Introduction

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The recent introduction of the euro and projects for monetary union in other parts of the world make the replacement of national currencies (either by a foreign currency or by a new, multilateral currency issued by a regional central bank) a topical issue. Related regimes are the tight linkage of the national currency through a currency board and the official or unofficial use of foreign currency - often referred to as "dollarisation". While these various monetary regimes differ in a number of respects, they have the common feature that they virtually eliminate the possibility of an independent monetary policy. Issues arising include the preconditions required for making these arrangements work, the institutions that need to accompany them, and the extent to which they harm the smooth functioning of the economy (for instance, by eliminating monetary policy flexibility and lender of last resort facilities).

Many of these issues were considered by a small group of senior central bankers at the BIS during a two-day meeting in September 2002. The first day focused on economic issues and the second on legal and practical issues. This volume contains edited versions of most of the papers prepared for the meeting.

The main economic issues discussed at the meeting were the following. First, and logically prior, is whether abandonment of an independent monetary policy is desirable. Do the benefits of enhanced credibility, predictability and stability of the macroeconomic framework exceed the costs associated with the inability to tailor monetary policy to the circumstances facing a particular country? This question has stimulated active debate since the early 1960s, with the optimum currency area literature suggesting the following criteria for successfully forgoing a national currency: labour mobility, existence of fiscal transfers, symmetry of shocks and a diversified industrial structure. Unfortunately, these criteria are not very good predictors of actual currency regimes, suggesting that political and institutional factors are also important in explaining currency use. This is especially the case for regional currency areas (RCAs), which are often accompanied by, or the culmination of, other regional integration initiatives. On the other side of the debate, it needs to be recognised that the theoretical advantages of monetary policy flexibility are often not attained, as monetary policy has in a number of countries been misused. In this context, RCAs, currency boards, and use of foreign currencies can be viewed as beneficial precisely because they remove the possibility of exercising monetary flexibility in a harmful fashion.

The discussion emphasised, however, that such monetary arrangements were not a panacea that would guarantee credibility and stability. They could in fact break down if fiscal policy were not disciplined or if the economy did not exhibit sufficient flexibility. This explained the attention given to the limits on fiscal deficits in the euro zone, both as preconditions to entry and as an integral part of the ongoing surveillance embodied in the Stability and Growth Pact. The experience of Argentina shows that even the straitjacket of the currency board does not necessarily discipline fiscal policy, ensure wage/price flexibility or guarantee credibility. Some participants pointed to official use of a foreign currency as a regime preferable to a currency board, at least with regard to credibility. But there are costs, in particular a loss of seigniorage and the impossibility of making a step change in the value of the currency to re-establish competitiveness.

A second important question, assuming that the first has been answered in the affirmative, is which of the regimes would be most suitable for a given country. As already noted, an RCA is most likely to emerge when there is already a strong sense of regional solidarity and other institutional

[1] This volume has greatly benefited from the cooperation and comments of the central banks represented at the meeting. Thanks also go to Lizzie Locke, Monica Mauron and Karina Tarling for secretarial assistance, to Arwen Hopkins, Nigel Hulbert, Tom Minic and colleagues in the Monetary and Economic Department of the BIS for editorial suggestions and to Jan Eastwood, Liliana Morandini and Gabriela Salvisberg for production assistance. The opinions expressed in this introduction are those of the authors and not necessarily shared by the Brookings Institution or the Bank for International Settlements.

manifestations of it. In the European Union's case, monetary union was the culmination of these other economic initiatives. There was much debate about whether this model is the only one, with a rough consensus emerging that it need not be (for instance, the CFA franc zone has been in existence for more than 50 years, much of that period without other significant elements of integration), but that to be successful and permanent, those other elements (customs union, macroeconomic coordination, harmonisation of taxes, removal of barriers to factor mobility, etc) needed at least to be constructed in parallel. While it was difficult to make a precise list of minimum requirements, in the absence of some of the other elements it was very possible that a negative shock would imperil the union by making it no longer attractive for one or several countries to remain in it.

A currency board or unilateral use of a foreign currency was more likely to be the response to a severe problem of lack of monetary policy credibility, effective monetary institutions, or both. These two regimes also have the advantage that they can be put in place quickly. Several of the economies with such regimes had adopted them during crises. Though the conditions that had made such regimes necessary might disappear, exit strategies were typically not contemplated for fear of harming the credibility of the commitment.

A third important question concerns the necessity to put constraints on other policies, in particular fiscal policy. It is generally accepted that in RCAs uncoordinated fiscal policies may have adverse spillover effects. For example, overexpansionary deficits that lead to unsustainable debt accumulation in one country can lead to higher interest rates or exchange rate overvaluation in other members of the union. In regional currency areas, this issue has generally been addressed through procedures for regional surveillance, with the European Union's Stability and Growth Pact being a prime example. The two African CFA franc zones have instituted similar procedures, although the definition of convergence criteria and the scope for sanctions differ.

While the advisability of such mechanisms is clear, there is ample scope for discussion concerning their modalities. Issues include whether to correct fiscal deficits for cyclical conditions, whether to exclude certain categories of spending or revenue, and how to ensure the achievement of convergence, eg through the threat of sanctions. As in other policy design, there exist trade-offs between the credibility and transparency of simple and uniformly applied rules and the flexibility that accompanies discretion to allow for each country's unique circumstances.

There are a large number of legal, practical and institutional issues that are associated with the introduction of a shared regional currency or the adoption of a foreign currency. Rather than being exhaustive, the conference focused on just three broad topics. The first topic concerned the rights and responsibilities of the issuing country when another country wishes to use its currency. It was generally agreed that there was no need to seek the permission of the issuing country when using its currency, although there were practical aspects that made its cooperation desirable, such as shipping banknotes and help with prevention of counterfeiting. As described in the country papers in this volume, major currency issuers had different responses to the use of their currency. In no case did they agree to share decision-making with respect to monetary policy, however, unlike the situation of RCAs.

The second question discussed was the appropriate legal and institutional structure for regional currency areas and for countries with a currency board. Again, there did not seem to be a single model. The European case involved a rich tapestry of supranational institutions, treaties and cooperation. Other currency areas were less advanced in this respect. Most felt that the timetable for monetary union needed to allow for extensive collaboration on monetary and other matters and for durable convergence of their economies.

As for currency boards, they differed in the extent to which their operations were specified either in the country's constitution or in its laws. The more constrained and difficult to change, presumably the more credible would be the currency board. In some economies, nevertheless, important changes could be made directly by the monetary authority.

Another legal issue in this area was the importance of legal tender legislation in ensuring the use of the domestic currency. It was pointed out that such legislation applied to just a small proportion of actual payments, since most of them were no longer made in notes and coin, but instead involved a transfer of bank deposits. In practice, currency boards often perversely encouraged the denomination of assets and liabilities in the foreign currency, and this could produce disastrous results for the financial system if the peg were abandoned.

The third major legal and practical area discussed was the payment system. A country using another country's currency would ultimately need access to that currency's payment system. Although there was an example of a system for clearing dollar payments outside the United States (in Hong Kong), if payments did not completely net out, access to the US clearing would be necessary. This could lead to problems of finality of settlement if the United States had embargoed the country initiating the payment.

In addition to the paper provided by the BIS, which is largely summarised in the discussion above, the volume also includes the following papers, prepared by officials at national and regional institutions, which are grouped together geographically.

The paper by Strauss-Kahn emphasises that monetary union in Europe was pursued not in isolation, but as part of a much broader process of regional integration with a number of dimensions. This experience suggests that other regions may need also to invest in building institutions, regional cooperation and surveillance, and achieve a measure of convergence before proceeding to the ultimate step of monetary union.

The next set of papers concerns the situation of European countries that are close to, or at least are aiming for, EU accession. Accession countries have had a variety of exchange rate regimes over the past decade and, moreover, these have evolved over time. The papers refer to Bosnia and Herzegovina, Bulgaria, Croatia and Malta; the first two of these countries currently peg to the euro via a currency board arrangement, Croatia keeps its currency fairly stable against the euro using a quasi-currency board and Malta pegs to a basket of currencies with a heavy euro weight. These arrangements are consistent with the requirements of the ERM II as long as fluctuations against the euro remain within 15% of a central parity. Given extensive unoffical use of the euro in these economies, the outright adoption of the euro might appear to be an attractive option, for instance in Croatia, but this would not be consistent with the market test required for EMU membership.

The countries of the Gulf Cooperation Council have undertaken an ambitious project for regional integration, described in the papers by Al-Bassam, Al Falasi, Al-Jasser and Al-Hamidy, and Al-Thani. A customs union and a common peg to the US dollar have been established in 2003, leading to a full monetary union and common currency in 2010. The countries of the region view the project as making a significant contribution to lowering transaction costs and stimulating regional non-oil trade, financial integration, and the credibility of macroeconomic policies.

The Common Monetary Area - or former rand zone based around South Africa - is an interesting case, since it has been in operation since the early years of the 20th century. The papers prepared by Foulo, Masalila and Motshidisi, and van Zyl give interesting perspectives on that experience. Although it involves the use of the rand by some neighbouring countries (Botswana no longer participates) rather than a more symmetric RCA arrangement, it is based on a treaty that provides for sharing of seigniorage by South Africa. Countries differ in the extent to which they give legal tender status to the rand (Lesotho does so, but Swaziland does not).

West Africa has a project to create a second monetary zone to complement the existing West African CFA franc zone, and to merge the two subsequently. The papers by Ebi and Ojo give details of that project, which involves a brief preparatory stage with an exchange rate mechanism for the participating countries limiting the fluctuations of their currencies against the US dollar. The timetable had aimed at establishing monetary union among the countries of the second monetary zone during 2003 but the Ojo paper details some of the problems member countries have had in achieving convergence, which is to be a precondition for proceeding.

The final paper, by Howard, notes that the United States does not discourage other countries from adopting the dollar as their currency. The United States is willing to assist in addressing some of the practical problems. However, the US authorities will not extend lender of last resort facilities or bank supervision to other countries using its currency, nor take into account their economic conditions when setting monetary policy.