

# Over- or Undervalued Euroland Entry?

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# Structure

- introduction
- points of reference
- historical examples
- Fundamental Equilibrium Exchange Rate
- estimates of the FEER for Poland
- the pre-ERM-II scenario
- strategic choice under EU restrictions
- conclusion

# Points of reference

- Bofinger, M., Wollmershäuser, T. (2002): EU Accession Countries: What Path to successful EMU Membership, in: Winkler, A. (ed.): Banking and Monetary Policy in Eastern Europe, Palgrave
- Bratkowski, A., Rostowski, J. (2001): Why Unilateral Euroization Makes Sense for (some) Applicant Countries - a response, with particular reference to Poland
- Driver, Rebecca and Peter Westaway (2001) Concepts of Equilibrium Real Exchange Rates, Bank of England
- Frowen, S. F., Hölscher, J. (eds.) (1997) : The German Currency Union of 1990 - A Critical Assessment, Macmillan
- Hölscher, J. (ed.) (2001): Fifty Years of the German Mark, Palgrave
- Orłowski, Lucjan T. (2000): A Dynamic Approach to Inflation Targeting in Transition Economies, [www.zei.de](http://www.zei.de)
- Williamson, John ed. (1994) Estimating Equilibrium Exchange Rates, Washington, Institute for International Economics

# Historical Examples

- Overvalued ERM-I entry
  - UK 1990
  - East Germany 1990
- Undervalued Bretton Woods entry
  - West Germany after 1950/51

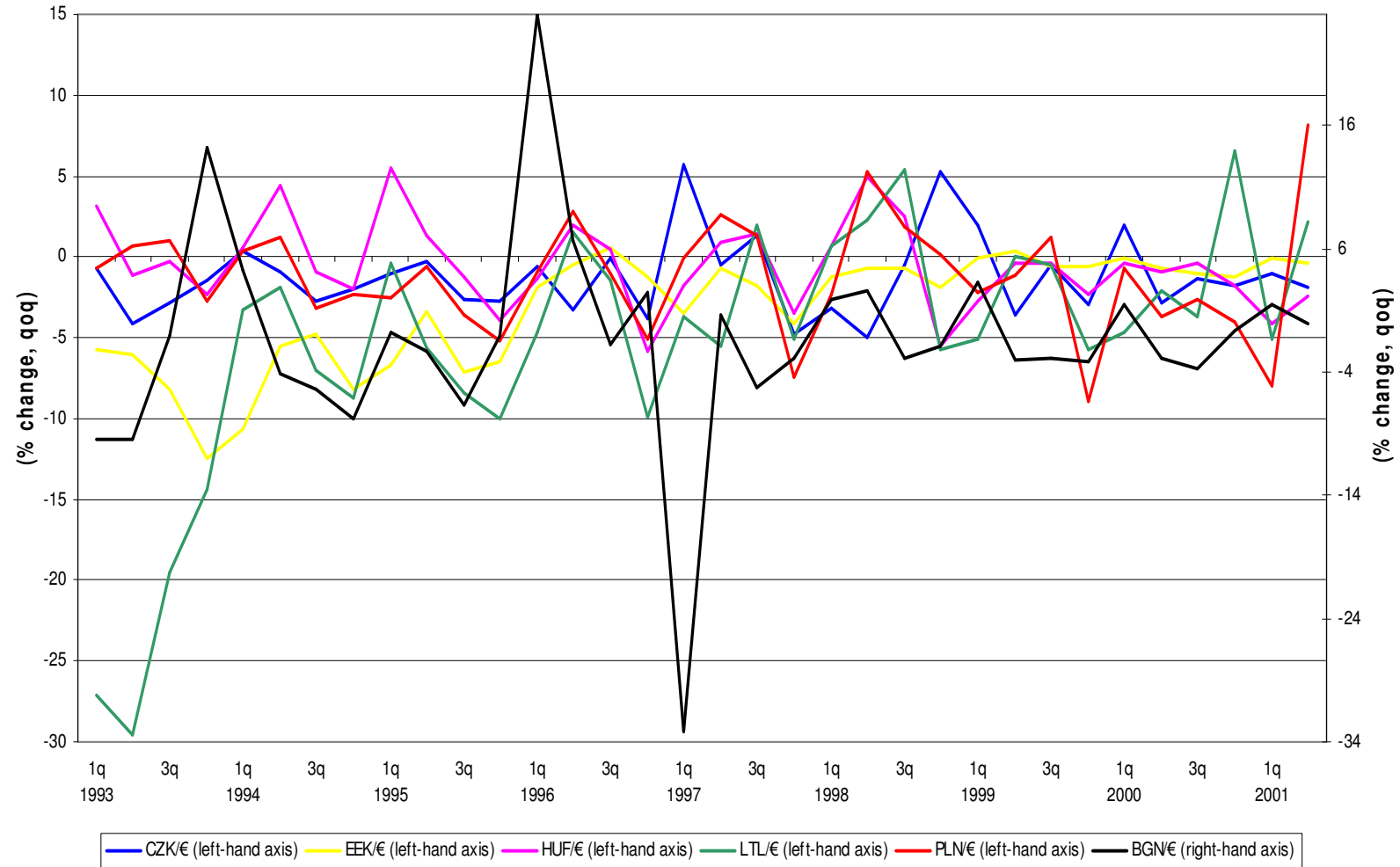
# The Pre-ERM-II Scenario

- success: Hungary
- on edge: Poland
- critical: Czech Republic
- Safe option: currency board
  - Bulgaria and the Baltics

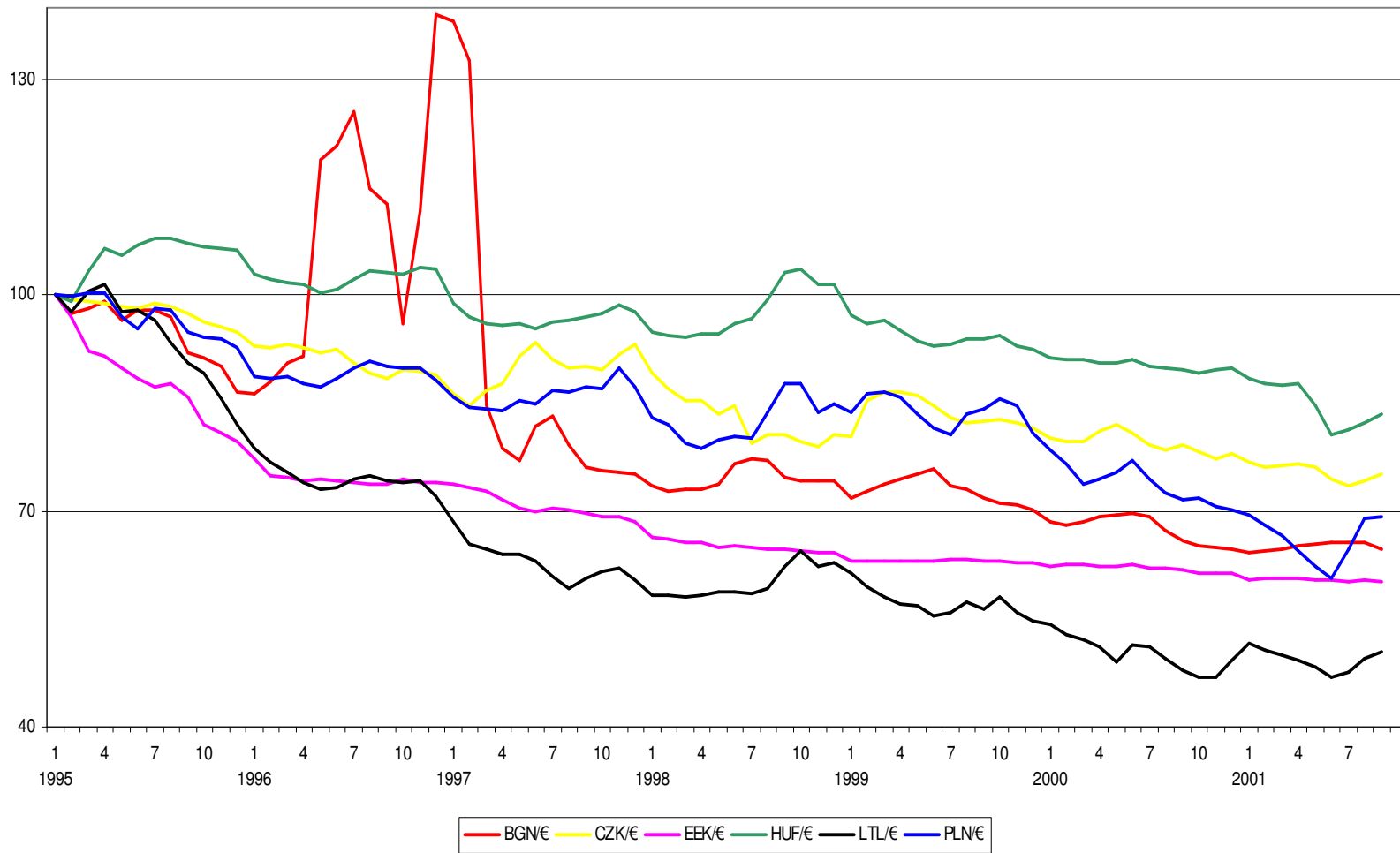
### **Box 1: ERM-II components**

- Precondition for participation in Euroland (and thereby for EU membership)
- Fixed parity to the Euro (floating within a band up to +/- 15%)
- Unlimited marginal interventions “pre-paid” by national central bank concerned and financed by the ECB
- Intra-marginal interventions can be financed by the ECB to a limited extent
- Confidential assessment of central parity

# Real exchange rate (%change, qoq)

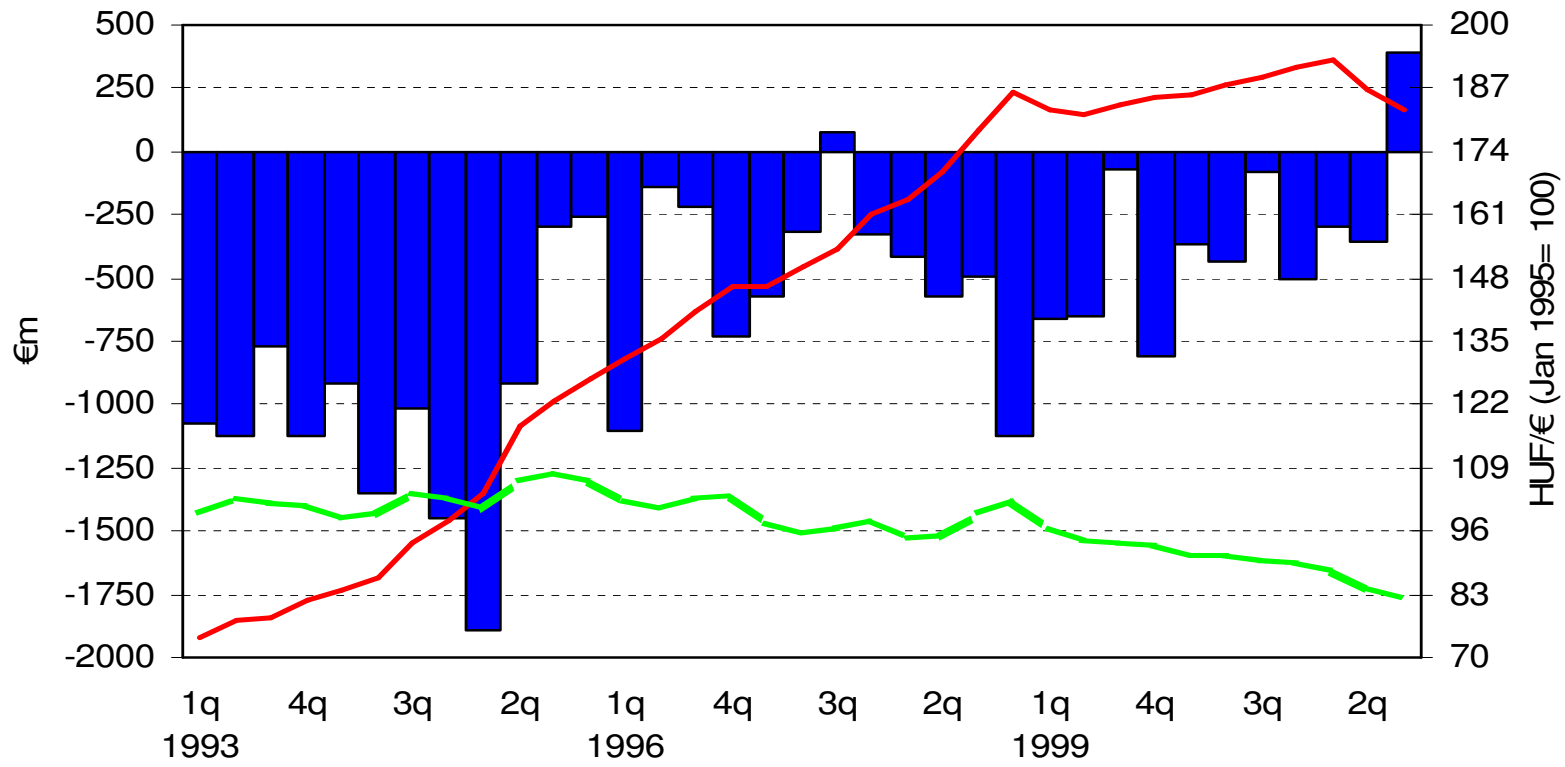


# Real exchange rate Jan 1995=100

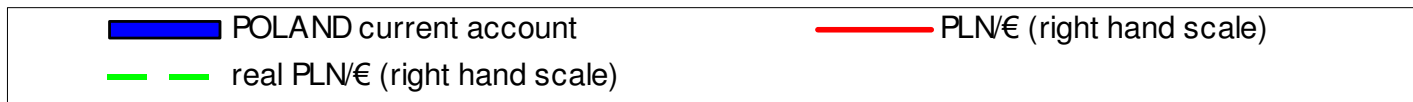
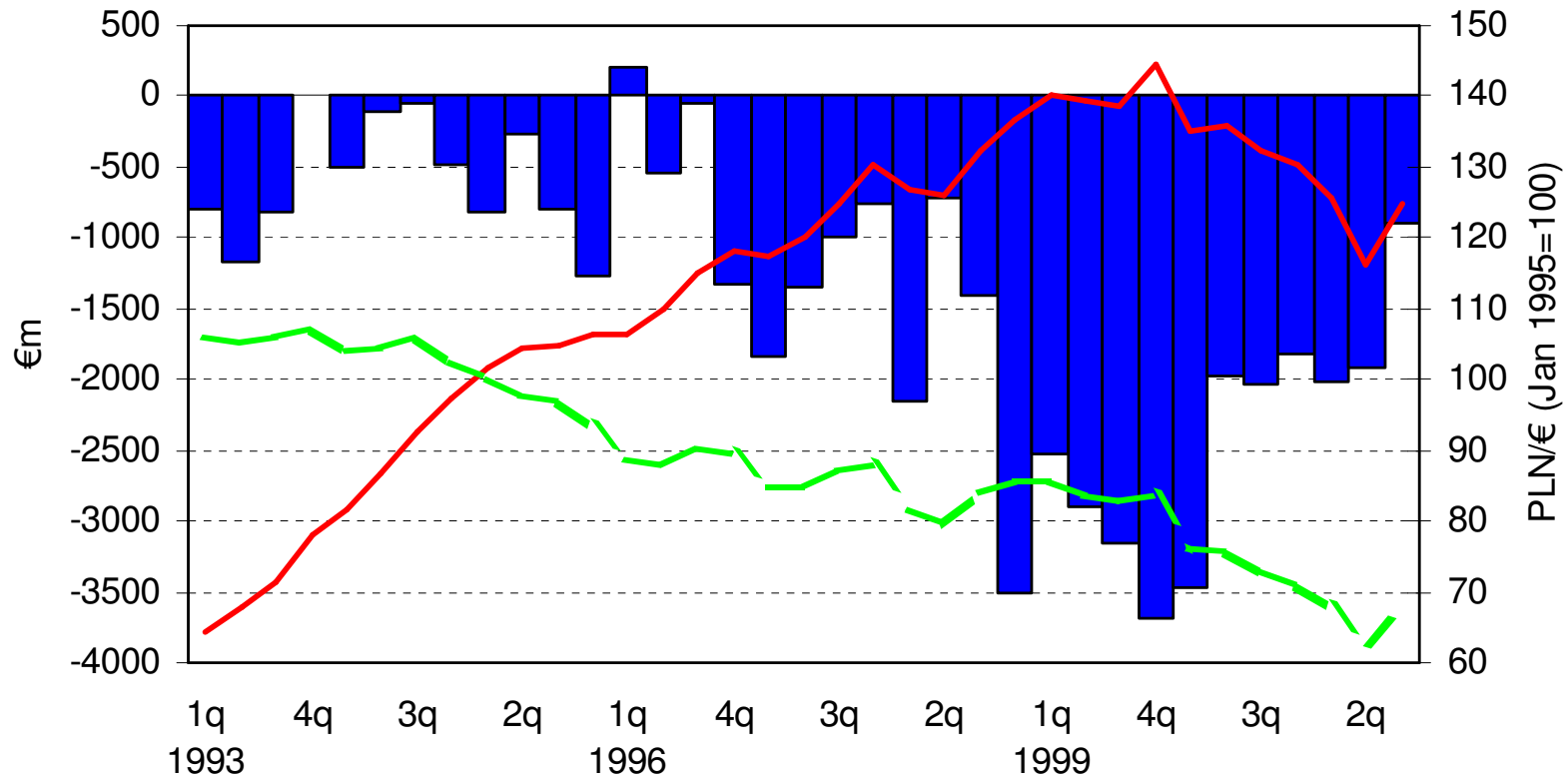




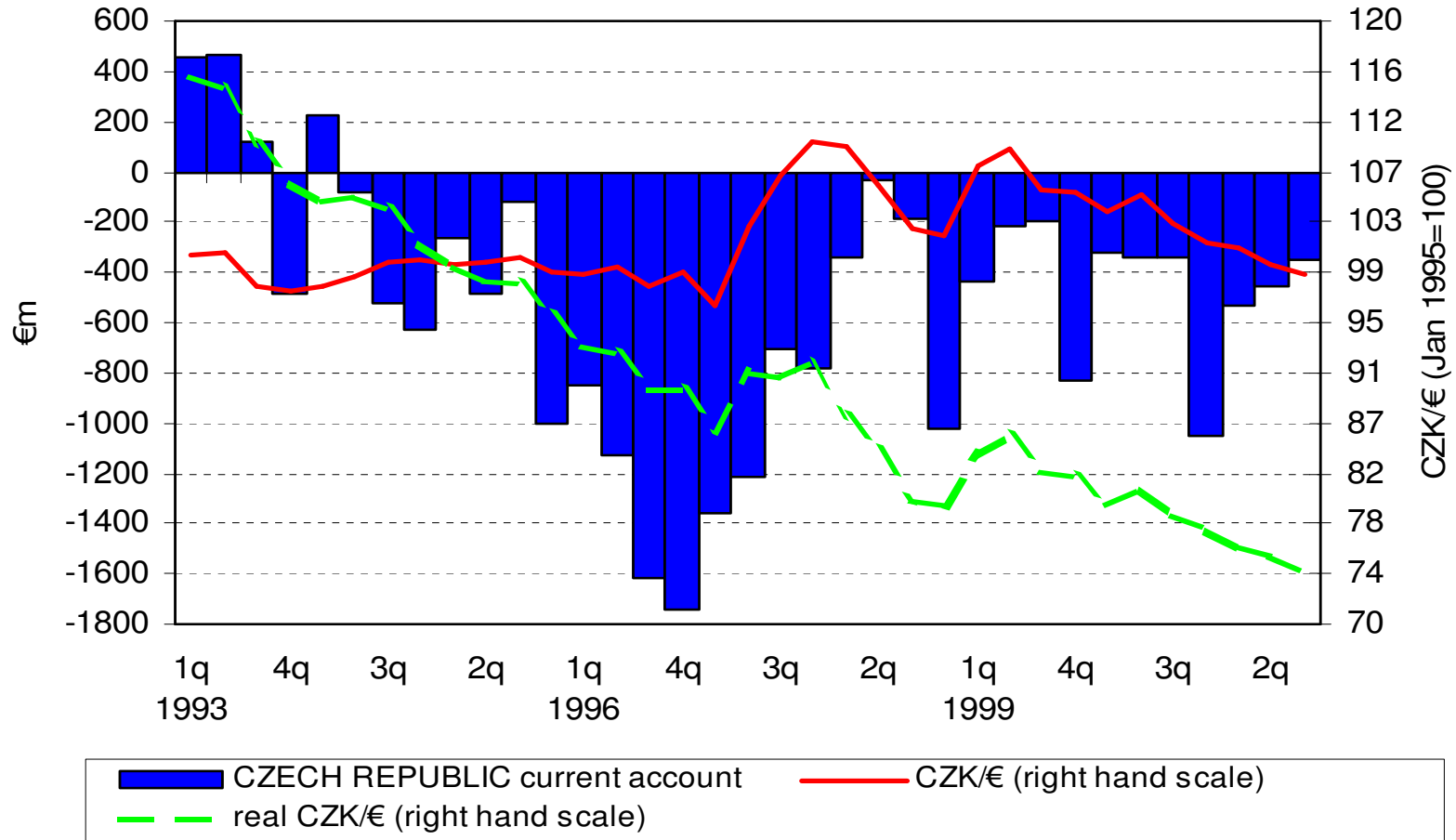
# Competitiveness and the External Balance Hungary



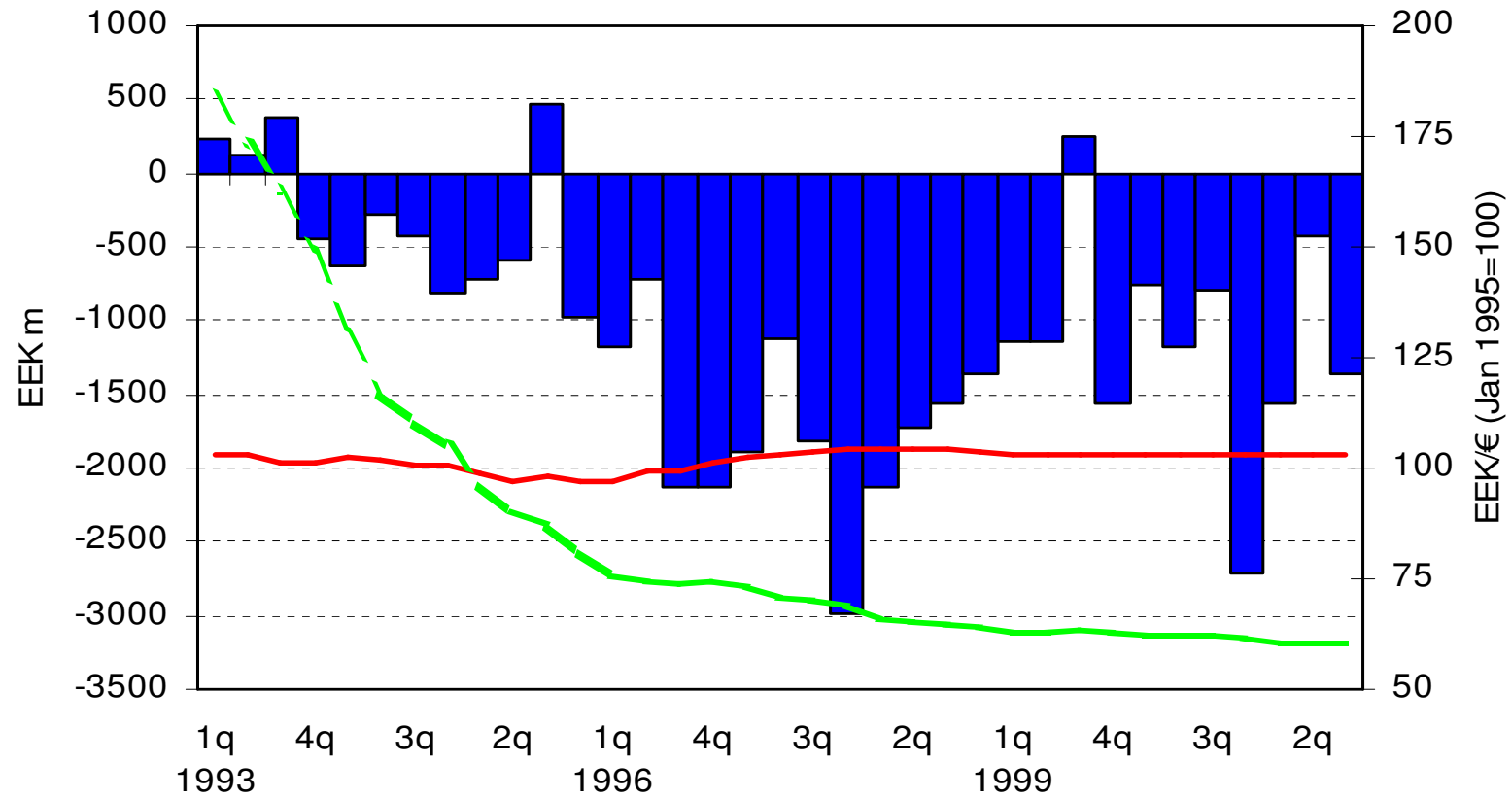
# Competitiveness and the External Balance Poland



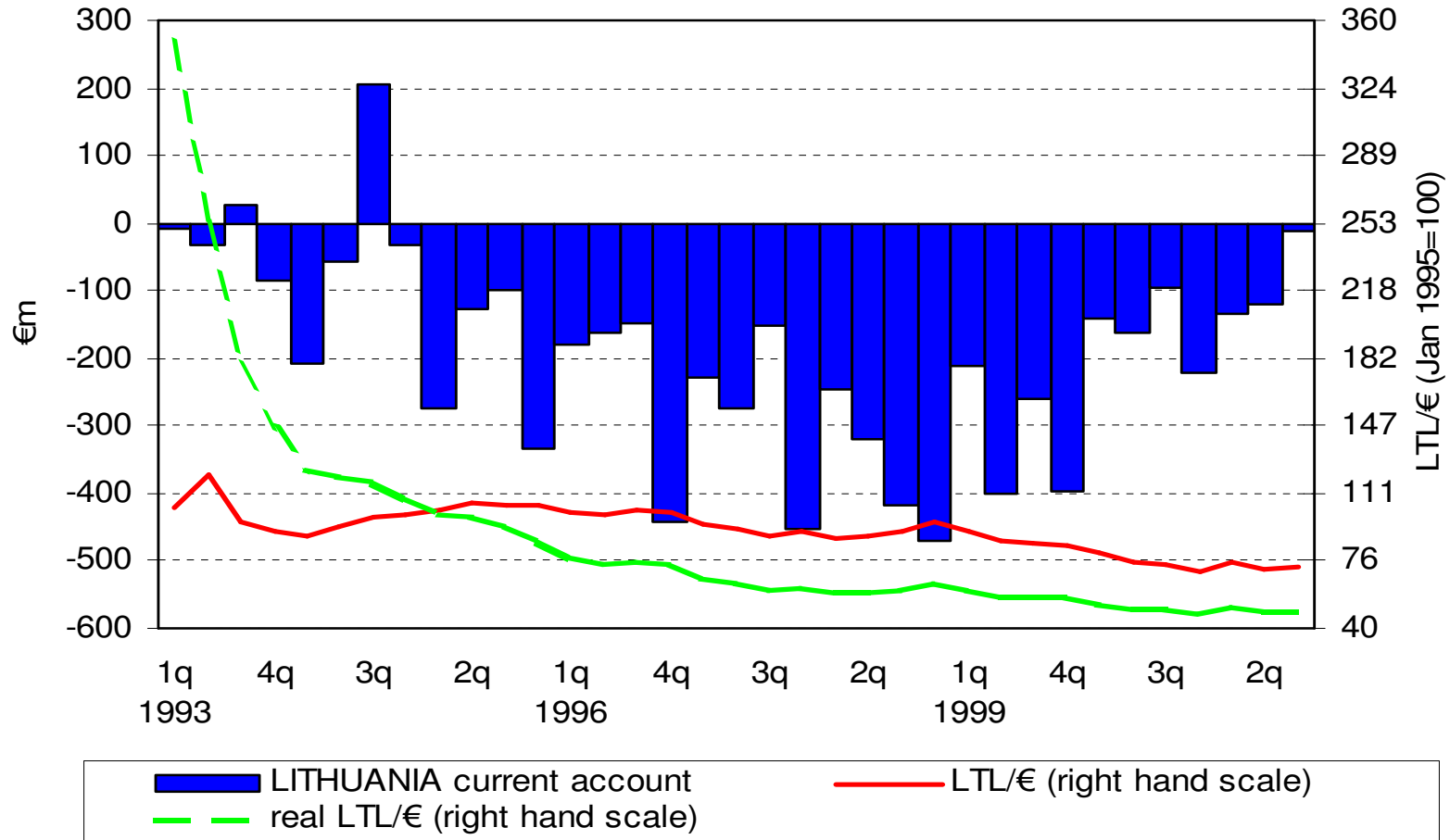
# Competitiveness and the External Balance Czech Republic



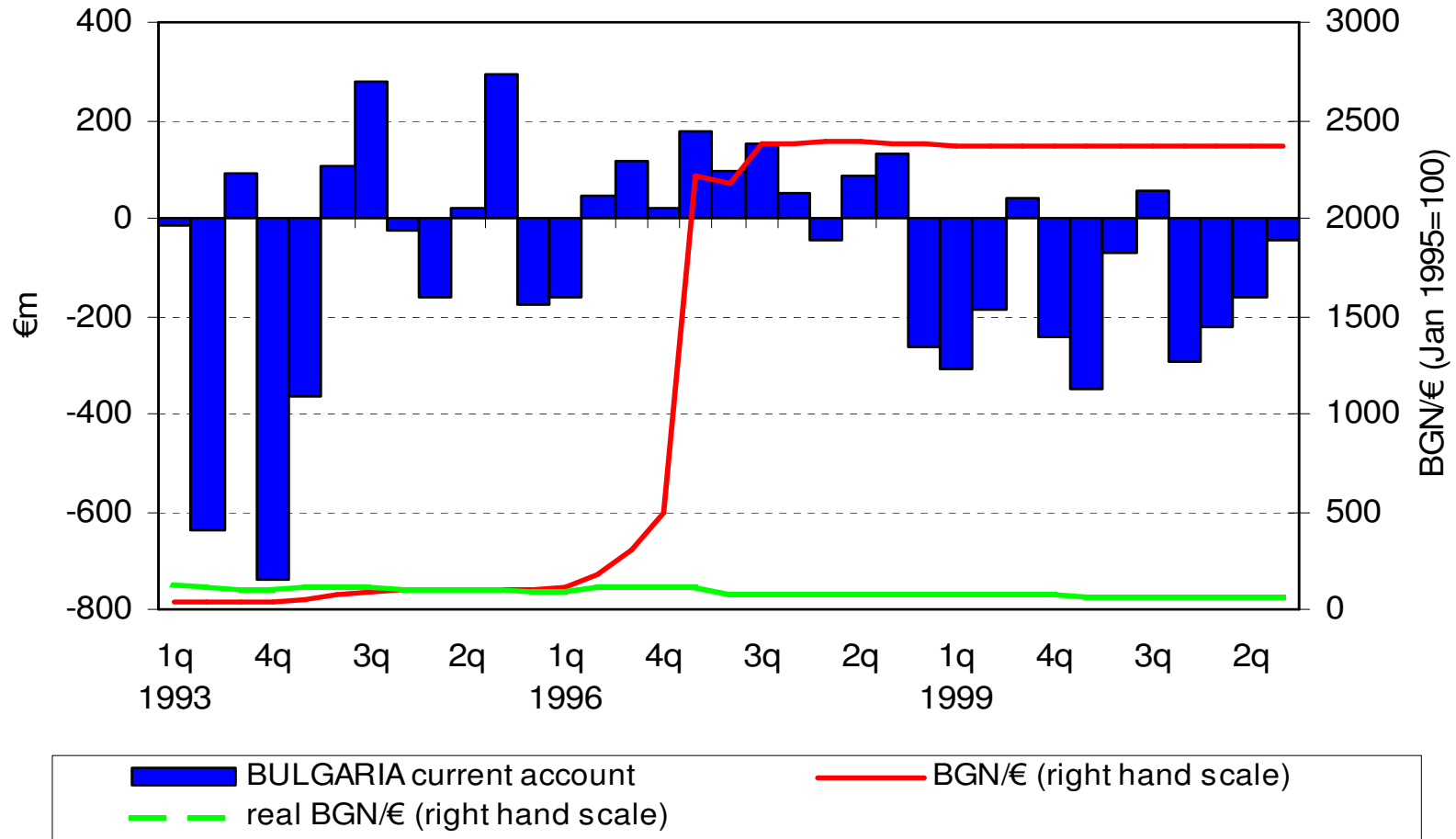
# Competitiveness and the External Balance Estonia



# Competitiveness and the External Balance Lithuania



# Competitiveness and the External Balance Bulgaria



# Fundamental Equilibrium Exchange Rate

- model of trend current account
- structural capital flows
- sustainable current account

# Model of the trend current account

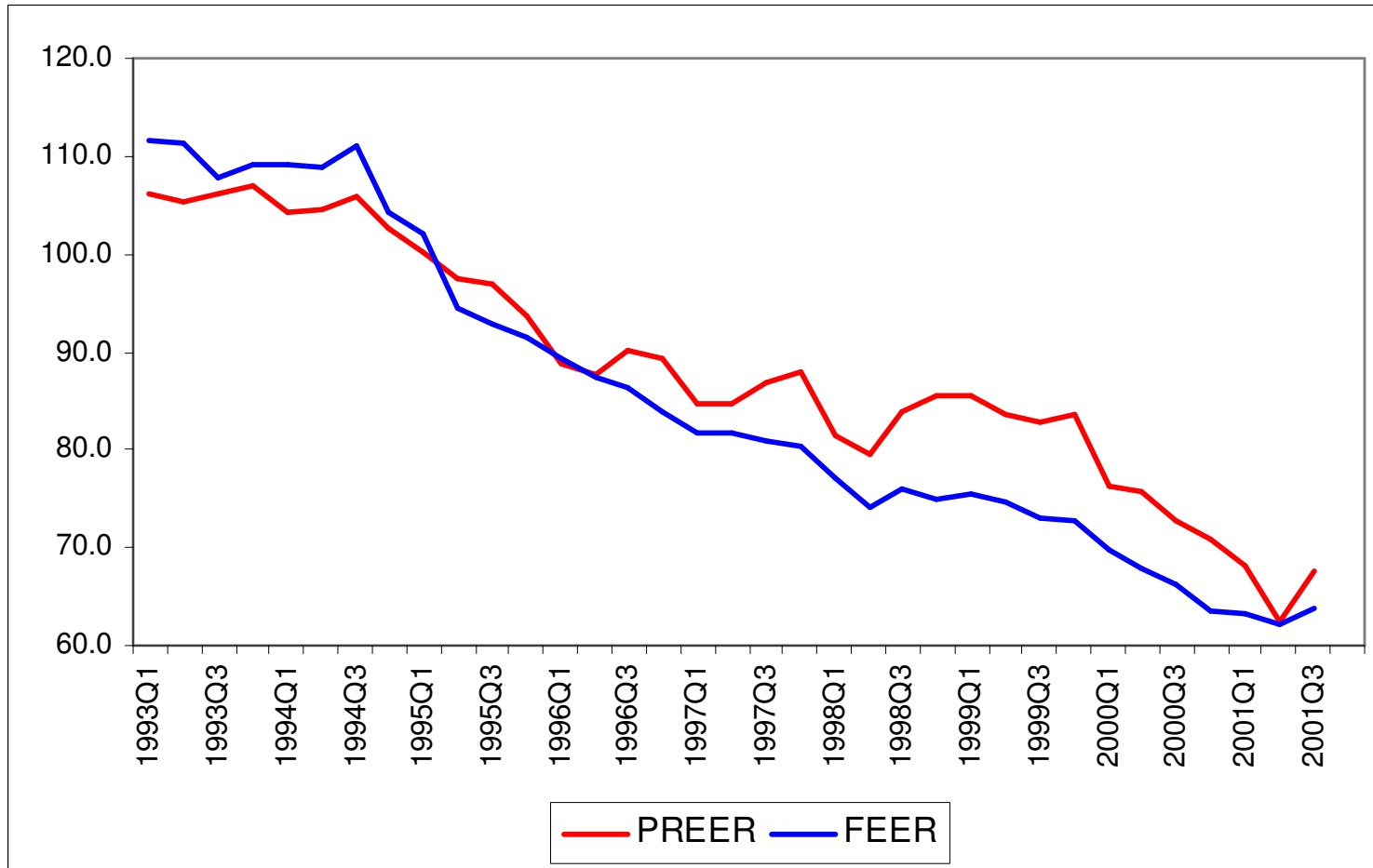
- model of aggregate trade
  - replacement of the actual value of exports and imports with the values the models predict
  - trade elasticities ensuring internal balance of the economy
- model of trend output
  - Hodrick-Prescott filter approach
- model of the trend current account consistent with internal balance



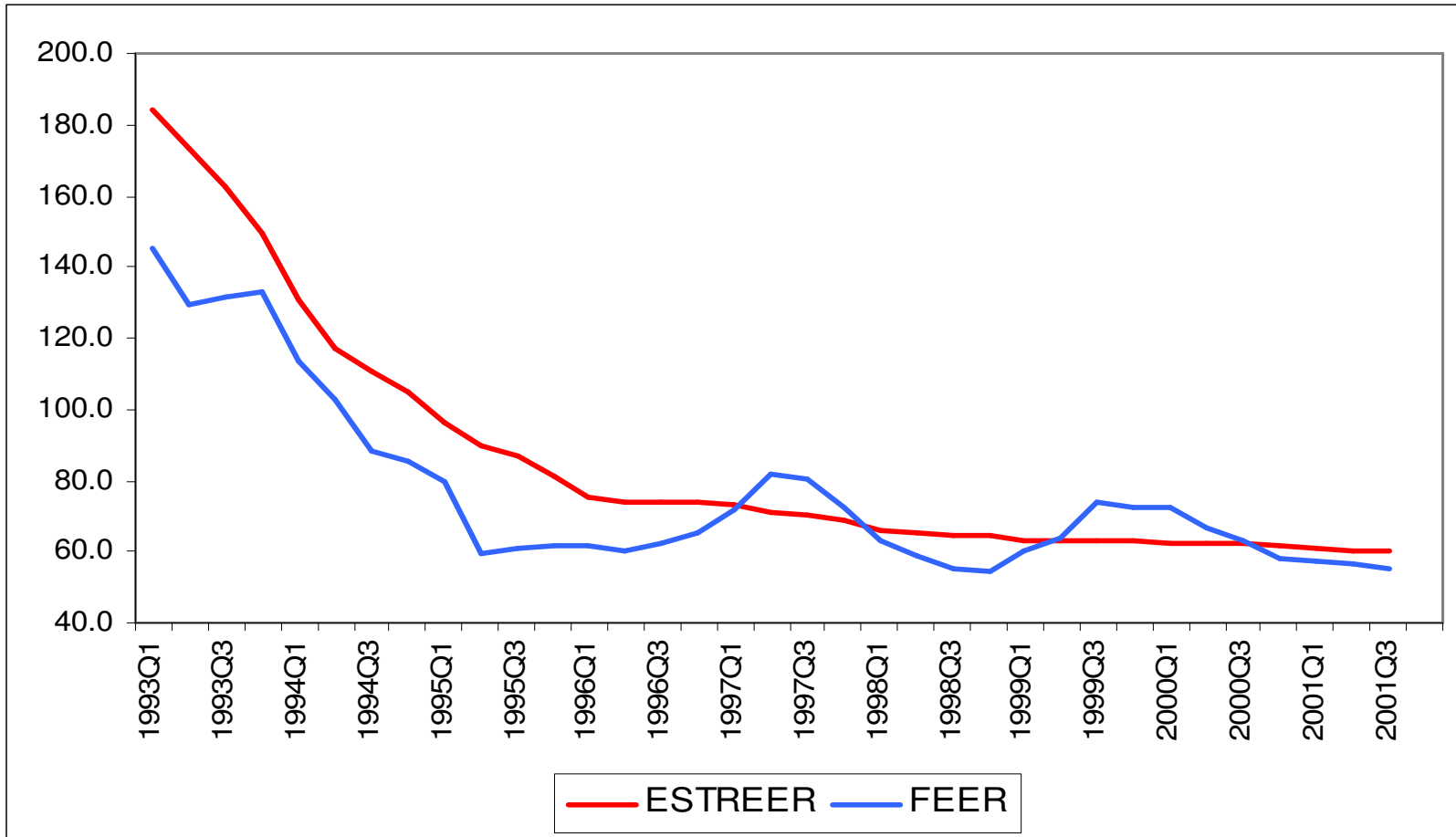
# Structural capital flows and sustainable current account

- the current account account corresponding to external balance
- estimating the real exchange rate compatible with internal and external balance

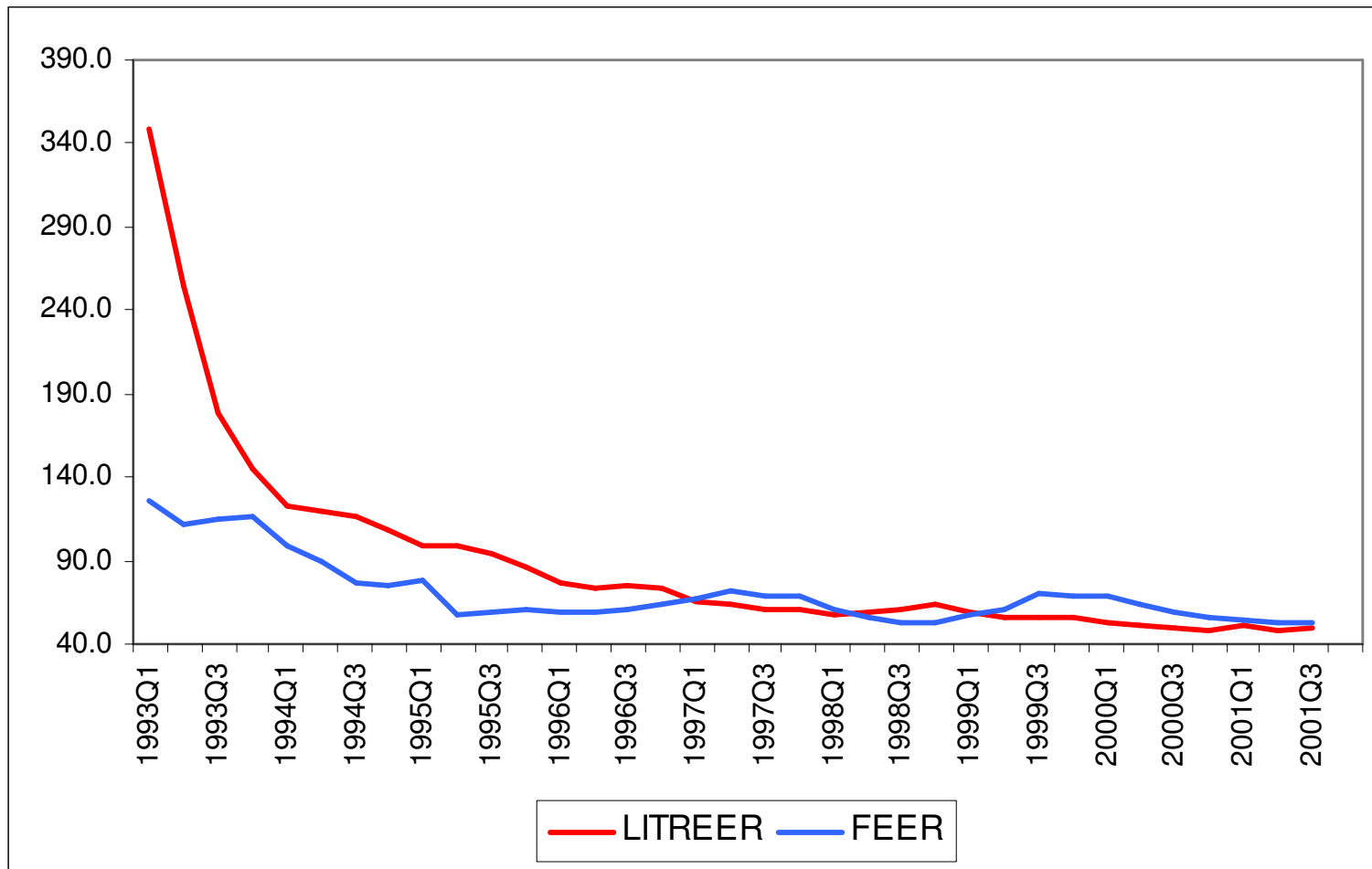
# Estimates of the FEER for Poland



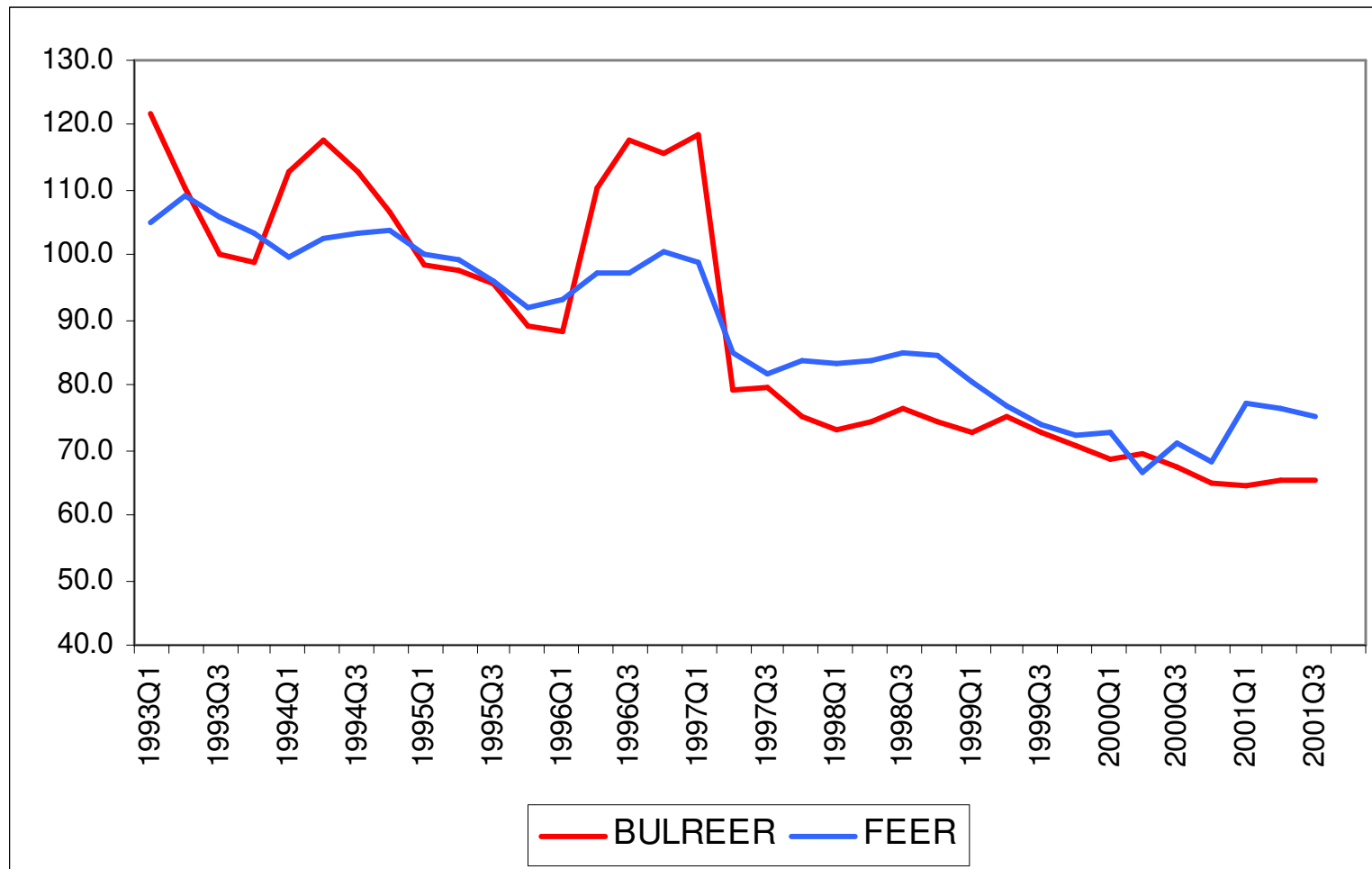
# Estimates of the FEER for Estonia



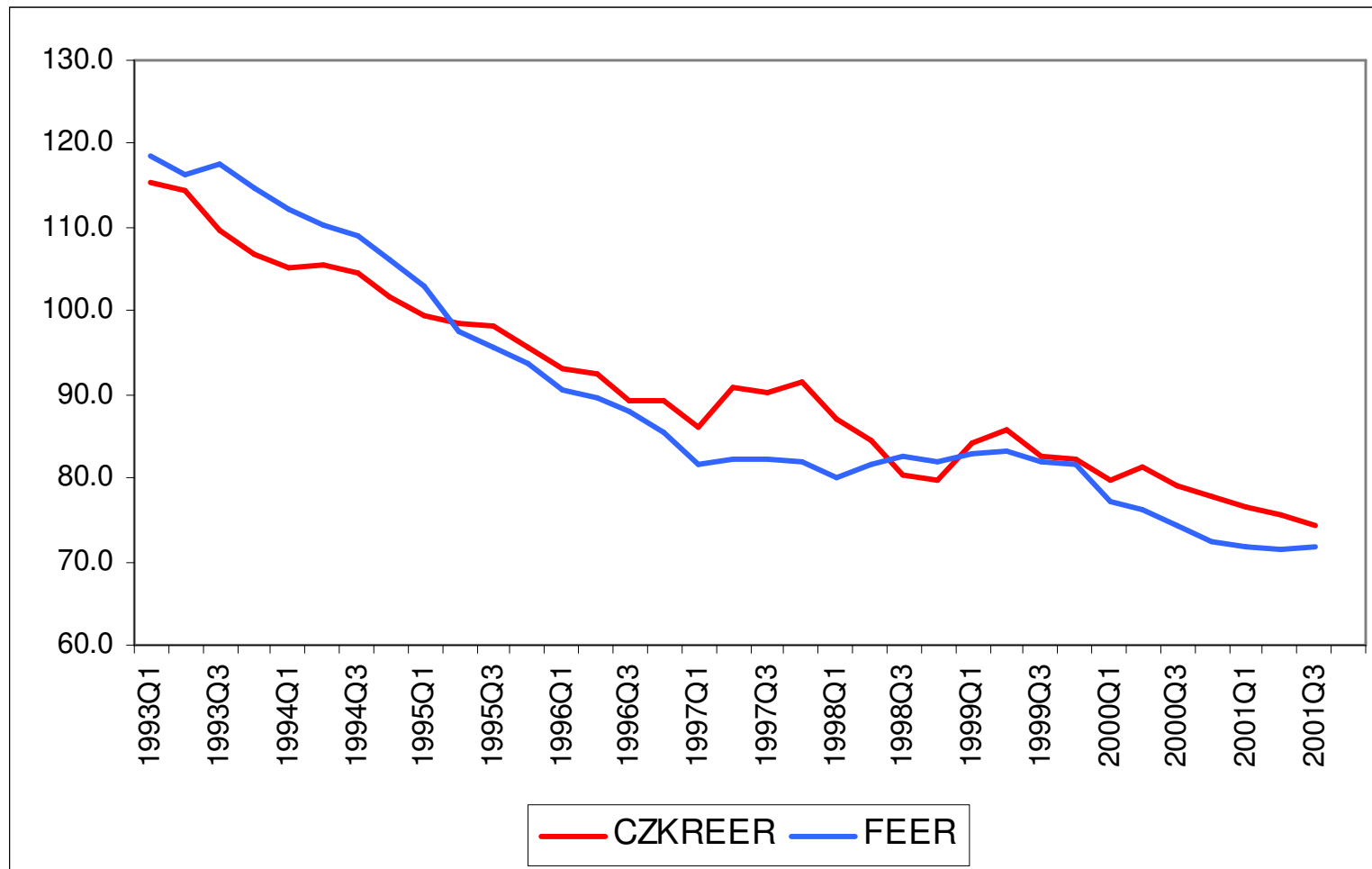
# Estimates of the FEER for Lithuania



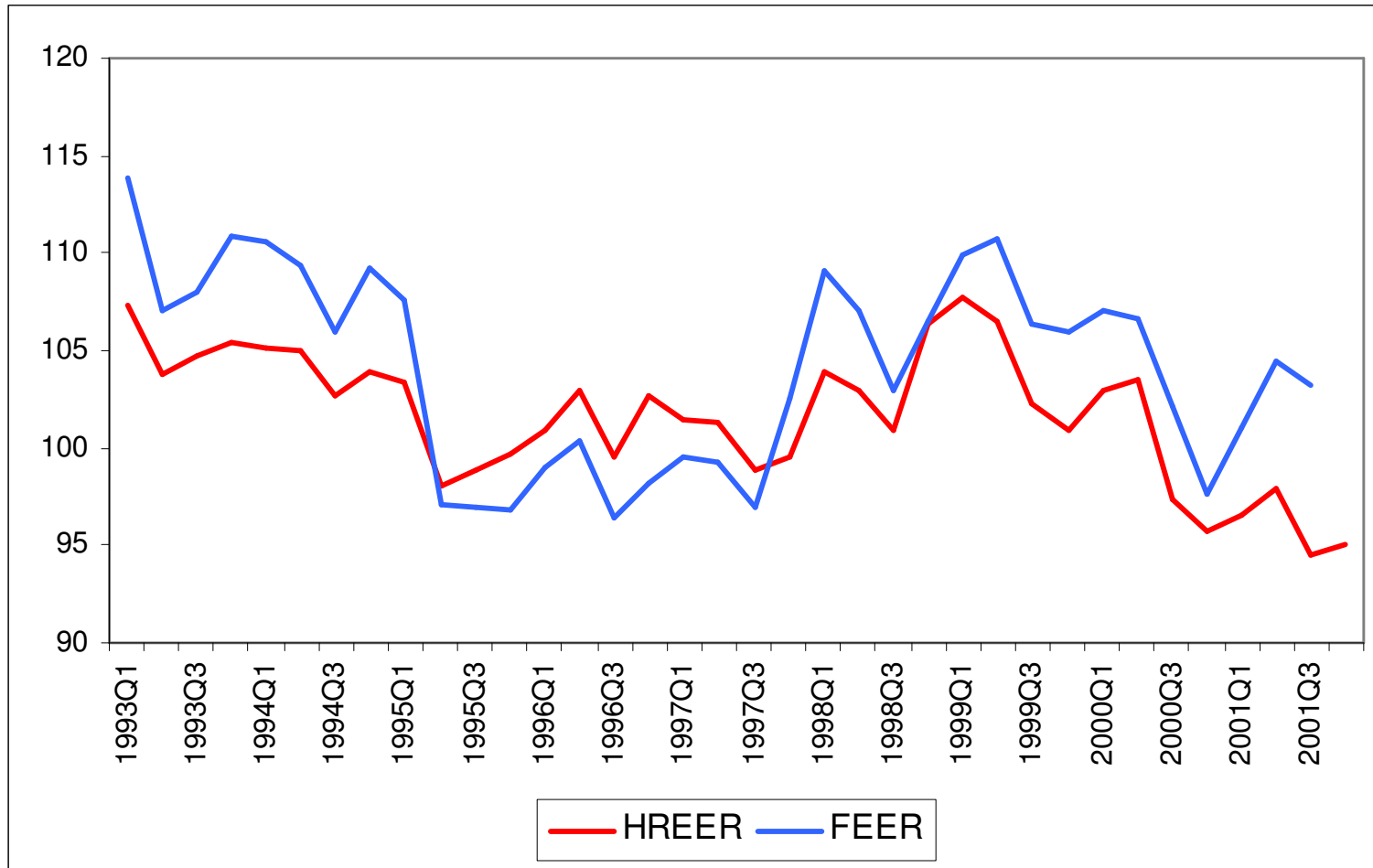
# Estimates of the FEER for Bulgaria



# Estimates of the FEER for the Czech Republic



# Estimates of the FEER for Hungary



## **Strategic Choice under EU Restrictions (= Maastricht Straight Jacket)**

- currency board
- peg + managed float
- delayed entry



**Box 2: Entry strategy and policy options**

|                                       | <b>monetary policy</b>                | <b>policy variable</b> | <b>country</b>                   |
|---------------------------------------|---------------------------------------|------------------------|----------------------------------|
| <b>currency board</b>                 | exchange rate targeting<br>(hard peg) | none                   | Lithuania<br>Estonia<br>Bulgaria |
| <b>Peg<br/>+ managed float</b>        | income targeting                      | i, P, e                | Hungary                          |
| <b>Managed float</b>                  | inflation targeting                   | i                      | Czech<br>Republic                |
| <b>Delayed entry<br/>(free float)</b> | direct inflation targeting            | i                      | Poland                           |

# Conclusion

- To avoid an overvalued ERM-II entry rate a strategy of stability oriented exchange rate undervaluation is advisable.
- Alternatives are delay or currency boards (= Euroisation?)