NÁRODNÁ BANKA SLOVENSKA

Slovak Road to the Euro Area

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7 October 2008

Presentation Outline

- Necessary policy adjustments and reforms
- Road to the fulfillment of Maastricht criteria
- Challenges to benefit from €

Beginning was not Easy

- **Low level of real and nominal convergence**

  Result of unstable development before 1998 and subsequent implementation of necessary stabilizing measures

- **In 2002 Slovakia did not meet Maastricht criteria**

  Positive trend was partially visible. The SKK exchange rate has stabilized, inflation and average interest rate declined. Public finance consolidation has started, but general government deficit was still very high

- **Economic performance and relative price level were below 50% of EU average**

  However, even in that time EU represented the most important trade partner (60% of export) and economic growth differential with EU was increasing

Consistent Strategy and Plans

- Euro adoption strategy in 2003 – set target for euro area entry in 2008 or 2009
- Specification of euro adoption strategy in 2004 – € target set in 2009
- National euro changeover plan approved in 2005
- New government in 2006 confirmed plans to adopt euro in 2009
- Updated Changeover plan in 2007

Euro adoption had broad political support in Slovakia

Monetary Policy Adjustments

- 2004 decision: from implicit towards explicit inflation targeting

Inflation targeting within ERM II

- What were/are the puzzles?
  - Assessment of exchange rate development with respect to Maastricht criteria fulfilment: close to parity – what does it exactly mean?
  - How to cope with appreciation trend, when to intervene, how to communicate exchange rate developments (in fact when to maintain silence) if it is necessary to consider exchange rate while deciding about interest rates?

Public Finance Reform

- Introduction of programme budgeting (3 years ahead)
- Creation of State Treasury and Agency for Debt and Liquidity Management
- Fiscal decentralization – delegation of responsibilities and their financing to local government
  - 93.5% of PIT revenues addressed to local governments
  - disadvantage: extra PIT revenues cannot be used for additional fiscal consolidation

Main Structural Reforms

- ✓ **Tax system reform**– flat tax, very simple system
- ✓ **Pension reform** – 2nd and 3rd capital pillars
- ✓ **Price deregulations** – major adjustment of relative prices
- ✓ Social, healthcare and education system adjustments

Other Structural Reforms

- Restructuring and privatization of banking sector (no bad loans now)
- Privatization of some state-owned enterprises (wages not higher than productivity)
- Abolishment of cross subsidies

  (pressure on inflation until 2005, now all regulated prices are at cost recovery levels, and energy prices are at or above EU average)
- Labour market reforms

  (towards its greater flexibility, reforms are oriented to active labour market policy)

Road to the Fulfillment

		EU entry May 2004	CR Oct 2004	Dec 2005	CR Dec 2006	Dec 2007	CR May 2008
Fiscal criterion[1] (% GDP)	public deficit	3.5	3.7	3.3	3.1	3.7	2.2
	public debt	42.8	42.6	43.6	34.5	30.4	29.4
	state of fulfillment:	NO	NO	NO	NO	NO	**YES**
Inflation criterion (HICP, %)		8.9	8.4	2.9	4.3	2	2.2
	state:	NO	NO	NO	NO	**YES**	**YES**
Interest rate criterion (%)		5.1	5.1	3.6	4.3	4.5	4.5
	state:	**YES**	**YES**	**YES**	**YES**	**YES**	**YES**
Exchange rate stability		out of ERM II	out of ERM II	member of ERM II	member of ERM II	member of ERM II	member of ERM II
	state:	NO	NO	NO	NO	**YES**	**YES**

1) Previous year figure known at the time of assessment
CR – Convergence reports of ECB and EC

Source: NBS, EC, ECB

Slovakia – 16th Country of the Euro Area

„(8 July 2008) Economic and Financial Affairs Council (ECOFIN) adopted final and formal decision allowing Slovakia to adopt the euro as from 1 January 2009.“

„The European Union's finance ministers adopted the legal acts necessary for Slovakia to adopt the euro on 1 January 2009. Based on a Commission proposal, they also decided that the Slovak koruna will be replaced by the euro at the rate of 30.1260 SKK to the euro.“

(Source: press releases of EC and NBS, 8 July 2008)

Maastricht Criteria were Met with a Sufficient Margin

Criterion	March 2008	Reference value	State of Fulfillment
Inflation (average, %)	2.2	3.2	☑
Interest rates (%)	4.5	6.5	☑
Public debt (% GDP)	29.4*	60.0	☑
Public deficit (% GDP)	2.2*	3.0	☑
ER stability	ERM II since Nov. 2005		☑

* Year 2007

Source: Eurostat, European Commission, MF SR, NBS

What are the Main Challenges Here?

- Impossible Trinity
- „Shooting Moving Target“
- Tailored for EU-15
- Balassa-Samuelson Effect
- Exchange Rate Pass-Through
- EU-12 itself fails to meet the criteria in longer-run

Impossible Trinity

- Country with open capital account cannot control both exchange rate and inflation.

  => As short as possible participation in ERM II

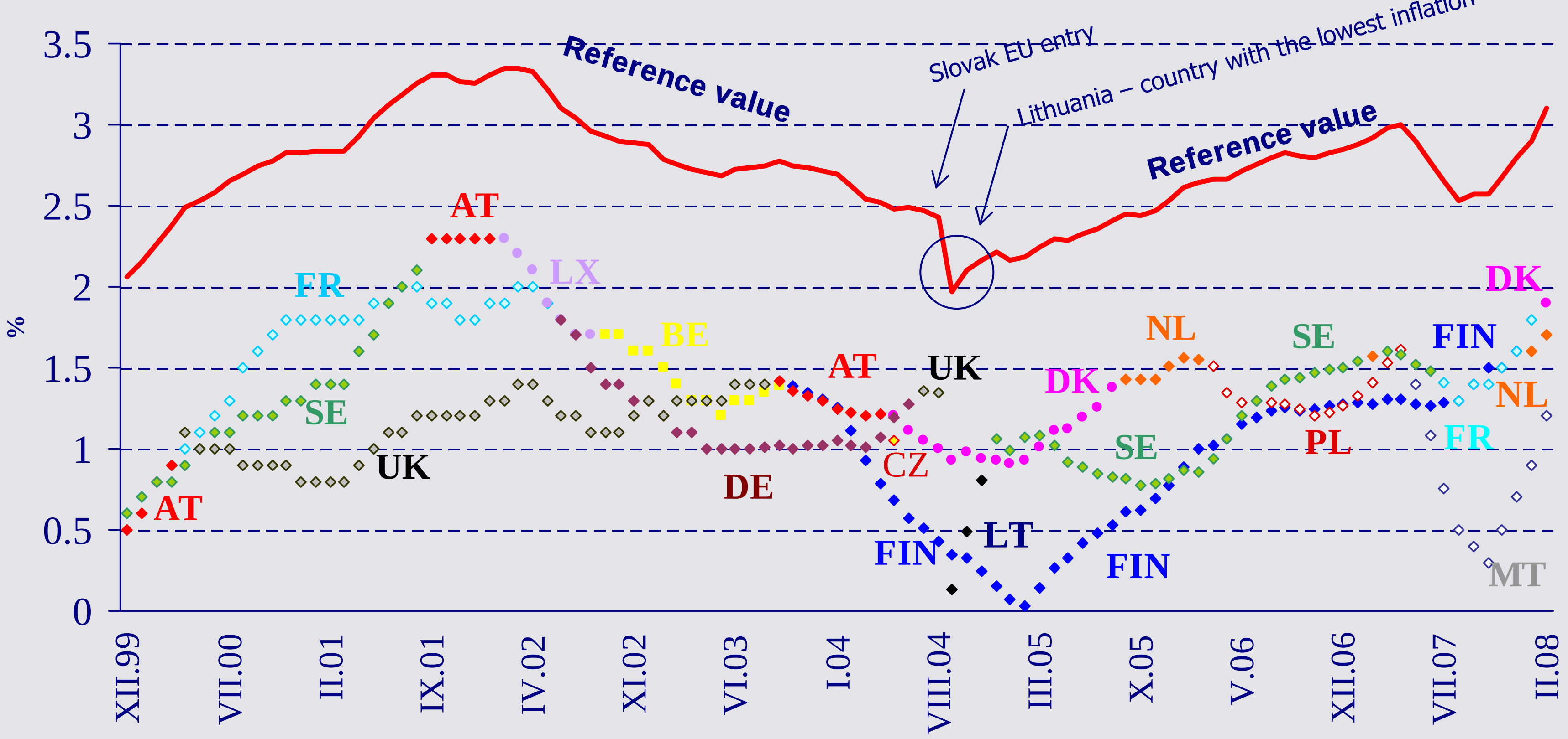
- Our solution:

  „Inflation targeting in the conditions of the ERM II“

  - Priority 1: Inflation
  - Priority 2: Exchange rate stability

Shooting Moving Target

- Inflation criterion is not known in advance. It often depends on development in countries out of euro area.



Source: Eurostat

The Criteria were Defined for EU-15

- Criteria were **tailored for** developed and relatively homogenous **EU 15** countries. Convergence process makes them harder for the New Member States (NMS).

	GDP per capita in PPS (EU-27=100)	Real GDP growth (y-o-y)	HICP inflation (y-o-y)
EU-15 (2007)	125.7%	3.1%	2.2%
NMS-12 (2007)	66.3%	6.5%	4.8%

* Simple averages

Source: Eurostat

Balassa-Samuelson Effect

⇒ Higher price increases in the non-tradable sector lead to higher headline inflation

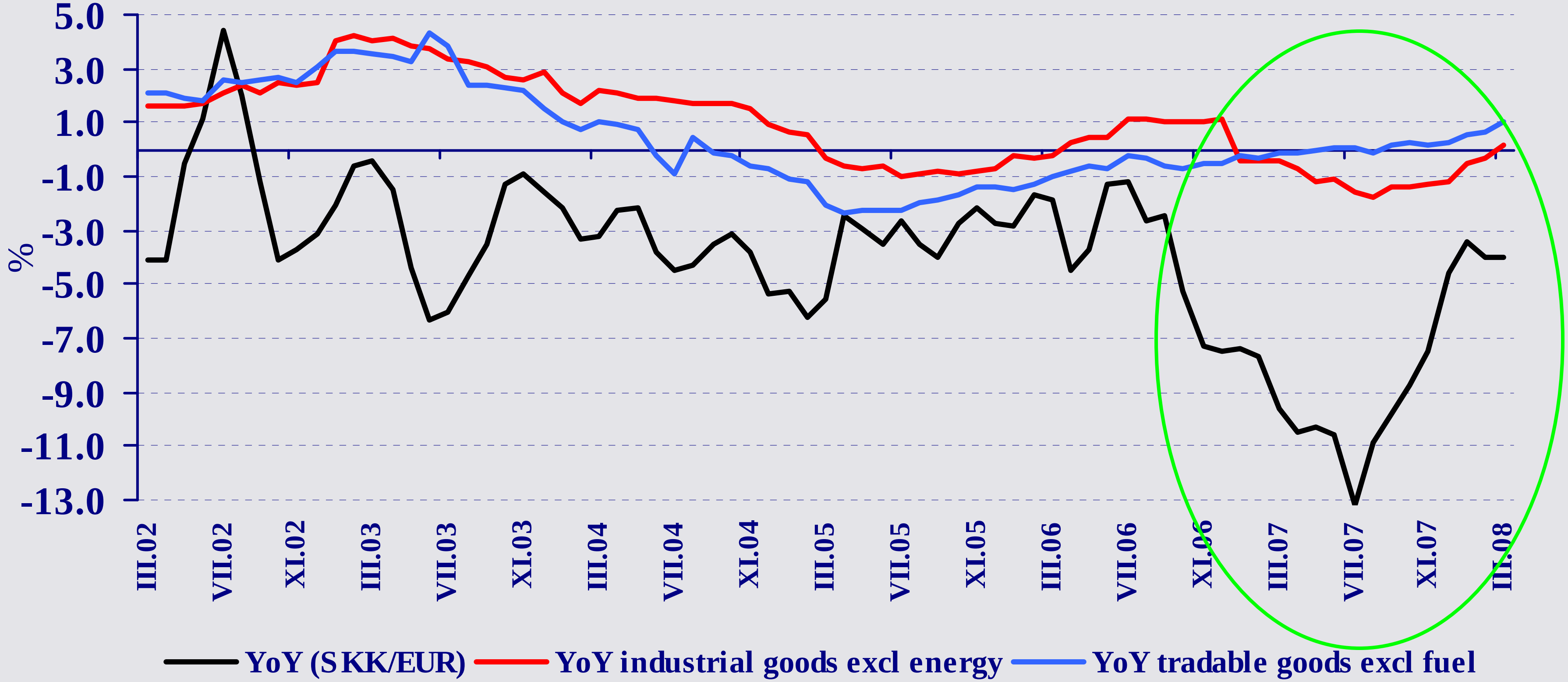
✓ Estimates differ significantly. Different authors – different methods – different results

✓ We expect only 0.7 p.p. contribution to headline inflation in medium term, due to several mitigating factors:

  - Wage increase in the tradable sector is lower that labour productivity growth
  - Wage increase in the non-tradable sector lags behind wage increase in the tradable sector
  - We have observed slight productivity increase in the non-tradable sector based on foreign direct investment inflow

Exchange Rate versus Inflation

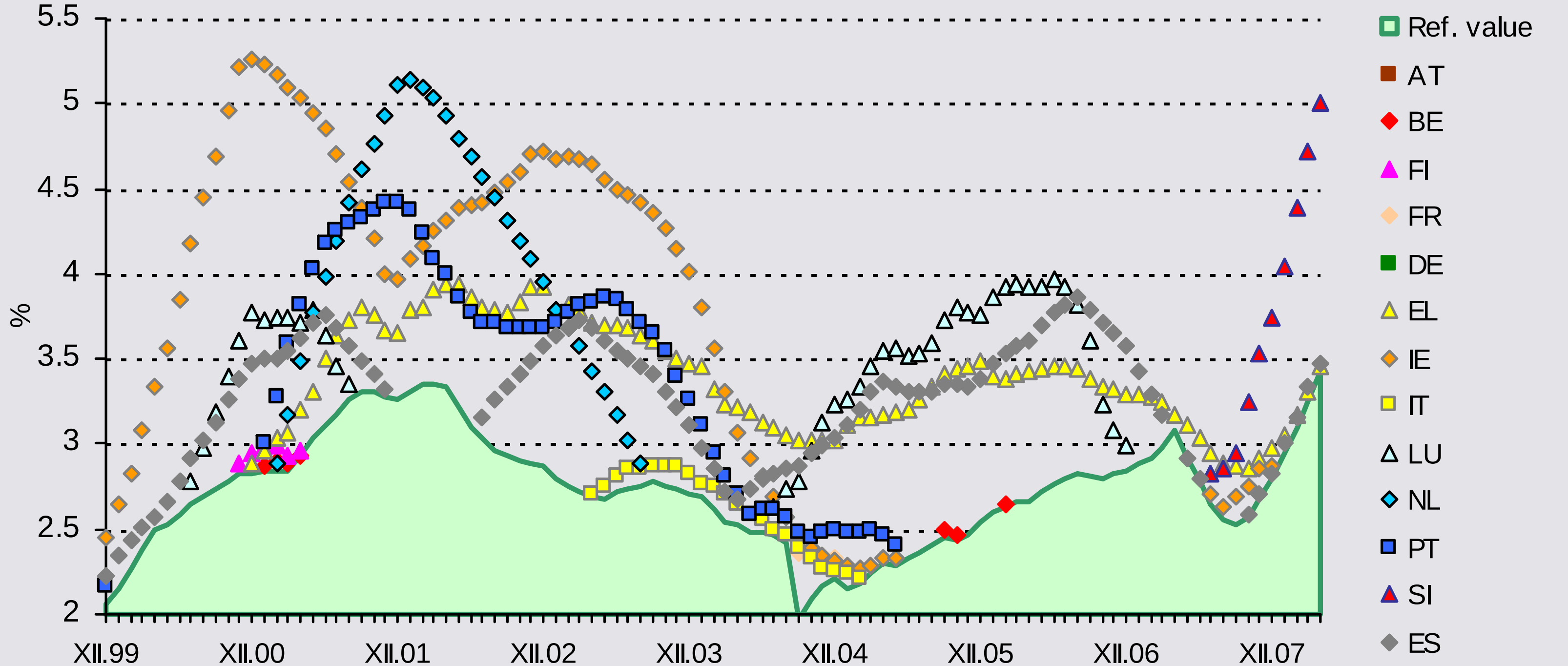
➢ Exchange Rate has only limited impact



Source: NBS, ŠÚ SR

Sustainability of Inflation Criterion

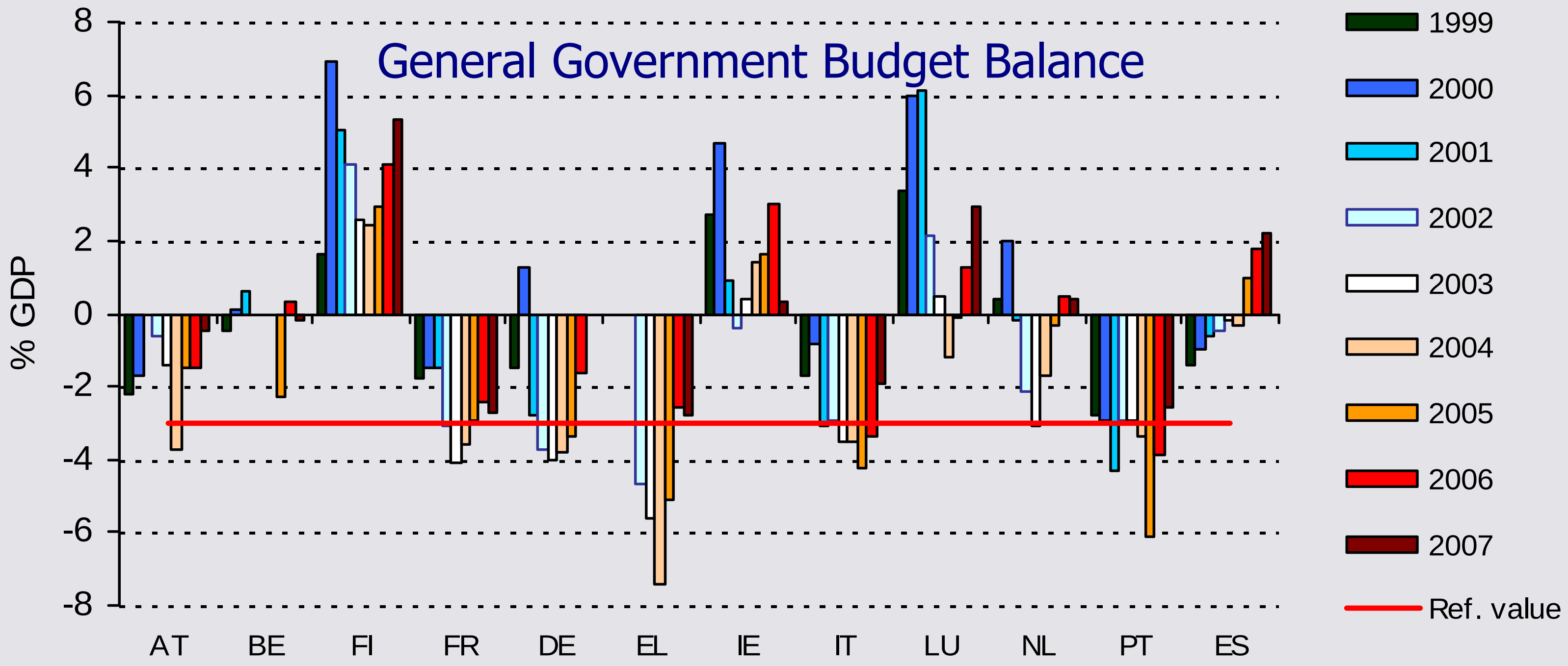
- Euro area countries fail to meet price stability criterion in long-run. Only Austria and Germany retained inflation below reference value after euro changeover.



Source: Eurostat

Sustainability of Fiscal Criterion

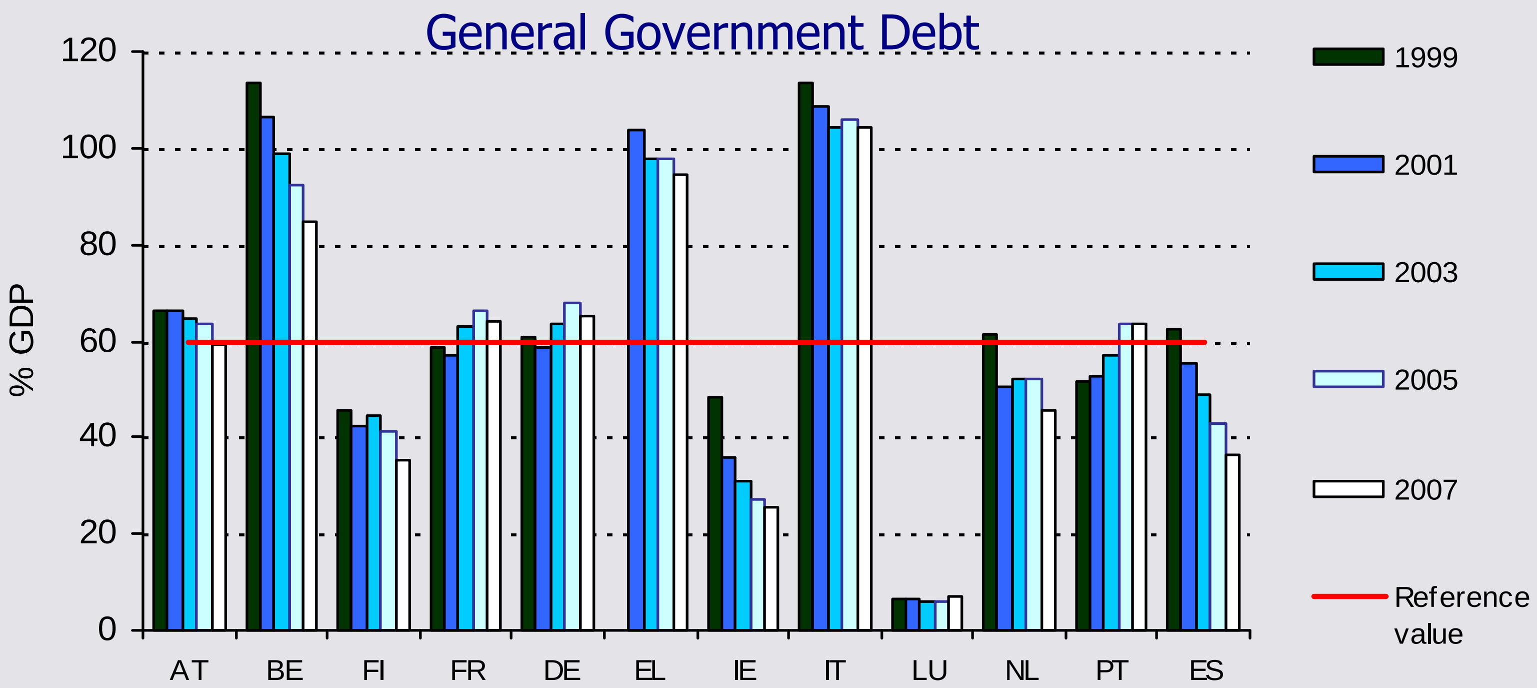
- Euro area countries fail to meet also fiscal criterion in long-run. Only Finland, Ireland and Luxemburg retained both deficit and debt below reference value after euro changeover.



Source: Eurostat

Sustainability of Fiscal Criterion

- Euro area countries are in average more indebted than NMS. Majority of them recorded debt higher than 60% of GDP.



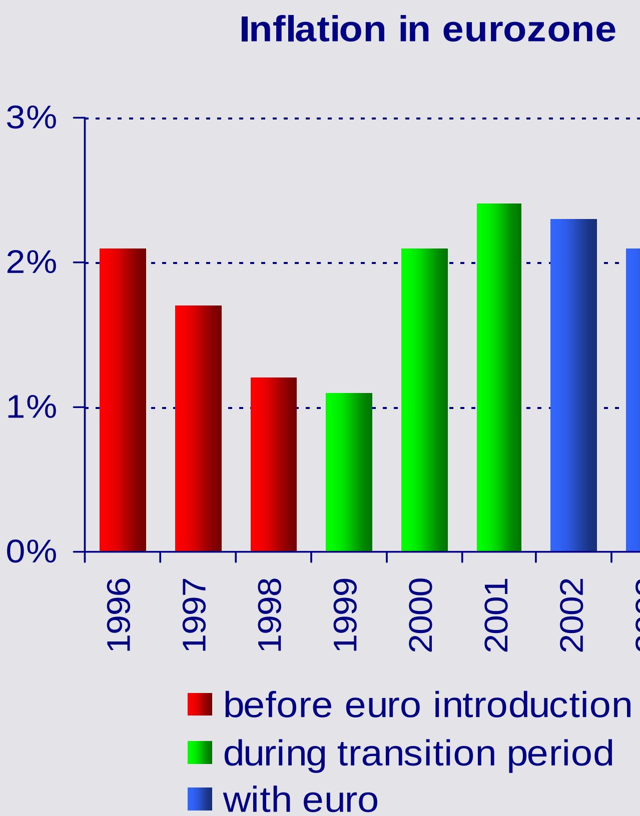
Source: Eurostat

Challenges to Benefit from €

Impact of Changeover on Inflation in Slovakia

- In our predictions we expect an impact of 0.3 p.p., the outcome may be different, if these risks materialise:
  - Increase of certain price before euro changeover
  - Misuse of external cost effects (food and energy price increases) for higher than justified price increase
  - Low inflation expectations and consumer protection system may reduce the overall impact

Will Euro Increase Inflation?



Source: Eurostat

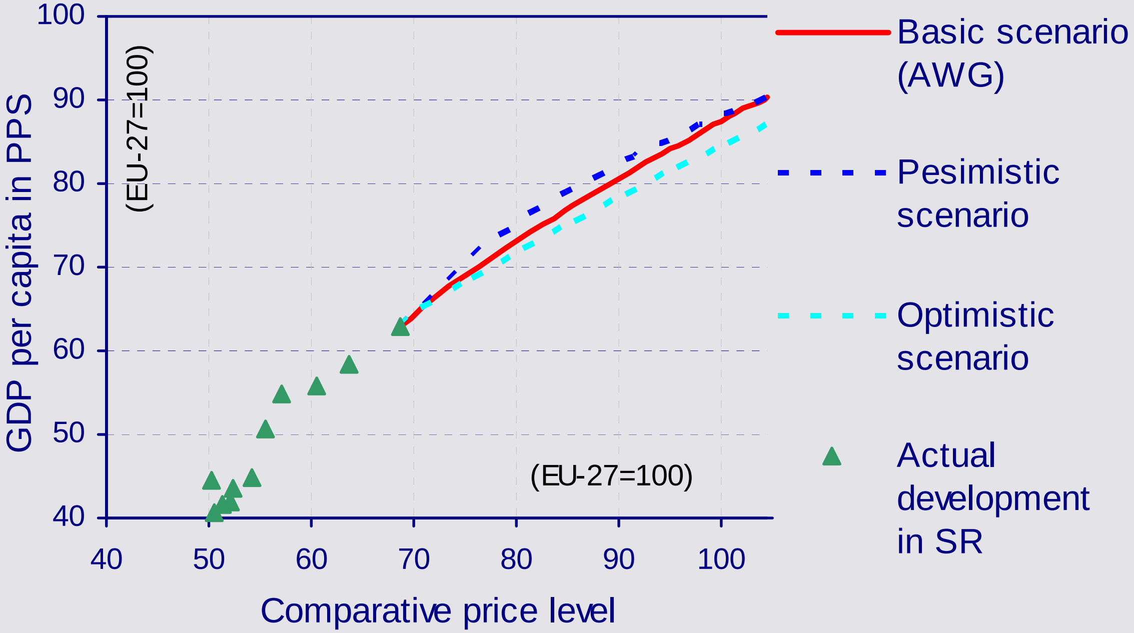
Probably yes

Slovakia catches up with the EU also in terms of price levels, after euro adoption inflation will constitute the only channel. The catching up process will be gradual.

Nevertheless, income will increase faster than prices.

Estimated Convergence Path

- There is still space to converge (GDP per capita at 70% EU)
- Output convergence and price convergence are interrelated



» 18 years to converge (AWG growth assumptions)

» 23 years to converge (10 year average growth)

» 6 years to converge (growth recorded in 2007)

Based on ECM : $\Delta(P_t) = 0.04 + 0.50\Delta(Y_t) - 0.12(P_{t-1} - 39.65 - 0.49Y_{t-1}) + \varepsilon_t$

Source: NBS

Estimated Inflation Development

Due to continuing process of convergence inflation rate in Slovakia is expected to be higher than in Euro area

How much higher?

Based on our baseline scenario the average annual inflation differential with EU is expected to be

1.2 p.p. [1]

(This does not necessarily mean that the reference value for inflation will be exceeded)

[1] **20 year average, annual inflation equals annual growth of relative price level**

Consumer's Inflation Perception

➢ Surge in perceived inflation - all Euro area countries phenomenon

- *In the euro area the changeover effect was approximately 0.3%, but people felt that prices increased much more*

Fighting against price jumps:

➢competition in retail

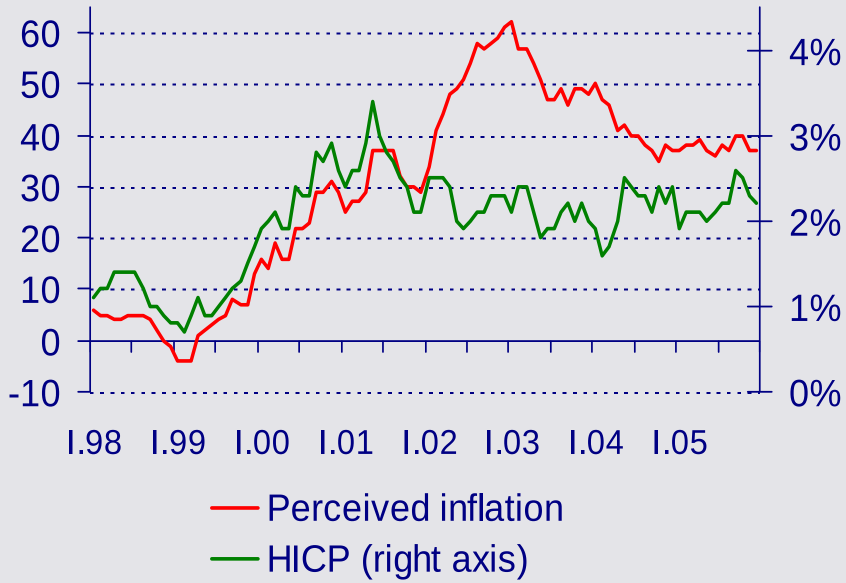
➢mandatory dual pricing

➢rounding rules

➢voluntary commitments of retailers and public pressure

- communication will be essential

Perceived inflation in eurozone



Source: Eurostat

Further Challenges

- To preserve wage development based on productivity
- Avoid growth of Balassa-Samuelson Effect
- Faster movement towards balanced general government budget and use of automatic fiscal stabilisers
- Efficient use of increased capital inflow
- Manage credit growth

Economic Policies to Support Euro Adoption

- Long-run goal: increase flexibility of the economy
  - Structural policies, especially labour market flexibility
    - → real (and nominal) wage flexibility
    - → geographical, sectoral and occupational mobility of labour sources
    - → flexible labour relations
- Movement towards knowledge economy
  - Higher support of human capital (education)
  - Investments in research and development

Euro adoption benefits are not automatic, will be realized only if euro is supported by appropriate policies

No One Strategy Fits All

- But we have learned:
  - Experience of NMS is more valid (convergence, big-bang approach, etc.)
  - It is worth to listen (EU, IMF recommendations)
  - Finish major structural reforms (Maastricht criteria sustainability)
  - Sustained exchange rate appreciation is in line with exchange rate sustainability (if based on fundamentals)
  - As short as possible ERM II membership (additional pressure)

2€

1€

Thank you for your attention

50, 20, 10 c

5, 2, 1 c