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"The Euro and East Europe: Six Insiders, Six Outsiders; Why So?"[1]

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Abstract

The essay discusses why six East European (EE) countries are "Euro Insiders" -- that is, have adopted the euro or have pegged their currencies to it -- and why the six others are "Euro Outsiders" -- that is, their exchange rates fluctuate vis-a-vis the euro. Understanding the rationale of each EE's country's choice about being a Euro Insider versus remaining a Euro Outsider requires an understanding of (1) the unconditional as well as conditional benefits and costs of adopting the euro, and (2) the conventional wisdom prevailing at different times on whether Economic and Monetary Union (EMU) is a well-designed, advanced integration device that benefits all members or whether it is a fundamentally faulty construction that may not survive for long, so outsiders should not join. This essay explores both issues, documenting the dramatic reversal of perceptions about the soundness of the EMU's design after its first decade of apparently successful performance, that is, after 2009.

A discussion of these background issues is the basis for assessing the individual EE's countries' choices of becoming Euro Insiders or remaining Euro Outsiders.What considerations had prompted the six EE countries to become Euro Insiders at various times? Were the individual country choices wise? Finally, what are the most probable scenarios about the outsiders becoming insiders in the foreseeable future?

Introduction

For a plausible understanding of why a particular EE country had taken or is taking its own approach regarding the euro a discussion of several background issues will be helpful.

The first is the legal-political-economic requirements for an EE country to adopt the euro. As latecomers to the European Union (EU) as well as to the EMU, the EE countries were not given the same options that the earlier candidates had. Specifically, all the newer members of the EU have a treaty obligation to eventually adopt the euro, although without a specific timetable on when to do so. By contrast, when the EMU had been agreed upon in Maastricht in 1992, all EU members at the time could choose whether or not to adopt the euro.

The second issue is a benefit-cost analysis of EMU membership. There are unconditional as well as conditional advantages and costs of adopting the euro. The conditional benefits and costs depend on

[1] I would like to thank my colleagues at Central European University, Laszlo Csaba, Mel Horwitch, Julius Horvath, and Laszlo Urban, as well as my other colleagues, Gabor Oblath and Imre Tarafas, for valuable comments and suggestion on an earlier version of this essay. Any remaining errors of fact or interpretation are the author's.

a country's historical, political, ideological, economic, social, cultural, and legal situation, which of course may change over time. Understanding the conditional benefits and costs is essential for interpreting the actions of each EE country at the time when it made the decision to adopt (or to link its currency to) the euro, as well as to assess the likelihood that today's Euro Outsiders will join the EZ in the foreseeable future.

The third issue concerns the complex design of the EMU, including the institutions and the policies that are supposed to make the arrangement work smoothly. While there was much controversy all through the 1980s and early 1990s when the EMU was still on a drawing board, during the EMU's first decade (1999-2008), conventional wisdom became that the original architects who prevailed at Maastricht were clearly right, that everything was turning out as good if not better than EMU's advocates had expected. This favorable perception was clearly a factor in Slovenia's and Slovakia's decisions to jump of the EZ bandwagon at the time when they did (2007 and 2009, respectively). In 2009 came the Great Recession. The hitherto hidden or forgotten design problems of the EMU have suddenly appeared. It has also become evident that the hope and the expectations of the EZ's architects -- that if and when the time came to fix the euro's design shortcomings, the political will to do so will be found --- have remained unrealized. Therefore, perceptions about the EMU became strongly negative, with a growing realization that Europe's common currency had several major design faults. This new conventional wisdom certainly has dampened the interests of EE's Euro Outsiders to become Euro Insiders today, or at any time soon. And the perception in EE that in the EZ's smoldering sovereign debt crisis the heavily indebted Southern members of the EMU had been treated rather harshly by the North has been reinforcing the Euro Outsiders' caution about adopting the euro.

This essay underscores the fact that monetary integration in Europe is not simply, or even mainly, a financial or an economic issue. It is also a political one. In certain situations, politics dominates all the others, in some cases for the better (at least that is how it may appear at first); in others, for the worst, standing as an obstacle to the resolution of various crises. The EMU itself, and the relationship between it and the EE countries, also involve historical, ideological, social, cultural, and legal aspects. One intended contribution of this essay is a multidisciplinary perspective on the issues.

East Europe Defined

EE is defined here as the 11 countries in the region that were members of the EU at the beginning of 2015, plus Serbia -- a candidate country for EU membership. In January 2014, the first intergovernmental conference took place between Serbia and the EU, signaling the formal start of Serbia's accession negotiations. Although it may take years before Serbia would be admitted as a full member, the country appears to be the next in line to join the EU, assuming of course that enlargement will continue. A further reason for including Serbia is the country's extremely high level of (informal) euroization.

Legal Aspects of Eurozone Membership

The Maastricht Treaty of 1992 had established the EMU; the common currency was introduced in 1999. Along with subsequent amendments, the Treaty specified that while then members of the EU had a choice on whether or not to join the EMU, countries that would be admitted to the EU later, as full members, would have the legal obligation to eventually adopt the euro , thus joining the Eurozone (EZ).[2] However, no timetable was set as to when a new EU member was supposed to join, other than stating that, when it is ready, its government must formally apply, that it must be found to have fulfilled all the Maastricht criteria (listed below), and that EMU's current members and the European Central Bank (ECB) would have to agree that the country was ready to adopt the euro.

Provisions of the Maastricht Treaty

Below is the list of the Maastricht "convergence" criteria which an EZ candidate country must comply with before it would be permitted to adopt the euro.

1. The government's annual budget deficit cannot exceed 3% of GDP.

2. Its stock of public debt cannot exceed 60% of GDP.

3. The inflation rate must be within 1.5% points of the average of those three members with the lowest-inflation figures.

4. Long-term interest rates must be within 2% points of the average of the three best anti-inflationary performers.

5. A candidate country must spend a minimum of two years in ERM II, during which fluctuations of its exchange rate vis-a-vis the euro must remain within +/- 15% of the central rate.[3]

6. Full domestic political independence of the central bank.

The logic of these requirements is indicated by their "convergence criteria" label. By fulfilling criteria #1 through #5 before adopting the euro, candidate countries are supposed to converge, in terms of key macroeconomic performance indicators, toward the "core" countries of Germany, France, and the Benelux nations. The assumption was that the more economically alike are the members of the EMU, the easier it will be for the ECB to decide and implement common monetary policies appropriate for the entire group and for each of its members.

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[2] EZ is a term used here interchangeably with the EMU. The UK and Denmark had formally opted out while Sweden decided not to enter ERM II (see next footnote) in order not to meet the exchange rate criterion because Sweden' EZ membership was rejected by its voters in a referendum.

[3] ERM = Exchange rate mechanism. ERM I was a system introduced by the European Economic Community in 1979 as part of the European Monetary System (EMS), designed to reduce exchange rate variability among EMS currencies.

The logic of criterion #6 is to make sure that each EZ member's national central bank would be able to carry out, without fail, the monetary policy instructions of the ECB, whose local subsidiary they would, in effect, become.

EMU's designers were aware that for the EZ to function well, it will be insufficient just to fulfill the Maastricht criteria prior to entry. It is also important that those key economic decisions that will remain in the hands of member governments -- fiscal policy -- should continue to be aligned among the members. It is with this objective in mind that prior to the birth of the euro, the so-called Stability and Growth Pact (SGP) had been agreed upon, namely, that Maastricht criteria #1 and #2 (both shaped by each member's fiscal policy decisions) will continue to be observed, permanently, by EZ members.[4]

Adopting the Euro: Benefits and Costs

To better understand the motives of those EE countries that have become Euro Insiders, as well as the attitudes of those that have remained Euro Outsiders (and their euro adoption prospects), let’s enumerate the benefits as well as the costs of euro adoption.

Certain benefits are unconditional, that is, they are (or would be) benefiting any country adopting the euro, irrespective of the country's economic circumstances, while the existence and extent of certain other benefits depend upon the specific circumstances of the country at the time.

The costs of membership are also partly unconditional and partly conditional, depending upon a country’s circumstances.

Unconditional benefits

1. EZ members save transactions costs when doing business with other EZ members. The more "open" an economy and the larger the share of its external economic transactions with other EZ members, the greater the savings. This means that the smaller an economy, the more open it is likely to be, and thus the larger will be this benefit of EMU membership relative to GDP.

2. Competition is enhanced, due to an increase in cross-border transactions and to the ease with which prices and costs can be compared across countries, since they are now stated in a common currency. This improves economic efficiency.

3. The irrevocable fixing of the exchange rate insulates the economy from currency speculation and from economic fluctuations caused by such speculation. This benefit will disappear for the country that is expected to leave the EZ, whether voluntarily or being forced to do so. (An example is Greece today: euro bank deposits and other euro assets in Greece, except cash, face a “redenomination” risk.)

[4] The provisions of the SGP were tightened by the so-called *fiscal compact*of 2012 (subsequently ratified by all EZ and several non-EZ countries of the EU). Some of the SGP’s new rules aim to prevent fiscal policies from heading in potentially problematic directions, while others are supposed to correct excessive budget deficits or excessive public debt burdens.

4. A combination of the above three benefits is likely to improve economic efficiency and thus macroeconomic performance, especially of GDP growth rates.

5. Having formally adopted the euro, a new member country participates in designing the ECB's institutions and policies, including those of the EZ's special funds, such as the European Stability Mechanism (ESM), established to assist EZ members.

Conditional benefits

6. A country with a history of high inflation, which is usually accompanied by economic, social and political upheavals, benefits from credibly and permanently transferring monetary policy decisions to a strong, prestigious, and independent central bank, such as the ECB. Such a transfer can be made directly, by joining the EZ; or indirectly, by credibly pegging the domestic currency to that of the euro. In either case, becoming a Euro Insider also means a firm commitment to responsible fiscal policies.

7. An EZ member running large, sustained current-account deficits can be assured of the financing of those deficits via a combination of (a) private (voluntary) capital inflows and (b) the automatic granting of *Target2* credits by the European System of Central Banks.[5] *Target2* credits automatically make up the difference between a country's current-account deficit and that portion of the deficit not covered by private capital inflows.

8. Being a Euro Insider can also be a financial "shelter" in case of global economic turbulences, such as the financial meltdown and the Great Recession that commenced in the Western world late in the last decade. *Ceteris paribus,* a Euro Insider is likely to obtain financial assistance more promptly and more adequately from the EU, from certain EZ facilities (such as the ESM), from partner EU governments, as well as from the IMF than those that are Euro Outsiders.

9. Becoming a Euro Insider is also a strong political declaration that the country places a high value on joining "Western" economic and monetary arrangements. Such a benefit can be very important to some successor states of the Soviet Union, such as the Baltic nations, as a way of further distancing themselves from Russia's orbit.

Similarly to benefits, some costs are certain; others depend on a country's circumstances.

Unconditional costs

1. The financial costs of membership. These costs include subscriptions to ECB's capital and to various EZ" rescue funds", such as the ESM. Although each member country's contribution is based

[5] For details, see Karl Whelan, "Target2 and Central Bank Balance Sheets" in *Economic Policy,* Vol. 29, issue no 77 (January 2014). "Target" is an abbreviation of "Trans-European Automated Real-time Gross Settlement System", which has been operating in some form in the EU for decades. In November 2007 the system was transformed to meet the requirements of a settlement system within the EZ, and was renamed Target2.

on its economic size, such costs are relatively more burdensome for the poorer members. For example, the requirement that Slovakia contribute to the EZ's bailout fund for Greece had caused a political crisis in Slovakia, on the grounds that it is unjust to require a poorer country's taxpayers to subsidize their counterparts in a richer country.

Conditional costs

2. Joining the EZ means giving up key aspects of national sovereignty to unelected EU officials in Brussels and to their counterparts at the ECB in Frankfurt. Therefore, some view the EMU itself as a highly undesirable and unwelcome undertaking, whether from the point of view of political philosophy or economic efficiency, or both.[6]

3. Giving up two key instruments of monetary policy—the exchange rate and the interest rate -- can be costly if the business cycles of a new member are not synchronized with those of the other members and if the new member's domestic adjustment capabilities are constrained. Adjustment capabilities are limited if a country has large public and/or external debts relative to GDP; high and inflexible budget expenditures, such as welfare-type payments; inflexible wage-setting practices, such as indexing wages to inflation; and low labor mobility.

4. If a prospective EZ member is at a much lower level of development than are the current members, then becoming a Euro Insider is likely to cause inflation in the new member state to be permanently higher than the EZ average and to trigger a credit boom. These are likely to happen for several interdependent reasons. First, the poorer EU countries -- eager to converge toward the more developed ones in terms of per capita GDP levels -- are more likely to experience above-average inflation to begin with. Furthermore, upon joining the EZ, the poorer new member is likely to experience fast productivity growth in its tradable sectors (typically helped by large capital inflows), leading to wage rises both in the tradable and non-tradable sectors, causing total-economy unit labor costs to rise.[7] This was certainly the case during the EMU's "sunshine decade" (1999-2008).[8] Since both short-term and long-term interest rates had converged quickly in the EZ, different national inflation rates resulted in substantial differences in real interest rates, becoming much lower (in some cases even negative) in the lower-income new members than in the higher-income older members.[9] Low nominal and especially low real interest rates in countries whose businesses and households were used to high nominal rates inevitable trigger a credit boom

[6] One of the most influential political figures holding this view is the Czech Republic's former Minister of Finance and former President of the Republic, Vaclav Klaus. In 2010, when still President, he wrote this in *The Wall Street Journal* (June 1): "Many of us [are] in favor or a looser form of European integration [but] against the so-called deepening of the EU and against the creation of a political union in Europe. People like me understood very early that the idea of a European single currency is a dangerous project which will either bring big problems or lead to the undemocratic centralization of Europe."
[7] This is the famous Balassa-Samuelson effect, amply documented in the literature.
[8] The EZ's "sunshine decade" is the author's term for that initial period when the establishment of the common currency was generally viewed as being an unmitigated success, based largely on the more rapid rate of "catching up" growth of the EZ's poorer members (Portugal, Italy, Greece, and Spain).
[9] On the convergence of EZ interest rates, see Agnes Benassy-Quere, *et. al.,*"Economic Divergence within the Euro Area: Lessons for EMU Enlargement" in E. Nowotny, *et. al.* (eds), *The Euro and Economic Stability: Focus on Central, Eastern and South-East Europe* (Cheltenham, UK: Edward Elgar, 2010), p. 136.

(especially in the construction, real estate and service sectors), contributing to cost-push as well as to demand-pull inflation. And the longer and stronger a credit boom, the more likely that it will cause severe economic problems when the credit bubble bursts, as it almost always does.

5. Just as the assurance of a more or less automatic financing of current-account deficits within the EZ is a membership benefit by the countries running sustained, large balance-of-payment deficits, countries running sizable payment surpluses within the EZ, such as Germany, may view them as costs, especially if they perceive the risk that the surpluses might not ever be fully settled.[10]

6. All Euro Outsiders have been frightened by the EZ's multiple crises that began in 2009 and have been continuing with greater or lesser intensity ever since -- the crisis of sovereign debt service, extreme weakness of many systemically important banks and other financial institutions, severe problems of intra-EZ competitiveness, and deep recessions and disappointing growth throughout the EZ. Influential voices have argued that some of the crises were triggered or exacerbated by the fundamental design faults of monetary integration among a large group of diverse countries.[11] Concerned about the very future of the EZ, and also about being "infected" if they join the group, most Euro Outsider countries have been assuming a "let's wait and see" attitude about becoming Euro Insiders.

EMU Design Debates and Design Faults

The likelihood of the Euro Outsiders joining the EMU has diminished in recent years with a better understanding **today** of the EMU's fundamental design faults than when the Maastricht Treaty was signed or during the EZ's "sunshine era", before the Great Recession.

Although there were debates during the 1980s and early 1990s on whether establishing a common currency then might be premature, the leading expert on what constitutes an "optimum currency area" (OCA), 1999 Nobel Laureate in economics Robert Mundell, endorsed the speedy establishment of the EMU. In fact, the Nobel Committee cited Mundell for his contribution in laying the foundations of the EMU, with the year of his Nobel award coinciding with the introduction of the euro.[12]

Mundell and other "monetarists" believed that the fixing of exchange rates and the adoption of a common currency would ensure sufficient convergence of the economies **after** the introduction of the euro so as to make the monetary union work. The EMU was also seen as stimulating structural reforms, especially in the Mediterranean countries, where labor market rigidities, non-competitive business sectors, excessive state regulation and corruption were seen as non-compatible with EMU

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[10] One of Germany's most influential economists and policy advisors, Hans-Werner-Sinn, wrote in 2012: "… if the euro breaks up and if the TARGET claims are not honored as legally valid titles, or the TARGET debtors are unable to repay while the TARGET-neutral countries object to share in the losses, … the TARGET surplus countries would lose their TARGET claims." *Target Losses in Case of a Euro Breakup* (CEPR Policy Portal), October 22, 2012 (http://www.voxeu.org/article/target-losses-case-euro-breakup).

[11] See George Soros, "A European Solution to the Eurozone's Problem", *Social Europe Journal,* October 4, 2013.

[12] For a comprehensive review of the OCA literature, see Julius Horvath, "Optimum Currency Area Theory: A Selective Review" (Oslo: Institute of Economies in Transition, Bank of Finland Discussion Paper #15 (2003); also available http://www.suomenpankki.fi/pdf/110655.pdf).

membership.[13] However, in those countries, complacency about fixing those problems became the rule, not the exception.

Furthermore, Mundell also supported the EMU on the grounds that the euro would help counterbalance the USD as the world's pre-eminent reserve and vehicle currency, even if the USD would remain the globe's dominant currency.

Opposed to Mundell and other monetarists were the "economists" who believed that the introduction of a single currency should be the crowning of a lengthy process of convergence of the economies seeking to adopt the euro. German economists were the most vocal representatives of this group and were thus always the strongest advocates of the most rigorous conditions possible for establishing the EMU and for countries to join the group.[14]

As we can clearly see now, by hindsight, the sceptics were proven right. They correctly identified the most basic design flaw of the EMU (#1 below), to which several other design problems must be added:

1. The most fundamental design fault with the EMU was the establishment of a monetary union prior to fiscal and political union. Such a never-before sequencing in economic history can be likened to putting horses before an imaginary cart, hoping that the cart (fiscal and political union) will materialize when needed. Of course, this problem is much easier to pinpoint with hindsight. Many also thought that to link countries monetarily but not politically would be a good idea. (One of EE's leading economists, Leszek Balcerowicz, former Minister of Finance and former Governor of the Central Bank of Poland, still believed, as of 2010, such a purely monetary linking to be a good idea. Balcerowicz attributes the EMU's current crises to the dysfunctional fiscal policies of several EMU members and to their lagging structural reforms[15]). Be that as it may, one should note that the dominant political objective of the EMU was not the establishment of a truly well-functioning monetary arrangement among a group of countries, but to "control" the prospective economic and therefore political might of Germany following reunification.[16]

2. A design fault related to the above was proceeding with EMU without a banking union. During a financial crisis, like the Great Recession, banking problems (due in no small measure to lax banking supervision by national banking supervisors) spilled over into fiscal difficulties as the states had to intervene to stabilize financial institutions in trouble. The effective transmission mechanism of a single monetary policy requires a healthy financial system in the member countries to create near uniform conditions in every part of the EMU. This requires a banking union as a complement to monetary union, with centralized banking supervision, a common bank resolution mechanism, and a

[13] Laszlo Csaba, "Developmental Perspectives on Europe", *Society and Economy* 36 (2014), p. 23.
[14] Alexandre Swoboda, "Robert Mundell and the Theoretical Foundation for the European Monetary Union". IMF paper, December 13, 1999 (https://www.imf.org/external/np/vc/1999/121399.htm).
[15] "A More Perfect Monetary Union", *Finance: The Magazine for Emerging Europe* (Summer 2010), pp. 26-27. Balczerowicz argues that the EMU could work even without a political union and without a common treasury if the fiscal incentives and safeguarding mechanisms would have been properly designed and implemented.
[16]For a discussion of the political background of the EMU, see Paul Marer, "The Eurozone Crises and Central and Eastern Europe", in Maciej Kisilowski (ed), *Free Market in Its Twenties*: *Modern Business Decision Making in Central and Eastern Europe* (Budapest, CEU Press, 2014).

unified deposit insurance system.[17] If a banking union would have been in place, it is doubtful that the excessive indebtedness of corporate and household sectors in several countries, which eventually caused such havoc in those countries' public finances, would have been allowed.

3. Another basic design fault of the EMU was its exclusive focus on the convergence of a fewkeymacroeconomic indicators, neglecting large differences among prospective members in their formal and informal institutional arrangements (such as the role of the state in the economy and wage-determination practices) as well as in culture (the mindset, such as the scale of, and the attitude toward, corruption). Differences in those areas were especially large between the EZ's "Northern" members (Germany, Belgium, Austria, The Netherlands, and Finland) and its "Southern" members (Italy, Greece, Spain, and Portugal).[18] As it is easy to see by hindsight, huge divergences in the latter areas have caused, cumulatively, basic incompatibilities between the two groups of countries. The design problem was to assume that the EZ would operate like the US, where lasting economic level differences between, say, California and Mississippi has not been causing irreparable harm for the United States to remain united. One important reason for the difference between the US and the EMU is the much weaker solidarity among the historically, politically, and culturally so fundamentally different nations in Europe as compared with the "melting pot" tradition and feature of the US.

4. Another design fault was that the he absence of effective sanctions enforcing the Maastricht criteria as well as the provisions of the SGP.[19]

5. Still another design fault was the non-recognition that the very creation of a monetary union without fiscal and political union might give rise to sovereign debt problemsfor which effective solutions were not designed. Specifically, sovereign debt problems are much more likely to arise in the most heavily indebted members of the EMU where all public debt is, in effect, in a "foreign" currency (that is, mostly in euros) whose issue member governments do not control. Hence, member countries facing debt-servicing problems are not in charge of their money supply and thus don't have the option of reducing debt-to-GDP ratios via inflation, which would be an option if a significant part of the public debt would be in the debtor country's domestic currency.

6. Serious competitiveness problemsare also more likely to arise in an EMU because EZ membership means that national governments give up the two main tools of improving intra-EZ competitiveness, exchange rate devaluation and interest rate adjustments.

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[17] Christian Noyer, Governor of the Bank of France, "Why the EMU Needs a Banking Union" in *The Euro Dilemma: Inside or Outside*. (Budapest: Hungarian National Bank Lamfalussy Lectures Conference series, 2014).

[18] France and Ireland sort of "straddle" between the two groups, in certain areas and at certain times exhibiting features characteristic of the Northern group; in other areas and at other times showing "Southern" characteristics.

[19] Italy and Belgium were accepted as EMU founding members even though both exceeded, by very large margins, Maastricht criterion #2. Greece was admitted even though it was common knowledge that it "complied" with the fiscal criteria only on paper, falsifying its economic statistics. And even Germany, as most other EMU members, has breached the provisions of the SGP numerous times. Altogether, there were more than 100 breaches of the SGP during EMU's first decade.

Euro Insiders and Euro Outsiders in East Europe

Having traced the historical, theoretical and factual backgrounds of the EMU, we are now ready to present and interpret the relationship between the dozen countries of EE and the euro (Table 1).

The first six countries listed are Euro Insiders: the first five had already adopted the euro during 2007-2014; the last having had its currencies pegged firmly to the euro since 1997.

If a similar tabulation would have been compiled in 2008, on the eve of the financial meltdown and the Great Recession, the ratios would have been reversed: only two EE countries had adopted the euro; the currencies of the four others were pegged to the euro.

The other six EE countries have remained Euro Outsiders. Strong circumstantial evidence suggests that none of them have a near-term or medium-term interest in adopting the euro.

Table 1. East European Countries and the Euro

Country	*EU membership*	*ERM II start date*	*Euro adopt date*	*Euro peg date*	*ER regime today or prior to the euro or peg*
Euro insiders (***EZ members***&*euro pegs*)					
Slovenia	2004	6/2004	2007		Managed floating
Slovakia	2004	11/2005	2009		Managed floating (1998-2005)
Estonia	2004	6/2004	2011	2002	Pegged to DM (1992-2002)
Latvia	2004	5/2005	2014	2005	SDR peg 1993-2005
Lithuania	2004	6/2004[20]	2015[21]	2002	USD peg (1994-2002)
Bulgaria	2007	not member	no plan	1997[22]	Hyperinflation/depreciation
Euro outsiders					
Czech Rep.	2004	not member	no plan	none	Basket peg (1993-95);[23] Managed floating (since 1997)
Hungary	2004	not member	no plan	none	Adjustable peg (1990-94); crawling band (1995-2001); euro target zone (2001-08));[24] managed floating (since 2008)
Poland	2004	not member	no plan	none	Peg/crawling peg (1990-2000); managed floating since 2000
Romania	2007	not member	no plan	none	Managed floating[25]
Croatia	2013	not member	no plan	none	Managed floating

[20] In 2006, the EU found that while Lithuania met 4 of the 5 Maastricht criteria, its average annual inflation in 2005 was 2.7% vs the limit of 2.6%.

[21] In June 2014, the EU Commission and the ECB found that Lithuania has met the Maastricht criteria so it can be expected to introduce the euro on January 1, 2015, for which legislation has also been cleared in Lithuania.

[22] Pegged at the time to the DM.

[23] Between Feb 1996 and May 1997, had an ER regime with +/- 7% fluctuations allowed. Speculative attacks on the koruna during the1997 Asia crisis led to the switch to managed floating.

[24] This was strikingly similar to ERM II: permitting +/- 15% fluctuations against the euro. For a brief explanation of the reasons for changing the exchange rate regime multiple times, see Marius A Zoican, "

[25] Details about the early 1990s: M. Birsan and M. Plesca, "Exchange Rate Policy during Transition: Romania" in Z. Sevic and G. Wright (eds.), *Transition in Central and Eastern Europe* (Belgrade: 2007), pp. 399-407.

Serbia[26]	not member	--	--	Peg/crawling peg (2000-06); managed floating (since 2006)

Hypotheses to Explain Country Choices

In a section above I listed a combined nine unconditional and conditional benefits of being or becoming a Euro Insiders and six combined certain and conditional costs of being tied to the euro.

Instead of attempting to prepare country-specific balance sheets of benefits and costs, perhaps also giving weights to each factor's presumed importance for a country -- an exercise that would likely yield an unsatisfactory "on the one hand and on the other hand" type of outcome -- the following plausible hypotheses are offered.

Hypothesis-1: "Every Euro Insider country in EE has had one overridingly important political or economic motive (in some cases a combination of such motives) to adopt the euro or to tie its currency to the euro."

Hypothesis-2: "For the EU member EE countries that have remained Euro Outsiders, the expected political and economic benefits of joining the EMU have not been demonstrably greater than the costs; their euro policies can be simply labeled as "drifting." (Note that not qualifying for euro adoption on the basis of unfulfilled Maastricht criteria is not included as a reason because if the country had an overridingly important political or economic reason to adopt the euro, it would have found a way to qualify).

It will be easier to marshal arguments and examples consistent with Hypothesis-1 than to do the same, convincingly, for Hypothesis-2. For one, it is more plausible to give reasons why an action was taken than why something was not done. Also, there are significant differences among the Euro Outsiders on why and how each has been "drifting", as discussed in the section below and under Summary and Conclusions.

Nevertheless, giving all outsiders the uniform "drifting" label does have a rationale: no country could officially state that it would never adopt the euro since each has a treaty obligation to do so. Therefore, whether a government is really against euro adoption "forever" or whether it is taking a genuine "wait and see" attitude on the issue, each must address the question in more or less the same way, whether it really means what it says or just to prevaricate.

Country Choice Rationales

Next follows a brief – country-by-country -- discussion of key facts and my interpretation the main reason(s) that brought a country into the EZ or kept it out of the EMU.

Focusing on the Euro Insiders first, the three Baltic States -- **Estonia, Latvia** and **Lithuania** -- offer the most clear-cut cases: each has had overwhelmingly important political as well as significant economic reasons for adopting the euro. The political reason: they place a high value on joining this

[26] Serbia's system transformation had begun in 2000. For details, see Radovan Jelasic, "Serbia: On the De-Euroization Road to the Euro" in Nowotny, *et. al. The Euro and Economic Stability (op. cit.)*, pp. 23-33.

"Western" economic and monetary arrangement, too, as an additional way of distancing themselves as far as possible from Russia's orbit (benefit #9). All three are tiny economies, so that the benefits of having *de facto* fixed exchange rate vis-a-vis their major economic partners are much greater than those benefits would be for larger countries (benefit #1). All three had entered ERM-II almost immediately after EU accessions (Table 1), and in all three there was (and remains) broad-based political and social support for EZ membership.[27] Until each finally qualified to join the EZ, the countries took the closest available substitute: pegged their currencies to the euro.

Slovenia's circumstances were/are quite similar to those of the Baltic States. It left Yugoslavia as soon as possible, establishing itself as an independent state in 1991. It, too, joined ERM II immediately after becoming an EU member in 2004 and was the first EE country to adopt the euro in 2007.[28] The step had strong domestic political and public support. And, as a tiny country with exports representing 50% or more of GDP – going mostly to fellow EZ countries -- it has been benefiting from a fixed exchange rate vis-a-vis its main economic partners. However, following the global financial crisis and the Great Recession, Slovenia experienced one of the steepest GDP declines in Europe. Its loss of competitiveness vis-à-vis neighboring non-EZ countries whose exchange rate had declined was certianly**a** factor. However, by far more important in Slovenia's poor performance were that (1) a large part of its economy has been sheltered from competition; (2) extreme structural rigidities: (3) lagging privatization of large enterprises; and (4) high corruption. These had all contributed to a severe banking crisis (2012-14), with many predicting at the time that Slovenia would also have to be bailed out by its EZ partners (a fate it had escaped, barely). It is important to note that Slovenia has been the only EE member of the EU that kept foreign banks largely out of the country. Slovenia preserved some of the most dysfunctional features of its pre-transformation economic system: banks continuing to have much too cozy relationships with enterprises, many still state owned. For all these reasons, I would **not** conclude that Slovenia had made a mistake in adopting the euro.

Slovakia's is a most interesting case. During its first eight transformation years (1990-1998) it was considered to be an unusually corrupt country, greatly lagging in political and economic reforms behind the rest of the Visegrad Four (the Czech Republic, Hungary and Poland). In September 1998, the opposition that won the election and formed a new government engineered the region's quickest and most dramatic changes in politics, economic system reforms, and economic policy. Simultaneously with EU accession negotiations (beginning in 2000), a strategy of introducing the euro as quickly as possible was also decided. The reasons for this dramatic about face were the economic philosophy and unusual political and economic expertise of key persons in the new government, a determined wish to irrevocably break with recent past policies, and the fervent desire to catch up to and perhaps leapfrog the Czech Republic -- a rival to which it has long been considered a junior and lagging partner. Ever since it had joined the EU (in 2004), entered ERM II (in 2005), and adopted the euro (in 2009), Slovakia's relative economic performance as well as its

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[27] See, for example, B. Banerjee, *et. al.,* "The Road to Euro Adoption: A Comparison of Slovakia and Slovenia" in M. Beblavy, *et. al., The Euro Area and the Financial Crisis", op. cit.,* p. 134.

[28] The stories of how Slovenia prepared for euro adoption and how its membership in the EMU constrained its government's ability to mitigate the impact of the Great Recession are told in V. Bole and L. MacKellar (eds), *From Tolar to Euro* (Ljubljana: Center of Excellence in Finance, 2010).

reputation have improved considerably, one evidence for which is the rapidly growing size of foreign investment. Slovakia did well to adopt the euro, as an integral part of a comprehensive economic reform package.

Bulgaria had no strong political but an overwhelming economic reason to tie its currency to the euro. After a terribly difficult early post-communist period, during 1996-97 Bulgaria experienced twin banking and currency crises, including hyperinflation, bringing the country on the verge of collapse. A radical new approach was needed; it was found by the newly elected government, pegging the currency to the DM (preparation and implementation during 1997-99), with the peg automatically switched to the euro in 2001.[29] Pegging a currency has meant that the monetary authorities gave up control over the money supply as well as the interest rates and the exchange rate, just as if the country had adopted the euro. That Bulgaria has been able to maintain its currency's peg, at the same fixed rate, for nearly two decades is a credit to its authorities' determination and to the public's support. While Bulgaria has periodically been toying with the idea of moving toward full EMU membership, that step is not a plausible option for it now, as long as its economy and politics continue to suffer from many serious ills.

Turning to the six Euro Outsiders, those four that had joined the EU during the decade of the 2000s -- the **Czech Republic, Poland** and **Hungary** (in 2004) and **Romania** (in 2007) -- had been toying, off and on, with the idea of moving toward adopting the euro. "Off and on" is an apt phrase. Each has published, and frequently revised, timetables of planned milestones to reach on the road to EZ membership. Depending on such factors as the preferences of the government in power, the experiences of EZ members from EE and the Mediterranean, and the prevailing global mood about the strengths and weaknesses of the EZ (that has fluctuated between lauding its benefits during 1999-2008 and damning its shortcomings since about 2010), the authorities in those four countries have vacillated between making a seemingly strong commitment to implementing their own timetable to introduce the euro, to revising the timetable time and time again, or simply stopping any concrete discussion of euro adoption.

Given the legal obligation of each EU member country to eventually adopt the euro, none has made an official statement that it would never do so. Today, the evasive statements we hear most often can be paraphrased as "we'll wait and see about developments in the EZ and will only join if and when it is the right time for us to do so." For most of them, the evasiveness of such declarations reflect not the hiding of policies on euro adoption, but the fact the policymakers in those countries really do not know if and when their country would be ready to join the EZ.

Apart from the above commonalities, there are also important differences within the four countries.

Most interesting is the stand of the **Czech Republic**. Already noted was the strong and principled opposition of one of the country's most influential politicians and statesmen, Vaclav Klaus, to the

[29] For an excellent study of Bulgaria's economic problems and its decision to peg, see Y. Atanasov and D. Valchanov, "Currency Board as An Exchange Rate Arrangement: The Bulgarian Experience". MSc in Finance thesis at the Aarhus School of Business, Aarhus University, Denmark (2011).

entire EMU concept (see footnote 6). Since he has supporters, the political-social consensus essential for smooth euro accession has been missing.

Most informative also is the domestic debate on whether the Czech Republic would really gain economic benefits by adopting the euro. The country's consistently prudent fiscal and monetary policies have allowed it to control inflation and maintain price rises and interest rates at levels similar to those achieved by the EZ's Northern group. Thus, the Czech Republic does not need "imported credibility." Based on this considerable achievement, its experts conclude that the Czech Republic doesn't need membership in the EZ to bring down inflation and the real rate of interest. Therefore, the debate about euro adoption boils down to an exchange rate regime choice: would it be better to have a fixed exchange rate vis-a-vis the euro by joining the EZ or would it be preferable to continue to maintain flexible exchange rates vis-a-vis the euro as well? The reasoning then goes: EZ membership would prevent potentially large exchange rate shocks, which, *ceteris paribus*, reduces macroeconomic volatility. However, at the same time, giving up exchange rate flexibility would also remove a channel of stabilization in case the economy suffers asymmetric shocks as compared with those experienced by the EZ's larger economies. That, in turn, would increase macroeconomic volatility. Economic models of the Czech Republic do not suggest that potential gains of improved macroeconomic stability arising from EZ membership would be greater than the prospective losses of the same attributable to EZ membership.[30]

Among the Visegrad countries, key aspects of **Hungary's** economic performance has been the opposite from those of the Czech Republic: irresponsible fiscal policies for a sustained period (2001-2007), resulting in the entire EU's largest cumulative budget deficits for that period and by far the highest public debt to GDP ratio among the East European members of the EU. The global financial crisis that had begun at the end of 2008 pushed Hungary to the precipice of sovereign debt default, were it not for a quick bailout loan of $25 billion arranged jointly by the EU and the IMF.

Hungary did not -- and still has not -- met most of the Maastricht criteria.[31] For the past decade, no serious government program has given priority to pursuing economic policies that would qualify the country for EZ membership. And with theincreasingly open antagonism of Viktor Orban's FIDESZ government toward the EU, arguing that Hungary must remain independent, there is little chance that more than lip-service would be given at any time soon to eventually adopting the euro. And, regrettably, public opinion has been so poisoned by the two successive FIDESZ governments' (2008-12 and 2012-16) relentless anti-EU rhetoric that it is doubtful that political and public opinion could easily be switched to support EZ membership.An influential official of the ruling Party stated in January 2015 that (1) Hungary would be worse off if it abandoned the forint; (2) EE

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[30] J. Hurnik, *et. al*., "The Czech Republic on Its Way to the Euro: A Stabilization Role of Monetary Policy Revisited" in E. Nowotny, *et.al.,* (eds.), *The Euro and Economic Stability: Focus on Central, Eastern and South-Eastern Europe* (Cheltenham, UK: Edward Elgar, 2010), pp. 48-68.

[31] The most comprehensive scientific assessment of what Hungary will need to do to successfully adopt the euro is a major essay by Judit Nemenyi and Gabor Oblath, "Rethinking Adopting the Euro" (in Hungarian), *Kozgazdasagi Szemle* ((Vol LIX, June2012), pp. 569-684. The main conclusion of the essay is that irrespective of the timing of euro adoption, it would be in Hungary's interest to meet as quickly as possible the EMU's Maastricht conditions because that would enhance international confidence in Hungary's economic policies and would improve prospects for Hungary's economic performance and convergence.

countries that have adopted the euro have obviously not benefited from it, for example, “Slovenia’s economy is in serious trouble, and in Slovakia prices went up when it adopted the euro”; and (3) adoption of the euro would require an amendment to the Basic Law (the constitution) since it specifies that the legal tender of Hungary is the forint.[32] A year earlier, the Governor of the Hungarian National Bank said that the Great Recession “crisis has shed light on the detrimental consequences of the premature adoption of the single currency. Hungary wishes to and will introduce the euro, but unless it is strong enough to do so, its best interest is to stay out of the euro area.”[33]

Poland is very different from both the Czech Republic and Hungary. Its policymakers and experts have been debating for years the pros and cons of the timing of euro adoption. Generally speaking, there appears to be more fundamental support for the euro, as well as for the EU than in the Czech Republic and in Hungary. The main reason seems to be Poland's pursuit of increased political and economic influence within the EU. One reason that Poland has a friendlier attitude toward the EMU is its interest in helping to shape the future of the EZ, as also that of the EU. What influential Polish supporters of EZ membership stress, based on the lessons learned from the experiences of the Southern members of the EZ, is the importance of the country being well prepared prior to adopting the euro. This will require implementing a further range of fiscal and labor market reforms necessary for the economy to become sufficiently flexible to be able to absorb any external economic shock that it might be experiencing. At the same time, being a relatively large economy, Poland likes, *ceteris paribus*, the flexibility that comes from retaining independent monetary and exchange rate policies.

Romania has also been "on and off" with respect to EZ membership. However, in contrast to Hungary, its repeated postponements of the date when it expects to join have more to do with making insufficient progress toward qualification than any kind of a serious political or economic doubt that adopting the euro would be a positive step. When Romania submitted its Convergence Program to the European Commission in 2013, Prime Minister Victor Ponta stated that "Eurozone entry remains a fundamental objective for Romania but we can't enter poorly prepared." He then added that 2020 was a more realistic target than the earlier dates that have been targeted and repeatedly postponed. Romania’s central bank has recently prepared amendments to the Constitution to make it legally possible to transfer its tasks to the ECB and to introduce the euro as the legal tender.

Croatia has become a full EU member only in 2013. In contrast to Slovenia and Slovakia, it has not pushed, simultaneously with EU accession, negotiations toward joining the EZ. One likely reason is that while attitudes toward EMU had been glowingly positive during the mid-2000s when Slovenia and Slovakia became EU members, attitudes today range from critical to skeptical to uncertain. And since Croatia has much less political imperative to adopt the euro than the Baltic States and

[32]Antal Rogan, FIDESZ majority leader in Parliament, as reported in *Origo News*, January 19, 2015.
[33] Gyorgy Matolcsy, “Hungary on Uncharted Waters” in the volume cited in footnote 17, p. 8.

Slovenia did a decade ago (nor is Croatia's economy quite so small as those just mentioned), its "let's wait and see" attitude is prudent.

For **Serbia**, not being an EU member -- and with many years to go before it would qualify for EU accession -- it is premature even to speculate about the pros and cons and the likelihood of euro adoption. In fact, one of Serbia's most pressing economic problems – wrote the then Governor of the National Bank of Serbia in 2010 -- is how to "de-euroize" its monetary system. Owing to the population's still fresh memory of hyperinflation and repeated dramatic depreciation of the domestic currency, businesses and households are reluctant to hold the *dina*r. Even in the face of interest rate incentives by Serbia's central bank to hold the *dinar*, there remains strong preference for the euro and other foreign currencies. Serbia's heavily euroized economy limits the effectiveness of domestic monetary policy and makes the country vulnerable to speculation-driven depreciation of the local currency.[34]

Five years after Governor Jelasic' 2010 statement just quoted, I contacted the former Governor and asked him whether Serbia would not have done better by pegging its currency to the euro, as Bulgaria did in 1997 (to the DM at that time, switching the peg later to the euro). He replied in the affirmative: "I was fully convinced 10 years ago that it does make sense to carry out an independent monetary policy even in the case of a small open economy. I would do it differently today. The cost of trying to convince people to trust the unpegged local currency simply does not work. Look at Croatia, where even today the majority of the deposits are in euros! If I had it in my power, I would peg the dinar to the euro tomorrow."[35]

Summary and Conclusions

Let the statements in italics below serve as the essay's summary and conclusions; the in-between text (not in italics) focuses on explanations and examples.

Every Euro Insider country in EE has had one overridingly important political or economic motive (in some cases a combination of such motives) to adopt the euro or to peg its currency to it.

In the case of the three Baltic States of Estonia, Latvia and Lithuania, the principal motive was political: to distance themselves from Russia's orbit by joining a Western monetary arrangement. This motive was reinforced by all three being small, open economies, with the other EZ members as their main commercial partners. Having the same currency as their partners reduces substantially the transaction costs; the smaller and more open an economy, the greater are the savings so generated. Before and after their severe economic downturn during the Great Recession (due in large part to allowing similar credit bubbles to arise as those experienced by the Mediterranean countries, Ireland, and several other countries in EE), these Baltic Tigers have been performing well. First pegging to and then adopting the euro were not the only reason for their economic

[34] For details, see essay by the former Governor of the National Bank of Serbia, Radovan Jelasic, "Serbia: On the De-Euroization Road to the Euro" in E. Nowotny, *et. al.* (eds.), *The Euro and Economic Stability* (*op. cit.)*, pp. 23-33.
[35] Mr. Jelasic is quoted with permission.

success. But those steps certainly did not hurt and almost certainly helped them to maintain sound economic policies and to correct earlier policy mistakes by "internal devaluation."

Slovenia shared with the Baltic States the same economic and similar political motives: being a small, open economy and distancing and distinguishing itself from the economically and politically more troubled other ex-Yugoslav countries.

3. Slovakia was the most unexpected, relatively early euro adopter (2009). The trigger was domestic politics: a strong belief by the government that came to power in 1998 that it must break with the economically dysfunctional past. Aiming to adopt the euro as quickly as possible provided the blueprint. The new government's market-oriented ideology and its implementation expertise gave the country a political window to take such a daring step, and made good use of the opportunity. The country's fervent desire to catch up to and perhaps leapfrog the Czech Republic reinforced the decision, as did being a small, open economy. There is domestic as well as international consensus that, on a net basis, Slovakia gained substantial, long-term benefited by adopting the euro.

Other than being a small, open economy, Bulgaria had a fundamentally different reason for pegging its currency to the euro: following a major economic crisis, including runaway inflation, it wished to import economic credibility and stability from the EZ. For such a step to be successful, the importer must subsequently follow prudent economic policies. In this respect Bulgaria can be said to have been partly successful (for example, in terms of fiscal, especially public debt, performance) and partly unsuccessful (weak structural reforms and continued high level of corruption).

The five EU-member EE countries that have remained Euro Outsiders typically did so because the expected political and economic benefits of joining the EMU have not been demonstrably greater than its costs. In brief, it was convenient for them simply to "drift".

Beyond this broad generalization, there are significant differences among the five.

The Czech Republichas long been pursuing relatively prudent economic policies so that it had no need to try to import stability from the EZ. Opposition to adopting the euro has also been vocal and influential on economic philosophy as well as on political ideology grounds. In the view of the EZ's opponents (such as Vaclav Klaus), EMU requires an excessive and unwelcome degree of economic centralization and the granting of too much political power to unelected officials.

Polandby and large shares the Czech Republic's economic policy prudence. And by being a relatively large economy, it prefers exchange rate flexibility to a loss of independent monetary policy.

Romania has had too many economic and political problems, so it has not been ready to apply to, nor to be received by, the EZ.

Hungary has been the *enfant terrible* of the EE outsider group; before the Great Recession because it had been in the breach with most Maastricht convergence criteria; since 2008 because the FIDESZ governments in power since then have been conjuring up enemies and is preaching maximum economic, financial, political, and legal independence, an attitude that would not be compatible with EZ membership.

Croatia, which joined the EU only recently, does not as yet qualify for euro adoption.

Serbia, the sixth Euro Outsider in EE, is a most interesting case. Since its EU membership is far from imminent, it cannot as yet contemplate euro adoption. However, influential voices today think that Serbia would benefit from becoming a Euro Insider by tying its currency irrevocably to the euro, as Bulgaria did almost two decades ago.

Perceptions of economists, politicians, and the general public about the benefits and costs of having an EMU and of being a member of it have changed dramatically from 1999-2008 and since 2009. The initial euphoria, engendering great expectations about the EZ's bright economic future, has crumbled during and since the Great Recession. Negative perceptions about the EZ and its many "design faults" are reducing greatly the likelihood that EE's Euro Outsiders would be interested in adopting the euro.

This statement can be applied with confidence to the region's current Euro Outsiders. This is so in spite of the three Baltic States appearing to be counter examples because all three adopted the euro on or after January 2009.

Two reasons can explain the apparent paradox. First, each Baltic country valued highly the political benefit of additional distance from Russia. No Euro Outsider in the region has a similar, strongly held political agenda. Second, their decisions to adopt the euro were made from Euro Insider positions already. Therefore, a decision to break their peg to the euro by substantially devaluing their currencies –strongly advocated at the height of the economic crises by many famous economists (including Nobel Laureate Paul Krugman) -- would have had devastating domestic economic impacts, triggering massive bankruptcies of their heavily euro-indebted businesses and households.

Even a minimum understanding of why and how the EMU was designed, how it is functioning, what are its prospects, and the evolving relationship between the euro and the EE countries requires a multidisciplinary approach. History, domestic and international politics, political philosophy, economics, economic ideology, finance, culture and the law are all relevant.

Examples of the relevance of each area can be found even in this short essay. For example:

History is relevant because the historical-memory-induced fear of Germany by France was ultimately responsible for the signing of the Maastricht Treaty, just after German reunification.

Domestic politics was crucial in Slovakia's unexpected leapfrogging of the other Visegrad countries in introducing the euro. Domestic politics in Germany and in Greece are the main obstacles why an EMU-saving compromise on Greece's monumental sovereign debt cannot, it seems, be found.

International politicshad been a factor in the UK's decision to opt out from the EMU.

Political philosophy and economic ideology were the twin reasons for Vaclav Klaus' vociferous and effective opposition to the EMU.

Most of the benefits and costs of EMU membership are economic.

Central to the operation and continued survival of the EMU are the financial decisions of the ECB as well as by actors on the financial markets.

Culture is a fundamental determinant of how seemingly identical institutions function differently in the various countries; it is also helps shape the long-term economic competitiveness of countries.

The lawis always central; for example, most countries wanting to adopt the euro must first modify their constitution.