

BANK OF ALBANIA

EUROIZATION OF THE ALBANIAN ECONOMY

AN ALTERNATIVE TO BE CONSIDERED

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ABSTRACT

The use of foreign currencies – particularly the US dollar and the twelve currencies constituting the euro – is present in Albanian environment, the same way they are used in all of the open economies in developing countries. The practice of foreign currency use in Albania extends from the price policies of the domestic commercial enterprises, to Albanian families holding their savings in foreign currencies, bank activities and their business relationship (in crediting the economy) etc.

This paper aims at introducing the level of domestic currency substitution, stressing the causes that lead to this phenomenon. By analyzing the implications that are brought forward by currency substitution on economic policies in general and on monetary policy in particular, this paper raises the need of taking a firm stand on this phenomenon, by offering the euroization of the Albanian economy as an alternative to be considered. With respect to this alternative, problems of economic convergence – implications coming from euroization (possible costs and benefits) etc. – have been treated in a modest way.

This paper raises many issues, some of which need to be studied very seriously, before an official political position is held. Because it is a discussion paper, remarks and suggestions are welcomed.

The opinions expressed in this discussion paper are personal thoughts of the author and not the formal position of the Bank of Albania. Please quote the source whenever you refer to the material.

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EUROIZATION OF THE ALBANIAN ECONOMY

Should it be an alternative to look into?

INTRODUCTION

Political instability that characterized the southern Balkan region throughout the last decade in 1990s, held this peninsula far away from the rest of the democratic countries in the continent. 'Isolationist'¹ policies against this underdeveloped European region could have been more costly in economic and political terms. The end of war in Kosovo and the beginning of democratization process in ex-Yugoslavia is giving new dynamics to the process of integration. Lastly it appears that the western position to cooperate with these peripheral countries has started to change.

The aspects of cooperation and integration processes extend at all political, economical and security dimensions, where each one of them is a component of a whole set of issues that are of main interest to be studied.

In the economic aspects of integration, problems vary from the infrastructure issues, to the customs union, monetary and fiscal policies, and so forth.

In this paper we shall focus on only one of the aspects of the process: the possibility of using the euro as our domestic currency. This proposal has been given by a CEPS² study as a possible variant for countries in our region. Recent debates on the monetary union have been turned into one of the most discussed topics amongst academicians.

¹ Until yearend 2000, none of the five regional countries (Albania, Bosnia Herzegovina, Croatia, FYROM and ex-Yugoslavia) had signed on the European Agreement (Agreement of Association). Only Albania and FYROM had signed a Treaty of Cooperation and Trade with EU, whereas the others have not had any contractual agreement with EU. At the Zagreb summit it was decided that negotiations on the Association and Stabilization Agreement should be open with FYROM and Croatia, while in the meantime, at least up to the time of this paper, perspectives to negotiate with Albania remain still undetermined.

² Center for European Policy Studies: A system for post-war south-east Europe, 1999

Countries in the European Union (12 countries) have adopted a single currency; many countries in Latin America are considering the dollarization of their economies, while Central and Eastern European countries together with former Republics of the Soviet Union are calling for a unilateral adaptation of euro as their legal currency.

This paper will try to explain what is implied by euroization of the economy; what is the level of the unofficial currency substitution up to this time and what important implications are presented to the economic policies. The *euroization* term in this paper has been used interchangeably with the *dollarization* term, which in literature is widely used instead of the word *currency substitution*.

1. WHAT DO WE MEAN BY OFFICIAL EUROIZATION OF THE ECONOMY?

Official euroization of the economy means that our domestic currency should be repudiated, and the new European currency – euro, one of the main currencies (perhaps the second after the US dollar) in international transactions – should be used instead. In this way, euro will have to be used in all classical functions of money.

The repudiation of the national currency and the use of a foreign country currency, which is a strong currency with an important role in international transactions, is not a new invention. Some countries in Latin America are using the US dollar as their national currency since the beginning of the past century. Panama is a good example of this.

Actually, 13 Latin-American countries have given an exclusive or dominant status to the US dollar as their currency in use.

More than 50 European and African countries have fixed their currencies to euro or to a currency basket, where euro is the main currency.

Academicians from many countries in Central and Eastern Europe together with former Republics of the Soviet Union are calling for a unilateral adaptation of euro as their local currency. Even in Balkan, many countries have given an exclusive status to euro.

Essentially, although the experiences of the countries that adopt another country's currency – a strong currency with an important status in international transactions – are very rare, the paradigm of "one-country-one-currency" has been questioned.

Box 1. Lessons from the Panama experience.

From 1904, the US dollar is used as a medium of exchange. From 1970, capital markets have been liberalized and state interventions have been almost eliminated from interest rates, banking and financial transactions. Panama has no central bank. Interest rates on deposits are less than 1 percentage point above LIBOR. Interest rate on bank loans is less than 2 percentage points above the rate applied in the US.

Performance of the macroeconomic indicators:

Inflation: Average annual inflation during the 1961-1997 period was 3 percent and, if we exclude the oil crisis during the 1973-1981, inflation averaged at 1.4 percent. Currently, inflation is less than 1 percent per year.

Growth rate: During 1960-1971 and 1978-1981, annual GDP growth rate was 8.1 and 2.5 percent respectively.

Stability: the volatility index of GDP and trade was 2.9 and 7.9 respectively. Whereas, for Latin American countries they were 4.7 and 15.1 respectively.

Source: Juan Luis Moreno-Villalaz, "Lessons from the monetary experience of Panama: A dollar economy with financial integration", *Cato Journal*, vol.18, no. 3 (Winter 1999).

2. CONDITIONS OF GOING TOWARD EUROIZATION

About half of the US dollars circulating out of the American banking system³, have emigrated outside United States. American money stock in other countries has grown three times faster than it has grown inside US. Based on the

³ About US\$60 billion are estimated to circulate in Russia and countries in former Russian federate.

Federal Reserve's estimations, 40 to 60 percent of US dollar amount in circulation are outside of US banking system, which is equal to USD200-300 billion (Nutti, 2001). Also, 30 to 40 percent of deutsche mark stock (DM) circulates outside Germany. It's because of these high figures – which speak for an unofficial dollarization of the economies in developing countries – that decision makers in many of these countries are considering the possibility of an official dollarization of their economies. Now, the question is: until what point could the unofficial dollarization continue? The alternatives remain either official dollarization or de-dollarization of the economy. On the contrary, an increase of the weight of dollarization could reach to a point that might bring on serious implications in the realization of the monetary policy.

Along the road to economic transition toward establishing a market economy, the transition economies, including our country, intensified their endeavor to financial liberalization. Not only foreign companies and citizens, but also locals were permitted to make deposits in foreign currency in the banking system.

On the other hand, domestic companies, in addition to making payments overseas in foreign currencies, they can also transfer their capital in the developed countries⁴.

Why do citizens in the developed countries prefer the American and European currencies? The main reason is the macroeconomic destabilization, especially high and unsteady levels of inflation and uncertainty in exchange rates. An important role is believed⁵ to play illegal traffic, fiscal evasion, etc. In the case of our country there are other factors also, especially the impact of remittances. Consideration about euroization or dollarization has not been examined in this paper. Such a decision is not only a consequence of economic factors and

⁴ Although companies are allowed to pay only for the transactions of economic activities, there are many evidences that prove that companies and individuals transfer part of their capital overseas. Capital outflows from Albania are reported on "World Investment Report", UNCTAD edition.

⁵ Alex Mourmouras, Steven H. Russell, Smuggling, Currency Substitution and Unofficial Dollarization: A Crime-Theoretical Approach, 2000, IMF WP//00/176.

regional developments, but also a geo-political consideration, which should take the necessary attention of the political leadership. For that reason, in the following analysis we will not make a distinction between euro and the US dollar in terms of the '*exchangization*' level of the economy.

Box 2. Euroization or Dollarization?

The image that appears to exist for Albania in Europe, as well as inside the country, is her orientation toward the dollar rather than euro. The official preferred position on the dollar is evident even from the fact that there are a number of taxes, that foreigners have to pay in our country in US dollars, like the tax to enter Albania for a foreigner (not a nice presentation for a European entering Albania); port tax; tax on consular procedures (entering fees, notary, document certificates, etc.); tax on radioamateur service to foreigners; tax on foreign vehicles; the payment of capital when opening a bank; payment of privatization fees to buy shares of strategic enterprises, etc. In the same manner, the system of reporting main macroeconomic indicators and our external position (balance of payment) is done in US dollars only.

The local opinion itself, maybe for merely psychological reasons, seems to be linked to the dollar, even though we think that euro plays a more significant role in our economic life than the US dollar does. By looking at the composition of the required reserves of commercial banks at the Bank of Albania, we conclude that the weight of savings in dollars equals to nearly 55 percent of total savings in foreign currency and 45 percent by the currencies constituting the euro. On the other hand, the fact that over 80 percent of trade transactions (foreign trade) is done with EU countries, it means that their invoices also are possibly – at almost the same percentage – done in currencies consisting the euro. Our borrowing in foreign currencies (foreign debts) has significantly increased its weight in currencies that consist the euro, amounting to about 30 percent of total foreign debts at the end of 2000 (including the inaccuracy of the figures, since all debts are reported in US dollars). From 1991, our country has benefited about 1 billion and 50 million euro from the European Union.

Dollarization, when seen as a currency substitution, is theoretically explained with the model of consumer portfolio selection, which is determined by the relative rates of return on domestic and foreign currency. This model explains⁶ the process for some of Central and Eastern European countries, but not that of the Latin American countries, where dollarization continues to stay at high levels, despite the fact that rate of return on domestic currency has increased in comparison with the rate of return on foreign-currency-denominated assets. Models that explain the behavior in this case are the models of '*hysteresis*.' Which model explains this phenomenon in the case of our country? To give an argument in favor of one or the other model it's important to make a prediction of how might the euroization process continue in the future. If the behavior is dictated by differences between real rates of return on domestic-and-foreign-currency-denominated assets, reducing the gap and equalizing them would limit euroization and could go toward de-euroization.

On the contrary, euroization will continue to be steady. To make it simple, if real interest rates on deposits in domestic currency and real interest rates on deposits on foreign currency tend to equal with each other, households have no incentives to hold their savings in foreign currencies, because interest rate income tend to be equal. In this case, households would use the domestic currency as a store of value. Thus, the level of exchangization would continue to fall.

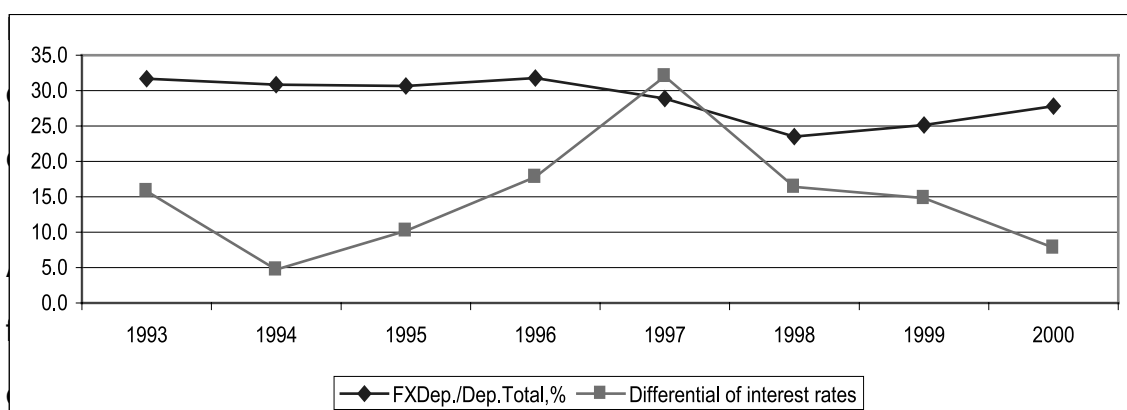
In the analysis of this issue, next we have presented the relationship between the differential of nominal interest rates on deposits in Lek and deutsche mark, and the ratio of foreign deposits to total deposits in the Albanian banking system. As we can see in Graph 1, while the differential of interest rates throughout 1994-97

⁶ Sahay, R. and C.A. Vegh, Dollarization in Transition Economies: Evidence and Policy Implications, The Macroeconomics of International Currencies: Theory, Policy, Evidence, ed. by P. Mizen and E.J. Pentencast, 1996

period has increased in a continuous way – which may be interpreted as increasing returns on domestic currency in comparison to foreign currency – the ratio of foreign deposits remains constant. During 1997-98, the differential falls dramatically while deposits decreased significantly⁷; also, during 1998-2000 period, while the differential continues to fall to the limit of about 16 points (i.e. interest rates start to somehow converge) the ratio of foreign deposits begins to increase.

So, in a simple graph analysis it could be said that there is a negative relationship between the decreasing gap of interest rates and foreign deposits in the domestic banking system. This implies that expectations of economic agents about the exchange rate exert negative influence in the selection of currency portfolio. As a result, interest rates policy and their permanent reduction, aiming at a convergence with that in the euro zone, can be expected to have an impact on the increase of euroization level of the economy.

Graph 1. The differential links between interest rates and deposits in foreign currency.



⁷ It should be stressed that 1996-7 period has been influenced by developments outside banking system, with the rise and fall of pyramid schemes; consequently, they can not be treated as a normal development.

use domestic currency, even after a macroeconomic stability has been restored in the country.

The internal and external conditions in favor of euroization are treated below.

2.1 Internal Factors

Recent years in transition have witnessed an increasing public preference to use strong European currencies and the US dollar, which, to some extent, has led to a partly euroization of the economy. Currency and asset⁹ substitution is a widespread phenomenon in all of the Southeastern European countries.

Currency substitution occurs when foreign-currency-denominated assets are being used as a medium of exchange, whereas asset substitution occurs when foreign-currency-denominated assets are used a store of value. As an indicator to measure the level of currency substitution we use the ratio of foreign deposits to monetary aggregate M1. On the other hand, when measuring asset substitution we use the indicator that is derived from the ratio of foreign deposits to monetary aggregate M2.

In the case of our country, the currency substitution level¹⁰ was 53 percent at the end of 2000. This means that, for every two-items of the national currency, there is more than one foreign currency item. Whereas asset substitution level at yearend 2000 was 24 percent.

⁸ Joannes Mongardini and Johannes Mueller, Ratchet Effects in Currency Substitution: An Application to the Kyrgyz Republic, IMF Staff Papers, Vol.47, No.2, 2000.

⁹ Currency and asset substitution (dollarization)

– i.e. citizens keeping part of their wealth in foreign currency

– is a feature of developing and transitional economies. That is a response to political and economical instability, to high inflation rate, and citizens' choice to diversify their wealth portfolio. In countries with high inflation, dollarization is quite widespread because people seek to be covered from the costs of keeping their money in national currency. However, dollarization has increased so compatibly in Latin America and Asia last years, though the stabilization programs have indeed been successful. See: Exchange rate arrangements and economic performance in developing countries, World Economic Outlook, IMF, October 1997, pp. 78-97.

Table 1. The dynamics of national currency and assets substitution level.

However, the indicators are not completely meaningful, since the foreign currency can circulate widely in Albania, yet it is immeasurable. An important part of people's savings in foreign currencies circulates outside the banking system. As a result, there are many reasons to believe that wealth and currency

	1993	1994	1995	1996	1997	1998	1999	2000
National currency substitution: deposits in foreign currency/M1, %	36	34.3	33.9	37.5	39.6	48	51.7	51.3
Assets substitution: deposits in foreign currency /M2, %	25.6	23	23	28	22.4	20.2	22.2	24

substitution level stays at even higher levels than is reflected in the above table. Nevertheless, even with these official figures Albania seems to have an economy with relatively high currency substitution level. The ratio of foreign deposits to total deposits is nearly 25 percent for Estonia, Moldavia, Uzbekistan, and Turkmenistan, and approximately 50 percent for Armenia, Azerbaijan, Georgia and Lithuania (Joannes Mongardini & Johannes Mueller, 2000).

Why do banks increase loans in foreign currency?

Banks give loans in domestic or foreign currency depending on net balances of the acting forces. On the one hand, lending in foreign currency would be more attractive the higher the depreciation risk, the higher the collateral (which itself is a function of the availability of tradable collateral), and the lower the financing and operating cost of these loans is. On the other hand, lending in domestic currency would be more attractive the higher the bank monopoly on borrowers of commercial goods, the lower the depreciation probability and their effect on loan default, and the lower the cost of growing deposits and loan management in domestic currency¹¹.

¹⁰ Indicators have been calculated with annual average data published in the Statistical Report of Bank of Albania, September 2001.

In the case of Albanian economy, there are also other considerations, which have an impact on the ratio of credits in foreign currency. In order to secure an economic growth, our country will continue to rely on foreign aids and grants, which are denominated in foreign currency, mainly in euro and US dollars. On the other hand, instability in exchange rates creates incentives for domestic banking system, especially banks with foreign capital, to increase their lending in foreign currency. Bank interest rates for Lek credits are characterized by high rates, reflecting a higher level of exchange rate risk; as a consequence, banks incline to increase the lending weight in other strong currencies. Data on credit to the economy from the banking system prove just the above arguments. The credit increase in foreign currency has been going on throughout the last decade. Measured as a ratio of foreign-currency credit to total credit to private sector, this ratio has increased from 37 percent at the end of 1998 to 80.5 percent in 2000. These developments present a particular importance to be analyzed because they expose businesses face to face with exchange rate risk¹², due to disagreements between assets and liabilities of firms' balance sheets.

2.2 External Factors

Access to monetary union means the beginning of a political and economic integration process of a country. This means: a safer, more stable, and more prosperous region than a split region outside Europe. In this sense, euroization could be a symbol of political and social integration in EU, by servicing as a catalyst for a more rapid economic and employment growth.

Albania belongs to Europe in normative as well as economic terms. European Union represents maybe the sole trade and investment partner. Because we still

¹¹ Luis Catao and Marco Terrones, Determinants of Dollarization: The Banking Side, IMF WP/00/146, 2000.

¹² Implications of Asian Crisis in the real sector have been explained by a good number of authors because of the impact of exchange rates on firms' balance sheets.

have a relatively low level of openness to world economy (Albania has the lowest ratio of foreign trade to GDP by comparison with other countries in the region) and since a further openness up to the levels of the developed economy with similar indicators of economic size is an inevitable fact but also a necessary in maintaining high rates of economic growth¹³, harmonization with European Union structures should begin to be taken into consideration, not only in terms of legislation and institutions, but also concerning monetary and fiscal policies. This means that, our monetary policy should comply with that of the European Central Bank.

Different studies have proved that changes in economic variables (interest rates, exchange rates and business cycles) in Euro zone countries have their impact on our economy, though we can not measure how much their changes can explain the behavior of our national economy.

This means that monetary policies of the European Union have their effects on our domestic monetary policy. If we entered the monetary union by using the same currency, economic hit resulting from exchange rates and interest rates are eliminated. Besides that, the process of economic integration with the monetary zone tend to create more similar trading and economic structures, reducing in this way the risk of asymmetry in economic hit.

On the other hand, considering that other countries in Central and Eastern Europe aspiring to a membership in EU, as well as those Balkan states that have almost fixed their currencies to euro, our country remains alone in the region which *de jure* has a completely shake system of currency conversion rate and not fixed to any of the strong currencies (dollar or euro).

¹³ A good number of empirical studies offer evidences of a link between economic growth and the level of economic openness. According to them, countries have achieved higher growth rates after a full economic liberalization in the short-run and long-run as well. For that reason, acceleration of growth rates and maintaining a regional stability would require its integration in EU. (See: Athanasios Vamvakidis "Regional Trade agreements or broader liberalization: Which path leads to faster growth?" IMF Staff Papers, Vol. 46, Nr.1 March 1999, pp. 42-68.

Exchange rate and Monetary Policy at regions of Sudeast Europe.

In the perspective of a greater regional, trading and customs integration, Albanian currency would be more risky to use for economic agents who operate in the region (due to higher volatility of our currency conversion rate), putting our country in a more unfavorable position. As a consequence, sustenance of competing positions would require a careful monitoring of regional monetary

Countries	Exchange rate	Monetary policy
Albania	Free float	Money increasement
Bosnia Hertzegovina	Fixed irrevocable to DM	Currency board
Bulgaria	Fixed irrevocable to DM (1997)	(Money increasement before 1997) Currency board
Croatia	Floating band to DM	Exchange rate
Macedonia	Pegged to DM	Exchange rate
Romania	Free float	Money increasement
Ex-Jugosllavia	Money increasement

Box 3: The experience of Montenegro

The most apparent element of reform strategies of Montenegro was the substitution of Yugoslavian dinar for the deutsche mark (DM), in order to give to its population a stable currency. The use of DM began in November 1999 and is considered as a success. After a few months, DM became the main currency in economic transactions and most of the taxes are paid in DM

The use of DM was accompanied by two actions:

- The Montenegrin government legalized its use; and
- The government started to pay salaries and pensions in DM.

By paying approximately 12.5 million euro in November 1999, it was sufficient that the economy to begin to use the DM because salaries were spent at local shops and returned to the government in the form of tax payments. The private sector also started to pay employees in DM and offer its prices in this currency. After a few months, the balance of deposits in DM in the payment system had increased to about 100 million, implying that 75 million were withdrawn from the underground economy and cash.

Source: Daniel Gros, "The Euro and the Balkans?" paper at the conference "When is a national currency a luxury", March 2001.

policies; on that account, they would influence our domestic monetary policy. In a long run perspective of getting a membership in the European Union, Albania will have to achieve and face:

- a rapid economic growth (even higher than that of EU);
- an evaluation of exchange rate from the performance of Harrold-Balassa-Samuelson effects;
- free capital mobility;
- the need to fulfill the requirements of Maastricht and join EMU within a few years after she enters into EU.

These factors are expected to bring on an increasing deficit in current account. Perhaps the best choice in this case¹⁴ is a fast unilateral adaptation of euro as national currency, even before we become a member in EU.

From this point of view, it could be said that both internal as well as external factors support the idea of going toward using euro or a monetary policy more linked to euro.

3. MONETARY SUBSTITUTION AND MONETARY POLICY

In order to fulfill her main objectives, achieve and maintain price stability, the monetary policy regime applied by Bank of Albania is one of money growth objective, through the control of money supply.

The analytical framework of this monetary policy strategy is based on quantity theory of money, where price level is seen as a function of money stock, velocity of money, and gross domestic production.

$P = M (V/Y)$ where P is price level; M is money stock; V is velocity of money; and

¹⁴ George Kopits "Implications of EMU for exchange rate policy in Central and Eastern Europe", IMF Working Paper 99/9; 1999

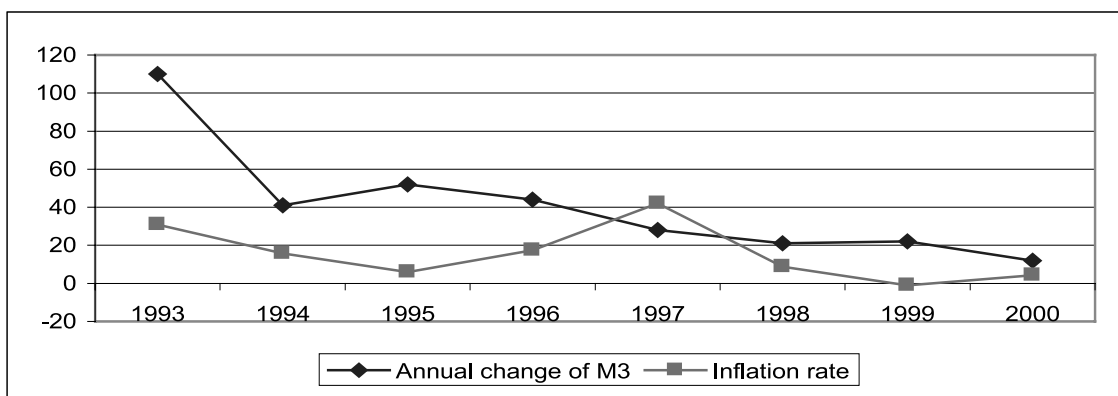
Y is real GDP.

According to the quantity theory of money, V and Y are determined independently and so they are independent of money stock. Real production (Y) is determined by supply factors (labor, capital, land and technology), while velocity of money (V) is considered as stable. The theory stresses that changes in money stock will be entirely reflected in price changes. In a dynamic context, this implies that growth in domestic money supply will be fully reflected in changes in inflation rate¹⁵.

Three principal conditions for a practical actualization of this monetary policy strategy are: money demand should be stable and predictable; there should be a strong and predictable relationship between money supply and price level; and monetary authority should have a full control on money supply.

Graph 2. Money supply and inflation

Currency substitution¹⁶ weakens the degree of satisfying the above conditions, especially the first two conditions, making money demand function be unsteady. This means that the control of money supply is difficult to use for predicting future inflation.



¹⁵ Money is neutral in its effects on real GDP.

The message received from Graph 2 is that: the relationship between money supply and inflation rate is weak because of instability of demand for money.

This fact has already been confirmed even by several studies¹⁷ written by various authors about the determinants of inflation in Albania. Many of them witness the presence of an important relationship between inflation and exchange rate. Another reflection on this issue is the fact that Bank of Albania's objectives, which are introduced at her monetary program, have regularly deviated from the forecasts (generally higher than the objective); in the same manner has the performance of inflation deviated from the determined objective (it has been below the level decided as objective).

Although tendencies seem to be falling for the two categories of money (M2 and M3), it is difficult for money demand forecasts – based on the velocity of money – to give reliable results, something which has practically led away from the program of money supply position. Instability of the function of money demand both in developing as well as developed countries is a fact proved by many empirical studies.

It is for that reason that during 1980s most of the countries in the world have turned from this monetary policy regime.

In conclusion of this simplified analysis, it can be said that effectiveness of monetary policy through controlling money supply remains doubtful. The change of monetary policy regime is an issue that requires a well-studied discussion in deciding on a new regime. Alternatives of a new regime remain in the choice between 'inflation targeting' and exchange rate.

¹⁶ Other factors that influence post-stability of the function of money demand are financial innovations and financial markets globalization. During the early years of transition, money demand is also under the effect of transitional economic hits, like disinflation swiftness and price level stabilization, institutional changes of the financial market etc., which is noticed even in the graph of velocity of money.

¹⁷ For some of them, see Ilker Dolmaç and Carlos Elbirt, 1998, "The main determinants of inflation in Albania", Policy Research Working Paper, No.1930, Washington, The World Bank.; Kalra Sanjay, 1999, "Inflation and money demand in Albania" Russian and East European Finance and Trade, Vol. 35, No.6; Maçellari, Kola, Mytkolli, 1999, "Kurset e Këmbimit dhe Tranzicioni Ekonomik".

Euroization as an alternative implies essentially an import of the culture of price stability, by combining inflation targeting with the performance of monetary aggregates as they are determined in the monetary policy regime¹⁸ of the European Central Bank.

4. GETTING A MEMBERSHIP IN THE MONETARY UNION

Euroization of the economy, in the way of a membership in EMU or as a decree of state authorities, means that our country is *de facto* being part of an economic and monetary union with the euro zone. What does it mean to be a member¹⁹ in a monetary union? There are three principal characteristics for that:

First, becoming a member in a monetary union means that you should give up your monetary sovereignty. Monetary policies, including the framework in which this policy is done and the strategies and instruments that are used, become European.

Secondly, monetary union is realized in a way that it should be prolonged in time. Once you enter it there is no turning back. Such a reversion would have an immeasurable political and economic cost.

Thirdly, the euro zone differs from all other monetary zones, which are usually defined as zones of a sole sovereign state.

Although they have a common monetary policy, member countries pursue decentralized policies on fiscal issues, such as budget, taxes, and social

¹⁸ Monetary policy regime by European Central Bank is based on two pillars: on the expected performance of inflation (a kind of inflation targeting) and on growth of monetary aggregate M3 at 4 1/2 percent.

¹⁹ We have to distinguish between a decree of the authorities in a unilateral use of euro as a national currency and getting a membership in the European Monetary Union. In the case of a unilateral euroization it has not been required to be a member of a monetary union and to comply with the criteria of convergence. However, because the final purpose is getting a membership in EU and EMU, this issue has been treated below in a monetary union framework and not simply as a unilateral euroization.

policies. In particular, fiscal policies have to be in accordance with rules and regulations as determined in the Treaty of Maastricht, and Growth and Stability Pact.

This means that a country can maintain its independency in planning and realizing its fiscal and budget policies, however this should be within a programmed and restricted framework, as determined in the Treaty (such as size of budget deficit and total debts, and restrictions on monetary authority to finance deficit in a direct way).

5. CRITIQUES ON MONETARY UNION

Critiques specified by classic literature regarding euroization/ dollarization are related to the following arguments:

Asymmetry of hits: i.e. supposing our domestic economy incurs a hit that could require our currency to depreciate (in order to win back competitiveness in exports) while euro zone monetary policy does not take into consideration this asymmetry. Not depreciating our currency would result in incomplete utilization of production capacities and higher unemployment rate. This situation could be eliminated if monetary policies were independent.

In this sense, loss of autonomy of monetary policy may be considered as a potential cost for entering into the monetary union. However, inability of a common monetary policy when responding to asymmetric hits to our national economy does not necessarily imply that our country cannot become part of an optimal monetary zone. A decision about this should be taken after an answer has been given to some fundamental problems:

First: can probability of asymmetric hits be changed by establishing a monetary zone and/or joining a monetary zone?

Second: has the autonomy of monetary policy been able to counterbalance external asymmetric hits?

Third: supposing that instruments of monetary policy have been effective in counterbalancing the hits; can other instruments of economic policies – such as fiscal policies or fiscal transfers in the euro zone – can they be equally effective in counterbalancing asymmetric hits?

Experiences in developing countries demonstrate that currency depreciations have had contradictory effects because they are in conjunction with growth in interest rates, and therefore, they eliminate positive competitive effects that are gained from currency depreciation. In the case of our country, several studies have proved that there exists no relationship – statistically important – between exchange rate and trade balance. On the other hand, currency depreciations have in any case been associated with increased interest rates in order to prevent further depreciation of the currency. As presented below in the graph, to prevent depreciation of domestic currency in relation to foreign currencies (which is presented by monthly changes in nominal exchange rate of the US dollar), interest rate for deposits almost doubled (the graph shows quarterly interest rates).

The growth of interest rates to these levels, in addition to costs carried to the banking system (and reflected on the balance sheets of the banking system), will have a negative impact on financing of businesses. On the other side, high volatility of exchange rates, which is an evidence of an actual risky currency,

influence changes of preferences to borrow and lend in foreign currencies. Therefore, policies to depreciate the currency in order to secure a fair competition in the economy remain controversial and debatable in economic literature (e.g. Calvo and Reinhart, 2000; IMF, 1999; Obstfeld et al., 2000; etc). From this of view, trade and fiscal policies can play a more important and influencing role than the use of exchange rates. Moreover, the causes of crises in our country have not been monetary in their origin but they were rather due to structural problems that our economy is facing. Thus, there is not much room for instruments of the monetary policy to be used as counter-cycle instruments and bring the economy in equilibrium. It is widely argued that levels of exchange rate, for instance, continue to be determined to a great extent by foreign currency inflows through informal channels.

Meanwhile, the long-established relationship between exchange rates and inflation makes attainment in stability prices – as a fundamental objective of the monetary authority in our country – to be really vulnerable and the fulfillment of monetary policy more difficult. Monetary unification would eliminate such pressures on exchange rates and as a result, the achievement of price stability would be more credible. Because the new currency is being used in a larger market, internal market forces would not affect the exchange rate of this currency.

The other critique is related to central bank's role as *the lender of last resort*. In preventing a bank failure, which would have important implications in the social and economic life of a country and in order not to allow the crisis to spread to other banks which could result in the collapse of the whole banking system, central bank plays the role of the lender during the period a bank is in crisis. Critics emphasize that the role of monetary authority as the lender of last resort

could be hit if the country would not have access to the European Central Bank's window discount²⁰.

Nevertheless, there exist alternative ways for offering liquidity to banks with liquidity shortage. For example, it could be created a *stabilization fund* or *contingency credit lines*, which might be useful to help banks in such positions (Calvo, 1999). Moreover, contingency credit lines in the circumstances of euroization could be less costly because there is no risk of currency depreciation that is linked to bankruptcy. Part of financing the establishment of these instruments could come from the seigniorage share based on an agreement signed with the European Central Bank.

In case of a unilateral euroization, central bank can carry out duties as a lender to the banking system, within the level of country's foreign reserves (Nutti, 2001). If there is a lack of sufficient liquidity, this might also be combined with credit from foreign banks.

Loss of Seigniorage

Since the time of feudalism, it was the right of the ruler of a country (seigniorage comes from the word "*seigneur*") to stamp hard money and put it into circulation. The ruler could decide that the value of the melted metal into money be high, so that money had a high real value; or he could stamp less precious metal into money, and maintaining the same nominal value of money.

In this case, the cost of producing hard money was lower than the stamped nominal value and the difference was called "*seigniorage*". In modern times, with the introduction of paper money, the cost of producing money is negligible with regard to its nominal value, i.e. seigniorage for all printed money is very high.

In this way, if a country decides to use other country's currency as its legal money, it has to give up all gains coming from this source of income. For that reason, one debatable issue of the literature on monetary substitution is also the effect of losing seigniorage. Even though this income is very low – about 0.5 percent of GDP – for countries with low rates of inflation²¹, still it may not be considered as negligible. In countries with high inflation rates this income may go up to 5 percent of GDP; thus, losses are even larger.

In the following analysis²²

Zdenek Tuma and Tomas Halub, "Two aspects of euroisation: Monetary Policy Independence and we have use the concept of 'opportunity cost of seigniorage' that is very much related to central bank's profits, and also with her ability to transfer resources to the state budget. The formula in this case is:

$$s = i \times \frac{MB}{P} - i_i \frac{RE}{P}$$

(s = seigniorage; MB = monetary base (amount of money in circulation plus reserves of banking system held at central bank); RE = banking system's reserves held at central bank; P = price level; i = market interest rate, and i_i = interest rate paid by central bank for banking system's reserves).

In order to show the relationship between opportunity costs of seigniorage, we are presenting it in a (simple) scheme of a consolidated balance sheet of a central bank:

²¹ Paul Masson, Miguel A. Savastano and Sunil Sharma, "The scope for inflation targeting in developing countries," IMF WP 97/130, 1997

²²"Seigniorage", paper presented on the Conference "When is a national currency a luxury?" 2001.

Assets	Liabilities
Net foreign assets (NFA)	Monetary base (MB) of which:
Net domestic assets (ND)	<i>Currency in circulation (CU)</i>
	Reserves (RE)
	Net bank capital (C)

If we suppose the country keeps only domestic-currency-denominated assets (i.e. net foreign assets are zero) and bank capital is zero, on the liabilities side we will have only the monetary base, for which central bank pays interest²³ only for a part of it: remuneration of reserves ($i_i \cdot RE$). On the assets side there will be only net domestic assets, which are equal to the monetary base ($ND = MB$) and make central bank have a profit depending on market interest rate: $i \cdot MB$. The central bank's profit, which would be transferred to the state budget, in this case would be: $i \cdot MB - i_i \cdot RE - C$ (where $C =$ expenditure for bank activities). On table (1) we have presented a rough estimation of the opportunity cost of seigniorage since 1994. We have used the yield of quarterly T-bills as market interest rate. By multiplying interest rate with annual average monetary base, we get the estimation of seigniorage (in current prices), which we will have to compare it with GDP in current prices, in order to measure the relative importance of this income source.

Table 1. Rough estimation of the opportunity cost of seigniorage

	1994	1995	1996	1997	1998	1999	2000
Currency base (bio.lek)	42,069	53,877	61,393	90,928	89,887	109,307	128,779
Interest rate, %	10	14.7	21.1	35.3	19.9	14.8	7.8
Seigniorage (bio.lek)	4,206.9	7,919.9	12,953.9	32,097.6	17,887.5	16,177.4	10,044.8
% of GDP	2.2%	3.5%	4.6%	9.4%	3.9%	3.2%	1.9%

²³ Bank of Albania has begun the remuneration of required reserves in October 2000.

As we see, income from seigniorage has gradually increased from 2.2 percent of GDP in 1994, and then they reached a very high level in 1997 and after that started to fall gradually to 1.9 percent in 2000. In the coming years, this income will fall further due to a low rate of inflation (as a consequence, due to reducing interest rate) as well as the effect of remuneration of banking system's reserves at the central bank. Nonetheless, even when this indicator reaches at the levels of developed countries (0.5 percent of GDP), still this source of income for our budget cannot be considered as negligible.

However, the central bank's profit that is delivered to the state budget does not necessarily equal to the seigniorage as estimated above.

The reason is that central banks keep also foreign-currency-denominated assets (NFA). Central bank's income, in this case, are subject to changing interest rates in foreign markets and the level of depreciation/appreciation of domestic currency in relation to foreign currencies on which assets are denominated.

Therefore, net profits of the central bank, which are delivered to the state budget, depend on the risk premium (the differential between domestic and foreign interest rates) and profit or loss that may be generated from unforeseen changes of exchange rate²⁴ depreciation/appreciation.

The higher the foreign reserves with respect to monetary base, the more important the influence of this factor is on income coming from seigniorage. In the case of Albania, net foreign assets of Bank of Albania amount to nearly Lek72 billion (about US\$508 million) or 56 percent of the monetary base.

²⁴ This expresses the opportunity cost of keeping foreign assets. Losses/profits in this case could be estimated by multiplying net foreign assets with the difference between domestic interest rates and interest rates on foreign currencies, which form foreign assets of the country, and with the level of depreciation/appreciation of domestic currency in relation to foreign currencies. However, the effect of this factor is still not evident in the case of Albania, because there are no foreign-currency-issued bonds yet.

Positive risk premium might be interpreted as a result of low confidence on domestic economy and authorities in comparison with other foreign economies. Therefore, increase of credibility on the domestic economy and authorities, together with a high level of foreign assets, make that financial value of having an independent central bank be not as high as presented from the estimation of income coming from seigniorage. Thus, financial losses too, cannot serve to fully argue against euroization of the economy.

6. CONSEQUENCES OF THE MONETARY UNION

The key implication presented by the realization of monetary union is that it requires a permanent economic convergence, in the sense that every particular state should be able to stay side by side with other member countries on a permanent basis, without recourse of national monetary policies or changes in exchange rate. Therefore, this convergence must be viewed on the background of free capital mobility and beyond national monetary policy. If a sole country possesses uniform economic and tax policies – the same way a national budget supports underdeveloped parts of the country, and therefore, eliminating excessive deviations in the economy – economic and monetary zone of euro does not possess such instruments. (It is still a debatable issue if a whole economic convergence of euro zone can be realized within the framework of a centralized system or a decentralized European framework). Sustainance of a permanent economic and monetary convergence within a European decentralized political system rests on two basic pillars:

- 1) Every country supports competitiveness in its economy; and
- 2) There is a readiness of member countries to permanently comply with rules and regulations as agreed upon in the Treaty.

Maintenance of competitiveness in every single country, as a fundamental condition for creating an optimal monetary zone, is founded on the requirements determined in the Treaty, the respect for which should be like a test of political readiness and countries' ability to maintain value of the domestic currency and exchange rate stability.

But economic convergence does not imply economic uniformity.

First, it does not imply uniformity of economic structures. Although competition puts pressure on finding efficient solutions, such solutions cannot be uniform everywhere. There are always rooms for different economic styles and traditions even within a monetary union.

Second, convergence does not imply uniform policies all over the region. On the contrary, a decentralized monetary union requires that national policies exercise their responsibilities for maintaining competitive economic structures. However, individual ways of acting, for instance in the area of taxes, should not lead to market distortions.

Third, convergence does not imply uniform and equal conditions of life and economic prosperity in all of the participating countries or regions. The framework in which the monetary union works could have been more favorable for less developed countries and regions and help them catching up to more advanced countries.

Full and permanent economic convergence, based on entirely market forces, is a crucial pre-condition for a politically-decentralized monetary union. Participating countries will have to obey the rules on particular aspects of economic policies.

7. ECONOMIC CONVERGENCE

In case the Albanian economy is euroized, European Central Bank should only fulfill the liquidity needs of Albanian economy, and is not obliged to take into consideration the particular needs of our economy when designing her economic policies. Thus, the decision on euroization – because it is an issue of empirical analysis – requires an examination of the fact whether Albania is an optimal monetary zone.

Theory of Optimal Monetary Zone (OCA), which was founded by Mundell (1961) and McKinnon (1963), is the most popular theory that is used to analyze costs and benefits of monetary integration, especially with regard to EMU. In essence, theory says that for countries or regions, which are exposed to symmetric hits or those possessing mechanisms for absorbing asymmetric hits, it could be optimal for them to adopt a common currency. In detail, this theory evidences the following criteria:

1. *Similarity of hits and business cycles*: asymmetric hits and business cycles raise the need for specific and adjusted policies in a country. In a common monetary zone it's impossible to adopt specific monetary policies.
2. *Level of openness*: a country where foreign trade has a large share in GDP could benefit from participating in a monetary zone.
3. *Products diversification*: a country whose exports are diversified would be less vulnerable if its sectors were hit. Therefore, it's less likely for these countries to use exchange rate as an adjusting instrument.
4. *Factors mobility (especially labor)*: high labor mobility relieves policies to adjust to asymmetric hits, and, as a consequence, it is not required to intervene in the exchange rate market.

5. *Fiscal transfers*: fiscal transfers can be used as alternative adjusting instruments (against exchange rates and labor mobility).
6. *The level of political integration and similarity in inflation rates*: differences in rates of inflation can cause losses in the level of competitiveness in countries with high inflation rates. On the other hand, a high level of political integration before joining a monetary union could result in lower costs for participating countries.

The stronger it is the relationship of the above factors among participating countries in a monetary union the higher the net benefits from partaking in a monetary union.

The issue we have tried to explain in detail in this material is the similarity of business cycles and trade integration between our country and those in the euro zone. In the analysis of business cycles similarities, we refer²⁵ to the theory of Frankel and Rose (1998), according to which, the first two criteria are endogenous. Close trade relations are likely to lead to a convergence of business cycles. Furthermore, close trade relations could possibly bring on a greater political integration²⁶ and give rise to a common monetary zone.

7.1. Level of openness: Trading among industries

According to OCA theory, if trading among industries has a large share of trade, then, if every thing else is held equal, business cycles among countries are deemed to be more similar.

²⁵ Jeffrey A. Frankel and Andrew K. Rose, "The endogeneity of the Optimum Currency Area criteria", *Economic Journal* 108 (July), 1998

²⁶ However, this opinion has not been supported by all authors. Krugman (1993) stresses that, when countries reach a higher level of trade relations, they get more specialized. Hence, business cycles are not symmetric anymore, but more asymmetric. Cit. Frankel and Rose.

Trading among industries is measured with the Grubel-Lloyd index (this index represents the part of the absolute value of trading among industries out of total

$$|T| = 1 - \frac{\sum I[XI_i - MI_i]}{\sum I[XI_i + MI_i]}$$

(X is exports, M is imports, and I is the product group)

According to Fidrmuc (1999), the above index was about 25 percent for Rumania and Bulgaria, and nearly 50 percent for Czech Republic and Hungary. In the case of Albania, this index is estimated to have been 40 to 45 percent during 1998-1999. Indeed, this figure is higher than for other countries like Greece, Turkey, Bulgaria, Rumania, Estonia, Poland, but is lower than Hungary, Slovakia, Czech Republic, and member countries in EU (*Appendix 1: Table on estimations of Trading among Industries Index (G-LL index)*).

The above indicator serves as evidence of a high level of convergence in Albania in comparison with core countries to join the EU and whose advantages from the membership are considered to be positive.

Nevertheless, this conclusion is subject to the degree of forces of the so-called trading among vertical industries (i.e. trading of different quality products) between EU and CEE countries and Albania. According to several studies, it is estimated that nearly 80 to 90 percent of trading among industries between EU and CEE is attributed to vertical trading among industries. However, the available literature gives very few arguments in furthering this issue.

7.2. Business cycle's convergence

In general, studies applying to the issue regarding the degree of convergence between CEE and member countries in EU rely on the analysis of correlations that exist between the index of industrial production volume²⁷ for Germany and candidate countries to join the EU.

²⁷Jarko Fidrmuc and Franz Schardax, "More "Pre-Ins" Ante Portas?" ONB, Focus on Transition, 2/2000

These studies have reported the following correlations:

	1991-1999	1993-1999
Austria	0.790	0.806
Italy	0.577	0.601
Switzerland	0.665	0.717
Czech Republic		0.372
Hungary	0.302	0.628
Poland	0.159	0.805
Slovakia		0.039
Slovenia		0.766

Because our data on industrial production and index in our statistics is simply based on state production and, therefore, it does not demonstrate a accurate degree of trading convergence, we have seen the degree of the relationship between GDP data for Albania and Italy, which is an EU member and the most important trading partner of our country, wherefrom the convergence is expected to be larger (her business cycles have a great influence on us). (GDP quarter data series have been changed into logarithms). The correlation coefficient during 1993-99 period is 0.829. This indicator expresses a high convergence degree of business cycles between Albania and one of the EU members, such as Italy.

In any case, the above result comes under two limitations too: the accuracy of GDP data in Albania, and time period taken into analysis, which is very short to show a precise tendency of the business cycle convergence. The period itself does not probably prove a whole business cycle. Perhaps, convergence might be demonstrated more accurately after five or ten years in the future. Economic structures and economic growth sources are also different. Consequently, estimations for different coefficients should be taken very carefully. Another factor of convergence and reducing the risk of asymmetric economic hits are

foreign investments. Their sensitive presence in industrial sectors makes these firms to be affected by economic hits the same way their mother companies are in their countries of origin. Net effect of this factor is the increase of the symmetry of economic hits.

7.3. Problems of real convergence

GDP per capita (PPP). If we choose this criterion, the gap between EU member countries and candidate states to EU membership is very big. GDP per capita for Hungary is about 47 percent of EU's GDP per capita; Czech Republic, 60 percent; Slovenia, 67.8 percent; while most of the other countries are below 40 percent. The convergence process, which is expected to be realized during the coming years, will be carried out in different paces for various sectors. Thus, this can be considered as a kind of asymmetric supply hits.

Price convergence. Average price level in our country is below that in EU. This implies that we expect a price level increase in the future, that is equivalent to the evaluation of lek. In case of euroization, this implies a higher rate of inflation. Another issue that is related to price convergence is the high level of individual price dispersion from the low average level of prices. This implies that the system of relative prices²⁸ in Albania is very different from that in EU. During the convergence process, these differences should also gradually reduce. The assumption is that prices will go up at different rates for different product-groups. This fact could be interpreted as a supply structure hit.

Economic structures of candidate countries in comparison to member countries are different. The share of agricultural sector in candidate countries is very high; it amounts to over 15 percent of GDP in some countries, compared to

²⁸ This fact has been proved empirically, and is an evidence of a high positive influence of inflation skewness. See, Phillip C. Rother, Inflation in Albania, IMF Working Paper, WP/00/207, 2000.

2.2 percent of GDP in EU. In the case of Albania the share of this sector is higher than every other standard (over 50 percent of GDP). These differences will create problems in EU's budget to finance agriculture, if we take into account the trade structure of these products and competition among different countries.

Another criterion that might serve to estimate real convergence is **capital market liberalization** and **free capital mobility**. This process allows us to judge whether candidate countries will be able to face pressures from competition and free market forces in EU. Whereas, to create a functional capital market, it might be useful to study the market structure itself. For instance, the market of ten-year government bonds can be used as a reference to real convergence of interest rates toward EU rates.

All these factors together infer the need of maintaining a flexible degree of stabilizing policies, hence retaining the independency of monetary policy.

CONCLUSIONS

Toward ERM2 or unilateral euroization?

Economic and political integration in European Union, which is a national aspiration, dictates that our issue, which has been discussed in this material, is not *whether* the Albanian economy will be euroized or not. **The issue is when is that going to happen?**

Although our economy has made important steps in economic reforms and is open to the outside world, still the process of transition seems to have a long way to go. Important restructuring of our economy remains to be realized during the coming years.

Under these circumstances, the main sources that could cause fluctuations in nominal exchange rates²⁹ are changes in the performance of productivity, salaries, monetary and fiscal policies, strength of financial institutions, and external economic hits. Even though the power of any of the above-mentioned factors has not probably been observed up to now due to weaknesses and inconsistent policies, in parallel with reforms and market consolidation, their impact will be significant in the near future.

This means that the way to joining the monetary union should be a timely phased process, in order to get a sufficient operational experience in managing a stable exchange rate regime.

²⁹George Kopits "Implications of EMU for exchange rate policy in Central and Eastern Europe", IMF Working Paper, 99/9; 1999

Although the formulation of accurate well-timed terms for a formal join of ERM2 would seem unreal, prior arrangement of a suitable term to achieve a monetary convergence would be necessary for the orientation of long-term monetary policies.

The other alternative is the unilateral euroization of the economy. This means that euro should be declared as the legal currency of the country, though we are not part of EMU yet. This might be a faster way to be admitted as a member country in the European Union.

Lastly, we believe that following the experiences of other regional countries would be the proper way of moving in the future. This would ensure the concurrence of Albania preparing to adhere to political, economic and monetary structures of EU, the same as other regional countries are doing.

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