

Comments on  
“The Eastern Enlargement of the EU and the Case for Unilateral Euroization”  
by Jacek Rostowski

Charles Wyplosz  
Graduate Institute for International Studies and CEPR

This is a very hard paper for me to comment upon, because there is so much I agree with. One reason why I agree is that the main conclusions seem perfectly sensible. The risk of destabilization capital inflows, which create a painful policy tradeoff and often reverse themselves for various good and bad reasons, is serious. The complexity of life when the Balassa-Samuelson effect kicks in further suggests that the Central and East European Countries (CEECs) are different from previous entrants and require a different treatment. Another reason why I agree is that I have been the co-author of a report for the EU Commission on precisely that issue, and that we were fairly supportive of euroization for some countries. The fact that the Commission has essentially blocked the release of the report indicates how sensitive the issue is. I start with a few comments on Jacek’s approach and then move on to the political sensitiveness question.

### **Balassa-Samuelson**

I will be, of course, the last one to dismiss the importance of the Balassa-Samuelson (BS)<sup>1</sup> effect. Both theory and evidence indicate that this effect will be at work. The two questions are: 1) how big is it likely to be? 2) what effects will it have.

On the size issue, I believe that Jacek vastly exaggerates his numbers. He bases his 7.5% per annum estimate on the experience of the Poland since transition started. This is misleading for two reasons. First, all CEECs underwent a sizeable undervaluation when they liberalized the exchange rate, so a significant portion of the subsequent real appreciation has been a correction. Second, as time passes by, the CEECs close the gap and therefore the BS effect declines. Eventually it will vanish. My own more recent work on this question (Halpern and Wyplosz, 2001), which tries hard to disentangle the correction from the trend, puts it at 2-3% p.a., and this estimate ranks among the highest. This is a big difference, and it drastically reduces the most dramatic aspects of Jacek’s own evaluation.

As for the effects, I find very interesting Jacek’s observation that the BS effect increases the net present value of income and that it will, as well, reduce the debt to GDP ratio. These are important considerations. Yet, inasmuch as the BS effect is already known, it is already incorporated in net present value considerations. Jacek observes that upward revisions of growth characterize transition, which might be true

---

<sup>1</sup> Quite correctly, Jacek invokes Harrod’s contribution. I will stick with the now standard, yet unfair, BS reference.

but unfortunately remains unsubstantiated. At any rate, he must also make the point that these revisions include the BS effect, which I expect is hard to make convincingly.

### **Fiscal policy and the current account**

A substantial contribution of the paper is to attract attention to the current account and to explore the links between the current account and fiscal policy. The details matter little – I am not too happy with the formalization but I buy most of the arguments – as some key conclusions are not disputed. The first one is that it is optimal for the transition countries to run external deficits. The logic of inter-generational consumption smoothing is strong. It creates a problem for the EU Commission and the incumbents because they reason under the Copenhagen principle of equal treatment, which is misguided. The saddest part of the story is that it now becomes a problem for the accessing countries, not for the incumbents.

Second, as Jacek correctly observes, monetary policy is unlikely to be a useful tool to deal with the external deficits, so fiscal policy may be called upon to fix a problem that may not require fixing. The paper gives a flavor of what we know: the current account effects of fiscal policy are not at all simple to track down. Much depends on the nature of the external disequilibrium and on the context in which fiscal policy is mobilized. Thus, stabilizing the current account may prove to be mission impossible, and yet the accessing countries may be blamed for it.

Not too much should be made of that point however. To start with, the convergence criteria do not refer to the current account. The criteria do refer to the budget deficit, and, on this matter, some accessing countries, e.g. Poland, may well benefit from external pressure. In addition, what really matters, for both external and internal balance, are the external and public debt to GDP ratios. The combination of fast growth and low interest rates, that Jacek predicts, imply that these ratios will be on a declining path, unless the current and public deficits are very large, since they evolve according to:

$$\Delta B = (r - n)B + D$$

where  $B$  is the (external or public) debt to GDP ratio and  $D$  is the (current or public) deficit to GDP ratio, with  $r$  the real interest rate and  $n$  the real GDP growth rate. The solution to deficits is not policy tightness but growth.

### **The exchange rate regime: economic arguments**

The most serious argument against EMS-2 is the risk of destabilizing currency crises. The usual answer, just be perfect and all will be well, is simply criminal. Past heroes of good macroeconomic behavior (Mexico, Korea, Argentina) have gone down in flames, so those who advocate rectitude remind us of the Pope<sup>2</sup> who sees abstinence

---

<sup>2</sup> With apology to our Polish hosts.

as *the* solution to the AIDS epidemics: self-fulfilling crises are like blood injection following an unexpected accident, they can bring about disaster. There are good reasons to expect significant capital inflows following accession to the EU, and these inflows will be mostly good. But they may instantly turned into panic outflows. If they do, not only will they create havoc, but they will re-set the clock for EMU admission, opening yet another two-year window of opportunity for further crippling crises.

Euroization is one alternative, floating is another one. As discussed below, euroization has its pros and its cons, so Jacek's conclusion that it is the only way to go is overstated. Countries which are already on the euro, like Estonia, have little reason to move away, float and re-enter. Others, which have been successful floaters, like the Czech Republic and Poland, may well find it more desirable to stay where they are until they join the EMU. Jacek's unstated assumption is that this solution is ruled out by the convergence criteria, but that can be negotiated. After all, that is exactly what Swedena and the UK are doing, and no one complains.

Finally, ERM-2 is not to be ruled out until we have explored ERM-2b. The key difference between ERM-1 and ERM-2 is that the former included an agreement on unlimited foreign interventions by the strong currency central banks in defense of currencies under pressure. This is how the French franc and the Danish krone survived in 1993. In 1992, the Bundesbank declined to fulfill the obligation to defend the Italian lira and Sterling, and both were ejected from the EMS. Fearful of such an embarrassing situation, ERM-2 has ruled out this commitment. As a result, the accessing countries are being asked to bear all the risks, with no support. Should that option be reconsidered, the resulting ERM-2b would become a much more attractive option.

### **Costs and benefits of unilateral euroization**

I largely agree with Jacek's characterization of the benefits from unilateral euroization. I would just observe that, as interest rates significantly decline, there is a serious risk of Irish-style boom with high inflation, which may lead to failing the inflation criterion. To avoid such a risk, fiscal policy will have to be super-tight for two years. Can such a commitment be elicited from the Diet?

I also agree with Jacek's dismissal of some of the costs that he mentions. Seigniorage is a non-issue and there is no helicopter rain of euro banknotes. The risk of a contractionary impact, at least initially, is equally misguided. I find his dismissal of the other arguments more cavalier, though. Inertial inflation is a problem, as Argentina showed, and it shows up as a contractionary effect some time down the road. Improving wage and price flexibility is one requirement, even if it is not sufficient. Jacek's response, that this has to be achieved anyway, even under EMS, is not convincing. Realignments are possible within EMS, not once the economy is euroized. It would much better to achieve a higher degree of flexibility before fixing the exchange rate. The BS effect can help, but under a more realistic estimate, it is too small to provide early relief. As for an up-front devaluation, it raises political questions (see below) and it is an inflationary shock anyway, as Poland experienced in

the early 1990s. Finally, real convergence is indeed another serious issue, one which remains the strongest argument against early EMU membership, unilateral or not.

Much the same can be said about lending-of-last-resort and the quality of the banking and financial systems. The view that large reserves, backed by credit lines, solve the problem is simply wrong. Here again, Argentina showed how and why. When the banking system starts collapsing, it is not central bank money that has to be bought back, nor even M1, but *all* bank liabilities *plus* positions that will be taken in the last minute when banks gamble for resurrection and financial institutions aim at speculative profits. One should be clear: when a banking system collapses, no known amount of reserves is sufficient.<sup>3</sup> As in the case of wage and price flexibility, the banking system must be strengthened before euroization, not after.

### **The exchange rate regime: political arguments**

The incumbents have made it abundantly clear that they are strongly against unilateral euroization. As discussed above, they have some economic arguments, but the balance of pros and cons does not explain the vigor of their opposition. Theirs are mainly political arguments.

The first argument is simply equal treatment. The incumbents see unilateral euroization as cheating, entering through the back door while everybody else used the front door. To economists, this may seem childish, but it is a view that will not go away and cannot be ignored. The only solution here is to negotiate, which means offering something in exchange.

The second argument is that the conversion rate ought to be agreed upon by all EMU countries. Incumbents fear that, with unilateral euroization, the exchange rate would be decided unilaterally as well. This issue is easy to solve by pledging to indeed seek a commonly agreed rate, which incidently runs against Jacek's proposal of an up-front devaluation.

The third argument is that as members of the EU, countries which euroize unilaterally may be able to seek support in the event of serious tensions, e.g. in the banking sphere. Not only would this create serious difficulties but it could also set a precedent. There is simply to easy answer to that question, which is related to lending-in-last-resort. The candidate countries ought to offer to abide by all the rules accepted by EMU members, in particular in the area of fiscal policy and bank supervision.

In the end, the incumbents see little benefits for themselves from unilateral euroization, and have no reason to challenge the procedure that prevailed so far. They hold the key, for they can keep permanently out of EMU those countries which move unilaterally. They have to be convinced, and economic arguments will not do. Jacek has more work ahead of him if he wants to build a truly strong case. I wish him good luck, for I believe that he is (mostly) right.

---

<sup>3</sup> The case of Hong Kong in 1997 may appear as a counter-example. But as the Hong Kong authorities are quick to emphasize, this is not example that most countries can follow.

## Reference

Halpern, László and Charles Wyplosz, 2001 “Economic Transformation and Real Exchange Rates in the 2000s: The Balassa-Samuelson Connection”, *Economic Survey of Europe* 1: 227-39.