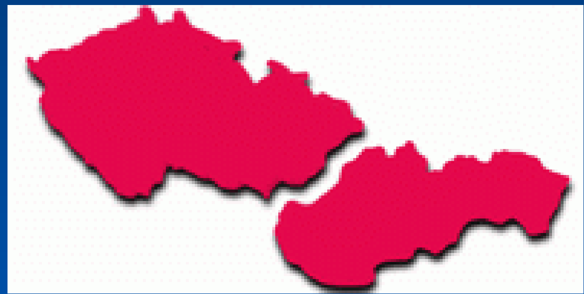
From Velvet Revolution to Velvet Dissolution: Monetary Aspects



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Selected indicators of the Czech and Slovak economies

	1948	1960	1970	1980	1989
National income (per capita)	0.61	0.74	0.79	0.85	0.88
Personal consumption (per capita)	0.81	0.82	0.86	0.91	0.91
Medical practitioners (per 1000 inh.)	0.57	0.83	0.91	1.01	0.93
University graduates (per 1000 inh.)	0.58	0.84	0.96	1.10	1.16
Capital-labour ratio	0.58	0.79	0.85	0.93	0.95

Note: Czech Lands = 100
Source: Dedek at al.: The Break-up of Czechoslovakia (Avebury 1996)

Act on the Czechoslovak State Bank

- Preparations started before 1989 by Communist government (many aspects still under the sway of the communist ideology)
- Termination of the monobank system (institutional separation of the central bank activities from the commercial banking sector)
- After 1989 the Act was adapted to market oriented framework (legislative foundations for a modern central banking system in Czechoslovakia)
  - Stability of the Czechoslovak currency as primary objective
  - Wide powers in the field of monetary policy, issuance of banknotes and coins, banking supervision
  - Substantial independence from the government

Dispute over the central bank arrangement

- Slovak view: inspiration by the US FED
  - Reserve banks enjoying independent legal status plus federal coordinating body
  - Implication: Existence of the Czechoslovak central bank as well as two republic reserve banks
  - Rights and responsibilities of these three banks would have to be determined by law
  - Demands: transfer of powers vis-à-vis foreign financial institutions, discretion in implementing centrally made decisions, financial autonomy
- Czech view: inspiration by the German Bundesbank
  - Existence of a single central bank internally structured on the regional prerequisites
  - Smooth implementation (existence of the Central Office for the Slovak Republic)
  - Concerns about the „CzechFed“: weak central body and subordination to powerful republic reserve banks

Historical events

- German model adopted: one central decision making body and two republic headquarters with wide executive powers
- June 1992 general elections: Slovak winning party with strong nationalistic programme and diverging view on further steps in economic transition
- Draft of the Slovak Constitution (§66): „The state establishes a reserve bank. Details will be determined by law.“
- Czech reading
  - Serious interference with the current legal system
  - Rejected idea of CzechFed put forward as an ultimatum
  - Weak federal body might jeopardize uniform anti-inflationary monetary policy
  - In case of a collapse of Federation the CR could continue to exist as an independent state

Division of SBCS balance sheet

- General methods of division of property
  - Territorial principle: property would be transferred to the successor state on whose territory it was located
  - Population ratio: property was transferred to the successor states in the ration of two to one
  - Reasonable adaptation of the principles were not precluded in individual cases
- Division of SBCS balance sheet (19 partial protocols)
  - Gold: 2:1 principle, compromise about the 7.5 tons of „Slovak gold treasure"
  - IMF assets and liabilities: special treatment 2.29 : 1
  - Territorial principle: loans and credits, currency in circulation
- Final disagreement (settled 10 years later !)
  - Aggregation of all protocols resulted in CNB claim about 22 bil. CZK (approx. 0.8 bil. USD); any cash transfer unacceptable for NBS
  - CNB decided to detain Slovak gold stored on the Czech territory

Common concerns

- Immediate currency separation would exacerbate the economic hardship of the split
- Switch to payments in convertible currencies would damage excessively existing economic and monetary relations
- Fixed exchange rate played the pivotal role in the design of economic transformation
- High status of Czechoslovak koruna will not to be automatically inherited by the succeeding currencies
- Intensive process of searching a workable solution

Monetary Agreement

- Concluded in October 1992 (among the thirty or so agreements negotiated before the split)
- No intention to establish a permanent monetary union (temporary arrangement envisaging the later introduction of two separate currencies)
- Monetary Committee highest authority endowed with decision-making powers to conduct monetary policy (parity representation of republic central banks)
- Fundamental inconsistency: coordination of economic policies at a time of strong divergent tendencies
- Expected duration of the Czech-Slovak monetary union
  - Official view: more than half of the year
  - Expert view: less than half of the year
  - Real life: 38 days (from January 1 to February 8)

Articles of Termination

- Failure of the Monetary Committee to agree on basic monetary issues
- Failure to keep the budget of one of the parties below 10 % (in terms of budget revenues)
- Failure to keep the external reserves of one of the parties above the monthly volume of imports
- Speculative capital flight from one country to another higher than 5 % of total bank deposits

Run on external reserves

Central bank purchases (-) and sales on the forex market (billions CSK/CZK)

	1992				1993				
Month	9	10	11	12	1	2	3	4	5
Balance	2.7	-2.8	3.6	8.8	17.1	-3.3	-6.8	-10.5	-13.5

- Some facts
  - On 22 December 1992 due to heavy speculation SBCS suspended trading for a while
  - In January 1993 NBS lost 60 % of its foreign exchange reserves and later introduced some current account controls
  - In January 1993 foreign banks terminated trades and ceased quoting bid-ask spreads
- Reasons
  - Uncertainty about consequences of the currency split
  - One way bet on devaluation of the Slovak currency (approx. 20 % overvaluation)
- Speculative transfers of deposits from SR to CR did not occur (they rose in both republics)

Currency separation

❖ Preparatory phase

- Commenced secretly one month after June 1992 Parliamentary elections
- Currency separation scenario never became a formal document
- Objective: establishing sufficient technical, logistical and legal prerequisites for currency separation if it becomes necessary

❖ Major technical issues

- True division of currency in circulation between the Czech and Slovak economies (2 : 1 ratio was completely hypothetical)
- Volume of Czechoslovak currency held by foreigners abroad
- Unclear duration of monetary union (preparations had to be accelerated till the end of 1992)
- Methods of differentiating the currency: i) Czech themes versus Slovak themes on banknotes; ii) temporary banknotes; iii) engraving stamps on banknotes; iv) stamping banknotes by special machines; v) gluing the stamps on banknotes

Differentiation of banknotes

- Coins and small banknotes (10, 20, 50 CSK) were not differentiated upon the separation
- A new release of 200 CZK banknote
  - Speculation of making the separation easier in the CR
  - Withdrawal of the old one featuring infamous communist leader Gottwald)
- Stamping
  - Engraving stamps on a portion of the 1000 banknotes
  - Gluing adhesive stamps on high denominations (100, 500, 1000 CSK)
  - Stamping was performed by more than 10000 people (during weekends in Jan and Feb in Komercni banka and in the CNB headquarters)
- Central bank receipts (2000, 5000 CZK)
  - Emergency money stock in case of occasional cash shortages in business transactions

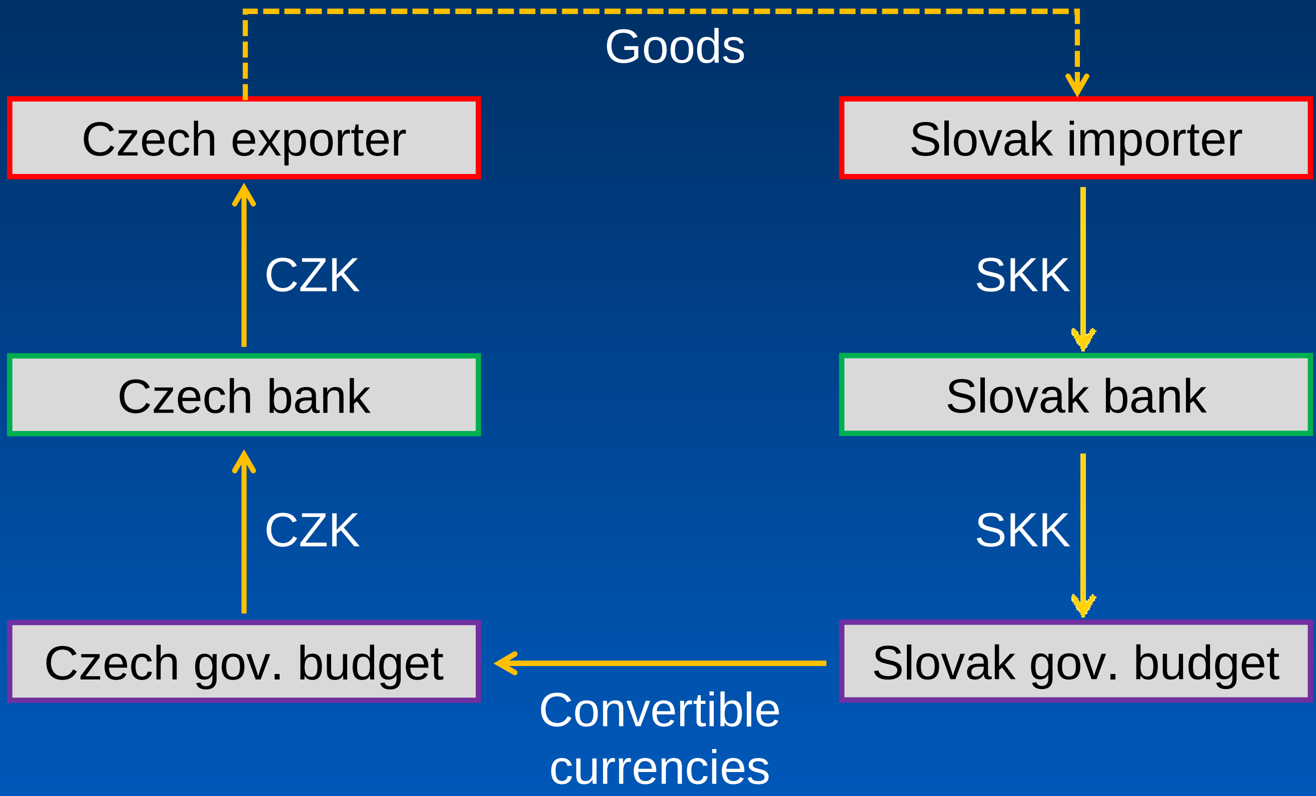
Some other technical measures

- Maximum personal limit for direct exchanges
  - 4000 CSK per person over 15 years and 1000 CSK under 15 years of age
  - Citizens encouraged to use banks‘ deposit instruments or send money orders to their own address
  - Foreigners allowed to exchange up to a proof of official purchase of Czechoslovak currency
  - Ex post exchanges allowed until 9 august 1993
- Four days for the execution of exchanges
- No dual circulation of old and new banknotes during exchange days
- Immediate suspension of all payments across CR-SR borders (between 3 and 7 February)
- All licenced exchanges required to stop selling foreign currency for private trips (until 8 Feb)

Clearing payment system

- Key issue: payment arrangement between CR and SR after the break-up
  - High integration and interdependence of successor Republics after a long-term coexistence
  - Negative experience from the collapse of trade among the former Soviet bloc countries
  - Backlog of assets and liabilities denominated in the Federal currency (who should bear the exchange rate losses in case of other than one to one ratio among successor currencies?)
  - Fixed exchange rate served as an anchor of the transformation process
  - Insufficient level of the external reserves (not high enough to meet the needs of business)
- Payment Agreement
  - Concluded on 4 February 1993
  - Framework for all Czech-Slovak financial transactions

CPS - motivation



Arrangement allowed participants in the Czech-Slovak mutual trade to make payments in their domestic currency, hard currencies were used only to settle payment imbalances

CPS – technical details

❖ Old block

- Used for settling claims and obligations from before the currency separation
- National monetary amounts converted into „clearing koruna“ (XCS) at the fixed exchange: 1 XCS=1CZK=1SKK
- Clearing balance settled every three months by payment in convertible currency, later by automatic transfer to the new block at the end of each month
- A 3 % interest rate charged for the outstanding balance

❖ New block

- Used to settle claims and obligations originated after the currency separation
- National monetary amounts converted into „clearing ECU“ (XCU) at the actual exchange rate vis-à-vis ECU (quoted by CB)
- Both central banks could independently adjust the rate vis-à-vis clearing ECU within the 5 % band
- A 5 % interest rate charged for the outstanding balance
- Permanent marginal credit of 130 mil ECU, excess amounts settled in convertible currencies (subject to penalty rate 15 %)

CPS – evaluation

❖ Performance

- Functioning without any major frictions, important factor in supporting Czech-Slovak trade after the currency separation
- Both central banks reacted to imbalances with realignments of clearing rates (some tensions due to the Slovak 10 % devaluation in June 1993)
- Overdrafts of the marginal credits were settled in due time

❖ Clearing speculation

- Duality of exchange rates between the two blocks opened up a wide area for speculation (i.e. Slovak importer makes a payment via the old block at 1:1 rate which is returned via the new block at 1.1:1 rate)
- Nonexistence of monitoring mechanism due to temporary nature of CPS

❖ Termination

- Different speeds of the Czech and Slovak transition towards the full convertibility („termination versus modification“ dispute)
- Unilateral decision of the CR to terminate the Payment Agreement as of 30 September 1995

Some lessons

- ❖ Unsustainability of temporary arrangements
- ❖ Determinants of orderly CR-SR currency split
  - ➢ Embryonic stage of financial markets (current account convertibility, heavy capital controls)
  - ➢ Keeping early preparations successfully secret
  - ➢ Political will to get over unforeseen hurdles that might easily block the process (Slovak gold, division of CB balance sheet)
  - ➢ Huge but still manageable amounts of banknotes subject to differentiation
- ❖ Negative impact on mutual trade
  - ➢ A sharp decline in Czech-Slovak trade already in 1992 (8.3 % exports to SR, 16.9 % imports from SR)
  - ➢ In 1993 Czech exports to SR fell by 25 % (last versus first quarter of 1993), much harder impact on the SR
  - ➢ Decline can be also partly attributed to inefficient forms of cooperation spurred by previous planning mentality „production for production“

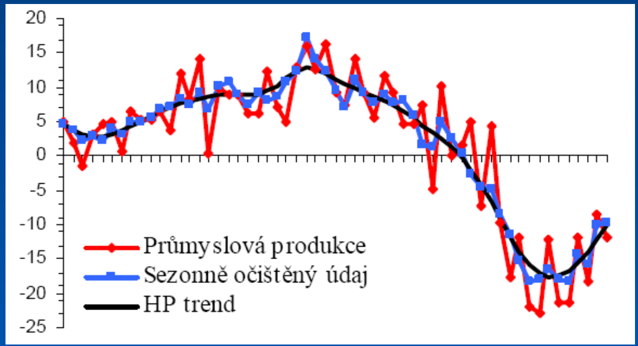
Timing of euro adoption in CR

- Eurostrategy (October 2003): anticipated accession 2009-2010
  - Institutional support (national coordinator, national coordination group)
  - April 2007: National plan for euro adoption approved
  - Yearly Progress reports submitted to the government
- Updated Eurostrategy (August 2007)
  - *… it would be unrealistic to plan on introducing the euro by 2010 and even to set any alternative target date …*
- Second Progress Report (March 2009)
  - *… there are a number of activities related to the future changeover to the euro in the Czech Republic that can be carry out in advance without knowing a binding term for the Czech economy joining the Eurozone...*“
- July 2010: new Czech government decides not to fix the date for euro adoption
  - *… coalition parties are prepared to initiate the adoption under assumptions that the single currency will be developing as a sustainable project and the compliance with agreed rules will be ensured by the Eurozone countries ...*

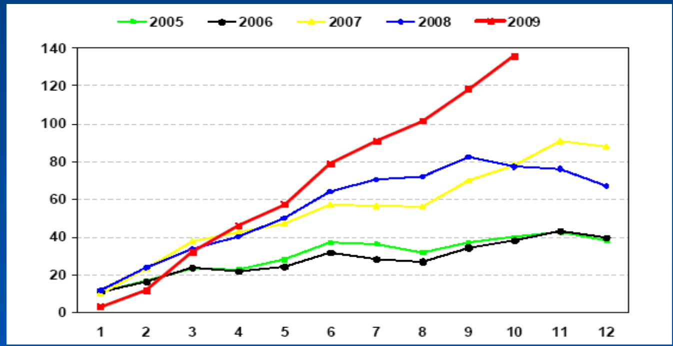
Performance in economic recession

- Decline in GDP
  - 2009. -4.1 %
  - 2006: 6.8 %, 2007: 6,1 %, 2008: 2,5 %

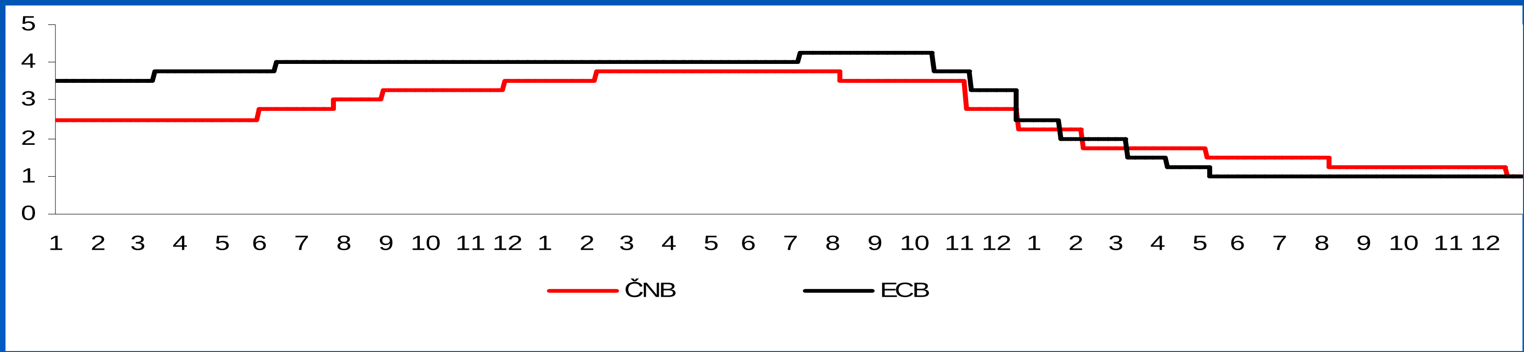
Industrial production



Trade balance



Monetary policy interest rates



Some current developments

- ❖ Declining general support for euro adoption
  - ➢ STEM (October 2010): only 30 % of respondents in favour of euro adoption while 70 % against
  - ➢ Insolvency problems of some Eurozone countries
- ❖ December 2010: Government adopted the document *Evaluation of Maastricht convergence criteria*
  - ➢ Czech Republic will not apply for the ERM II membership in 2011
  - ➢ Main efforts devoted to consolidation of public finances
  - ➢ Wait and see strategy regarding initiatives in strengthening Eurozone governance