SOUTHEASTERN EUROPE AND THE EURO AREA: THE EUROIZATION DEBATE

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Introduction

The integration of the transition economies of Central and East European Countries (CEECs) into the European Union (EU) structure is one of the most important national goals of these countries. In this context practical policy and economic analysis, since the beginning of the transition process, has been focusing mainly on integration aspects like political dialogue, trade, investment, the adoption of acquis communautaire and European financial and technical assistance. Recently, the choice of an exchange rate regime after the introduction of the euro, and the monetary integration of the CEECs with the EU have emerged as new additional policy and research topics (Köhler and Wes 1999, Masson 1999, Kopits 1999, Corker, Beaumont, Elkan and Iakova 2000, Masson 1999). Increasing trade and monetary integration between the EU and the CEECs, and progress in market reforms and external liberalization, as well as in the accession process, have intensified the debate about the proper exchange rate policy in transition countries and the path of their monetary integration into the EU's new monetary order. Most of the proposals recommend the introduction of a form of fixed exchange rates against the Euro, usually in the form of a currency board (Gulde, Kähkönen and Keller 2000, Freytag 1998).

The countries of Southeast Europe (SEE) form a special part of the CEE group of countries. For several reasons these countries still 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 (Petrakos 2001a and 2001b). The recent conflict in Kosovo has shown not only the magnitude of the adjustment problems in the region, but also its importance for pan-European stability and prosperity (Kotios 2001a). The consequence of this has been the introduction by the international community, after initiation by the EU, of a regional approach for the reconstruction and stability of the Balkan region (Stability Pact) and its integration into Europe (Kotios 2001b). In order to achieve the aims of the Stability Pact a set of national, regional and international policies and initiatives must be implemented (World Bank 2000). Many strategic analysis papers concerning this region include the monetary aspect in their approach (Gligorov 2000, Gligorov, Kaldor and Tsoukalis 1999, EastWest Institute 2000, CEPS 1999, Gros 1999). In these papers the formulation of a proper exchange rate policy is viewed as an important instrument for stabilization, development, regional co-operation and integration of the Balkan countries into EU. The complete integration into the payments system, money and capital markets of the Euro area through the euroization of the national monetary systems of SEE countries is also recommended by some authors as a proper strategy (CEPS 1999 and Gross 1999, Emerson 2000, Nuti 2000). Based on mainstream thinking concerning the choice of exchange rate regimes in the increasingly integrated world economy (about this discussion see Williamson 1999, IMF 2000, Velasko 2001), they reject many forms of an adjustable peg, as well as free floating for small, open, undeveloped economies with shallow foreign currency markets, which by definition are vulnerable to international shocks. Instead, they advocate the introduction of a hard peg in the form of a currency board or a unilateral euroization (Lewis and Sevic 2000). The euroization proposals recommend different paths of implementation (Steil and Woodward 1999). Some of the analysts propose the immediate introduction of DM/Euro as in Kosovo and Bosnia-Herzegovina, or as a parallel currency, as in Montenegro. Others suggest the establishment, starting now, of a Euro-denominated currency board national regime, with the use of the DM for parallel cash money, and, starting from 1.1.2003, the introduction of full euroization, including Euro bank notes.

The aim of this paper is to analyze the theoretical and practical aspects of the unilateral euroization approach. Section 2 focuses on the degree of integration between the transition Balkan countries and EU and its implications for monetary and exchange rate policy. The analysis of section 3 concentrates on the concept of unilateral euroization and especially the changes in national monetary order it implies. The potential benefits and costs for the countries of the SEE region are discussed in sections 4 and 5 respectively. A comparison between euroization and currency board arrangement is attempted in section 6. The EU position regarding unilateral euroization by non EU-members is discussed in section 7. In section 8, attention is given to the potential paths for implementing euroization. Finally, section 9 summarizes the main findings and attempts to answer the question if the Balkans should euroize.

The Euro-Balkans Economic Integration

The degree of economic integration between two economic areas is decisive for the choice of the proper bilateral exchange rate regime. Economic theory and policy have long since maintained that the more integrated are two economic areas the better it would be to establish a bilateral fixed exchange rate regime or a monetary union (Mundel 1961, McKinnon 1963, Kenen 1969, Rose 2000). In this context, the question, which arises is: How integrated are the EU and Southeast Europe economic areas?

Regarding contractual relations and institutional integration, the EU and the countries of the SEE region have in the 90's shaped a network of bilateral relations composed of different agreements (see Table 1), which reflect a different pace of integration for each transition country (Kotios 2001b). The differences in the stage of contractual relations between the EU and the countries of the SEE reflect divergences in the political and economic adjustment process in the SEE transition countries, assuming that the rapprochement of a transition country to the EU depends on a rigorously defined political and economic conditionality. For example, Bulgaria and Romania have signed (1993) accession agreements with the EU in order to promote political dialogue, to establish a free trade area, to develop economic co-operation and to encourage the gradual adoption of EU rules, policies and practices. Since 2000 Bulgaria and Romania have been negotiating their accession to the EU, and have been enjoying the benefits of the support mechanisms of the EU pre-accession policies. After the war in Kosovo the EU adopted a new regional approach for the countries of the Western Balkans, the so - called "Stabilization and Association Process". This approach aims at the protection of peace and stability, and fosters economic development in the region. It also seeks to improve the conditions for the integration and accession of the Western Balkan countries into European structures. The main components of the Stabilization and Association Process are the Association Agreements, similar in content to the European Agreements signed with the accession candidates Bulgaria and Romania. The signing of the Agreements between the EU and each of the five eligible Balkan countries, presupposes the fulfillment of well-defined political and economic terms. Failure to adopt the Stabilization and Association Agreement, however, does not deprive the countries of the area of the ability to enjoy, even to a lesser extent, the benefits of the Community preferential trade treatment through Autonomous Trade Preferences, the receipt of financial, technical, economic and critical aid, the political co-operation and political dialogue, even when they do not fully comply with the political and economic conditions. In 2001 the EU signed Stabilization and Association Agreements with the Former Yugoslav Republic of Macedonia and Croatia. Under consideration is the signing of such agreements with the other three countries of the western Balkans. Also, the EU has improved the existing autonomous trade preferences and provided autonomous trade liberalization for more than 90% of the western Balkan exports to EU.

Table 1. The Euro-Balkans contractual relations

	Trade & cooperation agreement and/or tariff preferences	Stabilization and Association Process		Europe agreement	Accession Partnership (Accession Negotiations)	Potential Member of EU
		Stabilization and Association Agreement (SAA)	Candidates for SAA			
Albania	+		+			+
Bulgaria				+	+	+
Bosnia and Herzegovina	+		+			+
Croatia	+		+			+
FYR Macedonia	+	+				+
Romania				+	+	+
Yugoslavia, FR	+		+			+

Source: Kotios (2001b)

Regarding trade integration, Table 2 shows that in 1999 the EU was the most important trade partner for the SEE countries (Petrakos 2001a, Kirkilis 2001). With exception of Bosnia-Herzegovina and the Former Republic of Yugoslavia, due to special conditions, more than 50% of the total trade of the SEE countries was carried out with the EU. Since the beginning of the transition process (1989) this tendency has been steadily increasing, thus a further increase is to be expected in the near future. The same tendency can be observed in the field of foreign direct investments. The biggest part of these investments flows from the Euro zone countries (see Rizopoulos 2001).

Table 2. The SEE external trade (1999)

	Trade with EU		Intraregional trade (8 countries)	
	Exports as % of total	Imports as % of total	Exports as % of total	Imports as % of total
Albania	89.9	77.6	2.1	7.0
Bulgaria	53.3	50.9	8.6	2.2
Bosnia and Herzegovina	42.3	37.6	42.9	33.7
Croatia	49.4	56.7	14.7	2.5
FYR Macedonia	50.9	50.7	20.4	20.7
Romania	66.0	62.7	2.9	0.9
Yugoslavia, FR	34.3	38.3	15.8	14.6
Greece	51.7	65.8	12.5	2.6

Source: WIIW Database

In addition to the increasing trade orientation of the SEE countries to the EU, a similar tendency can be observed in monetary integration. In many countries the DM/Euro has experienced an extensive use as deposit and asset nominator. According to Bishev (2000) the currency and asset substitution rates in the seven SEE transition countries are very high in comparison to other transition countries. In 1998 the average rate of currency substitution defined as the percentage of foreign currency deposits to M1 was 107.6% (see Table 3). The leading currency substitution countries were Bosnia-Herzegovina (423%) and Croatia (265%) and the countries with the lowest rates of currency substitution were Albania (45%) and FYR of Macedonia (45.8%). The average rate of asset substitution (foreign currency deposits to M2, 1998) was 42.5%. The rate of asset substitution ranges between 20.9% (Albania) and 80.3% (Croatia). The biggest part of foreign currency used to substitute for national currencies in the SEE region is the Deutsch Mark (Euro). This high rate of currency substitution occurs mainly because of political and economic instability and lack of credibility, characterizing, to a greater or lesser degree, all of the SEE transition countries. Also, despite the differences in exchange rate regimes (Table 4) the DM/Euro serves as the anchor currency for four SEE countries. Bulgaria, Bosnia-Herzegovina, FYR of Macedonia and Croatia pursue an exchange-rate-targeting monetary strategy, that means they have subordinated their monetary policies to the exchange rate objective, and hence (since 1.1.1999) to the monetary policy of the European Central Bank. The other three countries follow monetary targeting strategies that are less dependent on monetary developments in the Euro zone (Bishev 2000).

Table 3. Monetary integration with EU (1998)

	Foreign Currency Deposits to M1 in % (12 month average)	Foreign Currency Deposits to M2 in % (12 month average)	Dm/Euro as anchor currency for monetary policy
Albania	45.0	20.9	
Bulgaria	107.9	42.1	+
Bosnia and Herzegovina	423.6	80.3	+
Croatia	264.9	64.2	
FYR Macedonia	45.8	27.3	+
Romania	127.9	29.7	
Yugoslavia, FR	463.7 (1)	347.8 (1)	+
Total	107.6 (2)	42.5 (2)	

Source: Bishev 2000, and own calculations

(1) Including frozen (blocked) foreign currency deposits

(2) Average is calculated without including Yugoslavia

Table 4. Exchange Rate Regimes in SE Europe

Countries	*Exchange Rate regimes*			
	Currency Board Arrangement (1)	De facto peg arrangement under managed floating (against a single currency) (2)	Managed Floating with no preannounced path for exchange Rate (3)	Independently Floating (4)
Albania				X
Bulgaria	X			
Bosnia and Herzegovina	X			
Croatia			X	
FYR Macedonia		X		
Romania			X	

Source: IMF, Annual Report 2000, pp. 141-143

1. Currency Board Arrangement (CBA): A monetary regime based on explicit legislative commitment to exchange domestic currency for a specific foreign currency at a fixed rate. Domestic currency can be issued only against foreign exchange. The monetary base is fully backed by foreign assets. No place for discretionary monetary policy.
2. De facto peg arrangement under managed floating (against a single currency): The country pegs de facto (not formally) its currency at a fixed rate to a major currency, where the exchange rate fluctuates within narrow margin (e.g. of at most ±1%) around a central rate. The monetary authority stands ready to maintain the parity through intervention. The degree of monetary policy discretion is limited, however greater relative to CBAs.
3. Managed Floating with no pre-announced path for exchange rate: The monetary authority influences the movements of the exchange rate through active intervention in the foreign exchange market without specifying a pre-announced path for the exchange rate.

Independently Floating: The exchange rate is market determined, with any intervention. The monetary policy is in principle independent of exchange rate policy.

The achieved stage of integration between EU and SEE region as well as the implementation policies and the market dynamics, which will enforce it further, confirm that currency stability in the framework of a fixed exchange rate system is necessary to promote economic integration between the EU and the SEE region. But greater economic and financial integration is a necessary but not sufficient precondition for euroization. The decision to euroize indicates the political will of a country to introduce enormous institutional reforms and disciplines in order to improve and consolidate its political and economic image and transform the commitment to euroize into a virtuous circle between structural reform and market performance.

In the following, the analysis turns to the question of whether the proper exchange rate and monetary policy for the Balkan countries vis-à-vis the Euro and the Euro zone is unilateral euroization.

The Regime of Unilateral Euroization

The monetary regime of euroization (like dollarization) can take two forms: the de facto and de jure euroization (Berg and Borenszstein 2000, United States Senate 2000). De facto euroization means that market agents and people in their economic activities increasingly prefer to use the Euro instead of the national currency. Due to high current inflation, inflationary or devaluation expectations, people's distrust of national economic policy or political instabilities, national money cannot fulfill its functions. In these cases, a stable foreign currency progressively substitutes for national money without a formal decision or a policy intervention by monetary authorities. But national currency still circulates as a parallel currency, and national monetary authorities continue to exist.

De jure (or unilateral) euroization is based on a formal political decision and implies constitutional changes in the national monetary order. It includes the elimination of national currency and its complete replacement with Euro. In the case of unilateral euroization, the national monetary base is converted into European Central Bank notes and the Euro constitutes the sole legal tender and sole unit of account. A further implication is the disestablishment of the national central bank and of national monetary policy. Through the adoption of the European Central Bank's monetary policy the constellations of money demand and supply in the national market are self-regulated. The national central bank or a follow-up institution would merely undertake the surveillance of the national financial system. Under the regime of unilateral euroization there is no need for foreign currency reserves, for intervention on the exchange rate markets or for covering foreign balance deficits. The national monetary space of euroizing countries becomes a passive part of Euroland on which are registered all the monetary developments of Euroland, itself.

The question that arises, is why a country would prefer to give up its monetary sovereignty and monetary flexibility? It is well known that national currency is not only a crucial economic component and policy instrument but also a symbol of national independence and sovereignty, which is of vital psychological importance for the new SEE democracies. The answer could be that rational politicians consider that the expected advantages of establishing euroization will be more than the expected costs. The following two sections refer to this question.

The Potential Benefits of Euroization

The replacement of a national currency with the Euro eliminates the exchange risk that exists (Bratkowski and Rostowski 2000, Nuti 2000). The positive impact on trade and investments is correlated with the degree of trade and capital market integration between the euroizing country and the EU. But it does not eliminate the currency risks against other currencies (e.g. the dollar, the yen or pound). A first positive impact of eliminating currency risk leads to a reduction of risk premium and to a consequent lowering of interest rates (Table 5). What remains is default or country risk, which continues to depend on factors like political stability, level of public debt, budget financing, macroeconomic situation, etc. Lower interest rates would result in a lower cost of servicing public debt and also in higher level of investments and economic growth. The higher the currency risk, the higher the interest rate differences between Euroland and the euroizing SEE country and, consequently, the higher the expected positive growth effects of adopting the Euro.

Table 5. Selected Economic Indicators (2000)

	GDP (change in %, real)	Consumer prices, %	Current Account (USD mn)	Average interest rates (Discount rates)	Gross foreign reserves (excl. gold in mill USD)	M1, Money (in national currency)	Average exchange rate (national currency/Dollar)	M1, Money (in US Dollar)
Albania	7.8	-0.2	-151	8.5 (c)	481	116.9	150	779
Bulgaria	5.8	9.9	-701	4.7	3155	3632	2.123	1710
Bosnia & Herzegovina	5.0	2 (a) 15 (b)	-963	1.4	455	1295	2.074	624
Croatia	3.7	6.2	-800	5.9	3525	18030	8.28	2177
FYR Macedonia	5.1	10.5	-320	7.9	429	22388	65.89	339
Romania	1.6	45.7	-900	35	2470	46331	21692	2135
FRY	6.0	71.8	-400	26.8	n.a.	30194	37.46	n.a
Euroland (12)	3.4	2.3		4.4				

Source: WIIW Database, IMF, EU

n.a. non available

(a) Federation
(b) Srpska Republica
(c) 1999

A further effect of Euroization has to do with the reduction of foreign exchange transaction costs. The more integrated a Balkan economy with Euroland, the more important this reduction will become.

Lower transaction costs could lead to more intensive bilateral trade and to lower export and import prices.

Direct price linkages, inherent in a currency area, mean that price level and price movements in a euroizing Balkan economy, as a price taker, will be bound to price developments in Euroland. The higher the degree of openness of the euroizing country and the higher its trade with Euroland the closer would be these price linkages. According to Maastricht rules the ensuring of price stability and low inflation rates (e.g. up to 2%) is the only policy goal of the European Central Bank. If price stability in Euroland is assured, then the same would apply to a euroizing Balkan economy (Table 5). This link would result to lower inflation (similar to Euroland) that could improve business and investment conditions in the euroizing economy.

Euroization could also encourage fiscal consolidation and permanent fiscal discipline because there would be no central bank monetization of the budget deficit. Financing of such deficits would be possible only through financial markets. In case of an increase in public debt the result would be a decrease in credibility and worse borrow conditions.

It could also promote financial sector reform and stability due to the lack of a lender of last resort. It could eliminate currency risk and, consequently, currency and maturity mismatches, and also bring a closer integration with international banking and financial system.

The loss of a national monetary policy and restraints on the flexibility of fiscal policy emphasize the importance of income and structural policies for macroeconomic management. In the case of asymmetric shocks, prices of goods and production factors have to react in both directions flexibly. If not, the real costs of adjustment would be very high. In order to improve market flexibility the euroizing country could force labor market and other institutional and structural reforms (Eichengreen 2001).

The recent financial crisis has made it clear that small, open economies with liberated capital markets cannot be protected from contagion episodes, regardless of whether they have fixed or flexible exchange rate regimes. The most important consequences of these crises are banking crises, the collapse of national payment systems, the loss of foreign reserves, the abandonment of the peg or the overshooting of depreciation (in case of flexible exchange rates), a depreciation of economic activity, and social conflicts. These effects are much lower in large developed countries or in economic unions because of their strong banking systems, deep and wide financial and exchange rates markets, better crisis management abilities, etc. In the case of an international financial crisis, a monetary union protecting its participating economies is like a public good. It can also be "absorbed" passively, via euroization, by participating member countries. The conclusion is that euroization would tend to limit the incidence and magnitude of crisis and contagion episodes.

All the above-mentioned effects of euroization may force the process of economic integration with the EU, as well as intra-regional integration. Trade integration can be promoted especially by lower transaction costs and the elimination of exchange rate risks. The (passive) participation in Euroland could boost European and other direct investments in the euroizing country, as well as the establishment of foreign banks and other financial corporations. If the whole SEE region were to euroize, then intra-regional trade and capital transactions would be easier, more transparent and less costly. Intra-regional trade competition would be based on real economic factors and not on competitive devaluations. The impact of participation on political integration in the Monetary Union only, and not in the European Economic Union, is less obvious. But a common currency is a matter of common interest and could influence positively the attitudes of people in both areas towards better and deeper co-operation.

The Potential Costs and Risks

The establishment of the euroization regime could result not only in the above-mentioned benefits; it could also produce costs and risks (Wojcic 2000).

The most popular disadvantage is the loss of seignorage revenues accruing from the issue of legal tender. Seignorage is frequently measured as the increase in the volume of the monetary base, which is equivalent to the resulting central bank profits in present-discount-value terms. For all SEE transition countries the seignorage revenues are a significant percentage of GDP, and an important source of financing the public budget. The loss of this revenue would cause serious problems in public finance because of limited alternative sources. Low GDP, inefficient tax systems and a limited tax base characterize transition economies and especially the economies of the SEE region. Consequently these countries are still dependent on other sources of state financing such as seignorage revenues, import tariffs, public loans, privatization revenues and indirect taxation. But the loss of seignorage revenues and its effect on public finance could be compensated or overcompensated by the potential decrease in interest rates, as mentioned above.

The replacement of the national currency by the Euro would mean the purchase of domestic currency (the outstanding monetary base) against the Euro by the national central bank. It presupposes the existence of sufficient foreign reserves (Table 5). If these reserves cannot cover the necessary amount then there are other possibilities like loans and contributions by the EU.

A further risk of euroization has to do with the management of the national banking system. In case of bank crises it could impair the lender of last resort function of the national central bank. In order to prevent this risk, central banks, or a new institution, could create a special emergency fund. The introduction of high quality requirements as in Euroland could also act preventively. The privatization of national commercial banks and the openness of national money and capital markets has led to the establishment in the SEE transition countries of many foreign banks. These banks practice modern management and carry out, more or less, the control or surveillance of the home country's monetary authorities. It could be expected that after euroization more foreign banks will extend their branches into the euroized countries. The dominant presence in the local banking system of dynamic foreign banks would diminish the risk of banking crises and the need for a lender of last resort.

The adjustment to large asymmetric shocks might be the most important policy challenge in a monetary union. The appearance of such shocks is more probable when there are different economic structures, reverse economic cycles, and different foreign trade structures among the members of the monetary union. Because of the loss of important instruments of adjustment policy, the euroizing economy would need flexible wages and prices. Otherwise, such shocks could cause depression, increase in unemployment and social conflicts.

Euroization and Currency Board Arrangements: A Comparison

The successful implementation of Currency Boards in some transition economies (e.g. Bulgaria, Bosnia-Herzegovina, Estonia) has encouraged suggestions for an introduction of this regime in the other SEE countries. The Currency Board has also been viewed as a path to euroization. The question that arises is whether a Currency Board is similar to euroization and if such a regime is superior to the formal replacement of national money with the Euro.

There is no doubt that a Currency Board Arrangement (CBA) constitutes a hard peg version, and has impacts similar to unilateral euroization. But there are a lot of differences between the two regimes (about the deficiencies of CBA see Roubini 1998, Enoch and Gulde 1998).

At first, the introduction of a CBA would imply strong commitments and obligations regarding coverage of the monetary base, convertibility, exchange rates and economic policy. But national currency, foreign reserves, central bank and other monetary authorities would continue to exist. This would mean that an exit option would always be possible. On the other hand, Euroization is essentially irreversible and therefore more credible than a CBA.

In a CBA devaluation cannot be excluded. Hence, speculative attacks and destabilizing capital flows could occur. In the case of euroization these phenomena would be possible only against other currencies and refer to the whole Euro area, which has more effective means than a small country to introduce counter measures.

Because of devaluation risk in a CBA, interest rate differentials against the anchor currency would be higher than in the case of euroization. Current account deficits could cause capital exports, reduction of money supply and higher interest rates in the country implementing a CBA. Eventually, increased interest rates could counterbalance capital export and might also lead to a repatriation of exported capital or to additional capital imports. If the cause of current account deficits were the increase in domestic prices then the result would be a real appreciation of the national currency. But increased interest rates and real appreciation of a national currency, very probable in case of CBA, would cause competitiveness losses and a severe recession.

In case of large fluctuations of the monetary base and abrupt interest rate changes, domestic banking and financial system could be highly destabilized. This means that in a CBA the lack of a lender of last resort has a stronger negative impact on the financial system than in the regime of unilateral euroization.

A Currency Board could collapse if an attack on the domestic currency were to occur, as total domestic financial assets would be much higher than foreign reserves. In the best case foreign reserves could cover only the national monetary base. In the case of unilateral euroization such a collapse could not occur.

A further difference between the two regimes has to do with transaction costs. In a CBA these costs would still exist and hence would be higher than in the case of Euroization.

This short analysis could lead to the conclusion that euroization is superior to a CBA regarding transaction costs, currency risk, country's credibility and economic stability and growth. But for some countries the elimination of their national currency and the potential high costs of exiting from the Euro could be regarded as a disadvantage of euroization in comparison to a Currency Board.

The EU's Position Regarding Euroization

After the circulation of Euro bank notes, an expansion of its use in countries integrated into the EU economy, and the emergence of a broad Euro area (like the Dollar area) would be expected. This means that an expansion of de facto and de jure euroization in the periphery of Euroland is a very probable scenario. The more stable the Euro and the more successful the EMU, the more attractive it would be to use the Euro in other countries. Under these conditions, in an increasingly integrated European and world economy with free capital movement, Euroland governments or the European System of Central Banks could not prohibit this tendency.

Euroization, in general, could have some positive economic impacts on the EU. The first expected benefit could be an increase in the seignorage revenues of the EU's member states. These kinds of "windfall profits" would depend on the number and size of Euro bank notes that would circulate in other countries. Should the Euro become an attractive currency, these revenues could be a very important financing source for member states (HypoVereinsbank, 1999, p. 15). In the case of the U.S., the State realizes an annual $12 to 15 billion as additional revenue inflows resulting from the circulation of Dollar bank notes abroad (Cohen 2001).

A second benefit could result from the reduction of transaction costs and the elimination of currency risks in Euroland's trade and investment activities within the euroizing countries (or region). The size of these "denomination rents" (Swoboda 1968) for exporters, importers, investors, insurance companies, tourists etc., in the country of issue would depend on the intensity and magnitude of economic relations between the EU and SEE regions. A higher import demand for European goods and services and an improved environment for European foreign investment could be important benefits for European companies. In any case, the benefits for the EU are unlikely to be considerable, since the economic relations between the EU and the SEE transition countries are not significant for EU.

An extensive use of the Euro as a parallel currency abroad could also be important from a political point of view: It could be an indicator of the success of the Euro and the economy of Euro zone.

The main risk for the EU following an extended euroization would be an increase in the volatility of Euroland's monetary aggregates and a stronger pressure on ECB's monetary policy. For example, if money demand in euroizing countries were to be subject to sudden or frequent shifts, net flows would be generated that could increase the short term volatility of Euroland's monetary aggregates. In the case of a massive or frequent currency substitution in euroizing countries (e.g., Dollar instead of Euro), depreciation of the Euro, or an increasing volatility in exchange rate markets could be expected. From a theoretical point of view these risks seem to be important. But the experience of the spreading use of the Dollar outside the borders of the U.S.A (55 - 70 per cent of the total outstanding stock of U.S. banknotes, see Porter and Judson 1996) or other currencies (e.g., D-Mark, British pound) shows that it has very little or no evident impact on practical monetary policy. The use of the Euro as a national currency abroad would influence the aggregate demand in the euroizing countries and not in Euroland. Also, the Euro monetary base in SEE countries would be a very small part of the total. The movement of the Euro exchange rate against other currencies will depend on the monetary and real economic conditions and policy decisions in Euroland, and not on what happens in the small euroizing countries, which are "recipients" of the EU monetary policy.

In the euroization debate the EU's institutions (ECOFIN and Commission) have responded negatively (see Bratkowski and Rostowski 2000). Their main argument is mainly of an institutional nature: "…it should be made clear that any unilateral adoption of the single currency by means of 'euroization' would run counter to the underlying economic reasoning of the EMU in the Treaty, which foresees the eventual adoption of the euro as the endpoint of a structured convergence process within a multilateral framework", and "…the introduction of the Euro will ensure equal treatment between future Member States and the current participants in the Euro area" (ECOFIN 2000). According to ECOFIN's statement, all candidate states can gain access to Euroland only after fulfilling the Maastricht convergence criteria and according to the prescribed procedures. The recommended path to the EMU is: accession to EU, at least two years participation in the European Exchange Rate Mechanism (ERM II), and fulfillment of nominal convergence criteria. As the ECOFIN Council pointed out, during the pre-accession stage the candidate states need to meet the Copenhagen economic criteria, and ensure progress on real convergence and macroeconomic stability. In this context, the exchange rate would be an important instrument of the convergence policy, as well as "a yardstick of success in adjustment" (Deutsche Bundesbank 2000, p. 99).

As Bratkowski and Rostowski (2000) have argued, the EU's opposition to unilateral euroization is based on many misunderstandings. These could be summarized as follows:

- Unilateral euroization would mean a passive adoption of the Euro and not admission into the EMU. This implies that the unilaterally euroizing countries would not participate in the EMU's institutions and hence could not influence their monetary decisions.

- Through unilateral euroization the equal treatment between EMU member states and the new or future members would not be violated because euroizing countries would not be coequal members of the EMU, and because unilateral euroization would "…provide a better test of a country's commitment to price stability than the traditional route does, partly because it makes it harder for a country to temporarily repress inflation through nominal appreciation" (Bratkowski and Rostowski 2000, p. 14).
- A new member state of the EU, which had adopted the Euro unilaterally, would be admitted to the EMU after satisfying the public finance, inflation and interest rate criteria. The exchange rate stability criterion would be regarded as already having been fulfilled.
- Unilateral euroization would not imply any legal obligation to the European Central Bank to act as a "lender of last resort".
- Euroizing countries could not be considered as "free riders" on the Euro, because they would have to buy it, paying seignorage to EMU members.
- Unilateral euroization, as well as de facto euroization would mean an increase in demand for the Euro, and hence an improvement in its international reputation, which is a desirable outcome for EMU authorities.

Implementing Unilateral Euroization: A Potential Path

If a country should decide to euroize, then it must find asset of procedures to attain this goal. For a unilaterally euroizing country there would be different paths of implementation. The following discussion concentrates on some important technical aspects concerning preconditions, accompanying policies, implementation phases, institutional reforms, etc.

First of all, it must be emphasized that the decision to euroize is primarily a momentous political act and secondarily an economic and technical issue. Euroization would be an "imposed" monetary order and not a spontaneous one. It would presuppose a collective decision and enforcement by the state. This decision must be rational and accepted by the national society and economy, as well as by other co-operating countries. Based on this, the main steps toward euroization are considered below:

- Analysis of costs and benefits. This analysis in the form of an ex ante evaluation should be made to include all potential economic, social and political effects of euroization. It should be considered that euroization generates winners and losers, and that it would change entirely the function of economic policy and the structure of the economy.
- Negotiation with the EU on the feasibility of a monetary association agreement. Notwithstanding that the adoption of the Euro as a national currency would be attained unilaterally, i.e., without a previous acquiescence by the EU, there are many reasons for negotiating this step with EU. The most important reason is that the SEE countries are highly asymmetric in their dependence on EU markets, foreign direct investments, financial and technical assistance and political support. While all countries of this region are intended to become full members of the EU, they would have to accept and implement the acquis communautaire, according to the EU enlargement tradition. Since the EU insists that the Maastricht EMU criteria and procedures must be fulfilled before the accession to euro zone, then the candidate states have to follow that path, unless the EU changes its position against unilateral euroization in the sense discussed above.
- Development of the basis for a broad national consensus. As mentioned, euroization is a fundamental decision, which should not been taken solely on the basis of economic and technical considerations. It is critical that a country considering unilateral euroization should achieve a strong political and social consensus. This requires a serious, open and broad discussion of the pros and cons, and support by the business community, the financial sector, labor organizations and civil society.
- Announcement of the euroization decision and of a reform plan. The policy reform program should try to consolidate public finance, assure the sustainability of monetary stability, modernize the financial sector, liberalize the factor markets and introduce labor market reforms, which will

improve its ability to cope with asymmetric real shocks without recourse to monetary, exchange rate or even fiscal policy.

- Implementation of the reform plan in 4 or 5 years. Only after a successful implementation of the reform plan and after achieving the mentioned consensus should a country consider unilateral euroization. During that period the country could introduce a Currency Board as an instrument supporting the reform program and as an "antechamber" to full euroization.
- Assurance that the central bank has sufficient Euro reserves. Define a new role for the central bank (surveillance of banking system, lender of last resort) or establish a new institution for banking sector surveillance and liquidity.
- Development of a timetable for the date at which the exchange rate with the Euro would be set, the date on which the Euro would become legal tender, rules for the conversion and reinterpretation of old contracts, etc. An up-front competitive devaluation should be avoided because it could cause an increase in imported inflation and a loss of competitiveness. It could also cause tensions with EU and other third countries. Also, an up-front revaluation could cause serious damages to the competitiveness of the euroizing country.

Should the Balkans Euroize?

The above analysis has shown that the debate about unilateral euroization for SEE countries raises a lot of complicated theoretical and political questions. The answer to the question of whether transition countries like those in the SEE, which are highly integrated into the EU, should euroize cannot be answered univocally. The process of euroization in the SEE region poses both economic and political benefits and costs, few of which can be estimated in advance with some degree of precision. The estimation is very complex and, in most aspects, inherently subjective.

From a purely economic point of view it would seem that the expected advantages of unilateral euroization would more than compensate for the potential costs and risks (for an opposite view, see Wojcek 2000). But the results of the ex ante calculus must be interpreted under the presupposition that the new monetary regime would change the performance of economic policy and the structure of the economy in significant ways and with uncertain results. This uncertainty leaves much room for debate and disagreement.

The decision to euroize or not would be determined by political economy considerations (about this aspect see Frieden 2000). A state willing to euroize would have to make a very fundamental political and economic decision. It would be a decision with uncertainties, which, after implementation, could be reversed only with extremely high costs. Therefore the final decision on euroization would be dependent on the following political and economic criteria:

First, the political aspects refer, among others, to the EU position, to the national political and social consensus, to government strength and stability, to the existence of strong cross-border investing/financial interests and to import and export-competing producers. If the EU continues to oppose unilateral euroization, and insists on Maastricht procedures, then it seems unlikely that a transition country of the SEE region could proceed to such a decision. All these countries are dependent on EU market and financial assistance, and intend to become full members in the future. Under these circumstances a tension in their relations with the EU due to unilateral euroization would produce additional costs and risks for SEE countries. Strong governments with a pro-European public opinion would be able to choose a commitment to euroization, and might use it in elections. But also, it might be easier for a new government coming to the power in a time of hyperinflation or chronic high inflation to make such a fundamental decision. At the domestic level strong EU oriented economic agents and interest groups (e.g. financial institutions, international firms, borrowers) are more likely to want euroization. Producers of international tradable goods and import competitors are more likely to oppose it.

Second, economic aspects include trade openness and the degree of economic integration with the EU, correlation of economic conditions and the business cycle with those of the EU, inflation rate and inflationary expectations, level of foreign reserves, flexibility of markets, etc. The greater the commercial and financial integration and the greater the synchronization of the national business cycle with that of the EU, the greater would be the likelihood of euroization. The will to break the inflationary dynamic and to import discipline in economic policy might also influence this decision positively. Also, a positive impact could be expected should there be sufficient foreign exchange reserves and flexible factor markets and especially labor markets.

Politicians will make the ultimate decision about euroization after considering all the above-mentioned political economy aspects. The SEE transition countries are characterized by divergent political and economic structures, and, therefore, political economy considerations concerning euroization decision will vary. The economic effects of unilateral euroization would vary across SEE countries, and as would their evaluation among individuals and groups. Hence, further analysis would be needed to estimate the special economic and political conditions, which would favor or oppose euroization in each SEE transition country.

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