STRATEGY OF THE SLOVAK REPUBLIC FOR ADOPTION OF THE EURO

Continued from issue 8/2003

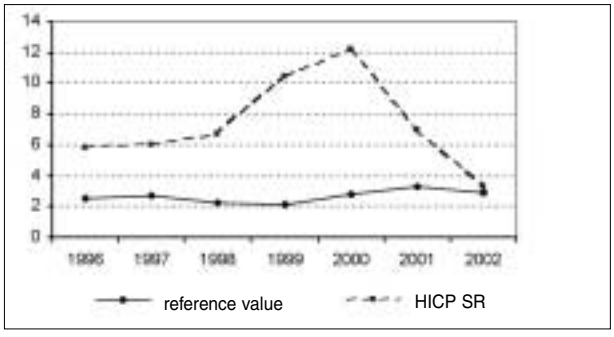
2.2 Nominal convergence (fulfilment of the Maastricht criteria)

Nominal convergence is characterised by the Maastricht criteria regarding inflation, fiscal deficit and debt, long-term interest rates, and exchange rate.

Inflation

The lowering of inflation in the Slovak Republic depends on the extent of administrative price adjustments and the scale of changes in indirect taxes. These measures have played a dominant role in price development. Since the beginning of transformation, they accounted for about four-fifths of price growth. According to NBS calculations, system-inherent core inflation was responsible for only one-fifth of price growth since 1990. Meanwhile, price growth fuelled by administrative measures had little effect on core inflation, which currently lies near the reference value – the Maastricht inflation criterion[1]. The development in the Harmonised Index of Consumer Prices (HICP) in the Slovak Republic and in the EU inflation benchmark (Graph 1) shows a major alignment of their values in 2002.

Graph 1 Development of inflation in the SR

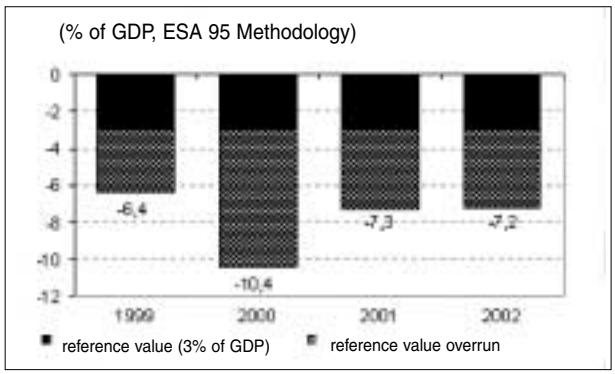


Source: Eurostat

Fiscal deficit and debt

The development in the fiscal deficit and debt (by ESA 95 methodology – Graph 2) was less satisfactory in the past. However, as preliminary approved (notified) estimates of these indicators suggest, fiscal deficit and public debt (ratio to GDP) are in a downward trend. The ratio of public debt to GDP, helped by privatisation earnings, has fallen to today's 44.3%[2]. Although the fiscal deficit has been falling since 2000, it still reached 7.2% of GDP in 2002. Given the great importance of fiscal policy in the EMU accession process, as well as inside the eurozone, this is a very high value, requiring deep-reaching and urgent reforms.

Graph 2 Fiscal deficit of the SR

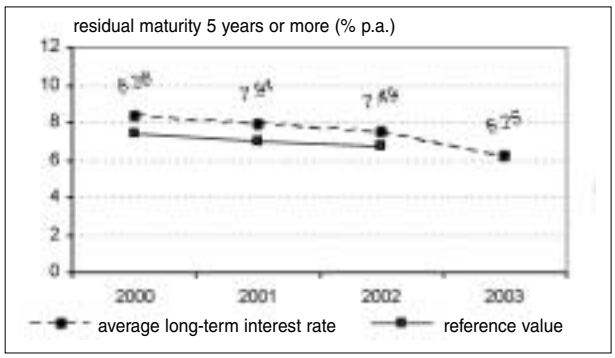


Source: Ministry of Finance of the Slovak Republic

Long-term interest rates

Long-term interest rates on government bonds (Graph 3) are decreasing gradually, owing to a decline in risk premium (improving rating for Slovakia's long-term liabilities), falling inflation and interest rates on domestic and foreign markets. Expectations of a stable or strengthening SKK exchange rate also play a part in the decreasing cost of debt financing on foreign markets. The impact of long-term expectations – of future convergence (decline) in inflation and interest rates in connection with EU and eurozone membership – is extremely important.

Graph 3 Long-term interest rate



Source: NBS

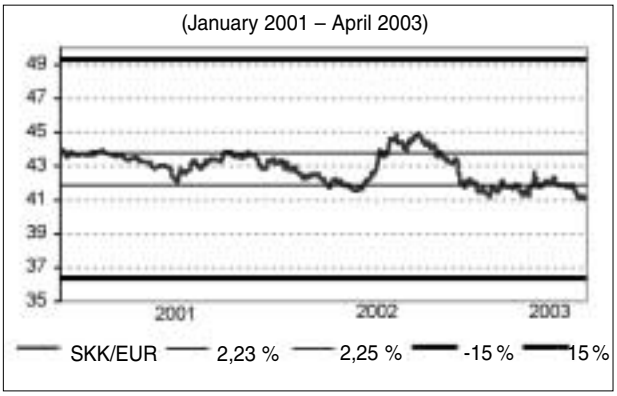
[1] 1.9% (April 2003). The Harmonised Index of Consumer Prices is the price inflation gauge used in the EU, allowing correct evaluation of inflation in individual countries on a common basis. To ensure that inflation data is comparable, it uses a common commodity, territorial and population base.

[2] The fiscal deficit and public debt values are subject to notification. The process is being revised as the methodology for deficit and debt determination refines.

Exchange rate

While the fixed exchange rate regime (with a gradually widening fluctuation band) was in place, the Slovak koruna barely moved – except shortly before the change of the exchange rate regime. The exchange rate faced pressure stemming from problems in the development of economic fundamentals (especially an accumulating external imbalance) as well as from non-economic factors. After abandoning the fixed exchange rate in October 1998, exchange rate fluctuations may have been greater, but, except for a short-lived swing just ahead of the implementation of stabilisation measures in May 1999 and in the summer of 2002, the SKK/EUR exchange rate travelled mostly within a range of ±3% (graph 4). However, it must be noted that this relatively moderate fluctuation was supported not only by NBS interventions (an instrument also applied in ERM II), but also by monetary policy decisions (changes in interest rates).

Graph 4 Development of the nominal SKK/EUR exchange rate



Source: NBS

Since the end of 2002, the Slovak koruna has been under pressure to appreciate fuelled both by expectations and real processes. The government programme objectives, the approved state budget, and the pending accession to the EU and the eurozone have all contributed to this significantly

3. Advantages and disadvantages Slovakia's adoption of the euro

A clear accession strategy on Slovakia's way to the monetary union will bring a new quality into the country-'s economic environment, a positive change for everyone involved. Both the business sector and the public stand to gain from adopting the euro. As firms in Slovakia will no longer be exposed to exchange rate risks against the euro, their long-term development planning will be more reliable. Hence, currently incurred costs associated with the hedging for businesses will be avoided. This should spur economic growth, benefiting citizens through higher employment and income. The adoption of the euro will mean lower currency conversion costs for everyone. A credible accession strategy will send a strong signal to investors, reflected in increased FDI inflow which, in turn, will speed up economic restructuring.

The positive effects of joining the monetary union also include:

- pressure on standardisation of domestic economic policy actions and reforms,
- pressure on implementation of a fiscal policy consistent with the Stability and Growth Pact and the resulting impacts on financial markets,
- increased price transparency,
- increased trade,
- an irrevocably fixed exchange rate promotes financial market and monetary stability,
- a stable business environment, resulting in faster real convergence,
- participation in the formulation of a common monetary and exchange rate policy (with respect to the approved voting right model).

The entry to the single currency area is generally associated with a dramatic change in the way an economy works, in particular due to the loss of its independent monetary policy. This is also seen as the greatest drawback of the euro adoption. It is argued that the adoption of the single currency makes it impossible to use monetary policy and the exchange rate to restore equilibrium if it is disrupted. However, both analyses abroad and local experience show that against a backdrop of liberalised capital flows and liberalised foreign exchange regime, the possibilities of exercising an independent monetary policy are in any case very limited. Although the NBS may take action to fend off short-term floods of speculative capital, given its potencial enormous capacity, the effect of such efforts is problematic. Exposure to global capital markets leads to instability which may be contained by co-ordinated policies, but can never be eliminated. For a small and wide-open country, entering the single currency area seems to be the solution.

The question of external imbalance also takes on a different perspective. Despite the fact that this problem is not made any the easier through entering monetary union, its nature is however made different from that in the case of a separate currency. With a national currency, an imbalance is manifested at the macroeconomic level through exchange rate pressure. Exchange rate movement – helped by speculative factors – can be quite volatile and it may take considerable national economic costs to tackle the situation (e.g. central bank interventions in the foreign exchange market, sterilising operations). When a country is inside the monetary union, the problem is transformed into an imbalance at the level of individual enterprises. Its solution can be spread more evenly over time and the overall national economic cost is lower.

To individual economies, adoption of the euro means existing in a common monetary area with a single monetary policy. Naturally, there are fears that a single monetary policy will not be able to respond to the specific

needs of individual economies[3]. This could be a problem in countries whose reactions to possible shocks are distinctly asymmetric[4] from the prevailing reaction of other economies in the monetary area.

Nevertheless, several analyses have found that the Slovak economy reacts to demand shocks neutrally or slightly symmetrically compared with the current EU, and its reaction to supply shocks (e.g. a hike in oil prices) is not asymmetrical either. Moreover, the symmetry in reactions to supply and demand shocks, and also synchronisation in economic cycles, is increased by the processes of intensified trade exchange, in particular where it takes place at the intra-industry level. Analyses examining countries which had joined the monetary union also revealed that membership in the monetary union has the effect of accelerating the process (of synchronisation and symmetry of reactions). Slovakia's economic growth will benefit from its involvement in a common monetary area. This follows from the fact that the Slovak economy is a small and very open one, whose production is bound to complement rather than substitute EU production in the future. The high degree of openness of the Slovak economy is amplified by the fact that most of its economic ties run to the EU area (Slovakia's exports to and imports from the EU – including the accession countries – are worth 150% of its GDP; exports to the EU – including the accession countries – make up 90% of total exports).

Despite this, we need to allow for the existence of asymmetric reactions to external shocks and for a temporary asynchrony of economic cycles. It is therefore crucial that other policies and markets – fiscal policy, labour market and wage policy, capital market[5] – come in to play the role of the stabiliser and help restore the balance with their flexible reactions.

Slovakia, too, is paving the way to that end. The liberalisation of capital movement is practically complete and the labour market is becoming more flexible, even though certain (temporary) restrictions to cross-border workforce migration remain from the side of the EU[6]. Other possibilities of adapting the economy depend on the flexibility of prices and wages. However, it is particularly important that public finance consolidation makes room for public finance to play an active role in economic stabilisation. As regards prices and wages, we need to stress the need for both-sided flexibility and the need to keep a reasonable wage growth (in touch with growth in the productivity of labour). There are past examples (Greece) where informal agreements on restraints in wage negotiations made during the process to adoption of the euro greatly contributed to a sustainable economic growth.

Besides, there are concerns that the stabilisation effort which reins in inflation may stifle economic growth. However, as experience from several countries going through the convergence process on their way to the monetary union demonstrates, in this process the nominal stabilisation of the economy did not impede economic growth; on the contrary, it was actually a supporting factor. As Table 1 implies, this was also the case in countries with a tradition of a relatively high inflation (Greece, Portugal, Spain, Italy), where the 1990s, on their way to the EMU, brought a major reduction in inflation coinciding with an accelerated economic growth.

Table 1 Development of inflation and economic growth in selected countries

		1992 – 1994	1995 – 1997	1998 – 2000
Greece	a	0,3	2,7	3,7
	b	11,7	6,5	2,8
Portugal	a	1,2	3,5	3,9
	b	5	2	1,8
Spain	a	0,8	3,1	4,3
	b	3,2	2,3	1,7
Italy	a	0,7	2,0	2,1
	b	2,8	2,7	1,3

Source: ECB
a – average annual GDP growth
b – inflation differential (difference between the inflation rate in the country concerned and the average inflation of the three EU countries with the lowest inflation)

Thus, past experience with the accession process shows that economic growth and falling inflation are not mutually exclusive. On the contrary, it shows that during the accession process to the monetary union, even in the case of potentially risky countries, a cumulation of positive stabilising effects (falling inflation) and the effects of an accelerating economic growth occurred. So, we may conclude that the processes of real and nominal convergence complement each other.

Some also argue that the process of approximation of price levels may lead to rising prices and falling standards of living. Since wages and other income are likely to grow faster than prices, the standard of living will increase even if the gap between price levels narrows. For that to happen, however, growth in labour productivity must stay ahead of real wage growth.

In the framework of the public discussion on the paper the opinion has often been presented that through entering the eurozone a devaluation of savings may occur, firstly in consequence of the premature fixing of the exchange rate, and secondly in consequence of higher inflation and lower interest rates. These opinions are

[3] We need to note the relative nature of the reflections on an optimum monetary area: inside every country (including Slovakia), there are regions which may not subscribe to the single nation-wide monetary policy either.

[4] The concept of symmetry and asymmetry is based on a simplified view – a shock is symmetrical if economies respond in the same direction – a slowdown or acceleration of economic activity.

[5] Given the limited potential of the national capital market, this applies especially to the possibility of using foreign capital markets.

[6] Another problem is a limited flexibility of workforce movement due to traditions and customs which make people reluctant to move for work.

based primarily on the belief that the nominal exchange rate of the koruna will in the case of not entering the eurozone appreciate. This however cannot be considered as an incontrovertible fact – as is now shown by examples from neighbouring countries – in particular in the case of the non-existence of a credible economic policy oriented on the future. Indeed, in the case of a non-credible policy that is not positively focused on the future it may happen that the exchange rate would actually depreciate.

In connection to this it need be said too that it will be necessary to convert to euro not only savings, but also the prices of those commodities for the purchase of which the savings are intended. With regard to this and the fact that through adopting the euro the savings/price relationship will not change significantly, there is no reason to suppose that the conversion of savings into euro would mean their real devaluation.

The second part of the argument as to the adverse affect on savings in adopting the euro is the consideration that in the case of entering the eurozone real interest rates in the SR will be lower than in the case of its non-entry. It is expected that this will be caused by higher domestic inflation and lower interest rates in the case of entry in comparison with the non-entry scenario.

This is not however a reason to suppose that the scenario without the euro would mean a more favourable development of the real value of savings than the scenario with the euro. It is probable that this variable will not differ significantly between the two scenarios. This is due to the fact that the act itself of adopting the euro cannot substantially disrupt the system of the relationships of domestic and foreign interest rates and exchange rates[7]. Moreover, one cannot exclude that the non-entry scenario could mean more adverse development – for example in the case where economic policy not sufficiently anchored on a credible aim would lead to higher inflation. Conversely, under the assumption of higher economic growth in the euro-zone entry scenario, savings could, through a higher rate of growth in incomes, develop more favourably than in the non-entry scenario.

Before the monetary union was established, several analyses were conducted to quantify the benefits of membership, e.g. as a percentage increase in GDP level or growth rate. Generally, it is difficult to quantify the effects of entering the monetary union, and existing estimates vary considerably. According to available estimates, the major benefit is an annual one percentage point increase in economic growth as a cumulative effect of lower transaction costs, eliminated exchange rate risk against the euro, and lower risk premium and interest rates.

Overall, we may conclude that the positive aspects of entry outweigh the negative ones. It appears that the most frequently cited disadvantages of joining the monetary union can be either doubted (non-existence of an autonomous monetary policy, contradiction between real growth and nominal stabilisation) or their adverse effect can be eliminated by appropriate economic reforms (e.g. in case of concerns over the implications of asymmetric shocks).

[7] This relationship is explained by the uncovered interest rate parity theory.

4. Outlook for future development in real and nominal convergence

4.1 Real convergence

Convergence of economic performance and alignment of price levels

Following EU accession, Slovakia's economic growth – despite a rising dependence on the economic situation in the EU – will pick up. This is the result of the catching-up process – the effect of material and immaterial technological progress driven by the adoption of new high-performance technologies and know-how.

The catching-up is also supported by the relocation of certain production facilities from other countries, in particular EU countries, to Slovakia. This not only expands the productive potential of Slovakia's economy, but also accelerates a rise of the productivity of labour and opens up new export markets.

Assuming that economic growth in the Slovak Republic will outstrip the EU's growth by an average of 1 – 2 percentage points and the real equilibrium exchange rate will appreciate by 1 – 2 per cent a year, the Slovak economy – in comparable parity[8] – will grow some 2 – 4 per cent faster annually. At that rate, Slovakia could get from today's level of roughly half the EU average to 75 per cent of EU average in a matter of 10 – 15 years.

Although the pace of price level alignment is likely to vary between different economic sectors and market segments, its overall speed should not exceed a limit where it could disrupt equilibrium. The alignment of wage levels, land and real estate prices (including rent) will gradually induce changes in price relations throughout the economy.

In connection with the process of the so-called market adjustment of price relations, it is important to note that, even though the price level is going to rise, real wages and income will also grow overall in this scenario. The standard of living, as a consequence of the growing economy, real wages and income will therefore increase at a fairly high rate. All this will happen only if under the abovementioned condition of labour productivity growing ahead of real wages. A prudent wage policy in the public sector is bound to play a key role in this respect.

To be continuet in issue 10/2003

[8] Real equilibrium exchange rate means an exchange rate level at which the economy is able to stand near its internal and external balance over a longer period of time.