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Economic policies on Slovenia's road to the euro area

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Abstract

On 1 January 2007, Slovenia was the first new EU member state to enter the euro area. Since June 2004, the Slovenian tolar participated in the exchange rate mechanism ERM-II with a central parity of 239.64 against the euro. This parity was also the conversion rate upon euro area accession. Applying a macroeconometric model of Slovenia, this paper analyses the macroeconomic effects of different conversion rates. These simulations are compared to a scenario with flexible exchange rates. The best results are obtained with the actual conversion rate. In addition, it is shown that the labour market performance can be significantly improved by cutting non-wage labour costs.

JEL classification: C53; E17; F15

Keywords: Slovenia; Euro area; Fiscal policy; Macroeconometric model

1. Introduction

On 1 January 2007, the euro area was enlarged for the first time since the euro cash changeover in 2002. In addition, Slovenia was the first of the eight countries from Central and Eastern Europe that had joined the European Union in May 2004 (together with Cyprus and Malta) to adopt the common currency. Becoming a part of the euro area further enhances the European economic integration of Slovenia. From the first day of membership onwards, the new member countries have been participating in the European Economic and Monetary Union (EMU). However, being EMU members does not imply introducing the euro immediately. Before having the right to adopt the common currency, the new EU member states are required to fulfil the criteria set out in the Maastricht Treaty. In May 2006, the European Commission and the European Central Bank

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decided that Slovenia fulfilled all relevant criteria. Thus, as of 2007, Slovenia replaced its domestic currency by the euro.

The choice of the exchange rate regime before adopting the euro was of particular importance. With effect from 28 June 2004, Slovenia joined the Exchange Rate Mechanism ERM-II of the European Monetary System. The ERM-II links the currencies of non-euro area member states to the euro. For each participating currency, a central parity against the euro and a standard fluctuation band of ±15% (±2.25% in case of the Danish krone) are defined. In the case of Slovenia, the central parity was set at 239.64 Slovenian tolar per euro. Introducing the euro requires that the member state has participated in the ERM-II without any break and without severe tensions during the two years preceding the examination of the situation regarding the readiness to join the euro area. Furthermore, it must not have devalued its currency on its own initiative during the same period. In addition to this exchange rate criterion, the Maastricht treaty requires sound public finances as well as low inflation and long-term interest rates.[1]

It is not required that the conversion rate at which the domestic currency is converted into euro upon euro area accession equals the central parity of the currency in the ERM-II. Thus, using SLOPOL, a macroeconometric model of the Slovenian economy, this paper analyses whether a better macroeconomic performance could have been expected with a somewhat lower or higher conversion rate. While no formal optimisation is undertaken, the implications for important macroeconomic indicators are explored. In particular, the effects on real GDP growth, inflation, employment, unemployment, the budget balance and the current account are investigated. These simulations are contrasted to a counterfactual experiment with totally flexible exchange rates, implying a postponement of euro area accession.[2]

As in the euro area monetary policy is conducted by the Eurosystem and the European Central Bank in particular, an independent monetary policy is no longer possible, and other policy instruments become increasingly important. This pertains, in particular, to policies affecting labour costs as an important determinant of the international competitiveness of domestic companies. This issue is explored by simulating the macroeconomic effects of cuts in direct taxes and social security contribution rates.

In Neck et al. (2004a,b), the issue of cutting non-wage labour costs is addressed in connection with the choice of the exchange rate regime. In these papers, a system of totally flexible exchange rates is compared to a crawling peg regime and a regime of completely fixed exchange rates. It turns out that the best overall macroeconomic performance can be expected with a ‘‘crawling peg’’, allowing a slight depreciation of the Slovenian tolar in 2006 before joining the euro area in 2007. In the present paper, the implications of different conversion rates upon euro area accession in 2007 are explored. As in Neck et al. (2004a,b), the implications of reductions in non-wage labour costs are also addressed.

[1] The Maastricht treaty requires that the general budget deficit and debt level shall not exceed 3 % and 60 %, respectively, in relation to nominal GDP. Furthermore, the inflation rate must not exceed by more than 1.5 percentage points the average inflation rate of the three best-performing member states in terms of price stability. The long-term interest rate must not exceed by more than 2 percentage points that of the three best-performing member states in terms of price stability.

[2] When applying structural macroeconometric models for simulations, the Lucas critique, representing a fundamental objection against the use of structural macroeconometric models without rational expectations, applies. Incorporating changes in the public’s expectation with the recognition of a new policy regime into the model will certainly be a major improvement, although, the short time series available for Slovenian data makes an attempt at executing it still more difficult than for countries with a longer history without structural breaks.