Boarding the Euro Plane:

Euro Adoption in the Czech Republic and Slovakia

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1. Introduction

Following the *Velvet Divorce* of January 1, 1993, Czechoslovakia was separated into two sovereign countries: the Czech Republic and Slovakia. Regardless of the different reform tracks both countries took, both managed to meet the *acquis communautaire* and be amongst the eight Central and East European Countries (CEECs) to join the EU on May 1st, 2004. By joining the EU, those countries committed to adopting the euro sometime in the future – that is, once they would meet the convergence criteria. Slovakia, the smaller of the two, adopted the euro on January 1, 2009. The Czech Republic meets many of the convergence criteria but has not made serious strides to adopting the euro.

This paper asks the following question: why did Slovakia adopt the euro while the Czech Republic did not? In order to join the euro, countries need to have met the so-called 'convergence criteria', which refer to inflation and interest rates, budgetary deficit and public debt and the independence of the central bank. However, these criteria can be best met if institutions are adapted to them and if domestic politics is conducive to making major political, institutional and economic changes.

The bulk of this paper seeks to explain the euro adoption strategies in the Czech Republic and Slovakia until 2010. The second part of the paper examines how each of these two countries have performed under the regime they joined (Czech Republic:

flexible exchange rates; Slovakia: in the euro area) and examines how that experience affected Czech and Slovak policies towards euro adoption and their performance during the euro crisis. The paper takes an eclectic approach based on constructivism and symbolism, historical institutionalism and domestic politics. The Velvet Divorce is considered a critical juncture and a divorce in the reforms, policies, institutional development and transition between both countries.

To answer the main research question, the paper examines five explanations based on the theoretical approaches highlighted. These five explanations are: *the inferiority argument* (Slovakia being less advanced and underdeveloped up until the 1990s); *European identity and the 'return' to Europe; symbolic factor of the currency; euroskepticism;* and *economic structure and trade relations.* The paper analyzes these explanations first, in order to understand the euro adoption outcome in both countries; second, to analyze the performance of both countries during the euro crisis; and, third, to highlight which of the five explanations helps us best understand the performance of both countries.

The economic cost-benefit analysis is not as important as these domestic factors since both euroskeptics and euro enthusiasts can use such an analysis to make their case. Moreover, for an open, small, export-based economy, with a small domestic market, such as Slovakia, some would argue that it would be in the economic interest of Slovakia to join the euro area as soon as possible. Regardless of the costs, the National Bank of Slovakia and Slovak economists believed the advantages of euro adoption would outweigh the costs (interviews with officials from the National Bank of Slovakia, 2010). While the economic explanation might be able to shed some light on the euro adoption strategy in the case of Slovakia, it cannot tell us much about the Czech case, for which a similar case could be made.

The next section lays down the analytical framework of the paper. Section three discusses the methodology and case selection. Sections four through nine analyze the various possible explanations regarding euro adoption in the Czech Republic and Slovakia. Section ten concludes by highlighting the main findings including a brief discussion of what theoretical explanation best explains these findings.

2. Theoretical Framework−An Eclectic Approach

The Velvet Divorce on January 1, 1993 served as a critical juncture that influenced the institutional development in the Czech Republic and Slovakia for the two decades that followed. Along with the domestic politics analysis and constructivism, we would be able to form a better understanding as to why the Czech Republic moved away from euro adoption while Slovakia joined the euro area. Before going into the empirics, let us briefly highlight the theoretical approaches that inform our analysis.

Historical Institutionalism

Institutions are considered crucial for understanding the preferences and reform path a country takes. Skocpol emphasizes the importance of organizational designs of institutions 'along with their overall patterns of activity, affect political culture, encourage some kinds of group formation and collective political actions (but not others), and make possible the raising of certain political issues (but not others)' (Skocpol, 1985: 21). The importance of historical institutionalism is its facilitation of our understanding of the developments of ideas, ideology, religion, culture and politics and the relations between them (Berger, 1982) over a longer period of time. Putnam argues that 'where you can get to depends on where you're coming from, and some destinations you simply cannot get to from here. Path dependence can produce durable differences in performance between two societies, even when the formal institutions, resources, relative prices, and individual preferences in two are similar' (Putnam, 1993: 179).

According to Skocpol, historical institutionalism 'views the polity as the primary locus of action, yet understands political activities, whether carried out by politicians or by social groups, as conditioned by the institutional configurations of governments and political party systems' (Skocpol, 1992: 41). This is significant when studying the developments in CEECs, which moved away from communism to a democratized system based on market economy principles. In historical institutionalism it is important to examine the choices and decisions made by political leaders regarding 'how much of the past to preserve in the modern political system' (Berger, 1973: 334). This falls under the concept of 'contextual causality' in which the 'causal workings of institutions may depend upon their historic contexts, which include the interpretations that political actors bring to institutions' (Immergut and Anderson, 2008: 353) – which was the case of the Czech Republic and Slovakia following their separation in 1993.

Constructivism, European Identity and Europeanization

In order to understand the decisions taken, let us first examine constructivist insights regarding the role of identity in political decisions. In fact, the issue of identity, the role of ideas as well as the usage of money as a symbol has been often ignored by political scientists studying euro accession strategies (Dyson 2007; Johnson 2008). Constructivists emphasize how ideas and identities are created, how they evolve, and how they shape how states interpret and react to their situation. Since the introduction of the euro and the expansion of the euro area eastwards, ideas and identities have been influencing the attitudes of euro area citizens and the way they identify themselves in European or national terms (Walt 1998; Risse 2003).

Following the end of the Cold War, the Europeanization process has been affecting decisions and politics in all New Member States (NMS). Various scholars point to a fast trend of institutional development that has been going on not only due to the EU incentives but also due to a social learning process (see Checkel, 2001; Schimmelfennig and Sedelmeier, 2004 and 2005). The effect of social learning and incentives can change due to issue area, time and different circumstances. It became easier to evaluate these factors especially after May 1, 2004 when the NMS joined the EU. Central banks are among the institutions that underwent changes and institutional developments and were affected by this trend. One of the main beliefs that were transferred to CEECs is the importance of central bank independence in the transformation process. Or to quote Juliet Johnson: 'protecting price stability and central bank independence is the key to economic development in democratic states' (Johnson, 2006: 363).

Despite the importance of the social learning process that was taking place involving international players and some epistemic communities (Haas, 1992), social learning is not able to explain the whole story, since the domestic politics situation has to be conducive to the change. This was not the case all the time as in several situations these ideas faced confrontation, which brings us to the domestic politics approach.

Domestic Politics

A domestic politics approach (inter alia Bulmer, 1983; Huelshoff, 1994; Ladrech, 1994; 1998; Elster, Offe and Preuss, 1998; Heipertz and Verdun, 2010), informs us why a government chooses one policy over another and is best able to explain the specific timing of policies. The elite's preferences and choices affect the outcome of the policy. The institutional, political, economic and public readiness to adopt the euro is highly dependent on the elites' decisions. Furthermore, the government's ideology and choices affect the central bank's policies and personnel such as appointing euroskeptic members to the national central bank's monetary council. Thus, policies that favor euro adoption depend on the presence of a euro enthusiastic government implementing sound economic policies that would allow the country to meet the convergence criteria and adopt the euro.

These domestic factors are not operating in isolation from the international economic factors. For instance, the EU could impose sanctions on member states if excessive deficits exist.[1] The global financial crisis of 2008-2009 showed that international events may have an important influence on the calculation of the costs and benefits associated with being part of the euro area. However, these effects can differ based on the domestic situation of the country.

Explanatory variables

From these three approaches we deduce five possible explanations regarding euro adoption outcome and the performance during the euro crisis:

First, *the inferiority argument*: Being less advanced and underdeveloped under communism and during the early 1990s created a sense of inferiority that the Slovaks wanted to get rid of. So joining the euro while the Czech Republic did not, would send a clear message to the Czechs and other EU countries that the supposedly ‘last’ would be among the ‘first’ newcomers to the euro area. It also presumably gives Slovakia a more influential role in the EU, as it is a partner in an important policy area. Therefore, Slovakia sought to adopt the euro to overcome an inferiority complex; while the Czech Republic did not have this issue in the same way.

Second, *European identity*: the sense of European identity might have pushed the newly established countries not only to join the EU but also rush to adopt the euro. Following independence, the image of Slovakia, as held by non-Slovaks, was that it was not Europe-oriented – especially during the mid-1990s when economic and political reforms slowed down with increased limitations to the freedoms and civil liberties under Prime Minister Mečiar. Thus, for Slovaks it was important not only to join the EU but also join the euro area and strengthen the status and influence of Slovakia at the EU level. It gave Slovakia a stronger sense of identity that was missing when it was still part of Czechoslovakia. Following the constructivist literature one could examine whether euro adoption was part of a ‘return to Europe’ strategy. In this case, the euro adoption strategy was used to create a stronger sense of belonging to Europe.

Third, *the symbolic factor:* the sentimental feeling regarding losing the Slovak koruna was not significant since it was a new currency that existed for very few years post independence. There is some literature that suggests that new currencies can be an expression of national identity and thus that these countries in search of identity would not easily give up the currency. The majority of the literature suggests that a young currency is not fully anchored into people’s self-identification with the currency as an important token of national identity (Gilbert and Helleiner, 1999). So it was no problem to accept the euro in Slovakia because the Slovak koruna was not seen as a currency important enough to salvage. As for the Czech Republic, it retained the Koruna, so the Czechs might be more attached to their old currency.

Fourth, *euroskepticism:* there are different degrees of euroskepticism/euro enthusiasm in both countries. One might be able to trace the underlying reasons to the reform path: the political, economic and institutional reforms taken by both countries might have led to different outcome. The highly euroskeptic attitude in the Czech Republic – reflecting the Czech president's euroskepticism – in comparison to Slovakia could have affected the attitude towards the euro and caused the Czech Republic to stay outside while Slovakia joined the euro area. The degree of euroskepticism in the Czech Republic and the lack of that same euroskepticism in Slovakia (post Mečiar) can explain their differing policies towards euro adoption.

Fifth, *economic structure and trade relations*: the economic structure and trade relations in Slovakia – especially automobile industry – with Germany accompanied by the perceived economic benefits contributes to Slovakia's more speedy euro adoption strategy. The Czech Republic did not have exactly the same push from euro area trading partners. The diversity of the Czech economy in comparison to the Slovak one (more dependent on the automobile industry in comparison to the Czech Republic) affected the efficiency of the automobile industry lobby in pushing for euro adoption. Therefore, the trade relations of Slovakia with Germany and other partners, compared to that of the Czech Republic, put Slovakia in a position that was more favorable to euro adoption policies.

Following this brief analysis of our analytical framework and the variables deduced from the theories, in which we argue that a mix of these three approaches is needed to understand why Slovakia adopted the euro, while the Czech Republic is still outside. The next sections examine the methodology and the five possible explanations that are deduced from the different theoretical frameworks.

3. *Methodology and Case Selection*

The selection of the cases in this paper is based on the Most Similar System Design. Why is it that two countries, that used to be one, end up having very different policies regarding euro adoption? In this paper we analyze which of the five variables are may be best able to explain the different outcome.

The analysis in the paper is based on (1) primary literature, such as reports by governments, central banks, European Commission, public statements made by EU officials and national governments' officials; few presentations by key informants at conferences (2) secondary literature, i.e., books, journal articles, newspaper articles, etc., and (3) elite interviews with key informants, such as members of ministries of finance, national central banks, in addition to officials and academics involved in the euro project in both the Czech Republic and Slovakia.

The primary sources are consulted to analyze the different policies adopted by the NMS, how they originated, why they were implemented and what is the expected outcome to be achieved from such policies. Then we examine which factors determine such policies and their outcome. In this second stage, we use secondary literature and interviews to find answers to our research question. The interviews with national government officials and key influential players who have been involved in euro adoption were conducted between April and July 2009. By conducting the interviews at that stage of the project, we were able to have a better understanding of the cases (as the research on primary sources was done prior to the interviews) and the questions were directed to find answers that could not be found in the primary sources. Moreover, the interviews were conducted at a critical moment: in the midst of the 2008-2009 financial crisis.

4. The Inferiority Argument – Does it hold?

Even prior to Communism, before the creation of Czechoslovakia following the end of the First World War, the Czechs were the more dominant group of the two. The Slovaks had little influence on the form and functioning of the newly established state at that time (Goldman, 1999: 3). The situation did not change with Communism in which the economic inequality and gap between the advanced Czech and less privileged Slovak lands continued. Prior to the Velvet Divorce, the Czech part of former Czechoslovakia was more advanced and dominant politically, economically and technologically. Following the separation, Slovakia inherited this underprivileged situation, yet managed to develop its economic situation, meet the convergence criteria and adopt the euro. Can this commitment be attributed to the inferiority feeling that pushed the Slovaks to do everything they can to overtake the Czech Republic development and progress?

The road to the EU and later Economic and Monetary Union (EMU) was not easy but is considered a historic moment for Slovakia. For hundreds of years, Slovakia had been a subordinate part of Hungary – and later in Czechoslovakia. It did not have its own state. Thus, joining the EU brought contentment to the Slovaks and strengthened the statehood of the country that became a sovereign member in the EU. These steps that Slovakia took, moved it ahead of other NMS – including the Czech Republic – that were considered more advanced and superior. Slovakia had till then always been left behind. With European integration it moved forward and become among the pacesetters '[it] makes Slovaks proud' (Interview with official at the National Bank of Slovakia, November 23, 2009).

Many politicians and the public considered adopting the euro in Slovakia as a worthy goal. Independent of any economic cost-benefit analysis for Slovakia, adopting the euro was the next rational step after accession to deepen the integration further. The fear from the past in which Slovakia was left behind and did not have its own voice created a large public and political support to adopt the euro (Interview with official at the National Bank of Slovakia, November 23, 2009). Furthermore, for centuries Slovakia lived on the periphery of international movements, Austro-Hungarian Monarchy in which Slovak were a minority and then in Czechoslovakia they were the minor of the two nations. Now the country is independent and it did not start successfully from the point of view of international community in which there was mistrust with earlier governments who were not considered to be EU or Western oriented. Now there is satisfaction in Slovakia that they are 'among first class in Europe', have same privileges as Germany, France, etc., share the same currency as those countries and were faster than others such as Czechs, Hungarians and Poles to adopt the euro and thus join the euro area that contained the major EU countries (Interview with official at the National Bank of Slovakia, November 23, 2009).

The psychological factor played an important role in pushing the Slovaks towards the euro and integrating further as it gave them satisfaction that the ‘last can be first’ and sit along with Germany, France and others not only in the various EU meetings but also in EMU meetings and ECB meetings – having an equal vote in the process. It also gave them the feeling that it is the first time in history during which they have a major say in important decisions and be part of a larger union illustrated by the fact that they can sit in and have a voice in EU meetings as an independent sovereign state.

5. *European Identity and the Return to Europe*

While there is almost an agreement in the academic literature that joining the EU marked a critical moment that brought NMS back to Europe, yet from the point of view of the NMS, things are perceived differently. Perhaps surprisingly, many do not agree with that depiction of the relevance of EU accession. In fact, when it comes to euro adoption, it is even less significant. For Slovakia, for example, during the interviews conducted there, most interview partners signaled that this slogan does not make much sense as they have always been in Europe, ‘nowhere to return to’ (Interviews with officials from the National Bank of Slovakia and Ministry of Finance, November, 2009). One official argued that maybe Slovakia was isolated from benefiting from Europe, but never left Europe. It was mainly a return institutionally back to Europe. The slogan ‘return to Europe’ was rather a politically ‘empty’ one, does not hold solid ground and does not reflect the reality as ‘we always felt Europeans’ (Interview with official at the National Bank of Slovakia, November 23, 2009). Indeed, Slovaks are among the five member states that identify most with the Europe, as 44 and 45 per cent in 2009 and 2010 respectively feel both ‘national’ as well as ‘European’ (European Commission, 2009 and 2010).

For Czechs, EU accession was a signal of returning to Europe. But euro adoption did not have that same connotation – although some added that ‘we always have been in Europe and never left’ (interviews with officials from the CNB and MoF, June 2009). In an interview by *Die Zeit* (2003), Czech President Klaus answered a question regarding EU accession by saying that the Czech Republic did not have a choice since the Czech Republic has been and will always stay part of Europe. ‘Today, one cannot exist without EU membership in Europe. This is a marriage of reason, not of love. For a Central European country which is not located on an island or on the edge of Europe, it is simply impossible not to join the EU’ (*Die Zeit*, online edition, 17/2003).

In history, Czechs have always been within ‘the German zone of influence’ so interview partners stressed: ‘why to pretend now otherwise and that the EU accession marks a return to Europe?’ The relevance of euro symbolism and that of the image of ‘return to Europe’ are not that significant (interview with official from the CNB, June 2009). Czech interview partners pointed out that the Czech Republic, and even Slovakia, has always belonged to Europe as it was at the crossroads between the East and the West, and Czechs ‘detested being classified as East European’ since it is a central European country (Brodský, 2003-2004: 10; see also Holý, 1996). For Czechs, the *Return to Europe* slogan is mainly returning ‘to a Europe to which they have always felt they belonged, and with which they have always claimed to have had strong cultural and historical ties’ (Brodský, 2003-2004: 10).

In both the Czech and Slovak cases, the European identity and return to Europe is not that significant not only with respect to the euro adoption but even regarding EU accession in which the interviews supported the argument that both countries have always been part of Europe even during the Cold War.

6. *Symbolism and Attachment to the Currency*

Slovaks did not really care about what the currency would look like, or what its name would be, since these matters do not affect their wealth. Slovaks until now do not connect much with a currency; they do not identify with it. They care more about how much money they make, how much they can buy with it and do not care whether it is in euro or in koruna. Yet one official added that people would definitely feel more European by having the euro in their pockets. However, he adds that this is more 'structured'. For example those who travel more would have a stronger feeling of European belonging by having the euro. Yet, this group is relatively small in comparison to the group of Slovaks who never left their country or just been to some neighboring countries such as the Czech Republic or Hungary. It does not really affect the way Slovaks feel about being European (interviews with officials from the National Bank of Slovakia, November 23, 2009). As was mentioned above, Eurobarometer data supports this argument, as Slovaks who feel both European and Slovak is about 44 per cent. Although 65 per cent of the Slovaks think that the euro is the main aspect of European identity (European Commission, 2012: 28), however, the percentage change of those who feel more European because of the euro in Slovakia is around 22 per cent while 76 per cent feel no change at all. Moreover, with the euro crisis and the economic difficulties faced by Slovakia, the national feeling is increasing at the expense of the European one.

Similar to Slovaks, most Czechs tend to think more in economic terms when it comes to euro adoption. Close to ninety per cent of the population thought about the costs and benefits of adopting the euro with respect to their salaries, pensions and personal accounts as having priority over other issues. In other words, how much they can buy with their salaries takes precedence over other concerns. One important difference with Slovakia is that around 67 and 61 per cent of the population in 2009 and 2010 respectively, thought that using the euro will make people feel more European (European Commission 2009 and 2010). This is mainly due to the fact that larger percentage of Czechs tends to travel abroad compared to Slovaks.

At the same time, Czech citizens did not consider the euro adoption issue to be all that important and did not view it as a priority or cause of stability (interviews with officials from the MoF, June 2009). Compared to other NMS, the Czech Republic is the most euroskeptic country of all those that joined the EU in the 2000s. Eurobarometer data for 2009 show that 54 per cent of the population was dissatisfied with the fact that the euro will replace their currency at some point while only 37 per cent was content with that prospect. Czechs 'like their currency' that has been strong and dates back to the 1920s (interview with official from the CNB, June 2009). Even during Communism, Czechoslovakia had a stable strong currency compared to other Communist countries. Czechs are '…very pragmatic. They have a preference for a stable currency. But as such the euro has nothing positive. Maybe they use it for travelling but not really associated with the issue of being more European or closer to the EU, if they had the euro as the currency' (interview with official from the CNB, June 2009).

So the symbolic effect of the euro is absent in the Czech case (interview with officials at CNB and MoF, June 2009). The Czechs are proud of the koruna and the Czech sovereignty (interview with key informant from Euro Team, June 2009). The Czech Republic have had a strong koruna and given the problems of the euro (weakened after its launch) and now the sovereign debt crisis, this situation increased the national symbol of the Czech koruna. It further lowered the trust in the EU institutions to 37 per cent in 2012 and increased the Czech 'fear that the crisis will ruin their car industry, the main pillar of the national economy' (*EUobserver,* January 25, 2013). This situation makes it harder for people to accept another currency and strengthened the euroskeptic view that was fostered by the former Czech President Klaus.

7. *Institutional, Political and Economic Reforms*

Most of the literature dealing with Europeanization in the NMS focuses on institutional effects. Our focus is on the effect on the CNB and some important reforms taken by the consecutive Czech governments. The continuous Europeanization process and the NMS entry to the EU affected not only the parties' ideology and party system but also the domestic politics (see Baun, Dürr, Marek and Šaradin, 2006). This process also served in creating the suitable environment for adopting the German model of independent central banks. Many EU and international financial institutions such as the Deutsche Bundesbank, Bank of England, International Monetary Fund (IMF), World Bank, Federal Reserves, Bank for International Settlements (BIS), etc, served in pushing these countries to adopt the necessary political, economic and institutional reforms to join the EU and later adopt the euro. These Western institutions provided the necessary training to a large number of those who work in the central banks including the Czech National Bank (CNB) and the National Bank of Slovakia (NBS) leading to a social learning process and transfer of 'ideologies, practices and internal organizational frameworks' (Johnson, 2003: 3; see also Johnson 2006; 2008).[2] Add to this the EU programs – such as Phare – which aimed at providing the Czech Republic and Slovakia with the necessary technical, financial and institutional assistance to move both countries away from the Socialist system to a new market economy similar to its fellow EU countries and to implement the EU *acquis.*

i. The Czech Case

In the case of the Czech Republic, the EU and other international institutions provided the necessary training and guidance, technical assistance and development to move the Czech institutions and their employees away from the socialist era and enable the various them to be more ready to play an important role in the developments needed regarding economic liberalization and being an active member in the EU. Experts from the EU members were also involved in the training process in order to 'familiarize bureaucrats in the Czech Republic […] with EU policy compliance' which resulted in the extensive diffusion 'of EU practices in the Czech financial and banking sector' (Vliegenthart and Horn, 2007: 148). This has created a financial epistemic community that was involved in the various financial institutions, such as the CNB, MoF, Czech Securities Commission, think-tanks, that adhere to the ideas and believes of the EU *acquis* and EMU and moves the Czech Republic and the NMS closer to the rest of the EU members.

The transfer of ideas, technical assistance and socialization led to the privatization that had as goal to transform the country into a capital-market economic system. However, this privatization process was not accompanied with the creation of 'a regulatory framework to keep these development in check' (Vliegenthart and Horn, 2007: 142). This led to missing a very important institutional reform and consequently that corruption still exists within the banking system, which did not follow suite regarding privatization, and meant that the ties between government officials and state-controlled banks was not severed. Besides, few years have passed since the Prague Stock Exchange started functioning and still there was no 'independent regulator' (*The Economist*, May 29, 1997).

All these developments led to the currency turmoil, economic recession and market failure in 1997. This pushed the Organization of Economic Cooperation and Development (OECD) to state that one of the building blocks of good governance and economic performance in the Czech Republic is the privatization of the state-owned banks (OECD, 2000: 79). However, the Czech government policies at that time regarding banks privatization was not very aggressive and not really taken seriously until it was hit by the 1999 financial crisis which led the government to the believe that fast action had to be taken (Vliegenthart and Horn, 2007: 143). This delay was not costless since it affected the overall economic performance and the 'market value' (OECD, 2000: 79). Such attitudes from the Czech elites showed that despite the learning process and socialization, what mattered most were their perceptions and decisions.

The social learning process played an important role in creating a pro-EU financial epistemic community that was involved in the various Czech financial institutions (such as the CNB, Czech Ministry of Finance, Czech Securities Commission, think-tanks). This community adhered to the ideas and beliefs of the EU *acquis* and helped move the Czech Republic closer to the rest of the EU members (Johnson, 2006; Vliegenthart and Horn, 2007). Moreover, there was a variety of EU programs – such as Phare program – which aimed at providing the institutions and administrations in the Czech Republic and Poland, such as the MoF and CNB, not only with the technical assistance but also to move the Czech Republic to a new market economy similar to its fellow western EU countries and to implement the EU *acquis* (Vliegenthart and Horn, 2007: 146-148). Since the Czech Republic and all CEECs wanted to move away from communism and rebuild their economies and institutions, they did not really have any other option but to accept what the EU and the international community offered: to ensure they become democratic, market oriented countries. One of the major things to be done was creating an independent central bank.

The establishment of this network of central bankers' community led to the creation of an independent CNB in 1993 that is far from the day-to-day calculations of the government. This is something that politicians do not favor and created a troubled relation with the CNB at least between 1997 and 2005 when the CNB board and the government had different views regarding macroeconomic policies and euro adoption.

Another important issue was the democratic system that emerged after the fall of Communism. In the Czech Republic, the democratic system gave the president important powers. The two term presidencies of Klaus strengthened the role of the president further. In the Czech case, the role of the euroskeptic President Klaus is of particular importance. The President first took office in 2003 and was re-elected in 2008 for a second term that ended in March 2013. He is a euroskeptic and was a very influential figure on the Czech political scene. During his two terms, he appointed officials to the central bank's monetary board, who shared his euroskeptic views and thus did not favor a speedy euro adoption process.[3] Klaus argued that the main economic benefits of European integration are the trade liberalization and the flow of Foreign Direct Investment (FDI). Any 'further economic or non-economic unification will be close to zero, if not negative' since Klaus believed that the costs of adopting the euro outweigh the benefits (Klaus, 2003). Klaus, 'a trained economist', 'saw the problems that a single currency would bring even before the euro was formally launched. […] the euro would create serious problems for the countries that accepted the single currency in place of their own national currencies' (Feldstein, 2011, online edition).

Despite the departure of Klaus, euroskepticism might prevail for a while. This euroskepticism is supported by the euro crisis, the view that the EU economic instability is to blame 'for the increasingly sharp downturn in the country' and the Czech history that created a belief that 'small-sized states must protect their sovereignty at all costs' (*EUobserver,* January 25, 2013).

ii. The Slovak Case

The early and mid-1990s were not impressive in the history of Slovakia. Following the Velvet Divorce, Slovakia started from an underprivileged economic situation characterized by decades of communist rule that privileged the Czech lands more. So Slovakia's economy and infrastructure were at a much lower place than the other NMS. In addition to that, the troubled political situation in the mid-1990s led to the exclusion of

Slovakia from the first round of EU accession negotiations. Yet, the economic reform started in the early 1990s and the political situation changed in the second half of the 1990s with the end of Vladimír Mečiar government's term.[4] All these changes allowed Slovakia to join the EU and be among the early NMS to adopt the euro in 2009.

Since we highlighted the role of Mečiar in creating a political situation that delayed EU accession negotiations, it is important to highlight the government and the president powers since they played important role in EU accession and euro adoption later. In comparison to the role of the presidency in the Czech Republic, the Slovak presidency is weaker and even more ceremonial. The strong position in the Czech Republic is not only because of the constitutional duties given to the president but also the personality of Klaus who was president between 2003 and 2013. So the weak presidency in Slovakia along with a strong independent central bank that has been pro euro did influence the euro adoption strategy. Although the president appoints and dismisses the governor and the vice governor, however, the appointment and dismissal of the monetary board is the duty of the government. This strengthens the independence of the central bank, which is different than in the Czech Republic where the president has a say in the appointment process.

Following EU accession on May 1, 2004, Slovakia took systematic and consistent policies regarding euro adoption with 2008-2009 as the target. In 2003, the NBS and Ministry of Finance published a report on euro adoption: *Strategy of Adopting the Euro in SR.* This report was followed by two other joint reports: *Specification of Euro Adoption Strategy and National Euro Changeover Plan for the Slovak Republic* (NBS and Ministry of Finance, 2003, 2004 and 2005). The government approved the euro adoption plan in

2005 which was confirmed with the new government following the 2006 elections that resulted in the *Direction-Social Democracy Party (Smer – sociálna demokracia*, Smer-SD) winning 29.14 per cent of the votes. While the major party in the former ruling coalition Slovak Democratic and Christian Union – Democratic Party (*Slovenská demokratická a kresťanská únia – Demokratická strana*, SDKÚ-DS) got only 18.35 per cent (Statistical Office of the Slovak Republic, 2006, online edition). The new coalition government led by Smer-SD leader Robert Fico did not change, however, the euro adoption target date and proceeded with the needed reforms to meet the convergence criteria. Along the same time, there were important in-depth analysis of the effects of the euro on various sectors in Slovakia such as on the economy, population and the business sector. All these studies were conducted by the NBS and confirmed that despite the costs the euro will be more beneficial for Slovakia (NBS, 2006; Árendás, 2006). The NBS believed 'that the Slovak economy could only fully exploit the benefits of monetary integration once inside the Eurozone area' (Pechova, 2012: 8).

Moreover, the government shared the same view of the NBS that adopting the euro is important to the development of the Slovak economy. Slovakia's position was to implement policies in favor of meeting the convergence criteria since they are considered 'inevitable, irrespective of accession. Effective public finance, education and health care systems, as well as a flexible labour market are essential for the problem-free operation of any economy' (NBS, 2003: 9). Both the government and the NBS agreed that all the required reforms to adopt the euro are 'a precondition for establishing a stable economic environment, reducing financial and monetary risks, and spurring the inflow of foreign capital' (NBS, 2003: 10).

8. *Economic Structure and Trade Relations*

Before dealing with the structure of the Czech and Slovak economies, it is important to ask the question, what are the perceived benefits and costs from euro adoption? How does each country measure the costs and benefits from the euro? According to some officials at the Czech National Bank, despite the argument that in the long term, euro adoption has significant macroeconomic benefits – at least by meeting the convergence criteria, countries will be more disciplined, that is debatable (interviews with officials from CNB, June 2009), since euro members have violated the criteria even before the financial and the euro crises. According to Czech officials, the main benefit of the macroeconomic outcomes would be price stability. This 'empirical evidence raises the question that if price stability is the only clear macroeconomic result of the euro area membership, what is left for a country [Czech Republic] that has achieved price stability on its own?' (Hurník, Tůma and Vávra, 2010: 194).

However, meeting the convergence criteria is a result of the political and economic policies of the consecutive governments, so in case there is a political will and sound economic policies to meet the criteria, then a country will manage to do so. Prior to the accession to the euro area, Slovakia managed to meet the convergence criteria, while the Czech Republic was very close to meeting them and in 2006 for example, it met the criteria on inflation, deficit, interest rate and debt (see tables 1 and 2).

[TABLES 1 AND 2 ABOUT HERE]

Since 2004, we could notice that the GDP growth of the Slovak economy has always been ahead of that of the Czech Republic with the exception of 2005 (see figure

1). The automobile industry in Slovakia accounts 'for 41 percent of overall industrial output' (*EUbusiness,* April 17, 2013).

[FIGURE 1 ABOUT HERE]

In the second half of the 1990s and early 2000s, the FDI flow into Slovakia increased considerably which was mainly due to the automobile industry, which was facilitated by an active foreign business lobby. These lobbyists (for example the German auto maker Volkswagen) pushed hard for euro adoption since their economic benefit would be significant (Haughton, 2010: 12; and interviews with various Slovak officials November 2009). The increase in car production has helped create thousands of jobs even after the economic problems of 2009 due to the crisis. The economic growth has benefited significantly from the Volkswagen (VW) plant in Bratislava, Peugeot/Citroen in Trnave and Kia in Žiline and the diversified international destination (such as South America, China, Brazil, etc.) (*Správy,* April 1, 2013). Thus the market for Slovak automobiles is not heavily dependent on the demand from EU countries only. Given that it is one of the largest employers in the country, with a significant share in the Slovak industry (41 per cent in 2012, see figure 2), means that the automobile industry lobby is one of the most influential in Victoria.

[FIGURE 2 ABOUT HERE]

The Czech Republic also relies heavily on the automobile industry; however, its economy is more diversified. The main foundations of the Czech industry 'are engineering and machine engineering, mining, chemistry and foodstuff production, followed by the energy industry, civil engineering and consumer industry' (The Czech Republic, Ministry of Foreign Affairs, 2013). The automobile industry accounts for around 19.8 per cent of the total Czech industry (see figure 3). This made the automobile lobby one important player among others which did not allow it to play a significant role in pushing for fast euro adoption.

[FIGURE 3 ABOUT HERE]

9. Financial and Sovereign Debt Crises

Prior to the ECOFIN Council decision on July 8, 2008 to allow Slovakia to adopt the euro as of January 1, 2009, the economic development of both countries had similar characteristics. Both economies were export oriented 'with their exports exceeding 80% of GDP [… and] exhibited a considerable level of nominal convergence before Slovakia's entry into the euro area was confirmed' (Jevčák, 2011: 2). By looking at 2007 for example, the inflation rate in both countries did not exceed the 3 per cent; interest rates in the Czech Republic and Slovakia were very close (around 4.3 and 4.5 per cent); the debt in both countries was less than 30 per cent of GDP and the deficit in both countries was within the reference value (see tables 1 and 2; also Jevčák, 2011). So has the exchange regime adopted by both countries influence their economic performance during the crisis?

Both crises affected the Czech Republic negatively, though not as bad as other countries (such as Hungary). The Czech industry – especially the automobile industry – suffered significantly. Most countries that the Czech Republic trade with were influenced negatively by the crisis and entered into recession. The negative effect of the crisis on the Czech main trade partners has had its implications on the Czech economy (see table 2). The growth of Gross Domestic Product (GDP) declined and the Czech Republic performance on the convergence criteria diverged from the levels needed to be ready for euro adoption, thereby giving the euroskeptic group a good argument against the fast accession.

Slovakia was not immune to the financial and sovereign debt crises effects. After having one of the highest GDP growth in 2006 and 2007 (8.3 and 10.5 per cent respectively), the GDP declined significantly the in crisis years (see table 1 and figure 1). However, with respect to GDP, it still performed much better than the Czech Republic during the crisis except for 2009 (see Figure 1). Moreover, the macroeconomic data also suffered from the crisis with deficit and debt increasing. In comparison to the Czech Republic, the deficit and inflation are higher than the Czech Republic as well as the unemployment rate that increased significantly. But we have to keep in mind that the unemployment rate in Slovakia was much higher even prior to the crisis (see Figure 4).

[FIGURE 4 ABOUT HERE]

According to the OECD (2009), the automotive industry was a blessing during the pre-crisis times and has become a curse in the post-crisis times contributing to the deteriorating economic situation. The global recession had a negative effect on the automotive industry that employs large percentage of the population. This situation is strongly related to the economic slow-down with the major trading partners – especially Germany, and the decrease in the demand for the Slovak products. Both the Czech Republic and Slovakia suffered from the decline of their exports (as a percentage of GDP) especially in 2009 before recovery started in both countries afterwards (figure 5).

[FIGURE 5 ABOUT HERE]

The relatively better performance of the Czech economy during the crisis with respect to the employment, deficit, 'real exports, as well as manufacturing production', the ‘overall financial market situation remained more stable in Slovakia’ (Jevčák, 2011: 10). This better performance at the financial level was facilitated by the ECB intervention that ‘was more aggressive and effective in easing monetary conditions than the CNB’ (Jevčák, 2011: 6). So generally speaking, it did not really matter much what type of exchange rate those countries had during the crisis as both economies performed somehow similarly. Being part of the euro lacking the flexible exchange rate did not really damage the Slovak export sector, ‘while euro-area membership provided an effective shield for its financial markets during the recent crisis period (Jevčák, 2011: 10).

Politically, the Czech government used the financial crisis, and subsequently the sovereign debt crisis, as a tool to support its position of delaying euro adoption. Before the crisis, the Czech Republic only missed two of the convergence criteria (inflation rate and the exchange rate). In the aftermath of 2008/2009 financial crisis, the economic situation has worsened. The entire effort of all groups (the CNB and both the government and opposition) is to deal with the fall out of the crisis – with euro accession not as a priority. Another matter that needs to be addressed by the elites is the reform of the pension system and the health care policies. Otherwise, there will be more pressure on the public debt and deficit which will lead the Czech Republic to lag further behind on meeting the convergence criteria. The crisis supported the long-standing position of ODS and the government that the Czech Republic will join when it is in its best interest. The population generally supports his position – they agree that joining the euro at the moment is a bad idea. *Medea Research* (in the Czech Republic) conducted an opinion poll in January 2011, which showed that 77 per cent of the Czechs are against euro adoption compared to 15 per cent who are in favor. The poll also showed that 57 per cent 'strongly disagree with joining the euro zone' (*Prague Daily Monitor*, March 4, 2011). The public is more skeptical regarding the entire European integration process in general and the euro in particular.

In Slovakia, despite all the problems the euro area is going through, the support for the euro remains among the highest. When asked by a Eurobarometer team if they are for or against a 'European economic and monetary union with one single currency, the euro', 80 per cent of the Slovaks were in favor (European Commission, 2012: T69).

10. Conclusion

We set out to analyze why Slovakia sought to adopt the euro while the Czech Republic did not. Let us revisit the arguments that we investigated to find out what different variables explain the different outcome in both countries.

The first explanation was Slovakia sought to adopt the euro to overcome an inferiority complex. The Czech Republic did not have this same issue. The paper showed that on the whole Slovaks indeed did feel inferior to Czechs. Some of the interviewees responded that the euro adoption strategy was inspired by seeking to overcome the inferiority complex, the 'little brother syndrome'. But not all interviewees agreed that this factor was present let alone decisive.

The second explanation, that the euro adoption strategy was used to create a stronger sense of belonging to Europe, was refuted with regard to both countries. The interviewees in both countries did not agree that the adoption of the euro was to signal a return to Europe. Thus, the ‘return to Europe’ argument was not seen to be important in either country.

The third explanation was that it was no problem to accept the euro in Slovakia because the Slovak koruna was not seen as a currency important enough to salvage. The Czech Republic had the same situation, however, and thus it could have been a non-issue for the Czech Republic as well. In the case of Slovakia, people did not have a strong preference for what currency they use. They care more about economic wealth than whether the national currency is the euro or the koruna. Compared to the Slovak case, the Czechs are proud of the koruna and its function of symbolizing Czech sovereignty.

The fourth explanation, that the degree of euroskepticism in the Czech Republic and the lack of that same euroskepticism in Slovakia over the same time period can explain their differing policies towards euro adoption, was supported by the analysis. Euroskepticism in the Czech Republic gained in importance with the election and further gained strength with the re-election of Vaclav Klaus (2003 and 2008 respectively). His euroskepticism has been very important on the Czech political scene. Not only did Klaus, when president, influence public opinion and policies, he also appointed euroskeptic officials to the central bank’s monetary board. In the case of Slovakia in early years since the velvet divorce the figure of Vladimír Mečiar had a similar dampening effect of European integration. However, once he left office in the late 1990s, Slovakia went into ‘catch up mode’ and managed to join the EU in 2004 (earlier than initially feared). Since that time such a strong euroskeptic person has been absent in Slovakia.

The trade relations of Slovakia with Germany and other partners, compared to that of the Czech Republic (the fifth explanation) put Slovakia in a position that was more favorable to euro adoption policies. In interviews we found support for this hypothesis in the case of Slovakia. There were various references to the automobile sector and FDI from Germany to Slovakia. The same strong connection is absent in Czech Republic. It is not certain whether the situation in the Czech Republic is that different on this matter but perhaps other factors are more important to determine the Czech stance on euro adoption (for instance euroskepticism of the President).

As mentioned at the outset, the economic cost-benefit analysis is not as important as explanations that focus on domestic politics, since both euroskeptics and euro enthusiasts can use a cost-benefit analysis to make their case. Moreover, for an open, small export-based economy, with a small domestic market such as Slovakia, some would argue that it would be in the economic interest of Slovakia to join the euro area as soon as possible but a similar argument could be made for the Czech Republic.

Furthermore one could argue that either country could also have chosen the fast or the slow route. Reviewing the five explanations we find that to understand the different outcome in the Czech Republic and Slovakia we need a combination of explanations. From an assessment of the five explanations we conclude that the dominance of the Euroskeptic President in the Czech Republic was an important reason why the Czech Republic was not interested in a fast path to euro adoption. In the Slovak case it seems that the absence of a Euroskeptic leader plus the fact that it had a weaker starting point were crucially important. With Klaus having left his position, euroskepticism seems to prevail for a while in the Czech society supported by the euro crisis and economic instability in Europe.

The points that stand out are that Slovakia wanted to profile itself, did not feel the need to demonstrate national identity and wanted to adopt the euro before the Czech Republic as a way to overcome its inferiority complex. The lobby from the automobile industry also played a role – albeit it a minor one. All in all, one can conclude that if a few factors would have been different in either country, the euro adoption strategy could have been different. But the specific existence of various above-mentioned factors meant that in the one country the government rushed to euro adoption (Slovakia) whereas in the other country (Czech Republic) its counterpart did not make similar strides towards euro adoption.

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[1] As per the convergence criteria, EU member states are not allowed to breach the 3 per cent reference value regarding their deficit except: (a) if the percentage of deficit to the GDP has been corrected and has come close to the reference value; (b) if the violation of the deficit criteria is only temporary and due to exceptional circumstances. In case the percentage of public debt to GDP exceeds the 60 per cent reference, then the debt of this country will be considered excessive (and in violation) unless the debt is improving and coming close to the reference value (*Consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union* (henceforth 'Consolidated Treaties') Article 126: Paragraph 2) (Ex Article 104 of the Treaty Establishing the European Community (TEC); see *Official Journal of the European Union* C321 2007 and *Official Journal of the European Union* C 83 2010).

[2] The creation of such ideology among central bankers does not mean that the economic outcomes will be the same domestically (for a discussion see Johnson, 2003).

[3] The current board members are either against euro project or euroskeptics (interviews with officials from CNB, June 2009).

[4] Mečiar, who was the prime minister for around 8 years (three terms from 1990-1998), detached Slovakia from its neighbors economically, politically and delayed the reforms (Allam, 2006: 191). The EU and the West criticized Mečiar for turning Slovakia into an autocratic regime.