“Problems of monetary integration with the euro area: the case of Poland”

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Over the past several years, Poland’s understanding of the financial variability of the free market economy and changes caused by its forces, as well as Poland’s ability to independently estimate causes & effects in the future have improved significantly.

Poland is observing and searching for economic fair play void of stealthy fraud and poor leadership. Poland has over one thousand years of national self-sufficiency; experience in world politics, far reaching trade partnerships, and lastly a grand heritage of a loyalty to liberty, affection for freedom, and an iron devotion to stand its ground.

Over those years, Poland’s understanding of geopolitical forces and her expertise in estimating the effects of those forces on herself, with or without the euro, has - as expected - improved extensively. Poland and the złoty are here to stay.

1. Conditions of effective functioning of a single currency area.

The transfer from Poland’s national currency, the zloty, to the euro will be beneficial; however, it is affixed with costs. Those affixed costs refer to monetary policy of the National Bank of Poland, i.e., NBP. The fact that some of the European Union member countries did not join the euro single currency area has logic of its own.

That is why the dilemmatic solution of Poland’s monetary integration with the single European currency of the euro requires the careful economic calculation of the profitability of this economic quagmire and precarious venture into Poland’s financial future, in particular because the decision to replace the złoty with the *euro* is irreversible.

While considering the dilemmas of integration, examining all the findings of the theory of optimal monetary area should be duly and diligently taken into account.

At this point, we will focus on the entire selection of the theory of optimal monetary area’s key requirements and vital conditions necessary for a country applying for membership to fulfill in order to be able to join a single currency area.

For a single currency area to characterize its functional stability and bring benefits to its member countries, it should fulfill a few important conditions.

The course of the business cycle in all the member countries of the single monetary area should be unidirectional, where all member countries should either be in a phase of recovery or recession.

If the uniform instruments of monetary policy are in place, then the effects should be similar in all of the single European currency regions. Otherwise, monetary policy will intensify inflationary pressures in some member countries, while elevating unemployment figures in others, contributing to discrepancies in economic expansion. So, GDP growth rate shouldn`t diverge deeply across single currency members.

In fact, the rate of GDP growth exceeded 6 percent in some euro countries in 2007, while in others the GDP growth oscillates around 1 percent. GDP growth of Germany and France reached merely 1.2 %– 1.5% in 2010 while Greece and Ireland notified GDP fall between 1.5% - 2.0% at the same time.

Certainly, it could be argued, that the imperatives are not only in the differences in the rates of GDP growth, but also in the degree of convergence of a business cycle in member countries.

In reality and by relation the correlation is far better than in a comparative analysis of the differences in the rates of GDP growth. The first studies to compare synchronization of the business cycle in Poland with that within the euro-currency-area are already known.

Converging of economic activity of Poland with countries that created the single currency area is oscillating in the neighborhood of 50 percent. It could be stated without great error, that this converging of the economic activity of Poland with that of countries that created the single currency is not yet in place.

Close response should be present to external supply and/or demand shocks of all member countries of the monetary union. A good example of an external supply shock is an increase in the price of oil. Different effects of increases in energy prices in selected regions of the monetary union could differentiate business cycles in those respective member countries.

The task of the Union though is to bridge the gaps in the economic development of individual regions. As is known, the euro currency member countries react differently to increases in the price of oil as a result of different conditions to the access to that raw material and incongruent energy consumption in production.

Such taking to task shall deepen the disparities of costs and conditions of production along with all the consequences for a greater differentiation in the European Union citizen’s income and standard of living.

The geographical structure of foreign trade is also different. Eastern European euro-currency-area countries have historically cultivated closer trade relations with Russia in contrast to Western European countries. This above stated reality originates, hence, that those distortions in trade exchange influence diverse impacts on business activity. An example of an external demand shock could be an influx of speculative capital into a country’s financial market.

The influx of foreign currencies causes an internal increase of the money supply and an overall increase in internal demand. The central bank, in such a situation, loses its control of the internal supply of currency in circulation, which in turn threatens macroeconomic stability. In finality it could end up in an inflationary spiral. An effective instrument in the absorption of external demand shocks could be a change in the rate of exchange of the domestic currency.

In the above situation of an influx of foreign direct investments, i.e., FDI, the policy of market appreciation of the rate of exchange of domestic currency could restrain internal inflationary pressures. Studies conducted by the NBP show that external demand shocks in Poland have an asymmetrical character in relation to external shocks that are touching countries with the euro currency.

The exchange rate of a domestic currency could be a fiscally effective instrument for lessening the negative implications of those external demand shocks on Poland's economy.

"If those external demand shocks in Poland will not be symmetrical in relation to the course of events in the Euro-area, then the acceptance of the euro currency will additionally escalate the fluctuation in production."

It seems so; the process of divergent reactions to external shocks within the euro-area member countries deepens. According to the comparative cost theory, we are observing in specific countries a long-term sector specialization process. Parallel to the above, this accompanied to those specialization processes are the processes of concentration of production.

Those particular countries are specializing in the manufacturing of precise products. A phenomenon of the domination of certain industries in a given European Union member country and a certain selectivity of development sets in as well. The situation of selected sectors and shocks touching them must therefore differentiate the state of economic prosperity.

In the end, those shocks related to sectors in selected countries participating in euro currency would lead to a greater fluctuation and differences in states of economic prosperity. Those particular European Union countries will asymmetrically react to external shocks.

This in turn, should mandate a dissimilar demand for monetary policy. The European central bank's uniform monetary policy will not be in a position to level out diversified causes of asymmetric shocks.

An anxiety exists, that differences in stages of economic development will give way to the preservation of, instead of the narrowing of, those differences.

There is also a peril, that in a long-term process of specialization, Poland would fall into a disproportionately dominating share of only labor-intensive production on account of its relatively low costs of labor.

The high-tech sectors and innovative production could bypass Poland, so in fact that could mean reinforcement of economic backwardness. Poland's economy is marked by both high degrees of resources and energy consumption. It is a remnant of the socialistic period of ineffectiveness in structural development.

In contrast are the economies of Western European countries, which developed more technologically advanced economies. In those countries of the old European Union the contribution of technological thought has definitely contributed a greater share in the national income than in Poland.

The above circumstances justify worries that eventual external shocks will have a rather diversified impact on *different* members of the euro area. So this in turn prompts a conclusion, that the course of the state of economy will not be unidirectional, but multi-directional.

There should exist throughout the entire monetary union of the euro almost full elasticity of prices and wages, and at that time the market mechanism should guarantee optimal allocation of factors of production.

Market laws are there in place to ascertain free flow of goods and services, financial capital and workforce to those regional economic spheres where the prices are higher than those regional economic spheres where the respective prices are relatively lower.

Production of goods should be developed where prices and earning capacity or profitability are higher at the expense of the regions where prices are less expensive. So in turn, this will lead to the equalization of prices and the supply of goods.

A similar economic phenomenon should ensue in the case of the flow of financial capital. Savings should flow where the interest rate is high at the expense of regions with a lower price of capital lending. A high interest rate is, after all, an expression of capital shortage, but at the same time, a low interest rate reflects its comparative surplus.

And now, as the result of the last financial crisis, one can notice rising divergence of market interest rates across euro area countries. In situation of uniform basic central bank interest rate for all members, this situation results in different real price of money and its different influence on real economies.

The law of one price and market mechanism should run to optimal redistribution of workforce in the whole euro area. The workforce should flow where earnings are higher at the expense of regions with lower wages. High earnings are the reflection of the shortage of supply of hands to work while low earnings express their oversupply.

Here a fundamental question emerges, whether price and wage elasticity that exists yet in Euro-land to a degree guarantees functioning of the law of one price?

This statement of ascertainment would be much too optimistic.

The degree of oligopolization of Euro-land's national economies, powerful unions of employers and professional trade unions are affecting rigidity of prices and wages. It is the rigidity of prices and wages that impedes the optimalization of redistribution of factors of production.

Another manifestation of the functioning imperfections of a market mechanism in the Euro-area is a still remaining set of restrictions in the service sector. Trade barriers and legal restrictions are simply, and quite frankly, intensifying. And, it obstructs the operation of competitive business functioning of Poland’s small and medium-size companies in the uniform economic area.

Above all, some of the Euro-area’s countries insert *in their trade laws* restrictions on the access of foreign capital to certain industrial branches of manufacturing. And it is done so for the consideration of the given country’s economic security.

Lastly, the application of the system of production limits, not infrequently, with a complicated system of subsidies, has vaguely to do with free competition. All of this affords that a key condition of the theory of optimal monetary area, i.e., free flow of factors of production is not existent in Euro-land.

2. Benefits From The Integration With Euro Area:

Poland has chosen floating exchange rate system for its currency. This flexible system results in high volatility of market exchange rate of zloty. In consequence, polish businesses have to bear exchange rate risk on its shoulders. In extreme situations, huge exchange rate changes can even destroy profitability of business undertakings.

If we consider export sector activity, it is obvious, that rather fixed not floating exchange rate system would be beneficial to Polish enterprises.

Monetary integration and exchange rate elimination should favor influx of FDIs to Poland from euro area and from countries beyond EU territory.

Poland, which is in the heartland of a huge European consumer market with an abundance of cost-effective labor, has a historical chance to become an exceptionally attractive location for a new influx of FDIs not only from European-based companies, but also from enterprises from the rest of the world interested in high quality investments.

However; the next question arises, whether the elimination of the exchange rate will rally the influx of new FDIs?

In these times it seems, rather, that the primary motive of investors related to the secure allocation of capital depends to a lesser degree or is secondary to the relevancy of the elimination of the exchange rate risk.

For example; the decisions pertaining to the construction of a production facility and the purchase of an already existing one depend first of all on such quantifying factors as tax rates, economic cost-benefit-earning-ratios and the state of its technological infrastructure.

As a consequence, issues of the exchange rate risk have become less relevant.

According to theory of optima monetary area, as a resulting consequence of the elimination of the exchange rate risk, and thereafter, merging Poland's national currency, the złoty, into the single pan-European currency of the euro, ought to enhance efficiency and effectuate development of inter-European trade.

So in result, the theory of optima monetary area should originate and materialize trade creation effect, but does it do so? Even so, in this case doubts arise as well.

In actuality; however, the participants of the single European market have long since been accustomed to a variety of business deals, designed to hedge against fluctuations of exchange rate risk, allowing them to precisely measure and ascertain return on their business undertakings

Truthfully, these technically complicated hedge deals are costly, yet effective.

Nevertheless, the history of the international market for currency exchange demonstrates that exchange rate risk, which is highly inclined to fluctuate, is not an obstacle to the dynamic trade growth.

For example, growth in volume of Poland's exports and imports, by 20 percent in 2007 and by 15% in 2010 was impressive. Probably then, the hedge deals and currency swap options, protecting the parties involved in currency exchange deals against fluctuations of the exchange rate, may eliminate anxiety from possible financial losses.

The pointing argument for the salutary effect of the unification of national currencies into one single currency for the dynamic of the overall growth of trade exchange within the euro currency area is, without a doubt, too optimistic.

The research studies on the effect of the trade creation in single European currency are already available. The mostfresh data show that elimination of the exchange rate risk between single European currency member countries has resulted in additional growth in mutual trade exchange between 5 and 10 %. The above score would not run us to optimistic expectations however.

An essential advantage of the usage of a single currency in euro area is the elimination of transaction costs associated with the purchase and sale of currencies. In consequence, uniform transaction currency has permitted to lower the cost of conducting business activity.

Because prices among the countries within the European Union will be expressed in a single European currency, the euro, their comparability will be made easier, so that, in turn, it will make rational the creation of an optimal economic record by business entities and it will, as well, facilitate the decision making process in relation to the allocation of capital. And to some extent, the above mentioned arguments are beyond discussion. Nevertheless, the gains in financial savings due to the elimination of transaction costs are not major.

In this era of electronic settlements transacted by computers, the transaction costs are rather slight, ranging around 0.1 percent of the European Union's GDP. The argument for financial savings cannot, however, be the key argument in favor of the liquidation of a national currency.

Increased competition within the Economic and Monetary Union as well as more generous external financing should incline Poland's companies toward modernization and innovation.

The accumulated efficacy of the above stated factors should stimulate faster economic growth. So in turn, the following question arises; *will the single financial market make access to financial capital easier for companies native to Poland?*

Nevertheless, the assumption of generousness of capital for Poland's companies after unification of the zloty to the single euro currency area is, at this time, a very optimistic scenario for the development of a single financial market in European Union.

Therefore, it is imperative to have in consideration as well, a more realistic scenario such as the issue of admittance of Poland's companies to new sources of financial capital. These possibilities of receiving credit or issuing bonds, hence, not only depend upon the size of the market but also upon the financial standing of the credit borrower. And from this point of view, not much will change as well.

In the credit application process, the company ought to be trustworthy, ought to have a really feasible business plan, which depends on entirely dissimilar factors than the integration of the local financial markets into a single European market. In this aspect not much will change as well.

After all these stated specifics, companies native to Poland have all possibilities for acquiring credits and/or issuing bonds in foreign denominated currencies, and on foreign financial markets, and at any moment.And out of these possibilities those domestic companies are fully taking advantage as it has been attested by their astronomical foreign indebtedness

.An incorporation of Poland1s zloty into euro area, will be conductive to the integration and development of a singular European financial market. The competition will intensify among the banks and other financial institutions. This will originate tender expansion in financial services and reduction of financial brokerage costs with the benefit to the clients of this sector. Also, the cost of funds transfer will submit to the influence of the Economics and Currency Union frame. And what is very important, increasing competition between financial groups should result in lowering market interest rates.

As a result of development of the financial market it should be easier for Poland's banks to obtain funds necessary for financial liquidity management.

3. Costs of integration with Euro-area

The costs of monetary integration with euro currency will be high.

One of those costs will be the loss of the right to issue currency by the national central bank, as well as the loss of seigniorage gain. In case of a sovereign state, seigniorage is an important source of revenue for national banks, where the central bank introduces money into the economy through the crediting of commercial banks. The interest on the credit granted to complete the liquidity of the banking sector is an element of revenue from the issuance of money. Granting credits to commercial banks is a natural not inflationary channel of completion of the shortage of money in circulation.

It appears that full liberty in the field of granting credits to commercial banks and saving them from the loss of liquidity is an important attribute of financial sovereignty of the sovereign state. In a country with its own sovereign currency, it is the national central bank that decides whether and when, and which banks are to be saved in the situation of threat of the financial crisis.

This possibility for acquiring aid is especially important for Poland's poorly equipped commercial banks that cannot rely on the financial aid from powerful foreign holdings having been operating on a global scale for tens of years.

The next question arises, *whether under threat of global financial crisis, native banks of Poland can count on the financial help from the European Central Bank?*

It seems that the domestic central bank and not a supranational bank is a more reliable guarantor to come to the rescue of commercial banks from the loss of financial liquidity. The latter, in its decisions, must therefore also be taken into account. And this decision may be completely different and may require quite different financial policy solutions.

Also it appears that the long-term endogenous or proceeding from within process of the integration of Poland's economy with the European Union's economy will most certainly result in price adjustment processes.

There will be a process of price convergence, i.e., the process of alignment of the level of prices in Poland with that of the European Union, which in turn will cause intensified inflation in Poland.

The process of price convergence results from the Balassy-Samuelson theory of uneven growth in labor productivity and similar wage growth in the manufacturing sector participating in international exchange, and in the sector of the economy not participating in primarily the service sector, including financial services.

.In a country supervising its own currency, the inflation growth rate could be restrained by nominal and real appreciation of the exchange rate. The resignation from and substitution of a national currency to pan-European currency deprives the country of Poland of a very important anti-inflation policy instrument. Exacerbation and intensification of inflation in Poland will, nevertheless, have further consequences.

With the same level of a basic interest rate in the entire Euro-area, relatively higher inflation in Poland will cause the real interest rate, i.e., nominal interest rate minus inflation index, to be very low or even negative.

A low price of lending capital, in real terms, may discourage people from saving and might lead directly to excessive credit expansion. In addition, a low price of lending capital exerts pressures, not only with a continuing intensity of inflation, but also with a crisis in the financial markets.

A significant economic cost for Poland will be the resignation or surrender of its sovereign NBP monetary policy, and therein, the relinquishment of its own policies of exchange rates, interest rates, and money supply,, as well as its policy of forming a foreign exchange agenda. The formation of money supply by the central bank could be a significant instrument of limiting economic fluctuations within a country.

For the present, the great probability exists that the European Central Bank will conduct its monetary policy, taking into consideration the state of the economies of the largest countries of the euro currency area. Pointing to that is the direction of a reform of the European Central Bank to floating an increased voting share of the economically strongest countries at the expenditure of countries with a weaker economic potential. For, the most important mechanism of a monetary policy is the interest rate instrument of the central bank.

Separate interest rate policy of the central bank seems to be highly beneficial in current macroeconomic conditions of Poland.

For example, an actual rise in the interest rate of the National Bank of Poland, as an effect of inflationary pressure (4.5%) and very low level of the base interest rate of the European Central Bank (1.0%), diminishes the risk of financial instability in our country. But, an unavoidable decline in the basic interest rate, at the moment of the adoption of the euro, would provoke an impetus for an increase in demand bank credits, as well as a speculative bubble. As a result, this could threaten a financial crisis in Poland.

The system of decision making in the European Central Bank is disadvantageous to smaller countries, in relation to the Euro-land countries with the largest and/or most prominent economic potential. Representatives of the richest countries, who are, as well, on the ECB Management Board, statutorily dominate the ECB Governing Council, which take up its strategic monetary decisions. So it is hardly possible for ECB decisions to collide with the interests of the richest countries, in the case of conflict of interest between individual countries.

The stronger is always right, so this maxim's correctness confirms the ECB decision-making system and validates how decisions are being made within the ECB system.

The annexation of zloty to the euro currency would indicate the relinquishment by the state of its own terms for an exchange rate policy.

As for Poland, its exchange rate policy still continues to constitute an important instrument for shaping economic activity as well as for the leveling of the negative effects of external shocks, i.e., sudden changes in international capital flows or in international trade.

The depreciation of the rate of the zloty, i.e., Poland's national currency, positively influences recovery of the price competitiveness of Poland's foreign trade, facilitating exports and decreasing imports.

The tool of export stimulation should, nevertheless, create possibilities of incidental correction and the restoration of the competitiveness of Poland's commodities on foreign markets.

Today, Poland is already a country with a fairly large share of its foreign trade contributing toward the creation of its GDP. The resulting outcomes of Poland's foreign trade on external markets have a significant impact on the state of the domestic economy. And premature surrender of an imperative instrument, which is the exchange-ability of the external value of its currency, will obstruct the abilities of policy to amortize or absorb consequences of external shocks.

The fluctuation of the euro exchange rate could, in the future, even restrain the state of the economy in Poland, instead of improving it. Hence, if appreciation of the euro currency does not accompany parallel increases of work productivity in Poland, then *will the price competitiveness of Poland's goods deteriorate?*

Poland's currency integration with that of the European Union will denote or imply the loss of control over Poland's national monetary policy; therefore, the weight of adjustment processes upholding stable prices will have to, consequently, rest alone on fiscal policy.

However, rigorous Maastricht Treaty conditions concerning permitted fiscal deficit and fiscal indebtedness limit do not give possibility to apply this important tool to shape real activity situation.

However, as has been acknowledged earlier, as well, in this sphere of public finance, the severely rigorous laws will appear, herein, as having a relationship to the necessity of adhering to the state of affairs of the Maastricht Treaty.

Could, thus, a probable policy of upholding a high rate of economic growth be feasible?

Subsequently, it might be possible to have several doubts in regard to that aforementioned question indeed. Additionally, the largest countries of the European currency area are currently not the best example for the replication of their fiscal policies within the sphere of economic growth. The relatively low GDP growth from 2003 to 2007 in France and Germany, around 2.0 – 2.5 percent annually and recession in the period 2008-2009, cannot be a pattern to be followed.

Such an economic growth rate in Poland would probably lead to the preservation of existing disparities in the standards of living among citizens within the European Union.

Therefore, Poland would be predestined to become a second-class country, a source and supply of low-cost labor, an area of resource intensive production, and of low complexity of technology.

The largest Euro-area countries are attaining worse macroeconomic indices than those of European Union countries that did not adopt the single euro currency.

For example, countries such as Denmark and Sweden not only achieved a higher GDP growth rate, in comparison with France and Germany, but also marked a lower unemployment rate and a more favorable situation in balancing a budget. Also, the first two countries, in relation to the state of affairs of competitiveness of their economies, were certainly in leading positions.

For that reason, projection of high, long-term economic growth, connected with a new place and/or area of work creation should be an indispensable requirement to reign in the phenomenon of the outflow of the skillful workforce from Poland. And migration of the personnel searching for employment, by decreasing the supply of the workforce, intensifies wage demands within the country. This, in succession, leads to actual wage growth, as well as increases in the costs of production and to higher inflation.

The necessity of adhering to inflationary limits, imposed by the Maastricht Treaty, consequently obligates the central bank to the interest rate increases and to the realization of a restrictive monetary policy. In eventuality, the outflow of the workforce from Poland abroad leads to the hampering of economic growth.

The efflux of the workforce has one more consequence for Poland's economy: it results in a decline in the pension income premium to the Social Insurance Fund. And therefore it impends or coincides with the imminent disintegration of the Social Security system.

There also exists another, more straightforward cost of monetary integration with the European Union's single currency. This cost is, it obligates transferring a huge part of the reserves of the National Bank of Poland to the European Central Bank.

Thereafter, Poland's central bank will not take up the issue of the *zloty* exchange rate ever again. And the National Bank of Poland, thus, will not be able to carry out interventions on foreign exchange.

As a consequence, these subject matters will be taken up by the European Central Bank, for which foreign reserves could be needed for intervention on foreign exchange markets in order to stabilize the exchange rate of the euro. Only part of these reserves will continue to be in the safekeeping of the National Bank of Poland. These reserves will eventually constitute protection in the event of any unfavourable, random incidents.

Poland's foreign exchange reserves are not as high as Poland would like them to be, at the moment, but are, rather, at the average of the international level. The obligation of transferring the foreign exchange reserves of the National Bank of Poland to the European Central Bank will undoubtedly be a substantial liability for Poland's economy.

4. Benefits vs. Costs of Poland's Monetary Integration

In *this* discussion on the monetary integration of Poland with the Euro-area, a lot of attention is generally paid to the benefits from this enterprise. It is not mentioned that there will be high economic and financial costs. And Poland will certainly incur the costs of integration with the currency of the euro, whereas the benefits from it are only plausible.

It is essential that the costs of integration may be initially incurred, before some positive aspects of this undertaking possibly become evident.

That is why Poland's decision to unite within the single currency monetary area of the euro, and give its monetary reigns away to the European Central Bank should in all probability be postponed until Poland is assured of economic success

Also, it would be advisable to make use of the upcoming decade to carry out an active state policy in order to maintain the high economic growth necessary to bridge the economic disparity between Poland and other member countries of the federation of sovereign states of the European Union.

It would be very difficult to quantify and summarize in financial terms all the benefits, as well as costs, of this integration. The series of benefits and costs of integration are by and large of the quality character therefore are impossible to express numerically and/or quantitatively. And the acid test or assessment attempt of all possible express occurrences and events accompanying the long term process of convergence in numbers would be saddled with an especially large mistake. So, it appears that there remains a performance grade test of quality nature, exclusively based on experiences of other EU member countries.

Full economic openness to competition from firms of euro area countries will require from polish enterprises abilities of adjustability to new, more difficult conditions of efficacy in a unified market. Firms native to Poland have to instruct themselves with insistent performance, rapid adaptation to ever-changing economic conditions and a relentlessly unyielding drive to innovation.Those are the conditions of betterment for the perpetuation of their competing positions within the demanding market of the European Union. The betterment of the competing position of Poland’s economy within the European Union, as an expression of a real convergence, is therefore, indispensable because the benefits of monetary integration should surpass its costs.

Without doubt, entering single currency area will set free endogenous sources of growth for innovation in Poland’s enterprises, as well as modernization of the entire economy. However, real convergence should be accomplished, before undertaking the decision of joining the euro monetary union. And real convergence condition needs active local policy mix to stimulate Poland`s economic growth.

5. Concluding Remarks

Integration with the euro area could bring benefits to Poland’s economy, but is also related to costs. The costs will surely be managed by Poland, while the benefits are only probable.

In the situation of a significant delay of Poland`s in relation to euro area, it would be beneficial to take advantage of the upcoming decade to maintain high rate of GDP growth under stable macroeconomic conditions. And close monetary integration with the euro-area will only be possible after completion of the real process of economic convergence. Real economic convergence means a long-term process of bringing Poland`s GDP per capita close to the average per capita income in euro countries. This process will take time but it will allow the level of the economic development of Poland approximate the level of euro member countries.

Premature currency unification poses the risk of preserving and escalating existing differences in the levels of economic development between Poland and euro area.