

CAPE VERDE: THE CASE FOR EUROIZATION

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Abstract

After 10 years of a fixed exchange rate against the Euro and a deepening integration with the European Union (EU), the authorities of Cape Verde maintain a strong commitment to nominal stability and are now considering the official euroization of the country.

Compared to the current pegging, euroization could be costly if the structural and/or cyclical conditions of Cape Verde require having control over the interest rates and the exchange rate. Given the strong economic and financial integration between Cape Verde and Europe, and the fact that Cape Verde records inflation rates at levels similar to those of the euro area, the relevant issue is whether the ECB monetary policy, set for the Euro Area (EA), fits the needs of Cape Verde. In order to answer this question, we empirically assess the synchronization between the business cycle of Cape Verde and the business cycle of the EA. For that purpose, we compute output gaps and then use conventional correlation measures as well as other techniques recently suggested in the literature. Replicating the methodology for each of the 27 EU countries, our results show that Cape Verde ranks better than several EU countries and even some EA countries.

We thus conclude that there is a strong case for the euroization of Cape Verde: euroization would secure the benefits already attained with the pegging to the euro and would warrant additional benefits, most likely with no costs stemming from inappropriate ECB monetary policies.

Keywords: Cape Verde, Euro Area, euroization, business cycles.

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