

OPEN QUESTIONS OF MONETARY INTEGRATION

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3.2. Currency board

3.2.1. Characteristics of a currency board

The currency board (CB), originally the monetary regime of colonies, ceased to be used on a large scale in the 60's, but is currently enjoying something of a revival. In the 80's, modern CBs began to be introduced, but no longer with the aim of fostering relations between dominant and subordinated economies. At present, the CB is applied as a potential tool for mitigating the effects of problems and changes in the economy, such as the facilitation of transition from a centrally planned to a market economy (Argentina, Bulgaria), the re-introduction of fixed exchange rates after a banking or government crisis (Hong Kong), and the creation of a stable institutional structure in countries hit by a war conflict (Bosnia). In addition, the idea of introducing a CB is under consideration in several other countries which are facing similar problems.

The CB system includes a monetary authority (MA), commercial banks, and other financial institutions. In addition, it contains a system of rules for these institutions and the government, related to the exchange rate regime, convertibility, government finances, etc..

The CB system comprises four components:

1. Fixed exchange rate tied to a reserve currency – reserve currency is a convertible foreign currency or commodity selected by the MA for its stability. The country where the reserve currency is issued, is referred to as the reserve country. If the reserve currency is a commodity, the reserve country will be the country using the CB. For the majority of CBs, a typical reserve currency is the British pound and/or the US dollar; the German mark has recently been replaced by the euro as a reserve currency. A reserve currency is not necessarily a currency issued by a central bank, but very few MAs select gold as reserve currency.

2. Automatic convertibility – the MA is to ensure the full and unlimited convertibility of banknotes and coins in relation to the reserve currency at fixed exchange rates. Although, as a rule, an MA of an orthodox type does not convert domestic deposits denominated in the local currency into the reserve currency, banks offer such a service for a modest charge. The MA assumes no responsibility for, and gives no guarantee of, the convertibility of bank deposits into the currency of the CB. This function is per-

formed solely by commercial banks. The MA is responsible only for banknotes and coins of own issue. Unlimited convertibility into the reserve currency means that, within an orthodox CB system, there are no restrictions on current or capital account transactions.

3. Prohibition on central bank lending to the government (orthodox MA) – In a CB system, the government may finance its expenditure only from taxes and loans, and not by issuing money and so accelerating inflation.

4. Long-term liabilities of the system (specified in the law pertaining to the central bank).

5. The reserve currency does not affect the open foreign exchange position of commercial banks.

The primary function of a modern CB is to ensure monetary stability and low inflation. To this end, three conditions must be met: sufficient coverage of the monetary base; adequately restrictive fiscal policy, which requires broad political support; and the existence of a sound financial system.

The CB is a mechanism reacting automatically to the inflow and outflow of foreign exchange. The system functions on the basis of changes in the money supply, which subsequently lead to changes in interest rates. Such changes conflict with the rate of exchange and indicate changes in GDP and the level of employment. It is basically the same regime as that based on fixed exchange rates, but the CB system provides less room for managing monetary policy. The strong guarantee of the exchange rates applied in this system indicates that the inevitable changes in interest rates and the related costs could be smaller.

Although MAs maintain foreign exchange reserves at or slightly above the level of 100%, commercial banks are not required to follow the example of MAs in CB systems. The level of excess reserves above the level of minimum required reserves represent only a few per cent of the total amount of liabilities, i.e. in a CB system, the monetary base is fully covered by foreign exchange reserves, but the monetary aggregate M1 (currency in circulation outside bank vaults + demand deposits) or M2 (currency outside bank vaults + demand deposits + time deposits) are not covered 100% by reserves.

The advantages of a credible CB are low inflation and interest rates. It has also been confirmed that the CB is a flexible monetary system, which has not yet been abandoned voluntarily. The CB system may prove unsuitable for countries with a weak banking system (except for the



initial stage, bank failures are rare in this monetary system, but such phenomena are common in current systems derived from the CB, since they contain all the problems from the previous systems) or countries sensitive to asymmetrical shock (note: the function of a lender of last resort is limited in CB systems). Another limiting factor is the inability of monetary policy to adjust the rates of interest or exchange in order to stimulate the economy. Therefore, the adjusting mechanism of a CB system must be controlled through wage and price levels, which can in general be characterised as rigid.

An orthodox MA does not attempt to control interest levels through the discount rate as a typical central bank. The system of fixed exchange rates tied to a reserve currency is supported by arbitrage, which maintains the rates of interest and inflation under a CB at roughly the same level as in the country of the reserve currency. An exception may be represented by countries where the CB is adopted at a time of high inflation. In such cases, the prices of most commodities in the reserve currency are relatively low, since there is a lack of confidence in the domestic currency. After the introduction of the CB and renewal of confidence in the domestic currency, we can speak about the equalisation of price levels, since inflation is higher than in the reserve country (though lower than before the adoption of the CB). This is a common phenomenon and exerts no economic pressure upon currency devaluation. Price differences diminish and the 12-month rate of inflation reaches one-digit figures (Argentina, Estonia, Latvia).

It is natural to expect that the CB ensures lower inflation than other systems. The lower inflation is a result of monetary discipline connected with the CB system per se and increased demand for money resulting from the credibility of the system. However, the effect of the CB on economic growth is not clearly defined, since the loss of flexibility in monetary policy could weaken the country's ability to react to external shock and restrict the rate of economic growth.

3.2.2. Strategies for transition to the euro in countries with a currency board

Countries where monetary policy is based on a modern CB, have no strategy for the abandonment of this regime¹. The CB is, in a certain sense, exposed to internal conflict: to enjoy its characteristic advantages, it must be treated as a long-term system, but later developments could lead to the application of a more flexible monetary policy. Countries considering the possibility of abandoning the CB system, gave up this idea first and foremost

¹ Lithuania originally planned to cancel the CB regime in 1999, but later abandoned the plan. At the end of June 2001, a change was announced in the reserve currency. With effect from 2 February 2002, the US dollar will be replaced by the euro at the rate of exchange (USD/EUR) set by ECB for 1 February 2002.

because they felt that the advantages of the system had not been fully utilised.

In candidate countries, the process of integration into EMU will take place in three stages: entry into the EU, participation in ERM II, and admission to the euro area. An important question is whether the CB system is compatible with requirements for the introduction of the euro.

It is generally accepted that, in the case of fast-track entry into the EU, various exchange rate regimes are acceptable. This experience is shared by countries which have already joined the EU. Therefore, if Estonia, Lithuania, and Bulgaria use a CB regime and are able and willing to maintain the necessary discipline, they would have no reason to change the system before entry into the EU. All the above countries have several years to wait before gaining admission and the abandonment of the CB regime in this period could make both market participants and the public unsure, affect their expectations, and reduce the credibility of the policy of central banks in those countries.

As for the CB, however, it is necessary to verify its compatibility with ERM II. In the stage preceding entry into EMU, the countries are considering the possibility of introducing central parity for the domestic currency in relation to the euro and keep exchange rate fluctuations within (15% of central parity. Participation in ERM II could facilitate the fulfilment of several goals: to foster nominal convergence, enable the market to test the stability of exchange rates, help countries to enter the euro area with an exchange rate at a reasonable level, and prepare central banks for operation in the euro area.

There are several arguments for transition from the CB to a more flexible system within ERM II. One of the arguments is that a regime enabling a specific exchange rate variability would show whether a country's macro-economic policy could pass the test of exchange rate stability. Such a system would, in principle, ensure that the country would not enter the euro area with inadequate parity. Another argument is that the MA could gain experience in the area of monetary policy before entry into the EMU. A certain degree of exchange rate flexibility could also foster nominal convergence by enabling the Balassa-Samuelson effect to be absorbed via a nominal appreciation in the exchange rate and by reacting to asymmetric shock through the nominal exchange rate.

Depending on how a CB functions in practice, there are several advantages supporting the idea of maintaining this system even during the period of participation in ERM II. Before the euro is adopted, it is important to test the stability of the exchange rate system, which is also possible in the case of a CB: the current account balance, level of foreign exchange reserves, monetary aggregates, economic growth, and interest rates clearly indicate whether the exchange rate is at an adequate level. The requirement of interest rate convergence before the adoption of the euro is

meant to provide a guarantee that the criterion for financial stability² is fulfilled.

The CB has a self-adjusting mechanism, which helps to ensure that the rate of exchange is at an acceptable level provided that prices and wages are flexible enough: while the nominal exchange rate is fixed, other prices maintain the real exchange rate at an adequate level. In countries using the CB and the euro as a reserve currency (Estonia and Bulgaria), the economic conditions are very similar to those in EMU Member States. Naturally, short-term imbalances may occur, but most important is that the exchange rates are not maintained through borrowings from abroad or at the expense of economic growth. Where, however, the CB system has been in use for several years, GDP and exports experience robust growth and the economy shows adequate flexibility in adapting to relative prices, there is little likelihood of a marked imbalance occurring in the economy.

It is questionable whether the market would be able, during the transition period with a flexible exchange rate regime, to find a suitably nominal parity to help the country to gain admission to the euro area. Three of the above economies are relatively small and their undeveloped foreign exchange markets were one of the reasons why these countries had decided to fix their currencies right at the beginning. It is more than likely that the said transition period would be characterised by higher exchange rate volatility since the participants in the market would speculate about the 'initial' level of the exchange rate. Abandonment of a well-functioning CB system could trigger an unfavourable reaction on the market, contribute to a loss of transparency, cause increased uncertainty among domestic and foreign investors, and affect the willingness of households to keep their savings within the domestic financial system. It is also questionable which monetary system would be the best in the period of transition.

Transition to a more flexible regime during ERM II could give rise to a number of legal, institutional, and practical problems in countries with a CB regime, since the relevant laws and regulations would have to be adopted. The introduction and testing of new instruments require investments, which would be used probably only during the short period of transition to ERM II and the euro, especially if the temporary regime included inflation targeting³.

² Full convergence is also required for the free movement of capital. From this point of view, the capital accounts of Estonia and Lithuania are very open for the time being. The foreign exchange law of Bulgaria (in effect since the beginning of 2000) takes into account the fact that most capital flows will be released, while the inflow of speculative capital remains subject to licensing procedure approved by the central bank.

³ In Estonia, for example, no government bonds or Treasury bills have been issued so far, since the budget is not dependent on domestic resources. Similarly, the Bank of Estonia has not issued a large amount of deposit certificates.

Despite the need for active monetary policy control, not all EMU countries had pursued an independent monetary policy before the euro area was created, e.g. the Austrian schilling and Dutch gulden had been tied to the German mark. As a result, their monetary policies were fully subordinated to the Bundesbank. The reasons for the adoption of such a system were similar to those for the two Baltic countries and Bulgaria.

Nominal convergence within a CB system will be partly affected by price adjustments, which will cause inflation to rise above the average level in the EU, but this is not expected to pose a problem. While nominal convergence is the main goal of transition economies intending to adopt the euro, in the case of strong growth in productivity in the tradeable sector, the real value of the currencies of these countries will have a tendency to appreciate (Balassa-Samuelson effect). With a CB system, the result will be a somewhat steeper increase in consumer prices than in the euro area. Owing to the adoption of the price system used in agriculture in EU Member States, harmonisation of excise duties, and the cessation of price liberalisation (in all the three countries), additional price shocks are to be expected. During the process of accession to the EU and EMU, this form of inflation should not be viewed as a sign of weak monetary policy or a threat to economic growth. Such a development would be a reflection of relative price adjustments rather than a sign of economic imbalance. The range of price adjustments will not be necessarily wide. Most price adjustments have already been carried out⁴ and the majority of national currencies in transition economies, which had originally been rather undervalued, recorded a permanent appreciation in real terms. We assume that real convergence will cause the Balassa-Samuelson effect to weaken and this will place CB regimes in a relatively favourable position in meeting the Maastricht criteria for inflation and interest rates.

On the basis of the above, we may say that the CB meets the criteria for ERM II. Apart from unforeseeable circumstances, direct transition to the euro would be the best solution for accession countries, which are able to maintain a functioning CB system up to the date of entry into EMU. This step would ensure that the dearly obtained macro-economic stability of these countries (the key to nominal convergence) is not exposed to risks and would help to maintain discipline in the course of structural reform made in the interest of growth (necessary for the achievement of real convergence).

The strategy of maintaining the CB system after entry into the EU up to the date on which the national currency is replaced by the euro, has its advantages and requires certain attention. The economic policy must remain consi-

⁴ At the time of entry into the EU, Portugal and Spain had a share of nominal GDP in PPP amounting to 0.39 and 0.56 respectively. For comparison, the same share in the case of Estonia is 0.39 and in the case of Bulgaria 0.28



stent with the CB system over several years, since the euro is expected to be adopted in the medium term. This means that fiscal policy must remain conservative to the extent that no excessive debt is incurred. If necessary, the financial sector would have to be strengthened. At present, the countries must continue with the structural reform, which contributes greatly to real convergence. In addition, flexibility in the labour market must be increased and institutional rigidity reduced.

Another factor that must be dealt with by countries with a fixed exchange rate regime, is a potential higher inflow of capital. Estonia and Lithuania have already experienced a marked inflow of capital (mainly in the form of direct investment) and Bulgaria is expected to follow a similar trend of development in near future. A massive inflow of capital may be a sign of success, but may also cause problems with foreign debt and excessive appreciation in real terms. To avoid such negative effects, fiscal policy will have to be tightened considerably, to the extent that the countries will be required to achieve a budget surplus. This is, however, a difficult task for transition economies, which are making preparations for entry into the EU (with growing expenditure on infrastructure and the task of implementing EU regulations and directives).

The CB system in transition economies will be subject to external shock. In this connection, we should note that these countries have been making great efforts to orient their trade towards the EU: almost 50% of the foreign trade of Bulgaria and Latvia takes place with EU countries, whilst Estonia accounts for 70%. As a result, the correlation of shocks and business cycles between EU countries and the above three transition economies, and the problem of asymmetrical shock, do not seem to be significant for these countries. The asymmetrical shocks may also result from a difference in the structure of production and demand. Further progress in the process of transition will, in all probability, contribute to the synchronisation of production in these countries and their partners in the EU.

3.3. Possibilities for the unilateral adoption of the euro and the currency board in Slovakia

The introduction of the single European currency prior to entry into the EU creates conditions for an upturn in foreign trade between Slovakia and EMU countries with a positive impact on the rate of economic growth in Slovakia, but the existence of nominal rigidity in the form of prices and wages reduces the capability of the Slovak economy to react to shock. At the same time, we should emphasise that eurosation does not entail the creation of a monetary union, since the unilateral introduction of the euro does not lead to the creation of a common market as it would in the case of monetary union.

Having analysed the individual effects of eurosation and taken into account the institutional position of the European Commission supported by ECOFIN and ECB, which is

in favour of the gradual adoption of the euro (entry into the EU, participation of the currency in ERM II, entry into EMU), we do not consider the unilateral adoption of the euro a suitable alternative for Slovakia.

A CB is a system which is usually considered for adoption in countries with marked deviations from sound economic development, which could be mitigated by the introduction of this system. Problems in these economies may occur either in the form of hyperinflation or marked exchange rate instability. The system is also suitable for countries undergoing transition from a centrally controlled to a market economy or post-war economies seeking stabilisation. However, the introduction of this regime in a country with a central bank such as the NBS, which has gained a positive reputation with its monetary policy, could give rise to speculation as to why the system had been adopted and which of the above risk factors had occurred in the economy to cause the central bank to take such a step. Subsequent speculation could give rise to inadequate reaction on the part of individual economic entities and weaken the potential advantages of the CB.

The adoption of a CB system requires a certain period of time and it is worth considering whether it would be suitable in the case of Slovakia to introduce such a regime in the relatively short time before entry into the EU, since the country already has a system enabling stabilisation of the economy and the factors that can be managed with the monetary policy tools of the NBS.

By this step, the National Bank of Slovakia would eliminate the possibility of playing an active part in affecting economic developments through monetary policy. The adoption of a CB would restrict the current functions of the NBS and the economy would not be stimulated through adjustments to interest rates or the rate of exchange. A CB system can be modified through wage and price adjustments; in Slovakia, both factors are seen as rigid, i.e. unable to adapt flexibly to the current trend in economic development.

As a result of the above factors, the unilateral adoption of the euro and the currency board in the case of Slovakia does not seem to be a suitable exchange rate system. In addition, implementation of the new system and the establishment of confidence require a certain amount of time, which would probably not be available with regard to the declared date of Slovakia's admission to the EU.

4. Conclusion

With regard to the integration of Slovakia into EMU, non-standard solutions, such as unilateral eurosation and the currency board, do not appear to be the most appropriate strategies. Despite certain positive effects, such systems would have, in our opinion, a predominantly negative impact on the Slovak economy. One of the strongest arguments against such alternatives is the possibility of a fall in public confidence out of Slovakia, due to the fact

that both systems are used, for the most part, in countries in the initial phase of transformation, countries with hyperinflation, or countries hit by a war conflict. In addition, the introduction of the above systems seems to be impossible with regard to the expected date of Slovakia's entry into the European Union.

In fact, the natural process of monetary integration appears to be the most suitable strategy. In this connection, however, the question of correct timing arises. Theoretically, this step should be taken at the time when the Slovak economy has reached an appropriately high level of structural, nominal, and real convergence. The material presented indicates that monetary integration is a dynamic process and that the Slovak economy is gradually approaching the EMU in all respects. The course of the OCA index shows that some progress has been made in structural convergence, which is, however, not accompanied by the same progress in fulfilment of the Maastricht criteria. From this point of view, the inflation criterion in particular is expected to cause problems, in connection with an unclear schedule for price deregulation. Such a schedule has still not been submitted even within the Pre-accession Economic Programme of the SR, which is a basic document for the pre-accession procedure in fiscal supervision. Exemptions required by the SR after entry into the EU (adjustments to regulated prices and indirect taxes) add a element of uncertainty into the course of inflation and the fulfilment of this Maastricht criterion. The liberalisation of certain regulated prices subsequent to the entry of Slovakia into EMU could be a potential cause for an asymmetrical shock, depending on the nature of the business cycle in the SR and EMU as a whole and the corresponding monetary policy. The process of adjustments to regulated prices should be completed in an earlier period and the entry of Slovakia into EMU should be timed accordingly. Early entry into EMU would also place restrictions on the deficit in public finances (Growth and Stability Pact), which would have a positive effect on macro-economic stability as well as the attractiveness of Slovakia to foreign investors. At the same time, the adoption of the euro would lead to a fall in interest levels, with a positive impact on economic growth and fiscal position; further positive effects would include a reduction in transaction costs, the elimination of exchange rate volatility, and, last but not least, a fall in inflation rate.

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The article has been written by a group of authors from the Monetary Division of the National Bank of Slovakia: Ing. Peter Ševčovic, Ing. Rastislav Čársky, Mgr. Katarína Trajlinková, Ing. Mariana Lisá, and Ing. Michal Doliak