

NATIONAL BANK OF SLOVAKIA

INSTITUTE OF MONETARY AND FINANCIAL STUDIES OF THE NBS

**Analysis
of Economic and Monetary Development
in the Slovak Republic from the Point of View
of Integration of the Slovak Republic
into the European Monetary Union**

Bratislava 2002

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TABLE OF CONTENTS

Introduction

1.	Convergence of the SR to the EMU	6
1.1.	The relationship between real and nominal convergence	6
1.2.	Comparing some attributes of the Slovak economy with selected EU states and candidate countries	7
1.3.	Characteristics of convergence of the SR to the EU	13
1.4.	Fiscal convergence	19
1.4.1.	Current status of public finances in the SR	19
1.4.2.	Medium-term criterion on the public finance balance: structural balance	21
1.4.3.	Performance of the fiscal sector of the SR in comparison with the EU	22
1.5.	Impact of convergence on the structure of financial markets	25
1.6.	Features of the Slovak economy in terms of its responses to shocks in comparison to the euro area countries	26
1.7.	Development in the external sector and increasing competitiveness	28
1.7.1.	Macroeconomic aspects	28
1.7.2.	Microeconomic and structural aspects	29
1.8.	Macroeconomic scenario of the convergence process	33
1.9.	Coverage, timing and an institutional framework for the EMU accession process	35
1.9.1.	Time frame of the accession process	36
1.9.2.	Assessment procedures for EMU member admission	38
1.9.3.	Changes in the institutional environment	39
2.	Monetary policy in the process of accession by the SR to the EMU	41
2.1.	On choosing the monetary policy regime	41
2.2.	Inflation convergence	42
2.2.1.	Taking catching-up factors into account in monetary policy with regard to inflation targets	42
2.2.2.	Promoting inflation convergence through appreciation of the nominal exchange rate	43
2.2.3.	Promoting inflation convergence by means of declining inflation expectations in the long term	43
2.3.	Exchange rate policy network	44
2.3.1.	Characteristics of membership in the ERM II	44
2.3.2.	Context for determining the exchange rate parity	45
2.4.	Adjusting monetary policy instruments	45
2.4.1.	Interest rate convergence in the final phase of converging the EMU	46
3.	Strategy of acceding the EMU by the SR – limitations and risks	47
3.1.	Inflation	47
3.2.	Fiscal deficit	48
3.3.	Current account deficit, foreign debt	49
3.4.	Exchange rate	50
3.5.	Prerequisites and conditions for meeting the Maastricht criteria	51
	Conclusions	53
	<i>References</i>	55

Introduction

The process of integrating the Slovak Republic (SR) into European institutions has reached the stage where membership in the European Union has more or less stopped to be a question mark and the question of future admission of the SR to the European Monetary Union (EMU) has become a priority. At the same time, entry into the EMU upon the accession to the European Union (EU) is not an option but a must, since for new Member States including Slovakia, the possibility of the so-called opt-out has not been deliberated. A question remaining is the time scale of the entry into the EMU, which is not explicitly determined, and the country has a certain, although limited freedom to shape it. When addressing this issue, it is necessary to formulate a strategy which would reduce potential additional costs to be incurred when the fulfilment of eligibility criteria for entry into the EMU is artificially speeded up, and which at the same time would reduce the losses to be incurred in the event that the entry is unnecessarily delayed. This document aims to outline the context relevant for the development of such a strategy.

In the first part of the presented analysis, the understanding of the process of convergence is first defined as a phenomenon that has two complementary and interdependent facets, real and nominal, which leads to the necessity of parallel progression along both lines. In order to assess the situation in respect to the accession process in the SR, it is important to compare the status and the dynamics of development of the Slovak economy with the economies of the current EMU members prior to their entry into the euro area, as well as of the present candidate countries. It can be stated that the parameters of the Slovak economy do not differ significantly from the parameters pertaining to the other countries compared. At the same time, there are some specific differences calling for specific solutions. In connection with this, there is a discussion on the issues of fiscal convergence, consequences of changes in the structure of financial market upon the currency transmission, as well as the issues related to the nature of potential responses of the Slovak economy within the euro area from the point of view of the optimum monetary area theory. Attention is also paid to the issues such as developments in the foreign trade sector and the competitiveness of the Slovak economy. Also presented here is an illustrative macroeconomic scenario of the convergence process, and a formal framework for accession to the EMU.

In the second part, the structure of problems to be faced by the monetary policy in the process of accession is characterised. The questions discussed here include the selection of a monetary strategy, as well as possible procedures for disinflation and the issue of exchange rate policy, which will in time gain in importance. In this context, account is given of the circumstances of membership in the ERM II, whose purpose is to prepare conditions for introducing a common currency in accession countries. It is noted that the monetary policy operates within the context of a whole economic policy complex and it is exactly the coordination of its individual components that constitutes a prerequisite for building up credibility vis-à-vis markets and thereby a sustainable favourable economic development.

In the third section, we provide a summary of a range of issues, which will have to be solved as part of the process of accession to the EMU, and an indication of their size. The improvement of indicators decisive in terms of the entry is preconditioned by completing reforms with which certain costs will be associated. From this viewpoint, the most important is a reform of the public finance system associated with reforms in other areas, (particularly pension and health care system reforms), which have to do with the fulfilment of the budget criterion. The performance of the inflation criterion came under pressure, chiefly due to the postponement of price deregulations. These facts also influence conditions for meeting the debt and interest rate criteria.

A consistent strategy for the process of accessing the EMU will require a close coordination of actions taken by the government and the National Bank of Slovakia (NBS), especially when it comes to the harmonisation of monetary, fiscal, and other policies. A successful assertion of the strategy is preconditioned by a social consensus with regard to the reforms needed. This will require cooperation between the two entities and employers and trade unions, especially when it comes to the regulation of wage development. Last but not least, an efficient information campaign targeted at the population at large, will be required.

1. Convergence of the SR to the EMU

Real and nominal convergence of Member States of the integration grouping is desirable both in terms of a problem-free functioning of the whole grouping, and even more importantly in the case of Slovakia, which through its economic weight cannot significantly influence the operation of the integration grouping, in terms of a problem-free functioning of individual countries within the grouping. Real convergence criteria primarily comprise per capita GDP, price and wage levels, but also some structural features. Nominal convergence is characterised by the Maastricht criteria.

1.1. The relationship between real and nominal convergence

A traditional view on the relationship between the real and nominal convergence sides of economic processes is based on their assumed counteracting quality (trade off), which means that a higher real growth can be achieved at the expense of higher inflation (and fiscal deficit) and vice versa. However, several empirical studies have shown that in the long run, there is a positive relationship between real growth and low inflation. As demonstrated in Tables 1 and 2, this also applies to countries with a tradition of relatively high inflation at the time of their accession to the EMU (Greece, Portugal, Spain, and also Italy)¹, and in which inflation was markedly reduced at concurrently accelerated economic growth during the 1990's. This led to a thesis on the complementary nature of real and nominal convergence that is presently upheld by the European Central Bank and the need for their parallel accomplishment.

Greece makes a particularly remarkable example of this. The example of Greece also documentates that the described developments were not unprompted, but occurred on the basis of the employment of a combination of relevant policies and their proper timing. Stabilisation-oriented monetary policy was based on the exchange rate in the role of the intermediate target. Systematic steps were taken to reduce government deficit, and the need for fiscal discipline was harmonised with a labour market policy that respected the need to raise international competitiveness in conditions of a relatively stable exchange rate. This was also supported by informal agreements on modesty in wage negotiations. Structural reforms focused on the effectiveness of markets' functioning were implemented, which in the final outcome facilitated the process of disinflation as well.

Table 1 Inflation differentials between selected EU countries and three best performing countries in terms of price stability (three-year averages)

	1989-91	1992-94	1995-97	1998-2000
Greece	14.8	11.7	6.5	2.8
Spain	3.5	3.2	2.3	1.7
Italy	3.4	2.8	2.7	1.3
Portugal	9.3	5.0	2.0	1.8
Average for 3 best performing EU countries (level)	2.9	1.9	1.0	0.8

Source: ECB (2002)

It can therefore be generally noted that during the process of convergence, which leads to the entry into the monetary union, there does not necessarily have to be a contradiction between the need for real growth and nominal stabilisation of the economy. Assuming a certain degree of flexibility of the exchange rate, macroeconomic policies oriented towards

¹ ECB (2002).

stability together with structural and institutional reforms designed to increase the flexibility of markets are able to reduce the rate of inflation and inflationary expectations and, at the same time, to support the catching-up process in real terms.

Table 2 Real GDP growth – year-on-year percentage change (at the 1995 constant prices)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Greece	3.7	0.0	3.2	0.6	-1.7	2.1	2.0	2.4	3.7	3.3	3.4	4.3	4.2
Portugal	5.1	4.4	2.3	2.5	-1.1	2.2	2.9	3.6	3.9	4.6	3.5	3.6	1.7
Spain	4.8	3.8	2.5	0.9	-1.0	2.4	2.8	2.4	4.0	4.4	4.2	4.2	2.7
Italy	2.9	2.0	1.4	0.8	-0.9	2.2	2.9	1.1	2.0	1.8	1.6	2.9	1.8

Source: OECD

It would be convenient for participating countries if a substantial part of the convergence process took place during the pre-accession period, when identified problems of the country can be resolved via specific measures of national policies. Countries, which at the beginning of their accession to the EMU most resembled Slovakia in terms of their economic features (Greece, Ireland, Portugal and Spain) recorded considerable progress in catching the level of other countries with regard to per capita GDP, productivity, and price level indicators.

Of the countries mentioned, Ireland has excelled most in this process. Fiscal policy and its favourable impact upon the foreign direct investment (FDI) inflow deemed it to be a catalyst for changing the nature of the country, which lagged considerably in the 1980's. This was coupled with agreements on mild wage increases as well as structural reforms chiefly directed at raising the flexibility of the labour market and increasing the competitiveness. However, apart from the application of proper economic policy, the development in Ireland can also be attributed to several specific favourable exogenous factors. A key role in this respect played an increased input of labour force into the economy based on demographic developments and migration and equally on an increased engagement of the population in economic activities. This was accompanied by a rising education of the labour force, which together with its low price also contributed to the FDI inflow.

1.2. Comparing some attributes of the Slovak economy with selected EU states and candidate countries

With a view towards assessing a starting position of the SR at the beginning of the process of accession to the EMU vis-à-vis selected EMU Member States, it will be interesting to compare some of the indicators of the Slovak economy with indicators for these countries at the same point of time prior to their accession.² Assuming that the earliest theoretically possible term for entry of the SR into the monetary union is the year 2006, then the Irish, Portuguese and Spanish figures for the year 1994 and Greek figures for the year 1996 will constitute an appropriate basis for comparison with the Slovak figures for the year 2001.

One of the most important indicators is the per capita GDP at purchasing power parity. Figure 1 clearly shows that in 2001, Slovakia did not reach the level of EU Member States subject to comparison five years before their integration into the Union, whereas its per capita GDP only accounts for approximately 50% of the average level in the euro area.³

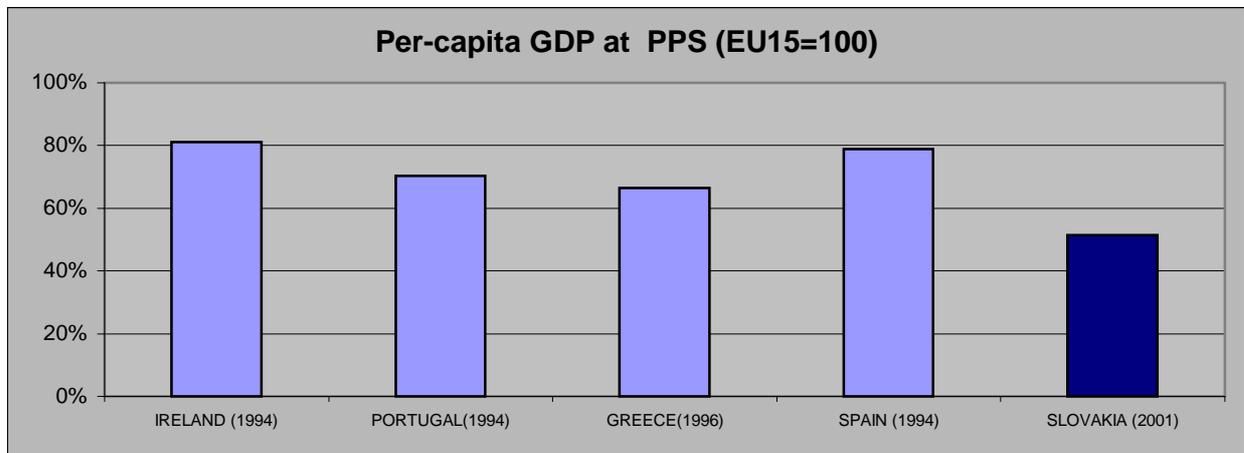
The indicator of economic openness – Figure 2 (the sum of exports and imports of goods and services expressed as percentage of GDP) shows that the Slovak economy is highly integrated into the international economy, with its indicator of openness being greater than

² By Csajbók-Csermely (2002).

³ These particular figures for the SR differ among various sources depending on the methodology used. The methodological issues encountered in the calculation of this indicator are clarified in section 1.8.

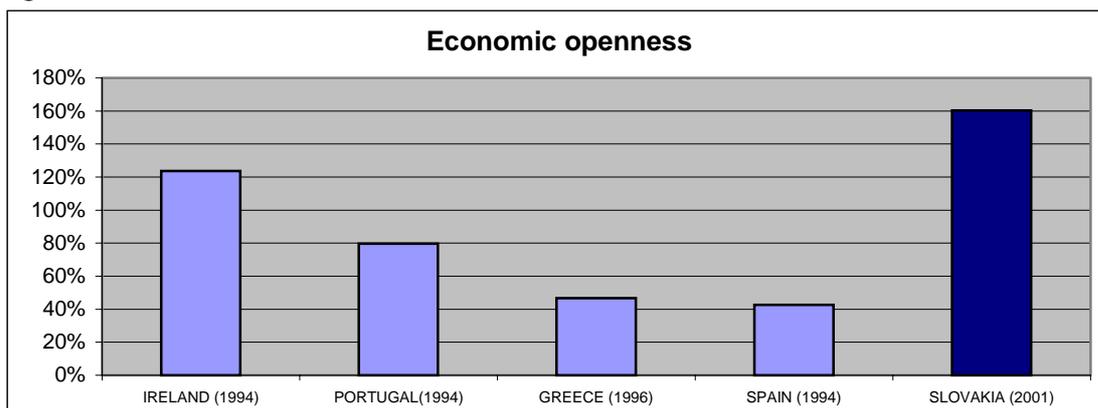
in the EU countries compared. Equally important is the intensity of integration of the Slovak economy as last compared (2001), at which time the economic openness of the SR was greater than in the majority of EU countries (Figure 3).

Figure 1



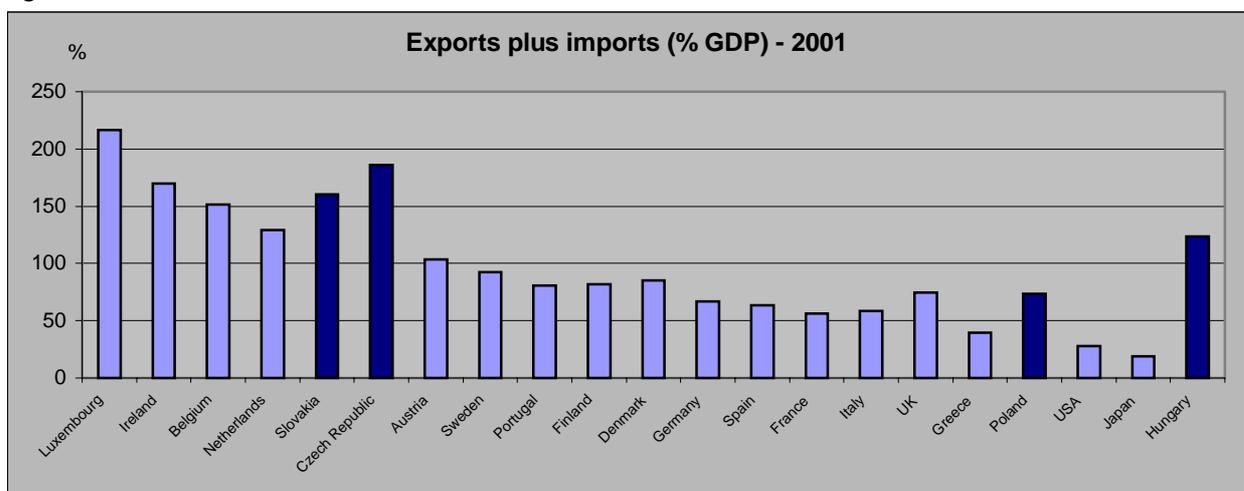
Source: Eurostat.

Figure 2



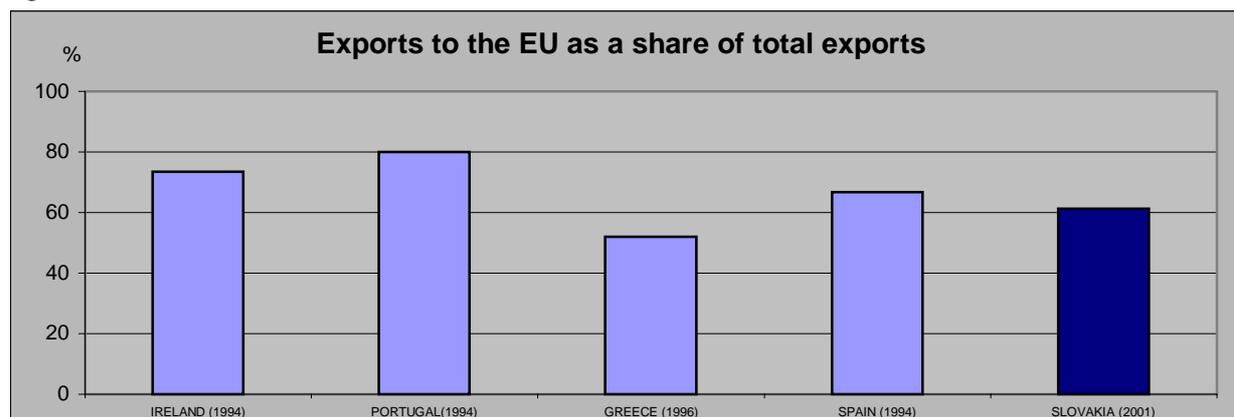
Source: OECD

Figure 3



Source: OECD

Figure 4



Source: OECD, ÚSSE SAV

The share of exports to the EU countries in total exports of the SR (Figure 4) fluctuates within a range typical of less developed countries at the same time before accession. The EU is the most important business partner of Slovakia and its importance continues to increase (Figure 4 + Table 3). However, in comparison with neighbouring candidate countries, the figures on exports to and imports from the EU are relatively lower. In 1995, exports to the EU accounted for 44% of the total Slovak exports, and in 2001 this share went up to 60%. The situation is different for imports from the EU, which account for one half of imports to the SR. This is caused by Slovakia's dependence for raw materials on countries of the former Soviet Union.

Inflow of foreign direct investments into the SR (Table 4) over the period subject to review was markedly lower compared to EMU members, but also the present candidate countries – in particular the Czech Republic and Hungary. In 1999, the FDI in the SR accounted for only 11.5% of GDP, whereas in Greece it was 17.7% and in Ireland 50.7% of GDP. Although in the years 2000 and 2001 the differences were reduced, a substantial difference between the SR and countries with the highest FDI inflow, the CR and Hungary, still persist. The FDI inflow can be expected to grow further in connection with our expected entry into NATO and the EU.

Table 3 Exports to and imports from the EU as a share of total exports and imports.

	Exports to EU				Imports from EU		
	1995	2000	2001		1995	2000	2001
Portugal	80	80	79	Portugal	74	75	73
Netherlands	80	79	79	Belg.+ Lux.	72	70	70
Belg.+ Lux.	77	75	77	Austria	76	69	67
Hungary	58	75	74	Špain	68	66	65
Špain	67	70	70	France	68	65	64
Czech Rep.	42	69	69	Íreland	64	62	63
Poland	60	70	69	Czech Rep.	42	62	62
Austria	66	61	64	Finland	65	62	62
Ireland	74	63	62	Poland	56	61	61
France	63	61	61	Hungary	74	58	58
Slovakia	44	59	60	Germany	59	55	56
Germany	57	56	56	Italy	61	56	55
Italy	57	55	55	Netherlands	63	50	52
Finland	58	56	55	Slovakia	52	49	50

Source: Eurostat, the 2001 data: Jan.- July
Canstat for candidate countries

The data on foreign direct investment in the EU “cohesion” countries in the period before and closely after the accession to the EU are not directly compatible with the current situation in the candidate countries, due to substantially lower degree of liberalisation of capital and uncompleted national official statistics at that time. Generally speaking, after a period of high net inflow in the first years following the entry into the EU, there has been a prevailing opposite tendency over the recent years and the resulting balance tends to be that of an outflow. A net outflow at the level of 1-2 % of GDP per annum was recorded in Portugal in 1998-2000. In Greece, the balance was approximately equilibrated, and in Spain the net outflow of FDI in 1999-2000 reached roughly 4 % of GDP per year. Quite typically for these countries, the net outflow of FDI is primarily an outcome of a high dynamics of capital exported outside the EU area and targeted at historically or culturally close regions. Spain and Portugal are mainly getting involved in Latin America (e.g., 40 % of FDI of Portugal in 1996-2000 was directed to Brazil), and Greece is getting involved in the Balkan countries. These developments are explained by growing globalisation and by a shift in the process of internationalisation of individual economies and corporations from foreign trade exchanges to exports of capital. As for their territorial orientation, there is an evident incentive to gain an additional comparative advantages, which the destination (usually developing) countries offers to these exporters of capital - and not only in the economic (cost) field.

Table 4 Foreign direct investments (cumulative figures, % of GDP)

	1999	2000	2001
Slovakia	11.5	19.4	23.0
Czech Republic	33.2	41.2	45.0
Hungary	42.8	42.9	42.9
Poland	17.6	20.3	22.9
Slovenia	14.5	16.3	17.6

Source: Canstat

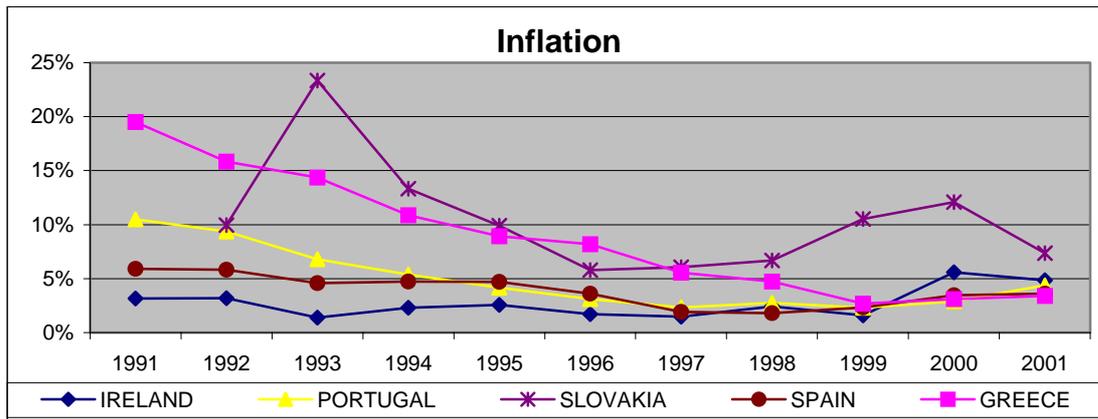
Figure 5 depicts the development of inflation. It is evident that five years before the entry into the EU, inflation was not at a desirable level in any of the countries subject to comparison. But it gradually declined. A different situation can be expected to appear in Slovakia where because of price deregulation, the inflation will continue to grow, which will raise greater requirements on the process of disinflation right before the entry into the EMU.

As for the government debt of the SR (Figures 6 and 8), the government deficit (in proportion to GDP) as well as the gross debt are relatively low in comparison with the EU countries. Compared to other candidate countries (Figures 7 and 9), the situation however is not so satisfactory: for example, the public debt in Hungary in 2001 stood at 53% of GDP and in Slovakia at 44%. But in Poland and the Czech Republic it reached lower levels. It must however be taken into account that there are some other government obligations, such as state guarantees and hidden environmental liabilities, which add to the debt in real terms.

When comparing economic structures, one of the most relevant indicators is the relative proportion of value added generated in different sectors (Table 5). Compared to the EU average, the SR exhibits a higher proportion of value added in agriculture, trade and industry. Except for services where this rate for the SR is lower than the minimum value in the EU, the figures for all the other sectors happen to fall within the bounds of the minimum and maximum EU values.

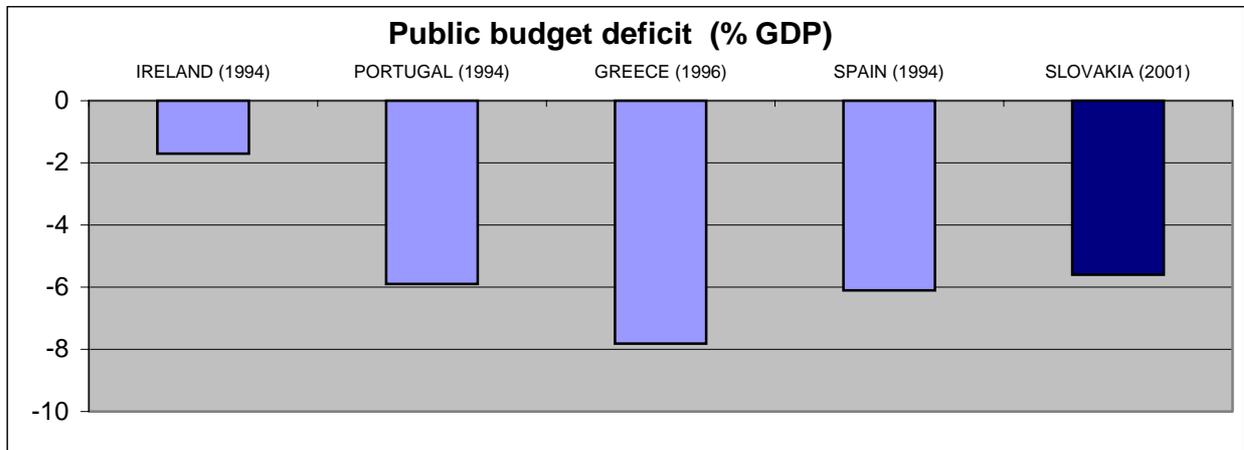
Also interesting is a relative employment rate in individual sectors (Table 6) – the employment rate in industry is markedly higher than the maximum for the EU. This sector generates a relatively high value added, which is however not proportionate to the number of people employed.

Figure 5



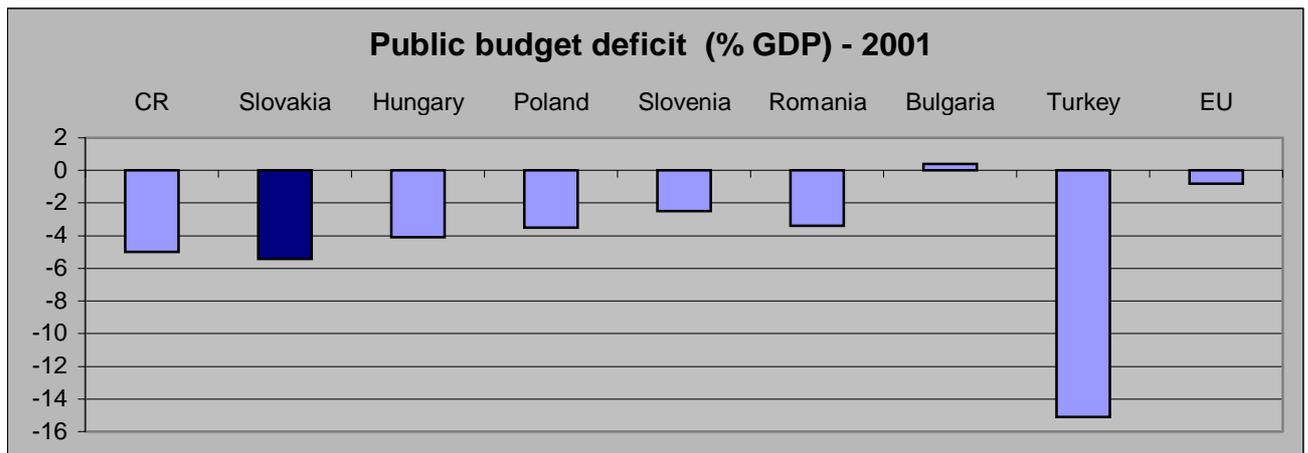
Source: OECD

Figure 6



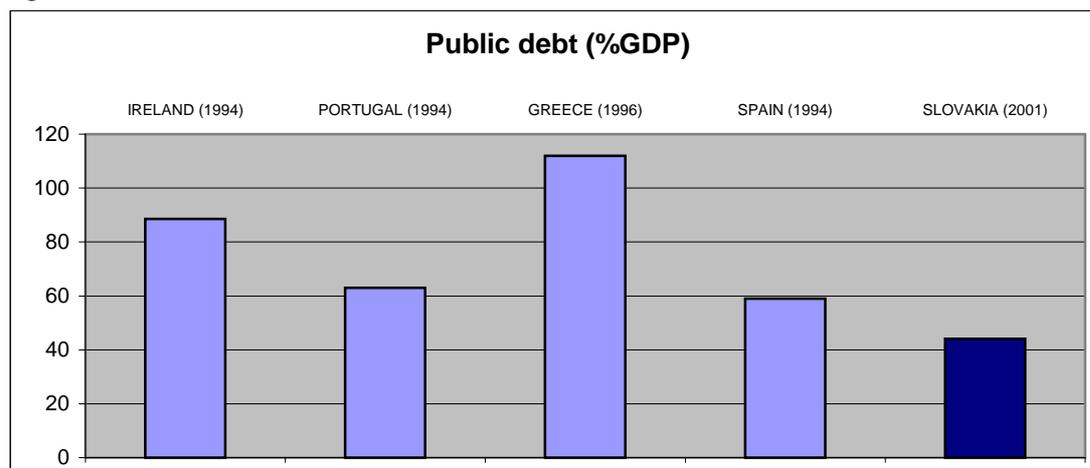
Source: ECB

Figure 7



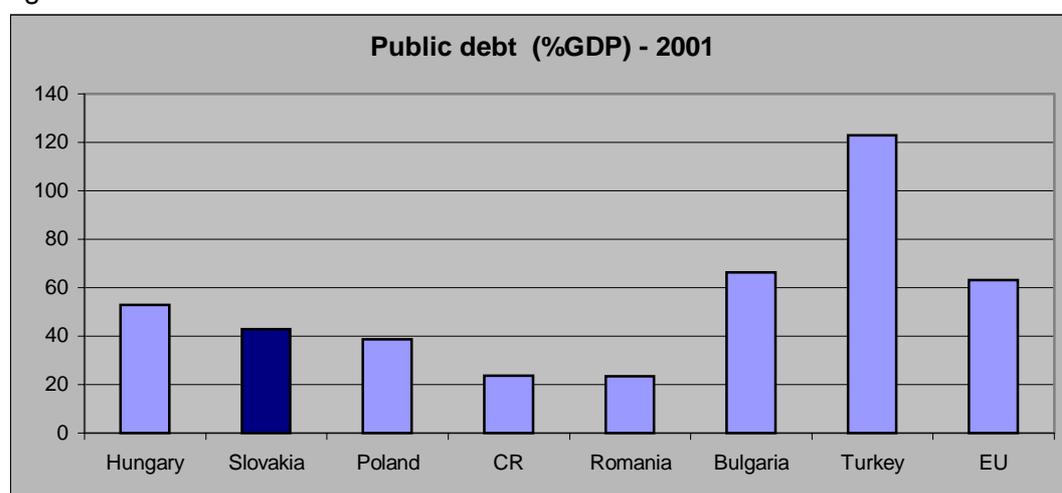
Source: National PEPs

Figure 8



Source: ECB

Figure 9



Source: National PEPs

Table 5 Share of value added by economic sectors (% of total)

	Slovakia	CR	Hungary	Poland	EU-15	EU-min	EU-max
Agriculture	4.2	4.1	4.4	3.4	2.6	0.8	8.9
Industry	25.0	32.9	28.0	25.4	23.8	15.2	32.8
Construction	4.7	7.1	4.8	7.5	5.4	4.2	7.9
Trade, transport, hotels	26.5	25.2	22.3	30.1	21.1	17.7	28.3
Financial services		15.7	20.9	16.1	25.9	17.9	38.6
Other services	39.6*	15.0	19.2	17.5	21.1	17.0	23.9

Data for 2001, except for EU-min and EU-max(1999)

* financial and other services taken as a whole

Source: Canstat, Eurostat

Based on the comparison of basic characteristics of less developed countries of the euro area five years before their entry into the EMU with the Slovak figures at the present time, the following can be noted:

- the per capita GDP level at purchasing power standard is lagging behind,
- there is a favourable situation with regard to economic openness indicators,
- we are lagging behind on comparative FDI inflow characteristics,
- the Slovak economy is characterised by a lower degree of people employed in the services sector,
- we have reached a lower proportion of value added in services.

Table 6 Share of employment by economic sectors (% of the total economy)

	Slovakia	CR	Hungary	Poland	EU-15	EU-min	EU-max
Agriculture	6.2	4.8	6.2	19.1	4.8	1.9	18.1
Industry	29.6	31.3	27.2	23.7	20.3	13.9	23.7
Construction	8.0	9.1	7.1	6.7	6.8	6.0	10.5
Trade, transport, hotels	23.1	24.0	26.0	21.9	26.9	22.3	28.2
Financial services	6.7	7.6	7.7	6.8	14.3	7.0	23.5
Other services	26.5	24.0	25.9	21.7	27.0	22.0	36.3

The 2001 figures, except for EU-min and EU-max (1999)

Source: Canstat, Eurostat

1.3. Characteristics of convergence of the SR to the EU

Even though the EU experienced several waves of enlargement, the forthcoming one will be unique in several respects:

- the majority of candidate countries are still undergoing the process of transformation
- whereas the former enlargements involved 2-3 countries, at present accession negotiations are underway with 10 countries
- however, major challenge is the development gap between the EU and the group of CEE candidate countries. Whilst the population in the EU will increase by 20% as a result of the addition of 10 candidate countries, the nominal GDP will only rise by approximately 4.5%
- there are big differences within the group of candidate countries itself. The level of per capita GDP at purchasing power standard ranges from 18,500 for Cyprus to 7,700 for Latvia. Likewise, the comparative price level ranges between 82% of the EU level for Cyprus to 38% in the SR (Figure 10).

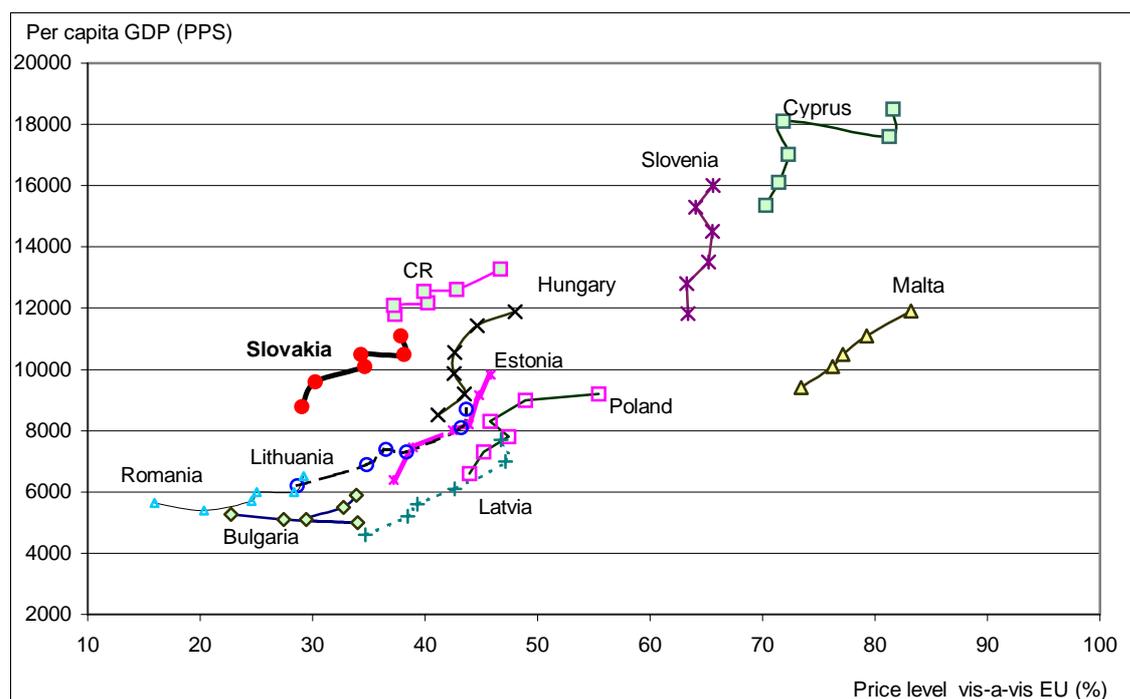
Catching up with the EU level is based on a combined effect of three factors: a more rapid growth of real GDP than in the EU, the existence of inflation differential vis-à-vis the EU and the appreciation of a nominal rate of currency against the euro. Reducing the gap as to per capita income (per capita GDP at the purchasing power standard) is therefore accompanied by an approximation of the price level in the EU countries, i.e. catching up in monetary terms – by way of inflation differential and appreciation of the nominal exchange rate, as is illustrated by Figure 10. In this Figure, the catching up by a country proceeds along the „north-east“ line.

The course of catching up on the part of individual countries is practically preconditioned by their starting position on the one hand, and the dynamics of growth, chosen disinflation strategy and exchange rate regime on the other. For example, Baltic countries, where there was a fixed exchange rate within the currency board, have been catching up through the

inflation differential. Hungary and Poland in the long run used the opportunity for step-by-step depreciation of the nominal rate, hand in hand with a slow disinflation. Slovenia pursued the policy of maintaining price competitiveness with the use of a managed floating at low inflation).

The position of Slovakia within the group of accession countries points to the need to catch up more rapidly in the direction of price level approximation. The process of catching up in the past took place rather on the basis of inflation differential (until this was reflected in the depreciation of a nominal rate upon a change in the exchange rate regime) than on the basis of real GDP growth⁴.

Figure10 Per capita GDP (PPS) and the comparable price levels vis-à-vis the EU, 1996-2001



Source: Eurostat

One important point in terms of the future is that already in the period prior to entry into the EMU, room for catching up in monetary terms is being narrowed, due to the necessity to meet nominal convergence criteria. Therefore, room will remain mostly for the most challenging (and slowest) way of convergence – by growing economic performance on the basis of competitiveness.

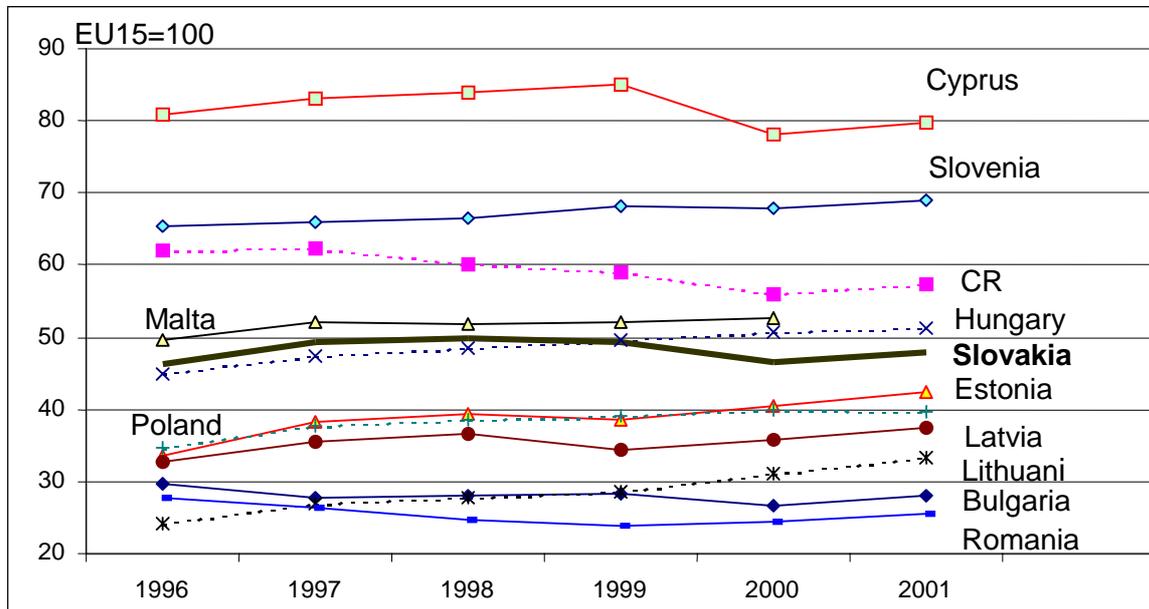
Catching up with the average per capita income level for the EU is however a „moving“ target, since hand in hand with the economic growth of the EU countries, this level continuously moves up. As indicated by Figure 11, catching up with the EU average has been progressing at a slow pace in the second half of the 1990's. The relative position of these countries compared to the EU average improved more significantly only in Slovenia, Hungary and Estonia. And in the case of Bulgaria, Romania and the CR, there was even a certain deterioration.⁵

⁴ IMFS (2000).

⁵ As was mentioned in section 1.8, the approximation of data for the calculation of the purchasing power parity of individual currencies against the euro introduces a certain distortion in these comparisons. On the top of that, in the case of the SR, the Eurostat data do not take the latest revision of GDP into account. Nevertheless, for the sake of illustrating the relative positions within the group of accession countries, we consider such a comparison as sufficient.

A question that still remains open is how the catching up will be reviewed in statistical terms following the subsequent enlargement waves. Will the level of EU15 become the reference value or the level of EU25 (or EU27) be taken as the basis?

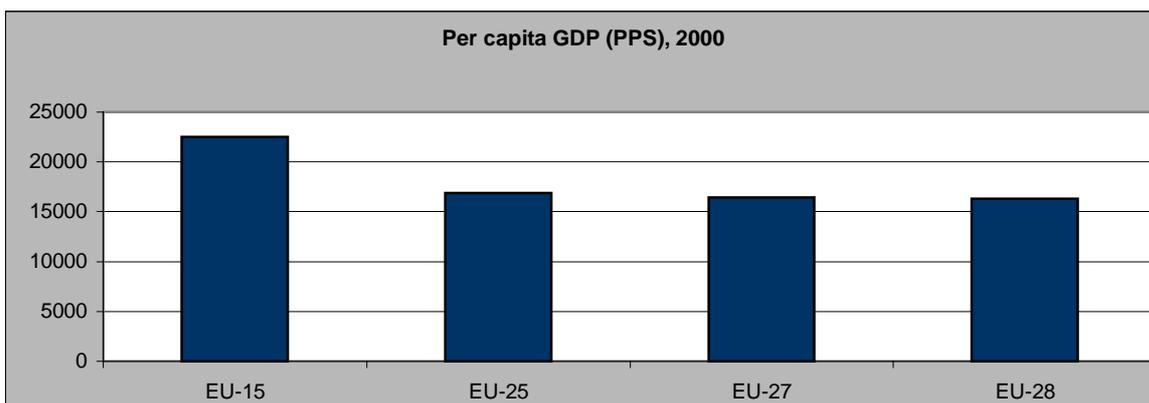
Figure 11 Per capita GDP compared to the EU average, in per cent



Source: Eurostat

An illustrative view of the changes in the EU per capita GDP average due to the CEE countries enlargement is given in Figure 12 by means of the PPS data for 2000. It is evidently the first wave of enlargement that will cause a principal change. The admission of remaining countries would only mean a mild drop in the European average.

Figure 12 Average per capital GDP level by different EU definitions



EU-15 = the current EU
 EU-25 = EU-15 + the relevant group of 10 candidate countries
 EU-27 = EU-25 + Bulgaria and Romania
 EU-28 = EU-27 + Turkey

For the sake of illustration (under considerably simplifying assumptions), the European Commission has presented a long-term outlook of the GDP growth – an estimate of a period of time that individual accession countries will need to reach 75 % of the average GDP level for the EU15 and, alternatively, the EU27⁶ average (Table 7).

Table 7 Per capita GDP at PPS, number of years before the country reaches 75% of the average

	EU 15	EU27
Bulgaria	31	31
Cyprus	-	-
CR	15	6
Estonia	19	16
Latvia	27	25
Lithuania	31	30
Hungary	11	7
Malta	43	26
Poland	33	33
Romania	34	33
Slovakia	20	16
Slovenia	1	-

The results indicate that

- the majority of countries would catch up with the EU27 average more quickly, for the simple reason that a reference value for the EU27 is lower than for the EU15
- „time gained“ by individual countries would be distributed asymmetrically in favour of countries that are already now closer to the EU level, due to the fact that even though a reference EU27 value would be lower, it would be growing more dynamically than the EU15 value
- „time gained“ by Slovakia could be 4 years in the case that the EU27 reference value is used instead of the EU15 value.

As was already mentioned, the process of catching up with the EU requires that the GDP growth is founded on a rising productivity of factors of production (labour, capital, technical advances) at a sustained control over cost factors. According to the Ecofin data, the cumulated GDP growth in the group of candidate countries over the period 1994-1999 was primarily based on a growing stock of capital and the overall productivity of production factors (technical advances) at a falling rate of employment.⁷

This result indicates that:

- a „capital intensive element“ prevails with regard to the growth in candidate countries – the sizeable growth in the physical volume of capital is however easy to understand because of the need to replace outdated production facilities dating back to the pre-transformation period and the process of restructuring that is currently underway,
- owing to such an output growth, the speed of the process of catching up substantially depends on the rate of investments,
- owing to the need for structural changes, the temporary decline in employment could be seen not just as a negative. However, in the long run, there will be a need for a turnover in the development of employment (creating new jobs = creating sources of income for the population), so that the catching up in the sense of a growing per capita income could materialise and income inequalities are not deepened in society,

⁶ European Commission (2001).

⁷ A similar statement has been made by e.g. Doyle, Kuijs and Jiang (2001) in relation to the countries of Central Europe in the period 1991-1999.

- owing to a relatively poor contribution of technical advances, technology standards and labour force qualifications are lower, with an existing potential for further qualitative changes.

With regard to the importance of investment for promoting growth, an important role in the process of catching up is played by other factors, such as

- growth of household savings adequate to the growth of investments. Otherwise, an increase in the current account deficit could endanger a sustainable growth of the economy
- financial intermediation - the stability of the financial sector, its size and costs of financial intermediation have a distinct direct effect upon domestic investments and, thereby also an indirect effect upon the real convergence
- foreign direct investments as a source of funding the country's investment needs, and, at the same time, the transfer of know-how as part of promoting technical advances⁸
- political, institutional and legislative environment, effective management of the corporate sector and factors of overall stability of the domestic environment that are sensitively assessed by foreign investors when providing funding
- as in the cohesion countries, further intensification of the process of catching up may be stimulated through a support from the EU structural funds, assuming there is a capacity for their effective application.

The degree of real convergence achieved, as measured by the aggregate per capita GDP indicator, only partially explains the nature of national convergence processes. It does not indicate their time profile (the degree of smoothness) or the formation of regional capacities in these economies, such as convergencies/divergencies across national economic areas. **At the regional level** (the NUTS2). income differential between the richest and poorest regions inside the candidate countries has been evidently increasing on average.⁹ Even though this finding contradicts the assumptions of a neoclassical theory of growth, under which a higher marginal productivity rate of factors should lead to a more rapid convergence in regions with a lower per capita income, empirically however it holds true that at the beginning of the process of catching up, there is an increase in income inequalities at the regional level of a country, which at the later stages of growth gradually diminish.¹⁰

Regional disparities usually increase because growth at the national level is supported by effects of growth poles that are formed in capitals and other large agglomerations. This relationship has been confirmed in the EU cohesion economies on a long-time basis. In Spain and Ireland, the pace of growth was higher and regional disparities enlarged. In Greece and Portugal, the pace of growth was lower and regional disparity was eased. Also in the SR, a declared striving for reducing regional disparities should therefore take the form of promoting regional initiatives to employ the resources from the EU structural funds (i.e. development of good projects) rather than any dirigistic policy, such as direct regulation of foreign investors, which could produce inappropriate allocation effects and, eventually, result in the restriction of overall growth.

The equalisation of price levels between the EU countries, or, in the case of the run-up countries, increasing the local price levels gradually to the EU average, represents an inseparable defining part of real convergence. The process of price catching up contains a certain inflationary load, which has potential implications on economic and monetary

⁸ See Hořková (1996-2002).

⁹ European Commission(2001).

¹⁰ This conclusion corresponds with a new theory of economic geography and trade that concentrates on agglomeration effects.

policies both for the accession process by candidate countries and their preparation for the entry into the monetary union, as well as the run-up countries within the current EU, and ECB monetary policy.

As a result of differences in the sectoral labour productivity in accession countries, there is a potential for dual inflation and real appreciation of exchange rates vis-à-vis business partners (the Balassa-Samuelson effect). This phenomenon can be of a mid-term or long-term duration. An important role with regard to the extent to which the B-S effect will show itself in the appreciation of a nominal rate and/or local inflation is played by the functioning of a wage mechanism. The higher the degree to which increases in nominal wages are restricted, the more distinctly can a country reach a nominal appreciation and low inflation without the impact of losing its competitiveness. Estimates of a structural component of inflation associated with the B-S effect put together for different groups of candidate countries move within a boundary of 1-2 percentage points per annum¹¹, which accounts for approximately a half of the average real appreciation for the CEE-10 countries against the EU over recent years. (In Slovakia, in the event of a more intense FDI inflow into the marketable sector, with a subsequent impact on a higher growth of labour productivity in this sector, the impact of a B-S effect could temporarily increase to the level of 3 percentage points per annum). A higher equilibrium rate of inflation in the country (due to the impact of the ongoing process of convergence) following the entry into the EU, should not be conceived as a threat to monetary stability due to its structural origin and nature (the convergence of prices to the level of more rich countries).

Despite a positive inflation differential that will exist among the future Member States of the euro area and its current members, the enlargement should not create any problems for the ECB monetary policy and price stability in the euro area in the short and medium term. In the first place because the economic weight of these countries in aggregate indicators of the euro area is small (and will continue to be so in the near future), so the national inflation figures will have a practically negligible effect on inflation in the euro area. In the second place, these countries will continually apply disinflationary monetary policy with the aim of achieving a nominal convergence before their entry into the euro area. Moreover, for the time being, the inflation differential exists even among the current EMU members (whose performance varies) without any significant impact on ECB monetary policy.

Attention needs to be paid to some other factors driving inflation, which may have a markedly more negative effect than the BS effect, namely the continuation of structural reforms and price liberalisation in areas such as telecommunications, power, transport and health care, whose impact on inflation is less steady and depends on the timing of respective reforms. In relation to structural reforms, the shifting of a portion of payments from the public budget to the population can be envisaged, so that some new items bringing inflationary impulses will appear in the consumer basket. These changes will influence the inflationary expectations of households, which then may stimulate wage (cost) inflation.

Owing to the need to complete structural reforms, any strategies (prematurely) oriented exclusively towards reaching a parity of inflation could potentially counteract the process of real convergence, or disregard the necessary inflation differential associated with a real convergence of income levels and levelling out of prices. Upon entry into the monetary union, these interim artificially suppressed risks of further nominal and real run-up could show up in losses in competitiveness and destabilising effects on the national macroeconomic environment. Whereas, on the other hand, the effects on monetary stability within the euro area would in principle be marginal and would not put the ECB principles of the single monetary policy at risk.

¹¹ For example, Kovács (2002).

It is therefore extremely important that any price adjustments having to do with or following from structural reforms are achieved as early as possible before entry into the monetary union. Likewise, the removal of any temporary adjustments must be timed so that subsequently they do not interfere with price stability targets.

1.4. Fiscal convergence

When it comes to the formulation of a mix of macroeconomic policies, the fiscal area in the SR represents a source of tension. The causes of high fiscal deficits lie in the costs of structural reforms on the one hand, but foremost, in their slow and inconsistent execution on the other.

The ECB analysis shows that during the convergence process a considerable reduction in the fiscal deficits and the debt-to-GDP ratio has been reached, which contributed to the establishment of overall conditions needed to maintain an environment suitable for non-inflationary growth. The fiscal consolidation was based rather on growing revenues, falling interest payments and/or cutting down of capital expenditure in proportion to GDP than on the reduction of primary expenditures. Also, temporary measures (such as tax increases) were used in different Member States to varying degree. Nevertheless, these measures have to be understood as a tool at a certain phase of economic cycle. They cannot in themselves be considered as a factor contributing to fiscal consolidation. That is why they had to be replaced with long-term measures, in order to exclude the growth in lending needs of the government in the years to follow.

As for the fiscal situation in the SR, this involves an analysis of the sustainability of the development of public finances, taking into account the methodological procedures applied in the EU from the point of view of commitments arising for the SR from its participation in the Stability and Growth Pact (SGP).

Under the SGP, the criterion of the public finance consolidation set within the medium-term programme of fiscal convergence is the achievement of a balanced or even surplus structural (i.e. cyclically adjusted) budget. This objective is motivated by the intent to create room for functioning of automatic stabilisers in the course of the economic cycle, where, by keeping track of a cyclically adjusted value of the budget balance, pro-cyclic behaviour of public finances should be prevented. In such position, the budget should not "eat up" a greater revenue from a period of economic expansion and, on the other hand, a slowing down of growth should not lead to a danger of exceeding the threshold for deficit criteria at 3 % of GDP.

In outlining the issues of consolidation of the fiscal sector of the SR in view of preparations for the accession to the SGP, we drew on the data and information from the updated Pre-accession Economic Programme of the SR (PEP, August 2002).

1.4.1. Current status of public finances in the SR

The development of a primary budget balance (i.e. a balance adjusted for interests paid on the government debt) indicates whether the public finances tend towards consolidation or expansion. In the EU countries, fiscal consolidation over the course of the 1990's contributed to the removal of debt in the government sector, or to the reduction of a debt servicing-to-GDP ratio, thanks to which (apart from other concerns) the primary budget positions in all the countries as well as for the EU taken as a whole attained positive values (Figure 13). Meanwhile, the primary balance in Slovakia fluctuated in the region of negative values (Figure 14), which from 1996 onwards has been matched by a growing proportion of the government debt to GDP.

In general, this trend is being justified notably by the costs of transformation (funding of the restructuring of the banking sector). The prediction of the public debt development within the PEP SR from 2002, envisages a partial reduction of debt service through the use of privatisation proceeds following the year 2002. The primary balance should for the first time attain a positive value in 2005, which, in the event the indicated downward trend starting from 2002 continues, should lead to an absolute decrease in the debt servicing ratio in the next few years, and to the consequent improvement of the primary balance.

From the viewpoint of future developments of public finances in the SR in accordance with the SGP requirements, it needs to be stressed that the mentioned privatisation revenues as well as other one-off or non-recurring funds used to reduce budget deficit, government debt and debt servicing only are of a supporting but not systemic nature.

Fig. 13 Development of primary balance in EU

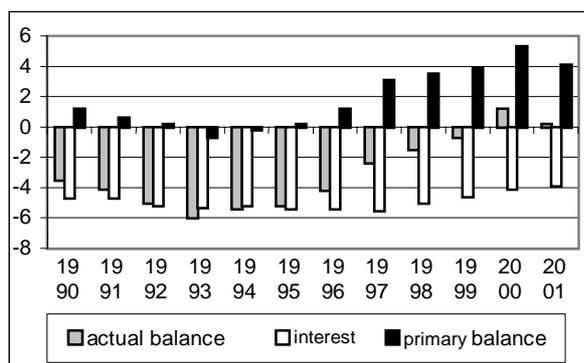
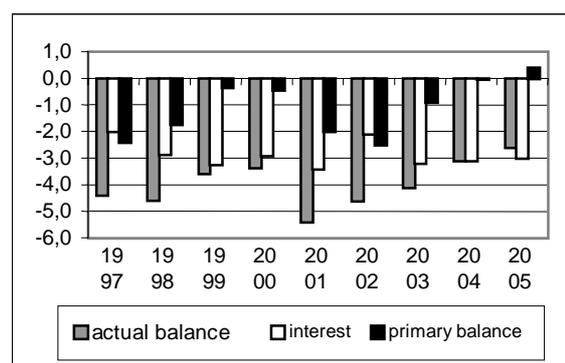


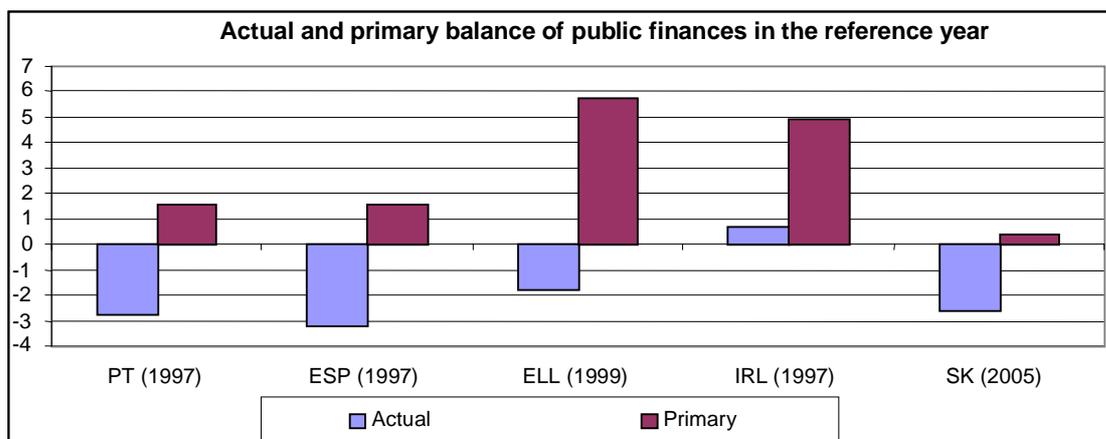
Fig. 14 Development of primary balance in SR



Years 2002-2005: prediction

An additional view of the fiscal sector performance in the SR and the degree to which it consolidated relative to the future need to fulfil the Maastricht criteria can be derived from a comparison between the present and predicted development of public finance deficits in the SR until the year 2005. Considering the earliest technically possible variant of entry of the SR into the monetary union (2007), year 2005 would make a reference year for assessing the fiscal criteria in SR in comparison with fiscal deficits of the 4 so-called EU cohesion countries in relevant reference years (1997, or 1999 for Greece, respectively).

Figure 15



The budget position of the SR in the potential reference year 2005 is weak even in comparison with these countries (Figure 15). The main indicator is once again represented by a primary balance, whose positive value for the SR will only be attained in the (reference)

year 2005, whereas in the countries compared, the primary balance was positive over the entire relevant portion of the pre-accession period. With a view towards a long(er)-term sustainability of public finances (including the reduction of the debt ratio), a favourable development of the primary balance was apparently one of the arguments in favour when assessing Spain's overall fiscal position, which in the reference year was still above the 3% Maastricht criterion.

To summarise, the development of public finances in the SR has as yet not established stimuli for the necessary fiscal consolidation. Whereas even a medium-term outlook until 2005 (PEP SR, August 2002), which could potentially become the earliest possible year for assessing the fiscal criteria for the entry of the SR into the monetary union, does not provide a convincing picture about a systemic consolidation efforts in the public finances of the SR.

1.4.2. Medium-term criterion on the public finance balance: structural balance

Whether public finances are sustained over a long or medium term in the positions as reviewed by the SGP will be decided by the success with which sufficient room has been created for the functioning of automatic stabilisers, i.e. how the structural balance of the public administration consolidated budget will develop. From a prediction of a cyclical development of the budget according to the PEP SR (Table 7) it is clear that despite the predicted reduction of the structural balance, its value (-2.7 % of GDP) in 2005 will still be far below an equilibrated value (not to mention a surplus), targeted obligatory under the SGP. This would mean that even in 2005 the fiscal sector of the SR will not be ready to undertake the function of a decisive, or under conditions of the monetary union, the only national tool to correct the impact of the single monetary policy on the economy of the SR. Possibilities for automatic stabilisers to act freely will still be considerably limited and will not give a guarantee that impacts of the economic cycle upon the public budget will be successfully handled. This, especially in the case of a slowed growth, could pose a serious danger that the threshold for a deficit of 3 % of GDP is exceeded.

Table 8 Prediction of the cyclical development of public finances in the SR by 2005

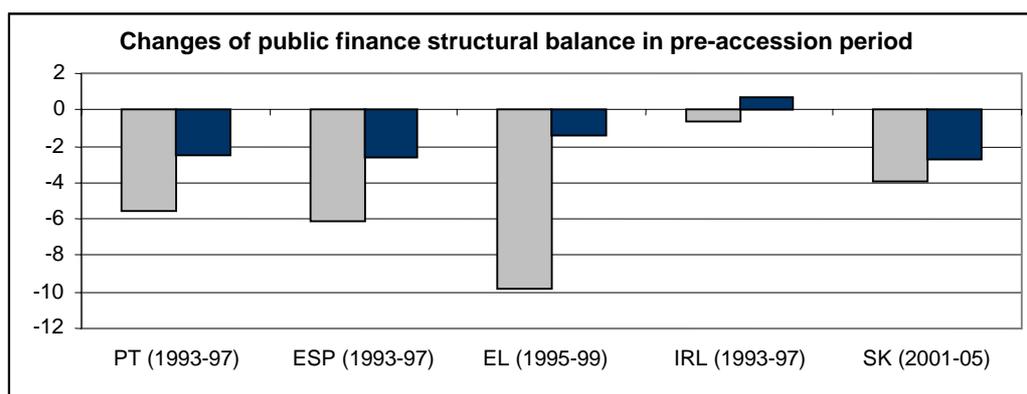
Ratios as % of GDP	2001 (actual)	2002	2003	2004	2005
1. GDP growth at constant prices	3.3	3.6	4.1	4.6	5.1
2. Deficit/surplus ¹	-4.6	-5.8	-4.1	-3.1	-2.5
3. Net interest payments	3.1	2.7	2.5	2.5	2.4
4. Potential GDP growth	4.5	3.7	3.4	3.6	3.6
5. Output gap	-2.3	-2.4	-1.7	-0.7	0.8
6. Cyclical budget component	-0.7	-0.8	-0.5	-0.2	0.2
7. Cyclically adjusted balance (2-6)	-3.9	-5.0	-3.6	-2.9	-2.7
8. Cyclically adjusted primary balance (7-3)	-0.8	-2.3	-1.1	-0.4	-0.3

Source: PEP SR August 2002; data according to the GFS 86 methodology.

¹ including the costs of banks restructuring .

A low predicted level of consolidation of public finances in the SR in the period prior to entry into the monetary union (once again with the potential reference year being 2005), is also documented by comparison with the structural balance changes in the group of EU "cohesion" economies over the same period of time (Figure 16).

Figure16



In addition, there will be other requirements to enhance the budget position that will follow in the SR, similarly as in the majority of EU countries, from a need to prepare solutions for budgetary impacts of the unfavourable demographic development such as increase in the old-aged-dependency ratio. It is possible to state in general that the greater the public finance structural balance surplus a country is able to achieve in the medium term, the larger space it will have for casual discrete interventions of its fiscal policy (including tax reductions).

In line with the new methodological procedures (2001) on determining medium-term fiscal objectives elaborated by the European bodies for the SGP (minimum benchmarks, budget deficit safety margins), when a fiscal convergence programme and medium-term objectives are compiled or updated, the SR will also have to take these requirements into consideration more and more definitely.

1.4.3. Performance of the fiscal sector of the SR in comparison with the EU

The performance of the fiscal sector in the SR (2001) in relation to EU averages is characterised by basic ratios of public finance revenue and expenditure to GDP (Table 9).

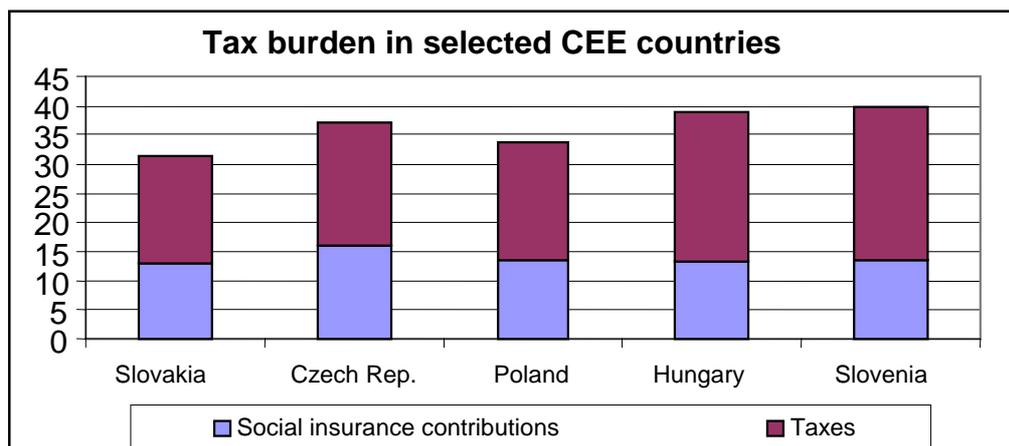
Table 9 Public finance revenue and expenditure, % of GDP

	EU-15	Slovak Republic, PEP 2002				
	2001	2001	2002	2003	2004	2005
1.Total revenue	46.3	41.2	42.4	41.3	40.7	39.8
2.Taxes	27.5	18.3	17.9	19.0	18.9	18.9
3. Social insurance contributions	14.3	12.9	13.2	14.3	13.9	13.4
4.Tax burden in total (2+3)	41.8	31.2	31.1	33.3	32.8	32.3
5.Other revenues	4.5	10.0	11.3	8.0	8.9	7.5
6.Total expenditure	46.5	46.6	47.0	47.8	46.3	42.2
7. Public consumption expenditures	19.8	18.3	18.5	19.4	18.7	17.7
8.Social transfers	16.0	10.3	11.1	10.3	10.2	9.7
9.Interest	3.6	3.4	2.1	3.2	3.1	3.0
10. Subsidies	1.3	1.2	1.1	1.1	1.0	1.0

Total tax revenue (including social insurance contributions) for 2001 amounting to 31.2 % of GDP was far below the EU-15 average, where there it accounted for 41.8 % of GDP. To illustrate this point, it should be mentioned that the level of tax income was even lower than in Ireland (31.3%), where the tax burden in 2001 was the lowest among the EU countries. This could lead one to assume that the SR has a very good position in the sense of a favourable business climate. In reality, the situation in Slovakia rather corresponds with a standard observed dependence between the level of tax burden and the income level of the country, where countries with a low income level also exhibit low tax revenue.¹² Also the tax burden in the other V5 candidate countries is below the European average (Figure 17). Again, by comparison, the SR ranks the lowest, which means that the SR has a competitive advantage of low tax and transfer obligations not only in relation to the EU average, but also within the region of relevant candidate countries.

Taken from the structure of tax burden expressed as total tax revenue broken down into direct taxes (income and property taxes), indirect taxes (VAT, excise duties and taxes on international trade and transactions) and the non-wage labour costs, i.e. transfers or social insurance contributions (Table 10), it is evident that the lowest proportion of direct taxes to total tax revenues in the SR correlates with the previously mentioned extraordinarily low overall tax burden in the SR.

Figure 17



Source: National PEPs 2002

At this point it is necessary to stress that it is the absolute value of tax rates that is so low in the SR. The current corporate income tax of 25 % is the third lowest tax rate after Hungary (18 %) and Ireland (24 %) and the highest personal income tax of 38 % is, after the CR (32 %), the second lowest within the OECD countries. Besides that, low budget revenue from direct taxes is also caused by an unsatisfactory effectiveness of tax collection (which, by the way, has also been repeatedly pointed out by the IMF), but also by an extensive latitude to apply deductible items on the tax base, tax evasion due to illegal work and the like.

¹² On the contrary, countries with a high level of income which as rule have developed the most generous social welfare systems in Europe („welfare states“) are typified by a high tax burden necessary to finance such expensive expenditures.

Table 10 The structure of tax revenue in the EU countries and the SR in 2001
(% of the total tax revenue)

Direct taxes		Indirect taxes		Social insurance contributions	
Slovakia	23.1	Sweden	27.5	Denmark	6.3
France	26.3	Belgium	28.7	Ireland	17.6
Greece	26.9	Germany	28.9	Great Britain	19.7
Germany	27.3	Finland	28.9	Finland	26.2
Netherlands	28.9	Netherlands	32.2	Luxembourg	27.9
Spain	29.8	Austria	32.2	Italy	30.1
Portugal	30.8	Spain	32.6	Sweden	31.1
Austria	30.9	EU-15	32.8	Portugal	31.1
EU-15	33.0	France	33.5	EU-15	34.2
Italy	33.7	Denmark	33.7	Belgium	34.3
Luxembourg	35.9	Slovakia	35.8	Greece	34.9
Belgium	37.0	Italy	36.1	Austria	36.8
Ireland	39.6	Luxembourg	36.2	Spain	37.6
Sweden	41.5	Great Britain	36.5	Netherlands	38.8
Great Britain	43.8	Portugal	38.1	France	40.2
Finland	44.9	Greece	38.2	Slovakia	41.0
Denmark	60.0	Ireland	42.8	Germany	43.8

Unlike that, obligations to make social insurance contributions have almost reached the European average¹³, with its share in the structure of overall tax burden in the SR reaching the second highest level (after Germany). Although, when it comes to the expenditure side of public finances in the SR, a high unemployment rate needs to be taken into account, which then raises high demands on unemployment benefits. It is however well known that the social system of the SR is ineffectively soft, with high demands on transfers to finance the system.

In terms of providing further consolidation of the public finances of the SR so as to achieve the conditions allowing for their safe movement into medium-term positions in accordance with the SGP criteria and to concurrently meet the yearly fiscal criteria, while posing no threat to the Maastricht parameters (3% of GDP for annual deficit and 60% of GDP, or a non-increasing ratio for the government debt), it will be important to consider:

- to what extent and with what success will the expenditure items be reduced first, via discrete measures, which can be summarised into a reform package to make the system of social welfare more effective; second, thanks to the effects of economic growth, which will bring down claims for social benefits for the unemployed, and generate higher tax revenue at the same time (in this context, particularly in the area of direct taxes);
- how the social system reform will subsequently make it possible to reduce transfer obligations, or the non-wage costs of labour. This should generate another stimulus for doing business and a subsequent dynamisation of growth.

In congruence with the innovations pushed through vis-à-vis the Member States by the European Commission as part of ongoing public finance reforms, recommendation can be made also for SR, to introduce (quantitative) rules in government expenditure. The adoption and observance of medium-term rules for expenditure growth, at a free fluctuation of

¹³ The Irish case is on the contrary a real reflection of an effective pro-business tax legislation with very low non-wage (transfer) labour costs.

revenue depending on economic activity, in fact constitutes ***the targeting of a structural budget balance***. Such procedures are already applied by several Member States (For further details see Public Finance in the EMU – 2001).

Conversely, when it comes to the revenue side of the budget, in relation to the ongoing discussion on further reduction of direct taxes in the SR, or the introduction of an even tax, we do not consider it as appropriate to launch a similar action without a prior demonstrable enhancement of the tax discipline, higher quality of tax collection, as well as a revision (narrowing down) of claimable deductible items from a taxable income assessment basis. The space for a further reduction of tax rates will have to be created by the strengthened tax-base owing to the effects of the aforementioned improvements, first and foremost, however, an overall improvement in the public finance deficit development in the SR.

1.5. Impact of convergence on the structure of financial markets

In the course of a convergence process, the nature and speed of the monetary transmission mechanism has been changing. Factors affecting these changes are of a structural nature, including regulatory changes in the real economy and in the financial markets prompted or facilitated by the process of convergence. The restructuring of the banking system, in connection with financial deregulation and liberalisation, should enhance the level of competition in the banking sector, with a potential accelerated transfer of market interest rates to retail interest rates. Another structural change, which should influence the monetary transmission mechanism, is a possible increase in the share of fixed and long-term loans in total loans thanks to a more stable macroeconomic environment. Also, the availability of funds via the financial markets should be increased, although in the field of financial intermediation, banks will continue to dominate.

Specifying the shape of the monetary policy transmission mechanism under our conditions is very problematic. This mainly has to do with uncompleted reforms in the microeconomic sphere disrupting standard ways of spreading monetary impetus into the real economy. This issue is currently subject to research. It has been shown that at present, the enhancement of competitiveness in the microsphere of the SR and the efficiency of a transmission mechanism is particularly influenced by the performance of the corporate sector. Despite the fact that the share of the banking sector within the financial market structure gradually declines, it still has a dominant position. At the same time, it has the strongest financial links to the corporate sector. The performance of the corporate sector therefore influences the allocation of disposable resources of the banking sector, achieved by its restructuring. A revival of lending activities is only partially influenced by the development of interest rates. A more important factor will rest in a higher intensiveness of real restructuring of the corporate sector. It will not only create room for growth in both segments and thereby for their improved performance, but also contribute to the standardisation of relationships between the macro and micro levels.

Although some of the partial results of analyses conducted so far have indicated the existence of an almost standard textbook relationship typical of a small open economy¹⁴, others¹⁵ rather prevalently point to the ambiguity of results and the need for their prudent interpretation¹⁶. Points mentioned include significant structural changes in the economy, its gradual integration into international financial markets, a changing economic situation of banks and undertakings, and other factors, such as the development of inflationary expectations associated with, inter alia, the credibility of the central bank. All these components introduce uncertainty into the results of model estimates based on historical

¹⁴ (Kuijs, 2002).

¹⁵ For example, Chudá a Ševcovic (2000).

¹⁶ Hajnovič (2001).

data. On the whole, an agreement has been achieved on the results of these analyses in that the only demonstrably working monetary policy channel in the SR is the exchange rate channel.¹⁷ The results of a recent IMFS paper on this topic follow the same lines¹⁸.

According to the findings of the ECB analysis, at a more advanced stage of accession for the introduction of the euro, the exchange rate transmission channel could become weaker, since the stability of the exchange rate against the euro will become a basis for the monetary policy. This was the case of practically all Member States of ERM/ERM II, which to an increasing extent profited from a higher exchange rate stability. A similar development can be expected also in the case of the SR upon its entry into the ERM II system.

1.6. Features of the Slovak economy in terms of its response to shocks in comparison to the euro area countries

According to the theory of optimum currency areas (OCA), the convergence of the structure of output and exports of an accession country with that of the monetary area, which this country wants to join, reduces the likelihood of asymmetrical shocks. It has been shown¹⁹ that within the process of accession, significant shifts have occurred in the run-up countries in this respect. The main features of such a shift consisted of a decreased share of agriculture and industrial production as well in the total value added and, concurrently, of a growing importance of the services sector with the latter trend being also pushed through in the entire euro area. At the same time, in the accession countries, there was a shifting underway towards the manufacturing of products which were less labour intensive and had higher value added. The causes to which the said changes were due may be classified into several groups. In the case of some traditional products (foodstuffs, clothing, shoes) there was a relative drop in demand and, at the same time, competitive pressure from countries with lower labour costs escalated. In general, the structural changes were caused by competitive pressures within the EU, with an important part in the possibility that structural changes are carried out being played by the FDI inflow. The FDI were in major part oriented towards sectors without tradition in the given countries.

Even though the results of empirical analyses concerning the asymmetrical shocks drawing upon historical data need to be interpreted with a large degree of caution, all in all they tend to confirm a thesis that the likelihood of asymmetrical shocks in the runup countries is falling hand in hand with the convergence of the characteristics of their economies with the euro area countries. Ecofin²⁰ noted a significant increase in the degree of economic interdependence between the EU countries and accession countries, with business and investment links, such as trading in goods and FDI, acting as the main force behind the reorientation of accession countries to the global and especially European markets. According to the Ecofin analyses, there was also an advanced synchronisation of economic cycles observed. According to the quarterly data on industrial output, the correlation with the industrial cycle in the EU countries has increased - most markedly in Hungary and the CR. These results are contrasted with a substantially lower correlation with the development of the overall GDP, which in the case of Slovakia and the CR is even negative.

Analyses of the Slovak economy data conducted so far by the NBS in this respect are not unambiguous as well. Some of them point to potential asymmetrical responses in the Slovak economy to shocks vis-à-vis the euro area countries, but also candidate countries.²¹ Other

¹⁷ For example, see Gavura (2000).

¹⁸ Nemeč, Benčik (2002).

¹⁹ ECB (2002).

²⁰ European Commission (2001).

²¹ Benčik (2002).

analyses²² do not exclude this, but concurrently record a tendency towards a decreasing likelihood of such a phenomenon. Nor in the near future can this question be expected to be unambiguously resolved at the analytical level.

What is decisive is that potential asymmetrical responses to the integration of the country into the EMU does not exclude the possibility of its integration, as long as there are mechanisms in place in the country which - under conditions of non-existence of the national monetary policy - eliminate the mentioned negative effects by other means. These are based in particular on the flexibility of prices and wages and the mobility of factors of production (labour, capital).

Under the theory of optimum currency areas two countries form an optimum currency area if the costs (negative impacts) of a common currency are lower than the benefits (positive impacts) of the common currency. Contrary to the views that were being formed at the time of creating the theory of optimum currency area²³ when the movement of capital was regulated, the current beliefs as to the possibility of applying a common currency emphasize that if the economy exhibits a sufficient ability to adjust itself to respond to a negative impact of a common currency when a shock occurs, then the chances of a monetary union to become successful are greater. The costs (negative impacts) of asymmetrical shocks are lower if the flexibility of the economy and economic processes is higher. The well-foundedness (optimality) of the monetary union is thus enhanced as well.

For example, if the regional mobility of the labour force is weak, the flexibility of the labour market must be increased in other ways – especially through a more flexible creation and termination of jobs, higher flexibility of wages, accommodation of the process of bargaining and the like.

The flexibility of response to asymmetrical shocks in the economy of Slovakia is limited, whether it be the labour market responses or potential fiscal policy responses which may leave small room for manoeuvring. It is therefore important to reduce the occurrence of asymmetrical shocks, or to promote processes for synchronising them.

Integration processes in the economy, especially the development of a sectoral division of labour should act to weaken asymmetrical shocks. Hand in hand with a growing FDI inflow, this can be expected to become more intensive. However, considering the comparatively poor FDI inflow so far, a rapid movement towards the EU and EMU will mean that the degree of interconnection of the economies and their financial systems achieved in the pre-accession period may not be sufficient enough to prevent asymmetrically destabilising impacts of some shocks on the Slovak economy (especially vis-à-vis Austria and Germany). For the time being, our relatively significant links to the economy of the CR could have stabilising effects.

Analyses of inflation differentials in the EMU have shown that the impact of some shocks on the economies of EMU member countries was asymmetrical and larger than expected. To be more specific, it was shown that since the creation of the EMU, the differentiation of inflation between member countries has been growing, with the number of countries that according to the inflation criterion would today not qualify for EMU membership growing as well. Developments in oil prices and the US dollar exchange rate over the past several years is considered to be an important cause of such a development. This shock then had asymmetrical effects on individual EMU economies.

²² MÚ NBS paper (2001).

²³ Mundell (1961).

From the time a country is heading for EMU membership, as well as on its being accepted as a member, the exchange rate will no longer be a monetary policy tool. Therefore, in terms of economic stability it will be important to create conditions mitigating the asymmetry of potential shocks in the real economy. A key prerequisite for such a solution is to deepen the integration of the Slovak economy into the EMU by means of intra-sector trade. Integration in this area has already become more intense, but not as yet satisfactory.²⁴ It will be equally important to create conditions in the economy to enable it to respond flexibly to eventual asymmetrical shocks.

Real convergence and integration with the EU and candidate countries' economies and, on the other hand, higher flexibility of the economy are therefore two ways how to stabilise the economy in the event of asymmetrical shocks after losing the possibility to use the exchange rate for stabilisation purposes.

1.7. Development in the external sector and increasing competitiveness

During the catching-up process, a current account deficit has as a rule been occurring or deepening, especially in connection with the upgrading of the economy. This tendency also has to do with the lowering of interest rates in the accession period, which influences the development of a country's balance of savings and investments, which is a mirrored reflection of the current account balance. The development in the external sector is on the whole dependent on competitiveness of the economy and its enhancement requires the activation of respective policies.

1.7.1. Macroeconomic aspects

Unfavourable development in the external sector in the period prior to accession to the EMU was typical of Greece and Portugal, and the current development in Slovakia is alike. In the period 1995-2000, the current account deficit in Greece deteriorated from 2.4% to 6.8%, and in Portugal from 2.4% to 10.1% of GDP. In both cases this result was substantially influenced by the balance of trade and likewise, in both cases growth in investments was not accompanied with the growth in domestic savings. This development is explained by optimistic expectations on a future growth of productivity and income in relation to accession to the EMU. This has raised demand for imports which had to be financed from foreign sources.

On the whole, it is possible to state that a current account deficit in the runup process is acceptable and even desirable in terms of enhancing the future performance of the economy providing that the rate of return on investments equals or is greater than the interests paid on foreign debt financing. In such a case, a higher investment will in the medium term increase the productive capacity of the economy, which creates conditions for raising exports and the substitution of imports by domestic supply.

On comparison with other both developed and transition economies, it is evident (Table 11) that the deficit in the current account of the balance of payments of the SR is extraordinarily high. Lying behind this deficit is a negative balance of savings and investments both of the government and private sector. As shown in the Table, the situation in the SR differs from Hungary and the Czech Republic, where the tendency of the government sector to incur debt is balanced out by savings (Hungary), or by a substantially lower degree of indebtedness in the private sector (CR during 1996-2000; in 2001, savings already exceeded investments according to the OECD analysis). The Slovak situation differs also from Poland, where the private sector is indebted to a much lesser extent. This probably has to do with the fact that in these countries the need to modernise the economy has been

²⁴ See Fidrmuc and Korhonen (2001).

to a much greater extent covered by a high inflow of foreign direct investments i.e. by non-debt financing and, thus, by a lesser need to draw upon foreign savings.

The negative balance of both sectors can be in the short-term to a certain extent explained: the governmental one such as being driven by high costs of structural reforms and the private one by modernisation of the economy. However, in the long run such a development is not sustainable, with a low inflow of FDI, when the effect of a twinning deficit is very sharp. It is certain that a sufficient inflow of FDI is currently a critical precondition for sustainable growth of the economy, in the context of its growing international competitiveness. On the other hand, gradual consolidation of public finances will form prerequisites for alleviating the crowding-out the displacement of private investments by excessive government activities, which will create larger space for private sector development.

1.7.2. Microeconomic and structural aspects

Increasing the competitiveness of the economy is of basic importance for sustainable development on the current account. In the first place, its enhancement is preconditioned by a stable macroeconomic environment characterised in particular by a credible fiscal and monetary policies together with structural reforms oriented to increase the effectiveness of the good, capital and labour markets. Drawing upon the experience of the four EU countries previously mentioned, the implementation of structural changes and modernisation of the economy, which led to its growing competitiveness, was definitively facilitated by the inflow of foreign direct investment as a direct consequence of an improved quality in the economic environment, which also comprised positive expectations associated with the envisaged accession to the EMU. Growing competition pressures due to the participation in the common market constituted an important catalyst of modernisation in these economies. Increasing qualitative standards of both material and human capital had partly to do with capital transfers from structural funds, as well as the Cohesion Fund of the EU, whose role is to promote the runup process in the countries lagging behind (countries with a per capital level of GDP below the EU average), in concurrence with stabilisation-oriented national policies.

A critical internal prerequisite for enhancing the competitiveness of the economy is the productivity growth, which in international trade exchange can be further supported or suppressed by exchange rate developments or by a targeted exchange rate policy, as long as the country has its own tools of exchange rate policy in hand. The sustainability of performance dynamics and competitiveness derived from this – and in conditions of a monetary union, i.e. in the absence of an exchange rate tool, depends solely on what part in productivity growth is played by domestic cost (price) and factor (labour, capital and changes in their qualitative characteristics expressed by technology advances) componets.

Table 11 Balance of savings and investments in the OECD countries (% of GDP)

	Current account			Government			Private sector		
	1996-00 <i>average</i>	2001	2003	1996-00 <i>average</i>	2001	2003	1996-00 <i>average</i>	2001	2003
Euro area countries									
Euro area in total	0.8	0.2	0.6	-2.0	-1.1	-1.0	2.8	1.2	1.6
<i>of which: countries with a surplus on the current account</i>									
France	2.2	1.6	1.6	-2.6	-0.9	-1.4	4.8	2.5	3.0
Italy	1.6	0.2	0.9	-2.9	-1.4	-1.1	4.5	1.6	2.0
Netherlands	4.5	3.7	4.3	-0.2	0.6	0.5	4.7	3.0	3.8
Belgium	4.4	4.9	5.9	-1.4	0.0	-0.5	5.8	4.9	6.4
Finland	5.8	7.1	6.9	1.1	3.7	2.2	4.7	3.5	4.7
<i>of which: countries with a deficit on the current account</i>									
Germany	-0.6	-0.7	-0.1	-1.7	-2.4	-1.8	1.1	1.7	1.8
Spain	-1.1	-2.4	-2.1	-2.4	-0.1	0.0	1.3	-2.3	-2.0
Austria	-2.8	-2.5	-2.2	-2.3	-0.7	-0.1	-0.5	-1.8	-2.1
Portugal	-7.0	-8.5	-8.1	-2.5	-1.8	-1.5	-4.5	-6.7	-6.6
Greece	-4.5	-4.7	-3.7	-3.4	0.2	1.5	-1.1	-4.9	-5.2
Ireland	1.2	-1.9	-1.3	2.0	3.2	1.9	-0.8	-5.1	-3.2
New market economies									
Poland	-5.2	-6.5	-6.0	-2.4	-4.4	-4.9	-2.8	-2.1	-1.2
Czech Republic	-4.6	-5.1	-5.3	-3.8	-8.0	-6.4	-0.8	2.9	1.0
Hungary	-3.8	-4.2	-4.2	-5.9	-5.7	-4.3	2.1	1.5	0.2
Slovakia	-7.7	-7.8	-8.4	-3.5	-3.9	-3.0	-4.2	-3.9	-5.4

Source: OECD

Productivity and cost of labour can be relatively simply assessed by the development of unit labour costs (ULC). In previous IMFS studies,²⁵ the following conclusions were drawn from a comparison of the ULC development in Central European accession countries²⁶:

- over the period 1993 – 2001, the productivity of labour in candidate countries grew more rapidly than in the EU. Its low starting position preconditioned a continuing large gap as to the performance of these countries vis-à-vis the EU,
- what is less favourable though is that this result was largely due to a downward or stagnating development of employment,
- accession countries exhibit the greatest approximation to EU productivity in sectors with the highest and lowest labour productivity – such as agriculture, financial and trade services; they also lag behind EU productivity in industry to a comparatively large extent,
- a development in the level of wages adjusted for the development of inflation (i.e. measured by the indicator of real unit labour costs – RULC) in relation to labour productivity is on the whole favourable. With the exception of the CR, the CEE countries followed the EU countries' downward trend of development of RULC.

²⁵ IMFS (2001,2002), Brucháčová (2001).

²⁶ Slovakia, Czech Republic, Hungary, Poland and Slovenia.

(Growth of RULC in the CR indicates an expansive nature of the wage policy in relation to the development of labour productivity),

- accession countries have a competitive advantage from an especially cheap labour force. Being small open economies, they rely a strategy of growth based on export performance. This strategy has been successful, providing that wages grow at a slower pace than productivity and that the exchange rate of their currency is not too strong,
- within the conditions of the SR, a more rapid growth of labour productivity at a roughly balanced growth of wages in the marketable sector (industry) as well as in the non-marketable sector (market services) indicates that there is potential in the SR for the existence of the Balassa-Samuelson effect,
- since real appreciation of currencies of candidate countries resulting from the inflow of capital and growth of productivity has the tendency of reducing the price competitiveness of exports, it is important for candidate countries to enhance their non-price competitiveness in addition to the price (cost) competitiveness by supporting changes in the output and export structures in favour of branches with a higher value added,
- the promotion of competitiveness comprises an increasing of labour market flexibility, creating a more effective taxation system, which will support the creation of jobs and reduce the overall tax burden within the economy.

In connection with maintaining price competitiveness, it is necessary to assess, in the case of candidate countries (CCs), whether upon their entry into the EU they will be able to maintain the development of wages in line with labour productivity and inflation. It is likely that the inflation rate will approximate the average EU level relatively slowly, since CCs must still continue to adjust to relative prices and in harmonisation of taxes. Therefore, inflation as yet does not unambiguously exhibit a trend towards deceleration. A lowering of ULC can be prevented by comparatively high inflationary expectations. Likewise, the introduction of EU social standards may raise pressures on the growth of wages in these countries.

As far as the impact of the FDI on the economy of Slovakia is concerned, according to several analyses firms with foreign participation prevailingly reach higher pace of growth of labour productivity than domestic enterprises. Frequently, this involves (especially in the case of large enterprises) an above-average performance within Slovakia and in some cases their productivity approximates the same as the parent companies. However, there is still room for improvement. For example, a substantial enhancement of effectiveness of the undertakings with the FDI can be achieved through a gradual shift from a simple production, intensive in terms of labour or raw materials, towards a more demanding sophisticated production.

A positive trend as to the inflow of the FDI into Slovakia can be expected in the future, especially because of continued privatisation as well as an improved image of Slovakia abroad.

In addition to the positive sides of the FDI inflow, some problems do exist

- the creation of value added by the Slovak exports is low, even in the case of undertakings with the FDI²⁷,
- there is the view that if the FDI entry evolves in the direction followed so far, we could become the „assembly workshop of Europe“, which would have an impact upon a structure of requirements in the labour market - stagnation, a lowering of demands

²⁷ This has also been confirmed by the latest IMFS analysis, conducted on the basis of results of a questionnaire in cooperation with the Technology University of Košice. (For details see Hošková, 2002).

- relating to professional requirements for a certain level of sophistication. This could lead to an increased drainage of educated experts to foreign countries,
- the comparative advantage of cheap labour used by foreign investors is not a permanent phenomenon to which long-term foreign investments could be tied. It is also necessary to strengthen the qualifications of the labour force and its creative abilities particularly through the development of the education system and promotion of national research.

Real performance of the economy or the dynamics of real convergence and competitiveness are behind a choice between a more rapid or slower strategy for entry into the EMU after admission to the EU. The desire candidate countries have in entering into the EMU can in principle be derived from the same motivation the current cohesion countries had for entering into the EC: to get integrated into, or not to get separated out from the „core“ West-European market space, and not to run the risk of weakening contacts with long-standing partners.

It would be one-sided to extract an interest in membership in the EMU only from the economic advantages of a single currency. By entering the EMU, a country gains economic (cost) advantages due to the introduction of a single currency (lower capital costs thanks to the removal of the exchange rate risk) on the one hand. However, it must envisage that the impact of a single currency (as a result of a loss of the national monetary policy and of the possibility of the exchange rate adjustment) will appear in sharpened competitive conditions on the other. An escalation of competition which the single currency will bring about, will not only have favourable effects on poorer-performing economies. Subsisting in the euro area market will become a critical task for national producers, since they will become direct players in this market. Besides competition in the goods market, competition for investment opportunities and funding in mutually interlinked markets will be intensified as well. For the current accession countries, it will probably be simpler to meet nominal convergence criteria rather than to keep their up-to-date positions in the European market (not to speak about the possibility of their expansion).

In the event that it choose the strategy of a later entry into the EMU, a country will run the risk of a „cooling off“ of domestic competition and reform striving, but, maybe, also the establishment of a certain psychological position of „an outsider“. Since each individual candidate country must the same time see other candidate countries as real competitors in the struggle for a place in the European market, a lagged entry into the EMU after better performing countries would probably be a less advantageous strategy.

1.8. Macroeconomic scenario of convergence process²⁸

The process of convergence is preconditioned by the action of a complex set of factors, so that any attempt at a prediction for a longer period of time must be approached with great caution.²⁹ For this reason the following simplified scenario shall be understood only as an illustration of a possible development or indication of its tendencies. This scenario has been arrived at from a reference variant of an alternative projection of the development of the Slovak economy in the years 2003-2006³⁰. From there it follows that should the development of the internal and relevant external environments in general correspond with the assumptions applied, then the trend of a moderate continuous, but systematic improvement of the macroeconomic performance of the Slovak economy, which began in 2000, should be sustainable even following the year 2002.³¹

The generation of real GDP in the SR should increase over the years 2003-2006 by 4.6 % per annum on average. Whilst in the years 1999-2002 it was by 2.6 % per annum on average (assuming that in 2002 it will rise by 3.7 %). On the other hand, the real GDP in the EU-15 taken as a whole, which in the years 1999-2002 increased by 2.2 % per annum on average, should in the years 2003-2006 increase by 2.6 % per annum on average³². The process of real convergence of the economic level of the SR (per capita GDP) to the EU-15 average not only could continue in the years 2003-2006, but its dynamics may accelerate compared to the years 1999-2002.

A country's economic level is by international comparison uniformly expressed by means of **per capita GDP at purchasing power parity** (PPS). The purchasing power parity of individual currencies against the EUR or against the USD, is investigated with an extensive statistical processing of a large number of prices of comparable goods and services within the European Comparative Project (ECP) organised by EUROSTAT in cooperation with OECD every three years. In recent years, the collected data is acquired through approximation, i.e. on the basis of aggregate statistical data on individual countries.

The most recent ECP processed so far concerns the year 1999. From the official results published by EUROSTAT³³, it follows that in 1999, per capita GDP in the SR stood at EUR 10,490 (PPS), which accounts for 49.3 % of the average per capita GDP in the EU-15 in 1999 (EUR 21,270). According to the calculations made by EUROSTAT, the relative economic level of the SR vis-à-vis the EU-15 worsened in 2000 (falling to 46.5 %), with this relation also being maintained at the same level in 2001.³⁴

²⁸ This section has been elaborated with the use of the Infostat materials submitted at the beginning of October 2002 on the basis of a contract of co-operation between IMFS NBS and Infostat for the year 2002. (For further details see Infostat (2002)).

²⁹ The possibility of a practical use of similar predictions is illustrated for example by the ECB forecasts, which are elaborated two years in advance, with the values on the upper threshold of an interval of forecast indicators for the second year of the time horizon frequently being as much as double the bottom threshold.

³⁰ Infostat (2002).

³¹ For more details see Infostat (2002).

³² According to the recent forecast of the LINK Project (Global Economic Outlook 2002) the trend of decelerating economic growth in the EU-15 as a whole should culminate in 2002, since GDP EU-15 should only increase by 1.1 % year-on-year. In 2003, its volume should rise by 2.3 % and in the years 2004 and 2005 by 2.6 % per annum. In combination with this, we can assume that in the year 2006, the economic growth in the EU-15 taken as a whole should get on a trajectory of long-term growth, which means that GDP EU-15 should rise by 3 % (Table 12).

³³ Pasanen (2002).

³⁴ It needs to be mentioned though that the result concerning the year 2001 is distorted, since it does not take into account – contrary to the results for the years 1999 and 2000 – a revised estimate of the nominal GDP SR. The result for 2001 takes into account the original estimate of the nominal GDP SR, which compared to the revised one is almost SKK 25 billion less.

In association with the presented results, it is necessary to make one explanatory remark concerning the methodology for calculating per capita GDP. Within its methodology, when calculating per capita GDP, EUROSTAT uses the indicator „total population“ taken from the System of National Accounts (SNA), which as a rule differs from a demographic statistics indicator of the same name. The reason why this point is important is because the results of a reference variant in the Infostat prediction, given below in the form that expresses a convergence between the economic level of the SR and the average EU-15 level in the years 2003-2006, was derived using the demographic statistics data. Namely, on the basis of a prognosis of the demographic development in the SR up to the year 2025, which was detailed by the Statistical Office of the SR in September 2002³⁵. For the sake of comparability, the level of per capita GDP at purchasing power parity in the SR was calculated using demographic statistics retrospectively for the years 2000 through to 2002.

From the results of these calculations it follows that in 2000, as a result of a lower pace of growth in the Slovak economy, the relative economic level of the SR vis-à-vis EU-15 deteriorated slightly: falling from 49.3 % in 1999 to 48.9 %. Though in 2001, as a result of a considerable slowdown of economic growth in the EU, the economic level of the SR in relation to the EU average increased to 50.2 %. Considering the fact that in the EU-15 the pace of economic growth will in all likelihood slow down in 2002 (Table 12), the relative economic level of the SR vis-à-vis the EU-15 should rise, reaching 51.5 %. According to calculations, per capita GDP of the SR should reach in 2002 approximately EUR 12,309 (PPS).

The results of a reference variant of the prediction indicate that in the years 2003-2006 the dynamics of real convergence of the economic level in the SR to the average economic level in the EU-15 should increase compared to the dynamics in 1999-2002. From these calculations, it would follow that in 2004 the economic level of the SR (per capita GDP) could reach 53.5 % of the EU-15 average and in 2006 more than 55 %. Per capita GDP in the SR in 2004 should amount to approximately EUR 14,000 (PPS) and in 2006 approximately EUR 16,000 (PPS).

Table 12 Expected development of selected indicators

	Gross domestic product of the SR constant prices, growth rates %	Per capita GDP of the SR current prices, 000 SKK	Per capita GDP of the SR by PPS % of the EU – 15 average	Comparable price level GDP % of the EU – 15 average	Gross domestic product of the EU - 15 constant prices, growth rates %	Population of the SR mean, mil. persons
1999	1.3	154.9	49.3	33.5	2.7	5.395
2000	2.2	168.3	48.9	35.8	3.5	5.401
2001	3.3	183.9	50.2	36.5	1.5	5.380
2002	3.7	198.2	51.5	37.6	1.1	5.379
2003	4.2	218.1	52.5	38.4	2.3	5.379
2004	4.5	239.4	53.5	39.1	2.6	5.378
2005	4.8	261.9	54.6	39.7	2.6	5.377
2006	5.0	286.2	55.7	40.0	3.0	5.375

³⁵ The mean population of the SR was on an upward move up until the year 2000 (Table 13). In 2000 it reached 5.401 million people and in 2001 it fell to estimated 5.380 million people. According to the SO SR prognosis, the mean population of the SR in 2002 will go down to 5.379 million people, and it should continue to fall in the years to follow and reach 5.378 million people in 2004 and 5.375 million people in 2006.

Also, there has been developed a projection of another aspect of real convergence relating to the approximation of a comparable price level in the SR to the average price level in the EU-15. According to the results of the ECP dated 1999, *a comparable GDP price level of the SR* only reached 33.5 % of the average price level in the EU-15 in the given year. At the same time, it follows from that that the ERDI coefficient of the SKK against the EUR (Exchange Rate Deviation Index, i.e. the exchange rate deviation expressed as a ratio of nominal and real exchange rates of a currency, which represents a reciprocal value of the comparable price index) stood at almost 3.0 (2.988) in 1999, which is an extremely divergent value.³⁶ Judging by the value of this coefficient, the real purchasing power of 1 euro in 1999 was SKK 14.77 only (according to PPS) and not SKK 44.12 (an average nominal exchange rate). In other words, in 1999 the purchasing power of monies of citizens of the SR in the EU countries was roughly three times less on average compared to what was indicated by a real purchasing power indicator.

The comparable price level in the SR in relation to the average EU-15 price level increased from 33.5 % in 1999 to 36.5 % in 2001. In 2002, it should rise to approximately 37.6 %. From the calculated results of a reference variant of predictions it follows that the upward move of the price level will continue, whereas in 2004, it should reach 39.1 % and in 2006 approximately 40.0 %. This means that the ERDI coefficient should gradually decline in the years 2003-2006. In 2004 though, this coefficient can still be higher than 2.5.³⁷

1.9. Coverage, timing and an institutional framework for the EMU accession process

A strategy for the process of accession must be based on a combination of an execution of prudent macroeconomic policies and the completion of structural reforms. Whereas in the SR a reform of the banking sector and decisive institutional changes in the country have been successfully completed, reforms of the corporate sector, health care system, education system and social welfare system lag behind. This causes an inefficient application of funds acquired from tax revenues and a continuous pressure on the budgetary system. The business environment is devalued by the inoperability of the state administration and court system, as well as by a generally high degree of corruption.

An inefficient functioning of the micro sphere as a whole translates into a greater uncertainty concerning the effect of macroeconomic policy measures, owing to the unclear shape of transmission mechanisms. During the EMU pre-accession process it is therefore desirable that structural reforms and consolidation in the fiscal area be consistently implemented.

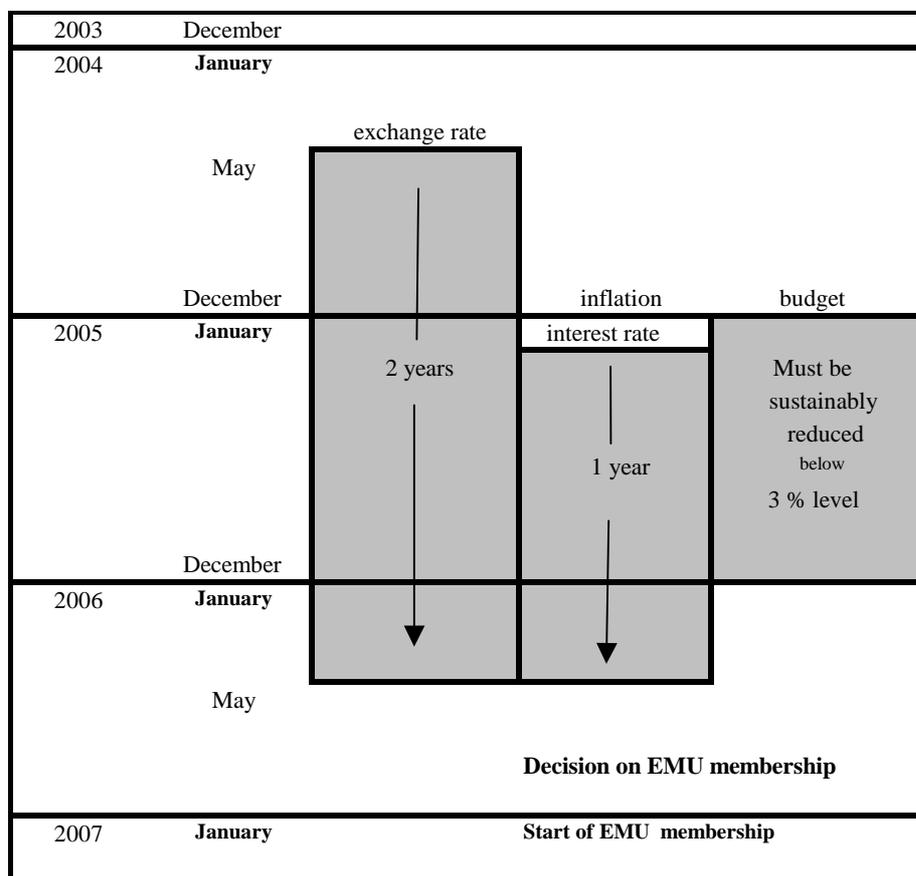
³⁶ The results of a research from 1999 (based on 24 OECD countries) have shown that there is a significant statistical interdependence between a comparable price level and the economic level of a given country. The results of this research indicate that the SR and the CR exhibit the highest deviations from this general interdependence at the level of above 20 percentage points. Accordingly, the price level in the SR in 1999 should theoretically reach as much as 54 % of the EU-15 average, and not 33.5 %.

³⁷ Further decline can be due to the fact that presently (which means two months following the development of the variant projections) the average rate of headline inflation in 2003 in comparison with a reference variant is already expected to be at least 2 percentage points higher, due to measures that the government has in the pipeline.

1.9.1. Time frame of the accession process

A time frame for the process of accession to the EMU with a corresponding performance of individual Maastricht criteria is depicted by the information in Chart 1. At the same time, Chart 1 expresses the earliest theoretically possible inclusion of the SR into the EMU.

Chart 1 Outline of the process of accession to the EMU



A distinct content and time horizon of individual steps taken in the process of accession as well as of its final phase become more clear from Table 14 and from a description given in the Convergence report together with a formal procedure for admission as an EMU member.

Table 14 Reference periods for the assessment of nominal convergence criteria

Criterion	Definition	EMU-11		Greece	
		Reference period	Reference value	Reference period	Reference value
Price stability	Average rate of HICP inflation in 3 countries with the lowest inflation + 1.5 % points	March 1997-February 1998	2.7 %	April 1999-March 2000	2.4 %
Fiscal deficit	Ratio of forecast or actual budget deficit to GDP	1997	3 %, or more, if demonstrably tends towards 3 %	1999	3 %, or more, if demonstrably tends towards 3 %
Gross government debt	Ratio of government debt to GDP	1997	60 %, or more, if demonstrably tends downwards	1999	60 %, or more, if demonstrably tends downwards
Long-term interest rates	Average interest rate in 3 countries with the lowest inflation rate + 2 % points	February 1997-January 1998	7.8 %	April 1999-March 2000	7.2 %
Exchange rate stability	Movement of exchange rate within the fluctuation band for at least 2 years without devaluation against any of the Member State currencies	March 1996-February 1998	ERM: fluctuation band +/- 15 %	April 1998-March 2000	ERM/ERM II: close to central parities

The presented time schedule corresponds with actual procedures used when the first phase of the EMU-11 was implemented in 1999 as well as when the Union enlarged with the addition of Greece in 2001 to EMU-12. The assessment report on the results of fulfilment of convergence criteria as of the year of the formation of an euro area was elaborated by the European Monetary Institute in 1998 (Convergence Report 1998). The assessment report on Greece was prepared by the ECB in 2000 (Convergence Report 2000) and in parallel by the European Commission (EC).

1.9.2. Assessment procedure for EMU member admission

The Convergence Report (hereinafter the "Report") is material elaborated by the ECB on the basis of requirements of Article 122(2) and Article 121(1) of the Treaty on the European Union (hereinafter the "Treaty"). The function of the Report is to inform the Council of the European Union, at least once every two years or at the request of a Member State with a derogation³⁸ „on the progress made in the fulfilment by the Member States with a derogation of their obligations regarding the achievement of Economic and Monetary Union“. The same mandate has been given to the European Commission which prepares its own Convergence Report. The two reports are submitted to the EU Council in tandem. Both of the reports represent a starting point for a procedure that according to Article 122(2) of the Treaty comprises the following further steps:

- the European Commission shall prepare a proposal for those countries for whom the derogation is to be abrogated;
- the proposal shall be consulted with the European Parliament;
- the proposal shall be discussed in the EU Council, meeting in the composition of the Heads of State or Government (Prime Ministers);
- The ECOFIN Council, acting by a qualified majority, shall decide on the proposal from the European Commission which Member States with a derogation fulfil the necessary conditions to abrogate the derogation of the Member State concerned, on the basis of criteria set out in Article 121(1).

The first Convergence Report was elaborated by the ECB in 2000 (Convergence Report 2000). The ECB has provided an evaluation of 2 countries with a derogation – Greece and Sweden therein. (Neither Great Britain nor Denmark requested that a Report be prepared about them for the year 2000.)

The Convergence Report gives an evaluation of a country in terms of its eligibility to enter the EMU. It contains the following:

- an account of the values reached on the nominal criteria by a country assessed over a reference period compared to reference values for the euro area
- a retrospective view of the economic and monetary development in the country which should convincingly attest to a continuity of the convergence process. (An analytical view of the euro area countries covered a period of 1990's.)
- a short-term and medium term outlook of the future economic development with an emphasis on the sustainability of monetary and fiscal stability values including the risks and main tasks arising in the field of fiscal consolidation with an emphasis on commitments arising from the Stability and Growth Pact.

Once again we shall use the example of Greece to specify the time required to cover the whole procedure concluding the process of accession to the EMU. Greece, a country which fulfilled the necessary conditions for the adoption of a single currency as from 1.1.2001, was confirmed at the summit of the ECOFIN Council in Santa Maria de Feira on 19 June 2000.

³⁸ Also the countries with a special status, who were not interested in participating in the EMU as from 1.1.1999, i.e. Denmark and the United Kingdom, may make a request for the preparation of the Convergence Report. However, Denmark participates in the ERM II.

The Council based its decision on Convergence Reports prepared by the ECB and the European Commission, on the opinion of the European Parliament and by a proposal from the European Commission. On the very same day the Council decided that a conversion rate between the drachma and euro will be the same as the central parity of the drachma against the euro in the ERM/ERM II, i.e. 340.750 GRD/EUR. In order to make the convergence of the drachma against its central parity in the ERM II easier, as early as 17.1. 2000 the drachma was revalued by 3.5 % at the request of Greece, and the process was concluded roughly in mid December 2000, several days before the convergence rate was irreversibly fixed. The Greek drachma was then replaced by the euro with effect from 1 January 2001.

1.9.3. Changes in the institutional environment

Certain changes in the institutional environment in the area of monetary and fiscal policy in the SR will follow with the admission of the SR into the EU and in relation to its future membership in the monetary union.

By gaining membership in the EU, Slovakia will at the same time become a Member State with a derogation in respect to its future membership in the euro area. As part of this status, it will acquire some important rights, but also obligations in the institutional frameworks of the monetary union, even though to a limited extent only.

In the area of monetary policy, the NBS will become a member of the European System of Central Banks (ESCB), thus committing itself to pursuing a monetary policy that does not contradict the principles of a single monetary policy of the European Central Bank (ECB). Participation in the ESCB involves certain costs that are associated with the subscription of a share in the ECB's capital. Regarding the fact that at present 15 EU Member States share the ECB's capital subscribed, the ECB upon EU enlargement will apparently have to increase its capital to accommodate the respective shares of new EU Member States or their national central banks.³⁹ It can be envisaged that the increase will be achieved in the same manner as in the case of the ESCB founding group. Which means in correspondence with the key set in the Statute of the ESCB. The key for the calculation of a subscription to the ECB's capital as well as for the distribution of profits (loss coverage) from the ECB's exchange rate operations take into account the country's share of the population of the EU and the share of its GDP in the euro area GDP in a proportion of 1:1.

However, it must be emphasised that the obligation to pay the whole share in the ECB's capital shall rest with national central banks who are members of the euro system. That means, only upon the country's entry into the monetary union. Central banks that are not a part of the euro system (or states that are not members of the euro area) are only obliged to pay 5 % of their calculated share in the ECB's capital. Under the Statute of the ESCB, this amount will be used to cover the costs associated with the membership of a national central bank in the ESCB.⁴⁰ However, the share thus paid will not give rise to an entitlement for the NBS to share in the profits from the ECB's exchange rate operations (seigniorage), or an obligation to share in the settlement of the ECB's contingent losses. Both of these financial implications of the NBS shareholding in the ECB's capital will become bilaterally claimable only after the whole share in the ECB's capital is paid. That means, once the NBS becomes a part of the euro system, or, once the SR becomes a member of the monetary union.

³⁹ Should there be no redistribution of the existing shares.

⁴⁰ For the time being, we do not dare to estimate the immediate costs (namely the payment of the 5 % share) regarding the fact that it is not as yet clear in what way will the ECB arrange the raise in its capital upon the admission of central banks of new EU Member States EU to the ESCB, by they will not be in the order of high figures.

In the area of public finances, Slovakia will have to accede to the Stability and Growth Pact (SGP). The function of the SGP is to ensure the creation of an environment in the public sector of Member States in the monetary union that facilitates the application of a single monetary policy across the whole euro area. At the same time, the SGP shall allow for the application of corrective fiscal procedures at national levels in the event that the impact of a single monetary policy on the development of national economies is undesirable.⁴¹ From a systemic point of view, it is important that the SGP, as an institutional partner of the ECB's single monetary policy, quantitative parameters of which are defined in the medium term, requires that commitments of Member States within the SGP be formulated for the medium term as well.

Certain obligations will arise to Slovakia as a non-member of the monetary union from its participation in the SGP. In the first place, it will have an obligation to submit and update a mid-term programme of its fiscal sector convergence every year. In addition to the observance of the Maastricht criterion of a public finance deficit of up to 3 % of GDP and a non-growing debt ratio of up to 60 % of GDP, the mid-term convergence programme shall have to aim at providing for an equilibrated or surplus structural (cyclically adjusted) balance of public finances in the SR.

In connection with the obligation of the SR to accede to the SGP upon its admission to the EU, the following needs to be underlined:

- the status of a non-member of the euro area (or of a country with a derogation) shall not allow full-force of this document applying to the SR – namely as concerns the SGP sanction mechanism of the excess deficit procedure;
- progress made in the fiscal sector convergence under the medium-term convergence programme will however be strictly monitored and assessed by the European authorities. A programme as well as actual results shall be subject to corrective recommendations from the ECOFIN Council in accordance with the excess deficit procedure;
- a requirement relating to a medium-term fiscal convergence programme (including methodological approaches in the statistical area) will not however be completely new demand, since a medium-term fiscal framework is already now a part of pre-accession economic programmes (PEP) of candidate countries (see PEP SR, August 2002).

⁴¹ For further details on public finances in conditions of the E(M)Ú and the Stability and Growth Pact see Komínková (2002) – the IMFS internal material.

2. Monetary policy in the process of accession by the SR to the EMU

In process of accession to the EMU, monetary policy must lead to the fulfilment of the Maastricht criteria by a targeted time limit for accession. The monetary policy must be transparent and credible. The fulfilment of these requirements is preconditioned by the selection of a suitable monetary policy regime so as to facilitate the process of disinflation and at the same time to limit the financial instability that might occur as a result of a potentially increased inflow of capital. This includes the necessity of choosing a realistic inflation target in the medium term, while taking into account impacts affecting inflation (the B-S effect, the impact of a continued price liberalisation, the transition of a part of non-market services - such as a part of the health care system - to market services, and the like). In choosing a monetary policy strategy, considerations of the appropriate mix of macroeconomic policies must also be covered, especially in relation to the fiscal policy, with which the monetary policy must be coordinated on a continuous basis.

2.1. On choosing the monetary policy regime

An universally applicable optimum form of the monetary policy does not exist, which is evidenced by different monetary strategies applied in accession countries in the past. In some countries (Austria, the Netherlands) a fixed exchange rate regime was applied for a lengthy time; from the 1970's and 1980's, respectively. In Portugal, an intermediate monetary target was used in the form of a crawling peg system (1977-1990), and then the exchange rate was fixed in 1990 to a basket of five currencies. A more freely defined monetary policy was applied in Italy, Spain and Greece. In Greece, the exchange rate target coexisted with the monetary target, which however upon the completion of liberalisation of capital flows in 1994 started to lose in importance, and upon the entry of Greece into the ERM in 1998, the money supply became rather a reference parameter. In the field of the exchange rate, starting from the 1980's, a limit on the local currency devaluation in the extent of the inflation differential against the main business partners was applied. Starting from 1996, the policy of relative stability of the local currency against the ECU was followed to which considerable importance was ascribed from the point of view of a lowering of inflationary expectations and of accelerating the process of disinflation. At the same time, starting from 1997, the central bank of Greece focused on the monitoring of other economic indicators, particularly influencing the development of core inflation.

Despite their aforementioned variety, a feature that the monetary policy systems in accession countries had in common in the 1990's was the increasing importance of the exchange rate. The experience so far from the ERM/ERM II functioning has pointed out the suitability of exchange rate flexibility at the early stages of integration, when the economic fundamentals of participating countries still differed widely. Furthermore, experience was made that if a country participating in the exchange rate system does not possess a credible local policy mix, as a result of doubts cast on the consistency of its direction into the EMU, its currency easily comes under pressure that is triggered by a mechanism originating outside the country itself. An example would be the ERM crisis of 1992 that was set off by the rejection of the Maastricht Treaty in Denmark. Great Britain and Italy, whose economies at that time exhibited signs of unbalances, were forced to withdraw from the ERM. Also affected was Spain, then Portugal and Ireland, whose currencies were devalued in order to maintain competitiveness.

The way in which the process of accession concluded in Greece, who acceded to the ERM in 1998, was quite instructive. Short before the accession, the drachma was attacked in conjunction with the Asian crisis. The central bank of Greece decided to devalue the currency, instead of the commonly used procedure based on a tightening of the monetary policy and on interventions in the foreign exchange market. As a result, the local currency came to be aligned with economic fundamentals, which later on, when Greece became

a part of the exchange rate system, enabled to withstand the pressures against it. Oppositely, prior to entry into the EMU, the currency was strong enough in 2000 to enable a revaluation of its central parity against the euro (by 3.5%).

It can be stated in general that a monetary policy operates in the context of a whole set of economic policies, and it is exactly their coordination that form a prerequisite for building up the credibility of a country vis-à-vis the markets. The current EMU member countries succeeded in the process of accession thanks to their credible monetary, fiscal and income policies as well as to a set of structural policies whose orientation was coordinated in the sense promoting nominal and real convergence. The application of such a system of policies prior to the accession to the ERM/ERM II significantly contributed to the establishment of the countries' credibility. Upon the integration into the monetary system, the framework for implementation of the policies was further strengthened, which subsequently had a positive influence on inflationary expectations and economic growth.

The present form of the NBS monetary policy, based on an implicit inflation targeting is not an obstacle to the execution of a successful convergence strategy. By its nature (profile), it is compatible with the policies of central banks of countries such as Italy, Spain and Greece in the pre-accession period. What is most essential is how it is harmonised with other components of the economic policy. In addition, the definition and execution of a clear-cut monetary policy could help to maintain its credibility. In connection with this, it needs to be considered whether a declaration of a clearly formulated monetary policy regime (an explicit inflation targeting comes into consideration) by itself does not help to persuade the markets about its credibility, even if problems arise with the accomplishment of its preconditions.

2.2. Inflation convergence

The inflation in accession countries including Slovakia is often influenced by a variety of factors such as the nature of macroeconomic policies (especially monetary and fiscal ones), rigidity in markets (particularly in the labour market), a low level of competition in some sectors of the economy, external shocks as well as other factors associated with the catching up. It is important to identify the individual factors in order to devise credible disinflation targets.

2.2.1. Taking catching up factors into account in monetary policy with regard to inflation targets

For the sake of the credibility of targets in this area during the process of convergence, it is necessary to take into account the catching up factors following differences between productivity growth in the tradeable and non-tradeable sectors which under certain circumstances may affect the inflation rate. For a certain period of time, these inflation targets may therefore differ from targets in the euro area.

Empirical estimates of the magnitude of these factors (the BS effect) in accession countries differ from estimates in the euro area countries who experienced the runup process. Nevertheless, the experience so far shows that the BS effect played only a limited role. For instance, according to MMF estimates⁴², the BS effect on average contributed 1.7 percentage points to a 14% average inflation in Greece over the period 1990-1996. The empirical studies in general demonstrate that inflation differences between the mentioned countries and the EMU average are explained by factors other than the BS effect. The example of Spain is given⁴³ where the differences in inflation between the tradeable and

⁴² According to the ECB (2002). The original source: IMF. (1999). Greece – Staff Report.

⁴³ According to ECB (2002). The original source: Understanding Spanish dual inflation. Documentos de Trabajo No. 0205. Banco de España. 2002.

non-tradeable sectors are caused by a higher profit margin within the service prices, which is possible thanks to lower competition in this sector compared to the production of goods that is exposed to international competition.

This has also been observed in the SR, where the impact of the BS effect on inflation is estimated to fall within the range of 1-2 %. Under a monetary programme for 2002, the NBS monetary division estimates this impact to be less than 1 %.

2.2.2. Promoting inflation convergence through appreciation of the nominal exchange rate

For inflation to converge to the Maastricht standard, a sufficient degree of flexibility of the exchange rate is required, so that the convergence could be achieved not only by a control of domestic inflationary pressures, but also with the aid of a certain degree of appreciation of the exchange rate. When the nominal exchange rate appreciates, the prices of imports go down, which brings about disinflation effect.

However, the actual experience of the runup countries in the euro area when the euro was introduced shows that although the real exchange rate appreciated, the appreciation accrued mainly, though not fully by means of price level increases, which means, not through the appreciation of a nominal exchange rate. Apart from other factors, this generally means that the (non-price) competitiveness of exports did not grow at a rate that would make it possible to increase the prices of products of the country concerned on the foreign market at a pace exceeding the domestic inflation rate.

At this stage of the process of convergence, a flexible SKK exchange rate system is suitable for creating room for a flexible development of the exchange rate. The appreciation of the SKK exchange rate is however preconditioned by a sharpened increase of (non-price) competitiveness of the Slovak production, in order to create room for the exchange rate appreciation.

2.2.3. Promoting inflation convergence by means of declining inflation expectations in the long term

According to the ECB findings, in some countries, wages linked to lower inflationary expectations together with a growing role of stabilisation-oriented macroeconomic policies, proved to be a tool for lowering the output costs of disinflation in the 1990's. The ERM membership, a target of the future introduction of the euro, and a growing credibility of low inflation targets associated with it, had an important influence on wage discipline, wage bargaining and the labour costs in Greece, Spain, Italy and Portugal. From this point of view, the prospect of inflation consistently declining also depends on the ability of the monetary policy to change significantly former habits and behaviour. From the experience of a number of euro area countries, it follows that successful membership in the ERM/ERM II was an important catalyst for evoking changes needed to accelerate the process of inflation convergence. This was most clearly demonstrated in countries with a history of high inflation rates such as Greece, Spain and Portugal. It is assumed that a declaration of inflation targets in the NBS monetary programmes and the NBS decisions on interest rates in relation to the prospect of membership in the EMU may play an equally positive role in inflation convergence as in the countries mentioned – considering the credible position that the NBS has within the framework of economic policy authorities in the SR.

2.3. Exchange rate policy framework

From the moment of acceding the EU, the exchange rate policy of a new member is considered to be an issue of a common interest. In principle this means that the new member cannot apply an exchange rate policy that would lead to any extensive fluctuations of the exchange rate, or to its disconnection from economic fundamentals.

At any time following the EU accession, a new member may apply to join the ERM II. From this it follows that a new member does not need to do so immediately after the accession to the EU. However, at the same time, it is expected not to unnecessarily postpone its joining. In practice it means that in the course of negotiations with the EU authorities, a country may be asked to join the ERM II if it is predisposed to function successfully in the exchange rate system.⁴⁴

2.3.1. Characteristics of membership in the ERM II

The ERM II system constitutes a necessary framework for a country's exchange rate policy prior to its admission to the EMU. It aims to help new Member States to consolidate their stabilisation policies, promote convergence and thus prepare conditions for the introduction of the euro. Membership in the ERM II offers both stability by means of credible ties to the euro and flexibility by means of a fluctuation band that ranges between +/- 15% against a central parity. In extreme cases the flexibility may also mean the rectification of the central parity, which in the event of devaluation however would mean a delayed introduction of the euro.

The experience of the present members of the euro area shows that participation in the ERM II requires correct and credible macroeconomic policies. Apart from other aspects, these include a stringent observance of convergence programmes in the years prior to and following accession to the ERM II. Moreover, the prospect of joining the exchange rate mechanisms should generally be considered to be realistic and, in the country concerned, there should be a general consensus with regard to the consequences of fixing the currency to the euro and definitive adoption of the euro.

When, during the starting period of the ERM operation, markets in some of the present euro area countries challenged the correctness of macroeconomic policies, pressures on their exchange rates used to frequently occur. Once the capital flows were fully liberalised, the stabilisation of exchange rates became more difficult. The experience of Greece in this respect shows that the exchange rate target was only sustainable when an overall policy framework was considered to be credible and withstood the testing by the market. Later on, participation in the ERM represented an increasingly important tool anchoring expectations with regard to the exchange rate and to ensure a discipline, especially by increasing interest in pursuing such an economic and monetary policy that would limit the risks of negative responses in the market segment and therefore speculative attacks as well.

A broader fluctuation band of the ERM/ERM II (the aforementioned fluctuation band of +/- 15%) and the possibility of adjusting the central parity through its revaluation gave the countries concerned the necessary freedom to deal with both volatility solely induced by the market and their needs oriented more towards the adjustment of economic fundamentals. A period of successful membership in the ERM II preceding the introduction of the euro can thus be considered also as a market test of the process of convergence.

⁴⁴ The following is stated in the Resolution on the ERM II 97/C 236/03 : „,Participation in the exchange rate mechanism will be voluntary for Member States outside the euro area. Nevertheless, Member States with a derogation can be expected to join the mechanism“. For further details see European Commission (2002).

2.3.2. Context for determining the exchange rate parity

The exchange rate parity must be determined and, if need be, adjusted in a timely manner to the level that is in line with economic fundamentals, through which the risk of its inappropriate setting at the end of the process of convergence is minimised. This risk consists of a potential overestimation of the exchange rate, i.e. setting the parity at a level that is not sustainable and would raise devaluation pressures during the country's functioning in the ERM II. (Contrawise, in the case of Ireland and Greece, a small revaluation took place 9 and 11 months before their joining the euro area in order to limit inflationary pressures due to a considerable monetary relaxation caused by a downward convergence of interest rates). On the whole, it can be stated that the exchange rate convergence should be accompanied by a consistent package of economic policies. Most decisively, the financial markets in the period between the final adjustment of the exchange rate and the adoption of the euro must be convinced that central parity will also become a conversion rate. This must be signalled to markets. The use of interventions must be consistent with the agreement on the ERM II.

Right decisions concerning the koruna exchange rate in the process of accession require analysis of the tendencies of a development of a equilibrium exchange rate. This issue is at present also subject to research. The IMFS analyses conducted so far in this area⁴⁵, using the econometric techniques, provide contradicting results that for the time being do not allow for unambiguous conclusions to be formulated.

So far, the development of the SKK exchange rate since the changeover of the exchange rate regime in 1998 shows that its volatility has not exceeded the band set in the ERM II. On the basis of favourable expectations that arose particularly in connection with the forthcoming integration of the SR into the EU and later on into the EMU, together with an expected dynamics of FDI inflow that could contribute in the short and medium term towards the growth of productivity and (non-price) competitiveness of Slovak exports, a tendency towards appreciation can rather be envisaged as to the development of the SKK nominal rate. With regard to the aforementioned as well as considering the fact that the central parity can be changed (revalued) within the ERM II, early membership of the SR in the ERM II can be considered as advantageous.

2.4. Adjusting monetary policy instruments

In order for the convergence of the operational framework to be successful, it is necessary to harmonise it with market principles. It must be founded on open market operations and should promote development of the interbank market. Early adjustment of monetary policy instruments is useful in that it familiarises lending institutions with the operational framework in the euro area. The strategy of the central bank of Greece was based on an early introduction of monetary policy tools that in principle were similar to, though not exactly identical with the tools of the Eurosystem as well as on a further step-by-step harmonisation of different technical parameters. The NBS has made a considerable progress in adjusting its monetary policy instruments. Thus, their final adjustment to the EMU circumstances should not disturb the monetary stability in the SR.

⁴⁵ Hajnovič (1999), Benčík, Zlacky (2002).

2.4.1. Interest rate convergence in the final phase of converging the EMU

In the final phase of the process of convergence, official interest rates must converge to their level in the euro area. This process was particularly noticeable in Greece, Spain, Ireland, Italy and Portugal, where there were considerable differences compared to the EMU standards prior the accession of these countries. This may also be the case of Slovakia. It is therefore necessary to examine the size of a stimulation effect of the interest rate reductions on the economy and their potential impact on the stability of domestic prices. This depends on several factors, e.g. on the anchor role of lower inflationary expectations or on the composition of personal incomes in the accession country. (For example, in the case of Greece, a negative income effect income on the household expenditures due to a decline in the interest earnings weakened the stimulating effect of lower interest rates). As was shown by the past experience, an important role in the interest rate convergence is played by the fiscal policy.

3. Strategy for acceding the EMU by the SR – limitations and risks

In order for EMU membership to be achieved, a strategy is to be implemented that in conclusion will provide for the fulfilment of the Maastricht criteria. In the course of Slovakia's direction into the EMU, this strategy must be sustainable in terms of the external position. It must also create prerequisites for meeting the conditions laid down in the Stability and Growth Pact after entry into the EMU. From the conditions listed, certain requirements on economic, fiscal and monetary policies and their coordination with each other will follow. In our previous work⁴⁶ we have already covered these requirements, so now we shall only recap them in short.

3.1. Inflation

First of all, one has to bear in mind an inflationary impetus due to the process of joining the EU. Our preliminary estimation on that (see also the analysis for the CR⁴⁷) is as follows:

Price deregulation	5 to 10% in total	(of total consumer prices, that is approximately 25-50% for controlled commodities)
Adjustment to the EU legislation	6 to 10% potentially	(this in particular concerns technical, environmental, and social standards and impact of introducing the common agricultural policy)
Market rectification of price relations and dual inflation	1 to 2% yearly	(at a stable exchange rate)

Whilst the implementation of technical, environmental and social standards will proceed step by step also after the admission to the EU, and may be absorbed through savings on other costs, the majority of price deregulations must take place within a time limit of the nearest 2 years (for minor adjustments within 5 years). One of the reasons for this is that their delaying could later on put an additional burden on the fulfilment of an inflation target which will in the course of the process be anyway hardened by inflationary impacts of the market rectification of price relations as well as of wage and price runup. In terms of disinflation and meeting the inflation target, a critical element would be a potential indexation of wages and the state budget.

Indexation of wages will pose a problem notably where wage increases are not matched by corresponding productivity growth. A GDP growth at constant prices, forecast at 3-5%, would create room not only for rapid productivity increases, but also for a growing employment. A rapid growth of productivity will subsequently create prerequisites for disinflation. Nevertheless, such a room might not be sufficient, should there be a failure in scaling down of the ex-post-inflation-based indexation or of adaptive inflationary expectations with a sufficient degree of reliability. It is therefore important that after the accomplishment of deregulations in the years 2003-2004, expected inflation and collective bargaining on (nominal) wages respond to a likely decline of inflation (to approximately 4-5%). The process of disinflation could be inadmissibly prolonged in the event, if inflationary expectations in the economy were excessively responsive.

⁴⁶ IMFS (2000-2002).

⁴⁷ Collective of authors (2001).

3.2. Fiscal deficit

A good estimate of the cost of reforms necessary in order for public finances to be sustainable, is a basis of any deliberations on the achievement of an acceptable deficit and indebtedness. These costs are (very roughly) estimated at:

Railways	2 plus % of GDP	This concerns unsettled services of public concern and the acute debt relating to the railway superstructure
Health care	2 plus % of GDP	This particularly concerns unsettled invoices
Power plants	4%	This concerns the reduction of indebtedness which is a prerequisite for the SE to be competitive
Environment ⁴⁸	1-10 %	This concerns environmental liabilities and antiflood measures
Guarantees	2-3 %	This concerns the exercise of guarantees which will escalate in the years to come
Banks	10-15 %	This concerns the cost of banks restructuring, the resource enhancement of the Deposit Protection Funds (FOV) and the settlement of a redistribution loan of the NBS from the SKB (TOZ)
Social insurance company	0 –30 %	This concerns the capitalisation of the social insurance company in accordance with a chosen social insurance model

In total⁴⁹ 21-66 % of GDP

The current level of public debt and debt-to-GDP ratio do not allow for the public debt to be further increased. In the opposite case, the condition of sustainable debt ratio would be breached. According to this condition, a public budget deficit is deemed to be sustainable, when – assuming unchanged conditions with regard to tax revenues, a given inflation and interest rates and a given GDP growth – as a result of this deficit, the ratio of debt to (nominal) GDP does not rise. If we substitute this condition relating to debt ratio with the current parameters, i.e. a GDP growth of 4%, an inflation of 3%, a 7% interest rate and a debt ratio of 40%, then a sustainable deficit (meaning that the GDP is not further burdened with additional debt) will be around 3%. If the debt ratio rose to 60%, the interest rate on the government debt and deficit financing would have to increase. If a resulting fiscal deficit was to be sustained in terms of the debt-to-GDP ratio, then the cost of debt servicing would displace other budget expenditure.⁵⁰

From the point of view of a debt generated by the public budget, the following points must therefore be considered. The costs of restructuring the banking sector has been included in the public sector debt. If it was covered from the privatisation proceeds, it would be possible to reduce a public sector deficit (according to the ESA95 methodology) by approximately 1%.

⁴⁸ The size of the acute so-called environmental debt and inevitable costs of antiflood measures are reviewed by the government. Experience gained in Slovakia and neighbouring countries in recent years shows that the cost incurred by the government in removing the consequences of floods are in the order of several % of GDP and their compensation requires the adoption of extraordinary fiscal measures lasting for several years.

⁴⁹ At present, there is a dispute pending between the SR and ČSOB in the matter of a claim of ČSOB against Slovenská Inkašná. In this dispute, the SR denies the legitimacy of the ČSOB's claim, the volume of which today has reached the order of dozens of billions of SKK.

⁵⁰ At the time being (2003), the projected deficit of public finances seems to be unsustainable from this point of view.

When new reforms are furthered, it is necessary to consider whether the envisaged costs of these reforms can be covered from the privatisation proceeds or savings, or whether it will be necessary to use debt financing, with the associated costs of debt service and a higher deficit, or whether these costs are to be covered based on higher payments imposed on businesses and households, with an accompanying one-off impact on inflation, or on the basis of higher taxes, with the same one-off impact on inflation. If we disregard immaterial differences, then the cost of reforms will either be covered without any impact on the deficit and debt, or with an impact on the debt and deficit, or with (the one-off) impact on inflation.

A social insurance reform is a specific issue, in particular with regard to a possibly great volume of the funding needed. The cost of implementing it will depend on the chosen model (PAYG and capitalisation structures, the age of joining the capitalisation system and others). A certain portion of the costs may be inputted into the system via increased transfers from the state budget on behalf of non-paying claimants. These currently account for approximately 2% of GDP. However, it needs to be emphasised that these payments will exert pressure on the budget management and will slow down the process of reducing the fiscal deficit.

To sum up, the costs of reforms going beyond the funding gained based on privatisation proceeds will exert pressure towards inflationary increases in the sources of the state budget funding, or towards increasing the budget deficit, or, if put the other way round, they will slow down the disinflation and the reduction of a deficit. It is therefore necessary to define a realistic model of financing the reforms, which will not inhibit Slovakia in its direction into the EMU.

3.3. Current account deficit, foreign debt

A high deficit in the current account is an issue that needs to be solved. A recommended cutdown on the government consumption provides only a partial solution. There is a need for such measures that would bring down private consumption by making it more expensive (e.g. VAT, excise taxes and deregulations, charges for public utilities), and also measures that would reduce disposable incomes on private consumption (such as the restriction of transfers). Both groups of these measures will only make sense as long as they do not translate into a higher public sector consumption. In terms of potential impacts on the balance of savings and investments, and thereby on the current account deficit, it is equally important to address any imbalances due to an excessive government consumption as well as imbalances due to an excessive consumption by households and corporates. At the same time, the issue is also on the supply side. This means that in principle three groups of measures will be involved:

- measures on the demand side, notably on the part of the government, but also households,
- measures on the supply side, especially aimed at improving the quality and range of products for personal consumption, access by our undertakings to distribution networks on the internal market,
- a larger penetration of our exports to foreign markets

The current level of a net debt does not raise any doubts as to the sustainability of our external position. If we draw upon the IMF view, and consider as sustainable a deficit in the current account that (expressed in the USD or the EUR) does not increase the rate of a net foreign debt (= a gross foreign debt less the NBS foreign exchange reserves) above a certain critical level, the current net foreign debt, understood in this way, would not pose

any problem, even if a deficit in the current account stands at approximately 8-9% of GDP.⁵¹ Should the aforementioned reforms be carried out using the proceeds from privatisation, the rate of foreign debt would be reduced. Just to make the picture more complete, let us add that a part of sources of funding earmarked for these reforms would be converted to korunas, which would reduce the indebtedness vis-à-vis local entities (banks) and increase the reserves of the banking sector (or eventually also of the NBS), another portion of these funds would be applied to reduce the foreign debt and, finally, a part of them would add to foreign assets (funds invested abroad by the social insurance company). It is evident that the local market will not be able to absorb potentially large volumes of these funds and an effort to place them domestically would disrupt the local financial market. It will therefore be necessary to develop a strategy for the funds to be invested by the social insurance company and at the same time to clarify how the monetary policy will respond to possible movements of such funds.

3.4. Exchange rate

The current level of the koruna exchange rate appears to be overvalued in terms of how the current account develops. The NBS does not have an exchange rate set as its target. Nevertheless, the exchange rate is important as a factor of inflation⁵².

Despite the fact that the exchange rate is not targeted under our monetary policy, all of its possible effects on the economy must be considered. Providing that it does not endanger inflation (which is a monetary policy target), it is possible to consider its other effects, such as the impact on the trade balance and the financial affairs of banks, undertakings and the government.

Weakening of the exchange rate makes the conditions for imports worse and generally enhances the results of foreign trade. However, it does not need to be beneficial from other points of view. In addition to inflationary impacts of depreciation, consideration must be given to the impact of (nominal) depreciation on indebted undertakings and the government as well as to the cost of capital imports, in particular the imports of technology. Regarding the fact that foreign exchange assets are prevalingly held by the NBS and it is mainly the undertakings and to a lesser degree the government that are indebted, the effect of exchange rate movements is asymmetrical. Depreciation has a deteriorating effect on the financial affairs of (indebted) undertakings⁵³. It improves the financial situation of the central bank, and thereby, in the event of transfers made by the central bank based on exchange rate gains, it also improves the situation of the government. Regarding a relatively high foreign debt of undertakings and banks, an account must also be taken of the extent of hedging against exchange rate risks, but also sovereign guarantees on foreign loans.

⁵¹ The IMF has calculated the so-called sustainable deficit for the SR as of April 2002 to be 5.8-6.8%. It is a current account deficit, which does not increase the foreign debt-to-GDP ratio. At that time it stood at approximately 37% of GDP.

⁵² As was already mentioned, several analyses have concluded that the transmission of monetary decisions by means of the exchange rate, the so-called exchange rate channel for the monetary policy, plays the most important part in the current NBS monetary policy. In addition to its impact on prices of imports and prices of marketable goods as such (a direct impact on inflation), its impact on domestic demand and prices of (financial) assets and liabilities (a subsequent indirect impact on inflation) is equally important.

⁵³ Hand in hand with the development of the financial market and improving financial management in Slovakia, the hedging of undertakings and banks against exchange rate fluctuations has been improving accordingly. Rather than having to incur exchange rate losses, indebted undertakings choose to bear the cost of hedging against exchange rate fluctuations. Besides that, several of them are hedged against the exchange rate fluctuation „in a natural way“, thanks to the fact that they export. To them, an exchange rate depreciation would mean increased (koruna) costs of debt servicing and concurrently increased (koruna) export revenues.

Conversely, nominal appreciation worsens the financial affairs of the central bank and improves the financial results of indebted undertakings. Moreover, the cost of monetary policy of maintaining a strong exchange rate must be considered.

In the event that a part of proceeds from privatisation are placed domestically and as a result of sterilised intervention in the form of sterilisation they become a part of the NBS foreign exchange reserves, the volume of sterilisation could reach SKK 150-200 billion. The volume of sterilisation is high already now – standing at almost SKK 120 billion.

By merely appreciating the exchange rate by 1 % at the current level of reserves, the NBS would incur exchange rate losses of more than SKK 3 billion. At the deliberated volume of sterilisation and at the current interest rates on the sterilisation, such a monetary policy may cause the NBS's losses to become even more profound, increasing, in addition, by more than SKK 10 billion (after the yield from invested reserves is taken into account). These costs already now have a significant impact, and may affect also the state budget deficit, as the NBS's losses resulting from a gradually higher appreciation of the exchange rate or from a long-term sterilisation of a large volume of liquidity cannot be resolved solely at the expense of the NBS existing reserves.

Nominal appreciation of the exchange rate may help in terms of disinflation. In our opinion though, it exerts a big pressure on the management of the NBS and/or the state budget. Such a strategy is only viable in the case that the necessary prerequisites are created in the NBS reserves or in the state budget.

To summarise: the exchange rate depreciation is a factor of inflation. It helps to improve price competitiveness, and worsens the financial affairs of debtors, who are not hedged against exchange rate risks, in particular undertakings. The appreciation of the exchange rate may facilitate disinflation, nevertheless it generates losses in the financial results of the NBS and (through that) of the state.

3.5. Prerequisites and conditions for meeting the Maastricht criteria

In line with the aforementioned, disinflation strategy must deliberate on several facts:

- inflationary impacts of deregulations (with a potential impact on formation of expectations), the impact of market-driven rectification of price relations and dual inflation, the impact of possible increase of charges on utility services to households and VAT and excise tax increases,
- high costs of the monetary policy, particularly if the central bank was to face a high deficit in the current account on its own, without an appropriate support lent by a budgetary policy, wage policy and economic policy targeted at competitiveness (against imports, as well). These costs are further increased due to sterilisation of a sizeable inflow of funding earned in privatisation. The deepening of the central bank's losses in the event of a nominal appreciation of the exchange rate is a separate issue that should be subject to discussion and agreement with the ECB,
- support provided from the government budget may only be limited owing to a currently high debt rate, high current deficit and resistance to cutting it down, as well as high current and future cost of reforms,
- in order for the budgetary issues to be resolved by increasing the budget revenues in a way other than through tax increases (that means, at the cost of a temporarily increased inflation), systemic measures, such as those to improve the tax collection, would have to be adopted. But these measures in themselves are likely to temporarily increase inflation, too.

From what was said above, the following recommendations can be concluded with regard to the possible procedure to be coordinated between the NBS and the Government of the SR, employers and trade unions in conjunction with Slovakia's direction into the EMU:

- to implement any measures that might increase inflation at an earliest possible time (in 2003) and to the minimum necessary extent. (Some deregulations will only be carried out in 2004, with their possible impact on increasing inflation also occurring in 2005),
- within the collective bargaining, to push through to the maximum possible extent wage adjustments in relation to the future (falling) inflation. This means that wages should not be indexed retrospectively (accommodatively), but looking ahead (prospectively). Likewise, to try to influence the course of things so that any additional costs are deliberated in anticipation of future decreases in inflation as much as possible,
- to further consolidate the budget and reduce the deficit using as much as possible (or exclusively) expenditure reductions,
- to choose a strategy for carrying out reforms which to the greatest possible extent draws upon the application of both past and future proceeds from privatisation so as to avoid pressures on incurring a significant public finance debt (and the costs of debt servicing), or on large volumes of funding to be spent from the budget to help to finance reforms,
- to implement reforms to the maximum possible extent, so that the foreign debt is cut down and the assets of the social insurance company are invested almost exclusively in the foreign financial markets. This should help to reduce costs of the monetary policy related to sterilising excess liquidity,
- to schedule the entry into the EMU so that decisive issues (deregulations, tax and other measures and reforms impacting upon the expenditure side of the budget) are implemented before the entry.

Conclusions

Membership in the EMU will be a logical continuation of Slovakia's membership in the EU. Several facts attest to the benefits of this membership being achieved at an earliest possible time. The conception of the „earliest possible“ membership should however be realistic. First and foremost, EMU membership should be attained after the completion of reforms that might significantly influence the fulfilment of the Maastricht criteria and commitments arising from the Stability and Growth Pact. If the fulfillment of the Maastricht criteria was to bring about secondary (echo) effects, the scale of these effects needs to be reviewed⁵⁴. What is particularly important is a sustainable reduction of the public finance deficit (in line with the ESA95 methodology) and a reducing of inflation without its suppression.

Accomplishment of the Maastricht fiscal criteria in 2005⁵⁵ is only a theoretical possibility considering the current state of affairs. A time schedule for a possibly earlier entry into the EMU (in 2007) is problematic, especially owing to administrative delays and processes postponed. In addition, for the inflation criterion to be fulfilled, all deregulations would have to take place in 2003. In order for the budget criterion to be fulfilled, all the costs of reforms would need to be covered on wholly with privatisation proceeds, and the redistribution via public budgets would need to be cut down to the same extent only, to which public expenditure is reduced. The public debt reduction and interest rate decreases would result in a reduced interest paid on debt service by 1.0-1.5% of GDP in 2005, thus creating room for reducing the deficit below 3%.

According to the present considerations that mainly rely on the programme proclamation of the Government of the SR and concern **the second alternative of the EMU accession schedule**, the Maastricht criteria are envisaged to be fulfilled in 2006, the assessment to be made during the course of 2007 and the admission to the EMU to take place in 2008. The fact that counts against this variant is that in 2006, a year decisive in terms of the given time schedule, a parliamentary election should be held. This could (as a result of the so-called political cycle) make the fulfillment of the Maastricht criteria less certain. It would therefore be appropriate to adopt measures and undertake commitments to reduce this uncertainty.

We also agree with the view that our economy should operate under the ERM II for the shortest possible time. What counts in favour of this is the benefit to be derived in terms of the monetary policy of a credible central bank from the flexibility of the exchange rate prior to the accession to the ERMII and risks and consequences of limitations on exchange rate movements under the ERMII in combination with the fulfillment of the Maastricht criteria. According to the aforementioned time schedule, an application for ERMII membership should be filed during the course of 2004, whilst it is assumed that the SR would be a part of the ERMII in the years 2005-2006. In 2006 it would also meet the criteria on inflation, interest rates and a deficit (and debt).

⁵⁴ Examples of the secondary effect of fulfilling the Maastricht criteria might include delayed responses of the economy to interest rate reductions, growing budget expenditures as a response to interim expenditure restrictions, „running off“ of inflation as a result of suppressed indexation of wages or other costs.

⁵⁵ According to the diagram in Chart 1, application for the ERM II is to be filed in 2004. The assessment comprising all the formal procedures associated with the entry into the EMU would take place in 2006.

There are several issues and tasks that still have to be addressed. First of all, it needs to be clarified, negotiated and agreed (before the ERMII application is filed) at what exchange rate parity Slovakia will join the ERMII. If the economy is to maintain the chosen exchange rate parity, the rate must correspond with an „equilibrium rate“ for the period of Slovakia’s functioning in the ERMII (2005-2006, but also 2007!) and in the period immediately following the entry into the EMU. In determining this equilibrium rate, the following should be taken into account:

- the performance and competitiveness of our economy over the given period, i.e the internal and external equilibria (the so-called fundamentals),
- the interest in (stable) investment into domestic assets, namely FDI, and requirements following from foreign debt servicing,
- the flexibility of the economy and of economic policies.

The third option rests in targeting the fulfillment of the Maastricht criteria to the year 2007. In the event of such a time schedule, it would be enough for Slovakia to file an application for membership in the ERM II during the course of 2005. It is a well established fact that in the first year of a new government being in their office, adoption of measures required for the fulfillment of the Maastricht criteria would be easier. Also, further steps to promote the economic stability (in the year following the criteria achievements and in the first year of EMU membership) could thus be taken in a period not subject to pressures commonly present during another stages of the political cycle.

When making a decision concerning these deadlines, it is important to coordinate the procedure with the neighbouring candidate countries, in particular with the CR, with whom Slovakia has the closest business relations. A possible earlier entry of the CR would bring about a significant change in the conditions under which the economy, and especially foreign trade of the SR, operate.

It is equally important that a wide social agreement is reached with a wide range of stakeholders, such as the government, parliament, employers and trade unions, concerning common advancements in fulfillment of the pre-accession targets. Equally important will be adoption of such a PEP that will guarantee Slovakia’s direction into the EMU. Finally, there is also a need for an efficient information campaign targeting the population at large.

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