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How Acceptable are the Costs Compared to Benefits Brought by Euroisation of Kosovar Economy

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Since January 1st 2002 in compliance to UNMIK (United Nations Mission Interim in Kosovo) regulation no.1999/4, EURO ("EUR") is adopted as legal currency in Kosovo and it became the de facto currency of the country. All client accounts held in Central Bank of Kosovo (CBK) and in other commercial banks were converted in EUR by un-converted exchange rate of DEM 1,95583 for a EUR. Consequently, in practice, since Euro has legal tender (which means that a payment in Euro cannot be refused) and since accounts are kept in this currency, almost all the transactions made in Kosovo are denominated and paid in Euro. Utilization of a sustainable currency was important in maintaining macroeconomic stability and played a key role in the reestablishment of people's trust in the financial sector. On the other hand, CBK is not a money emission bank and in this way does not perform monetary and exchange policies. The currency regime that Kosovo has adopted might be very challenging given the absence of traditional monetary and exchange rate instruments. The key concern, therefore, remains on whether the right policies (such as fiscal and structural policies as well as those related to the financial sector) will support this regime. The objective of this paper is to present the costs and benefits brought to the Kosovo economy by the utilization of Euro as its main currency in circulation, and to what extent are the costs acceptable compared to the advantages that were brought by the introduction of Euro in the Kosovo economy.

Keywords: *Kosovo economy, German Mark, Euro, Cost, Benefits*

Introduction

One of the challenges that Kosovo has faced after the conflict was to choose the monetary structure. Having under consideration the rapid reaction on possesion of cash for currency exchange and dissolution of yugoslav "dinar" as a instrument of transaction, it was not a surprise that in September of 1999, by its one of the first regulations "on the currency allowed for use in Kosovo", UNMIK legalised the use of German Mark and other foreign currencies in Kosovo. In fact, it was the popullation of Kosovo who adopted the German Mark as its common currency. UNMIK regulation simply identified the German Mark as the currency by which the budget, financial data and public institutions accounts, agencies and institutions, and UNMIK itself would do be established. At the same time, this regulation would offer the parties the freedom to any contract or other transaction of will and to name such a transaction by a largely accepted and mutually approved currency. Furthermore, this regulation would dissolve all controls and limitations from possesion, use or decision on any currency into cash money or in any bank account, held domestically or outside of territory of Kosovo.

The German Mark was adopted in a one-sided manner, as a legal currency de facto in Kosovo, and there was no negotiation with German Bundesbank or with European Central Bank at the time[1]. It followed two decades of extreme monetary instability along with high level of unofficial use of German Mark as a reserve value and instrument of exchange. In the pre-conflict period, the German Mark was the most used currency; there were high amount of cash money in circulation. Population was familiarized with this currency. By adoption of DEM as legal tender in a unilateral manner by the Organization of United Nations in Kosovo (UNMIK), the change into the euro was a natural continuation implemented by the states

[1] The fifth conference of the Bank of Albania, 24-25 March 2005 (Michel Svetchine, Kosovo Experience with Euroization of its economy), page 252

of European Union[2]. Remittances sent by Kosovar diaspora in 2002 rated over € 500 million caused a regular and considered fluctuation of money in Kosovo over the years. This income was almost in form of physical money. After the end of conflict, in absence of banking services in Kosovo major part of the foreign direct assistance in Kosovo made the physical money incomes necessary.

CBK always tries to implement financial policies, which will in a near future be part of the system of the European Central Bank (ECB). Euro is an official currency in Kosovo since February 2002 but Kosovo is not member of Euro zone since as a precondition for a country to get included in ECB, as well as in Euro System is joining of such a country into the European Union (EU). The fact that ECB monitors and supervises the flow of money, transfers, payments, and loans in Kosovo means in a way that CBK is member of ECB although by not having equal rights (for example it has not the right to emit money). This means that Euro should be announced as legal currency in Kosovo, although Kosovo has not become part of EMU. But one-sided Euroization will not be a possibility for side-skipping foreseen steps by Tractate for adoption of Euro.

The beginning of 2009 marks the 10th anniversary of euro, the currency that approached the economic and financial policies of hundreds of millions of Europeans. Euro countries now enjoy a larger and safer market with less risk from devaluation and inflation. Euro is now the largest currency in Europe and among the strongest currencies in the world. Euro provided Kosovo with a stable monetary environment; it alleviated economic transactions with the key Kosovo trade partners etc. However, it also provided a cost for the Kosovo economy such as loss of seignior age income, loss of sovereignty over the monetary policy. However, the costs may be considered acceptable compared to the advantages that were brought to the Kosovo economy by the introduction of Euro.

[2] http://www.bqk-kos.org/?cid=1,135&archive=true, Euroisation outside euro-zone: assets and challenges the experience of Kosovo, page 1

Costs and benefits of the joint currency

The costs of monetary union derive from the fact that when a country abandons its national currency, it also gives away another instrument of its economic policy, which means it losses the ability to enforce its national monetary policy and exchange rates. In other words, in the complete monetary union, the central national bank either ceases to exist, or it has no real power. This means that the country that joins the monetary union will not be able to change the price of its value (with devaluation and evaluation), to determine the quantity of the national currency in circulation, or change the short-term interest rates[3].

It is known that various countries have various norms of economic development. Countries that usually have problems with trade balances, if they join the monetary union, would not be able to cover the deficit in the trade balance by means of devaluating the national currency, in order to make products of that country more competitive in the external market. Countries also differ due to the fact that they have different fiscal systems. These differences often compel countries to use various combinations of financing the budgetary deficit. The budgetary deficit may be financed by borrowing and emitting currency or by increasing the inflation. Therefore, countries with less developed fiscal systems, compared to the other countries of the monetary union, will face a higher cost of increasing revenues by increasing the tax norm even through it would be more favorable to increase revenues by means of inflation. However, by joining the monetary union, in case of countries with a lower inflation rate, which they have to respect, they have to increase taxes, or allow their deficit to increase furthermore.

While the common currency costs are more linked with macroeconomic management, the benefits more often ocurre in microeconomic level. The elimination of the national currency and transition to the common currency brings along the expectation of benefits in economical efficiency such as:

- Decreasing the cost of transaction of member countries

[3] Paul De Grauwe (2003), Economics of Monetary Union, University of Leuven, Belgium

- Improving the allocation efficiency of the price mechanism
- Higher price transparency has an impact on the increase of competition, by which means the consumer benefits
- Stimulation of integration in the other fields (financial, institutional, political)
- Positive impact on the trade flow within the Union.

Elimination of the transaction cost toward another currency surely represents the most noticeable benefit from the monetary union. These costs diminish when the countries utilize the common currency. CE Commission has pre-calculated the following benefits resulting up to the number between 13 and € 20 billion in a year[4]. This presents one of fourth up to the half of one percent of GDP of the Community. This, at first sight might seem not important. Although, it is a benefit that must be added to the list of other benefits from the common market. Information in various countries demonstrates that about 5 percent of bank revenues are fees that are paid to banks during the exchange of national currencies. Therefore, these costs diminish upon joining the monetary union.

Also, the elimination of transaction costs brings the indirect benefits (even though these benefits are hardly measured). The introduction of euro should bring along higher transparency as far as the prices, which means consumers may see the prices in common currency units and are able to make comparison and to trade deal better. Lower transaction costs and greater transparency, according to many supporters of Euro are considered two greatest benefits of using the common currency.

It is known that economic agents base their decisions related to production, investments and consumption on information that is provided to them by the price system. If the prices are uncertain, the number of decision for the above purposes will decrease, meaning that the price system becomes an indicator for undertaking the right economic decisions. Therefore, with the utilization of the joint currency, which as a precondition requires adherence to many criteria defined by the ECB, the risk of inflation decreases and this provides a signal for the individuals to undertake decisions on production or investment.

[4] Paul De Grauwe (2003), Economics of Monetary Union, University of Leuven, Belgium, pg. 60

The existence of the joint currency also stimulates integration in the other fields, whether financial, institutional or political. And, surely the existence of the joint currency stimulates greater trade cooperation within the framework of the union countries.

Kosovo's benefits from Euro - Support to financial sector development

The financial crises in former Yugoslavia have eroded significantly the confidence in the banking system of that time. Thus, with inflationary experience and the collapse of Dinar, it would have been very hard to bring back the confidence in the newly established financial sector in Kosovo, without implementing a stable currency. The adoption of euro, therefore, has been very helpful in increasing public confidence in the banking sector and given that liabilities and assets of the banking sector are now denominated in euro, banks are not at least exposed to the currency mismatch risk (or exchange rate risk). As a result of euro being a strong and stable currency, almost all deposits are denominated in euro[5].

Euroization supported the development of the Kosovo Financial Sector, which had to be established from scratch after the conflict. Initially, there were no banks in Kosovo and all transactions were practically carried out in cash. For nearly two years the sole financial entity in Kosovo was Micro Enterprise Bank (MEB), which was specialized in micro-loans. However, two other years show an explosive development of the banking sector in Kosovo. During the period of March – November 2001 six (6) banks were established, which created the necessary competition in this sector.

In 2002 and 2003, seven trade banks in Kosovo got significantly enlarged. Bearing in mind the low level of economic development in Kosovo and negative experience with the banks in the past, the Banking System in Kosovo is characterized with great participation of foreign banks. Domination of foreign banks is evident with regards to their number and the entire participation with funds in the banking sector. In 2009, foreign banks represented six (6) of eight (8) commercial banks that operated in

[5] http://www.bqk-kos.org/?cid=1,135&archive=true, Euroisation outside euro-zone: assets and challenges the experience of Kosovo, page 31

Kosovo which make up 91. Six[6] percent (91.5 percent in 2008) of overall funds in banking sector. It is imported to be pointed out that the Banking sector in Kosovo is continuously widening its activities. This is shown through continuous increase of contribution to Gross Domestic Production (GDP). The participation of the Banking sector Funds to GDP has increased to 56.5 percent in 2009, from 47.0 percent in 2008[7]. The Banking sector Funds has achieved an amount of € 2,1 billion in 2009, which represents an increase of 21.5 percent compared to 2008. In volume, loans were increased to 9.2 percent, and were financed mainly by the increase of deposits.

It is to be mentioned that all banks in Kosovo achieved to meet, and large part of them exceed minimal amount of required capital of € 5 million by bringing it in line with EU Instructions.

Reduction of physical cash in circulation

Reduction of physical cash in circulation was one of the main objectives of the CBAK. This change ensured a unique possibility in order to achieve this objective and, at the same time, helped in consolidating the Banking System. The CBAK planned to exchange family amounts up to DM 1,000 for each person free of charge, and levied a tariff of 2 percent for amounts between DM 1,000 to 10,000. This was also the maximal allowed cash amount for exchange. Amounts exceeding DM 10,000 had to be deposited in Euro as bank deposits.

Introducing maximal limits on exchanged amounts and determining clearly the final term of double circulation of currency encouraged very much holders of cash to deposit their money in banks instead of risking by not exchanging their funds in due time. This strategy was stimulated by banks, which had already improved and increased their services in order to attract new clients to open bank accounts. Implementation of this project was not that simple and it was followed by some problems. The greatest problem certainly was the continuous lack of trust in the banking system. In earlier times, trade banks of Kosovo had only 24 offices at their disposal, while CBAK was operating through a network of 23 offices, of which more

[6] http://www.bqk-kos.org/?cid=1,69, Financial Sector Bulletin, Prishtina, 2010, page 8

[7] http://www.bqk-kos.org/?cid=1,134, Annual Report 2009, page 40

than a half were small local agencies, which opened only during limited working hours, and seven (7) mobile groups of banks. However, a three months period, prior to replacement of cash currency, had marked an increase of about € 300 million in bank deposits. The amount of deposits in the banking sector in 2007 reached to € 1.14 billion, which was 23.5 percent more than in 2006.

Introducing Euro in circulation was completed successful in 28 February 2002. So, as of this moment Kosovo economy got "Euroized" completely and efficiently[8]. Euroization is often defined as adoption of Euro to be a legal and official currency by a country outside the Eurozone. This means that Kosovo does not maintain independent monetary policies and it also does not control interest rates. It is a country that has accepted Euro as its own official currency but it is still not member of the European Monetary Union.

Monetary stability

Euroisation had brought to Kosovo the much needed monetary stability. By lowering inflation and eliminating exchange rate risk, euroisation has given to Kosovo, in a post war context, a stable monetary environment, which is necessary for economic development, but of course it is not sufficient.

At the time when Kosovo had chosen Euro, annual inflation was over 40 percent. Its official currency (Dinar) was completely devaluated and its use was almost inexistent. UNMIK was not simply replacing a national devaluated currency but was placing a healthy monetary foundation necessary for economic, social and political reestablishment for the coming years[9].

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[8] Myrvete Badivuku-Pantina: Costs and benefits of Euroization in Kosova, 3rd International Scientific Session "Challenges of the Knowledge Society", University "Nicolae Titulescu", 2009, Bucharest, page 8

[9] Erdin Maloku, Politika monetare dhe Banka Qendrore e Republikës së Kosovës – avantazhet dhe disavantazhet e përdorimit të euro-s në Kosovë, Prishtinë, 2010, page 66

Inflation in Kosovo did not disappear immediately after introducing the DM and later Euro. In 2000-2001, Kosova marked double digits of inflation in spite of being helped by foreign donations and private revenues. As a result of this, inflation was evidently deferred and it is currently under the Eurozone inflation percentage. Certainly, there are other contributory factors in addition to Euroization, such as, for example, high level of unemployment and low economic activities. Kosovo economy, in 2009, recorded a deflation rate of 2.4 percent, which was mainly driven by the decrease of import prices.

In general, adoption of Euro as a national currency established monetary stability in Kosovo. Risk of devaluation of the national currency disappeared. CBK, which acts as a fiscal agency to local administration, does not take exchange risks while administrating official reserves. These reserves are being invested mainly in Eurozone countries, in central banks and financial institutions. In the same manner, Euroization in Kosovo has hindered the possibility of having double norms of exchange of currency, legal and informal. This in fact should lead to a lower cost of borrowings and to an increase of investments, encouraging improvement of economy and social welfare.

However, the global financial crisis which impacted the whole globe, has had its effects in Kosovo as well, especially in attracting foreign investments and remittances. Gross Domestic Product marked a growth, economic growth decreased to 4.4 percent in 2009 from 5.4 percent in 2008. Public expenditures marked a growth by 39 percent and represented about 14 percent of the GDP in 2009. Trade deficiency was 37 percent of the GDP and exports represented only 8.6 percent of the imports and only 6 percent of the GDP in 2009[10].

[10] http://www.telegrafi.com/ekonomi, Kriza ka goditur edhe kosovën

Reduction of transaction costs

The reduction of transaction costs related to a lower number of foreign exchange transactions is often considered to be among the most important benefits of a monetary union[11].

Euroisation in Kosovo implies the elimination of transaction costs with economic agents that also use euro but, of course, it does not eliminate transaction costs with those using other currencies. The elimination of transaction costs will be expected to ease foreign exchanges and more broadly to increase the productivity of the economy. Moreover, the use of euro added with no exchange controls, allow Kosovar entrepreneurs to trade without being hampered by the burden of bureaucratic exchange control rules. However, whether or not Kosovo can benefit from the reduction of transaction costs depends on its ability to reallocate labor and capital - previously employed in financing foreign trade operations- to more productive purposes, such as other financial activities or other economic activities. Anyway, the low transaction costs generated by the use of euro are to be seen as an additional element to foster economic growth, but not as a key factor. High deficit of trade balance keeps being a great challenge for the economy of Kosovo. The high dependence of the Kosovo economy on the import of goods and the low level of exports led to persisting high trade deficit. As a consequence of the global crisis impact, in 2009, both imports and exports declined, whereas the trade deficit marked a moderate annual growth. High import rates have and an impact on the trade deficit in 2009 which was at € 1.7 billion (44.5 percent of GDP), while coverage of imports with exports was merely 8.6 percent[12]. As in previous years, the deficit was mainly covered by remittances of Kosovo's working abroad and by the donor sector.

[11] Jan Zika, IES FSV UK, Cost and benefits of a monetary union, European Economic Policies, 2005-2006, page 5

[12] http://www.bqk-kos.org/?cid=1,134, Annual Report 2009, page 51

Macro-economic stability

Euroization in Kosovo also had some long-term policy objectives. It is expected that Euroization in Kosovo will take care of economic stability, and will solve the problem of credibility as well as mainly improve the fiscal discipline by eliminating the possibility of emission of money in order to cover budgetary deficits. Following a long period of time, when other conditions are met, all these factors should have an impact in attracting direct foreign investments for Kosovo[13]. Also, it was thought that joining a strong international currency shall result with a reduction of interest norms, by making investments more attractive, which would result positively by developing the local economy.

Reduction of interest rates

Lower nominal interest rates in terms of the reference currency are likely, thus promoting investment and growth[14]. One of the supposed benefits of euroisation is having interest rates similar to that of the issuing country. The introduction of the euro to Kosovo was expected to lower the cost of capital and to push for faster economic growth.

Table 1: Interest rates in EU and Kosovo in 2009

Commercial Banks Effective Interest Rates in (%) Average (August - December 2009)		
	Interest Rates	
	Kosovo	EU
Deposits		
Households : over 2 years	5.38%	2.53%
Non-financial corporations : over 2 years	4.58%	2.77%

[13] http://www.bqk-kos.org/?cid=1,145, Kosovo Experience with Euroization of its economy

[14] D.MarioNuti, Cost and benefits of unilateral euroisation in Central Eastern Europe, January, 2002, page 7

Loans		
Households : up to 1 year	13.00%	7.28%
Non-financial corporations: up to 1 year	15.44%	4.17%

(*Sources: CBK, ECB 2009*)

However, Table 1 shows a significant difference between the prevailing interest rates in the EU and Kosovo. In particular, the interest rates in Kosovo are notably higher than those of the EU. More importantly, the interest rate spread in Kosovo indicates that households enjoy a discount as compared to non-financial corporations, compared to the interest rate spread in the EU, where non financial corporation's enjoy the discount, the financing priorities of the EU differ from that of Kosovo. Specifically, it may be argued that the cost of capital in EU is cheaper for non-financial corporation's than households, whereupon investments in the EU will be encouraged. Conversely, the cost of capital for households in Kosovo is cheaper than for non-financial corporations. This may further explain the slow rate of investments in Kosovo.

Even if interest rates are sometimes considered to be high in Kosovo, they would have been higher should Kosovo had its own domestic currency, since interests rates would have to cover risks related to expected inflation and to currency fluctuation, not to mention the costs of the funding, which would have been very high with an unsecured and unstable currency.

Reduction of currency risk

According to Eichengreen (2002), higher volatility in the domestic currency leads to higher default or sovereign risk. Ultimately, this leads to higher debt-servicing costs. Many countries having their own currencies face higher borrowing costs due to default and sovereign risks. The euroisation in Kosovo promises to eliminate the possibility of currency devaluation. As such, the domestic risk in Kosovo has disappeared giving the domestic firms the possibility to have higher access to both, domestic and international financial markets. The theory prescribes that both investments and economic growth are expected to increase in Kosovo as an emerging economy due to the lower cost of credits[15].

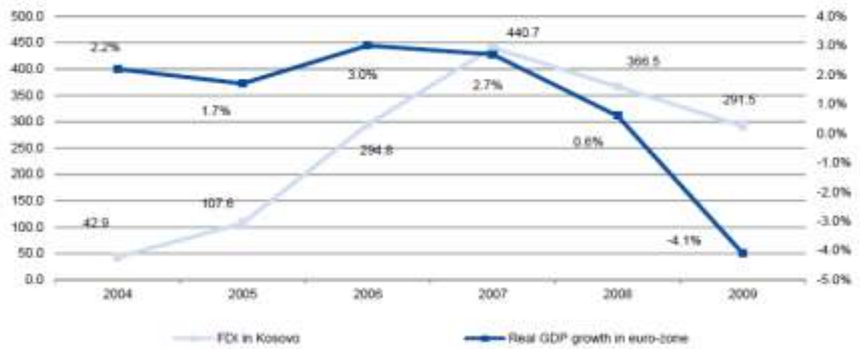

Figure 1: Foreign Domestic Investments in Kosovo and economic growth in Euro zone

Source: Annual Report of CBK (2009)

In contradiction to the theory, euroisation in Kosovo neither helped in lowering the borrowing cost neither in increasing the investments in major scale. Compared to other western Balkan countries with their own currencies, Kosovo has higher borrowing cost and lower economic growth. Yet, borrowing costs and growth are not solely dependent on the choise of exchange rates. Instead other institutional characteristics of the economy of Kosovo greatly affect its economic performance, particularly the lasck of stable state institutions. Moreover, neither the government nor domestic firms can rely on foreign lending. Further, the lack of explicit guarantees discourages foreign direct investments.

Shortcut of monetary integration into Euro area

One of the arguments for euroisation is faster economic integration into the euro area. This entails an increased level of market integration where it is expected that trade restrictions will be lowered. An improved access to international financial markets is also expected.

[15] Erdin Maloku, Politika monetare dhe Banka Qendrore e Republikës së Kosovës – avantazhet dhe disavantazhet e përdorimit të euro-s në Kosovë, Prishtinë, 2010, faqe 70

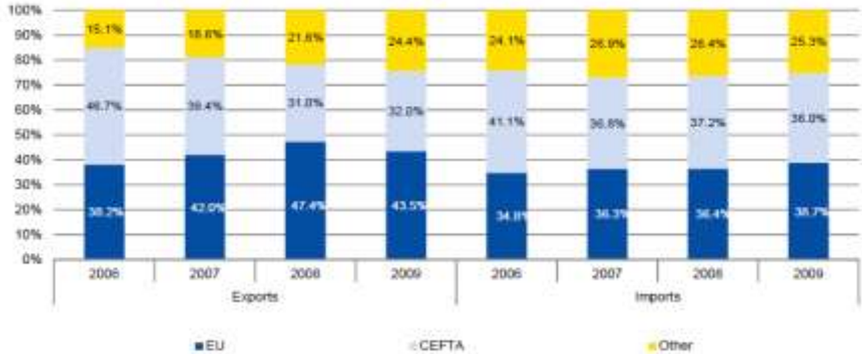

Figure 2: Structure of trade by trading partners, in percent

Source: Annual report of CBK (2009)

Considering the data on Kosovo, trade with EU has considerably increased as a result of the lower transaction costs associated with the use of the euro. The European Union (EU) countries and CEFTA[16] member states remain the main trade partners to Kosovo, with which Kosovo conducted 74.4 percent of trade in 2009. Kosovo exports to EU countries during 2009 declined by 24.7 percent, which is higher than the decline rate in the exports to CEFTA countries, reflecting the stronger impact of economic crisis in the EU countries. However, the share of exports to EU countries in total Kosovo exports reached at 41.5 percent in 2009, which represents a growth of 2.8pp compared to 2008[17].

The EU and CEFTA countries were the main trade partners of Kosovo also in terms of imports, accounting for 38.7 percent and 36.0 percent of total imports, respectively. The largest part of imports from EU countries consists of products imported from Germany, which in 2009 amounted at € 235.4 million or 12.4 percent of total imports.

[16] Central European Free Trade Agreement

[17] http://www.bqk-kos.org/?cid=1,134, Annual Report 2009, page 52

Euroization costs for Kosovo

Although Euroization, as outlined above, had a positive impact in Kosovo's economy, it also created costs. However, such costs may be considered as resistible compared to its advantages. The following are considered more evident costs to Kosovo's economy:

Lost of seigniorage incomes

Seigniorage means incomes benefited by difference created between nominal value of emitted money and real production costs of such emission. The main and direct cost of euroisation in all countries is the loss of seigniorage revenue from the issuing a domestic currency, because the member states do not represent any longer the official currency issuer used in the country. It is known that budget deficit may be financed by taking loans and by emitting money or by increasing monetary basis (by increasing inflation). With euroisation, economies do not have access to printing money thereby cannot provide themselves with a source of financing in emergencies[18]. When a country joins a monetary union, it should naturally maintain the inflation norm within limits determined by the Union. Hence, if less developed countries join a union of more developed countries then they have to reduce their inflation norms since developed countries maintain a low inflation. Hence, authorities are obliged to use different kinds of polices such as emergency taxes in order to finance their expenditures.

In transition economies seigniorage is usually fairly low, of the probable order of 1-2 per cent of GDP (Schobert, 2001)[19].

In case of Kosovo, the lost of seigniorage incomes is considered as a very low cost. If Kosovo would issue its own domestic currency, the potential incomes from producing the money would be very low or even negligible. As the matter of fact, Kosovo went through a double currency system (DEM and dinar), and later went in use of the powerful of DEM and then in to use of Euro, the use of domestic currency would be low having in

[18] Jetmir Likaj, Euroisation in Kosovo : Benefits and costs, Amsterdam, July 2006, page 32
[19] Domenico Mario Nuti, Albania and Euro, page 9

mind that people living in Kosovo would keep their savings in Eur. As a result, with this high scale of euroisation the use of domestic currency would be very low in Kosovo. In general, the costs caused by deficient sources stemming from production of money for Kosovo is extremely left aside by the stability and credibility brought by euroisation.

Loss of sovereignty over monetary policy

Adoption of a currency by a country, which is different from the national one, makes the Central Bank of such a country not to maintain its monetary policy since in this case this function shall be transferred to the European Central Bank, which is responsible for keeping stable prices in the Eurozone. But, some years ago, the CBAK had initiated a dialogue with the European Central Bank, which resulted in signing a Memorandum of Understanding (MoU) concluded between these two institutions. By means of this MoU the CBAK was exempted of a part of financial obligations dealing with transportation of Euro banknotes and currencies in circulation in Kosovo.

The loss of independent monetary policy in Kosovo should not be taken as a major cost. Since the economy of Kosovo is still in a state of transition, it is quite beneficial to have a stable monetary policy. Having gone through hyperinflation in its history, it would have been very difficult for Kosovo to build its credibility with its own currency.

Loss of "regulative powers" of national policies

Countries that apply completely free currency exchange rates and do not belong to the monetary union have the possibility, based on their policies, to devaluate their currency in order to generate possible benefits based on the expansion of trade. When a country faces loss of competitiveness of the local products, then it will, through devaluation of local currency, influence in increase of competitive capabilities of local products by creating possibilities to increase exports[20].

[20] Myrvete Badivuku-Pantina: Costs and benefits of Euroization in Kosova, 3rd International Scientific Session "Challenges of the Knowledge Society", University "Nicolae Titulescu", 2009, Bucharest, page 10

Difficulties in implementing "the lender-of-last-resort" function

The stability of the banking system depends on the ability of the central bank to provide short-term credits to bank and other financial institutions in case of liquidity risk. Thus, euroisation removes tha capacity of issuing money by putting difficulties in the lender-of-last-resort function. However, Chang (2000) and Wojcik (2000)[21] argue that there are three other ways to substitute this function. First, the government could provide liquid funds to commercial banks, either by accumulating foreign reserves or by borrowing from international financial institutions.

Firstly, the lender-of-last-resort function in Kosovo is quite difficult to be replaced. Given that the government of Kosovo is facting a current account deficit of 16 percent of GDP, it has neither excess funds nor a huge amount of foreign reserves.

Secondly, the huge presence of two foreign banks, with a market share of deposits of 68 percent in the Kosovo banking system reduces the need for a lender-of-last-resort function. Foreign banks can easily obtain funds from their headquarters in case of liquidity risk.

Thirdly, the CBK has been continuously increasing the minimum capital requirements for banks reaching a level of euro 5 million to be applied in 2006. According to the Basel capital adequacy standards, aggregate capital for the banking system has reached 17.9 percent of the risk-weighted assets as of 31 December 2009. This policy may be considered as a substitute to the lender-of-last-resort.

In conclusion, the three alternatives to the lender-of-last-resort function cannot be applied in Kosovo without incurring significant costs to the economy as a whole.

[21] Jetmir Likaj, Euroisation in Kosovo : Benefits and costs, Amsterdam, July 2006, page 31

Conclusions

Adopting a foreign currency as an anchor in the Balkans is not a new phenomen. Sice the second half of the 20th century, former Yugoslavian countries have used the DEM either as a first or second currency. By and large, the political divorce of the Yugoslavian republics has further commented the role of the DEM in these economies, resulting in recommendations of unilateral official euroisation. However, unilateral official euroisation has the potential for both considerable benefits and sizeable costs.

The adoption of euro in Kosovo has been very beneficial in bringing macroeconomic stability in the economy, which is of high importance. The inflationary experiences accompanied with the collapse of the financial system in former Yugoslavia during the 1990s have destroyed the confidence in the domestic currency and as a result, led to the high degree of currency substitution, in Kosovo as well as in its neighbors. Given Kosovo's unique political and economic situation, the need for a stable monetary environment is crucial for building a healthy macroeconomic framework. Therefore, adoption of euro as the legal tender of the Territory was very beneficial.

Euro has brought to Kosovo the much-needed monetary stability by reducing inflation, eliminating the exchange rate risk which, in turn, helped reducing the transaction costs and promoting trade and investments.
Yet theory has promised much more. Regarding the reduction of transaction costs, although trade with the EU has increased, international trade is still concentrated on the neighboring non-euro countries. While currency risk has been eliminated, Kosovo has yet to fully utilize this benefit due to the luck of state status. Moreover, instead of reducing domestic interest rates, euroisation has not managed to lower the rates. As it is, Kosovo has the highest rates in the Balkans.

Like any medicine, euroisation is associated with a few side effects. The loss of independent monetary and exchange rate policy has been in the forefront of arguments. Although the adoption of the euro entails a loss of competitiveness regarding the exports, monetary policy has only a temporary effect. Only permanent solutions, in the form of fiscal policies, can pump up production and promote exports. The loss of seigniorage revenues is immaterial in the case of Kosovo since Kosovo did not have its own currency prior to euroisation.

To face possible constraints in the use of traditional monetary mechanisms, a prudent banking supervision is of utmost importance. Prudent measures are the best way to ensure financial stability, as part of the broader macroeconomic stability goal. Special prudential measures form the basis of a healthy financial system, which can become a promoter of the broader growth and development goals in Kosovo.

The path to European integration foresees the adoption of euro in the future. By having taken this step and with the help of the international community, Kosovo will not just prepare itself for a possible EU integration, but can actively use the euro as a tool to be ahead in the drive to join the EMU.

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