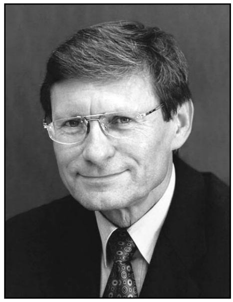
The Euro Goes East



Leszek Balcerowicz

Thank you very much Mr. Chairman,
I welcome this opportunity to address such a distinguished audience.

I would like to start with two basic assumptions. First, we are not discussing whether the euro will go east or not, because we are assuming Poland and other candidate countries will enter the European Union with the status of a country with derogation, so sooner or later they will be obliged to join the Monetary Union as well. Therefore, the issue under discussion is not “if”, but “when” and “how” i.e. what is the optimal timing and the optimal path.

Secondly, one should assume equal treatment of candidates and present EU member countries i.e. fulfilling the Maastrich Criteria, no less no more. There should be no additional criteria like, for example, a required level of financial deepening, as it would indicate an unequal treatment of candidate countries.

Taking the second assumption of the entry into the EMU as granted, I would like to focus on the core issue, which is the question of optimal timing.

My basic point is, that, firstly, early entry into the Monetary Union is possible and secondly, that it is preferable to the delayed one. By early entry I mean entry close to the earliest possible date, which one can recognise to be around year 2006, given the assumption of entry to the European Union in 2004. It is this time neighbourhood we need to consider. The points would be as follows.

First of all, let me say, that, in my opinion, arguments applicable to Poland are also largely true for other candidate countries in most of the cases.

Poland has achieved a relatively high level of structural convergence with the European Union. It can be measured, for example, by a share of exports to the EU in relation to all exports. This number is actually higher in Poland right now than it had been in Greece, Portugal and Spain before their respective entries to the EU and the MU. We have also achieved a high degree of cyclical convergence. These two points combined, translate to a situation in which Poland is not so sensitive any more to, what is called, an asymmetric shock.

Second, we have achieved a tremendous extent of disinflation. Inflation in Poland this year would be between 4% and 5% and similar figures will apply to other candidate countries. If one compares this data with inflation rates in some of the EU countries, one cannot see much of a difference – look at the Netherlands.

Third, Poland had managed to achieve a high level of disinflation while introducing a high level of price liberalization. It means there is only a limited scope for further corrective inflation. All but few prices are completely liberalized and driven by healthy market conditions.

Fourth, in respect to the so-called Balassa-Samuelson Effect, I agree with President Duisenberg, that it is mostly an empirical issue. I think the extent of this effect has been overstated and overdone in many theoretical studies. Empirical data in respect to Poland has shown, that in the past the contribution of the BS-Effect to the overall inflation rate has been in the range from 1% to 1.5%.

As a matter of fact, the BS-Effect is also present in the Eurozone, in countries like Greece and Portugal. This is not the reason for, as some people heralded, a weak euro. Problems of Greece are not responsible for a weak euro that is, if one thinks the euro is weak.

The already mentioned disinflation, the limited scope for future corrective inflation, and the manageable level of the BS-Effect make the Maastricht Inflation criteria achievable. Fiscal criteria must be met in the interest of the countries concerned, as it would contribute to their economic growth.

Fifth, there is an intermediate period between the date of entry of Poland and other candidate countries into the European Union and membership of the Monetary Union. The question is, what is the optimal length of this period? I would like to point out, that it might be a rather turbulent time. Economic forces behind convergence and rapid capital flows might create an economic roller-coaster. It may well be in the interest of the candidate countries to make this period as short as possible.

Sixth, it is true that any country entering the EMU need to fix the exchange rate. One should not take for granted, however, that the longer the period of the intermediate regime the better, as it is not always true that a longer waiting produces more information about the proper rate of exchange. It may produce just more noise.

Seventh, both further efficient disinflation and strengthening long-term economic growth require completion of certain structural reforms in the candidate countries. There is no way around it. In the case of Poland, the liberalization of the labour market and an increased participation rate is badly needed. Fiscal reforms must concentrate on rationalising the spending and not just increasing taxes. Privatisation needs to be completed and it should include the banking sector. We have to strengthen competition in fuel and energy sectors. The legal framework needs to be adjusted to be more efficient.

The earlier deadline of the entry to the EU could act as a powerful motivating device to complete those reforms. I am a great believer in deadlines and I think they help to achieve success. Delaying the entry could do more harm than good, as it could weaken the incentive to complete the necessary and often politically costly reforms.

Eighth, flexibility of the rate of exchange is a poor substitute for structural reforms.

Ninth, I agree there is evident fear among certain existing EU members, including Germany, that once Poland, Hungary, Slovakia or Latvia enter the EMU, the euro could weaken. I do not find any rational argument supporting this proposition.

Firstly, as I pointed out, an earlier date of entry would mobilise the candidate countries to complete the structural reforms.

Secondly, candidate countries combined make up for only around 6% of the enlarged EU GDP. Any negative impact the enlargement might have, which is unlikely, will in any case be highly subdued.

Thirdly, I think the reason behind the relative weakness of the euro, is not Greece or Portugal or the other EMU members but something different. The entry of Poland and other countries into the EMU, assuming they complete reforms, will not weaken the euro at all. Finally, as for today there are differences in the rate of inflation given the BS-Effect in the EMU countries, hence why should there be a problem for others, with inflation only marginally different from the EU average, to join the Eurozone?

Tenth, the earlier entry of the candidate countries into EMU would allow them to start reaping the related advantages (more price transparency, reduced transformation costs, stronger macroeconomic framework) at an earlier date.

Summarising, we should not oppose nominal and real convergence. One should not assume there is an unavoidable conflict between the two. Firstly, results of nominal convergence, a low inflation rate among them, are one of the foundations of the long-term economic growth. Secondly, the great harmoniser between the real and nominal convergence are the structural reforms. The more reforms one has implemented, the less costly disinflation is and the stronger the longer term economic growth.

I would finish up with the main point. The strategy on behalf of the European Union should not be to delay the entry of the candidate countries into EMU but to encourage the candidates to complete structural reforms. The cost of disinflation would be lowered and the long term economic perspective would be helped. This is a win-win strategy as it helps the candidates and ensures the existing EU members that the new members would be economically stable and dynamic.

Thank you very much.