

Euro – a Step in the Right Direction?

By Juraj Karpis
INESS, Slovakia

The bell tolls for the Slovak crown as the year 2008 comes to an end. The year 2009 brings the Euro to Slovakia and nothing can change it. The current worldwide financial crisis followed by general economic slowdown uncovered some positives as well as risks that the new currency presents.

The path towards euro began in earnest at the end of the year 2005 as Slovakia entered European Exchange Rate Mechanism ERM II. Although the strengthening Slovak Crown forced authorities to move the Central Parity around which the national currency was supposed to fluctuate in the ERM system together two times, Slovakia officially fulfilled all Maastricht Criteria and in July 2008 completed the approval process accepting the final conversion rate set by The Economic and Financial Council of the European Union.

The fact that the final conversion rate was 22% stronger than the first central parity at the time of ERM II entry illustrates the progress that Slovakia underwent in the past years. Reforms in all parts of the economy during both governments led by Prime Minister Mikuláš Dzurinda brought Slovakia back to its feet. Pension system reform, healthcare reform but especially labor code reform and tax reform attracted many foreign investors. The dramatic economic growth that followed helped to radically decrease unemployment and brought public finance back into shape. And these huge steps in the real convergence of Slovak economy towards European Union average were reflected in the strengthening of the Slovak crown.

The discussion of when to join a European Monetary Union was dominated by the opinion, the sooner the better. This unique, widespread political agreement was supported also by Slovak central bank, public opinion and majority of experts. Lonely voices arguing for later entry (or no entry at all) were ignored and received almost no attention. The current Prime Minister and leader of the leftist party SMER-Sociálna demokracia Robert Fico was strategically cautious in his statement about Euro adoption just before the elections. But his cautious attitude disappeared a couple of months after he took over power and he publicly stated that he and his ministers would fully support the commitment of the last government to adopt the Euro in the soonest possible term – January 2009. This public statement of the new government sent an eagerly awaited signal to foreign investors. It meant that also the new leftist coalition would accept the 3% state budget deficit criterion and this message decreased investor's worries about the immediate future of the Slovak economy. This relief was immediately felt by the Slovak crown exchange rate which came back to the path of continuous appreciation. This event illustrates the positive effect that the Euro brought even before Slovakia had adopted it. The effort of a country to fulfill Maastricht criteria limits its politicians in their desires to please their voters with unsustainable and expensive policies and presents a kind of a guarantee to foreign investors about the future development of the country they have invested in.

Other advantages of the Euro for the economy include lower transaction costs, abolishing the exchange rate costs, higher transparency of prices and lower costs of capital. All of these factors should, according to Slovak central bank, lead to a higher volume of international trade, increased direct investments and eventually faster economic growth and higher living standards. Against too optimistic expectations about an increase in international trade just because of Euro can be mentioned the fact that Slovakia already is a very open economy with exports equaling the volume of gross domestic product. Further, the empirical evidence among old EU countries that adopted Euro in the past didn't show substantial deepening of their international trade, either.

There are some risks associated with the Euro as well. As Slovakia enters the Euro zone, it will lose its sovereign monetary policy. In the future, the Slovak economy, although not in perfect synchronization with business cycles of old member countries' economies, will have to accept the unified monetary policy. If Slovak growth substantially surpasses the growth of other EU countries in the future, expansive monetary policy can lead to overheating and bubble creation.

Another potential risk is the lack of real convergence. Despite the above mentioned positive development in wealth creation in Slovakia in the recent years, gross domestic product per capita and price level are still substantially behind the EU average (In the year 2007 the Slovak GDP per capita in PPP was 69 % of EU 27 average). Till today, the catching-

up process happened by way of the strengthening of Slovak crown against other currencies and price increases as well. From 2009 on, the convergence will only be possible through faster price increases, which is a negative message for Slovak savers. The relatively faster inflation in combination with negative real interest rates will progressively decrease the value of their savings. The increase in the rate of growth of the price level immediately after Euro adoption became a problem in Slovenia, which adopted the Euro in 2007, even though their price level before entry was already much closer to the European average. This negative example was probably what the European central bank had in mind, when it publicly stated its worries about the sustainability of low inflation in the coming years in Slovakia.

The cost and benefit analysis was seriously shaken by recent events in world financial markets. The Credit crunch and massive losses of the financial institutions and big banks all around the world created an environment of substantial insecurity and made long-term predictions almost impossible. Sudden risk aversion and lack of liquidity brought about an outflow of capital from emerging markets. Neighboring currencies were the victims. The Polish zloty and Hungarian forint were hit the hardest. The Euro became a protecting shield for the Slovak crown which depreciated approximately 50% less than the unprotected Czech crown. Although currency stability is widely recognized as a plus for the economy, one has to bear in mind that it also means that the foreign investors, Slovak labor became relatively more expensive compared to its neighbors.

Because of frequent usage of high financial leverage, the European banks were among the hardest hit. Many of the biggest European banks were on the brink of bankruptcy in the last months. This fact alarmed political leaders who used huge amounts of public money to save them and to guarantee their operations and deposits of citizens. Costly rescue packages combined with severe economic slowdown all over Europe will strain public finances of the biggest Euro countries. And indeed, several European leaders already expressed their opinion that in coming years the Stability Pact with its budget deficit limits won't be the most important factor on their minds. This is a bad signal for Slovakia as the huge public spending financed by deficits of the biggest Euro countries will only add to already present inflationary pressure from the lagging price level convergence. Slovak citizens will therefore bear their part of the rescue costs even though their banks were healthy and invested in relatively secure Slovak assets. The tight credit markets in Europe reversed one of the supposed advantages – lower capital costs. The Slovak banking system with surplus liquidity will enter a Euro zone in January 2009, in which liquidity is scarce. It means not lower, but higher costs of capital for Slovak subjects.

Politically the EURO project was considered a success. But the current crisis will thoroughly test its viability. One monetary policy in combination with various sovereign fiscal policies makes it possible to spread the costs of irresponsible fiscal moves of one country onto all Euro holders. This fact can lead to tensions among Euro zone countries which can be unsustainable in the long run. Recent developments on the financial and capital markets with severe slowdown in the economic growth bring about a lot of insecurity about future developments. Slovakia enters the Euro zone in times of dramatic changes and it is therefore very difficult to make judgments about the results of this step. Although many advantages such as stability are surely welcome, problems of the Euro zone countries channeled through Euro to Slovakia pose risks as well. Whether the Euro was a step in the right direction will only be shown in the future.

Juraj Karpis
www.INESS.sk