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# Economic News

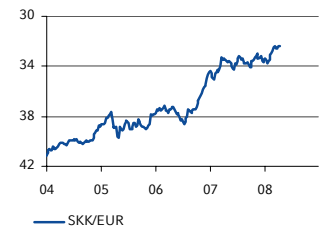
## SLOVAKIA'S EMU ENTRY BID

### Slovakia: Knocking on the Eurozone's Door

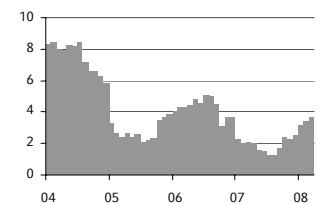
Slovakia has submitted a formal application for European Monetary Union membership as of 2009. Although Slovakia has met all of the convergence criteria, its application could still be rejected for lack of sustainable convergence. However, we do not believe this will happen. If admitted, Slovakia will become the 16<sup>th</sup> country to join the EMU, and the rotation of voting rights within the ECB council will go into effect as a result.

- Slovakia wishes to enter the European Monetary Union as of 1 January 2009, at which time the Slovakian koruna would be replaced by the euro. This marks the first time a major Central European transformation country has applied for membership in the EMU. The decision on the country's membership application constitutes a precedent upon which the potential applications by Poland, the Czech Republic and Hungary will be decided in future. Against this backdrop, the upcoming **decision will set the standard for other countries wishing to join the EMU.**
- On May 7 the European Commission and ECB will present their recommendations, on the basis of which the European Council of Heads of State and Government, and subsequently the Ecofin Council, will take their final decision in June on EMU membership. Although Slovakia has already satisfied all of the quantitative Maastricht criteria, it remains uncertain whether it will be admitted into the EMU. In addition, the Maastricht Treaty mandates "sustainable price stability", i.e. Slovakia's membership bid could be rejected for **lack of sustainable inflation levels.** The Maastricht Treaty also stipulates a "sustainable financial situation". Slovakia plans to meet this criterion by aiming for a budgetary deficit of 2.0% of GDP for this year and 1.7% for the coming year.
- The sustainability of inflation levels is the critical point which could still result in Slovakia's application for 2009 EMU membership being rejected.

Slovakian koruna



Source EcoWin, WestLB Research

Inflation  
% y/y

Source EcoWin, WestLB Research

### Convergence Criteria

	Reference value	Poland	Czech Republic	Hungary	Slovakia	Lithuania	Latvia	Estonia	Bulgaria	Rumania
Inflation <sup>1)</sup>	3.2	3.2	4.4	7.5	2.2	7.4	12.2	8.3	9.3	5.9
Long-term interest rate <sup>2)</sup>	6.5	5.6	4.4	6.8	4.5	4.6	5.4	6.4	4.7	7.1
Budgetary deficit <sup>3)</sup>	-3	-2.0	-1.6	-5.5	-2.2	-1.2	0.0	2.8	3.4	-2.5
National debt <sup>3)</sup>	60	45.2	28.7	66.0	29.4	17.3	9.7	3.4	18.2	13.0
Member of ERM II	since	-	-	-	25/11/05	28/6/04	29/4/05	28/6/04	-	-

Quelle Eurostat, EZB.

1) in % zum Vorjahr, Durchschnitt Apr.07 - Mrz.08.

2) in %, Durchschnitt Apr.07 - Mrz.08.

3) in % des BIP, Stand 2007.

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- According to unofficial reports, in a pre-release version of its convergence report the ECB noted that **inflation was supported by the firm koruna in recent years** and that the absence of this support going forward could jeopardise the sustainability of price stability. The Slovakian koruna firmed by an average of 4.5% p.a. during the past five years, which helped to contain inflation. A counterargument would be that the need for price adjustments has diminished in the course of the transformation process, thereby dampening inflation expectations. As a result, unlike in the past, inflationary pressure – even without support from the exchange rate – is not expected to be quite as strong as before.
- While the risk of a rejection or postponement of Slovakia's accession bid should not be dismissed, **we believe it is more likely that the application will be approved**, with a warning that the country must not reduce its efforts to lower inflation. Ultimately, the decision will probably also be based on **political considerations** as well as economic ones. A rejection could support the country's euro sceptics and disappoint the population, which has undergone the sacrifices necessary to meet the convergence criteria. A rejection despite Slovakia's success in meeting the quantitative convergence criteria would therefore be unfortunate from a political perspective.
- The conversion rate for the Slovakian koruna into the euro has also yet to be decided. At a current market rate of around 32.33 SKK/EUR, the koruna is trading at a clearly firmer level than its central rate of 35.44 SKK/EUR. It is therefore likely that the **conversion rate will be more closely aligned to the current market level**.
- **The principle of rotation will apply in the ECB council** when the number of member countries reaches 16. The six members of the ECB's executive board will maintain a permanent voting right. Fifteen voting rights will be rotated among the 16 chairmen of the national central banks (or more following future accessions) based on the principle of representativeness. This is determined according to the size of the economy (measured in terms of nominal GDP) and financial sector (measured in terms of the aggregate balance sheet of monetary financial institutions). As long as the number of member states does not exceed 18, the chairmen of the central banks of the five largest euro countries (including the chairman of the German Bundesbank) will always have a right to vote.

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