From the Koruna to the Euro

Elena Kohútiková[1]

Slovakia is one of the few countries to have successfully introduced two currencies and two monetary policies in its economy in a relatively short period of time. This fact offers us an opportunity to compare (1) the period following the establishment of both an independent state and an independent currency with (2) the period when the national currency was changed and Slovakia joined the euro area.

1 The Slovak Koruna

The second half of 1992 was extremely dynamic and brought the decision to split Czechoslovakia into two independent states on January 1, 1993. One of the issues discussed at that time was the establishment of a new central bank in Slovakia that would assume all the responsibilities that a central bank must fulfill. However, it was also decided that – in the first few months following the setup of both the new states and the new central banks – the Czech Republic and Slovakia would each conduct their own economic policies while maintaining a common monetary policy. In other words, the decision was made to create a monetary union between the two new states and to use the Czechoslovak koruna as the common currency.

Initially, the monetary union was meant to exist for at least six months to allow both countries to prepare the launch of their own currencies and monetary policies. For the monetary union to work, the bank boards of both central banks transferred the responsibilities associated with monetary policy management to a Monetary Committee, in which both countries were each represented by three central bank delegates. After only a short period of time, however, it was clear that the monetary union was not feasible, mainly because of the different economic policies of the two states. The differing economic structures certainly played a role, and in addition, Slovakia had yet to establish all the institutions necessary for running the new state. Fiscal policy objectives likewise varied, and, eventually, the two states agreed to discontinue the monetary union and to introduce separate currencies on February 8, 1993.

That date marked the birth of the Slovak koruna and the day when the new Slovak central bank, Národná banka Slovenska (NBS), began to conduct an independent monetary policy. At first, the Slovak koruna was fixed to a five-currency basket and later to a basket consisting of two currencies – the Deutsche mark and the U.S. dollar – at a ratio approximating the shares of the two currencies in the current account. The new currency got off to an extremely difficult start. It was generally expected that the Slovak economy and the Slovak koruna would be a weaker link in the former federal republic. As a result, the new Slovak currency faced distrust by investors as well as Slovakia's businesses and the general population, particularly in its first five months. The subsequent 10% devaluation, which was supported by several administrative measures (e.g. the introduction of an import surcharge), by monetary policy and the NBS (both were increasingly gaining respect), successfully steered the Slovak koruna – after the first difficult year after its adoption – onto the standard route of a transition economy.

The restructuring of Slovakia's economy and financial sector, which got underway in 1999, as well as transparent privatization and changes in the legal, social and tax systems and also in the labor market environment made the economy

[1] *Member of the Management Board and Deputy Chief Executive Officer of VÚB Bank. Member of the Bank Board (1994–2006) and Deputy Governor (2000–2006) of Národná banka Slovenska.*

– which at first had been trusted by only a few – a leader among the countries changing from socialism to a market-oriented economic system. Public finance reform in particular received close attention in many European countries, and the tax reform project was followed by several European countries. The consolidation of public finances and the reduction of the fiscal deficit enabled the central bank to enhance the quality of banking regulation and to standardize the implementation of monetary policy. The NBS thus succeeded in harmonizing its monetary instruments with those used elsewhere in Europe.

Despite the fact that Slovakia had significantly lagged behind in some areas of integration (e.g. into NATO and the OECD), it successfully caught up with integration trends thanks to its economic transformation and in-depth economic reforms. In 2004, when it joined the European Union along with nine other countries, the country's geographical affiliation with Europe was complemented by economic affiliation. As the Treaty of Accession stipulated monetary integration for all the new Member States, the NBS and the government of Slovakia subsequently started contemplating when full monetary integration with the euro area could be achieved.

2 The Decision on Euro Adoption

As early as 2002, when the public finance reform – the most challenging and most crucial prerequisite for euro adoption – was implemented and when it was obvious that Slovakia would successfully complete the EU integration process along with the other countries, the NBS in cooperation with the Slovak Ministry of Finance initiated the preparation of the Strategy of Euro Adoption in Slovakia. The first part of the strategy comprised an analysis of the Slovak economy and its outlook, with an emphasis on the degree of economic integration and independent monetary policy implementation. This analysis showed that thanks to the restructuring of the economy and reforms Slovakia had come to attract large foreign direct investment (FDI) inflows, mainly into the real economy, which significantly increased the economy's openness to around 170% of GDP. As a result, the economy became very sensitive to exchange rate fluctuations. At the same time, the economy's openness limited the NBS's options to independently use its monetary instruments to interfere in real economic developments. According to the analysis, the euro would bring clear benefits for the economy and the Slovak population if the economic development triggered in the late 1990s continued.

The analysis and the draft Euro Adoption Strategy were discussed and approved in 2003 by both the NBS and the Slovak government and became the beacon for the introduction of the euro in Slovakia. Based on the 2003 analysis, 2008 and 2009 were indicated as potential years for euro adoption. In 2004, the NBS and the Slovak government discussed the revised Strategy of Euro Adoption in Slovakia and made an unequivocal decision: They designated January 1, 2009, as the date for introducing the euro, since adopting the euro in Slovakia at the envisaged time would have significantly more benefits than disadvantages for the economy and the population. They also approved the road map for the entire process and a detailed time schedule to ensure a seamless transition to the euro.

The Slovak government thus gave a very clear and historically important signal about the Slovak economy, both at home and abroad: Slovakia would continue to reform its economy and implement a reasonable economic and monetary policy to pave the way for the country's euro adoption. The Slovak parliament's confirmation of the adopted route to the euro is also considered a critical moment as it not only enhanced the credibility of the strategy but also was to shape the turn of events beyond the respective parliamentary term.

The Euro Adoption Strategy, whose key features and individual steps were finally defined in 2004, was fulfilled step by step both in terms of the economic (Maastricht) criteria and the legislative measures and alongside technical preparations for the euro changeover. In 2005, the National Euro Changeover Plan for the Slovak Republic was adopted. Slovakia's thorough fulfillment of the Euro Adoption Strategy and the National Euro Changeover Plan sent a clear signal about the country's determination to reach its goal. 2006 saw the establishment of the office of the Plenipotentiary of the Government of the Slovak Republic for the Introduction of the Euro, which was charged with coordinating the efforts of individual working groups and preparing an effective communications campaign aimed mainly at the Slovak population. The population was meant to see the euro as a step moving the country forward. The information campaign began in late 2005 with the design of the Slovak euro coins, which were selected in a public opinion poll. Based on these results, the Bank Board of the NBS chose three motifs that are currently used on Slovak euro coins.

3 Entry into ERM II

In line with the adopted Strategy, in 2005, Slovakia entered the European exchange rate mechanism (ERM II) and fixed the Slovak koruna exchange rate to the euro. Slovakia adopted a standard approach, which means that the central parity of the Slovak koruna to the euro was fixed at the market level, and opted for the standard fluctuation band of ±15% around the central parity.

Entry into ERM II was another crucial step on the way to the euro. Not only was it a very strong commitment to the national economy, but it also showed countries abroad that Slovakia was serious about its changeover to the euro. Participation in the exchange rate mechanism was a unique experience not only for Slovakia, but also for other countries that planned to introduce the euro, in particular countries with a flexible exchange rate regime. After all, Slovakia was the first of the new EU Member States to enter ERM II with a flexible exchange rate regime. The market responded with an immediate strengthening of the Slovak koruna, which confirmed the irrevocability of the journey toward the euro.

The Slovak koruna steadily strengthened, except for a short hesitation immediately after parliamentary elections in 2006. In March 2007, the central parity of the Slovak koruna was revalued for the first time. This revaluation will surely be of interest to analysts as well as countries aspiring to adopt the euro. The new central parity was not set at the market rate, but rather at the (lower) equilibrium rate. The market response was unexpected for many economists: The Slovak koruna significantly strengthened in a short period of time instead of returning to its "balanced level." The latter had been expected, not least due to the method of determining the new central rate, which the market considered to be different from that set by the authorities. In fact, the Slovak koruna exchange rate jumped by more than 3% in response to the change in the central rate. From late November 2005 (ERM II entry) until mid-March 2007, the Slovak koruna firmed by a total of 15% against the euro.

Slovakia's strengthening currency did, however, not hamper economic growth. Owing to the well-defined road map to the euro, combined with a rational economic policy and, in particular, the implementation of profound structural reforms, foreign capital inflows were booming, mainly in the form of greenfield investments,[2] and the economy started to flourish. This lent support to the market sentiment that the economy could handle an even stronger exchange rate.

Slovakia experienced record-breaking economic growth and its fiscal deficit fell along with unemployment, the latter having for many years been one of the biggest problems in Slovakia. The Slovak koruna, which started to strengthen gradually, was then affected by the anticipated decision regarding its final central rate. In May 2008, slightly more than one year after the first central rate revaluation, the second revaluation took place – and again the central rate was not set at the market level, but this time at the stronger end of the fluctuation band of ±15% around the previous central parity.

It was a great move forward from the last revaluation – by nearly 18%, and this level was soon understood by the market as a potential exchange rate level. The market exchange rate then only slightly strengthened toward this limit. In my opinion, this revaluation method will also be subject to analysis as to how it was determined and how markets responded. The conversion rate was not set on the standard day (Friday), but on Wednesday, which was a big surprise for the financial markets.

4 The Introduction of the Euro

In July 2008, the "economic" preparations for the introduction of the euro were completed by an official decision that Slovakia met the requirements for euro adoption with effect from January 1, 2009, and the conversion exchange rate was set, as expected, at the central rate determined in late May. It needs to be clearly said that, prior to the second revaluation, hardly any analyst or economist had expected such a strong conversion rate. The exchange rate, which was set by using a "forward-looking approach," reflected the anticipated development of the Slovak economy over the period of one to two years.

Following that date, all businesses in the Slovak economy significantly stepped up their preparations for the introduction of the euro, and today we can state, without any doubts, that the euro was introduced in Slovakia without any difficulties. Besides the completion of the preparations by Slovak businesses and the broad-based communications campaign, two issues resonated in Slovakia just before the changeover to the euro.

The first issue was the frontloading of euro banknotes and coins, which was an extremely complex process in terms of logistics and organization but was carried out seamlessly due to excellent cooperation among the NBS, commercial banks and entities that received euro cash before the official changeover date of January 1, 2009. The second issue was to persuade people to exchange all their available cash that they had at home at commercial banks before the changeover to avoid long lines after the start of the new year. This was also carried out without any difficulties. The thorough preparations paid off in the end and I believe that everybody was surprised at how smoothly the entire process went.

[2] *Slovakia, for instance, became the world's largest producer of cars per capita.*

The global financial and economic crisis started to affect Slovakia shortly after the decision that the country would adopt the euro as its national currency. Following the restructuring of the real economy and the banking sector, the financial sector was in very good shape and was thus not directly hit by the financial crisis, also thanks to the adoption of a very conservative business approach. Naturally, there will be some indirect implications, such as nonperforming or restructured loans, as the economy slows down and unemployment increases.

5 Potential Impact of the Crisis

The impact of the financial and economic crisis on an economy which has just introduced the euro will be the third issue of interest to analysts and economists. However, the key question here is about the relationship between the single currency and the development of GDP and other economic variables during a crisis and the subsequent gradual recovery of the economy – and only time will provide the answer to this question. Today, several months after the euro was introduced, it is very difficult to answer the question of whether the EU Member States with independent monetary policies are currently at an advantage. After all, a simple assessment of the currency components will not suffice; the openness of the individual economies and their dependence on foreign demand for growth will certainly play a key role, as will the stage of the economic cycle the country was in when the crisis hit. For Slovakia, the high GDP growth of 2007 and 2008 became unsustainable when foreign and subsequently also domestic demand fell sharply, and GDP declined even more markedly. On the other hand, a rational fiscal policy and the recovery of the economy over the past ten years combined with the effect from the single currency should trigger a faster return to economic growth once the crisis lets up. The future will show whether the introduction of the euro was prudent in this respect; I believe that the answer to this question will be positive.

6 Conclusions

To recap, Slovakia is a country that experienced two fundamental currency changes in the past 16 years. Comparing the two periods reveals several similarities but significantly more dissimilarities.

In 1993, the introduction of the Slovak currency was by necessity carried out swiftly, following on the heels of the establishment of the Slovak Republic, which lacked both an economic history of its own and a central banking track record, and because the monetary union with the Czech Republic had been extremely short-lived. This notwithstanding, the era of the Slovak koruna is regarded as a very successful period, not only because of the considerable commitment and enthusiasm involved in building the institutional aspects of the new economy, including the central bank, but also due to the approach to addressing the issues associated with the new currency. At first, the Slovak koruna had to pass a hard test to prove its viability, but after a few small "stumbles" it started its – as we know now – successful existence.

By contrast, the introduction of the euro in 2009 was preceded by elaborate preparations as would be expected from such an extensive project that was to impact not only the whole economy, but also every single citizen of the country. Carefully prepared and consistently implemented, the changeover to the euro proved to be a success. The guiding principles were reasonableness and a systematic approach to addressing relevant issues, including many uncertainties as to whether the step taken is the best one. In fact, doubts about the success of the future changes characterized both periods.

One of the essential questions was whether the population would accept the new currency, would get used to it and would understand it as the conclusion of Slovakia's integration into the European Union. Would Slovaks feel more European with the single currency? Today, several months after Slovakia's adoption of the euro, even the worst skeptics are surprised at how readily people accepted the new currency and identified with it. Public support for the new currency has reached more than 80%, clearly exceeding expectations. Similarly to the Slovak koruna, the euro faces a hard test in its new home country in light of the impact of the global financial crisis on the Slovak economy. I believe that the euro will pass it as successfully as did the Slovak koruna after its adoption.

At any rate, the story of Slovakia's euro adoption will be a useful lesson not only for economic theory, but also for countries, including non-European ones, striving to achieve monetary integration. With regard to the enlargement of the euro area, Slovakia has opened a new era for countries with flexible exchange rate regimes. Studying Slovakia's journey to the euro will definitely facilitate their monetary integration process. Additionally, the process has revealed weaknesses and/or partially outdated aspects of the Maastricht criteria, the mandatory two-year maintenance of a local currency with a flexible exchange rate regime in ERM II being just one example. Also from that point of view, the adoption of the euro in Slovakia has been a historical and successful event.