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NO. 7

ECONOMIC RELATIONS WITH REGIONS NEIGHBOURING THE EURO AREA IN THE "EURO TIME ZONE"

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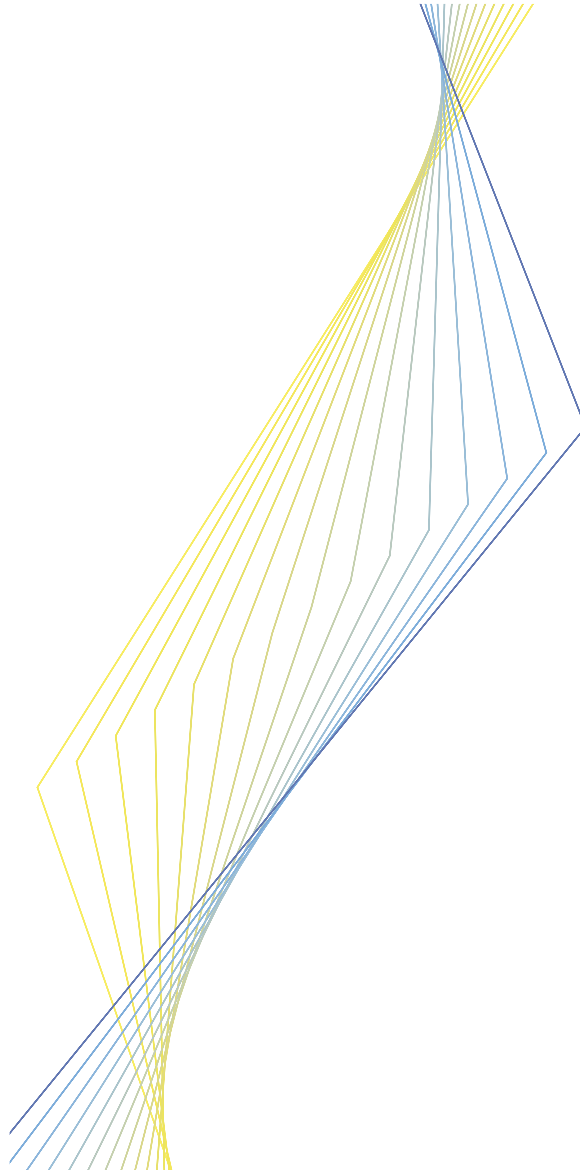

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Executive summary

This Occasional Paper reviews the economic, monetary and financial relations between the EU and the euro area and countries in a broad set of neighbouring regions. While in this context the attention of policy-makers and academics has recently focused on those countries that are candidates for EU membership, this paper goes beyond this limited group. It focuses instead on a belt of another about 80 countries that surround the euro area in a broad geographical sense and that are mostly classified as transition, emerging market or developing economies. These countries belong to four main regions: the Western Balkans; the European part of the Commonwealth of Independent States; the Middle East and Northern Africa; and Sub-Saharan Africa.

These countries are labelled, for the purposes of this paper, as belonging to the "Euro Time Zone" (ETZ), as most of them are within the longitudes or time zones that broadly correspond to those of the euro area. In many respects, these countries are diverse, belonging to different continents and having reached different levels of economic development. However, some common features can also be identified. One of these common features is the fact that the EU/euro area is their largest trading partner and the largest originator of international bank credit, foreign direct investment and official development assistance. From a euro area perspective, these countries account for a relatively small share of external trade, but they are important as providers of energy, other raw materials and agricultural products.

The paper analyses the relevant links at four levels: institutional links, trade links, financial links and monetary (i.e. exchange rate) links. One of the features common to all the 'ETZ' countries is the fact that they enjoy special relations with the European Union in institutional terms: the EU has had a policy of association with neighbouring countries since the creation of the European Economic Community in the 1950s, and has intensified this policy since the late 1980s. Beyond more general goals of political co-operation, these agreements have been designed to strengthen trade integration, open up the current (and in some cases the capital) accounts and facilitate direct investment in both directions. The 'ETZ' countries' trade with the EU has been characterised by the dominance of natural resources, even if the share of manufactured goods in EU imports from 'ETZ' countries more than tripled between 1980 and 2000. Turning to financial links, 'ETZ' countries are relevant for euro area banks, as they account for one third of the exposure to emerging market economies.

The existence of monetary ties, i.e. the importance of the euro in the countries' exchange rate policies, seems to be a function of the strength of the other ties. Those countries with the most binding institutional arrangements, the highest share of bilateral trade and a significant presence of euro area banks, are those that use the euro most intensively as an anchor for their exchange rate policies and/or as a parallel currency alongside the domestic currency. This holds particularly true for countries in the Western Balkans and Northern Africa. Conversely, countries with the least developed institutional links, the lowest presence of euro area banks and whose production structure is specialised in raw materials (especially oil), tend to exhibit no orientation to the euro, despite their geographical proximity and – in some cases – intense trade relations with the euro area. This applies in particular to Russia, other CIS countries and most countries in the Middle East.

1 Introduction

Economic and institutional relations between the euro area and the 13 countries that are candidates for entry into the European Union[1] (EU) have attracted considerable attention in recent years. Their relations with the EU – in the form of a particularly tight association in the early 1990s, upgraded to an "accession process" in the second half of the decade – have been building blocks in the successful transition from planned to market economies, and have fostered a rapidly growing economic and financial integration with the euro area. For ten of these 13 countries, the accession process will culminate in entry into the EU by 2004, marking the largest enlargement of the EU in its 50-year history.

Much less emphasis has been given to the economic links between the euro area, as the fullest form of integration in the European Union, and the wider semicircle of countries to the east, south-east and south. The euro area is, in a broad geographical sense, surrounded by a belt of around 80 such countries that are classified as transition, emerging or developing economies. These countries belong to four main regions: the Western Balkans; the European part of the Commonwealth of Independent States (CIS) including Russia; the Middle East and Northern Africa; and Sub-Saharan Africa. Some of the countries in these regions, in particular those in the CIS and the Balkans, are currently engaged in a process of economic and institutional transition from centrally planned economies, following a path similar to the one of most EU accession countries. Other countries – especially on the southern border of the Mediterranean, in the Middle East and in Sub-Saharan Africa – have reached different stages of economic development, but the economic links between many of them and the EU have intensified in recent years.

With respect to the EU and the euro area, the 80 neighbouring countries in the regions mentioned above share two other characteristics besides geographic proximity. First, they have a long history of tight interaction with Europe which has given rise to today's economic and institutional relations; second, they are formally associated with the European Union by way of special agreements. These agreements fall into four categories, with each category being specifically designed for each of the corresponding regions: the Stabilisation and Association Agreements for countries in the Western Balkans; the Partnership and Co-operation Agreements for Russia and the Commonwealth of Independent States; the Mediterranean Agreements for countries around the Mediterranean; and the Yaoundé-Lomé-Cotonou type of agreements for African countries (as well as for some countries in the Caribbean and the Pacific, which are not dealt with in this paper). Many of these institutional arrangements have important economic implications insofar as one of their central aims is to foster trade and financial relations between the EU/euro area and the countries concerned.

This paper reviews the economic aspects of the institutional arrangements and analyses economic relations – i.e. trade, financial and monetary (exchange rate) links – between the EU/euro area and the set of around 80 countries in the four regions mentioned above. As the countries in these four regions together are broadly located within the time zones or degrees of longitude roughly corresponding to those of the euro area (Central European Time –2/+3 hours), this paper uses the term "Euro Time Zone" (ETZ) as an ad hoc label for the entire group of countries.

It should be recognised that while the 'ETZ' is used as a summary label, there is an obvious degree of arbitrariness in subsuming some 80 countries under the same heading; hence, the term is used in quotation marks throughout. It is indeed one of the aims of the paper to explore whether and how the factors considered before – broad geographical proximity to the euro area and an extensive set of institutional links with the EU – are reflected in a particular network of economic links between the euro area and its neighbouring regions in a broad sense.

1 Bulgaria, Cyprus, Czech Republic, Hungary, Estonia, Latvia, Lithuania, Malta, Poland, Romania, Slovakia, Slovenia, Turkey.

Some of the issues dealt with in this paper are similar to those sometimes addressed in more formalised approaches (gravity models of international trade, cluster analysis, etc.). The paper is, however, intentionally more descriptive and offers a large amount of qualitative and quantitative information extracted from different sources. It does not seek to formalise intensity indicators of relations with 'ETZ' regions, or to compare them with other regions of the world.

The paper is organised as follows: Section 2 highlights the main features of the four regions and their multidimensional factors of closeness to the euro area. Section 3 analyses the institutional links between the EU and the regions of the 'ETZ'. Sections 4 and 5 focus on the economic links, considering trade and financial linkages. Section 6 reviews exchange rate and monetary policies in the 'ETZ' countries. Section 7 draws some tentative conclusions from the analysis.

“Euro Time Zone” countries

Western Balkans

Commonwealth of Independent States

Middle East and Northern Africa

Sub-Saharan Africa

-2 -1 CET +1 +2 +3

2 'ETZ' regions and their closeness to the euro area

2.1 'ETZ' regions and countries

For the purposes of this paper, the countries located in time zones close to that of the euro area (Central European Time –2/+3 hours) are considered as belonging to the "Euro Time Zone" (ETZ).[2] The 'ETZ' comprises 81 countries, has 20% of the world's population, but as a whole accounts for only 5% of world GDP. This imbalance between GDP and population shares reflects, among other things, the sharp contrast in the level of economic development between 'ETZ' countries and the euro area (which accounts for only 5% of the world's population but 20% of world GDP).

2 *While the northern, southern and western borders of the 'ETZ' are clear, there are uncertainties as to the exact location of the eastern border. This could be set so as to include Iran as part of the Middle East, along with Russia, Kazakhstan, all Black Sea countries and all that are west of the Caspian Sea. Given that 80% of Russia's population lives to the west of the Ural Mountains, this justifies the inclusion of Russia in the 'ETZ'. In any event, it has to be acknowledged that this delineation is somewhat arbitrary: for instance, Turkmenistan has not been included whereas Kazakhstan is part of the 'ETZ', even though both countries border the Caspian Sea. The inclusion of Kazakhstan in the 'ETZ' is justified by its close links with Russia.*

Box 2.1

'ETZ' countries (81)

Western Balkans: (5)

Albania	Croatia	FR Yugoslavia	
Bosnia and Herzegovina	FYR Macedonia		

European CIS: (8)

Armenia	Belarus	Kazakhstan	Russia
Azerbaijan	Georgia	Moldova	Ukraine

Middle East and Northern Africa: (19)

Algeria	Israel	Morocco	Syria
Bahrain	Jordan	Oman	Tunisia
Egypt	Kuwait	Palestinian Territories[1]	United Arab Emirates
Iran	Lebanon	Qatar	Yemen
Iraq	Libya	Saudi Arabia	

Sub-Saharan Africa: (49)

Angola	Djibouti	Madagascar	Senegal
Benin	Equatorial Guinea	Malawi	Seychelles
Botswana	Eritrea	Mali	Sierra Leone
Burkina Faso	Ethiopia	Mauritania	Somalia
Burundi	Gabon	Mauritius	South Africa
Cameroon	Gambia	Mayotte	Sudan
Cape Verde	Ghana	Mozambique	Swaziland
Central African Rep.	Guinea	Namibia	Tanzania
Chad	Guinea-Bissau	Niger	Togo
Comoros	Kenya	Nigeria	Uganda
Congo, Dem. Rep.	Lesotho	Rwanda	Zambia
Congo, Rep.	Liberia	São Tomé & Príncipe	Zimbabwe
Côte d'Ivoire			

1 *The Palestinian Territories (West Bank and Gaza), while not a sovereign state, belong to the so-called partners in the EU's Barcelona Process (partnership with 12 Mediterranean countries and territories, see 2.2), and are thus included in this Box.*

Table 2.1

"Euro Time Zone" - Population and GDP in 2001

Region	Population (million)	As % of world population	GDP (USD billions)	As % of world GDP
Western Balkans[1]	24.8	0.4	32.1	0.1
European CIS	239.9	3.9	393.9	1.3
MENA[2]	317.7	5.2	826.0	2.7
Sub-Saharan Africa	687.2	11.3	312.8	1.0
All 'ETZ' countries	1,269.6	20.8	1,564.8	5.1
Memorandum:				
Euro area	303.1	5.0	6,089.9	19.6
Non-euro area EU	74.2	1.2	1,795.7	5.8
Accession countries	170.7	2.8	410.7	1.3
Other European countries	12.0	0.2	418.2	1.3
World	6,085.7	-	31,049.3	-

Source: IMF World Economic Outlook.
1) GDP data for the Western Balkans excluding Yugoslavia.
2) GDP data for MENA excluding Iraq.

The Middle East and Northern Africa (MENA) is the most important of the four 'ETZ' regions in economic terms. Its GDP exceeds the combined GDP of the Western Balkans, the European CIS and Sub-Saharan Africa. However, it has only one-quarter of the four regions' overall population, pointing to its comparatively higher income level. In contrast, Sub-Saharan Africa accounts for more than one-half of the four regions' population, but contributes only 20% to their overall GDP, reflecting the fact that it has the lowest level of economic development in the 'ETZ'.

The remainder of this section gives a brief overview of the regions constituting the 'ETZ' and identifies the major links between the four regions and the euro area.

2.1.1 *The Western Balkans*

The five states referred to in this paper as constituting the "Western Balkans" (Albania, Bosnia and Herzegovina, Croatia, the Federal Republic of Yugoslavia and the Former Yugoslav Republic of Macedonia) are, with the exception of Albania (and together with Slovenia) the successor countries of the former Socialist Federal Republic of Yugoslavia.

What remains of the Yugoslav federation today is the Federal Republic of Yugoslavia which comprises two member states, Serbia and Montenegro. Further to an agreement signed on 14 March 2002 under the auspices of the EU between the two member states – which is still presently undergoing ratification – the FR Yugoslavia is expected to become a new federation called "Serbia and Montenegro". Kosovo is also formally a territory of the FR Yugoslavia, but it is now administered by the United Nations Mission in Kosovo – UNMIK – following UN Security Council Resolution no. 1244 of 1999.

The population of the five Western Balkan countries totals 25 million. Internally, the region remains highly fragmented from an ethnic point of view. No other European region saw more conflict in the 20th century and, according to the European Commission, at least 200,000 people perished during the wars of the 1990s. The United Nations (Office of the United Nations High Commissioner for Refugees – UNHCR) estimates that 2 million people are still displaced in the area. Croatia has the largest GDP per capita, whereas the other countries show income levels far below those of the euro area.

Table 2.2

Population, income and growth in the Western Balkans

Country	Population 2001 (million)	GDP (USD billions)	GDP per capita 2001 (USD)	Average annual growth rate 1992-2001
Albania	3.4	3.9	1,159	5.4
Bosnia and Herzegovina	3.9	4.3	1,103	n.a.
Croatia	4.8	20.4	4,234	1.6
FYR Macedonia	2.0	3.4	1,650	-0.6
FR Yugoslavia	8.6 [1)]	10.9	1,270	n.a.

Sources: IMF World Economic Outlook, EBRD (2002), IMF (2002).
1) Excluding Kosovo population.

Looking ahead, all countries in the region are exposed to serious economic challenges:

- First, war has had catastrophic consequences on all countries' economies. Poverty has become a real issue. In FR Yugoslavia and Bosnia and Herzegovina, in particular, output stood in 1999 at 50% of its 1989 (pre-war) level.

- Second, while more dynamic growth is needed, the countries are not in a position to finance reconstruction and remain heavily dependent upon foreign aid.

- Third, a deep reform of the financial sector is required everywhere. Reform has made progress in FYR Macedonia and Croatia, and seems to accelerate in the FR Yugoslavia, whereas it is proceeding at a slower pace in Albania and Bosnia-Herzegovina.

In order to re-establish conditions of growth, Western Balkan countries are pursuing regional co-operation policies in parallel with a strategy of gradual integration into EU structures. Such co-operation has been encouraged by the international donor community with the creation of the Stability Pact for South Eastern Europe:

- The Stability Pact includes all countries of South-East Europe, the EU and its Member States, the other G10 countries and the international financial institutions. It is a network for the co-ordination of all international and regional players, created with the additional aim of enhancing regional co-operation and initiating projects with a specific regional feature in the Western Balkans and in neighbouring areas.

- Two regional funding conferences have successfully taken place in 2000 and 2001. The donor community undertook to provide some USD 5.4 billion to finance projects of interest for the reconstruction of the region.

- Under the auspices of the Stability Pact for South Eastern Europe, the ministers of trade and economy of Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania and FR Yugoslavia signed a Memorandum of Understanding in June 2001 seeking to fully liberalise trade in the area through a network of bilateral agreements.

2.1.2 The Commonwealth of Independent States (CIS)

The CIS was set up in 1991, embracing all the internationally acknowledged states that emerged from the former Soviet Union, with the exception of the three Baltic states. It is a rather loose framework for political and economic integration in the region. The heads of state meet once a year, while other committees within the CIS have gradually been set up (e.g. since 1993 the finance ministers have met regularly in the framework of an Economic Committee). However, the CIS is not an institution endowed with decision-

Table 2.3

Population, income and growth in the European CIS

Country	Population 2001 (million)	GDP (USD billions)	GDP per capita 2001 (USD)	Average annual growth rate 1992-2001
Armenia	3.8	2.1	557	-2.1
Azerbaijan	7.9	4.5	720	-3.3
Belarus	9.4	11.4	1,211	0.0
Georgia	5.2	3.2	608	-4.9
Kazakhstan	14.9	22.2	1,501	-0.9
Moldova	4.3	1.6	369	-7.1
Russia	145.2	309.9	2,135	-3.7
Ukraine	49.1	37.6	765	-5.9

Source: IMF World Economic Outlook.

making powers.[3] The CIS countries considered in this paper are Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Moldova, Russia and Ukraine.

Russia is by far the most influential country in the CIS, having a population 50% larger than those of the other seven European CIS countries put together. Moreover, its GDP is four times higher than the combined figure for the other countries. The rather uneven distribution of per capita incomes reflects (i) long-term development trends, including the legacy of Soviet economic policies and (ii) the uneven distribution of natural resources. Whereas Belarus, Ukraine, Georgia, Armenia and Moldova do not have any significant raw material reserves, Russia, Kazakhstan and Azerbaijan are energy-rich countries and are major producers and exporters of oil and gas (EBRD, 2001). Russia holds one-third of all proven gas reserves world-wide and its oil reserves are estimated to amount to 4.6% of total world reserves and 12.8% of reserves outside the Middle East.

All CIS countries underwent a deep transition recession in the early 1990s which was much more severe than in most EU accession countries. Whereas growth resumed in the Caucasian states as early as the mid-1990s, Kazakhstan, Moldova, Russia and Ukraine only saw their first year of significant positive growth in 1999/2000. Since then, however, the region has been experiencing strong growth, supported by high commodity prices, the depreciation of the Russian rouble after the 1998 financial crisis, generally prudent macroeconomic policies and buoyant domestic demand. Structural reforms have gained momentum in all countries with the exception of Belarus, although an extensive transition and reform agenda remains, in particular in the area of corporate governance and financial sector reform.

2.1.3 The Middle East and Northern Africa

The Middle East and Northern Africa (MENA) is a highly heterogeneous region in terms of population and wealth, but also in terms of political structure. With more than 65 million inhabitants each, the most heavily populated countries are Iran and Egypt, whereas eight countries have a population of less than five million. GDP per capita ranges from USD 400 in Yemen to USD 28,000 in Qatar. Oil

3 *Furthermore, over the last decade other sub-regional communities have been founded, such as the Russia-Belarus Union, the Association between Georgia, Ukraine, Uzbekistan, Azerbaijan and Moldova (GUUAM) and the Eurasian Economic Community (EAEC) bringing together Russia, Belarus, Kazakhstan, Kyrgyzstan and Tajikistan. Whereas Russia and Belarus are seeking to establish a future common citizenship and a monetary union, the GUUAM group and the EAEC have more modest aims, focusing on trade and general economic and political co-operation. In all three cases, however, tangible results have been very limited so far. In addition, there are a few regional conflicts threatening political stability and economic development, for example in the separatist regions of Transdniestria in Moldova, and Abkhazia and South Ossetia in Georgia, and the conflict between Armenia and Azerbaijan over Nagorno-Karabakh.*

Table 2.4

Population, income and growth in selected MENA countries

Country	Population 2001 (million)	GDP (USD billions)	GDP per capita 2001 (USD)	Average annual growth rate 1992-2001
Algeria	30.9	54.9	1,775	2.2
Egypt	66.4	96.8	1,456	4.2
Iran	68.5	114.1	1,665	4.1
Israel	6.4	110.5	17,335	4.5
Morocco	29.2	33.5	1,147	2.4
Saudi Arabia	21.3	166.7	7,822	1.4
Tunisia	9.7	20.0	2,059	4.9

Source: IMF World Economic Outlook.

resources are the major determinant of wealth in the region and are distributed unevenly across countries. MENA includes some of the most important oil-producing countries, like Saudi Arabia and Iran, and almost 70% of the world's proven oil reserves are concentrated in the region. The wealth gap within MENA creates migration pressure both within the region and from several MENA countries to Europe. With the exception of some small oil-producing countries, Israel is the only high-income country with a development level comparable to that of Western Europe. Its GDP per capita amounts to approximately three-quarters of the euro area average figure, and is thus higher than in some euro area member states. Israel is also the only highly industrialised country in the region (and indeed in the entire "Euro Time Zone"). In terms of overall GDP, Saudi Arabia, Iran, Israel and Egypt are by far the largest economies. Growth performance in the region is very diverse, but generally less dynamic than in key emerging market economies.

The Arab League is a regional framework for political and economic integration consisting of 22 Arab states. Within the Arab League, the Arab Monetary Fund fosters monetary co-operation. However, the Arab framework does not include Iran or, of course, Israel, two major players in the region, and suffers from a lack of political coherence. Other frameworks for regional integration are the Arab Maghreb Union (AMU: Algeria, Libya, Mauritania, Morocco, Tunisia) which has not made much progress due to internal political conflicts, and the Gulf Co-operation Council (GCC: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates). The GCC, so far the most successful framework for regional integration, intends to establish a customs union in 2003, and to introduce a single currency in 2010.

2.1.4 Sub-Saharan Africa

Sub-Saharan Africa is a highly heterogeneous area in terms of population and wealth. It comprises 49 African countries, including the islands of Madagascar, Comoros, Cape Verde, Mauritius and Seychelles. By far the most highly populated country is Nigeria, with 132 million inhabitants. The second country in terms of population size, South Africa (45 million), is however the largest in terms of output, and accounts for approximately one-third of the GDP of the African continent as a whole. Notwithstanding South Africa's smaller population and larger economy relative to Nigeria, and excluding Seychelles whose economy is driven by tourism, GDP per capita in Sub-Saharan Africa is highest in Gabon and Equatorial Guinea, both of which are endowed with natural resources, oil in particular.

Most Sub-Saharan African countries, however, are classified as low-income economies. Moreover, richer countries like Gabon and South Africa, whose level of economic development is similar to that of some European countries, exhibit high income inequalities.

Integration projects have been high on the agenda of Sub-Saharan Africa countries since

Table 2.5

Population, income and growth in selected countries of Sub-Saharan Africa

Country	Population 2001 (million)	GDP (USD billions)	GDP per capita 2001 (USD)	Average annual growth rate 1992-2001
Benin	6.5	2.4	372	4.9
Burkina Faso	12.7	2.5	196	3.8
Cameroon	15.8	8.5	542	2.4
Central African Republic	4.0	1.0	246	1.7
Chad	7.7	1.6	209	3.3
Côte d'Ivoire	17.5	10.4	595	2.5
Equatorial Guinea	0.5	1.9	4,079	27.2
Gabon	1.2	4.6	3,743	1.2
Guinea-Bissau	1.2	0.0	200	1.2
Mali	11.4	2.6	227	4.1
Niger	11.1	1.9	173	2.1
Nigeria	131.6	41.1	311	2.7
Republic of the Congo	3.0	2.9	964	1.6
Senegal	9.9	4.6	467	4.0
South Africa	44.9	111.7	2,490	2.1
Togo	4.9	1.3	255	1.9

Source: IMF World Economic Outlook.
This table covers the two key countries (Nigeria and South Africa) and the 14 CFA franc zone countries.

independence in the 1960s, but results so far have been mixed. For instance, African countries decided further to the Lusaka summit in July 2001 to overhaul the Organisation for African Unity (OAU), an international organisation created in 1963 including 53 African states, and to create an "African Union".[4] Four other major regional integration frameworks exist in Sub-Saharan Africa: the Southern African Development Community (SADC), the Economic Community of West African States (ECOWAS), the CEMAC *(Communauté Economique et Monétaire de l'Afrique Centrale)* and the UEMOA *(Union Economique et Monétaire Ouest Africaine)*. All four fora have addressed monetary co-ordination explicitly, most notably the CEMAC and the UEMOA, which form the CFA franc zone, and the five English-speaking countries of ECOWAS where a monetary union project has recently made its first steps.

The potential for integration remains considerable, and is one of the key objectives of the Lomé Conventions and of the Cotonou Agreement (see section 3). Indeed, a large majority of countries in the region belong to the "ACP group" (the African, Caribbean and Pacific countries), with which the EU has developed privileged trade and financial relations through international agreements.

2.2 Multi-dimensional factors of closeness to the euro area

By definition, the main common feature shared by all 'ETZ' countries is their relative geographic proximity to the euro area. However, besides distance, other factors define closeness to the euro area: history, institutional and political co-operation, and economic and financial relations.

As regards the closeness of the Western Balkans to the euro area, it is interesting to note that during the Cold War, prior to the break-up of Yugoslavia, the region – Albania excepted – had been relatively open to the West, in the framework of the Non-Aligned Movement of which former Yugoslav President Tito was one of the founders. During the last

4 *One of the aims of which is to create a common currency and a common central bank within the next 20 years. Indeed, the central banks of the member countries met to this end in August 2001.*

Box 2.2
Other factors of 'ETZ' countries' closeness to the euro area

– Historical ties

In many cases the relations between euro area countries and 'ETZ' countries are based on historical ties. For example, the close monetary link between the 14 countries of central and western Africa forming the CFA franc zone, which have a fixed parity to the euro, is basically explained by these countries' colonial past and the special relationship they have preserved with France since their independence.

– Institutional and political co-operation

Since the significant "wave of independence" of former colonies in the 1960s, the EU has developed a comprehensive policy of co-operation agreements with various regions of the world. Institutional and political co-operation is especially close with the regions bordering the EU. Examples are the Barcelona Process with Mediterranean countries and the Lomé agreements with African, Caribbean and Pacific (ACP) countries (recently replaced by the Cotonou agreement).

– Economic and financial indicators

Economic, financial and monetary variables are of primary importance when assessing the closeness of a given country to the euro area. Trade plays a crucial role in this regard, followed by financial flows, in particular in the form of foreign investment. With respect to the public sector, the extent of official development assistance is another indicator of closeness. Finally, the role of the euro in third countries' and entities' exchange rate regimes deserves attention as it usually reflects the degree of economic and financial integration.

decade links with Western Europe experienced a setback because of the conflicts in the region. Also in institutional terms, it was not until recently that the Western Balkans benefited from association agreements with the EU similar to those that had been offered to central and eastern European countries in the early 1990s. Only in recent years, after free elections were held in Croatia and Serbia, have institutional and political relations with the EU gathered momentum. Through the arrangement of new tailor-made institutional frameworks for this area (the Stabilisation and Association Agreement; the Stability Pact for South Eastern Europe), countries in the region are endeavouring to open a perspective of future integration in the European Union. Notwithstanding ups and downs in institutional and political relations, the euro today plays a key role in all the exchange rate regimes of the region, and the EU is the main trading partner of all five countries.

The relations between the EU and today's members of the Commonwealth of Independent States (CIS) developed during the 1970s along the lines of the so-called Ostpolitik (both bilaterally, between the EU Member States and the then Soviet Union, as well as multilaterally, for instance through the so-called Helsinki Process). The then European Community concluded trade co-operation agreements with the Soviet Union in the 1980s. However, only after the collapse of the Soviet Union did relations gain momentum. Partnership and Co-operation Agreements (PCAs), based on the respect of democratic principles and human rights, setting out the political, economic and trade relationship with the EU and its partner countries have been signed with European CIS countries. In general, ties between the EU and the European CIS are heavily influenced by (i) the fact that the EU accession of central and eastern European countries is in an advanced state, and as a result some CIS countries will have a much longer common border with the EU in the near future, and (ii) the importance of Russia, both in political and economic terms. Russia is the EU's sixth-largest world trading partner and is by far the largest trading partner of the EU among the 'ETZ' countries,

as well as being a major supplier of gas and oil and the largest debtor of euro area banks among the 'ETZ' countries. Meanwhile, the EU is Russia's main trading partner and its largest creditor.

Relations between Europe and the Middle East and Northern Africa have developed since the 1970s. In order to open a new phase of regional co-operation, in 1995 the European Union and 12 Mediterranean partners launched the so-called Barcelona Process, which sought to create a new framework for partnership between the EU and Algeria, Cyprus, Egypt, Israel, Jordan, Lebanon, Malta, Morocco, the Palestinian Territories, Syria, Tunisia and Turkey. The three main topics of the Barcelona Process are: (i) political and security partnership, (ii) economic and financial partnership, (iii) partnership in social, cultural and human affairs. One of the objectives of the Barcelona Process is to create a Euro-Mediterranean Free-Trade Area (target date: 2010). However, according to most analysts the Barcelona-Process has not fulfilled expectations so far, as reflected, for example, in the low rate of disbursements from financial programmes, the slow progress in implementing Association Agreements and the difficulties encountered in drafting a Charter for Stability and Security. The heterogeneity of the 12 partners involved in the process, in both political and economic terms, is often seen as a major problem. Moreover, the unresolved Middle East conflict is an impediment to the Euro-Mediterranean dialogue. Notwithstanding these difficulties, for the Middle East and Northern Africa as a whole and for most of the countries it covers, the EU is by far the most important trading partner. Trade links with Mediterranean countries, especially the Maghreb, are particularly strong. Ties with the Arab Peninsula are comparatively less developed, although the EU did conclude a co-operation agreement with the Gulf Co-operation Council in 1989, which contains a commitment to enter into negotiations on a Free Trade Agreement.

Most Sub-Saharan African countries have strong historical ties to Europe as most of them were once European colonies. European languages are widely used, even as official languages. Furthermore, many countries have preserved special ties with their former colonial power after independence, such as the Commonwealth of Nations for former British colonies, and the framework of Francophone summits. More importantly from a monetary point of view, the 14 countries of the CFA franc zone have maintained a fixed parity against the euro, and the EU is by far the most important trading partner for most countries in the region. For instance, it accounts for more than 40% of the CFA franc zone countries' external trade. In addition, about one-third of South Africa's and Nigeria's external trade is conducted with the EU.

3 Institutional links

Over recent decades, the European Union has set up a well-established institutional framework underpinning its relations with the countries in the "Euro Time Zone" (ETZ). The founding fathers of the then European Economic Community (EEC) pursued objectives of openness and solidarity vis-à-vis countries that were particularly close to Europe, both geographically and historically. Europe developed these relations according to the principles of preferential trade relations, financial aid, the transfer of know-how and support for economic and social development. Recently, dialogue on foreign and security policies has been added to the EU's external relations.

The EU's institutional links are clearly focused on neighbouring regions. Although a number of agreements exist with countries in other areas of the world (e.g. trade agreements with Latin American countries), the full multi-dimensional network of institutional relations described in this section has been developed only with the four regions subsumed under the 'ETZ' heading.

- With the so-called "Western Balkan" countries (Albania and the former Socialist Federal Republic of Yugoslavia, excluding Slovenia) the EU has signed, or is presently about to negotiate, Stabilisation and Association Agreements.
- With Russia and the former Soviet republics (excluding the three Baltic States) the EU has concluded Partnership and Co-operation Agreements.
- With the countries surrounding the Mediterranean, the EU has concluded or is negotiating Euro-Mediterranean Agreements.
- With almost all countries of Sub-Saharan Africa (as well as several countries from the Caribbean and the Pacific) the EU has entered into the Cotonou Agreement, the last of a long series of agreements signed in Yaoundé and Lomé since the early 1960s.

This typology of four different types of agreement[5] did not exist until a few years ago. Originally, the European Economic Community had only two categories of relations: (i) association agreements, "involving reciprocal rights and obligations, common actions and special procedures", and (ii) other co-operation agreements, of a less binding and more specific nature.

Today, the EU has de facto overcome the original dichotomy of the EEC bilateral agreements between association and co-operation, since relations with all four 'ETZ' regions – despite the different labelling with four types of agreement – share the common design of increasing integration between the European Union and its neighbouring areas. The aim of this section is to illustrate the four types of agreements in order to draw some conclusions on elements common to them.

3.1 "Stabilisation and Association Agreements" with the Western Balkans

The Stabilisation and Association Agreements (SAAs) with countries in the Balkans have the most far-reaching implications since their preambles attribute explicitly to the signatories the status of "potential candidate for EU membership", a status also approved by the European Council in Feira in June 2000. Independently of whether Western Balkan countries will be offered candidate status in the future, the degree of integration sought in the SAAs is deeper than with any other non EU-country.

SAAs seek the gradual development of a free trade area between the EU and the Western Balkans. At the end of a 10-year transition phase the associated partners will be part of a

5 *The European Union has concluded other co-operation agreements with other 'ETZ' countries (e.g. with the member states of the Gulf Cooperation Council and Yemen).*

Box 3.1

Stabilisation and Association Agreements

In force	*Signed, not yet ratified*	*Negotiated, not yet signed*	*Negotiations yet to start*
None	FYR Macedonia[1)]	Albania (preliminary)	Bosnia and Herzegovina
	Croatia[1]	Federal Republic of Yugoslavia (preliminary)	

1 "Interim Agreements", anticipating trade liberalisation, have come into force prior to the ratification of the broader agreements.

free trade area for goods and services.[6] Balkan countries will also implement rules on the establishment of companies, capital movements, competition, intellectual property and public contracts with the EU. The agreements additionally establish the right for Community credit institutions and other providers of financial services to receive "a treatment no less favourable than that accorded to own companies or to any third country company, whichever is the better".[7] As with intra-EU rules on the free circulation of services, credit institutions will benefit from the right of free establishment in the EU and in the Balkans, based on the mutual recognition of bank licences.

A financial programme called CARDS[8] supports SAA agreements with grants of €4.6 billion for the period 2000-2006. CARDS is focused "mainly on building up an institutional, legislative, economic and social framework directed at the values and models subscribed to by the European Union and on promoting a market economy". The European Investment Bank has also extended €350 million-worth of loans to the region. Finally, the EU has established a European Agency for Reconstruction in 2000, to which it may delegate the implementation of CARDS.

3.2 "Partnership and Co-operation Agreements" with CIS countries

Partnership and Co-operation Agreements (PCAs) were designed in the early 1990s, shortly after the start of CIS countries' transition from planned to market economies. They aim for a relatively low degree of integration between the EU and the respective countries. For instance, they do not contain any direct commitment to progress towards a free trade area, although they do seek "to create the necessary conditions for the future establishment of a free trade area". In fact, they state that such a development shall only be put into effect by virtue of "new agreements between the parties". For this reason, any progress towards the free movement of capital in PCAs is conditional upon and restricted by exception clauses (e.g. the right of free establishment for credit institutions is stated in the text of PCAs, but subject to limitations, such as a ceiling on foreign ownership of the banking system).

PCAs are supported through the financial programme TACIS[9], which promotes transition to a market economy and the strengthening of democracy and the rule of law in the partner States. In 1991-1999, total commitments to all CIS countries amounted to €4.2 billion. For the period 2000-2006, €3.1 billion has been earmarked.

In view of the latest progress made by some CIS economies towards more stable economic conditions, PCAs might now need new and more ambitious targets. For instance, the

6 *Free trade for goods only applies to industrial goods; trade liberalisation for agricultural goods is not foreseen in the current agreements.*
7 *Stabilisation and Association Agreement with FYR Macedonia (article 48).*
8 *Community Assistance for Reconstruction, Development and Stabilisation.*
9 *Technical Assistance to countries in the Commonwealth of Independent States.*

Box 3.2

Partnership and Co-operation Agreements

In force	*Signed, not yet ratified*	*Negotiated, not yet signed*	*Negotiations yet to start*
Armenia	Belarus		
Azerbaijan			
Georgia			
Kazakhstan			
Moldova			
Russian Federation			
Ukraine			

European Union and Russia have established a High-Level Group to examine the concept of a "Common European Economic Space", seeking to further integrate the EU and Russian economies on the basis of legislative harmonisation, regulatory convergence and the gradual development of a free trade area. This would give a new dimension to the EU's relations with Russia.

Box 3.3

The EU's relations with Russia

The bi-annual EU-Russia Summits – attended by the Presidents of the European Commission and the Russian Federation, as well as by the head of state or government of the country holding the rotating presidency of the European Union – are the highest level form of institutional co-operation.

The "Co-operation Council between the European Communities and their member states, on the one part, and the Russian Federation, on the other part" has regularly convened every year since its first meeting in January 1998, shortly after the entry into force of the Partnership and Co-operation Agreement. Trade (including customs co-operation, foreign direct investment, WTO entry) and economic co-operation (structural reforms) are issues permanently on the agenda judging by the joint communiqués published after the meetings.

At a technical level, the EU-Russia "Subcommittee on Economic, Financial Issues and Statistics" has regularly discussed economic policies in the EU and in Russia, under the joint chairmanship of the European Commission's Directorate General for Economic and Financial Affairs and Russia's Ministry of Economy.

In order to pursue its policy vis-à-vis Russia, the European Union has identified a medium-term strategy (the "Common Strategy on Russia", approved by the European Council of Ministers in June 1999), which sets out the principles, instruments and means of the EU policy. One of the pillars of the Common Strategy is the "integration of Russia into a common European economic and social area". Moreover, in 2000 the Russian government approved a "Strategy towards the European Union 2000-2010".

3.3 "Euro-Mediterranean Agreements"

The then European Economic Community signed the Ankara Agreement with Turkey as long ago as 1963 and granted association status to four Mediterranean countries (Cyprus, Malta, Morocco and Tunisia) in the early 1970s. However, the long-standing relationship between the two sides of the Mediterranean sea took shape only with the

Box 3.4

Euro-Mediterranean Agreements[1]

In force	*Signed, not yet ratified*	*Negotiated, not yet signed*	*Negotiations yet to start*
Israel	Algeria[2]	Syria[2]	
Morocco	Egypt[2]		
Palestinian Territories	Jordan[2]		
Tunisia	Lebanon[2]		

1 *Cyprus, Malta and Turkey – which are also part of the Euro-Mediterranean partnership (Barcelona Process) – additionally have the status of candidate countries. They are not therefore considered 'ETZ' countries as they are now part of the accession process.*

2 *While the new generation of agreements (Euro-Med agreements) has not yet been ratified, the technical "Co-operation agreements" with the EU, signed in recent decades, are still in force. Such agreements will be superseded when the new agreements enter into force.*

Euro-Mediterranean Agreements (EMAs), an integral part of the so-called Barcelona Process. EMAs do not imply, however, that these countries have the status of candidate countries.[10]

The EMAs pursue the goal of a gradual development of a free trade area after a 12-year transition phase.[11] They also set out some rules on the establishment of companies, capital movement, competition, intellectual property and public contracts with the EU. The degree of integration sought in the agreements with countries in the Mediterranean is lower than is sought in the agreements with the Balkan countries, but higher than in those agreements concluded with the CIS countries. The right of establishment for credit institutions is stated as an aim only: "the Association Councils will make recommendations for achieving the objective" and other legal texts are necessary to establish a fully-fledged right. The agreements with Israel and Lebanon are an exception, as they immediately included rules regarding the free establishment of financial institutions.

EMAs are supported by the MEDA[12] financial programme, which includes financial and technical measures "to accompany the reform of economic and social structures in the framework of the Euro-Mediterranean Partnership". During the period 1995-1999 (so-called MEDA I), the programme was worth around €3.4 billion. For the period 2000-2006 (MEDA II), the programme is endowed with €5.3 billion, to which a lending programme of €7.4 billion from the European Investment Bank should be added.

3.4 The "Cotonou Agreement" with Sub-Saharan African countries

In the early 1960s, the then European Economic Community entered into the first association agreements (the Yaoundé Agreements of 1962 and 1969) with countries in Africa, the Caribbean and the Pacific. The association agreements were repeatedly renewed, with the Lomé Convention (Lomé I in 1975, Lomé II in 1979, Lomé III in 1984 and Lomé IV in 1989, with its subsequent revision). The Cotonou agreement (2000) is the sixth agreement in this series. Unlike other arrangements with 'ETZ' regions, all Yaoundé-Lomé-Cotonou arrangements have been multilateral (and not bilateral) conventions.

The Cotonou Agreement states that each participant will conclude with the EU a bilateral "Economic Partnership Agreement"

10 *However, Cyprus, Malta and Turkey, which are part of the Euro-Mediterranean Partnership, have been attributed the status of candidate countries separately.*

11 *Free trade for goods only applies to industrial goods; trade liberalisation for agricultural goods is not foreseen in the current agreements.*

12 *Mesures d'Accompagnement (accompanying measures).*

Box 3.5

Cotonou Agreement

The Cotonou Agreement has been ratified. It is a single, multilateral agreement. The 76 counterparties from Africa, the Caribbean and the Pacific include the following 'ETZ' countries:

Angola, Benin, Botswana, Burkina Faso, Burundi, Cameroon, Cape Verde, Central African Republic, Chad, Comoros, Democratic Republic of the Congo, Republic of the Congo, Côte d'Ivoire, Djibouti, Equatorial Guinea, Eritrea, Ethiopia, Gabon, Gambia, Ghana, Guinea, Guinea-Bissau, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, Mozambique, Namibia, Niger, Nigeria, Rwanda, Senegal, Sierra Leone, South Africa[1], Sudan, Swaziland, Tanzania, Togo, Uganda, Zambia, Zimbabwe.

1 The EU has entered into a "Trade, Development and Co-operation Agreement" with South Africa, complementing the Cotonou Agreement.

(EPA), which is a "new World Trade Organisation (WTO)-compatible trading arrangement", with a view to "removing progressively barriers to trade between them and enhancing co-operation in all areas relevant to trade". These new (bilateral) agreements shall be negotiated by 31 December 2007 at the latest. In April 2002 the European Commission presented proposals to negotiate EPAs with all partners of the Cotonou Agreement. EPAs would combine trade liberalisation with development policies.

The EDF[13] is the financial programme for the countries participating in the Cotonou Agreement. The EDF – which is financed by national contributions outside the EU budget – has operated since the late 1950s, when the European Economic Community was created. In the last four decades, the EDF has extended €42 billion and the European Investment Bank provided €6 billion in loans to these countries. The endowments for 2002-2005 amount to €13.5 billion, and loans from the European Investment Bank to €1.7 billion. According to the Cotonou Agreement, the scope of financing is very diverse, and may include not only technical co-operation, but also measures which contribute to alleviating debt burdens and balance of payments problems and to supporting macroeconomic and structural reforms and policies.

3.5 Elements shared by all EU agreements with 'ETZ' countries

Three features are common to all the EU agreements with the different 'ETZ' regions: (i) the agreements are part of Community Law; (ii) they seek to extend some of the features of the single market outside the EU; and (iii) they create a similar institutional framework, along the lines of some institutional features of the EU itself.

(i) All of the above-mentioned agreements are international treaties that legally bind EU institutions and the EU Member States. As stated by the European Court of Justice in 1973, and reiterated regularly since then, the international agreements concluded under Articles 300 and 310 EC form an integral part of Community Law from the date they come into force.[14] The European Commission has the task of ensuring that the agreements' provisions are applied. While agreements normally have to be complemented by EU legislation, the Court of Justice has also stated that, in particular circumstances, provisions in agreements must be regarded as being "directly applicable", i.e. when they confer rights and duties directly to companies or individuals.[15]

13 European Development Fund.
14 Cf. the Haegemann vs. Belgium case (Case 282/73).
15 Cf. the Demirel vs. Stadt Schwäbisch Gmünd case (Case 12/86).

(ii) The agreements are part of a common policy of support and integration, which the EU conceived as a response to the need for stability in its close neighbourhood. Stability is always pursued along two lines: integration and financial support.[16] The agreements involve a large number of sectors, some of which are also immediately relevant from a monetary perspective. Besides granting the right of free establishment for financial institutions, several agreements also liberalise capital movements, either immediately (Euro-Mediterranean Agreement with Israel) or gradually (Stabilisation and Association Agreements). Other agreements liberalise payments for current account transactions in a freely convertible currency, simply adding some rules liberalising capital movements related to direct investments and permitting the repatriation of profits (e.g. other Euro-Mediterranean Agreements). In some cases, the agreements refer to the possibility of further liberalising portfolio investments and commercial credits, financial loans and credits to non-EU residents with longer maturities (e.g. the Partnership and Co-operation Agreement with Russia). Several agreements commit counterparts not to introduce new restrictions of any sort. However, all agreements contain provisions authorising counterparts to adopt temporary restrictions in case of serious balance of payments difficulties.

(iii) The agreements all establish a similar set of common institutions: ministerial councils, technical committees and parliamentary committees. In some cases, they are flanked by summits at Head-of-State level. As a rule, these fora meet once a year.

- The summits are political events organised at the highest level, with the participation of the President of the European Commission, the head of state or government holding the EU Presidency, and the highest political authorities of the country with which the EU entered into an agreement.

- The ministerial councils supervise the overall application and implementation of the agreements, and serve as institutions for regular political consultation. The councils are composed of the foreign ministers and the Commissioner for External Relations. They also have the power to formally adopt binding decisions or non-binding recommendations; these legal instruments also form an integral part of Community law.

- The committees assist the councils in carrying out their duties, ensuring continuity of the relationship and the proper functioning of the meeting. They meet at senior official level, if required more frequently than once a year. They are complemented by a series of sub-committees whose compositions vary depending on the technical expertise required. For many years the normal practice has been to create up to eight or nine sub-committees, one of which considers economic, financial and monetary affairs.

- The parliamentary committees consist of delegations from the European Parliament and from the parliaments of either a single country (e.g. Russia) or from a small group of countries (e.g. Ukraine, Belarus and Moldova).

In a nutshell, if all agreements were fully implemented, the EU would be at the centre

16 *In addition to the funds mentioned in the main text, the EU may also support balance of payments or government budgets of a subset of 'ETZ' countries using exceptional measures which are not formally contained in the agreements. This so-called "Macro-Financial Assistance" benefits countries with which the EU maintains "close political and economic links, taking into account especially their geographic proximity and the Union's economic, commercial and political interests". Between 1990 and 2001 the EU earmarked €5.7 billion for loans and grants to these countries, of which €3.3 billion was directed to accession countries and the remainder €2.4 billion to 'ETZ' countries (Albania, Algeria, Armenia, Belarus, Georgia, Kosovo, FYR Macedonia, Moldova, Montenegro, Ukraine, and FR Yugoslavia). This assistance is conditional on "the existence of a significant and commonly identified residual external financing gap, which is based on a comprehensive and complete quantitative assessment and transparent background documentation, over and above the resources provided by the IMF and other multilateral institutions and despite the implementation of strong economic stabilisation and reform programmes". The assistance is released in successive tranches, "the disbursement of each of them being conditional upon the fulfilment of macroeconomic performance and structural adjustment criteria". (Text as updated at the ECOFIN Council Meeting of 8 October 2002).*

of a much larger free trade area with its legal foundation in the four sets of arrangements (or in successor agreements still to be negotiated). This free trade area would extend some of the economic achievements of the EU itself, for instance in terms of the free establishment of credit institutions and the free circulation of capital. It would be underpinned by mostly bilateral institutional arrangements, all of which, however, are based on the implementation of Community Law and on intense networking between EU institutions and the respective countries' authorities.

4 Trade relations and energy supply

Trade is one of the key issues on which the agreements between the EU[17] and the "Euro Time Zone" countries are built, and discussions on trade feature prominently in the institutional fora established under these agreements. Trade relations are marked by an asymmetry in mutual trade dependency, since the EU represents a much larger share of its neighbours' trade than vice versa. In fact, the EU represents about 40% of the total external trade of the 'ETZ' countries, making the EU by far the main trading partner for most of them. By contrast, the 'ETZ' countries represent only 16.5% of total EU trade, even though they are the main suppliers of agricultural goods, raw materials and fuels to the EU, accounting for more than 60% of EU imports in these product categories.[18]

4.1 The EU perspective

4.1.1 Trade Features

In the second half of the 1990s, one-third of the EU's trade with the group of less advanced countries[19] was conducted with the Western Balkans, the European CIS, MENA and Sub-Saharan Africa. In fact, the 'ETZ' countries represent the largest EU export market and the second largest EU import market after Asia, making up roughly 16.5% of total EU trade. MENA is by far the most important region for EU trade, accounting for roughly 50% of all EU trade with 'ETZ' countries.

At a country level, Russia, Saudi Arabia, South Africa and Israel are the EU's main 'ETZ' trading partners. In 2000 these four countries accounted for roughly 40% of EU trade with the four regions, with Russia being by far the most important of these trading partners, representing 12% of EU exports to and 22% of EU imports from 'ETZ' countries.

However, since the early 1980s, the importance of 'ETZ' countries for EU trade has declined. There are three main reasons for this:

a) The export performance of many MENA and European CIS countries depends heavily

17 Given the single market status of the EU and thus the absence of any rule of origins for EU countries, an analysis of the EU as a whole is preferred to one for the euro area only. Hence, trade relations are computed with all 15 countries of the EU rather than with the 12 euro area countries.

18 If not explicitly mentioned otherwise, all figures related to EU trade are based on extra-EU trade net of intra-EU trade.

19 Less advanced economies are defined using the IMF Direction of Trade classification as all countries that do not belong to the industrialised country group (i.e. the EU, the United States, Japan, Canada, Iceland, Norway, Switzerland, Australia and New Zealand).

Table 4.1

'ETZ' countries' share of total EU trade

(1980-2000; in percent)

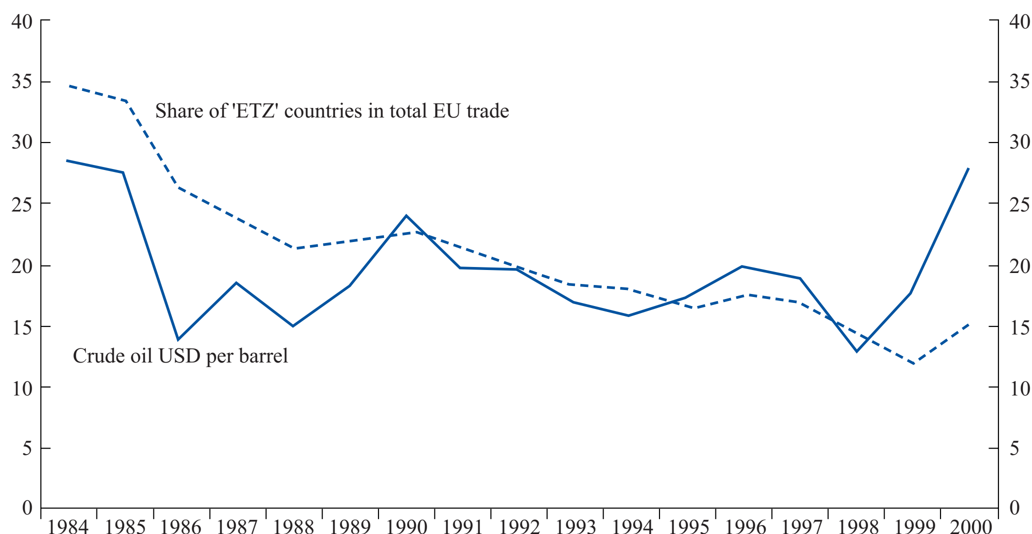
	1980-1984	1985-1989	1990-1994	1995-2000
Exports				
Western Balkans	1.9	1.9	1.4	1.2
European CIS	4.9	4.1	3.4	3.4
MENA	22.2	13.2	12.1	9.6
Sub-Saharan Africa	8.7	5.6	4.4	3.4
All 'ETZ' countries	37.8	24.8	21.4	17.5
Memo: Accession countries	*4.0*	*3.7*	*6.6*	*11.4*
Imports				
Western Balkans	1.0	1.6	1.2	0.6
European CIS	6.5	5.1	4.2	3.9
MENA	23.1	12.0	9.9	7.6
Sub-Saharan Africa	7.7	6.7	4.8	3.5
All 'ETZ' countries	38.4	25.4	20.0	15.5
Memo: Accession countries	*3.3*	*3.7*	*5.4*	*8.9*

Sources: Comtrade, own calculations.

Chart 4.1

Share of 'ETZ' countries in total EU trade and oil price

(USD; in percent)



Sources: Bloomberg, Comtrade, own calculations

on the price of commodities such as oil, gas and other raw materials, which are their main export goods. Since MENA and the CIS represent around 75% of total EU trade with 'ETZ' countries, the share of all 'ETZ' countries in EU trade is correlated with fluctuations in commodity prices, in particular oil prices. As the prices of these commodities have tended to decrease in real terms for most of the 1980s and 1990s, the share of EU trade with 'ETZ' countries has declined as well.

b) Low growth and high levels of formal and informal trade restrictions are considered factors explaining the poor trade performance of Africa over the last three decades (Rodrik, 1998).[20] In line with this general trend, Sub-Saharan Africa's share of extra-EU trade steadily declined from 8% in the early 1980s to 3.5% in 1995-2000.

c) Transition, financial crises and political or military conflicts in many countries of the European CIS and the Western Balkans have been impediments to trade. Trade with the Western Balkans declined significantly in the first half of the 1990s as a consequence of the break-up of the Yugoslav federation and stagnated in the second half of the decade. Exports to and imports from the CIS were particularly hit by the Russian financial crisis and its negative effects in 1998/1999.

Finally, the 'ETZ' countries' declining share in EU trade can at least partly be explained by a diversion effect linked to stronger trade relations between the EU and the accession countries, as these countries' share in EU trade rose substantially from 4% in 1990 to around 12% in 2000.

4.1.2 Product structure

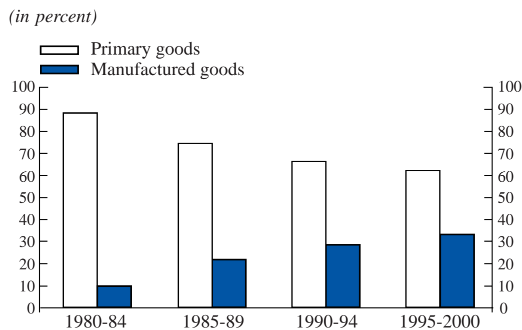
Trade between the EU and 'ETZ' countries is dominated by primary goods. The share of primary goods, i.e. food, crude materials and fuels, is almost three times higher than in total EU imports, although it declined from more than 80% in the early 1980s to close to 60% in 1995-2000. In contrast, the share of manufactured goods in EU imports from 'ETZ' countries has more than tripled in the same period, as imports of low value-added manufactured and semi-manufactured goods, like clothing and clothing accessories,

20 Africa's share in world trade declined from roughly 3 percent in 1980 to about 1.5% in 1999 (Subramanian, 2000).

Chart 4.2

Structure of EU imports from 'ETZ' countries, 1980-2000

(in percent)



Sources: Comtrade, own calculations

Chart 4.3

Structure of EU exports to 'ETZ' countries, 1980-2000

(in percent)

Sources: Comtrade, own calculations

increased significantly.[21] Accordingly, there are signs of a very gradual convergence to the structure of total EU imports, where manufactured goods represent 70% of the total.

The structure of EU exports to 'ETZ' countries has been very stable over time. It broadly reflects the structure of total EU exports, which is clearly dominated by manufactured goods which account for more than 80% of total exports.

A detailed analysis using the Standard Industrial Trade Classification (SITC) reveals that the share of iron and steel and specialist machinery for use in particular industries experienced the most significant and broad-based decline in EU exports to 'ETZ' countries. Conversely, the share of telecommunication products and electrical machinery in total EU exports to 'ETZ' countries has increased.

A comparison of EU trade structures with the four regions reveals that product composition changed most significantly in EU trade with the European CIS, mainly reflecting the process of transition in the latter economies. For example, the share of iron and steel in EU imports from the region more than doubled in the 1990s, while the share of this product group in EU exports to the CIS declined from 6.9% to 1.9%. On the other hand, the EU was able to increase its exports of cars to the CIS considerably (to 6.7%, up from 1.7% in 1990), whereas exports of road vehicles from the CIS to the EU – as a share of total exports to the EU – declined from 2 to less than 0.2%.[22]

4.1.3 Contribution to trade in different product categories

The dominance of natural resources in EU trade with 'ETZ' countries becomes evident again when calculating their market share in total EU trade with regard to different product groups. The EU heavily relies on the 'ETZ' countries for fuels, agricultural goods and raw materials. MENA is the major supplier of fuel products, the European CIS provides both fuel and raw materials, and Sub-Saharan Africa contributes significantly to EU imports of agricultural products. Hence, almost 40% of total EU imports of primary goods are from 'ETZ' countries. However, in line with the trend observed in the previous section, the market share of 'ETZ' countries in these product groups had declined from about 60% in the early 1980s to less than 40% by the late 1990s.

Where exports are concerned, the analysis shows that interestingly enough the share of 'ETZ' countries in EU exports is higher for primary than for manufactured goods. This is just the opposite of what was observed 20 years ago. From a regional point of view, this development is mainly related to exports to

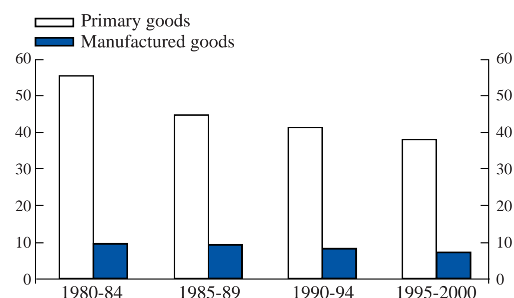
21 For the period 1980-2000 a similar trend can be observed with regard to total EU-imports, albeit at a different level. In 1980, roughly 60% of EU imports were primary goods, whereas manufactured goods represented only 40% of total EU imports.

22 For an in-depth analysis of the development of EU-Russian trade from 1993 to 2000 see Soos, Ivleva and Levina (2002).

Chart 4.4

Share of 'ETZ' countries in total EU imports, 1980-2000

(in percent)



Sources: Comtrade, own calculations

Chart 4.5

Share of 'ETZ' countries in total EU exports, 1980-2000

(in percent)

Sources: Comtrade, own calculations

MENA and Sub-Saharan African countries, as their share in EU exports of manufactured goods dropped by roughly 60%. This is why food is the only product category where the 'ETZ' countries account for more than 30% of total EU exports.

4.2 An 'ETZ' Countries' Perspective

4.2.1 *Trade Features*

'ETZ' countries are, on average, relatively open economies. With a trade share in GDP of almost 70% and an export/GDP ratio of 36%, they are more exposed to trade than developing countries in general and even more so than high-income countries. Only the countries of East Asia and the Pacific show a higher degree of trade openness.

Despite the high degree of openness, in the period 1995-2000 the 'ETZ' countries accounted for only 7.3% of world exports and 6.5% of world imports. However, since industrialised countries largely dominate world trade with a market share close to 65%, a comparison with the group of less advanced countries seems more appropriate. Here, 'ETZ' countries rank second, as their share of the less advanced economies' total exports and imports amounts to around 20%, compared with 54% for Asia and 16% for Latin America.

Exports by 'ETZ' countries mainly consist of primary commodities, although diversification has increased considerably in the last two decades, primarily at the expense of fuel products. Among manufactured goods, textiles, clothing and mechanical products are major export items of the region. The share of manufactured goods has quadrupled since 1980, now accounting for more than 40% of 'ETZ' countries' total exports. This picture – which applies to exports to the entire world – does not change significantly when considering exports to the EU only.

The structure of imports has remained remarkably stable. Since the 1980s the shares

Table 4.2

Trade openness, 2000

(as a % of GDP)

	'ETZ' countries	Latin America & Caribbean	East Asia & Pacific	Developing countries	High-income countries
Exports	36.4	17.3	42.1	28.5	21.6
Trade	69.7	36.1	80.5	55.8	42.6

Sources: World Bank, own calculations.

Table 4.3

Structure of 'ETZ' countries' exports and imports

(1980-2000; in percent)

		1980-84	1985-89	1990-94	1995-2000
Exports	Primary goods	90.7	74.0	63.4	53.4
	Manufactured goods	*9.1*	*24.7*	*35.6*	*42.5*
Imports	Primary goods	24.9	24.9	21.9	26.2
	Manufactured goods	*74.0*	*73.4*	*76.1*	*70.6*

Sources: Comtrade, own calculations.

of primary and manufactured goods have been fluctuating at around 25% and 75% respectively. The structure is somewhat less diversified if one considers imports from the EU only, where manufactured goods have an even larger share.

The composition of trade varies across the four regions, as the Western Balkans have a rather untypical trade structure. Manufactured goods, not primary goods, are their main export item, in particular textiles and transport equipment. Hence the structure of trade for the Western Balkan countries resembles more that of the European Union than that of the other three regions considered in this paper.

This is because the export structure of the European CIS, MENA and Sub-Saharan Africa is dominated by primary goods. Fuel products alone account for 36-40% of the total exports of these three regions. Since the countries of Sub-Saharan Africa are also the main exporters of food and raw materials, the share of primary goods in total Sub-Saharan African exports amounts to 65%.

Turning to the structure of imports, manufactured goods account for 70% of total imports to the Balkans, MENA and Sub-Saharan Africa. Only the CIS has a significantly lower share as a result of stronger import demand for food and fuel products, largely reflecting intra-CIS trade because energy resources are unevenly distributed within the region.

4.2.2 *The role of the EU*

The EU is by far the largest trading partner of most 'ETZ' countries. The EU absorbs 36% of their total exports and provides 42% of their imports.[23] However, over the last two decades the EU has lost market share, in particular with regard to exports and imports to and from Sub-Saharan Africa.

23 The importance of the EU as an export market for many 'ETZ' countries is also stressed by Barro (2001).

Table 4.4

Structure of exports and imports for the 'ETZ' countries and the four regions[1)]

(1995-2000; in percent)

		Balkans[2)]	CIS	MENA	Sub-Saharan Africa	All 'ETZ' countries
Exports	Primary goods	25.4	50.2	50.0	65.3	53.4
	Manufactured goods	*73.1*	*42.5*	*49.7*	*30.8*	*42.5*
Imports	Primary goods	27.3	38.3	23.1	25.9	26.2
	Manufactured goods	*68.2*	*56.0*	*75.1*	*71.1*	*70.6*

Sources: Comtrade, own calculations.
1) Including intra-regional trade.
2) 1995-1999.

Table 4.5

The share of the EU in 'ETZ' countries' trade

(1980-2000; in percent)

	1980-84	1985-89	1990-94	1995-2000
Exports				
Western Balkans[1)]	54.6	41.5	54.1	47.5
European CIS	n.a.	n.a.	n.a.	27.5
MENA	43.8	48.7	33.2	39.0
Sub-Saharan Africa	49.9	54.8	41.9	36.7
All 'ETZ' countries	45.2	50.2	35.3	36.4
Imports				
Western Balkans[1)]	59.2	44.9	52.4	53.8
European CIS	n.a.	n.a.	n.a.	28.3
MENA	46.6	46.6	45.5	43.8
Sub-Saharan Africa	52.8	58.0	48.1	42.3
All 'ETZ' countries	48.7	49.2	45.0	41.6

Sources: Comtrade, own calculations.
1) 1981-84, 1988-89, 1992-94, 1995-2000

In the Western Balkans, dependency on the EU is particularly high. More than half of external trade is conducted with the EU. Meanwhile, with less than 30%, the European CIS countries exhibit the lowest EU trade share among the four regions considered, primarily because of substantial intra-CIS trade. Among the group of advanced countries, the EU is the largest trading partner of the European CIS.

While the share of EU imports in total MENA imports has been fairly stable over the last 20 years, the fluctuations of the market share of MENA exports to the EU clearly reflects changes in the price of oil and other commodities. EU trade links are particularly strong with the Mediterranean countries, especially those of the Maghreb, while transactions with the Arab Peninsula are more limited. Although EU export and import shares in total trade have declined since the late 1980s, the EU is still the most important trading partner for most Sub-Saharan African countries. Within the region, the EU accounts for roughly 40% of the CFA franc zone countries' exports and more than 45% of their imports. Moreover, the bulk of the trade (about one-third) of the two most important countries in the region – South Africa and Nigeria – is done with the EU.

4.3 Regional integration

Regional integration among 'ETZ' countries is underdeveloped, as intra-regional trade accounts for just 18% of the total trade of the 'ETZ' countries.[24] The remarkable exception is the European CIS, which has an intra-regional trade share of 33%.

Political conflicts, high tariffs, a legacy of central planning or inward-oriented policies based on import substitution and self-sufficiency, differences in economic strategies within the sub-regions (i.e. countries following market-oriented policies and countries relying on a high degree of government involvement), similar factor endowments and production structures are major reasons explaining the lack of regional integration. Trade relations between the four regions are even less developed. The only really significant trade relations are between the Western Balkans and the CIS, and between Sub-Saharan Africa and the MENA countries.

In the Western Balkans civil war, ethnic conflicts, a variety of trade restrictions, weak capacity in trade-related institutions and a re-orientation towards the European Union

24 For the sake of comparison, regional trade among the ASEAN countries and among the Mercosur countries was 21% each in 1995 (Jadresic, 2000).

Table 4.6

Intra-regional trade among 'ETZ' countries and regions: share of exports

(as a % of total exports, average 1995-2000)

	Western Balkans	CIS	MENA	Sub-Saharan Africa	'ETZ'	EU
Western Balkans[1)]	**19.1**	4.1	1.6	2.9	27.7	47.5
CIS	0.4	**30.3**	2.5	0.3	33.5	27.5
MENA	0.2	1.1	**10.1**	1.1	12.5	39.0
Sub-Saharan Africa	0.0	0.4	2.9	**14.9**	18.2	36.7
All 'ETZ' countries					**18.5**	36.4
EU	1.2	3.4	9.6	3.4	17.5	**59.6**

Sources: Comtrade, own calculations
1) 1995-1999

strongly hampered intra-regional trade in the 1990s. However, the legacy of economic relations in the former Yugoslavia was strong enough to ensure that intra-regional trade in the Balkans is still higher than in MENA or Sub-Saharan Africa. In recent years, a number of bilateral free trade agreements have been negotiated to promote trade between the countries of the region. However, the patchwork of agreements and implementation practices seemed to have increased the complexity and the level of distortion of trade rather than reducing it (World Bank, 2001).[25]

The European CIS exhibits a very high level of integration, with intra-CIS exports accounting for 30% of total exports and intra-CIS imports representing 36% of total imports. Strong ties with Russia, that still partly reflect the economic legacy of the former Soviet Union,[26] dominate intra-CIS trade, with Russia accounting for about one-half of all intra-regional trade. Trade relations are, however, asymmetric. While less than one-fifth of Russia's trade is conducted with European CIS countries, one-third of the latter's total trade is with Russia. Even stronger integration is hampered by recurrent disputes over energy supplies and by a patchwork of bilateral and multilateral trade arrangements between CIS countries.[27]

Intra-regional trade among the MENA countries accounts on average for 8.5% of overall trade. Political conflicts, high tariffs,

25 In June 2001, Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania and FR Yugoslavia signed a Memorandum of Understanding on Trade Liberalisation and Facilitation. Its major goal is to establish a network of Free Trade Agreements in the region.

26 Intra-CIS trade has declined steadily since the collapse of the Soviet Union (Havrylyshyn and Al-Atrash, 1998). However, according to Fidrmuc and Fidrmuc (2000) trade relations between Russia, Belarus and Ukraine are still much more intensive than a standard gravity model of trade would predict.

27 See ECE (2001).

Table 4.7

Intra-regional trade: share of imports

(as a % of total exports, average 1995-2000)

	Western Balkans	CIS	MENA	Sub-Saharan Africa	All 'ETZ' countries	EU
Western Balkans[1)]	**5.6**	6.2	3.4	0.5	15.7	53.8
CIS	0.4	**36.6**	1.3	0.5	38.8	28.3
MENA	0.1	2.5	**7.4**	1.3	11.3	43.8
Sub-Saharan Africa	0.0	0.7	6.1	**9.9**	16.7	42.3
All 'ETZ' countries					**17.2**	41.6
EU	0.6	3.9	7.6	3.5	15.5	**57.5**

Sources: Comtrade, own calculations.
1) 1995-1999

contradictory economic policy strategies among the countries involved, differences in per capita incomes, and a similar factor endowment are strong barriers in this respect.[28]

The situation is broadly similar in Sub-Saharan Africa. Despite being characterised by a large number of trade agreements[29], the region shows low levels of integration to date, with just 12.5% of trade being conducted within the area.[30] South Africa, the most developed country in the region, exports only around 12% of its goods and services to other sub-Saharan countries, and imports from the region are even lower at 3%.

4.4 'ETZ' countries as major energy suppliers

'ETZ' countries are crucial with regard to world energy supply. Currently, 50% of oil and 40% of natural gas production come from three 'ETZ' regions: MENA, CIS and Sub-Saharan Africa. Their importance will even increase in the future, as 80% of all proven oil and gas reserves are concentrated in these regions. Some estimates state that in 2020 some 40% of the world's oil production will come just from the Persian Gulf (at present roughly 30%). The bulk of reserves, particularly oil, are located in the Middle East, with Saudi Arabia alone accounting for 25% of proven reserves. Where natural gas is concerned, Russia, too, plays a major role, and the Caspian Sea reserves are not negligible either.

In contrast, reserves in the major oil and gas consuming regions, North America and Europe, are significantly below their present share of production. For the euro area, it is worth noting that the UK and Norway only command small reserves. In the medium term their share in Europe's energy supply is likely to decrease and will have to be replaced by other sources, with estimates indicating that North Sea oil reserves will be exhausted within 25 years if production continues at its present rate. This is why, according to EU Commission estimates, the EU's dependence on oil imports, which is already high at 75% of its oil supplies in 2000, is likely to increase further and exceed 85% in 2020.[31]

These data highlight the importance of these regions for Europe with regard to energy supply. Political and economic developments in countries commanding large reserves of oil and gas could thus increasingly have a crucial impact on world energy prices going beyond the influence they already have today. It is worth noting in this context that the major recessions in the industrialised world in the last three decades have been related to oil price hikes, which in turn were closely linked to political events in the Middle East: the Yom Kippur war in 1973, the Iranian revolution in 1979 and the Gulf war in 1991. Moreover, price developments in the euro area are influenced considerably by oil price movements, although to a lesser extent than in the 1970s (ECB, 2000), as energy-source diversification has led to a decline in the contribution of oil to Europe's primary energy consumption. A continuation of this process could further reduce the significance of oil prices for the euro area economy in the future, but this process will be slow, and any forecast regarding its path of development is surrounded by great uncertainty insofar as it will be dependent upon technical progress in (i) the exploitation of alternative energy sources, (ii) the more efficient use of oil, and (iii) political decisions, e.g. concerning the use of nuclear, solar, wind and hydrodynamic power.

28 Using a gravity model, Al-Atrash and Yousef (2000) find that intra-Arab trade is lower than what would be predicted given the size of economies involved and the distances between them.

29 For details, see Subramanian (2000), and section 2.2.4.

30 A substantial number of African countries do not have trading relationships with other African countries. Trade within Anglophone Africa (Ethiopia, Ghana, Kenya, Malawi, Mauritius, Nigeria, South Africa, Tanzania, Uganda, Zambia and Zimbabwe) has shown signs of dynamism over the last decade (Subramanian and Tamirisa, 2001).

31 For a detailed analysis of medium- and long-term oil market developments and a proposed EU strategy see European Commission (2000).

Table 4.8

The role of 'ETZ' countries in oil and gas supply

(Data for end-2000; reserves = proven reserves; as a percentage of the world total)

Region	Oil		Natural Gas	
	Production	Reserves	Production	Reserves
MENA	36.1	69.3	13.3	39.6
Russia + other CIS[1)]	11.0	6.4	27.8	37.8
Sub-Saharan Africa	5.3	3.1	0.7	2.8
All 'ETZ' countries	52.4	78.8	41.8	80.2
Memorandum:				
Europe	*9.2*	*1.9*	*12.0*	*3.5*
North America[2)]	*18.1*	*6.1*	*31.3*	*4.9*
South/Central America	*9.7*	*9.0*	*3.9*	*4.6*
Asia/Pacific	*10.6*	*4.2*	*11.0*	*6.8*

Sources: BP (2002), own calculations.
1) Including Turkmenistan and Uzbekistan.
2) Including Mexico.

Table 4.9

Oil export dependency of 'ETZ' countries

Net oil exports as a percentage of total exports[1)]	Countries
> 90	Nigeria, Libya, Oman
80-89	Angola, Yemen, Kuwait, Rep. of the Congo, Saudi Arabia
70-79	Iran, Gabon, Equatorial Guinea
60-69	Syria, Algeria, Qatar
40-49	United Arab Emirates
30-39	Cameroon
20-29	Bahrain, Russia

Sources: IMF WEO October 2000.
1) Averaged over 1995-97.

The importance for world energy supply is mirrored by the oil export dependency of many 'ETZ' countries. This reveals the lack of diversification in their economies, which makes them dependent on oil price movements.

The oil price increase in 1999 and 2000 and its implications for the euro area economy have led to political initiatives at the EU level to intensify contacts with the major energy-supplying countries. The European Commission has suggested setting up an ongoing dialogue on oil market developments with OPEC and its principal member states – most of which are 'ETZ' countries – with the aim of achieving stable prices. In addition, energy-related issues are likely to play an increasing role in EU relations with Russia. At the EU-Russia summit in October 2000 the two sides agreed to develop an "EU-Russia energy partnership". As oil price volatility has a negative impact on both the major oil producer and consumer countries, measures to stabilise oil prices and to smooth volatility would be in the interest of both sides, whereas agreement on an appropriate level of oil prices is more difficult to achieve. OPEC plays a particularly significant role in influencing world prices, although it currently accounts for only about 40% of world oil production. This is mainly due to its spare capacity for oil production. While non-OPEC producers more or less fully exploit their production capacity, several OPEC producers, in particular Saudi Arabia, have sufficient spare capacity to increase production even in the short run in the event of increasing demand or a shortfall of supply from other countries.

Box 4.1

The impact of oil dependency: the case of the member countries of the Gulf Co-operation Council (GCC)

Six countries on the Arabian Peninsula – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the U.A.E. – form the Gulf Co-operation Council. The GCC countries account for 20% of world oil production and 45% of proven world oil reserves. All GCC countries except Bahrain and Oman are OPEC members. Oil production has lifted the level of economic development and living standards enormously in recent decades. The GCC countries changed from being essentially subsistence economies in 1970 to extremely wealthy countries as early as in 1980. With a GDP per capita of about USD 28,000 and USD 26,000 respectively, Qatar and the U.A.E. are among the wealthiest countries in the world.

However, the dominance of the oil sector as the driving force in the economy also makes GCC countries extremely dependent on oil price developments. On average the oil sector contributes roughly one-third to GCC GDP, roughly two-thirds of government revenues are oil revenues, and oil exports account for approximately 80% of total GCC exports.

Oil dependency of GCC countries

(Data for 1998)

Share of oil in:	Oman	Kuwait	S. Arabia	Qatar	U.A.E.	Bahrain
GDP[1]	30.5	38.7	29.6	35.9	20.7	13.4
Gov. revenue[2]	71.4	60.0	65.3	59.0	67.3	47.0
Exports[3]	87.7	88.1	84.1	79.0	38.2	54.0
Overall oil dependency[4]	189.6	186.8	179.0	173.9	126.3	114.4

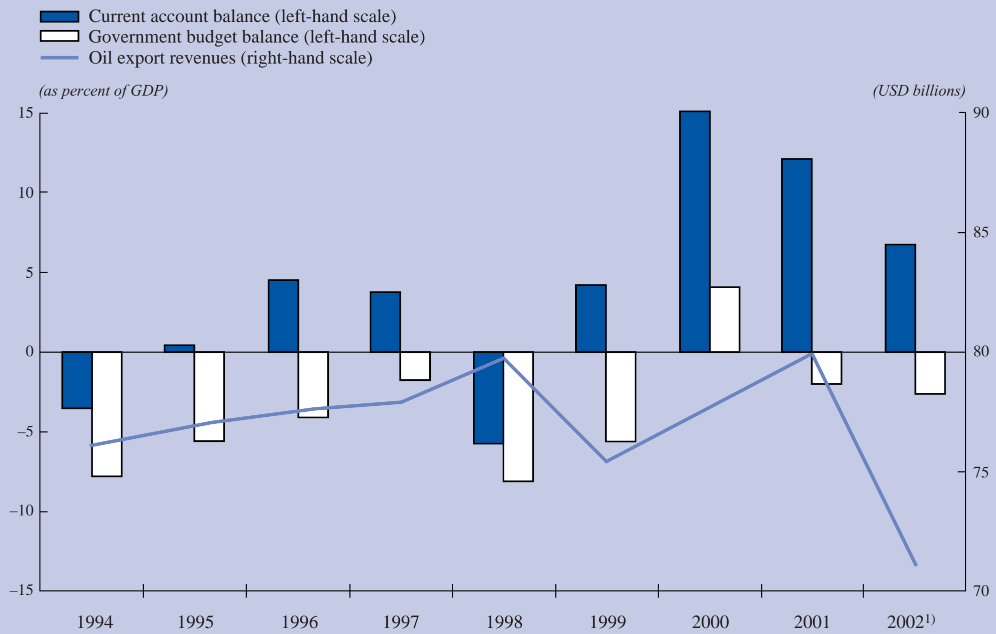
Source: IMF.
1) Oil and gas sector's share of GDP.
2) Oil and gas revenue/total government revenue including grants and investment income.
3) Oil and oil products' share of total exports.
4) The sum of the oil shares in GDP, government revenue and total exports is taken here as an indicator of the country's overall oil dependency.

The heavy dependence of government finances on oil revenues reflects the weak fiscal basis of GCC countries, where, for example, there is no such thing as personal income tax or a general consumption tax (like VAT). The high proportion of oil in GCC countries' overall exports leads to a translation of oil price volatility into trade volatility and into the volatility of current account balances and government budget balances.

Governments in all GCC countries have identified diversification as one of the major challenges for their economies and declared the reduction of their oil dependency as a key economic policy priority. They have realised that neither the public sector nor the oil industry alone will provide sufficient job opportunities for their young and growing populations. The development of the private non-oil sector is thus seen as crucial to ease the increasing labour market pressure. The need for diversification is particularly strong in countries like Bahrain and Oman, whose oil reserves are limited and are expected to run out in about 20-25 years. In contrast, the oil reserves of Saudi Arabia, the U.A.E and Kuwait will not be depleted for a much longer period at present levels of production. As regards the diversification of their economies, progress among the GCC countries is slow, with Bahrain and the U.A.E. having achieved the most tangible results so far. Bahrain has established itself as a financial hub for the Gulf region and beyond for the Arab world – particularly in Islamic banking – and is, together with the U.A.E., the least oil-dependent country of the GCC. Tourism, transport and the related services are other areas where Bahrain and the U.A.E. are trying to gain ground. The exploration of natural gas resources is seen as another important source of diversification upon which Saudi Arabia and Qatar have pinned much of their hopes (Qatar has the third largest gas

Box 4.1 (continued)

Implied effects of oil price movements for the GCC



Sources: IMF WEO
1) Projection.

reserves in the world). It should be borne in mind, however, that a switch from oil to gas as the major source of export revenues would not solve the problems of the Gulf countries, which are instead related to their role as primary commodity exporters. They would still face the consequences of price volatility, particularly as natural gas prices tend to fluctuate in line with oil prices.

5 Financial linkages

Financial linkages are an important factor of integration in the world economy. However, international financial linkages can only be developed if domestic financial systems are sound and efficient (IMF, 2001). With a few exceptions, the financial sectors of the 'ETZ' countries are small, underdeveloped and fragile. Accordingly, it comes as no surprise that their degree of financial integration with the world economy is rather low.

Bank lending and official development assistance funds provided by multilateral and bilateral creditors account for 70% of 'ETZ' countries' debt, with the euro area being the main source of financing. The 'ETZ' countries lead the way among the group of developing countries for euro area bank claims and are the largest recipients of official aid provided by the EU. With regard to FDI and portfolio flows, obstacles to foreign involvement in most countries are so large that their amount, even compared to other developing countries, is rather low from a euro area perspective. However, FDI flows have increased over the last decade, with euro area companies being the largest direct investors.

There are clear differences between the four regions. In the Western Balkans, links to the euro area are the tightest, not only with regard to financial instruments and the currency denomination of most of these instruments, but also in terms of direct involvement of euro area banks in domestic financial markets. There are also strong financial links with the CIS, with euro area banks being the region's major creditor. In general, resource-rich countries are the main targets of EU companies and banks, not only in the CIS but also in MENA and Sub-Saharan Africa. In the latter two regions, the financial linkages to the euro area are strong, but not as dominating as in the Western Balkans and to a lesser extent the CIS.

5.1 Domestic financial sectors

With a few exceptions, notably some MENA countries and South Africa, financial sectors are small, with most of their activity concentrated in the banking sector. Capital markets are either non-existent or underdeveloped, with low levels of trading, low liquidity and very few listed companies.[32] However, banks do not underpin economic growth either, as many of the following characteristics can be observed in several countries:[33]

- a dominant role of the state, which owns a large portion of banks' capital;
- insufficient capitalisation, with many banks having a capital adequacy ratio below 8%;
- instruments of "financial repression", like privileged access to funds for some sectors of the economy;
- private banks operating as pocket or agent banks, i.e. mainly serving as financial arms of their owners;
- a very limited role of foreign banks, with the exception of the Western Balkans;
- a lack of risk-based credit allocation and of competition between banks, resulting in a high share of non-performing loans;
- large spreads between lending and deposit rates;
- weak banking supervision and regulation (although there has been a tendency toward

32 In its World Development Report the World Bank (2000) listed only 21 'ETZ' countries with active stock markets. These countries were: Armenia, Botswana, Côte d'Ivoire, Croatia, Egypt, Ghana, Iran, Israel, Jordan, Kenya, Kuwait, Lebanon, Morocco, Namibia, Nigeria, Russia, Saudi Arabia, South Africa, Tunisia, Zambia, Zimbabwe. The total market capitalisation in 1998 was USD 380 billion, which at that time amounted to 46% of the stock market capitalisation in Germany. South Africa had by far the largest stock market, accounting for almost half of the total stock market capitalisation in 'ETZ' countries.

33 The following summary of the evidence is based on Gelbhard and Leite (1999); Le Gall and Nsouli (2001); the World Bank (1989, 1993, 2002); EBRD (1998); and Winkler (2002).

Table 5.1

Selected financial indicators in 'ETZ' countries

(unweighted averages, 2000; in percent)

	Western Balkans	CIS	MENA	Sub-Saharan Africa	All 'ETZ' countries	Memo: Euro Area
M2/GDP[1)]	32.2	17.1	63.8 [2)]	30.7 [3)]	35.9	66.7
Domestic Credit/GDP	36.5 [4)]	18.7	78.7 [5)]	26.0 [6)]	40.0	134.5
Currency/M1	48.9	66.1	42.7 [7)]	42.2 [8)]	50.0	18.8

Sources: IMF, World Bank, own calculations.
1) Also includes data for 1998 and 1999 when 2000 is not available.
2) Excluding Iraq, Lebanon and the Palestinian Territories.
3) Excluding Democratic Republic of the Congo, The Gambia, Mayotte, São Tomé & Príncipe, Sierra Leone and Somalia.
4) Excluding Bosnia and Herzegovina and FR Yugoslavia.
5) Excluding Iraq, Israel, Libya, Oman, U.A.E. and the Palestinian Territories.
6) Excluding Comoros, Democratic Republic of the Congo, Djibouti, Equatorial Guinea, Eritrea, Gabon, the Gambia, Guinea Bissau, Liberia, Mauritius, Mayotte, Namibia, São Tomé & Príncipe, Seychelles, Somalia, Sudan and Swaziland.
7) Excluding Iraq and the Palestinian Territories.
8) Excluding Democratic Republic of the Congo, Mayotte and Somalia.

greater compliance with the Basel core principles);

- accounting, auditing and corporate governance lacking transparency and accountability;
- and an underdeveloped judicial and legal enforcement of collateral rights.

These structural weaknesses are reflected in low indicators of financial development, such as the ratio of liquid liabilities (M2) to GDP, the ratio of domestic credit to GDP and the ratio of currency in circulation to M1.

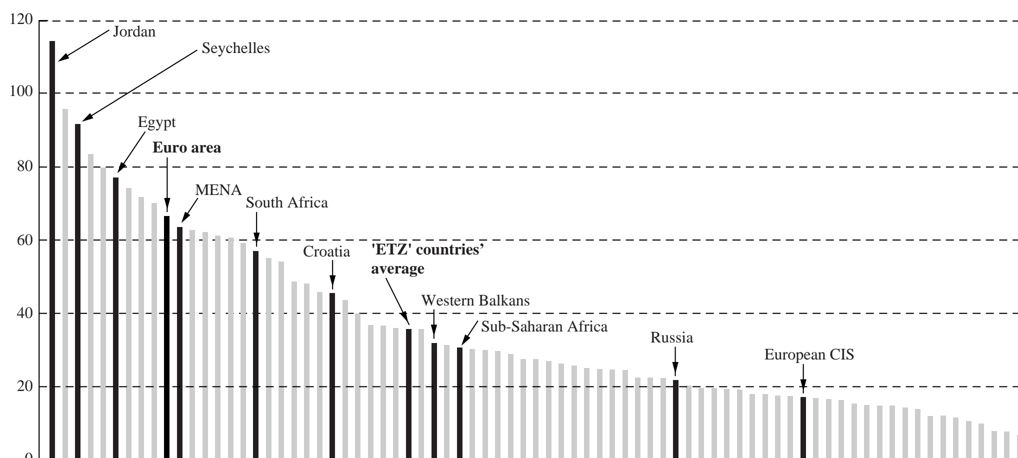
Country-specific analysis reveals that only MENA countries, South Africa and the island states of Mauritius and Seychelles have financial systems whose financial depth, as measured by the M2/GDP ratio, is comparable to that of the euro area.

Financial intermediation in 'ETZ' countries is also underdeveloped. The amount of credit to the economy is particularly low in the CIS,

Chart 5.1

Financial depth of 'ETZ' countries[1)]

(M2/GDP, in percent)



Sources: IFS, IMF country reports, own calculations
1) 2000, or latest available data

Sub-Saharan Africa and the Western Balkans, whereas in MENA countries credit is in much more ample supply. However, since many MENA countries shield domestic enterprises from the competitive pressures of globalisation (World Bank, 2002), the high level of credit has to be interpreted with caution. On an aggregate level, domestic credit to GDP for all 'ETZ' countries is on average less than one-third of the ratio for the euro area.

Finally, many 'ETZ' countries are still fairly cash-based economies and exhibit a relatively high currency-to-M1 ratio, reaching values of more than 70% in some CIS countries. Even in MENA countries, the share of currency in circulation in M1 is more than twice as high as in the euro area.

5.2 International financial linkages: debt structure

5.2.1 International capital flows to 'ETZ' countries: an overview

With some exceptions, 'ETZ' countries have not been among the main recipients of international capital flows, namely bank loans, portfolio flows or foreign direct investment.[34] Rather, the bulk of the increasing capital flows to emerging markets in the 1990s has been directed to East Asia and Latin America.[35] Clearly, many 'ETZ' countries have not been affected by the recent trend of financial globalisation. In particular Sub-Saharan Africa has been largely spared (Calvo and Reinhart, 1998; Calvo 2001). There are at least four reasons for this:

34 It is worth recalling that most international capital flows remain within the group of developed countries (IMF, 2001d).

35 In any case, there is a heavy concentration of flows, with six developing countries accounting for 75% and 70% of total portfolio and FDI flows respectively in the period 1970 – 2000 (IMF, 2000a). South Africa is the only 'ETZ' country on this list, being the fifth largest recipient of portfolio flows in this period.

Box 5.1

Euro area banks in the Western Balkans

Over the last decade, some regions, notably Latin America and the EU accession countries, have experienced a strong increase in foreign bank presence in the domestic banking markets (IMF 2000a; Clarke, Cull, Peria and Sánchez, 2001; Buch 2002). In most 'ETZ' countries such developments have been more subdued, with the exception of the Western Balkans where euro area financial institutions have invested heavily. In Croatia, for example, banks with a majority of foreign owners hold more than 80% of total assets (CEC, 2002). The Albanian private banking sector is completely in foreign hands, with banks from Greece and Italy being major investors. Euro area banks have been key players in the reconstruction and privatisation of the banking sector of Bosnia and Herzegovina (IMF, 2001b). Even in Serbia, it was the banking sector that saw the fastest reaction from foreign investors (all of them euro area banks) in response to the opening up that occurred when the new reform-oriented government took office in 2001.

The strong presence of euro area banks and financial institutions in the Western Balkans is attributable to three main factors:

- Banks followed the non-financial firms of their home countries that were already active in the region. Since these companies are mainly from the euro area, for historical reasons and because of geographical proximity, euro area banks are the major investors in the Western Balkans.
- Local authorities actively encouraged a foreign presence in their domestic markets when they discovered the need to restructure and privatise their banking systems.
- Progress in monetary stabilisation and the strong role of the euro in the exchange rate regime and/or as a deposit currency has lowered risk and facilitated entry by euro area banks and financial institutions.

- The weak institutional framework of most domestic financial sectors highlighted in the previous section. Portfolio equity investment, for example, is strongly linked to the degree of financial development in the recipient countries (Lane and Milesi-Ferretti, 2000).

- Most ‘ETZ’ countries have maintained a rather restrictive regulatory framework where capital account transactions are concerned.[36] Of course, in comparison to the status quo of the early 1990s, the recent liberalisation record of the transition countries in the Western Balkans and the European CIS has been quite impressive. In the mid-1990s Russia liberalised capital Tc(36)Tj10 0 0 10 172TfTetely, butition

Table 5.2

External debt of ‘ETZ’ countries

	Total debt (in USD billions, 2000)	Percentage of total ‘ETZ’ debt (2000)	Total debt (as a % of GDP, 1999)[1)]
Western Balkans	14.8	3.1	34.8[2)]
CIS	110.6	23.1	36.6
MENA	193.3	40.4	26.8[3)]
Sub-Saharan Africa	159.5	33.4	51.6
All ‘ETZ’ countries	478.2	100.0	34.1[4)]

Sources: BIS, IMF, World Bank, own calculations.
1) Unweighted averages.
2) Excluding FR Yugoslavia.
3) Excluding Bahrain, Iraq, Lebanon and the Palestinian Territories.
4) Excluding Bahrain, Iraq, Lebanon, the Palestinian Territories and FR Yugoslavia.

‘ETZ’ countries’ debt stands at 34%, with Sub-Saharan Africa being the region with the highest level of debt.[39]

Bank loans are the dominant form of external financing, followed by multilateral and bilateral claims and loans. Non-bank trade credits represent almost 20% of total debt, whereas external financing via debt securities accounts for only 10% of total borrowing. ‘ETZ’ countries finance themselves on a rather long-term basis, with only 20% of total debt being due within one year.

Although bank loans are predominant in the external debt structure, closer inspection reveals that this stems largely from the situation in the MENA countries. Indeed, 56% of total MENA debt is financed by bank loans whereas in the other regions bank loans represent less than one-third of total external financing. The debt structure of MENA countries is also very different with regard to the share of official claims of multilateral and bilateral creditors: only 17% of MENA debt is in the hands of official creditors, whereas the CIS and the Western Balkans financed around 30% of their debt via official channels, and Sub-Saharan Africa as much as 43%.

Non-bank trade credits account for a similar share, around 20%, of the external financing of all regions. Strong regional differences again emerge when analysing the share of external debt financed by issuing securities abroad. Whereas Western Balkan countries – notably Croatia – are able to finance more than 23% of their debt by issuing securities abroad, this form of financing represents only 6% of total Sub-Saharan Africa debt.

5.2.2 International bank lending

‘ETZ’ countries account for only 3% of international bank claims worldwide. However, given the industrialised countries’ predominance in international capital markets,[40] it is more appropriate to restrict comparisons to the group of developing countries. Within this group, ‘ETZ’ countries rank third behind Asia and Latin America, being debtors in roughly 24% of consolidated bank claims of BIS reporting banks.

Whereas the share of ‘ETZ’ countries in total bank lending to developing countries has exhibited a remarkable degree of stability over the last 15 years, the relative importance of the four regions has changed significantly. In the 1990s, CIS countries became the second largest borrower in the region, while MENA and Sub-Saharan countries lost ground. On a country-by-country basis there is a high degree of concentration, with more than 70%

39 The most highly indebted countries in Sub-Saharan Africa are São Tomé & Príncipe with a debt-to-GDP ratio of 507%, Guinea-Bisseau (423%) and Somalia (282%). Among the MENA countries, Syria has a debt-to-GDP ratio of 136%, whereas in the CIS Molodva (73%) and Georgia (57%) are examples of highly indebted countries. At the other extreme, Botswana has a debt-to-GDP ratio of 9% and Belarus of only 3%.

40 Developed countries, including offshore centres, represent almost 90% of total BIS and total euro area BIS reporting banks’ claims because the BIS statistics include claims on BIS reporting countries themselves.

Table 5.3

Structure of external debt of ‘ETZ’ countries

(December 2000; end of period, as a % of total stocks)

	Bank loans	Debt securities issued abroad	Brady bonds	Non-bank trade credits	Multi-lateral claims	Official bilateral loans
Western Balkans	26.7	23.5	0.0	18.1	26.2	5.5
European CIS	30.6	16.7	0.0	25.5	24.5	2.6
MENA	56.1	8.2	0.2	18.3	6.6	10.7
Sub-Saharan Africa	29.4	6.3	2.3	18.1	31.1	12.8
All ‘ETZ’ countries	40.7	9.7	0.9	19.7	19.4	9.6

Sources: BIS and IMF, own calculations.

Table 5.4

Consolidated international claims of BIS reporting banks

(as a percent of claims to developing countries)

	Western Balkans	CIS	MENA	Sub-Saharan Africa	All 'ETZ' countries	Memo: Asia	Memo: Latin America
1985-1989	1.8	0.0	13.5	8.8	24.1	20.0	42.4
1990-1994	0.9	2.1	12.8	7.4	23.2	30.4	32.8
1995-2000	1.2	6.4	10.0	5.9	23.7	38.5	30.2

Sources: BIS, own calculations.

of total claims being accounted for by 15 of the 81 'ETZ' countries.[41]

As in other regions of the developing world, the share of short-term bank loans has decreased significantly since the Asian financial crisis.[42] In 2000, 47% of bank loans to 'ETZ' countries had a maturity of up to and including one year. Among the major borrowers only Kuwait, Saudi Arabia, South Africa and the U.A.E. had more than 60% of their liabilities with a short-term maturity.

– The euro area perspective

'ETZ' countries are major borrowers of euro area banks, accounting for 32% of euro area banks' claims on developing countries. Accordingly, Latin America and Asia, the largest debtors among developing countries worldwide, rank behind 'ETZ' countries with

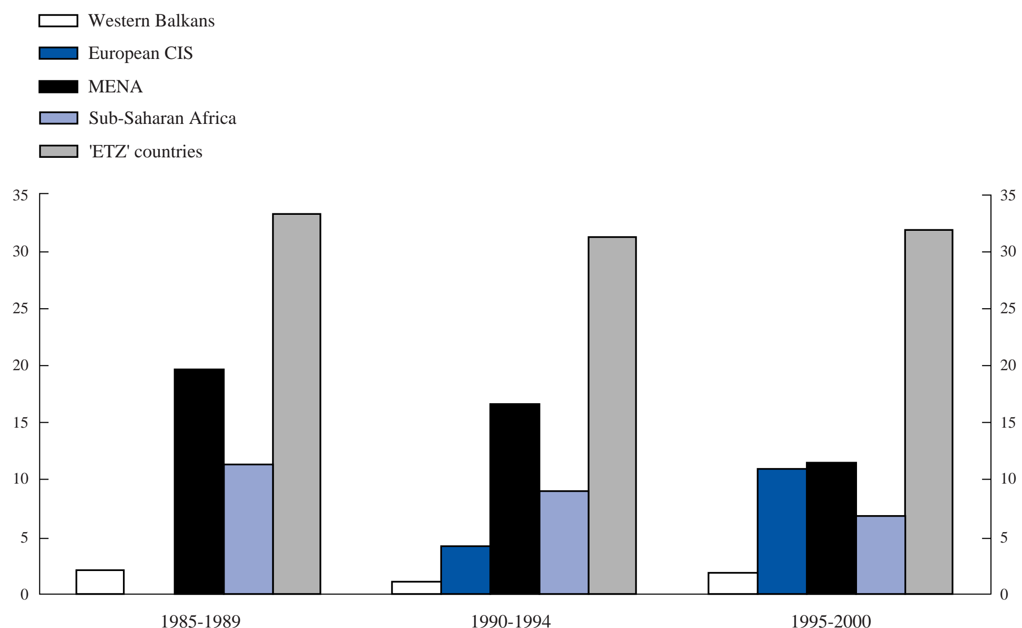
41 These countries are: Croatia, Russia, Algeria, Egypt, Iran, Israel, Kuwait, Morocco, Oman, Qatar, Saudi Arabia, Tunisia, U.A.E, Kenya and South Africa.

42 For details see Dadush, Dasgupta and Ratha (2000).

Chart 5.2

Share of 'ETZ' countries in euro area banks' claims[1)]

(in percent)



Sources: BIS, own calculations.

1) On developing and emerging market countries, period averages.

respective shares of 29% and 27%. In 2000 the outstanding portfolio of euro area banks amounted to roughly USD 137 billion. Russia is by far the largest debtor of euro area banks, accounting for roughly 22% of total claims. South Africa, Iran and Croatia are also major debtors, with more than USD 6 billion outstanding debt.

A reorientation of euro area financial flows towards the Balkans and the European CIS and away from MENA and Sub-Saharan Africa countries is a recent noteworthy trend. Despite increasing slightly in absolute amounts, the shares of MENA and Sub-Saharan Africa have declined significantly since 1985, whereas loans to the CIS increased to more than one-third of total lending to 'ETZ' countries. Wars in the Western Balkans left their mark on the international banking statistics as well, with euro area bank lending to the region decreasing by more 30% from 1985 to 1993. Since then, however, the exposure of euro area banks to the Balkan area has expanded by more than 700%, to almost USD 18 billion in 2000.

Claims on the Western Balkans are predominantly denominated in euro, and more than 37% of total claims on the CIS are euro-based. On an aggregate level, however, outstanding claims by BIS reporting banks to 'ETZ' countries are mainly denominated in USD, whereas only 25% of total claims are denominated in euro.[43] The share of euro-denominated lending rises when only claims by euro area banks are considered: 42% of total euro area banks' claims are denominated in euro.

– The 'ETZ' countries perspective

'ETZ' countries are highly dependent on international bank lending by euro area banks, as these banks account for 67% of total claims. Euro area banks clearly dominate the market in the Western Balkans and the CIS, and are also the main lenders to MENA and Sub-Saharan Africa.

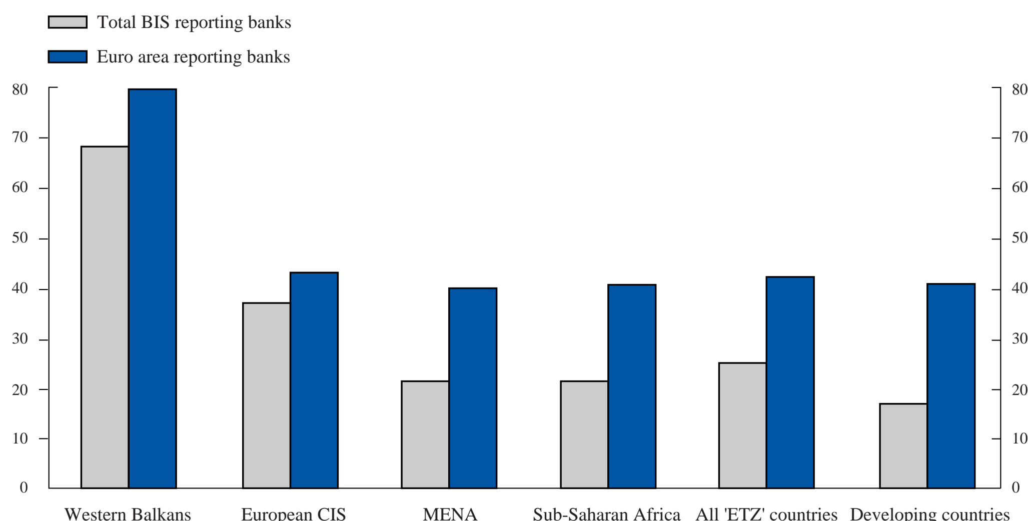
In the Western Balkans, financial efforts to reintegrate the region into the world economy have mainly been driven by European institutions. The same holds true for the CIS. Over the last 15 years, euro area banks have also become the dominant source of financing in Sub-Saharan Africa, accounting for roughly

43 The share of euro-denominated claims on 'ETZ' countries (24.9%) is slightly higher than the share of euro-denominated claims on developing countries in general (16.7%).

Chart 5.3

Share of euro-denominated bank claims on 'ETZ' countries

(in percent)



Sources: BIS, own calculations.
On total claims (end of 2000)

Table 5.5

Share of euro area banks' claims on 'ETZ' countries

(in percent)

Year	Western Balkans	European CIS	MENA	Sub-Saharan Africa	All 'ETZ' countries
1985-1989	44.2	–	51.5	45.7	48.9
1990-1994	58.7	87.1	57.4	54.2	59.9
1995-2000	81.6	85.0	57.9	58.3	66.8

Sources: BIS, own calculations

60% of total international borrowing. With regard to MENA it is noteworthy that there are major differences within the region: whereas international bank claims on Northern Africa are mostly (75%) held by euro area banks, only 25% of those claims on the Middle East are in the portfolios of euro area banks.

5.2.3 Bond markets

At the end of 2000 total outstanding debt securities of 'ETZ' countries issued abroad amounted to USD 44.7 billion,[44] accounting for only 10% of total international debt securities issued by developing countries.[45] Bonds issued by Russia accounted for almost 40% of the total debt securities issued abroad; other 'ETZ' countries that tapped international capital markets to a significant extent were Israel and South Africa.

Bonds are mainly denominated in US dollars. Euro-denominated bonds, including bonds issued in euro legacy currencies, mainly Deutsche Mark, represent only 27% of total bonds issued between 1980 and February 2002.

A more precise analysis, however, reveals that the Western Balkans, i.e. Croatia, issued debt overwhelmingly in euro and euro legacy currencies. The share of the euro is also above average for debt securities issued by countries from Sub-Saharan Africa, which are essentially bonds issued by South Africa. On the other hand, with the exception of Algeria, Morocco and Tunisia, MENA countries have almost exclusively issued US dollar-denominated bonds.

5.2.4 Official development assistance

In the 1990s the 'ETZ' countries received about 50% of all the development funds provided by donor countries worldwide. Among the four regions, Sub-Saharan Africa

44 The figure does not include countries labelled as "offshore centres" in the joint BIS-IMF-OECD database, such as Bahrain, Lebanon and Liberia.

45 For the sake of comparison, the value of outstanding debt securities of all 'ETZ' countries is less than the value of total debt securities issued by Brazil.

Table 5.6

Bonds issued by 'ETZ' countries[1)]

(1980-2002)

	in USD billions	As a % of total 'ETZ'	Share of euro-denominated bonds[2)]
Western Balkans	2.9	5.4	87.7
European CIS	21.6	39.9	23.5
MENA	16.5	30.4	14.5
Sub-Saharan Africa	13.2	24.3	36.7
All 'ETZ' countries	54.2	100	27.0

Sources: Bondware, own calculations.
1) Excluding offshore centres.
2) Including euro legacy currencies.

Table 5.7

Official development assistance

(1990-1999)

	1990-1999	1990-1994	1995-1999
Western Balkans[1)]	3.7	1.3	6.5
European CIS[1)]	8.7	7.4	10.3
MENA[1)]	27.9	31.0	24.2
Sub-Saharan Africa[1)]	59.8	60.4	59.0
All 'ETZ' countries (as a % of world aid)	52.9	54.3	51.3
Worldwide (in USD billions)	502.4	266.9	235.5

Sources: World Bank, own calculations.
1) As a % of all 'ETZ' countries.

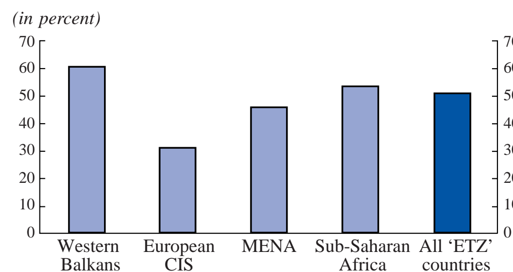
is the largest aid recipient, which highlights the importance of official development assistance (ODA) in total external financing for this region. MENA countries received 28% of the total, with Egypt and Israel alone accounting for 15% of total aid to 'ETZ' countries. Russia, the third largest recipient, accounted for more than half of ODA provided to the European CIS.[46] Finally, financial aid to the Balkans rose by almost 500% in the aftermath of the Dayton Peace Agreement of 1995, increasing the share of this sub-region in total ODA funds to 'ETZ' countries to 6.5% in the second half of the 1990s.

The EU Member States and the European Commission are major providers of official development assistance to 'ETZ' countries. In the period 1995-2000, 51% of total net ODA flows from members of the OECD's Development Assistance Committee (DAC) to 'ETZ' countries originated in the EU. The Western Balkans profited the most from EU assistance, whereas the EU contributed only 31% of ODA flows to the CIS.

Table 5.4

EU share in ODA flows to 'ETZ' countries

(in percent)



5.3 Foreign direct investment

Over the last decade annual Foreign Direct Investment (FDI) inflows to 'ETZ' countries increased in line with the trend observable worldwide, rising from less than USD 8 billion in 1989-1994 to more than USD 24 billion in the period 1995-2000. The European CIS was the main FDI recipient, whereas MENA and Sub-Saharan Africa lost ground in relative terms, although in absolute amounts FDI to these regions more than doubled.[47]

'ETZ' countries account for only 3.4% of total FDI inflows worldwide. Restricting the analysis to the group of developing countries, the share increases to 13%, which is still much lower than their share in other financial flows analysed in this section.[48]

There are a number of obstacles hampering private investment in the 'ETZ' countries, such

46 The ten largest recipients, accounting for roughly 40% of the total ODA to 'ETZ' countries, were Egypt, Russia, Israel, Tanzania, Bosnia and Herzegovina, Zambia, Mozambique, Ethiopia, Uganda and Ghana.

47 With regard to FDI inward stocks, in 2000, 'ETZ' countries accounted for 4.3% of total FDI inward stock, valued at USD 270 billion (which was about the same as the combined FDI stock of Argentina and Brazil). Since foreign investment in the Soviet Union and the former Yugoslavia was not allowed, these regions had no FDI history prior to 1989. Accordingly, their share in total FDI stock within the group of 'ETZ' countries is only gradually increasing. In 2000 they accounted for about 18% of total FDI stock in 'ETZ' countries, while MENA and Sub-Saharan Africa represented 39% and 43% respectively.

48 'ETZ' countries' share of FDI outflows is even lower, accounting for less than 1% of world FDI outflows and only 8.4% of the FDI outflows from developing countries. However, over the last decade, Russian companies and individuals became major foreign investors: in the period 1995-2000 more than 30% of FDI outflows from 'ETZ' countries were from Russia.

Table 5.8

FDI inflows

(1989-2000)

	1989-1994 (in USD billions)	1989-1994 (as a % of all 'ETZ' countries)	1995-2000 (in USD billions)	1995–2000 (as a % of all 'ETZ' countries)
Western Balkans	0.26	3.4	1.31	4.6
European CIS	1.78	22.8	9.85	40.9
MENA	3.30	42.2	6.44	26.7
Sub-Saharan Africa	2.47	31.6	6.69	27.8
All 'ETZ' countries	7.82	-	24.08	-

Sources: UNCTAD, own calculations.

as political and macroeconomic instability, poor governance, weak and non-transparent legal and regulatory frameworks, and a lack of business opportunities, market size and export orientation.[49] This is why many countries have a poor FDI record, with some of them, in particular in Sub-Saharan Africa, having annual FDI inflows of less than €50 million. FDI inflows are significant only in resource-rich countries like Russia, Kazakhstan and Azerbaijan in the CIS, Angola and Nigeria in Sub-Saharan Africa, and Saudi Arabia in the MENA region, where Israel is the only non-oil country attracting a significant amount of FDI.[50] In some of these countries, however, FDI inflows actually represent a significant share (larger than 10%) or even the bulk of total investment.

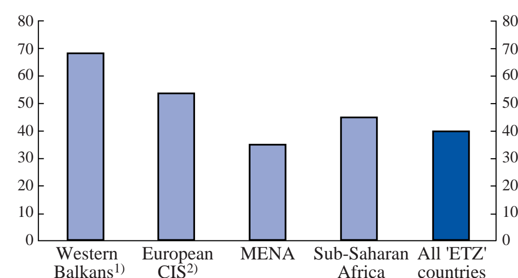
In the period 1995-2000, euro area investments dominated FDI flows to the Western Balkans and the CIS, whereas in Sub-Saharan Africa and MENA countries they represented respectively 45% and 35% of the total. For all 'ETZ' countries, the euro area accounted for 40% of total FDI inflows.

From a euro area perspective, however, the Western Balkans and the CIS received only 8% and 15% of total euro area FDI flows to 'ETZ' countries from 1995 to 2000, whereas Sub-Saharan Africa was the major recipient, attracting almost half of all euro area FDI to the four regions. Annual investment patterns are, however, quite volatile. For example, in 1999 when the political and economic situation in the Western Balkans and the CIS improved, the share of these two sub-regions in total euro area FDI to 'ETZ' countries was 35%.

Chart 5.5

Share of euro area countries in FDI flows to 'ETZ' countries

(in percent)



Source: Eurostat, own calculations.
(1995-2000 average)
1) Albania, Croatia, FR Yugoslavia.
2) Belarus, Russia, Ukraine.

49 For a detailed account see Broadman and Recanatini (2001), Agénor, Diwan and Al-Kibbi (2000), Basu and Srinivasan (2002) and Singh and Jun (1995).
50 However, it has to be noted that FDI inflows to some of these countries, for example Saudi Arabia and Russia, have been highly volatile from one year to the next..

6 Exchange rate and monetary policy

Compared to the current level of trade and financial relations and the goal of further economic co-operation or integration between the EU and the "Euro Time Zone", the role of the euro in the 'ETZ' countries' exchange rate regimes is relatively limited. Only in the Western Balkans and in Sub-Saharan Africa is the euro a reference currency for the exchange rate policy of a significant number of countries. In the CIS and in MENA most countries peg their currencies to the US dollar, either de jure or de facto.[51] When it comes to economic determinants, the role of the euro in the design of exchange rate policies is generally more important in countries where the euro is also used as parallel currency, as it is in the Western Balkans. The role of the euro is less important in countries whose trade relations to the EU are dominated by primary goods, since these are mostly quoted and invoiced in US dollars.

Many 'ETZ' countries rely on external monetary policy anchors (euro and US dollar) rather than on domestic anchors, on account of the widespread absence of developed financial markets and weak banking systems. Nevertheless, finding the right balance between monetary and exchange rate policies is a challenging task for most central banks, and some countries have recently tried to focus more strongly on domestic objectives, in particular inflation developments. In practice, however, the exchange rate remains the dominant channel for monetary policy for most countries given the preference for a stable exchange rate motivated by the so-called "fear of floating": this arises from the potential for inflation pass-through stemming from high exchange rate volatility and the size of their foreign currency-denominated liabilities (Calvo and Reinhart, 2002).

6.1 Overview of exchange rate policies

Overall, more than half of the 'ETZ' countries or territories (44 out of 81) have an exchange rate regime involving an external anchor, including official euroisation, currency boards and peg arrangements with either fixed or crawling rates.[52] A total of 14 countries officially declare that they manage their currency with no pre-announced path for the exchange rate, while 23 countries declare that they have an independent float.

Formally, more than one-third of all 'ETZ' countries (29) have an exchange rate arrangement involving a link to the euro. These countries are located in the Western Balkans, MENA and Sub-Saharan Africa (most notably the CFA franc zone countries). Conversely, only seven 'ETZ' countries officially declare that their exchange rate arrangement involves an exclusive link to the US dollar.[53]

51 De jure exchange rate regimes are those arrangements that are officially declared by the countries concerned and are classified by the IMF. De facto exchange rate regimes concern the actual practices of countries, and can only be identified econometrically.

52 The two examples of euroisation reported in the table, Montenegro and Kosovo, are not sovereign states but territorial communities within the Federal Republic of Yugoslavia.

Table 6.1
Official exchange rate arrangements in 'ETZ' countries

	Euroisation	Currency Board	Pegs	Managed float	Free float
Western Balkans	2	1	1	2	1
European CIS	-	-	1	4	3
MENA	-	-	15	2	1
Sub-Saharan Africa	-	1	23	6	18
All 'ETZ' countries	2	2	40	14	23

Source: IMF (2001).

Table 6.2

Exchange rate arrangements involving a link to the euro

Exchange rate regime	Number	Countries/territorial communities
Euroisation	2	Kosovo, Montenegro
Currency board arrangement	1	Bosnia and Herzegovina
Peg arrangements (including peg to the SDR and other currency baskets involving the euro)	17	• Pegging only to the euro: 14 African countries whose legal tender is the CFA franc, plus Cape Verde, Comoros and FYR Macedonia
	5	• Pegging to the SDR[1)]: Botswana, Libya, Qatar[2)], Saudi Arabia[2)], and the United Arab Emirates[2)]
	3	• Pegging to other currency baskets including the euro: Kuwait[2)], Morocco and Seychelles
Crawling fluctuation bands	1	Israel (basket)
Total	29	

Source: Ibid.
1) The SDR is a basket of currencies, including the US dollar, the euro, the Japanese yen and the pound sterling.
2) As of January 2003, the currencies of GCC countries will be formally pegged to the US dollar.

However, a reference to the euro does not necessarily imply a strong and effective euro orientation in the exchange rate policy of a country. For instance, the euro may have a limited share in a currency basket dominated by the US dollar, as in Kuwait. Hence, de facto, the presence of the US dollar is more widespread than officially reported. Indeed, empirical estimates seem to suggest that many European CIS and Sub-Saharan countries that formally declare they have floated their currencies, re they 41lly pegged them to the US currency.[54]

6.2 Exchange rate policies in the Western Balkans and Sub-Saharan Africa: a significant role for the euro

Western Balkans

Among 'ETZ' countries, geographical proximity seems to be a key determinant in the choice of the euro as an external anchor, given that its influence is strongest in the region which is closest to the euro area: the Western Balkans. Here, exchange rate arrangements always involve the euro, covering almost the full spectrum of exchange rate regimes, from very hard pegs to relatively free floats:

- The two largest countries of the region – Croatia and FR Yugoslavia – together with FYR Macedonia, tightly manage their respective currencies against the euro. Empirical estimates appear to suggest that the euro is the only reference currency for Croatia, while it is the dominant currency for FYR Macedonia.[55]
- Bosnia and Herzegovina adopted a currency board in August 1997 with a 1:1 exchange rate between the domestic currency, the konvertible marka (KM), and the German

53 These countries are: Djibouti (currency board); Egypt, Eritrea, Iraq, Jordan and Oman (peg with fixed bands); and Zimbabwe (peg with crawling fluy 41tion bands).

54 See the technical appendix 6.7 for an explanation of the methodology used to determine whether 'ETZ' countries that declare they have a managed or a pure float de facto peg their respective currency; see also the empirical results reported in Table 6.6.

55 Brada and Kutan (2001) even show that base money in Croatia is linked by a stable long-run (co-integrating) relationship to base money in Germany, but this is not the case for FYR Macedonia (or Albania). Empirical results for Yugoslavia are not reported in Table 6.6 as comprehensive data were available only at a low (monthly) frequency from the National Bank of Yugoslavia, resulting in an insufficient number of degrees of freedom. Since January 2001, when the authorities offici1lly 1llowed it to float on the foreign exchange market, the dinar has been five times more stable (standard deviation-wise) against the euro than against the US dollar. Prior to this date, the dinar was offici1lly pegged to the Deutsche Mark.

mark. After the introduction of the euro in 1999, the KM remained pegged to the euro.

- Two territories (Kosovo and Montenegro) have euroised unilaterally and introduced the euro as legal tender.

- Albania is the only country in the region for which the US dollar is the main reference currency, although the estimates reported in table 6.6 tend to indicate that the euro may also play a role in the reference basket of the lek.

The influence of the euro in the Western Balkans is supported by all of the factors considered in this paper, as these countries are tightly tied to the EU in institutional terms and were granted the status of "potential candidates to the EU" by the Feira European Council of June 2000. Moreover, they have substantial trade and financial links with the euro area. Lastly, the euro (like its legacy currencies, most notably the Deutsche Mark and, to some extent, the Austrian schilling) is used extensively in the region as a parallel currency.

Sub-Saharan Africa

Partly as a result of history, the euro also enjoys a substantial role in 14 Sub-Saharan Africa countries that belong to the CFA franc zone, and Comoros. Twelve of these countries had been French colonies and their currencies had been pegged to the French franc before World War II.[56] The CFA franc zone encompasses two distinct monetary zones:

- The Union Economique et Monétaire Ouest Africaine (West African Economic and Monetary Union) that comprises eight countries: Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo.

- The Communauté Economique et Monétaire d'Afrique Centrale (Central African Economic and Monetary Community) that comprises six countries: Cameroon, Central African Republic, Chad, Republic of the Congo (Brazzaville), Equatorial Guinea and Gabon.

The GDP of the whole franc zone represents only 0.5 % of the GDP of the 15 EU countries. Its total population is around 90 million. The West African part is dominated by Côte d'Ivoire, the Central African part by Cameroon, which account for 40% and 48% of the output of their respective regions. Each monetary zone has its own central bank, the Banque Centrale des Etats d'Afrique Occidentale (BCEAO, located in Dakar, Senegal) and the Banque des Etats d'Afrique Centrale (BEAC, located in Yaoundé, Cameroon).[57] They issue two distinct currencies, the Communauté Financière de l'Afrique (CFA) franc and the Coopération Financière Africaine (also CFA) franc, along the same principles:

- Fixed parity with the French franc and, since 1999, against the euro (100 XFA = 1 FRF or 655.957 XFA = 1 EUR).

- Free capital mobility between France and the two monetary zones – although a number of practical constraints exist within the franc zone – and harmonisation of exchange control regulations.

- Guarantee of convertibility of the CFA franc into the French franc by the French Treasury through the availability, in principle, of unlimited liquidity in French francs, as required.[58]

56 The "franc des colonies françaises d'Afrique", or CFA franc, was established as early as 1948, with a fixed exchange rate against the French franc. The responsibility for issuing currency and overseeing the functioning of the zone was shifted to two regional central banks following the independence of the French colonies in the early 1960s.

57 Representatives of the French Treasury and the Ministry of Foreign Affairs sit on the executive boards of the two regional central banks and on that of the central bank of Comoros. In addition, a Banque de France representative sits on the BEAC Executive Board.

58 As stipulated in the EU Council Decision of 23 November 1998, the guarantee of the French Treasury implies only a commitment of a budgetary nature. In particular, the EU Council Decision explicitly states that nothing in the agreements between the franc zone countries and France can be construed as implying an obligation on the part of the ECB or any other national central bank of the Eurosystem to support the convertibility of the CFA franc.

- In return, the BCEAO and the BEAC must keep at least 65% of their foreign assets in an operation account held at the French Treasury, provide for exchange cover of at least 20% of their sight liabilities and impose a cap on credit extended to each member country equivalent to 20% of that country's public revenue in the preceding year.

The long-standing peg to the French franc has been both conducive to, and supported by, strong trade links between the euro area and the franc zone countries. However, since the franc zone's exports are primarily commodities – for which the price is set on world markets – they tend to be mainly invoiced in US dollars.

Furthermore, EMU seems to have had a "demonstration" effect on West African countries, providing a reference model of monetary integration (see Box 6.1). Conversely, in the rest of Sub-Saharan Africa (Eastern Africa and Southern Africa) the euro plays hardly any role.[59]

6.3 Exchange rate policies in the CIS and MENA countries: a limited role for the euro

MENA

In MENA, the official reference to the euro in a number of countries through the SDR (Libya, Qatar, Saudi Arabia, United Arab Emirates) or via other currency baskets involving it (e.g. Kuwait) is, to a large extent, misleading. Only two countries of Northern Africa, Morocco and Tunisia, tightly manage de facto their respective currencies with regard to the euro, although the US dollar also seems to play a role in their reference baskets. Morocco, in particular, pegs its currency to a basket which reflects the share of the country's main trading and financial partners. Although the exact composition of the basket is not disclosed, the authorities announced in spring 2001 that they had increased the euro's share, probably with a view to regaining competitiveness vis-à-vis Morocco's trading partners further to the nominal appreciation of the US dollar in recent years. Indeed, Morocco – together with Tunisia – has tight trade links with the euro area which accounts for more than 60% of their exports and imports. On top of that, both countries have long-standing relations with some euro area countries, France in particular.

Unlike in Morocco and Tunisia, in other countries a reference to the euro in a currency basket has not translated into actual pegging. Oil-producing countries which formally peg to the SDR (Bahrain, Qatar, Saudi Arabia and the United Arab Emirates) de facto peg their currency to the US dollar since that is the invoicing currency of the commodity they export. Likewise, other oil-producing countries such as Algeria, Kuwait, Iraq and Iran tend to either formally or de facto peg to the US dollar, probably with a view to stabilising their export revenues.[60]

Other MENA countries such as Egypt, Lebanon and Syria, and, to a lesser extent, Jordan have close trade ties with the euro area, but these do not translate into an exchange rate arrangement focused on the euro (Sturm, 2001). For instance, Egypt's trade with the euro area accounts for over 30% of total exports and imports (compared with less

59 The South African rand is itself a regional anchor currency within the Common Monetary Area which comprises Lesotho, Namibia, South Africa and Swaziland.

60 EMU may nevertheless have intellectually influenced the Gulf region, as there are plans to introduce a single Gulf currency. At their summit in Manama/Bahrain at the end of 2000, the heads of state of the six countries of the Gulf Cooperation Council (GCC) – Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates – decided to draw up a working plan and a timetable to establish a unified currency. They thereafter agreed at the GCC summit in Muscat at the end of 2001 on the following steps and timetable for the establishment of a monetary union: (i) by the end of 2002 all national currencies of GCC countries are to be pegged to the US dollar, (ii) a legislative framework for a single currency is to be set up by 2005, (iii) a single currency is to be introduced by January 2010.

Box 6.1

Monetary integration in West Africa

A recent initiative by five West African states suggests that Economic and Monetary Union (EMU) in the euro area has had a "demonstration effect" in the region: in 1999 the Gambia, Ghana, Guinea, Nigeria and Sierra Leone launched an ambitious project to set up a second monetary union in West Africa, the West African Monetary Zone (WAMZ), alongside the existing West African Economic and Monetary Union. The five countries of the WAMZ have initially committed to a tight timetable whereby they would adopt a common currency by January 2003 and would work towards merging their monetary zone with the West African Economic and Monetary Union by January 2004.[1] There are recent indications, however, that these deadlines will be postponed.

EMU is the explicit reference used when setting up the WAMZ:

- An interim institution, akin to the European Monetary Institute, the West African Monetary Institute, is in charge of the technical preparation of the monetary union, employing staff from all five countries participating in the project.
- In the run-up to monetary union, countries are required to respect four primary convergence criteria, some of which resemble the Maastricht criteria applied for EMU: (i) inflation rate in single digits by 2000, coming down to 5% by 2003; (ii) central bank financing of budget deficits below 10% of the previous year's tax revenue by 2000; (iii) gross external reserves to cover a minimum of three months (2000) and six months (2003) of imports; (iv) budget deficit-to-GDP ratio below 5% in 2000 and below 4% in 2002.
- Progress made towards convergence is regularly reviewed by the Convergence Council, an institution that brings together ministers and central bank governors of the five participating countries.
- With a view to fostering nominal convergence and exchange rate stability, an Exchange Rate Mechanism has been established, resembling the ERM II mechanism, with +/-15% fluctuation bands. However, given the countries' denomination of external debt and trade, the US dollar has been chosen as the reference currency.[2]
- An awareness-raising campaign, partially comparable to that for the euro, has been launched to inform the general public about the forthcoming monetary union.
- The West African Central Bank (WACB) will determine the single monetary policy among the five countries. The national central banks will be in charge of monetary policy implementation at the national level. The primary objective of the WACB will be price stability. Price stability is defined as an inflation rate below 5% when the union is launched.

The planned monetary union would create an area of significant importance in Africa and could be a model for other developing or emerging market economies. The five countries together have a population of 150 million. Adding the eight Western Africa CFA franc zone countries would increase the area's total population to more than 220 million, with a combined GDP of USD 74 billion.

1 *For a comprehensive survey on the project, see Masson and Pattillo (2001).*
2 *There are three main reasons possibly explaining why the US dollar is used as the reference currency for the West African ERM: (i) the bulk of central banks' reserves are held in US dollars; (ii) it is the dominant invoicing currency of these countries' exports; (iii) it is the prevailing quotation currency of their monies on the foreign exchange market.*

than 15% for the United States) but the country pegs its currency to the US dollar. Egypt, in particular, embarked on an exchange rate-based stabilisation programme in 1991, pegging the pound to the US dollar. This arrangement served the country well insofar as it brought inflation down to relatively low levels; however, it has proved problematic in recent years because of the appreciation of the US dollar vis-à-vis the currencies of Egypt's main trading partners, which put pressure on the current account and led to several devaluations. More flexibility has been introduced in the exchange rate regime recently, but discussions on its optimal design are still ongoing.

Like Egypt, Israel embarked on an exchange rate-based stabilisation strategy in 1985, after inflation rates had reached three-digit levels. It first pegged to the US dollar and then switched to a currency basket. The exchange rate regime became increasingly flexible over the course of time as a fluctuation band was introduced whose width widens automatically and is currently more than 40%. Israel is different from the rest of the MENA countries in that it has managed to almost complete the transition from an external to an internal monetary anchor with the successful introduction of direct inflation targeting in the early 1990s. However, empirical estimates seem to suggest that de facto the Israeli shekel tends to shadow the US dollar.

European CIS

Most countries, including Russia, seem de facto to peg to the US dollar, although, on average, more than one-third of their trade is with the euro area. In particular, the most important stabilisation tool for the Russian central bank in the aftermath of the 1998 crisis has been active interventions on the FX market to counter the tendency of the rouble to appreciate in nominal terms. This appreciation stemmed from strong current account inflows brought about by favourable oil price developments. Central bank interventions have resulted in the rapid accumulation of foreign exchange reserves. More generally, the strong US dollar focus of European CIS countries may be justified by the fact that it is the dominant parallel currency circulating in the region. In addition, European CIS countries' external liabilities are, to a large extent, like those of MENA countries, US dollar-denominated, providing an argument for giving the US dollar a role in their exchange rate regimes. This is particularly the case for Russia as it is an important producer of commodities that tend to be quoted and invoiced in US dollars.

6.4 The euro as a parallel currency in the Western Balkans and the Mediterranean

The euro is used as a means of payment and a store of value in the Western Balkans and in some countries of the Mediterranean. This means that in these regions the euro circulates in the form of cash (mainly banknotes) to a degree that is significant for the economies concerned, and that also a considerable share of bank deposits are denominated in euro.

According to Eurosystem estimates, by September 2002 around EUR 26 billion in banknotes had been shipped out of the euro area. While there is widespread evidence that the bulk is circulating in the Western Balkans, EU accession countries, and Turkey, there are no precise details of the geographical destination of the shipments, with the exception of one single month. On the occasion of the cash changeover to the euro in January 2002, the Eurosystem shipped euro banknotes one month in advance, in December 2001, against deposit of collateral (thereby having an exact information of their destination). This operation was technically referred to as "frontloading", the initial provision of banknotes to meet initial cash needs. The country breakdown shows that the Western Balkans and Northern Africa together accounted for 25% of the total euro banknotes frontloaded.

Table 6.3

Frontloading by Eurosystem NCBs of euro banknotes outside the euro area

(December 2001)

Destination	EUR million	Share (%)
Turkey	1,502	38.5
Industrialised countries	1,273	32.7
Western Balkans	529	13.6
Northern Africa	436	11.2
Accession countries	121	3.1
Sub-Saharan Africa	25	0.6
Community of Independent States	11	0.3
Total	3,896	100

Source: ECB.

A currency breakdown of foreign currency deposits reveals that the use of the euro as a store of value is concentrated in the Balkans. Outside this region, the share of euro-denominated deposits drops significantly. Unfortunately, data on foreign exchange deposits including a currency breakdown are missing in several countries.

Table 6.4

Euro-denominated deposits as a percentage of total foreign currency deposits in selected 'ETZ' countries

(December 2001)

Country/Region	Share (%)
FR Yugoslavia	100.0
Croatia	82.6
Bosnia	82.4
Israel	15.3
Belarus	7.1
South Africa	6.0
Ukraine	5.8
Lebanon	5.7
Moldova	5.4
Egypt	4.2

Source: Padoa-Schioppa (2002).

The use of the euro as a parallel currency is particularly high in the Western Balkans. Here, the euro and its legacy currencies, primarily the Deutsche Mark (see Seitz, 1995), have performed all the functions of a parallel currency over the last decade:

- Means of payment. During the 1990s, at a time of hyperinflation and banking crises, the Deutsche Mark was used as a means of payment in the Federal Republic of Yugoslavia, with the population making payments extensively in foreign banknotes.

- Store of value. Croatia and Bosnia-Herzegovina currently demonstrate the second type of use. The population makes wide use of foreign currency as a financial asset for savings in banks, but uses it much less for cash payments. The population uses the kuna and the convertible marka for daily transactions, which reflects the authorities' achievements in bringing down inflation. However, the share of foreign currency deposits over total bank deposits has continued to increase particularly in Croatia, notwithstanding improvements in overall macroeconomic conditions and the banking system, as banks have offered foreign currency-denominated products to their customers as a sign of their renewed strength.

- Monetary policy device. Croatia also offers an example of the third type of use.[61] The central bank has regularly issued "Croatian National Bank Bills" denominated in foreign currency (DEM/EUR or USD) since 1998. These debt instruments, which have short-term maturities (63, 91, 182 and 364 days), are issued through weekly auctions in which only domestic credit institutions can participate. The central bank has also regularly held foreign currency auctions to "maintain liquidity of payments in the country and abroad", and imposed reserve requirements on foreign currency accounts.[62]

- Legal tender. The cases of Montenegro and Kosovo illustrate how a foreign currency can be used as legal tender. Kosovo, a province of Serbia in the Federal Republic of Yugoslavia, and since 1999 under the temporary administration of a United Nations mission (UNMIK), used the Deutsche Mark as the "preferred currency" further to UNMIK regulation No. 1999/4. Likewise, Montenegro, the smaller of the two member states of the Federal Republic of Yugoslavia, unilaterally declared the Deutsche Mark parallel legal tender to the Yugoslav dinar in November 1999. In January 2001 the Deutsche Mark became sole legal tender. In early 2002, both territories successfully operated the changeover to euro banknotes.

In contrast, many countries in the CIS, MENA and Sub-Saharan Africa do not use the euro as a parallel currency and are instead characterised by a high degree of US dollar-based currency and asset substitution. This is,

61 Other cases are Montenegro and, among the accession countries, Slovenia.
62 Croatian National Bank (2002).

Box 6.2

The economics of a parallel currency

The "parallel currency" concept is multifaceted. For analytical reasons, economists differentiate between four uses: (I) as a means of payment; (II) as a store of value; (III) as a monetary policy device, and (IV) as legal tender.[1]

1 Means of payment

Households may use a foreign currency to carry out domestic payments, a phenomenon called, "currency substitution". In economies suffering from (sometimes extraordinarily) high inflation and distortions in the price mechanism, referring to a foreign currency is a convenient way to measure the relative scarcity of goods. The reference to a foreign currency is normally limited to transactions involving large amounts of money (e.g. the purchase of real estate or cars) or regular payments (e.g. the payment of a rent); in extreme cases, it may be also extended to the pricing of all retail goods.

2 Store of value

Foreign banknotes may be also used as a store of value, for instance in the form of "under the mattress" banknote holdings. However, economic agents may resort to more sophisticated devices, for instance by opening a foreign currency-denominated bank account or purchasing other foreign currency-denominated financial assets. This is called, "asset substitution". Likewise, governments and corporations may solicit investors to purchase foreign currency-denominated assets, by issuing domestic securities denominated in that foreign currency. Alternatively, governments may directly turn to foreign investors to cover the bulk of their domestic financing needs. Credit institutions receiving deposits in foreign currency may hedge their foreign exchange exposure by granting foreign currency-denominated loans to domestic companies. The latter may have incentives to keep a substantial part of their liquid assets in foreign currency if a large part of their turnover depends on foreign trade.

3 Monetary policy device

If monetary aggregates are predominantly in a foreign currency, the central bank may conduct monetary policy operations in that currency, too, as an additional vehicle for operations with the banking system. For instance, the central bank may issue short-term debt securities in foreign currency and repo them against foreign currency deposits. It may modify the conditions applying to reserve requirements on financial liabilities in foreign currency, as a direct monetary policy instrument. The central bank may also decide to set up financial infrastructures – e.g. wholesale payment systems – explicitly dedicated to supporting domestic activities in foreign currencies.

4 Legal tender

Lastly, a country may officially decide to forego its own currency, assigning legal tender status to a foreign currency. As a result, the foreign currency becomes the official national currency and acquires all the attributes of the domestic currency. All contractual relations and any other monetary obligations (including non-contractual ones) are operated in the foreign currency. Other changes are introduced in parallel in the monetary sphere, for instance modifications of the competencies of monetary authorities, amendments to banking legislation, new conditions for the implementation of contractual obligations, etc.

1 For a literature review, see Baliño, Bennett and Borensztein (1999).

for instance, the case of the largest economies of the European CIS (Russia, Ukraine and Kazakhstan) and the countries of the Caucasus (Georgia and Armenia). Russian households still resort extensively to foreign cash as a means of transactions and a store of value, in particular US dollar banknotes, even if recently there have been signs of an increasing interest in euro banknotes. The share of foreign currency deposits in total deposits in Russia

has decreased somewhat since the historical high registered shortly after the August 1998 financial crisis, but still accounted for 38% at the end of 2001.

6.5 Exchange rate arrangements, trade structures and oil invoicing

With the exception of Morocco and Tunisia, the role of the euro in the exchange rate policies of CIS and MENA countries seems to be considerably less developed than their significant institutional, trade and financial relations with the EU and the euro area would imply. This is somewhat surprising in view of the standard optimal currency area literature which maintains that trade direction, financial links and the choice of the reference currency for exchange rate policy should be inherently intertwined. On the one hand, excessive exchange rate volatility may, at least in theory, be a major impediment to trade. On the other hand, strong and increasing trade relations are seen as a precondition for a more rigid exchange rate arrangement within a group of countries, as they increase the correlation of business cycles, thereby reducing the probability of asymmetric shocks.[64]

One element explaining this apparent contradiction is the high share of primary goods in CIS and MENA exports to the EU. Most primary goods are traded on world markets and tend to be mainly quoted and priced in US dollars (ECB, 2001a). Accordingly, although the trade relations of most 'ETZ' countries are clearly dominated by trade with the EU, this does not imply that the orientation of domestic monetary and exchange rate policies towards the euro would help reduce terms-of-trade shocks. A

64 This is the view of the optimum currency area literature. However, since standard Ricardian theory suggests that as countries specialise more in production, as their trade relations increase, they could become more vulnerable to asymmetric shocks, creating a need for the exchange rate to become more flexible, so that economies can adjust to these shocks. Empirical evidence provided by Frankel (1999) supports the view that stronger trade relations are linked with higher income correlation, reducing vulnerability to asymmetric shocks.

Box 6.3

Energy invoicing and network externalities

Today, oil price formation occurs through the complex interaction of spot, term and futures trading for different qualities of crude oil, with three major reference points: London (the Brent market for North Sea oil), Dubai and New York. London strongly influences price formation everywhere outside North America, including the Dubai market. The use of one currency (the US dollar) in all markets for energy creates important network externalities, which thus favours the status quo.

Given these network externalities, a "critical mass" would be required to make possible a partial switch to a multi-currency quotation system (for instance, New York quoting prices in US dollars and London in euro). A switch to a multi-currency system could be only initiated by those oil producers that have particularly close trade ties with the euro area. This would primarily apply to the North Sea oil producers, the United Kingdom and Norway, but also to Russia and North African producers like Algeria and Libya, which together account for approximately 25% of world oil production. Oil producers on the American continent with close links to the US, like Mexico and Venezuela, would have no incentive to follow such a move, and the Gulf producers would find themselves somewhere in the middle.

Of course, any transition to a multi-currency quotation system might complicate interaction on oil markets. Therefore, it would have to have very strong support from operators ready to accept higher transaction costs during the initial phase. Some authors believe that any competitive coexistence between the US dollar and the euro in the oil market would not last any great length of time as it would tend to be unstable. In the longer run, in all likelihood, they maintain that one of the two currencies would have to prevail (Noreng, 1999).

crucial issue for CIS and MENA countries is therefore the invoicing of energy (oil and gas) in US dollars.[65]

This line of reasoning is supported by the fact that the euro's role is more prominent in the Western Balkans and some Maghreb countries such as Tunisia and Morocco. The share of trade with the EU in these countries is somewhat above average, but the main qualitative difference with other 'ETZ' countries is that trade relations with the EU are less dominated by primary goods. However, it has to be acknowledged that there are other 'ETZ' countries with similar characteristics, for example Egypt and Lebanon, which are nevertheless largely US dollar-oriented. This suggests that trade is an important, but by no means the only or the decisive criterion of monetary links between countries.

6.6 Key features of monetary policy

Over the last two decades a broad consensus has been reached in academic and policy-making circles alike with regard to the final objective of monetary policy (price stability), the institutional set-up of the central bank (independence) and the choice of instruments (market-based or indirect instruments). While the ECB's monetary policy framework definitely reflects this consensus, that of many 'ETZ' central banks is also guided by these principles.[66]

Central banks are given a clear legal mandate to maintain the internal and external stability of their respective currencies.[67] In some cases (e.g. Armenia, Croatia, Israel, Kenya, South Africa, Tanzania and Tunisia) price stability is openly referred to, although it is only precisely defined in Israel and South Africa which have adopted a direct inflation targeting strategy.[68] Some central banks, in particular in Sub-Saharan Africa and MENA countries, are assigned other, broader, objectives.[69] For instance, central banks in Mauritius, Oman, South Africa, Ukraine and in the West African Economic and Monetary Union have to promote economic growth, while in Algeria, Botswana, Croatia, Qatar and the United Arab Emirates they are required to support economic policies conducted by other public authorities.

Turning to the instruments available to central banks to reach their respective objectives, most claim to use the full spectrum of direct and indirect monetary policy instruments, such as reserve requirements, standing facilities and open-market operations. In practice, however, most central banks are still faced with a number of challenges, including the establishment of their independence in a difficult institutional environment, gaining credibility without an appropriate inflation track record, and pursuing disinflation programs. In particular, inflation has still failed to reach single-digit levels in the largest part of the European CIS and of Sub-Saharan Africa (South Africa being a notable exception) over recent years (see Chart 6.1).[70] In contrast to these regions, the large majority of MENA countries have managed in recent years to

65 For an overview of this issue see Noreng (1999).

66 As a brief reminder, the salient features of the ECB's monetary policy are: (i) a commitment, as a prime objective, to price stability which is clearly defined as an increase in the harmonised index of consumer prices of below 2% over the medium term; (ii) without prejudice to this objective, support for EU economic policies; (iii) a two-pillar strategy based on (a) a reference value for the growth of money supply and (b) a broadly based assessment of the outlook for future price developments; and (iv) the use of a variety of monetary policy instruments, namely regular refinancing operations, standing facilities, fine-tuning operations and minimum reserve requirements (ECB, 2001b).

67 See Table 6.5 for details.

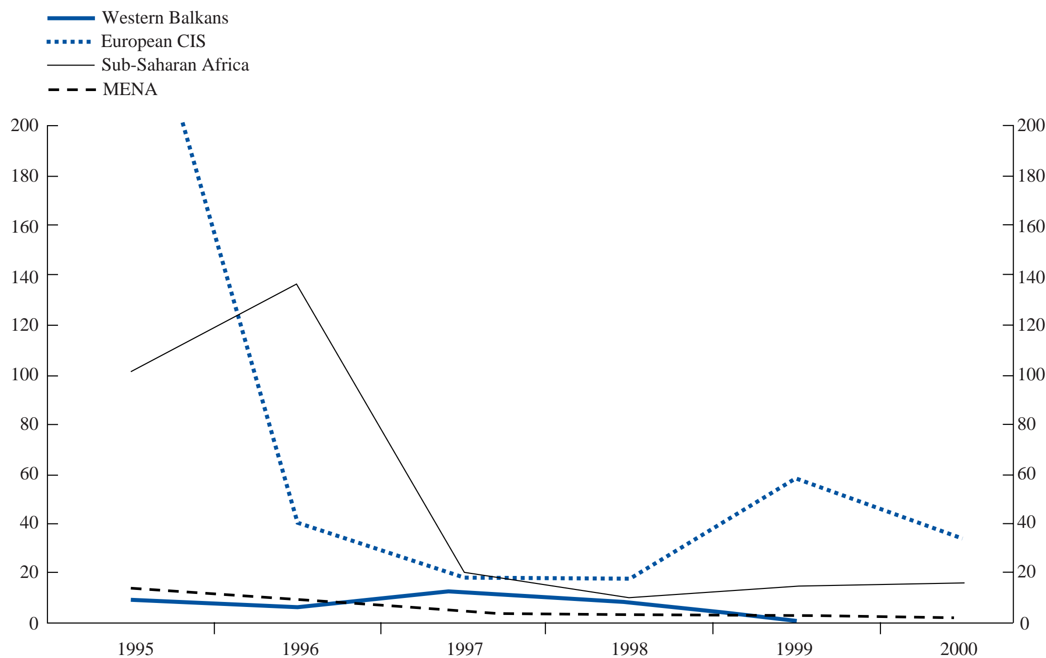
68 In Israel the inflation target, set by the government in consultation with the central bank, is between 1 and 3% per year from 2003 onwards, while in South Africa the inflation target (average CPI growth) is between 3 and 6% for 2002.

69 This obviously comes on top of other operational functions, such as the issuance of the domestic currency, or of other tasks which are not directly related to monetary policy per se, such as the supervision of the banking and of the financial sectors.

70 Average inflation figures in the Western Balkans exclude Bosnia and Herzegovina as well as Yugoslavia, owing to data unavailability. Likewise, average inflation figures in MENA exclude Iraq, Lebanon, Libya, the Palestinian Territories and the United Arab Emirates, while in Sub-Saharan Africa they exclude Comoros, Djibouti, Eritrea, Liberia, Mayotte, São Tomé & Príncipe and Zambia.

Chart 6.1
Inflation in ETZ countries

(Unweighted arithmetic averages of yearly changes in consumer prices, in percent)



Source: IMF (International Financial Statistics)

bring their inflation rates down to close to euro area levels, mainly by successfully pegging their currencies to an external anchor. Inflation has been reduced to very low levels in the Western Balkans, except in FR Yugoslavia.

Although there are some exceptions, the widespread absence of developed financial markets, combined with weak banking systems, weighs heavily on practical monetary policy implementation in a large number of 'ETZ' countries. In particular, money markets are often undersized and skewed towards very short-term maturities (from overnight to a few weeks), with few active transactions between banks, while refinancing operations with the central bank account for the bulk of market activity. Indirect monetary instruments are hardly used and are undermined by a number of obstacles such as a lack of collateral and insufficient market liquidity. In some cases, direct monetary policy instruments are the most widely used device, including high minimum reserve ratios, binding legal ceilings on lending rates and restrictions on banks' portfolio allocation, sometimes with a view to dragging resources toward sectors considered to be strategic.[71] Faced with these challenges to the control of their domestic money supply, most 'ETZ' countries have tried to rely on an external anchor, thereby limiting their ability to conduct a purely domestically-focused monetary policy.

71 *This is not the case in the inflation targeting economies, Israel and South Africa, as pointed out in Schaechter (2000); these enjoy larger and relatively more developed financial systems than most 'ETZ' countries.*

Table 6.5

Overview of the monetary policy framework in selected ‘ETZ’ countries

(as of mid-2002)

Country	Objective(s)			Instruments			
	Currency stability	**Additional objective(s)***	**Intermediate target**	**Minimum reserves (%)**	**Other direct instruments**	**Standing facilities**	**Open-market operations**
				Western Balkans			
Bosnia-Herz.	✓	-	-	10		Currency board arrangement	
Croatia [1]	Price stability	Support economic policy	N.a.	19	N.a.	✓	✓
FYR Macedonia	✓	N.a.	Euro/denar exchange rate	3.5-8	Credit ceilings	✓	✓
FR Yugoslavia	✓	Lower inflation expectations, reserves growth	N.a.	24.5	Credit ceilings	✓	✓
				European CIS			
Armenia	Price stability	N.a.	Broad money and base money	8	Influence on the “reference rate of bank interest”	✓	✓
Azerbaijan	✓	N.a.	N.a.	10	✓	✓	✓
Georgia	✓	N.a.	N.a.	✓	Temporary credit restrictions	✓	
Moldova	✓	N.a.	N.a.	7	N.a.	✓	✓
Kazakhstan	✓	N.a.	N.a.	N.a.	N.a.	✓	✓
Russia	✓	N.a.	N.a.	10	N.a.	✓	✓
Ukraine	✓	Economic growth	M3	15	N.a.	✓	✓
				Middle East and Northern Africa			
Algeria	✓	“Orderly” development of the economy	N.a.	N.a.	N.a.	✓	✓
Egypt	✓	N.a.	N.a.	15	N.a.	✓	✓
Israel [2]	Price stability	Economic growth	No	Unused	N.a.	✓	✓
Kuwait	✓	N.a.	N.a.	N.a.	Lending rate ceilings	✓	✓
Morocco	✓	N.a.	M1	Credit ceilings, restrictions on interest rates and loans have been abolished		✓	✓
Oman	✓	Sustained economic growth	Exchange rate stability	✓	Credit, deposit and interest rate ceilings	✓	✓
Qatar	✓	Support national economy	Exchange rate stability	2.75%	Lending limits	✓	✓
Saudi Arabia	✓	N.a.	Exchange rate stability	7	Liquidity reserve ratios	✓	✓
Tunisia	Price stability	Real exchange rate stability	M2, M3, M4	N.a.	N.a.	✓	✓
United Arab Emirates	✓	Support national economy	Exchange rate peg	1%-30%	Lending, interest rates and fees limits	✓	N.a.

Table 6.5 (continued)

Country	Objective(s)			Instruments			
	Currency stability	Additional objective(s)*	Intermediate target	Minimum reserves (%)	Other direct instruments	Standing facilities	Open-market operations
			Sub-Saharan Africa				
Botswana	✓	Support development goals	N.a.	✓	Control of credit and credit interest	✓	N.a.
Ghana	✓	N.a.	Money, credit aggregates	✓	✓	No policy rate	✓
Kenya	Price stability	N.a.	N.a.	Cash ratio requirements	N.a.	✓	✓
Mauritius	✓	Strengthen economic prosperity	N.a.	No longer used		✓	✓
Rwanda	✓	N.a.	N.a.	8%	N.a.	✓	✓
South Africa[3]	Price stability	Sustainable growth	No	2.5% (Not actively used)	✓	✓	✓
Tanzania	Price stability	N.a.	Money supply, reserves, exchange rate stability	✓	N.a.	✓	✓
WAEMU	✓	Economic growth	Coverage of base money by reserves	Varies across countries	Ex-post control of credit quality	✓	✓

Source: information released by central banks on their respective websites.
Note: (*) other than financial or banking stability; (✓) qualifies for the respective category; (N.a.) Not available.
1) The central bank issues short-term securities ("bills") in euro (as well as in kuna and US dollars).
2) Direct inflation targeting since 1992 (target 1-3% from 2003 onwards).
3) Direct inflation targeting since 2000 (average CPI growth between 3% and 6% for 2002).

6.7 Technical appendix: Revealing de facto exchange rate pegging in 'ETZ' countries

The method first outlined by Frankel and Wei (1994) is used to examine whether 'ETZ' countries that declare officially that they float, manage or peg their currency to a foreign currency or a basket of currencies, in fact peg it to the US dollar or the euro.

To this end, the following OLS regression is run:

$$\Delta\ln[(e/CHF)_t] = \alpha + \beta_1\Delta\ln[(EUR/CHF)_t] + \beta_2\Delta\ln[(USD/CHF)_t] + \beta_3\Delta\ln[(JPY/CHF)_t] + \varepsilon_t$$

where the local currency e is regressed on a constant, α, the euro, the US dollar and the Japanese yen (used as a control variable), with the Swiss franc used as the numeraire; the β coefficients are the parameters (weights of the basket) to be estimated, and ε_t is a well-behaved disturbance term.[72] The model is estimated for 37 'ETZ' currencies for which data are available from Bloomberg, sampled at a weekly frequency in the first two years of the euro's existence (January 1999 to February 2001).

The results are shown in Table 6.6. Each entry represents the percentage change in the local

72 All variables are in (natural) log form; Δ stands for the first-difference operator and the subscript t for time. The Swiss franc was chosen as numeraire as the latter should not be correlated with the currencies of the basket (to minimise multicolinearity-type problems). For other applications of the Frankel and Wei (1994) methodology (on Asian currencies), see McKinnon (2000) or Bank of England (2000), who also use the Swiss franc as numeraire, or Benassy-Quéré and Coeuré (2000) for an in-depth discussion of the problems raised by the choice of the numeraire and the limitations of this methodology.

Table 6.6

De facto exchange rate pegging in 'ETZ' countries

Country (currency)	Euro	US dollar	Japanese yen
Western Balkans			
Albania (lek)	0.47[1)]	0.77[1)]	-0.04
Croatia (kuna)	0.95[1)]	0.14	-0.01
FYR Macedonia (denar)	1.13[1)]	0.58[1)]	-0.09
European CIS			
Armenia (dram)	0.25[2)]	0.98[1)]	0.00
Azerbaijan (manat)	-0.07	0.98[1)]	-0.04
Belarus (rouble)	0.45	0.79[1)]	0.17
Georgia (lari)	-0.19	1.04[1)]	-0.22
Ukraine (hryvnia)	0.13	1.34[1)]	-0.22
Kazakhstan (tenge)	-0.25	0.93[1)]	0.03
Moldova (leu)	0.36	0.70[1)]	0.21[3)]
Russia (rouble)	-0.56	0.92[1)]	-0.02
Middle East and Northern Africa			
Algeria (dinar)	0.68[2)]	0.56[1)]	-0.05
Bahrain (dinar)	0.00	0.99[1)]	0.00
Israel (shekel)	0.23	0.92[1)]	0.06
Iraq (dinar)	-0.16	1.11[1)]	-0.01
Iran (rial)	-0.04	0.99[1)]	0.00
Jordan (dinar)	0.08[3)]	1.00[1)]	-0.01
Kuwait (dinar)	0.09[1)]	0.88[1)]	0.03[1)]
Lebanon (pound)	0.04	0.98[1)]	0.00
Morocco (dirham)	0.57[1)]	0.42[1)]	0.04
Oman (rial)	0.09[3)]	0.99[1)]	0.00
Qatar (riyal)	0.00	1.00[1)]	0.00
Syria (pound)	-0.23	0.89[1)]	0.04
Tunisia (dinar)	0.85[1)]	0.37[1)]	0.00
United Arab Emirates (dirham)	0.00	1.00[1)]	0.00
Sub-Saharan Africa			
Burundi (franc)	-0.31	-0.61[1)]	0.36[2)]
Botswana (pula)	-0.68[2)]	-0.10	0.08
Democratic Republic of the Congo (franc)	-0.60	-0.13	0.21
Eritrea (nafka)	-0.87	-0.09	0.08
Ghana (cedi)	-1.35[3)]	0.18	0.22
The Gambia (dalasi)	-0.48	-0.10	0.04
Guinea (franc)	-0.17	-0.15	0.09
Kenya (shilling)	-0.64[3)]	0.12	0.01
Malawi (kwacha)	-0.37	0.00	0.00
Mozambique (metical)	-0.52	-0.14	0.18
Nigeria (naira)	-0.62	-0.06	0.19
Tanzania (shilling)	-0.48	0.07	0.05

Note: (1), (2), (3) indicate significance at the 1%, 5% and 10% level of confidence respectively.

currency with respect to a 1% change in the euro, the US dollar and the Japanese yen respectively. For example, a 1% change in the exchange rate of the euro vis-à-vis the Swiss franc was typically associated with a 0.95% change in the exchange rate of the Croatian kuna against the Swiss franc in the same week.

7 Final remarks

This paper has explored the intensity of economic relations between the euro area and a set of around 80 emerging, developing or transition economies located in four regions: the Western Balkans; the European part of the Commonwealth of Independent States; the Middle East and Northern Africa; and Sub-Saharan Africa. These countries, for the sake of simplicity and with some degree of arbitrariness, have been labelled together as belonging to the "Euro Time Zone". They are not candidates for EU accession and, for the most part, are not even in Europe.

The analysis showed that the Western Balkans is the region most tightly linked to the euro area in economic terms. It is also the region with the highest potential for integration with the EU, the strongest institutional ties, where the euro plays the greatest role in the countries' monetary and exchange rate policies, and the region with the strongest presence of euro area banks.

Of the other three regions, the European CIS is the one with particularly strong banking links to the euro area, while the links with Sub-Saharan Africa are based mainly on trade, the monetary relations between France and the CFA franc zone, and official development assistance flows. In absolute terms, MENA countries are, by far, the main trading and financial partners of the EU. This mainly reflects their higher income levels compared with the other regions, in particular in the resource-rich economies like those of the Arabian Peninsula, and the importance of oil imports for the EU.

However, despite their diversity, the four regions have a number of interesting features in common:

- While bilateral agreements between the EU and other regions in the world, such as Latin America or Asia, also exist, institutional links with many 'ETZ' countries have a much longer history, cover a much wider range of issues and exhibit – on average – a stronger commitment to economic integration and co-operation from both sides.

- Indeed, while the euro area has developed significant trade relations with Latin America and Asia, in the group of developing countries 'ETZ' countries are more dependent on EU trade than other regions are. Likewise, of all the members of this group the 'ETZ' countries represent the largest export market and the second largest import market for the EU. In particular, 'ETZ' countries are the main suppliers of agricultural goods, raw materials and fuels, accounting for more than 60% of EU imports in these products. In particular, energy is of crucial importance for the euro area.

- 'ETZ' countries are the main debtors of euro area banks among the group of developing countries and the largest recipients of official aid provided by the EU. Moreover, they are highly dependent on the euro area and the EU with regard to bank lending, official development assistance and FDI flows.

Compared with the intensity of institutional, trade and financial links, the role of the euro in exchange rate policies of the 80 countries is relatively limited. To date, even 'ETZ' countries with strong links to the euro area economies seem to have preferred a reference to the US dollar in their exchange rate policies. Nevertheless, the euro is the currency of reference of the Western Balkans, and an important anchor for some countries in Sub-Saharan Africa and Northern Africa.

Overall, countries that are either geographically particularly close to the euro area (often direct neighbours) and historically linked to it have the strongest institutional, trade, financial and monetary links with the euro area. There is rather more mixed evidence with regard to countries well endowed with natural resources: while trade and financial links are strong, monetary links are rather weak. This seems to be the case because natural resources are traded on world

Table 7.1

Overview of the links between 'ETZ' countries and the euro area

(in percent)

Type of link	Western Balkans	European CIS	MENA	Sub-Saharan Africa	All 'ETZ' countries
Institutional links					
Agreements	Stabilisation and Association Agreements. Status as potential candidate for EU membership.	Partnership and Co-operation Agreements. Promotion of trade, investment and economic relations.	Euro-Med-Agreements Euro-Mediterranean free trade area targeted for 2010	Cotonou Agreement Preconditions for future liberalisation of trade	
Trade links					
Share of the EU in trade (exports/imports), 1995-2000	47 / 54	27 / 28	39 / 44	37 / 42	36 / 42
Export structure (primary/ manufactured goods), 1995-2000	25 / 73	50 / 42	50 / 50	65 / 31	53 / 42
Financial links					
Euro area banks' ownership of domestic banking sectors	High	Low	Negligible	Negligible	
Share of euro area banks in total BIS reporting banks' claims on the region, 1995-2000	82	85	58	58	67
Share of euro-denominated bank claims in total bank claims on the region, 2000	68	37	21	21	25
EU share in Official Development Assistance flows to the region, 1995-2000	61	31	46	53	51
Share of FDI flows originating from euro area countries to the region, 1995-2000	68	54	35	45	40
Monetary and exchange rate policies					
Role of the euro as a reference currency	Very large	Small	Small	Large[1] / small	
Degree of unofficial euroisation	High	Low	Low	Low	

Source: authors' compilation, based on sections 3-6.
1) CFA franc zone.

markets where prices are quoted in US dollars, while exports tend to be invoiced almost exclusively in US dollars.

Hence, the evidence provided in this paper suggests that there are strong institutional and economic relations between the euro area and the four regions subsumed under the heading "Euro Time Zone". Given that these countries, located in relatively close geographical proximity to the euro area, receive less attention than other emerging market economies, this conclusion is of relevance both for the 'ETZ' countries and the euro area. Moreover, with the forthcoming EU enlargement, these links may well become even stronger in the future.

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