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THE PROSPECTS OF POLISH MEMBERSHIP IN THE EMU ON THE BACKGROUND OF GLOBAL RECESSION 2007–2009

1. Introduction

Global recession of 2007–2009 has had a significant impact on functioning of the Eurozone and has provoked many controversies concerning both accession of new countries (including Poland) to monetary unions as well as legitimacy of creating unions by countries of different development levels and different degrees of fiscal discipline.

Should Poland become a full economic and monetary union member? If the answer is yes, another question arises – when? How should economy and the state get prepared for this move? There are no unambiguous answers to these questions. The aim of this paper is to outline possible answers and, first of all, to formulate problems for the discussion.

2. Factors determining the relationship between the benefits and costs of full Economic and Monetary Union membership and opportunities and threats in the case of Poland

The monetary union as a uniform currency area of single currency and uniform monetary policy implemented by the supranational central bank may be a source of vital benefits for the countries creating it. The benefits are connected with the disappearance of the exchange rate costs, disappearance of the exchange rate risk in economic relationships among countries forming the union, stability of prices and employment and real GDP growth.[1]

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[1] About cost – benefits see: [.G. Grubel, *The Theory of Optimum Currency Areas*, „Canadian Journal of Economics", May 1970, pp. 318–324; P.R. Krugman, M. Obstfeld, *International Economics. Theory and Policy*, wyd. 5, Addison – Wesley Publishing Company, Massachusetts

On the other hand, the countries forming the monetary union resign from their own monetary policies (including the exchange rate policy) as a macroeconomic stability tool. Thus, restoring the economic equilibrium in the case of economic shocks can be based on the market adjustment mechanism and, to some extent, on using the fiscal policy. However, the latter is not a very effective or refined instrument of macroeconomic stability and moreover in the medium- or long term it leads to increased budget deficit, public debt and interest rates.[2]

The theory of optimum currency areas points to the criteria which should be met by economies of the countries forming the monetary union. Meeting these criteria is considered indispensable to ensure efficient operation of adjustment mechanisms restoring the economic equilibrium in particular countries and in the entire union as a currency area.

These criteria include high labour and capital mobility both geographically and among sectors, openness of economies, production diversification, flexibility of markets, prices and wages.[3] What is more, it is pointed out and explained that countries forming the monetary union should be characterised by similar levels of economic development and similar mechanisms of economy functioning which are understood as similar levels of GDP per capita and similar economic growth rate, inflation rates at a similar level, similar levels of budget deficit and public debt in relation to GDP, and similar legal systems.[4] What is also emphasized is the significance of the economic integration degree and similarities or simply synchronisation of business cycles.[5]

2000, pp. 622–630; P. De Grauwe , *Unia walutowa,*PWE, Warszawa 2003., p. 15–32; S. Bukowski, *Teoretyczne podstawy i realizacja unii monetarnej krajów członkowskich Wspólnot Europejskich. Szanse i zagrożenia dla Polski*, Wydawnictwo Politechniki Radomskiej, Radom 2003, pp. 65–66]

[2] Bukowski S., op.cit. pp. 61–62.

[3] Mundell R., *A Theory of Optimum Currency Areas*, „The American Economic Review" Vol. 53, September, 1961; McKinnon R.I., *Optimum Currency Areas*, „The American Economic Review" Vol. 53, September 1963;. Kenen P.B, *The Theory of Opium Currency Areas: an Eclectic View*, (w:) Mundell R.A., Swoboda A.K. (red.) , *Monetary problems of the International Economy*, Chicago University, Chicago 1970; De Grauwe P. , *The Economics of Monetary Integration*, wyd. 3 uzup., Oxford University Press, Oxford 1997, pp. 7 –10.; W.H. Buiter, *Macroekonomic Policy During a Transition to Monetary Union*, Centre for Economic Policy Research, August, No 1222, 1995, p. 30–31.

[4] Grubel H.G., *International Economics*, Homewood, Illinois 1977, pp. 452; Wood G.E., *European Monetary Union and the U. K. – A Cost Benefit Analysis*, „Surrey Papers in Economics" No 3, September, University of Surrey, Guildford 1973; Magnifico G., *European Monetary Unification for Balanced Growth: a New Approach*, Princeton University Press, Princeton 1971.

[5] Krugman P.R., Obstfeld M., *International Economics. Theory and Policy*, wyd. 5, Addison – Wesley Publishing Company, Massachusetts 2000, pp. 622–630; Frankel J.A., Rose A.K., *The Endogenity of the Optimum Currency Area Criteria*, CEPR, Discussion Paper Series, No 1473, 1997.

On the basis of the theory of optimum currency areas it can be concluded that the countries which differ significantly as far as their economic development and mechanism of economy functioning are concerned should undergo the process of real convergence before they create a monetary union understood as a uniform currency area of single currency and uniform monetary policy implemented by the supranational central bank. What we mean here by real convergence is a process of deep structural and institutional changes in economy leading to the convergence of integrating economies as regards the levels of economic development, mechanism of functioning, the course of business cycle as well as the process of convergence to the criteria of the optimum currency area.

J.A. Frankel and A.K. Rose, who formulated the hypothesis of the endogeneity of optimum currency area criteria, represent a different opinion. According to them, historical data do not determine whether a given country is a good candidate for a monetary union In accordance with this hypothesis, formation of a uniform currency area creates conditions for a more intense intra-industry trade. This, in turn, is a factor leading to the convergence of business cycles. A high degree of integration in the field of trade (first of all through the development of intra-industry trade) in the case of countries of relatively well synchronized business cycles should lead to transformations of idiosyncratic economic shocks (i.e. the ones which are specific for a given economy) into an internationally coordinated business cycle.[6]

The literature on the subject lists the following factors determining the benefit-cost (stabilization losses) relationships connected with accession to and participation in the monetary union of single currency and uniform monetary policy.

- degree of the labor market flexibility, including wages (the higher the degree is, the lower the costs),
- degree of labor force and capital mobility (the higher the degree is, the lower the losses are),
- degree of openness of economy (the higher it is, the lower the losses are),
- degree of production and economy diversification (the higher it is, the lower the losses are),
- level of international competitiveness of economy (long-term competitive ability),
- degree of a given economy integration with economies of the currency area countries[7].

In the last case it is important to what degree a given country's economy is integrated with the uniform market of commodities, labor and financial market.

[6] Frankel J.A., Rose A.K., op.cit.

[7] De Grauwe P. , op.cit., p. 5–19, 69–86; Krugman P.R. , Obstfeld M., op.cit., p. 625–627.

It seems that even if we accept the endogeneity hypothesis of the optimum currency area criteria, the process of real convergence is necessary if the monetary union is to be formed by countries of different levels of economic development. What is more, deep structural and institutional changes are indispensable if economies of these countries are characterized by relatively rigid markets, prices and wages, a relatively high inflation rate, high budget deficits and public debt. In the case of economic shocks within the monetary union or in individual member countries (asymmetric shocks), the burden of adjustments will mainly lie with the market mechanism.

There is a relationship between a sustainable fulfillment of the nominal convergence criteria which have been discussed in the Introduction and real convergence.

The real convergence processes should lead to macroeconomic stability and sustainable fulfillment of the nominal convergence criteria.

From the point of view of the classical theory of optimum currency areas, the real convergence is most essential. On the other hand, from the point of view of the endogeneity hypothesis of the optimum currency area criteria, the achieved degree of business cycle synchronization is most essential.

According to the Report of the National Bank of Poland, in the case of Polish economy some progress in real convergence with the Eurozone countries was noted in the years 1999–2009. The business cycle in Poland is synchronised to a large extent with the Eurozone cycle and in particular with the cycle in Germany.[8]

The expected benefits of joining the Eurozone include: lower exchange rate risk and lower transaction costs, lower costs of bank servicing for enterprises and households, reduced uncertainty concerning price formation, reduced macroeconomic risk, diversification of risk within the framework of integrated financial markets (vital from the point of view of smoothing out the business cycles and financial system stability), increased trade exchange with abroad, increased investments and higher GDP. On the other hand, the expected disadvantages include: costs related to speculative attacks on the Polish zloty in the period of two years of its stabilization in the European Exchange Rate Mechanism II, costs related to the replacement of the zloty by the euro, costs related to the risk of losing international competitiveness by Polish economy as a result of re-evaluation of the exchange rate and costs of macroeconomic stability as a result of asymmetric shock occurrence.

It is worth mentioning that durable benefits from the Economic and Monetary Union membership will accumulate in the medium- and long term, whereas the accession costs – in the short term. It must be emphasized, however, that the

[8] The National Bank of Poland's Report on full membership of the Republic of Poland in the third stage of the Economic and Monetary Union, NBP, Warszawa 2009.

scale of benefits and their relationship relative to costs will depend on the macroeconomic policy implemented both before the accession as well as during the membership in the monetary union. During the preparations for accession, the macroeconomic policy should focus on reforms aiming at creation of conditions for flexible operations of markets including labour market, fiscal stability, stimulating entrepreneurial spirit and competitiveness of companies. Also privatisation of the remaining state enterprises, banks and insurance societies should serve this purpose.

3. Nominal convergence

At present Poland does not meet any of the convergence criteria except that of public debt. Moreover, what is very important, the indicators referring to the budget deficit to GDP ratio and public debt to GDP ratio worsened (see: Table 1).

Table 1 Poland – convergence criteria

Year	Rate of inflation (HICP) (%)	Budget deficit/GDP (%)	Public debt/GDP (%)	Long term interest rate (%)
2008	4,2	–3,7	47,2	6,1
2009	4,0	–7,1	51,0	6,1
2010*	3,9	–7,3	53,9	6,1
Reference value (%)**	1,0	3,0	60,0	6,0

*Data for 2010 concern period of 1.01 – 23.04.2010.

** reference value for inflation and long term interest rates concern period of April 2009–March 2010, for budget deficit – concern 2009.

Source: Own based on: *Raport o konwergencji*, Europejski Bank Centralny, Maj 2010 s. 33.

An increase in both quantities points to progressing destabilization in the area of public finance. This has been a result of the lack of public finance reforms in the period since1999 due to the electoral cycle. A high share of rigid expenditure in the budget (it rose in the period 2000–2007) at the slowed down economic growth in the period 2008–2009 and lower tax revenues constitute the foundation of the growing deficit. It is worth pointing out that budget expenditure is highly irrational and ineffective from the point of view of achieving social goals which it is to serve (e.g. expenditure on health service). Worsening of the budget deficit to GDP ratio and public debt to GDP ratio does not only move Poland away from the date of joining the Eurozone but also raises the macroeconomic risk and threatens with lower rating by rating agencies, which may cause unexpectedly negative reactions of financial markets.

4. Global recession and fiscal crisis in the Eurozone and Poland's full Economic and Monetary Union membership

Business cycle, economic growth and recession are natural phenomena in market economy, as natural as high and low tides, or the phases of the moon. Recession is a natural mechanism of clearing the economy of inefficient economic units and a mechanism of restoring the economic equilibrium after the economic growth induced turbulence.

Observations of the cycle and results of scientific research indicate that business cycle fluctuations cannot be reduced to one traditionally understood set of phenomena such as output, employment and investment fluctuations. They should be treated as a whole set of phenomena affecting one another[9]. In the upward phase of the business cycle (economic boom and growth) we deal with a self-stimulation mechanism, whose components include: alleviation of financial restrictions, increase in asset prices, currency appreciation as well as growth of economic efficiency at the micro-economic level and growth of the profit rate. These processes are usually accompanied by a growing inflation rate. Before the peak of the upward phase barriers start to occur in the form of deficiency in production factors, which leads to higher prices and production costs, lower rates of return on capital and the occurrence of financial restrictions. In the downward phase, a fall in production, employment and economic efficiency is observed as well as losses at the microeconomic level, lower asset prices and currency depreciation. These types of changes are a natural component of the business cycle. However, in some cases the above changes can become stronger, which is unnatural in comparison to the regular course of the cycle[10] These cases may concern the occurrence of economic shocks, demand- or supply-side ones, monetary and currency related ones, fiscal ones, etc.

Economic shocks are understood as unpredictable economic and/or political events either stimulating economic growth (favorable ones) or causing recession (negative ones). They can lead to a boom in economy which occurs earlier than it could be expected from a regular, predictable course of the cycle, a rapid and earlier slump and recession, a higher economic growth rate and longer lasting upward phase, or a deeper and longer recession.

Shocks of financial nature in the situation when the financial system of economy is liberalized and adjusts easily to the fluctuations in economic activity are particular cases. In such circumstances a tendency to take risks in pursuit of

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[9] Barczyk R. , Kąsek L. , Lubiński M. , Marczewski K. , *Nowe oblicza cyklu koniunkturalnego*, PWE, Warszawa 2006, p. 15.

[10] Minsky H.P., *The Financial Instability Hypothesis*, „ The Jerome Levy Institute of Bard College Working Paper, No 74, Blithewood. May 1992, p. 14–15.

higher return rates on capital is an important factor stimulating changes in economy. This particular aspect is reflected in many theoretical concepts and among others in H. Minsky's financial instability hypothesis.

H. P. Minsky drew attention to increasing fragility of the financial system before the top point of the cycle. He also claimed that in market economy, the period of growth is followed by the emergence of financial structures susceptible to deflation, a decline in the value of assets and deep depression[11]. The problem, however, is rooted in the fact that the amount and structure of liability repayments are explicitly determined, whereas revenues are subject to business cycle fluctuations.

The financial system fragility is also manifested in the fact that seemingly slight disturbances can lead to a sudden economic slump.

A factor which strengthens unfavorable tendencies can be expansive economic policy – both fiscal and monetary one – leading to the occurrence of speculative bubbles, especially in the real estate market. On the other hand, a stricter monetary policy leading to bursting of the speculative bubble usually causes an immediate collapse of the business cycle. Allegedly, this, among others, may have been the case in the American economy when the FED raised interest rates in the years 2004–2006.

Recapitulating, recession would have appeared in the years 2007–2009, because this was a natural consequence of the business cycle logic. Yet, its severity was determined by a large scale of the financial crisis. The causes of this crisis should be looked for in the nature of the system and financial mechanism in the market economy. Still, its severity results from the following:

- Expansive monetary policy of the US government,
- Exacerbation of monetary policy by raising the FED interest rates on federal funds in the period from July 2004 to July 2006 in the USA,
- Development of financial engineering and its large-scale usage (ABS, CDO, etc.) at poor risk assessment accomplished by rating agencies,
- Creation by the state of an impression of less strict limitations for companies and related to this higher expectations of companies,
- Detachment of corporate management from the ownership supervision and related to this pursuit of high return rates at a price of high risk.

Countries of very high share of rigid expenditure in budget spending and high public debt in relation to GDP, by using public debt rollover become particularly vulnerable to the crisis of public finance and long-lasting recession. Financial market responses to all signals concerning a country's macroeconomic risk in connection with budget deficit and debt are violent.

Growing public debt relative to GDP, caused by a growing budget deficit leads to a higher risk of investment in treasury bonds and difficulties with

[11] Ibidem, p. 4–5.

placing new issues in the market. This also means higher profitability of bonds in the financial market and difficulties in obtaining capital for debt servicing and repayment at the maturity date falling in a given year. Increasingly higher interest rates are necessary to encourage investors to buy bonds due to a higher investment and a country's macroeconomic risk. This, in turn, leads to higher public debt and further difficulties in debt repayment, necessity of further bond isses and, in case of no possibilities of placing them in the market, to insolvency.

All the above mentioned are accompanied by the contagion effect: reduced ratings for further countries of high debt and public deficit to GDP ratio, higher costs of debt servicing and difficulties in placing new issues indispensable for obtaining capital for debt repayment in the case of still further countries.

The case of Greece is noteworthy in this context. It shows how financial market responses to a growing macroeconomic risk lead to a deep financial crisis and government's loss of capability to settle liabilities on account of public debt.

The cases of Portugal, Spain, Ireland and Italy in the period of 2008–2010 are further examples of contagion effect and fiscal and financial crisis spreading to other countries.

Experiences of these countries from the Eurozone reveal that lack of fiscal stability, excessive share of rigid expenditure in budget spending, high budget deficits and public debt relative to GDP lead to deep, adverse economic shocks which result in a higher risk of insolvency, reduced competitiveness of economy, significant GDP drop and high unemployment. Resigning from their own monetary policy and currency is particularly dangerous in the case of countries of lower international competitiveness of their economies and unstable macroeconomic policy. A case in point here is Greece. Restoring economic equilibrium and raising competitiveness in foreign trade requires either a depreciation mechanism at a volatile exchange rate (devaluation at fixed exchange rate) of national currency or, in the case of lack of such tools, adjustments on the side of prices and wages. In the case of low flexibility of commodity and labor markets it is not possible.

The first test to macroeconomic stability of Polish economy, including the fiscal one, shall be a two-year period of stabilizing the zloty exchange rate in the ERM II. The experience of speculative attacks on the Polish zloty at the end of 2008 indicate that one must take into consideration serious consequences of speculations in the situation of a fixed exchange rate with the fluctuation band of +/– 15%. Budget deficit and high public debt relative to GDP will certainly become the factors destabilizing Polish currency and encouraging such speculative attacks.

In the membership period, also the impact of the lack of sustainable fiscal stability will be dangerous. Adoption of uniform currency on the one hand creates a broad market for placing treasury bonds issues, but, as it was indicated above, success of such operations depends on ratings and risk assessments by financial markets. These, in turn, are affected by the stability of public finance. The experience of the Eurozone countries in the field of public finance reforms shows that limiting the budget deficit in relation to GDP to a reference value of 3% by raising taxes and "cosmetic" cuts in expenditure do not stabilize public finance durably[12]. Besides, raising taxes and a higher indicator of fiscalism slow down the economic growth rate in the long term. High taxes including income taxes of high progression have an adverse impact on the economic growth rate in the long term. High tax burden disturbs decisions of economic entities, raise labour costs (increase in non-wage costs), reduce private savings rate and reduce effectiveness of the production factor use. This is confirmed by results of empirical investigations by, among others, W. Easterly, S. Rebelo[13].

Thus another type of reforms is indispensable. They should be based on reduction of budget expenditure including the so called rigid expenditure. This should be accompanied by a change in the structure of budget expenditure. Priority should be given to the expenditure on science, R&D, education, infrastructure, efficient legal system and public order functioning. Balancing the budget should also mean a lower share of public goods in economy to the benefit of private goods. The reform of the social insurance system is also indispensable. The previous one was halted.

The reform of expenditure should be accompanied by a tax reform which would aim at reduction of the tax burden for enterprises and households.

Fiscal tightening does not have to cause a decline in the output in the short-term, but in both short- and long term can stimulate economic growth. Two types of effects of fiscal policy tightening can be distinguished: Keynesian and non-Keynesian. The Keynesian approach assumes that that a change in the public sector demand is stronger or bigger than a change in the private demand, which leads to a drop, or in the case of fiscal policy tightening a drop in the output. In the non-Keynesian approach it is assumed that a change in the public sector demand is weaker or smaller than a change in the private sector demand. Therefore stimulating the output growth through higher state expenditure is not very effective, whereas reducing of this expenditure (public sector demand) leads to higher output[14] The non-Keynesian approach is more and more often

[12] Demertzis M., Hallet A.H., Rummel O., "*Is the European Union a Natural Currency Area, or Is It Held Together by Policy Makers*?"," Weltwirschaftliches Archiv. Review of World Economies", Band 136, 2000, Heft 4.

[13] Easterly W., Rebelo S., *Fiscal Policy and Economic Growth: An Empirical Investigation*, NBER Working Paper, No 4499, Cambridge, October 1993.

[14] See more on the subject: Rzońca A., *Czy Keynes się pomylił? Skutki redukcji deficytu w Europie Środkowej*, Wydawnictwo SCHOLAR, Warszawa 2007, pp..19–31.

confirmed by the results of empirical investigations. F. Gavazzi and M. Pagano analyzed the effects of fiscal policy tightening in Denmark after 1982 and in Ireland after 1989. In the former case public consumption was cut and taxes were raised, whereas in the latter only public expenditure was reduced. In both countries the average GDP growth in the period of fiscal policy tightening was higher than in previous years.[15] A. Alesina and R. Perotti analyzed the effects of severe fiscal policy tightening in 20 OECD countries in the period of 1960–1994. Results of their research indicate that improvements in public finance were more durable when fiscal consolidation was accomplished by reducing state expenditure on wages and transfers and not by tax raising. Besides, in the period of fiscal consolidation which brought about a sustainable effect and was implemented through budget cuts in the period of budget deficit reduction, private consumption increased as well as private investments and the output.[16]

Results of A. Rzońca's research which included effects of fiscal policy tightening in post-communist countries (Hungary, Latvia and Lithuania) in the 1990s[17] confirmed the thesis about the non-Keynesian effects of fiscal consolidation. The non-Keynesian behaviour of the output dynamics was more frequent in the examined countries than in well-developed countries. The author also came to the conclusion that stronger integration of Central and Eastern Europe's countries after 2000 creates chances that the impact of the positive supply-side shock induced by fiscal tightening on the output should overweigh the shock in domestic demand[18].This refers to Poland too.

Unfortunately, the process of public finance reforms is usually a long one, even in favorable political circumstances, as can be exemplified by R. Reagan and M. Thatcher's reforms. This type of reforms encounters vital barriers which, among others, include: the electoral cycle, resistance of state bureaucracy and resistance of different privileged social groups. The reforms aiming at making the labor market more flexible are equally difficult due to the resistance of the trade unions, not to mention the reforms aiming at simplifying the economic law and removal of barriers to the entrepreneurship. However, without radical reforms the date of a relatively safe introduction of the Polish zloty into the ERM II and last but not least accession to the Eurozone will be an increasingly distant one. The experience of the Eurozone countries indicates that without macroeconomic stability it is not possible to achieve more benefits than costs in the long-term.

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[15] Gavazzi F., Pagano M., *Can Severe Fiscal Contractions Be Expansionary? Tales of Two Small European Countries*, NBER Working Paper No 3372, Cambridge 1990.

[16] Alesina A., Perotti R., *Fiscal Adjustment in OECD Countries: Composition and Macroeconomic Effects*, NBER Working Paper No 5730, Cambridge ,August 1996.

[17] Rzonca A., *Czy Keynes się pomylił?...*op.cit., pp. 159–294.

[18] Ibidem, p. 292.

5. Conclusions

The date of Polish membership in the EMU becomes more and more distant. Political declarations concerning quick introduction of the Polish zloty into the ERM II and the monetary union membership are deprived of any economic sense without the political will to introduce economic reforms into the area of public finance (including social insurance), labour market and deregulation of economy. To enter the EMU at any price is possible. It is possible even to meet the nominal convergence criteria in an artificial way. But what then? Without durable changes ensuring immunity of economy to economic shocks it is difficult to talk about future benefits from the euro adoption. What is left are threats. It is explicitly shown by the experience of some Eurozone countries.

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(Summary)

Global recession of 2007–2009 has had a significant impact on the Eurozone functioning and has aroused much controversy over the monetary union membership of the new countries (including Poland) as well as the legitimacy of the monetary union formation by countries of different development levels and different degrees of fiscal discipline.

Should Poland pursue full membership in the Economic and Monetary Union? If the answer is yes, then the question arises "when"? How should economy and the state get prepared for this move? There are no unambiguous answers to these questions. The aim of this paper is to outline possible answers and, first of all, to formulate problems for the discussion.

The experience of the Eurozone countries from the period of 2007–2009 indicate that the economies which fulfilled the nominal convergence criteria in an "artificial" way, i.e. without thorough reforms in the area of public finance, markets – including labour market – have incurred high costs of the recession in the situation when they have neither their own currency not monetary policy. Poland's full membership in the Economic and Monetary Union should be preceded by thorough reforms consisting in market (including the labour market) deregulation and liberalisation and the public finance reform. In the case of public finance the changes which are necessary refer to both reducing expenditure and taxes. The change in the public expenditure structure is also indispensable.