Euro adoption: What we have learned so far

Editorial by Christoph Rosenberg

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The eurozone is these days preparing to admit two more countries, Malta and Cyprus. They are following Slovenia which, as first post-communist new member state of the EU, adopted the euro earlier this year. Should Poland be in a hurry to follow their lead? If yes, what still needs to be done?

The NBP has now taken a commendable lead to revisit the arguments in favor and against adopting the euro and, by implication, the urgency of fulfilling Poland's commitment to join the eurozone. It also seeks to broaden the discussion beyond the narrow circle of experts. Reason enough to review the insights that have been gained since the NBP first tackled the question in its thorough report of March 2004 and, at the time, concluded that euro adoption should be pursued as a matter of urgency.

Let me highlight some of what we have learned in three areas: First, how switching from national currency to euro affects prices. Second, how the anticipation of euro adoption is already now changing economic behavior. And finally, how best to prepare the economy for life within the eurozone.

The euro and inflation

In a recent survey by the European Commission, 4/5 of Poles thought that introducing the euro will lead to an immediate jump in the cost of living. They often point to the experience in countries that have already adopted the euro, where many people believe firmly that consumers were the main losers of the euro. So are the Poles' fears justified?

First, remember that prices in Poland are set to rise toward levels in the old member states, no matter whether the euro is adopted or not. This is a natural process, inherent in the convergence process and a by-product of rising living standards. The overall price level in Poland has already risen from 44 percent of the EU average in 1995 to 55 percent in 2005 and most economists think that this trend will continue.

Secondly, stories about wide-spread price hikes when the euro was introduced for cash transactions in 2002 are simply not corroborated by the statistical evidence. There is a curious discrepancy between perceived and actual inflation, something that has intrigued economists and psychologists alike. The ECB in a paper published last year noted that prices of some food items that are consumed frequently but constitute a small share of household spending, such as a cup of coffee, did rise disproportionally, as some restaurant owners

rounded up the conversion rate. People extrapolate from these price hikes to the general price level, forgetting that big ticket items, such as housing rents were converted at the exact exchange rate.

Finally, the recent experience in Slovenia shows that excessive mark-ups by some retailers and restaurateurs can be preempted by introducing double-pricing well in advance of the actual changeover date. Healthy competition on the retail level and wage discipline also helped. As a result, euro adoption has, at least so far, had a small effect on prices in Slovenia: average inflation in the first five months of 2007 was 2.7 percent, only 0.1 percentage points higher than in the same period in 2006.

Anticipating the euro

Euro adoption may still be some years off, but it is already affecting the interest rate and currency at which Polish households take out mortgages, and corporates and the government issue bonds. Poles can therefore enjoy some of the euro's benefits already now, as investing has become cheaper. But this does not come without risks.

Recent IMF research shows that borrowing spreads are a full percentage point below what can be explained by Poland's fundamentals. It is not possible to disentangle enthusiasm about EU membership from expectations about its future eurozone membership. There is evidence, however, that financial markets are pricing the expectation that Poland's interest rates will approach those of the euro area into their long-term lending contracts. As a result, credit is relatively cheap and investment affordable, and this contributes to the current economic boom. The flip-side of this "EU halo effect" is that it can disappear if the markets should change their positive outlook. The result could be higher interest rates and a drying-up of foreign financing.

The anticipation of euro adoption is having another more immediate impact on borrowing behavior. Already more than a quarter of all loans in Poland are not denominated in zloty, but in euro or in Swiss Franc (a currency closely linked to the euro). This has two implications.

First, as the trend to foreign exchange borrowing continues, domestic monetary policy gradually loses its ability to influence the economy. To be sure, the NBP still plays formidable and highly desirable role to keep the present upswing in growth balanced and enduring. But for those borrowers who are indebted in foreign currency, the interest rates set by Poland's Monetary Policy Council matter only to the extent that they affect the exchange rate. Much of the cost of their debt servicing is already de facto decided at the ECB in Frankfurt. By joining the euro zone, Poland would have a voice in those decisions.

Secondly, those who borrow in foreign currency expose themselves to the risk of an exchange rate depreciation. This is what happened last summer to many borrowers in Hungary, who suddenly saw their debt servicing cost shoot up when the forint (albeit temporarily) came under pressure. In Poland, households with mortgages in foreign currency but incomes in zloty are particularly vulnerable. Euro adoption would eliminate such

currency mismatches and thus relieve both borrowers and investors from the risk that the exchange rate will move against them. It is thus a win-win situation for both sides.

How best to prepare for life in the euro

Preparing for euro adoption is often seen in terms of meeting the so-called Maastricht criteria, the EU's formal entry conditions. But euro adoption is not a goal in itself and meeting the criteria is no guarantee for success in the euro zone. Some of the present members, such as Ireland, have thrived while others, such as Portugal, have floundered. This shows that giving up one's independent monetary policy can come at a price, unless accompanied by broader policy changes. Almost a decade after the euro was first introduced, two lessons from the first wave of eurozone members that stand out.

First, creating a flexible economy is key. Wages, prices and the budget must be able to adjust quickly if economic circumstances change. Otherwise, with exchange rate devaluations and interest rate cuts no longer possible, there can be painful swings in output and employment. Poland still has some work to do in these structural areas. The budget leaves little room to make discretionary changes; product market flexibility and the business environment are weak compared to other euro candidates; and the labor market requires particular attention, as confirmed by many studies.

Secondly, fiscal policy must avoid a pattern of high spending in good times and low spending at bad times, especially in the run-up to euro adoption. The windfall of lower debt servicing cost (as borrowing spreads fall) and revenue buoyancy (as the tax base temporarily surges) is put to better use by reducing public debt rather than increasing spending—even if this entails somewhat less growth in the short term. Portugal did the opposite, running a highly procyclical policy around the time it joined the euro zone. Its boom soon turned into a bust and the country has been recording some of the lowest growth rates in the EU.

Portugal's experience suggests that the "structural" fiscal deficit—the deficit corrected for the economic cycle—should be well below the 3 percent Maastricht limit, especially for countries like Poland where the level of public debt is still high. This would allow the government to deal with economic shocks—such as the loss of competitiveness experienced by Italy's and Portugal's textile industry—without ending up in the EU's excessive deficit procedure and experiencing a rise in public debt..

These policies are of course desirable in their own right. Euro adoption provides an additional argument for pursuing them forcefully and in a coordinated fashion.

Euro adoption—how soon?

Adopting the world's second-most-used currency and joining a monetary union that includes Poland's main economic partners entails large economic pay-offs. As the markets anticipate the euro, some of these are already materializing now. There is a strong argument to lock in these benefits as soon as possible.

This does not mean, however, that the government should single-mindedly focus on reducing the fiscal deficit below 3 percent of GDP and joining the exchange rate mechanism, the two Maastricht criteria that are not met currently. Much more work still needs to be done, if Poland is to thrive in the euro zone. Giving up monetary policy requires sharpening the remaining tools at the policy maker's disposal--a fiscal policy characterized by small deficits, low debt and flexible spending, as well as creating a nimble, business-friendly environment.

It will take vision and political determination to move along this broad reform agenda, which goes well beyond the traditional realm of NBP and Ministry of Finance. The good economic times that Poland is now enjoying present an opportunity to do so.

The papers quoted in this article can be found at www.imf.org/cee.