Finding Stability in a Time of Crisis: Lessons of East Asia for Eastern Europe

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Summary

This paper examines the options of small open economies in Eastern Europe pegged to the Euro, in a time of crisis. Specifically, should Bosnia and Herzegovina, Bulgaria, Latvia and Lithuania move to full Euro area accession, as Estonia, Slovakia, and Slovenia have done, or follow the examples of Poland, the Czech Republic, and Hungary, and opt out of the Euro area? Clearly, it is in times of crisis that choices about membership in a monetary union are most critical. After all, in normal times, exchange-rate regime choice, while interesting, is not a front and center policy issue.

Like the members of the Euro area, these countries are vulnerable to sudden stops, when collateral constraints become binding in the wake of adverse shocks, or simply due to contagion effects from nearby countries, even when public debt is trivial (as the experience of Hong Kong shows). This paper argues that it is precisely in these times of adversity that it makes sense to be in a monetary union. For these transition economies of Eastern Europe, the monetary union is the Euro area.

While Hong Kong was not in a "de jure" monetary union with the United States, it currency board allowed it to function as a quasi "de facto" monetary union. With large abundant reserve holdings of U.S. dollars, the monetary authority of Hong Kong at the time of the Asian crisis was able to provide to banks and financial markets special funding, much as the Federal Reserve board provided special funding to financial institutions at the time of the crisis in 2008.

This paper makes use of the small open economy model of Mendoza (2010), with extensions for nominal rigidities. The model generates “sudden stop events”, with recurring normal business cycle shocks (to total factor productivity and world interest rates) rather than by assumed exogenous contagion effects. However, with the same model, we are able compare adjustment of a Hong Kong style contagion effect, with and without the benefits of emergency financing.

The message of this paper to Bosnia and Herzegovina, Bulgaria, Latvia and Lithuania is that bad things can happen, in the form of sudden stops, when adverse business cycle shocks trigger binding collateral constraints (as in the Euro area economies), or by simple contagion effects (being in the wrong region of the world at the wrong time, like Hong Kong). Given that bad things can and do happen, it is much better to be in a credible monetary union than not.