

Krzysztof Rybiński: The euro adoption – assessing benefits and costs

Address by Mr Krzysztof Rybiński, Deputy President of the National Bank of Poland, at the panel discussion at the American Chamber of Commerce, Warsaw, 17 January 2007.

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Only a few weeks ago the eurozone was enlarged for the second time. Slovenia became the first of the ten new member states of the EU and the thirteenth country to share the common European currency. This seems to be a good occasion to return to the, once lively, discussion about the advantages and disadvantages of joining the euro.

However, before I proceed, I would like to make two important points. First, I would like to note that views presented here are my own and they do not represent the official position of the National Bank of Poland. Second, my economic background allows me to speak in terms of standard economic variables: output, consumption, prices etc. On the other hand, I do not feel competent to speak about highly immeasurable values like national pride. Notwithstanding the fact that people might derive utility from the pure fact of having in their wallets banknotes with Polish kings instead of European bridges, I have no idea how to measure this utility and how to compare it to the utility derived from more standard arguments of preference functions like consumption. For this reason I will speak in terms of standard macroeconomic variables, bearing in mind that this is certainly not the full story.

If economists speak about the advantages and disadvantages of joining a common currency area, they ultimately end up comparing the costs and benefits of accession. This is also the way I would like to proceed. However, bearing in mind that what is known, has already been described in several voluminous reports (NBP 2004 for Poland, Csajbok, Csemerly 2002 for Hungary, HM Treasury 2003 for the UK), I will try to focus on issues which are less familiar to the general public or which are potential risk factors. The nature of these issues is that they are mainly concentrated on the cost side of the analysis. Thus, it might seem from my lecture, that I mainly care about the costs or that costs outweigh benefits. Let me, in the very beginning, stress that this is by no means the case. As stated by the President of the National Bank of Poland, Mr Sławomir Skrzypek, an in-depth assessment of the costs and benefits of the euro adoption in Poland needs to be periodically repeated in order to make sure that we take into account all important factors of the fast changing global economy. The National Bank of Poland is willing to play a key role in stimulating the public debate about the costs and benefits of the euro adoption. Today's panel is a good opportunity to contribute to this debate, and I would like to thank the American Chamber of Commerce for offering this opportunity.

Let me begin with the benefit side. Economists typically concentrate on three sources of economic benefits related to monetary union. These are:

- lower transaction costs,
- lower interest rates,
- trade creation.

Transaction costs is an issue of particular relevance for people who sit today in the audience. Everyone exchanges currencies, knows what spreads are and could even possibly calculate how much his company would save on transaction costs if there were no exchange rates. This is also relatively unsophisticated for the whole economy, and has been estimated to be approximately 0.2% of GDP in Poland (NBP 2004). Not much, but worth saving.

Lower interest rates induce investment, thus strengthening the productive capacity of the economy and making higher output and consumption possible. We expect that in the case of Poland the interest rate adjustment after eurozone accession will reduce long-term rates by more than one percentage point. Any estimation of the exact impact on investment, output and consumption is subject to several assumptions. Nevertheless the NBP's analyses show that an interest rate reduction will be the main source of benefits from joining the euro (Borowski 2003).

The benefit we know the least about is related to **trade creation**. In a groundbreaking study Rose (2000) estimated that joining a currency union may boost cross-country trade by over 200%. Most economists agreed with the direction and mechanism behind this – the single currency eliminates the uncertainty related to exchange rate movements and thus diminishes the risk related to foreign trade. However, the estimated scale seems to be much exaggerated. One problematic issue is related to the

fact that before the eurozone, we did not have examples of currency unions between developed countries. So the Rose study was based on data on currency unions involving poor and/ or small countries. As noted by Micco, Stein and Ordonez (2003), “one does not need to be a eurosceptic to wonder whether such findings are directly applicable to Europe’s single currency”.

Follow-up studies (e.g. Rose and Wincoop (2001), Kenen (2002), Persson (2001)) attempted to correct the Rose estimates but arrived, rather inconclusively, at anything between a 50% and 150% growth of bilateral trade. Recently, the first studies based on euro area data emerged. These show that the trade creation effect of the euro was substantial, although (until now) by an order of magnitude smaller than the original Rose estimate (e.g. Micco, Stein and Ordonez (2003)). Our knowledge about trade creation effects of the euro is still far from complete and we will probably have to wait another 10+ years to have enough data to draw firm conclusions about its magnitude in the eurozone.

Now let me move to the cost side. As already noted in contrast to the benefits, some costs have a contingent character. They are tail-events – rather unlikely but with a possibly high impact if they happen. Let me concentrate on two issues:

- asymmetric shocks,
- arising micro- and macroeconomic imbalances.

Shocks are by definition something we cannot foresee. **Asymmetric shocks** are shocks that affect only selected member(s) of a monetary union. Such events are considered the biggest threat to unions (Mundell 1961), because joining a common currency area substantially reduces the set of policy tools which could be used to mitigate the impact of the shock. Let us assume that a negative demand shock affects the Polish economy (e.g. consumers decide to buy less goods and services). In the short and medium run this brings about a reduction in output and higher unemployment. As long as Poland has its own currency, it can use both monetary and fiscal policy to stimulate demand and reduce the impact of the shock on output and employment. Moreover, the exchange rate might adjust (depreciate) and thus make our exports more price-competitive. Once in the eurozone, two of these channels are closed. First, there is no independent domestic monetary policy which could lower interest rates, and one should not expect the ECB to react to a local shock. Second, after joining the eurozone the exchange rate disappears, so there can be no exchange rate adjustments.

Accordingly, the only policy tool left after euro area accession is fiscal policy. For this reason it is of crucial importance to run a balanced budget in the medium run, so that in case of negative shocks, there is room for increasing the deficit and thus buffer the shock. Additionally, there are also economic forces which can bring the economy back to equilibrium. The most prominent is wage adjustment – after a negative shock falling wages can help reduce the cost of production and as a consequence prices. This will increase demand and help the economy return to equilibrium. A crucial prerequisite for this channel to operate smoothly is a flexible labor market – only if wages adjust immediately can increasing unemployment and an economic slowdown be avoided. We know, however, that this downward wage flexibility is rarely seen in real life.

Regarding asymmetric shocks one thing seems certain. We are not able to foresee if serious asymmetric shocks are going to affect the Polish economy after joining the euro or not. We can only speak in terms of probabilities, and given the data, it seems that the probability of huge shocks seems limited. The Polish economy is strongly integrated with the eurozone, with a majority of exports going to the common currency area. Moreover, most studies (e.g. Fidrmuc, Korhonen 2003, Eickmeier, Breitung 2005) show a relatively high correlation of business cycles between Poland and the eurozone. This substantially reduces, but does not eliminate, the risk of asymmetric shocks. Looking ahead one can see potential risk factors. One of them is production clustering. If the recently observed trend for country specialization (e.g. Slovakia specializes in producing cars, India in business process outsourcing) holds on, it may increase the risk of asymmetric shocks in the future (De Grauwe 2003). Another example of a possibly distant future asymmetric “shock” is global warming. A recent report cited by Financial Times (FT, 6 January 2007) shows that the Northern members of the eurozone are likely to profit and the Southern members to suffer from the climate change. Nevertheless, whatever the likelihood of shocks, it remains of crucial importance to maintain a balanced fiscal perspective and flexible labor market which can absorb shocks, should they arise.

Now let me move to the possibility of **rising micro- and macroeconomic imbalances**. Such imbalances can take the form of lending booms, current account deficits or increasing inflation pressure. Such a set of symptoms in a monetary union member country reveals in most cases one common cause – real interest rates that are too low. Economists have for a long time argued that each

economy has an appropriate, long-run level of the real interest rate called the natural rate of interest (Wicksell 1898). Keeping interest rates at this (unfortunately unobserved) level should guarantee that the economy will remain in equilibrium – output will not exceed production capacity and inflation will remain stable (Woodford 2003). This is what implicitly or explicitly most inflation targeting central banks are trying to achieve.

One of the problems with joining a common currency area might be that real interest rates in this area will be lower than the natural rate of the new member. Recent research shows that this might be the case for Poland, where the natural rate has remained in the past above the euro area level (Brzoza-Brzezina 2006). For Poland entering the eurozone means lower nominal interest rates (the spread on long-term rates remains between 100 and 150 basis points) and higher inflation (due to the catching up process). Together this means a drop in real interest rates, which could induce people and enterprises to substantially increase borrowing, and spend the loans on consumption and investment goods. What could be the consequences of this?

First, if borrowing accelerates massively, banks may start granting loans without properly checking their customers' creditworthiness – this could result in bad debt problems. It is a well known phenomenon (e.g. Demirgüç-Kunt, Detragiache 1998, Gourinchas et al. 2001) that lending booms are often followed by banking sector crises. Fortunately recent research on the potential for lending booms in Poland after euro area accession forecasts a rather moderate increase in lending (Schadler et al. 2005, Brzoza-Brzezina 2005), and shows that the expected credit growth is rather an equilibrium phenomenon – a structural adjustment that should not have negative consequences (Kiss et al. 2006). Nevertheless, even if a serious lending boom during euro area accession seems unlikely, policymakers should remain vigilant and prudent banking sector supervision should be the right answer to such worrying developments.

Second, higher domestic demand can fuel inflation pressure and increase imports, thus leading to a higher current account deficit. As to the second phenomenon, it seems that while outside a monetary union deep current account deficits worry investors and can, in extreme situations, lead to currency crises, for countries that have already joined the common currency they do not matter much. An example of the three Baltic States (Estonia, Latvia and Lithuania), whose currency board arrangements are close equivalents of a monetary union, shows that enormous current account deficits (9-16% of GDP in 2006) have no apparent negative consequences for the economy.

The case is, however, different with inflation pressure. In theory the margin for local demand-driven price increases in small member states of monetary unions is very narrow. This is guaranteed by the so called law of one price – the expectation that the same product should have the same price in various countries of a monetary union. In practice, however, there are several obstacles for this law to hold perfectly – some goods cannot be traded, most goods do not have perfect substitutes, there are transportation costs and tax differentials – so local demand pressures can play a role in driving prices in monetary union member states. As a consequence, products manufactured in these countries become more expensive and such countries lose competitiveness (e.g. Estrada, Lopez-Salido 2001). It is relatively difficult to foresee how the Polish economy will react to demand pressures once in the euro area. However, as in the case of asymmetric shocks, labor market flexibility is probably the best answer to the described phenomena. It allows a smooth and relatively painless adjustment if the economy loses competitiveness.

Summing up, I have discussed selected aspects of the cost-benefit analysis of Poland's adoption of the euro. Although the costs may seem substantial, one has to bear in mind two things. First, the probability that these costs will have to be incurred is relatively low. Second, their magnitude depends crucially on domestic policy – prudent banking sector supervision, labor market reforms and sound fiscal policies to name a few. In my view, given the evidence that reforms have been halted in many countries after entering the eurozone, these measures should be taken before the euro area accession.

Thank you for your attention.

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