PERSONAL VIEW - by Jacek Rostowski

ADOPTING THE EURO

The economies of Eastern Europe should avoid the danger of an appreciation bubble by unilaterally switching to the single currency now

Central European countries are becoming victims of their own success. Estonia, Hungary and Poland have found that as their reforms become well established, and as their future membership of the European Union becomes an ever clearer prospect, growing capital inflows have to be offset by higher current account deficits.

Policymakers' main worry is that capital inflows can cause an increase in the nominal value of currencies that feeds on itself. Because domestic companies expect the exchange rate to rise, they tend to borrow more capital from abroad and foreigners try to anticipate appreciation by investing before it happens. Rapidly spiralling current account deficits may then make the country vulnerable to a currency crisis if sentiment changes.

In this situation, traditional policy instruments are ineffective. With floating exchange rates, governments that raise short-term interest rates may cause an appreciation of the currency and a further deterioration in the current account, while those that reduce interest rates risk inflation.

Tightening fiscal policy may also be ineffective. If a government is prudent, the country may become more attractive to investors. But if it increases the budget deficit, it will stimulate domestic demand, making the current account deficit worse.

Controls on capital movements are ruled out by the requirements of EU membership. In fact they need to be totally liberalised over the next few years. So how can the danger of an appreciation bubble be avoided? For countries with sufficient international reserves, such as Estonia and Poland, the solution is simple: introduce the euro unilaterally and abolish the domestic currency as fast as possible.

Preparation of the financial and fiscal systems can be expected to take about two years, which would mean that the countries would be ready to adopt the euro in January 2002, just when euro notes begin to circulate. Unilateral adoption would be achieved simply by introducing in 2002 the law that would otherwise replace the zloty or crown on entry into economic and monetary union in about seven years time.

National central banks would use their international reserves to exchange domestic notes for euro notes and to redenominate their other liabilities, mainly to commercial banks, in euros. In Poland's case, this operation would leave the central bank with a reserve fund of about E15bn, which could be used for last resort lending to protect the banking system. Since this covers 25 per cent of all bank deposits and 90 per cent of current accounts, it should be ample.

Unilateral adoption of the euro should be even more credible than establishing a currency board, because the national currency ceases to exist and all contracts become euro-denominated. Any subsequent withdrawal from the euro-zone would require the introduction of a new domestic currency - a lengthy and disruptive process. In addition, unilateral euroization would last less than five years, since the countries involved should be full voting members of the European Central Bank by January 2007.

Euroization would also allow central European applicants to avoid the trap of the inflation criterion set under the Maastricht treaty. At present central European prices are 40 per cent of the level in Austria. As rapid productivity growth in manufacturing occurs, wages rise at the same rate without reducing the competitiveness of traded goods produced in the country.

In Hungary labour productivity in manufacturing has been growing at 13 per cent annually. This pushes up wages and prices in the non-traded sector of the economy such as services and construction. Price levels will converge along with productivity to West European levels. Unfortunately, the Maastricht inflation criterion does not take this process into account. For full membership of Emu, countries must achieve an inflation rate no higher than 1.5 per cent above the average of the three best performing members. At present, this implies a rate of 1.9 per cent. Over recent years Poland has experienced an average real appreciation of 7.5 per cent per year - the amount by which prices have risen over and above the depreciation of the currency. Therefore, to meet the inflation criterion, it would have needed a 5.5 per cent annual nominal appreciation, which would have devastated its competitiveness. In other words, Poland could have maintained its competitiveness with a fixed exchange rate and an inflation rate of 5 per cent, if the inflation originated only in the non-traded sector.

Requiring the central European applicants to satisfy the inflation criterion means imposing an unnecessary recession on them prior to Emu entry. The nonsense of the criterion for fast-growing countries is illustrated by Ireland breaking it this year, as soon as it became a member. Successful unilateral adoption of the euro for four or five years would demonstrate applicants' readiness for both EU and Emu membership, and the irrelevance of the Maastricht inflation criterion.

Countries adopting this course also have the benefit of choosing the conversion rate of their currency into euros themselves. They can therefore pick a somewhat devalued rate which will give them greater competitiveness for a while, something which is impossible when following the traditional route to EMU, since the conversion rate has to be agreed with existing EMU members.

Finally, unilateral euro adoption would be expansionary rather than contractionary for the countries adopting it. Interest rates would come down to close to euro-zone levels and the disappearance of exchange rate risk would further encourage direct investment. This would come without the danger of an upward spiral in the value of the currency, since nominal appreciation would be impossible.

What would be the costs? First, there would be a modest loss of seignorage - income gained by central banks from issuing money. But from this, we can deduct the costs of monetary operations to offset the effects of capital inflows. The cost of servicing government debt would also fall along with interest rates.

More seriously, there could be a danger of capital inflows leading to loose lending practices, growing bad debts and ultimately a banking crisis. This is why the scheme requires that Central European central banks improve their supervisory capacities in advance. The author is head of the economics department at the Central European University, Budapest, and Chairman of the Macroeconomic Policy Council at the Polish Ministry of Finance.

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