IT'S POLITICS, STUPID! – EMU ENLARGEMENT BETWEEN AN ECONOMIC ROCK AND A POLITICAL HARD PLACE –

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With the accession of the new member states in 2004, it was widely taken for granted that the subsequent introduction of the euro in these countries would merely be a formality – a purely technical process. Indeed, at the outset, all countries of central and eastern Europe (CEEC)[2] voiced their intention to join the eurozone as soon as possible. Two years later, much of this momentum has been lost. Of all CEECs, only Slovenia will manage to introduce the common currency already on 1 January 2007. All other countries have either not committed themselves to the fulfilment of the economic conditions for eurozone membership or have not managed to meet them yet. Estonia and Lithuania, which also aimed at a eurozone membership in 2007, had to postpone their entries. The same holds for Latvia whose target date of 2008 was revoked recently by the government. The Baltic states' difficulties stem from their high inflation rates which are at odds with one of the stipulations of the Maastricht convergence criteria.[3] However, they along with Slovenia and Slovakia have already taken the road towards the euro by entering the fixed exchange rate mechanism (ERM II), a step that has not even been taken yet by the Czech Republic, Hungary and Poland. Indeed, these latter countries have either only announced a vague entry date for 2010 (Czech Republic and Hungary) or do not even have a target date at all (Poland).

Prerequisites of EMU membership are at odds with political incentives

This begs the question of why this allegedly technical procedure has stalled recently, especially in the three biggest states. We maintain in this article that not only inconsistencies in the Maastricht criteria, as is often claimed in the economic debate, are the reason for these difficulties. Rather, in a context of real convergence, the economic prerequisites of EMU membership are at odds with the political incentives that decision-makers face in their countries. There is no doubt that EMU membership offers the prospect of economic gains; as De Grauwe and Schnabl (2004, 243) correctly put it: "The CEE countries have the unique opportunity to complete the catch-up process of an emerging market with the interest rate of a highly developed economy." The usual questions apply, however: who will benefit, when do benefits materialize and how much of these benefits can be reaped? There will be losers and winners in this process, and even winners may want to have their benefits now rather than twenty years from now. In a democratic society, and we are talking about democracies here, these preferences will not only be expressed economically in the market place but also politically by the act of voting. If voters are myopic and biased towards present consumption, they will reward governments who promise present consumption and punish those that ask them to wait. Governments seeking majorities in the voting process may be tempted not only to promise immediate higher consumption, but also to deliver it by increasing transfers, cutting taxes on households, providing subsidies and public goods for consumption. The resulting budget deficit may hamper growth and increase the danger of inflation but secure political survival and societal support for the

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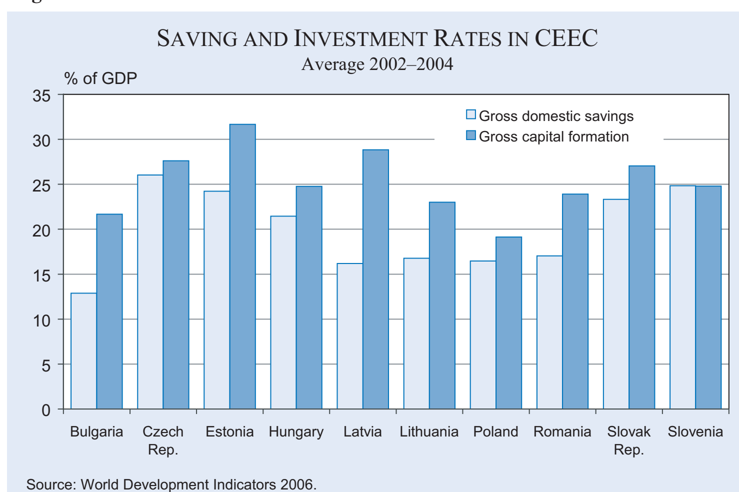
[2] In this article, we will focus on the new member states from central and Eastern Europe. We also looked at Bulgaria and Romania, since most likely they will join the EU 1 January 2007.

[3] The Maastricht criteria set out the economic obligations that need to be fulfilled before adoption of the common currency is granted. In particular, these criteria demand that the budget deficit and total government debt do not exceed 3 percent and 60 percent of GDP respectively. Moreover, compared to those three member countries that boast the highest price stability, applicant states' inflation rates and long-term interest rates may not exceed the reference group's inflation rates and long-term interest rates by more than 1.5 percent and 2 percent respectively. Finally, all countries need to prove their exchange rate stability by fixing their exchange rates for at least two years within the framework of the European Monetary System (ERMII) without devaluing against the currency of another member state.

EU. The immediate political costs associated with necessary economic reforms may induce policy makers particularly in the bigger CEECs to postpone necessary economic adjustment required for entering the eurozone. The economic rationale may thus conflict with the political rationale.

Figure 1



Source: World Development Indicators 2006.

Long-term prospects and short-term solutions

As is often the case, telling the story of a political dilemma starts within an economic context. Comparing the current per capita income levels of the CEECs with those of the eurozone average and projecting them into the future shows that all CEECs will still need at least one or two generations to catch up with the eurozone member states (see Table 1).

It seems reasonable to assume that new member states will try to speed up the catching-up process. High growth rates require high investment rates. Yet the new member states feature low domestic saving rates. The result is that, with the exception of Slovenia, all of these countries exhibit a considerable savings gap, with Estonia leading the pack with a striking 15.7 percent difference (see Figure 1). This imbalance is reflected in large current account deficits that are needed to fill the gap between saving and investment rates. These range from around 2 percent in Slovenia to as high as almost 13 percent in Estonia (see Figure 2).

The negative difference between exports and imports of goods and services can be considered as the continued use of foreign savings. From the point of view of welfare economics, this can be understood as imports of resources. From a monetary perspective, this implies capital imports to finance the current account deficit and to stabilize the exchange rate. To run a high current account deficit is a risky strategy. It entails volatilities and may easily end up in a currency and banking crisis. The inflow of foreign capital needed to stabilize the exchange rate cannot be taken for granted. The very open CEEC are not the U.S., their financial markets are rather small and less deep, and their currencies are not the US dollar. Recent experiences in Asia and Latin America give testimony to the havoc wreaked when investor sentiments turn sour. Hence, although some economists have argued that from a theoretical perspective there should be no reason to be concerned about current account deficits (Sachs 1981), recent lessons of many emerging markets should provide a warning that in the medium- to long-run CEECs' exter-

Most of the CEEC have big gaps between saving and investment rates and hence big current account deficits

Table 1

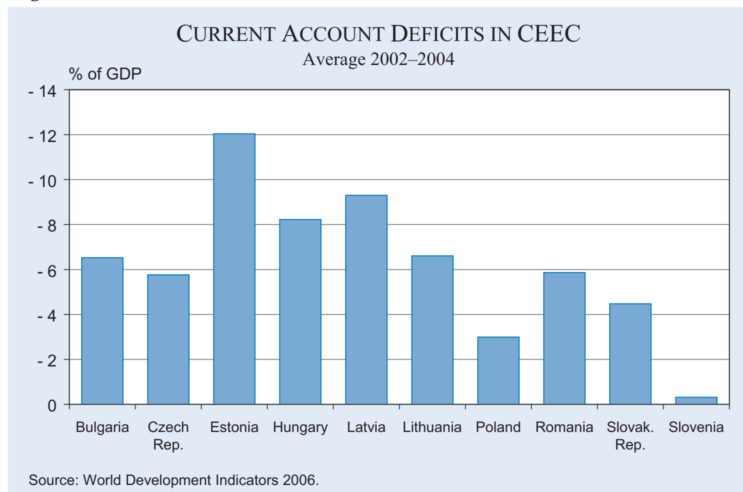
Time for convergence to 100% of EMU-GDP per capita for different growth scenarios

Country	**Average growth 2000 to 2005 continued** (average growth rates in brackets)	at 8% growth rate
Slovenia	34 years (3.37%)	10 years
Czech Republic	53 years (3.79%)	19 years
Hungary	43 years (4.65%)	21 years
Estonia	21 years (8.04%)	21 years
Poland	76 years (3.39%)	23 years
Slovak Republic	52 years (4.43%)	24 years
Lithuania	25 years (7.58%)	24 years
Latvia	21 years (7.20%)	23 years
Romania	54 years (5.76%)	36 years
Bulgaria	53 years (6.05%)	37 years

Notes: Base year is 2005. EMU's per capital GDP is assumed to grow by 1.5% per year. Countries have been ranked according to the level of real convergence achieved in 2005.

Source: Own calculations based on World Development Indicators 2006.

Figure 2



Source: World Development Indicators 2006.

nal imbalances could pose a threat to macroeconomic stability (Edwards 2004). In the long run, large current account deficits imply risks for monetary stability as well as the fundamentals of an economy, even if most capital inflows to the CEEC are still foreign direct investments rather than more volatile portfolio flows. Yet despite these risks, in the short run CEECs have no politically viable alternative to a current account deficit route if they want to pursue fast economic catching-up.

This all holds true for transition economies everywhere. For the CEEC, however, entering the EU in 2004 has helped a lot to stabilize capital inflows because it fuelled favourable market expectations about future economic stability and growth. These positive expectations would be even reinforced in case of EMU membership. Joining a single currency abolishes the currency risk and reduces the inflation risk. Therefore, expected eurozone membership further increases the confidence of international financial markets. It helps to ensure that capital keeps on coming in and makes large current account deficits less risky in the medium run.

To ensure a continued inflow of capital, price stability is needed and small fiscal deficits

From a purely economic perspective, the policy prescriptions seem to be clear: enter EMU as fast as possible to reduce the danger of currency-induced volatilities. If CEECs wait too long, the result could be large exchange rate movements, which may induce sudden current account corrections; or a currency crisis could be triggered by strong current account movements. If markets become convinced that the euro will not be introduced eventually, then capital could be redirected. Often voiced recommendations that these countries should finish their structural reforms or complete real convergence first, seem ill advised. The risks associated with such a delay are not worth taking.

To ensure a steady inflow of capital, favourable conditions are needed: price stability is paramount. There is already pressure on prices from the supply side because of the productivity catch-up in these countries. To prevent high inflation, domestic demand has to be in equilibrium with overall supply. This implies that the burden of macroeconomic stability lies on fiscal policy. The size of the needed fiscal adjustment depends on the size of the current account deficit given continued low saving rates and the need for high investment rates. Estimating sustainable levels of the current account is complicated, however, and necessarily depends on the methodology employed and the underlying assumptions about steady state values of the important economic variables. However, if the currently slower growing CEEC, such as Hungary or Poland, tried to speed up the convergence process, then the burden on fiscal policy would be heavier still. Even a simple back-of-the-envelope projection for these countries would end up with very high investment rates and extreme current account deficits, given current low private saving rates and a growth rate of, for example, 8 percent.[4] This would call for a very prudent fiscal policy with extremely low deficits. Some governments would even have to run budget surpluses to ensure macroeconomic equilibrium between supply and demand and to prevent demand-driven inflation.[5] This is especially true for the big CEEC with their high fiscal deficits. What this reasoning implies is that the 3 percent deficit margin of the Maastricht fiscal criterion seems to be rather too generous for most of these countries. Table 2 provides an overview of country-specific growth rates (averages of 2003 to 2005) and the country-specific situation of the general government balances. The last column displays some, however crude, assessments of the needs for fiscal adjustment if countries want to speed

[4] While this seems to be an extraordinary high growth rate, it has to be noted that the Baltic countries had even higher ones in the last few years.
[5] Precise quantitative estimates depend on a number of crucial assumptions of, for example, private saving rates and the marginal product of capital. That is why we only point out the qualitative implications without providing exact numbers.

Table 2

Economic growth, general government balances, fiscal pressures

Country	Strong economic growth above 8%	Moderate growth between 3% and 6%	General government budget close to balance or in surplus	General government budget of – 3% or lower	Fiscal adjustment needed for 8% growth
Bulgaria		x	x		
Czech Republic		x		x	**
Estonia	x		x		
Hungary		x		x	**
Latvia	x				
Lithuania	x				
Poland		x		x	**
Romania		x			*
Slovak Republic		x		x	**
Slovenia		x			*
Note: Growth rates and general government balances are averages of 2003 to 2005.					

Sources: Eurostat, WDI.

up economic growth. No star points to a somewhat comfortable situation with regard to the budget balance (like in Estonia), one star (like for Romania and Slovenia) indicates the need for moderate consolidation efforts. A country with two stars seems to be in a bad situation because it would need a reduction in its fiscal deficit to achieve the goal of a higher growth rate at stable prices given the necessary current account deficit.

An economic rock …

There are quite some lessons to be learnt. The most important one is that fiscal policy becomes a dependent variable and is no longer at the discretion of policy makers. The economic rationale of the catch-up process requires a specific budget strategy to ensure macroeconomic equilibrium, thereby stabilizing low inflation rates and creating confidence in the sustainability of the current account deficit. However, politically this may be very hard to sell. It may be even harder to sell the decision of joining ERM II right away and, later, the eurozone. These decisions entail forgoing monetary sovereignty and the inevitable loss of the exchange rate and monetary policy as policy instruments. This may not come with high costs for small countries, like the Baltics with their already existing currency board arrangements. As the discussion above amply demonstrated, fiscal policy also has only a very limited capacity as a macroeconomic instrument, which will leave CEECs, once in ERM II, without any macroeconomic instrument at all.[6] The burden of adjustment would then be on wages, prices and employment. At this stage, this seems to be unacceptable for the big CEEC.

Giving up macro-policy sovereignty is politically hard to sell

Fulfilling the Maastricht inflation criterion is also not an easy task because it may be judged as overly restrictive. First, ECB monetary policy is based on the eurozone inflation average, whereas the Maastricht inflation criterion judges price stability in comparison to the three EMU countries with the highest price stability. Secondly, the inflation criterion does not take into account that transition countries have structurally higher inflation rates due to the catch-up process itself, which entails different productivity developments in sectors of tradable and non-tradable goods. The former sector, exposed to international competition, experiences higher productivity leaps than purely domestic sectors. As a result, prices and wages in the latter are also pushed up leading to a surge in inflation – the famous Balassa-Samuelson effect.

This productivity induced price pressure could be solved by letting the currency appreciate. Yet, the exchange rate criterion demands that countries willing to join EMU peg their currency to the euro for at least two years, obeying a narrow fluctuation band of 2.25 percent.[7] This is not enough room to accommo-

[6] Recent conflicts about monetary policy and “blame games” between governments and central banks in Poland (in 2002) and Hungary (ongoing), as well as reform efforts that reduce the independence of the central bank (Czech Republic in 2000), give testimony to the ongoing struggle of policy makers to keep monetary policy in their reach.

[7] ERM II came into being in 1997 and has actually a standard fluctuation band of ± 15 percent. Nevertheless, the Commission decided to apply the 2.25 percent band of ERM I as an exchange rate criterion. Note that ERM I de facto collapsed in 1993 due to massive speculative attacks, making the Commission’s insistence on applying the narrow fluctuation margin hard to understand.

date the inflationary pressures created by the catch-up process, thereby rendering it very hard for countries observing high economic growth rates to fulfil both the inflation and the exchange rate criterion simultaneously. Indeed, Estonia and Lithuania, which could not even exploit the 2.25 percent margin because they run currency board arrangements that are permitted within the ERM II framework, failed to qualify for eurozone membership in 2007 because they missed the inflation target.

Moreover, ERM II is a tricky economic prerequisite for another reason. As has been forcefully argued before (Begg et al. 2003), a soft peg regime such as ERM II combined with a completely liberalized capital account, which is mandated by the *acquis communautaire,* may become very vulnerable to currency distress and may therefore lead to sudden current account corrections, endangering the convergence process. Capital flows would become more volatile, and more short-term portfolio flows would be attracted under such a regime.

Fulfilling the Maastricht inflation criterion may be too demanding

As a result, CEECs are faced with an inflation criterion that is a little bit too strict and in combination with ERM II somewhat contradictory, as well as an exchange rate criterion that is potentially risky.

… and the political hard place

Given these economic rocks, a reasonable economic policy is necessary, especially with respect to the timing of accession. EMU entry should not be delayed for too long, because CEECs need to ensure the stability of the current account. Yet, too fast an approach is also not viable because the political challenges associated with meeting the prerequisites for euro adoption are even more daunting. We know from modern political economy research that politicians do respond to short-term electoral pressures that are not necessarily in line with the long-run needs of the economy. Therefore, economic policy serves as a tool to garner votes, and policies that are damaging at the polls will rarely be enacted.

Accession to the European Union has created high hopes among the people in the CEECs for a fast increase in their standards of living. These hopes may be easily disappointed. A Eurobarometer poll one year after EU accession showed that 74 percent of the respondents in the new member states considered their economic situation to be "bad" (European Commission 2005). Thus, governments are expected to deliver exceptional growth rates (as is currently the case in the Baltic states) or face serious electoral punishment. The political instability currently observed in some CEECs regarding government durability can be partly attributed to disappointments stemming from the gap between personal economic gains and individual expectations – Poland, Bulgaria and Hungary are only a few recent examples in this respect.

Voters in CEECs have a clear benchmark for their expectations, which is the income level of the western European countries. They expect fast convergence to these standards. We have shown above that this takes at least one or two generations (see Table 1). It is reasonable to assume that voters are much more short-sighted. They want to have the cake now and eat it soon. This is the catch: growth is needed for economic convergence, but at the same time the populaces yearn for fast increases in consumption. This dilemma translates into the challenges for fiscal policy and the government budget. On the one hand, the economic rationale requires fiscal discipline given the aim of long-run growth. On the other hand, voters want governments to enable public and private consumption.[8] This may help to explain why many of the CEECs boast such high public expenditure rates given their level of economic development, with Hungary even exhibiting an expenditure rate of more than 50 percent of GDP. If governments follow the economic rationale, re-election is seriously at risk. If they follow the political rationale, they may stay in power but a fast increase in economic wealth will not be attainable.

Looking at the expenditure rates of the CEECs, it is evident that the bigger countries, which tend to be more heterogeneous in terms of preference distributions and social cleavages within the population, exhibit higher spending levels. Parties and candidates compete for political power by offering pork and redistribution: the more diverse the populace, the more spending is needed to secure office. This is even more necessary once economic growth slows down.

[8] Alesina and Fuchs-Schündeln (2006) try to explain the preferences for redistribution of west Germans and east Germans. They find that people who grew up in the Communist part have much stronger preferences for redistribution and state intervention. They attribute these finding to the experience of a paternalistic, intrusive state under socialism. We would expect the same pattern in all CEECs, since they all share a similar socialist experience.

From this perspective, the Baltic states are in a favourable position: they are small, and had enormous growth rates in the last two years, ranging from 7.5 percent in Lithuania up to 10.8 percent in Latvia. As a result, a political window of opportunity to enter EMU has opened up there. However, the tight inflation criterion prohibits their quick accession. It is doubtful that even under these favourable economic circumstances, governments have the political willingness to implement the austerity measures that would be needed to curb inflation.

Table 3

Possible Scenarios for EMU entry

Fast entry 2007	**By 2010**	**Intermediate, still unclear**	**Longer term, but still conceivable**	**Another Sweden?**
Slovenia	Estonia, Latvia, Lithuania	Slovakia	Czech Republic	Hungary, Poland

The three biggest CEEC are in the trickiest situation, and similar arguments could also be made with respect to Slovakia. They have rather high fiscal deficits, not only compared to the 3 percent Maastricht criterion but also with respect to what would be necessary given their current account deficits (see Table 3). Yet engaging in budgetary retrenchment is politically difficult. As a result, entering the ERM II straightjacket is postponed and the eurozone is officially considered as not advisable (a position currently taken by Poland). Political decision makers simply have no incentive in these countries to take on the front-loaded costs of approaching EMU membership, demanding painful fiscal adjustment and the giving up of the monetary emergency exit. The costs are immediate and would be felt at the next elections, while the timing for reaping the benefits remains unclear. The EMU entry date is not fixed and depends on the fulfilment of the not-easy-to-achieve and somewhat contradictory inflation and exchange rate criteria. Policy makers would lose their last crucial economic instrument that is a valuable tool for political competition.

Given this political dilemma, we do not expect the Czech Republic, Hungary and Poland to change their current reluctance to introduce the euro anytime soon. Given the current growth rates, budgetary conflicts and the political dilemmas pointed out above, we attempted to make an informed guess about EMU entry prospects; these are summarized in Table 3.

The Baltic states are on track and should therefore manage to introduce the euro, once the inflation criterion is fulfilled. This will happen when the currently very high growth rates slow down and the strong growth in domestic demand recedes. Slovakia is in a somewhat unclear position, having entered ERM II, but still needing to consolidate its budget. The Czech Republic suffers from the problems explained above, but very recently experienced a surge in economic growth, which could open up a window of opportunity for policy makers. Finally, Hungary and Poland are in a situation in which striving towards the euro seems politically not viable. We expect them, just as Sweden, to postpone EMU entry for the foreseeable future.

Evasion tactics and how to prevent another Sweden

All CEECs are so-called 'members with a derogation' and are obliged to introduce the euro once they fulfil the Maastricht requirements. Unlike Great Britain and Denmark, they do not have an opt-out clause. However, the belief that the euro is simply an option is widespread in the CEECs. A recent Eurobarometer poll (2006) showed that in every CEEC surveyed (Bulgaria and Romania were not included), a great majority of the respondents thought that euro introduction is not obligatory. As a result, a strategy of blaming the need for painful fiscal adjustments on the introduction of the euro will not work in any of these countries. Sweden provides a good example of how to avoid the euro. Countries not willing to incur the economic and political costs may follow this example and postpone entry into ERM II – indefinitely if politically necessary.

The three bis CEEC have no incentives to incur the economic and political costs of EMU but are obliged to introduce the euro

Given these economic and political realities and to ensure sustainability of the CEECs' economic catch-up strategy, fast entry into EMU is essential. If market participants became convinced that a country would not introduce the euro in the foreseeable future, a redirecting of capital flows to other CEEC would likely occur, entailing a current account reversal with all its adverse consequences for financial stability and sustainable economic growth. Hence, a combination of domestic policy measures and political incentives by the EU seems to be necessary. Introducing the right institutions might help mitigate the political obstacles.

At the domestic level, CEECs should encourage private savings to reduce the current account deficit in the long run. This could be achieved, for example, by introducing pension reforms that induce households to rely less heavily on pay-as-you go pension schemes and more on personal savings (see Bolle and Pamp, forthcoming). Some CEECs have started moving in that direction, but much more is needed. In addition, growth strategies of the CEECs have to be linked to a strengthening of the export base, thereby diminishing the current account deficit. Both of these strategies are aimed at the medium to long run. Nevertheless, CEECs have to stabilize capital inflows by widening and deepening domestic financial markets. Given high capital inflows, efficient allocation becomes paramount and overheating as well as asset-price bubbles are serious threats in fast growing transition economies (see Bolle and Meyer, 2004).

Beyond domestic efforts, the European Union should engage in technical as well as financial assistance to help CEECs tackling their budgetary dilemma. With regard to technical assistance at the domestic level, one may think of introducing budgeting systems for improved governance like "Zero Base" and "Outcome Focused Budgeting" in Great Britain (Ellis and Mitchell 2002). At the European level, already existing budget coordination mechanisms in the framework of the broad economic policy guidelines could be strengthened with the help of institutions like the Bureau of European Policy Advisers (BEPA). This may even lead to an annual review process of the progress made by CEECs towards EMU membership. This would resemble the pre-accession process, where the Commission closely monitored progress and published annual reports. This institution building could be complemented by financial assistance in a similar way as the EU's pre-accession instruments that provided funds to CEECs in return for commitments to implement the prerequisites of EU accession. Countries undertaking the necessary steps towards the eurozone could be financially rewarded through investment grants that should be earmarked for investment spending. The institutional and financial incentives together could also help domestic policy makers in CEECs to play soft tight-hand strategies with their voters.

Beyond domestic efforts to diminish current account deficits, the EU should give technical assistance

Eurozone enlargement is a political process. Simply telling the CEECs to reduce their budget deficits and in some cases even create surpluses is not an advice that policy makers in those countries could follow easily, given high hopes of the populace and next elections always just around the corner. Providing positive political incentives and offering external constraints would make it easier for policy makers to implement the necessary economic steps.

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