

DEVELOPMENT OF THE CZECHOSLOVAK KORUNA EXCHANGE RATE

Ing. Radovan Majerský

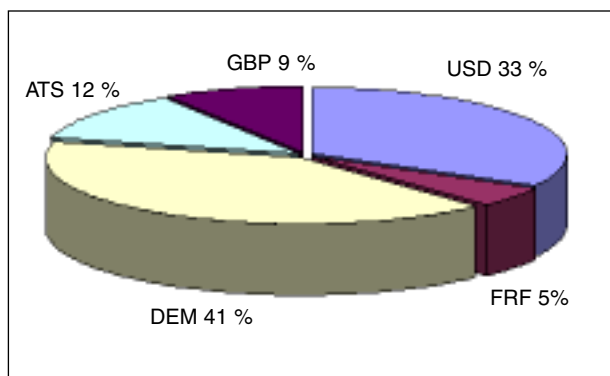
Continued from issue 1/2004

Development of the CSK exchange rate over the years 1989 – 1990

The situation in 1989 displayed all the signs of a top-down managed economy. All prices whether for goods or work were administratively governed. In 1988 the attempts to introduce a real, single foreign exchange rate began to manifest themselves, where there had been long term monetary disequilibrium.

From 1 January 1989 the dual exchange rate was replaced by a single exchange rate, which however was still different for trade and non-trade payments. This exchange rate was created on the basis of linking the official exchange rate and the exchange rate coefficients and margins. As a consequence of the world-wide tendency to exclude gold from currency systems the Czechoslovak koruna's link to the gold content was cancelled. The currency basket remained, only the weighting of the individual currencies represented changed. This concerned the following changes: USD 0.3287; DEM 0.4093; ATS 0.1232; GBP 0.0905 and FRF 0.0482.

CSK currency basket in 1989



November 1989 came to be a breakpoint not only as regards the political situation, but also in the economic field. It represented the beginning of a complex process of the economy's as well as a whole society's transformation. The main aims of economic reform were outlined in the memorandum for the International Monetary Fund and in the Economic Reform Scenario. In 1989 foreign exchange auctions were introduced, representing the beginning of the

creation of a foreign exchange market in Czechoslovakia. Foreign exchange resources were assigned normatively on the basis of foreign exchange earnings of exporters and importers. It was traded in "lots", where 1 LOT = CSK 10 000. Later the market was expanded to include the public and government organisations.

According to the Economic Reform Scenario four variants of progressive amendment were at first set out for the Czechoslovak koruna exchange rate, which was later reduced to two variants.

The first variant represented setting the koruna exchange rate at the level of approximately 20 CSK/USD. This variant was supposed to be more advantageous from the short-term social aspect; its disadvantage however was the very low value with regard to the overall state of the Czechoslovak economy. There also existed the danger of further devaluations.

The second variant forecast setting the Czechoslovak koruna exchange rate at a level of 24 – 30 CSK/USD. An advantage of this was the possibility of covering further smaller devaluations; a disadvantage was the quite significant social impact. In the end the variant with the higher rate of devaluation was adopted.

The process of bringing the Czechoslovak koruna exchange rate on to a realistic basis took place over three stages, representing in practice the devaluation of the foreign exchange rate: 1st stage – 8 January 1990, 2nd stage – 15 October 1990; 3rd stage – 28 December 1990.

The Czechoslovak koruna exchange rate in this period was unrealistic, which was the main reason that led to the later three devaluations. A priority aim of these devaluations was to put the koruna exchange rate on a realistic footing vis-à-vis other currencies and to support the process of bringing the balance of payments into equilibrium. The balance of payments in relation to freely tradable currencies had a negative balance, while in relation to the Soviet rouble it had a positive balance.

The first devaluation was made on 8 January 1990 and unified the exchange rates of trade and non-trade payments at the level of 17 CSK/USD. This set-



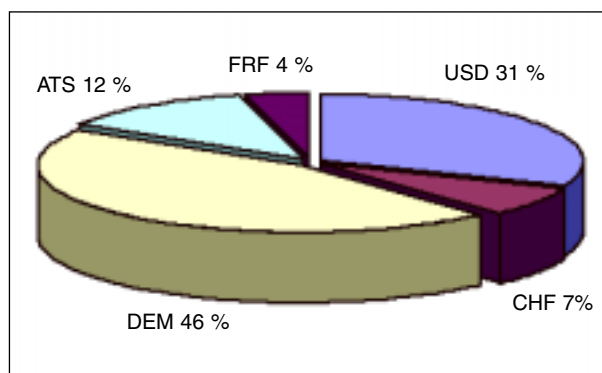
ting of the exchange rate vis-à-vis freely tradable currencies represented a devaluation of approximately 19%. The koruna exchange rate thereby adjusted also in relation to the rouble, which in the final consequence meant a revaluation of the Czechoslovak koruna by 10%. In unifying the exchange rate for trade and non-trade payments a devaluation also occurred, for trade payments by 14%, for non-trade payments by 44%. Concurrently a form of agio and disagio vis-à-vis the Soviet Union, Bulgaria, Hungary and Poland was introduced. For the rouble the agio (disagio) introduced was in the amount of 10%, i.e. an oscillation in the range from CSK 8.10 to CSK 9.90. In relation to Hungary an agio (disagio) of 10% was used, and for Poland and Bulgaria an agio (disagio) of 5%. For tourism a new exchange rate was also set, citizens could purchase foreign currency at the tourist exchange rate of 38 CSK/USD. This exchange rate was derived from the market exchange rates existing on the foreign exchange markets.

Following the implementation of the first devaluation, positive changes were expected, which nonetheless did not occur. Economists forecast that there would be changes mainly in the field of the balance of payments. The export ability of enterprises did not strengthen, indeed there continued to be more than a 30% loss on exports (in the field of freely tradable currencies). In consequence of the devaluation and increase in export opportunities the export grew by only 16%. Czechoslovak enterprises in their expectations of further devaluations paid for imports of foreign production in cash or in advance, which had the consequence of leading to a worsening in the balance of payments.

The second devaluation was made on 15 October 1990. It was caused by the behaviour of enterprises that attacked the foreign exchange reserves of banks, paid for imports in cash and in advance. Foreign exchange reserves of Czechoslovakia at that time fell to the level of USD 1 billion. The Czechoslovak koruna exchange rate was adjusted to the level of 24 CSK/USD. The devaluation was in the extent of approximately 55% against the preceding value. Following the adjustment of the exchange rate also domestic demand for foreign exchange fell and began to equal the supply of foreign exchange within the country. The basic aim of this devaluation was to reduce domestic demand for foreign exchange and to bring it into balance with supply, which was partially fulfilled.

In the process of bringing the koruna exchange rate on to a realistic footing a third devaluation was made on 28 December 1990. This devaluation unified the exchange rates for trade and non-trade pay-

CSK currency basket in 1990



ments at the level of 28 CSK/USD, which meant a depreciation against the exchange rates of trade and non-trade payments by 16%, but concurrently an appreciation of the tourist exchange rate by 12%. The Czechoslovak koruna exchange rate since 1981 had been set on the basis of a currency basket of five currencies of advanced economies. The shares of these currencies were changed for the first time in 1989. The second change came into effect in connection with the third devaluation of the koruna. The weightings of the individual currencies in the currency basket were adjusted as follows: DEM 0.4552; USD 0.3134; CHF 0.0655; ATS 0.1235; and GBP 0.0424.

Another important step, with effect as of 1 January 1990, was the introduction of an import surcharge in the amount of 20%, suppressing domestic demand for foreign exchange. In practice this meant a further depreciation of the Czechoslovak koruna exchange rate to the level of 33 CSK/USD.

These changes were the basis of extensive measures in restructuring the Czechoslovak economy. Setting the optimal value of the koruna became a subject of various discussions. Some claimed that the exchange rate was exaggeratedly devalued. Representatives of the State Czechoslovak Bank justified their approach by the fact that the exchange rate set in this way would cover in the future further minor devaluations. The suitability of the foreign exchange policy applied was confirmed by the fact that it was not necessary to adjust the foreign exchange rate over the course of the following three years. The International Monetary Fund proposed a further devaluation by 18%. Developments however have proven that this was not necessary in the period and the International Monetary Fund's fears were ungrounded.

Maintaining a stable exchange rate has been essential for further economic reform steps in the country. In Czechoslovakia there was an effort to introduce internal exchangeability of the koruna, libera-



liberalisation of external relations and price liberalisation. The stability of the foreign exchange rate has limited possibilities for speculation and created favourable conditions for foreign investment.

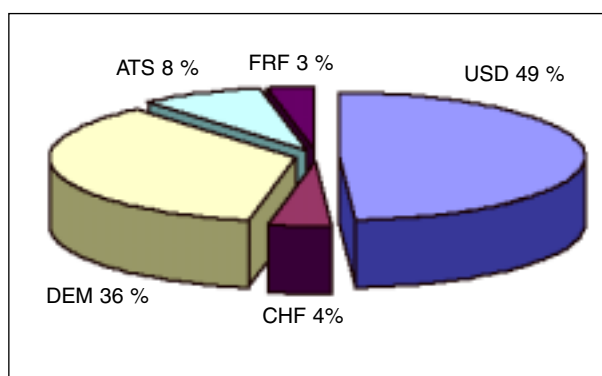
Development of the CSK exchange rate over the years 1991 – 1992

As at 1 January 1991 internal convertibility of the Czechoslovak koruna was introduced. This strategy was a component of the Economic Reform Scenario. Internal convertibility allowed Czechoslovak subjects with a foreign trade authorisation to purchase convertible currency at commercial banks (for settling liabilities resulting from the import of goods and services from abroad). From 1 February 1991 this right was extended to all business subjects entered in the Commercial Register. On the other hand, however, these subjects had to sell off to commercial banks all resources in convertible currency that they gained abroad. This enabled the cancellation of the administrative way of allocating foreign exchange funds in the economy.

The basic points of the transformation launched in 1989 were the liberalisation of foreign trade, setting the foreign exchange rate and its stability on a realistic footing, the liberalisation of retail and wholesale prices and the commencement of the privatisation process.

Following the introduction of import liberalisation an increase in demand for foreign currency was expected. The exchange rate at this time was set at the level of 28 CSK/USD. To maintain this exchange rate it was necessary to implement various regulatory measures, including for example regulation of import payment conditions, a limit on tourism, and an import surcharge in the amount of 20%. Stabilisation of monetary development in Czechoslovakia was partially successful. The internal purchasing power of the Czechoslovak koruna settled down. Through the passage of time citizens' confidence in the Czechoslovak koruna began to recover, which was manifested in an increased rate of saving in the domestic currency. Supply and demand for foreign exchange came into equilibrium on the market in consequence of the improved development of the balance of payments. While concurrently supporting exports, imports were maintained at an acceptable level. In this stable development of opinions emerged at the State Czechoslovak Bank on the possibility of a revaluation of the koruna. Following the elections in June 1991, however, the situation changed. Cracks began to appear in the joint state of the Czechs and Slovaks and voices

CSK currency basket in 1991



began to call for a division of the federation. The exchange rate was set with the help of a currency basket of five currencies in these weighting ratios: USD 0.4907; DEM 0.3615; ATS 0.0807; CHF 0.0379; FRF 0.0292.

The exchange limit for Czechoslovak koruna in tourism was increased from CSK 5 000 per person to CSK 7 500, which meant an increase of 50%. On 1 July 1992 an amendment to the Foreign Exchange Act came into effect enabling entrepreneurs not entered in the Commercial Register also to purchase foreign exchange. A change occurred also in the field of the monetary policy applied by the Czechoslovak State Bank. Whereas hitherto direct instruments had prevailed in monetary policy, in 1992 indirect instruments began to gain the upper hand.

In August 1992 foreign exchange fixing was introduced on the interbank market. Daily foreign-exchange fixing applied by the Czechoslovak State Bank was to assist in taking world prices into account in the internal economy. The Czechoslovak koruna exchange rate was set not only on the basis of a currency basket of five currencies, but also on the basis of supply and demand for foreign exchange. The difference between the resultant exchange rate and its value calculated on the basis of the currency basket was not allowed to exceed $\pm 5\%$. Whereas previously the activities of the Czechoslovak State Bank had been limited to irregular purchases and sales of freely tradable currencies, from this month onwards trades mainly in American dollars and Deutschmarks began to be effected daily. The central bank was authorised to purchase and sell any quantity of foreign currency. The bank of issue purchased foreign exchange funds from commercial banks, or sold foreign exchange funds to them in the case of surplus supply or demand for them.

Foreign exchange reserves of the Czechoslovak central bank increased in the first half of August 1992, reaching the level of CSK 5.5 billion. This situation was caused by purchases of foreign exchange



funds by the Czechoslovak State Bank, prevailing over sales. Only in the last quarter of 1992 did foreign exchange reserves begin to diminish. This was caused by extensive interventions by the central bank in an effort to maintain the stable exchange rate of the Czechoslovak koruna. Strong pressures on the foreign exchange rate had begun to appear in consequence of expected inflation, the federation's break-up and the currency separation. The Bank succeeded in maintaining a stable exchange rate and Czechoslovakia was the only post-communist country not to devalue over the course of the two years. In 1989 the Czechoslovak koruna exchange rate was at the level of approximately 15 CSK/USD; at the end of 1992 it already stood at 28 CSK/USD. While in 1989 the real exchange rate was 70.9 index points, against the base year of 1985 = 100, in 1992 it had a value of only 55.0 points.

Following this complicated development, in 1993

there occurred what was then the most significant event in the monetary field in the new-era history of the Slovak Republic. On 1 January 1993 The Czech and Slovak Federal Republic split into two separate republics, the Czech Republic and the Slovak Republic. A consequence of this was a currency separation and the establishment of the Czech koruna and the Slovak koruna.

Bibliography:

1. Jonáš, J.: Bankovní krize a ekonomická transformace, 1998.
2. Izák, V.: Transmisní mechanismus měnové politiky – úvěrový kanál, 1998.
3. Čihák, M., Holub, T.: Měnový výbor – cesta z dilemat centrálního bankovníctví v ČR, 2000.
4. Bankovníctví 13/1997.