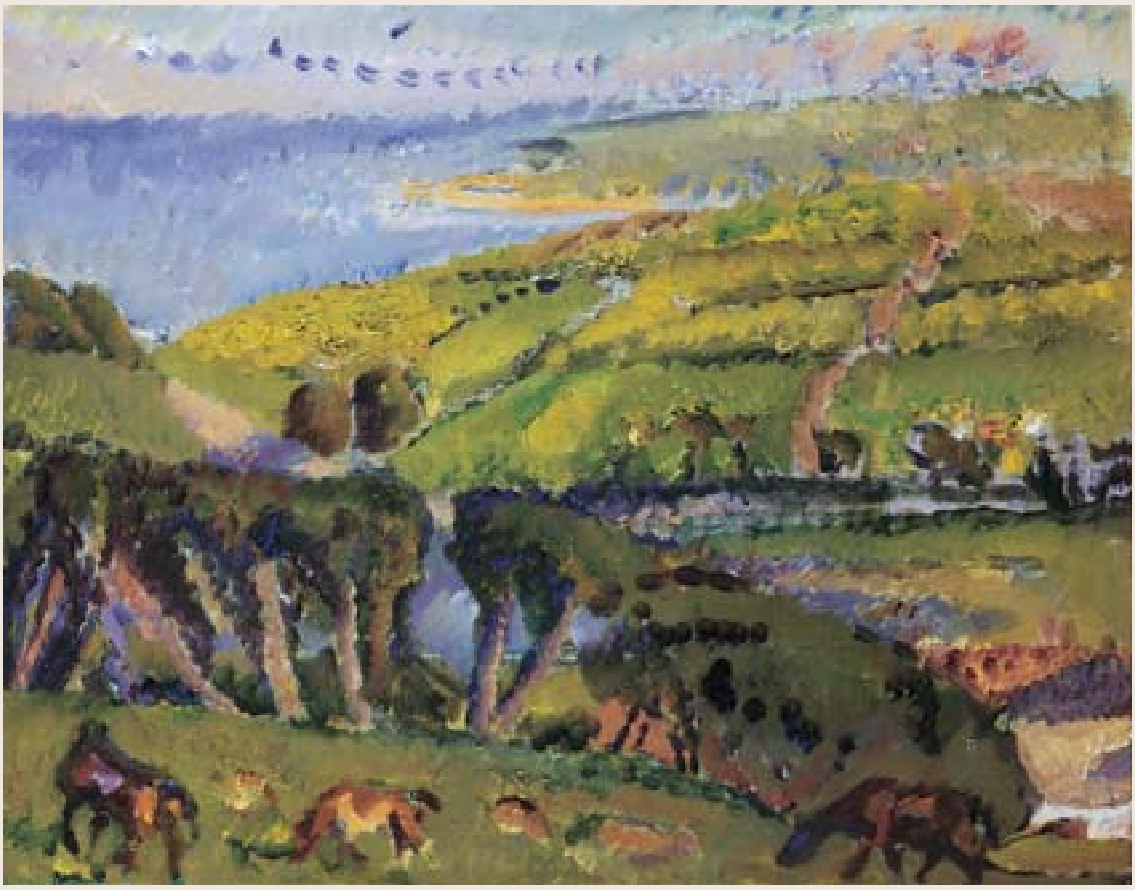

What price the euro?

The social impact of euro-zone accession for the new member states

Summary

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Introduction

This summary of the book *What price the Euro? – The social impact of the euro-zone accession for the new member states* is designed to achieve two aims: first, to present more concisely the information contained in the full version with an overview analysis for those whose need is for a general grasp of developments and the book's main conclusions rather than detailed information on every country; and secondly, by translation into five languages (including 3 central-eastern European languages), to enable wider access of the project results.

The research project behind this publication was a joint undertaking by the Swedish SALTSA network and the European Trade Union Institute for Research, Education and Health and Safety (ETUI-REHS).

The idea of a project on the social and economic development implications of the eurozone accession of the new Member States from Central and Eastern Europe emerged from a series of research projects on the European Employment Pact. Previous ETUI studies have covered the Cardiff, Cologne and Luxembourg processes and have focused on, among other things, the interdependence of macroeconomic and employment policies. One publication examined the relevance of the European Employment Strategy to the new Member States. It was logical to examine what impact the run up to the euro, involving the adoption of the Stability and Growth Pact criteria, might have on overall development prospects and in particular on labour markets. By now it is clear that the medium-term macroeconomic policies of the new Member States are being determined by the timetable of their EMU accession, with far-reaching implications for the whole economy and society. As one of the basic ambitions of the European Employment Pact is to find a balance between macroeconomic policy and sustainable employment growth, and the central objective of the Lisbon strategy is 'more and better jobs', it is crucial to examine how these objectives manifest themselves in the new Member States in the context of eurozone accession.

Our aim was to provide an overview, country by country, of how the policy choices related to euro adoption emerged and how they appear in public debates and at the level of national social dialogue. We also examined the potential impact of eurozone accession on real convergence, social protection and employment growth.

The Stability and Growth Pact (SGP) criteria are well known and well documented (Gros et al. 2004; ECB 1999). However, it is worth recalling their main features and the underlying rationale.

> It is a unique feature of the eurozone that monetary policy is centralised in the hands of the European Central Bank (ECB), while fiscal policy remains decen-

> tralised in the hands of the individual member states. It was therefore recognised that to support the ECB's responsibility to maintain price stability and to prevent free-riding, fiscal policy had to be subject to rules in order to ensure discipline of public finances. These rules consist of two pillars. First, member states' general government deficit/GDP ratio cannot exceed 3% (only under exceptional circumstances) and its general government debt/GDP ratio cannot exceed 60% (in cases of a higher debt ratio, it must be reduced). How were these reference values chosen? It has been suggested (Thygesen, 2002) that 60% was the average debt ratio of the EU Member States in 1990 and if countries kept their deficit at the 3% limit, their debt would converge to 60%, assuming that nominal GDP is rising at a trend rate of ca. 5% real growth (assumed to be the potential output growth of the EU at that time) plus 2% inflation (in line with the ECB's inflation target). (Orban and Szapáry 2004)

Euro adoption is framed by a very particular context in the CEE new Member States. Being transformation economies in dynamic change, their social and economic environments are fundamentally different from those of the established market economies of the eurozone. The first question which arises is, what is the urgency of imposing the 'strait-jacket' of the euro on these countries that are so different from the core eurozone countries and find themselves in a different phase of development?

Examining recent debates on eurozone accession one may wonder to what extent the issue is being tackled on a rather simplified, technical basis at most levels of policy making. It is taken for granted that early entry into the eurozone is beneficial for the development of all these countries.

Horst Koehler (at that time director of the IMF) in a keynote speech at an international conference said:

> Joining the common currency area will provide a further significant boost to economic development [in the CEE countries – *BG*] through increased trade and financial flows by lowering transaction costs and eliminating market risks. But this is not the time to relax. The gains from adopting the euro will not accrue automatically.

Some external observers add that certain difficulties and sacrifices are to be expected from fulfilment of the Maastricht criteria, but that they will be compensated by euro adoption. Lower risks and higher trade and investment are expected and a surplus growth rate is also assumed (European Policy Centre 2004; IMF 2004).

On this interpretation, the question merely concerns how governments will be able to ease the bitter pill of fiscal and monetary adjustment for their citizenries. A World Bank report (World Bank 2004) states that 'the Visegrad countries (in particular the Czech Republic, Hungary and Poland) will need a longer period to bring fiscal deficits – and in some cases inflation (Hungary and the Slovak Republic) – under control, and will not be in a position to adopt the euro until 2008–10', then adds 'Weak popular support for governments and political instability in some countries is complicating economic policy-making and reform implementation'. Zsigmond Járai, President of the Hungarian National Bank, stated in an interview that 'the introduction of the euro is a question of power: while it is an advantage for enterprises, it has costs for politics, as the budget deficit must be pushed down' (Napi 2004).

Even the title of government plans on the timetable of eurozone accession is telling, namely 'convergence plans', often incorporating the term 'meeting the convergence criteria', as if the fiscal and monetary convergence involved in meeting the Maastricht criteria were part and parcel of achieving the overarching aim of all new Member States, namely economic and social convergence with the core countries of Europe (referred to more precisely as 'real convergence'). Moreover, the political climate of the national approaches is peculiar. After the lengthy process of EU accession with its culminating period marked by 'a rush into the EU' with all the technicalities of transposition of the *acquis*, now the new Member States find themselves 'rushing into the eurozone' under the same momentum. And while meeting the Copenhagen accession criteria was seen as a race, with countries closely monitoring one another's performance, the same pattern can be seen in relation to eurozone accession.

Peter Papánek, spokesman of the Slovak Finance Ministry, stated: 'We have a realistic chance of fulfilling the Maastricht criteria on time. For a small and open economy like Slovakia it is of the greatest interest to join the developed economies as soon as possible'. He added: 'Even so, Slovakia will not be the frontrunner, as Estonia, Lithuania and Slovenia will be quicker' (*Népszabadság* 2005).

The framework of EMU accession appears more in a context of 'managing' and 'fulfilling' than of a conscious policy choice based on weighing up the pros and cons of the process in terms of national development priorities and discussions with the social partners.

Evaluations of the impact of euro adoption on real convergence, social welfare and employment have not been carried out in any of the countries concerned and the topic has not been addressed in publications or debates.

If we examine the situations of the individual countries we must emphasise that the new Member States cannot be handled as an homogenous group when assessing the potential benefits and drawbacks of EMU entry and its timing.

First, there is a fundamental difference between countries according to currency regime. For the Baltic States with their currency board arrangements (or hard peg in the case of Latvia), their failure to maintain an independent monetary policy means that there would not seem to be substantial benefits to be gained from a long transition period. For the countries with floating currencies and individual monetary policies, however, it is a much more complex issue in relation to which national characteristics and country priorities become decisive.

At the same time, the CEE countries have important common features that distinguish them from the current eurozone countries.

In this context, three major considerations arise:

1. Their different macroeconomic profile, characterised by substantially lower GDP levels, with more dynamism (for example, close to 10% nominal growth rates, high but uneven productivity growth), ongoing transformation and convergence (catch-up process).
2. Higher social risks in the form of a 'welfare deficit' accumulated during the transformation, with severe labour market tensions (low employment and/or high unemployment) and an increase in poverty and inequalities which need special attention, especially if the European Social Model is taken as reference.
3. Economic backwardness, implying a need for greater investment. Public investments in infrastructure, health care, education, research and development and environmental protection are badly needed for these countries in order to induce convergence with their more developed EU counterparts and to comply with their commitments related to adoption of the *acquis communautaire*.

Our thesis is thus twofold:

1. Due to their different macroeconomic profile and transformational character, the SGP criteria in their present form are not appropriate for the CEE new Member States.
2. On the other hand, due to their specific post-transition character, higher social risks and economic backwardness, higher public investment, welfare spending and employment growth are required, as a result of which the inadequate monetary and fiscal criteria will result in unnecessary constraints and thus harm their development prospects. This also clashes with the objectives of the Lisbon strategy and the principles of the European Social Model.

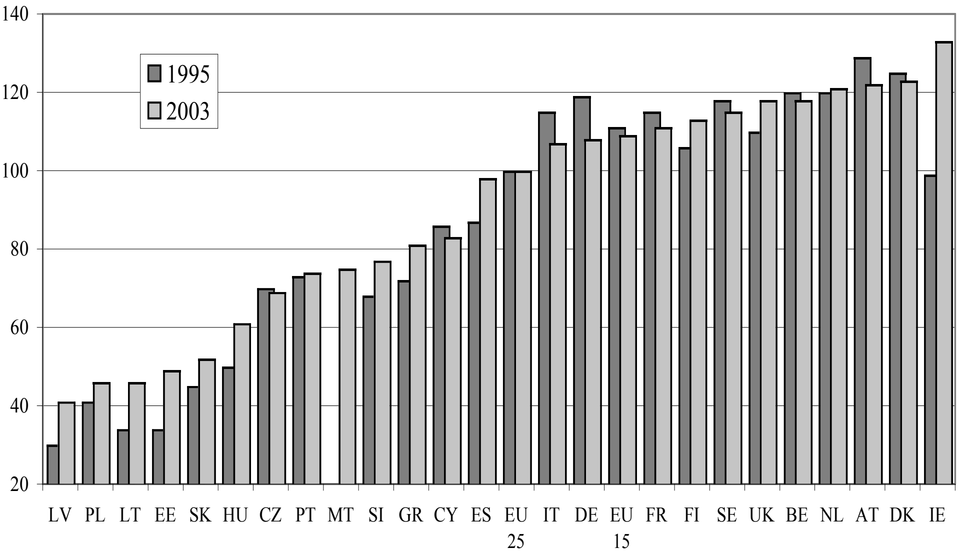
1 Macroeconomic framework in the new Member States

The new Member States of Central and Eastern Europe have important common features that distinguish them from the current eurozone countries. In this section, we shall present the most striking differences in terms of macroeconomic development.

1.1 Economic dynamism and transformation

CEE countries are substantially poorer than their Western counterparts. Their GDP per capita is roughly 50% of the EU-25 average, taking differences in purchasing power into account (without this correction – at exchange rate parities – it would be less than a quarter).

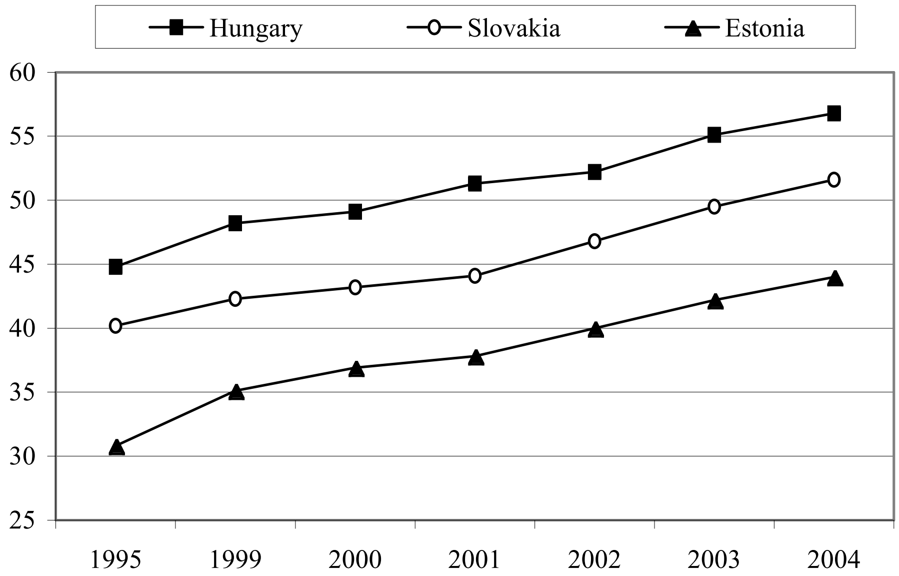
Figure 1: GDP per capita 1995–2003 in PPS (EU-25=100)



Source: ETUI/ETUC (2005) Benchmarking Working Europe, Brussels

Real convergence, the major objective of these countries, is well under way. Figure 2 shows this in more detail in the case of three countries. In the period 1995–2004 GDP per capita rose substantially compared to the EU-15 average (PPP), from 30.8% to 44.0% in Estonia, from 40.2% to 51.4% in Slovakia and from 44.8% to 56.8% in Hungary.

Figure 2: GDP/capita as % of EU-15 average at PPP, 1995-2004



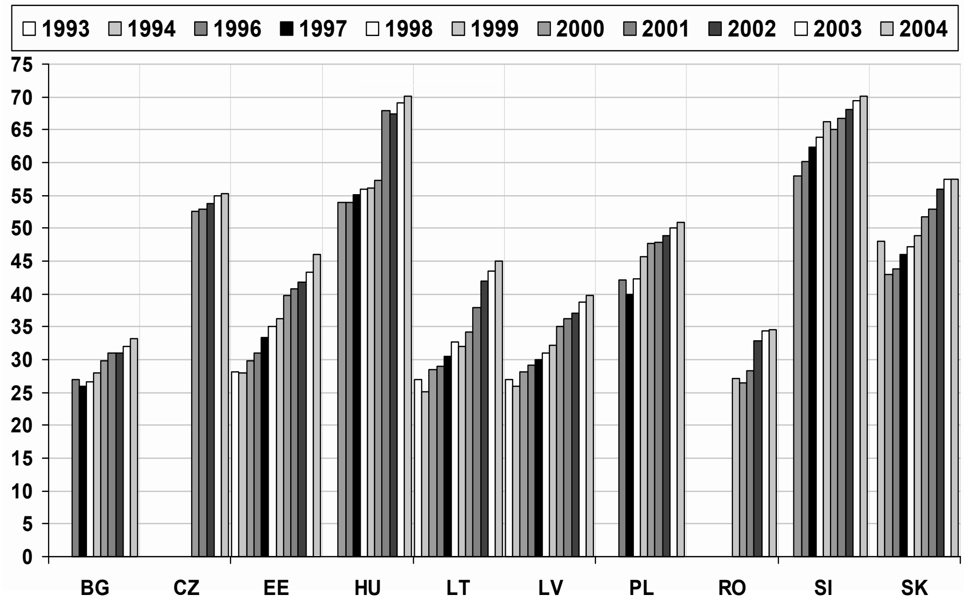
Source: L. Podkaminer et al., WIIW Research Reports 303 (2004).

The second important feature is greater dynamism and their 'transformational character'. National economies still under transformation are characterised by dynamic growth, including extraordinary and uneven productivity increases. Their 'transformational character' also manifests itself in terms of distortions (different price and cost structures) as an inheritance of the previous economic model and disproportionalities (wage and productivity relations) due to turbulent transformation processes. The fundamental restructuring required by their reintegration into the world economy and the transition to a market economy remains incomplete in these countries (large and inefficient agricultural sectors in some countries, as well as unresolved problems related to steel, coal and mining). These factors have consequences for future development.

Real GDP growth in the new Member States is around 5% on average, twice as high as the EU-15, with nominal growth rates close to 10% in most cases.

Productivity improvements have also been spectacular showing steady catch-up towards the EU-15 average. Figure 3 presents average productivity at PPP (in exchange rate terms catch-up is much more spectacular, although the levels are lower). It is also a feature of transformation (catching up) economies that productivity developments are uneven among sectors. The dynamism of industrial productivity and in general in the tradable sector of the economy is much greater than in the non-tradable sector. This phenomenon will have a major impact on future development (see section 2.2).

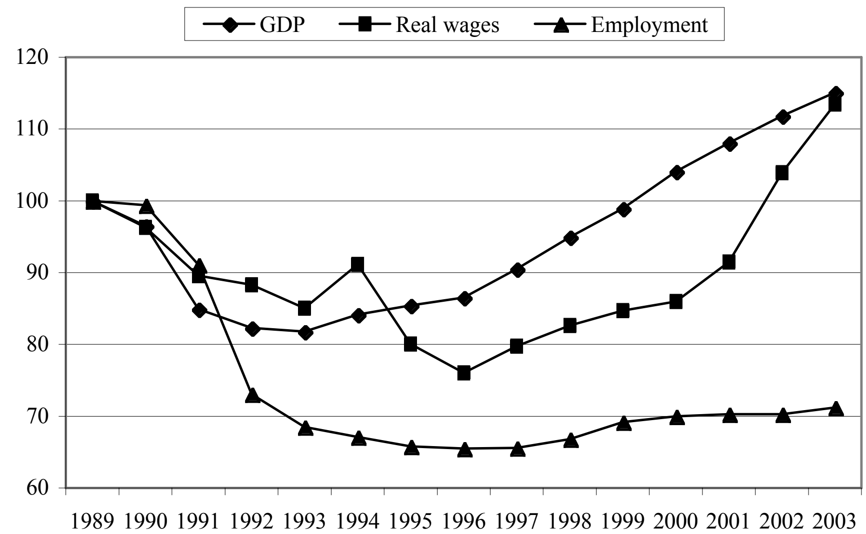
Figure 3: Labour productivity in terms of product per worker at PPP, % of EU-15 average



Source: based on Eurostat (taken from the chapter on Estonia).

The 'transformational character' of these countries also appears in other forms. If we look at some of their development characteristics in the past decade, turbulent processes can be observed, which we can demonstrate here with the example of Hungary. Figure 4 does not depict a balanced

Figure 4: Hungary: GDP, real wages and employment, 1989–2003 (1989 = 100)



Source: Benchmarking Working Europe (ETUI 2005).

development pattern. What is most striking is how the GDP growth trend diverges from the development of employment (this is a common feature of all CEE countries, labelled 'jobless growth'). Wage developments did not keep pace with productivity developments, leading to corrections in the most recent period. These imbalances will probably result in further corrections in the future, requiring a certain macroeconomic flexibility.

Price and cost structures are also quite different in the new Member States in comparison with the EU-15, manifesting themselves in terms of a substantial gap between exchange rate and purchasing power parities.

Table 1: Relative price levels of household final consumption, including VAT, 2002

EU-25	96
EU-15	100
Euro-area	**97**
Czech Republic	53
Estonia	56
Cyprus	83
Lithuania	51
Latvia	50
Hungary	55
Malta	72
Poland	57
Portugal	74
Slovakia	44
Slovenia	73

Source: Eurostat (based on the Czech Republic chapter).

It is also decisive that wage and productivity levels are much lower compared to the EU-15.

Table 2 clearly shows that the wage gap between the CEE new Member States and the EU-15 (here represented by Austria) is substantially greater than the gap in productivity. This indicates that wages are not only low in absolute terms, but also lagging in relation to economic performance (productivity level). In some countries, such as Hungary, Slovakia and the Czech Republic, this wage/productivity gap is quite substantial.

All this must be seen in the context of recent dynamic wage increases. As Figure 5 indicates, real wage increases in most CEE new Member States in 2000–2003 substantially outperformed wage developments in the eurozone members. In some countries, such as the Czech Republic, the Baltic States

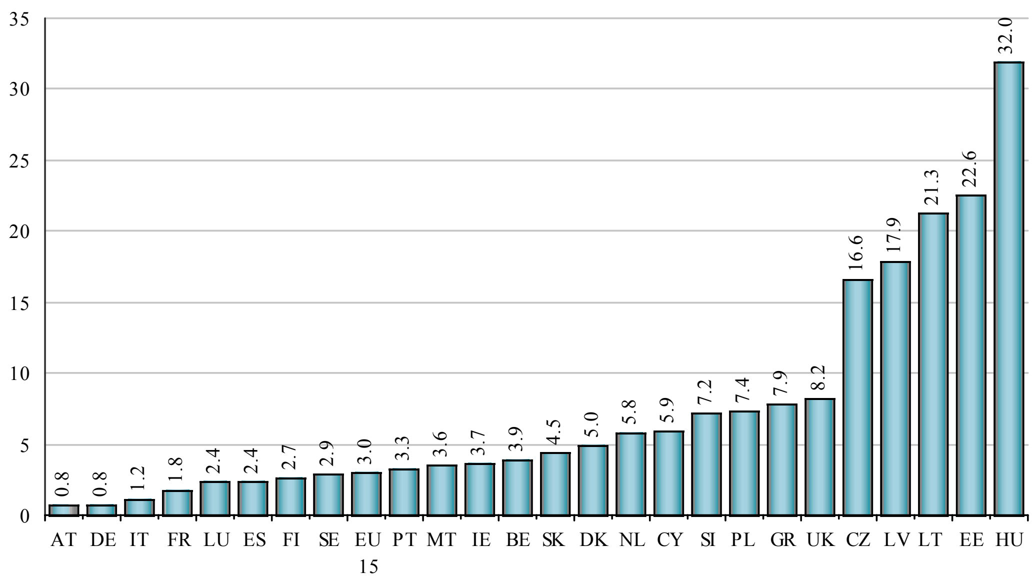
Table 2: Labour productivity and wage levels in CEE-8 compared with Austria (2003)

	Labour Productivity (GDP per worker, PPP)	Wages (PPP)
Czech Rep.	64	43
Hungary	65	42
Poland	51	44
Slovakia	56	31
Slovenia	73	61
Estonia	45	37
Latvia	42	29
Lithuania	46	29
Austria	100	100

Note: Austria = 100.

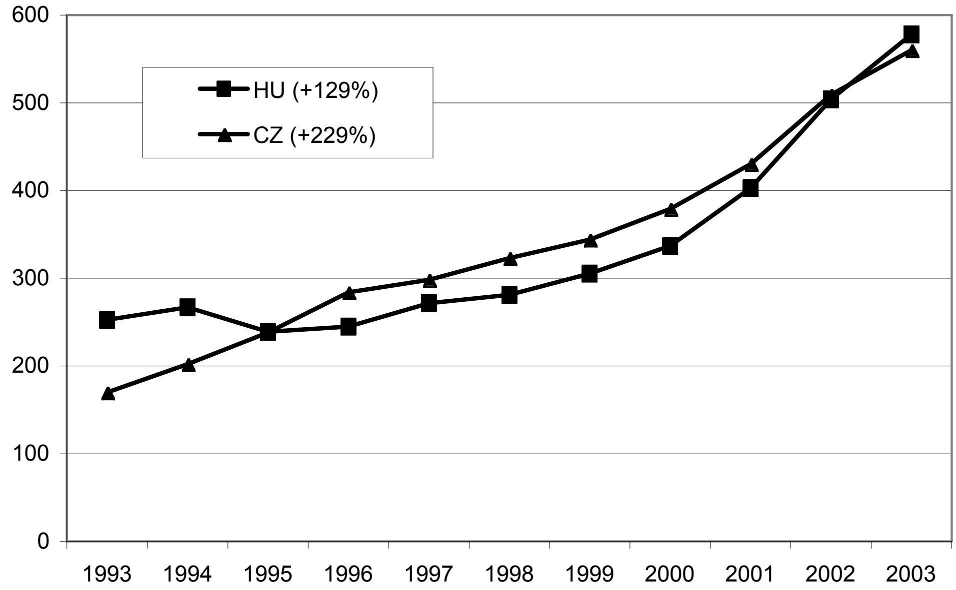
Source: Podkaminer and al. (2004), based on the Czech report.

Figure 5 : Real wage growth 2001–2003 (2000 = 100)



Source: ETUI/ETUC (2005) Benchmarking Working Europe, Brussels.

Figure 6: Wage development dynamics in the Czech Republic and Hungary in euros (average wages)



Source: WIIW database 2003, ETUI 2004.

and, especially, Hungary it was seen as unsustainable.[1] It can, however, also be seen as an adjustment building on previously accumulated productivity reserves. As we have seen, wage levels are still far behind productivity levels. There is still a long way to go, although the Maastricht criteria cast doubt on further corrections for the time being.[2]

Figure 6 also shows on the examples of the Czech Republic and Hungary how wages (expressed in euros) have increased over the last decade. (Here it may be noted that the 32% real wage increase indicated for Hungary in Figure 5 for 2000–2003 appears as an increase of 60% in euro terms!).

Figure 6 also presents the impact of the appreciation of CEE currencies against the euro. Such an adjustment (a combination of high real wage increases and currency appreciation) will also not be possible under the SGP criteria.

Another important factor should also be emphasised here. The case of Hungary with its 'wage correction' provided an important lesson. Although

1. Excessive wage increases (beyond productivity increases) were criticised by economic analysts, European institutions and international investors. The process was seen not only as jeopardising competitiveness, but also as generating inflation and thus endangering economic stability and monetary convergence. On the other hand, exports were not affected.
2. Primarily because the inflation target would be threatened by such 'corrections'.

it did not cause a setback in terms of economic performance (especially export performance and foreign investment), it did result in a setback in terms of monetary and fiscal convergence through which Hungary found itself at the end of the queue in terms of EMU accession. Interestingly, however, this process has triggered important qualitative changes in the structure of the economy and brought about an upgrading of foreign investments, shifting towards higher value added and less labour intensive activities.

There is a broad consensus that a ‘low wage profile’ does not represent the future for these countries. It will be an important challenge to break out of the low wage profile while at the same time not endangering EMU accession or, once inside EMU, the ‘upgrade’ process.

The figures and tables we have presented demonstrate the turbulent economic processes and unbalanced character of transformation and catch-up economies. The bottom-line is that further corrections are still to come, requiring macroeconomic flexibility.

1.2 The Balassa-Samuelson effect

A number of characteristics of transformation economies are expressed by the Balassa–Samuelson effect.

The Balassa–Samuelson effect (Balassa 1964; Samuelson 1964) may be considered crucial in determining suitable exchange rate policies for the accession countries before joining EMU.

In a developing economy catching up with income levels in more economically advanced countries, productivity in tradable goods sectors will tend to rise faster than in non-tradable sectors (United Nations 2001, 1). Since wage increases tend to be more or less the same in all sectors, relatively faster productivity growth in the tradable sector of accession countries will convert into a higher inflation rate if the exchange rate remains constant (Buiter and Grafe 2002).

The Balassa–Samuelson effect is due to the productivity growth differential which results in an equilibrium appreciation of the real exchange rate in a catch-up economy (Szapári 2004).

Simulation results show that the effects could be quite different in individual countries (Egert 2002). The findings show that in the Czech Republic, Slovakia and Slovenia the impact of productivity growth on the inflation differential relative to Germany ranged from 0.9% to 1.3%. In Poland and Hungary, the impact of the Balassa–Samuelson effect is greater than in other countries, ranging from 2.6% to 3.5% in Hungary and from 1.5% to about 3.3% in Poland. Doyle et al. estimate the size of the Balassa–Samuelson effect to be on average 1% to 3% a year (Doyle et al. 2001, 10).

Over the last couple of years all CEE currencies have experienced strong real appreciation against the euro.

The Balassa–Samuelson effect means on average that in the case of fixed exchange rates inflation will be higher by 1% to 3% compared to the EU average. In other words, the equilibrium level of inflation is 1 to 3 percentage points higher in the CEE new Member States than in the EU-15 (de Grauwe 2004).

György Surányi, former president of the Hungarian National Bank, sums up the contradictory impact of the SGP criteria in a recent publication, as follows: 'As the potential growth rates of the CEE new Member States are higher, productivity is improving at higher speed as well, so their currencies will appreciate in real terms. Under these circumstances, there is no way of meeting the exchange rate stability criteria and the inflation criteria simultaneously' (Surányi 2005).

1.3 Consequences: stricter SGP criteria for the CEE countries than for current EMU members

Nominal growth rates in the new Member States fluctuate between 7% and 11%, as a result of real growth rates of 4–5% and consumer price indexes 2–4 percentage points higher than in the eurozone. Assuming that a sustainable fiscal situation is based on a GDP/debt ratio not exceeding 60%, the maximum tolerable fiscal deficit is 4–5% a year for the CEE countries. The nominal criterion must therefore be stricter when applied to the CEE candidates for EMU (Surányi 2005).

The same nominal criteria of the SGP when applied to the CEE new Member States are stricter and less appropriate than for the present members of the eurozone. This is clearly the case with inflation and the fiscal criterion (it is also well known that most CEE countries have government debt levels well below the 60% mark).

We have also mentioned that the transformation character and inherited 'disproportionalities' (for example, price, cost and wage levels) of these countries make corrective adjustments necessary. These cannot be made in the 'straightjacket' of Maastricht.

The result is that applying the SGP criteria in the same nominal manner hampers growth potential, employment growth and real convergence.

2 Welfare challenges and investment needs

CEE new Member States are also different because they have higher social risks and badly need public investment (infrastructure, education, employment, research and development).

As economies in transformation that have successfully managed a fundamental structural change in the past decade, most of them face serious social and welfare challenges, differing from country to country. Even the World Bank has warned of the welfare risks of eurozone accession in one of its recent reports, pointing to unemployment, poverty and high and growing regional differences (World Bank 2004). It is widely known that employment rates are characteristically low, with the exception of Slovenia and the Czech Republic, in some countries aggravated by high unemployment (especially Poland and Slovakia), poverty and social exclusion. Health care and education spending has declined in the last decade and labour market policies are under chronic budgetary constraints. András Inotai, a Hungarian economist, characterises this situation as the conversion of an initial 'modernisation deficit' into a 'social deficit' (Inotai 1999). The analogy refers to the fact that besides foreign direct investment, the other major source of structural change and modernisation in these countries in the last decade has been social protection cuts. A substantial redirection of income has taken place from the population to the business sphere. This also explains why in critical phases of restructuring, wage development lagged substantially behind productivity increases (for example, Hungary in the mid 1990s, Slovakia in 2000–2003).

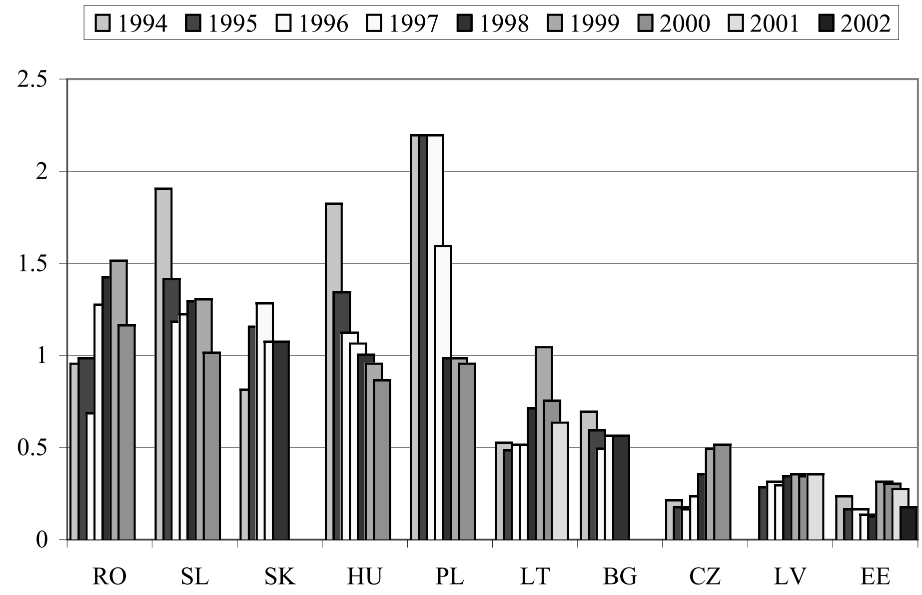
If we look at employment issues and objectives, as also addressed by the country reports contained in this publication, the National Action Plans for Employment (NAPE) of most countries have formulated ambitious goals to improve the situation, with particular attention to the employment rate, youth unemployment, long-term unemployment and at-risk groups.[3]

Figure 7 shows that labour market policy expenditure is very low and in some cases declining. It is worth adding that expenditure on active measures makes up a tiny – and in most cases declining – proportion of total spending (for more on this issue see Galgoczi, Lafoucriere and Magnusson 2004).

NAPE provisions on upgrading active labour market policies were often pushed into the background, as budgets were insufficient to cover even the passive measures.

3. For more details on the NAPEs of individual countries, see the country chapters of this publication.

Figure 7: Labour policy expenditure



Source: Raum Eamets's overview report, based on Eurostat data, 2003.

It is worth asking how the ambitious NAPE objectives of the new Member States match up to their monetary and fiscal convergence plans in the run-up to the euro.

Keune and Rhodes (Keune and Rhodes 2005) examined the EMU candidates in two dimensions: (i) 'public expenditure pressures' and (ii) 'welfare stress'. The 'social risk index' was made up of three components: unemployment, risk of poverty and old-age dependency ratio. By combining these factors, they identified different social risk levels among the EMU candidates and assessed the social challenges facing these countries in their run-up to the euro.

Slovenia is the best performer in the CEE group, with low welfare stress, high social spending and relatively low debt.

The Czech Republic, while suffering from low-to-moderate debt and high deficits, has a low level of social expenditure, a high employment rate and a low level of 'welfare stress'.

These two countries are not facing serious social welfare problems in the process of euro adoption.

The Baltic States have a medium employment level, low deficits and low social spending, but a high level of 'welfare stress'; they need not fear a further deterioration of their welfare situation due to fast-track entry into the eurozone, but they will have to address their welfare problems within EMU.

Hungary is in an intermediate situation, with high debt, high deficit levels and a medium level of social spending. With a relatively low ‘social stress index’, EMU, while being a constraining factor, is not likely to threaten the social situation.

Slovakia and Poland can be seen as risk countries, where the public expenditure constraints of EMU could result in serious social tensions. With low employment rates and high unemployment, as well as high welfare stress, these countries face substantial social challenges and difficult policy choices in the course of EMU accession.

On the other hand, public investment in education, health care, research and development, infrastructure and environmental protection are of primary importance for the future development of all these countries. Moreover, substantial investment (for example, in infrastructure and the environment) are obligatory under the *acquis communautaire*. It should be noted that even if financial transfers from the EU regional and cohesion funds will help with these objectives, the net impact on fiscal positions will be negative. While national contributions (a precondition of EU transfers) are paid from central budgets, subsidies go directly to the economy (for example, agricultural producers) or into investments.

Such investment is urgently needed if these countries are to develop from ‘low wage subcontractor’ status towards knowledge based societies. Paradoxically, ongoing developments in some new Member States aimed at abandoning the low wage profile and strengthening the ‘knowledge based profile’ may well come under constraint if the SGP criteria are interpreted rigidly and on a short-term basis.

3 Different monetary policy approaches

The basic thesis is that open economies with close trade links to the EU will benefit from fixed exchange rates as the transaction costs for international trade decline. With the cost of foreign exchange risk eliminated, more division of labour within the enlarged euro area is expected to increase welfare. Frankel and Rose (2002) have suggested that the merits of monetary union membership are quite significant – trade with other currency union members is expected to triple, thereby boosting real growth and welfare gains. IMF experts also argue the trade generation effect of currency union, with gains also in terms of foreign direct investment.

3.1 The theory of 'optimum currency area'

The EMU accession of the CEE countries has been widely discussed within the framework of the theory of optimum currency area (OCA), as put forward by Mundell (1961) and McKinnon (1963). The main criteria applied are openness and asymmetric shocks. Within the OCA framework, countries considering joining a monetary union will weigh the potential benefits of exchange rate stability for international trade against the costs of giving up monetary policy independence.

The trade of the CEE accession candidates with the EU-15 as a percentage of GDP is about as high as for the present EMU members after more than four years' EMU membership. Exports to the EU as a percentage of GDP average 28.7% for the CEE countries in comparison with 26.8% for the EMU member states (2001). Economic integration with the EU is much stronger for the CEE countries than for the Member States outside EMU – Denmark, Sweden and the UK (16.5% on average) – which would undoubtedly qualify them for joining the currency union (De Grauwe and Schnabl 2004).

Another important aspect is the synchronisation of economic cycles, resilience to asymmetric shocks, flexibility of prices and wages and international labour force mobility. Some of these criteria are not fulfilled by the present members of the euro area. In future, and considering possible divergent developments, this could produce high costs related to the maintenance of monetary union.

Given that economic structures and business cycles in Central and Eastern Europe are quite different from those in the EU-15, in combination with the assumption that labour mobility and wage flexibility are restricted, the

CEE countries probably do not qualify for EMU accession, at least if the OCA criteria are applied. De Grauwe also adds, ‘nevertheless, EMU accession seems to be tempting as most CEE countries have expressed their strong intention to join the EMU as soon as possible’ (De Grauwe and Schnabl 2004).

3.2 Exchange rate regimes in new CEE Member States

The choice of monetary regime and exchange rate policy have been crucial for the transition countries as small open economies (with the exception of Poland) vulnerable to external developments. Developments of the exchange rate systems of CEE countries are summarised in Table 3.

Estonia, Lithuania and Bulgaria, through a currency board arrangement, and Latvia through a conventional hard peg have maintained a hard peg in relation to a single anchor currency, the euro, while at the same time other countries have either remained with floating pegs or moved towards more flexible systems, like Slovakia or Poland.

Table 3: Evolution of exchange rate regimes in the new Member States

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Bulgaria	8	8	8	2	2	2	2	2	2	2
Estonia	2	2	2	2	2	2	2	2	2	2
Lithuania	2	2	2	2	2	2	2	2	2	2
Latvia	3	3	3	3	3	3	3	3	3	3
Malta	3	3	3	3	3	3	3	3	3	3
Hungary	7	5	5	5	5	5	5	4	4	4
Cyprus	4	4	4	4	4	4	4	4	4	4
Czech Rep.	3	3	6	7	7	7	7	7	7	7
Poland	5	6	6	6	6	6	7	7	7	7
Romania	7	7	7	7	7	7	7	7	7	7
Slovenia	7	7	7	7	7	7	7	7	7	7
Slovakia	3	3	6	6	8	8	8	8	8	8

Notes: 1 – Dollarisation/euroisation, 2 – currency board, 3 – conventional fixed pegs, 4 – horizontal bands +/– 15%, 5 – crawling pegs, 6 – crawling bands, 7 – managed float (with ER path), 8 – independent float.

Source: DG ECFIN, National Banks (Raul Eamets).

Experience shows that the currency board arrangement has been very successful in curbing inflation within a short period (especially above the 10% mark), while differences in growth performance cannot be clearly attributed to currency regimes. As Raul Eamets states in the chapter on Estonia, the success of the currency board arrangement lies to a great extent in fiscal discipline, which has been maintained in all the Baltic States. There is a second crucial element in relation to a currency board arrangement, namely choosing the right entry exchange rate (with undervalued currencies) leaving enough room for maintaining competitiveness later on due to inflationary differences. The currency board arrangement combined with financial discipline has helped to restore credibility and provide protection from currency speculation.

Table 4: Fiscal and monetary convergence, planned EMU accession

	Inflation			Budget balance**			State debt			EMU entry
Country	2004 ave.	2004 Dec.	2005 ave.	2003	2004	2005*	2003	2004	2005*	
Slovenia	3.6	3.3	2.9	–2.0	–2.3	–2.2	29.5	30.9	30.8	2007
Estonia	3.0	4.8	2.6	3.1	0.5	0.2	5.3	4.8	4.4	2007
Lithuania	1.1	2.8	2.8	–1.9	–2.6	–2.5	21.6	21.2	21.7	2007
Latvia	6.2	7.4	3.4	–1.5	–2.0	–2.8	14.4	14.6	15.4	2008
Cyprus	1.9	3.9	2.1	–6.4	–5.2	–2.9	70.9	74.9	71.4	2007
Malta	2.7	1.9	2.7	–9.6	–5.2	–3.7	70.4	73.2	72.0	2008
Slovakia	7.4	5.8	4.0	–3.7	–3.8	–3.8	42.6	43.0	44.2	2009
Poland	3.6	4.4	3.2	–3.9	–5.4	–4.1	45.4	45.9	47.6	2010
Czech Republic	2.6	2.5	2.8	–12.8	–5.2	–4.7	37.8	38.6	39.4	2010
Hungary	6.8	3.6	3.3	–6.2	–5.5	–5.2	59.1	59.9	59.5	2010

Notes: * prognosis; ** without private pension funds (otherwise in the case of Poland and Hungary ca. 1% points less).

Source: EC, ECB, prognosis based on national sources, EC and Ecosoc (2005).

The ERM II period

Special risks are attached to the ERM II period, as several experts have pointed out. Charles Wyplosz argued in the *Financial Times* (Wyplosz 2003) that EMU accession countries within the ERM II system are especially vulnerable to speculative attacks, with eventual destabilising effects. He argues that the ERM II system is not an appropriate framework for the fiscal and monetary convergence of the CEE countries. The transitional period of two years does not seem well founded. Looking at exchange rate volatility over the last five years, no movements have exceeded the 15% band.

4 Benefits and risks of eurozone accession

4.1 The 'mainstream' approach

Mainstream economists, including the IMF, most experts, financial institutions, and the majority of policy-makers in the corresponding countries see the positive and negative aspects of EMU membership in rather technical terms (European Policy Centre 2004; IMF 2004).

Seen from the perspective of the EMU, as a whole:

Positive factors

- The small size of the new Member States compared to the eurozone (5–6%) in GDP terms should facilitate its enlargement.
- Most new Member States can show a solid overall performance in terms of stability and nominal economic convergence criteria.
- The catch-up process – real economic convergence – is well under way.

Negative factors

- In some of the new Member States strong efforts are still needed to meet the Maastricht convergence criteria, notably in bringing inflation and public deficits down (which might give rise to political difficulties in some countries).
- Some countries are still experiencing very high levels of unemployment.
- Huge current account deficits are often the 'downside' of high levels of FDI, especially in the Baltic States, Hungary and the Czech Republic.

Seen from the perspective of the EMU candidates, the following mainstream arguments are most often raised:

Positive impact

It is expected that EMU accession will result in an increase in growth rates, thus boosting real convergence of GDP with the EU average. Estimates count on temporary growth-rate falls of between 0.3 and 0.8 percentage points, followed by gains of 0.2 to 0.4 percentage points in the coming years (European Policy Centre 2004). According to the IMF (IMF 2004), ‘over the long term, euro adoption could raise GDP by an additional 20–25 percent in most Central European countries’. This would be a result of the following factors:

- Lower interest rates, leading to higher investment accompanied by lower costs of public debt servicing.
- Elimination of exchange rate risks and lower foreign trade transaction costs (Oblath 2003).
- Better environment for FDI due to increased credibility.
- Possible stimulus for structural reforms through the disciplining impact of ERM II participation on domestic policies.
- Increased macroeconomic stability and further convergence of business cycles.
- Once inside EMU, the option of influencing the monetary policy of the ECB to a greater extent than these countries’ relative economic weight might otherwise allow.

4.2 A critical approach

Based on the country reports contained in this publication and the macroeconomic considerations about transformation economies, the following arguments may be put forward.

As already mentioned, the different macroeconomic profile, in relation to the EU-15, of the new Member States calls into question any rigid application of the SGP criteria to them. As is well known, the SGP criteria in their present form have also been heavily criticised within the EMU, and the performance of the EMU countries, especially Germany and France, in contrast with the UK and some Nordic countries that are not EMU members provides no encouragement.

The Balassa–Samuelson effect due to high and uneven productivity developments results in a higher equilibrium inflation rate (at a constant exchange rate) than in the EMU countries and in accordance with the SGP criteria. A higher inflation rate could result from other things too, however. Two factors in particular are often neglected in discussions of the issue.

1. Cost and price structures in the CEE new Member States are still substantially different due to historical reasons (for example, regulated

prices, suppressed inflationary pressures, and so on) as expressed in the gap between purchasing power parity and market exchange rates (ratios range from around 1.3 in Slovenia to 3 in some of the Baltic States and Bulgaria, with an average value of around 2). The current gap, together with its distortions, is likely to be fixed within the EMU 'straitjacket'.

2. The imbalance between wage and productivity levels (mentioned above). For historical reasons and due to the nature of the transformation, current wage levels are substantially behind productivity levels if the wage/productivity ratio of the EU-15 is taken as reference. This means that there is a 'productivity reserve' in these economies, which would theoretically allow wage increases beyond productivity growth, as seen in Hungary in the last three years. Due to application of the SGP inflation constraint in these countries wage convergence is coming under pressure.

However, it is an objective of most CEE new Member States to abandon their low wage profile and promote the development of a knowledge-based economy. Forcing inflation rates to meet the SGP level could hamper productivity development, growth and real convergence.

There are also problems with the fiscal criteria.

The aim behind the SGP criteria was sustainable public finances by maintaining an appropriate public debt/GDP ratio. The rigid SGP criteria – including a 3% public deficit/GDP ratio – were tailored to the growth rates of the current EMU countries and to the debt levels of the most indebted countries, such as Belgium and Italy. EMU candidates with public debt levels well below the 60% mark and nominal growth levels close to 10% could well maintain annual deficits of 4–4.5% without increasing public debt (Surányi 2005).

Given that the 'straitjacket' of the current SGP rules is unlikely to fit the specifics of these countries, growth, employment and real convergence would seem to be in real danger.

Further arguments refer to welfare risks and public investment, as already mentioned. Most transformation countries are afflicted by a 'welfare deficit' and are in desperate need of well targeted public investment.

Here the principles of the European Social Model and the Lisbon agenda are indicative. It should also be seen that there is a clear contradiction between the objectives of the Lisbon agenda and the current SGP criteria regarding the new CEE Member States. The relation between the SGP criteria and the principles of the European Social Model can also be seen as 'ambiguous'.

The clash of objectives is apparent if the principles of the European Social Model are considered. While on the one hand the EU-15 countries are becoming increasingly concerned about what they call ‘social dumping’ from the East, rigid application of the SGP criteria imposes serious constraints on CEE countries, preserving distortions in price and cost structures, and disproportionalities between wage and productivity levels.

There is also a contradiction in relation to different levels of integration with the EU. An absurd situation will arise when new Member States enter EMU but still do not enjoy one of the basic EU freedoms, freedom of labour. This will represent a serious asymmetry, particularly given the fact that with less monetary and fiscal freedom, member states would need more mobility and flexibility in other areas to absorb eventual shocks. This is why the ECOSOC working document advises new Member States not to enter EMU before the end of the transition period for the free movement of labour (ECOSOC 2005).

It seems therefore that the main story in relation to EMU accession and its timing is not the ability of these countries to cope with the SGP criteria (as is almost universally declared) but rather its rationale and impact. Naturally, the timing of the process is most amenable to rational action. The main question in policy terms concerns how the agenda of EMU accession suits the national priorities of the new Member States.

4.3 Lack of social dialogue

It depends very much on the specific circumstances of individual countries and also on national priorities, what the optimal trajectory of EMU accession would be. Unfortunately, public debates and social dialogue have not been held in most of the countries concerned. The general public, but also the social partners are not fully aware of the risks, since they have not yet been properly informed.

A comparative study by the European Foundation for the Improvement of Living and Working Conditions (EIRO 2004) examined the role that national-level ‘social pacts’ between governments and social partners might play in paving the way for the new Member States and candidate countries to join Economic and Monetary Union (EMU). National tripartite institutions might be seen as an advantage as regards the successful coordination of a macroeconomic issue of this kind. The fundamental issue in the new Member States and candidate countries (as the study put it) was ‘to what extent the existing national-level institutions are prepared to cope with the socio-economic challenges stemming from adhering to the

Maastricht criteria' and take an active role in the development of the EMU accession agenda.

In fact, as our national reports revealed, the social partners (with some exceptions) have not been involved in discussions about the eurozone accession agenda or in the elaboration of national monetary and convergence plans.

One exception is Slovenia, where the genuine involvement of the social partners from the beginning culminated in a Social Pact. Some social dialogue took place in the Czech Republic, where the trade unions contributed to a decision to put aside the first version of the EMU accession plan that aimed at early entry. The Czech and Moravian Trade Union Confederation (CMKOS) has elaborated its own risk assessment on the foreseeable social impacts of the EMU accession. In the other countries, however, the role of social dialogue has ranged from merely formal to marginal.

Paradoxically, the social partners in most countries have been involved in the elaboration of the National Action Plans on Employment with their ambitious employment policy targets. No one was really aware of the potential contradictions between these policy targets and the consequences of rapid eurozone accession.

It is even more peculiar that in its progress reports the European Commission put pressure on the – at that time – candidate countries to strengthen social dialogue and, within the European Employment Strategy, urged the involvement of the social partners in the drafting of the National Action Plans for Employment. This pressure bore fruit, as year after year social dialogue, at least in the context of the NAPEs, has made progress. This has been much less the case in relation to the monetary and fiscal convergence plans laying down the agenda of eurozone accession.

4.4 Country-specific features

As we mentioned at the beginning, the CEE new Member States cannot be treated as an homogenous group. There are two main groups of countries: (i) the Baltic States with their currency board arrangements (or hard peg) and (ii) the rest.

For the Baltic States staying outside EMU or choosing a longer transitional period would not offer any additional benefits, as the currency board arrangement already limits the scope of independent monetary policy. Their philosophy (as the Estonian report describes) has been that 'the rigidities of monetary and fiscal policies had to be offset by social and labour flexibility'. As we saw in the respective country reports, tight fiscal policies were a prerequisite for the successful maintenance of a currency board arrangement. For these countries it was a logical choice to adopt the euro as soon as possible. This does not mean, however, that the mismatches that appear in the context of the other countries would not have an impact on these countries. Constraints on social spending and public investments, such as the lower than potentially sustainable inflation rates, are also relevant here. Moreover, these countries have the lowest public debt and the highest growth, meaning that potentially higher deficit ratios would not undermine the basic stability criteria of public debt sustainability.

Even so, their policy options do not offer a viable alternative to an 'earliest possible' eurozone accession scenario. There is also broad consensus about fast-track adoption of the euro. It is another matter that the social partners were not involved in policy debates and macroeconomic policy formulation. The impact of this, however, was more limited in case of the Baltic States, as their room to manoeuvre and policy options were much tighter than elsewhere.

However, if the Baltic States would like to get closer to the principles of the European Social Model, they will have to increase their low levels of social spending. Furthermore, if they would also like to abandon the low wage profile of their economies, a somewhat higher inflation rate would offer them more room to manoeuvre.

Slovenia is a special case, having taken a gradualist approach and with a social pact underpinning the fast-track adoption of the euro. Slovenia represents best practice among the EMU candidates, although it is true that its level of economic development and starting position were much more favourable than those of the other countries. Still, Slovenia's practice of wide social dialogue should be an example to the others. (Slovenia is probably the only country which can manage fast-track EMU accession without substantial side effects on growth, employment and future convergence prospects.)

For the rest of the CEE new Member States, the situation is more complicated. Problematic cases are the 'Visegrad Four' countries that make up roughly 85% of the GDP of the current EMU candidates.

Among these countries, as country reports revealed, a number of different practices can be identified. Even so, it is a common feature that public awareness of the issues is at a very low level. The population, including the social partners, is almost entirely unaware that eurozone accession is not simply a technical matter, but something that will have a direct impact on development prospects and living standards. This is the responsibility of all political actors and the media. No systematic debate has been conducted on the policy options, the alternatives or the consequences. Although a number of documents and development strategy papers are being circulated, from national development strategies through action plans on employment to monetary and fiscal convergence plans, debate on how these policy options are interrelated has not been on the agenda.

Against this background, the four countries have different strategies, but ironically will probably end up in the eurozone in the same year, likely to be 2010. (To the appeal of the Polish finance minister to V4 colleagues to coordinate EMU entry and aim for 2010, the Slovak finance minister issued a flat rejection: 'we are not going to wait for the others, in *Népszabadság* 2005).

The most systematic approach among these countries, accompanied by partial social dialogue, was that of the Czech Republic, where trade union views influenced decision-makers to abandon the initial 'fast-track approach' of the EMU accession agenda. Given the low 'welfare stress' characteristic of the Czech Republic, its current track for the euro-zone seems to be the most realistic and sustainable within the V-4 country group.

In Hungary the political disagreement between the Finance Ministry and the National Bank injected unnecessary tension into the process of monetary and fiscal convergence towards the EMU. Instead of a deliberate strategy based on the country's characteristics and national priorities, a number of unrealistic commitments followed by corrections have undermined the credibility of both fiscal and monetary policy, resulting in a loss of confidence among (mostly short-term financial) investors. The current government has a political priority in balancing the welfare situation and gives fiscal adjustment a secondary place in its priorities. Open debate and a clear strategy have so far, however, not been seen.

Poland with its chronic employment problems and social tensions (having the highest 'welfare stress' among CEE countries) faces difficult policy choices in its EMU accession strategy. Previous enthusiasm about the Euro had given way to a more cautious approach. As stated in the Polish report: the 'euro as soon, as possible' strategy has been counterbalanced by the 'euro at the right time' position. It is an open question, however, how the different positions of political actors will be settled within the framework of a coherent national strategy.

Slovakia, as a pioneer of liberal economic reforms within its 'latecomer catch-up' strategy, has made spectacular improvements in its public finances and macroeconomic performance indicators. As a result of these, it positions itself as the Visegrad country with the highest chances of first entry to the EMU by 2009. Given the extremely high social price paid in the last years and the generally high "welfare stress" of the country – and also in light of the upcoming elections – it is still an open question whether this strategy will prove to be sustainable.

All these countries would have benefited greatly from clarifying how euro adoption will fit into their medium- and long-term development strategy, including the national priorities outlined in their National Development Plans.

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