

## EUROPEAN MONETARY UNION, THEORY AND PRACTICE: THE SLOVENE EURO AND THE FUTURE OF EMU

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### **I. Introduction**

The European Monetary Union (EMU) had a long history before the single currency, the euro, was introduced in 1999, but the entry of the actual euro banknotes and coins into circulation on 1 January 2002 made the idea of EMU both very real and seemingly irrevocable. Eleven states qualified to join the euro upon its launch in 1999, with Greece joining as the twelfth member in 2001.<sup>1</sup> Of the ten states that joined the European Union (EU) on 1 May 2004, Slovenia became the first to qualify to adopt the euro, on 1 January 2007, and that experience will be the focus of this paper.<sup>2</sup>

Slovenia is a young state, having gained independence in 1991 from the Socialist Federative Republic of Yugoslavia, and having previously been ruled by a succession of foreign powers including the Franks, the Venetians, the Hapsburgs, Napoleon, Fascist Italy, Nazi Germany, Hungary and the Serbian monarchy. Having achieved full sovereignty only recently, it might seem strange that independent Slovenia almost immediately sought EU (and NATO) membership. Perhaps the Slovenes believe in the idea of safety in numbers: With only two million Slovenes and a long history of uneasy relations with (if not outright domination by) their neighbors, the assurance of equality with the other nations of Europe within the political structure of the European Union must seem like a good deal.

Whatever the motivation, Slovenia quickly emerged as the best-prepared candidate country by the time of its actual accession to EU membership, became the first of the new members to adopt the euro just two and a half years later, and capped off its achievements by being the first of the new members to hold the rotating presidency of the EU, from January to June 2008.

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<sup>1</sup> The founding members of the eurozone were: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

<sup>2</sup> The others joining in 2004 were Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, and Slovakia. Bulgaria, and Romania have also since joined the EU, in 2007. Both Cyprus and Malta adopted the euro in 2008, and Slovakia in 2009.

The paper is organized as follows: the first section after this introduction reviews optimum currency area (OCA) theory, followed by a section looking closely at the Maastricht criteria. The fourth section looks at the mechanics of the Slovene accession to the eurozone, while the fifth section discusses the political connotations of the symbology used on the euro banknotes and coins themselves, particularly with regard to Slovenia. The sixth section briefly looks at what has happened in the Slovene economy in the first eighteen months after adopting the euro. Finally the conclusion notes the implications of Slovenia's experience for candidate countries and ponders whether the Maastricht criteria have outlived their usefulness.

## **II. Optimum currency area theory and EMU**

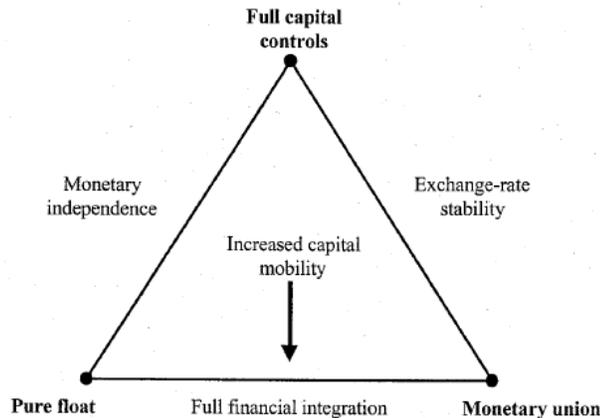
The underpinnings of European Monetary Union should be the theory of optimum currency areas (OCA). Robert Mundell, the major theorist in this area, developed his ideas in the late 1950s and early 1960s, when the Bretton Woods fixed-exchange rate regime still existed. His "A Theory of Optimum Currency Areas," published in late 1961, was part of a debate between advocates of the fixed-exchange rate regime and those who preferred flexible exchange rates. Rather than taking sides, however, Mundell instead concentrated on the question of when it makes sense to move from flexible to fixed exchange rates, or rather on the question of what are "the conditions that countries should satisfy to make a monetary union attractive, i.e. to ensure that the benefits of the monetary union exceed its costs" (De Grauwe 2006: 712).

One of the key insights in Mundell (1961) is that in order to be an OCA, an area must not be prone to asymmetric macroeconomic shocks since the easiest recourse following such a shock is intervening in the foreign exchange markets to alter the exchange rate. This is not an option for the affected area if it is in a monetary union. The only other way to adjust is by moving labor, but labor mobility is notoriously hard to achieve and usually not a viable option.

But Mundell also notes that the more open an economy is, the less useful the exchange rate will be as an adjustment mechanism. Large, closed economies are able to use it effectively, but small, open economies can not and therefore they would stand to lose very little by joining a monetary union. This point was illustrated by Frankel through his "Impossible Trinity" (figure 1), which states that it is impossible to simultaneously have (1) an independent monetary policy, (2) perfect capital mobility, and (3) fixed exchange rates (Frankel 1999: 7). An economy can be at any two points on the diagram, but not all three at the same time. Currently, the trend of increased global capital mobility is pushing towards the bottom of the diagram and away from full capital control, leaving pure floating

exchange rates and monetary union (fixed exchange rates) as the only options. So if a small, open economy cannot make effective use of monetary independence anyway, monetary union emerges as a viable option.

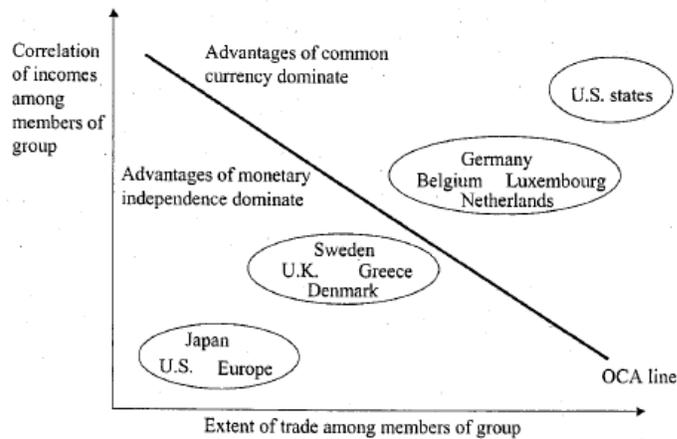
Figure 1. The Impossible Trinity (Frankel 1999: 7).



Frankel (1999) also uses another useful illustration (figure 2) that establishes what he terms the “OCA Line.” He establishes the key parameters of an OCA as being the “correlation of incomes among members of a group” and the “extent of trade among members of a group,” and the OCA line itself represents the combinations of the two parameters at which point the benefits of joining a monetary union outweigh the costs. The first parameter relates to the degree of symmetry in the economies considering the monetary union: the more economies are symmetrical, the less an adjustment mechanism is needed. Similarly, the more trade between two economies, the less symmetry is required, but, logically speaking, such a low degree of symmetry would itself argue against the formation of a monetary union because of the increased potential for asymmetric shocks.

According to Frankel’s reckoning, of the states that have joined eurozone, only Germany and the Benelux actually fall on the side of the OCA line where the benefits outweigh the costs; Greece (a member of the eurozone), and Denmark, Sweden and the UK (not members of the eurozone) all fall on the side where the costs outweigh the benefits (figure 2). De Grauwe (2006) builds upon Frankel’s OCA line image (figures 3 and 4), but alternates the trade parameter first with flexibility, and then with integration (defined similar to Frankel’s trade parameter).

Figure 2. Two key parameters in the OCA Criterion (Frankel 1999: 14).



De Grauwe (2006) nicely traces the evolution of what led to the ultimate realization of EMU. While the idea of EMU had been around for decades, based on Mundell (1961) “[t]he presumption of many economists at the end of the 1980s was that the EU countries should be located to the left of the OCA lines in (figures 3 and 4)—i.e., given the degree of integration achieved in the EU there was still too much asymmetry and too little flexibility for the EU to form a monetary union whose benefits would exceed the costs” (De Grauwe 2006: 714). This began to change in the early 1990s with the collapse of the European Monetary System (EMS), a post-Bretton Woods fixed exchange rate regime for European Economic Community members. “The EMS-crisis convinced many continental European economists that a choice had to be made for one of the two ‘corner solutions’ in exchange rate regimes, i.e. full flexibility of exchange rates or monetary union. Many decided that the latter would be the least bad choice” (De Grauwe 2006: 715).

That decision was bolstered by the elaboration of a new OCA theory based on a little-known paper Mundell published in 1973 that De Grauwe (2006) terms “Mundell II.” Here, the main idea is that floating exchange rates can be a major liability insofar as they can be “a target of destabilizing speculative movements and thus a source of asymmetric shocks.” By this logic, then, there is nothing to lose in giving up an exchange rate but rather everything to be gained insofar as the economy will be “eliminating a source of asymmetric shocks” (speculative attacks) (De Grauwe 2006: 714). Further, integrated capital markets within a monetary union actually operate as an “insurance mechanism against

asymmetric shocks” further sweetening the idea of monetary union (De Grauwe 2006: 715).

Figure 3. Symmetry and Flexibility as OCA Criteria (De Grauwe 2006: 713).

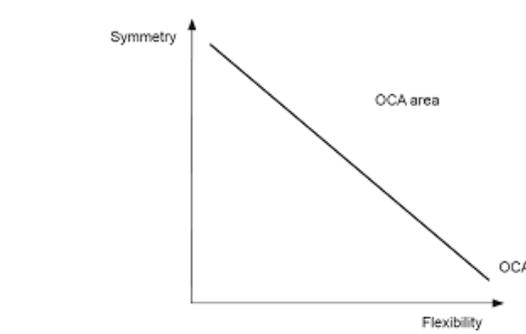
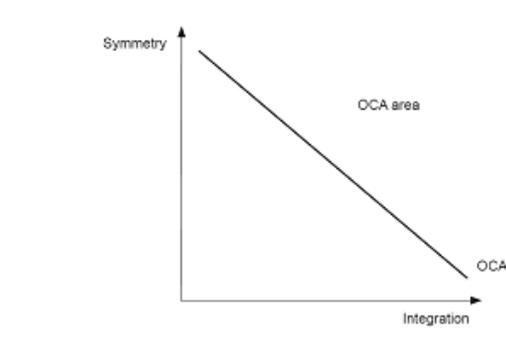


Figure 4. Symmetry and Integration as OCA Criteria (De Grauwe 2006: 713).



Mundell II was a monetarist theory stressing “that activist monetary policies become sources of instability and that central banks should focus on their core business which is to maintain price stability,” whereas Mundell I was Keynesian, “stressing that in a world of price and wage rigidities monetary policies, including exchange rate policies, can be used effectively to stabilize the economy” (De Grauwe 2006: 715). Monetarism was ascendant in the late 1980s, and this further facilitated the adoption of Mundell II and accelerated the final drive for EMU.

Ultimately, however, the final decision appears to have been a political tradeoff between France, leading a monetarist camp that believed a quick monetary union would lessen the overall cost, and Germany, leading

an economist camp that still felt monetary union would only be possible as the culmination of a long convergence process. With the fall of the Berlin Wall, France feared that a change in the balance of power in Europe was in the offing. In order to ensure Germany's continued involvement in the unification of Europe, the French gave EMU the final push, requiring that it go forward as quid pro quo for accepting German reunification. The victory of the monetarist camp was signed into EU law with the Treaty of Maastricht in 1992, which came into force on 1 November 1993. Feldstein (1997) was right on target when he wrote that

the decision will not depend on the economic advantages and disadvantages of a single currency. The decision of whether or not to form a monetary union will reflect deeply held political views about the appropriate future for Europe and about the political advantages and disadvantages to the individual countries and even to the individual political decisionmakers themselves... The actual decision will depend overwhelmingly on the preferences of the German and French political leaders. (Feldstein 1997: 23)

And that is exactly what happened.

### **III. The Maastricht Criteria**

Apart from providing the legal basis for EMU, the 1992 treaty also set the so-called Maastricht criteria that would determine when a country was ready to enter the final stage of EMU, the single-currency eurozone. The four criteria are:

1. an annual rate of inflation no greater than 1.5 percentage points higher than the average of the three lowest rates in the European Union (i.e., not just among eurozone members);
2. two criteria related to government finance: (a.) a budget deficit no greater than 3% of annual GDP; and (b.) government debt no greater than 60% of annual GDP;
3. at least two years spent in ERM (exchange rate mechanism) II with normal fluctuations ( $\pm 15\%$  of a central rate against the euro), without a devaluation; and
4. long-term nominal interest rates on government debt no greater than two percentage points above than the average of the three lowest-inflation countries' interest rates (again, among EU members rather than eurozone members).

There were also a few relatively minor technicalities, such as the fact that the central bank must be independent of political interference, and national legislation must be harmonized.

Clearly, these criteria do not have any connection to either Mundell I or Mundell II. “Only the fiscal criteria have any hope of being rationalisable in terms of optimal currency area considerations, and even there the connection is weak: the two Maastricht fiscal criteria are neither necessary nor sufficient for fiscal sustainability” (Buitert and Sibert 2006b: 5). There is nothing about unemployment, symmetry of economies, and so on. Even more troubling is the fact that the Maastricht criteria are not hard-and-fast rules but rather have proven easily malleable with sufficient political will:

So although the Germans had insisted on having “black tie only” on the invitations, everyone who wanted to join was admitted. The Belgians came in their lounge suits. The Italians and Greeks didn’t even have a jacket or tie! The whole episode demonstrated the political nature of the euro project, rather than any long-run economic viability. Believe it or not, more countries are lining up to join the euro today. Some are waiting outside the club dressed in jeans and trainers. (Durrant 2006)

Nevertheless, this may not be such a big problem if one adheres to a belief in endogenous optimum currency areas, which holds that economies that enter into a monetary union do not have to form an OCA from the start but will become one *ex post facto* by virtue of the monetary union itself. There are risks, however, given the Krugman Exception which holds that the specialization of regions in a monetary union creates asymmetries that actually take the union further away from forming an OCA (Frankel 1999: 24–26; De Grauwe and Mongelli: 2004). For now, though, it does seem that the eurozone is moving closer to becoming an OCA endogenously.

Euro supporters certainly would hasten to point out here that, despite the shoddy economics, the political *fait accompli* is a positive step for another reason: “...the single currency has had the psychological effect of binding together the Continent, easing cross-border purchases for consumers and reducing the cost of transactions” (Bilefsky and Wood 2006). Feldstein (1997) made a similar observation, though perhaps not with much optimism: “[t]here can be no doubt that eliminating individual currencies would be a major psychological and substantive step towards a European central government” (Feldstein 1997: 24).

Given the political nature of EMU and the lack of relevant, stringent criteria, it is puzzling that the states that joined the EU in 2004 and 2007 were not included in the eurozone immediately but rather have been

compelled to work towards fulfilling the Maastricht criteria (that many current eurozone members themselves no longer fulfill—if they ever did in the past). Moreover, the discussion of OCA theory above fully supports the position of Buiter and Sibert:

[f]rom the point of view of the economic fundamentals emphasized by optimal currency area theory, it is in the interest of all eight new Central European members (the CE8) to join the Eurozone as soon as possible. They are all too small, too open and too vulnerable to speculative attacks against their national currencies to be optimal currency areas. For the smallest ones among them, it is indeed doubtful whether a national currency is a viable option in the medium to long run. (2006b: 2)

Because the EU has insisted on maintaining the Maastricht criteria and interpreting them more strictly for potential members than for current members, the accession process has been slow going. In 2006, as will be described below, Slovenia was allowed to join the eurozone on 1 January 2007, while Lithuania was excluded for only a minor deviation (an inflation rate of 2.7 percent, just 0.1 percent over the limit at that time). Both Cyprus and Malta joined on 1 January 2008 and Slovakia on 1 January 2009. For the rest, eurozone membership must wait, despite the risks to the candidate states and the low probable cost to the existing members.

#### **IV. Slovene accession**

In 2006, Slovenia became the first of the new EU members permitted to join the eurozone, after years of working towards fulfilling the Maastricht criteria. The accession process culminated in convergence reports issued by the European Commission and the European Central Bank (ECB) in 2006, which led to an invitation by the European Council to join the final stage of EMU and, finally, to adopt the euro.

The convergence report of the European Commission reviewed the harmonization of national legislation, went through each of the Maastricht criteria and evaluated progress since the previous convergence report undertaken in 2004. Sufficient progress was deemed to have been made on harmonization of legislation. Price stability was recorded at 4.1 percent, well above the 2.4 percent limit in 2004, but the twelve-month average in March 2006 was just 2.3 percent against the now 2.6 percent limit; Slovenia fulfilled the inflation criterion. The two criteria related to government finance were already fulfilled in 2004, and continued to be so in 2006. While Slovenia had only been in ERM II for two months at the time of the 2004 report, by 2006 it had successfully stayed in ERM II for twenty-two months and has “stayed close to the central rate with maximum deviations

of 0.16 percent on the depreciation side and 0.10 percent on the appreciation side of the fluctuation band.” Finally, Slovenia had also fulfilled the interest rate criterion in 2004, and in 2006 it did so again, with its 3.8 percent rate well below the 5.9 percent limit. The report concluded: “In the light of its assessment on the fulfillment of the convergence criteria, the Commission considers that Slovenia has achieved a high degree of sustainable convergence” (European Commission 2006). The ECB convergence report echoed that of the EC. The ECB did not make a final recommendation, but it was clear that Slovenia had fulfilled all of the criteria for membership in the eurozone.

On 11 July 2006 the European Council—or more specifically the Economic and Financial Affairs Council (ECOFIN)—accepted the two convergence reports and announced that it had decided to allow Slovenia to join the eurozone, effective 1 January 2007 (Council of the European Union 2006). Six months were thus provided to organize the changeover from the Slovene currency, the tolar (SIT).

The method chosen for the changeover was the so-called “Big Bang” approach—the “irrevocable locking of the exchange rate and simultaneous introduction of the euro banknotes and coins.” As of 1 January 2007, the euro and the tolar circulated simultaneously, with the tolar to lose its position as legal tender after two weeks (though tolar can still be exchanged for euros even today at the national bank). Ultimately, “[m]ore than 80% of the tolar banknotes, in value, had been returned to the Slovenian central bank by 11 January 2007, compared with only 40% of the legacy notes in the first wave of countries (i.e., 2002)” (European Commission 2007).

One of the few issues that emerged during that process, though minor, stemmed from the fact that the final exchange rate was set at SIT 239 = 1€, making for some difficult math for consumers. The government foresaw this, however, and distributed 760,000 free calculators which seems to have worked (Bilefsky and Wood 2006). The fact that prices legally had to be displayed in both tolar and euro (at the central parity exchange rate) beginning as early as 1 March 2006 was a further help.

The Commission was upbeat: “The changeover to the euro in Slovenia was a swift and smooth affair and although the price of some goods and services increased, overall inflation has remained broadly stable....” It was also noted that not only did the “Big Bang” approach work, but it appeared to work better than the gradual process used when the euro was first introduced in 1999, with euro coins and banknotes only being distributed beginning in 2002. The Commission took this as a lesson for

future enlargements, since it was useful for “minimising costs and burdens on businesses” (European Commission 2007).<sup>3</sup>

Another factor contributing to the successful changeover was the “fact that Slovenians were already familiar with the euro owing, in particular, to their proximity with euro-area members Austria and Italy,” which also bodes well for future enlargements, since many of the other likely candidates also will be familiar with the currency from their eurozone neighbors (European Commission 2007).

Slovenes themselves were enthusiastic about the coming of the euro, though a general fear of price hikes was omnipresent. The Commission judged this to have been overstated. While some “unusual rises” were noted, the overall effect was minimal:

Based on the preliminary information reported by the Slovenian statistics office, Eurostat puts the total impact of the changeover on consumer price inflation during and after the changeover period at 0.3 percentage points, which is similar to the experience of the first-wave changeover. A separate study by the Institute of Macroeconomic Analysis and Development of Slovenia estimated the effect of the changeover on inflation at 0.24 percentage points. (European Commission 2007)

Nevertheless, beginning in April 2006 the Slovene Statistical Office had undertaken a special project specifically designed to detect euro-related price hikes, and found little of note – until the month before the changeover. At that time, various prices rose primarily due to the “upward rounding of prices” largely to account for the awkward tolar-euro exchange rate. The biggest incidents concerned prices in restaurants and cafes, which spiked up to 3.2 percent and eclipsed the previous high-water mark for previous Decembers, 0.3 percent in 2003. The greatest spikes were logged for hors d’oeuvres (4.8 percent) and desserts (4.5). “According to information given by restaurant owners, some of them raised their prices because they had not raised them for some time, while for some restaurants and cafes one could notice that their prices increased due to euro changeover” (Statistični urad Republike Slovenije 2007b).

A similar project was undertaken by the Slovene Consumers’ Association (ZPS) and the International Consumer Research Institute (MIPOR), which began monitoring the prices of a set basket of goods and services in February 2006. Similar to the Statistical Office’s findings, “[p]rice increases did not start to show up until November 2006” (Deloitte

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<sup>3</sup> It must be noted, however, that the small size of the country surely facilitated the process, and so it remains unclear whether this approach would be as smooth in a larger country.

Consulting 2007: 45). Consumers themselves were encouraged to send in the price hikes they themselves noticed, and from 29 December 2006 to 10 January 2007 more than 750 tips had been contributed. A black list of companies that had increased prices by 6% or more was released on the basis of this survey data in December 2006 (Deloitte Consulting 2007: 45).<sup>4</sup> Overall, however, their findings were not too dramatic:

...between February 2006 and February 2007, 42% of prices for services remained constant, 8% decreased and 50% went up. The corresponding figures for goods were 39%, 26% and 35%. However, between November 2006 and February 2007, over the full basket, 56% of prices remained constant, 25% went down and 19% went up. For services, the corresponding figures were 52%, 8% and 40%; for goods, they were 58%, 26% and 16%. (Deloitte Consulting 2007: 46)

Unfortunately, Slovenes were already wary because of the experiences perceived in 2002 in nearby Italy and Austria, and all of the attention paid to the possibility of price hikes with the introduction of the euro seems to have left a negative impression and affected consumers' price expectations. Despite the evidence to the contrary, "83.4% of consumers believed that prices went up with the introduction of the euro; 56% believed they went up significantly" (Deloitte Consulting 2007: 46). Notably,

[t]he fact that increases tend to be in the cost of eating and drinking out, and in everyday personal services, which are often not contestable, inevitably creates a perception of higher prices, and the message about the overall limited level of price increases is not likely to counteract this perception. (Deloitte Consulting 2007: 6)

This could be a problem in the future as the eurozone expands further, insofar as "[i]t is more than likely that other countries will therefore have to combat a further perpetuation of the idea that the introduction of the euro is inflationary..." (Deloitte Consulting 2007: 6). As far as Slovenia goes, the ZPS/MIPOR project may inadvertently have helped warp the general public's perceptions, but at least one positive has been noted: the project has been credited with "(a) having been highly influential in making companies 'think twice' before increasing prices, and (b) developing a consumer rights' culture in Slovenia by raising awareness of a right to fair prices and a right to complain" (Deloitte Consulting 2007: 46–47). Future accession countries may do well to study this case.

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<sup>4</sup> The project utilized the website [www.evropotrosnik.si/](http://www.evropotrosnik.si/), which unfortunately is no longer active.

### V. Semiotics of the Slovene euro

EMU and the Maastricht criteria are inherently political, but an even greater dose of politics can be found in the notes and coins themselves. This is to be expected, as theorists of nationalism have long observed the symbolic power of currency: “As a product of the state, money creates a link between the state’s political identity project and its citizens” (Raento et al. 2004: 930). The symbolic power of the euro should not be underestimated: “For Europeanists seeking a tool to forge a unified identity among diverse cultures, the answer was not to be found in a common language like Esperanto, but in a single currency” (McNiell 2004: 16). Since the banknotes and coins are used daily by most eurozone member state citizens, they become the focal point of that psychological effect.

The banknotes are the same for all countries within the eurozone and each has a window or gateway on the front symbolizing “the European spirit of openness and cooperation,” and a bridge on the back symbolizing “communication between the people of Europe and between Europe and the rest of the world.”<sup>5</sup> A different architectural style is used for each denomination, but none are explicitly identified with any known structure. At least one Slovene critic has questioned the design, noting that “...there is, indeed, something artificial about euro banknotes. They are—if we look at them clearly—completely lacking in character. To put it bluntly, they resemble a Europeanisation imposed from above” (Debeljak 2004: 104).<sup>6</sup> Further,

Unlike national currencies, the euro is too timid to show a face and too reticent to suggest a biography, to give pride of place to any story. Not a single human being appears on these crisp banknotes. Incapable of inspiring any sense of recognition, of *de fibula narratur*, these notes are abstractions, ideas suggesting little, if any, tangible or familiar sensual quality... What we must sadly infer from the euro banknotes is that post-Maastricht Europe is a land with no founding event, destiny, or battle for independence... (Debeljak 2004: 104).

The coins, however, are significantly different. One side of the coins, similar to the banknotes, has an image common to all member states. Prior to 1 January 2007, the two largest coins (i.e., €2 and €1) had a map of western Europe without borders and the next three largest coins (i.e., 50¢, 20¢ and 10¢) had a map of EU member states with borders shown); after 1

<sup>5</sup> cf. [www.ecb.int/bc/euro/banknotes/html/index.en.html](http://www.ecb.int/bc/euro/banknotes/html/index.en.html).

<sup>6</sup> McNiell goes further: “...it remains true that despite the functioning of the Euro as a casual mode of European consciousness-building, the decisions which drive the Euro’s value and performance are being taken at a level ever more remote from European citizens” (2004: 16).

January 2007, all five coins now have a map of Europe (without borders) that includes the new members from Central and Eastern Europe. The three smallest coins (i.e., 5¢, 2¢ and 1¢) have a globe with Europe in the center.

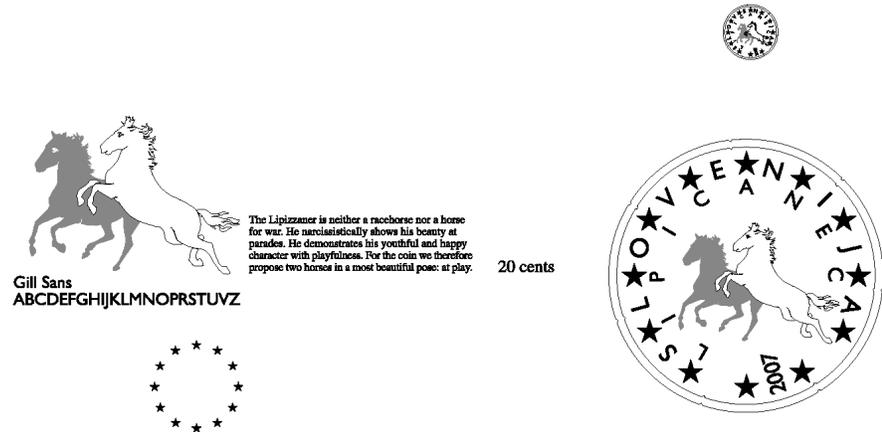
The second side, however, is more interesting in that it has an image chosen specifically by each participating member state. Raento (2004) has analyzed the national side of the euro coins of all member states and found that the identities of the member states come through in every case: “In one way or another, all national designs on euro coins are related to the state or the nation’s achievements and values,” while “the maps on the common side of the euro coins create a continuous link to the supranational ideal of politically and economically integrated, culturally harmonious Europe, thus supporting the political identity project behind the new currency” (Raento et al. 2004: 950–51).<sup>7</sup> Each coin, therefore, reinforces the idea of a united Europe while simultaneously accentuating national specificities.

Some states (Belgium, Ireland, Luxembourg, and Vatican City) choose to use a single image on all eight coin denominations; most use three images; a few (Austria, Greece, Italy, and San Marino) have a different image on all eight coins. Slovenia has joined this last group.<sup>8</sup> Most of the eight images are symbolic of Slovene culture: the national poet France Prešeren (€2), the father of the Slovene language Primož Trubar (€1), the country’s highest peak, Mount Triglav (50¢), and an parliament building (not constructed) by architect Jože Plečnik (10¢). Two more are relatively generic: a sower (5¢) and a stork (1¢). The remaining two, the Lipizzaner horses on the 20¢ piece and the *Knežji kamen* (Prince’s Stone) on the 2¢ piece were controversial.

The Lipizzaner horses (figure 5) are relics of the Austro-Hungarian Empire (of which Slovenia was a part until 1918). While they come from a stud farm in Lipica (present-day Slovenia), they won fame at the Spanish Riding School in Vienna and as such are disputed between Slovenia and Austria with each country claiming the horses as their unique cultural heritage. On this issue, however, Austria was officially displeased but did not push the point. A government spokesperson told the BBC that “There were talks with Slovenia on that topic, but it is not a reason to interfere in good, friendly bilateral relations with Slovenia” (Mulvey 2006).

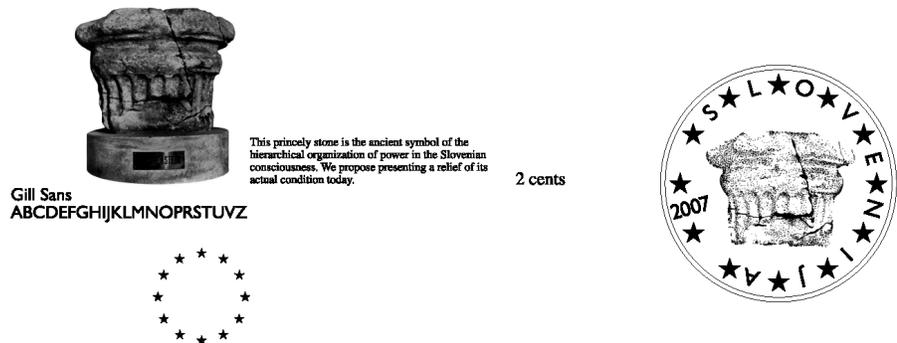
<sup>7</sup> Velikonja views this pessimistically: “...this is a good metaphor for *equality within Europe and its respect for diversity*. The expression of national peculiarities is limited to ‘small change,’ in this case euro coins, while important issues such as bank notes are subject to uniformity” (2005: 31, fn. 71).

<sup>8</sup> cf. [www.ecb.eu/bc/euro/coins/html/index.en.html](http://www.ecb.eu/bc/euro/coins/html/index.en.html).

Figure 5. Slovenia's 20¢ euro coin: The Lipizzaners<sup>9</sup>

The controversy over the Knežji kamen (figure 6), however, was not taken so lightly. The Knežji kamen was used in the medieval period in a ceremony for the installation of the prince of Karantanija and later the Duchy of Carinthia (conducted in the Slovene language) that was continued under the Franks and later the Austrians until it was finally abolished by Maria Theresa in the eighteenth century (Manske 2005).<sup>10</sup>

Figure 6. Slovenia's 2¢ euro coin: The Knežji kamen



<sup>9</sup> All images of Slovenia's euro coins in this article are from [www.evro.si/en/slo-and-euro/slovene-euro-coins/slovene-euro-coins.pdf](http://www.evro.si/en/slo-and-euro/slovene-euro-coins/slovene-euro-coins.pdf)

<sup>10</sup> Manske 2005.

After World War I, however, much of the territory of the former Duchy of Carinthia fell to Austria, and the Knežji kamen today is held at the regional museum in Klagenfurt. Slovenes consider the Knežji kamen part of their political history and insist the use of the image is not a political message aimed at Austria, but Austrians in Carinthia feel the same and further believe that Slovenia's attachment to the stone represents territorial aspirations to southern Carinthia (about 14,000 Slovenes still live there). "German-speaking Carinthians accept that the Slovene language was spoken at these enthronement ceremonies in the seventh century. But they also say that the stone and what it symbolizes has become an important part of Austrian-Carinthian regional identity" (Brix 2006).<sup>11</sup>

The choice of the Knežji kamen for the two-cent piece therefore evoked a loud outcry led by Carinthia's far-right-wing governor, Jorg Haider. Slovenes downplayed the controversy, with Carinthian Slovene leader Marjan Pipp, tongue in cheek, stating that "[w]hen one looks at the Austrian euro coins and finds different sorts of plants on them, one would also have to make sure that these grow exclusively in Austria" (Manske 2005). It is worth mentioning that the Slovenes had tried to use the Knežji kamen on currency before, upon independence in 1991, but removed the image, after Austrian protests, in the interest of smoothing Slovenia's entry into the European Union; now that Slovenia is a full member, it has successfully defended its claim and the Knežji kamen remains on the Slovene 2€ euro coin despite the concerns emanating from Carinthia.

A delay in the arrival of the euro coins to Slovenia in preparation for their 1 January 2007 entry into circulation explicitly highlighted the significance of the national side of the coins to member states. Slovenia's coins—296.3 million of them, valued at €104 million and weighing 1465.2 tons—were minted at the Mint of Finland. Though they began arriving in shipments of thirteen-week intervals as of 4 September 2006, there was concern that there would not be enough on the big day. Slovenia was lucky to be small: "minting coins is one of the most time-consuming aspects of the changeover process, and in a large country it can take well over a year or more to mint sufficient coins if only one mint is used" (Deloitte Consulting 2007: 25).

There was talk early on of simply using another country's coins to make up the difference, but, tellingly,

this was a politically unacceptable solution even in a country with a high level of acceptance of the introduction of the euro. Indeed, creating an image of the new coins as one of being particularly attractive relative to other countries' and

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<sup>11</sup> Brix also notes the similarities between this controversy and the one between Macedonia and Greece over the name "Republic of Macedonia."

emphasising the use of the Slovene language on the coins was seen as a key element in part of the preparations for the introduction of the euro and acceptance of the euro. Having photos of actual coins available for this purpose at the earliest possible stage was seen as important. (Deloitte Consulting 2007: 25)

Given the significance states place on the coins (more so than the banknotes), it is understandable but ultimately ironic that such controversies can and do arise with the euro, a tangible step towards European integration. Blix (2006) notes that it is interesting that “hardly anybody suggested looking at the issue from a European point of view (as a chance to promote common cultural heritage)” despite the obvious opportunity.<sup>12</sup>

## VI. Slovenia in the eurozone

Since Slovenia formally adopted the euro as its currency, one thing became clear—inflation may have been kept under control in the run-up to the adoption, but it later emerged as a significant problem that could have repercussions for other potential eurozone members in the future, since “...Slovenia’s post-euro adoption inflation pattern is likely to be used as a benchmark by EU bodies for the next applicant from east-central Europe, Slovakia, and subsequently the larger east-central European countries.”<sup>13</sup>

In the 2006 convergence reports, Slovenia secured a 2.3 percent twelve-month average rate of inflation in March 2006, 0.3 points lower than the 2.6 percent limit. In January 2007, at the time of the euro’s adoption, the rate had crept up to 2.8 percent and a few months later in July it was already at 4 percent—“more than double the euro area average, and over one percentage point higher than that of second-placed Greece.”<sup>14</sup> One projection estimates the inflation rate for 2008 at around 5.3 percent.<sup>15</sup> The public’s inflationary expectations seem to be perpetually adjusting upwards,

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<sup>12</sup> There is another irony about the euro, as well: the insistence by the EU on the spelling of the very word. Slovene, along with Lithuanian, Latvian, Maltese and Hungarian, would naturally use “evro” rather than “euro,” and appealed to the ECB to do just that. Greece and Bulgaria were given exceptions, as they use different alphabets (cf. Reuters 2007). However, the ECB’s 2006 convergence report explicitly noted that “[o]nly when all national legal acts use the correct spelling of the word ‘euro’ will Slovenia comply with the Treaty requirements.” The Slovenes eventually bowed to the EU, as the “finance minister and the governor of the Bank of Slovenia were unanimous that the spelling euro should be used in official communications with European institutions and other member states, as well as on coins” while “in everyday life in Slovenia” the spelling evro will be maintained (Velikonja 2005: 31–32).

<sup>13</sup> The Economist Intelligence Unit, *Viewswire*, 14 September 2007.

<sup>14</sup> *ibid.*

<sup>15</sup> The Economist Intelligence Unit, May 2008: 7.

with “[t]he price-perception component of the EU Commission’s monthly consumer survey for Slovenia ... hitting new record highs in every month since November 2007, a sign that high inflation is becoming incorporated into household expectations.”<sup>16</sup>

Part of the jump in January was attributed to euro-adoption price hikes, but that would not explain the further jump by July. To some extent it can be explained by increased energy prices: “the government has a clear case when it says the rise in overall inflation has been dictated by global factors such as higher prices for foodstuffs and energy.”<sup>17</sup> A bigger problem, however, is that Slovenia has registered a higher rate of economic growth—hitting 6.1 percent in 2007 as compared to just 2.6 percent for the eurozone as a whole.

This greater growth is inherently inflationary if it is beyond the country’s capacity, as the economy can fall out of internal balance and overheats, but Slovene authorities insist that the record-level inflation registered as of late is in fact a reflection of a strong economy rather than any significant trouble:

Slovenia’s growth rate—6 per cent this year, a 10-year high, and an expected 4.6 per cent for 2008, according to European Commission forecasts—is comfortably above the European average. At 4.9 per cent unemployment is low. The country’s export sector has grown robustly, up more than 17 per cent in the first nine months of this year, according to the finance ministry. However, such positive data have done little to dispel concerns about the underlying state of the economy. (Studemann 2007)

The 2006 Commission convergence report had already noted that there were potential problems with the Slovene economy, even as Ljubljana had clearly fulfilled the Maastricht criteria. On inflation, the report noted:

In a longer-term perspective, the final convergence of domestic interest rates to the euro area level and the possibility of an increase of the value-added tax rate envisaged in 2007 represent risk factors to inflation. Slovenia therefore needs to remain vigilant to protect its low inflationary environment and a favourable competitiveness position. A more ambitious fiscal policy stance would help to mitigate risks to inflation and wage moderation should be continued beyond 2006. (European Commission 2006: 4)

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<sup>16</sup> The Economist Intelligence Unit, May 2008: 13.

<sup>17</sup> The Economist Intelligence Unit, *Viewswire*, 14 September 2007.

The 2006 ECB convergence report also noted

potential additional second-round effects stemming from recent energy price increases, in conjunction with a strengthening of domestic demand and possible adjustments in administered prices may exert significant upward pressure on wages and inflation. A particular uncertainty associated with wage developments is that the new wage agreement for 2006 and beyond has not yet been concluded. (European Central Bank 2006: 36)

Part of the inflation in Slovenia, the report pointed out, could be chalked up to price harmonization with the rest of the bloc: “GDP per capita and price level are still lower in Slovenia than in the euro area,” and inflation will be inevitable to some extent as prices catch up (European Central Bank 2006: 36).

EU and ECB authorities have spoken out, calling on Ljubljana to rein in inflation, with Economic and Monetary Policy Commissioner Joaquín Almunia going as far as saying that Slovenia is sending “a bad signal” to potential members (Kraske 2008). In late April, the head of an IMF mission to Slovenia, Piritta Sorsa, advised that the country “should tighten its budget policy and aim for a surplus this year to curb inflation expectations.” She further advised that the government should “avoid excessive pay rises, which would only worsen the situation.” Other steps that could be taken include the lessening of bureaucratic hurdles, the enabling of greater competition, the increasing of labor flexibility and further privatization (Novak 2008).

People are speaking out at home as well. A November 2007 protest in Ljubljana saw almost 70,000 people demonstrating against inflation and calling for more social justice (Kraske 2008). One strike set for 30 January 2008 was only called off at the last minute when the government agreed to a 3.4 percent public-sector wage increase, and another planned for 6 February cost the government a 4.7 percent private-sector wage increase and a €20 increase in the minimum wage (though employers later renege on the deal).<sup>18</sup> However, since productivity is relatively good (registering a 6.1 percent increase in 2006 and a 7.9 percent increase in 2007), “this suggests that a full-blown wage-price spiral is still unlikely, although it is a risk, particularly if inflation does not peak in the next month or two, or if productivity growth falls.”<sup>19</sup>

Beyond just inflation, other problems may also be looming on the horizon. On top of everything else, the Commission report also pointed out

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<sup>18</sup> The Economist Intelligence Unit, *Viewswire*, 11 March 2008.

<sup>19</sup> The Economist Intelligence Unit, May 2008: 13.

that the demographic trends in Slovenia put the country in a high-risk category in terms of sustainability. Declining birth rates and generous pension benefits could ultimately be a recipe for disaster (European Commission 2006: 5). The ECB report went further, noting that “[a]ccording to the latest projections by the EU’s Economic Policy Committee and the European Commission, Slovenia is expected to experience a substantial increase in age-related public expenditures amounting to 9.7 percentage points of GDP in the years to 2050” (European Central Bank 2006: 38).

It does not seem clear exactly what has happened to create such inflation in Slovenia since January 2007, but it is likely a combination of several of the factors mentioned above. Since extrapolating the exact factors and their weight is an enormous challenge, it is unclear how Slovenia will manage, but one thing is clear: the country’s experience so far can be seen as a warning to the other eurozone members, who are surely aware of the fact that the remaining potential members are all significantly less developed and have higher growth rates; this could mean integrating them would be far more difficult than has been the case with Slovenia, which is at least closer to full convergence with the other eurozone economies.

### **VII. Conclusion: Quo vadis, eurozone?**

In some ways, Slovenia’s accession to the eurozone is old news—Cyprus, Malta and Slovakia have since joined. Further, the small size of Slovenia’s economy and its relative symmetry with the other eurozone members (e.g., Portugal and Greece especially), perhaps differentiate the Slovene experience from the rest. These facts certainly facilitated Slovenia’s meeting the Maastricht criteria and thereby joining the eurozone, but many of the others, are having considerable difficulties.

The question emerges of whether it is time to change the Maastricht criteria. This could be interpreted as changing the rules in the middle of the game, or holding potential new eurozone members to a different standard than old. However, this would not be the first time such discrimination has been practiced—indeed numerous examples could be found in the 2004 and 2007 members’ experiences during their accession to the EU. Further, if the Maastricht criteria were aligned to OCA theory and real economic concerns, it could easily be argued that this would both ensure a more stable euro and also a fairer deal for potential new members.

One more factor certainly bears mention: “There is little solid evidence that the euro’s introduction has boosted economic growth, and the failure to punish persistent violations of the budgetary rules has seriously

undermined the bloc's claim to promote fiscal stability."<sup>20</sup> Further, the power of conditionality to compel reform before eurozone accession dissipates almost immediately upon entry into the bloc, as has been seen with the pre- and post-accession behaviors of the new members included in the 2004 and 2007 rounds of European Union enlargement. If eurozone members are going to push for any further reform in the candidate countries, it must be accomplished before accession.

Angelov (2006) argues that, even beyond the issues with regard to OCA theory, the Maastricht criteria are bad in another way: the situation prevailing when they were drawn up has changed significantly and they are now out of synch with actual needs. The EU has doubled and the members' economies are more diverse (in terms of per capita GDP, growth rates and even monetary systems: "currency boards, for instance, [were] unknown in the EU until the Baltic countries joined the Union in 2004"). He singles out the inflation criteria in particular as being discriminatory, as the Central European countries have higher GDP growth rates than the older EU members, which tends to give them higher inflation. He notes that the high growth in Ireland in 2000 and 2001 was similarly accompanied by higher inflation; "This means that Ireland, despite the economic miracle that made it the fastest growing economy in the EU, would not pass the inflation criterion" (Angelov 2006: 82, 84). Even the economies for which the Maastricht criteria were drawn up have trouble with them, and so it is no surprise that countries with significantly different economies would face even greater problems.

While he believes the best way forward is to amend the inflation criterion or even to abolish it, "the slow pace of EU procedures makes that far from a practical proposition." Therefore, Angelov advocates "a more radical approach"—"abolish the Maastricht criteria altogether" and allow new EU members to join the eurozone immediately. Since the 2004 and 2007 enlargement countries' economies are so small, it would not affect the monetary union significantly but it would (à la Mundell II) bring significant benefits to the new member states (Angelov 2006: 84–85). Since the powers that be would be horrified at the prospect of allowing this outright, Angelov suggests the new members simply take it upon themselves to get the ball rolling: "If some of them do it the European Commission and the ECB will be forced to recognise the fact—no one can reasonably expect that a country would abandon the euro as its currency so as to fulfill criteria that would allow it to once again adopt the euro" (Angelov 2006: 87). He terms this move "unilateral euro-ization."

Buiter & Sibert (2006a) agree, but take a closer look. They identify three costs to unilateral euro-ization: (1) "the entrant would forego the

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<sup>20</sup> The Economist Intelligence Unit, *Viewswire*, 3 January 2007.

seignorage revenue a country earns by issuing its own currency”; (2) “the country would not have a seat on the Governing Council of the ECB”; and (3) “the country would have no lender of last resort in the event of a financial crisis as it could not print its own euros.” However, the costs under (1) would be negligible, the “Governing Council is already so large that it cannot function as a meaningful deliberative body,” and problems arising from (3) would be rare. Further, they note that while the Commission and ECB would object, “they have no legal grounds for opposing it” (Buiter and Sibert 2006a: 85, 87).<sup>21</sup>

Such an approach would see a jump in eurozone membership (though not all would be likely to make the move—Poland, for example, seems hesitant about adopting the euro one way or the other). Here it may be worthwhile to note that this expanded eurozone could accentuate the concerns raised by Feldstein (1997). One was that “[t]he emphasis on common economic and social policies will reduce the scope for the experimentation and competition that would otherwise lead to reductions in the current extremely high levels of structural unemployment.” He also predicted tensions between, especially, France and Germany over monetary policy (and foreign and military policy should EMU lead to a more federalized union). Third, he was alarmed that “[t]he Maastricht treaty contains no provisions allowing a country to leave the monetary union once it has joined” and therefore “[m]embership in the monetary union and the adoption of a single currency is intended to be permanent.” Finally, he suggested that were EMU to lead to a more federalized Europe, it could upset global balances of power: “Only time would tell whether the creation of such a global power would be a stabilizing or destabilizing influence on world peace” (Feldstein 1997: 41–42).

The first caution is worth noting, particularly in the case of unilateral euro-ization, but since the unilateral eurozone members would not (immediately) be involved in setting policy, they could theoretically maintain a bit more room for experimentation. The second issue, however, is unlikely and in fact unilateral euro-ization could even unite France and Germany in opposition to it. Feldstein’s third concern could actually be resolved in the case of unilateral euro-ization, as such a move could convince certain eurozone members that formulating an exit option would be desirable. The final point, however, could be the most pressing. Were a sizable number of states to opt for unilateral euro-ization without causing much of a problem, the result would be a eurozone that more closely matches the larger EU membership and therefore could lead to a more

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<sup>21</sup> It should be noted as well that Andorra, Montenegro, and Kosovo have already unilaterally euro-ized, and while the Commission and ECB have objected, they have been unable to prevent the euro from circulating in these two places. A precedent, therefore, may already be in place.

unified Europe that very well could make more of an impact on the world at large, particularly if the unification were extended into foreign and military policy as Feldstein notes. None of Feldstein's concerns, therefore, seem overly pressing at this time.

What will happen to the Maastricht criteria, as well as what will happen to Slovenia now that it is within the eurozone are questions for the future. It is unlikely, regardless of the low cost and high benefits, that unilateral euro-ization will emerge as a viable option. It is likely, however, that the Slovene economy will adjust to its new circumstances and will ultimately thrive in the eurozone; however, the Slovene economy now depends more than ever on developments in the eurozone overall. EMU may not be in line with OCA theory, but the psychological benefit noted above of the euro increasing a European perspective comes through clearly – never before in its young history has Slovenia been so integrated with the rest of Europe, and the Slovene authorities can certainly be proud of the achievement, regardless of the current economic turbulence.

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