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THEORETICAL FOUNDATIONS OF THE DEPENDENT MONETARY REGIMES

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Abstract

The purpose of the present article is to present a comprehensive framework to analyse main characteristics and institutional forms of the dependent monetary regimes. A country's monetary regime is an extension of its geopolitical and geo-economic place in the international system. The dynamic monetary dependence/independence of a particular country is a direct continuation of, as well as 'serving', the (geo) political and economic dependence/independence of that country. That dependence does not mean that small countries do not benefit from this type of monetary and political regimes; on the contrary – in most cases it is the most appropriate, so to speak, "optimal" form which, if skilfully managed, minimises losses under a given external structural constraint. As a rule, in dependent countries, external sources of money supply dominate domestic sources. Peripheral and dependent countries cannot borrow on international markets in their own national currencies. They borrow in major world currencies and become vulnerable to currency (exchange rate) risk. The inflow of external capital, in turn, requires a corresponding stable institutional and political environment. Therefore, the external equilibrium (external stability), i.e., the state of the balance of payments and especially its financial (capital) account, as well as the dynamics of the exchange rate, become central parameters for the development of the peripheral countries. It is interesting to add that the imposition of a dependent regime in small and peripheral countries is accompanied by the imposition and dissemination of economic views, theories and ideas ("economic narrative"), which legitimise this new monetary regime and prepare the imposition of a certain economic development model.

Key words:

monetary system,
monetary regime,
dependent monetary
regimes, monetary history

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Monetary Dependence: General Perspective

For the purpose of reflecting on the subject, we will define monetary regime as a ‘set of formal rules of monetary behaviour, as well as mechanisms of their enforcement’ (Magnin and Nenovsky, 2020)¹. Within the monetary regime, two components (sub-regimes) can be distinguished – internal and external – which often conflict with each other (as we will see further below).

The first, external component (external rules) we can call ‘exchange rate regime’ (ERR). It covers the legal rules of exchange rate formation (through the market or through monetary authorities’ interventions), as well as the mechanisms of convertibility of national currency into foreign currency (from full convertibility to full control). Albeit often overlooked in the analysis of the exchange rate mechanism, convertibility is an essential component of it (Guillaumont-Jeanneney, 2015). The degree of convertibility can be linked to the ‘quality’ of national currency. Higher convertibility means higher currency ‘quality’ (Schuler, 1999)².

The second, internal component of the monetary regime (internal monetary rules), can be referred to as ‘monetary policy regime’ (MPR). Monetary policy is related to the influence on the monetary base, and on money supply in general (this includes domestic credit), on liquidity and generally on GDP domestic components. Monetary policy is associated with the interest rate policy (i.e. with the different channels of transmission mechanisms), and nowadays with quantitative and qualitative easing and the active management of the yield curve. Monetary policy can be discretionary or conducted according to pre-set rules (rule of full coverage of the monetary base with foreign exchange assets, rule of monetary aggregate growth, Taylor’s rule, ‘Central Bank (CB) loss function’ and CB response function’, and so on, and so forth). Some configurations incorporate rules whereby the internal component of the monetary regime – monetary policy – is completely eliminated, such as the Currency Board and dollarization.

If we add to the monetary regime (consisting of these two components) the informal rules of monetary behaviour (those arising from the traditions and monetary practices of the population and economic agents), we come to the definition of the ‘monetary system’ of a given country (Figure 1).

¹ We follow the familiar definition of institution made by D. North (1990 a, b), for details see Desquilbet and Nenovsky (2004), Nenovsky and Rizopoulos (2003).

² Schuler defines “type of exchange rate” and “type of monetary authority”. With regard to the type of exchange rate, a distinction is made between: fixed, controlled and floating, and with the type of monetary authority: discretionary authority and rule-bound authority. The rule-bound authority in turn falls into: currency boards, quasi-currency boards, private central banks, absence of national monetary authority, temporary monetary authority, etc. (Schuler, 1999). Convertibility is often cited as a major advantage of Currency Boards (Coats, 2007).

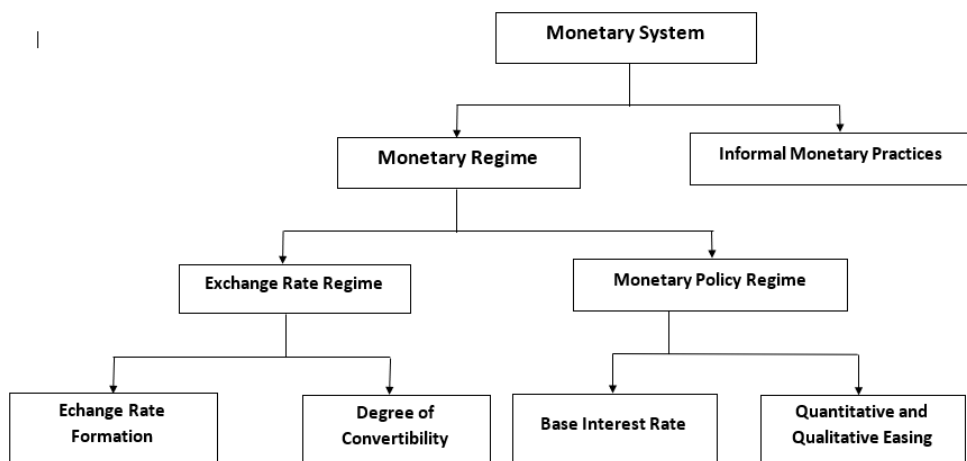


Figure 1. Structure of the monetary system

Source: the authors

We will clarify that monetary behaviour encompasses the economic agents participating in a given monetary payment community (in this case the nation state), and is linked to the processes of measurement, calculation, accounting, payment and saving (the enumeration follows the familiar functions of money).

Monetary regime, i.e., the formal, codified monetary relations (such as, *inter alia*, informal monetary relations) reflect the power relationships, economic interests, and strategies of the key political and economic actors or groups of actors. Power relationships are manifested both within monetary communities and among communities. Actors can be grouped in different ways subject to the needs of the analysis and the research context (external/internal, debtors/creditors, by sector, etc.). History has shown it many times: the change of the monetary regime goes hand in hand with the change of the political regime, the monetary crisis is also a political crisis³. Deep, systemic political changes are accompanied by radical, systemic monetary changes. Such was, for example, the transition from a communist planning system to a market capitalist one in the former Eastern European countries, including the Balkans.

From the standpoint of the study, i.e., of the “dependent monetary regime (DMR)”, it is particularly important to distinguish between national and foreign actors, including national and foreign monetary authorities (Central Banks). This analytical differentiation is important because, most generally, a country’s monetary regime is an extension of

³ See for example Aglietta and Orléan (1982).

its geopolitical and geo-economic place in the international system. Structurally, the political, military and economic power hierarchy, the relationship of dominance among individual nation-states within the world economy, determine and actively interact with the hierarchy of national money. Political and economic sovereignty go hand in hand with monetary sovereignty⁴. The literature and the press often feature the existence of a “monetary pyramid” and a “hierarchical and de-territorial monetary geography” (B. Cohen’s research, 1998 and 2015⁵, is especially important in this regard). The monetary pyramid actually reflects the hierarchy, the relations of dominance in the pyramid of economic power of individual countries. In a similar vein, de Bernis writes:

“The money of the dominant production system is not only dominant money, it is presented as ‘world money’. [...] There is dominant money, that of the dominant production system in a world of heterogeneous money“ (de Bernis, 1987, 925, 934)

Furthermore, ever since its birth the world capitalist economy has developed as a dynamic, i.e. changing, hierarchical system, displaying cyclical phases of different periodicity and character. The pyramid changes its structure, especially at its top layers – those of the leading currencies. The monetary system and monetary regime of smaller countries follow these cyclical patterns. Of particular importance are the alternating phases of globalisation and de-globalisation (national or regional), which are accompanied by the alteration of international monetary regimes with national (regional) ones (more specifically ‘monetary nationalism’). In the modern monetary world, the place of national money in the hierarchy of money and credit is manifested also through their suitability to be used in different swap lines (Mehrling, 2015). Swap lines within G6 are the second most important liquidity instrument today (after the dollar), and bilateral swaps among other CBs, where the Chinese CB is particularly active, come right after them.

It follows from the foregoing that the dynamic monetary dependence/independence of a particular country is a direct continuation of, as well as ‘serving’, the (geo)political and economic dependence/independence of that country⁶. We will see further these relations manifesting in the modern monetary systems of the Balkan countries, i.e., in the post-communist period, after 1990 (Chapter 5), just as in the long-term historical perspective from 1870 to 1990 (Chapter 6). The historical perspective is particularly

⁴ Helleiner (2003), Lo Vuolo and Pereira (2018).

⁵ ‘Monetary space’ and the concepts of “dominance“, “monetary dominance“ including, are concepts introduced by François Perroux and D. de Bernis (B. Cohen notes the pioneering role of Perroux)

⁶ The Digital Dollar Project writes: “If payment systems could bypass Western banks heavily linked economically and geopolitically to US dollar reserves, the effectiveness of economic sanctions as a central and unifying tool of our foreign policy would be at serious risk.” (White, 2020).

interesting. It shows how the alteration of the leading centres of attraction (geopolitical and economic) also determines the nature of the Balkan monetary regimes.

How is the subordination, the dependence of the monetary regime explained on a more specific level? From the onset we should emphasise that a dependent monetary regime, like dependent capitalism in general, can be successful systems (under certain conditions), and overall the practice shows that they are such because they take into account the structural realities of the international order. In this sense, our analysis is not normative in nature and “dependence” does not carry a negative connotation to us. It is an analytical concept⁷.

Small and peripheral countries are catching up in their economic development (by different quantitative and qualitative criteria). As a rule, they are geopolitically dependent, of low economic and military ‘weight’; their elites are unable to unite around a common goal, and they have no effective internal governance mechanisms in place (Cohen, 2015). Their general domestic institutional and political instability is crucial, and it makes the monetary regime highly vulnerable to fluctuations in the political cycle and conflicts of interest, power struggles, corruption, etc. The monetary regime is dominated by fiscal policy. Often DMR are born after military conflicts, or after financial and monetary crises, after a severe crisis of statehood. The political instability is even more pronounced in systemic changes (such as those experienced by former communist countries)⁸.

To overcome falling behind economically, these countries need specific institutions and mechanisms.⁹ These institutions and factors are not many. Apart from the central role of the state, the ‘role of external capital’ is also present, be it in direct investments or in the form of debt. The need for external capital is dictated by insufficient domestic savings, and the generally low technological level and limited competitive export opportunities. Peripheral and dependent countries cannot borrow on international markets

⁷ Monetary dependence has been interpreted and can be interpreted within the framework of various theoretical approaches to economic development (see for Africa, Dixon-Fyle, 1978). Without providing an overview, we will note the different contemporary approaches of Marxism (A. Emmanuel, S. Amin, G. Arrighi), of the ‘world-economy’ (O. Cox, E. Wallerstein), of the Latin American structuralists (R. Prebisch, C. Furtado, D. Prates, R. Lo Vuolo, JM. Pereira), of F. Perroux and the school in Grenoble (G. de Bernis), of modern international political economy, etc. Most approaches ‘condemn’ this dependency, but it can be viewed in a purely positive light, for example by supporters of ‘realism’ in international political economy, the monetarists (M. Friedman, R. Mandel, H. Johnson, S. Hanke, among others), etc. In our text we have followed our own generalisations, in particular observations of real monetary processes.

⁸ See overview of the theoretical approaches to monetary regimes in “economies in transition” (Grittersová, 2014).

⁹ Interesting in this respect are, for instance, the contributions of A. Gerschenkron (1962) on the role of catching-up institutions and the ‘theory of import institutions’, to name a few.

debt denominated in their own national currencies (“original sin hypothesis”). They borrow in major world currencies and become vulnerable to currency (exchange rate) risk. The inflow of external capital, in turn, requires a corresponding stable institutional and political environment. A leading condition for foreign capital, as well as for the involvement of foreign financial institutions, in addition to favourable tax conditions, is the introduction of a monetary regime that could ensure the return on this capital and its predictability. This implies a low level of risk (currency and political). It follows that the monetary regimes of the peripheral and catching-up countries are built in a way that suits the political and geopolitical interests of the leading capital centres. The political regimes in the dependent countries can be viewed in a way similar to that of the monetary regime (they must be stable and loyal to the geopolitical centre and their financial institutions).

We should note once again that dependence does not mean that small countries do not benefit from this type of monetary and political regimes; on the contrary – in most cases it is the most appropriate, so to speak, “optimal” form which, if skilfully managed, minimises losses under a given external structural constraint. Whenever attempts were made to introduce a stand-alone independent monetary regime (floating or pegged), in the presence of geopolitical dependence, they were unsuccessful and generally ended in a financial and political crisis.

Therefore, the external equilibrium (external stability), i.e., the state of the balance of payments and especially its financial (capital) account, as well as the dynamics of the exchange rate, become central parameters for the development of the peripheral countries. Also, we know from national accounting that the balance of payments is linked to the monetary sector and is a source of money supply. As a rule, in dependent countries, external sources of money supply dominate domestic sources (domestic credit, for example). The monetary regime of the small, peripheral and catching-up economies is directed outwards. It is international in nature and in most cases its definition and management are delegated to the lead centre. The dependent monetary regime includes a strict (rigorous) monetary policy (rule-bound), which follows that of the centre, as well as the pegging of the national currency to that of the leading centre (or the complete abandonment of the national currency¹⁰). Milton Friedman calls them “unified currency” regimes (Friedman, 1973).

Here it is appropriate to add that when considering the diversity of capitalism, Drahokoupil and Myant (2011) define the ways of financing the current account of the countries from Eastern Europe, i.e., their integration into the world economy as

¹⁰ Fixed exchange rates, free convertibility, and the observance of externally set rules are considered manifestation of “monetary internationalism”, while floating and controlled exchange rates and discretionary policy, pursuing domestic economic targets, are considered “monetary nationalism”. This principled distinction is presented in the pioneering book of M. Heilperin (Heilperin, 1939). Similar ideas were developed in Schuler (1999).

a key criterion for determining the differences in the trajectories of post-communist capitalisms (the authors define a total of six such trajectories)¹¹. However, the authors do not elaborate the topic of the monetary regime, which, in our opinion, is closely linked to the international integration of these countries.

Furthermore, the restrictive monetary regime can exist in a comprehensive institutional matrix, encompassing rules on public finances (fiscal conservatism and low disproportionate taxes), on the labour market (its flexibility, weak unions, etc.), on the industrial structure (dependence on Transnational corporation located in Western countries), on the financial system (the presence of branches of foreign banks, dependent on their Western parent banks), etc. (see Magnin, 2020 and Magnin and Nenovsky, 2020). The concept of institutional complementarity is most relevant here.¹² A simplified graphic representation of the institutional matrix, i.e., institutional complementarity, is given in Figure 2.

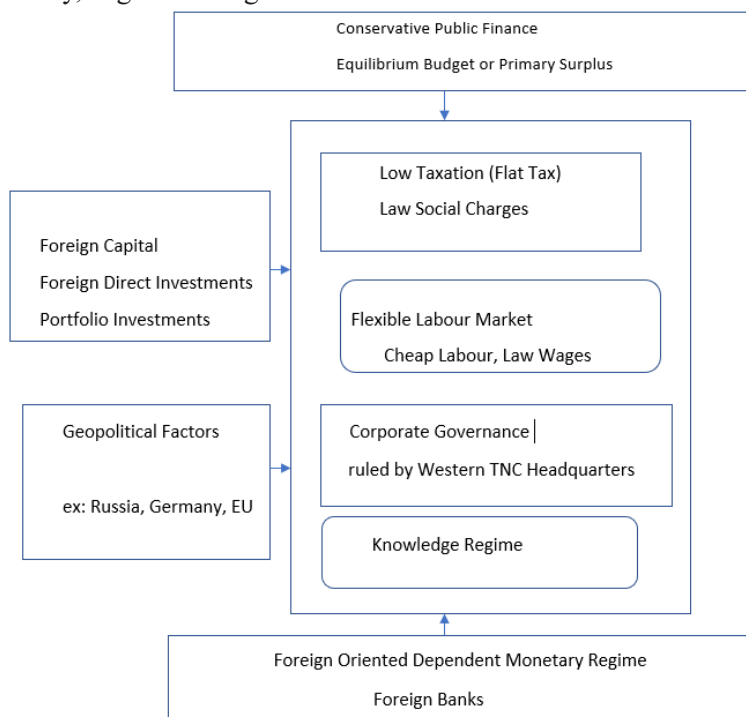


Figure 2: Dependent Capitalism: Institutional Matrix and Interconnections

*Source: Magnin and Nenovsky, 2020, p. *, plus an update*

¹¹ It is worth noting that as early as 1979, A. Thirwall linked the specifics of the monetary regime with the nature of the current account.

¹² Amable (2003), Aoki (1994).

Finally, it is interesting to add that the imposition of a dependent regime in small and peripheral countries is accompanied by the imposition and dissemination of economic views, theories and ideas (“economic narrative”), which legitimise this new monetary regime and prepare the imposition of a certain economic development model. Moreover, as a rule, the development of economic thought in dependent countries follows that in the centre where the country gravitates (Marinova and Nenovsky, 2019)¹³. In this sense, one can speak of the existence of a certain “intellectual dependence” (a kind of “soft power”). For example, in the 1930s, “corporatist ideas” and “clearing payment theories” were popular among Bulgarians due to the influence of Germany and Italy. After World War II, these were the socialist ideas and Soviet “anti-monetary theories” due to the influence of the USSR. The following chapters 5 and 6 present a number of examples from the monetary history of the Balkan countries, which is a series of such cycles of monetary dependence, going hand in hand with the dominance of certain economic and monetary ideas.

Elements of dependent monetary regimes

If we limit ourselves to the purely economic dimensions (as far as they can be separated from the (geo)political ones), the dependent monetary regime is characterised by the following main characteristics.

First, *with regard to the exchange rate regime (ERR)*, a passive and liberal exchange rate policy is followed. By their nature, these regimes are international. Most often, a fixed exchange rate is resorted to, or pegged to a foreign anchor currency (the currency of a leading country, primarily the dollar, or a basket of leading currencies). This is accompanied by free convertibility. This choice is accompanied by the accumulation of significant foreign reserves, which guarantee the chosen level of the exchange rate. Foreign exchange reserves are invested in highly liquid assets, gold and most often debt securities of the country whose currency is chosen as an anchor. The aim is to ensure the convertibility of the national currency, as well as to reduce currency risk¹⁴. Within passive exchange rate regimes (as we will see below), a legally fixed coverage of the monetary base with highly liquid foreign assets (currency board regime)¹⁵ is often added.

¹³ See also Nenovsky and Penchev (2015), and Nenovsky and Mihaylova-Borisova (2015).

¹⁴ This way, a specific mechanism is reached, whereby national resources are transferred to the centre, as the resources that could be used in a national economy are invested in foreign financial assets (Schwartz, 1993, 170).

¹⁵ Or of the quasi-currency board, depending on the percentage of coverage and the percentage of domestic assets on the balance sheet.

In another configuration, the national currency is completely abandoned as legal tender, i.e., a foreign currency is accepted as such (Schobert, 2003). In this case we are talking about unilateral dollarization, or euroization. In this configuration, foreign exchange reserves are significantly lower (they only serve to pay off debt and finance imports), but are initially spent on the purchase of dollar (or euro) banknotes. Participation in a common monetary union can also be seen as a passive and dependent regime, in so far as a small country does not have a serious influence on the common monetary policy.

In any case, although to a different degree, the monetary sovereignty of the dependent country is limited or completely abolished: it is delegated to foreign monetary authorities. This abandonment of monetary sovereignty is manifested in the basic functions of money, first abandoning the national unit of saving, then the function of payment, and finally the unit of measurement.

Secondly, in the above connection we can also note the consequences of the dependent regime in terms of *competitiveness*, often identified with the dynamics of the real exchange rate. It is true that the tendency is for the national currency to appreciate, which, when productivity increases insufficiently, leads to a reduced competitiveness of exports, to an increase in imports, and as a result to deterioration of the current account. The appreciation of national money comes along different lines, but mostly due to higher growth rates of national prices and wages compared to those in the anchor country (catching-up effect known as Balasa-Samuelson). The appreciation of the exchange rate causes an inflow of capital, which generally compensates for the current account deficit. However, they make the system unsustainable, which in turn requires conservative public finances (balanced budget and low domestic debt), as well as a restriction on domestic credit. Of course, this appreciation of the national currency depends on the geographical structure of exports, and there are mechanisms that work in the opposite direction, deterring the appreciation. Among them, for example, is the “discipline effect”, which, in the absence of devaluation, forces economic agents to become more productive (Nenovsky et al., 2001).

Third, where it exists, the internal component of the monetary regime, that of *monetary policy (MPR)* (mostly interest rate policy), is also forced to passively follow the monetary policy movement of the anchor CB. The monetary base and the money supply in general are determined endogenously by the demand for money, and the money supply passively adapts to demand. Thus, the monetary authorities of the small country find it difficult to also control the domestic sources of money supply. This passivity is expressed not only by the automatic following of the anchor-CB interest rate, but also by the fact that foreign banks dominate the banking system, i.e., they determine the dynamics and conditions of the money and credit market (and its possible vulnerability

due to the movement of speculative capital within these banking groups, between the headquarters and branches of these banks, credit bubbles, etc., Nenovsky and Villieu, 2011). The interbank market and liquidity in dependent countries also reflect the dynamics of international markets. This is a further constraint on national sovereignty, because systemic banks have foreign capital and can be a tool for promoting foreign strategic interests. The payment system is also closely linked to the leading economies (in some cases it is outside the country, such as at the beginning in Estonia)¹⁶.

Fourth, from what has been said, it follows that *the financial stability network* has obvious limitations. The LLR (lender of last resort) function is either minimised (Currency Board) or completely eliminated (dollarization). Of course, it can be assumed that, under certain conditions, in a liquidity crisis, foreign banks will be refinanced from outside, through their ‘parent banks’ (and respectively from the foreign CB). Practice shows that most often this does not happen. A system of deposit insurance and banking supervision remains in the hands of the national monetary authorities (often banking regulations can be used as a monetary policy instrument)¹⁷. It is important to add here that various mechanisms can possibly fulfil the role of LLR, such as the Banking Department in Bulgaria, protection swaps, formal or informal arrangements with anchor CBs, agreement with the IMF, as well as *ad hoc* mechanisms such as the Vienna Initiatives of 2009 and 2012 (where 15 Western banks, with the participation of a number of MFIs, pledged support to their subsidiaries in Emerging Europe)¹⁸, etc.

Fifth, as a general result of the above characteristics, a country with a dependent monetary regime partially or completely loses control over its *internal adjustments* (at the expense of *external adjustments* and stability), it can neither “postpone them” nor “pass them onto other countries” and actors. It can “postpone” them at the expense of the IMF, but against certain reforms. And to “postpone and pass on adjustments” according to Cohen (2015) are the main manifestations of “monetary power”. The opposite takes place: foreign disequilibria are transferred to the dependent countries, and these countries are forced to react with internal, national mechanisms (for example, the policy of austerity). As already mentioned, within the banking groups, resources can be transferred from the dependent countries towards the banking centres. Furthermore, it can be assumed that when the response in a peripheral country is by way of restrictiveness, an authoritarian, and generally forceful, political regime becomes most effective.

¹⁶ The payment system is particularly important in dependent regimes, the example of the crisis in dollarized Panama is illustrative. Some countries in the former Yugoslavia (Bosnia and Herzegovina, for example), whose payment systems were in Belgrade, had similar problems.

¹⁷ However, under certain conditions, they may also be limited. For example, from October 1, 2020, Bulgaria and Croatia join the EU Banking Union without being part of the euro area. Thus, the national central banks of both countries lose control over the leading and systemic banks.

¹⁸ <http://vienna-initiative.com/>

Generally speaking, the monetary power of small countries is extremely limited: they have neither power resources (political, military, financial, etc.), nor can they influence the behaviour or shape the preferences of other countries (“monetary power as a relation”) (Nenovsky, 2007). The asymmetry in the international power space of money, in fact, is not new – it has been a characteristic feature since the time of the international gold mine; it existed in the late 19th century until WWI, where creditor countries dominated (Simmons, 1996).

Sixth, we can add that under the dependent monetary regime, the sources of monetary income (seigniorage) shrink because a large part of the money supply is in foreign currency¹⁹. We will recall that the seigniorage can be divided into two components: (i) monetary seigniorage (income of the Central Bank received from the issue of banknotes and coins) and (ii) bank seigniorage (income of the Central Bank received from the transformation of maturities). With banking seigniorage, the Central Bank performs the functions of a normal financial intermediary (it profits from a positive difference between the return on financial assets and its non-monetary liabilities). Under dependent monetary regimes, bank seigniorage is practically very limited, a zero, and may even be negative (in attempts to pursue an active monetary policy)²⁰.

Finally, in a regime of dollarization and euroization, when the dollar and the euro circulate as official currency, we can also speak of leaving the “*symbolic*” sovereignty. Money is part of the symbols of any sovereign national government (Heilleiner, 1996). As we have known since the time of the “father” of the sovereignty theory, Jean Bodin, the right to mint coins and receive income from it is an inalienable part of the rights of every sovereign, be it a monarch in the past or the people (nation today) (in the face of the state and CB)²¹. However, we must make the proviso that the classical monetary sovereignty is becoming increasingly difficult to implement in today’s global and interdependent world. It becomes necessary for the monetary sovereignty to become cooperative and shared. The subsidiarity principle is even more frequently applied in the monetary sphere (Zimmermann, 2013). According to some authors, the monetary sovereignty however can be regarded also as a continuously developing system of values as regards money and the monetary system, marked by the historical context and national specificities²².

¹⁹ For discussion see Fischer (1982), Schobert (2003), and a number of articles of the latter.

²⁰ The case of Lebanon is similar, as are the losses of the Central Bank in the financial crisis of 2019 (see Nenovsky and Chobanov, 2020.) Under the dependent regime, the inflation tax is also eliminated (Hanke, 2002, Hanke speaks of an inflationary component of seigniorage).

²¹ See Helleiner (2003). The issue of monetary sovereignty and seigniorage is disputed during the choice between a currency board or euroisation in Kosovo and Bosnia and Herzegovina (Coats, 2007).

²² Also, Zimmermann (2013).

Institutional forms of the dependent monetary regime

We have already mentioned that monetary dependence is manifested primarily in relation to the monetary regime (although it also has a place in informal monetary practices, the familiar process of “monetary, currency substitution”). In an order of increasing dependence we can distinguish the following forms of monetary regimes.

(i) *Fixed (pegged) exchange rate* regime (various configurations are possible here)²³. Convertibility can vary in degree, but in general dependent regimes have wide convertibility. The elements of monetary policy (especially sterilisation) are minimised, and if there is such, it closely follows the course of the monetary policy of the leading country. Monetary policy has a pre-set framework due to the relationship between the balance of payments and the monetary sector. In this configuration there is, albeit limited, a space for LLR. What remains is deposit insurance and a scope for banking supervision. Any active monetary policy in a fixed exchange rate regime, regardless of the degree of convertibility, sooner or later leads to imbalances (disequilibria), and this results in crises and devaluations, or control and a parallel foreign exchange market. There is a contradiction between the two components of the monetary regime – internal (ERR) and external (MPR), see Figure 1. According to Kurt Schuler and Steve Hanke:

“Discretionary monetary authorities such as central banks have generally been unsuccessful at maintaining rigid exchange rates because they have done so in an inconsistent way. An analysis of the supply and demand for money shows the contradiction in using sterilised intervention to simultaneously target the exchange rate and the nominal supply of money, as almost all central banks do sometimes and many do most of the time.” (Schuler, 1999, 85)

“Pegged rates invariably result in conflicts between exchange rate policies and monetary policies. [...] Balance-of-payments crises erupt as a monetary authority increasingly offsets the reduction in the foreign component of the monetary base with domestically created base money.” (Hanke, 2002, 91)

(ii) *Currency Board*, which is a comprehensive system of rules both in terms of exchange rate (ERR) and in terms of domestic money supply (MPR). In addition to legally fixing the exchange rate to a stable major currency, there is also a legal 100% (or less) coverage of the monetary base and of the main liabilities of the Central Bank, with highly liquid foreign exchange assets. Convertibility is complete²⁴. In this

²³ According to the IMF, pegged rates are: conventional peg, stabilized arrangements, crawling peg, crawl-like arrangements, pegged with horizontal bands (IMF, 2020).

²⁴ According to Guillaumont-Jeanneney (2015, 34-36), the Currency Board is an administratively set exchange rate, unlike other fixed exchange rate regimes, where the central bank intervenes. The Currency Board is generally well received by the IMF because it helps implement its stabilization programs. The currency board is often run by a foreigner (eg Bosnia and Herzegovina).

case, the balance sheet of the Central Bank, as a rule, eliminates domestic sources of monetary base, and completely abandons the active monetary policy. The monetary base is determined endogenously by the demand for money²⁵ (Hanke, 2002). In this configuration, the CB cannot influence the liquidity in the system, just as it cannot perform open market operations or act as a LLR (i.e., the moral hazard and the “principal-agent” problem are limited), etc. The balance sheet of the Central Bank or of the Currency Board (Issue Department within the Central Bank) is published weekly or monthly. In each particular national case, residual liquidity impact options may be found, but these are rather exceptions. The Currency Board is considered sustainable (viable) due to the strong “credibility / trust effect” (carried by the anchor currency) and as a consequence of the “discipline effect” and the systemic nature of tight budgetary constraints (see for details Desquilbet and Nenovsky, 2004). Theoretically, unlike controlled exchange rates, there is no contradiction between the two components of the monetary regime in the Currency Board (Schuler, 1999). It is interesting to note that M. Friedman, who is often considered the guru of floating exchange rates, actually preferred currency boards (or as he calls them “unified currency”) for small and peripheral economies²⁶.

“[A] unified currency assures a maximum degree of integration of the country in question with the greater world. [...] So I believe there is no conflict between wholehearted advocacy of floating rates for major countries and the existence of currency blocs of smaller countries attached to the major countries.” (Edwards, 2020, pp. 14-15)

According to an in-depth study by S. Edwards, Friedman was the progenitor of the bipolar model of monetary regimes, which was later adopted by the IMF (Fischer, 2001).

“Friedman’s had two preferred monetary and exchange rate arrangements for the poorer countries: flexible exchange rates, where market forces determined the value of the currency at every moment in time, and a unified currency regime, where the exchange rate is irrevocably fixed and the central bank is abolished” (Edwards, 2020, 18).

In practice, there are various institutional departures from the classical principles of a currency board (mostly 100% coverage of the monetary base, etc.) (Camillieri Gilson, 2002, Nenovsky et al., 2001). These departures from the principles, and especially attempts to carry out sterilisation operations, inevitably lead to a financial crisis²⁷ (Hanke, 2002a). However, it should be noted that unlike the colonial versions of Currency Boards (often called first generation CB), today the movement of capital

²⁵ The demand for quasi-money, in principle, i.e., not only under a Currency Board, is endogenous.

²⁶ Friedman also proposed this model during his visit to socialist Yugoslavia in March 1973 (see chapter 6).

²⁷ The case of Argentina.

is leading and creates certain instability, both in the direction of speculative credit growth and rapid withdrawal in a crisis (see Box 1) This also applies to the next form – dollarization. This instability can occur both through the banking system (Gedeon, 2013) and through other types of external capital inflows, such as EU funds (Nenovsky and Villieu, 2011, Nenovsky and all, 2013).

(iii) *Dollarization, euroization*, i.e., systems where a foreign currency is officially adopted as legal tender, and the national currency is completely abolished (with certain exceptions where small-value national coins circulate) (Schobert, 2003). In this extremely dependent monetary form, monetary authorities do exist, however they can only provisionally be called Central Bank (e.g., the Central Bank of Montenegro, Fabris et al., 2004). Convertibility is complete. There is no monetary policy. It is necessary to put foreign currency banknotes into circulation, which is done by a one-time conversion of foreign reserves into banknotes, or their purchase. This regime completely links the dynamics of monetary processes with those of the leading centres, and is extremely disciplining for public finances. Most often, this regime is imposed from outside, by external economic and political forces.

Box 1

Price level determination under the Gold Standard (GS) and Modern Currency Board (CB)

If we extend Kydland and Wynne (2002) presentation of the GS, we could present the GS and CB price level determination as follow. First assume that the supply of money M^S is given by: $M^S = \frac{1}{\lambda} eF$, where $0 < \lambda \leq 1$ is the degree of coverage of the inside money by outside money, e is the nominal price at which the monetary authority stands willing to buy and sell the outside money, F is the stock of outside money which evolves according to the difference between exportations X and importations IMP : $\Delta F = X - IMP$. The demand for money is given by: $M^D = f(\pi^e, z) Py$, where π^e is expected inflation, z is a vector of other variables determined demand for money, P is general price level and y is real income.

If we suppose money market equilibrium ($M^D = M^S$) we can obtain the price level under GS as:

$$(1) \quad P = \frac{eF}{\lambda f(\pi^e, z)y} = \frac{e \sum (X - IMP)}{\lambda f(\pi^e, z)y}$$

Under the CB (especially second generation) there are some important structural changes: (i) the coverage exist only for the base money, not the all monetary stock (ii) with the development of the bank money, nowadays the monetary stock is far

(ii) with the development of the bank money, nowadays the monetary stock is far bigger than the money in circulation (this stresses the role of the banking system and the role of money multiplier), (iii) nowadays the capital account presents a key part of the balance of payments, when in the previous time the balance of payment was closer to the trade account. Let $M^S = \mu H$, where H is monetary base, and μ is the money multiplier, assume that only H is covered by F . Taking into account the role of capital flows in the determination of the stock of outside money, let $\Delta F = X - IMP + \Delta K$, where ΔK represents net capital flows. In turn $\Delta K = \Delta K_{FDI} + \Delta K_{FDIS} + \Delta K_{DEBT}$, where ΔK_{FDI} is a sustainable FDI, ΔK_{FDIS} is FDI in speculative sectors and ΔK_{DEBT} is debt capital.

We obtain the price level under CB:

$$(2) \quad P = \frac{\mu e \sum (X - IMP + \Delta K_{FDI} + \Delta K_{FDIS} + \Delta K_{DEBT})}{\lambda f(\pi^e, z)y}$$

Comparing (1) and (2) it is obvious that the price level determination is much more instable under CB because of the two behavioural variables such as money multiplier μ and net capital flows ΔK , especially ΔK_{FDIS} and ΔK_{DEBT} .

Source : Desquilbet and Nenovsky (2004, 22) and update

(iv) Finally, *membership in a Monetary Union*. At first glance, this monetary form differs from those already enumerated in that it allows national “participation” in a common active monetary policy. There is a talk of “shared monetary sovereignty”, where the small country is involved in monetary policy decisions. Formally, the small country owns the LLR, and receives part of the monetary income, seigniorage. It must be said that these advantages are illusory. An important condition for successful participation in a common area is the synchronous movement of the cycle of the dependent country with the cycle of the anchor country, which is rarely achieved, as well as symmetry of shocks. The common monetary policy is pursued in the interests of the leading countries, which dominate politically and economically that union. It follows the objectives and interests of the major countries in the monetary union or of the group interests associated with those countries. The experience of the few monetary unions of the past, as well as of those existing today, demonstrates this. An important feature, often left out of the field of analysis, is the choice of ERR for the whole area. For example, the euro area chooses a floating exchange rate, the CFA zone a fixed one, and the Caribbean Monetary Union operates as a Currency Board.

With all conditionalities, within the summary of dependent configurations (Figure 3), we can outline two groups: depending on whether there is a contradiction between

the two components of monetary policy or if they are in sync, the former being highly volatile whereas the latter are relatively more sustainable and longer lasting. The former includes various types of pegged arrangements, the latter – currency boards and dollarization. The monetary union is somewhere midway.

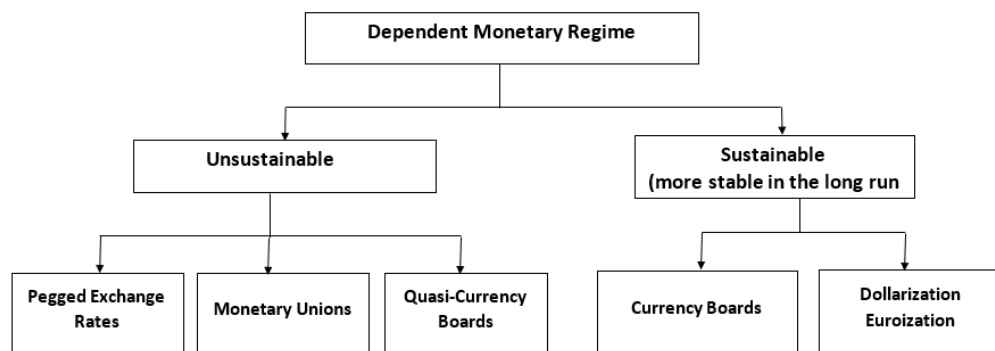


Figure 3 Dependent monetary regimes

Source: the authors

This list of institutional configurations is most often viewed from the standpoint of conventional monetary “theory of optimal monetary zones” and “the choice of optimal exchange rate regime” (for arbitrage “costs/benefits”, “credibility/ flexibility”, etc.)²⁸. Without denying their benefits, the above approaches cannot explain the emergence of dependent monetary regimes. Political and geopolitical factors are leading and this has been shown many times. For example, the choice of currency board regimes in the Baltic countries in the early 1990s, and later the German mark as official legal tender in Montenegro, was a visible manifestation of the desire of the national elites, as well as the external centres, to replace the geopolitical anchor: in the first case to replace Russia with Germany and the EU, and in the second – Yugoslavia (Serbia) with Germany²⁹. International political economy is trying to conceptualise these issues.

We must add the consideration that for small countries, the political cycle leads to extreme instability of their monetary regimes, which become hostage to the political struggle, and most often leads to inflation, devaluation and financial crisis (often referred to as “financial and inflationary trauma”). That is, in small countries, the dependence of the monetary regime on domestic factors is relatively greater and more harmful than their external dependence (that of the external monetary centres). The history of monetary regimes in the Balkans shows this.

²⁸ Mongelli (2002).

²⁹ See for example Abdelal (2005), Feldmann (2013), Schobert (2003).

Finally, in addition to monetary regimes, dependence can also occur in informal monetary practices that are also part of a country's monetary system. The most common form is that of "*currency substitution*". It is expressed in the preferences of the economic agents of the small and peripheral country to pay, measure and save in a stable foreign currency, chosen by consumers and producers.

Basically, these processes are dictated by the rate of inflation and the depreciation of the exchange rate. The fact is that the Balkan countries are an area with a strong currency substitution, which is closely monitored and regularly studied (for example, by the Austrian Central Bank³⁰). Currency substitution can be observed both in the official sector – in the balance sheets of banks (loans and deposits in foreign currency) and in the informal (undeclared) economy. In the grey sector, in general, payments in foreign banknotes and in large denominations are extremely common. These substitution processes further shrink the fiscal base (as well as the sources of seigniorage) of the peripheral countries, which, as we have pointed out, are forced to comply with a conservative financial policy.

As an appendage, we will recall that in the synopsis of monetary hierarchy within the monetary pyramid, B. Cohen lists the following types of national money (in an order of increasing dependence and abandonment of monetary sovereignty) - (i) top currency, (ii) patrician currency, (iii) elite currency, (iv) plebeian currency (v) permeated currency, (vi) quasi currency and (vii) pseudo currency (Cohen, 1998, 113-118, and Cohen, 2015, 15-19). In our opinion, in this ranking the Balkan currencies, with very few exceptions (and in certain periods), represent the last three types of currency (permeated currency, quasi currency and pseudo currency³¹).

As a whole, however, the (formal or informal) monetary hierarchy and monetary dependency cannot be eradicated. It needs to be managed successfully. Strong and weak currencies have always existed in history (Asselain and Plessis, 2003). From a historical perspective, this hierarchical nature has always existed, either within the colonial monetary systems, or the international monetary system – i.e. between individual colonial monetary systems and other areas. The historical dependence and hierarchical subordination of monetary regimes in the Balkan countries have also been a well-documented fact since the time of the Latin Monetary Union.

In the fifth chapter we will present illustrations of the presented theoretical constructs, focusing on the modern dependent regimes on the Balkans (Currency Boards and Euroization), and in the sixth chapter we will make a "long" historical excursion into the evolution of the monetary regimes of the Balkan countries from the end of the 19th century to the present day.

³⁰ See also ECB, Windischbauer (2016)

³¹ We will also note a number of new studies regarding the monetary pyramid from the positions of the Modern Monetary Theory (Bonizzi et al., 1999). In general, they say nothing new.

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