Slovakia and the Euro:
How Slovakia has Out-paced its Visegrád Neighbors on the Path to Economic and Monetary Union

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ABSTRACT

JILL MARIE CARROLL: Slovakia and the Euro: How Slovakia has Out-paced its Visegrád Neighbors on the Path to Economic and Monetary Union
(Under the direction of Dr. John D. Stephens)

Adoption of the euro is a requirement for the twelve New Member States which joined the European Union in 2004 and 2007. Before a country can replace its national currency, however, it must meet a number of economic criteria as established in the Maastricht Treaty. The aim of this paper is to explain why, of the four Visegrád states, Slovakia is the only one to have adopted the euro. This outcome seemed particularly unlikely given the backward nature of Slovak politics during the 1990s and the state of its economy compared to its more advanced neighbors: Poland, Hungary and the Czech Republic. This paper argues that political will is the single most important factor in determining when a country will adopt the euro. The paper identifies economic size as a significant secondary factor, the implications of which do much to explain the divergence in Central Europe.
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INTRODUCTION

The Maastricht Treaty, adopted in 1993, officially established the European Union (EU) and laid the foundations for the creation of the euro as the common currency among its member states. Adoption of the euro is a requirement of EU accession for the twelve countries that joined the union in May 2004 and January 2007. There are no special opt-outs as there were for the UK and Denmark, although as Sweden has demonstrated, there is no effective deadline to join the eurozone either. To qualify for entry and participation in the Economic and Monetary Union (EMU), New Member States must meet the Maastricht convergence criteria and participate in the Exchange Rate Mechanism (ERM II) for at least two years. Timing of euro adoption depends on how fast each member state achieves “a sufficient degree of sustainable nominal convergence” (Issing 2005:1) as measured by the Maastricht criteria. Officially, the New Member States (NMS) are expected to take the necessary steps to comply with the criteria and to join the eurozone, currently comprised of 17 EU members that use the euro, although there is no official timeline or penalty for failure to do so.

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

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

**The Maastricht Criteria and Exchange Rate Mechanism**

According to the Treaty of Accession 2003, which concerns EU accession for the ten countries which joined in 2004, in order to participate in EMU all NMS must meet the following criteria:
• An average annual inflation rate no more than 1.5 percent above the average of the three best-performing EU members for the twelve months preceding the examination
• An average nominal long-term interest rate that does not exceed the average rates of these three member states by more than 2 percent over the same one year period
• Public debt of no more than 60 percent of a country’s GDP
• A budget deficit that does not surpass 3 percent of GDP
• Participation in ERM II for at least two consecutive years without severe tensions or bilateral devaluations with any other Member State

The following tables provide a comprehensive look at how the Visegrád Four performed against the Maastricht criteria from 2000 to 2009. Figures in bold represent a country’s compliance with the benchmark rates as mandated by the Treaty and a few general observations can be drawn from a quick glance at the data. It is evident that the Czech Republic and Poland have been able to meet to most of the criteria most of the time. Inflation and interest rates have stayed within or near the specified limits and the public debt has not exceeded 60 percent of GDP in either country. The Czech Republic actually appears to be the best and most consistent perform-er overall. Meanwhile, Hungary stands out as a perpetual failure on all measures and the fiscal deficit appears to be the most difficult criterion to meet for all four countries. What is less apparent but perhaps most noteworthy about the data are the huge strides that Slovakia made in order to meet the criteria. In just a few years, the country’s deficit was drastically slashed, inflation and interest rates were also brought down and, perhaps more importantly, all three measures were consistently maintained at lower levels. Slovakia’s improvements were unmatched by any of its neighbors and even the Czech Republic, initially better poised to become the leader of the pack, did not keep up.
### Table 1. Budget Deficit as a percentage of GDP

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Source: Eurostat

### Table 2. Public Debt as a percentage of GDP

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Source: IMF, Historical Public Debt Database

### Table 3. Annual HICP Inflation Rates (%)

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Source: IMF, European Central Bank Convergence Reports for 2000-2010
*Figures for 2000-2003, 2005 and 2008 are the author’s calculations based on IMF annual data.

### Table 4. Average Annual Long-term Interest Rates (%)

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Sources: Eurostat, OECD, European Central Bank Convergence Reports
*All figures for 2000-2003 and 2005 taken from Eurostat; reference values are author’s calculations
**Reference Value for 2008 is based on OECD data; author’s calculation
Once a country demonstrates adherence with the Maastricht prescriptions for public finances, interest and inflation rates, it must participate in the Exchange Rate Mechanism (ERM II) for at least two consecutive years before adopting the euro. ERM II was designed to reduce exchange rate variability and achieve monetary stability in preparation for EMU. It also serves as a tool for evaluating potential EMU membership. The European Central Bank (ECB) uses ERM II to test the fiscal discipline of new members, enhance exchange rate credibility and provide multilateral support for the exchange rate regime (Beblavý 2007:287).

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

The rigidity of ERM II entails potentially high risks for participant countries that do not already maintain exchange rate parity with the euro through soft pegs or currency boards. A country’s options for exchange rate regimes range from very strict to very loose. Pegs and currency boards entail bilateral exchange rates that are fixed to another country’s currency, whereas “floats” allow the exchange rate to be determined by market forces (Klein & Shambaugh 2010, pp.14-15). Compliance with ERM II therefore requires a fundamental shift in currency regime for countries that use inflation targeting or a floating currency. The Czech Republic and Poland, for example, use a combination of direct inflation targeting and managed floats which means policies to maintain exchange rate parity with the euro may not
be compatible with policies geared towards Maastricht convergence or price stability objectives. Alternatively, for the smaller Baltic countries (Estonia, Latvia and Lithuania) whose currencies have been closely aligned with the euro for several years, participation in ERM II is practically irrelevant as they have already ceded control over their monetary policies to a large extent (Beblavý 2007:286).

Although the criteria allow for some latitude such as a temporarily excessive deficit under certain circumstances and a higher ratio of government debt to GDP if it is deemed to be “sufficiently diminishing,” they have been quite rigidly applied to the NMS. Lithuania, for example, was denied entry to the eurozone in 2006 for having an inflation rate of 2.7 percent which was just fractionally outside the 2.6 percent benchmark rate for the twelve-month period before its examination. This was despite the fact that Lithuania had had the lowest average annual inflation rate of any EU member state since 1999, plus a budget deficit and public debt well below the Maastricht limits at 0.5 percent and 18.7 percent respectively (Johnson 2008:835). It has been made clear that a NMS which fails to comply with the criteria will not be allowed to join the eurozone.

Furthermore, the bar for eurozone admission has been raised for the NMS. The stipulation that inflation rates maintain parity with “the average of the three best performing EU members”, for example, is much stricter than what older member states were forced to comply with. The fifteen more senior EU members only had to demonstrate inflation rate convergence with the countries of its own choosing. The target rate Lithuania just barely missed was based on the performance of Finland, Sweden and Poland, the three EU countries with the lowest inflation rates of the preceding 12 months. However, only Finland uses the euro, which means that of the “top three performers” with whom Lithuania was expected to
converge, two were outside the eurozone and thus not subject to its monetary constraints (Mulhearn & Vane 2008:179; Johnson 2008:835).

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

**DIVERGENCE IN EURO ADOPTION STRATEGIES**

Since obtaining EU membership, the NMS have diverged significantly in their strategies for euro adoption, despite several macroeconomic and structural similarities. This development has contrasted sharply with the enthusiastic push for EU membership in which the applicant countries made every effort to qualify for European Union accession (Johnson 2008). In order to meet the Copenhagen criteria for EU membership the NMS had to make numerous political, legislative and economic adjustments, many of which were far-reaching and rather intrusive. Many of the rules required fundamental changes to the existing institutional architecture and applicant countries had to demonstrate considerable achievements in terms of democratic openness, human rights and market reforms. Despite such an aggressive reform agenda, all ten of the 2004 NMS arduously strived to comply.
Kenneth Dyson (2007) has identified broad clusters of euro area accession strategies that can be grouped according to their economic structures, geo-strategic contexts and post-communist legacies. The Visegrád states share common features in their economic structures and exhibit a greater continuity in post-communist state and administrative legacies. All four have inherited large welfare states and, compared to the Baltic states and Slovenia, have been much less successful in executing fiscal discipline. The Visegrád states also have a higher degree of cyclical convergence with the other EMU countries, but because of domestic economic and social policy are not incentivized to push for rapid euro adoption (Dyson 2007).

In the run up to EU entry, almost all the NMS expressed their commitment to pursuing EMU and the standard target date for euro adoption was set for 2008. Just one year later, however, the Visegrád states pushed their official target dates back to 2010 at the earliest, while unofficial briefings suggested dates as late as 2012 or 2015 (Country Monitor 2005; Dyson 2007). Hungary stood out by consistently failing to meet any of the Maastricht criteria. In Poland, inflation has been problematic and the government has demonstrated a persistent lack of expenditure discipline and has therefore failed to bring its budget deficit to within the 3 percent upper limit. Although fulfilling the economic criteria was less challenging for the Czech Republic, the reluctance of elected officials to pursue membership has postponed setting a target date for EMU entry. Meanwhile, Slovakia became an unlikely outlier in the group by reiterating its commitment to join ERM II and adopt the euro as soon as possible. Why did the Czech Republic, Poland and Hungary opt to lag behind while Slovakia forged ahead?
THE LEFT, THE RIGHT AND THE EURO

The most important determining factor in any country’s decision to adopt the euro is the political will to meet the Maastricht criteria and join ERM II. Governments are expected to actively pursue eurozone accession which means taking the measures necessary to keep the public debt, the budget deficit, and interest and inflation rates within the specified limits to comply with Maastricht. There is no entity with the authority to compel a country to enter ERM II, thus an unwilling government will certainly impede euro adoption. In this section I will examine how the ideological, economic and lifestyle preferences of the parties in power have shaped each country’s path towards EMU. I assess the effect this has had on each country’s ability to meet the Maastricht criteria as well as on general orientations towards EU integration. I also address how euroskepticism fits more squarely within the existing party systems of Central and Eastern European (CEE) countries than in Western Europe which helps explain the different trajectories in the Visegrád Four.

For the four Central European countries, the fiscal deficit has been the largest constraining factor in Maastricht criteria compliance (see Table 1). The failure to bring deficits below the 3 percent limit is not due to an inability to meet the benchmark, however, but rather a lack of political will and fiscal discipline, particularly with regards to social spending. For example, the Czech Republic, Hungary and Poland do not have difficulties raising revenue to fund their welfare states. They have also experienced several years of strong economic growth which means their deficits are not merely cyclical. Although employment levels have been consistently lower than the eurozone average in all four countries with the exception of the Czech Republic, it is expenditure which has been the Achilles heel for the three larger Visegrád states (Beblavý 2007:285). As shown in Table 5,
all three countries have expenditure to GDP ratios much higher than those of the Baltic states and Slovakia. Here again it is worth noting Slovakia’s progress. In 2000 the country had the highest expenditure to GDP ratio but gradually decreased spending to levels consistent with its neighbors’ and then even further to levels similar to those in the Baltic countries. In fact, Slovakia went from the having the highest expenditure among all eurozone and CEE countries in 2000, to the \textit{lowest} level in 2007 and 2008. Only Bulgaria and Romania had lower spending in 2009 (IMF 2010).

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Source: IMF, World Economic Outlook (October 2010)

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

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

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

As mentioned above, all four Visegrád states inherited large Communist-era welfare states and have been less successful with fiscal management than other post-Communist countries (Beblavý 2007; Dyson 2007). The Czech Republic, Poland and Hungary have chosen to implement post-Communist welfare states but have not employed the fiscal discipline necessary to fully fund them (Beblavý 2007:285). Although this factor has played a smaller role in postponing euro adoption in the Czech Republic, concerns over social spending have hindered Polish and especially Hungarian efforts to bring their budgets deficits within the 3 percent upper limit set by Maastricht—despite public avowals by political leaders in both countries that they were committed to meeting the criteria and planned to adopt the euro as soon as possible. Slovakia, on the other hand, has taken steps to emulate the more fiscally prudent Baltic models (Beblavý 2007: 285). Moreover, one of the primary reasons Slovakia leapt ahead of its peers was due to the harsh austerity measures it carried out to rapidly meet the criteria.

Another dimension that is useful to consider when examining political parties in Central and Eastern Europe is the different way in which euroskepticism is aligned with left-
right dichotomies. Support or opposition to European integration is motivated by socioeconomic issues in both Eastern and Western Europe: those who believe they will benefit from globalization and Europeanization are open to change and support deeper integration; those who fear they will be the economic losers from these international processes are reluctant to change the status quo (Marks et al. 2006). Similarly, the axis of party competition in both Eastern and Western Europe reflects a conflict between defenders and opponents of the status quo regarding property rights and modes of distribution (Kitschelt 1992, cited by Marks et al. 2006).

The difference arises from the way party competition has developed. Marks et al. (2006) have separated supporters from opponents of EU integration in terms of gal-tan positions where “gal” represents green/alternative/libertarian and “tan” stands for traditionalism/authority/nationalism. In the West, where capitalism is the status quo, gal values are associated with the economic left. In the East, however, where non-market distribution of resources has been the norm, the economically liberal right is associated with gal values. In both East and West, euroskepticism is most prevalent among radical left and radical tan parties. However, because radical left and radical tan values align within the same parties in CEE countries, euroskepticism is much more easily absorbed into the existing axis of party competition. Since radical tan values correspond with the far right in Western Europe, euroskepticism is seen manifest in both extreme right and extreme left parties and thus politically awkward for mobilizing voters (Marks 2006; Vachudova & Hooghe 2008). In Eastern Europe it has been smoothly incorporated into the existing party systems and easily seized upon as a divisive political issue.
POLITICS BY COUNTRY

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

Hungary

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

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

Czech Republic

The governments of the other Visegrád countries changed hands in the next elections and produced three very different outcomes. In the Czech Republic, the right-wing Civic Democratic Party (ODS) came to power and won enough seats to be able to rule alone as a minority government. The party is led by the notoriously euroskeptic Václav Klaus, who is not only fiercely opposed to deeper European integration but EMU in particular. He has repeatedly cited the euro as a perfect example of misguided European policy and derides the fact that it was first and foremost a political project and not based on purely economic underpinnings. Despite having already fulfilled most of the Maastricht criteria and being forecast to bring its budget deficit within the 3 percent upper limit by 2012, the Czech Republic’s date for euro adoption was unlikely to be a policy priority with the ODS at the helm.
The Civic Democrats’ stance on EU integration is rather surprising given its right-wing stance on economic issues. In fact, according to the data collected in 2002 and 2006 by Hooghe et al (2010), the ODS was the sole outlier in terms of its position on EU integration. While all other CEE parties considered to be economically right-wing and “gal” were pro-Europe, the ODS was the only euroskeptic right-gal party (Marks et al 2006). An interesting caveat to this observation, however, is that of all the Visegrád parties surveyed in 2002, ODS registered the highest level of internal dissent regarding EU integration (Hooghe et al 2010).

**Poland**

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

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

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

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

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

**Slovakia**

The Slovak case also clearly demonstrates the importance of politics in joining the eurozone although for different reasons. Under the corrupt Prime Minister Vladimir Mečiar, Slovakia spent most of the 1990s regarded as a veritable pariah state (Johnson 2008). In the West he was constantly criticized for his autocratic style of government, disregard for democracy and the shady privatizations that took place during his rule. Mečiar was not even afforded diplomatic visits by nearly all Western European leaders during his tenure and Slovakia was famously called “a black hole in the heart of Europe” by the then US Secretary of State Madeleine Albright (Kacer & Tupy 2005). Although the public was strongly in favor of joining the EU, Slovakia was rejected from the first round of EU membership as the country under Mečiar could not meet the Copenhagen political requirements.
Slovakia did not pursue EU membership until the center-right coalition led by Prime Minister Mikula Dzurinda came to power in 1998. Re-elected in 2002, the Dzurinda administration used its mandate to carry out extensive fiscal and structural reforms, pursue EU membership and meet the Maastricht criteria. As the public increasingly felt the effects of Dzurinda’s austere economic policies, it became clear that he stood to lose the 2006 elections. In order to ensure continued fiscal discipline and entrench Slovakia in its path to the euro, the Dzurinda government moved the country into ERM II in November of 2005 (Johnson 2008; Rosenberg 2008). This decision effectively tied the hands of future administrations and locked the country into an EMU-bound trajectory. ERM II commits a country to fiscal rectitude by immediately becoming the country’s foremost symbol of credibility. This component of the Maastricht criteria is effective not because of EU enforcement, but because a withdrawal from the process is likely to instigate dramatic ramifications in the financial markets (Johnson 2008). This is exactly what happened in Slovakia.

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

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

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

The costs and benefits of an early EMU membership have been widely discussed within the theoretical framework of Optimum Currency Areas (OCA) (De Grauwe and Schnabl 2004). In order for a currency union to be successful, the region must have: labor mobility; openness with capital mobility and price and wage flexibility; similar business cycles; and a risk-sharing system such as a redistribution mechanism to transfer money to
areas which have been adversely affected by the first two characteristics (“Optimum Currency Area” 2010). The Stability and Growth Pact (theoretically) prevents fiscal transfers, but labor and capital are mobile as a result of the original rules which established the EU in 1993. Thus, we can examine the other two components of a successful monetary union—labor market flexibility and business cycle correlation—to determine whether these may help explain the divergent paths to the euro among the four Visegrád states.

I begin this section with an analysis of labor market rigidity and wage flexibility in Central Europe to assess whether these factors make euro adoption more or less attractive for each of the four countries. I find that labor markets and wages are not as rigid as many had previously assumed and do not provide a deterrent for euro adoption. On the contrary, these factors appear to be more conducive to euro adoption than in some Western European countries and existing eurozone members. In the second part I look at business cycle correlation to determine whether the adjustment costs of eurozone accession help explain the divergence between Slovakia and its neighbors. By all measures, it seems the costs of euro adoption based on OCA theory would have been the highest for Slovakia.

**Labor Market Rigidity**

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

Boeri and Garibaldi (2006) refute such claims. They note that in the five years prior to the Eastern Enlargement productivity gains had outstripped wage increases in the NMS while the business sector in EMU countries during this same period experienced a cumulative growth in wages which exceeded productivity growth (Boeri and Garibaldi 2006). In their study they compared the institutional features of the existing EMU members to those of the NMS and found that labor markets were no more rigid in the NMS than in the (at that time) 12 eurozone members. They point out, for example, that minimum wages were kept very low throughout the transition to a market economy, employment protection legislations (EPL) were actually less restrictive in the NMS, and union density and coverage rates were much lower than in the comparison countries. The authors contend that the persistence of high unemployment in these countries was related to productivity enhancing job destruction in the aftermath of prolonged labor hoarding rather than a by-product of structural rigidities.

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

A lack of labor market flexibility is often perceived to be the key element in dampening the potential gains from EMU. There are wide disparities not only across national borders but also among regional labor markets which implies a lack of flexibility both within and across labor markets. Buettner’s (2007) study of 343 regions, in 13 countries and across 11 years provides a useful comparison of regional labor markets between both NMS and older member states. His analysis shows that, overall, the NMS display significantly higher regional wage flexibility than some of the more established EU members although this varies among eurozone countries as well as NMS. Moreover, although regional unemployment disparities in the NMS lead to wider income disparities across regions, the variations in unemployment tend to be less persistent in the NMS. His results suggest that labor market flexibility should not have been a deterrent to EMU entry for the NMS any more so than for other EU member states.

**Business Cycle Correlation**

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

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

Ben Nabil (2009) lists the results of 14 different studies of business cycle correlation within CEE countries that use a variety of methods and analyze different components of business cycle symmetry between 1998 and 2004. The studies use Germany, the eurozone or EU member states as a point of reference and compare all ten or a subset of CEE countries. Results vary from high to low correlation depending on the method employed and the aspect measured but even similar studies produced contradictory conclusions. From his analysis of
previous studies, Nabil concludes that business cycles in the most advanced acceding countries seem to be strongly correlated with those of the euro area, particularly for Hungary. This suggests that, at least in terms of business cycle correlation, euro adoption would have been less costly for the Czech Republic, Poland and Hungary than for Slovakia as they were more economically advanced.

In Nabil’s own analysis he examines and compares the way in which business cycles move over time in the euro area and the CEEs to determine whether a convergence may be observed that would support the argument that Europe can form an optimal currency area. He found that Hungary and Poland showed the highest correlation with the euro area business cycle overall. Similarly, when he compared the relationship between supply and demand shocks, the three larger Visegrád countries along with five other CEEs demonstrated the highest correlation values for demand shocks while correlation with Slovakia was insignificant. Results concerning supply shocks proved to be much more asymmetrical: they were negative in Slovakia and the Czech Republic while Hungary and Estonia exhibited the most positive results (Nabil 2009: 34). Nabil’s study along with his examination of several previous case studies of business cycle correlation in CEE countries is further evidence that Slovakia should have been the least likely Visegrád candidate to have pursued early euro adoption.

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

In terms of the costs and benefits of EMU, the most compelling argument for why Slovakia has come from behind to surpass its Visegrád peers is that economic size largely determines the pros and cons of euro adoption. Size is important because it affects dependence on foreign trade and, as a consequence, exchange-rate regime choice. The most
oft-cited benefit of a currency union is reduced transaction costs, and since small countries with open economies tend to be highly dependent on foreign trade, the benefits are more substantial. External market forces have a greater impact on their prices, growth, and government revenue, which means stable exchange rates vis-à-vis their main trading partners are extremely important to monetary policy. External forces also tend to discipline fiscal policy more effectively in small as opposed to large economies which, combined with a fixed exchange-rate, effectively decreases the amount of autonomy a state has over its fiscal policy. The opposite is true for economically larger countries like Poland, Hungary and the Czech Republic. Less dependence on trade means their economies are more stratified and their currencies provide wider scope for financial speculation. The rigidity of ERM II thus entails much higher risks as monetary intervention is necessarily curtailed and independent devaluations are prohibited (Johnson 2008).

Juliet Johnson (2008) compared the NMS of the 2004 enlargement and points out that all ten arduously strived to meet the Copenhagen criteria but that after 2005 the group separated into “pacesetters” and “laggards” when it came to meeting the Maastricht criteria. She attributes this split to the costs and benefits associated with adopting the common currency and notes that the group of “pacesetters” which included Slovakia (plus the Baltic states and Slovenia) all had far lower GDPs than the “laggards”—Poland, Hungary and the Czech Republic (Table 6). In fact, these five small states had met both of the fiscal criteria for Maastricht before joining the EU, and all petitioned for more rapid adoption of the euro and entered ERM II as soon as they could.
Table 6. Nominal Gross Domestic Product (GDP) in millions of USD

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
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<th>2007</th>
<th>2008</th>
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<tbody>
<tr>
<td>Poland</td>
<td>171.2</td>
<td>190.4</td>
<td>198.2</td>
<td>216.8</td>
<td>253</td>
<td>304</td>
<td>341.7</td>
<td>425.3</td>
<td>529.4</td>
<td>430.7</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>56.7</td>
<td>61.8</td>
<td>75.3</td>
<td>91.4</td>
<td>109.5</td>
<td>124.6</td>
<td>142.6</td>
<td>174.2</td>
<td>216</td>
<td>190</td>
</tr>
<tr>
<td>Hungary</td>
<td>47.3</td>
<td>53.4</td>
<td>66.8</td>
<td>83.9</td>
<td>102.6</td>
<td>110.2</td>
<td>112.9</td>
<td>138.4</td>
<td>155.5</td>
<td>129.5</td>
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<tr>
<td>Slovakia</td>
<td>20.5</td>
<td>21.1</td>
<td>24.5</td>
<td>33.3</td>
<td>42.2</td>
<td>47.9</td>
<td>56</td>
<td>75.3</td>
<td>95.2</td>
<td>88.2</td>
</tr>
<tr>
<td>Slovenia</td>
<td>20.4</td>
<td>23.1</td>
<td>29</td>
<td>33.8</td>
<td>35.8</td>
<td>39</td>
<td>47.4</td>
<td>45.7</td>
<td>48.6</td>
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<tr>
<td>Lithuania</td>
<td>11.4</td>
<td>12.2</td>
<td>14.2</td>
<td>18.6</td>
<td>22.5</td>
<td>26</td>
<td>30.1</td>
<td>39.1</td>
<td>47.2</td>
<td>37.1</td>
</tr>
<tr>
<td>Latvia</td>
<td>7.8</td>
<td>8.3</td>
<td>9.3</td>
<td>11.2</td>
<td>13.8</td>
<td>16</td>
<td>20</td>
<td>28.8</td>
<td>33.9</td>
<td>25.9</td>
</tr>
<tr>
<td>Estonia</td>
<td>5.7</td>
<td>6.2</td>
<td>7.3</td>
<td>9.8</td>
<td>12</td>
<td>13.9</td>
<td>16.8</td>
<td>21.7</td>
<td>23.7</td>
<td>19.3</td>
</tr>
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</table>

Source: IMF, World Economic Outlook (October 2010)

Moreover, the post-communist states needed to establish credibility in their monetary policies during the transition to a market economy. For smaller states with inexperienced central bankers and less economic certainty, one way to do this was to establish exchange-rate pegs or currency boards. This demonstrated to domestic and international actors that a government was committed to responsible monetary and fiscal management and had the simultaneous side effects of stabilizing the economy and converging with the EU market (Tuma 2003; Šmídková 2004; Johnson 2008). As a fragile new state in the wake of a problematic divorce from the Czech Republic, a credible currency and macroeconomic stability were especially symbolic issues for Slovakia (Dyson 2007). The Czech Republic, by contrast, was exceptional in that it had already established one of the most credible economies of the NMS, was the first post transition economy to introduce inflation targeting in 1997, and had successfully kept inflation consistent with European levels (Gomez and Lytle 2009) thereby garnering investor confidence. Since the danger of macroeconomic instability is even greater for small and open economies with international capital mobility, the benefits of EMU accession seem to be significant (De Grauwe and Schnabl 2004).
Poland, Hungary and the Czech Republic were not incentivized to adopt the euro in the same way that Slovakia and the other small NMS were. Although the governments recognized the long-term benefits of adopting the euro, the economic benefits in the short and medium term were less evident. Both academics and policy-makers advised that joining the eurozone too soon could hinder economic growth as there were significant investment needs and productivity and price levels were well below the EU average. Additionally, the costs of entering ERM II too quickly were potentially very high. For the larger economies, entrance to ERM II represented a loss of useful monetary policy flexibility with no guarantee of a timely entrance to the eurozone. The smaller states had already given up this autonomy which meant entering ERM II did not represent a significant or particularly controversial change for them (Šmídková 2004; Johnson 2008).

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

**CONCLUSION**

All New Member States are obligated to eventually replace their national currencies with the euro. They are expected to take the necessary steps to fulfill the Maastricht
convergence criteria and seek entry to ERM II. However, as there is no treaty requirement to join by a particular date, the timing is essentially left up to politicians. The decision to join the eurozone therefore involves a political judgment about the appropriate balance between domestic concerns, macroeconomic stability and the degree of sustainable convergence with the existing eurozone economies. It is also bound up with the nature of a country’s economic structure, administrative legacies and the electoral incentives of politicians (Dyson 2007).

The NMS are thus individually responsible for their own euro entry strategies, which are not a matter for negotiation with the EU or eurozone member states.

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

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

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


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