

## **Slovakia's Path to Euro Adoption—A Blueprint for Poland?**

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The Polish government plans to publish by the end of this month its strategy for adopting the euro in 2012. As the policymakers think through the issues that Poland will face on its path to the euro, it is useful to take a look at the experience of our southern neighbor Slovakia, which is set to join the eurozone on January 1, 2009.

Of recent eurozone entrants, Slovakia is clearly the most relevant precedent for Poland. It shares many of its characteristics in terms of geography and initial degree of income convergence with the old EU member states. Importantly, Slovakia was operating an inflation targeting monetary regime before it entered the exchange rate mechanism (ERM2)—the two-year period before euro adoption when the exchange rate may only fluctuate within a narrow band. This is similar to Poland but unlike the other three recent euro adoption cases (Slovenia, Malta, Cyprus) where exchange rates were tightly controlled before and during ERM2.

Slovakia's economic performance in the run-up to euro adoption is widely considered a success. Not only did the country comfortably meet the Maastricht criteria, it managed to grow rapidly during this time while keeping inflation in check. Political tensions around the change in government in 2006 and sporadic shifts in emerging market sentiment led to some exchange rate volatility, but the intervention band under ERM2 truly tested only briefly, when the new elected prime minister briefly questioned the euro adoption target date. The fiscal deficit was reduced to below the limit of 3 percent of GDP, albeit not by a wide margin.

Will Poland be able to repeat Slovakia's experience? Let's consider six factors that contributed to Slovakia's successful path toward euro adoption.

First, euro adoption long enjoyed broad public support in Slovakia. Central Bank and Ministry of Finance devised a joint euro adoption strategy as early as July 2003—6 ½ years before the targeted adoption date—and collaborated closely throughout the process. The necessary legislative changes were implemented smoothly, no change in the constitution was necessary and there were no calls for a referendum. Compared to Slovakia, political support for euro adoption in Poland looks more tenuous. Moreover, its timetable for completing the necessary preparatory steps is considerably shorter.

Second, Slovakia implemented wide-ranging structural reforms before entering ERM2, actively supported by the IMF at the time. The share of the public sector in GDP was substantially reduced, the tax system was revamped (including its famous 19-percent flat tax regime) and the labor market was liberalized. These reforms supported fiscal consolidation and, together with joining the EU, jump-started a surge in FDI inflows, notably in the car and electronics industry. Importantly, they removed supply-side constraints to investment. The resulting strong productivity gains, especially in export-oriented sectors, allowed Slovakia to

maintain competitiveness in the face of two substantial revaluations of the koruna. Compared with Slovakia, structural reforms in Poland have been more modest to date, although some important measures (such as completing the government's privatization plans, removing red tape, a reduction in personal income taxes and tighter early retirement provisions) are now in the pipeline. Nevertheless, as measured by the World Bank's "Doing Business" survey, Poland's business environment today is considerably weaker than Slovakia's in 2005.

Third, wage growth in Slovakia remained relatively modest throughout its membership in ERM2; it never exceeded productivity growth and therefore contained underlying inflation pressures. This may be partly related to the labor market reforms earlier this decade and a high rate of unemployment in 2005. Also, Slovakia did not experience net emigration like other new member states. In contrast, labor market conditions have been much tighter in Poland lately, with wage growth exceeding productivity measures.

Fourth, the Slovak koruna was slightly below its equilibrium level in 2005, according to National Bank of Slovakia estimates. This provided a cushion to deal with the subsequent strong appreciation without undermining competitiveness. In contrast, the Polish zloty is believed to be on the strong side, at least until the recent depreciation.

Fifth, global inflation trends worked in Slovakia's favor. The era of "great moderation", characterized by cheap imports from Asia, helped to bring down core inflation. While the recent commodity price boom partly fell into the Maastricht assessment period, it came too late to push inflation above the reference value. Poland may face larger challenges to meet the inflation criterion as global inflation, especially in emerging markets, is still high, the labor market is now quite tight, and core inflation has been creeping up. Lately, however, commodity prices are tumbling.

Last but definitely not least, conditions on global financial markets are very different today than in 2005. Slovakia's time in ERM2 coincided with a period of record high global liquidity and positive sentiment towards emerging markets, especially the new EU member states. Strong capital inflows easily financed Slovakia's large current account deficit and supported the steep nominal appreciation the koruna against the euro (21 percent from ERM2 entry in November 2005 until the terminal parity was fixed in July 2008). While not decisive, this made it easier to meet the Maastricht inflation criterion. Needless to say, the outlook for financial markets is now considerably more gloomy. Not only will Poland not be able to count on sustained capital inflows, conditions on money and foreign exchange markets are extremely volatile.

The main lesson for Poland from Slovakia's experience is that preparing for the euro means redoubling the reform effort. This is all the more important because the external circumstances in Poland today are more difficult than they were for Slovakia in 2005-08. The reform measures mentioned above, which are now in the Sejm a good first step to improve Poland's prospects to not only meet the Maastricht fiscal criteria against the background of a slowing economy, but to also to remove bottlenecks to investment and ensure net capital inflows to sustain a widening current account deficit. Further labor market reforms are

essential if wage growth is not to exceed productivity growth, a key element in Slovakia's success story.

On when to enter ERM2, the Slovak experience has two lessons. First, a broad consensus on the timing and modalities of euro adoption is a crucial precondition. The comprehensive euro adoption strategy, now under preparation in cooperation between Ministry of Finance and NBP is important in this regard. But support for euro adoption in 2012 has to reach beyond Swietokrzyska Street and result in a speedy resolution of potential constitutional obstacles. Entering ERM2 without such a consensus would be a mistake. Secondly, successful ERM2 membership will need to rely on stable capital inflows. It may therefore be prudent to wait until conditions on financial markets have stabilized. The time can be used to push forward the above-mentioned structural and fiscal reforms, which in any event are necessary whether Poland enters the euro in 2012 or not.