Krzysztof Rybiński: The role of the EURO for the future of Poland

Speech by Mr Krzysztof Rybiński, Deputy President of the National Bank of Poland, at the International Conference "The role of the EURO for the future of Poland", Warsaw, 15 June 2007.

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Only a few months ago the eurozone was enlarged for the second time. Slovenia became the first of the twelve new member states of the EU and the thirteenth country to adopt the common European currency. Now two other countries, i.e. Malta and Cyprus, are knocking on the euro's door, and others are lining up for the "monetary club membership". This seems to be a good occasion to return to the, once lively, discussion about the advantages and disadvantages of joining the monetary union.

Indeed, there are still more reasons to come back periodically to the euro cost & benefit debate, since we have more and more data, the world changes rapidly and even economic theory is subject to evolution. Let me illustrate this with one example. It has long been a widely accepted view that asymmetric shocks are the biggest threat to currency unions. Nowadays some respected economists think it may not be the case. And thus, Willem Buiter and Erik Nielsen in their recent paper (2007): "Mundell on His Head: Asymmetric shocks are good for you, thanks to Economic and Monetary Union in Europe", argue that home bias has been receding in the Eurozone, so an increasing number of households and companies now hold a Euro-wide portfolio. In finance it is good when returns on particular assets are negatively correlated, because it helps you to diversify risk and achieve the better risk-return tradeoff. Therefore, if asymmetric shocks hit monetary union, it will result in negatively correlated returns on euro-zone assets portfolio, so such portfolio holders will be better off in comparison with a scenario of a symmetric negative shock. Of course this train of thought may seem too narrow, since it boils down merely to the capital income analysis and loses sight of other effects of asymmetric shocks, such as those on the labor market situation. Nevertheless, this example provides a clear evidence that our cost and benefit analysis may change every so often in tandem with new ideas that smart people come up with.

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 whole 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 many issues have 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 conference is a good moment to contribute to this debate, and I would like to thank the organizers for offering this opportunity.

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

- lower transaction costs,
- lower interest rates,
- financial integration,

- trade creation.

Elimination of **transaction costs** incurred by companies and households in relation to the zloty/euro exchange rate is among the most obvious benefits of the single currency. These costs include, *inter alia,* the bid-ask spreads, fees accompanying exchange rate operations and costs of hedging against exchange rate risk. Any company could possibly calculate how much it 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).

Research shows that the elimination of the exchange rate fluctuations and the coordination of monetary policy within the euro zone have been the main driving forces behind the **financial integration** in Europe (Fratzscher 2001; Galati and Tsatsaronis 2001; European Commission 2002; ECB 2006). Integration, in turn, promotes competition in financial markets, leading to an improved efficiency in financial intermediaries and a reduction in the cost of their services. A single currency provides domestic companies with an access to more liquid and deeper financial markets, which not only drives down the cost of capital, but also allows better risk diversification. Therefore, apart from stimulating economic growth, development of financial market also reduces output fluctuations. Since empirical research indicates that countries with relatively less developed financial markets benefit the most from financial integration (Giannetti et al. 2002), we believe that Poland should be among the largest beneficiaries of this process (NBP 2004).

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 have 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's 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 have emerged. These show that the trade creation effect of the euro has been substantial, although (until now) by an order of magnitude smaller that the original Rose's 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 occur. Let me focus 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 Polish 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 monetary union, the Polish currency will be replaced with the euro, so the zloty/euro exchange rate adjustments will no longer be available.

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 an 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 occurrence 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, though 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**. They 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 – too low a level of real interest rates. 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 still exceeds 100 basis points) and higher inflation (due to appreciation of the real exchange rate related to the catching up process, with no longer available nominal exchange rate channel). 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 extending 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 at 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 protect oneself against the risk of such developments.

Second, higher domestic demand can fuel inflation pressure and increase imports, thus leading to a higher current account deficit. As for the latter, 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 such developments 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, as yet.

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 loose 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 looses competitiveness.

Summing up, I have discussed selected aspects of the cost-benefit analysis of Poland's adoption of the euro, with a special focus on issues which are less familiar to the general public. As I argued, some costs will materialize if asymmetric shocks hit the enlarged eurozone. We do not know the likelihood of such shocks though, so it is impossible to calculate the expected value of costs related to these events. We know, however, that the probability of asymmetric shocks declines with rising similarity or progressing real convergence of the EU economies. Let me also stress that the magnitude of costs depends crucially on domestic policy – prudent banking sector supervision, labor market reforms and sound fiscal policies to name a few. Adoption of proper policies reduces future potential costs related to euro-zone membership and, at the same time, enhances future benefits. 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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