

CENTRE FOR NEW AND EMERGING MARKETS

**Discussion Paper Series
Number 8**

**THE COSTS AND BENEFITS OF EURO-ISATION IN CENTRAL-EASTERN
EUROPE BEFORE OR INSTEAD OF EMU MEMBERSHIP**

**Mario Nuti
London Business School
University of Rome "La Sapienza"**

September 00

Earlier drafts of this paper were presented at the Sixth Dubrovnik Economic Conference, on "Exchange Rate and Financial Vulnerability in Emerging Markets", 29-30 June 2000; and at the 12th Annual Meeting of the Society for the Advancement of Socio-Economics, London School of Economics, 7-10 July 2000, Panel on "The Economic Impact of Exclusion from EU and EMU". Acknowledgements are due to Vincent Koen, Jacek Rostowski and Milica Uvalic, as well as participants in both Conferences, for useful comments and suggestions. Financial support from the ESRC Programme "One Europe or Several?", Project n. L213 25 2003, is gratefully acknowledged.

Contact details:

Anna M Malaczynska

Tel: +44 (0)20 7706 6964

Fax: +44 (0)20 7724 8060

www.london.edu/cnem

Summary

Countries unable or unwilling to join a Monetary Union can introduce dollarisation or, more recently in central eastern Europe, DM- or Euro-isation, whether in the form of a Currency Board permanently linking the national currency to the dollar/DM/Euro, or in the form of formal replacement of the national currency by dollars/DM/Euros. Schemes of this kind, familiar from Hong Kong or Argentina, have been introduced recently especially in the Transition Economies: e.g. Currency Boards in Estonia, Lithuania, Bulgaria, Bosnia; DM-isation in Kosovo and in Montenegro, also discussed in Poland and Bulgaria; prospective Euro-isation advocated for some post-Yugoslav republics.

Potential benefits from such way of replicating membership of a currency area include: the reduction of transaction costs and the benefits of ensuing greater trade and investment integration; the lower interest rate that is expected from adopting a stronger and more credible currency; the avoidance of both the turbulence associated with floating exchange rates, and the vulnerability to capital inflows/outflows generating speculative crises in case of fixed exchange rates even if successful; the ability for a government to borrow in the same currency in which its expenditure is denominated and actually incurred.

However, the adoption of an external or common currency also has costs, as well as exaggerated advantages. Large scale currency reserves are needed both to establish Currency Boards or to formally replace a national currency. Even Currency Boards do not preclude the possibility of major financial crises, for demand for foreign exchange could very well exceed the amount of primary money, which is the only component of money supply fully matched by the Board's reserves. Underlying necessary trends of real revaluation, commonly observable in developing and in transition economies, may actually fuel inflation when nominal exchange rates are kept stable.

A country's fundamentals may be highly specific and at odds with those of the country of area of the alternative currency, i.e. shocks can be asymmetric. There is a loss of seigniorage, though a country could arrange to share it with the Central Bank of the currency of choice. There is financial fragility from the loss of a lender of last resort, though a Currency Board can still take this role if it has free reserves.

The net benefits from using an external or common currency, as well as the full implications for the country or area issuing that currency, require a theoretical exploration of all the relevant factors and an empirical measurement of their relative weight in specific countries at a given time.

1. Introduction

The current simultaneous EU enlargement and monetary unification are about to create an unprecedented economic segmentation in Europe. Previous instances of enlargement and deepening treated equally old members among themselves and, subject to short-lived transition arrangements, old and new members. Countries were either in or out of the EC; any other diversification pre-existed and was not actually generated by the progress and pattern of European integration.

Membership of the European Monetary Union (EMU) is an integral part of the *acquis communautaire*, which new and old members alike are committed to implement – subject to three qualifications (see Temprano Arroyo and R.A. Feldman, 1999):

- 1) possible “derogations”, such as those negotiated by the UK and Denmark, which at present no new member is expected to request, let alone necessarily obtain if they did;
- 2) before joining EMU, at least two year successful participation in the Exchange Rate Mechanism¹, which Sweden has failed to implement to date;
- 3) before examination of a country’s application to join EMU, achievement of the other Maastricht Treaty standards for monetary and financial convergence, in terms of public debt and deficit, inflation and interest rates²; failure to achieve these

¹ The ERM to which the Maastricht Treaty referred was replaced from 1-1-1999 by ERM-II, including criteria such as the development of market integration, current-account balance, monitoring of unit labour costs and other price indices.

² More precisely, in addition to two year ERM-II membership: 1) an average rate of inflation over a period of one year before the examination, not exceeding the average of the three best performing member states by more than 1.5%; 2) an average nominal

standards delayed Greece membership of EMU until the Lisbon summit of June 2000.

Europe, therefore, even if all new members opted to join EMU at the earliest possible date (and *a fortiori* if they did not), in the European Union's transition to a fully integrated and enlarged Monetary Union is going to be segmented into at least four groups:

- members of both EU and EMU (at present 12 including Greece);
- members of the EU which are either excluded (Greece until recently) or self-excluded from EMU (UK and Denmark; Sweden), soon to be joined by the next batch of new members for at least their first two years ERM participation after accession (unless a record of exchange rate stability was treated as equivalent to ERM, see below);
- 10 applicant countries from central Europe already engaged or soon to be engaged in detailed accession negotiations: Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia; plus Cyprus and Malta and, more recently, Turkey, followed – or perhaps overtaken, for instance in the possible case of Croatia - by other countries from south-eastern Europe. All these countries' admission to EU is subject to economic and political conditions and will be staggered over time beginning not earlier than 2003-4;
- the rest of Europe and of the FSU, excluded from EMU at least for the foreseeable future.

long-term interest rate on government bonds, also over a period of one year before the examination, not exceeding by more than two percentage points the average of the three best performing member states in terms of price stability; 3) a government deficit of at most 3% of GDP and 4) a government debt of at most 60% of GDP – unless the ratio for both deficit and/or debt is close to the reference values and either has already declined substantially or exceeds the reference value only temporarily.

Union and Euroland enlargement is going to have – in the words of ECB President Wim Duisenberg – “deep and wide-ranging consequences” for the ECB (The Economist, 29-1-2000; see also Bekx 1998).

Before EMU membership or, for the excluded or self-excluded, *instead of* EMU membership, there are two possible and, most important, *unilateral* ways for countries to secure a closer monetary integration with the EMU area if they wish:

The first is the adoption of a Currency Board managing a domestic currency linked to the Euro or (until 2002 when Euro coins and banknotes will first appear) to any of the EMU-member currencies; for the sake of convenience and of psychological impact the currency – whatever it is called – could also be scaled so as to make its unit equivalent to one Euro, at no extra cost.

The second, more drastic alternative is the *official* adoption of the Euro or, until it has a bodily existence, of any of the EMU-member currencies – plausibly the DM – as the exclusive or primary domestic means of payment, which in many countries is facilitated by already existent *unofficial* DM-isation or dollarisation.

This paper seeks to identify the theoretical and empirical issues involved in these options, and to evaluate Euro-isation costs and benefits for both accession candidates and the EU and its member states, drawing policy conclusions which should be relevant also for EU outsiders.

2. Euro-isation to date

Both a Currency Board and domestic currency replacement can be regarded as forms of *Euro-isation* (by analogy with the more euphonic *dollarisation*, on which see Calvo 1999, IMF 1999, US Senate JEC 1999, Berg and Borensztein 2000). The Currency Board is Euro-isation in a broad sense, while the use of the actual Euro or other EMU-area means of payment are Euro-isation in a strict sense – though both falling short of the full-fledged Euro-isation obtained through full EMU membership.

Currency Boards with links to the DM or the Euro already exist in Estonia (8 kroons = 1 DM, i.e. EEK 15.6466=1 Euro), Bulgaria (with the lev in 1997 originally tied to the DM then in 1999 re-pegged to the Euro, which is the same thing, BGL 1.95583=1 Euro) and Bosnia, with the “Convertible Mark” equivalent to the DM. Lithuania has a Currency Board linked to the US dollar (from 1994, 4 litas = 1 US\$; see Korhonen 1999, 2000). Any currency whose exchange rate is irrevocably tied to a currency, the DM, which in turn is irrevocably fixed to the Euro, obviously is already indirectly pegged to the Euro. Thus these countries could, like Bulgaria, switch from a link to the DM to a link to the Euro (as they would have to do anyway in mid-2002 when the DM is totally replaced by the Euro) at a stroke. This could be followed by a re-denomination of their domestic currency so as to equal one Euro, opening the possibility even to beat the ECB at printing the first Euro denominated banknotes. Indeed Estonia has put forward precisely such a proposal for implementation in 2001 already before its accession (OECD, 2000). A working group was set up by Premier Mart Laar to analyse the issue further; according to the vice-president of the Estonian Central Bank, Mr Peter Lohmus, the main issue for Estonia is ensuring the “smoothest, least volatile way into the euro system”, but no new issues could possibly arise that do not arise already under the Currency Board regime.

The Euro is also the reference currency for the exchange rate pegs in the Czech Republic, Slovakia and Slovenia (on the extremely diversified exchange rate regimes in the transition, see Nuti 1996a, Backe’ 1999; Lavra 1997). Poland, Hungary and Romania are only partially linked to the Euro (the first two respectively at 55% and 70% only), the residual still being represented by the US\$ (see Nuti, 2000a).

The Lithuanian Currency Board link to the US\$ justifies the much lower degree of euro-optimism there (see Korhonen 1996); the same considerations apply to any other country which has succeeded in maintaining a fixed exchange rate in relation to a reference hard currency other than the Euro or an EMU-member currency, such as Latvia’s lat (since 1994, an informal peg to the SDR has been maintained, at 0.8 lats=1SDR, +/- 1%).

It can be argued that an EMU candidate that has experienced a period of pre-accession Euro-isation in either form – Currency Board or currency replacement by an EMU currency – should have the two-year ERM-II membership requirement shortened or even waived. Indeed the same treatment may be plausibly requested by any other

country that has maintained an exchange rate stability comparable to that of ERM-II in the run up to accession. The Latvian Lat, for instance, having maintained its peg to the SDR in spite of the August 1998 Russian crisis and its significant impact on all Baltic economies, also deserves to have its two years waiting time significantly shortened; Latvia's foreign minister Indulis Berzins has announced that his country hopes to join the euro-zone as early as 2003. Neither enlargement nor successful unilateral Euroisation were being contemplated when the Maastricht Treaty was being negotiated – hence the case for relaxing the two-year ERM-II membership, though not automatic, is exceptionally strong.

Informal DM-isation already exists on a large scale in Eastern Europe and the FSU, though often dominated by (informal) dollarisation. In 1995 the German Bundesbank estimated that about 30% to 40% of all DM notes and coins in circulation were held abroad (Seitz 1995), which compares with a Federal Reserve estimate of 40%-60% for the US dollar (corresponding to \$192-288bn, Feige et al., 2000). Montenegro has formally adopted the DM as a dual legal tender next to the Yugoslav dinar; the DM is *de facto* the domestic currency in Kosovo. Any DM-ised country would eventually – in 2002 – become strictly Euro-ised.

Proposals for an extension of the Currency Board regime have been put forward for other EU accession candidates, e.g. by Mundell 1998, Gros 1999, CEPS 1999 (for a similar plan for Argentina see Hanke and Schuler 1999; for a cautionary comment on such proposals see Daviddi 1999). Bratkowski and Rostowski (2000) recommend an early official replacement of the Polish zloty by Euro.

3. Advantages of Euro-isation.

By and large the prevailing view, both in economic literature and in policy circles, is that Euro-isation has immediate, and dominant, positive net advantages, especially in transition countries where government institutions lack the credibility and track record needed to successfully adopt alternative exchange rate regimes and the monetary policies necessary to back them.

An argument for dollar- or Euro-isation is the national governments' ability to overcome their inability otherwise to borrow internationally in their domestic currency (Hausmann, 1999, 2000). Euro-/dollar-isation also avoids both the volatility and inflationary bias of floating rates, and the vulnerability to speculative crises of fixed rates that are not irrevocably fixed (see Mundell 2000). Even successful regimes of fixed exchange rate can be made vulnerable by their own success, as they attract capital inflows which lead to real revaluation undermining competitiveness; at some point those flows can be easily, suddenly and massively reversed. Irrevocably fixed rates, unlike pegs subject to intermittent adjustments, do not encourage speculation – as demonstrated by the experience of EMU members since May 1998 as opposed to the September 1992 ERM crisis and its abandonment by the UK and Italy (a difference neglected by Larrain and Sachs, 1999, in their feeble rehearsal of arguments against dollarisation).

In addition, the benefits of Euro-isation, as in the case of monetary unification, are:

- lower transaction costs, precisely as for the EMU members;
- greater economic integration, through both greater trade and greater foreign direct investment, especially if Euro-isation is accompanied by mutual trade liberalisation or possibly a free trade area without the considerable restrictions still impeding trade with present European Associates candidates for accession (see section 9 below);
- probably lower basic interest rates in comparable units than otherwise would be the case (though interest rates are invariably higher than in the reference country, for they are subject to risk premia for any individual country or borrower), in the case of a Currency Board; maybe even lower interest rates for domestic currency replacement by actual Euros.

Finally, Euro-isation would involve automatic, self-regulating adjustments in money supply, which in both cases – Currency Board and currency replacement – would be determined by trends in domestically held foreign assets, expanding for a balance of payments surplus and contracting at times of deficits, as it is supposed to happen under a gold standard.

Unlike partial, unofficial Euro- or dollar-isation, total and official currency replacement would not complicate the choice of intermediate targets of monetary policy by introducing a dual currency component in the money supply, and would not impress the shocks of exchange rate adjustments on producers and financial institutions.

Initially, Euro-isation might be accompanied by a degree of under-valuation of the old currency with respect to the Euro; this weakness may be compounded by an initial weakness of the Euro with respect to other hard currencies (as in 1999-2000). Under-valuation might be a blessing in disguise for the viewpoint of competitiveness and employment (though not for inflation; see below).

4. Possible disadvantages: differences from EMU membership

While it is perfectly possible that Euro-isation forms should yield the expected net advantages, this should not be by any means a foregone conclusion. It is not just a question of a possible rejection of Euro-isation on grounds of national pride, with countries temporarily or permanently excluded from EMU hanging on to a domestic currency as a symbol of national sovereignty. *Whether forms of Euro-isation can be successful is an empirical question, depending on the relative strength of accompanying disadvantages.* In fact the local adoption of the Euro as domestic currency – whether as a banknote or as a backing for domestic banknotes – is not at all the same thing as being a member of EMU.

There are distinct disadvantages associated with the operation of a Currency Board with respect to EMU Membership (see Nuti et al., 1995, 1997).

- I) A Currency Board regime needs initial endowment with sufficient foreign exchange reserves to back the entire currency in circulation (whether new or unchanged) at the permanently fixed exchange rate pre-selected by the government. Estonia benefited from the return of 11 tonnes of gold which had been sent to the West before 1940; Lithuania also benefited from the return of 6 tonnes of gold as well as purchases from the IMF (OECD 2000). Other countries might be less fortunate: Bratkowski and Rostowski claim that Poland (with US\$ 26bn, i.e. twice the reserves necessary to back or replace the domestic

currency), the Czech Republic and Slovenia certainly could afford Euro-isation, while Slovakia and Hungary are classed as “possible”.

Gros (1999) suggests that the resources necessary to introduce a Currency Board (which he estimates at \$269mn for the Former Yugoslav republics, probably an under-estimate) could be borrowed, but this would undermine credibility and lead to expectations that the exchange rate would not be permanent but would only last as long as the loan would last and be renewed. The arrangement would be indistinguishable from an ordinary fixed exchange rate regime subject to occasional adjustments. Instead reserves must be instantly and permanently available against possible requests for conversion, therefore a Currency Board cannot be run on borrowed money – unless, as in Bulgaria, finance is being provided only partly by Bretton Woods institutions, and on a long term basis, in which case foreign lending amounts to assistance and really might as well take the form not of a loan but a gift.

- II) Loss of seigniorage – the revenue obtained from issuing domestic currency. Such loss is sometimes under-estimated (for instance Bratkowski and Rostowski, 2000, neglect the loss of likely *increases* in seigniorage after shedding the domestic currency) but it can also be over-played (e.g. by Larrain and Sachs 1999). In the Currency Board case this loss could be offset at least partly by interest earned on reserves. Also, seigniorage sharing arrangement could be agreed with the ECB (Calvo 1999, Daviddi 1999); such an arrangement is contemplated for dollarised countries by the International Monetary Stability Act of 2000, introduced in the US Senate by the Chairman of the Joint Economic Committee Senator Connie Mack. According to Larry Summers “In the long term, finding ways of bribing people to dollarise, or at least give back the extra currency that is earned when dollarisation takes place, ought to be an international priority ...” (Quoted in US-Senate Joint Economic Committee, 1999): the same argument would apply to Euro-isation.

- III) Lack of a lender of last resort, which would involve a considerable degree of financial fragility, particularly serious in the early stages of transition. The International Monetary Stability Act cited above specifically states that “The Federal Reserve System has no obligation to act as a lender of last resort to the financial systems of dollarised countries” (Section 2.b). The mythical advantage

of a Currency Board is that the domestic currency is “fully backed” by foreign exchange (e.g. see *The Economist* 29-1-2000). Thus the Board could only lend as a last resort only any excess reserves it might have over and above what is required to back the domestic currency; such reserves would be substantial in Poland but nowhere else in the area.

Unfortunately all that is backed up by foreign exchange is primary money, i.e. M0, whereas in a currency crisis there is absolutely nothing to prevent the public from wishing to convert into foreign exchange more than M0, up to their entire liquid assets, i.e. anything up to M2. In this case limits would have to be introduced – whether *de facto* or *de jure* – on the convertibility of bank money into cash, thus re-instating a monetary segmentation which was one of the typical features of the old-style centrally planned economy. In a “normal” monetary economy this occurrence is prevented – short of a total melt-down – by the national Central Bank acting as a lender of last resort, in principle standing-by to provide unlimited liquidity at a penal interest rate against good quality securities.

It follows that *either* the country has an arrangement for the ECB *to act as* lender of last resort – which would expose ECB and ultimately the Euro to an intolerable risk for countries not constrained to Maastricht Treaty parameters of fiscal and monetary convergence - *or* the ECB *does not act* as lender of last resort in the Euro-ised country, in which case its financial system will be particularly fragile, and a financial crisis would take the form of a premium for DM/Euro cash over DM/Euro bank money. Stand-by arrangements by private banks taking on a lender of last resort function (Calvo, 1999) may have limited effect. Banks could be bankrupted as a result, not for straight insolvency, which might be regarded as a necessary and even desirable development, but for sheer illiquidity artificially created by the Currency Board rules of monetary issue. The problem would be aggravated by the fact that the ECB could not take on any responsibility for the supervision of financial institutions in Euro-ised countries (a provision to that effect is included in the US International Monetary Stability Act for the Federal Reserve System).

- IV) Impossibility of eliminating entirely the risk of a parity change – whether under a Currency Board regime or even currency replacement (Larrain and Sachs 1999 regard this as irreversible, while Bratkowski and Rostowski 2000 contemplate the a possible reversal). By linking its domestic currency to a more credible currency a government – contrary to what is widely believed – cannot acquire the other currency’s credibility; government policy credibility will be the product of its own and the other currency’s credibility (in other words, the strength of a chain cannot be greater than that of its weakest link). Currency replacement, say, with DMs might give rise to a DM scarcity unless interest rates were raised (or aggregate demand otherwise lowered) enough to match demand for and supply of cash.
- V) The transformation of current account deficits arising in a domestic currency at the risk of currency crises into regional under-development risks in a single currency area, especially without the provisions for transfers from the EU budgets which would only benefit EU members. Bratkowski and Rostowski (2000) see the rise of current account deficits as the inevitable consequence of consumption-smoothing in countries experiencing or expecting growth acceleration, and regard the elimination of currency crises risk as a major benefit of Euro-isation. Even if this benefit was so obtained, it would be matched by the risk of regional under-development instead, which may be potentially more difficult to deal with, and span over a longer run, than a temporary currency crisis.

5. Possible disadvantages: unsuitability of any peg to the Euro

In addition to the disadvantages due to Euro-isation falling short of full EMU Membership, there is the possible unsuitability of the Euro as a pegging currency *in any form*. Namely:

- I) The Euro may not be the preferred currency in the country’s invoicing practices in foreign trade. Settlement practices are often regarded as relevant but they are immaterial. For instance, Helmut Aancans, head of monetary policy at the Latvian central bank, is quoted as saying that “Our structure of settlement

currencies reflects the SDR basket ... When the euro goes down the dollar goes up and there is no net instability” (FT 16 February 2000). But such stability only obtains if the SDR is the currency in which contracts are denominated. The Lithuanian Lita, pegged to the US dollar, has appreciated instead in real terms with respect to other currencies used in its pricing and invoicing, thus incurring a large scale current account deficit. “Trade in Euros is not as big as trade in dollars” (Lithuanian CB deputy governor Arvidas Krejzde, FT 16/2/00), but 40% of their foreign trade is with the EU and appreciation is therefore a non-negligible problem.

- II) Moreover, a number of countries have raised a very large part of their external debt in US dollar: in 1997 the share of dollar-denominated external debt was 77.9% in the Czech Republic, 75.1% in Bulgaria, 61.6% in Lithuania, 46% in Poland, against DM shares respectively of 4.7%, 4.7%, 6.2%, 9.9%, (Deutsche Bank Research, 2000). For such countries any Euro devaluation with respect to the dollar, such as it has occurred in the first eighteen months of Euro’s life in 1999-2000, would raise the domestic burden of foreign debt service; a significant re-denomination of external debt would have to accompany their Euro-isation.

- III) Inflationary implications of *any* fixed peg to the Euro (i.e. even short of a Currency Board) to the long term real exchange rate revaluation which has been observed and can be expected in all transition economies. Real revaluation is usually associated with the so-called Harrod-Balassa-Samuelson effect, of faster productivity in tradables driving up wages and prices in non-tradables, but this effect can easily be overplayed: after all, tradables are both inputs in non-tradable goods, and substitutes for non-tradables. Regardless of this effect, or in addition to it, *any* exchange rate (whether fixed or floating) at which convertibility is introduced in inflationary and troubled times is bound to be undervalued in real terms. For a fixed nominal exchange rate, real revaluation can only be achieved through a positive inflationary differential with respect to the peg currency. Far from aiding the control of inflation, in such circumstances a fixed exchange rate regime can turn into an inexorable inflationary machine. The necessary real revaluation could be only be achieved without inflation through a nominal revaluation.

Of course a real revaluation can be inconsistent with the parallel commitments to price stability and nominal exchange rate stability within the bounds of the Maastricht criteria, and unilateral Euro-isation can be seen (Bratkowski and Rostowski, 2000) as a way to evade those bounds. However the very broad fluctuation margins envisaged by ERM II (+/- 15%) and the applicability of the Maastricht inflation limits only in the run up to EMU membership – for just one year before examination – should still leave large enough scope to accommodate the necessary real revaluation without violating the Maastricht criteria for price and nominal exchange rate stability.

- IV) More generally, unsuitability of the monetary policy pursued by the ECB to the fundamentals of the countries undertaking Euro-isation. Apart from providing liquidity to Euro-ised countries against foreign exchange, the ECB would have no obligation to consider their particular needs; just as, in the International Monetary Stability Act quoted above, it is stated that “the Federal Reserve System has no obligation to consider the economic conditions of dollarised countries when formulating or implementing monetary policy” (Section 2.b). De Grauwe and Aksoy (1997, see also De Grauwe and Lavra 1997) investigate whether Central European countries are part of a European optimum currency area (as theorised by Mundell in his classic 1961 article) and conclude that they are not.

Of course the stabilisation needs of transition economies may not leave much margin for an independent monetary policy, which is totally lost for any fixed exchange rate regime, but the instant abatement of inflation may not necessarily be the best policy, as confirmed by the dominant success of the Polish economy which for all the talk of shock therapy has been dis-inflated at an excruciatingly gradual rate. Moreover, all central eastern European transition economy are facing extremely challenging issues of social welfare reform, on a greater scale than the rest of Europe (see Nuti et al., 2000). Before worrying about convergence, many transition regions such as Serbia or Kosovo would have to worry about reconstruction (IMF and World Bank, 1999). Also, the experience of Bosnia, where the DM continues to circulate as a parallel currency (though to a rapidly diminishing extent), shows that even the adoption of a Currency Board can be ineffective unless it is preceded by extensive economic and political

reforms.

All the arguments in this section make a case not against unilateral Euro-isation per se but, more generally, against early membership of EMU. However, seeing that the main, indeed the only point of unilateral Euro-isation is that of replicating the effects of joining EMU earlier than otherwise possible, these are also arguments against unilateral Euro-isation.

6. Costs and benefits for ECB and the EMU Members

Euro-isation of countries outside EMU would also involve advantages and disadvantages for the ECB and for EMU members (on the mutual impact of EU and transition economies, see Nuti 1994, 1996b). The main advantage would be seigniorage, net of the possible net cost of ECB sterilisation of the Currency Board country's Euro bonds and deposits if their effects on Euro monetary expansion are judged to be excessive. An additional advantage would be avoiding the complications generated by the growth in ECB governing council's membership following EMU enlargement (which otherwise would require complex solutions such as the drawing of constituencies, rotation, or outright exclusions). The main disadvantage would be the risk of a monetary expansion in the Currency Board country generated by its accumulation of non-Euro assets, if it was sufficiently threatening to induce some loss of ECB control over the monetary mass of Euros and Euro-substitutes; in view of the small size of the accession economies, however, this is a remote possibility.

Euro-isation in the strict sense of currency replacement would have similar implications for the Euro-ised country, except that its introduction would probably be partial and spontaneous at the end of a hyper-inflation process, its legalisation the only form of necessary administrative sanction; loss of seigniorage (unless it was shared out by the ECB) would be unmitigated; all the other drawbacks of a Currency Board would apply. For the ECB and the EMU-area, the risk of monetary expansion originating outside would be much less likely for outright currency replacement than in the Currency Board case, because the ECB would retain control over primary Euro-supply.

7. Convergence?

A great deal of attention has been given both to financial and monetary convergence as represented by the Maastricht criteria (table 1), and to the progress of systemic transition as exemplified by the EBRD scoreboard in the Transition Reports of 1994-1999 (table 2). On both counts the picture is encouraging, at least for the front-runners lined up for accession, but also very misleading. The share of government deficit and debt in GDP are below or near the Maastricht parameters; inflation and interest rates are much higher but still within striking distance in most cases; the transition progress recorded by the EBRD, especially in privatisation and foreign trade, is impressive. But Maastricht criteria ignore essential and worrying features of transition economies such as quasi-fiscal deficits and debt, due to public contingent commitments, extra-budgetary funds, hidden subsidies; they also ignore non-performing loans in the balance sheets of state banks, or the low share of credit to the private sector, the low capitalisation and/or low liquidity of financial markets throughout transition economies, as well as the extraordinary volatility of their rates of return (see EBRD, 2000). Once quasi-fiscal items are taken into account, even seemingly virtuous candidates such as the Czech Republic lose much of their attraction (see Drabek, 2000). The share of credit to the private sector appears to be inversely related to the share of bad loans (EBRD, 1997). Transition economies seem to have either low market capitalisation or low ratio of value traded to market capitalisation (i.e. illiquidity) of their stock markets – e.g. respectively 2.6 and 36.3 per cent of GDP in Romania, 39.7 and 3.9 per cent in Russia – or both, e.g. 5.8 and 7.6 per cent in Bulgaria and 6.2 and 11.6 per cent in Latvia (EBRD, 2000).

The EBRD indicators suffer from an over-optimistic bias, not least because of the adoption of scores ranging from 1 to 4+ instead of starting from zero, which therefore credit even transition non-starters with an achievement of over 20% of the road to a full-fledged market economy (see Nuti, 2000b). They also neglect any notion of minimum requisites for a country to operate as a market economy, or of possible weights to be attached to their different indicators, or of the relative difficulty of making progress at different points of their scores and in different fields. *Real* convergence of transition economies – apart from their almost instant convergence to EU unemployment average and variance, not requested by any treaty but promptly achieved already in the early 1990s – appears to be a much slower and more protracted process than anticipated (see Kolodko, 2000; see also Salvatore, 2000).

These considerations invite greater caution in assessing the progress of new members' convergence to single European Union standard – and therefore in evaluating the net advantages to be obtained from both their membership of the EMU and from possible EMU membership surrogates.

8. Improved trade access versus monetary integration

The primary purpose of monetary integration, and of Euro-isation as its earlier substitute, is that of promoting the economic integration of central-eastern European countries with the EU. This purpose could be achieved, to a much greater extent than it is being achieved under current arrangements, simply by the EU unilaterally removing or at any rate reducing residual trade barriers with those countries, such as those of CAP, quotas for lower duty trade as in textiles, impositions of “voluntary” as in the case of steel, anti-dumping provisions, and other measures of contingent protection in case of “injury” or “likely injury” to national producers. The European Association Agreements signed with all accession candidates envisaged the creation of a free trade area in ten years, in two stages, with the immediate removal of quantitative restrictions and the gradual abatement of import tariffs at a faster rate (but from a higher level) in the EU, but the process – speeded up by only six months after the momentous Copenhagen summit that paved the way to eastern enlargement – is still incomplete and residual barriers, though falling, are still a significant impediment to trade. Meanwhile European Union members have turned their trade balance with the ten accession candidates from a deficit of ECU 2bn in 1989 to a steadily increasing surplus up to over ECU 21bn in 1998.

The EU surplus occurs with every single one of the ten countries; it originates primarily in manufacturing products, especially for investment and intermediate goods, but it arises even for food and beverages – with the exception of Hungary – and for labour intensive products – with the exception of the Czech Republic, Romania and to a smaller extent Bulgaria (see Smith, 2000).

In these circumstances there is no justification for the European Union to resist by means of artificial barriers a higher volume of imports from central-eastern European countries – whether or not they are accession candidates. The relative impact of EU trade opening on these countries can be gauged by reference to the well known asymmetry in the importance of mutual trade turnover, amounting to 3-4% of total trade for the EU and around 60% for central-eastern Europe. Greater trade access granted by the EU could be matched by parallel, automatic or conditional reduction of remaining barriers to EU exports in central-eastern European countries, such as import surcharges and other, mostly retaliatory restrictions. Greater central-eastern European net exports would not only speed up real convergence but also alleviate social problems and – last but not least – presumably reduce labour migration pressures to the EU.

The two ways to intensify economic integration – monetary unification or Euro-isation, and the removal of residual trade barriers – are not at all in conflict with each other, and could be pursued simultaneously, mutually enhancing their effectiveness. Indeed, they could be pursued and implemented *even before accession*. It is simply inappropriate – for the EU and accession candidates alike – to place almost exclusive emphasis on enlargement and monetary unification neglecting at the same time the existing, immediate opportunities for deeper and faster trade integration.

9. Conclusions

To a visitor from outer space the arrangements of the present EMU-area and those of the wider Euro-area enlarged to include strict Euro-isation and/or Euro-backed local currency would be absolutely indistinguishable. But there would be an immensely important difference, in the different role of the ECB, which in a strictly Euro-ised country would not act as a central bank. Namely, the ECB would not a lender of last resort; it would act – by definition – as an institute of issue but would not have any responsibility towards a Euro-ised non-EMU-member country in deciding its monetary or exchange rate policy.

Ultimately the net balance of costs and benefits, both for the Euro-ised country and for Euroland and its members, is an empirical question depending on the degree of monetary, real, and institutional convergence already achieved before Euro-isation and its subsequent progress; initial endowment of currency reserves; initial currency of choice for invoicing and payment practices in foreign trade; the size and denomination of foreign debt; the already existing degree of utilisation of foreign exchange in the domestic economy; international credibility of domestic monetary institutions; the degree of co-operation between domestic and European institutions, both political and monetary.

Current trends in financial and monetary convergence, and even more so in institutional and real convergence, are probably over-optimistically evaluated by observers and officials. *Positive net advantages may well derive from Euro-isation but should not be taken for granted. Meanwhile, the unexploited potential for greater economic integration through greater trade access to EU markets should not be neglected.*

REFERENCES

BACKE' Peter, "Exchange rate regimes in central and eastern Europe", Focus on Transition, 2, Osterreichische Nationalbank 1999

BEKX Peter, The implications of the introduction of the Euro for non-EU countries, DGII, EURO PAPERS no. 26, July 1998.

BERG Andrew and Eduardo BORENSZTIEN (2000), The Pros and Cons of Full Dollarisation, IMF Working Paper, WP/00/50.

BLEJER Mario I. and Marko SKREB (1999), Balance of Payments, Exchange Rates, and Competitiveness in Transition Economies, Kluwer Academic Publishers, Boston/Dortrecht/London.

BRATKOWSKI Andrzej and Jacek ROSTOWSKI (2000), "Unilateral adoption of the Euro by EU applicant countries: the macroeconomic aspects", 6-th Dubrovnik Conference, 29-30 June.

CALVO, Guillermo (1999), On dollarisation, University of Maryland, www.bsos.umd.edu/econ/ciecalvo.htm.

CEPS (1999), "A system for post-war South-East Europe", Working Document No. 131, Brussels.

DAVIDDI Renzo (1999), "'Hyper-fix' exchange rate regimes and transition", DG-II, European Commission, Brussels.

DE GRAUWE Paul and V. LAVRA (Eds, 1997), Inclusion of central European countries in the European Monetary Union, Leuven.

DE GRAUWE Paul and Y. AKSOY (1997), Are Central European countries part of the European Optimum Currency Area?, Ljubljana.

DRABEK Zdenek (2000), "Are even balanced budget sustainable", ASSA Conference Paper, Boston, January.

EBRD-European Bank for Reconstruction and Development (1994-1999), Transition Report, yearly issues, London.

EBRD (2000), Transition Report Update, London, May.

Economist (The), "The ECB heads for turbulence", 29 January 2000, pp. 106-7.

FEIGE Edgar L., M. FAULEND, V. SONJE and V. SOSIC, "Unofficial dollarisation and currency substitution revisited", 6-th Dubrovnik Conference, 29-30 June 2000.

Financial Times (The), "Baltic states knock on gates of euro-zone", 16 February 2000.

GROS Daniel (1999) An Economic System for Post War South East Europe, companion paper of CEPS WD No. 131, Brussels.

HANKE Steve and Kurt SCHULER (1999), "A dollarisation Blueprint for Argentina", Foreign Policy Briefing, CATO Journal, No 52.

International Monetary Fund (1999), "Monetary policy in dollarised economies", Occasional Paper n. 171, Washington.

HOUSMANN Ricardo (1999), "Should there be Five Currencies or One Hundred and Five", Foreign Policy, Fall.

HOUSMANN Ricardo, Ugo PANIZZA and Ernesto STEIN (2000), "Why do countries float the way they float?", Inter-American Development Bank-BID, Working Paper #418, Washington, May.

International Monetary Fund and World Bank (1999), "The economic consequences of the Kosovo crisis", Washington.

KOLODKO Grzegorz W. (2000), "Globalisation and catching-up: From recession to growth in transition economies", IMF Working Paper n. 100, Washington.

KORHONEN Iikka (1996), "Dollarisation in Lithuania", Review of Economies in Transition 5/96, Bank of Finland, Helsinki.

KORHONEN Iikka (1999) "Some implications of EU membership on Baltic monetary and exchange rate policies. BOFIT Online 6/99; forthcoming as Working Paper of Robert Schuman Centre, European University Institute, Florence.

KORHONEN Iikka (2000), "Currency Boards in the Baltic countries: What have we learned?", Post-Communist Economies, Vol. 12, n. 1, March.

LARRAIN Felipe and Jeffrey SACHS, (1999), "Why Dollarisation is More Straightjacket than Salvation", Foreign Policy, Fall.

LAVRA V. (1997), Exchange rate policies of central European countries in the context of European Monetary Integration, Ljubljana.

MUNDELL Robert A. (1961), "A Theory of Optimum Currency Areas", The American Economic Review, LI, n.4, November, pp. 509-517.

MUNDELL Robert A. (1998), "Exchange rate arrangements in transition economies", Dubrovnik Conference Paper June 1998, in Blejer and Skreb, 1999, pp. 95-130.

MUNDELL Robert A. (2000), "Currency Areas, Volatility and Intervention", forthcoming in the Journal of Economic Modeling, 2000.

NUTI D. M. (1994), "The impact of systemic transition on the European Community", in S. Martin (Ed.), The Construction of Europe, Dordrecht, 1994.

NUTI D.M. (1996a), "Inflation, interest and exchange rates in the transition", The Economics of Transition, vol. 4(1).

NUTI D.M. (1996b), "European Community response to the Transition: Aid, Trade Access, Enlargement", The Economics of Transition, vol. 4(2).

NUTI D. M. (2000a), "The Polish Zloty 1990-1999: Success and Under-performance", American Economic Review, Papers and Proceedings, May

NUTI D.M. (2000b), "On the over-optimistic bias of EBRD indicators of Transition Progress", Seminar Paper, ESRC, 7 June, LBS

NUTI D.M. (with John Eatwell, Michael Ellman, Mats Karlsson and Judith Shapiro, 1995), *Transformation and Integration: Shaping the future of central eastern Europe*, IPPR, London.

NUTI D.M. (with John Eatwell, Michael Ellman, Mats Karlsson and Judith Shapiro, 1997), *Not 'Just Another Accession' - Political economy of EU Enlargement to the East*, IPPR, London.

NUTI D.M. (with John Eatwell, Michael Ellman, Mats Karlsson and Judith Shapiro, 2000), *Hard Choices, Soft States: social welfare policy in the transition*, IPPR, London.

OECD, Baltic States: A regional economic assessment, Economic Surveys, Feb.2000.
ROUSSENOVA Lena (1997), The Bulgarian Currency Board, World Bank, Sofia.

SALVATORE Dominick (2000), "Narrowing the structural gap in Transition Economies", Conference Paper, Austrian Ministry of the Economy, Vienna, June 2000.

SEITZ F. (1995), "The circulation of Deutsche Mark Abroad, Discussion Paper 1/95, Deutsche Bundesbank, Economic Research Group.

SMITH Alan (2000), *Return to Europe*, Cambridge University Press.

TEMPRANO-ARROYO Heliodoro and Robert A. FELDMAN (1999), "Selected transition and Mediterranean countries: an institutional primer on EMU and EU accession", *Economics of Transition*, Vol. 7(3), pp. 741-806.

US-Senate Joint Economic Committee (1999), *Encouraging Official Dollarisation in Emerging Markets*, Washington, April.

Table 1. EMU Convergence Criteria: Central and East European accession candidates in comparison (January 2000).

	Inflation rate, % p.a.			Gvt. Balance, % of GDP			Gvt. Debt, % of GDP			Long-term interest rates	Exchange rate regime
	1997	1998 ¹⁾	1999 ²⁾	1997	1998 ¹⁾	1999 ²⁾	1996	1997	1998 ¹⁾	on government bonds	1 January 2000
Ref. Value	2.7	2.1	2.0	-3.0	-3.0	-3.0	60.0	60.0	60.0	6.77 (10Y)	ERM II
BG	1,082	22.3	2.0	-3.0	1.0	n.a.	n.a	n.a	n.a	n.a	Currency Board (EUR)
CZ	8.5	10.7	2.5	-1.2	-1.5	-3.8	9.9	10.3	10.7	7.01 (5Y)	Flexible
EE	11.2	8.2	3.3	2.2	-0.3	-3.0	6.9	5.6	4.6	n.a	Currency Board (EUR)
HU	18.3	14.3	9.0	-4.5	-4.8	-4.3	71.5	62.9	59.8	9.17 (10Y)	Peg (EUR)
LT	8.9	5.1	1.6	-1.8	-5.8	-7.0	n.a	n.a	n.a	n.a	Currency Board (EUR)
LV	8.4	4.7	2.2	0.1	-0.8	-3.8	n.a	n.a	n.a	n.a	Peg (SDR)
PL	14.9	11.8	7.0	-1.3	-1.2	-3.0	51.1	46.3	41.0	10.15 (10Y)	Peg (EUR/USD basket)
RO	154.8	59.2	45.0	-3.6	-3.1	-5.0	24.3	26.1	26.4	n.a	Flexible
SI	8.4	8.0	7.5	-1.7	-1.4	-1.0	23.2	23.5	24.0	n.a	Flexible
SK	6.1	6.7	10.6	-4.4	-5.8	-3.2	n.a.	n.a	n.a.	n.a.	Flexible

n.a. = not available

1) Expected

2) Forecast

Sources: EBRD, DBR.

From: Deutsche Bank Research, Euro Watch n. 82, February 2000.

Table 2. Progress in transition in Central and Eastern Europe, the Baltic states and the CIS

	Private sector share in % of GDP, mid-1999 (EBRD estimate) *	Enterprises			Markets and trade			Financial institutions	
		Large-scale privatisation	Small-scale privatisation	Governance & enterprise restructuring	Price liberalisation	Trade & foreign exchange system	Competition policy	Banking reform & interest rate liberalisation	Securities markets & non-bank financial institutions
Albania	75	2	4	2	3	4	2	2	2-
Armenia	60	3	3+	2	3	4	2	2+	2
Azerbaijan	45	2-	3	2	3	3+	1	2	2-
Belarus	20	1	2	1	2-	1	2	1	2
Bosnia & Herzegovina	35	2	2	2-	3	3-	1	2+	1
Bulgaria	60	3	3+	2+	3	4+	2	3-	2
Croatia	60	3	4+	3-	3	4	2	3	2+
Czech Republic	80	4	4+	3	3	4+	3	3+	3
Estonia	75	4	4+	3	3	4	3-	4-	3
FYR Macedonia	55	3	4	2	3	4	1	3	2-
Georgia	60	3+	4	2	3	4	2	2+	1
Hungary	80	4	4+	3+	3+	4+	3	4	3+
Kazakhstan	55	3	4	2	3	3	2	2+	2
Kyrgyzstan	60	3	4	2	3	4	2	2+	2
Latvia	65	3	4	3-	3	4+	3-	3	2+
Lithuania	70	3	4+	3-	3	4	2+	3	3-
Moldova	45	3	3+	2	3	4	2	2+	2
Poland	65	3+	4+	3	3+	4+	3	3+	3+
Romania	60	3-	4-	2	3	4	2	3-	2
Russian Federation	70	3+	4	2-	3-	2+	2+	2-	2-
Slovak Republic	75	4	4+	3	3	4+	3	3-	2+
Slovenia	55	3+	4+	3-	3	4+	2	3+	3
Tajikistan	30	2+	3	2-	3	3-	1	1	1
Turkmenistan	25	2-	2	2-	2	1	1	1	1
Ukraine	55	2+	3+	2	3	3	2	2	2
Uzbekistan	45	3-	3	2	2	1	2	2-	2

The "private sector shares" of GDP represent rough EBRD estimates, based on available statistics from both official (government) sources and unofficial sources. The underlying concept of private sector value added includes income generated by the activity of private registered companies as well as by private entities engaged in informal activity in those cases where reliable information on informal activity is available. Here the term "private companies" refers to all enterprises in which a majority of the shares are owned by private individuals or entities. The roughness of the EBRD estimates reflects data limitations, particularly with respect to the scale of informal activity. The EBRD estimates may in some cases differ markedly from available data from official sources on the contribution to GDP made by the "private sector" or by the "non-state sector". This is in most cases because the definition of the EBRD concept differs from that of the official estimates. Specifically for the CIS countries, official data in most cases refer to value added in the "non-state sector", a broad concept which incorporates collective farms as well as companies in which only a minority stake has been privatised. *From EBRD Transition Report 1999, November, London.*

Large-scale privatisation

- 1 Little private ownership.
- 2 Comprehensive scheme almost ready for implementation; some sales completed.
- 3 More than 25 per cent of large-scale enterprise assets in private hands or in the process of being privatised (with the process having reached a stage at which the state has effectively ceded its ownership rights), but possibly with major unresolved issues regarding corporate governance.
- 4 More than 50 per cent of state-owned enterprise and farm assets in private ownership and significant progress on corporate governance of these enterprises.

Small-scale privatisation

- 2 Substantial share privatised.
- 3 Nearly comprehensive programme implemented.
- 4 Complete privatisation of small companies with tradable ownership rights.
- 4+ Standards and performance typical of advanced industrial economies: no state ownership of small enterprises; effective tradability of land.

Governance & enterprise restructuring

- 1 Soft budget constraints (lax credit and subsidy policies weakening financial discipline at the enterprise level); few other reforms to promote corporate governance.
- 2 Moderately tight credit and subsidy policy but weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate governance.
- 3 Significant and sustained actions to harden budget constraints and to promote corporate governance effectively (e.g. through privatisation combined with tight credit and subsidy policies and/or enforcement of bankruptcy legislation).

Price liberalisation

- 2 Price controls for several important product categories, state procurement at non-market prices remains substantial.
- 3 Substantial progress on price liberalisation: state procurement at non-market prices largely phased out.

Trade & foreign exchange system

- 1 Widespread import and/or export controls or very limited legitimate access to foreign exchange.
- 2 Some liberalisation of import and/or export controls; almost full current account convertibility in principle but with a foreign exchange regime that is not fully transparent (possibly with multiple exchange rates).
- 3 Removal of almost all quantitative and administrative import and export restrictions; almost full current account convertibility.
- 4 Removal of all quantitative and administrative import and export restrictions (apart from agriculture) and all significant export tariffs; insignificant direct involvement in exports and imports by ministries and state-owned trading companies; no major non-uniformity of custom duties for non-agricultural goods and services; full current account convertibility.
- 4+ Standards and performance norms of advanced industrial economies: removal of most tariff barriers; WTO membership.

Competition policy

- 1 No competition legislation or institutions.
- 2 Competition policy legislation and institutions set up; some reduction of entry restrictions or enforcement action on dominant firms.
- 3 Some enforcement actions to reduce abuse of market power and to promote a competitive environment, including break-ups of dominant conglomerates; substantial reduction of entry restrictions.

Banking reform & interest rate liberalisation

- 1 Little progress beyond establishment of a two-tier system.
- 2 Significant liberalisation of interest rates and credit allocation; limited use of direct credit or interest rate liberalisation ceilings.
- 3 Substantial progress in establishment of bank solvency and of a framework for prudential supervision and regulation; full interest rate liberalisation with little preferential access to cheap refinancing; significant lending to private enterprises and significant presence of private banks.
- 4 Significant movement of banking laws and regulation towards BIS standards; well-functioning banking competition and effective prudential supervision; significant term lending to private enterprises; substantial financial deepening.

Securities markets & non-bank financial institutions

- 1 Little progress.
- 2 Formation of securities exchanges, market-makers and brokers; some trading in government paper and/or securities; rudimentary legal and regulatory framework for the issuance and trading of securities.
- 3 Substantial issuance of securities by private enterprises; establishment of independent share registries, secure clearance and settlement procedures, and some protection of minority shareholders; emergence of non-bank financial institutions (e.g. investment funds, private insurance and pension funds, leasing companies) and associated regulatory framework.