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Credibility and Convergence: Did Euroization Deliver for Montenegro?

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Abstract

Using Montenegro as a case study, this paper evaluates the viability of currency substitution, in this case euroization, as a response to increased financial volatility. Proponents of euroization outline a series of expected benefits, while critics point to what they perceive as much larger costs. The paper contrasts the macroeconomic developments of Montenegro and how it fared during the Global Financial Crisis and the shock triggered by the Covid-19 pandemic with the performance of its regional peers and the euro area overall. The findings are contrasted to how the various expectations played out for Montenegro, drawing further lessons on the role of monetary policy and domestic monetary sovereignty.

Key words: Monetary policy, Euro, currency substitution
J.E.L. classification: E42, E50, F30

1. Introduction

In an increasingly uncertain global context, where the repercussion of the shock triggered by Covid-19 and the spillovers of Russia's war in Ukraine and a global financial system reshaped by geopolitical tensions, exchange rate and capital flow volatility are putting additional pressures on policymakers, particularly in emerging and developing markets (Drehmann and Sushko, 2022). Within this context, debates around the issue of dollarization and currency substation more broadly are remerging as a possible path towards gaining more credibility in financial markets and thus achieving more stable outcomes, as well as to speed up the convergence and integration with a stronger anchor (Winkler et al., 2004). Euroization, refers to the full, or partial replacement of a domestic currency with the euro, an occurrence that is overall less common than dollarization, largely due to the it being a much younger currency.

This paper will focus on the case of Montenegro, a small open economy in the Western Balkans that unilaterally adopted the euro as its sole currency. This paper provides an overview of the main features of euroization identified by different strands of the literature, and the possible channels of transmission to the economy. Through a contrast of developments in Montenegro and its regional peers, which have not taken the step to unilaterally adopt the euro, this paper examines whether how euroization has played out for Montenegro, and whether it has enhanced its convergence with the euro area and the credibility of its policies. Montenegro, along with its partially recognized neighbor Kosovo are the only two countries that have moved to adopt the euro fully and unilaterally as their only official currency, a step that is distinct from the adoption of the euro by European Union (EU) members who join the European Monetary Union (EMU) upon meetings the established criteria. It is this type of adoption, and substation of a domestic currency that is the focus of this analysis.

2. Literature review

Full euroization results in an abdication of a country's ability to issue coinage and of its sovereignty over monetary policy decisions, which can be described as the adoption of a "hyper-fixed" exchange rate regime (Nuti, 2002). Adopting the euro would address the issue of exchange rate volatility, as well as make transactions with the anchor area less costly, however it would immediately result in the central bank losing its ability to act as a lender of last resort, support domestic fiscal policy through the purchase of bonds, and inject liquidity, (Winkler et al., 2004). Within the literature there are diverging views about whether these features are to be perceived as costs or benefits which are reminiscent of the overall debates around the idea of currency unions (Rochon and Seccareccia, 2003).

For proponents of euroization, one of the main perceived advantages of currency substitutions is generating a positive sentiment amongst investors and having the policy credibility of the anchor area extended to them (Winkler et al., 2004). Through this confidence channel, integration with the anchor would increase through investment and trade, and overall convergence would speed up (Berg and Borensztein, 2000). The inability to support domestic spending, which ensures fiscal discipline is within this perspective a benefit. However, the flip side of a stable exchange rate is the inability to use it as a response to external shocks. For proponents of euroization two competing explanations ensue on why despite this risk, the perceived benefits of euroization continue to outweigh the costs. One is that other adjustments mechanisms such as wage and price flexibility are available due to increased trade and financial integration (Mundell, 1961). Another reasoning suggests that exchange rate adjustments, as well as monetary tools overall have no long-term impact over output (Arestis and Sawyer, 2006).

In other strands of the literature, euroization is met with more skepticism. De Paula, Fritz and Prates (2017); Fritz, de Paula and Magalhães Prates (2018) empirically analyzed exchange rate volatility and capital flow fluctuations and concluded they are overwhelmingly linked to global cycles, rather than country-level policies or perceived credibility. It follows that euroization would have limited impacts on investment flows, and furthermore, that interest rate differentials will persist due to different perceived currency risks (Fields and Vernengo, 2013). Thus, there is a much higher cost resulting from the loss of a domestic lender of last resort, with the likely outcome being a financial environment with a high cost of credit and lower investment (Ponsot, 2019). Izurieta (2003) further raised the issue of a potential significant impact resulting from the loss of the exchange rate as an adjustment mechanism to an external shock, as such shocks would deteriorate the current account position, concluding that overall euroization would hamper a countries long-term growth trajectory. The lack of an exchange rate adjustment could further hamper competitiveness and further weaken the external position of a euroized economy, which is more likely to become dependent on external financing (Missaglia, 2021).

3. Research methodology

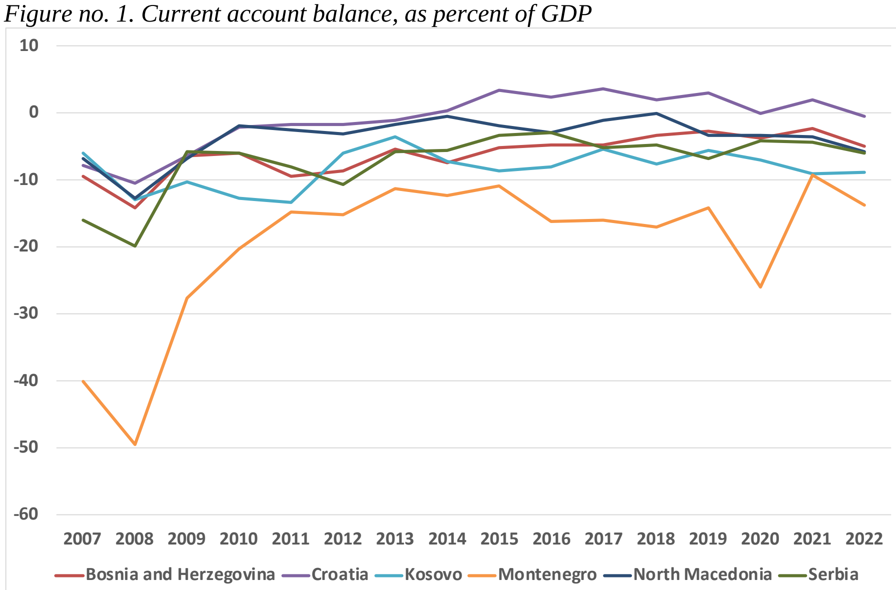
This study investigates whether currency substitution in Montenegro increased its convergence with the Euro Area and improved its overall economic performance, as proponents of this measure suggest. Towards this goal, we use macroeconomic indicators, collected through databases provided by the International Monetary Fund (IMF) and the World Bank, as well as information provided by IMF country reports and look at both the domestic performance of its economy, as well as its external position. Data from Montenegro's central bank is used for detailed information on its external accounts and to obtain a breakdown of sources and direction of foreign investment.

To provide a benchmark, we compare Montenegro's performance in some areas to its regional peers, as well as to the euro area members. As regional peers, we focus on Bosnia and Herzegovina, Croatia, North Macedonia, Serbia, and Slovenia, which alongside Montenegro make up the former members of Yugoslavia, but also represent an economically diverse sample of countries with different income levels and industries. The findings of this empirical analysis are contrasted and analyzed within the context of the literature on euroization, using Montenegro as a case study for how risks and benefits of such a measure can potentially materialize.

4. Findings

In its report on Montenegro, the IMF noted the countries' large external imbalances, which are attributed to a lack of competitive, weak exports, and a large reliance on external financing for its euroized economy, noting the need to attract investments towards a more diversified economy with higher value added exports (International Monetary Fund, 2022a). Montenegro's current account deficit stands out amongst its peers and reached almost half of the size of its entire GDP during the Global Financial Crisis (GFC). The current account balance as a percent of GDP is shown in Figure 1. Montenegro had a larger deficit pre-dating the GFC, and while it narrowed in the years after it consistently surpassed 10 per cent of its GDP and widened to about 25 per cent of GDP when Covid-19 hit its economy. This deficit in the context of a euroized economy means Montenegro needs to consistently find external sources of financing, through either investment, borrowing or remittances to fill the gap.

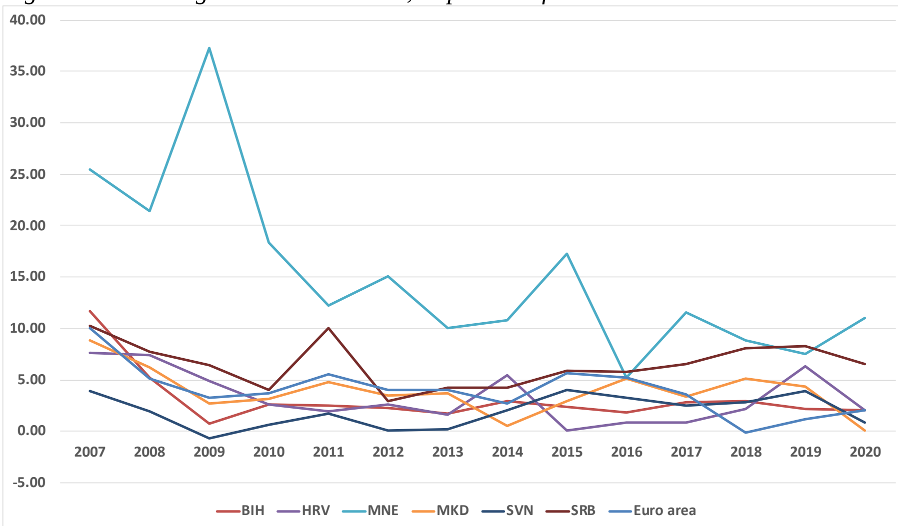
Figure no. 1. Current account balance, as percent of GDP



Source: (International Monetary Fund, 2023)

One area where Montenegro outperformed its peers is in its ability to attract large amounts of Foreign Direct Investment (FDI), as shown in Figure 2. Montenegro has almost consistently brought in large amounts of FDI, which during the GFC made up almost a third of its entire GDP. These high levels of FDI are consistent with the idea that the euro would increase foreign investment. However, the quality of the investment, and its long-term impact require further scrutiny. Reports from Montenegro's Central Bank document that a large amount of FDI is directed towards purchasing real estate (CBM, 2022). Apart from FDI, other sources of revenue and currency for Montenegro are remittances sent by workers from abroad, as well as increasingly services purchased by foreign tourists visiting the country (International Monetary Fund, 2022b). However, these inflows are insufficient to cover the financing needs of the government, which relies on large amount of external borrowing (International Monetary Fund, 2022b).

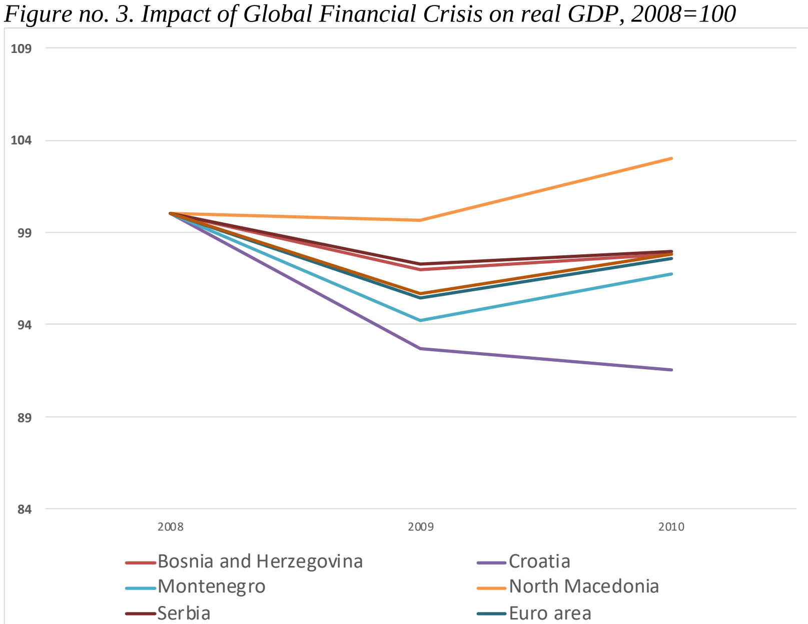
Figure no. 2. Foreign Direct Investment, as percent of GDP



Source: (World Bank, 2022)

In the last two decades, the global economy was hit by two large external shocks, first following the 2008 GFC, then the shock triggered by the Covid-19 pandemic. Figure 3 shows the impact on real GDP on Montenegro and its peers of the GFC. Indexed on 2008 values, Figure 3 illustrates the cumulative impact on real GDP in 2009 and then in 2010.

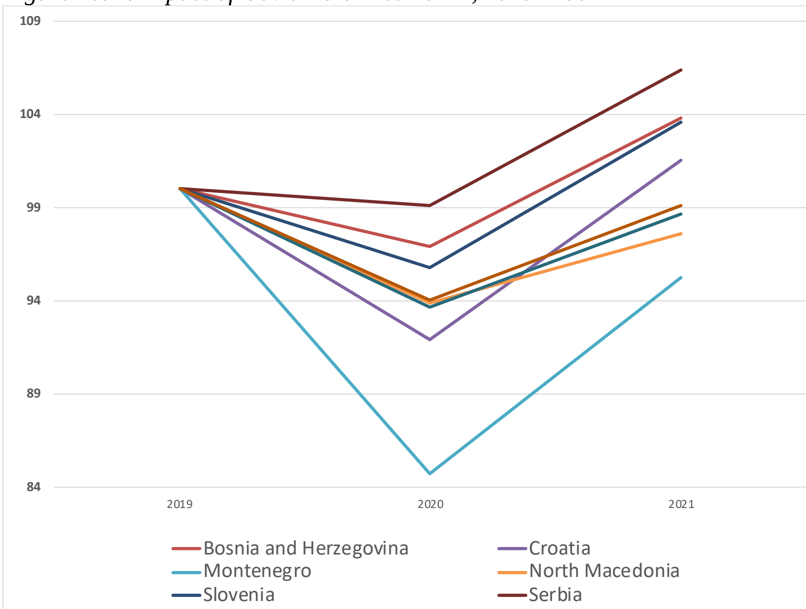
Figure no. 3. Impact of Global Financial Crisis on real GDP, 2008=100



Source: Authors' calculation based on (International Monetary Fund, 2023)

In the aftermath of the GFC, Montenegro had a similar trajectory to its peers and the euro area overall, with a decline in its GDP in 2009 and a slow recovery but with its economy still below 2008 level in 2010. In 2020, the aftermath of Covid-19, things looked differently. The increased reliance on external financing and tourism for Montenegro after the GFC and as part of its recovery, amplified the impact of the Covid shock. Figure 4 illustrates how Montenegro is an outlier in the case of the Covid-19 pandemic.

Figure no. 4. Impact of Covid-19 on real GDP, 2019=100



Source: Authors' calculation based on (International Monetary Fund, 2023)

Montenegro's tourism industry provided a lifeline in the aftermath of the GFC but increased its exposure to the pandemic. Its lack of competitiveness and decreasing trade levels with the EU make it difficult to address the imbalances (International Monetary Fund, 2022a). Montenegro's largest trading partner, Serbia, is outside of the EU or euro area, and account for over a quarter of all transactions, while trade with EU countries has been in a steady decline since the GFC (Economist Intelligence Unit, 2023). High unemployment in Montenegro persists and remittances from a large share of the population living aboard are essential to its economy (International Monetary Fund, 2022a).

5. Conclusions

The performance of Montenegro's economy over the last years does not support the idea that currency substitution increases integration or convergence with the anchor. Montenegro has struggled to respond to the two large shocks and has become less, not more integrated with the EU. In an increasingly connected global economy prone to shocks, the loss of exchange rate mechanism and monetary policy seems to have limited Montenegro's growth trajectory and set the country on a path of growing imbalances. A further question that arsis is what type of monetary policy tools a country such as Montenegro would have been able to use absent euroization. Future work plans to look at the response of its peer, which all have financial systems that are partially euroized, yet maintain their own sovereign currencies as well (Brown and Stix, 2015).

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