

# EXCHANGE RATE MANAGEMENT OR CURRENCY REPLACEMENT

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## Introduction

In the 1990s, the monetary environment significantly changed with the birth of the European Monetary Union, globalisation, and greater international financial markets integration. These developments resulted in an unprecedented financial crisis in the history of international finance for many countries around the world; though some problems arose due to government policies. Consequently, these developments refined the debate on economic crises – explaining causes, establishing early warning signals, and creating solutions – more comprehensively emphasising economic principles.

Since the 2002 Argentinean crisis, the debate on exchange rates regimes has evolved. Fixed but adjustable exchange rates (“crawling peg”), once preferred by economists following developing countries, were replaced with either of two more extreme alternatives: a free flexible exchange rate or currency board (official dollarisation, Fischer 2001). In fact, the Argentinean crisis appears not to have favoured fixed exchange rates; however, many scholars do not agree with that course of action and are convinced that this episode did not jeopardise the more favourable official dollarisation alternative. Furthermore, many researchers considered Argentina’s experience a failure and a bad application of the monetary board regime. Prior to the crisis, many academics and researchers suggested that Argentinean authority’s transition from official dollarisation towards a devalued peso exchange rate.

Though minister Cavallo pursued his debt restructuring programme, the currency board regime ultimately failed. At the same time, Argentinean economy’s dollarisation had reached too high a level to be easily pesoified. The moral of this story is that when an economy’s dollarisation reaches a certain level, the role of monetary policy is significantly limited, leaving few alternatives in solving expected economic breakdowns; however, official dollarisation may probably be one possible solution. It should be emphasised from the beginning that currency replacement is not a magic cure or tonic for macroeconomic illness.

This article aims at analysing the degree of Albania’s euroisation and considering possible monetary policy options regarding the exchange rate. Although the Bank of Albania (BoA) has declared that it will adopt a monetary policy regime in the future based on inflation targeting; this article suggests the exchange rate as an alternative.

The role of the exchange rate and the degree of an economy’s euroisation are based on economic agents, aiming at demonstrating the extent of monetary appreciation/depreciation costs.<sup>2</sup>

## Exchange Rate Developments and Monetary Stability

Graph 1 shows that the Albanian lek’s nominal exchange rate has undergone significant changes compared to the two main currencies (euro and dollar). The instability of the foreign currency market since 1999 is seen in the standard deviations table which appears higher

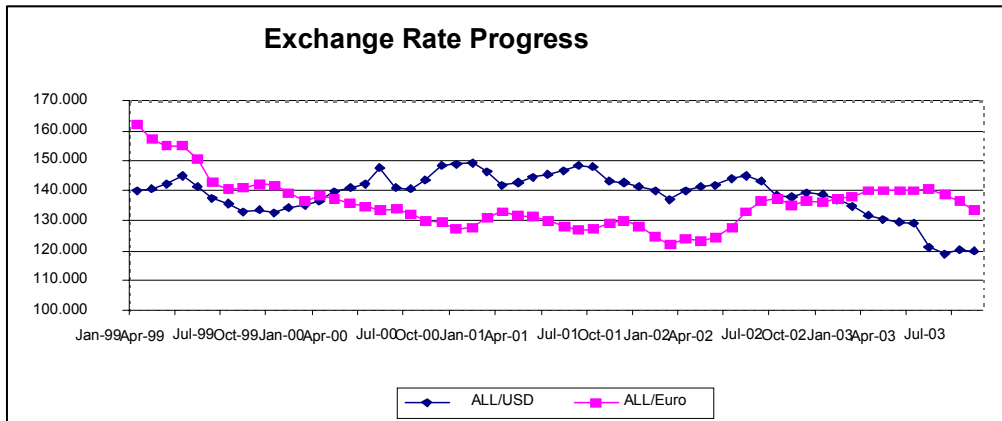
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<sup>2</sup>For further discussion on costs and benefits from euroism, see Selami Xhepa (2002), “Albanian Economy’s Euroism: An Alternative for Consideration,” Working paper, No 1(7/02), Bank of Albania.

compared to 1993-1996. Recently, the dollar appears much more unstable against the euro. While the domestic market was at first sceptical of accepting the euro, now it appears that market confidence has increased since its introduction; therefore, the dollars 8.5 fluctuation (volatility indicator measured by the standard deviation) is only 5.7 for the euro, demonstrating the greater stability and trust of market towards the euro.

Graph 1: Exchange rate of the lek against the dollar and euro.



| Standard Deviation: | LEK/USD | LEK/Euro |
|---------------------|---------|----------|
| 1993-1996           | 6.7     |          |
| 1997-2002           | 10.6    |          |
| 1999-2002           | 7.3     | 8.5      |
| 2002                | 8.5     | 5.7      |

Since 2002, real currency appreciation, accompanied by current account deficit deterioration, has left the market expecting a future decline in the nominal exchange rate. The challenge for monetary authorities is to adjust the exchange rate without allowing great market fluctuations; especially when sources that sustain and protect the foreign currency market equilibrium are outside their control.

Even in mid and long-term perspectives, due to economic changes, the current account deficit is expected to deepen and in real terms the exchange rate will continue to appreciate. In these circumstances currency replacement could be seen as a preferable option.

Due to the great foreign currency circulation in Albania, high volatility would cause more market instability and possibly high domestic currency depreciation that would negatively impact the economy.

To what extent is the banking system exposed to exchange rate fluctuation and the risk of market depreciation? And is it possible for unhedged foreign currency to compromise banking system balance and lead to economic contraction? This has been the subject of many studies, especially following the Asia crisis when foreign currency depreciation reduced the banking system's net worth, and impacted growth in other economically linked countries. Albania's banking system is not strongly affected by foreign currency fluctuations, and private sector bank credits are at low levels (6.5% of GDP at the end of 2002). Despite this, the currency imbalance between assets and liabilities in the banking systems indicates its general net worth during periods of serious exchange rates fluctuations.

The effect of the exchange rate in balancing the banking system is expressed in the following formula:<sup>3</sup>

$$w = A - Nd - eNf$$

Therefore, if monetary depreciation is high the banking system's net worth will decline.

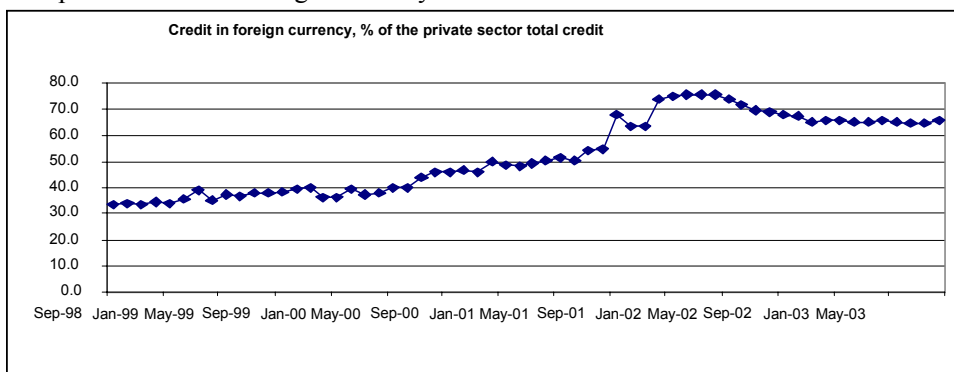
There is a degree of risk if banking system liabilities equal banking system investments; in other words if foreign currency deposits in the banking system are recorded in the national currency as banking system investments (giving credits and portfolio investments). Otherwise, if banking system investments are in the same currency as liabilities, domestic currency exchange rate changes will not be reflected as such during periods of imbalance in the banking system. The influence is indirect only if the borrower, unable to transfer the foreign exchange, declares bankruptcy while repaying bank credit.

Banking system data analysis taken from supervisory reports reveals that assets denominated in foreign currency constituted 37.2% of the total of banking system's balance, whereas foreign currency liabilities constituted 37.5% at the end of 2001. Hence, from a monetary standpoint banking system assets and liabilities are equal.<sup>4</sup> The data also demonstrates that the banking system shifts exchange rate risk towards other economic agents (private sector loans in foreign currency).

### The Exchange Rate and bank loans to private sector

Private sector credit continues to remain very low relative to GDP; however, the most important banking system credits offered continue to be denominated in foreign currency. At the end of 2002, 70% of all private sector credits were issued in foreign currency. This implies that assets (bank credits) on businesses balance sheets are expressed partly in foreign currencies, while revenues are expressed in domestic currency which becomes problematic since credits must be repaid in the currency they were issued.<sup>5</sup> Deposits and sales are recorded in domestic currency. When repaying credit, businesses are obliged to go to the foreign currency market to buy the necessary currency.

Graph 2: Credits in Foreign Currency



To maintain profits against foreign currency depreciation, businesses must raise prices for their products to compensate for exchange rate depreciation. Therefore, exchange rate

<sup>3</sup>where  $w$  = net worth;  $A$  = banking system assets in the national currency;  $Nd$  = passives denominated in national currency;  $Nf$  = passives denominated in foreign currency;  $e$  = domestic currency exchange rate compared to the foreign currency in which passives have been denominated.

<sup>4</sup>The difference between the few actives and passives in foreign currency is expressed in the position of the banking system in the foreign currency market.

<sup>5</sup> To determine an accurate figure, report industry or sector data is needed for the level of debt/equity ratio (borrowed capital/own capital) which is difficult to obtain.

fluctuations represent dangers to private sector assets and liabilities by creating currency imbalance. If the exchange rate change fails to initiate a rise in product prices, the business will fall into bankruptcy, thus setting off a chain reaction in the banking system, due to unpaid credits.

### Exchange Rate and Public Debt

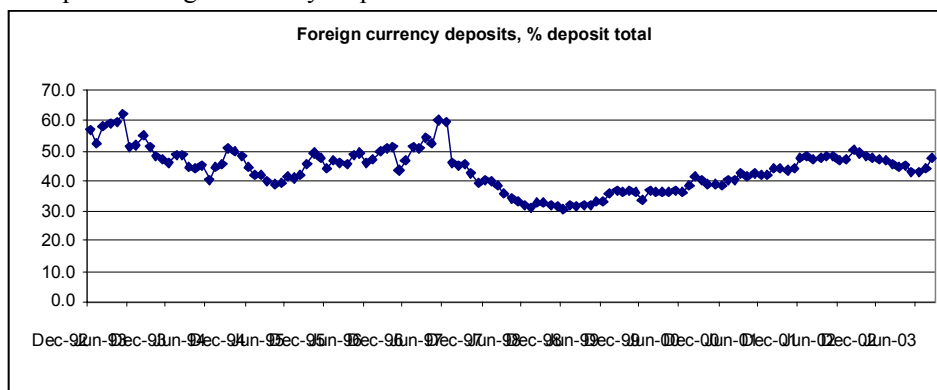
A considerable percentage of public debt is denominated in foreign currency. According to the Ministry of Finance, approximately 35% of public debt is denominated in foreign currency.

On the other hand, it is logical to assume that a large part of the money circulating outside the banking system is in foreign currency, especially in real estate transactions. It could be concluded that the foreign currency in circulation is much higher than official statistics from the banking system indicate.

### Exchange Rate and household ‘Sector’

The lack of faith in the lek seems to have motivated many families to hold their savings in other stronger currencies, such as dollars or euros. During the first years of transition monetary instability was high, so it is not surprising that almost half of all bank deposits were in foreign currencies. Throughout the 1990s, however this trend has remained strong, demonstrating either general doubt of a strengthening lek, or scepticism regarding de-dollarisation (increased use of the lek over foreign currencies). The cost of macroeconomic stability had already been paid once, and the continued preference of foreign currencies is considered as protection against having to pay a second time (for macroeconomic instability due to price fluctuations).

Graph 3: Foreign Currency Deposits<sup>6</sup>



### The Influence of Monetary Policy on the Exchange Rate

Exchange rates express an economy’s internal and external balances, which suggests that exchange rate equilibrium is reached when an economy’s internal and external balance is at equilibrium. Therefore, in the long-term, a currency’s exchange rate against other foreign currencies is determined by economic developments. Meaning, any country’s foreign currency crises cannot simply be blamed on monetary policy.

In his study, Tanner<sup>7</sup> analysed the role of monetary policy in the exchange rate process for 34 developing countries (including Albania), and demonstrated that the BoA intervention index

<sup>6</sup> This brief analysis shows that the economy maintains a high dollarisation level. Circulation of foreign currencies has been great both as a method for protecting value and for business transactions.

<sup>7</sup> Evan Tanner, "Exchange Market Pressure, Currency Crisis, and Monetary Policy: Additional Evidence from Emerging Markets," IMF WP/02/14, January 2002.

in the foreign currency market is relatively high.<sup>8</sup> In the period 1994:9 – 1999:7, the intervention index is 0.92, dropping significantly in the following years (index of 0.027 in 1998:7 – 1999:7).<sup>9</sup> In periods of great market fluctuation, intervention intensity has been more significant which is noted in these index values according to analysed periods where the index value during the entire time is higher than all other analysed sub-periods.

This implies that regardless of high intervention intensity, authorities have not been able to maintain the exchange rate norm within reasonable intervals of fluctuation. The domestic currency depreciation compared to the US dollar for one year (1997) exceeded 40%, which can be described as a monetary crisis.

Because the current account deficit is deepening and the prospect of regional and EU economic and trade integration is deepening, an alternative/preferable option would be to replace of the lek with the euro.

### **Trade Integration and Foreign Currency Policy**

Albania is interested in the progress of multilateral negotiations of the World Trade Organisation framework; however, the effects of European and regional integration are much more important. Europe is Albania's natural and most important trade partner, with which approximately 90% of Albania's trade is conducted. Changes in the trade regime are reflected in domestic economic changes.

With the conclusion of trade liberalisation negotiations (free movement of goods) Albania is expected to achieve trade balance, and that the free trade area will be established possibly by the end of 2008. In 2004, a network of bilateral trade agreements will be implemented according to commitments by countries included in the regional trade liberalisation initiative (SEE-7). The final objective is to establish a free trade area among these countries starting in 2008.

With greater regional trade and customs integration, Albanian currency could be considered economically risky (due to its high exchange rate volatility), thus placing the country in an unfavourable position. Because neighbouring countries follow an exchange rate policy linked to the euro (except Romania and Serbia which have monetary policies similar to Albania's), there is greater security and stability in trade transactions with these countries. Preserving competitive positions requires careful monitoring of regional monetary policies, which results in regional countries influencing the country's monetary policies.

In the long-term, Albania's prospective EU membership will mean:

- Faster economic growth (higher than the EU itself);
- Appreciation of the exchange rate (from Harrold-Balassa-Samuelson effects);
- Free movement of capital;
- Implementation of Maastricht criteria; and
- Membership in the EMU shortly after joining the EU.

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<sup>8</sup>The BoA index is configured as a ratio of the variation of change in foreign currency reserves to the sum of the variation of change in domestic currency reserves and domestic currency depreciation compared to the US dollar.

<sup>9</sup> The value of this index would be 1 in the case of the fixed exchange rate regime and 0 in the free fluctuation regime.

These factors are expected to increase the current account deficit. The best solution for this is the unilateral adoption of the euro as the national currency, prior to Albania's EU membership.<sup>10</sup>

Research analysing trade and currency has indicated a close connection among variables. Andrew Rose, a pioneer in this field, has quantified in his studies the degree of this connections influence.<sup>11</sup> According to him, countries sharing the same currency trade up to three times as much as compared to those which have different currencies. Other authors do not contest the effects of these policies but only the degree of their success. Equally important to promoting trade is reducing currency volatility: the more stable the currency, the more active the trade.

From this viewpoint, regional countries implementing monetary policies closely connected to exchange rates have a greater chance of profiting from trade integration with EU countries. Moreover, some trade analysts believe that such policies create trade diversification among regional countries; hence, both internal and external factors support the idea of transitioning towards use of the euro or monetary policy linked to the euro.

### **Conclusions**

The Albanian economy uses relatively high amounts of foreign currency; however, as Albania's goal is European integration, the dilemma is not between de-euroisation and euroisation, because official euroisation will occur in a matter of time.

This article aimed at demonstrating the necessity of a timely monetary replacement. As a result, exchange rate developments create repercussions in Albania's sensitive economy. The article proves the economy spreads exchange rate threats to other areas, so that the economy as a whole is at risk. Albania's monetary authorities must be attentive to exchange rate fluctuations; consequently, the euroisation alternative is economically more favourable and beneficial, in concert with the expected positive effects of establishing a regional and EU free trade area.

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<sup>10</sup> George Kopits, "Implications of EMU for Exchange Rate Policy in Central and Eastern Europe," IMF Working Paper 99/9, 1999.

<sup>11</sup> For more discussion, see, Andrew Rose, "One Money, One Market: Estimating the Effect of Common Currencies on Trade," NBER Working Paper 7432, 1999; J.A. Frankel and A. Rose, "Estimating the Effect of Currency Unions on Trade and Output", NBER Working Paper 7857, 2000.