

SLOVAKIA ON THE ROAD TO THE EURO

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Slovakia considers it a big challenge to take part in Western European integration. This is evidenced by all the work it has put in to gain admission to the European Union. Talks about the country's accession are now in the final phase and current developments indicate that the Slovak Republic will become

a member of the EU with effect from 1 May 2004.

In filing its application for admission to the EU, Slovakia also undertook to join the monetary union, since the accession documents include the commitment for Slovakia join the euro area. The only question is the date of entry into EMU (Economic and Monetary Union), which is not specified in the Treaty, so the country is, to



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a certain extent, still free to follow its own policy in this respect. With regard to the latter, an appropriate course of action will have to be adopted to minimise the additional costs attached to any acceleration in fulfilment of the criteria for entry into EMU, at the same time as reducing losses

arising from any undue delay in entry.

The closeness of the date of admission to the EU and the moment when a decision will have to be made in respect of Slovakia's path onwards to integration, and entry into the preparatory phase of EMU - ERM II, underline the relevance of several theoretical questions which have become burning practical issues.

Entry into the euro area – pros and cons

Monetary union is the final phase in the process of economic integration, in which a new member state can enjoy all the advantages of integration. These advantages can be summarised as the elimination of numerous uncertainties and the emergence of a more favourable environment for both citizens and entrepreneurs. The adoption of the single currency will, first and foremost, eliminate the exchange rate risk, reduce the level of transaction costs, and increase the transparency of the market in terms of prices. Slovakia will be better protected against external shocks, and the economy will be more closely linked to the euro area, with a consequent positive effect on the country's image

and the inflow of foreign capital through direct investment. On the whole, there will be increased pressure for the standardisation of domestic economic-policy measures and reforms, the implementation of budgetary policy in accordance with the Stability and Growth Pact, with favourable effects on the financial markets. Last but not least, the stability of business conditions will increase, releasing the country's potential for economic growth, which will lead to acceleration in real convergence and improvement in economic stability.

In connection with our entry into the euro area, the negative aspects of joining have also been raised during discussions. The most frequently mentioned disadvantages are the loss of the freedom to pursue an independent monetary policy, the difficulty of synchronising the



Slovak economy with EMU and the resulting inadequate reactions of the national economy to the common monetary policy, insufficient labour market flexibility, inadequate consolidation of public finance, unfinished structural reform, and the resulting inadequate flexibility of fiscal policy, together with incomplete liberalisation of certain markets, including price deregulation and the associated risks for inflation.

However, a closer look at the 'disadvantages' of joining EMU reveals that, in most cases, the disadvantages do not really stem from membership of the monetary union, but from the risks arising from the country's inadequate preparedness to participate in the operation of the monetary union and to cope with open competition on the international market. In other words, the aforementioned disadvantages will be disadvantages irrespective of whether we are inside or outside the euro area. For example, an excessive fiscal deficit would hamper the government's possibilities of stabilising the economy against external shocks, put a damper on business, and emasculate monetary policy even in the event of the SR remaining outside the euro area. At the same time, the abandonment of price deregulation would represent a risk for the Slovak economy regardless of whether the country becomes a member of EMU or not.

For a small and very open country such as Slovakia, the advantage of having an independent monetary policy is not quite as significant as usually presented. As an example, we can mention the developments from the last few months of 2002 and the beginning of 2003, when short-term capital movements pushed the monetary policy of the NBS into a situation in which serious problems had to be resolved in connection with exchange rate developments. In the opinion of the IMF mission to Slovakia at the end of last year, the risks involved in such developments can be minimised by accelerating preparations for entry into the euro area. Finally, we should mention in this connection that, after entry into the euro area, the SR will have the opportunity to take an active part in the formulation of common monetary and exchange rate policies, which would seem to be, in the light of the above, comparable to an independent monetary policy.

Programme for EMU entry and time-related aspects

It appears that the above risks can be most easily addressed by the adoption of a consistent programme and the process of accession to EMU, involving compliance with the Maastricht criteria, represents – in this respect – an appropriate framework. The NBS has long been of the opinion that EMU should become reality as

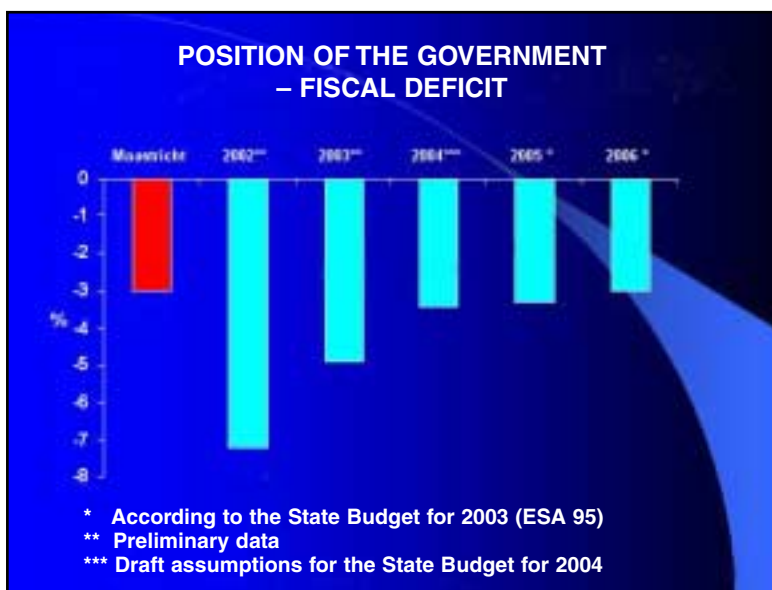
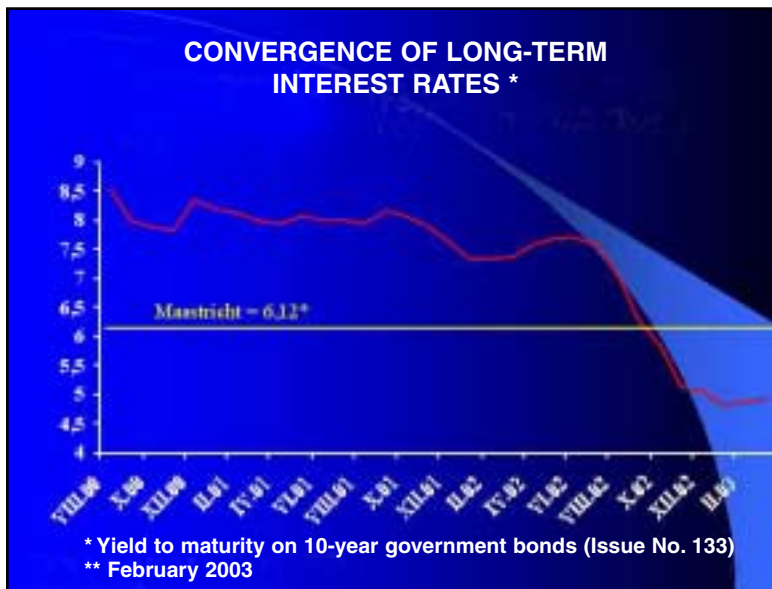
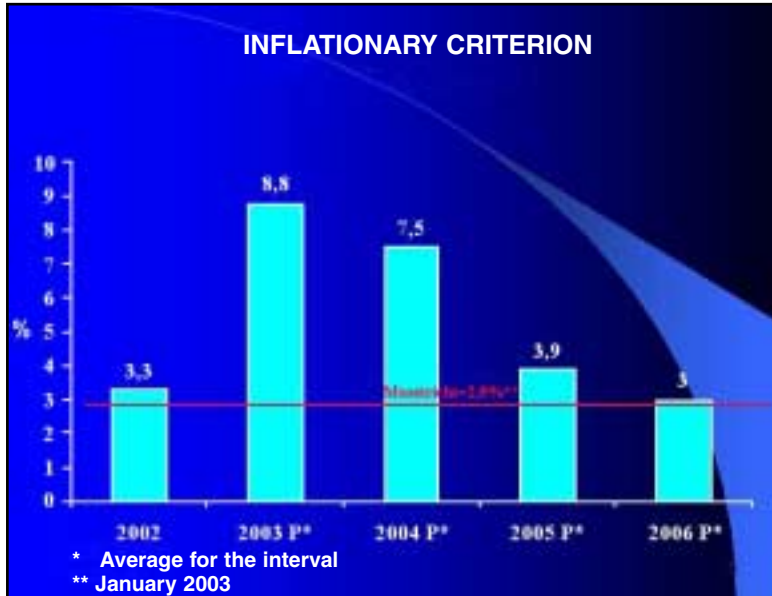
soon as possible, i.e. when the SR is ready and prepared to meet the relevant criteria.

There is no point in postponing the entry should the economy allow compliance with the said criteria on a sustainable basis, for this would lead to unnecessary losses (non-utilisation of the advantages of membership). On the other hand, it is illusory to think that entry is solely a question of the will to become a member of the euro area. We shall have to meet certain criteria in the prescribed areas (exchange rate stability, inflation, long-term interest rates, fiscal deficit, and debt) in a sustainable manner, i.e. by not accelerating the process of convergence artificially (for a specific one-off purpose). Otherwise, our application for entry will simply be rejected.

In this respect, a common strategy is being prepared by the two most important pillars of economic policy – the Government and the National Bank of Slovakia – a strategy for the country's entry into EMU, designed to optimise the process of reform with a view to meeting the Maastricht criteria in a sustainable manner, with respect to other aspects. One of them is the co-ordination of the accession process, with regard to the strategies of other accession countries. This is important since a delay in our admission to the euro area could result in a competitive disadvantage in comparison with our Central European neighbours.

By accelerating the process of preparation for entry into the euro area, it is possible to minimise the risks involved in the transition period (from now to the date of entry into EMU). This would shorten the period during which the Slovak economy would be exposed to the attention of speculators, which could disturb the stability of the economy. This attitude is in line with the hypothesis on which the above mentioned strategy of the NBS and the Government is based, according to which participation of the Slovak currency in the ERM II should be as short as possible for the above reason. So, the SR should neither expose itself unnecessarily to the uncertainties of the transition period nor postpone its entry into EMU, but should join the euro area as soon as the (nominal) Maastricht criteria are met.

Improvement in the indicators related to fulfilment of the Maastricht criteria is conditional upon the completion of reforms, which will be accompanied by certain costs that could have a negative effect on compliance with the said criteria. In this respect, the reform of the system of public finance and related reforms in other areas, especially the pension reform, the implementation of which requires expenditure on setting up a pension fund, will exert pressure on the budget deficit and endanger fulfilment of the fiscal criterion, and consequently the debt and interest rate criteria. At the same time, the realisation of the till now postponed price



deregulation will complicate the process of disinflation towards the prescribed values. These aspects will naturally have to be taken into account in the said strategy.

Experience of EMU members with the accession process

An advantage for Slovakia and the other accession countries lies in the possibility of utilising the experience of those member states which had, at the time of accession to EMU, an economy similar to that of Slovakia (Ireland, Spain, Portugal, Greece). Based on NBS studies, we may say that the parameters of the Slovak economy do not substantially differ from the parameters of the above countries roughly at the same time prior to entry into EMU (the comparison is based on the assumption that the SR will join the euro area in 2007 – 2008). So we have enough time for making analogies, but should not forget that the character of the international environment in which the accession process is taking place, will have changed during the intervening years.

Experience with the accession of the above countries indicates that there is no contradiction between the real (per capita GDP, price level) and nominal (Maastricht) criteria of convergence. Numerous empirical studies show that, within the process of convergence in the said countries, leading to entry into EMU, there was no contradiction between the needs of real growth and nominal stabilisation in the economy. Macro-economic policies aimed at stability, but allowing a certain degree of exchange rate flexibility, together with structural (and institutional) reforms, designed to increase the flexibility of the markets, enabled these countries to make considerable progress in catching up with the other countries in terms of per capita GDP, labour productivity, and price levels. This fact casts doubt on opinions in Slovakia, according to which the process of meeting the Maastricht criteria should be preceded by reaching a certain level of real convergence.

It would be most useful if the conver-



gence process could take place within the period of accession, when the country's specific problems could more easily be addressed through specific measures taken at national level. Such a course of action is, however, no alternative to a fast and comprehensive reform in the required areas, only part of the same.

Summary

Preparation for entry into EMU is in fact a programme for the standardisation of economic (as well as other) parameters of the country concerned in line with the conditions of open international competition. The related reforms should be carried out irrespective of the country's integration into Western European structures. In addition, integration into the euro area represents an opportunity for the economy to function in the stable and secure environment of EMU.

A consistent strategy for accession to EMU will require that the steps of the Government and the NBS are closely co-ordinated, in connection with the harmonisation of monetary and fiscal, as well as other policies. We should add that a prerequisite for the success of such a strategy is nationwide consensus with respect to the reform. This underlines the importance of co-operation with employers and trade unions, especially in the area of wage regulation, accompanied – mainly in connection with the reform of health care and the social system – by an effective public information campaign.

Integration into EMU is an extremely demanding process. It is, however, well worth the effort made in achieving thorough implementation of the reform. The result would be an economy of a different quality and, what is of vital importance and may serve as a key factor in motivating the public, could bring about a major improvement in living standards.

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