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 economies 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

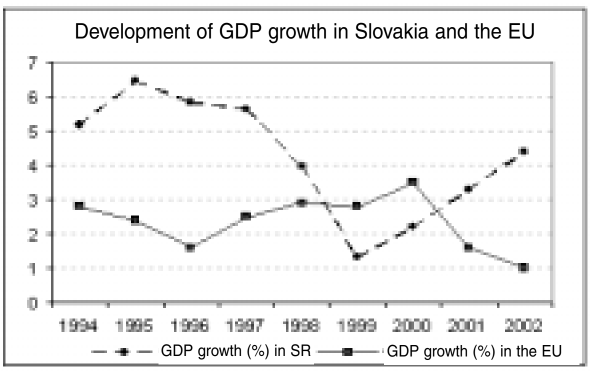
PPS (Purchasing Parity Standard)
ERDI (Exchange Rate Deviation Index)

[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.

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[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.

To be continued in issue 9/2003