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Slovakia

Slovakia is a small country located within Eastern Europe which has a note worthy historical past. During World War II Slovakia was under the rule of Nazi party within Germany. After the war the Soviet Union occupied the area and combined the Czech Republic with the Slovak Republic, current day Slovakia, creating Czechoslovakia. On January 1, 1993, after decades of disagreement in many ways, the Czech Republic decided to separate from Slovak Republic. This decision was long due to the impact of the drastic increase in the GDP and the high level of inflation. Slovakia believed that the very high level of inflation would critically affect their ability to import goods. This landed a significant blow on the Slovakian population. Slovakia was seeing a decline in their growth as a country, and they felt it was best to make a change.

On May 1, 2004, Slovakia officially became a member of the European Union. The primary reason for Slovakia to join the European Union was to attract more investments. They wanted to make a statement to the rest of the world which would show that Slovakia's economy is one in which someone could invest their time in. Adopting the Euro would better Slovakia's image, and send a strong statement to the rest of the world. In order to adopt the Euro a country's economy must be approved by the EU, and meet a number of criteria. The country must meet political standards, and economic standards, and accept the Acquis Communautaire. To meet the political criteria, the country must have respect for human rights and have protection of minorities. To meet the economic criteria, the country must be able to withstand the competitive pressure in the EU. To meet the acceptance of the Acquis Communautaire, the country needs to “harmonize the system of law” with the EU.

On June 3, 2008, the European Commission approved Slovakia’s application to adopt the Euro after clarifying that Slovakia achieved the criteria for joining the Euro zone on interest rates, budget deficits, and inflation. The European Commission warned them to be prepared to fight the high inflation with the fiscal policies. On January 1, 2009, Slovakia adopted the Euro as its national currency. They were the 16th country to adopt the Euro. They wanted to improve their market economy after it was devastated by dictatorship. But before they adopted the Euro, they had to commit toward the Euro in the Treaty with EU on April 16, 2003

In order for a country to adopt the euro they must meet the criteria of the “Maastricht Criteria”, which is mandatory for the European Union member states to meet in order to enter final stage of the European Economic and Monetary Union. The criterion includes 4 mandatory pieces that need to be met. First of which is on the topic of inflation rates; the country which wishes to adopt the currency should have an inflation rate of no more than 1.5 percentage points higher than the average of the three best performing member states of the EU. Second is on the topic of government finance. The annual government deficit to gross domestic product must not exceed 3% at the end of the last fiscal year. Additionally, the ratio of gross government debt to GDP must not exceed 60% at the end of the previous fiscal year. The third criterion which must be met is that the country must have joined the exchange rate mechanism (ERM) which resides under the European Monetary System. They must qualify for ERM for at least two years, and not have devalued its currency during this time period. Many countries fulfill this requirement by fixing their exchange rate to the euro which enables not only their currency to meet this exchange rate criteria but also forces inflation to be equal to that of the European Union members. Lastly, the fourth criteria which must be met is that the nominal long term interest rate must not be more than two percentage points higher than the long term interest rates within the three lowest inflation rate members. The main purpose of the Maastricht Criteria, also known as the euro convergence criteria, is to maintain price stability within the Eurozone. Within this work we will go into specific detail about how Slovakia met each of these criteria and hence was successful within adopting the euro.

When analyzing the current account data we see an increase within Slovakia's capital account through the difference between Slovakia's net exports and net imports. As seen through the data, Slovakia's current account is positive which expresses that exports were greater than imports in order to keep foreign reserves high. Whilekeeping the current account positive, Slovakia was simultaneously borrowing foreign currencies from the rest or the world as shown through the increasing positive balance of their financial capital account prior to 2009. This is essential for Slovakia as they must have a large foreign reserve account in order to be successful in the process of adopting the euro. Through analysis Slovakia kept their exports high and borrowed the euro in order to be successful during the process of exchanging their domestic currency, the koruna. The decrease in reserves within early 2009 signifies the final stage in the adoption process of the euro. The reserves are physically being released from the country's reserve account into the economy by the government. In months prior to the date of adoption, Slovakia's mint was tasked to produce 500 million euro and cent coins. On September 5th, 2008 the NBS announced that by the end of the year Slovakia planned to transport over 7 billion euros in banknotes from Austria and to mint coins worth 167 million Euros in order to pre-stock the country with the new currency. It was decided that these coins were to be distributed throughout the country starting in November 2008 for the preparation of the adoption date, January 1st 2009 as decided by the European Union. Through analysis, it can be seen that these coins were being distributed as the money supply increase as shown by the M2 charts at the end of this report.

As shown by the current account and financial capital account charts, Slovakia assumed a normal common negative balance in their current account after 2009. This is because after the currency was adopted, the country started to import more than they exported. In addition we see that during this same time period the financial capital account started to increase and this represents an inflow of money into the country that was either borrowed money or money from the sale of assets. This financial capital account is increasing in order to cover Slovakia's current account deficit which is represented by the negative balance within the current account.

From the years of 2002 through 2008, Slovakia's inflation rate ranged from 2 percent to 5 percent to 9 percent, with their highest inflation rate of 9.23% coming in the year 2003 and their lowest inflation rate of 2.38% coming in the year 2007. We do notice a steady decline in inflation from 2003 to 2007 probably because they knew that they had to get their inflation rate down in order to enter the European Union. On May 2008, the European Commission approved Slovakia's application and recommended the bid during the EU's finance minister meeting. Slovakia had to stay within 1.5 percentage points of the harmonized index of consumer prices average rate of the three EU member states with the lowest inflation. The three states with the lowest inflation were Malta (1.5%), the Netherlands (1.7%), and Denmark (2.0%). That comes out to an average inflation of 1.7% plus the 1.5% leeway equals to a 3.2% inflation that the European Commission gives to member looking to convert to the euro. Slovakia was able to meet this requirement by having an average inflation rate of 2.2% from April 2007 to March 2008. The reason that Slovakia was able to meet these requirements was because of strong productivity growth and decline in labor costs. With that being said, Slovakia's inflation has been increasing ever since they adopted the euro. This necessarily is not a bad thing because economists expected inflation to occur as the effects of inflation are normal when the Slovak koruna appreciates to the euro. Also, tight labor market conditions and emerging holdups in some labor markets pose a serious threat of accelerating wage growth. An increase in energy prices pose an upside threat to inflation due to the fact that the recent hike in oil prices had not been reflected on consumer prices.

The Maastricht criteria also include language on governmental finance which each country must meet. Slovakia had to have a government deficit below three percent of their GDP, and their debt to GDP had to be fewer than 60%. By the end of 2007, Slovakia was able to achieve a government deficit of 2.2% of their gross domestic product. Slovakia also achieved to have their general debt ratio to be 29.4% of their GDP, well below the benchmark of 60% that the European Commission sets. Despite this achievement, Slovakia still has to comply with the medium/ long term objectives detailed in the Stability and Growth Pact, which says that they must decrease their debt to GDP ratio from 29.4% to .8%. Along with the criteria mentioned, Slovakia was also able to meet the average level of long term interest rates by achieving a 4.5% interest rate level compared to the 6.5% interest rate level goal,between April 2007 and March 2008.

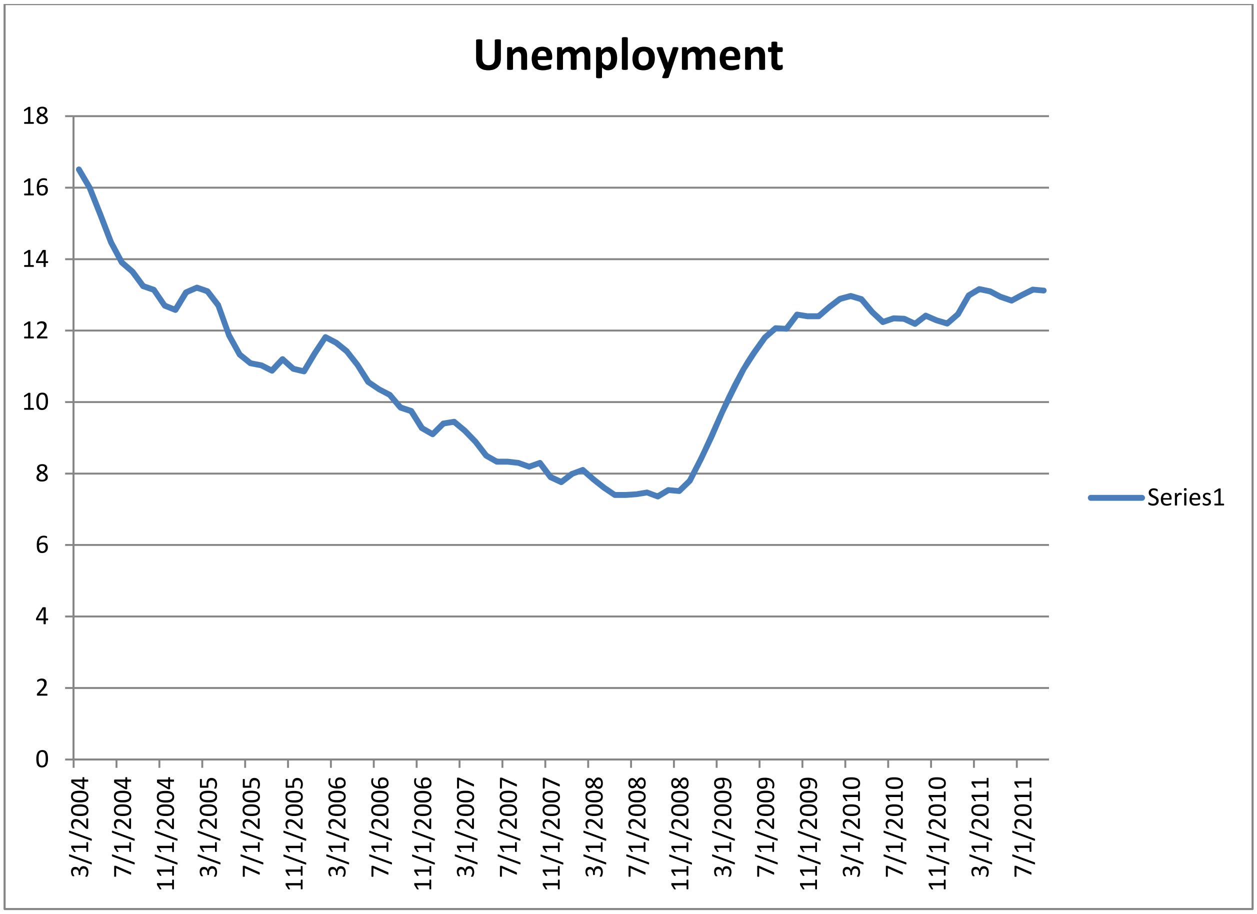
In order to establish easier trade across European countries the European exchange rate mechanism (ERM) was introduced in 1979. The ERM was essentially a set of currency standards which a country must meet to be able to maintain ERM status. The ERM's goals were to reduce exchange rate variability among European states. This would allow trade and capital to easily flow throughout Europe. The ERM was based on fixed currency exchange rate margins among a basket of European currencies. Individual currencies were allowed to float within 2.25% of the Basket of European currencies.

On December 31st 1998 the value of the basket of currencies was frozen and that value became the value of the Euro. In 1999 the ERM was replaced with ERM II. ERM II is a required component countries must meet in order to use the Euro. Countries wishing to use the Euro must value their currency within a 15% floating range against the Euro. This means that the currency must move in the same direction of the Euro within 15% range. ERM II essentially ensures that a country will be able to handle the economic pressures that come along with using the Euro.

When a country first decides to enter ERM II, a base exchange rate with the euro is set. Ideally this would be a fixed rate, however very few countries choose to fix their currency. In order to maintain ERM II eligibility, the exchange rate is allowed to deviate from the base exchange rate by no more than 15% above or below. In the case of Slovakia, ERM II was implemented in 2005. Their assigned value was 38.455 Korunas to Euros. The most the currency ever floated was 12%. Due to Slovakia's strong economy the base exchange rate was revalued in 2007 and again in 2008 at 35.4424, and 30.126 accordingly. By the time they adopted the Euro on January 1st 2009 their exchange rate only had deviated 1.9% from the base. The final exchange rate was 30.126 Koruna's to Euros.

The final criteria for the Maastricht treaty concerns long term interest rates. The treaty states that the nominal long term interest rates must not be more than 2 percentage points higher than the average long term interest rate of the three states with the lowest inflation. This standard ensures that there will be price stability within the Eurozone even with the entry of new members. The states with the lowest inflation levels were Malta, Netherlands, and Denmark, each with long term interest rates at 4.8%, 4.3% and 4.3% respectively. This means that in order to fulfill the criteria on interest rates, Slovakia must not have an interest rate higher than 6.5%. From the period dating April 2007 to March 2008 long term interest rates were 4.5 percent, meeting the mandatory long term interest rate criteria as stated within the Maastricht Criteria. This average interest rate is significant because this was the specific interest rate that the European Central Bank used for the decision process, hence enabling Slovakia to proceed in the process of adopting the euro.

It can be seen throughout this piece the reasoning behind why a country would adopt a strong currency. By adopting the euro Slovakia is holding itself to a higher economic standard. The euro enables the country’s government to have financial discipline specifically within managing the country’s debt levels which is essential to the overall health of the nation’s economy. In addition inflation has less of an impact on Slovakia due to the fact that during the time of rising or falling prices, the affects of inflation would be dampened on Slovakia because every member of the European Union share the same inflation rate. There is both a trade benefit since they are now part of significant union the shares the same currency. Finally, the Euro will help facilitate trade throughout Slovakia and Europe by providing a common unit of exchange. All of these aspects will aid Slovakia in its future endeavors, as it grows to become a more relevant piece in world trade and politics.


Unemployment
18
16
14
12
10
8
6
4
2
0
3/1/2004
7/1/2004
11/1/2004
3/1/2005
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11/1/2005
3/1/2006
7/1/2006
11/1/2006
3/1/2007
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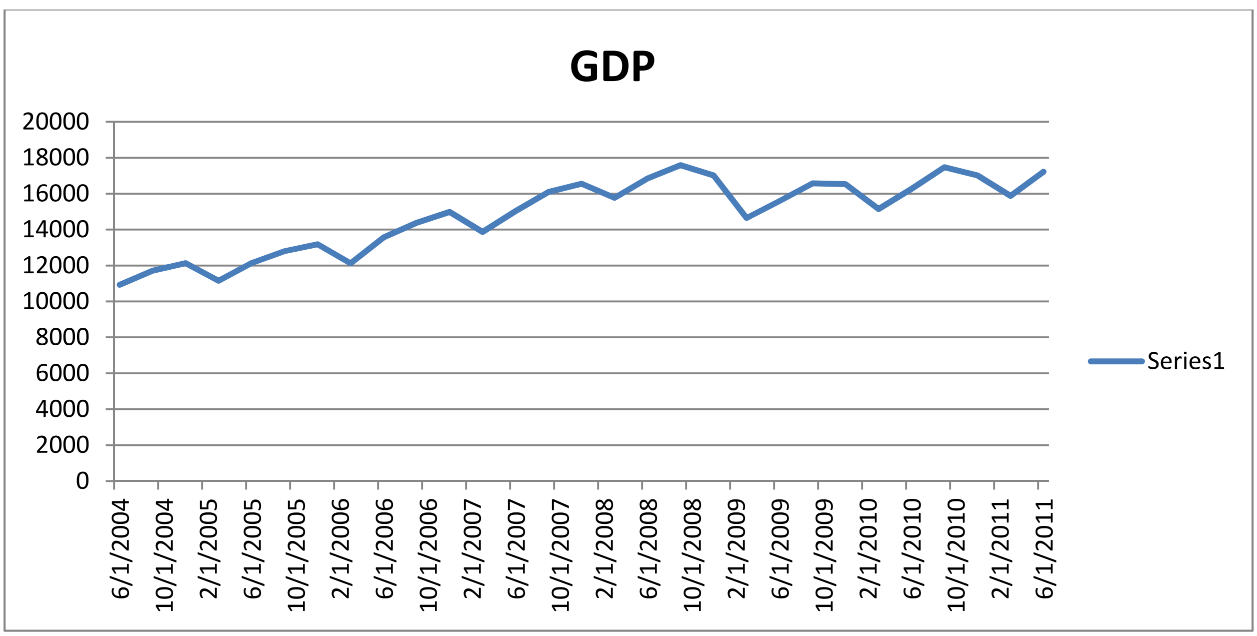
Series1


GDP
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18000
16000
14000
12000
10000
8000
6000
4000
2000
0
6/1/2004
10/1/2004
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6/1/2005
10/1/2005
2/1/2006
6/1/2006
10/1/2006
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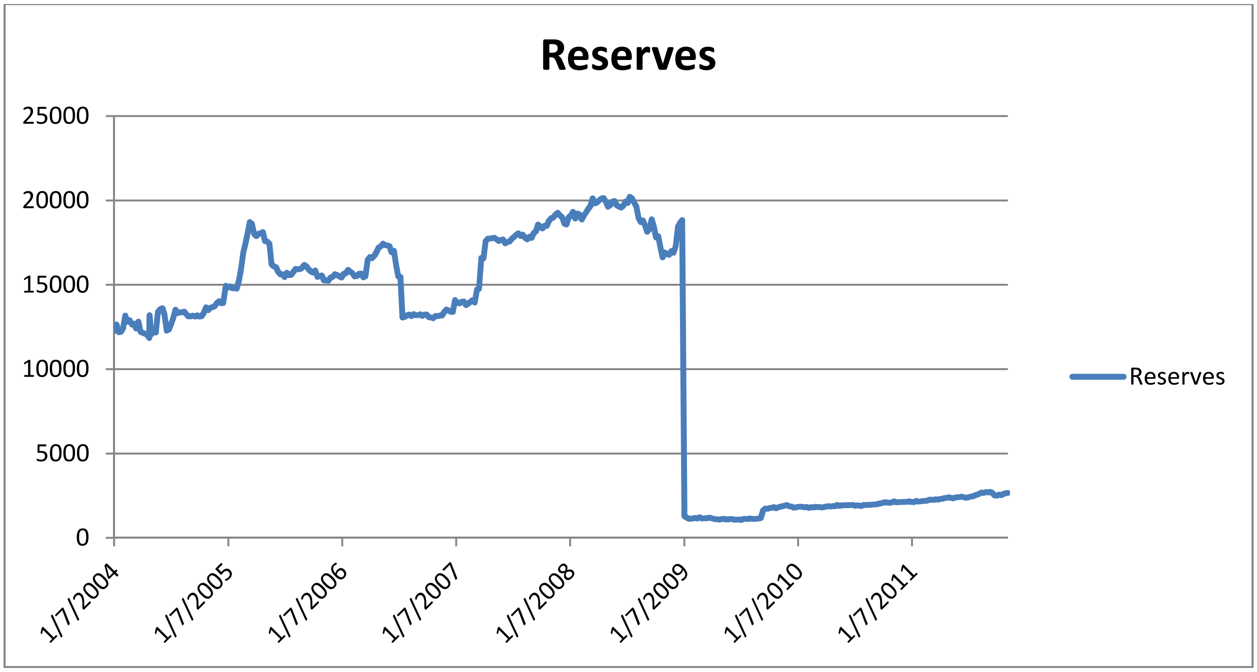
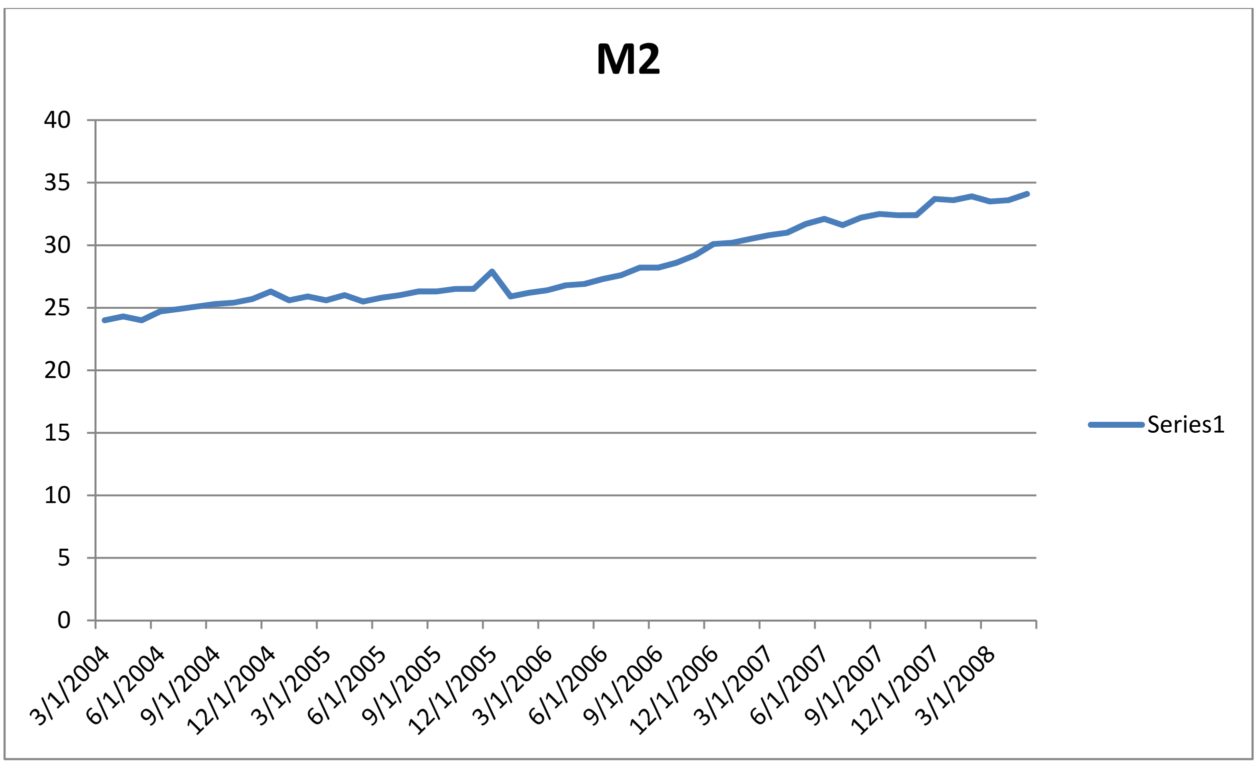
Series1


Reserves
25000
20000
15000
10000
5000
0
1/7/2004
1/7/2005
1/7/2006
1/7/2007
1/7/2008
1/7/2009
1/7/2010
1/7/2011
Reserves


M2
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35
30
25
20
15
10
5
0
3/1/2004
6/1/2004
9/1/2004
12/1/2004
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6/1/2005
9/1/2005
12/1/2005
3/1/2006
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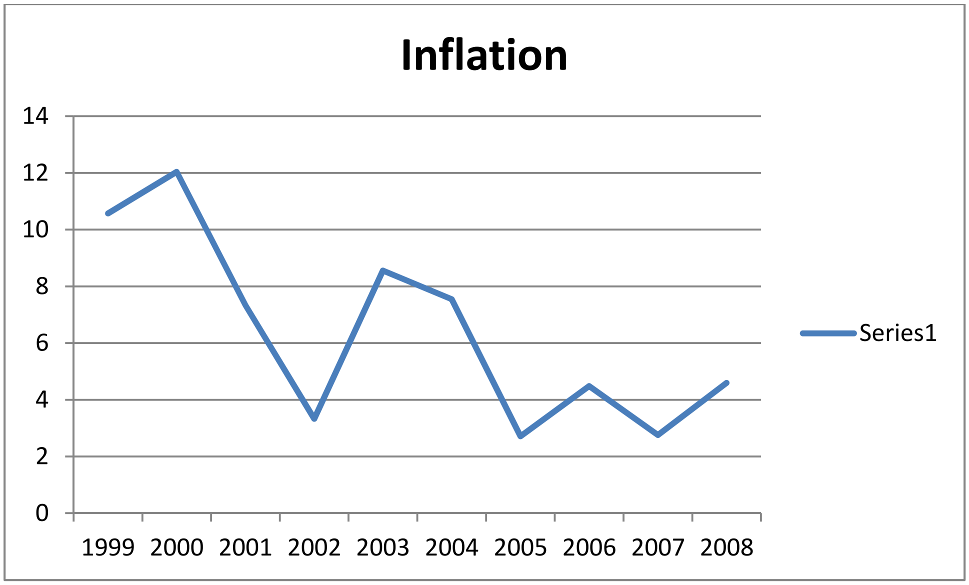
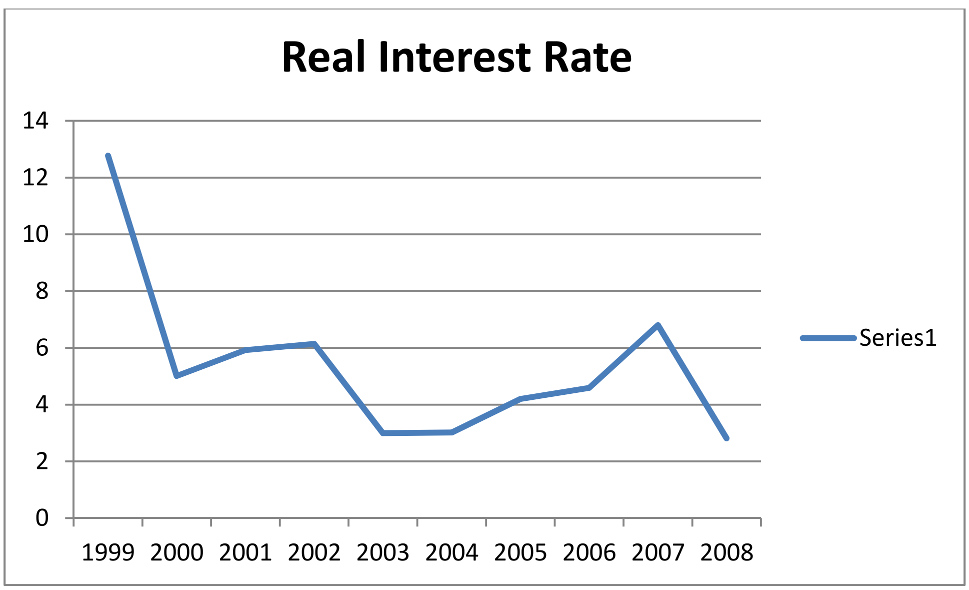
3/1/2008
Series1


Inflation
14
12
10
8
6
4
2
0
1999 2000 2001 2002 2003 2004 2005 2006 2007 2008
Series1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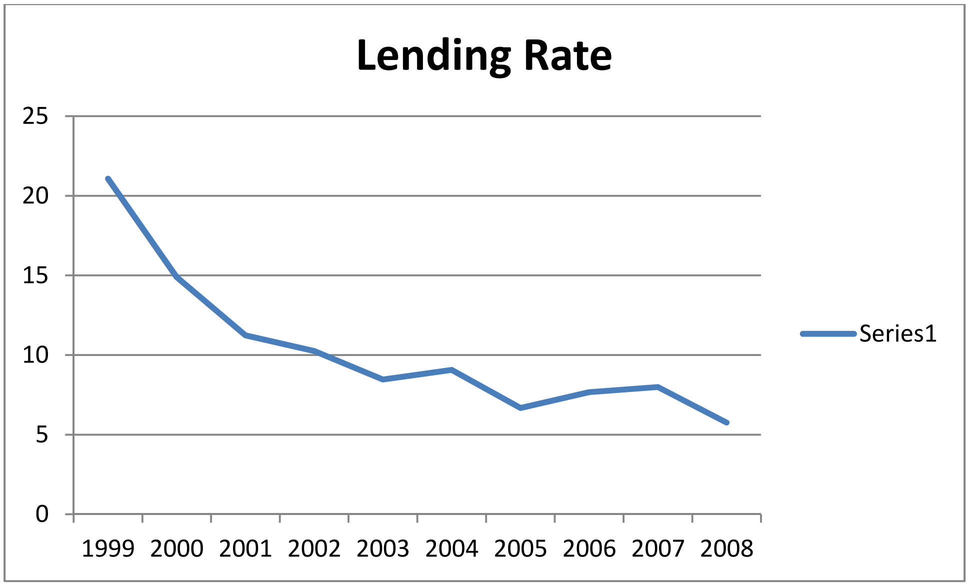
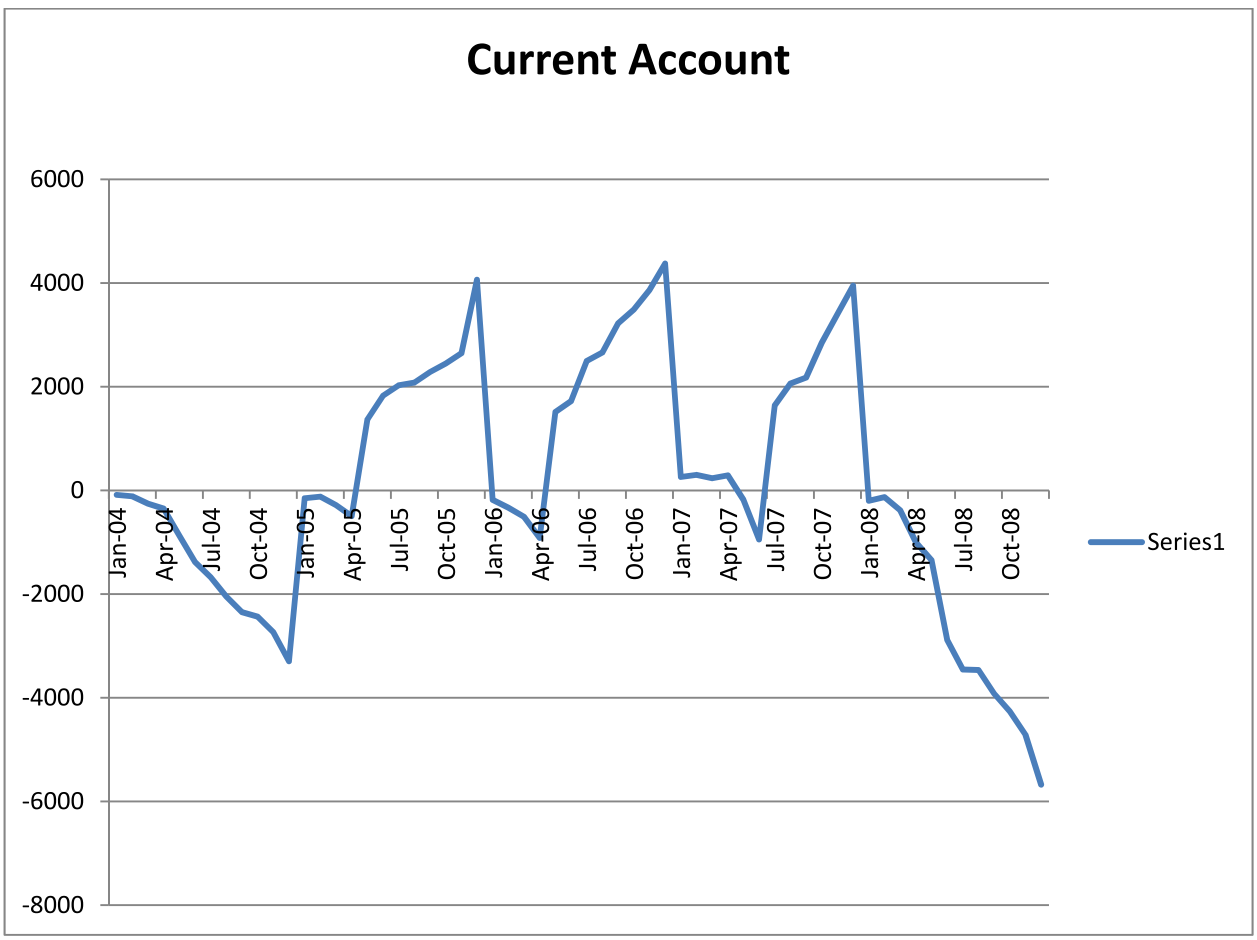
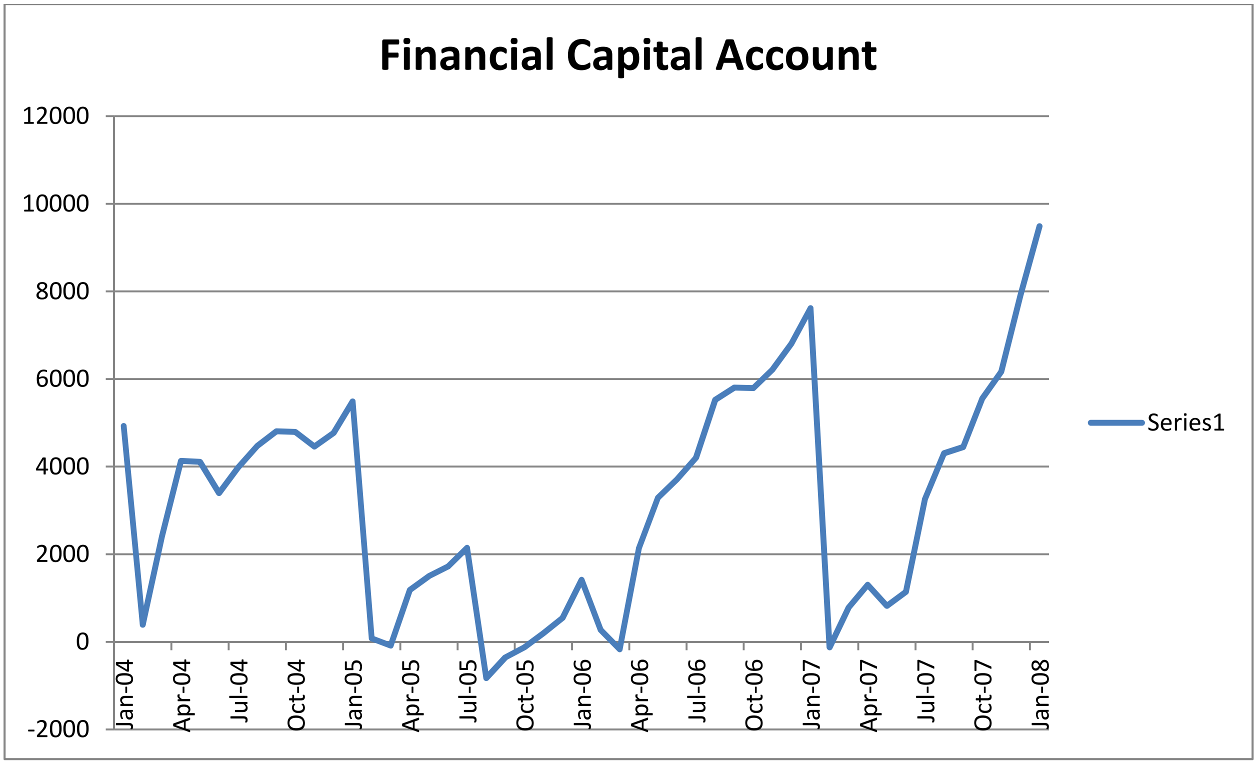
10
8
6
4
2
0
1999 2000 2001 2002 2003 2004 2005 2006 2007 2008
Series1



Lending Rate
25
20
15
10
5
0
1999 2000 2001 2002 2003 2004 2005 2006 2007 2008
Series1



Current Account
6000
4000
2000
0
-2000
-4000
-6000
-8000
Jan-04 Apr-04 Jul-04 Oct-04 Jan-05 Apr-05 Jul-05 Oct-05 Jan-06 Apr-06 Jul-06 Oct-06 Jan-07 Apr-07 Jul-07 Oct-07 Jan-08 Apr-08 Jul-08 Oct-08
Series1


Financial Capital Account
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10000
8000
6000
4000
2000
0
-2000
Jan-04
Apr-04
Jul-04
Oct-04
Jan-05
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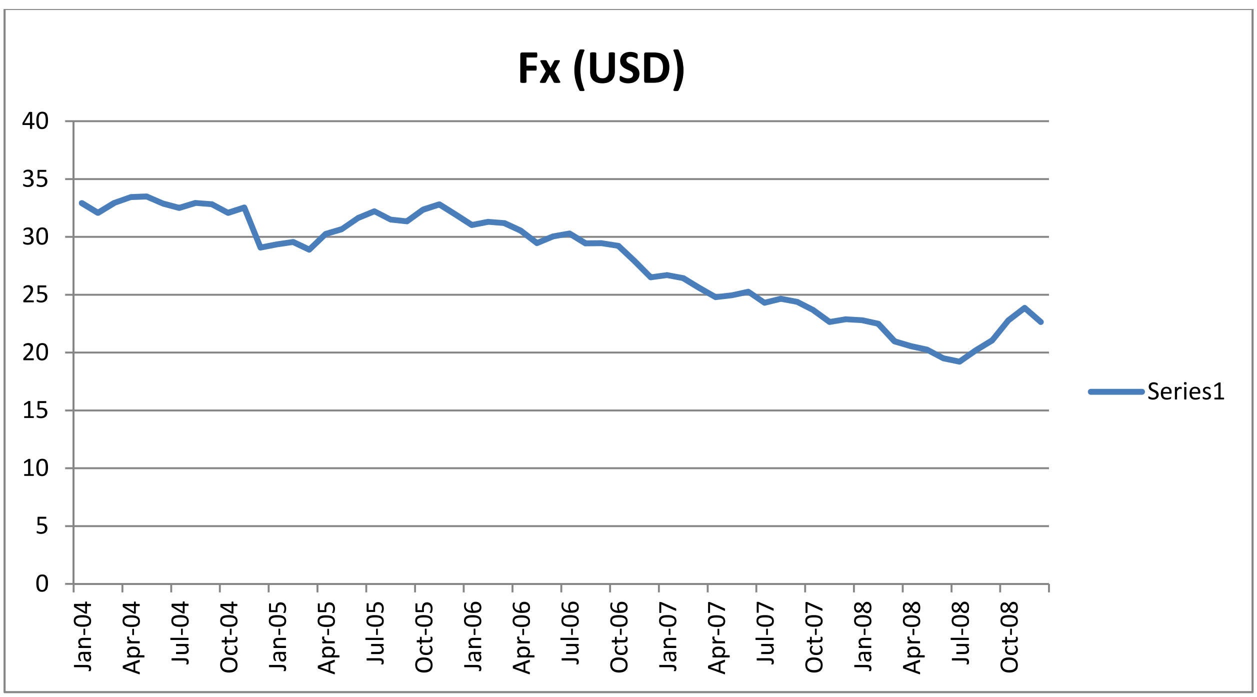
Oct-07
Jan-08
Series1


Fx (USD)
40
35
30
25
20
15
10
5
0
Jan-04
Apr-04
Jul-04
Oct-04
Jan-05
Apr-05
Jul-05
Oct-05
Jan-06
Apr-06
Jul-06
Oct-06
Jan-07
Apr-07
Jul-07
Oct-07
Jan-08
Apr-08
Jul-08
Oct-08
Series1

Fx (EUR)

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11/17/2004 - 12/31/2009 Daily   Local CCY

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