MACROECONOMIC POLICY IN SLOVENIA PRIOR TO MONETARY UNION ACCESSION

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Abstract

This article deals with expected elements of macroeconomic policy prior to Slovenia's accession to the European Monetary Union (EMU). At first I briefly consider the convergence of economic variables in the monetary union and the potential new member. My inferences about expected economic policies are based on the fiscal theory of price determination. Joining the monetary union means fixing the exchange rate, so the country will strive for a low inflation rate, predicting a restrictive monetary policy. However, according to fiscal theory, stabilization also requires compatible and therefore restrictive fiscal and income policies.

1. Introduction

In May 2004, ten countries, including Slovenia, joined the European Union (EU). This has had and will continue to have profound effects on their economic policies. Unlike current member states, the new members will also have to adopt measures and policies to join the European Monetary Union (EMU). The purpose of this paper is twofold: to examine the compatibility of Slovenia's economic structure with that of the EU, and to investigate the likely nature of monetary, fiscal, and income policy in Slovenia within this context. Although the focus of this article is on the Slovenian experience, similar challenges face other acceding countries.[1]

During the period prior to adopting the euro, the acceding countries will have to pay special attention to disinflation (or maintaining a low inflation rate) and to limiting exchange rate fluctuations during the Exchange Rate Mechanism (ERM2) participation period.[2] Accession of

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[1] Jonas (2001) and Tarafas (2002) discuss economic policies in the Czech Republic and Hungary, respectively, prior to EMU accession.

[2] In June 2004, after this article was completed, Slovenia fixed its "central" parity with respect to euro at about 240 Slovenian tolars to one euro.

an economy to a monetary union demands yielding national monetary sovereignty[3] and fixing the exchange rate. The latter prevents economic isolation from foreign influences by adjusting exchange rates. The absence of monetary policy and a fixed exchange rate make fiscal policy a much more attractive tool for stabilization during the business cycle.

Due to exchange rates' volatility, fixing can occur at parities that do not reflect actual, "real" relationships between the economies merging into the monetary union. This may lead to large flows of production factors[4] that in a monetary union can no longer be prevented through economic policy measures in a member country. To avoid these flows, the acceding economy attempts to harmonize its structure and policy with those that exist within the union. Maastricht criteria explicitly require harmonization of new member countries (for nominal factors); the need to temper larger possible flows of production factors implicitly require it.

My inference about the nature of economic policy prior to accession to the monetary union is based on the fiscal theory of the price level.[5] The theory maintains that aggregate government liabilities (not only money) determine the price level in an economy. Therefore, compatible monetary and fiscal policies are a necessary condition for successfully reducing inflation.[6] In an open economy, inflation is determined simultaneously with the exchange rate.[7] Thus exchange rate stabilization also depends on compatible fiscal and monetary policies,

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[3] Schoors (2002), Frensch (2001), Schobert (2003), and Merlevede et al. (2003) examine the effects of different timing on possible unilateral euroization, the choice of the exchange rate regime, the effects of EU originating shocks in acceding countries, and the effects of accession on seigniorage and interest rates.

[4] Adopting a common currency can be compared to two lakes with surfaces at different levels, connected by a channel with a barrier. When the barrier is removed or opened, the lakes' levels will equalize. However, this process will cause more or less strong flows towards one or the other lake, depending on the difference in the surface levels. Similarly, accession of a country to a monetary union can cause the flow of production factors in one or the other direction if economic circumstances on both sides differ substantially.

[5] As developed in Leeper (1991), Sims (1994), Woodford (1994, 1995), and others.

[6] Mikek (2004) interprets the reforms in New Zealand in this framework.

[7] Daniel (2001) and Mikek (2001) discuss fiscal theory in an open economy.

which set forth the constraints on the policy mix. To achieve low inflation and stable exchange rates in Slovenia prior to joining the monetary union, rather restrictive monetary and fiscal policy are to be expected.

Section 2 of the article discusses "real" convergence and presents data on productivity, real exchange rate, and the labor market for Slovenia and selected other small European countries. Past monetary and fiscal policy in Slovenia is briefly described in section 3, along with the Maastricht criteria and the volatility of the exchange rate, inflation, budget deficit, and public debt. In section 4, I apply the logic of the fiscal theory of price determination in combination with the Maastricht criteria to speculate on likely monetary, fiscal, and income policies in Slovenia.

2. Real convergence

Following comments on the need for economic compatibility between the monetary union and potential member country, section 2 briefly examines the current situation in Slovenia and some other small European economies as relates to "real" elements of convergence: GDP growth, productivity, real exchange rate, and the labor market. Both aspects of convergence, real and nominal, are closely related. Changes in the supply side elements of real convergence foster an economic environment that stimulates nominal convergence and vice versa.[8]

Disparities between the monetary union and the acceding economy can be substantial.[9] Both parties are nevertheless separated by the exchange rate.[10] In general, both the *real exchange rate* (when we deal

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[8]   Cf. discussions by Mencinger (2002) or Štiblar (2003).

[9]   Boreiko (2003) reports Slovenia and Estonia to be the leaders in terms of both real and nominal convergence and points out that the other countries have made substantial progress in terms of real convergence. Due to poor economic performance, Poland is excluded from the leading group in his results.

[10]   The disparities will not cause the flows of production factors when the exchange rate at the moment of accession corresponds well to the fundamentals. Here "fundamentals" refer to productivity, labor market variables, technology variables, and the like. In contrast, "nominal" factors depend mostly on monetary conditions. Korhonen (2003) examines the harmonization of the business cycles in individual acceding countries and

with the productivity gap) and the *nominal exchange rate* (when we deal with inflation differences) can adjust to equalize domestic and foreign prices. But within a monetary union the exchange rates, and therefore the mechanism for price "equalization," do not exist. Thus the quantity of production factors has to adjust to the differences between the economies, which implies flows of the factors over the borders (especially for small, open economies such as those of the new EU members).[11]

Both substantial inflows and outflows of production factors are a shock for an economy. They may wedge a temporary gap between actual and equilibrium values of the variables during the adjustment period. Due to a range of factors, exchange rates are very volatile and sensitive to these international flows.[12] However, accession to the union irrevocably fixes the exchange rate. It is therefore advantageous to avoid such gaps and to fix the rate at a parity that reflect the fundamentals well. To achieve a compatible economic structure and a smooth exchange rate "landing," countries will first join the European Exchange Rate Mechanism (ERM2). The ERM2 is thus an instrument for easing possible accession shocks and fine tuning the future fixed exchange rate parity.

2.1. Productivity. Productivity measures the efficiency of the use of scarce resources for production, and thus their profitability and, consequently, also their allocation. Productivity is likewise the main determinant of real output growth. GDP growth in Slovenia has been much higher than in Europe (figure 1). This, of course, reduces the substantial difference per capita output levels. The Slovenian per capita GDP is only about 68% of the European average (EU-15 amounts to 25,200 USD as compared to Slovenia's 17,291 USD, table 1).

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the EMU and finds that Hungary and Slovenia are relatively synchronized with the EMU.

[11]   This so-called "real" adjustment (which replaces the "nominal" adjustment of exchange rates) causes large changes in input markets, social welfare, and economic performance. Lavrač and Žumer (2003) conclude that Slovenia is well prepared to join the EMU and is relatively less likely to be exposed to asymmetric shocks after joining.

[12]   For example, due to a larger inflow of capital just before accession, the home currency becomes relatively scarcer. Foreigners investing in the home economy are demanding local currency, which appreciates the domestic money. This harms exports since domestic goods become relatively more expensive abroad.

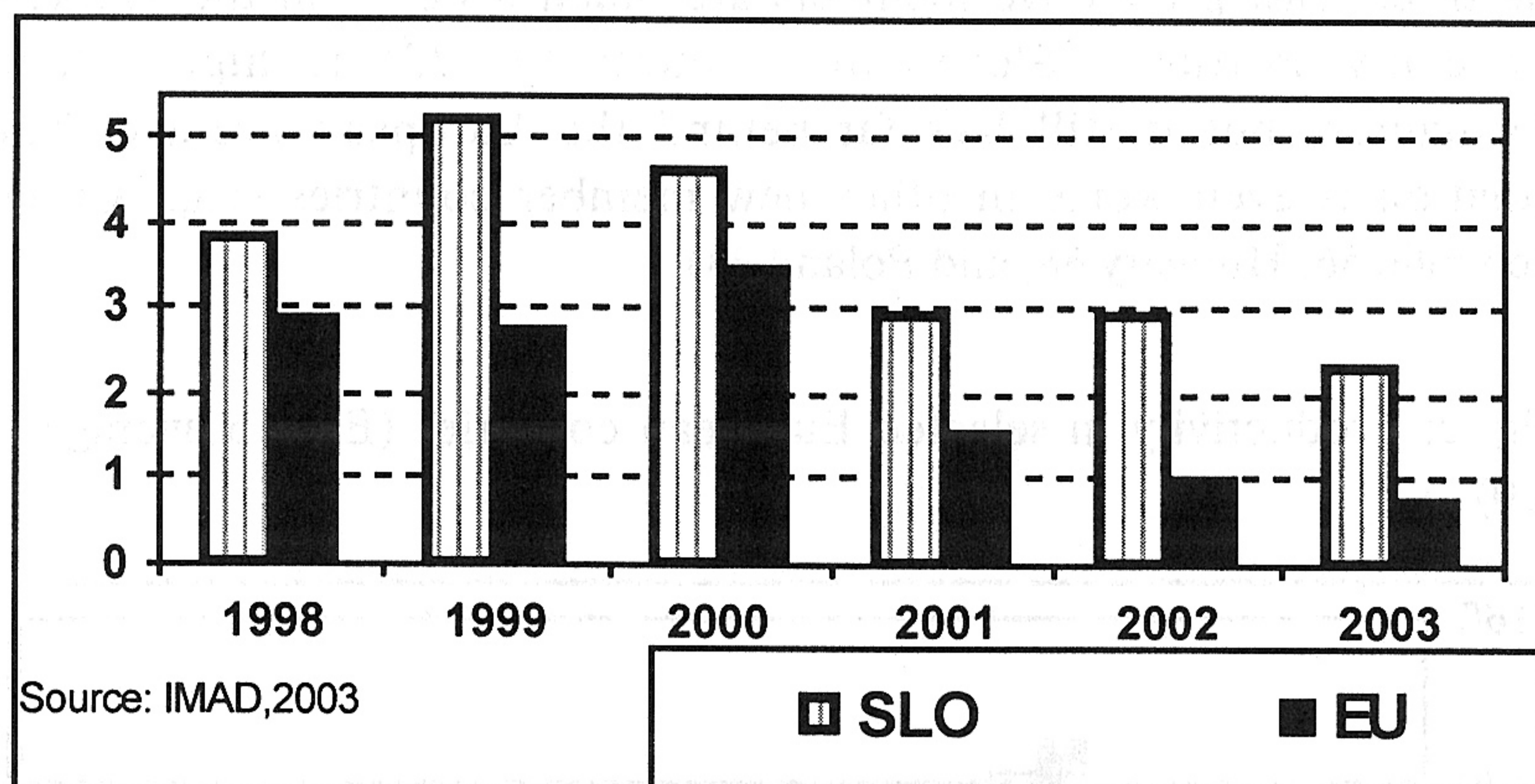Fig. 1: Growth rates of real GDP 1998–2002 (%)

Source: IMAD,2003

Table 1: per capita GDP in selected small European countries, 2000–2001 (adjusted for price level differences - PPP based)

|	2000	2001
Austria	27,001	27,800
Belgium	26,190	26,900
Denmark	29,061	29,900
Finland	25,175	25,900
Greece	16,817	17,800
Ireland	29,174	31,400
Netherlands	27,836	28,600
Portugal	18,021	18,700
Czech Republic	13,800	15,090
Hungary	12,200	13,430
Poland	9,550	10,320
Slovenia	16,433	17,291
EU-15	24,377	25,200

Source: IMAD, 2003

Figure 2 shows productivity levels in selected European countries and some new EU members. The three most productive EU members (Belgium, Ireland, and Luxembourg) have much higher productivity

levels than the average (Luxembourg more than 30% higher). In contrast, the three least productive members are much lower than the average, especially Portugal. Slovenian productivity (73) is higher than Portuguese, but it still lags far behind the European average. The situation is even worse in other new member countries (e.g., Czech Republic 56, Hungary 66, and Poland 48).

Fig. 2: Productivity in selected European countries (EU-15 average = 100)
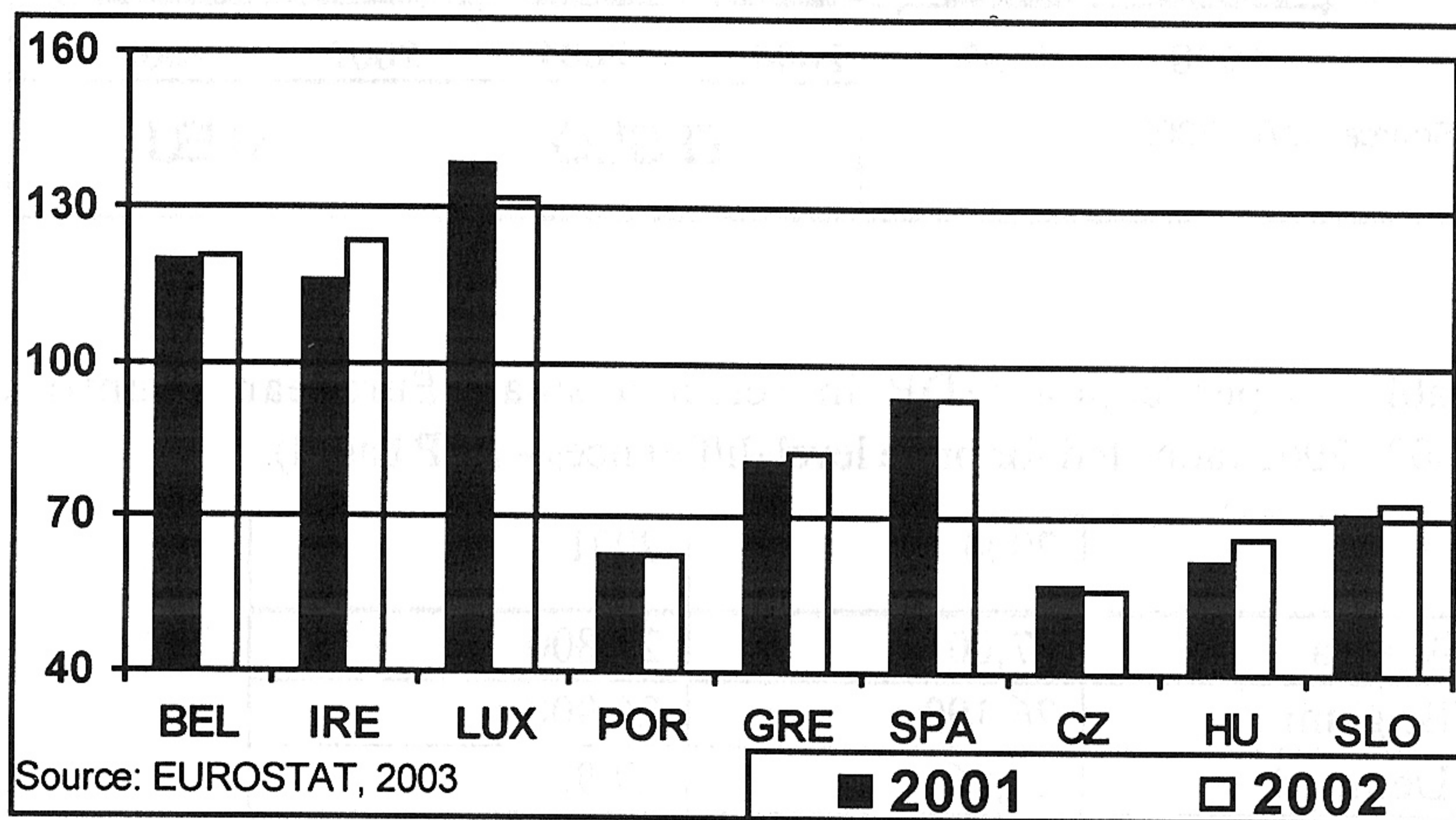
Productivity in Slovenia from 1995 to 2002 increased by 28%, as compared to 8% in the EU (figure 3). This reflects the productivity catch-up process.[13] On average, Slovenian productivity growth for this period was 3.6%, while for the EU it was 1.1% per year.[14] On the surface, this growth is quite impressive. However, the average for new EU members was 28.1%.

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[13]   Program (2003) provides further details.

[14]   Productivity presented here is measured as real GDP per employed person. However, the figures based on gross value added (GVA) are not much different. For example, during the period 1995–2000, GVA-based productivity in Slovenia increased by 23% and GDP-based by 21%.

Fig. 3: Productivity growth 1995–2002 in the EU, Slovenia, and new EU members (%)

Source: EC, 2003; own calculations
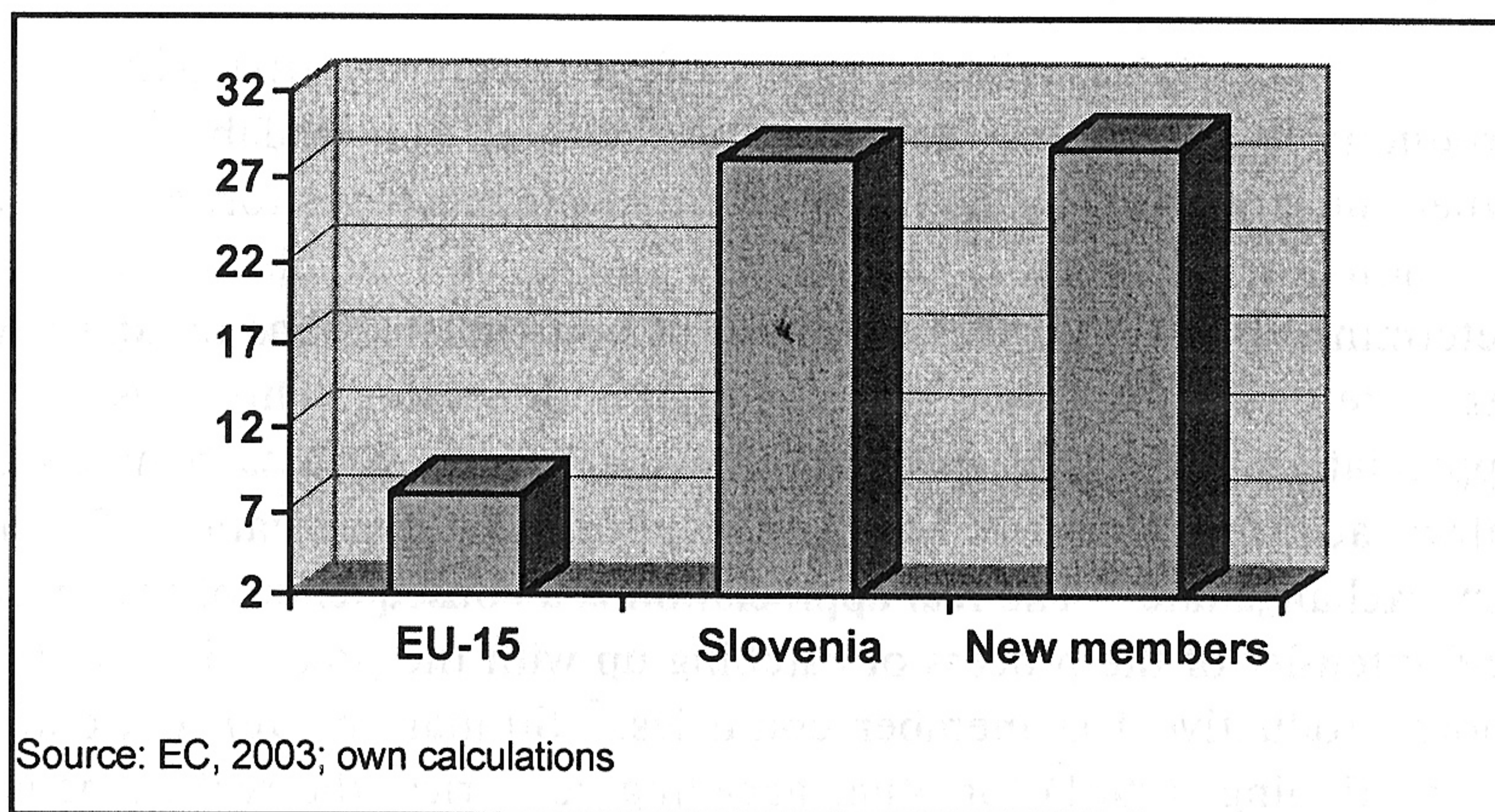
Given the current level of productivity (figure 2) and growth rate, it would take more than thirteen years to reach the European productivity average. The continuation of the current dynamics is simply not realistic.[15] Therefore, we can expect it will take at least fifteen years for Slovenia to reach the European average. The central bank estimates that it will take about twenty-five years (Program, 2003). The situation is thus much less favorable than the graphs presented might suggest.

2.2. Real exchange rate. In the long run, the real exchange rate reflects the relationship between the GDP in two economies. It can be defined as a ratio that shows the number units of domestic goods that can be traded for a foreign unit. Thus the dynamics of the real exchange rate are directly linked to the efficient use of resources (productivity) and are the most important determinant of international trade flows. For small, open economies, which trade a large part of their GDP internationally, the real exchange rate is crucial. Larger short-run deviations from the equilibrium just before accession to the monetary union are undesirable for two reasons: they cause disequilibrium in international trade flows

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[15] The growth rates calculated starting at lower levels are higher than those starting at higher levels. Previous calculations based on data in Stapel (2001) for the earlier period, 1995–98, showed a slightly more optimistic picture.

and we do not want such an exchange rate to become fixed at the moment of accession.

The Balassa-Samuelson effect explains disparities in productivity growth between the tradable and non-tradable sectors. When the growth of productivity in the tradable sector is stronger than in the non-tradable sector, the relative prices of tradable (which are determined by world prices) in terms of non-tradables has to adjust to facilitate paying the same real wages in both sectors. This causes the appreciation of the real exchange rate. Due to the Balassa-Samuelson effect, acceding countries have experienced some appreciation of their real exchange rate.[16] The real appreciation is a consequence of the speed and intensity of the process of catching up with the productivity of the more productive EU member countries.[17] Similar to DeBroeck and Slok's findings (2001) for other acceding countries, the real exchange rate in Slovenia has on average appreciated slightly in the last few years (figure 4).

2.3. Labor market. Rigidities on labor markets are surely one of the factors that contribute substantially to comparatively high unemployment rates in Europe. For 2002 they were 5.8 for the U.S. and 7.4 for the EU (ILO methodology). The highest unemployment rates in the EU were in Spain (10.6) and Greece (9.9). The Slovenian unemployment rate was 6.4 (IMAD, 2003). Compared to the rest of Europe, the rigidities are

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[16] Smidkova et al. (2003) finds that in four out of five studies, acceding countries (with the exception of Slovenia) had a somewhat overvalued real exchange rate at the end of 2001 and cautions that the exchange rate will not automatically be in line with fundamentals just prior to joining the EMU.

[17] Coudert (2003), however, links the real appreciation to the exchange rate regime, claiming that the pegged currencies are more prone to such real appreciation.

For a relatively successful transition country with strong productivity growth in the tradable sector, such an appreciation, due to the Balassa-Samuelson effect, is not surprising. Dobrinsky (2003) attempts empirically to test the Balassa-Samuelson effect for acceding countries. The "catch-up" effect (as it is called sometimes) has been moderate in Slovenia. The central bank estimates that a moderate 1 to 1.5 percentage point annual appreciation of the real exchange rate can be expected until the tradable sector achieves convergence (Program, 2003). "The catch-up process is an equilibrium process and the real appreciation caused by it does not jeopardize the competitiveness of the Slovenian economy" (Program, 2003).

Fig. 4: Effective real exchange rate of the Slovenian tolar 1996–2003 (growth rates based on consumer prices)

y= -0.58x + 100.88

Source: IMAD, 2003;data for 2003 refer to July
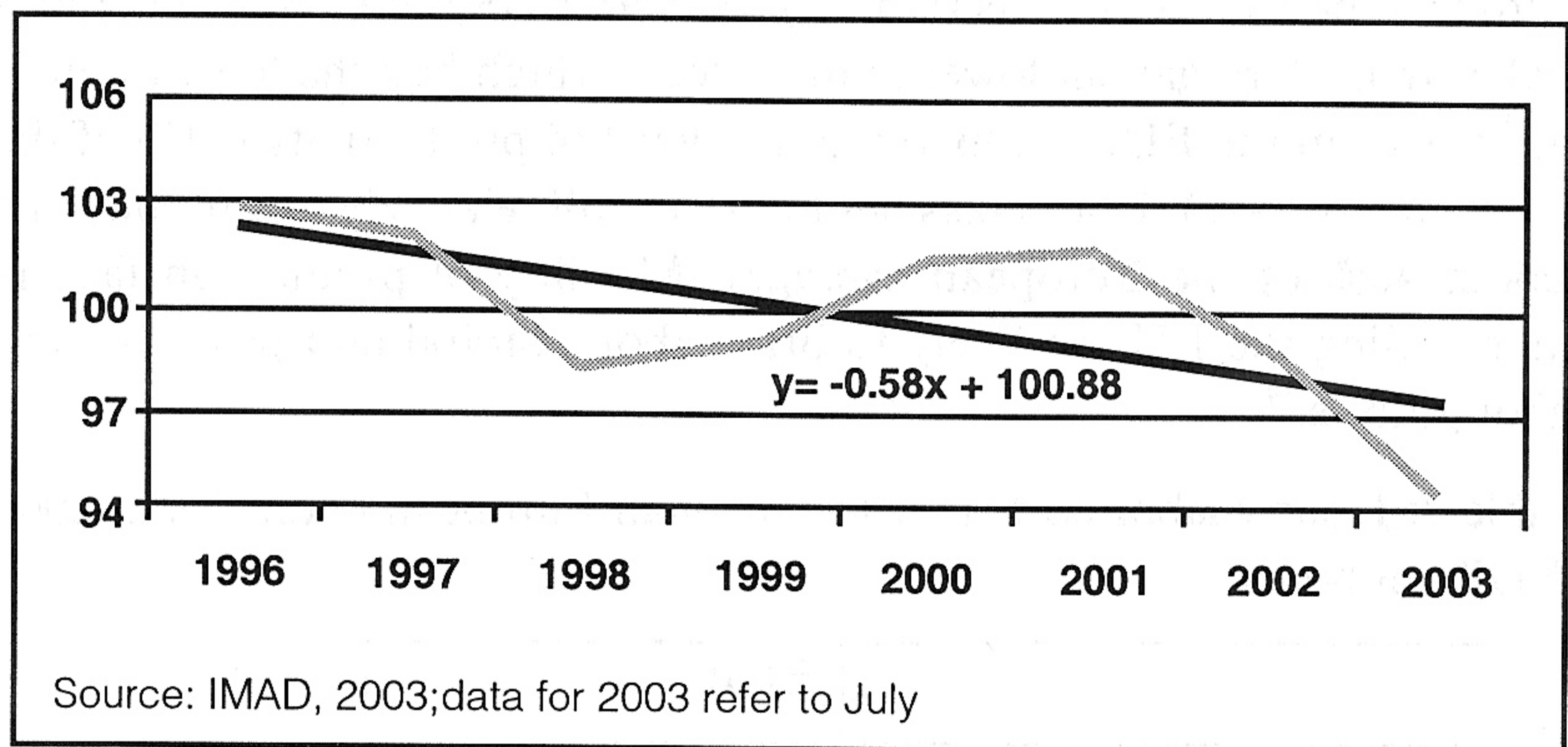
relatively stronger in Slovenia. This is due to the socialist past, the strong tradition of trade unions, and significant social changes with lively redistribution of ownership (i.e., privatization and denationalization). The rigidities exert a significant influence on the dynamics of the price of labor.[18] Labor costs per unit of product have increased gradually over the last few years, at about 0.5 percent per year (figure 5).

Fig. 5: Real labor costs per unit of product in Slovenia 1996–2002

y= 0.5 = 100.46

Source: IMAD, 2003

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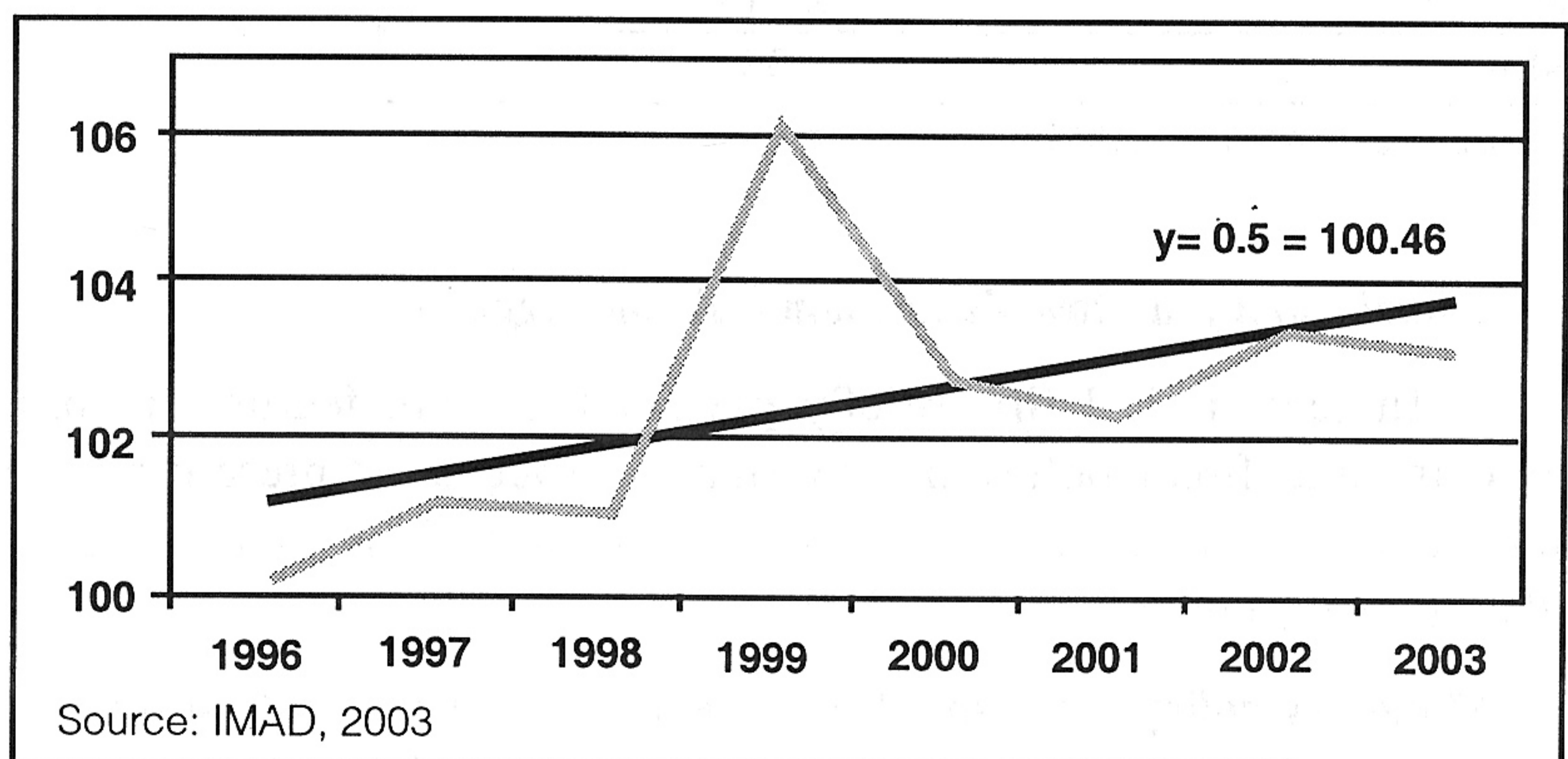
[18] Sectoral synchronization of wage increase demands among trade unions (such as the one that happened in 2002 among judges, doctors and others) in the public sector may cause inflationary pressures (IMAD, 2003).

Despite increases in real labor costs per unit of product, the level of hourly labor costs in Slovenia is relatively low, about 40% of average European hourly labor costs (table 2). At 8.98 EUR/hour, Slovenia ranks higher than Portugal but lower than Greece, which had the lowest hourly labor costs in the EU. Compared to the level of productivity (71% of the European average), labor costs per hour are still relatively low in Slovenia (about 40% of the European average). Mobility of production factors after joining the EU are likely to bring about capital and possibly even labor inflows.[19]

Table 2: Hourly labor costs in selected small European countries in 2000 (EUR per hour)

	EUR
Austria	23.60
Denmark	27.10
Finland	22.13
Greece	10.40
Ireland	17.31
Netherlands	22.99
Portugal	8.13
Czech Republic	3.90
Hungary	3.83
Poland	4.48
EU-15	22.19
Slovenia	8.98

Source: Paternoster, 2003

3. Economic policy in Slovenia and nominal convergence

In section 3, I first briefly present the main features of past monetary and fiscal policy in Slovenia. I proceed by presenting the Maastricht criteria and comment on the volatility of the exchange rate, inflation, budget deficit, and public debt.

3.1. Monetary policy. In a small, open economy, it is hardly surprising that "the exchange rate regime and exchange rate determination have

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[19]   Funck and Pizzati (2002) offer an overview of labor market issues in the context of EU enlargement.

been the pillars of Slovenian economic policy" (Mencinger and Mrak, 2003). Managed floating of exchange rates has been in place in Slovenia since 1991. The Bank of Slovenia used the money base as a target up until 1998. However, even during this period "while targeting money, the Bank of Slovenia tried to prevent excessive real appreciation and volatility of the exchange rate" (Mencinger and Mrak, 2003).[20]

Successful sterilization on the foreign exchange markets was achieved through capital flow barriers during the second half of the 1990s. This allowed independent dynamics of money and exchange rates (Bole, 2003). But during 1999, most of the remaining capital barriers were lifted within the EU accession process. The deregulation of capital flows brought about a strong increase in net financial inflows. During 2001 and 2002 they reached about 8% of GDP (Bole, 2003). These were monetized on the foreign exchange markets and in the second half of 1999 caused a notable increase in the magnitude and volatility of the money supply.[21] The central bank was thus forced to switch the target.

After 1999 the central bank targeted the real interest rate. In this way it regulated the desired restrictivity of monetary policy (given the inflation expectations[22]) by squeezing interest-sensitive home expenditures. This tempered the growth in prices of non-tradables and thus directly affected the inflation rate (Bole, 2003). Real interest rate targeting has been combined with targeting the desired nominal depreciation to achieve uncovered interest parity and prevent substantial capital flows.

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[20]   Aglietta et al. conclude that other Central European countries also managed to avoid excessive exposure to hot money, which permitted them to adjust their exchange rate regimes away from hard peg and pure floating. Van Foreest et al. (2003) make the interesting conclusion that the choice of the foreign exchange regime (also for acceding countries) is not "of first order of importance" for achieving high output growth. Hochreiter and Wagner (2002) also study the choice of the exchange rate in acceding countries.

[21]   Interestingly, due to changing the currencies that were replaced by the euro, the Slovenian narrow money supply jumped by more than 30% during a period of only two months (Bole, 2003).

[22]   Orlowski (2003) tests a model of inflation and exchange rate risk premiums within the context of inflation targeting using data for Hungary, the Czech Republic, and Poland.

Suggestions for a similar monetary policy in acceding countries can be found in the literature. Devereux (2003) finds that the best policy is one of flexible inflation with some weight attached to exchange rate stability. Barrell et al. (2003) discuss the choice of alternative exchange rate regimes prior to joining the EMU and concludes that Poland would benefit the most by fixing the exchange rate, but Slovenia and the Czech Republic should keep the exchange rate floating. His results are inconclusive for Hungary and Estonia. Additionally, Bofinger and Wollmershauser (2001) suggest a strategy of flexible exchange rate targeting where central banks simultaneously manage interest rates and exchange rates for the acceding countries.

3.2. Fiscal policy. Slovenia adopted a gradual approach for its public finance reforms.[23] Most of the reforms were smooth and gradual. The radical reform of the "communal system," aimed at separating central and local governments and practically centralizing state functions, is an exception (Mencinger and Mrak, 2003).

In this manner, the tax system has been gradually converging with that in EU member states. The ratio of total taxes to GDP is a bit lower than the EU average (Mencinger and Mrak, 2003). Similarly, the rates of Value Added Tax in Slovenia are comparable to European rates (20% in Slovenia versus 19.5 in Europe). But the distribution of different taxes differs from that across Europe. Štiblar (2003) reports that the Slovenian effective tax rate on consumption is about 30% higher than the EU level. In contrast, the effective tax rate for corporations is only about 58% of the European average. Tax reform that should redistribute the tax burden from heavily taxed labor to capital is underway.

The allocation of the share of Yugoslav debt to Slovenia (16.3%) was a major contributor to Slovenian public debt. The rehabilitation program of the Slovenian banking system by which "bad" loans were converted into public debt was the second major contributor to the public debt (Mencinger and Mrak, 2003). Despite strong fiscal pressures during the transformational depression of the initial transition period, the level of debt remained relatively low. However, the dynamics have changed recently, as I discuss below.

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[23]   Other acceding countries also had to adjust their fiscal policy prior to EMU accession. Halpern and Nemenyi atudied the Hungarina case (2001), and Rapacki (2002) the Polish experience.

Generous retirement benefits could not be preserved through a period of economic deterioration. Among other changes, full indexation was abandoned. In 1999 a new law introduced a flexible retirement age. These changes were not sufficient to restrict the growth of expenditures, which were due partly to demographics (Mencinger and Mrak, 2003). The retirement system still depends heavily on transfers from the central government.

To reduce health care expenditures, the Ministry of Health proposed reforms in 2003. The proposal stresses justice, accessibility, quality, and efficiency. Many economists roundly criticized it.

Accession to the EU has brought about a substantial reduction in revenues from customs duties, down from about 15% of all tax revenues in 1992 to only slightly above 2% in 2002 (Mencinger and Mrak, 2003). Additionally, the sales tax was replaced by the Value Added Tax in 1999. This caused a jump in the share of sales tax/VAT in tax revenues from 60 to 67%. Yet by 2002 the number had returned to its pre-VAT levels of about 54% of tax revenues.

After accession in May 2004, fiscal flows between the EU and Slovenia will emerge. Mencinger and Mrak (2003) estimate the net inflows at about 0.5% of GDP. However, taking into account expenditures related to Schengen border arrangements and top-up payments for agriculture, the overall fiscal effect of accession is about negative 1% of GDP.

Fiscal policy is determined through interactions in the political system, mainly between the government and the parliament, where the ruling party has an overwhelming majority. In contrast, the monetary authority is formally independent. However, both economic policy makers understand the need for cooperation and have lately prepared a joint "Program for entering the EMU and adoption of the Euro" (Program, 2003).

3.3. Maastricht criteria. The importance of economic harmonization was also the basis for the Maastricht criteria for EMU accession. These require that countries joining the monetary union have: a) public debt no larger than 60% of GDP; b) a budget deficit no larger than 3% of GDP; c) inflation within a 1.5 point deviation from the average of the three countries with the lowest inflation; and d) a long-run interest rate within

2 percentage points of the average of the three countries with the lowest interest rates.[24] The influence of the deficit and public debt on inflation was the main reason for making them explicit parts of the Maastricht package. The connection can be explained as follows: A state in financial trouble may resort to an increase in government liabilities (money or bonds) and in this way produce high inflation. In such circumstances people can understand an increase of government bonds (and not only quantity of money!)[25] as an increase of their wealth, leading to an increase in aggregate demand. Given the aggregate supply, this increases the price level. Such an increase in deficit and public debt may contribute to the growth of inflation and economic instabilities.

3.4. Volatility of the exchange rate and inflation. Inflation increases the variability of relative prices and the volatility of exchange rates. Accession to the monetary union fixes the exchange rate and therefore it is desirable to temper the volatility of the exchange rate just prior to this. The central bank has been successful in stabilizing the official exchange rate of the Euro (figure 6). From January 2000 to October 2003 deviations were never very large (at most a bit more than 0.5), but have decreased substantially since 2000.

Inflation that is low and compatible with the monetary union is a necessary condition for joining the union. The gap between European and Slovenian inflation rates is gradually closing (figure 7). The trend line in figure 7 shows about a 1.5% average annual decline during the observed period. Although the inflation rate in Slovenia for 2003 was 5.6% (IMAD, 2004), it reached about 3.6% annually in February 2004. Due to substantial efforts aimed at reducing the relatively high inflation[26] in accordance with the program for adoption of the Euro (Program, 2003), it is still falling. European inflation also dropped and in February

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[24]   Budget deficit, public debt and high long-run interest rates serve as indicators of economic stability. The interest rate measures the credibility of economic policy and expectations of future inflation.

[25]   Check e.g. Leeper (1991) or Woodford (1994).

[26]   This is also partly due to stricter limitations on the growth of prices under direct administrative control.

2004 stood at 1.6 %.[27] Slovenian inflation for 2004 is predicted to amount to about 4.9% (IMAD, 2004).[28]

3.5. Budget deficit and public debt. Although the public debt, at less than 30% of GDP (compared to about 62% average for the EU in October 2003), is far under EU levels, its recent dynamics are much less favorable (table 3, figure 8). The deficit in Slovenia reached 3% of GDP in 2002 and the number will not be much different for 2003. The last column of table 3 shows that the increase in the ratio debt/GDP in Slovenia during 1999–2002 was the highest among the countries shown (only the Czech Republic has a larger increase). While there was a substantial increase in Slovenia, public debt in the EU was falling during this period (most remarkably in Ireland, the Netherlands, and Denmark).

Fig. 6: Standard deviations of the tolar/EUR exchange rate (monthly) 2000–2003

$y=0.3617e^{-0.0193x}$
$R^2=0.6423$

Source: BS, 2003; own calculations

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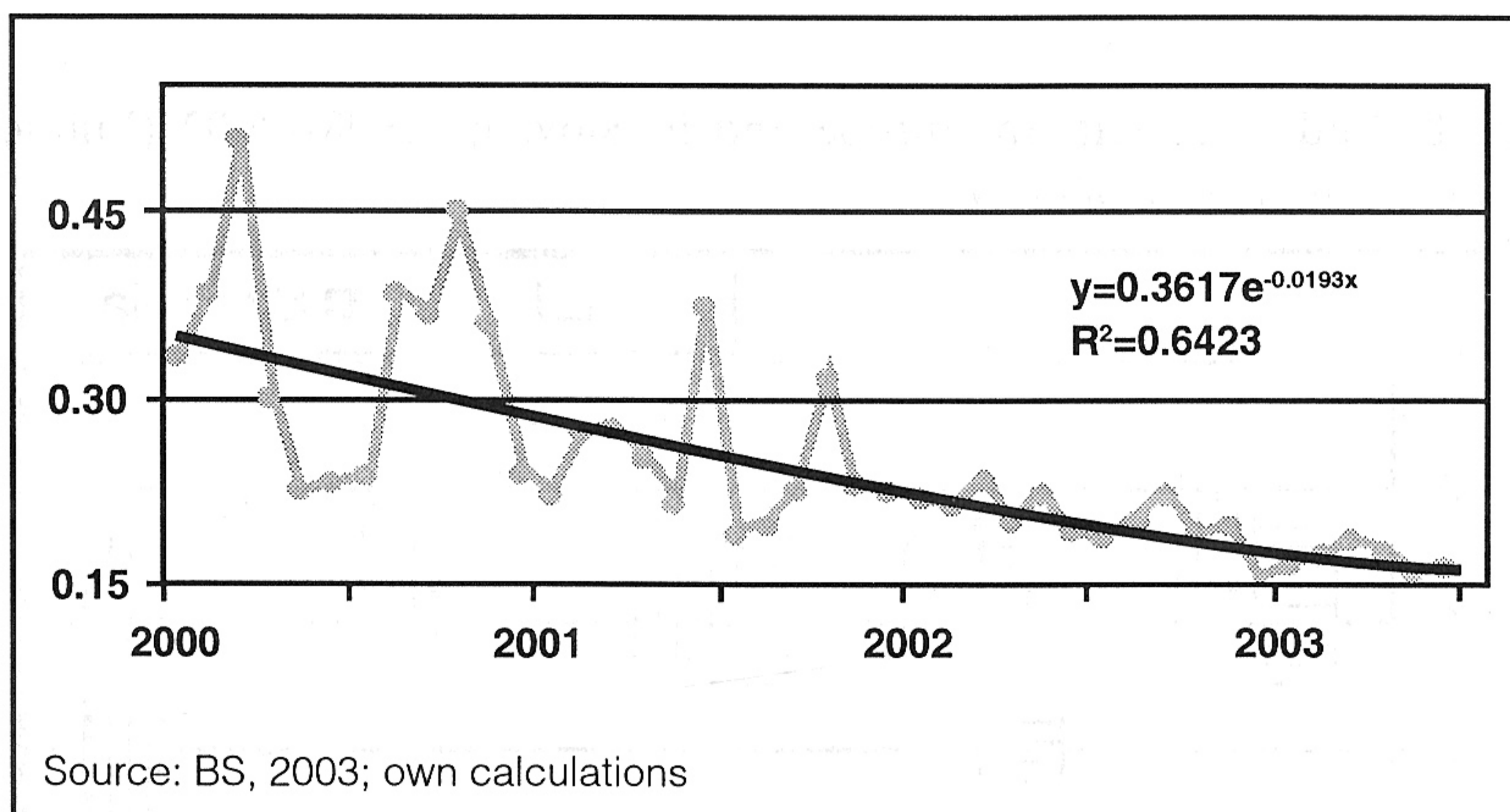
[27] Thus it is becoming likely that Slovenia will actually be ready to join the ERM2 by the end of 2004.

[28] The Balassa-Samuelson effect can cause relatively higher inflation rates; however, the central bank estimates it to be moderate and that "catch-up with the most developed EU countries does not jeopardize price stability."

Backe et al. (2003) find that the major driving forces of price formation in the acceding countries were: liberalization during the transition to a market economy, the prospective EU accession, and the catch-up process. Arratibel et al. (2002) also study inflation dynamics in acceding countries and, in contrast, find that the Balassa-Samuelson effect is not a prominent factor.

Fig. 7: Inflation rate in Slovenia and the EU-15 (annualized monthly rates, June 2001–February 2004)
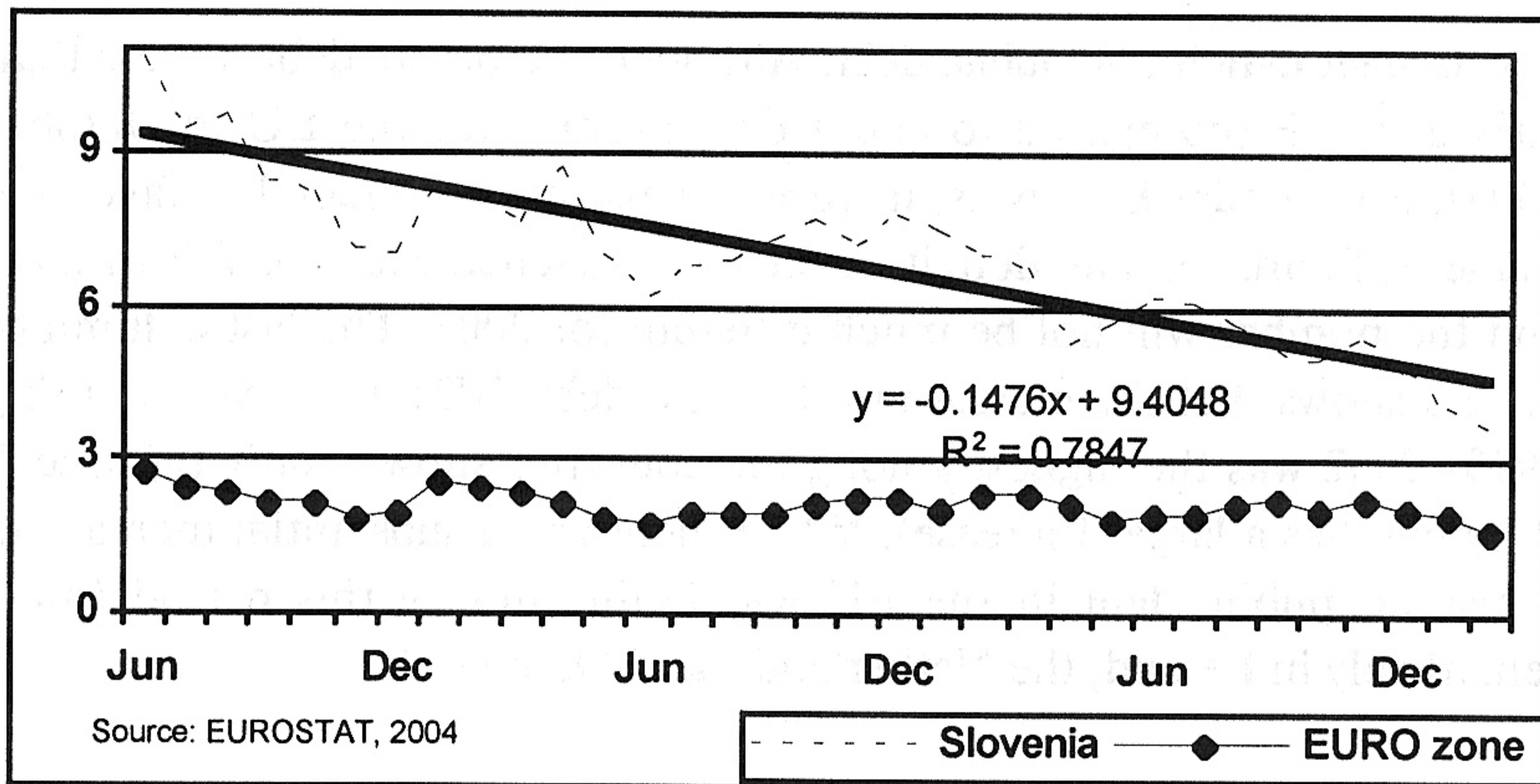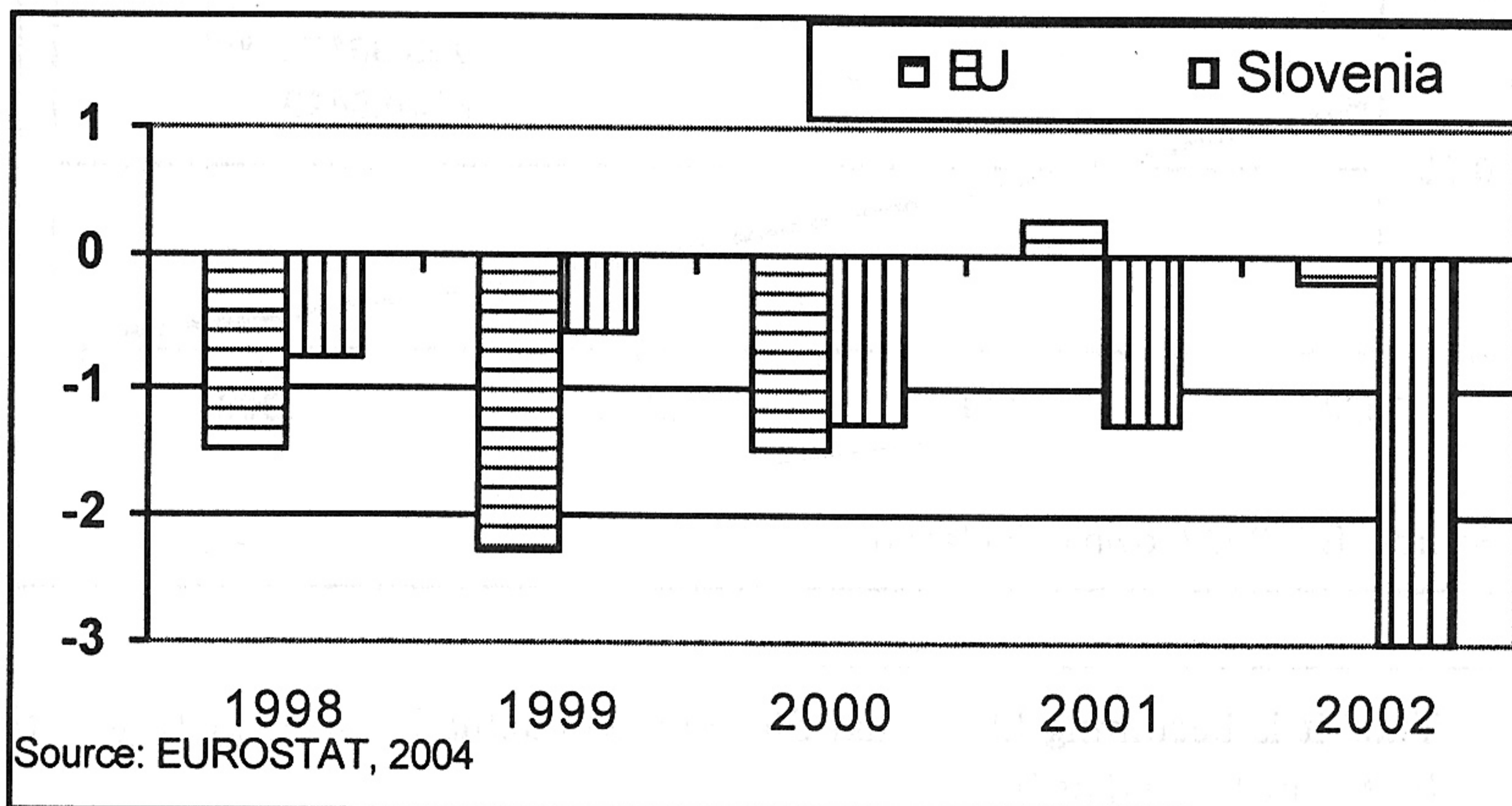

$$y = -0.1476x + 9.4048$$
$$R^2 = 0.7847$$

Source: EUROSTAT, 2004

- - - - - Slovenia   —◆— EURO zone

Fig. 8: Budget deficits in Europe and in Slovenia 1998–2002 (Public finance outcome, % of GDP)

□ EU   □ Slovenia

Source: EUROSTAT, 2004

4. Likely macroeconomic policy stance

Inferences about macroeconomic policy can be based on two cornerstones: a) the need to meet the Maastricht criteria, and b) the fiscal theory of the price level mentioned above.

Table 3: Public debt for selected European countries (in % of GDP)

	2002	Increase in the ratio debt/GDP 1999–2002
Austria	67.9	0.59
Belgium	105.8	-7.92
Denmark	45.5	-14.15
Finland	42.7	-9.15
Greece	104.7	-0.48
Ireland	32.4	-33.33
Netherlands	52.4	-16.96
Portugal	58.1	7.00
Czech Republic	27.1	86.90
Hungary	56.3	-7.70
Poland	41.8	-2.11
Slovenia	26.9	9.80
EU-15	67.3	-0.30

Source: IMAD, 2003; own calculations

4.1. Monetary policy

Thesis 1: *Prior to and during ERM2 participation, we can expect a rather restrictive monetary policy.* The ERM2 period is a transition during which countries' exchange rates should be kept within a 15% band around the central parity (Corker, 2000). The gradual fixing of the exchange rate during this period will no doubt be difficult since it will have to be tightly connected to disinflation.[29] Slovenia seems to have succeeded in bringing down the inflation rate, partly due to the tighter grip on prices directly under administrative control. The Maastricht criterion regarding inflation is likely to be met within 2004.

A few issues may arise prior to or during the ERM2 participation period. First, disinflation is likely to increase the real interest rate (at least in the short-run), bringing about capital inflows and pressures for appreciation of the exchange rate.[30] However, the latter is not compatible

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[29] Devereux (2003) studies two alternative monetary policies in this context.

[30] Monetary policy will have to pay special attention to the so-called hot, speculative capital. Its flows can have disastrous consequences for small

with fixing the exchange rate. The effects of the possible sale of assets to foreigners could be very similar.

Second, attempts to fix the nominal exchange rate can cause larger volatility in the real exchange rate (given the inflation rates). This is the main determinant of international trade flows and, for a small, very open economy like Slovenia; it is of crucial importance. For this reason, the Slovenian central bank has been paying close attention to exchange rate dynamics. When it tries to fix the nominal exchange rate during ERM2, however, this will no longer be possible. Lower inflation rates are thus the condition for avoiding larger volatility in the real exchange rate and international trade flows.

Third, growing disparities between productivity in the tradable and non-tradable sectors would, due to the Balassa-Samuelson effect, cause pressures for increases in non-tradable prices. This could feed into higher inflation rates, which again is not compatible with fixing the exchange rate.

Fourth, fixing of the nominal exchange rate (which, due to necessary disinflation, requires contractionary monetary policy) can cause a range of problems with liquidity in both enterprises and the whole financial system.

Fifth, social and political tensions may increase as a result of restrictive monetary policy. The situation in the first half of 2002 could serve as an example for possible tensions on the labor market. In an economy with well-organized trade unions, we can expect attempts to raise wages. This occurred in 2002 in the public service sector (doctors, judges, etc.) Such attempts increase government expenditures and, given the strict budget constraints, the government has to make cuts elsewhere. Such wage increases expand aggregate demand and bring about inflationary pressures.

In the past, Slovenian monetary policy managed to avoid major escalations of social tensions, but it paid the price with higher inflation rates. Recently, though, restrictive monetary policy with substantial success in bringing down inflation has been observed. In summary, in the

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open economies, as we could recently see in Asian, Russian or numerous Latin-American currency crises. Kopits (2002), for example, discusses the design of macroeconomic policies in acceding countries and in Latin America.

period before accession to the monetary union monetary policy will necessarily be restrictive.

4.2. Fiscal policy

Thesis 2: *Fiscal policy in the period prior to joining the monetary union will also be relatively restrictive.* Let us discuss some elements that lead to such a conclusion.

Let us suppose the opposite: that fiscal policy in the pre-monetary union period is *not* restrictive. This means an increase in government expenditures relative to fiscal receipts. The government finances this through borrowing from the public. Economic agents understand such an increase in government debt as an increase in their wealth, and increase consumption, aggregate demand, and price level. This is exactly what the monetary policy is striving to avoid. Thus expansive fiscal policy harms central bank attempts to limit inflation. It is even possible that such a fiscal policy prevents any disinflationary effects of monetary policy. From this it can be inferred that the activities of monetary and fiscal policy will have to be compatible if they are to lower inflation, which is a necessary condition for joining the monetary union. Relatively restrictive fiscal policy is therefore to be expected. The Program (2003), prepared jointly by the central bank and the Ministry of Finance, clearly incorporates the need for such close cooperation between both authorities in the process of participating in the ERM2 and adopting the euro.

Restrictive fiscal policy almost inevitably means tensions in the political system.[31] We expect relatively limited budgetary means for different uses.[32] Additionally, it is very likely that the restrictive fiscal policy will clearly point to the need for higher social efficiency, especially for a more efficient administrative apparatus (which we hope is already

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[31]   After 1999, there have been two key developments in public finance. On the expenditure side, the wage increase pressures took the leading role from the transfer pressures. Increases in wages changed the structure of current government expenditures since they squeezed out other expenditures (Bole, 2003).

[32]   We have already mentioned the fiscal flows between the country and the EU.

happening, although at a snail's pace), and for greater efficiency of projects financed through the budget.[33]

Compared to monetary policy, the fiscal policy has several disadvantages: it is relatively more complicated (long procedures in the political system) and therefore the emergence of its final effects has longer time lags. Despite this, in the future fiscal policy will have a more important role for the regulation of business cycles (especially after joining the ERM2 and then the monetary union).

4.3. Income policy

Thesis 3: *Due to restrictive monetary and fiscal policies, social tensions (given weak economic growth[34]) will make the income policy difficult.* The relationship among restrictive monetary and fiscal policies and social circumstances in the country has already been mentioned. Let us only reiterate that social welfare circumstances may render economic policy more difficult. Consider the policy maker whose preferences take into account not only economic but also political and social welfare considerations. Due to economic policy measures, the social welfare situation will likely worsen and it will be relatively more difficult to achieve compromise among social partners.

It is possible to avoid these social and political tensions if GDP grows fast enough to relieve the social and economic burden of restrictive economic policy.[35] Long-run growth can also contribute to price stabilization.[36] Such growth could be reached especially by improving productivity, both in enterprises as in the economy as a whole. Thus we are completing the circle and returning to the "real" elements of required economic compatibility, which should facilitate "smooth" accession to the monetary union. Another important factor that can contribute to

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[33]   Participation in projects financed by the EU requiring national financial participation is surely a good step in this direction.

[34]   For 2003 only about 2.3%.

[35]   Mencinger (2002) puts it in the following words: "A stagnation of some duration would quickly change what are now only academic 'asymmetric shocks' into serious economic problems and opposition to monetary policy."

[36]   "Success or failure under ERM2 regime will namely much more depend on economic growth, 'equilibrium' exchange rate, and current account balance than on inflation and budget balance" (Mencinger, 2003).

appropriate economic growth is, of course, the growth of exports. The volatile global economic environment was to blame to a high degree for the slowdown in 2003 (with GDP growth for the year at only 2.5%). But since the competitiveness of the home economy will be based primarily on a good productivity record (since control through management of the exchange rate by monetary policy will no longer be possible), growth in productivity and the rapid introduction of new and better technical and managerial methods is the most important necessary condition for smooth accession to the monetary union.

5. Conclusion

Joining the EU requires that Slovenia also join the European Monetary Union. However, there are substantial differences in productivity and also in inflation and monetary circumstances between both economies. To lower or maintain the low inflation rate needed for fixing the exchange rate and accession to the monetary union, we can expect restrictive monetary policy (inflation), restrictive fiscal policy (deficit and public debt), and possible tensions in the social and political systems (if economic growth proves to be unsatisfactory).

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POVZETEK

MAKROEKONOMSKA POLITIKA V SLOVENIJI
PRED VSTOPOM V DENARNO UNIJO

V članku razpravljamo o ekonomski politiki pred vstopom v Evropsko denarno unijo (EMU). Najprej se ozremo na konvergenco ekonomskih spremenljvk v denarni uniji in novi potencialni članici. Svoje sklepanje o potrebni makroekonomski politiki utemeljimo na fiskalni teoriji določanja cen. Z vstopom v unijo se država odreče nadzoru deviznega tečaja, zato želi v obdobju tik pred vključitvijo znižati inflacijo na primerljivo raven. Uspešna stabilizacija pa zahteva tudi kompatibilno, omejevalno proračunsko in politiko dohodka.