THE PHENOMENON OF EUROISATION – OPPORTUNITY OR A THREAT FOR THE EU ACCEDING COUNTRIES' FINANCIAL STABILITY?

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ABSTRACT

Adopting the euro as legal anchor seems to be the ultimate goal of acceding countries and thus, accession to EU is only an intermediate step on that way. Although the EU legislation clearly defines the way towards the adoption of the euro as a legal tender, the geographical proximity of these countries to the euro area and strong trade and financial ties, resulted with broad and voluntarily use of the euro, by the most of EU candidate and potential candidate countries-known as the phenomenon of euroisation .

Many countries which have registered moderate or extensive use of euro, parallel to their national currency , have experienced benefits , but risks and additional cost as well, which were even more emphasized during the recent sovereign debt crisis, This implies that the policy's choice whether "to euroise or not to euroise" is shifting over time, and need extensive economic cost-benefit analysis .

This paper aims to analyze the phenomenon of euroisation, its benefits and risks and to suggest the level of euro use among the EU acceding and potential candidate countries, to assure stability and development of their economies.

Key words: *euroisation, costs and benefits, EU acceding countries.*

Introduction

The market forces driven spontaneous substitution of national currencies with foreign currency is characteristic of all open contemporary economies, resulting from economic integration.

Being one of the most important economic integration today, European Union has introduced specific steps and rules for EU accession and formal adoption of the euro. However spontaneous and vote of confidence in the euro by citizens of EU acceding and potential candidate countries, was more than evident in the past ten years , which can be clearly illustrated by their currency behavior.

Namely, in most countries of the Western Balkans, the bulk of bank deposits are denominated in euros, and euro is the most important foreign currency for the denomination of deposits, loans and liquid assets. More precisely, the euro banknotes in circulation for 2013 reached the value of 956 billion euro, out of which 20%- 25% of the euro banknotes in circulation are held by people outside the euro area, in particular in the Western Balkans. Having in mind that the use of euro outside the euro area in 2003 was estimated to be worth € 36 billion, accounting for around 10% of the total euro currency in circulation, it is easy to conclude the dramatic increase of the process of euroisaton over the mentioned ten-years period which covers both global financial and sovereign debt crisis in Europe. However, the recent sovereign debt crisis and negative impact which was made on the EMU members put forward a question of euro survival and many countries in Europe outside the euro-zone, analyzed whether to support further euroisation or to undertake the measures that would moderate the trend of euro growth, starting the reversible process of so called de-euroisation .

Phenomenon of Euroisation- How many faces does it have?

In broad terms, euroisation denotes the use of a foreign currency (i.e. the euro) in the domestic monetary system of a non-issuer country. "Euroisation" is then just an adaptation of the term "dollarisation", which define the use of the dollar in non-issuer countries, essentially Latin America economies.

As a part of Europe, the Balkans and other EU acceding countries consider the adoption of the euro as an ultimate goal of both citizens and authorities, therefore, the question is not *whether* they will adopt the euro, but *when* and *how*.

The EU legislation clearly defines the way towards the adoption of the euro as a legal tender, according to a three-step institutional path.

1. The first step consists of the accession to EU.
2. In the second step, the Member State must undertake procedures to participate in the "new" Exchange Rate mechanism, (ERM-II) which involves setting a central parity with the consent of EU officials and the respect of fluctuation bands without devaluation.
3. The third step starts, two years after the ERM membership without *tensions*, when the Member State would fulfill Maastricht criteria, countries will be allowed, according to the EU legislation, to adopt the euro as legal tender.

However, in practice we have experienced, different forms and levels of euroisation, which makes this phenomenon, more complex and challenging to analyze.

Namely, the euroisation can appear in different forms, such as[1]:

- cash substitution – the use of foreign currency in domestic circulation;
- asset substitution – denomination of bank deposits, securities and financial instruments in foreign currency. Besides the foreign currency in domestic circulation, cross-border deposits are usually also treated as a form of asset substitution;
- denomination or indexation of wages and prices in foreign currency.

Besides the formal adoption of euro through the institutional process prescribed by EU, the theory and practice recognize: *unofficial, unilateral* and *consensual euroisation.*

Unofficial euroisation denotes a phenomenon where economic agents voluntarily use the euro alongside the national currency. The spontaneous euroisation results from business concerns and is not a deliberate government policy of unilateral adoption of the euro.

Unilateral (and official) euroisation is the unilateral decision of a sovereign country to abandon its national currency partially or entirely in favor of adopting the euro as legal tender without joining EMU. In other words, unilateral euroisation means transition to the euro without having signed an appropriate agreement with the EMU member countries and the relevant EU institutions, nor fulfilling the nominal convergence criteria.

Consensual euroisation can be defined as an official introduction of the euro as legal tender, without respecting the institutional path of EMU, but resulting from an agreement between the euroising country and EU officials.

Depending on the degree of cash substitution and the forms of euroisation – substitution of assets and/or cash – euroisation is divided into *moderate* and *extensive*.

While *moderate euroisation* mainly means partial denomination of assets in the euro, *extensive euroisation* means the use of euro banknotes as well as extensive denomination of assets in euro. In extreme cases, the indexation of wages and prices can occur. As a rule, the indexation of wages and prices can only take place in a country where assets and banknotes have already been extensively substituted.

The motives of euroisation can differ, in different forms and types of euroisation. While moderate euroisation reflects the globalization of the world economy and integration of the markets, the reasons for extensive euroisation lie, first and foremost, in the instability of the economic policy

[1] Eesti Pank,. 'Euroisation in Estonia and its impact on the economy', *Kroon and Economy Publications*, No. 1. (2002, pg 23-25.

of a concrete country or the internal or external imbalance of the economy. In the case of extensive euroisation or dollarisation the real sector is keeping its assets in foreign currency in order to reduce risks and foreign currency is circulating in the form of cash as well as account money.

The partial substitution of assets due to moderate euroisation facilitates the development of financial intermediation by creating additional ways to reduce the costs of international financial transactions, lowering market risks and diversifying asset portfolios. The latter is true mostly about the countries with less developed financial markets and limited opportunities of alternative risk covering options

The benefits and costs of euroisation

a) Benefits- Arguments for euroisation

Fostering macroeconomic stability:

Euroisation is expected to foster macroeconomic stability by solving the credibility problem that arises when a domestic central bank is unable to pre-commit itself to a low rate of inflation. By explicitly adopting the monetary policy of the issuing country, which enjoys a high degree of credibility, inflation and interest rates in the euroised economy are assumed to converge towards the level of the issuing country.

Lower risk premia: If risk premia are owing to currency and not to country risk, dollarisation/

euroisation should lead to lower risk premia, because a sharp and sudden devaluation of the domestic currency against the anchor currency is ruled out by definition. In particular, if a country is confronted with a currency mismatch (foreign currency borrowing by public or private sector entities without major foreign currency revenues), euroisation could eliminate this problem and therefore reduce the sovereign risk.

Domestic financial sector development:

Dollarisation/euroisation is expected to support the development of a country's financial sector, because a stable currency is a precondition for financial development, leading to strong and steady economic growth.

Elimination of transaction costs: The elimination of costs of exchanging the domestic currency into the currency of the anchor currency is the most visible effect of euroisation, with the cost savings being proportional to the number of transactions conducted in foreign currency.

Stronger economic and financial integration: Euroisation is expected to foster a country's economic integration with the economy of the issuing country. In particular, trade integration is likely to deepen owing to lower transaction costs and the elimination of exchange rate uncertainty, assuming that trade is fairly liberalized. As a consequence of higher economic integration, euroisation might lead to real convergence in terms of GDP levels and convergence of business cycles with the issuing country. Finally, shocks might become more symmetric between the euroised country and the respective anchor country, while business cycles might become more synchronized, in turn further fostering integration.

b) Costs- Arguments for de-euroisation

***Loss of an adjustment mechanism*: With euroisation, a country loses the use of the monetary policy** instrument as a mechanism enabling it to adjust in the wake of asymmetric shocks and to react to fluctuations in the business cycle that are not in line with those in the anchor country. Accordingly, the euroised economy has to rely on other adjustment mechanisms to avoid substantial output swings owing to asymmetric shocks or unsynchronized business cycles with the issuing country.

Loss of the lender of last resort function: With euroisation, the domestic authorities lose the ability to respond to a sudden run on bank deposits by acting as a lender of last resort. In particular, the authorities are unable to inject an unlimited amount of liquidity into the payment system to prevent a default on deposits, as the amount available to purchase bank assets and to recapitalize distressed financial institutions is restricted to the country's stock of foreign reserves.

Loss of seigniorage:[2] The most direct cost of unilateral euroisation is the loss of seigniorage revenues from issuing a domestic currency, as these revenues will shift from the domestic monetary authority to the monetary of the issuing country. The loss of seigniorage includes both one-off "stock" costs arising from replacing the national currency in circulation with foreign banknotes and coins, and "flow" costs arising from the loss of the future earnings stemming from the flow of new currency printed every year.

However, the economic cost-benefit analysis of any policy' choice whether "to euroise or not to euroise" is shifting over time, depending the economic development of the country, level of integration with EU markets , and mostly to the economic and financial stability of the countries which already officially adopted euro as their national currency.

"To euroise or not to euroise" policy for Balkans EU candidate countries

The trend of euroisation which was emphasized by the acceding EU countries in 2005 and 2007 [3] , was even extended over the countries from the Western Balkans, while Montenegro has unilaterally introduced euro as the national currency without fulfilling Maastricht criteria.

At the beginning, the euroisation, in one form or another, brought positive movements in these countries especially to those ones who have low development and growth rate, such as Montenegro, (and Kosovo as well) introducing euro as official domestic currency without joining EU[4].

In 2002, when Montenegro officially adopted the euro as domestic currency, it has one of the lowest level of GDP per capita in the Region, implying the annual amount of €1,800 per capita.

Indeed, right after the introduction of euro, inflation rates declined rapidly, achieving the rate, close to euro area levels. These positive trends have been maintained till the beginning of the global financial crisis, when the inflation rate increased at the level of 9%, followed by slow recovery period. The latest figures, however, indicates the acceptable inflation rates at the level of and 3%, which is close to EU criteria. The beginning of sovereign debt crisis (2009) had extremely bad impact on the economy of Montenegro , reducing dramatically its GDP growth from positive growth of 10,7% in 2007, to negative one, (-5,7%) in 2009 . Although systemic risks appear to be manageable, there are pockets of vulnerability. The banking sector is exposed to macro-financial risks due to the openness of the economy, limited scope to diversify, and modest range of tools available to the authorities to promote macroeconomic stability.

.In other Balkans EU acceding countries (Croatia and Macedonia and later on Serbia), the euroisation started slowly but was intensified during 2005-2009. Especially, Croatia which was on its way towards EU membership, registered high portion of FX assets and liabilities in the banks' balance sheets. In Macedonia for example, more than 50% of banks loans and deposits were denominated or indexed in euro and in Serbia these figures were over 70%.

However , the sovereign debt crisis which severely "attacked" the euro zone countries in 2009 and 2010 (with no prospects for soon recovery for some of them), change the attitude of the monetary authorities , banks and private entities in the West Balkans countries to be more cautious regarding the extensive use of euro in their financial transactions , savings and credit activities.

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[2] Seigniorage may be counted as revenue for a government when the money that is created is worth more than it costs to produce it. This revenue is often used by governments to finance a portion of their expenditures without having to collect taxes.

[3] In the mentioned period 17 new countries having a status of candidate countries, joined the EU, most of them without official introduction of the euro as national currency, but with moderate to extensive use of euro in deposit and credit activities of the banking sector.

[4] European authorities were not involved in the euroisation process in Montenegro or in Kosovo. There are no agreements between the European Union and Montenegro or Kosovo about the use of the euro as their official currency. Moreover, there is no official link between the two countries financial systems and the euro area.

Namely, although these countries haven't introduced any official de-euroisation strategy, they have deployed some of the macroprudental measures to moderate or even stop the trend of eurosiation. Namely, reserve requirements that favour banks' local currency liabilities are used by Macedonia, and the different reserve requirement ratios are complemented by different rates of remuneration. Macedonia also abolished its separate liquidity ratio for denar and foreign exchange deposits.

In Croatia, the authorities have introduced foreign exchange liquid asset requirements, which oblige banks to hold a certain percentage of their foreign exchange liabilities as liquid foreign exchange assets. With regard to higher risk weights for foreign exchange loans, only Croatia has used this approach, but abolished the regulation in 2010 due to alignment with the Capital Requirements

As a result of these measures and the rumours about euro sustainability in Eurozone, the share of FX deposits has dropped more intesivly at the liability side, while the loans indexed in euros were still at the high level in the bank's total assets. The most evident drop of euro denominated deposits and loans is registered in Macedonian banking sector , decresing its deposit share from over 65% to 48% , while the share of euor denominated and indexed loans marked decrese from over 70% to 45% at the end of 2013.The drop of FX deposits and loans is also evident in Croatia . The portion of over 70% (for both euro denominated loans and deposits) was decreased at the level of 64% for loans and 58% for deposits in Croatian banking sector.

Serbia is still experiencing high level of inflation and hasn't introduced any de-euroisation measures, so its banking sector faces with extensive euroisation, reaching portion of 73% FX indexed loams and 78% of FX deposits in total banks' deposits.

CONCLUSIONS

Partial substitution of assets that results from the euroisation, facilitates the development of financial intermediation, by allowing further reduction of the costs of international financial transactions, lowering of market risks and diversification of asset portfolios.

However the excessive euroisation in the country while official currency exist dicrese the power of intruments of the monetary authority to figtnt with financial stability and overdebtness of the country , which turns to be the biggest problem within Eurozone area during the financial crisis. The countries that have extensive euroisation in the banking balance sheets or even unilateraly introduced euro have at first stage might experience the high level of GDP growth, but during the crisis period they share the problems from Eurozone, more evidently than the other countries

As euroisation does not seem to be a straightforward substitute for integration, countries should carefully consider the option of relying on a suitable domestic anchor for monetary policy before opting for unilateral euroisation, despite the latter's alleged merits as a device for achieving macroeconomic stability.

Macro-prudential and regulatory measures can be used to moderate the trend of euroisation, or even to revert it in the process of de-eurosiation. However, different measures seem to have different effects when it comes to deposit or credit de-euroisation. Regulatory measures like reserve requirement differentials help deposit as well as credit de-euroisation. Meanwhile, prudential policies such as higher provision requirements for foreign exchange loans and tighter limits on banks' net open positions created incentives to better reflect currency risks, thereby fostering credit de-euroisation.

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