C Unofficial euroisation in CESEE countries

By Katalin Polgar and Li Savelin

Currency substitution is a widespread phenomenon in emerging and developing economies, whereby a foreign entity's currency replaces the local legal tender in some of the main functions of money (most prominently as a store of value, but also as a medium of exchange and even as a unit of account). The euro is used for this purpose in some central, eastern and south-eastern European countries, particularly in the Western Balkans. Unofficial euroisation is a salient feature of the banking systems in most EU candidate and potential candidate countries, in particular Albania, Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia and Serbia.[62] It is also present in Turkey, but with a lower degree of currency substitution, and, because the US dollar also plays a role, unofficial euroisation is much less prominent there.

This section, the third special feature, briefly reviews the driving factors behind this phenomenon in these countries, its main drawbacks as well as measures taken to address these, and progress in strengthening the use of local currencies. The special feature shows that unofficial euroisation of loans and deposits is determined by a host of factors, such as confidence in the domestic currency, trade relations with the euro area and remittances. Because unofficial euroisation may give rise to financial stability risks and constrain the effectiveness of monetary policy decisions, several countries in the region have introduced measures to encourage the use of local currencies. The special feature shows that there are tentative signs that local currency use is progressing in the countries concerned, albeit slowly and largely restricted to loans.[63]

Drivers of unofficial euroisation and related risks

An important factor in unofficial euroisation is often the lack of confidence in the domestic currency. Memories of macroeconomic instability in the not-so-distant past, such as periods of high or even hyperinflation (see **Chart 31**), or substantial depreciation of the local currency implying a major loss in the value of savings (see **Chart 32**), mostly coupled with a very short and/or poor track record of monetary policy and the general institutional environment, reduce confidence in the domestic currency. This low confidence in turn prompts economic agents to use the currency of a foreign entity for the various functions of money, in parallel to (and often dominating) the domestic currency.

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62 Being officially euroised entities with an EU candidate or potential candidate status, Montenegro and Kosovo (this designation is without prejudice to positions on status, and is in line with UNSCR 1244/1999 and the International Court of Justice's Advisory Opinion on Kosovo's declaration of independence) are not discussed here.

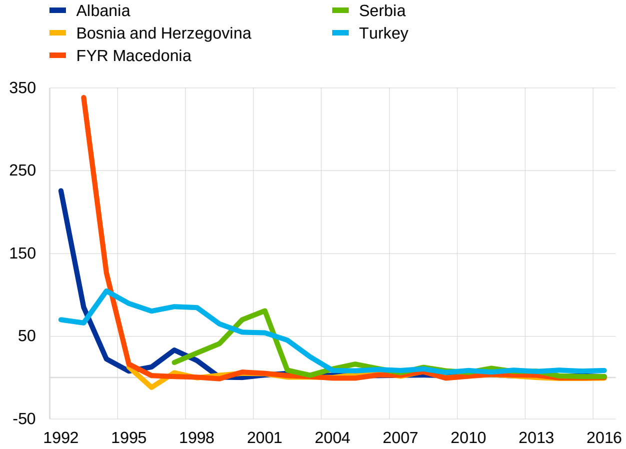
63 On related issues, see also Box 6 on the use of euro cash in the region as well as Beckmann, E. (2017), "How does foreign currency debt relief affect households' loan demand? Evidence from the OeNB Euro Survey in CESEE", *Focus on European Economic Integration*, 1, pp. 8-32.

Chart 31

Confidence in the domestic currency lowered by memories of high inflation…

CPI inflation

(year-on-year changes, 1992-2016)



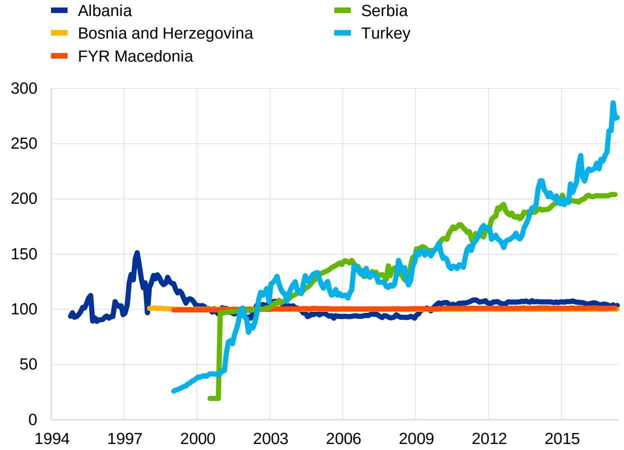
Sources: IMF World Economic Outlook and ECB staff calculations.

Chart 32

…as well as substantial depreciation of the local currency

Exchange rates

(national currency to the euro: average 2002 = 100)



Sources: Haver Analytics, national authorities, Thomson Reuters and ECB staff calculations.

Low confidence and high uncertainty are also reflected in a higher risk premium associated with the domestic currency. The factors listed above give rise to higher country risk and thus a higher risk premium priced in for domestic currency assets and liabilities. As a result, interest rates are higher in the countries concerned than in advanced economies, providing an incentive to seek funding in foreign currency. The high share of banks' liabilities denominated in foreign currency in turn provides a stable source of funding, and an incentive to hedge on the asset side, thus affecting lending as well. The difference between foreign exchange and domestic lending rates is thus supportive of foreign currency-denominated or indexed lending, although the spread has declined in most countries, especially in Serbia (from 11 percentage points in 2013 to 5 percentage points in 2016, which remains the highest in the Western Balkans). In Turkey, the spread increased during the same period, and, at 11 percentage points in 2016, continues to be wide.

Strong integration via trade, migration, remittances and financial channels also supports the role of the euro in prospective EU countries. Trade integration is aided by several factors, including geographical proximity, historical ties and the European Union's Stabilisation and Association Process that inter alia aims to reduce trade barriers between the European Union and its partners. Trade with the euro area constitutes on average 51% of total merchandise trade in the four Western Balkan economies discussed here, while it is lower in Turkey at 29% (2015 figures). In addition, labour migration to the euro area is driven by persistently high unemployment rates in many EU candidate and potential candidate countries, which make remittances (mostly denominated in euro) an important source of income in the region. Financial channels such as high foreign bank ownership also reinforce integration with the European Union, in particular in the four Western Balkan countries under review. This is evidenced by the high share of banking sector assets controlled by euro area-headquartered entities in these countries, which was 61% on average in 2016.

Unofficial euroisation is a financial stability risk in the event of sudden and substantial exchange rate fluctuations and limits monetary policy's room for manoeuvre. From the perspective of financial stability, unofficial euroisation, in particular the high share of foreign currency lending, constitutes a risk. In the event of exchange rate depreciation, unhedged borrowers will find it difficult to repay their loans denominated in or indexed to foreign currencies, implying that borrowers' exchange rate risk translates into a credit risk for banks. Monetary policy frameworks have mitigated such risk by providing nominal exchange rate stability (in the former Yugoslav Republic of Macedonia) or even by adopting a currency board arrangement (in Bosnia and Herzegovina). However, widespread loan euroisation still constrains policy choices and limits the degree of freedom for monetary policy. This holds true even in the case of inflation-targeting frameworks (in Albania and Serbia), where exchange rate flexibility remains relatively limited, as financial stability risks may materialise in the case of strong downward nominal exchange rate adjustments when major shocks occur. Furthermore, euroisation impedes the transmission of monetary policy impulses and thus limits its effectiveness.

Recent trends and progress in strengthening the use of local currencies

Most EU candidate and potential candidate countries have recognised the risks and constraints related to a high degree of unofficial euroisation, and are making efforts to promote the use of the local currency. This is a long-term challenge and progress crucially hinges upon preserving macroeconomic and financial stability for a prolonged period of time. While this is a necessary condition, it may not be sufficient, as suggested by similar experiences in other regions.[64] Macroeconomic stability can be complemented by other (primarily prudential) measures as well as the development of local capital markets, embedded in a carefully designed concerted strategy involving all relevant stakeholders.[65] In its interactions with the EU candidate and potential candidate countries as part of the pre-accession EU surveillance process, the ECB recommends the adoption of such strategies. This reflects the aforementioned specific risks and drawbacks of the high degree of unofficial euroisation in this group of countries and the need for sustainable convergence with the European Union. It does not entail a deviation from the neutral stance as regards the international role of the euro, even though recommending de-euroisation may entail a reduction in the international role of the euro in the region.

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[64] See Windischbauer, U. (2016), "Strengthening the role of local currencies in EU candidate and potential candidate countries", *Occasional Paper Series*, No 170, ECB, April.

[65] G20 leaders have welcomed the actions undertaken by international financial organisations to support the development of local currency bond markets, including intensifying efforts to support low-income countries (see G20 Leaders' Communiqué at the Hangzhou Summit, 4-5 September 2016).

Some countries have already adopted or are considering adopting comprehensive strategies aiming to promote the use of the local currency, and others are also applying measures of which this is a desired (side-)effect. Authorities in Serbia adopted a "dinarisation" strategy in 2012, in which both the central bank and the government committed to a macroeconomic environment supporting the use of the local currency. In Albania, a similar strategy is currently being developed. Prudential measures applied either in these strategies or elsewhere generally include lower reserve requirements for domestic currency liabilities compared with foreign exchange liabilities, more favourable remuneration of reserve requirements in local currencies than in foreign currencies, banning of foreign currency loans not denominated in euro, mandatory down-payments for foreign currency loans, loan-to-value limits applied exclusively for foreign currency-denominated mortgage loans, higher risk weights for foreign currency lending to unhedged borrowers and creating incentives for banks to attract domestic currency deposits. Moreover, as part of Serbia's "dinarisation" strategy, the government aims to issue dinar-denominated debt and applies preferential tax and subsidy policies. Prudential measures are also accompanied by efforts to develop primary and secondary bond markets for local currency securities, and by educational activities which aim to increase awareness both of the risks involved and of hedging possibilities.

As a result, there are encouraging signs of progress in de-euroisation in the countries concerned, although this progress remains slow and is largely concentrated on the lending side. Foreign exchange-denominated and indexed lending as a share of total loans has declined in the last few years in all four Western Balkan countries concerned (see **Chart 33**).[66] In 2013, for instance, this share ranged between 52% (in the former Yugoslav Republic of Macedonia) and 73% (in Serbia), but in 2016 the range for these same countries was 45% to 69%. In these countries, foreign exchange loans are predominantly denominated in euro, and, accordingly, the share of euro-denominated loans was lower in 2016 than in 2013 in all of the countries concerned. The compression of the spreads between foreign exchange and domestic lending rates also contributed to this fall. Notwithstanding this trend, the share of euro lending in total lending remains high in the four countries concerned (on average 53% at end-2016). Lending to the corporate sector remains in most cases the main driver of loan euroisation, which may limit vulnerabilities to financial stability because hedging against exchange rate risks and a higher share of income in foreign currencies is presumably more frequent among corporations than households. In Turkey, the whole foreign currency loan portfolio is from the corporate sector, due to regulatory provisions prohibiting foreign exchange borrowing by households.

Progress on the deposit side remains so far more limited or absent. On average, in the four Western Balkan countries concerned, foreign currency-denominated or indexed deposits as a share of total deposits declined by about

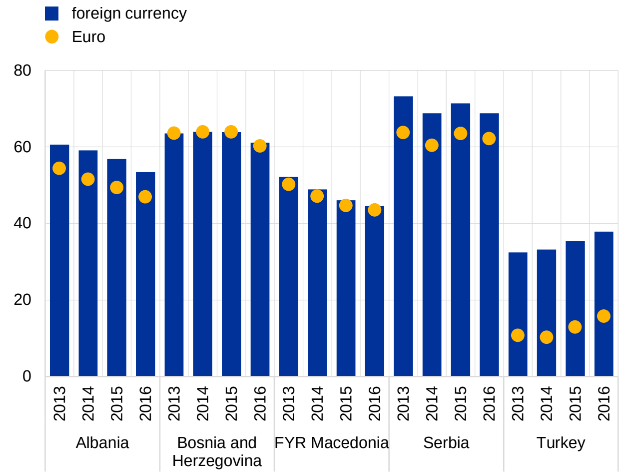
66 In Turkey, foreign currency-denominated or indexed loans as a share of total loans increased during the same period, but remain below the shares of other prospective EU countries analysed here. Moreover, due to the greater role of the US dollar, euro-denominated lending as a share of total lending was only 16% in 2016.

3 percentage points to 50% between 2013 and end-2016, mainly driven by Serbia (see **Chart 34**). From the point of view of the banks, ample foreign currency deposits mitigate their exposure to direct exchange rate risks. However, they also provide a stable source of funding for foreign currency lending, which suggests that strengthening the use of local currency is not possible without significantly reducing the incentives to save in foreign currency.

Chart 33

Foreign exchange-denominated and indexed lending as a share of total loans has declined

Foreign currency loans (outright or indexed) as percentage of total loans

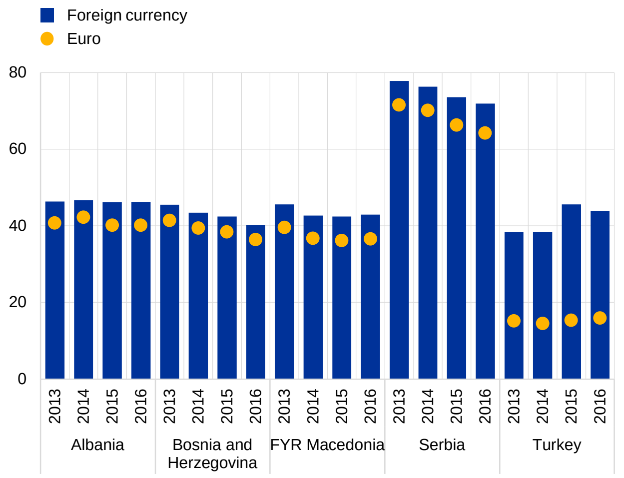


Sources: Haver Analytics, national central banks and ECB staff calculations.
Notes: Foreign currency-denominated and foreign currency-indexed lending to households and non-financial corporations (private and public). Lending to total economy in the case of Bosnia and Herzegovina due to lack of data.

Chart 34

Progress on the deposit side remains so far more limited or absent

Foreign currency deposits (outright or indexed) as percentage of total deposits



Sources: Haver Analytics, national authorities and ECB staff calculations.

Notes: Foreign currency-denominated and foreign currency-indexed deposits from households and non-financial corporations (private and public). Deposits from total economy in the case of Bosnia and Herzegovina and time deposits for Albania due to lack of data

Looking ahead, successful strategies will have to build on the support of all relevant stakeholders. In addition to preserving or achieving macroeconomic stability, emphasis will need to be placed on developing local capital markets while including measures targeting the deposit side as well. The development of local capital markets is an important prerequisite to support the use of the local currency. Issuance of debt in the local currency is an important part of this, coupled with the development of primary and secondary bond markets.[67] For a successful reduction of foreign currency lending, it is also necessary to reduce the share of foreign exchange-denominated deposits. This is an area in which progress has so far remained more limited. Measures targeting deposits, therefore, such as differentiated reserve requirements, should also be applied as part of a strategy to strengthen the use of local currencies. In addition, it is important to raise public awareness of exchange rate risks as part of educational efforts related to this strategy.

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67 Limited economic size and small local investor and issuer bases are likely to hamper the development of deep and liquid local currency bond markets in the region, however.