

Main results of “The Euro Changeover in the Slovak Republic: Implications for Inflation and Interest Rates”¹

Presentation by Andrew Dean, OECD Economics Department, in Bratislava, 17 July 2008

Thank you for inviting us to this event today - which prolongs the fruitful and long-standing collaboration between the Slovak Republic and the OECD.

The study whose main results I present in a minute has been prepared against the background of the euro adoption in 2009. It complements our regular *Economic Survey*, the next of which will be released in early spring 2009.

While in the current study we focus on the effects of euro adoption on inflation and interest rates, the *Survey* will take a broader perspective, dealing with the main challenges for macroeconomic and structural policy arising from euro area membership.

Let me turn now to the results of our study, which has been discussed with delegates from the Slovak Republic and delegates from other OECD member countries in a seminar on 9 July in Paris.

The main aim of the study is to investigate the implications of euro adoption in Slovakia for inflation and interest rates with an attempt to quantify their likely size as well as their consequences for the general public.

The analysis is based on the experiences of existing euro area member countries, in particular the 2002 changeover, for which most information is available.

The presentation is divided into three different sections (slides are attached at the back):

- The effects of euro changeover on inflation
- The effects of euro changeover on interest rates
- Policy recommendations arising from the paper

The presentation closes with a summary of the key points.

1. This presentation is based on an OECD study “The Euro Changeover in the Slovak Republic: Implications for Inflation and Interest Rates” by Felix Hüfner and Isabell Koske, which is being issued as an Economics Department Working Paper with a preliminary draft already available on the website of the Slovakian Ministry of Foreign Affairs, (<http://www.mzv.sk/>). Thanks are due to the Slovakian authorities for supporting this project and to the two authors and Andreas Wörgötter for their contributions to this presentation.

EFFECTS ON INFLATION

Effects of the cash changeover on consumer prices will be concentrated in certain sectors...

- The cash changeover can be expected to lead to significant price increases in a number of sectors, most notably in services sectors, but little effect in many others. [*see slide 2*]
- Estimates based on the euro changeover in 2002 show for example price increases of
 - 5% for newspaper & periodicals
 - 2% for restaurants
 - 2½% for hairdressing salons.
- The impact on the aggregate (HICP) inflation rate, however, is likely to be small. Applying the experience of existing euro area member countries to the case of the Slovak Republic, the cash changeover is estimated to increase aggregate consumer prices by 0.3 percent between July 2008 and July 2009.
- It should be noted that rounding effects do actually work in both directions with an, admittedly smaller, share of prices actually recording cuts around the changeover date.

...with price increases likely to be smaller in more competitive sectors [*see slide 3*]

- Product market competition appears to have played a major role in determining the extent of euro changeover-related price increases in the first-wave euro area countries.
- As such, the overall lighter product market regulation in the Slovak Republic compared to other euro area members and the associated higher level of competition should help to contain price increases around the euro changeover.

Higher income households more affected by price increases [*see slides 4 & 5*]

- The price increase we estimated implies that a typical household will incur additional consumption expenditures of SKK 504 (€16.7) per year as a result of the changeover.
- The effect will weigh more heavily on citizens with higher incomes as they spend a larger share of their income on those goods and services for which the highest price increases can be expected. Also, families with children will be more affected than single person households.
- Among employment groups, the unemployed and retired citizens are least affected.

Cash changeover might raise inflation perceptions, but not inflation expectations
[see slide 6]

- Although the overall actual price effect of the cash changeover was very small in most euro area countries, inflation perceptions increased notably after the changeover as there was a widespread feeling among the public that the euro had brought about significant price hikes.
- However, in most member countries the effect was perceived as temporary by citizens so that inflation expectations remained unaffected and second-round effects did not materialize.

Past exchange rate appreciation will help to damp inflation until mid-2009

- The conversion rate between the Slovak koruna and the euro has been fixed on 8 July and with euro adoption the exchange rate channel impact on inflation will gradually disappear. As the pass-through of past exchange rate changes into prices is operating with long lags, exchange rate changes prior to euro adoption, notably a nominal appreciation of about 20%, will still affect domestic inflation for some time going forward. This lagging effect could reduce consumer price inflation by 1½ percent over the period June 2008 to June 2009.

Inflation likely to be higher than in euro area over longer term, though to what extent is uncertain

- The strong real exchange rate appreciation of the Slovak koruna over the past years was at least partly backed by the development of economic fundamentals such as the strong rise in productivity in the open sectors driven by large FDI inflows. The real appreciation is likely to continue for some time going forward, although maybe to a lesser extent than in the past. Once in the euro area, any real appreciation, typical of a catch-up country, will be generated by an inflation rate that exceeds the average inflation rate in the remaining euro area countries.

EFFECTS ON INTEREST RATES

Short-term interest rates and government bond yields have already fully converged [see slide 7]

- On capital markets, the adoption of the euro will lead to an equalization of short-term interest rates and the elimination of the exchange rate risk premium in bond yields vis-à-vis the euro area.
- With one-month money market rates already at the euro area level and the exchange rate risk premium near zero, this adjustment already took place. The remaining government bond spread vis-à-vis Germany of around 50 basis points is in line with other euro area member countries of similar perceived creditworthiness and is thus likely to persist after euro adoption.

Retail interest rates remain noticeably higher than in the euro area... [see slide 8]

- However, retail interest rates in the Slovak Republic are significantly above euro area levels for **loans**. For example, a new mortgage loan with initial interest rate fixation between 1 and 5 years cost 6.15% in the Slovak Republic, but only 4.96% in the average euro area country. Differences are even more sizeable for household consumption loans with long interest rate fixation periods.
- In addition, interest rates that customers receive for **deposits** are lower in the Slovak Republic than in the euro area.

...and euro adoption should foster financial integration and interest rate convergence

- Experience from euro area countries suggests that the adoption of the euro fosters the convergence of interest rates. This is because of the effects of financial integration. Greater integration raises price transparency and lowers transaction costs, which should foster more cross-border activities and thus more competition in the national markets.
- Deeper financial integration following euro adoption is thus likely to lead to a convergence of Slovak retail interest rates towards lower euro area levels. This process may extend over several years, however. In case interest rates fully converge to euro area levels interest rates for a typical mortgage may be up to 1.5 percentage points lower.

Households will benefit more than non-financial companies, and borrowers more than depositors

- Among the population, borrowers will benefit more from the retail interest rate convergence (through a downward adjustment to euro area levels) than depositors (through an upward adjustment of deposit rates to euro area levels) and households benefit more than non-financial companies.
- Most of the benefits of retail interest rate convergence will accrue to the population in the Bratislava region, as most of the loans and deposits are located in this area. Lower mortgage loan interest rates are also likely to support the development of house prices, although the speed and extent of the impact is surrounded by considerable uncertainty.

POLICY RECOMMENDATIONS

In the short term efforts are needed to reduce the impact of the cash changeover price increase

- Emphasize in public information campaigns and negotiations with retailers that euro adoption does not automatically mean rounding up prices.
- Change publicly determined prices and fees strictly according to the conversion rate.
- Consumer protection organizations should consider putting together representative samples of consumer baskets and maintain a “beauty contest” for retail chains, which is publicly accessible.
- Programmes to compensate for the price level effects of euro adoption should be limited to low income groups, especially families with children. General transfer increases would only stimulate price increases and should be avoided.
- Remove remaining administrative obstacles to increasing supply; arguments in favour of regulation, referring to health and safety concerns, should be carefully examined to avoid that such concerns are misused as entry barriers which protect insiders.
- Encourage social partners to exclude changeover costs (such as menu costs) from wage and price negotiations in the current and next rounds.

In the medium term it will be important to limit inflationary pressures and a boom-bust cycle

- A competition friendly regulatory environment, which keeps entry barriers low and avoids administrative overheads and red tape, is a powerful ally for the changeover campaign. Although regulatory changes need time to exercise an impact it is now the time to use this opportunity. Network industries are one key area for reform.
- The government should investigate, in co-operation with the central bank and financial market supervisors, how far barriers to the establishment of a more competition friendly market structure in financial services exist.

- Limit the risk of a boom-bust cycle associated with higher inflation (Balassa-Samuelson effect):
 - Increase measures to increase the scope for competition in domestic services sectors in order to close the gap of productivity growth with the (international competition exposed) export manufacturing sector. Such a measure would reduce the Balassa-Samuelson effect directly.
 - Introduce measures to reduce the attractiveness of loan-financed asset bubbles, in particular a capital gains tax. Such a measure would reduce the attraction of investing in a bubble market.
 - Maintain a prudent fiscal stance and avoid, in particular, expanding general transfer programs.
 - The government should continue to improve the incentives to work as well as to search for work and to participate in lifelong learning in order to be employable longer. Such measures would increase the overall supply of labour and avoid a premature overheating of the labour market.
 - Establish a regulatory environment which allows the development of a rental housing market. This would reduce the need to enter the housing market as a buyer in order to satisfy a housing need.

SUMMARY [*see last slide*]

- Euro changeover effects are likely to be small in aggregate; consumer prices might rise by 0.3%, but are likely to be concentrated in certain service sectors
- Higher income households and families will be more affected, unemployed and retired persons less affected (based on their consumption bundle)
- Large convergence potential exists for retail interest rates, where over the medium-term a convergence towards the lower euro area levels can be expected
- Convergence potential is largest for consumption and mortgage loans
- Longer-term structural challenges associated with euro adoption will be addressed in the next *Economic Survey* (likely publication in the early months of 2009)



The impact of euro adoption on inflation and interest rates in the Slovak Republic

Andrew Dean, OECD

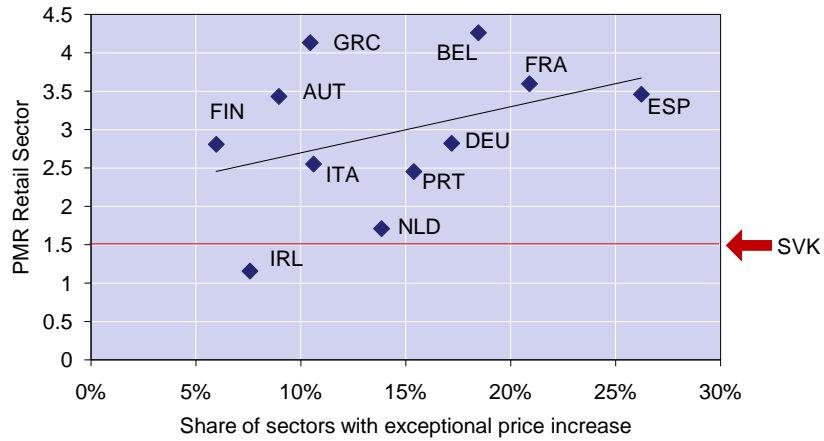
Bratislava, 17 July, 2008

Significant changeover related price hikes will most likely take place in service sectors.

Sector	Number of countries with significant changeover effect	Average size of changeover effect (in %)
Cleaning, repair & hire of clothing	9	3.0
Hairdressing salons & personal grooming establishments	9	2.4
Newspapers & periodicals	8	5.1
Recreational & sporting services	8	5.4
Domestic & household services	6	4.8
Restaurants, cafés & the like	6	2.0

The HICP weights of the sectors imply a changeover-related increase in the aggregate euro area HICP of 0.3%. The calculations for the Slovak Republic point to a similar changeover effect.

Price hikes were more prevalent in countries with low product market competition.



The positive relationship between PMR and the changeover effect is confirmed in a formal regression analysis.

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Households with children are likely to incur higher costs due to the changeover.

	Price level effect (in %)	Financial impact per household (in €)
By household type		
Single person	0.14	5.1
Single parent with dependent children	0.19	10.8
Two adults	0.16	10.3
Two adults with dependent children	0.25	20.9
Three or more adults	0.23	22.0
Three or more adults with dependent children	0.20	20.0

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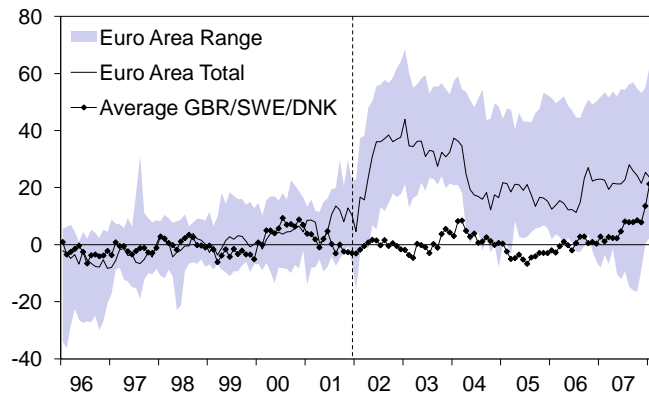
The unemployed and the retired are likely to experience smaller losses in purchasing power.

	Price level effect (in %)	Financial impact per household (in €)
By socioeconomic category of reference person		
Manual workers	0.20	16.1
Non-manual workers	0.26	24.2
Self-employed	0.26	25.0
Unemployed	0.09	4.1
Retired	0.10	4.5

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Although changeover effects were small, inflation perceptions increased markedly.



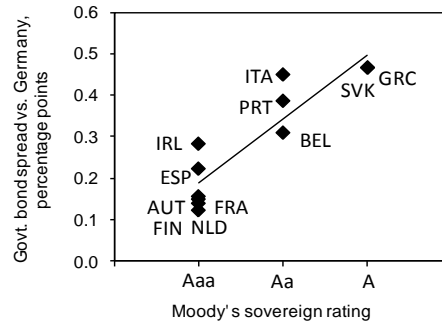
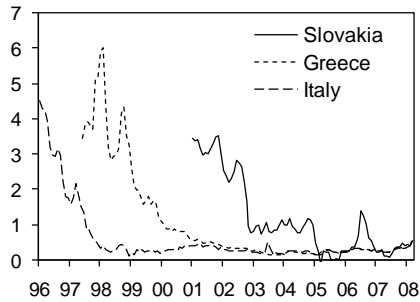
Note: The graph shows the perception gap, defined as the difference between perceived inflation and actual inflation (i.e., a positive value of the gap means that citizens felt that inflation was higher than it actually was).

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Long-term interest rate differential vis-à-vis Germany has diminished.

10yr gov't bond spreads vis-a-vis Germany



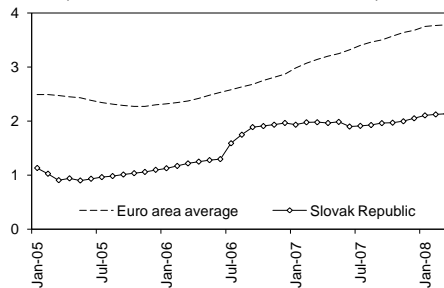
Measures of default risk suggest that the current interest rate differential vis-à-vis Germany will persist after euro adoption.

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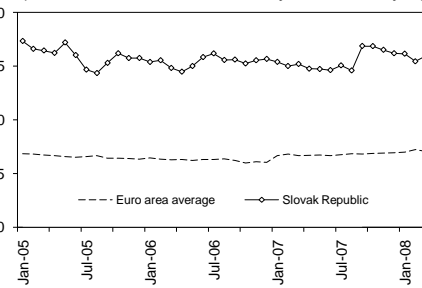


Retail interest rates with a large convergence potential.

Interest rate on deposits
(redeemable at notice > 3months)



Interest rate on consumption loans
(interest rate fixation over 1yrs/below 5 yrs)



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Summary

- Changeover effects on aggregate consumer prices likely to be small (0.3 percent); concentrated on services sectors.
- Higher income households and families more affected, unemployed and retired less affected.
- Large convergence potential for retail interest rates, in particular consumption and mortgage loans.
- Forthcoming *Economic Survey* will address longer-term structural challenges associated with euro adoption.