MINISTRY OF FINANCE
OF THE SLOVAK REPUBLIC

institute for financial policy

International Conference on

10 Years of the €uro in Slovakia

Session 1: Macroeconomic Perspective of Euro Area Membership

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Agenda

- Tensions during ERM II participation
- Slovakia’s experience with the euro
- Future challenges

Preparation for EU membership and euro adoption

- Slovakia excluded from first group of EU applicants as political landscape not in line with Copenhagen criteria.
- Accession negotiations launched in February 2000, but still joined EU along with other applicants in May 2004.
- Policy strategy for euro adoption evolved concurrently with preparations for EU membership.

  --adopted combined program for ERM II entry and euro adoption in July 2003
- Broad-based political and social support for fast track euro adoption objective

Meeting the Maastricht criteria: Inflation and inflation sustainability

- The inflation criterion comfortably met.

  --Possible luck factors: the market's confidence in exchange rate appreciation and decreasing world energy and food prices in 2008

- Inflation sustainability scrutinized critically by ECB and EC

  --ECB had "considerable" concerns regarding sustainability of inflation convergence

  --EC also considered the upside risks to inflation to be "considerable"

Concerns about inflation sustainability

- Three concerns flagged by ECB and EC

  (1) Concern that the Government's policy of restraining administered price adjustments from 2006 onward after entering ERM II was suppressing administered prices below cost-recovery levels.

  (2) Concern that the economy was overheating: conventional estimation methods showed sharply rising positive output gap in 2007–2008

  (3) Concern that inflationary pressures were likely to pick up once nominal appreciation of the Slovak koruna ceased upon euro adoption

IMF's analysis on inflation sustainability (as communicated to ECB and EC)

- Regulated prices did not seem artificially suppressed when benchmarked against unregulated prices of similar goods and services
- The increase in energy prices, measured in euros, was faster in Slovakia than in the euro area
- Regulated energy price increases were broadly in line with commodity price increases, measured in koruna terms
- Exchange rate shocks filtered through to prices slowly in Slovakia
- Indicators such as trade deficit and wage growth showed little signs of overheating
- Demand side pressures were found to be absent if the Kalman filter method of estimating output gap was used (This method is better able to capture a structural shift in potential growth path driven by supply-side impetus).

Interpretation of the exchange rate stability criterion

- Frequent discussions with ECB and EC officials on the interpretation of exchange rate stability criterion.
- On this basis, NBS officials considered it likely that:

  --real exchange rate appreciation generated by structural factors may be acceptable;

  --nominal appreciation seen as part of deliberate policy to reduce inflation would be frowned upon

Meeting exchange rate stability criterion: Censure

- NBS did not intervene when exchange rate began to appreciate following ERM II entry in Nov 2005, but communicated to the market its support for a more appreciated koruna.

- On 31 January 2006, following instructions from EC and ECB, the NBS announced publicly that it would no longer comment on exchange rate developments.

Meeting exchange rate stability criterion: Scare

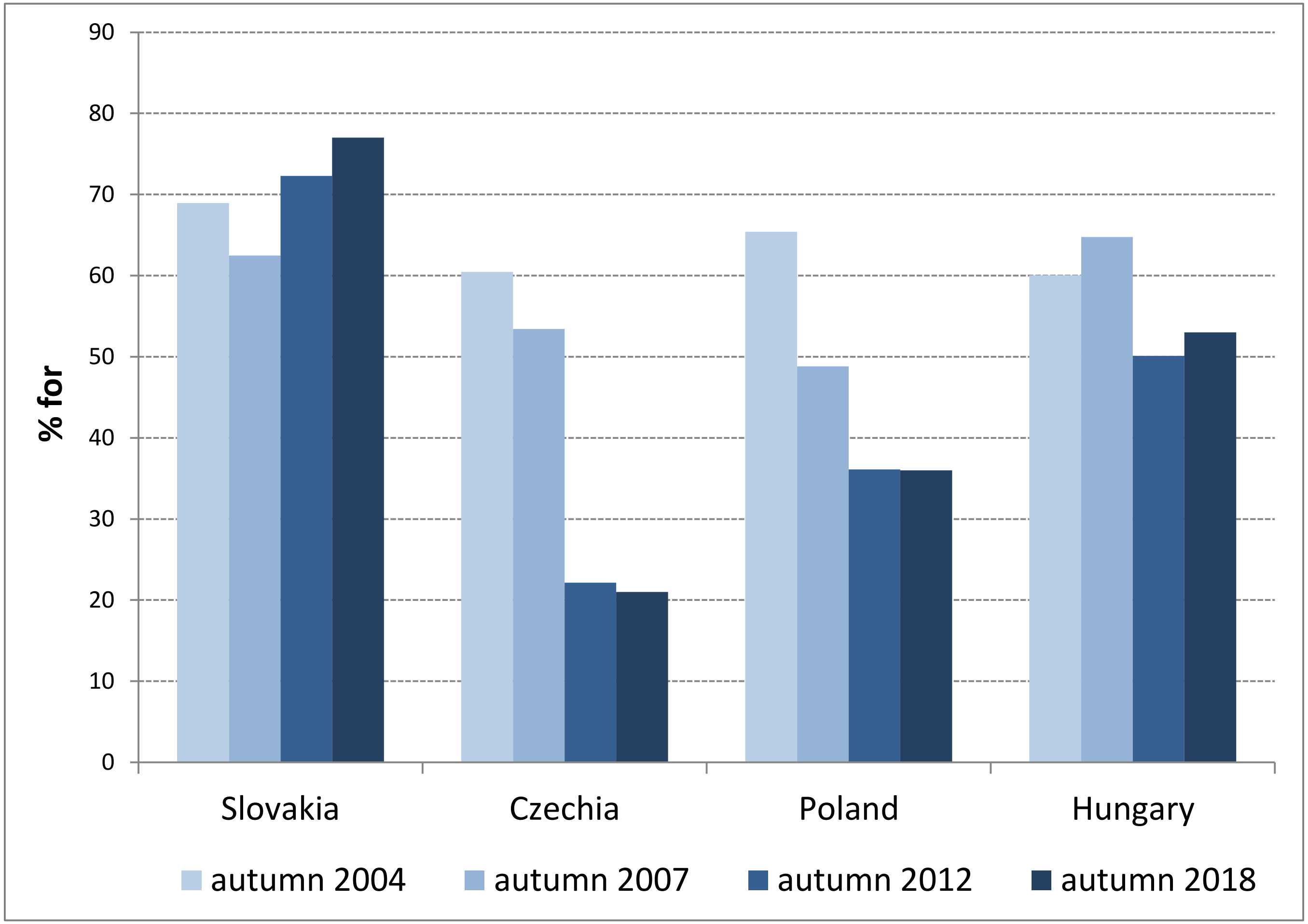
- Sharp depreciation of the koruna below central parity in June-July 2006 following unclear communications from the newly elected government regarding whether it would stick to the objective of euro zone entry in 2009.
- Fearing breach of the informal lower limit of 2.25% on the depreciation side of the ERM II band, NBS intervened to the tune of €3.085 billion and increased the policy interest rate
- Market conditions calmed only after Prime Minister and Finance Minister declared their support for the original target euro zone entry date of Jan 2009.

Meeting exchange rate stability criterion: Fulfilment

- Subsequently, continuous appreciation pressures on account of strong capital inflows.
- Interest rate adjustment and FX market interventions had limited effect, and two revaluations of the central parity in the run up to conversion became unavoidable
- The 2nd revaluation of the central parity was set at a rate higher than the prevailing market rate and corresponded to the top edge of the ±15% band under the previous central parity
- PM Fico pushed for the “best exchange rate for the people” and the revised central parity was adopted as the final conversion rate in July 2008
- Final conversion rate was some 22% more appreciated than the central parity set at the time of ERM II entry

Sentiment toward the euro

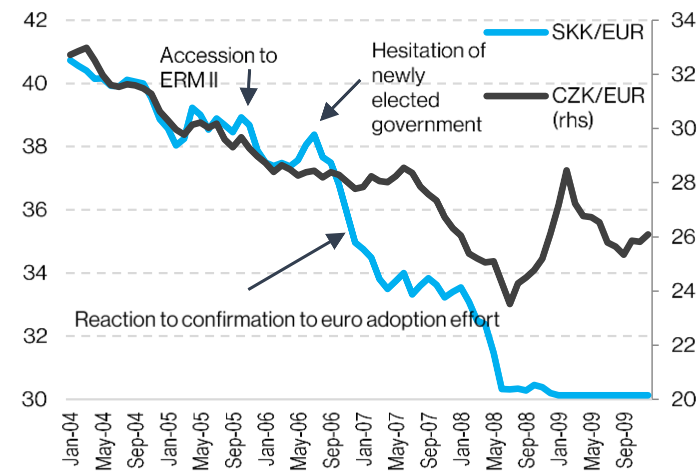
(% in favour of a European economic and monetary union with a single currency, €)



Source: Macrobond, Eurobarometer.

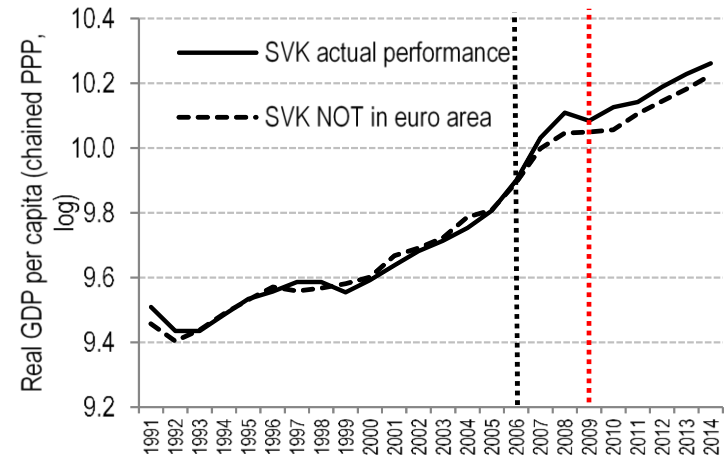
Benefits from euro can be observed before the adoption itself

Effects of euro adoption can be observed before the actual adoption



Source: IFP

Benefits from the euro may be sizeable before the euro adoption itself (in 2014 the euro benefit is 4% of GDP)

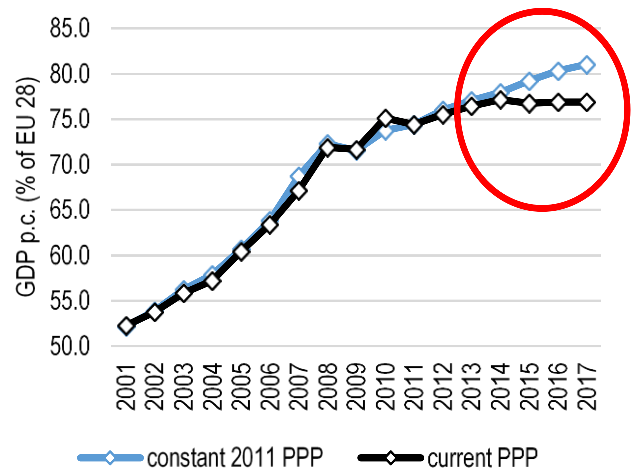


Source: IFP, Penn World Tables 9.0

- The expectations from joining the euro area were set high. Before accession, the estimated long-run benefits vary from 7 to 20 % of GDP. Afterwards, the estimated interval is more conservative.
- Ex-post assessments of the euro adoption vary between 1 to 10 % of GDP. Results depend on whether one take into account the anticipation effect or not.

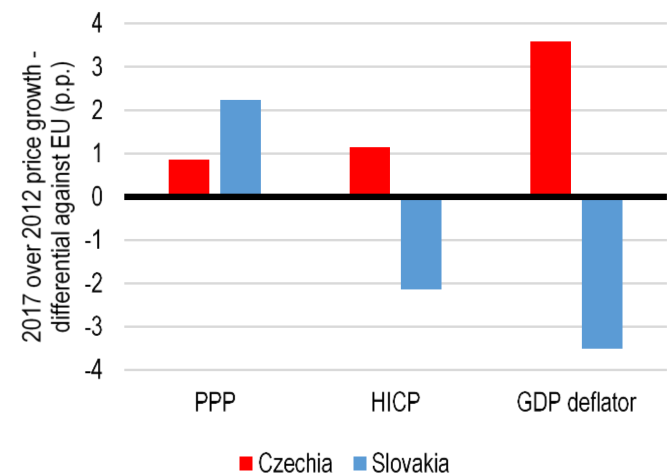
Is Slovakia converging or not?

When using PPP 2011 as a base, the convergence continued and exceeded 81% EU average in 2017



Source: IFP, World Bank

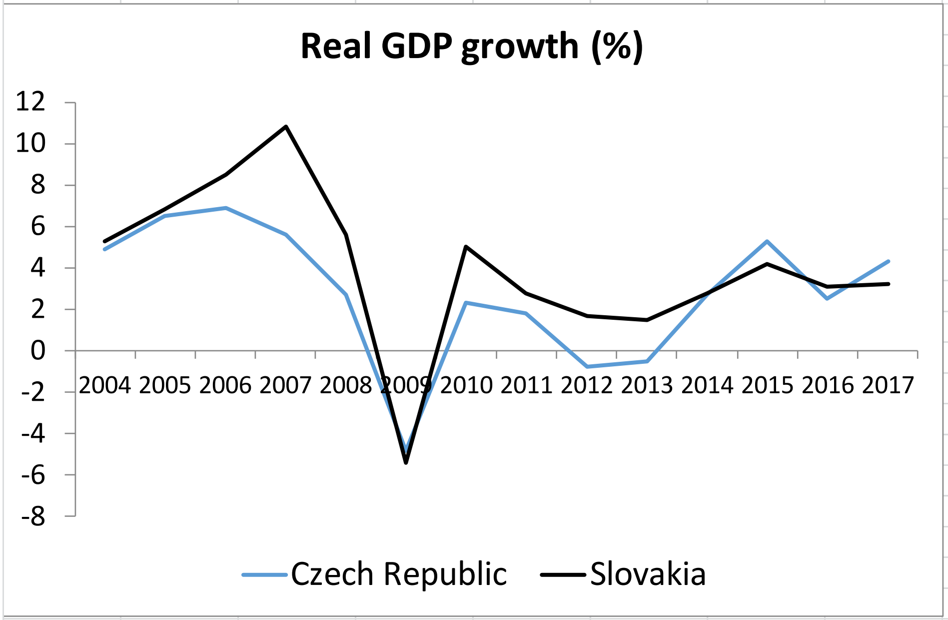
HICP and GDP deflator decreased whereas PPP prices increased, thus slowing down the convergence process

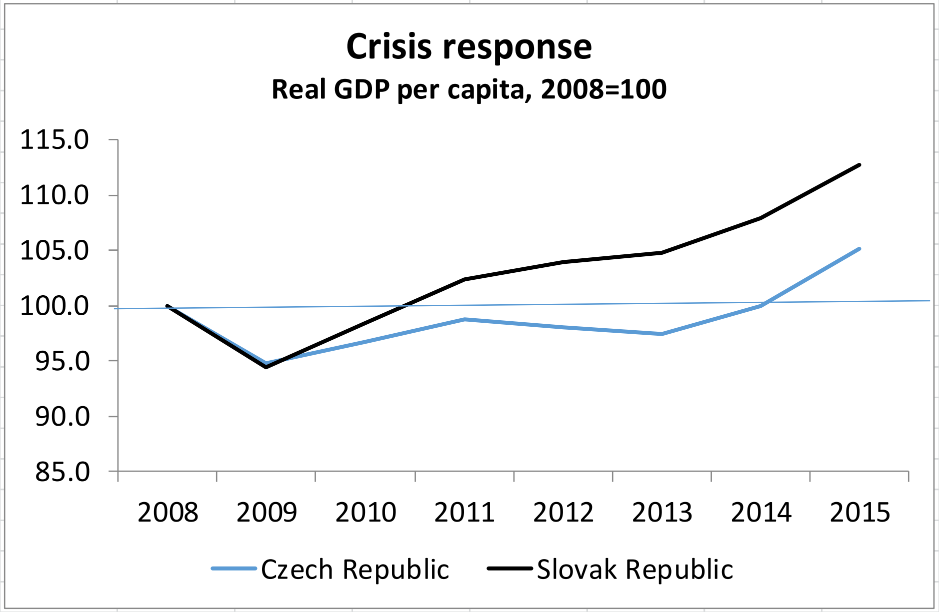


Source: IFP, EUROSTAT

- After adjusting for PPP, the Slovak convergence got stuck at 77% of the EU level.
- This is due to Slovak PPP measurement which indicates an increase in the price level, whereas the HICP and GDP deflator a show decrease in the price level during 2012 – 2017.
- The opposite is true for CZ, where the price growth was slowest within the PPP measurement.
- When using constant PPP in 2011 as a base year, the convergence continues as the GDP per capita exceeded 81% of the EU average in 2017.

Did Slovakia suffer more because of the euro during crisis?

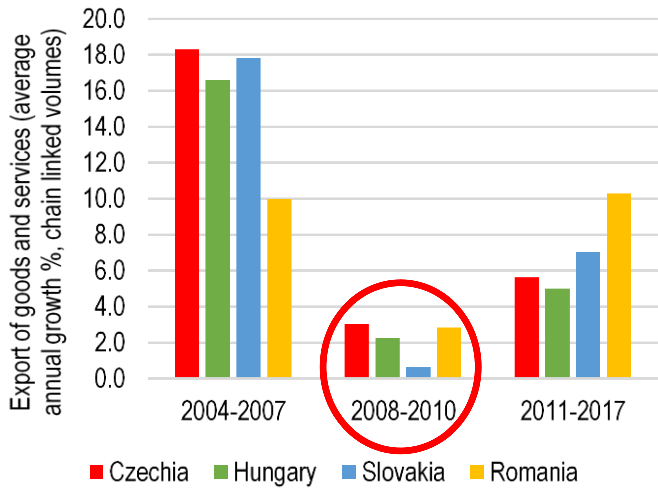




- The negative effect of the crisis on GDP was more prolonged in the Czech Republic than Slovakia. It took six years for the level of GDP per capita to return to pre-crisis level in Czech Republic compared to two years in Slovakia.

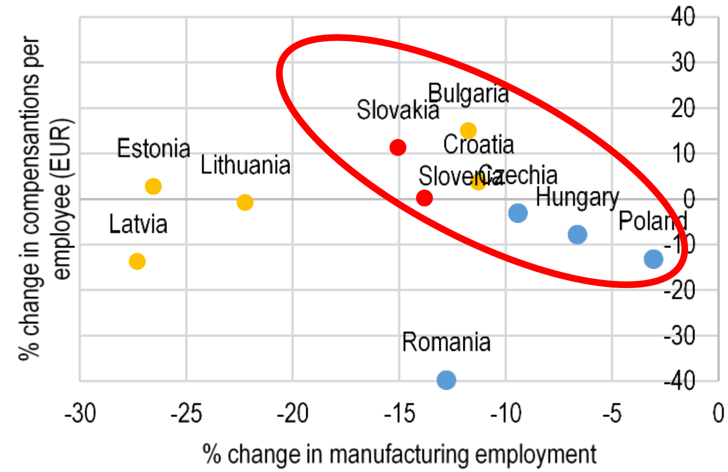
Did Slovakia suffer more because of the euro during crisis?

Export of goods and services perform poor in SK during crisis (average annual growth %, chain linked volumes)



Source: IFP, EUROSTAT

Did the depreciation help in crisis? (focus on 2008Q2-2009Q4)



Source: IFP

- Importantly, the timing of the euro adoption in Slovakia coincides with the onset of the global financial crisis in 2009. This leaves Slovak economy essentially without the possibility for the currency to depreciate and to prop up the net export.
- For small open economies, wage flexibility should save jobs. Indeed, there is some negative correlation in the region between the change in the manufacturing employment and the change in compensations per employee in EUR during crisis.
- In addition, the export performance during recession was relatively slower in Slovakia when compared to CZ and HU.

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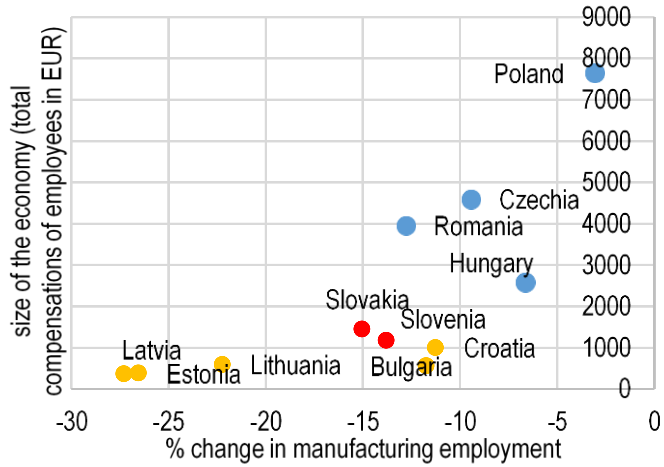
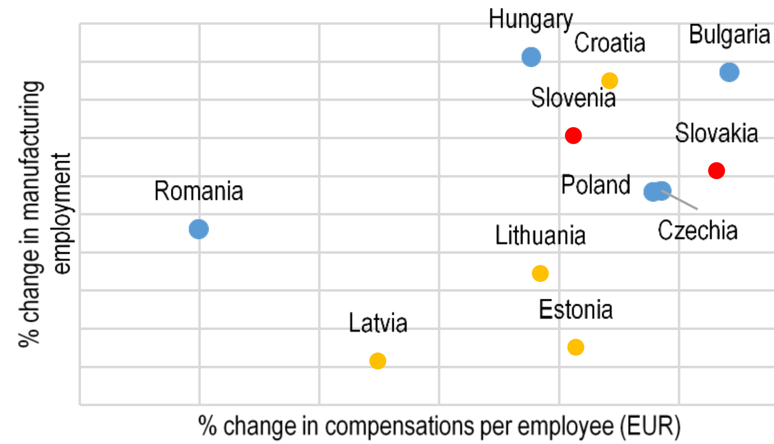
Did Slovakia suffer more because of the euro? Maybe not

The bigger the economy the better for employment



Source: IFP

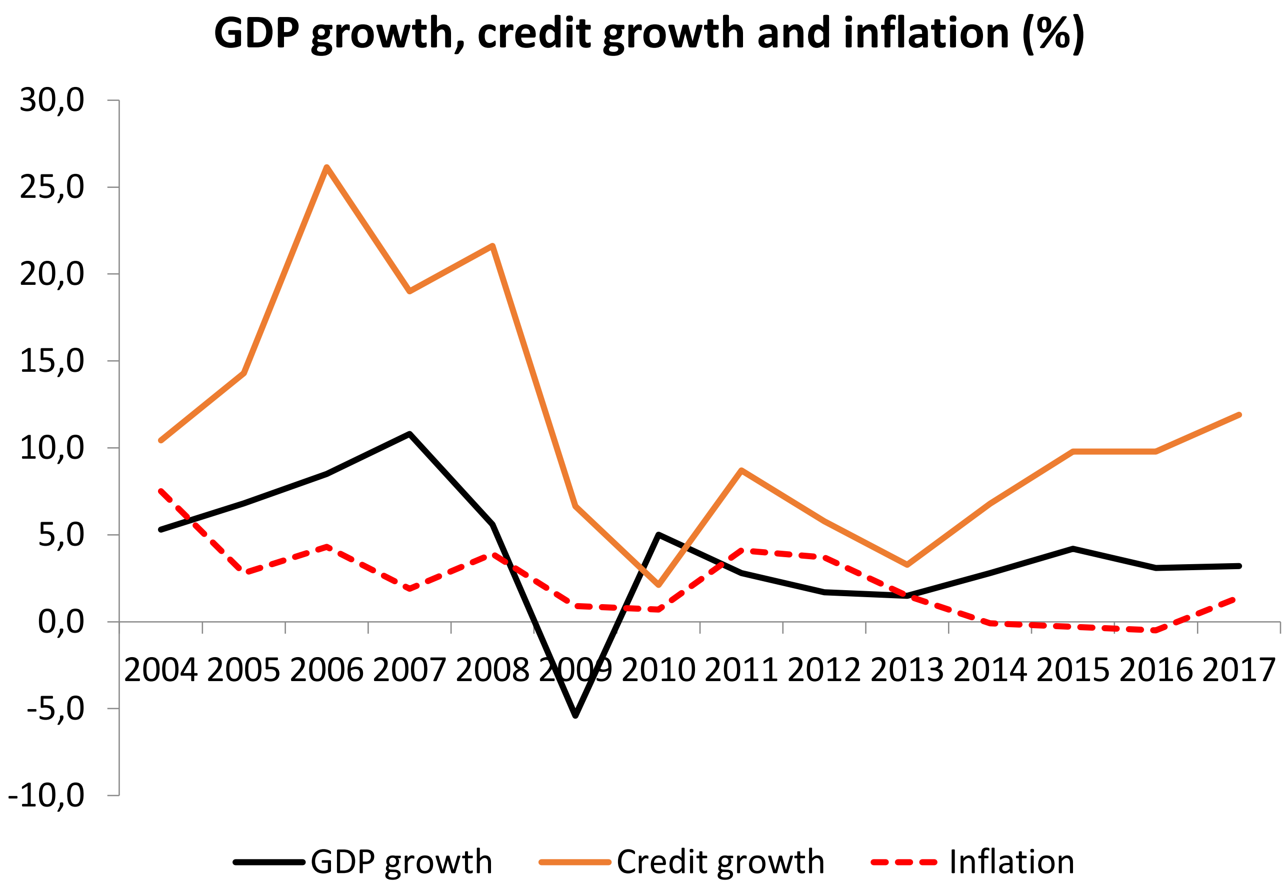
The relationship between compensations and employment reverses when adjusted for the size of the economy



Source: IFP

- Change in the employment correlates with the *size of the economy* and the size of the economy also correlates with the exchange rate movements
- Size of the economy correlates with ER movements, perhaps because big economies are not affected by ER swings, while small economies tend to avoid huge swings as the consequence might be much larger and they tend to fix their exchange rates or join the eurozone
- Thus, economies with euro or fixed ER may suffer more, not because of the inability of ER adjustment, but because they are small and affected more by crisis
- After controlling for size, the relationship b/w employment and compensations per employee *reverses*

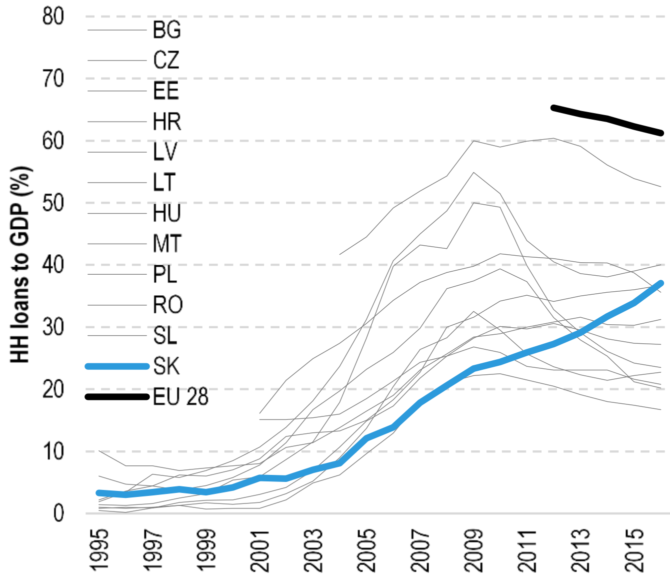
Real business cycle and financial cycle in Slovakia



Inflation continued to fall even after credit growth picked up

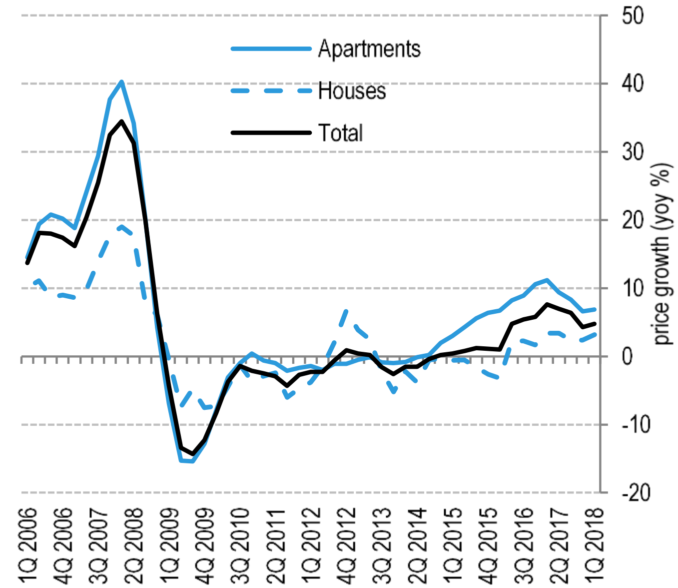
Future challenges with euro

Household debt to GDP rising fast in Slovakia



Source: IFP, EUROSTAT

House prices so far under control



Source: IFP, EUROSTAT

- Faster convergence may increase nominal wages and inflation as the monetary authority is unable to adjust interest rates.
- This highlights the importance of macroprudential policy, which should tackle any excessive growth of debt and imbalances in the banking sector.
- Prices of housing are so far under control.

Thank you