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# University of California Berkeley

CENTER FOR INTERNATIONAL AND DEVELOPMENT  
ECONOMICS RESEARCH  
Working Paper No. C95-055

## A Proposal to Introduce the ECU First in the East

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Economics, Washington, D.C.

and

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France

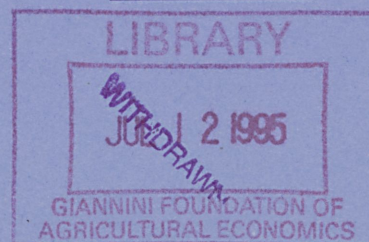
June 1995

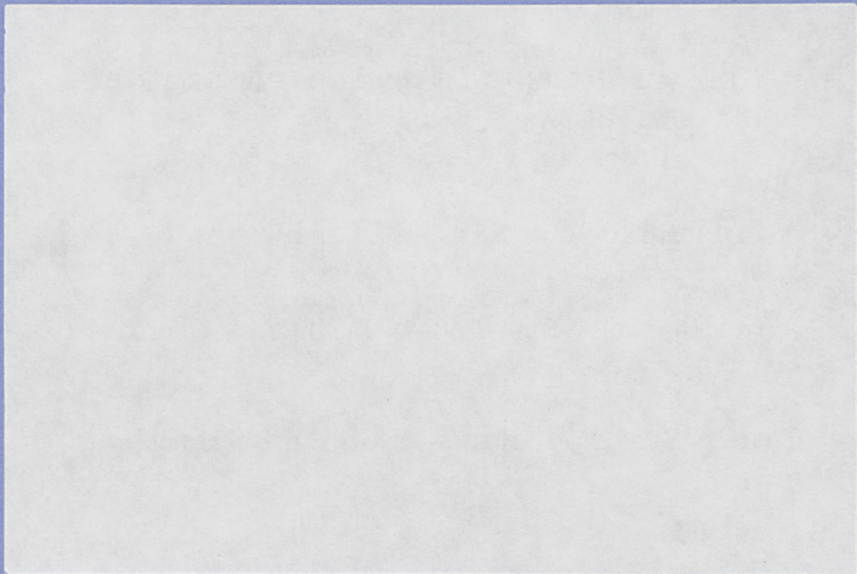
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**Abstract**

*First problem:* Some of the countries of Eastern Europe and the former Soviet Union are sufficiently eager for price stability that they are willing to sacrifice monetary sovereignty, and to tie their fate to a reliable international currency. Neither the Deutschmark nor the dollar, however, quite fits the bill to be that currency. *Second problem:* Western Europe is eager to make progress toward its goal of monetary union by 1999, with the ECU (European Currency Unit) as the common currency, but momentum is stalled. *Solution to both problems:* The ECU should receive its "first run" as a lawful medium of exchange in one of those Eastern European countries.

revised, March 23 and June 8, 1995

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*First problem.* Some of the countries of Eastern Europe and the former Soviet Union are sufficiently eager for price stability that they are willing to sacrifice monetary sovereignty, and to tie their fate to a reliable international currency. Neither the deutschmark nor the dollar, however, quite fits the bill to be that currency. *Second problem.* Western Europe is eager to make progress toward its goal of monetary union by 1999, with the ECU (European Currency Unit) as the common currency, but momentum is stalled. *Solution to both problems:* The ECU should receive its "first run" as a lawful medium of exchange in one of those Eastern European countries.<sup>1</sup>

This proposal requires some elaboration. We will begin by reviewing briefly the currency arrangements that have been tried, spell out each of the two problems in greater detail, and then explain our proposal and its advantages.

#### **Eastern European experience with exchange rates**

From the very beginning of their transition process, the formerly planned economies have adopted very diverse exchange rate arrangements. In fact, nearly every possible regime has been tried (Table 1). At one end of the spectrum, a number of countries have allowed their exchange rate to float relatively freely: this is the case of Romania, Bulgaria, Macedonia, Russia, Ukraine, Slovenia and Latvia. At the other end of the spectrum, the exchange rate has been fixed, as in the Czech and Slovak Republics. Estonia has even adopted the hardest variety of fixity, a currency board system whereby it only creates money when its foreign exchange rate reserves increase, while losses of reserves automatically force a contraction of the money supply. It has been joined by a former floater, Lithuania. In between, Poland maintained for nearly a year and a half a fixed exchange rate, and then has switched to a crawling peg, allowing the currency to depreciate according to a preannounced schedule, an arrangement adopted all along by Hungary.

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<sup>1</sup> The German government prefers the capitalized spelling to the French-sounding ecu (and has recently said it wishes to change the name altogether).

**Table 1. Exchange Rate Regimes Since the Beginning of Transition**

Country	Regime
Albania	Managed Float since July 1992
Bulgaria	Managed Float since Feb. 1991
Croatia	Fixed (DM): 1991:12 to 1992:3 Crawl: 1992:3 to 1993:10 Managed float since 1993:10
Czech Republic <sup>a</sup>	Fixed (basket with US\$, ÖS, FF, SF) from 1990:12 to 1993:5. From 1993:5: basket is DM (65%) and US\$ (35%).
Estonia	Fixed to DM. Currency board
Hungary	Adjustable peg since before 1989 <sup>b</sup> Reference basket: ECU (70%) and US \$ (30%)
Latvia	Managed float since July 1992. Implicitly pegged to SDR.
Lithuania	Floating Currency Board since 1994:4, pegged to US \$.
Macedonia	Managed float since 1992:4
Poland	Fixed <sup>c</sup> (US\$ then basket) from 1990:1 to 1991:10. Crawling (basket) peg since then. Basket: US\$ (45%), DM (35%), £ (10%), FF (5%), SF (5%).
Romania	Managed float since 1992:8
Russia	Managed Float since 1991:12
Slovak Republic	Fixed (5 currency basket as Czech Republic with adjusted weights) since 1990:1
Slovenia	Managed float since 1991:10
Ukraine	Multiple exchange rates

Source: Halpern and Wyplosz (1995)

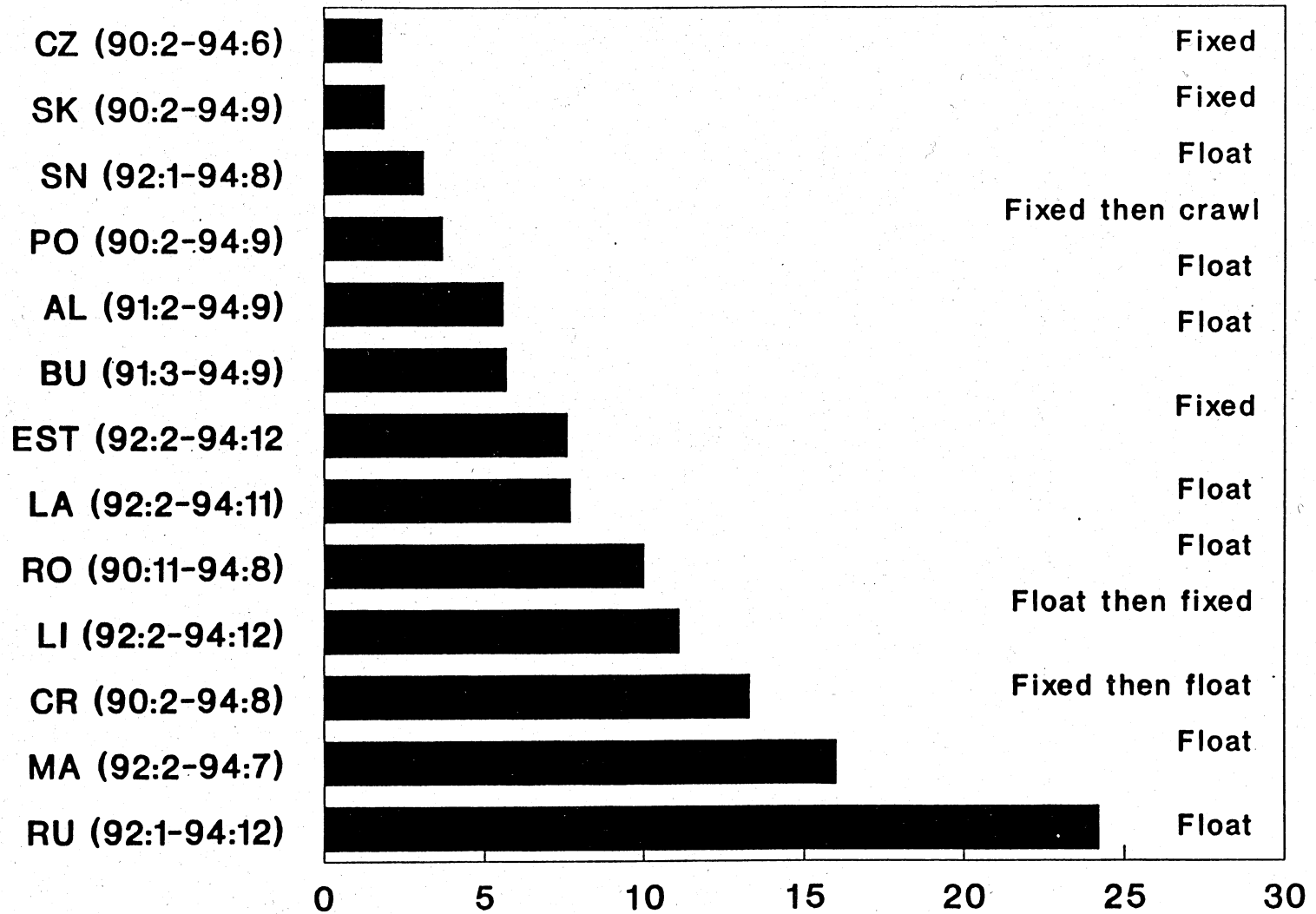
Notes: (a) The Czech Republic is considered as a continuation of Czechoslovakia.

(b) Depreciations occurred in 1989:3 (5%), 1989:5 (6%), 1989:12 (10%), 1990:2 (5%), 1991:1 (15%), 1991:11 (5.8%) and then in more frequent smaller installments (3 times and a total of 5.5% in 1992, 15% in 5 times over 1993 and 16.8% in 7 times in 1994).

(c) One devaluation (16.8%) in 1992:5.

(d) One devaluation (10%) in 1993:7.

### Average Monthly Inflation Rate (%)



From these diverse experiments, a clear lesson emerges, as Figure 1 illustrates.<sup>2</sup> Those countries that have elected to fix their exchange rates exhibit much lower rates of inflation than those which have let their currency float. While the high inflation floaters like to argue that the exchange rate must remain flexible as long as inflation remains high, it is hard not to see causality running the other way around, from exchange rate fixity to monetary discipline, to low -- or at least sharply declining -- inflation. Thus it is likely that, either to solidify progress or to hasten inflation reduction, more Eastern European countries will want to peg their currencies.

### **A problem for Eastern European countries: What currency should one adopt?**

Each country must decide for itself the extent to which it is willing to give up monetary independence. The costs of linking to a foreign currency are (1) the loss of the ability to undertake discretionary monetary expansion or contraction when facing disturbances that are different from those affecting the foreign country, and (2) the loss of seignorage. The advantages of linking to a foreign currency are (1) the elimination of transactions costs and risk emanating from exchange rate uncertainty vis-a-vis the foreign currency, and (2) an anchor for expectations regarding monetary policy, which assures the public that inflation is unlikely. Because the public's inflation expectations are an important determinant of wage- and price-setting behavior, such an anchor helps to lower the actual inflation rate that is consistent with a given level of output. In general, a country is more likely to decide to sacrifice monetary independence if (i) it is very small, open, and well-integrated into the international economy, (ii) it craves further rapid integration with a major neighbor or neighbors, or (iii) it desperately needs to import monetary stability, due to a history of hyperinflation or absence of stable institutions.<sup>2</sup>

These matters are often phrased as a stark choice between a floating exchange rate and a fixed exchange rate. In reality there is an entire spectrum of options, with at least seven distinct points along the spectrum, as the discussion in the preceding section of arrangements in place illustrated. At one extreme is (1) pure floating, with no central bank operations in the foreign exchange market at all. (The United States during the years 1981-84 came close to this polar case.) Next comes (2) managed floating, followed by such intermediate regimes as (3) target zones and crawling pegs.

A country makes a commitment to subordinate monetary independence to the exchange rate anchor when it announces a peg. One version is (4) a basket peg, which is in some ways a weak commitment. In theory, there is no reason why a commitment to fix the currency to

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<sup>2</sup> For a review of exchange rate based stabilizations, see Sahay and Vegh (1994).

<sup>2</sup> These principles from the literature on optimum currency areas are reviewed, and applied to the context of Eastern Europe and the former Soviet Union, by Willett and Al-Marhubi (1994). The general issues are also reviewed in Caves, Frankel and Jones (1996), Eichengreen (1994), and Frankel (1995).



a weighted average of trading partners' currencies should be any less firm a commitment than a policy of fixing to one international currency. In practice, most governments with basket pegs keep the weights secret, and then are able to fiddle with them from time to time without immediate detection. Even when the weights are publicly announced, a commitment to a home-grown basket peg cannot be monitored in the marketplace on a daily basis quite as readily as a commitment to a known unit (like the ECU or SDR) or to a single foreign currency. In practice, there are very few cases of countries announcing an individualized basket peg and then sticking to it, with unchanged parameters, for longer than a few years.<sup>3</sup>

Thus a slightly stronger commitment is (5) the announcement of a fixed exchange rate in terms of a single major foreign currency (or, in days gone by, in terms of gold). Exchange rate commitments are readily broken, however, as countless historical examples from all parts of the world, of which Mexico is only the most recent, remind us. Even the members of the African franc zone (CFA) devalued in January 1994, after 46 years at a 50-to-1 peg to the french franc.

A firmer commitment is (6) a currency board, defined as a legal rule to fix the exchange rate, and to use foreign currency reserves to back central bank issue of the domestic currency on a one-to-one basis. This newly-fashionable device is currently in place in Estonia and Lithuania, in addition to Hong Kong and Argentina.<sup>4</sup> Even the commitment of a currency board can be abandoned under great stress however, and the currency devalued, if those who passed the law change it, or if the central bank feels unable to continue paying out foreign exchange reserves despite the law.

The firmest commitment is (7) literally to adopt the currency of a neighbor as legal tender domestically. The few examples include Panama and some Pacific islands that use the dollar,<sup>5</sup> and some southern Africa countries that used the rand until recently. Even in the case of a common currency, a region can break away if it wants to badly enough, as Slovakia did from its Czech partners. The disintegration of the ruble zone among the countries of the former Soviet Union represents the most important example in recent years. But such splits are very awkward (and unlikely to be undertaken solely on economic grounds).<sup>6</sup>

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<sup>3</sup> Lowell (1992), Frankel (1995, 57-58).

<sup>4</sup> The case in favor of currency boards is made by Hanke, Jonung, and Schuler (1993). A neutral survey of the subject is provided by Williamson (1995).

<sup>5</sup> The Marshall Islands and Micronesia. The Australian dollar is legal tender in Kiribati and the Italian lira in San Marino.

<sup>6</sup> Such a split would be marginally easier if the currency had previously been given a different physical appearance among the constituent parts of the union, for example, local names and portraits of national heroes on one side of the currency, as the European Union foresees for the ECU (and as the CFA has). Then future breakaway regions could declare one brand of ECU henceforth different from another. They would still face the problem of disentangling bank accounts, however.

We take no position here, one way or the other, on the desirability of Eastern European countries' abandoning monetary independence. We merely observe, again, that there has already been some willingness to do so on the part of some Eastern European countries. We predict that others will be inspired by these experiments to follow suit.

The question we address is the international currency to which such a country should yield up its fate. We offer three variants of the proposal, one for countries that wish to adopt a fixed exchange rate, one for those who opt for a currency board, and one for any country that might decide to go all the way by giving up its currency altogether.

Let us call our Eastern European country Ruritania. The deutschemark is perhaps the most obvious candidate for the international currency to which Ruritania might decide to yield up its monetary independence. But there are at least three drawbacks with pegging to the deutschemark. The first drawback concerns the cross-rates: fluctuations in the exchange rate between the mark and other major currencies will create volatility for trade and financial transactions between Ruritania and foreign countries (other than Germany itself, and the few other countries that are currently pegged to the mark). The second drawback is one of political sensitivity: Ruritarians may as a principle not wish to subordinate their economy to Germany. The third drawback is the most practical: Ruritania's central bank must somehow acquire enough deutschemark reserves to make the peg credible. Under the currency board or currency union options, it must acquire enough reserves to buy out the entire existing domestic monetary base. Furthermore, the acquisition of a mark stabilization fund in the transition would not be the end of the matter. The country must continue to earn marks in the future, so that the money supply grows along with the economy. In other words, Ruritania would have to pay seignorage to Germany.

The dollar is another possible candidate for the international currency to which Ruritania might decide to yield up its monetary independence. But the first drawback mentioned above would be even worse in the case of the dollar than in the case of the mark. The reason is that the countries of Eastern Europe and the former Soviet Union trade more with Europe than with the United States. The second drawback might be either better or worse, depending on local political sensitivities. The third drawback, the loss of seignorage, would be the same for the dollar as for the mark.

A currency basket with publicly announced weights would be the best solution to the first problem, and perhaps to the second, but would be of no help on the third. Furthermore, as already noted, commitments to home-grown currency baskets tend to be less clean, easily monitored, and credible, than commitments to existing currency units.

What's an economy-in-transition to do?

## **A problem for Western Europe: How to restore momentum toward currency union?**

In a process of political or economic integration, momentum is important. In the bicycle analogy, not to move forward is to fall over. One historical interpretation of actions taken by Jacques Delors and other European leaders in the mid-1980s is that the drive for EMU was inspired in part by a desire to continue the momentum toward integration. The accession of Greece, Spain, and Portugal was complete, and progress toward military or political integration was considered more difficult than monetary integration. Thus the Maastricht Agreement of 1991.

The crises of 1992 and 1993 derailed the process, for reasons that we need not go into here. The commitments of the Exchange Rate Mechanism were overwhelmed by huge speculative short-term capital flows.<sup>7</sup> There is little reason to think that things will necessarily go any better in 1997, or even 1999, as long as speculators remember how easy it was to make money betting against the process in 1992.

The derailing of the train to EMU can be measured in the stunted growth in the international use of the ECU in financial markets. Momentum is particularly important in this area, as an individual bank or corporation will choose to use a given international currency only to the extent that it believes others will be using it. Use of the ECU as an international currency had been growing before the 1992 crisis, but fell thereafter. At end-1993, only 1 per cent of external bank loans worldwide were denominated in ECUs, down from 8 per cent in 1990. Only 2 per cent of external bond issues (meaning international issues, foreign issues, and special placements) were denominated in ECUs, down from 8 per cent in 1990.<sup>8</sup> Clearly the ECU has run into some trouble.

## **A solution to both problems: Adopt the ECU in Eastern Europe first**

To repeat what was said at the outset, our proposal applies only to a country, Ruritania, located in Eastern Europe or the former Soviet Union, that decides to give up its monetary independence. This could be a decision either to fix its exchange rate, enact a currency board, or adopt an international currency as legal tender. The proposal is that the unit to which it links its fate should be, not the mark, the dollar, or an individual currency basket, but rather the ECU.<sup>9</sup> The government in question would go to Brussels, and offer to be the first country to accept the ECU as money, thereby providing a much-needed shot-in-the-arm of momentum toward eventual widespread adoption of the ECU in Europe. (Actually, this would take the

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<sup>7</sup> For example, Eichengreen and Wyplosz (1993).

<sup>8</sup> Caves, Frankel and Jones (1996). The source is Tavlas and Ozeki (1991), as updated by Tavlas.

<sup>9</sup> Versions of this proposal have been made before, e.g., Steinherr (1990, pp.66-75) and Frankel (1990, p.11).

agreement of the Council of Ministers, if not the EU Heads of State.)

In return, the EU would have to provide, free of charge, a fund of ECUs equal to Ruritania's monetary base (less a fraction to allow for international reserves that Ruritania should already possess). Under the fixed-rate or currency-board options, the ECU fund would be a stabilization fund, used to intervene on the foreign exchange market so as to keep the price of the Ruritanian currency fixed in terms of ECUs. Under the more extreme option, the ECU fund would literally become the monetary base. In the case of the stabilization fund, the transfer of ECUs from Brussels to Ruritania would simply be a financial transaction among monetary authorities of the sort that EU members already engage in routinely. In the more extreme case, the EU would have to cooperate with Ruritania in issuing actual ECU currency for the first time, presumably with Ruritania's name and national hero on the flip side of it. In either case, there would be no budgetary resource cost to the EU members in creating some ECUs to give to Ruritania. There would of course have to be legal assurances and safeguards to make sure that Ruritania used the ECUs for the stated purpose. That is, if Ruritania ever abandoned the ECU commitment, whether the commitment were a peg, a currency board, or legal tender, it would then be obligated to repay the money to the EU. One option is that the European Monetary Institute in Frankfurt would undertake a yearly review of the arrangement, to make sure that Ruritania was not engaging in domestic credit creation that might jeopardize the peg. Conditional on this certification, the EU would each year grant Ruritania a small amount of ECUs as additional flow seignorage, in a proportion equal to the growth rate of Ruritania's GDP minus the interest rate earned on its holdings of ECU reserves.

### **Benefits for West and East**

Both western Europe and eastern Europe stand to benefit from such a move. Yet it will sound utopian. First, because the West is still reeling from the deeply bruising exchange crisis triggered by the process of ratification of the Maastricht Treaty. Yet the Treaty exists and cannot be easily dismissed. What has been lost is the momentum. Public opinions see the historical challenge but fear the near term risks. How then could the West support what would be seen as an extension of the Treaty which, in addition, would surely require massive funds?

Our proposal will also look utopian in the East. There hopes of a prompt "return to Europe," a quick accession to the EU have been dashed. The Easterners have discovered resistance, second-thoughts, and self-interested calculations in the West. They see the move to monetary union as halting, and increasingly a selection process for the fittest. How could they, the poorest end of the continent, be at the forefront? It turns out that the poor can help the rich as much as the rich can help the poor.

Recall the three drawbacks, from Ruritania's viewpoint, of pegging to an existing currency. Our proposal addresses each of them. First, the weights in the ECU, a basket of Western European currencies, come much closer to the weights in Ruritania's trade than relying completely on the dollar, or even the mark. The ECU is the natural anchor for Eastern

countries, especially as the DM is increasingly being jolted by events unrelated to intra-European disturbances. Second, most countries in Eastern Europe, rather than fearing political domination by Western Europe, crave rapid integration with it. Indeed, adopting the ECU would be desirable from the viewpoint of most of these countries, as a strong signal that they wish to link their fate with the EU. Finally, assuming that the EU perceives the advantages of the proposal for advancing its own agenda, and thus is willing to put up the ECUs, the seignorage issue would be solved. In fact, some eastern European countries have already started to use the ECU as an anchor. What is needed, for the Eastern countries, is to formalize this arrangement. This can be done unilaterally, but a better alternative is to seek an official endorsement.

The West has much to gain from the move as well. First, as Eastern Europe will become an increasingly important trade partner, the same reasons that made the EMS an attractive step within the West will argue in favor of ever greater exchange rate fixity throughout the continent. Second, this step will contribute to the prospects of the ECU rivalling the dollar as an international currency, an idea that many Europeans find attractive. More importantly, however, the emergence of an ECU zone in the East will please both supporters and adversaries of the Maastricht Treaty. Supporters will see a twist of destiny increasing the likelihood of an eventual shift to the Single Currency because opponents will see their fears reduced. Indeed, opponents more than anything come from the group of those who fear excessively tight bonds dissolving existing nation-states. That the ECU be born in the East means that it is destined to spread over the whole continent, removing the specter of an early move to federalism.

#### **Which are the likely candidates?**

We have noted that a country would be more eager to attach its currency to the ECU, the smaller and more open it is, and the more important is the objective of price stability. In addition, one often mentioned reason why several countries have not adopted a fixed exchange rate system has been the lack of sufficient foreign exchange reserves. Support from the EU is therefore another important criterion likely to influence would-be candidates. It is easy to envision four tiers of countries.

The first tier includes the four so-called Visegrad countries, the Czech and Slovak Republics, Hungary and Poland. These countries have a formal agreement with the EU that they will join "as soon as possible," and are eager to do so. Trade with the EU now accounts for more than 50% of their total trade, this share having doubled since the beginning of transition. They have achieved low, or tolerable in the case of Poland, inflation rates. Not surprisingly, these are the countries with the highest degree of exchange rate fixity. The Czech and Slovak republics are already partly on an ECU peg. Poland and Hungary crawl vis a vis baskets where the ECU figures prominently.

For them, the formal loss of policy independence is limited. Slovenia could easily

belong to this tier.<sup>10</sup> It is even smaller and more open than the others. So far, because of the dominating influence of foreign trade for its economy, Slovenia has refused to peg its exchange rate for fear of losing competitiveness.

The second tier includes countries which have been floating, with trade links to the EU developing more slowly and where price stability has been elusive so far. This group includes Albania (the top performer of the group), Bulgaria and Romania. These countries are those that stand to benefit most from adopting the ECU, since their economic and political institutions have proven to be too weak to maintain long enough strict policies.

The third tier of countries is made of the three Baltic states, Estonia, Latvia and Lithuania. Two of them have abandoned monetary independence as they are on a currency board: Estonia having adopted the DM and Lithuania the US dollar. Latvia is officially floating but has adopted such a strict monetary policy that its currency has even been appreciating vis a vis the DM. In these countries, with rapidly developing ties to Finland and Sweden, two new EU members, the shift to the ECU would pose few economic difficulties.

In the last tier are the long shot cases: former components of Yugoslavia (Croatia and Macedonia) and of the USSR (Russia, Ukraine, Belarus). These countries have yet to develop trade with the EU. They have been floating (Croatia having abandoned an early peg) and often have faced deep depreciation. In some cases, there has been some progress in bringing inflation down but the achievements are fragile. While these countries would enormously benefit from an irreversible anchor, they are probably unwilling to jump and it is highly unlikely that the EU would take the risk.

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<sup>10</sup> Slovenia stands apart because of historical political difficulties with neighboring Italy.

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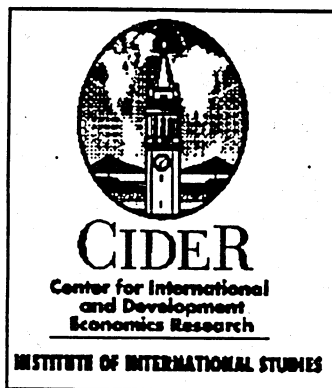
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