EU Enlargement: Euroisation in the Western Balkans (Part III)

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A strong presence of foreign currency has been identified as an important structural feature all around the Western Balkans region[3]. It is largely seen as a legacy of political and economic turbulences of 1990s, leading to unilateral euroisation in Kosovo (under UN 1244/99)[4] and Montenegro and high levels of unofficial euroisation in the other economies. This article investigates the presence of the foreign currency in the economy and discusses its benefits and costs, also in light of the recent economic crisis.

Stock-taking of euroisation levels in the Western Balkans

The term *euroisation*[5] refers to a situation when economic agents of one country use the currency of another country. The literature makes a clear distinction between *de jure euroisation* (also referred to as fully, unilateral or official euroisation) and *de facto euroisation* (also referred to as partial, financial or unofficial euroisation).

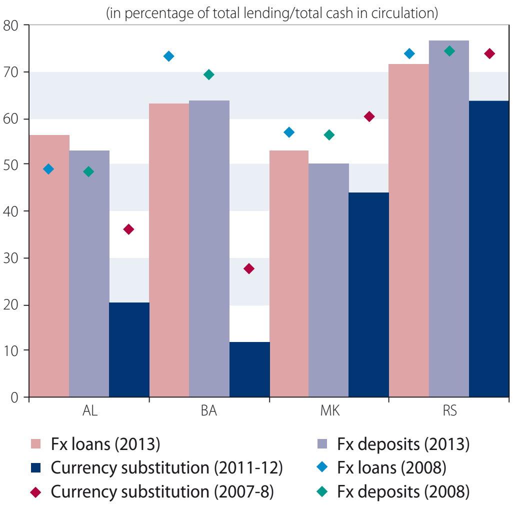
The official euroisation refers to a situation when a country introduces euro as its official (sole) legal tender. This process does not necessarily require the replacement of the local currency, but this trend is more common over the world than the coexistence with the local currency. In this regard, an important distinction has to be made between two options, namely whether the foreign currency (Fx) has been introduced with the consent of the foreign country or whether it has been introduced unilaterally.

The unofficial euroisation occurs when the foreign currency is not a legal tender, but it displaces the domestic currency as a store of value, unit of account and means of exchange. In this process, economic agents voluntarily opt to hold a large share of their financial wealth in foreign currency cash (*currency substitution*), deposits (*asset substitution*) or loans (*liabilities substitution*). Asset and liability euroisation could be seen as a part of a broader category, the so-called *financial euroisation*. Furthermore, when the local prices or wages are set in (or indexed to) a foreign currency, one refers to it as *real euroisation*.

The specificity of the Western Balkans is that both de jure and de facto euroisation are present in the region. Kosovo and Montenegro abandoned their independent monetary policy via unilateral euroisation of their economies. Other countries are unofficially euroised, however to a different extend.

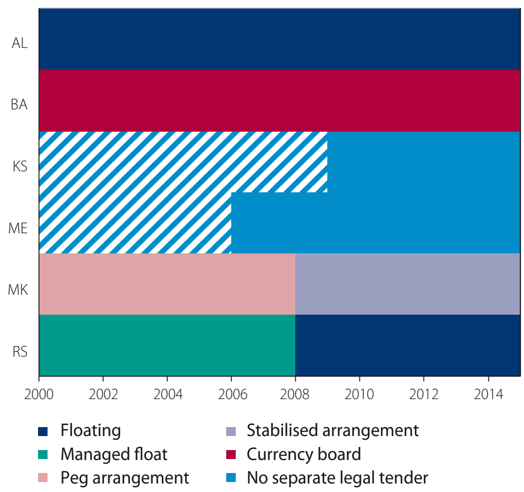
Both asset and liability euroisation remains high in the region (Chart 1). Serbia reports the highest values for both Fx-lending and Fx-deposits

Chart 1 Financial and real euroisation (in percent of total lending/total deposits/total cash in circulation)



Sources: National central banks, OeNB Euro survey and author's compilation.
Note: For AL, share of Fx-deposits in total assets is showed. Country abbreviations as in footnote 3.

Chart 2 Exchange rate regimes



Sources: AREAER (IMF) and author's compilation.
Notes: Country abbreviations as in footnote 3. A different pattern is used to indicate unilateral eurosition of KS and ME in the period when they were not independent jurisdictions.

1 *Národná banka Slovenska.*
2 *The article should not be reported as representing the views of Národná banka Slovenska (NBS) or any other institutions the author has been associated with. The views expressed and mistakes made remain of the author.*
3 *This term refers to Albania (AL), Bosnia and Herzegovina (BA), Kosovo (KS), Montenegro (ME), FYR Macedonia (MK) and Serbia (RS).*
4 *This designation does not constitute a position on the status of this territory and is in line with UNSCR 1244/99 and the opinion issued by the International Court of Justice on Kosovo's declaration of independence.*
5 *The term euroisation could be interchangeably used with the term dollarization. The term dollarization is more often used in the literature regardless of the currency used to replace the national currency. Euroisation is mostly used in the European context, where the local currency is substituted by the euro. As the euro has a predominant role in the countries analysed, we will exclusively use the term euroisation throughout this article.*

throughout the whole period (72% and 77%, respectively in 2013), whereas the levels for Albania and FYR Macedonia are 15-20pp below on average. With the exception of Albania, data suggest somewhat lower financial euroisation in 2013 compared to the pre-crisis levels.

Nevertheless, the Fx-loan and Fx-deposit ratios do not capture the whole scale of euroisation as transactions often take place outside of the banking channels. The amount of foreign cash circulating in an economy is rather difficult to measure. We use survey data on currency substitution index to cover this aspect (Chart 1). The index is in particular high for Serbia and FYR Macedonia, indicating a high level of real euroisation. The levels have been substantially reduced since the crisis, possibly on the back of lower remittances from abroad.

Root causes of euroisation in the region

Euroisation in the Western Balkans is rooted in a long history of macroeconomic instability, political uncertainty and related mistrust in the quality of institutions. The policy challenges of the transition process were aggravated by a series of wars in the 1990s and early 2000s.[6] As such, the newly created democracies, following the dissolution of the former Yugoslavia, were facing a double challenge of re-building their economies in the post-war and economic transition context.

A history of hyperinflation is widely acknowledged as one of the driving forces for euroisation, undermining trust and discouraging savings in the national currency. Overall, the literature suggests that the persistence of high euroisation is linked to long-term memories of economic crisis and a belief of high risk of their recurrences.[7] Between 1990 and 1994, the Yugoslav dinar denomination was changed four times and the region experienced one of the longest and the second largest hyperinflation rate in the world.[8] In 1994, the currency was finally pegged to the Deutsche Mark (DM) within the newly created Federal Republic of Yugoslavia,[9] however it was officially devaluated again in 2000, following the Kosovo conflict. As a consequence, both Montenegro and Kosovo opted for their monetary independence from Serbia, based on unilateral euroisation model.

In the transition process, the countries suffered from different crisis. For example, Albania, although not involved in any armed conflict in the region; it experienced a country-specific crisis based on pyramid schemes. Largely financed by abundant remittances, more than two thirds of Albanians had invested in these schemes, developed in the informal credit market. The system collapsed in 1997, leading to mass riots, collapse of the currency and an inflation spiral.

At the same time, an abundant supply of foreign capital inflows has provided easy access to FX-lending at low interest rates in an environment of perceived exchange rate stability. As a consequence, the liability side of banks´ balance sheets have become heavily Fx-denominated (or Fx-indexed). The perception of relative exchange rate stability has been further reinforced by the prevalent choice of fixed exchange rate regimes, present also today (Chart 2).

Furthermore, the solid binding to the euro has been reinforced on the back of economic and financial links with the euro area[10] as well as the overall EU integration process, with expectations regarding the introduction of the European currency in the near future. The long history of migrants working in the euro area countries also plays an active role, as reflected in the relatively large euro savings of households. As a consequence, Fx-denominated deposits dominate the asset side of banks´ balance sheets.

Although the euroisation in the Western Balkans reflects in a large extend rational economic behaviour of private economic agents, it is associated with important drawbacks. The policy makers face several challenges. First, the economic agents bypass the monopoly of the national authorities over the currency and payment systems by choosing other than the national currency. Second, it weakens the monetary transmission channel, with the central bank having less room to influence macroeconomic aggregates. Third, although euroisation has been conducive to financial deepening of the region, its by-products – currency mismatches have gained considerable attention during the recent crisis. Furthermore, the financial system is vulnerable to capital flows and depreciation risk and the ability of the central bank to act as a lender of last resort is restricted (non-existent in the case of unilateral euroised countries). Having the EU integration of the region in mind, it is worth to mention that the greater use of local currency would not weaken the long-term goal of euro adoption. On the contrary, greater monetary policy control would facilitate the stability of macroeconomic conditions, which is a precondition for euro adoption.

Is unofficial euroisation in the Western Balkans irreversible?

The economic crisis could be seen as an opportunity to reverse the euroisation pattern as the crisis has made both policy makers and the general public alike aware of its negative consequences. Moreover, the euro area sovereign debt crisis seems to have improved the perception of some domestic currencies relatively to the euro (see OeNB Euro Survey). Furthermore, policy-makers support for de-euroisation seems to have strengthened as well.[11]

A lot of progress has been made all around the region in the recent years, many of them in line with recommendations made by the ESRB on lending in foreign currency.[12] First, the authorities have strengthened measures to protect consumers (e.g. in both Serbia and Albania clients now

6 The war in Bosnia and Herzegovina and Croatia (1992-95), Kosovo war (1998-99) and the civil conflict in FYR Macedonia (2001).
7 See e.g. Beckmann and Scheiber (2012).
8 See e.g. Fabris et al (2004).
9 The country consisted of the territories of Serbia, Montenegro and Kosovo.
10 For details, see Orszaghova (2014a).
11 In this respect, refer e.g. to the Memorandum on the Strategy for dinarisation of the financial system, signed by the Serbian government and the central bank in 2012.
12 European Systemic Risk Board. For details, see OJ C 342 (22.11.2011).

13 European Bank for Reconstruction and Development.
14 Originally, it was the Deutsche Mark (DM) that was introduced as the sole legal tender in the territory of both Kosovo and Montenegro (the so-called "d-markisation"), later replaced with the euro in 2002.
15 United Nations Interim Administration in Kosovo. For details, see Regulation No. 1999/4 on the Currency Permitted to Be Used in Kosovo (UNMIK/REG/1999/4) and related Administrative Direction No. 2001/24 of 21 December 2001, which replaced Administrative Direction No. 1999/2 of 4 October 1999.
16 For details, see Fabris et al (2004)
17 Namely Andorra, Monaco, San Marino and Vatican City. All four countries are allowed to issue certain amounts of their own euro coins.
18 Such as Saint-Pierre-and-Miquelon, which is formally part of France, but not of the EU.
19 These agreements are concluded on the basis of Article 219(3) of the Treaty on the functioning of the European Union (TFEU). For more details, see ECB Monthly Bulletin (April 2006).
20 The Western Balkans is considered as one of the most sensitive regions worldwide with respect to euro counterfeiting and is one of the target regions of the EU Pericles programme.

receive specific information on exchange rate risk associated with Fx-credit) and to monitor the borrowers´ creditworthiness by banks, including an assessment about their ability to withstand adverse exchange rate movements. Furthermore, all Western Balkan countries have been actively using reserve requirements and reserve bases, differentiating between domestic and Fx-loans, in order to tackle the high euroisation of their economies. Third, with the process of the implementation of Basel II standards in the region, the national supervisors require financial institutions to incorporate the Fx-lending risks into their internal risk management systems and to cover adequate capital under Pillar II of the Basel II framework.

Furthermore, the authorities, with support of the EBRD,[13] have taken some measures to develop local currency capital markets, in particular hedging markets and secondary markets in T-bills. They are committed to maintain a vibrant market for local currency financial instruments and to progressively expand the maturity of these instruments. The main purpose of this initiative is to reduce the interest differential between the low price of Fx-loans and the higher price of the local currency loans.

It shall be noted, however, that euroisation is deep-rooted in the Western Balkan economies. Despite the recent regulatory and policy environment, which is more conducive to the use of local currencies, the level of euroisation could be expected to decline only very gradually over time, subject to overall macroeconomic stability of the countries concerned.

Unilateral Euroisation in Montenegro and Kosovo (under UN 1244/99)

Both Kosovo and Montenegro have introduced the euro[14] as the sole legal tender in their territories. The decision of the national authorities was a response to decades of hyperinflation, economic decline and de facto euroisation, which the two territories experienced in 1990s. In the process of the gradual dissolution of the unified state with Serbia, the process of asserting monetary sovereignty could be also seen as an important act of political independence.

In both cases, the first decision was made in 1999. In Kosovo, the UNMIK[15] defined the DM as the designated currency, which was replaced by the euro in 2002. Similarly, Montenegro introduced a parallel currency system in 1999, in which the DM was allowed to circulate alongside the then legal tender. As of 2001, the DM became the only legal tender in Montenegro, replaced by the euro in June 2002.[16]

It shall be noted that Montenegro and Kosovo are not the only countries outside the EU that use the euro as their sole legal tender. This is also true for some European microstates[17] as well as some dependent overseas territories.[18] However, their use of the euro is based on an international monetary agreement.[19] Not such an agreement was signed with either of the Western Balkan economies. As a consequence, the EU has little power to monitor and to impose EU legislation over European currency-related issues in these two jurisdictions, such as with respect to the fight and prevention against euro fraud and counterfeiting or prevention of money laundering. Moreover, the two countries are not obliged to be compliant with specific EU rules on banknotes and coins.[20]

The euro was initially introduced in the territories of Kosovo and Montenegro that did not have a status of a sovereign state. At that time, the process was seen as a means for economic stabilisation under limited political autonomy and the position of the EU on their euroisation was deemed

Box 1

Official EU position on unilateral euroisation

Policy position on unilateral euroisation

Any unilateral adoption of the single currency by means of "euroisation" outside the Treaty framework would run counter to the economic reasoning underlying Economic and Monetary Union, which foresees the eventual adoption of the euro as the end-point of a structured convergence process within a multilateral framework. Unilateral "euroisation" cannot therefore be a way of circumventing the stages foreseen by the Treaty for the adoption of the euro.
(ECOFIN Council report, 8 November 2000)[1]

Specific declaration on Montenegro

Montenegro's present use of the euro […] is fully distinct from euro area membership. The Council recalls that unilateral "euroisation" is not compatible with the Treaty […]. An EU Member State cannot adopt the euro and join the euro area without fulfilling all the criteria defined in the Treaty. […] Taking into account the above, the implications of the Treaty framework for Montenegro's Monetary regime will be detailed in due course, at the latest by the time of possible future negotiations for accession to the EU.
(Council decision, 13831/1/07 REV 1, 15 October 2007)

1 The position was also reiterated in the Policy Position of the ECB Governing Council (18 December 2003) as neutral rather than of direct policy relevance for the EU.[21] After declaring their independence from Serbia, both countries were recognised as eligible for the EU membership in line with other Western Balkan countries.[22] As a consequence, the official EU position on unilateral euroisation by the EU enlargement countries became applicable to them. The EU sees the monetary regime of unilateral euroisation by countries eligible for the EU membership as incompatible with the EU Treaty and it has actively discouraged it as it represents bypassing the convergence process, foreseen by the EU Treaty (Box 1).

No provision of the EU Treaty states explicitly that a country joining the EU must have its own currency, different from the euro, however the Treaty is based on this assumption. There is therefore no Treaty-based procedure for full participation in the Economic and Monetary Union (EMU) in case where a country already uses the euro as a legal tender. Every applicant is supposed to fulfil Maastricht convergence criteria, however two out of them might be difficult to measure in the case of a unilateral euroised economy. Namely, the exchange rate criterion for assessing the nominal convergence of the economy with the euro area cannot be directly applied. Moreover, it is also virtually impossible to extract information from the long-term interest rates.

Montenegro opened negotiations with the EU in June 2012 and the screening report on the economic and monetary policy (Chapter 17) was submitted by the European Commission to the Council in March 2014. In the related negotiation process, Montenegro stated its preference for the continued use of the euro as a legal tender as well as its expectation not to join the euro area on the day of its accession to the EU. In line with the ECOFIN declaration on Montenegro (Box 1), it was agreed that the concrete modalities to be used for assessing the convergence of Montenegro's economy will be determined during the accession negotiations. As such, this issue has become very topical and a balanced solution, in terms of both its consistency with the EU Treaty and its political feasibility, needs to be found.

Although the decision on the monetary regime in Montenegro is subject to further negotiations, one could expect that it would lie somewhere between two extreme options, namely the obligation of Montenegro to introduce its own currency (upon its EU membership at the latest) and the formal acceptance by the EU of Montenegro's euroisation, with some modalities on when (and whether at all) the country officially joins the euro area. Whereas the former entails substantial operational and changeover costs to the Montenegrin economy, the latter is inconsistent with past EU policy statements. Moreover, its major drawback is that it sets a precedent for Kosovo and possibly for other authorities in case they encounter problems in the convergence process.

21 See e.g. Jean-Claude Trichet´s speech of 29 November 2004 where he reiterates the neutral position of the Eurosystem regarding the internationalisation of the euro.

22 On the current status of the countries in the EU enlargement process, see Orszaghova (2014b).

Box 2

It is not all about the euro: CHF-indexed housing loans

Although the euro has a predominant role in the Western Balkans, some loans were also denominated or (more often) indexed to the Swiss franc (CHF). Among the Western Balkan economies, the phenomenon was widespread in particular in Serbia and Bosnia and Herzegovina, but some other Central, Eastern and South-Eastern European (CESEE) countries were also affected, with the most prominent case being Hungary.

Cheap CHF-denominated debt spread across CESEE during the real-estate bubble in the 2000s. Profiting from interest rates far below of those in their local currencies, the borrowers failed to understand the embedded Fx-risk. Furthermore, as the local currencies were gaining value before the crisis, the CHF-indexed loans appeared extremely cheap. Contrary to the Western Europe, where a substantial share of CHF-lending was extended to non-resident enterprises, the bulk of CHF-credit in the CESEE was offered as mortgages to domestic households.[1]

The current problem of CHF-loans servicing could be seen as the legacy of the bad banking practice of Fx-lending to unhedged borrowers before the financial crisis. In Bosnia and Herzegovina, it is primarily linked to a single bank group – Hypo Alpe Adria Group (HAA).[2] At end-2013, household loans with CHF-clause amounted to 5.5% of total household loans. Moreover, almost half of them were classified as non-performing at end-2013 (compared to 19% at end-2011). The problem is even more profound in Serbia, where almost every third housing loan was CHF-indexed (30.7% of total household loans at end-2013, compared to its 1.4 % share in the corporate sector).[3]

Since the global financial crisis, currency fluctuations of the CHF have sent strong shock waves across the region. The CHF-loan holders suffered badly since 2008, when the value of CESEE currencies relative to the CHF tumbled, on the back of investors´ preference for seemingly secure currencies. The situation worsened further in 2010 with the onset of the euro area debt crisis, when the euro devalued against the CHF, taking the CESEE currencies down as well (Chart 3a). Then, a respite arrived on 6 September 2011, when the Swiss National Bank (SNB)

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13. Report by the (ECOFIN) Council to the European Council in Nice on the exchange rate aspects of enlargement, Brussels, 8 November 2000, Council of the European Union press release no. 13055/00
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introduced a cap against the euro (1.20 CHF per EUR) as a response to a massive overvaluation of the CHF. The third shock wave came in early-2015, following the decision of the SNB of 15 January 2015 to discontinue the minimum exchange rate between CHF and EUR. The CHF almost instantly rocketed up against the CESEE currencies (Chart 3b).

The behaviour of market participants and regulatory authorities differs across CESEE countries, depending on the gravity of the problem, history of responses and the impact of these loans on the overall economic environment and financial stability. So far, the authorities in both Serbia and Bosnia and Herzegovina pursued a renegotiation of loan conditions as the primary solution.[4] In Bosnia and Herzegovina, the two banking agencies have introduced provisional measures in 2009 which have allowed rescheduling of loan liabilities of physical and legal entities affected by the global crisis. Furthermore, following the recent move of the SNB, the authorities held a series of meetings on the HAA group, requesting a quick solution and repayment of the CHF-loans. The agreeable solution is to be sought between the bank and the client.

In Serbia, the central bank banned any household lending in foreign currency other than the euro already in June 2011, which contributed to the reduction of CHF exposures. Furthermore, it issued recommendations on CHF-indexed housing loans in May 2013, accepted by market participants. It has foreseen a temporary reduction of loan instalments. They have been recalculated at the exchange rate valid on the day of loan extension adjusted by maximum 8% due to currency appreciation. The deferred instalment payment is to mature 3 years after the original maturity. Following the SNB decision in early-2015, the central bank is considering further steps how to relieve the CHF-loan holders, contemplating between a systemic solution applicable to all market participants and an individual solution between the banks and their debtors.

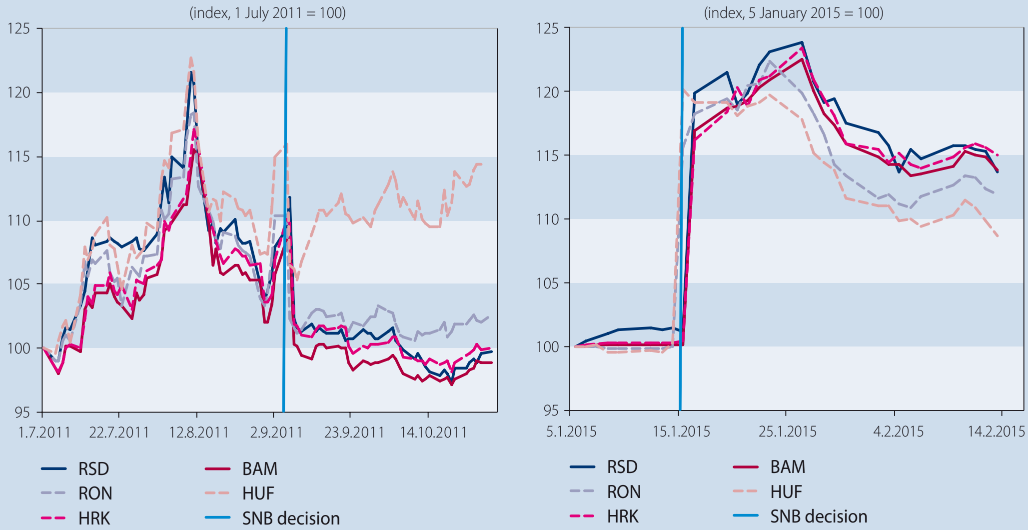
1 For details, see Brown et al (2009).

2 In this respect, it is worth noticing that the Fx-lending activities of the group in the Western Balkans were recognised as one of the causes for the nationalisation of the bank by the Austrian government (see OJ L 2014/341/EU, 14.06.2014). At end-2014, the country agreed to sell HAA´s subsidiaries in the Western Balkans to a consortium of the private equity firm Advent and the EBRD.

3 See 2013 Financial Stability Reports of the respective central banks.

4 For comparison, in the two most affected countries, the authorities opted for solutions, which put a higher burden on the banking sector: The Hungarian authorities imposed a mortgage conversion programme on credit institutions in November 2014 and in Croatia, the government decided in early-2015 to freeze the franc-kuna payment rate for loans at pre-15 January levels for one year.

Chart 3a & 3b Exchange rate movements of regional currencies against CHF



Sources: Haver Analytics and author's calculations.
Note: Currency symbols for Serbia (RSD), Bosnia and Herzegovina (BAM), Romania (RON), Croatia (HRK) and Hungary (HUF).