Flash Comment

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Slovakia: FX revaluation could hurt competitiveness

The European Commission last night released a statement that the ministers of the 15 euro zone countries, plus officials from Denmark, the Baltic states and the European Central Bank (ECB), have approved a 15% revaluation of the koruna's central parity within the ERM-II – see the statement *here*. The action happened on request from the Slovak government.

The central parity for EUR/SKK is now 30.126, down from 35.442, and this is the second time within a year that it has been adjusted to a lower level – see *Flash Comment - Slovakia: Surprise revaluation of SKK parity*, 19 March, 2007. The decision has been taken just two weeks after the commission confirmed Slovakia's bid to become the 16th member of the Euro currency area as of January 2009 – see *Flash Comment - Slovakia: Euro adoption accepted, but...*, 7 May, 2008.

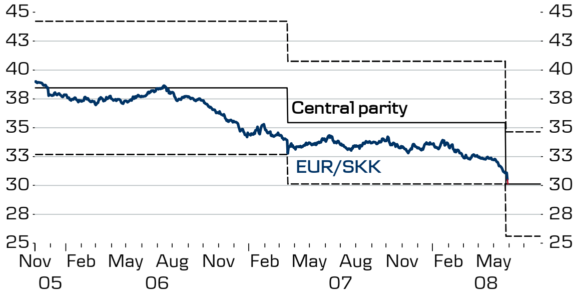
In recent months, the currency appreciation has accelerated as the Slovak PM, Mr Fico, recently said that the conversion rate should be as strong as possible, thus fuelling speculation in the currency markets. Since the New Year, SKK has appreciated by more than 10% and more than 23% since Slovakia entered the ERM-II in November 2005. Today, EUR/SKK moved to roughly 30.20-30 after trading around 31 yesterday afternoon. Even though the European Commission says that the currency appreciation reflects strong productivity growth in Slovakia, which we do not disagree on, the latest strengthening does not reflect improved fundamentals, but is purely driven by speculation in the markets.

Going forward we expect the conversion rate to be set around the new parity – EUR/SKK 30.126 – and perhaps even a little stronger, when the EU finance ministers in July endorse euro zone entry as of January 2009. Such a strong conversion rate fuels pressure for a significant tightening of fiscal policies going into 2009-10. If the ECB keeps its key rate unchanged at 4.0% during 2008, the Slovak central bank will have to lower its key rate by 25bp before New Year, and thus bring monetary easing in an economy, which grows briskly and where inflationary pressures are clearly rising. Hence the need for fiscal tightening and structural reform will become more evident in the coming years. Otherwise inflation will rise rapidly, which, in combination with a strong conversion rate, will seriously erode Slovakian competitiveness, despite strong productivity growth rates.

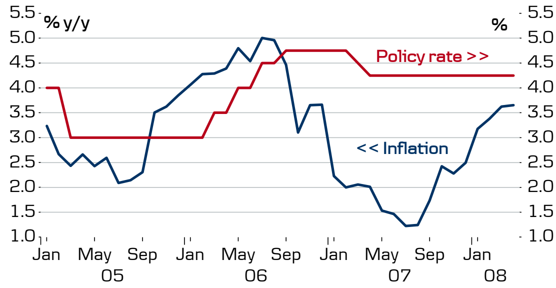
The revaluation has had positive spill-over effects to the other CEE countries, which strengthened against EUR today. Despite the positive sentiment in the CEE currency we do not see much upside for these currencies going into H2 08. The Slovakian PM, Mr Fico, will host a press conference today at 12.45 CEST on the change of the central parity rate.

See charts overleaf

Another revaluation



A less benign inflation outlook



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