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### **Why Lithuania and Estonia could fare well in eurozone**

From Mr. Ashoka Mody and Mr. Christoph Rosenberg

Sir Wolfgang Munchau (“Monetary union is not for the poor”, January 30) argues that Estonia and Lithuania are too poor to join the eurozone. To be sure, he makes a number of valid points reflecting the debate on the Maastricht inflation criterion and the importance of factor and product market flexibility for success in a monetary union. But he wrongly jumps to the conclusion that low per capita incomes imply inflexibility. In fact, both countries have rather flexible economies. By measures of firm entry and exit as well as the operation of labour markets, they fare substantially better than many richer countries of the eurozone.

Mr. Munchau (rightly) warns against entering the European monetary union at an overvalued exchange rate. But he (wrongly) implies that this is a bigger risk for poor countries than for rich ones. And his specific considerations on the appropriateness of exchange rates in Estonia and Lithuania are questionable.

First, he points to large current account deficits as evidence that the currencies are overvalued. Large deficits can be a sign of overvaluation. But alternatively, and more benignly, they can be a sign of a large investment inflows in response to capital scarcity, high rates of return and flexible economic structures. Second, he fails to mention that Estonia and Lithuania have successfully operated currency boards for over a decade – navigating through fair and foul circumstances, including the Russia crisis, with growth rates among the highest in Europe. While the virtues of exchange-rate flexibility are significant in many contexts, Estonia and Lithuania have committed to a different path. On this basis, supporting policies have been put in place, and businesses and households have made financial decisions. Not only have these countries coped well without recourse to currency fluctuations, but also they have financial and economic structures that would make using the exchange rate risky.

Suggesting that real income convergence – productivity and income levels equal to those in western Europe – is a prerequisite for adopting the euro misses another important point. For countries that have strong fiscal policies and flexible economic structures, close trade and financial integration that euro area membership would bring would hasten real convergence. One need look no further than Ireland to see the evidence.

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