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A Post-Crisis Eurozone: Still an Attractive Offer for Central Europe¹

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The economic crisis led the eurozone to become a more deeply integrated area. The redesign of its institutional architecture significantly changes the perception of the costs and benefits of the membership of the zone. In this regard, the Central and Eastern European countries (CEE) are reassessing the effects of eurozone accession, by reviewing the set of arguments for and against further integration. The overall result of this review is still in favour of further integration, but successful accession requires comprehensive preparations from the candidates.

The currently reforming eurozone is not the same single currency area as it was in the immediate wake of crisis. The risks and benefits have different weights now than they did then. The changing architecture and economic governance of the zone hinders Central and Eastern European countries' clear assessment on eurozone entry. The reforms of the zone are so complex and multidimensional that the overall outcome for the candidates is unclear. The obligation to join the area,² and prioritising the question “when” over the question “if” does not help to clarify how the CEE's strategy towards entry should look.

This raises the question of whether the current, reformed conditions have made the eurozone attractive enough for the CEE countries to join, or whether they discourage entry. To answer this question it is first necessary to clarify the “pre-crisis” consequences of entering the eurozone. According to the Ministry of Finance of Poland (which perceives the net balance to be positive),³ the short and long-term benefits include the increased reliability of national economic policy, elimination of trade risks, reduction of transaction costs, a lowering of interest rates (which should induce more investment and consumption), a deepening of financial markets' integration, and an increase in trade. These benefits should contribute to better economic growth. Apart from these points, a pre-entry eurozone country upon joining would gain influence on ECB and Eurogroup decisions. The counterbalance effects of adopting euro included the risk of higher prices, the cost of complying with Maastricht criteria, technical and administrative costs, the risk of a short-term boom in consumption that would damage external competitiveness, and long-term costs

¹ This paper reflects the conclusions drawn from the conference “(EU) Economic Governance in the Making—the CEE Perspective”, held as part of the RAstaNEWS project, and it also reflects the author's personal thoughts.

² In fact, because of the lack of an opt-out, the CEE countries should not consider “if” they will join the eurozone but “when” (M. Larch, “Remaining outside the eurozone: an increasingly attractive option for CEE?”, presentation during the conference “EU Economic Governance in the Making—the CEE Perspective,” RAstaNEWS project, 2014).

³ “Bilans kosztów i korzyści wprowadzenia euro w Polsce w świetle najnowszych badań,” Ministry of Finance, Warsaw, 26 October 2010.

associated with losing autonomy in regard to monetary and exchange rate policy (including the risk of asymmetric shocks with little room to counter them, and little space to adjust to global changes).

The evolution of the eurozone modifies the pre-crisis balance with four main game changers. First, there has been a fact-based revalidation of the pre-crisis expectations on the pure economic benefits and costs of entry. Second, new short and long-term stabilisation mechanisms have been established. Third, the new, more pro-active, European Central Bank's (ECB) monetary and broader economic policy has been launched. And, last but not least, a new framework for the banking sector, designed specifically for the eurozone, is in place. When taken together, these modifiers favour joining the eurozone.

Expected Economic Consequences of Eurozone Entry

Since the beginning of the eurozone crisis at the end of 2009, the attractiveness of the single currency area in, economic terms, declined from the point of view of the CEE countries. Verification of the impact of eurozone membership on individual economies during the crisis played a key role in redefining the attractiveness of joining. Some economic benefits of eurozone membership appeared to be conditional over time,⁴ less significant, or lower than expected.

The most vaunted gain of entering the eurozone for a "catch up" country such as Poland, or any other CEE state before the crisis, was always the promise of lower interest rates.⁵ This is what the peripheral countries that entered the eurozone hoped for. But the view of interest rates as an advantage has recently been questioned by some economists.⁶ Paradoxically, lower interest rates could trigger low or unsustainable growth in the longer term. This is because cheaper capital offered by the eurozone's core members has not always been used to finance investment, but all too often to finance consumption and wage growth. This left the pace of productivity growth far behind wage growth, and in the case of the CEE it might call the sustainability of the catching up process into question.

The other thing is that lower interest rates create a moral hazard, as it encourages reckless investment, such as in the housing market, creating bubbles or macroeconomic imbalances.⁷ This moral hazard meant that the crisis hit most in the countries that enjoy low interest rates. Without the common currency, their rates would probably be significantly higher and would therefore have not induced asset bubbles. Hence, the argument of low interest rates is less tempting to the CEE than it was before the crisis.

The other important benefit of the common currency that proved to be lower than expected or less clear is the boost to trade caused by the decrease in trade costs. In the pre-crisis view, because there was no exchange rate risk, trade was cheaper than it would have been without the common currency. From this perspective, businesses do not need to pay additional capital to internalise risk, and thus overall trade increases. This argument is important, as the eurozone is, for the CEE countries, a significant trade partner. However, analysis of empiric data only partly supports this hypothesis. Some data suggest that membership of the eurozone (or indeed any currency union) increases trade significantly,⁸ while the analyses give more modest results.⁹ In light of this, the most obvious benefits turn out to be unclear, or less significant to the CEE region than expected.

⁴ J. Jaworowski, "Introductory speech during the conference 'EU Economic Governance in the Making—the CEE Perspective'," RAstaNEWS project, 2014.

⁵ J. Jaworowski, "Introductory speech...", *op. cit.*

⁶ Compare with: http://wyborcza.biz/biznes/1,101716,17468951,Niskie_stopy_procentowe_hamuja_wzrost.html (accessed 23 February 2015).

⁷ See: <http://www.ekonomia.rp.pl/arttykul/1179482.html> (accessed 16 February 2015).

⁸ See, for example: T. Sadeh, "The euro's effect on trade," *European Union Politics*, 2014; A. Cieřlik, A. Michaćek, J.J. Michaćek, "The Impact of the Common Currency on Exports of New EMU Members: Firm-level Evidence for Slovenia and Slovakia," 2013.

⁹ See for example: M. Camarero, E. Gómez, C. Tamarit, "EMU and Intra-European Trade: Long-run Evidence Using Gravity Equations," *The Papers*, no. 10/25, 2012, Department of Economic Theory and Economic History of the University of Granada; M.J.G. Bun, F.J.G.M. Klaassen, "The Euro Effect on Trade Is Not as Large as Commonly Thought," *Oxford Bulletin of Economics and Statistics*, vol. 69, no. 4, 2007, pp. 473–496.

The crisis proved that some economic costs were underestimated, and that imbalances between eurozone members were especially harmful. The quiet assumption in the wake of the eurozone's beginning that the states would converge within the currency union was weakened severely. Differences remained and thus the imbalances increasingly appeared to be a burden for the states. The problem was that the ECB had too few options to address the issue of imbalances in some states, while the lack of a single economic policy for the whole area only amplified them.

A problem linked with the imbalances is the ECB's focus on the stability of the entire eurozone, rather than on the particular (smaller) states. If these states (as with current candidate countries) had different business cycles than the biggest states, or than the eurozone in general, the ECB was unlikely to have adjusted its monetary policy to suit them, instead favouring the majority. Hence the CEE countries risk becoming victims of the divergence of cycles between them and the eurozone after entry.

New Architecture for Stability

Since the beginning of the crisis, the negative developments in the eurozone (the overall downturn of the zone, the banks' insolvency, and the necessity to design rescue packages for some southern members) prompted intense reforms of the zone's architecture. Some economic costs, such as high exposure to systemic risk, or the occurrence of imbalances, can now be alleviated thanks to the new institutional framework. This game changer would rather incentivise the CEE countries to join the eurozone as the political reforms make the currency union more prepared to enlarge. But are such changes sufficient encouragement?

The institutional changes can be divided into two groups. The first consists of ad hoc measures, including temporary anti-crisis funds (the Greek Loan Facility, European the Financial Stability Facility, and the European Financial Stabilisation Mechanism), EU budget assistance (the European Economic Recovery Programme), and the European Central Bank's unorthodox liquidity measures (such as Long-Term Refinancing Operations, Outright Monetary Transactions and Quantitative Easing). The second group consists of permanent solutions, including better coordination of fiscal policies and, more broadly, of economic policies under the legislation packages (the "Two Pack", the "Six Pack and the Fiscal Compact) and under the European Semester Framework (such as the Macroeconomic Imbalance Procedure), as well as the founding of the permanent anti-crisis fund (the European Stability Mechanism) and introduction of the Banking Union, aimed at calming down the situation on the financial markets and stabilising the banking sector.¹⁰ In short, these measures have secured the future of the eurozone, as the new architecture would stabilise economies in the long term.

These short and long-term solutions already to be having a positive effect on the eurozone, as the situation on the financial markets has indeed calmed down, and the interest on 10 year bonds has stabilised at a low level, even in the case of southern members (except for Greece). This shows that the reforms have returned at least a fragile trust in eurozone. Moreover, the growth forecast for 2015 are positive (1.5% for the entire zone), while public debt in 2015 is expected to decrease for the first time since the beginning of the crisis, giving hope for positive developments in the future.

But post-crisis political and institutional integration of the eurozone also has a darker side. It limits room for manoeuvre of individual states regarding the economic policy (including fiscal harmonisation), thus creating constraints on adjusting to prevailing macro-economic conditions. Since the CEE countries enjoyed freedom to conduct their own policies in response to the economic crisis, and as these policies appear to have been more successful than those of the eurozone members, the eurozone's new corset might even further discourage them from joining. Moreover, mandatory contributions to permanent rescue funds, possibly reaching up to 1% of GDP, would be a negative balance against the effects of domestic fiscal policy in the short-term, and thus might even cause the CEE "outs" to postpone any decision on adopting the euro. This rescue fund money would go to the richer but worse managed countries, such as Greece, which

¹⁰ M. Larch, "Remaining outside the eurozone..." *op. cit.*

would raise concerns among CEE societies about the fairness of the integration process within the eurozone. Nevertheless, even this negative aspect cannot outweigh the possible gains arising from these institutional and political reforms.

The ECB's Approach in Times of Crisis

Among the most important and positive post-crisis ad hoc solutions are those implemented by the ECB, and they require a separate discussion. Before the crisis, the ECB's role was limited to maintaining the stability and value of the euro. The crisis greatly changed this approach, with the ECB adopting a bold, unorthodox and pro-growth profile. The CEE, fearing the ECB's passive pre-crisis policy, which was limited to monetary goals, need no longer have such concerns. The ECB's new approach gives the eurozone hope for growth, but also assures the CEE countries that they would not lose their momentum as a result of the catching-up process, when joining the eurozone.

The banking crisis in the eurozone, as during the Great Depression in 1930s or during the Japanese lost decades (1991-2010), impeded the commercial banks' money creation process, despite nearly zero percent interest rates.¹¹ As in the past, the ongoing crisis weakened the domestic general demand, which amplified the banks' inability to extend loans because of losses. The traditional loosening of monetary policy ends at zero interest rates, but the unorthodox measures that changed the banks' assets may revive lending.

As compared to very early crisis stage and Jean-Claude Trichet's modest response (doubling liquidity-swap lines with the U.S. Federal Reserve, reducing interest rates in the late 2008, and launching short-term maturity operations and a covered bonds programme in 2009), the scale of unorthodox operations gained tempo as the crisis continued. Since the rule of Mario Draghi (in November 2011), the ECB has acted boldly and, in the opinion of German economists, controversially,¹² to stabilise the financial markets in the eurozone.

In this context, the ECB's announcement that it will do "whatever it takes",¹³ and its initially modest actions to increase liquidity on the financial markets (such as Long-Term Refinancing Operations [LTRO] or Outright Monetary Purchases [OMT],¹⁴ and lately the much braver Quantitative Easing [QE]), shed light on possible new benefits arising from joining the common currency club. These actions bring new stability within the eurozone and may dispel the nightmare of the "Japanese effect", that is, a eurozone with a long-lasting period of deflation and no growth, which, combined with ageing societies and huge public debt, is a looming problem for eurozone governments. The goals of all these unorthodox monetary loosening measures are to reduce the banks' potential losses, lower the long-term interest rates, and halt the decline of asset values.¹⁵ The side effect of quantitative easing is even more important, as depreciation of the currency may help eurozone members to regain competitiveness. These actions offer strong argument in favour of CEE countries adopting the euro, as they no longer need to worry that monetary policy would hamper their pro-growth efforts. While the ECB's pre-crisis approach would certainly have stopped the growth of CEE countries, due to the uncompetitive exchange rate of the common currency, post-crisis activity would depreciate the euro and then improve the competitiveness of the CEE countries after entry to the eurozone. Hence this seems to be the most effective game changer, compared to the others.

Yet the additional ECB money on the market may not necessarily contribute to the growth, as, due to the liquidity trap, banks might not circulate it to the real economy. Or the actions may prove to be too late, or

¹¹ A. Sławiński, "ECB trapped at zero lower bound," presentation during the conference "EU Economic Governance in the Making—the CEE Perspective," RAstaNEWS project, 2014.

¹² K. Matussek, "ECB's 'Whatever It Takes' Questioned by Top German Court," *Bloomberg Business*, 7 February 2014.

¹³ See: www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html (accessed 18 February 2015).

¹⁴ A. Villafranca, "The new QE: Is it desirable? Is it enough?," presentation during the conference "EU Economic Governance in the Making—the CEE Perspective," RAstaNEWS project, 2014.

¹⁵ A. Sławiński, "ECB trapped...", *op. cit.*

on too small a scale.¹⁶ There are also concerns that the ECB's action would distort the market, harming, for example, savers and pensioners, or that there would be an increased risk of imbalances in the area arising from too low interest rates. The evidence shows, however, that QE plays a positive role in the eurozone; the exchange rate has weakened and growth prospects are increasingly positive.

A Banking Union—a New Incentive to Join the Eurozone

Another game changing argument is the creation of the new institutional framework intended to secure the eurozone's banking sector, which favours “ins” over “candidates” or “outs”. The advantage for the eurozone members is mainly based on the ECB's leading position in the Banking Union, notably in the Single Supervisory Mechanism and in Single Resolution Mechanism. The CEE countries, being outside the eurozone, would have little impact on ECB policy in formulating the activities of these two mechanisms. The new architecture, apart from strengthening coordination between the fiscal policies, offers a new framework for the fragile banking sector in the eurozone. The more macro-prudential settings, arising from Capital Requirements Directive IV and the Capital Requirements Regulation, have been introduced, paving the way for the Banking Union, which is designed to break the negative feedback loops between banks and public finances.¹⁷ This new Banking Union consists of the Single Supervisory Mechanism (a supervisory framework with the ECB in a leading role), a single rule book (mainly in regard to capital requirements), the Single Resolution Mechanism (responsible for efficient risk management of banks facing serious difficulties), and a unified eurozone deposit guarantee system.

The impact on the ECB's policy is important for the CEE countries as their banking sectors are more dependent on the interbank market than are Western banks. Indirectly, this means that the banks in Central and Eastern Europe were dependent on financing from their mother banks, mainly from countries in the eurozone,¹⁸ and were therefore exposed to a risk from the credit crunch.¹⁹ Thus the problems of the mother banks, which finance their subsidiary operations in Central and Eastern Europe, would be transmitted.

This means that the new Banking Union framework influences the CEE banking sector, even if these countries are not members of the Banking Union.²⁰ So the way that mother banks solve their problems, and the way they are regulated, have an important impact on the local banking sectors in the CEE countries. Even if joining the Banking Union does not automatically guarantee much more power to the national supervisors, it is better to influence the ECB as a eurozone member than to stand aside and let the regulated and ECB-supervised eurozone banks control the CEE banking sectors.

Economic Ambiguity, Political Clarity

The crisis-induced reforms in the eurozone significantly changed the balance of benefits for the CEE, and the costs of entry, and these changes require more attention from the candidate countries compared to in the pre-crisis state. The possible influence on the banking sector within the Banking Union, mainly through the ECB, as well as the positive effects of the ECB's flexible and unorthodox pro-growth policy and the stabilising institutional framework, would work in favour of the CEE countries after accession to the eurozone. Only a revision of the basic economic arguments speaks for more caution regarding the entry process.

¹⁶ A. Villafranca, “The new QE: Is it desirable? Is it enough?,” presentation during the conference “EU Economic Governance in the Making—the CEE Perspective,” RAstaNEWS project, 2014.

¹⁷ M. Larch, “Remaining outside the eurozone ... ,” *op. cit.*

¹⁸ Z. Darvas, G. Wolff, “Should Non-Euro Area Countries Join The Single Supervisory Mechanism?,” *Bruegel Policy Contribution*, 2013.

¹⁹ A. Hryckiewicz, M. Pawłowska, “Czy nowy nadzór spełni swoje zadanie? Zmiany w nadzorze finansowym w Europie oraz ich konsekwencje dla Polski,” *Materiały i Studia NBP*, 2013.

²⁰ K. Bednarek, speech during the conference “EU Economic Governance in the Making—the CEE Perspective,” RAstaNEWS project, 2014.

However, the overall re-assessment of the balance of pros and cons of entering the eurozone, as a result of the game changers mentioned above, should encourage the CEE countries to revise their standpoint more towards the positive, but with additional preparedness.

Although the CEE countries are obliged to adopt the euro, it is not specified when and under what conditions this should take place. This enables, and should indeed encourage, the candidates to adopt the “wait and work” strategy, which would prepare them as much as possible to minimise the risk of eurozone membership and avoid a repeat of the problems of the PIIGS (Portugal, Ireland, Italy, Greece and Spain).

The reason the CEE countries need to make domestic efforts to join the eurozone (although not at any cost) lies in the fact that the political advantages of membership are even more important than the economic ones. The creation of the eurozone was politically motivated, and it shapes the direction of European integration. Reform of the EMU has not yet finished, and deeper integration, for example, in the field of taxation, but also in broader and more complex terms, is only a matter of time. In this context, June's “Deeper and Fairer Economic and Political Union” report, by five presidents, shows the potential for further political and economic re-design.

Moreover, the vision of the completed political union is becoming increasingly more realistic, and certainly the role of the eurozone would then be substantial. The crisis even amplified the zone's place at the core of European integration. This happened through the emergence of supervision for European banks, the creation of rescue funds, and the strengthening of coordination between economic policies not only in the eurozone, but also in the rest of the EU, with the eurozone as a model. Ties between the European Commission (through the commissioner for economic and monetary Affairs and the euro) and the eurozone bodies (the Eurogroup and the ECB) were also reinforced. Because of the crucial role of the eurozone in the integration process, those countries on the outside would have less of a say on the direction of changes when the time comes.



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