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THE COSTS AND BENEFITS OF EURO ADOPTION IN SLOVAKIA

KORZYŚCI I KOSZTY Z PRZYJĘCIA EURO NA SŁOWACJI

Abstrakt

W niniejszym opracowaniu przedstawiono historię wejścia Słowacji do strefy Euro. Przeanalizowano pierwsze efekty z przyjęcia nowej waluty na podstawie najnowszych danych z gospodarki. Celem badania było przedsyskutowanie spodziewanych korzyści, jak np. elimiacja ryzyka kursowego, spadek kosztów transakcyjnych, stabilność cen, wzrost wymiany handlowej i poprawa wiarygodności kredytowej. Te efekty oczekiwane dzięki przyjęciu euro zostały skonforntowane z bieżacymi danymi z rynku. Ostatecznie postawiona została hipoteza, mówiąca, że pozytywne efekty z przyjęcia nowej waluty są głównie skutkiem tego, że Słowacja jest małym krajem. Metodologia użyta w niniejszym opracowaniu oparta jest przede wszystkim na krytycznym przeglądzie literaturowym najnowszych publikacji.

Słowa kluczowe: *euro, Słowacja*
Numer klasyfikacji JEL: *E00, N14*

Introduction

Maastricht criteria, also known as the convergence criteria have been introduced by the Treaty on European Union. They define conditions which must be fulfilled by a country in order to become a member of the Economic and Monetary Union. It is of course possible to unilaterally adopt euro as the domestic currency, but it is not recommended by European Central Bank (ECB). Moreover it leads to the loss of power in monetary policy at all. By the usual procedure of entering the Eurozone a country puts its own representatives in EBC. However unilateral euro adoption was done by some small countries, e.g. Andorra, Kosovo, Monaco, Montenegro, San Marino and Vatican.

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1. Euro convergence criteria

These criteria relate to monetary policy, fiscal policy, exchange rate and interest rates. More precisely, inflation in the previous year may not exceed by more than 1.5 percentage points the average of the inflation of the three EU countries with the most stable prices. Inflation is measured by the HICP index.

The deficit may not exceed 3% of GDP, and debt may not exceed 60% of GDP. Aspiring to the Eurozone a country must also participate in the European Exchange Rate Mechanism for at least 2 years and has to be welcomed by ECB. Moreover it is required that the domestic average nominal long-term interest rate does not exceed by more than 2 percentage points the rate determined on the basis of these three countries considered in case of inflation level. The average nominal rate of long-term is understand as treasury bill yield.

2. How Slovakia met the criteria

Having satisfied these criteria, Slovakia joined the Eurozone on 1st January 2009. In order to meet the fiscal criteria one of the most serious problem was the pension system reform. Some problems were also generated by high costs of building highways in 2005 and 2006. Although the deficit in 2005 was 2.8%, it has risen up to 3.2% in the next year. Happily between 2007 and 2008 it was reduced to 1.8% and 2.1% respectively. The next problem was to reduce government debt, which in 2005 was 34.1% of GDP. In subsequent years it was 30.5%, 29.6%, 27.9% respectively [EUROSTAT, 2012].

Slovakia has joined European Exchange Rate Mechanism on 28th November 2005. But it has taken quite a long time to fulfil the conditions related to the level of inflation. In 2005 and 2006 it was 2.8% and 4.3% respectively, which was surely far from the required conditions. Only in 2007 the inflation dropped to 1.9%, but then it has risen up to 3.9% in the next year. Long-term interest rate were 3.5% in 2005, 4.4% in 2006, 4.7% in 2007 and 4.5% in 2008 [Klucka, Lelakova, Streclova, 2009; EUROSTAT, 2012].

In June 2008 the exchange rate of euro and koruna was set. It was also made compulsory to display prices both in euro and koruna till the end of 2009.

On its way towards the Eurozone low unit labour costs were increasing the competitiveness of the Slovak economy. Labour force in Slovakia is skilled and relatively cheap (although mobility is still, after the Eurozone accession, perceived as small). Structural reforms were done. Especially the taxation systems were changed and social spendings were reformed. The share in GDP of state-own sector was heavily declined in order to increase the attractiveness of labour market to foreign investors. It was also important to stabilize the inflation and interest rates, because they were very volatile. Wages were increasing slower than the dynamics of the economic growth, thus affecting the persistence of low inflation [Trichet, 2008; Rosenberg 2008].

3. First effects of euro adoption

The fulfilling convergence criteria had a positive impact on Slovakia GDP, which grew strongly. It was growing on average by c.a. 8.5% per year between 2005 and 2007. Employment has been increasing by about 3% annually in this period. Moreover the dynamics of the economic growth in Slovakia was c.a. 5.6% higher than in the Eurozone countries.

It is often argued [Torój, 2012] that the drop in GDP in 2009 would not occur if Slovakia would remain with its own currency. An example of Poland is given, which by depreciation of zloty against euro was able to keep economic growth. Based on New Keynesian DSGE model it is argued that similar situation would have happened in Slovakia.

After entering the Eurozone inflation remained at low levels. However it should be noted that most of the government's efforts focused on the price control. Indeed, it was suspected that simultaneously with the change of currency traders will raise prices. Such a situation did happen in some other countries. To avoid such a thing a very stringent law was voted, which permitted even the imprisonment for overcharging.

But the prices should have even significantly decline due to the access to Eurozone. It is because before setting fixed exchange rate in mid 2008, koruna has strengthened over the past two years by more than 20% against the euro. This situation, together with the strengthening of the euro itself, in the period after the entering of Eurozone by Slovakia, and together with global crisis impacts, resulted in perception that the Slovak goods were becoming less competitive.

For example the number of tourists declined much. Slovakia noted the biggest drop in foreign tourists in 2009 from European countries. The number of visitors from neighbouring countries (especially Poland and Hungary) drooped even by 47%. Moreover the revenues from accommodation and food establishment reached the level from 2005 despite the fact that till 2008 these revenues were rapidly growing. This fact has forced hoteliers to reduce the prices. Moreover some major companies selling goods in Slovakia decided to cut their prices. It was done because Slovaks started to do the shopping in neighbouring countries [Lalinsky, 2010]. Such a behaviour may have had a global impact on country's economy, because Slovakia is a small country. In a bigger country only a local effect could have been observed, especially in border regions.

On the other hand due to low interest rates of ECB Slovak companies reached access to cheap credits. Even though credit policies were strengthening, the overall effect was that the number of new credits increased. This was not observed in other Visegrad Group countries. The drop of competitiveness is perceived then only as a temporal [Kupich, 2011]. However in 2009, prices in Western Europe were declining, while inflation in Slovakia was decreasing even more slowly. As the result the inflation in Slovakia was higher than in the three most stable Eurozone countries [Cukiernik, Karpis, 2010].

In the face of global crisis the Slovak government decided to set up a broad rescue package. The tax-free amount was increased, the process of VAT refund for companies was accelerated, rules for self-employed were simplified, the system of subsidies for the purchase of new cars was introduced, a law allowing the state to take over bankrupt companies was passed, if such companies are considered strategic ones. As the result in 2009 the deficit exceeded 8% of GDP, while the forecasts had been around 2.1%.

As the result the European Commission launched Excessive Deficit Procedure against Slovakia. It will require a further reduction in public expenditures. As far as now it is assumed that the convergence criteria, with respect to the deficit, will be met again in 2013. At the same time it is recommended to continue consolidation of government spending, reduce the risk of growing inflation, rationalize the government expenditures, increase the effectiveness of structural policy, improve the business environment, reduce the unemployment, increase the efficiency of fiscal policy and liberalize the energy market [Kupich, 2011].

The entry to the Eurozone resulted in increase of investor confidence. For example the interest on Slovak government bonds was 2 percentage points lower comparing with the Polish ones. Moreover ratings of Slovakia by S&P's, Moody's and Fitch have systematically been increasing since the beginning of negotiations on accession to the Eurozone. From BBB+ rating in the beginning of the century Slovakia reached A+ rating [SARIO, 2011].

Table 1: Main macroeconomic indicators for Slovakia

	2006	2007	2008	2009	2010	2011
deficit (in %)	3.2	1.8	2.1	8.0	7.7	4.8
debt (as % of GDP)	30.5	29.6	27.9	35.6	41.1	43.3
inflation (in %)	4.3	1.9	3.9	0.9	0.7	4.1
real GDP growth (in %)	8.3	10.5	5.8	-4.9	4.2	3.3
unemployment (in %)	13.4	11.1	9.5	12.0	14.4	13.5
change in export of goods and services	28%	26%	13%	-17%	20%	15%
change in import of goods and services	26%	22%	15%	-19%	21%	10%

Source: Own elaboration based on EUROSTAT, 2012

4. Size effects

Researches [Ohr, Ozalbayrak, 2012] show that small countries in European Union does not create a homogeneous group. However almost all of them have very open economies and are therefore easily affected by external shocks. The question of high financial credibility is usually more important for them than autonomy of monetary policy.

However this policy may be especially useful in case of shocks, so costs and benefits are hard to compute in short term [Zeman, 2012]. Nevertheless increases in trade are often agreed to be more beneficial than costs from losing a power in monetary policy. It is important to stress that in case of Slovakia trade turnover is around 160% of GDP and 80% of all trade is done with EU countries. These are one of the highest ratios in European Union. Many researches state that a trade of a small country should heavily increase after monetary union [Badinger, Breuss, 2009; Nardis, Santis, Vicarelli, 2008], but some argue that such expectations are exaggerated [Havranek, 2010]. It is also important to notice that the banking sector in almost all foreign owned now [Akal, Inancli, 2012].

In case of monetary union a common currency erases the risk of exchange rate fluctuations, which is a crucial case in the presented situation. Moreover a country gains access to a large market with no exchange rate risk. However some argue that small countries, usually with greater specialization in production, are more exposed to asymmetric shocks than big countries and therefore monetary union is less suitable for them [Jones, Frieden, Torres, 1998].

Conclusions

Note that since the beginning of this century, despite changes of governments, Slovakia systematically kept its way to fulfil the convergence criteria. The entry of the Eurozone was a priority for various governments and politicians. Slovaks are generally satisfied with euro and the voices of discontent are very rare. But they are increasing in the face of the current financial crisis. Some argue that agreeing on the common currency was a mistake and will result in Slovakia paying for problems of other countries. The trade growth, increase in FDI and faster increase in living standard are the most disputed and questioned long-term benefits of euro adoption. It is also important that Slovaks are the biggest euro enthusiasts in Europe and are very confident in EU institutions. It may be that the current success of euro adoption lays rather in psychology than in the core facts and figures. Nevertheless it seems that more definite opinion about Slovakia's euro adoption should be made in a few more years after more through studies.

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