ARGUMENTA OECONOMICA
No 1 (28) 2012
PL ISSN 1233-5835

I. INAUGURAL LECTURE FOR OPENING THE ACADEMIC YEAR 2011/2012

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RECENT EVENTS IN THE EURO AREA AND THE FORTHCOMING MEMBERSHIP OF POLAND

The future of the euro area is like the Leaning Tower of Pisa. Invariably intriguing, it requires strengthening that would prevent it from leaning out even further. Likewise, the euro area needs strengthening. Once the process is completed, we will be able to resume our deliberations as to the best timing for Poland's accession to the euro area.

One might ask whether not being part of the euro area is generating costs for the Polish economy. Well, this is not the right question to ask. Recent traumatic experiences of several euro area countries pose a different question: how should the euro area change and how should we prepare to join so that our economy benefits?

My lecture today is divided into two parts. First, I shall run briefly through the causes of the severe disturbances which have recently occurred in the euro area. The second part of the lecture will deal with factors to be considered when considering Poland's accession to the euro area.

1. THE CAUSES OF THE DEBT CRISIS IN THE EURO AREA

What was the main cause of the recent crisis of the euro area?

There is no doubt about it – Paul De Grauwe has been writing about it for years. Insufficient political integration has generated a risk resulting from insufficient coordination of economic policies. This risk has just materialized. Almost from the very beginning – as the euro area was created–the competitiveness of the euro area economies started to become increasingly divergent, resulting in a steady deterioration of many countries' competitiveness versus the German economy.[i] The process of gradual erosion of competitiveness of some euro area countries was aggravated by volatile credit booms observed in the mortgage markets of those countries.

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Having pointed out the main cause of the dire straits of the euro area I do not intend to finish my lecture, therefore I shall briefly take you back to the evolution of opinions about the benefits and costs related to the membership of the monetary union.

Let us begin with the answer to the question: Why was Robert Mundell initially sceptical about the project of the European monetary union ?

His original theory of the optimal currency area assumed that the benefits of creating a monetary union would exceed its costs if price-wage flexibility were perfect and labour mobility were high. At the outset, Robert Mundell was sceptical about the degree to which these conditions could be met, thus he was sceptical about the chances to accomplish an optimal currency area in Europe. He argued that under insufficient price flexibility and imperfect mobility of production factors the costs involved in abandoning monetary policy autonomy (i.e. a floating exchange rate) might exceed the benefits.

When did Robert Mundell change his mind?

After the collapse of the Bretton Woods system, it turned out that exchange rate volatility was much higher than expected,[ii] so Robert Mundell concluded that establishing a monetary union is a way to protect economies against the destabilizing impact of exchange rates fluctuations.[iii]

Why did people come to believe that the costs of losing monetary policy autonomy were low?

The reason was the experience of the 1970s, which changed the way monetary policy was perceived. The idea that came to prevail in that time was that monetary policy should aim exclusively at stabilization of inflation expectations and that the key "instrument" of monetary policy should be the credibility of central banks. Thus, the handover of monetary policy to a common central bank that was to follow in the footsteps of the Bundesbank, was supposed to benefit many countries of the future euro area by means of "imported credibility", conducive to stabilization of inflation expectations. The opinion about the low costs of abandoning monetary policy was also supported by the conclusions from the real business cycle theory, corroborated by empirical research, arguing that economic growth fluctuations could be accounted for by technology shocks, that is, they were not about business cycle fluctuations, but merely about changes of the potential growth rate that should not be targeted by the monetary policy.[iv]

What influences affected the institutional framework of the euro area?

In the world of the new neo-classical synthesis concepts, with a major role played by the real business cycle theory, the government's "irresponsible" fiscal policy is thought to be a key factor capable of throwing

the economy off-balance is. This is one of the reasons why the only institutional safeguard set up in the euro area was the Stability and Growth Pact. Although up to the 1990s it was contemplated to establish a federal budget[v] that would be used *inter alia* to mitigate the consequences of asymmetric shocks, in the end such a budget was never created.[vi] And as we know today, it was not governments, but banks that proved to be "irresponsible".[vii] Even if the requirements of the Stability and Growth Pact often were not met, it was only Greece that exhibited a constant and quick increase in the relation of the public debt to GDP. Ireland and Spain were even running longstanding budget surpluses that enabled them to reduce the relation of the public debt to GDP.

Why was it previously believed that the Stability and Growth Pact alone would suffice to coordinate the economic policies in the euro area?

It was assumed that the decrease in interest rates following accession to the euro area would boost investment in fixed assets in the so called peripheral countries, thus resulting in a rapid merging of the economies of the euro area into a single organism. The process of integrating the member states' economies into one was supposed to be reinforced by a jump in trade expected after the introduction of the common currency.[viii] As late as 2003, when the UK was pondering its accession to the euro area, a 40 per cent increase in trade was expected.

It was also assumed that a natural coordination of monetary policy in the euro area will be ensured by price competition in the common European market; hence the differentiation of competitiveness of member states' economies will be avoided.

In actuality, all those expectations were met to a degree too small to trigger an automatic coordination of economic policy in the euro area. The declining interest rates favoured construction booms rather than investments modernizing the economies of member states. The increase in trade was much lower than expected.[ix] The price competition did not prevent the differentiation of cost competitiveness within the euro area.[x] The unsustainable credit booms were the factor contributing to the loss of cost competitiveness of many euro area countries versus the German economy.[xi]

What was the reason for the failure to effectively reduce the scale of credit booms in Spain and Ireland?

For a long time, credit expansion did not raise concerns because it was believed that the system of capital requirements, newly established after many years of negotiations (Basel II), would mean that the banks effectively

adjusted the amount of their capital to their potential losses, thus protecting themselves against insolvency risk.

The Bank of Spain was the only central bank in Europe that imposed additional capital requirements (resembling those stipulated by Basel III), thus preventing big Spanish banks from insolvencies (while Ireland saw their banks bailed out with taxpayers' money), yet being unable to save the Spanish economy from the consequences of the breakdown in the construction boom.

Until recently it was believed that a tighter fiscal policy might alleviate credit booms. Therefore Ireland's and Spain's budget surpluses were perceived as a sign that their economies "are doing just fine". Certainly, politicians did play a role here as they had started to enjoy the popularity they owed to construction booms and would not listen to economists warning that such an expansion in lending is unsustainable and doomed to collapse.

Why did the euro area have no emergency mechanism at the outbreak of the fiscal crisis in Greece?

Previously, it was assumed that the no-bail-out clause would be binding (article 103 of the Treaty). It was also assumed that establishing a federal-level budget or emergency fund will be a source of moral hazard. Why was the European Financial Stability Facility established after the outbreak of the crisis in Greece and headquartered in Luxembourg as a special purpose vehicle rather than in Brussels as a new community institution? The intention was to avoid the impression that the establishment of the new institution will open the gate to fiscal transfers inside the euro area ("transfer union").

Why did the Germans insist – from the very beginning – on the treasury bonds of the euro area countries being furnished, as of 2013 – when the EFSF is transformed into the European Stability Mechanism (ESM) – with a Collective Action Clause (CAC), providing for their redemption at a discount, which is tantamount to risk of aloss for investors?

Possibly the Germans decided that since the Stability and Growth Pact did not provide sufficient incentive for the euro area countries to conduct "disciplined" fiscal policies (something they had experienced themselves), they decided that what was needed was *market discipline* in the guise of long-term rational investors (apparently to be found in the financial markets) who would impose risk premiums on treasury yields corresponding with the budget position of a given country.

What could have mitigated the sovereign debt crisis in the euro area?

A possible solution could be issuing joint eurobonds. The best known variation of the a concept would involve the issuance of joint "blue" eurobonds, in which member states could participate unless their relation of the public debt to GDP exceeded 60 per cent. Beyond this ceiling, "red" bonds would have to be issued, with a significantly higher interest rate, as their redemption would not be jointly guaranteed by all member states.[xii]

The issuance of joint bonds would be very advantageous for the euro area. A vast and highly liquid bond market would be created, generating high global demand. Eventually, joint bonds will probably be issued. Before it happens, though, some institutional changes will take place to streamline the management mechanisms of the euro area.

One of the beneficial changes has been a decision to apply – in addition to the excessive deficit procedure (EDP) – the excessive imbalances procedure (EIP), under which the economies of the euro area countries will be gauged in terms of their capacity to maintain internal and external equilibrium, as well as their ability to sustain competitiveness in the global market.

The pace and nature of institutional changes in the euro area will be one of the major factors influencing our future decision on when to join the euro area.

2. POLAND'S MEMBERSHIP IN THE EURO AREA

When considering the best time for Poland's accession to the euro area, we must obviously examine the consequences of adopting the common currency.

Will the decline in interest rates lead to more investment in productive assets?

One of the key expected benefits of establishing the euro area was the rise in capital formation due to falling interest rates. The experience of the euro area countries, however, calls for caution because – as mentioned above – the reduction in interest rates has rather contributed to credit booms in mortgage markets than to an increase in investment conducive to the modernization of the euro area's economies. Poland should therefore consider one more factor, namely the fact that the natural interest rate in the Polish economy, which is undergoing the process of real convergence, is higher than that in the euro area countries. This means that upon joining the

euro area, interest rates in Poland would be below the levels conducive to the equilibrium in the economy.

We also need to consider the fact that the renunciation of autonomous monetary policy in Poland may result in emergence of a feedback loop between the credit boom and the decline in real interest rates due to the inflationary pressures caused by the credit boom – as was experienced by Argentina, the Baltic states, Ireland and Spain.

Can a supervisory policy fully replace monetary policy as a tool of restraining unstable credit booms?

Opinions have been articulated recently that if we can no longer use monetary policy after joining the euro area, then we could use the instruments of supervisory policy instead. I personally advocate the use of supervisory instruments in order to stabilize not just the financial system, but the entire economy. To this end, the central bank's effective influence on macro-prudential policy is required. Nevertheless, if someone believes that supervisory policy can totally replace monetary policy– as an instrument to impede unsound credit booms – then they overlook at least two issues.

First, supervisory policy – like fiscal policy – is much less flexible than interest rate policy. For obvious reasons, one cannot change capital requirements as frequently as interest rate levels. Second, one should consider the strong trends toward harmonization of supervisory regulations in Europe. Intense disputes of these issues are currently taking place. Many countries, including Poland, adhere to maximum liberty for local supervisors in using supervisory instruments to restrain unstable credit booms. Such a position is represented by the European Systemic Risk Board whose member I am privileged to be, but the European Commission tends towards maximum harmonization of prudential standards in the European banking law.[xiii] We would hope for the issue to be resolved in the way we favour; yet, no decisions have been taken so far and the final solution will most likely involve a compromise of some sort, whose shape is impossible to predict at the moment.

Does the exchange rate adversely influence trade and economic equilibrium?

As we all know, empirical research has never corroborated an argument that volatile exchange rates are detrimental to trade.[xiv] Favourable effects were expected with the introduction of a common currency.[xv] And yet again, empirical research has significantly revised former opinions demonstrating that the increase in trade following the introduction of a common currency was relatively small.[xvi]

Is an economy outside the euro area exposed to increased fluctuations in exchange rates?

The answer to this question is difficult, because the exchange rate is the least predictable variable to imagine. We can however recall what happened to the Polish zloty recently. During 2005-2007, the zloty was surprisingly strong, steadily appreciating in tandem with the rising equilibrium exchange rate, thus enabling inflation to stabilise without losing the competitiveness of Polish exports. During the global banking crisis, the zloty depreciated sharply, as did other currencies of the emerging economies. For a long time now, the zloty has been stable again; however, the increase in the risk premium in international markets stopped its appreciation.

In this respect, the stability of the Swedish crown and the British pound in the last decade – before the outbreak of the global banking crisis – is remarkable.[xvii] This phenomenon has yet not been empirically analysed and fully explained; however, there might be some analogy with the Canadian dollar and its negligible changes versus the US dollar due to the close integration of both economies.

Why did the Czech Republic not decide to promptly join the euro area?

Inflation in an economy undergoing a period of real convergence tends to exceed inflation in developed countries. One of the factors boosting inflation in real-convergence countries is the adjustment of domestic prices to prices in the developed economies. The Czech National Bank decided that the preferred form of nominal convergence should not involve the increase in prices as expressed in domestic currency (before joining the euro area) but an increase in prices in terms of the euro, as a result of appreciation of the Czech crown, whose exchange rate was strengthening at a pace close to the appreciation of the equilibrium exchange rate.[xviii] As a consequence, the appreciation of the Czech crown neutralized the inflationary pressure resulting from the Balassa-Samuelson effect and did not lead to a deterioration in the competitiveness of Czech exports. Whenever the Czech crown was strengthening too fast, the Czech National Bank intervened in the currency markets.

When will Poland join the euro area?

The above considerations have led me to the conclusion that until major changes in the systems of euro area management and European banking supervision are implemented, to determine, *inter alia,* to what extent we can use supervisory policy to curb excessive credit growth, what seems an appropriate solution in our situation is to use a floating exchange rate and to implement structural reforms which will allow Poland to join the euro area

with a modern economy, which is both efficient and resilient to external shocks.

In my opinion, the euro area that we will join will be a new, reformed currency union whose future will be as clear as the one we used to know before the global financial crisis.

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