Slovakia and the Euro: No Need To Rush In

Marian L. Tupy[*]

Presented at the Conservative Economic Quarterly Lecture Series (CEQLS) held by the Conservative Institute of M. R. Štefánik, Bratislava, June 16, 2005

Introduction

On January 1, 1999, 11 members of the EU replaced their national currencies with a single currency, the euro (€). The monetary policies of the eurozone members then ceased to be autonomous and are now set by the European Central Bank (ECB) in Frankfurt, Germany. As George Tavlas, research director at the Bank of Greece, argues in a recent Cato Journal article, the establishment of the common currency was meant to increase economic efficiency in Europe by 1) reducing transactions costs, 2) removing uncertainty created by exchange-rate fluctuations, 3) facilitating easy price comparisons, 4) increasing the "network effects involved in the use of money (the more widely a currency is used, the more useful it is to the holder because there is a greater number of other users, 5) enlarging of the foreign exchange market and reducing price volatility and the ability of speculative attacks on the currency, 6) improving allocational efficiency of the financing process by providing borrowers and lenders a broader spectrum of financial instruments, 7) reducing inflation in those member states, whose central banks had a record of succumbing to political pressures and following inflationary policies, and 8) reducing market segmentation and encouraging additional intra-European trade and investment.

In the political sphere, the euro was meant to pave the way for a Europe-wide political union. Helmut Kohl, for example, believed that "Without monetary union there cannot be political union, and vice versa." His successor, Gerhard Schroeder, said, "The introduction of the common European currency was in no way just an economic

* Marian L. Tupy - Assistant Director, Project on Global Economic Liberty, Cato Institute (USA), mtupy@cato.org

decision." Dominique Strauss-Kahn, the former French finance minister, believed that the euro was a prerequisite to an "economic government of Europe." The former French Prime Minister, Lionel Jospin, shared the same sentiment.

On the other hand, the requirement that eurozone members maintain the same monetary policy and the same interest rates deprives national governments of policy tools traditionally used to address their own macroeconomic problems. In the past, when a country had a recession not shared by other EU countries, its central bank could expand the money supply, with the goal of boosting domestic demand and moderating the recession. With monetary policy turned over to the ECB, this kind of response is no longer possible. A common monetary policy will be useful for moderating only Europe-wide business cycle fluctuations. When European countries experience cyclical expansions and contractions at different times, the sacrifice of monetary autonomy may cost them a great deal. Under the terms of the EU accession, Slovakia is obliged eventually to join the eurozone.

Business Cycle Fluctuations

In order to harmonize business cycle fluctuations in different European countries, European decision-makers adopted the Exchange Rate Mechanism (ERM). They hoped that the ERM would stabilize exchange rates and reduce inflation, thus smoothing the way for the adoption of the euro. The ERM established a central exchange rate between different European currencies and the European Currency Unit (ECU). That central exchange rate effectively determined central cross-rates between different European currencies as well. The ERM gave national currencies an upper and lower limit on either side of this central rate, or band, within which they could fluctuate.

Because of the Bundesbank's reputation for maintaining currency stability, the ERM became a system where the exchange rate bands were maintained with respect to the Deutsche Mark (DM). The DM became the unofficial reserve currency. Thus, when

Britain intervened to buy pounds, she sold DM in exchange for pounds. Only Germany was free to set her monetary policy. Other countries have reduced their control over monetary policy and intervened only when the exchange rate got too close to the edge of the band. Some countries, especially those with history of high inflation, were only happy to do so.

The reunification of Germany, however, led to a massive increase in government expenditure. In order to combat the threat of inflation, the Bundesbank drastically increased German interest rates. Higher interest rates in Germany attracted the inflow of money from other ERM member states. Other ERM members tried to stop the outflow of money by increasing their own interest rates, but failed. Spain and Portugal devalued their currencies, while Britain and Italy were forced out of the ERM altogether.

Despite the crisis of the ERM in 1992, the currency's ability to stay within the re-constituted ERM margins remained one of the convergence criteria used to determine whether that currency would join the euro in 1999. However, the objectivity of the EU Commission with regard to the evaluation of the fulfilment of the convergence criteria has been questioned. For example, in 1996 the EU Commission found that "a majority of Member States had not yet made sufficient progress towards achieving a high degree of sustainable convergence." Just one year later, all ERM members with the exception of Greece got a green light to proceed toward the euro.

As Otmar Issing, member of the Executive Board of the European Central Bank argues, the ERM members succeeded in harmonizing their inflation and annual deficit rates. The harmonization of the government debt rates, on the other hand, proved largely unsuccessful. That is why Italy and Belgium were given a special permission to proceed toward the euro without fulfilling the convergence criteria. Other countries, France among them, sold some of the state assets in order to meet the convergence criteria. More recently, Greece admitted to "cooking the books" before her accession to the euro in 2001.

Does economic convergence matter? Some scholars of the optimum currency areas (OCA) have pointed out that the adoption of a single currency may actually lead to greater harmonization in the long run. Thus, the argument goes, the US today is more of an OCA than it was before the American currency union. Needless to say, the American OCA was helped by labor mobility that the eurozone does not possess. The linguistic differences in the eurozone and housing market rigidities make labor mobility unlikely anytime soon.

Still, the developments in the eurozone since the euro launch suggest that the convergence “straight-jacket” prior to the euro-launch involved too many “one-off deals” that had little to do with real long-term economic convergence. That is to say that following the euro-launch, some of the economic indicators began to diverge. Portugal, for example, became the first country to break the eurozone deficit ceiling in 2001. Since then a number of countries, Germany and France included, reneged on their deficit obligations. [Figure 1]

Likewise, the differences in public debt continue to widen. In 2000, for example, the French and the German explicit public debt was 57.2 percent and 60.2 percent respectively. (Implicit debts of many eurozone economies make them, in the words of Lawrence Kotlikoff, professor of economics at Boston University, “effectively bankrupt.”) By 2003, it increased to a respective 62.6 percent and 63.8 percent. [Figure 2]

Similarly, differing growth and inflation rates in Europe suggest that convergence remains elusive. Between 2000 and 2004, Ireland’s GDP and inflation grew at compounded average annual rates of 6.2 percent and 4.1 percent respectively. Over the same time period, Italy’s GDP and inflation grew at compounded average annual rates of 1.3 percent and 2.5 percent respectively. So, professor Milton Friedman may have been right when he argued in his August 2001 *Corriera Della Sera* interview that

Ireland needed monetary tightening and Italy needed monetary loosening. [Figures 3 and 4]

As previously suggested, in the absence of harmonized business cycles, negative consequences of a single interest rate can only be offset by massive labor inflows to economically expanding countries and large financial transfers to economically contracting countries (as is the case with individual states in the USA). But, European labor continues to be relatively immobile. Large financial transfers don't seem realistic either, because the member states lack the political will and the necessary resources. In the past, Germany could be counted on to bankroll pan-European financial transfers. Germans did so gladly for reasons of historical guilt and because they were economically prosperous. That is no longer the case. Germany's compounded average annual growth rate between 2000 and 2005 was 1.2 percent and the new generation of Germans, for good reasons, no longer feels the guilt experienced by the preceding generation.

What to do about the low growth in the eurozone?

All in all, the risk of the eurozone's susceptibility to a possible asymmetric shock seems to me to persist. The dilemma, as I see it, is as follows. So far, the economic performance of the eurozone has been unimpressive. Between 2000 and 2004, the eurozone grew at a compounded average annual rate of 1.7 percent. With a compounded average annual rate of 2.8 percent, economic growth in the United States was 65 percent higher. The economies of France, Germany and Italy, which collectively account for some 70 percent of the eurozone's GDP, are in obvious trouble. To stimulate economic growth, those countries could take measures to reduce their spending, liberalize their labor markets and stop obstructing further liberalization of the product market throughout the EU.

The recent humiliation of Germany's Chancellor Gerhard Schroeder in local poll in North Rhine-Westphalia and his subsequent call for early general election show, that the German public is not ready for liberal reforms. Thus, the opposition CDU already promised to reverse some of the liberalizing measures undertaken over the past few years by Herr Schroeder. If anything, the defeat of the EU Constitution in France shows that the French public opinion is even more opposed to the "Anglo-Saxon" way of doing things. As for Italy, Prime Minister Silvio Berluscioni, recently thrashed in the local polls, seems to be heading for a massive defeat in the next year's general election.

Alternatively, as President Klaus of the Czech Republic wrote in 2004, the eurozone members could go ahead with the process of further harmonization. "I am convinced that any eurozone problem will be in the future interpreted as a consequence of the lack of harmonization (of nominal unification) and will lead to another wave of a creeping harmonization," Klaus wrote. "Such an unnecessary and counterproductive harmonization (and centralization), which tries to eliminate comparative advantages of individual countries, is one of the most worrisome elements of the whole European integration process," he continued.

In the past, Brussels vigorously pursued the policy of harmonization of European rules and regulations that restrain the ability of European countries' to offer investors better business conditions than their neighbors can. That left tax rates, which continue to be determined at a national level, as one of the most important policy tools that European countries use in order to attract investment. The Central and Eastern European countries have been most aggressive in pursuing this particular developmental strategy. For example, Estonia has a zero percent corporate tax on reinvested or retained profits. Latvia and Lithuania have corporate tax rates of 15 percent; Hungary 16; Poland and Slovakia 19.

Of course, the new member states use lower tax rates to compensate for the lower productivity of their workers and their high level of government corruption. But the tax rates in CEE are sufficiently low to get the attention of the older EU members. For example, partly as a result of tax reduction in neighboring Slovakia, Austria's top corporate tax rate was lowered from 34 to 25 percent. Those EU members that cannot afford to cut taxes due to excessive budgetary commitments would prefer to see the tax rates in Europe harmonized upward. Herr Schroeder, for example, has tried to browbeat the new members into reversing their business-friendly economic policies in 2004. Hans Eichel, Schroeder's finance minister, said, "The currency union will fall apart if we don't follow through with the consequence of such a union. I am convinced we will need a common tax system."

The German politicians may well be the least qualified to call for such measures. They are the ones who preside over one of the most botched-up attempts at economic development in the post-communist era. By artificially increasing the cost of labor in the former East Germany, the German politicians consigned large number of East Germans to seemingly perpetual unemployment. Today East Germany continues to be a huge sinkhole that has already swallowed well over DM 2 trillion in wealth transfers from West Germany. Should the new members succumb to German pressure, switch course and adopt the policies currently practiced by the welfare states of Western Europe, the consequences for the new members would be devastating.

So far, the CEE leaders were so far able to squash such ideas. Their long-term prosperity depends on their ability to utilize their comparative advantages, including low taxes and flexible labor laws. They cannot afford to adopt protectionism of France and Germany. One unintended consequence of the schism between the economic needs of the new members and Western European welfare states has been the resounding defeat of the EU Constitution by the French voters, most of whom, it would seem, live in perpetual terror of the archetypal "Polish plumber," who will take their job and who see the EU Enlargement as a terrible mistake.

The pressure, therefore, is rising for yet another alternative – to browbeat the ECB into lowering of the interest rate. However, such move could result in the loss of the ECB's credibility and raise the spectre of inflation. Will the ECB withstand the inevitable political pressures? Perhaps it will. The question is what will happen to the

ECB's low inflation policy if the eurozone continues to experience low growth and unemployment worsens? Under such circumstances, some countries may have to withdraw, thus putting the future of the eurozone in jeopardy.

Recommendations

The new EU members, whose citizens continue living in relative poverty, need to generate rapid economic growth and catch up with the West. If that goal requires an independent monetary policy, then that is the policy they should adopt. It is heartening to see, therefore, that some economists in CEE began to think along those lines. One such economist is the board member of the Czech National Bank, Robert Holman. In an interview with Bloomberg News in May 2005, Professor Holman said, "The eurozone economy has been growing very slowly in the past five years, and among other factors, it could have been caused by having the common currency." "I would not rush with euro adoption," he continued.

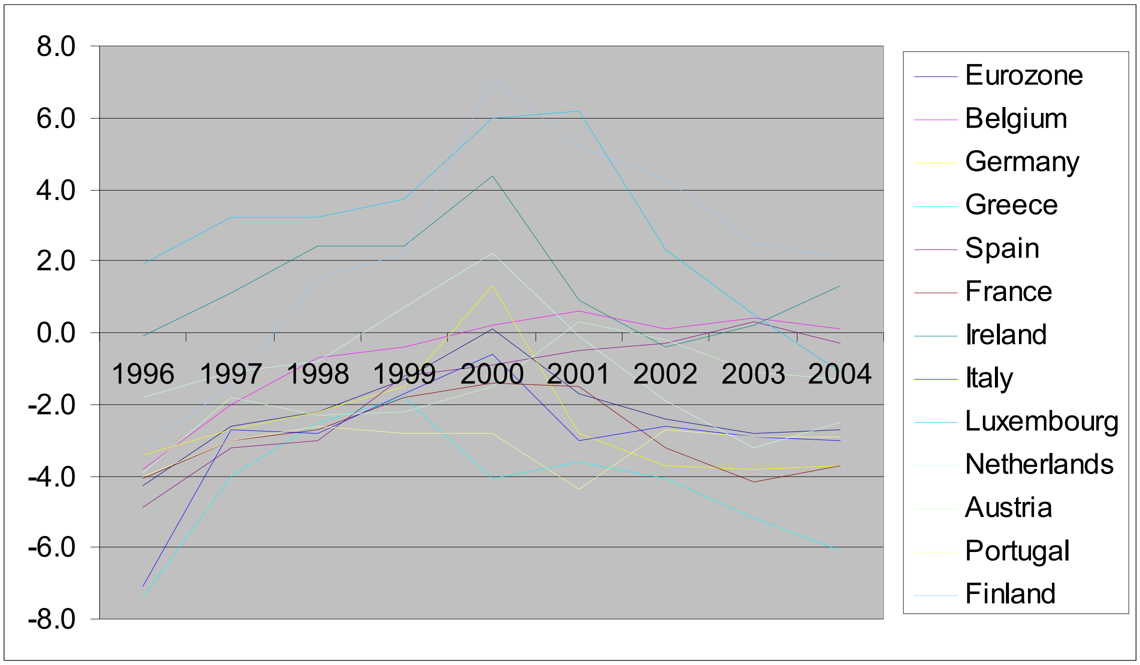
Like the Czechs, the Slovaks are in a privileged position. Though they are obliged to adopt the euro eventually, the Czechs and the Slovaks can do so at the time of their choosing. To be sure, there are considerable benefits to joining, but the risks seem considerable too. So, is there a way for Slovakia to obtain the benefits of joining the Euro, without the accompanying costs?

I believe that currency competition would achieve both goals. By making the euro (possibly along with the US dollar) a legal tender in Slovakia, Slovak companies would be able to eschew most of the transaction costs. Currency competition is vital for another important reason. Most central banks in transitional economies continue to suffer from low credibility. Questions over their independence from political pressures persist. Currency competition would serve as a useful check on central banks' behavior, though making central banks legally independent and staffing them with knowledgeable and professional personnel is also important. In addition, care needs to be taken to ensure that the Slovak foreign exchange market remains free.

Slovak companies will thus be able to exchange crowns for foreign currency at the lowest possible cost.

In conclusion, Slovakia should be in no rush to get rid of the crown altogether. Rather, Slovak politicians should introduce currency competition, sit back, wait and see whether Milton Friedman's 2004 warning of a "strong possibility" of the collapse of the eurozone over the next few years comes true.

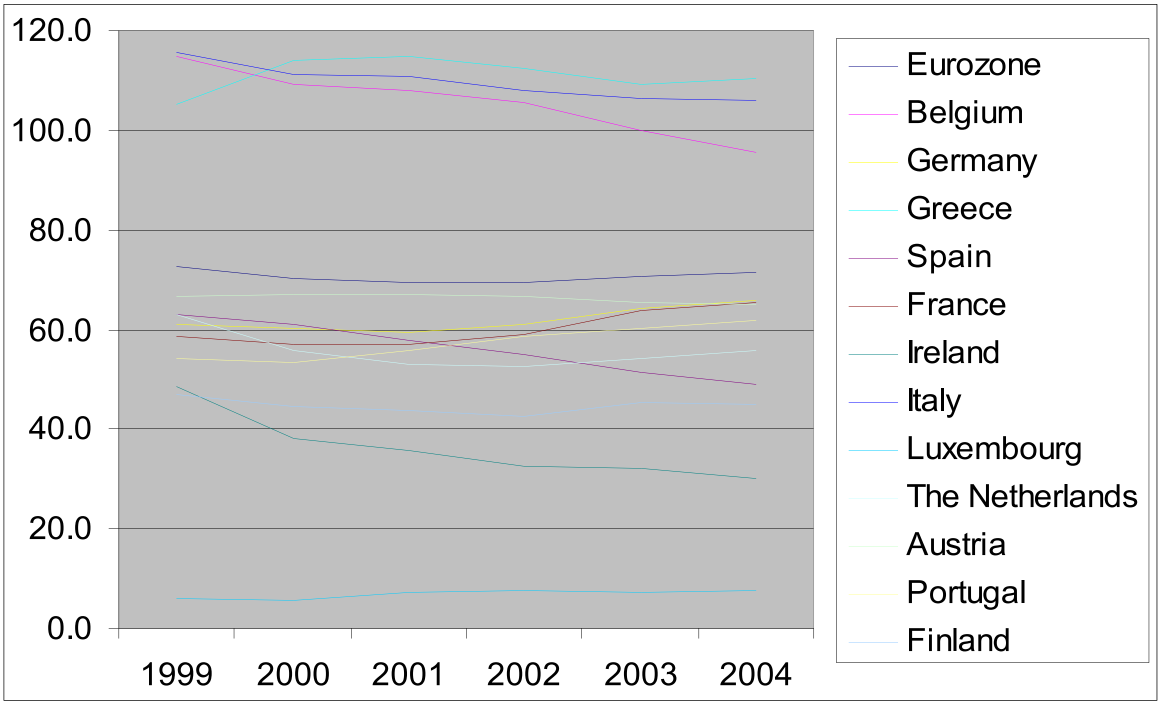
Figure 1: Annual budget deficits as a percentage of GDP



	1996	1997	1998	1999	2000	2001	2002	2003	2004
Eurozone	-4.3	-2.6	-2.2	-1.3	0.1	-1.7	-2.4	-2.8	-2.7
Belgium	-3.8	-2.0	-0.7	-0.4	0.2	0.6	0.1	0.4	0.1
Germany	-3.4	-2.7	-2.2	-1.5	1.3	-2.8	-3.7	-3.8	-3.7
Greece	-7.4	-4.0	-2.5	-1.8	-4.1	-3.6	-4.1	-5.2	-6.1
Spain	-4.9	-3.2	-3.0	-1.2	-0.9	-0.5	-0.3	0.3	-0.3
France	-4.1	-3.0	-2.7	-1.8	-1.4	-1.5	-3.2	-4.2	-3.7
Ireland	-0.1	1.1	2.4	2.4	4.4	0.9	-0.4	0.2	1.3
Italy	-7.1	-2.7	-2.8	-1.7	-0.6	-3.0	-2.6	-2.9	-3.0
Luxembourg	1.9	3.2	3.2	3.7	6.0	6.2	2.3	0.5	-1.1
Netherlands	-1.8	-1.1	-0.8	0.7	2.2	-0.1	-1.9	-3.2	-2.5
Austria	-3.9	-1.8	-2.3	-2.2	-1.5	0.3	-0.2	-1.1	-1.3
Portugal	-4.0	-3.0	-2.6	-2.8	-2.8	-4.4	-2.7	-2.9	-2.9
Finland	-3.2	-1.5	1.5	2.2	7.1	5.2	4.3	2.5	2.1

Source: Eurostat

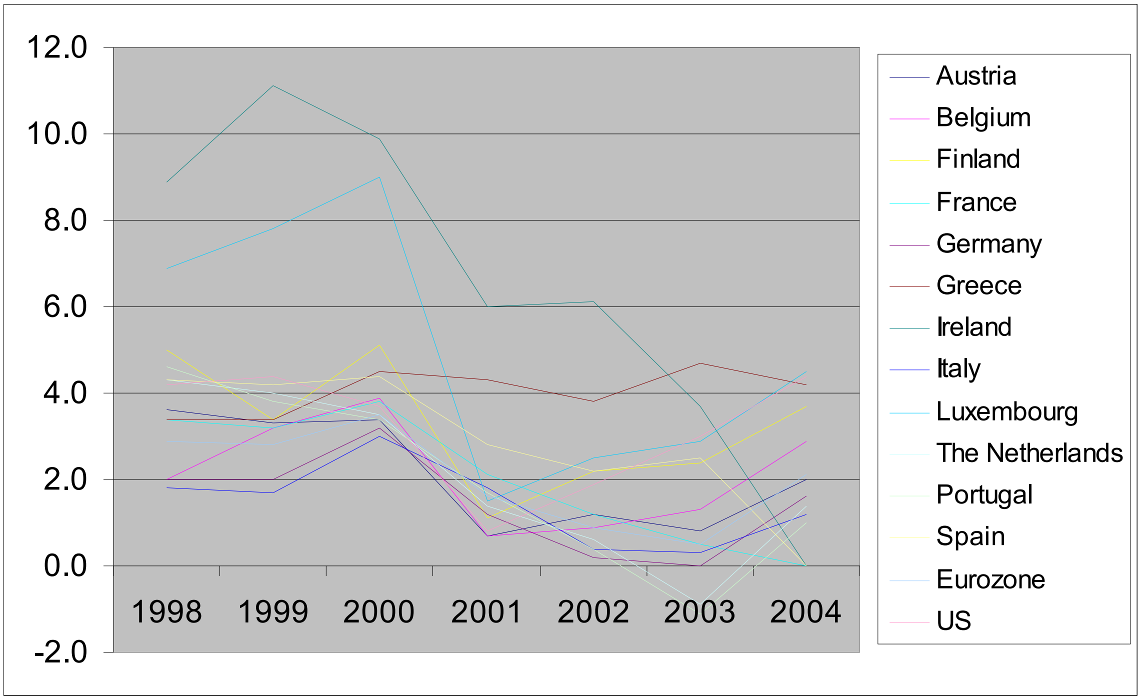
Figure 2: General government consolidated gross debt as percentage of GDP



	1999	2000	2001	2002	2003	2004
Eurozone	72.7	70.4	69.6	69.5	70.8	71.3
Belgium	114.8	109.1	108.0	105.4	100.0	95.6
Germany	61.2	60.2	59.4	60.9	64.2	66.0
Greece	105.2	114.0	114.8	112.2	109.3	110.5
Spain	63.1	61.1	57.8	55.0	51.4	48.9
France	58.5	56.8	57.0	59.0	63.9	65.6
Ireland	48.6	38.3	35.8	32.6	32.0	29.9
Italy	115.5	111.2	110.7	108.0	106.3	105.8
Luxembourg	5.9	5.5	7.2	7.5	7.1	7.5
The Netherlands	63.1	55.9	52.9	52.6	54.3	55.7
Austria	66.5	67.0	67.1	66.7	65.4	65.2
Portugal	54.3	53.3	55.9	58.5	60.1	61.9
Finland	47.0	44.6	43.8	42.5	45.3	45.1

Source: Eurostat

Figure 3: GDP growth rates in the eurozone (percentages)



	1998	1999	2000	2001	2002	2003	2004
Austria	3.6	3.3	3.4	0.7	1.2	0.8	2.0
Belgium	2.0	3.2	3.9	0.7	0.9	1.3	2.9
Finland	5.0	3.4	5.1	1.1	2.2	2.4	3.7
France	3.4	3.2	3.8	2.1	1.2	0.5	2.5**f**
Germany	2.0	2.0	3.2	1.2	0.2	0.0	1.6
Greece	3.4	3.4	4.5	4.3	3.8	4.7	4.2
Ireland	8.9	11.1	9.9	6.0	6.1	3.7	5.4**f**
Italy	1.8	1.7	3.0	1.8	0.4	0.3	1.2
Luxembourg	6.9	7.8	9.0	1.5	2.5	2.9	4.5
The Netherlands	4.3	4.0	3.5	1.4	0.6	-0.9	1.4
Portugal	4.6	3.8	3.4	1.7	0.4	-1.1	1.0
Spain	4.3	4.2	4.4	2.8	2.2	2.5	2.7**f**
Eurozone	2.9	2.8	3.5	1.6	0.9	0.5	2.1
US	4.2	4.4	3.7	0.8	1.9	3.0	4.4

Source: Eurostat

Figure 4: Inflation rates eurozone (percentages)

	1998	1999	2000	2001	2002	2003	2004
Austria	0.8	0.5	2.0	2.3	1.7	1.3	2.0
Belgium	0.9	1.1	2.7	2.4	1.6	1.5	1.9
Finland	1.4	1.3	3.0	2.7	2.0	1.3	0.1
France	0.7	0.6	1.8	1.8	1.9	2.2	2.3
Germany	0.6	0.6	1.4	1.9	1.3	1.0	1.8
Greece	4.5	2.1	2.9	3.7	3.9	3.4	3.0
Ireland	2.1	2.5	5.3	4.0	4.7	4.0	2.3
Italy	2.0	1.7	2.6	2.3	2.6	2.8	2.3
Luxembourg	1.0	1.0	3.8	2.4	2.1	2.5	3.2
The Netherlands	1.8	2.0	2.3	5.1	3.9	2.2	1.4
Portugal	2.2	2.2	2.8	4.4	3.7	3.3	2.5
Spain	1.8	2.2	3.5	2.8	3.6	3.1	3.1
Eurozone	1.2	1.1	2.1	2.4	2.3	2.1	2.1
US	1.6	2.2	3.4	2.8	1.6	2.3	2.7

Source: Eurostat