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Ever Closer Monetary Union? –

Euro Adoption in Central Europe

1. Introduction

Central and eastern Europe[1] is an admirable success story. Only fifteen years after having overthrown their communist regimes, most countries can boast a stable democracy and striving market economies. Political stability, low wages, a well educated workforce, and good institutions have attracted strong foreign direct investments and capital inflows. As a consequence, growth rates have been substantial while inflation remains moderate. It is worth to remember that success has not been self-evident at the beginning of the 1990s. The transition period started out painfully, and most countries experienced a decline in output and employment in the beginning. It took many years until the (economic) living standards of the pre-transition period were reached again. In the meantime, economic misery could have well triggered political backlash because disappointed people might have turned against a system which has failed to deliver the expected prosperity. It is partly thanks to the perspective of membership offered by the European Union that this has not happened. The incentive to join this club of wealthy nations plus some generous transfers upfront, have been strong arguments to stay on the chosen track towards democracy and market economy and to endure the temporary slump. This is not to say that everything looks bright: Despite strong growth, most of the countries in central and eastern Europe are still poor, the political environment is more volatile, and the growth trajectory is based on foreign capital. Moreover, after the immediate target of membership was achieved in May 2004 (only Bulgaria and Romania have to wait a little longer), one catalysing incentive to structure future policies will be missing. On the contrary, people might want to see rewards for their efforts, for instance in the form of steeper

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[1] We talk about the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia, as well as about Bulgaria and Romania.

wage increases or increased transfers. This can potentially undermine the next step—ie, the adoption of the euro as legal tender. The success of this process depends as much on economic conditions as on the political consensus to do so. Unlike EU-enlargement, the adoption of the euro will inspire less enthusiasm.

After joining the European Union (EU) in May 2004, most countries in central and eastern Europe are required to adopt the euro as legal tender in the foreseeable future. In fact, they are already members of the European Monetary Union (EMU) with a derogation—ie, they will join the eurozone as soon as the they fulfil the Maastricht criteria. Since the Maastricht criteria include a two-year membership of the European Exchange Rate Mechanism 2 (ERM2), the earliest possible date for accession would be 2006. The new member states have not been granted an opt-out clause, a provision which allowed Denmark and Great Britain to stay out, so that the only possibility to avoid EMU would be failure to fulfil the formal requirements—as done by Sweden currently.

Enthusiasm towards the euro has seen ups and downs, and there are deep rifts of opinion within the countries. Central banks have been among the most loyal supporters of a fast euro adoption, while governments are typically more cautious. This observation is probably surprising because it will be the central banks which lose out monetary policy to the European Central Bank (ECB). Usually, public authorities are reluctant to hand over competencies. However, many central banks regard a monetary policy conducted by the ECB as the better and more cost-effective way to guarantee price stability. The ECB enjoys a higher credibility as an institution than any central bank in the new member states. Moreover, it will be unable to respond to individual needs and wishes because it has to design monetary policy for the eurozone as a whole. It is much easier for the ECB than for a national central bank to refuse an accommodating monetary policy when confronted with rampant unemployment, soaring budget deficits, and other economic woes. This adds to the credibility of a European monetary policy, and reduces the threat of time-inconsistent decisions.

Two problems are raised frequently in the discussion (see also table 1). The first is the state of public finances in many new members: Budget deficits are high, and there is little evidence that fiscal retrenchment would emerge. On the contrary, the softening of the Stability Pact during the last year suggests that munificent countries receive a milder response from the European side as well as from domestic groups. Central banks have repeatedly called for cuts in fiscal deficits because they fear that they will eventually translate into higher inflation. But governments face a hard time following this call because fiscal deficits are considered necessary to fight unemployment, maintain low taxes (to attract foreign investments), and to pay for the desired upgrade in infrastructure and education. Cutting deficits could prove hugely unpopular, and central banks have obviously too little clout to talk governments into it. Moreover, the decline in interest rates on public bonds has reduced the real burden of debt and makes the current spending habits less painful. In a monetary union, this might be different because fiscal policy would be the only remaining macroeconomic instrument. If stretched to the limit it cannot be used as a shock-absorber anymore. Determining this limit is of course a matter of judgement but many observers consider current deficits as too high.

Table 1: Enthusiasm for the euro?
Central banks' visions and concerns

Country	ERM2	Planned year of euro adoption	Main issues
Czech Republic	No	2009/2010	• Budget deficits and public debt • High unemployment • Susceptibility to macroeconomic shocks
Estonia	Yes	2006	• Currency board already in place • High current account deficit and unemployment • Constitutions requires balances budget
Hungary	No	2008	• Soaring budget deficits • Substantial exchange-rate volatiliy • Low employment rate
Latvia	Yes	2007	• High current account deficit and unemployment • Fixed exchange rate vis-à-vis euro
Lithuania	Yes	2007	• High current account deficit
Poland	No	2006/2007	• Euro adoption is considered to boost economic growth in the long run • Short-term adjustments may be painful • High budget deficits
Slovakia	No	2009	• High unemployment • Volatile inflation rate
Slovenia	Yes	2007	• High inflation rate • Indexation of prices and wages

Source: National central banks, various reports and publications

The second concern is over current account deficits. The new members are arguably the first class of countries which has successfully implemented a development strategy based on foreign capital imports. This is remarkable not least because previous success stories—including Germany and Japan after World War II, the Asian tigers, and most recently, China—have started with current account surpluses and a strong export industry. The new members from central and eastern Europe on the other hand are net importers of goods and services, and hence capital, at magnitudes between 2 and 12 percent of GDP (see table 2). In principle, these capital imports should accelerate convergence with western European living standards because domestic investments are less constrained by domestic savings. And higher investments, ideally, translate into higher growth in the medium and long run. However, international capital flows have proved to be a capricious force. A sudden reversal of this trend could have devastating effects on local economies which in turn might trigger political turmoil.

Table 2: Characteristics of new and prospective EU members

Country	GDP per capita (PPP, USD)	Unemploy-ment rate	School enrolment (1996)	ICRG	I/Y	Current account balance (%GDP)
Bulgaria	7,130	19.4	76.8	71.8	19.9	-4.4
Czech Republic	15,780	8.1	91.4	76.8	28.1	-6.5
Estonia	12,260	12.6	103.8	73.5	31.4	-12.3
Hungary	13,400	5.7	100.6	76.3	24.0	-4.0
Latvia	9,210	12.8	83.7	76.5	27.3	-7.7
Lithuania	10,320	17	86.3	76.3	22.5	-5.2
Poland	10,560	18.2	96.3	75.8	19.1	-2.6
Romania	6,560	6.6	78.4	69.8	23.1	-3.3
Slovakia	12,840	19.3	94.0	74.5	31.2	—
Slovenia	18,540	5.9	91.7	79.8	23.5	1.7
Germany	27,100	7.8	103.7	82	18.0	2.3

Sources: GDP per capita at PPP (current international USD) for 2002, Unemployment rate (% of Labour force) as of 2001, Secondary School Enrolment (% gross) as of 1996, by World Development Indicators, World Bank 2004; ICRG composite Indicator of 2003 by PRS Group (2003); I/Y is gross capital formation (% GDP) for 2002, current account balance (% GDP) by World Development Indicators, World Bank 2004.

The prospect of joining EU and eventually EMU has inspired confidence among international investors. Institutional quality, such as the respect of property rights and the rule of law, has been identified as a key variable for economic success by many development economists (for instance, Rodrik, 2003; Meyer 2005), and the enlargement process has played a big role in promoting good institutions in the new member states. The conditions for joining the EU were formulated during the Copenhagen summit and include a functioning democracy, a market economy prepared to prevail in the Single Market, as well as the adoption of the *acquis communautaire*, the legal heritage of the EU. Most investors believed that the carrot of enlargement offered to the countries of central and eastern Europe was a convincing incentive to implement reforms and to follow EU requirements. And they were happy to invest. Look no further than, say, Belarus or Moldova, to be reminded that success in eastern Europe could not have been taken for granted.

Capital flows to eastern Europe express the expectation of a smooth integration into the Single Markets, including EMU. The literature knows this view as “convergence play”. Were this expectation to be disappointed, a swift reversal of flows could be the consequence. A similar reversal happened during the Asian crisis when economic stars fell from grace. Adjusting to the Single Market is a painful process and now that the carrot of enlargement has passed, the incentives may have shifted. Two important characteristics have changed since May 2004, when the first wave of applicants has entered the EU. First, the prospect of joining the EU cannot be taken as an instrument to enforce compliance anymore because these countries have already joined. This may slow down structural reforms and fiscal consolidation because the former applicants do not have to fear to be turned down on the ground of missing economic adjustment. Second, people in the new member states may start demanding higher standards of living quickly as a reward for the successful integration into the EU and as expression of further economic convergence. The acceptance of high income differentials as well as tough reforms may fade once people consider themselves to belong to the same economic club of their rich neighbours.

This combination on the road to euro can prove quite explosive, in particular because the European Exchange Rate Mechanism 2 (ERM2)—through which all candidates have to pass for at least two years without realignment prior to joining EMU—provides a formidable instrument to translate unfulfilled expectations into financial and economic trouble. Like any other currency regime, the success of ERM2 depends on the commitment of the political powers to accept the disadvantages that may be associated with it, and to communicate the advantages. An exchange-rate target such as ERM2 is more delicate than other economic goals because of its self-propelling properties. If a continuing devaluation of the domestic currency occurs, those who transfer their assets back into euros or dollars first are better off than those who wait longer because by then, the currency might be worth even less. Investors who expect devaluation withdraw their money as fast as possible to minimise losses. This can result in violent exchange-rate movements even if the trigger was relatively minor.

Public approval of economic policies may fade if unemployment soars (already high in most new members) or if convergence to western living standards is considered too slow. The overriding consensus to join the EU should not be taken as evidence that everybody is also poised to adopt the euro. The current opt-outs demonstrate that EU-membership is well possible without EMU-membership. Without a formal opt-out provision, countries may still stay out of EMU by following the Swedish example which failed to fulfil all Maastricht criteria deliberately, as some say.

2. Economics of European Monetary Unification

Is it a good idea to join a monetary union? The main arguments to decide this question have been developed by Robert Mundell in many articles and books which have been published since the 1960s until today (Mundell, 1961, 1968, 1973, 2000). Coincidentally or not, he received his Nobel Prize in 1999, the same year the euro was introduced. Coincidentally or not, he argued also the case for the euro in a series of articles which appeared in the *Wall Street Journal* a year before (Mundell, 1998).

A monetary union is a strong form of a fixed exchange-rate system, probably the strongest. Therefore, the arguments for and against fixed exchange rates can be applied. The most important feature is that fixing an exchange rate also means that an autonomous monetary policy is (almost) impossible—at least as long as capital controls are to be avoided. This can be shown with David Hume's price-specie flow mechanism (developed in the late 18th century), and more recently with, again, Robert Mundell's macroeconomic trilemma (Mundell, 1968).

In market economies, a fixed exchange rate is maintained by intervention on the foreign exchange market. The central bank typically buys and sells foreign and domestic currencies as to keep the price of the domestic money measured in terms of an anchor currency at the desired rate. Its main restriction is that it can only print domestic money and disposes of limited foreign currency reserves only. Any monetary policy which does not follow the one from the anchor currency is self-defeating because it triggers interventions on the foreign exchange market which nullify the initial step. Consider the following example: A central bank might want to give a macroeconomic stimulus to the domestic economy by increasing money supply faster than in the anchor economy. This would lower domestic interest rates and ideally boost domestic investments and consumption. However, since interest rates in the anchor economy are now higher, it would also trigger capital outflows and put the exchange rate under pressure. To prevent a depreciation, which would violate the objective of fixed exchange rates, the central bank must sell foreign reserves and buy domestic money. In doing so it reduces money supply (foreign reserves are part of the money base) until it is back at its initial level. An independent monetary policy is nearly impossible—only minor instruments, for instance adjusting reserve requirements, remain available. Monetary policy in a monetary union is agreed upon by all members and must be a compromise between the needs of the different countries. Although, all participants have some influence, they are typically unable to implement a monetary policy fully designed to domestic needs because this might not be endorsed by others. Balancing the costs of losing autonomous monetary policy with the benefits of a fixed exchange rate is therefore the key to the assessment of a monetary union.

An autonomous monetary policy, and hence flexible exchange rates, is particularly precious in the presence of real wage and price rigidities. If a country is hit by an adverse economic shock, for instance a sudden decline in global demand for its products, then the necessary response is a cut in prices and wages in order bring supply and demand back to equilibrium. If prices and wages are unable to move, then the adjustment takes place via unemployment. Most observers regard this as the worse option. With regard to a monetary union, asymmetric shocks are a problem because they would require different monetary responses which, by definition, are impossible (Mundell, 1961).

The potential for asymmetric shocks can be assessed against a number of criteria. A country with a well diversified production structure is typically more resilient because shocks in one sector can be balanced with a good performance in others (Kenen, 1969). Also, a symmetric shock can have asymmetric effects when the transmission channels are different across countries. For instance, a change in interest rates does have a moderate effect on household consumption when loan contracts typically include a fixed interest rate for a longer period of time, such as in Germany. The pass-through of interest-rate changes is slower than in a country where mostly loan contracts with flexible interest rates are applied, such as in the United Kingdom.

Openness is another important criterion. In a very open economy, as measured by the volumes of exports and imports in relation to gross domestic product, the scope for autonomous monetary policy is limited anyway because adjustments in the exchange rate would pass through to domestic prices quickly. Therefore, it is easier for small open economies to forgo monetary autonomy and adopt fixed exchange rate because monetary policy is a weak instrument in the first place (McKinnon, 1963).

It should also be mentioned that removing exchange-rate volatility removes an important source of monetary shocks as well. It is a theoretically and empirically well established finding that exchange-rate volatility is often higher than volatility in economic fundamentals (Dornbusch, 1976; Meese and Rogoff, 1983), and that therefore removing a flexible exchange rate may actually reduce volatility, albeit an adjustment mechanism is lost (Mundell, 1973).

According to this analysis, those countries qualify for monetary union, which are less susceptible to asymmetric shocks, or have mechanisms in place to offset these shocks without recurring to monetary policy. Such mechanisms are wage and price flexibility, labour migration and fiscal transfers. The case for an independent monetary policy is also based on diverging business cycles because a booming economy requires a restrictive monetary stance to prevent it from overheating, while an economy in recession would appreciate some monetary stimulus. How should the monetary authority react if both are in the same currency union?

Most observers have rightly concluded that Europe is not an optimum currency area, because business cycles are not well synchronised, wage and price flexibility is low, and fiscal transfers and labour migration is not welcome. However, in our view, many observers wrongly concluded that Europe should therefore not form a monetary union, because they underestimated peoples' ability to adapt to new environments. People respond to the incentives and constraints set by monetary union and create what is needed to form an optimal currency area. The idea of an endogenous optimum currency union has been developed in parallel by a number of authors (Frankel and Rose, 1998; Bolle and Neugart 2000).

When economies are deprived of a certain adjustment mechanism than the pressure mounts on other instruments. Take the German experience as an example. Nominal wage cuts would have been unthinkable only a few years ago, but now more and more employees are prepared to accept them as recent wage deals suggest.[2] Since Germany has lost monetary autonomy, real wage adjustments by monetary or exchange-rate means are ruled out. Employees responded to this loss of flexibility by allowing nominal wage flexibility. A recent report by the National Bank of Poland (2004) points in the same direction and argues that euro adoption would impose wage discipline and increase wage flexibility.

The driving forces are real and financial integration which receive a boost through monetary unification. EMU adds to the dynamics of the Single Market because it increases price transparency and helps forging a European capital market, which makes cross-border financing in Europe much easier. In a widely cited article, Jeffrey Frankel and Andrew Rose (2000) argue that belonging to a currency union triples trade, and that each additional percentage in trade boosts output by 1/3 percent over 20 years: They conclude that “Poland could raise its income by as much as 20 percent by joining the euro zone” (Frankel and Rose, 2000: p 22). Moreover, the trade creation can indeed be attributed to lower transaction costs, stronger competition and transparency of prices because most models control for free trade agreements when assessing the benefits of currency union (Schadler, 2004). These results are not undisputed, though. In a recent paper, Berger and Nitsch (2005) argue that joining a currency union—especially EMU—is rather one out of many policy steps, and that each step contributes to trade creation. Once they control for this trend, joining EMU ceases to have any statistically significant effect on trade. Hence, they caution against the expectation that joining EMU would automatically boost trade. Countries which decide to stay outside EMU might nevertheless enjoy intensified trade if only they participate in the remaining series of policy steps (eg, joining the Single Market).

EMU has some additional features which are uncommon to previous monetary unions, namely monetary and fiscal restrictions imposed by the Maastricht criteria. Moreover, the new member states of the European Union in central and eastern Europe are special in that they are mostly quite poor transition economies with the desire to converge to living standards of western Europe quickly. Both facts create additional tensions which need to be taken into account.

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[2] Recent wage deals at Siemens and DaimlerChrysler disguised nominal wage cuts as longer working hours without higher pay.

According to the Maastricht criteria, only those countries are allowed to join the eurozone which can show fiscal prudence and nominal convergence upfront. This means that inflation and long-term interest rates may not be much higher than the average in the eurozone, that the budget deficit should be below three percent of GDP, and that indebtedness should be below 60 percent of GDP or show a declining trend at the very least. In addition, membership of the European Exchange Rate Mechanism 2 (ERM2) is a prerequisite.

These criteria have been lauded and criticised ever since they were designed. Advocates claim that convergence is needed to ensure that the eurozone would be an optimum currency area, which it is not. Opponents argue that nominal convergence is achieved automatically when joining monetary union, and that the remaining macroeconomic policy instrument—ie, fiscal policy—should not be restricted.

For the new EU members, these criteria may prove particularly painful: Low inflation may be hard to achieve because poor and fast growing countries tend to have higher inflation rates due to the Balassa-Samuelson effect, which is estimated to add 1-2 points to consumer-price inflation (Kovács et al., 2002). To compensate this effect, monetary policy must be tougher—probably causing unemployment in the short run. Limiting fiscal deficit may create additional tensions for basically three reasons. First, the new members might want to spend more in order to upgrade infrastructure, education facilities, and institutions to western European standards. Limiting the state’s ability to borrow against future revenues may postpone these investments and reduce growth (Wagner, 2002). Second, low taxes are used to attract foreign investments in the private sector, although many old members decry this as unfair competition. Anyway, the loss in tax revenues will at least temporarily boost the deficit. Third, adjusting to a monetary union is not always a smooth and frictionless process. Potential losers may need compensation in order to keep political and social stability: The trade creation delivered by monetary union increases economic efficiency by boosting specialisation and division of labour—but it also means that industries without comparative advantage will perish. This can result in economic hardship for affected workers and regions where these industries are concentrated, and governments may want to accommodate this process with transfers and (hopefully) temporary subsidies to allow for a gradual rather than abrupt adjustment.

The requirement to stay within ERM2 for at least two years prior to joining the euro is also often seen with some scepticism. Soft pegs, such as ERM2, have become unpopular among many economists, for they lack the credibility of fixed regimes, and the shock-absorption capabilities of fully flexible regimes. In particular after the Asian crisis of 1997, corner solutions—ie, either fully flexible or fixed exchange-rate regimes—have become fashionable. The Hungarian experience illustrates that transition through ERM2 may become a bumpy ride: In 2003, the Hungarian National Bank defended an appreciation of its currency by monetary expansion, and subsequently had to fight depreciation pressures (as consequence of the monetary overhang), which eventually led to a downward realignment of the forint.

Expectations of future economic and political performance play the crucial role in determining today's macroeconomic variables. All new member states in central and eastern Europe, except Slovenia, are net importers of capital at magnitudes between 2.6 and 12.3 percent of GDP (figures are for 2004, taken from the World Development Indicators database). This translates into high domestic investment rates (typically much higher than in western Europe) and boosts growth. Strong capital imports have also contributed to the trend real appreciation of currencies in the new member states which took place over the past years. However, such a situation is not without risk. If, for whatever reason, capital flows reverse, and the new members turn into net exporters of capital at substantial magnitudes, the exchange rate may plummet and cast these countries into currency crises. Such a currency crisis can have devastating economic effects, in particular through the balance-sheet effect. If private and public debt is denominated in euro rather than in local currency, then a depreciation of the domestic money would inflate the real value of debt and push many banks and firms into bankruptcy and the economy into severe recession. This mechanism could be observed many times during the currency crises in the recent past (Mishkin, 1998). To assess this threat, it is therefore necessary to look at the stability of capital flows.

The current stream of capital towards the east can be explained by the low level of capital endowment and the high level of total factor productivity (TFP). Most development economists use indicators of education (eg, school enrolment ratios) and institutional quality (eg, the ICRG indicator) as a measure for TFP. It shows that, most new members are not far behind the old members. Hence, the remaining gap in GDP per capita (still, most new members are less than half as rich as, say, Germany) can only be explained by a backlog in capital endowment per worker (Bolle and Meyer, 2004). Both factors combined increase the expected profitability of investments, and hence, attract foreign capital. But the sustainability of capital flows is at risk once a shift in expectations takes place, for instance because the expected profits fail to materialise.

Such shifts in investor sentiments happen sometimes. Prior to 1997, the Asian Tigers were seen as the stronghold of economic growth and dynamism—hence, the name "Tiger". But a currency crisis in Thailand triggered a general reversal of capital flows and initiated what is now called the Asian crisis (Eichengreen, 1999). The optimism and enthusiasm for a certain region or industry (think of the new economy) may turn sour and the market response can be quite violent. Often, such shifts are preceded by over-investment. Fast growing economies are susceptible to overheating and asset-price bubbles because some investors react pro-cyclically, and expect that past performance will last, albeit some *mean-reversion* would be more realistic. Consider the average price/earning (P/E) ratio of shares at the Warsaw Stock Exchange. From 1998 to 2003 it increased from 16.3 to 284.9—ie, in 2003 shareholders needed more than 284 years of current profits to redeem the share price.[3] Obviously, they expect company profits to soar in the future, which would bring down the P/E to more modest levels. Most observers regard a P/E ratio of around 15 as healthy. If profits fail to meet expectations, share prices may drop accordingly and deliver huge losses to shareholders.

Over-investment is a problem of inadequately allocated financial resources. The financial sector is therefore a key to assessing the threat posed by potentially volatile capital flows. However, financial sectors in the advanced central and eastern European countries are in a fairly good shape. The banking sectors are dominated by foreign financial institutions: on average, nearly three quarters of total banking assets belong to banks with a majority of foreign owners. The lowest share is in Slovenia (55 percent); the highest is in Estonia at 97.5 percent. Foreign (owned) banks bring experience, modern risk management, and access to international capital markets. They are less susceptible to lend for political reasons because they feel more committed to their shareholders than to local politicians. This typically accelerates economic restructuring because ideally only profitable firms and investments receive funding, whereas those with a bleak outlook do not. In return, governments might be less inclined to bail out foreign banks in trouble which reduces moral-hazard effects in the first place. The downside is that foreign banks are less experienced in local markets and may

[3] Figures are published at www.wse.com.pl/zrodla/gpw/spws/ang/wskaz_rok_akcji.html by the Warsaw Stock Exchange.

cut lending to small and medium sized enterprises. On balance, most observers regard foreign entry as beneficial and a catalyst for reform (Meyer, 2004)

Table 3 provides further details. It shows that all countries except Poland have reduced the percentage of non-performing loans and proceeded with banking sector reform compared to 1998. Banking sector reform stagnated in Poland and Lithuania, as well as in Hungary which already reached the top notch (hence no further improvement). There is no uniform trend with regard to domestic credit supply to the private sector. Slovakia and the Czech Republic experienced a sharp decline in credit supply, whereas Hungary and Latvia saw strong increases. Also, the levels of credit supply are quite diverse. Poland shows only limited credit supply at 17.9 percent of GDP, whereas Slovenia is financially more advanced with credit supply at 43.3 percent of GDP.

Table 3: Financial sectors in central and eastern Europe

Country	No of banks /foreign owned	Non-performing loans (in percent)	Domestic credit to private sector (percent of GDP)	EBRD index of banking sector reform (0-4)
		(change since 1998)		
Bulgaria	35/25 (+1/+8)	4.4 (-7.6)	25.8 (+13.6)	3.3 (+0.6)
Czech Republic	35/26 (-10/+1)	5.0 (-17.7)	17.9 (-26.1)	3.7 (+0.7)
Estonia	7/4 (+1/+1)	0.5 (-3.5)	33.7 (+9.4)	3.7 (+0.4)
Hungary	38/29 (-6/+1)	3.8 (-4.1)	42.3 (+18.1)	4.0 (-)
Latvia	23/10 (-4/-5)	1.5 (-5.3)	38.8 (+24.9)	3.7 (+1.0)
Lithuania	13/7 (-1/+2)	2.6 (-9.9)	19.9 (+10.6)	3.0 (-)
Poland	58/46 (-25/+15)	25.1 (+13.3)	17.8 (+0.3)	3.3 (-)
Romania	30/21 (-6/+5)	1.6 (-56.9)	9.5 (-3.1)	2.7 (+0.4)
Slovakia	21/16 (-6/+5)	9.1 (-35.2)	25.0 (-17.1)	3.3 (+0.6)

Slovenia	22/6 (-8/+3)	9.4 (-0.1)	43.3 (+12.7)	3.3 (+0.3)

Source: EBRD Transition Report 2004. Figures are for 2003.

With a quite advanced financial system, the risk that investments are fundamentally misallocated appears moderate. This reduces the threat of a substantial shift in investors' confidence. This is not to say that investments in central Europe are free of risk. On the contrary, investments in poor and economically volatile countries are typically riskier than in mature markets. But as long as investors feel sufficiently compensated for taking these risks, capital will keep flowing eastward.

3. Political acceptance and economic stability

It is a fundamental principle of democracies that policies have to be accepted by the electorate, otherwise an opponent with a competing policy-mix might win over. This does not mean that every policy must be popular, but on balance, the government and legislature cannot act persistently against the will of the people.

Joining the EU has been a widely popular move, although it required many painful adjustments. Compliance with the *acquis communautaire*—the 80,000 pages of European legislation—was basically not negotiable. Economic liberalisation and opening in the post-communist time has forced many painful adjustment programmes, and the switch from a planned to a market economy has left many people at the margins. Unemployment is a particular problem: it exceeds 10 percent of the labour force in Bulgaria, Poland, Slovakia, and in all of the Baltic States. A somewhat higher unemployment rate in eastern Europe was to be expected because it is still hard for many people with qualifications suited for a planned economy to integrate smoothly into a market economy. In particular if it is elderly or badly educated people. However, high unemployment can be a formidable source of strive, and unhappy people may take to the streets. Some studies claim an initial job loss of one million for all new members in the early years of EU accession (Kiander et al, 2002). Migration to many western European countries is limited, especially because Germany and Austria feared an inflow of cheap workers into their already congested labour markets. The question of migration from eastern Europe has even stirred unease in the more liberal minded economies, such as the United Kingdom which has traditionally embraced immigrants.

The factors pull in the same direction: increasing unemployment in the new member states plus mounting reservation in the old members to absorb surplus labour from the east may both spur unhappiness and dissatisfaction with the process of Europeanisation. Already, people in the new members are more sceptical with regard to the benefits of membership in the European Union. A recent survey by *Eurobarometer* reports that people in the member states are typically less enthusiastic towards the European Union, in that fewer people regard membership as “a good thing” and more people say it is “neither good nor bad” (Eurobarometer 62, 2004). The proportion of neutral answers hovers around 40 percent in Latvia, the Czech Republic, Slovenia, Slovakia, and Poland, suggesting that it may be still too early for many people to assess fully the new situation, but also that public approval may fade quickly.

The private sector plays a crucial part in the run-up to EMU. It may assume a stabilising or destabilising role. Economic volatility may increase because the scope for monetary adjustments is reduced. Imagine the following situation of a country that has already joined ERM2. It will be hit by a real economic shock which boosts domestic inflation (think of excessive wage increases). The exchange rate will come under pressure and depreciate against the euro. If it reaches the lower bound, the central bank has to intervene and increase domestic interest rates in order to prevent a further depreciation. In the short run, this will add to domestic unemployment because consumption and investment are discouraged. Since unemployment is already high in most new member states (see table 2), this can create considerable social tensions. Unemployed people may take to the streets and put the government under pressure. To mitigate unemployment and to secure public support, it might want to a boost domestic demand by either fiscal or monetary means. But fiscal policy is limited by the Maastricht criteria, and monetary policy is restricted by the exchange-rate target. At some point the government has to decide which goal it values higher: euro adoption or fighting (short-term) unemployment. If it decides for the latter, it can leave ERM2, let its currency devalue, and boost domestic demand. Investors who hold assets denominated in domestic currency will try to anticipate this step because the value of their assets plummets after devaluation. Therefore, they will sell them as soon as they consider the government too weak on staying in ERM2. Since selling these assets puts additional pressure on the exchange rate, this expectation can become self-fulfilling.

At the end of day, it is a political decision whether to stay in ERM2 when the going gets tough. A strong government which does not have to fear replacement can endure higher unemployment and an unhappy electorate easier than an already tarnished one. It is also important to look at the public support for the euro because a government can leave ERM2 easier if its people show little enthusiasm for it. That said, a change in the political sphere or public attitude towards the euro can have economic repercussions, for instance in the form that when a euro-sceptic party is elected, investors may expect a weaker stomach to stick to ERM2 in difficult times, and hence, start selling domestic assets earlier.

4. Conclusions

Membership of the European Union is something many countries in Europe aspire to. It serves as a powerful incentive, and is seen by many as a reward and expression for successful economic reforms and stable and reliable democracy. The perspective of membership in this club of wealthy nations has helped to endure the painful adjustments in the early days of transition and reduced the chances of a political backlash. Current applicant states—ie, Turkey, Bulgaria, and Romania—show how much effort they are prepared to devote to this end. Few observers doubt that in the long run, not only the Balkans but also Ukraine, Moldova, and Belarus will join the EU.

Membership of the European Monetary Union has inspired less enthusiasm, but already four out of eight new member states in central Europe have adopted the European Exchange Rate Mechanism 2 (ERM2) in preparation of joining the eurozone—probably as early as 2006. The period within ERM2 can be a delicate time because the goal of joining EMU is not as commonly shared as joining the EU. Hence, it is well conceivable that the decision to adopt the euro will be postponed if economic or political conditions are not considered ripe. The examples of Denmark, Sweden and the United Kingdom show that the euro is not a prerequisite for being a respected EU member, since the three decided to stay out.

It is also telling that only those countries have adopted ERM2[4] which have had fixed exchange rates anyway or where textbook economics would advocate fixed exchange rate because they are small and open economies. The real test will be when the bigger economies

[4] In addition to Slovenia and the Baltic states, Cyprus, Malta and Denmark are members of ERM2.

of Poland, the Czech Republic and Hungary decide to move through ERM2 towards the euro. Here, the costs and benefits are less clear cut.

Economic and political expectations play a crucial part. Expectations translate into capital flows because investments are allocated where the expected profits are highest. The high present capital inflows into the new member states therefore suggest that most investors have a quite positive outlook. But during ERM2, economic volatility may increase—at least in those countries which have not already pegged their currencies—because monetary policy will be subordinated to the exchange rate target. Higher volatility may also shift the economic outlook because investors may change their expectations during bad times. Due to the self-propelling relation between capital flows and exchange rate movements, minor events can have great repercussions. When investors feel that the current exchange rate target is unsustainable, they will remove their capital and the exchange rate will come indeed under pressure. The expectations may become self-fulfilling. It is important to acknowledge that sustainability is a political criterion because the costs of higher unemployment or sluggish growth have to be balanced against the desire to stay on the track towards the euro. Investors therefore do not only take into account economic fundamentals but also the political determination to endure economically bad and thus unpopular times.

A clear and credible commitment to the euro which is commonly shared in the public would have a stabilising effect on expectations because investors would not fear a change in strategy even in hard times. Unfortunately, the euro enjoys less support than EU accession did. It was also controversial in many of the old member states: Germans mourned the symbolic and emotional value of the Deutschmark, and the French referendum was won only with a very narrow margin. But unlike the new member states in central Europe, they had to worry less about the capital account. For the new member states, embarking on euro adoption without a clear public and political commitment can be a risky strategy.

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