

Joining the Euro Area: Euro Adoption Policies since 2004

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This paper seeks to understand euro adoption policies in the ten member states that joined the European Union (EU) in 2004. It adopts a domestic politics approach to explain the different policies in the different member states. The paper concludes that the willingness of the government, a weak opposition, a central bank that is favourable to euro adoption and the lack of domestic institutional veto points are necessary conditions for a fast euro adoption.

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Although the European Union (EU) treaty stipulates that all EU member states must join the euro area (except countries with an opt-out) not all have rushed to adopt the euro. Despite ten member states entering the EU at the same time (2004), how can we understand the different speed with which these countries have joined the euro area? Slovenia joined the euro area in 2007, Cyprus and Malta in 2008, Slovakia in 2009, Estonia in 2011, Latvia in 2014 and Lithuania in 2015. The other three—the Czech Republic, Hungary and Poland—remain outside the euro area for different domestic reasons. This paper builds on economics and political science literature and argues that domestic variables are key to understanding the different euro adoption strategies. This paper makes the following arguments: First, countries that joined the Exchange Rate Mechanism-2 (ERM-2) soon after joining the EU found it much easier to adopt the euro in comparison to those that did not. Second, having a pro-EU government is a necessary but not sufficient condition to adopt the euro. Third, the existence of

veto points in the domestic political system reduces the likelihood of fast euro adoption. Fourth, although central banks have been made technically independent, the appointment process is often highly political – compromising the independence of central bank – which in turn has impacted euro adoption negative or positively.

I. Understanding Euro Adoption

There are various ways to explain euro adoption policies in the ten New Member States (NMS). Economists typically look at macroeconomic conditions to determine whether or not a country may be in a good position to join the euro area. They focus on whether a country has ‘caught up’, the ‘openness’ of the economy (share of trade to Gross Domestic Product, GDP), whether its business cycle is in sync with the monetary union and whether it would be economically feasible for such a country to give up the exchange rate instrument as an adjustment tool (Buiters, 2000; De Grauwe and Schnable, 2004; Eichengreen, 2012). Such an analysis is however ill-equipped to explain the political processes that change those macroeconomic conditions that increase the chances of meeting the convergence criteria.

By contrast, the International Political Economy (IPE) literature studies the conditions under which countries might opt for fixed exchange rate regimes (e.g., Willett, Chin and Walter, 2014). Some of this literature focuses in particular on domestic factors (e.g. Bernhard and Leblang, 1999; Hallerberg, 2002). This literature suggests that a choice for any exchange rate regime may be influenced by either ‘policy demanders’ (e.g., interest groups, voters) (Frieden, 1991) or ‘policy suppliers’ (e.g. political parties, legislatures, bureaucracies) (Bernhard, Broz and Clark, 2002). However, we find the factors examined unable to explain the specific government policies, the success of those policies, and thus the

resulting outcome regarding euro adoption. Some of the literature on Economic and Monetary Union (EMU) has also emphasized the importance of the domestic setting and domestic actors (Sandholtz, 1993; Dyson and Featherstone, 1999; Verdun 2000; cf. Sadeh and Verdun, 2009 for an overview). Yet few earlier studies have explicitly addressed the question of how to understand the divergence in outcome in the euro adoption process among NMS, or why member state governments change their mind on preferences regarding euro adoption when we do not see changes in trade flows and the like (Dyson, 2006, 2008; Johnson, 2006; Epstein and Johnson, 2010; Pechova, 2012; Dandashly, 2015; Dandashly and Verdun, 2016). Building on these insights the remainder of this paper focuses on the role of government and opposition, central banks, and institutional veto points which we think have the most explanatory capacity for understanding euro adoption policies in these ten NMS.

II. Euro Adoption in the Ten New Member States

Of the ten NMS that joined in 2004, to date seven countries—those that joined the ERM-2 in either 2004 or 2005, i.e., Cyprus, Malta, Slovenia, Slovakia, Estonia, Latvia and Lithuania—have adopted the euro. On 28 June 2004, Estonia, Lithuania and Slovenia became part of the ERM-2 followed by Latvia, Cyprus and Malta in April 2005. The Baltic states, Cyprus, Malta and Slovenia, are all small open economies with a Gross Domestic Product (GDP) of less than 36 billion euros per year at 2013 market prices (Eurostat, 2015). Indeed, each of these six national economies only represents between 0.1 to 0.3 per cent of EU GDP of 13 trillion euro (Eurostat, 2015). Slovakia joined in the midst of the financial crisis. It too has a small open economy (76 billion euro per year or 0.6 per cent of EU GDP) (Eurostat 2015) and had already joined the ERM-2 in 2005. By the time the financial crisis came around, the three largest NMS that joined in

2004 (Czech Republic, Hungary, and Poland) were the only ones left not to have embarked on a system of fixing the exchange rates to the ERM-2. We will discuss three groups of countries in turn.

A. The First Four Fast Movers: Slovenia, Cyprus, Malta and Slovakia

The cases of Cyprus, Malta, Slovenia and Slovakia beg the question whether small open economies may be structurally more likely to adopt the euro. The process of euro adoption in those countries suggests that a few factors have been crucial in euro adoption. First, they had joined the ERM-2 in advance and in most cases they had been keen to maintain stable exchange rates. Second, the government of the day in these countries considered it an important symbol to adopt the euro, so as to have their nation-state be seen as closer to the ‘core’ of the EU. In some cases there was a change in the government that considered a change in euro adoption policy. Yet those governments realized quickly that financial markets would ‘punish’ them for u-turning on the matter (for example the case of Slovakia in June/July 2006). In some cases, government consisted of a number of policy entrepreneurs who were keen to adopt the euro. Some of them put democratic processes to the side in order to push through the legislation needed to facilitate euro adoption (Slovenia).

B. The Baltic States – Adoption after Initial Set-back

Despite its commitment to join the euro in 2006, Lithuania was rejected for euro membership because the Commission judged that it had missed the inflation criterion by 0.1 per cent. As mentioned above, it nevertheless managed to meet the criteria in 2014 and joined the euro on 1 January 2015. The case of Latvia diverges in that it did not make the same serious attempt to meet the criteria as Lithuania did in the middle of the first decade of the 2000s. In the aftermath of the

onset of the financial crisis, Latvia was hard hit by the crisis, harder than any other member state in 2009, and thus was initially unwilling and unable to concentrate on euro adoption. Yet against the recommendation of the European Commission and the International Monetary Fund (IMF), it chose not to abandon the currency board (interviews with Latvian officials, October 2009), and to keep its commitment to euro adoption. It subsequently made steady progress to meet the convergence criteria and ultimately joined the euro in 2014.

C. The Euro Outs – Czech Republic, Hungary and Poland

There is no clear political consensus within the Czech Republic, Hungary or Poland regarding euro adoption. All three countries have had domestic problems and internal struggles. The Czech Republic experienced a long-time conflict between the Czech National Bank (CNB) on one hand and the government and the former president on the other—before the monetary board was changed during the two presidential terms of Václav Klaus. The Czech Republic did not take action to take further steps to join the euro even though they met many of the criteria. Hungary had a macroeconomic situation that would have made it easy to adopt the euro sooner rather than later but the government did not pursue the policies needed to enable early euro adoption. In Poland, the domestic problems leading to euro accession delays are several: struggle between the National Bank of Poland (NBP) and the government during various periods; a struggle between the consecutive PO governments and the opposition; and some constitutional issues that need to be resolved before joining the euro. The Polish case is particularly tricky. In order to join the ERM-2 means obtaining a two-thirds majority in parliament to amend the constitution. Furthermore, observers were concerned to remain ‘stuck’ in ERM-2 because there is also a two-thirds majority needed to move from the ERM to the euro area and because of economic and

political concerns about meeting the criteria and/or a willingness to adopt the euro at that point.

The three euro outs, did not fix their exchange rates as the other seven had done. In trying to meet the convergence criteria, the other seven countries had other convergence criteria to meet (notably the inflation criterion), but did already meet the exchange rate criterion.

III. Conclusion: Towards a Domestic Politics Approach of Euro Adoption in the Ten New Member States

In this paper we sought to explain the different outcomes of euro adoption policies in the ten member states, that joined the EU in 2004. The paper shows that the underlying domestic political reasons for that results have been different. While macroeconomic analysis concentrates on the extent to which the countries are close to meeting the convergence criteria, such an analysis does not explain why some countries—such as the Czech Republic, Hungary and Poland—that were close to meeting the convergence criteria in the 2000s, gradually abandoned setting an early date, whilst others kept pushing for speedy euro adoption.

Reflecting on these ten cases we conclude that in order to understand euro adoption strategy a domestic politics approach offers valuable insights into de facto euro adoption outcomes. The analysis presented here shows that a focus on macroeconomic indicators is insufficient to explain why NMS change their stance on euro adoption. Countries like the Czech Republic have been close to meeting the convergence criteria but have waived—initially being more positive, but then for clearly political reasons becoming more opposed to euro adoption, without any change attributable to macroeconomic conditions.

Much more fruitful is an analysis of government preferences and policies, the perception of the opposition and the role of national central banks in relation

to the governments as well as constitutional factors. We find that all these factors play important roles in the process of euro adoption even if some factors are more important than others. The most important factor in these three cases is the stance of the government in power. Where the government is pro-European there is a much stronger likelihood that it will aim for euro adoption. By contrast, having a eurosceptic government (or president) in place poses as a real obstacle to euro adoption. Yet merely having a pro-European government is insufficient. Governments also have to be willing to pursue a genuine effort to meet the convergence criteria, often at the expense of other government goals. In some cases (e.g., the case of Poland) the government is restricted more than others by the need for a constitutional change and ensuing two-thirds parliamentary majority required. Thus in such a case the dynamics between government and opposition play a larger role than in those cases where there is no such need. In addition, the governments can appoint members of the monetary board, and have done so strategically in these three NMS, which resulted in the central banks' ability to push for euro adoption being curtailed by the government.

In summary we find the domestic political factors explain euro adoption policies in the ten countries. They range from government-opposition dynamics, electoral cycles, the relationship between the government and the central bank and the different idiosyncratic domestic institutional structures.

REFERENCES