Discussion of
“Finding Stability in a Time of Crisis: Lessons of East Asia for Europe” by Paul D. McNelis

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Summary

• The paper compares the effects of sudden stops of capital flows:
  1. Fixed exchange rate regime
  2. Fixed exchange rate regime with large currency reserves (the case of Hong Kong in 1998)
  3. Currency union

• The results are used to draw lessons from Hong Kong’s situation in 1998 for the decision of eastern European countries (Bosnia and Herzegovina, Bulgaria, Latvia and Lithuania) to join the euro area or not

• Model of Mendoza (2010) is extended by downward nominal wage rigidities which are important for analyses with fixed exchange rate and currency unions

• Model is solved nonlinearly

• Main finding: currency union membership mitigates costs of sudden stops
Comments 1

• Highly relevant and timely topic
  – Joining a currency union is a decision that is not easily reversible so that such analysis is very important
  – There are few historical episodes of sudden stops in currency unions. Hence the situation in Hong Kong might be the case that closest resembles the decision situation of Bosnia and Herzegovina, Bulgaria, Latvia and Lithuania
Comments 2

- Not sure whether the paper fully accounts for all relevant characteristics of a currency union membership

  - Currency union membership in the model: additional funding from central bank which eases collateral constraints. No disadvantage of currency union membership.
  - Contagion within the euro area might be higher than outside
  - Capital flows within the currency area matter. Spain and Portugal were exposed to sudden stops within the euro area. Currency membership imposed a disadvantage as real depreciation is only possible via lowering prices and wages (downward nominal wage rigidities)
  - If there is doubt about the indefinite existence of a currency union or the membership of a country depends on its solvency, there is currency risk
  - Political constraints might impose restrictions on the amount of borrowing from the central bank (parameter $\Phi$)
  - Paper considers only crisis times, but not normal monetary policy
Comments 3

• The exercise shows that having a exchange rate peg + currency reserves is equally beneficial as joining a currency union

• So, the conclusion that Bosnia and Herzegovina, Bulgaria, Latvia and Lithuania are better of by joining the euro area must be based on the assumption that they cannot accumulate as many reserves as Hong Kong or are more vulnerable then Hong Kong’s economy

• To fully understand the relevance of the results a description of the economic and institutional situations of Hong Kong in 1998 and Bosnia and Herzegovina, Bulgaria, Latvia and Lithuania today would be useful

• The paper is about fixed exchange rate vs. currency union. So, the comparison to Poland, the Czech Republic, and Hungary (flexible exchange rates) is not clear