Slovakia in eurozone

Peter Goliaš, INEKO

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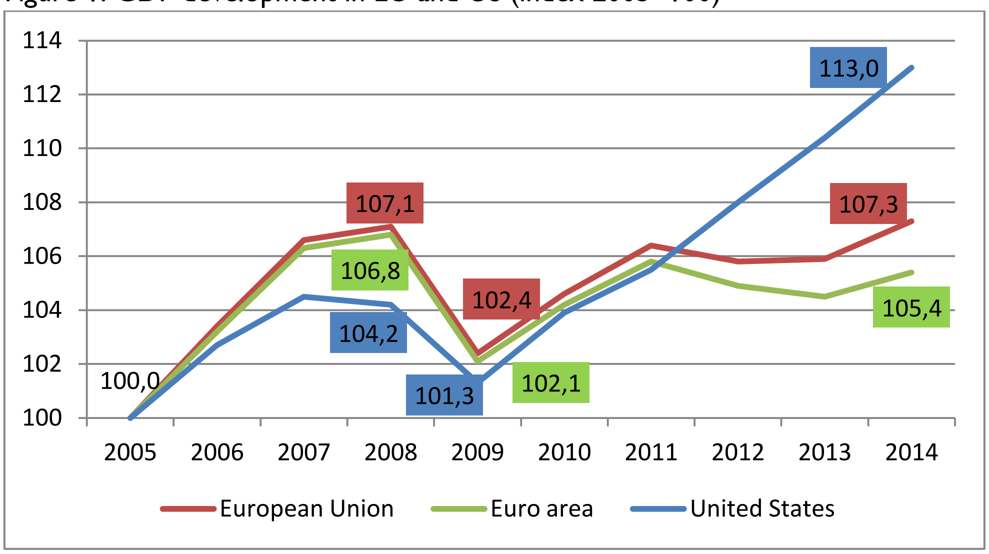
(1) Crisis in the eurozone: what in your opinion are the most important challenges that eurozone is facing and why, and what ideas for reforms would you suggest

Poor economic performance after the 2008 financial crisis is the key challenge that eurozone is facing. According to Eurostat, the gross domestic product (GDP) of eurozone was in 2014 just 105.4% of its 2005 level and still below its pre-crisis peak of 106.8% in 2008. For comparison, the GDP of the whole European Union (EU) was in 2014 at 107.3% and of the Unites States (US) at 113.0% of its 2005 level.

Figure 1: GDP development in EU and US (index 2005=100)



Source: Eurostat

Similarly, the unemployment rate in the eurozone was at 11.6% at the end of 2014 compared to 10.2% in the whole EU and 6.2% in the US.

The public gross debt of the eurozone is still growing and it was at 91.9% of GDP at the end of 2014 compared to 85.8% in 2011. For the whole EU the figure was at 86.8% at the end of 2014.

The inflation was slowing down in the past years. The harmonized index of consumer prices (HICP) in Euro area fell to 0.4% in 2014 and was even negative in the first months of 2015.

The danger of deflation combined with poor after-crisis economic performance point out the structural weakness of the Euro area. The countries with the common currency have given up the possibility to accommodate their economies to external shocks by the exchange rate adjustment. To remain competitive, they need to have more flexible labour market as well as the product markets. Current economic problems suggest that this flexibility is not sufficient. The European Central Bank (ECB) has obviously driven out the imminent risk of deflation and improved the economic outlook by launching a quantitative easing program that will last from March 2015 at least until September 2016. However, the potential of this measure is limited and the long-term economic prospects of the member countries depend mostly on how they will use the respective time for implementing structural reforms.

Poor economic performance has important implications also for a political landscape. The trust to traditional political parties is declining and the popularity of populist, anti-EU or anti-euro parties is growing in several member states. The examples include National Front in France, UK Independent Party in United Kingdom, Jobbik in Hungary, People's party in Danemark, Syriza and Golden Dawn in Greece, Alternative for Deutchland in Germany, as well as Freedom parties in Netherlands and Austria.

The victory of Syriza in Greek parliamentary elections in early 2015 is a threatening example of what could happen if populist parties overtake the power. Stopping reforms in Greece increased the risk that the financial aid provided by international donors in the aftermath of crisis would not be repaid and Greece would be even more dependent on further international support. Most of this aid has been provided from the eurozone members either directly or through the special financial stability mechanisms. Thus the potential Greek default would have direct implications for other eurozone members. Compared to 2010 the risk of contagion and eurozone breakup is much lower now thanks to the new institutions such as the European Stability Mechanism (ESM), the Outright Monetary Transactions (OMT) introduced by ECB in 2012 or the forming Banking Union. Despite that the Greek default would mean financial losses for the member countries and would cause even bigger turbulences in Greek economy that might finally lead to its exit from the eurozone.

To face these challenges the Euro area member states should do following[1]:

- **Require strongly conditional assistance to countries taking financial aid.** In case of insufficient reform effort, the aid should be stopped. The financial help should be regarded as an investment that has its own rate of return. The creditor countries can influence their rate of return by setting conditions on the indebted countries that help it regain its competitiveness and by enforcing the implementation of these conditions. Nevertheless if the indebted countries refuse to meet these conditions the rate of return virtually declines to zero or is even negative. In such case it is better to stop providing further financial support.
- **Enforce independent and centralised supervision over public finances.** The interventions to stabilise the eurozone (e.g. ESM, OMT, quantitative easing) have brought relief from market pressure. However, they have also brought higher risks of moral hazard, such as the risk of delaying necessary measures. To prevent moral hazard, the European Commission, as well as formal debt brakes and budget councils, should guard the public debt and deficit levels of eurozone members, both in the short-term and in the long-term. The Stability and Growth Pact was designed to meet this purpose. Unfortunately it proved to be too weak and was circumvented too often. It is important that the Fiscal Compact signed in 2012 better serves its purpose.
- **Implement structural reforms.** To improve competitiveness and foster growth the member countries should adopt structural reforms, such as the introduction of a more flexible labour

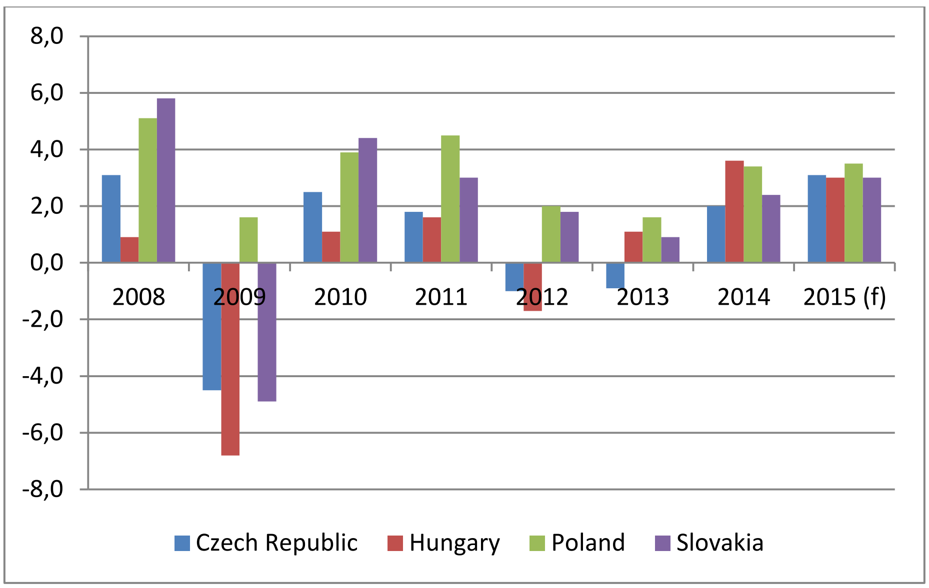
[1] For more detailed list of recommendations see Golias Peter, Juryzca Eugen: Solutions to Public Debt Crises in the EU: Seek Returns on That Investment (Views from Slovakia), INEKO, 2014, http://www.ineko.sk/file_download/787.

code, financially sustainable pension and health care system, more transparent public procurement, and more efficient public expenditures. Especially the highly indebted countries should cut public expenditures, launch privatisations and use revenues for repaying the debts. Every country should have a roadmap for implementing structural reforms for the decade ahead. The EU should complete the single market for goods and services. These measures should be an essential part of the solution to the EU debt crisis because they guarantee long-term public finance sustainability.

(2) Six years with the Euro: the balance of profits and losses

Slovakia introduced euro on January 1st 2009. The conversion rate was fixed in July 2008 on a strong level of 30.126 Slovak crowns for one euro. In 2009 the global financial crisis (Global Recession) hit the Slovak economy. The effect of the crisis was much bigger than the assumed effect of euro adoption. Both events happening at the same time make it difficult to assess the sole euro-impact. However, comparison with other Visegrad countries which does not have euro but were also hit by the crisis allows for partial evaluation.

Figure 2: Real GDP growth in Visegrad countries (in %)



Source: Eurostat; OECD forecasts for 2015

Key costs and benefits of euro adoption in Slovakia:

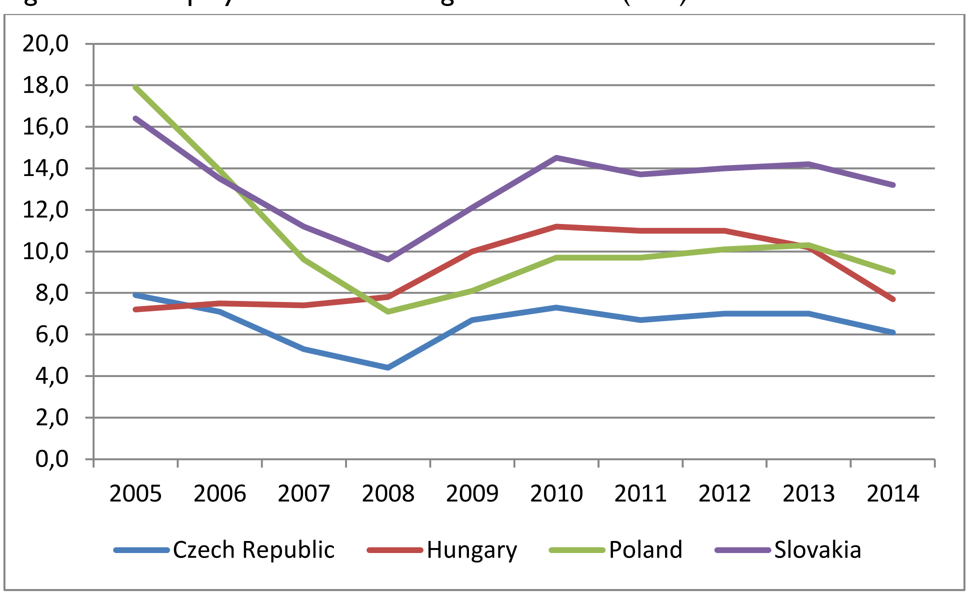
- **Conversion costs are more than compensated by lower transaction costs:** The National Bank of Slovakia (NBS) calculated[2] one-off currency conversion costs at 0.3% of GDP. At the same time NBS concluded that the most immediate benefits of euro adoption have materialized and the transaction costs declined by 0.3 % of GDP yearly, which is a permanent effect.
- **Loss of national monetary policy needs to be compensated by fiscal policy and flexible labour and products markets:** After fixing the exchange rate, Slovakia cannot react

[2] For NBS references mentioned in this article see the presentation of the Deputy Governor of the NBS Jan Toth: http://www.ineko.sk/file_download/769

to external shocks by adjusting monetary policy. It has to use counter-cyclical fiscal policy and relies more heavily on flexible adjustment of its labour and products markets. The Global Recession that hit the country in 2009 was a big test of both these tools. Indeed, the government provided a fiscal stimulus to the economy in 2009 and 2010 when it did not reflect steep decline in tax revenues and kept the public expenditure at the same or even higher values. As a result, public finance deficit jumped from 2.4% of GDP in 2008 to 7.9% of GDP in 2009 and 7.5% in 2010. This was reflected in a steep growth of the gross public debt limiting the space for further fiscal stimulus (also thanks to the internal debt-brake rules introduced in 2012). In private sector, the exporters could not benefit from a weaker currency and they had to accommodate solely by decreasing costs. Indeed, in 2009 the employment in manufacturing fell deeper in Slovakia than in the Czech Republic driving up the overall unemployment rate.

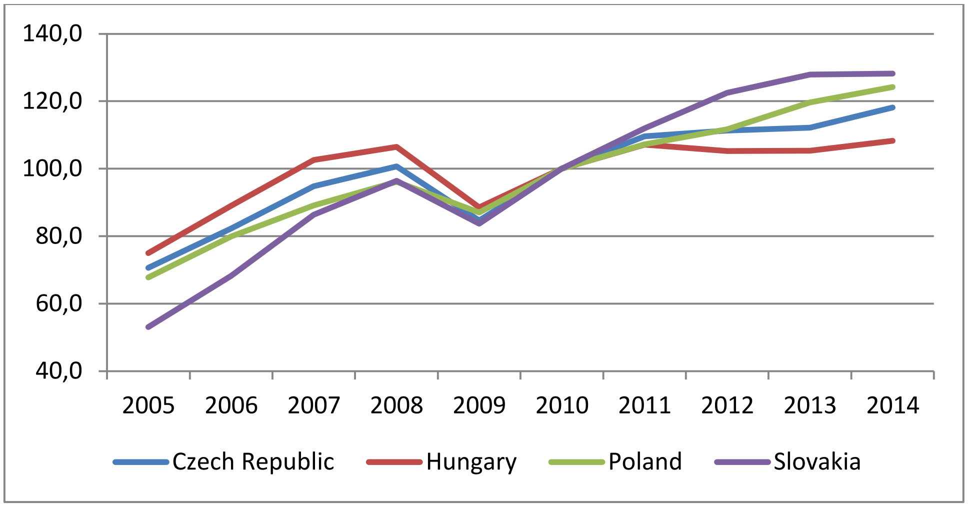
- **Stable nominal but volatile real exchange rate:** The nominal exchange rate stability allows for better planning and in the long-term it should help to increase investment, trade, and potential GDP. However, the NBS concluded that these effects are not yet visible mainly due to the long-lasting impact of the Global Recession. Moreover, important trading partners kept local currencies. According to the Statistics Office of the SR, Slovakia exported 28% of its exports in 2013 to the Czech Republic, Hungary and Poland (all having their own currency) and 44% to eurozone countries. Thus, the strong conversion rate and the depreciation of currencies in the Czech Republic, Hungary and Poland shortly after the crisis onset led to real exchange rate overvaluation in 2008-2010 documented by the NBS. Slovak products suddenly became more expensive in those markets and the exporters had to accommodate by cutting costs and prices. However, mainly cutting labour costs is less flexible and takes longer time. Indeed, the unemployment rate in Slovakia was rising over 2009-2010 faster than in other Visegrad countries (Figure 3). On the other hand, since 2011 the currencies in the Czech Republic, Hungary and Poland appreciated which led to real exchange rate undervaluation persisting at least until 2013 and providing stimulus to the Slovak exporters. Indeed, the Slovak export grew faster over 2011-13 in Slovakia compared to the Czech Republic (Figure 4). This may be the key reason why Slovakia avoided recession in 2012 and 2013.

Figure 3: Unemployment rate in Visegrad countries (in %)



Source: Eurostat

Figure 4: Export volume for Visegrad countries (index 2010=100)



Source: Eurostat

- **More emphasis on public finance stability:** The euro adoption required fulfilling the Maastricht criteria (including public finance deficit below 3% of GDP and public debt below 60% of GDP) which brought more attention to the public finance stability in the pre-accession period. After euro adoption and rapid increase in public finance deficit in 2009, Slovakia entered the Excessive Deficit Procedure – corrective arm of the Stability and Growth Pact of the EU which imposed further pressure on fiscal prudence.
- **Unexpected costs of resolving the eurozone public debt crisis:** Slovakia, along with the other eurozone Member States, is a participant in the financial aid programmes that currently provide assistance to Greece, Portugal, Ireland, Spain and Cyprus. Slovakia has taken part in all of the rescue programmes implemented in the eurozone with the exception of the first Greek bailout. Its total contribution exceeds €2.6 billion, or 3.6% of its GDP, and its total participation in the European Stability Mechanism (ESM) accounts for 7.1% of its GDP.
- **International financial backup:** The public debt crisis in eurozone led to a series of measures providing for financial backup of member countries. These include mainly the OTM introduced by the ECB in 2012, the European Financial Stability Facility (EFSF) introduced in 2010 and replaced by the ESM in 2012 as well as the quantitative easing program launched by the ECB in 2015.

(3) Lessons learned from the Slovak euro membership: the most important recommendations for other CE states

- Savings from lower transaction costs are much higher than the costs of conversion.
- For the country considering adapting euro, it is important if its key trading partners have the euro or not. If most of them do not have the euro the euro-country may face real exchange rate volatility (especially in times of economic shocks) which may have adverse effects on its exports and employment. On the other hand, the higher is the share of trade with eurozone countries, the higher is the real exchange rate stability (after adopting euro) with positive effects on the economy. Therefore, in case of countries with intensive trade relations it should be more advantageous to adopt euro simultaneously.

- The euro-country might be tempted to use more fiscal stimulus to compensate for the loss of national monetary policy. The risk is growing deficit and public debt to levels which are unsustainable. Therefore it is useful to establish internal rules guarding public debt.
- In times of economic shocks it is crucial that the country adjusts its economy by flexible labour and product markets. To prevent rise in unemployment the employers should be able to adjust wages.

(4) Conclusions

- Slovakia offers a clear example of positive immediate effects of adopting euro displayed in lower transaction costs by 0.3% of GDP annually. However, it still does not offer a clear example of positive long-term effects on investment, employment, and economic growth. This is mainly due to the unique event – Global Recession – hitting Slovakia exactly at the time of adopting euro and blurring the euro-effect. Nevertheless, Slovak experience confirms the need for flexible labour and product markets to compensate for the loss of national monetary policy. Moreover, it proves the importance of having the same currency for a group of countries with intensive trade relations.