

ALBANIA AND EURO

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1. INTRODUCTION

In June 2001 the European Commission recommended that negotiations be opened with Albania on a “Stabilisation and Association Agreement”.

The European Council invited the European Commission to present draft negotiation directives; subject to further approval by the Council negotiations should begin in spring 2002. An Association Agreement is the first step on the long path to EU membership, should Albania decide to apply.

For all new Member States, in turn, accession necessarily involves membership of the European Monetary Union – after a two-year participation in the Exchange Rate Mechanism II (ERM-II)¹⁵ and fulfilment of the Maastricht conditions for monetary and fiscal convergence.¹⁶

The frontrunners among the present ten central eastern European accession candidates countries¹⁷ (plus Malta and Cyprus) are expected to join the EU around 2006, and EMU around 2008; in principle Albania might be able to join the EU in 2008 and the euro in 2010.

The prospect of joining Europe in a not too distant future is a great achievement. In 1991, when it began its transition process, Albania started from the most unfavourable conditions in the whole of central eastern Europe; it was totally isolated after the break with both the Soviet Union and China, had strict and unreformed central planning, autarky and virtually no private property.

In 1989-92 Albania lost over 40 percent of its real GDP, but subsequent steady and sustained growth – with the exception of 1997 when GDP declined by 7 percent – made Albania one of the very few transition countries that by 2000 had overtaken their 1989 level (by 3 percent). Albania became a WTO member in September 2000; its open trade regime is rated 1 out of 10 on the IMF trade restrictiveness index. Inflation, initially in the three digits range, came down to virtually zero in 1999 and has stayed down. Domestic and external imbalances are still present but have been sharply reduced. Systemic and structural changes have been initiated. By July 2001 the IMF, reviewing Albania's Poverty Reduction and Growth Facility (PRGF) expressed high praise for its performance:

¹⁵ From 1-1-1999 the ERM envisaged by the Maastricht Treaty was replaced by ERM-II, with the same band of variation of +/- 15 percent but including additional criteria such as the development of market integration, current-account balance, monitoring of unit labour costs and of other price indices.

¹⁶ These are 1) an average inflation rate in the year before the examination, not exceeding the average of the three best performing member states by more than 1.5 percent; 2) an average nominal long-term interest rate on government bonds, over the same period, not exceeding by more than two points the average of the same three states; 3) a government deficit of at most 3 percent of GDP and 4) a government debt of at most 60 percent of GDP – unless these ratios are close to the reference values and either have already declined substantially or exceed the reference value only temporarily.

¹⁷ These are the so-called Luxembourg group: Hungary, Poland, Czech Republic, Slovenia, Estonia; plus the so-called Helsinki group: Slovakia, Latvia, Lithuania, Bulgaria and Romania.

“Sound macroeconomic management and the implementation of structural reforms have resulted in continued high growth and financial stability in Albania. GDP is growing at more than 7 percent and inflation has remained low. Fiscal policy remains on track, supported by ongoing improvements in revenue collection. A cautious monetary policy, now implemented through indirect instruments, aims to keep inflation within a 2-4 percent target range. The privatisation agenda is nearing completion, following the recent announcement of the tender for privatisation of the Saving Bank.

The authorities’ policies for 2001 include bold reforms in the electricity sector, in order to eliminate supply shortages that could threaten growth prospects. The efficiency and governance of revenue administration are being strengthened, building on recent improvements in customs administration. A further priority is to improve the financial and legal framework for investors, as part of the process of creating a favourable environment for private sector activity”. (*IMF, News Brief No. 01/59, 13 July 2001; emphasis added*).

This combination of apparently sound fundamentals and a rather long waiting time before EU accession and even longer before EMU membership raises a number of questions. First, should Albania now establish a closer link to the euro, for instance a fixed exchange rate or a crawling band/peg in place of the current exchange regime of managed float? Second, should Albania take stronger unilateral action towards a hyper-fixed exchange rate with the Euro? This kind of “euroisation” would take one of two forms: either (1) official and total lek replacement by the Euro; or (2) a Currency Board linking the lek to the Euro at a parity irrevocably fixed. What would be the costs and benefits of such operation for Albania? How would gradual convergence to EU standards affect those costs and benefits? What would be the implications for the conduct of negotiations with the EU? These are the questions reviewed and discussed in this paper.

2. THE LEK, THE EURO AND THE DOLLAR

The lek exchange rate regime of managed float presents some interesting characteristics:

(i) like the currencies of all transition economies, without exception, the lek has followed a trend of real revaluation. This is an

equilibrium phenomenon, due not only to the Belassa-Samuelson effect (productivity in the production of tradables exceeding that in non-tradables and driving up wages and prices in the sector of non tradable goods) but also and especially to the natural undervaluation of currencies at the beginning of transition, due to political uncertainties and risks and to inflationary expectations (see below, section 6).

(2) unlike any other currency in the area except for brief and temporary spells, the lek has appreciated also in nominal terms thanks to low inflation, instead of appreciating only in real terms through a positive differential inflation higher than nominal devaluation.

Thus the effective (trade weighted) exchange rate, putting 1995=100, fell rapidly in the first half of the crisis-year 1997 from 110 to 75, then recovered already in the second half of 1997 and appreciated both in nominal and even faster in real terms to 130 and 140 respectively in mid-2001 (see Figure 1). This is remarkable especially considering the rapid narrowing of interest rate differentials with respect to both euro-zone currencies and the dollar, which should have weakened the lek.

(iii) real revaluation does not seem to have damaged greatly Albanian competitiveness; a relatively large trade deficit has been transformed into a reasonable current account deficit of the order of 7 percent of GDP, easily covered by remittances from abroad (believed to be in reality about double the official estimate of \$500mn), privatisation-related capital inflows and measured tourist services; indeed the Central Bank of Albania has been accumulating foreign reserves to a comfortable level, at the end of March 2001 amounting to \$648mn corresponding to 4.4 months imports (IMF 2001a).

(iv) the lek appreciated faster with respect to the euro than to the US dollar; in recent years it seems to have shadowed the dollar (see Figure 2). This is surprising in view of Albanian trade with the EU being a hundred times larger than with the United States. In 2000 trade with the EU corresponded to over 90 percent of Albanian exports (of which 70.3 percent to Italy, 12.9 percent to Greece, 6.6 percent to Germany), and 75 percent of imports (of which 36.2 percent from Italy, 28 percent from Greece, 5.5 percent from Germany). Conversely, trade with the United States represents only 0.8 percent of Albanian exports and 0.7 percent of imports; even if all non-EU trade (including that with ex-CMEA,

amounting to 2.1 percent of exports and 11.4 percent of imports) was treated as dollar trade it would be still under 10 percent of exports and one quarter of imports.

Gligorov (2001) writes that for Balkan countries, including Albania, "euro is the monetary future of the whole region", but for Albania we could say, *on the basis of trade direction considerations*, that the euro is its monetary present. Yet the US dollar has a dominant role in Albania as unit of account, store of value and means of payment. An extensive survey of the Albanian foreign exchange market was conducted in 2000 (involving all 13 commercial banks and 21 foreign exchange bureaus, 50 informal market dealers, the largest 150 enterprises and 100 individuals; see Baleta and Celiku, 2000). It turns out that 67.8 percent of interviewees preferred to use the US dollar in their transactions, 86.2 percent regarded the dollar as "the most important currency that guides them in decision-making". The euro did not improve its position in 2000 relatively to 1999.

Moreover, foreign exchange deposits have been high and growing (see Figure 3), representing 27.8 percent of total deposits in 2000, projected at 28.9 percent in 2001 (IMF, 2001b); according to bank officials at least half of foreign deposits are estimated to be in dollars. Hard data are hard to come, but a relatively large pool of dollars in circulation fits with the discrepancy between official and unofficial estimates of foreign remittances (mostly dollars), with the widespread belief of a large-scale informal economy, and with the experience of other Balkan countries. It cannot be by chance that in the Albanian foreign exchange market in December 2001 the dollar commanded a premium over the DM and the other euro-currencies with respect to their cross rates in the world market. This dominant role of the US dollar – as we shall see below – casts some doubts on whether Albania should adopt a closer link to the euro.

3. FLOATING VERSUS FIXED EXCHANGE RATE REGIMES

In the early 1990s the so-called Washington consensus on transition economies did not include a recommended exchange rate regime. A floating rate was believed to be good for countries with nominal price and wage rigidity, large size and low foreign trade openness, a high incidence of asymmetric shocks, low diversification of production, low factor mobility across borders especially for labour; conversely for fixed exchange rates.

Basically it was believed that a floating rate would maintain competitiveness and therefore employment, at the cost of higher inflation, while a fixed rate would, on the contrary, contain inflation at the expense of competitiveness and therefore employment; the choice of the inflation/unemployment trade-off was a matter for sovereign governments. Moreover, any exchange rate successfully maintained has a tendency to justify itself through its impact on domestic inflation; and the performance of any exchange rate regime depends strictly on the monetary policy that accompanies it. Thus the complete range of exchange rate regimes can be found in transition economies, from freely floating to fixed and hyper-fixed, through all the intermediate regimes of managed floating, crawling pegs, wide and narrow bands.

In the late 1990s a new orthodoxy has emerged, namely the “bipolar” view favouring either hyper-fixed rates, i.e. formal currency replacement or a currency board, or a fully floating rate (see Fisher 2001). Intermediate, pegged exchange rate regimes, even if successfully sustained – indeed often *especially* if successful – make an economy vulnerable to capital inflows/outflows that first strengthen the currency to non-sustainable and non-competitive levels then depress it beyond reason with sudden precipitous withdrawals causing panic and collapse. Thus in the second half of the 1990s there has been a marked switch away from intermediate regimes towards the extremes, of either floating or hyper-fixed rates (see Fisher 2001, who however regards a crawling peg with inflation targeting as a reasonable compromise).

Out of the two extremes, a floating exchange rate is often associated with inflationary bias, volatility and recurring turbulence (Mundell 2000).¹⁸ If we accept this argument, hyper-fixed exchange rate regimes seem the more desirable option in a country that exhibits deep trade integration with the area whose currency it adopts.

4. HYPER-FIXED EXCHANGE RATE REGIMES

¹⁸ 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 rehearsal of arguments against dollarisation).

There is a remarkable, though often little understood, similarity between membership of a Currency Union, formal currency replacement and a Currency Board regime.

Membership of a Currency Union involves total and formal currency replacement by the Union currency, at a negotiated exchange rate and usually subject to convergence conditions – for EMU, EU membership and the Maastricht conditions mentioned above. There are additional rights and obligations such as representation in the ECB Governing Council;¹⁹ sharing automatically in seigniorage directly or indirectly; the transfer of the bulk of domestic reserves to the ECB, involvement in economic policy coordination and supervision, respect of the so-called “growth and stability” pact.

The effects of negotiated and agreed membership of a single-currency monetary union – say the dollar, or the euro – can be approximated by unilateral dollarisation or euroisation, understood as a commitment to a so-called “hyper-fixed” exchange rate regime, which takes one of two forms:

(1) Total and official currency replacement, undertaken unilaterally, without or before membership of a Currency Union. Of course, the more an economy is dollarised informally, the closer it will come to a formally dollarised ***economy, without ever getting there, for those prices which are usually expressed in domestic currency – notably wages – are never instantaneously and fully indexed (if at all) to the dollar exchange rate.***

(2) A Currency Board issuing domestic currency only in exchange for convertible currencies at a permanently fixed rate with respect to the reference currency. When this arrangement is introduced the pre-existing currency may be kept or replaced, as long as it is covered by foreign reserves at the same rate. For the sake of convenience and of psychological impact the domestic currency – whatever it is called – could also be re-denominated so as to make its unit equivalent to a unit of the reference currency, say the euro (like Argentina’s peso parity *vis-a-vis* the US dollar established in 1991 and ended in January 2002).

In this paper the terms dollarisation/euroisation are being used to designate *both* currency replacement and currency board regimes,

¹⁹ With EU enlargement probably new rules will have to limit the size of the ECB Governing Council through a *rota* or a constituency system, so as not to make it too unwieldy.

except when dealing with their differences when the two will be specifically indicated. The similarity between the two regimes, and their closeness to a Monetary Union, are best understood in terms of switches from one to the other.

A Currency Board can switch to currency replacement at any time, at the costs of losing a sovereignty symbol and interest on the reserves used to withdraw the national currency from circulation, and the benefits of reducing further any residual risk premium on its exchange rate and of not having to manage the currency. Costs and benefits would be mirrored in a hypothetical, possible reverse move from generalised use of a foreign currency to a Currency Board linked to it. Membership of a Monetary Union is equal to formal and total currency replacement plus the rights and obligations of membership, mentioned above. These differences and similarities are clearly little understood by both the ECB and the European Commission, when they accept the adoption of a currency board by accession candidates (e.g. Bulgaria) but reject currency replacement as if it involved the same rights as EMU membership (see below, section 8).

5. INFORMAL PARTIAL DOLLARISATION/EUROISATION

Total and formal currency replacement should not be confused with partial and informal currency substitution. For a long time the DeutchMark (and therefore the euro, from 1 January 1999 for non cash transactions, from 1 January 2002 also for cash) has been used extensively in central eastern Europe and the Former Soviet Union (FSU), next to and often in preference to the US dollar, as unit of account, store of value and means of payment together with the domestic currency. This kind of informal, partial “dollarisation” is common also in other countries especially in Latin America, where it has been the object of extensive research (see Calvo 1999, IMF 1999, US Senate JEC 1999, Berg and Borensztein 2000). The Federal Reserve estimates that in 1998 40-60 percent US dollar notes and coins, corresponding to \$192-\$288bn, circulated abroad (Feige et al., 2000). The DM was used widely outside Germany especially in central eastern Europe. In 1995 the German Bundesbank estimated that about 30-40 percent of all DM notes and coins in circulation were held abroad (Seitz 1995). Since then, at least in a sample of five transition economies (Croatia, Hungary, Slovenia, Czech Republic and Slovakia), there appears to have been (i) a decline in both DM and US\$ holdings and (ii) a switch from DM to US\$ (Stix 2001), probably in the attempt to avoid the fiscal and penal consequences of foreign

exchange holdings surfacing into the open in the conversion from DM to euro after January 2002.

Sometimes this informal currency substitution is regarded as a reverse Gresham's Law, good money chasing bad money away instead of the other way round, but this is not correct. Gresham's Law applies to *dis-equilibrium* fixed rates between legal tenders, with debtors naturally preferring payments in the weaker (i.e. officially overvalued) currency. With informal dollarisation both currencies are good, each better than the other only in performing different specific functions, their relative advantages defining a flexible exchange rate between the two, not prefixed by law but determined by economic agents. In Soviet-type systems in the old days foreign currency was used, even when it was illegal, because of domestic currency debasement by actual and repressed inflation, and because of its greater liquidity and safety; after the transition, mostly because of continued inflationary expectations much higher than in foreign exchange prices.

In view of the lek's sustained real *and* even nominal revaluation, very low inflation and falling interest rate, the continued high degree of dollarisation and DM/euroisation in Albania is a somewhat puzzling phenomenon. Moreover, in view of the trade direction considerations above, it is equally puzzling to find a greater use of the dollar than of euro-zone currencies, in spite of trade with the EU being a hundred times larger than trade with the USA (see section 2 above).

The most plausible explanation for these currency puzzles is bound to be the extensive dollarisation of both assets and liabilities, in the public and in the private sectors, and the dominance of dollar in foreign trade invoicing regardless of the currency area of trading partners. The euro may have failed to substitute the dollar because of its weakness after its launch in January 1999, in turn due to a combination of lower EU growth, lack of political unity and representation in the euro-area, and poor management. Until January 2001 the lack of banknotes and coins clearly restricted the use of the euro as a means of payment and therefore its attraction as alternative currency; while the introduction of euro banknotes and coins raised transaction costs for the holder of euro-currencies at the point of conversion.

Informal dollarisation and euroisation, as in Albania, is both an advantage and a hindrance when considering the formal adoption of a hyper-fixed regime: the switch is facilitated by the relatively

large amount of foreign exchange in circulation, but given the dual US\$ and euro circulation a *de-linking of the economy away from the currency that would no longer used must be implemented*. As things are at the moment, a possible Albanian switch to a hyper-fixed exchange rate could only take the form of a currency board linked to a euro and dollar basket, which would bring about the benefits of a hyper-fixed regime but not those of a single currency area.

6. EUROISATION BENEFITS

For an extensive treatment of the economic implications of euroisation we refer to Nuti (2001); here we will consider those costs and benefits in relation to Albania. *In general we find that both costs and benefits have probably been exaggerated, that there are likely to be positive net effects, that these net benefits are likely to be all the greater with the progress of convergence to EU standards.*

On the benefit side, we find the following:

(i) *Greater exchange rate certainty.* In theory both currency replacement and Currency Boards involve a permanent, irreversible commitment to a fixed exchange rate. As Larrain and Velasco (2001) put it, "One cannot easily devalue a currency that does not exist, or one whose exchange rate is set by law". However they speak as devil's advocates for, on the contrary, a currency that does not exist can always be brought back into existence and, when the exchange rate is set by law it can also be changed by law. Indeed Bratkowski and Rostowski (2000) in the same breath recommended zloty replacement by euros and contemplated a possible reversal. It remains to be demonstrated that such policy reversals would be so expensive as to stop the government from deciding them; the point may come when the government has no other choice (as in Argentina in December 2001) and the greater cost of reversal (with respect to other exchange rate regimes) may make a crisis worse rather than prevent it. Strictly speaking there is no such a thing as a hyper-fixed exchange rate regime. Indeed even common currency areas can be split again (as in the Soviet Union, or the CSFR, or Yugoslavia), while in the case of currency replacement and especially of Currency Boards there remains always a non-negligible residual risk of devaluation, clearly visible in the interest rate premium almost invariably prevailing for debtors of equivalent ratings. It is significant that in Bosnia in 2001 the DM should

continue to circulate as a parallel currency next to a DM-linked currency (though to a rapidly diminishing extent), showing that even the adoption of a Currency Board can be ineffective unless it is preceded by extensive economic and political reforms. *This gain for Albania, in view of its background of stability and orderly appreciation, is bound to be very small.*

(ii) *Greater credibility of government policies.* It is often argued, even for a fixed exchange rate policy and, *a fortiori*, for a hyper-fixed regime, that a government lacking policy credibility and a track record can “borrow” credibility by anchoring the national currency to a strong and credible currency. However, it is questionable whether credibility can be borrowed, for the strength of a chain cannot be greater than the strength of its weakest link, which here is the credibility of the national government commitment to such or indeed *any* policy. Suppose Russia had adopted a Currency Board at the end of August 1998, after defaulting on over \$40bn worth of government dollar debt, and of an even larger public debt denominated in roubles; it seems naïve to believe that a commitment to a permanently fixed parity to hard currencies then would have been judged as credible by international financial markets. *In Albania, with an independent and well-managed Central Bank, this gain would be negligible.*

(iii) *Lower transaction costs.* Undoubtedly the use of a common currency as both measure of value and medium of exchange leads to lower transaction costs, though these savings have probably been exaggerated. It is true that anybody switching from one of the 12 currencies of the euro-zone into each other in succession and back to the initial currency would lose most of its initial stake in commission charges; even for a modest 2 percent commission charge on each transaction one would lose almost one quarter of the initial amount. However nobody in his right mind would be so inefficient as not to gear the composition of one’s currency portfolio to the likely pattern of actual expenditure. As a result the total gain in the circumstances is unlikely to be much higher than 2 percent even if total expenditures are 100 percent mismatched with total revenues. Such complete mismatching is totally implausible, so that the gains in transaction costs are more likely to be of the order of, say, 1 percent of the value of transactions or less. The use of a single unit of account makes prices more transparent, but we do not seem to have much difficulty in comparing relative prices (domestic/foreign) when travelling in foreign countries using different currencies, or comparing price lists in different currencies.

Hence *in general transaction cost gains are undoubtedly there but probably are overestimated, and Albania is no exception.*

(iv) *Lower interest rates.* Lower nominal interest rates in terms of the reference currency are likely, thus promoting investment and growth. The country risk premium, however, especially with a Currency Board, in practice is never completely eliminated and can remain substantial. In Argentina, for instance, after ten years of a Currency Board successfully linking the peso to the dollar at parity, in November-December 2001 on the eve of default a crippling interest rate premium prevailed of the order of 25 percent rising to 40 percent over the dollar rate. In all probability interest premiums will be lower than with alternative exchange rate regimes, but not necessarily zero even in the case of total currency replacement. Besides, over and above a country risk (equal to the risk on sovereign borrowing) there remains a premium covering borrower's default risk. Undoubtedly both the government and private investors benefit from a common currency through their ability to borrow internationally in their domestic currency, the same in which expenditure is denominated and actually incurred (Hausmann 1999, Hausmann *et al.* 2000). Again, such benefit is probably exaggerated in economic discussions. Moreover in Albania the interest rate has already been falling significantly, with the rate on 3 months T-bills going from 35.9 percent in 1997 to 7.8 percent in 2000; *interest rate gains, if any, in Albania would be small.*

(v) *Greater macroeconomic stability.* A reassuring aspect of both currency replacement and Currency Board is the presence of automatic, self-regulating adjustments in money supply, determined by changes in domestically held foreign assets, similar to those occurring under a gold standard. The speed and intensity of such self-regulating adjustments are unlikely – as they were under the gold standard – to be sufficient to ensure complete stability, but they are also incapable of doing any damage. Again, there is a small but probably exaggerated benefit from a Currency Board or currency replacement.²⁰ More significant gains in stability might come from the “bipolar” argument discussed above. Bratkowski and Rostowski (2000) see the elimination of currency crises risk as a major benefit of euroisation. But a common currency does not really eliminate *costlessly* the risks of current account deficits arising with a domestic currency, it simply transforms them into risks of regional under-development. Such

²⁰ In an economy which is already extensively euroised, moving to total and official currency replacement would eliminate the complications of dual components in money supply, in setting intermediate targets of monetary policy.

risks may be potentially more difficult to deal with, and span over a longer run, than a temporary currency crisis (especially without the provisions for transfers from the EU budget which would only benefit EU members). *For Albania, as well as in general, gains on this account would be small.*

(vi) *Greater trade and Foreign Direct Investment.* Until recently empirical work has failed to find a reliable empirical connection between monetary arrangements and trade flows. Andrew Rose (2000), on the contrary, claimed a dramatic effect of currency unions on trade; he found that countries that use a common currency trade almost 300 percent more with each other than similar countries with different currencies, though he could not indicate the source of the incredibly large effect that he measured and warned readers against drawing dramatic policy implications from his results in connection with EMU and other actual currency unions. Torsten Persson (2001), however, qualified substantially and cut to size Rose's conclusions. He supposed that countries that adopt a common currency are a self-selected group, in that they are also those for which a common currency has the largest effect on trade, and considered other possible determinants of trade intensity. As a result the impact of a common currency appears to be considerably smaller at about 40 percent, and much less precise.²¹

This drastic re-consideration of trade expansion is best understood by analogy with medical research, where the effectiveness of a particular treatment for those treated cannot necessarily be generalised to all untreated patients. By the same token the effect estimated for existing currency unions or currency areas, whatever its size, cannot be confidently extrapolated to a group of central and east European countries whose only common feature is a fairly similar former communist economic regime, and whose main feature in common with the euro-zone it wishes to join is proximity. Moreover, the euro-zone's already high share in their foreign trade weakens, rather than strengthening, expectations of further growth.

A positive impact on trade may have, indirectly, an adverse impact on Foreign Direct Investment, which at least to some extent is a

²¹ Rose's rejoinder renews claims of a large and precise estimate of the impact of a common currency on trade, but discussant Patrick Honohan and the *Economic Policy* Panel at which these papers were presented concluded that "the apparent trade effects of currency unions – whether large or small" may really be due to the simultaneous adoption of other policies by the countries concerned" (Editors' Introduction, *Economic Policy*, October 2001, p. 260).

substitute for direct trade (see Bevan and Estrin 2001); for a common currency to have a positive net overall impact on FDI such an adverse impact would have to be more than compensated by positive effects that a common currency may have on general business climate and re-exports prospects. At the same time the lower interest rate expected of the adoption of a common currency must dampen inflows of *financial capital*.

On balance, the sizeable though not spectacular gain of the order of 40 percent on foreign trade is a significant gain also for Albania.

7. EUROISATION COSTS

Unilateral euroisation would also have costs:

(i) First and foremost, a *loss of seigniorage* – the revenue obtained from issuing domestic currency, usually defined as the real value of the change in base money.²² In the Currency Board case some of the seigniorage otherwise accruing to a Central Bank is preserved through the interest earned on reserves. Under currency replacement the loss of seigniorage on the mass of foreign exchange in domestic circulation is total, except that a seigniorage sharing arrangement could be agreed with the Central Bank that governs the chosen currency (Calvo 1999, Daviddi 1999); such an arrangement was contemplated for dollarised countries by the International Monetary Stability Act of 2000, introduced in the US Senate by the then Chairman of the Joint Economic Committee Senator Connie Mack, and later shelved. 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 euroisation. Seigniorage loss resulting from euroisation 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 transition economies seigniorage is usually fairly low, of the probable order of 1-2 percent of GDP (Schobert, 2001), but

²² There are also other definitions, such as the nominal interest rate on real base money, or net revenues from central bank operations related to the creation and management of base money (which are one component of central bank transfers to the state budget). For a discussion and estimates for central eastern Europe see Schobert 2001.

Albania seems to be an exception. Schobert estimates that in 1994-99 in Albania seigniorage represented on average 4.1 percent of output and 18.2 percent of fiscal revenues, higher than in other high seigniorage countries like Belarus, Ukraine and Romania and much higher than under 2 percent of GDP for Poland, Hungary and the Czech Republic. Clearly Albanian seigniorage in the period in question is high because of a combination of high inflation and low fiscal revenue, in a country that by comparison with other transition economies is exceptionally well monetised. With the improvement in both Albanian inflation and fiscal revenues *seigniorage is bound to be falling but would still involve a substantial loss from unilateral euroisation*. Also, low seigniorage in transition economies is often due primarily to large scale losses from sterilisation operations by central banks; such losses are largely due to high domestic interest rates, and therefore avoidable, thus adding to the loss of *potential* if not of actual seigniorage.

(ii) *Initial reserves*. Large-scale foreign currency reserves are needed to establish Currency Boards or to formally replace a national currency. At birth a Currency Board must be endowed 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 that 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). Bratkowski and Rostowski (2000) 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 euroisation, while Slovakia and Hungary are classed as "possible". Other countries wishing to euroise might be less fortunate: 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 and its subsequent renewals. Instead reserves must be instantly and permanently available against possible requests for conversion, therefore a Currency Board cannot be run on borrowed money, or it would become indistinguishable from an ordinary fixed exchange rate regime subject to occasional adjustments. 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. *Albania would be able*

to cover with its foreign reserves about 70 percent of its base money, thus being close enough to manage with some foreign assistance and long term loans from international financial institutions, like Bulgaria.

(iii) *Loss of a Lender of Last Resort.* 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). Unfortunately all that is backed up by foreign exchange is base money, i.e. M0, whereas in a currency crisis – as spectacularly demonstrated by Argentina in December 2001 – 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 must be introduced – whether *de facto* or *de jure* – on the convertibility of bank money into cash, thus re-instating a monetary segmentation that was typical of the old-style centrally planned economy. Such limits have been observed in Argentina’s crisis, where they have been a major cause of riots and social unrest.

In a “normal” monetary economy a cash shortage is prevented 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. A Currency Board can act as Lender of Last Resort (LLR) only within the bounds of excess reserves over and above M0 coverage; under total and formal currency replacement the central bank can equally continue to act as lender of last resort within the bounds of its residual foreign exchange reserves left over after the currency change. In Poland such reserves would be substantial, equivalent roughly to half the money supply, but this opportunity is not present anywhere else in the area. In a liquidity crisis these margins may be insufficient to maintain an orderly monetary circulation. Some liquidity may be provided by foreign banks (Calvo, 1999), but at some point even foreign banks may prefer bankruptcy to further involvement (as, again, in Argentina 2002); the LLR function remains significantly impaired. In order to avoid a cash shortage interest rates will have to rise in order to attract foreign exchange and to induce the public to reduce their demand for money, but it cannot be presumed that an interest rate level equilibrating demand for and supply of cash should necessarily always exist. Banks could be bankrupted not for their underlying insolvency, in which case bankruptcy might be regarded as a necessary and even desirable development in transition economies, but for sheer

illiquidity artificially created by the Currency Board rules of monetary issue, and the consequent interest rate rise.

In principle the LLR function could be partly fulfilled by the Central Bank of the common currency, even without membership of the currency union. But there is no statutory provision for such a role; indeed the International Monetary Stability Act cited above specifically stated 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). A formal arrangement for the ECB to act as LLR to countries that lacked convergence even by the Maastricht criteria would expose the euro to a very great risk; but without such an arrangement, financial fragility would ensue. The problem would be aggravated by the fact that the ECB could not take on any responsibility for the supervision of financial institutions in euroised countries.

After unilateral euroisation the Central Bank of Albania would not have any own reserves left to undertake a role of Lender of Last Resort; while there seems to be no provision in law for the Bank to fulfill that role, in practice that option is now open to the Bank and the loss of such an option might be significant in the event of a financial crisis.

(iv) *Loss of national monetary policy.* Any fixed exchange rate regime necessarily restricts the scope for domestic monetary policy. The permanent adoption of a common currency, in any form, necessarily delegates monetary policy to the Central Bank responsible for the maintenance of price stability. Of course the stabilisation needs of transition economies may not leave much margin for an autonomous monetary policy, 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 pace over ten years. Moreover, all central eastern European transition economies are facing extremely challenging issues of social welfare reform, on a greater scale than the rest of Europe (see Eatwell et al., 2000), which may require country-specific approaches to macroeconomic management.

The policy followed by the European Central Bank may be at odds with the euroising country's fundamentals. The probability of asymmetric shocks within EMU is being reduced by adherence to the Maastricht criteria and by the so-called "stability and growth" pact, but cannot be eliminated. *A fortiori*, euroised countries that

are not in EMU will be more likely to suffer from asymmetric shocks.

The loss of a domestic monetary policy resulting from euroisation is clear but should not be exaggerated. A Currency Board may be unable to conduct *any* monetary policy, but is still fully “independent” with respect to political authorities. Once a government has delegated to a fully independent Central Bank the maintenance of price stability, it has already abdicated its monetary sovereignty. Then it matters little whether a National Central Bank or an equally single-minded and independent super-national or foreign Central Bank manages the currency used.

(v) *External debt denomination.* External debt may be denominated in currencies other than the euro, typically dollars. A number of transition countries have raised a very large part of their external debt in US dollars: in 1997 the share of dollar-denominated external debt was 77.9 percent in the Czech Republic, 75.1 percent in Bulgaria, 61.6 percent in Lithuania, 46 percent in Poland, against DM shares respectively of 4.7 percent, 4.7 percent, 6.2 percent, 9.9 percent, (DBR, 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 euroisation, or offsetting transactions in foreign exchange forward markets would have to be entered on a vast scale. In Albania most of public debt is internal (42% of GDP) and foreign debt at 27 percent of GDP is relatively small. *This would be a relatively minor problem, not difficult to tackle, though action would have to be taken and a cost would be incurred.*

(vi) *Invoicing practices.* In some countries, as we know to be the case in Albania (see section 2 above), the euro may not be the preferred currency in foreign trade invoicing practice, which may be difficult to change. Settlement practices are often regarded as relevant but they are immaterial. For instance, Helmut Aancans, head of monetary policy at the Latvian central bank, was 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” (*Financial Times* 16 February 2000). But such stability only obtains if the SDR is the currency in which contracts are denominated. The Lithuanian Lita, while being pegged to the US dollar, appreciated instead in real terms with respect to other currencies used in its pricing and invoicing, thus causing a large

scale current account deficit. "Trade in euro is not as big as trade in dollars" (Lithuanian CB deputy governor Arvidas Krejzde, *ibidem*), but 40 percent of Lithuanian foreign trade is with the EU and appreciation was therefore a non-negligible problem.

In Albania the dominant role of the US dollar in invoicing and settlement even in trade with the EU is undoubtedly a major obstacle to euroisation – unilateral or even via eventual EMU membership. *Invoicing practices will have to change beforehand, or euroisation will have to be postponed or replaced by a Currency Board type link to both the euro and the dollar.*

(vii) *Inflationary impact of real revaluation.* All transition economies have introduced convertibility at a significantly undervalued exchange rate; invariably they all have undergone real revaluation falling gradually towards a position of around twice the ratio between the Purchasing Power Parity (PPP) exchange rate and the actual rate.

Real revaluation is usually associated with the so-called Harrod-Balassa-Samuelson effect, of faster productivity in the tradables sector driving up wages and prices in non-tradables sectors (see Coricelli 2001), but this effect can easily be overplayed. First, this is bound to be a world-wide trend, reflected in the evolution of world prices, therefore only *differential* higher growth for productivity in tradables over non-tradables matters, in comparison to the rest of the world; this may well be positive for transition economies catching up with best-practice techniques (Buiter, 2001), but not as high as domestic differences in productivity between the two sectors. Second, tradables are both inputs in non-tradable goods, and substitutes for non-tradables, which rather reduces the relevance of the classification. 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 under-valued in real terms.

For any fixed nominal exchange rate, subsequent unavoidable real revaluation necessarily involves a positive inflationary differential with respect to the peg currency. Far from aiding the control of inflation, in such circumstances any fixed exchange rate regime can turn into an inexorable inflationary machine. The necessary real revaluation could only be achieved without inflation through a *nominal revaluation*, which is the way experienced by Albania, alone among all transition economies (see section 2 above).

Unilateral euroisation would eliminate for Albania the option to continue such non-inflationary real revaluation process.

Of course a real revaluation can be inconsistent with the parallel commitments to price stability and nominal exchange rate stability involved by Maastricht criteria (Rollo 2001), and unilateral euroisation can be seen (Bratkowski and Rostowski, 2000) as a way to evade those constraints. However the very broad fluctuation margins envisaged by ERM II (+/- 15 percent of central parities) and the applicability of the Maastricht inflation limits only in the run up to EMU membership – for just one year before examination – should still allow EMU candidates to accommodate the necessary real revaluation without having to euroise unilaterally. After EMU membership they could – like Ireland – continue to inflate as needed, only subject to fiscal constraints.

8. CONVERGENCE TO AN OPTIMUM CURRENCY AREA

De Grauwe and Aksoy (1997, see also De Grauwe and Lavra 1997) argue that central eastern European countries are not part of a European optimum currency area (OCA), as theorised by Mundell in his classic 1961 article, i.e. as a fairly homogeneous region with synchronized cycles and symmetric response, flexible prices and factor mobility. Gligorov (2001) puts it more strongly, arguing that no Balkan country – including Albania – is an optimum currency area *in itself*, let alone jointly with other Balkan country or with the European Union. McKinnon (2001) notes that in a little known contribution to OCA literature Mundell (1971) stresses the advantages of some diversity for the sake of risk diversification within the area. Moreover it has been suggested that close trade links may actually promote economic convergence, thereby making OCA criteria endogenous (Frankel and Rose, 1997 and 1998).²³ Arguably the diversity exhibited by transition economies in the 1990s exceeds the degree of diversity that might actually be good for an OCA, and which may set in motion endogenous convergence. There can be no doubt that the costs discussed in the previous section would be considerably reduced with the convergence of transition economies to the euro; benefits possibly might also be reduced, but proportionately less than costs. Convergence must be understood not only for the monetary and fiscal parameters but also for real and institutional ones.

²³ Kenen (2000) shows that trade links do not ensure business cycles convergence, unless countries are already sufficiently similar, but Fidrmuc (2001) includes the impact of intra-industry trade thus confirming the endogeneity hypothesis.

(i) *Monetary and fiscal convergence* as represented by the Maastricht criteria has received a great deal of attention. The basic idea is that convergence can be realised not endogenously through trade links but as a result of deliberate policy measures; indeed most of the accession candidates seem to have made significant progress towards fulfilling those criteria, which appear well within their reach. In Albania the share of government debt in GDP, at about 70 percent, higher than the average 50 percent in transition economies but below the euro-zone average of 73 percent in 2000²⁴.

A government deficit of 9 percent in 2000, however, though falling, is three times the maximum allowed by the Maastricht treaty, and IMF emphasis on the internally financed deficit of 3.25 percent is a well-meaning but incomprehensible complacency, even if total Albanian debt still has a long way to go before reaching Belgian or Italian proportions. It is true that the deficit can be reduced below the limit of 3 percent of GDP by drastic measures rather fast, if there is political will, but clearly public revenue is still low at 22.4% of GDP (with expenditures at 31.4 percent) and must rise in Albania to get closer to EU levels. Albanian inflation is well within Maastricht targets,²⁵ but interest rates are not.

The trouble is that Maastricht criteria ignore essential and worrying features of transition economies such as quasi-fiscal deficits and debt, due to extra-budgetary, delayed and/or contingent public expenditure and commitments, including hidden subsidies and non-performing loans in the balance sheets of state banks. Maastricht criteria do not include 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

²⁴ IMF projections envisage a reduction by of Albanian debt of 50% by 2010 under favourable macroeconomic conditions, but even under less favourable conditions public debt dynamics may not be unduly worrisome (IMF 2001b, p. 5). External debt at 27-28 percent of GDP, and no short maturities, is well manageable for a debt service burden at 4.5 percent of the value of exports and expected to remain under 6.25% until 2005. The net present value of external debt to export ratio is 83%. In 2000 Albania reached a Paris Club rescheduling agreement with Austria, France, Italy and the Netherlands; full repayment was made to Denmark. More limited progress has been made in negotiations with London Club of commercial creditors.

²⁵ Rother (2000) finds that relative price adjustments impose an upward bias on inflation in Albania, especially due to downwards price rigidities; in these conditions monetary policy should allow for some positive inflation, as some factors driving higher inflation represent equilibrium adjustments that should not be resisted. Such inflationary trends likely to persist in the future

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 percent of GDP in Romania, 39.7 and 3.9 percent in Russia – or both, e.g. 5.8 and 7.6 percent in Bulgaria and 6.2 and 11.6 percent in Latvia (EBRD, 2000). Further progress in approaching Maastricht inflation targets may come expensive.²⁶

Here Albania is in a mixed position. Bank restructuring has already taken place, and already surfaced in the rise in public debt from 63 to 69 percent of GDP. However, pension reform is necessary due to non-sustainability of a system where the dependency ratio (contributors/beneficiaries) through ageing, unemployment and evasion dropped from 4.5 in 1990 to 1.6 in 1993 and 0.8 in 1999 (though rising to 0.9 in 2000 through a rise in contributors; see Treichel 2001). At the same time, Albanian financial markets are greatly underdeveloped, with virtually no secondary market in government bonds, a large bank share in their primary market, and a stock exchange still in its infancy.

(ii) *Real convergence*, in the view of some observers, is not a meaningful concept (Gros 2000) but on the contrary can be easily identified as convergence of real incomes per capita – a process of catching-up which is already labelled “real convergence” by the ECOFIN Report of November 2000 (p. 2) – and therefore of labour productivity and wage rates; of real interest rates, rates of unemployment, capacity utilisation. Accession candidates have an income per capita ranging from 7 percent of the EU average in Bulgaria to nearly 50 percent in Slovenia; even at PPP exchange rates those differences are lower respectively at 23 percent and 70 percent but still large (EC-DG II, 2001). Albania is still lagging behind, not only in income per head but more worryingly in structural convergence, looking at a structure of employment of 11.5 percent in industry, 51.0 percent in agriculture, 14.8 in construction, 3.5 percent in transport, and 19.2 percent in other services.

²⁶ In October 2001 in Warsaw the ECB Vice-President Christian Noyer said that “Central and eastern European countries should not try to qualify for euro-zone membership by suppressing inflation so quickly that they hinder the growth of people’s real incomes” (*Financial Times*, 16 October).

With sustained differences in income per capita the cost of cohesion policies (through structural funds and other transfers) is bound to be large, and it is not clear whether it can be contained within current EU limits of 4 percent of the recipient country's GDP. Such re-distribution policies would be further enhanced if the EU supported national farmers, whose share in employment and GDP in accession candidates exhibits extreme diversity both within the group of new members and with respect to the Union of 15. Growth rates are bound to be much faster in the central-eastern accession countries, engaged in a catching up process which is probably more inflationary and requires a more accommodating monetary policy than that which suits the present euro-zone of 12. 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 – real convergence appears to be a much slower and more protracted process than anticipated (see Kolodko, 2000; see also Salvatore, 2000).

(iii) *Institutional convergence* also would appear to have been making rapid progress, at least for the front-runners lined up for accession, judging from EBRD assessment of systemic transition achievements in the scoreboard published yearly since 1994 in its Transition Reports. Especially in areas such as privatisation and foreign trade, transition scores are impressive, even for Albania. (See Table 1 for a comparison with both other Balkan countries like Romania and Bulgaria and frontrunners like Poland and Hungary). However, 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 percent of the road to a full-fledged market economy (see Nuti 2001). Moreover the EBRD approach neglects 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 evolution and in different fields. In particular, banking systems, financial markets and regulatory regimes are not yet sufficiently developed, for the very good reason that they had to be set up *ex novo* instead of being re-structured as the other production sectors.

According to the IMF (2001b) “Despite the improvements of recent years, the Albanian Economy continues to face institutional and infra-structural weaknesses, necessitating a bold program of structural reform.” The memory of the 1997 pyramid banking

collapse – on a scale of half of a year's GDP – is still lingering; it was caused primarily by the inadequacy of the formal financial system, with state banks failing in their role as savings intermediaries, and private banks slow in emerging and devoted primarily to trade finance rather than attracting deposits. The authorities dealt well with the problem though acted rather late (Jarvis 2000).

Economic relations between advanced market economies like the EU-15 and economies with an incomplete market system are similar to those previously entertained with centrally planned Soviet-type systems; they can appear – and at the microeconomic level they can be – mutually advantageous but are not a good foundation for efficient economic and monetary integration.

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

Habib (2001) argues that, on balance, the case for unilateral currency replacement is weak in the Czech Republic and Hungary, because although converging they do not need to import monetary stability and credibility, are not highly euroised and would not gain a significant reduction in risk premia. In Poland, as a medium size relatively closed economy, an autonomous monetary policy could smooth the economic cycle; but the country could gain from a reduction in interest rate and risk premium by replacing the zloty by the euro – as long as labour market rigidities were tackled. Bulgaria presents all the favourable conditions for an early adoption of the euro (though Roussenova 2001 is much more cautious in her assessment). A strong case for euroisation is also made by Sulling (2001) in the case of Estonia; basically the move from Currency Board to currency replacement is less traumatic than the same move starting from other exchange rate regimes.

9. EU AND ECB POLICY TOWARDS UNILATERAL EUROISATION

Both the European Commission and the European Central Bank leave accession candidates free to adopt any exchange rate regime they choose, including a Currency Board, as confirmed by their acceptance of those of Bulgaria, Estonia and Lithuania. Some time after accession the new Member States will be expected to join ERM-II, which is incompatible with fully floating

rates, and with pegs (whether fixed or crawling) against anchors other than the Euro. But euroisation in a strict sense, understood as domestic currency replacement by the euro, on the contrary is strictly ruled out by the EU until not only accession but also full convergence and negotiated acceptance into EMU:

“Any unilateral adoption of the single currency by means of “euroisation” would run counter the underlying economic reasoning of EMU in the Treaty, which foresees the eventual adoption of the euro as the endpoint of a structured convergence process within a multilateral framework. Therefore, unilateral “euroisation” would not be a way to circumvent the stages foreseen by the Treaty for the adoption of the euro.” (EC 2001a, p. 21, emphasis added; see also an identical statement in EC-DG-II 2001 and in the ECOFIN Report to the Nice summit of November 2000).

For a full-fledged criticism of both the legal and economic foundations of this aversion to currency replacement we refer to Nuti (2001). From a legal viewpoint, the Maastricht Treaty sets conditions for EMU full membership and says nothing to stop any non-member, whether or not an accession candidate (or indeed even a EU member not qualifying for EMU membership), from adopting the euro as domestic currency. By replacing its currency with euro, a country would renounce completely the 15 percent margin fluctuation either way vis-a'-vis the euro envisaged by ERM-II; such a greater commitment to a stable exchange rate should be rewarded, not penalised. From an economic viewpoint, EU aversion to unilateral euroisation is probably induced by three considerations:

First, the fear that participation in the euro-area (though not in EMU) by weaker countries might destabilise the Euro, neglecting that the central eastern candidates represent under 6 per cent of the enlarged Union's income and 3 per cent of its money supply. A greater threat – if any – would be more likely to come from the unilateral euroisation not of accession candidates but of outsiders, in view of their lesser degree of convergence to EU parameters.

Second, the fear that political pressure might be brought to bear on the ECB to take into account the particular needs of euroised countries, except that the ECB would be under no obligation to do so and would remain fully independent in the formulation of its monetary policy.

Third, the fear that the exchange rate at which a country unilaterally euroises might be excessively undervalued, thus

undermining the competitiveness of EU exports. These fears are not justified, in view of (i) the large scale current account deficits, in general and especially towards the EU, of all accession candidates and especially those that have adopted a currency board, which justify an element of under-valuation when a hyper-fixed rate is selected; and (ii) the higher inflationary pressure in economies that grow significantly faster than current EU members, which is bound to erode any initial gain in competitiveness from under-valuation.

It is not clear what conceivable gain might come from candidates running a Currency Board, in order to satisfy EMU criteria according to EU documents on enlargement (such as ECOFIN 2000), first moving from their long-standing fixed exchange rate to a presumably stronger rate negotiated with EMU countries, then floating for two years within a 15 per cent band of variation with respect to the Euro, and finally locking their exchange rate irrevocably on EMU membership. This appears to be the kind of perverse scenario beloved by currency speculators, who with such rules of the game may succeed in destabilising the best-behaved and most solid candidate economy. The only credible exit from a Currency Board linked to the euro seems precisely instant currency replacement at parity. If that exit is accepted at some stage, there is no reason why currency replacement should not be allowed at any other time an accession candidate may wish to do it.

10. CONCLUSIONS

For Albania, costs and benefits from unilateral euroisation are bound to be the fairly small except for the benefit of significant trade expansion and the cost of significant seigniorage loss. Such a cost is bound to fall with persistent low inflation and rise in the share of government revenue. A major obstacle is represented by widespread informal dollarisation, which is at odds with both unilateral euroisation and eventual EMU membership after accession. Perhaps the actual introduction of euro banknotes and

coins (from 1-1-2002) will reverse dollarisation. Without de-linking the economy from the dollar the only hyper-fixed regime that could be introduced in Albania is a Currency Board linked to a euro/dollar basket, which would yield the advantages expected of a hyper-fixed exchange rate regime but not those of a common currency. Unilateral euroisation in the form of total formal currency replacement is at present ruled out by EU and ECB authorities, but Albania like all other transition economies including accession candidates should have a good case for negotiating their consent.

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Table 1. EBRD Transition Progress Scoreboard, *Transition Report 2001*.

	Albania	Romania	Bulgaria	Poland	Czech
Private sector share of					

GDP mid 2001	75	65	70	75	80
Enterprises small scale privatization	4	4-	4-	4+	4+
Large scale privatization	2+	3+	4-	3+	4
Governance and enterprise Restructuring	2	2	2+	3+	3+
Markets and trades Price liberalization	3	3+	3	3+	3
Trade and foreign Exchange system	4+	4	4+	4+	4+
Competition policy	2-	2+	2+	3	3
Infrastructure					
Telecoms	3+	3	3	4	4
Electric power	2+	3	3+	3	3
Railways	2	4	3	4	2+
Roads	2	3	2+	3+	2+
Water					
Waste water	1	3	3	4	4
Financial institutions					
Banking reform and interest rate liberalization	2+	3-	3	3+	4-
Securities markets and non-bank financial institutions	2-	2	2	4-	3

