Specification of the Strategy for Adopting the Euro in the SR

This document is drawn up in connection to the Strategy for Adopting the Euro in the SR and specifies in further detail the accession process towards the euro area. The subject of this document focuses firstly on the assessment of meeting the Maastricht Criteria, which is the basis for the Government's decision on the SR's entry into the euro area. In connection with this there follows a broad definition of the individual stages of the accession process and their terms of reference, requirements for individual types of policies are also defined, where these are to support overall economic and financial stability in the period prior to entry into monetary union and in the period following entry. Finally, the framework of the technical and organisational preparation for implementing the euro is defined. The entry of the Slovak Republic into the euro area is forecast for 1 January 2009.[1]

1. Assessment of fulfilment of the Maastricht Criteria and convergence of the Slovak Republic

The decisive basis for adopting a decision on the further course of the accession process towards the euro area is the prospect of meeting, in a sustainable manner, the Maastricht Criteria in the field of inflation, public finance deficit and debt, long-term interest rates and exchange rate stability. This is both a condition for the acceptance of the Slovak Republic's application for accession to the euro area, as well as a prerequisite for the efficient functioning of the Slovak economy in the euro area.

At present not all the Maastricht Criteria are as yet fulfilled, the Slovak economy however is headed towards their sustainable fulfilment by 2007 at the latest. The outlook for a continuation of the process of real convergence is also improving. The results of reforms in the economy are beginning to show through, which have brought in particular an improvement in the state of public finance and the domestic business environment. The reforms have been accepted by leading international institutions, as well as by foreign investors, for whom the Slovak economy is becoming an attractive area for investing.

The current results of economic growth bear witness to the fact that the economy - supported by an effective economic policy - is headed towards an increase in performance and competitiveness whereby, through a feedback effect, there are also created suitable conditions for completing reforms and for fulfilling the nominal Maastricht Criteria.

The assessment of the SR's convergence may be broadly summarised in the following way:

The inflation criterion is as yet not fulfilled. The average value of the harmonised index of consumer prices (HICP) for the past twelve months is 8.7%[2], which significantly exceeds the reference value of the indicator for meeting the inflation criterion (2.5%) in the same period. The high inflation in Slovakia is, however, currently almost exclusively a consequence of the administrative price adjustments (deregulation of prices, changes to excise duties, unification of the VAT rate). The last important administrative price interventions were made in 2004. A significant decline in inflation will subsequently occur in 2005, and in 2006 the inflation

[1] In the case of not including the costs of pension reform into the public finance deficit, accession on 1 January 2008 is possible. This however is with the assumption that a decision to not include the costs will be adopted within a period within which it will be technically possible to carry out the necessary steps for accession in 2008.
[2] Average for June 2003 – May 2004, source: Eurostat.

criterion should already be fulfilled, when inflation should reach 2.5%[3], while the estimate of this criterion is 2.7%. In the assessment year 2007 it is predicted that inflation in Slovakia will be at the level of 2.5% (the estimate for the inflation criterion[4] is 2.8%). The relatively stable development of core inflation (2.3% in June 2004) may be considered as favourable for the development of inflation over the medium term. The development of wage and labour costs in Slovakia does not either act as a factor in raising inflation, and with regard to the increasing flexibility of the labour market, domestic cost factors should not represent a risk for price stability over the medium term. These prospects are also strengthened by consolidation efforts in the area of public finance.

The **public finance deficit criterion** set at the level of 3% of GDP is currently not fulfilled. In comparison with 2002, however, 2003 saw a significant decline in the deficit from 5.7% of GDP to 3.5% of GDP. This occurred primarily thanks to tight budget restrictions and structural reforms. For reducing the public finance deficit to a level not exceeding 3% of GDP and for fulfilling the Maastricht Criterion it will above all be necessary to complete and maintain the ongoing structural reforms in public finance. Budgetary consolidation is necessary in the field of the primary balance in connection with the fact that the interest costs of debt servicing over the period of the coming three years will not decrease significantly.

After including the costs of pension reform (i.e. after taking account of the fall in incomes from pension insurance in the framework of the second pillar) the criterion for the amount of the fiscal deficit should be fulfilled in 2007, when the public finance deficit should reach 3% of GDP.

Slovakia is fulfilling the **public debt criterion**. The reference value set at 60% of GDP has not been exceeded in the past. In 2003 public debt represented SKK 511.3 billion, which is 42.8% of GDP. In the coming years public debt will increase in nominal terms, in particular in the central government segment. Here, in 2005, concurrently with the onset of the pension system reform, there will be manifested the effect of the transformation of a part of the implicit debt in the pension system on the explicit one through the fact that numbers of insured persons will enter the second pillar. Privatisation revenues set aside will be used to cover the fall in incomes in the first pillar. Following their exhaustion the State will have to cover this shortfall by budgetary means. Thanks to the expected dynamic growth of GDP and consolidation of current budget management, however, the share of the public debt will stabilise at a level around 46% of GDP.

For **assessing the exchange rate stability** according to the Maastricht Criteria the basic systemic conditions, which are participation in the exchange rate mechanism ERM II and the agreed SKK/EUR central parity, have as yet not been fulfilled.. The subsequent assessments for the period of July 2002 through to June 2004 therefore have limited predictive value. The nominal exchange rate over the monitored period – following a short-term depreciation caused by negative pre-electoral expectations at the beginning of the period - gradually appreciated. The total appreciation against the initial value of 1 July 2002 reached 9.8% (as at 30 June 2004). This value is to a certain degree distorted (overvalued) by a weak initial value of the exchange rate at the beginning of the period. When assessing the exchange rate stability on the basis of deviations from the mean value, the nominal exchange rate in the same period moved mostly within the band of +/- 3% around the mean value, which is substantially less

[3] According to the Updated Monetary Programme of the NBS for 2004
[4] Estimates have been based on data from the Stability and Convergence Programmes of the 25 Member States of the EU.

than permitted by the standard fluctuation band (+/- 15%) set in the ERM II operating conditions.[5]

The positive development of the SR's macroeconomic fundamentals allows for the prediction that the future will not see pressures for a depreciation of the exchange rate. With regard to the appreciation trend prevailing in the recent period, the setting of the central exchange rate parity upon accession to ERM II will be of extraordinary importance for maintaining the exchange rate movement close to parity, where this maintenance is a component of the assessment in the framework of the evaluation procedure. For assessing exchange rate stability, however, the appreciation trend, provided that it is supported by improving macroeconomic fundamentals, should not represent a barrier. This, together with the hitherto relatively stable development of the nominal exchange rate, leads to the conclusion that Slovakia should not have any serious problems with fulfilment of the exchange rate stability criterion. Thus, as it has been to date, the aim of monetary policy in the exchange rate area will be to limit any significant fluctuations in the exchange rate from its equilibrium course through an appropriate combination of interest rate and intervention policy.

The expected development of the exchange rate may however be influenced by various external factors (geopolitical development, the movement of speculative capital, unfavourable development on world markets and in the region, the timing of neighbouring countries' accession to ERM II, etc.). These factors of uncertainty may, however, be viewed rather as one of the reasons for the SR's early accession to the euro area.

Over the period of the past 12 months Slovakia has also fulfilled the **long-term interest rate criterion** (the average for the past 12 months was 5.13%[6], where the reference value is 6.46%). According to projections up until 2007 the development trend of long-term interest rates in the SR will be approximately the same as that in the EU, therefore fulfilment of the long-term interest rate criterion should also not be threatened either in the following years.

A summary overview of the prospects for fulfilling the Maastricht Criteria in the assessment year 2007 is illustrated in the table below:

	2007	
	Forecast development	Criterion
Inflation (%)	2.5	2.8*
Interest rates (%)	5.7	7.6*
Public debt (% of GDP)	45.4	60
Fiscal deficit (% of GDP)	3**	3

***** *The estimate of the criteria values has been calculated from the convergence and stability programmes of the EU25 countries.*
*** in the case of including pension reform costs in the deficit*
Sources: The forecast development of inflation is taken from the Updated Monetary Programme of the NBS for 2004, the development of interest rates and the fiscal deficit from the recent projection of the Ministry of Finance of the SR (21 July 2004). The forecast

[5] The stability of the exchange rate may also be assessed positively against the narrow fluctuation band of +/- 2.25%. The mentioned depreciation of the nominal exchange rate at the beginning of the period evaluated against the initial value did not exceed the narrow band limit. Although the depreciation against the mean value exceeded the narrow band limit, for both evaluations it is however true that this was only for a short time in consequence of circumstances of a non-economic nature.
[6] The average for June 2003 - May 2004, source: Bratislava Stock Exchange.

development of the public debt is taken from the Convergence Programme of the SR for 2004 - 2010.

It may be said that the outlook for the development of the decisive indicators for assessing the fulfilment of the Maastricht Criteria fulfils the preconditions for the SR's entry into the euro area within the proposed time period. With regard to the fact that the growth in the price level will decrease with the termination of administrative adjustments over the coming years, the determining variable for creating the conditions for implementing the euro in 2009 will then be reducing the public finance deficit in compliance with the programme.

It is at the same time necessary to take heed of the fact that sustainable fulfilment of the Maastricht Criteria is not a straightforward process, but rather a process containing various risks. The risks of failure in fulfilling individual criteria and preventive measures for their elimination are given in Table 1 in the table appendix. By and large it may be said that the risks identified may be eliminated by means of individual policies and their appropriate combination.[7]

Besides nominal convergence, the process of the **real convergence** of the Slovak economy towards the EU is also underway. In 2003, GDP per capita at purchasing power parity in Slovakia was 48.3% of that for the EU15, labour productivity reached 55.2% and the relative price level 45.7%.[8] Slovakia ranks among the most dynamic economies according to its rate of growth. In the 1st quarter of this year the economy grew on a year-on-year basis by 5.5% with a relatively balanced structure of growth. Economic growth is already bringing benefits to the population - household consumption reached 3%-growth on a year-on-year basis following a demanding period of reforms (in particular price deregulations) and recovering from negative growth. GDP growth in Slovakia significantly exceeds that of the original EU15 (in the same period the economy there grew by 2.3%), as well as the new EU25 (growth of 2.4%). Through the continuing faster rate of growth, especially compared to the EU15 countries, labour productivity is also growing. With regard to this fact, the real convergence of the Slovak economy towards the EU average is continuing. Thanks to the reforms made Slovakia's competitiveness is also increasing against other EU countries. This is manifested in a substantially improved situation on the current account of the balance of payments in comparison with the past.

A high degree of convergence may also be seen in the institutional and legal fields, which has been formed with a view to the prospect of operating in the euro area.

Forecasts show that the faster growth and thereby also further convergence will continue also in the future. Therein will be manifested also an integration effect connected with Slovakia's accession to the EU, which will later be strengthened by the SR's entry into the euro area. Fast economic growth and further convergence of the Slovak economy towards that of the EU will be supported by a restructured banking sector and a healthier financial market. Support for this process will also comprise an appropriate combination of monetary and fiscal policies, the effective application of other economic policies and the inflow of foreign direct investments. Large investments in the automobile industry in particular will be of cardinal importance for increasing performance of the Slovak economy. The effect of these factors will be strengthened by a clear strategy aimed at adopting the euro.

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[7] A more detailed discussion of these risks is covered by Appendix 2. Part 3 of this text and Appendix 2 are also focused on the issues of the formation of individual policies and their combination.

[8] Source: Eurostat.

2. Material and time identification of main stages of the process leading towards the euro adoption

The SR's accession process to the euro area will be carried out gradually in individual stages, each of which has its separate significance. The nature of the individual phases is on the one hand given by the rules for assessing the fulfilment of the Maastricht Criteria, and on the other hand is influenced by the specific conditions in Slovakia. On the basis of an analysis of the conditions in the SR and taking account of past experience of the euro introduction, this process may be divided into four stages:

1st stage:	From the present (*from September 2004*) until entry to ERM II
2nd stage:	From entry to ERM II until the Decision of the Council of the EU on euro area membership
3rd stage:	Transitional period from the Council's Decision until euro area membership
4th stage:	From entry into the euro area, introduction of the euro into the cash and non-cash payment systems alongside the simultaneous withdrawal of the Slovak koruna from circulation

The individual stages of the accession process may be outlined as follows:[9]

In the **first stage**, which covers the period from the present through to entering ERM II, there must, with the help of reforms, be achieved the state, where during membership in ERM II, the economic, financial and monetary stability of the economy is ensured in particular through fiscal policy and labour market policy. The reason for this is the fact that the possibilities of the monetary policy and the effectiveness of its instruments which are, with regard to the liberalised movement of capital already at present limited, will be further restricted. Strengthening the role and effectiveness of fiscal policy and other policies will make it possible to achieve such a level of nominal convergence that will mean the sustainable fulfilment of the Maastricht Criteria within the course of the assessment period during the SR's membership in ERM II. Simultaneously, it will create the conditions for a stable development of the economy following the SR's entry into the euro area, when the monetary policy of the NBS will be replaced by the single monetary policy of the European Central Bank.

ERM II (Exchange Rate Mechanism II) is an exchange rate mechanism in which the currency of each country must participate for at minimum two years prior to assessment of convergence. The aim of the mechanism is to prepare an economy for operating in monetary union. During membership in ERM II, fulfilment of the Maastricht exchange rate criterion is concurrently tested, and the combination of policies supporting it is also assessed. The condition is to prove the exchange rate stability of the currency simultaneously with the ability of the economy to fulfil, at latest within the two-year period, the four nominal criteria (monetary and fiscal) of convergence. ERM II provides participant countries the conditions for stable exchange rate development (on the basis of support for stabilising exchange rate development from the side of the ECB, provided that the causes for the volatility do not lie in the incorrect setting of domestic policies). On the other hand, room for flexibility is provided: the standard fluctuation band for exchange rate movement is +/- 15% around the central

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[9] A framework time schedule for introducing the euro in the SR is presented in Table 2. Table 3 gives a rough schedule of the important dates in the framework of the individual stages of the SR's accession process to the eurozone.

parity, allowing a short-term deviations of the exchange rate without breaching the Maastricht Criterion.

During the course of the first stage key decisions will be made foreshadowing the specific form of the whole process of entering the euro area. The Slovak Government will designate a National Coordinator for the process of introducing the euro, who, during this stage, will draw up a National Plan for Introducing the Euro in the SR. On the basis of assessing the state of reforms and the prospects for nominal convergence, the SR Government, in cooperation with the NBS, shall commission the Minister of Finance of the SR and the Governor of the NBS to negotiate with bodies of the European Union on accession to ERM II[10], a part of which will also be the issue of setting the central parity of the Slovak koruna against the euro.

The value of the central parity will significantly influence the country's macroeconomic development and therefore it is important to set it correctly. Setting of the central parity should take into consideration the development of the equilibrium exchange rate and at the same time take account of the exchange rate development on the foreign exchange market in the period prior to the central parity being set. An undervalued central parity could lead to the economy overheating and subsequently to higher inflation, which would threaten fulfilment of the inflation convergence criterion. An overvalued central parity would weaken the competitiveness of the Slovak economy, and besides this, it could indirectly support speculative attacks on the koruna and threaten fulfilment of the exchange rate criterion. This would disrupt the credibility of the integration strategy.

Setting the central parity will be the result of a joint assessment by representatives of the SR and other partners within a top secret negotiation procedure. It is necessary to emphasise that with regard to the sensitivity of information concerning the central parity in relation to the financial markets, no participant in the negotiations may provide any information on this issue outside the official framework.

Determining the central parity variable does not mean any pre-determining of the final exchange rate of the koruna against the euro upon entry into euro area. Decisions on the central parity and on the koruna/euro conversion rate will be separate; they will be adopted in different periods and will be the results of different decision-making processes. Furthermore, during membership in ERM II, the central parity may be re-valued by means of a standard procedure.[11] This will enable the determination of the koruna/euro conversion rate to adapt to the development of economic fundamentals. This flexibility at the same time deflects potential speculative attacks on the currency.

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[10] The first precondition for entry of the SR into ERM II, which is accession to the agreement between the ECB and the central banks of the EU Member States - non-eurozone members, is already fulfilled, since this agreement has been in force since 1 May 2004. (The Agreement of 29 April 2004 between the European Central Bank and national banks of Member States not belonging as at 1 May 2004 to the eurozone, amending the Agreement of 1 September 1998 on operating procedures for the exchange rate mechanism in the third stage of Economic and Monetary Union). The ERM II system is described in detail in Appendix 1. An application for entry to ERM II is submitted to the ECOFIN Council, the negotiations take place in the Economic and Financial Committee (EFC), the members of which are representatives of the EU Member States, the European Commission and European Central Bank.

[11] Without consequences for extending the period of membership in ERM II, it is however not possible, even with the help of this procedure, to devalue the central parity; the parity may only be revalued.

The latest possible deadline being considered for entry to ERM II is by the end of the 1st half of 2006. This means that the first stage would last approx. 16 to 22 months (*from September 2004*).

In the **second stage**, which is the period from entry to ERM II until the Decision of the Council of the EU on the abrogation of the derogation, (and thus on membership in monetary union), it will be necessary through a coordinated economic policy to achieve fulfilment of the Maastricht Criteria in inflation, public finance deficit and public debt, as well as interest rates and to maintain exchange rate stability pursuant to the ERM II rules.

A key precondition for fulfilling the Criteria will be a policy mix in which fiscal policy in particular will dominate, where it, together with other policies and the ECB policy, will gradually replace the stabilisation role of the independent national monetary policy. A condition for this is the completion of the respective reforms.

A significant means of protection against speculative attacks on the koruna during membership in ERM II will be the ECB cooperation in stabilising the development of the koruna exchange rate in the framework of the fluctuation band. Intervention support of the ECB will be automatic at the limit of the band set, the ECB may, but is not obliged to, participate in any possible interventions made by the NBS within this band. The ECB and the NBS may cancel automatic interventions in the case of a threat to the aim of price stability.

The basis for assessing the fulfilment of the exchange rate convergence criterion is that the country must have been operating in ERM II at the time of the assessment for at least two years and the market exchange rate of the currency may not have exceeded the agreed fluctuation band within the assessment period. Nonetheless, the criterion is deemed fulfilled in the case of movement of the exchange rate "close to parity"[12] without "severe tensions", especially without devaluation of the parity against the euro. Appreciation of the exchange rate within the frame of the fluctuation band, however, is not a barrier to the positive assessment of exchange rate stability. The issue of "severe tensions" is evaluated on the basis of an assessment of the extent of exchange rate deviations from the central parity, the development of the short-term interest rate differentials against those of the euro area, and the role played by foreign exchange interventions in stabilising the exchange rate.[13] The assessment of the exchange rate criterion fulfilment will thus be of a complex nature. The overall context of domestic policies and economic development, as well as the situation on the financial market will be assessed.

The overall assessment of a country's fitness to introduce the euro will, besides the evaluation of the fulfilment of nominal convergence criteria and exchange rate stability, assess also the results of market integration, the situation on the current account of the balance of payments, the development of unit wage costs and other price indices.

[12] According to the standard methodological annex for the evaluation of the individual Maastricht Criteria which forms an integral part of convergence reports, in the Convergence Reports of the EC on Sweden and Greece from 2000 as well as on Sweden from 2002, for fulfilment of the exchange rate stability criteria, the exchange rate was to be maintained within the band of ±2.25% around the central parity.

[13] The expression "severe tensions" may mean an adverse development on the current account and in the framework of the whole balance of payments, the exceeding of the depreciation band, the need to use high short-term interest rates to stabilise the exchange rate, the loss of price competitiveness, etc.

In the case of a positive assessment by the EC and ECB that the SR has during its membership in ERM II achieved sustainable convergence,[14] the Council of Europe in composition of the heads of State shall adopt, acting by a qualified majority, a decision on abrogation of the derogation status[15] and on the acceptance of the SR as a member of the euro area. The decision on the conversion rate, with which the SR enters the euro area and whereby the Slovak koruna becomes a denomination of the euro, shall be made by a unanimous vote of the Council in the composition of the euro area Member States together with the SR[16].

The duration of the second stage is on the one hand limited by the period during which the fulfilment of the exchange rate criterion is monitored (at minimum 2 years), to which it is necessary to add a period (of approximately 3 months) necessary for carrying out the formal evaluation and approval procedures. No maximum period is set. In the conditions of the Slovak economy and in the case of an appropriate setting of the combination of economic policies, no reason should arise justifying a prolongation of the compulsory two-year period for monitoring the fulfilment of the exchange rate criterion.

Accession to ERM II will mean the definitive confirmation of the SR's intention to introduce the euro within the set deadline. This will also become the reason for the official commencement, or substantial intensification of organisational and technical preparations.

The **third stage** is a transitional period between the Council Decision and the beginning of the SR's membership in the euro area itself. This period will be primarily intended for the completion of technical and organisational preparations for entry into monetary union and for introducing the euro as legal tender.

The preparations of the public sector (legislation, changes in the information systems of tax offices, social insurance and other institutions), as well as the private sector, in particular banks and the business sector for the changeover to the new currency will culminate. Upon the date of entering the euro area all economic entities must be technically fully able to carry out all cash and non-cash transactions in euro. The necessary information must also be available to the rest of the public.

At this stage the koruna will continue to operate in the framework of ERM II and only on the date of entering monetary union will the Slovak koruna become a denomination of the euro and the NBS will cease to be an independent monetary authority.

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[14] The factual evaluation of the fulfilment of conditions for membership in the eurozone will be presented in convergence reports by the EC and ECB.

[15] "At least once every two years, or at the request of a Member State with a derogation, the Commission and the ECB shall report to the Council in accordance with the procedure laid down in Article 121(1). After consulting the European Parliament and after discussion in the Council, meeting in the composition of the Heads of State or Government, the Council shall, acting by a qualified majority on a proposal from the Commission, decide which Member States with a derogation fulfil the necessary conditions on the basis of the criteria set out in Article 121(1), and abrogate the derogations of the Member States concerned." (Article 122(2) of the Treaty establishing the European Community).

[16] "If it is decided, according to the procedure set out in Article 122(2), to abrogate a derogation, the Council shall, acting with the unanimity of the Member States without a derogation and the Member State concerned, on a proposal from the Commission and after consulting the ECB, adopt the rate at which the ecu shall be substituted for the currency of the Member State concerned, and take the other measures necessary for the introduction of the ecu as the single currency in the Member State concerned." (Article 123(5) of the Treaty Establishing the European Community).

In the case of a standard course of the monitoring and assessment process in the framework of ERM II preparations in the third stage should last approximately 6 months.

The **fourth stage** will begin on the date of the SR's entry to the euro area. All financial transactions in the economy will be carried out in euro, the Slovak koruna will be merely a denomination of the euro. Over the course of this stage euro bank notes and coins will be introduced into cash circulation and concurrently the Slovak koruna will be gradually withdrawn from circulation. The period necessary for withdrawing the Slovak koruna from circulation in the SR, in comparison with the countries which introduced the new currency at the beginning of the euro area's operation, will be relatively short. The shortness of this period is accounted for by the fact that the SR will be acceding to euro area with the euro functioning in circulation; an important role will also play the experience gained from introduction of the Slovak currency shortly after establishment of the independent Slovak Republic.

3. Requirements for individual policies that should support overall economic and financial stability in the period prior to entering the euro area, in particular in ERM II and in the period following entry

Credible and consistent policies are the basis for fulfilling the Maastricht Criteria and for proceeding real convergence. The present Member States of the euro area were successful in the accession process to monetary union thanks to credible monetary, fiscal and income policies as well as thanks to the use of a complex of structural policies, the overall orientation of which was coordinated towards assisting nominal and real convergence. The application of such a system of policies significantly contributed to create credibility and positive expectations for inflation and economic growth. Achieving the same situation in the Slovak Republic requires consolidation of the instruments and options of individual policies as well as their optimal combination.

3.1. Fiscal policy

Over the coming years fiscal policy will play a crucial role in maintaining economic stability. Over the period of manoeuvring the economy into the euro area it will have to:

- in the first place ensure convergence - consolidation of public finance and the sustainable fulfilment of the budget deficit and public debt criteria,
- support monetary policy for fulfilling the inflation criterion,
- support monetary policy in stabilising the development of the nominal exchange rate of the koruna against the euro over the medium term,
- support stabilisation of the development of the real economy in the case of the emergence of endogenous or exogenous shocks.

Although the fulfilment of these tasks will not be exclusively a matter of fiscal policy, it is clear that the demands on it are going to grow even prior to adopting the euro. Following the accession to the euro area its role will be even more important with regard to the fact that it will (in coordination with other policies), in the case of asymmetric shocks, have to replace the stabilisation functions of the national monetary policy, the execution of which will have been taken over by the European Central Bank. For this it is necessary to complete the reform of public finance. Fulfilment of the budget deficit criterion is sustainable, if, over the course of an economic cycle, the public finance deficit does not exceed the limit of 3% of GDP in the case of the free operation of automatic stabilisers and ordinary fluctuations of economic activity. In the conditions of the Slovak economy it should be sufficient for the sustainable fulfilment of the budget deficit criterion over the medium term that the structural deficit of GDP falls below 2% of GDP. The principle however applies that a responsible fiscal policy should be directed towards achieving the long-term sustainability of public finance. In practice this requires that public finance is gradually directed towards balanced management. The Convergence Programme for 2004 to 2010 declares the Government's commitment to achieving this goal. This would make room for the free operation of automatic stabilisers without the threat that the fiscal deficit would exceed the critical level of 3%.

The convergence programme forecasts that the share of incomes to the public budget in GDP will settle at the level of 37.5%. The fast rate of economic growth (on average around 4.5% annually[17]) will make it possible for the necessary reduction in the deficit at the rate of 0.7 - 0.8% of GDP annually to be achieved also alongside a real growth in budget expenditures[18].

With regard to the uncertainty in the estimates on the consequences of reforms carried out, the fulfilment of the course of consolidation according to the Convergence Programme requires increased attention, on the side of incomes, to the development of the tax quota I (the share of tax incomes in GDP), the fulfilment of social insurance and health insurance incomes. If needed, measures will be sought for introducing the necessary corrections. On the expenditures side the approved budgetary frameworks will be thoroughly applied.

A short-term or multi-year decrease in the growth of the economy or deep cyclical fluctuations represent the most serious potential effects for public finance consolidation. Their impacts on the deficit however should not be greater than 1% of GDP. The ongoing real convergence practically excludes the possibility that economic growth would be halted and a long-term decline in the economy's rate of growth below 2% is also unlikely. Nonetheless, even in the case of such a rate of growth in the economy the necessary consolidation could be undertaken.

On the other hand, faster consolidation of the budget is also possible, should the economy grow faster than forecast in the Convergence Programme. In this case care will be taken to comply with budgetary discipline, otherwise the structural deficit could worsen. Funds exceeding the approved budget will be used primarily to reduce the public finance deficit.

The consolidation of public finance is at the same time a condition for the sustainable development of the state debt. Fulfilling the public debt criterion is sustainable, if the level of debt does not exceed, in ordinary fluctuations in economic activity, the criterion limit for debt (60% of GDP). The stricter condition for debt sustainability requires that in the case of the free functioning of automatic stabilisers and ordinary fluctuations of the economy the level of debt over the long term does not grow. In the conditions of the Slovak economy it should be sufficient for the sustainable fulfilment of the public debt criterion that the public finance deficit criterion is fulfilled on a sustainable basis. The fast rate of growth of the economy's potential (4% or more at constant prices) will make it possible in the coming years to not

[17] The Updated Monetary Programme of the NBS forecasts a GDP growth of up to 5-6% over the period 2006 – 2007.

[18] The fast rate of economic growth will even allow the budget deficit to be reduced by up to 1.5% of GDP annually, while maintaining the real volume of expenditures.

increase the level of debt above the present level of approximately 45% of GDP, provided that the public finance deficit criterion is sustainably met.[19]

3.2. Monetary policy

In standard economic conditions monetary policy enables a central bank to create an environment for maintaining price stability. However, in the conditions of a small, highly open transitional economy with the liberalised movement of capital, such as those of the Slovak economy, monetary policy already in the period prior to entering ERM II is of limited effectiveness, even despite the fact that the NBS can in principle still use all the standard instruments and procedures.

Accession to ERM II will be a further step in limiting the operating room for monetary policy: inflation must converge into a field, which means fulfilling the respective Maastricht Criterion, and the exchange rate, the importance of which will be increased in ERM II, must move within a defined fluctuation band. Achieving the convergence of inflation requires that the factors affecting it – influence of other policies, in particular fiscal and wage policy, external influences, as well as factors connected with catching up (the Balassa-Samuelson effect[20]) are taken into account. The NBS will still have available the option of using short-term interest rates, their use however will have limitations. These will be given by the level of such rates in the euro area, towards which the NBS rates are gradually to converge.

For supporting exchange rate stability, the NBS will be able to use also interventions on the foreign exchange market. Through cooperation in interventions the support of the ECB will be of great significance in meeting the convergence targets within ERM II, as this support can rebuff potential speculations against the koruna and thereby prevent disruption to the fulfilment of the exchange rate and inflation criteria.

Besides the monetary policy instruments of the NBS and the cooperation of the ECB in interventions, the disinflationary strategy and exchange rate stability will be supported by a credible framework of other domestic policies, as well as the efficient functioning of the financial sector.

Exchange rate stability in the pre-accession period could be adversely influenced by a possible reversal in the movement of capital (in particular the short-term capital). Substantial elimination of this risk is possible through the country's accession to monetary union. The benefit of a fixed exchange rate will in the case of Slovakia compensate for the disadvantage of losing a national monetary policy governed by the NBS. This fact is therefore one of the main motives behind the early adoption of the euro and the move over from the execution of a national monetary policy by the NBS to the single monetary policy of the ECB.

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[19] In a long-term outlook it is however necessary to reckon with the effects of demographic changes which will be manifested in ageing of the population. The result may be that the costs of transforming the pension system will be settled in conditions of slower economic growth. The programme for proceeding in public finance consolidation creates sufficient room for the sustainable fulfilment of the debt criterion.

[20] The essence of this effect is that labour productivity growth is faster in the tradable sector than in the non-tradable sector. In consequence of the tendency of wages to balance out throughout the whole economy, prices in the non-tradable sector will grow faster than in the tradable sector and cause faster price growth in the whole economy. This faster price growth, however, does not threaten the competitiveness of the economy. Moreover, hitherto experience of the less advanced original and new Member States of the EU shows that the BS-effect played only a limited role. Estimates of the BS-effect, calculated for the SR, range in the interval of 0.5 - 2%.

3.3. The labour market

A critical consequence of any instability are impacts on employment. These will be more moderate, if the instability in the development of the economy is quickly removed or suppressed so that it is not directly reflected in increased unemployment. It is also important that the labour market manages to absorb the fast growing demand for labour, which can be a consequence of fast economic growth, but this without accompanying wage-induced inflationary pressures. Such a functioning of the labour market must, at the same time, take into account the applicable conditions of the cross-border movement of labour force.

It may be said that the development of the labour market conditions in Slovakia is headed towards its greater flexibility and ability to counter possible imbalanced impulses. The growth of employment currently contributes to a decrease in unemployment; the minimal level of indexation, flexibility of real wages and even partial (conditional upon region and sector) nominal downward flexibility of wages highlight the labour market flexibility.

Reform in the social sphere, tax reform, as well as the amendment to the Labour Code are enabling a further increase in labour market flexibility, in particular through strengthening the motivation to work. Reserves exist in the wider use of flexible forms of employment and in legislation governing illegal work. In comparison with the present members of the euro area the institutional characteristics of the Slovak labour market are already more flexible.[21]

The deferral of retirement age will in the coming years partially act against a reduction in unemployment. Although persistently high unemployment will seemingly mitigate the need for further increase in labour market flexibility, measures in this direction are inevitable, because the qualitative, structural aspects of the equilibrium are more and more becoming the centre of attention in the labour market. Regional mobility of the workforce is also still relatively low and requires support programmes.

3.4. The financial sector

A liberalised financial market with the free movement of capital can, to a substantial degree, compensate for insufficient mobility of the workforce and mitigate the impact of potential shocks on individual economies and regions.

The Slovak financial market is gradually incorporating into the European financial space. Regulation of the domestic financial market is adapting to EU standards and cooperation programmes have been concluded with partner supervisory authorities. This creates the prerequisite for a smooth integration of the Slovak financial market into the European financial market. Following successful restructuring the banking sector is as a whole stabilised and sufficiently competitive. Its capital adequacy and financial stability are above-standard. It has the preconditions and room for fast growth, and maintains a low degree of credit risk. Capitalisation has been significantly increased. In the future, however, banking sector will be exposed to cross-border competition and, likewise, competition from other segments of the financial market is increasing.

[21] Peter Backé, Christian Thimann et al.: The acceding countries' strategies towards ERM II and the adoption of the euro: An analytical review, ECB, 2004.

The increase in competition on the market and reduction in interest rates, due also as a consequence of the approximation of the monetary environment in the SR to that of the euro area, contains a potential risk of the emergence of a “credit boom”. The present low levels of households indebtedness, the existing room for a growth in business sector and bank assets create suitable conditions for such a fast growth in loans. Preventing an uncontrollably fast growth of loans or a decrease in the quality of loans, which would cause disequilibrium, is a task of a forward-looking banking supervision. It is also necessary to increase the level of the financial management of banks and businesses, including also implementation of the international accounting standards.

4. **Outline of the organisational and technical preparation for introducing the euro in the SR**

The introduction of the new currency will affect all entities of the society and this fact will be reflected in the technical and organisational preparation requirements. Preparation for adopting the euro will run in the public sector hand in hand with the private sector, it will concern both organisations and individuals. It will be elaborated in detail in the National Plan for Introducing the Euro, where all technical details will be harmonised into a consistent system of changes which will ensure a smooth introduction and operation of the euro. Preparation has a material, time and institutional aspect. A description of the steps that need to be taken prior to introducing the euro is based also on the experience of present members of the euro area in their adoption of the euro. In contrast to them, however, the situation in Slovakia is simpler, since the euro already exists. A large majority of enterprises and a part of the population has experience with using the euro. The existence of cash euro allows Slovakia to take a ***big-bang approach*** to introducing the euro, i.e. the simultaneous introduction of cash and non-cash euro[22]. In this way a certain duplication in steps is removed and the process of adopting the euro will be simpler.

4.1. Main material issues of the organisational and technical preparation for introducing the euro

From the material aspect, the process of organisational and technical preparation contains a large number of details that will be elaborated in detail in the National Plan for Introducing the Euro and in the framework of operating procedures of working groups created on its basis. The material framework which will define the process of preparation is the identification of the main fields which will be affected by the changeover. This will concern mainly the specification of systems in which changes will occur following the introduction of the euro. Separate attention must be devoted to the banking sector which will, in introducing the euro, play an indispensable role, and to the communication strategy. It will also concern the solution of certain accompanying issues connected with introducing the new currency, such as the issue of price increases upon currency conversion.

4.1.1. Systems that will be affected by the introduction of the euro

In connection with the introduction of the euro it will be necessary to realise changes that will affect a broad spectrum of fields, of which we may mention in particular applicable legal

[22] The first 11 countries of the eurozone introduced euro in scriptural form on 1 January 1999 and the cash euro was introduced after a three-year transitional period on 1 January 2002 (including Greece, where with regard to the two-year delay in entering the eurozone its transitional period lasted only 1 year).

standards, regulations, as well as measures, methodologies, communication systems, personnel systems and other specific fields.

The field of information systems will be of extraordinary importance. Every system used for the creation and storage of financial information in the national currency will be influenced by the euro changeover. Among the main information systems that will be influenced by the euro changeover are accounting, billing and payment systems, systems of financial planning and budgeting, the system of managing the state treasury and legal databases.

Separately, it is necessary to identify systems which with regard to their “hidden functioning” may be overlooked, such as cash desk terminals and other types of payment terminals producing financial information. These systems may contain comparative historical information (e.g. turnover in the same period of last year), calculate cumulative data on turnover (which is used in cash balancing), and where these are often interconnected with other systems. Enterprises often use several information systems which produce financial information in their own internal regime. This applies in particular for large enterprises in which primarily standardised software products are used. Many departments in these enterprises, however, use additional types of software over which the parent company need not necessarily have oversight.

Managing such extensive changes requires that preparation is commenced in sufficient time in advance. This has in practice already started and is currently underway in working groups at the NBS, in public administration departments, in the banking sector and business associations, in the form of identifying the extent of necessary changes and their time demands.

4.1.2. The role of the banking sector and the cash changeover

The banking sector will have important functions in preparing the economy for the euro introduction in both the non-cash and cash payments. Its role will be to ensure the smooth supply of the euro, the exchange of koruna for euro, and the koruna’s fast withdrawal from circulation.

Frontloading the banking sector with euro currency for its smooth introduction into cash circulation in the SR shall be ensured by the NBS in accordance with the regulations of the ECB[23]. It is expected that the frontloading of cash currency to the NBS and commercial banks will be effected in the last quarter prior to “E-day” (entry into the euro area) and that commercial banks will distribute the cash currency (sub-frontloading) to the retail sector 1 month prior to the entry.

Following the euro changeover, the cash koruna will be in dual circulation with the euro for the shortest possible time. During the dual circulation it will be possible to pay in koruna, but retailers will only give out euro. Following the termination of the dual circulation, the koruna

[23] The logistics of the frontloading operation of banks with euro currency, its distribution to other target groups, accounting relations between the central bank and commercial banks in this operation, the defining of collaterals for securing against credit risk is contained in the ECB Measure: “Adopting Certain Provisions on the 2002 Cash Changeover. Guideline of the ECB of 10 January 2001” (ECB/2001/1).

shall lose its validity definitively. It will be possible to exchange koruna for euro only in commercial banks and the NBS, later only in the NBS.[24]

4.1.3. Communication strategy issues

An integral part of the National Plan will be an efficient communication strategy. The communication strategy must address all layers of the population and business sector. The main part of the campaign will run during the third stage of the process of adopting the euro prior to the final introduction of the euro and the cash changeover. Increased attention must be given to potentially sensitive groups (pensioners, children, handicapped persons and people living alone).

The content of the communication campaign will cover, among others, the following topics:

- An explanation of the advantages and disadvantages ensuing from a membership in the monetary union for the population and small enterprises.
- Familiarisation with the euro banknotes and coins, calculation of prices from koruna to euro.
- An explanation that during the third stage the koruna will still be in the ERM II system of exchange rates, so the market rate may differ slightly from the irrevocable conversion rate (following the harmonisation of interest rates with those of the euro zone these deviations should be minimal).
- Familiarisation with the fact that the koruna will cease to exist in the scriptural payment system immediately on the date of introducing the euro, i.e. 1 January 2009 ("E-day").
- An explanation that though koruna banknotes and coins will become merely a denomination of the euro in the cash payment system from the moment of adopting the euro, they will be accepted in cash payments without restriction as legal tender throughout the whole period of dual circulation. The koruna banknotes and coins will, however, gradually be withdrawn from circulation.
- The schedule and possibilities of exchanging the Slovak currency for the euro.

The aim of the information campaign will be to contribute to the smooth changeover to the euro. The main emphasis will be placed on the campaign targeted at the population. The business sector and public administration institutions will in the framework of the communication strategy be provided with the clear and timely information, but no persuasion or education campaign will be developed in respect of these entities. All entities and institutions must be clear that as at "E-day" they must be prepared for using the euro.

The experience of the current euro area members will be used in the information campaign. The European Commission and the ECB have expressed great interest in contributing to the effectiveness of the information campaign. On the basis of their own initiative also banks and other financial institutions, retail chains and non-profit organisations may participate.

In order to introduce the common currency it will be necessary to outlay certain costs both at the state level and in the private sector. According to the calculations of the European Central Bank the changeover to the euro of the first 12 member states cost 0.3 – 0.8% of GDP. In the case of the Slovak Republic it will be appropriate to focus, by means of a suitable

[24] Already now an unofficial dual circulation, i.e. the possibility to pay also in euro, exists on the basis of the voluntary decision of retailers and service providers.

communication strategy, on preparing the whole society properly for the introduction of the common currency and thus concurrently minimise the costs necessarily outlaid in connection with this. The preparations for a successful changeover to the common currency in business sector will require more time prior to the entry date itself to euro area. Case studies in the euro area member states have shown that the best approach is to prepare an internal corporate plan for the euro changeover. Data from enterprises that managed the changeover to the common currency without any problems show that the stage of planning consecutive steps in the changeover to the common currency took them from three to twelve months. The highest conversion-related costs must, as a rule, be borne by retail networks and financial institutions which must, besides the changeover itself in the field of internal accountancy, software and other activities, outlay additional expenses related to the need for sufficiently informing their clients of the euro changeover. From the above it results that the time aspect of the preparation to the common currency must not be underestimated.

For the above reasons the individual parts of the communication strategy targeted at the three basic groups of its recipients – the public sector, private sector and inhabitants – will take place in sufficient advance and will significantly contribute to the preparation of the whole society for a smooth implementation of the new currency.

4.1.4. The issue of price increases due to currency conversion

In the period immediately following the introduction of the euro the possibility exists of a transitional increase in inflation in consequence of implementation costs and rounding. Experience from the euro area countries show that the influence of implementation costs on inflation was suppressed to a significant degree through competition. Competition also limited the room for price increases in consequence of rounding. Despite this, price increases were recorded which, though overall very limited, were considered by consumers as significant.[25] High perceived inflation creates discontent among inhabitants with regard to the new currency and by means of inflationary expectations it may lead to wage and inflationary pressures in the future.

Similar pressure for price increases may also arise in conditions of the SR. During the critical period of re-pricing from the koruna to the euro and the subsequent rounding, it is therefore recommended that increased attention is paid to this field (monitoring, presentation of gentlemen's agreements, but also drawing the public's attention to incorrect procedures).

It is also possible to use dual pricing as a certain form of price control in the retail sector. Though the obligation of dual pricing will arise only on the date of the SR's entry into the euro area, it is possible to initiate informal dual pricing already prior to that date as a part of a policy of transparency and the correct approach to consumers.

4.2. The time aspect of the technical and organisational preparation of the euro changeover

In terms of the overall framework the time horizon for technical and organisational preparation is defined by the sequence of individual steps of the accession process and their time demands. From the communication aspect as well as from the aspect of creating a

[25] According to statistical data the real inflationary effect of implementing euro was very small, about 0.1-0.2%, but inhabitants perceived the growth in prices as many times higher. According to research carried out by the European Commission 84.4% consumers were convinced that the price conversion was harmful to them.

sufficient time space for carrying out necessary measures, a suitable date for the official[26] commencement of the technical and organisational preparation for implementing the euro in the SR is the accession to ERM II. As at that date the appointed National Coordinator should start intensive working as well as media activity.

The considered scenario of the Slovak koruna accession to ERM II enables a sufficient time space for managing the conversion even of the most complex financial information systems.[27] Technical as well as administrative preparation for introducing the euro in the SR thus should not create log-jams and preconditions exist for it to run smoothly and, from the aspect of the technical provision, reliably.

In introducing the cash euro, the state of using the euro as tender even before entry into the euro area will be important. The share of the euro in the total value of cash payments in the SR is still very low, it however is possible to expect that this is going to increase, whereby the stimulus for the public's increased interest in the euro will probably be the definite confirmation of the SR's acceptance to euro area. It will be necessary to monitor the development of the euro's share in the total cash payments during the period of the unofficial dual circulation. This indicator will be the basis of the requirement for the production (or a loan from the Eurosystem) of euro banknotes, in order to cover the needs of the cash circulation of the SR upon monetary conversion at the time of entry into the euro area.

4.3. Institutional provision for adopting the euro

The technical and organisational preparation of the euro changeover in the SR will take place under the leadership of the National Coordinator (the Minister of Finance of the SR) in close cooperation with the National Bank of Slovakia and European institutions, in particular the European Commission and the European Central Bank.

The National Coordinator in cooperation mainly with the NBS will ensure the elaboration of the National Plan for Introducing the Euro in the SR, which will cover the main technical and organisational aspects of the whole process and its time schedule. The law will set out the tasks for the National Bank of Slovakia itself in the field of frontloading the necessary volume of euro cash currency for circulation in the SR with the parallel withdrawal of Slovak banknotes and coins.

The European Commission on the basis of positive experience in introducing euro in 1997 - 2002 established the Public Administration Network II (PAN II), a commission for consultations and coordination of the procedures of individual countries in adopting the euro. The role of PAN II is to intermediate information useful in introducing the euro and exchanging experience and plans among countries which are about to introduce the euro in the near future. The European Commission will monitor and prepare reports on the procedures of individual countries.

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[26] As already mentioned above, the practical preparation has already begun and through acceding to ERM II further activities should have been launched, the most important of which is the elaboration of the National Plan for Introducing the Euro and the creation of the respective organizational structures.

[27] From experience of the current euro area countries as well as from the preliminary statements from departments, or relevant divisions of the NBS it results that the adjustment of financial information systems including the most complex ones to the euro is possible within the time frame defined by membership in ERM II. Time demands on administrative preparation, including changes in legislation and amendment of documents and materials which are in the agenda of the public administration are even smaller and are estimated at approximately 1 – 1.5 years.

The coordination task of the ECB concerns fields that will fall within the competence of the NBS. This concerns in particular the issues of providing for the production and distribution of euro banknotes and coins in the individual stages of introducing the new currency, the solution of the issues of dual circulation as well as the exchange of invalid banknotes and coins of the national currency for the euro.[28] The ECB Guidelines will mostly have the nature of binding normative provisions which will create the legal framework for the whole logistics of the euro changeover in the SR.

Conclusion

The state as well as the outlook for fulfilling the Maastricht Criteria allows to express a conclusion on the reality of the SR's entry into the euro area on 1 January 2009. Although fulfilment of the Maastricht Criteria is not without risks, these may be eliminated by means of individual policies and their combination.

Reduced effectiveness of the monetary policy will require the activation and coordination of other policies. After the accession to monetary union other policies will fully take over the stabilisation tasks of the monetary policy of the NBS to eliminate any potential asymmetric shocks that the performance of the single monetary policy of the ECB will not be able to take account of. The importance of fiscal policy will be increased most. Reforms in the labour market and a flexible wage policy should contribute to a reduction in the consequences from any potential imbalances upon employment. Supervision over the financial market must operate in a forward-looking and anti-cyclical manner countering the risks of the emergence of adverse asset price bubbles and, in coordination with fiscal policy, also against a possible overheating of the economy from a credit boom.

After entry into the euro area, combination of fiscal and other policies should result in fast economic growth while simultaneously fulfilling in a sustainable manner the Stability and Growth Pact fiscal criteria.

The Specification of the Strategy for Adopting the Euro represents also the basic framework for the realisation of practical measures connected with adopting the euro. The Government shall commission the Deputy Prime Minister and Minister of Finance to negotiate, in cooperation with the Governor of the National Bank of Slovakia, with the Council of the European Union on the accession of the Slovak Republic to ERM II and to set, in cooperation with the European Union bodies, the central parity of the Slovak koruna against the euro. The

[28] Ensuring the euro cash currency is subject to the jurisdiction of the Eurosystem. The Governing Council of the ECB may approve the production plan of the euro cash currency for the new Member State only after the official abrogation of the derogation status and the confirmation of its acceptance to the euro area at the Summit of the Council of the EU in the composition of the heads of state and government. In the case of the scenario for the SR with the forecast accession to the euro area on 1 January 2009, this status should happen in June 2008, i.e. the time space for the production of the necessary volume of euro banknotes and coins would be approximately 6 months (until 1 January 2009). The ECB sees a possibility of the extension of this timeframe by approximately 2 months by the way of a conditional approval of the production plans for the cash currency by the Governing Council of the ECB immediately after the positive assessment and approval of convergence reports. The risk ensuing from the possible non-abrogation of the derogation for the SR would then have to be borne by the Slovak side. The third possibility could be a loan of the cash currency for the SR from the Eurosystem's stocks. The issue of ensuring euro banknotes and coins for the future euro area countries is being currently opened at the level of the ECB. (The Changeover Scenario and Allocation of the Launch Production among the Acceding Countries. ECB, March 2004.)

Government shall appoint a National Coordinator for the process of introducing euro in the Slovak Republic who will prepare in the first half of 2005 the National Plan for Introducing the Euro in the SR, containing the necessary details of the accession process to euro area. With regard to the fact that the change in the currency unit will affect the whole society, the transformation process will have to be realised in cooperation with the broadest sphere of entities possible. Great attention shall be paid to the information campaign, in particular in relation to the population. Its aim will be the perfect preparedness of all subjects for using the euro.

Risks of non-fulfilment of the Maastricht Criteria **Table 1**

	Risk	Possible consequence	Prevention - Compensation
Price development	Balassa-Samuelson effect	Growth in wage inflation ensuing from the increase in wages of the non-tradable sector not reliable with the labour productivity development	Influencing the breakdown of the real exchange rate appreciation tendency into inflation and the nominal exchange rate appreciation
	Wage indexation	Inertia of the current high inflation	Agreements on wage growth with trade unions
	Fast growth in loans (credit boom)	Impact on the economy overheating and inflation growth	Forming disinflationary expectations Strict, forward-looking banking supervision and correct financial management of banks and enterprises
	Sudden strong weakening of the exchange rate	Growth in inflation in consequence of the pressure on exchange rate	Thorough coordination of monetary policy with other policies and their correct timing, The earliest possible entry to the eurozone
	Conflict between the aim of price stability and exchange rate criterion following entry to ERM II	Breaching inflationary criterion or in an extreme case disqualifying from ERM II	Consolidation of instruments and possibilities of individual policies and an optimum policy-mix, Support of the ECB in possible interventions
	Disinflationary expectations failure	Reflection in the calculations of economic entities and acceleration of price growth	Credibility, transparency and continuity of the whole process
Deficit	Political risk – change in the basic aims of fiscal policy Reliability of expected budget revenues with regard to the reforms performed Long-term nature of the reform effects and the resultant limited predictive ability Decline in the growth of the economy, cyclical fluctuations	Non-fulfilment of budgetary tax revenues, social insurance revenues, revenues from the EU and their impact on a deepening of the deficit Deepening of the planned deficit Impact on consolidation of public finance	Increased attention to the development of individual items, with the operative introduction of necessary corrections. Application of the approved budgetary frameworks in expenditure spending Real convergence minimises the probability of a decline in the economic growth below a sustainable degree of consolidation
Exchange rate	Reversal in movement of capital	Impact on exchange rate stability in the pre-accession period	Thorough coordination of monetary policy with other policies and their correct timing, The earliest possible entry to eurozone

	Inappropriately set central parity Conflict between the aim of price stability and the exchange rate criterion following entry to ERM II	Exchange rate instability in ERM II Failure in maintaining the exchange rate within the fluctuation band – in an extreme case	Credible underlying analyses Consolidation of instruments and possibilities of individual policies and an optimum policy-mix, Support of the ECB in possible interventions

Broad time schedule for introducing the euro in the SR **Table 2**

	1st stage	2nd stage	3rd stage	4th stage
Content	Preparation and adoption of the SR Government's Decision on Accession to ERM II.	Accession to and performance in ERM II, EC´s and ECB´s assessments of fulfilment of the conditions for acceptance of the SR for the eurozone member .	The Decision of the Council of the EU on fulfilment of the conditions for the acceptance of the SR for the eurozone member.	Entry to the eurozone and introduction of the euro into circulation.
Possible time plan	At latest by June 2006	June 2006 – June 2008	June 2008	1 January 2009
Major tasks	(Accession of the NBS to the Agreement of Central Banks, 29 April 2004) Initiation of procedures for the ERM II Committee negotiations on accession of the SKK to ERM II in the ERM II Committee, setting the central parity and fluctuation band. Completion of reforms to a degree creating the conditions for economic, financial and monetary stability after entry to ERM II.	Exchange rate stabilisation. Preparation of laws, directives and other administration; Conversion of IT systems to the euro; Adjusting corporate business strategies for managing integration and growing competition.		Simultaneous introduction of the euro into cash and scriptural payment systems. Withdrawal of the koruna from circulation. Efforts to minimise costs related to these processes.
Macroeconomic issues	Continuation of budget consolidation and reducing of the rate of inflation.	Performing the economic policy mix for functioning in ERM II. Setting the NBS monetary policy instruments.		Delegating the NBS monetary policy to the ECB. Setting the macroeconomic policies corresponding to the need for maintaining the orientation on stability and flexibility.
Preparation of the public sector	Establishment of a task-force with representatives of competent parties and a broad identification of material and time requirements of the technical and administrative preparation for the euro. Constitution of the National Coordinator for Introducing the Euro.	Implementation of necessary administrative institutional and technical changes.	Finalising the formation of institutional and technical conditions for introducing euro. Preparation for dual pricing. Preparation of the State budget in euro.	Dual pricing of goods, services and labour.
Preparation of the private sector	Informal/primaryinformation activities	Implementation of necessary changes. Preparation of technical conditions for introducing euro.	Finalising the preparations. Unofficial dual pricing.	Dual pricing.
Preparation of inhabitants	Informal/primary information activities of the Government of the SR	Intensive information campaign in various media (the European Commission requires that the information campaign for inhabitants run at least a year and half prior to the introducing the common currency itself).	Finalising the information campaign with an emphasis on possible risk groups.	Granting additional practical information for inhabitants (e.g. possible operation of a free info-line, etc.)
Potential risks	Insufficient dynamics in fiscal consolidation.	From the side of the EU – possible pressure on staying in ERM II longer than 2 years. A policy-mix not harmonised with the	Insufficiently completed institutional and technical preparation for introducing the euro. Delay in the deadline for adopting	Potential technical and administrative shortcomings.

		agreed central parity. Failure in adherence to the preparation time schedule.	euro, loss of credibility abroad and subsequent risks for financial and economic stability.	

Table 3

Orientation schedule of important dates
within the individual stages of the SR's accession process to the eurozone:
Entry into the eurozone on 1 January 2009
1st stage
• April 2004: "The Agreement of 29 April 2004 between the European Central Bank and the national central banks of the Member States outside the euro area on 1 May 2004 amending the Agreement of 1 September 1998 laying down the operating procedures for an exchange-rate mechanism in stage three of economic and monetary union."
• September 2004: - Discussion of the Specification of the Strategy for Adopting the Euro in the SR and deciding on the date of the eurozone entry in Government of the SR - Designation of a National Coordinator for the Process of Introducing the Euro in the SR - Authorising the Minister of Finance of the SR and the Governor of the NBS to negotiate with the European Union bodies on entry to ERM II and on setting the central parity of the Slovak koruna exchange rate against the euro
• September 2004 – June 2005: Elaborating the National Plan for Introducing the Euro in the SR
• September 2004 – November 2004: Informal consultations on the entry to ERM II with bodies of the European Union
• By June 2006: Graduation from accession procedures to ERM II with the authorities of the European Union
2nd stage
• at latest by June 2006: Entry to ERM II
• May 2008[1]: EC and ECB Convergence Reports •
• May – June 2008: Assessment procedure in the European institutions
• June 2008: Decision of the Council of the EU on the abrogation of the derogation
• June 2008: Setting the SKK/EUR conversion rate
3rd stage
• June – September 2008: Ensuring the necessary amount of euro banknotes and coins for cash circulation in the SR
• September – October 2008: Frontloading of the NBS and commercial banks with euro cash currency
• Mid-December 2008: Sub-frontloading of the retail sector with euro cash currency
• June – December 2008: Informal dual pricing
• By the end of December 2008: Conversion of ATMs, vending machines and other facilities working with the use of coins or banknotes

[1] In the case of entering ERM II at the end of June 2006, this and other dates would be shifted, the date for adopting euro would however remain unchanged.

4th stage
• 1 January 2009: Entry into the eurozone
• January – June 2009: Dual pricing
• January 2009: Withdrawal of the Slovak koruna from circulation
• February 2009 - … Continuation in exchanging invalid Slovak currency.

Appendix 1

Institutional and procedural aspects of the exchange-rate mechanism ERM II

According to Article 124 of the Treaty on European Union *each new Member State, following accession to the EU, is obliged to consider its exchange-rate policy as a matter of common interest*. This means that it is obliged to avoid policies that could lead to an excessive fluctuation of the exchange rate or to breaking its development away from economic fundamentals. The primary aim of the central bank's monetary policy of a new Member State remains that of price stability. These principles are important for the financial and economic stability of the EU, deepening mutual economic integration of Member States and the smooth functioning of the internal market. For the same reasons also the economic policies of the new Member States are a subject of common interest, and therefore are subject to coordination and multilateral evaluation procedures (the Stability and Growth Pact, convergence programmes, Broad Economic Policy Guidelines –"BEPG", the Cardiff Report). The choice of a specific monetary and exchange-rate policy strategy following accession to the EU is however within the powers of the Member State.

New Member States following their accession to the EU have the status of a Member State with derogation (from using the euro). The abrogation of the derogation and the introduction of the euro requires the sustainable fulfilment of the nominal convergence criteria and institutional-legislative conditions. One of the convergence criteria is the proving of exchange-rate stability of the national currency against the euro, which is tested for a period of at least 24 months in the institutional framework of the exchange-rate mechanism ERM II.[1] No deadline for incorporating a national currency into ERM II is prescribed by European legislation; its determination is within the powers of the Member State's government. In deciding on the date for accession to ERM II it is however essential to take account of all facts that may, during the currency's functioning in ERM II, influence its exchange-rate stability – favourably or unfavourably.

1. Basic description of ERM II

The legal basis of ERM II comprises two documents: the *Resolution of the European Council on the establishment of an exchange-rate mechanism in the third stage of economic and monetary union* (Amsterdam, 16 June 1997) (hereinafter referred to as "the Resolution") containing the basic principles, aims and characteristics of ERM II, and the *Agreement of 1 September 1998 between the European Central Bank and the national central banks of the Member States outside the euro area laying down the operating procedures for an exchange rate mechanism in stage three of Economic and Monetary Union* (hereinafter referred to as "the Central Banks' Agreement"). The legal basis of ERM II is thus not the Treaty on European Union, but an intergovernmental multilateral agreement.

The first essential step for participating in ERM II is the accession of a national central bank of the EU new Member State to the Central Banks' Agreement. The document is signed by the ECB, the central banks of Member States outside the eurozone and the central bank of the new Member State. The Agreement formally confirms that with the entry into the EU the national central bank of the new Member State becomes a component of the European System

[1] ERM II is the European exchange-rate mechanism which on 1 January 1999 (at the start of the third stage of economic and monetary integration, i.e. the establishment of the eurozone) replaced the original ERM, a component the then European Monetary System founded in 1979.

of Central Banks (ESCB), and is thus subject to the legislation of the ESCB ("the ESCB acquis") on the functions and functioning of ERM II.[2]

The second condition for participation in ERM II is the successful graduation from accession procedures, the essence of which lies in a decision on the central parity of the participating currency against the euro and the fluctuation band around this parity.

The economic and institutional significance of ERM II lies in two facts:

1. it assists Member States participating in ERM II to coordinate and direct their policies towards achieving a stable macroeconomic environment and supports the structural reforms necessary for the fast nominal and real convergence towards the environment of the eurozone economies,
2. it has a principal role in assessing the convergence criterion of exchange-rate stability, i.e. one of the conditions for entering the eurozone, and the legislation of which is covered by Article 121(1) of the Treaty on European Union and Article 3 of the Protocol on the Convergence Criteria.

ERM II from the technical aspect represents a fixed exchange-rate system with a set central parity of the currency participating in the system against the euro and a permitted fluctuation band around this parity (a soft peg exchange-rate regime). Sustainable operating in ERM II therefore – similarly as in the case of other fixed exchange-rate regimes – requires mutually consistent economic policies aimed at macroeconomic stability supporting the maintenance of the agreed central parity.

2. Central parity and the fluctuation band

The agreed *central exchange-rate* (central parity) should reflect economic fundamentals (the export and production capacity of the economy, the development of the balance of trade and balance of payments). At the same time it should take account of the market exchange rate of the currency over the past period. The agreed central parity may not take account of the interests of any lobby groups.

The central parity does not predetermine the final conversion rate against the euro upon accession to the eurozone[3]. Each party to the common agreement, including the ECB may initiate a confidential procedure for *revaluing the agreed central parity*. A revaluation of the central parity may be necessary in particular in conditions of real convergence, for example if in consequence of economic development a change in the equilibrium exchange rate occurs (as in the case of Greece), substantial changes occur in external competitiveness or in the case of an inconsistency in macroeconomic policies.

The central parity should be set close to the medium-term equilibrium exchange rate so that it is credible for markets and thereby the risk of speculative attacks is reduced. Too soft (undervalued) central parity would motivate the markets towards attacks, which would shift

[2] The NBS and the national central banks of other new Member States of the EU acceded to this Agreement on the date of their entering the EU (The Agreement of 29 April 2004 between the European Central Bank and the national central banks of the Member States outside the euro area on 1 May 2004 amending the Agreement of 1 September 1998 laying down the operating procedures for an exchange-rate mechanism in stage three of economic and monetary union).

[3] Decisions on central parities and conversion rates are separate, being adopted at different times and are the results of different decision-making processes.

the spot exchange rate to the upper limit of the fluctuation band. In justifiable cases however a long-term stronger exchange rate than the parity is tolerable. Where the trend of the exchange rate's appreciation would continue, it is possible to initiate a procedure for revaluation of the central parity. Revaluation does not breach the criteria of the ERM II regime[4].

Too hard (overvalued) a central parity represents a potentially more serious risk. An attack by the markets would mean a shift of the spot rate into the depreciation part of the fluctuation band, in which exchange rate movement is limited. If the attack were sufficiently strong, the exchange rate could fall below the lower limit of the fluctuation band, which would breach the exchange-rate stability criterion and lead to exclusion from the ERM II regime. The whole procedure of acceptance into ERM II would have to be repeated. Re-acceptance into ERM II would however be complicated by weakened credibility of the economy. If the exchange rate were to remain over the long term or repeatedly enter the devaluation band this could cause a non-fulfilment of the exchange-rate criterion, even if the exchange rate did not exceed the fluctuation band limit.

A further important element of ERM II is the *agreed fluctuation band*. Its standard spread is ± 15% from the agreed central exchange rate. According to Article 2.4 of the Resolution it is however possible, at the request of the given Member State, to agree also a *narrower band*. In principle this is however possible only in the case of a country achieving a high degree of economic convergence with the eurozone states.[5] The appropriateness of the formally agreed narrower band can be reconsidered at the initiative of either of the parties involved.

With regard to the fact that the legal basis of ERM II is an inter-governmental multilateral agreement, the decision on the central parity and standard fluctuation band is made on the basis of a joint agreement between the ministers of finance (economy) of the eurozone Member States, the ECB and the ministers of finance (economy)[6] and the central bank governors of Member States outside the eurozone participating in ERM II (at present Denmark, Slovenia, Estonia, and Lithuania, and in the future possibly other new Member States of the EU). Participants to any decision on a narrower fluctuation band are the minister of finance (economy) and the governor of the central bank of the country concerned, the ministers of finance (economy) of the eurozone countries and the ECB.

All these decisions are preceded by preliminary consultations in the respective institutions and bodies of the EU, namely, the Economic and Financial Committee (EFC), General Council of the ECB and the competent committees of the ECB. The final decisions are reached in the framework of the EFC Exchange-Rate Procedure.

3. ERM II accession procedure

Each country applying for the entry to ERM II will be assessed on the case-by-case basis. Over the course of individual procedural steps and in decision-making the principle of equal treatment will be maintained with the new Member States as with the current eurozone Member States.

[4] An undervalued exchange rate (parity) may cause price increases in imported goods and thereby threaten fulfilment of the inflation criterion.

[5] Denmark is at present a participant in ERM II with a jointly agreed narrow fluctuation band of ± 2.25%.

[6] Neither the Resolution nor other legal standards of the EU do lay down the ministerial department precisely with regard to the fact that competences of various departments in individual Member States differ. In the case of Slovakia this issue should concern, with regard to its content, the Minister of Finance.

An acceding country shall be represented in negotiations by its Minister of Finance (economy) and governor of the central bank, or other authorised representatives. Negotiations shall as a rule take place at weekends and in secret. The report on the accession of a new member to ERM II and on the agreed central parity of the new Member State's currency shall be published by the ECB and the new member prior to the opening of markets.

In the interest of a full and open discussion on the central parity and fluctuation band, the Member State assessed must not, prior to the negotiations, make any unilateral public statement regarding the desirable setting of these parameters.

4. Interventions

The width of the fluctuation band and the central exchange rate determine the intervention points in the form of intervention exchange rates of the Member State's currency against the euro. In accordance with the agreed fluctuation band (standard or narrow) the ECB and participating national central banks (NCBs) shall establish, by common accord, intervention exchange rates (Article 1.2. of the Central Banks' Agreement). The upper and lower values of the agreed intervention exchange rates shall be notified to the market jointly by the ECB and NCB.

Interventions at the margins, if the spot exchange rate reaches the values of the intervention exchange rate, are in principle automatic and unlimited. However, the ECB and the non-euro area NCBs participating in ERM II may suspend the compulsory interventions, if this were to raise a threat to their primary aim, i.e. maintaining price stability (Article 3.1. of the Central Banks' Agreement).[7] In deciding whether to suspend intervention, the ECB or the NCB concerned shall take due account of all other relevant factors, including the credible functioning of ERM II and opinions of other competent bodies. The ECB and the NCB concerned must notify, on a confidential basis, other participating CBs of euro area states and non-euro area Member States of any intention to suspend intervention at the margins.

Interventions are a supportive instrument for exchange-rate stabilisation. The number and volume of interventions depends on the credibility of the set central parity and fluctuation band. The scope and need for interventions may be limited by correct policies (consistent with the parity and band fixed), or (if necessary) timely reconsideration (revaluation) of the central parity.

The ECB and the NCBs participating in ERM II may also agree to *coordinated intramarginal margins interventions* (e.g. in the case that the NCB's effort is to maintain the exchange rate in a band narrower than that officially agreed to). However, the ECB need not to automatically support this type of intervention, in contrast to interventions at the margins.

In the case of all non-compulsory interventions (including the *unilateral non-coordinated intramarginal interventions*) the intervening CB is obliged to request the prior consent of the Member State CB whose currency features in the intervention (together with the currency of

[7] In the framework of ERM II the exchange rate stability is thus for all participating currencies subject to the primary aim of price stability.

the intervening bank) in any volume exceeding the mutually agreed limit for the non-compulsory interventions.[8]

For the purpose of interventions in euro and in participating non-euro area currencies, the ECB and each participating NCB shall open for each other *very short-term financing facilities*. Their initial maturity is three months. The very short-term financing facility for financing interventions at the margins of the agreed (standard or narrow) band are automatically available and unlimited in their amount. The debtor central bank shall make appropriate use of its foreign reserve holdings prior to drawing on the facility.

On the basis of a request of the debtor central bank the original maturity may be automatically extended by another three months. The total debt resulting from the automatic extension of the maturity may never exceed the ceiling fixed for the accession of central banks to the very short-term financing facilities for the purpose of financing interventions according to Annex II to the Central Banks' Agreement.[9] Up to this limit it is possible, by means of very short-term financing facilities, to finance also interventions within the fluctuation band.

Mutual claims and liabilities resulting from the mentioned operations between the ECB and the participating NCB may be netted out following the mutual agreement.

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[8] A similar procedure is also used in transactions other than interventions that cover at least one currency of a non-euro area state participating in ERM II or the euro, and the volume of which could influence the exchange rate between the two currencies concerned. In such a case the two central banks concerned should agree to the manner for minimising any potential problems, including considering the option of making the transactions on a direct basis.

[9] From an indicative calculation of the new ceilings for very short-term financing facilities based on a fixed component for all non-euro area national central banks and a variable component calculated on the basis of the national central bank's share in the ECB' key capital, the resultant limit for the NBS is EUR 450 million.

Appendix 2

Policy requirements supporting overall economic and financial stability prior to entering monetary union, in particular in ERM II, and in the period following entry

Introduction

Fulfilment of the Maastricht Criteria, exchange-rate stability around the central parity without apparent tension and instability in the economy in the period of operating in ERM II and the subsequent adoption of the euro and monetary policy of the ECB without destabilising the economy require that the economy and its individual elements (institutions, markets, sectors) undergo a development that:

1. enables nominal convergence pursuant to the Maastricht Criteria in a sustainable manner,
2. supports the stability of the convergence process, operation in ERM II and the adoption of the euro, and this also through the action of automatic stabilisers,
3. supports economic stabilisation following any possible shock through the coordinated application of policies, in particular fiscal and monetary,
4. supports economic stabilisation after any possible shock through the flexible reaction of institutions, markets and sectors of the economy.

Slovakia already today fulfils the convergence criteria for public finance debt and the level of long-term interest rates. Achieving nominal convergence requires primarily budgetary consolidation so that the Slovak Republic is able to maintain a deficit below the limit of 3% of GDP and reduce the average annual rate of inflation below the criterion value at the time of the country's assessment[1].

1. Fiscal policy

Over the coming years fiscal policy will play a crucial role in maintaining economic stability. In the period leading up to entering the eurozone it will have to:

- primarily ensure convergence - consolidation of public finance and the sustainable fulfilment of criteria for the deficit and debt,
- support monetary policy in fulfilling the inflation criterion,
- support monetary policy in stabilising the development of the nominal exchange rate against the euro, and this through the fundamental support of stabilising the development of the equilibrium exchange rate,
- support stabilisation of the real economy in the case of endogenous or exogenous shocks.

It is clear that the demands on fiscal policy will grow already prior to adopting the euro. Following entry to the eurozone the burden borne by fiscal policy will be even greater, since the monetary policy of the ECB will be aimed at maintaining price stability in the eurozone as a whole. Without active adaptation of fiscal policy its effects on the SR economy need not be optimal. It will be the fiscal policy which, in cooperation with other policies, will ensure overall economic stability. Therefore it is necessary that for fulfilling these tasks fiscal policy creates room so that in the case of the operation of automatic stabilisers or in the case of adopting discrete stabilisation measures conditions of the Stability and Growth Pact are not

[1] It is estimated that in 2006 – 2007 the criterion value should be approximately 2.7 – 2.8% (HICP)

breached. This room is to be created by the consolidation of public finance, directiong it in particular towards a balanced budget.

1.1 The issue of budget consolidation

Consolidation of the budgetary situation has been underway for several years now at a relatively fast pace. It has been accelerated in the past two years[2] as part of a conscious strategy, the basis of which comprises structural reforms and the aim of which is the fulfilment of conditions for entering the eurozone. The current level of the budget deficit (3.5% of GDP in 2003, ESA 95) is higher than the criterion value for fulfilling the Maastricht Criteria. The outlook for budgetary management[3], moreover, forecasts in the development of the overall and structural deficit in the coming years a slight transitional worsening[4]. In the case that the costs of transforming the pension system are not included in the deficit, the 3%-level of the total deficit will be reached in 2006, and by 2010 the public budget will have reached a surplus of 0.6% of GDP. In the case of including the costs of transformation, the public finance deficit should reach the level of 3% of GDP only in 2007[5]. Subsequently in 2010 the public finance deficit should be only 0.7% of GDP. This means that the consolidation of public finance will continue also after having achieved the 3% deficit level, at a rate of approximately 0.8% of GDP annually.

The rate of economic growth and rate of consolidation

Budgetary consolidation relies primarily on fast economic growth. This enables the share of the deficit in GDP to be reduced without a reduction in real expenditures[i]. The Convergence Programme forecasts that the share of incomes to the public budget in GDP has settled at approximately 37.5%. The average rate of growth in the SR economy up to 2010 should be around 4.5%[6]. In the case of a complete halting in the growth of real volume of expenditures the share of expenditures and the share of the budget deficit in GDP will decrease by more than 1.5% GDP annually[7]. Such a restriction on expenditures and such a fast reduction in the deficit however are neither realistic nor necessary. It is possible to achieve the necessary reduction in the deficit at a rate of 0.7 – 0.8% of GDP annually, following the implementation of planned structural reforms, even if some of the public budget expenditures grow in real terms.

Structural reforms and the rate of consolidation

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[2] The public finance deficit in 2001 represented 6.0%, in 2003 only 3.5% of GDP.

[3] Data is based on the Convergence Programme (CP) and Medium-Term Budgetary Outlook (MTBO), of the Ministry of Finance of the SR, 2004.

[4] As a consequence of budgetary relations between the SR and the EU (even if the SR as a whole will significantly profit from entry) and the costs of pension reform.

[5] Despite the EUROSTAT decision to include the costs of transformation, the evaluation of the deficit defined in such a manner is not yet completely clear. In the case of a better than forecast development of public finance it is possible to achieve a reduction in the deficit to 3% of GDP already in 2006, even in the case of including the costs of transformation.

[6] The Updated Monetary Programme of the NBS forecasts that over the period 2006 – 2007 GDP growth may be even higher (5 to 6%).

[7] Such a rate of reducing the deficit is theoretically possible, because it counts on, as already stated, the **complete halting in the growth of the real value of** public budget **expenditures** as a whole and, moreover, it counts on the fact that **income growth will depend directly on GDP growth** and the growth in the expenditure deflator is identical to the GDP deflator.

In the case of certain types of expenditures it is necessary to count on real growth. Growth in average real wages in the public sector should over the medium term approximately copy the growth of real wages in the private sector. These will grow at a rate of 2-3% annually[8]. Savings in real wages may be achieved only if the process of improving the efficiency of public administration is continued and labour productivity in the provision of public services is further increased. This requires the completion of **reforms in particular in public administration, education system and healthcare**, which will lead to staffing savings. For example, the Convergence Programme forecasts growth in the average real volume of wages in the public sector at a rate of 2%. Faster real wage growth will be possible only through realising staffing savings.

Expenditures on goods and services may be decreased in the case where these goods and services have been hitherto purchased in a surplus or inefficient manner. Otherwise it is necessary to maintain at the very least the real volume of these goods and services. Development will probably lead to ensuring public services through their purchase from the private sector. This could contribute to staffing savings in the public sector.

Transfers to enterprises, in particular agricultural enterprises, depend to a large degree on reforms in the EU. These reforms are, among other things, also an important factor in the competitiveness of Slovak agriculture vis-à-vis the other agricultural industries of other EU Member States.

The volume of transfers to inhabitants from the public budget is given by two factors. Firstly, it is necessary to maintain a certain proportion between the average level of certain transfers (in particular where these represent the sole source of income) and the average income. If their level is not inappropriate it is necessary to maintain also their average real level. Secondly, their volume, in particular in the case of transfers of a social nature, changes over the course of an economic cycle. The actual solution to savings in this field is a reduction in the number of recipients. This should be made possible by the way of a thorough displacement of the actual dependency rate on the respective (social) benefits and a decrease in unemployment.

Social insurance expenditures depend on the number of insured persons and the valorisation of their claims. Savings are expected also from eliminating abuses of the system[9]. The predicted slowdown in the growth of the number of insured persons through the deferral of retirement age to 62 years will bring expected long-term savings, only if the labour market manages to absorb at least a part of this extra growth in the workforce, and if no large-scale early retirement occurs. In the case of newly recognised pensions valorisation of claims at present is calculated from average wages and recognised pensions are subsequently valorised according to the Swiss method (50% growth of nominal wages, 50% growth of consumer prices). It is forecast that in the future the retirement age will be further increased to 65 years (and the number and volume of pensions will thus be reduced) and the valorisation of recognised pensions will be made only in line with inflation.

Health insurance expenditures depend on the realisation of respective reforms. These should ensure that the following shares in GDP are stabilised:

- payments from insurance companies 5.2% of GDP,

[8] The Convergence Programme (Ministry of Finance of the SR), Medium-Term Monetary Outlook (NBS)

[9] E.g. sickness insurance, invalidity insurance.

- direct payments of insured persons 1.3% of GDP.

The sum of payments of 6.5% of GDP should cover healthcare costs. An important element of the proposed reforms is the introduction of pressure for the economic management of bodies in the healthcare industry. In the long term the Convergence Programme reckons that the share of healthcare expenditures in GDP will grow, though the total burden of growth will not necessarily be borne by public finance.

The share of revenues to public budgets in GDP should be more or less constant at the level of 37.5%. This development requires that both the share of non-tax revenues in GDP as well as the share of funds from the EU at approximately 2.3% of GDP be maintained also after 2007, or that the parameters of the tax and delivery systems be adjusted so that total revenues in GDP remain unchanged. In the case that this does not happen, the redistribution through public budgets will be smaller and pressure for reducing expenditures greater. This pressure may be mitigated, if the economy grows faster. Therefore it will be necessary to make a complex assessment of all further proposals for reducing the tax burden.

Budgetary consolidation and the reduction of budgetary expenditures

The reduction of budgetary expenditures (their share in GDP) is the most efficient way how to reduce the budget deficit. Reducing expenditures not relying on structural reforms represents a short-term solution, which can have only limited extent. The reduction of the deficit in such a discrete budgetary measure relies on the connection between budget revenues and expenditures. Reduced demand in the economy, caused by a reduction in expenditures, subsequently leads to the fact that also revenues to the budget are decreased. This decline on the budget revenue side is however less than the decline in budgetary expenditures. The reduction in the deficit following the decrease in expenditures by 1% of GDP may theoretically be as much as 0.6% of GDP. The actual effect depends to a large extent on when over the course of the year the expenditures are restricted and with what time delay the real savings show through. If the restriction is concentrated in the first months of a year, it will be reflected in the full extent. If the restriction is made only at the end of the year the reduction in the current year deficit will be less and the budgetary restriction will influence also budgetary management in the following year.

1.2 Sustainability of debt and sustainability of consolidation

The level of gross public finance debt in Slovakia represents 42.83% (31.12.2003). On the other side public sector assets (deposits and cash) represent approximately 13.63% of GDP (31.12.2003) and thus the net level of debt is less than 30% of GDP (29.2% as at 31.12.2003). Although existing conditional and hidden liabilities move in the range of 5-10% of GDP, they are more than covered by mobilisable tangible and intangible assets. This means that for assessing the level of debt we can work from a level of around 43% of GDP (gross) or 30% of GDP (net).

Sustainability of debt

The condition of public finance debt sustainability is that deficit financing does not increase the level of debt[ii]. In order that the level of public debt does not change, the share of the primary budget deficit in GDP must compensate for the share of debt interest costs in GDP. The interest costs on the debt depend on the difference between the level of interest rates and the rate of economic growth. The higher the level of economic growth above the level of interest rates, the deeper the primary deficit (negative balance) can be and conversely, high interest rates with slow economic growth require a positive primary balance, if we want to avoid increasing the level of debt. For example, the specific figures for the SR economy show that the primary deficit in 2004 could also be negative. It should however be better than -1.2% of GDP, so that the current level of (gross) debt is not increased.

Risk of growing indebtedness

It generally applies that growing indebtedness increases the risk premium and thus the interest rate in financing a debt. The risk premium is higher in countries that are less economically and politically stable. Transforming economies have a higher risk premium and although they may be temporarily able to finance their debt also under better conditions, over the long term they must reckon on worse debt financing conditions. Besides this, there is in these countries a greater volatility of GDP and budget revenues. Maintaining the level of indebtedness in these countries is possible only if the level of debt itself is not too high. Estimates (by the IMF[10]) state that a country in a transformation should not have a level of public budget debt above 25% of GDP. Through entering the European Union and implementing structural reforms Slovakia is gradually ridding itself of the term "transforming economy". The prospect of membership in monetary union increases confidence in domestic policies, improves the outlook for debt financing costs and increases the sustainable level of debt to approximately 50% to 60% of GDP. Slovakia's current level of debt of 43% of GDP thus appears acceptable. Its further reduction is nonetheless desirable. It is necessary especially in order to strengthen positive expectations in relation to the long-term development of the economy and to not lose investors' confidence.

Costs of pension reform

In assessing the level of net debt, which represents less than 30% of GDP[11], it is necessary to draw attention to the costs of transforming the pension system. Transformation costs are estimated over the long term at up to 2% of GDP annually. The interest costs of such a debt would be more than 1.5% of GDP[12]. It may be argued that the deficit ensuing from settling transformation costs does not represent a direct loosening of fiscal policy and that these costs should not be taken into account in assessing the fiscal position - deficit. It is however necessary to take heed of the fact that these costs, unless they are settled from budgetary savings, contribute to the public finance debt. Were budgetary consolidation to be aimed at achieving a balanced budgetary position, but did not take account of the costs for transforming the pensions system, the safe fulfilment of the deficit criterion (3% of GDP) would not be guaranteed in the long term. It is thus clear that maintaining a balanced budget should also take account of these costs. Furthermore, in the long term a slowdown in the economy's growth is expected in consequence of the decline in labour force resources[13]. Slower growth could subsequently cause a halting or reversal in the development of the level of public finance debt.

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[10] Schadler, S., Drummond, P., Kuijs, L., Murgasova, Z., van Elkan, R.: Euro Adoption in the Accession Countries Vulnerabilities and Strategies. Paper for Conference on Euro Adoption in the Accession Countries, Czech National Bank, Prague February 2004.

[11] Complex Analysis of Public Sector Debt, Ministry of Finance of SR, 2004

[12] The estimate of the costs and total volume of costs depends on what interest is shown by insured persons in saving for pensions in the 2nd pillar. It cannot be excluded however that the annual costs for transformation will be higher, for example 1.5% and the total volume of transformation costs will be as much as 50% of GDP.

[13] This is one of the expected manifestations of Slovakia's ageing population.

As we have stated, if the economy grows quickly, for example at rates above 4% annually, and real interest rates are low, for example 1-2%, it will be possible to stabilise the rate of public finance debt[14] even if the public budget results in a primary deficit[15]. Such a situation is created through the convergence of (long-term) interest rates to the level of those in the eurozone and itwill persist for a certain time following entry to the eurozone due to real convergence[16]. It is a unique situation, enabling in the coming period the settlement of pension reform costs through the primary deficit, but despite this it would not lead to a growth in the level of debt. In the future, in the case of a slower growth of the economy, the transformation costs of pension reform would already create pressure for a growth in the level of debt and the need for further budget consolidation.

1.3 Cyclical development of the budget and risks of exceeding the 3% deficit

Aiming at a balanced budget may appear an ambitious target for public finance. Formally this target results from the commitments made in the framework of the Stability and Growth Pact. The actual reason for reducing the deficit towards this long-term aim is to achieve a long-term sustainability in public finance. Naturally, economic fluctuations may deflect the level of the deficit from its structural level in one direction or the other. If we want to guarantee that the budget deficit, even despite these deviations, does not exceed the upper limit (3% of GDP), it is necessary that the structural deficit over the long term moves on average sufficiently below this upper limit or towards a balanced position. Besides this, it is necessary to take heed of the fact that measuring itself of these fluctuations and their forecasting is problematic and represents a source of uncertainty in relation to the budget results[iii].

Cyclical variability of the budget

Determining the development of the budget over the course of an economic cycle relies on knowledge as to how the budget reacts to (cyclical) development in the economy. Usually this is based on the simplified assumption that budget revenues change in a linear manner with changes in gross domestic product[17] and that their reaction is immediate, without any time delay. The cyclical movement on the side of expenditures is connected with the changes in certain components of expenditures. For example, social benefits or pensions paid out react to developments on the labour market – in particular to unemployment. Other components on the expenditure side are usually set autonomously and do not have a direct relations to the economy's development – they do not have a cyclical character[iv].

The variability of output over the economic cycle in Slovakia moves between 1 to 2%. The elasticity of total budget revenues to output is less than 1 – we estimate it at 0.8 – 0.9. This means that cyclical fluctuations on the revenue side of the budget should move in the band of 0.3 – 0.7% of GDP[18].

[14] The share of public debt in nominal GDP.
[15] Were the costs for transforming the pension system to be higher, for example 1.5% of GDP, it would be possible thanks to fast growth to stabilise the level of debt at approximately 50-60%.
[16] Thanks to the faster growth of the SR's economy and gradual approximation of price levels in the SR to those in the EU.
[17] The respective elasticity of budgetary incomes in (nominal) GDP is unitary or close to one.
[18] 0.4*(0.8 to 1.8)% = 0.3 to 0.7% GDP.

The reaction of employment to economic growth in Slovakia has been relatively weak[19]. Growth in the economy is relying prevailingly on the growth in the total factor productivity and therefore the high economic growth is increasing employment only by a small degree and conversely, a slowdown in growth has smaller impacts on employment than in advanced countries of the EU. Besides this, high unemployment in Slovakia is primarily of a structural nature and a large part of social payments is paid out on a permanent basis (in connection to the high share of long-term unemployment). The economic cycle has a certain influence on social insurance expenditures. Changes on the expenditure side of the budget over the cycle are in total in Slovakia relatively small. We estimate the respective effects on the budget expenditure at 0.1 to 0.2% of GDP.

The total effect of the economic cycle on the budget deficit will be in the range of 0.4 – 0.9% of GDP, though we consider values of up to 0.5% of GDP as more probable.

A slowdown in growth and the impact of demand and supply shocks

From the aspect of budget stability and the risk of exceeding the 3% deficit limit it is necessary to take into consideration not only cyclical variability of output and budget, but also total variability. As we have stated, a fast rate of consolidation depends on fast economic growth. We can forecast that over the **long term** economic growth should not slow down below the limit of 2%. This results from knowledge of the catching-up process. The latter is faster in countries with a low level of production, such as Slovakia. Although in the case of such a slowdown in economic growth the room for consolidation is reduced[20], the necessary rate of consolidation is not threatened. It is however necessary to reckon with a certain negative impact on the deficit (of less than 0.5% of GDP) in such an economic slowdown. Nor can the possibility of large **short-term** fluctuations in consequence of various shocks and disruptions be excluded. A deep, though only temporary, decline in the rate of economic growth may have consequences on fulfilling budgetary aims. With a fast rate of economic growth there is usually connected also the risk of large fluctuations in the rate of growth, including such fluctuations that may threaten the fulfilment of the target value for the deficit. It is necessary to reckon on this also in Slovakia’s future economic development.

Overall assessment of sustainability over the budget developmentt

From the partial estimates stated above it ensues that the variability of output, in consequence of the action of short-term shocks and the cyclical development of the economy, should not exceed 2 – 4% of GDP, and thus, the resulting fluctuations in the budget deficit should not exceed 2% of GDP. Fluctuations in economic activity will more likely be less than 2% of GDP and impacts on the budget should not exceed 1% of GDP. This thus means that if the public finance deficit is successfully reduced below 2%, the probability of exceeding the 3%-limit over the course of a cycle or in consequence of ordinary economic fluctuations will be small. If we reach a position close to a balanced budget, any exceeding of the 3% deficit limit will be highly improbable.

A fluctuation in economic activity counter to the prevailing trend may have the nature of a standard economic cycle, or may be a multi-year slowdown in the economy, or may represent a short-term reaction to a demand- or supply-side shock. The budget balance may be worsened or improved against the long-term trend by these fluctuations. A

[19] The fluctuation of employment in connection with the fluctuation of output is described by Okun’s Law.
[20] To less than 1% of GDP annually.

possible worsening of the balance should not however threaten the overall direction toward achieving a balanced budget. After attaining a balanced structural budget position fluctuations in the budget should not represent a danger from the aspect of maintaining a budget deficit below the limit of 3% of GDP, nor from the aspect of the sustainability of the level of debt.

1.4 The budget as an automatic stabiliser of shocks

If on the one hand it is possible that cyclical fluctuations in the budget will not be large, on the other hand this means that the budget will fulfil the role of an automatic stabiliser only within a limited extent. In the period of a boom only a small volume of the additional funds will be withdrawn from the economy to the public budget via higher taxes and deliveries and in the period of a recession only a small volume of the additional funds will be released into the economy via lower taxes, the social system and unemployment support (we have estimated the overall impact at less than 0.5% of GDP). Besides this, Slovakia as a very open economy does not absorb such an impulse in the internal economy – the prevailing part, approximately 60 – 70%, of the fiscal impulse is absorbed in imports.

The disadvantage of weak automatic stabilisation by means of the budget lies in the fact that one instrument for stabilising the economy will not be sufficiently effective. Economic policy must reckon with this fact. In connection with entering the eurozone,necessary will be not onlyl cardinal reforms enabling budgetary consolidation and measures for establishing a balance, but also room for discrete fiscal policy interventions in the case of the emergence of adverse shocks. In this regard it will be necessary to consider whether automatic stabilisation through suitable measures needs to be strengthened.

2. Monetary policy

Reduction in monetary policy autonomy

The essence of the problem facing monetary policy in the coming period lies in a certain loss of the NBS monetary policy autonomy in conditions where it is to achieve exchange-rate stability and where, concurrently, the movement of capital is liberalised[v]. In the past, liberalisation was not complete (exchange-rate risk and the risk premium created certain room for the autonomous movement of interest rates). Movement of the exchange rate was possible, though within a regime of managed floating the short-term fluctuations ensuing from market fluctuations were eliminated. The effects of the free movement of capital were partially eliminated by foreign exchange interventions..

The problem of the central bank of a small country, such as Slovakia, is that its possibilities for intervention are limited – the volumes of funds for intervention are usually less than those which foreign investors are able to use in a currency attack or massive speculation. The central bank would in the case of a large movement of capital on the foreign exchange markets be forced to either surrender autonomous interest-rate policy, thereby losing a basic instrument for influencing developments (of inflation), or would have to accept exchange-rate movements caused by capital movements. This would have the consequence of high exchange-rate volatility, serious disruptions and the inefficient decision making of households and enterprises in relation to abroad, and serious consequences for overall economic stability. A small open economy such as that of Slovakia cannot afford a completely free exchange rate. The ERM II mechanism is, though, a regime in which exchange rate stability is directly required.

The issue of interest rate convergence

Besides the reduction in autonomy, monetary policy prior to entering the eurozone faces a further task. On the one hand, long-term interest rates and inflation are to converge to the level of those in the eurozone. Short-term rates should also be at such a level that immediately following entry to the eurozone no monetary shock occurs due to a sudden loosening of monetary policy. On the other hand, as a consequence of catching up to the eurozone, the real (and also nominal) exchange rate has a tendency to strengthen. In result there arises a specific situation – real interest rates, not admitting interest rate arbitrage[21], should in Slovakia be low or negative. This could have an impact on overall macroeconomic stability, due to the fact that risks of a credit boom, growth of domestic demand and of overheating of the economy may be increased. (This issue is dealt with in a separate part of the document, page 13).

Monetary policy of the NBS prior to entering ERM II

At present monetary policy in the SR is performed in an environment of a relatively extensive administrative interventions in the price level and negative real interest rates. The positive interest-rate differential against abroad, together with the favourable development in the fiscal area and productivity growth, as well as in connection with generally favourable expectations, creates pressures for a strengthening of the exchange rate.

The inflow of capital, which is an accompanying sign of the stated facts, has a dual nature. It can take the form of foreign direct investment, which from the aspect of the need to overcome the lack of physical capital may from the material aspect be unequivocally welcomed. This inflow of capital is connected with the privatisation activities of the government and with investment in the private sector[22]. On the other hand, it can concern the short-term inflow of speculative capital with a potentially destabilising effect. In assessing the inflow of foreign capital it is important to differentiate the inflow of FDI from the inflow of speculative capital.

The issue is a sudden movement of large volumes of speculative capital. The specific causes of an inflow lie in increased demand for Slovak assets, which is caused by a growth in their attractiveness, in consequence of which investors join the “convergence game”. In the background there are significant differences in interest rates in comparison with the eurozone and also the expected future appreciation of the Slovak koruna. The connection is also to the removal of political uncertainty (accession to NATO, the EU) and the further liberalisation of the movement of capital following accession to the EU.

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[21] This relies on the real condition of interest rate parity.

[22] In order to limit significant exchange-rate volatility the NBS buys up foreign exchange privatisation revenues from the government, whereby the foreign exchange reserves are increased. The koruna equivalent of privatisation revenues is, depending on their use, directly or indirectly, fully sterilised. Though privatisation revenues thus increase the sterilisation position of the central bank, they do not however have any influence on the exchange-rate movement.

FDI headed toward the private sector may induce a certain pressure for exchange-rate appreciation. On the other hand however they contribute to increase the competitiveness of the economy, the growth of potential output, labour productivity and to an acceleration in the real convergence process. Over the medium term they thus represent an impulse for the appreciation of the equilibrium real exchange rate. (Assessment of the stated facts in the Convergence Programme).

In connection with the inflow of speculative capital the NBS essentially has the possibility to exercise three procedures (or a combination of them):

- To implement a sterilised intervention in an effort to avoid too strong or too fast appreciation of the koruna. Systematic sterilised intervention would however be counter-productive, since it keeps Slovak assets undervalued and supports the inflow of capital.
- To allow an appreciation of the koruna, which would lessen the advantages of any possible convergence game and thereby also the stimuli for a short-term inflow of capital. This is possible only if the appreciation of the exchange rate does not adversely affect competitiveness.
- To reduce interest rates. This would to a certain extent lessen stimuli to convergence games, but on the other hand threaten unleashing demand-side pressures. This may mean a renewed increase in the current-account deficit of the balance of payments and an increase in inflation.

The NBS endeavours in its procedures to combine in an optimal manner options stated. In the case of the emergence of more significance pressures for an appreciation of the koruna not corresponding with economic fundamentals, it intervenes on the foreign exchange market, or reacts to the inflow of speculative capital through a change in key rates. Reducing key rates with the view of limiting unjustified growth in the appreciation of the Slovak koruna, however, impinges on the limit, given by the price target.

It is clear that none of the monetary policy measures in isolation, nor even a combination of them, is sufficient to eliminate the issues connected with the inflow of speculative capital. This is based on investors' expectations that the value of Slovak assets will continue to rise. Steps which can be undertaken for stabilising this process lie in the coordination of all relevant policies including their timing. As regards the limiting of negative influences there may occur in particular:

- the setting of the policy mix towards a tightening of fiscal policy and a loosening of monetary policy, and this in the sequence stated so that the disinflationary process or current account of the balance of payments are not threatened, where the overall effect of these policies should be moderately restrictive,
- the application of an incomes policy, which relies on the non-inflationary development of wages,
- the realisation of fiscal and structural reforms. These are of key importance also for supporting growth in productivity and competitiveness.

Monetary policy of the NBS following entry to ERM II

Entry to ERM II means further limits for monetary policy: the exchange rate must move in a defined fluctuation band and inflation must converge into a range meaning the fulfilment of the respective Maastricht criterion. The use of short-term interest rates also has its limitations. Besides other things, short-term interest rates at the end of the country's operation in the ERM II must not be too far from those of the ECB, otherwise the country at the time of introducing the euro, when the interest rate conditions set by the ECB will already apply, will be threatened with instability caused by a sudden change in interest rates.

In contrast to the present, over the time of Slovakia's entry and operation in ERM II the extent and impact of administrative interventions on inflation will be reduced and other factors crucial for further disinflation will come to the forefront. In addition to classic factors, such as costs (wage, energy, imported), they will be primarily: the nature of macroeconomic policy (monetary and fiscal policy, namely), the mutual setting and time management of policies, rigidity in markets (for example on the labour market), the level of competition in certain sectors of the economy, exogenous shocks. Factors connected with catching up, caused by the BS-effect, will however continue to operate[23]. It may even be expected that their effect will grow. A significant role in disinflation will play (dis)inflationary expectations, where their importance lies in particular in reducing the economic costs of disinflation[24]. For example in Greece, Spain, Italy and Portugal the direction towards the eurozone and the related confidence in disinflation and the disinflationary targets had its influence on wage discipline,wage negotiations and labour costs. A recent example are agreements signed between the Slovenian government and trade union representatives for the public administration and for the private sector on wage growth over the years 2004 – 2006, i.e. over the period of Slovenia's membership in ERM II. The reducing of inflation depends also on the ability of monetary policy to influence significantly (or maybe to change) previous habits and behaviour in the economy. Experience from many eurozone countries also shows that membership in ERM / ERM II itself was an impetus to accelerate the disinflation[25].

The current form of the NBS's monetary policy based on implicit inflation targeting is not in principle a barrier to perform convergence strategy. From the aspect of its nature (clear definition) it may be compared with, for instance, the national central banks' policies of Italy, Spain and Greece in their pre-accession period. The harmonisation of monetary targets with other components of economic policy and the credibility of the inflation target will be essential.

Following accession to ERM II the exchange rate, besides inflation, will also become a monetary policy target. It should however be subordinate to fulfilling the main aim, which is price stability. With regard to the fact that over the longer term a conflict between the aim of price stability and that of the exchange rate may occur, Slovakia's membership in ERM II should not exceed the time required for fulfilling the Maastricht exchange-rate criterion[26]. Even if the conditions of ERM II prefer exchange rate movement close to the central parity, convergence of the economy and growth in its competitiveness may result not only in an appreciation of the equilibrium real exchange rate, but also in pressure for a strengthening of the nominal koruna exchange rate against the euro. The stimulus for a further appreciation of the equilibrium real exchange rate will primarily be an inflow of foreign direct investments, growth in productivity and competitiveness of the economy, which such investments bring. The presumed appreciation of the exchange rate connected with the inflow of FDI should thus not have an adverse effect on the Slovakia's balance of trade. Monetary policy should also correct the significant short-term fluctuations of the exchange rate from its equilibrium course caused by speculative capital movements. In connection to this use of interventions on the foreign exchange markets is expected, and this also with the support of the ECB. The

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[23] The previous experience of acceding countries however shows that the BS-effect plays only a limited role. In the conditions of the SR estimates of the extent of the BS-effect's operation range in an interval from less than 1% to at maximum 2% of the influence on inflation.

[24] The costs of disinflation are usually measured in terms of the decline in output, or the slowdown in its growth.

[25] This was most clearly demonstrated in countries with high inflation in the past, such as Greece, Spain and Portugal.

[26] This position in principle does not mean that ERM II is understood as a "waiting room", but it means that this period is sufficient for achieving the desired progress in nominal as well as real convergence.

sterilisation of any possible privatisation revenues is assumed to continue by their depositing in the NBS account[27].

Following the change in the exchange rate regime in 1998 the nominal exchange rate of the koruna against the euro gradually stabilised. Any significant fluctuations have been caused largely by non-economic factors. In the past two years the nominal exchange rate has even gradually appreciated. The assumption is that the stable development of the exchange rate will continue also after entering the ERM II exchange rate mechanism.

3. The financial market

A liberalised financial market represents, in contrast to the situation which characterised economies 40 years ago at the time of the emergence of the optimum monetary area theory, a substantial change in conditions for operating in a monetary union. The movement of capital towards unused and cheap workforce enables that real and nominal shocks in a national economy within the monetary union must not have fatal consequences on economic activity, and this despite the unliberalised conditions of workforce movement from Slovakia to the rest of the EU. A prerequisite of such an operation of the financial market is its full and efficient integration. The direction and entry to the eurozone will further change the conditions for functioning of the financial market including the banking sector in Slovakia, through removing the exchange-rate risk in the movement of goods and services and capital between the eurozone and the Slovak economy. Therefore it may be expected that competition on the domestic financial market will continue to grow, in particular foreign competition.However, increase may be expected also in the market room and allocation efficiency and competitiveness of the domestic financial sector. The integration of the domestic financial sector in the EU financial sector (eurozone) will bring about a principal improvement in the preconditions for stability. However, the increased risk of consequences from global disequilibria or crises must not be omited.

Slovakia and the single financial market of the eurozone

Currently the single financial market of the eurozone is still at a formative stage. Only the adoption of necessary legislative standards at the European-wide level and their coherent implementation and enforcement at the national levels will enable to achieve the maximum benefit resulting from an integrated financial market and common euro currency. Stronger integration of the financial services market in the eurozone will enable growth in competition between stock exchanges and other financial intermediaries, increase in the liquidity of financial and capital markets and better diversification of portfolios. The result should be a fall in the costs in acquiring share capital, a fall in costs for businesses in acquiring resources through bond issues, cheaper financing through bank loans, growth in the share of financing via bond issues in overall debt financing and a higher quality of services provided. Subsequently, the macroeconomic effects should bring material benefits in the form of higher economic growth and an increase in employment in eurozone.[28]

[27] It is assumed that the balance of trade deficit over the years 2004 – 2007 should move in the range of 3 – 5% in GDP (current account deficit in the range of 2 – 4%). Convergence Programme of Slovakia for 2004 – 2010).

[28] A study prepared for the European Commission (London School of Economics, 2002) states an estimate that the combined influence of a fall in acquiring share capital, a fall in the costs of bond and credit financing and a growth in the share of bond financing in the total debt financing will lead to additional growth in real GDP in the Union over the long term (10 years) of 0.3% to 2.0%. For most Member States, the mentioned study however estimates additional growth within the range of 0.9 to 1.2%. Overall employment in the Union will increase by 0.5%.

The transposition of all new key directives into national legislations is expected at latest by 2007. In the forecast period for adopting the euro in the SR (2008 - 2009), some of the mentioned positive effects should have already begun to appear in the eurozone. At the same time, in this period it may be expected, for the same reasons, that activities in the field of European financial sector consolidation will intensify, which may be reflected also in the financial sector in Slovakia[29]. Consolidation via mergers and acquisitions of financial institutions leads to a higher market concentration. Concentration in the banking sector will bring about a growth in efficiency.

Growth potential of the Central & Eastern European region

The Slovak financial sector as well as financial sectors of the other acceding countries of the Central and Eastern Europe (CEE) are, in comparison with the Western European countries, still at a relatively low level of development. Typical of them is the dominant share of the banking sector and the relatively low level of financial intermediation. The growth potential of the financial sector of acceding countries from the Central and Eastern Europe is large. Its full use is related to the economic catching up with the Western European countries (real convergence), with post-privatisation restructuring, modernisation and consolidation of the sector and standardisation of the legislative and institutional environment. With the aid of foreign capital and related technological and managerial know-how to the Slovak banking sector the process of building up a modern financial services sector has been intensified. Its efficiency is being improved and its stability strengthened. At the same time financial integration of the Slovak economy into the EU has been deepened.

Through acceding to the EU, in particular through a change to the regulatory environment and the resultant influence of the growth in competition, further deepening of the financial sectors of acceding countries, including Slovakia, and a more active role of the financial sector in the efficient allocation of funds are expected. A more developed financial sector will thus at the same time generate pressure on restructuring of the business sector towards increasing its performance and productivity and improving corporate governance and management[30]. Deepening the financial sector (in its structure and size) and a full integration of the domestic financial sector into that of the eurozone are important also as preconditions for the efficient transmission of monetary policy.

Accession to the EU and adoption of the euro will have for Slovakia prevailingly positive influence on the internal financial stability. To a large extent this is already apparent as a consequence of:

1. standardisation of the legislative and institutional environment for conducting financial institutions, their regulation and supervision, progress in solving insolvency and bankruptcy cases,
2. the pressure of European institutions on policies (in particular on fiscal policy) in the context of the coordination mechanisms for economic policies of Member States.

[29] In this context, of key importance is, probably the most problematic, (from the aspect of the ability to achieve European compromise with regard to its text) the Takeover Directive. However opinions exist that even favourable institutional environment will not accelerate European-wide consolidation in the financial sector. Barriers are language and culture, but in particular the high regulatory costs for financial institutions in consequence of unharmonised financial supervision at national levels and inconsistent national implementation of the European regulation standards for financial services.

[30] This "cleaning up" of the business sector occurred in, for example, the period of economic stabilisation and restructuring and privatisation of the banking sector in 1999 - 2001.

The risk of a credit boom

Recent essays and studies (BIS 2004, Tůma 2004, Flynn and Golden 2003) draw attention to the fact that the accession to the EU and adoption of the euro will not solve all challenges for financial stability for the acceding countries, but may actually bring about new risks. Among the relatively often mentioned risks that may arise following accession to the EU and subsequently to eurozone it is the risk of the economy overheating, connected with risks for the financial sector, resulting from the financial (credit) boom[31]. Though the current macroeconomic and financial indicators in Slovakia do not signal the existence of these risks, the possibility cannot be excluded that we will have, to a greater or lesser extent, to face them in the coming future. Prudence is important for the following reasons:

1. Adoption of the euro and the already mentioned other factors (continuing internationalisation in the finance business, technological progress and financial liberalisation) will facilitate even more the movement of capital from and to the economy (financial sector) of the SR. Growing financial integration may cause a change in the volume and structure of capital flows.
2. Entry to the eurozone is connected with nominal convergence, a component of which is also a fall of interest rates to those of the eurozone, thus increasing the affordability of loans.
3. The ongoing economic growth (real convergence) and the overall improving economic situation may induce optimism with regard to the future development and subsequently a greater willingness of economic entities to enter into debt.
4. The weak effect of monetary policy before entering the eurozone and the loss of monetary autonomy after adopting the euro limits the ability to react effectively to the economic cycle.

Ad 1: The growing credibility of the Slovak economy, introduced reform measures, openness of the economy and higher efficiency of investments support capital inflow and expectations that the inflow of foreign direct investments will continue also in the future[32]. An advantage resulting from FDI is stability and the positive effect on the growth of the economy's potential thanks to the technology transfer, know-how and subsequently the higher labour productivity. This however does not guarantee that the FDI inflow may not be suddenly suspended. To predict how the short-term, and thus the more volatile forms of capital, will behave is much more difficult. Their movement will be determined by the perception of the future development in Slovakia from the side of investors and by the expected development in domestic policies. Convergence of interest rates to those of the ECB may partially reduce the inflow of this form of capital. Real catching up however will continue to provide investors speculating on a strengthening of the Slovak koruna exchange rate with an opportunity for profit. Moreover, since Slovakia is a relatively small market, the behaviour of this capital will be affected by the development in the markets in the Central and Eastern Europe region.

[31] An overheating of the economy is a consequence of an inappropriate, excessive level of economic activity, exceeding its potential. There are various macroeconomic causes for overheating, for instance excessive consumption and investment or foreign demand shock. A credit boom represents one specific risk. A credit boom represents a high, unsustainable growth in loans with regard to the long-term trend of credit growth.

[32] Another important factor affecting the FDI inflow are investment stimuli for foreign investors provided from public funds.

Ad 2: The effort for the earliest possible accession to eurozone is conditional upon the nominal convergence of the economy of the acceding country to the eurozone economy. In the framework of the nominal convergence the approximation of key interest rates of the national central banks of the acceding countries to those of the ECB also takes place. A fall in key interest rates will make loans cheaper for businesses and households. A possible inappropriate and excessive growth in loans may lead to a fast growth in asset prices, mainly those of real estate, which may be unsustainable. The growing value of assets used as collateral supports further indebtedness and growth in consumption. The credit boom may thus lead the economy above its potential, consequently inflation, prices and the volume of assets will increase. An excessive and inappropriate growth in bank loans thus may cause the economy to overheat. Subsequent correction accompanied by a cooling of the economy, by way of credit restriction and a fall in asset prices, represents a problem not only due to its destabilisating effect on the real economy, but in particular due to the fact that it increases the risk of financial crises.

Ad 3.: The growing competition and effort to gain, or sustain the share in the banking market with a large growth potential will create pressure for higher exposure of banks to the business sector[33]. We expect that this will be accompanied by an improving institutional environment, a falling level of risk and a decline in the cost of credit resources for businesses by simplification of administrative requirements in arranging credit and loans. The number of productive and competitive projects, mainly in the field of small- and medium-sized enterprises and the improving income situation of households will have a favourable impact on the growth of credit. The arrival of foreign companies with good and long credit history in the domestic market may be another factor for growth in credit activity of banks in relation to non-financial corporations.

The Slovak banking sector as a whole may be considered as stabilised and competitive. It reports above-standard parameters of capital and financial stability. Following its restructuring it has achieved balance-sheet equilibrium. It has the prerequisites and room for fast growth and maintains a low rate of credit risk. It has significantly increased its capitalisation. It reports standard values for profitability parameters and stabilised reproduction of cash-flow. However, it is at the same time necessary to emphasise that banking sector assets in relation to the scope of flows of incomes in the economy are small, which is probably related also to the competition from foreign providers of financial services. At present, also in consequence of reducing interest rates, it is exposed to the growing competition of other segments of the financial sector and growing cross-border competition. Banks will be affected by pressure resulting from reduced foreign exchange operation earnings and a fall in interest rates. In the medium term the monetary conditions and economic environment will generate stimuli for a strengthened growth of credit exposure of the financial sector against non-financial corporations and households. Also the increased competitive pressure in the financial sector and the room for growth in banks' assets, on the one hand, in the combination with the currently low level of debt and low credit risk of

[33] The hitherto low volume of loans to non-financial corporations is, besides the monetary policy conditions, determined mainly by the relatively high level of risk in the business sector and the related high costly credit process. The high level of risk in the business sector is the result of uncertainty with regard to the influence of the SR's accession to the EU on competitiveness of many Slovak businesses, a still inefficiently functioning system of the rule of law, unclear reporting relating to efforts for tax optimisation and the overall low level of corporate governance and management which often does not correspond to internationally recognised standards. On the other hand many businesses prefer solving their financing through their own retained profit. With the increase in the number of large companies with a foreign stakeholding an improvement in corporate culture may be expected.

households as well as unused room for the growth in assets of business sector[34], on the other hand, create the conditions for a fast growth in loans.

Ensuring financial sector stability and overall economic stability will rely on:

1. strong and healthy financial institutions with good management and corporate governance. These create pressure also for the standardisation of the business sector. Internal control and risk management systems in banks and other financial intermediaries must naturally be of a high quality.
2. flexible forward-looking and risk-oriented financial supervision. A high-quality legislative framework for financial regulation and supervision performance in accordance with the worldwide best practices is essential.
3. a good legislative framework governing the rights of the creditors in cases of bankruptcy and insolvency. Closely related to this is the efficient working of courts in enforcing the relevant rights,
4. an appropriate macroeconomic policy mix, in particular of fiscal and monetary policies, which aggregately should be slightly restrictive,
5. a prudent wage policy and flexible employment and labour market policies,
6. an economic strategy focused on the building up the potential for sustainable economic growth, in particular on supporting stable foreign direct investments.

4. The labour market

Following accession to ERM II the labour market will be exposed to shocks that are currently partially absorbed by the exchange rate and eliminated by monetary policy. Therefore it is essential to know to what degree the Slovak labour market is prepared for this situation.

In essence this concerns assessing certain characteristics of the labour market’s flexibility, such as:

1. wage flexibility (minimisation of wage indexation and nominal and real flexibility),
2. workforce mobility (workforce flexibly reacting to the situation on the market – workforce migration for work),
3. efficient functioning of the labour market institutes – (flexible adjustment of the legislative environment regulating the labour demand and supply, nature and cooperation of trade unions),
4. shock absorption – (ability of wages to absorb short-term shocks at the expense of unemployment).

4.1 The state of the labour market in the SR

Certain structural employment issues

Unemployment in Slovakia is characterised by high share of long-term unemployment. Reducing unemployment in the SR is happening in particular at the expense of short-term unemployment. Fluctuations in long-term unemployment have been mainly due to an active labour market policy in the form of seasonal work and temporary employment. Long-term unemployment, following the termination of temporary jobs and short-term contracts, has been reflected firstly in the growth of short-term unemployment and overall has been persisting at a high level.

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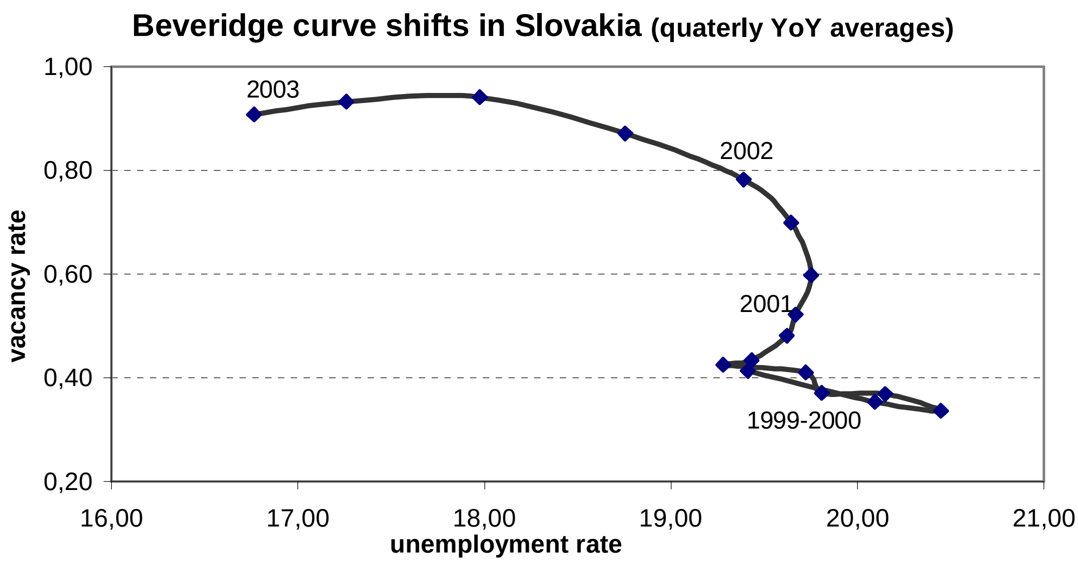
[34] Businesses do not exploit the room for asset growth resulting from their achieved rate of profitability.

In less developed regions the slight increase in employment has been drawing, directly or indirectly, from the sources of short-term unemployment. A large group of long-term (or permanently) unemployed people remains unchanged and is becoming, in large part, unemployable. On the other hand, in economically more developed regions the free capacity of promptly usable workforce is to a large extent exhausted, or only low. In the Bratislava region the rate of unemployment is even approaching the natural rate of unemployment. The increase in employment has thus begun to draw directly or indirectly mainly from the long-term unemployed and from migrating inhabitants. In this region, the level of long-term unemployment has been falling faster than the level of the short-term unemployment. Faster developing Slovak regions should draw their workforce from more backward regions. This process should be ensured through increasing the internal and inter-regional migration of the workforce with the support of measures resulting from the employment strategy.

Looking at the Beveridge curve[35] in the picture below it is clear that at the start of the employment growth trend in 2001 the labour supply was growing fast (in the form of the vacancy rate), while the rate of unemployment has as yet not reacted. In 2002 labour demand recovered and began to absorb labour supply, a consequence of which was a faster move on the curve leftward. Despite the constant growth in labour supply, in 2003 labour demand completely exhausted the registered supply and the curve turned to the lower levels of the unemployment rate at a stabilised level of available jobs. The course of the Beveridge curves differs between regions.



4.2 Wage flexibility

The degree of impact on the labour market caused by a demand or supply shock is dependent upon the reactions of wages and employment to a possible disequilibrium. The problem occurs in particular when wages are indexed according to inflation – past (ex post), current or

[35] The Beveridge curve expresses the relationship between the rate of unemployment and the rate of free jobs[35] in the labour market. The closer the Beveridge curve is to the zero point, the more efficient is the structure and functioning of the labour market in matching the unemployed and free jobs and thus the lower is the rate of the structural unemployment. Values in the graph represent annual averages.

forecast (ex ante). *Ex ante* nominal wage indexation is very rare in Slovakia. Neither is the complete compensation of inflation from past years common[36]. On the other hand wages agreements contain the linking of growth in nominal wages to growth in labour productivity only in extraordinary cases. This economically most acceptable form of wage contract[37] should have greater weighting (with the inflow of foreign investments to the production sector in Slovakia, its more frequent use may be expected). In Slovakia collective agreements are mostly renewed each calendar year, which is a relatively short period. This increases labour market flexibility[38]. Subsequent indexation in Slovakia is also only of little significance. Low indexation of wage development in the SR is a precondition for flexible wages. Flexible wages, their linking to labour productivity are however not a common part of the collective agreements.

Real flexibility expresses the ability of real wages to have a stabilising effect after demand shocks. Adopted stabilisation measures of fiscal policy in the past (e.g. in 1999 and 2003) were accompanied by a fall in real wages. This points to a certain real flexibility in wages[39]. The nominal flexibility expresses the quality of nominal wages to react to the development of a cycle. More specifically it is whether wage contracts and in practice actually allow a decline in nominal wages. Nominal flexibility of wages is important in particular in the case of low inflation, when it represents an important precondition for employment stabilisation. Since inflation over the whole economic history of Slovakia has been prevailingly high, it is not possible to convincingly confirm or reject the statement on nominal wage flexibility. A certain sign of rigidity in nominal wages in the SR is that over recent years they have grown at a steady trend, despite inflation fluctuations. The rate of nominal wage flexibility in the SR is significantly differentiated between regions and sectors. Distribution of the growth, or decline in nominal wages in the sectoral and regional division shows also a partial downward flexibility in nominal wages. With a growing rate of unemployment growth in nominal wages is limited. Likewise, growth in nominal wages is lower in sectors reporting a higher rate of part-time employment, where the legislative protection of the employee is less (construction, retail). Flexible forms of employment are increasing nominal flexibility in certain branches at the regional level. Nominal flexibility, it appears, is also increased by unregistered employment[40].

4.3 Institutional aspects of the labour market

Amendments in the Labour Code (by Act No 210/2003 Coll.) were of benefit for making the labour market more flexible. This concerns mainly conditions for arranging and terminating the labour contract for working hours of less than 20 hours weekly, enabling a significant reduction in the protection of such employees, and implementation of a new institute of the temporary suspension of work performance. Employers began to use this institute mainly at the beginning of 2004 as a replacement for cancelled agreements on work activity. This

[36] Compensation for inflation from past years into the growth in nominal wages concerned in particular the more significant price deregulations and adjustments in excise duties in 1999 and 2003.

[37] The industrial sector in relatively flexible labour markets of the EU anchors growth in nominal wages at the level of approximately 50% to 60% of the labour productivity growth.

[38] Collective agreements in Slovakia do not in most cases establish the interim wage indexation. An exception is formed by wages set by law and certain wage tariff scales which are indexed according to a minimum wage level.

[39] Naturally, this concerned a mutual relationship, a fall in demand resulted also from the fall in real wages.

[40] Semi-legal employment represents a payment of a certain part of the wage to the employer in cash, over the agreed reduced gross wage.

institute should help to achieve more flexible and simpler way of hiring; subsequent increase in the share of persons employed through this type of labour contract should assist in reducing unemployment and increasing the efficiency of the business sector functioning. Likewise, compared to the original state, the possibility of the immediate termination of the labour contract has been extended in cases of a serious violation of work discipline, which were before only a reason for a notice of termination. In general, these measures have increased the flexibility of hiring. The Labour Code thus provides a sufficiently flexible framework for employment relations, preserving with the standard social measures of employee protection.

The influence of trade unions on the formation of wages and labour costs is dependent on the degree of their representation, coordination and nature of their activity in the collective bargaining process. The degree of trade union organisation in employment over the past 8 years has decreased significantly. The agenda of trade unions comprises in particular wage agreements.

Labour market reforms and flexibility

The basic idea behind social reforms in 2003 was to make the labour market more flexible by strengthening the motivation to work, namely through increasing the differentiation between wages and benefits from a passive labour market policy, by making registration at labour offices stricter, or through supportive programmes of active labour market policy. Strengthening the motivation to work and establishing agencies for temporary employment should by the end of 2004 be reflected in a more flexible hiring and in a better matching process, mainly in the low-qualified workforce segment of the labour market.

The combined effect of tax reform and social reform , by extending the gap between the tightened unemployment benefit assignments r and reduced social support on the one hand and increased disposable income in the lowest part of the wage distribution on the other hand, should increase the motivation to work and thus remove one of the most serious rigidities existing in the Slovak labour market in the past.

4.4 Workforce mobility

The level of workforce mobility is a precondition for the efficient functioning of the labour market. This is dependent upon stimuli for mobility and the benefit from employment in relation to the economic and social costs of commuting, moving and living (transport prices, prices on the real estate market, etc.). The rate of inter-regional labour mobility is also a starting point for international labour mobility following accession to the EU. It appears that the slope of the population to move for work is low and that there is a discord in the structure of the qualified workforce and that the costs which inhabitants must outlay on migration for jobs are high. Workforce migration through moving in the SR is currently, despite significant regional differentiation, relatively low. The moving balance as one of the partial indicators of population movement reached in 2002 only 1.67%, of which only 0.38% were between individual regions, and 0.51% between districts. It may be assumed existence of a significantly higher, un-registered rate of long-term commuting to work (internal as well as abroad), without impact on the official statistics of the moving balance for work[41].

[41] The prepared amendment to the act amending the status of permanent residence could make actual migration flows in the SR more transparent.

Local (daily) commuting to work is widespread in particular in the Bratislava and Trnava regions. This is caused mainly by the motivation of a higher average wage and more developed infrastructure. In other regions the effect prevailing mostly is that of price barrier and transport costs[42], an undeveloped real estate market and low slope to change (conservative thinking). Legislative support for migration in the form of single-sum contribution for moving for work does not have a sufficiently motivating effect to compensate for the prevailing migration barriers. Insufficient motivation to move for work (even despite a reduction in unemployment benefits) and high costs of moving (mobility barriers) contribute to the high rate of inter-regional differentiation in wages and unemployment in Slovakia. It is expected that in the coming period more massive measures supporting migration for work, in the form of refunding transport costs, workforce mobility support from the side of employers as well as the initiatives in housing support, should be adopted from the resources of both domestic as well as European funds. In the medium term it is therefore possible to expect a slight increase in internal migration for work, which could to a certain degree fulfil the stabilisation function in the case of local asymmetric shocks. Sectoral asymmetric shocks will not though even over the medium term be able to rely on the stabilisation function of the international mobility of workforce, and this mainly due to the linguistic and cultural barriers. An exception to international migration[43] will with the highest probability be the border areas on the south, west and north-west of the SR. A low level of workforce mobility could be compensated for by capital mobility. Any possible investment stimuli should be harmonised with investment in the transport and telecommunications infrastructure of these regions.

A partial closing of the labour market following accession to the EU from the side of the most Member States should not influence in any significant way the situation in the Slovak labour market. For qualified employees the limitation remains only in administrative form as it has been to date. The limitation concerns in particular the less qualified workforce. Nonetheless, the latter has, even without this limitation and besides a low slope to migration in the European market, also a low chance to gain the job.

4.5 Identification of certain risks in the labour market

A high rate of unemployment currently suppresses wage inflation. A fast growth of the economy may however gradually exhaust the existing potential of readily-employable workforce in the future. If the forecast growth in employment and a fall in unemployment according to the CP[44] were to become reality, the development could result in inflationary pressure on important regional markets and in certain professional segments of the labour market[45]. Currently this pressure only contributes to a growth in the regional differentiation of wages, but in the medium to long term the impact of wage inflation may be substantial. It is therefore necessary to put in a timely manner explicit emphasis on activation and professional preparation of the unemployed and on the support of development of a more sophisticated production and productive activities that will create room for further growth in labour productivity, increase in wages and growth of the economy. Investment in education, science

[42] More than 40% of unemployed people state the main reason for their weak interest in migrating for work is the cost of transport.
[43] According to estimates of Infostat approximately 110 000 Slovak citizens worked abroad in 2001, of which more than 60 000 in the Czech Republic.
[44] Convergence Programme of the Ministry of Finance of the SR, 2004.
[45] The lack of workforce in certain professions, or surplus of workforce in others is beginning already to show in selected regional markets and in selected professions.

and research are especially important. Room exists also in increasing the share of productive sectors of the economy and in reducing the share of the public sector in the total employment[46].

Pressure on the labour market will be also caused by deferring the retirement age. According to CP the elimination of the high rate of unemployment should occur through a growth in employment. In order to continue in unemployment reduction, employment must over the coming years grow quickly so that by the end of 2009 the labour market can absorb a part of the approximately 109 000 persons who will potentially add to unemployment due to the deferral of the retirement age[47]. Un-registered work, despite measures in the social field, continues to operate as a rigidity in the labour market. Significant demand for this type of employment exists in regions with a high rate of unemployment. Though there is room for more efficient control and revealing of illegal work within the existing legislation, effective measures are still merely being sought. Support for more flexible forms of employment and self-employment is also necessary. Both these institutes are factors of flexible wage development and hiring. Compared to the EU as well to other acceding countries the SR achieves a low level in these forms of employment. While in the EU countries the average rate of part-time employment is at the level of 18%, in the SR this labour market flexibility channel is used only to a very low degree - not even 2% of the economically active population. Comparing these figures with neighbouring countries, in the Czech Republic part-time employment is also used only at a level of less than 4%. Following the amendment to the law providing for part-time work and the tax reform, the increased use of this institute should appear eventually in the increase of this indicator for the SR.

5. Requirements for individual policies

From the presented analysis it results that tasks which will be fulfilled by individual policies in the period prior to adopting the euro and following entryinto the eurozone will gradually change. However individual policies in isolation are not able to fulfil these tasks. Their coordination is necessary, both in time as well as in space. The reduction in the NBS's monetary policy autonomy represents a key problem.

Nominal convergence

The Slovak economy is in the process of catching-up. One of the consequences is the existence of the Balassa-Samuelson effect. This causes, among other things, the equilibrium SKK/EUR exchange rate to appreciate. This appreciation represents in fact a "contribution" of the economy and economic policy to the convergence. The rate of equilibrium appreciation of the real exchange rate depends to a large extent on the growth of foreign trade competitiveness, in particular on the basis of FDI inflow. Several NBS analyses show that currently the **equilibrium** appreciation of the real exchange rate has accelerated. In particular investments directed at present mainly in the automobile industry may substantially accelerate the equilibrium rate of appreciation. One of the possibilities of how to support the convergence process lies in exploiting the fact that the equilibriumd real exchange rate of the

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[46] In 2002, the government sector in Slovakia formed in 2002 21% of total employment, which was one of the highest shares among the acceding countries. Moreover, Slovakia as the only country reported a growth in this share. (OECD Economic Overviews 2004).

[47] This calculation does not cover the option of early retirement. It is not expected that this option, given by law, would be used on a massive scale due to its income-discriminatory nature. Moreover, the use of this clause would have only a short-term effect (up to 1 - 2 years) on the overall decline in the forecast accumulated growth of productive inhabitants. In the medium and long term this effect is negligible.

koruna against the euro is strengthening. This strengthening of the real exchange rate is opening the room also for a strengthening of the nominal exchange rate and the safe fulfilment of the exchange-rate criterion during operating in ERM II. In parallel with the strengthening of the nominal exchange rate, the inflation differential between the SR and the eurozone will be reduced. In order to achieve this, it is necessary that other policies do not operate counter to the equilibrium strengthening of the real exchange rate. A key role must play the fiscal policy – setting of expenditure side of the budget, and the government wage policy.

The basic task of monetary policy over the coming period will be to reduce inflation to a level which will mean fulfilment of the inflation criterion. At present inflation is high due to terminal phase of administrative price deregulations. Reducing inflation requires that the overall setting of policies – the policy mix – supports disinflation. The risk is represented primarily by the secondary effects of the currently high inflation – in particular its further expansion through cost and wage indexation. Though price growth in the energy industry has not been directly reflected in processing industry prices (also due to competitive pressure), it does not mean that this price impulse has been definitively suppressed. It may progress into processing industry prices progressively over the long term, in particular in connection to a coming boom. Fast productivity growth in industry is the basic precondition that this does not happen. A role in suppressing this inflationary impulse will, though, have to be played also by wage policy. Likewise, the risk of additional wage indexation has not been completely eliminated. That would cause inertia of the current high inflation. In order to manage this situation coordination of fiscal and monetary policies is necessary, where the basis are fiscal measures. A contingent monetary restriction would slow the convergence process down and stimulate the inflow of speculative capital.

Convergence pursuant to the Maastricht Criteria requires that the consolidation of public budgets takes place as fast as possible and that fiscal objectives of the respective reforms – tax, social, pension and health reform – are fulfilled. It is necessary to ensure the highest possible drawing of funds from the EU in order to prevent the emergence of pressures for drawing funds from the state budget. Following the completion of price deregulations it is necessary to prevent the emergence of secondary inflationary effects (in particular through suppressing wage indexation) and thoroughly regulate prices in network industries. Monetary policy must shift its emphasis over to medium- and long-term inflationary aims.

Stability

Exchange-rate stability, in particular reducing the risk of depreciation, should be based on the growth of competitiveness on the basis of FDI, on the credible influencing of inflationary expectations and reducing inflation. Foreign direct investments should then become a motor for fast sustainable economic growth. Fast economic growth is, as mentioned above, a key precondition for consolidating public finance. Ensuring fast economic growth is the basic task of economic policy.

Fiscal policy will gradually take over other tasks in ensuring monetary stability. Its ability to adopt timely measures for economic stabilisation after any possible shocks, the achievement of a close to balance budget position, and discipline so that the fiscal policy itself does not become a source of uncertainty and disorders, are preconditions for stability in ERM II. It will be fiscal policy in particular that will be responsible for sustaining the fundamental balance. It will be optimal if such a degree of public finance consolidation is achieved, in the shortest possible time, that also automatic stabilisers can operate in their full scope. An important role will also playother policies. Importance is given to the preventive and counter-cyclical supervision over the financial market, in particular the banking supervision. The financial market, thanks to its restructuring and integration, thanks to the privatisation of banks, is prepared to flexibly react to any possible disequilibria. The credible performance of the euro-adoption strategy, consistent macroeconomic policies and instruments, provided by ERM II, should be sufficient for the financial sector not to be a source of instability for development over the coming years. Prerequisites for the labour market operation in a stabilising manner are a restrained government wage policy, flexible functioning of the labour market based on measures adopted in social field and in the Labour Code, making other regions accessible for investment, and the regional orientation of investment stimuli. Attention needs to be paid also to the timely solution of instabilities in the real estate market and in other partial markets.

A basic scenario for fulfilling the Maastricht Criteria could be as follows:
Economic policy and the orientation of structural policies should create the prerequisites for fast economic growth, budgetary consolidation and appreciation of the real exchange rate at the required stability of the nominal exchange rate. Fiscal policy and government wage policy should ensure that even in the case of the continuing convergence of (short-term) interest rates the real exchange rate will appreciate in an equilibrium manner, that inflationary pressures will not arise and that disinflation, possibly accelerated by nominal exchange rate appreciation, will occur. This should guarantee nominal convergence – disinflation, a fall in (short-term) interest rates and the safe fulfilment of the Maastricht long-term interest rate criterion, the introduction of the euro without destabilisation following the adoption of short-term interest rates of the ECB and exchange-rate stability (with possible appreciation of the nominal exchange rate during operating in ERM II).

For a short period monetary policy will use a (broad) fluctuation band, movements of short-term interest rates (for making speculative capital uncertain), interventions, including the use of options provided by ERM II – in particular for sustaining a stable exchange rate development. Real (demand) shocks and fluctuations will be stabilised in particular by fiscal policy. Automatic stabilisation by means of the budget has at present a limited effect. It will therefore be necessary to reconsider its strengthening by a suitable policy or short-term discrete counter-cyclical measures.

Reforms on the labour market and flexible wage policy should enable the elimination of a part of (asymmetric) shocks in order to decrease their impacts on inflation and employment. They should also enable that wage indexation and wage inflation are further limited. Financial market supervision should operate in a forward-looking and counter-cyclical way against the risk of price bubbles and in coordination with fiscal policy also against the risk of the economy overheating from a credit boom. The risk of the economy overheating should be also reduced by economic policy focused on regionally diversified growth in the economy's potential.

Long-term expectations targeted at disinflation (low inflation) and exchange-rate stability will in this period be of extraordinary importance. Besides those created by credible orientation on the eurozone, other sources of strengthening these expectations will also be important. This will concern in particular increasing the emphasis on medium-term aims in communicating the monetary policy and consistent asserting of credible medium-term budgeting. The Convergence Programme, sustainable consolidation of the budget and periodic medium-term budgeting should set the course ahead to eurozone, providing a formal framework.

Conclusion

Fulfilment of the deficit criterion is sustainable, if over the course of the economic cycle the public finance deficit does not exceed the limit of 3% of GDP under free functioning of automatic stabilisers and ordinary fluctuations of economic activity. In conditions of Slovakia it should be sufficient for sustainable fulfilment of the deficit criterion that the structural deficit falls below 2% of GDP. *The fast rate of economic growth and structural reforms implemented create the preconditions for consolidation of the public budget in accordance with aims of the Convergence Programme. The programmed consolidation is possible also in the case of a slowdown in economic growth and in the case of common cyclical or other fluctuations in economic activity.*

Fulfilment of the debt criterion is sustainable, if in the case of ordinary fluctuations of economic activity the level of debt does not exceed the criterion limit for debt (60% of GDP). The stricter sustainability condition for debt requires that under free functioning of automatic stabilisers and common fluctuations of the economy the level of debt does not grow on a long-term basis. *In conditions of Slovakia it should be sufficient for the sustainable fulfilment of the debt criterion that the deficit criterion is fulfilled in a sustainable manner. A fast rate of the economic potential growth (4% and more at constant prices) enables to maintain the level of debt over the coming years atthe current level of approximately 45% of GDP provided that the deficit criterion is fulfilled in a sustainable manner. Over the long-term it is however necessary to count on the effects of demographic changes, which will be reflected in the population ageing. The result may be that the costs of transformation of the pension system will be settled in conditions when the economy will be growing at a slower rate.*

Fulfilment of the inflation criterion requires that inflation in Slovakia in the year when the Slovak Republic will be assessed is below the level of the criterion's value. The latter will be determined by the three EU countries with the lowest inflation. The risk for fulfilment of this criterion is represented in particular by the following:

- If we fail to manage the transition towards the environment of low inflation from 2005, after the termination of important deregulations. *It will be essential to convince the public of the expected low inflation (to form low inflationary expectations) and ensure that the* ***expected*** *low inflation becomes the basis for the projection of budgetary expenditures, wages in the public and private sectors, business contracts in general,*
- If we fail to create and sustain low inflationary expectations and if we fail to suppress the impact of the Balassa-Samuelson effect on inflation. *Of extraordinary importance is in particular the sustaining of low inflation and assertion of low inflationary expectations in those sectors of the economy in which productivity and cost efficiency grow slowly,*
- If there occurs a reversal in the development of the exchange rate towards a large depreciation. *It is necessary to sustain the interest of foreign direct investors in investing in Slovakia. The strengthening of the exchange rate should be appropriate to the economy's possibilities and should not rely on unstable foreign capital.*
- If in decreasing interest rates we fail to prevent the emergence of a credit boom with its manifestation in a subsequent overheating of the economy in the period of Slovakia's evaluation, in particular if we fail to sustain the overall restrictive mix of fiscal, wage (income) and monetary policies. *It is necessary in particular to programme the expenditure side of the budget, wage development and development of other incomes in the economy so that they in aggregate correspond to the targeted low inflation.*

- If an asymmetric shock causes a significant deviation in the development of inflation in Slovakia and other EU countries and if the inflation criterion is made significantly stricter. *Though important negative influences (e.g. an oil price shock, USD exchange rate, etc.) affect the Slovak economy and the economies of the EU countries partially symmetrically, the inflation target for the Slovak economy should be set with a certain reserve for the case of such (asymmetric) development. From the weighting of these influences (in the SR and the EU countries) and their probable size in the short-term period it results that sufficient reserve in fulfilling the inflation criterion represents 0.2%. With regard to the forecast fast rate of public finance consolidation and the overall restrictive mix of budgetary, wage, income and monetary policies no domestically initiated asymmetric demand shock should arise.*

Fulfilment of the exchange-rate criterion requires that during a period of two years the exchange rate remains close to the fixed central parity without severe tensions and without the need to devalue the central parity. As sign of tension is deemed an adverse development on the current account and the balance of payments, exceeding of the depreciation band, the need to use high short-term interest rates to stabilise the exchange rate, loss of price competitiveness, etc. A risk for fulfilment of the exchange-rate stability criterion is represented by the following:

- An incorrectly chosen (overvalued) central parity. *Though the precise determining of the equilibriate exchange rate and central parity is not problem-free, Slovakia has a certain advantage in long-term equilibrium appreciation of the real exchange rate. It allows that also in the case of slight overvaluation of the central parity against the equilibrium exchange rate upon entering ERM II, the equilibrium exchange rate will "catch up" with the central parity and no need to devalue the central parity will arise. Under a well-chosen central parity Slovakia should not have any problems in fulfilling the exchange-rate stability criterion. A prevention against the incorrect setting of the central parity is also the operation of monetary policy against an inappropriate strengthening of the exchange rate, in particular such as that caused by the inflow of unstable financial capital,*
- A inappropriate loosening of the budgetary and monetary policy mix. *In this context we consider as important in particular the mutually harmonised reduction of interest rates, the level of exchange rate appreciation, and reducing of the risk premium. An overall restrictive budgetary, wage and monetary policy mix is also important.*
- A sudden reversal in the movement of capital – the capital outflow. *Besides the correct setting of monetary policy and the overall policy mix it is necessary that confidence in the economy's orientation is not lost.*

Fulfilment of the (long-term) interest rate criterion means that long-term interest rates in Slovakia will not be higher than the criterion level. This is 2% higher than the average long-term interest rates in the three EU countries with the lowest inflation. The risk of non-fulfilment of this criterion lies in particular in the fact that the overall development of the economy will threaten the fulfilment of other convergence criteria and delay entry to the eurozone, possibly also for an indefinite period. *Long-term expectations, in particular the prospect of eurozone membership are decisive for the level of long-term rates in Slovakia. Movements of short-term rates and fluctuations of inflation, provided they do not threaten the overall orientation on the eurozone, should not, in particular with the approaching date of accession to the eurozone, threaten the fulfilment of this criterion.*

A basic prerequisite for fulfilling the Maastricht Criteria is further progress in real convergence. It is important in particular to sustain the current fast economic growth which is based on growth in productivity and competitiveness. *If the Government and the NBS fulfil commitments in performing reforms and the orientation of monetary development in accordance with the aims of the Convergence Programme and Medium-Term Monetary Outlook, then Slovakia should fulfil, on a sustainable basis, the deficit and inflation criteria from 2007 (or possibly from 2006, if the costs of pension reform are not taken into account in evaluating the deficit). Budget consolidation by 2010 according to the CP will enable Slovakia to fulfil the debt and deficit criteria also in the long term, when the economy and public financ will be affected by demographic changes.*

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[i] If Slovakia's public budget revenues grow at approximately the same rate as nominal GDP, the proportion of public sector revenues to GDP will be constant[i]. If the economy grows at the rate g, the share of expenditures in (nominal) GDP is Qy, then the halting of real growth in expenditures means a budget consolidation (reduction in deficit) by:

$$Qy(t+1)-Qy(t) = Qy(t)*g/(1+g) =^{i} Qy(t)*g \qquad (1)$$

In the case of Slovakia where the share of expenditures is approximately 40% and the economy is growing at a rate of approximately 4%, the halting of real growth in expenditures reduces the budget deficit by approximately 1.5% of GDP.

[ii] The known relationship applies:

$$d(t+1) = d(t) + d(t)*(r-g) - delta,$$

where d(t) is the level of (public budget) debt at the time t; r is the (nominal) interest rate on the public debt; g is the rate of (nominal) GDP growth; and delta is the primary balance (of the public budget) in proportion to GDP. From this there ensues the condition for the sustainability of debt:

$$delta > d(t)*(r-g) \qquad (2)$$

[iii] In the case of comparing and using the results of this analysis which were obtained by various methods (for example, Roger, W., Ongena, H.: The Commission Services Cyclical Adjustment Method. Banca d' Italia. Indicators of Structural Budget Balances, Rome 1998), it is necessary to take heed of the fact that interpreting the results – the ascertained cyclical component of development – in the case of using various methods need not be identical. The cyclical component, determined through breaking down a time sequence with the help of the H-P filter, represents a deviation from the long-term trend, whereas cyclical components ascertained with the help of a model, for example the production function, express deviations from the potential and are, as analyses show, as a rule biased. Negative deviations predominate, which can give the interpretation that **the economy (according to these modelling methods) operates prevailingly at a level below potential**. It is also shown that these cyclical deviations, ascertained with the help of various methods, are of varying size, where the differences are often in terms of multiples. The production function enables the potential output to take account also of structural disruptions in the development of factors, for example, a productivity shock.

[iv] More complex estimates of the budget cyclical development rely upon defining a specific basis for individual components of a tax revenue and the specific elasticity of this revenue to (cyclical) changes in the basis. Knowledge of the elasticity of budget revenues in EU countries highlights[iv] certain differences in the elasticities of individual types of revenue to the budget (taxes and contributions to insurance funds):

Type of tax	**elasticity**
Corporate income tax	**1.7-2.5**
Personal income tax	**0.8-1.9**
Insurance	**0.5-1.0**
VAT + Excise duties	**0.8-1.0**

Other	**1.0**
Average (weighted)	**0.84-1.25**
Time shift[iv]	**0.6-1.0**

Some refining in determining the cyclical component is necessary, when a significant tax is very sensitive to the economic cycle. This applies in particular to corporate income tax, since the profitability of enterprises fluctuates significantly according to stage of the economic cycle. Similarly, in some countries the progressiveness of personal income tax is very high, or fluctuations in personal income (wages, social transfers) over the course of the cycle may be large. The elasticity of insurance premiums to cyclical fluctuations is usually less than 1, (for example, because the measurement bases are not fully adjusted). Usually revenues from indirect taxes have full, unitary elasticity. The resultant picture – of weighted elasticity – is nevertheless relatively multifarious. It is important to take account of the permitted time shift in the payment of taxes, in particular in the case of substantial changes to taxes from the short-term aspect. The budget reacts to the economic cycle also on the expenditures side. In a period of an economic boom employment grows and with a well-set social security system the number of recipients falls, as does the volume of social benefits paid out and conversely, in a period of recession the number of social security recipients and the volume of contributions increases. A role is also played by how strongly employment and unemployment react to the economic cycle. This reaction is different in standard economies (in the EU) and different in transforming economies.

[v] There are three "marginal" possibilities:

1. The basic monetary policy instrument of the NBS, interest rates, may in the conditions of completely liberalised capital movements be used autonomously only if the exchange rate is sufficiently flexible. In this case the central bank can autonomously decide on interest rates in order to influence the development of the domestic economy,
2. If the exchange rate should be fixed or stable, as required by ERM II and later the eurozone, then in the conditions of liberalised capital movement the central bank cannot set interest rates completely autonomously – these must track the movement of interest rates in the economy with which the SR economy is integrated in terms of trade and capital flows – i.e. the eurozone economy,
3. If the central bank wanted to set interest rates autonomously and concurrently maintain the fixed or stable exchange rate, capital movements would have to be regulated. Such a possibility however – with regard to the stage attained in integration to the eurozone – does not come into consideration.

The formal explanation of the situation facing monetary policy in the conditions of the liberalised movement of capital is provided by the uncovered interest rate parity theory. This says that in conditions of the completely liberalised movement of capital the net present value of the exchange rate e (t) equals its expected value E(e (t+1)) , adjusted by the interest rate differential (r (t) – rf (t)) and the risk premium risk (t): e (t) = E(e (t+1)) + (r (t) – rf (t)) – risk (t)

Short-term movements of the exchange rate are, according to this relationship, influenced by expectations, the interest rate differential and the risk premium. If the exchange rate should be stable, then the current exchange rate e(t) is approximately equal to the expected exchange rate E (e(t+1)). The risk premium however provides room for a non-zero interest rate differential. In the case of a fixed exchange rate the risk premium equals 0 and the domestic and foreign interest rates must be identical. The expected exchange rate and the risk premium, provided that we can influence them, may provide monetary policy with a certain degree of autonomy – room for the autonomous movement of interest rates. This is important for coordinated fiscal and monetary policy in the period leading up to the eurozone. If fiscal policy changes expectations in relation to the real exchange rate, the room for interest rate movement also changes. This room, or "autonomy", may be used by monetary policy for solving tasks in the internal economy.

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