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# BRIEF HISTORY OF CURRENCY SEPARATION – CASE STUDY OF CZECH AND SLOVAK KORUNA

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## Abstract:

This paper aims at describing the process of currency separation of Czech and Slovak koruna and its economic and political background, highlights some of its unique features which ensured smooth currency separation, avoided speculation and enabled preservation of the policy of a stable exchange rate and increased confidence in the new monetary systems. This currency separation was higly appreciated and its scenario and legislative background were reccommended by the IMF for use in other countries. The paper aims also to draw conclusions on performance of selected macroeconomic variables of the two successor countries with impact on monetary policy and exchange rates of successor currencies.

## Keywords:

currency separation, exchange rate, monetary policy, economic performance, inflation, payment system, central bank

**JEL Classification:** E44, E50, E52

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## 1. Introduction

Last decade of 20th century was an important period either from political either from economic aspects. Developed market economies mainly in Western Europe and Northern America were on the margin of recession, and in most centrally planned economies the political regimes were collapsing, starting a period of crucial political changes, which resulted, in some cases, into separation of multinational federations and birth of new states. Along with these political changes majority of centrally planned economies addopted, at a faster or slower rate, market based economic structures.

Many studies have been published on the process of market structures adoption in post-communist economies including the former Czechoslovakia. The so called „fathers of transformation“ were the most impartnt authors: Klaus (2015), Ježek (2006), Tříska (2002) and other authors as Holman (2000), Dědek (1996), Kočenda (2000), Jonáš (1997), Dvořák (2009). This paper is focused on the case of former Czechoslovakia, splitted, in early transformation era, into two new states – Czech Republic and Slovak Republic. An inherent consequence of this split, like in all newly born economies, was the federal currency separation. As the process of separation in Czechoslovakia was unique and numerous countries used this scenario and legislative background when performing their currency separations in the later years, this paper is aimed to describe the process of monetary separation in Czechoslovakia and highlight its crutial stages. The paper aims also the draw conclusions on economic performance of the two successor countries with impact on monetary policy and exchange rates of successor currencies.

## 2. Political and economic background of the break-up of the Czechoslovak Fedetation

International political situtation in the early 1990s after the break-up of the bipolar system stressed the right of every nation for self-determination including independence. Origin of the czech and slovak koruna was a logical consequence of separation of the two nationas after the fall of teh Iron Curtain. After regaining indepencence also other post communist states issued their own currency as an expression of sovereingty. Fortunatelly in the case of Czechoslovakia the „divorce“ of the two Nations was not so dramatic as for example in the case of Jugoslavia, where long lasting fights had frozen economic development for many years.

In Czechoslovakia, shortly after the so called „Velvet revolution“ in November 1989, pressures of the Slovak political representation aimed at a shift of legislative and executive powers to the level of national Republics. Main controversies between Czech and Slovak leading political parties arised about constitutional set-up and scope and speed of economic reform**.** In the Czech Republic a radical transformation to market economy after 40 years of economic stagnation under centrally planned economic structure acquired wide spontaneous support. On the other hand, the Slovak economy, had been experiencing an economic miracle and under central planning system became an industrialized economy. From the beginning, dissaproval with the policy of state intervention was less pronounced. The transformation process was often accused of insensivity vis-a-vis the specific needs of Slovakia.

The Czech and Slovak economies coexisted under one federation, exept from a short period during WWII, for over 70 years. The economies had, quite intuitively, many common trends in macroeconomic performance. Compared to the other post-communist countries the starting conditions of the Czechoslovak economy were favourable (very low foreign debt, relatively high households consumption, sound government budgets and reasonable inflation rate).

However, some crutial dissimilarities can be observed between the two parts of the Federation. The list of so called Slovak specifics compared with the Czech economy usually include (Čapek et al., 1992):

- higher dependency on imports
- orientaion of most exports to the former command economies market and USSR
- higher share of the armament industry
- higher concentration of production facilities manufacturing semi-finished goods
- lower efficiency of the Slovak economy vis-a-vis the Czech one

Under these arguments the Slovak politicians and economists emphasised the need of applying the country specifics in the conception of the economic reform, disagreed with the concept and progress of radical („cold turkey“) economic reform so called „Czech way“ and asked for a socially oriented market economy and implementation of more expansive economic policies. Impossibility of consensus on character of economic policy confirmed after elections in summer 1992 and in a very short time it was decided that the federation would be split on Dec 31 1992.

At this point, the question about the monetary separation was not „if“, but rather „when“. The two national currencies came into de iure existence at the moment of separation of the two states, that is on January 1st 1993. The proper monetary separation came into effect on Feb 8th 1993 when the czech and slovak koruna were separated de facto in exchange rate 1CSK=1CZK=1SKK. During this very short monetary union the former common currency (czechoslovak koruna) was in use in both newly created authonomus states.

## 3. Currency separation

Before the monetary separation the Czechoslovak koruna was, as all command economies ´s currencies, not freely convertible. Exchange rates differed depending on the scope of transaction (export/import rate, non business rate, incoming turist rate, resident tourist rate, etc.) The central bank and political authorities supervised very strictly the purpose of exchange. Differencials in various rates brought into live black money market. Some individuals made fortune by trading foreing convertible currencies with local residents.

Favorable conditions for black market existence dissapeared shortly after introduction of a single/market rate of CSK in 1990. This market rate was based on the US dollar and devaluated the Czechoslovak koruna in total by 80% compared to the official „communist“ rate. This so far unprecedented devaluation of CSK seemed to be very painfull for residents, however it meant the first step towards full and free convertibility.

By 1992 a currency basked was established (USD 49%, DEM 36%, ATS 8%, FRF 3% a CHF 4%) and fixed rate monetary policy was implemented (band +-0,5%) until 1996. Transformation of the Czechoslovak economy brought real risks of hidden inflation and devaluation caused inflation. The federal central bank voted for a very tight monetary policy in order to cope with these risks. Consequences of the tight monetary policy on transformation economic crisis in late 90´s were discussed by many authors, e.g. Bulíř (1993a, 1993b), Dvořák (2009), Fidrmuc et al. (1999), Knapík (2005), Kunert & Novotný (2008), Kysilka (1993), Prokop (1994), Surga (2012). Nevertheless this tight monetary policy led to some painful consequences, the inflation risk was averted.

The obvious intensions of Slovakia to create its own independent economic policy indicated that the successor states were likely to introduce separate currencies. After the break-up of the Federation, the question about the monetary separation was the timing. On January 1st 1993 the federation was de iure separated into two independent states – Czech and Slovak Republics, but both used the former federal/ common currency (CSK). For a short period the two states were in a monetary union. An achieved priority of the economic policy was to prevent the split of Federation from undermining monetary stability and confidence in domestic currency.

Both Republics wished to gain more time before currency separation as it was understood that a switch to payments in convertible currencies would induce a rapid decline in production. Process of searching for a workable monetary settlement resulted in Oct 1992 in a Monetary Agreement. It demanded a coordination of economic policies inconsistent with divergent tendencies of economic performance and political climate in the two Republics. A Monetary Commitee was established with executive powers to decide on common monetary policy. Either contracting party was allowed to withdraw from the Agreement under specified conditions concerning budget deficits, external reserves, speculative capital flow between the two economies and Monetary Commitee consensus.

In Slovakia, where the requirement of a coordinated application of economic transformation was increasingly understood as an enforced subordination of the Slovak economy to the Federal one, the benefits of a common monetary policy were being questioned and the Monetary Commitee was not succeeding in reaching consensus in monetary policy. Most economic agents started expecting the currency separation to take place soon and to be followed by an immediate devaluation of the Slovak Koruna (Kysilka, 2009). There were concerns that these expectations could cause speculative transfer of deposits from Slovak to Czech banks. Despite its only a 38 days duration, the single currency period provided time for ensuring the technical and logistical background of currency separation and preparing a framework of payments for transactions after the separation.

Preparation and implementation of the scenario of currency separation were very elaborate despite the fact that the preparatory works commenced in July 1992. Several methods were considered for differentiating the bankonotes (such as circulation of notes with Czech themes (20, 100 and 1000 denominations) in the CR and those with Slovak themes and text (10, 50 and 500) in Slovakia; gluing stamps on bankonotes; new banknotes emission or engraving stamps on banknotes). Preparations for currency separation coincided with the planned release of two new Czechoslovak banknotes (200 and 1000 denominations with Czech themes – the 200 note was intended to replace the 100 one featuring K. Gottwald and the 1000 had to be replaced for security reasons). Regardless the labouriosity, gluing stamps seemed to be the most reliable choice for marking the three highest denominations (100, 500 and some 1000 notes). A portion of the 1000 notes has been stamped by engraving and the new 200 note was released into circulation. The 10, 20 and 50 banknotes accounted for 3% of the total value of currency in circulation, but represented 45% of the volume of banknotes. For this reason these notes were not stamped. Coins represented another 3% of the total value of currency in circulation (Surga, 2012).

In order to avoid speculative transfers, strict conditions of exchange were established for households. The maximum amount a person was allowed to change directly at bank counters became one of the most sensitive issue. The sum of CSK 4000 per resident over 15 years of age and CSK 1000 per resident under 15 (applicable to both parents) was decided to be technically and logistically manageable maximum. Note on exchange was recorded in the ID. Citizens were encouraged to use banks´ deposit instruments or to send money orders to their own address to dispense with currency over the limit. As Dědek (1996) states, only 4 day time period was allowed for exchanges of the general public, ex post exchanges for serious reasons was possible till 9 August. Paraller circulation was opposed for two reasons – anticipated devaluation of the SK threatened to provoke speculation and, secondly, two types of valid notes might have created problems for business bookkeeping and the handling of banknotes in banks.

In order to keep the general public informed and, thus, avoid speculation, some complementary processes were implemented:

- right after the official announcment by Prime Ministers, the media introduced a wide information campain on main principles and technical background of money exchanges.

- both parties suspended payments accross the border

- sale of foreign currency for private trips was stopped

- a clearing payment system between the Czech and Slovak Republic was designed

A very detailed timetable helped the sucessfull course of currency separation. Day of validity of new currencies was established for 8th February 1993 (Day D). Prokop (1994) sumarizes detailed scenario of acts foregoing and following to day D.

D (Day) minus 7,6,5

- Distribution of banknotes to the institutions effecting the exchange

D minus 6 - TV presentation by the Prime Minister

- Providing the media with a complex set of information
- Launching on TV of an instruction programme on the new banknotes and the rules of exchange
- Termination of direct transfers over the CZ-SK border

D minus 5

- Launching of the information campaign in the media

D minus 4,3,2,1

- Exchanges for the public at the exchange points

D minus 1

- Termination of validity of the Czechoslovak banknotes on midnight of D-1

D

- Validity of new Czech and Slovak banknotes

D minus 1, D, D+1

- Exchange of banknotes for business

D, D+1

- Exchange of banknotes for foreigners at selected banks

D+180

- Deadline for exchanging currency over established limit

September 1994

- Deadline for release of the new (unstamped) Czech banknotes and coins

As mentioned above, due to a long-term coexistence in one state, the economies of both Republics were higly integrated. Introduction of the clearing payment system (4 Feb 1993) along with the Customs Union contributed substantially to minimize shock from currency separation for exporters and importers. The clearing system was organized in two blocks (Prokop, 1994 and Dědek, 1996):

- the old block used to settle claims and obligations from before the currency separation with accounting unit XCS1=CZK1=SK1. The balance was settled by payment in convertible currency
- The new block used to settle claims and obligations which originated after the currency separation with accounting unit clearing ECU.

Clearing was terminated in Sept 1995 under the following considerations:

- Different speed of the Czech and Slovak programmes towards the full converitbility
- Growing forex reserves of both Republics from the 3Q 1994
- Slovak clearing devaluation which discriminated Czech exporters

Last but not least, assets and liabilities of the Federal central bank had to be dealt. The question of fair division of balancesheet has been for long disputed, but represented represented only a part of the complicated division of federal property. The final solution was result of negotiations on a higher level. Three methods of division(two-to-one principle implemented also for division of other federal property, territorial principle (credits and deposits of commercial banks, immovable assets), or by special agreement (gold reserves and assets and liabilities against IMF)). The federal property division was naturally very complicated and it is not aim of this paper to elaborate more details.

From 25 years later perspective it can be stated that thanks to speed and success of the overall operation of monetary separation, economic activity was not disrupted.

# 4. Macroeconomic performance of successor economies

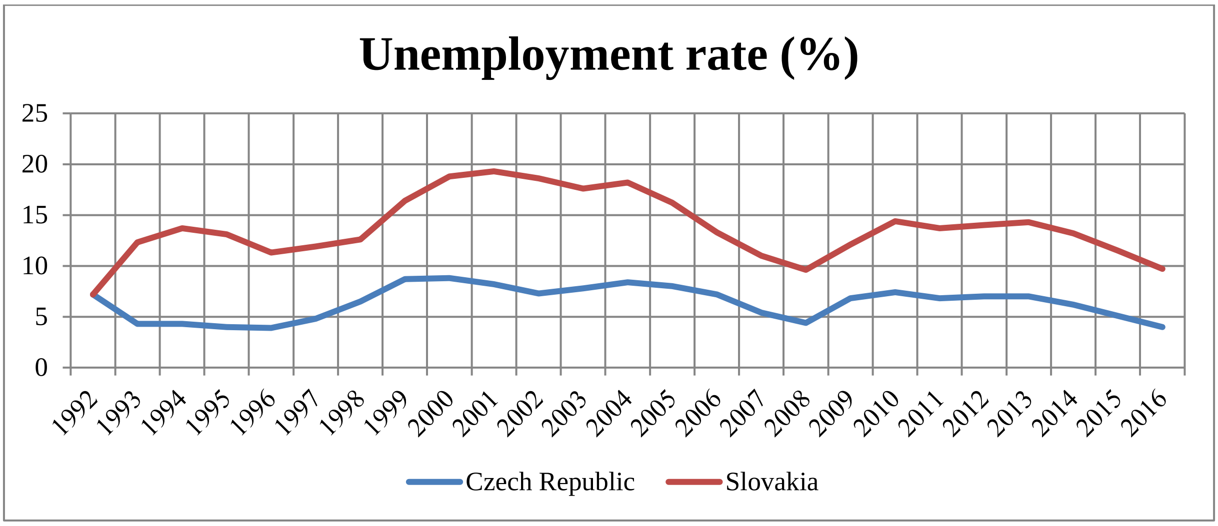
Major fears in the two economies consisted in consequences of interrupted internal trade relations and therefore narroving of the domestic market. In the Slovak case, the economy was also weakened by discounted redistributions and necessary investments into infrastructure. From longer term point of view, none of these fears maaterialized. The following chapter presents basic macroeconomic indicators which show how the economies coped well with the transformation process after the separation of the Federation.

## 4.1. Unemployment

The unemployment rate in the CR after the break-up of Czechoslovakia remained the lowest in CE. The SR, where the unemployment rate had been historically higher, assumed the very good third position. Unemployment in the Czech Republic was being at very low rates during 1990´s and 2000´s and indicated lower variation compared with Slovakia as well. The graph 1 shows annual averages of unemployment rates in the two economies. In 1992 data for Federal unemployment rate were available and in both parts of the Fedaration the unemployment was relatively low – not exceeding 8%. The transformation of the economy was at early stage and jobs created in the communist era were dissapearing only gradually. After the split of Federation, the unemployment rates started to differ more substantially. In the Czech Republic an important share of industry was oriented to be exported and was competitive on“west markets“ and the industry in Slovakia was weak with a big share of military production which collapsed totally during transformation. This development can be seen from the graph 1. The early stage of transformation in 1990´s was most painful for the Slovak part of ex-Czechslovak Federation. Not surprisingly, real wages grew significantly faster in the Czech Republic.

**Graph 1: Unemployment rate (%)**



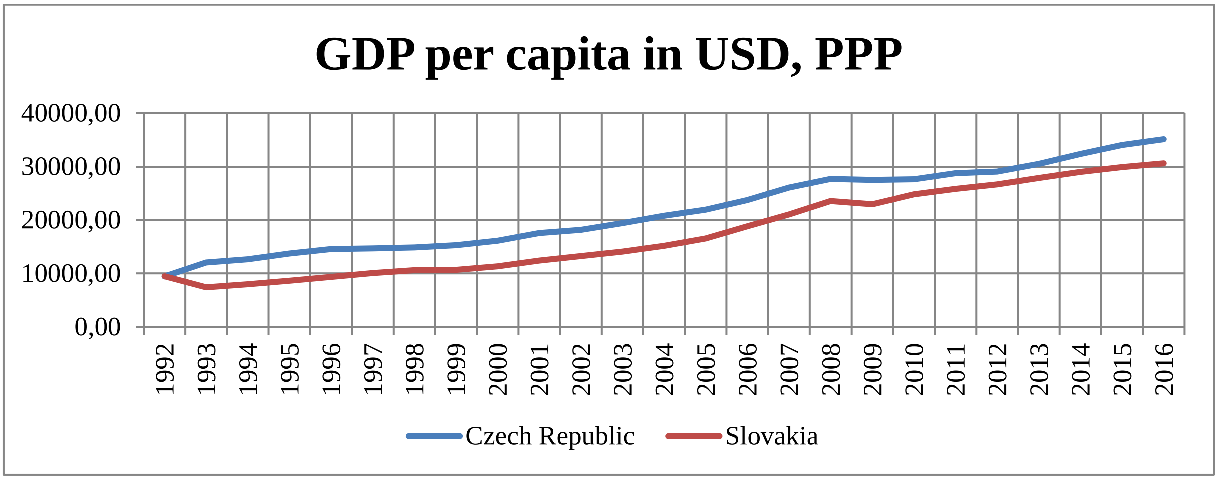

*Source: Švejnar and Terrell (1996), OECD (2017a)*

## 4.2. GDP

As all centrally planned economies, both Czech and Slovak Republics under Czechoslovak Federation faced slow growth caused by low productivity and low GDP per capita during communist era. Although transformation brought further temporary GDP decline, both economies started to grow continuously after the split of Federation. In 1993 Slovakia faced the worst relative decline in GDP (CR -0,9, SR-4,1), caused, as mentioned above, mainly by differences in the area of foreing trade and industry structure in both economies. The 1994 brought unexpectedly high growth in Slovakia driven by devaluation of the SKK (summer 1993) and by devaluation within the clearing system which increased exports to the CR by 12,5%. Exept from the period 1996-98 the two economies were facing similar trend of GDP growth and were converging to other EU economies. The two year gap in convergence in the Czech economy was caused by a bank and monetary crisis in the Czech Republic. The growth rate have been, wtih exeption of a short period during 1999-2000, slightly higher in Slovakia.

**Graph 2: GDP per capita in USD, PPP**



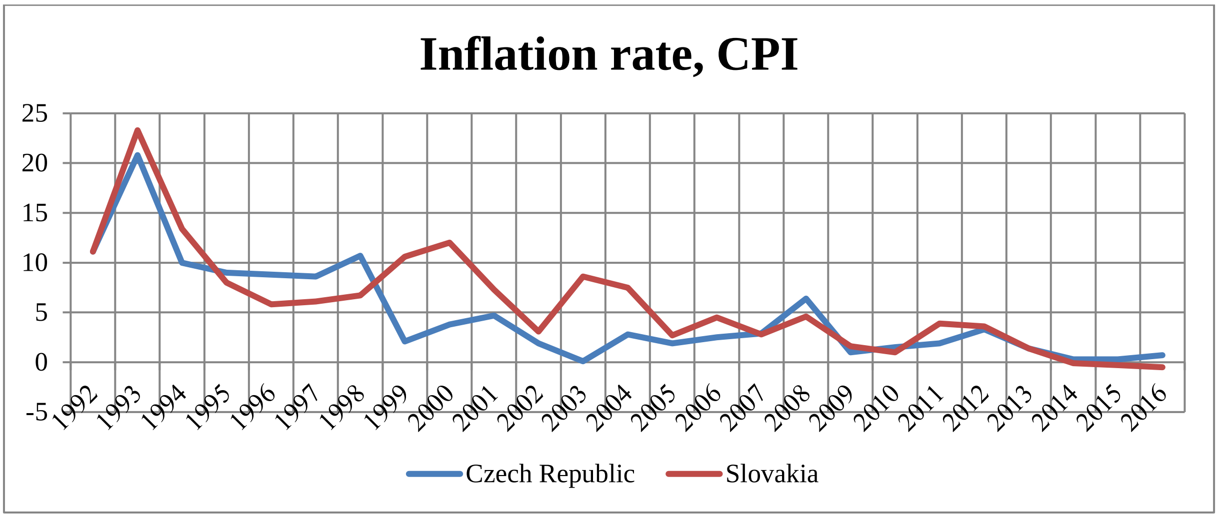

*Source: OECD (2017b)*

### 4.3. Monetary policy and inflation rate

The succeeding Republics strived to maintain both internal and external monetary stability and to minimize price increases. More restrictive policy of the NBS was partly due to Slovakia´s more difficult starting position and inflationary pressures associated with deficit financing. Strong inflow of foreign capital to the CR (interest rate differencial, privatisation revenues, FDI) stimulated demand for restrictive monetary policy by Czech National Bank.

As shown in graph 3, inflation rate before the split of the Federation was almost identical and remained so in 1993 and 94. Despit the was double digit (introduction of VAT and price leberalization), it was still lower than in other CE economies. Again, exept from short periods of fluctuation, the inflation is stabily lowering in both economies. The currency separation succeeded in being inflationary neutral which helped, undoubdtedly, the transformation process of both Czech and Slovak economies.

**Graph 3: Inflation rate, CPI**



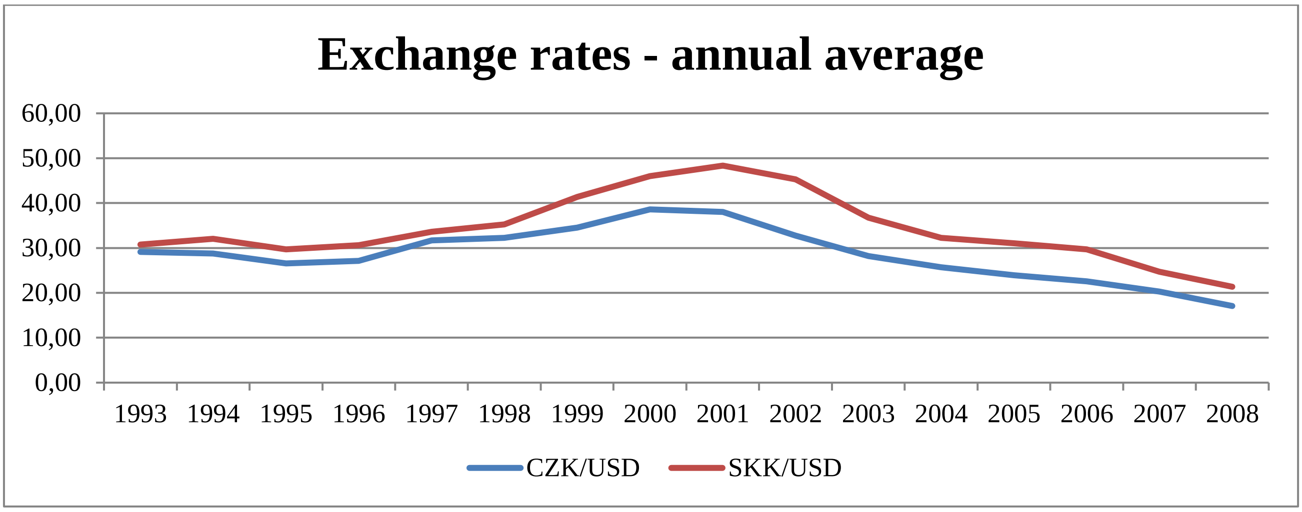

*Source: OECD (2017a)*

### 4.4. Exchange rate of Czech and Slovak Koruna

In the moment of Federation split, the exchange rate established 1CSK=1CZK=1SKK. Nevertheless all above mentioned actions against speculations, the market expected devaluation of SKK shortly after the currency separation. This was the case. Tourist exchange rate (determined by banks on bases of Supply x Demand principles) lowered in some banks already 2 days after the currency separation to the values around 0,85 CZK/SKK and differed between banks. Devaluation of SKK by 10% was efected in July 1993. Further development of exchange rates is shown by Graph 4. Since 2001 both currencies were steadily appreciating. In 2008 Slovakia adopted Euro.

The currency separation enabled preservation of the policy of a stable exchange rate and increased confidence in the new monetary systems. Short periods of depreciation were recuperated quite quicky. Despite high inflow of foreign capital in both successor economies, negative consequences in regards of inflation and exchange rate were avoided. Positive enviroment for Czech and Slovak banking sectors seems not to have been injured.

**Graph 4: Exchange rates – annual average**




*Source: The World Bank (2017)*

## 5. Conclusion

The Czech Koruna is very close to its 25th anniversary. Introducted in 1993, Czech and Slovak currency separation was a logical consequence of the split of Czechoslovak Federation. Both countries stood at the beginning of transformation from centrally planned to market structure and fears about further economic development were very spread. The split of federation and, above all, separation of the federal currency had to be performed very efficiently. This paper is focused first on the currency separation process itself and second on description of further economic performance of successor economies.

As data show, formation of national economies – Czech and Slovak Republics – was a favorable solution for a federation of two states with different fundaments. Both new economies succeeded in keeping stable and low inflation, grew steadily and converged to the EU economies. Czech, as well as Slovak Republic joined European Union and their entrance to EMU seemed to be only a question of timing. From longer point of view, both currencies were appreciating, gaining back the real undervauation from early transformation years, and last but not least coped well with strong spekulative pressures during the transformation era. Although both economies were fulfilling the Maastricht criteria, EURo adoption, as a political decision was effetuated in the Slovak Republic only (2008). The Czech decisionmakers voted for keeping own monetary policy. The economic crisis started in 2008 opened new questions about disparities within the EU and issues and limits of its further existence. Some serious fiscal disparities showed to be a break for growth of less developer countries within the EU. Traditional question about Euro adoption in the Czech Republic was postponed to an indefinite term (Singer 2012).

The Czechoslovak currency separation was higly appreciated by international authorities thanks to its perfect planning, communication and clearing system. Its effectivness minimalized the shock for both economies and enforced continuity of strong economic relations between the two new republics. The scenario and legislative background of the currency separation were reccommended by the IMF for use in Moldova, Turkmenistan, Uzbekistan and other countries.

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