SLOVAKIA WITHIN THE CONTEXT OF EUROPEAN INTEGRATION

WHERE WE WERE AND WHERE WE ARE HEADED FORE

Marián Jusko
Governor of the National Bank of Slovakia

National Bank of Slovakia Governor Marián Jusko attended an international scientific conference held by the University of Economics in Bratislava on 9–10 October 2003, on the occasion of the 50th anniversary of the establishment of the Faculty of the National Economy. The conference was entitled 'Transition Economies in the Process of European Integration'. At the conference, the NBS Governor delivered a lecture on 'Slovakia within the context of European integration – where we were and where we are headed for'. In his introductory remarks, Mr Jusko stressed the importance of an international conference being held at the time when Slovakia's ambition to join the European Union is being fulfilled. He also mentioned that the NBS had played a major role in the preparation of a strategy for the introduction of the euro in the SR. In the main part of his lecture (which is published herein), Mr Jusko focused on the process of transformation as experienced by the Central Bank and presented his views and expectations with respect to the future course of European integration.

Fortunately, the Slovak Republic has never been hit by hyperinflation. Except in the first few years following the Velvet Revolution, the country's inflation rate has been kept below a level of 10%, with the lowest figure being recorded in 2002 (3.3%).

The primary objective of the NBS is to keep the rate of price inflation at an acceptable level, in other words, to maintain price stability. With regard to the basically favourable course of price developments, however, inflation itself has never posed a major problem for the NBS. This is connected with the fact that the level of price inflation is affected, first and foremost, by government intervention in regulated prices, the consequences of which cannot be (and are not recommended to be) eliminated through monetary policy tightening.

In connection with the phenomenon of price regulation, the NBS has moved to define so-called 'core inflation', which expresses, with a certain simplification, the success of monetary policy. This component of inflation has, however, never replaced the overall Consumer Price Index as the Bank's centre of interest, for the CPI is clearer to the average citizen and truly reflects the trends in the cost of living.

After 2004, the convergence of regulated prices to the level of justified costs is expected to come to an end, as well as the tax reform in the area of indirect taxes. The rate of overall inflation will gradually approach the level of core inflation. After this period, i.e., over the medium term, overall inflation is expected to fluctuate around the level of the EU countries, bringing the process of disinflation to an end. This is expected to enable us to prepare to meet the Maastricht inflation criterion in 2006 – 2007.

With regard to the increased openness of the Slovak economy (ca. 160% of GDP), an important role is being played by exchange rate developments. For that reason, before 2001, the priority of the NBS had been to maintain the stability of the national currency (i.e., both internally, in the form of inflation, and externally, in the form of exchange rate stability); and until 1998, a fixed exchange rate regime had been applied.

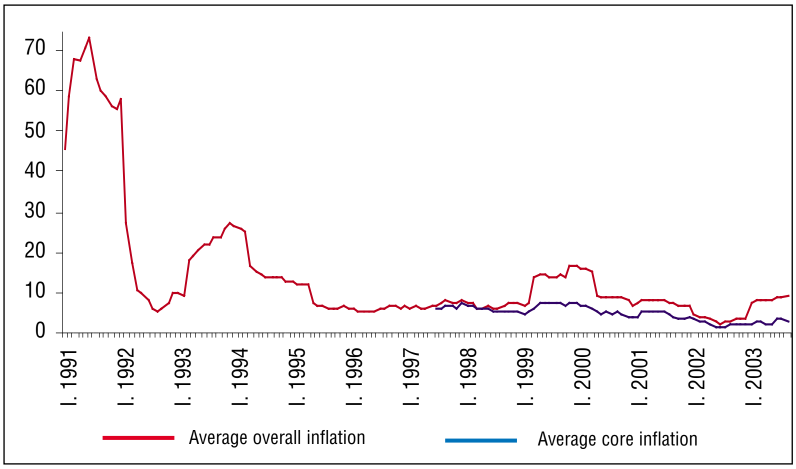
The state of an economy is mirrored in the exchange rate of the local currency. Any internal imbalance is reflected in exchange rate developments. The exchange rate is also affected to a considerable extent by non-economic developments (positive or negative), which are mostly of a political nature. The value of the exchange rate is a kind of barometer of overall economic development and is subject to abrupt changes, which are in many cases important for the economy. Changes in the exchange rate are transferred to the economy and thus affect the level of prices as well as the rate of GDP growth (which is connected with the fact that exports and imports account for an average of 70 – 80% of GDP, each).

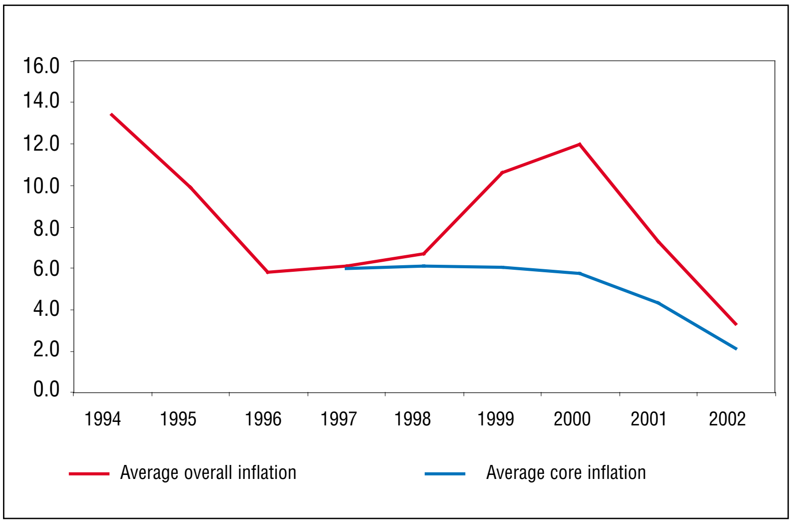
The Bank's approach to exchange rate developments and its activities on the foreign exchange market has been affected, for the most part, by the liberalisation of payments on the current and financial accounts. The elimination of direct administrative tools has led to the introduction of new instruments. Thus, interest rates and central bank interventions on the interbank foreign exchange market have replaced the system of the access conditions of commercial banks to NBS foreign exchange fixing.

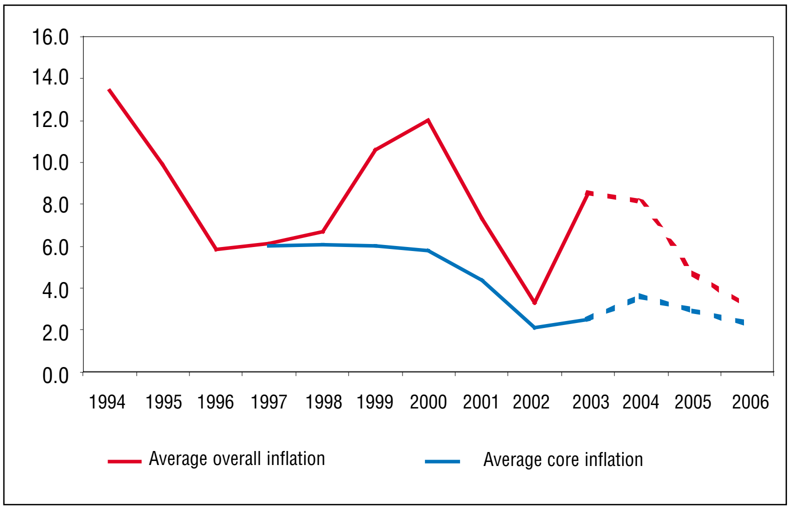
Within the exchange rate regime, there has been one devaluation since 1993, followed by several changes in the fluctuation band, from ±0.5 % to ±7.0%. The liberalisation of capital movements, combined with a complicated political situation in Slovakia, and multiplied by the run-up to the general election and the impact of the Russian crisis, ended the era of a fixed exchange rate regime, based on a basket of two (previously, five) currencies. The floating exchange rate system was introduced in 1998. At present, the reference currency is the euro, which indicates that the NBS has adapted to the new currency structure of Slovak foreign trade.

However, exchange rate developments are modified to some extent by the NBS, especially if they are inconsistent with the actual performance of the economy. It is in the best interest of the NBS to prevent short-term capital from becoming a major source of exchange rate fluctuation, independent of the economy and fundamental reality. The money market plays, as in the past, a key role in the current exchange rate system as a supplementary instrument for foreign exchange intervention, either in the form of restrictions on refinancing or sterilisation, or through direct changes in interest rates. After the introduction of floating and the consequent exchange rate depreciation, the exchange rate of the koruna to the reference currency was relatively stable: it fluctuated within a range of +5 to –10%. This means that, up to now, we have managed to modify and stabilise the exchange rate (except for short-term fluctuations) during periods of pressure for depreciation or appreciation, through the activities of the NBS.

Course of overall inflation since 1991

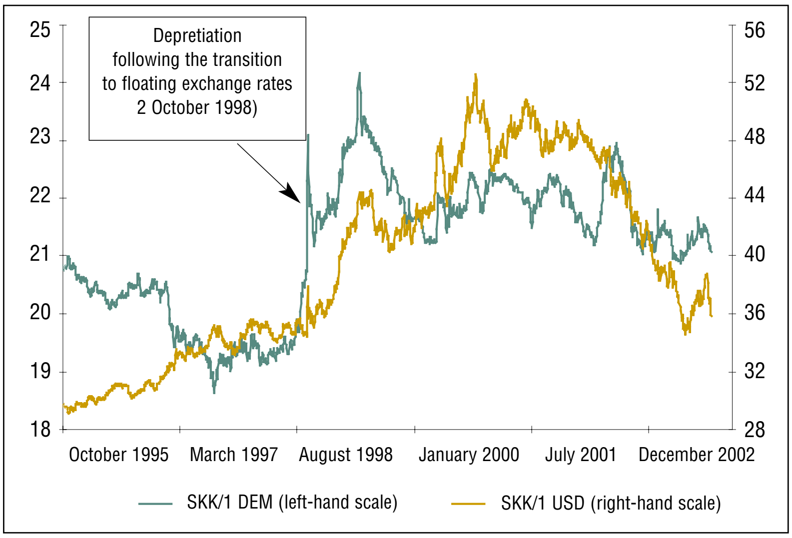




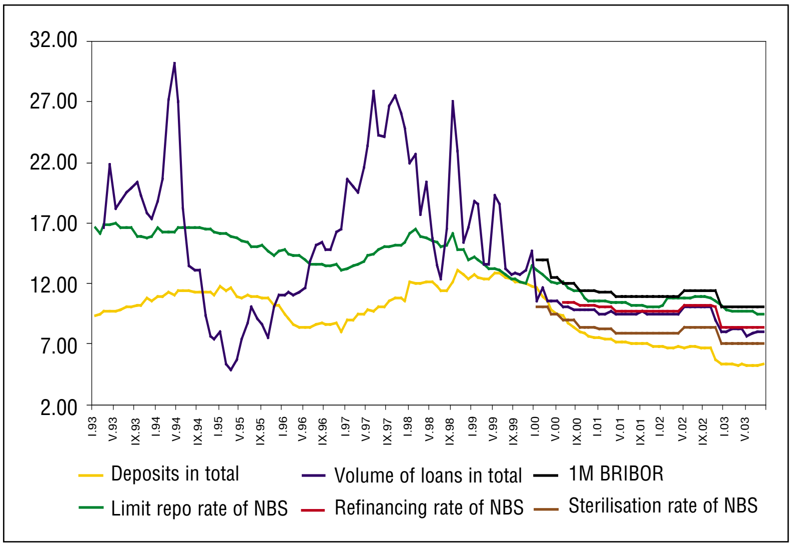


In the case of favourable developments in public finances, it is possible to expect that pressure for appreciation will dominate over the medium term. Part of this pressure will probably stem from a favourable trend in the real economy, caused by accelerated growth in labour productivity. This is expected to be one of the driving forces of convergence towards the level of EU

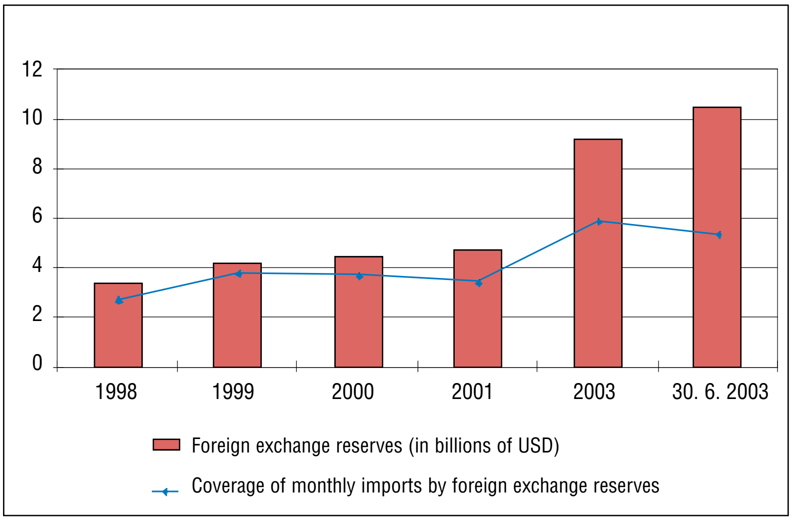
Development of the SKK exchange rate



Selected interest rates in %



Foreign exchange reserves of the NBS



countries. Before the adoption of the euro, we expect no substantial change in the exchange rate system. Our intention is to join the ERM II for a period of membership as short as possible. The rationale behind this plan is an attempt to avoid speculative short-term investments, stimulated by the delimitation of the fluctuation band, as happened in the case of Hungary.

The chronology of monetary developments indicates that the monetary policy of the NBS has undergone numerous changes in the course of convergence towards standard practices applied in the advanced world.

The monetary-policy instruments of the NBS have also undergone substantial changes. The NBS used credit limits, provided redistribution and/or other refinancing loans, and prescribed the volume of trading with commercial banks, which subsequently affected the level of interest rates, i.e. the NBS applied a so-called quantitative method of monetary control. Subsequently, the NBS had to conduct its monetary policy under conditions of a liquidity surplus in the banking sector, i.e., in an environment of transition from refinancing to sterilisation. Since the NBS had indirectly provided loans to the public sector in the previous period, we had to deal with the consequences of a credit boom and credit crunch, the closure of several commercial banks, and the privatisation of other banking institutions.

Subsequently, the NBS started placing more and more emphasis on the application of interest rates as an instrument fully compatible with the tools of the ECB. As a result, basic interest rates were introduced for two-week repo tenders and overnight transactions for refinancing and sterilisation purposes. This led to the stabilisation of the money market rates, which now fluctuate within a prescribed range. In connection with the actual and predicted course of macroeconomic developments, and the need to modify any unjustified trend of appreciation in the exchange rate, the key interest rates of the NBS were lowered by roughly 2 – 3 percentage points.

This reduction was also mirrored in the lending and deposit rates of commercial banks for primary customers. With regard to the ambition of the Slovak Government to join the EU and the predicted disinflation, the interest rate reduction is expected to continue.

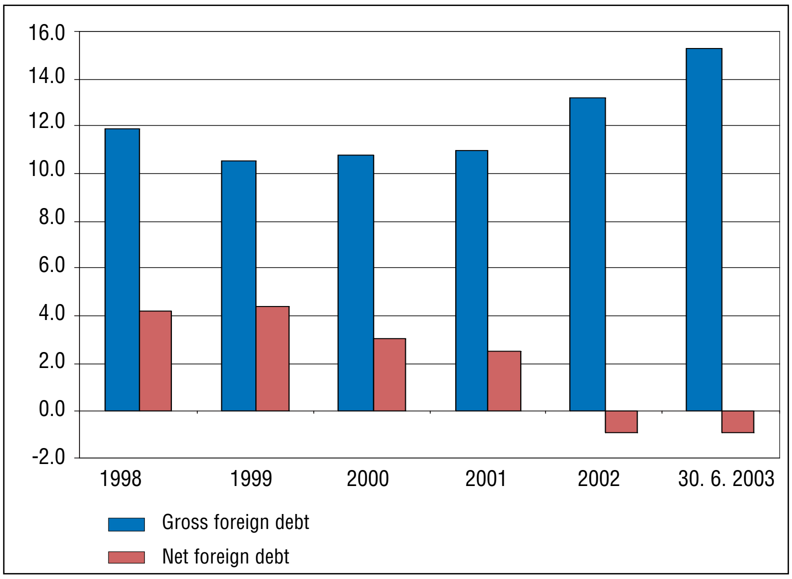
The harmonisation of the Bank's monetary-policy instruments led to a reduction in reserve requirements for commercial banks, in the form of a change in the ratio of minimum reserves. As a result, the liquidity of commercial banks increased by a total of ca Sk 30 billion. A further Sk 100 million came from the NBS, due to an influx of privatisation proceeds into the domestic economy. As a result of this development, accompanied by the crediting of interest to the Government's account (which must not be in debit) and the payment of interest on funds allocated for pension reform, the expenses of the NBS increased. We expect that after entry into the euro area, the NBS will again be on the refinancing side, because the free liquidity of the present member states will spread over the common money market, and the refinancing position of the ECB will weaken to a certain extent.

The privatisation activities of the Slovak Government have led to growth in the foreign exchange reserves of the NBS, the volume of which can be classified as more than sufficient in comparison with both the average volume of monthly imports and the involvement of short-term capital.

Due to growth in the foreign exchange reserves of the NBS, the volume of Slovakia's total foreign exchange assets has exceeded the volume of total external debt. Thus, the position of the SR has improved, from that of a net debtor to that of a net creditor.

In conclusion, I wish to state clearly that the SR has completed (as the charts indicate) a substantial part of the transformation process. The prepared tax reform, pension reform, and creation of conditions for continued inflow of foreign capital in the form of direct investment, will move the Slovak economy further on the road of convergence with (rather than transformation towards) the level of the EU countries. The commitment of the Government to reduce the fiscal deficit and the prepared reforms represent a sound and essential basis for an increase in real economic performance, the stabilisation or appreciation of the exchange rate, and a basis for sustainable growth. We expect that the whole process under analysis will end with the adoption of the single currency and the country's admission to the euro area, over the medium term.

External debt USD billions



In the first half of 2003, the Ministry of Finance and the NBS prepared a draft strategy for the introduction of the euro in the SR. According to this strategy, the euro should be adopted as soon as the country is ready and prepared to meet the Maastricht criteria in a sustainable manner. This also means that the euro is to be adopted only after the successful implementation of the aforementioned reforms, which are vital for the maintenance of convergence and stability during ERM II, the fulfilment of the Stability and Growth Pact, and for growth after entry into the euro area.

After public discussion, the Government discussed the draft and decided to update the strategy in the first half of 2004. We assume that, at that time, it will be possible to specify the cost of the reforms and the time necessary for their implementation. These reforms are essential for the adoption of concrete measures within the scope of the strategy, especially for entry into the ERM II.

Under the conditions of the SR, the year 2008 appears to be the earliest possible date for the adoption of the single currency, which means that the Maastricht criteria will have to be met in 2006. Setting a deadline for the fulfilment of these criteria, especially that concerning the fiscal deficit, is within the competence of the Government, since the meeting of the other criteria will also be affected by this deadline. The criteria for long-term interest rates and the public debt have already been met. Hence, the consolidation of the public budget is vital for the selection of an appropriate strategy for the adoption of the euro.

On the basis of practical experience, I expect that the single European currency will be introduced in the Slovak Republic within the first ten years of the 21st century, with all the consequences (mostly positive) of a monetary union.