Monetary and fiscal policy in a newly independent Scotland: lessons from the dissolution of Czechoslovakia?

Frantisek Brocek, Department of Economics, University of Strathclyde

Abstract: This paper looks at the creation of the Czech Republic and Slovakia and its transitionary monetary union to illustrate the challenges - and opportunities - that a newly independent Scotland might face. The paper provides a background to the economic consequences of the dissolution on both the Czech Republic and Slovakia, their divergent paths in terms of economic policy and growth and the reasons why their monetary union was short-lived. The lessons from this experience are then drawn with regard to the issues that might face a newly independent Scotland, were policy to follow the recommendations of the recent Sustainable Growth Commission report. Though not strict parallels, the economic experience of the dissolution of Czechoslovakia does have some lessons for a newly independent Scotland to consider.

I Introduction

The recent Sustainable Growth Commission report sets out the vision that Scotland could retain the pound sterling for an extended transition period after Scotland gains political independence from the UK. Clearly, retaining the pound post-independence would reduce transaction costs such as the costs of currency conversion or the need for businesses to revalue their assets and liabilities. Furthermore, it could help reduce exchange rate uncertainty and help ensure that business and consumer confidence remains in place immediately after independence. However, the question of whether there would be fiscal and macroeconomic tensions between Scotland and rUK post-independence would be crucial for the sustainability of any transitionary monetary union. There are few international case studies that can be used to judge the success or otherwise of monetary union between two countries. An interesting example is the dissolution of Czechoslovakia in 1993 and the monetary arrangements that followed. The creation of the Czech Republic and Slovakia is sometimes referred to as the "two-step break up", as it involved first the political creation of the Czech Republic and Slovakia on 1st January 1993 and a subsequent creation of an independent monetary position 38 days later on 8th February 1993.

This paper discusses the background of how the Czechoslovak transitory monetary union was formed, its fiscal implications, how the monetary union ended, and how the two countries fared in the years afterwards. This paper will also discuss the main lessons for a newly independent Scotland, such as the importance of expectations of financial markets and the need for symmetric macroeconomic developments with the rest of the UK for the sustainability of a transitory monetary union.

II The Czechoslovak transitionary monetary union

The *federal* state of Czechoslovakia was a twentieth century construct and dates back to 1918 when it was created in the aftermath of the dissolution of the Austro-Hungarian Empire. During the Second World War, the state split with the First Slovak Republic created as a satellite state of Germany, with limited sovereignty. Subsequent seizure of power by the Communist Party of Czechoslovakia after WWII led to the reunification of Czechoslovakia as a *unitary* socialist state under Soviet influence. During the Prague Spring in 1968 however, the Constitutional Law of Federation reinstated Czechoslovakia's official federal structure, which promised a common state consisting of two equal nations. However, despite its federal structure, the communist government concentrated its centralised power and policy-making powers in Prague, which led to the build-up of discontent amongst many Slovaks.

The modern day dissolution of Czechoslovakia was a result of the 1992 parliamentary elections. The decision to dissolve Czechoslovakia was taken by then Czech Prime Minister Vaclav Klaus and Slovak Prime Minister Vladimir Meciar, as a political decision without the constitutional backdrop of a referendum. At the time, the main points of disagreement between the Czech and Slovak governments were the redistribution of power between the federation and constituent republics and the design of future reforms. In order to mitigate the immediate negative economic effects of the dissolution of Czechoslovakia, such as an abrupt decline in bilateral trade or cross-border investment, the decision was taken to retain a common currency, a customs union, and a common labour market. The monetary union would see both countries retain the Czechoslovak crown for a period of six months with further extensions to be considered after this period.

The monetary union agreement stipulated that each side had the option to withdraw from the union if: (1) the fiscal deficit of either country exceeded 10%; (2) foreign exchange reserves in either country fell below one month's worth of its imports; (3) inter-country capital transfers exceeded 5% of total bank deposits; (4) the Monetary Policy Committee was unable to reach agreement on fundamental monetary policy issues (Fidrmuc, Horvath, and Fidrmuc, 1999). The former monetary policy authority, the State Bank of Czechoslovakia (SBCS), was replaced by an independent central bank for each country and a joint monetary board was established with a 50:50 representation from each central bank to take decisions on joint monetary policy.

III Fiscal implications of the monetary union and independence

It is hard to judge the immediate fiscal impact of the monetary union on both countries' economies due to its (very) short-lived existence. However, post the ending of the monetary union in February 1993, both the Czech Republic and Slovakia experienced a recession with Czech GDP falling by 1% and Slovak GDP falling by 4% (Fidrmuc, Horvath, and Fidrmuc, 1999). To a large degree, this was a reform-induced recession associated with the transition from centrally planned economies to free-market economies. The contraction in GDP could have also been partly induced by the after-effects of the 1991 global recession. Nevertheless, the costs associated with building new institutions, the decrease in mutual trade, and the cessation of any fiscal transfers between the two countries also contributed to the deepening of the recession. According to Sujan and Sujanova (1994), the overall costs associated with the dissolution were 2.1% of Czech and 5.7% of Slovak GDP.

The liabilities of the federal state, such as banknotes, commercial bank reserves held by the federal central bank, and debt obligations towards the IMF, were divided 2:1 according to the population ratio between the Czech Republic and Slovakia. Immovable assets were taken over by the country where they were located with all other assets being divided by their population ratio. Throughout the post-war history of Czechoslovakia, Slovakia had consistently been a net recipient of fiscal transfers from the Czech Republic. The estimates of the size of the net fiscal transfer in 1992 vary in size from 13.5 billion Czechoslovak crowns (CSK) (Hajek et al., 1993) to CSK 25 billion (OECD, 1994), equivalent to between 4.4% and 8% of Slovak GDP. Given the non-zero sum nature of the fiscal transfers, with the dissolution of Czechoslovakia the Czech Republic gained and Slovakia lost the value of the implicit liability to continue these fiscal transfers into the future.

IV The ending of the Czech / Slovak monetary union

The abrupt ending of the Czech / Slovak monetary union was associated with underlying and long-term structural tensions between the countries' economies and immediate developments around the dissolution of Czechoslovakia. Firstly, the monetary union and the Czechoslovak crown failed to achieve credibility in the financial markets. The newly-established joint monetary committee was comprised of the governors and two senior officials from each central bank. However, as the markets correctly anticipated, the countries' divergence in macroeconomic variables such as unemployment and GDP growth before and after the dissolution of Czechoslovakia made decisions in pursuit of the common interests of the single currency impossible. Higher unemployment and weaker growth meant that Slovak authorities were in favour of lower interest rates and competitive devaluation of the Czechoslovak crown, whereas this was clearly not in the best interest of their Czech counterparts. Although the decisions on monetary policy were made by the joint monetary committee, the implementation of policy decisions was left to the national central banks. This contributed to a dysfunctional institutional design for conducting monetary policy and led to an undermining of the Czechoslovak crown's credibility on financial markets.

This lack of credibility was expressed in a parallel exchange rate of the Czechoslovak crown relative to the US dollar (i.e. the exchange rate quoted by commercial banks) which climbed to be 78% higher than the official exchange rate (Firdmuc, Horvath, and Fidrmuc, 1999). Furthermore, due to the poor competitiveness of the Slovak economy relative to its neighbours, a devaluation of the new Slovak crown was expected at the end of the 6-month transition period. In anticipation of this, large capital outflows from Slovak to Czech banks occurred in late 1992 and at the beginning of 1993. Furthermore, Slovak importers sought to repay their debts as soon as possible, while Czech importers wanted the exact opposite. The gradual outflow of currency from Slovakia to the Czech Republic further worsened the tensions associated with the single currency, as Slovak banks were prone to significant reductions in their liquidity[3] which threatened to force them into insolvency, were no government action taken.

[3] The impact of severe decline in back liquidity, such as in the 2008 banking crisis, demonstrate the severely destabilising effects for the real economy.

A single currency maximises economic efficiency if the region where it is used is an 'optimum currency area'[4]. The Czechoslovak experience suggests that the two countries were not an optimum currency area and that there were several asymmetric developments in the two economies. Optimum currency area literature argues that labour mobility is a key adjustment mechanism in the event of asymmetric shocks (Mundell, 1961). In the event of an asymmetric shock, such as a decrease in demand for goods in a country, high labour mobility can bring the goods market back into equilibrium by workers migrating to another country and reducing the natural rate of unemployment in the domestic country. However, if labour mobility is low, the adjustment must come through higher prices and lower wages. The data from Czech Republic and Slovakia suggests that there was a low degree of inter-regional / inter-country labour mobility. This magnified the pre-existing, pre-dissolution macroeconomic impacts of the differences in unemployment rates between the two countries. In December 1992, the unemployment rate was 2.6% in the Czech Republic and 10.4% in Slovakia. Close to a year after the dissolution, in December 1993, the difference had increased even further; Czech unemployment increased to 3.5% and the Slovak rate increased to 14.4% (Fidrmuc, Horvath, and Fidrmuc, 1999).

Industry specialisation and the synchronisation of business cycles are also important factors for a successful optimum currency area. The incidence of asymmetric shocks is much smaller in a diversified economy than in a specialised one. In the case of Slovakia, most of its industry was built in the period after the 1948 communist takeover with a focus on heavy engineering, metallurgy, and the chemical industry (Pavlinek, 1995). The communist political objectives were also mirrored in the reliance on the military equipment industry where a substantial amount of exports was directed to the former Soviet bloc. On the other hand, Czech industry was more diversified and focused on high value-added sectors. The reliance of Slovakia on heavy and military industries may have amplified the asymmetric shocks which in turn contributed to the collapse of the monetary union.

[4] The theory of 'optimum currency area' was first introduced by Mundell (1961) and shows that countries should join a monetary union if the costs of doing so are lower than the benefits. The four main criteria for a region to form an optimum currency area are: (1) an integrated labour market where labour can move freely, (2) flexibility of pricing and wages, along with mobility of capital, (3) A redistribution mechanism to redistribute capital to parts of the area that have suffered because of labour and capital mobility, (4) a synchronisation of business cycles between the participating regions or countries.

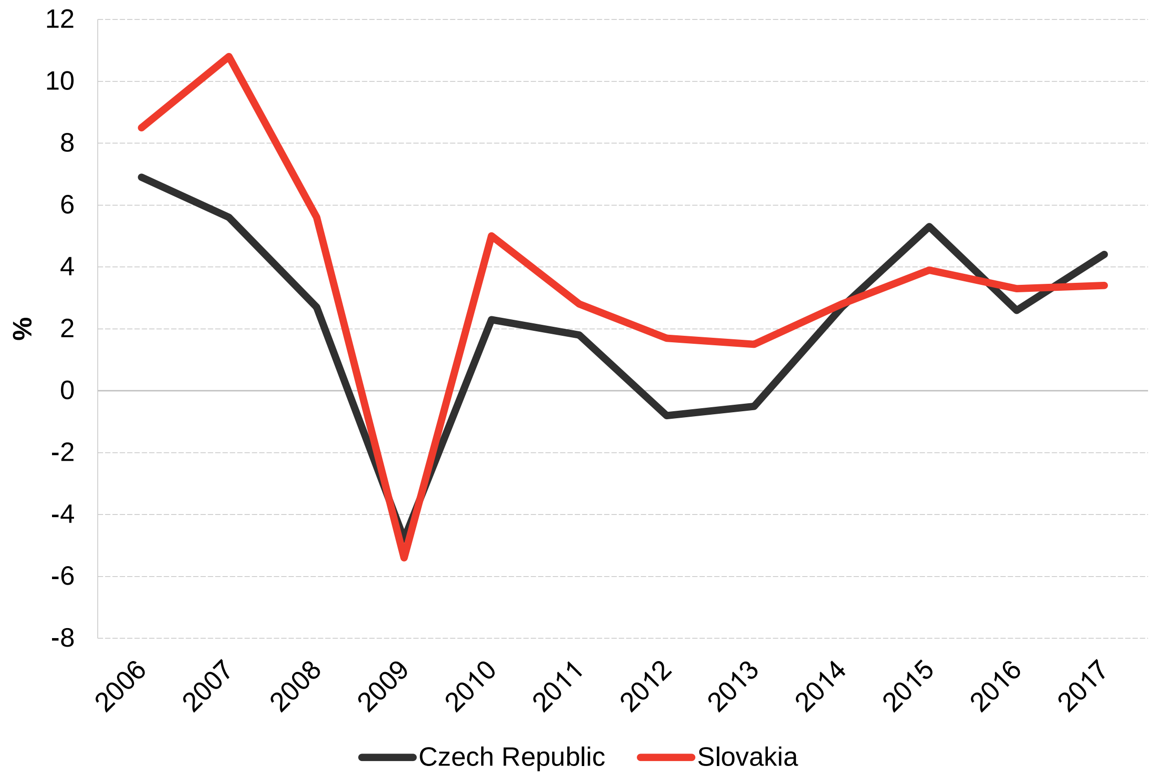
A lower correlation of permanent output shocks (i.e. long-term trends in GDP growth between the two countries) can be a destabilising factor for a currency union. If countries in a currency union do not have synchronised business cycles the central bank will struggle to offset economic recessions and contain inflation for the whole area. Data suggests that the correlation of permanent output shocks between the Czech Republic and Slovakia ranged from 0.34 and 0.53 for different time periods between 1948 to 1990 (Fidrmuc, Horvath, Fidrmuc, 1999). This was much lower than other monetary unions such as the US, where the correlation of permanent output shocks ranged from 0.69 to 0.86 (Fidrmuc, Horvath, Fidrmuc, 1999). These developments suggest that the monetary union was experiencing structural tensions throughout its history that were further amplified after the dissolution of Czechoslovakia. These factors created macroeconomic imbalances which it is argued contributed to the collapse of the post-dissolution transitionary monetary union.

V The path from monetary union to the Eurozone

The fortunes of Slovakia and the Czech Republic after dissolution were very different in the 1990s. The Czech Republic pursued a path of reform and market liberalisation that led it to achieve economic success in the late 1990s, while Slovakia remained stuck in a period of secular stagnation with a government led by Prime Minister Meciar which had no enthusiasm for reforms. Despite averaging economic growth of 6% between 1994 and 1996 and over 4% until 1998, the Slovak economy remained fragile and on an unsustainable path (Šuster, 2004). The output gap created by the 1991 recession was finally overhauled by 1996, but growth was fuelled mainly by expansionary fiscal policy (Šuster, 2004). As expected, this expansionary fiscal policy was associated with a high government deficit (4.7% in 1998) and a build-up in government debt (28.9% of GDP in 1998, up from 11.5% in 1996). Long-term unemployment continued to grow with the unemployment rate reaching a high of 15.6% in 1998 (Šuster, 2004). After the 1998 election a reformist government took power and started to modernise the Slovak economy. Bold free market reforms and fiscal policies aimed at stabilising government debt to fulfil the Maastricht criteria enabled the start of Slovakia's entry to European Union (EU) in 2004. Subsequently, tax breaks and tariff breaks, subsidies for new employment and government commitments to build infrastructure were made. This helped draw in foreign direct investment (FDI), particularly into the car industry. This significant increase in FDI contributed to Slovakia posting the fastest economic growth in Central Europe with it being nicknamed the "Tatra Tiger".

During its entry into the EU, Slovakia committed to adopt the Euro once it had fulfilled the conditions set out in the Maastricht Treaty. Market-induced reforms of the early 2000s changed the structure of the Slovak economy and enabled convergence in macroeconomic variables towards the EU average. During the transition period, agriculture and industry, lost a great deal of their share of the economy, while services gained significantly (National Bank of Slovakia, 2003). The reforms and transformation of the Slovak economy enabled the country to join the Eurozone in 2009. Zudel and Melioris (2016) estimated that by adopting the Euro, Slovakia gained a 10% boost in real GDP per capita by 2011. The benefits came mainly from the reduction in transaction and administrative costs and an increase in FDI and trade with key partners such as Germany.

Figure 1 Real GDP growth rate in Czech Republic and Slovakia



Source: Eurostat

In 2004, both the Czech Republic and Slovakia joined the EU, but the Czech Republic decided not to adopt the Euro. The decision was a policy choice of Czech government and was based on the backdrop of beliefs by the Czech National Bank that real economic convergence towards the

Euro area in areas such as price stability and industry specialisation had not been sufficient (MoF CZ and CNB, 2017). As shown in Figure 1, in the years immediately after the adoption of the Euro, Slovakia achieved higher GDP growth than the Czech Republic. Despite other factors (e.g. public spending providing a boost to aggregate demand) which could have contributed to this difference, it is clear that Slovakia benefited from adopting the Euro.

VI The Sustainable Growth Commission and the Scottish context

The Sustainable Growth Commission (2018) report suggests that a newly independent Scotland would need to achieve a substantial reduction in in its fiscal deficit to gain credibility in the markets and at that point it could make an orderly transition to a new currency.

The report suggests that Scotland retains the pound sterling for an extended period after any vote for independence. During this period Scotland would face an interest rate regime set by the Bank of England. The Sustainable Growth Commission suggests that after the 'transition period' Scotland would establish its own 'new' currency. The report offers a roadmap and sets out plans for financial regulation, banking, and the creation of a Scottish Central Bank (Sustainable Growth Commission. 2018). The Czechoslovak experience shows that if two newly independent countries face one interest rate, but their economies start diverging in terms of macroeconomic variables (e.g. GDP growth, inflation, unemployment, fiscal deficit) the central bank might find it difficult to set an interest rate which will be suitable for economic conditions in both countries.

Scotland and the UK outside of London, share broadly similar characteristics. Key economic indices for Scotland tend to be similar to the UK average, albeit the London-effect does pull the UK number higher. The structure of the two economies are more similar than in the Czech and Slovak case, although the existence of oil in the Scottish economy is one key difference. However, whilst there may be economic similarities, the Czechoslovak case highlights how any meaningful differences, whether at the outset of independence or building up over time, have the potential to unsettle the underlying monetary union. Indeed, if the very purpose of independence is to build a different economy to the UK, then it necessarily follows that the system will become less stable.

As highlighted earlier, Slovakia was a net recipient of fiscal transfers before 1993, with estimates of the size of the transfer varying from between 4.4% to 8% of GDP.

The Sustainable Growth Commission (2018) concedes that a newly independent Scotland would inherit a substantial fiscal deficit of circa 6% of GDP and it sets out a plan for reducing the deficit over a 10-year period. However, any 'new' Scottish currency would need to gain credibility in the financial markets on the day after independence. Given an expected fiscal deficit of such a scale, there is a risk that financial markets could put the 'new' Scottish currency under substantial pressure.

VII Conclusions

The story of the dissolution of Czechoslovakia shows that transitionary monetary unions can be, depending on pre-existing circumstance, unstable. The main economic factors that led to the collapse of the Czechoslovak currency union were a low correlation of permanent output shocks, low labour mobility and a mismatched industrial composition (e.g. a higher concentration of heavy and military industries in Slovakia compared to the Czech Republic). A dysfunctional institutional design for monetary policy and pressure from the financial markets led to the rapid collapse of the Czechoslovak crown. Despite the fact that the Czechoslovak experience is an interesting case study of the feasibility of a monetary union after the split of two countries, it does need to be viewed within a wider economic, political and social context.

It needs to be remembered that the Czech Republic and Slovakia were centrally planned economies for over 40 years prior to their attempt at sustaining a monetary union. Transition economies of such nature face many structural issues which the UK and Scotland simply would not, given over 300 years of political union and over 100 years of democracy and stable institutions. The path of market liberalisation and reforms after the monetary union collapsed led to faster growth in the Czech Republic relative to Slovakia. It was only with radical reforms in the early 2000s that led Slovakia to become the "Tatra Tiger". The sustained convergence in macroeconomic variables towards the EU average allowed the country to complete its successful entry into the EU in 2004 and into the Eurozone in 2009, which have underpinned Slovakia's success story to date.

The Czechoslovak monetary union experiment shows that even small structural differences between two economies can make them more vulnerable to asymmetric shocks and will make the creation of a stable optimal currency area difficult. If Scotland was to remain part of the

Common Travel Area, high labour mobility between Scotland and the rest of the UK could act as an adjustment mechanism to offset some of any macroeconomic imbalances.

Whatever decision is taken however, perhaps the most significant lesson is that the expectations and behaviour of financial markets – like it or not – need to be borne in mind at all times. This will be true whether trying to maintain a monetary union or introducing a new Scottish currency.

In summary, the Czechoslovak experience shows that the post-independence transitionary monetary union proposed by the Sustainable Growth Commission in Scotland could face challenges. At the same time however, the Slovak experience shows that with the right mix of institutional reforms accompanied with membership of the EU and Eurozone, there is a route to economic growth and increases in living standards.

References

Fidrmuc, J., Horvath, J. and Fidrmuc, J. (1999). The Stability of Monetary Unions: Lessons from the Breakup of Czechoslovakia. Journal of Comparative Economics, 27(4), pp.753-781.

Hajek, M. et al. (1993). Ceskoslovenska ekonomika v zaveru roku *1992*. Czech National Bank Research Paper 3. Prague: Czech National Bank.

Ministry of Finance of the Czech Republic and the Czech National Bank (2017). Assessment of the Fulfilment of Maastricht Convergence Criteria and the Degree of Economic Alignment of the Czech Republic with the Euro Area. [online] Available at: https://www.cnb.cz/miranda2/export/sites/www.cnb.cz/en/monetary_policy/strategic_documents/download/maastricht_assessment_2017.pdf [Accessed 20 Jun. 2018].

Mundell, R. (1961). A Theory of Optimum Currency Areas. American Economic Review, 51(4), pp.657-655.

National Bank of Slovakia (2003). Strategy of the Slovak Republic for the Adoption of the Euro. [online] Available at: https://www.nbs.sk/_img/Documents/BIATEC/BIA08_03/2_5.pdf [Accessed 20 Jun. 2018].

OECD (1994). Economic Survey of the Czech and Slovak Republics. Paris: OECD.

Pavlínek, P. (1995). Regional development and the disintegration of Czechoslovakia. *Geoforum*, 26(4), pp.351-372.

Sujan, I. and Sujanova, M. (1994). The Macroeconomic Situation in the Czech Republic. CERGE-EI Working Paper Series, [online] 46. Available at: https://ssrn.com/abstract=1558106 [Accessed 20 Jun. 2018].

Sustainable Growth Commission (2018). *Scotland - the new case for optimism*. [online] Available at: https://www.sustainablegrowthcommission.scot/report/ [Accessed 20 Aug. 2018].

Šuster, M. (2004). Developments of Slovakia's Economy since 1990; in Bruno S. Sergi and William T. Bagatelas, editors: The Slovak Economy and EU Membership: How a Small Country Emerges in the Context of Globalization. Bratislava.

Šuster, M. (2018). *E-mail correspondence regarding the Czechoslovak monetary divorce and its lessons for a newly independent Scotland.*

Zudel, B. and Melioris, L. (2016). Five Years in a Balloon: Estimating the Effects of Euro Adoption in Slovakia Using the Synthetic Control Method. OECD Economics Department Working Papers, 1317.

Author Details

Frantisek Brocek

University of Strathclyde

frantisek.brocek.2015@uni.strath.ac.uk