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Panel speech<sup>1</sup>

**Poland and EURO**  
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In my speech<sup>2</sup> in June this year I outlined the key benefits and costs of adopting the euro. Let me briefly restate what they are:

On the benefits side of adopting a common currency economists usually mention the following factors: lower transaction costs, lower interest rates, financial integration and trade creation. When speaking about costs economists usually cite two groups of factors: asymmetric shocks and arising micro- and macroeconomic imbalances. It is important to note that some costs will materialize if asymmetric shocks hit the enlarged eurozone. We do not know the likelihood of such shocks though, so it is impossible to calculate the expected value of costs related to these events. We know, however, that the probability of asymmetric shocks declines with rising similarity or progressing real convergence of the EU economies. Let me also stress that the magnitude of costs depends crucially on domestic policy – prudent banking sector supervision, labor market reforms and sound fiscal policies to name a few. Adoption of proper policies reduces future potential costs related to eurozone membership and, at the same time, enhances future benefits. In my view, given the evidence that reforms have been halted in many countries after entering the eurozone, these measures should be taken before the euro area accession.

The last twenty years have been unusually good for the global economy. Growth was high and less volatile, inflation fell to low levels in both developed economies and in emerging

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<sup>1</sup> Views presented today are my own and do not necessarily represent the official position of the National Bank of Poland and the Polish Financial Supervision Authority.

<sup>2</sup> Rybinski K. (2007) “The Role of the EURO for the Future of Poland”, speech by Krzysztof Rybinski, Deputy Governor of the National Bank of Poland, 15 June 2007, <http://www.nbp.pl/publikacje/wyklady/rybinskiadesti.pdf>

markets. Real returns enjoyed by investors in bond and equity markets were higher than ever in the post-war history. There are however signs that this “Great moderation” era may be coming to an end. If this is the case then the coming years may prove truly challenging for the central banks in EMU-graduation zone. Let me explain in some detail several factors that justify such claim.

1. **Agflation**, is the rise of inflation due to increase of food prices. In recent months we have witnessed a significant increase of food prices, grain and oilseeds being the leaders. Prices of food products on international markets has risen by almost 40 per cent within last two years and prices of grain and oil seeds has almost doubled within this period. Many forecasters suggest that this trend will not end in the nearest future. There are several explanations of such situation. Firstly, rising oil prices increase demand for alternative sources of energy, biofuels being high on the agenda in many regions. In effect industrial demand for food commodities will further rise. By the way, it is worth to mention what may be the ecological consequences of growing biofuels production. Spiegel online on 26<sup>th</sup> September 2007 described a research led by the Nobel-price winning chemist Paul Crutzen which had found that biofuels emit even 70 percent more greenhouse gases than fossil fuels. In effect, global warming may accelerate and lead to further increase in frequency of disasters such as floods, droughts, and unexpected weather changes that may have negative effects on crops. Secondly, food prices will be lifted up by an increasing demand for agriculture products in the emerging markets, especially in Asia, as the catching-up process progresses. It is worth keeping in mind that the share of food in the CPI basket is some 10 pp. higher in Poland than in the eurozone, so agflation, if it materializes, will lead to inflation divergence.
2. **One cannot exclude a possibility that other commodities prices may continue to rise as well.** Demand for commodities has already substantially risen in recent years. The “problem” lies again in the emerging markets. Fast growing economies create still growing demand for all sorts of commodities, especially metals and fuels (for example: oil consumption in China has doubled within last 10 years). As the result, prices of metals and energy commodities have doubled since the end of 2004. Although prices of these products do not affect consumer inflation directly, in the medium term will contribute to further increase of inflation volatility.
3. **Migration.** One of the major obstacles is the massive emigration of workforce observed in the New Member States after joining the European Union. In Poland and

the Baltic states some 4 to even more than 7 percent of a labour force attracted by higher wages, job availability and better living conditions migrated so far to the EU-15. This has led to severe tensions in many industries pushing wages and unit labour costs up. High corporate profits have provided a cushion yet, but, if this situation continues, many companies will be forced to raise prices to remain profitable.

4. **Rising unit labour costs.** Growing tension on the labour market is present in all CEE countries, but Baltic and Balkan States seem to be the most threatened by rising labour costs. Annual average dynamics of unit labour costs in the second quarter of 2007 in CEE accounted to 8 per cent and in the group of Baltic and Balkan states the figure was over two times higher. This shows that sooner or later (rather sooner) enterprises will stop cutting their profit margins and will be forced to pass growing operational costs on consumers.
5. **Challenges to keep fast productivity growth.** We live in a global knowledge economy, which is driven by innovation – technological, business-process or customer related. The crucial factor to succeed in the global knowledge economy is the country's ability to develop intellectual capital. Only those who understand the importance of innovations for growth will thrive and prosper in the coming decades. Unfortunately, CEE region lags badly behind the leaders in terms of its current and future ability to generate innovation. One of indicators measuring current ability to innovate is the number of researchers. In the mid-1990s CEE-4 (the Czech Republic, Hungary, Poland and Slovakia) and Asian NIEs had similar number of researchers per million people, while two years ago NIEs had almost twice as many persons employed in R&D per million people in comparison with CEE-4. Future knowledge potential of particular country or region can be measured by tertiary enrolment ratio. Tertiary enrolment ratio in the CEE-4 countries improved to 50 percent in 2004, but still remains well below 62 percent in the EU-15 and 82 percent in the United States.. Because of a relatively small population and a number of structural deficiencies it is very unlikely, that increase in the number of students in CEE-4 that have occurred in recent decade will translate into higher innovation potential in the coming years, unless a dramatic change in policies in CEE-4 is made. This is also confirmed by a dramatically low number of patents registered in the CEE countries and extremely low number of scientific publications. As the ability to generate great ideas in the CEE region is limited, it seems that in the transition period the most important

modernization channel in the region was through foreign direct investments. Indeed CEE became a very large recipient of FDI, with FDI stock to GDP ratio topping 40 percent in CEE-4 region. Only NIEs economies managed to attract higher FDI stock in relation to GDP and enjoy higher FDI annual inflows. However, in the global knowledge economy it is important to attract foreign direct investments to sectors that can become globally competitive, in particular to these sectors that export high-technology, i.e. high value added goods or services. While CEE-4 significantly improved the structure of exports, the high-tech goods account for only 12 percent of manufactured exports, which is the world worst result, lagging even behind Latin American countries. NIEs are world leaders and China is about to take over the second post from the United States. Above data suggests that in the long run low ability to generate innovation combined with low value added FDI may harm the CEE ability to improve productivity.

On top of above-mentioned factors I should also add that in the last few years we have witnessed a very fast growth rates of asset prices in CEE. The amount of loans granted to households increased 3.5 times since 2004 and almost 10 times since 2000. Low deposit rates and economic upturn in CEE after EU accession encouraged both financial institutions and individuals to move toward more risky forms of investment. As a result, real estate prices soared after 2004 and equities listed on stock exchanges reached historical highs. Since 2003 major stock exchange indexes in CEE increased on average by almost 300 percent. While part of this asset price and credit growth may be explained by structural factors often referred to as “convergence”, the observed rates of growth are clearly unsustainable and they contribute to economic imbalances. This poses additional policy challenge for central banks and financial market regulators in the region and may warrant further actions aimed at maintaining prudential lending practices.

And finally one comment about the eurozone entry. According to official government and NBP forecasts Poland will fulfill all eurozone entry criteria this year (fiscal deficit, public debt, inflation, long-term interest rates). The only criterion not met will be two-year ERM2 membership without significant currency depreciation. If Poland had joined the ERM2 in the first half of 2005, as I formally proposed in January 2005, we would have been able to join the eurozone in January 2008. This opportunity has been lost, and now meeting the Maastricht

criteria will become more challenging. If stagflation is with us to stay, and central banks decide to keep CPI close to the target, high sacrifice ratio implied by flat Phillips curve may require significant growth slowdown. In such case meeting fiscal criteria will be challenging amid slowing tax revenues. If, on the contrary, central banks treat stagflation as a typical negative supply shock, then meeting inflation criterion will be challenging. Finally, if strong exchange rate appreciation continues, we may just make it will both fiscal and inflation criteria, but we will enter eurozone with heavily overvalued exchange rate, which may harm growth for many years if not decades.

This is a real “Gordian knot” to be solved by CEE central banks, financial market regulators and governments. The “Alexandrian solution” would be massive acceleration of productivity enhancing reforms, especially in the area of knowledge economy, where the CEE countries are badly lagging behind other regions. If we don’t accelerate reforms we may still be lucky, there could be few years in a row with good global crops, or someone will finally produce cheap hydrogen-powered car to replace gasoline, resulting in a collapse of oil prices. But I would not bet the country future on the assumption of being lucky.

Thank you for your attention.