To peg or

In the summer the CEP organised a conference to look at the experience of countries that have adopted the dollar or another currency as their own. Ellen Meade speculates on how the lessons from that conference might apply to the countries about to join the European Union.

by Ellen Meade

not to peg

Some countries in eastern Europe may accede to the European Union in about two years time. This would put them on track to adopt Europe's single currency from 2006. Unlike Great Britain, which can still decide whether or not to join the euro, these countries in eastern Europe will not be able to opt out of monetary union. The question facing them is *when*, not *if*.

Several well-known economists, including Willem Buiter of the European Bank for Reconstruction and Development and Jacek Rostowski of the Central European University, have argued that countries in eastern Europe should adopt the euro now, either unilaterally or by prior arrangement with the EU. (This second option is often referred to as "consensual euroisation".) In this case, the euro would circulate in parallel to the domestic currency, or perhaps replace it altogether. In any event, this action would require authorities to fix the value of the domestic currency in terms of the euro, rather than participating in the so-called ERM2 target band arrangement for two years before entering EMU.

The basic idea of "euroisation" is not particularly new. It is a form of official currency substitution in which the domestic legal tender of a country is replaced by a reserve currency. Economists generally regard official currency substitution as the "hardest" form of pegged exchange rate regime, one that is more difficult to reverse than a currency board. Such official currency substitution has become known as "dollarisation," even if the currency chosen to replace the domestic currency is the euro or some reserve currency other than the US dollar.

Andorra, Monaco, San Marino and the Vatican City already use the euro as their domestic currency (the euro replaced the legacy currency that was already in use). In eastern Europe, Kosovo and Montenegro also have euroised. A number of other economies use an external currency for their legal tender (see Table 1). From this table two striking facts emerge: first, most of the economies "dollarised" many decades ago; and, second, the population in these economies is very small, ranging from 56 persons on Pitcairn Island to 3.5 million in Puerto Rico. Before the adoption of the dollar in Ecuador (population 12.9 million) in 2000 and El Salvador (population 6.1 million) in 2001, the average population in dollarising countries was 450,000. Countries that have dollarised have traditionally been miniscule in economic terms, with strong trade ties to the reserve currency country and relatively undeveloped domestic financial markets. In fact, size may an important determinant of success with respect to "dollarisation". If this is the case, the 1997 debate on dollarisation in Argentina, the recent adoption of the dollar in Ecuador and El Salvador and the calls for adoption of the euro in countries in transition to EU membership can be seen as fundamentally different in that these countries are all much larger than the traditional "dollariser".

A large academic and policy literature was written in the late 1990s, motivated by proposals that Argentina should replace its then-successful currency board, which linked the peso one-to-one with the US dollar, with a dollarisation arrangement. A primary focus in this literature was on the appropriate exchange rate arrangement when financial liabilities are denominated in a reserve currency while financial assets are denominated in the domestic currency. Large "liability dollarisation" makes a country vulnerable to adverse balance sheet effects arising from changes in the exchange rate. Liability dollarisation can be seen as reducing the range of values for the exchange rate that domestic authorities can tolerate. Berg and Borensztein (2000) provide a good summary of the pros and cons of dollarisation in the context of the Argentine debate.

Some, like Enrique Mendoza of the University of Maryland,

Other economic policies must be appropriate

Table 1 Economies Using Another Currency as Domestic Legal Tender

Country	Population	Political Status	Currency used	Since
Andorra	63,000	Independent	Euro (French franc and Spanish peseta since 1278)	1999
Channel Islands	140,000	British dependencies	pound sterling	1797
Cocos Islands	600	Australian external territory	Australian dollar	1955
Cyprus, Northern	180,000	de facto independent	Turkish lira	1974
Greenland	56,000	Danish self-governing region	Danish krone	Before 1800
Guam	150,000	U.S. territory	U.S. dollar	1898
Kiribati	80,000	Independent	Australian dollar	1943
Liechtenstein	31,000	Independent	Swiss franc	1921
Marshall Islands	60,000	Independent	U.S. dollar	1944
Micronesia	120,000	Independent	U.S. dollar	1944
Monaco	30,000	Independent	Euro (French franc since 1865)	1999
Nauru	8,000	Independent	Australian dollar	1914
Niue	2,000	New Zealand self-governing Territory	New Zealand dollar	1901
Norfolk Island	2,000	Australian external territory	Australian dollar	Before 1900
Northern Mariana Islands	48,000	U.S. commonwealth	U.S. dollar	1944
Palau	18,000	Independent	U.S. dollar	1944
Panama	2.5m	Independent	1 balboa = US$ 1; uses dollar notes	1904
Pitcairn Island	56	British dependency	New Zealand and US. dollars	1800s
Puerto Rico	3.5m	U.S. commonwealth	U.S. dollar	1899
Saint Helena	6,000	British colony	pound sterling	1834
Samoa, American	60,000	U.S. territory	U.S. dollar	1899
San Marino	24,000	Independent	Euro (Italian lira since 1897)	1999
Tokelau	1,600	New Zealand territory	New Zealand dollar	1926
Turks and Caicos Islands	14,000	British colony	U.S. dollar	1973
Tuvalu	10,000	Independent	Australian dollar	1892
Vatican City	1,000	Independent	Euro (Italian lira since 1929)	1999
Virgin Islands, British	17,000	British dependency	U.S. dollar	1973
Virgin Islands, U.S.	100,000	U.S. territory	U.S. dollar	1917
Ecuador	12.9m	Independent	U.S. dollar	2000
El Salvador	6.1m	Independent	U.S. dollar	2001
Kosovo			Euro	
Montenegro			Euro	

Source: Levy Yeyati and Sturzenegger (2002).

see the fundamental advantage of dollarisation in terms of "institutions substitution", a process by which dollarising countries "borrow" the monetary policy institutions of the reserve currency country. In this view, dollarisation is superior to a currency board largely because, under dollarisation, the domestic central bank is "replaced" with the central bank of the reserve currency issuer.

In the best circumstances, dollarisation eliminates currency risk and, possibly, reduces default risk. The extent of these gains depends, of course, on how irreversible dollarisation is perceived to be. Ideally, gain in credibility from "institutions substitution" will substantially narrow the spread on dollar liabilities issued by the dollarising government, relative to those issued by the US Treasury, producing lower domestic interest rates.

Key to successful dollarisation, however, is that other economic policies must be appropriate. In particular, dollarisation is a commitment by the monetary authority only and does not guarantee a responsible fiscal policy. Ultimately, a lax fiscal policy will push up interest rates and undermine the monetary regime. For example, credibility gains from Argentina's currency board were high in the early years following its adoption in 1991, but eroded over time as the government failed to consolidate its fiscal policy. In a recent monograph, Mussa (2002) provides an interesting discussion of Argentina's downfall.

Table 2 Argentina's Quasi-Monies in Circulation
(Millions of Argentine pesos)

	Denomination	December 2001	March 2002
Federal government	**Lecop**	**1,039**	**2,649**
Provincial "own" securities		**1,627**	**2,591**
1. Buenos Aires	Patacones	822	1,591
2. Buenos Aires, City	Porteno	–	–
3. Catamarca	Ley 4748	26	31
4. Chaco	Quebracho	50	100
5. Cordoba	Lecor	200	300
6. Corrientes	Cecaror	193	185
7. Entre Rios	Bonfe	54	148
8. Formosa	Bocanfor	33	50
9. Jujuy	Patacon	–	6
10. Mendoza	Petrom	–	–
11. La Rioja	Debt Cancelation	8	8
12. Tucuman	Bocade	98	173
Quasi-monies:			
Total		2,666	5,240
As percent of pesos in circulation		23.2	45.6

Source: De la Torre, Levy Yeyati, and Schmukler (2002),

Several econometric studies have shown that inflation performance improves under a hard peg currency regime. Ghosh, Gulde, and Wolf (2002) found that inflation is 10.5 percentage points per year lower under a hard peg than under a floating exchange rate. In their study, "hard peg" regimes include currency boards as well as dollarisation. Of the 10.5 percentage point reduction in inflation, 4.5 percentage points derive from lower money growth in the pegged regime (the "discipline effect"), while the remaining 5.5 percentage points represent the credibility gain associated with the hard peg regime (the "confidence effect"). As the methodology makes no distinction between pegs maintained for a series of years and a series of pegs sustained for a single year, the study was not able to say anything about whether the discipline or confidence effects associated with the peg diminish over time.

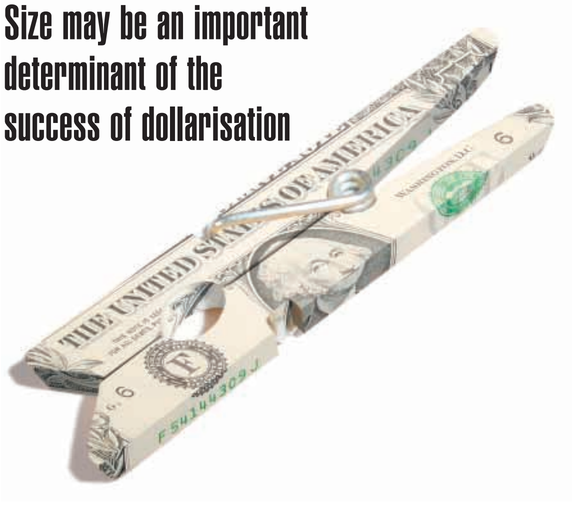
The literature on dollarisation generally does not distinguish between cases where it is pursued in isolation, or is part of a broader integration agenda with the country that issues the reserve currency. In practice, there is more than one way to dollarise or euroise. During the 1997 debate in Argentina, the central bank president Pedro Pou saw dollarisation not as a single policy choice, but as a range of policy options from unilateral to full monetary union. With unilateral dollarisation or euroisation, the country adopting the reserve currency asks nothing of the issuer, whereas broader forms of dollarisation or euroisation involve some set of on-going obligations for the issuer of the reserve currency and thus require mutual agreement by the two countries to a treaty or bilateral arrangement.

Argentina's flirtation with dollarisation in 1997 was in the context of a monetary treaty with the United States that would have provided for some sharing of seignorage revenue to fund a lender-of-last-resort facility. In the extreme, a monetary union such as the euro area could be seen as the most cooperative form of arrangement, in which participating countries share a currency and decision-making power.

Dollarisation and euroisation raise important issues about the degree of responsibility or commitment of the issuer to the country adopting the issuer's currency. When the policy is not unilateral, the issuer has some stake in its success (although the degree of this stake depends on the exact requirements of the arrangement). The commitment of the issuer can also serve to "bind in" the dollarising or euroising country, particularly if this commitment involves several steps that will lead ultimately to further integration between the two countries. Thus, dollarisation in Ecuador, which was a unilateral undertaking in response to an economic and financial crisis, differs from dollarisation in El Salvador, which was part of a broader trade and integration strategy with the United States. And euroisation in Andorra, Monaco, San Marino and the Vatican City differs fundamentally from potential euroisation in EU accession countries, because the latter countries seek eventually to join monetary union and participate fully in the monetary policy decision making of the European Central Bank.

In the Argentine case, US authorities opposed a monetary treaty for fear that it would ultimately impose broader responsibilities, or at least generate a perception that the US was playing a role in the supervision of Argentine banks, acting as lender of last resort and taking the Argentine economy into account when setting US interest rates. Argentina's proposed monetary treaty, in fact, provided only

Size may be an important determinant of the success of dollarisation



for the US to share in seignorage revenue and did not involve broader obligations. Despite that, the view of US authorities was that any treaty, no matter how narrow in scope, was a political symbol that could serve to create obligations for the currency issuer in times of crisis. In the debate over euroisation in accession countries, the opposition of European policy officials to this initiative could be seen as reflecting fears that European authorities would be held accountable in the event of a crisis, even for the results of unlilateral decisions.

If dollarisation is to provide major credibility gains, it must be widely viewed as irreversible and as an irrevocable commitment to replace the domestic legal tender with the reserve currency. However, the reversal of dollarisation is not particularly difficult to implement. For example, Liberia de-dollarised in 1998 after 54 years of using the US dollar in parallel with its domestic currency. And, in Argentina, the number of parallel currencies in circulation increased dramatically as the crisis deepened and the currency board linking the peso to the US dollar was abandoned (see Table 2). Thus, linking the currency decision to a broader integration strategy can make dollarisation seem more irreversible and enhance its credibility.

Many commentators have advocated early euroisation in accession countries as an interim exchange rate arrangement during the transition to EMU. A target band system, they argue, is crisis-prone and euroisation would be the best regime to forestall a speculative attack on their currencies. European officials do not see the so-called ERM2 machinery as crisis-prone, because of the wide bands around the central rate. At this point, financial markets are betting that the candidate countries will join the EU, so the credibility gains associated with a move to euroisation would be limited. However, euroisation might be helpful in limiting financial market speculation in the event of a long and unexpected delay in the accession process.

According to the Maastricht Treaty, the Council of Ministers must approve the rate at which a currency joins the euro. That requirement would appear to rule out unilateral euroisation, in which an accession country would select its own conversion rate. However, as has been pointed out, there are two Treaty-consistent options: (1) joint selection by the Council and the accession country of the rate at which the domestic legal tender is converted into euros (the "consensual" option); or (2) a currency board arrangement in which the euro is legalised as a parallel currency for use alongside the domestic currency of the accession country. Either way, such use of the euro in the run-up to accession would appear to make some sense as a transition measure to discourage speculation, so long as it is implemented in the context of sound macroeconomic policies and is not in clear violation of the Maastricht Treaty.

Interestingly, a discussion similar to option (1) above arises in the context of a UK referendum on the euro. Richard Layard of the CEP and others claim that a referendum will need to specify the rate of the pound's conversion into the euro. This would appear to require that the British government pre-negotiate the pound's conversion rate with the Council of Ministers.

* This article brings together perspectives from the recent conference "Dollarisation and Euroisation: Viable Policy Options?" hosted by the LSE on May 24-25, 2002. The conference programme and papers are available on: http://cep.lse.ac.uk/events/conferences/dollarization. A fuller account of the conference by Ellen Meade, Nikolas Müller-Platenberg and Massimiliano Pisani will be published in November by the CEP as an Occasional paper No.17.

It must be viewed as irreversible

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