STRATEGY OF THE SLOVAK REPUBLIC FOR ADOPTION OF THE EURO

On 16th July, 2003 the Government of the SR discussed the joint proposal of the Ministry of Finance of the SR and the National Bank of Slovakia: the Strategy of the Slovak Republic for Adoption of the Euro. The document which has been the subject of public discussion, professional conferences and seminars is the draft programme approach of the Government of the SR and the NBS in the issue of entering the eurozone. Following its approval by the Government it is to be the starting point for specifying and setting out further steps in the accession process. It is a strategy that does not set a precise deadline, but rather speaks of a timetable of 2008 to 2009. We publish the main part of this draft, the complete text in Slovak including appendices can be viewed on the website of the Office of the Government of the SR: www.government.gov.sk and on the National Bank of Slovakia website: www.nbs.sk.

Upon EU accession, Slovakia will become a member of the Economic and Monetary Union, granted a temporary exemption from some of its obligations as a monetary union member. It is expected that this exemption will be revoked once Slovakia meets the relevant (Maastricht) criteria, and the country will go on to join the single currency area. The commitment made by signing the Treaty of Accession does not allow the country to be in the EU and stay outside the monetary union on a permanent basis.

In its programme statement, the Slovak Government expressed its determination to create the conditions for achieving the Maastricht criteria by 2006. The National Bank of Slovakia repeatedly declared its support for entry into the euro area on the earliest possible date. The rationale behind it is that a full advantage of the benefits coming along with the integration process can only be taken at its final stage – inside the monetary union. This opinion is based on an evaluation of the current condition and prospects for the development of real and nominal convergence of the Slovak economy to the EU's, a consideration of various aspects of Slovakia's accession into the eurozone, and the resulting assessment of the positive and negative implications of the adoption of the single currency[1].

1. Commitments of the Slovak Republic and criteria for entry in the eurozone

1.1 Commitment of future membership of the Slovak Republic in the eurozone

The current EU legislation contains no provisions in respect of the monetary union permitting EU member states to obtain the kind of opt-out status held by Denmark and the United Kingdom. Although by signing the Maastricht Treaty, these countries agreed to conduct economic policies promoting the development of the monetary union, they did not wish to join the monetary union at that time[2]. Any other country acceding to the EU after the signing of the Maastricht Treaty (1992) thus automatically assumes the obligations arising from the Treaty, including future membership in the monetary union and the adoption of the single currency.

This applies also for Slovakia. Article 4 of the EU Treaty of Accession[3] of the Slovak Republic states: "On the date of accession, each member state shall become a participant in the economic and monetary union as a member state with derogation pursuant to Article 122 of the EC Treaty". Therefore, Slovakia's decision-making on eurozone entry does not concern the basic question of entry (i.e. whether or

[1] Since 1999, the NBS has been preparing regularly studies dealing with the issues of real and nominal convergence of the Slovak economy to EU countries, as well as the questions of eurozone entry. The conclusions drawn in these and other studies authored in the Slovak Republic and abroad by various institutions were used as sources in compiling this paper.

[2] This solution is provided in relevant protocols attached to the Maastricht Treaty: Protocol on certain provisions concerning the United Kingdom of Great Britain and Northern Ireland; Protocol on certain provisions concerning Denmark).

[3] "Act on the conditions of accession … the Slovak Republic … and on amendments to treaties establishing the European Union".

Table 1 Maastricht criteria

Criterion	Definition	Reference period
Price stability	Inflation must not exceed the average rate of inflation (measured as the Harmonised Index of Consumer Prices) of the 3 EU member states with the lowest inflation +1.5%	Average for the last 12 months before assessment
Fiscal deficit	Ratio of projected or actual budget deficit to GDP must not be higher than 3%, or must tend to this value to this value convincingly	Last calendar year before assessment
Gross government debt	Ratio of government debt to GDP must not exceed 60%, or must not grow	Last calendar year before assessment
Long-term interest rates	Interest rate must not exceed the average interest rate of the 3 EU member states with the lowest inflation +2%	Average for the last 12 months before assessment
Exchange rate stability	Membership in ERM2, exchange rate floating within a ±15% fluctuation band, but close to the central against EUR, no devaluation against any other member state's currency	For at least 2 years before assessment

not to enter), but rather the time horizon when the entry should occur. This also means that the Slovak Republic undertakes to conduct an economic policy which is consistent with the economic policy principles applied in the Economic and Monetary Union.

1.2 Eurozone admission criteria

As a condition for EMU membership, a country must be prepared to adopt the euro as the single currency and be able to fulfil the obligations arising from the Stability and Growth Pact. The formal condition for a country's preparedness to adopt the single currency is the fulfilment of a set of nominal convergence criteria, the so-called Maastricht criteria (Table 1).

2. State of real and nominal convergence of the Slovak Republic to the EU

In any integrated group, real and nominal convergence of economies of individual members is desirable both for the stable functioning of the whole group and for the problem-free functioning of individual countries inside the group. Since the outset of the accession process, the Slovak Republic has made progress in real and nominal convergence to the economic and monetary area of the EU and eurozone.

2.1 Some real convergence achievements

The real convergence criteria include in particular GDP per capita, as well as the price level and structural, legal, and institutional characteristics.

Convergence of economic performance and alignment of price levels

The progress made in “catching up” in economic performance and price levels is illustrated in Table 2.

Table 2 documents a convergence tendency, i.e. Slovakia's level of GDP per capita in purchasing power parity is nearing the EU average, as well as a price level approximation[4]. However, the convergence process has not been a fluent one, where approximation in 1996-1998 was achieved in an unsustainable manner – at the cost of excessive foreign borrowing. As a consequence, after inevitable measures were taken to stabilise the economy, the GDP per capita in PPS and the price level ratio strayed from EU values for a short spell. Since 2000, and notably in the last two years, both indicators are converging again, and this trend is expected to last in

Table 2 Comparison of economic performance and price levels between Slovakia and the EU

	1995	1996	1997	1998	1999	2000	2001	2002
GDP per capita SR/EU (%, EUR)	15.63	16.48	17.84	17.92	16.51	17.49	18.28	19.53
GDP per capita SR/EU (%. PPS)	45.97	47.94	49.46	50.05	49.50	46.21	47.26	47.80
Price levels SR/EU (%)	34.00	34.37	36.07	35.80	33.35	37.86	38.67	40.87
ERDI	2.94	2.91	2.77	2.79	3.00	2.64	2.59	2.45

Source: Statistical Office of the Slovak Republic, Eurostat, NBS

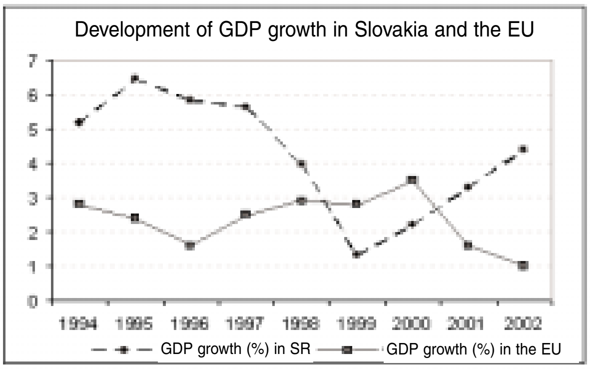
PPS (Purchasing Parity Standard)
ERDI (Exchange Rate Deviation Index)

[4] The ERDI indicator expresses the deviation of the nominal SKK/EUR exchange rate from the SKK/EUR exchange rate in purchasing power parity. Its reverse value is a measure of the comparability of the price level in the Slovak Republic (in %) to the EU.

the years ahead. In 2002, GDP per capita in purchasing power parity reached about 48% of the EU level. The price level in the Slovak Republic was at approximately 41% of the EU's, which is equivalent to an ERDI value of 2.45. This means that the purchasing power of the Slovak koruna in the EU market is about 41% of its purchasing power in the domestic market (i.e. a product[5] that a Slovak citizen can buy for SKK 1 on the Slovak market would cost him SKK 2.45 on the euro area market). Or, vice versa, that the purchasing power of the euro on the Slovak market is 2.45 times higher that on the EU market (a product that an EU citizen buys for 1 euro at home would cost him 41 cents on the Slovak market).Seen from this perspective, the alignment of price levels is one of the indicators of real convergence and means a growing purchasing power of the Slovak koruna on the EU market.

Thanks to its growing performance, the Slovak economy is able to better satisfy its consumption and investment demands, and prepared to do relatively better in fulfilling the obligations coming with EU membership[6]. The process of Slovakia's catching up with the EU's economic level happens in two ways: through a faster real economic growth (graph 1), driven in particular by a rising productivity of labour, and/or through an appreciating real exchange rate of the Slovak koruna against the euro.

Graph 1



Source: NBS, Eurostat

So far, faster real growth relied on higher economic growth and rising productivity of labour which outstripped EU countries by some 2% a year (at internal constant prices). The catching up in the productivity of labour (which still remains fairly low in absolute terms – at about half the EU average) in Slovakia was supported by sizeable investments, including FDI, which sparked a technological renewal and increased the effectiveness of factors of production. An equally important role in increasing the productivity of labour has been played by measures designed to cut labour costs by reducing over-employment.

The second way to economic catching-up is the actual approximation of the SKK/EUR exchange rate in the purchasing power parity to the current nominal exchange rate, which means that the real exchange rate strengthens and price levels line up. So far, the price level alignment illustrated in Table 2 has been primarily the result of a more rapid price growth in Slovakia, compared to the EU. As the Slovak koruna lost ground against the euro, in particular in the wake of the 1993 devaluation and the freeing of the exchange rate in 1998, the price level alignment lost much momentum.

The mechanism of price level alignment follows certain rules, with wage growth playing the main part. A sustainable alignment of wage and price levels must be based on a wage growth which does not generate wage (cost) inflationary pressure, where its speed is limited by growth in labour productivity. It is for this reason that wage growth must not outstrip the rate of labour productivity increases.

As noted above, the economic catching-up can be helped by an approximation of the real exchange value of our production as compared to EU production, i.e. by price level approximation based on appreciation of the real exchange rate of the Slovak koruna against the euro. In this context, the Balassa-Samuelson effect may be an important factor. This economic concept is based on faster growth in the labour productivity in the tradable sector of countries trying to catch up with EU countries. The catching-up in the productivity of labour is also happening in the non-tradable sector (market services), but at a somewhat slower rate. Since wages in both the tradable and non-tradable sectors tend to grow at a near-identical pace, their growth in the non-tradable sector comes at the price of higher inflation. This leads to higher headline inflation and an appreciating real exchange rate. Analyses estimate this kind of exchange rate appreciation in Slovakia at 1 – 2% a year. What is important about the exchange rate appreciation based on the Balassa-Samuelson effect is that it is a balanced appreciation which does not threaten competitiveness or external equilibrium.

Integration of the Slovak economy into the EU

The Slovak economy is increasingly shifting the focus of its foreign trade to the territory of today's EU.

[5] Meaning a representative – "average" product.
[6] Large gaps between economic levels in Slovakia's regions pose a certain problem for the country. While Bratislava reaches EU average, other regions lag behind.

Currently, over 60% of its exports go to EU markets. Following the entry of the acceding countries to the EU in 2004, the EU will be the destination for up to 90% of Slovakia's exports. Likewise, as several analyses suggest, the Slovak economy is becoming ever more involved in intra-sectoral trade with EU countries, which makes up a considerable portion of total exports to the EU.

The structure of Slovakia's economy is increasingly similar to that of the EU's. During the transition period, agriculture, and industry, lost a great deal of their share, while services gained share significantly. In trade with the EU, more sophisticated and less price-sensitive products are increasing their share. These products need less exchange rate support to keep their competitive edge. Real convergence can be expected to continue after EU entry, and EU membership is bound to give the process an extra boost.

The inflow of foreign direct investment into Slovakia is still lower than in the case of neighbouring countries. Even though "new" investments are seen as particularly important for economic growth, the so-called privatisation investments are also crucial for the development of economic potential and growth, because, besides prospects for development investments, they increase the overall productivity of production factors (i.e. so-called immaterial technical progress). In addition, they contribute a great deal to the cultivation of the economic environment.

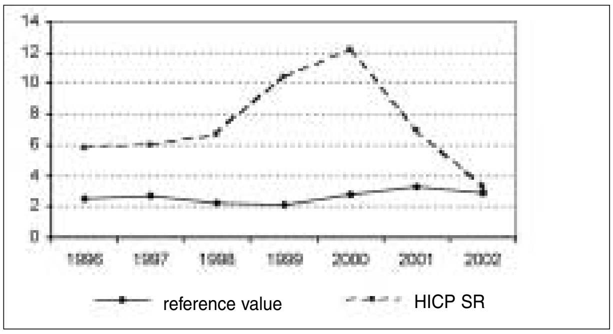
2.2 Nominal convergence (fulfilment of the Maastricht criteria)

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

Inflation

The lowering of inflation in the Slovak Republic depends on the extent of administrative price adjustments and the scale of changes in indirect taxes. These measures have played a dominant role in price development. Since the beginning of transformation, they accounted for about four-fifths of price growth. According to NBS calculations, system-inherent core inflation was responsible for only one-fifth of price growth since 1990. Meanwhile, price growth fuelled by administrative measures had little effect on core inflation, which currently lies near the reference value – the Maastricht inflation criterion[7]. The development in the Harmonised Index of Consumer Prices (HICP) in the Slovak Republic and in the EU inflation benchmark (graph 2) shows a major alignment of their values in 2002.

Graph 2 Development of inflation in the SR

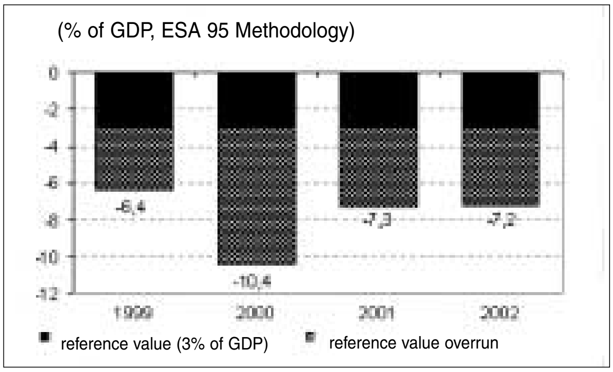


Source: Eurostat

Fiscal deficit and debt

The development in the fiscal deficit (by ESA 95 methodology – graph 3) and debt was less satisfactory in the past. However, as preliminary approved (notified) estimates of these indicators suggest, fiscal deficit and public debt (ratio to GDP) are in a downward trend. The ratio of public debt to GDP, helped by privatisation earnings, has fallen to today's 44.3%[8]. Although the fiscal deficit has been falling since 2000, it still reached 7.2% of GDP in 2002. Given the great importance of fiscal policy in the EMU accession process, as well as inside the eurozone, this is a very high value, requiring deep-reaching and urgent reforms.

Graph 3 Fiscal deficit of the SR



Source: Ministry of Finance of the Slovak Republic

Long-term interest rates

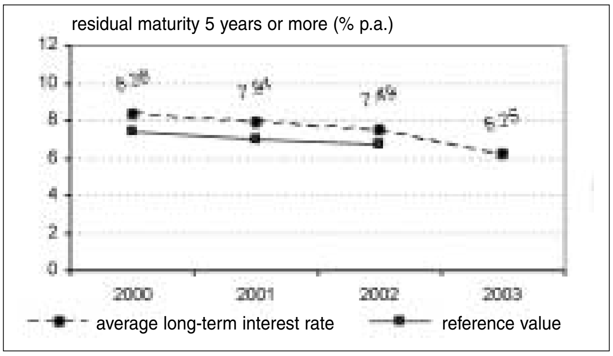
Long-term interest rates on government bonds (graph 4) are decreasing gradually, owing to a decline in risk premium (improving rating for Slovakia's long-term liabilities), falling inflation and interest rates on domestic and foreign markets. Expectations of a stable or strengthening

[7] 1.9% (April 2003). The Harmonised Index of Consumer Prices is the price inflation gauge used in the EU, allowing correct evaluation of inflation in individual countries on a common basis. To ensure that inflation data is comparable, it uses a common commodity, territorial and population base.

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

SKK exchange rate also play a part in the decreasing cost of debt financing on foreign markets. The impact of long-term expectations – of future convergence (decline) in inflation and interest rates in connection with EU and eurozone membership – is extremely important.

Graph 4 Long-term interest rate

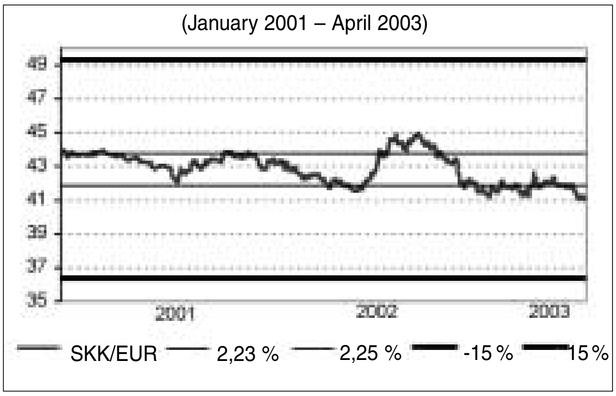


Source: NBS

Exchange rate

While the fixed exchange rate regime (with a gradually widening fluctuation band) was in place, the Slovak koruna barely moved – except shortly before the change of the exchange rate regime. The exchange rate faced pressure stemming from problems in the development of economic fundamentals (especially an accumulating external imbalance) as well as from non-economic factors. After abandoning the fixed exchange rate in October 1998, exchange rate fluctuations may have been greater, but, except for a short-lived swing just ahead of the implementation of stabilisation measures in May 1999 and in the summer of 2002, the SKK/EUR exchange rate travelled mostly within a range of ±3% (graph 5). However, it must be noted that this relatively moderate fluctuation was supported not only by NBS interventions (an instrument also applied in ERM II), but also by monetary policy decisions (changes in interest rates).

Graph 5 Development of the nominal SKK/EUR exchange rate



Source: NBS

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

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

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

The positive effects of joining the monetary union also include:

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

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

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

To individual economies, adoption of the euro means existing in a common monetary area with a single monetary policy. Naturally, there are fears that a single monetary policy will not be able to respond to the specific needs of individual economies[9]. This could be a problem in countries whose reactions to possible shocks are distinctly asymmetric[10] from the prevailing reaction of other economies in the monetary area.

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

Despite this, we need to allow for the existence of asymmetric reactions to external shocks and for a temporary asynchrony of economic cycles. It is therefore crucial that other policies and markets – fiscal policy, labour market and wage policy, capital market[11] – come in to play the role of the stabiliser and help restore the balance with their flexible reactions.

Slovakia, too, is paving the way to that end. The liberalisation of capital movement is practically complete and the labour market is becoming more flexible, even though certain (temporary) restrictions to cross-border workforce migration remain from the side of the EU[12]. Other possibilities of adapting the economy depend on the flexibility of prices and wages. However, it is particularly important that public finance consolidation makes room for public finance to play an active role in economic stabilisation. As regards prices and wages, we need to stress the need for both-sided flexibility and the need to keep a reasonable wage growth (in touch with growth in the productivity of labour). There are past examples (Greece) where informal agreements on restraints in wage negotiations made during the process to adoption of the euro greatly contributed to a sustainable economic growth.

Besides, there are concerns that the stabilisation effort which reins in inflation may stifle economic growth. However, as experience from several countries going through the convergence process on their way to the monetary union demonstrates, in this process the nominal stabilisation of the economy did not impede

Table 3 Development of inflation and economic growth in selected countries

		1992 – 94	1995 – 97	1998 – 2000
Greece	a	0,3	2,7	3,7
	b	11,7	6,5	2,8
Portugal	a	1,2	3,5	3,9
	b	5	2	1,8
Spain	a	0,8	3,1	4,3
	b	3,2	2,3	1,7
Italy	a	0,7	2,0	2,1
	b	2,8	2,7	1,3

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

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

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

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

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

economic growth; on the contrary, it was actually a supporting factor. As Table 3 implies, this was also the case in countries with a tradition of a relatively high inflation (Greece, Portugal, Spain, Italy), where the 1990s, on their way to the EMU, brought a major reduction in inflation coinciding with an accelerated economic growth.

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

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

In the framework of the public discussion on the paper the opinion has often been presented that through entering the eurozone a devaluation of savings may occur, firstly in consequence of the premature fixing of the exchange rate, and secondly in consequence of higher inflation and lower interest rates. These opinions are based primarily on the belief that the nominal exchange rate of the koruna will in the case of not entering the eurozone appreciate. This however cannot be considered as an incontrovertible fact – as is now shown by examples from neighbouring countries – in particular in the case of the non-existence of a credible economic policy oriented on the future. Indeed, in the case of a non-credible policy that is not positively focused on the future it may happen that the exchange rate would actually depreciate.

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

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

This is not however a reason to suppose that the scenario without the euro would mean a more favourable development of the real value of savings than the scenario with the euro. It is probable that this variable will not differ significantly between the two scenarios. This is due to the fact that the act itself of adopting the euro cannot substantially disrupt the system of the relationships of domestic and foreign interest rates and exchange rates[13]. Moreover, one cannot exclude that the non-entry scenario could mean more adverse development – for example in the case where economic policy not sufficiently anchored on a credible aim would lead to higher inflation. Conversely, under the assumption of higher economic growth in the euro-zone entry scenario, savings could, through a higher rate of growth in incomes, develop more favourably than in the non-entry scenario.

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

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

4. Outlook for future development in real and nominal convergence

4.1 Real convergence

Catching-up

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

The catching-up is also supported by the relocation of certain production facilities from other countries, in parti-

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

cular EU countries, to Slovakia. This not only expands the productive potential of Slovakia's economy, but also accelerates a rise of the productivity of labour and opens up new export markets.

Assuming that economic growth in the Slovak Republic will outstrip the EU's growth by an average of 1 – 2 percentage points and the real equilibrium exchange rate will appreciate by 1 – 2 per cent a year, the Slovak economy – in comparable parity[14] – will grow some 2 – 4 per cent faster annually. At that rate, Slovakia could get from today's level of roughly half the EU average to 75 per cent of EU average in a matter of 10 – 15 years.

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

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

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 6)[15].

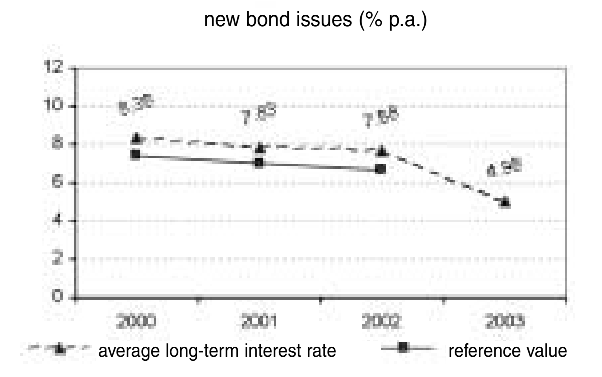
The key to this outlook is a sound performance of public finances. Confidence in the Government's declared aim to consolidate public finances by 2006 (or earlier) may turn out to be a decisive factor for this development to materialise. The intention is to cut back the public finance deficit below 5% 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

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

[15] 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.

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

Graph 6 Long-term interest rate



Source: NBS

expected interest rate decline, such development would also consolidate public debt[16].

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.

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[17], 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).

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