Ben Slay
UNDP

Comments on Jacek Rostowski's "The Eastern Enlargement of the EU and the Case for Unilateral Euroization"

General Comments

This is a very interesting and potentially important paper. Many observers have pointed out that EMU membership for transition economies via satisfying the Maastricht monetary convergence criteria—which were designed for EU countries entering into a monetary union—will be messy. This paper implicitly poses the very important question: "What if these countries were to join the monetary union by some other road than Maastricht?" Should a CEE country attempt to unilaterally adopt the Euro prior to fulfilling the Maastricht criteria for EMU membership, an investigation into the possible consequences should start with this paper.

At the same time, I found the paper to be more provocative than insightful. This is mostly because (in my view), the paper focuses on the wrong issues. The key questions for transition economies seeking to join EMU are not about whether to unilaterally euroize. The key questions are instead whether:

1) euroization (and the associated surrender of macro policy discretion) for such economies is desirable in the first place;

2) the prospective benefits of EMU membership will exceed the obvious costs (in the form of output and employment losses that may result from the pursuit of contractionary monetary and perhaps fiscal policies that will probably be needed to meet the Maastricht Treaty's inflation and interest-rate targets);

3) how to minimize these costs of joining EMU; and

4) the optimal set of "transitory" exchange-rate mechanisms.

These brief comments are not the appropriate forum for exploring these questions. Let me instead raise two other points about the paper:

5) An equally important question—and one that is not explored in the paper—concerns the EU/ECB's likely reaction to unilateral euroization. In practice, this could be harshly negative. A nascent ECB that is worried about its credibility is unlikely to respond feebly to unilateral euroization. Loss (or higher costs) of access to the ECB payments system, reductions in pre- (or post-) accession transfers, and indefinite exclusion from ECB governance structures, could certainly be potent ECB counter-measures. The harshness of this reaction could in turn depend on such factors as: (a) the number of CEE countries that might attempt this unilateral euroization (strength is in numbers, and Poland has more bargaining power than Estonia); and (b) what else the EU/ECB might have on its plate at the time. In other words, to be persuasive, the paper should focus on the "other actor" as well as the CEE countries.

6) The paper's basic argument rests on the premise that the Balassa-Samuelson effect makes the real effective appreciation of the CEE currencies inevitable. While this argument is perfectly plausible, it is a little difficult to reconcile with the concerns voiced in a number of

places about currency crises or sharp devaluations. If the underlying trend is toward REER appreciation, if FDI or long-term portfolio investment finances much of these deficits, if these countries enjoy investment-grade credit ratings, and if they are abandoning discretionary fiscal and monetary policies (as would presumably be required under the stability and growth pact), it's not clear why we should be worried about current account or currency crises.

Specific comments:

7) Section 1, point 4: "The need to satisfy the Maastricht criteria and join EMU within a few years of EU accession" for CEE economies is not for me self-evident. If Britain, Sweden and Denmark do not "need" to join EMU, why is it that the applicant countries will have no choice? Fear that being "left behind" will hurt the investment environment? Exchange rate risk? (But this can be dealt with by a firm peg, as well as by euroization.)

8) "The best solution, for those countries with sufficient international reserves, is rapid unilateral adoption of the euro as their domestic currency, even before they join the EU." This is very, very strong. Surely the consequences of possible ECB counter-reaction—"spontaneous euroization will be punished"—must be taken into account? Surely a currency board would provide most of the benefits of euroization without the sanctions-related costs? The paper would be stronger, in my view, if it dealt explicitly with such arguments.

9) Regarding the "Stylized facts on economic trends in the applicant countries", it would be good to mention that—unlike most CIS and some Balkan economies—the CEE countries' creditworthiness is sufficient to borrow in the manner described here. It's not only a question of "demand" for current account deficits: it's a matter of the markets' willingness to supply foreign savings to these countries.

10) In the mathematical section the argumentation suddenly switches from the CEE (or first-wave accession) countries to the "Visegrad 3". The logic of this switch is not clear—especially since a number of other CEE countries (including the three Baltic states, Slovakia, and Slovenia) have at present made more progress with EU accession than Poland has. This can be seen both in the number of EU accession chapters closed, or in the approximation of these countries' exchange-rate mechanisms to the EMS2 (not to mention the EMU) framework(s).

11) I don't find the mathematical modelling that is done in sections (3) and (4) terribly plausible. This is because I do not believe that fiscal policy in transition economies has much of an effect of real spending or output levels, regardless of the exchange rate regime. I think fiscal policy in transition economies is best when it is transparent, promotes supply-side, long-run growth determinants (education, infrastructure, etc.), focuses on reducing inequalities and poverty, and goes hand-in-hand with structural reforms of state administration, the financial sector, and social services. This can be (and is) done by affecting the composition, rather than the level, of real output. Moreover transition economies that want to join EMU are likely to have to hit the Maastricht deficit and debt targets, which also preclude discretionary fiscal policies. Invoking the Fleming-Mundell model to show that fiscal policy under certain conditions can have a big impact on spending and output seems neither useful or sensible.

12) Section 5, paragraph 2 incorrectly describes Poland's exchange-rate regime as of the "wide fluctuation band" type. This is inaccurate: the zloty has floated (with no band) since 2000. (Hungary now has such a regime, but unlike the Czech regime, the NBH does not intervene to keep the exchange rate within its "implicit target".) Also, the listed disadvantages of floating regimes do not include higher exchange-rate risk.

13) The "benefits and costs" section, by calling on "the NCB to run the lender of last resort facility for the banking system", is a bit confusing. What's the point of Euroizing if the NCB can still pursue discretionary monetary policy??

14) At least some of the benefits ascribed to "rapid unilateral euroization" would also accrue under "normal" euroization (i.e., satisfying the Maastricht criteria). They key question is whether the costs would be higher or not. Rapid unilateral euroization for Estonia—with its currency board and relatively advanced preparations for EU membership—would be comparatively easy (abstracting from the ECB sanctions issue). For Poland or Romania—with their more flexible exchange rate regimes and weaker preparation for EU accession—the costs would be higher.

15) The paper does not mention that, for countries whose exchange rates deviate substantially from 1:1 (i.e., 1 Euro = 250 forints) euroization could serve a desirable "denomination" function.