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Slovakia

On Route to the Euro Zone

Briefing Note

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Author: **BAHR, Christine**
Policy Department Economy and Science
DG Internal Policies
European Parliament
Rue Wiertz 60 - ATR 00L042
B-1047 Brussels
Tel: +32 (0)2 284 07 22
Fax: +32 (0)2 284 69 29
E-mail: christine.bahr@europarl.europa.eu

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Slovakia

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1. Executive Summary

The current report aims to provide an assessment of the Slovak economy focussing on the intended entry of Slovakia into the euro zone. Slovakia has not yet officially applied to be assessed with regard to its convergence but is expected to do so as soon as the European Commission's Spring Economic Forecast is out. Data from that forecast will give a very clear indication as to the fulfilment of the convergence criteria. The European Commission and the European Central Banks would then present their respective convergence reports in May.

The list of issues analysed in this briefing reflects the Maastricht criteria for convergence.

Convergence criteria synopsis

- **Compatibility of national legislation:** Remaining issues highlighted in the 2006 Convergence Report were addressed in a recent change to the National Bank of Slovakia (NBS) Act which came into effect on 1 January 2008. A full legal assessment of the changes by the ECB and the Commission will have to determine whether these changes now suffice.
- **Price stability:** Rising energy prices have caused HICP inflation to rise since 2005. At the same time high economic growth and growing confidence in the government's commitment to entering the euro area on schedule contributed to a marked appreciation of the exchange rate which in turn exerted a decreasing effect on inflation. Slovakia's annual inflation rate (12 months moving average[1]) reached 2.1% in February 2008 and thus was comfortably below the 3.1% reference value. The main issue in assessing convergence will be that of sustainability of low inflation.
- **Exchange rate stability:** The Slovak koruna has participated in ERM2 since 28 November 2005. Expectations of strong economic performance and a relatively smooth path to euro zone membership caused the koruna to appreciate from the second half of 2006, a development that finally, in March 2007 led to a revaluation of the central parity with the approval of the EU Member States by 8.5% from SKK38.46 to SKK35.44. The NBS has since continued to counter appreciation pressures. The koruna has been held at around 6% above the new central parity. The average exchange rate SKK/EUR is forecasted at about 33.50 in 2008 and this could be very close to the rate at which the koruna might be tied to the euro.
- **Government budgetary position:** Slovakia is at present subject to an Excessive Deficit Procedure which must be lifted prior to giving a positive assessment to join the euro zone. In October 2007 Eurostat revised upwards its estimate of the 2006 deficit to 3.7% of GDP and may yet enact further revisions that would influence the consolidated budget outcome for 2007, currently estimated at a deficit of 2.7% of GDP which would be below the reference value. However, concerns remain as to the sustainability of low budget deficits in Slovakia.
- **Long-term interest rate:** The long-term interest rate criterion is self-fulfilling for countries that are moving towards achieving convergence. If a country is believed to soon join the euro area, its long term rate will automatically converge to the euro area level. This is the case of Slovakia. Already at the time of the last convergence report in 2006, Slovakia fulfilled the criterion on convergence of long-term interest rates. In February 2008, the average long-term interest rate in Slovakia was 4.52%, well below the reference value of 6.45%.

[1] This measure is the one used for convergence assessment purposes.

European Commission Autumn 2007 Forecast

Main features of country forecast - SLOVAKIA

		2006		Annual percentage change							
	bn SKK	Curr. prices	% GDP	92-03	2004	2005	2006	2007	2008	2009
GDP at constant prices		1638.0	100.0	-	5.4	6.0	8.3	8.7	7.0	6.2
Private consumption		941.8	57.5	-	4.2	7.0	6.1	6.9	6.2	5.6
Public consumption		297.4	18.2	-	2.0	-0.6	4.1	2.1	2.9	2.8
Gross fixed capital formation		432.1	26.4	-	5.0	17.5	7.3	7.2	6.6	6.1
of which : equipment		230.3	14.1	-	-0.5	24.0	15.2	10.2	8.6	7.4
Exports (goods and services)		1402.2	85.6	-	7.9	13.8	20.7	19.9	12.6	9.1
Final demand		3116.2	190.2	-	7.0	10.9	13.0	12.1	8.9	7.1
Imports (goods and services)		1478.2	90.2	-	8.8	16.6	17.8	15.9	11.0	8.1
GNI at constant prices (GDP deflator)		1588.4	97.0	-	6.7	2.9	7.7	8.7	7.1	6.2
Contribution to GDP growth :	Domestic demand			-	4.0	8.2	6.1	6.2	5.7	5.2
	Stockbuilding			-	2.3	0.6	0.4	-0.3	0.1	0.1
	Foreign balance			-	-0.9	-2.8	1.7	2.7	1.2	0.9
Employment				-	-0.3	1.4	2.3	1.9	1.5	1.0
Unemployment rate (a)				-	18.2	16.3	13.4	11.2	9.7	9.0
Compensation of employees/head				-	9.2	5.1	7.7	7.1	6.9	7.3
Real unit labour costs				-	-2.7	-1.8	-1.0	-2.1	-1.3	-0.9
Savings rate of households (b)				-	-	-	-	-	-	-
GDP deflator				-	6.0	2.4	2.7	2.5	2.6	3.0
Private consumption deflator				-	7.4	2.6	5.1	2.3	2.6	3.1
Harmonised index of consumer prices				-	7.5	2.8	4.3	1.7	2.5	3.0
Trade balance (c)				-	-3.8	-5.9	-5.9	-2.4	-1.2	-0.4
Current account balance (c)				-	-2.5	-7.9	-7.7	-4.4	-2.9	-2.0
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				-	-2.3	-8.1	-7.9	-4.2	-2.7	-1.6
General government balance (c)				-	-2.4	-2.8	-3.7	-2.7	-2.3	-2.4
Cyclically-adjusted budget balance (c)				-	-1.6	-2.1	-3.4	-3.0	-2.7	-2.6
Structural budget balance (c)				-	-1.6	-1.1	-3.4	-3.0	-2.7	-2.6
General government gross debt (c)				-	41.4	34.2	30.4	30.8	30.7	30.6

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.

New forecasts will be made available on 28 April 2008. These upcoming forecasts will be decisive for gauging the general direction of convergence exercise.

2. Compatibility of National Legislation

The examination of the compatibility of national legislation, including the statutes of the national central banks, with Articles 108 and 109 of the Treaty and the Statute of the ESCB/ECB requires an assessment of compliance with the prohibition of monetary financing (Article 101 EC); the prohibition of privileged access (Article 102 EC); consistency with the ESCB's objectives (Article 105.1 EC); central bank independence (Article 108 EC); and integration of national central banks into the ESCB (several EC Treaty and ESCB Statute articles).

In the 2004 Convergence Report, the Commission's assessment on legal convergence concluded that legislation in Slovakia was not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute. Following this report, the Act on the National Bank of Slovakia (NBS Act) was amended in 2004 and in 2005, without however addressing the incompatibilities highlighted. Therefore, at the time of the December 2006 Convergence Report, the Commission still judged that, as regards central bank integration into the ESCB at the time of euro adoption as well as the prohibition of monetary financing, legislation in Slovakia was not fully compatible with Article 109 of the Treaty and the ESCB/ECB Statute.

The ECB equally found in its convergence Report of December 2006 that national legislation needed to be further adapted to fulfil all requirements. With regard to NBS independence, the ECB concluded that the provisions for the dismissal of Board members should be aligned with the wording of Article 14.2 of the ESCB/ECB Statute. As regards monetary financing and privileged access, the power of the NBS to grant credit to the Slovak Deposit Protection Fund was found to be incompatible with the Treaty. Finally, in view of the NBS's legal integration into the Eurosystem some shortcomings were detected with regard to tasks, instruments and financial provisions mainly in relation to a failure to recognise the powers of the ECB in these areas.

These issues were addressed in a recent change to the NBS Act which came into effect on 1 January 2008. A full legal assessment of the changes by the ECB and the Commission will have to determine whether these changes now make the Slovak provisions fully compatible with the Treaty and the ESCB/ECB Statute. A number of articles that were explicitly mentioned by the ECB in the last convergence report stand unchanged in the revised Act (e.g. the provision on the auditing of the NBS). It remains to be seen from the assessments of the ECB and the Commission whether the general clauses binding the NBS to act within the rules and provisions for the Eurosystem as of the day of euro introduction will render national legislation compatible with euro zone membership requirements.

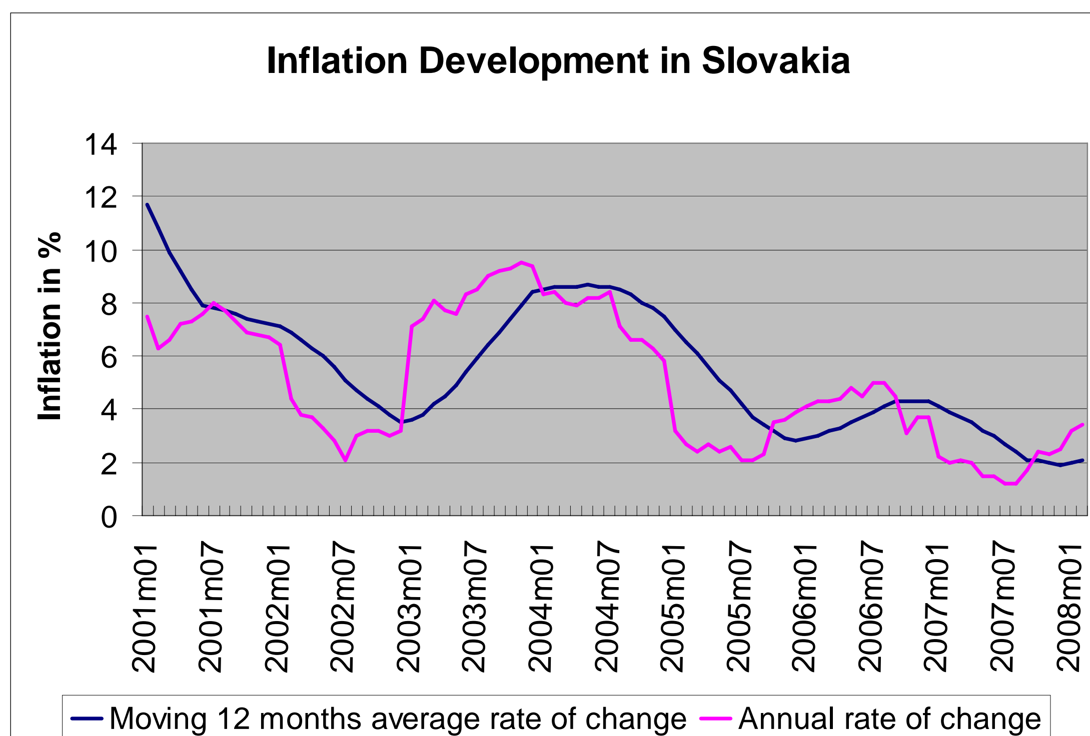
3. Price Stability Criterion

The price stability criterion is defined in the first indent of Article 121(1) of the Treaty: “the achievement of a high degree of price stability […] will be apparent from a rate of inflation which is close to that of, at most, the three best performing Member States in terms of price stability”.

Article 1 of the Protocol on the convergence criteria further stipulates that “the criterion on price stability […] shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-performing Member States in terms of price stability. Inflation shall be measured by means of the consumer price index on a comparable basis, taking into account differences in national definitions”. The requirement of sustainability implies that a satisfactory inflation performance must essentially be achieved by the adequate behaviour of input costs and other factors influencing price developments in a structural manner, rather than reflect the influence of temporary factors. Therefore, the convergence examination includes an assessment of the underlying factors of inflation and of medium-term prospects. It is also assessed whether the country is likely to meet the reference value in the months ahead.

The inflation reference value was calculated to be 3.1% in February 2008 with Malta (1.2%), the Netherlands (1.7%) and Denmark, France, Finland and Sweden (1.9% each) the best-performing Member States.

In recent years, Slovakia has experienced volatile, and at times high, HICP inflation, reflecting the impact of external factors and adjustments in administered prices and indirect taxes as well as the catch-up process of the economy. The koruna's trend exchange rate appreciation in 2002-2005 exerted a moderating effect on inflation. More recently, domestic demand pressures and energy prices have contributed to a pick-up in inflation from 2.8% on average in 2005 to about 5% in the summer of 2006.



HICP inflation increased markedly from the third quarter of 2005 mainly owing to the rise in energy prices, reaching a peak in the third quarter of 2006. At the same time high economic growth and growing confidence in the then new government's commitment to entering the euro area on schedule contributed to a marked appreciation of the exchange rate which in turn exerted a decreasing effect on inflation.

Inflation developments were heavily influenced by trends in world energy prices, the unwinding of the base effects of the large increases in several regulated utility prices, and decreases in regulated prices in January 2007 that were, according to the IMF, in part attributable to margin compression by distributors under pressure from the government.[2] These regulated utility price decreases would lead to a significant dampening of inflation. The development resulted in the contribution of regulated energy prices to annual inflation falling by 1% in January 2007 as the large increase in such prices one year earlier dropped out of the base, cutting HICP.[3]

Slovakia's inflation value (12 months moving average) reached 2.1% in February 2008 and thus was comfortably below the 3.1% reference value.

Will low inflation be sustainable?

Inflation dynamics in Slovakia will be closely scrutinised until the assessment of Slovakia's euro adoption. Strong economic growth with strong demand and wage growth as well as, and in particular, the continued buoyancy of world commodity prices could yet endanger the objective of fulfilling the Maastricht criterion on inflation as the low energy efficiency of the Slovak economy relative to that of its EU partners suggests that it may be more vulnerable to high global energy prices.

It is difficult in the current economic climate to find inflation forecasts that already take into account the latest global economic developments. Most data originate in the autumn of 2007. Therefore, the Commission's Spring Economic Forecast, due on 28 April, will make interesting reading. Below a table giving different forecasts for inflation in Slovakia in 2008 and 2009:

	European Commission[4]	Ministry of Finance of Slovakia[5]	IMF[6]	OECD[7]	Economist Intelligence Unit[8]
2008	2.5%[9]	2.3%	2.0%	2.2%	2.7%
2009	3.0%	2.6%	2.0%	N/A	3.0%

[2] The Slovak authorities stressed towards the IMF that the impact of the downward adjustments in regulated prices was sustainable in that they would not negatively affect cost recovery and the ability of the utility companies to maintain and renew their infrastructure.

[3] The NBS forecasts a decline in the contribution of regulated energy prices to inflation from 2.2 percentage points in 2006, to 0.4 percentage points in 2007 and to 0.3 percentage point in 2008.

[4] European Commission Autumn Economic Forecast, November 2007.

[5] Convergence Programme of Slovakia for 2007-2010, update November 2007.

[6] IMF Article IV Consultation, Staff report, June 2007.

[7] OECD Economic Survey: Slovak Republic, April 2007.

[8] Economist Intelligence Unit, Country report Slovakia, March 2008.

[9] Reasons: For 2008: Increase in excise taxes on cigarettes and accelerating electricity, water and food prices. For 2009: Fading out of impact of exchange rate pass-through combined with higher energy prices and a further increase in the excise taxes on cigarettes.

The one major risk to satisfying the Maastricht inflation convergence criterion would be further large increases in international energy prices as energy prices have a much larger weight in the HICP in Slovakia than in other EU countries. The authorities will also need to remain vigilant to contain domestic inflation pressures given that the economy is estimated to be operating above potential in 2007 and that the labour market has tightened rapidly. With scope for tightening monetary policy constrained by the need to keep the koruna within its ERM2 currency bands and in view of the time lag before tightening would impact on the economy, fiscal policy would need to play a role in easing short-term pressures. The Commission remarked in this context that the Slovak government should stand ready to adopt a more restrictive fiscal stance should inflation turn out higher than the government's forecast, which it nevertheless characterised as unrealistic.

In a study on the effects of euro adoption on the Slovak economy staff of the NBS find concerns about higher inflation in the long-term perspective justified. Living standards and the price level of Slovakia are only a little higher than half the average of the EU. With fast economic growth Slovakia will be catching up with the EU not only with regard to living standards, but inevitably also in price levels. After irrevocably fixing of the exchange rate, higher inflation in Slovakia will be the only channel for catching-up in price levels. Based on several methods, the study estimates that for several years after joining the euro area Slovak inflation will be on average approximately 1.5% higher than the average inflation in the euro area mainly caused by faster productivity growth and consequently the Balassa-Samuelson effect and by the increasing weight of services in the consumption basket while the prices of services increase faster than the prices of goods. Such equilibrium inflation should not represent a risk of instability or loss of competitiveness for the economy. Prices may converge only gradually when such development is supported by the increase of productivity, real wages and purchasing power.

4. Exchange Rate Criterion

The Treaty refers to the exchange rate criterion in the third indent of Article 121 as "the observance of the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other Member State".

Article 3 of the Protocol on the convergence criteria stipulates: "The criterion on participation in the exchange rate mechanism of the European Monetary System (…) shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period".

The relevant two-year period for assessing exchange rate stability in May 2008 would be May 2006 to April 2008.

The Slovak koruna has participated in ERM2 since 28 November 2005. Before ERM2 entry, Slovakia operated a managed float and the koruna initially appreciated moderately against the euro and then remained close to the future central rate. Since ERM2 entry, the koruna has remained above the central parity rate of SKK38.46 except for a limited period in the summer of 2006: During May-July 2006, negative investor sentiment on emerging markets as well as concerns about the election outcome and the course of policies led to depreciation pressures on the koruna resulting in the NBS intervening heavily in the foreign exchange market to stem these pressures.

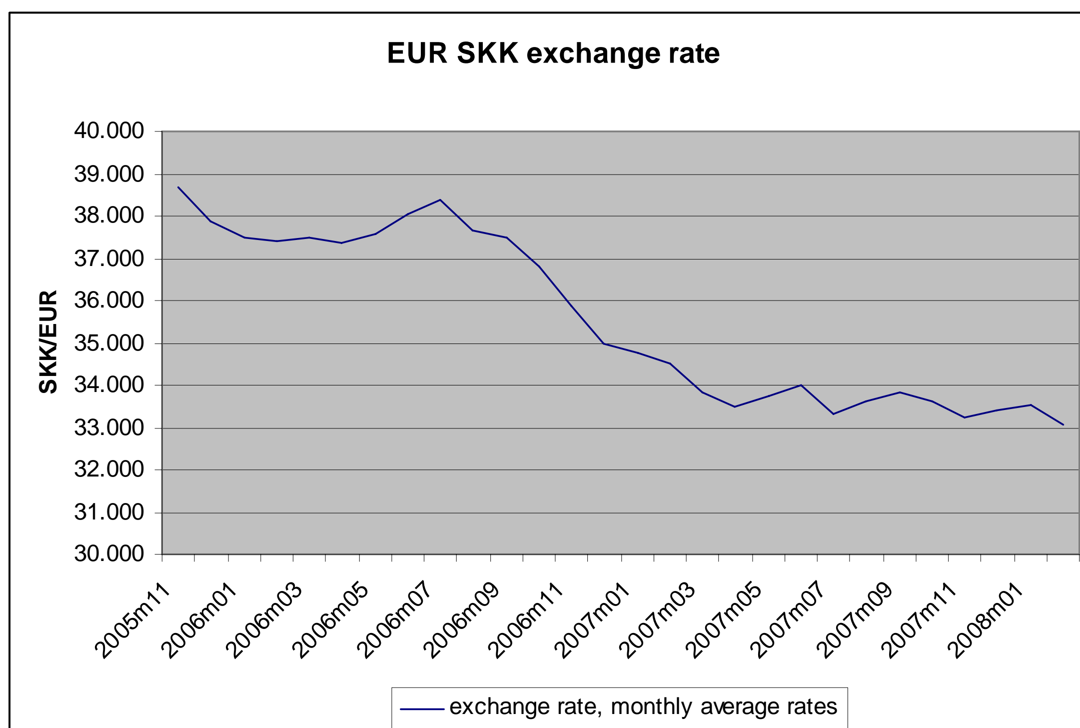
Expectations that Slovakia's economic performance would be strong and its path towards joining EMU relatively smooth, combined with euro appreciation against the US dollar, caused the koruna to appreciate sharply from the second half of 2006.

At the end of 2006, as the koruna approached the upper edge of the ERM2 ±15% band, the NBS began countering appreciation pressures through verbal and direct interventions and prolonged rejection of bids during regular repo auctions. Eventually in mid-March 2007, with appreciation pressures persisting, significant inflows of foreign direct investment followed by the progressive acceleration of economic growth and a possible substantial appreciation of the estimated equilibrium real exchange rate, the central parity was revalued with the approval of the EU Member States by 8.5% to SKK 35.44 which was below the prevailing market rate.

The Slovak authorities noted that the revaluation of the central parity of the koruna was justified by Slovakia's improved economic fundamentals. The productivity growth differential vis-à-vis the euro area had widened in 2006, and a sizeable part of the upward pressure on the exchange rate reflected productivity-driven equilibrium real appreciation. But the authorities also had to note that the revaluation entailed risks. It increased the room for further appreciation within the ERM2 band and could induce additional speculative inflows. It also increased Slovakia's vulnerability to investor sentiment turning bearish, as the cushion for accommodating depreciation had become smaller relative to that before the parity adjustment.

The NBS has since continued to counter appreciation pressures, utilising foreign exchange intervention and rejection of repo bids in open market operations. The koruna has such been held at around 6% above the new central parity.

More recently, turmoil in global financial markets has increased the koruna's volatility. There is a risk that the NBS will revalue the koruna's central ERM2 rate ahead of euro adoption, should the currency continue to trade well above its current central rate. This could cause some further turbulence in the foreign exchange market.



Source: Eurostat

The NBS sees a number of risks for the fulfilment of the criterion of exchange rate stability: Inappropriate loosening of the mix of budgetary and monetary policies, a sudden turn of the capital movement, in particular its outflow; a loss of credibility of the direction of the economy.

Investors expect the SKK exchange rate to be strongly influenced by euro adoption related issues in the first half of 2008 despite the real economy's continued development. Furthermore, the timetable for the final steps or the institutional environment surrounding the convergence assessment is likely to influence decision-making about a possible revaluation of the koruna central parity within ERM2. Such revaluation is not expected to happen before the convergence assessment as this could complicate the assessment of whether the exchange rate has been stable enough, or whether it was closer to a crawling peg regime.[10]

What could be the final conversion rate SKK/EUR?

Bearing in mind that the real exchange rate development is important for price competitiveness the considerable strengthening of the koruna since October 2006 and the persistence of appreciation pressure could potentially pose a threat to competitiveness. The average exchange rate SKK/EUR is forecasted at about 33.50 in 2008[11] and this could be very close to the rate at which the koruna might be tied to the euro. In real effective terms this means that the koruna would appreciate modestly in 2008.

[10] While the Treaty talks about „in particular … shall not have devalued" this would not exclude to view continued appreciation as contrary to fulfilling the criterion.

[11] Economist Intelligence Unit, Country report, March 2008.

The Slovak authorities, in talking to the IMF, were giving priority to euro adoption but were also committed to socially inclusive growth. Hence, they were concerned about the rapid pace of exchange rate appreciation and the risk of an overly strong final conversion rate. In their view, an overshooting of the koruna from the equilibrium level was likely to undermine the competitiveness of traditional manufacturing firms as well as small and medium-sized enterprises, where productivity gains were lower. However, there are inherent difficulties of measuring equilibrium rates in transition economies and, according to the IMF, competitiveness of the Slovak economy remained satisfactory according to most indicators.

In the eyes of the OECD the real exchange rate has appreciated sharply in recent years, rising at an annual average rate of 4% over 2000-2006. With the NBS estimating the long-run equilibrium rate of real exchange rate appreciation (or equivalently, the Balassa-Samuelson effect) in Slovakia at around 1 to 1.5% per year, and notwithstanding the great deal of uncertainty surrounding the measuring of equilibrium real exchange rates, currency appreciation may have got ahead of fundamentals recently.

There are non-negligible risks involved in entering a monetary union with an irrevocably overvalued (or undervalued) currency. This choice is a basic political-economy trade-off between competitiveness and purchasing power, respectively.

Overvaluation generally brings along some degree of loss of competitiveness. In an environment of fixed exchange rates, competitiveness can be restored through a painful process of downward wage and price adjustments, something unlikely to happen in a high-growth environment as in Slovakia. Alternatively, competitiveness can be restored through significant productivity growth.

Productivity growth is likely to be strongest among traded goods, where technology spillovers exist from abroad. As wages in the tradables sector rise with productivity, they eventually also increase wages in the non-tradables (e.g. services) sector. As a result, prices of non-tradables will increase. Thus increased productivity should give rise to real exchange rate appreciations through higher inflation.

Maintaining competitiveness with an overvalued nominal exchange rate, high productivity growth necessitates this higher inflation. Therefore, higher inflation than in the rest of the euro area has to be allowed to exist. Without this (relatively) higher inflation, the overvaluation worsens and the effects on competitiveness will be more severe. This questions the rationale of the low (sustainable) inflation criterium.

Alternatively, if the conversion rate is set too low, the economy could overheat. This would result in excessive inflation and possibly bubbles on financial and property markets, thereby creating financial stability risks.

Low inflation sustainability and the role of the exchange rate

The impact of the exchange rate upon inflation is measured by the exchange rate pass-through coefficient. The Ministry of Finance of Slovakia argues that the coefficient is close to 0.1 (a 10% appreciation reduces inflation by 1%) with the NBS seeing the coefficient between 0.1 and 0.2. These potentials to reduce inflation would naturally disappear once the nominal exchange rate is tied to the euro.

There is a reasonable chance of a final revaluation of the central parity to between 32.5 and 33.5 before July, in order to ensure that the conversion rate doesn't represent devaluation from market levels, if the koruna were tied to the euro at the central parity. Such devaluation from market rates could be an inflationary factor in 2008 and 2009.

Considering the above, the IMF has not been unreasonable to encourage NBS officials to communicate to market participants the possibility that the final conversion rate could be different from the prevailing market rate to prepare market participants for such a possibility.

5. Government budgetary position

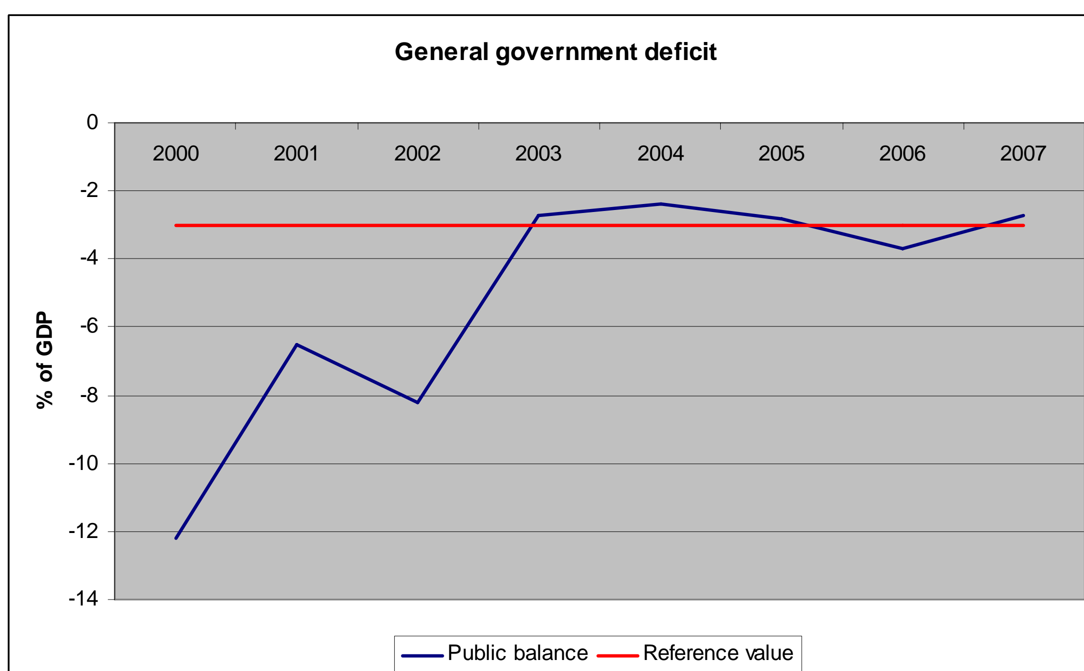
The convergence criterion dealing with the government budgetary position is defined in the second indent of Article 121(1) of the Treaty as "the sustainability of the government financial position: this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104(6)". Furthermore, Article 2 of the Protocol on the convergence criteria states that this criterion means that "at the time of the examination the Member State is not the subject of a Council decision under Article 104(6) of this Treaty that an excessive deficit exists".

Slovakia's 2007–09 budget framework was aimed at meeting the euro zone entry objective. Fiscal consolidation would rely mainly on a reduction in expenditure in relation to GDP while the authorities planned higher expenditure on health care, pensions and other social spending, as well as agriculture.

Slovakia is at present subject to a Council decision on the existence of an excessive deficit which must be lifted prior to giving a positive assessment of Slovakia's preparedness to join the euro zone. The Council recommended Slovakia to take action in a medium-term framework in order to bring the deficit below 3% of GDP by 2007 in a credible and sustainable manner. Slovakia's general government deficit reached levels of around 7% of GDP at the beginning of the decade but has been reduced substantially since 2002.

In October 2007 Eurostat revised upwards its estimate of the 2006 deficit to 3.7% of GDP, from 3.4% previously, and may yet enact further revisions that would influence the consolidated budget outcome for 2007. This suggests that the risks surrounding the nominal achievement of the Maastricht criterion have not dissipated.

For 2007 Eurostat estimates the deficit to have reached 2.7% of GDP which would allow for the Excessive Deficit Procedure to be lifted.



Source: Eurostat

General government debt has declined significantly since 2000, when it stood at some 50 percent of GDP, and is now well below the reference value (30.4% of GDP in 2006).

There are concerns about the sustainability of low budget deficits in Slovakia. At the end of January the Commission published its assessment of the government's latest convergence programme update of November 2007. The Commission acknowledged that Slovakia's excessive deficit was likely to have been corrected in 2007 but also reiterated its long-standing criticism that not enough was being done to consolidate public finances in the light of exceptionally strong economic growth.

In particular, the Commission pointed out that an adjustment to the budget goals would be needed in order to provide a cushion against breaching the upper limit for the deficit of 3% of GDP, and that the expenditure cuts planned to achieve budget consolidation lacked detail and were back-loaded to 2009-10, thereby increasing their uncertainty. Most likely in response to this assessment, the Slovak government expressed willingness to increase its consolidation effort in 2008, possibly bringing the deficit below 2% of GDP, from the currently planned 2.3%

Moreover, the budget's reliance on the continuation of exceptionally strong GDP growth underlines the risk of a deficit overshoot, which could prevent Slovakia from joining the euro area in 2009. An overshoot would also make it much more difficult to meet the medium-term objective of reducing the structural deficit by 2010.

6. Long-term interest rate levels

The fourth indent of Article 121(1) of the Treaty requires “the durability of convergence achieved by the Member State and of its participation in the exchange rate mechanism of the European Monetary System being reflected in the long-term interest rate levels”. Article 4 of the Protocol on the convergence criteria further stipulates that “the criterion on the convergence of interest rates (…) shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions”.

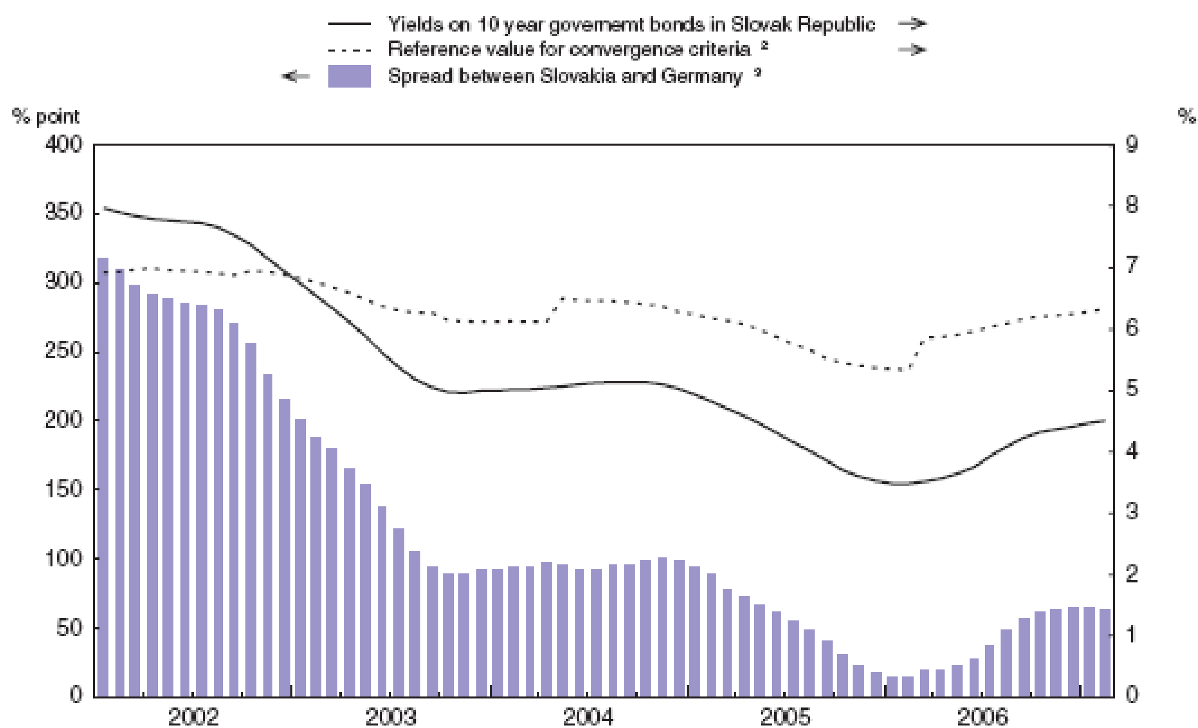
The interest rate reference value was calculated to be 6.45% in February 2008 using the values for Malta (4.77%), the Netherlands (4.29%) and Denmark (4.3%).

The long-term interest rate criterion is self-fulfilling for countries that are moving towards achieving convergence. If a country is believed to join soon the euro area, its long term rate will automatic converge to the euro area level. This is the case of Slovakia.

Already at the time of the last convergence report in 2006, Slovakia fulfilled the criterion on convergence of long-term interest rates. In February 2008, the average long-term interest rate in Slovakia was 4.52%, well below the reference value of 6.45%.

Average long-term interest rates in Slovakia have been below the reference value since EU accession. The spread *vis-à-vis* euro area long-term benchmark bonds had been declining markedly since the adoption of the government's reform programme in 2002 and had become negative for several months in 2005, before turning positive again in 2006 in response to a pick-up in inflation and subsequent hikes in the key policy rates. Slovakia fulfils the criterion on the convergence of long-term interest rates.

Convergence of long-term interest rates



1. 12-month moving averages.
2. Average of long-term interest rates of the three best-performing EU Member States in terms of price stability plus 2 percentage points.
3. Difference in percentage points between Slovak and German yields on 10-year-government bonds.

Source: Eurostat and OECD calculations.

7. Other factors relevant to economic integration and convergence

Article 121 of the Treaty also requires an examination of other factors relevant to economic integration and convergence. These additional factors include financial and product market integration, the development of the balance of payments on current account and the development of unit labour costs and other price indices. The latter are covered within the assessment of price stability.

Additional factors have also been examined at the time of the last convergence assessment in 2006, including product and financial market integration and balance of payments developments. The Slovak economy is highly integrated with the EU. In particular, trade and FDI relations with other Member States are extensive and integration of the domestic financial sector into the broader EU sector has progressed substantially, mainly through a significant degree of foreign ownership of financial intermediaries. Slovakia's current account balance has been highly volatile in recent years reflecting swings in export performance driven by new FDI-related production capacities, in particular in the automotive sector. The worsening of Slovakia's external position in 2006 has been driven by dynamic private consumption and an increase in FDI-related imports. Substantial new export-oriented production capacity is expected to boost exports in the coming years. The current account deficit has been mainly financed by large net FDI inflows.

8. Conclusion

Slovakia is seen to be on track to satisfy the criteria for entry to the euro area in January 2009. This raises the challenge of ensuring that policies are compatible with maintaining good economic performance in a currency union.

A problem that could arise in the first years of euro area membership is that adjustment to the decline in real interest rates associated with the elimination of currency risk and adaptation to a rise in steady-state inflation associated with Balassa-Samuelson effects (estimated to be 1-1.5% per year in the long run) in a currency union could contribute to a post-entry boom-bust cycle, calling for a counter-cyclical fiscal policy.

Through multiplier and accelerator effects, adjustment to lower rates would be likely to entail some overheating. In addition to increasing the current account deficit, this would tend to increase domestic inflation (especially for assets such as housing), further reducing real interest rates temporarily and hence reinforcing the boom. The ensuing loss of competitiveness would at some time slow the economy to below the trend rate, eventually enabling competitiveness to be restored and the economy to return to trend, though such an adjustment period could prove painful.

In the longer term, adjustment to idiosyncratic shocks will have to occur entirely through changes in domestic wages and prices owing to the absence of a floating national currency. Maintaining macroeconomic stability in these circumstances calls for preserving flexibility in labour and product markets.

Policymakers need to ensure that policy settings are such that Slovakia copes well with being inside the euro area. Otherwise, Slovakia's euro zone entry can cause considerable harm to the Slovak economy.