

The Czechoslovakian experience

Economic perspective

8th June 2011

Earlier in the week I wrote on the possibilities of an end to the eurozone. This piece looks at the mechanics of a currency union exit by outlining the end of currency union between the Czech Republic and Slovakia in the break-up of Czechoslovakia. It provides some insight into what a Greek exit may look like.

In October 1992 the Czech and Slovak governments (effectively Czechoslovakia was a federal state) agreed to retain the Czechoslovak Koruna as the currency of each state post the break-up of Czechoslovakia which was to occur on January 1 1993. The agreement lasted just 38 days and is instructive for the current eurozone situation.

Slovakia was not as competitive as the Czech Republic. It largely relied on out-dated Soviet era heavy industry in comparison to a relatively more modern Czech economy. As a result Slovakia was failing to attract foreign investment, and therefore hard currency, in the same way that the Czech economy could. In addition, the Czech Republic started with a balanced budget but Slovakia was forced to run a significant deficit. In 1993 it was 33% of GDP but was just 7% by 1994. While politically the two countries wanted to maintain currency union, it became clear that it was not economically possible particularly because firms in both countries began to stock pile hard currency at the expense of domestic banks. By February 4 1993, a split was inevitable and it occurred on February 8.

There are two interesting aspects to the split that have some relevance to Greece today; the technical aspects of issuing new currency and the response of banks and individuals.

The split was facilitated by up to 13,000 government workers in both countries stamping currency notes with either a Czech or Slovak note. The Czechs, who had more faith in the value of their currency, only stamped the high denomination notes, the Slovaks stamped all notes. People in both countries were exhorted to deposit as much money as possible in bank accounts while there was only a small window (four days) to exchange a small amount of old cash for new cash. In addition, to prevent speculation, border controls were increased to stop large-scale movements of capital.

Immediately, individuals and banks began to understand that the original exchange rate of one Czech for one Slovak koruna was not going to be maintained. From the moment the Prime Minister of Slovakia announced the split there was an immediate surge in Slovaks opening Czech accounts. After just one week of this deposit surge Czech banks began quoting an 80.15:100 exchange rate. Western bank lending to Slovakia had all but disappeared. The market effectively forced the devaluation on the Slovaks.

It also should be added that much of the split negotiation occurred in secret.

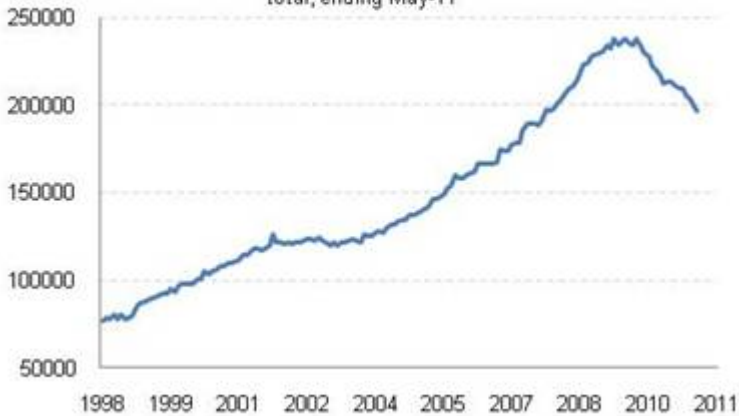
Ultimately, the split has done a lot for Slovakia; faster growth than the Czech Republic and a more stable economy that was, ironically, able to enter the eurozone a few years ago.

Consequences for Greece and a eurozone exit

It seems relatively simple. Urge all Greeks to put all their money in the bank, print new currency at an arbitrary exchange rate and then let the market do the rest. The problem is getting the Greeks to put all their money in the bank.

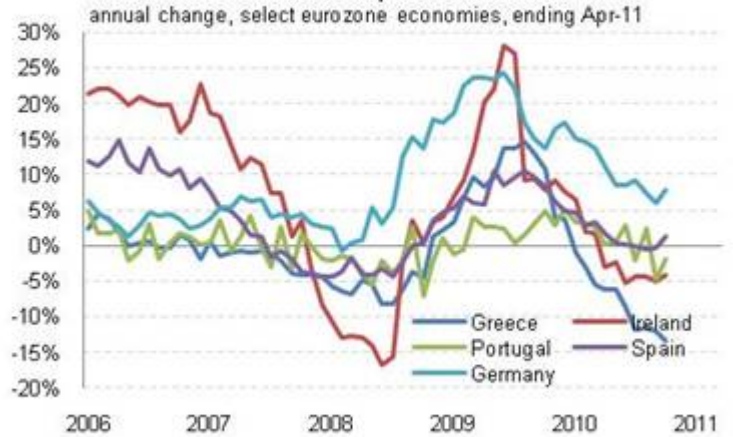
Already, this problem is evident. There are many stories of Greeks buying aggressively in the London property market to protect the value of their savings. It is also evident at a macro level in their savings. The first chart shows household and business deposits at Greek banks shrinking by 17% from their December 2009 peak. The second chart shows eurozone demand deposits, slightly different, in five eurozone economies. The relative performance of each economy nearly matches the view CDS markets have of their debt i.e. Greece has the steepest fall in deposits and the worst CDS spread; only Portugal and Ireland are around the wrong way.

Greece household and business bank deposits
total, ending May-11



Source: Bloomberg

Bank deposits



Source: Bloomberg

It seems Greeks, who knows about the Greek government, are preparing for a eurozone exit.

For further information

Stephen Halmarick	Head of Investment Markets Research	+61 2 9303 3030	shalmarick@colonialfirststate.com.au
Belinda Allen	Senior Analyst, Investment Markets Research	+61 2 9303 3110	ballen@colonialfirststate.com.au
James White	Senior Analyst, Investment Markets Research	+61 2 9303 2645	jwhite@colonialfirststate.com.au

For further information

Regional Managing Director, Australia and New Zealand

Joanna Davison +61 2 9303 7007

Institutional Business Development and Consultant Relationships

Matt Russell +61 2 9303 7024

Ali Karmali +61 2 9303 6070

Tracey McNaughton +61 2 9303 2695

Trent Koch + 61 2 9303 7653

Institutional Relationship Management

Liz Krajewski +61 2 9303 2927

Dan Bristow +61 2 9303 6311

Helen Squadrito +61 2 9303 6142

Hugh O'Neill +61 2 9303 6116

Simon Good +61 3 8628 5681

Harry Moore +613 8618 5532

Nadene Moore +61 3 8628 5615

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