

## Implications of the crisis for economics and the economy

**Abstract:** The third Days of Poznan University of Economics took place on 23-24 February 2011. The PUE welcomed a special guest – Professor Marek Belka, the President of the National Bank of Poland. On 24 February Professor Marek Belka delivered a lecture on “*The European dimension of the global financial crisis*”. Later that day, in the main Auditorium, Professor Marian Gorynia, the President of the University, chaired a panel debate focused on “*Implications of the crisis for economics and the economy*”. Following the moderation of Prof. Gorynia, the panelist: Dr. Andrzej Byrt, Prof. Waldemar Frąckowiak, Prof. Stanisław Gomułka, Dr. Jacek Kseń and Prof. Marek Ratajczak, referring to Prof. Belka’s theses, discussed three major topics: macroeconomic aspects of the crisis, contemporary position and scope of responsibility of central banks and the problem of political control over economic processes.

**Keywords:** financial crisis, central banks, European integration, regional economic integration, globalization, political control.

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Marek BELKA

President of the National Bank of Poland

### The European dimension of the global financial crisis – a lecture delivered at the Poznań University of Economics, 24 February 2011

The current major financial crisis hasn’t transformed into a great economic crisis as did the one of 1929–1933. Today – just two and a half years after Lehman Brothers’ collapse, which many regarded as the climax, rather than the beginning, of a financial crisis – quite decent rates of economic growth are reported around the world. It’s pointed out, however, that the growth is uneven; there is talk of not just two but three speeds.

Emerging markets, such as China, Brazil and India are growing so fast (Brazil maybe not so fast but more reliably) that we start to fear overheating of these econ-

omies. The US economy is growing by about 3% annually – still too little to rectify the difficult situation in the labour market, which is crucial in maintaining the American style of social organisation. Finally, the purportedly sclerotic European Union has recovered, at least as a whole, from the recession, reporting a growth of just below 2%.

Clearly, the differences may be accounted for by these economies' nature, different potential rate of growth and different stage of development. And if we look at the economic history of these regions or groups of countries throughout the last decades, this is a rate of growth that can only be expected. But commentators, analysts, politicians and the media are most interested in Europe as a source of potential instability, not only on a continental scale, however important it might be for Poland, but also for the world economy. This European dimension of the global financial crisis is what I'd like to discuss in today's talk.

Why Europe? After all, it wasn't in Europe that the crisis started but somewhere between Wall Street and the City of London. I don't know where exactly, somewhere in between those two financial centres. However, it was on Europe that analysts and economic politicians focused their attention from the very beginning of the crisis. This is where the biggest problems were rightly expected to occur. At the risk of sounding simplistic, I would say that the cause lies in the incompleteness of European integration.

Europe has become integrated economically, politically and socially to an extent that has no precedent in history, either European or world history. Some great achievements of this integration include – starting with ourselves – the enlargement of the initial integration very far beyond what used to be the hard core of Europe's highly developed economy. This provided Europe with stability, and facilitated or accelerated civilisation and economic progress in the countries that at various moments caught up with the hard core.

The European Union's great achievement is its common market. It is not completed yet, but as far as the transfer of goods is concerned, the matter is practically finalised.

As for the transfer of labour force, we are close to completing this process, at least from the formal point of view. A free transfer of labour will never produce such results as in a single-language economic union which is the United States. But we know at least that in recent years, following new members' EU accession, labour-force mobility has increased considerably. In fact, we have seen such waves of labour-force mobility in Europe in the last few decades – not just recently but throughout the whole period.

We grumble that the services market is not fully unified. This is true, but I think that, while complaining, we overlook the fact that in the past few years we have made a considerable – or even dramatic – change for the better in this respect, but this is not the most important thing. The financial market has been totally integrated.

This financial integration includes not only EU countries but also countries of the European Economic Area, namely, Switzerland, Norway and Iceland. The integration has made the European Union more vulnerable to the crisis than other regions.

Financial integration means that each country participating in the European currency area accepts the fact that a financial institution operating in any other part of this area (i.e., in another country participating in the European economic area) can establish its branches on another territory, or in another country of this area, without permission and, as it turns out, without significant local, that is national, banking or financial supervision. To put it briefly, there's complete freedom in the area of finance, which strongly stimulates economic growth and business activity. In fact, we can no longer imagine a world in which we need foreign currency permits, in which an entrepreneur needs to get a permit for international money transfers. But at the same time, this has also caused phenomena such as the expansion of those small Icelandic banks throughout Europe; and when they collapsed, the problem was who should pay for that. An example of an unfinished integration. Financial integration – yes; but not integration in cleaning after a disaster, because we are not integrated enough to know who is to cover the cost of failed financial undertakings.

The most important thing, however, and the greatest, the most spectacular achievement of European integration in recent years has obviously been the introduction of a common European currency, not to the whole of Europe yet, not to the whole European Union, but in as many as seventeen countries. We can say that the majority of the European territory has a single currency. A big step towards not only economic, but also political, unification.

I believe that the euro is a fantastic, though unfinished, political project. Anyway, every ambitious project in the world is political in its nature; later on, economists, busy as bees, have to fix the mistakes. Every great event is political in its nature. Helmut Kohl, for instance, is criticised for integrating the East German and West German economies, adopting a one-to-one exchange rate between the East German and the West German currency. From the economic point of view, this was total nonsense, an economic disaster for the East German industry. Do you think it could have been different? Of course it couldn't. The whole operation, the undertaking called Germany's unification wouldn't have happened; it would have led to an economic revolt or at least violent unrest, even in such a stable country, with such stable people as Germans if anybody had tried to tamper with this. That was a manifestation of a good political instinct. Granted, with disastrous economic consequences, which had to be eliminated through a dozen or so years of work.

It's the same with the introduction of the euro. If the leaders of European countries had contemplated sometime in the early 1990s whether or not the European Union was an optimum currency area, we would still be contemplating this. The longer I live and the more experience I have, including international ones, the more

deeply I believe in the idea of the economy being subordinated to politics, including the great political mistakes the economy has to put right, as it were.

Let's go back to the euro. I can say, then, that it was the existence of the euro that caused Europe's numerous economic problems. Now you may think you are dealing with some eurosceptic who calls for Poland never to join the euro zone and criticises the very idea of introducing the euro. Nothing of this sort: you are dealing with a euroenthusiast, but one who first of all likes to bring to light particularly unpleasant facts. And the most unpleasant fact is that the euro project is unfinished, first of all, from the economic point of view, and second, from the political point of view, but it's a political project, after all.

What does this consist in? Or, perhaps, let's first put it like this: how to reconcile the existence of the euro with problems the European economy is experiencing today? At this point I'd like to say a word or two about our region – because blood is thicker than water, but this matter is less important from our point of view, too – and then move on to the euro zone, to the European Union, and to problems there which remain unsolved.

When the crisis started, it was thought that its epicentre would be our region of Central-Eastern Europe. Some expected it to be a black hole of the European economy which, because of the integration of the financial system (i.e., banks) would suck in many West European countries, especially those that are deeply engaged in our region, say, Austria, Belgium and the Netherlands – smaller countries with large banks engaged in our region. Those were potential victims. I saw this with my own eyes because I was with the International Monetary Fund then, and I could see that that's how the European problem was perceived at that time. Indeed, at first it seemed to be like this: Latvia, the Ukraine and Hungary came first, Romania a bit later, other countries, Serbia, not only countries of our region because Iceland proved to be very sensitive, very much exposed to the crisis. Suddenly, it turned out that those countries were experiencing problems. What was the cause? The countries were dependent on a massive inflow of capital, primarily from Western Europe. We could say that, if you were looking or are still looking at the world economy, what was going on between Western Europe and Eastern Europe was consistent with economic theory. Capital should flow “downwards” because in a less developed country profitability should, on average, be greater, so capital should flow there. And that's what happened, which increased the rate of economic growth, the level of consumption, but also the level of manufacturing capacity. It was as we expected, but when the crisis erupted the inflow of capital stopped rapidly. It was expected that not only would the inflow stop but the capital would escape. Fortunately, nothing of this sort happened. It was expected that our countries would experience not only a sudden fall in manufacturing output; the trade channel and exports collapsed overnight, you can say Lehman Brothers, and that a full crisis of the banking system would follow. It was feared that banks, most of which were in fact branches of foreign banks,

would escape, as they did in East Asia in 1997–1998, and in the history of Mexico, Brazil and other Latin American countries. Clearly, this would have entailed a currency collapse and crisis. We expected that countries with a currency board wouldn't maintain currency stability. We feared, for instance, that Latvia's system, which is almost "currency-board", would collapse, that it would be necessary to devalue their currency, the lat, which would, of course, have produced numerous disastrous results for that economy, at least in the short term. It turned out that even though many of them were indeed hit by the crisis, this happened with some outside help, and nowhere did it turn into some nightmare or black hole.

First, it's clear that the crisis caused sometimes a rapid, and by no means short-term, decrease in production. The Baltic states suffered, on average, a 20% decrease in GDP. We can say this is a period of dramatic adjustment following an equally dramatic period of rapid growth. We can say that, in 2008–2009, a miraculous hand somehow turned the three countries back to 2004–2005. A tragedy, we could say, but not quite. The Latvians we talked to, tough people, said they were experiencing a crisis, but the real crisis had been when they were being deported to Siberia: another type of historical memory, which helped politicians, but first of all people of those countries, to survive the 20% fall, even though this is unpleasant and causes frustration among many.

No one, however, experienced a currency collapse, including countries such as Poland, Romania, Hungary or the Czech Republic which had flexible, rather than fixed, exchange rates. From mid-2008, the Polish zloty started to depreciate, but that occurred after a previous period of the most rapid increase in value; since that time, the zloty has remained at more or less the same level. I can clearly recall that, at the moment of our EU accession, €1 was worth 4 zlotys and \$1 cost about 3 zlotys. What is it like today? Exactly the same. In the meantime, we've experienced huge currency fluctuations, but this is by no means dramatic. No country, except the Ukraine, has seen a banking system catastrophe. But so far, not even the Ukraine has reported a single case of a foreign bank withdrawing or rapidly giving up its business activity. Naturally, there are changes in ownership, but no fire sales, no sudden sell-offs in panic because in the last ten years the banks have proved to be jewels in the crown of those international banks, and they are easily and readily sellable at high prices.

Which means that although our region proved to be very sensitive to the economic and financial crisis, it quickly and quite effectively dealt with it; perhaps unevenly, because some countries of our region continue to be in very serious trouble, but there was definitely no black hole, and no one sees the situation of our region as a threat to the European economy. On the contrary, it's the poor health of West European banks that distresses us today and that may, at least potentially, cause economic instability in our region.

Let's move on now to Western Europe. Western Europe has also committed some petty sins. As in the United States, the housing markets of Ireland, Spain and, to

some extent, Great Britain, developed their own speculative bubbles. The European banking system has its dubious and weak spots, too, but it has turned out that these are not Raiffeisen, Erste or UniCredit, which are massively engaged in our region, but Germany's Landesbanken or Spain's Cajas, about which it's not clear whether they follow a high-quality investment policy. Long before Lehman Brothers, probably a year earlier, practically no one talked of a crisis. Everyone looked with contentment at the strength of the euro, which had become a wonderful protective umbrella against the crisis. What did this consist in? On the one hand, it turned out that for a long time all euro-zone countries continued to have very easy access to the capital market, even those countries which shouldn't because, say, they were running up huge debts: Greece primarily in the public sector, Portugal first of all in the private sector. It turned out that the market wasn't effective, couldn't differentiate Germany from Greece, and set practically the same prices for bonds issued in the two countries. In other words, from another perspective, the yields paid in the market by Greece were only slightly (a few dozen base points) higher than Germany's. It's a typical example of the market's lack of effectiveness. But when the market is ineffective, it ultimately becomes more effective, although it often tends to overreact, but it doesn't last forever.

But let's go back to the first months of the crisis. It transpired that it's easy and pleasant for euro-zone countries to roll debt cheaply, and when problems arise it turns out there's only one really integrated, really strong institution in the European Union – the European Central Bank – which can give the market an adequate level of solvency and, it appears, for very different periods, which can hardly be regarded as a solvency policy. If the central bank provides solvency for a period of one year, then this is no longer a solvency policy but an anti-solvency policy, or one concerning the solvency of banks. What's more, contrary to what we thought was written in European treaties, the European Central Bank, when the time comes, can finance the deficits of euro-zone countries without any legal problems. It can't do so in the primary market, so it does this in the secondary market. A Greek bank buys Greek government bonds, then pledges them and achieves euro solvency at the European Central Bank. This is something that makes President Jean-Claude Trichet and his team uncomfortable, but lack of comfort is always less uncomfortable than a catastrophe, so it turns out that, for many months, a euro-area country was in a comfortable position in terms of access to liquid funds in comparison with non-euro-zone countries. Hungary had to ask Washington and Brussels for a loan, as did other countries of our region. This had seemed exotic to euro-area countries until there was a burst.

Everybody knew but no one wanted to see that euro-zone countries were in a completely different situation in terms of public finances and the economy's general debt. The crisis also showed that the economy is one whole, that the dichotomy between the public sector and the private sector was of no significance. When

the time comes, the taxpayer has to pay for the private sector's mistakes – Ireland is the best evidence of this. So if a country was too much in debt, it suddenly turned out that, with a smaller appetite for risk and poorer ratings of particular countries' economies, access to capital markets of some of these countries was suddenly restricted. The problem was no longer much higher spreads, or interest rates in the private investor market – a market is private investors who invest on their own or on someone else's behalf, but they do invest; they must be encouraged by economic conditions to invest. Now, it suddenly transpired that some countries not only had to pay more for capital borrowed in the market but had no access to it.

As we could see, the euro area wasn't prepared for the crisis. Creators of the euro were aware that there was some maladjustment, that a common currency should be based on a common budget policy. When America's Fed issues bonds and the Chinese buy them, they know that somewhere at the end is the American taxpayer, who will have to buy them. In the case of Europe, what taxpayer will buy bonds, say Eurobonds issued by the Irish, the Irish taxpayer or another one? After all, there's no common European budget. What we call a common European budget, from which we get money for the cohesion fund or agricultural policy, accounts for 1/40 of member states' budgets. So there is no common budget which would guarantee the solvency of bonds issued in euros.

This was clear from the very beginning, so attempts were made to prevent today's situation by formulating a foundation treaty and creating a monetary union, which obliged member states to follow a responsible budget policy. But, first, there were no serious sanctions, and second, from the very beginning of the euro's existence, i.e. from 1999, hardly any countries, and hardly ever, conformed to the rules set out there. Besides, the rules were not formulated precisely enough. We can still recall the 3% deficit that can't be exceeded. In fact, if we read the Maastricht treaty more closely, we'll find that the 3% is a maximum level which shouldn't be exceeded in an economic slump. During a boom, the deficit should be lower and the budget balanced. Greece never reached 3%; and a real tragedy for the monetary union's cohesion was the fact that, in 2003–2004, both Germany and France exceeded the 3% limit, and there was no one strong enough to punish them. Moral corruption set in.

Another issue euroenthusiastic economists pointed to was that if a country joins the euro zone, thus giving up its own monetary policy, it has to compensate for these deficiencies, if need be, with a right policy in other areas. We've talked about budget policy; but it's also a policy of economic stimulation through, say, innovation, that is, generally speaking, through taking care of an economy's high competitiveness. Since we can't "artificially" devalue the lira, the escudo or the Finnish mark, then we must guarantee a country's competitiveness by means of a more flexible labour-market policy, employees' less aggressive behaviour over pay policy, and all the other policies. Therefore, euroenthusiasts believed that introducing the euro would speed up reforms. What happened was quite the opposite. The umbrella of

a common currency slowed down the reforms because it ensured that there would be no warning signs in the form of a currency crisis. Without a monetary union in, say, Italy, if it turned out that the wrong economic policy was being carried out, then the lira would be depreciating, which would serve as a warning sign for the government, a signal to take some action, and would alarm the public opinion. But with a single currency which was hard as steel there was no reason to do anything, so the reforms were put off. Until when? Well, until now that the situation is most difficult. Ladies and gentlemen, I've been following politics for a long time and I know that reforms are made when the situation is bad. When the situation is good, as someone said, "good times are to enjoy". This is, of course, self-mockery and bitter irony, but that's how it is. In general, we implement difficult reforms when we are made to do so, not when we really should.

The crisis showed, then, that there was no common budget policy, there were no instruments for the time of crisis either in one country or in important financial institutions. There's no one who could warn of black clouds gathering, tensions building up, imbalances occurring in the euro zone's economy and in the whole European economy. An institutional architecture was hastily created, mainly in 2010, something that should have been done at the very beginning of the euro's existence. But such institutions are created as a result of a difficult compromise because the 17 or 27 countries sometimes have conflicting interests. "Good times are to enjoy", so why enter into some difficult negotiations? This is being done only now, and now we see an accelerated process of creating European institutions.

First, a fund was established to help Greece. When Greece was collapsing, it turned out that Spain might collapse, too, which would have been a serious matter; so something bigger was established, namely, the European Financial Stability Facility, which formally has about €440 billion, though in fact it's much less. Recently we were visited by Klaus Regling, the Facility's head, who came here to encourage us to buy bonds. We may do so because this is good investment; at least, it seems better than *bunds*, or German papers, and seems safe, if anything can be safe in today's world. In addition, the European Systemic Risk Board is being set up to observe the economy and detect any imbalances. Coordination of the supervision of financial institutions, including banking ones, is also being strengthened. The supervision will continue to be exercised by national supervision bodies, but what body will have jurisdiction over Deutsche Bank? Although the name is Deutsche Bank, this is primarily an American bank operating in several dozen countries. And what supervision body is to be responsible for a multinational bank which collapses in all the countries? These are the problems that Europe is trying to solve only today.

The European Union isn't a state, of course. But we must be aware that, thanks to the various institutions I've mentioned here, the euro area is in fact acquiring characteristics of a state. A consequence of this is a Europe of two speeds. Those who

have adopted the euro already are, quite rightly, encouraged by Germans to agree to a greater coordination of economic policies.

What about us – should we join this? I remember everybody saying before the crisis that, from the economic point of view, joining the monetary union is beneficial because of lower transaction costs, better access to capital, etc. And with one exception (interest rates in Poland will be lower) this is a mixed blessing. Lower interest rates mean, on the one hand, a faster economic growth, but when they are too low, the economy may get so overheated that it will result in a higher inflation rate; so only pros, even too many of them. The argument “against” concerned politics and sovereignty: losing monetary independence, the country being “less Polish”. Today, the reverse is true. Today we need, first, to adjust our public finances and our economy more than we thought was necessary a few years ago. Second, we need to wait until the monetary union builds its institutions and stabilises. Entering a house which is no longer on fire but still smells of burning isn’t very wise – it’s wiser to wait. But while the economic dangers of joining the European Union have decreased, political dangers have intensified. Even if we adopted the euro today, the yields on our bonds wouldn’t be as low as German or French ones. They would obviously be lower than those on zloty bonds today because there would be no exchange-rate risk, but I don’t know if they would be much more expensive, that is, if their yield would be lower than on our Eurobonds, which we issue in the European or the world market. Perhaps a little bit, but not considerably. The benefits would be smaller then, but the danger of economic overheating, which is an effect of too low interest rates, would be lower, too. And just as this political, sovereignty argument used to be against the union, against the euro, today it’s quite the opposite. Today, as we face a dangerous prospect of a Europe of two speeds if we stay outside the euro zone all the time – ten years, twenty years – this is a recipe for political marginalisation, something we wouldn’t like to happen. Do we want to stay on Europe’s sidelines? Is this what Europe expects from us? Probably not.

Our dilemma is different, then. When I’m asked when we’ll join the euro zone, my answer is, When we are prepared for this and when the euro zone is prepared for this. And more specifically? I say, more specifically, I don’t know. I think if you set a deadline, this is the best way to miss it. Various people in Poland have suggested various dates, but I never have. And when I’m asked by Germans – I often meet various German entrepreneurs, politicians or financiers – when we’ll adopt the euro, my answer is, When you invite us... And this is only a half-joke.

Thank you very much.