STAGES OF INTRODUCING THE EURO IN THE SR

**RNDr. František Hajnovič, Ing. Zora Kominková, CSc, Ing. Marián Nemec, CSc,
National Bank of Slovakia**

In July 2003 the Government of the SR and the NBS adopted the joint document "Strategy for Introducing the Euro in the SR". The content and scheduling of the process for adopting the euro is an essential precondition for specifying a definite Strategy and elaborating it into further, more detailed, procedures, which will then lead to the introduction of the euro in the SR.

We are aware that each segmentation of the whole process, which begins with today's state, i.e. the period in which the discussion on adopting the euro has begun and on the day when the sole valid currency in circulation in Slovakia will be the euro and monetary policy will be determined by the European Central Bank (ECB), is a relative one. Working from the experience of countries that have already passed through this process (for example, Finland[1], France[2], Ireland[3]) or that have analysed it in detail (for example, Sweden[4]) we can discern five stages in the accession process to the eurozone:

1st stage: From the present through to entering exchange rate mechanism ERM II.

2nd stage: From entering ERM II through to the decision of the Ecofin Council on membership in monetary union.

3rd stage: Transitional period from the decision of the Ecofin Council through to membership in monetary union.

4th stage: Membership in the monetary union with the euro in scriptural transactions only.

5th stage: Introduction of the euro into cash circulation.

This development process, transferred to the conditions of Slovakia, is specified in more detail in the following text with the fact that we foresee the technical possibility of the parallel operation of the 4th and 5th stages[5]. The timing of the individual stages has, in terms of the framework, the role of characterising the period necessary for implementing the individual stages, as well as the whole process of adopting the euro in the SR[6].

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1st Stage:

From the present through to the SR entering ERM II

In this stage Slovakia expects several important events. Firstly, in May 2004 Slovakia will become a member of the European Union. In the following period the Government of the SR will adopt a decision on entry to ERM II. This should happen only after it is clear that reforms will make it possible for other policies will support economic, financial and monetary stability and convergence following entry to ERM II and the sustainable compliance with the Maastricht Criteria following entry into monetary union. Entry to ERM II should also be the stimuli for the commencement of the organisational and technical provision for the whole process of introducing the euro in the SR. The time Slovakia spends in ERM II should be as short as possible. The core decision on entering ERM II is the negotiation of (decision on) the central parity against which exchange rate stability following entry to ERM II will be assessed. The economic pre-condition of this decision is achieving such a state of

[1] Pekkarinen, J. et al.: Finland and EMU. EMU Expert Working Group Report. The Prime Minister's Office, Publication 1997/26, október 1997, Helsinki.

[2] Neveu, N.: The Euro Cash Changeover in France: Assessment and Main Conclusions. Banque de France Bulletin Digest, No 107, november 2002.

[3] National Changeover Plan in Ireland /www.irlgov.ie/.

[4] Genberg, H. et al.: Managing Sweden's Transition to EMU. Graduate Institute of International Studies/Center for Business and Policy Studies, január 2000, Stockholm.

[5] We base this on the fact that the difference in timing between the introduction of the euro into the cash-free system of payments and cash circulation (banknotes and coins) in the eurozone countries was partially necessitated by technical factors (the printing of the money), in particular however by the experimental environment of the "big bang". Let us recall that the introduction of euro banknotes and coins into circulation was realised in all 12 countries including Greece from 1 January to 28 February 2002, where Greece had entered the eurozone with a two-year time delay. From this it can be seen that the period of the cash-free euro in Greece lasted 1 year (in other countries of the eurozone 3 years). In countries which are to enter the eurozone by the end of this decade, we foresee that an "emulation effect" will be in operation, which other than the physical existence of the euro currency itself will not only accelerate, but also reduce the costs of the whole process of the changeover to the euro.

[6] The model time framework for adopting the euro in the SR, together with a description of the individual stages with regard to the various sectors specifics, the risks and tasks is summarised in a table in the second part of this article in issue no. 6/2004.

reforms, in particular in public finances and in the labour market so that:

• fiscal policy and labour market policy support economic, financial and monetary stability during the period in ERM II,

• it may be expected that over the course of the two years from entering ERM II such a degree of nominal convergence will be achieved that will mean the sustainable compliance with the Maastricht Criteria and a positive assessment by the Ecofin Council.

• it may be expected that after entering monetary union the overall stability of the economy will not be threatened in the medium-term.

For entering the ERM II mechanism a decision of the Government of the SR will be necessary and at the same time sufficient[7]. Entry itself however requires a respective agreement between the NBS and the ECB and its details will be specified through subsequently highly confidential negotiations with the ECB and the European Commission[8].

Achieving convergence of inflation, interest rates and public debt is possible by 2006.If we consider the current assumptions and possibilities of the SR realistically, in particular in the field of consolidating the budget and reducing the deficit, then we would be able to enter ERM II on 1.1.2005 in the case that the fiscal deficit is not influenced by the costs of pension reform. An evaluation by the Council[9] could in this case on the basis of results in 2006 be positive.

If the fiscal deficit grows in consequence of the costs of pension reform, achieving the necessary fiscal convergence will require further consolidation lasting 1 to 2 years. Slovakia would then enter ERM II at the earliest in 2006. However, Given the fact that 2006 is an electoral year it is less suitable to continue with budgetary consolidation.For this reason, this year is also less appropriate for opening the negotiations on entering ERM II.

The Slovakia's strategy for adopting the euro is based on the assumption tah the Slovak koruna will spend the shortest possible time in ERM II. Despite this, there is also a third legitimate possibility, this being the case where the SR would enter ERM II already in 2005, although the process of budgetary consolidation would take place up until 2006. An advantage of this solution is that ERM II would operate as a disciplinary framework upon the economic policy of the government in the electoral period and following the elections in 2006. This solution does not exclude the possibility that the testing of Slovakia for 2006 could still turn out successfully. Its disadvantage is the fact that a potential slowdown in consolidation could threaten fulfilment of the exchange-rate stability obligations and the convergence process in the ERM II framework and, thus, weaken the credibility of the strategy. It is thus an alternative that contains a certain degree of risk.

A critical parameter for entering ERM II is the exchange-rate parity. Its determination cannot rest on absolute or relative purchasing power parity (PPP). Equilibrium of Slovakia's real exchange rate, as a country in the process of catching up, will probably strengthen and the exchange rate equilibrium will be determined also by other policies. It cannot even be excluded the fact that upon achieving convergence in inflation it will be necessary to slightly appreciate the koruna's nominal exchange rate against the euro. Moreover, the determining of exchange-rate parity will have to respect also the opinions and economic interests of member states of monetary union and EU states participating in ERM II. At present the following facts are seen as important in determining the exchange-rate parity:

• assessment of the degree of macroeconomic equilibrium,

• the speedof the balanced appreciation of the exchange rate (Balassa-Samuelson effect),

• what structural changes having an effect on the equilibrium exchange rate may be expected[10],

[7] In accordance with the Act on the NBS, within the competence of which falls exchange rate policy, the decision on entering ERM II will rest upon a recommendation from the NBS.

[8] The Agreement of 1 September 1998 between the European Central Bank and the national central banks of member states outside the euro area laying down the operation procedures for an exchange rate mechanism in stage three of the Economic and Monetary Union. Entry to ERM II, including the agreement of the central parity shall be decided at the inter-governmental level. The decision on central parity shall be made on the basis of the mutual agreement of the ministers of the states of the eurozone, the ECB and ministers and governors of central banks of member states outside the eurozone participating in ERM II, with the participation of representatives of the European Commission and following consultations with the Economic and Finance Committee (EFC).

[9] The procedures in evaluating progress in convergence and the cancellation of the derogation status are the subject of Articles 121 and 122 of the Treaty on the EU. The starting point is the Convergence Report of the member state with a derogation, which is drawn up in parallel by the ECB and the European Commission regularly every two years (or at the request of the given state). The reports are submitted to the Council. Following consultation with the European Parliament and on the basis of recommendations the Council, in the composition of heads of state or prime ministers, decides by a qualified majority on the proposal of the Commission, whether the member state for which a derogation applies fulfils the necessary conditions for introducing the euro. A qualified majority is defined as two thirds of the votes of the representatives of states for which a derogation does not apply, weighted according to Article 205, or according to the new division of votes in the EU-27 framework laid down in the Treaty of Nice (2001), which is to enter into force on 1 November 2004 (with a half-year transitional arrangement from 1.5. to 31.10.2004).

[10] This concerns such possible changes as result from the realisation of large capital investment projects and which significantly change the competitiveness of the economy (in particular in exports).

• how will critical policies be set, especially during the period of operating in ERM II,

• how will their setting be changed following entry to monetary union.

It is not excluded that exactly the assessment of the stated questions will lead to the fact that during participation in ERM II it will be necessary to appreciate exchange-rate parity. Here is on the other hand necessary to emphasise that the possibility of an additional adjustment (appreciation) of exchange rate parity in the framework of ERM II means that the value of the central parity set upon entry to ERM II need not necessarily anticipate the value of the irrevocable conversion exchange rate against which at the end of the convergence process the koruna will be exchanged for the euro.

Summary: the 1st stage could in the ideal case last until 31.12.2004 and Slovakia would enter ERM II on 1.1.2005. If the costs of pension reform increase the fiscal deficit, this stage could be prolonged by 1, 2 or possibly 3 years, which would mean also a respective shift of entry to ERM II and monetary union. The possibility that consolidation of the budget would be taking place during Slovakia's time spent in ERM II does appear problematic.

2nd Stage:

From entering ERM II following the decision of the Ecofin Council on whether Slovakia has fulfilled the conditions for acceptance as a member of monetary union.

In this period it will be primarily necessary through a coordinated policy to achieve nominal convergence to the Maastricht Criteria and maintain exchange-rate stability for a period of at least two years. The decision of the Ecofin Council on the cancellation of the derogation status rests on the Convergence Reports, which are prepared on an ongoing basis by the European Commission and the ECB, the essence of which lies in providing an answer to the question whether the SR has achieved the necessary "sustainable convergence"[11]. Subsequently to the Council's decision on the acceptance of the SR as a union member, the Council shall also decide on the exchange-rate parity at which the SR will enter the eurozone, or on the conversion rate at which the koruna will become a denomination of the euro. The decision shall be approved by the member States of the monetary union.

Slovakia should stay in ERM II only for the period required for testing its preparedness for membership in monetary union, i.e. two years. As a guide to the date of entering the eurozone it is here necessary to count on a period for preparation of the evaluation report, approval procedures and the time from the decision on the acceptance as a member of monetary union to actual entry. The optimum case would be for the evaluation Convergence Reports to rely on data for the years 2005 and 2006 (and on current data for 2007 - in the case of the evaluation of interest rates, inflation and the exchange rate). This data will be available in the first quarter of 2007, with the preparation of evaluation reports to follow. Subsequent consultation with the European Parliament and the preparation of reports by the Economic and Finance Committee for discussion in the Ecofin Council through until the final decision being made takes approximately three months. This means that the Council's decision on abrogation of the SR's derogation status, or on the acceptance of the SR as a member of monetary union may be expected sometime in mid-2007. The stage following entry to ERM II through to this decision will thus take about 30 months, ending in June 2007.

The essence of the 2nd stage and a precondition for its successful accomplishment is however primarily the realisation of policies leading to a positive decision by the Council. Sustainable convergence in our conditions means the sustainable reduction of the public finance deficit to a limit of 3% of GDP (or less) and the setting of such policies, in particular monetary, fiscal and labour market (wage) policies that enable the convergence of inflation and the necessary stability (or appreciation) of the exchange rate. For this the following in particular are necessary:

• The credible setting of exchange-rate parity.

• Support for a fiscal and monetary policy mix that will act as a prevention against speculative attacks. This means primarily that monetary policy need not counteract pressure on the exchange rate through the use of interest rates, and that a stabilisation of the situation would be supported by fiscal and wage policies.

In this it is important how the band of exchange-rate stability is defined. It is known that the standard band in the framework of ERM II is the wide band with a tolerance of +/-15%. This wide band relates only to market-conditioned exchange rate movements. Such is also an appreciative movement of the exchange rate in consequence of a market correcti-

[11] The decision is adopted by the Council following consultation with the European Parliament and the heads of member states.

on to price relations (the B-S effect) or fluctuations in the exchange rate in consequence of speculative market pressures. The narrow band with a deviation of +/-2.25% around the central parity is intended for exchange rate movements that are system-conditioned.Here, exchange-rate movements should not exceed this band, in the case of the appropriate setting of domestic policy parameters , or should not exceed it in a depreciative direction.

ERM II in each case provides a sufficiently wide band for the movement of the exchange rate so as to cause uncertainty among market players. The width of the band at the same time gives sufficient room for the movement of short-term interest rates for fulfilling the condition of interest rate parity. Thanks to this, monetary policy may be more active in stabilising the situation.

Regardless of the fact that ERM II guarantees marginal as well as intramarginal interventions by the ECB and that during operating in the framework of ERM II through until the abrogation of the derogation (until the declaration of the date for acceptance as a member of monetary union) there remains the possibility of adjusting the central parity prior to the definitive fixing of the conversion rate,the exchange-rate parity should be set credibly and should be supported by other policies. The instruments of ERM II, the sufficiently wide fluctuation band and a monetary policy aimed at exchange rate stability will create conditions ensuring also the foreign exchange market to operate on the exchange rate in a stabilising manner.

Summary: In the ideal case a favourable evaluation and decision by Ecofin on the acceptance for membership in monetary union, including the setting of the conversion rate, could be achieved in the course of June 2007.

To be continued in issue 6/2004