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One Euro from the Atlantic to the Urals?

Daniel Gros*

The EU has started accession negotiations with 10 countries in Central and Eastern Europe (CEE). Moreover, a number of other countries, mostly from the area of the Former Republic of Yugoslavia, but also including Turkey, have also been recognised as having a "European vocation". It is thus likely that practically the whole of Central and Eastern Europe will soon have a concrete perspective of EU membership and thus, eventually, also of participation in the eurozone.

To become member of the EU does, of course, not imply immediate EMU memberhip. On the contrary, the official doctrine on the path to EMU is: "First join the EU, then converge towards the Maastricht criteria, then join the ECB". This is the way the initial group of countries had to go. This doctrine might still be useful if one thinks about full participation in the eurozone, which implies that the country concerned will have a seat on the Board of the ECB and can thus influence the policy of the eurosystem. However, in an environment characterised by the constant threat of currency crisis and unstable capital flows, a different approach might be needed for Central and Eastern Europe. Moreover, the euro might also become the anchor for countries that are not candidates for EU membership. The purpose of this contribution is thus to discuss the stabilising role the euro could play in the larger Europe from the Atlantic to the Urals. The main thesis is that a single currency euro zone from the Atlantic to the Urals should not be looked as a distant perspective, but a concrete possibility for this first decade of the new millennium.

There is an alternative approach to the official path to EMU membership

Who would benefit from the euro?

In thinking about the optimal exchange rate regime for Central and Eastern European three groups of countries should be distinguished, according to their relative strength:

1. Fiscally and institutionally very strong countries with Maastricht-conforming policies;
2. countries that are not yet at the Maastricht level, but have the necessary institutions and are heading in that direction;
3. countries in states of acute financial crisis, with very weak institutions.

1) The very strong countries, i.e. countries that could become members of the EU at any time and that fulfil the Maastricht criteria most of the time (e.g. Switzerland and Estonia) gain from pegging to the euro because the EU is anyway their major trading partner. Moreover, pegging to the euro gives financial markets an anchor for longer-term expectations, thus reducing the impact of financial shocks. For these countries the classic criteria of the Optimum Currency Areas approach are close to being fulfilled as their economic structures are close to that of the EU. However, even if they have a strictly economic interest in joining the euro area, these countries can afford the luxury to wait and see. Given their strengths they can comfortably survive outside. Even for these countries, however, the step from a tight euro-peg to full euroisation is likely to bring benefits as they would thus experience considerable savings in transactions costs. This applies with particular force to the case of Estonia, which has already foregone the use of the exchange rate with its currency board, which linked the Kroon originally to the DM. As this link is not to be changed anyway, the introduction of the euro in cash form can only yield additional benefits that will be important for an economy in which exports amount to close to 100% of GDP.

2) The middling countries, with moderate inflation rates (now usually below double digit) and fiscal deficits, for example the countries of central Europe. These countries are also in an intense process of structural change whose outcome is difficult to foresee. They might therefore need some flexibility in their real exchange rate for some time.

But the cost of retaining some flexibility in the exchange rate is that this leaves open the threat of

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speculative attacks, especially given their rather large current account deficits, as the example of the Czech Republic has recently shown. However, the Czech experience also suggests that the cost of such an attack is serious, but limited, and does not result in outright catastrophe as in the case of Russia. The costs and benefits of different exchange rate regimes are thus often finely balanced and must be considered case by case. It is sometimes argued that EU membership, and later ERM membership should be a sufficient protection against speculative attacks for the new member countries from Central and Eastern Europe – and that they therefore would not need to adopt extreme measures like euroisation. The experience with the currency crises of 1992–1995 in the EU shows, however, that even countries with stable institutions, that were members of a tight ERM, can at times be buffeted severely by shocks coming from financial markets.

For the "middling" countries one can therefore conclude that they would benefit from retaining a national currency and some freedom to adjust the exchange rate if foreign exchange markets do not become a source of instability themselves. In an ideal world the exchange rate would be a policy instrument to adjust to country-specific shocks. But experience has shown that this is no longer the case when capital markets are opened. For this group of countries the key consideration might thus be the timetable for the liberalisation of capital movements.

3) The very weak cases, namely countries that are very far from fulfilling any of the requirements for EU membership in general (and the Maastricht criteria in particular). These countries usually have large fiscal deficits and high inflation, their currencies are often under pressure and real interest rates are very variable, often patently unsustainably high when the government tries to stabilise the economy. These countries would gain from being able to enter the euro-area, because that would be a way to import sensible macroeconomic policies and decisively gain the confidence of financial markets. Since the alternatives are hyperinflation and/or enormous risk premia on foreign debt, the benefits of this confidence effect and of a stable currency can far outweigh any potential costs of not being able to react to asymmetric shocks with exchange rate changes.

In countries with a weak fiscal administration seigniorage can be an important source of revenue for the government, but high inflation rates also have economic costs (and erode the real value of tax revenues). Seigniorage considerations are thus not a sufficient argument for a high inflation regime. But a credible low inflation regime cannot be created overnight by conventional means. This is why one has to resort to unconventional measures.

Another key advantage of full euroisation would be its systemic impact, in transforming the political economy inside the country and thus the chances of healthy economic growth. In some parts of Eastern Europe the banking system is still a conduit for large scale corruption and political intervention in the economy. A political class that cannot run large deficits and that cannot control the banking system will be forced to leave more room for really productive private enterprise. Supporting loss-making state enterprises, or just favouring politically well connected "business men", will become more difficult and the cost will become more apparent because it would have to go through the budget. Entrepreneurs will learn to concentrate on managing their enterprises more efficiently because that will become the main avenue for success. Political connections will count for less. Petty corruption and favouring some enterprises through tax breaks etc. will of course remain, but the sums that can be allocated this way pale in comparison with the wealth that can be controlled through the banking system and large scale inflationary finance.

Euroisation has many advantages for the weakest group of accession countries

The main argument usually advanced against euroisation (or currency boards) is that this makes it more difficult to adjust the real exchange rate. This argument is based on the observation that in well established economies nominal wages and prices are usually rigid in the sense that they are very difficult to lower. However, this argument does not apply to many of the countries in CEE. In many of them wages are not set in national agreements and can thus adjust much more easily to market conditions. Moreover, in the less stable countries in Central and Eastern Europe wages are often anyway set either explicitly or implicitly in DM. In these cases devaluation cannot achieve an improvement in competitiveness. These countries therefore risk ending up with the worst combination of unstable financial systems and rigid labour costs. Any attempt to have national monetary policies would face, at any rate, considerable problems as the DM is already playing an important role in the banking system of many countries in CEE.

There is only one concrete example of a country that has given up its currency for an extended period. This is the case of Panama. This country is usually considered to constitute a special case that could not serve as a model for countries in Central and Eastern Europe. However, the annex shows that this view is mistaken. Panama is similar in size to a number of countries in this region, and its economic structure is also not that different. Panama has used the US dollar for almost 70 years and has fared rather better in economic terms than its immediate neighbours.

How to anchor to the euro?

One way for non-EU countries to enter the euro area is to opt for a currency board, as is already being done by Bosnia, Bulgaria, Estonia and Lithuania. The first three chose the DM as the anchor and are now, in macroeconomic terms, de facto members of the euro area. A currency board can deliver the benefits of credibility with financial markets and low inflation as these examples have shown. However, as the experiences of Argentina and Hong Kong also show, even currency boards that are run very conservatively can come under attack. While the mechanism of the currency board itself is usually technically unassailable, these attacks are costly because they lead to increases in domestic interest rates which have a negative effect on demand. Defending a currency board is thus technically easy, but can have a high price in terms of unemployment. Financial markets know this and this is why a currency board is never 100% credible. This weakness of currency boards has recently prompted the Argentine government to consider plans to switch totally to the US dollar.

One way to anchor a currency is through a currency board, but the radical solution is the adoption of the euro as the domestic currency

The economic benefits of full dollarisation or euroisation are similar to those resulting from a currency board, but they are more certain. They can be reaped even by countries whose institutional and political weakness would leave doubts in the market that it could follow the rules of the game of a currency board (e.g. Russia and the Ukraine). Under a currency board regime the country still has a domestic monetary authority, which might cede to government pressure and violate the rules of the currency board, e.g. by giving credit to the government.

Therefore the radical solution of unilateral, total adoption of the euro as the domestic currency offers even more benefits, compared to the currency board, for countries with very weak institutions. The case of Argentina suggests that the idea is one of practical, not just theoretical interest. But it is not to be thought of as something more for advanced emerging markets such as Argentina. On the contrary, in the case of Central and Eastern Europe euroisation meets the objection that the national authorities would still be quite free to abandon their commitment to the monetary rule of the currency board, which in present circumstances would mean costly interest rate risk premia. Abandonment of the euro would be much more costly in political terms. Total euroisation should thus be a more credible regime.

Implementation and cost

Euroisation is also technically straightforward. The key is that the government of the country in question would just declare that at a certain date the national currency is substituted by the euro and the old national cash will be exchanged into euro notes and coins at the current market rate.

The national monetary authorities (which could anyway be abolished) would, of course, have no seat on the Governing Council of the ECB, which would thus not be affected, but it would still be preferable to have an explicit agreement on the details of euroisation. For example, there should be an undertaking to radically liberalise the domestic banking system (in particular allowing EU banks to acquire local ones) and a proper banking supervision. EU authorities, including the national central banks in the Eurosystem should be able to provide the required technical assistance.

One consequence of euroisation is that the country concerned loses its seigniorage, which would instead accrue to the ECB. This is one of the reasons why countries that are on a currency board regime hesitate to switch to the full adoption of the euro. However, in the case of countries that are candidates for membership this obstacle can and should be overcome. The most direct way to avoid a transfer of seigniorage from the rich EU to its poor future member countries in Central and Eastern Europe would be to provide the initial endowment in euro via a zero interest rate loan from the EU to the countries concerned. In this way the countries which adopt the euro do not lose

their seigniorage (their central banks can invest their present reserves or they could be used to retire public debt). The loan would have to be repaid upon accession as full member, or if the country de-links from the euro. The net cost for the EU would be zero. The debt service on the EU budget would be offset by the higher monetary income of the eurosystem.

The sums involved would anyway be modest, compared to the EU budget, and the size of the overall euro money supply. The combined mass of cash in circulation of the 10 applicants is about 20 billion euro. With a long term interest rate of about 5% this would lead to a debt service for the EU budget of about 1 billion euro, about 1% of the overall EU budget. Member countries would anyway receive a similar[1] amount in the form of their shares in the higher monetary income distributed by the Eurosystem.

What is in it for "us"?

Is there any danger for the stability of the euro? This is difficult to conceive. First of all, the Eurosystem would continue to gear its policy only towards price stability in the euro area. But could severe economic difficulties in countries that have euroised not create difficulties for the euro area as well, so that the ECB would be under strong indirect pressure to relax? The combined GDP of the 10 applicant countries is about the same as that of Sweden, or around 5% of the GDP of the euro zone. Even in the unlikely event that all of them adopt the euro – and experience difficulties because of a tight policy pursued by the ECB – it is thus difficult to see how their situation could influence significantly the stance of the Eurosystem.

It is actually more likely that countries that have euroised would prefer a tighter policy by the ECB because they are likely to grow faster than most countries in the euro zone. As their price levels converge to the EU average their measured inflation rates are also likely to be higher so that real interest rates are likely to be much lower than in the euro area. Countries that have euroised are thus likely to find themselves in a similar position as some of the current euro zone countries that are growing fast and would therefore prefer higher interest rates. To the extent that countries that have euroised exert any pressure on the ECB at all, it would probably go in the direction of a tighter policy. All this suggests that euroisation by a large part of Central and Eastern Europe cannot endanger the stability of the euro.

The real gain for Europe would be that euroisation would contribute to stabilising the part of Europe that has so far not participated in the political and economic stability European integration has brought to its Western half.

1 Not exactly zero if the interest the EU institutions pay on their borrowing is higher than the return the ECB obtains from its investments. Another complication is that all 15 governments contribute to the EU budget, but only the 11 euro area governments would receive a share of the revenues of the ECB. However, as the sums involved are minor this issue can be neglected.
While it is straightforward to account for the initial endowment of cash it is more difficult to deal with subsequent developments from an economic point of view. If a Euroised economy grows its demand for cash should also grow. Unless the EU makes further loans of its currency the country in question would have to run a balance of payments (either current account or capital account) surplus. However, the magnitudes would again be so small that this is not an important issue.

Annex

Euroisation: Any Lessons from the Panamanian Experience?2

Lessons from Panama

The main example of a country that has adopted a foreign currency is Panama. A brief review of the experience of that country is therefore instructive. Panama uses the US dollar, has no central bank and no official foreign exchange reserves (they are not needed). This arrangement has by now worked without technical problems for almost a century. The "Balboa" is mainly used for accounting purposes and exists only in the form of silver coins.

In the following we will address three key issues that arise when discussing euroisation for Southeast Europe. 1) Is Panama just an uninteresting special case? 2) Are perfect labour markets a pre-requisite for the adoption of a foreign currency? 3) Can euroisation protect against financial shocks? The answers, in short, are: no, no and yes.

1) Is Panama a useful example for Southeast Europe (SEE)?

Panama is often perceived as a special case which has no relevance for other situations. Even a superficial examination reveals, however, that in three key areas there are close parallels to the countries in SEE.

2 This section is based on information from the IMF and Moreno-Villalaz (1997).

i) *Size*. Panama has a population of about 2.7 million, larger than a number of countries in CEE. Its total GDP, around $ 9.000 million is in the same order of magnitude as that of Bulgaria.

ii) *Weakness of institutions*. Panama also resembles the countries of SEE in that is has rather weak administrative structures and democratic institutions.

iii) *Importance of transfers from abroad*. Panama is often perceived as an artificial country that lives off the canal, but has no significant economic activities of its own. But this impression is wrong. The country does have a sizeable industry. Exports of goods are at the same level, per capita, as in its larger neighbour, Colombia, and agriculture occupies a similar share of the population.

Moreover, the transit fees from the Canal make Panama actually more comparable to the accession countries in CEE for which the "euroisation" option should be considered because these countries will also receive substantial transfers from the EU. These transfers will at first increase (upon accession) and then decline, which will require substantial changes in relative prices. However, these problems are not insurmountable. Panama had to deal with large swings in the revenues from the canal, but there was never any question that the country would need a flexible exchange rate to deal with them. The importance of the revenues from the canal should also not be exaggerated. In 1998 total revenues from the canal amounted to about $ 650 million, equivalent to about 7% of GDP. The canal is not a free lunch, however; operating costs were of a similar magnitude (with about one half for labour). The (net) rent the country receives from the canal is thus probably only around 3% of GDP, which is about what the countries in CEE can expect from the EU structural funds alone. The canal is relatively more important for public finances. The Canal authorities and user charges contribute about $ 150 million to an overall budget of about $ 1.1 billion. But again, a similar effect would operate through the structural funds.

Many parallels with CEE countries

2) Are perfect labour markets a prerequisite for the adoption of a foreign currency?

It is often argued that a national currency is needed as a safety valve in case domestic price and wage pressures mount, and that such pressures arise more often in poor countries. This concern is not borne out in the case of Panama. There has been no long-term price pressure on the dollar/Balboa link. On the contrary, over the last thirty years prices have actually increased less in Panama than in the US, on average by 1.7% each year. Over the entire period (between 1967 and 1997) the US CPI increased by about 370%, whereas in Panama the increase was only 170%. There is also absolutely no indication that Panamanian labour priced itself out of the market. Unemployment in Panama hovers presently around 13%, but this compares well with other Latin American countries and is close to the experience of many countries in CEE. The data from overall employment is even more encouraging. Despite its young population, the overall employment rate (employment/population) is 33%, which is much higher than its Latin American neighbours (Colombia 15%, Guatemala 8%) and again close to the values of the countries in CEE with their much older population.

This is not to say that the labour market in Panama is perfect. On the contrary, it was actually the model for the Harris Todaro model of a dual labour market in which there are two sectors: an international and modern one and a traditional rural one. The first sector pays above-market clearing wages to reduce the incentive to shirking. (High transactions costs make it impossible to enforce contractual behaviour by labour.) The second, traditional sector absorbs surplus labour at a wage rate that is determined informally through household and other non-market activities (subsistence agriculture, small-scale commerce, etc.). In equilibrium there is substantial unemployment in cities until the cost of moving there just equals the expected wage differential (which in turn depends on the probability of finding a job, i.e. the unemployment rate). This is exactly what is likely to happen in parts of CEE. A different monetary regime does not change the fundamental reasons for this dual economic structure, which characterises many Central American countries. But the experience of Panama shows that a stable currency regime does not increase the problems that result from such a dual labour market. On the contrary, each time Panama had to face a major political or economic crisis (e.g. US embargo, oil price increase) the informal sector was able to absorb the surplus labour released by the formal sector without excessive unemployment problems in the cities.

Most countries in CEE have imperfect labour markets whether or not they adopt the euro quickly. Their problems are likely to be similar to the ones faced by other countries, like Panama, with a similar income per capita (and weak institutions), but different from the ones facing EU members with their highly developed social systems. The experience of Panama suggests that not having a national monetary policy does not worsen the unavoidable problems that arise from dualistic labour market structures.

3) Can euroisation protect against financial shocks?

The clear answer here is yes. Adopting the dollar has protected Panama against most financial problems and allowed it to survive the recent global financial crisis much better than other countries in the region. The latest IMF report notes that its economy was affected by the fall in demand in the rest of the region, but there were no signs of financial instability in Panama itself. Deposit and lending rates remained essentially at the average of the 5 preceding years (around 7 and 10% respectively) whereas dollar equivalent rates in other Latin American countries were often 20 percentage points above Libor. Dollarisation thus protects the domestic economy against external financial shocks.

A key issue for many countries with large external debts is to what extent euroisation could lower the risk premium paid on foreign debt. For a country with an external debt to GDP ratio of 100% (e.g. Bulgaria) a risk premium of 10% (not unreasonable under current circumstances) implies an additional annual transfer of 10% of GDP to foreign creditors. The experience of Panama shows that euroisation could be a big help in this area as well. The public external debt of Panama is also substantial, now around 60% of GDP (after a peak of 75% in 1995), but the government never had to pay a large risk premium on its indebtedness. Why should dollarisation lead to radically lower risk premia also on external debt? Per se, the monetary regime does not cure the chronic difficulties of the public sector in countries with weak institutions to raise tax revenues (and limit pressures for more expenditure). But euroisation has two important consequences.

First of all, it eliminates the difference between external and internal debt. This in turn has two consequences: the government cannot discriminate against foreign creditors and it cannot rely on a captive domestic market to finance deficits.

Secondly, it eliminates a key source of uncertainty about the capacity of the government to service external debt because with euroisation the large swings in the real exchange rate that result from the large sudden depreciations which often arise during currency crisis are no longer possible. Russia is a case in point. When the exchange rate of the rubel quadrupled last year (going from 6 to 24 rubles per dollar) the capacity of the Russian government to service its foreign debt was cut to one fourth (and the price of Russian eurobonds went to 25% of their face value). After a year, domestic prices have doubled so that the real devaluation is "only" 50%, but this still implies that the dollar value of Russian tax revenues has been halved (and the price of Russian eurobonds went back to 50%). With euroisation swings of the real exchange – and the price of foreign debt – of this order of magnitude will not happen. Euroisation thus improves debt service capacity in a number of ways. A much lower country risk premium is therfore entirely appropriate.

Euroisation limits the swings in the real exchange rate