STRATEGY OF THE SLOVAK REPUBLIC FOR ADOPTION OF THE EURO

Continued from issue 9/2003

4. Outlook for future development in real and nominal convergence

4.1 Real convergence

Integration of the Slovak economy into the EU

Our foreign trade orientation on the EU may accelerate in the future, on two different fronts. Assembly operations and reprocessing will continue to step up the foreign trade turnover. At the same time, we may expect a gradual development of subcontracting activities which, taken together, will open up the economy towards the EU and intensify intra-sectoral trade. We expect to see similar processes happening to an ever increasing extent in other economic sectors as well, e.g. in the financial sector. In this respect, it will be vital to deepen the integration in particular through the intra-sectoral international division of labour and to develop productions with higher added value.

Fixing the future of the Slovak economy to monetary union, combined with the positive effects of EU membership, may further strengthen these tendencies thanks to a reduced investment risk and transaction costs in trade. Here, it is important to send out a clear signal in form of the eurozone accession programme with a clearly defined timetable for the fulfilment of admission criteria.

4.2 Nominal convergence

The fulfilment of the Maastricht criteria will depend on several decisions and their timing.

Inflation

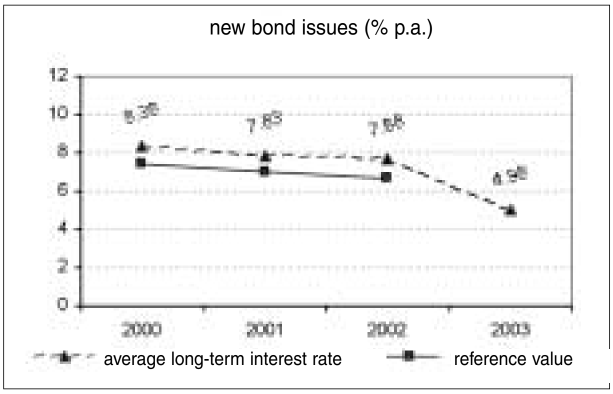
Inflation, after slowing down temporarily in 2002, picked up to around 8% in 2003. The latest estimates for 2004, assuming completed deregulation (save for small exceptions) and an expected hike in indirect taxes, suggest inflation at around the 2003 level. After that, inflation should go into a decline and its further development should be affected only to a minor extent by finishing deregulation (water supply and sewage disposal) and a gradual market adjustment of price relations. The process of disinflation might be speeded up by nominal exchange rate appreciation, provided it is deemed necessary and there is room for it. It is necessary that the period of deregulation and other inflationary pressures is kept as short as possible and that these impulses are as low as possible. They should be accompanied by a non-inflationary wage policy and a tight fiscal policy – that is the only way to set up the room for a major inflation decline after 2004.

Long-term interest rates

Based on the development in inflation, and depending on how the equilibrium exchange rate and trade balance fare, room will be created gradually for an interest rate decline.

Long-term interest rates could level off near the rates applied in EU countries. The main factors here should be falling inflation expectations and, in particular, the anchoring of future monetary developments and long-term expectations in the eurozone. This tendency can already be observed today (Graph 1)[1].

Graph 1 Long-term interest rate



Source: NBS

The key to this outlook is a sound performance of public finances. Confidence in the Government's declared aim to consolidate public finances by 2006 (or earlier) may turn out to be a decisive factor for this development to materialise. The intention is to

[1] The average yield on issues made in 2003 (by the end of March) was 4.98% p.a., with the lowest at 4.90% p.a., coinciding with a constantly falling risk premium.

cut back the public finance deficit below 5% in 2003, below 4% in 2004 (according to state budget assumptions), and on below the 3% Maastricht limit by 2006. Given the present situation in the indebtedness of public finances, and the expected interest rate decline, such development would also consolidate public debt[2].

Exchange rate

In the period preceding the accession to the ERM II, the SKK/EUR exchange rate should head towards a level which is advantageous for the economy with a view to its medium- to long-term balance. The essence of ERM II membership is to maintain the nominal exchange rate at the level of an agreed parity, or within a defined fluctuation band. Since during ERM II membership, the monetary policy is already confined by this exchange rate limitation, the role of the fiscal policy will be that much more important. It is therefore crucial that once a country is inside the ERM II, the budget is consolidated to a degree where, if necessary, it can find the reserves needed for a co-ordinated action of monetary and fiscal policies in order to maintain exchange rate stability.

Fiscal deficit and debt

The current situation indicates that the process of public finance consolidation marks a milestone in the eurozone accession process. Obviously, attaining the objective to reduce the fiscal deficit below 3% of GDP by 2006 will require reforms designed primarily to bring a new quality to the budget expenditure side. The reform must result in a sustainable position in public finances in line with the requirements laid down in the Stability and Growth Pact. Reforms must be implemented so as to reduce foreign indebtedness. That should help cut the monetary policy cost of sterilising excess liquidity. Otherwise, we could see a monetisation of the reduced cost of debt service coupled with a mounting (unrealised) central bank loss. The process of budget consolidation should be concentrated into the shortest possible period of time (three or four years at most) and should involve radical reforms changing the face of the expenditure side of the budget, among other also by shedding certain expenditures to the private sector.

[2] Ministry of Finance of the Slovak Republic estimates suggest that public debt (by ESA 95 methodology) should be below 50% of GDP.

5. Overall conclusions and the time and action framework of the strategy

In its real and nominal characteristics, the Slovak economy is drawing close to the economies of its future European partners and with the EU accession, the whole process will accelerate and deepen. The adoption of the single currency will represent the accomplishment of the integration process.

On the other hand, as a prerequisite for the sustainable introduction of the single currency and monetary policy, the Slovak economy will have to go through systemic changes to increase its flexibility – the ability to flexibly respond to eventual asymmetrical shocks. Labour market reforms and public finance consolidation will play an important role.

These facts bring us to the following conclusions:

- the Slovak Republic commited itself to join the eurozone by signing the EU Accession Agreement. At the same time, the Slovak Government and the NBS see the adoption of the single currency as the pinnacle of the integration process, meaning that only at that stage can the country exploit fully the advantages of all of the effects of integration,
- the Slovak Republic should adopt the euro as soon as possible, i.e. at the moment when the Slovak economy can meet the Maastricht criteria in a sustainable manner. This is implied in particular by the potential benefits of eurozone membership for economic growth and for the development of a stable economic environment,
- reforms which have to be carried out in order to meet the criteria for accession to the euro area are inevitable, irrespective of accession. Effective public finance, education and health care systems, as well as a flexible labour market are essential for the problem-free operation of any economy,
- an important argument in favour of the earliest possible membership is the need to fix the positive long-term inflation and interest rate expectations. A clear-cut and credible strategy is an important element for fixing and sustaining these expectations, with a positive effect on a whole spectrum of areas of the economy,
- a consolidated budget situation plays a key role in stabilising the economy during the implementation of the euro area accession strategy. It is therefore necessary to consolidate the budget situation in a sustainable manner before the year Slovakia is put to the test of ERM II,
- in designing specific steps in the strategy for accession to the monetary union, it is necessary to

be realistic about the time it takes to implement inevitable reforms and about the cost (social, fiscal and other) to be paid along the way.

Knowing this, there are several recommendations the government and the central bank should adopt in support of the presented strategy:

- take all measures liable to increase inflation as soon as possible and in the necessary extent,
- in collective negotiations, push on for wage adjustment respecting future (falling) inflation (wage growth in the budgetary sector should not create room for wage pressure in the business sector). Not to allow real wage growth to outrun growth in labour productivity. Likewise, to act that other expenses anticipate as far as possible the future reduction in inflation,
- further consolidate the budget and reduce the deficit primarily by cutting expenditures and improving tax collection,
- time euro area entry so that major reforms (deregulation, tax and other measures, reforms affecting the budget expenditure side) are already finished,
- throughout the period, the NBS is set to play a key role in shaping (dis)inflationary expectations.

A credible government policy, in particular reforms aimed at a sustainable consolidation of public finances, wage arrangements anticipating disinflation, and a credible fixing of long-term expectations to the date of adopting euro will be crucial for a disinflationary policy and exchange rate stability.

Reforms related to eurozone entry are a precondition for establishing a stable economic environment, reducing financial and monetary risks, and spurring the inflow of foreign capital. In this context the reform of public finances and pension reform, as well as healthcare and education reforms are of key importance. Their targeted and timely implementation is necessary regardless of adopting euro and any delays would only run up the related cost. Moreover, implementing of reforms in the framework of fulfilling the Maastricht criteria is advantageous, since it necessitates a consistent framework of relevant policies.

From the aspect of the overall process of accession to monetary union, entry into the exchange rate mechanism ERM II is a key decision. In ERM II, Slovakia will have at least two years to demonstrate its ability to maintain the exchange rate of the Slovak koruna against the euro stable at an agreed parity. Already before the EMR II entry, it is necessary that all decisive reforms are finished, that no measures causing significant inflation growth (deregulation) are still at work, and that budget consolidation is complete. Other reforms should be set underway in a credible manner, with an explicit content and implementation timetable. Although during this time, exchange rate stability will also be supported by the intervention policy of the ECB[3], fiscal and monetary policies also need to be co-ordinated to prop up the exchange rate. The time spent inside the ERM II should be as short as possible. Any deviation in policies from the pre-defined path during this period would mean a serious threat to fulfilment of the stabilisation criteria (especially the exchange rate criterion).

Although it is premature at this stage of the preparation of our euro area accession strategy to talk about precise timetables or the horizon for our entry, it may be expected roughly in 2008-2010. If the Government's programme statement is fulfilled, if the NBS's assumptions about the performance of the nominal accession criteria materialise, and if the required reforms reach an advanced stage of implementation, the earliest realistic target for the entry would be 2008. Since the entire process of adopting euro takes about 4 years, negotiations on the central parity of the Slovak koruna preceding the ERM II entry would have to begin at the time of Slovakia's accession to the EU, and the country could join the ERM II in 2005.

An important aspect to bear in mind, when considering the speed of our accession to the eurozone, is the progress made by other countries, especially our immediate neighbours (Czech Republic, Hungary and Poland). It is obvious that any lagging behind on our part would send a negative signal to financial markets and investors. This could also happen if our accession strategy was implausible, or if there were problems in its fulfilment caused by subjective reasons. In this respect, the establishment of conditions for meeting the Maastricht criteria by 2006 would be an important positive sign for the business sector and foreign investors of the credibility of our eurozone accession strategy, as well as clear evidence of progress being made down the road towards accession. On the other hand, any delay in the accession process, leading to a later entry compared to neighbouring countries, would mean a severe handicap in terms of higher costs or in missing out on the positive effects of entry, as well as damaging the overall image of the country (with implications, for instance, for lower FDI inflow compared to the acceding countries).

---

[3] It is not possible to expect that the ECB will intervene in order to correct fluctuations caused by unappropriate domestic policy-mix.