REPORT

THE POLISH INSTITUTE OF INTERNATIONAL AFFAIRS

MEMBERSHIP IN THE REFORMING EURO AREA
A CENTRAL-EASTERN EUROPEAN PERSPECTIVE

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RAstaNEWS
Macro-Risk Assessment and Stabilization Policies with New Early Warning Signals
European Commission
SEVENTH FRAMEWORK PROGRAMME

THE POLISH INSTITUTE OF INTERNATIONAL AFFAIRS

MEMBERSHIP IN THE REFORMING EURO AREA A CENTRAL-EASTERN EUROPEAN PERSPECTIVE

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This report presents the main points, an assessment, and conclusions and recommendations of the discussion at the scientific workshop "Membership in the Reforming Euro Area: The CEE Perspective", which took place at the Polish Institute of International Affairs in Warsaw on 25th June, 2013

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Executive Summary

On 25th June 2013, the closed-door scientific workshop "Membership in the Reforming Euro Area: The CEE Perspective" took place at the Polish Institute of International Affairs. It was the first event organised as part of the Rastanews project ("Macro-Risk Assessment and Stabilisation Policies with New Early Warning Signals") The aim of the workshop was to initiate a discussion on the project and to provide some food for thought on the work in the upcoming months centred on the particular deliverables of Work Package 6 of the project. This report intends to summarise the objectives set up there and along with the recommendations it offers to contribute to the overall efforts to provide a framework for a revised EMU necessary to achieve EU stability and regain credibility in the eyes of the rest of the world.

Over the course of the workshop, serious discrepancies in the macroeconomic potential of the EU Member States and an insufficient level of economic convergence were identified. This incongruence is clearly reflected in these economies' competitiveness and reflected in their current account balances. Therefore, the current crisis should be called rather a "balance of payments crisis" than a crisis of the euro currency.

The current level of economic and fiscal integration has proved insufficient and further efforts should be made to enhance the governance mechanisms of the EMU. Financial markets must regain the belief that the euro project is resilient. For this to happen, they may need to see a strengthening of the EU's role, including the European Central Bank's (ECB) mandate, in crisis resolution. Yet, the situation depends also on the results of structural reforms in the Member States. Any further steps in euro area integration, especially in the field of banking supervision, should also take into account the specificity of the CEE countries, including their banking sectors.

Germany's role as a major power in the eurozone is crucial. Berlin opposes ideas that increase its exposure to the risks of other eurozone members. There will probably be no major change in the German approach towards the crisis after the September 2013 elections, as there are no easy solutions that could be accepted by the public in that country regardless of which political parties form the next government.

The discussion in the workshop gave thorough insight into the problems connected with eastern eurozone enlargement. Political factors have been given extra significance in deliberating eurozone accession. Further developments in the eurozone and the creation of financial assistance mechanisms have affected the CEE countries' analysis of the economic costs and benefits of joining the eurozone. It has been widely acknowledged that the benefits arising from eurozone membership are not automatic, but rather conditional and may be substantially stronger or weaker depending on both the situation in the eurozone and the economic policy decisions of a particular country. Furthermore, the Maastricht criteria do not automatically ensure a proper convergence process, and countries such as Poland are focusing their efforts on more comprehensive convergence criteria.

Last but not least, the political aspects of full EMU membership were discussed, with a special focus on the positions of the Czech Republic, Hungary, and Poland. Domestic political elites in these countries seem to be in disagreement about the prospect of prompt euro adoption. The absence of a specific timeframe for joining the eurozone seems to be exacerbated by social opposition to adopting the common currency. However, with new eurozone governance underway, these "pre-in" EMU members will be threatened by certain marginalisation in the EU decision-making process if they do not vocalise their aspirations for EMU membership.

Introduction

The closed-door scientific workshop "Membership in the Reforming Euro Area: The CEE Perspective" was the first thematic event organised as part of the Rastanews project. It was attended by a select group of eminent scholars, economic experts, civil servants and policymakers. The programme was designed according to the research objectives of Work Package 6, namely discussion about the model for revised economic governance architecture in the EU and euro area. The aim of the workshop was to **assess the prospects of future enlargements of the eurozone and the role of Central and Eastern Europe (CEE) in that process**. Although the discussion concerned the whole CEE region, the emphasis during the workshop was put on the experience of Poland, Hungary, Czech Republic and Slovakia.

As the workshop was in fact inaugurating the Rastanews project, it aimed to assess the current developments in the euro area in macroeconomic, institutional and political terms. In gathering both representatives of academia and EU decision-making practitioners, it made it possible to reconstruct the **current situation in the eurozone**, thus offering a thorough basis for future deliberations as part of the project (the first workshop panel). The identification of the roots of the crisis in the eurozone, displaying the drawbacks of its architecture as well as an assessment of the role of the main players in enhancing eurozone resilience and thus in the irreversibility of the euro project, allowed the participants to draw up the **challenges and benefits for CEE countries of eurozone enlargement**. Here, Slovakia's euro accession served as an adequate model for the other relatively similar CEE economies and facilitated participants' efforts to identify an optimal path to euro adoption (the second workshop panel). Moreover, the workshop discussion did not intend to avoid the **current political picture in the CEE countries and their governments' strategies concerning eurozone enlargement**. The workshop panellists presented the current state of play of their respective country's domestic discourse, which turned out to be particularly helpful in identifying the CEE's concerns and expectations concerning the future shape of the eurozone.

The goal of Work Package 6 is to deliver concrete policy recommendations for both the euro area Member States as well as the CEE region that would be also easily accessible by a broader audience. This intention guided the process of drafting both the agenda of the workshop taking place at the Polish Institute of International Affairs as well as this report. Hopefully, the content of the report, together with the conclusions and recommendations drawn by PISM experts, can successfully contribute not only to further research under the Rastanews project but also to the quality of public discussion in the countries that are obliged to become full members of the Economic and Monetary Union.

I. Eurozone Crisis: What Crisis?

The first part of the workshop discussion focused on a **general assessment of the situation in the eurozone**. First, an attempt was made to identify the actual roots of the problems the euro area is encountering. The crisis revealed that EMU macroeconomic governance mechanisms have been ill-suited to deal with macroeconomic imbalances, while budgetary discipline has been an insufficient answer to the dynamic development of the financial markets. In addition, the unregulated innovations in the banking sector that led eventually to the global financial crisis made capital flows within the eurozone more harmful than ever before.

The panel discussion revealed that there is **no common understanding of the roots of the ongoing crisis**. For some participants, it is in the foundations of European monetary integration, which they said were laid too early and were driven by the belief that a single currency would prompt economic growth and convergence among the EU Member States. Yet, the euro area has never fulfilled the criteria of an optimum currency area, and the level of economic convergence is still not sufficient. On the other hand, monetary integration can be

seen as a natural consequence of economic integration, including several attempts since the 1970s to eliminate exchange rate risk. It seems, therefore, that the current crisis is of an existential character and the reasons for it lie much deeper than the current discussion concerning economic problems such as unemployment or sluggish growth.

The next point in the discussion concerned the **mechanisms causing economic divergence in the eurozone**. The panellists suggested it was not only the outcome of the undisciplined fiscal policies undertaken by Member States but paradoxically also the consequence of market mechanisms. The **diversity inside the currency union** has been reflected by capital flows from northern creditor countries to southern debtor countries. The transactions worked both ways—the southern euro area states benefitted from the availability of capital while the northern economies gained higher returns from exported capital. However, those capital flows, which had been moving from Northern Europe to the southern eurozone Member States, were not used to modernise economies, as initially intended, but were directed mostly to the housing market and financial sector. As a consequence, these flows lowered the pressure on local enterprises to increase competitiveness and eliminated incentives for governments to implement economic reforms.

Thus, the role played by **competitiveness** in measuring economic convergence was extensively elaborated over the course of the experts' discussion. If assessed by productivity rates, this factor reveals **considerable differences between the Member States**. The productivity of several eurozone members had been changing in recent years in different directions, improving in Germany and decreasing in Spain, Portugal, Italy and Greece. This divergence was reflected clearly by the current account balances of these countries, justifying those who took to **defining the current crisis as a "balance of payments crisis"**. Some of the panellists even pointed out that **the current crisis should not be understood as a crisis of the common currency but rather as one of several eurozone Member States.** They argue this understanding should directly refer to the causes: profligate fiscal policies (Greece), lack of competitiveness (Portugal, Spain, Italy) and asset bubbles (Spain, Ireland). These structural problems in several euro area members, which are still far from being resolved, influence the current condition of the eurozone.

What Is Wrong with Crisis Management?

Since the beginning of the crisis, the EU Member States have adopted various anti-crisis measures of mitigating or preventive character. The new economic governance mechanisms modifying the Stability and Growth Pact (SGP) were put in place, and the eurozone created special assistance instruments, including the permanent European Stability Mechanism. The European Central Bank took unprecedented actions, including lowering interest rates, buying government bonds on secondary markets, and providing liquidity for the banking sector. With the announcement of a new instrument in September 2012, Outright Monetary Transactions (OMT), the ECB largely contributed to easing the crisis.

The new mechanisms of EU economic governance were assessed during the workshop as steps in the right direction but still **far from sufficient**. The austerity plans accompanying the financial assistance programmes implemented so far in the south of the eurozone were perceived as having harmful effects on economic growth. The scope of these effects was underestimated by international institutions such as the IMF or ECB and put Member States' efforts to consolidate their budgets at risk.

The workshop participants were confident that public spending cuts, if implemented consistently, can reduce the budgetary deficit without harming growth. However, **southern European countries were in fact increasing taxes far more than reducing public expenditures**. Even though increasing the burden on the private sector might be politically easier for governments, it does reflect negatively in economic growth perspectives.

The discussion also raised the point that the **markets' belief in the irreversibility of the euro is very important in order to reduce the risk premium**, which is widely perceived as the main obstacle in attempts to restore growth and stabilise the economies of the EMU in the short period. On the other hand, taking into account the current predicament of the European economies, it could be politically difficult to continue with fiscal consolidation when economic stagnation causes social and political instability. **The persistent climate of economic stagnation could give rise to social unrest** and lead to a search for political solutions outside the eurozone.

Germany's Role

It comes as no surprise that a considerable part of the discussion was dedicated to Germany's position on eurozone anti-crisis measures. A truism is to say that Berlin has become the new gravity centre in the euro area, although Berlin feels uneasy with assuming full leadership and responsibility in the euro area. There are many voices critical of the German efforts as insufficient, yet **economists tend to disregard the internal institutional, political and legal constraints of the country's position in the crisis**, which the workshop attempted to illuminate.

Currently, one of the hottest debates in the EU concerns the **idea of debt pooling** within the eurozone. This idea does not inspire enthusiasm in Berlin. From the German perspective, expanding in its financial obligations to other EMU members could increase its public debt, while the German government's goal is first to stabilise the debt then reduce the ratio, which is high, above the usual limit of 60% of GDP. That requires adopting a balanced budget at the federal level to 2016, and to 2020 at the sub-federal level. It has also been pointed out that continuous financial assistance to other eurozone countries is a subject of concern in Germany. Although it is still rather unlikely that one of the eurozone members would leave, any potential losses for the Bundesbank as a result would have to be covered by Germany's federal budget. In this scenario, inflation would pick up in the medium run, which is Germans' biggest fear.

Several different options for German economic policy have been elaborated. The bulk of ideas have focused on reducing Germany's current account surplus to help southern eurozone Member States regain competitiveness, for example, by decreasing the domestic savings rate, especially in the public sector in Germany. This kind of policy would, however, increase the deficit, which would be very unpopular and violate the provisions of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (the so called fiscal compact). Therefore, it is unlikely to happen. Another idea would be to allow a higher inflation rate in Germany, but it would be very hard to achieve this goal. According to the calculations presented, in order for the southern states to sufficiently increase their competitiveness, the inflation rate in Germany in the period 2014–2018 should be 6.6% per year. This level could be achieved by such things as significant wage increases—about 40% in five years' time. In general, **inflation is the biggest concern for German politicians and the public**. There is consensus within the country on that matter, therefore **no change in the German line after the parliamentary elections in fall 2013 should be expected**. The German position in the future is likely to continue to be to exert pressure on restructuring the affected economies and rebalancing their public finances.

During the workshop discussion, the benefits that the eurozone crisis brings to the German economy were pointed out, for example, the negative interest rates on German bonds, which permits the country to restructure its public debt. Therefore, there were some opinions that Germany should take more of the burden on itself. The problem of debt mutualisation was also raised. Some speakers expressed an opinion that without debt mutualisation, in the long run it would be difficult to maintain the integrity of the monetary union. However, in Germany there is a feeling that this would increase hazard on the part of some eurozone countries.

The ECB and Banking Sector

One of the central issues of WP6 is the role of the European Central Bank in long-term rescue mechanisms, and thus considerable discussion was devoted to the **measures undertaken so far by the ECB**. The ECB activity during recent months and claims by its president, Mario Draghi, that it will do everything necessary to save the euro have led to relative stability in the euro area. During the discussion, the announcement of **OMT was judged as significant step in the right direction**, but **several of the participants expressed doubts as to whether these measures were sufficient**. However, it was agreed, though, that the ECB is acting in a difficult political and legal context that limits its room to manoeuvre. For instance, the ECB has tools to restore monetary policy transmission, e.g., negative rates for commercial bank deposits or a more aggressive policy of buying securities, which would be however difficult to implement because of the diverse national interests of the EMU members.

This diversity of Member States' interests stepped into the limelight in a discussion about **future banking supervision system** within the eurozone, commonly referred to as the banking union. In this context, the discussion was enhanced by a presentation on **foreign direct investment (FDI) in the banking sector in CEE countries**. The region's banking sector is characterised by a large share of ownership by big euro-area banking groups. This raises questions about the **inequality of relations between subsidiaries and parent institutions**. Before the crisis, FDI inflow to the CEE banking sector (with the exception of Slovenia) had been substantial, resulting in a dominant share of foreign capital and a large share of the banking sector in the FDI stock. The foreign capital inflow contributed to lowering interest rates but at the cost of weak or missing local banking structures and strong dependence on foreign banks, which are features of a "dual banking system". That situation can hold **considerable risks for CEE economies**. The large capital outflows at the end of 2008 and at the beginning of 2009 had adverse effects on some CEE economies through exchange rate fluctuations, liquidity problems and increases in interest rates. It also caused a decrease in accumulated reserves in the CEE-10 region. What's more, the dual banking system—two different regulatory structures - has also been criticized for ignoring local economic development needs and focusing on maximizing profits in the short term. Therefore, it has been extensively acknowledged that **the CEE's banking sector dependency should be considered in a broader picture of the economic model of the CEE countries**. It should not be passed over in discussions on the future financial integrated framework of the euro area architecture.

The Way Forward—Improving Competitiveness?

The final point of the discussion concerned the most important factor of the crisis, i.e., the competitiveness problems among eurozone members as reflected in current account imbalances. It was agreed that **there is some concrete evidence of structural reforms in southern Europe**, for instance, in decreases in unit labour cost, budget deficit reductions, deleveraging of their banking sectors, and decreases in Target 2 imbalances. The adjustments seem to be not only cyclical but also of a structural nature. **Yet, there are still a lot of open issues** such as competitiveness to be tackled by the Member States. For instance, for Italy, this factor constitutes a more significant challenge than the level of its debt. The lack of genuine competition in the southern euro area countries prevents prices from adjusting to labour costs. Some participants pointed out that the structural adjustments in the southern euro area countries should also include adjustments in Total Factor Productivity and other institutional issues such as corruption, the shadow economy, or their inefficient taxation systems**. Some economies should better use the assets they have and put an emphasis on innovation**. It was noted in the course of discussion that labour flexibility is necessary but when excessive it might lead to a decrease in consumption through instability in household incomes. Fiscal discipline for some governments, including Italy, is necessary, but fiscal consolidation through recession and deflation could lead to a closing down of manufacturing. In addition, the monetary channel

should be restored to regain a fully operating credit system and reduce debt costs in the southern economies. This could considerably assist in the structural reform processes in the southern euro area countries.

II. Enlarging Euro Area: Lessons (to Be) Learnt

Having drawn the general causes of the sovereign debt crisis and the role of certain Member States and the European Central Bank, the second part of the workshop focused on the **experience of some CEE countries** arising from their membership in the EU. The participants agreed that the **decision to join or not to join the euro area is mainly of a political character but it should be preceded by a careful cost-benefit analysis in economic terms**. The same holds for the decision on opting for a certain exchange rate regime. That is why even though they are quite similar, the CEE economies chose different exchange regime rates. Poland, Hungary, Czech Republic and Romania have a floating regime, whereas Bulgaria adopted a currency board.[1]

Cost-Benefit Analysis

One has to take into account that the available **economic tools cannot give a definite answer about the breaking point between the costs and benefits of eurozone accession**. Yet, the general opinion is that small and open economies with a synchronised business cycle with the rest of the euro area are potentially likely to benefit more from euro accession. Therefore, it is a paradox that countries with the most flexible labour schemes with economic cycles correlated with the EU-17 are outside the euro area (Denmark and the UK). The most considerable costs from euro adoption come from the loss of independent monetary policy and technical currency changeover.

The main benefits from accession come from the elimination of exchange rate risk, reductions in transaction costs, lower costs for capital, and increases in FDI inflow. Taking the example of Slovakia, all of these factors could increase the convergence of its economy with the rest of the euro area. According to analyses by the National Bank of Slovakia, accession may bring an increase of 7 to 20% in GDP in the longer term.

Yet, the **developments of the situation in the euro area might incur some additional economic and political costs** for both euro area members and those getting ready for accession. The creation of temporary and permanent financial assistance programmes and mechanisms in the eurozone—the Greek Loan Facility (GLF), European Financial Stability Facility (EFSF), European Financial Stabilisation Mechanism (EFSM), European Stability Mechanism (ESM)—have added up to the current obligations arising from eurozone membership. Slovakia can easily serve as a case study here. In 2011, the Slovak government collapsed over the issue of extending the powers of the EFSF. The country did not take part in the first assistance package to Greece, the GLF, but has taken part in all subsequent financial assistance packages and became a member of the European Stability Mechanism. For the latter, the eurozone members were obliged to deliver capital on the basis of an ECB contribution key. The possible reduction of the debt of some southern eurozone countries may incur costs for Slovakia and the other eurozone countries in the future. Therefore, the theoretical exposure of the country in the worst scenario may come to around 20% of its GDP. This factor changes considerably the cost-benefit analysis of its euro area membership.

Accession to the third stage of the Economic and Monetary Union is a long process. It also contains a compulsory **2-year membership in the Exchange Rate Mechanism II (ERM)**, as

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[1] Estonia and Lithuania joined ERM II in 2004, and Latvia in 2005. Estonia joined the euro area in 2011, and Latvia becomes a full EMU member in 2014.

part of which the country's currency cannot fluctuate more than 15% in relation to the agreed central exchange rate. Slovakia has had to re-evaluate its currency twice, by more than any of the countries in ERM before. The appreciation of the currency under ERM is more welcomed by other eurozone countries while depreciation is often considered a means of increasing competitiveness against other eurozone states. The policymakers in a country entering ERM need also to be aware of the classical impossible trinity, thus the impossibility of keeping both independent monetary policy and exchange rate targets when the freedom of capital movement is allowed.

Poland: Optimal Path to the Euro and New Convergence Criteria

It was concluded that one of the major lessons drawn from the crisis is that meeting the Maastricht criteria is not enough to adopt the euro. These criteria could include: competitiveness, quality of governance or general economic situation in the candidate country. Despite the continuous convergence process, various classifications by several institutions, such as the Worldwide Governance Indicators from the World Bank, the Corruption Perception Index, Global Competitiveness Index or Doing Business, show that the CEE countries are considerably below the eurozone average. In addition, every CEE economy has different problems. Their divergence from the euro area is visible in the Macroeconomic Imbalance Procedure Scorecard, which indicates that several CEE countries experience problems with their Net International Investment Position, while others have a high level of unemployment or excessive current account deficits. Besides this, while nominal and real convergence should occur, progress in the institutional integration process is crucial, too.

Countries should set their own domestic convergence criteria. For Poland, it was proposed that a new set of self-imposed criteria be established based on modified Maastricht criteria: interest rates, inflation, fiscal balance, stability of the exchange rate in the long run (especially the real exchange rate), and proper macro-prudential policies in the financial markets. **Setting these criteria could help the government set the proper priorities and implement them**. It would be beneficial not only from the perspective of integration with the euro area but also for the sake of the economic situation in these countries.

The correlation of the most positive and negative scenarios covering the cost and benefit analysis of Poland's euro-adoption show that the country stands to gain from joining the zone. However, considering the experience of Spain, Portugal and Greece, the question that arises is, when? The payoff in the short, medium and long terms does not show the whole picture. **There is a need to address several hidden mechanisms in assumptions about the benefits of the adoption of the euro**. A new way of thinking, focused on looking at the objectives not as goals but rather as outcomes, should be applied. **The euro is an opportunity; one should look at the net benefits from the euro as conditional and endogenous**. More attention needs to be paid to ensuring that the assumed benefits of the euro hold despite changing circumstances. For example, the calculation of short-term gains is based on an assumption that the real exchange rate is constant, but if the real exchange rate appreciates, then a reduction in trade could be observed. The other benefits, based on reduced interest rates, are assumed to increase investment; however, they may also increase consumption. Low interest rates are also assumed to lead to productive investments. However, experience shows that investment in some countries after euro adoption was directed to the financial or housing sectors, which later destabilised their economies. There is also the assumption that lower interest rates lead to increased government saving, which then leads to reduced debt. However, it is not certain that a government will save, instead it may choose to spend the potentially saved money for any urgent need.

The **reluctance of the CEE countries to join the euro area**, as indicated during the workshop, is being justified by the fact that after the outbreak of the eurozone sovereign debt crisis **the cost-benefit analysis of eurozone accession changed**. After the emergence of the

crisis, it came out that the perceived economic benefits may not be attractive enough and thus, the countries sought further political analysis, which was covered in a subsequent part of the workshop discussion.

III. Politics of Euro Area Membership: Views from Prague, Warsaw and Budapest

The third theme of the discussion was devoted to the individual CEE countries' perspectives. Offering a political background for the CEE countries' actions naturally complemented the workshop deliberations. **The political approach to the euro in the Czech Republic, Hungary and Poland was a central focus of the discussion**. This was supplemented by a presentation on the European Commission's role in arguing for structural reforms in the CEE countries to make them sufficiently competitive and thus better prepared to adopt the euro in the future.

The proposed intervention schemes oscillated around the **CEE countries' major problem of being caught between a rock and a hard place in recent discussions about the future of the EMU**. As non-euro members, the Czech Republic, Hungary and Poland have limited influence on the development of euro area architecture, though they are committed to being a part of it sometime in the future. It is worth recollecting that all of the CEE countries are legally bound by the provisions on the Economic and Monetary Union, with a temporary derogation set in Article 139 of the Treaty on the Functioning of the European Union (TFEU). They are therefore, obliged to aim for abrogating the derogation status, which would be manifested by fulfilling the Maastricht convergence criteria. Thus, the majority of questions directed to the panellists focused on the **CEE countries' political willingness to aim to lift the derogation** and the implications arising from their current status as "pre-in" Member States.

The participants confirmed that the sovereign debt crisis, and thus growing social opposition towards the euro currency[2] made the CEEs more reluctant towards a fast track on euro adoption. In the Czech case, **the governing party, ODS[3], pledged at one of its congresses to call for a referendum on whether euro membership should be officially on the table**. Keeping in mind also the lack of political consensus on euro-related issues and the resulting, noticeable polarisation of the debate among the ODS itself and among other political elites, the Swedish scenario[4] cannot entirely be excluded in the Czech case. This assumption can be additionally strengthened by the observation of the situation indicated during the workshop that Czech EU policy has been largely reactive in recent years, which can be best seen in the case of the Euro Plus Pact and the TSCG, of which the Czech Republic is not a part.

The Polish government seems to be more consensual on euro accession. **In the eyes of Polish policymakers, accession to the eurozone is not only about the economy but also mainly about consolidating its political influence in the EU decision-making process**, which according to one expert present at the workshop seems to be often ignored by Czech elites. The intention to become a member of the core integration circle has been indicated i.a. in the last annual address of the Polish Foreign Minister on goals of Polish Foreign Policy in 2013.[5] It was

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[2] Euro introduction in Poland is opposed by 64% of Polish respondents, see: Public Opinion Research Center, "Hopes and Fears Related to Introduction of the Euro", in: *Polish Public Opinion*, March 2013, http://www.cbos.pl/PL/publikacje/public_opinion/2013/03_2013.pdf.

[3] At the time the seminar was held, the Czech government was about to resign due to an ongoing investigation of Prime Minister Petr Nečas' closest aides.

[4] Sweden is formally obliged to adopt the common currency. However, Swedish society in a referendum in 2003 refused to give up its national currency and join the eurozone.

[5] An address by the Polish minister of Foreign Affairs on the "Goals of Polish Foreign Policy" in 2013.

underlined, however, during the workshop that this should be preceded by intense preparations that would enable Poland to benefit from euro accession and further strengthen its political significance on the EU stage.

Meanwhile, **in Hungary there is no consensus in pushing forward with the common currency**. Even before its EU accession, Hungary in 2002 adopted its own path to the euro, aiming at adopting the common currency in 2007. However, over time the date was postponed for several reasons but mainly due to the problems with meeting the convergence criteria. Since the last parliamentary elections in 2010, the political climate for joining the euro area has changed. **The ruling coalition emphasises the role of the state in international economics, thus its logical consequence is that the national currency is performing a symbolic role.** The position of the policymakers is strengthened by the Hungarian public's mistrust of the common currency. Victor Orbán's government remains sceptical of the possible benefits of euro adoption. In April 2013, the Hungarian prime minister stated that Hungary cannot seriously consider joining the euro as long as the discrepancy in GDP per capita between Hungary and the EU is still too high. Membership in the third EMU stage could be considered if the economy reaches 90% of eurozone GDP per capita. Knowing that, in 2012 it was only 65%, which is the same as in Poland, so it may still take some time to reach this threshold. The economic policy of the Hungarian government is distinct compared to the other CEE countries. It fights against foreign capital, accusing it of crowding out Hungarian-owned enterprises and causing massive unemployment during the crisis when it was suddenly withdrawn from Hungary. These claims receive considerable support among society.

The other reason to keep the forint is the intention to use the exchange rate of the national currency to influence the balance of foreign trade. Yet, this strategy might imply considerable costs for the Hungarian economy in the longer term and would have an adverse effect on its competitiveness. Another argument against the euro is that the catching-up process is connected with higher inflation. Higher inflation could provide more tax income, but it would only be possible if the forint were still in use. Another reason is that EMU fiscal integration will be important. In fact, the coordination of fiscal policies and redistribution among member countries is necessary to solving the eurozone's problems.

Reforming the Euro Area: The 'Pre-ins' Dilemma

What complicates these governments' strategies concerning euro adoption is the dynamic evolution of the eurozone itself, which imposes new sets of obligations on its members. For instance, establishing the European Stability Mechanism as a backstop for the eurozone member states imposes in practice additional legal and financial obligations for its members in the form of paid-up capital and guarantees to the ESM, which were not on the negotiating table when the CEE countries were about to enter the EU.

By advocating the coherence of the EMU integration process with the EU institutional framework, **the "pre-ins" have managed to secure to some extent the inclusive character of some of the designed instruments**, such as euro summits as part of the Treaty on the Stability, Coordination and Governance in the Economic and Monetary Union or the Single Supervisory Mechanism—a first element of a banking union. The "wait-and-see" approach towards the euro area identified by some workshop participants might get complicated, however. Poland, Czech Republic and Hungary could be confronted soon with growing expectations to share not only the rights but also obligations arising from this more inclusive character of eurozone governance, which could be followed by an expectation of a clear commitment to join the eurozone.

European Commission's Role in forging reforms

Political credibility and **CEE engagement in reforming their economies to fulfil the convergence criteria** is also **measured by the way they cooperate with the European Commission** in the annual cycle of the European Semester, particularly in terms of Country Specific Recommendations. As pointed out during the workshop, **complying with the Commission's recommendations on the necessary structural reforms, tailored to each Member State-specific economic structure, would prove these states' determination to join the eurozone** sooner rather than later. The European Commission, therefore, even though it does not set timing for the CEEs to adopt the euro, does play the role of stimulating the necessary reforms and urging the CEE countries to improve their economy's competitiveness before joining the eurozone.

Over the course of the workshop, the problem with implementation of the new provisions for economic governance were touched upon. The European Commission, which has acquired new formal competences in both the preventive as well as the corrective arms of the Stability and Growth Pact and under the fiscal compact, often faces reluctance from the Member States to comply with the new set of rules. The recent example of France criticising the Commission's CSR as intruding too much on national competences[6] poses a question about the efficient execution of EU economic surveillance, particularly of the largest economies. This only undermines the Commission's authority in performing its role of stimulating further reforms in the CEE countries.

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[6] In this European Semester cycle, the European Commission recommended France reform its pension system and cut labour costs to allow it to narrow its budget deficit. This only met with strong criticism by the country's governing elites, shedding light on the lack of efficient EU law enforcement in the EMU.

Conclusions and Recommendations[7]

- After the outbreak of the global financial crisis, the EU introduced numerous mitigating and preventive measures, yet the level of economic and fiscal integration, especially in the euro area, is not sufficient. **The lack of belief in the irreversibility of the euro project is currently one of the biggest obstacles to stabilising the situation within the eurozone**. However, one should note that the **common currency is not the ultimate goal but an instrument to improve the EU's welfare**. An effort should be made to develop a feeling among the societies of the Member States that the enhanced economic governance aims to prevent any similar crisis from happening again, and thus will serve all the Member States.
- Improving EU economic fundamentals is not only about EU governance. Boosting trade with non-European markets should remain a priority as a possible source to stimulate growth in the EU. However, in the common actions to improve trade with non-European markets the EU should not lose sight of the endogenous growth potential in the Union itself. **More focus should be made therefore on the development of the EU internal market and on removing existing barriers, liberalising services, including e-commerce, and supporting labour mobility.**
- Concerning the labour market, there is still too little employment flexibility in the EU, and the countries are evidently stuck on high taxes on wages and a high level of bureaucracy, making the adjustment processes longer and less effective. Given these factors, the private sector prefers to extend working time rather than employ new workers. Modifications of the level of taxes and administrative burden could be considered as a means to boost EU companies' competitiveness.
- **In Germany, no major change in its anti-crisis approach can be expected after the September elections**. The new German government will continue to put pressure on the southern eurozone states to continue structural reforms and austerity. But, if Germany does not want to remain the only industrialised country in the EU, it should be a leader, not only in terms of fiscal consolidation but also concerning setting up and applying the new growth model in Europe.
- **The issue of euro adoption causes political controversies and can be a source of party divisions concerning EU affairs**. The dilemma of whether to join an unstable euro area now or expose one's country to the risk of drifting away from the core of the EU decision-making process cannot be simply resolved by means of economic tools. **Nevertheless, a careful cost-benefit analysis should be a prerequisite of any political decisions concerning euro area membership**. The analysis undertaken in the CEE countries should not avoid politically controversial issues such as the possibility of debt restructuring in some euro area countries and its implications for other eurozone members.
- The most important issue to be tackled by the CEE countries regardless of the question of their euro area membership is the general condition of their economies. **The real convergence of non-euro economies should be their most important focus**. To achieve this goal, it could be useful to adopt a set of self-imposed criteria as part of the pre-membership strategy. These goals should be fulfilled as part of a long-term convergence strategy. The most successful way to fulfil nominal and real convergence criteria lies **in improving competitiveness based on innovation**. In this field, the Czech Republic has an outstanding place, compared to the other CEE countries, in innovation rankings (for instance, the sub-index of innovation from the Global Competitiveness Report for 2012–2013 is significantly higher than for other new Member States in the region).

[7] The conclusions and recommendations express the authors' point of view and are not entirely based on the discussion during the seminar, yet they are in line with a majority of the opinions expressed.

- Another important issue is the necessity to have strict fiscal policy while **improving the Net International Investment Position**, because the current position is unfavourable to these countries. With such a negative ratio, significantly exceeding 50% of GDP and in some cases even worse (with the exception of the Czech Republic and Slovenia), exposure on the international financial markets, and quite weak national financial institutions, the risk of instability is a burden on the CEE countries. Furthermore, this indicator has worsened over time. Thus, the need to strengthen national financial agents is recommended, provided it is consistent with the Single Market rules.
- In the eyes of the CEE countries, **new eurozone governance is in the making. The sovereign debt crisis, particularly in its earliest phase, made the competing interests of the euro area members and the rest of the EU more evident**. While the existing eurozone members seemed to prefer cooperation marked by confidentiality and preferably including just the "17", the "pre-ins" and future eurozone members have struggled to have insight into the decision-making process concerning the euro area. This has been additionally complicated by the eurozone Member States adhering to intergovernmental forms of cooperation (euro summits) and measures based on the differentiated integration platforms (EU international law agreements: ESM, TSCG). However, in 2012 there was observed less of an appetite to "go differentiated". The final Council position on both the Single Supervisory Mechanism as well as the European Banking Authority modalities seem to prove this finding.[8] This constitutes a more favourable environment to reconcile both the eurozone members and "pre-in" rationales and argue in favour of inclusive and transparent eurozone governance.
- **Recent anti-crisis measures**, such as the fiscal compact or the Single Supervisory Mechanism **have so far left certain room for non-eurozone Member States to decide if and to what extent they would like to participate in these structures**. Thus, it is up to the CEEs to decide how many obligations arising from enhanced budgetary discipline and the integrated financial framework they would like to take up.[9] For the moment, they seem to be taking a "wait-and-see" approach towards euro membership. However, the CEEs might be faced sooner or later with expectations raised by the euro area of taking a clear commitment with regards to their intentions to adopt the common currency, at the cost of inclusiveness in eurozone governance. Latvia's prompt eurozone accession and Lithuania's preparations might play an important factor in redefining the euro area's current approach towards the CEE countries.
- Since 2011, the European Union has developed pretty robust economic governance, encompassing measures designed to enhance coordination of economic policies (the "six pack" and "two pack"). However, the **European Commission's newly acquired competences are not being executed efficiently due to Member States' resistance to commit themselves to structural reforms**, which could cause their governments to lose popularity at home. The existing gap between national and EU politics—in the limelight since the outbreak of the crisis—has raised questions about the Commission's mandate to urge economic reforms in the Member States. Therefore, new ways of enhancing the Commission's legitimacy should be explored. By identifying and explaining the CEE country's economic specificities and their societies' concerns, Rastanews could facilitate dialogue between the Commission and Member States as part of the European Semester.

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[8] The best example of this is the evolution of the term "SSM participating member state".

[9] Please note that the golden budgetary rule and its transposition is binding on eurozone members only, while non-euro members can voluntarily bind themselves to these provisions. So far, neither Hungary nor Poland has raised the issue. This remains in contrast to Denmark, which indicated its willingness to comply with all of the fiscal compact's provisions.

– The sovereign debt crisis has put the European Central Bank in the limelight of the anti-crisis-related decision making process. The **ECB's actions, including the launch of the OMT instrument, have probably been more convincing for the financial markets than many of the European Council summits.** The growing role of the European Central Bank in economic governance, however, provokes **questions concerning the limits on its mandate and interference in handling the crisis**. This debate will only reinvigorate itself once the Constitutional Court in Karlsruhe issues a verdict on the OMT operations and answers whether they are legally feasible with German basic law. The Rastanews project, gathering economists, political scientists and lawyers, could contribute to analysing the impact the ECB might have on further eurozone integration.

Scientific Workshop Programme

09:15-09:30 Registration, welcome coffee

09:30-09:45 Welcoming remarks

- **Roderick Parkes**, Polish Institute of International Affairs (PISM)
- **Patrizio Tirelli**, University of Milano-Bicocca
- **Antonio Villafranca**, Institute for International Political Studies (ISPI)

09:45-10:00 Opening Speech:

Artur Nowak-Far, Undersecretary of State, Polish Ministry of Foreign Affairs

10:00-11:30 Session 1: The Situation in the Euro Area: Between the Governance Reforms, Macroeconomic Risks, Stagnation and Political Instability

Speakers:
- **Zoltán Gál**, Institute for Regional Studies, Hungary
- **Ognian Hishow**, Stiftung Wissenschaft und Politik, Berlin
- **Patrizio Tirelli**, University of Milano-Bicocca, Milan
- **Antonio Villafranca**, Institute for International Political Studies (ISPI)

Chair: **Anna Visvizi**, DEREE, American College of Greece, Athens

11:30-11:45 Coffee break

11:45-13:15 Session 2: Eurozone Enlargement: Past Experience and Possible Economic Challenges for the CEE Countries

Speakers:
- **Ettore Dorrucci**, European Central Bank
- **Tamás Mellár**, University of Pécs
- **Martin Šuster**, National Bank of Slovakia
- **Cezary Wójcik**, Warsaw School of Economics

Chair: **Paweł Tokarski**, Polish Institute of International Affairs (PISM)

13:15-14:00 Lunch

14:00-15:30 Session 3: Changing Euro Area: the CEE Perspective

Speakers:
- **Tomasz Gibas**, European Commission Representation Office in Poland
- **Julius Horvath,** Central European University, Budapest
- **David Král**, Europeum Institute for European Policy, Prague
- **Patryk Łoszewski**, Polish Ministry of Finance

Chair: **Roderick Parkes**, Polish Institute of International Affairs (PISM)

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