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To link to this article: https://doi.org/10.1080/08911916.2003.11042892

Published online: 08 Dec 2014.

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Dollarization Out, Euroization In

It is undeniable that enthusiasm for dollarization, that is, the unilateral adoption by a country of the U.S. dollar as legal tender, has waned over the last few years. At its apogee, dollarization was embraced by policy circles in Washington, officially endorsed by Argentina in 1999, and adopted by Ecuador in 2000. In fact, it was once heralded, if not as a panacea, certainly as a credible solution to many economic ills, owing to the “undisputed gains” in trade arising from common currency areas (Rose 2000: 20).

Since then, however, economists have witnessed the quasi-collapse of dollarization as a credible policy choice, in North American as well as in many (larger) Latin American economies, paralleling the refusal of Argentina to dollarize after the collapse of the local currency board. Considering the wealth of research work still being done on the topic, however, it is clear that dollarization is still of great interest, as is the topic of common (or optimum) currency areas.

Interestingly enough, however, while the notion of a common currency has recently floundered in the Americas, it has flourished in Europe, where official euroization is endorsed by an increasing number of countries interested in adopting the euro as sole legal tender. A large currency bloc is forming in Europe and is spreading fast.

The purpose of this paper is to address this strange fact of decreasing interest in dollarization and increasing attention in euroization by aca-

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-demics as well as policy makers. We will argue that the recent fall and rise of essentially the same phenomenon can be explained, respectively, by the negative macroeconomic effects that dollarization has elicited in the Americas over the long run and by the hoped-for benefits that it has been raising for a number of countries in the so-called Euro-Time Zone (ETZ). The next section briefly discusses the pros and cons of common currency regimes (dollarization), and addresses the possible causes of the decline of dollarization in the Americas. In the third section, we turn our attention to the increasing fervor over euroization, and discuss a number of factors—that still have to be provided in many ETZ countries—that supporters of this exchange-rate regime point out as being necessary in order for this strategy to provide some beneficial effects in those countries adopting it. In the last section, we conclude that despite this “euro-phoria,” proponents have yet to address some of the more fundamental problems that are likely to result from this exchange-rate regime as time goes by.

On Dollarization

While the idea of a common currency may be traced back to Robert A. Mundell’s (1961) seminal analysis of optimum currency areas, the rise of dollarization (and the establishment of a number of common currency areas) parallels the rise of several financial crises in the last decade or so. The string of crises in Mexico, Asia, Russia, Brazil, Turkey, and Argentina has forced many emerging countries to reconsider the way they deal with international capital flows and their destabilizing effects on local currencies. In this sense, the notion of dollarization, and of common currency areas in general, seems to be tied to an increased sense of desperation over unstable foreign exchange markets. This is certainly the case with Ecuador, a country that dollarized in 2000 following the collapse of the local currency, the sucre. Dollarization was also considered seriously in Argentina, with the looming collapse of its currency board.

The debate over common currency regimes, and dollarization, in particular, has narrowly focused on the advantages and disadvantages of dollarization, with proponents generally arguing that the benefits largely outweigh the costs of it. This generally applies to both official and de facto dollarization. Among the advantages (see, for instance, Berg and Borensztein 2000), economists generally agree that dollarization leads
to any or all of the following benefits, arising generally from the gains in economic efficiency (De Grauwe 2000):

- Elimination of exchange-rate risks
- Increased capital inflows
- Lower inflation rates
- Lower interest rates and, thus, lower cost of capital
- Elimination of transaction costs (currency conversion fees)
- Increase in foreign trade
- Closer integration with the U.S. and global economies
- Improved labor market flexibility
- Increased economic growth

It is assumed that eliminating the local currency and adopting the U.S. dollar leads to the adoption of the prevailing monetary policy in the United States and, hence, to credibility in international markets. In this sense, dollarization would lead to the implementation of credible monetary policies in dollarized countries and would guarantee market discipline, which, in turn, would lower the overall “country risk.” As a result, international investors would find domestic securities more attractive, which would lead to increasing capital inflows (largely in the form of foreign direct investment) or would at least prevent abrupt capital outflows. In particular, elimination of devaluation risks could have some positive effects on the overall country risk, thus leading to further falls in domestic interest rates, with a number of positive effects on the domestic economy in terms of stimulating investment, employment, and output growth.

What is interesting to note at this juncture is that economists generally argue that the act of adopting a common currency leads to closer economic ties between the various countries, particularly owing to the reduction in transaction costs, and hence, the belief that dollarization is a logical—if not rational—solution to currency crises. This conclusion is in open contrast to the views expressed, for example, by Jean-François Ponsot (see his contribution in this issue), according to whom if dollarization is to occur, countries must in the first instance have strong economic, if not political, ties before they embark on this exchange-rate regime, otherwise, the latter strategy is doomed to fail. It is, therefore, not merely a matter of whether to dollarize, but also a question of when to dollarize (see Eichengreen 2002).
As for the disadvantages of dollarization, the literature focuses on the following points:

- Loss of seigniorage
- Loss of control over monetary and interest rate policies
- Loss of the central bank’s role of lender of last resort
- Loss of flexibility in exchange-rate policy

Yet, although these losses are generally agreed upon, proponents of dollarization have often argued that these are actually disguised benefits that can enhance the economic gains from adopting the U.S. dollar.

For example, the loss of seigniorage is usually thought to be important, so much so that some economists consider it to be substantial (Chang 2000). Proponents of dollarization have pointed out, however, that there can always be some revenue-sharing arrangement, as suggested in the now-defunct 1999 Mack Plan (named after Senator Connie Mack of Florida; see Schuler and Stein 2000). Such revenue-sharing plans would ease the painful financial losses associated directly with dollarization. Countries, therefore, have no need to bear the full brunt of seigniorage losses. Further, many proponents of dollarization argue that losing seigniorage revenues can actually have some positive effects on those countries that have a hyperinflation record, because it forces fiscal discipline upon populist governments. Dollarized countries would then benefit from price stability similar to the U.S. standard.

As for the loss of an exchange-rate mechanism, this too is seen in a brighter light. Dollarization is not equivalent to a regime of irrevocably fixed exchanged rates, as countries would no longer have the opportunity of opting-out. (We are assuming that the economic consequences of de-dollarizing a country are too great, although Jameson [2003b] argued that an exit solution always exists.) This would certainly place crisis-stricken countries in dire situations if a general devaluation would be seen as a competitive way of addressing a depressed international aggregate demand. But, as Calvo (2002) argued, devaluations in emerging markets, and in Latin American countries in particular, have traditionally been contractionary and not expansionary as economic theory would have us believe (see also Edwards 1989). Usually the situation has initially been accompanied by higher rates of interest, further dampening the local economy (see Hausmann et al. 1999). Hence, losing control over exchange-rate policy, they argued, could actually be beneficial.
to emerging markets: dollarization eliminates the “devaluation option” and the negative economic consequences that are traditionally associated with it.

The losses of monetary sovereignty and of the central bank’s role as a lender of last resort are often cited in the literature as problems. Under dollarization, the local central bank ceases to exist for monetary policy purposes. The country loses, obviously, its ability to set interest rates as well as any mechanism by which it (or rather its central bank) could intervene to prevent a collapse of the banking system during a financial crisis. This is a major difference between dollarization and a common currency area, where the lender-of-last-resort function of the newly created, albeit supranational, central bank would still remain in effect.

On both counts, however, these are not seen as problems for proponents of dollarization. The loss of monetary policy autonomy simply suggests that dollarized countries substitute an inefficient monetary policy for an efficient— that is, American, and anti-inflationary— policy. It is thus assumed that by virtue of its inflation-combating skills, the Federal Reserve is a better central bank than the local central bank. As for the loss of a lender of last resort (LOLR), some economists, such as Calvo (2002), have argued that in emerging economies, the central bank’s function as lender of last resort has actually worsened already fragile economies. According to Calvo (2002), relying on the lender-of-last-resort function of the central bank can actually be inflationary and, thus, magnify the existing banking problem.

Besides, the lender-of-last-resort function of a central bank is not as necessary as critics have charged, according to Calvo (2002). He further maintained that there are other ways of furnishing liquidity to a banking system in need of it. The Treasury could set up either a “stabilization fund” or emergency credit lines with banks directly. At the very limit, private American banks could act as lenders of last resort in the event of a bank run through some prearranged terms and conditions.

Critics have maintained, however, that the ability to set monetary policy and interest rates is linked to national sovereignty. A country able to set policy is a country that is able to influence the future course of its economy. Monetary policy is essential for a country’s sovereignty. Giving up monetary policy under dollarization is tantamount to tying the country’s (monetary authorities’) hands to the whims of the Federal Reserve, which sets policy according to the U.S. business
Proponents of dollarization, however, do not necessarily consider the loss of monetary sovereignty as a disadvantage. They argue that if business cycles in the United States and in dollarized economies are more or less synchronized, then abandoning monetary policy in the latter economies is not an issue. In their view, increased economic integration is likely to synchronize business cycles across a common currency area. U.S. interest rates would, or should, correspond to the interest rates that would have been set in the dollarized country. Further, because dollarized countries are often prone to currency and financial crises, the adoption of U.S. monetary policy will simply impose upon them policy discipline. Given their recent history of low inflation rates and price stability, the U.S. monetary policy would restore a sense of stability in dollarized countries. In a nutshell, dollarization leads to “better policies” (Powell 2000).

Finally, as some critics have argued, fiscal policy may be constrained by monetary conditions under dollarization, thereby creating some further obstacles for a dollarized economy to overcome to conduct independent macroeconomic policy. As a country is subject to U.S. interest rates, high rates will place an unnecessary burden on public debt, which may prevent dollarized countries from pursuing an independent fiscal policy. Yet, this is also seen as a good thing. Dollarization would not only impose better monetary policies but also better fiscal policies that would force deficit-holding and indebted countries to restructure their debt and curtail “irresponsible spending.” As adoption of the Maastricht Treaty has shown, there is a loss of confidence in the ability of fiscal policy to have any positive impact on output, growth, and employment. In the words of Arestis and Sawyer, “Monetary policy has, thus, been upgraded and fiscal policy has been downgraded” (Arestis and Sawyer 2005: 4).

Now, the debate over the pros and cons of dollarization has resulted in a stalemate. The list of advantages and disadvantages has been debated ad nauseam, with no significant progress made to date. This debate has taken place in a context of greater liberalization over the last twenty years or so, and, more specifically, in the context of the complexity of the problems caused by liberalization of emerging markets and Latin America. Yet, one area remains to be debated thoroughly. In fact, one of the issues largely ignored concerns the banking system. As
liberalization occurs at a greater scale, multinational banks are increasingly overtaking the banking system in many Latin American countries. This may be one of the more pressing issues. To be sure, dollarization implies also dollarizing the banking and financial systems. This usually increases the presence of foreign institutions and banks in the dollarized country. Berg and Borensztein claimed that dollarized countries would “establish a firm basis for a sound financial sector, which would provide the basis for a strong and steady economic growth. . . . One of the most profound effects attributed to dollarization in Panama is the close integration of its banking system with that of the United States” (Berg and Borensztein 2000: 14–15). Recently, however, Gnos and Rochon (2005) looked at this issue more closely and argued critically that “it is time to ‘reform the reforms’. . . . [O]ne of the important factors that needs to be addressed is the composition of credit supply, both in terms of who supplies credit and to whom it is supplied.” While this issue warrants more scrutiny, it is beyond the scope of this paper and will be left out of the analysis here.

Now, while the issue of dollarization was once a prominent topic of research, especially after the external debt crisis of the 1990s, it has virtually dropped off policy agendas in the Americas—at least in the United States, Canada, and Mexico. It is true that it remains a possible exchange-rate strategy in some countries, such as Costa Rica and Guatemala (which are already partially dollarized), but these are small open economies with strong economic ties with the United States. In the larger Latin American countries, like Brazil, dollarization remains a very distant possibility, at best. This is particularly true after the collapse of the Argentinean currency board following the 2002 currency crisis.

The paradox is that dollarization remains a vivid point of interest in Europe, as we will discuss in the next section. There are many reasons that may account for the current lack of interest in dollarization in the Americas. Benjamin J. Cohen (in this issue) provides a number of reasons why Americans may have lost interest in pushing this policy choice. While we fully agree with Cohen’s assessment, we think that dollarization is a two-way street, so to speak, inasmuch as interest in it has not only waned in the United States, but it has lost much of its appeal to many Latin American countries as well.

The disinterest in dollarization from Latin American countries can be attributed to two important events: the collapse of the Argentinean cur-
The collapse of the currency board in Argentina in December 2001 (January 2002) represented a strong opportunity to gauge the strength of dollarization as a credible policy regime. Until then, only small countries chose to dollarize, while large countries had resisted. In fact, one could argue that Argentina was a test country for dollarization. To be sure, Argentina had officially endorsed dollarization, and its currency board was certainly a step toward official dollarization. Hausmann (1999) was an early advocate of such a regime: his theory of the “original sin” shows that a country’s inability to borrow in its own currency can lead to financial instability and an economic straightjacket. Such a currency mismatch must thus be solved. In this respect, the fact that Argentina chose the “pesification” of its economy rather than dollarization largely contributed to the demise of dollarization.

The second reason for the end of dollarization is to be found in the U.S. dollar. On this front, several arguments can be put forth. Of course, the refusal of the U.S. Federal Reserve to allow foreign countries to have a say in the U.S. monetary (interest rate) policy is surely a catalyst. In this sense, dollarization is not like other common currency arrangements, such as the euro area. As Ponsot (2003) argued, dollarization is definitely not the same as monetary union. At best, dollarization can be considered as an “asymmetrical” monetary union. In this regard, dollarization, or, more specifically, the abandonment of domestic monetary and fiscal tools, may have proved to be too costly for many countries.

A further argument, in our view, is the recent dramatic decline of the U.S. dollar and its appearance of weakening. Indeed, from 2002 to 2004, the U.S. dollar has lost almost 25% of its value against the euro. This, we believe, has led to a fall in the confidence in the value of the U.S. dollar, especially with the current economic slowdown and the large external (trade) deficit. There could, therefore, be a perception that the U.S. dollar is no longer a “strong” or “stable” currency. Of course, the relative decline of the U.S. dollar may be explained by the fact that nominal interest rates in Europe have been kept higher than in the United States. Nonetheless, owing to the “psychology” of money speculation and international investors, a lower-valued dollar might no longer be an attractive choice for them.

These are key questions to be addressed by both academics and policy makers. Also, if dollarization is really “path dependent” as Jameson...
(2003b) maintains, then the recent events indicate that, at least for some time to come, dollarization is not a policy choice for several Latin American countries. If this is true, then what about euroization?3

**From Dollarization to Euroization**

The 1999 financial crisis that hit Brazil and contagiously affected Argentina not only gave rise to a debate on the pros and cons of official dollarization in Latin American countries but also triggered a discussion over the costs and benefits of the unilateral adoption of the euro ("euroization")4 as legal tender in those countries wishing to join the European Union (EU) and, beyond them, in several ETZ countries. For instance, Rostowski (1999) called for an early adoption of the euro for the most advanced countries of Central and Eastern Europe that were, at that time, candidates to join the EU, while Gros (1999) extended this proposal to Southeastern European countries.5

The discussion on euroization started from a debate on the choice of the exchange-rate regime most suited for transition economies in order for them to avoid currency crises and their negative effects on output, growth, and employment. Due to the full liberalization of international capital flows, successful transition countries attract portfolio as well as direct investment flows from abroad. This elicits exchange-rate appreciations that are likely to hamper the competitiveness of these countries and, moreover, affect their export-led growth negatively. As argued by Begg (1998), for example, the 1997 exchange rate crisis that hit the Czech Republic—when the koruna fixed peg to the Deutschemark collapsed in May 1997—can be explained by massive short-term capital inflows that destabilized the Czech economy and gave rise to financial turmoil. Further, in the run-up to the euro changeover, the euroization debate regained momentum when Buiter and Grafe (2001) put forward the idea to introduce the euro as parallel currency in the then ten EU accession countries. This proposal has since been advocated by other authors, who, in the words of Coricelli, argue in favor of an early adoption of the euro by any countries wishing to join the EU, because “[i]n a context of liberalized capital flows the adoption of the euro would eliminate the vulnerability of the countries to sudden shifts in capital flows, and their disruptive effects on the domestic financial sector” (Coricelli 2002: 412). This strategy, in fact, has been discussed not only in those countries, like Bulgaria and Estonia, which already had a currency board
based on the euro, but also in Poland (see, e.g., Bratkowski and Rostowski 2001, 2002), in Balkan countries (Gros 1999, 2002), as well as in more general terms (Mundell 1999; Bâché and Wójcik 2003). According to the euroization proponents, officially adopting a foreign currency will solve the long-standing credibility problem of the local monetary authorities and eliminate the inflation bias that results from monetary policy discretion as well as time inconsistency (see Alesina and Barro 2001; Dornbusch 2001).

Now, both the European Commission and the European Central Bank (ECB) have responded negatively to the proposal to euroizing EU candidate countries unilaterally. “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” (European Commission 2001: 21). In the view of the EU institutions, unilateral euroization would undermine the convergence process enshrined in the EU Treaty, and it would also imply circumventing the multilateral assessment process that EU countries have designed for would-be members (European Commission 2002). As a result, the possibility for EU candidate countries to adopt the euro unilaterally has been dropped on legal as well as institutional grounds. It remains, however, a form of exchange-rate strategy that several countries in the ETZ might consider to eradicate the potential for a currency crisis. As a matter of fact, official euroization or dollarization has become common policy advice by international financial institutions as well as by academics, basically as a result of the “corner solutions” debate and the “fear of floating” (Fischer 2001; Calvo and Reinhart 2002). To be sure, in 2002, two territories officially and unilaterally euroized in the Western Balkans, namely, Kosovo and Montenegro, while there are a number of other territories or independent countries that have been euroized since the euro cash changeover (Table 1).

As Table 1 shows, most of the euroized countries or territories are very small, with populations less than 500,000, so that one may define them as “microstates.” Further, in the cases of Kosovo and Montenegro, two territories that resulted from the disintegration of the former Socialist Federal Republic of Yugoslavia, the decision to officially euroize has been taken more on political rather than on economic grounds. In fact,
the Western Balkans (namely, Albania, Bosnia and Herzegovina, Croatia, the Federal Republic of Yugoslavia, and the Former Yugoslav Republic of Macedonia) “must cope with serious political tensions and regional conflicts, highly fragmented markets, adjustment rigidities and transition deficiencies, low growth, and a vicious circle of poverty and underdevelopment” (Kotios 2002: 25). The design of a suitable exchange-rate strategy, and monetary policy, is therefore a crucial step for economic stabilization and development in the Balkan area after the civil war that destroyed the local economy at the end of the twentieth century. These territories, however, are not yet in a position to finance postwar reconstruction and development, and thus remain heavily dependent on foreign transfers (multilateral aid). Further, their financial sector is highly underdeveloped; all indicators of financial development, such as the M2/GDP ratio, the ratio of domestic credit to GDP, and the ratio of currency in circulation to M1, are lower with respect to any international standards. In particular, euro area banks have played key roles in the recon-

Table 1

<table>
<thead>
<tr>
<th>Euroized Countries or Territories (as of June 30, 2004)</th>
<th>Population</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Euroized countries</strong></td>
<td></td>
</tr>
<tr>
<td>Andorra</td>
<td>69,865</td>
</tr>
<tr>
<td>Monaco</td>
<td>32,270</td>
</tr>
<tr>
<td>San Marino</td>
<td>28,503</td>
</tr>
<tr>
<td>Vatican City</td>
<td>921</td>
</tr>
<tr>
<td><strong>Euroized territories</strong></td>
<td></td>
</tr>
<tr>
<td>Kosovo (estimated population)</td>
<td>1,900,000</td>
</tr>
<tr>
<td>Réunion</td>
<td>766,153</td>
</tr>
<tr>
<td>Montenegro</td>
<td>680,158</td>
</tr>
<tr>
<td>Martinique</td>
<td>429,510</td>
</tr>
<tr>
<td>French Polynesia</td>
<td>266,339</td>
</tr>
<tr>
<td>New Caledonia</td>
<td>213,679</td>
</tr>
<tr>
<td>French Guiana</td>
<td>191,309</td>
</tr>
<tr>
<td>Mayotte</td>
<td>186,026</td>
</tr>
<tr>
<td>Wallis and Futuna</td>
<td>15,880</td>
</tr>
<tr>
<td>Saint Pierre and Miquelon</td>
<td>6,995</td>
</tr>
</tbody>
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*Source: CIA World Factbook 2004, authors’ elaboration.*
struction and privatization of the banking sector in Bosnia and Herzegovina (International Monetary Fund 2001), and they clearly dominate the credit market in the Western Balkans (Mazzaferro et al. 2002: 41–42).\textsuperscript{10} In these territories, the financial linkages to the euro area are, therefore, tight,\textsuperscript{11} in respect also to the currency denomination of the financial instruments used in a framework where capital account transactions have mostly been liberalized.

Despite this close financial integration with the euro area, however, even in the two officially euroized territories of Kosovo and Montenegro, one can observe that “interest rates on loans and deposits have varied widely, reflecting different risk profiles of banks and their corporate customers” (Winkler et al. 2004: 42). This different dynamics is also reflected in the fact that both long-term and short-term nominal interest rates have been evolving out of line with those of the euro area. Moreover, the argument put to the fore by euroization advocates that the entry of foreign banks in emerging markets contributes to the efficiency and stability of the local financial sector by instilling some competitive pressure in the domestic banking system (see International Monetary Fund 2000), is not so straightforward as it might seem. As noted by the International Monetary Fund, in fact, “foreign banks will likely examine whether or not to inject capital on a case-by-case basis, trading off future value (including reputational effects) against cost. Minority shareholders are viewed as less likely to make capital injection during periods of financial stress” (International Monetary Fund 2000: 70). Moreover, there is also the question of whether foreign banks will honor their contractual obligations in crisis time rather than default (see Backé and Wójcik 2003). Hence, unilateral adoption of the euro is not enough, at least for the time being and according to the empirical evidence available so far, for euroized territories in distressed areas of the world to rebuild their economies after civil war or political turmoil in a framework that protects them from financial and banking crises.

These empirical results can be substantiated on theoretical grounds. In an officially euroized economy, the central bank has relinquished its clearing-house and lender-of-last-resort joint functions. As pointed out by Bui\'ter, this means that “there is no adequate substitute, in the short run, for the ability to create your own legal tender in unlimited quantities” to settle interbank debt obligations (Bui\'ter 2000: 12). Consequently, and contrary to the claim generally made by euroization advocates—according to whom the unilateral adoption of the euro is likely to elimi-
nate the interest rate premium and, thus, reduces interest rates—in a euroized economy, the central bank’s limited capacity (in accommodating the banks’ demand for settlement balances) would affect the structure of interest rates, which may differ from the interest rate structure observed in the euro area. In the former economy, interest rates may be higher than in the euro area, where there is an integrated settlement system in the form of the European System of Central Banks under the aegis of the ECB, and in which the potential for a bank run or even for a banking crisis is strongly limited by the existence of a lender of last resort. As Nuti noted, in fact, there remains a country risk premium that cannot be completely eliminated and that can even be substantial for euroized economies: “In all probability interest premiums will normally be lower than with alternative exchange rate regimes, but not necessarily zero even in the case of total currency replacement” (Nuti 2002: 425). To put it succinctly, euroization eliminates the currency risk premium but does not reduce default risk per se. In addition, it does not remove the risk of capital flow reversals or the risk of financial or banking crises (Habib 2000: 12).

Further, and more importantly, unilateral euroization will dispose of the exchange-rate instrument and of monetary policy, so that any adjustment in the economy has to occur via wages and prices, which may give rise to output and employment losses if wages are not flexible enough (Backé and Wójcik 2003: 217). As a matter of fact, as suggested by the euro area empirical evidence available so far, disposing of an independent monetary policy at the national level does not lead necessarily to speeding up those labor market reforms aimed at providing greater flexibility (see Eichengreen 2002). Also, recent data on unemployment rates in the euro area clearly show that employment has not increased since the 1999 launch of the single currency, and no real convergence on that point has been observed over the last four years (1999–2003) (Figure 1).

Euroization also implies a strong political commitment to guarantee the sustainability of the general government financial position, namely, a budget close to balance or even in surplus. As Berg and Borensztein (2000) argued, in this connection, a fiscal deficit may provoke foreign investors to escape the euroized economy by selling off government securities or other domestic assets. In addition, an increase in public-sector indebtedness may trigger default pressures and thus put the credibility of the exchange-rate regime at stake. All this points to the need to impose fiscal discipline in a number of transition, or emerging, econo-
In several cases, these fiscal transfers come from one single country, which is, by and large, the “anchor country” of the exchange-rate arrangement. These transfers generally depend on strong political and historical links between the euroized territory/jurisdiction and the anchor country or currency area. Hence, although they may serve as buffer stock in the case of an asymmetric shock hitting the euroized economy, they do not seem to stem from any economic policy reasoning—as would, by contrast, be implied by the “old” optimum-currency-area theory (see Winkler et al. 2004).

Finally, because the ECB refuses to “monetize” any unilaterally euroized economies, the latter need a permanent current account surplus or stable capital inflows (mainly in the form of foreign direct in-
vestment) over the long run in order for them to avoid any credit crunches that might result in interest rate hikes, with their negative effects on output and real growth. As Ponsot (2004) pointed out in the case of dollarization, this amounts to saying that euroized economies need a high degree of trade and investment links with the euro area, in order for this exchange-rate strategy to provide the positive effects that its proponents advocate on mere theoretical grounds. Clearly, an inflow of euro must be observed to accommodate the needs for initial finance by firms, either as a result of net exports to the euro area or as net capital inflows from that area. Now, if we consider the most favorable case in this respect within the ETZ, that is, the Western Balkan area, and, in particular, the two already officially euroized economies, namely, Kosovo and Montenegro, we notice that their “trade balances have been recording sizeable deficits, reaching about 50% of GDP in Kosovo and 35% of GDP in Montenegro” (Winkler et al. 2004: 43). Moreover, their trade flows largely concern the neighboring former Yugoslav republics, while trade integration with the euro area is still limited and rather poor (Table 2).

As Table 2 shows, both the exports and the imports share of total EU trade with the Western Balkans is tiny and has even been diminishing over the last twenty years or so. This negative trend, as well as the figures in Table 2, are seriously worrying when considered with respect to both the absolute percentages and the trend of the EU trade share over the same period as regards the new member countries (EU-10). On account also of the low product diversity as well as the highly concentrated export industry of the Western Balkans, and the low tourist attraction from euro-area countries, it seems plausible to conclude—on the basis of both old and new optimum-currency-area theoretical arguments—that unilateral euroization in the ETZ countries (among which the Western Balkans are in the most favorable position as regards the notional benefits of this exchange-rate strategy) would not protect their economies from financial crises broadly defined. “In a number of cases, euroisation would just delay the outbreak of the crisis, as easier access to external financing would allow a longer financing of imbalances than under alternative monetary regimes. Clearly, this would raise the eventual scope of adjustment needs and add to real variability. In other cases, euroisation may precipitate the events. This is conceivable in the case of a bank run which could be quickened if depositors perceive imperfections in the lender-of-last-resort arrangement that relate to the euroisation regime” (Backé and Wójcik 2003: 219).
Conclusion

Over the last few years, academics and policy makers have intensively debated the pros and cons of dollarization. In this respect, the theory of optimum currency areas à la Mundell (1961) as well as its more recent extensions by Rose (2000) and the ensuing literature have much influenced the establishment of common currency areas and the adoption of a foreign currency as sole legal tender in a number of developing, emerging, and transition economies. The willingness by many ETZ countries to adopt the euro unilaterally is a further example of this theoretical influence. This paper aimed at discussing the fall of dollarization and the rise of euroization, drawing from the practical outcome of the former policy and its alleged benefits in terms of economic stabilization. We think that dollarization/euroization does not warrant these benefits over the long run. In fact, this exchange-rate strategy is likely to affect economic performance negatively, as it disposes of monetary and fiscal policy autonomy and of a lender of last resort that may prove to be crucial in a time of crisis. This suggests that many countries considering dollarization/euroization today should “think it over twice” before adopting such a policy.

Notes

1. This is in no way an exhaustive list. For instance, as pointed out by Jameson (2003a), El Salvador chose to convert all financial transactions to U.S. dollars, and

Table 2
The Western Balkans’ Share of Total EU Trade, 1980–2000 (in percent)

<table>
<thead>
<tr>
<th></th>
<th>Exports</th>
<th>Imports</th>
<th>Exports</th>
<th>Imports</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980–1984</td>
<td>1.9</td>
<td>1.0</td>
<td>4.0</td>
<td>3.3</td>
</tr>
<tr>
<td>1985–1989</td>
<td>1.9</td>
<td>1.6</td>
<td>3.7</td>
<td>3.7</td>
</tr>
<tr>
<td>1990–1994</td>
<td>1.4</td>
<td>1.2</td>
<td>6.6</td>
<td>5.4</td>
</tr>
<tr>
<td>1995–2000</td>
<td>1.2</td>
<td>0.6</td>
<td>11.4</td>
<td>8.9</td>
</tr>
</tbody>
</table>

Source: Comtrade (Commodity Trade Statistics Database, New York), authors’ elaboration. EU-10 subsumes the ten new member countries of the EU as of May 1, 2004, and includes, namely, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovenia, and Slovakia.
in Guatemala, the government now allows transactions to be carried out in currencies other than the local currency, the quetzal.

2. ETZ countries surround the euro area in a broad geographical sense and belong to four main regions: the Western Balkans, the European part of the Commonwealth of Independent States (CIS), the Middle East and Northern Africa (MENA), and Sub-Saharan Africa. Generally speaking, these countries are classified as transition, emerging market, or developing economies. Most of them are within the longitudes or time zones that broadly correspond to those of the euro area. This is why we may subsume them under the ETZ label, as proposed by Mazzaferro et al. (2002).

3. Many of the concepts discussed in this section will be reviewed in the next section, but in a different context. In our view, in fact, there are parallels between dollarization and euroization, even though, as noted in the previous section, dollarization is on the wane, while euroization seems to be gaining strength.

4. Like dollarization, euroization can take two forms: de facto or de jure euroization (see Berg and Borensztein 2000). De facto euroization means that economic agents prefer using the euro instead of the local currency as a means of payment (currency substitution) and as a store of value (asset substitution; see Müller 1999; Feige 2003). This kind of euroization is typically the reaction of market agents to a loss of confidence in the local currency but might also be related to the growing importance of underground economic activities insofar as the latter are settled using foreign currency (Feige 2003: 359). A foreign currency substitutes, in these cases, for the local currency without a formal decision of the national monetary authorities, which continue to be in charge of monetary policy making as far as the local currency exists (see Vujčić 2004). De jure (or unilateral) euroization, in contrast, is based on a formal political decision and implies institutional changes in the national monetary order. The local currency is eliminated and replaced by the euro, which becomes the sole legal tender in the euroized economy. This is the situation that we consider in this section and that we address from an economic policy perspective.

5. According to Backé and Wójcik, “[t]he idea of an early introduction of the euro was first aired by the Slovenian Prime Minister Drnovsek in December 1996 when he said on the sidelines of the European Council meeting in Dublin that ‘Slovenia will do its best to join monetary union as soon as possible, perhaps even before full EU membership’” (Backé and Wójcik 2003: 202). See Wójcik (2000) for a review of the first wave of the official euroization debate.


7. The Journal of Money, Credit, and Banking as well as the Journal of Policy Modeling devoted special issues to these topics in 2001.

8. Note, however, that euroized countries debated and negotiated their unilateral adoption of the euro with the ECB.

9. The Federal Republic of Yugoslavia comprises two member states, Serbia and Montenegro, and a territory, Kosovo, which has been administered by the United Nations Mission in Kosovo (UNIMIK) as established by the 1999 United Nations Security Council Resolution no. 1244.

10. Note that for foreign banks, it is less problematic than for domestic banks to engage in euroized countries, because the former banks do not need the safety net of a local lender of last resort; they already have such an institution in their home country. This is an issue to be addressed later.
11. This is also the case, though to a lesser extent, for a number of other ETZ countries (see Mazzaferro et al. 2002: 35–44).


13. An “anchor country” is a country with currency that is officially adopted by a third country.

14. Let us point out, in passing, that contrary to euro-area countries, unilaterally euroized countries have, by definition, no representatives on the ECB Governing Council. As the first ECB President pointed out on several occasions, the single monetary policy of the euro area considers the macroeconomic performance and forecasts for that very area: the economic conditions in unilaterally euroized countries play no role in the monetary policy decision-making process of the ECB.

15. As from May 1, 2004, the EU consists of 25 member countries, because it has been enlarged to include Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovenia, and Slovakia.


17. The International Monetary Fund (1998: 74–75) adopted a taxonomy according to which four main types of financial crises may be observed: currency crises (characterized by speculative attacks, ending with a devaluation or with massive intervention of the monetary authorities on the foreign exchange market); banking crises (featuring an actual or a potential bank run, which provokes a suspension of internal convertibility or induces government intervention); foreign-debt crises (when either private or public institutions in a country are unable to serve their external debt obligations); and balance-of-payment crises (resulting from a structural unbalance between absorption [current account] and sources of financing [capital account]).

References


Hausmann, R. 1999. “Should There Be Five Currencies or One Hundred and Five?” *Foreign Policy* 116 (Fall): 65–79.


