflation in January 2009," *Biatec*, vol. 17, no. 3, 2009, pp. 14–18.

[4] A combination of two words: "teuer" ('expensive' in German) and "euro."

(EFSF) expansion.[5] Slovakia eventually decided to participate in other assistance programmes, which included €7.73 bn in guarantees for EFSF and €5.77 billion for the European Stability Mechanism (ESM). Even though the theoretical exposure is up to €13 bn (around 20% of Slovak GDP in 2010), the actual cost is the difference between sovereign financing and the interest rate from the loans; which in most cases might be beneficial. Nevertheless, in the future we might expect some losses on the second Greek support programme. Any future cost-benefit analysis should incorporate the costs of funding and operating the ESM, understanding that the original structure supporting the euro was incomplete and missing a fiscal component.

Looking at the benefits side of adopting the euro, our analysis has shown a strong rationale for joining the euro area. Direct benefits were estimated at 0.4% GDP, mostly connected with the elimination of financial and administrative transaction costs. Other direct benefits included lower cost of capital, better resistance to currency crises, lower exchange rate risk against the dollar, and higher price transparency. However, the dominating factor is the dynamic long-term effect. Based on the Rose Effect[6] of currency unions on trade and GDP, we estimated the euro can initiate a 7–20% increase in Slovakia's GDP in the long term.[7] Although the magnitude of the effect is very uncertain, even the lower bound of the interval would be a significant boost to output, and eventually to living standards.

MANAGEMENT OF THE PROCESS

One has to remember that euro adoption is a three- to four-years long project that requires an adjustment of economic policies and careful project management. Membership in the Exchange Rate Mechanism (ERM) has to be in parallel with technical preparations. Finally, the country is being evaluated by the European Commission and the European Central Bank (ECB), and after the European Council gives its endorsement, the decision is taken by the Ecofin Council approximately six months before "€-day." In Slovakia, the initial decision to strive to adopt the euro as soon as possible was

[5] Slovakia did not take part in the Greek Loan Facility.

[6] Introduced in A.K. Rose, "One Money, One Market: The Effect of Common Currencies on Trade," *Economic Policy*, vol. 15, no. 30, April 2000, pp. 7–46.

[7] J.A. Frankel, A.K. Rose, "An Estimate of the Effect of Common Currencies on Trade and Income," *Quarterly Journal of Economics*, vol. 117, no. 2, 2002, pp. 437–466.

taken in 2003, even before the country joined the EU. In 2004, "as soon as possible" was narrowed down to mean by 2009, which was the earliest opportunity to meet the Maastricht criteria. The arguments for (and against) the euro's adoption in Slovakia were summarised in a National Bank of Slovakia "Policy Paper" from 2006.[8] An earlier version of the study was discussed in the Slovak parliament and served as a basis for the political decision to start the path towards euro adoption. The next stage was the elaboration of a detailed changeover plan, with a description of all the necessary steps and a timeline.[9] The plan turned out to be a role model for some other Member States, perhaps indicating the generality of the practical steps towards euro adoption.

In parallel with practical preparations, another challenge was to meet all the convergence criteria. Slovakia ended up exploring new ground, especially in the exchange rate stability criterion. Formally, this requires membership in ERM II. A country must remain under ERM II without severe tension for at least two years before evaluation. Its currency is allowed to fluctuate up to ±15% off the agreed central exchange rate. When necessary, the exchange rate is stabilised by intervention led by the European Central Bank in cooperation with the national central bank of the given country. Before Slovakia entered ERM II, there were two precedents in which there was a revaluation of the central rate: Ireland and Greece. In contrast to those countries, which revalued once and to a limited extent (by 3% and 3.5%, respectively), central parity between the Slovak Koruna and the euro in the ERM II system was adjusted twice and quite significantly. The second revaluation was a full 15%—as much as the fluctuation band allowed. The positive assessment of the exchange rate criterion by both the Commission and the ECB indicated that movements of the exchange rate on the strong side of the band are not considered 'tensions' and that even a significant revaluation of ERM II central parity is admissible if supported by economic fundamentals (in the Slovak case, there was a significant increase in productivity relative to the euro area, coupled with capital inflows and estimated significant appreciation of equilibrium real exchange rate).

We have to be aware of the classical Impossible Trinity. In a country with free capital flows, it is impossible to always meet both inflation

8 M. Šuster *et al.*, *op. cit.*

9 "National Euro Changeover Plan for the Slovak Republic," 2005.

and exchange rate targets. Monetary policy alone cannot guarantee both of them. So, it is necessary to rely on general macroeconomic stability or other supportive policies, or sheer good luck. Even if the exchange rate and/or inflation are stable in the long run, exposure to short-term fluctuations remains. In a small country like Slovakia, there was always a risk that the exchange rate could jump due to exogenous factors, such as a crisis in a third country. There is also asymmetry in the evaluation of the stability criterion. In appreciation territory, there is scope to use the full 15% band. In the depreciation zone, the currency should not exceed minus 2.25%. The appreciation should not be volatile, but slow and accompanied by increasing competitiveness. As argued above, revaluation does not seem to be as much of a problem as devaluation. This asymmetry comes from the historical institutional aversion in the EU to competitive devaluations, so when a currency appreciates under ERM II, the rest of the euro area will not complain, as their price competitiveness improves. Another aspect connected with an appreciating exchange rate is lower pressure on inflation. The stronger exchange rate in Slovakia certainly helped it meet the inflation criterion. Currently, when the exchange rate is irrevocably fixed, the inflation rate is still under control. It is slightly higher than in the rest of the euro area, but it is not excessively high and is in line with the convergence process.

Last but not least, when preparing a national path to the euro, it is necessary to bear in mind the difference between the strategic decision and the management of the changeover process. These two tasks require two different sets of skills. Few economists possess both, so perhaps it could be advisable to ensure that experienced project managers can assist in the preparation of strategic decisions. They could advise on the feasibility of the plans and on potential risks of the whole project.

PERSPECTIVES

The creation of financial assistance mechanisms—EFSF and ESM—was an explicit acknowledgement that euro area countries are directly exposed to fiscal problems in other members of the currency union. It showed that the no-bailout rule expressed in the EU treaties proved to be a non-credible threat. The sovereign debt crises forced the EU to start the process of deeper economic, fiscal and financial integration, especially in the euro area. This resulted in improving the economic governance mechanisms, such as the "six-pack," "two-pack" and the fiscal compact, which led to strengthening the preventive and corrective arms of the Stability and Growth Pact, the new Macroeconomic Imbalance Procedure, and the introduction of stronger national rules concerning debt and deficits. Further work is in progress, including that on a banking union, which will rely on centralised supervision of systematically important financial institutions (SIFI), common restructuration, resolution and deposit insurance mechanisms. A banking union should break the vicious circle between financial sector instability and sovereign instability. Yet, a fiscal union, with stronger coordination, centrally planned deficits and Eurobonds is politically very difficult to achieve.

Besides all of these (ongoing) improvements of the euro area institutional architecture, one has to bear in mind that the sovereign debt crisis is not a crisis of the euro currency, but a crisis of individual countries and was caused by profligate fiscal policies (Greece), lack of competitiveness (Portugal, Spain, Italy), and asset bubbles (Spain, Ireland). The euro currency is not at risk, but its internal architecture is evolving and the structural problems of several euro area members are still far from being resolved. Therefore, in making future decisions about euro area membership, one has to take these factors into account and understand that the future euro area will be very different from what it used to be.

CZECH REPUBLIC AND THE EUROZONE: BETWEEN EU TREATY OBLIGATIONS AND POLITICAL PREFERENCES

DAVID KRÁL[1]

OVERVIEW: AN END TO THE CZECH CACOPHONY IN SIGHT?

The Czech voice in the current debate on the Economic and Monetary Union (EMU) is difficult to describe, though one could possibly use many adjectives: confused, reactive, troublesome, cacophonic. Part of this is probably attributable to the polarised discourse among the Czech political elites on Europe at large. The future of European integration is often seen in black-and-white terms: either less Europe, or at least the preservation of the status quo, and retaining as much power as possible at the national level, or move in the direction of the creation of a European "super state" with many more powers centralised at the EU level. This simple vision of the EU's future makes cross-party consensus particularly challenging. But in the Czech case, the situation is even more intriguing as the discourse has been shaped by autonomous players on the political scene, such as former President Vaclav Klaus, or the Czech National Bank and its current eurosceptic board appointed by him. But the different visions of the political parties are not the only factor that can explain the ambiguity of the Czech position. The lack of the capacity or willingness of Czech political leaders to think strategically and beyond their incumbent term of office has recently resulted in uncoordinated reactions, sending different signals to both the domestic audience and European partners.

There is hope for things to start moving in the right direction after the government adopted a new strategy document for the EU in May 2013.[2] This document defines Czech policy preferences for various areas of EU action. A substantial part of it reflects on the current developments in the eurozone and gives quite detailed guidance as

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[2] "Stretegie působení ČR v EU: Aktivní politika pro růst a konkurenceschopnou Evropu" ('Strategy of the activity of the Czech Republic in the EU: active policy for growth and competitive Europe').

to what the Czech government thinks about the short-, medium- and long-term proposals on the table, such as the EMU Blueprint. The fact that the document was adopted, despite a strong divergence inside the coalition of Prime Minister Petr Nečas, can be considered an achievement and a desired step to make Czech policy on the EMU more consistent. But the resignation of the government shortly after its adoption puts its continued existence and relevance into question once again. Given the speed with which the new measures around the eurozone evolve, the Czech position risks falling back to square one of an inconsistent, non-visionary and ad-hoc policy.[3]

JOINING THE EURO: THE CARDINAL, YET MOST DIFFICULT QUESTION

The attitude of Czech policymakers towards the deepening EMU is stuck on several dilemmas. The Czech Republic realises that a functioning and solid eurozone is of vital importance because of the Czech economy's high degree of interconnectedness with it, and with Germany in particular. At the same time, Czech policymakers do realise that strengthening the eurozone will require much more pooling of sovereignty among the EMU members, especially in terms of fiscal and overall economic policy coordination. This is becoming tricky as the Czech Republic still has a legal obligation to join the third phase of EMU, and thus will have to give up more of its national economic policy prerogatives in the future. The Czechs have never resigned from this legal obligation, despite calls by former President Vaclav Klaus that an opt-out should be negotiated. Furthermore, full participation in EMU brings financial obligations as well, in terms of participation in the European Stability Mechanism (ESM) or possibly in common resolution or joint deposit insurance in case of a banking union. With their relatively healthy public finances and banking sector, the Czechs are afraid that they would find themselves contributors rather than recipients of various EMU rescue mechanisms. The Czech government has followed with anxiety the possible repercussions of these debates, which brought down the

[3] This paper address mainly the attitudes of the 2010–2013 coalition government led by Prime Minister Petr Nečas, consisting of Civic Democratic Party (ODS), TOP09 and LIDEM. At the time of the writing of this paper, the caretaker government appointed by President Miloš Zeman after the resignation of the former government has failed to get a vote of confidence. Although the caretaker government formally remains in power, its term is likely to be short-lived, as the country is heading for an early election on 25/26 October.

government in neighbouring Slovakia. Selling full participation in the EMU to the Czech electorate thus seems for the time being an extremely challenging task.[4]

The fact that the eurozone is an extremely dynamic phenomenon and Czech policymakers cannot clearly see the endgame makes the adoption of the euro a non-issue for the time being. Even those parties who are clearly in favour of the single currency, such as the Social Democrats (CSSD), do not make a clear case for targeting eurozone accession. Former Prime Minister Petr Nečas has argued that although Czech citizens agreed to adopt the euro in the 2003 accession referendum, it applied to a very different kind of eurozone than we see emerging today. To this end, he pledged his party (Civic Democratic Party, ODS) to hold a referendum on the future accession, thus paving the way for what can be called a "Swedish scenario." With the currently extremely low level of trust in the single currency, it is difficult to envisage an affirmative outcome of a popular vote.

Because of the lack of consensus inside Nečas' coalition, the new EU strategy does not stipulate an obligation to call a referendum, but acknowledges that eventual euro adoption would have to be planned only when the major reforms in the eurozone determining its final shape are undertaken. This vague formulation, given that the reform process in the eurozone is extremely dynamic and the endgame is unknown, implies that euro adoption might be put on hold for many years to come. Yet, the Czech government seems to be more eager to contribute to the ongoing debates, while recognising that its leverage as a non-eurozone member would be minimal. There is, however, some trust inside the Czech government that it aligns on many matters of fiscal discipline and economic governance with some members of the eurozone, particularly with Germany, somewhat increasing its leverage. Whether this would be the case without a clear signal about the Czech willingness to join the club, however, remains highly doubtful.

[4] The support for the euro in the Czech Republic is the third lowest in the EU, after the UK and Sweden, with 25% of Czechs in favour and 71% against; see: *Standard Eurobarometer 79*, Spring 2013, published July 2013, http://ec.europa.eu/public_opinion/archives/eb/eb79/eb79_first_en.pdf.

THE CZECH VISIONS FOR A GENUINE EMU

A Banking Union: Against the Piecemeal Approach

The new Czech EU strategy also stipulates attitudes towards the rising architecture of a genuine EMU, as proposed by the Commission and which is to be based on three pillars: an integrated financial framework, an integrated fiscal framework, and an integrated economic policy framework. After the previous period of largely uncoordinated responses to various proposals and measures, this gives some hope that the Czech views will be better structured and more coherent.

The Czechs were at first highly concerned about the plans for the banking union, due to the fact that about 95% of Czech banking assets are controlled by banks incorporated in the eurozone, making the Czech case rather specific among the non-eurozone countries. For this reason, the Czechs considered themselves stakeholders in the debate and were not happy that the individual pillars of the banking union (i.e., common supervision, common resolution and joint deposit insurance) were not discussed as a package. Joint supervision is probably the least controversial issue for the Czech government, as long as it is able to keep domestic oversight of its financial sector. The initial concerns of the Czech government related in particular to the risk of changing the legal form of Czech banks from Czech joint stock companies (thus, subject to supervision by the Czech National Bank) to branches of eurozone-incorporated banks (which would bring them under the supervisory remit of the ECB). The Czech government agreed with the banking union (which it threatened to veto initially) after getting assurances that there would be no incentives for banks to change their legal form. However, when it comes to the other two contemplated pillars of the banking union—a common resolution mechanism and common deposit insurance scheme—the Czech government is much more sceptical. According to it, the EU-wide rescue mechanism should really be in place only in exceptional cases and as a last resort. The government believes that the joint system of deposit insurance will increase the risk of moral hazard whereby banks will undertake more risky operations if they perceive they have back-up from EU-wide mechanisms. A bail-in system, whereby the main burden for a possible bankruptcy would be borne by the banks themselves, thus represents the government's preferred policy option.

Fiscal Policy Coordination: In German Medicine We Trust

The Czech government's view of "fiscal responsibility" is that fiscal discipline, coupled with further liberalisation of the internal market, is the best medicine to tackle the current crisis in the EU and in the eurozone in particular. The fact that the Czech Republic did not sign the Treaty on Stability, Coordination and Governance in the EMU (the "fiscal compact") might thus seem rather surprising. The reasons lie in the Czech domestic political constellation rather than in the content of the treaty. The Czech government endorsed most of the provisions of the treaty, but quite a large part of the prime minister's party (ODS) simply did not accept that such measures should be imposed at the EU level. The Czech government tabled proposal for a so called "financial constitution," envisaging a constitutional enactment of a debt brake as well as balanced budget rules, which was not adopted. In this sense, the Czechs have acted as "de facto" signatories to the fiscal compact, playing down the importance of possible institutional ramifications, such as non-participation in Euro Summits. The Czech government can currently feel rather comfortable in supporting fiscal discipline and stricter enforcement of its rules, due to the differentiation between the eurozone and non-eurozone: the Czechs are currently not exposed to a stricter sanctions regime under the "six-pack" or fiscal compact, even if they decide to join the latter.

In terms of further steps in fiscal coordination, the Czech approach is very cautious. First, the budgetary issues are considered to be a prerogative of national policymaking and national parliaments, as that is where the political responsibility lies. Without profound changes in EU policymaking, further transfers of fiscal competences to the EU would hardly be acceptable. Second, the new EU strategy sees as the most problematic part the possibility of debt mutualisation (Eurobonds), and such a step can be undertaken only after a profound strengthening of economic and budgetary coordination in the eurozone. The Czechs fear that this might create incentives for certain Member States to incur greater indebtedness, thus posing moral hazard. However, given the sceptical attitude of Germany to Eurobonds, the issue is not on the agenda for the time being.

Economic Policy Framework: Structural Reforms and the Single Market as Part of the Solution

The Czechs also do realise the need for Member States to undertake structural reforms that would improve intra-EU competitiveness to produce a healthier eurozone. But, they say, this should be done primarily using the existing instruments envisaged in the treaties (particularly Articles 121, 122 & 136 of the TFEU) rather than creating new measures that would deepen the open method of coordination.[5] However, even the existing instruments should be deployed only insofar as they do not encroach on the single market and would not result in a diminishment of the funds allocated to EU-wide structural policy. The Czech government is rather concerned about proposals that could lead to a *de facto* binding character of Council country-specific recommendations through special contractual instruments, or financial incentives to Member States to undertake structural reforms, such as the proposed Convergence and Competitiveness Instrument (CCI). This soft method of regulation would in reality result in binding forms through the additional conditionality attached (in case of contractual arrangements), or some re-allocation of Union structural policies could occur (in case of CCI), directed towards to the debtor countries inside of the eurozone. The Czech government still considers the economic policy to be a national policy, which is to a certain degree co-ordinated EU-wide, and would prefer to have a profound debate about the functioning of current instruments before coming up with new ones.

The other important element in the Czech approach is that rather than coordination of economic policies, the EU should make use of the unfinished agenda of the EU single market liberalisation, which would have a positive impact on growth and jobs as well as on competitiveness. Among these, the free movement of services and digital or energy markets are considered to provide ample opportunities. In this respect, the Czechs could find a group of like-minded countries that would support further steps in this direction.

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[5] The open method of coordination (OMC) is usually associated with the Lisbon, and more lately, Europe 2020 strategies, and involves soft policy tools, such as peer pressure amongst the EU Member States, benchmarking, blaming and shaming, etc. For more details, see, for example, A. Missiroli, "A Little Discourse on Method(s)," *European Policy Brief*, no. 2, June 2011, http://ec.europa.eu/bepa/pdf/publications_pdf/a-little-discourse-on-methods.pdf.

However, they could also give ground to negative reactions as the economic crisis increases the appeal of protectionism across the EU.

THE WAY FORWARD: A FLEXIBLE AND OPEN EUROZONE WITH NO NEGATIVE IMPACTS ON THE SINGLE MARKET

The Czech approach towards measures intended to strengthen the EMU has changed, despite the fact that euro adoption is not on the agenda at the moment. It is more strategic in its outlook, although very cautious in terms of judging possible implications. The Czechs now want to participate more actively in the debates, although their impact on the actual policy outcome will surely be limited as long as they do not prove that they are serious about embracing the euro as their ultimate goal.

The Czech government in this context realises that more differentiation in integration is inevitable for the sake of the eurozone and the EU as such. A multi-speed (or for that matter more flexible) EU is thus not seen as a major risk.[6] This is primarily because the Czech Republic—at least rhetorically—still embraces participation in the third phase of EMU, and secondly because it believes that the current eurozone does not constitute a coherent group of countries capable of creating a core, thus triggering the creation of a multi-tier Europe. However, there are certain limitations that the Czechs would like to see respected to feel comfortable with the deepening integration in the current EMU. First, the eurozone should remain an open area for those who fulfil the rules and are willing to join. Second, none of the measures adopted for the eurozone should have a negative impact on the single market, which is seen as a cornerstone of European integration. Third, there is a very strong preference to use existing instruments and especially to work within the treaty framework. These are seen as the best guarantees to avoid the emergence of a multi-tier Europe. There is a great deal of frustration from the pattern set by the negotiation of the fiscal compact, which prompted fears that

[6] There is a distinction in the Czech thinking between a multi-speed and multi-tier EU. "Multi-speed" implies that the Member States are aiming towards the same integration goal (in this case EMU) at different paces, while the project remains open, transparent and within the EU treaty framework. "Multi-tier" entails the eurozone becoming a relatively closed entity of its own with its own institutions, policies, and possibly other instruments (e.g., a separate budget)—kind of a union within the Union. For matters of simplification, we are using those terms here. However, it should be pointed out that with recent developments within the EMU, the distinction becomes rather blurry.

it could become a standard method of doing business in the EU. But even with respect to these three conditions, it is not guaranteed that the Czechs would be happy with any measures proposed or adopted with the view that one day they would be binding on them. This will remain the case as long as the Czech political scene remains highly polarised and until there is a broader political and societal consensus as to how much more power the Czechs are ready to share with their fellow Europeans. Joining a very different eurozone thus remains a matter of strategic choice that Czech politicians have yet to make.

PART III

POLAND AND THE EUROZONE —DELAYED MEMBERSHIP

POLAND'S PLACE IN THE EUROZONE RUNAWAY TRAIN: AN ASSESSMENT FROM AN ECONOMIC PERSPECTIVE

PAWEŁ TOKARSKI[1]

In March 2013, public opinion in Poland was electrified by the view expressed by Paul Krugman on his blog that "Poland is not yet lost" and criticising its accessions plans to the euro area.[2] A number of opponents have subsequently challenged this judgment by arguing that membership in the currency union would give Poland influence over the plans for closer eurozone integration.[3] Although it is largely agreed that the rationale of the currency union has mostly political standing, nevertheless it is worth looking at the entry challenges from the economic perspective. Quite often in Poland, euro area accession is depicted by a metaphor of a "train leaving the station," with eurozone integration departing as Poland remains on the platform. However, euro accession is neither a cure-all for economic problems nor a guarantee of influence in the decisions concerning a "genuine" Economic and Monetary Union. A closer look at the euro area reveals that its members are far from enjoying equal footing. This concerns especially those covered by economic adjustment programmes, which in fact, were moved promptly from first class to third class. Regardless of the question of eurozone stability, which still remains open, Polish economic decision-makers should first make enquiries themselves about the state of Poland's economy. Euro accession cannot be considered as a short-term political decision, but rather as a long process of structural reforms putting the country's competitiveness on a different level and achieving better convergence with the rest of the common currency area. The aim of this article is to assess briefly the major economic obstacles on Poland's way to the euro.

NOMINAL CONVERGENCE CRITERIA

The question of fulfilment of nominal convergence criteria is usually a starting point in the analysis on eurozone accession. According

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[2] P. Krugman, "Poland Is Not Yet Lost," *The Conscience of a Liberal*, 27 March 2013, http://krugman.blogs.nytimes.com/2013/03/27/poland-is-not-yet-lost.

[3] "Poland to Krugman: don't patronise us over euro choice," *Beyond Brics* (blog), *Financial Times*, 28 March 2013.

to the Poland's Ministry of Finance, in October 2013 Poland fulfilled the criteria of price stability and long-term interest rates. In 2012, the debt-to-GDP ratio was 55.6%, so below the reference value.[4] The European Commission assesses that the debt-to-GDP ratio will reach 58.9% in 2014.[5] In 2012, the general government deficit reached 3.9% GDP, considerably above the 3% limit. Therefore, Poland finds itself in the Excessive Deficit Procedure with the deadline for correction set for 2015.

Although the inflation, interest rate and fiscal criteria impose certain challenges for acceding countries, the largest challenge lays elsewhere. Looking at the experience of other acceding countries, especially Slovakia, the required participation in Exchange Rate Mechanism II (ERM II) seems to be the most difficult challenge as far as nominal convergence criteria are concerned. Poland's current government does not give any clue as to a possible date of participation in ERM II. On the contrary, there are voices that Poland can access the euro area on special conditions. The governor of the National Bank of Poland, Marek Belka, has indicated that perhaps the required presence in ERM II could be avoided.[6] Yet, this demand seems unlikely to be the answered in a positive manner as the obligation to stay within the mechanism for two years without devaluation has a strong legal basis.[7]

CHALLENGES OF REAL CONVERGENCE

The durable fulfilment of the nominal convergence criteria largely depends on the real convergence level of a candidate country with the other euro area members. The theories that can shed some light on this problem are focused on the conditions for forming an Optimum Currency Area; however, it cannot deliver any precise tools for economic policymaking. The factors usually enumerated that can decrease the cost of currency union membership and vulnerability to

[4] Republic of Poland Ministry of Finance, *Monitor Konwergencji Nominalnej*, October 2013.

[5] European Commission, European Economic Forecast, *European Economy*, 2, 2013, Spring 2013, http://ec.europa.eu/economy_finance/eu/forecasts/2013_spring/pl_en.pdf.

[6] '"Belka: Polska powinna ubiegać się o zwolnienie z obowiązku pobytu w ERM2," *Obserwator Finansowy*, 4 April 2013, www.obserwatorfinansowy.pl/dispatches/belka-polska-powinna-ubiegac-sie-o-zwolnienie-z-obowiazku-pobytu-w-erm2-2.

[7] Art. 140.1 TFEU and Art. 3 of Protocol no. 13.

shocks are: development measured by GDP per capita, correlation of business cycles, labour mobility, unit labour cost, openness of the economy, production diversification, and structural similarities.[8]

Even a general overview of Poland's economy shows that despite huge progress in economic convergence the country still has considerable distance to go to catch up to the other euro area members. One has to take into account the historical determinants of the country's economic performance. Only in 1989 did Poland start its long and winding road of economic transformation from a centrally planned economy to an efficient market economy. The catching-up process has largely accelerated since EU accession. In 2012, Poland's GDP per capita reached 66% of the EU-28 average, compared with 51% in 2004.[9] Yet, the transformation is far from complete and the country's economy is still affected by numerous complex structural obstacles and bottlenecks defended by powerful interest groups. In fulfilment of the Lisbon strategy indicators, Poland scored as one of the worst performers, especially in the area of information society and knowledge triangle, business R&D investments, and quality of higher education.[10] The recent Council recommendation in the framework of the European Semester also points out various challenges for Poland's economic decision-makers, especially in areas such as fiscal policy, the labour market, education, and facilitation of a business environment.[11] One of the major problems in Poland's economy is stagnation of private investment, which in the long term can widen the technological gap between the country and the rest of the euro area.[12] Poland's competitiveness problems are reflected also in other indicators, such as a low share of exports in GDP or the structure of exports, in which high technology goods have a symbolic share. The unfavourable international net investment position, worsened by the global financial and economic crisis was –66.3% in relation to the

[8] See for instance: R. Baldwin, Ch. Wyplosz, *The Economics of European Integration*, 4th edition, McGraw and Hill, London, 2012, pp. 401–432.

[9] Measured by PPS, source: Eurostat.

[10] M. Koczor, P. Tokarski, *From Lisbon to Europe 2020. Lisbon Strategy Implementation in 2010: Assessments and Prospects*, PISM Report, Polish Institute of International Affairs, Warsaw, 2011.

[11] Council of the European Union, *Recommendation for a Council Recommendation on Poland's 2013 National Reform Programme and Delivering a Council Opinion on Poland's 2013 Convergence Programme for 2012–2016*, Brussels, 19 June 2013.

[12] S. Krajewski, "Specyfika gospodarki polskiej a korzyści i zagrożenia związane ze wstąpieniem do strefy euro," in: P. Krajewski (ed.), *Gospodarka Polski w perspektywie wstąpienia do strefy euro. Ujęcie ilościowe*, PWE, Warszawa, 2012, p. 63.

country's GDP in 2012. This was mainly caused by a negative current accounts balance. A strongly negative international net investment position might potentially be a source of vulnerability, and in case of exogenous shocks, cause some adverse effects, such as a liquidity crisis.

Therefore, the main question concerning eurozone accession should not be "when" but "how." The attempt to enter the third stage of EMU should be proceeded by comprehensive long-term reform plans, which should be focused on eliminating the structural obstacles enumerated above. A special focus should be on facilitation of the business environment for small and medium-size enterprises, which are producing the lion's share of Poland's economic output.[13] The most recent studies also underline the necessity of sound preparation of euro area membership, by anticipating possible challenges caused by euro accession, such as curbing excessive demand by anti-cyclical banking regulations and restrictive monetary policy. It is also necessary to keep sound public finances as that may play the role of stabiliser.[14]

There are other considerable challenges in the years to come. In the next 20 years and longer, Poland, similar to other CEE countries, will have to face a population decline, which will be a major factor determining the sustainability of its economic model. Yet, the solution requires a long-term strategy supported by considerable public resources, which are unlikely to be deployed in the current political circumstances. Similar to the Swedish scenario, regardless of whether Poland's eurozone accession process will be slowed down or suspended, Poland will need to keep sound economic policies and considerably increase its competitiveness.

NEW CONVERGENCE CRITERIA?

It is rather common knowledge that the official nominal convergence criteria lack credible scientific justification. What's more, some of these criteria are not adhered to by many of the current eurozone members while they are imposed on the acceding countries. In the past there have been numerous attempts to choose

[13] M. Gorynia *et al.* (eds.), *Poland's Entry into the Eurozone and Its Potential Impact on the Internationalisation of Polish Companies*, Warsaw, 2013.

[14] K. Sum, *Przystąpienie Polski do strefy euro w świetle analizy porównawczej procesów integracji walutowej w Polsce i w Hiszpanii*, SGH, Warszawa, 2013.

more suitable indicators, however without any broader consensus.[15] Even before the economic crisis there appeared several voices that the Maastricht criteria are far from sufficient.[16] The eurozone debt crisis laid bare that the eurozone needs a more comprehensive set of indicators to assess a candidate country's real convergence with the other members of the currency union.

In the public discussions in Poland, there were several proposals to create a new set of convergence criteria that could help measure the real convergence of Poland's economy to the rest of the eurozone. Similar voices can be heard in other CEE countries. For example, Hungarian Prime Minister Viktor Orbán, has recently announced that the country will be ready to join the third stage of EMU when GDP level per capita reaches 90% of the eurozone. Considering the current level is 65%, the fulfilment of this criterion is not likely to happen soon.[17] Poland's minister of finance claimed that eurozone accession could be possible when the general government's gross debt-to-GDP ratio goes down to 40%.[18] Yet it can be questionable, knowing first that two-thirds of Poland's budget expenses have fixed legal standing, so cutting the debt-to-GDP ratio might be an uphill task. Second, the low level of Spanish or Irish public debt before the outbreak of the crisis did not prevent them from having problems. Anyway, it is very unlikely that Poland could reach this level in the next five years. The other indicator proposals most frequently put forward concern the GDP-per-capita level, average interest rate, unemployment, exchange rate stability, or budgetary balance.[19] Again, the experience of the southern eurozone countries indicates that a more comprehensive set of indicators should be applied.

Poland can face several other bottlenecks that can also have an adverse effect on the economy, especially when it is exposed to

[15] See for example: T. Bayoumi, B. Eichengreen, "Ever Closer to Heaven? An Optimum Currency Area Index for European Countries," *European Economic Review*, vol. 41, no. 3–5, 1997, pp. 761–770; for more recent analysis of the real EU convergence process: M.T. Borsi, N. Metiu, *The Evolution of Economic Convergence in the European Union*, Discussion Paper, Deutsche Bundesbank, no. 28/2013.

[16] A. Ahearne, J. Pisani-Ferry, "The Euro: Only for the Agile," Bruegel Policy Brief, 2006/01, Brussels, 2006.

[17] V. Gulyas, "Hungary Needs Much Higher GDP to Join Euro, PM Says," *Wall Street Journal*, 16 July 2013.

[18] "Droga do euro wiedzie przez mniejszy dług," *Rzeczpospolita*, 19 April 2013.

[19] J. Rostowski, welcoming speech at the conference "Polska droga do euro" ('Poland's road to the euro'), 19 April 2013, www.instytutobywatelski.pl/14591/wydarzenia/konferencja-polska-droga-do-euro-19-kwietnia-2013-r-godz-1100-warszawa.

exogenous shocks. These problems include an overgrown and inefficient public sector, including the judiciary, overregulation, and administrative burdens, poor quality law and constant changes in the regulatory framework, corruption, and even the strength and quality of social control through independent media. These problems should also be tackled as it can considerably weaken the long-term economic performance of a country. Yet, the experience of institutional economics shows that some structural economic reforms cannot be successful without reforms of political systems. This new set of auxiliary convergence criteria self-imposed by an acceding country is a step in the right direction. However, it cannot take shape as a barrier justifying political insertion on the way towards the euro. This should be an element of a broader long-term economic convergence strategy aimed at the elimination of structural obstacles and at increasing the overall economy's competitiveness, and adopted for at least 10 years and evaluated on a regular basis.

EU-LEVEL INCENTIVES

Although the major responsibility for macro-economic policies relies in the hands of the national governments, the eurozone countries also have vested interest in supporting the real convergence process.[20] The new funds provided in the new Multiannual Financial Framework (MFF) 2014–2020, if used effectively by the future euro area members, may substantially contribute to the real convergence process. So far, EU-level coordination of national economic policies often hit the rock of national sovereignty or is weakened by political cycles.[21] The recent reforms reinforced the economic governance in the EU by strengthening the preventive and corrective arms of the Stability and Growth Pact. Yet it seems the European Commission is very reluctant to test its new tools for political reasons. The EU instruments, such as Council recommendations issued during the European Semester, are likely to have more teeth in the years to come. The macroeconomic conditionality mechanism, introduced for the MFF 2014–2020, will give the Commission more levers to influence the macroeconomic and fiscal policies of the Member States, especially

[20] M. Bölle, H.D. Jakobsen, "New Risks Ahead: The Eastward Enlargement of the Eurozone," *Intereconomics*, November/December 2001.

[21] A. Rettman, "France Says Brussels 'Cannot Dictate' Economic Policy," *Euobserver*, 30 May 2013.

those receiving large inflows from EU cohesion policy, including Poland. The planned Convergence and Competitiveness Instrument could also be directed at the real convergence process of future euro area members. Yet, most of the burden lies on the Member States efforts, and it will not change in the foreseeable future. It is hard to imagine that difficult and costly structural reforms could be achieved without broad political support at home. In Poland's case, the appetite for reforms may be decreased by the looming, unfavourable context of domestic politics.

CONCLUSIONS

The experience of several Member States shows that both acceding countries and the eurozone should put more emphasis on better preparing the economies of candidate countries. This is also valid in Poland's case, where many economic sectors are characterised by considerable structural flaws. There is a general opinion that Poland's eurozone accession before 2020 is extremely unlikely due to domestic political and legal constraints. It does not mean that the country is doomed to freeze its accession preparation. The problems with real convergence cannot be used as a justification for a lack of economic reforms. Regardless of the fact of whether Poland joins the euro area in the foreseeable perspective, it needs to reform its economy and market-related institutions, and counteract its negative demographic trends. These efforts should be supported by existing and new EU economic governance mechanisms. Therefore, the eurozone accession process should be included in a broader strategy of long-term economic reforms that will complete the economic transformation process. Without it, Poland risks that even if it boards the eurozone train, it may have to take a place that is relatively distant from first class. Yet, one also has to take into account that euro accession will largely depend on the situation in the euro area. There are numerous risks of various natures threatening euro area stability in the years to come. Should the tensions and uncertainty in the euro area persist, it might seem cheaper to stay on the railway platform than to buy an expensive euro ticket.

POLAND'S EUROZONE PERSPECTIVE: LEGAL IMPLICATIONS OF THE DEROGATION

AGATA GOSTYŃSKA[1]

MEMBER STATES WITH A TREATY DEROGATION: IS THERE ROOM FOR MANOEUVRE?

Eurozone governance is still in the making. The process of strengthening the economic arm of EMU goes hand in hand with the further institutionalisation of the euro area. The European Stability Mechanism (ESM) and Treaty on Stability, Coordination and Governance in the EMU (fiscal compact), both conducted in the form of an international agreement outside the legal framework of the European Union, offer a new platform for the eurozone's further consolidation. And yet, they take a toll on the euro area's relations with Member States with a treaty derogation, creating new dilemmas and hurdles, not just in regards to their future accession but also their ability to influence ongoing developments.[2]

Member States with a treaty derogation are, however, diverse in their approaches towards euro area accession. Although *de jure* they are all obliged to adopt the common currency, and thus their euro accession preparations are subject to regular assessment by the European Commission (EC) and European Central Bank (ECB), in practice they navigate the convergence process, which offers them certain political leeway with Sweden as the most obvious example.[3]

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[2] There are two types of derogations in regards to the third stage of EMU: by treaty and by protocol. The latter refers only to Denmark and the United Kingdom, the status of which is stipulated in the protocols attached to the Lisbon Treaty. Denmark and the UK have the freedom to decide if the abrogation procedure should start even if the Maastricht criteria are fulfilled. This seems to be in contradiction to a legal situation in which Member States with a treaty derogation, automatically enter the abrogation procedure once they fulfil the criteria. For more, see A. Nowak-Far, "Komentarz do art. 139 Traktatu o Funkcjonowaniu Unii Europejskiej" ('Commentary to Article 139 of the Treaty on the Functioning of the European Union'), in: A. Wróbel (ed.), *Traktat o funkcjonowaniu Unii Europejskiej* ('Treaty on the Functioning of the European Union'), t. II, Wolters Kluwer, Warszawa, 2012, p. 820.

[3] A. Nowak-Far, "Zasadnicze instytucjonalne i prawne wymiary przystąpienia Polski do strefy euro" ('Basic institutional and legal dimensions of Poland's accession to the Euro Area'), in: Biuro Analiz Sejmowych, *Wprowadzenie euro w Polsce – za i przeciw* ('The introduction of the euro in Poland: pros and cons'), Warszawa, 2013, p. 27.

Moreover, while the Baltic States, strongly hit by the economic crisis, have reaffirmed their interest in adopting the common currency, with Latvia becoming the eighteenth euro area member as of January 2014, others, such as the Czech Republic, Hungary and Poland, have opted for a "wait-and-see approach" making their declaration as to the entry date dependent on developments in the euro area.

This article focuses on Poland's legal convergence process. It assesses the compatibility of the national system with EU law and points to the major legal hurdles associated with adopting the euro. Since the convergence process is partly determined by domestic politics and opinion polls, which in the Polish case show moderate support for euro adoption, the governing elites have so far been reluctant to set a firm euro roadmap. However, it is argued here that this might spoil the domestic political discourse and reinforce calls for a referendum on the euro. This points to something of a legal quandary. The government risks effectively becoming reliant upon a referendum on euro accession to alter the constitutional rules on the independence of its central bank and thus to clear the domestic legal hurdles to euro area accession. Yet, this poses some concerns about the legal validity of any such referendum, given that the country is already committed to join euro area under EU treaty law.

AMENDING THE CONSTITUTION: THE QUESTION OF THE CENTRAL BANK'S PREROGATIVES AND INDEPENDENCE

Further eurozone institutionalisation is not the only matter Polish political elites should be concerned with in developing a strategy for integration with the euro area. In their convergence reports, both the European Commission and the European Central Bank (ECB) have pointed to the necessary adaptation of the Polish legal system to the EU treaties and to the Statute of the ESCB (European System of Central Banks) and ECB.[4] Aiming for this legal compatibility would, however, also require amendment of the Polish constitution. The role of the National Bank of Poland as the institution responsible for formulating and carrying out Polish monetary policy is defined in Poland on the constitutional level, in its chapter devoted to public

[4] Protocol no. 4 to the Treaty on the Functioning of the European Union, O.J. E.U. C 326/230, 26 October 2012.

finances.[5] Once Poland joins the euro area, the NBP's competences with regards to monetary policy will be transferred to the EU level. Similarly, once the National Bank of Poland is integrated into the Eurosystem, the scope of the portfolio of the Bank, its governor, and its Monetary Policy Council will have to change. This will particularly concern prerogatives such as issuing currency and formulating monetary policy, which in the Polish legal system are determined at the constitutional level (Art. 227).

Maintaining the independence of the central banks within the Eurosystem is indispensable for the European System of Central Banks (ESCB) to achieving price stability. The ECB pays particular attention in its convergence reports to whether national legislation constricts the central bank's independence.[6] Therefore, most likely the legal adjustments would also touch on Art. 198 of the Polish constitution, which refers to the liability of the governor of the National Bank of Poland. It stipulates that the governor of the National Bank of Poland along with others, including the president, prime minister and ministers, bear liability before the State Tribunal for breaches of the constitution or any other law related to his office. The governor of the National Bank can thus be dismissed from office if a State Tribunal verdict prohibits this person from occupying management positions or holding posts of particular responsibility in public bodies.[7] The grounds for dismissing a governor seem to exceed those described in the ESCB and ECB statute, and according to the ECB that has potential negative implications on the central bank's independence.[8]

[5] The Constitution of the Republic of Poland of 2 April 1997, www.sejm.gov.pl/prawo/konst/angielski/kon1.htm.

[6] The ECB pays particular attention to measures safeguarding a national central bank's independence, including its governor, as well as to those prohibiting monetary finance and privileged access to the ECB and national central bank as stipulated in Art. 123 TFEU.

[7] The Act on the National Bank of Poland as of 29 August 1997, Journal of Laws 2013, no. 908, in conjunction with the Act on the State Tribunal as of 26 March 1982, Journal of Laws 2002, no. 11, item 925, with further amendments.

[8] The ECB is of the opinion that a bank governor should not be dismissed for any reasons than those stipulated in the ESCB-ECB statute as it creates room for influence to be exercised by the organs appointing the governor. It has also suggested domestic law directly repeat the wording of the statute; Zespół Roboczy ds. Dostosowań Prawnych, "Doświadczenia państw członkowskich Unii Europejskiej w wybranych obszarach dostosowań prawnych związanych z wprowadzeniem euro," *Europracowania*, Biuro Pełnomocnika Rządu ds. Wprowadzenia Euro przez Rzeczpospolitą Polską, ('The experience of the EU Member States in selected areas of legal adjustments related to the introduction of the euro, drafted by the working group on legal adaptation'), material of the working group for legal adaptation to

It is also expected that Member States with a treaty derogation will provide in their national legal system an appeals procedure in case a governor is dismissed. This should include an *explicit* reference to the Court of Justice of the European Union, missing in Polish law.[9] Finally, a central bank's independence should also be guaranteed by audits conducted by external auditors, as pointed out in Art. 27 of the ESCB and ECB statute.[10] This again would require amendments to the Polish Constitution with regards to the Supreme Audit Office (in Polish, Najwyższa Izba Kontroli, or NIK), which, as a constitutional body in Poland, is authorised to control the National Bank's activities. The scope of NIK's competences will have to be redefined, keeping in mind that some of its prerogatives would be taken over by external auditors once Poland enters the eurozone.[11]

Keeping in mind the reluctance of the major opposition party towards any further shifting of competences to the EU level, not to mention euro area accession, the current government would find it difficult to gather the constitutionally-required two-thirds majority necessary for the proposals to get through the Sejm, the lower chamber of the Polish parliament.[12] It is also rather unlikely that the next parliamentary term would bring any new developments in this regard.[13] This is also perhaps why some academics have focused on the possibility of adapting the Polish constitutional order to euro

the euro, *Europracowania*, the Office of the Government Plenipotentiary for Euro Adoption in Poland, no. 10, August 2011, p. 10.

[9] As has been rightly pointed out by Piotr Kucharski, the State Tribunal's verdict seems to only constitute a premise for the Sejm to dismiss the governor, and thus it is a source of potential dispute between both organs, of which one is a prime player in removing the governor from office. This also creates legal uncertainty as to which action should in fact constitute the basis for referring the matter to the Court of Justice, see: P. Kucharski, "Odpowiedzialność konstytucyjna Prezesa NBP w świetle prawa UE" ('Constitutional liability of the Governor of the National Bank of Poland in light of EU Law'), *Europejski Przegląd Sądowy*, August 2010, p. 26.

[10] Protocol 4, *op. cit.*

[11] A. Bisztyga, "Konstytucyjne aspekty przystąpienia przez Polskę do strefy euro" ('Constitutional aspects of Poland's accession to the euro area'), in: A. Sroka, K.A. Wojtaszczyk (eds.), *Polska na drodze do euro* ('Poland on its way towards the euro'), Instytut Nauk Politycznych, Warszawa, 2009, p. 200.

[12] Art. 235 of the Polish Constitution, 2 April 1997, www.sejm.gov.pl/prawo/konst/angielski/kon1.htm.

[13] As indicated by the Polish prime minister himself: see an interview with Prime Minister Donald Tusk, "Jestem liderem, a nie kilerem" ('I am a leader, not a killer'), *Gazeta Wyborcza*, 5 July 2013.

area accession without amending the constitution.[14] This possibility is derived from the EU's supremacy rule and argues that since the delegation of powers to the EU was undertaken in accordance with the Polish constitution and thus in the policy areas where the European Union has acquired the competences to act, EU law should have supremacy to the domestic legal order, including the constitution.[15] However, the Polish Constitutional Court is of the opinion that none of the ratified international agreements that Poland is bound to enjoys primacy over the Polish constitution, thus meeting the legal convergence criteria without constitutional amendments seems to be legally unfeasible.[16]

IS A REFERENDUM ON THE EURO COMPATIBLE WITH THE EU TREATIES?

The lack of consensus on adopting the euro on the Polish political scene, stoked by the still-uncertain situation in the eurozone, has overshadowed the work of the Government Plenipotentiary for Euro Adoption in Poland, who is responsible for developing a National Changeover Plan.[17] Aware of the possible implications of an unwelcome deterioration of the sovereign debt crisis on the one hand and further eurozone consolidation on the other, Warsaw has shifted its focus from setting a firm roadmap to euro adoption, to further developments in the eurozone.[18] By broadening its strategy for euro integration to include developing its fourth pillar concerning stability in the euro area, Warsaw has gained some additional time for it to set

[14] M. Jungnikiel, "Polska na drodze do euro: zagadnienia prawne" ('Poland on the way to the eurozone: legal aspects'), in: *Polska na drodze do euro, op. cit*., pp. 170–171. Compare with: A. Bisztyga, "Konstytucyjne aspekty przystąpienia przez Polskę do strefy euro" ('Constitutional aspects of Poland's accession to the euro area'), in: *Polska na drodze do euro, op. cit*., pp. 204–205.

[15] *Ibidem*.

[16] See in particular the verdict of the Constitutional Tribunal with regards to the constitutionality of the Accession Treaty, K 18/04, OTK-A 2005, no. 5, item 49.

[17] Currently, this function is carried out by Jacek Dominik, undersecretary of state, Ministry of Finance. For the extensive list of plenipotentiary prerogatives, please see: "Regulation of the Council of Ministers of 13 January 2009 on the establishment of the Government Plenipotentiary for Euro Adoption in Poland," Journal of Laws, no. 11, item 60, 2009.

[18] "Sprawozdanie za okres od 1 października 2012 do 31 marca 2013 r. z działalności Pełnomocnika Rządu do spraw Wprowadzenia Euro przez Rzeczpospolitą Polską" ('The report for the period from 1 October 2012 to 31 March 2013 on the activities of the Government Plenipotentiary for Euro Adoption in Poland'), Warszawa, 6 May 2013.

a possible euro entry date.[19] And yet, the lack of a roadmap for euro adoption has also strengthened the hand of the political forces calling for a referendum on euro adoption. Keeping in mind lingering social scepticism towards the euro, in which 58% oppose such a move, arguments in favour of holding a referendum on this matter might find fertile ground within society.[20]

In accordance with the Polish constitution, nationwide referendums can be held on matters of particular importance for the country, as indicated in Art. 125. This includes granting consent for the ratification of an international agreement that may delegate some of the state's competences to an international organisation (Article 90 of the Constitution). The outcome of such a referendum would be binding if more than half of the citizens eligible to vote participate in it. However, holding a referendum on adoption of the euro is legally questionable. In 2003, by way of referendum, Poles agreed that the Accession Treaty should be ratified by the Polish president. As Poland's accession to the third stage of EMU was an integral part of the EU accession negotiations, the 'yes' votes back in 2003 to join the EU also included adoption of the euro.

Still, if the Swedish scenario comes to pass in Poland and a referendum is called, the issue of how to pose the question in the referendum is likely to appear. Questions such as, "do you support euro introduction in Poland?," or, "when should the euro be introduced in Poland?," seem not to be legally feasible, as both contradict the spirit of the abrogation procedure once accession criteria are fulfilled.[21] A referendum would bear political implications, too. It motivates political elites to better organise and present in an argumentative way both the pros and cons for euro adoption to Polish society. However, its potential non-binding result could simply reinforce the existing domestic divisions about Poland's further integration with the EU.

[19] The other three pillars encompass: (i) sustainable fulfilment of the convergence criteria, with particular focus on fiscal discipline, (ii) other measures, including institutional ones, aimed at strengthening the potential of the Polish economy and better functioning of the common currency area, (iii) development of the National Euro Changeover Plan and keeping it updated. For more, see: *Convergence Programme. 2012 Update*, Warsaw, April 2012, p. 5, http://ec.europa.eu/europe2020/pdf/nd/cp2012_poland_en.pdf.

[20] *Monitor opinii publicznej nt. Euro w Polsce* ('Monitor of public opinion in Poland on the euro'), Ministerstwo Finansów, no. 5, August 2013, www.mf.gov.pl/documents/764034/1002547/monitor+opinii_08_2013.pdf.

[21] See: C. Kosikowski, "Prawne aspekty wejścia Polski do strefy euro" ('Legal aspects of Poland's accession to the euro area'), *Państwo i Prawo*, no. 12, 2008.

Low turnout would only raise some doubts in regards to a democratic mandate for further steps with the euro and could complicate Polish European policy on matters referring to a genuine Economic and Monetary Union.[22]

CONCLUSIONS

The matter of the legal convergence required by a Member State with a treaty derogation does not attract much by way of media attention and is often left on lawyers' desks. However, the legal compatibility of the national system is assessed equally with economic convergence criteria by both the EC and ECB. Therefore, it should not slip from the horizon of any Member State preparing for euro adoption, especially since the adaptation of the national system is a time-consuming and politically demanding process. The adaptation of the national system is not a technical exercise, either. A review of the wide range of national legislation, with an eye to making it compatible with EU law, is preceded by an analytical exercise focused on gathering experience from other Member States that have adopted the euro and requires consultations with the ECB.

Under the aegis of the Government Plenipotentiary for Euro Adoption in Poland, some analytical work has already been undertaken, providing necessary material for further practical legal steps. However, this work points to the necessity of constitutional changes, which are most challenging. Due to the laborious procedure to amend the constitution and the two-thirds majority requirement in the Sejm, the legal work is in practice held hostage to the domestic political scene, which is clearly divided on euro-related matters.

The lack of political consensus on eurozone accession at home has so far not affected the Polish position at the EU level and its relations with euro members. Poland has managed to stave off the exclusivity of the new eurozone instruments, including the euro summits envisaged in the fiscal compact. Together with other "pre-ins," it has also negotiated the possibility to enter into close cooperation with the ECB under Single Supervisory Mechanism rules.[23] The domestic

[22] A. Nowak-Far, *op. cit.*, p. 36.

[23] European Commission proposal for a Council regulation conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions (COM(2012)0511), see also: European Parliament resolution of 12 September 2013 on the respective proposal.

debate has not resonated widely on the EU stage so far. It is also unlikely that the Commission would call it a breach of EU law if a referendum on the euro was eventually held.[24]

Nevertheless, in the longer term any long-lasting gridlock, especially in regards to legal convergence—which is more dependent on political will than on economic statistics—might weaken Poland's European credentials and its hand in arguing for inclusion in eurozone instruments. More strongly vocalising Poland's aspirations with regards to the euro area might become inevitable in order not to dish its efforts to build bridges between euro and non-euro members.

[24] See also: R.M. Lastra, J.-V. Louis, *European Economic and Monetary Union: History, Trends, and Prospects*, Queen Mary University of London, School of Law Legal Studies Research Paper, no. 136/2013, p. 34.

POLITICS AS A MAJOR FACTOR DETERMINING POLAND'S EUROZONE ACCESSION

DAMIAN WNUKOWSKI[1]

The political factor, although often underrated in public debate, has played a major role in tightening European cooperation in many areas, including monetary integration. Therefore, the common currency should be recognised not only as an economic project but also as a tool for strengthening political bonds among Member States.[2]

Along with accession to the EU, Poland and other CEE Member States have committed themselves to join the third stage of EMU once they have fulfilled the convergence criteria (through the so called derogation clause). The decision concerning the adoption of the common currency in Poland, though, is not only economic but also largely a political matter. This is reflected in the ongoing public discussion among the political establishment and society that the euro's introduction is either a step forward in the process of catching up to Western European states, or a mistake that would entail an economic slump and further limits on the country's sovereignty. Poland's current authorities recognise the eurozone as the "core" of the future decision-making process in the EU, and therefore regularly signal Poland's willingness to be a part of it.[3] The aim of this article is to analyse the evolution of Polish governments' attitudes towards euro introduction since the country's EU accession in 2004, as well as the current state of play and prospects of political debate. So far, three different time periods can be identified, which fully reflect national political cycles.

EURO-DEADLOCK (2004–2005)

Since Poland's EU accession in May 2004 until October 2005, the country was ruled by a technical government with Marek Belka

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[1] Damian Wnukowski is an analyst in Polish Institute of International Affairs (PISM).

[2] See: P. de Grauwe, "Some Thoughts on Monetary and Political Union," in: L.S. Talani (ed.), *The Future of EMU*, Palgrave Macmillan, Basingstoke, 2009, pp. 9–28.

[3] PAP, "Polska musi mieć wpływ na prace w eurolandzie" ('Poland must have an affect on work within the eurozone'), *TVP Parlament*, 14 December 2012, www.tvpparlament.pl. In recent years, it has been noticeable that the Eurogroup often forms a stance on certain issues in common with the EU.

as prime minister, which until August 2005 was supported by the left wing of the political scene, i.e., the Democratic Left Alliance (SLD). The cabinet was regarded as supportive of the idea of euro adoption. Poland's willingness to converge with the eurozone was signalled by the resumption in July 2004 of the activity of a working group for Poland's eurozone accession, which had been set up in 2002. The group was composed of representatives of the Ministry of Finance and the National Bank of Poland (NBP). Subsequently, in August 2005 the Ministry of Finance published the document "Integration of Poland with the Euro Area—Conditions for membership and the strategy for managing the process," which included the identification of the main challenges for Poland's economic and institutional convergence with the eurozone.[4] At that time, Prime Minister Belka even claimed that Poland would be able to introduce the euro in 2009.[5]

Leszek Balcerowicz, president of the NBP from 2001 to 2007, also strongly supported Poland's efforts to become a eurozone member and asserted that the country "cannot afford" to postpone entry.[6] Even before EU accession, the NBP with Balcerowicz at the helm strongly endorsed fast-tracking the third stage of EMU accession, arguing that it would prompt political decisions concerning structural reforms.[7] However, no formal steps towards integration with the eurozone during Belka's tenure were made. The reason for this could have been the fear in society of price increases after euro adoption (a phenomenon noticed after Poland's EU accession).[8]

[4] Polish Ministry of Finance, *Integracja Polski ze strefą euro: uwarunkowania członkostwa i strategia zarządzania procesem* ('Poland's integration with the euro area: conditions for membership and the strategy for managing of the process'), August 2005, www.mf.gov.pl.

[5] "Belka: Budżet na 2006 r. jest wstępem do przyjęcia euro w 2009 r." ('Belka: 2006 budget is an opening for introducing the euro in 2009'), *Puls Biznesu*, 13 May 2005, www.pb.pl.

[6] L. Balcerowicz, speech given to the Polish parliament, 18 July 2006.

[7] R. Zubek, "Poland: Unbalanced Domestic Leadership in Negotiating Fit,"' in: K. Dyson (ed.), *Enlarging the Euro Area: External Empowerment and Domestic Transformation in East Central Europe*, Oxford University Press, Oxford, 2007, p. 200.

[8] P. Woźniak, *Economic and Political Challenges of Acceding to the Euro Area in the Post-Lehman Brothers' World. Country report: Poland*, European Policies Initiative, Open Society Institute, Sofia, October 2009, p. 21, www.eupi.eu. In other eurozone member states, while higher prices after accession were seen mainly in sectors in which price changes are most perceptible, such as food or coffee (the so called cappuccino effect), in fact the data show overall inflation in the participating states did not increase significantly.

POSTPONING EURO ACCESSION AD CALENDAS GRAECAS (2005–2007)

Between October 2005 and November 2007 there was a coalition of three parties—Law and Justice (PiS), League of Polish Families (LPR) and Self-Defence of the Republic of Poland (SRP)—led by Kazimierz Marcinkiewicz and (from July 2006) Jarosław Kaczyński. This coalition marked a u-turn of Poland's political scene as well as in the government's approach to euro adoption.

All of the members of the coalition were unanimous in criticising the idea of entering the common currency area. PiS, the strongest coalition member, indicated that possessing autonomous monetary policy is indispensable to the Polish economy and rapid adoption of the euro could decrease the country's competitiveness. Moreover, the national currency was also projected by PiS as an important symbol of Poland's sovereignty. Although, PiS did not totally refuse to introduce the euro in the future, it signalled that its support for the project depended on Poland's progress in catching up to the Western European states.[9] The excessive deficit procedure, which was imposed on Poland in May 2004, as well as the decreasing support for euro adoption among Poles[10] were used by the government as reasons to postpone the common currency's introduction.[11] As a result, work on Poland's possible membership in the euro area was suspended until 2007 when a new government came into power.

THE SLOW PACE TOWARDS THE EURO DURING THE ECONOMIC CRISIS (2007 ONWARDS)

Civic Platform (PO), which won the 2007 parliamentary elections, created a coalition government with the Polish Peasant

[9] S. Salembier, J. Wtorek, *Polityczno-ekonomiczne implikacje kalendarza przyjęcia wspólnej waluty euro przez nowe państwa członkowskie Unii Europejskiej* ('Political and economic implications of the euro adoption calendar of the new EU member states'), demosEUROPA – Centrum Strategii Europejskiej, 30 January 2007, www.demoseuropa.eu.

[10] Eurobarometer shows that in April 2007 about 46% of Poles supported replacing the zloty with the euro, while 42% were opposed to adoption of the euro. A year earlier, those indicators were 50% and 39%, respectively. See: Eurobarometer, *Introduction of the euro in the New Member States: Analytical Report*, Gallup Organization, June 2006, p. 35.

[11] The excessive deficit procedure was also imposed on Slovakia in 2004, which did not affect the country's common currency adoption plans. Slovakia became a member of the eurozone in 2009.

Party (PSL). PO, which had a decisive voice in economic affairs, was considered at the time by the public as a liberal political party attached to deep European integration and support for eurozone accession as beneficial to the Polish economy in the long term.[12] Although Donald Tusk, PO's leader and prime minister after the 2007 elections, officially insisted on fast-tracking Polish accession to the euro area, no precise roadmap was made. PO only indicated that besides meeting Maastricht criteria, actions preventing unjustifiable inflation should be undertaken in the run-up to eurozone accession as that was still one of the public's main concerns about adoption of the euro.[13]

However, in September 2008, Prime Minister Tusk mentioned the year 2011 as a realistic date for adopting the euro, then in the first half of 2009 postponed that to 2012.[14] The change could have been a consequence of the emerging global financial crisis and the noticeable slowdown of the Polish economy between 2007 and 2009, resulting in a growing budget deficit considerably above the Maastricht criteria. The obstacles were not only economic in nature. Introduction of the euro could have been easily blocked by the opposition and by then-President Lech Kaczyński. Thus, Prime Minister Tusk's announcements about the date of entry to the eurozone should be rather interpreted as underlining the government's legitimacy in order to have influence in future EMU reform discussions. To back up that impression, numerous initiatives were undertaken, such as the 2009 establishment of a Government Plenipotentiary for Euro Adoption in Poland and the National Coordination Committee for the Euro Changeover. Moreover, at the beginning of 2010, a public finances consolidation programme aimed at meeting the nominal convergence criteria was announced.

Meanwhile, the growing tensions in the euro area resulted in enhancing the belief among Polish society that adoption of the common currency lacked benefits. According to a Public Opinion Research Centre (CBOS) survey, conducted in April 2010, 49% of

[12] *Polska zasługuje na cud gospodarczy* ('Poland deserves the economic miracle'), Civic Platform 2007 Election Programme, www.platforma.org.

[13] Eurobarometer indicates 81% of those polled thought that the euro's introduction would result in growing prices. See: Eurobarometer, *Introduction of the Euro in the New Member States: Analytical Report*, Gallup Organization, May 2007, p. 40.

[14] "Tusk: Przyjęcie euro w 2012 r. jest realne" ('Tusk: adopting the euro in 2012 is realistic'), *Wprost*, 17 April 2009, www.wprost.pl.

respondents were against the euro's introduction in Poland, and only 41% supported it (compared to the first quarter of 2009 when support was 52%).[15] In March 2011, public support for euro adoption fell to only 32%,[16] probably due to the rising economic problems in Greece and Ireland. The results of the public surveys had to be taken into account by all political parties in the context of the 2011 parliamentary elections. It also decelerated the Polish government's plans concerning the euro's introduction. After the 2011 parliamentary election, the PO–PSL coalition remained in power but common currency adoption plans were not even mentioned in ruling parties' election programmes, which reflected the decreasing public interest in the euro project.

Strong negative impressions of the situation in the eurozone's economy at that time in comparison to the relatively stable situation in Poland increased aversion to the adoption of the common currency among Polish society. Public opinion surveys from May 2013 show only 30% of Poles support euro introduction, while about 58% are against.[17] Therefore, given the parliamentary and presidential elections of 2015, as well as the European Parliament elections in 2014, the government will probably not make any clear declarations concerning eurozone accession in the near future.

Diverse views on the common currency matter are noticeable on the political scene, which is not favourable to changes in domestic law required for the euro's introduction.[18] The ruling PO–PSL

[15] "Wprowadzenie euro w Polsce – poparcie, skutki, poinformowanie" ('Euro adoption In Poland—support, results, information'), *CBOS*, Warszawa, June 2010, www.cbos.pl. Decreasing public support for euro area accession could be a result of the economic turmoil in Greece in the first half of 2010.

[16] "Wprowadzenie euro w Polsce – akceptacja, skutki, uwarunkowania" ('Euro adoption in Poland—acceptance, results, circumstances'), *CBOS*, Warszawa, April 2011, www.cbos.pl.

[17] „Sondaż Ipsos: 30 proc. Polaków za wprowadzeniem euro, przeciw 58 proc." ('Ipsos Survey: 30% of Poles support euro adoption, 58% are against'), *PAP*, 19 August 2013, www.pap.pl.

[18] Significant differences concerning euro's introduction plans have been presented, such as during parliamentary debates. In February 2013, in the debate on the ratification of the fiscal compact, the issue of the common currency's adoption in Poland was touched on. A representative of PO, Prof. Dariusz Rosati, declared the eurozone to be the EU's "hard core"—the group of states that makes efforts to deepen cooperation and economic coordination. Rosati added that euro introduction is a "strategic choice" that would give Poland the opportunity to take part in the decision-making process. In turn, abandoning the euro could result in diminishing Poland's political position and would mean it could only implement decisions made by the Eurogroup.

coalition, even with the support of some opposition left-wing parties such as SLD or the Your Movement (former Palikot Movement) which strongly support euro area membership, does not possess the two-thirds majority in parliament to pass the required constitutional changes.[19] The main opposition party (PiS) objects to introduction of the euro in the current social and economic conditions, and suggests holding a referendum on the matter.[20] Although entering ERM II is possible even without constitutional changes, it is commonly acknowledged it is necessary to do so to avoid putting the zloty's stability at risk without the certainty of a final political decision on euro adoption. Hence, serious steps towards the third stage of EMU integration can be made no earlier than after the 2015 parliamentary elections[21] provided that the pro-euro parties gain a two-thirds majority. Given the election calendar and the length of the eurozone entry procedure,[22] Poland could adopt the common currency not earlier than in 2019–2020.

Polish authorities emphasise that entering the euro area is not only an economic issue but also, and no less important, a political matter as the eurozone will arguably convert in the coming years to one with a strict core of decision-makers within the EU. Thus, euro area membership offers the opportunity to participate in euro summits and Eurogroup meetings, which affect common policies in several important areas from Poland's point of view. This includes such subjects as banking supervision[23] or creating a separate fiscal capacity for the euro area in the near future.[24] Therefore, having a presence

[19] Adoption of the common currency requires amending the Polish constitution, such as the level at which monetary policy would be conducted by the ECB instead of the NBP.

[20] "PiS proponuje referendum ws. euro. PO: Zobaczymy po wyborach" ('PiS proposes referendum concerning euro adoption. PO: We will decide after the elections'), *Wirtualna Polska*, 27 March 2013, www.wiadomosci.wp.pl.

[21] "Komorowski: Decyzja ws. euro w 2015 r." ('Komorowski: Decision concerning euro adoption will be made in 2015'), *Polskie Radio*, 7 May 2015, www.polskieradio.pl.

[22] Two years in ERM II is mandatory, but given the time required for consultations before entering ERM II and the decision-making procedure in the EU Council pertaining to approval of adoption of the euro, the whole process can last as long as three years.

[23] It is a particularly important matter given the high share of foreign capital in Poland's financial sector. At the end of 2011, that was more than 60% (for comparison, the average for the EU is around 30%).

[24] The eurozone budget project was mentioned by Herman Van Rompuy, president of the European Council, in his report "Towards a Genuine Economic

in the decision-makers club remains a strong political incentive. Yet, economic factors still play a certain role in shaping the pace of convergence to reach the third stage of EMU. President Bronisław Komorowski's statements put more emphasis on meeting real convergence criteria, which are in his view indispensable to gaining the benefits of euro adoption.[25] In turn, the Polish government seems to consider the state of public finances as a focal point of its eurozone integration efforts.

CONCLUSIONS

The ongoing economic crisis has shown that the predicted political and economic benefits of joining the euro area could entail additional obligations related to the new financial assistance mechanisms established by the euro area. Therefore, entering the third stage of EMU is currently one of the most difficult dilemmas for Poland concerning European matters. It implies a division between the main political forces and among society. It shows that although the public debate is focused on economic factors, the decision on eurozone entry or whether to choose a more flexible integration model will have a strictly political character.

Yet, entry to the third stage of EMU also implies the necessity of wide public approval, which is now at a very low level. Taking into account the long timeframe for benefits from convergence efforts, including tough public finance reforms, as well as the upcoming election marathon in 2014–2015, the political parties will not be arguably willing to risk losing voter support by forcing fast-track euro adoption in Poland.

and Monetary Union," released in 2012. See also: F. Zuleeg, J.A. Emmanouilidis, "A Budget for the Euro Zone?," *European Policy Centre Commentary*, Brussels, 15 October 2012, www.epc.eu.

[25] The aim of these efforts is to ensure job creation and increase the Polish economy's competitiveness, widely perceived as one of the most important conditions for gaining benefits from euro introduction.

GENERAL CONCLUSIONS

The contributions, although thematically diverse, allows us to formulate some general conclusions concerning EMU integration. It seems that the authors share the general opinion that there is no silver bullet for the eurozone's problems. Many proposals, including those on debt monetisation or increasing the public deficit in Germany to offset macroeconomic imbalances in the southern eurozone member countries might be extremely difficult to put in place, as they are unacceptable to the German public. It is common knowledge that the euro area states need to address the asymmetry in eurozone economic development. Because of the level of intra-EMU trade in the amount of total trade by bloc members, competitiveness gains by one member are reflected by a loss of competitiveness by one or more other countries. This is the case for Germany, which expanded its trade surplus at the cost of other members, for example, Spain, which in turn recorded a higher trade deficit. In order to regain some competitiveness, austerity has been imposed in the GIPS countries to increase the savings rate. This does not seem to be paying off yet, and thus an internal devaluation in the south of the eurozone could turn out to be the most realistic scenario in the near future. The opposite approach—having the north reduce its saving rate by increasing wages and allowing higher inflation—has been ruled out as economically unrealistic. The bulk of the adjustment cost will have to be borne by the trade deficit states.

The troika approach to Greece might also need to be reconsidered. More emphasis on structural changes in its highly ineffective public sector, overregulation and excessive taxation of the private sector should be stressed in applying the common rules.

The sovereign debt crisis revealed that insufficient attention has been paid by the euro area candidate countries to broader economic and institutional convergence. The Greek case shows that only a coherent approach, with a healthy economic structure and a strong institutional environment underpinning nominal convergence criteria will likely prove sustainable.

The sustainability of euro adoption should be secured by achieving not only nominal convergence but also legal and institutional criteria. The case of Spain and Portugal teaches us that euro area accession does not guarantee automatism in the economic convergence process.

This should be seen as a by-product of sound economic policy, both before and after eurozone accession.

The success of euro area enlargement does not exclusively lie in the convergence process of the candidate countries' economic policies, but also in the reliability of the eurozone reform process. The lack of confidence in the future shape of the eurozone architecture has affected the "pre-ins" strategies and strengthened a call to properly fix the euro area first before the door is opened for the next round of euro enlargement. This strong rationale for non-eurozone countries to expect euro members to live up to the challenges posed by the crisis could in fact stimulate a reform process in the eurozone itself.

Euro adoption should be perceived as an opportunity, which if not carefully cashed in, might well turn into weakness. For the CEE countries it constitutes an opportunity unless it incurs an unfavourable complacency that leads to losing the right incentives to run sustainable policies. Thus, candidate countries should make good use of the EU mechanisms, such as Council recommendations within the European Semester as well as the planned Convergence and Competitiveness Instrument, which can possibly constitute a useful tool to support proper macroeconomic policy in the CEE states.

The situation in the eurozone banking sector is one of the greatest preoccupations of policy-makers. In October 2012 and 2013, the European Council reiterated the non-discrimination principle for new banking supervision and resolution.[1] Therefore, the specificity of the banking sector in the CEE should be taken into account when the new resolution mechanism is designed. The CEE banking sector is characterised by a so called dual-banking model with weak or missing local banking structures and strong dependence on foreign financial institutions. This system can potentially transmit contagion to the region and leads to the conclusion that domestic deposit bases should be developed.

The discussion concerning the costs and benefits of currency unions was evident among many of the scholars' writings. The outcome of the discussion about intra-EU trade issues is not conclusive as to a positive eurozone impact on trade; however, the voices of critics are heard more often lately. The data collected

[1] European Council, "24/25 October 2013 Conclusions," *EUCO* 169/13, Brussels, p. 15.

show that the differences between the eurozone members and the reference to non-eurozone members in intra-EU and intra-euro area trade changes do not particularly favour eurozone membership. Only for Slovakia is the euro-effect substantial. In other cases, other factors seem to have major impacts on trade, including the economic performance of the trading partners.

The Czech Republic, Hungary and Poland are legally obliged to join the EU currency union. The lack of declarations on a euro adoption date derive not only from non-fulfilment of macroeconomic criteria but also from growing scepticism in those countries concerning the potential benefits of adoption of the common currency, which is naturally fuelled by the ongoing financial and sovereign debt crisis. In this context, joining the euro area is no longer perceived as a guarantee for improving living standards and avoiding economic crisis in CEE countries. It is perceptible in Hungary, where the national currency is seen as an important part of the country's sovereignty, that authorities are determined to avoid the question of the common currency until the country catches up to Western European states in terms of economic development.

Czech European policy towards a Genuine Economic and Monetary Union is stuck in certain dilemmas. On the one hand, decision-makers acknowledge that a solid eurozone is of vital importance for the Czech economy due to the high degree of interconnectedness, but on the other hand, they are concerned with the accompanying transfer of competences to the euro area that would be necessary to move forward in the EMU. This, together with no clear picture of the final euro area architecture, eclipses the issue of adopting the euro in Czech domestic discussions. With relatively healthy public finances, Czechs are concerned about finding themselves in the position of contributors rather than recipients of eurozone assistance mechanisms. The collapse of the Slovak government in 2011 around the issue of the country's contribution to the financial assistance mechanism (EFSF) has not gone unnoticed in the Czech Republic. The Czech Republic seems to be attached to the current division of competences between the EU and the Member States with regard to economic policy. Its priority is a single market agenda, and thus it prefers forging further liberalisation of the single market and making good use of this agenda to stimulate growth, rather than to enhance the process of coordination of economic policies. However, if the latter turns inevitable for the stability of the eurozone, the Czechs think it should be designed as an integral part of the current institutional framework.

The current Polish governing elites assess the euro membership not only in economic but also political terms. Whereas euro area is perceived as an emerging core of the decision-making process within the EU, Poland's assent up the rank member states is interlinked with its decision on joining euro area. However, it is a moderate social support for euro introduction, reflected by recent polls, which has guided the government so far. The lack of a final roadmap for euro adoption is a result of both uncertainty with the situation in the eurozone itself but also a lack of wider political consensus on this matter at home, which is additionally antagonised by political disputes on the necessity to organise a referendum on the euro. In the longer term the country's ambiguity on euro adoption might however complicate Polish European policy in narrowing the gap between the euro "ins" and "outs."

It seems that accession to the euro area should not be considered a short-term political goal, but rather as an element of a long-term strategy focused on improving the competiveness of the acceding country. This is especially valid for Poland, the economy of which contains in large part sectors that are stuck behind major structural obstacles.

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FIGURES AND TABLES