THE COSTS AND BENEFITS OF CURRENCY CONVERGENCE: THE CASE OF POLAND

Political decisions regarding the economic sphere always require a compromise as they are enmeshed in conflicting interests. It seldom happens that a given envisaged theoretical solution has virtually only pros and totally no cons. If that were the case, economists would be unnecessary as there would be no matter subject to comparative analyses, or their task would be as easy as it seemingly is to assess which of the good and defect-free scenarios is better.

Reality, however, is far more complicated, to such an extent, at times, that no wonder even the most professional circles, rational in their assessments, are unable to reach a consensus. This is all the more obvious if a problem is complex, multi-layered, likely to generate conflict, if it goes beyond one country's borders and the time horizon typical of politics, and, most of all, when benefits and losses intersect. Estimating their balance is difficult and risky as it must rely not only on correct economic models but also on making various assumptions, which are controversial by their nature.

This is exactly the situation of the common multi-state currency areas. Some of them have been successfully functioning for years. Curiously enough, this happens in poor, sometimes very poor countries, as is the case of CAF (XOF) franc used by 14 African states, or of the East Caribbean dollar (XCD) bringing together six countries and two dependent territories (Kolodko 2011). However, the most important common currency area is that of the euro (EUR), which has been circulated for 15 years now in – currently – 19 European Union member states and in 11 countries and territories which do not belong to the EU. Moreover, currencies of some other states are more or less strictly linked to euro. While other common currency zones are faring quite well, serious problems are mounting in the Eurozone. It's not surprising then that some – recently more often due to the world financial crisis – are predicting the collapse of the common European currency

(Brown 2012) or calling for its controlled elimination and for returning to national currencies.

Certainly, the Eurozone reality is far from what is theoretically assumed for the so called optimum currency area (Mundell 1961) and it’s been a known fact for a while that macroeconomic tensions as well as structural and institutional weaknesses at the time euro came to being where greater than it was presented (Mundell 2000; Mundell 2003; McKinnon 2002). Neither is the situation as good as others claim: “The idea that the euro has "failed" is dangerously naive. The euro is doing exactly what its progenitor (…) predicted and planned for it to do” (Palast 2012).

In the opinions and projections I express, I am far from the nationalist megalomania, such as nurturing a pipedream of Poland becoming a “great power” or even a “European economic power”. We are in for nothing of that sort and while such illusions provoke more amusement than anger, we need to be aware of how great Poland’s contemporary significance is in geopolitics, especially on the continental scale. Undoubtedly, it is greater in the context of politics than economy, but the intersection of those two elements is truly stronger than ever before. In this very context, it is worthwhile and necessary to look at the challenges facing Poland in relation to euro. Other post-socialist countries also have similar dilemmas, and as the European Union expands, there will be more of these, but here let me focus on threats and opportunities shaping up for Poland in this area. Of course, the future of its economy will depend on many other factors and the potential euroization, i.e. putting the euro into circulation, is not the most important matter, but definitely one deserving special attention. The reason is measures aimed to improve the economic structure, the institutional reinforcement, the macroeconomic stability and the pro-growth economic policy may bring even better effects, if they are coupled with being part of the common euro currency zone.

Global turbulences and European drift

Everybody knows that: things happen the way they do because a lot happens at the same time. The build-up of crisis phenomena and processes in the global economy and its various regions is already so significant that, while not long ago it was the ambition of nearly every luminary of social sciences, especially of the economic ones, to write a text about globalization and European integration, now the pendulum is swinging back and we're in for a crop of publications about the move away from globalization, isolationism and nationalisms, protectionism, and, as regards our continent, about the prospect of the breakup of the European Union. Neither the globalization reversing not the Union's breakup is by any means inevitable, but both are possible, which has its obvious implications. Hence a few fundamental questions should be asked in science, and a few assumptions made in politics. The nightmare is that, again, theory is failing to provide, on time, hints for practice and it becomes increasingly risky, or even fatally wrong.

Firstly, it should be determined whether globalization is indeed in reverse or even has ceased, or it is and will be continued (Kolodko 2011 and 2014). There is no absolute certainty, but I believe that despite the growing protectionist tendencies and various nationalisms, sometimes referred to as the economic patriotism, it is an irreversible process. This is due to the nature of the contemporary and future technological progress, and, most of all, due to the supranational networking of economies and of the system of powerful interests of trans-national corporations. If so, we may turn our back at the world, but instead, we should integrate with it, in a smart manner, that is by maximising, in economic terms, our own benefits and minimising the inevitable attendant costs. This is true of large and smaller countries alike, especially the latter ones as they should develop the most in the open economy. Curiously enough, and also surprisingly to many, currently China is becoming the champion of opening and free trade and the advocate for globalization, while the United States, under the new administration, may take the opposite positions.

Secondly, being situated where Poland is – at the heart of Europe – one needs to strengthen the scientific case for the far-reaching European integration and adopt an assumption in the development strategy and policy that it is not only desirable but actually unavoidable to continue this process. Moreover, for medium sized and small countries, the participation in a regional integration, especially one having such an advanced form as the European Union, is the best way to adapt to the challenges, that is to threats and opportunities involved in the inevitable globalization. Specific conclusions follow from this observations for non-European countries that are enmeshed in their attempts at regional integration.

From destruction to construction

Of course, if somebody claims that, in the light of the growing xenophobia and parochialism – from the USA to France, from Venezuela to Nigeria, from the United Kingdom to Turkey – there will come a turning point after which globalization will collapse; if somebody believes that, as a result of the drift of the last several years, EU is in the state of inevitable decomposition, then he or she is asking quite different questions to those we are dealing with here. What I am striving to answer is how to escape forward, how to couple economic and political dilemmas to move from the threat of destruction to the opportunity of constructing something better.

Poland has virtually nothing to offer to the world and cannot directly support globalization – as we produce just under 0.9 per cent of the global output, and represent just 0.5 per cent of the world's population; and yet, at the European level, maybe ironically, we have never had a greater chance to make a creative contribution.

If the *raison d'etat* is to care for a dynamic and triply sustainable (in economic, social and environmental terms) development amidst peaceful co-existence with our surroundings, then Poland should join the Eurozone. It's not about us having the right and duty to do so under the treaty of accession, supported by a national referendum, but about this being profitable to us, to the society and economy. I hasten to add that, on balance, since, as nearly always, we need an objective profit and loss account here. And, of course, not unconditionally.

Economists have their idiosyncrasy of attaching too much weight to economic issues. Well, this is our domain, while, in reality, economic interests are all too often sacrificed at the altar of politics; all too often, the non-economic lack of common sense prevails over economic pragmatism. This is why such pragmatism should be sought all the more. However, let us start from politics.

If Poland's government, having a definite support of the president and a majority in both houses of parliament, should announce, in concert with the National Bank of Poland, its readiness to start efforts to adopt euro, this would change not only the European politics. In a situation where a structural and institutional crisis of the EU is underway, where the scenario of the "Europe of two speeds" can be more and more clearly seen on the horizon, where new nationalism rather than new pragmatism (Kolodko 2014b) seems to be taking the upper hand (Economist 2016), strengthening one of the main links of the process that is the European common currency project, would be of fundamental importance to the economic integration with all of its political and cultural consequences. And not only to ours, the European one, as the EU is being watched with attention worldwide – from MERCOSUR in South America to ASEAN in South East Asia, from SADC in the south of Africa to ECOWAS in its West, from NAFTA to SAARC in South Asia. If the integration in Europe is successful, it will also gain momentum in other parts of the world, and the regional integration processes are a great way to adapt to the challenges of globalization.

Poland joining the Eurozone would have a special meaning in the light of the United Kingdom exiting the European Union. As part of the Eurozone, Poland would immediately cease to be a peripheral country and become an important element of the core of this formation, on par with Spain having a similar population potential, and the Netherlands, which has fewer inhabitants but is clearly richer. Things could be that way, especially that the position of Italy, unable to cope with its secular stagnation, is relatively weakening. The courageous accession of the tiny Lithuania to the common currency area two years ago did not change the continental geopolitics, whereas our accession to it (which would be possible in 2020 at the earliest) would be of major significance.

Since we're talking about politics, it's clear that we need to take the opportunity to give up on the illusory attempts to replace the Weimar triangle with the Visegrad square and let go of the pipedreams of a Poland-led intermarium. Poland is not supposed to lead but it should not be on the margin, either. Poland accepting euro and euro accepting Poland can only help it because with our potential we don't mean much in the world, but we do in Europe. Being part of the Eurozone, we would mean even more in the European Union, while the Union, in turn, would mean more in the global economic and political game. This may be once again a case where quantity translates into quality.

Benefits and costs

Political arguments will surely prevail, but, truly, what should be more important is the economic ones. I would not advocate a decision on such an important issue as replacing the existing national currency with common European money, if I had any doubts as to the profitability of this venture. But I would not force such a solution, either, without first garnering support for it among a greater part of the society, which today is against it. The society, however, can be convinced with rational arguments proving it would be beneficial to them. There already was such a time more or less ten years ago, when a great majority of Poles were in favour of the euro, but the politicians did not follow the *vox populi* then. Now they should not go against it, but instead garner relevant support as a result of a matter-of-fact and fair debate.

Here, I leave aside the imperative to make a relevant amendment to the Constitution, because if the Law and Justice government, in the current political set-up, put forward this proposal, it would easily have the necessary qualified quorum, as it would get support also from some MPs from the opposition benches. This is especially true of those who constantly declare their support for free market economy and European integration.

The greatest benefit would be the elimination of the currency risk in the area where turnover is settled in euro (and in currencies quite rigidly linked to it), and this accounts for ca. 70 per cent of our exports and imports. Many entrepreneurs are disoriented as to the profitability of various ventures as they do not know what their costs and revenue will be in international relations, and thus they have no guarantee as to their potential transactions. This uncertainty spreads to the sphere of investment, because as there's no telling what will be profitable to manufacture, the profitability of investment projects is also unknown. The exchange rate unpredictability is one of the underlying causes of the relatively low capacity utilisation, followed by a weak dynamics of investment or, at times, its absolute level even diminishing. Since this is obviously harmful to the economic growth, the introduction of the euro would eliminate this factor.

At the end of the day, the prices of goods and services that we buy on the market include transaction costs resulting from converting zlotys into euro and back in exports, imports and foreign travel. On that account, as it can be estimated, we pay, first as manufacturers, and then as consumers, over a dozen billion zlotys more. This is roughly what we spend on the 2-3 percentage points of the higher VAT. Latvians and Slovenians are spared this cost (and, at the same time, easy gain for financial intermediaries, banks and currency exchange bureaus, from which we should expect resistance to the introduction of the euro).

All this, by contributing to Polish companies' greater international competitiveness on the microeconomic scale and better stability on the macro scale, would drive the economic growth, and, consequently a more palpable improvement of the population's standards of living. I believe that being part of the Eurozone, in the next decade, we could achieve a roughly 0.5 per cent higher yearly GDP growth. This is a lot as, in terms of compound interest, this would give as much as 25% more in just one generation.

There is no validity to counterarguments put forward by the opponents of the euro, who claim that once we convert our earnings to it – with the average gross salary amounting to EUR 1200 in 2020 – they will drop in real terms; by no means. Not in principle as all prices will be converted as per the same rate, including rents and also taxes. So the purchasing power of earnings – salary, pension, scholarship, social allowances, profits – will be the same before and after the convergence. Yes, there will be cases of prices being rounded up, but, on the one hand, the scale of this phenomenon will be blocked by the strong consumers' position and by the competition on the market, and, on the other hand, prices will be rounded down sometimes, too. Surely, this will not represent an inflationary impulse as inflation is a process of the overall price level growing, and in this cases we would, at most, deal with a short-term friction.

It's also hard to defend the argument that by having our own currency we can be shielded from the impact of external shocks. Sometimes we can, and sometimes the exchange rate fluctuations do more harm than good. Before the weakening of the Polish zloty helped Poland after the shock wave of the global economic crisis in the years 2008-09, the overvaluation of our currency – and let me remind you that at its peak it was exchanged at ca. 3.20 per euro – had carried with it a series of bankruptcies, even those of well governed companies. It contributed to a near-demise of the export-oriented shipbuilding industry, and it was hardly the only casualty of the practice of yielding to the dogma that a free and fully floating exchange rate system is perfect. Then, the undervalued exchange rate of PLN 4.90 for 1 euro was temporarily helpful, but earlier on the exorbitant rate of PLN 3.20 was doing permanent damage, eliminating from the market a number of well governed companies with skilled and disciplined staff. And I suppose it goes without saying that if the euro had been in circulation in Poland for years, like in Slovenia, where it was introduced in 2007, there would have been no foreign currency-indexed mortgage crisis, or the problem of the Swiss franc debtors.

A lesser burden of debt

A major benefit of the euroisation of the Polish economy would be the palpable reduction of public debt and costs of its servicing. Poland's reserve assets amounts to nearly EUR 110 billion, or roughly one fourth of our national income calculated in GDP terms. It's a lot and it's very ineffective as, on balance, this costs us ca. 2% of the GDP, which stems from the variation between the percentage rate of reserves and that of the public debt. In other words, on the one hand, Poland has large funds invested in very low interest foreign securities, mainly secure and stable bonds to finance budget deficits of reliable governments from the US and Canada to Germany and France, to Australia and New Zealand; on the other hand, the government issues its own bonds and sells them abroad at a much higher interest rate. It's as if we were borrowing our own money from somebody, but at a higher interest rate than the one this person pays us for lending it to them.

On our way to the euro, we need to rationally use these reserves, and there is no better way than to earmark their significant part – maybe up to 75 per cent – to repay some of the foreign debt. This would mean reducing the public debt by 17 percentage points, to ca. 35 % of the GDP. Then we would find ourselves in the better league of countries, as the rating of the Polish economy would go up, both the official one expressed by credit rating agencies and the real one, expressed by financial markets.

I realize that it won't be easy to redeem our debt in foreign currencies, as the profitability of our bonds is very attractive to their holders. If we succeeded for less than the equivalent of 75% of reserves, even half of it would be of great significance. The same amount could go to a special sovereign welfare fund, out of care for the next generation, and the rest – to pay the contribution to the European Central Bank's capital and to the minimum reserves.

This would be a qualitative change leading to Poland's better international financial position and, while we're at it, to a drop in interest rates. Meanwhile, the budget would carry year to year a quantitatively lesser burden of the public debt. I hasten to add that this idea will face the most fierce attack – and, of course, not a direct one but one using other arguments – from the advocates of the international financial world, for whom it is as advantageous as it is costly for Polish taxpayers, to maintain such huge foreign currency reserves, on the one hand, and quite a big foreign debt, on the other; roughly a third of the debt is obligations to foreign partners.

Convergence exchange rate of paramount importance

Assuming that all this time we'll comply with Maastricht currency convergence criteria – the way we finally do, and which is under threat if the current government's policy is continued (Assessment 2016) – what matters most is the exchange rate at which the euro should be introduced. It is fortunate that zloty happens to be weaker now; it is estimated to be undervalued by 10-15 per cent. This is a good starting point for negotiating the convergence exchange rate, which should stand between 3.80-4.00 zlotys per euro. It's very important as an undervalued exchange rate drives imported inflation while overvalued zloty is harmful to exports by Polish companies, and, after all, we should pursue the strategy of export-driven growth. In other words, export should grow faster than import, and both these categories should grow faster than the GDP. To make it happen, export must be cost-effective but import cannot be too expensive, either. Hence the trick is to find an economically balanced exchange rate and to negotiate it politically first as the reference exchange rate and then as the one used for the final convergence.

It's worth pointing out that wit Poland accepting the euro and the euro accepting Poland, we would see the trend reverse. Indeed, while pessimist opinions seem to be predominant, also in some professional circles, the strengthening of the common currency area by the largest of the 11 post-socialist transformation economies could contribute some optimist notes. While refraining from overestimating the expectations and from giving them more importance than to hard material facts, this is indeed important.

So is it worth going towards the euro? Do chances of success, the arguments for, and the economics and politics of the whole endeavour speak in favour of it? Can we solve the Grexit problem, as there must be a clarity on this matter before we commit (Galbraith 2016, Kolodko 2016)? Yes, though we must be aware of the attendant risk and of the huge area of uncertainty. Nevertheless, it’s easier to get away scot-free from the current crisis with Poland in the euro and the euro in Poland, and it may be beneficial to Poland, too.

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