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ECONOMIC POLICY IN DOLLARIZED ECONOMIES WITH A SPECIAL REVIEW OF MONTENEGRO

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APSTRACT

Complete dollarization is a relatively rare phenomenon, but in the last few years it has drawn a lot of attention, and an increasing number of papers have been dedicated to this problem, and the number of countries that decide to take this step confirms this. This paper discusses the benefits and weaknesses of dollarization, both theoretically and on the basis of the experience of dollarized countries.

Special attention is given to Montenegro. The contents of this analysis are the history of the monetary system in Montenegro, the determining factors regarding the Euroisation of Montenegro, and a comparison of economic performance. At the end of the paper we give explicit recommendations regarding further economic policy in Montenegro, bearing in mind the relatively limited number of available instruments. The conclusion is that dollarization creates the prerequisites for accelerated economic growth, but in no way can it be treated as a substitute for economic reforms.

Key words: dollarization, economic policy, Montenegro, monetary system

JEL Codes: E40, E42, E52, G28

CONTENTS

LIST OF ABBREVIATIONS

CBM - Central Bank of Montenegro

BiH – Bosnia and Herzegovina

DEM – Deutsch Mark

DFI – Direct Foreign Investments

EBRD – European Bank for Reconstruction and Development

ECB – European Central Bank

EiT - Economies in Transition

EMU – European Monetary Union

EU – European Union

FED – Federal Reserve System (USA)

FRY – Federal Republic of Yugoslavia

GDP – Gross Domestic Product

IMF – International Monetary Fund

NBY – National Bank of Yugoslavia

OECD – Organization for Economic Cooperation and Development

SFRY – Socialist Federal Republic of Yugoslavia

USA – United States of America

USD – US dollar

WTO – World Trade Organization

"Policy-initiated dollarization is like wiring your mouth shut to lose weight. It is effective in the short-run, but unless you undertake life-style changes (eating habits, exercise) you are not a healthier individual, just a thinner one." (Mann C., "Dollarization as Diet")

1. Introduction

Any currency that does not have gold coverage entails a big or a small risk. In the situation when the price of gold in the world markets fluctuates, returning to the gold standard would not itself guarantee the stability of a country's national currency. With the increase in the number of independent countries after World War II, the number of currencies has grown dramatically. Following inadequate economic policies, the existence of a great number of currencies proved to be misguided. In the last decade, a reverse trend has emerged – the number of world currencies has been reducing. Many economists, especially after the establishment of the European Monetary Union, think that there are real prospects that we are heading towards a world with only two or three currency blocs.

Dollarization is not a new term, but comes from a phenomenon that was "out-of-date"[1] and it has become an instrument of economic policy that has been recommended by economists in the last decade. The question is: What options do small countries, such as Montenegro, have? Should they accept a unilateral dollarization, or dollarization within a monetary union? Bearing in mind that only a few years ago, the largest blocs, primarily the USA and the countries of the EU, were not ready to share their seigniorage, and practically the only option was a unilateral dollarization. With the establishment of the EMU the positions of the USA were endangered and a potential threat was the conversion of the USD to the EUR. Due to competition on a global level, the willingness of the largest blocs to create monetary unions with other countries will be more intensive in future.

This paper consists of four parts. The first part defines the term "dollarization"; the second one discusses economic policies in dollarized economies, its benefits and weaknesses, as well as some experiences of these countries. The third part shows the evolution of the monetary system in Montenegro and motives for dollarization. Bearing in mind that Montenegro has conducted an official dollarization, the fourth part of this paper deals with economic policy in such conditions.

[1] *The greatest number of countries used foreign currencies as legal tenders in the 19th and at the beginning of the 20th century.*

2.What is dollarization?

The term "Dollarization", that is, "Euroisation"[2], implies several different monetary systems sharing one common characteristic – the broad use of a foreign currency as the means of exchange for formal or informal transactions. It is undeniable that the two most widespread currencies are the USD and the EUR. The degree of dollarization can be best verified by the fact that some two thirds of the USD issue are held outside the USA[3]. In the mid-90's, the Bundesbank estimated that some 40% of the issued value of the German Mark was used by foreigners.[4]

Official dollarization occurs when a foreign currency has the exclusive status as the full legal tender[5] and a national currency does not exist. Another option is that several foreign currencies are used as legal tenders, but this is rather rare.[6] In the group of officially dollarized economies nowadays only 16 of them are independent countries, including Montenegro.

Official semi-dollarization implies the situation where both foreign and a national currency are used as legal tenders. Montenegro was in this situation at the beginning of its monetary reform with the introduction of the German Mark as a means of payment. This system is used today in Haiti, Bahamas, Liberia, Cambodia, and some other countries.

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[2] *The authors shall not use the term Euroisation further in the text, but dollarization, as the latter is in common use for all the countries that use a foreign currency as legal tender regardless of whether it is the USD or any other currency.*

[3] *Aguado, S., 200, "Transatlantic Perspectives on the Euro and the Dollar: Dollarization and other Issues", University of Alcala, Spain*

[4] *Schuler, K., 200, "Basics of Dollarization", Joint Economic Committee Staff Report, USA*

[5] *In some dollarized economies, the USD circulates along with the national currency, but solely as small-value coins. This is primarily due to the relatively high transport cost of coins.*

[6] *An interesting fact is that the USA belonged to the category of "dollarized economies" as a foreign currency was used until 1857.*

Box 1. Dollarized Economies

Officially dollarized – the USD: a) independent states: East Timor, the Marshall Islands, Micronesia, Palau, Panama, Ecuador, El Salvador; b) dependencies: the Pitcairns Islands (New Zealand), the Cocoa Islands (Great Britain), the British Virgin Islands (Great Britain); c) the USA territories: Guam, the American Virgin Islands, Puerto Rico, American Samoa, the North Mariana Islands.

Officially dollarized – other currencies: a) independent states: Andorra (the EUR), Lihtenstein (the Swiss Franc), Monaco (the EUR), Nauru (the Australian dollar), San Marino (the EUR), Tuvalu (the Australian dollar), Vatican (the EUR); b) dependencies: the Cocoa Islands (the Australian dollar), the Cook Islands (the New Zealand dollar), Greenland (the Danish krone), Niue (the New Zealand dollar), the Norfolk Island (the Australian dollar), St. Helena (the British pound), Tokelau (the New Zealand dollar); c) other regions: Montenegro (the EUR), Kosovo (the EUR).

Officially semi-dollarized – the USD: the Bahamas, Cambodia, Laos, Haiti, and Liberia.

Officially semi-dollarized – other currencies: Bhutan (the Indian rupee), Brunei (the Singapore dollar), the Canary Islands (the British pound), the Isle of Man (the British pound), Lesotho (the South African rand), Namibia (the South African rand), Tajikistan (use of other currencies permitted).

Source: Meyer, S., 2000 "Dollarization: An Introduction", Presentation for the Friends of Global Independence Center, and Winkler, A., Mazzafero, f., Nerkich, H., and Thimann, C., 2004 "Official Dollarization/Euroisation: Motives, Features and Policy Implications of Current Cases", Occasional Paper Series, No. 11, European Central Bank.

Unofficial dollarization is the situation where due to the lack of confidence in the national currency a foreign currency is used as a means of payment, a unit of account, and a store of value[7], but not as the official legal tender. It is not possible to provide accurate statistics on the number of countries with unofficial dollarization, but this type of dollarization is more widespread than official adoption. Another way to measure unofficial dollarization is by the proportion of the national currency deposits and foreign currency deposits in the domestic banking system. A recent survey conveyed by the IMF in the mid-90's showed that, according to this methodology, 52 countries could be categorized as unofficially dollarized.[8]

[7] *Foreign bonds, foreign currency deposits abroad, foreign currency deposits in the domestic banking system, and foreign notes in wallets and mattresses may be used as a store of value.*
(Savic, N., 1999, "Valutni Odbor, dolarizacija i eurizacija", Ekonomist, br. 14, Beograd)
[8] *Schuler, K., 2000, "Basics of Dollarization", Joint Economic Committee Staff Report, USA*

This was the situation in Montenegro before monetary reform, but nowadays it exists in most economies in transition and in most developing countries.

Box 2. Unofficially dollarized countries

Unofficially dollarized countries – the USD: Most of Latin America (especially Argentina, Bolivia, Mexico, Peru, and Central America), most of the Caribbean, most of the former Soviet Union (especially Armenia, Azerbaijan, Georgia, Russia, and Ukraine), Hong Kong, Mongolia, Mozambique, Romania, Turkey, Vietnam, and so on.

Unofficially dollarized countries – other currencies: Some former French colonies in Africa (the EUR), most of the Balkans (the EUR), Macau, parts of China, Belarus (the Russian ruble).

Note: The list of unofficially dollarized countries is not exhaustive because the extent of unofficial dollarization is difficult to measure.

Source: Schuler, K., 2000, "Basics of Dollarization" Joint Economic Committee Staff Report, USA.

Monetary union can be considered as the fourth variant of dollarization, and is when several countries use a common currency. At the moment, the European Monetary Union is the only true example[9] of this, although there are some indications that monetary union could be established on the American Continent in the future.

Almost all countries that have accepted either full or partial dollarization had to experience unofficial dollarization first. As a rule, unofficial dollarization comes after or during periods of hyperinflation and/or devaluations (depreciations) that is, anticipating their occurrence. First, a foreign currency becomes the means of savings to avoid potential losses due to macroeconomic instability. Then, the foreign currency becomes the unit of account, first in property and higher-value products transactions, then gradually including more products, and finally, it becomes a means of payment. In fact, dollarization is the result of rational behaviour by individuals, undertakings, and others who strive to protect their property from losing its value, as the result of disastrous economic policy.

The country of primary currency, the currency used by dollarized economies, reaps substantial benefits:

- it gets seigniorage (the difference between the cost of printing or minting money and its face value),

[9] *Some types of monetary union exist in Africa in the Rand zone.*

- exchange rate risk is eliminated in trade with the country in question,
- the cost of foreign trade transactions reduces as there are no more foreign exchange rate fees, and the like,
- the opportunities for dumping are diminished, especially for currency dumping,
- possible failures in monetary policy have smaller effects because they are spread to a greater number of countries and their intensity weakens,
- it promotes the international standing of the country or countries concerned, and their position in the world market and influence.

A serious risk the country that issued the primary currency may face is that a country may opt for another currency (e.g. to start using the Euro instead of the US dollar). Such an occurrence en masse could create very serious problems.

The dollarization phenomenon is continuously increasing, which can be verified by the IMF data on the constant increase in foreign currency deposits to total deposits, as shown in the table below:

Table 1
Contribution of foreign currency deposits[10], in %

Region	Number of countries	1996	1997	1998	1999	2000	2001
South America	8	45.8	46.1	49.9	53.2	54	55.9
EiT	26	37.3	38.9	43.5	44.3	46.9	47.7
Middle East	7	36.5	37.2	37.7	37.5	38.2	41.9
Africa	14	27.9	27.3	27.8	28.9	32.7	33.2
Asia	13	24.9	28	26.8	28.8	28.2	28.2
Central America and Mexico	7	20.6	20.8	22	22.1	22.5	24.7
The Caribbean	10	6.3	7.6	6.8	6.7	6.1	6.2
Developed countries	14	7.4	7.5	7.5	6.7	7	6.6

The table clearly shows that in all the regions, except in developed countries, dollarization is on the increase.[11] This leads to the conclusion that in most of the world, primarily in developing countries, there is no confidence in national currencies, that is, in domestic monetary policies, which begs the following question: What would happen if those countries switched to official dollarization?

[10] *The table has been taken from Ostojic, D. 2003, "Dollarization", Preduzetnicka ekonomija, Vol. III, 12/2003, Podgorica*
[11] *An exception is the Caribbean, but due to their size, specific geographical position, and business activities they do not undermine the conclusion.*

3. Economic policy in dollarized economies

A number of the provisions setting out the rights and obligations of IMF membership imply that each member will have its own currency. However, in practice, countries have been able to accede to membership in the IMF while using another member's currency.[12]

Dollarization makes sense if the following requirements are met:

- a country is rather small[13] and dependent upon foreign trade,
- a country had a recent history of hyperinflation,
- revenues from seigniorage are relatively small due to widespread unofficial dollarization, and
- there are foreign currency reserves which would enable the exchange of the national currency with any other foreign currency.[14]

The additional criterion that has been emphasized lately relates to close economic relations with the USA (for example, the EU, in the case of euroisation).

Another dilemma may be: if a country has opted for dollarization, which foreign currency should it use as the legal tender? The recommendation is normally that it should accept either the currency that had been widespread during the period of unofficial dollarization, since it has the highest credibility with citizens and the business sector, or the convertible currency used in most foreign trade transactions with a view to reducing transaction cost and establishing better economic relations. In most cases these two criteria suggest the same currency.

Should a country dollarize officially at the beginning or at the end of the reform process? According to S. Meyer, the key issues include reducing the budget deficit, strengthening the banking system, and making the labour market more flexible.[15]

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[12] Gianviti, F., 2002, 'Use of Foreign Currency under the Fund's Articles of Agreement", General Counsel, IMF

[13] If the last two dollarized countries, Ecuador and El Salvador, are excluded, the populations in other officially dollarized economies are around 20 million.

[14] The optimal currency area theory is not given special attention in the paper as the authors accept the position of economists who believe that the older variant of this theory is not applicable since with accepted dollarization the requests set out in this theory become endogenous variables.

[15] Meyer, S., 2000 "Dollarization: an Introduction", Presentation for the Friends of Global Independence Center

Although there is general agreement in theory on the benefits and weaknesses of dollarization, there is still no consensus on whether and in which conditions dollarization should be recommended as an instrument of economic policy.

Earlier economic analyses suggested that the cost of official dollarization is too high. However, unofficial dollarization has been widespread in the last decade, and the financial innovation that reduced the share of currency in GDP, together with the reduction in inflation in most countries has diminished the potential costs of dollarization.[16] It is obvious that full dollarization has numerous advantages, but also a number of weaknesses. The following table shows the benefits and weaknesses of aspects of the policy of full dollarization:

Table 2
Benefits and weaknesses of full dollarization

Benefits	Weaknesses
Provides low inflation rate (similar to that in the country of "reserve currency)	Loss of foreign currency reserves
Limits the possibility of misuse of monetary policy	There is no opportunity to adjust the level of foreign exchange
Lower interest rates as the result of low inflation and lack of devaluation risk	Limited possibility of conducting an independent monetary policy
Accelerates development of domestic capital market	There is no issue premium
Transaction costs in international economic relations reduce	There is no possibility of using inflation tax in extraordinary situations
Alleviates integration of domestic companies in international economy, and induces an increase of direct foreign investments	Limits possibilities of using the lender of last resort policy
Induces an increase in foreign trade	One-off shocks: currency translation, new software, changes in accountancy, and similar.
Greater budgetary discipline	Increased value drain in balance of payments problems
Eliminates currency risk	

[16] *Bogetic, Z., 2000, "Official Dollarization: Current Experiences and Issues", Cato Journal, vol. 20, no.2, 2000.*

3.1. The Benefits of Dollarization

All empirical studies unambiguously showed that with an increase of dollarization the inflation rate decreases, especially when switching to the system of full dollarization. The credibility of monetary policy is no longer an issue as the money supply and exchange policy are no longer under monetary and political authority. At the same time, official dollarization yields positive results especially if several unsuccessful stabilization programs preceded it.[17]

The price arbitrage strives to balance the prices within small margins of divergence with the prices of the country of primary currency. Therefore, it is likely that the inflation rate will increase to some extent in the initial phase of dollarization due to price adjustments, and price stability will be achieved in the subsequent phase. However, all prices will not be the same, especially those of non-tradable products and services (as a rule, these prices will rise much faster due to limited competition), and state controlled prices, if such exist. The experiences of dollarized economies show that dollarization leads to equalizing inflation with the one in the country of primary currency only in the long term.

There are certain discrepancies regarding interest rates. As Mr Galvo points out: "it is naive to expect that official dollarization will lead to automatic price and interest balancing with that in the world as the problem of credibility will not vanish immediately."[18] To wit, interest rates strive to balance, but they increase for a country risk. Otherwise, foreign banks and individuals would invest in the country and the increased demand would balance interest rates. The higher the country risk, the greater the difference between interest rates. According to C. Mann, dollarization does not necessarily lead to the reduction in interest rates as risk premium on interest rates will still exist depending on the budget deficit, the quality of the financial system, and on the flexibility of the labour and product market.[19] We would add to these arguments the influence of the degree of development of an economy and the efficiency of the legal system. However, it is reasonable to expect that dollarization will induce a gradual decrease in interest rates, and, bearing in mind the aforementioned reasons, it is unlikely that any balancing of interest rates with those of the country of primary currency will occur automatically.

According to I. Goldfajn and G. Olivares[20], the reduction in interest rates in dollarized economies could well be the result of the liberalization of the financial system rather than the result of dollarization itself. Anyway, it is very difficult to separate these two effects.

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[17] *Calvo, G. and Carlos, V., 1992, "Currency Substitution in Developing Countries", IMF Working Paper 92/40*

[18] *Calvo, G. and Carlos, V., 1992, "Currency Substitution in Developing Countries", IMF Working Paper 92/40*

[19] *Mann, C., 1999, "Dollarization as Diet", Institute for International Economics, www.iie.com/publications/papers/manno499.htm*

[20] *Ilan Goldfajn and Gino Olivares, 2000, "Is adopting Full Dollarization the solution?" Looking at the evidence", Departamento de Economia Puc – Rio, Texto para Discussao, no. 146*

Officially dollarized economies, which enabled the full participation of foreign financial institutions, became highly integrated in large and liquid world financial markets.[21] The implementation of full dollarization may increase the efficiency of financial markets by creating long-term markets and with a better allocation of resources than other currency regimes.

The reduction of domestic interest rates can facilitate the repayment of foreign and domestic debts because if a state debits with a domestic financial market, it will incur lower repayments due to the reduction in interest rates.

Dollarization may have an effect on the improvement of fiscal discipline. A government becomes aware that the option of issuing more currency to cover a budget deficit no longer exists, so it adopts a policy of low budget deficit or a policy of a balanced budget. The introduction of rigid fiscal limits is also facilitated as the possibilities of subsidizing "moribund" state enterprises and illiquid banks are restricted. Tornell and Velasco represent the viewpoint that a priori dollarization does not provide strict fiscal limitations: "Full dollarization contributes to a greater fiscal discipline in comparison to a flexible exchange regime only if the fiscal authorities are sufficiently aware and worried about the future."[22]

By using econometric methodology (the gravity model) Rose's point estimate is that two countries that share the same currency trade substantially more (over three times[23]) than countries with their own currencies.

The introduction of a hard currency gives the right signal to foreign investors as they are guaranteed stable operating conditions in the country. Additionally, dollarization may reduce the external costs of borrowing for the government by reducing currency and country risk.

On one hand, the introduction of a foreign currency will curtail speculative financial crises, since local investors and speculators will not be able to create them as the foreign currency is connected to all world markets. On the other, if the US dollar is to be the subject of speculations by "big players", the import of speculative crises can be possible.

According to Z. Bogetic, dollarization may have favourable distributional benefits. To wit, in the environment of high inflation, certain categories (the young, the wealthy, businessmen) are often better able to preserve their wealth from devaluation than are other categories (such as pensioners, the poor, and

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[21] *Savic, N., 1999, "Valutni Odbor, dolarizacija i eurizacija", Ekonomist, br. 14, Beograd*

[22] *Tornell, A. and Velasco, A., 1995, "Fiscal Discipline and the Choice of Exchange Rate Regime", European Economic Review, vol. 39*

[23] *Rose, A.K., 2000, "One Money, One Market: Estimating the Effects of Common Currencies on Trade", Economic Policy, vol. 15 (30)*

so on), as it requires the possession of property (government securities often require a minimum value that can be unavailable to certain categories) and knowledge.[24] Dollarization practically prevents this kind of redistribution.

3.2 The Weaknesses of Dollarization

The first problem dollarized economies face is the loss of foreign currency reserves, as they have to be spent in exchange for the national currency. If a devaluated money supply is a consequence of hyperinflation, that is, if the real value of the money supply is small, then the loss of foreign currency reserve will be small as well. Additionally, dollarized economies lose the opportunity of issue premium (seigniorage), which represents the difference between the cost of printing or minting money and its face value. This is not a one-off loss, as it is often considered to be, but has a flow character as, in line with the growth of nominal domestic product or some other targeted variable, a country continuously issues money. The money supply in dollarized economies is regulated exogenously, i.e. it is determined by the situation of the country's balance of payments.

A potential compensation for the loss of seigniorage would be a division of issue premium with the country of primary currency. This possibility is currently used only by Lesotho and Namibia which have an agreement with South Africa on the division of issue premium of the South African rand. Although "the great powers" were not interested in the past to share issue premium with other countries, the introduction of the Euro and the growing competition of the three biggest blocs will induce the greater willingness in these countries in the future to share issue premiums. In a proposal by the US Senator Mack Connie, the USA would cede up to 85%[25] of issue premium.[26] A similar idea was presented by R. Baro who thought that the USA could provide the newly dollarized countries a one-time exchange of the national currency with the USD, whereby the FED would hold the national currency as a form of collateral if a country decided to return to it.[27] However, the USA has not done anything about these propositions so far. The problem is the fact that a country may decide to reintroduce its national currency in the future so the USA would face a loss on issue. In such a situation, collateral in the form of the old national currency would not mean much, obviously, since the country could issue a brand-new currency or drastically devalue the old one.

Monetary policy and exchange rates as instruments of economic policy cannot be used in dollarized economies. They do not have their representatives in the central bank of whose currency they use, nor the opportunity to affect its monetary policy. The restrictions regarding the possibility of conducting

[24] Bogetic, Z., 2000, "Official Dollarization: Current Experiences and Issues", Cato Journal, vol. 20, no.2

[25] The remaining 15% would be used for covering the cost of printing money and for sharing issue premiums of other already dollarized countries, such as Panama.

[26] Meyer, S., 2000, "Dollarization: an Introduction", Presentation for the Friends of Global Independence Center

[27] Baro, R., 1999, "Let the Dollar Reign from Seattle to Santiago", Wall Street Journal, 8 March 1999

an independent monetary policy may be a problem, especially if countries are in different phases of the economic cycle. Thus, if the country of primary currency faces a recession, it will reduce interest rates and follow stimulative policies, whereas a country that uses this currency may be expanding, thus requiring completely opposite policies. The creators of economic policy actually have only fiscal policy at their disposal, but it cannot represent an adequate solution to all shocks. However, the growing regionalization of the world causes a weakening of national sovereignty in the field of economic policy, especially with small countries, thus diminishing the adverse effect of dollarization on national sovereignty in economic policy.

A potential danger for dollarized economies is that they are affected by errors in USA monetary policy (or any other country whose currency is used). This hypothesis is completely real, but the earlier errors in monetary policies of many countries that have switched to the dollarization system have been much greater than those the FED will ever make in the future. With a view to avoiding this danger, S. Henke suggests that in the case of dollarization a country should have an exit strategy. This means that in a case of devaluation of the currency used, a country could switch to another foreign currency. This option always exists in unilateral dollarization, unless you do not enter into formal monetary union with the country that issues the lead currency.[28] In the case of unilateral dollarization the country retains a part of its monetary sovereignty, whereas if dollarization is introduced by entering into formal monetary union with the USA (or other country), in which the dollarized country participates only by sharing seigniorage, then monetary sovereignty would be lost completely.

The opportunity to react to exogenous shocks is also limited in dollarized economies, as exchange rate policy can no longer be used as an adjustment instrument.

In case of systematic problems in the banking systems of dollarized economies there is no option for the central bank to play the role of the lender of last resort through money issue. This option stays if it is possible to provide assets from other sources. Backe and Wojcik suggest that the solution to this can be prescribing high liquidity standards,[29] but they can at the same time mean an increase in costs for the banking system and hence an increase in interest rates. At the same time, e dollarization itself diminishes the probability of the occurrence of a systematic crisis in the banking system because the deposits placed are in a hard currency, and because many foreign banks are present in dollarized economies.

Dollarization induces one-off shocks. They primarily manifest themselves as currency adjustment charges, necessary adjustments of software, accounting systems and similar to the operation of the new currency; the banking system incurs loss as it no longer receives revenue from currency conversion (at the same time, this represents a gain for both the economy and consumers), and so on.

[28] *Black Electorate, 2003, "Exclusive Interview with Economist Steve Hanke", www.blackelectorate.com*

[29] *Back, P. and Wojcik, C., 2002 "Unilateral Euroisation: a Suitable Road Towards Joining the Euro Area for Central and Eastern European EU Accession Countries"*

On the basis of an empirical study in 13 Latin American countries, Gomis-Porqueras and his associates have determined that when a banking system crisis occurs in a dollarized economy, it lasts longer than that in countries which use a national currency.[30]Although the authors do not give the explanation for this phenomenon, we believe that it can be easily explained. To wit, no central bank would stand back in the case of a major banking crisis, bearing in mind the chain effect for the entire economy. It is most likely that it would try to help the banking sector with primary issue loans, which would probably induce a lower or a higher inflation rate that would partially devalue national currency deposits, thus reducing the actual burden of the banking system debt. However, if deposits were in a foreign currency, the result of inflation would be the exchange rate adjustment, and the actual burden on the banking sector would not diminish. Since inflation and devaluation cannot devalue banking deposits, the IMF suggests that it is of great importance to control banks in dollarized economies so that they could not grant loans to the borrowers that cannot repay them in due time.[31]

Backe and Wojcik warn of possible effects which are often overlooked in dollarization theories. A leap in prices and salaries is most probable in the first phases of dollarization. Bearing in mind the high elasticity of demand for services, an increase in salaries may stimulate demand, primarily for non-tradable services, which may lead to an accelerated price growth in those sectors. This effect may diminish the competitiveness of a country, at least in the short term, but if it entails the reallocation of resources or strong pressure to increase salaries, it may happen in the long term, as well.[32]

A threat exists in a situation of non-competitive domestic production. This problem does not occur exclusively because of an inefficient economy, but also through any increase in salaries to harmonize with the countries of the reserve currency, and the fact that the reserve currency could be undervalued. In such conditions, devaluation as an instrument for improving competitiveness no longer exists, and the alternatives are a reduction in wages and the prices of products. Experience shows that this reduction occurs only through economic recession, as the rigidity of wages and prices is very strong in most countries.[33]

A potential threat may be a request by the country that has issued the currency to ban its use in another country. In the opinion of the IMF, a rejection of such a request would represent a violation of international law.[34] This question has never occurred in reality for two main reasons: seigniorage and the fact that the country that uses a foreign currency is so small that it cannot influence the monetary policy of the country

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[30] *Gomis-Porqueras, P., Serrano, C., Somuano, A., "Currency Substitution in Latin America: Lessons from 1990s", World Bank, 1997*

[31] *Balino, T. and others, 1999, "Monetary Policy in Dollarized Economies", Occasional Paper, No. 171, the International Monetary Fund*

[32] *Backe, P., Wojcik, C., 2002, "Unilateral Euroisation: a Suitable Road Towards Joining the Euro Area for Central and Eastern European EU Accession Countries?"*

[33] *Aguado, S., 2000, Transatlantic Perspectives on the Euro and the Dollar: Dollarization and other Issues", University of Alcala, Spain*

[34] *Gianviti, F., 2002, "Use of Foreign Currency under the Fund's Article of Agreement", General Counsel, IMF*

of primary currency. It is unlikely that this question will be raised in the future, but this possibility should not be excluded in theory. To wit, the use of a foreign currency reduces the money supply, so an additional issue is necessary. If a dollarized country decided to introduce its own or some other foreign currency, then a great amount of money would return to the country of primary currency and cause a serious impact on its monetary policy.

It should be stressed that the critics of dollarization also think that it is acceptable as a permanent regime for small economies (authors' note: less than one million inhabitants) and a temporary instrument for large economies where monetary policy is out of control and is destabilizing.[35]

3.3 The Economic Performance of Dollarized Economies

The effects of dollarization on the economic performance of a country are difficult to determine since, on one hand, a very small number of countries have a statistically important dollarization history[36], and on the other hand, most of the dollarized countries are very small and specific in terms of their geographical position and the structure of their economic activities. The following table shows the performance of some independent dollarized countries:

Table 3
Characteristics of independent dollarized countries

Country	Population	GDP (USD billion)	Currency	Year of dollarization
Andorra	73,000	1.2	EUR, its own coins	1278
Northern Cyprus	180,000	1.4	Turkish lira	1974
East Timor	857,000	0.2	USD	2000
Salvador	6,100,000	12.2	USD, Colon	2001
Ecuador	12,400,000	18.7	USD,	2000
Kiribati	82,000	0.1	Australian dollar, its own coins	1943
Liechtenstein	31,000	0.7	Swiss franc	1921
Marshall Islands	61,000	0.1	USD	1944
Micronesia	120,000	0.2	USD	1944
Monaco	32,000	0.8	EUR	1865
Nauru	10,000	0.1	Australian dollar	1914
Palau	17,000	0.2	USD	1944
Panama	2,700,000	8.7	USD, its own coins	1904
San Marino	26,000	0.1	EUR, its own coins	1897
Tuvalu	11,000	n.a.	Australian dollar, its own coins	1892
Vatican	1,000	n.a.	EUR, its own coins	1929

[35] *Schuler, K., 2002, "Dollarization at the Intersection of Economics and Politics "Luncheon speech at the conference "Euro and Dollarizaton", Fordham University Graduate School of Business, New York*

[36] *Currently, only 16 independent countries are dollarized.*

The experiences of many countries have shown that drastic monetary reform (dollarization is just one of the options) is fruitful, as a rule, at least in its initial stages. This was undoubtedly confirmed by currency boards in Bulgaria and Bosnia and Herzegovina, Mr Avramovic's program in Serbia, monetary reform in Argentina (initial stages), the introduction of a new currency in Brazil, the stabilisation program in Israel, the dollarization in Panama, and many others.

Dollarized countries have higher GDP per capita, on average, than countries with their own currency. Twelve dollarized countries belong to the group of the forty richest countries in the world, and only five dollarized countries have GDP per capita lower than USD 1,500. The following table confirms the aforementioned:

Table 4
GDP per capita in dollarized economies and countries with their own currency

	Average value	Median
World (all countries and jurisdictions-total of 228)	8,800	4,780
Countries with their own currency (all countries and jurisdictions-total of 228)	8,200	4,200
Dollarized countries (all countries and jurisdictions-total of 46)[37]	11,120	8,850
Independent	9,400	4,500
Dependencies	12,340	11,150

Source: Winkler, A., Mazzafero, F., Nerkich, H., Thimann, C., 2004, "Official Dollarization/Euroisation, Features and Policy Implications of Current Cases", Occasional Paper Series, No. 11, European Central Bank

S. Edwards has come to somewhat different conclusion. He points out that dollarized economies have much lower inflation rates, lower GDP rates, and similar fiscal performances to the countries with their own currency. He does not give any definite conclusions regarding dollarization, but suggests that dollarization would generate more costs than profit to large countries with variable trading relations, and which are not integrated in the international economy to a great extent, and in which financial transactions are mostly in domestic currencies.[38] However, bearing in mind a relatively small sample, its specificity, and the lack of sufficient reliable data (which Edwards also points out), it is difficult to accept these conclusions as generally acceptable theoretical postulates. One definitely valid conclusion that can be drawn from this research is that dollarization itself is not an arrangement which guarantees economic prosperity.

[37] *Excluding Pitcairn Islands, Cocoa Islands, Vatican, Eastern Islands, and Norfolk Islands.*
[38] *Edwards, S., 2001, "Dollarization and Economic Performance: An Empirical Investigation", NBER Working Paper, No. 8274, Cambridge*

In their joint paper S. Edwards and I. Magendozo show that dollarized countries, as a rule, have lower price increase rates than those they can be compared with, and which are not dollarized. On the other hand, they came to the conclusion that the countries that had substituted their currencies had lower rates of economic growth than comparative countries that had not done so. This can be explained by the inability of these countries to adjust to external disturbances, such as costs of capital and trade flows.[39]

Some dollarized economies have relatively bad economic performances. This can be explained primarily by the fact that this group of countries have opted for dollarization after deep recessions, hyperinflation episodes, macroeconomic instability, and so on. Therefore, it is unreasonable to expect that dollarization itself can lead to an accelerated economic growth. It can create only one of the necessary prerequisites – stable economic conditions.

Most dollarized countries have problems with their balance of payments. According to the European Central Bank, of 50 countries with the highest foreign trade deficit, 25 are dollarized countries.[40] This is not a surprising conclusion since foreign exchange rate policy cannot be used to reduce imports, and a foreign convertible currency to be used to reduce transaction costs and cheapens imports.

Backe and Wojcik believe that unilateral euroisation may encourage economic growth, but this kind of growth is not sustainable either in the medium or in the long term. Their conclusion is that unilateral euroisation is not a magical formula that would speed up of increasing GDP per capita of EU accession countries to that of the average GDP of the EU.[41]

With the introduction of dollarization, some countries abolished central banks believing that the loss of the issue function eliminates the need for their further existence. This solution proved very poor in some countries since an efficient bank supervision system was lost, although it is possible to establish specialised agencies.[42]

As a rule, dollarized countries receive substantial revenue from tourism. On the list of first fifteen tourism countries (for the number of tourist nights as a percentage of the total number of citizens), ten of them are dollarized countries.[43] This data might appear insignificant at first sight, but it is very important bearing

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[39] *S., Edwards and I. Magendozo, "Dollarization, Inflation and Growth", NBER Working Paper No. 8671, December 2001.*

[40] *Winkler, A., Mazzafero, F., Nerkich, H., Thimann, C., 2004, "Official Dollarisation/Euroisation: Motives, Features and Policy Implications in Current Cases", Occasional Paper Series, No. 11, European Central Bank.*

[41] *Backe, P. and Wojcik, C., 2002, "Unilateral Euroisation: a Suitable Road Towards Joining the Euro Are for Central and Eastern European EU Accession Countries?"*

[42] *Bergsten, F., 1999, Alternative Exchange Rate Systems and reform of International Financial Architecture", Testimony before the Committee on Banking and Financial Services, United States House of Representatives.*

[43] *Winkler, A., Mazzafero, F., Nerkich, H., Thimann, C., 2004, "Official Dollarisation/Euroisation: Motives, Features and Policy Implications in Current Cases", Occasional Paper Series, No. 11, European Central Bank.*

in mind that most of dollarized countries run substantial deficits in their foreign trade balances, so that tourism is a very important source of income which practically prevents outflows of currency.

Research conducted by Mazzafero shows that the acceptance of dollarization increases the probability of receiving foreign assistance (grants) from the country whose currency is in use. By analysing grants given by the 7 most developed countries in the period 1981 – 2000, he has discovered that of 179 developing countries that received foreign grants, only 65 countries received more than 20% of their total grants from one country. Of these 65 countries, 32 received grants from the country whose currency they use.[44]

The experience of most Latin American economies has revealed that dollarization is connected to the hysteresis effect, that is, the situation when in inflationary conditions a part of the national currency is substituted by the foreign currency, and after inflation the foreign currency is not crowded out and the national currency does not regain primacy.[45] One of the reasons may be that once adjustment costs have been paid and business activities adjust to this monetary system, economics entities are not ready to pay for any readjustment to the system that is likely to experience a new crisis.[46]

Exit strategies for official dollarization are rather rare. They were often the result of a struggle for independence in the distant past, and the only example in modern history is Liberia where dollarization occurred due to the reduction of money in circulation, civil war, and the high fiscal deficit. As there is no empirical evidence, it is difficult to forecast what would happen to the economic performance of a country that opted for this strategy. Dedollarizations in unofficially dollarized countries have occurred more often. Whether it was voluntary (e.g. much higher interest rates for domestic currency deposits) or forced (Bolivia, Mexico, Peru and other countries have conducted forced conversion of foreign currency deposits), dedollarization has caused adverse consequences, as a rule.[47]

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[44] *Rose, A. K., 2000, "One Money, One Market: the Effects of Common Currencies on Trade", Economic Policy, vol. 15 (30)*

[45] *Gomis-Porqueras, P., Serrano, C., Somuano, A., "Currency Substitution in Latin America: Lessons from 1990s", World Bank, 1997*

[46] *George M. von Furstenberg, 2000, "Dollarization: Needed Monetary Reconditioning or Expropriation, http:/php.indiana.edu/čvonfurst/G89916.pdf.*

[47] *For more details see Calvo, G. and Carlos, V., 1992, "Currencyt Substitutions*

4. The History of the Monetary System in Montenegro[48]

4.1. Monetary Development in the period 1945 – 1991

The financial system in SFRY was dual and consisted of the central monetary institution – the National Bank of Yugoslavia (NBY), which was the core of the system, with six national banks of the member republics, and two national banks in autonomous provinces. Commercial banks existed in the form of primary banks, specialized financial institutions, post office savings banks, saving and credit cooperatives, and the so-called internal banks that were financial services to large enterprises with limited financial autonomy. The Social Bookkeeping Department (SDK), as an "independent" state agency, provided financial control of all enterprises, and simultaneously functioned as the state treasury and auditor.

With the new Constitution in 1974 the member republics obtained more rights and responsibilities in decision making on financial and economic issues.[49] Decentralization left deep scars on political, social, and especially economic life of the former SFRY. By leading more and more independent economic policies and monetary system penetrations, the member republics disabled the uniform and consistent conducting of monetary policy at the federal level. Accumulated foreign debts, bad use of foreign credits and their bureaucratic allocation (the same as with domestic sources of income) resulted in periodical devaluations and foreign exchange fluctuation losses, i.e. the accumulation of losses in the National Bank of Yugoslavia. To wit, the NBY conducted a policy of taking over the exchange rate risk from the banking system, which was socially owned, and mostly from the enterprises it was crediting (these were also socially owned, and not privately owned enterprises). The second most important characteristic of the banking system was direct allocation of loans instead of profitable allocations, with the policy of soft budgetary limitation for all socially owned banks and enterprises, at the same time. Wrongly allocated loans led many banks to illiquidity and insolvency crises, and the economy was directed towards mutual lending. With the lack of banking loans, this lending led to an increase in mutual indebtedness and the illiquidity of enterprises. Another important characteristic of the monetary system was such currency hedging where the NBY took over the currency risk from the banking system which was not profit motivated, but non-economically oriented. This system resulted in the accumulation of huge foreign exchange losses which in 1987 amounted to 70% of the total liabilities of the republic national banks, i.e. some 24% of GDP.

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[48] The analysis of the monetary system in Montenegro before dollarization was mainly based on the work of Bogetic, Z. and Hanke S., 1999, "Projekat valutnog odbora za Crnu Goru – Crnogorska marka", Radio Anetena M and

[49] Decentralisation of the financial sector was formalized in 1972 with the reform of the NBYinto the system similar to the American Federal Reserve System (FED) so that republic national banks had some independence in creating instruments of monetary policy on the republic level.

The main characteristics of the financial system in the 1970s and the 1980s were high inflation, growing quasi-fiscal deficit financed by the NBY, a soft currency, and a growing problem of illiquidity and insolvency of banks. Besides inflation, this system generated periodical devaluations, which led to the redistribution of wealth and income from Dinar assets owners to the owners of net Dinar debts and foreign currencies (privileged socially owned enterprises and individuals). So, the average annual inflation in the twenty-year period from 1971 to 1991 amounted to 76%, which put the SFRY third from last in a group of 108 countries (only Zaire and Brazil were behind it). High inflation, which induced the fall in effective interest rates (which were usually negative), and frequent devaluations led to a decline in citizens' confidence in the national currency. Consequently, this resulted in the fall in Dinar deposit by citizens as hard currency deposits replaced them, usually in German Marks and rarely in US Dollars. That way the former SFRY also became an unofficially dollarized country.

The reduction of banks' foreign exchange reserves caused the reduction of the NBY's foreign exchange reserves as well, resulting in the further devaluation of the national currency, which brought additional insecurity to every day life. At the same time, from the early 1960s there was a slowdown in economic growth, so that in the period 1980 – 1985 the average annual GDP growth rate amounted to 0.6%[50]. This slowdown occurred simultaneously with the increase in foreign indebtedness and the irrational use of foreign loans. This period was also characterized by growing unemployment (in the period 1952 – 1985 the average annual unemployment rate amounted to 10.3%[51]), which resulted in a large outflow of the labour force to foreign countries.

The aforementioned situation eventually led to hyperinflation of 2,040% in 1989. As the reaction to this worrying situation, the Federal Government of that time, supported by the IMF, introduced a detailed stabilization program in order to reduce the inflation. Thus, on 18 December 1989 the Dinar was pegged to the (West German) Mark in a ratio of 7:1, which enabled the partial convertibility of the Dinar as of 1 January 1990. In order to make this pegged exchange rate possible it was necessary to increase interest rates on loans with commercial banks to 40% p.a. (in West Germany they amounted to 3% to 4%). However, the maintenance of a fixed exchange rate, even temporarily, and the conduct of an autonomous monetary policy was practically possible only in the short term. So, the reduction in inflation was successful until June 1990, but the annual inflation rate that year still amounted to 300%, which was 100 times more than in Germany. As the result, the real effective exchange rate of the Dinar grew by 85%, which caused a fall in exports and real GDP by 7.6%. Foreign exchange reserves grew from less than USD 6 billion in December 1989 to USD 10 billion in August 1990. However, they soon drastically fell instigated by the growth in expenditure, both investment and personal, which was primarily created by the disproportionate and unsustainable increase in salaries that was one of the severest systematic problems of the self-governing

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[50] Statistical Yearbook of SFRY for 1987, the Federal Statistics Bureau.
[51] Federal Statistics Bureau (1986), Yugoslavia: 1945-85, Statistical Review, Belgrade

economic system of that time. The increase in subsidized loans, which the NBY had to grant to certain enterprises and banks, significantly contributed to the failure of this stabilization program. At the same time, the necessary institutional changes were not conducted, and the NBY continued to take over foreign exchange losses from commercial banks and it was simultaneously exposed to the pressures and unsynchronised behaviour of the republics‘ national banks. Thus, by the end of 1990 foreign exchange reserves fell to the level existing before the stabilization program.

In order to prevent a further fall in the foreign exchange reserve, on 28 December 1990 the Government announced a devaluation of the Dinar to 9 Dinars for 1 German Mark. The same day, the Parliament of the Republic of Serbia illegally ordered commercial banks in the Republic to grant Dinar loans to certain enterprises in the Republic to the amount of 18.3 million Dinars (some USD 1.8 million at the time). This marked the beginning of the end of the NBY‘s credibility as a monetary institution, and the republics‘ national banks supported this by using reserve requirements and liquidity loans for drawing out foreign exchange reserves from the NBY. This process ended in April 1991 when the disintegration of SFRY occurred.

4.2. Monetary Situation in the Period 1992 to 1999

After the disintegration of SFRY, two former member republics – Montenegro and Serbia formed the Federal Republic of Yugoslavia (FRY) on 28 April 1992. In the new country the monetary system was re-centralized, wherein the National Bank of Montenegro (NBM) lost its autonomy and became a regional office of the National Bank of Yugoslavia whose main office was in Belgrade. Thus, the National Bank of Montenegro was no longer governed by the Governor, who had been previously appointed by the Parliament or the Government of the Republic of Montenegro, but by the Director General who was appointed by the Governor of the NBY in Belgrade.

The new monetary system implied several more changes. The Social Bookkeeping Department (SDK) ceased to exist, and payment operations migrated to the Accounting and Payment Bureau (ZOP) which functioned as a part of the NBY. The payment system, as the “nervous system” of the financial system in FRY, consisted of several entities: NBY/ZOP, banks, the Post Office, and so on. At the same time, the NBY managed the giro accounts of these entities, i.e. the bearers of payment operations, and giro accounts of economic and other legal entities. The NBY performed the daily and periodical clearing of liabilities by accounts, managed accounts for money issue, deposits, and loans. The roles of banks and the Post Office were far less important (receiving payments and payments for private citizens‘ accounts, and similar operations for private citizens). A participant in payment operations (an enterprise, institutions and other legal entities, a private citizen) could have only one commercial account.

A high level of monetary and financial centralization was established, which was easy to be manipulated and which enabled unbelievable misuses due to the non-existence of any legal state and financial discipline, and this resulted in hyperinflation in the period 1992 – 1994. Full responsibility for this fell on the NBY, as the center of monetary and financial discipline, Central SDK (there were also republic SDKs), and interest groups which were able to control them. Due to its position in the hierarchy and its economic (lack of) power, Montenegro was not able to match the NBY in the misuse of this centralized system.

In February 1992, after the crash of the common market and simultaneous outbreaks of war in two former Yugoslav republics, the monthly inflation rate in Serbia and Montenegro was 50%, reaching 100% in June the same year. This percent represents the general threshold that defines hyperinflation. At the end of 1993, inflation amounted to 3, 508, 091, 786, 746%, which represents the longest in duration, and the second highest hyperinflation rate in the world.

A huge bureaucratic apparatus of the former SFRY was supporting the increase in inflation, generated by printing money. Most of the apparatus stayed in Belgrade, but they did not show the slightest intention to deal with fiscal adjustments in the existing situation, although it was obvious that the war spreading in 1992 would not be short-lived.

War conditions were often the reasons for the loss of monetary and economic compass, which constantly speeded the race between prices, foreign exchange rate, and money (the same as in disintegration of Austro-Hungarian monarchy), so former SFRY was not an exception in this regard. The embargo that the United Nations imposed against SRY in May 1992 on almost all commercial transactions and expanded it to all commercial transactions (except for humanitarian aid) in April 1993, additionally deteriorated overall economic situation. At the same time, all SRY state subjects‘ foreign currencies and physical assets held abroad was frozen. This drastic limitation was effective until January 1994.

All the aforementioned reasons led to the fall in GDP per capita from USD 2,000 p.a. in 1991 to USD 1,000 in 1993. This is usual for countries experiencing hyperinflation, and in SRY it was also followed by high fiscal deficit which was constantly monetized thus directly “feeding” inflation. The growth in fiscal deficit induced the increase in expenses, especially for the army, taking care of refugees, and social security for the increasing number of workers losing their jobs during the embargo and due to the fall in production. The fall in economic activities also implied the reduction in tax base and tax income, which created another incentive for the growth in fiscal deficit. Thus, the level of tax income during 1993 fell to 1/6 of its value from 1991. The hyperinflation itself contributed to the fall in tax incomes – it would devalue them in the period from their calculation to their collection (Olivera –Tanzi effect).

During the hyperinflation, other types of “grey” money issue financed fiscal deficit, as well. Namely, although the NBY was the main creator of money supply by printing money, it is obvious that at one point it was no longer able to efficiently control the expansion of the monetary basis which was under a great influence of the republics‘ governments. The governments could do that exactly because of the existence of the pillars – the republic national bank, the SDK, commercial banks, and privileged enterprises. Thus grey money was created when a deposit account of a bank or an enterprise (which was formally under the SDK control and republics national banks) was illegally credited without counter-indebtedness on some other account. After some time, the difference between nominal deposits in the banking system and those in the NBY balances would be balanced by additional enormous printing of worthless Dinars, i.e. by NBY loans. The additional channel of grey issue was situated in widely spread negative balances in the accounts of state and parastatal organizations, individuals, and banks.

4.3. Stabilisation Program in 1994

Burdened with harder and more chaotic situation in the economy, unsatisfied citizens who, besides the poverty, were affected by the war conditions and sanctions, the government conducted a monetary reform in January 1994 led by Mr Dragoslav Avramovic, a former employee of the World Bank in retirement, who became the Governor of the National Bank of Yugoslavia soon afterwards. This program introduced a “Super Dinar” pegged to the German Mark in a ratio of 1:1 and only a month after 15 zeros were taken off from the old Dinar. Although it was promoted that the program represented the leaning on a modified variant of currency board, this was only declarative. This de facto non-convertibility, the existence of foreign exchange controls, and a non-market use limitations of foreign currencies and foreign trade flows (only for the import of “essentially important goods”) represented the key features of the “Super Dinar” system, inherited from the former system in essence. Additionally, the program did not impose institutional limits for issuing the new Dinar, which are the main request and the rule of the currency board.

The program itself failed in focusing on several key undertakings in economy. Instead of reducing fiscal expenditure, which was estimated as impossible in those conditions, including salaries and social security from the budget, the program introduced a tax reform which was characterized by some unpopular measures, such as lump sum, fixed corporation taxes differentiated by sectors and enterprises. Moreover, a tax on trips to abroad, payable in German Marks, was introduced.

At the same time, although they were finally relieved of the destructive hyperinflation, the prices fell, and they accepted the Dinar for some small payments, the citizens never trusted the program entirely. Therefore, all larger transactions remained in foreign currency, usually the German Mark that continued to be the citizens‘ savings currency. Thus, after a short increase in Dinar deposits of few months only, they fell again. One of the reasons was the lack of aspiration and initiative by the government to deal with the frozen foreign currency deposits, as well as with the new ones and the deposits that the citizens had lost in the period of hyperinflation.

As the implementation of the program continued, the NBY lowered interest rates to 9% and maintained them at that level until July 1994, using them in way as previous monetary authorities – as a support for agriculture. However, banks soon started to compensate for the lost interest by introducing special fees on financial services, demanding high collateral for loans and, finally, by setting higher interest rates than those previously agreed with the NBY. In spite of large fines, the banks soon started paying unofficial premiums of 15%-20% on the Dinar to the German Mark exchange rate thus indicating a devaluation of the Dinar in the near future. It happened on 26 November 1994 – the Dinar depreciated by 62.6% in comparison with the US Dollar, and then again by 57.9% on 1 April 1998. In October 1999, the Dinar was two and a half times weaker in the black market than its official value of 6 Dinars for 1 German Mark (DEM 1 = DIN 15). This was a clear signal to the Montenegrin government to start working on monetary independence. A continuation of this agony did not only mean the impoverishment of the state and its citizens, but it also would become a more and more serious political problem.

4.4. The Introduction of Dollarization in Montenegro

At the beginning of 1999 the Montenegrin government started looking for a way to establish monetary independence for Montenegro. Starting from the practice of several years of both citizens and the business sector to perform transactions in and save in German Marks, the Montenegrin government chose a dollarization model with the German Mark as the local national currency.[52] Instead of the Dinar, the world's worst currency at the time, as estimated by S. Hanke[53], Montenegro introduced a parallel currency system – one in which the German Mark was made the legal tender and allowed to freely float alongside Montenegro's other legal money, the Dinar (2 November 1999). The entire process was conducted swiftly and without the support and guidance of the IMF. At the time when the German Mark was introduced as the means of payment, the government was operating with a fiscal deficit of about 20% of GDP.[54] As of January 2001 the German Mark (DEM) became the only legal tender, and since June 2002 the official means of payment has become the Euro.

The Monetary Council[55] ran the National Bank of Montenegro of that time from the moment the German Mark was adopted until the establishment of the Central Bank of Montenegro. Until the establishment of the central bank, during 2000 and 2001, this body enacted numerous regulations and acts which enabled the German Mark to be fully accepted as the means of payment, accounting, and hoarding.

Montenegro also met all theoretical requirements for a successful implementation of dollarization. It was a small, highly open country with experience of hyperinflation in the past, with almost no seigniorage income, with a great contribution of foreign trade with the EU, and substantial flexibility in the labour force (a great number of people were employed outside Montenegro).

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[52] *Regulation of the Use of the German Mark as the Means of Payment With a View to Protecting theEconomic Interests of Montenegro (Official Gazette of the RM, no. 41/99 and 22/00)*

[53] *Hanke, S., 2000, :The Beauty of a Parallel Currency", www.cato.org/cgi-bin/scripts/printtech.cgi/dailys/01/14/00/html*

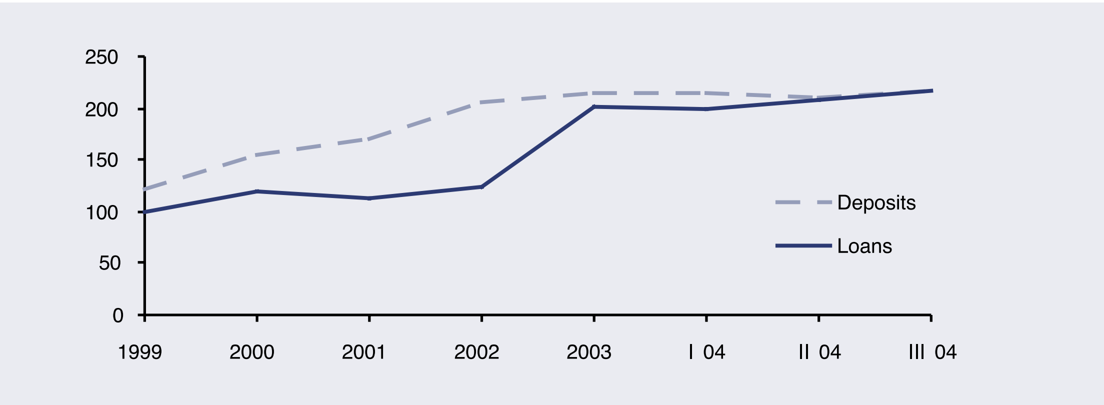
[54] *Hanke, S., 2000, "Some Reflections on Monetary Institutions and Exchange Rate Regime". Tesimony before the International Financial Institutions Advisory Commission United States Congress.*

[55] *The Regulation on the Appointment of the Members of the Monetary Council (Official Gazette of RM, no. 41/99, 45/99 and 39/00)*

The American emissary Mr Robert Gelbard, in his testimony before the United States Senate Foreign Relations Committee in 2000, described such a system and the policy of that time as the guiding light for the rest of the region.[56]

The introduction of dollarization, the situation in the monetary, financial and banking sectors of Montenegro began slowly but surely to show signs of increasing citizens‘ confidence in the new monetary regime. Modest at first, the increase in deposits soon became notable, and during 2003 loans, mostly short-term ones, grew significantly. However, it should also be stressed that, at this time, long-term loans also recorded growth.

Graph 1
Change in deposits and loans with banks in Montenegro (in EUR million)



Source: The Central Bank of Montenegro
(data for deposits exclude frozen foreign currency deposits)

The level of GDP has increased in the last few years, but cannot be evaluated as satisfactory yet.

Inflation is constantly decreasing, and after an inflation rate of 128% in 1999, inflation of 4.5% is anticipated this year.

Fiscal deficits have been reduced to a reasonable level, and since 20% of GDP in 1999, it has ranged from 8.6% to 6.9%. The balance of payments current account deficit has also been decreasing, as has foreign assistance.

[56] *Dajkovic, A., 2004, "A Model for the Balkans", www.zmag.org/dajkovic.htm*

Table 6
Current account deficit and foreign assistance (in USD million)

	2001	2002	2003
BoP current account balance	- 175,017	-152,995	-114,033
Foreign assistance	142,616	91,973	65,511

In Table 7 we present macroeconomic indicators in Montenegro and countries in the region which are at the same level of economic development. In assessing economic performance it should be taken into account that the transition process in Montenegro (and Serbia) started much later due to economic-political problems.

In the end, it is hard to conclude to what extent Euroisation has contributed to the improvement of Montenegro's macroeconomic performance since economic reforms, which significantly contributed to the economic growth, were conducted at the same time.

Table 7
Comparative review of macroeconomic indicators of Montenegro and countries in the region in 2003

Country	Inflation rate	GDP growth rate	GDP per capita in USD	DFI per capita in USD mil.	BoP current account in % of GDP	Foreign debt/ GDP	GDP level 1989 = 100
Montenegro	6.7	2.5	2300	67.10	-7.3	31.9*	79.5
Serbia	8.5	3**	2300	113.3	-11.7	69.8	65
BiH	n.a.	3.5	1376	84.5	-15.0	46.9	54
FYR Macedonia	1.5	3.0	1886	50	-7.4	40.4	76
Albania	3.5	6.0	1565	48.3	-8.0	24.5	121
Bulgaria	2.0	4.5	1984	115.3	-4.9	70.3	80
Romania	14.5	4.2	2091	62.2	-4.7	33.2	87

Source: EBRD, Transition Report, 2003
CBM statistics
Federal Statistics Bureau
** preliminary data;*
*** estimate*

5. Recommendations for the Economic Policy of Montenegro

The first question, that is, dilemma, is whether Montenegro should retain the Euro or introduce its own currency. There is no empirical evidence on the abandonment of dollarization in modern history, so there are no examples of other countries whose experiences could be used to draw some conclusions. The only example is Liberia, but it abolished dollarization during the whirlwind of a civil war and an extremely difficult economic situation. The fact that no country has opted for the abandonment of dollarization, although some of them have a dollarization history of more than one century, suggests that the prevailing opinion is that the abandonment of dollarization would be detrimental. We believe that there are many more arguments to support this hypothesis at this moment:

- Macroeconomic stability has just been established, and it is most likely that switching to another monetary regime would induce a deterioration of macroeconomic credibility;
- Theories of behaviour of individuals show that in a situation of uncertainty individuals resist change and try to retain current positions;
- The hyperinflation experience is still "vivid" and it is likely that in a situation of uncertainty, economic entities would try to protect their property by increasing prices;
- The experiences of unofficially dollarized countries has shown that the strong hysteresis effect would still be present after macroeconomic stability was established, which would probably happen to Montenegro. This means that a part of transactions would be in Euros, which would contribute to an increase in the grey economy and a reduction in fiscal income;
- The introduction of a domestic currency would be a bad signal for investors who prefer doing business in a hard currency;
- Except for the state, which would restore its foreign exchange reserves, the currency conversion would generate expenses for the currency conversion commissions for both citizens and the economy, and increase costs in software conversions, accountancy, and so on;
- In a situation of macroeconomic stability there are almost no examples of radical monetary reforms.

The Euroisation process creates stable and predictable business conditions, but it cannot be a substitute for economic reforms. In fact, a statement by Kurt Schuler, the German Minister of Economy, uttered three decades ago is truly valid: "Stability is not everything, but without stability, everything is nothing".[57] A quality currency is a necessary, but not a wholly sufficient prerequisite for rapid economic development.

[57] *Cordeiro, J.L., 2002. "Different Monetary Systems: Costs and Benefits to Whom?", Centro de Deivulgacion del Conocimiento Economico, Caracas, Venezuela*

Box 3. The European Central Bank's Stance on Unilateral Euroisation of EU Accession Countries

The European Central Bank (ECB) holds the Euro area to be a multilateral currency zone of the EU member countries with clearly defined mutual responsibilities. With the establishment of the EMU, criteria were defined to be fulfilled by the member countries in order to enter the Euro area. That is why the ECB opposes unilateral Euroisation.[58] The ECB standpoint is that unilateral Euroisation nullifies the economic justifications for the existence of the European Monetary Union, that is, the convergence process before accepting the Euro. This does not refer to small countries, such as Andorra, Monaco, and Vatican.

It should be stressed that at the moment when Montenegro accepted the German Mark as its currency the EMU did not yet exist. After its establishment, a logical step was the replacement of the German Mark with the Euro.

Jolly Dickson, the EU representative (Director of the European Commission Agency for Economic and Financial Operations), stated that the EU does not oppose o the Euro as the official currency in Montenegro, but he also added that the acceptance of the Euro as the national currency should not be the end of adjustments to European standards, and that the introduction of the European currency does not mean that this process would be completed successfully.[59]

The first step towards the implementation of dollarization would be the choice of currency. Bearing in mind that the most widespread currency in informal flows was the German Mark, and that most foreign trade was with European countries, then the selection of this currency can be considered to be correct.

A possible dilemma is whether the Central Bank is necessary bearing in mind that some dollarized countries abolished their central banks, as they no longer had the money issuing function. We believe that the Central Bank is essential, not only to control the banking system, but also to control cash flows, influence the liquidity of the banking sector (and indirectly of the entire economic system), and to influence the amount of money in circulation. The experiences of many dollarized countries that abolished their central banks have shown that banking crises in these countries are more frequent.

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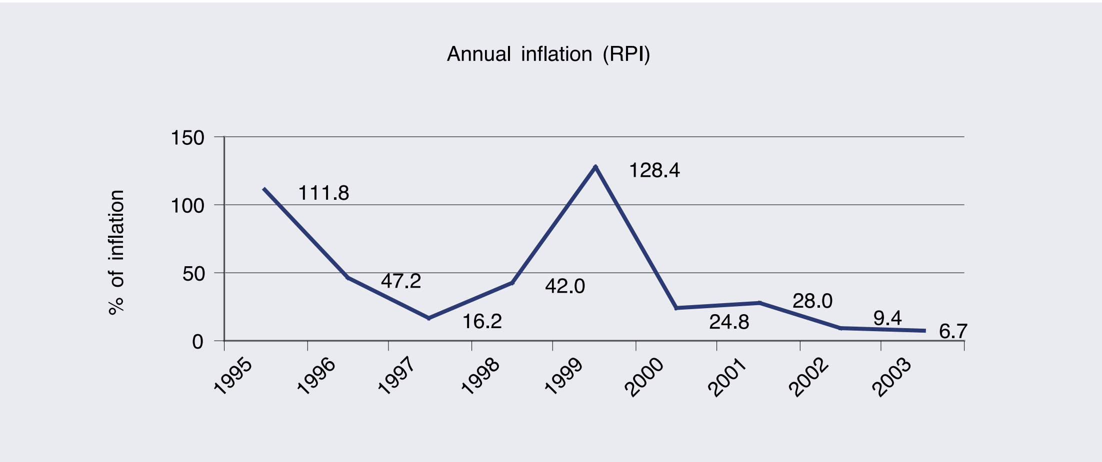
[58] Winkler, A., Mazzafero, F., Nerkich, H., Thimann, C., 2004, "Official Dollarisation/Euroisation: Motives, Features and Policy Implications in Current Cases", Occasional Paper Series, No. 11, European Central Bank

[59] International Conference dedicated to the new European currency, 24 October 2001, the representative office of HVB bank in Belgrade

Since the banking crises in these countries last longer, it is necessary to continue following policies of strict banking system supervision to international standards with a view to preventing crises since other instruments are limited. Basically, full dollarization reduces the currency risk, but not the risk of unfulfilled obligations.

After the introduction of dollarization, inflation in Montenegro did not automatically balance with that in Germany, i.e. the EU. This had been anticipated since dollarization leads to price equations only in the long term. The first years bring normal price growth since some prices tend to equalize with those of the country of primary issue.

Graph 2
Inflation rates in Montenegro



Source: Monstat

A trend of a gradual convergence of the inflation rates in Montenegro to those in the EMU was present in the last two years and has continued in 2004 (compared to December 2003, inflation in the first five months of 2004 amounted to 1.6%). The greatest threat to the convergence process of the inflation rates may be an increase in the prices of non-tradable products and services due to the absence of domestic and foreign competition. The growth in these prices had a great effect on the last year's inflation rate. A faster increase in these prices may encourage an irrational allocation of resources thus sending the wrong signal to investors. In order to avoid this, it is essential to enact and implement new antitrust regulations.

If we compare the minimum and the maximum interest rates, we can conclude that interest rates are falling. This is not only the result of dollarization but also successfully implemented banking system reform. However, interest rates are still intolerably high because dollarization has eliminated only one of the risks, the currency risk, while according to the banks, other risks are still present – the country risk and the client risk. With a view to reducing interest rates numerous measures should be undertaken including the following: activating the Agency for Deposit Protection, the more efficient working of the legal system in settling commercial disputes, an improvement in legal solutions regarding insurance for the collection of accounts receivable, a reduction in the inflation rate, the formation of a Guarantee Fund, state corporations to guarantee housing loans, and so on.

Without the possibility to print money, the only option to finance a deficit is through borrowing, mainly foreign, which additionally exerts negative influences on the economic situation. We can conclude that fiscal discipline is more a necessary prerequisite than a natural consequence of dollarization and other foreign exchange regimes. Therefore, it is essential for the Government to follow a policy of a balanced budget in the following years; otherwise, a direct consequence will be an increase in foreign borrowing and domestic interest rates.

The dilemma whether foreign exchange reserves are necessary should not exist. They can be somewhat lower in the case of the existence of a national currency since there is no longer the need to protect the foreign exchange rate, but the need for all the other functions of foreign exchange reserves remains.

Negotiations between Montenegro and the European Union on contributions to the issue premium would be very useful, however, it is unlikely that such negotiations would be fruitful at this moment. The right time to start negotiating will be when Montenegro becomes a member of the EU (this does not imply the future status of the State Union of Serbia and Montenegro), in order to prevent the introduction of ae national currency that would be converted to the Euro.[60]

The potential introduction of some national money in the form of coins to avoid their transportation costs (which has been done by some dollarized economies) would be counterproductive at this moment. There is too great a danger that the newly established credibility would be disturbed and for retailers and the economy to avoid using the domestic coins and to start increasing prices.

Like most dollarized countries, Montenegro has problems with its balance of payments, so it is necessary to undertake a number of measures to encourage exports. The most important would be: deregulation of foreign trade procedures, state assistance in gaining international quality standards, the establishment of the Agency for Crediting and Insurance of Export Transactions, granting subventions in line with WTO rules, and the protection of the domestic market.[61]

[60] *If the EU would reject an agreement with Montenegro on sharing the issue premium before access to the EMU, a rational policy would require the introduction of a national currency; otherwise, the loss of foreign exchange reserves would be equal to the money supply.*

[61] *These are protection measures implemented in all developed economies, such as the prevention of dumping, the prevention of importing non-certified products and products that do not meet quality standards, and so on.*

In spite of euroisation, Montenegro still has a high country risk, which results in the low rating of Montenegro in international and economic circles, which additionally has repercussions on foreign investments, reforms, and overall transition. With a view to diminishing the country risk it is essential to undertake numerous measures: resolve the final status of the State Union; reach an internal political consensus on the continuation of reforms and internal political stability; accelerate the accession to international institutions in which Montenegro (the State Union) has not yet acceded, such as OECD, the World Trade Organization, the EU, the Partnership for Peace, and others; increase the efficiency of the legal system; accelerate the privatisation process and the restructuring of the economy, as well as all other reforms, and so on.

Finally, we may conclude that the euroisation in Montenegro has had an effect on the increase in stability and business predictability. However, euroisation itself cannot start economic growth, and it should not be a substitute for economic reforms. Therefore, the continuation and the acceleration of economic reforms is, in fact, the only possible solution.

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