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EUROISATION OUTSIDE EURO-ZONE: ASSETS AND CHALLENGES
THE EXPERIENCE OF KOSOVO

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Abstract

This study analyses the potential benefits and challenges that unilateral euroisation brings to Kosovo. In general, the study assessed that euroisation in Kosovo was beneficial in bringing the macroeconomic and financial stability and solving the problem of confidence in the currency. Euroisation has also eliminated transaction costs and promoted trade between Kosovo and countries using euro. The study also addresses the questions of the absence of part of the usual monetary policy tools and revenues. The benefits provided by a full scope euroisation in Kosovo outweight the costs, having in mind the size and the structure of its economy which is part of an area already fully or partially euroised. Since there is a need for the Kosovo economy to benefit from a stable banking industry and, in addition, BPK is not a lender of last resort, a strong banking supervision has been implemented.

JEL classification: E31, E4, E52, G28
Keywords: Euroisation, exchange rate, monetary policy, Balkan Region, Kosovo

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CONTENTS

1. INTRODUCTION

Kosovo and Montenegro are recent examples of euroisation, whereas the parallel use of euro, US dollar, or previously deutschmark (DEM), alongside a national currency, has been widespread in the Balkan region and Central Eastern Europe as well.

Euroisation in Kosovo was a natural consequence: the Territory's highly volatile monetary environment in the wider regional context, and a large inflow of remittances from the diaspora, made the parallel use of the DEM a fact. With the adoption of DEM as the legal tender unilaterally decided by the United Nations Mission in Kosovo (UNMIK), the subsequent changeover to euro was a natural continuation, implemented in cooperation with EU Member States.

This study focuses on the benefits of the use of euro and the challenges faced by Kosovo. The following section examines the phenomenon of euroisation in a broader context introducing definitions and exploring different cases of euroisation with local and regional outlook. Section three examines the symbiosis between euro and the wider macroeconomic framework, focusing on fiscal, monetary and external sector and the labor market. Section four focuses on monetary constraints resulting from euroisation, with an assessment on how these challenges can be overcome. The final section deals with financial supervision, as part of the consequences of euroisation.

2. EUROISATION IN PERSPECTIVE

2.1 Concepts and Definitions

In economic literature, 'dollarization' became the first term used to describe the large use of a foreign currency together with the national one, or even the adoption of a foreign currency as the legal tender by a third country, instead of its national one. The term came to prominence because of the widely used nature of the US dollar as the leading international currency. The introduction of euro, however, and the large size of the euro zone economy – comprising 16% of the world's GDP – have made the European single currency a serious competitor to the US dollar. Hence, the term 'euroisation' has emerged to describe either the use of euro as the legal tender in the country that has chosen to adopt it, or the use of euro as a partial substitute of a national currency.

Euroisation can take different forms: (i) official or *de jure*, as a currency regime among countries of European Union (EU), which have joined the Economic and Monetary Union (EMU) and, as a consequence, abandoned their national currencies; (ii) unofficial or *de facto*, when the national currency remains the legal tender, but large part of the financial assets or liabilities of residents are kept in euro or used for transactions and payments as it is a widespread phenomenon in South East European (SEE) countries; and (iii) unilateral, following the decision of government of the country or territory not belonging to EMU opting for the use of euro as the legal tender (Kosovo and Montenegro).

2.2 Membership to the Euro Zone

The idea of establishing a single currency area – a monetary union – stemmed from early European initiatives to achieve monetary integration through stabilizing exchange rates and reducing inflation.[1] The creation of the EMU originates from the Maastricht Treaty (1992) that specifies the nature of economic criteria, which fulfillment and subsequent evaluation forms the basis on which membership to the EMU is granted. The criteria define the process of convergence in fiscal and monetary matters, specifically dealing with public finances, inflation rates, and exchange rates.

[1] See http://europa.eu.int/comm/economy_finance/euro/origins/origins_3_en.htm

2.3 Full and Partial Euroisation

Apart from the definition given above and the forms that euroisation can take, euroisation can also be either full or partial: it can be full under both official and unilateral, or partial under unofficial. The entrance into force of the EMU in January of 1999 is an example of full euroisation, when eleven countries of the EU joined the EMU by adopting euro as their legal currency whereas their national currencies remained the subdivisions of it. In 2002, euro banknotes and coins were put into circulation in the twelve EMU member states, followed by the withdrawal of national currencies by respective member state central banks (CBs). Twelve EU countries now share the same monetary policy, which is conducted by the European Central Bank (ECB).[2]

In May 2004, ten countries of Central Eastern Europe (CEEC) plus Malta and Cyprus joined the EU without being presently members of the EMU. However, joining the monetary union could take long time for some of these countries due to the challenges in bringing in line their high current budget deficits and high public debt with the EMU macroeconomic requirements. On the other hand, Estonia, Lithuania and Slovenia have made the first steps by joining the Exchange Rate Mechanism II (ERM II).

Both partial and full euroisation, either unofficially or unilaterally, has occurred in many CEE and SEE countries (in 2001, around EUR 13.5 billion were deposited in euro-denominated accounts outside the euro zone, especially in CEEC). Prior joining the EU, the degree of currency substitution in many CEE countries was pervasive whereas it became even higher in the process of joining the EU. According to the German Bundesbank, 30% - 40% of DEM notes and coins in circulation were out of the Germany before 2002. Nevertheless, the use of DEM was not as strongly established as the one of euro nowadays in CEE and SEE countries, if we consider, for example, the rate of unofficial euroisation observed in Bulgaria, Albania, Serbia, Croatia, and Bosnia and Herzegovina, where euro is currently used for private transactions, while Kosovo and Montenegro represent cases of unilateral full euroisation.

[2] The twelve member countries first joining the EMU were Austria, Germany, France, Belgium, Finland, Netherlands, Ireland, Italy, Luxembourg, Portugal, Spain while Greece joined the EMU in 2001.

2.4 Euroisation and Currency Board Arrangements

The currency board arrangement (CBA) is a currency regime in which a country pegs the national currency to either one or a basket of strong foreign currencies. The central bank of a country with a CBA can only issue domestic currency when it is fully backed by foreign exchange reserves. The superiority of the CBA thus, is that it restores the credibility of the national currency through lower inflation and through disciplining public finances, but at the expense of loosing flexibility in the conduct of monetary policy. Therefore, many economists consider CBAs and euroisation as similar phenomenon in a broad sense. Euroisation and CBAs are similar in the sense that in both regimes, countries lose their monetary policy autonomy. The differences between a CBA and euroisation, however, exist in the sense that a country using a CBA can, theoretically, at any time, remove its peg or switch to another type of linkage, if the current one becomes unsustainable. This means that always remains some degree of currency risk in a country using a CBA, since a devaluation, which will affect the credibility of the national currency, is still possible.

In transition economies CBAs were adopted in Bosnia (1997), Bulgaria (1997), Estonia (1992), Latvia (1997), and Lithuania (1994). All of these countries have committed to CBAs and all are now pegged to euro following their peg to DEM, except for Latvia where the Lat was pegged to SDR, and Lithuania, which currency was pegged to the US dollar. The experience with the currency boards in Bulgaria and Bosnia were quite favorable given that highly volatile monetary environment they had in the past would have induced huge economic and social costs, if inflation were to be fought with the usual monetary tools. Thanks to the use of CBAs, the inflation rate was, for example, brought down to a single digit level (0.9%) in Bulgaria in 1998 from the exceptionally high levels of around 1,000% in 1997. On the other hand, Bosnia managed to restore credibility as a result of the peg to the DEM and consequently euro; as a result, in 1998 inflation rate reached to 5.1% whereas in 2002, the annual inflation rate was among the lowest in the region reaching 0.4%. Despite the benefits in price and macroeconomic stability derived from the CBA, these countries did not restore entirely the credibility problem of their national currencies therefore they still remain highly euroised (Bulgaria having around 59% of deposits denominated in foreign currency which in Bosnia was around 48% in 2004).

2.5 Situation in the Balkan Region

2.5.1 History

The history of unstable monetary system in Former Yugoslavia resulted from the overvalued exchange rate, weak external position, accumulated fiscal deficit and low growth of productivity and as a result, Yugoslavia experienced a hyperinflation of over 50% per month. The failure of policy decisions to address inflationary pressure as well as the external shocks partly related to the increase in oil prices pushed the crisis to intensify and consequently to destroy public confidence in the national currency which resulted in a high degree of currency substitution.

In 1994 Yugoslavia experienced a monthly inflation rate of 313 million percent which was accompanied with political instability, and hence leading to a gradual replacement of the national currency by the DEM. Although Yugoslavia had successfully exited from hyperinflation in 1994, it could not restore the credibility of its national currency and avoid the use of DEM as a way to store the value. Furthermore, the large migration of Yugoslav citizens to Western Europe (especially Germany) partly contributed to a high degree of DEM-isetion of Former Yugoslavia. Moreover, banks were allowed to have foreign currency accounts and paid indexed interest rates to attract deposits in foreign currencies into the banking sector.[3] In addition to these, after joining GATT (1966), Germany became Yugoslavia's main trading partner and most of the goods and services were paid in DEM. Germany was also Yugoslavia's main creditor whereas the inflow of most of investments from Germany added to the prevailing high degree of DEM-isation.

There are many lessons to be learned from this experience while the most important one is that the effectiveness of monetary policy in a context of a high degree of currency substitution is limited, especially if decision makers are not ready to face the high political and social costs which could result from the implementation of a strict monetary policy. Since the breakup of Yugoslavian Federation, its former Republics introduced their own national currencies. Most of them were successful in establishing a stable currency by implementing either fixed or floating regimes, nevertheless they still remain highly euroised.

[3] The interest rates in DEM were by two percent higher than those existing in Germany and they were paid in DEM. The interest rates on Yugoslav dinar were even lower than inflation.

2.5.2 Present situation

Countries in the region have adopted a variety of exchange rate regimes ranging between hard fix (such as euroisation and currency boards) and free floats, with different degrees of flexibility (see table 1). However, the nature of their exchange regimes has changed during the transition period. At present, all of these countries have been positioned apparently into bipolar extremes and adopted either a hard fix (e.g. euroisation in Kosovo and Montenegro, and a currency board in Bosnia and Bulgaria) or some form of flexible regimes (the rest of Former Yugoslav Republics and Albania). Nevertheless, in practice, the differences are not so huge, since the countries which have chosen a flexible regime have, in practice, targeted a floating band with the euro (or with the US Dollar in the case of Albania).

Table 1. Developments of exchange rate regimes in the Balkan area (from 1990 to 2002)

Country	Introduction of currencies	Period	Exchange rate regime	Currency basket / Target currency
Albania		1990-92 1992	Fixed peg Free float	US dollar
Bosnia and Herzegovina	Bosnia introduced its own Dinar in spring 1992, set at par with Yugoslav Reformed Dinar. The old dinar was replaced with new BH dinar in August 1994 at a ratio of 10,000:1. The new currency, the Konvertible Marka (KM), was introduced in 1997;first pegged to the Deutsche mark, and with the introduction to euro it is now tied to the euro.	1997- 1998 1999	Currency board Currency borad	DEM Euro
Bulgaria		1991 -1996 1997- 2000 2001	Managed Float Currency Board Currency Board	 DEM Euro
Croatia	In 1991 Croatia introduced its own dinar, as a transitional currency, set at par with Yugoslav New Dinar. In 1994, Croatian dinar was replaced with Kuna.	Until 1993 Since 1994	Fixed peg Managed float	DEM DEM target band de facto
Former Yugoslav Republic of Macedonia (FYROM)	In 1992, Macedonia introduced its own currency, the Denar.The Denar was set at par with Yugoslav New Dinar whereas in 1993, the Denar was replaced with new Denar set at a ratio 100:1.	Until 1993 Since 1994	Fixed Peg Managed float	DEM DEM target band
Montenegro		Until 1999 1999-2001 since 2001	Parallel currency DEM-isation Euroisation	DEM and Dinar DEM as legal tender Euro as legal tender
Slovenia	In 1991, Slovenia introduced its own currency, the Tolar. The substitute money vouchers were used until the bank notes were issued in September 1992. There was an indexation of its financial instruments in DEM-Euro.	Until 1999 After 1999	Managed float Managed float	DM shadow + real exchange rate rule Euro shadow + real exchange rate rule
Yugoslavia	The rump-state of Yugoslavia kept the old republic's currency, the dinar experiencing in 1990 one of the worst hyperinflations in history. In July 1992, a Reformed Dinar replaced the New Dinar at a rate of 10:1. In October 1993, the October Dinar replaced the Reformed dinar at a rate of 1,000,000:1. In January 1994, the 1994 Dinar replaced the October dinar at a ratio of 1,000,000,000:1. Later that month, the 1994 Dinar was introduced in parallel to the New (Super) Dinar at a ratio of 13,000,000:1; the New (Super) Dinar was set at par with the German Mark.	1992 2002	Fixed peg Managed float	DEM DEM and since 1999 Euro

Source: Starr (2004), Daviddi and Uvalic (2003), and CBs of respective countries

Slovenia implemented a managed float regime with the peg to euro within the band. Since 2004, however, Slovenia joined the ERM II, imposing a floating band of ±15 percent vis-à-vis the euro.

Croatia also implemented a managed float regime with the primary policy objective being price stability. Despite a low inflation and a stable currency, Croatia is still facing high degree of euroisation, with around 64% of total deposits being denominated in foreign currency in 2004. As a response to this, exchange rate stability remains an intermediate policy objective in the monetary policy framework of Croatia.

The managed float exchange rate regime has been adopted in *Serbia* since 2002. Currency substitution remains very high: in 2004 around 80% of total deposits were in foreign currency. In practice, Serbia's exchange rate regime is considered as near peg, considering the country's CB frequent interventions to maintain the Dinar-Euro rates at stated parity. However, in 2004, Serbian dinar depreciated against euro by around 14.0%.

Montenegro has unilaterally euroised following the adoption of the DEM as the legal tender in 1999 and, since than has achieved price stability, effectively ending years of uncontrolled inflation. From a 128% inflation rate in 1999, inflation rate was brought down to 4.3% in 2004.

Following the de facto peg to DEM until 1993, *FYR of Macedonia* has implemented managed float regime since 1993 and has succeeded in maintaining price stability. Nevertheless, FRYOM still keeps as its important intermediate target of the monetary policy the exchange rate stability against euro. [4] In fact in 2004 Macedonia was experiencing negative inflation growth of 0.4% from +1.2% in 2003 or +5.5% in 2001. Currency substitution remains high in FYROM, with over 40% of total deposits being denominated in a foreign currency.

Bosnia and Herzegovina introduced the CBA in 1997, initially pegging the convertible marka (KM) to DEM at a one-to-one basis. With the introduction of euro, KM was pegged to euro at a rate 1.95583. This regime proved to be successful in bringing inflation down and achieving monetary and financial stability.

[4] Daviddi and Uvalic, (2003)

Albania has implemented a free float regime since 1992. In the early years, inflation, though declining, was very high until 1995. However, after 1995 inflation declined to one digit level and since 1999 Albania has scored exceptionally well in maintaining its price stability. In 2004, inflation was reduced to 2.2% reflecting gradual appreciation of lek against euro, allowing the CB to achieve its monetary policy target of 3% of annual inflation growth. Despite official claims that the country operates on a free float regime, there is a debate among many economists that Albania in fact has some kind of a currency board with the currency pegged to the US dollar which is a so-called phenomenon of 'fear of floating.'[5] Currency substitution in Albania remains high, with foreign currency denominated deposits (mainly in US dollar) reaching at 67% of total deposits.

2.6 Eurosation in Kosovo

Since January 2002, the Euro has legal tender in Kosovo and has become the de facto currency of the Territory. UNMIK Regulation No. 1999/4, dated 2 September 1999, "On the currency permitted to be used in Kosovo", specifies in section 1 that "Parties to a contract or any voluntary transaction may denominate such transaction in any currency agreed upon by the parties. Unless proven otherwise, such an agreement shall be deemed to exist with regard to any foreign currency that is widely accepted in the Territory of Kosovo".

Consequently, any currency could theoretically be used in Kosovo, provided all parties involved in a transaction agree. Nevertheless, only the currency (or currencies) designated by the Regulation could be used to keep accounts and to perform compulsory payments.

Administrative Direction No. 1999/2 dated 4 October 1999, "Implementing UNMIK Regulation No. 1999/4 of 2 September 1999 On the Currency Permitted to be used in Kosovo" designated Deutschmark (DEM) as the only currency to formulate accounts and to perform compulsory payments.

Due to the changeover of DEM into Euro, Administrative Direction No. 2001/24 dated 21 December 2001, "Amending Administrative Direction No. 1999/2 implementing

[5] Daviddi and Uvalic, (2003)

UNMIK Regulation No. 1999/4 on the currency permitted to be used in Kosovo", replaced DEM by Euro (1 EURO = 1.95583 DEM). Consequently, in practice, since Euro has legal tender (which means that a payment in Euro cannot be refused) and since accounts are kept in this currency, almost all the transactions made in Kosovo are denominated and paid in Euro. The distribution of euro bank notes was made by the Banking and Payments Authority of Kosovo (BPK) with the help of the EU member countries. The BPK is not an issuing bank and hence it does not carry out the monetary or exchange rate policy.

The currency regime that Kosovo has adopted might be very challenging given the absence of traditional monetary and exchange rate instruments. The key concern, therefore, remains on whether the right policies (such as fiscal and structural policies as well as those related to the financial sector) will support this regime. In other words, the absence of traditional monetary policy instruments in Kosovo imposes the need for mechanisms such as labor mobility, wage and price flexibility to mitigate the possible shocks. In addition to this, the absence of lender of last resort function in hands of the BPK imposes the need for stronger banking supervision and regulation to ensure financial stability in Kosovo.

3. EUROISATION AND MACROECONOMIC FRAMEWORK

The adoption of a stable foreign currency has been prompted by willingness of the countries which intended to achieve macroeconomic stability through low inflation and higher credibility. Euroisation can help achieving monetary and financial stability, fiscal discipline, and could bring to an increase in trade among countries using euro. We look at each of these by focusing on the effects of euro on the sectors such as fiscal, monetary, external and the labor market.

3.1 Euro and the Fiscal Sector

Fiscal imbalances such as high budget deficits and high public debt were characteristic of many countries in transition which have experienced serious currency crises. Particularly, expansionary fiscal policies put pressure on CBs to monetize their deficits and hence contributed to the devaluation of their currency. With the adoption of euro, the CB cannot print money therefore the government cannot put pressure on it to use short-run expansionary policies. Thus, the advantage of euroisation is that it disciplines the fiscal policy given that the budget deficit cannot be monetized. Nevertheless, even with euroisation, the ability of the authorities to perform appropriate structural policies is essential to ensure macroeconomic stability.

The history of unstable monetary system accompanied with the deterioration of the banking system in Former Yugoslavia has significantly eroded the credibility of authorities towards the public. The adoption of the euro as a legal tender has helped authorities in Kosovo to reduce inflation and, as a result, to restore the credibility of macroeconomic policies. Fiscal policy in Kosovo can be considered as a unique case given that Kosovo does not have access to foreign borrowing and budget deficit cannot be monetized. Therefore, the only way for the government to maintain a sane fiscal balance is by expanding the tax base and lowering expenditures, or to be subsidized by international donors.

3.2 Euro and the Monetary Policy

3.2.1 Inflation

Euroisation commits to a stable currency which, in turn, helps reducing inflation. In particular, economic agents base their expectations on the past history of inflation and adjust their behavior accordingly. In the course of the adoption of euro, Kosovo have achieved great progress in terms of price stability with inflation rates being now close to the euro area levels. However, the fact that in 2001 inflation rate in Kosovo remained higher than that prevailing in the euro area (11.6% in 2001 whereas in 2002, inflation declined to 3.6%) suggests that factors influencing inflation rates in Kosovo were not only of monetary nature. In fact, they were partly influenced by real factors, such as the distortions in the supply and demand equilibrium. In particular, prices in Kosovo were mainly influenced by the increase in demand driven by the high inflow of the international community and of remittances from the diaspora, while the further reduction in inflation was partly influenced by the increasing capacities of supplies to face the demand.

In general, it is difficult to assess precisely the impact of euroisation in price evolutions in Kosovo in the early 2000, despite the fact that the use of a stable currency had without doubt a positive effect. Besides, even within the monetary union, inflation rates differ among countries. Indeed, countries with higher growth rates are more likely to face higher inflation rates than the average.

Euroisation had brought to Kosovo the much needed monetary stability. By lowering inflation and eliminating exchange rate risk, euroisation has given to Kosovo, in a post war context, a stable monetary environment, which is necessary for economic development, but of course it is not sufficient.

3.2.2 Interest Rates

Since euroisation reduces inflation and also eliminates the currency risk, this could initially bring to a decrease in nominal interest rates which are composed of aside default risk premium, administrative and funding costs, and of course margin, with expected inflation, exchange and liquidity risk premiums. Even if interest rates are sometimes considered to be high in Kosovo, they would have been higher should Kosovo had its own domestic currency, since interests rates would have to cover risks related to expected inflation and to currency fluctuation, not to mention the costs of the funding, which would have been very high with an unsecured and unstable currency.

The implication of high interest rates for the economic development is high given that with higher cost of capital, investments are lower which would consequently hamper economic growth. However, interest rates are not only determined by monetary and foreign exchange factors, but also by real factors such as propensity to save and marginal productivity of investments, as well as the expectations for future risks and among others, the credit risk.[6] Therefore, a further decrease of interest rates is strongly linked with a reduction of credit risk.

Interest rates in Kosovo appear to have decreased since the first introduction of euro in January 2002, however they remain high compared to interest rates in the euro area. This is consistent with the fact that interest rates in Kosovo are determined, among others, by the credit risks and other factors of uncertainty. On the contrary, interest rates on deposits are converging to the current interest rates in the euro area, which is consistent with a free exchange regime in Kosovo and the presence in the Territory of

[6] Backé and Wójcik (2003)

commercial banks offering depositors a reasonable level of protection. If lending rates appear to be high in Kosovo, in comparison with their average level in the euro zone, they are in fact similar to those observed in other Balkan countries. The benefit which derived from the euroisation on interest rates in Kosovo is nevertheless indisputable, having in mind that euroisation has favored the development of a young banking sector, which does not have to include in its costs any exchange risks –and consequently any interest margin to cover them. Whatsoever, the effect of euroisation on interest rates would have been even more tangible in a context of a more secured legal and business environment.

3.2.3 Exchange rate

Exchange rate risk arises from possible fluctuations on exchange rate on two or more currencies. The effects of a depreciation of the national currency are two folds: a lower value of assets denominated in this currency, an increase of the value of liabilities denominated in foreign currency. This will have negative implications for the banking system through higher defaults while indirectly affecting the economy through lower availability of credit. [7] With the adoption of euro, the risk from the exchange rate fluctuation has been eliminated. Thus, with a stable exchange rate, the uncertainty of investors for their future profits is reduced which, in turn, is expected to encourage investments. Moreover, the stable exchange rate fosters macroeconomic stability and hence increases foreign direct investments (FDI), which will ease an inflow of new technology and open up new markets.

As a result of the use of euro, Kosovo's economy is not confronted with exchange rate risks with its main partners, which tends to reduce the effects of other factors of uncertainty for foreign investors. Nevertheless, according to IMF, investment rates have been low in Kosovo compared to regional standards[8], reaching 22.3% in 2003 and 22.8% in 2004, which clearly demonstrates that if monetary stability is necessary to foster economic development, it is not sufficient, since different types of constraints, related to the Kosovo's global macroeconomic and political framework, could hamper economic development and offset the benefits of a stable monetary environment.[9]

[7] In case of devaluation of the currency, many firms may face losses therefore they will not be able to repay their loan.
[8] Kosovo-Gearing policies toward growth and development", IMF report, November 2004
[9] The inflow of FDI, among others, depends on the unit labor cost, infrastructure, the size of the domestic market, export opportunities and the quality of institutions.

3.3 Euro and the External Sector

The lack of competitiveness of exports and moreover the lack of exports is the main problem facing Kosovo's economy, whereas growth is mainly import-led. Kosovo's economy can only finance a minor part of its imports, whereas the remaining part is highly dependent on workers' remittances and foreign aid.

The absence of exchange rate policy cannot be considered as a challenge for Kosovo to stimulate its exports given its small and emerging economy as well as the specific situation of the Territory. Indeed, exports in Kosovo should be stimulated by means other than the exchange rate policy, such as an increase in productivity, which is obviously the only way to develop sustainable export growth. In short, the increase in competitiveness, through a labor intensive economy, can only be determined by the unit labor cost and relative prices[10] and not by any exchange rate effects. Moreover, the idea according to which a small and weak economy as Kosovo could rely on its exchange rate to foster its exports is mostly inappropriate.

Given that local market is small, exports remain the most important source for growth in Kosovo, apart from international assistance and remittances. The composition of imports, being a good measure of the economic activity in Kosovo, is also mainly dominated by consumer goods, meaning that the increase in imports is not improving the ability to export, since few imports are devoted to purchase equipments. The current account deficit in Kosovo, therefore, remains high which in 2004 accounted for 30.1% of GDP. [11] The current account deficit has, however, declined since 2002 from 36.0% to 31.1% in 2003 which accompanied by the negative growth in prices suggests that the process of increasing the competitiveness has already started in Kosovo. The decrease in prices is the result of the downward pressure of mainly prices of non-tradable goods, which, as mentioned above, in the after war period were driven by the increase in demand due to high inflow of international funding and remittances. The fall in prices of these goods, as a result, will be expected to encourage the reallocation of resources into more productive economic sectors such as import and export competing sectors. The main challenge for Kosovo thus, remains to create a favorable environment which encourages growth of private activity mainly of import competing sectors which

[10] This is the first stage for national competitiveness development which refers to the factor conditions and that is the availability and quality of factors of production (Porter, 1990).

[11] Current account balance before foreign assistance. Source: IMF staff estimates, (AIDE MEMOIRE, July 2005).

will induce the public to substitute imports, and in the export competing sectors in order to improve Kosovo's current account balance.

Remittances have become an important source of income in many transition economies. Currently, remittances are important source of income for Kosovo as well. The importance of remittances can be considered both in terms of microeconomic and macroeconomic effects given that they increase the income of households and hence consumption, and on the other hand, they are a source of financing of the current account deficit. Moreover, given that they increased during the recession and may decrease during the booms in the economy they might be considered as a more stable source of income than the capital inflows are.

In Kosovo, remittances are used to finance mainly the consumption of imported goods, though they could have also been used to build export capacity and create new jobs. According to IMF estimates, worker remittances have remained stable since 2002 onwards. In 2004, remittances have been estimated at 13.6% of GDP and they covered 18.6% of total household consumption, representing a fall by 1.2 per cent compared with 2003. 44.1% of total imports of consumer goods are covered by remittances which represent a decrease of 6.0 percentage points compared with 2003. With regard to the inflow of remittances in Kosovo, the role of euroisation can be considered as very positive since the absence of both foreign currency risks and exchange control as a result of euroisation, give strong incentives to kosovars living and working abroad to bring their savings back in Kosovo. While with the existence of a domestic currency, remittances would have been kept in strong foreign currency, leading to the increase in currency substitution as well as constraining the monetary policy action.

3.3.1 Kosovo and Its Economic Partners: transaction costs, trade, and investments

One of the benefits deriving from the adoption of euro is the elimination of transaction costs related to foreign payments. Euroisation in Kosovo implies the elimination of transaction costs with economic agents that also use euro but, of course, it does not eliminate transaction costs with those using other currencies. The elimination of transaction costs will be expected to ease foreign exchanges and more broadly to increase the productivity of the economy. Moreover, the use of euro added with no exchange controls, allow Kosovar entrepreneurs to trade without being hampered by the burden of bureaucratic exchange control rules. However, whether or not Kosovo can benefit from the reduction of transaction costs depends on its ability to reallocate labor and capital -previously employed in financing foreign trade operations- to more productive purposes, such as other financial activities or other economic activities. Anyway, the low transaction costs generated by the use of euro are to be seen as an additional element to foster economic growth, but not as a key factor.

Another benefit of euroisation is related to the positive effects on trade. The increasing trade is likely to contribute positively to the economic growth because Kosovo will benefit from economic specialization. Indeed, when the country experiences an increase in exports, it will require more capital accumulation which, in turn, will spur investments and bring about the need for new technology and know how. In general, empirical evidence suggests that the impact of monetary union on the size of trade is statistically significant and positive. According to Rose (2000), countries with a common currency, trade over three times as much as countries which use different currencies. Moreover, Rose (2000) argues that the impact of a common currency is, in order of magnitude, larger than the effect of bringing the exchange rate volatility to zero with separate currencies. Another study by Frankel and Rose (2000) find large potential benefits on trade from using a common currency and that this additional trade has positive effects on growth. Authors find that if the ratio of foreign trade to GDP increases by 1.0 percentage point it will lead to the increase in GDP per capita by 0.33% over 20 years.

Since 1999, the euro zone countries became Kosovo's important trading partners. In 2003, 37.5% of Kosovo's exports were directed towards euro-zone markets, while 20.4% of imports came from this group of countries. The share of the euro zone countries in Kosovo exports fell slightly to 25.2% whereas their share in imports increased further in 2004 reaching 25.9% of total imports. In 2004 compared to 2003, 6.7% growth in the value of Kosovo exports to the euro zone and 16.4% growth in the value of imports (in euro) were reported[12]. According to the figures, the trade with euro-zone countries has remained broadly stable over time (in 2005 33.0% of Kosovo's exports and 23.5% of its imports were with these countries).

[12] BPK, Monthly Statistics Bulletin

On the other hand, trade is still focused with FYR Macedonia which represented 19.5% of total exports and 14.4% of total imports in Kosovo in 2003. In 2004, this share fell slightly to 17.0% for exports and increased to 18.4% for imports. Similarly, the share of exports to Serbia and Montenegro decreased by 15.6 percentage points from 2003 to 3.4% in 2004 while imports decreased by 9.2 percentage points reaching 6.8% in 2004. However, as mentioned above, the use of euro in these countries is widespread, suggesting that these transactions may have been done in euros, and hence there is no exchange rate risk and no need for hedging against it.

The elimination of the exchange rate risk and the reduction of the transaction costs may have led to the increase in the price transparency and hence increase in competition in the market of goods and services since public can now compare the prices of goods and services more easily. The increase in competition is likely to put pressure in the reallocation of capital and labor in a more efficient use and hence increase their productivity. Higher competition will be beneficial for kosovars who will benefit from lower prices and better services. Moreover, a greater competition from euroisation is one of the factors that will encourage greater innovation and an inflow of new technologies, which consequently will have positive impact on growth and employment.

3.4 Euro and the Labor Market

In the absence of monetary policy and exchange rate policy, there should be alternative mechanisms in the economy for adjusting to the likely asymmetric shocks. The labor market mechanism such as labor mobility and wage flexibility is an efficient mechanism for absorbing the negative effects of asymmetric shocks. The more effective are the mechanisms, the lower will be the effects of the absence of the usual monetary tools.

With euroisation, Kosovo has no direct monetary policy and hence any decrease in the net foreign assets (in tandem with the developments in the current account deficit) will be adjusted with the process of the monetary contraction, which is likely to lead to the increase in interest rates and, consequently to the decline in the economic activity and hence a decline in output and prices. However, for this adjustment to take place in

Kosovo there is a need for mechanisms such as labor mobility and wage[13] and price flexibility, in order to adjust to any economic shock hitting the economy. In case of structural shocks, labor mobility and mostly salary adjustments may be considered superior to devaluation as the appropriate mechanism to respond to shocks. Nevertheless, barriers such as those related to language and culture, qualification mismatches and institutional barriers restricting entry to the EU labor markets could potentially create constraints to the labor mobility in Kosovo. On the other hand, nominal rigidities inside the Territory could also be a matter of concern, especially if lower wage adjustments are only observed in the private sector.

The absence of a comprehensive monetary policy in a small open economy as Kosovo may not be considered as bringing additional substantial costs. In other words, it is beneficial for Kosovo which economy is still in an emerging stage, to have a stable monetary basis. Furthermore, given the volatile monetary history, it would be difficult for Kosovo to rebuild the credibility of its own domestic currency, which in turn would encourage currency substitution and a neutralization of the effect of any independent monetary policy. Kosovo as a small open economy is highly vulnerable to external shocks, thus any movement in world prices or high inflow or outflow of capital would put pressure in its currency to either appreciate or depreciate which would, consequently, hamper its economic activity and lead to a decline in credibility. The challenge for Kosovo thus, remains in its capacity to implement consistent macroeconomic policies, accompanied with the appropriate fiscal and labor policies as well as the development of a sound financial system.

4. EUROISATION AND MONETARY ACTION

4.1 Absence of Seigniorage Revenues

One of the direct effects of unilateral euroisation is the absence of seigniorage revenues deriving from the issuance of a domestic currency. [14] Seigniorage incomes cannot be expected in countries which are spontaneously euroised, whereas members of the EMU

[13] Any fall in demand will result in the lower production and employment. With labor mobility in place, there will be a shift of workers from the economy facing the fall in demand to the economy which experiences an increase in demand which consequently will restrain the growth in unemployment. On the other hand, the fall in demand will lead to a marginal fall in productivity therefore there is a need for wage adjustments. In the case of rigid wages the fall in demand will lead to a higher unemployment.

[14] Seigniorage is the difference between the value of money and the cost to produce it.

participate in the sharing of these revenues from the issuing of the euro. Nevertheless, in transition economies, revenues from seigniorage are low.[15] The consequences of an absence of seigniorage revenues can be divided in two types: 1) "stock" costs related to all the expenses faced to replace the domestic currency in circulation by euro notes and coins and then to maintain an appropriate quantity and quality of cash circulation and, 2) 'flow' costs related to the foregone income from the issuing of domestic currency.

Stock costs for Kosovo cannot be considered as high given first that DEM was already in circulation at the time of euro changeover as a substitute of Dinar, and second due to the amount of euro banknotes directly brought by kosovar expatriates when coming back to their homeland. Moreover, even if Kosovo would have issued its own domestic currency, it would nevertheless be highly euroised and the possible income from seigniorage would have been low or negligible. It should be emphasized that since Kosovo have experienced a dual-currency system (DEM and Dinar), and then moved towards a strong currency (DEM and then euro), the use of a possible domestic currency would have been low given that people would continue to protect their savings by keeping them in euro. As a result, with the high degree of euroisation, the seigniorage revenues would in any case be very low in Kosovo. In general, the cost arising from the absence of seigniorage revenues for Kosovo is strongly offset with the higher stability and credibility brought about from the euroisation.

4.2 Constraints and Means for Actions on Interest Rates

As mentioned above, euroisation strongly reduces monetary policy autonomy and the use of its main instruments. Namely, in a euroised territory outside the euro zone, the central bank has no direct influence on interest rates and consequently is not able to use such instrument to influence the economy in general (such as output, unemployment, prices etc). Given that it is euroised, monetary authorities in Kosovo have no direct action on interest rates. Instead interest rates are determined by the market.

Nevertheless, this does no mean that authorities are not without any means to influence the level of interest rates in particular through structural actions, namely by

[15] Shobert (2001).

increasing competition between the actors, by implementing a favorable fiscal policy towards the banking sector, or by reducing the factors of uncertainty for the lenders.

In fact, in a place like Kosovo, where the main component of interest rates is devoted to face the costs of both credit risks and uncertainty, and not to cover the cost of funding, all actions which could reduce uncertainty and credit risks are most welcome, since they have a stronger influence on the level of interest rates than the cost of the funding, which is the target of a traditional monetary policy. For example, in Kosovo, a better transparency of corporate accounts, sound corporate governance, a more secured legal framework, a more efficient Court system, not to mention an improvement in risks management in most of the commercial banks, would have a stronger effect on the level of interest rates, than a strong reduction of the cost of funding, which is already comparatively low.

Moreover, if a domestic currency were to be created in a Territory like Kosovo, both depositors and lenders would be tempted to operate through a strong foreign currency, namely in euro, and consequently on the basis of interest rates which would not be influenced by any local central banking authority. In other words, in the context of Kosovo, the monetary transmission mechanism on interest rates from a local central bank would be ineffective.

4.3 Constraints and Action on Banking Liquidity

The nature of the banking industry implies that banks finance part of their long term loans with short term deposits, and thus accept a certain level of liquidity risk. If all depositors decide to withdraw their sight deposits, the bank run off is more likely to occur. An individual bank failure can, thus affect the decision of depositors in other banks as well and hence lead to the crisis spread out. The role of central bank as a lender of last resort (LLR) is therefore, to provide short term loans to the bank facing liquidity shortage in order to stabilize the banking sector, as well as to avoid bank panics and prevent the effect of the availability of credit in the economy. However, there is a distinction between the role of a central bank in providing short term liquidity for temporary needs through repurchase agreements based on eligible assets pledged against the liquidity provision, and its possible action to ”save a bank” or, in other words, to prevent a failure thanks to money creation. In any cases, modern central bank strongly rejects the idea of saving a problem bank through money creation.

BPK is not an issuing bank therefore it has no ability to act as a LLR. As a result, BPK will have very limited room to maneuver, should any temporary shortage of liquidity in the banking sector happen. On the other hand, if the BPK would have the possibility to act as a lender of last resort, it would have raised the temptation for commercial banks to take more risks, since these banks could have expected to be helped in case of problems. Besides, in an emerging economy like Kosovo, there is no debt instrument which could be easily used as an eligible asset against the liquidity provided from the central bank. Moreover, should a systemic crisis happen, the traditional monetary instruments, could be useless.

In general, if the local currency is mainly used by consumers to perform the daily transactions, but not to operate through banks high transaction, which are denominated in euro or in US dollar as it is largely observed in the Balkan region, a national central bank which could only issue its own national currency is disarmed if a bank is short of one of the hard currencies which is widely used.

Besides, the absence of the LLR function in Kosovo can be somehow mitigated by a high participation of foreign banks in the domestic banking sector, and namely in the inter-bank market, when it will develop. Local bank facing a temporary shortage of liquidity could thus, borrow either on the local market from foreign banks which in any case have access to liquidity through or directly to banks located in the euro zone.

Given that BPK has not the ability to act as LLR, there is a need for the special prudential measures for supervising and regulating the financial system. The existence of higher requirements (such as liquidity, solvency, etc) on banks may constrain them in the short run, but in the long run they are important for maintaining the stability of the banking sector which is crucial for sustainable economic growth. Therefore, effective banking supervision accompanied by an adequate fiscal policy is a key instrument to secure the financial system.

5. EUROISATION AND FINANCIAL SUPERVISION

The financial crises in former Yugoslavia have eroded significantly the confidence in the banking system of that time. Thus, with inflationary experience and the collapse of Dinar, it would have been very hard to bring back the confidence in the newly established financial sector in Kosovo, without implementing a stable currency. The adoption of euro, therefore, has been very helpful in increasing public confidence in the banking sector and given that liabilities and assets of the banking sector are now denominated in euro, banks are not at least exposed to the currency mismatch risk (or exchange rate risk). As a result of euro being a strong and stable currency, almost all deposits are denominated in euro.

The main challenge remains in ensuring that the financial system is sound and solvent. Even if there is the possibility for the central bank to act as a LLR, the soundness of the banking sector is a priority, given that providing insolvent banks with liquidity is not the way to set up appropriate basis to a sustainable economic growth. Moreover, as already stated, it is not the role of central banks to provide liquidity to insolvent banks. Banking crises, as well as weak financial systems, lead to a low availability of credit, as experienced by several Balkan countries during the past two decades, and consequently have a negative impact on economic growth.

In order to keep the banking sector liquid and solvent, the best instrument which could be used by any financial and monetary authority is to set up, implement and enforce a strict banking supervision. This in turn brings to the need for a comprehensive prudential framework to promote sound banking practices, which covers namely strict risk management proceedings, precise internal control requirements and adequate corporate governance. An efficient regulatory framework for an effective banking supervision also comprises the setting up of different financial ratios to monitor capital adequacy, permanent solvency, credit risk division, and appropriate liquidity. A strict and on-going supervision, combining both on-site and off-site capacities, is the best way to foster banking stability and to avoid any systemic crisis.

Apart from supervisory rules, a lot of countries have already established safety nets such as deposit guarantee schemes[16] which are used for protecting depositors,

[16] Deposit insurance is a guarantee that covers depositors from the loss of their deposits, up to a threshold and under certain conditions.

maintaining the credibility in the banking sector and as a result reduce the probability of a run off of deposits, due to a sudden panic within depositors. Although these schemes might have increased the confidence in the banking sector, they may lead to a rise of a moral hazard problem since banks may have more incentives to take on excessive risks. More generally, deposit protection schemes are always partial, since it is impossible to provide a comprehensive coverage to all deposits, whatever their amount. Consequently, if deposit insurance schemes could possibly reduce the risks of a sudden panic within small depositors, it cannot prevent large or medium sized deposit holders to rush to withdraw their savings based on the common saying “first to come, first to be helped”. For the time being, Kosovo has not established a deposit insurance scheme yet.

The responsibility of the BPK, as the competent bank supervisor in Kosovo, is basically, first to prevent any excessive risk taking through an adequate prudential regulatory framework; second, to detect, on due time through an effective supervision, any potential weaknesses in the banking sector which could endanger deposits as well as a sane credit distribution, and; third, if needed, to treat any problem bank, with namely the aim of protecting public savings and deposits. In other words, the role of a bank supervisor at the BPK is neither to keep an insolvent bank alive, or to protect its shareholders from any losses, but should a bank become undercapitalized or insolvent, to ensure, on due time, an early exit, first to protect the failed bank’s depositors, and second, to prevent any domino effect, which could bring to a systemic crisis and consequently put in danger not only the soundness of the banking sector, but the economy as a whole. No need to mention that in the last decades banking crises in South East Asia (1997), Russia (1998), and Argentina (2001-2002), to recall only the major ones, had disruptive effects not only on the financial sector, but also on the main macroeconomic equilibriums.

Modern financial supervision frameworks rely more and more in market discipline, in particular when the main financial institutions have issued equities, bonds and other debt instruments in organized financial markets. Market discipline relates namely to the regular disclosure of standardized data. In a perfect world, when financial information is comprehensive, accurate, audited, understandable as well as costless, the market could be in an adequate situation in order to discriminate between good and bad banks, without the help of any supervisor. The market could either discipline poor performing banks, or claim for an adequate remuneration of the risks taken. However, for the time being, and namely in emerging countries, the market is not in a position to do so, due to the asymmetry of information. That means that depositors are not in a position to discriminate on an appropriate way between the banks. Moreover, if depositors would be provided on due time with precise information, most of them, in particular in emerging country, have not yet the financial background to use them efficiently. As a result, one way to overcome this problem is, in one hand, to encourage the disclosure of as detailed as possible financial information under the control of the external auditors and regulatory institutions and, on the other hand, to perform an effective prudential supervision. That is why, in Kosovo, commercial banks are currently required to publish their balance and financial results, while the BPK is enforcing the rules issued to maintain the soundness of the financial sector. Regarding these objectives, the use of euro in Kosovo does not bring any kind of direct disruptive effects, but on the contrary, encourages the banking supervisor to closely monitor commercial banks and to perform a stringent supervision.

The soundness indicators for the commercial banks in Kosovo reveal that the banking sector as a whole is compliant with the BPK regulation, which are in line with the main international standards. Capital adequacy for the total banking sector was around 14% in 2005. The ratio of non-performing loans (unpaid loans after 90 days) to total loans remained stable at around 2.0% during the period of 2001-2005. Earnings and profitability ratios have also shown improvements, with the ratio of net interest margin reaching around 6.0% in 2005 while the liquidity ratio[17] attained 44.5% in 2005.

[17] Liquidity ratio is measured as the ratio between liquid assets and total assets.

6. CONCLUSION

The adoption of euro in Kosovo has been very beneficial in bringing macroeconomic stability in the economy which is of high importance given the emerging stage in which Kosovo currently is. The inflationary experiences accompanied with the collapse of the financial system in former Yugoslavia during the 1990s have destroyed the confidence in the domestic currency and as a result, led to the high degree of currency substitution, in Kosovo as well as in its neighbors. Given Kosovo's unique political and economic situation, the need for a stable monetary environment is crucial for building a healthy macroeconomic framework. Therefore, adoption of euro as the legal tender of the Territory was very beneficial.

Euro has brought to Kosovo the much-needed monetary stability by reducing inflation, eliminating the exchange rate risk which, in turn, helped reducing the transaction costs and promoting trade and investments. The absence of most of the monetary mechanisms in Kosovo is deemed outweighed by the benefits of using euro. In a certain way, Kosovo is in an advanced situation since small open economies are anyway strongly constrained in the potential use of their domestic monetary instruments, while simultaneously, they have to face the disruptive effects of a double currency circulation, and the unbalanced competition between a national currency and a strong foreign one. If the use of euro outside the euro zone is supposed to complicate the way to deal with asymmetric shocks, the appropriate answer is to rely on labor market and price adjustment mechanisms. As euro is expected to encourage more foreign investors to invest in Kosovo, export industries are likely to strengthen in the future and therefore bring to an improvement of the current account deficit.

To face possible constraints in the use of traditional monetary mechanisms, a prudent banking supervision is of utmost importance. Prudent measures are the best way to ensure financial stability, as part of the broader macroeconomic stability goal. Special prudential measures form the basis of a healthy financial system, which can become a promoter of the broader growth and development goals in Kosovo.

The path to European integration foresees the adoption of euro in the future. By having taken this step and with the help of the international community, Kosovo will not just prepare itself for a possible EU integration, but can actively use the euro as a tool to be ahead in the drive to join the EMU.

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