10 YEARS OF THE NATIONAL BANK OF SLOVAKIA

Otto Sobek

The 1st of January 2003 is not only the date of the 10th anniversary of the founding of an independent Slovak Republic, but also that of its central bank – the National Bank of Slovakia. This is an occasion for us to look back over its activities to date.

The National Bank of Slovakia is the second Slovak central bank in our history. The first was the Slovak National Bank, which operated in the years 1939 to 1945. This, similarly as the National Bank of Slovakia, was established hurriedly without any real long-term preparation, indeed it may be said from the scratch. Despite this, it operated in the difficult conditions of its existence as a wise and relatively successful institution. The task of a more detailed evaluation of its activity is left to Slovak economic historians.

The preparations for establishing the National Bank of Slovakia began in 1992, when the split of the federation became certain. On 18th November 1992 the National Council of the Slovak Republic adopted Act no. 566/92 Zb. on the National Bank of Slovakia. This Act was at the time largely inspired by the current Act on the German Federal Bank. The Act conceived the National Bank of Slovakia as a highly independent central bank, something which has in its later development shown to be a correct and foresightful solution. (The independence of the NBS was further strengthened by an amendment to the Act on the National Bank of Slovakia no. 149 of the Digest of Laws of 6th April 2001.) The National Bank of Slovakia from the very outset had favourable institutional conditions created for it so that it may perform its activity, which throughout its existence it has managed to use effectively. It has also managed to overcome relatively successfully the fact that at the time of its establishment there were in Slovakia no experts with practical experience in executing monetary policy.

Act no. 566/92 Zb. formulated the main task of the National Bank of Slovakia as ensuring currency stability, which was in accordance with formulations prevailing in most states at that time. Currency stability as the main task of monetary policy does however have the disadvantage that it relates to a relatively unclear term, containing at the very least two elements: internal stability of the currency in terms of stability of the price level and external stability expressed via a stable exchange rate of the domestic currency vis-à-vis foreign currencies. The fact that these two elements can come into conflict without any clear determination of priority led later to the fact that in most acts on central banks currency stability as the aim of monetary policy has been replaced by the clearer and less ambiguous term "price stability" – in Slovakia this change was made by an amendment to the Act on the NBS in 2001.

In the first years of its existence the NBS, in accordance with the previous policy of the State Bank of Czechoslovakia, was oriented towards maintaining the exchange rate of the Slovak koruna vis-à-vis a currency basket comprising the Deutschemark and American dollar, which was seen to be an anchor for the favourable development of the Slovak currency. This policy was successful in the sense that the NBS managed to maintain an almost unchanged exchange rate of the Slovak currency vis-_-vis these currencies up until the year 1998. Internal appreciation of the Slovak koruna, which was connected with maintaining an unchanged nominal exchange rate, did not however always correspond to the interests of the Slovak economy. Since October 1998 the NBS has moved over to a flexible exchange rate of the Slovak koruna and has begun to focus primarily on the domestic aspects of currency development.

The National Bank of Slovakia has since its establishment pursued a moderately monetarist monetary policy. This means that it has focused exclusively on the battle against inflation and maintaining a stable exchange rate of the Slovak koruna and has not set itself the aim of appropriately influencing the development of the economy as would correspond to a Keynesian economic policy. It has in its policy achieved significant success. Inflation, which in 1993 reached 25%, had up to the year 1996 fallen to 5.4%. Despite the NBS's monetarist policy, the situation in the real economy was developing from 1994 very positively and GDP growth in Slovakia was among the highest in Europe. Development in Slovakia thus essentially has confirmed the monetarist thesis that for ensuring favourable economic development it is sufficient to create suitable conditions through ensuring internal and external currency stability. In the period monitored full convertibility of the Slovak koruna has been achieved and currency operations on the balance-of-payments current account have been liberalised.

The favourable development of the Slovak economy, however, was influenced from by the deficit of the state budget. Slovakia's state budget has since 1993 been in deficit. In 1997, the state budget deficit reached its highest level to date, which was brought about by the fact that in that year the state budget for the first time began to operate a policy of economic expansion (for example, motorway construction), to which the National Bank of Slovakia reacted by tightening its monetary policy, which in accordance with monetary theory brought about a marked growth in interest payments. Strong competition between the need to cover the state budget deficit and the credit demands of businesses, resulted in a further hike in interest rates leading more than once to an absolute impossibility of acquiring a loan. The necessity to maintain set mandatory minimum reserves and high interest rates for their non-fulfilment led to an interest rate on short-term loans on the banking market at a level of around 20%. The adverse development of the balance of payments and state budget deficit had the result that the fall in the rate of inflation stalled and inflation again began to rise. Speculative short-term movements on the foreign currency market led to such a drain on the currency reserves of the NBS that the National Bank of Slovakia on 1st October 1998 decided to cancel the fixed linking of the Slovak koruna to the currency basket comprising the DEM and USD and to move over to a floating exchange rate of the Slovak koruna which meant a concurrent fall in its exchange rate.

The new government, which came into office following the 1998 elections, was faced primarily with the need to solve the growing economic imbalance in Slovakia. Through adopting various measures it succeeded in halting the growth of negative trends, but only at the cost of a marked slowdown in economic growth and a further growth in the rate of inflation. Only in the years 2001-2002 did the situation again begin to improve - economic growth again picked up and inflation declined significantly. (In this however, the fact cannot be ignored that the record low inflation in 2002 is a consequence of the fact that the government in its pre-electoral year postponed the implementation of several measures in the area of regulated prices).

An overview of the long-term development of certain important indicators relating to the currency is shown in the table on page 10. The figures clearly show the negative influence of the expansionary fiscal policy of the years 1996 – 1998, which led to a deficit in the balance of payments and to an excessively high state budget deficit.

Of the monetary policy instruments used the fixed exchange rate and direct monetary instruments in the form of credit limits were at the beginning the most important. Indirect instruments such as rediscount bills, Lombard loans and auctioned refinancing loans played a less significant role. With the development of the banking sector the importance of indirect instruments used (auctioned refinancing loans) has also grown, which however have gradually been replaced by open market operations. In 1995 a significant liquidity surplus in the banking sector forced the NBS for the first time to use an active sterilisation monetary policy, through issuing its own treasury bonds. In the summer of 1995 BRIBOR was for the first time listed officially. Double repo trades were also used for drawing off surplus liquidity from the banking sector.

The transition to qualitative management continued also in 1996, when open market operations became dominant. The importance of credit limits gradually declined even to the point where the NBS completely abandoned these and other direct instruments. In this year the NBS also the first time set an interest rate goal in the form of an interest rate corridor, which is based on the current market situation and on the linking of interest rate activities to BRIBOR. The adverse development of the state budget in this year forced an increase in mandatory minimum reserves to 9%. At same time there was also introduced a foreign currency position for banks as a form of indirect regulation of lending activities in a foreign currency. The basis of monetary policy at this time was to draw off surplus liquidity and thereby limit the possibilities for commercial banks to provide further loans.

In 1997 monetary policy was oriented on maintaining external currency stability, which necessitated a return to quantitative liquidity management. Interest rate management was replaced by a system of regulating the volume of banking sector liquidity, which was reminiscent of the situation prior to 1996. The banking sector reacted to the measures adopted through an increase in interest rates, which exhibited significant fluctuations - BRIBOR stopped being listed. The biggest problem (unique in economic practice) became the fact that short-term interest rates significantly exceeded the level of long-term interest rates.

Also in 1998 emphasis was placed upon quantitative liquidity management. We have already mentioned that in this year the fixed exchange rate of the Slovak koruna that had applied up until that time was replaced by a floating exchange rate. The whole year was characterised by large fluctuations in the koruna and instability of BRIBOR.

In 1999 the NBS focused primarily on limiting excessive growth in inflation, again by means of influencing target aggregate volumes. It introduced the option of automatic drawing of lombard loans for commercial banks, which were provided at a variable interest rate derived from BRIBOR with a 5% premium. In practice however this new instrument of monetary policy did not have a real influence on banking sector liquidity, because repo trades remained the main instrument, these performed via auction. In this period the central bank had to make various investments on the foreign currency market in order to lower excessive volatility in the exchange rate. During the year the foreign currency position of banks was cancelled and concurrently mandatory minimum reserves were introduced also for non-resident banks.

An important turning point in the use of monetary policy instruments was the year 2000, when the NBS again attempted to return to qualitative liquidity management through reintroducing a refinancing and sterilisation policy. The main aim of the National Bank of Slovakia for the year 2000 was to maintain a stable price level, expressed in terms of core inflation, i.e. inflation excluding the effect of changes in regulated prices, indirect taxes and subsidies. Under the mutual coaction of monetary and fiscal policy there occurred in this period renewed economic recovery, helped not least also by a reduction in interest rates on loans. Since February the NBS has set interest rates for overnight trades and repo rates have also played an important role. Commercial banks have thereby gained unlimited access to re-financing sources and have deposited surplus funds at the central bank, which has contributed to a stabilisation of the money market and reduction in interest rate volatility. Repo tenders have gradually taken on the form of a strategic instrument ensuring the aims of the central bank over the longer term. There is thus a combination of overnight trades, representing a stabilising element, and longer-term repo trades of NBS treasury bills, communicating the strategic objectives of the central bank, which in sum corresponds to guidelines issued by the European Central Bank.

The emphasis on qualitative management continued also in the subsequent period. In the field of indirect instruments repo trades continued to dominate, where the repo interest rate gradually replaced the discount rate, which in practice in Slovakia had never been of great importance. Since the year 2002 the central bank has ceased to use bill operations and lombard loans and continued to decrease mandatory minimum reserves, which fell to 5% for commercial banks and 3% for savings banks.

An amendment to the Act on the National Bank of Slovakia was also adopted in 2001, this further strengthening its independence. The most significant change in comparison with the original act is the change of the central bank's objective from that of being to maintain currency stability to the aim of maintaining price stability, whereby the National Bank of Slovakia moved towards a policy of inflation targeting. At the same time the new Act cancelled the possibility of financing the state budget.

The long term aim of monetary policy in Slovakia is, in co-ordination with fiscal policy, to stabilise financial and monetary development while continuing liberalisation of the balance of payments. The NBS has set itself the goal of achieving a level of inflation of approximately 3 - 4% in 2005, which would probably represent a fulfilment of the Maastricht criteria. From the long-term point of view foreign direct investment and external funds for restructuring internal and external debt will have an important role in any success in monetary policy. It will be necessary to regulate the exchange rate of the Slovak koruna vis-à-vis the euro so that exchange rate stabilisation in the period prior to acceptance for European Union membership and the fixing of the exchange rate at the moment of the expected acceptance as a member of the European Monetary Union is made at a level that is maintainable and will not cause destabilisation in the Slovak economy.

Overview of selected monetary indicators (as at year end)

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Real GDP growth (%)	-3.7	4.9	6.7	6.2	6.2	4.1	1.9	2.2	3.3
Inflation rate	23.2	13.4	9.9	5.4	6.1	6.7	10.6	12.0	7.3
State budget deficit (% of GDP)	-6.2	-4.9	-1.5	-4.2	-5.7	-5.6	-3.7	-3.1	-4.6
M2 growth (% annually)	33.3	18.6	21.2	17.0	10.5	10.8	11.7	12.6	10.3
Interest rates on 3-month deposits				8.0	15.1	18.5	15.0	6.8	6.2
Average interest rates on newly provided loans by commercial banks				13.5	12.1	18.6	12.6	10.8	8.9
Balance of payments deficit (% of GDP)	-5.0	5.2	3.7	-10.4	-9.5	-10.1	-4.9	-2.3	-8.7
Gross foreign debt (billion USD)	3.6	4.3	5.5	7.8	10.7	11.9	10.5	10.8	11.3
NBS foreign exchange reserves (billion USD)	0.4	1.7	3.4	3.4	3.2	2.9	3.4	4.0	4.2
Exchange rate SKK / USD	33.2	31.4	29.6	31.9	34.5	35.8	42.3	47.1	48.2
Exchange rate SKK / EUR							42.5	43.8	43.1