NATIONAL BANK OF SLOVAKIA

MONETARY AND EXCHANGE RATE POLICY IN SLOVAKIA

Zora Komínková

Institute of Monetary and Financial Studies of the NBS
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After two years of macroeconomic and monetary stabilization (1993-1994), Slovakia has represented a central European country, where a disinflation process has continued simultaneously with a rapid economic growth. In 1996, serious imbalances in the external sector emerged which persisted in 1997-1998. Removing of the external disequilibrium will require a new package of stabilization measures. This, unfortunately, is coming in the period, when the European Union is expecting positive growth effects from its monetary integration and introduction of the single currency euro.

Table 1 Selected indicators of the Slovak economy

	1995	1996	1997	1998
GDP (real growth in %)	6.8	6.6	6.5	4.4[1]
CPI (yearly average)	9.9	5.8	6.1	6.7
Fiscal deficit (sufficit) /GDP	(0.5)	0.9	4.4	
Current account deficit /GDP	2.3	-11.2	-9.9	-10.1 (Q3)
Gross external debt (USD bill.)	5.8	7.8	9.9	11.9 (Sept.)
Gross external debt per capita (USD)	1099	1473	1867	2201 (Sept.)

Source: Statistical Office of the SR; National Bank of Slovakia. [1]Preliminary estimate.

The article discusses monetary and exchange rate policies of the National Bank of Slovakia (NBS) with respect to development trends in the real economy, over the period 1995-1998. Potential impact of the euro on the Slovak economy is considered in the last part of the article.

MONETARY POLICY

Goals, targets, instruments

By law, the monetary policy goal of the NBS is ensuring the internal and external stability of the Slovak currency - the Slovak crown (SKK). In the extent that does not jeopardise this goal, the monetary policy should promote the economic growth. The main monetary policy target is to control the rate of inflation, which was performed through two intermediate targets: (1) a fixed exchange rate[1] of the Slovak crown (as a longer-term target) and (2) the annual growth of the money supply expressed by the monetary aggregate M2. The operational variable is central bank money (the monetary base), which is regulated by changes in discount and Lombard rates[2], open market operations, and minimum reserve requirements (MRR). Apart from this, the year 1995 was the last year, when direct regulations (credit limits for largest banks) of the money stock growth were used.

The two-target monetary policy orientation might be considered in some extent misleading from the theoretical point of view, given the inability to control the money supply in conditions of the fixed exchange rate. In fact, the leading criterion of the monetary policy of the NBS was maintenance of the fixed exchange rate, all over the period concerned.

[1] On 30 September 1998, the fixed rate regime was canceled and replaced by floating.

[2] In practice, the regulative role of these rates was rather marginal. The discount rate served probably as an indicator signalizing the orientation of the monetary policy of the NBS during 1995-1996, when several cuts in the rate occurred placing it from 12 % to 8.8 %, the latter remaining unchanged up to present days. The use of the Lombard rate (at a level of 15 %) was very limited over the whole period concerned, as banks were not automatically allowed to withdraw these sources.

Nevertheless, yearly increase in the money supply M2 was regularly announced as an intermediate target of the Monetary program of the NBS. Thus, reaching of the final inflation goal was conditioned by stable exchange rate (fixed within a fluctuation band) and by yearly increase in M2 (and of the domestic credit) relative to the expected growth of the real GDP and unchanged income velocity (nominal GDP/M2).

Table 2 Monetary targets of the NBS

	Monetary Program		**Actual values**	
	M2	**Rate of inflation[1]**	**M2**	**Rate of inflation[1]**
1993	12 %	17.0 %	18.3 %	25.1 %
1994	13.2 %	10.0-13.2 %	18.9 %	11.7 %
1995	12.3 %	8.0 %	21.2 %	7.6 %
1996	11.6+/- 0.6 %[2]	6.0-7.5 %	16.5 %	5.4 %
1997	10,7 %	4.9-5.8 %	8.7 %	6.4 %
1998	9.4 %	5.6-5.9 %	2.7 %	5.6 %
1999	6.0 %	5-7 %[3] (7-9%)[4]		

[1] Yearly rate Dec./Dec.; [2] Revised value of June 1996 (originally: 13.2 %); [3] Pure inflation;
[4] Including increase in regulated prices by 10 %.

As shown in Table 2, there was not a direct relation between the dynamics in M2 and the rate of inflation in the Slovakia´s economy. Several reasons for differentials between the targeted and actual values of the M2 growth and for a week interrelation of this aggregate and the rate of inflation in Slovakia might be cited. Apart from the systemic reason related with the fixed exchange rate regime, the stability of the money multiplier between the base money and the M2 aggregate was not perfect; statistical data were inadequate (short time series) and without knowledge on time delays between monetary and real variables; the assumption of unchanged money velocity was not true; the whole transmission mechanism was imperfect, due to volatile macroeconomic and microeconomic environments. In addition, the character of the monetary policy of the NBS was accommodative: seeing a decline in inflation, the NBS estimated it could foster the economic growth by allowing the M2 growth ahead of the target (or, the real GDP growth differed from growth rates the NBS used to devise its monetary programs).

Control of M2 growth

Control of the money supply growth was the primary role of the monetary policy of the NBS. Sources of monetary expansion differed over the period: while in 1995 it was a dynamic inflow of foreign exchange resources resulting from favorable development of the current account, in 1996 it was an enormous increase in foreign bank loans for financing large amounts of imports pulled by dynamic increase in domestic demand. Simultaneously, the lending activities of banks in domestic currency with the private sector grew rapidly. Finally, in 1997-1998, the main factor of the monetary expansion was government lending related with financing budget deficits and extra budgetary investment projects (namely highways).

The monetary development of 1995-1996 resulted in an excessive growth of liquidity in the Slovak banking sector. Sterilization activities of the NBS performed by current open market operations were enhanced with purchasing the own bills of the NBS. Issuing NBS-bills became regular during 1996, since, given a favourable government budget performance, the limited amount of T-bills were not able to take care of the growing liquidity of the banking sector.

The sterilization policy of supporting economic growth resulted in an extreme dynamics in the M2 growth. Tightening of the monetary policy came in July 1996. In order to slow down the lending activities of banks, the NBS adopted a package of measures orientated against both, domestic and foreign currency credit expansion. The ratio of required minimum reserves was increased (unified) to 9 % (as compared with the former 9 % on demand deposits and 3 % on time deposits) and the Lombard rate was increased to 15 % (by 2 points). In addition, a special foreign exchange regulation (the "foreign exchange position of bank for monetary purposes", see below) was introduced.

Further tightening of the monetary policy occurred at the beginning of 1997, when quantitative liquidity management was introduced and banks lose the automatic access to refinancing resources of the NBS. On the other hand, an unexpected huge increase in government sector´s financial requirements occurred this year. As shown in Table 3, worsening of the government budget performance together with opening of large highway projects resulted in a typical crowding out effect of the government spending upon the private sector investment.

Table 3 Bank credit to the private sector (yearly percentage changes)

	1993	1994	1995	1996	1997	1998
Total credit to enterprises and households	10.8	1.9	14.7	18.2	2.2	5.7
- credits in SKK	9.1	0.5	12.3	16.8	0.9	3.7
- credit in foreign currency	118.9	77.8	57.6	35.7	14.9	24.9
Memorandum item:						
Net credit to government[1]	77.5	-0.5	-11.6	4.7	44.3	41.4

[1] including net credit to National Property Fund.
Source: Monetary Survey of the NBS 1993-1998; in current exchange rate.

The inconsistency of fiscal and monetary policies resulted in a rapid increase in interest rates, which, altogether with external imbalances, led to an attack against the Slovak crown, in May 1997. Critical development in the foreign exchange market caused a lack of liquidity, resulting in a limitation in interbank market trading. Finally, the official BRIBOR rates quotation was stopped[3] and temporary replaced by unofficial monitoring of interbank interest rates. The threat of devaluation was warded off with the aid of temporary suspending the refinancing of the banking sector. Nevertheless, the situation on the foreign exchange market affected the monetary environment during the remaining period of the year: highly volatile development of money market interest rates though stopped, interest rates stabilized at a higher than previous level,moving to 20-25 %. The inflation accelerated, reaching 6.4 % at the end of the year[4], i.e. increased by 1 percentage point, as compared with 1996.

The aim of the monetary policy in 1998 was to maintain the fixed exchange rate of the Slovak crown and to slow down the increasing inflation trend from the previous year. There was supposed also some space for reducing interest rates.

The control of the money supply faced all over the year with pressures on the foreign exchange market. Devaluation expectations of the public increased since the beginning of the year, then additionally fostered by the financial crisis in Russia and following outflow of resources from the "emerging markets". In addition, there was in play also a domestic

[3]BRIBOR = BRatislava InterBank Offering Rate. Since July 1995, BRIBOR on overnight, 1-month, and 3- month deposits are announced; since March 1996 a 6-month BRIBOR was introduced. During the end-May period, highest interbank rates were reached: the overnight at the level of 185.00 %, 1-month 62.50 %, 6-month 45.00 %.

[4]Some part of the increased inflation was due to the introduced import surcharge of 7 % since the beginning of the year (that was not expected in the monetary program of the NBS).

political situation marked with uncertainties on the future development after the parliamentary elections.

The exchange rate of the SKK depreciated due to large foreign exchange purchases by domestic as well as foreign banks, namely after bringing down the ratings of Slovakia. The reaction of the NBS was a reduction of refinance activities of banks. During June and July, excessive liquidity in the banking sector, formed by growing budget deficit and by resources from abroad devoted to finance government debt service, led the NBS to adopt sterilization policy. In August and September, a massive outflow of foreign exchange reserves of the central bank occurred, due to continuous interventions of the NBS at the foreign exchange market. In spite of this, devaluation expectations persisted and uncertainty of commercial banks on access to refinance resources grew accompanied by increase in interest rates. As of 1 October 1998, the fixed exchange rate regime of the SKK was replaced by the floating one.

The dynamics of main monetary variables in 1998 was slower then programmed in the Monetary program of the NBS. Yearly increase in money supply M2 (in a fixed exchange rate) reached 2.7 %, i.e. a level highly below the program. However, this was namely due to a significantly higher (-42.3 %) then expected (-12.7 %) decrease in net foreign assets. Credit to the private sector increased by 4.4 % (as compared with the programmed 8.6 %), which, together with the increase in net credit to government by 35.3 % represented an increase in net domestic assets by 11.2 % (as compared with the programmed 13.5 %).

The growth dynamics of inflation that accelerated, due to increased excises and some liberalization steps in regulated prices from the beginning of the year to the highest June´s level of 7.4 %, slowed down, reaching the programmed bottom value of 5.6 % in December.

The development of interest rates in 1998 was rather favorable, as compared with 1997. The previous volatility of interest rates was reduced, which enabled reintroduction of listing of 1-3-month BRIBORs in February 1998. Interest rates had a decreasing trend in the first half of the year, thereafter they increased unevenly. The average BRIBOR rates in December 1998 reached 16.12 % for 1-month deposit rate (Dec. 1997: 24.42 %), 17.29 % for 2-month rate (Dec.:1997: 25.54 %) and 18.26 % for 3-month rate (Dec.: 1997: 26.48 %).

FOREIGN EXCHANGE POLICY AND EXCHANGE RATE REGIME

During 1993-1995, the foreign exchange policy of the NBS operated within the system of limited convertibility of the currency. The exchange rate of the SKK was fixed to a currency basket of DEM and USD in the ratio 60:40.[5] The fixed rate experience from the beginning of transformation proved to be successful as a nominal monetary anchor, promoting a rapid slow down in inflation. In addition, the performance and territorial restructuring of the export sector toward market economies was promoted after the CMEA-market break-down.

During 1994-1995, the balance of payments developed favorably. Foreign exchange reserves of the banking sector grew with an increasing dynamics due to a rapid expansion of the export sector activities. Therefore, a new foreign exchange act, introducing convertibility of the Slovak crown on the current account transactions was approved.[6] The act entered into force on 1 October 1995.

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[5]This ratio was derived from the currency structure of the Slovak foreign trade and all over the concerned period proved as rational.

[6]The act enables a gradual liberalisation of the capital account transactions as well (excluding the final stage of transition toward a full convertibility). The time and subject schedule of the process were

Within the framework of the new foreign exchange act, adjustments were made in foreign exchange management, in order to enable a more flexible performance of the exchange rate policy. As of 1 January 1996, the fluctuation band[7] of the SKK was extended from +/-1.5% to +/-3%. Further extensions to +/- 5 % and to +/- 7 % followed, as of 16 July 1996 and 1 January 1997. Thus, the maneuvering space for the exchange rate policy was enlarged so that the NBS could react more flexibly on the balance of payments development, especially with regard to control of short-term capital inflows.

Innovations in foreign exchange trading between the NBS and commercial banks were adopted, as well. In order to support development of the interbank foreign exchange market, a currency band of +/- 0,25% for commercial banks trading at the foreign exchange fixing of the NBS was introduced, minimum required amounts traded on the fixing were increased (to USD 300,000, or DEM 500,000 respectively) and some obligations of banks related with the NBS´s fixing performance were removed. In 1995, due to under-developed interbank foreign exchange market, the share of the NBS´s fixing in the total amount of domestic foreign exchange operations was prevailing (close to 70 %). Since 1996, trading among commercial banks prevailed, representing roughly 95 % of the Slovak interbank foreign exchange market.

On may state that during 1994-1996, the NBS was successful in maintaining the fixed exchange rate of the currency. The exchange rate policy made flexible use of the fluctuation band. No intervention of the NBS on the foreign exchange market in favor of supporting the fixed rate was required. The exchange rate of the SKK was determined mainly by the commercial banks´ supply and demand at the foreign exchange fixing of the NBS.

The impact of the current account development on the stability of the exchange rate seemed to be rather secondary, as financing of the current account deficit, which rapidly deepened since 1996, was ensured by resources from the financial account. However, apart from continuos increase in financial credits to enterprises, a huge increase in short-term speculative capital inflow was recorded in 1996. In order to solve the problem, the regulation "monetary position of bank for monetary purposes" was introduced. The regulation imposed upon banks a required foreign exchange assets/liabilities ratio, adjusted with regard to resident and non-resident origins.[8] It came into force on 31 December 1996. To this date banks were obliged to reach the ratio of 0.65. The remaining uncovered position would be penalized by increasing minimum reserve requirements. For 1997, the ratio was increased to 0.70 (on 31 March) and to 0.80 (on 30 June).[9] The ratio of 0.80 remained in force in 1998, as well.

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arranged with regard to the economic restructuring conditions in Slovakia and in accordance with the liberalization codes of the OECD. Large part of the capital account transactions was liberalized in December 1996. Next steps followed in April 1998. Final stage (excluding purchasing of real estates by non-residents in Slovakia) is scheduled for 2000.

[7] The NBS by intermediate of the "Auction Committee" weekly determined in what part of the fluctuation band the exchange rate of the SKK could move during the next week. By July 1996, limitation of +/-0.1 % for daily fluctuations against the basket parity was set; thereafter, the limitation was canceled.

[8]The position was constructed with the numerator representing the bank´s total foreign exchange assets minus foreign exchange assets with residents and the denominator representing the bank´s foreign exchange liabilities plus liabilities with non-resident banks denominated in Slovak crowns.

[9]An inconvenient feature accompanying fulfilment of the ratio was that banks adjusted their positions just to the prescribed date (to the end of the month), by the way of trading in short-term foreign assets and liabilities, which caused a high volatility of them. Therefore, a daily data base for calculating the

Serious external imbalances characterized by current account deficit close to 10 % of GDP and by growing external debt burden persisted in 1997. In spite of this, the exchange rate remained relatively stable. As compared with the end-year value 1996, the currency depreciated by 1 %, moving the exchange rate of the SKK to 2 % below the basket parity.

In 1997, however, the Slovak crown, like other emerging market currencies, was exposed to devaluation pressure, due to instability on world financial markets. The attack against the SKK culminated at the end of May. In fact, it was due to a combination of factors, of which the most significant was not a direct speculation on the part of foreign investors. As by the opinion of the NBS, the pressure on foreign exchange reserves of the central bank was dependent upon the crown liquidity of commercial banks, the NBS, in order to ward off the threat of currency devaluation, suspended refinancing of the banking sector, temporarily. The operation was successful and the fixed rate was remained. As promoting factor of maintenance of the fixed rate played a relatively low degree of Slovak interference in international capital markets.

In 1998, deterioration of the external sector continued and devaluation expectations of the public increased. The current account deficit reached 10.1 % of GDP (Q3 1998). The exchange rate level was maintained artificially by high amounts of government lending abroad that represented an inflow to foreign exchange reserves of the central bank. The situation changed significantly after the financial crisis in Russia and retire of foreign investors from the transition economies. A massive conversion of domestic currency resources into foreign exchanges as well as typical devaluation behavior in foreign trade payments occurred within the public. As a result, net foreign assets of commercial banks decreased. The exchange rate of the SKK fell quickly to the bottom of the fluctuation band.

The NBS faced with a continuous depreciation of the currency tried to solve the problem by interventions in favor of maintaining the currency basket unit below the interbank foreign exchange market level. Due to direct interventions, foreign exchange reserves of the NBS decreased within a short period of time by roughly USD 1 billion, reaching 2.5 average monthly imports in August, compared with the previous levels exceeding 3 monthly averages.

As the devaluation expectations were not stopped, the Bank Board of the NBS decided to leave the fixed exchange rate regime and to let the Slovak crown to float, as of 1 October 1998. The fluctuation band, the currency basket of the SKK and the foreign exchange fixing of the NBS were canceled. The exchange rate of the SKK was defined against the DEM, which became a reference currency for monitoring the development of the exchange rate of the SKK. As concerns potential foreign exchange interventions, there was decided that in the future the NBS would intervene namely with the aim of reducing the volatility of the exchange rate. Interventions in favor of changing the level of the exchange rate have not been expected.

The development of the exchange rate of the SKK after introduction of the floating regime was quit satisfactory, during the last three months of 1998. At the beginning of October, however, the SKK depreciated by 18 % below the former central parity. Then, the exchange rate appreciated and indicated a rapid tendency to stabilize. Measured against the DEM, it depreciated by 1.6 % during October. In December, the exchange rate of SKK/DEM moved 3-6 % (from 21.480 to 22.081) below the 2 October level.

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ratio was introduced, since July 1997 (as compared with the previous 10 days base). This lead, on the one hand, to a substantial moderation in the foreign liabilities (assets, as well) volatility, but, on the other hand, to an important increase in the short-term indebtedness (by USD 2 billion, approximately) of the Slovak banking system.

MONETARY PROGRAM OF THE NBS FOR 1999

Monetary program of the NBS for 1999 is based on the assumption that the new Slovak government will tighten its fiscal policy. Restrictions are expected namely in government investments and wage growth in State administration.[10]

The inflation target for 1999 will be measured by pure inflation,[11] programmed at a level of 5-7 %. An increase in regulated prices by 10 % is expected, which could bring an additional increase in CPI by 2 percentage points. The impact of any other additionally price deregulations on the CPI is calculated in the same relation. There is not expected introduction of the import surcharge. Among external price factors, a moderate increase in commodity prices is expected. Within other conditions of the monetary development in 1999, reduction in current account deficit, no interventions in favor of changing the trend of the exchange rate of the SKK and a prudent monetary policy of the NBS are taken into account.

The programmed dynamics of main monetary variables in 1999 will be consistent with reduced real growth of the economy, i.e. at a level of 3 % increase in GDP, reduced share of the current account deficit in GDP to 5.5 %, whereby the fiscal deficit should not exceed 1.3 % of GDP. Then, the growth of net domestic assets could reach 8 %, the money stock M2 6 % and private credit (to enterprises and households) 8.7 %, on the yearly base.

The level of the external debt should not change significantly as compared with 1998, i.e. it could represent USD 12-13 billion. However, as a result of the announced cancelling of the foreign exchange position of bank for monetary purposes (as of 1 April 1999), an additionally reduction in foreign short-term indebtedness by roughly USD 2 billion should occur, so that the end-year level of gross foreign debt of the SR should not exceed USD 11 billion.

Apart from removing of the above foreign exchange regulation, following changes in monetary policy instruments are announced for 1999: enlargement of the basis for MRR by the way of incorporating the crown deposits of non-resident banks and foreign exchange liabilities against the non-resident banks into the basis, as of 1 April; an automatic access to the Lombard credit will be allowed and the Lombard rate will follow market (BRIBOR) rates increased by 5 %.

EXPECTED IMPACTS OF THE EURO

Introducing of the euro was firstly reflected in a decision of the Bank Board of the NBS from May 1998, which announced that in the currency basket of the SKK the DEM would be replaced by the EUR, since 1 January 1999. After introducing the floating exchange rate regime of the SKK, this intention was modified. By the end 1998, the DEM was a reference currency for defining the exchange rate of the SKK; since 1 January 1999, this role is playing EUR or, DEM as a denomination of the EUR. The initial level of the exchange rate of the Slovak crown was set at 42.746 SKK/EUR. A solution of an immediate close anchoring of the SKK´s exchange rate to the EUR was not accepted, given the current intermediate stage

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[10]As for the 1st quarter 1999 the Slovak government declared budgetary provisory and the preparation of the State budget is being in work, there are no exact data for the fiscal sector development in 1999, to this time.

[11]Defined as core inflation plus price index of consumer basket, excluding foodstaffs.

of generating a new equilibrated exchange rate of the SKK.[12] However, such solution is not excluded for future exchange rate arrangement of the Slovak currency.

The preparation of Slovak commercial banks on introduction of the euro was intensive, during 1998. Most of banks accepted the "eurostrategy" in supply of their services, since 1999. Currently, clients are allowed to open their accounts in euro in Slovak banks, however, massive real use of these services can be expected rather slowly in a relative longer period of time. In the first line, there will be probably large firms interested in the euro services, in order to hold their positions on the euromarkets and to take of their advantages. For small businesses, the impact of the euro will be more controversial, mainly from the point of view of a strengthened real competition in the euro-area. Therefore the trade-off between immediate or gradual use of the euro-accounts is in this case of a secondary importance. Probably, among these firms, rather a slow dynamics of trading in euro may be expected in a short run.

When considering the impacts of the euro on the Slovak economy, positive as well as negative aspects are to be taken into account. Increased competition on the euromarkets can be valuated as prevailingly positive, for firms importing from this area. On the other hand, for exporting firms, this can have a negative impact and will require new efforts in increasing their export performance. Similar can be the impact of the strengthened competitiveness of firms (including banks) from the euro-area on activities of Slovak firms and banks at the domestic market. Therefore, unavoidable increase in performance of the Slovak banking and real economic sectors will be required.

In the field of capital movements, reduction of exchange rate risks within the EMU member´s states, could result in a lower intensity of capital inflow to non-member States. Apart from such a probable crowding-out effect on long-term foreign investment toward Slovakia, one should take into account also similar impact on short-term investment, despite the fact that the interest rate differential between the Slovak crown and the euro will remain in play. As a result, some slow-down in the capital inflow from the EMU to Slovakia may be expected temporarily.

In order to avoid the mentioned negative consequences of the euro introduction on the Slovak economy, there is necessary, in a short-time, to create more attractive conditions for foreign capital and namely foreign direct investment inflow to Slovakia.[13] From a long(er) horizon of time, however, there is the only alternative: to follow continuously the strategy of reaching the status of a full membership of Slovakia in the European Union.

In summary, the potential impact of the euro on the Slovak economy should be, in our opinion, considered in connection with all monetary and real factors, which are represented not only by the euro as a single European currency, but by the whole building of the European Economic and Monetary Union. While, in a short run, some technical aspects related directly to the introduction of the euro could prevail, in a longer run, searching for ways of maintaining and promoting the economic performance and competitiveness must become the main challenge of the euro for Slovakia. Progressing in the "real" convergence is a precondition for fiscal and monetary convergence and, last but not least, for convergence of the Slovak monetary transmission mechanism (wherein interest rates are generated as a result

[12]Taking into account also uncertainties about the development of the exchange rate of the EUR, and the fact that a high share (around 40 %) of the Slovak imports is paid in USD.

[13] Fulfilment of this task will be, at present, more complicated, due to unfavorable development of the creditworthiness of Slovakia, which resulted in worsening of Slovakia´s international ratings by the largest rating agencies, over March-June 1998. In addition, these ratings were confirmed or brought down again, in February 1999.

of a quantitative control of credit expansion) to the European one (wherein interest rates are the main regulative instrument for controlling the money supply). Only after reaching all these component parts of convergence, there will be correct to state that Slovakia will be really prepared for entry and will be able to profit from advantages of the unified Europe.