Yves Mersch: Tenth anniversary of the euro in Slovakia

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the International Conference to mark the tenth anniversary of the introduction of the euro in Slovakia, Bratislava, 11 January 2019.

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Accompany charts of the speech.

I am honoured to be in Bratislava today and to speak before such a distinguished audience. This conference marks the tenth anniversary of the euro in Slovakia, which in fact is a double anniversary as it coincides with twenty years of the euro.

What could be a better anniversary gift, or a clearer symbol of the vitality of our single currency, than Slovakia's success since the introduction of the euro on 1 January 2009?

Slovakia has achieved an impressive real convergence of living standards towards the EU average. The key ingredients of this success have been the country's willingness to grasp the opportunities offered by EU membership and the adoption of the euro.

Indeed, on the economic side fundamental institutional reforms allowed Slovakia to transition to a vibrant market economy and adopt a highly successful export-led growth model, which underpinned real convergence. Reforms rather than continued devaluation or requests for financial assistance is the recipe for success.

Nevertheless, this should be no reason for complacency, as the next stage of convergence is bound to be harder. Neither EU membership nor the single currency offer an "autopilot" for strong economic growth.

I will therefore argue that relentless efforts in the pursuit of institutional quality and good governance are essential in order to raise the country's long-term growth capacity.

The drivers of Slovakia's success

Within just three decades, Slovakia has made a remarkable economic transition from a centrally planned economy to a market economy that is closely integrated into the Single Market. The significant efforts made during the transition have clearly paid off.

Having all but doubled since the early 1990s, Slovakia's real GDP per capita stands at just over 80% of the EU average.[1]

Equally impressive has been the pace of economic convergence, which exceeded expectations based on the initial level of Slovak national income.[2] Slovakia has managed to achieve a per capita GDP level above that of most other countries in central and eastern Europe (CEE), and close to catching up with that of Slovenia and the Czech Republic (Chart 1).

Much of this success is rooted in the country's remarkable institutional transformation in the context of joining the EU.

Slovakia's accession to the EU gave momentum to its convergence efforts and provided it with an external institutional anchor.

Fundamental reforms such as the establishment of a clearly defined system of property rights, effective economic law enforcement and institutions to curb fraud and anticompetitive behaviour were crucial in allowing Slovakia to operate in a market economy and to cope with competition and market forces.

Access to the Single Market and adoption of the *acquis communautaire* have contributed to Slovakia's success in two ways.

First, the removal of trade barriers and application of European-wide standards considerably reduced the cost of doing business across borders, fostering trade and encouraging the country's participation in European value chains.[3]

Second, a more stable and predictable legal and regulatory environment improved investor security and contributed to a rapid inflow of foreign investment, providing the economy with the necessary foreign capital, know-how and technology to increase its competitiveness.

The Slovak economy became deeply integrated into the Single Market, with an export share of almost 100% of GDP, well above that of other CEE economies (Chart 2), and almost 20% of jobs depending on EU exports to the rest of the world.[4]

The resulting significant economic convergence eventually paved the way for the introduction of the euro.

Many saw the loss of an independent monetary policy and the inability to respond to external shocks as the most significant cost of joining the euro area.

However, Slovakia's high degree of openness had made it difficult for its national central bank to manage the business cycle in the face of volatile capital flows. The exchange rate had more often become a source of shocks rather than a shock absorber.[5]

So the benefits of adopting the euro were compelling.

One immediate benefit was the stabilisation of Slovakia's exchange rate with key trading partners and the elimination of currency conversion costs. Research shows that euro adoption thereby contributed to a 12% increase in Slovakia's exports to the euro area.[6]

A further advantage of the introduction of the euro was the strengthening of Slovakia's macroeconomic institutions. Adopting the euro gave further impetus to institutional convergence and allowed Slovakia to anchor its macroeconomic institutions in a stronger European framework.

In the run-up to euro adoption, numerous amendments to the Slovak institutional framework were made to ensure convergence with EU requirements, which were closely monitored by the European institutions as in the ECB Convergence Report.[7]

High standards were required for the independence of the central bank, particularly for the personal independence of executive board members.[8] Safeguarding institutional independence is crucial when European monetary policy coexists with national financial and labour market policies and where interests may not always be aligned.

The embedding of Slovak institutions in a stable European institutional framework therefore contributed to macroeconomic stability during the crisis and increased investment and trade.

Indeed, in comparison with the Czech Republic, which has very similar economic structures, Slovakia has experienced faster economic growth since 2009. Although the Czech Republic was able to pursue an independent monetary policy during the crisis, Slovakia managed to maintain a 0.9 percentage point advantage over that country in terms of average annual GDP growth between 2009 and 2016.[9]

As a result, the gap between Slovak and Czech GDP per capita narrowed from 21% in 2008 to 13.8% in 2017.

The importance of institutional quality for long-term convergence

May Slovakia's success continue for many years to come. In the long run, though, it cannot be taken for granted that Slovakia's growth model will continue to deliver strong growth; convergence with EU countries could slow. Slovakia risks falling into the so-called middle-income trap, whereby middle-income economies tend to follow a lower growth trajectory.

Much of the country's growth depends on its ability to attract foreign investment, skills and technology to raise productivity. However, the country has now started to experience a slowdown in foreign investment, technology diffusion and labour productivity.[10]

For Slovakia to avoid the middle-income trap, it could be useful to develop new strategies focused on domestic innovation. Above all, this would lead to more productive firms, more private capital and more skilled labour to spur long-term growth.

Such improvements, however, often depend on setting the right institutional conditions. Indeed, institutional quality has proved to be an important factor in achieving higher incomes in the long run.[11] Factors such as inefficient public administration, weak control of rent seeking, tax evasion and corruption hamper competition and economic inclusion.

Slovakia ranks below the euro area average in some of these areas, as measured by the most commonly used institutional governance indicators. More importantly, while most other new euro area countries showed some improvement over the past decade, reform momentum in Slovakia appears to have slowed after the euro was adopted (Chart 3).

By improving in two key areas, Slovakia could help foster the right domestic conditions for businesses to thrive.

One area is improving the business environment. According to the World Bank's Doing Business Indicator, Slovakia ranks below the new euro area countries, in particular in areas such as starting a business, protecting minority investors or dealing with construction permits (Chart 4). Moreover, 55% of entrepreneurs perceived corruption as a problem for doing business in the country, according to the Eurobarometer in 2017. [12]

Another area for potential improvement is the judicial system. According to the Organisation for Economic Co-Operation and Development (OECD), the integrity of the legal system and independence of the judiciary are perceived as insufficient (Chart 5).[13] Improving the independence and transparency of the judicial system could help in the fight against corruption and increase public confidence in the state.

Addressing these issues would also create the conditions for national businesses to fully exploit the potential of the Single Market and contribute to sound and inclusive growth.

Conclusion

As we celebrate ten years of euro adoption, Slovakia has become a success story for the convergence process in the EU. The country can be proud of having achieved impressive economic and institutional convergence in such a short time.

Slovakia's success shows that EU accession and the adoption of the euro can create considerable opportunities – opportunities that can be seized, or wasted. Slovakia is a positive example of a country that has seized the opportunities of European integration through fundamental institutional reforms.

Nevertheless, continued efforts in the pursuit of institutional quality and good governance are needed in all euro area countries in order to reap lasting benefits from Monetary Union. This includes strict compliance with the doctrine of central bank independence.

For Slovakia, further improving the business environment and judicial system would help promote continued economic success over the next ten years.

I'm confident that sound domestic and European institutions will support sustainable growth and contribute to maintaining confidence in the euro and the European project.

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1 Real GDP per capita in terms of purchasing power parity as a percentage of the EU28 average in 2016.

2 See *Economic Convergence in the Czech Republic and Slovakia*, European Commission, 2018.

3 See Blind, K., Mangelsdorf, A. Niebel, C. and Ramel, F. (2018), "Standards in the global value chains of the European Single Market", *Review of International Political Economy*, Volume 25, Issue 1.

4 See ec.europa.eu/trade/policy/in-focus/trade-and-jobs/

5 See Suster, M. (2006), "The effects of euro adoption on the Slovak economy", BIATEC, Volume XIV, 6/2006.

6 See www.banque-france.fr/sites/default/files/slidesjaanikamerikull.pdf

7 ECB Convergence Report, May 2008.

8 ECB Opinion of 27 October 2009 on Národná banka Slovenska's independence (CON/2009/85).

9 See ec.europa.eu/info/sites/info/files/economy-finance/eb034_en.pdf

10 See Chiacchio, F., Gradeva, K. and Lopez-Garcia. P. (2018), "The post-crisis TFP growth slowdown in CEE countries: Exploring the role of Global Value Chains", *Working Papers Series*, No 2143, ECB, April.

11 See Masuch, K., Moshammer, E. and Pierluigie, B. (2016), "Institutions and Growth in Europe" CEPS, April.

12 Flash Eurobarometer 457, Businesses' attitudes towards corruption in the EU, October 2017.

13 OECD, Economic Surveys, Slovak Republic, June 2017.