

Comments on Rostowski.

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Rostowski provides a very good case for the early adoption of the Euro for a country like Poland. Its main arguments extend to the other candidate countries. It is striking that critics of such a view have not come up yet with convincing counterarguments.

In a world of perfectly functioning markets for goods, labor and capital, and complete financial markets, the exchange rate would be irrelevant, as just a nominal unit of measure of the output of a country in terms of another nominal unit of measure, the one adopted for the output of foreign countries. In such a context, the exchange rate, as the relative price of two monies would be totally indeterminate, as people would be indifferent between using and holding one money or the other.

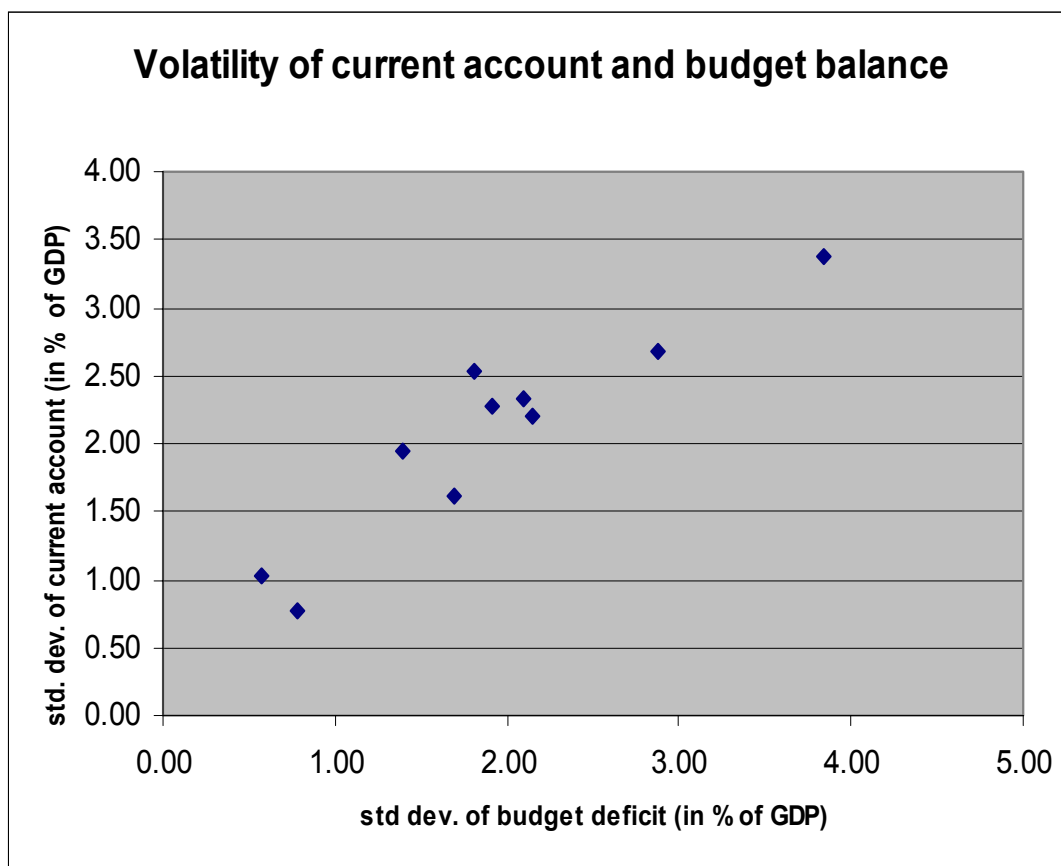
Thus, to talk in a meaningful way about the role of exchange rates we must have in mind a world that deviates from a perfectly functioning Arrow-Debreu economy. It seems to me that opponents to the adoption of the Euro reason mainly in terms of two types of models, coming from opposite schools of thought, one traditionally Keynesian, the other monetarist: one is the “elasticity” approach to the balance of payments, whereby the exchange rate would affect real competitiveness and thus trade flows. In this regard, there is the presumption that a country can persistently use the exchange rate as an instrument to gain competitiveness and thus gain output at the expense of foreign countries. The relevance of such approach is highly debatable and its desirability for countries joining a common trading area highly questionable. The second model is a simple monetarist model in which flexibility of the exchange rate allows freedom in conducting domestic monetary policy. Important theoretical and empirical work of the last ten years illustrates how for emerging economies such a freedom in conducting monetary policy is largely illusory (see Calvo (2001, for a recent insightful discussion). The lack of actual freedom is caused by the presence of

¹ The views expressed in this paper are personal and cannot be attributed to the European Commission.

significant foreign debt, “dollarization” of the economy and sensitivity of domestic inflation to the exchange rate. These facts are well documented for Latin America, and the case of Argentina cannot be used to dismiss the desirability of dollarization or euroization as Argentina never adopted the dollar. As recently argued by Jeffrey Sachs, the problem of Argentina was that she did not adopt the dollar. Dollarization is indeed one of the options to get out of the current situation, as it is apparent that Argentina cannot afford to let the exchange rate to freely float.

Rostowski provides an insightful analysis of why the above issues are relevant for transition economies, and especially for Poland. I share many points of the analysis and thus I would like to emphasize a point of disagreement, which I believe weakens Rostowski analysis. This point is the discussion on fiscal policy. While it is true that the current account deficit for transition economies is an equilibrium features of a fast growing, catching up economy, I believe that the statement on the irrelevance of fiscal policy for the current account is wrong, and it, in fact, it weakens the argument in favor of Euroization. Indeed, one of the reasons for the vulnerability to currency crises of transition economies, and for emerging economies in general, is associated to weak fiscal institutions. There are weak “Ricardian” effects in emerging economies, and therefore changes in fiscal balances affect the current account (see Reisen (1998) for instance). As stressed by Talvi (1996) fiscal policy tends to be highly volatile and pro-cyclical in emerging economies because governments tend to spend in “good times” fiscal revenues that are temporary in nature. Expenditure tends to be more rigid and thus more difficult to contract in “bad times”. Current account deficits tend to be higher than implied by private sector decisions. But during good times, international markets tend to be generous with emerging economies and borrowing is rather easy. As the access to international capital markets for emerging economies is precarious (see Gavin et al. (1996)), when bad times occur, borrowing becomes difficult. As a result, the current account has to be adjusted, and this adjustment is often associated to fiscal contractions, that make even worse the outcome. Note, that shifts in international flows to emerging markets can be associated to exogenous factors related to the state of the economy, mainly of financial markets, in countries in the center, mainly the U.S.. These features characterize transition economies as well. Chart 1 displays the association between volatility of budget deficit and volatility of the current account deficit for countries that are candidate to accessing the European Union during the 1990s. The correlation is striking.

Chart 1. Volatility of budget deficits and current account deficit



In contrast with Rostowski's view, I believe that this association works in favor of the desirability of euroization, because it is one of the main sources for the exposure to large shocks to transition economies. If the budgetary process were very effective, and fiscal policy could credibly assist monetary policy, the vulnerability of emerging markets and transition economies would be much less serious. However, there are intrinsic weaknesses on the fiscal side for emerging economies and for transition countries as well, that are economies in which institutional development is still far from that of advanced market economies. The process of rapid growth is associated to large structural change, with large swings in unemployment rates and relative prices. There is a need for large public investment in infrastructure to sustain growth. Furthermore, safety nets are crucial to compensate the losers in the process of growth. These forces create large demands on the budget, demands that cannot be easily financed by a weak revenue base. Fiscal policy, in such a context, may become destabilizing. The adoption of the euro will not solve this weakness. However, it may contribute to reduce the large negative consequences of this weakness.

References

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