



IN OR OUT?

The Politics of Euro
Accession for Eastern
European Member States



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Eastern European Member States

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Preface

The stabilisation of the eurozone is one of the big challenges Europe is presently facing.

While in some states of the EU the euro is still considered to be a critical integrative factor for the European Union, in others it is seen as an unfinished project, whose internal trade and financial imbalances create international redistributions and political strains, which are hard or impossible to resolve within the realm of national policies. While different models for reforming the currency union are being broadly discussed, the fact that another six countries are supposed to enter this Union is hardly mentioned in the debate.

In the non-euro member states both views of the euro are detectable. Acceding to the eurozone as fast as possible is not or is no longer a self-understood political goal, but a question open for political debate – even if the Maastricht Treaty stipulates that all member states that meet the criteria must adopt the common currency. The four larger non-euro member states are presently silent about the euro. Rather, introduction of the euro is a political topic which is kept far away from the table of priorities.

Poland, the Czech Republic, Hungary, Croatia, Bulgaria and Romania differ substantially in terms of political and economic characteristics. For some of these countries, their national currencies are an instrument for economic governance, others are substantially euro-ised and can hardly benefit from holding on to their national currencies. The political camps are split over the question of adopting the euro in some countries, in others there is no clear stance towards the issue.

There are many factors impacting country preferences, but a few stand out: country's size and economic openness, internal and external balance (budget and current account balance, public debt), financial structure (use of foreign currencies), overall economic structure, wage setting and other mechanisms and

institutions, experience with monetary and exchange rate policies and capacities for internal adjustments (e.g. internal devaluations) when external macroeconomic shocks hit their economies. Last but not least, general policy orientation towards EU institutions will also affect a country's stance vis-à-vis adopting the euro.

The Maastricht Criteria that should have ensured stability within the eurozone and set the path for economic convergence and prosperity for new members have delivered sufficiently neither from the perspective of the eurozone member states nor from that of the non-euro-member states.

One way of looking at potentials for euro area eastern enlargement is to look deeper into the economies of the non-euro-member states and their political traditions and present preferences. In this respect, it is important to understand institutional legacies, economic structures, performances and their interplay with politics in order to recognise factors which will determine economic cost-benefit of adopting the euro (which may be different for different countries).

While the studies we present here originally aimed at discussing the potential effects of joining the euro, it became obvious that most East European countries do not plan to join at the current moment with the exceptions Bulgaria and Croatia.

The general feeling is that the Monetary Union is currently not very attractive, as long-known problems of the euro-area remain unsolved. The flawed institutional set-up, combined with more recent discussions – for instance - about the Italian fiscal stance seem to make staying out of this club the most attractive option. Consequently, some countries prefer to peg their currencies more or less closely to the euro, and to keep the option of joining later.

Only Bulgaria and Croatia have the feeling of having nothing to lose, but only to gain in joining the euro. The other four countries do not expect relevant positive effects in the short term but are afraid of long-term negative consequenc-

es due to the higher probability of (private) net lending booms in the wake of lower real interest rates that might end up in collapse. Adding this fear to the dysfunctional set-up of the European Monetary Union, continuing growth problems in peripheral member countries, plus the current conflict with Italy makes introduction of the euro highly unattractive.

Nevertheless, all countries enjoy benefitting from close ties to the core countries, and stable exchange rate developments by voluntarily and one-sidedly pegging to the euro, and the option to join the club later, should the Monetary Union manage to solve its institutional problems and allow for stable growth even in peripheral economies.

Zoltán Pogátsa

Introduction: The Adequacy of Adoption of the Euro for Less Developed Economies.

In the initial period of the eurozone, academic and media discussions about the euro tended to focus on the upsides. These included:

1. The willingness of countries to give up their own currencies for yet another *symbol of a united Europe*;
2. The *abolition of conversion costs*;
3. The *elimination of exchange rate risk*;
4. As a consequence of the previous two, the *increased willingness of firms across Europe to engage in trade with each other*. This last one was the main economic goal, but it has been raised that trade in Europe had been growing even without the euro, making the trade argument weaker than it seems at first sight.

Then there was the impact on monetary policy, namely:

5. that central banks would have to hold *significantly less currency reserves*, as a huge number of parities would disappear within Europe.

These were the pro arguments for Europe as a whole. As for individual member economies, emerging ones in particular, the agitation was mostly focused on stability. Many of these weaker economies had experienced inflation, budget deficits affected by political cycles, and in some cases even high levels of indebtedness. It was suggested that eurozone membership would end all of this and bring much needed macro-stability. This is of course a twisted argument, as the logic flows exactly in the opposite direction: **it is not the euro that ensures stability, but a country having to**

prove that it has fulfilled the criteria of fiscal and monetary stability before entering. Not vice versa! Thus, stability comes from an internal effort, not from some mysterious external cause.

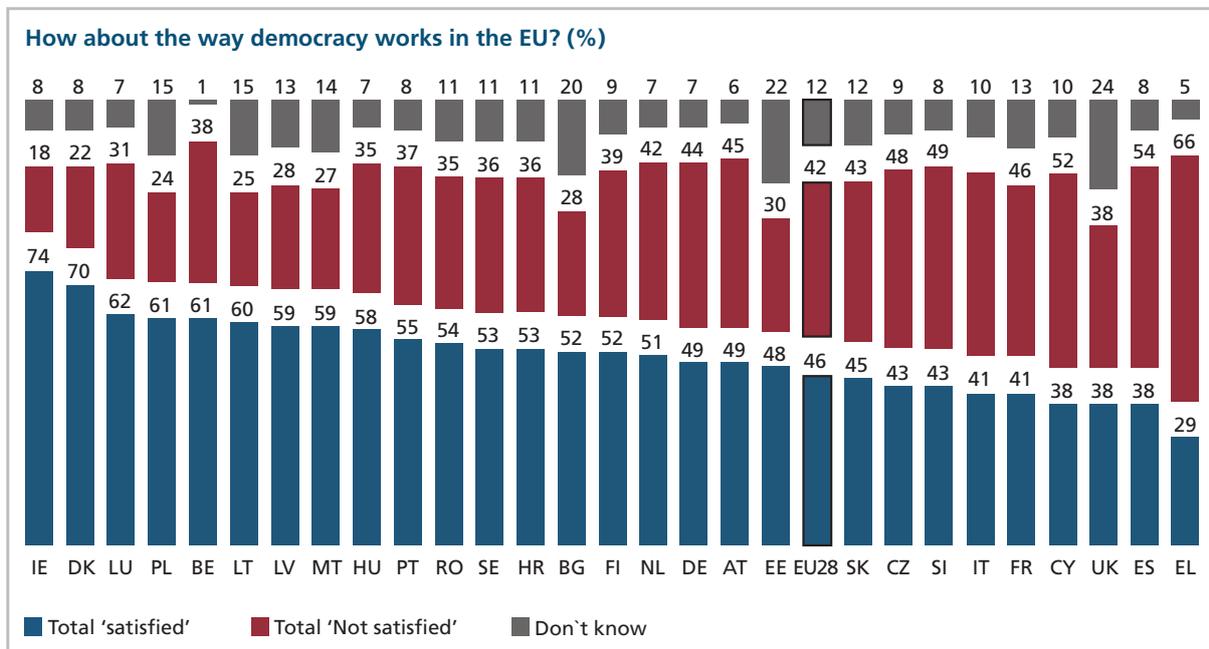
The argument can be made, of course, that the external constraints of monetary union help reign in profligate politicians and serve as some kind of pressure. What does it say, however, about the state of democracy in EU member states if it takes such external pressure to achieve macroeconomic stability? How internalised will the virtue of this stability be, if it is portrayed by domestic politicians as Commission pressure for austerity, restraint and curtailment? In fact, such an argument elevates both monetary and fiscal authority to a community level without guaranteeing the direct means of accountability that parliamentary elections provided. How are European citizens to influence these policies at the European level, if it is steered by the European Commission, a depoliticized body of non-elected technocrats? (With the benefit of hindsight, the situation is even worse: it was not even the Commission which directed the eurozone, but the unregulated, non-transparent and unaccountable informal meeting of finance ministers...¹⁾)

The question of accountability was not only a theoretical one. As it turned out, the eurozone 'constitutionalised'²⁾ one specific economic philosophy, that of extreme fiscal conservatism, and effectively arrested attempts at implementing all other alternatives, even mild Keynesian anti-cyclical challenges. In the longer run this greatly undermined accountability in the European Union, deepening the already existing democratic deficit, and **turning tens of millions of Europeans** against each other and **against the European integration process**. Unfortunately, this is what has happened, as attested by Eurobarometer surveys about support for the European Union, especially in peripheral economies hardest hit by the eurozone crisis.

1. Varoufakis 2017

2. Bugarcic 2013

Figure I.1 – The populations of the member states that have been hardest hit by the eurozone crisis are still most critical of the EU



Source Eurobarometer 2018 89.2, QA25b

The debate on the benefits and disadvantages of the eurozone became somewhat more diverse only after the eruption of the 2008 global financial crisis, its continuation as the eurozone crisis, and especially the culmination of the latter in the 2015 Greek crisis. Nowadays concerns about the weaknesses of the Italian economy inform this debate.

In what follows, we shall identify the three main schools of thought on the euro, looking at it from the point of view of a less developed economy.

The mainstream “Merkelian” view

The mainstream view sees the eurozone crisis predominantly as a sovereign debt crisis. The symbolic embodiment of this view is German Chancellor Angela Merkel, who, as head of the strongest economy of the eurozone, was the defining personality during the handling of the eurozone crisis in the decade after 2008. It is also

the official view of the famous Troika institutions: the European Commission, the European Central Bank and the International Monetary Fund.

This interpretation does not recognise any significant structural faults in the eurozone construction. It sees the problems arising predominantly from reckless overspending by the member state governments, called ‘sovereigns’ in economic parlance. This profligacy is supposed to have led to an increased debt burden in these member states, which in turn made the market-based refinancing of these state debts more and more costly, as investors insisted on higher and higher yields if they were to lend to increasingly risky states. **Hence the understanding of the crisis as a ‘sovereign debt crisis’.**

The most well-known culprits according to this interpretation were famously labelled the PIGS (Portugal, Ireland, Italy, Greece and Spain) in the business press. However, they were only

the countries that came to be at the forefront of the crisis, but the list of eurozone member states that suffered included Cyprus, Slovenia, Lithuania, Latvia, Estonia and even Finland.

This mainstream view hypothesizes that increasing state debt is always a problem, and that higher levels of state debt make a country riskier. Reckless politicians try to buy off voting blocs by lavish spending, and they then leave behind debt for later generations to clear up. Thus, in essence this view represents a critique of democracy, a time inconsistency between parliamentary cycles and debt cycles, where the necessary checks and balances are absent in representative democracies to keep irresponsible politicians in check. However, rather than offering a domestic political-institutional solution to this defect at the national level, the Merkelian assessment sees the solution externally, at the European level. This takes the form of the communitisation of monetary policy to the level of the European Commission. This institution would be tasked with overseeing the fiscal policies of eurozone member states and would have the power to sanction them if their budgets showed excessive deficits. This would keep in check unsustainable debt paths before they became acute in countries that have a history of being fiscally irresponsible.

The mainstream view also approves of so-called Fiscal Councils at the national level, which are expert bodies tasked with forming an opinion on the budget proposals of the government. These, however, are toothless tigers. They might have technocratic prestige in the eyes of some, but no competencies to veto or sanction. They are also problematic from the point of view of democratic accountability: they tend to represent the views of the mainstream (neoclassical, fiscally conservative, anti-Keynesian, anti MMT, etc.) epistemic community, rather than the true diversity of the profession of an economist.

The mainstream view provides no explanation for why member states were bailed out during the crisis years. According to the rules of the eurozone, this should not have happened. It had been made clear to participating states that there

would be no bailouts by either the European Central Bank or by other member states. This was also the official position of Angela Merkel and eurozone institutions at the very beginning of the crisis. Representatives of the mainstream view often imply that it was an act of kindness, and of 'European solidarity' that these rules were not followed, and the certain member states of the eurozone decided to 'come to the aid' of their fellow Europeans who had 'sinned'.

Once a government is identified by the mainstream view as being too profligate, it is then compelled to carry out austerity policies. Austerity as a policy was theorised by the Italian-US economist Alberto Alesina.³ The supposed dynamic is that economic stabilisation restores confidence in the business community, who then start investing again.

This view has been challenged by a number of publications. Baldacci et al, for instance, show⁴ that, with a strong track record, the benefit of debt reduction, in terms of insurance against a future fiscal crisis, turns out to be remarkably small, even at very high levels of debt to GDP. For example, moving from a debt ratio of 120 percent of GDP to 100 percent of GDP over a few years buys the country very little in terms of reduced crisis risk, translatable as yield premium on newly issued debt.

According to Alesina, **austerity is supposed to be effective because cutting back on excessive public spending restores the confidence of the business community to invest**, in the belief that there will be no need for further stabilisation. However, in reality austerity often has opposite, negative effects:

- In the short term: **austerity leads to a drop in demand due to firings and a reduction of wages** in the public sector, this cuts into the

3. Alesina, Alberto F.; Ardagna, Silvia (October 2009). „Large Changes in Fiscal Policy: Taxes Versus Spending“. NBER Working Paper No. 15438.

4. Baldacci, Emanuele, Iva Petrova, Nazim Belhocine, Gabriela Dobrescu, and Samah Mazraani, 2011, "Assessing Fiscal Stress," IMF Working Paper 11/100 (Washington: International Monetary Fund).

revenues of the private sector, whose customers they had been;

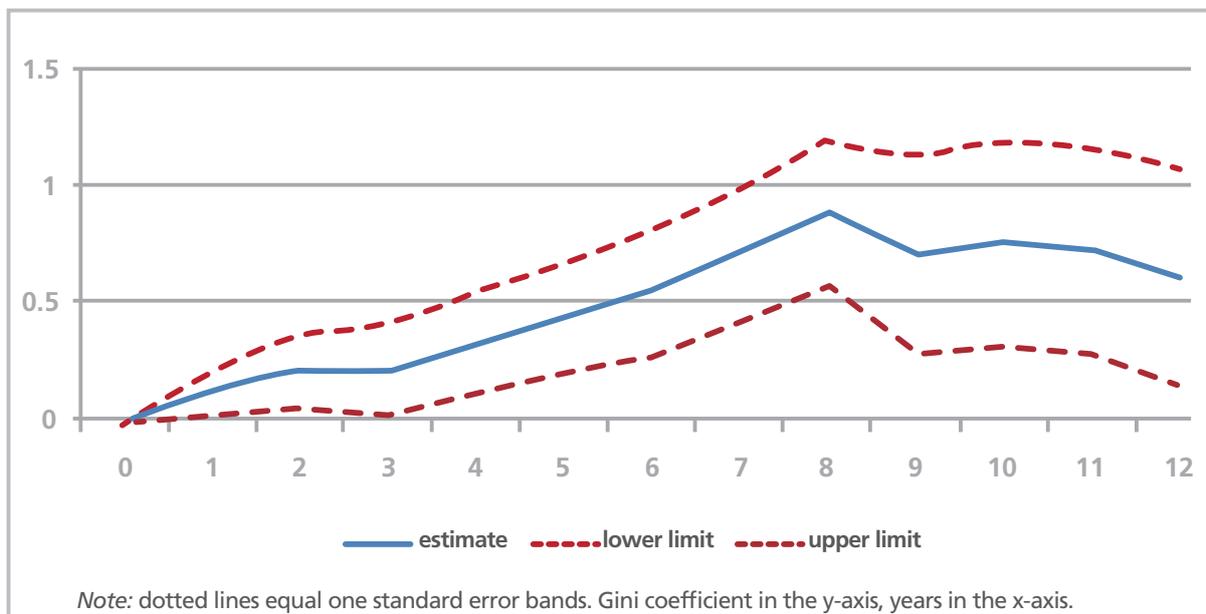
- also in the short term: **raising taxes undermines the profitability** of the business sector;
- in the longer /term: austerity means **underfinancing of state subsystems that underpin competitiveness**, such as public education, health, social security and public transport;

- in terms of trade: austerity is a “beggar thy neighbour” policy, as **domestic spending is demand for exports** of other eurozone members.

As a consequence of the above, in real life austerity does not restore the confidence of the business sector, but rather undermines it.

Ball et al found that on average, a consolidation of 1 percent of GDP increases the long-term unemployment rate by 0.6 percentage points and raises by 1.5 percent within five years the Gini measure of income inequality.⁵

Figure I.2 The effect of x years of austerity on inequality measured by the Gini coefficient



Source: Ball et al.

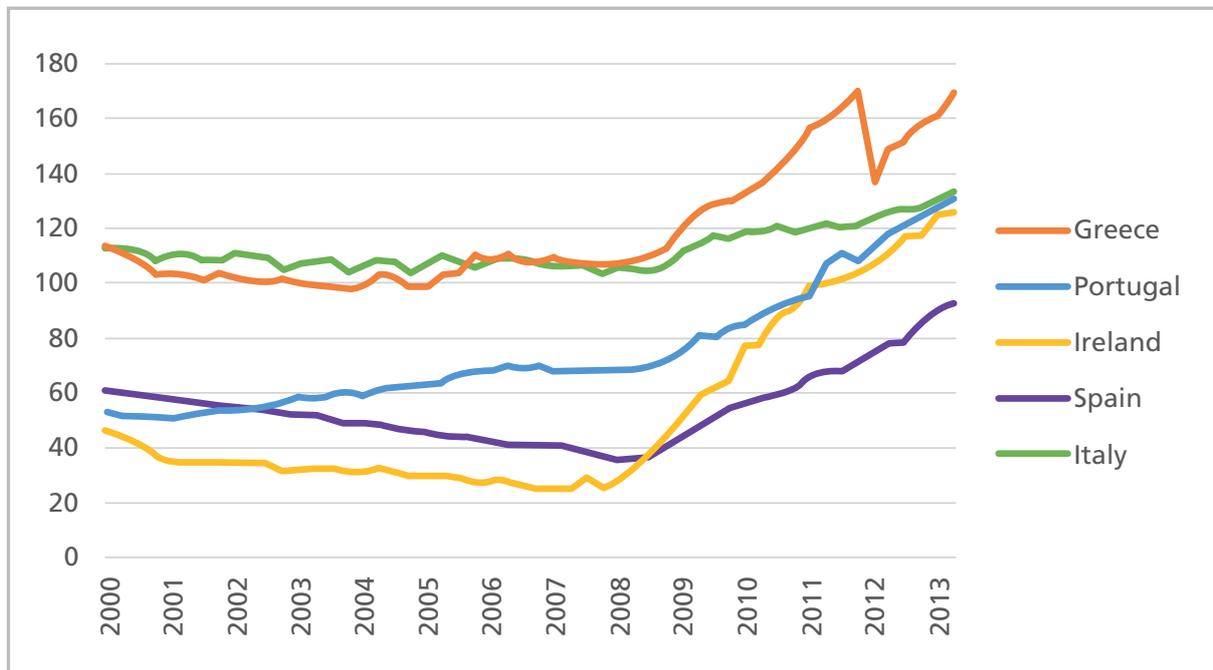
The Keynesian view

While the Merkelian view is still the dominant narrative of the eurozone, its absolute hegemony has been challenged in European public debates by its Keynesian alternative. In academic circles it is represented by economists such as Paul Krugman, Joseph Stiglitz, Thomas Piketty, Yanis Varoufakis, James Galbraith and others.

This view challenges the mainstream view in that it does not see the eurozone crisis primarily as a sovereign debt crisis. If it were indeed that, then we would see in the data rapidly rising sovereign debt levels during the eurozone years, to be followed by rapidly decreasing debt paths during the years of austerity that followed. Yet we see the opposite.

5. Ball, Laurence, Davide Furceri, Daniel Leigh, and Prakash Loungani, 2013, “The Distributional Effects of Fiscal Austerity,” UN-DESA Working Paper 129 (New York: United Nations).

Figure I.3 State debt as a percentage of GDP in selected EU economies



Source: Eurostat

Of the PIIGS group, only in the case of Portugal do we see the debt to GDP rising rapidly during the eurozone years (2000-2008). In every other case the debt path either stagnates or even decreases. Once austerity kicks in, however, after 2009, we see again the opposite of what is supposed to have happened according to the mainstream narrative. Rather than decreasing, the state debt to GDP ratio begins a dramatic ascent in every single case. **The mainstream narrative of a sovereign debt crisis followed by the remedy of debt decreasing austerity is simply not born out by the facts.**

As an alternative explanation, the Keynesian view points to structural faults in the eurozone. The following structural faults are identified:

- 1) The problem of inadequate interest rate. The eurozone is not an optimal currency area, which in economic parlance means that the boom and recession cycles of member states are not in synch. This effectively means that

it is impossible to find an adequate common interest rate for the eurozone, which in turn has highly destructive effects.

Interest rates lowered by central banks in recessionary periods discourage savings and channel capital towards investments to boost economic activity. Interest rates raised by central banks during overheated boom periods channel money away from investments, towards savings, thereby reducing the inflationary pressure. The policy choice between the two options is clear in a national economy that is either in a boom or a trough. However, in a monetary union where some member states are in recession and others are simultaneously experiencing high growth, the common central bank has no adequate policy options left.

If it chooses to raise interest rates to accommodate the overheated economies, it concurrently sends recessionary economies

into economic euthanasia. If it opts for the opposite policy alternative of lowering interest rates to accommodate the recessionary economies, it concomitantly creates an asset price bubble in the high growth member states. This bubble creates the false impression of prosperity, but sooner or later it bursts.

In the European Union, where there is a developed Northwest and a less developed South and East, discrepancies of economic cycles are coded into the setup by default. The Southern and Eastern peripheries are expected to grow faster than the core, since this is what allows for economic convergence in the longer term. If there was no growth differential, there would be no convergence, which in itself would threaten the unity of the block. *If there is convergence between member states, it is impossible to set a common nominal interest rate that is adequate for all.*

In the initial decade of the eurozone, the European Central Bank decided to go for the more popular second option of the two wrong choices. It accommodated the slow growth and sometimes even recessionary economic centre by lowering interest rates. As a consequence, cheap money created the illusion of increased prosperity on the periphery in the form of an asset price bubble, primarily in the real estate sector around Dublin and on the Mediterranean coastlines. High growth economies tend to have higher inflation rates as well. Hence the low nominal interest rate from Frankfurt was coupled by higher inflation in the periphery, resulting in often negative real interest rates: the banks paying for you to take their money, in order to invest in property that would undergo an exponential increase in value year after year. In the longer term, however, this led to increased private indebtedness, massive imports and a bubble that burst in 2008.

This is a problem, because wages are a key component of price setting, and prices in turn are a key component of export competitiveness.⁶ Thus reducing wages in one member state can distort the functioning of the monetary union through upsetting its trade balance. This is precisely what happened when the Schröder government in Germany pushed through its infamous Agenda2000/Hartz reforms. It reduced the wage/value added (GDP) ratio of the German economy by almost as much as 10 percentage points. Along with outsourcing the low-end production phases of German-led transnational value chains to Eastern Europe, where wages were even lower, this ensured *vast export price competitiveness* for German exporters. Germany developed a massive trade surplus, while countries in the periphery developed a trade deficit. The European Commission has repeatedly sent warnings to Berlin, raising alarm that its trade surplus vis-à-vis other member states is blowing up the monetary union. Wage earners in Germany, especially low-income earners also suffered: Germany now has a sizeable low wage cluster. Thus, Keynesians argue that the eurozone needs to coordinate its wage policies in order to avoid upsetting the internal trade balance.

A frequent objection to this critique of the eurozone is that if this policy worked well for Germany, then rather than criticising it, other member states should follow suit. This is wrong for two reasons. Firstly, it is a form of redistribution within the country from low-income earners to high-income earners. Secondly, amongst member states of the monetary union it is a sort of 'beggar thy neighbour' policy, in that *demand in one country is exports for another country*. When low-income German workers earn less, their purchasing power decreases, and this reduces the ability of Italian or Spanish exporters to export to Germany. Thus, if each and every member state of the monetary union would attempt

- 2) **The wage competition problem.** The eurozone does not have a common wage policy.

6. Mundell 1961.

to become price competitive by suppressing wages, total demand for imports would collapse in the monetary union. This is exactly the opposite of the original intention of creating a monetary union in the first place: to enhance international trade.

- 3) **Non-availability of devaluation.** In economic history it is nigh impossible to find a successful catch up that did not involve either periodic depreciations of the national currency, or outright devaluations. Many would object that competitiveness should not be achieved through devaluation, and they would be right. In the longer run, competitiveness should come from innovations in technology and the business process. However, national economies might run into situations when their competitiveness might be restored temporarily, in the short term through devaluation. This policy tool was used regularly by Scandinavians as much as by the Far Eastern Tigers, by China in recent decades and as much as the United States previously.

Unfortunately, in the eurozone devaluation is not an option, as participating states give up their own national currencies. Given the enormous disparity between the massive trade Germany developed during the eurozone decade, as opposed to the massive trade deficits experienced by the Southern periphery, depreciation or outright devaluations would have been offsetting and stabilising mechanisms according to the Keynesian school.

- 4) **Constitutionalised austerity and the lack of demand.** The characteristic view of the Keynesian school is that demand drives investment, and that in order to stabilise crises, either private entities or the state must create demand. As Piketty,⁷ Duménil and Lévy,⁸ and others have shown, during the decades of neoliberalism the concentration of income and wealth in the hands

of the 'super-rich' has meant that that *lower income groups have been unable to exert enough effective demand to purchase the goods and services created by the economy.* The result has been a kind of under-consumptionist challenge, the problem that current income cannot soak up all of current consumption. The 'solution' that has developed was pairing current consumption with future income, that is, by creating increasing mountains of private debt. Thus, in recent years we have been purchasing current production from our future incomes, and even the income of future generations. This might be a temporary fixture, but not a sustainable solution.

Austerity has made things even worse. Contrary to Alesina, the chief theorist of austerity, businesses in real life do not feel their confidence restored when their customers are fired, their wages frozen, or when taxes on businesses are increased to squeeze out government revenues. Quite the opposite, they experience austerity as further worsening of their economic contexts, and as Keynes would predict, they delay their investments. This further worsens the general economic situation, once again destabilising public finances. Thus, the economy goes into a vicious circle, a never-ending downward spiral. Austerity is self-defeating.

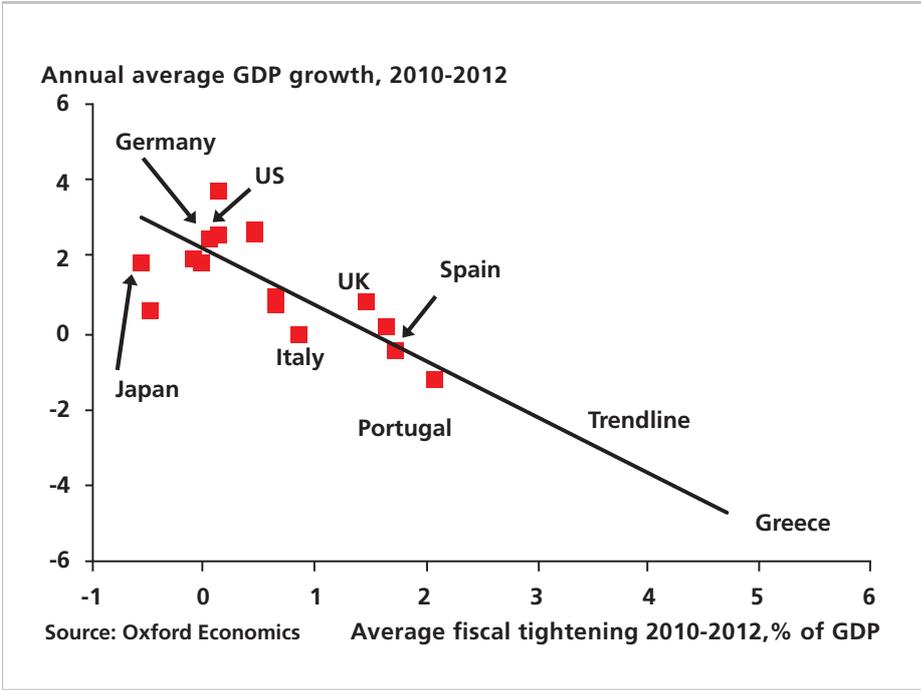
In fact, we can show that the EU conditionality of austerity has damaged peripheral countries in the eurozone.

The eurozone reacted to the crisis by imposing austerity on its members. This philosophy is likely to continue in the future as well and will be further engraved in stone by handing over competencies to the Commission to supervise the fiscal policies of member states. This is likely to have a damaging effect on the growth prospects of further member states joining as well.

7. Piketty 2014

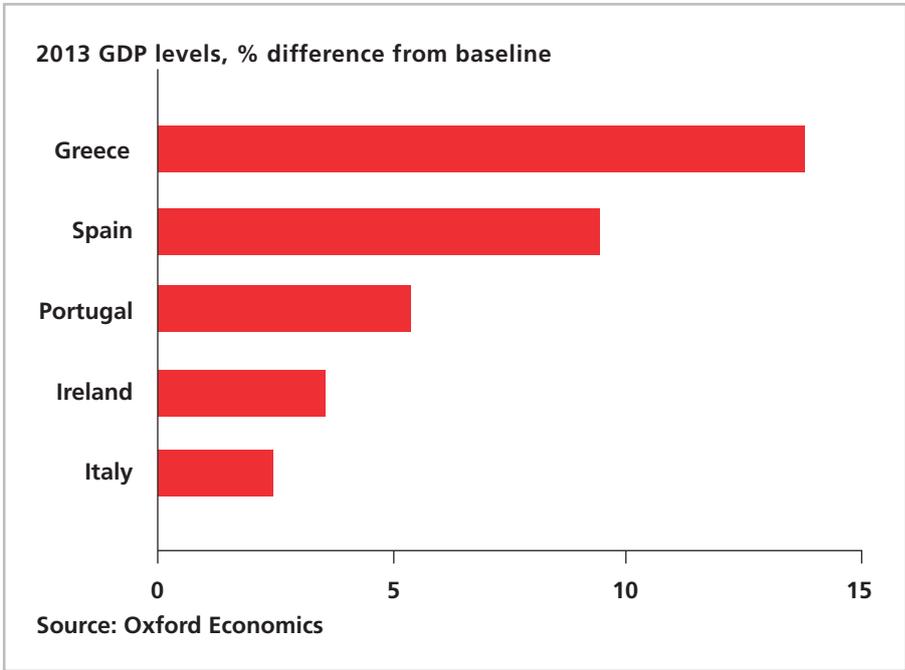
8. Duménil és Lévy, *The Crisis of Neoliberalism* 2011

Figure I.4 The more austerity, the worse the GDP trend



Source: Oxford Economics

Figure I.5 – Austerity has damaged the peripheral economies of the eurozone 2008-20



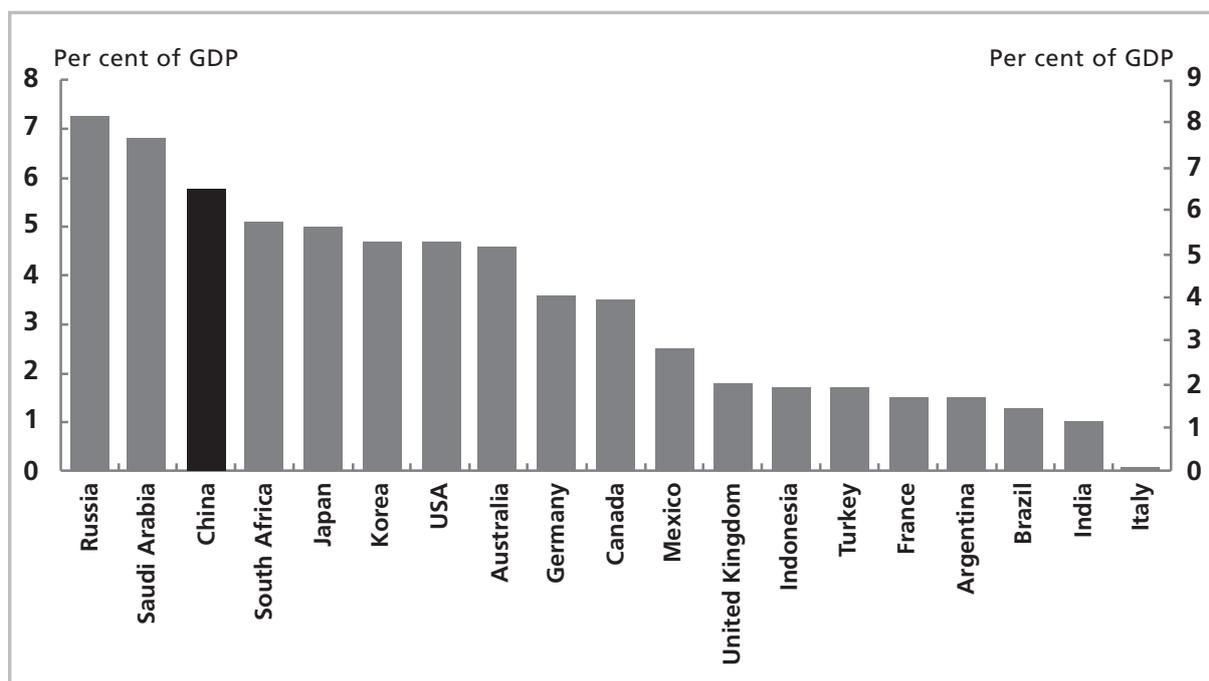
Source: Oxford Economics

In fact, the only European Union member state that did not have a crisis after 2008 was Poland. Prime Minister Donald Tusk, who had campaigned on a neoliberal platform during the prior elections, would then become a born-again Keynesian when he had to face the crisis once in power. For a number of years, he implemented a Keynesian countercyclical policy of 7-8% of GDP.

It was as a consequence of this policy that Poland evaded the crisis. This would not have been allowed in the eurozone.

If we look beyond Europe, we find that most other major economies reacted to the crisis in a different way. Rather than fiscal contraction, they chose expansion.

Figure I.6 – Fiscal stimulus as a reaction to the crisis, across the globe, outside of the eurozone 2009-10



Source IMF 2010

Russia and Saudi Arabia are oil economies, but the case of China is a relevant comparison. Not only did Beijing implement a major Keynesian anti-cyclical investment programme, but it did so in a way as to counterbalance the previous opening of regional disparities.

The Chinese stimulus included social measures, such as the building of schools and hospitals, but also a network of highways and high-speed railways that now reach into the poorer mainland. In fact, China now has 27,000 km of high-speed rail,

more than the rest of the world added together. Both the tracks and the carriages are made domestically. The cost of tickets is significantly lower even in comparison to European normal speed travel. The shift of passenger travel to the high-speed network has enabled more freight capacity on the traditional network. Not only was the stimulus useful to fill in for falling private demand, but it also represented infrastructural and social investment, and was a form of industrial policy. This example shows how misguided the eurozone policy of austerity really was as a response to the crisis.

Figure I.7 – The massive Chinese stimulus helped avoid the crisis

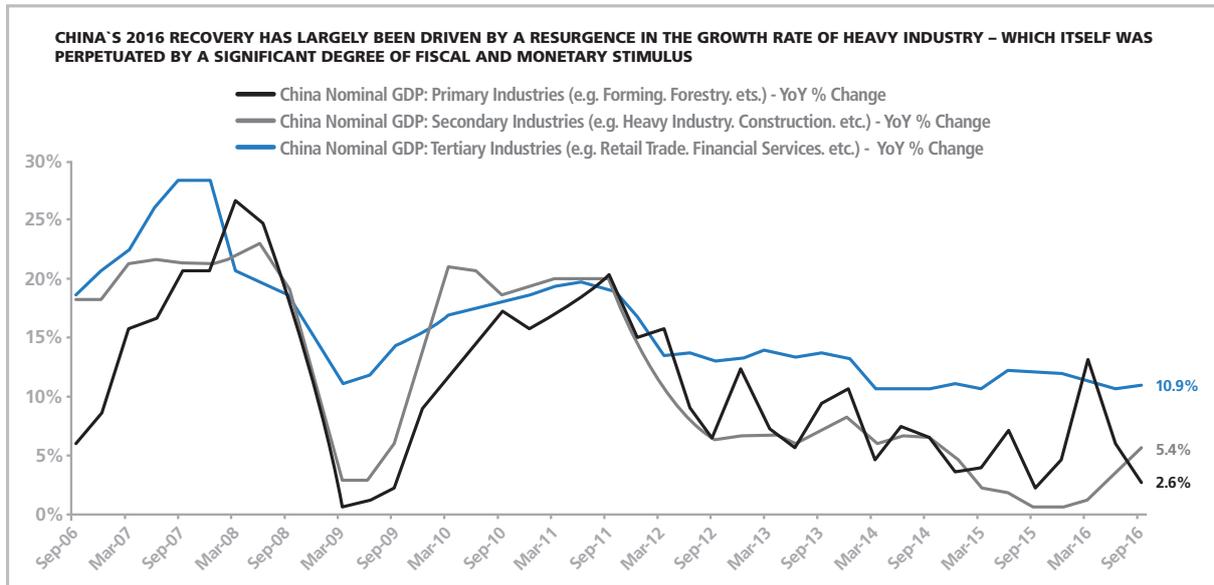
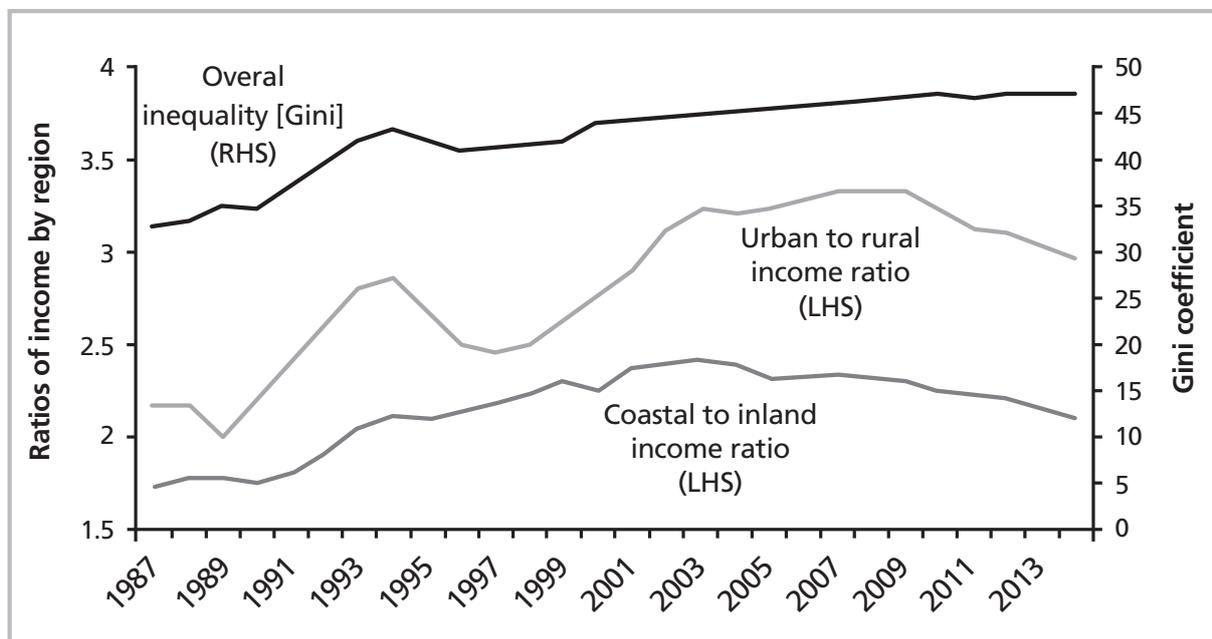


Figure I.8 The Chinese stimulus also helped lessen internal regional disparities (Source: Yukong)



Source: CIA World Factbook; National Bureau of Statistics of China

Should balanced or surplus budgets be preferred?

Balanced or even positive budgets might sound like prudent policy to voters, especially if it is sold to them with the analogy of the household, the prudent Swabian housewife that does not spend more than she earns. If the family did go on a binge, surely, we would have to tighten our belts in our private life? It is often raised by politicians that the state is no different. However, this analogy is dangerously misleading. Few voters realise that since the state draws its revenues from the private economy through taxation, a positive state balance means drawing resources out of the private economy that the private sector cannot spend. The state budget having a deficit, however, means that the state is creating extra demand that enters the economy and has a multiplying effect in the private sector.

The Keynesian alternative is government spending. Keynesian economists point to the fact that decades of neoliberalism have resulted in neglected public infrastructure and underfinanced human capital forming subsystems. When motorway bridges collapse in Italy, it is because of a sustained lack of investment in renewal. When the health status of Greeks deteriorates, this decline of the human capital is due to withdrawal of funds from the health system. When education standards across Europe drop according to PISA assessments, it is due to austerity in the educational system. Thus, there is plenty of space for the government to intervene by investing sensibly and creating extra demand.

If your reading of the crisis is based on profligate sovereign overspending, then obviously more debt does not seem like a convincing way out. However, as we have seen, the actual data does not support the explanation of sovereign profligacy.

Government spending might be financed by one of two sources. Either the state might issue new debt, or it might print money. Neither of the two is allowed under the regulations of the eurozone.

As for issuing new debt, Keynesian economists have repeatedly drawn attention in recent years to the fact that interest rates have been very low, close to zero and even negative during the decade of the eurozone. When should the state borrow, if not when it is effectively free to borrow - when new money can be added into the economy at no cost?

The other source of money for government spending might be printing it. The analogy between state and household finances is also flawed because households do not have the right to print their own money, whereas a state does. It can always add more of its own currency into circulation.⁹ The upper limit is always inflation of course. However, inflation occurs only when more money chases an unchanged volume of goods produced. In a recession, however, when state prints more money, this is not the case. By definition, in a recession firms encounter less demand than what they have capacity to produce. When they experience a rising demand, they respond by increasing output, as they are interested in selling more. Thus, increased money supply chases an increased volume of output, not an unchanged volume of output. Inflationary pressure is absent.

The above applies of course to issuing debt in the domestic currency. Naturally, becoming indebted in a foreign currency is damaging in the longer term, as states do not have the right to print another state's currency. Unfortunately, we must draw attention to the fact that from a member state's perspective the euro has in effect been a foreign currency in this respect: member state central banks have been not allowed to print it freely. Thus, relying on increasing the amount of euro in circulation requires a consensus at the level of the European Central Bank.

It is also very obvious from the facts that Europe needs a more progressive income tax system and a tax on inheritance and wealth in order to ensure redistribution and effective demand at the lower end of the income and wealth range, as proposed by Piketty, Zucman and others.

9. Wray 2012

The Marxian view

Keynesian interpretations of the crisis have successfully challenged the mainstream Merkelian view in recent years. However, as far as actual economic policy is concerned, we have not seen any challenge to the hegemony of the mainstream position. Austerity is still the dominant recipe for the solution of crisis.

Keynesian solutions were successfully implemented in Poland, the only EU country that did not go through a recession after 2008. Poland, however, is not in the eurozone. Outside the European Union, both the United States and China successfully implemented Keynesian responses. When Greece, a member state of the eurozone, attempted such a policy in 2015, this was rejected by the Troika, and eventually the government was brought to succumb to further austerity by the European Central Bank, cutting off liquidity assistance to the Greek commercial banking system.¹⁰

We can therefore conclude that the mainstream Merkelian approach is so much ‘constitutionalised’ into the eurozone construction that even the Keynesian alternative, which had been mainstream from the late 1930s to the early 1970s, appears an ambitious challenge.

Marxian economists, however, have gone as far as to challenge even this Keynesian alternative. They argue that the Keynesian interpretation of economic cycles, whereby it is demand that drives investment, is false. Keynesians think this because investment is the only variable that is not determined by the functioning of the economy itself. It is either determined by expectations about the future, as in the case of private investment, or government policy, as in the case of government investments.

Marxians disagree. They claim that investment is in fact driven by a certain factor that is inherently part of the economy: profitability. Capitalist firms only invest if they expect to make a profit on their investments.

Econometric studies¹¹ on NBER crises going back to 1947 indicate that annual growth rates of profits have almost zero (0.03) correlation with the rates of growth of both investment and wages. This is because profits rise and fall before investment and wages, meaning that it is a leading variable. Data show that profits stop growing, stagnate, and then start falling a few quarters before the recession, when investments and wages start falling. This is in contrast with the Keynesian (and Kaleckian) view that profits start declining because investments decrease due to ‘animal spirits’, or expectations about the economy. A fall in wages that would lead to a decline in investments, as the under-consumptionist view would suggest, is also at odds with the empirical evidence.

In addition, at the end of recessions, profits grow at a quarterly increase of around 10 per cent. In the same quarters, however, wages grow by only around 1% and investment by 1.2%. This is inconsistent with the view that a preceding rise in wages, consumption or investment causes the end of the recession.

If these econometric studies are true, it means that even the Keynesian narrative is inadequate, the structural problems of the eurozone are deeper, and demand management by the state as a solution will not be a fix in the longer term.

Summary

The mainstream, “Merkelian” view of the eurozone crisis being a sovereign debt crisis based on previous profligacy is not borne out by fact on the ground. Austerity being a remedy, being able to reduce indebtedness and guarantee competitiveness, is also not supported by evidence from the eurozone.

Europe needs at least a Keynesian alternative, where redistribution ensures demand, and capital is invested counter-cyclically into human resources and infrastructure. This might happen through redistributive taxation, issuing debt that would almost be free (close to zero interest) at the moment, or printing money, which will not result in inflation as output will also adjust upwards.

10. Eichengreen 2015; Wyplosz 2015; Grauwe de 2015

11. Tapia 2018

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Katarzyna Sum

Poland

The topic of Poland's euro area accession has been debated intensely since 2004, when our country joined the European Union (EU). Several paths and scenarios of adoption of the euro occurred, including fast tracks, gradual adaptation, even the scenario of unilateral adoption of the euro i.e. the introduction of the new currency without participation in the union and in the decision-making processes. Over the last 15 years the political and social stance for adoption of the euro evolved from an optimistic one towards a sceptical one (Riedel, 2017). A negative attitude towards joining the eurozone occurred particularly after the recent financial crisis from 2007-2010, even amongst previously euro-enthusiastic environments. The euro area was viewed as unstable and participation in it as risky. Now that the sovereign debt crisis in the euro area has been overcome, the discussion about Poland's accession has started again. A factor additionally contributing to the renewed willingness of closer monetary integration is the new political setting in the EU, particularly the fact that the perspective of Brexit weakens the non-euro area part of the EU. The disintegration tendencies in the EU might marginalise the role of countries which stay outside the eurozone.

An important milestone in the debate was the letter to the Prime Minister in 2017 signed by renowned Polish economists about the necessity of enhancing monetary integration. The debate intensified and several points of view emerged. One should note that, despite the fact that the adoption of the euro in Poland is regaining political salience, the current government is reluctant to join the eurozone. Also, the attitude of the Polish society towards joining the eurozone is rather sceptical (according to Eurobarometer data), which creates the problem of the legitimacy of the accession.

The renewed discussion requires an analysis of Poland's readiness to join the eurozone and the outlining of the necessary reforms that would

help to benefit from the accession and mitigate the risks. Hence the aim of the study is to conduct a cost benefit analysis of the adoption of the euro in Poland and the formulation of recommendations concerning potential accession pre-conditions besides the Maastricht criteria. The subsequent sections are focused on the likely effects of introduction of the euro in Poland.

Likely Effects of the Introduction of the Euro in Poland

When analysing the likely effects of the adoption of the euro in Poland one must distinguish between economic and political consequences, as well as short term and long-term effects. The commonly named economic advantage of the introduction of the euro is the possibility to reap benefits from lowered interest rates brought about by the single monetary policy. The interest rates in Poland, since its EU accession, have been substantially higher than in the eurozone. Lower interest rates mean easier access to loans for firms and a lower cost of capital, ensuring a potential boost of economic growth. This can happen provided that the investments triggered after the decrease of interest rates are located in undertakings that increase long term economic productivity, rather than in activities that lead to overheating or boom and recession cycles, particularly in real estate.

A further immediate positive effect expected after the adoption of the euro is the lowering of transaction costs for companies involved in international trade with euro area countries. Given that the euro area is a substantial trade partner for Poland this effect might be particularly important and long term. Potentially a common currency might be conducive to a more favourable environment for boosting foreign trade and increasing the income of domestic firms. This way it might contribute to higher economic growth. To enable such an optimistic scenario one has to point out again the necessity of proper investment to increase economic productivity, and improve the competitiveness of Polish firms.

An additional argument raised by the proponents of euro adoption is the lowering of public debt servicing costs, since the euro denominated bond yields are expected to be lower than the ones currently issued in Polish zlotys. However, one should take into account that the yield i.e. the cost of government debt will depend largely on the condition of the real economy. Instructive examples are the surging yields of the periphery countries¹² after 2010, despite their participation in the euro area.

The adoption of the euro should also contribute to the long-term political stability of Poland. The political arguments for joining the euro area have gained substantial salience in recent years, given the disintegration of the EU after the financial crisis from 2007-2010 and the perspective of Brexit. The adoption of the euro would allow Poland to have a vote on monetary policy in the eurozone and help hence to avoid the marginalisation of Poland's role in the EU. Moreover, adopting the euro would allow the country to participate in the decision-making process concerning the banking union of which currently Poland is not a member. Joining it while staying outside the euro area entails the lack of voting rights concerning the banking union and hence can be viewed as risky. Once the banking union is fully built up, joining it might help Poland to fully reap the benefits of economic integration.

On the other hand, joining the eurozone also brings certain risks. The renouncement of autonomous monetary policy and exchange rate deprives the economy of important adjustment tools in the case of the occurrence of asymmetric shocks¹³ or economic downturns. Economists stress that asymmetric shocks in Poland may occur due to differences in market structures, institutions and GDP level compared to euro area countries. Research suggests that the impact of the loss of autonomous monetary policy on the economy might not only affect GDP and prices, but also the business cycle, consumption, the labour market,

as well as welfare. It is stressed, however, that these costs may be lower if, after accession to the euro area, the business cycles of the member countries become more synchronised and less prone to asymmetric shocks and economic volatility (Gradzewicz, Makarski 2013).

A serious risk also arises in connection with lowered interest rates. If the investments triggered by the lowered interest rates are placed in non-productive sectors, or the benefits resulting from easy access to loans and cheaper credit are immediately consumed, this might lead to overheating, unstable credit booms and subsequent recessions. The lowering of interest rates may hence lead to the build-up of macroeconomic imbalances i.e. large price increases particularly in real estate, loss of competitiveness of Polish firms due to relatively expensive products and, as a consequence, balance of payments deficit. This risk materialised in the euro area periphery countries (Sum, 2013). The risk of building up such imbalances in Poland is substantial, taking into account the differences in GDP levels between Poland and the euro area countries. The experiences of peripheral countries which joined the euro area are very instructive in these terms, particularly that the differences in their GDP levels compared to the core euro area were much smaller than in the case of Poland.

The opponents of adopting the euro also view the loss of sovereignty in terms of money issuance and monetary policy conduct as a threat related to joining the euro zone. From the above overview of benefits and costs of Poland's joining the euro area one can conclude that the advantages are mostly long term, while the risks are mostly short term.

To see a more detailed picture of the balance of advantages and costs, and to draw conclusions about the necessary precautions enabling the reaping of benefits and mitigating the costs of joining the eurozone, the following sections analyse the likely effects of the introduction of the euro on the functioning of key areas of the Polish economy.

12. Portugal, Ireland, Italy, Greece and Spain.

13. Events that affect one country in a different way than the others e.g. a price increase or GDP decrease due to idiosyncrasies of the economy.

Wages and Employment

According to the Optimum Currency Area (OCA) theory, which describes the necessary conditions for introducing a single currency, the labour market is one of the potential adjustment channels after asymmetric shocks. After adopting the euro, when the current adjustment instruments will not be available anymore, it may constitute one of the tuning tools. Adjustments can take place through changes in the number of employees in the respective firms, the number of working hours and wage aftershocks. This means that the labour market has to be flexible.

Poland differs substantially in terms of labour market regulations and institutions from the euro area countries. This should not, however, be viewed as a serious impediment in adopting the euro, since there are substantial differences between the existing eurozone countries in these terms too. The differences concern areas like: the unemployment insurance system, unionisation, wage setting mechanisms, wage rigidity regulations, minimum wage regulations, wage indexation mechanisms, active market policy measures and expenses, Employment Protection Legislation, regulations concerning flexible employment contracts and regulations enabling the adjustment of the working hours to the economic cycle (NBP, 2014). These differences persisted in the euro area countries despite the ongoing monetary integration, hence, one could also expect a similar effect in Poland.

What can be viewed as an impediment is the fact that the quite rigid labour market in Poland, high firing and hiring costs, as well as the rather passive measures¹⁴ of fighting unemployment might hamper the functioning of this adjustment tool.

A positive aspect is the high international labour mobility in Poland (European Commission, 2018) which can be an alternative adjustment channel to the labour market. Given persistent unemployment rates after asymmetric shocks and real

wage rigidity, labour mobility might be helpful in eliminating imbalances. However, one must stress that this comes at a potentially high social cost. Moreover, labour mobility is not a solution for short term shocks, since people will not be able to relocate immediately. For this purpose, other adjustment tools on the national level and mitigating measures should be developed.

An additional issue is that, potentially, the introduction of the euro might put pressure on wage increase, due to the price increase owing to lowered interest rates. However, such an increase is unjustified without a rise in labour productivity. Without increasing productivity, higher wages lead to a price surge and to a loss of competitiveness of companies. If such a scenario materialises, this will create an additional impediment in the functioning of the labour market as an adjustment tool. An economically justified increase in wages will not result from the adoption of the euro; it is only possible through the improvement of the productivity and competitiveness of companies. Productivity and competitiveness enhancing measures could be primarily the modernisation of companies, investment in new technologies and R&D.

Prices and Inflation

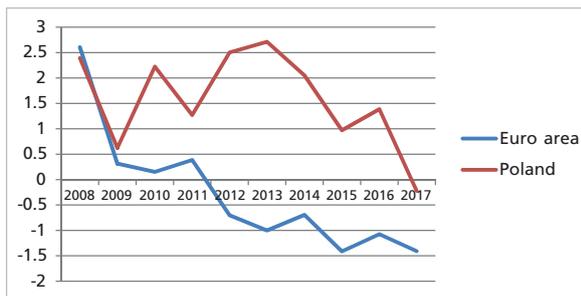
The adoption of the euro is expected to have a substantial impact on price developments in Poland. The lowering of interest rates due to the single monetary policy will create inflationary pressures. According to economic research, the level of the natural interest rate i.e. guaranteeing stable inflation and economic growth, has been higher in Poland since its EU accession than in the euro area. Also, during this time, the observed interest rates in Poland have been substantially higher than in the eurozone (Brzoza-Brzezina, 2006). Figure 1.1 shows the divergence of real interest rates between Poland and the eurozone in 2008 - 2017.

As one can see, during the time of the financial crisis in 2008-2009, the real interest rates in Poland were aligned with ones in the euro area and

14. Passive measures focus on mitigating the effects of unemployment, i.e. in the form of unemployment benefits, as opposed to active measures, e.g. consisting of training programmes for the unemployed.

declined from 2.4% to 0.6%. After 2009 the interest rates in Poland returned temporarily to their pre-crisis levels and declined sharply after 2013 to reach the value of -0.2% in 2017. In the eurozone, on the other hand, real interest decreased steadily after the crisis to reach the level of -1.4% in 2017.

Figure 1.1: Real interest rates in Poland and in the euro area



Source: European Commission data.

The inflationary pressures, triggered by the lowered interest rates, will to some extent be determined by the degree of the economic catching up process. The smaller the differences in GDP levels between Poland and the eurozone are, the smaller the expected price increase pressure will be. This tendency is due to the so-called Ballassa-Samuels effect, which in short consists of the phenomenon that in catching-up economies, due to faster productivity growth compared to developed economies, the inflation level is higher. One has to note that the differences between the GDP levels in Poland and in the euro area will not be alleviated for a long time. What is more important is to elaborate proper strategies boosting productivity and long-term economic growth before the adoption of the euro and to provide necessary adjustment tools to prevent price increases after accession to the euro area.

Moreover, persisting low real interest rates create the threat of an unstable credit boom and the emergence of speculative bubbles. This particularly concerns the real estate market. Given optimistic expectations concerning wage increases and the low cost of credit after adopting the euro,

this risk might be viewed as substantial. An additional factor exacerbating this risk in Poland is the underdevelopment of the housing rental market. Proper regulation enabling, for instance, better access to the rental market during the expected emergence of a credit bubble could mitigate this problem.

One should stress that low interest rates do not have to lead to unstable credit booms, provided that the financial system is properly regulated. The Polish financial system is mainly dominated by banks, hence banking regulation plays a crucial role. Banks should cut down on lending during economic booms and increase it during downturns. Essential macroprudential tools are secured within the recently adopted EU Capital Requirements Regulation (CRR) and Capital Regulation Directive (CRD IV) called also the CRDIV/CRR package, which entered into force in 2013.

CRD IV was implemented in Poland in 2013. It regulates the rules for establishing banks, capital buffers, and bank supervision. It also introduces new regulations concerning corporate governance and remuneration, aimed at counteracting excessive risk taking. Since it has the form of a directive, it leaves room for national discretion of the authorities. The CRR operationalises and specifies the regulations under CRD IV. It refers to capital risk coverage, leverage, market discipline and disclosure requirements. It is directly binding in all EU member states. The CRD IV/CRR package should be helpful in counteracting excessive lending booms.

Nevertheless, one has to point out that economic booms occur mainly locally, hence there is also the need to provide macroprudential tools on the country level, which would be adjusted to domestic conditions (Sławiński, 2010). In Poland macroprudential supervision is executed by the Committee of Financial Stability which encompasses members of four supervisory bodies: The National Bank of Poland, the Commission of Financial Supervision, the Ministry of Finance and the Bank Guarantee Fund.

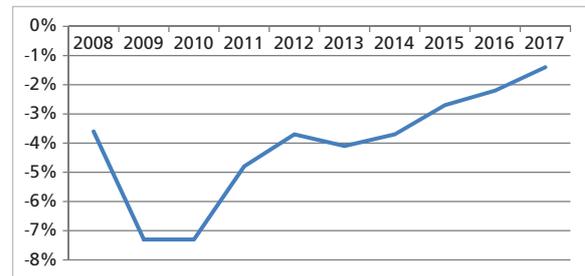
Fiscal Situation

To join the eurozone, Poland has to fulfil the Maastricht criteria including the fiscal criterion according to which the public deficit and debt should not exceed 3% and 60% respectively. Hence, theoretically, the adoption of the euro should create more discipline in public finance. Another positive impact of adopting the euro on the fiscal situation should be the above-mentioned lowering of public debt servicing costs.

One should stress that, once Poland joins the eurozone, fiscal policy will become an important stabilisation tool, since the exchange rate and interest rate instrument will not be available anymore. In order for this tool to work, fiscal policy should be countercyclical i.e. the government should curb the expenses in good times, in order to be able to support the economy in bad times. The possibility of conducting countercyclical policy depends on the ratio of the so-called fixed expenses i.e. legally determined, which have to be borne regardless of the economic situation e.g. social insurance or support for local government entities. According to the data of Ministry of Finance the share of fixed expenditures in the Polish budget has been increasing over the last decade and amounts to approximately 75% of the total expenses. Hence, it might be an impediment in the adjustment tool function of fiscal policy. Moreover, one should note that the government has a very limited influence on the expenses of local governments. Furthermore, after accession to the eurozone the government would particularly have to monitor the whole scope of debt, including the development of foreign debt. Otherwise, a large external imbalance might lead to a worsening of public deficit, similarly to how it happened in the periphery countries. All the above-mentioned factors may inhibit the possibility of quick reactions via fiscal policy tools in the case of shocks.

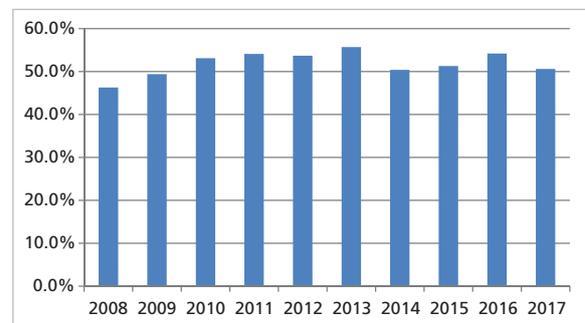
Figure 1.2 and figure 1.3 show the development of the public balance and debt in Poland during the period 2008-2017.

Figure 1.2: Public balance in Poland in 2008-2017



Source: Eurostat.

Figure 1.3: Public debt in Poland in 2008-2017



Source: Eurostat.

As one can determine from the data presented, currently the public finance situation in Poland can be viewed as stable. Our country meets the Maastricht criteria concerning the level of public deficit (1.4% GDP) and debt (50.6% of GDP). However, one should stress that the current situation is to a large extent a consequence of a positive upswing in the economy. In the case of the occurrence of downturns the necessary adjustment tools are scarce. The adoption of the euro in such a situation creates the risk of large economic imbalances.

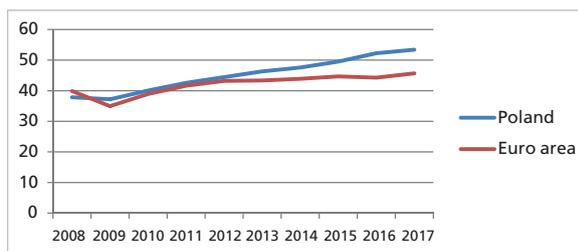
Regional Cooperation and Trade Integration

An important benefit from accession to the eurozone is the strengthening of regional cooperation and trade integration, since the elimination of the exchange rate is expected to create a more stable business environment. Companies should be open for more international cooperation due to less volatile income from foreign trade transac-

tions and a more predictable financial situation. The majority of research papers indicate that the introduction of the euro should boost foreign trade, even up to 59% (Borowski, 2008).

According to the OCA theory, the more open a country's economy is, and the higher its trade integration with the other member countries is, the more it can benefit from joining a monetary union. The openness of the economy is defined as the share of exports or imports in GDP, while the degree of integration is defined as the share of trade with the eurozone of the whole value of foreign trade. Figure 1.4 shows the openness of the Polish and euro area economy measured as exports to GDP in 2008-2017.

Figure 1.4: The openness of the Polish and euro area economy measured as exports to GDP in 2008-2017



Source: World Bank data.

As one can determine, the degree of openness of the Polish economy is at a comparable level to the average openness of the euro area countries. Between 2008-2017 this figure rose from 37.8% of GDP to 53.4% of GDP in Poland and from 39.9% of GDP to 45.7% of GDP in the eurozone.

One can hence conclude that Poland can benefit from accession to the euro area in terms of trade integration to the same degree as the cur-

rent euro area members. Given that the degree of trade integration amounts to around 60%¹⁵ and Poland's main trade partners are euro area countries, the benefits from fixing the exchange rate could be substantial.

Moreover, one should note that, according to the OCA theory, the process of trade integration might be endogenous, i.e. after adopting the euro the degree of trade integration may increase (Frankel and Rose, 1996). Hence the benefits of the adoption of euro may be even greater than expected before the accession.

An additional benefit of the adoption of the euro in terms of regional cooperation is the fact that the fixing of the exchange rate and the creation of a more stable business environment might also attract more foreign direct investment, which could be conducive to increased economic growth.

However, one should stress that the introduction of the euro could also affect a negative channel impacting foreign trade. As mentioned, it might trigger a price increase and subsequently the loss of competitiveness of Polish firms. It will not be possible anymore to use the exchange rate to correct the price increase, hence Polish exporters will lose their competitiveness. To prevent such a scenario, one should eliminate several structural weaknesses of the Polish economy on the micro and macro level, particularly the low competitiveness of companies (NBP, 2014). Polish companies would benefit substantially from creating a better environment for the development of entrepreneurship, i.e. favourable tax policies, labour market regulation and improved funding possibilities which would help to cope with foreign competitors after the adoption of the euro and to reap fully the benefits of the enhanced business environment.

15. Own calculations based on OECD data.

Conclusions

One can conclude that Poland's accession to the eurozone can bring substantial benefits for our country, but it also entails considerable risks. One should underline that the long-term benefit resulting from accession to the eurozone will be increased political stability, since the disintegration tendencies in the EU might marginalise the role of countries which stay outside the eurozone. Also, substantial economic benefits can result from accession, provided Poland is properly prepared for the adoption of the euro.

Since the introduction of the single currency is predominantly a monetary phenomenon, the main actions which should be taken concern the regulation of the financial system. Proper macroprudential policy and particularly banking regulation should help to prevent unstable credit booms and their drastic effects, triggered by the lowered interest rates. However, one should stress, that macroprudential policy cannot act as a substitute for monetary policy, since it has no immediate impact on the economy. The degree to which Poland can avoid the emergence of an unstable credit boom will determine the balance of costs and benefits of adopting the euro.

To minimise the further mentioned risks the authorities should have new adjustment tools available to replace monetary policy and the exchange rate. Given that the labour market has substantial limitations to function as an adjustment instrument, due to its rigidity, and labour mobility can serve only as a socially costly, long-term adjustment tool, the main burden falls on fiscal policy instruments. Taking into account the large share of fixed expenses in the Polish public budget, the availability of this instrument is limited. The improvement of functioning of the channel of fiscal policy is one of the preconditions that asymmet-

ric shocks can be mitigated and the convergence process after accession can happen gradually.

To avoid the building up of large external imbalances, the fundamentals of the Polish economy should be strengthened, particularly the productivity and competitiveness of companies. This will help to avoid the worsening of the competitive position of exporters and enable Poland to take advantage of accession. The strengthening of competitiveness will mostly be carried out on the micro level, i.e. it will depend on the undertakings of firms. In terms of policy recommendations, one must stress the necessity of creating better conditions for entrepreneurship and the functioning of companies, e.g. favourable tax policies, wage setting mechanisms or improved availability of funding. Such measures would allow the costs of functioning of firms to be cut. Currently these costs are relatively high, due to tax policies and labour market rigidities, as well as impediments in financing firms.

Careful preparation for accession also involves a debate on the conditions of conversion of the zloty to the euro - an issue not mentioned in this short analysis. A good solution would be the arrangement of a convenient exchange rate stabilisation during the transition period while the zloty would participate in ERM II system.

A very important issue is the legitimacy of the adoption of the euro among Polish citizens. On a national level, a thorough discussion about the terms of the accession and its potential effects is necessary. This discussion should concern particularly the commonly expressed fears of price increase after the conversion. On a European level the strengthening of the participation of the citizens in the decision-making process would be desirable. A step in this direction would be, for instance, the strengthening of the role of the European Parliament.

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Laurian Lungu

Romania

By joining the European Union (EU) in January 2007 the Romanian economy has, implicitly, pledged to join the European and Monetary union (EMU). For now, Romania has a derogation regarding the adoption of the euro, but has committed itself to introducing the euro in the future. The Treaty on the functioning of the EU (Article 140) specifies that at least every two years¹⁶ both the European Commission (EC) and the European Central Bank (ECB) have to report to the European Council the progress made with respect to the convergence criteria of each EU member country which is not yet a eurozone member. The convergence criteria take into consideration both economic indicators (price stability, budget deficit and public debt, exchange rate stability and the convergence in long-term interest rates) as well as the compatibility of the national legislation with the ‘acquis’ (see **Table A.1** in Annex). According to the latest report by the EC (EC 2018), among the six countries with a derogation for the adoption of the euro¹⁷, there is currently no one who would fulfil all the criteria (see **Table A.2** in Annex).

Since becoming an EU member, the adoption of the euro has been a recurrent topic in Romania. So far there have been three attempts to set a year for adopting the euro, all of them driven by the political establishment. The first attempt dates back to 2009, when the government announced plans for entering into the ERM II, in the 2012-2014 period. As these dates got closer the plan was aborted, given the non-compliance with the convergence criteria. At the end of 2014 the authorities set the target year for

the adoption of the euro to be 2019. This was once again abandoned for the same reasons as before. The latest target year for adopting the euro is 2024, which was put forward in March 2018 by the largest party in the current governing coalition, the Social Democratic Party (PSD). This time round a National Commission for the Euro Adoption was set up. Its members are representatives of all stakeholders in the economy (political parties, business representatives, trade unions, the National Bank, the Ministry of Finance, academia, independent experts, etc.) and its objective is to come up with a National Plan for the adoption of the euro by the end of 2018. It also aims at building a consensus across various stakeholders through the preparation of a technical document – which will assess Romania’s risks and benefits of adopting the euro and put forward a strategy for achieving this objective. While the presence of a technical document marks a remarkable improvement from the previous two attempts of adopting the euro – which were based simply on political statements, with no economic justification behind them¹⁸, it is still somewhat uncommon to commit politically to a target year first, before the defining elements of the strategy are known.

However, the PSD is not the only political party keen to support the adoption of the euro. The National Liberal Party (PNL), which is the second-largest party in the Parliament also acknowledged that adoption of the euro is a “fundamental objective”.

The Romanian population has, in general, a favourable attitude towards the euro (see Figure 2.1). At nearly 70%, Romania has the highest share of population who are in favour of introducing the euro among the six NMS¹⁹.

16. Or at the request of a member state which is not yet a member of the eurozone.

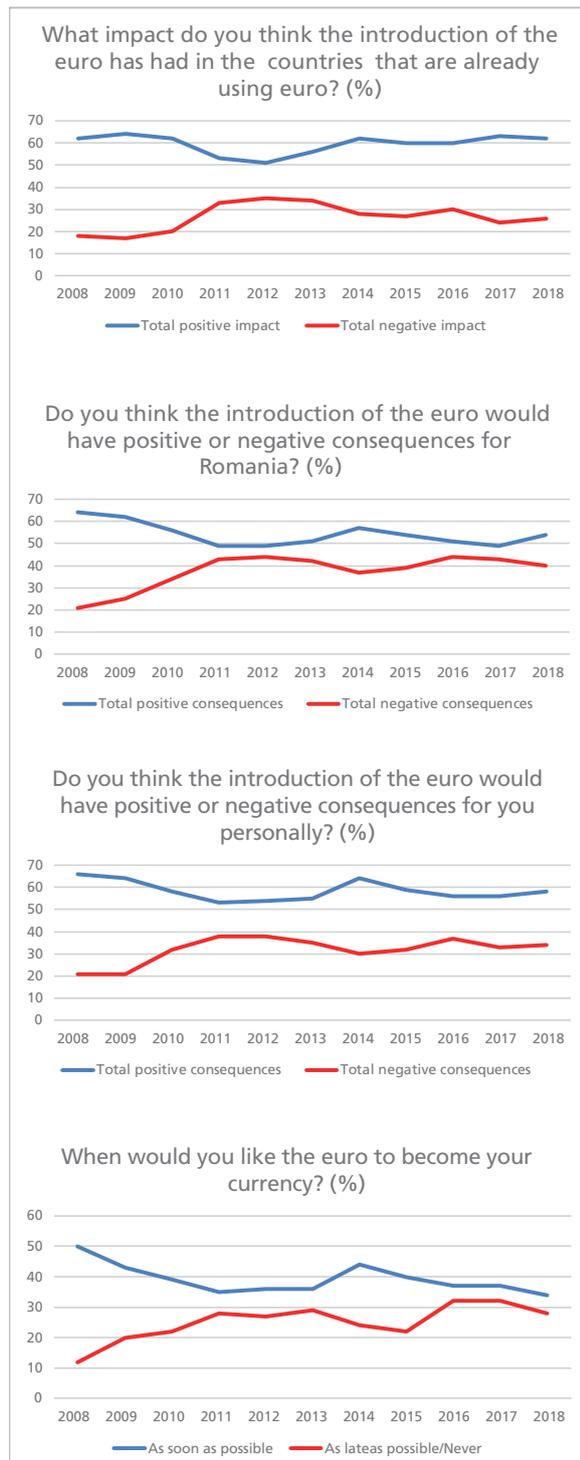
17. The six countries are Bulgaria (BG), Czechia (CR), Croatia (HR), Hungary (HU), Poland (PO) and Romania (RO).

18. Well documented works of economic analysis on the impact of adopting the euro in Romania have been lacking.

19. To our knowledge, the first comprehensive study on this topic was that of Daianu et al. (2017).

Here NMS is used for the six countries which are EU members, but not in the EZ yet, and have a derogation for joining the euro area, i.e. BG, CR, HR, HU, PO and RO.

Figure 2.1 Opinions About Euro Adoption



Source: Flash Eurobarometer 465, April 2018.

At an institutional level, a Committee for Preparing the Changeover to the Euro has been set up at the National Bank of Romania (NBR) since early 2010. Also, at a national level there is an Inter-ministerial Committee, set up in 2011, which aims at coordinating preparations for the introduction of the euro. This is chaired by the Prime Minister and includes top level representatives from the Ministry of Public Finance, the NBR, other public authorities and institutions, as well as from employers' associations and trade unions.

This analysis looks at some issues which are mostly related to the Romanian labour market, from the perspective of adopting the euro. It also touches briefly on the fiscal criteria and regional trade aspects. It aims to highlight the potential costs and benefits of the adoption of the euro in these fields.

Likely Effects of the Introduction of the Euro in Romania

By joining the eurozone, EU countries will give up their control over monetary policy. As a consequence, the flexibility of labour markets will play a key role in the adjustment of the economy in face of economic shocks. It is well documented that the structure of the labour market (see for example Christoffel et al. 2007) impacts the transmission of shocks to marginal costs and inflation and thus it affects the transmission of monetary policy to the economy. Beyond this however, the characteristics of the labour market, such as its institutional structure, the degree of labour market rigidity or the unionisation rate are in themselves sources for economic fluctuations. In the absence of exchange rate adjustment, internal devaluation – i.e. achieved through wage adjustment – becomes the main channel through which competitiveness can be preserved in the short term²⁰.

20. There is also a strand of literature that argues that internal devaluation might not be always effective because lower competitiveness in some countries in the eurozone (i.e. Italy, Greece, Spain, etc.) is related to the types of products they export and not to the fact that their labour is expensive.

A comprehensive analysis of the costs and benefits of adopting the euro is beyond the scope of this paper²¹. However, from an economic point of view, one measure of real convergence, namely GDP/capita in purchasing power standards (PPS)²², could be used as a rule of thumb for judging the level of preparedness of a country for introducing the euro. As can be seen from **Figure A1 in the Annex**, Romania had a GDP/capita of 63 (EU-28 = 100), the fourth highest among the six NMS. At 89, Czechia has the highest level of real income convergence, followed at some distance by Poland with 70. Both Romania and Poland have recorded the highest growth rates in income convergence over the last decade, around 2.5%/year. As a guidance, a potential date for adoption of the euro can be inferred by setting a threshold for GDP/capita in PPS together with some assumptions on future growth pace, as in Lungu and Kallai (2015). However, this should be taken only as a crude measure and not as a substitute for a more complex analysis. As such, convergence in per capita income levels, while not being a prerequisite for joining the EZ, is an important objective of the economic integration process.

Wages and Employment

In a monetary area, when economic cycles are not fully harmonised and transfer mechanisms²³ across member countries are not fully developed, as it the case with the EMU, the functioning of the other adjustment mechanisms, notably those in the labour market, acquire greater importance. Employment in Romania has been following a downward trend since 2008, falling from 9.5 to 8.8 million persons (see Table 2.1 below). This has been a consequence of an unfavourable demographic trend, which is expected to worsen in the years to come²⁴. The unemployment rate followed the business cycle fluctuations. It went up from 5.8% in 2008 to a peak of 7.2% in 2011, as austerity measures, aimed at addressing the build-up of macroeconomic imbalances in the pre-2008 boom period, were implemented. Subsequently, the unemployment rate fell to 4.9% in 2017 as economic recovery got stronger. The long-term structural unemployment rate currently stands at 1.8%, pressured also down by labour migration trends.

Table 2.1. Employment, Unemployment and Activity Rate

| | Youth unemployment rate, %, 15-24yrs | Unemployment rate, %, 15-74yrs | Part time workers, % of total population | Employment, 15-64yrs, thousands | Active population, % of total population, 20-64yrs | Self-employment, thousands |
|-------------|--------------------------------------|--------------------------------|--|---------------------------------|--|----------------------------|
| 2008 | 18.6 | 5.8 | 8.6 | 9,457 | 68.2 | 1,570 |
| 2012 | 22.6 | 6.8 | 9.3 | 8,849 | 69.5 | 1,587 |
| 2016 | 20.6 | 5.9 | 7.4 | 8,696 | 70.3 | 1,279 |
| 2017 | 18.3 | 4.9 | 6.8 | 8,812 | 72.3 | 1,308 |

Source: Eurostat

At 18.3%, the youth unemployment rate is slightly below its pre-crisis level, but above the eurozone level of 16.8%. Given the tight labour market, this might seem peculiar. It can be explained by the

skills mismatch, relatively limited internal labour mobility, and the low starting salary levels.

Post 2018-crisis labour market trends have revealed the slightly diminishing importance of the standard unemployment rate as an explanatory

21. Such an analysis would need to take into account various aspects of real, nominal, and institutional convergence, including long-term welfare analysis.

22. PPS is an artificial, common currency of the EU-28. One PPS can buy the same amounts of goods and services in each member country. Thus, variables expressed in PPS allow for direct comparisons among EU member states.

23. Such as automatic stabilisers, for instance

24. At the current rate, the total population is projected to shrink from the current 19.6 million people to around 17 million people by 2040.

variable for wage growth and economic activity in several countries. In a new research paper (Bell and Blanchflower, 2018) the authors suggest that underemployment²⁵ – i.e. the persons who would like to work more but do not have anywhere to do so – has become a more relevant variable for labour market policies. In their paper, Romania's underemployment stood at 7.2% in 2016, only 1.3% above the headline ILO unemployment rate.

The labour activity rate in Romania remains high, at over 72%, but a large number of employees work, in fact, abroad (see below). The number of self-employed people, despite falling since 2008, remains elevated, a trend more visible especially in agriculture. As they do not, in general, pay taxes, this accentuates some of

the challenges fiscal policy is confronted with (see below).

In the economic theory there is a direct link between the real economic convergence and the evolution of labour productivity. If real wages per employee grow in parallel with real productivity, this implies that wage developments are more or less consistent with changes in labour supply and demand – at full employment.

Over the last decade Romania's nominal labour productivity has risen at a rate of 2.9% per year, the highest among NMS (see Table 2.2 below). However, despite that, given the initial low level, labour productivity is still slightly less than half when compared to the EZ level.

Table 2.2. Nominal labour productivity per hour worked, % of EU28 total (based on Mill. PPS), current prices

| Year\Country | EZ | BG | CR | HR | HU | PO | RO |
|--|-------|------|------|------|------|------|------|
| 2008 | 112.0 | 39.0 | 72.8 | 61.2 | 59.7 | 50.3 | 45.8 |
| 2012 | 111.2 | 43.4 | 70.2 | 61.7 | 68.2 | 59.5 | 50.2 |
| 2016 | 111.6 | 45.1 | 73.4 | 63.5 | 62.8 | 59.2 | 55.9 |
| 2017 | 111.4 | 46.3 | 73.6 | 64.2 | 63.8 | 61.1 | 59.3 |
| Annual Average Growth Rate 2008-2017, % | -0.1 | 1.9 | 0.1 | 0.5 | 0.7 | 2.2 | 2.9 |

Source: Eurostat

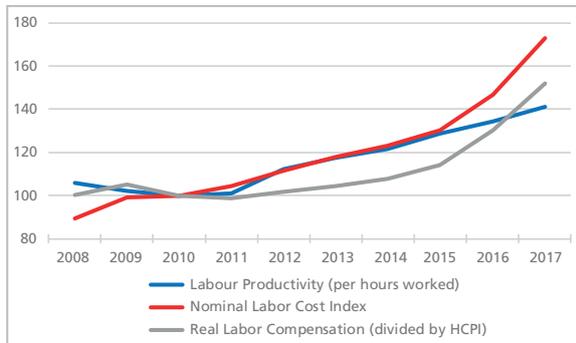
The advancement in labour compensation, most notably after 2015, has pushed up labour costs and, starting with 2017, overtook labour productivity (see figure 2.2 below). This trend is likely to be exacerbated in 2018 as excess demand persisted. Substantial wage increases in recent

years are partially a consequence of tightening of the labour market. But fiscal policy had also had an impact on wages, more notably net wages. These are going to be affected by the recent shift in social security contributions²⁶ from the employer to the employee (see Figure 2.3).

25. As different economies recovered from the global financial crisis, some relaxed labour regulations, creating more precarious part-time jobs to drive down the headline unemployment rate. This increased the underemployment rate.

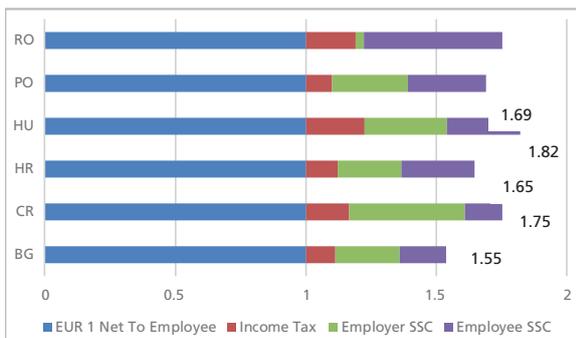
26. In 2018 social contributions were shifted almost entirely onto employees, thus altering the wage structure and transforming the financing of social protection.

Figure 2.2 Labour Productivity and Compensation, 2010=100



Source: Eurostat

Figure 2.3 Employer's Cost for EUR 1 Net Employee Pay, NMS



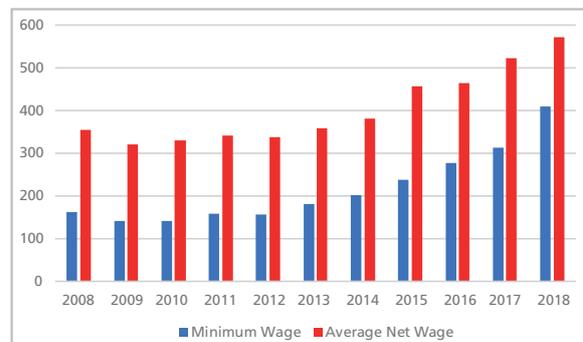
Source: James Rogers and Cécile Philippe (2018).

The aggregate data level masks the deep existing asymmetries among various economic sectors. The relationship between real wages and labour productivity holds for the private trading sector (i.e. manufacturing). As these companies compete in international markets, they cannot afford themselves large deviations from the wage-productivity equilibrium for extended periods of time. In practice, the tightness of the labour market, the degree of competition in the economy and wage push factors will determine the amplitude of these deviations. However, public sector wages have been set according to a different mechanism. Given that public sector activities are largely non-tradable, they are not facing competition and thus can be increased

without paying close attention to the wage-productivity relationship. Over the last years public sector wages went up constantly, often recording double-digit growth. As a consequence of that, the ratio of public sector wage to the economy average has returned again to over 160, after the massive post-crisis adjustment efforts²⁷.

The trend in wage growth has been partly influenced by the evolution of minimum wages. These have witnessed remarkable increases (see Figure 2.4), increasing almost threefold since 2009, to the equivalent of EUR 410 in 2018.

Figure 2.4 Minimum and Average Net Wages, EUR, current prices



Source: Stoiciu (2017) and Own Calculations

A statutory minimum wage was introduced in 1990. The minimum wage setting process requires the government to have prior consultations with social partners. Starting in 2012, the government implemented a so-called wage growth economic policy, whereby minimum wages have been increased in successive steps, at an accelerated pace. As a consequence, the gap between minimum and average wage has been shrinking continuously, while the share of labour contracts set at the minimum wage level in total labour contracts rose to 32% in 2018, from 14% back in 2014. The increases in minimum wage will impact labour productivity and economic activity in the near future¹³. In PPS terms, minimum wages in Romania are already second highest among NMS, after Poland (see Table 2.3).

27. The ratio of public sector to average economy wages reached a high of 180 before the crisis and then fell to 120 in 2011, driven by a 25% cut in public sector wages, coupled with wage growth freezes

Table 2.3 Minimum Wage Indicators in NMS

| | Min wage, July 2018, EUR/month | Average annual growth rate in min. wage (EUR/month), %, 2008-2018 | Min wage, July 2018, PPS/month | Min Wage as a % of median gross monthly wage, % |
|-----------|--------------------------------|---|--------------------------------|---|
| BG | 261 | 8.8 | 539 | 56 |
| CR | 469 | 3.4 | 672 | 43 |
| HR | 466 | 2.2 | 688 | 46 |
| HU | 445 | 5.0 | 720 | 60 |
| PO | 480 | 3.6 | 878 | 53 |
| RO | 410 | 11.5 | 796 | 51 |

Source: Eurostat

Continuing to increase the wage convergence between Romania and the EZ is a prerequisite for adoption of the euro. The increase in domestic purchasing power can be achieved through higher productivity. Also, the structure of value chains in the economy will need to gradually shift in order to capture higher value-added activities.

Migration and Labour Mobility

Labour mobility has been a central topic of the post crisis debates in the eurozone. Relatively low intra-EZ states labour mobility is a result of a mix of exogenous factors, such as linguistic and cultural barriers, but also other factors that are in fact endogenous to economic policy, such as the limited level of harmonisation in the tax and pension systems, in bank lending, or in the recognition of professional qualifications.

However, these factors appear to have little impact on Romania's emigration. Since 2000, the year when Romania started talks for the EU accession, the net stock of Romania's emigrants has advanced at an annual rate of 7% globally, growing more than threefold. Towards Europe, Romania's emigration rate expanded considerably, growing at an annual rate of 8.7% (see Table 2.4 below).

After Romania joined the EU, in 2007, migration rates have increased, both for the highly-skilled (especially physicians²⁸) and low skilled migrants, with migrant outflows gradually shifting towards EU countries. According to UN data, at the end of 2017 almost 3.6 million Romanians lived abroad, 3.2 million in Europe, with Italy, Spain and Germany – all EZ countries – being the main destination. These three countries together account for almost three quarters of the stock of Romanian migrants.

Table 2.4 Romania – Select Emigration Statistics

| | Year | World Total | | | | | |
|--|-----------|------------------|------------------|---------|-------|-------|------|
| | | <i>of which:</i> | Europe | | | | |
| | | | <i>of which:</i> | Germany | Italy | Spain | UK |
| Total Stock Emigrants (Thousands) | 2000 | 1139 | 765 | 323 | 119 | 8 | 7 |
| | 2017 | 3579 | 3143 | 592 | 1040 | 652 | 231 |
| As % of total | 2017 | | 87.8 | 18.8 | 33.1 | 20.8 | 7.4 |
| Annual Growth Rate, % | 2000-2017 | 7.0 | 8.7 | 3.6 | 13.6 | 29.1 | 22.5 |

Source: Own Calculations based on United Nations data²⁹.

28. More than a quarter of Romanian physicians were estimated to be working abroad in 2013 (see WB 2018).

29. UN survey available at <http://www.un.org/en/development/desa/population/migration/data/estimates2/estimates17.shtml> (Accessed October 2018)

As a share of emigrants in total population, Romania ranks second among NMS, at 18.3%³⁰, after Croatia at 22.1%. This high outflow has had a negative impact on the domestic labour market, and implicitly on the working-age population growth. Partially as a consequence of this, the domestic unemployment rate has fallen to record low levels. The high emigration rate of skilled workers appears to have negatively affected the real productivity growth (EC 2014). Supply shortages in sectors such as information and technology, health and education, science and engineering or technicians tend to be mostly permanent (IMF 2016) and have impacted GDP growth negatively. On the other hand, however, emigrants' remittances have constituted a constant source of inflows into the economy, channelled towards either investment or consumption³¹.

In Romania, domestic labour mobility is rather low. Employees prefer to work in countries with higher productivity when compared to Romania. At current rates, wage differentials between domestic regions with high unemployment rates and other regions across the EU are still high enough to incentivise external rather than internal migration. This phenomenon is also supported by the existing high level of domestic house ownership - at almost 97% in 2017 - a variable which traditionally has an explanatory power in the determinants of labour mobility.

Given that both Romania's labour external migration and the migrants' share in total population are already quite high - in absolute terms and relative to other NMS countries - joining the EZ is unlikely to bring more benefits in the short and medium term. Unless domestic living costs catch up significantly, a reversal in migration trends looks unlikely.

Prices and Inflation

A high degree of inflation convergence is mandatory for proper functioning of monetary policy in the EZ.

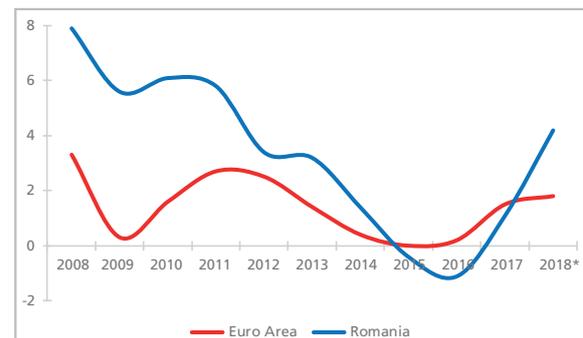
30. Romania's total population at the end of 2017 was estimated at 19.6 million.

31. Remittances appeared to have a positive impact on the reduction of poverty and income inequality (UNCAD 2011)

A common monetary policy coupled with decentralised fiscal policies make large cyclical inflation differentials across EZ member countries difficult to deal with. Therefore, price level convergence, between Romania and the EZ average is an imperative precondition before adopting the euro. If the price level of tradable goods is easier to equalise, the prices of non-tradables adjust more slowly. This happens because catching up in terms of productivity and real incomes would implicitly require a temporary higher price level in the non-tradable sector.

Annual average inflation in Romania followed a downward trend from 2008 until 2016. Over this period, it fell from 7.9% to -1.1%, initially driven by the drop in aggregate demand and, later on, by a reversal of tax increases, notably VAT, enacted after economic recovery started to strengthen (see Figure 2.5 below).

Figure 2.5 Annual Average Inflation, %



Source: Eurostat and EU Convergence Report 2018

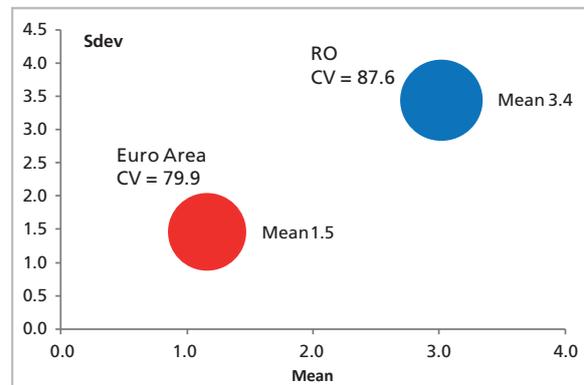
However, since the start of 2017 the annual inflation rate has started to rise once again, slightly exceeding expectations. Several factors have contributed to this. Excess demand, a tightening of the labour market, increasing labour costs, import prices pass-through, the role of administered prices³² and the discretionary behaviour of fiscal policy³³. The latter is a relatively important driver of the component of unanticipated inflation.

32. Administered prices have a slightly larger weight in the Romanian HICP basket than in the EZ, 14.1% vs 13.4% in 2017.

33. Taxation in particular strongly influenced Romanian inflation. In 2016 for instance, the harmonised inflation consumer price index (HICP) measured at constant taxes was 2.1%, more than 3 percentage points higher than the headline HICP rate, after the VAT rate was cut from 24% to 20%.

One salient feature of Romanian inflation is that it has a higher volatility compared to the EZ average. Figure 2.6 below depicts this. Over the period 2008-2017, both the mean and the standard deviation of Romanian annual average inflation was twice as high as that of EZ. The coefficient of variation (CV) – which is a measure of variability of inflation in relation to its mean – at 87.6, was higher than in the EZ. This puts into a different perspective the efforts Romania will need to make in order to fulfil the Maastricht criteria of inflation. Since 2008, barring the 2014-2016 period, when price changes were negative or close to zero, Romania failed to comply with the inflation criterion (see Table 2.5).

Figure 2.6 Inflation Volatility, Romania and Eurozone



Source: Own Calculations using Eurostat data over the time period 2008-2017. See also Lungu (2018)

Table 2.5 Romania - Inflation Criterion Fulfilment between 2008-2018

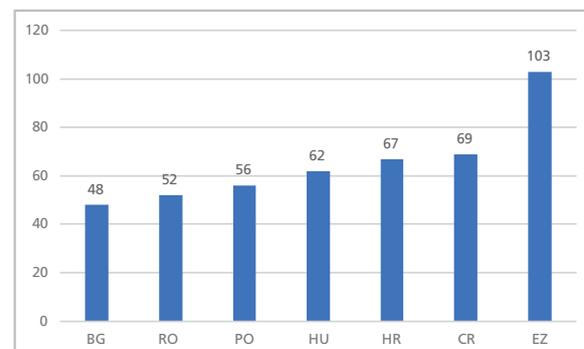
| Year | 2008 | 2010 | 2012 | 2013 | 2014 | 2016 | 2018* |
|---|------|------|------|------|------|------|-------|
| Inflation Criterion, % | 3.2 | 1.0 | 3.1 | 2.7 | 1.7 | 0.7 | 1.9 |
| Romania, average inflation rate, % | 7.9 | 6.1 | 3.4 | 3.2 | 1.4 | -1.1 | 4.2 |

Source: EU Convergence Report (2018) * - Forecast.

Beyond discrepancies in inflation dynamics across business cycles in Romania and the EZ, there are also significant differences in the price levels³⁴ for consumer goods and services³⁵. For instance, in 2017 the price level index for household final consumption expenditure in the EZ was double the level in Romania (Figure 2.7). This reveals the remarkable size of the gap that needs to be bridged before Romania joins the EZ. Subsequent to the adoption of the euro, price dispersion tends to become smaller, as stressed in Cavallo et al. (2014).

Romania will not be able to join the EZ unless a certain (relatively high) degree of price level convergence is achieved first. In the absence of that, the adjustment will necessarily be made via wages, with sizable long-term painful effects for the labour market.

Figure 2.7 Price level index for household final consumption expenditure, 2017, EU-28=100



Source: Eurostat

34. Price dispersion is also common across EZ members.

35. See the publication "Comparative price levels of consumer goods and services" by Eurostat, available at https://ec.europa.eu/eurostat/statistics-explained/index.php/Comparative_price_levels_of_consumer_goods_and_services. Accessed 04 November 2018.

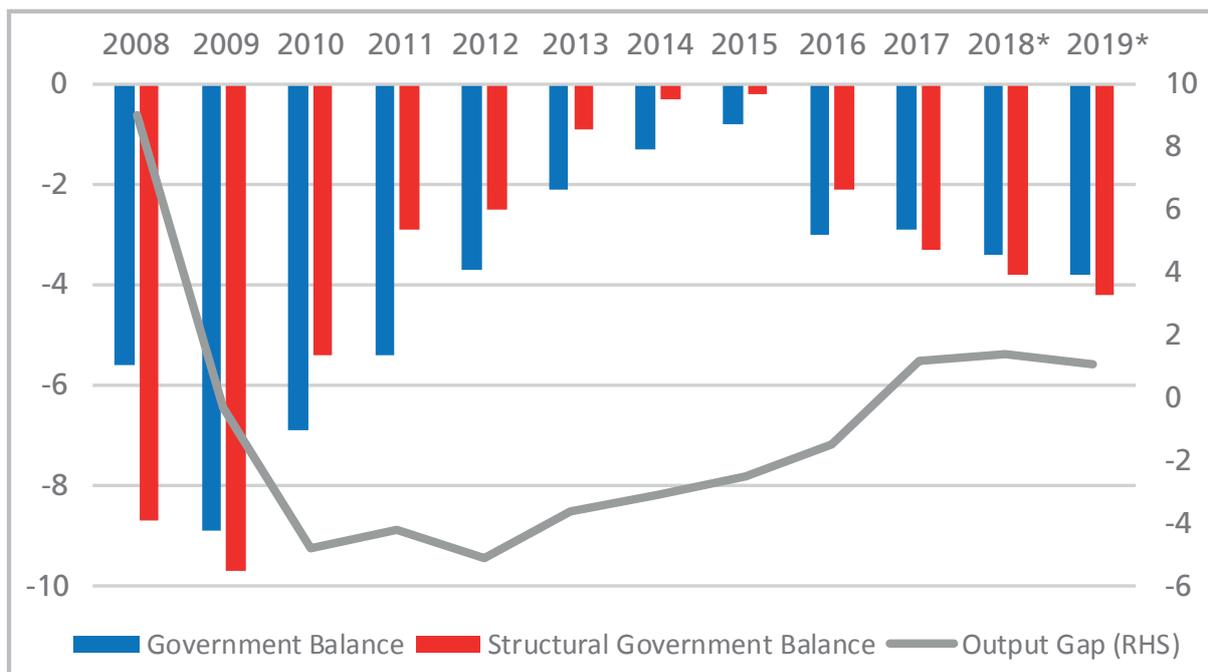
Fiscal Situation

The government's taxation and spending decisions influence aggregate demand, thus complementing the monetary policy actions in stabilising the economy against economic shocks. If Romania were to join the eurozone, a more active fiscal policy could potentially compensate for the loss of monetary policy independence³⁶. Therefore, discretionary changes in fiscal policy, such as those altering tax rates or the structure of government expenditures would require active decisions to stabilise the economy, with the objective of limiting strong adverse effects on intergenerational equity. Given this, fiscal policy economic impact assessments would prove to

be fundamental in designing effective policy actions. This would constitute a serious drawback as the current capabilities of domestic public sector authorities for complex impact assessments appear to be rather limited.

The Government Budget Balance. Gains in fiscal consolidation achieved after 2009 have been gradually squandered away since 2015 as economic growth resumed and fiscal policy has been increasingly used to stimulate demand, unnecessarily, through tax cuts and wage increases. The government balance deficit has been on a rising path (see Figure 2.8 below) and EC forecasts a deepening of the deficit, above the -3% of GDP Maastricht limit in the short term³⁷.

Figure 2.8 Government Balance and Output Gap, % of GDP



Source: EC (2015a), EC (2018a), * - EC forecasts.

36. In the standard Mundell-Fleming model, which provides a framework for the monetary and fiscal policy analysis of a small open economy, fiscal policy is likely to have a stronger effect on the economy than monetary policy in a fixed exchange rate regime.

37. In practice however, the authorities might be able to maintain the deficit below the Maastricht limit by reducing public sector investments. This policy has been applied over recent years, in effect public sector investment becoming the budget's residual value set in such a way as to meet the Maastricht criteria.

One major issue of Romania joining the EZ would be its level of government revenues. At 30.7% of GDP in 2017, this is less than two thirds of the EZ level and by far the lowest among NMS countries³⁸. More importantly, fiscal revenues from tax receipts have been falling rapidly from the equivalent of 20% of GDP in 2015 to 16.6% of GDP in 2017, as successive tax cuts, supporting a procyclical

fiscal policy, drastically reduced tax-related revenues (see Table 2.6). The low tax/GDP ratio is a structural issue in Romania. A relatively large informal economy³⁹ and low tax compliance⁴⁰ are among the main factors that have been keeping the tax revenues/GDP ratio hovering around 32% (with a minimum of 29.4% in 1996 and a maximum of 35% of GDP in 2015) since 1995.

Table 2.6 Select Fiscal Related Issues, Romania (RO) vs Eurozone 19 (EZ). All variables are expressed in percentages of GDP.

| | Total Government Revenues | | Total Government Expenditure | | Tax Receipts | | Social Security Contributions | | Public Sector Employees Compensation | | Public Sector Gross Capital Formation | |
|-------------|---------------------------|------|------------------------------|------|--------------|------|-------------------------------|------|--------------------------------------|------|---------------------------------------|-----|
| | RO | EZ | RO | EZ | RO | EZ | RO | EZ | RO | EZ | RO | EZ |
| 2008 | 32.4 | 44.4 | 37.8 | 46.6 | 18.3 | 25.0 | 9.9 | 14.7 | 10.1 | 10.1 | 6.5 | 3.3 |
| 2012 | 33.6 | 46.1 | 37.2 | 49.7 | 19.0 | 25.5 | 8.7 | 15.3 | 7.8 | 10.4 | 4.9 | 2.9 |
| 2016 | 31.9 | 46.0 | 34.9 | 47.5 | 17.9 | 26.0 | 8.1 | 15.2 | 8.2 | 10.0 | 3.6 | 2.6 |
| 2017 | 30.7 | 46.1 | 33.6 | 47.0 | 16.0 | n/a | 8.5 | n/a | 9.0* | n/a | 3.4* | n/a |

Source: Eurostat and Romania Ministry of Finance; * -estimate.

Traditionally, political business cycles introduce an additional source of uncertainty in the economy. Electoral promises are sometimes fulfilled at the expense of non-compliance with EU legislation. For instance, the structural deficit has increased above its -1% of GDP target - consistent with the medium-term budgetary objective (MTO) – over the last four years.

Social Security Contributions (SSC). Starting with 2018, there has been a radical change in the Romanian tax code regarding the payment of SSC to the budget. Besides the reduction in the effective number of contributions owed by both the employer and the employee, from six to three, the amendments to the tax code envisaged the transfer of SSC from the employer to the employee. Thus, the

SSC rate payable by the employee now stands at 35% of the gross wage, while the employer's SSC payable rate is 2.25%. These changes are expected to increase the SSC received by the government from 2018 onwards. But it is likely to have some adverse effects on other revenue categories.

The budgetary constraints prevent larger spending on social security contributions⁴¹. Social benefits paid amounted to 10.8% of GDP in 2017, a quarter higher than the amounts collected (see Figure 2.9). In absolute terms, transfers from the budget towards social security were almost the same in Romania and the EZ, the equivalent of around 2.5% of GDP. But the EZ spends much more on social security, the equivalent of 16.8% of GDP in 2017, than Romania.

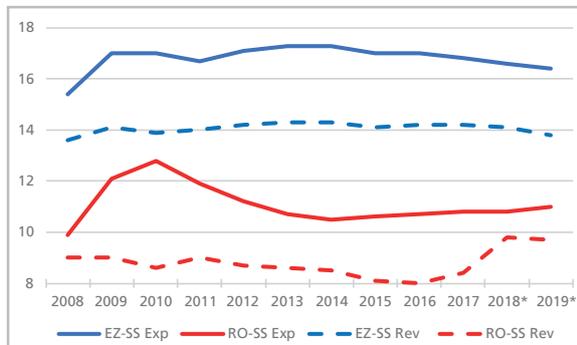
39. Using the OECD methodology, the Romanian National Institute Office estimated the size of Romania's informal economy to be 22% in 2014. There is a large share of self-employment. Data from AMECO puts this figure at 34% of the total employed workforce in 2017 (vs 18% in the EU).

40. Tax compliance remains low across most of the tax revenue categories. The VAT gap in Romania in particular (i.e. the difference between the so-called theoretical VAT revenue and the VAT that is actually collected) at 36% is the highest in the EU (see also CASE et al 2017).

41. Public sector wages, together with social security spending, amount to two thirds of total government expenditure.

38. At the end of 2017, the total revenue/GDP ratios in the NMS were: BG 36.2%, CR 40.5%, HR 45.8%, HU 44.7% and PO 39.7% (Eurostat).

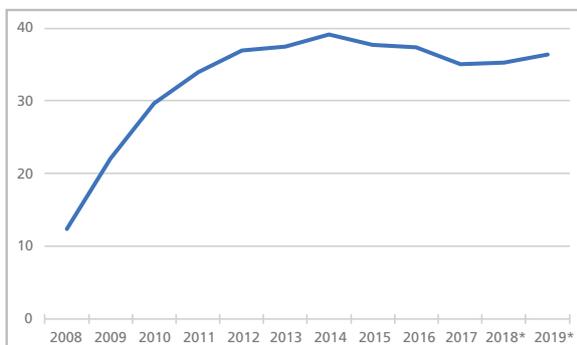
Figure 2.9 Social Security Revenue and Spending, % of GDP



Source: AMECO. * - Forecast

Public Sector Debt. Romania's public debt/GDP ratio went up from a low of 12% to 35% in 2018 (see Figure 2.10). Future demographic pressures and the expected increase in costs related to health care and long-term care are likely to put additional upward pressure on public debt/GDP ratio⁴².

Figure 2.10 Public Debt as % of GDP



Source: AMECO

Regional Cooperation and Trade Integration

Romania has an open economy and it is integrated with the EZ through both trade and investment. More than three quarters of Romania's exports go towards EU countries (see Table 2.7).

The EZ is the largest trading partner, absorbing 45% of Romania's exports in 2017. Trade openness is relatively high, in 2017 it stood at 45% of GDP. The share of trade with the EZ has been going up over recent years, reaching 25%.

Germany, Italy and France are the largest trade partners in the euro area, the three of them together absorbing 40% of Romania's exports.

Regional trade links are quite strong, the NMS, as a whole, making up 14% of Romania's total exports. Turkey is also an important trading partner in the region.

For years Romania has been running a trade balance deficit as excess demand could not be met by domestic production capacities. The trade balance deficit has been following the business cycle patterns. More recently, trade balance has started to deteriorate, due to increased domestic consumption.

However, a significant part of imports represents items used in the intermediary production processes. Over the 2000-2016 period Romania's export market shares rose almost four times, helped by moderate increases in unit labour costs. Market share gains came mainly from the machinery and equipment export industry - accounting for almost half of the increase in market shares in 2016. The vehicle industry together with the transport and telecommunication sector also contributed to market share gains.

After the 2008 crisis a larger part of trade which relates to EU production chains has been increasingly acquired (see Figure 2.11). Its share of regional value chain integration, particularly in manufacturing and business services, has been rising, in parallel with the increase in specialisation across the regional European value chains.

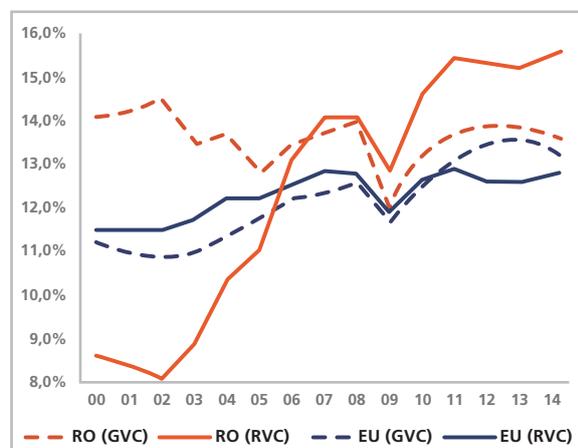
42. In its last issue of Convergence Report (EU 2018a) the EC simulations show that, in the no-policy change scenario, the debt to GDP ratio could go above the 60% reference by 2028.

Table 2.7 Romania, Exports and Balance of Trade Statistics, 2017 Data

| | | Total Exports, Bn EUR | Percentage in Total Exports, % | Net Trade, Bn EUR |
|---|----------|-----------------------|--------------------------------|-------------------|
| World | | 62.7 | | -12.9 |
| | Intra EU | 47.5 | 75.8 | -9.8 |
| | Extra EU | 15.2 | 24.2 | -3.1 |
| | Eurozone | 33.9 | 44.8 | -7.1 |
| Top 5 trade destination countries - Western Europe | | | Percentage in EU-28 Exports, % | |
| | GE | 14.4 | 22.9 | -0.78 |
| | IT | 7.0 | 11.2 | -0.55 |
| | FR | 4.2 | 6.8 | +0.23 |
| | UK | 2.6 | 4.1 | +0.87 |
| | ES | 1.9 | 3.0 | -0.16 |
| Exports to NMS Countries | | | | |
| | BG | 2.1 | 3.4 | -0.05 |
| | CR | 1,8 | 2.9 | -0.37 |
| | HR | 0.2 | 0.3 | +0.05 |
| | HU | 2.9 | 4.7 | -2.70 |
| | PO | 2.0 | 3.1 | -2.15 |
| Exports to Turkey | | 2.1 | 3.3 | -0.92 |

Source: Computations based on Eurostat and Romania National Institute for Statistics data.

Figure 2.11 Changes in Regional and Global Value Chain Trade



Source: Stehner et al. (2017). RVC (GVC) indicates the share of regional (global) value chains trade, as a percentage of total value-added trade in the economy. It is based on World Input Output Tables, 2014.

Adopting the euro would lead to the elimination of the risk of the exchange rate, thus reducing transaction costs⁴³. In turn, this could stimulate exports of existing firms and encourage non-exporters that previously limited their operations to the domestic market. Eliminating the risk of the exchange rate between Romania and the EZ should contribute to foreign trade expansion and the related benefits: increasing specialisation and scale of production, increased investment and the transfer of new technologies and “know how” to the country.

43. See for instance Blanchard, O., and F. Giavazzi (2002) or Rose (2000).

Conclusions

In the absence of the exchange rate as an adjustment instrument, if Romania were to join the euro, its economy would need to be more flexible. Here, flexibility refers to the ability of both factor and product markets to absorb the effects of an asymmetric shock through changes in relative prices and wages and to the effectiveness of fiscal policy as an instrument of countercyclical stabilisation.

Under a fixed exchange rate labour mobility – both internal and external – would be a key mechanism in the amortisation of asymmetric shocks in a euro area that still exhibits barriers to migration. There is a set of policies that could enhance labour market flexibility which exploit the existing market trends, such as extending flexible forms of employment (part-time, flexible hours and temporary employment). However, the policies that would stimulate further labour mobility across the EZ and NMS cover a wider range of potential interventions, ranging from further deregulation in financial and insurance markets and banking, to property markets.

However, it is essential that convergence in nominal variables is first reached. A large number of them, especially those related to financial variables, were not covered at all, being beyond the

subject of this paper. Price level adjustment, closer to the EZ average, would be paramount. This can only be achieved through increases in productivity. Romania, as other NMS countries, has become increasingly integrated into the value-added EU chains. Increased level of specialisation should lead to higher intra-industry trade with EZ countries and thus a closer synchronisation with EZ business cycles. Although in theory, joining the EMU should increase trade volume with EZ countries, in practice it is rather difficult to estimate such effects – as they are already ongoing.

Fiscal policy in Romania would need to be more disciplined if Romania were to join the EZ. With the current level of tax revenues/GDP ratio Romania would find it difficult to implement effective redistributive effects across domestic regions. With an ineffective fiscal policy, the risk is that potential output in the fixed exchange rate scenario would fall below the level that would have prevailed under flexible exchange rates, leading to a loss of welfare.

Making steps towards setting up some sort of a central fiscal authority in the EZ would also improve the coordination between national fiscal policies, and between the ECB's monetary policy, leading thus to lower output and inflation volatility across the whole EZ.

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Vladan Hodulak

Czech Republic

The Czech Republic joined the EU in 2004 and upon its entrance it promised, like every other country joining the community after 1992, that it would adopt the single European currency as soon as the economic and political conditions allowed. The government and the Czech national bank had started with preliminary preparations for this process even before the country joined the EU. In 2003 they released the Joint plan for the adoption of the euro in the Czech Republic (Vláda ČR, ČNB 2003). The first plan envisioned entrance into the eurozone in 2010, but the Czech government failed to join the ERM II (one of the entry conditions) and the exact date had to be postponed (Vláda ČR, ČNB 2007). First, it was set as 2012, but with the unfolding of the eurozone crisis the date was postponed again. The Czech government has not yet announced any new definite date for its adoption of the single European currency.

The Czech Republic could have theoretically already joined the eurozone on several occasions. The Czech economy met the Maastricht criteria even before the eurozone crisis and has no substantial problems fulfilling them now (European Commission, Directorate-General for Economic and Financial Affairs 2018). But the Czech government has been deliberately postponing its entrance into ERM II and for this reason it formally does not meet one of the official requirements for entrance into the eurozone. This is a very similar approach that Sweden has employed ever since it joined the EU in 1995 and the Swedish precedent together with the turmoil in the eurozone has allowed the Czech Republic to dodge its official promise to adopt the common currency without much pressure from the European commission and other member states, at least for now.

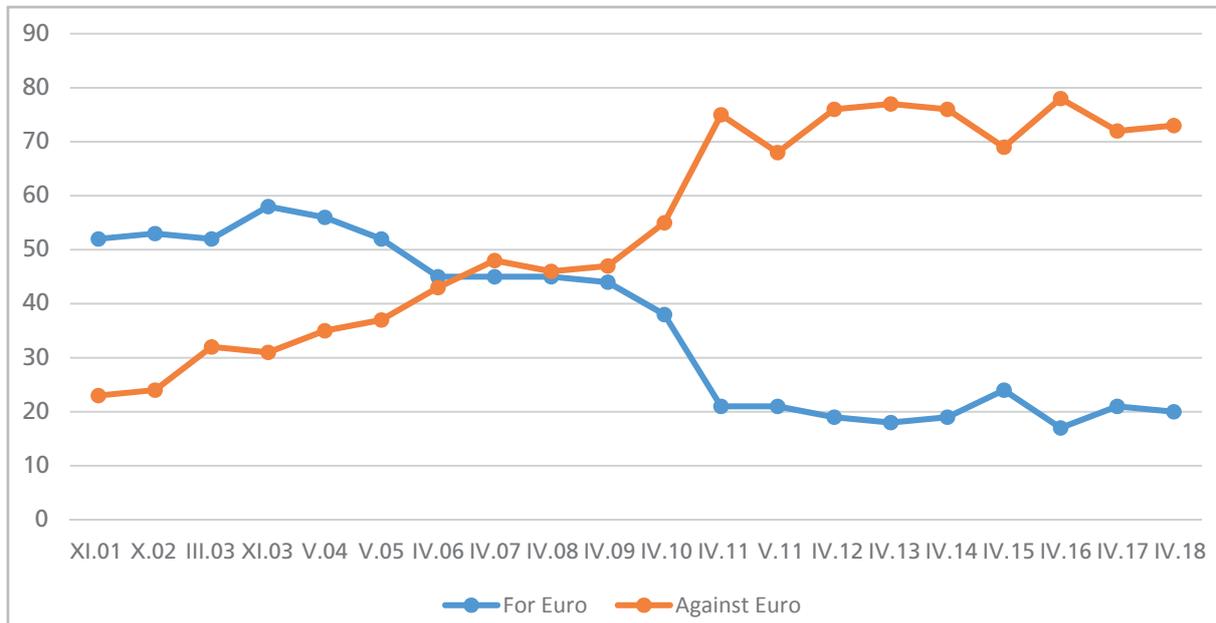
Officially, the Czech Republic follows the (quite elaborate) National plan for Euro adoption that was adopted by the Government of the Czech Republic in 2007 (Vláda ČR 2007). The whole process has been supervised by the Ministry of Finance, which established the National Coordination Group for the Euro Adoption in the Czech Republic led by Oldřich Dědek (Ministerstvo financí 2013). But in reality, there has

been very little progress, owing to the fact that the government has yet to decide on the exact date for adoption of the euro. There are doubts as to whether there is enough political consensus to undertake such a decision in the foreseeable future at all.

These doubts stem from the persistently negative opinions towards adopting the euro among both the Czech political representation and the general public. Both groups have mutually reinforced their views throughout the years. The leading Czech politicians had expressed their doubts about the functioning of the eurozone even before the global financial crisis. One of the main voices against adopting the euro has been the president of the Czech Republic Václav Klaus. Public opinion about the matter was clearly positive only shortly after the country joined the EU. The number of supporters and opponents evened out by 2006, in 2010 the public opinion moved strongly against the adoption of the single currency and this unambiguously negative stance has entrenched itself among the Czech public ever since (Figure 3.1).

The recent Czech political representation has predominantly negative attitudes towards the introduction of the euro to the national economy in the foreseeable future. The Czech prime minister and leader of the by far strongest political party in the Czech Chamber of Deputies (29.64 %) Andrej Babiš claims to be satisfied with the national currency and according to him, adoption of the euro is a low priority issue (ČTK 2018). His coalition partners, the Czech Social Democrats (7.27 %), are for the adoption but their position has seriously weakened over the last few years, and they did not move much in that direction when they had the opportunity to do so as the strongest party in the previous government. The Czech communists (7.76 %), who tolerate the recent government, are against the adoption. The Civic Democrats (11.32 %), currently the largest opposition party, are strongly against the entrance into the eurozone in its present form. The extreme-right SPD (10.64 %) are vigorously against the euro and would like to emulate the UK and leave the EU completely. There are three political parties that are for the euro in principle, but would prefer to wait for the most suitable moment; these are the Pirates (10.79 %), the Christian Democrats (5.80 %) and STAN (5.18 %).

Figure 3.1: Opinions on the adoption of the Euro in the Czech Republic in time (in %).



Source: Hanzlová (2018), Občané ČR o budoucnosti EU a přijetí eura – duben 2018.

The only party that has consistently declared itself for the earliest possible adoption of the common European currency is the liberal TOP09 (5.31 %).

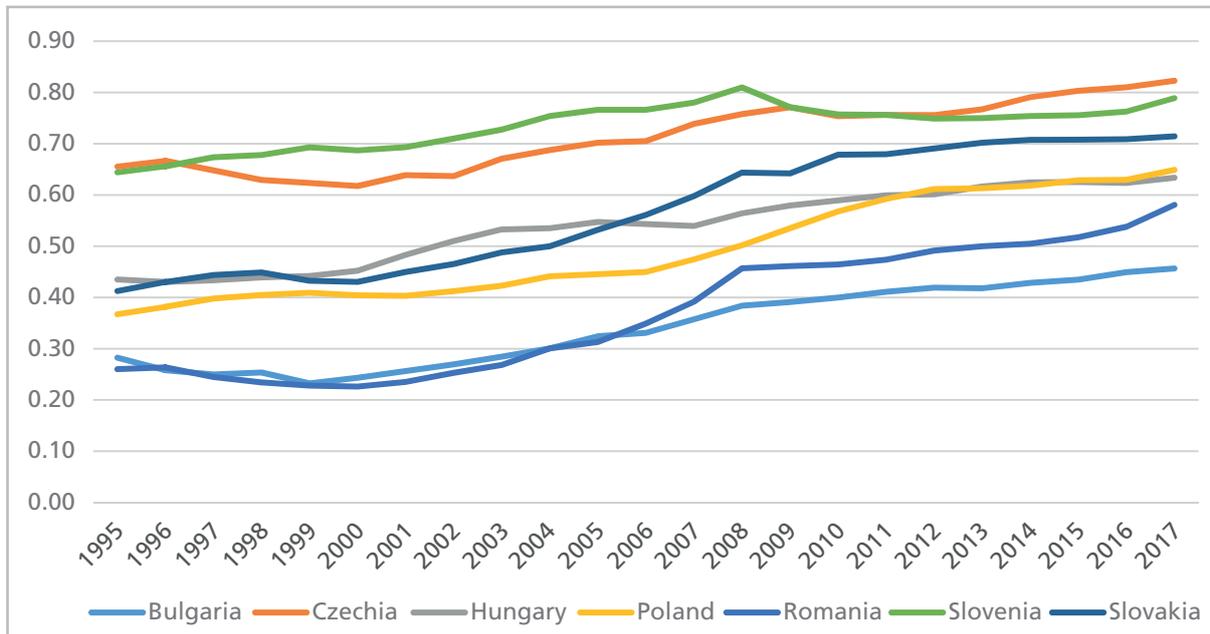
The issue has not been at the forefront of the public discussions in the last several years and there seems to be a tacit understanding among the population that the Czech Republic will not adopt the euro at least in the next 5-10 years, if ever. The opponents of the move have claimed that the current eurozone is very different from the original one and that the validity of the original Czech commitment is therefore questionable (Krutílek 2013). The proponents of the adoption of the single currency warn that the Czech Republic would become isolated in the EU and therefore lose its influence over the future development of the community (Niedermeyer 2017). The main economic interest groups support membership of the eurozone in principle, but there are some differences. The Confederation of Industry of the Czech Republic pressures the government to declare the official date for adoption of the euro and warns against too many delays that could move the Czech economy to the econom-

ic periphery of Europe (Svaz průmyslu a dopravy ČR 2017). The Czech-Moravian Confederation of Trade Unions is not against joining the euro *per se* but claims that the real economic convergence to the level of the core EU countries is a much more important goal and this goal can be more readily achieved outside the eurozone, at least for the time being (Fassmann, Ungermann 2018).

Likely Effects of the Introduction of the Euro in the Czech Republic

The Czech Republic is a small open economy, highly dependent on its trade with the EU, particularly with the eurozone. Since 1990 the economy has undergone a very slow process of real economic convergence, which has somewhat accelerated in the recent years but in general has been very unsatisfactory (Figure 3.2). In reality, the other central and eastern European (CEE) countries have converged to the Czech Republic (and Slovenia) more than the Czech Republic to the European core.

Figure 3.2: GDP per capita, real expenditures in PPS EU 28 (EU 15=1)

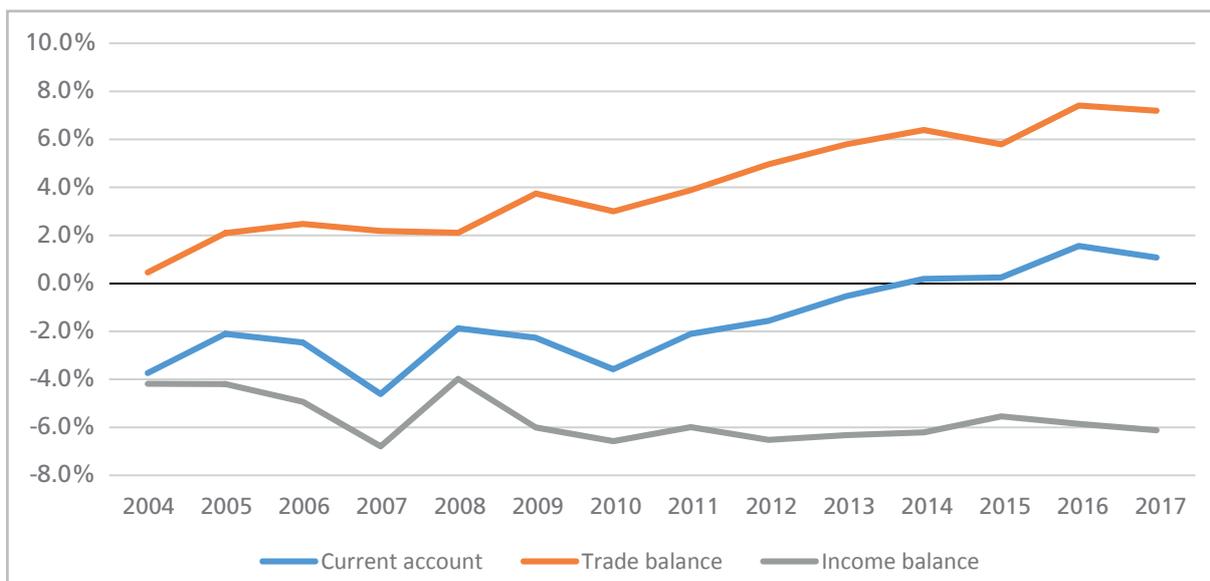


Source: Eurostat (2018a). Purchasing power parities (PPPs), price level indices and real expenditures for ESA 2010 aggregates. Own calculations.

At the first glance, the Czech economy has solid macroeconomic fundamentals. Recently, the GDP growth has accelerated (4.5% in 2017), the level of unemployment is one of the lowest (if not the lowest – around 3%) in Europe and the inflation has been very low for a decade (0.3-3.3% per year).

However, there have been some underlying worrying trends. The Czech Republic experiences huge income outflows (Figure 3.3) and the productive structure of the economy suggests that it has been locked in a very precarious position within the global value chain (Krpec a Hodulak 2018).

Figure 3.3: The Czech current account and its components (% of GDP, current prices)



Source: Czech National Bank (2018), ARAD data series system, own calculations.

The following text will attempt to analyse the potential costs and benefits of the Czech entrance into the eurozone over several dimensions of the Czech economy. However, a warning is in place here; there are very few known definite costs and benefits and the total value of those that are known with some accuracy is not very significant. Many potentially much more important aspects depend either on the actual CZK/EUR exchange rate upon the entry, which is as yet completely unknown, or are of structural and institutional nature and their impacts are only possible, not certain. The structural and institutional effects cannot be calculated with any reasonable degree of certainty at the moment, but I will provide some broad guidelines for their assessment.

In general, some of the usual expected effects of the adoption of the common currency that were predicted by earlier studies (Lacina a kol.2007) such as increased inflow of investment and re-orientation of trade flows towards the euro-area member states have to a significant degree already materialised and further substantial increases in these effects are highly unlikely. For example, the Czech Republic already conducts most of its trade with other EU countries (83%) and more specifically the eurozone (66%). For this reason, the analysis will not delve into these much further.

Wages and Employment

In the international context, the Czech development strategy has so far resided on two main pillars – undervalued currency and disproportionately low labour costs that do not reflect the real productivity of the workforce. This strategy has been in place since early 1990s and was reinforced by the devaluation of the CZK and the fixed exchange rate that the Czech National Bank maintained between 2014 and 2017. In this re-

spect the Czech economy does not differ much from the other CEE countries in its basic philosophy, but as the devaluation demonstrates, it has definitely been more consistent in pursuing it in practice. The lower price level and comparatively very low labour costs have been one of the main components that have ensured the high competitiveness of the country that have materialised in massive trade surpluses in the recent years (over 7% of GDP, Figure 3.3). It is also one of the decisive factors behind the recently extremely low level of unemployment.⁴⁴

The Czech labour unions made calculations for 2013 which compared the average unit labour costs and productivities in Germany and the Czech Republic. They concluded that the labour purchased in the Czech Republic produced approximately 1.5 more output for the same costs than in Germany (Fassmann, Ungerman 2015).⁴⁵ Therefore, the Czech Republic still enjoys strong price competitiveness, although the situation has been slowly changing in the last few years.

There are two channels that facilitate the real economic convergence - one is the increase in price levels and the other is the appreciation of the national currency. Adopting the euro would mean that the exchange rate channel for convergence would be abandoned and convergence would have to be facilitated by other means. This is not impossible, but recent empirical findings suggest that it is more difficult to converge once a country joins the eurozone (Fassmann, Ungerman 2018). Therefore, the level of achieved real convergence and the nominal exchange rate upon the entry to the eurozone is of paramount importance. The following table depicts three possible scenarios for development of Czech labour costs presented by the economic experts of the Czech labour unions.

44. The Czech Republic has always had one of the lowest levels of unemployment among the CEE countries since 1989.

45. Obviously, the productivity level is much higher in Germany but so are labour costs. The resulting number is arrived at by comparing the relative costs and productivities in the respective countries.

Table 3.1: When will Czech labour costs converge to the labour costs of the most developed European countries?

| Country | Number of years needed to fully converge (2004-2014 benchmark) | | |
|-----------------|---|---|---|
| | At 27 CZK per EUR and the he pace of convergence of the last 10 years | At 10 % stronger exchange rate and the pace of convergence of the last 10 years | At 20 % stronger exchange rate and the pace of convergence of the last 10 years |
| Norway | never | never | 495 |
| Denmark | 207 | 122 | 86 |
| Belgium | 185 | 113 | 80 |
| Sweden | 147 | 95 | 68 |
| France | 112 | 76 | 56 |
| The Netherlands | 113 | 76 | 55 |
| Finland | 134 | 83 | 58 |
| Austria | 103 | 69 | 50 |
| Germany | 84 | 59 | 45 |
| Czechia | 0 | 0 | 0 |

Source: Fassman, Urgeman (2018), pp. 19.

All these scenarios have to be taken with a pinch of salt, but they point to some very disturbing facts. The table draws a bleak picture for the Czech economic convergence in the case of fixing the exchange rate i.e. adopting the euro too soon. Therefore, the question boils down into this: would joining the eurozone stimulate the economic growth enough so as to compensate for the loss of the exchange rate channel of convergence in labour costs (and wages)? This is a very difficult question to answer, since there are too many uncertainties. On one hand, there will definitely be some reduction of transaction costs for firms as a result of using one currency. This should lead to some productivity gains. But estimates of these are only between 0.28% and 0.5% of GDP (Helísek a kol. 2009, Pečinková 2008). The other positive influence might be the increase in price transparency, since all prices would be listed in euros. This could also lead to some increase in competitive pressures and more productivity gains. However, most of these as well as other benefits originally ascribed to the single currency (increase in trade and investment) have probably already materialised and further increases might be rather insignificant. On the other hand, once inside the eurozone, the Czech Republic

would not be able to use its monetary policy according to its needs and the fiscal policy will be seriously restrained. This can seriously diminish prospects for future economic growth. These points will be elaborated upon further in the text.

Migration and Labour mobility

The Czech Republic has one of the lowest percentages of foreign-born population. The latest available data published by OECD are for 2013 and the figure for the Czech Republic is only 7.1% (OECD 2018). This number is even more striking if one considers the fact that most of these foreign-born inhabitants are Slovaks. But at the same time this number has increased significantly since 2004 and the country has experienced a substantial increase in inflow of foreign labour since 2009. Apart from Slovaks, the main EU nationals that have been migrating to the Czech Republic are Bulgarians, Romanians, Hungarians, Poles and Germans.⁴⁶ The Czech Republic has

46. Apart from these the Czech Republic harbours a significant number of labourers from Ukraine and Vietnam.

experienced a net increase in workforce through migration because the Czechs have been very reluctant to move abroad permanently in search for work (second only to the Slovaks) (Fries-Tersch, Tugran, Rossi, Bradley 2018: 42). At the same time, due to the geographical position of the Czech Republic, there is a noticeable number of people commuting to work abroad but living in their home country. The number of Czech commuters has been rising continuously. The overall figure more than doubled between 2010 and 2017 and now stands at approximately 62,500 people (Eurostat 2018b).

There are two ways in which adopting the single European currency can influence migration and labour mobility from the Czech economy. First, workers will not have to exchange their currencies any longer, which will reduce the costs of working abroad for both Czechs working outside the country and for foreigners willing to work in the Czech Republic. However, this will probably not play any significant role in the overall assessments of the costs and benefits and will therefore not have much real effect. Second, the potentially much more pronounced effect could originate from the increased price transparency. Due to the depressed price levels in CEE countries, their average real wages are much higher than their nominal equivalents. This makes working abroad very attractive, since the nominal wage differentials are still very high. The size of these differentials is currently still to some degree distorted by the exchange rate. The convergence of both wages and prices would reveal the full extent of the differences and could lead to a significant increase in the number of Czech cross-border commuters. This would create pressures on domestic employers to increase wages, which, in turn, could attract more foreign labourers to the Czech Republic. However, it is extremely difficult to make any serious predictions since, according to the 2017 annual report in intra-EU labour mobility, the similarity of languages and common cultural heritage continue to be an important determinant of labour mobility even in comparison with purely economic incentives (Fries-Tersch, Tugran, Rossi, Bradley 2018: 109).

Prices and Inflation

As a result of its preferred economic strategy, the Czech Republic currently has a much lower price level than those typical for Western Europe. I have already mentioned the two convergence channels that have been so far available to the Czech economy. Joining the eurozone would create a regime of a *de facto* fixed exchange rate, which would preclude any further appreciation of the Czech currency. The convergence would have to work solely through the price channel. Earlier studies predicted a possibly substantial risk of higher inflation after the adoption of the single currency in the Czech Republic (Lacina a kol. 2007). And a more recent paper published by the ECB finds some significant evidence for the long-term relationship between real convergence and inflation, which can be measured as the link between GDP per capita levels and price levels (Diaz del Hoyo, Dorrucchi, Heinz, Muzikarova 2017).

There are two most relevant explanations for rising prices after the Czech entrance into the eurozone. The first theoretical explanation is based on the so-called Balassa-Samuelson effect. According to this theory, countries converge in GDP per capita levels mainly through productivity increases in the tradable sector of the economy (sectors engaged in international trade) that are followed by increases in prices of non-tradables (sectors producing for domestic consumption). The effect should be higher, the larger the relative productivity growth differential in the tradable to non-tradable sector of the Czech Republic also in comparison with the rest of the eurozone is, and also the larger the share of non-tradables in consumption is. However, there are both theoretical and empirical problems that make exact prediction of the relative importance of this effect difficult. First, it is extremely difficult to precisely delineate tradables from non-tradables in reality. And second, it is difficult to isolate the effects of Balassa-Samuelson effect from other historical influences on inflation. With this in mind, we can make some comparisons that can give us an idea about the effects on the price level in the Czech Republic. On one hand, there is a sizeable productivity differential between the Czech tradable and non-tradable sectors, which should

intensify the effect. On the other hand, the Czech Republic is already highly export-dependent, and its non-tradable sector is comparatively smaller, which should mitigate the intensity of the effect. The usual contribution of the Balassa-Samuelson effect to the inflation of the country is between 1% and 2%, with the number for the Czech Republic being 1.6% (Lacina a kol. 2007: 40).

The second reason for expected higher domestic inflation in the Czech economy stems from the nominal wage differentials between the Czech Republic and its more developed neighbours that are already members of the eurozone. The effects of these differences on labour mobility have already been mentioned in the previous text. The increasing number of commuters/long term labourers leaving the Czech Republic for Germany and Austria will, in combination with the already low level of unemployment, lead to intensive upward pressure on wages which could result either in decreasing profits of the Czech companies or increasing prices. Overall, one should definitely expect some increase in inflation in the first years after the Czech Republic joins the eurozone. The extent of this increase is uncertain but should not be unbearably high.

Fiscal Situation

There are two types of costs related to the future development of the Czech budget balance and public debt in relation to the entrance into the eurozone. The first can be estimated with reasonable accuracy. These are the costs that are incurred automatically upon the entrance of any country and are related to the institutional structure of eurozone. The Czech Republic will have to pay substantial contributions to the European Stability Mechanism. This is a permanent inter-governmental organisation set up by the eurozone for its member countries that need financial assistance. The current estimates of the Czech contribution are around 50 billion CZK that the Czech government would have to pay outright from the national budget and another up to 380 billion that the country has to be ready to provide at the time of emergency. Some more 9-21 billion will have to be paid as an obligatory contribution

to the Single Resolution Fund (Fassmann, Ungerman 2018: 56, 67). This fund is one of the pillars of the newly established Banking union and is meant to provide financial assistance to the largest European banks during banking crises.⁴⁷ However, these costs can only be roughly estimated, the final size of the Czech contributions will be determined before the entry and will depend on the condition of the Czech economy and the prevailing exchange rate at the time.

The second type of costs is only hypothetical, and very controversial, but could be enormous and therefore is worth mentioning. Among the often-claimed benefits of the common currency are fiscal discipline and prevention of currency crises. But these claims are implausible, especially after the 2010 eurozone crisis, and are based on very problematic assumptions about the relationship between states and their currencies. A monetary sovereign country (a country issuing its own currency) cannot be in any meaningful sense “forced” into insolvency in the currency it issues by financial markets since it can always monetise its debt (Goodhart 1998). This can or does not have to be inflationary, but that is another issue.

Joining the eurozone means giving up national monetary sovereignty and joining a club that as of now does not have any plausible mechanism for resolving long-term macroeconomic imbalances that would not impose a disproportionate cost onto affected countries. From its establishment, the eurozone has attempted to enforce rules that would deter countries from pursuing policies leading to macroeconomic imbalances. The eurozone crisis is definite proof that this strategy has failed spectacularly. The eurozone has been trying to prevent another failure by imposing even more and stricter rules, hence the Fiscal compact and Banking union.

But there is no guarantee that this will work in the future.⁴⁸ Once in the eurozone, member

47. This contribution is supposed to be temporary. Most of the capital should be later provided by the largest commercial banks in the eurozone.

48. And the whole approach might be seriously misguided. Spain went through a serious crisis that was primarily caused by the private, not public sector of the economy. For elaborate analysis of this issue see Mitchell 2015.

countries cannot choose their own policies in a time of crisis. They have to abide by the rules imposed upon them by the European Commission and the ECB and the track record of these institutions has so far been unimpressive, to say at least. The austerity measures that the affected countries had to implement not only created dismal economic growth, but effectively further increased their debt to GDP ratio. A monetary sovereign country that has only an insignificant portion of its debt denominated in foreign currencies can always use its fiscal and monetary policy at will and reflate the economy in order to overcome the crisis earlier (Mitchell 2015). The Czech Republic not only has very low levels of public debt, but only about 11% of that debt bears a foreign exchange risk (Ministerstvo financí ČR 2018: 15).

The present economic fundamentals of the Czech economy and its strong integration into the (primarily German-controlled) European production chains suggest that it is unlikely that the country will go through a similar type of crisis that decimated the southern wing of the EU. However, this could easily change once the Czech Republic accepted the euro. The rising prices and wages dissociated from the real productivity growth could lead to increases in demand and could shift the Czech current account into deficit. This would be accompanied by rising foreign debt and could lead to a crisis of very similar nature to that we saw in Southern Europe.

Regional Cooperation and Trade Integration

Whereas the previous paragraphs pointed to the disadvantages and potentially massive costs related to the entrance to the eurozone, here we will mention two potentially high costs that could materialise if the Czech Republic decided to stay outside the club.

First, the eurozone crisis has prompted the member countries to deepen their integration in several important aspects (e.g. the Banking union). The countries outside of the eurozone do not fully participate in this development and cannot fully

influence its final outcomes. This is a serious problem, since the number of conditions and regulations that the Czech Republic will be expected to adopt upon its entry into the eurozone has been rising without the Czech government having any say about it. Furthermore, this development could create a situation where the Czech Republic would be left out of future decisions on deepening European integration in areas that relate to the economic and monetary union.

Second, of course, there is always the possibility that the Czech Republic could postpone its membership indefinitely. But there are several problems with this proposition as well. First, this is effectively free riding on the system and could be faced with retaliatory measures in the future. Second, if this uncooperative stance were adopted by every country, the European Union could disintegrate rapidly. The stable European political environment and stable European economy is a vital Czech national interest. The Czech economy is extremely dependent on the EU, particularly on Germany. Free riding on the system could backfire on the country, by joining the eurozone the Czech Republic would demonstrate that it accepts the moral responsibility for the future development in Europe. Furthermore, the country could then actively try to influence the future reforms in a desirable direction.

Conclusions

There are very few costs and benefits of the entrance to the eurozone that can be determined with any reasonable certainty and these are not very significant. There are also some potentially huge costs and benefits that could materialise both if the Czech Republic joins the eurozone and if it decides to stay outside. But these are virtually impossible to quantify.

However, there are things that could be done to mitigate the cost of adopting the euro. First, the Maastricht criteria should not be the main indicator of readiness, at least not for the Czech government. The Czech economy should achieve a reasonable level of real economic convergence

with the eurozone to curb the build-up in macroeconomic imbalances after the entry. The EU could help with this process, e.g. through cohesion funds. Second, the eurozone should address

the problems with intra-eurozone imbalances more vigorously. This would, however, have to entail some form of a fiscal union and that does not seem very likely, at least in the foreseeable future.

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Zoltán Pogátsa

Hungary

Prior to Hungary's accession to the European Union in 2004, the adoption of the euro was treated mostly as a symbolic issue that is part and parcel of a country's entry into the European Union, much like the adoption of purple passports or blue highway signs for trans-European corridors. Since the entire issue of European Union membership was understood as a stamp on the credentials of the given country as "democratic", "Europeanised" and "developed", the adaptation of the euro was latently understood as a kind of civilisational benchmark that is to be achieved. This understanding, which treats the euro as a question of identity symbolism rather than an economic challenge, has stuck with a large part of the population. Thus, one still encounters headlines in the Hungarian press worrying that less developed Bulgaria might be able to adopt the euro before Hungary, without the article ever problematising whether or not the euro might be advantageous for these countries economically. There is still a latent understanding of adoption of the euro as a kind of competition within the region, in which Hungary is one of the laggards.

Part of the reason for this understanding is that prior to the 2008 global financial crisis, which then led to the eurozone crisis, the adoption of the euro was portrayed as one-sidedly advantageous, without any serious negative consequences. For a long time, the main point of reference in this respect was a 2003 official study by the Hungarian National Bank, which correctly enumerated potential advantages, but failed to find any significant potential downsides.

The debate became somewhat more varied only after the eruption of the 2008 global financial crisis, its continuation as the eurozone crisis, and especially the culmination of the latter in the 2015 Greek crisis. Nowadays concerns about the weaknesses of the Italian economy inform this debate.

In what follows, we shall identify the actors in Hungary that represent the three main schools of thought on the euro public debates.

In Hungary, the mainstream view, which sees the eurozone crisis predominantly as a foreign debt crisis, is shared by many of the former Liberal elites. Their political blocs are now in their third parliamentary term in opposition, and are in disarray, unlikely to return to power. Therefore, the social positions of these Liberal elites are severely weakened. Figureheads of this liberal intellectual block include academic economists László Csaba, Ákos Péter Bod, Éva Palócz, the news portal HVG, and the business portal Portfolio. Socialist politician MEP István Újhelyi is a key representative of this mainstream view and has initiated unsuccessful signature campaigns for the immediate introduction of the euro. There was a distinct lack of interest in the matter in the wider public, partly because of the political peripherisation of the Socialist Party and MEP Újhelyi himself, partly because the political situation of Hungary pushed economic issues into the background.

It must be added that this mainstream view is shared by many political opponents of the Orbán regime - not for economic reasons, but because - correctly or not - they perceive the euro as another external constraint on Viktor Orbán himself. Since they are unable to capture the imagination of enough voters inside the country to topple and replace Orbán, they put their faith in external constraints by the European Commission and the European Parliament. It is also a reoccurring concern in the limited remaining opposition press that Orbán might try to lead Hungary out of the European Union. Eurozone membership would then be a possible obstacle to that in the eyes of some.

Austerity as an idea, while rejected by the majority of the population, still has a certain following in the Hungarian public. It is symbolised by former finance ministers Lajos Bokros and László Békesi, and has a limited but vocal following amongst those who equate it with responsible technocracy, in contrast with irresponsible politicians.

The Keynesian narrative of the eurozone has been represented in Hungary by the Green and New Left political currents. The news portal MÉRCE, the social theory magazine Új Egyenlőség

are advocates of this reading. Leading exponents of these views include economists Péter Róna, former EU Commissioner László Andor and Zoltán Pogátsa. However, as the debate moves ahead, more and more economists who had formerly been advocates of the mainstream view seem to move towards this more critical interpretation.

It is also interesting that the Finance Ministry of the Orbán government, as well as the Hungarian National bank, headed by Orbán's previous minister of the economy, both subscribe to this view, rather than the mainstream Merkel narrative. Even though it now meets almost all the criteria, Hungary is not in a rush to adopt the euro. The official position of the HNB is that Hungary will be ready to introduce the common currency once it reaches about 90% of the EU average GDP. This view is consistent with the non-optimal currency union critique.

Marxian views towards the eurozone, claiming that the Keynesian demand management by the state were inadequate and the structural problems of the eurozone were even deeper, are held in Hungary by a small but vocal minority around the journal *Eszmélet*. Prominent exponents of this view are economists Annamária Artner and Péter Farkas, as well as by philosopher Miklós Gáspár Tamás.

Likely Effects of Introduction of the Euro in Hungary

Wages and Employment

The employment situation in Hungary is shaped mostly by the following forces:

- a.) increasing outward labour mobility towards Western EU countries with higher wage levels, predominantly Austria, Germany and the UK;
- b.) the inadequately financed and poorly performing educational and retraining systems;
- c.) massive public works programmes operated by the government (approx. 200,000 – 220,000 employees);
- d.) the demand effects of the EU cohesion fund investment into labour intensive sectors (ca. 173,000);
- e.) foreign direct investment, especially in the automotive industry.

The adoption of the euro is unlikely to have any significant effect on these developments. Two less significant channels can be identified: wage and price transparency after the adoption of the euro might increase pressures on outward labour migration, and the impossibility of a competitive devaluation after the adoption of the euro might slow down FDI inflow if wages continue to increase faster than productivity.

Wages in Hungary are set predominantly by market forces in the case of the average/median wage, and by the government in the case of the minimum wage. Wage bargaining at the national level exists formally, but due to the extreme weakness of trade unions it is effectively the government that sets minimum wages.

Wage setting is a national prerogative in the European Union and is theoretically not affected by membership in the eurozone, although it must be mentioned that for instance in the case of Greece the Troika did make it a condition for bailout to end national level wage bargaining. Thus, if anything, eurozone membership might be a hindrance towards strengthening trade union rights and collective rights of workers.

Migration and Labour Mobility

Labour mobility towards other countries might increase as a consequence of adopting the euro. One well-known consequence of a monetary union is wage and price transparency. On the whole, Hungarians are not used to calculating in euros, and therefore wage and price levels in other EU countries are somewhat distant from their

everyday lives. The moment Hungary adopts the euro, comparability is created. Both wage levels for similar jobs, as well as price levels for food, clothing, petrol, housing, etc. become readily available in the same currency. This is very likely to increase pressures on outward migration as, due to continued lower productivity, Hungary is expected to have significantly lower wage levels for a long time to come.

Prices and Inflation

It is a commonly held view that in countries that have introduced the euro, there was a sudden bout of inflation. This view is mistaken. It probably arises from the fact that small items consumed frequently (such as an espresso) were often rounded up to the euro. However, overall consumer price indexes, which cover a wide array of goods and services, do not demonstrate that introducing the euro would automatically result in inflation shocks.

If there is a problem with inflation in the eurozone context, it is to do with higher growth leading to higher inflationary pressures in the longer run. As we have outlined in the discussion about the non-optimal currency area, if Hungary as a peripheral economy does converge through higher growth rates, it is also expected to have higher inflation rates. (If Hungary does not have higher growth rates, it will not converge, which in itself is a problem.) These higher inflation rates are likely to have problematic effects if the nominal interest rate from Frankfurt continues to be low. Low or negative real interest rates might blow an asset price bubble, as in the case of the Mediterranean and Irish periphery. Budapest is already experiencing a significant property price bubble, which has led to a housing crisis, as prices for both renting and buying are out of reach for ordinary and especially low wage earners.

Fiscal Situation

As we have already mentioned, the mainstream sovereign default narrative of the EU has led to per-

ceived solutions that are based on the communitisation of fiscal policy. This is highly problematic, as fiscal policy is not a technocratic issue that can be calculated without democratic participation. Issues of taxation, redistribution and investment are based on value decisions by the voting constituency. Therefore, democratic legitimation is needed for fiscal policy, which at the nation state level is gained through parliamentary elections. Communitisation places fiscal policy above democratic legitimation, as the European Commission is not a directly elected body, and not even a political but a technocratic body in its current form.

The technocratic constitutionalising of fiscal policy in the eurozone today is based on the ideology of austerity. Adoption of the euro is therefore equivalent to constant austerity as an external constraint. This can clearly be seen in the approach of the European Commission and the European Central Bank to crisis management in the eurozone countries. The Lisbon/Europe2020 strategy of human resources-based competitiveness, the official strategy of the EU that had passed through national and community level decision-making, was shunned completely for austerity. Austerity in public document is formulated as “prudent fiscal policy”.

As the current political situation stands, Viktor Orbán’s Fidesz party is likely to rule in Hungary for a long time to come. The policy of this party is already based on austerity. Human resource (re)producing state subsystems are already heavily underfinanced. Adoption of the euro, along with its outside conditionality would therefore bring no significant change in the current situation. As an example: the Fidesz party has literally made it part of the Basic Law (Constitution) that state debt must be reduced to below 60%.

Regional Cooperation and Trade Integration

Hungary is a very open economy in an international comparison. It is well integrated into the economic space of the European Union even without the adoption of the euro. It is effectively an economic *hintergrund* of the German economy, with strong

regional integration with neighbouring economies (Slovakia, Czech Republic, etc.) as well.

The inflow of foreign direct investment has also been very strong in recent years, especially in the automotive sector. On top of Audi, GM and Suzuki, in recent years Mercedes and BMW have both opened large-scale production plants in the country. This process has taken place in spite of the political climate of the country and the retaining of the Forint as a currency.

Conclusions

Based on the above analysis, it is recommended that Hungary adopt an intermediary position between full adoption of the euro and remaining outside. This intermediary position would involve fixing the Hungarian forint to the euro, through entering the exchange rate mechanism but not actually adopting the currency. This was the choice adopted by Denmark and Sweden.

The advantage of this policy is that it imports all the positive aspects of stability associated with

the euro, without permanently embedding Hungary in a monetary framework that has not proved itself to be unquestionably successful. The effect of stability arises because the market will perceive a fixed currency as being effectively part of the eurozone. The flexibility comes from the fact that a.) if needed, the forint can decouple and can be devalued b.) austerity as an outside conditionality does not become compulsory c.) Hungary will retain its right to print its own currency.

In order to make the eurozone more successful, a massive overhaul of the system is needed at a European level.

This would mean:

- a.) Finding a fix for the problem of the inadequate nominal interest rate problem in a suboptimal currency union (possibly through taxation of asset price bubbles);
- b.) Adopting a common wage policy for the eurozone; and
- c.) Deconstitutionalising austerity, adopting Keynesian policies of demand management.

Gancho Ganchev

Bulgaria

The Bulgarian politicians and economists disclosed a strong interest in the implementation of the common currency shortly after the introduction of the euro and before the country was even a member of the EU. This can be explained by the intention of avoiding the hard macroeconomic restrictions imposed by the Currency Board Rule instigated in 1997. As soon as in November 2002 the former Bulgarian Prime Minister Ivan Kostov in a joint discussion paper, published by the Bulgarian National Bank, suggested unilateral euroisation of the Bulgarian economy (Kostov & Kostova, 2002). The idea was firmly rejected by the ECB and EC, but later, after the accession of Bulgaria to the EU (2007) and the formal commitment to join the eurozone in the future, the discussion about the impending implementation of the common currency legitimately re-emerged.

It was the Finance Minister and Deputy Prime Minister Simeon Djankov (2009-2013) who was the first to officially submit the question about Bulgaria's accession to the eurozone to the European Commission. However, the troubles with the Bulgarian fiscal deficit after the Global Financial Crisis and the uncertainties related to the European debt crisis along with the eurozone restructuring predicaments rendered it impossible for Bulgaria to apply for ERM II.

Later, in January 2015, the Finance Minister Vladislav Goranov changed the approach and came to the conclusion that it would soon be possible for Bulgaria to join ERM-II. After the unanticipated 2017 parliamentary elections won by the Boyko Borissov's GERB, the new coalition government expressed its intention to apply for the ERM II. Under the Bulgarian presidency of the Council of the European Union in the first half of 2018, the Prime Minister announced that he would pursue applications for both ERM-II and Schengen. As a result, Bulgaria sent a letter to the Eurogroup in July 2018 stating its request to join the ERM II.

However, the eurozone governments postponed Bulgaria's ERM II accession up to July 2019, due

to some doubts concerning the stability of the Bulgarian banking system. Bulgaria is obliged to meet some supplementary conditions, not included in the Maastricht Treaty, namely: to join the banking union at the same time as ERM (signifying that Bulgaria's banks must first pass stress-tests); to strengthen supervision of the non-banking financial sector and to fully implement the EU anti money-laundering rules, as well as to comprehensively implement the measures under the Cooperation and Verification Mechanism (CVM). Later the Bulgarian Government approved a special Action Plan to meet the new requirements.

In general, all the important Bulgarian political parties support the strategy of accession to the eurozone, but with different views about the speed and the required preconditions. The most frequent objection is that the country should first more successfully catch up with the eurozone countries and only after substantially closing the gap in terms of GDP per capita could Bulgaria carry on with adopting the euro. It should be mentioned also that Bulgarian public opinion becomes gradually less and less enthusiastic about the euro - in 2004 more than 70% of Bulgarians supported the introduction of the collective currency, while in 2018 this ratio fell to about 40%. The main reason for this negative evolution is the concern that accession to the eurozone may trigger price escalation and a decline in real incomes. At the same time the positive attitude towards the euro is based on the expectation that membership of the eurozone will create an insurance mechanism providing financial assistance in times of crisis (Valev, 2012).

Bulgaria meets in general the Maastricht convergence criteria, obligatory for the eurozone accession. According the 2018 ECB Convergence Report, Bulgaria currently encounters the inflation, interest rate, fiscal deficit, government debt and exchange rate criteria, however it still faces some macroeconomic imbalances and "does not comply with all the requirements for central bank independence, the monetary financing prohibition, and legal integration into the Eurosystem" (ECB, 2018).

Likely Effects of the Introduction of the Euro in Bulgaria

Any attempt to assess the impact of some extensive streamlining of the macroeconomic mechanism gearing the attainment of internal and external equilibria requires some theoretical background. In our case these are the theories of the optimum currency areas (OCA). According to Mundell (Mundell, 1961) and Scitovsky (Scitovsky, 1958), the main criterion for the foundation of an optimum currency area is the free movement of labour and capital. The mobility of the factors of production guarantees the adjustment of the economy to the asymmetric shocks in the absence of exchange rate instrument. In addition, it was considered that countries with similar production systems and developed intra industry trade are more likely to establish a monetary union (Kenen, 1969).

Given these preconditions, and with the strengthening of the economic integration between countries, the benefits of the common currency progressively outweigh the costs of the loss of the autonomy of the macroeconomic policy. Later Frankel and Rose (1998) argued that since the stronger mutual trade penetration implies a higher degree of correlation between the business cycles of the integrating countries, the sequence of the preconditions can be reversed, i.e. the countries with a low level of integration may be allowed to access the currency area because the membership itself will increase the synchronisation of business cycles.

Another approach to the optimum currency areas is the so-called risk-sharing theory. According to this concept, (see Artis and Hoffmann, 2006) the interregional mutual financial investments allow for better sharing of economic risks between countries, irrespective of synchronisation of business cycles. The countries can benefit from the intensive financial interdependence, even if the integration aggravates the regional heterogeneity of the production structures in the context of Ricardian international trade specialisation. The risk-sharing approach implies that, when comparing costs and benefits of accession to the eu-

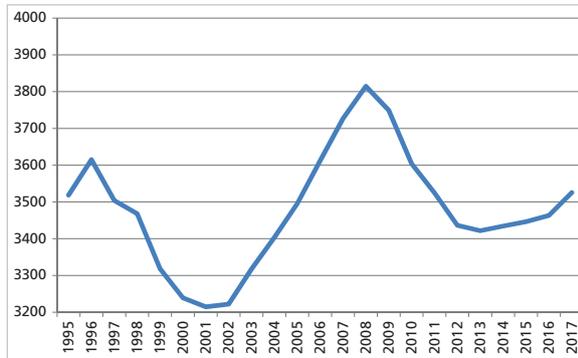
rozone, we should take into account the penetration of mutual capital markets and intraregional income flows.

In the case of Bulgaria there is an additional difficulty when evaluating costs and benefits of participation in the eurozone. This is related to the Currency Board imposed lack of autonomy of the monetary and to some extent of the fiscal policy. This means that the country not only does not incur loss of autonomy benefits, but may even enjoy some advantages of autonomy, by implementing the common monetary policy. Theoretically, it would be possible for the country not to join the eurozone directly, but first restore monetary autonomy and next proceed with entering the eurozone. However, such a strategy implies different sequencing and timing of economic policy measures and, what is more important, a different political setting - up to now no Bulgarian political party has ever expressed any will to assume the responsibility of exiting the currency board regime and of encountering the uncertainty of transition to free floating and autonomous monetary policy. This is why we confine the analysis to the variant of direct shift from currency board regime to accession to the eurozone.

Wages and Employment

The free movement of labour is a precondition for OCA participation, so the Bulgarian labour market is of special interest. As we can see from figure 5.1, the number of employed people in the Bulgarian economy follows a cyclical dynamic. The period 2002–2008 is marked by labour intensive growth. After the 2008–2010 crisis employment declined substantially and was still below the pre-crisis level. During the crisis, the main instruments of reducing labour costs were the cutting of employment and the use of flexible wage components (Paskaleva, 2016). The data indicates that the productivity of labour, after some transitory decline in year 2008, resumed the growth at rate, very close to its pre-crisis shape. Consequently, in terms of labour, the 2008–2010 crisis indicates a well-defined transition from extensive to intensive growth (See Ganchev, 2018).

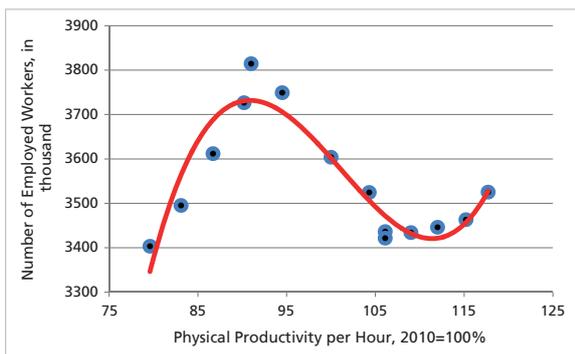
Figure 5.1 Number of Employed Workers, in thousands



Source: National Statistical Institute

The connection between productivity of labour and employment is additionally illustrated in Figure 5.2. As we can see, the relationship between employment and productivity is non-linear, i.e. the increase of productivity in the periods of economic downturn does not preclude the decline of the number of employed workers. This is a strong argument for a demand management oriented economic policy, not allowed under the Currency Board regime, but possible in the case of the eurozone monetary policy, although the ECB does not formally enjoy double mandate prerogatives (see Ganchev, 2017).

Figure 5.2 Employment and Productivity, 2004-2017

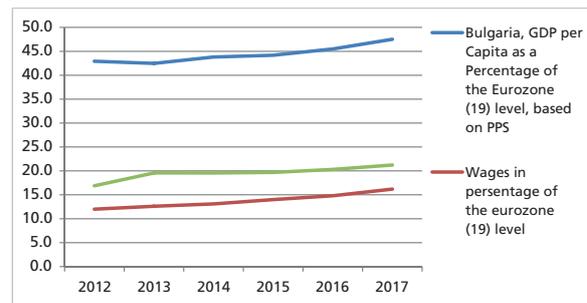


Source: National Statistical Institute

The level of domestic wages and salaries in Bulgaria is still greatly below that of the EU and the eurozone. This can be explained by both the low productivity and the comparatively low level of prices (undervaluation of the national currency in real terms). As we can see from Figure 5.3, the

GDP per capita based on PPS is more than twice as high as the GDP in nominal terms. We also observe that the share of the nominal wages is lower than the respective share of the nominal GDP, which reflects a relative underpricing of labour.

Figure 5.3 Comparative Wages and GDP per Capita

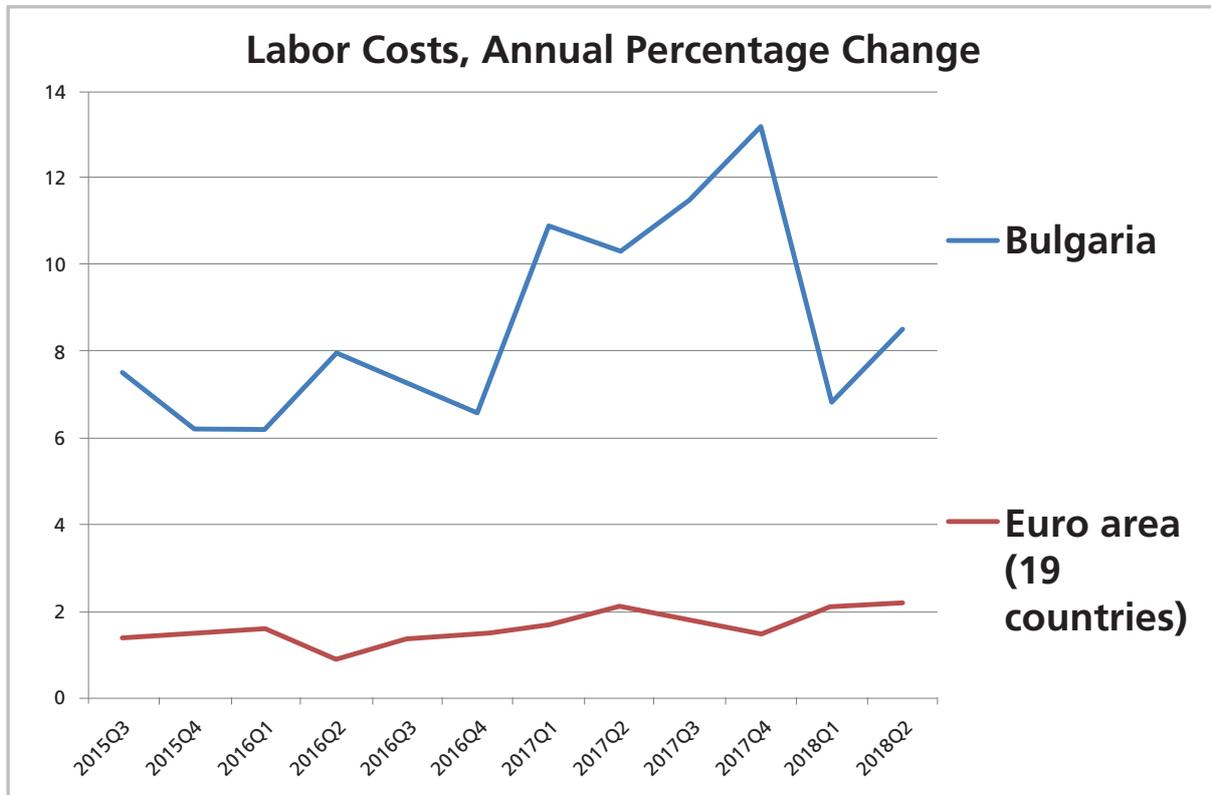


Source: Eurostat

It must be said, furthermore, that the labour market is characterised by some positive trends - a strong growth of remunerations, declining unemployment and an increasing employment rate. We can also observe some increase in the unit labour costs (see for details EC, 2018). Nevertheless, the Bulgarian economy is still not in a situation of overheating. The wage setting process in Bulgaria is decentralised, so accession to the eurozone will not affect the wage dynamics excessively. The only institutional mechanism that can influence the process of wages convergence is the fixing of the minimum wage. Though settling the minimum wage is criticised for lack of transparency and clear criteria, it is totally controlled by the Government and does not represent a real threat to macroeconomic stability.

On the other hand, accession to the eurozone will inevitably accelerate the process of price and wage convergence to eurozone levels as a result of the increased price transparency. These trends can complicate the problems with the unit labour costs and the price competitiveness of Bulgarian companies (see Figure 5.4).

Figure 5.4 Labour Costs, Annual Percentage Change



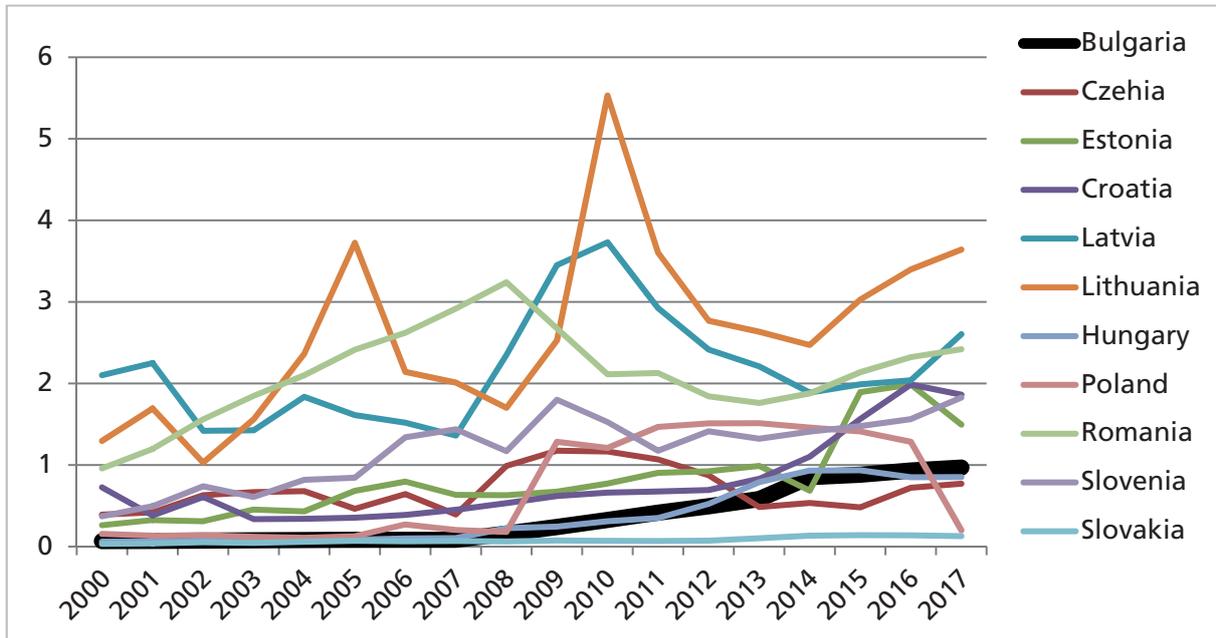
Source: Eurostat

Migration and Labour Mobility

The Bulgarian labour market is strongly influenced by the free movement of workers in the EU. However, as we can see from Figures 5.5 and 5.6, the intensity of emigration and immigration of labour is below the average degree in the post-communist countries. Nevertheless, the movement of workers strongly influences the domestic labour market. The main reason for the emigration of the workforce is the low level of domestic wages. The econometric research demonstrates that emigration creates labour shortages and triggers

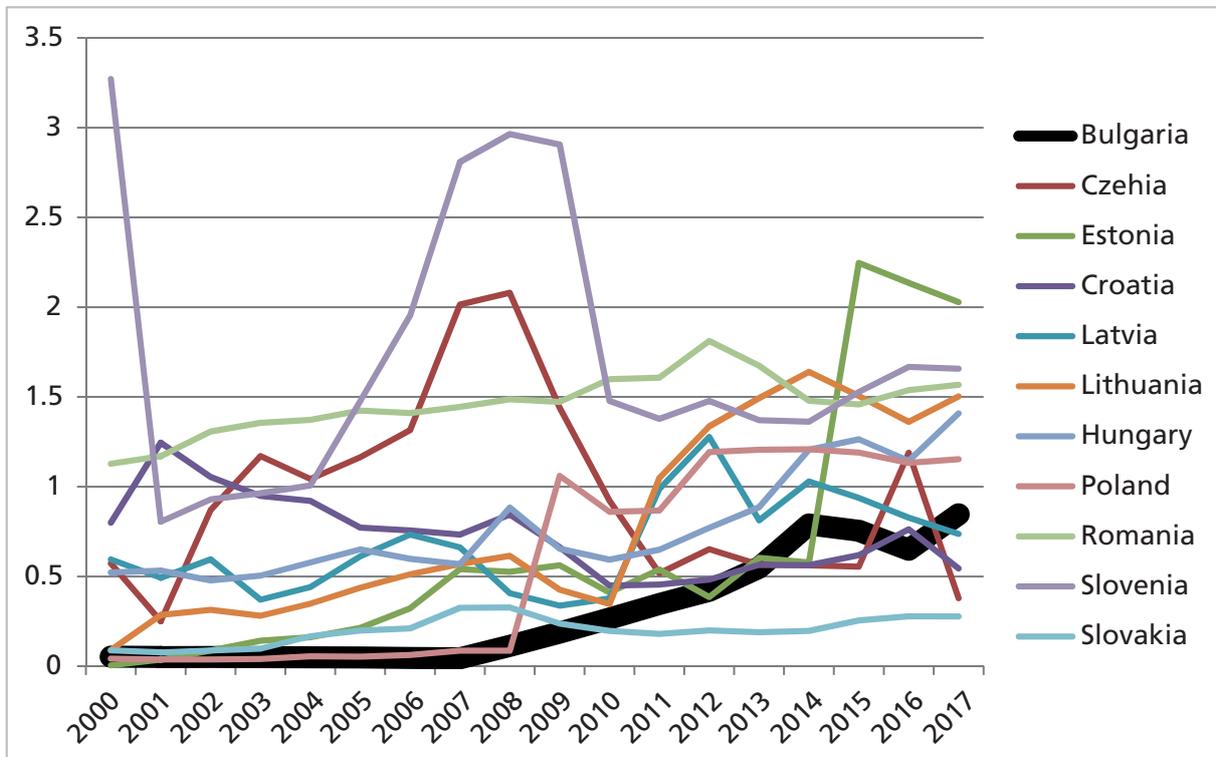
an acceleration of wage growth with a lag of 1-2 years. Furthermore, this leads to some increase of the unit labour costs, but at the same time boosts the productivity of labour in the context of the efficiency wage theory. On the other hand, the stronger wage growth attracts workers from non-EU former socialist countries or prompts the return of Bulgarian labourers from abroad. These complex interdependences will inevitably accelerate in the case of accession to the eurozone. The final impact on the economic growth and the efficiency of utilisation of labour resources can be expected to be positive.

Figure 5.5. Labour Emigration in % of Working Population



Source: Eurostat

Figure 5.6: Labour Immigration in % of Working Population



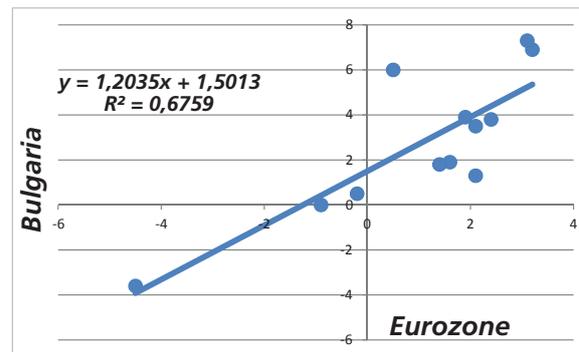
Source: Eurostat

Prices and Inflation

Bulgaria meets the Maastricht criterion for inflation. The problem is, however, what can be expected after accession. In particular, the price level adjustment related to the changeover to the euro can be analysed on the basis of the real effective exchange rate (REER) theory (see Ruscher and Wolf, 2009). The REER depends on the nominal exchange rate, domestic and world general price indices and domestic and world price indices of tradable goods. In the case of introduction of the euro we can anticipate that the price level of tradables expressed in euro should equal that in levs before the replacement of the national currency, divided by 1.95, which is the present fixed exchange rate. However, the imperfections on the non-tradables market may provoke some transitory inflation, due to the introduction of the collective currency. Moreover, if there are some macroeconomic swings, associated with the accession to the eurozone, the prices of tradables may also cause some supplementary price level hikes. This can happen, for example, if the broad money supply expands as a result of the decline in the compulsory requirements of reserves, which in the case of the ECB are at just 1% of certain liabilities, compared to 10% in the case of the Bulgarian National Bank. So the Bulgarian government needs a strategy to deal with this type of complications. Such a plan must contain measures against speculations with basic market supplies, temporary money supply controls and other aspects.

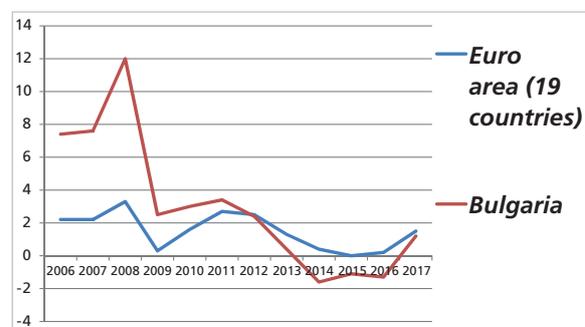
Bulgaria's economic growth is relatively high and strongly correlated with the eurozone, as we can see from Figure 5.7. The comparative inflation dynamics between Bulgaria and the eurozone are presented in Figure 5.8. The particularity is that, without inflationary targeting, inflation in Bulgaria is more volatile than that in the eurozone - we can observe strongly distinctive inflation/deflation cycles. These cycles destabilise the real sector and slow down economic growth. So, admission to the eurozone can be considered as a positive move from the point of view of establishing conditions for stable and sustainable economic growth.

Figure 5.7 Real GDP Annual Growth Rate, 2006-2017



Source: Eurostat

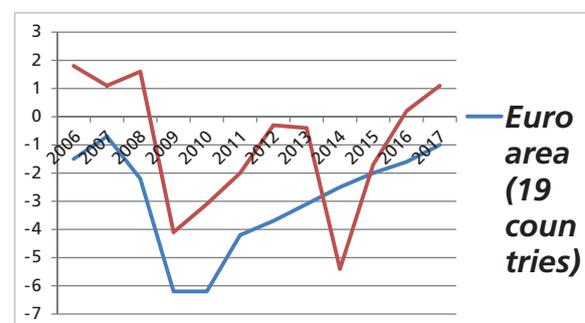
Figure 5.8 Annual Inflation Rate



Source: Eurostat

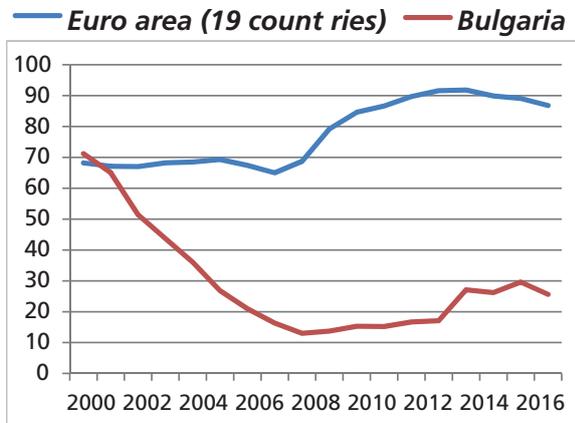
The most important Maastricht criteria concerning the eurozone accession are related to the stability of the fiscal sector. In Figures 5.9 and 5.10 we can see a comparison between Bulgaria and the eurozone countries in terms budget deficit and government debt.

Figure 5.9 General Government Deficit in % of GDP



Source: Eurostat

Figure 5.10 General Government Gross Debt in % of GDP

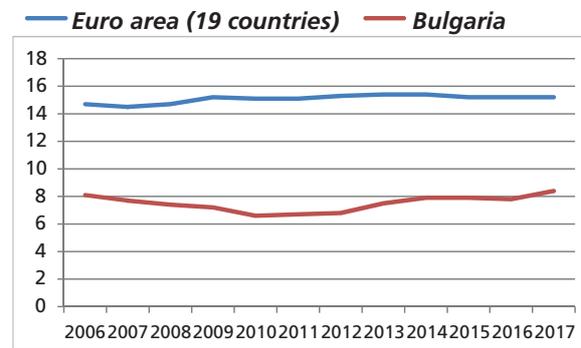


Source: Eurostat

Both figures demonstrate that Bulgaria in general outperforms the eurozone countries from the point of view the formal criteria of fiscal financial stability (see also Marinova, 2016). The only exception is the budget deficit in 2014, an exception due to the crisis with the Corporate Trade Bank and the respective abnormal government spending. Bulgaria also displays a strong ability to overcome the post crisis public debt upsurge. The Bulgarian fiscal sector financial behaviour renders superfluous the reservations about Bulgaria’s accession to the eurozone on the grounds that it can repeat the Greek debacle.

However, in terms of social policy, Bulgaria is seriously lagging behind the eurozone countries, which is demonstrated in Figure 5.11. These circumstances are important, given the fact that Bulgaria is characterised also by low income per capita, a high percentage of people living below the poverty line and high inequality in incomes. Accession to the eurozone can potentially worsen some of these parameters, especially income inequality and poverty. Therefore, if Bulgaria needs some additional requirements and policy recommendations, these are in the social sector.

Figure 5.11 Net Social Contributions in % of GDP



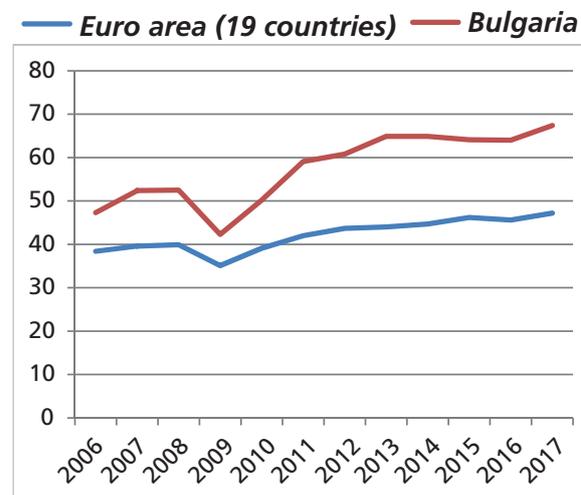
Source: Eurostat

Regional Cooperation and Trade Integration

Foreign trade and integration are particularly important since the related features are decisive from the point of view of the traditional theory of the OCA. It is supposed that the benefits from joining the respective OCA will increase with expansion of the mutual trade penetration, participation in international value chains, the increased mobility of capital and labour and the greater synchronisation of economic cycles.

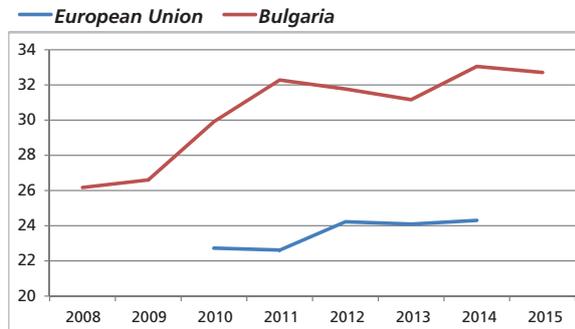
Paradoxically enough, the share of exports in GDP, as well as the share of the value added in foreign controlled enterprises in Bulgaria is higher than that of the eurozone countries, as we can see from Figures 5.12 and 5.13.

Figure 5.12 Exports of Goods and Services in % of GDP



Source: Eurostat

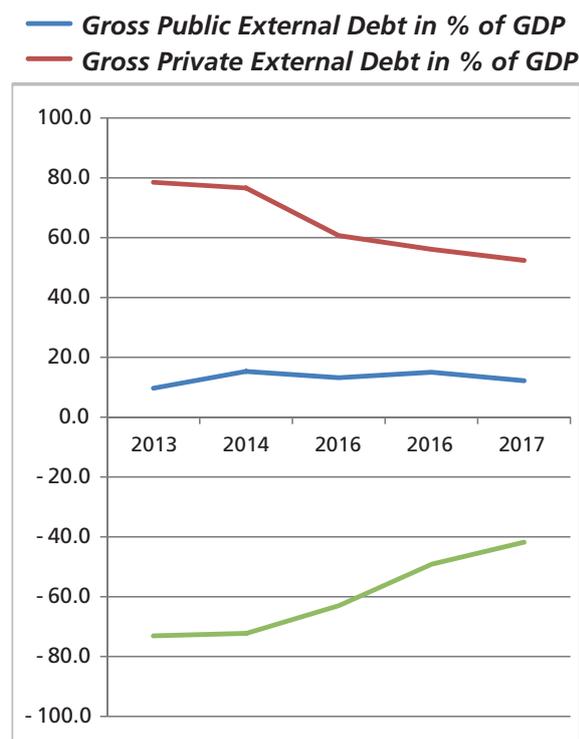
Figure 5.13 Value Added in Foreign Controlled Enterprises in % of GDP



Source: Eurostat

These circumstances, together with the free movement of the factors of production (labour and capital), mean that the Mundell-Kenen conditions are fulfilled and that we can expect that the benefits of joining the eurozone outweigh the costs, especially if we take into account that there are no costs related to the loss of the autonomy of monetary and fiscal policy in the case of Bulgaria. We can expect also that Bulgaria will improve its position in terms of foreign trade quota, value chains participation, intensity of labour and capital movements and synchronisation of economic cycles after the accession to the eurozone.

Figure 5.14 Bulgaria’s External Position Indicators



Source: Eurostat

From the point of view of the risk-sharing theory we should also take into account mutual capital penetration. In the case of Bulgaria risk sharing implies improving the net international investment position of the country. The respective trends are represented at Figure 5.14. As we can see, public and private external debts are decreasing, as well as the net international investment position. At the same time the official hard currency reserves and the private capital outflow are mounting. It follows that the country is able to a higher extent to compensate the negative economic shocks via capital income from abroad, though symmetry in this respect is still far away.

Conclusions

Our conclusions can be summarised as follows:

First, the Government and all the important political parties in Bulgaria support accession to the eurozone, although with different views about the speed and sequencing of the necessary economic measures. The concept “better in than staying out” prevails (see also Yorgova, 2011). Public opinion is also in favour, but with declining intensity.

Second, Bulgaria meets all the formal criteria for accession to the eurozone in terms of inflation, interest rates, fiscal deficit, government debt and exchange rate stability. According to the ECB and the EC Bulgaria still needs some additional improvement in the fields of legislation, banking sector stability and money laundering procedures. Bulgaria is ready with an action plan to resolve these issues.

Third, the cost-benefit assessment confirms that in the case of Bulgaria we can expect benefits to exceed costs from the point of view of the achieved level of foreign trade, mobility of factors of production and participation in value chains. The net international investment position is still negative, but declining. We can anticipate that accession to the eurozone will further improve all the parameters that determine the positive assessments of cost-benefit analysis. Bulgaria may enjoy additional benefits from lower official hard

currency reserves, lower interest rates, better credit market conditions and an improved credit rating. Some Bulgarian economists evaluate the net benefit of adopting the euro at some 15% of GDP in a 20-year horizon (Ganev, 2009).

Fourth, nevertheless, Bulgaria is still lagging behind the eurozone countries from the point of view of income per capita, social security and revenue equality. However, it is not preferable to postpone accession until the gap is closed, since remaining under the Currency Board Regime will hinder economic growth. The argument that by adopting the euro Bulgaria will lose an important degree of freedom to foster growth and to deal with crises at home (see Enderlein, Guttenberg and Mannweiler, 2018), ignores the fact that under the Currency Board Regime Bulgaria's degrees of freedom are certainly less than they would be in the eurozone. The alternative to go through the flexible exchange rate regime is not politically feasible, as already mentioned.

Fifth, there are several threats to the successful accession to the eurozone. These warnings are related to the income policy, social stability, macroeconomic developments and private sector indebtedness.

The income policy should avoid stagnation of the wages and salaries, because this has a negative impact on emigration and internal demand. Furthermore, the efficiency wage effect makes

possible some temporary excess growth of wages over current productivity. This is partially confirmed by model simulations, validating that inflationary pressures arising from real catch-up processes under the Currency Board Rule seem not to prevent compliance with the Maastricht inflation criterion (Blessing, 2007). On the other hand, any unwarranted wage escalation may boost unit labour costs and worsen the competitiveness of Bulgarian producers. So the government needs a credible long-term income policy.

Social stability also raises questions. The possible acceleration of inflation caused by accession to the eurozone will inevitably affect the real incomes of the vulnerable social groups. The government should be ready with a special social safety net dedicated to defending poor and retired people.

The macroeconomic threats also should not be underestimated. The probability that Bulgaria will repeat the Greek crisis is not high, but the country may face problems similar to those in Ireland. In particular, we can expect that the credit conditions will improve after the accession and this can lead to a fast increase of the private sector leverage. To avoid this, combined efforts of BNB and the government are necessary. The respective measure may include improved supervision, additional fiscal reserves and better coordination with the ECB, the EC and the IMF.

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Velimir Šonje

Croatia

In late October 2017, the Croatian centre-right government and the central bank presented the “Euro Strategy”. The document was officially adopted by the Government in May 2018. Ambition to apply for adopting the euro via initialising its first step – ERM II entry - is expected to happen around Croatia’s EU Presidency in the first half of 2020. Thus, Croatia is expected to join Bulgaria in aiming for the introduction of the euro.

The Croatian “Euro Strategy” is a document that aims to explain that the introduction of the euro will bring more benefits than costs in Croatia. This position is supported by the pivotal centre right party HDZ and their liberal centre coalition partners, as well as the central bank. However, general public is divided about European issues. 50% or slightly above this threshold support the euro, although some opinion polls with less precise questions indicate support below 50%. Mainstream media support the project. Industry leaders and the banking association firmly stand behind the idea of adopting the euro. They believe that pressures on better economic policies, institutional reforms, financial stability, elimination of currency risk, reduction of interest rates and elimination of the transaction costs of currency conversion outweigh potential costs related to loss of monetary sovereignty. Trade unions did not express one view.

Most stakeholders are aware that full use of monetary sovereignty and a fluctuating exchange rate is close to impossible in a small and open economy where most financial transactions are organised via omnipresent international banks, which encompass 91% of the market measured by total assets in Croatia. On top of this, people mostly save in euros rather than in domestic currency. This preference was shaped as long as half a century ago, and it is subject to strong inertia, almost impossible to change by deliberate policy action.

Despite potential advantages, prospects for introduction of the euro are vague. Anti-establish-

ment populist parties are mostly against the EU and the euro. They view all European institutions as constructs without democratic legitimacy and a lack of accountability which, in their view, endangers sovereignty and the rights of people. For the time being, the anti-EU/euro block is not strong, but support is rising. Presently, only the anti-establishment Living Wall (Živi zid), which is supported by around 13% of voters, is an openly anti-EU party and against the euro. Right-wing oriented “Bridge” (“Most”), which is currently supported by 7-8% of voters, was silent on the matter but their leader recently opted for a referendum.

Other influential political stakeholders, including social democrats, are silent about the issue. Passivity and opportunism may turn out to be the greatest obstacle for the introduction of the euro. Traditionally, Croatian social democrats (SDP) were strong pro-Europeans. However, party is in disarray after defeat in the elections in 2015 and a repeated failure in early elections of 2016. SDP is fully oriented towards domestic policy issues, lost in intra-party battles, and not interested in key international and EU policy themes, especially when the incumbent centre-right government takes the lead on an international front.

The first step in assessment of the future prospects for introducing the euro in Croatia is to understand the fundamental reasons for the current pro-euro stance by Croatian authorities. The chapter describes the “nothing left to lose” economic argument, which is a rational technocratic argument that makes sense in very small and open economies which have already undergone substantial financial and trade integration with wider areas and political units, such as the EU.

Likely Effects of Introduction of the Euro in Croatia

Table 6.1. lists costs and benefits of adopting the euro as presented in the Euro Strategy document adopted by the Croatian Government in May 2018 and amended by the author (amendments are marked by the asterisks).

Official cost-benefit Table 6.1. lists the elimination of currency risk on top of factors which are expected to bring about a positive impact on trade and investment. This view may be an overstatement. Real effects of financial integration may be largely exploited before the adoption of the euro due to EU integration. If financial risks are easy to manage in an economic environment without major unexpected shocks, so risks can be calculated, benefits of a common currency for long-term investors

and trade mostly materialise before entry into the monetary union. Hence the importance of elimination of currency risk in terms of positive impact on trade and investment may be exaggerated unless authorities think about indirect channels. The most important indirect channels are related to better policies. If adoption of the euro led to structural reforms and better economic policies, that may indeed facilitate investment, international trade and growth. However, this is highly uncertain.

Table 6.1: Costs and benefits of adoption of the euro in Croatia

| BENEFITS | | COSTS | |
|---|------------|--|------------|
| Description | Importance | Description | Importance |
| Elimination of currency risk | High | Loss of monetary autonomy | Low |
| Lower interest rate | Medium | One-off price adjustment at times of euro introduction | Low |
| Liquidity and interest rate transmission* | Medium | Risk of excessive capital inflows | Low |
| Lower risk of currency and BoP crisis | Medium | Cost of conversion* | Medium |
| Lower transaction cost | Low | Transactions with ECB (1) | Low |
| Positive impact on trade and investment | Medium | Participation in stability mechanisms such as ESM (2) | Medium |
| Share in Eurosystem seigniorage | Low | | |
| Access to ESM | Low | | |

Source: Government of the Republic of Croatia and the Croatian National Bank, Eurostrategy (2017).

Transaction (currency conversion) costs were assigned low importance in the government version of Table 6.1. As that may be a severe understatement, in the table above its impact is changed to medium strength. Introduction of the euro and savings for costs of currency conversion (including elimination of currency ask-bid spreads) would save estimated 0.25% of GDP per year to households, tourists and companies in Croatia. This is a material impact, especially if one calculates these savings as permanent: the present value of permanent savings of 0.25% of GDP per year, which now accounts for profits of exchanges and banks, may turn into a non-negligible real resource for funding consumption and investment in the long term.

Next, studies on determinants of interest rates have shown that a significant reduction may be

expected after introducing the euro. Depending on the type of interest rate, expected reduction (that is, lower rates than otherwise would be) ranges between 0.5 and 1 percentage point. Interest spread - the difference between banks' lending and deposit rates - may diminish up to 0.3 percentage points due to the adoption of the euro.⁴⁹

Some of the benefits related to interest rates may come through improved interest rate channel transmission of monetary policy. Local government bonds will become eligible collateral for transactions with the European Central Bank. This may have a beneficial effect on the development of the markets of public debt instruments:

49. Euro Strategy, 2017, Croatian Government and Croatian National Bank. Similar estimates about impacts on interest rates were also reported in Croatian Banking Association papers, HUB Analyze no. 59 and 60.

more buyers, more liquidity and greater transparency. Second, a countercyclical monetary policy under ECB's conduct may be transmitted more precisely than under local monetary policy, due to greater market depth, lower financial risks and lower interest rate volatility.

Croatian and eurozone business cycles are closely correlated. This means that the necessary condition for an optimum currency area is met. This finding was confirmed by both older and more recent independent research on business cycle coordination.⁵⁰ This is not surprising: four out of five main Croatian trading partners are euro area countries (Italy, Germany, Slovenia and Austria). The fifth major trading partner, Bosnia and Herzegovina, has a currency board type of hard peg vs. euro. Most tourists come from these countries as well. In general, Croatian trade with the EU has increased since entry into the EU in 2013 from a 58% share in total trade of goods in 2012 to 65% in 2017. Therefore, Croatia is surrounded by the euro; the share of trade with countries that have adopted the euro is on the rise and it is reasonable to expect that the ECB's interest rate policies will be aligned with the cyclical position of Croatian economy.

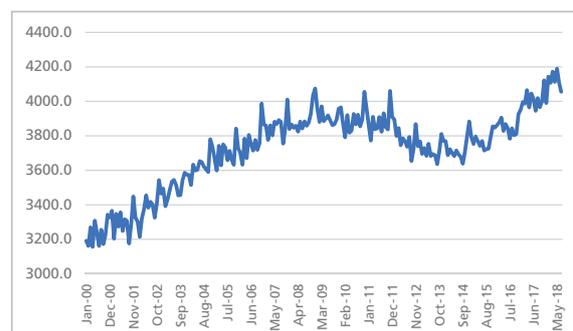
With 4 million people, Croatia fits the pattern of small open economies in CEE which have recently adopted the euro: Slovenia (population 2.1 million), Slovakia (5.4 million), Estonia (1.3 million), Latvia (2 million) and Lithuania (2.8 million). Aiming to have the euro may be viewed as an endogenously driven political decision due to "nothing left to lose" situations. Such situations are more likely to emerge in smaller countries that cannot use their own monetary policy for the benefit of substantial external adjustment due to pass through effects on inflation, relatively large foreign debt and other limitations to domestic monetary policy.

50. Besides correlation, economists emphasise fluctuations i.e. amplitude of the business cycle. The Croatian business cycle is more volatile compared to the **eurozone** cycle, but it does not mean that domestic monetary policy is better positioned to deal with volatility. To the extent that domestic monetary policy implies changes in the nominal exchange rate, it can increase volatility due to well-known phenomena labelled original sin: a close positive correlation between the nominal exchange rate and money market rates emerges at times of crises. Also, there are structural measures (e.g. lower regulatory costs and better institutions for creditor and debtor protection) that may reduce banks' lending rates in order to turn them into more effective counter-cyclical instruments. Structural measures can be more effective in the monetary union.

Wages and Employment

Figure 6.1. shows real average wage developments in Croatia in this century and Table 6.2. shows a comparison of major labour market indicators between Croatia and Slovenia. Slovenia is chosen for comparison not only because it is Croatia's neighbouring country and the two countries share common history in former Yugoslavia, but primarily because it is an example of a relatively developed former socialist economy without significant emigration, which adopted the euro more than a decade ago. The data indicate three major conclusions: (1) real wage growth during recovery after a prolonged economic crisis of 2009-2014 in Croatia is more rapid compared to growth before 2009, primarily due to the lack of supply of labour after emigration started; emigration increased the bargaining power of Croatian workers;⁵¹ (2) Croatia has a high structural unemployment which is rapidly declining (last data on unemployment rate as of Q3 2018 is 7.3%) but the employment rate is still the third lowest in EU (higher than in Italy and Greece), (3) the supply of labour is structurally limited in many occupations (e.g. IT, construction, tourism and logistics), which quickly transmitted into real wage growth when economic growth occurred in late 2014. After EU entry, the process was speeded up by emigration of workers, which made structural labour market imbalances more widespread.

Figure 6.1 Real average wage in Croatia 2000:01 - 2018:07



Source: Croatian National Bank, Author's calculations

51. The annual average growth rate of real average wage 2000-2009 (Jan to Jan) was 2.4% and the annual average from Jan 2015 to Jan 2018 was 3%, despite a faster **average** GDP growth before Great Recession. Part of the difference may be explained by faster technological change in the second period after the crisis. However, it is hard to imagine technical progress having a major impact in such a short period. Therefore, the major difference should be attributed to labour mobility after EU entry.

Table 6.2. Main labour market indicators: Croatia and Slovenia, annual averages

| | 2000 | 2008 | 2017 | 2018 (Q3) |
|----------|---|-------|-------|-----------|
| | Employment rate (% of active population 20-64y) | | | |
| Croatia | -- | 64.9% | 63.6% | - |
| Slovenia | 68.5% | 73.0% | 73.4% | - |
| | Unemployment rate | | | |
| Croatia | 15.6% | 8.6% | 11.1% | 8.1% |
| Slovenia | 6.7% | 4.4% | 6.6% | 5.2% |

Source: Eurostat

Emigration is a key social and economic issue in Croatia, widely debated by politicians, academia and media, often in a state of moral panic. Official estimates indicate net emigration of 0.5% - 0.8% of population per year since 2015 and unofficial sources claim it to be even higher.

An optimistic view is that this is post-entry aspirational emigration, which also occurred in southern EU countries after entry and lasted for about five years, then stopped. Following this line of argument, the emigration created a lack of supply of labour locally, which induced wage pressures, rising living standards and pressures on technological development since 2015. An indirect positive effect obviously lies in higher remittances from the EU (approaching 5% of GDP), although it is ironic to have domestic demand fuelled by people who have left the country. However, on a more positive note, there are speculations that people who left the country invest back in it and some of them will return home with capital (savings) and marketable skills.

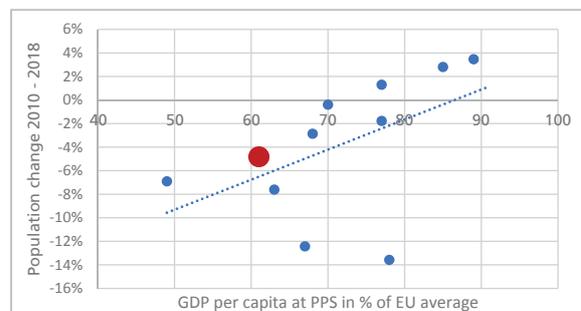
The more pessimistic view is that the loss of people is permanent. It will reduce potential long-term growth and increase problems in social systems, notably public health and pensions. So the question is: will the lack of intra-euro area fiscal transfers prevent long term real convergence, cementing Croatia's developmental position at present 60-65% of real income per capita of EU average? This may potentially breed anti-EU sentiment.

An important observation is that emigration is not widespread in the Adriatic region, which is blessed with prosperous tourism, and in North West-

ern Croatia, which has living standards closer to the EU average. Emigration is higher in the eastern part of the country, Slavonia, which has been depressed since the war of 1991-1995. Fiscal transfers cannot compensate for labour mobility and ensure even regional development, except if transfers could be made extremely large as a percentage of local GDP. Simply put, the force of labour mobility is much stronger than the force of economic policies and fiscal transfers. People leave before capital flows in. This principle is in place already within the country and within the EU. The most important thing to understand is that labour mobility is already working at the EU level, regardless of membership in the monetary union. The EU, not the eurozone, is a fundamental unit of integration, which has induced movements of people.

Figure 6.2. confirms that migrations, which are the main determinant of population change in the short term, are related to the level of economic development regardless of having the euro or not.

Figure 6.2 Changes in populations in 11 NMSs vs real GDP per capita 2010-2018 (Croatia in red)



Source: Eurostat

Notice the correlation between the level of economic development, as reflected in GDP per capita at purchasing power standard, and changes in population, which largely reflect migration flows. This correlation holds for both eurozone members and EU members which did not adopt the euro. For example, Croatia, Bulgaria, Romania and Hungary are not in the euro area and they experienced a larger decline of populations than Slovakia and Slovenia, for example, which have adopted the euro. Czech Republic also recorded population growth, but not because it is not in the euro area. Czechia is the most developed former transition country, close to EU average in terms of economic development.

Correlation in Figure 6.2 is not very strong because of Latvia and Lithuania positioned at the bottom of the graph. This is not because they adopted the euro several years ago (emigration has slowed down since then, actually). The reason is that the two Baltic states were much closer to Romania, Bulgaria and Croatia 10-20 years ago in terms of development level, but they grew rapidly and in a volatile manner. Hence their overall social development lags behind the level indicated by GDP alone. The lesson to be learnt from Baltic experience is that the level of development needs to be established for a longer period of time, like in Slovenia and the Czech Republic, in order to prevent emigration. Some economists think that a lack of social policies in the so-called neoliberal regimes of the Baltic states is the prime reason for the result shown in the figure.⁵² However, the relationship between population changes and development level shows that emigration primarily depends on relative real incomes at home vs. target countries of emigration, such as Germany, Austria and Ireland (the main destinations for Croatians). Therefore, adoption of the euro is migration-neutral in the short term; there is no mechanism of impact of the euro on migrations in the short term. In the long term, the contribution of the euro to the size of population will depend on the relationship between the adoption of the euro and quality of economic policy, economic growth, and living and social standards.

52. Bohle and Greskovitz in their *Capitalist Diversity on Europe's Periphery* developed a classification of types of capitalism, with neoliberal regimes in Baltic states, which differ from other types.

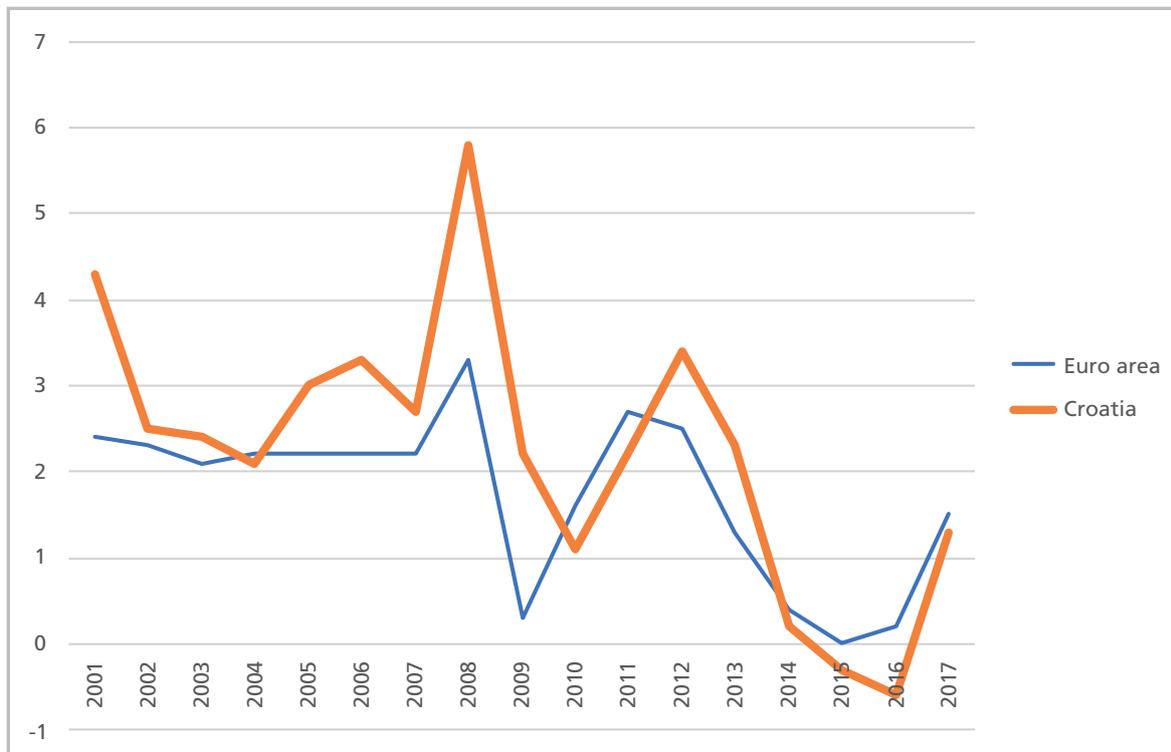
Prices and Inflation

Inflation dynamics converged across the CEE region in the long term. This is an expected outcome of integration and convergence, reflected in the close correlation of inflation rates across the EU. However, the path was bumpy, as shown in Figure 6.3. Croatian rates of inflation were significantly higher during the pre-crisis boom. Only in the more recent period of growth after 2014 did inflation settle on a path slightly below euro area inflation. This also reflects relatively weak economic growth in Croatia. With an average rate of GDP growth of 2.9% in 2015-2018 Croatia lagged behind CEE peers, although this rate of growth was higher than the EU average, especially in terms of per capita growth.

The period of high inflation until 2008 was related to strong capital inflows before 2008. It was partly driven by irrational exuberance, and market and government failures. Both growth and inflation were related to domestic demand overheating and the accumulation of macroeconomic imbalances most vividly expressed in current account deficits (more details below). The cooling-off period after 2008 reduced imbalances and normalised inflation rates, which is reflected in the downward trend of inflation in this century. Croatia is capable of controlling inflation, and even of having a lower inflation rate than the euro area; but the lesson learnt is that inflation volatility depends on capital inflows because the country is small and open.

With core inflation rates under heavy influence of domestic demand, which was driven by credit funded from capital inflows before the crisis, the critical question is: can domestic monetary policy affect the exchange rate without affecting inflation? It can do neither, because in a small, open and financially integrated economy, a number of unintended consequences drive the relationship between the exchange rate and prices.

Figure 6.3 HICP rates of inflation 2001 - 2017, annual averages, Croatia and Euro Area



Source: Eurostat

First, benefits from fluctuating nominal exchange rates may be limited if the nominal exchange rate volatility produces negative shocks as well. That happens if there is a close positive correlation between the nominal exchange rate and the money market interest rate (called the original sin by economists) and/or if the external debt or FX debt in general (part of FX debt is domestic) is high. In Croatia, the FX debt of all sectors ranges between 130% and 140% of GDP. Therefore, a 10% lower exchange rate implies 13-14% of GDP negative wealth effect measured in domestic currency, which propagates recessionary impulses instead of alleviating them: the wealth effect negatively affects investment and consumption decisions.

Second, if changes of nominal exchange rate (weaker currency) spill over onto price changes, which is more likely in a small and open economy compared to a large one, due to dependence on imports and lack of domestic substitutes (e.g. energy and technology), monetary policy

cannot affect the real exchange rate substantially. At best, the ability of the central bank to affect the real exchange rate by changing the nominal one is limited.

Third, elasticities of exports and imports to real exchange rate changes may be limited, so the reaction of net exports may be meagre or even moves in the opposite direction.⁵³

Fourth, if macroeconomic policy lacks credibility, expectations may change in unfavourable ways that offset the desired effects. For example, if government raises public consumption and people expect that they will have to pay for it in the future (e.g. via higher taxes), households may diminish their consumption, thereby offsetting effects of higher government consumption.

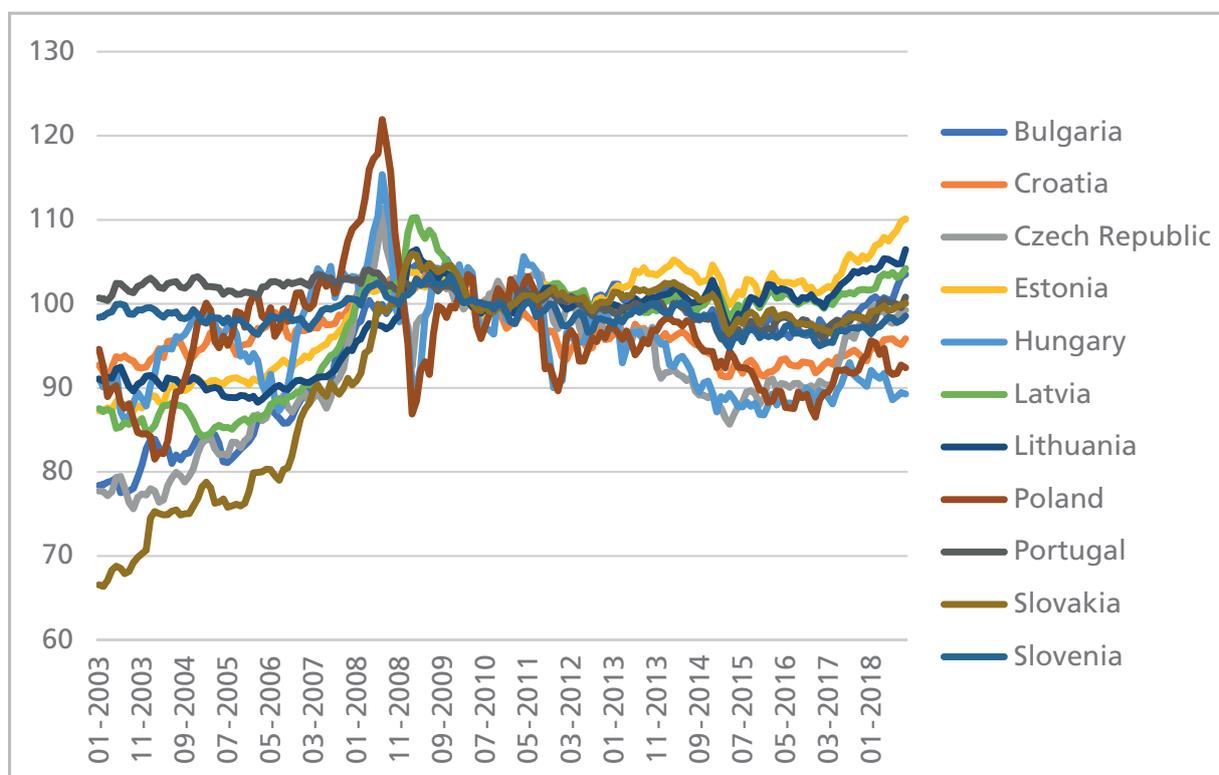
Therefore, small size, openness, financial integration, lack of policy credibility, unintended

53. The Marshall-Lerner condition says that the sum of elasticity of exports to the real exchange rate and the absolute value of elasticity of imports to the real exchange rate must be greater than one.

wealth and currency portfolio composition effects, as well as volatile expectations may lead to a “nothing left to lose” situation, meaning that loss of monetary autonomy is fiction. This makes giving up one’s own currency close to a situation of a “free lunch”, notwithstanding low inflation due to “rounding-up” of prices at times of cash conversion, which is generally minimal (econometric studies indicate up to a 0.2% one-off effect).

In a region dominated by small open and financially integrated economies the aforementioned effects are expected to create a correlation among the real exchange rate short term fluctuations of individual countries. Figure 6.4. shows that real exchange rates in New Member States are indeed becoming more correlated, which indicates the working of common exogenous shocks that are hard to absorb by autonomous domestic monetary and exchange rate policies.

Figure 6.4. Real effective exchange rates in NMS, 2003:01 - 2018:06 (depreciation=down)



Source: www.bis.org

Significant exchange rate re-alignments (real depreciations) like in Poland, Hungary and the Czech Republic during the Great Depression (see volatility in 2008 in Figure 6.4.), came as a consequence of exchange rate overshooting in pre-crisis times, which was related to their more flexible exchange rate regimes. Drops of real values of currencies at the onset of the recession were corrections without major impact on the long-term levels of the real exchange rates. So volatilities of real exchange rates differ, due to different exchange rate regimes. Of course, long-term levels of real

exchange rates do differ, due to different starting points and long-term productivity developments; however, there are short term correlations as well, indicating limits of domestic policies.

The lesson to be learnt is that the stance of countries towards adopting the euro may be endogenous. Bulgaria chose its currency board 20 years ago and Croatia chose a narrowly managed float (both vs. the deutsche mark at that time, and euro today). The Croatian nominal exchange rate vs. the euro has moved within a very narrow band of

around +/- 4.2% since 2000 and the band is a little wider if calculated since 1994. It is very hard to believe that authorities in Bulgaria and Croatia were so ignorant that they missed real opportunities to gain more in terms of economic growth and employment by making exchange rates more flexible.

Financial history matters, too. Croatia and Bulgaria lived through financial turmoil in the 90s (and during socialist times as well). Financial shocks in Croatia and Bulgaria were stronger historically than in Hungary, Poland and the Czech Republic. Such experiences shaped preferences for exchange rate stability and the euro. This is also reflected in FX savings with domestic banks: 67% of savings in Croatia is denominated in foreign currencies (mainly the euro) and more than 50% of the total balance sheet of Croatian banks is in foreign currency, which is largely driven by local currency preferences, not by external capital inflows, as banks' foreign liabilities have diminished substantially since 2010. In addition, there is a presence of the euro in the shadow economy, supported by the extremely large tourist sector in Croatia (FX revenue of 19% of GDP). These facts of life make the proposal to adopt the euro logical and sound.

Macroeconomic and monetary theory textbook models tend to exaggerate potentials of a flexible exchange rate policy for the creation of benefits via raising net exports in response to negative shocks. Many discussions about optimum currency areas and joining the eurozone start from the assumption that there is always something left to lose by giving up one's own currency. After all, the ERM II exchange rate band of +/- 15% around central parity was designed under the assumption of ever-present benefits of (nominal) exchange rate acting as a shock absorber rather than a shock propagator, at least in the short term. However, the +/- 15% band has never been used in the most recent cases of adopting the euro. Baltic countries never changed their

rigid exchange rate regimes inherited from the pre-ERM period during their (long) stay in ERM II before introducing the euro. Slovenia used it very narrowly and Slovakia had to revalue parity due to pressures on the appreciation of the Slovak Koruna while in ERM II due to fantastic performance of its exports 2004-2008.

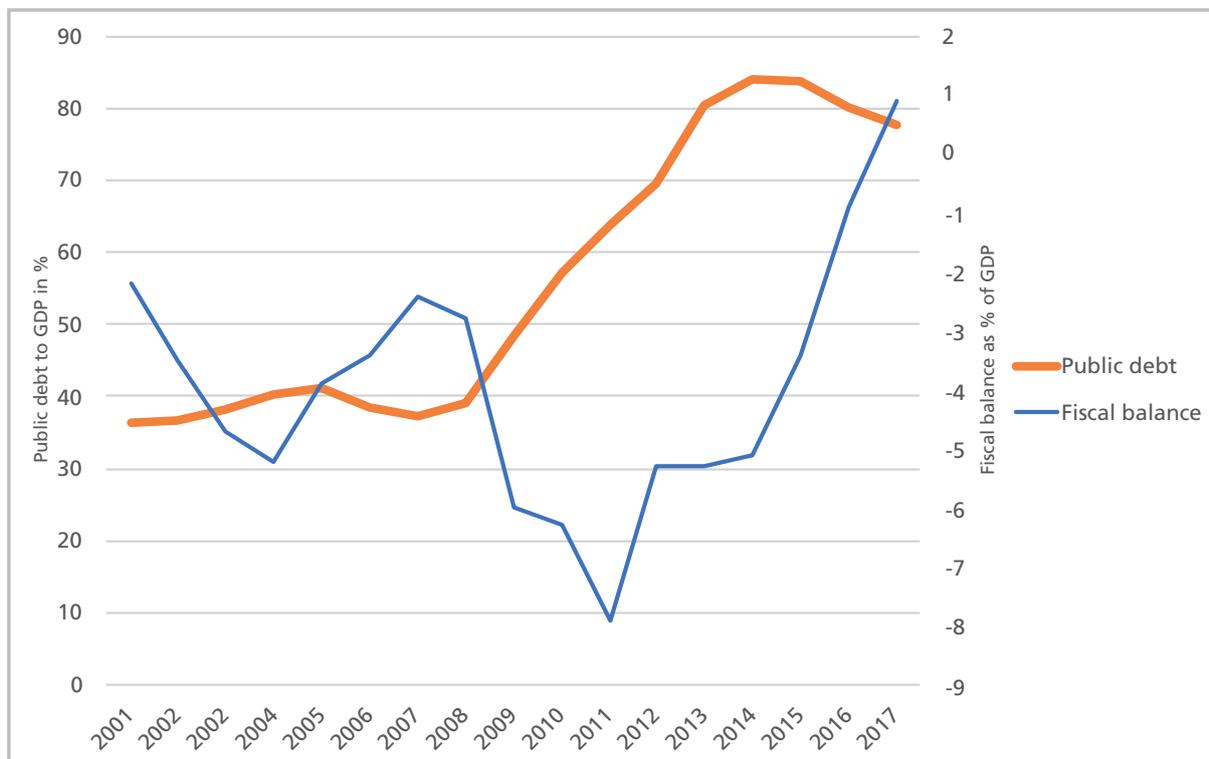
Thus, present exchange rate regimes with rigid exchange rates in Croatia and Bulgaria should be understood as economically and democratically tested, widely accepted and endogenous. It means that adoption of the euro should be seen as an evolution. It is not a big change compared to present arrangements. Countries like Croatia and Bulgaria have learned how to evolve without exchange rate flexibility.

Fiscal Situation

Questions of fiscal discipline are deeply rooted in the construction of the euro area. The political and economic philosophy of the monetary union is based on the simple assumption that a sustainable monetary union consists of member countries which follow common fiscal rules such as the Stability and Growth Pact and Fiscal Compact. This reflects a lack of faith in market discipline. This view is also deeply rooted in European monetary history. So let us briefly look why that view may be wrong and how this thesis can be illustrated in the case of Croatia.

After entry into the EU, Croatia entered the Excessive Deficit Procedure (EDP), due to both excessive deficit and public debt. The roots of problems were established in the pre-crisis period, when Croatia recorded a fiscal deficit of 3.5% of GDP on average, mainly related to government investment in infrastructure. Structural deficit was much higher than 3.5%, because the economy was growing faster than potential GDP in those years. Clearly, this was a fiscal policy error.

Figure 6.5 General government fiscal balance and public debt ratios in Croatia as % of GDP 2004-2017



Source: Eurostat

The first hit of the crisis in 2008-09 happened via the international trade channel and contraction of private investment and then continued around 2010 via a sudden ceasing of capital inflows and reductions in public sector investment. Authorities refused to ask for IMF assistance for populist political reasons, but they had ambition to conduct countercyclical fiscal policy. It resulted in an explosion of government bond yields in the initial stage of the crisis (above 6% for 10-year bonds). Public debt increased rapidly and provoked the government's panic attempts to close the fiscal gap by imposition of additional taxes at the time of both waves of recession in 2009 and 2012. Tax-based attempts to pursue fiscal adjustment were not successful and they expectedly led to unnecessary austerity and prolonged recession. Croatian economic performance after 2008 was the worst in the EU after that of Greece.

Since 2014, when the Croatian economy began to recover, governments have been cautious enough, partly due to the Excessive Defi-

cit Procedure, to save some fiscal space for continued fiscal adjustment. The resulting fiscal surplus (for the first time realised in 2017) and economic growth produced a downward path for public debt ratio. Croatia exited the EDP in 2017 and currently it meets Stability and Growth Pact fiscal criteria for public debt. The ratio of public debt to GDP is declining at a rate which is faster than 1/20 of the difference between actual public debt ratio and 60%.

Still, there are questions about the future fiscal path that are left without credible answers. Firstly, Croatia's relatively high general government revenues and expenditures of 45-46% of GDP leave very little space for tax or expenditure-based counter-cyclical fiscal policy in the future. Secondly, a relatively short period of fiscal prudence opens the question of long-term fiscal credibility. The public debt ratio is expected to go down to 74% by the end of 2018, 70% in 2019 and on, but the question of fiscal reaction when the next crisis reaches the shore is an open one. Cro-

atia currently pays around 2% on a 10-year euro-bond (twice as high a yield as Bulgaria's) and still awaits to re-win an investment grade for sovereign bond issues from international ratings agencies. This is expected to happen in spring 2019. Croatian fiscal policy is good, but still not good enough to earn full credibility; the legacy of the recent past is still present and reflected in government bond yield (and spread close to 2 percentage points vs. comparable German bonds) because Croatian fiscal mismanagement prevailed in the 2000s, before the crisis, and it was driven by an unhappy marriage between exuberant government spending that arose as a product of weak fiscal institutions and populist politics fuelled by capital inflows.

Nevertheless, nowadays there should be more faith in the impossibility of repeating fiscal mismanagement of the dimensions recorded before and during the crisis. Three mitigating factors are at play: (1) after EU entry, Eurosemester provides for both better prevention and correction of imbalances (Croatia also exited the Macroeconomic Imbalance Procedure in February 2019), (2) the financial system is better supervised, which puts sand into the wheels of unsustainable intra-EU international capital flows, and (3) both Croatian authorities and markets have learned something; given the higher sensitivity of financial markets nowadays, any serious mismanagement would lead to interest rate signalling (risk would be priced-in), prompting government correction of the fiscal stance. Bond yield spreads like Italy vs. Germany or Croatia vs. Bulgaria show that markets are selective and awake regarding the fiscal solvency of countries, with or without the euro. This is promising because market discipline is a much more powerful discipline device than political rules.

In a wider scheme of things, problems of monetary union and fiscal policies are reflected in an old dilemma: are monetary unions possible without fiscal unions (and how this dilemma looks when viewed from the Croatian perspective)?

In theory (the theory of optimum currency areas), monetary unions can work if labour is mobile

and/or there are fiscal transfers between members of the union. Fiscal transfers substitute for labour mobility. For example, if people stay in an economically depressed area (no mobility), fiscal transfers from growing regions raise living standards of people who stay. This principle led some observers and policy makers to the conclusion that there is no monetary union without fiscal union. Indeed, some big political personalities that shaped EU history, such as French President Francois Mitterrand and the whole generation of European federalists, believed that monetary union is a step towards political / fiscal union.

This conclusion is wrong. Even in theory, monetary union can function without common fiscal policies if labour is mobile. Even if it isn't, monetary union can work properly if bond markets work properly, and that will happen if member governments can default in an orderly manner. The assumption that an EMU member could not default was widespread before the Greek crisis and strongly defended by the ECB and Commission until 2011, but it killed market instincts.

Also notice that political preferences and institutions may shape monetary union without fiscal union. The United States had a monetary union long before significant elements of the fiscal-transfer union were built, from 1792 to the Great Depression in 1929-1933, when the federal budget surpassed 3% of GDP for the first time in US history. One has to acknowledge that in the EU, at present, there are democratic national barriers for the creation of a transfer union as voters in many countries, Germany in particular, do not want to give up national control over tax revenues.

The broader discussion on monetary union architecture is not so important for Croatia because the size of its economy is minuscule; its GDP represents 0.43% of euro area GDP. As a result, small fiscal redistributions via regular use of EU funds from the existing EU budget have a substantial effect on the Croatian economy. Indeed, fiscal transfers via use of EU funds played a role in generating Croatia's pro-euro stance. The use of EU funds and their contribution to

living standards was used as an important argument during the referendum on Croatia's entry into the EU in 2012.⁵⁴

Croatia entered the EU on the 1st of July 2013, but the use of EU funds took several years to take off. 2018 was the first year when withdrawals from EU funds minus Croatia's contribution to common EU budget made a substantial contribution to Croatia's economic growth, approaching 1% of GDP. Use of EU funds probably contributes to a mildly positive Croatian stance towards the euro. However, it is not expected to be decisive in terms of final public stance towards adoption of the euro.

Regional Cooperation and Trade Integration

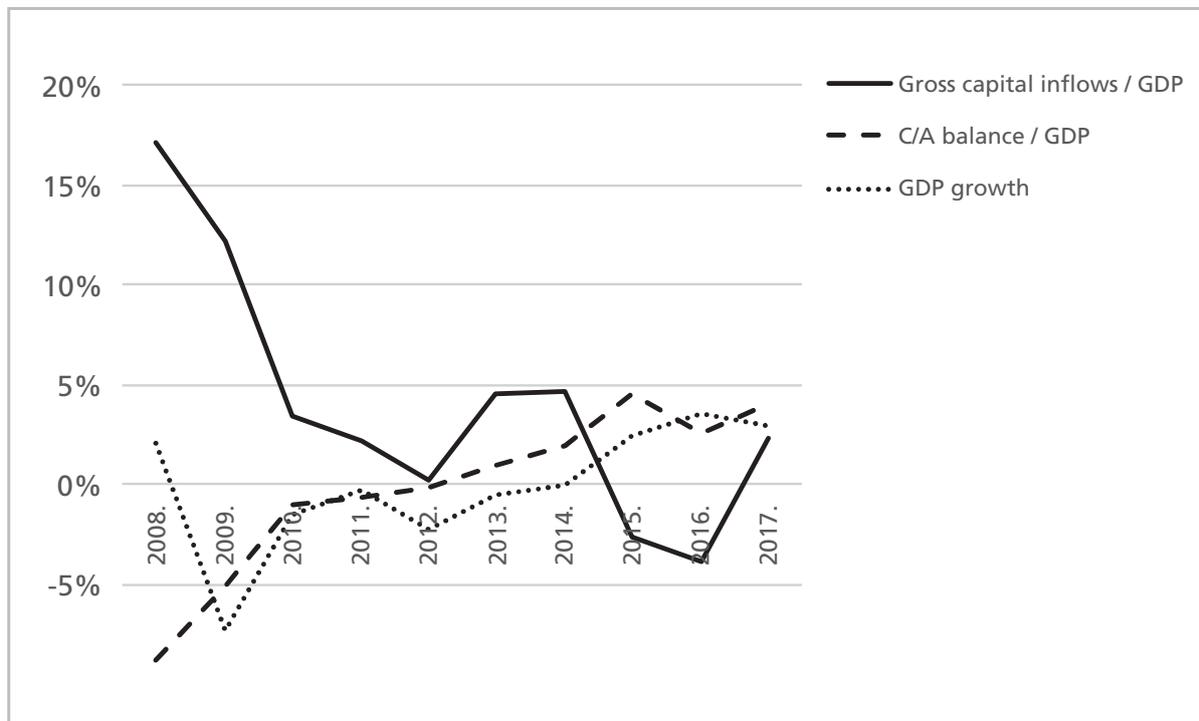
Croatia is a late EU entrant. It was too late to catch up with the first round of FDI and trade effects, which were widespread around the 2004 round of enlargement. As explained above, Croatia was on time to catch up only with the first round of capital flow effects because of early internationalisation of its banking system: Italian and Austrian banks dominate the local market.

Figure 6.6. shows gross capital inflows to the amount of 17% of GDP in 2008, which was brought down to zero four years later. Croatian authorities could not produce a counter-cyclical effect of this

relative size with domestic policies. The fiscal reaction probably produced unintended pro-cyclical effects, rather than an absorption of external shock. Even if Croatia had had larger fiscal space, it could not have ensured a fiscal response of appropriate size, given the size of the sudden ceasing of capital inflows after 2008. The same applies to exchange rate adjustment: even if the central bank had been able to create some space for adjustment by nominal/real depreciation (which is in itself questionable), it was not realistic to expect substantial positive reaction of exports at times when international trade was rapidly contracting and economic decision-making horizons shortened substantially. In this perspective, giving up local currency does not mean losing a shock absorber.

Since 2010, gross capital inflows have fluctuated within the manageable band of +/- 5% of GDP. The current account of the balance of payments adjusted accordingly and has turned into surplus since 2012. Consequently, both nominal and real exchange rates are more stable, and central bank spot FX interventions rarely occur (every 3.3 months on average after 2009). It would be easy to determine an equilibrium exchange rate for currency conversion, so-called central parity. After the recovery, which started in late 2014, Croatian economy has been growing on a sustainable path between 2.5% and 3% annually, with a good prospect of continuing to do so, accompanied by a healthy external position.

54. The referendum was held on the 22nd of January 2012. 66% of those who voted voted yes. Turnout turned out to be very low - 43% of voters. However, lists of voters had not been updated for years before, so total number of voters was seriously overestimated at 4.5 million. In general elections three years later, after an update of voters' base, the total number of citizens with voting rights was reduced substantially; hence the turnout was 50% or higher.

Figure 6.6 Gross capital inflows⁵⁵, current account balance and GDP growth 2008 - 2017

Source: Croatian National Bank, Croatian Statistical Office

In this respect, adoption of the euro is an opportunity to facilitate balanced growth of the Croatian economy in a wider EMU context. Also recall that Croatia's main trading partners (Italy, Germany, Austria and Slovenia) are using euro, and its fifth main trading partner (Bosnia and Herzegovina) has a euro peg via a currency board arrangement that effectively makes it a euro area country. The share of trade with the euro area is rising. Most financial flows and flows of services occur within this group of countries, which makes Croatia part of a wider optimum currency area of the euro.

Conclusions

In small, open and integrated economies with a labour force that is mobile across borders, monetary union is the logical final stage of integration. However, identity politics, populism, tensions within the EU and diverging visions of its future

create political uncertainties regarding the future of the euro area. Many participants in the lively public debate in Croatia make a simple point which attracts more and more attention: why go there if it is going to break up?

Mainstream political parties still hold their main centre left and centre right political positions in Croatia, but both parties are burdened with a backlog of corruption, clientelism and lack of capacities for sound policy making. This has fed political alternatives. Alternative political options are not strong to the extent like in Poland and Italy, but they are on the rise. Alternatives are good in terms of stronger political competition and call for more transparency as well as searches for more inclusive growth, but they are bad due to the fertile ground they provide for anti-EU coalitions and movements as well as for extreme political philosophies and ideas that negate any positive political potential.

55. Gross capital inflows are composed of increase in liabilities related to FDI, portfolio investment and liabilities of other sectors.

Given the changing political environment, the big question is: how would the process of adopting the euro affect politics and vice versa?

The EU integration up to this stage was not only perceived, it indeed was, too technocratic. The euro is especially vulnerable in this respect. The lack of democratic accountability of the ECB is less of a problem (although refusal to publish even meeting minutes after a time lag is not helpful); the major problem is that many see the euro area and Eurosemester as additional vehicles for imposing policy discipline from the outside, which is understood by new political movements as a vehicle which undermines national sovereignty. This is the fundamental reason for present clashes between Italy and the European Commission and it also fuels Polish and Hungarian reluctance vis-à-vis the project for adopting the euro. Croatian populists use the same political arguments. As such, adopting the euro is really not about the calculation of economic cost-benefit; adopting the euro is about identity, collective emotions and history, because many interpret the euro as an additional technocratic mechanism imposed on the lives of people. Authorities will have to deal with this sentiment.

Coming back to narrower economic issues, Croatia currently meets the Maastricht / Stability and Growth Pact criteria. Croatia has substantially improved the external position of its economy and the fiscal position as well. This was reflected in Croatia's exit from Eurosemester procedures of excessive deficit and macroeconomic imbalances. However, on their way towards the euro area, both Croatia and Bulgaria will face the usual objections regarding the quality of institutions, corruption and other blind spots of their economic and social development. These are not clearly written as criteria for adoption of the euro. So, the final question is: will discretionary pressures on

euro candidates mount beyond macroeconomic criteria during the euro accession process, and what political reactions will they trigger in applicant countries?

The technocratic view sees adopting the euro as an opportunity to impose additional criteria and push for reforms. Technocrats in Zagreb, Brussels and Frankfurt may see this as a desirable thing to do. However, it raises the risk of breeding an anti-EU mood. The lack of transparency and criteria known in advance, especially regarding ERM II entry, and a feeling that a country is making serious political effort with a delayed reward (e.g. "treating a country like a child") breeds the opposite from that which is expected - a backlash against the euro and the EU. It may ultimately lead to policy failure in the long run. Policy makers should take this into account as the EU and the euro area are searching for new energies and political philosophies after the recent crisis.

It is important not to underestimate how much countries like Bulgaria or Croatia have already changed. They are much more similar to Central European countries than 10 or 20 years ago. They are members of the EU, deeply integrated into the EU in terms of trade, finance, investment and movements of people. Their people travel and seek jobs across the Union. They are already small wheels in the wider mechanism of the integrated single market.

Governments of euro candidate countries should ensure widespread public debate and support for the euro because economic arguments do point to more benefits than costs of adopting the euro. Rational debate would lead to adopting the euro and the point is to keep the domestic as well as European debates in the domain of rationality and convince the public that the euro is not only sustainable but really beneficial for people.

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Annex

Table A.1 Economic and Legal Criteria For Joining the Eurozone

| Criteria | Reference value | Short description |
|--|--|---|
| Economic convergence | | |
| Prices | Not more than 1.5 percentage points above the rate of the three best performing member states. | “the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability” |
| Fiscal | Deficit criterion, not more than 3% of GDP | Not under the excessive deficit procedure at the time of examination |
| | Debt criterion, not more than 60% of GDP. | Idem, as above. |
| Exchange rate | ERM 2, deviations from a central rate within +/-15%. | The criterion on participation in the Exchange Rate Mechanism (ERM) of the EMS “a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism on the EMS without severe tensions for at least the last two years before the examination”. |
| Long term interest rate | Not more than 2 percentage points above the rate of the three best performing Member States in terms of price stability. | “the durability of convergence achieved by the Member State with a derogation and of its participation in the exchange-rate mechanism being reflected in the long-term interest-rate levels” |
| Legal convergence - compatibility of national legislations with the Treaty | | |
| The aim of assessing legal convergence is to facilitate the Council's decisions as to which Member States fulfill 'their obligations regarding the achievement of economic and monetary union'. In the legal domain, such conditions refer in particular to central bank independence and to the national banks' legal integration into the euro zone. | | |

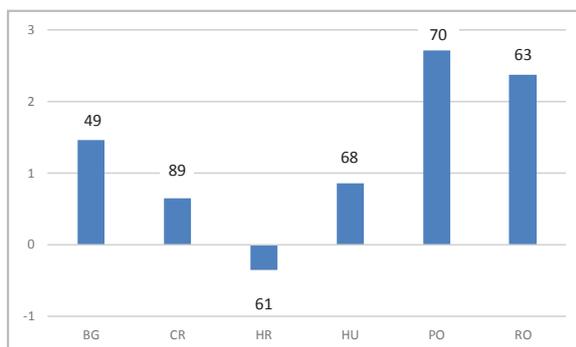
Source: (ECB, 2016)

Table A.2 NMS Euro Adoption Criteria Fulfilment

| Compatibility of Legislation and Fulfilment of Convergence Criteria (as of 23 Apr 2018) | | | | | |
|---|---------------------|---------------------------|---------------------------|----------------------------|-----------------------------------|
| | Legal compatibility | Price stability criterion | Fiscal criterion (no EDP) | Exchange criterion (ERMII) | Long-term interest rate criterion |
| Bulgaria | no | yes | yes | no | yes |
| Czech Republic | no | no | yes | no | yes |
| Croatia | yes | yes | yes | no | yes |
| Hungary | no | no | yes | no | yes |
| Poland | no | yes | yes | no | no |
| Romania | no | no | yes | no | no |

Source: EU Convergence Report 2018

Figure A2.1 Annual Average Growth in GDP/capita at PPS, 2008-2017, %.



Source: Eurostat and Own Calculations. Figures on top of the bars represent GDP/capita in PPS at the end of 2017 (EU-28=100).

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