Common European Currency: Challenge to Poland

Openings remarks at the conference on: "Common Currency and its Future: Lessons for the New Member States", Warsaw, 15 October 2008

Wspólna europejska waluta. Wyzwanie dla Polski

Uwagi wprowadzające podczas konferencji „Wspólna europejska waluta i jej przyszłość: wnioski dla nowych krajów członkowskich Unii Europejskiej"

Zbigniew Hockuba[*]

The current crisis that poses an unprecedented challenge to the world's major central banks, including the European Central Bank, is also a challenge for European economic and monetary integration. In the opinion of some commentators, the euro area, which celebrates its 10th anniversary this year and is proud of the good progress and numerous successes in integration (European Commission 2008), is not fully prepared to stave off the effects of the financial crisis.

Undoubtedly, the present financial crisis is one of the major economic developments of recent years. The depth of the crisis is vast and so is the scope of tensions it has generated. Federal Reserve Chairman Ben Bernanke, who addressed the National Association for Business Economics on 7 October 2008 and discussed the steps taken by both the Fed and the Bush administration, said: "These are momentous steps, but they are being taken to address a problem of historic dimension" (Bernanke 2008). By referring to the historic dimension Bernanke meant the threat of collapse of the whole financial system of the United States and other countries of the world. The threat may produce huge negative consequences to the functioning of the real economy. Every economy needs credit to provide funding to current economic processes whereas absence of liquidity may indefinitely halt regular economic activities. The U.S. economy has already slowed down considerably, its housing sector is in deep recession and the unemployment rate has risen to over 6 percent. According to some forecasts, GDP is even expected to fall next year.

Only a few months ago, many economists argued that Europe might avoid the crisis. This reasoning was called a decoupling hypothesis. According to this concept, the growth paths of the Unites States and Europe were to be largely independent of each other. However, the course of the developments has falsified this hypothesis. As in the case of previous crises, the economic slowdown, albeit delayed, has also affected many euro area countries and may become equally as painful. As a result, the pace of economic growth in the euro area in the second quarter of 2008 slowed considerably. As compared with the first quarter of the year, it dropped to minus 0.2 percent, and amounted to 1.4 percent in comparison with the corresponding

[*] National Bank of Poland, Member of the Management Board; University of Warsaw, Economic Sciences Department. Opinions presented in this speech reflect the author's personal views. The author would like to thank Michał Brzoza-Brzezina, Tomasz Ciszak, Juliusz Jabłecki, Marek Rozkrut and Ewa Rzeszutek for valuable comments.

period of 2007. The JP Morgan Investment Bank has even recently lowered its 2009 GDP growth forecast in the euro area close to 0 percent. The economic situation varies among countries. Iceland, Ireland, Spain, Italy and Denmark have so far been the worst affected countries, while Germany and France have been affected to a lesser extent.

Speaking of the situation the world economy is in, it is worth pausing for a moment to reflect on the resilience of the Polish economy to shocks related to the financial crisis and heightened inflation on the fuel and food markets. The Polish economy has not reported any considerable negative effects of the global financial crisis as yet. A drop in confidence caused prices on the Warsaw Stock Exchange to fall considerably but the real economy has so far not been affected by the declines. Economic slowdown is expected in 2009, but it should be moderate. After an increase observed throughout 2007 in line with the global trend, inflation most likely peaked in summer 2008. Our forecasts indicate a gradual fall of inflationary pressure. The Polish banking system is widely regarded as stable and free from risky mortgage market-related instruments. This is confirmed by assessments made by the Polish Financial Supervision Authority and results of analyses conducted at the National Bank of Poland. Admittedly, some liquidity problems have recently occurred in the interbank money market but it has to be pointed out that they stem mainly from the drop in general confidence in the global financial markets. The NBP's activities related to the announcement of a confidence package containing liquidity-enhancing instruments, should improve the situation in this respect.

Let's go back for a moment to the claim shared by many observers that the current financial crisis poses a challenge to the euro itself. A crisis is always a test for the existent structures and solutions. The crisis-related shocks are a test of the stability and resilience of the system and its adaptability. Until now the euro seems to be the world's most successful project regarding the creation of a monetary union. Joaquin Almunia, the European Commissioner responsible for Economic and Monetary Affairs, told at the EU conference organized to mark the 10th anniversary of the launch of the euro that the single currency is a major success, that it has created a zone of macroeconomic stability, has contributed to growth in employment, has increased trade between the EU Member States, as well as enhanced investment and financial integration. The euro has become the symbol of growing political integration in Europe and a pillar of the international monetary system. Surely, this assessment has not been changed by the developments taking place during a few months following the conference. Nevertheless, the single currency faces the entirely new challenges caused by the intensified crisis in the world and its impact on the financial and economic systems of the euro area.

It is not my goal to fully identify these challenges. However, I would like to highlight the problem that from today's point of view seems to be the most essential. The issue concerns the preparation of the euro area to defend itself against the effects of the financial crisis in an effective manner. When the crisis started it was clear that a European institutional framework for cross-border banking supervision was not in place. The Memorandum of Understanding, signed by the finance ministers, the presidents of the central banks and the presidents of the financial supervisory authorities of the European Union countries, which entered into force on 1 June 2008 does not solve the issues related to ensuring financial stability in the European Union. The European Commission and the European Parliament continue their work on developing a new set of regulations. It is possible that the existing regulations will be considerably amended. The crisis of Fortis bank, which was saved after the three Benelux countries quickly agreed on a bailout package, showed a certain dysfunctionality of the Stability and Growth Pact. Bail-outs of financial institutions may lead to a substantial increase in the budget deficits and thereby to flouting the Pact's rules, and raise objections from the point of view of the EU state aid regulations. In turn, allowing a financial institution to go bankrupt may have a negative influence on the banking system of the euro area as a whole.

The coming months will show how Europe will cope with the effects of the crisis. On the one hand, every crisis brings threats, but on the other hand, it also creates an opportunity to introduce necessary changes, which would not have been given sufficient support had the crisis not occurred.

Let me now proceed to issues related to Poland's preparation to adopt the common currency. As you know, Poland pledged to adopt the euro when it signed the Accession Treaty, but the date of fulfilling this obligation was not specified. It is within the Polish government's discretion and this decision should be taken in consultation with the National Bank of Poland. In the first half of September 2008, the Polish Prime Minister Donald Tusk confirmed the country's readiness to adopt the euro in a few years' time. Following this declaration, steps have been taken by the government and the NBP to ensure the fulfilment of the Maastricht convergence criteria in 2011, and to prepare the so-called path of entry to the exchange rate mechanisms (ERM II).

As you are well aware of, countries bidding to join the euro area are required to meet the formal monetary and fiscal criteria laid out in the Maastricht Treaty. Currently, Poland fulfils the fiscal, inflation and interest rate criteria. In the past few years, Poland's economic growth rate was high, above 6 percent, which facilitated the fulfilment of the criteria. There are some concerns about the inflation criterion. Although Poland still fulfils this criterion, in the past few months the average annual inflation has been running exactly at its upper bound. It is worth pointing out that in July and in August, the CPI stood at 4.8 percent, which meant that Poland was a country with the lowest inflation rate in the region. Only Slovakia reported similar indicators.

It is known that the process of integration with the euro area entails economic benefits. Fulfilment of the convergence criteria leads to low inflation and reduction of the public sector debt, whereas the adoption of the single currency reduces transaction costs and foreign exchange risk. However, theoretical research on the concept of optimum currency areas, started by Mundell (1961) and McKinnon (1963), and further developed by Frankel and Rose (1998), as well as the experience of the euro area countries show that the fulfilment of the formal convergence criteria provides no guarantee that the outcome of the adoption of the euro by a given country will be always positive. The example of Portugal, which after the accession to the euro area was for many years grappling with the issues of low growth and high unemployment, is especially telling here. The lesson of Portugal suggests that a country which intends to participate in a monetary union should carry out a number of structural reforms before it adopts the single currency. Making the labour and product markets more flexible is one of those activities that foster the maximisation of chances and minimalisation of threats related to monetary union membership, according to extensive literature covering the subject. Improvements in this area increase the capacity of the economy to effectively respond to asymmetric shocks and at the same time reduces the cost of losing the tool of autonomous monetary policy. The lower the flexibility of the economy bidding to become a member of the euro zone, the bigger emphasis should be put on the similarity of its structure and convergence of the economic cycle with the countries forming the currency union. Generally speaking, membership of the euro area implies participation in a demanding economic project for which one has to be well prepared.

The problem of a likely contradiction between the process of nominal and real convergence has emerged in discussions on New Member States and euro adoption criteria. In the New Member States that exhibit a relatively lower level of economic development, the average price level is considerably lower than that in the developed countries. The structural changes that are taking place, the increase in labour productivity, and the related Balassa-Samuelson effect raise the average price level. Following entry into the euro area, higher inflation will lead to a drop in real interest rates. How the economy will respond to this and how it will adjust to the new equilibrium is a vital problem that requires further in-depth research.

The process of monetary integration in Europe is the subject of extensive research carried out at academic centres all over the world. The National Bank of Poland has undertaken to prepare a report on Poland's participation in the third stage of economic integration, in particular on specifying euro adoption-related costs and benefits. Today's conference aims to present the results of the research and analyses on the monetary integration, carried out at world's leading universities. The results will be taken into account when preparing the report. I would also like to express my conviction that conclusions included in the report will serve the politicians involved in the decision making process concerning the establishment of a timetable for the adoption of the single currency, as well as assessing the degree of the preparation of the Polish economy to join the euro area.

References

Bernanke B.S. (2008), *Current Economic and Financial Conditions*, an address before the National Association for Business Economics 50th Annual Meeting, 7 October, Washington, D.C.

European Commission (2008), *EMU@10 Successes and Challenges after 10 years of Economic and Monetary Union*, "European Economy", No. 2, Brussels.

Mundell R.A. (1961), *A Theory of Optimum Currency Areas*, "American Economic Review", Vol. 51, pp. 509–517.

McKinnon R.I. (1963), *Optimum Currency Areas*, "American Economic Review", Vol. 53, pp. 717–724.

Frankel J., Rose A. (1998), *The Endogeneity of the Optimum Currency Area Criterion*, "Economic Journal", Vol. 108, pp. 1009–1025.