Risks of Slovakia's Membership in the EMU

By Peter Gonda*

Introduction

The Slovak President and Prime Minister by signing the agreement about accession to the European Union (EU) in April 2003 bound Slovakia to membership of the Economic and Monetary Union (EMU). In September 2004 the Government of the Slovak Republic approved the document "Specification of Strategy for the Euro Adoption in the Slovak Republic" in which the government proclaimed the intention to already replace the Crown by the Euro in 2009. This declaration limited space for discussion about the none-profitability of EMU membership for Slovakia, but to have a discussion is still important. To abandon a domestic currency exchange rate (that represents both a price and important source of information for the market) and give up domestic monetary policy to more centralized monetary policy (implemented by the European Central Bank (ECB)) is a very serious decision that will have a substantial impact on all Slovak citizens. The decision represents risks that have the potential to be weightier than the benefits of having only one currency in Slovakia.

1. Starting points for concerns - barriers to the (fast) accession of Slovakia to the EMU

Initial barriers to the Euro adoption in Slovakia are: [1]

- negative experiences brought by monetary unions in the past (especially those with a political background);
- systemic problems in the Euro zone;
- substantially different economic conditions in Slovakia when compared to the conditions within current EMU members.

1.1. Negative experiences with monetary unions in the past

Previous attempts to unify various regions in a common monetary union have been carried out so far have either failed (e.g. Latin Monetary Union or Scandinavian Monetary Union in the 19th century) [2] or have unfavourable effects on citizens, e.g. the unification of West and East Germany in 1990. The unification was based on a politically (without taking into account market conditions) fixed exchange rate between the West German and East German Marks 1:1. The negative economic, social and non-economic consequences of the monetary union in the unified Germany have been deepening permanently during the last 15 years.[3] In this particular case it was a country and people with the same language and

* Peter Gonda, Ph.D. (petergonda@institute.sk), an economic analyst for the Conservative Institute of M. R. Štefánik.

[1] It is obvious that the first two barriers are generally valid and stand not only for Slovakia.

[2] The article´s objective is not to deal with historical links of monetary unions. The failure of the Latin Monetary Union (established in 1865 by France, Switzerland, Belgium and Italy) and the failure of the Scandinavian Monetary Union (established in 1872 by Sweden, Norway and Denmark) are mentioned just to illustrate the point.

[3] Enormous subsidies provided by West Germany for East Germany (around 1 billion Euro) have brought several very serious problems. The most obvious ones are a high long-term unemployment rate and a significant drain of qualified labour from East Germany. Also a dependency of a substantial number of citizens in the former East Germany on outside support and their inclination to extremist political parties pose

mentality (although deeply distorted by socialism in eastern regions). Compared to Germany, the monetary union involving various different states of Europe that have abandoned not only their currencies but have also given up some other features of their state sovereignty, is a historical experiment and precedent.[4]

1.2. Systemic problems in the Euro zone

The conditions in the Euro zone as they are today are far away and probably will be getting more and more distant from a functional monetary union. Economic, cultural and heterogeneous language, various economic conditions and experiences, low labor mobility and flexibility are ultimate factors telling us that Europe is not and in the foreseeable future will not be a suitable place for the creation of a monetary union that could be sustainable in the long run without having negative impacts on people.

A comparison with monetary union in the USA may serve as an example (Table No. 1). While the USA is one (homogenous) state with one language, in Europe, languages make barriers, particularly to labor mobility. In the USA the differences among respective regions as to their economic performance are smaller. Although the difference between Texas and California is marked for instance, the differences that exist among Greece and the south of Italy or Luxembourg are more significant, not to mention new members of the EU.

Regulations in the USA are not so wide and what is more important – the labour market and labour force are more flexible. Prices in the USA are more flexible too. The Unions have a significantly lower influence on wage policy than the Unions in Europe. In many European countries the Unions extensively interfere in economic decision making and economic policies.

Table No. 1: Comparison of some characteristics of the monetary union in the USA and the EMU

	USA	EMU
Smaller differences in economic performance and economic cycles	x	
Fewer regulations and more flexible markets, especially labour market	x	
Higher mobilty of labour and capital	x	
More flexible wages and prices	x	
(Federal) fiscal transfers	x	
Other similar features – central government, one language...	x	

Note: The Table No. 1 does not show absolute values of respective indicators, they are expressed only relatively and the sign “x” means that a given indicator is present to a more significant extent.

Source: Author, Feldstein (1997), Rockoff (2000).

a problem.

[4] See more in Eichengreen (1993) a Gedmin (1997).

At present the EMU is characterised by an instability, mainly instability in rule observance – especially with respect to the "Pact of Stability and Growth". The most obvious proof of this is the non adherence to the criteria of public finance deficit particularly in France and Germany, and what is more, there is no regress on that either.

The above mentioned facts along with a too wide scale of regulations (not only on the labour market but also as regards trade) pose problems that are getting worse and are even more emphasized by generous and costly social systems and a centralisation of decision making (on a supranational level). One fixed rate that bounds economies (especially in Germany and France) causes economic problems (hindering of economic growth and high unemployment rate).

1.3. Initial barriers within the Slovak economy

It is not only the problems in the Euro zone but also set conditions and capability of economic subjects that make substantial barriers to an early accession of Slovakia to the EMU.

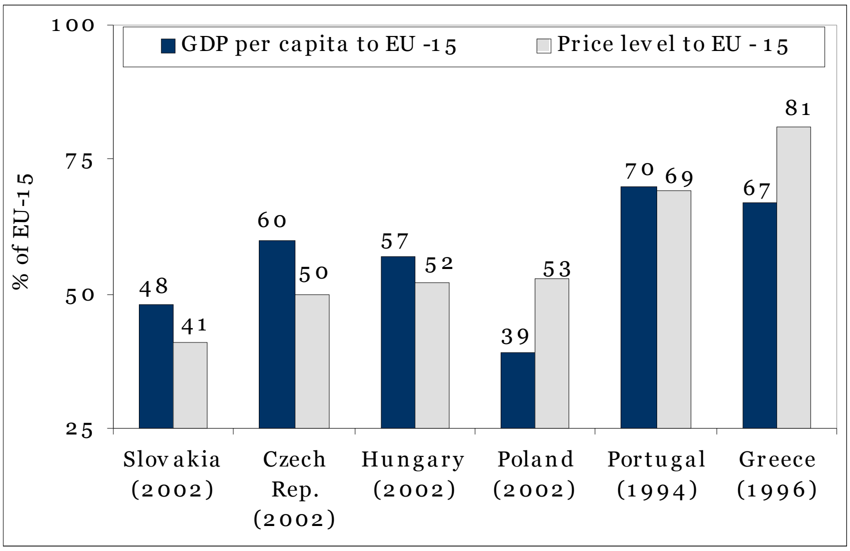
The main barriers to Slovakia's membership of the EMU are:[5]

- economic lagging behind (level of prices and wages) when compared with current Euro zone countries (that is even worse when compared with the USA);
- low labor flexibility and restrictions from transitional periods, particularly on the labour market;
- low flexibility of prices and wages;
- limits regarding fast meeting the nominal (Maastricht) convergence criteria.

Slovakia with its economic performance and technological development still significantly falls behind western countries and the difference between Slovakia and the EU belittles only imperceptibly. Slovakia's gross domestic product (GDP) manifested in the purchase power parity reached approximately 48% of the average in the EU countries in 2003, while in 1995 it was approx. 46%. Similar, although a little smaller difference between Slovakia and the EU is in labor productivity. Domestic price level is getting closer to the EU average a little bit faster but it is still more behind the EU level than GDP for instance (Diagram No. 1). As to prices and economy, Slovakia is behind more significantly than Portugal and Greece (the countries with the lowest economic performance) before their accession to the EMU (Diagram No. 1).

[5] It has been outlined „only" substantial economic starting points on purpose. They are characterized in detail for instance in the publication issued by the Conservative Institute of M. R. Štefánik „Economic Impacts of the Accession of Slovakia to the European Union" (Bratislava, 2002)

Diagram No. 1: Comparison of economic and price level between the V4 Countries and Portugal and Greece in relation to EU-15 average



Note: The data regarding the V4 Countries cover results in 2002, the data regarding Portugal and Greece cover the period of five years before their accession to the EMU.[6]
Legend: GDP– Gross Domestic Product

Source: Eurostat (2002, 2003), ŠÚ SR (2003), diagram by author.

A low comparative price level confirms economic underdevelopment in Slovakia, what at the same time means higher competitiveness supported by lower prices (what is a comparative advantage for Slovakia today). This situation corresponds with so-called ERDI – Exchange Rate Deviation Index that corresponds to almost 2,5 while in Portugal it was only 1,5 in 1994. Deformed structure of the economy oriented towards low value added products is also one of the initial barriers. Moreover, in Slovakia production and export depend on only few companies.

In addition to low flexibility and international mobility Slovak labor is limited also by a transitional period which does not allow Slovak citizens to get a job in majority of the EU countries (up to 7 years after the accession of the Slovak Republic to the EU). But also prices and wages – another (micro) economic indicators - are not and will not be flexible that soon.[7]

On the other hand, there is a favourable precondition for Slovakia's membership in the EMU – there are many links between Slovak subjects and the subjects in the countries that either are or will be members of the EMU. For instance, almost 90% of Slovak export goes to the EU countries and the other three V4 Countries.

2. Vaunted and overrated benefits

The accession to the Euro zone will mean several benefits brought by the Euro adoption – first of all savings from decreasing costs for transactions (there will be no charges or commissions for foreign currency exchange) and reduction in exchange rate risks. These savings are (not only in Slovakia) overrated because they will not be that significant also due to forwardness of financial services. Only the citizens more frequently travelling in the

[6] At the time of the accession to the EMU, Portugal (1999) reached approximately 74% economic level and 73% price level and Greece (2001) 71% economic level and approximately 81% price level of the EU average.
[7] For more details see the publication by Gonda (2003).

Euro zone countries and some entrepreneurial subjects (oriented towards the EMU market) will make more profit of the fact. The subjects developing trade with other countries in dollars (Slovnaft, US Steel or SPP) might become relatively disadvantaged by regulatory trade policy of the EU towards outside countries. At the same time it is true that savings on lower transaction charges will be compensated by reduction in transaction profit for the bank that will lose the revenues coming from the Euro exchange.

Keeping up with other V4 Countries might also represent one of the potential benefits of the fast accession to the EU. It would work as a psychological "anchor" for investors and not as a direct economic advantage. On the contrary, if Slovakia remains outside the EMU and rest of the V4 enters the zone sooner, it could make Slovakia more attractive than the Euro zone countries for investors. Condition of this is more consistent implementation and financing of economic reforms. This fact accompanied by "a market cushion" of flexible exchange rate and other preconditions making investments into the Slovak crown attractive could create more favourable economic conditions (higher profits and lower costs) for investors than in the new EMU member countries.[8]

Other declared advantages as e.g. the EMU – "a guarantor" of economic reforms, a significant contribution to economic growth and participation of Slovakia in the ECB´ s monetary policy, are being overrated and have to be questioned. This is particularly true when we speak about pressure supposedly put on discourage of reforms, especially on public finance reform. Sizeable general government deficits in Germany and France prove it.

3. Relativization and circumvention of costs and risks

Despite the benefits brought by replacement of the Euro for the Crown (but not by Slovakia's membership in the EMU) there are some more serious risks and costs related to the EMU membership that citizens will have to bear. These risks will be a consequence of the following facts:

- missing exchange rate of the crown will mean loss of a natural balancing mechanism i.e. flow of funds between Slovakia and other countries, loss of fundamental indicator of development of the country (e.g. investors´ trust), and also loss of a tool serving to "punish" an undisciplined government.

- monetary policy tools will be shifted to a more centralized and difficult to control institution – the European Central Bank (ECB).

The real risks will be assessed in two blocks:

1. Risks and costs related to political centralization in the EU (overall risks)

2. Risks and costs resulting from unpreparedness of the Slovak economy (risks of an early accession)

[8] As regards foreign investments, membership in the EMU is not that important as for example a membership in NATO, OECD or the EU. On the other hand, investors need first of all stable and transparent conditions in order to achieve company´ s growth with as low as possible costs. Early accession of the Slovak Republic to the Euro zone may speed up increase in wages and prices which also means increase in costs.

3.1. Overall risks

The main risks of the Euro zone membership are linked with bureaucratically forced termination of domestic currency and with further development leading to political centralization in the EU (transfer of decision making from a national onto more centralized level).

Decisions within so centralized monetary policy of the ECB will be less effective under the Slovak conditions than decisions of the National Bank of Slovakia. The unified monetary policy of the ECB deepens problems in some countries already today (for instance in Germany that has too highly regulated labour market and generous welfare system)[9]. There is a real risk that (also) Slovak economy will experience negative impacts brought by the centralised and unified monetary policy of the ECB that is little effective and difficult to control.

The most probable and, at the same time, the most risky variant of development in the EU direction is harmonization of other economic conditions including tax and social sphere.[10] This development is being confirmed by actually implemented proposals and steps – e.g. minimum rates of indirect taxes and proposal of equal profit tax – these and other similar specific proposals (e.g. draft of the European constitution) might, in case they are adopted, mean a pressure leading to higher taxes and financially more demanding welfare standards in Slovakia.

European planners give only seemingly economical reasons for further unification of conditions when they condition sustainable functioning of the Union by even conditions in other spheres, including public finance, too. The problem is that they cannot imagine Europe to have several currencies.

In the Union, one currency is neither necessary nor economically tenable condition for the Union's functioning. But it has been forced upon all by the EMU. Harmonization "from above" is being executed right now and heads from a monetary union towards a fiscal union and to a federal state.

Deepening centralization along with increasing regulation on the market, bureaucratization, from above implemented harmonization and direction towards federalization of the Union will mean competition limitation and restricting of personal responsibility and thus lead to averaging out and hindering of economic subjects´ productivity within the EMU. This would also increase the dependency of Slovakia's development on the Euro zone and slow down (or stop) convergence of Slovakia to the Euro zone level of economic performance and living standard.

3.2. Risks of an early accession [11]

It has been supposed that the risks will be more real and costs for Slovak citizens higher in case of early accession to the Euro zone. The Euro zone experiences significant instability today.

---

[9] Germany joined the EMU (and replaced the Euro for the mark) at the time when the exchange rate between the mark and Euro was overvaluated.

[10] Continuation of present condition – a centralised monetary policy featuring with various independent budgetary policies - could be an alternative to centralization of fiscal policies into one and to direction towards one state. But this condition results in higher costs caused by undisciplined "free-riding" fiscal policies or by „fiscal moral hazard" (Issing, 1997) and it preserves less effective monetary region.

[11] These risks apply not only, but especially, on early accession of Slovakia to the EMU.

If Slovakia tries to join the Euro zone too early the risks and costs will be higher already when joining ERM II.[12] It will limit exchange rate flexibility and manoeuvre space for monetary policy. Altogether with the initial barriers it may mean:

- fixing of parity of the Euro – crown rate that will be significantly different that its long-term balanced level, this will cause increase in costs and have negative impacts on economic performance in case of any speculative attacks or any other outside influences;[13]

- conflict between the objectives of price stability and objectives of a stable exchange rate;

- limitation of opportunities for implementation and financing of consistent economic and social reforms (e.g. pension system reform).

The variant of early accession of Slovakia to the EMU – i.e. the variant of accession at the time when Slovakia is significantly behind as regards prices and the economy and there are high restrictions on free employment during the transition period – may result in higher inflation, relative losses of savers and/or cyclic deviations of GDP and unemployment rate after losing the exchange rate of the Crown.

Higher inflation and faster getting closer to the price level in the EMU will be pushed by the money flowing from abroad and the fact that there will be no exchange rate and, in the long run, also by balancing of price levels (i.e. appreciation of the real exchange rate by a higher inflation rate than today the EMU countries, not by appreciation of the nominal exchange rate as it is today). The monetary policy of the ECB and the criterion of low inflation rate will work against this development. The ECB´ s monetary policy will probably try hard to hinder increase in inflation rate, especially when this type of development will occur also in other new member states in the Euro zone. This policy might be implemented despite the fact that it will mean hindering of economic growth of new EMU countries.

If Slovakia enters the EMU too early, the crown will be replaced by the Euro when being on a lower appreciation level than could be in a later period and this could result in relative losses for savers.

It is very likely that after giving up the domestic currency and accession to the instable monetary union that unites very different regions there will be cyclic fluctuations of economic performance and unemployment rate. They may occur as a result of any sudden change while having no correction mechanisms (especially when there is no exchange rate) to balance the situation – e.g. drain of substantial amount of foreign capital (decrease of money in circulation), any considerable change in the ECB´ s policy or any asymmetric shocks. [14]

These unfavourable impacts on the Slovak economy are real especially in case of an early accession to the EMU. They will be based on existence of major differences in economic performance, productivity, price and wage levels between Slovakia and current EMU

[12] ERM II (Mechanisms of exchange rates) means mandatory (minimum 2 years) period before the accession to the EMU, during which the exchange rate between domestic currency and the Euro should be relatively stable (officially it may float around +/- 15%, although also the limit +/- 2,25% is assessed). A country must not devaluate its currency within this period for instance.

[13] The risk of speculative attacks will be higher when capital mobility is higher and if the Crown is forced to move within the fluctuation range lower than +/-15%. The attacks on the Forint in 2003 and problems that the Hungarian Central Bank had to face despite having the fluctuation range +/-15% are a memento for other countries.

[14] Feldstein, 1997.

countries. Differences in economic cycles might by enhanced also by continuing stagnation in bigger countries of the Euro zone.

These significant differences in economy structures and conditions may exceed positive effects of huge trade contacts between Slovak and EMU economic subjects as well as they will exceed positive effects of the presumption that ”existence of common currency in several countries will help to cushion negative impacts of asymmetric shocks thanks to a better division of risks and portfolio diversification.[15]

An early accession will help to preserve low flexibility of the Slovak economy (also low labor mobility and inflexible prices and wages). All this, accompanied by administrative barriers to employment in majority of the EU countries (until 2011 maximum) and lasting dependence of production, export and employment rate on only few companies in very vulnerable sectors (particularly car and steel industries) will enhance negative effects.

Conclusion

The way and speed of adoption of the European currency confirm that the Euro is a tool of political centralisation within the EU. Such a development in the Union is against traditional values that were sources of wealth in part of Europe in the past (competition principles, personal freedom and responsibility). It ties down the economy in Slovakia that has not finished transformation and structural reforms yet, therefore discourage faster convergence of Slovakia to the economic conditions of the EMU countries and hinders faster development towards the living standard usual in the Euro zone.

A free trade zone without barriers and regulations featuring various conditions and currencies might be an answer to the question how to proceed with economic integration in Europe in the future.

The accession of Slovakia to the EMU should be conditioned by meeting the criteria of acceptable value development in the Union and by Slovakia's meeting the economic criteria. I consider discontinuance and removal of centralisation, harmonization and regulatory trends in the Union and return to free market and unlimited competition principles to be an acceptable value development.

In my opinion not only nominal (Maastricht) criteria but also the criteria for assessment of the real economic performance are to be met, only then Slovakia might be considered to be ready.[16]

Postponement of the accession of Slovakia to the EMU (if it does not disintegrate in the mean time) means not to force Slovak citizens into too high risks and advocate of the western civilisation values.

The author is an analyst for the Conservative Institute of M. R. Štefánik.

The article is based on a series of lectures Slovakia and the EMU - Without Stars in the Eyes (Bratislava, Slovakia, 10 July 2003) and Risks of Slovakia´s Accession to the Eurozone (Bratislava, Slovakia, 7 September 2004. It is available at http://www.institute.sk.

[15] Mundell, 1973.

[16] The assessment is to be done based on own economic tests (analogically as in Great Britain) that will compare subjects reactions, positive and negative effects in both situations with and without the crown exchange rate.

References

EICHENGREEN, B.: European Monetary Unification. Journal of Economic Literature, September 1993, pp. 1321-1357.

FELDSTEIN, M.: The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability. Journal of Economic Perspectives. Number 4-Fall 1997, pp. 23-42.

ISSING, O.: A German Perspective on Monetary Union. Gedmin, J. (ed.): A Single European Currency. American Enterprise Institute for Public Policy Research. Washington, D.C. 1997.

GONDA, P.: Main Risks of Slovakia's Membership in the EMU. Hospodárske noviny, 22.7.2003.

GONDA, P. et al.: Economic Impacts of the Accession of Slovakia to the European Union. Conservative Institute of M. R. Štefánik. Bratislava, 2002.

http://www.aei.org

http://www.cato.org

http://www.cepin.cz

http://www.etrend.sk

http://www.heritage.org

http://hm-treasury.gov.uk

http://www.nber.org

http://www.nbs.sk

Specification of the Euro Adoption Strategy in the Slovak Republic. The Government of the Slovak Republic. September 2004. http://www.government.gov.sk

MUNDELL, R.: Uncommon Arguments for Common Currencies. In.: Johnson, H. G. - Swoboda, A.K (ed.): The Economics of Common Currencies, Allen and Unwin, pp. 143-32.

ROCKOFF, H.: How Long Did Take the United States to Become an Optimal Currency Area? NBER Working paper series on historical factors in long run growth. National Bureau of Economic Research. April 2000.

SCHWARTZ, P.: The Euro, For and Against. TREND 23.10.2004. http://www.etrend.sk.