

**EXCHANGE RATE OF THE SLOVENIAN TOLAR IN
THE CONTEXT OF SLOVENIA'S INCLUSION IN
THE EU AND IN THE EMU**

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WORKING PAPER No. 1, 1999

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Editor of the WP series: Peter Stanovnik

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This paper is also available on Internet home page: <http://www.ier.si>

Ljubljana, January 1999

Introduction

Creation of the European economic and monetary union (EMU) and successive introduction of the European single currency, the euro, is a historic event, which will lead to fundamental changes in the EU economies. These changes will undoubtedly have a significant impact on the economies of the Central European transition countries, candidates for a full membership in the EU, similarly as the preparations of the EU countries for the EMU and their efforts to meet the Maastricht convergence criteria have already affected the Central European economies. Policy-makers and other decision-makers at various levels (enterprises, banks, government bodies) will have to adapt to the changing environment, first by adjusting to the irrevocably fixed exchange rates among the EU currencies participating in the EMU and then by adjusting to the introduction of the euro and to the elimination of national currencies in the euro zone. This paper, however, does not concentrate on these otherwise important issues of the impact of the EMU on the Central European countries. It focuses primarily on the most direct questions related to the EMU for these countries - why, how and when Slovenia and the other Central European EU candidate countries will be ready to join the EMU.

The group of Central European countries to which Slovenia should compare itself includes the Czech Republic, Hungary and Poland. They (together with Estonia and Cyprus) belong to the group of countries, which started official negotiation for a full membership in the EU in March 1998. It should be mentioned as the outset that this group of countries is rather homogenous as regards the fulfilment of the Maastricht convergence criteria, or in other words as regards their readiness for joining the European monetary integration. In general, they fulfil both fiscal criteria (fiscal deficit, public debt), but fail to meet the three monetary convergence criteria (inflation rate, long-term interest rate, stability of the exchange rate). The Czech Republic and Slovenia, where the inflation rate has stabilised in the high single-digit figures, perform better than Hungary and Poland in terms of both fiscal and monetary Maastricht criteria.¹ While the analysis in this section is broadly relevant for the entire group of the Central European countries, special attention is given to Slovenia, which can be considered as the most advanced within the group in terms of per capita GDP and the readiness to join the European monetary integration process.

¹ As Central European countries are not required to comply with the Maastricht convergence criteria, official data on their fulfilment of these criteria do not exist. Some unofficial estimates can be found in Backé and Lindner (1996) and Temprano-Arroyo and Feldman (1988).

Exchange rate arrangements in Central European countries

In the period of transition individual Central European countries have chosen very different and completely uncoordinated monetary and exchange rate systems and policies. The exchange rate regimes of these countries cover the whole spectrum of possible solutions: Slovenia decided for a (managed) floating exchange rate system, the Czech Republic used a fixed exchange rate system until recently, when it switched to a floating regime. Poland and Hungary opted for some interim solutions. Poland first decided for a fixed, but adjustable peg system, while now it practices a crawling peg regime, which is also in use in Hungary.² Membership of these countries in the CEFTA has remained an unused opportunity to harmonise their monetary and exchange rate policies. Their association agreements with the EU do not restrain their monetary and exchange rate autonomy either. However, it can be expected that in their EU accession period and in the negotiations for a full membership in the EU, the Central European countries will be subject to some pressures and obligations for the co-ordination and harmonisation of their monetary and exchange rate systems and policies, with the aim of better preparing them for their future inclusion in the ERM 2 (Exchange Rate Mechanism 2) and in the EMU.

Differing exchange rate regimes in individual Central European countries reflect, first, their different starting positions (availability of their international monetary reserves in the first place), and second, their preferences between the two alternative goals of the exchange rate policy: a) stabilising role of the nominal exchange rate as the nominal anchor in the economy for repressing inflationary pressures and expectations, and b) equilibrating role of the real exchange rate as an instrument for preserving international competitiveness of the economy and for equilibrating the balance of payments. Obviously, fixers had some preference for the first, and floaters for the second solution, while interim solutions such as adjustable peg and crawling peg tried to make the best (or to avoid the worst) of both extreme solutions.³ While differences in the exchange rate regime appear considerable at the first sight, in practical implementation of the exchange rate policies they turn out to be less pronounced. Fixers occasionally had to change the official rate or had to widen permissible bands of fluctuations around them, while floaters had to intervene substantially on the foreign exchange market to influence the developments of the market exchange rate. In fact, a specific paradox with respect to the exchange rate system can be observed: while fixers

² More details on exchange rate systems of Central European countries in their transition periods are available in Radzyner and Riesinger (1996), Begg (1996) and Lavrač (1997).

³ For the argumentations in favour of a "corridor" exchange rate system as a compromise solution, see Tullio (1997).

moved towards increased exchange rate flexibility, floaters are considering, as a part of their longer-term EU accession strategies, how and when to move to a fixed exchange rate system.

Exchange rate arrangements in Slovenia

Since Slovenian independence in 1991 Slovenia chose the system of a managed floating exchange rate.⁴ At the beginning Slovenia had no international monetary reserves (they were held in Belgrade and were lost) and inherited high inflation (more than 200% annually). In this circumstances it would be unrealistic to try to sustain a fixed exchange rate. It would have to be changed very often, which would led to negative expectations and inflation-devaluation spiral. Since we had this experience in Yugoslavia, Slovenia did not want to repeat this, but decided for a floating system. The main emphasis was on control of monetary aggregates (base money as the intermediate target), while exchange rate would be left to the market, at least in principle. The floating exchange rate was much opposed to by foreign advisers (IMF, J. Sachs), who claimed that fixed exchange rate should be used as a nominal anchor to gain macroeconomic stability. Slovenia disobeyed, and its floating brought good results - inflation steadily came down, to present high single digit level. IMF on its yearly missions steadily criticised Slovenia for its exchange rate system, until 1997/8, when after Asian and Czech crises it recognised advantages of more flexible exchange rate arrangements. The problem in Slovenia was high capital inflow, mostly due to interest rate differential. Therefore, exchange rate intervention, most of it of sterilised nature, was quite substantial. Over the years, Slovenian tolar depreciated from 32 tolar/DM to current 95 tolar/DM. In the long run, it was quite following the PPP (purchasing power parity rule). Constantly there was some real appreciation, but of a moderate size, at least when compared to other transition economies. In some subperiods, with the existing inflation differential towards the EU, nominal exchange rate stayed almost unchanged for about half a year, which led to substantial short-term appreciation of the real exchange rates, and claims of exporters to do something about the exchange rate, in fact for the central bank to intervene to push the nominal exchange rate nearer to the PPP level. However,

⁴ Slovenian managed floating exchange rate system 1991 is described in more detail in Lavrač and Stanovnik (1997) and Mencinger (1997).

competitiveness of Slovenian exports was in fact not seriously harmed, as Slovenian balance of payments on current account throughout the period remained roughly in equilibrium (trade deficit in goods was compensated by services surplus), contrary to other Central European transition countries. It should be understood that the equilibrium real exchange rate is a function of a number of fundamental real variables which themselves change over time.⁵ The attempt to maintain the real exchange rate at a constant level in line with the purchasing power parity rule may therefore lead to adverse movements in an economy's competitiveness and general macroeconomic disequilibrium. The concept of an equilibrium real exchange rate whose aim is to establish the external and internal equilibrium position of an economy is especially delicate in transition economies. These economies are going through massive structural changes whose dynamics directly affect the determination of the equilibrium real exchange rate. We can conclude that Slovenian managed floating worked quite well, the only real problem is that the Central bank in time exhausted its capacities for intervention, since large sterilisation with various securities and its servicing (interest) costs exhausted its budget.

Nominal exchange rate in the context of monetary integration

In all of the Central European economies the main challenge for their exchange rate policies was how to cope with large and persistent capital inflows and how to prevent too strong real appreciation of domestic currencies, which undermined their competitiveness and their current account balances. These problems were dealt with in more detail in the previous section of the paper. Here we are interested primarily in the nominal exchange rates in the context of preparation of these countries for joining the EU and its EMU in the near future. European monetary integration is primarily about stabilising the nominal exchange rates. The EMS (with its ERM and its successor ERM 2) is a specific system of fixed (though adjustable) nominal exchange rates among the member countries. The EMU goes one step further, as it requires the irrevocable fixing of the exchange rates among the member countries in the first phase, and as much as the complete elimination of nominal exchange rates among the member currencies, when the EMU moves to the single currency and the national currencies of the member countries are given up in the next phase. In the process, candidate countries will go through a period of successively giving up their monetary and

⁵ For a discussion on the real exchange rate in Slovenia, see Jazbec and Lavrač (1988).

exchange rate sovereignty. First, they will lose some autonomy in their exchange rate policy, at the latest when they join the ERM 2. Next, they will lose their nominal exchange rate as an instrument of adjustment as it becomes irrevocably fixed in the EMU, and finally, they will lose their nominal exchange rate as such as they give up their own national currency when joining the euro area. Nominal exchange rates among the euro zone countries will disappear, but there is still some scope for real exchange rate changes among them, as is the case among the regions within a country. Nominal exchange rates will, on the other hand, matter only externally, for the euro area as a whole, meaning they will be outside the control of the individual (and particularly of the small) EMU member countries.

Informal and formal inclusion in European monetary integration

For the moment Slovenia is not included in any form of the European monetary integration. It enjoys its full monetary sovereignty, with its own currency, the central bank, autonomous monetary and exchange rate policy. Its full monetary sovereignty is even not restricted by Slovenian participation in the IMF, BIS and in the EU institutions, where mostly only consultations take place.

Obligations and opportunities related to the European monetary integration derive from the prospective membership of Slovenia in the EU. In principle, member countries of the EU are included in the institutions of the European monetary integration, such as the EMS (European Monetary System) and the EMU. However, at least until now it could be observed that the inclusion in the European monetary integration is not necessarily direct - immediate and for all EU members. Greece became the EMS member only in March 1998, and some of the other EU member countries did not join the EMS until they were monetarily mature enough. It should be mentioned that they joined the EMS at their own will and they were able to leave the EMS when they found its requirements too restraining (Great Britain, Italy). In the case of the EMU, the opt-out countries (Great Britain, Denmark, Sweden) decided not to participate in the euro area, at least in the first phase.

Until the Central European countries join the EU, they can not formally and institutionally enter its mechanisms of monetary integration. Membership in the EMS, in the ERM 2 and in the EMU is open only to EU members. Slovenia can therefore for the moment, while waiting for their EU membership, only unilaterally, informally and functionally adjust to the mechanisms of the European monetary integration, but can not join these institutions formally. In the transitional period Slovenia can shadow the EMS by following its rules and

requirements, with the aim of better preparing itself for the future inclusion in the ERM 2 and in the EMU. Since Slovenia uses a floating exchange rate system, in this period it could (after bringing its inflation rate down to the level near to the EU inflation rate) make a switch to system of a fixed exchange rate and try to sustain the fixed exchange rate without adjustments (or with only occasional and minor adjustments of the fixed exchange rate), in line with the requirements of the EMS.

Slovenia could go even further in its unilateral adaptations to the prerequisites of the European monetary integration. It could, by irrevocably fixing the exchange rate, peg its currency to, say, German mark (as Austria and Netherlands did) or to the euro, when this opportunity opens in 1999.⁶ In this case Slovenia would commit itself to a de facto monetary union with the monetary area of the German mark or of the euro. This leads to the loss of the monetary sovereignty, as the country loses its exchange rate policy and as its monetary policy comes in the function of sustaining the fixed exchange rate. The problem of unilateral de facto monetary unions is that such a country bears all the costs (loss of the monetary sovereignty), while it participates in only some of the benefits of the monetary union. Additionally, such an unilateral commitment to the irrevocable fixing of the exchange rate can never be perceived so binding and definitive as in the case of a formalised and institutionalised bilateral de iure monetary union.

EU accession criteria and membership in the EMU

In this section, the focus is primarily on the other alternative - the formal and institutional inclusion in the European monetary integration process, which is closely related to the accession in the EU. First, it should be cleared out whether the membership in the EMU for the Central European candidate countries is mandatory or voluntary, starting from the fact that some of the present EU members were in a position to decide whether they want to join the EMU (and the EMS and ERM 2 for that matter) or not. The requirements of the EU membership, which are perhaps not known enough in the candidate countries, include the fact that the membership in the EMU is mandatory for the future EU candidate countries, although the formulation of this requirement seems softer and more flexible. Criteria for the EU accession, which were formulated at the Copenhagen Summit in 1993, include, among other, capacity of a candidate country to take up all obligations from the EU membership (*acquis communautaire*), including the adherence to the aims of political, economic and

⁶ The case of Austrian de facto monetary union is described in Hochreiter (1997).

monetary union.⁷ In practical interpretation this means that a candidate country has to agree to join the EMU as soon as it is ready, i.e., as soon as it meets the Maastricht convergence criteria on a sustainable basis. In other words, obligation to participate in the EMU arises from the membership in the EU. The Central European countries will therefore not be in a position to opt-out of the EU. If they had some problems with surrendering their monetary sovereignty, they would be advised not to join the EU in the first place and would be probably excluded from the negotiations for the EU membership.

Any considerations about the expected costs and benefits of the EMU for Slovenia and about the expected net cost/benefit effects may be analytically interesting, but are not any more relevant for decision-making on whether to join the EMU or not. These issues could be relevant at a time before Slovenia decided it wanted to join the EU in the first place. Now it would look odd if a candidate country fullheartedly invested a lot of efforts in the EU accession, but would then not be willing to participate in its crowning project, the EMU, say for its feelings that the implied loss of its monetary sovereignty was too high a sacrifice (similarly to what an EU member country like Great Britain could afford to do). EU member countries would, frankly speaking, not be willing to accept such a country among themselves. Another theoretical possibility is that a candidate country, when joining the EU, would deliberately tactically delay the fulfilment of the Maastricht convergence criteria.⁸ Such a solution would, however, not be accepted from the EU side with much understanding, and would in the first place harm such a country itself.

In our view, Slovenia should not see its future membership in the EMU as a problem. Its future membership in the EMU is consistent with its goal of a full membership in the EU. Slovenia should aim at meeting the Maastricht criteria on a sustainable basis and on a healthy ground as soon as possible in order to be in the first group of the candidate countries to join the EMU. The aim of an early membership in the EMU can be justified on the basis of the assessment that in the case of Slovenia the expected benefits would exceed the expected costs of its inclusion in the EMU. In the following, we offer some arguments to support the expectations that Slovenia can expect, at least in principle, net benefits from joining the EMU.

⁷ Dixon (1998) and European Commission (1997) elaborate further on the relationship between EU accession criteria and membership in the EMU for Central European candidate countries.

⁸ Sweden followed this example, by deliberately not joining the ERM, and thereby not meeting the Maastricht convergence criterion on exchange rate stability.

Costs and benefits of EMU for Slovenia

On the benefits side, the main expected benefit of the membership in the EMU is that because of first irrevocably fixed exchange rates and the use of the single currency next, Slovenian trade with the EU would not be exposed to exchange rate fluctuations, uncertainties, risks and associated costs, as well as to conversion costs within the euro area. This should lead to lower costs and to increased stability of trade, resulting in larger trade and capital flows with the EU and in deeper integration in the EU internal market. It needs not be proved that for a small open economy like Slovenia this is of a vital interest. The next benefits from the EMU are linked to the expectations that euro is likely to be a very stable currency. In this case, Slovenia can expect lower inflation and interest rates, with favourable effects on its monetary stability, investment and economic growth. Finally, Slovenia would participate in the seigniorage revenues from the creation and use of euro and would participate in the formulation and implementation of the European single monetary policy. It would also benefit from the economies of scale in pooling of the international monetary reserves and from the use of the euro as a potentially prestigious international currency, rivalling the dollar in its leading role as the international currency. These last benefits from the EMU would in the case of Slovenia of course be of a merely symbolic nature, according to its low proportional weight in the EMU.

On the costs side Slovenia will in principle have to bear the same sacrifices from the inclusion in the EMU as the EU members of the euro zone. First, there is the loss of the national currency, which is painful in itself, considering the symbolic and prestigious dimension of a currency. The Central European countries are in this respect in no worse position than the EU members of the EMU. In some cases, for them this sacrifice could be even less pronounced, since some of the currencies have a short history (Slovenian tolar for example) or have a poorer track record than the EU currencies. Second, the loss of the autonomy in monetary policy and particularly the loss of the exchange rate as an instrument of adjustment could represent a problem, but not of the magnitude which would be specifically painful for Slovenia. Monetary autonomy is in itself to some extent a questionable concept if a country is integrating in an area with a stable (or more stable, to be precise) currency. In this case monetary autonomy means in the first place the possibility of leading less responsible monetary policy and to misuse the monetary policy for some other (fiscal or redistribution) goals. In this sense the loss of monetary autonomy needs not necessarily be a loss worth grieving. In academic circles the prevailing view is that in a small open economy without capital controls monetary autonomy is in fact more or less just an

illusion. The loss of the exchange rate autonomy may represent a more severe problem. To what extent the loss of the exchange rate instrument is really a cost of the inclusion in the EMU, depends mostly on two factors - exposure to the so called asymmetric shocks and functioning of the alternative mechanisms of adjustment to these shocks, which substitute for the exchange rate when this instrument is given up as a result of the inclusion in the EMU.

Optimum currency area view on Slovenian membership in the EMU

So far we have concentrated on general assessment of costs and benefits of the monetary union, which at least in principle holds true on a general level for all member countries, present and potential, of the EMU. The theory of the optimum currency area, however, emphasises certain structural characteristics of the economy, which determine whether for an individual country it is better to join a broader monetary union or to stay an independent monetary area with its own currency. The optimum currency area theory also suggests where the boundaries of the optimum currency area should be, or in the case of the EMU, how large it should optimally be. According to this theory the main structural characteristics, which determine whether a country should join a monetary union, are the following: size, openness, diversification of production and exports, and geographical concentration of trade. According to these criteria, the Central European countries as a group or individually seem quite suitable for joining the EMU. Slovenia, for instance, which is a small, very open and diversified economy with a high share of exports going to the EU, appears to be a model country suitable for monetary integration. In an economy with such structural characteristics we can expect that benefits of the EMU will increase and costs decrease, so that the net expected benefits from the EMU should increase, at least compared to other economies with different structural characteristics. Such an analysis is for the moment of course possible only in principle and on general level. Concrete estimations and quantifications of costs and benefits of the EMU for Slovenia and the other Central European economies are a demanding task which still needs to be done and which was hardly accomplished even for the EU member countries.⁹

Empirical research conducted in the framework of two ACE-Phare research projects indicates that Slovenia is not expected to be exposed to serious specific asymmetric shocks, which would hit its economy but not other parts of the EMU or EU as a whole. This results

⁹ The most comprehensive analysis of costs and benefits for the EU member countries can be found in Emerson (1992), De Grauwe (1994) and Gros (1995).

from the findings that, first, Slovenia has the product structure of its exports to the EU very similar to that of the intra-EU trade¹⁰ and second, from the evidence that more symmetric than asymmetric shocks can be expected in Slovenia and that its economy is rather synchronised with the cycles in the EU economies.¹¹ If this is the case, Slovenia should not meet specifically difficult problems when joining the EMU, since it would not have to rely heavily on the exchange rate as an instrument of adjustment to these asymmetric shocks. In these circumstances, giving up the exchange rate as an instrument of adjustment when joining the EMU is not a severe sacrifice, which even further improves the expected ratio of benefits/costs of the EMU for Slovenia. To deal with symmetric shocks, which are to hit the entire EMU, traditional instruments of adjustment - monetary and exchange rate policy - are still at disposal at the level of the EMU as a whole.

Adjustments which Slovenia will still need to face when joining the EMU because of its possible (or probable) lower (or in time declining) competitiveness of its economy on the EU internal market, will have to be borne (just like in the EU member countries in the EMU) in the first place by real wages and greater flexibility of the labour market in general. Possible alternative mechanisms of adjustment, such as mobility of labour within the EMU or fiscal transfers within the EMU area, are for well known reasons not expected to play a role worth mentioning. It can therefore be concluded that for Slovenia the inclusion in the EMU will make sense only when it beforehand prepares itself to be able to sustain the competitive pressures on the EU internal market. Not surprisingly, this is the main point and the main requirement in the process of negotiations for the full membership in the EU, anyway. In the opposite case, the loss of the exchange rate as an instrument of adjustment when joining the EMU might really be too big a sacrifice. If the exchange rate policy is no longer available while alternative mechanisms do not function (they do not exist or are not flexible enough because of the built-in rigidities), a candidate country which faces problems with its international competitiveness on the EU markets could start to decline in economic growth and employment. It would become a depressed region in the EMU, which would be the final high cost of an unsuccessful inclusion in the EMU.

Maastricht convergence criterion on exchange rate stability and the ERM 2

Having dealt with the question why, we now come to the question of how and when Slovenia should join the EMU. This question in fact involves a set of related sub-questions.

¹⁰ See Gros and Vandille (1994).

¹¹ See De Grauwe and Aksoy (1997).

The first refers to the time dimension (when, in which year) it is expected to join the EMU. The second addresses the issue of whether Slovenia will join the EMU directly, or will first join the ERM 2. The third discusses the dilemma whether Slovenia would join the EMU before, after, or at the time of its EU accession.

According to the most probable scenario which is implicit in the documents of the European Commission, the Central European countries are first expected to join the ERM 2, probably at the time of their accession to the EU, and then, somewhat later, perhaps after a few years, to join the EMU. In Agenda 2000 the possibility of their simultaneous entrance in the EU and in the EMU is not excluded, but is considered as less probable and even less appropriate solution, which is in fact not advised to the Central European countries. This attitude derives from the belief that these countries will not be able to reach the required macroeconomic stability as defined in the Maastricht convergence criteria on a sustainable basis and on healthy grounds in the relatively short time before their accession in the EU. Any postponement of the Eastern enlargement process of the EU would of course increase the possibilities of the simultaneous inclusion of these countries in both the EU and the EMU. It would give them more time to meet the required standards of macroeconomic stability, but, on the other hand, such a delay would not be in the interest of the candidate countries and would bring out some new problems.

It is definitely clear that Slovenia will not be able to join the EMU before the time of its accession in the EU (as could be heard from an overoptimistic representative in Slovenia). Membership in the EU is open only to the members of the EU. Even for them the strict Maastricht convergence criteria safeguard the future stability of the single currency, which is a prerequisite of the success of the EMU project as a whole. The present rules, which restrict the membership in the EMU only to EU members will certainly not change.

Will Slovenia be in a position to join the EMU at the time of its accession in the EU? In principle this is possible, but two problems, a formal one and a substantial one, would have to be overcome. The formal problem lies in the definition of the Maastricht convergence criterion on the exchange rate stability. It requires, among other, that the currency of an EMU candidate country has to be for at least two years participating in the ERM (or ERM 2, which is going to be the relevant reference at that time), before it can join the EMU. On the other hand, according to the present rules, a country can not join the EMS and its ERM (or ERM 2) until it becomes a member of the EU. It follows that Slovenia would first have to join the EU and the ERM 2 at the same time, and then wait for at least two years, merely

to formally fulfil this convergence criterion, even if all other Maastricht criteria were already met. The way out of this formal obstacle could be found in one of the following solutions:

- a) The Maastricht convergence criterion on the exchange rate stability could be modified or at least flexibly interpreted in view of changed circumstances at that time (newly established ERM 2, emergence of new candidate countries, already functioning euro etc.). It seems that some flexibility of this criterion was already applied when it was decided that Italy and Finland fulfil this Maastricht criterion, even if their currencies were, strictly formally speaking, not participating in the ERM for two years beforehand.
- b) The rules which define that membership in the EMS and its ERM (or ERM 2) is open only to EU members and not to the candidate countries, could be modified or at least flexibly interpreted in view of changed circumstances. In academic circles the idea on an early inclusion of the Central European candidate countries in the ERM 2, even before their accession to the EU, emerged a couple of years ago. One of the possible timings for the inclusion of the good performing Central European countries in the ERM 2 could be after they conclude the negotiations for a full membership in the EU, at a time while they wait for the ratification of their EU membership agreement. At that time they would obviously already be assessed as ready for joining the EU.¹²

The arguments in favour of an early inclusion of the Central European countries in the ERM 2 are the following:

- a) It would enable these countries to overcome the above mentioned formal rigidity of the Maastricht criterion on exchange rate stability, which at the moment prevents the simultaneous entrance of the Central European candidate countries in the EU and in the EMU, even if they were economically ready for it and fulfilled all other Maastricht convergence criteria,
- b) It would give the ERM 2 some meaning, substance and needed critical mass. If these countries were not allowed to join the ERM before their EU membership, the ERM 2 may be a rather “lonely” place in the period 1999-2002 or even further, as it would include only a couple of voluntarily participating pre-in EU countries. Wider membership would give the ERM 2 more meaning and importance. It should be remembered that at the time the ERM 2 was designed, there was a general belief there would be more, say some five or six countries participating in the ERM 2 at the beginning,
- c) An early inclusion of the Central European candidate countries in the ERM 2 would give them the opportunity to get used to the European concepts of monetary and exchange

¹² Bernard (1997) discusses alternative scenarios of joining the ERM 2 for the Central European countries.

rate responsibility, discipline, co-operation and solidarity. They could learn to see their exchange rates as a matter of common concern and collective decision-making, thereby preparing themselves for an easier inclusion in the EMU after the required two-year period in the ERM 2.

Maastricht convergence criteria for Slovenia and other Central European countries

Another problem of a more substantial nature, which can also prevent Slovenia from joining the EMU at the time of its EU accession is that it is very questionable whether it will in fact be able to reach the required macroeconomic stability, as defined in the Maastricht convergence criteria, by the time of its EU accession. First, let us have a look at how Slovenia complies with the Maastricht convergence criteria at the moment. Inflation has stabilised at the level of high single-digit figures, presently at around 8%. Long-term interest rates can be assessed only roughly, since in Slovenia a long-term instrument such as a ten-year government bond, which should be representative and liquid on the secondary market, and which should be the benchmark for the figure on the interest rate convergence, is non-existing. With this limitation in mind, long-term exchange rates can be estimated at the level of 15-20%. Obviously, Slovenia does not comply with the Maastricht exchange rate stability criterion, first, as it is not a member of the ERM, second, as it uses the system of a floating exchange rate, and third, since the stability of the exchange rate is not sufficient, compared to the standards of monetary integration. Fiscal deficit is, after a couple of years when it was practically zero, in 1997 above 1% of the GDP. Public debt can be estimated at above 30% of the GDP.¹³ Taken as a whole, Slovenia fulfils both fiscal criteria with a sufficient margin. It can safely be said that Slovenia will not have problems complying with the two fiscal convergence criteria also in the near future. However, Slovenia does not meet the three monetary convergence criteria. The main problem is the inflation rate which is too high for the standards of the European monetary integration. Lowering of the inflation rate should be the main task of policy-makers in Slovenia in the next few years before its EU accession. Lowering of the inflation rate to the level at least close to the European inflation rate is a prerequisite for any further steps on the way towards European monetary integration: First, for a switch to the system of a fixed exchange rate (before, or at least at the time of joining the ERM 2) and, next, for joining the ERM 2 and then the EMU.

¹³ Methodology for the assessment of data on Maastricht convergence indicators for Slovenia is based on Lavrač and Lavrač (1996).

When discussing the Maastricht convergence criteria for Slovenia, we are aware of the fact that uncritical interpretation of the results in meeting the convergence criteria may be rather problematic. Maastricht criteria are sometimes misused in transition countries. First, they were wrongly interpreted as the EU accession criteria. For the moment the Maastricht criteria are meant only to measure the readiness of the EU member countries for joining the EMU. Second, EU never asked the transition countries to report about the compliance with these convergence criteria. Therefore, any estimation of the fulfilment of the Maastricht convergence criteria for the transition countries can only be unofficial and wage, as the data are based on non-harmonised local statistical methodologies. Some of these indicators, such as long-term interest rate and public debt, have quite different economic meaning in the transition countries than in the context of developed market economies. Third, Maastricht convergence criteria are based on the assumption that the country in question has already gone through the first two phases of the creation of the EMU, including full liberalisation of capital flows, which is in general not the case in the transition economies.¹⁴ Misuse and misinterpretation of the fulfilment of the Maastricht convergence criteria could lead to some ridiculous conclusions, such as that on the basis of compliance with these criteria it would seem that Croatia or Albania, which mechanically fulfilled all the Maastricht criteria, were closer to the EMU than Slovenia (or even Italy, which about a year ago still did not meet any of the criteria). It is of course quite clear that these countries will join the EMU in just the opposite order.

EMU issues in the Slovenian EU accession strategy

In October 1997 Slovenia issued its official Strategy of the EU accession,¹⁵ which also defines the expected timing of the Slovenian entry in the EU and the EMU. According to the Strategy, Slovenia should join the EU in 2002 and the EMU in 2005, three years later. Within this context, it is expected that Slovenia should lower the inflation rate to 3-5% yearly by end 2001 and to the Maastricht reference value by end 2004. If we start from the optimistic scenario of Eastern enlargement of the EU in 2002 as the earliest possible date, this is considered to be the most realistic approach towards the dynamics of Slovenian inclusion in the EMU, even if wishes called for an earlier inclusion in the EMU, perhaps even at the time of Slovenian accession in the EU.

¹⁴ Backé (1997) and Ilzkovitz (1996) come to similar conclusions regarding limitations of Maastricht Criteria for Central European countries.

¹⁵ Slovenian EU Accession Strategy is published in IMAD (1998).

The main reason for this two-stages approach to the Slovenian inclusion in the EMU can be found in the assessment on when the required macroeconomic stability on a sustainable basis could realistically be expected. The Strategy starts from the belief that the required macroeconomic stability, as defined in the Maastricht convergence criteria, can be achieved only if structural reforms and sectoral adjustments are undertaken first. Delaying or neglecting these reforms could undermine the achieved macroeconomic stability or endanger its sustainability. The Strategy therefore defines six main areas of important structural reforms and their timing in the four years before the expected accession in the EU. These sectoral reforms include liberalisation of prices, reform of the tax system (introduction of VAT) , reform of the social security sector (pension reform), reform of the enterprises sector, reform of the financial sector (privatisation of banks, opening the sector to foreign competition), and reform of public utilities. Without these reforms, macroeconomic policies would be overburdened with chasing the Maastricht criteria, which could lead to unnecessary losses in economic growth and employment. Convergence criteria could of course be met “artificially”, with aggressive monetary and fiscal policies, but in this case structural problems would be simply swept under the carpet, while macroeconomic problems would shortly break open. Taken all this into account, the two-stages approach to the EMU seems a realistic option and is in fact in line with the recommendations of the European Commission, which suggest that candidate countries should first focus on the EU accession, and then concentrate on the EMU requirements.

Finally, if we take a closer look at the inflation rate, which is the most important indicator of the readiness of Slovenia for its future joining the ERM 2 and the EMU, it can be concluded that in the next two years there is not much room for the lowering of the inflation rate. Liberalisation of prices with adjustment of some relative prices and the introduction of VAT at least in the short run do not work in favour of lowering the inflation rate. However, in the next few years before the EU accession inflation could be lowered to the level of 3-5% yearly, which is already close to the European level. This would enable a switch from a floating to a fixed exchange rate system, and joining the ERM 2 at the time of Slovenian accession in the EU. In the next few years it should not be a problem to lower the inflation rate further to the Maastricht reference value, so that Slovenia would be ready to join the EMU in 2005.

Conclusions

Central European countries have in their transition periods chosen different exchange rate regimes, covering the whole spectrum from fixed to floating exchange rates. So far they were free to decide on their optimal exchange rate arrangements, but it can be expected that in the process of negotiations for the EU accession these countries will be forced, as part of the *acquis communautaire* of the Third stage of the EMU, to harmonise their exchange rate systems and policies.

Slovenia has since its independence in 1991 chosen the system of a managed floating exchange rate, against the advice of the foreign experts and the IMF. Managed floating exchange rate system performed well in Slovenia, as it helped to bring down inflation to the single-digit level, while sustaining balance of payments equilibrium and relatively satisfactory economic growth. Specific Slovenian combination of managed floating and capital controls proved effective in the circumstances of a small open economy exposed to significant capital inflows, particularly when taken into account the lessons from recent currency crises in various parts of the world.

Although real exchange rate remains an important issue in Slovenia, stabilisation of the nominal exchange rate comes in the focus when we discuss Slovenian integration in the EU and in the EMU. In the process Slovenia will successively have to give up the exchange rate as an instrument of adjustment. First, Slovenia will have to make a switch from a floating to a fixed (but still adjustable) exchange rate system, then it will have to join the ERM 2 as a specific mechanism of fixed exchange rates designed specially for the pre-in countries. Finally, Slovenia will have to irrevocably fix its exchange rate, as the national currency will be given up to be substituted for by the euro. There will of course still be some scope for the real exchange rate changes, as in the case of regions within a country.

The costs and benefits of joining the EMU for Slovenia are in principle similar to those in the EU member countries. Additionally, in the case of Slovenia as a small open and diversified economy with a high proportion of trade oriented to the EU, according to the theory of the optimum currency area, its benefit/cost ratio of joining EMU can be expected to increase. Empirical research has shown that Slovenia is not expected to be specifically exposed to the so-called asymmetric shocks, as its trade structure is similar to that of the EU and as its economy is rather synchronised with the cycles in the EU economies. It seems that losing the exchange rate as an instrument of adjustment, resulting from the future

inclusion in the EMU, should not be a severe sacrifice for Slovenia, particularly if the emphasis on sustaining international competitiveness of the Slovenian economy would shift from the exchange rate instrument towards a more flexible labour market.

At the time of the EU accession (or even before, as suggested in the study) Slovenia should join the ERM 2 and a few years later Slovenia should be ready to join the EMU. Maastricht convergence criteria should be kept as a benchmark for stability-oriented macroeconomic policies in Slovenia, but basic structural reforms should be undertaken first in order to meet the Maastricht convergence criteria on a healthy and sustainable basis.

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