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EXCHANGE RATE POLICY AND INTEREST RATES IN SMALL AND OPEN ECONOMIES – SOME EVIDENCE FROM EUROPE

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Exchange Rate Policy and Interest Rates in Small Open Economies - Some Evidence from Europe

1. What theory says?

One of the recurrent issues in the international economics is the choice of an exchange rate regime. It pertains both to the academia and to policy makers, with the latter being permanently challenged to make a choice on a sound basis, i.e. a choice, which is best suited to the needs of the economy. The literature on exchange rate regimes is quite reach and enduring. Seminal papers of Mundell (1961), McKinnon (1963), and Kenen (1969) sought to show that the choice of an exchange-rate regime depends on the features of the economy. In other words, there is no right, or wrong exchange rate policy. According to Frankel (2003) not a single regime is right for all countries, and not a single regime is right for a country for all times.

Very often, the actual economic episodes are an important guideline for revisiting the theoretical underpinnings of the choice of an exchange rate regime and the "recipes" offered to countries in this regard. The International Monetary Fund, which is safeguarding the international monetary stability, is a permanent reviewer in the area of choosing the exchange rate regime. Until the burst of the global crisis, it provided **three major analytical reviews in this area** which were supposed to shed some more light on the issue.

The first one was in 1999 (Mussa and others, 2000), and came after several episodes of capital account crisis and collapses of exchange rate pegs. These episodes resulted in the well-known **bipolar view** - either adoption of a "hard peg" or a pure floating exchange rate, without any role for the intermediate options. The view was momentary; it ended with the collapse of the Argentinian currency board in 2002, and was followed by a new "formula" in 2003 (Rogoff and others, 2004). As pegs were considered vulnerable and prone to crisis, the mainstream solution was to go for **flexible rates**. In practice, it was a rare case, meaning that except for a few major economies, free floaters do intervened on the foreign exchange market to prevent free float of the exchange rate. Almost none central bank was indifferent to the value of its currency. In fact, this practice opened a room for a new concept - the "fear of floating". As argued in Calvo and Reinhart (2002), the fear arises from the facts that depreciation has a high pass-through to inflation, adverse balance sheet effects and loss of policy credibility.

This mismatch between what the literature was suggesting and what the actual policy was, yielded into a third, and the most comprehensive review on exchange rate practices in 2009 (Ghosh, Ostry and Tsangarides, 2011). It used *de jure* and *de facto* classification of the exchange rates and assessed the impact of exchange rate on the macroeconomy (monetary and fiscal policy, inflation, output growth and volatility, cross border trade and capital flows, crisis susceptibility and external adjustment). The study pinpointed the merits of peg exchange rate regimes - anchoring inflation expectations and enhancing trade links. In general it went in line with the commonly stated advantages in the literature in favor of hard pegs - increase of policy credibility, higher fiscal discipline, higher propensity for implementation of the structural reforms, relatively easy to operationally implement,

transparent and relatively easy target to be understood and verified by the public (Angelovska-Bezoska, 2015). Also, when it comes to developing country with high currency substitution the need for a stable exchange rate becomes even more apparent as high currency substitution tends to increase the exchange rate volatility (Berg and Borensztein, 2000). But, the IMF study also revealed some disadvantages of fixed exchange rate regimes. It constrains the use of other macroeconomic policies (interest rate parity condition is a constraint on the monetary policy, which usually leads to higher interest rates and less autonomy in fiscal policy, sometimes precluding room for countercyclical response to shocks), the susceptibility to crisis was higher and the room for "quick" fix of the external sector was narrower. Thus, the study can be interpreted as a deviation from the mainstream solution of flexible exchange rates, emphasizing that the proper regime will depend on many country specific features.

Free-floating exchange rate regime is taught to offer more discretion to monetary policy, which is in full control of monetary aggregates. Exchange rate can serve as a shock absorber and lead to lower interest rates in the economy, thus stimulating aggregate demand. The negatives are that in the absence of stable institutions and credible policies it can lead to loose fiscal policy, high public debts and high inflation.

If it is to sum up, there are important trade-offs in the choice of exchange rate regimes. However, at the end of the day, whether a country can utilize the positives of the chosen regime is conditioned on the health of its economic fundamentals and the soundness of its policies. Hence, in essence the exchange rate regime in small open economies is of secondary importance behind the fundamentals, macroeconomic policies and structural reforms. Actually, it does not matter what the exchange rate policy is, as long as the country has disciplined fiscal policy, flexible labor market, business friendly environment, efficient public institutions, innovative and vibrant private sector. Such environment would keep economy competitive, imbalances low and confidence in domestic economy high. In the absence of structural reforms a floating exchange rate economy would have to adjust its exchange rate through depreciation. That would always be a second best solution. The consequence would be high inflation, macroeconomic imbalances, uncertainty and unpredictability, and eventually high interest rates. On the other hand, lack of structural reforms in a fixed exchange rate economy would lead to higher interest rates and limit the growth prospects through this channel.

Small economies without a track record of structural reforms as defined above would benefit from borrowing credibility from a nominal anchor economy. But in order to maintain credibility they would have to embark on structural reforms. Fisher (2001, p.15) analyzing countries with currency pegs states: "For such a country, the emphasis then has to be on internal labor and capital mobility, and wage and price flexibility. Fiscal policy can play a counter-cyclical role provided the fiscal situation is strong enough in normal times…Such policies are of course desirable in any economy, but the need for them is greater if the exchange rate is not available as a tool of adjustment."

The basic precondition when choosing an anchor currency is to be in the optimal currency area (OCA) with that economy. The traditional criteria for OCA are openness, labor mobility, fiscal cushions, symmetry and political willingness to accept neighbors' policies. Frankel adds additional criteria, such as the need to import monetary stability, the desire for further close integration with an anchor country, the extent to which the foreign currency is

already used, access to an adequate level of reserves, rule of law and a strong, well supervised and regulated financial system.

To illustrate the main thesis, two different groups of small open economies are compared. The first group contains Austria, Netherlands and Denmark. They had anchored their monetary policies on Germany even before the Exchange Rate Mechanism (ERM) and later successfully continued in ERM 2 and eventually in the EMU (apart from Denmark, which choose to stay in ERM 2). The second group consists of Spain, Italy, Greece and Portugal. They had a history of adjustments through devaluations before and during the ERM, eventually entered the EMU but came into troubles when challenged by the world financial crisis.

A brief description of the main characteristics and challenges of the Macedonian model of exchange rate peg to DM/EUR is also provided.

The note concludes with the main messages drawn from the comparison of the two groups of EU economies.

2. EU Economies that choose Germany as an anchor

Austria

Since May 1953 till the end of the Breton woods system, Austria maintained exchange rate peg to the US $. In the seventies, it experimented with a peg to a basket of currencies and the "snake"[2] policy. Its relatively autonomous monetary policy coupled with the first oil shock led to plunge in the current account deficit in 1977. Eventually, after the second oil shock in 1979, it pegged its currency to the German Mark (DM). After few minor adjustments, Austrian schilling remained virtually unchanged since 1981 until the introduction of euro. There was broad consensus in the Austrian society regarding exchange rate peg to the DM. On the challenges posed by the real shocks and structural problems in the early 80's, it responded with social consensus, real wages moderation, layoffs in the inefficient nationalized industry and fiscal consolidation. These policies remained their trademark ever since.

Netherlands

After the collapse of Bretton woods system, the Netherlands followed the "snake" policy and later entered the ERM 1. It decided to peg to the DM because of the strong integration to the German economy, which accounted to 30% of the total Dutch external trade. Economic cycles of the two economies were closely synchronized. Almost 90% of the cyclical changes in the German economy were transmitted to the Dutch economy with very short time lag. Pegging to the DM, the central bank has borrowed the credibility of the Deutsche Bundesbank. Interest rate policy was subordinated to the exchange rate peg and gradually converged to the German interest rates. In 1993, when the fluctuation band of ERM was widened to 15%, the Netherlands concluded a bilateral agreement with Germany

[2]The "currency snake" was the first attempt of European monetary cooperation in the 1970s, aiming to limit fluctuations between different European currencies. It was an attempt to create a single currency band for the European Economic Community (EEC), essentially pegging all the EEC currencies to one another.

committing to +-2.25% fluctuation band. In reality, in the whole period from 1983 until the introduction of euro, the Dutch gulden never fluctuated more than +- 0.5%.

Denmark

After the "snake" exchange rate policy in the seventies and entrance into ERM 1 in 1979, Denmark started the eighties with high inflation, unemployment and budget deficit. Its bonds' yields were exceeding 20%. Policy rate was double digit. In such situation, Danish policy makers decided to abandon the policy of adjustments through currency devaluation. Interest policy was put in the function of the exchange rate peg. Danish interest rate followed German interest rates adjusted for appropriate risk premium. Backed by the structural reforms in the Danish economy, interest rate policy succeeded to maintain stable exchange rate of Danish krone to the DM and later EUR since 1987 until today. Today there is a broad consensus regarding the exchange rate peg policy.

3. EU economies that used adjustment through the exchange rate

Greece

The period when the Greek drachma was pegged to the US dollar, known as the "golden era" of the drachma, represented one of the longest period of economic growth and monetary stability of Greece. After the collapse of the Bretton Woods system, the drachma uncoupled from the US dollar and floated against a basket of currencies which led to a policy of rapid sliding against the major currencies, soaring inflation and poor GDP growth. Although it became a member of EEC in 1981, Greece did not seek participation in the European Monetary System. In the middle of 1989, the Bank of Greece began to implement the "hard drachma" policy, by which the drachma was allowed to depreciate relative to the ECU by less than the full inflation differential. This policy had at its center both fiscal consolidation and an exchange rate peg. The Convergence Program allowed for a smoother and gradual fiscal and structural adjustment of the Greek economy. In the beginning of 1999, the drachma joined ERM 2 with a standard fluctuation band of ±15%. Greece adopted the euro in 2001.

Spain

From 1959, Spain was part of the Bretton Woods System, pegging to the U.S. dollar. In the period of European monetary integration processes, Spanish Central Bank had objectives to reduce inflation to German level and to stabilize the exchange rate. The challenge was to reconcile these aims with a rapidly changing economy affected in particular by trade, financial and capital account liberalizations. A specific problem was the presence of significant capital inflows in the late 1980s caused by two main factors: various reforms, EU membership in 1986 and tight monetary policy with high interest rates. Spain entered ERM in 1989. Although inflation and interest differential with Germany were declining, EMS crisis and other turbulences in the foreign exchange markets lead to four formal devaluations of peseta against DM. In August 1993, the ERM margin was expanded to 15% to accommodate speculation against few EU currencies including Spanish peseta. The peseta was replaced by the euro in 2002, following the establishment of the euro in 1999.

Italy

Until 1971, the monetary strategy in Italy was constrained by the Bretton Woods fixed exchange rate regime. After abandonment of Bretton Woods system, in a short period Italy implemented a dollar standard (Smithsonian agreements) and attempted to link the European currencies (Currency Snake). Afterwards, Italy introduced a fixed exchange rate for current account transactions and a flexible rate for financial transactions. In 1973, the fixed rate for current account transaction was abolished and Italy had a flexible exchange rate until 1979, when it joined the ERM with a broad band of +/-6%. In January 1990, Italy entered the narrow band (± 2.25 per cent) of the EMS. This period was characterized by a strong commitment to maintain the exchange rate fixed. The reserves followed a decreasing trend from the second half of 1990 that culminated in September 1992 with a devaluation and temporary suspension of the lira's participation in the ERM. Then it switched to a managed float. From 1996, lira was again pegged *de facto* and *de jure* to the Deutsche Mark. In 1999, Italy adopted the euro.

Portugal

In 1949, Portuguese escudo pegged firmly to the dollar until the declaration of its inconvertibility. After the "snake" exchange rate policy (1973-1975), there was a first experiment of gradual devaluation against a currency basket. After two significant devaluations in 1977 (10% and 25%), a scheme of crawling peg was adopted to ensure permanent support to competitiveness. In 1992, the Portuguese escudo was integrated in the exchange rate mechanism of the ERM. The fluctuation band was enlarged to ± 15% in 1993. From 1999 onwards, the Portuguese monetary unit ceased to exist legally, as a consequence of the integration of Portugal into the euro zone.

4. Which group performed better?

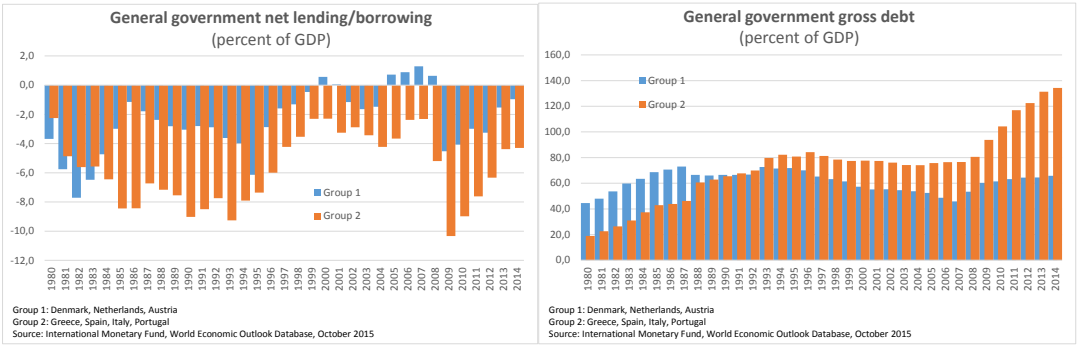
Although the assessment of the performances of countries under the scrutiny requires tools that are more formal, yet even a simple visual inspection of data in a longer time span might reveal some notable differences. All of the countries in the sample, with few minor exemptions, entered the ERM from the very beginning in 1979. Yet some of them were continuously running in the fixed exchange rate mode, while some of them allowed for some flexibility in certain periods. Therefore, it is interesting to see policies and economic outcomes of the two groups of economies. Those who anchored their exchange rate policies to Germany will be named "group 1" and those who relied on exchange rate adjustment will be named "group 2".

The behavior of the fiscal policy is an important layer, where a difference might be seen when comparing countries with fixed and with more flexible exchange rate regimes. The first one usually runs a more prudent policy, and keeps a track record of "acceptable" public debt levels. Data comparison more or less confirms this notion. Group 1 economies entered the ERM with higher fiscal imbalances and twice-bigger public debt levels than the group 2 economies. Yet, they immediately embarked on consolidation of their public finances. Since mid-eighties, their budget deficit has continuously been below the 3% threshold with few exceptions in the recession years. Consequently, they have maintained public debt level below 60% threshold. During the peak of the cycle before the global financial crisis (GFC) in 2008, they run countercyclical fiscal policies, thus reducing public debt to around 40% of GDP. Such prudent policies opened space for countercyclical fiscal policies during the recession following GFC. Budget deficit rose at the beginning, but started to decline and

stabilized to around 1% of GDP in 2014. A rise in public debt was also seen, but on average, it did not go much above the accepted threshold of 60% of GDP.

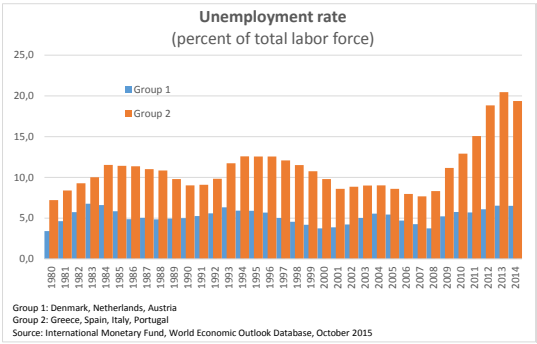
Group 2 economies entered ERM 1 with lower fiscal imbalances. However, lack of fiscal discipline led to rising budget deficits in the next 15 years quadrupling the public debt to 80% of GDP. Few years before the introduction of euro, they reduced budget deficits below the threshold of 3% of GDP to satisfy entry criteria. Loose fiscal policies quickly returned after their euro zone entry when they were breaching the threshold even during the peak of the economic cycle. After the GFC, their fiscal imbalances soared to unsustainable levels. Budget deficits rose sharply, leading to a severe rise in public debt as well. In fact, half of the increase in public debt level in these countries in the period 1980-2014, occurred exactly in the last seven years of lingering global crisis.

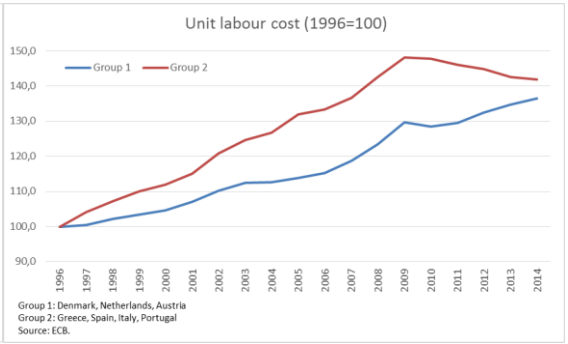
Chart 1



The path of unemployment rate shows the different labour market policies of the two groups of economies. At the beginning of ERM, both groups had low unemployment rate. Flexible labour market policies conducted by the group 1 maintained the unemployment rate stable at around 5%, with minor fluctuations depending on the economic cycle. After rising above 10% in the group 2, the unemployment rate has remained stubborn at that level up to the GFC, when it soared above 20%. The gap between the unemployment rates of the two groups of countries has been negative for the whole period in focus. On average, the unemployment in the first group is lower by close to 6 pp, but the gap got wider on the backdrop of the crisis, reaching close to 10 pp in the last seven years. This pattern was probably expected as the growth deterioration was more pronounced in the second group of countries, and hence the larger slack on the labour market occurred. Yet it is also an indication of labour market rigidities and past labour policies, which had to be corrected with the burst of the crisis, thus resulting in major unemployment increase. Some evidence on labour market inefficiencies is offered by the unit labour cost data, as well. Unit labour costs were on a rising track in both groups, with faster growth in the second one, contributing to a widening gap between the two. This pattern showed that in both groups of countries, the rise in wages was not in line with the productivity growth, a trend more pronounced in the second group, signalling larger problems on the labour market and erosion of competitiveness.

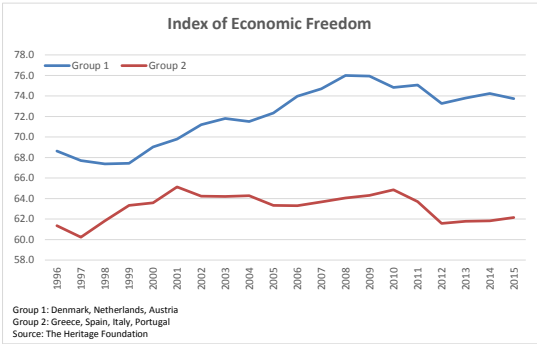
Chart 2

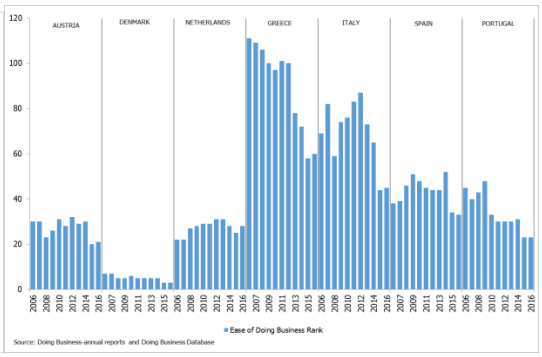




Reforming the structure of the economy, making it more flexible and diversified, and hence more growth conducive and less vulnerable, should be a corner stone of the economic policies in all the economies, regardless of the chosen exchange rate. How well an economy performs in this respect is difficult to be gauged, as structural reforms are quite comprehensive concept. Yet, we can use certain indicators, which can give us a flavor on the differences among the countries. In this respect, business friendly environment is without doubts important feature of structural reforms. As a relative measure of it, the World Bank's Doing Business ranking is used. Although one could argue that it is not exhaustive in its coverage, it is the most comprehensive indicator evaluating business environment. Group 1 economies are significantly better ranked since the beginning of the publishing of this report. Only recently, some tangible improvement of the group 2 economies can be seen reflecting structural reforms that they have been undertaking within their adjustment programs after the GFC. Moreover, similar results for the two groups of economies are offered by the Global Competitiveness Index of the World Economic Forum. The Index of Economic Freedom which embodies several important segments (rule of law, fiscal freedom and government spending, regulatory efficiency and open markets), also pinpoints notable differences between the two groups of countries, with the first group outperforming the second one. It is noteworthy, however, that in the run up to the EMU entrance, there was a notable increase in the reforms in the second group of countries, after which stagnation occurred, to be followed by slight worsening amidst the recent crisis. Thus, the gap between the two groups of countries has significantly widened since 2002.

Chart 3

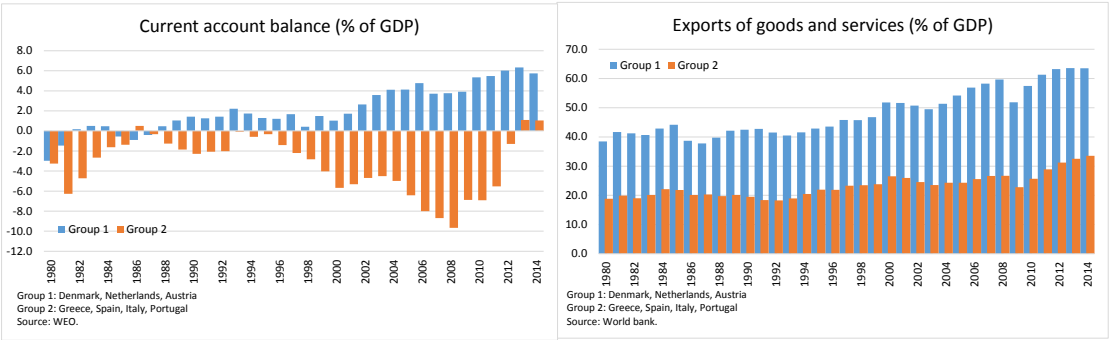




The comparison of the external sector position between the two groups is not straightforward, as both groups are at a different stage in their real convergence process. The first group is close to 30% above the average GDP in the EU-28 countries, while the second one is by about 15% below the average. Hence, the saving rate in the first one is

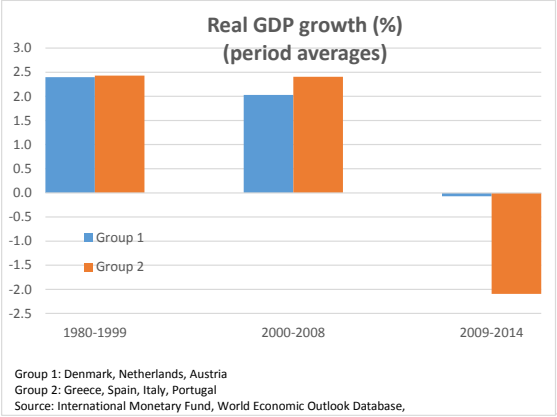
expected to be higher than in the second one, yielding into more superior performances of the current account. The data comparison shows that in general the first group of countries runs current account surpluses almost continuously. In the last couple of years, given the subdued demand, the surplus is being kept at a level twice above the historical average. The second group is constantly in a mode of current account deficit, which eroded significantly in the 2000-2008 period, on the backdrop of falling risk premium, rising capital inflows, fueled demand and hence rising external imbalances. Since the focus of the study is on the impact of the exchange rates, a logical step forward would be to see whether the first group of countries' export performances were hindered by the peg, and vice versa. Yet, contrary to common wisdom, group 1 economies had much better external sector performance than group 2 (where up till the acceptance of the EURO the countries used to some extent the exchange rate adjustment). Export as a share of GDP rose from 40% at the beginning to 60% in the last decade. On the other side, in spite of the several adjustments of the exchange rates during the ERM, group 2 economies experienced very weak export performance. Only after recent structural reforms, group 2 economies balanced their current accounts and for the first time increased export as a share of GDP to 30%. More or less the same conclusion holds when trade deficit data is observed. In the first group of countries, on average for the whole period, trade deficit was in surplus of close to 4% of GDP, while in the second group a deficit was observed, also of around 4% of GDP.

Chart 4

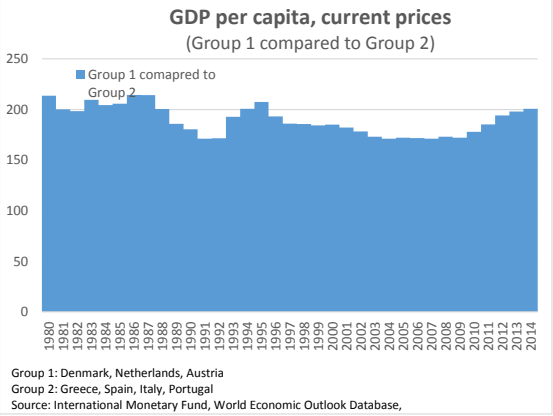


Prudent economic policies and structural reforms should eventually yield in a more vivid growth and faster real convergence. Hence, the growth and economic development level are the most common points of comparison, when overall performances among different countries are compared. By screening the level of convergence between the two groups of countries, one can conclude that the second one was always lagging behind. Albeit there were phases in which the gap was narrowing, it remained wide. Obviously, the second group of countries did not manage to achieve much faster growth compared to the first one, as to enable faster convergence. When observing the growth dynamics, two issues can be pinpointed. First, until the start of the EMU, on average, both group of countries were growing at almost the same pace – no major differences were seen, despite the difference in their exchange rate policy. Similar conclusion holds when growth performances are observed after the start of the EMU, until the burst of the global financial crisis. Second, when the crisis broke out, despite the fact that all countries were having the same exchange rate policy - monetary union (except for Denmark), the drop of the GDP, on average was more severe in the second group of countries, compared to the first group. Large pre-crisis imbalances in the fiscal and external sector and structural/competiveness challenges in the second group are good candidates to explain the different responses of the economies to shocks.

Chart 5



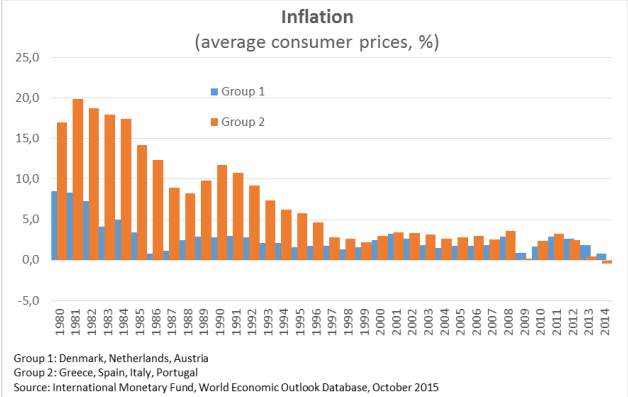
Group 1: Denmark, Netherlands, Austria
Group 2: Greece, Spain, Italy, Portugal
Source: International Monetary Fund, World Economic Outlook Database,



Group 1: Denmark, Netherlands, Austria
Group 2: Greece, Spain, Italy, Portugal
Source: International Monetary Fund, World Economic Outlook Database,

At the beginning of ERM both group of economies coped with high inflation, though the problem was much more pronounced among the group 2. Very disciplined peg to the DM supported with structural reforms quickly restored the price stability among the group 1 economies. Afterwards, inflation was not an issue for them anymore. On the other side, group 2 was troubled with high inflation up to the second half of nineties when they had to satisfy Maastricht criteria for entrance into the euro zone. In the aftermath, no major inflation pressures have been observed across the board, which is in line with the global "great moderation" of small output gaps and low inflation. Nevertheless, in the monetary union, group 2 economies continued to have by one third higher inflation than group 1. The last two years are an exception, as the slack in the second group of countries is larger, thus putting downward price pressures.

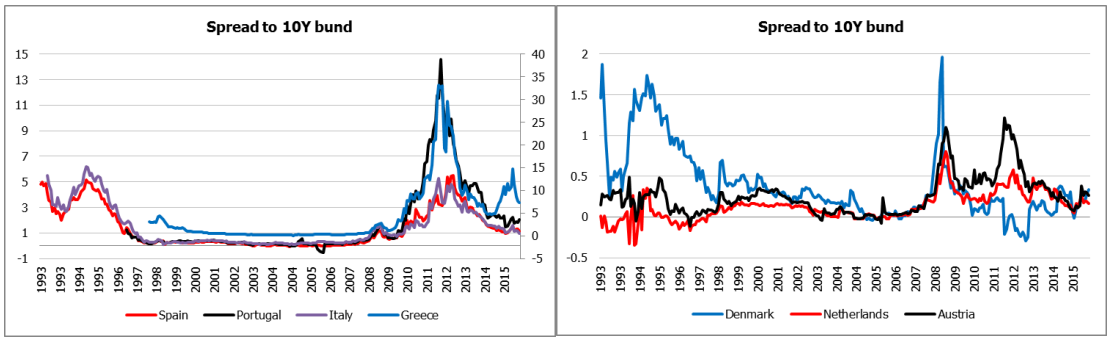
Chart 6



Group 1: Denmark, Netherlands, Austria
Group 2: Greece, Spain, Italy, Portugal
Source: International Monetary Fund, World Economic Outlook Database, October 2015

Inflation performance was mirrored in the interest rates policy. While the group 1 economies had to keep some spread to the German interest rate as a risk premium, it was within 50 b.p. for Austria and the Netherlands, and 150 b.p. for Denmark. The spread was much higher for group 2 economies as a consequence of the high inflation. Only when inflation was lowered to the German level before the introduction of euro, group 2 economies were able to converge with the interest rates. During the first decade of euro existence both groups enjoyed low spreads compared to Germany despite significant differences in export and fiscal performance. Obviously, single currency umbrella was masking the flaws of group 2 economies. GFC put under market pressure weaker group 2 economies whose interest rate spreads significantly increased.

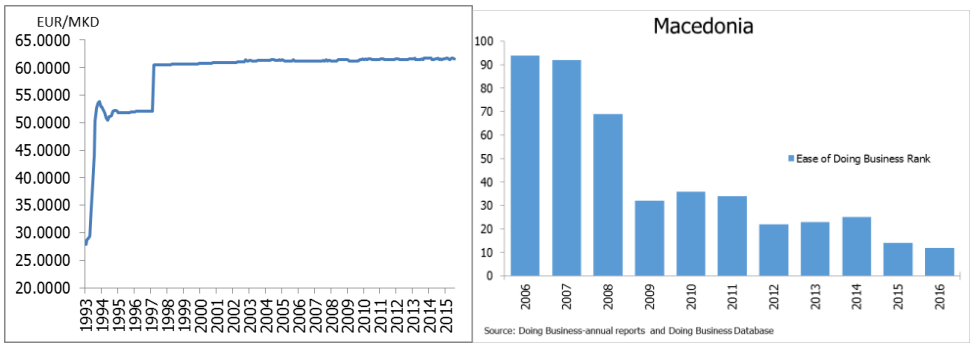
Chart 7


Spread to 10Y bund
Spain
Portugal
Italy
Greece
Spread to 10Y bund
Denmark
Netherlands
Austria

5. Case of Macedonia

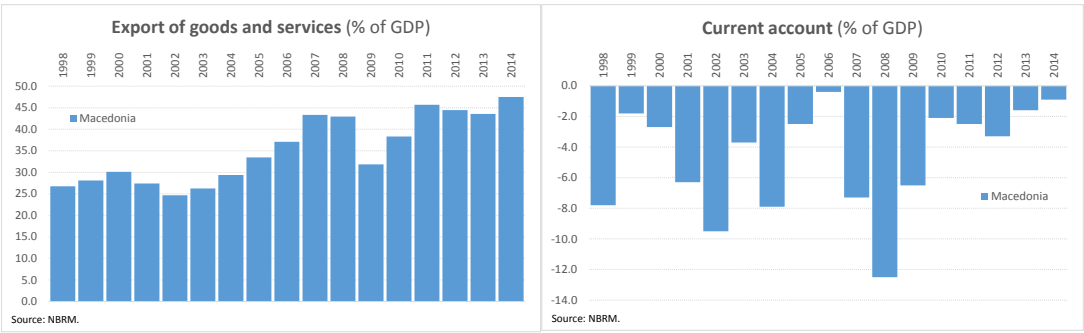
After the monetary independence in April 1992, Macedonia based its monetary policy on money supply targeting. After initial hyperinflation in 1992 and 1993, structural adjustment program supported by the IMF started in 1994. Although the inflation was decelerating, still the current monetary strategy did not have the capacity to bring it to a lower level and to anchor inflation expectations. Hence, in October 1995, policy makers decided to adopt exchange rate as an intermediate target of monetary policy. Shift in strategy was explained with several factors: unstable money demand in transition period, importance of exchange rate in a small open economy, transparency of the exchange rate as a monetary target and visibility for the economic agents. In 1997, Macedonian denar was devalued by 16% to DM. Since then the exchange rate of the denar to DM/EUR has remained unchanged.

Chart 8



When screening the economy, in general we could distinguish three periods. The first period was marked by policy-makers' efforts to stabilize the economy suffering from initial transition shocks and lasted up to 1997. The second period was the longest and lasted till the GFC. It was characterized with partial and sluggish structural reforms and weak FDI inflows. Consequently, export remained stagnant at around 30% of GDP and raised slightly above 40% on the eve of the GFC, mostly because of high commodity prices. Current account was a chronic problem. The balance was partially kept by disciplined fiscal policy with almost balanced budget. The rest had to be covered by high policy interest rate. Exchange rate was challenged in few occasions, in 2001, 2004 and 2008 and defended with large hikes in policy rate. Interest rate was fully subordinated to the exchange rate peg.

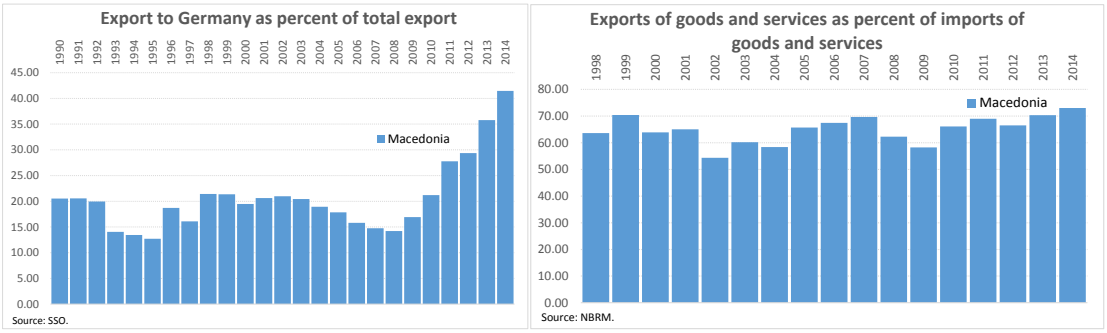
Chart 9



The third period started in 2010. It is characterized with the global slowdown and euro zone confidence crisis. In such external environment the policy makers has strengthened

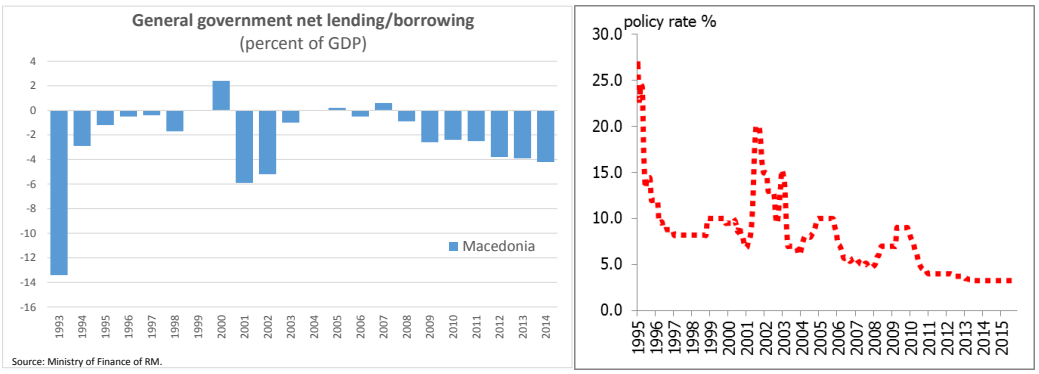
structural reforms that started shortly before GFC. They have significantly improved business environment and conducted active policies of attracting FDI in automotive industry. These policies have resulted in acceleration of FDIs in the tradable sector diversifying the structure of our economy in favor of higher value-added products. This, in turn, have led to export growth and tangible reduction of current account deficit to 2% of GDP in average. New productive capacities in automotive industry linked domestic economy to the resilient German economy which increased its share in total export from 15% in 2008 to 40% in 2014. The new industrial plants have caused decoupling of Macedonian economy from the sluggish EU growth. As a result, Macedonian economy is the second fastest growing after Poland in the period 2008-2014.

Chart 10



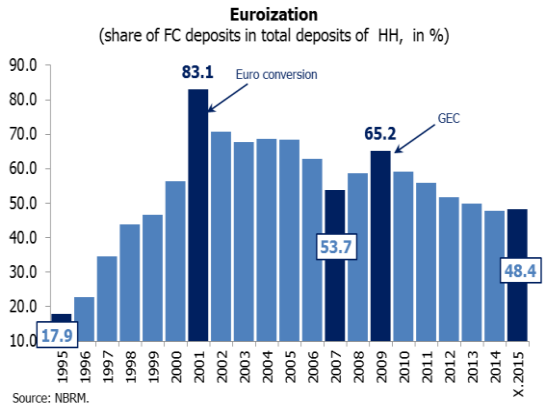
Policy makers actively used fiscal policy to compensate for the weaker private and external demand after the GFC. Budget deficit has been maintained between 3% and 4%. Nevertheless, the positives from the business environment improvement and strong external sector prevail over weaknesses of fiscal sector, thus enabling significantly lower policy interest rate compared to second period. Part of the credit goes to the international environment of low interest rates too. The policy rate has remained at the historical low of 3.25% but still far from the zero lower bound typical for the ECB. Budget consolidation would certainly contribute to lowering the spread between denar and euro interest rates.

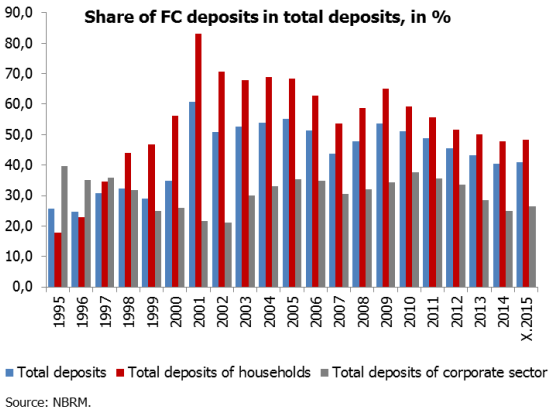
Chart 11



In the absence of significant interest rates sensitive capital inflows, the key factor for foreign currency demand is the level of euroisation. Starting from 80% in 2001, the level of euroisation has declined. The central bank is engaged in promotion of domestic currency household savings through active use of reserve requirement ratios. Above described structural policies, plus specific measures of the central bank have led to the reduction of foreign currency deposits of households to 48% of total household deposits.

Chart 12





However, the cross-country experiences suggest that progress towards de-euroisation takes time. The right policy response depends on country circumstances. In the case of Macedonia, macroeconomic stability, exchange rate peg, strong institutions, stable banking system have contributed to higher confidence in the domestic currency (Kadievska-Vojnovik, 2015). However, the legacies from past matter! We can reduce it, but probably we can never eliminate euroisation in full.

Conclusions

Structural reforms are the basic pre condition for a successful and sustainable currency peg that would be conducive to economic growth. Or, by the words of Draghi in his speech in Sintra 2015: "Structural reforms increase both potential output and the resilience of the economy to shocks. This makes structural reforms relevant for any central bank, but especially in a monetary union".

Interest rate policy in a pegged economy has to be subordinated to maintaining exchange rate peg regardless of the cycle of the economy. Fiscal policy has to maintain low budget deficits. In such monetary policy regime, interest rate is an indicator of the imbalances in the economy. Less disciplined fiscal policy - higher interest rates; weaker business environment – higher interest rates; weaker external sector – higher interest rates.

On the other side, floating exchange rate regime does not mean freedom in setting the policy interest rate. There is high pass through to inflation and at the end, interest rates will have to be raised. Transmission is different but the outcome is always the same.

Small open economies do not have big choice. Do structural reforms or fail.

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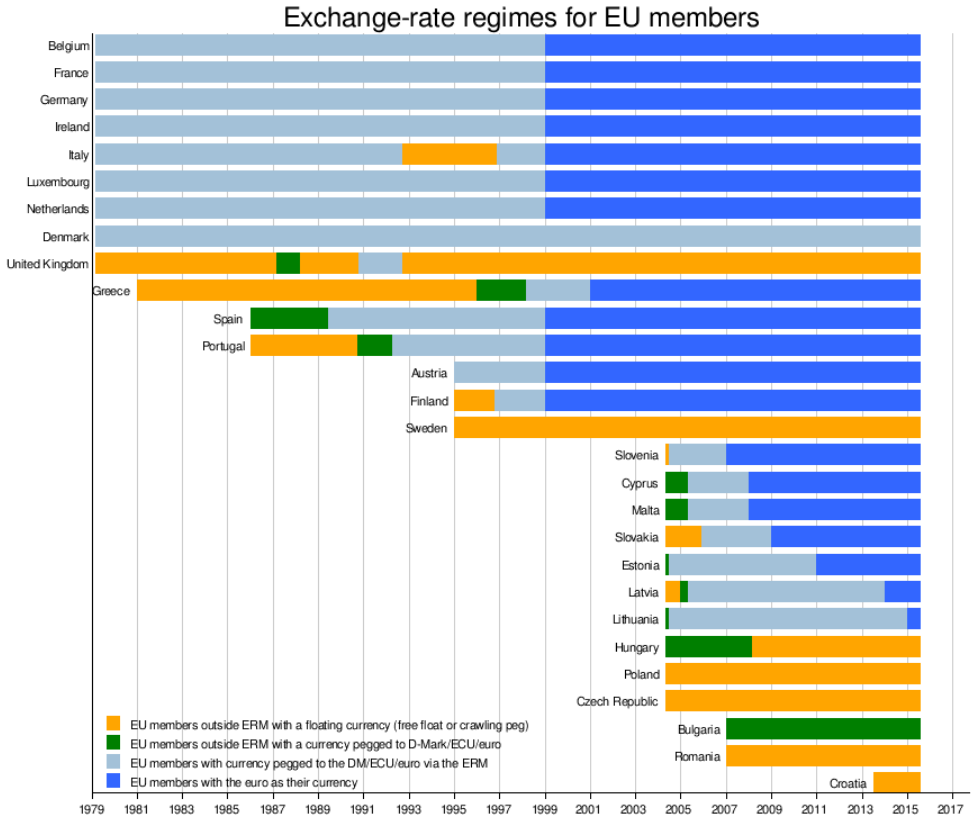
Appendix 1


Exchange-rate regimes for EU members
Belgium
France
Germany
Ireland
Italy
Luxembourg
Netherlands
Denmark
United Kingdom
Greece
Spain
Portugal
Austria
Finland
Sweden
Slovenia
Cyprus
Malta
Slovakia
Estonia
Latvia
Lithuania
Hungary
Poland
Czech Republic
Bulgaria
Romania
Croatia
EU members outside ERM with a floating currency (free float or crawling peg)
EU members outside ERM with a currency pegged to D-Mark/ECU/euro
EU members with currency pegged to the DM/ECU/euro via the ERM
EU members with the euro as their currency
1979
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2017