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Jelena Galic*

* Deloitte doo, Belgrade
Managing Director
Business Advisory Services

E-mail:
jgalic@deloittece.com

Does the currency board regime provide an exit strategy: example of the transition economy in the process of EU/EMU accession

Abstract: The theory of international economy does not provide an unambiguous answer to the question which exchange rate regime is optimal for a certain country. Faced with macroeconomic instability, high inflation expectations and poor growth, a number of European transition economies have opted for the currency board regime. The author of the paper analyses the advantages and disadvantages of this regime. In addition, the question that arises is whether this regime provides an exit strategy, what the costs of abandoning the regime are and what could be the alternative strategy for countries which are abandoning the regime. The paper concludes that, in addition to alternative possibilities for abandoning the currency board regime, this regime is still a more superior option for countries in the EU accession process.

Key words: currency board, exit option, credibility, EU accession.

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Introductory remarks on the choice of exchange rate regime

The issue of choosing an optimal exchange rate regime is a key issue in macroeconomics on which there is no consensus. The optimal exchange rate regime for a country depends on the type of external pressures to which the country is exposed. In countries with significant capital mobility, the choice of the exchange rate regime is more complicated. In such conditions there is a strong pressure on the nominal and real exchange rates to amortize the negative consequences of a sudden inflow or outflow of capital, so a pure floating or a credible fixed exchange rate is recommended as a preferable option. In addition, the pure floating exchange rate has incurred certain costs in small and open economies (with diversified production and strong ties with another major economic area) as a consequence of uncertainty due to persistent and large fluctuations of the exchange rate (which in turn has adverse effects on foreign economic activity and growth). In such circumstances, the fixed exchange rate is a preferable option. However, the fixed exchange rate is to have a positive effect on macroeconomic stability it must be supported by other economic policies, other consistent policies, adequate economic environment, and political ʻʼmaturity“. Examples of many countries throughout the history have shown that a fixed exchange rate in the long-term has failed simply because countries have always been guided by short-term political goals instead of long-term economic stability and prosperity. In order to eliminate discretionary abuse of monopoly over the primary issue function, many countries have been recommended to focus on very strong forms of fixed exchange rates, such as the currency board, monetary union, optimum currency area, and full dollarization.

Table 1: Factors determining the choice of exchange rate regime and the possibility of monetary association

Features	Consequences of the choice of exchange rate regime
Economy size	Larger economy – more flexible exchange rate
Openness of economy	More open economy – flexible exchange rate is less attractive
Diversification of production / import structure	Diversified production – better to apply a flexible rate
Geographic concentration of trade	Greater share of trade with one large country – greater incentives to tie the national currency to the currency of that country
Divergence of domestic and world inflation	Larger differences in relation to the inflation in the major trading partner countries – greater need for more frequent adjustment of exchange rates
Level of economic / financial development	Higher level of economic and financial development – greater possibility for introducing a flexible foreign exchange rate
Labor force mobility	Greater labour force mobility – easier and less costly adaptation to external shocks through a fixed exchange rate
Mobility of capital	Greater mobility of capital – flexible exchange rate preferred
Foreign nominal disturbances	Shocks more liable – flexible exchange rate preferred
Domestic nominal disturbances	Domestic disturbances are more likely – fixed exchange rate more attractive
Real shocks	Increased sensitivity of the economy to real shocks (internal or external) – flexible exchange rate preferred
Credibility of policy makers	Little confidence in the economic policy makers – fixed exchange rate is more attractive as the nominal anchor

IMF, 2007, *Review of Exchange Arrangements, Restrictions and Controls*, IMF Monetary and Capital Markets Department, Washington

With respect to alternative institutional monetary regimes, all practical cases may be classified in three basic models:

1. Classical central bank,
2. Currency board and
3. Euroisation.

Table 2 presents basic features of the above mentioned three regimes.

Table 2: Basic features of alternative monetary systems

Description	Central bank	Currency board	Euroisation
Possibility of conducting discretionary monetary policy	yes	no	no
Function of the „lender of last resort"	yes	no	probable
Possibility of monetization of deficit	yes	no	no
Stabilization of domestic prices	difficult	probable	easier
Access to European capital market	difficult	yes	easier
Likelihood of banking crises	high	yes	small
Currency risk	yes	probable	no
Interest rate oscillations	less probable	probable	probable
Liquidity risk	high	probable	low
Systemic risk	probable	probable	low
Transaction costs	high	high	low
Costs with respect to price conversion	no	no	yes
Costs of amendments to legislation	no	no	large
Costs of foreign debt servicing	high	high	low

Source: systematized table based on: EC, 2005., *Seminar on Currency Boards in the Context of EU Accession*, Enlargement Paper ECFIN/360/05/EN; Aguado, S., 2005., *Transatlantic Perspectives on the Euro and the Dollar: Dollarization and other Issue*s, University of Alcala, Spain; Lane, P., 2006., *The Real Effects of EMU*, IIIS Discussion Paper No. 115, Dublin Institute for International Integration Studies

For candidate countries in the EU integration process, to choose the monetary regime, the following criteria are relevant (Lane, 2006): a) *efficiency of the economy and integration process* (the ability to meet the nominal and real criteria for the EU and EMU membership, which is most closely related to traditional measures of efficiency of monetary regimes – minimization of fluctuations of internal and external purchasing power of a currency, and to the assurance of low inflation), b) *effectiveness of the strategy of integration into the global system* (capacity of a monetary regime to ensure as smooth as possible inclusion in the global financial and development trends) and c) *political efficiency* (capacity and credibility of the monetary regime to counter short-term policy goals and meet the criteria of economic and social convergence).

The regime of the currency board has a relatively long history dating back to the British colonies. In the period after World War II, the interest in this regime significantly reduced and it has been revived with the transition processes in Eastern Europe, where a number of countries under this regime grew. The reasons for the disappearance of the currency boards[1] are manifold, but can be summarized as follows (Schuler, 2003):

- The Keynesian doctrine of the time emphasized the positive role of the government in creating economic trends, while the establishment of a central bank was set as a priority;
- Given the fact that currency boards were mainly established in territories under a direct or indirect dominance of the United Kingdom, the desire for an independent central bank was imposed as one of the key aspects of the newly acquired independence and breaking with the colonial past;
- The British pound proved quite unstable[2] during the validity of the Bretton Woods system of fixed exchange rates and the currency boards which were tied to the pound accordingly[3] lost their credibility and provided the government with a reason to abandon them in favour of the central bank.

The renaissance of currency boards (Bogetic, 1997) began in early 1990's. During this period, currency boards were adopted by Argentina (1991-2001), Estonia (1992), Lithuania (1994), Bulgaria (1997) and Bosnia and Herzegovina (1997).

Currency boards are usually introduced in small and highly open countries[4] which economies have faced macroeconomic instability in the recent past, most often with high inflation (or hyperinflation) or distrust in e monetary policymakers.

The currency board is a temporary arrangement in countries that have obvious commercial and other benefits from being tied to a strong currency. Countries that are exposed to speculative influences or which may reach a phase of strong

[1] In the said period, currency boards were retained in only several small island nations such as Singapore, Hong Kong and Falkland Islands.

[2] In the period 1940 -1967, the pound devalued several times, dropping from the initial value of 4.03$ to 2.40$.

[3] A large percentage of currency boards have used the pound as their reserve currency.

[4] Argentina, which had the currency board in the period 1991-2001, is an exception.

real depreciation tend to have the currency board as a long-term arrangement. In some cases, the currency board may be the solution in the interim period to support the currency until the credibility of institutions and systems is strengthened or until large exogenous changes in the economic environment create the conditions for introducing a different exchange rate or currency arrangement. An early exit from the currency board arrangement can limit the risk of overvaluation on one hand, but it can also cause a serious loss of credibility of policy makers, on the other hand (unless the abandonment of the system is connected with exogenous shocks which clearly confirm that).[5]

The consequences of the currency board failure can be large and painful. In this regard, various exogenous (trends in the international market of goods, capital and services) and endogenous system disorders (mainly caused by non-compliance with or inadequate implementation of the currency board rules), may lead to adjustments, and to the exit from the currency board arrangement. The adaptation of the system is done through appreciation, depreciation, a move to the float or a move to a new reserve currency, and the exit from the currency board arrangement may basically be performed in two ways: a) by returning to the full monetary sovereignty, via the classic central bank and b) with the full loss of monetary sovereignty, via the introduction of euroisation. The occurrence of one of these modes depends primarily on the reasons / motives that caused the need for adjustment or the need to exit the system.

Reasons and alternative options for abandoning the currency board

The introduction of the currency board was, in almost all transit economies, where it had been introduced in recent history, the result of inability of economic policy makers to deal with a severe macroeconomic instability. In such circumstances it was impossible to build the institutes of a market economy. This obviously made it obvious that only one clear, firm and transparent system may bring stabilization effects, primarily in the area of price and currency stability.

The abandonment of the currency board arrangement may be necessary due to:

[5] In other words, this is another confirmation of the usefulness of the currency board arrangement as the solution for countries that wish to delay the introduction of the full central banking function until they are sufficiently developed to be able to switch to the central banking system. However, on the other hand, it is a very attractive solution for high-inflation countries which seek to implement a strong stabilization programme to restore the credibility of their economic policies.

1. Large external shocks or internal pressures that the currency board arrangement can no longer absorb, which can disturb the currency stability,
2. Slackening in the preservation of credibility of the established system or in the establishment of new institutions,
3. Determination to join the monetary union.

In that sense, the adjustment of the currency board arrangement may be performed along one of the following routes (EC, 2005):

- *Appreciation* – if there is asymmetric information that the appreciation of a currency is imminent, capital will be attracted. Future dynamics of the monetary market is hard to predict, but there is a possibility that the stability of the market will be shaken by the appreciation strategy (i.e. large capital inflow, predominantly of speculative nature).
- *Depreciation* – if depreciation is anticipated, it will reflect on the capital ''flight'' as those who own property nominated in domestic currency will intend to convert it into the reserve currency. As long as there is no technical margin to the increase of domestic interest rates which may balance the money market, there is the limit to how long the banking system can cope with the shock in interest rates. In addition, there is a great danger of ''the breaking'' of banks. Administrative arrangements may be designed to alleviate the pressure on banks, caused by the withdrawal of deposits. The existing contracts denominated in local currency can quickly be converted into the reserve currency (equivalent in value), or the convertibility of bank deposits may be temporarily suspended. However, these measures can seriously damage the credibility of economic policy makers. As in the case of appreciation, one should consider announcing the move to the "sliding parity," as a way to minimize the costs of the loss of credibility incurred due to the failure to comply with the exchange rate rules. However, the »downslide« creates the risk of losing control over inflation (which happens in the case of appreciation), which may jeopardize the previously achieved stabilization results. This means that it can be very difficult to correct heavily overvalued exchange rate.
- *Move to floating* – a move towards floating may be an adequate exit strategy, particularly if the currency of the currency board is under pressure. When the exchange rate deviation is not too high, the country will not want to opt for free floating right away: the currency will be allowed to float within margins, which will gradually be expanded or converted until they "disappear". The risk contained in the move to floating, or the risk of loss of nominal anchors must accurately be measured and taken into ac-

count. It is much easier to manage the floating within narrow margins in case of initial appreciation than in case of depreciation.

- *Move to a new reserve currency* – the next option is to change the reserve currency. The goal is to achieve real effective appreciation (depreciation) through a gradual nominal appreciation (depreciation) of the new reserve currency against the currency basket of trading partners. Assuming that the shift will happen against an exchange rate defined by the market (on the day of its implementation), this will not lead to the destabilization of capital flows, even though the consequent changes in the structure of domestic interest rates will have a certain impact. The usefulness of such a shift will be limited due to difficulties in terms of predictability of future exchange rate trends and the impact on the real exchange rate of the reserve currency.
- The introduction of greater flexibility into the system from the aspect of its orthodoxness and *a gradual move to a central banking system* shall mark the return of a full monetary sovereignty.
- Abandonment of the currency board, *with the introduction of euroisation*, shall mark the loss of monetary sovereignty in full.

The key question when choosing the moment to abandon the arrangement is whether that move would seriously threaten the established credibility. If the system is introduced as an interim solution until all the functions that are specific to the central bank are established / developed, then the development level of the established functions will determine the moment of the exit strategy implementation. In this case, the exit from the currency board arrangement is more of a success than a failure. In addition, when higher results of monetization of economy are achieved there is a dilemma whether it is it still optimal to retain the currency board arrangement if the necessary currency is covered and the balance of payments surplus is achieved. In such situations, the abandonment of the currency board and the shift to the central banking system may be seen as a part of the normal evolution (development) flow.

If the currency board has been introduced to restore the system credibility, then its abandonment may prove more problematic. In this case, the exit from the currency board arrangement is defined by the moment when policies which are being implemented become strong and stable enough in the long-term, thereby creating a guarantee that the established credibility of the system will be sustainable when the currency board is abandoned. The higher the risk of the loss of credibility by abandoning the currency board arrangement, the greater the need for stronger policies. The whole process can be facilitated or hindered if the currency is facing the pressure of appreciation or depreciation (i.e. in a situation where there is a significant deviation from the real exchange rate). In such situations, it is expected, above all, from the fiscal policy to be firm and credible, so that it can amortize certain impacts on the credibility of the system at the moment of abandonment of the currency board (Gulde, Kahkonen, Keler 2000, Buiter 2001).

In order to analyze transit economies, which have introduced a currency board for the purpose of stabilization, achieved results may be a sufficient indicator whether it is time to exit the system or not. If the implemented reforms in the real and financial sectors are not at the level that can ensure the retention of confidence in the national currency, the currency board should be retained. This, however, would be simple if the decision to abandon the currency board were not influenced by other factors (such as the consideration of effects on the balance of payments position and further growth, if such a rigid system were retained and if a shift to the use of other monetary policy instruments that allow certain flexibility of the system were not made, or by taking into account the need for the fulfilment of nominal and real convergence criteria, if these countries wanted to join the EU).

However, taking into account all of the aforesaid reasons for abandoning the currency board arrangement, the determination of the analyzed transit economies to join the EU opens the possibility to retain the system during all stages of EU accession, until the last step of entry of these countries into the euro-zone is made (when it is necessary to check real possibilities and capacities of the country with respect to meeting not only nominal but also real convergence). There are several reasons that make this option logical (Katsimi, 2004):

1. the results already achieved under the currency board arrangement which are positive (in terms of the attained price and currency stability, fiscal and financial discipline),
2. the size and openness of these economies (all of them are small and very open) indicates the limited utility of abandonment of the currency board arrangement and the move to the conduct of discretionary monetary policy and the floating exchange rate,
3. relatively successfully established fiscal discipline in these countries, along with a balanced relation and an established credibility of monetary and fiscal policy.

However, the retention of the currency board in the EU integration process imposes the necessity of certain adjustments to the system, its operational rules, but in a manner so as not to jeopardize its future credibility and thereby open a space for new inflationary trends.

There are two possible ways to abandon a currency board as a system that has temporarily been introduced:

- re-establishment of a central bank with the option of conducting discretionary monetary policy,
- introduction of euroisation.

The first option of abandoning the currency board, which includes the shift to a central banking system, can have several adverse aspects when it comes to transition countries, and one of the most important to emphasize is the one related to the fact that in the central banking system having the option to conduct discretionary monetary policy, the local authorities take responsibility for the overall conduct of the economic policy, and thus have the discretion which may prove fatal in insufficiently stable transition conditions. In addition, there are other dangers, as well (Gulde, Kahkonen, Keler 2000, Mehl, Winkler 2003):

- The possibility of losing the restored confidence in the currency because the competent institutions may lack the capacity to pursue the monetary policy independently (political pressures and the pressures of certain lobby groups can cause the "new" and insufficiently strengthened central bank to succumb to pressures for monetization of fiscal deficits and subsidies to the real economy - the case of FR Yugoslavia and the implementation of the stabilization program in the early 1994, which was based on the principles of the currency board; after 6 months, the strict currency board rules were abandoned, which resulted in the introduction of an increasing degree of discretion in monetary policy and ultimately resulted in the devaluation of the exchange rate and the re-escalation of inflation);
- The complexity of procedural actions when there is a change in legislation (that requires the consent of all interested, or relevant respondents, e.g. in case of Bosnia and Herzegovina it may be a serious obstacle, since it is necessary to ensure the consensus of both entities, the international community and all relevant national institutions in the process, while having in mind that the monetary policy is conducted at the state union level, the fiscal at the level of individual entities in terms of direct tax policy, i.e. at the state level in terms of indirect tax policy; in such circumstances, and it would be extremely difficult for the central bank to pursue discretionary monetary policy without influencing stability);
- Inadequate capacity of the "new" central bank in establishing relations with other central banks and international financial institutions, with a liability to find itself in a position where public expectations are not met in terms of accession to the wider commercial, financial and monetary areas (primarily the Euro zone).

According to all these reasons, while recognizing the fact that all transit economies under the currency board arrangement are oriented towards the EU integration, the option of abandoning the currency board arrangement by moving to the central banking system is quite uncertain and there are many negative practical examples (e.g. FRY in 1994 or Lithuania from 1997-1999 when the Resolution which envisaged three stages of a gradual abandonment of the currency board arrangement and the move to a full central banking system was adopted, but was not subsequently successfully implemented). On the other hand, the option of a unilateral euroisation is not a realistic option because of the sharp opposition of the EU, i.e. the ECB.

Exit strategy for the currency board regime

In case of countries in transition under the currency board arrangement, there are three alternative strategies for the monetary regime in the process of EU integration:

- Shift to the central banking system with the elements of discretionary monetary policy;
- Retention of the currency board arrangement with or without modification;
- Euroisation.

Restoration of the central banking system with a greater or lesser degree of discretion or the pursuit of monetary policy based on strict rules (as under the currency board arrangement) are the choices which are the closest to the standard procedure to join the EMU. This means a gradual move from the solid system of exchange rate regime and move to the managed floating exchange rate, which should allow (monitor) the meeting of inflation target (Buiter 2001, Katsimi 2004).

The standard procedure of the EU accession involves three phases:

- The first phase is the period from the beginning of negotiations until the accession to the EU. During this period, a country has no bilateral obligations towards the ECB in terms of choice of the exchange rate policy. The country itself may freely choose its monetary and currency regime (from total float to official euroisation).
- The second phase covers the period from the EU accession to joining the EMU. During this stage, the country needs to adjust its exchange rate

policy. The obligation for the EU Member States, which are outside the EMU, to coordinate the exchange rate policy is defined within the ERM2 (exchange rate mechanism 2).[6]

- The third phase covers the last 2 years before entering the EMU (i.e. the Euro area); in this period, the potential candidate's compliance with the convergence criteria is evaluated. At this stage, the choice of exchange rate policy is not independent. Potential candidates must participate in the ERM2 without the possibility of devaluing their own currency against the currencies of other Member States.

In November 2000, the Council of Europe took the view that although the currency board based on the Euro as a reserve currency is not a substitute for participation in the ERM2, it can be regarded as a regime that can be included in the ERM2 mechanism, and the primary purpose of supporting the discipline imposed by the ERM2 mechanism. This means that countries with the currency board, which is based on the Euro, do not have to change their monetary and currency regime twice: first to switch to the floating within the ERM 2 mechanism, and then later to the fixed one upon entering the Euro area. In any case, this attitude must be considered on a case-by-case basis and will enable the central parity rate to be set on the basis of the mutual agreement between the candidate country and the EU/ECB. The example of Bulgaria confirms this as in 2007 Bulgaria became an EU Member State and retained the currency board as the monetary-exchange rate regime

Participation in the ERM2 mechanism means the introduction of the exchange rate target zone. For the countries under the currency board arrangement this can have different consequences. For example, the introduction of wide fluctuation margins of the exchange rate may cause certain imbalances and moving

[6] ERM2, as a framework for establishing relationships between the currencies of Member States, was defined under the Resolution on the Amsterdam Treaty of June 1997, as well as under agreements between the ECB and central banks of Member States outside the euro-zone as of September 1998. The Member States were recommended to enter the ERM2 without restriction. The EU Member States outside the euro-zone can independently decide to join this system. Countries that join the ERM2 tie their currency to the Euro exchange rate with a maximum fluctuation of + / - 15%. Within these boundaries, the national central banks may intervene automatically and indefinitely. In addition, at all times, national central banks and central banks of EMU and the ECB may suspend any intervention that threatens to undermine the basic goal: price stability. The level of exchange rate fluctuations and boundaries are defined by mutual agreement between the ECB, EU finance ministers and central bank governors of Member States outside the ERM2 euro-zone. In order to increase the credibility of the system of fixed exchange rate, this mechanism provides short-term financing of the national central banks by the ECB for a period of 3 months.

away from the Maastricht criteria. There are several reasons for such a phenomenon (Schadler, Drummond, Knijs, Margasova, Van Elkan 2005):

- First, the EMU experience indicates that countries that were implementing the Bundesbank monetary policy more stringently (or tightly tied their exchange rates to the fluctuation of DM) met the convergence criteria more easily and did not suffer large shocks due to the pressures coming from ERM2 (in the period 1992 - 1993.). In addition, it is known that the European countries which had strong links with the German economy managed to attain a greater degree of convergence (Austria, Belgium, the Netherlands). However, deviations of the currency board arrangement (which was based on the Euro as a reserve currency) would be in contradiction with the experience of European countries during the creation of EMU.
- Second, the inclusion of these countries in ERM2 could increase the uncertainty of their economies to a large extent. Basic principles of ERM2 provide a degree of discretion, which may jeopardize credibility.
- Third, although the introduction of the currency board arrangement has reduced currency fluctuations and foreign exchange risk, this advantage would be lost in the ERM2 system (due to the defined margins + / - 15%). Since there is a strong link between devaluation and inflation, this may indicate a higher rate of inflation. In addition, it is possible to negotiate a more narrow margin of fluctuation (for example, Denmark has agreed to + / - 2.5%), given the importance of the exchange rate as the nominal anchor in Denmark). The introduction of narrow margins provides less benefit from the participation in the EMU in relation to the existing currency board arrangement. The main reason for participation in the ERM2 system is a more flexible nominal exchange rate that makes it easier to respond to shocks. Narrower fluctuation margin reduces the level of flexibility to the one that is not more useful in comparison to the effects of a fixed exchange rate under the currency board arrangement. In addition, the ERM2 system provides greater opportunity for making profits through speculation than the currency board arrangement. This is generally known as the syndrome of fear of the floating exchange rate, which was especially pronounced in Bulgaria (Hristov, Zaim, 2003). Striving to reduce fluctuations in the exchange rate within narrower margins has resulted in the retention of the policy of higher interest rates (the price of the less credible exchange rate), which will eventually delay the convergence of interest rates in these countries with those in the euro-zone. Higher exchange rate risk (in the case of participation in the ERM2 system can affect the portfolio of commercial banks and result in a banking crisis, which can then be converted into foreign currency (foreign exchange) risk, in general. The fixed exchange rate

under the currency board arrangement represents implicit protection of banks and companies from foreign risk.

- Fourth refers to the question: which model of monetary policy should lead to the central bank in countries that have abandoned the currency board, but have not yet acceded to the EU? Practice indicates that the strategy of inflation targeting is the preferential option for flexible exchange rate regimes. However, there is the following question: whether, as with defined goals, it is possible in a short period of time to introduce a credible monetary policy based on inflation targeting and simultaneously meet the convergence criteria regarding inflation, interest rates and exchange rate fluctuations? By methodological review of the basis of inflation targeting and by analyzing the conditions that must be met before, it can be said that this is not a desirable exit strategy for countries with the currency board. Abandonment of the currency board arrangement and the transition to inflation targeting along with meeting the Maastricht Agreement convergence criteria is not possible in the short-term. The basic contradiction lies in the fact that inflation targeting requires greater flexibility in interest rates, i.e. conditions that cannot be met with simultaneous participation in the ERM2 system.

Participation in the ERM2 system is possible if the exchange rate flexibility and the conduct of partially independent monetary policy are able to create conditions for a more rapid nominal convergence (by meeting the Maastricht criteria). Therefore, the general conclusion would be that it is difficult to argue that the participation in the ERM2 system would automatically bring more benefits than costs to countries under the currency board arrangement (Cincibuch, Vavra, 2002).

Upon the EU accession, countries with the currency board may retain the currency board arrangement or opt for the unilateral euroisation. *In the event of unilateral euroisation*, it must be done with the consent of, and in agreement with, the EU, which is highly unlikely. This means that euroisation should be achieved by purchasing the necessary amounts of Euros using foreign exchange reserves before the country becomes a member of the EMU, even before it acquires the status of the EU Member State. However, the EU is against such arrangements since they are not based in the EU Acquis and Member States have no special interest in accepting such arrangements. A country in the system of unilateral euroisation, having the EU candidate status can neither enter the EMU nor have the right to vote in the ECB Board of Governors. In addition to the fact that “early euroisation” (unilateral euroisation), which implies acceptance of the Euro before the EU accession, must be approved by the EU, it requires certain conditions to be met by the country that opts for unilateral euroisation: a) a widespread use of the Euro in the domestic economy, b) a completely free movement of capital, c) a strong banking system, with regulations that will be in accordance with the EU banking regulations, as well as unhindered presence of EU banks in the domestic territory. "Early euroisation" will not have negative consequences only in this case (Backe, Wojcik, 2002).[7]

However, taking into account the said limitations, we can conclude that the currency board is an acceptable solution. Successful examples of Estonia and Lithuania, and the last example of Bulgaria indicate that the retention of the currency board upon the EU accession is an optimal solution. Joining the ERM2 will bring about minor changes in terms of exchange rate policy (since the determination of parity against the Euro is a "common issue" of the EU Member States). However, at this stage (ERM2) on the road to the Euro area, it is desirable to retain the currency board arrangement for several reasons: a) both systems (ERM2 and currency board) require certain macroeconomic adjustment mechanisms, b) the regime change that can bring about a certain degree of uncertainty is avoided and c) greater synchronization of business cycles is to be expected. Of course, the retention of the currency board arrangement can be successful only if good and stable results are achieved in terms of nominal and real convergence prior to the EU accession.[8]

According Katsimi (2004), on one hand, the ERM2 system ensures flexibility through: a) the conduct of active monetary policy, b) the possibility of aligning with the equilibrium, the market exchange rate, c) the fact that a part of the

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[7] Costs of "early euroisation" constitute the loss of seigniorage and the lack of the function of "the lender of final resort." These costs need not be high in case of stable economies with the banking sector which is largely "controlled" by EU banks and the currency board arrangement with "excess reserves" which can be used when acting in the function of the lender of final resort or for amortization of the public debt (expressed as a reserve currency).

[8] The empirical study Fiquet, Nenovsky (2006) which focused on the analysis of: a) the degree of nominal, real and financial convergence of the new EU Member States (Bulgaria and Romania), as well as the degree of synchronization of their business cycles with the EU, b) reaction (resistance) of these countries to a variety of external and internal shocks and c) balancing (adaptation) mechanisms for these shocks, indicated to a certain extent the superiority of Bulgaria (in the currency board regime) in relation to Romania (in the regime of inflation targeting with a floating exchange rate). Namely, Bulgaria achieved nominal convergence more quickly and easily, but was far behind in attaining real convergence. In addition, Bulgaria's economy was more elastic to shocks (the shocks had sharper, stronger effect, but were more quickly overcome in Bulgaria in comparison with Romania) and had more responsive mechanisms for adjusting the currency board arrangement to experienced shocks. The reason for this, above all, lies in a balanced fiscal policy and the provision of the "fiscal reserve" in order to facilitate the response to future shocks associated with the further integration process.

real appreciation, which comes with higher inflation in the candidate countries (Balassa-Samuelson effect), can be absorbed by the fluctuation of the nominal exchange rate. However, on the other hand, retaining the currency board arrangement in ERM2 until the last stages of entry into the Euro area and acceptance of the Euro may be justified as follows:

- Market "testing" of the exchange rate is possible even if it is fixed, through a market evaluation of the level and sustainability of current account deficit and the level of interest rates;
- It is highly unlikely that, if the currency board is present in the course of a certain number of years, the exchange rate will be far from the equilibrium value, especially after a long period of macroeconomic stability (with intensive growth of exports and production);
- Even with the acceptance of the exchange rate flexibility within the ERM2, the period before the final acceptance of the Euro and joining the Euro area (approximately 2 years), in which the exchange rate needs to "reach" its equilibrium value, is short;
- Acceptance of the flexibility of ERM2, which implies an active monetary policy, requires the creation of certain institutional capacities in the monetary policy, which are in turn not required if the Euro is accepted (i.e. institutional capacities should be established only temporarily, for a few years);
- The real exchange rate appreciation in the context of the currency board does not have to be a factor of disturbance because the real appreciation becomes less important with the progress of real convergence and, in parallel, it can be viewed as a natural phenomenon that occurs as a normal side effect of the success of transition (which means that it is seen as the real exchange rate appreciation and not as a macroeconomic imbalance).

Concluding remarks

On the basis of the aforesaid facts, it seems that the currency board is a convenient monetary and currency arrangement that provides a good framework for meeting not only the Copenhagen criteria, but also the criteria of nominal and real convergence from the pre-accession phase to the final stages of Euro acceptance.

The conclusions which can be made regarding the retention of the currency board in the EU accession process are the following:

- In the pre-accession period, there are no restrictions to the exchange rate policy (any exchange rate regime is acceptable, including the currency board);
- Following the EU accession, exchange rate policy is a common issue in the Member States of the EU / EMU (while it is still possible to retain the currency board arrangement, provided that it is jointly estimated as more beneficial);
- At some point following the accession, the timing of entering the ERM2 has to be considered by the Member States and subject to the compliance with the conditions for participation;
- Joining the ERM2 can be a suitable exit strategy for countries with the currency board, it can protect the currencies of these countries from market uncertainties (which can occur with the exit from the currency board), making them a part of a flexible and stable oriented mechanism related to a wider economic area;
- Moreover, the ERM2 can provide the Member States with narrower fluctuation margins than the standard ones, which will be defended by automatic intervention and financing;
- The ERM2 mechanism may specify the solution in terms of the central rate, the standard fluctuation margins and the reduction of the fluctuation margins for each potential candidate country, subject to a bilateral agreement (which means that if a country having the potential candidate status and being under the currency board arrangement wants to retain the currency board, this is to be defined under a special arrangement and agreement);
- It is highly unlikely for a country which has been given the possibility of derogation or a long period of transition towards the single market, to have access to the ERM2, since this mechanism implies full compliance with the requirements;
- "Early euroisation" or unilateral euroisation defined as the acceptance of the Euro in the pre-accession phase is unacceptable as an exit strategy from the currency board arrangement, because such a candidate country must adopt the EU Acquis when applying for the EU membership, which implies all rules, policies and procedures that are defined in the agreements for entering the Euro area.

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