Monetary policy challenges in a non-euro EU country

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Ladies and gentlemen,

Let me first thank the organizers for giving me the opportunity to speak at this forum. Since this is a breakfast meeting and you have a terrific lineup of speakers today, I will try to be brief and get right to the point. I would like to share with you some thoughts on what the euro crisis and its legacy implies for non-euro EU countries, such as Poland.

1. The lessons from the euro crisis

I think it is fair to say that the euro crisis was a game-changer in our thinking about the viability of currency unions in general and euro accession in particular. As you all know, the theoretical case for the euro was the theory of Optimum Currency Areas developed by Robert Mundell in early 1960s and later refined by many others. The theory stipulated that to make a currency area work you needed essentially two things: labor force mobility and some sort of budgetary transfers on the federal level. The two features were to make up for the loss of natural asymmetric shock absorbers such as independent monetary policy and freely floating exchange rates. Although, frankly, the early euro area had neither of those features, the belief at the time was – first – that countries would engage in structural reforms increasing the flexibility of

their labor markets and – second – that economic integration would reduce the likelihood of asymmetric shocks in the first place.

Unfortunately, the recent crisis revealed that the currency union not only hasn't eliminated asymmetric shocks, but in fact might have induced a major shock itself. This goes back to the argument that inflation rates would not converge quickly across the monetary union, due to Balassa-Samuelson effects and overly loose fiscal policies. With a single nominal interest rate determining the cost of borrowing, this meant that low real rates in the periphery fueled spending booms financed by huge capital flows from the core countries. All the subprime crisis did was to cast doubt on the sustainability of this process, triggering the familiar "sudden stop" scenario, called by Paul Krugman "the mother of all asymmetric shocks".

But I think the impact of the crisis was so severe not only because – with limited labor force mobility and no serious federal fiscal transfers – the adjustment to the asymmetric shock had to be painful. There were also two other factors at play which exacerbated the initial problem.

First, there was the negative feedback loop between sovereign and bank solvency. Euro area banks have over the years built up considerable exposures to their domestic sovereigns – higher than their counterparts in the UK or the US. In the face of a marked fiscal deterioration – resulting from government response to the crisis – this debt load has encouraged speculation on banks' solvency, which required European governments to intervene and rescue banks, which in turn increased the riskiness of sovereign bonds, threatening banks even further.

Second, as argued perhaps most forcefully by Paul de Grauwe, due to various institutional limitations it was not clear in the initial stages of the crisis whether the euro area had a lender of last resort for governments in quite the same sense as

other countries. In any case, market participants seemed to think that it didn't and consequently priced the risk of default of Spain much higher than, say, the UK despite the latter's higher debt-to-GDP ratio at the time. This is not to say that there were no legitimate reasons for the Eurosystem to act differently than a non-EA central bank, but this different position of the ECB vis-à-vis euro area sovereigns has made it more difficult to stop the self-fulfilling default trajectories.

2. Non-euro EU countries are here to stay

One obvious implication of all this is **that euro area needs institutional reforms that will make it more robust and more flexible in tackling shocks**. And, indeed, serious work is already underway on this front with the ESM and the SSM to name just two key pieces of legislation. Yet, although we can expect Banking Union to weaken the link between banks and sovereigns, I don't think it can eliminate it altogether – at least as long as government debt retains its preferential regulatory treatment.

The second implication is that the European Community cannot afford to once again underestimate the risks of premature expansion of the euro area. There are the Maastricht criteria which should be met over the long run, of course. **But, half-jokingly, I propose a tougher test: if a country doesn't have as competitive an economy as Switzerland, as flexible a labor market as Denmark and as disciplined public finances as Estonia, it should think twice about adopting the euro. Clearly, these criteria can only be taken half seriously, but at least they give a sense of the scale along which countries should measure their capacity to join**. Moreover, countries that do not score well on my test, should not hope that any of their potential economic deficiencies can be miraculously fixed by the euro.

The bottom line here is that non-euro EU member states are probably here to stay – at least for the foreseeable future – and for good reasons so. But if that is the case,

then it makes sense to ponder challenges faced by monetary policymakers in such countries. This is indeed what I intend to do now focusing on the case of Poland which I am obviously most familiar with.

3. Autonomous monetary policy in a world of no autonomy

To set the stage let me just say that Polish economy has weathered the crisis remarkably well. Since 2008 GDP in Poland grew by over 20% which is really something, if you consider that during that time euro area GDP has not even managed to break even. At the same time, inflation has been kept under control, averaging 2.7% over the past decade which is practically at the NBP’s target of 2.5%.

Part of this success is attributable to the floating exchange rate. Note, that from the point of view of an external investor, wages in Po**land have fallen by roughly 30% in early 2009 with no painful renegotiation of contracts or labor force changes simply by letting the zloty depreciate** – something that wouldn’t be possible in a currency union.

But of course it would be naïve to say that we are immune to developments in the euro area. To the contrary. With over 50% of our exports going to the euro area, and 25% to Germany alone, it is no wonder that price and output dynamics in Poland are strongly correlated with those in the euro area – even if the scale of the movements is somewhat different. Moreover, over 55% of our banking sector assets are owned by financial institutions from the euro area – most notably in Germany and Italy. We are thus not only closely linked to the real side of the euro area economy, but also to its financial sector. And cross-border lending from European banks is one of the channels through which ECB monetary policy impulses can feed through to the Polish economy.

This brings me to the key challenge for conducting monetary policy in Poland and perhaps also in other non-euro EU member states. **This challenge consists in having to conduct autonomous monetary policy under conditions of strongly limited autonomy.** This limited autonomy is not due to any institutional or legal restrictions, but a consequence of the free movement of international capital and cross-border financial linkages. And capital-flow and exchange-rate volatility that come with it can have a powerful adverse impact on macroeconomic and financial stability. Very loose global liquidity conditions and near-zero interest rates in core markets have encouraged capital inflows to emerging markets – especially those with relatively high real interest rates and developed capital markets. Through a well-known mechanism, such capital inflows may lead to excessive strengthening of the domestic currency, undercutting the competitiveness of firms in the tradable sector. They can also fuel credit booms and provide incentives for greater use of foreign currency denominated liabilities, which in turn may lead to unsustainable balance sheet structures – something many countries in Central and Eastern Europe, including Poland, have struggled with.

And now we come to the dilemma: if it is the interest rate differential that's driving capital inflow, then it might seem natural to respond by aligning interest rates in emerging economies with those in core markets. But, after all, interest rates in emerging economies were higher for a reason. Depending on the economy in question, cutting rates too low could fuel an internal- rather than external-financed boom, with similarly adverse consequences.

These considerations remain highly relevant for non-euro EU countries even as the Fed is exiting from its unconventional monetary policy measures, since the ECB is going in the opposite direction. This means that capital flow volatility is still to be expected in the euro area neighborhood.

This is certainly not to say that a new round of monetary policy easing by the ECB is unwelcome. To the contrary, as I have stressed above, given close trade ties and the correlation of inflation and output between Poland and the euro area, any measures supporting demand in the euro area are desperately needed. But the challenge of responding to capital-flow and exchange-rate volatility remains.

I cannot pretend to have a universally applicable solution, but I can offer some suggestions based on our experiences in Poland.

First, I think a case can be made for central banks to "lean against the wind" in the FX market. Let me explain what I mean by this. Before the crisis, the consensus was that inflation targeting central banks should only care about the exchange rate to the extent that it affected inflation. I'm afraid this is no longer enough. Of course, as I've stressed above, it is generally good to have a freely floating exchange rate. It serves as a buffer against asymmetric shocks and introduces some volatility in the FX market which should discourage complacent attitudes towards risk. But at the same time short-term FX developments can pose financial stability concerns, even if they have limited direct impact on inflation. The central bank should lean against such developments, because if it doesn't, its inflation target could become compromised in the longer run anyway. **Hence, central banks need to strike the right balance between, on the one hand, reacting against temporary swings in FX during "risk-on-risk-off" phases and, on the other hand, suppressing FX risk and with it market discipline.**

Second, although monetary policy itself cannot be autonomous, it can and should be supplemented by autonomous macroprudential policy. Macroprudential policy should remain autonomous because the developments that it is designed to handle are inherently local, rather than global. For example, housing and labor market characteristics are markedly different across EU countries and so different LtV or DTI can

be appropriate in different jurisdictions. And having a locally-oriented macroprudential policy makes the lack of autonomy in interest rate policy less problematic, as it allows the central bank to keep rates more aligned with core markets without jeopardizing financial stability.

Finally, with a "leaning against the wind" approach to FX developments and autonomous macroprudential policy limiting the risk of credit booms, the central bank should be flexible in its pursuit of the inflation target. Although I am not a particular fan of baseball, I like Warren Buffet's saying that great players watch the field, not the scoreboard. Similarly, the central bank should look at underlying processes, rather than be obsessed by keeping inflation on target every year.

And on this note, I feel I should end – wishing you further inspiring discussions and a nice, productive day. Thank you.