Central Europe Economic Letter

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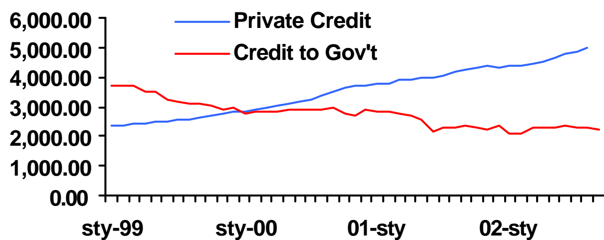

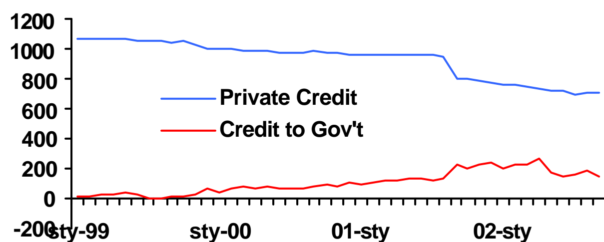

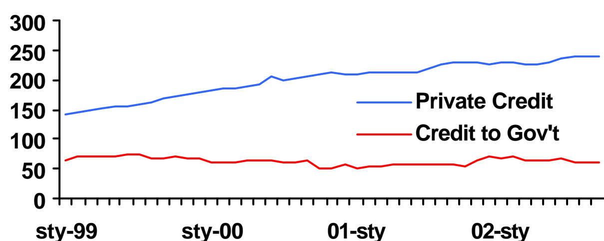

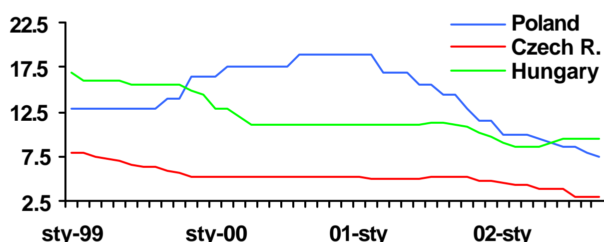

Monetary Policy: Little Bang for the Forint, Koruna, Zloty

This note takes up where the previous month's exercises left off: it looks at how credit has been rationed among major recipients. Standard monetary survey data (monthly) for the past four years yielded predictable results but also led to some unexpected policy conclusions.

The three economies differ in funding patterns. As recently as early 1999 Hungary channeled almost twice as much money to the government as to the private sector. Yet by late 2002 the reverse was true (see graph 1). In the Czech Republic the government hardly borrowed on a net basis in early 1999 but the deepening banking crisis forced it to later on. Finally, Poland paints a picture of stability with net lending to the government roughly level.

One layer below reveals equally differing trends. In Hungary bank financing of non-financial corporations rose 85% (all data in nominal local currency) but household loans shot up well over 200% (all in the same period). In the Czech Republic, by contrast, corporate lending *fell* 40% as banks struggled under the weight of bad loans. Yet net consumer debt *rose* 60%, pointing to the importance of credit quality in times of cyclical change.

These results confirm what we have already learned from the history of transition: Hungary took a long time to work off the crowding-out effect dating back to the 1994-1995 public-sector crisis. And the Czechs are paying now with public funds for the neglect of their banking reform.

But the really intriguing corollary may be this: there seems to be little relationship between the cost of money, the volume of lending, the investment cycle, and economic growth. Poland has gone from tight to easier money, and from state-owned to well-run banks, but its lending pattern, capital formation, and growth bear little relation to one another. In the Czech, despite no fresh lending, investment and growth flourished. And private borrowing kept expanding in Hungary through a period of high rates.

Perhaps too much emphasis is put on the conduct of monetary policy as a vehicle for growth. Not only is the elasticity of *demand* for credit with respect to its cost low, but the *supply* elasticity is equally disappointing. Clearly structural impediments played a role in the Czech Republic's meager record. But one cannot explain away Poland's investment collapse over the past two years without seeing that it coincided with a period of drastic reductions in interest rates and record bank profits. The upshot must be that monetary policy has limited impact on the real cycle.

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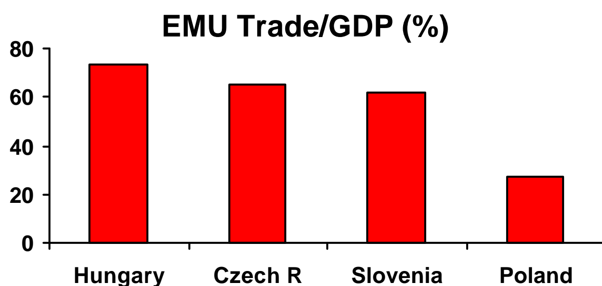
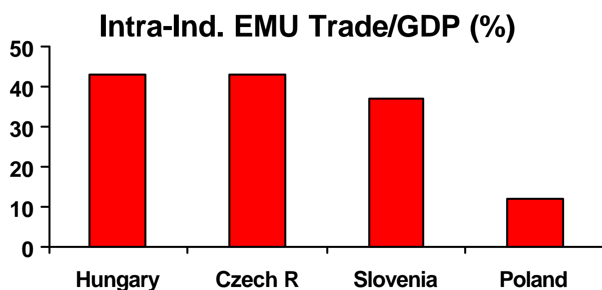
The Rush To Join the EMU Club: Danger Ahead?

The 'if' and 'when' of EU accession negotiations seem to have been decided: the ten candidate countries will join the Union some time in 2004. What is left is the formal approval of the terms by the applicants' governments and through popular referendum votes. The recent markets' rallies indicate that investors have faith in the ultimate will of both sides to clinch the deals.

With the positive sentiment reigning supreme at the moment it is not too early to ponder the next step. Virtually all future EU members profess firm willingness to adopt the euro. The question centers only on the timing and the final conversion rate. Leaving aside the latter point - which is technical - I see some unexpected new reasons to re-think *early* accession to the EMU.

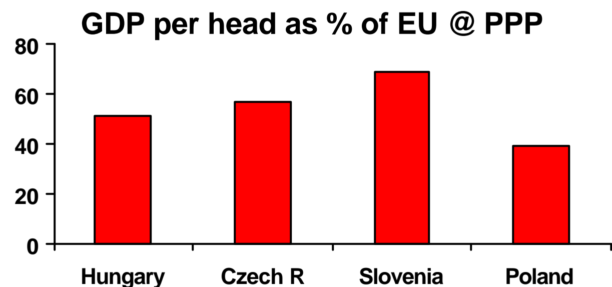


To depart, let's accept each EMU candidate country's (EMUCC) claim that it represents an optimum currency area within the existing EMU zone. There is no clear consensus that this is indeed the case. But then, some existing EMU members (e.g. Greece) have weaker cases to prove their compatibility with the monetary union than Hungary or Slovenia. All of this is immaterial to my argument, however. By the common yardsticks of cycle integration (see graphs 1, 2, 3), Hungary, the Czech Republic, and Slovenia have the greatest claims to the common currency while Poland has the weakest one (from among this sample of four).

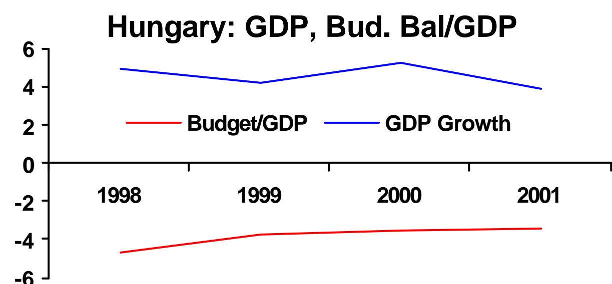


The salient assumption about giving up monetary sovereignty is that adjustments to economic changes will be assured by flexibility elsewhere, e.g., in prices or wages. Also, other channels of intervention ought to be effective, such as fiscal policy. Economic convergence (similar levels of income, interest rates, inflation, etc.) is supposed to indemnify against a possibility that (some) outside shocks hit harder in one region/country than in another.

An ingenious argument is often advanced to embrace the euro early. It states that the convergence criteria themselves represent a worthy objective. In this version, the straightjacket of "stability" ratios delivers where discretionary domestic policy fails. In other words, if national governments cannot or are unwilling to hold inflation down and keep fiscal deficits in check, the supranational body will force them to. Brussels and Frankfurt will bring "irresponsible" parties to their senses.

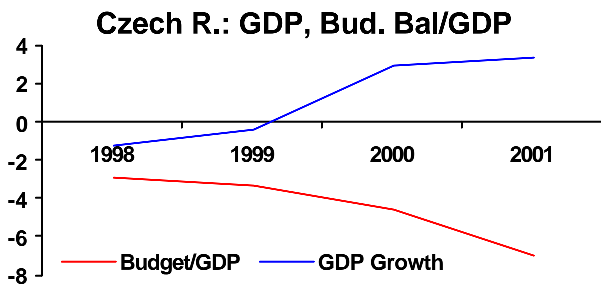


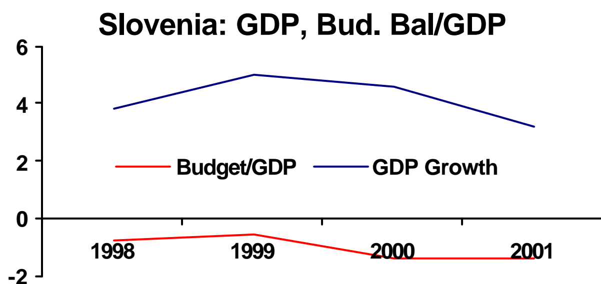
At first sight, this appears to be a tempting proposition, particularly for the emerging European transition economies. Save for the Czech Republic in the early nineties and Slovenia, all other EMUCCs have been rather profligate fiscally regardless of the cycle (see the four graphs below). It is doubtful anyway that all countries would meet all of the Maastricht convergence criteria (inflation, interest rates, budget deficit, public debt) by, say, 2005 in order to adopt the common currency the following year. Unlike in the case of the EU accession, EMU accession need not happen at one time.

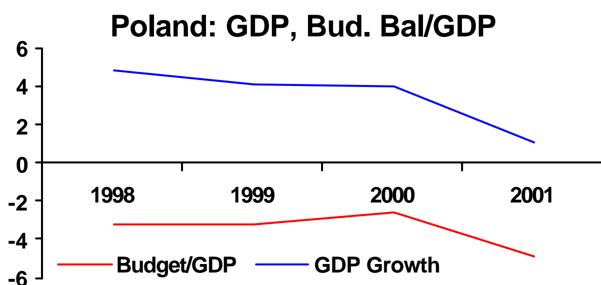


Some countries might be willing and ready to join early (Hungary, Estonia), others might be willing but not ready (Poland, Slovakia), while still others might be ready but not willing (Czech Republic). But, as they say, sometimes just running to snatch a rabbit is as valuable as actually catching it. The notional objective of meeting the Maastricht rules might offer benefits to some economies. Still, they always risk losing some credibility among

investors when they fail to make the grade by the prescribed date.







The monetary integration of Europe will be completed eventually regardless of how much economic sense it makes. The die has been cast and the momentum is on. The EMUCC have no choice but to join one day. That is because in the end the EMU – like the EU itself – is foremost a political project. But the EMUCC have every reason to think hard about the timing and consider all the pros and cons of early accession. Recent developments beckon to pause for thought.

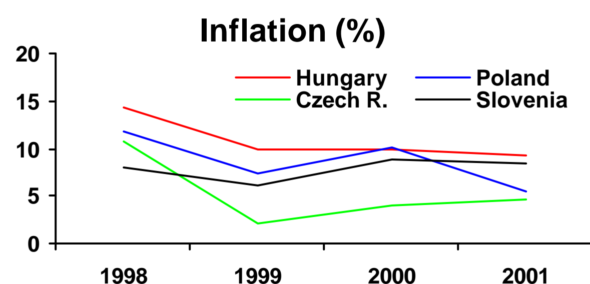
France, Portugal and Germany have transgressed its stability pact obligations in the immediate past: their budget deficits fell under an agreed-upon floor. Under normal rules the offending parties would have to rectify the negligence and adjust fiscally or face financial retribution. Yet neither have the offenders undertaken to correct spending nor has Brussels/Frankfurt pulled out a stick and exacted penalties (so far). This happened probably because the national authorities regard the threat of recession – with its attendant rise in unemployment and social discontent – to be greater evil than possible reprimands or penalties from Frankfurt. In times of crisis, a government reaches out to any policy suitable for countercyclical potency. Since the central bank has been slow to ease monetarily, fiscal loosening was all there was left to use.

Herein lies the danger for early euro adopters. The credibility of governments vis-à-vis investors and citizens rests on “stability” as defined in the stability and growth pact. Investors trust that the straightjacket of “prudential” ratios imposed by the pact at least partially insures against macro risks. And citizens have faith that their hard-earned euros will hold value in the face of shocks or cyclical changes because national governments are supposed to be held to account by Brussels/Frankfurt.

Alas, the promised stick of harsh financial penalties turns out to be malleable. This presents moral hazard to the EMUCC. They could be enticed to “make” the initial entry criteria in full knowledge that the hard budget constraints of continuing membership are in fact much softer. This may not immediately harm their economies but it will have negative external effects on the EMU as a whole. Investors will see through it: they will consider the entire zone to be prone to greater risk and will price its assets accordingly. It is possible, too, that the rather cool reception the EU Commission is extending toward plans for early euro adoptions partially stems from this external risk.

Rushed preparations for EMU entry ahead of its economic time might also be viewed by EMUCC investors with suspicion. It is uncertain how much of a problem this could pose. A weaker exchange rate might actually be welcomed by the authorities, which will grapple with the final conversion rate. But higher market interest rates could cause problems on many fronts.

It is too early to speculate about the possible scenarios and their detailed effects. Today’s enthusiasm for the euro among the EMUCC appears to be an extension of their joy over re-uniting with Europe. That Poland – which has the weakest case for joining – is “ready” while the Czech Republic – which fits better in the club – wavers, is an early warning of possible dangers to come. EMUCC have the freedom to decide when they want to join. They ought to exercise this latitude judiciously.



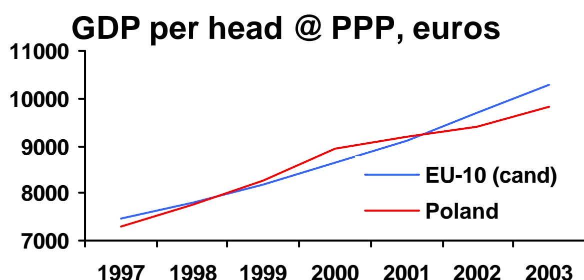
Poland & Geostrategy: Some Loose Thoughts

As economists we condition ourselves to think in terms of the short run, and often statically to boot. By contrast, much could be gained by stretching the analysis of the Polish business cycle beyond the much talked-about "economic turnaround" and its expected timing. I see an interesting introspection to the oft repeated "return to the path of fast growth". Here is what I mean.

There is no denying that fast GDP growth is the indispensable medicine for unemployment reduction, real income gains, and more equitable distribution of wealth. But how "fast" is fast? Is Poland losing much (anything?) by placing itself in the middle rows of Europe's economic leagues rather than at the top?

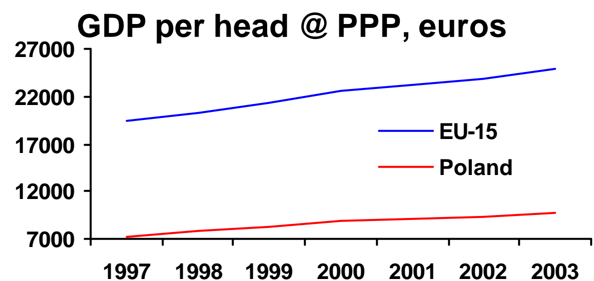
These are important questions. Poland still ranks as one of the poorer nations from among those acceding to the EU despite the fastest cumulative GDP growth over the past decade. Robust catch-up of Poles' real income is in the interest of every EU taxpayer for obvious reasons. But it's not only Europe that cares about the success of Poland. As a country of reasonable economic weight and commensurate political clout, Poland stands a chance to play a regional role – say, similar to that of South Africa in its own neighborhood.

Several capitals root for the success of Poland. In Brussels it's mostly about money (structural funds) but not only. The eurocrats count on the country's strong say in reforming the EU institutions, including its common agricultural policy. In Kyiv Poland is seen by the western-leaning reformers as a partner for rapprochement with the West. Finally, Warsaw's "Atlantic Connection" reposes in its key NATO role. Similar to the UK, Washington sees in Poland a multi-faceted "strategic" ally.



Source: Eurostat

In geopolitical terms Poland stands to reap some not-insignificant benefits, which I term "external". It is not unlike goodwill on a macro scale. In this analogy, a country is worth more than its "book value" (extent of the market, quantity and quality of its capital and labor, value of its infrastructure etc.) if its negotiating and political pull in Brussels is substantial, if its voice is heard in Washington, at the UN or if it is sought after as a peace-broking intermediary in international conflicts. The Poles might ask: "what good comes out of it all when we don't aspire to a power status; and besides we feel cozy as it is." Just not worth the effort, they could add.

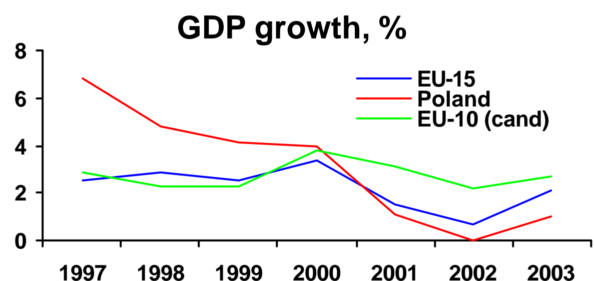


Source: Eurostat

I believe it's worth the effort. First, it pays to be respected and counted on as a close friend. Those who remember September 1939 don't have to be reminded. Second, international recognition goes hand in glove with trade relations, flow of capital or one's place on the business map of the world. Those who are richer and more influential deal the cards; that's how it was, and it will stay that way. Some Poles might shoot back: "well, but the goodwill is already at hand so what's the trouble all about"?

It's all about not losing it.

Poland will forfeit its goodwill gradually if it doesn't embark on a fast track of closing the economic gap with the rest of Europe. Robust GDP growth is a *sine qua non* condition for success of this strategy. Likewise, Warsaw will lose its clout in Brussels, Kyiv and Washington if it becomes unstable politically or – worse – if it turns its back on an engaged foreign policy.



Source: Eurostat

Many countries are banking on an economically strong and politically astute Poland. The country has everything to gain from meeting this challenge. If politicians of all stripes in the Sejm heed at least this much, then there are grounds for optimism.

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