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Preface

In May 2004, Poland joined the Economic and Monetary Union (EMU) as a member state with a derogation. The derogation covering the single currency is temporary. This means that Poland is required to comply with the convergence criteria and introduce the euro. Adoption of the single currency entails permanent pegging of the zloty to the euro and giving up the possibility of pursuing an independent monetary policy, as well as the requirement to join the European Stability Mechanism and the emerging banking union.

Poland's current strategy of integration with the euro area is defined by the Council of Ministers and rests on four pillars[1]:

- *Pillar 1*. Orientation of Polish economic policy towards permanent compliance with the convergence criteria, in particular with regard to fiscal discipline.
- *Pillar 2*. Undertaking of additional measures to strengthen the potential of the Polish economy, including in the institutional sphere.
- *Pillar 3*. Thorough preparation of technical and organisational aspects of the process.
- *Pillar 4*. Stabilisation of the situation in the euro area, particularly as concerns its institutional strengthening.

Entry into the euro area is "only" and "even" an opportunity to realise the scenario of accelerated economic growth and increased wealth of society. Analyses conducted before the financial crisis indicated that the introduction of the euro in Poland should increase the GDP level, both in the short- and long-term. However, the experience of the euro area countries, particularly during the recent crisis, suggests that adoption of the euro is connected with the risk of increased macroeconomic instability and a slowdown in economic growth, above all in the case of countries with weak macroeconomic fundamentals. This means that the scenario of accelerated growth after adoption of the single currency should be treated as an opportunity only which one should know how to take advantage of.

The opportunity to accelerate economic growth in Poland as a result of adopting the euro depends on whether the institutions of the euro area and the potential of the Polish economy will be strengthened. In considering the opportunities and threats associated with the adoption of the single currency, the most important factor in determining the external environment of the currency union is the current shape and future evolution of the euro area institutional structures (pillar 4. strategy). In this respect, the key challenges are related to the degree of fiscal, economic and financial integration. The most important internal factor, i.e. dependent on the national economic policy, is the extent to which the Polish economy is prepared to become part of the single currency area. It is recommended that prior to taking the decision to join the euro area, a well-considered reform programme should be implemented, which will strengthen the fundamentals of the Polish economy and adapt it to the conditions necessary for the functioning of the currency union (pillar 2. strategy).

[1] The strategy was presented in the document of the Council of Ministers *Convergence Programme. Update 2014*.

The report discusses the economic challenges of Polish integration with the euro area. In particular, the first part of the study titled "Strengthening of euro area institutions" shows to what extent the institutional changes that have already been introduced, as well as those that are still ahead, improve the foundations of the single currency area and what the consequences of these changes are for the Polish economy. Therefore, part one deals with the issues related to the fourth pillar of the strategy of integration with the euro area. The second part of the study titled "Strengthening the potential of the Polish economy", based on an analysis of the experience of the euro area countries, discusses the conditions necessary for the efficient functioning of the Polish economy in the euro area. The study examines which structural features of the member states' economies increased the likelihood of the scenario of accelerated economic growth, and which features increased the risk of growing macroeconomic imbalances. Hence, part two discusses issues related to the second pillar of the integration strategy. It should be stressed that the study is not a comprehensive analysis of the effects of Poland's adoption of the euro: among others, it does not deal with the political effects of remaining outside the euro area. The study focuses exclusively on the economic challenges and in this sense it represents only a check list of questions that require solutions before the adoption of the euro.

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Part I. Strengthening of euro area institutions

Introduction

The sovereign debt crisis exposed numerous weaknesses in the institutional set-up of the Economic and Monetary Union (EMU). Firstly, it turned out that mechanisms of coordination and supervision over domestic fiscal policy are not sufficiently effective in order to avoid excessive indebtedness of member states[1] and ensure anti-cyclical fiscal policy. Secondly, a significant weakness was the lack of effective instruments (both market-based and non-market-based ones) to shape the remaining areas of economic policy. This also applies to mechanisms that incentivize the governments of euro area countries to carry out reforms that would prevent the loss of competitiveness and hinder the build-up of macroeconomic imbalances, would limit the costs of adjustment in periods of economic downturn, and would reduce structural divergences between these countries. Thirdly, the crisis showed that the decentralised model of financial supervision is inappropriate in a situation in which there are strong links between the banking systems of individual member states, and also that the regulations in force in the banking sector are ineffective from the point of view of limiting threats to financial and macroeconomic stability. Fourthly, the absence of crisis management mechanisms, including the absence of procedures and instruments of financial support for member states facing illiquidity or insolvency, turned out to be a significant problem. Fifthly, the crisis has highlighted the low effectiveness of the decision-making system in the euro area.

The institutional weaknesses revealed by the crisis led to a series of reforms in the EU as well in the euro area. The majority of the institutional reforms were implemented in all the member states of the European Union (EU). However, due to the strong financial and trade links, and also due to the restrictions placed on the economic policy of the euro area countries as a result of their membership in the currency union, the adverse effects of the institutional weaknesses were in their case significantly greater than in the remaining member states of the EU. Thus, some of the institutional changes were confined only to the countries of the euro area (Two Pack, the European Stability Mechanism (ESM), some elements of the macroeconomic imbalance procedure).

Reforms were to a large extent implemented while maintaining the existing institutional model, which assumes the coexistence of a single monetary policy and national fiscal and economic policies. In order to improve the functioning of the existing model, it was decided to introduce reforms aimed at the following:

- improving fiscal discipline in member states (European Semester, reform of the Stability and Growth Pact (SGP), Directive on requirements for budgetary frameworks of Member States, Fiscal Compact, Two Pack);
- reducing the risk generated by inappropriate economic policy in the remaining areas (Macroeconomic Imbalances Procedure, Euro Plus Pact);
- creating mechanisms for crisis management and financing (macroeconomic adjustment programmes, Two Pack, ESM, the European Central Bank's (ECB) Outright Monetary Transactions (OMT));

[1] Given the scope of the study, which concentrates on institutional reforms in the euro area, in this study the term "member states" shall refer to states that are members of the euro area.

- adjusting the degree of integration of the European financial safety net to the degree of integration of the financial markets in the EU (European Supervisory Authorities (ESAs), the European Systemic Risk Board (ESRB)) and a change in the regulations of the banking sector (regulatory package CRDIV/CRR);
- improving the effectiveness of decision-making process in the euro area (strengthening the role of the Eurogroup).

One exception to the above-mentioned alterations to the existing institutional model is the creation of the banking union, which involved centralisation of supervision and resolution at the European level. In October 2013, the Council of the EU adopted a regulation establishing the first element of a banking union: the Single Supervisory Mechanism (SSM), which entered into force on 4 November 2014[2]. The regulation on the second pillar of the banking union, i.e. the Single Resolution Mechanism (SRM)[3], was adopted by the European Parliament in April 2014 and next by the Council of the EU in July 2014. The SRM Regulation establishes the Single Resolution Board (SRB) as the main decision-making body, as well as the Single Resolution Fund (SRF), whose funds will be used to carry out resolution procedures. In relation to the deposit guarantee, which in the literature is regarded as an important element of the banking union (Pisani-Ferry et al. 2012), the main change was further harmonisation of DGSs introduced by Directive 2014/49/EU[4]. However, since no pooling of national deposit guarantee funds was foreseen, *de facto* there is no centralised third pillar of the banking union.

Despite the wide range of reforms, economists and policy makers are convinced that the institutional set-up of the euro area remains incomplete. This conviction was reflected in two reports published in November and December 2012 – the report of the European Commission (EC 2012a) and the report by the President of the European Council (Van Rompuy et al. 2012) outlining a stage-based strategy towards a genuine economic and monetary union. Apart from the need to create a banking union, the documents advocate the deepening of fiscal, economic and political integration. In particular, a proposal for the creation of a well-designed fiscal capacity of a limited scale, constituting a system protecting euro area countries against the consequences of asymmetric shocks (Box 4), has been put forward. A comprehensive study on the institutional change which is necessary to ensure the long-term stability of the euro area was also prepared by experts from the Tommaso Padoa-Schioppa group (2012). Reports on the desired institutional frameworks for the euro area in the scope of financial (banking union) and fiscal integration (fiscal union) were also prepared by experts from the IMF (Goyal et al., Allard et al. 2013). Moreover, numerous articles on the deepening of euro area integration in various dimensions (financial, fiscal, economic and political integration) were published by economists of the Bruegel Institute (see Pisani-Ferry et al. 2012, Wolff 2012, Pisani-Ferry et al. 2013).

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[2] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions and Regulation (EU) No 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending the Regulation establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation No 1024/2013.

[3] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, Official Journal of the European Union, L255/1 of 30 July 2014.

[4] Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes, Official Journal of the European Union L173/149 of 12 June 2014.

The solutions proposed in these studies with respect to the institutional set-up of the euro area are largely based on indications of the optimum currency area theory, concerning the necessary conditions to limit the costs related to the abandonment of independent monetary policy and floating exchange rate. A number of arguments in the current debate on institutional reform in the euro area were already put forward in the 1970s at the early stage of conceiving the idea of European integration, and later in the 1980s and 1990s during the work on the Maastricht Treaty, which contained the legal framework for the creation of the EMU (see Werner Report 1970, MacDougall Report 1977 and Delors Report 1989). These arguments were rooted in the optimum currency area theory and raised doubts about the efficiency of the currency union between heterogeneous economies, with centralised monetary and exchange rate policy coupled with fiscal policy and other areas of economic policy falling under the control of the national authorities. The optimum currency area theory identifies the institutional factors which limit the costs resulting from the lack of monetary and exchange rate policy independence by the following (see Friedman 1953, Mundell 1961, Kenen 1969):

- reducing the risk of asynchronous fluctuations[5] in the regions that make up the currency union;
- reducing the costs of economic adjustments to asynchronous fluctuations.

The first group of factors includes institutions supporting economic integration and the convergence in economic structures of member states of the euro area (e.g. institutions strengthening the single market and the deepening of trade integration). The second group of factors involves mechanisms of fiscal and financial integration and institutions that increase the mobility of factors of production, as well as policies aimed at increasing price and wage elasticity.

This part of the report has four main aims. The first aim is to provide a synthetic description of the institutional change that has been carried out in the euro area in recent years. **The second aim**, of a positive character, is to identify the potential weaknesses of the current institutional set-up of the euro area, which in the long-term may threaten its stability or involve significant costs in the form of output and employment volatility. These analyses take into account the current economic conditions such as the high level of indebtedness of some member states and the strong structural divergence between euro area countries (in terms of production structure, the quality of human capital and level of capital resources). **The third aim**, of a normative character, is to analyse the institutional solutions which could limit these shortcomings. Above all, the proposed institutional reforms presented in the reports of the European Commission (EC 2012) and the report by the President of the European Council (Van Rompuy et al. 2012) are analysed in this report. However, it also analyses other solutions presented in the studies on the future of the euro area. **The fourth aim** is to assess the influence of the planned institutional changes on the Polish economy, including their implications for Poland's integration with the euro area. The analyses are conducted in three areas:

- fiscal integration,
- economic integration,
- financial integration.

[5] Asynchronous cyclical fluctuations may be the result of both asymmetrical shocks (i.e. demand or technology shocks affecting only one region in the currency union), as well as an asymmetrical economic response to common shocks resulting from a different institutional or structural features of individual countries/regions that make up the currency union.

Chapter 1 discusses the possibility of using national fiscal policy as a tool to stabilise the business cycle. There is also a discussion on the merits of sovereign debt pooling and of creating fiscal capacity in the euro area as an instrument that allows for better international risk-sharing and limits the economic divergence between countries that make up the currency union. Further, Chapter 1 assesses the consequences for the Polish economy of the introduction of changes in the above-mentioned areas, taking into consideration two scenarios: Poland as a future member state of the euro area and Poland as a country remaining outside the euro area during the period of implementation of the analysed instruments. Chapter 2 focuses on the institutional reforms which could – first of all – reduce the structural divergence between the euro area member states. This in turn would limit the destabilising functioning of the real interest rate channel and would improve the real exchange rate channel (Box 4). Secondly, such reforms could also boost the effectiveness of adjustment through mobility of factors of production. The consequences for the Polish economy of implementing two solutions strengthening economic governance in the EU are also discussed: a solidarity mechanism and *ex ante* coordination of plans for major economic policy reforms. Again, it analyses the two scenarios mentioned above. Chapter 3 discusses the regulatory and institutional changes related to the organisation of a financial safety network that were introduced in the European Union in response to the financial crisis. In particular, it focuses on the solutions adopted in the context of the creation of the banking union. The analysis presented in this chapter is also conducted from the perspective of a country that belongs to the euro area, a country outside the euro area and remaining outside the banking union, as well as from the point of view of participation in the banking union as a result of establishing close cooperation (assessment of the conditions for establishing close cooperation).

Chapter 1. Fiscal integration

1.1. Current principles of formulating fiscal policy in the euro area

The EMU was created as a currency union in which fiscal policy is decentralised. The budget of the EU is not a tool for economic management in the euro area. Moreover, its size is limited. The adoption of such a solution was dictated by political considerations. Unlike the fiscal union, it did not require far-reaching political integration, which would involve limiting the autonomy of member states in the areas subject to centralisation.

In order to limit the risks related to the maintenance of decentralised fiscal policy in the currency union, common fiscal rules and surveillance procedures were introduced. However, these turned out to be ineffective. Already at the onset of designing the institutional framework of the EMU, it was recognised that leaving fiscal policy in the hands of member states could give rise to the moral hazard or increase the risk that the irresponsible policies of one of the members could threaten the remaining members as well as the common monetary policy. It was also recognised that with the abandonment of their independent monetary and exchange rate policy, member states would need to have sufficient room for anti-cyclical fiscal policy to smooth economic fluctuations. Therefore, the Maastricht Treaty introduced a no bailout clause (the EMU as a whole and member states are not responsible for the liabilities of other member states and cannot assume them), a ban on monetary financing and fiscal convergence criteria. The latter were supplemented in 1997 by the Stability and Growth Pact (SGP), which is a set of fiscal rules in force in the EU and the procedures aimed at ensuring the enforcement of these rules. However, the crisis revealed that the above-mentioned mechanisms of supervision over national fiscal policy were not sufficient to prevent excessive indebtedness of member states and ensure that national fiscal policy will be an effective tool to stabilise the business cycle.

The crisis prompted the decision to reform supervision and coordination[6] of fiscal policy in the EU. In December 2011 a package of legal acts came into force aimed at strengthening economic governance, making up the Six Pack[7], while in May 2013 the Two Pack[8] came into force. The new regulations introduce

[6] The term "coordination" in relation to fiscal policy in the euro area has two different meanings. Firstly, it is a set of instruments and actions aimed at identifying common frameworks for fiscal and economic policy and the resulting obligations to take fiscal and economic policy decisions at a national and international level. Secondly, as the enforcement of fiscal discipline in member states (based on fiscal rules) in order to avoid the adverse effects of irresponsible policy of individual states for the functioning of the monetary union.

[7] The Six Pack covered Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States, the following regulations of the European Parliament and of the Council: 1) Regulation (EU) No. 1173/2011 on the effective enforcement of budgetary surveillance in the euro area, 2) Regulation (EU) No. 1174/2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area, 3) Regulation (EU) No. 1175/2011 amending Council Regulation (EC) No. 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies, 4) No. 1176/2011 on the prevention and correction of macroeconomic imbalances, and the Council Regulation (EU) No. 1176/2011 amending Regulation (EC) No. 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure.

[8] The Two Pack covered two regulations of the European Parliament and of the Council: 1) No. 473/2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area; 2) No. 472/2013 on the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability.

changes to the provisions that make up the SGP, both in the preventative and corrective arm. The new system of rules was additionally strengthened by the Fiscal Compact[9] (see Treaty on Stability, Coordination and Governance in EMU, TSCG), which came into force in January 2013.

Box 1. The most important weaknesses of the SGP revealed by the sovereign debt crisis

1. Inappropriate construction of fiscal rules, politicisation of their application and insufficient ownership of European rules by national authorities. The protocol on the Excessive Deficit Procedure annexed to the Maastricht Treaty provided for the assessment of fulfilment of the criteria on public finance sustainability to be based on two reference values – the public finance balance not lower than -3% of GDP and the general government (GG) debt not higher than 60% of GDP. The states whose GG debt in the middle of the 1990s exceeded 100% of GDP were not capable of lowering it to the reference value fast enough to be able to join the euro area from the beginning of its existence. However, since there existed a strong political will to allow all the interested EU members to join the euro area, when assessing compliance with the criteria on public finance sustainability, a loose interpretation of the reference value for the GG debt was applied. This was allowed by the Maastricht Treaty itself, which provided that the criteria of public finance sustainability can be met in the situation in which the GG debt to GDP ratio exceeds 60%, yet is reduced and is approaching the reference value at a "satisfactory pace". After accession of countries with a high level of indebtedness to the euro area, in the following years the reference value for the GG debt was practically ignored, despite the fact that it is the level of indebtedness rather than the deficit that directly determines the solvency of the country in question. The application of the reference value for the deficit was also problematic. The GG deficit depends on the cyclical position of the economy, resulting in the reference value often being exceeded in conditions of economic slowdown. This, in turn, caused resistance to undertaking pro-cyclical budget cuts deepening the scale of the recession. Since the decisions under the so-called excessive deficit procedure are taken by the ECOFIN Council, in other words by the finance ministers of the EU states, the effect of this resistance was usually to treat mildly the states that did not observe the rules and to extend the deadlines for meeting commitments[10]. At the same time, the SGP did not contain the tools to effectively encourage member states to undertake fiscal adjustments in the boom phase in order to create sufficient room for anti-cyclical fiscal policy during a downturn. The problem was also insufficient ownership of the European fiscal rules by national authorities. Compliance with the rules was not perceived as being in the interests of the country. As a result, these rules played too small a role in the national budget process.

2. Weakness of the statistical base of the European fiscal rules. The statistics of public finance that are the basis of the SGP are not always reliable, as the example of Greece and Portugal has shown, where the data on the level of the general government deficit was revised on numerous occasions. Once the revisions have been taken into account, the current data suggest that both of these countries throughout the whole period of functioning in the euro area had never recorded a deficit below the reference value of 3% of GDP[11]. Moreover, these countries as well as, for example, Italy, Belgium and France, tried to circumvent the fiscal rules several times with the help of temporary one-off measures and accounting tricks to improve the budget balance (Koen and van den Noord 2005).

3. Improper consideration of macroeconomic conditions in the operation of the European fiscal rules.

[9] The Fiscal Compact is a colloquial term for part of the regulations of the TSCG related to fiscal policy (Title III of the Treaty).
[10] An extreme case of this was the situation in November 2003 when the ECOFIN Council, contrary to the recommendations of the European Commission, decided not to take further action in the framework of the excessive deficit procedure against France and Germany. The decision was later recognised as unlawful by the Court of Justice of the EU.
[11] In the case of Greece, the scale of the revision of the budget balance between the data published in spring after completion of the budget year and the final data was on average 3.1% of GDP in the period 2000-2009.

The financial crisis showed that the rules contained in the SGP did not sufficiently take into account the fact that there could be significant macroeconomic and financial imbalances underlying the positive development of nominal values describing the situation of public finance. The bubbles in the real estate market that appeared in some of the euro area countries (Spain, Ireland) in the period prior to the global crisis, resulted in the rapid growth of tax revenue, much greater than would have been expected by using traditional methods of assessing the influence of the business cycle on public finance[12]. After the outbreak of the global recession and the bursting of the speculative bubbles, during two years the public finance balance in these countries shifted from surpluses to deficits exceeding 10% of GDP. From the current perspective we can see that these surpluses were not the effect of a disciplined fiscal policy, but were the result of extraordinary growth in tax revenues caused by the growing imbalances in the economy. Moreover, the support provided to the banking sector by the governments of some countries (Spain, Ireland) after the speculative bubbles had burst, led to a sharp rise in the public debt in these countries. In the case of Ireland, it was precisely these costs that to a large extent raised public debt to the level of over 100% of GDP, resulting in the loss of access to market funding.

The most important changes aimed at eliminating weaknesses in the model of supervision and coordination of fiscal policy pursued by euro area member states, including weaknesses in the SGP (see Box 1)**, are as follows:**

- An improvement in the construction and introduction of the new European fiscal rules in order to increase the likelihood that the application of these rules will reduce liquidity threats for the country and result in countercyclical fiscal policy. With this aim the following were undertaken:
  - more emphasis was placed on meeting the public debt criterion through the implementation of rules related to the pace of its reduction in the country in which the general government debt to GDP ratio exceeds 60%. Thanks to the operationalization that was carried out, the debt criterion may be treated as equal to the deficit criterion in decisions related to the excessive deficit procedure;
  - when applying the fiscal rules and evaluating member states' compliance with them, more emphasis was placed on fiscal effort in structural terms:
  - In order to ensure that countries will maintain structural balance at the level of the medium-term budgetary objective (MTO) or will strive quickly enough to reach this level, a new public expenditure rule was introduced, according to which the rate of expenditure growth should not exceed the rate of growth of potential GDP (as far as the possible surplus growth of expenditure is not accompanied by balancing discretionary measures on the revenue side). This rule aims to encourage the assignment of extraordinary budget revenue (arising from a cyclical improvement in the economic situation) to debt reduction, rather than a constant increase in expenditure. It should reduce the risks related to the fiscal effects of growing macroeconomic imbalances.

[12] Morris et al. (2009) estimated that in the countries where these phenomena were particularly large, i.e. in Ireland and Spain, extraordinary tax revenue related, among others, to the speculative bubbles, resulted in an increase in the relation of tax revenues to potential GDP by 5.6 percentage points and 7.2 percentage points respectively.

- In order to increase the role of structural variables in the assessment of the fiscal position of the country, a quantitative definition of deviation from the MTO and of significant deviation from the adjustment path towards the MTO has been introduced[13].

Thanks to the adopted solutions, the enforcement of fiscal policy discipline is to take place over the business cycle, and not only when the general government (GG) deficit exceeds 3% of GDP. At the same time, they should help to reduce the risk that striving to fulfil the criteria for the GG deficit will result in excessively pro-cyclical fiscal policy in conditions of economic downturn or recession (this is to be supported by the possibility of extending the deadlines for the correction of excessive deficit in countries experiencing adverse shocks, providing these countries make a sufficient fiscal effort in structural terms).

- The introduction of solutions which are to strengthen the enforceability of fiscal rules by European institutions and limit political influence over fiscal policy surveillance. These solutions include the following:
  - Additional financial sanctions[14] (in relation to those provided for in the Treaty – art. 126 para 11);
  - A new system of voting (reverse qualified majority), which increases automaticity of sanctions and thus makes decisions to apply them less likely to be politicized: the recommendation of the European Commission on financial sanctions is recognised as accepted, providing it is not rejected by the Council by a qualified majority of votes.

- The implementation of solutions increasing the role of fiscal rules in national policy making, including solutions which are to increase ownership of European rules and improve their enforceability. In 2011 the requirement was introduced to establish in all EU countries fiscal rules with a clearly defined aim, scope, methods of monitoring their compliance, consequences for non-compliance, and clauses allowing for temporary deviations from the rules[15]. Moreover, when adopting the TSCG, member states of the euro area undertake[16] to introduce the following into national law (through provisions of binding force and permanent character, preferably constitutional)[17]:

[13] In accordance with the Six Pack, the reference value to determine whether the member state is making sufficient efforts to achieve its MTO is an improvement in the structural balance by 0.5% of GDP annually. In the case of countries in which the debt to GDP ratio exceeds 60%, this effort should be greater. A significant deviation from the adjustment path leading to the MTO takes place when all the following conditions are met: 1) deviation from the recommended correction path is at least 0.5% of GDP in one year, or an annual average of 0.25% of GDP over two consecutive years; 2) the growth in public expenditure, adjusted for the impact of discretionary measures on the revenue side, exceeds the growth rate of potential GDP, and the deviation has a total impact on the GG balance in the amount of at least 0.5% of GDP over one year or cumulatively over two years.

[14] It was established that when a particular country fails to eliminate (contrary to the recommendation of the Council of the European Union) a significant deviation of the structural GG balance from the MTO, the condition exists to impose a financial sanction in the form of an interest-bearing deposit amounting to 0.2% of GDP. Moreover, when the Council of the European Union decides to launch the excessive deficit procedure against a member state, it will be obliged – on the basis of a separate decision of the Council – to place a non-interest-bearing deposit at the level of 0.2% of GDP, if the state was required to make an interest-bearing deposit in the preventive arm of the SGP, or if significant deviations from the obligations defined in the SGP have been identified (e.g. GG debt or deficit significantly exceeds the reference value). The deposit will be transformed into a fine in the case of non-compliance with the recommendations of the Council relating to the appropriate correction of the deficit or debt.

[15] Council Directive 2011/85/EU on requirements for budgetary frameworks of the Member States.

[16] Among the signatories of the TSCG that are not members of the euro area, Denmark and Romania have declared themselves to be bound to it in accordance with par. 14 of the Treaty.

[17] Implementation of the provisions of the TSCG on budget rules into national law is to be monitored by the Court of Justice of the EU. Lack of implementation may result in financial sanctions being imposed on the country in question.

  - the requirement that the annual budgetary position of the general government be balanced or in a surplus, which is considered to be fulfilled if the structural balance corresponds to the MTO, set at the level of at least -0.5% of GDP (or -1.0% of GDP when the GG debt is significantly below 60% of GDP and there are no threats to the country's public fiscal sustainability);
  - automatic correction mechanisms in the case of deviations from the MTO or from the adjustment path towards it (providing the deviations are not justified by exceptional circumstances).

- Enhancing the coordination of budgetary and economic policy (including a strengthened role of the European Commission in this process) in order to better reflect both the European dimension and the remaining areas of economic planning in the national fiscal policy.
  - The implementation of the European Semester synchronises the deadlines for submission to the European Commission of national reform programmes (including plans of structural reforms) and stability programmes as well as the assessments of member states' economic and fiscal policy. The timetable of the European Semester has been set so that the Council's recommendations on fiscal and economic policy are addressed to member states at the early stages of planning national policy (before the budgets have been presented to the national parliaments)[18].
  - As part of the Two Pack, a common budgetary timeline has been introduced for member states: they are obliged, among others, to submit to the European Commission their draft budgetary plans for the next year by 15 October. The European Commission – in the case of serious violation of obligations arising from the SGP – can require amendments to the draft.
  - Monitoring and surveillance by the European Commission has been strengthened over countries that are under the excessive deficit procedure, countries experiencing or threatened with risk to financial stability or in receipt of support from the ESM (mainly through increased information requirements and granting the European Commission powers to formulate proposals for corrective measures).
- The introduction of solutions aimed at improving the public finance statistics by, among others, extending the competences of Eurostat, increasing the independence of national statistical offices, and establishing financial sanctions for the manipulation of deficit and debt statistics.

Despite the series of comprehensive reforms, the basic model of fiscal policy formulation and fiscal discipline in the euro area remains unchanged. Coordination of fiscal policy still consists mainly in enforcing discipline in member states based on fiscal rules. The governments of member states continue to decide about fiscal policy, while the enforcement of the European rules, despite a certain strengthening of the role of the European Commission, remains in the hands of the ECOFIN. Moreover, there is a lack of fiscal mechanisms allowing for macroeconomic risk-sharing (except for crisis resolution mechanisms, see Chapter 1.2): the countries experiencing economic shocks must rely on their own stabilising fiscal policy, whose room for manoeuvre will be dependent on the public finance discipline in the previous years.

[18] Before the European Semester was implemented, the discussion on policy plans took place at the beginning of the year in question, after the adoption of the national budgets.

Table 1. Action undertaken in the years 2010-2013 to improve fiscal discipline in the EU

Towards a new architecture of economic management in the EU: action undertaken in the years 2010-2013
▪ Strengthening of the Stability and Growth Pact (Six Pack, Two Pack) ▪ Strengthening of the preventative arm of the SGP ▪ Greater emphasis on debt criterion ▪ Increased automatism in the decision-making process regarding the imposition of sanctions, limiting the influence of political factors on decision-making ▪ Monitoring and assessment of draft budgetary plans of member states, including the possibility for the European Commission to intervene ▪ Strengthening supervision over countries experiencing serious financial difficulties
▪ Fiscal Compact ▪ Structural deficit no higher than 0.5% of GDP (1% of GDP in the case of member states with debt less than 60% of GDP) ▪ Balanced budget rule implemented into national law ▪ Strengthening of supervision and coordination of economic policy ▪ Monitoring by the Court of Justice of the EU of the implementation (but not compliance) of the principles into national legislation
▪ Euro Plus Pact ▪ National reforms in areas of competitiveness, employment, stability of public finance and financial stability
▪ New institutions for crisis management ▪ EFSM, EFSF (since 2010) and ESM (functioning since 8 October 2012)

Source: Own elaboration.

1.2. Emergency financing for euro area sovereigns

The financial crisis gave rise to the need to develop mechanisms for crisis management in the euro area. When the financial crisis broke out, the euro area did not have at its disposal a set of procedures and instruments for crisis management, nor did it have financial support mechanisms for countries whose public finances were threatened with loss of liquidity or insolvency.

Escalating crisis forced the implementation of permanent emergency financing mechanisms for member states of the euro area. Financial assistance initially took the form of bilateral loans, coordinated by the European Commission (in the case of Greece), and, at the next stage, loans under ad hoc mechanisms (the European Financial Stabilisation Mechanism – EFSM; European Financial Stability Facility – EFSF) conditioned by the adoption of a macroeconomic adjustment programme. Each time, the International Monetary Fund (IMF) was involved in the assistance programme. Amid intensifying financial market tensions, pursuant to the intergovernmental agreement of euro area member states, a permanent emergency financing mechanism was established in the form of the European Stability Mechanism (ESM), whose activities were launched on 8 October 2012.[19]

[19] On 11 July 2011 the member states of the euro area signed the Treaty establishing the ESM, which was then sent for ratification by competent authorities in accordance with the internal procedures in force in individual countries. Only ten days after

The task of the ESM is to obtain funding and offer support to member states that are experiencing or threatened by serious financing problems, when it is necessary for protecting the financial stability of the euro area and its members. Therefore, just as in the case of the IMF support, the ESM offers assistance to member states of the euro area experiencing disturbances in the normal access to market funding or facing the risk of such disruptions. The ESM, which has the status of an international financial institution, finances its activities by raising funds in the capital markets.

The instruments of support for states that have lost financial stability evolved with the experience gained in fighting the debt crisis. At first a necessary condition to obtain financial assistance was the adoption of a strict macroeconomic adjustment programme involving a comprehensive package of reforms to be implemented in order to help the country to return to financial stability. However, after some time the decision was taken on the potential extension of the forms of support to include intervention in the debt market (primary and secondary), precautionary assistance in the form of credit lines (similar to the assistance offered by the IMF), assistance for the financial sector (if it is the root of the problems), and also direct assistance for financial institutions (direct recapitalisation). The new forms of support provide a lesser degree of interference in economic policy of beneficiary states than in the case of loans conditioned on the macroeconomic adjustment programme.

The forms of support available as part of the ESM include the following:

- financial assistance in the form of the Precautionary Conditioned Credit Line (PCCL) for euro area countries characterised by a stable economic and financial situation and fulfilling the established set of criteria, or in the form of the Enhanced Conditions Credit Line (ECCL) for countries that have a basically stable economic and financial situation, yet fail to fulfil the above-mentioned criteria;
- a loan conditioned on the adoption of the macroeconomic adjustment programme by the beneficiary state;
- direct recapitalisation of financial institutions or their indirect support, through loans to governments of member states, whereby, in accordance with the provisions of the Eurogroup of June 2013, the possibility to apply the first of these instruments is determined by the establishment of the SSM and is restricted by the EUR 60 bn limit (which can be changed by the Board of the ESM)[20];
- the purchase of government bonds in the primary or secondary market.

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the treaty establishing the ESM was signed – amidst growing risk of a contagion effect that could have affected Spain and Italy – it was decided to modify it in order to make the rules of the Mechanism more flexible (the modified version of the Treaty, taking into account these and other amendments aimed at increasing the effectiveness of the Mechanism, was signed in February 2012). The Treaty establishing the ESM came into force in October 2012.

[20] The Eurogroup also established that direct recapitalisation of financial institutions with funds from the ESM will be possible after fulfilling the following conditions: 1) the country applying for aid is not able to provide full support to the financial institution without putting at risk the stability of its own public finances, or there exists a risk that as a result of providing such support it will lose access to market funding; 2) the granting of support for the member of the ESM is necessary in order to maintain financial stability of the euro area or the member state; 3) the financial institution does not meet (or will not meet in the near future) the capital requirements established by the ECB and is not able to obtain capital from private sources; 4) the institution is of systemic importance or constitutes a serious threat for the stability of the euro area as a whole or the member state in question. In terms of the burden shared between the state applying for direct capital injection of the institution and the ESM, it has been agreed that: 1) when the Common Equity Tier 1 (CET) ratio is below 4.5%, before granting aid by the ESM, the member state must capitalise the bank in order to achieve the above-mentioned level; 2) when CET exceeds 4.5% the member state must provide parallel support to the ESM, for the first two years at the level of 20% of total public aid for the financial institution in question and 10% in the following years.

The ESM was designed so as to minimize the moral hazard which is naturally associated with the establishment of emergency financing mechanisms. Access to funds from the ESM is dependent on fulfilling the conditions tailored to the forms of assistance, which reduces the risk that the availability of such an instrument weakens the incentive for euro area members to conduct responsible fiscal and economic policy. Among forms of assistance available under the ESM, the least stringent in terms of requirements for the economic policy are the following: access to the PCCL and direct assistance for financial institutions. In the case of the ECCL, the beneficiary state is obliged to undertake corrective measures that will help to identify and eliminate weaknesses and avoid future problems with access to market finance. Moreover, during the period of the availability of the ECCL, the beneficiary country is subject to enhanced supervision by the European Commission. Even more stringent criteria apply to loans for countries that have lost access to market funding. Since 1 March 2013, the provision of assistance is also dependent on the prior ratification of the TSCG and implementation of the provisions of the Fiscal Compact into national laws. Taking into consideration that the use of funds under the ESM may be associated with increased restrictions for national economic policy, and may also cause stigmatisation resulting from resorting to emergency financing mechanisms, there is a risk that member states will delay taking a decision to apply for access to the ESM funds. This reduces the effectiveness of the ESM as a mechanism of risk-sharing between countries of the euro area.

The total capital subscribed to the ESM is EUR 702 bn, of which EUR 80 bn is capital paid by member states of the euro area, while EUR 622 bn is callable capital. The paid-in capital can be increased, since the income from financial sanctions imposed on euro area member states that do not comply to the rules of budget discipline or with the requirements of the macroeconomic imbalance procedure, will be transferred to the ESM. The effective lending capacity of the ESM has been set at EUR 500 bn. Together with the level of subscribed capital, it is subject to regular review by the Board of the ESM, at least every 5 years. In March 2012 it was decided that the EFSF will continue to fund the previously agreed assistance programme for Greece, Ireland, and Portugal, also after the launch of the ESM. Thus, the maximum total lending capacity of the EFSF and the ESM amounted to EUR 700 bn.

It should be noted that when joining the euro area, Poland will have to ratify the Treaty establishing the ESM and contribute an appropriate amount of paid-in capital. Taking into consideration that the Gross National Income per capita in Poland is less than 75% of the EU average, the amount of paid-in capital that we would have to pay can be estimated at EUR 3.9 bn, i.e. 1% of GDP. When joining the euro area, Poland would have to pay this amount to the ESM; however, the payment would be spread over a five-year period (in equal instalments). The Polish share of the callable capital would amount to approx. EUR 33.8 bn, i.e. 8.7% of GDP.

The role of the ESM as an insurance mechanism for the euro area countries was strengthened by the ECB's announcement of the OMT programme. Taking into account the high level of the GG debt of the euro area member states, the volume of funds from the EFSF and the ESM was initially judged by financial markets participants as being too low. Although these funds were sufficient to secure the financing of the current borrowing needs of Greece, Ireland, Spain, Portugal and Italy, due to the concerns of the financial markets participants regarding the long-term solvency of the GG sector of these countries, the EFSF and

ESM could not be an effective guarantee for their GG debt[21]. However, the ECB's announcement of the OMT programme in September 2012 became such a guarantee. OMT provides for unlimited, secondary market purchase of short-term sovereign bonds (with a maturity of up to 3 years) of the euro area member states that apply to the ESM for assistance and undertake to implement a recovery programme (not necessarily in the form of a macroeconomic adjustment programme), or bonds of the current beneficiaries of assistance programmes, after they regain access to market funding. It can be judged that the announcement of the OMT programme, together with the establishment of the ESM, reduced the risk related to the inability of the central banks of the euro area countries to play the role of a lender of last resort, protecting these countries from vicious sell-offs in the government bonds market. The effect of such solutions was a decline in the perceived risk of the break-up of the euro area and the related redenomination risk, which helped to stabilise the situation in the financial markets (Coeuré 2013). However, it should be noted that the OMT – unlike the ESM – is not one of the permanent instruments of the euro area. It is a programme within a range of non-standard monetary policy instruments which, as unconventional action undertaken in extraordinary circumstances, are as a rule of a temporary character.

1.3. Further fiscal integration

1.3.1. The case for a euro area fiscal capacity

Unlike in the case of fiscal federations or unitary states, in the euro area there is no fiscal capacity which could be used to stabilise the business cycle of the whole region (Box 2) and allow macroeconomic risk-sharing. By implementing a permanent emergency financing mechanism in the form of the ESM, the euro area gained a fiscal instrument for sharing the risk related to strongly asynchronous economic developments, thus mitigating the costs of macroeconomic adjustments. This type of mechanism is commonplace in fiscal unions (Box 3). However, while solutions adopted in fiscal unions, such as the banking union or inter-regional transfers and the redistribution of funds through central budget, are risk-sharing instruments *ex ante*[22], the risk sharing made on the basis of emergency instruments available under the ESM is mainly of an *ex post* character (this does not apply to the ESM credit lines). As the IMF (2012) indicates, the disadvantage of this type of risk-sharing is that it takes place after the threat to the stability of the economy in question has already materialised, which means that it involves higher macroeconomic costs than solutions of an *ex ante* character.

[21] Emergency funding mechanisms supplying liquidity to countries that have lost access to market finance can be an effective tool to stabilise the situation in the financial markets only when the market participants believe that the beneficiary of financial assistance is able to pay in full its liabilities. When there are concerns about the solvency of a given country, the prevention of a sell-off of its bonds requires that the funds available under such emergency financing mechanism are sufficient not only to fill the gaps in financing current borrowing needs, but also to finance part or all of the public debt, thus constituting a credible ceiling for the scale of possible debt restructuring (see Trzcińska 2013).

[22] Risk-sharing mechanisms of an *ex ante* character are instruments that allow to mitigate the adverse effects of GDP shocks on consumption and are established before the occurrence of the shock. Risk-sharing based on automatic stabilisers or the capital market (asset ownership) has such a character. In turn, *ex post* mechanisms are established after the occurrence of an adverse shock. This type of risk-sharing takes place, for example, through the credit markets: economic agents that are experiencing an adverse shock to their current income can take on liabilities, thanks to which they reduce the effect of the shock on current consumption.

Box 2. The functions of a federal fiscal policy

In the literature on fiscal federations, which provides normative guidelines as to the assignment of particular roles performed by fiscal policy to the federal and sub-federal level, priority is given to the federal level in performing the stabilisation and redistribution roles (Musgrave 1959, Oates 1972). With respect to the former, the literature sometimes also differentiates between stabilisation in the strict sense, consisting in the use of countercyclical fiscal policy conducted by the central authorities to mitigate the shocks affecting the whole of the federation, and the insurance role, based on temporary transfers to regions affected by idiosyncratic shock (Darvas 2010). In turn, the redistribution role involves the permanent transfer of income from richer to poorer regions. In sub-chapter 1.3.1 the grounds for deepening fiscal integration in the euro area through the establishment of a fiscal capacity are analysed through the prism of the three above-mentioned roles of a federal fiscal policy.

Box 3. Fiscal risk-sharing mechanisms in fiscal federations and unitary states*

All the effectively functioning monetary unions consisting of heterogeneous regions have in place fiscal instruments that allow for macroeconomic risk-sharing. These instruments include: safeguards for the functioning of the banking sector (not always clearly defined *ex ante*[23]), common social insurance systems, public investment, expenditure on public administration and defence and joint debt issuance.

Net transfers between regions in a fiscal federation mainly reflect the activity of centralised automatic stabilisers, and to a lesser extent the discretional decisions of the central authorities or ad hoc transfer mechanisms. This centralisation mainly concerns expenditure on unemployment benefits[24] and CIT, PIT and VAT revenues. In some federations (e.g. in Germany) there are additional inter-regional transfer mechanisms which as a rule play a redistribution role, but at the same time mitigate asymmetric shocks.

Empirical research confirms that in many fiscal federations, transfers stabilise fluctuations in regional income or consumption, although the scale of resulting mitigation of the shocks is not generally large. For example, the estimates of the IMF (2012) show that gross transfers in fiscal federations react significantly to changes in regional output gaps, having a 5-10% mitigating effect on short-term fluctuations in GDP per capita caused by of both idiosyncratic and common shocks. Earlier research on the United States and Germany also showed a similar effect of fiscal risk-sharing in terms of mitigating shocks to regional GDP (at the level of 10 to 20% of the shock; Mellitz, Zumer 2002, von Hagen 2007, Hepp, von Hagen 2013).

*The experience of other fiscal federations and unitary states can provide certain indications on the direction of desired institutional changes in the euro area. It should be remembered that – firstly – the euro area is not a political union, thus

[23] As Allard et al. (2013) indicate, in the United States, Canada, Australia and Belgium, safety nets for the banking sector (including funds for resolution or deposit guarantee schemes) are either managed by the federal authorities or are guaranteed by the federal budget should the funds that they have at their disposal be insufficient. In the Swiss system, which is financed by funds from the private sector, there are no such *ex ante* mechanisms; however, the federal government provided *ex post* support for banks of systemic importance (e.g. UBS in 2008).

[24] An exception compared to other federations is the United States, in which the unemployment benefit system is to a large extent decentralised: the state systems of unemployment insurance are financed by the state income taxes. Although these systems must meet minimum requirements established at a federal level, they differ significantly between each other in terms of the level of unemployment benefit and the eligibility criteria. However, in the case of strong adverse economic shocks, programmes are launched to combat unemployment that are financed or co-financed from federal funds, which supplement the activities of the state systems (Dullien 2013; see also sub-chapter 1.3.2).

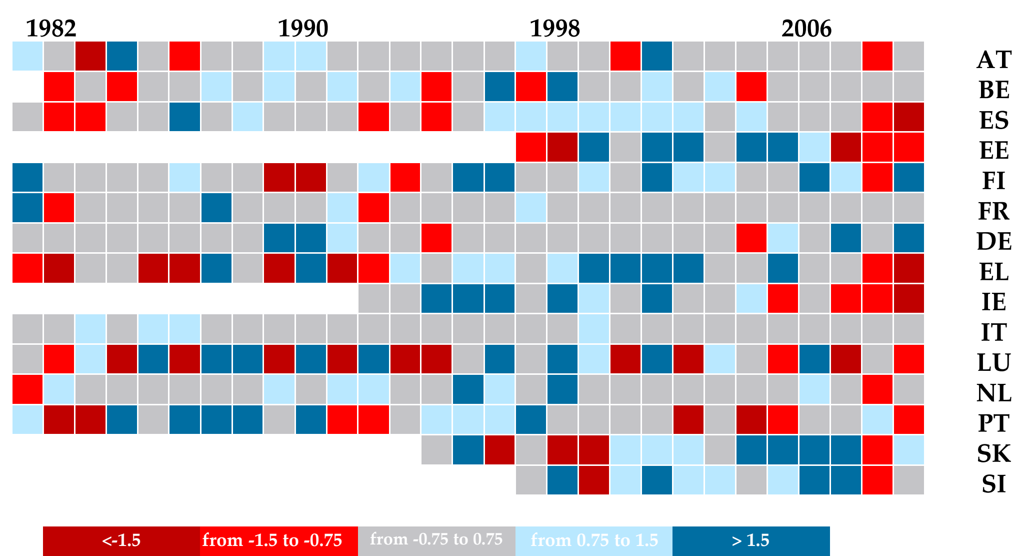
some solutions whose effective implementation is possible in fiscal federations will not be possible to implement in the euro area until they are accompanied by a deepening of political integration. Secondly, it should be noted that federal institutions currently operating in other currency unions are the result of a decades-long processes, with underlying political will to deepen integration, based on a common history, culture, language, or common threats. Finally, there are significant institutional differences between euro area member states and the process of creation of institutions deepening fiscal, economic or financial integration could be considerably more difficult than in the case of fiscal federations, where these institutions were often created through establishment of new institutions rather than centralisation or harmonisation of diverse sub-federal solutions.

Both in the reports of the European Commission and the President of the European Council, and in the studies of economic experts (Allard et al. 2013, Tommaso Padoa Schioppa Group 2012, Wolff 2013), the proposed solutions on the deepening of fiscal integration in the euro area include a fiscal capacity allowing for (*ex ante*) risk-sharing of asymmetric shocks (the proposals regarding the design of the fiscal capacity are presented in sub-chapter 1.3.2). The grounds for the implementation of this type of solution, presented in the studies, include the following:

- relatively high incidence of asynchronous fluctuations and potentially strong contagion among euro area economies;
- low effectiveness of alternative mechanisms of adjustment to asymmetric shocks in the euro area (see Box 4 and Box 5).

Referring to the first of the above-mentioned arguments, it should be noted that – contrary to the expectations formulated before the creation of the euro area – operating inside the currency union did not lead to a reduction in the occurrence of asymmetric shocks (Figure 1). Some member states experienced a distinct shock in terms of a sharp fall in borrowing costs after the creation of the euro area. This resulted in unstable credit booms (Spain, Ireland) or weakened the incentives of governments to implement structural reforms and appropriate countercyclical fiscal policy (Greece, Portugal, Italy). The latter countries were also affected by the growing competition from emerging economies in the global markets (Chen et al. 2012). Moreover, the consequences of these shocks turned out to be much more serious than expected. Banking crises caused by the collapse of the credit booms in the wake of the global financial crisis proved to have such significant fiscal consequences that they threatened the stability of public finance in Ireland and Spain. In the conditions of the crisis-induced recession, the stability of public finances was also threatened in those countries which were characterised at the outset by a high level of debt and structural problems, reflected in high current account deficits (Portugal, Greece). At the same time, due to the strong links between the banking systems of the euro area countries, and also strong bank-sovereign feedback loops, there was a rapid transmission of adverse shocks (contagion) between euro area countries.

Figure 1. Idiosyncratic shocks affecting GDP growth in the euro area member states (% of GDP)*



Note: Idiosyncratic shocks are defined as that part of shocks affecting GDP growth of individual countries, which is not explained by shocks affecting aggregate euro area GDP growth.
Source: own elaboration based on Allard et al. (2013).

Box 4. Macroeconomic adjustment mechanisms in the currency union

Since the national authorities in the currency union are not able to use economic policy instruments such as the nominal exchange rate or interest rates, macroeconomic adjustments must be made through other instruments, such as the following (European Commission 2006):

i. market-based price and quantitative adjustments;
ii. fiscal policy (mainly by employing automatic stabilisers, to a lesser degree through discretionary changes in fiscal policy);
iii. international risk-sharing through fiscal transfers or through the financial markets (return on owned assets or the possibility of incurring foreign debt);
iv. mobility of production factors (particularly labour force).

The basic scheme of analysis of the macroeconomic adjustments in the currency union differentiates two main adjustment channels: the real interest rate channel and the real exchange rate (competitiveness) channel. An asymmetric shock leading to an increase in inflation in one of the regions of the currency union results in two opposing effects:

- **destabilising** the economy through lower real interest rates, which is conducive to a further rise in inflation (real interest rate channel),
- **stabilising** the economy through the appreciation of the real exchange rate, leading to a worsening of external competitiveness and lowering of export growth as well as – subsequently – domestic demand and prices (real exchange rate channel).

The low level of centralisation of economic policy in the euro area increases the importance of market-based adjustment through prices and quantities. When deciding on leaving the fiscal and economic policy competences at a national level, the founders of the euro area assumed that market-based adjustment

through prices and quantities combined with fiscal rules – the compliance of which will create space for anti-cyclical fiscal policy at a national level – and limited transfers designed to reduce regional and structural differences (cohesion funds under the EU budget), would allow an effective stabilisation of the business cycle in member states. In particular, it was implicitly assumed that in the medium and long-term the stabilising real exchange rate channel would predominate over the destabilising real interest rate channel, ensuring effective smoothing of the business cycle amidst a lack of independent monetary policy and adjustment of the nominal exchange rate.

The effectiveness of the competitiveness channel in the euro area proved to be too weak to ensure stabilisation of the member states' economies in the face of the pro-cyclical effect of the real interest rate channel. Research for the regions in the United States shows that after approx. 3-4 years the real exchange rate channel begins to dominate over the pro-cyclical real interest rate channel (Arnold, Kool 2004). However, the effectiveness of the real exchange rate channel in the euro area proved to be markedly lower than expected at the time its institutional framework was created. The concerns of some economists were confirmed (Eichengreen 1993, Decressin, Fatas 1995). As early as the 1990s they pointed out that the too low level of mobility of production factors and the relatively high degree of wage and price rigidity in the countries that were to form the euro area would prevent them from making effective adjustments to asynchronous fluctuations. Empirical research confirms that in some member states of the euro area in the period before the financial crisis there was an asymmetry in the process of adjustments through the real exchange rate channel: in the expansion phase the appreciation of the real effective exchange rate followed relatively quickly, while the process of restoring competitiveness through changes in relative prices was relatively slow (European Commission 2006). The inadequate effectiveness of adjustments through the competitiveness channel is also indicated by the difficulties in restoring macroeconomic equilibrium in some of the euro area countries after the crisis, as evidenced i.a. by a strong rise in unemployment.

The relatively low effectiveness of the real exchange rate channel in some of the euro area countries is rooted in their institutional and structural weakness. The relative strength of this channel depends, among others, on the regulation of the product and labour markets, the degree of economic openness, the size of the economy and the strength of its integration with the remaining countries of the currency union. Labour market institutions that limit the response of wages to the fall in production or product market institutions that hinder the reallocation of resources will weaken the impact of the competitiveness channel. The relatively slow adjustment through this channel can also be expected in economies that are characterised by a low degree of openness.

The pro-cyclicality of the real interest rates channel was strengthened by the structural weaknesses of the member states and financial integration. In line with expectations[25] the real interest rates channel led to an increase in cyclical fluctuations. The strength of this channel was increased by the relatively high, e.g. in comparison with the United States (Altissimo et al. 2006), persistence of inflation, which was a derivative of, among others, the ineffectiveness of domestic product and labour markets[26]. However, there is no convincing evidence that the diverging level of interest rates alone had a strong destabilising effect on the euro area economies (Mongelli, Wypłosz 2009, Collingnon 2012). It was rather the rapid financial integration in the form of an increase in cross-border banking activity, which played an intermediary role in the flow of savings from northern member states of the euro area to periphery countries, that had such an influence. This helped to finance the credit booms in the real property markets in the latter group of econ-

[25] Such expectations were formulated by, among others, Walters (1990) and are currently known as the so-called Walters Critique. He showed that a common monetary policy will be expansive (restrictive) in countries in which inflation and GDP growth are higher (lower) than the euro area average. As a result, a common monetary policy will deepen divergences in cyclical positions and inflationary differentials between member states and destabilise their economies.

[26] Jaumotte, Morsy (2012) indicate, for example, that the persistence of inflation is increased by a high degree of employment protection legislation and the level of unionisation as well as by coordination of wage bargaining at a sector level.

omies (Armold, van Ewijk 2012).

Currently it is difficult to assess to what degree the reforms in response to the sovereign debt crisis (including structural reforms in the euro area member states) will improve the functioning of market-based adjustment through prices and quantities, i.e. will strengthen the real exchange rate channel and weaken the pro-cyclicality of the real interest rates channel. In the period preceding the financial crisis, market and non-market incentives to pursue reforms aimed at improving the competitiveness channel and limiting the adverse effects of the real interest rates channel were not strong enough to prevent the build-up of significant macroeconomic and financial imbalances. The debt crisis forced through this type of reform – both in individual countries (reform of labour and product markets in countries most adversely affected by the debt crisis), and on the EU level (changes in the regulation and supervision of banks). These reforms are aimed at improving the adjustment ability of individual economies of the euro area. However, one should note that, firstly, it is still difficult to judge at the moment to what degree the labour and product market reforms implemented in recent years will improve the functioning of the competitiveness channel[27]. Secondly, market and non-market incentives did not act in equal measure on all the euro area economies in which significant inflexibility in the labour and product markets was identified (e.g. lack of significant services market reforms in France and Germany).

However, even assuming that future market-based macroeconomic adjustment through prices and quantities in the euro area (interest rate channel, real exchange rate channel) will be more effective, measures aimed at increasing the effectiveness or the establishment of the remaining adjustment mechanisms could be seen as desirable. It is worth noting that even in the much more flexible economy of the United States, a role not to be neglected in stabilising the regional business cycle is played by such adjustment mechanisms as risk-sharing through credit markets and interstate ownership of assets, fiscal transfers and mobility of resources. Therefore, it could be concluded that measures aimed at improving the functioning of the real exchange rate and real interest rate channel in the euro area should be supplemented by measures ensuring or increasing the effectiveness of the remaining adjustment mechanisms.

Box 5. The effectiveness of mechanisms of adjustment to asymmetric shocks in the euro area

Alternative – to fiscal policy and international risk-sharing – mechanisms of adjustment to asymmetric shocks, i.e. adjustment of prices and mobility of production factors (Box 4), are considered to be insufficiently effective in the euro area:

- **Some of the euro area member states' economies are characterised by relatively high wage and price rigidities.** The persistence of price and wage inflation in the euro area as a whole is higher than in the United States (see, for example, Duarte, Robalo Marquez 2013)[28]. At the same time, there are significant differences between individual countries in this respect[29]. Slow adjustment of wages

[27] Firstly, it should be noted that in economic literature there is no consensus on what system of labour market institutions will guarantee optimal employment adjustment, without negatively affecting, at the same time, its security, labour productivity or functioning of the labour market (Auer 2007). Secondly, the success of structural reforms implemented in individual countries is, to a large extent, dependent on the general institutional environment. For example, as Acemoglou et al. (2008) and Prati et al. (2013) show, in countries in which institutional constraints imposed on the executive arm are weak, one can expect low effectiveness of structural reforms, among others, due to the possibility to withdraw the implemented changes (see also Eggertsson et al. 2013).

[28] Adjustments of consumer prices in the euro area are made on average every 4-5 quarters, while in the United States such adjustments are made every 2-3 quarters (Dhyne et al. 2006).

[29] Among the member states of the euro area, the lowest frequency of consumer price changes was observed in Italy, Spain and Germany (Dhyne et al. 2006). On the other hand, the greatest nominal wage rigidity was noted in Greece, Italy, Portugal and France and the greatest real wage rigidity, in Belgium, Spain and France respectively (Banco de España 2011).

and prices in some of the member states translates into divergent reactions of economies to common shocks and increases costs of adjustment to shocks (for example, the broad scope of wage indexation was among causes of a sharp rise in unemployment in Spain after the financial crisis).

- **The mobility of the labour force in the euro area is too low to become an effective mechanism of adjustment to asymmetric shocks.** The relatively low mobility of the labour force in the euro area seems to be confirmed by the fact that only approx. 1% of the working-age population in the EU-15 countries in a given year change the place of residence inside their own country, and approx. 0.1% change the country of residence (IMF 2012). In the United States, on the other hand, approx. 3% migrate, while 2.5% of the working-age population move from state to state on an annual basis. As the European Commission (2013) shows, in the euro area countries on average only 4% of the working-age population come from another member state of the EU. Therefore, it is not surprising that labour mobility in response to asymmetric labour demand shocks is weaker in the euro area than in the United States, while the absorption of shocks is made to a greater degree through changes in the labour force participation rate (L'Angevin 2007).

International risk-sharing through the capital and credit markets mitigates the effects of asymmetric shocks in the euro area countries to a relatively low degree. The impact of fluctuations in GDP on income or consumption in individual countries or regions of the currency union could be mitigated by the financial markets (see Box 4). The risk associated with asymmetric shocks could be reduced by residents – firstly – through asset diversification, in other words through owning assets (e.g. shares in enterprises), whose value (and income thereon) depends on GDP growth in another region or country. Secondly, this risk can also be reduced through the credit market: the smoothing of incomes or consumption as a result of an adverse shock may take place thanks to the possibility to take on liabilities towards residents of other regions/countries. Empirical research indicates a relatively low effectiveness of mechanisms mitigating the impact of fluctuations in GDP on consumption in the euro area. Analysing a panel of 15 euro area economies in the period between 1970-2010, Furceri and Zdzienicka (2011) argue that only approx. 34% of GDP shocks are mitigated while the corresponding percentage for Germany and the United States is 80% and 75% respectively[30]. In particular, in comparison to those countries, in the euro area a markedly smaller percentage of shocks are mitigated through cross-border/cross-regional ownership of assets (see below). Moreover, the authors show that the percentage of unmitigated GDP shocks in the euro area countries rises from 66% on average over the business cycle to 78% during deep recessions. This research also indicates that the only effective channel for mitigating GDP shocks in the period analysed was the adjustment of savings of the private sector connected with the possibility to borrow abroad. However, the effectiveness of this channel diminished after the creation of the euro area. It must be assumed that the functioning of this channel has been further weakened as a result of a strong outflow of foreign capital from the periphery countries of the euro area during the sovereign debt crisis and the persistent fragmentation of the financial markets.

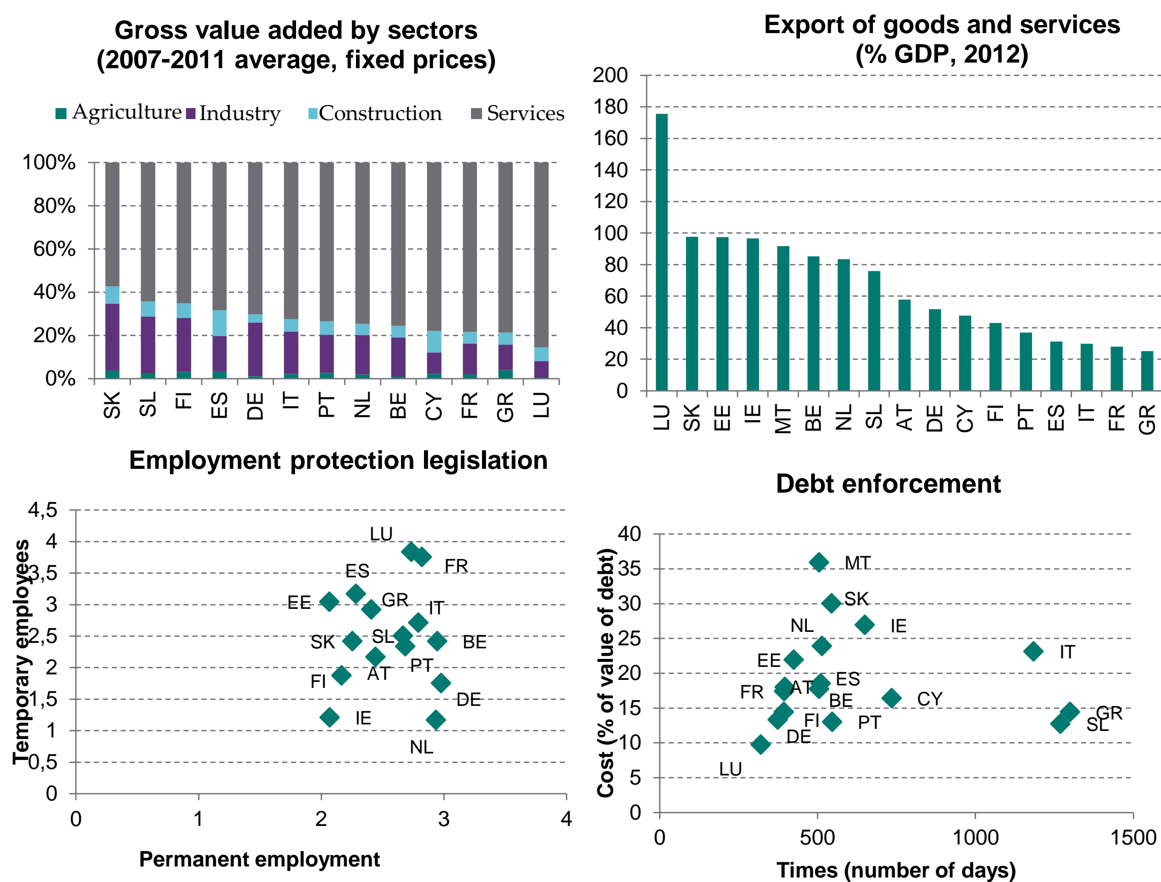
At the same time, it is worth noting that the changes introduced in response to the crises in individual euro area countries and in the institutional architecture of the EU/euro area, were aimed at reducing the

[30] Similar research was conducted by the following: Asdrubali et al. (1996) for the United States, Sorensen and Yosha (1998) for the OECD countries and European economies, Melitz and Zumer (1999, 2002) for the United States, Great Britain and Italy, Afonso and Furceri (2008) for 25 European economies and Hepp and von Hagen (2013) for Germany. The conclusions of these studies are consistent with those presented above. Moreover, the estimates of Kalemli-Ozcan et al. (2005) indicate that in the years 1996-2000 the financial market was responsible for the mitigation of approx. 10% of income shocks in member states of the euro area.

occurrence of asymmetric shocks and contagion. However, the following doubts relating to the effectiveness of these solutions may be raised:

- Firstly, it is not yet known how effective the new regulations on banking capital and liquidity (CRD IV/CRR) or the creation of macroprudential policy frameworks in EU member states will be in reducing the risk of banking crises. And it was precisely the outbreak of the latter that was one of the driving forces behind the sovereign debt crisis in the euro area. Further, it is far from certain how that risk will be transformed by the creation of the banking union between member states of the euro area and those EU countries remaining outside the euro area, which undertake so-called close cooperation (see Chapter 3). For this reason, and also taking into account the large size of the banking sector in the euro area, it cannot be excluded that in the future the euro area countries, in particularly those that are importers of foreign capital, will still face recession and banking crises with significant (in relation to GDP) fiscal repercussions.
- Secondly, at the moment it is difficult to assess the long-term effectiveness of the changes to fiscal and economic governance frameworks implemented in response to the crisis in reducing the risk of wrong national policy triggering strong adverse asymmetric shocks (see Chapters 1 and 2). However, it is worth noting that the creation of the ESM, together with the announcement of the OMT programme, reduced the risk of the occurrence of vicious sell-offs in sovereign bond markets, thus reducing the risk that such disturbances will trigger asymmetric shocks, causing strong contagion.
- Thirdly, it is difficult to expect that the structural reforms being implemented at the moment in some of the member states will rapidly eliminate significant differences in the specialisation of production and the level of productivity and competitiveness observed between the euro area member states (Figure 2). Not only profound institutional differences, resulting from a distinct historical background and a divergent evolution of socio-political systems of these countries, but also the differences in geographical location underlie this diversity. Taking this into consideration, these economies may be expected to continue to respond differently to common shocks as well as often face asymmetric shocks.
- Fourthly, it is worth noting that one of the consequences of the sovereign debt crisis is the increase in the relative significance of extra-euro-area trade of member states, which will increase their exposure to idiosyncratic shocks.

Figure 2. Selected aspects of structural and institutional diversity of member states of the euro area



Source: Data from Eurostat, OECD, AMECO, own calculations.

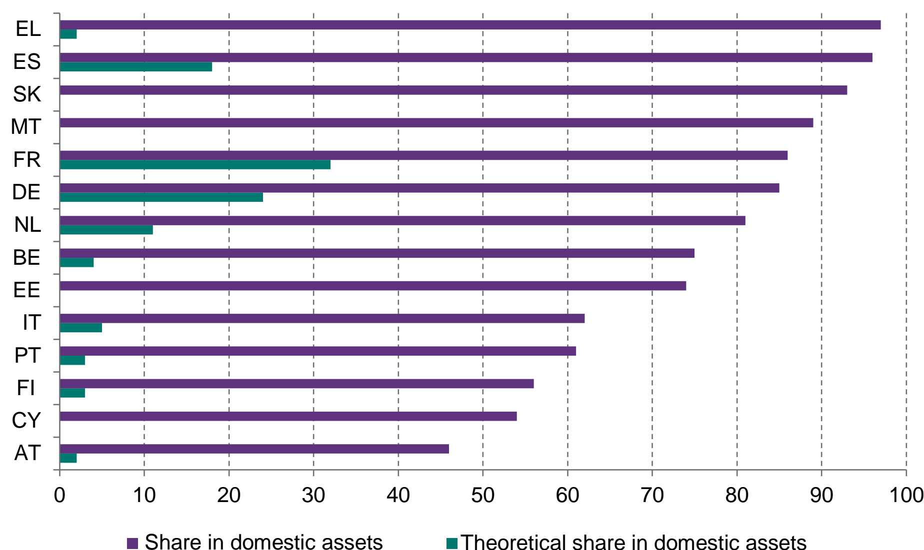
In reference to the second argument justifying the establishment of a fiscal capacity that would enable better absorption of asymmetric shocks in the euro area, i.e. low effectiveness of alternative adjustment mechanisms, the following should be noted:

- Changes in the fiscal policy framework should improve the stabilisation properties of national fiscal policy, whereby in the most indebted countries of the region the possibility to conduct counter-cyclical fiscal policies will remain limited in the short- and medium-term. A strengthening of fiscal policy framework in the euro area countries, in particular, the adoption of solutions aimed at increasing the role of fiscal rules in the national budget process, should theoretically reduce the risk associated with the lack of appropriate space to conduct counter-cyclical fiscal policies at a member state level. Changes reducing the risk of the build-up of macroeconomic and financial imbalances that could significantly worsen the situation of public finances, should also have the same effect (see Chapters 2 and 3). Moreover, the increased emphasis on adjustment in structural terms put in the application of fiscal rules should reduce the risk that compliance with these rules will weaken the possibility to conduct counter-cyclical fiscal policy. In practice, however, one could point to a number of doubts as regards these assumptions:

  - Firstly, they are based on the premise that solutions increasing the role of fiscal rules in the budget process will be implemented into national law in such a way as to guarantee high compliance. They also assume that the EU macroeconomic supervision will function effectively. At the current stage, it is difficult to determine whether these assumptions are not too optimistic.
  - Secondly, the currently high and growing level of GG debt and the high indebtedness of the private sector in some member states of the euro area significantly limit the possibility to stabilise the business cycle with the help of domestic fiscal policy. Moreover, one can expect that this restriction will continue for many years, exposing these countries to the risk of increased fluctuations in economic activity. The implementation of fiscal solutions allowing the (*ex ante*) macroeconomic risk-sharing could offer improved business cycle stabilisation in these countries. This would at the same time reduce the risk of permanent income divergence between member states, which in turn could adversely affect the political stability of the euro area.
- The effectiveness of adjustment to macroeconomic shocks could increase in the euro area countries as a result of the currently implemented structural reforms. However, it is difficult to expect that adjustment to shocks through changes in prices and wages (internal devaluation/revaluation) would be effective enough, particularly in the case of strong shocks such as those observed during the financial crises, to reduce the need to mitigate them with the use of alternative adjustment channels (see Box 4). Moreover, it seems that after stabilisation of the situation in the financial markets, the incentives to implement reforms declined in some countries where significant structural weaknesses have been identified (France, Italy).
- The creation of the banking union will have similar effects on the effectiveness of the adjustment to macroeconomic shocks. During periods of economic collapse and financial crises, it is often impossible to mitigate shocks through the international credit channel (Box 5) due to the high risk aversion among investors. The sovereign debt crisis has shown that during periods of financial turmoil there is a strong potential for debt capital outflow from the weakest euro area economies and their banking sectors31. The creation of the banking union should reduce the risk associated with a sudden outflow of capital and limit the negative bank-sovereign feedback loops. However, as the analyses presented in Chapter 3 indicate, the above-mentioned risk cannot be expected to be completely eliminated.

[31] The consequences of this outflow have been mitigated by the launch of emergency financing mechanisms for countries which have lost access to market financing (bilateral loans, EFSF, ESM) and the ECB's support to the euro area banking sector (changes in the conditions of liquidity providing operations).

Figure 3. Percentage of equities listed on national stock exchanges in the portfolios of investors from member states of the euro area.



Note: The theoretical share in domestic assets is equal to the ratio of capitalisation of the domestic stock market to the capitalisation of the market of the whole of the euro area.
Source: own study based on Bruegel (2013).

- The need to implement a fiscal capacity in the euro area allowing for better mitigation of asymmetric fluctuations could be limited by fostering the development of cross-border asset ownership. The rapid integration of the financial markets in the euro area observed before the financial crisis affected mainly the wholesale interbank market and the sovereign bonds market. Integration in the remaining areas of financial intermediation was markedly weaker. For example, in the equity segment a relatively high degree of home bias was observed (Balta, Delgado 2009; Figure 3), in particular in the case of assets of non-financial enterprises (see Jochem, Volz 2011). This indicates that the smaller scale of integration of the equity market is, among others, due to differences in, for example, regulations on post-trading services (Regling 2010) or, more generally, the lack of harmonisation of bankruptcy laws. Institutional changes and other measures aimed at strengthening cross-border ownership of equities would increase the effectiveness of market mechanisms in mitigating asymmetric shocks (Hoffmann, Sørensen 2012; Box 4). It is worth noting in this context that in the case of equities there is less risk of a sudden stop in the face of adverse shocks than in the case of debt instruments.
- The implementation of solutions supporting the mobility of the labour force would have a similar effect. Not only language and cultural barriers are underlying the low level of mobility of the labour force in the euro area, but also institutional barriers such as differences between labour markets and social security institutions, the lack of possibility to transfer entitlement to parts of pension benefits, barriers in access to regulated professions as well as those related to the recognition of diplomas and professional qualifications. The removal of the above-mentioned barriers would be desirable from the point of view of increasing the effectiveness of the mobility of the labour force as a mechanism to absorb asymmetric shocks.

- However, one can expect that even in the case of a significant improvement in the above mentioned mechanisms of adjustment to asymmetric shocks, some of the economic fluctuations of the member states will remain unmitigated. In this context it is worth noting that even in the case of economies that are much more flexible than the euro area (such as the United States), characterised by a greater degree of financial integration, fiscal mechanisms of risk-sharing play a significant role in mitigating fluctuations in economic activity (see Box 3).

To summarize the above discussion, it should be stressed that although the potential for the occurrence of relatively strong asymmetric shocks will most likely continue to exist, the creation of the ESM along with the announcement of the OMT programme has significantly reduced the risk that these shocks will result in the liquidity crises affecting individual euro area countries and escalating into solvency crises that would threaten the integrity of the currency union. The introduction of additional risk-sharing mechanisms (e.g. a fiscal capacity) might help to stabilise fluctuations in the business cycle in individual member states. Should the institution managing the fiscal capacity be allowed to take on liabilities to cover temporary deficits, an improvement in the stabilization of common euro area business cycle may also be expected. Introducing a fiscal capacity would also support a more effective policy-mix in the region, would strengthen the credibility of the euro area and would reduce the risk of political instability resulting from a permanent income divergence between euro area countries. However, the need to implement a fiscal capacity could be reduced by measures improving alternative mechanisms of adjustment to macroeconomic shocks (the creation of the banking union with a suitable structure, the strengthening of the national fiscal policy frameworks, enhancing cross-border ownership of equities, reduction of wage and price rigidities, facilitating labour force mobility). However, these measures could be insufficient in the case of the most indebted member states, characterised by significant structural weaknesses. Such a situation poses the risk of permanent income divergence between member states of the euro area and calls for the implementation of additional forms of support for these countries (see Chapter 2).

1.3.2. Options for the euro area fiscal capacity

In the literature the following options for a fiscal capacity for the euro area are proposed (Padoa-Schioppa Group 2012, Dullien 2013, Allard et al. 2013, Pisani-Ferry et al. 2013):

- federal budget,
- rainy day fund,
- common unemployment insurance system,
- fiscal backstop for the banking union.

These solutions and the challenges associated with their implementation are discussed in the later part of the sub-chapter. Before presenting the individual solutions, however, it is worth pointing to a number of conditions, the fulfilment of which will increase the stabilising effect of individual solutions and thus will maximize the benefits of their implementation. From this point of view, it may be beneficial to implement solutions which do the following:

- **will rely, as far as possible, on automatic stabilisers.** Since delays in decision-making and implementation which are a characteristic of the discretionary fiscal policy may lower its effectiveness in stabilising the business cycle (Cogan et al. 2010), solutions relying on automatic stabilisers (i.e. those categories of public sector expenditure and revenue which are strongly correlated with fluctuations in economic activity, e.g. income taxes, unemployment benefits) are more desirable.
- **will allow discretionary adjustment in situations of large common shock.** Although as indicated above, solutions based on automatic stabilisers would in principle be preferred, in the case of large, common shocks it would be desirable to supplement them with discretionary measures. This kind of action could be an effective stabilising tool for euro area economies in response to common shocks, in situations in which the possibility of applying a common monetary policy would be limited due to the low level of interest rates (the zero lower bound) or due to the strong structural differences between the economies making up the euro area. For this same reason, solutions that allow temporary budget deficits in the case of an economic downturn would be preferable. Unlike solutions aimed exclusively at mitigating the effects of asymmetric shocks, they could reduce the cyclical fluctuations in the euro area as a whole and not only in individual economies. However, they must be accompanied by mechanisms that ensure automatic repayment of the jointly incurred debt when recovery ends.
- **will minimise the space for intergovernmental negotiations on launching transfers.** In order to limit the space for political conflicts and excessively long intergovernmental negotiations on launching transfers, which could significantly limit the business cycle stabilisation property of the fiscal capacity, more beneficial solutions would be those in which this type of transfers would be largely automatic.
- **will be based on own revenue sources or a predefined share in the national tax revenues rather than contributions from member states.** The establishment of the euro area fiscal capacity based on contributions from member states (of a structure similar to the one in force in the case of the EU budget) is associated with risk of excessively politicized decisions on the size of these resources and – as regards discretionary expenditure, which, as earlier pointed out, can play a stabilising role when faced with large common shocks – how they are spent. Systems based on own revenue sources, e.g. taxes sensitive to business cycle fluctuations, or a predefined share of national tax revenue, would have a greater stabilisation power. Under such a system the size of the resources that go to the common system would automatically adjust to the current economic situation.
- **will be implemented through suitable amendment of the Treaty on the Functioning of the European Union (TFEU).** In accordance with the analysis of the legal services of the European Parliament, there exists the possibility to create a fiscal capacity for the euro area without the need to amend the Treaties. Fiscal capacity could be created within the scope of the EU budget or outside of it based on article 352 of the TFEU or on an international treaty. The institution managing the fiscal capacity could be in this case the European Commission or an agency established especially for this aim. In the case of the creation of fiscal capacity managed by an institution with a separate legal personality, the principle of unity of the EU budget and its completeness (Art. 310 (1) TFEU), would, however, require the European Parliament to be granted with budget supervision powers with regard to a fiscal capacity, similar to those currently exercised with respect to the EU budget. Moreover, fiscal capacity could be created outside the EU budget only if the functions that it would fulfil could not be fulfilled by the EU within its competences. The last criterion could be overly restrictive when designing the fiscal capacity, taking into account that the EU has shared competencies with member states in the scope of economic, social and territorial cohesion. More generally, payments made by the fiscal capacity would have to be essential to achieve the goals set out in the TFEU, providing that the TFEU does not establish any special

competences or does not exclude competences of the EU in the scope in question (Art. 352 TFEU). According to the legal services of the European Parliament, the above-mentioned article does not allow, for example, the creation of a common unemployment insurance system. A change in the Treaty would also be required if the fiscal capacity were to be based on own sources of revenues (unlike the contributions of member states or share in national taxes). There are also doubts as to whether the current Treaties would allow equipping the institution managing the fiscal capacity with borrowing capacity. Moreover, treaty changes would be required when introducing solutions providing for automatic transfers, unless they were necessary to guarantee financial stability of the euro area as a whole and unless the provision of all necessary financial assistance would be subject to strict conditionality (Art.125 and Art 126 of the TFEU(3)). Although solutions compatible with art. 125 of the TFEU (containing the so-called no bailout clause) include those, in which decisions on expenditure (both as regards the purpose of the expenditure and the principles of initiating it) made by the institution managing the fiscal capacity would be of a discretionary nature, there are also doubts as to whether the current organisational structure of the EU guarantees a sufficiently high degree of democratic control and accountability of such an institution. This is particularly important should it be possible for the institution to take on liabilities in the name of the member states of the euro area (as earlier indicated such a possibility would be welcomed as it would increase the stabilising power of the fiscal capacity). The above discussion leads to the conclusion that in order to fulfil the criteria for the creation of the fiscal capacity for the euro area, which would guarantee its high stabilising powers and sufficiently high degree of democratic control and accountability of institutions managing it, it would be necessary to amend the TFEU.

The federal budget. In discussions on the federal budget of the euro area it is pointed out that it could be financed by the contributions of member states (depending, for example, on the size of GDP). An alternative solution would be to link the revenues to specific tax instruments. As Pisani-Ferry et al. (2013) and Allard et al. (2013) indicate, public goods which could be financed by such a budget could include expenditure on public infrastructure and social security systems32. However, establishing federal budget would require further harmonisation of tax policy and at least a limited harmonisation of spending policy and social security systems. Creating a federal budget would have the advantage of allowing (ex ante) macroeconomic risk-sharing. The pooling of risk would be ensured by both the revenue side (thanks to the operation of automatic stabilisers the contribution of the country experiencing an adverse shock would be smaller), and the expenditure side (the country experiencing adverse shocks would have access to an unchanged level of public goods financed from the federal budget; it could also receive discretionary transfers from the central budget). It is also stressed that the creation of a euro area budget and empowering the institution managing it to take on liabilities in the financial markets could improve the response of fiscal policy in the euro area to common shocks, as compared to the situation in which the possibility for individual countries to pursue counter-cyclical fiscal policy may be limited by difficulties in access to market financing or by fiscal rules (Cottarelli 2012).

[32] With regard to expenditure on defence or public administration, which are the domain of the federal budget in fiscal federations, it is difficult to find justification for funding them from the euro area budget and not the EU budget.

Box 6. Redistribution of income and the stability of fiscal federations

Besides the function associated with the stabilisation of the business cycle in response to asymmetric or common macroeconomic shocks, an important role of central fiscal mechanisms in fiscal federations is the redistribution of income between regions. Permanent redistributive transfers are aimed at reducing the risk of political instability which could result from deep disparities in incomes and living standards between regions. The impact of permanent fiscal transfers on the stability of the federation is ambiguous. On the one hand, by preventing further deepening of disparities in living standards, redistributive fiscal transfers can considerably reduce the risk of collapse or secession from the union. On the other hand, excessive transfers, too strongly limiting inequalities can also encourage the secession of regions that are net contributors (Le Breton et al. 2001). The scale of possible redistribution made through the central budget should therefore reflect the preferences of the regions, which in the case of strong divergences of such preferences could be difficult to achieve.

In this context, it is worth noticing that the redistribution of incomes between member states of the euro area is significantly lower than between the states of the United States (Darvas 2010)[33]. The redistribution of income between member states of the euro area currently takes place only to a limited extent, through the EU budget. Due to the small size of the EU budget (1.12% of the EU GDP in 2012) the possibility of income redistribution between member states of the euro area is relatively small in comparison to the scale of redistribution between regions in fiscal federations. For example, in the United States the federal budget revenues from individual states account for 10% to 20% of their GDP, while the federal funds transferred to state budgets account for 9% to 31% of their GDP; however, in the European Union the majority of member states pay into the EU budget from 0.8% to 0.9% of their GDP and receive EU funds from 0.5% to 3.5% of their GDP.

However, the introduction of a federal budget is associated with the following challenges:

- The creation of a federal budget would require a stronger political union between euro area countries.
- In order to achieve effective stabilisation of the business cycle of the euro area as a whole, the institution managing this budget should be authorised to take on liabilities in the financial markets. This would require the implementation of solutions preventing excessive indebtedness, including the creation of effective democratic control over such an institution.
- Should a significant part of the budget expenditure be of a discretional nature, an important challenge would be to ensure strong legitimisation of the institution managing the budget and the introduction of institutional solutions guaranteeing an effective spending policy[34].
- Marked differences in the level of public sector spending between euro area countries are indicative of strongly varying preferences of citizens of these countries as far as the scope and quality of services provided by the state are concerned. This divergence of preferences means that it will be very difficult

[33] The federal system of transfers and taxation fulfils not only a redistribution role, but also an insurance role. Estimates of the scale of redistribution guaranteed by this system indicate that income redistribution between poor and rich regions is responsible for the mitigation of approx. 20% of the shock affecting income/production in the state in question. However, in practice, as the IMF (2012) points out, it can be difficult to distinguish between net transfers that play an insurance role and those that play a redistribution role.

[34] As Rodden and Wibbels (2010) showed when analysing seven fiscal federations, discretionary transfers from central governments to regional governments are most often either pro-cyclical or a-cyclical. Thus, contrary to the assumptions, these transfers do not mitigate adjustments to asynchronous shocks.

to reach the necessary compromise on which public goods would be financed from the federal budget and also on the method of their provision and funding.

- It will be necessary to delegate some of the powers to impose taxes and decide on public expenditure to the central level, which means at the same time that the current fiscal sovereignty of member states will be significantly limited. This solution also requires stronger safeguards against moral hazard than other fiscal capacity options under consideration.
- This solution – to a greater extent than other fiscal capacity options discussed below – is also associated with the risk of permanent transfers between euro area countries. The impact of such transfers on the integrity of the fiscal union is ambiguous (Box 6).

The mechanism of financial assistance for countries experiencing adverse idiosyncratic shocks (rainy day fund[35]). As part of this solution, the creation of a central fund has been proposed, to which member states would make contributions in good economic times. These funds would be launched in order to provide support to public finance systems in countries experiencing adverse shocks. Pisani-Ferry et al. (2013) propose that the system should be based on the assessment of the cyclical position (output gap) of member states. Similarly, von Hagen and Wyplosz (2008) propose that payments into and disbursements from the fund should represent the difference between the specified share in tax revenues[36] and the size of this share, adjusted for cyclical fluctuations. An alternative solution is to make transfers to/from the system dependent on deviations of economic growth from the euro area average (Tommaso Padoa-Schioppa Group 2012). Yet, in practice the effectiveness of the latter solution may be low since the differences in the level of economic development between member states of the euro area are likely to be translated into differences in average GDP growth rates. There are also proposals to make transfers conditional on bond yields[37] of member states deviating from the euro area average (Wolff 2012) and on the deviations in unemployment levels (Dullien 2013). Furceri and Zdzienicka (2013) estimate that contributions at the level of 1.5-2.5% of GDP[38] would be sufficient to mitigate approx. 80% of shocks affecting the level of incomes in individual member states. Thus, the scale of the rainy day fund would be moderate in relation to the total of budget incomes/revenues in the euro area. Therefore, this solution would not require such a strong limitation of fiscal sovereignty of member states and deepening of political integration as the euro area budget.

[35] This type of fund operates in some states of the United States. However, they are of a sub-federal and not federal nature, i.e. they allow the inter-period mitigation of income of a given state, but not transfers between states. Rainy day funds play an important role in many states, taking into account that the rules of a balanced budget that are in force in these states limit the possibility to conduct counter-cyclical fiscal policy.

[36] The authors argue that they should be VAT revenues, since these are more strongly correlated with demand shocks than revenues from income tax and also that they react faster to cyclical movements in the economy.

[37] Transfers would be launched only when these deviations are recognised as excessive.

[38] It should be noted that funds from the ESM and EFSF together make up a total of 7.5% GNP of the euro area.

Table 2. Assessment of the proposals on the creation of a fiscal capacity in the euro area

Characteristics of the proposal	Central budget	Rainy day fund	Common system of insurance for short-term unemployed	Fiscal backstop for the banking union
Ease of implementation	Low	Medium	Medium	Medium
Possibility to stabilise the euro area business cycle	High	Medium, if the institution managing the budget will be equipped with borrowing capacity	Medium, if the institution managing the budget will be equipped with borrowing capacity	None
Possibility to absorb idiosyncratic shocks	High	High	Medium	None, except for large banking crises
Transparency of the transfer system	Low	Low	High	High
Risk of significant redistribution transfers	High	Low	Low	High in cases of large banking crises
Risk of politically biased expenditure decisions	Medium/High (depending on the scale of discretionary expenditure)	Medium	Low	High in cases of large banking crises
Risk of moral hazard	High	Medium	Medium	Medium

Source: own elaboration.

The implementation of a rainy day fund entails the following challenges:

- The fundamental issue in the case of this solution is to correctly define the situation in which resources would be disbursed. This solution should be constructed so that transfers are automatic and not subject to political negotiations, as is the case with the existing emergency financing / crisis resolution mechanisms such as the European Stability Mechanism (ESM).
- Such a system should not weaken the incentives of member states to conduct a responsible economic policy. Thus, it is pointed out that the disbursement from the fund should take place only in the case of sufficiently strong shocks of an exogenous nature and, which have not been caused by mistakes in economic policy. In practice, the identification of such shocks is, however, complicated and difficult to undertake in real time (compare the challenges associated with estimating the output gap). Therefore, this system would not be very transparent, which could adversely affect its legitimacy.
- To limit the likelihood that the rainy day fund would increase moral hazard, this solution should guarantee that the net position (i.e. the difference between the aggregate payments to the fund and disbursements from the fund) of individual countries should remain close to neutral over the business

cycle[39]. Otherwise, if such a system led to permanent transfers to some member states, other countries could take measures to reduce payments to the fund.

Common unemployment insurance system. The next of the proposed options assumes the creation of an unemployment insurance system on the euro area level. In the case of this solution, economic stabilisation proceeds similarly as with the rainy day fund. However, disbursements from the fund would not be conditional on the latent variable, such as the output gap, but on changes in the level of unemployment, which are more closely linked to cyclical fluctuations. In a period of economic downturn, a country that records an increase in unemployment would become a net beneficiary of the fund, which would limit output gap volatility. It is proposed that this system would be financed by pooling part of the social insurance contributions. At the same time, taking into consideration differing levels of long-term unemployment in member states , it is proposed that the common system would cover only the benefits of the short-term unemployed (length of benefit eligibility would be limited to one year). In this way, the risk of large redistribution would be reduced. Also the risk that creating a common unemployment insurance system would weaken incentives for labour market reform in countries with high unemployment would be limited. In comparison with the previously discussed fiscal capacity options, the advantage of this solution would be its automatism and lack of politicized expenditure decisions. Moreover, the creation of a common unemployment insurance system would require a certain harmonisation of labour market institutions in order to minimise the risk of permanent redistribution from countries with more effective labour market institutions to the poor performers. This harmonisation could be recognised as desirable since the divergences of labour market institutions across euro area member countries are the source of asymmetric reactions of these economies to common shocks.

The implementation of a common unemployment insurance system entails the following challenges:

- The unemployment rate responds slowly to fluctuations in economic activity, which means that the extent of stabilisation of these fluctuations, ensured by the common unemployment insurance system, can theoretically be smaller as compared to the discretionary transfers and transfers based on an assessment of the cyclical position of the economy. However, it should be noted that the experience of other federations shows that in practice the transfers aimed at combating unemployment respond to fluctuations in economic activity faster than other transfer mechanisms (Engler, Voigts 2013).
- The unemployment benefit system does not cover the so-called flexible forms of employment, which have become widespread in a number of member states of the euro area and which respond much faster to strong asymmetric shocks than traditional forms of employment. An increase in the scale of stabilisation guaranteed by the common unemployment benefit system would require this system to cover non-standard forms of employment (von Hagen, Wyplosz 2013) and the harmonisation of institutional solutions in this area.

Fiscal backstop for the banking union. As previously indicated, among the shocks especially requiring the implementation of a fiscal risk-sharing mechanism in the euro area, are those that are generated by the functioning of the banking sector. The banking sector in a number of member states is very large in relation

[39] Such neutrality would be achieved, for example, if the distribution of asymmetric shocks between member states of the euro area was random. Due to their large structural and institutional divergences, it is difficult to expect that it would be the case in reality.

to their GDP (see Chapter 3). The potential effects of shocks generated by this sector could therefore be so severe that, firstly, their mitigation only by using the tools of national fiscal policy (even taking into account the possibility of a bail-in) may not be possible (see the experience of Ireland and Spain during the crisis). Secondly, these shocks can threaten the stability of the whole region due also to the strong links between banking systems of the euro area member states and the remaining EU countries. Thus it is indicated that the banking union should be supplemented by a suitable fiscal backstop (see Chapter 3). This type of safeguard could be all the options for a fiscal capacity in the euro area (including those discussed above), based on credible powers of the managing institution to impose taxes, issue bonds, or enforce the payment of contributions from the individual member states. Pisani-Ferry and Wolff (2012) suggest that an institution should be created on the central level of the euro area that would be granted limited and conditional powers to impose taxes. The resources obtained in this way would serve to finance the resolution of banks, should the funds allocated for this purpose from other sources prove to be inadequate, which could occur in the case of systemic crises. At the same time, it is worth noting that the backstop for the banking union would be supposed to guarantee, above all, its credibility. The resolution of banks subject to common supervision would have to be – as provided by the regulation on the Single Resolution Mechanism – financed firstly by contributions from the banking sector accumulated in the Single Resolution Fund (SRF), and if these funds proved to be insufficient – the national public funds would be used (i.e. from the national budgets), and next the resources of the ESM (see Chapter 1.2).

The implementation of a common fiscal backstop for the banking union entails the following challenges:

- As in the case of the federal budget of the euro area, a significant challenge would be to guarantee an adequate legitimisation of the institution managing the backstop and authorised to impose taxes targeted at financing the resolution of banks. This challenge would encompass the safeguarding of democratic control over its activities.
- Taking into consideration that the costs of systemic crises could be significant, and that in the case of large banking crises there is a risk of significant fiscal transfers between member states, a serious challenge would be to design institutional solutions that would reduce the risk of politicized spending on resolution of banks funded by common fiscal resources.

To sum up the above discussion, options for a euro area fiscal capacity appearing in the literature differ in terms of their potential effectiveness as tools for mitigating cyclical fluctuations. The implementation of a federal budget of the euro area offers the greatest stabilising potential – both in relation to asynchronous shocks and those affecting the whole of the euro area. However, this solution requires far-reaching political, legal and institutional changes in the euro area. Among the remaining solutions, the common unemployment insurance system seems to be the solution with a high potential for stabilising the business cycle thanks to it being based on automatic stabilisers and at the same time thanks to its relative transparency. However, even this solution requires far-reaching legal and institutional changes in the euro area and its member states.

1.3.3. Proposals for sovereign debt pooling

Even if the decentralised decision-making on fiscal and economic policy is maintained, it is possible to introduce fiscal solutions that allow a greater degree of macroeconomic risk-sharing, e.g. by pooling sovereign debt of euro area countries. The solutions proposed in the debate on the future of the euro area as regards sovereign debt pooling do not provide for the creation of a central fiscal authority which would assume (in whole or in part) the debts of countries and which would have its own sources of income allowing it to service this debt.

Pooling of the sovereign debt of member states could bring the following benefits:

- the creation of a new class of safe, liquid assets in the financial market, less sensitive to changes in market sentiment than the bonds of individual countries;
- limited bank-sovereign feedback loops, e.g. as a result of enabling banks to invest in Eurobonds whose ratings and value would be dependent on the fiscal situation of the entire euro area and not a single country;
- better functioning of the monetary policy transmission mechanism;
- limited fragmentation of financial markets;
- fiscal discipline, on condition of a suitably designed system of incentives;
- a fall in the average interest rate on debt in the case of periphery countries of the euro area (in some variants).

The proposed solutions in the scope of sovereign debt pooling in the euro area demand that individual countries assume the liabilities of the remaining countries of the region. The liability could be of several or joint and several. In the first case, each member state would be liable for its share of the common bonds issuance, according to a defined key. In the case of joint and several liability, each member state would be liable not only for its own share in the issued common bonds, but also for part of the liabilities of each of the other member states which fails to perform its obligations (European Commission 2011). In both cases, but particularly in the case of joint and several responsibility, the risk of moral hazard would arise, i.e. states that incur excessive liabilities may bet on being bailed out by the remaining euro area countries.

Due to moral hazard, solutions with limited mutualisation of liabilities are given preference. The problem of moral hazard can be resolved in two ways. The first of these is far-reaching economic, political and financial integration, guaranteeing the euro area control over the budget policy of the individual countries. Such a situation allows for full mutualisation of the euro area members sovereign debt. According to the European Commission (2011), such a solution would maximise the benefits of debt pooling. However, due to the scale of political and legal changes (amendment of the EU Treaties) related to the necessary deepening of integration, its adoption, at least in the short-term, is unlikely. The second solution, posited by many economists, is partial mutualisation. Under this solution only part of the debt of individual countries would be mutualised, while the rest of the liabilities will maintain a national character. It is assumed that common bonds will have seniority over national debt. In such a situation, there is only a small risk that an individual country will not be able to pay their share of the common bonds, and thus burden the remaining members of the union.

The first proposal of partial mutualisation of the euro area sovereign debt assumes that it will cover debt below 60% of GDP. The first proposal of limited mutualisation of euro area member states' debt was presented by economists of the Bruegel Institute in May 2010 (Delpla, von Weizsäcker, 2010). It proposed the pooling of the debt of each country to the level of 60% of GDP (so-called "blue bonds"), while debt above this level would remain a national responsibility (so-called "red bonds"). The key challenge related to this solution is the transition from the current state of affairs and the exchange of previously issued bonds for "blue" and "red" ones. In the peripheral countries of the euro area, whose debt currently exceeds 100% of GDP, the share of "red" bonds would be significant. These liabilities would most likely be evaluated by the market as riskier than the currently operating bonds due to the existence of an alternative in the form of "blue" bonds and their privileged character. Consequently, there is concern that the debt servicing costs in these countries would not fall and the quality of the bond portfolio of banks would not improve. Thus, the expected benefits of debt mutualisation would only materialise to a small extent.

In October 2011 an informal group of economists, Euro-nomics, proposed to use financial engineering to create safe debt instruments based on government bonds. This proposal provides for the creation of the European Debt Agency (EDA), which would issue two types of debt securities – privileged, Euro-Safe-Bonds (ESBies) and subordinated bonds. Both of these would be collateralised against the member states' government bonds purchased by the EDA. A failure of a member state to honour its bonds would be absorbed by holders of the subordinated bonds. In this way, with appropriate proportions of both types of securities issued by the EDA, ESBies would be very safe instruments in which banks could invest. This would bring about the above-mentioned benefits to financial stability. The size of the issues by the EDA, and thus the size of government bond purchases by the Agency, would be limited to, for example, 60% of GDP. Therefore, some share of national government bonds would continue to be traded on the market. Nevertheless, taking into consideration the assumed role of the EDA on the market, the influence of the Agency on the price and yields of the bonds would be significant, by which the activities of the Agency could be subject to political influences.

In November 2011 the German Council of Economic Experts proposed the so-called debt redemption pact (*Schuldentilgungspakt*), consisting of the pooling of sovereign debts exceeding 60% of national GDP. This proposal assumes that these liabilities, with a seniority over the remaining part of the debt, would be repaid within 25 years. The safe Eurobonds would be thus only of a transitional character, and not a permanent one. The advantage of this proposal is the safeguarding of borrowing needs for the coming years, particularly for the peripheral countries. However, its temporary character and very small disciplinary effect of such a financing constitutes its disadvantage. Countries participating in this mechanism would finance their borrowing needs with the help of common bonds only for a few years. After reaching the limit set for the common bonds, they would issue national debt on the same principles as is currently the case.

The fourth proposal of sovereign debt pooling worth noting is the so-called Eurobills (Hellwig, Philippon 2011). This is a variation of the "blue" and "red" bonds proposal, but it assumes that mutualised debt will have only a short-term character and that it will amount to up to 10% of GDP. As the authors argue, the short-term character of the Eurobills would make it easier to use them as a disciplining mechanism. If a country defaults on its commitments on fiscal discipline, there is a possibility to exclude that country from the issuance of bills. The decision on such an exclusion would be considered at least once a year. Therefore,

in practice such a disciplining mechanism would contain an element of discretionary judgement (whether the country honoured the commitments), and thus would be subject to political pressure.

In November 2011 the European Commission presented the green paper with proposals on the possibility of introducing Stability Bonds (European Commission 2011). It presents three variants of sovereign debt pooling – pooling of the whole of the debt with joint and several responsibility, pooling of part of the debt with joint and several responsibility, and partial debt pooling with several (not joint) responsibility.

A serious barrier to implementing the above-mentioned proposals, which the European Commission (2011) and other studies drew attention to, could prove to be the legal framework, both at a European and national level. According to some legal opinions, the so-called no bailout clause provided for in art. 125 of the TFEU excludes the member states from assuming joint and several liability, although the bilateral aid given to Greece and the creation of the EFSF could contradict this (Claessens at al. 2012). Delpa and von Weizsäcker (2010) and European Commission (2011) admit that the implementation of their proposals could require changes to the Treaties, while, for example, the authors of Euro-nomics (2011) indicate no need for such changes as one of the advantages of their proposal. In some countries, e.g. in Germany, the barrier to adopting the above-mentioned solutions could prove to be their incompatibility with national legislation, including at a constitutional level.

1.3.4. Challenges posed by the deepening of fiscal integration in the euro area

The increase in the scale of fiscal integration in the euro area will require a strengthening of the mechanisms of disciplining national fiscal policy and a further improvement in the effectiveness of fiscal supervision in the euro area. The increase in macroeconomic risk-sharing with the use of fiscal instruments entails the risk of weakened incentives to conduct responsible fiscal and economic policy at the national level (Persson, Tabellini 1996). Hence the implementation of such instruments should be accompanied by a strengthened framework for disciplining national fiscal policy, e.g. through market-based mechanisms and also through a further improvement in the quality of EU supervision over the domestic budget policy.

Assuming that in the case of a deeper fiscal integration, market mechanisms would continue to play a dominant role in disciplining national fiscal policy, it will be necessary to restore the credibility of the no bailout clause. The experience of other fiscal federations shows a wide spectrum of possible institutional solutions that could reduce moral hazard should fiscal integration deepen in the euro area, covering both market-based systems, as well as frameworks providing for strong control powers of the centre (Box 7). It is worth paying attention to the fact that the maintenance of the current system of disciplining fiscal policy in the euro area, which assumes a large role of market mechanisms and relatively weak control powers of the centre, will entail the following challenges:

- the credibility of the no bailout clause, which is key for the effectiveness of the functioning of this system (Bordo et al. 2013), was significantly weakened as a result of the sovereign debt crisis. Some economists argue that the credibility of the no bailout clause could be restored through the creation of permanent institutional solutions for public debt restructuring (di Mauro, Zettelmeyer 2010, Mody

2013, Wyplosz 2013[40]). For example, it has been proposed to strengthen the no bailout clause through the introduction of contingent convertible bonds (cocos). This idea assumes that all medium and long-term public bonds of the euro area countries would contain the option to automatically extend the maturity or otherwise restructure the debt. The conditions for automatic restructuring would be clearly specified in the debt instrument's legal documentation (Weber et al. 2011, Barkbu et al. 2011, Broke at al. 2013, Mody 2013). Restructuring could be triggered, for example, by the exceeding of the pre-defined threshold of the public debt to GDP ratio. In such a situation, the extension of the maturity or other kind of debt restructuring would take place automatically, without the need for the bondholders and holders of other debt instruments to express their consent. Brooke et al. (2013) propose that the extension of the maturity should be associated with continued coupon payments under the existing rules. Further, the maturity should be linked to country's participation in the EU/IMF programme, and the operation involving a particular bond/debt instrument could be carried out only once. The strengthening of the no bailout clause would result from the stronger market discipline. The possibility of launching automatic debt restructuring would reduce the risk of investors implicitly assuming a bail out by other member states, which would improve market valuation of the issuer's credit risk. This would be reflected in the national bond yields[41]. However, the implementation of this type of solution is unlikely due to the likelihood that it would boost government financing costs. Moreover, legal considerations are a barrier to its implementation.

- also crucial for the effectiveness of the system will be ensuring the credibility of fiscal rules at the level of individual member states. An important role will be played here by the quality of implementation of the Fiscal Compact. It can be judged that the process of building credibility of the reformed fiscal rules in the short and medium-term will most likely be hampered by structural problems and the high level of public and private debt in some countries.

It could also be desirable to further increase the degree of enforcement of fiscal rules in the euro area by European institutions. It can be judged that the reduction of moral hazard in the euro area will require the strengthened enforcement of fiscal rules rather than the introduction of additional fiscal rules. Currently, the number of fiscal rules in the EU is higher than in the majority of fiscal federations. However, the system of sanctions for non-observance of the rules in the EU is rather moderate, and the corrective action is weak. Allard et al. (2013) note that once the fiscal capacity is created in the euro area, it will be possible to make transfers from the budget dependent on whether the given country observes the fiscal rules and implements the recommendations on economic policy. Among the possible solutions which, however, entail a significant limitation of fiscal sovereignty of member states, is also the delegation to European institutions of powers to veto national governments' decisions on fiscal policy.

Another challenge related to the deepening of fiscal integration in the euro area is related to the financing of the fiscal capacity. The introduction of new sources of tax revenues to finance the central fiscal ca-

[40] Wyplosz (2013) argues that in order to restore the credibility of the no bailout clause it would also be necessary to give up the enforcement of fiscal discipline under the Stability and Growth Pact and the possibility to use the ESM to provide financial assistance to governments of member states.

[41] Additional benefits include, among others, a more appropriate distribution of the costs of restructuring and assistance programmes, because they would involve the private sector to a greater extent (the current owners of the debt instruments). According to the calculations of Brooke et al. (2013), the extension of the maturity of bonds prior to Greece entering the EU/IMF programme would have reduced the size of assistance for Greece from the official sector down to EUR 45 bn (the total assistance for Greece from bilateral loans and two aid programmes is almost EUR 250 bn).

pacity can adversely affect the potential growth rate of euro area economies, in which the level of taxation is already relatively high. In particular, this risk can be recognised as significant should the creation of the fiscal capacity be linked with an increase in the level of taxation of labour and capital. Both the average and marginal levels of taxes on labour and taxation of corporate profits in some euro area member states (among others, France, Germany, Italy) are relatively high as compared to the OECD countries. Form this point of view, more beneficial seem the solutions which would assume the transfer of some of the national tax income to the European level or the creation of new tax sources with potentially smaller distortionary effects than taxation of labour and capital (e.g. taxation of consumption).

Box 7. Disciplinary mechanisms in fiscal federations

When analysing the mechanisms disciplining fiscal policy at a sub-federal level, in force in 13 selected fiscal federations[42], Eyruad (2012) argues that the most frequently used instruments limiting moral hazard are fiscal rules. Direct means of control, such as annual expenditure limits set by central authorities and cooperative mechanisms, e.g. negotiations on fiscal goals, are used much more rarely. Among the fiscal rules applied in the federations under analysis, the most common are rules of balanced budget (among them dominate the rules defined by the nominal budget balance, while rules based on the structural balance and the so-called "golden rule"[43] are less widespread) and rules concerning the debt.

As shown in the analysis by Allard et al. (2013) of sub-federal disciplinary practices and the enforcement of compliance to fiscal rules in seven fiscal federations[44], two opposing types of solutions can be distinguished.

Firstly, disciplining of sub-federal policy can be based mainly on market mechanisms, i.e. the evaluation of credit risk of sub-federal units by the financial markets. Such a system is in force in the United States and Canada. Its important elements are self-imposed fiscal rules, used by sub-federal administrative units to signal their commitment to sound fiscal policy, as well as the no bailout clause. The credibility of the latter is supported by the historical examples of sub-federal units defaults. The no bailout clause is also enhanced by the presence of federal fiscal mechanisms[45] that mitigate the adverse impact of shocks, including bankruptcy of federal governments, on the economic activity in the region (see Box 3).

Secondly, control over the sub-federal fiscal policy in federations can be based predominantly on non-market mechanisms. Examples of such a system are the solutions in force in Brazil and Germany. What is characteristic for them are the strong taxation powers of the federal government and also significantly greater control over expenditure and the level of indebtedness of sub-federal units than in the United States. The implementation of fiscal rules which are imposed on these units is often reinforced by a system of sanctions and corrective actions. The latter involve the assumption by the central authorities of direct control over certain areas of economic policy of the regions and limits on incurring debt. The implementation of this approach, however, is unlikely in the euro area, as it would significantly limit the sovereignty of member states. Moreover, the experience with implementation of macroeconomic adjustment programmes shows that a significant problem when implementing solutions that would assume

[42] The federations analysed by the authors are Argentina, Australia, Belgium, Brazil, Canada, Germany, India, Mexico, South Africa, Spain, Switzerland and the United States.
[43] This allows to take on public debt only in order to finance capital expenditure.
[44] The federations analysed are Argentina, Belgium, Brazil, Canada, Germany, Switzerland and the United States.
[45] It is worth noting that the need for such mechanisms in the United States is increased by the fact that the fiscal rules adopted by individual states induce fiscal policy pro-cyclicality.

direct control by the central authorities over national economic policy could be the lack of ownership of the implemented measures, thus significantly reducing their effectiveness. Allard et al. (2013) stress that the arrangements with strong prerogatives of the centre originate from the not too distant experience of sub-federal units bailout. Hence the credibility of the no bailout clause in those federations would be too low for them to rely solely on market mechanisms of disciplining fiscal policy.

To summarise, taking into account the specific nature of the euro area, which is an association of countries which have sovereignty in the majority of areas of economic policy and which declare their preference to maintain the largest possible scope of sovereignty, it can be judged that the first option of disciplining fiscal policy (i.e. assuming the predominant role of market mechanisms) is better suited to the architecture of the euro area.

1.3.5. The impact of deepening fiscal integration in the euro area on Poland

Taking into account that at this stage, the details of the final architecture of the fiscal capacity for the euro area are unknown, as is the issue of how the possible debt pooling will be achieved, one can discuss the implications of these changes for Poland only in a very general way. In the proposals of the European Commission (2012a) and van Rompuy et al. (2012) on further fiscal integration in the euro area, the solutions discussed in chapters 1.3.2 and 1.3.3 involving the creation of a central fiscal capacity and the sovereign debt pooling appear as measures that are to be implemented in the medium and long-term. Taking into account the relatively distant time horizon foreseen for their implementation, these solutions are not currently the subject of EU negotiations. Moreover, it seems that as of now there is little political will to implement them. Hence an assessment of the impact of implementing the above-mentioned solutions on the functioning of the Polish economy is possible only on a relatively general level, taking into account the previously discussed proposals on how the solutions would be designed. This assessment is made with the assumption that in the future Poland will become a member state of the euro area. However, also indicated are the consequences of adopting solutions such as the fiscal capacity and sovereign debt pooling in the euro area in the case of Poland remaining outside the euro area at the moment of implementation.

The effects of creating the fiscal capacity from the perspective of Poland as a future euro area member state

Should the euro area countries decide to create a central fiscal capacity and Poland take the decision to join the euro area, this would have the following implications for the Polish economy:

a. **reduced cyclical fluctuations in the Polish economy as a result of improvement in macroeconomic stability of its main trading partner, i.e. the euro area.**

The creation of the central fiscal capacity in the euro area would increase its stability, which would positively affect the stability of the Polish economy. As indicated in sub-chapter 1.3.1, the creation of the fiscal capacity potentially offers a series of benefits as a result of increased ability of the fiscal policy to reduce volatility of the common and country-specific business cycles in the euro area. The benefits also involve increased credibility of the region. The scale of the increase in macroeconomic stability driven by the creation of the fiscal capacity is, however, difficult to establish *ex ante*, due to the lack of detailed information on

how in practice each of the options of implementing such a solution would look, and thus to what extent they would give rise to the above-mentioned benefits. Without adopting oversimplifying assumptions, it is therefore impossible to carry out a quantitative assessment of the spillovers to the Polish economy (e.g. in the scope of a fall in GDP and inflation volatility) coming from a lower cyclical fluctuations in the euro area countries that would follow the creation of the fiscal capacity.

b. a fall in the risk associated with the limited space for smoothing asymmetric shocks in the Polish economy after joining the euro area;

The existence of a fiscal capacity at a currency union level making possible macroeconomic risk-sharing between participating countries is desirable from the point of view of a country joining such a union. By alleviating the adjustment of member economies of the currency union to asymmetric shocks, it reduces the costs of giving up an independent monetary and exchange rate policy as macroeconomic stabilisation tools. The existence of a fiscal capacity is especially desirable when strong restrictions are imposed on the national fiscal policy by fiscal rules both on a national and European level. The existence of the fiscal capacity on the currency union level also reduces the challenges posed by adjustments through the competitiveness channel: in the case of large shocks such an adjustment may require considerable changes in prices and wages, which may give rise to the risk of excessive fall in domestic demand or the appearance of Fisher's deflationary spiral. Admittedly, Poland should strive to have at the time of euro adoption, firstly, sufficient room to conduct counter-cyclical fiscal policies even in the case of large shocks. Secondly, Poland should aim at an economy characterised by highly effective mechanisms of wage and price adjustment and resource relocation. However, in the light of the challenges mentioned above related to the adjustment to asymmetric shocks, one can judge that the existence of a central fiscal capacity would be a beneficial mechanism safeguarding the Polish economy against excessive fluctuations of output and employment after adoption of the euro.

c. the risk of relatively permanent transfers from the Polish economy to other euro area economies;

The creation of a common fiscal capacity in the euro area entails the risk of permanent transfers from the Polish economy to other countries. This can be limited; however, it would be at the expense of the stabilising properties of this solution. It would be possible to design a system that could guarantee a neutral net position of all the member states (i.e. that they will post only temporary deficits), but only if the system were to be based on complicated rules (e.g. estimates of the output gap, as is foreseen by the proposals on the rainy day fund). However, such a solution would have low transparency and estimates of the output gap would possibly be subject to discretion. Among the remaining options of fiscal capacity discussed in sub-chapter 1.3.2, a common unemployment insurance system is associated with lower risk of permanent transfers than the federal budget, particularly if the former were designed in a way that minimizes the risk (Box 8). Firstly, since the federal budget covers more expenditure categories than the common unemployment insurance system, it would be much more difficult to establish the rules of reducing the risk of permanent transfers between the euro area countries. Secondly, the creation of a federal budget would mean a greater extent of discretionary spending than in the case of the common unemployment insurance system. However, the stabilising properties of a common unemployment insurance system would be weaker than in the case of a federal budget. At the same time, it should be noted that in the case of both options, relatively permanent transfers from the Polish economy to other countries in the euro area cannot be entirely ruled

out. Therefore, a high degree of democratic control and accountability of authorities managing the fiscal capacity is desired.

Box 8. The possibility of reducing the risk of permanent transfers between euro area countries under the common unemployment insurance system

Both the European Commission (EC 2012a) and van Rompuy et al. (2012) note that the fiscal capacity should be designed so as to reduce the risk of permanent transfers between euro area countries. It also seems that only such solutions have a chance of gaining sufficient political support. An article of the working group chaired by R. Strauss of the Directorate-General for Employment, Social Affairs and Equal Opportunities of the European Commission shows that a common unemployment insurance system which is to reduce the risk of permanent transfers between member states should do the following:

- **cover only the short-term unemployed,** excluding frictional and seasonal unemployment (which is greater, for example, in countries where tourism accounts for a large share of GDP). It is proposed that the common unemployment insurance systems should include persons unemployed from 3 to 12 months. Taking into account that the usual, maximum period of unemployment benefit eligibility in Poland is 6 months, the implementation of common standards could therefore extend this period. The deactivating impact of this change on the unemployed would most likely not be very large. However, combined with the likely increase in the level of benefits (see below) it could boost wage growth and lower the cost competitiveness of the Polish economy.

- **be based on harmonised criteria on unemployment benefit eligibility** (e.g. in terms of the length of the contribution period). It should be noted that currently these criteria in Poland are more restrictive than on average in the euro area countries (Esser et al. 2013). Hence the risk that if Poland were to become a member of the common unemployment benefit system, it would have to loosen these criteria. This is particularly the case should harmonisation result in the extension of the unemployment insurance system to categories of the employed that are not currently covered by unemployment insurance in Poland (self-employed, employees on atypical contracts).

- **be constructed in such a way that benefits from the common system for the eligible unemployed from the euro area shall constitute the base benefit** (preferably defined based on the replacement rate)**,** possibly topped up at a national level. Given the strong diversity of preferences of euro area countries regarding the level of social security, it can be expected that the benefits offered under the common system will be established at a moderate level in relation to income obtained from paid employment. A 50% threshold is suggested in studies that propose the implementation of this type of system. In the case of Poland, the adoption of even such a moderate threshold would increase the level of benefits paid out to the unemployed. This could lead to an increase in wage level in Poland as a result of growth in the reservation wage, and consequently, worsened cost competitiveness of the Polish economy.

d. the transfer of fiscal and economic policy sovereignty to the European level and the need to harmonise selected regulations;

The creation of a euro area fiscal capacity will inevitably involve the transfer of part of the fiscal and economic sovereignty to the euro area level. This could proceed through the delegation of some of the

decision-making powers to the authorities managing the fiscal capacity, and also through increased harmonisation of selected regulations. The scale of this delegation will depend on the size of pooled funds and the chosen option of fiscal capacity. As indicated in sub-chapter 1.3.2, the largest scale delegation of sovereignty would take place in the case of the federal budget, while the smallest scale delegation would be in the case of the rainy day fund.

The harmonisation of regulations driven by the need to create a fiscal capacity could require a strengthening of Poland's structural competitiveness before joining the euro area. With regard to the need for harmonisation of selected regulations, from Poland's point of view, extending it to other areas such as the labour market (which would be necessary e.g. if the fiscal capacity took the form of a common unemployment insurance system) or corporate taxation could be particularly important. On the one hand, harmonisation of regulations could be desirable, since it reduces the risk that the Polish economy will react to common shocks differently from the other economies of the euro area (see Part II of *The economic challenges of Poland's integration with the euro area*). Moreover, the harmonisation of regulations is crucial to reduce moral hazard and the risk of permanent transfers between member states. On the other hand, given that certain regulatory solutions (e.g. the low level of legal protection of atypical employment, the low level of unemployment benefit and minimum wage compared to other EU countries) add to the cost competitiveness of the Polish economy, it can be expected that the harmonisation of regulations in the areas indicated above would require a strengthening of Poland's structural competitiveness.

Conclusion: *The creation of a fiscal capacity in the euro area is economically beneficial from the point of view of Poland as a future member state of the euro area, since it would allow to reduce the business cycle volatility both in euro area countries that are Poland's main trading partners and in the Polish economy.*

Conclusion: *The harmonisation of regulations related to the implementation of such solutions could translate into reduced cost competitiveness of the Polish economy. This increases the need to precede membership of the euro area with a strengthening of the structural competitiveness of the Polish economy.*

The results of creating a fiscal capacity in the period in which Poland remains outside the euro area

If the fiscal capacity solutions were to be implemented in the euro area prior to Poland's decision to join, this may have the following implications for Poland.

a. The risk of a deepening of the phenomenon of a "two-speed Europe"

The creation of a fiscal capacity in the euro area will entail a deepening of political integration between the countries that establish it. This process may adversely affect integration in the European Union (i.e. result in the so called "two-speed Europe") and the political position of Poland if Poland decided to remain outside the euro area for a relatively long time. This risk may be reduced by Poland's participation in de-

signing new institutional solutions with respect to fiscal capacity for the euro area based on the EURO+[46] formula.

The scale of political integration required by the individual fiscal capacity options is, however, diverse. Moreover, there exists the possibility to reduce the need to implement it through deepening integration of the financial markets in the euro area. The greatest scale of political integration between euro area countries would be required if a federal budget is established, and the smallest in the case of implementation of solutions such as systems of transfers based on the cyclical position of the economies. Additionally, as indicated in sub-chapter 1.3.2, although the creation of a fiscal capacity in the euro area would improve its functioning, it is not the only possible way of enhancing its long-term stability. The usefulness of the fiscal capacity can be assessed as high, mainly in the case of large shocks (e.g. a banking crisis), which may negatively affect public finance sustainability once fiscal policy is used to mitigate their effects. In this context, it should be noted that the risk of such a situation occurring has to a certain degree been reduced by the introduction of solutions for resolution of banks and the creation of the banking union, including through the establishment of the Single Resolution Fund financed by banks' contributions (see Chapter 3). However, further reductions of risk require, firstly, regulatory changes, which would increase the integration of capital markets in the euro area (e.g. partial harmonisation of bankruptcy law, sub-chapter 2.2 and Cœuré 2014). Secondly, it would be appropriate to supplement the banking union with a suitable backstop, to be used in situations in which the resources of the SRF are depleted (which may occur in the case of large crises), and with a common deposit guarantee scheme. The implementation of the latter would further reduce the negative bank-sovereign feedback loops. At the same time, it is judged that a fiscal backstop for the banking union and a common deposit guarantee scheme will require a smaller scale of political integration between member states of the euro area than the federal budget, a common unemployment insurance system or rainy day fund. To summarise, supplementing the banking union with a fiscal backstop and a common deposit guarantee system could be considered a substitute for a central fiscal capacity in the euro area and would require a smaller degree of political integration between its member states.

b. the possibility to reduce the size of the European Union budget

It is impossible to determine at this stage the impact of the creation of the fiscal capacity on the size of funds received by Poland from the common EU budget due to the planned reform of the Multiannual Financial Framework. If the euro area countries decide to create a fiscal capacity aimed at stabilising their economies, this could adversely affect the size of the European Union budget or – should the fiscal capacity be created as part of the EU budget[47] – the level of funds from the budget allocated to all EU countries, including funds dedicated to supporting the convergence process. However, at this stage one cannot state to what degree the future reduction in expenditure allocated to all EU states would affect the position of Poland, which remains a net beneficiary of the EU budget. Due to criticism of the EU budget[48] and EU initia-

[46] This formula assumes the opening of new integration projects for interested non-euro area states. It was applied in the case of the Euro Plus Pact, the Fiscal Compact and the first two pillars of the banking union.
[47] According to the report prepared by the legal services of the European Parliament, the Treaties allow the separation in the EU budget of expenditure which would be "allocated" to a certain group of EU countries, in this case, the euro area countries.
[48] The EU budget is criticised, among others, for not being growth-enhancing enough, as a result of a too weak focus on investment in research and development, cross-border infrastructure projects and measures aimed at increasing employment.

tives aimed at its reform[49], there is considerable uncertainty about the size, form and way of financing of the future EU budget (i.e. which would be in force after the Multiannual Financial Framework for the years 2014-2020).

c. **an increase in the scope of legal and administrative adjustments to be implemented before adoption of the common currency.**

One effect of the creation of a central fiscal capacity in the euro area will be an increase in costs of legal and administrative adjustments needed for the adoption of the common currency. As indicated in Chapter 1.3.3, the creation of a central fiscal capacity in the euro area could entail changes in the TFEU and the harmonisation of some regulations, inducing the need for amendments in national legislation.

Conclusion: *The deepening of fiscal integration in the euro area involves the risk of a "two-speed Europe", i.e. a deepening of political divisions in the EU as a result of deeper integration of the euro area. However, the scale of this risk varies, depending on the solutions adopted: it is smaller in the case of a strengthening of fiscal safeguards for the banking union, the greatest in the case of the federal budget of the euro area. The deepening of fiscal integration through the implementation of a fiscal capacity will also increase the scope of necessary adjustments in Poland before joining the euro.*

Possible opt-in

If the euro area undertakes measures aimed at creating a central fiscal capacity and with an opt-in option, when considering whether Poland should join such a mechanism while remaining outside the euro area, one should take into account the following issues:

Firstly, having at its disposal an independent monetary and exchange rate policy, Poland has less need to use alternative mechanisms for mitigating adjustment to asymmetric shocks or common shocks for the Polish economy and the euro area.

Secondly, the creation of a fiscal capacity – regardless of its final form – will involve the transfer of sovereignty in selected areas of fiscal and economic policy to the European level, and will therefore limit the freedom to shape national macroeconomic policy.

Thirdly, regardless of the option of the fiscal capacity adopted, there is a risk of relatively permanent fiscal transfers between participating member states. Therefore it cannot be excluded that Poland will be a net payer in such a system.

Fourthly, opting in to the above-mentioned mechanisms will limit the problem of remaining outside the main current of European integration due to not being a member of the euro area.

[49] On 25 February 2014 the Presidents of the European Parliament, the European Commission and the European Council officially initiated a high-level group chaired by Mario Monti, which is to present proposals on alternative ways of financing the EU budget to the system based on contributions from member states.

The effects of sovereign debt pooling for Poland

The pooling of the euro area sovereign debts, although not essential for maintaining the integrity of the currency union, would bring significant benefits as described in sub-chapter 1.3. An increase in financial stability, an improvement in the monetary policy transmission and a strengthening of fiscal discipline would be welcome from the point of view of Poland as a country outside the euro area, as well as its future member. However, as indicated in Chapters 1.3.3 and 1.3.4, the design of a mechanism allowing to achieve these benefits and at the same time acceptable for both the states with a high public debt level and those with a low debt level, will in practice be a difficult task due to the risk of moral hazard and the differences in indebtedness among countries, including a high debt level in the case of peripheral economies.

Implications of sovereign debt pooling from the point of view of Poland as a future member of the euro area

In the light of the above-mentioned points, in order to be able to consider the solutions for sovereign debt pooling as improving the stability of the euro area, and consequently, as being welcomed by Poland, they would have to fulfil certain conditions. These depend on the adopted option of debt mutualisation – whether it would be full or partial.

In the case of full debt mutualisation, both taking into account the stability of the euro area and the future liability of Poland as a euro area country for the debts of other states, it would be necessary to implement a strict safeguard against moral hazard, which in this situation would be a serious threat. This safeguard would have to ensure that all the euro area countries have an impact on the fiscal policy of individual members. This would entail a far-reaching restriction of member states' sovereignty in the field of fiscal policy. Therefore, the adoption of such a solution is most unlikely (see sub-chapter 1.3.4). In the case of partial debt mutualisation, the adopted solutions should fulfil the following conditions:

- **the setting of a limit of common debt at a level guaranteeing low risk of insolvency.** The proposals of partial debt pooling presented in the debate (see sub-chapter 1.3.3) fulfil this demand, since all of them provide for the common debt limit at the level of 60% of GDP or lower. Combined with the seniority of Eurobonds over the national debt, this should guarantee a low risk of insolvency.
- **no discretionary elements in mechanisms regulating the functioning of Eurobonds,** since this would entail the risk of their vulnerability to political pressure. This applies in particular to the share of the common debt ascribed to individual countries. This should be determined in an objective way (as a relation to GDP), without leaving room for interpretation, even in extraordinary situations such as, for example, a revision of GDP or a deep recession. Moreover, access to financing from common bonds should not be dependent on fulfilling criteria of a discretionary nature, such as the requirements of assistance programmes or recommendations under the excessive deficit procedure. Such a of solution was an element of the Eurobills proposal (Hellwig, Philippon 2011); however, it would give rise to serious political risk. For example, one can imagine a situation in which the loss of access to financing through Eurobonds/Eurobills would lead to market tensions. The threat of such a situation would automatically lead to pressure on the European Commission to recognise that the country in question fulfils its obligations with regard to fiscal adjustments, even in a situation in which there were no sub-

stantive grounds for this. This would risk weakening the enforcement of European fiscal rules and would question their credibility.

- **pooling of a sufficiently large part of the existing debt, while ensuring safeguards against moral hazard.** In particular, this applies to the debt of peripheral countries, provided that it is recognised as being sustainable. When a substantial part of the liabilities of these states is of national character and is subordinate to the Eurobonds, it may prove that the debt is perceived as riskier than it is at present and the costs of servicing it will increase. Such a risk exists, for example, in the case of the proposals of the Bruegel Institute on implementing "blue" and "red" bonds. A large share of subordinate debt could increase average interest rates on public debt and consequently, a worsening of fiscal perspectives. Through a fall in the value of existing bonds in banks' portfolios, it could also adversely affect the stability of the financial sector. In order to mutualise a significant part of the debt and, at the same time, reduce the risk of moral hazard and obtain the acceptance of countries with a low level of debt, the option to gradually reduce the limit of common debt falling on individual countries can also be considered.
- **clear and objective principles of the possible use of Eurobonds as a fiscal safeguard of the banking union or a counter-cyclical mechanism** (e.g. the possibility to increase the size of the common debt in the case of a deep recession).

Conclusion: *Mutualisation of sovereign debt, although not necessary to maintain integrity of the common currency, may improve its functioning. From the point of view of Poland as a future member state of the euro area, it is most important that any future option of debt pooling contains strong safeguards against moral hazard (the establishment of sufficiently low limits of common debt issuance, the adoption of objective criteria on the limit of common debt per individual country).*

Sovereign debt pooling in the euro area and public debt servicing in Poland

A separate aspect of the debt mutualisation in the euro area that is important for Poland is the possible impact of such a solution on the Polish government bonds market in a situation in which Poland remains outside the euro area. The impact of implementing common bonds in the euro area on the financial markets will of course depend on the final form of the adopted solutions. However, it seems that in every variant which fulfils the conditions described above, the common bonds will be very safe instruments, and thus will have very low yields. Therefore, they will compete to a limited degree with Polish government bonds as long as Poland remains a converging economy, remaining outside the euro area. In such a situation interest rates and thus government bond yields may be expected to be higher in Poland than in the euro area. This justifies the assessment that Polish government bonds will remain an attractive instrument of one of the most credible issuers of the emerging markets group. The euro area common bonds would be competition mainly for the government bonds market of the United States, which currently is the only one offering the liquidity approaching that which could be obtained by pooling the debt of the euro area, and at the same time offering instruments with an AAA rating. In the case of European countries with a high level of development but not belonging to the euro area, there is a potential risk of an increase in debt servicing costs following the establishment of common bonds in the euro area. This problem could also affect Poland, but in the rather distant future, i.e. after reaching an income level approaching that of the euro area countries, providing that by that time Poland has not adopted the common currency. However, the scale of this effect would be limited, because already the creation of the euro area, and consequently of a large

Treasury bonds market denominated in a common currency, has led to a decline in liquidity premiums on the government bonds market. This has been confirmed, for example, by the research of Bernoth et al. (2006).

Possible opt-in

The implementation of Eurobonds could have a measurable positive impact on the reduction of debt servicing costs in Poland if countries remaining outside the euro area also participated in the debt pooling[50]. At the end of 2013 the Polish public debt denominated in foreign currency stood at less than 13% of GDP, which included 8% of GDP denominated in euros. This debt could be subjected to pooling. The extension of access to financing from common bonds to countries outside the euro area would involves greater risk for the remaining countries due to the presence of foreign exchange risk. However, this problem could be solved by setting a sufficiently low limit of debt under pooling in the case of countries outside the euro area (e.g. 20% of GDP). Another obstacle to the participation of non-euro area countries in the system of common bonds would be the establishment of the principles of their liability for the debts of euro area states. However, due to the previously mentioned safe character of common bonds and the negligible risk of their non-payment, the formulation of such principles should be possible.

Conclusion: *The pooling of debt of the euro area members states in the period in which Poland remains outside the euro area should not constitute a threat for the Polish Treasury bond market. Moreover, Poland could gain measurable benefits by opting in the project of partial debt pooling if such an option were made available.*

[50] With the possible exclusion of states with derogation which have no plans to adopt the common currency.

Chapter 2. Economic integration

2.1. The current model of economic governance in the euro area

2.1.1. The properties of the current economic governance model

In accordance with the current institutional model of the EMU, conducting economic policy (to be precise, economic policy in relation to areas that are not subject to common policy) remains the domain of member states of the EU[51]. However, economic policy measures are subject to a coordination process at the EU level. Apart from fiscal policy (which is analysed in Chapter 1), this process covers in particular employment policy and structural policy in the broad sense of the term.

While the original institutional model for the EMU assumed certain mechanisms to enforce fiscal discipline (fiscal rules) and supervision of compliance with common rules by the EU institutions, the so-called soft method of coordination was mainly applied to the remaining areas of economic policy (Box 9). This model did not cover formal (i.e. going beyond peer pressure) mechanisms enforcing implementation of formulated recommendations and commitments adopted. On the one hand, it was based on the guidelines for member states economic policy (known as the Integrated Guidelines)[52] formulated in line with the Lisbon Strategy[53] and adopted by the European Council. These guidelines were supposed to be followed by member states in the development and amendment of the National Reform Programmes and formed the basis for the European Commission and the Council to address country-specific recommendations concerning economic policy. On the other hand, the so-called open method of coordination, based on the principle of voluntary participation of member countries, was also applied to coordinate member states' economic policy[54].

Box 9. Models of economic policy coordination

Economic policy coordination within an integrated economic area can take various forms, ranging from the exchange of information, agreement on selected economic policy goals, to the agreement of all the goals and instruments of this policy. In the literature there are three distinct models of economic policy coordination, under which it is possible to combine various forms of coordination (see Znoykowicz-Wierzbicka 2012):

[51] Areas of economic policy conducted jointly mainly include the common monetary policy in the case of euro area states and trade policy, competition policy, transport policy, agricultural policy and fisheries policy – in relation to all EU states.

[52] The National Reform Programmes were implemented for economic governance in the EU in 2005, replacing the numerous reports on economic policy conducted by member states that were in force earlier.

[53] The integrated guidelines for economic policy were adopted the first time by the European Council in 2005, when the Broad Economic Policy Guidelines, containing recommendations for economic authorities of member states on macroeconomic and structural policy, were integrated with the Employment Guidelines.

[54] The open method of coordination is the framework for coordination of economic policy and international cooperation between member states and covers the following: 1) establishes, at an EU level, the common aims to be achieved by member states, 2) determines the best methods for achieving the goals that have been set: establishes the quantitative and qualitative indicators and benchmarks, 3) translates European guidelines into national and regional policy, 4) provides for periodic monitoring, evaluation and mutual assessment of measures.

1) **hard policy coordination**, assumes coordination in the form of common policy. Under this model the common goals are achieved by supranational institutions that are authorised to take binding decisions in the specified areas of economic policy.
2) **mixed policy coordination**, assumes the adoption of general principles of pursuing economic policy and mechanisms for enforcing their compliance (including possible sanctions) that are binding on all countries, while leaving the decision-making in a particular field to national governments.
3) **soft policy coordination**, assumes that responsibility for economic policy coordination rests exclusively on national governments. This model provides for the establishment of non-binding general principles of coordination and the possibility for supranational institutions to formulate recommendations that have no legal force for national governments.

The weaknesses of the euro area economies, their growing structural heterogeneity and the imperfect EU system of surveillance of the macroeconomic situation, which were revealed as a result of the financial crisis, have forced changes in the model of economic policy coordination in the EMU. The adoption of a common currency launched processes which – in conditions of considerable diversity of euro area economies already at the stage of its creation, rigid structures of these economies and the pursuit of pro-cyclical macroeconomic policies – led to growing disproportions in competitiveness of individual euro area states and serious macroeconomic imbalances threatening the economic and financial stability of the euro area. In order to reduce the occurrence of this type of phenomenon in the future, institutional changes have been implemented aimed at strengthening supervision of EU institutions over economic policy pursued at a national level, and thus, the scope of the coordination process has been extended.

Box 10. The legal basis of economic policy coordination in the EMU

Economic policy coordination of member states is achieved mainly on the basis of Treaty provisions. In accordance with Art. 121 para. 1 of the TFEU, member states of the EU regard their economic policy as a matter of common concern and coordinate it within the Council of the EU. Key elements in ensuing the effectiveness of the coordination process are the following: the adoption of the broad guidelines of economic policy of EU member states (art. 121 para. 2) and regular assessment of consistency of the pursued national policies with the broad guidelines formulated for the whole of the EU (art. 121 par. 3). However, the basis for strengthened coordination within the euro area is art. 136, which, with respect to the euro area countries, provides for the possibility to adopt measures necessary for the proper functioning of the area (para. 1). Similar resolutions in relation to employment policy were included in Title IX of the Treaty – "Employment" (in art. 145-149), which states that EU member states regard promoting employment as a matter of common concern and shall coordinate their action in this respect within the Council the EU (art. 146 par. 2). Recommendations regarding employment policy pursued by EU member states are issued by the Council of the EU on the basis of art. 148 para. 4. On the basis of this article, every year the Council of the EU issues recommendations on the implementation of broad guidelines for economic policy of euro area states.

The current method of economic policy coordination is also based on secondary legislation. This includes, in particular, the Regulation on the prevention and correction of macroeconomic imbalances[55].

[55] The Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances and the Regulation (EU) No 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area.

The legal basis for the coordination process is also the TSCG (see sub-chapter 1.1). A number of measures are also based on obligations of a legally non-binding character, such as those included in the Euro Plus Pact.

The changes in the institutional framework of economic policy coordination of euro area countries that were implemented in response to the crisis include the following:

- replacement of the Lisbon Strategy implemented in 2000-2010 through its modification – the Europe 2020 strategy, which is a new strategy for employment and growth in the EU. The Europe 2020 Strategy contains priorities aimed at smart, sustainable and inclusive economic growth as well as objectives determined at an EU level in five areas (employment, innovation, education, social exclusion and climate change). The initiatives undertaken in connection with the implementation of the strategy are supposed to help to eliminate factors hampering potential growth of member states' economies. Every year member states shall submit National Reform Programmes, containing measures consistent with the integrated guidelines for economic policy, formulated on the basis of the Europe 2020 strategy.
- implementation of the European Semester (functioning since January 2011), which integrates fiscal policy coordination, based on the SGP (see subchapter 1.1), with structural policy coordination. It also involves an evaluation of compliance of the policies pursued by member states with the integrated guidelines formulated on the basis of the Europe 2020 strategy. Compared to the pre-crisis framework for economic policy coordination, the advantage of the European Semester is that recommendations on economic policy of member states are formulated by EU institutions *ex ante*, i.e. before domestic budgets are prepared and approved.
- implementation of the Macroeconomic Imbalance Procedure (MIP), establishing sanctions and enforcement mechanisms for economic policy recommendations aimed at member states in which there are excessive macroeconomic imbalances (see below for details).
- adoption of the TSGC, establishing the legal basis for further strengthening of economic policy coordination of signatory countries.
- strengthened monitoring of economic policy of countries under the excessive deficit procedure (by making it compulsory for these countries to submit economic partnership programmes containing a structural reform programme aimed at improving competitiveness and stimulating economic growth) as well as strengthened surveillance of economic policies of those euro area countries that are facing serious difficulties as regards their financial stability or are using the PCCL under the ESM (see subchapter 1.2; among others, by regular review missions by the European Commission in liaison with the ECB, and increased reporting requirements and the supply of information by the membership country). In particular, with the strengthened surveillance, the European Commission has gained the possibility to formulate recommendations adopted by the Council by a qualified majority of votes on the need to provide a country with financial assistance and prepare a draft macroeconomic adjustment programme. Sanctions have also been introduced for non-compliance with the adjustment programme[56].

[56] Non-compliance with the adjustment programme may cause the suspension of obligations or the withholding of payments to the country in question by the European Regional Development Fund (ERDF), the European Social Fund (ESF), the Cohesion Fund (CF), the European Agricultural Fund for Rural Development (EAFRD), and the European Maritime and Fisheries Fund. it is also worth noting that, in accordance with guidelines for political cohesion for the years 2014-2020 adopted by the Council of the EU in December 2013, the European Commission can also request the suspension of obligations (the request is accepted, unless the Council of the EU rejects it with a qualified majority of votes) or the suspension of payments (this may take place

- the adoption of the Euro Plus Pact, whose signatories have set more ambitious goals compared to those set by the Europe 2020 strategy and have agreed to mutual monitoring of their implementation by the heads of governments or heads of state, carried out under the European Semester (for details see below).

The existing method of economic policy coordination is a system based on country-specific recommendations formulated under the European Semester. The economic policy coordination process of the euro area, implemented under the European Semester, includes the following elements:

- setting the strategic goals to be achieved by the European Union at the supranational level;
- assessment of the plans prepared by individual member states in the National Reform Programmes and the Stability Programmes as well as an attempt to ensure their compliance with the general objectives through the formulation of Country Specific Recommendations (CSR) and recommendations for the euro area as a whole;
- assessment of the measures undertaken by member states (on the basis of bilateral consultations that the European Commission carried out with member states), the issue of recommendations or taking of decisions on corrective measures (under the Excessive Imbalance Procedure (EIP)).

The most important EU institutions are involved in this process on a permanent basis, i.e. the European Council and the Council of the EU[57] at the decision-making phase, and also the European Commission with respect to formulating recommendations and monitoring their implementation.

An important element of the coordination process is the macroeconomic imbalance procedure (MIP). Its aim is the early detection of macroeconomic imbalances which could threaten the stability of not only the economy of the state in question, but also the economies of other member states and of the whole euro area and EU. The MIP provides for the implementation of national economic policy measures which could eliminate the emergence and build-up of macroeconomic imbalances (preventative arm) as well as eliminate the existing macroeconomic imbalances (corrective arm). Under the procedure the following stages of economic policy surveillance of member states can be distinguished:

- **early warning.** Identification of factors that could lead to the emergence or build-up of macroeconomic imbalances takes place annually and is based on the MIP scoreboard, i.e. the set of indicators representing various aspects of internal and external balance of the economy. The results of this review are presented in the Alert Mechanism Report (AMR).
- **detailed analysis of the macroeconomic situation.** If the above indicators are at a level signalling macroeconomic imbalance, the European Commission conducts an in-depth review of the economic, financial and fiscal situation in the country in question. On this basis, the European Commission assesses the existence of serious or excessive macroeconomic imbalances. The results of the analysis should be reflected in measures presented in the National Reform Programmes and the Stability Programmes that are planned for implementation by the member states indicated. The results of the analyses are also the basis for the country-specific recommendations, formulated and published by the European

after a decision of the Council of the EU taken by a qualified majority of votes) if the country in question does not implement corrective measures under the excessive deficit procedure or macroeconomic imbalances procedure.

[57] Formally, decisions are taken by the Council of the EU, as a rule ECOFIN; however, in practice discussions and the most important agreements concerning the member states of the euro area are carried out in the Eurogroup, made up of ministers of finance or of the economy of euro area member states.

Commission (at the end of May each year), which are then endorsed by the European Council and adopted by the Council of the EU.

- **launch of the excessive imbalance procedure (EIP).** This occurs in the case of member states in which the European Commission has identified excessive macroeconomic imbalances. In such a case, the European Commission recommends that the member state presents a corrective action plan with implementation timetable. This recommendation is accepted by the Council of the EU. The Commission monitors the progress with pursued corrective actions on an on-going basis.
- **sanctions.** Penalties for euro area states are applied when the European Commission considers that recommended corrective measures have not been effectively applied. In the first place, an interest-bearing deposit is submitted by the member state. However, ultimately, in the case of further problems with effective corrective action, the Council of the European Union, on the basis of recommendations of the European Commission, may convert the deposit into a fine of a maximum annual level of 0.1% of GDP of the euro area member state in question.

The next element of the economic policy coordination process is the Euro Plus Pact, which was adopted by the European Council on 24 March 2011. The agreement was signed by the heads of state or governments of all euro area countries[58]. The contracting parties expressed their readiness to undertake additional, more ambitious commitments (compared to those in the Europe 2020 strategy) as well as measures to improve competitiveness and economic convergence, together with fixing the deadlines for their implementation. The countries that joined the Euro Plus Pact committed themselves to achieve the following jointly set goals: an improvement in competitiveness, promotion of employment, enhancing public finance sustainability, and a strengthening of financial stability. The signatories of the agreement committed themselves to present annually a list of specific measures aimed at achieving the agreed goals, which are included in the National Reform Programme and the Stability Programme. The selection of the most appropriate means by which to achieve these goals is left to the individual states, which make this choice while taking into account the specific challenges of economic policy[59]. The parties to the agreement also undertook to consult with each other their plans on all the important economic reforms which, when implemented in one state, may have an impact on the situation in other member states. The implementation of the commitments is assessed once a year by the heads of state or government on the basis of the report prepared by the European Commission. The advantage of the Pact over the recommendations of the European Commission formulated in the European Semester is that the signatories themselves undertake to implement specific measures for stability and competitiveness. Thus, countries are more likely to identify with these commitments.

The TSCG, which came into force on 1 January 2013, also focuses on strengthening economic policy coordination. The provisions relating to economic policy coordination between the states-parties to the agreement are contained in Title IV of the TSCG (Economic policy coordination and convergence). In accordance with article 9 of the Treaty, the parties agree to work jointly towards economic policy coordination, ensuring the proper functioning of the EMU and fostering of economic growth through increased convergence and competitiveness. The aim of the measures undertaken by member states – signatories of the agreement – is identical to that of the Euro Plus Pact: to increase competitiveness, promote employment, increase the stability of public finances and strengthen financial stability. In article 10 of the Treaty the parties express their willingness to make use of the legal instrument, provided for in the TEU and TFEU, of

[58] In addition, Bulgaria, Denmark, Latvia, Poland and Romania also joined the Pact.

[59] The Pact contains a list of good practices and suggestions of possible measures in specific areas, which could additionally be used in determining the national list of initiatives.

enhanced cooperation on issues of importance for the proper functioning of the euro area, while preserving the integrity of the single market. In turn, article 11 of the Treaty imposes the obligation to discuss major economic reforms as well as – in justified cases – to coordinate *ex ante* such reforms. The aim of this process would be to indicate the best practices and to act towards increasing economic policy coordination of the states-parties to the agreement.

The issue which is gaining importance in the discussion on further economic integration is the so-called social dimension of the EMU. In this respect it is proposed to carefully monitor the social situation and the situation in the labour market of EMU member states, and also to ensure close coordination of both social policy and employment policy of euro area member states, while respecting the competencies of member states. There is also stress on the need to include a growing range of social partners (employers and trade unions) in the consultation process of proposed solutions relating to the EMU. Based on the European Commission's proposals[60], in October 2013 the European Council endorsed the extension of the Joint Employment Report (which is part of the Annual Growth Survey) with a scoreboard of key employment and social indicators[61]. Additional indicators in this area have also been introduced as a supplement to the Alert Mechanism Report, in order to better reflect the social consequences of macroeconomic imbalances and the implemented adjustment process.

2.1.2. Challenges related to the current economic governance framework in the euro area

Changes in the institutional framework of economic policy governance in the EMU, implemented as a response to the financial crisis, do not fundamentally alter the economic integration model which was in force earlier. In addition to the areas covered by the common policy and subject to harmonisation of regulations at a community level, the soft economic policy coordination model is still largely used in the EMU, based on intergovernmental coordination of member countries' policies, as are the recommendations formulated by the European Commission and adopted by the Council. Compared to the solutions in force before the crisis, there has been a strengthening of the role of the European Commission and the Council in terms of influencing the economic policy of countries facing macroeconomic and fiscal imbalances (in particular, countries which are under strengthened supervision procedures and macroeconomic adjustment programmes). In particular, the power of the European Commission to issue recommendations on the need to include a specific country in financial assistance and a macroeconomic adjustment programme can be considered a significant sanction.

The existing coordination model still assumes *a priori* the existence of strong incentives (mainly market-based) for the national authorities to undertake reforms, as well as their close cooperation with community bodies that do not have the right of legislative initiative in relation to member states. European institutions, above all the European Commission, besides recommendations, can also apply other methods of communication with member state governments. However, in accordance with the principle of subsidi-

[60] Contained in the Communication "*Strengthening the social dimension of the Economic and Monetary Union*", which was published on 2 October 2013. (European Commission 2013a)

[61] The indicators proposed by the European Commission are as follows: (1) the participation rate, (2) the long-term unemployment rate, (3) young people not in education, training or employment (NEET), (4) the at risk of poverty and social exclusion rate.

arity, both the prioritisation of the needed reforms and the selection of measures remains the exclusive prerogative of the national states. As a result, the actual implementation of the recommendations depends mainly on the identification of the government and national parliament with the position of the European Commission.

In view of the above, the following key risk factors for implementing economic policy recommendations, including those relating to structural reforms, should be indicated:

- **Insufficient impact of market-based incentives.** The creation of the euro area was accompanied by the conviction that financial markets will discipline effectively the governments of member states. The latter will be compelled to conduct economic policy helping to maintain macroeconomic (and fiscal) stability as well as implement reforms that improve competitiveness. However, in practice the market assessment of credit risk of individual governments was not effective: the assessment of macroeconomic outlook of some of the economies of the euro area was excessively optimistic and did not adequately take into account their fundamental weaknesses. What is more, the excessively optimistic assessment of credit risk could have weakened the incentive to implement reforms in some cases. Also, competition in the single market did not discipline the governments of all member states to implement reforms ensuring higher competitiveness and improving alternative (in relation to monetary policy and exchange rate changes; Box 4) adjustment mechanisms. Although the sovereign debt crisis brought about sovereign credit risk reassessments, it is worth noting that the introduced solutions leading, in fact, to growing mutualisation of risk in the euro area countries (ESM, OMT programme) may adversely affect the disciplining of national policy by financial markets (Chapter 1).
- **Political factors.** Due to the fact that the positive social and economic effects of structural reforms are spread over time and often seen only in the medium or long-term, while the costs of reforms are incurred mainly in the short-term, the governments of member states may not be inclined to undertake the reforms with the highest social cost in fear that they will adversely affect their likelihood of being re-elected.
- **Insufficient understanding and ownership of advised reforms and the country-specific recommendations.** Although it is the member countries themselves (through the Council of the European Union) who adopt the recommendations on economic policy proposed by the European Commission, there is as problem with the ownership of the recommendations, resulting from the lack of involvement of national parliaments in the process of their adoption. This weakens support for the recommendations of the European Commission, adversely affecting their implementation. As Hallerberg et al. (2012) indicate, individual national parliaments differ greatly as regards their interest in European documents. Moreover, generally the recommendations aimed at member countries under the European Semester attract less attention of members of parliament than national strategic documents[62].

However, in this context it is worth noting that at the EU level measures were undertaken to strengthen the monitoring of the implementation of recommendations addressed to member states. The European

[62] While the long-term budgetary plans were discussed during the plenary session in 2011 in 12 of the 17 countries of the euro area, the plenary discussion on the Stability and Convergence Programmes (whose content is consistent with the long-term budgetary plans) took place only in France, Spain, Luxembourg Portugal and Slovenia. In as many as five countries (Austria, Finland, Greece, Holland, Spain and Malta) neither the parliamentary budget commission nor the commission for European affairs discussed the Country Strategy Programmes. It was addressed by the budget commission only in Luxembourg, Germany, France, Italy and Slovenia (Hallerberg et al. 2012)

Commission commenced close monitoring of policy committments implementation as decided at the meeting of the European Council on 24 and 25 October 2013. As a result of these decisions, the European Commission made a temporary review[63] of the status of implementation of the Council of the European Union recommendations, both by individual member states and by the euro area as a whole. The review concerned the progress made in the last 3 years, taking into account reforms undertaken since the beginning of the first cycle of the European Semester. It identified the shortcomings in the implementation of the recommendations adopted in 2013. The strengthened monitoring of the implementation of the recommendations is aimed at improving the accountability for the commitments.

The literature identifies the following weaknesses of the current model of economic policy coordination in the euro area:

- no link between the hierarchy of country-specific recommendations and the importance of the challenges faced by the given country and the euro area. The current prioritisation of European Commission recommendations formulated under the European Semester reflects the legal status of the individual recommendations. The highest status is assigned to recommendations related to the SGP, which are legally binding, backed up by sanctions and established in the TFEU. These are formulated in a more detailed way than recommendations in areas that remain the competence of member states. Such a way of prioritisation can give rise to improper understanding of the hierarchy of needs and challenges for economic policy of euro area countries, and likewise the measures which should be taken in the first place to prevent adverse economic and financial phenomena. The weakness of such prioritisation of recommendations is also that it does not indicate which measures in a given member state are a priority due to them having the greatest, most direct impact on the functioning of the currency union and the other economies.
- recommendations formulated in a too general way. It has been indicated that too broadly formulated recommendation reduces the strength of the communications of the European Commission and the Council of the European Union. Derruine and Tidermann (2011), point out, for example, that Sweden and the Netherlands, despite achieving very good results for employment, under the European Semester received recommendations on employment policy with exactly the same content as countries that recorded much worse results (Estonia, Ireland, Slovenia). However, it is worth noting such an approach of formulating recommendations gives member states some discretion regarding the best way to implement the recommendations. This, in turn, may not only increase the ownership of the recommendations, but may also allow to better take into account the country-specific situation when designing solutions aimed at achieving goals that have been set at the EU level.
- insufficient links between the recommendations and issues related to the functioning of the currency union. The recommendations apply to many areas of economic policy; however, they constitute rather a set of solutions that are relevant for most of the developed economies and do not necessarily refer to issues related to the functioning of economies in a currency union.

[63] This review was published together with the *Annual Growth Survey* in the form of two appendixes. Appendix 1 – with a table representing an overview of country-specific recommendations for 2013-2014 and Appendix 2 – *Progress in key areas of the country-specific recommendations*, as well as the Commission staff working document *Overview of progress in implementing country-specific recommendations by member state*, SWD(2013) 800 final.

2.2. Options for deeper economic policy integration in the euro area

In principle, deeper integration may be desirable in those areas that influence the following:

- systemic stability of the currency union through reducing the risk of permanent macroeconomic imbalances which would threaten the integrity of the euro area;
- efficiency of adjustment mechanisms (Box 4), which reduce social costs resulting from asymmetric shocks or asymmetric effects of common shocks;
- internal cohesion through strengthening mechanisms equalising the income of individual euro area countries.

Measures aimed at accelerating the integration of member states' economies and the convergence of economic structures may be implemented through the following:

- increase in the number of areas covered by the common policy;
- strengthened coordination of national economic policy;
- extension of areas subject to harmonisation of regulations at a community level.

The possibility to extend hard economic policy coordination in the euro area to new areas – assuming the delegation of decision-making in a particular area of economic policy to a supranational institution (combined with providing this institution with the necessary finances or powers to resource them) – is strictly connected with deepening fiscal and political integration between the countries of this region. Since this issue has already been discussed in Chapter 1, the next part of this sub-chapter will address two remaining possibilities of deepening economic integration in the EMU; i.e. increasing the degree of coordination of national economic policies (through coordination of structural reforms and the implementation of solidarity mechanisms) and the harmonisation of regulations.

Coordination of major reforms

Among the arguments in favour of strengthening coordination of euro area member states' economic policy by coordinating structural reforms, the following are mentioned:

1) **uncoordinated implementation of structural reforms in euro area member countries results in them becoming a source of asymmetric shocks**, increasing the diversity of the cyclical position of individual economies (Gomes et al. 2011). This may adversely affect the effectiveness of the common monetary policy.
2) **coordination of structural reforms in member states of the currency union would increase the positive effects of reforms and would promote a more equal distribution of their costs between member states.** Gomes at al. (2011) show that coordination of reforms aimed at increasing the competitiveness of economies would increase the benefits of reforms enjoyed by individual euro area states. It is also shown that greater possibility to mitigate short-term effects of reforms through a common monetary policy (Bentolila, Saint-Paul 2001, Everaert, Schule 2006) could be a positive effect of the synchronisation of structural reforms in euro area countries.

Box 11. Coordination and integration of economic policy in fiscal federations (areas of coordination and integration)

As in the case of fiscal integration, a certain – although naturally imperfect – point of reference for the economic integration model in the euro area (through increasing the degree of harmonisation of regulations, extending the areas of common economic policy or strengthening coordination of national policy) may be federal states with a much longer history of functioning as a single monetary area.

Above all, it should be stressed that the aim of economic policy integration in federal systems is not the full harmonisation of regulations or tax regimes, but the protection of a single market and the prevention of a race to the bottom, i.e. an excessive lowering of regulatory standards in regions that are competing with each other. In conditions of capital and, to a lesser extent, labour mobility, regulatory competition between national states and regions is likely to take place. The aim of this is to solicit external investors or highly-qualified workers and raise the productive potential of the economy. That is why the federal government has the right to change the sub-federal regulations if they threaten the principle of the single market, the functioning of the common monetary policy, or they have an adverse effect on the economic situation in other regions (Broadway, Shah 2009). At the same time, regulatory heterogeneity at the sub-federal level is not treated as undesirable in principle. In particular, it is worth noting that the existence of non-linear dependencies between the degree of regulation, e.g. the level of wage negotiations (at the level of the company, the sector and the whole economy), and the competitiveness of the economy means that the harmonisation of institutions through "averaging" could give worse results or even no results (see Weyerstrass et al. 2006).

When analysing the potential areas requiring deeper economic integration in the euro area, we should highlight the distinction between areas of policy that are left to the states/provinces (with a certain amount of coordination) and the areas which are almost exclusively the domain of federal institutions in the analysed fiscal federations. Firstly, areas of economic policy with a strongly redistributional character, such as pension systems, health insurance systems and other social services, are financed mainly from the central budget or from federal earmarked funds. This is justified by the stabilising property of federal transfers and the lower average costs of servicing such a system (economies of scale). Secondly, industrial and investment policy are carried out on subsidiarity principle, whereby there is a division of obligations with regard to the maintenance of the infrastructure. Responsibility for logistic and transport infrastructure of a significance for the whole of the country lies with the federal institutions, while the sub-federal units can receive additional earmarked transfers to develop regional infrastructure. Thirdly, the regulations relating to education and the labour market are generally left to the sub-federal governments, subject to compliance with the rules determined at a national level (e.g. the principle of non-discrimination of employees, or the standardisation of final exams, a similar school age, and harmonisation of the teaching syllabus). This is justified by the different needs of the local labour markets, although the lack of uniform regulations such as the labour code could reduce labour mobility. On the other hand, it should be noted that the adverse effect of divergent regulations in the labour market is offset by greater freedom to shape the conditions of employment contracts in the analysed countries (the USA, Canada and Australia) compared to in Europe, and by the dominance of one official language.

The adoption of the TSCG created the legal basis to strengthen economic policy coordination of euro area countries by *ex-ante* coordination of plans of major reforms. However, the provisions of the TSCG are general and need to be clarified at the level of secondary legislation. For this reason, at the current stage the provisions are not yet in force (art. 10 and 11). In accordance with the announcement of the European Council meeting held on 26-27 June 2013, the European Commission was to present a legislative proposal

on *ex-ante* coordination of major economic policy reforms. On 20 March 2013, the European Commission published a communication on *ex-ante* coordination of plans of major economic policy reforms (COM (2013) 166), thus beginning the consultation process within the EU. The results of the consultation were to be subsequently reflected in the draft legislative proposal, although at the current stage it is not yet known when such a proposal will be presented by the European Commission and when the discussion in the Council on this issue will be resumed.

According to the initial proposals, *ex-ante* coordination of structural reforms would take the form of a discussion at an EU level of plans of individual member states on major reforms. Before final decisions are taken at a national level, an assessment and discussion of these plans would reduce the risk of adverse effects of economic policy of a particular member state on the functioning of the whole of the EMU (among others, due to the fact that it would be easier for the remaining member states to foresee shocks arising from the economic policy of the member state in question and adjust to them). According to the initial proposals of the European Commission announced in the communication of March 2013, coordination would apply to reforms on competitiveness and employment, on the functioning of goods and services markets and network industries as well as tax system reforms (likely to have an impact on employment and economic growth) or reforms of the financial markets. All euro area member states would be subject to obligatory *ex-ante* coordination (with the exception of those that are covered by the macroeconomic adjustment programme and for this reason are subject to strict reporting and monitoring requirements)[64]. The information would be submitted on the initiative of the member state or on request of the European Commission or the Council. Drafts of reforms would be reviewed by the European Commission, which could suggest changes. *Ex-ante* coordination would in principle be an integral part of the European Semester, using the existing instrument to this aim.

It is unlikely that the process of *ex ante* coordination of economic reform as proposed by the European Commission would significantly reduce the risk stemming from ill-designed major policy changes or its asynchronous implementation by euro area member states. The discussion of reform plans at an EU level may have a positive influence on the shape of reforms thanks to the exchange of experience and benchmarking, which may be conducive to the convergence of the major elements of reforms implemented by euro area countries. However, for this to work it must take place at a suitable stage of drafting the reform – when the details of the reform are already known, allowing an assessment of the proposals, but at the same time when it is still possible to introduce significant changes to the draft reform – which could be difficult to put into practice. Moreover, with the lack of formal mechanisms to enforce changes recommended by the European Commission and the Council to the reform plans, countries must recognise the changes proposed by these institutions as reasonable. This could be difficult to achieve if justification for this type of change is not the positive impact of the reform in a given country, but rather its likely adverse effect on other member states (e.g. reforms increasing the cost competitiveness of an economy recording a current account surplus). Identification with the changes proposed by the European Commission and the Council may also be weakened if the planned reform is submitted for assessment by the European Commission rather than by a particular country. Moreover, taking into account that it may be difficult to define and estimate spillovers from economic reforms, a crucial problem may be the very identification of the reforms that should be submitted to the *ex-ante* coordination process. Furthermore, the assessment and discussion of plans of major economic

[64] The remaining member states of the European Union may be covered by the coordination process on a voluntary basis.

reforms does not significantly reduce the risk that the reforms implemented by individual countries will be a source of asymmetric shocks. The *ex-ante* coordination process does not involve synchronisation of reform implementation in euro area countries[65].

Taking into account the challenges posed by the implementation of *ex-ante* coordination of major reforms, the implementation of this instrument cannot be expected to bring significant benefits in the form of improved functioning of the euro area and of Poland as its future member state. As indicated above, the *ex-ante* coordination of major reform plans entails a series of implementation problems (the problem of selection of reform to be assessed, the problem of the timing of the assessment, weak enforcement of changes to the plans, proposed by the European Commission and the Council of the EU). Therefore, it is unlikely that the implementation of this instrument will reduce the risk that governments of euro area countries will pursue economic policies which, in the long-term, will weaken their competitiveness, lead to the build-up of severe imbalances and threaten economic stability. Such a policy is often not so much the result of badly designed reforms, but the lack thereof. Moreover, it is also unlikely that the proposed mechanism of *ex-ante* coordination would lead to convergence of policies and regulations of member states, reducing the risk that they will react differently to common shocks. Thus the likely impact of this instrument on the macroeconomic stability of the euro area, and thus of Poland as its future member state, could be assessed as marginal.

Possible opt-in

The proposal of the European Commission allows the possibility for EU countries outside the euro area to participate in *ex-ante* coordination on a voluntary basis. As indicated earlier, this tool would mainly constitute a platform for the exchange of information and best practices, which is why participation in it would not incur economic costs. At the same time, joining the mechanism of *ex-ante* coordination in the period preceding the adoption of the euro will be beneficial from the point of view of reducing the risk of Poland remaining outside the mainstream of European integration.

***Conclusion**: It is unlikely that implementation of ex-ante coordination of major reform plans would markedly improve the functioning of the euro area. Therefore, its significance in terms of the balance of opportunities and threats related to Poland's adoption of the euro is low. The implementation of this instrument will also not have a significant economic impact on the functioning of the Polish economy in the period before Poland joins the euro area.*

Solidarity mechanisms strengthening the propensity to implement reforms

Due to the insufficient effectiveness of market incentives in compelling countries to pursue structural reforms, there is a need to strengthen non-market mechanisms that would increase the member states' propensity to implement such reforms. The changes in the economic governance framework which were introduced in response to the crisis increased the possibility of EU institutions to initiate structural reforms in countries in which macroeconomic balance has been significantly disturbed, which are experiencing

[65] Such synchronisation appears to be rather unrealistic in a situation in which deadlines for implementing reforms depend on many important domestic factors, while both the effects of the reforms themselves and their distribution over time are burdened with a considerable uncertainty.

serious difficulties in relation to financial stability, or are covered by a macroeconomic adjustment programme. However, it is desirable to create such an institutional framework which would encourage euro area countries to undertake reform efforts before they experience persistent excessive macroeconomic imbalances or before they lose their competitiveness. In particular, it may be in the interest of the currency union to introduce financial support mechanisms for states which implement costly social reforms in areas whose functioning has a direct impact on the effectiveness of the monetary union. The instrument of contractual obligations, supported by a solidarity mechanism is the response to the said risk. The proposal concerning the general principles of this type of solution was presented by the European Commission in its communication of March 2013 on the Convergence and Competitiveness Instrument (CCI)[66]. This instrument provides for the conclusion of agreements between member states and EU institutions/the European Commission, under which member states would undertake to implement reforms in line with the recommendations under the European Semester[67]. In return, they would receive financial assistance, which should elicit support for reforms at a country level. The European Council, which in December 2013 reached an agreement on the main elements of such a solution (named by the Council *mutually agreed contractual arrangements*) postponed the discussion on the detailed design of this instrument to October 2014. Therefore, at the moment there are no decisions regarding the shape of the contractual arrangements and associated solidarity mechanisms (see below), as instruments of financial assistance for countries implementing reforms aimed at improving competitiveness and strengthening convergence[68]. As van Rompuy (2012) indicates, solidarity mechanisms may be the embryo of a future common fiscal capacity for the euro area.

Contractual arrangements aimed at increasing the propensity of the euro area countries to implement economic policy reforms would have to be based on the following principles:

- contractual arrangements would be intended for all euro area states except for those that are under a macroeconomic adjustment programme[69];
- the scope of the reforms which could be the object of this type of agreement is very wide and covers the policy and measures supporting economic growth and employment (reforms of the labour and product markets, reforms increasing the effectiveness of the public sector, measures supporting innovation, education, vocational training, employment and limiting social exclusion).
- member states are to be given the freedom to set economic policy targets and the means to achieve them. A suitable involvement of national parliaments and social partners in the realisation of commitments is desirable. This is to increase ownership of the adopted commitments and the feeling of responsibility for their implementation.

[66] The European Commission presented the proposal to create the Convergence and Competitiveness Instrument on two occasions: in the November 2012 communication "*A Blueprint for a deep and genuine economic and monetary union*" (COM(2012) 777) and in the communication opening the consultation process within the EU, which was published on 20 March 2013 (COM(2013) 165).

[67] In accordance with the analysis of the legal services of the European Parliament, the existing treaty solutions allow this type of agreement to be concluded, provided the agreement will be a legally non-binding Memorandum of Understanding (MoU). Moreover, the income and expenses of this mechanism will have to be subject to the law and budget principles of the EU, while the implementation of the contractual arrangement will be subject to the scrutiny of the European Parliament.

[68] Further work on the system of mutually agreed contractual arrangements and solidarity mechanisms will be carried out, in accordance with the decision of the European Council, by its President, in close cooperation with the President of the European Commission. The results of this work are to be presented in October 2014.

[69] These agreements are also to be available on a voluntary basis for EU countries outside the euro area.

- draft agreements are to be prepared by the member states in question and agreed with the European Commission, and then accepted by the Council of the EU. The European Commission will monitor the implementation of the commitments.

The solidarity mechanisms accompanying these agreements would be designed to take into account the following guidelines:

- they cannot financially burden the member states which have not joined the partnership system;
- they cannot be instruments for income equalisation between member states;
- they shall not be financed from the general budget of the EU (Multiannual Financial Framework);
- they are to take into account the budget sovereignty of member states;
- every financial assistance will be of a legally binding character.

An assessment of the contractual arrangements and the solidarity mechanisms accompanying them has been hampered by the fact that crucial issues connected with their design are not yet known. In particular, there needs to be clarification on the form of the financial assistance instruments (e.g. loans, subsidies, or guarantees), source of financing, the size of financial resources, and the maximum allocation to beneficiary countries. Moreover, it is necessary to specify in detail the principles of granting financial assistance, the method of monitoring the implementation of the commitments and the procedure in the case of non-compliance[70]. The way of addressing the above issues will significantly influence the effectiveness of the proposed solutions. For example, if the financial assistance is granted in the form of a loan or guarantee, its use by the member states most likely to be interested (i.e. characterised by structural weaknesses and a high level of public debt) could be limited due to their reluctance to increase the debt of the general government sector. At the same time, it will be a major challenge to establish the rules of granting financial assistance in such a way that they do not lead to deliberate delaying of reforms in order to receive such support. However, it is worth noting that the risk of moral hazard – indicated as one of the key arguments against deeper fiscal integration in the euro area – would be relatively moderate in the case of solidarity mechanisms. Linking the solidarity mechanisms with the contractual arrangements would significantly reduce the temptation to abuse the system compared with the situation in which the given country – as a member of a fiscal union – received unconditional transfers from the central budget.

The introduction of suitably designed solidarity mechanisms could reduce – although most likely to a limited degree – the risk connected with the lack of a fiscal capacity in the euro area. As shown in Chapter 1, the limited degree of (*ex-ante*) macroeconomic risk sharing on the basis of fiscal mechanisms is a major challenge for those economies of the euro area that are characterised by structural weaknesses and a high level of public debt, which allow no room for countercyclical fiscal policy. This gives rise to the risk of a permanent divergence of incomes and economic structures between euro area member states. The introduction of financial assistance mechanisms for countries that decide to implement socially costly economic reforms could accelerate the reorientation of economic structures in peripheral countries towards tradables or the shift in export specialisation towards highly-processed goods where they can compete with developing countries on a non-price basis. This would limit the threat to their external sustainablitity related to their functioning under the single currency area, fostering at the same time economic and political cohesion

[70] According to the proposals of the European Commission, in the case of non-compliance with the provisions of the agreement, the European Commission would call on the signatory of the agreement to correct the shortcomings. Should the shortcomings not be corrected or should be of a serious nature, the European Commission would refuse or withhold payments. Similar measures would be applied if reforms or their consequences were reversed.

of the euro area. However, it should be expected that the reduction in risk related to structural diversification between member states of the euro area as a result of contractual arrangements and associated solidarity mechanisms will be limited. Not only the absence of economic policy response to the rigidity of the labour and product markets, but also unfavourable geographical location, or such factors as, for example, the education and specialisation of the labour force underlie the weaknesses of the euro area economies. Although the latter are the result of institutional weaknesses, it is possible to change them in the long-term only. At the same time, it is worth noting that instruments removing barriers in access to external funding for the non-financial private sector, i.e. both the establishment of the banking union, and the means supporting the development of the capital market-based financing constitute a complimentary solution to contractual arrangements and a solidarity mechanism.

Some of the rules presented by the European Commission for the design of solidarity mechanisms limit the potential effectiveness of these instruments as tools for reducing the risk of divergence of incomes and economic structures of the euro area economies. Firstly, a major weakness of the proposed solutions is that they do not cover countries that are under the macroeconomic adjustment programmes. The financial assistance received by these countries under the adjustment programmes is used to service the accumulated public debt. However, these countries do not receive financial support that would help to alleviate the short-term costs of far-reaching economic reforms which they are implementing and which cannot be mitigated with the help of fiscal policy. At the same time, it is worth noting that it is precisely in the case of these countries that there is the greatest risk of permanent divergence of income in relation to the remaining countries of the region. Secondly, the requirement that solidarity mechanisms should not be tools for equalising income between member states also limits the potential effectiveness of this instrument (in practice it excludes support in the form of subsidies). It could also be difficult to put into practice, taking into account that the structurally weaker economies would require support when implementing changes in economic policy more often than the remaining countries of the region. Therefore, it may prove impossible to avoid relatively permanent transfers to those countries. Finally, it can be judged that the sense of introducing contractual arrangements is determined by the establishment of solidarity mechanisms. Without the latter, it is difficult to expect that member states would have strong enough incentives to fulfil the obligations that arise from the contractual provisions.

The introduction of contractual arrangements and associated solidarity mechanisms could have the following implications for Poland as a future member state of the euro area:

a. **a fall (although rather limited) in risk connected with delayed implementation of structural reforms in member states of the euro area**

As shown above, the high degree of interdependence of currency union member states means that the policies carried out by one country could have an adverse effect on the stability of the whole area and the remaining economies belonging to it. In particular, the lack of pre-emptive actions to halt the emergence of macroeconomic imbalances and prevent a fall in competitiveness could weaken the macroeconomic situation of a member state to the point where it becomes a threat to the political integrity of the region and the stability of the common currency. Such a possibility represents a risk for Poland as a future euro area member. Also, due to being a member of the euro area, Poland would have to participate in the costs of defending the integrity of the euro against the adverse effects of the above-mentioned phenomena (support under the ESM, the fiscal effects of the ECB programmes).

As a general rule, the introduction of instruments which will limit the risk associated with delayed implementation of structural reforms in euro area states can therefore be considered positive from the point of view of the Polish economy. However, as indicated earlier, their effectiveness will largely depend on how they will ultimately be designed:

- what the scale of assistance available under such an instrument will be: the larger the scale of assistance, the greater the incentive to undertake reform efforts;
- whether it will be of a non-repayable subsidy, a low-interest loan, or a guarantee: although the second and third solutions will limit moral hazard to a greater extent and incentivise national authorities to implement growth- and employment-enhancing reforms, this form of support may not generate sufficient incentives to undertake reforms (particularly in conditions in which it is relatively cheap to obtain funds on the financial markets);
- whether the terms of use will lead to financial support of economies that do not need such support to implement reforms (including economies of a high structural competitiveness).

Taking into account the fact that at this stage the design of the contractual arrangements and the associated solidarity mechanism have not been specified, it is difficult to determine precisely its effectiveness as an incentive to implement suitably constructed structural and institutional reforms. At the same time, it is worth noting that even in the case of implementing structural reform recommended by the European Commission and the Council of the EU, it cannot be taken for granted that the balance of benefits and costs associated with functioning inside the euro area will significantly improve in the short or medium-term for the structurally weakest economies of the region. Therefore, a rather limited fall in the risk associated with structural diversity between euro area member states should be expected.

a. **the possibility of permanent transfers from the Polish economy to other euro area economies or in the opposite direction**

The need to introduce contractual arrangements supported by a solidarity mechanism concerns mainly economies with low structural competitiveness. These economies may require more support when implementing changes in economic policy than the remaining countries of the region. Therefore, it may prove impossible to avoid relatively permanent income transfers to those countries, despite the fact that the instrument will be designed in a way that reduces such a risk. From Poland's point of view, the need to resort to solidarity mechanisms associated with contractual arrangements will depend on how high its structural competitiveness will be after joining the euro area. The higher the competitiveness of the Polish economy, the lower the likelihood that Poland will have to use such an instrument and the greater the probability that it will be a net contributor in the system.

Possible opt-in

As in the case of *ex ante* coordination of the major reform plans, the European Commission indicated the possibility for participation of countries outside the euro area in contractual arrangements supported by solidarity mechanisms on an opt-in basis. Poland's participation in this mechanism could accelerate structural reforms aimed at strengthening structural competitiveness, which is crucial in the preparation process for euro adoption. It is worth noting that Poland is currently an economy with relatively high cost and price competitiveness compared to other EU economies, while the level of its structural competitiveness remains

relatively low (see Part II of the report). However, participation in the mechanism will be associated with two types of costs. Firstly, these will be costs of financing the mechanism (due to the legal restrictions discussed in sub-chapter 1.3.2 of this study these will most likely be contributions from member states). In this respect, a very important issue from Poland's point of view will be the way of determining the conditions for granting financial assistance. Taking into account Poland's relatively low level of structural competitiveness, it would be undesirable if Poland were now to be a net contributor under the system. Secondly, limited sovereignty in the field of designing structural reforms will be another cost, since these reforms will be subject to evaluation by the European Commission and the Council of the EU. Whether the contractual arrangement will be signed or not will be conditional upon such evaluation.

Conclusion: *Contractual arrangements supported by a solidarity mechanism will only be capable of reducing structural diversity between euro area member states to a limited degree. Therefore, their introduction will only marginally change the balance of opportunities and threats associated with Poland's adoption of the euro. In particular, it is doubtful whether it would translate into a significant fall in the risk posed to the long-term political integrity of the euro area by the fact that participation in the currency union is economically costly for its structurally weakest economies.*

Conclusion: *Joining the mechanism of contractual arrangements supported by a solidarity mechanism in the period preceding Poland's membership in the euro area could accelerate actions aimed at increasing the structural competitiveness of the Polish economy. The criteria for granting financial assistance under the contractual arrangements should, however, be defined in such a way as to eliminate the risk that net beneficiaries of the system will be economies with high structural competitiveness at the expense of the less competitive economies.*

Harmonisation of regulations

Apart from the above-mentioned grounds for coordination and synchronisation of structural reforms, there also exist a series of economic policy areas in which, from the point of view of the functioning of the currency union, it would be justified not to introduce coordination, but instead full or partial harmonisation of regulations. There remain high structural divergences between economies of the euro area member states. Although this heterogeneity results from a series of factors independent of economic policy (geographic location, natural resources, history, social preferences), a significant reason for this is also the diversity of the business environment and regulations. This diversity results in a different response of individual economies to demand and technology shocks, as well as shocks related to globalisation. This also means a different response to changes in the nominal interest rate and in effect, the inadequateness of the common monetary policy of the economies of euro area countries (the one-size-fits-none problem). Partial or full harmonisation would be desirable as regards regulations which influence labour and capital mobility, the effectiveness of resources allocation and the social costs associated with the price and quantity adjustments (e.g. bankruptcy law).

At the outset, it is worth noting that the harmonisation of regulations entails the following challenges:

- uniform regulations may function differently in different institutional environments. In order to eliminate diversity in terms of the response of a given area of the economy to common shocks it may be necessary to adopt different regulations, tailored to the specifics of the country in question.

- in the case of a large institutional diversity of euro area countries, there is a risk that the harmonisation of only certain elements of institutional systems may reduce the effectiveness of the whole system in a given country (e.g. such an effect could be, for example, expected in the case of extension of unemployment benefit eligibility in countries that have stricter regulations in this area and at the same time insufficiently effective institutions for monitoring and activating the unemployed).

An area in which it may be desirable to harmonize regulations across the euro area states is the labour market, which at the moment is characterised by a much lower degree of harmonisation than the product market. Besides the fact that the heterogeneity of labour market regulations in the euro area translates into diverse responses of these economies to common shocks, it may also be a factor hindering further fiscal integration. For example, the establishment of a fiscal capacity in the euro area in the form of a common system of unemployment benefits given such a large variety of national labour market institutions raises concerns about the actual stabilising effect of such a solution (Dullien 2013). The gradual convergence of the labour market institutions in euro area countries could also bring benefits for public finances through the reduction of the scale of the so-called "tax optimisation", i.e. registration of fictional employment in countries with a lower tax wedge or the exploitation of loopholes in the social transfers system. It is also worth noting that the lack of harmonisation in the case of some of labour market institutions restricts labour force mobility between countries. The IMF (2010) mentions the following labour market regulations, the harmonisation of which would be growth-enhancing: labour taxation, the unemployment benefits system and regulations in the field of employment protection legislation.

Another area which is indicated as in need of increased harmonisation of regulations is the services market. Since the diversity of regulations in the EU has an adverse impact on the intensity of trade (see Gill, Raiser 2012, Golub 2003, McCallum 1995), the completion of the single market for services (where regulations are still more diversified than in the product market) is one of the priorities of the EU, as expressed by the Single Market Act II (see Monti 2010, European Commission 2012). It is pointed out that the completion of the single market in the provision of services could bring significant benefits for European economies, firstly, in terms of increased level of market openness, and secondly, in lower oligopolistic rents in the services sector, particularly in network industries[71]. In conditions of fixed nominal exchange rates, the reduction of price rigidity resulting from oligopolistic rents in the intermediate goods sector would allow an improvement in the functioning of the real exchange rate channel. Given the highly detailed level of national regulations, the actual strengthening of competition on the services market is possible rather through obligatory harmonisation (e.g. in areas of barriers to entry, use of network infrastructure, regulated professions, principles of responsibility of service providers and supervision by professional associations etc.) than through implementation of country-specific recommendations.

The allocation of labour and capital in euro area countries could also be corrected through the harmonisation of regulations influencing the provision of cross-border services, foreign direct investments and public-private partnerships and facilitating public tenders in other euro area countries, etc. The varying degrees of protection for investors and trading partners, in particular the regulations relating to payment bottlenecks and bankruptcy and recovery law, translate into varying responses of the economies to changes

[71] In this context it is worth drawing attention to the fact that as Alegra et al. (2004), Wölfl (2006) and Bourlès et al. (2010) point out, the higher competitiveness among producers of intermediate goods (energy, transport and logistics services, legal services) would have a positive impact on the price competitiveness of final goods.

in the nominal interest rate and their potential for productive capacity growth and for exploiting economies of scale. It is worth noting that a significant part of the above-mentioned areas are to be regulated in the next few years through transposition of directives and regulations under the Single Market Act II.

The external competitiveness of euro area countries is also linked to the functioning of the strategic transport and energy infrastructure. For this reason, an improvement in the quality of the most important hubs or transmission networks would bring benefits to a greater number of countries, improving their international competitiveness and intensifying trade within the currency area. In order to minimize the risk of free-riding, amidst non-existent central budget of the euro area, it would be beneficial to create the legal and institutional framework for infrastructure investment to be conducted jointly by euro area members. A complimentary solution could be the gradual standardisation of regulations relating to transport or energy, also with the delegation of part of the prerogatives, and transfer of financial resources, to a community level.

The quality of transposition of community law into national legislation is closely related to the previously cited arguments in favour of the harmonisation of regulations and institutions in euro area countries. Euro area member states, just as in the case of members of federations, may have incentives to increase their own prosperity at the expense of other members of the common market (interjurisdictional competition) through protectionist national regulations, where the given area of economic policy remains autonomous or the choice of measures for the realisation of community goals remains the decision of the country (Broadway, Shah 2009). As Monti (2010) shows, it is in euro area countries more often than non-euro area countries that the transposition of community regulations is carried out in a selective, discretionary, or excessive manner (gold-plating).

Chapter 3. Financial integration: the banking union

3.1. The financial safety net in the euro area before the crisis

3.1.1. The basic principles of the functioning of the financial safety net in the euro area before the crisis

The creation of a currency union in 1999 did not have a direct impact on financial regulatory policy and the institutional financial stability framework in the euro area. Since the inception of the euro area, **the same principles and legal bases as regards measures aimed at financial stability have applied to the euro area as to the whole of the European Union.**

Also the European Central Bank was not given direct responsibility for supporting financial stability in the euro area. Pursuant to art 127 par. 1 of the TFEU and art. 2 of the Statute of the ESCB and of the ECB[72], the main aim of the ESCB is to maintain price stability. The mandate in such a wording focused ECB's mission on monetary policy, without placing any emphasis on financial stability functions. In the provisions of the Treaty and the Statute, only indirect reference is made to financial stability. Art. 127 par. 5 of the Treaty states that the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system. Moreover, pursuant to art. 25 of the Statute, the ECB may offer advice and consultation to the Council, the Commission and the competent authorities in the member states on the scope and implementation of Community legislation relating to the prudential supervision of credit institutions and to the stability of the financial system. The Council of the EU, the European Commission and the competent authorities of member states are obliged to consult all legislative initiatives on this issue with the ECB. The functions of the ECB relating to the financial supervision and financial stability were therefore of an advisory and opinion-making character. Formally, at the time when the ECB was established, the function of promoting financial system stability was limited to activities aimed at improving the efficiency and safety of the payment system. Yet, while national central banks of the Eurosystem could have in place regulations which assigned them financial stability responsibilities , this issue remained in the hands of national jurisdiction. To conclude, the promotion of financial system stability was not centralised at the ECB upon the establishment of the euro area[73].

The competencies and responsibility for financial system stability in the EU and the euro area were in the hands of the national authorities (Box 12).

[72] The Statute of the European System of Central Banks and of the European Central Bank constitutes protocol number IV to the TFEU.

[73] Pursuant to art. 14 par. 4 of the Statute, national central banks may perform other functions than those defined in the Statute, unless the Governing Council, acting by a majority of two-thirds of the votes cast, considers that they are contrary to the objectives and tasks of the ESCB. The central banks perform these functions at their own risk and do not consider them to be a part of the functions of the ESCB.

Box 12. The national financial safety nets

National financial safety nets usually consist of the following institutions:

- a supervisory authority (or authorities) – responsible for issuing licences and conducting on-going prudential supervision over banks and other financial institutions;
- a central bank – playing the role of a lender of last resort (emergency liquidity assistance, ELA);
- a ministry of finance – having legislative initiative and being the administrator of public finance;
- a deposit guarantee fund – responsible for payout of guaranteed deposits (pay-box) and also in some cases, engaging in restructuring measures of banks (risk-minimizer).

Financial safety net institutions are complementary and can only function effectively as a whole.

In EU legislation there are three principles which are decisive for the organisation of the financial safety net in the EU and the euro area:

The first principle relates to the single passport, which serves to ensure the freedom to provide banking services throughout the EU. According to this principle, other member states are obliged to recognise the banking licences issued to credit institutions in home countries. Therefore, this gives banks the right to provide cross-border services and pursue activities in the form of branches in jurisdictions of any EU member state without the need to obtain separate permission from the supervisory authority of the host country, but only on the basis of a licence issued by the supervisory authority of the country of origin (home country), after notification of the intention to provide services in the jurisdiction of the host country.

The second principle establishes the primacy of home country supervisory authorities, in other words, the country in which the head office of the bank is located and also in which it has obtained its licence. When the bank conducts cross-border activities through a branch, these branches are generally subject to supervision by home country supervisory authorities[74]. When the bank conducts activities beyond the borders of its home country through a subsidiary, supervision over these companies is carried out by host country competent authorities. However, supervision of the activities of the banking group as a whole is conducted by home country supervisory authorities (consolidated supervision).

The third principle requires supervisory authorities of the home country and the host country to cooperate and exchange information. To this end, the capital requirements directive of 2009 (the so-called CRD II) required the creation of supervisory colleges for cross-border banking groups (art. 1 par. 33). The leading role in them is played by the consolidated supervisor, in other words, the competent authority of the member state in which the dominant institution has its main seat (the so-called EU parent credit institution).

The issue of cross-border crisis management was practically not addressed in the EU and the euro area. The relations between the national authorities were based on non-binding memoranda of understanding (MoU), which focused mainly on the issue of information exchange . At first, signatories of the MoU of 2003 were only supervisory authorities and central banks; however, ministries of finance also joined the MoU of 2005. However, the solutions adopted in these agreements proved to be insufficient and in June

[74] The host country authorities supervise liquidity management of the branch conducting activities in the country in question.

2008 another agreement was signed, pursuant to which the objective of crisis management is the protection of financial stability in all EU countries. An important new aspect was the recommendation for countries in which cross-border banks conducted activities to sign Voluntary Specific Cooperation Agreements (VSCAs), on the basis of which Cross-Border Stability Groups (CBSGs) would be created for specific banks. The objective of these groups would be to better organise cooperation between countries in case of a crisis of the bank in question.

The MoU as a formula for cooperation proved to be ineffective during the recent crisis. The weakness-weaknessw of the MoU lies in its legally non-binding character. In a situation in which financial stability is the responsibility of national authorities and possible costs of the crisis are incurred by the local taxpayer, crisis management was conducted from the perspective of individual jurisdictions and national financial stability. Therefore, the supervisory authorities usually took unilateral action without consulting supervisors of other countries in which the given banking group operated or even not informing them of their intention to take action. However, at the same time, it should be stressed that the costs of assistance in most cases were incurred by the taxpayers of countries in which the banking groups affected by the crisis had their head offices (e.g. Ireland, the United Kingdom, the Netherlands, Austria and Belgium). Since in the majority of cases these were large banking groups, the costs of rescuing them proved to be so significant that they severely burdened the budgets of the home countries. As a result, the banking crisis turned into a sovereign debt crisis and some euro area countries had to ask for international financial assistance from the EU and the IMF (e.g. Ireland).

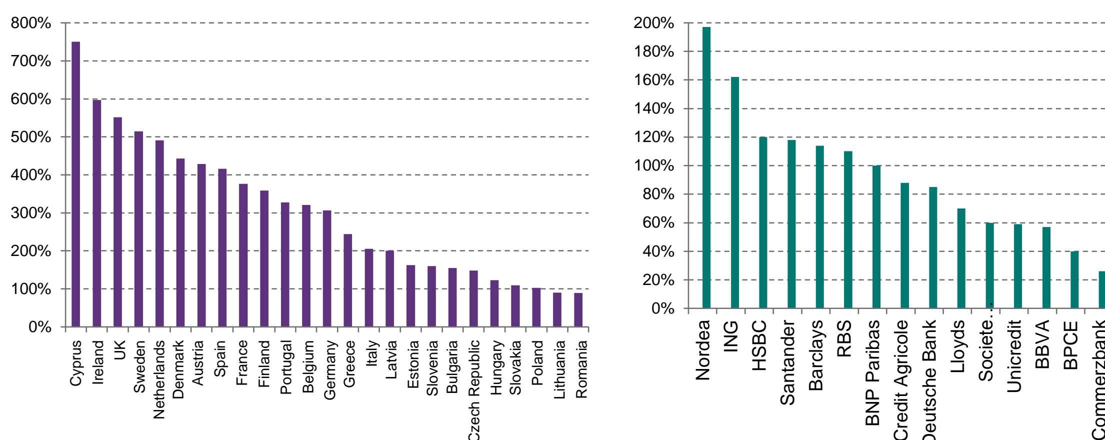
3.1.2. Experience from the financial crisis – a catalyst of institutional changes to the financial safety net in the EU

The conclusions drawn from the crisis became the impulse for institutional changes in the financial safety net of both the EU and the euro area. In the light of the crisis, the observed structural changes in the financial system in the euro area highlighted the need to introduce significant changes in regulations and the supervision process. After the crisis it turned out that the condition of the financial sector has a much greater influence on the real economy than was earlier assumed, while price stability is a necessary, albeit insufficient condition to achieve financial stability. Therefore, the importance of financial stability increased as an objective of the central bank and the financial safety net. However, it requires a clear allocation of responsibility for financial stability and a clarification of the central bank's mandate in this respect (BIS, 2011).

The financial crisis has highlighted the problems associated with the discrepancies between the cross-border banking model in the EU and decentralisation of responsibility for financial stability vested in national authorities (Fonteyne et al. 2010) and the fiscal consequences of decisions taken in the context of crisis management that were borne by local taxpayers. In the years preceding the financial crisis, the banking sector in the EU developed rapidly. Not only domestic but also cross-border mergers and aquisitions led to the establishment of banks with a systemic importance on both a country and EU scale. In 2005 the ECB identified 46 banking groups of systemic importance, conducting significant cross-border activity, whose assets were approx. 68% of EU banking sector assets (Pisani-Ferry et al. 2009). In turn, on the 2013 FSB G-SIFIs list of 29 Global Systemically Important Financial Institutions, over half (15) are European banks. In some countries the value of single bank assets exceeds the level of GDP generated in this country (e.g. Nordea in Sweden, ING in the Netherlands, Santander in Spain, HSBC in the United Kingdom; Figure

4, left-hand panel), while the share of large international banking groups in EU banking sector assets stands at nearly 2/3. The crisis proved that such a structure can threaten the stability of the financial system and public finances.

Figure 4. Banking sector assets in relation to GDP in EU countries (left-hand panel) and assets of selected banks in relation to the GDP of the country of origin (right-hand panel).



Notes: for clarity the values for Luxembourg (2223%) and Malta (948%) were not included in the graph.
Source: Liikanen Report (2012) and own calculations on the basis of data for 2012 from the ECB Statistical Data Warehouse.

3.1.3. Micro-prudential supervision

The crisis highlighted the need to strengthen the coordination of efforts aimed at promoting financial stability at the central EU level. On request of the European Commission, a High Level Group was set up, chaired by Jacques de Larosière. Following the recommendations of the Group, the first stage of reform of financial supervision in the EU was implemented. As a result, on 1 January 2011, among others, the following European Supervisory Authorities (ESAs), responsible for micro-prudential supervision, began operations:

- European Banking Authority (EBA),
- European Securities and Markets Authority (ESMA),
- European Insurance and Occupational Pensions Authority (EIOPA)

The ESAs were created by transforming the following previously functioning committees: the Committee of European Banking Supervisors (CEBS), the Committee of European Securities Regulators (CESR) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). As a rule, the ESAs do not perform direct supervision of financial institutions in the EU. Such supervision still remained in the hands of the national competent authorities. However, one of the main tasks of the ESAs is to establish common regulatory standards and supervisory practices for the EU financial sector, in particular, through preparing draft guidelines, recommendations and technical standards. The ESAs also have the power to settle disputes by way of mediation between national competent authorities.

3.1.4. Macro-prudential supervision

Based on the experience of the crisis, it also proved desirable to introduce macro-prudential supervision in the EU as a new element of the financial safety net. The recent financial crisis highlighted that supervision only at the micro level, i.e. of individual financial institutions, is not sufficient to ensure the stability of the financial system as a whole. It is necessary to look at the financial sector from a systemic perspective. Supervisors' focus on the condition of individual entities could lead to an underestimation of the external adverse effects arising from collective behaviour of individual institutions, particularly from the systemically important financial institutions (SIFISs). Research into the interdependence between institutions and contagion channels also proved to be significant. To accomplish this, systemic supervision is needed, i.e. macro-prudential supervision, which not only identifies and analyses, but also actively mitigates systemic risk and helps reducee pro-cyclicality arising from, among others, capital requirements and business cycle fluctuations. In this regard, there is a need to create a solid institutional framework and allocate power to use macro-prudential tools both at a national and EU level.

Therefore, proper conduct of macro-prudential policy in the EU requires the establishment of an institutional framework for this policy both at a European and national level, together with a clear division of responsibility at both levels.

At the European level the European Systemic Risk Board (ESRB) is responsible for macro-prudential supervision. The ESRB was created in December 2010, also following the recommendations of the Larosière report. Its task is to prevent and mitigate systemic risk to financial stability in the EU. To this end, the ESRB can issue warnings and recommendations for remedial action. These can be addressed to, in particular, the EU as a whole, EU member states, the ESA or national supervisory authorities. ESRB's warnings and recommendations are not legally binding, and recommendations are subject to an "act-or-explain" mechanism – the addressee must act on them or provide an adequate explanation in case of inaction (Regulation establishing the ESRB, 2010).

Moreover, the ESRB plays an important role in motivating EU member states to create a macro-prudential framework at a national level. In December 2011, the ESRB issued a recommendation on the macro-prudential mandate of national authorities (Recommendation of ESRB, 2011), pursuant to which the EU member states should establish appropriate authorities responsible for macro-prudential policy by June 2013[75]. In turn, in April 2013 the ESRB issued a complimentary recommendation on intermediate objectives and instruments of macro-prudential policy (Recommendation of the ESRB, 2013). This contains useful guidelines for national macro-prudential authorities and ensures a minimum level of harmonisation of strategy and instruments available to those authorities in EU countries.

Key role of national authorities. The Recommendation of the ESRB (Recommendation of ESRB, 2011) indicates the need to create macro-prudential supervision in the EU at a national level. Also in the opinion of the IMF (IMF, 2011), the effectiveness of European macro-prudential architecture requires suitable institutional foundations for macro-prudential supervision at a national level. This will allow for clearallocation of this function within the national safety net, reduce the risk of national authorities refraining from action in the case of growing systemic risk (inaction bias) and establish a set of tools to mitigate this risk. The effec-

[75] However, ultimately in accordance with the decision of the General Board of 18 June 2014, the deadline for implementing the recommended measures was extended to 28 February 2014.

tiove conduct of this policy in the European dimension requires the commitment of national authorities, and flexibility in applying macro-prudential tools for the following reasons:

- national authorities have experience and detailed knowledge on the specific nature of the functioning of national financial systems;
- lack of sufficient financial cycle synchronisation in euro area countries, with the absence of autonomous monetary and exchange rate policy, requires a flexible application of macro-prudential tools depending on the risk inherent in the national financial system in question.

The central bank should play a leading role in macro-prudential oversight – such are the recommendations of the IMF (IMF 2011), BIS (BIS 2011) and the ESRB (Recommendation of ESRB, 2011). At a country level macro-prudential supervision can be organized according to two basic models, i.e. (1) in a collegial body bringing together the financial safety net institutions or (2) remain the exclusive competence of one institution. In practice, these models take various modified forms, depending on many criteria, e.g. choice of the leading institution, role of the central bank and the minister of finance, and range of competencies of the individual institutions (Nier et al. 2011). Regardless of the model adopted, the leading role in macro-prudential supervision should be played by the central bank, mainly due to its well-established independence and experience in conducting macroeconomic and financial system analyses (published in the form of financial stability reports). Due to their wide range of independence, central banks will be more inclined to implement – independently of the political cycle – measures, whose positive effects may be seen only in the long term. Central banks also have strong incentives to carry out preventive measures, since they are the first to undertake intervention in the case of systemic risk materialisation.

Macro-prudential policy instruments available to national supervisory authorities also are included in the so-called CRDIV/CRR package, which has been in force since 2014 includes Directive 2013/36/EU (CRD IV, 2013) and Regulation (EU) No 757/2013 (CRR, 2013) (as well as under the so-called flexibility package (art. 458 CRR)). A certain flexibility in shaping the parameters of macro-prudential policy is particularly important for euro area countries, which do not have the possibility to use interest rate or exchange rate policy in response to shocks.

3.1.5. Crisis management

The financial crisis also triggered institutional changes in crisis management framework both at the national and European level in order to ensure greater coordination of action. At the national level financial stability committees[76] were created as platforms for exchanging information and coordinating actions taken by national financial safety net institutions. The establishment of such committees resulted from the recommendation which the ECOFIN adopted as early as in 2006. At the European level, pursuant to the provisions of the MoU 2008, Cross-Border Stability Groups (CBSGs) were set up. These groups were created either for a particular banking group or for a particular region. The following are examples of regional CBSGs: the Austrian Cross-Border Stability Group, consisting of Austria and Central and Eastern European countries in which subsidiaries of Austrian banks have a significant market share (e.g. Hungary, the Czech Republic, Poland, Slovakia, Slovenia), and the Nordic-Baltic Cross-Border Stability Group for 8 Scandinavian and Baltic countries. It should also be noted that in parallel to the CBSGs, Crisis Management Groups (CMGs) were created under the auspices of the Financial Stability Board (FSB) for global systemically im-

[76] During the crisis financial stability committees were created in, among others, Belgium, Poland, Portugal, Romania, Italy and Lithuania. More in EBC (2010).

portant banks (among which there are European banks). The composition of the CBSGs and CMGs is similar and includes representatives of the main financial safety net institutions, i.e. the supervisory authority, central bank and ministry of finance of individual countries where a given banking group operates; however, CMGs include countries beyond the EU.

3.1.6. Deposit guarantee systems

The uncoordinated action of individual Member States undertaken at the beginning of the crisis, involving the raising of the coverage level or even the introduction of blanket guarantees for deposits, was the direct reason for the amendment of the Directive on Deposit Guarantee Schemes (DGS). The problems of banks in some EU countries caused a dramatic fall in the depositors' confidence and even bank runs[77], which seemed to be a purely theoretical threat in the times of deposit guarantee schemes. In response to these events and in order to prevent a further escalation of the crisis, some Member States increased the coverage level, including the introduction of blanket guarantees[78]. However, these measures were in accordance with Directive 94/19/EC, which set only a minimum coverage level of EUR 20,000. Due to the possible threat for the single financial services market and disturbances to the level playing field for banks arising from the lack of harmonisation in respect of deposit guarantees, at the ECOFIN meeting held in October 2008 it was decided to raise the minimum deposit guarantee level. Directive 2009/14/EC[79], resulting from these decisions, obligated Member States to provide a minimum coverage level of EUR 50,000. At the same time, the directive established a harmonised coverage level of EUR 100,000, which was to be reached by the end of 2010. The amended directive also shortened the payout period from 3 months (with the possibility of extending it by a further 6 months) to 20 working days (with the possibility of extending it by another 10 working days).

In July 2010 the European Commission presented a draft directive amendingDirective 94/19/EC, which aimed at achieving greater harmonisation in the functioning and financing of deposit guarantee funds in the EU. The new Directive 2014/49/EU[80] maintains the harmonised coverage level at EUR 100,000. The main areas in which changes were introduced are as follows: 1) the way of financing the national deposit guarantee funds – on an *ex ante* basis, 2) the target level – 0.8% of covered deposits[81], 3) the payout period – shortened to 7 working days in 2024[82]. Moreover, the directive states that the contributions paid by banks to the deposit guarantee fund depend on the bank's risk profile. This means that banks conducting riskier activities will contribute more to the fund. In the event that available financial means of a DGS are insufficient, the directive foresees the possibility to impose on banks an obligation to pay extraordinary contributions

[77] A striking example of this was the case of Northern Rock in the United Kingdom.

[78] Blanket guarantees were introduced by Austria, Denmark, Germany, Ireland, Slovakia and Slovenia. More on the subject of the use of blanket guarantees during the crisis in: L. Laeven, F. Valencia, *The Use of Blanket Guarantees in Banking Crises*, IMF Working Paper WO/08/250, International Monetary Fund, October 2008.

[79] Directive 2009/14/EC of the European Parliament and of the Council of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay, Official Journal of the EU 68/3 of 13.03.2009.

[80] Directive 2014/49/EU of the European Parliament and of the Council of 16 April 2014 on deposit guarantee schemes, Official Journal of the EU L 173/149 of 12.06.2014.

[81] The directive gives Member States the possibility to establish a higher or lower target level, providing that this level is not lower than 0.5% of covered deposits.

[82] The shortening of the payout period may be introduced gradually. Member States may set the following payout periods in the transitional period (to 2024): 15 working days – from 1 January 2019 to 31 December 2020, and 10 working days – from 1 January 2021 to 31 December 2023.

(on an *ex post* basis) as well as to borrow on a voluntary basis from other national deposit guarantee schemes, which may be treated as a certain form of mutualisation.

3.1.7. Resolution procedures

An important weakness of the pre-crisis financial safety net arrangements in the EU was the lack of bank resolution regulation as well as authorities responsible for conducting such aprocess. Supervisors lacked both the powers and the tools to intervene effectively in banks which faced financial problems generating arisk of destabilisation in the whole financial system. As a result, crisis management in the EU boiled down to granting public support on a wide scale. The measures undertaken by Member States during the crisis can be classified in three categories: recapitalisation[83], asset relief measures[84], guarantees on banks' liabilities and liquidity support[85] (Figure 5).

The European Commission took steps to harmonise and increase the effectiveness of crisis management regulations. In June 2012 the European Commission presented a draft directive on recovery and resolution of credit institutions (BRRD). **The new Directive 2014/59/EU[86] came into force in January 2015.**

The BRRD obligates Member States to designate resolution authorities and equip them with suitable tools and powers for intervening in the rights of banks' owners and creditors. The harmonised resolution toolkit includes the following: 1) the sale of business tool – sale of part or the whole of a bank to a private purchaser without the consent of shareholders of the bank under resolution, 2) the establishment of a bridge bank and transfer to it of some or all of the assets and liabilities of a bank under resolution, 3) the asset separation tool (applied together with other instruments) under which part of the assets[87] of a bank under resolution is transferred to a separate asset management vehicle and 4) write-down and conversion of debt to equity, i.e. a bail-in tool. As a last resort, in the event of a systemic crisis, the Member States are allowed – under emergency measures – to provide public support in the form of recapitalisation or temporary nationalisation. The directive also introduces the obligation to prepare recovery plans[88] and resolution plans[89]. Moreover,

[83] In the period from 2008 to 2012, EUR 413.2bn (i.e. 3.2% of GDP of the EU) was assigned to recapitalisation, of which the most was in the United Kingdom (EUR 82.4bn), Germany (EUR 63.2bn), Ireland (EUR 62.8bn) and Spain (EUR 60bn).

[84] In the period from 2008 to 2012, asset relief measures were the least used instrument. EUR 178.7bn (i.e. 1.4% of the GDP of the EU) was assigned to this form of aid, of which the most was in Germany (EUR 80bn), the United Kingdom (EUR 40.4bn), Spain (EUR 28.4bn) and Belgium (EUR 17.1bn).

[85] The use of the instrument in the form of a guarantee and liquidity support reached its peak in 2009, when it stood at almost EUR 906bn (i.e. 7.7% of the GDP of the EU), of which the most was in Ireland (EUR 284.2bn), the United Kingdom (EUR 165bn), Germany (EUR 135bn) and France (EUR 92bn).

[86] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, Official Journal of the EU L/173/190 of 12.06.2014.

[87] Most often bad quality assets which adversely affect the financial result of a bank are subject to such transfers.

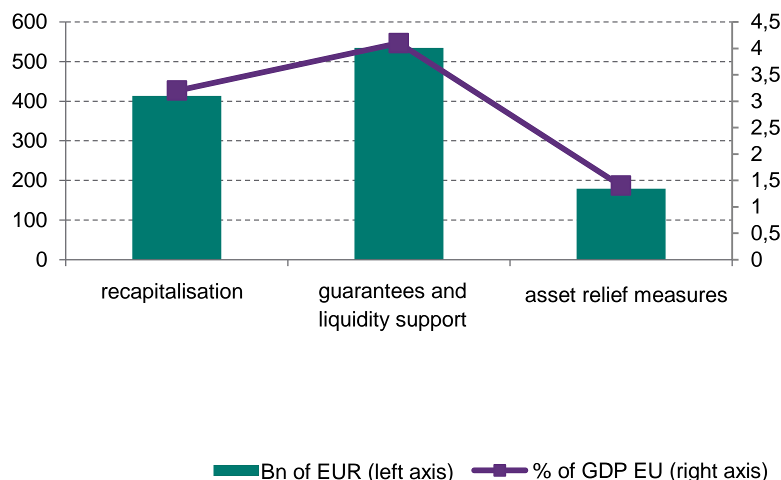
[88] Recovery plans are to be prepared independently by the institutions and then approved by the supervisor. However, the responsibility for preparing, maintaining and regularly updating the plan rests with the institution. Recovery plans are to contain proposals for measures that could be taken by the institution in response to potential shock scenarios (e.g. liquidity problems) in order to rebuild its long-term viability.

[89] Resolution plans are to be prepared by a resolution authority in cooperation with the supervisory authority. These plans should take into account a series of scenarios both of an idiosyncratic and systemic character, as well as identify the key functions of the institution in question. On this basis, possible resolution measures using specific resolution tools (i.e. transfer of assets to a bridge bank or to a bad bank) are proposed. An important element of a resolution plan is also to define the financing

the EU countries are obliged to establish resolution funds financed *ex ante* by banks' contributions. The resolution funds shall have a target level of at least 1% of covered deposits to be reached within 10 years. In order to increase the effectiveness of cross-border crisis management, resolution colleges are set up - on the basis of supervisory colleges – consisting of representatives of the following financial safety net institutions from countries where a given banking group operates: 1) resolution authorities, 2) supervisory authorities, 3) central banks (in the case that the central bank does not play a supervisory role), 4) ministries of finance (in the case that the ministry of finance does not have resolution powers), 5) deposit guarantee funds. Moreover, a representative of the EBA is also a member of a resolution college.

Ahead of the adoption of the EU directive, influenced by the experience of the recent crisis, many Member States implemented recovery and resolution procedures into their legal systems. The procedures in individual countries[90] differed on some issues, e.g. on the range of resolution tools available or the entities involved in the process. The adoption of the BRRD means the introduction of a certain harmonisation of resolution procedures and tools in the EU. This is necessary in order to ensure that appropriate national authorities can take rapid and coordinated measures in the case of a cross-border crisis.

Figure 5. Forms and size of public support for the financial sector in the EU in the years 2008-2012.



Source: Own analysis on the basis of the European Commission data.

of the whole process. Resolution plans will only be implemented when the situation of the failing institution is so bad that the trigger conditions for the resolution process are met.

[90] For example the United Kingdom, Denmark, Germany, the Netherlands, Portugal and Romania introduced their own resolution procedures.

3.2. Banking Union

3.2.1. Reasons for the creation of a banking union

The crisis triggered a negative feedback loop between the financial condition of banks and sovereigns, particularly in some euro area countries (Greece, Ireland, Portugal, Spain and Cyprus). The structure of the financial sector in Europe forms the origin of the negative feedback loops between the sovereign debt crisis and the banking crisis. Before the crisis there was a significant increase in the value of banking sector assets in EU countries. The ratio of bank assets to GDP was 334% in the EU in 2013, which was significantly higher than ratios in other advanced economies, e.g. the USA (86%) and Japan (196%). As a result, the European economy and public finances are heavily dependent on the situation of banks. During the recent crisis there was a deeply-rooted belief that governments cannot allow the largest banks to fail, since this would pose the risk of a collapse of their economies. In the case of Ireland and Cyprus, this was the direct cause for seeking financial assistance from the EU and the IMF.

Supervisory policy did not always react appropriately to the build-up of risks that could trigger a crisis. The principle of home country supervision hindered effective supervision of large, cross-border banks. Along with the development of the crisis, national supervisors assumed that disclosing weaknesses of the banks in their jurisdictions could raise market expectations about the need to recapitalise these banks. Meanwhile, as a result of high public finance indebtedness in euro area countries and the related need for fiscal consolidation, governments of these countries were not be able to bear the burden of further bank support measures. This is why a natural tendency to underestimate the real capital needs of banks was reinforced, thus postponing difficult decisions. This was reflected in supervisory forbearance and the strengthening of the negative bank-sovereign feedback loop in the long term.

Due to the fact that the financial crisis in the EU was concentrated in euro area countries, reforms (including the banking union project) focus on improving the functioning of the euro area. However, the banking union is open to non-euro countries which may participate through establishing close cooperation (opt-in), without the need to join the euro area. **The concept of a banking union is based on the transfer of powers from a national to a pan-European level in the following areas:**

- prudential supervision of the banking sector (Single Supervisory Mechanism - SSM),
- recovery and resolution of banks (Single Resolution Mechanism – SRM).

3.2.2. The first pillar of the banking union – the Single Supervisory Mechanism

The idea to create a banking union is an attempt to limit pre-crisis weaknesses in the financial safety net arrengmeents that we have identified above. The TFEU gives the possibility to grant the ECB certain powers of banking supervision on the basis of art. 127 par. 6[91]. This article provides a legal basis for the project of the first pillar of the banking union – a Single Supervisory Mechanism, which was proposed by the Eu-

[91] "The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings."

ropean Commission in September 2012. By using such a legal basis, it was possible to introduce reforms in a relatively short time – without the need to make treaty changes in a lengthy procedure of intergovernmental negotiations and their ratification by all EU member states. The fast introduction of the banking union is also the result of using this project as a crisis management tool in the recent euro area crisis. The SSM Regulation came into force in November 2013[92], while the ECB took over supervisory functions on 4 November 2014.

The ECB was entrusted with responsibility for microprudential supervision over credit institutions in the euro area. SSM is a system (similarly as the ESCB) of supervisory authorities – the ECB and the national supervisory authorities. The ECB exercises direct supervision over systemically important banks whose total value of assets exceed EUR 30bn or 20% of GDP, as well as over banks that are beneficiaries of the EFSF/ESM support. Moreover, national authorities may, if they consider it justified, put other banks under direct supervision of the ECB, while the ECB may also do this on its own initiative. Noththstanding the above-mentioned criteria, the provisions of the SSM Regulation provide that the ECB shall carry out direct supervision of at least the 3 most significant banks in the given country[93]. National supervisors exercise day-to-day supervision over smaller banks in accordance with standards established by the ECB and support actions taken by the ECB by carrying out the ECB's instructions and participating in Joint Supervisory Teams.

In view of the ECB's new functions, a new internal body has been established in the ECB – the Supervisory Board. Pursuant to art. 26 par. 1 of the SSM Regulation, the Supervisory Board is composed of the following: the Chair and Vice Chair, four representatives of the ECB and one representative of national competent supervisory authorities from each Member State participating in the SSM. All members of the Supervisory Board act in the interests of the EU as a whole. **The Supervisory Board is not a decision-making body of the ECB – the Governing Council is formally responsible for all decisions taken by the ECB.** Drafts of micro-prudential decisions are prepared and adopted by the Supervisory Board and then sent to the Governing Council of the ECB for final approval. The decisions of the Supervisory Board are taken, as a rule, by a simple majority of its members (each member has one vote). The draft decision prepared by the Supervisory Board is presented to the Governing Council of the ECB for approval and will be considered adopted, unless the Governing Council raises objections within the specified time (usually no longer than 10 working days). There is also provision for emergency situations, in which it will be possible to examine the draft decision within 48 hours.

The SSM, whose members are euro area countries pursuant to the SSM Regulation, is open for countries from outside the euro area to join on an opt-in basis. Including banks from outside the euro area in the single supervisory mechanism is conditional on the ECB's decision to establish close cooperation. The

[92] Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (hereinafter "Regulation on the SSM").
[93] Pursuant to art. 6 of the Regulation on the SSM. On 4 September 2014 the ECB published a list of the 120 important credit institutions under the direct supervision of the ECB in the SSM in accordance with the criteria indicated (on the basis of data at the end of 2013). The list will be updated at least once a year. The assets of the important credit institutions constitute approx. 85% of the assets of the banking sector in the euro area. Moreover, the ECB published a list of less important institutions which will be under the supervision of the national supervisory authorities.

ECB issued a decision[94] regulating the process of establishing, suspending and terminating close cooperation. Countries outside the euro area may apply to the ECB to establish close cooperation[95]. It is established on the basis of the ECB decision, which specifies the method of transferring supervisory powers and the starting date of close cooperation. Moreover, while an opt-in country may terminate close cooperation (at its request) , the ECB on its own initiative has the possibility to suspend or terminate the close cooperation.

Macro-prudential policy in the SSM remains in principle the responsibility of the national authorities, although the ECB is also entrusted with certain powers. The only powers of the ECB in this area is the possibility to apply more stringent measures from the harmonised[96] macro-prudential toolkit. The SSM Regulation provides that the ECB may directly apply only higher requirements relating to capital buffers than those set by the national authorities, and may also apply more stringent measures aimed at reducing systemic risk[97]. The regulation introduces a coordination mechanism between the ECB and the national authorities for the the use of macro-prudential tools. The national competent authorities are obliged to inform the ECB in advance (with 10 working days' notice) of their intention to introduce macro-prudential instruments and appropriately duly consider objections and suggestions of the ECB regarding the calibration of applied tools (the same procedure applies in the case of a tightening of macro-prudential tools on the initiative of the ECB). In addition, the national authority may propose to the ECB to apply more stringent macro-prudential tools in order to address the specific situation of the financial system and the economy.

Before taking over supervisory powers, the ECB carried out a Comprehensive Assessment of the banks and their balance sheets in the countries participating in the SSM. The aim of the assessment was to provide a kind of "opening balance sheet" on the date on which the ECB took over responsibility for supervision of banks in the euro area. The ECB published a list of 130 banks from euro area countries[98] which were subjected to the assessment. The Comprehensive Assessment was carried out in cooperation with the national supervisory authorities of countries participating in the SSM. The assessment consisted of three elements: i) an assessment of the most important types of risk, ii) an Asset Quality Review (AQR) and iii) a stress test carried out in cooperation with the EBA.

At the meeting of the ECOFIN Council of 15 November 2013, the order of undertaking measures in the event of bank capital shortages identified as a result of the assessment was determined. Financial institutions should prepare recovery plans, and capital needs should in the first place be covered by pri-

[94] Decision of the European Central Bank of 31 January 2014 on the close cooperation with the national competent authorities of participating Member States whose currency is not the euro (ECB/2014/5).

[95] The request should be submitted at least five months before joining the SSM. It should contain a commitment to comply with the instructions and guidelines of the ECB, provide information and supervisory documentation and to implement appropriate amendments into national legislation. As part of the assessment of the request, the ECB makes a comprehensive assessment of the supervised entities and presents its preliminary decision within 3 months of receiving the request. Close cooperation is established on the basis of the ECB decision, which specifies the method of delegation of supervisory powers and the start date of close cooperation.

[96] The powers of the ECB relate to macro-prudential tools regulated mainly in the CRDIV/CRR package.

[97] The powers of the ECB to tighten parameters relate only to macro-prudential instruments which have been harmonised by EU regulations, in other words, they do not include such instruments as loan-to-value (LtV), the leverage ratio and debt-to-income (DtI).

[98] The ECB is open to supervisory authorities of countries outside the euro area conducting a similar assessment in accordance with the methodology of the SSM.

vate/market sources (including raising capital on the market and retention of profits). In the second place, member states should ensure capitalisation of banks from national public sources while complying with the state aid rules in the EU (published by the European Commission in the so-called "banking communication"[99]) and applying resolution procedures. In third place, shortages may be covered by capital support mechanisms existing in the EU. This may be done through a loan from the ESM via the national budget if the bail-in mechanism is applied earlier and if this is done in accordance with the state aid rules. Support under the ESM may take the form of direct capitalisation of the given institution (within the limit of EUR 60bn from the ESM fund, which can be used for this purpose)[100].

The ECB published rules on the practical functioning of the SSM, which are to clarify provisions of the Regulation on the SSM. On 25 April 2014 the ECB issued a framework regulation on the rules of cooperation with the SSM, setting out, among others, the methodology of assessment of the systemic importance of credit institutions (in order to classify whether they will be under direct supervision of the ECB). The ECB framework regulation also sets out the rules of conducting supervision and the supervisory procedures inside the SSM (e.g. the set-up of Joint Supervisory Teams). The document contains the rules of cooperation and the division of tasks between the ECB and national authorities regarding micro- and macro-prudential supervision. It also defines the language in which communication should be conducted, among others, between the supervisors in the SSM[101]. However, the framework regulation of the ECB is only of a general character and does not go beyond the scope defined in the SSM Regulation, leaving the ECB a significant degree of discretion in the way in which it fulfils its supervisory functions.

3.2.3. Dilemmas related to the creation of the SSM

3.2.3.1 Legal basis

The creation of the SSM was treated as an urgent, high-priority reform, therefore the existing legal framework was used (art. 127 par. 6 of the TFEU). The functioning of the banking union on the basis of the TFEU means that opt-in countries can participate in the banking union in a different legal environment than euro area countries. This results from the following Treaty provisions:

- the ECB does not have powers to take direct action against credit institutions which have their head office in a country participating in the SSM but remain outside the euro area. In accordance with art. 139 of the TFEU, acts of the ECB, including regulations, decisions, recommendations and opinions do not apply to countries outside the euro area (covered by derogation)[102]. This means that the establishment of close cooperation requires a non-euro area country to introduce a series of necessary changes

[99] Communication from the Commission on the application, of 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis ('Banking Communication').
[100] Press Release, 3271st Council meeting Economic and Financial Affairs, Brussels, 15 November 2013.
[101] In accordance with art. 23 and 24 of the framework of cooperation in the SSM, the ECB and the national competent authorities accept the provisions relating to their mutual communication and language regime in the SSM. In turn, in the case of documents sent to the ECB by the supervisory authorities or natural persons or legal persons subject to the ECB's supervisory procedures, these documents may be prepared in any of the official languages of the European Union.
[102] A list of ECB acts is defined in art. 132 of the TFEU and covers regulations, decisions, recommendations and opinions.

in national legislation (among others, with respect to prudential supervisory powers), in order to enable the ECB to exercise effective supervision via the national authorities in the SSM.
- The countries outside the euro area have limited influence on the decision-making process of the SSM (more below).

To ensure stability and cohesion of the whole banking union, it is desirable, at least in the long term, to strengthen the legal basis of the creation and functioning of the SSM. Treaty changes would be a chance to ensure equal status (equal rights and obligations) of all SSM member states, regardless of their membership in the euro area, through institutionalisation of close cooperation. Granting decision-making powers on supervisory matters to the Supervisory Board would also shorten and simplify the existing decision-making process in the SSM.

A similar postulate applies to the extension of the legal framework related to the creation, financing and use by banks of the ESM' s funds. For euro area countries there is a capital support mechanism based on the Treaty establishing the ESM. The launch of the SSM should have allowed the direct capitalisation of banks from ESM funds, i.e. not via the national budgets of member states. Support under the ESM is, however, available only for banks from the euro area. Meanwhile, in order to ensure a level playing field, it would be desirable to give direct access to capital support under the ESM also to banks from non-euro countries which have decided to opt in. The decision to accept the country into the banking union could be dependent on its simultaneous signing of the Treaty establishing the ESM (however, this would require, inter alia, changes to the Treaty).

3.2.3.2 Micro-prudential supervision

The division of responsibilities between the ECB and national authorities in the field of micro-prudential policy should be clear, since it will be the basis of the effective functioning of the SSM. In accordance with art. 6 of the Regulation on the SSM, the ECB performs its tasks in the SSM in cooperation with the national competent authorities. The ECB is responsible for the effective and consistent functioning of the SSM and should establish a clear cooperation framework between the ECB and national competent authorities. Therefore, it is important to set out precisely the mechanisms of cooperation between the ECB and national supervisory authorities, as well as the practical division of responsibilities. This would avoid any overlaps of work and limit the risk of conflicts arising over areas of competences and gaps in supervision[103]. As mentioned above, not only is establishing the cooperation framework important, but so is its practical implementation.

An enhanced ECB role would help centralise management of the SSM and would make it possible to act to a wider extent according to common supervisory standards as well as maintain greater consistency of the whole mechanism. A significant role of the ECB would help reduce the risk of forbearance of national supervisors. At the same time, the enhancement of the ECB's role should not be at the expense of human resources from the national level. National supervisors posess better knowledge of the specificities of local markets andhave more experience in the field of micro-prudential supervision than the ECB. Due to the shortage of supervisory staff, another dilemma in the relations between the ECB and national authorities is

[103] An improvement in the quality of supervision by conferring to the ECB new powers, requires additional efforts to ensure the ECB's operational capacity to carry out its supervisory role – both in the form of off-site analysis and on-site inspections.

finding the right balance between, on one hand increased staffing needs of the ECB and the usee of the experience of national authorities, and on the other hand, the risk of excessive draining of staff from national authorities. While the above-mentioned cooperation framework in the SSM is an attempt to clarify the relationship between the ECB and national authorities, its operationalization and the effectiveness of the SSM in practice still remains open.

3.2.3.3 Macro-prudential supervision

Leaving macro-prudential policy, in principle, within the competence of the national authorities and enable the ECB only to tighten its parameters should be assessd positively. The key role of the national authorities is justified, since they know the specificities of the local market and have more experience in the field of macro-prudential policy. Thus, they can potentially calibrate better the macro-prudential tools in response to risks specific to the local market. Moreover, financial cycles in the SSM countries are not fully synchronised, which gives rise to the need to ensure the flexible implementation of macroprudential tools depending on the specific systemic risks in a country in a given phase of the cycle. This is particularly important in the case of the absence of the possibility to respond to shocks with monetary policy and exchange rate tools in euro area countries in an unconstrained way. On the other hand, the ECB has the possibility to tighten macroprudential policy on the basis of an objective and independent assessment of systemic risk in a particular country. This could be justified by the desire to reduce systemic risk that extends beyond just one SSM country. It also creates the opportunity to reduce the inaction bias of national authorities, e.g. as a result of different systemic risk assessments or ineffectivness of national decision-making processes. Moreover, the ECB can identify potentially negative cross-border effects arising from the application of macro-prudential tools at a national level and coordinate their use in the SSM. By adopting a supranational perspective, the ECB also takes potentially wider perspective than the national supervisors when identifying and assessing structural systemic risks, e.g. by quantifying bank's systemic importance not only on a national level, but also on the level of the SSM. Nevertheless, it will take time for the ECB to build its competences and resources in this field.

The mechanism of duly considering by the national authorities and the ECB of mutual opinions (objections) regarding the application of macroprudential tools, i.e. the extent to which they will be binding, remains an open issue[104]. At the current stage it is also not clear how the ECB, by tightening the macro-prudential policy tools, will take due account of the specific situation of the financial system, the economic situation and the business cycle in the individual countries and calibrate the parameters of macro-prudential tools accordingly. These issues will have to be clarified at a working level in within the cooperation framework between the ECB and national macroprudential authorities.

3.2.3.4 Close cooperation (opt-in)

The SSM is open for EU countries outside the euro area to join on an opt-in basis. Unlike the euro area countries, non-euro countries have a choice, and not an obligation, to participate in the banking union. A

[104] Pursuant to art. 5 of the Regulation on the SSM, in the event that the national authority wishes to apply harmonised macro-prudential tools, it shall inform the ECB of its intention 10 working days prior to taking such a decision. The ECB may express the reasons for its objections within 5 working days. In this case, the national authority shall duly consider the ECB's reasons prior to taking further appropriate action. The symmetric mechanism of duly considering the reasons of national authorities applies in the case of a tightening of the parameters of harmonised macro-prudential tools on the initiative of the ECB.

binding deadline by which non-euro countries could join the SSM through establishing close cooperation has not been specified[105]. This can take place at any time on the request of the country in question and through the ECB's decision on establishing close cooperation. In this case, the non-euro area country undertakes to follow the instructions and guidelines of the ECB, provide information, and supervisory documentation and implement any necessary changes into national legislation[106]. Before submitting the request, the non-euro area country may therefore assess to what extent the benefits of joining the banking union outweigh the costs of limiting the role of the national financial safety net (which functions effectively, as in the case of Poland).

It is difficult at the initial stage to assess the benefits of SSM participation, since its effectiveness has not yet been verified in practice. An attempt could be made to qualitatively assess potential benefits for a non-euro country establishing close cooperation. Close cooperation is an opportunity for an opt-in country to participate in a pan-European mechanism and benefit from increased European integration, which could translate into improved attractiveness of the country's financial sector for foreign investors. This is conditional on the effective functioning of the SSM in practice and the building of the confidence of market participants. A non-euro country with a banking sector in a weak condition could be better placed to notice the potential benefits arising from SSM membership. However, for countries with a stable banking system, such as Poland, this aspect has lower importance. Common supervisory standards and unified regulations can also make it easier for banks to conduct cross-border activities in SSM countries[107]. This could also affect the attractiveness of the country as a destination for investment from the perspective of international banking groups. In turn, from the point of view of the host non-euro area country supervisory authority, SSM participation provides easier access to information about parent banks from countries participating in the SSM, which usually include parents from the euro area. This allows host non-euro area countries not only to better assess the condition of parent banks, but also to participate in Joint Supervisory Teams for banking groups. SSM participation can therefore reduce the problem of coordination between the host country (e.g. Poland) and the home country (a euro area country). However, centralisation of supervision does not in itself seem to be a sufficient condition for its increased quality and it is difficult to evaluate *ex ante* the effectiveness of the SSM.

At the same time, participation of a non-euro country in the SSM on the basis of close cooperation entails a series of limitations resulting from the SSM construction. As already mentioned, due to treaty provisions, non-euro countries have neither access to the ESM, nor to the liquidity facilities in euro from the ECB. Entry to the banking union through close cooperation does not change this. As a result of restrictions contained in the TFEU, the SSM Supervisory Board is not a decision-making body of the ECB. Therefore, the Governing Council is formally responsible for all the decisions of the ECB, regardless of their character. Opt-in countries can participate only in the work of the Supervisory Board, but are excluded from the decision-making process at the level of the Governing Council, which limits their influence on the whole decision-making process in the SSM. Meanwhile, an opt-in country has to strictly follow the instructions of the

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[105] It should be stressed that the country's entry into the euro area means its automatic entry into the banking union.
[106] Considering the current situation (2014) and on the basis of preliminary calculations, if Poland was to establish close cooperation with the ECB, banks covering approx. 2/3 of Polish banking sector assets (as entities dependent on a euro area parent and the three "most important" banks incorporated in Poland) would be subject to the direct supervision of the ECB.
[107] The potential benefit for banks functioning in Poland could also be the harmonisation of supervisory standards, which could reduce operational and compliance costs.

ECB in the field of microprudential supervision, even if – in an extreme case – this could have an undesirable effect on the national banking sector.

An opt-in country in the SSM, unlike the euro area country, has the possibility to terminate close cooperation. This solution was introduced as a safety measure in the decision-making process of the SSM. It is a response to the restricted participation of an opt-in country in the decision-making process within the SSM – lack of non-euro countries' participation in the work of the ECB's Governing Council is a consequence of treaty provisions. Although termination of the close cooperation always occurs on the basis of the ECB's decision, it may, however, be taken in two cases: on the initiative of the ECB or on the request of the opt-in country.

The ECB has the possibility to suspend or terminate close cooperation on its own initiative in two cases:

- If the opt-in country does not comply with the obligations set out in the SSM Regulation (among others, if it does not comply with the guidelines and instructions of the ECB).
- If the Governing Council objects to a draft decision of the Supervisory Board, the opt-in country may inform the ECB of the reasons why it does not agree with the objection of the Governing Council. In the event that the Governing Council maintains its objection, the opt-in country may inform the ECB that it shall not be bound by the potential decision on the amended draft decision of the Supervisory Board[108].

In turn, opt-in countries may also terminate close cooperation on their request in two cases:

- If the opt-in country does not agree with a draft decision of the Supervisory Board, then it shall inform the Governing Council of the reasons for its objection. Next, the Governing Council shall take a decision on the matter taking into full consideration the reasons submitted and shall present in writing the reasons for its decision to the member state in question. After the Governing Council has taken the decision on the matter, the opt-in country may request the ECB to terminate close cooperation with immediate effect – in which case it will no longer be bound by the decision.
- The opt-in country may request the ECB to terminate close cooperation at any time after three years from the establishment of close cooperation.

However, it cannot be excluded that the termination of close cooperation may entail operational and reputational risks, particularly for the non-euro area country whose close cooperation is terminated. Such a decision would probably result in negative market reaction.

In addition, the creation of the SSM will most likely support capital and liquidity management at the highest level of consolidation of groups operating within the SSM (Constâncio 2013). The ECB (pursuant to art. 7 and 8 of the CRR) may be inclined to waive the application of the prudential requirements to individual entities, enforcing them only at the level of groups supervised within the SSM, while expecting par-

[108] In this situation, prior to taking the decision on the suspension or termination of close cooperation, the ECB shall take into consideration in particular, the following: i) whether the failure to suspend or terminate the close cooperation could threaten the integrity of the SSM or have adverse fiscal effects in the SSM countries, ii) whether the authority of the country in question adopted measures which, in the opinion of the ECB, ensure that credit institutions in the country submitting its justified objection are not treated more favourably than those in the remaining SSM countries and whether the measures in question are also effective in achieving the goals of the SSM.

ent entities to guarantee the transfer of assets and liquidity to their subsidiaries should subsidiaries' solvency or liquidity be threatened. In the case of banks from euro area countries, such a situation should not increase the risk as they have access to liquidity facilities from the ECB and possible funding from the ESM. However, this may constitute a threat for an opt-in country, which does not have access to the above-mentioned backstops. Moreover, from the perspective of a host country outside the euro area, in the case of establishing close cooperation, the national supervisory authority will not be able to resort to the EBA' s mediation and will be bound by the decision taken in the SSM decision-making process on which, in turn, it would have only limited influence.

Conclusion: *Due to the conditions resulting from the existing TFEU and the Treaty establishing the ESM, an opt-in country has limited influence on the decision-making process within the SSM and no access to the ESM backstop. Moreover, the country's opt-in decision does not automatically grant access to euro liquidity through, for example, currency swaps with the ECB. As a result, the establishment of close cooperation within the SSM at the current stage entails substantive limitations and uncertain benefits, particularly taking into consideration the stable situation of the Polish banking sector.*

Conclusions: *Treaty changes aimed at strengthening the legal foundations of the SSM should take into account the need to create equal rights and obligations of euro area and non-euro area countries within the SSM.*

3.2.3.5 Relations with countries outside the banking union

In the case that a country remains outside the SSM, changes concerning the banking union will not have a direct influence on the supervision conducted by the national supervisory authority. It should be noted that regardless of whether Poland establishes close cooperation or not, due to the significant share of foreign capital (mainly from the euro area) in Polish banking sector assets , parent banks from euro area countries will be supervised by the ECB. However, assuming the effective functioning of the SSM and high quality of ECB supervision, this creates an opportunity to improve the condition of parent banks, which would be beneficial from the perspective of Poland as a host country.

It is important that the SSM takes care to maintain appropriate relations with host countries outside the SSM. Pursuant to art. 17 of the SSM Regulation, the ECB should respect a fair balance between all countries of the SSM, and in the relations with countries outside the SSM – a balance between home and host countries. One of the aspects of this cooperation is the relationship between the SSM and the host country remaining outside the banking union. On the one hand, the creation of the SSM, where the ECB's scope of supervision will be larger than that of any existing consolidating supervisor, provides from the perspective of the host country an opportunity to enhance cross-border supervisory cooperation (work of the colleges of supervisors), e.g. through a reduction in the number of parties participating in discussions within the colleges of supervisors inside the SSM. The ECB will represent home countries belonging to the SSM in the colleges, which means for host countries that they will have one partner in the form of the ECB instead of several or a dozen existing parent supervisors (from SSM countries). This should help to harmonize operational principles and facilitate the development of a uniform culture of cooperation in the colleges. Therefore, the creation of the SSM will most likely help to coordinate the relations between home countries (from the SSM) and host countries (remaining outside the SSM). However, on the other hand, it cannot be fully excluded that the ECB – being responsible for the functioning of the whole of the SSM – will concentrate

only on the euro area, which could lead to an underestimation of the country-specific risks. In particular, this could concern a host country with entities belonging to banking groups from the SSM, if they are deemed less important from the point of view of the group as a whole, as well as from the pan-European perspective.

Conclusion: *From the point of view of Poland as a country remaining outside the banking union, the benefit of the creation of the SSM will be the strengthening and harmonisation of supervision over parent banks from SSM countries and the harmonisation of principles of cross-border supervisory cooperation, which will be an opportunity to enhance home-host relations.*

3.2.3.6 Relations between the SSM and ESRB

The creation of the SSM influences the functioning of the ESRB, and the existing relations between the ECB and the ESRB may result in a conflict of interests and coordination problems. The ECB plays a significant role in supporting the activities of the ESRB in terms of administration, statistics, analysis and research. The ESRB Secretariat, located at the ECB, is responsible for the day-to-day activities of the ESRB. Moreover, the President of the ECB chairs the General Board of the ESRB. After the establishment of the SSM, the existing relations between the ECB and the ESRB may lead to a conflict of interest. A conflict of interest may arise from the following:

- the possibility for the ESRB to issue warnings and recommendations to the ECB in its supervisory capacity,
- the chairing by the President of the ECB of both the General Board of the ESRB and the Governing Council of the ECB,
- the risk of limited resources of the ESRB (staff and financial resources), resulting from, on the one hand, new supervisory tasks of the ECB, and on the other hand, growing responsibilities of the ESRB,
- the dependence of the ESRB on access to information and data, the administrator of which is the ECB.

In order for the ESRB to function effectively, the ESRB requires greater independence from the ECB, as well as a strengthening of its analytical (IMF, 2013) **and financial resources**, which will help to mitigate conflicts of interest. The current review of the functioning of the ESRB will be an opportunity to implement such changes. It is important to strengthen the position of the ESRB and its role in the harmonisation of the national frameworks of macro-prudential supervision. It is also important to enhance (among others, personnel) the independence of the ESRB from the ECB, which could entail, for example, the creation of an additional position – "Managing Director" of the ESRB, whose role would not be played by the President of the ECB. The strengthening of the ESRB's role and its independence from the ECB would allow the ESRB to formulate independent assessments of threats to financial stability. The advantages of the increased ESRB role stem from the wider scope of its powers – the ESRB covers not only the banking sector, but the whole EU financial system. Due to the interconnectedness between the banking sector and other parts of the financial system, it is also important that the ESRB analyses to a greater extent than previously systemic risk and the tools of its mitigation also in the non-banking sector (e.g. the insurance sector). Moreover, the geographic scope of the ESRB is wider than that of the ECB (EU countries and the EU as a whole, and not only countries belonging to the banking union). This wider approach of the ESRB will allow for the coordination of activities of national macro-prudential authorities in the EU. It is of key importance that the ESRB en-

sures coordination of measures supporting the stability of the non-banking sectors of both SSM countries and the remaining EU countries. Moreover, in the case of the banking sector, the ESRB can foster cooperation between the SSM and countries outside the SSM. It is justified that the ESRB continues to issue warnings and recommendations, addressed to (which would require clarification) both the ECB as a supervisory authority and national macro-prudential authorities (including in SSM countries). The ESRB should also continue to define the general framework of macro-prudential policy and have the possibility to participate in the calibration of macro-prudential instruments in close cooperation with the national authorities (IMF, 2013)[109].

In particular from the perspective of a country remaining outside the SSM, an enhanced role of the ESRB is perceived as a desirable direction of reforms. This would allow, among others, to ensure better coordination of macro-prudential policy between countries inside and outside the SSM.

Since the ESRB focuses on the EU as a whole, countries outside the euro area, including Poland, currently have a relatively greater role and influence on the work and the decision-making processes of the ESRB than in the case of the work of the Financial Stability Committee (FSC) in the ECB, which usually meets only in the euro area (SSM) composition. In addition, in the case of Poland, the President of Narodowy Bank Polski participates in the Steering Committee and the General Board of the ESRB, and representatives of NBP are actively involved in the work of the committees and working groups of the ESRB. As a result, the ESRB is a forum in which the voice of countries outside the euro area is heard and respected.

Conclusion: *The role of the ESRB should be strenghtened, as well as its resources, and its independence from the ECB should be increased.*

3.2.4. The second pillar of the banking union – the process of restructuring and resolution of banks

The delegation of supervisory powers to the European level should also be accompanied by the transfer of responsibility to act at the time a bank is declared insolvent (crisis management). Together with the establishment of the SSM, it is also necessary to ensure at a European level the mechanism for proceeding with banks facing bankruptcy.

Recognising this need, in July 2013 the European Commission presented a **draft regulation establishing a Single Resolution Mechanism** (SRM), the second pillar of the banking union. In April 2014 the regulation was adopted by the European Parliament, and in July 2014 by the Council of the EU. The regulation on the SRM[110] will fully come into force in 2016.

[109] It is also important to avoid on an operational level the duplication of work carried out by the committees and working groups of the ECB and the ESRB as well as to obtain synergy effects. Until the introduction of possible legal changes to the functioning of the ESRB, its mandate cannot be reduced/narrowed by the exclusion of the banking sector and the SSM countries. Moreover, due to the often similar personal composition, meetings of the ESRB's Advisory Technical Committee and the ECB's Financial Stability Committee (as well as their sub-structures) could be organised according to a back-to-back formula, together with coordination of meetings agendas of both authorities. Existing organisational structures could be used to meet the needs of both the ESRB and the SSM, basing on existing cooperation and providing support by the ECB to the work of the ESRB.

[110] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution

The SRM Regulation covers countries participating in the SSM, which is aimed at ensuring the cohesion of the banking union. The regulation provides for the establishment of a Single Resolution Board (SRB) as a resolution authority for the SSM/SRM area. The SRB will function in two sessions: plenary and executive. **In the plenary session**, the SRB will be composed of a chairman, four members appointed by the Council of the EU (so-called permanent members) and one representative of a national resolution authority from each participating country. Each member of the SRB shall have one vote. In addition, representatives of the European Commission and the ECB may participate in the meetings of the SRB as permanent observers without the right to vote. The tasks of the Board in the plenary session shall include the approval of the annual work programme and the budget for the coming year, as well as the annual report on the SRB activities. Moreover, the Board in the plenary session is to take investment and financial decisions, among others, on the need to collect additional *ex post* contributions, voluntary borrowings, and the use of alternative financing means. Moreover, if the specific resolution action requires support from the resolution fund exceeding EUR 5bn or if the use of the resolution fund in the last 12 months reaches the threshold of EUR 5bn, the Board in its plenary session shall decide on the activation of the resolution process. However, as a rule the decision to place a particular credit institution under resolution is to be taken by the Board in the **executive session**[111]. Its composition shall be limited to a chairman, permanent members and representatives of the national resolution authorities from the jurisdictions in which the given group operates. Moreover, the Board in its executive session may invite to participate at its meetings permanent observers and a representative of the EBA as well as national resolution authorities of non-participating Member States when the discussion concerns a group that has subsidiaries or branches of systemic importance operating in those jurisdictions.

Pursuant to the regulation, the decision-making process activating a resolution procedure begins when the SRB determines that the following conditions are met, i.e. 1) the bank is failing or likely to fail[112], 2) there is no reasonable prospect that any private sector measures or supervisory action, including early intervention measures, would prevent its failure, 3) resolution measures are necessary in the public interest. The ECB assesses whether the bank is failing or likely to fail[113]. If all of the above conditions are met, the SRB prepares a resolution scheme, i.e. a specific plan for conducting a resolution process for a given bank, determining which resolution tools will be used and also whether funds, and how much funds from the SRF will be required to support the process. As a rule, the SRB in its executive session adopts the resolution scheme by reaching joint agreement. If a consensus has not been achieved, the chairman and permanent members shall take a decision by a simple majority, whereas the chairman shall have a casting vote. If the resolution scheme assumes the use of SRF funds exceeding EUR 5bn or if in the course of the last 12 months

Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, Official Journal of the European Union, L 255/1 of 30.07.2014.

[111] The tasks of the executive session also include the following: 1) preparation, assessment and approval of resolution plans, 2) setting the minimum requirement for own funds and eligible liabilities (MREL) for the given institution, 3) application of simplified requirements for certain institutions in accordance with the principle of proportionality.

[112] According to the regulation, this condition is deemed to be met if at least one of the following circumstances: 1) the bank infringes, or there are objective grounds to expect that in the near future the bank will infringe the requirements for continuing authorization , including the situation when the bank has incurred or is likely to incur losses which deplete its own funds or a substantial part thereof, 2) the assets of the bank are lower than its liabilities, or there are objective grounds to expect that such a situation will occur in the near future, 3) the bank is unable, or there are objective grounds to expect that in the near future it will be unable, to pay its debts or other liabilities as they fall due, 4) extraordinary public support is required.

[113] The SRB may also determine such a fact if the ECB does not make an appropriate assessment.

the net use of SRF funds reaches the threshold of EUR 5bn, then the decision on activating the resolution process is taken by the SRB in its plenary session. After adoption of the resolution scheme by the SRB, it is submitted to the European Commission, which has 24 hours to endorse it or express its objections. During this time, the European Commission may propose to the Council of the EU to object to the resolution scheme on the grounds that the public interest criterion is not met or to take a decision (positive or negative) regarding changes of the amount of funds required for conducting the resolution process. This means that the Council of the EU may block the resolution process for two reasons only: 1) lack of public interest and 2) use of the SRF funds. The resolution scheme comes into force if none of the aforementioned institutions express their objections. The Regulation on the SRM indicates that the Council of the EU takes decisions on these matters by a simple majority. Nevertheless, due to the fact that the Council of the EU brings together all the EU Member States (and not only those participating in the banking union), a declaration on the voting arrangements[114] in these particular cases was also adopted at the meeting of ECOFIN in December 2013. According to the declaration, when the Council of the EU is to take a decision on the above-mentioned issue, the members of the Council of the European Union from the SSM/SRM countries agree among themselves whether to accept, reject or amend the proposal presented by the European Commission. The representatives of the Member States not participating in the banking union shall exercise their right to vote in a manner such that it does not block the adoption of the decision by the Council of the European Union in a way agreed by the Member States participating in the SSM/SRM.

The regulation introduces a division of tasks in the SRM between the SRB and the national resolution authorities. The SRB is responsible for the smooth and effective functioning of the whole mechanism. In particular, it is responsible for preparing resolution plans and adpoting decisions on resolution in the case of systemically important banks, banks subject to direct supervision of the ECB and cross-border banking groups. The national resolution authorities carry out tasks in relation to the remaining banks; however, they are responsible for activating the resolution process only when the SRF funds are not required. All the decisions on the resolution process which assume the use of SRF funds are taken by the SRB. The regulation also gives Member States the possibility to assign to the SRB all the tasks which can be carried out at a national level.

The regulation provides for the establishment of the Single Resolution Fund (SRF), the resources of which will be used to conduct the resolution process. The fund will be financed on an *ex ante* basis from contributions paid in by the banking sector. During the transitional period, which will last 8 years from the entry into force of the regulation, a dual system consisting of national compartments and a mutual part of the fund will function.

The principles for transfer of contributions by participating Member States to the Single Resolution Fund and the rules for use of the resources collected in the fund are contained in the intergovernmental agreement (IGA) signed on 21 May 2014[115]. The idea behind the adopted solutions is that the costs of the resolution process should, in the transitional period, be partly covered from national sources, and partly from mutualised fund, whereby the national compartments will be gradually reduced and the mutual part of the fund will be increased accordingly. In the first year, 40% of the funds will be mutualised, and in the second year - 60%. The remaining 40% will be mutualised gradually over the next 6 years. After the elaps-

[114] The text of the declaration is available on the website
http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%2018137%202013%20INIT.
[115] The signatories of the IGA are all the EU countries with the exception of Sweden and the United Kingdom.

ing of the transitional period, a single resolution fund will remain with a target level set at 1% of covered deposits of all credit institutions authorized in the SSM/SRM countries, which according to the 2011 data, constitutes approximately EUR 55bn. The IGA provides for temporary transfers of funds between national compartments and the use of alternative funding means. It should also be noted that the IGA regulates financial issues related to the entry into the SRM of Member States whose currency is not the euro, including transfer toward the SRF of an appropriate amount of contributions. The issues concerning the termination of close cooperation and exit from the SRM, including the recoupment of contributions paid in to the SRF, are incluced in the SRM Regulation.

3.2.5. Dilemmas related to the creation of the SRM

3.2.5.1.The decision-making process in the SRM

The arrangements for the decision-making process of the SRB should take into account the need for a rapid response and ensure the operational capacity of the resolution process. This requires an appropriate degree of centralisation of decisions, while taking into account the votes of the participating Member States. At the same time, the strength of the vote of a national authority should not depend on whether it represents home or host country. The decision-making process should therefore be appropriately centralised, and at the same time should ensure the right balance between the votes of home and host countries. It seems that the adopted voting arrangements for the SRB in its executive session fulfil this postulate. Members of the SRB in the executive session should strive to reach a joint agreement, otherwise the decision is taken by the chairman and the permanent members by a simple majority. This may urge the national resolution authorities to develop a compromise solution that takes into account, to the greatest extent possible, the opinions and remarks expressed by them.

The procedure for the final adpotion of the decision on activation of the resolution process seems to be too complex and time-consuming. In a crisis situation, when time is of the essence, decisions must be taken efficiently and swiftly. An ideal solution is to conduct the whole process within 48 hours (over the weekend). Hence, the decision-making process should be simplified to the maximum and should involve the minimum number of parties. The involvement of the Council of the EU prolongs the decision-making process and may introduce an additional element of uncertainty arising from the lack of clear premises for the Council decisions. Ideally, a resolution scheme adopted by the SRB should enter into force, unless the European Commission raises objections.

Due to the dynamic and unpredictable character of crises, it may prove necessary to revise or update the resolution scheme while carrying out the resolution process. The regulation confers such a right on the SRB; however, all changes must be once again submitted for approval to the European Commission and the Council of the EU. It seems that this may significantly slow down and hinder the rapid reaction of the SRB. Hence, in the optimal solution, another approval by the European Commission and the Council of the EU would be required only in cases where modifications introduced to the resolution scheme would increase the use of the SRF funds considerably.

Conclusions: *The decision-making process for the resolution procedure is multi-staged and involves many institutions, which makes it complex and time-consuming. As a result, this could weaken the possibility of a rapid response in a crisis situation and adversely affect the operationalisation of the resolution process within the banking union.*

3.2.5.2. Financing a resolution process[116]

It is essential to provide adequate funding of the resolution process. As the supervisory powers in the banking union are transferred to the European level, the resolution costs should also be covered from a mutual fund. This would be in conformity with the principle that responsibility for decisions taken and decision-making powers should be allocated at the same level of authority, i.e. at the European level. This would also help to break the negative feedback loop between the sovereigns and their banks. An additional argument in favour of this approach is the fact that the ECB conducted a comprehensive assessment of banks and their balance sheets before taking over supervisory responsibilities. This exercise was aimed at ensuring that banks under ECB supervision are well-capitalised and resistant to shocks. Thus, it will not be possible to argue that the bad situation of a bank is the result of negligence and omissions of the national supervisor, since the capital shortages identified by the ECB should be filled. It is assumed that banks entered the new system with "cleaned" balance sheets.

A key issue should be to ensure that the funds gathered in the SRF are mutualised from the beginning of the functioning of the SRM. The progressive mutualisation of the resolution funds in the banking union has at least three disadvantages: (1) it may perpetuate contradictions arising from the fact that decisions on bank supervision and activation of a resolution process have been moved to the central level, but a part of costs is still borne at the national level; (2) it does not allow to break the direct link between the financial standing of banks and the fiscal situation of euro area Member States (maintenance of the negative feedback loop); (3) it could cause tensions and conflicts of interests between decision-makers at the central and national level – representatives of national authorities will not be willing to place under resolution a bank operating in their jurisdiction, knowing that the majority of costs will have to be covered from national sources.

The weaknesses of the adopted financial arrangements presented above show that it is not an optimal solution. It would be desirable to create a single fund, without a division into national compartments, from the very beginning of the functioning of the SRM,. The following arguments are in favour of such an approach:

- A single fund in the SRM would simplify decisions on resolution financing, in particular, when the process concerns a cross-border group. Thus, as all funds would be mutual, the problem of burden sharing would disappear. Also, problems with possible transfers between national compartments would be eliminated. Faster identification of the means to finance the resolution would certainly accelerate the general decision-making process on the activation of the resolution procedure.
- During the transitional period a single fund would have at its disposal greater means than a fund which is only partly mutualised, thus increasing its financial capacity. A larger and better capitalised

[116] This fragment refers exclusively to the issue of financing from the Single Resolution Fund (SRF). However, it should be mentioned that the SRF funds are not the first and main source of covering resolution-related costs. In the first place these costs are to be borne by shareholders and the non-insured creditors of the bank under resolution through a bail-in (capital write-down and conversion of debt to equity). In addition, national deposit guarantee funds will also contribute to resolution financing.

SRF would contribute to greater effectiveness of the resolution process and would, therefore, enhance the credibility of the whole mechanism.

The credibility of funding arrangements will also largely depend on the creation of an adequate backstop, which could be used as a last resort when the SRF funds are exhausted. The ESM could play the role of such a backstop mechanism; however, this issue has not been finally settled yet. Moreover, an important dilemma is the fact that the ESM funds are available only to countries belonging to the euro area. In view of the above, while respecting the principle of equal treatment of all countries participating in the SSM/SRM, the possibility to ensure either an equivalent backstop mechanism also for the non-euro area countries or a new mechanism for all Member States participating in the banking union regardless of their currency, remains an open issue.

It should also be noted that recitals of the IGA, which will apply together with the SRM Regulation, indicate that during the transitional period a common backstop will be developed. Such a backstop should facilitate borrowings by the SRF. However, before such a backstop is available, in the transitional period Member States should ensure bridge financing from national sources or from the ESM.

Conclusion: *The weakness of resolution financing arrangements in the banking union is the lack of full mutualisation of the SRF from the beginning of its functioning.*

3.2.5.3. Participation in the SRM on the close cooperation basis (opt-in)

If a non-euro area Member State establishes close cooperation with the ECB, it becomes a member of both the SSM and the SRM. The acceding country pays in its contribution in an amount that would have been transferred if it had participated in the SRM from the beginning of its existence. If close cooperation with the ECB is terminated, the participating country whose currency is not the euro automatically ceases to be a member of the SRM as well. This entails an obligation to establish a national resolution fund in accordance with the BRRD. The SRM Regulation provides for the recoupment of contributions that the Member State concerned has transferred to the SRF; however, the decision on the amount of financial means to be recouped shall be made by the SRB, taking into account the following criteria: (i.) the reason for terminating close cooperation with the ECB, (ii.) resolution procedures in progress, and also (iii.) the economic cycle of the Member States leaving the SSM/SRM. Nevertheless, the funds should be recouped in an amount sufficient to fulfil the requirements of the BRRD on having in place an appropriately funded national resolution fund.

It should be noted that the recoupment of contributions is assessed differently from the perspective of the euro area and from the perspective of a participating Member State whose currency is not the euro. For euro area countries, reimbursement of contributions already paid in by an opt-in country is not advantageous, since it diminishes the funds of the SRF. However, from the point of view of a non-euro area country exiting the SSM/SRM, such recoupment is extremely important. Otherwise, the country leaving the banking union would be forced to establish a national resolution fund required by the BRRD in a very short time, which would impose a significant burden on the banking sector. Moreover, it cannot not be excluded that during the period of creating the national resolution fund, it might prove necessary to carry out a resolution process in its jurisdiction. The absence of a resolution fund could constitute a threat to the effective conduct of this process and thus to financial stability.

Another important issue for non-euro area countries considering joining the banking union is the back-stop. To a certain degree, the ESM could be treated as such a backstop; however, some changes to the rules of its functioning would be necessary. Moreover, an important weakness – from the point of view of an opt-in country – is the fact that non-euro area Member States cannot use ESM funds, even if they decide to join the banking union. In the optimal shape of the banking union one backstop mechanism equally accessible to all participating countries should be ensured. Such a mechanism, strengthening the financial capacity as well as the credibility of the SRM, could be an incentive to join the banking union.

Conclusion: *The fact that the amount of funds recouped to an opt-in country leaving the SRM is discretionary and depends on the SRB judgment, puts into question the rationality of the decision on establishing close cooperation with the ECB. Moreover, from the point of view of opt-in countries, a weakness of the SRM financing arrangements is the absence of a backstop mechanism accessible for participating countries whose currency is not the euro.*

3.2.5.4. Relations with countries outside the banking union

The complex decision-making process could hinder cooperation and coordination of crisis measures taken by the SRM and countries not participating in the banking union. This is extremely important in the case of a cross-border group resolution, particularly of banks headquartered in the euro area whose subsidiaries or branches operate outside the banking union. From Poland's perspective, as a country out-side the banking union, an extremely important issue is the SRB due analysis of the effects that the measures undertaken within the SRM will have on financial stability in non-participating countries[117].

Should it be necessary to activate a resolution process in relation to a cross-border group with its head of-fice on the SSM/SRM territory, the SRB in its executive session shall cooperate within the resolution colleges with the resolution authorities of non-participating countries in which the group has subsidiaries or branches. Such an obligation to cooperate arises from both the SRM Regulation and the BRRD, which gov-erns relations between the SRM, represented by the SRB, and resolution authorities of non-participating countries. While such obligation to cooperate should be assessed positively from the perspective of a coun-try remaining outside the banking union, there are two aspects that could hinder effective cooperation in practice.

- Many parties will be involved in the process of developing a resolution scheme. On the part of the SRM this will be the SRB in its executive session, and in specific cases also in a broader plenary com-position. Moreover, resolution authorities of non-participating countries where a given group has its entities will also participate in this work. Reaching a compromise on the resolution scheme within such a large group will be challenging, particularly in a short time.
- It is possible that decisions agreed within the resolution colleges, i.e. between the SRB and resolution authorities of non-participating Member States, could be questioned by the European Commission or the Council of the EU within the SRM internal decision-making process. In such a situation, non-participating countries cannot be sure that the resolution scheme agreed within the resolution college will be in fact realized. In the event that the resolution scheme proposed by the SRB is modified by the

[117] Such an obligation arises from art. 6 of the SRM Regulation.

European Commission or the Council of the EU, and its final version does not correspond with the earlier arrangements agreed with the resolution authorities of the countries outside the banking union, these countries should be prepared to undertake independent resolution measures.

It should be mentioned that in accordance with the BRRD, a national resolution authority may object to a group resolution scheme and undertake independent measures to safeguard financial stability in its jurisdiction. This means that for non-participating countries, it is desirable to have in place a robust national financial safety net and a resolution fund with high financial capacity.

Conclusion: *The complex decision-making process involving many parties (SRB, European Commission, Council of the EU) is a weakness of the SRM, which in a crisis situation could materialise and thus it discourages countries from joining the banking union. Staying outside the SRM, will enable Poland to undertake its own independent decisions on resolution of local institutions, in accordance with the BRRD.*

3.2.6. The third pillar of the banking union – deposit guarantees

An important element of the banking union should be a Single Deposit Guarantee Scheme (SDGS). In Van Rompuy's first report of June 2012 (Van Rompuy, 2012a) it was argued that the integrated financial framework in the EU should also include the European system of deposit guarantees, but in later editions of the report (from October and December 2012) this proposal disappeared. At the initial stage there are no plans to establish a third pillar of the banking union, i.e. a single deposit guarantee system. After reaching a compromise on the SRM Regulation, it was announced that the banking union was completed[118], which shows the lack of political will to continue work in this respect. Responsibility for deposit guarantees in the euro area will continue to rest with the national authorities, despite the fact that supervision and assessment whether a bank meets conditions for resolution are in the hands of the ECB. However, the problem is that the credibility of the deposit guarantee system depends on the credibility of the government which stands behind it. Depositors may fear that their deposits will not be paid out in the case of a bank failure when a state itself is in a weak financial condition – this happened in Ireland, Cyprus, Greece and Spain.

The creation of an SDGS also seems to be important in the light of the provisions of the SRM Regulation. Pursuant to the regulation, national deposit guarantee funds may contribute to the financing of a resolution[119]. As a result, part of the responsibility for the decisions taken at the supranational level remains at a national level, which may cause additional tensions between countries in the decision-making process. The creation of a single deposit guarantee scheme would help to eliminate this inconsistency.

At least in the medium term, deposit guarantees in the banking union will be based on a harmonised network of national deposit guarantee funds, which was achieved by the amendment of the directive on DGS. The main harmonized areas are the following: (i.) the method of financing the national deposit guarantee funds – on an *ex ante* basis, (ii.) the target level of the deposit guarantee fund – 0.8% of covered deposits, (iii.) payout period – 7 working days to be reached in 2024. In addition, the possibility to make mutual voluntary borrowing between national deposit guarantee funds was introduced. It seems that harmonisa-

[118] Statement of the President of the European Commission, J.M. Barosso of 20.03.2014, http://europa.eu/rapid/press-release_STATEMENT-14-77_en.htm?locale=en.

[119] The deposit guarantee schemes participate in the financing of the process via the bail-in mechanism. The deposit guarantee scheme shall be liable for the amount of covered deposits.

tion of the way national deposit guarantee funds are financed and voluntary borrowings between the national DGSs introduced by the DGS directive are the only forms of centralisation that have been allowed in this area at the initial stage of the banking union.

However, the effectiveness of the banking union requires the creation of all of its pillars at a centralised level. While supervision is conducted by the central authority – the ECB – similarly responsibility for the safety of bank deposits should also be centralised and in this way separated from the fiscal situation of an individual country.

When assessing the existing deposit guarantee scheme in Poland, it should be stressed that it is effective and has high financial capacity. The new directive on DGS introducing further harmonisation of the deposit guarantee schemes in the EU does not affect the functioning of the Polish deposit guarantee fund, which has been financed on an *ex ante* basis from the beginning of its existance and already exceeded the target level set in the directive. The shortening of the payout period to 7 days is a purely technical adjustment. The absence of a third pillar of the banking union, namely a single deposit guarantee scheme means that the possible accession of Poland to the banking union on an opt-in basis would not require any changes in the functioning of the Bank Guarantee Fund concering the management of the national deposit guarantee scheme.

Conclusion: *The absence of the third pillar of the banking union should be assessed as a weakness of the banking union from the point of view of both the euro area and non-participating countries, including Poland. Without an SGDS, the European financial safety net will not ensure the full achievement of the purpose of the banking union, which is, among others, to break the negative feedback loop between the banks and public finance.*

Summary Part I

The sovereign debt crisis revealed numerous weaknesses in the institutional set-up of the euro area in the field of (i) fiscal integration, (ii) economic integration and (iii) financial integration. The existing mechanisms proved to be insufficiently effective to prevent the build-up of fiscal and macroeconomic imbalances, as well as imbalances in the financial system. In addition, the experience of the last crisis has highlighted the need to introduce common crisis management mechanisms.

The weaknesses revealed by the crisis have led to a series of institutional changes in the euro area. Despite the fact that the reforms already in place and in the process of being implemented cover many aspects of the functioning of the single currency area, they do not change fundamentally the present institutional model of the euro area, based on the combination of a common monetary policy and decentralised fiscal and economic policy, coordinated – to various degrees – at an EU level. In this respect, the changes in banking supervision, centralising decision-making competences at a supranational level, can be described as the furthest-reaching.

Emergency financing for governments and fiscal integration

The introduction of permanent emergency financing mechanisms for governments of the euro area (ESM) as well as the ECB' s announcement of a programme of conditional government bond purchases (the OMT programme) was a very important policy change. The introduction of these mechanisms significantly reduced the risk that liquidity crises in the government securities markets, triggered by a sudden increase in risk aversion among financial market participants (not necessarily related to changes in the economic fundamentals), will threaten the stability of public finance and the financial sector, not only of individual economies, but of the whole of the euro area. Thanks to the introduction of the ESM and the announcement of the OMT programme, the threats to the stability and integrity of the euro area have been significantly reduced.

Despite comprehensive changes introduced in response to the crisis as regards formulating and disciplining fiscal policy in the euro area, among some economists there is a conviction that there is a need for further fiscal integration in the region. In response to the institutional weaknesses revealed by the crisis, a series of changes have been introduced. Among them, in particular, the improvement in the construction of fiscal rules and measures aimed at strengthening the national fiscal policy frameworks may be regarded as positive. They increase the likelihood that the euro area countries will take into account the fiscal rules when formulating national policy and will take measures aimed at correcting deviations from the adopted rules. However, even after the introduced changes, the model of fiscal integration in the euro area is characterised by a series of weaknesses. These are, in particular, the following:

- **The potentially insufficient effectiveness of enforcement of the existing rules remains a threat to the effectiveness of fiscal policy coordination in the euro area**, including a risk of politicisation of commitments monitoring. The enforcement of European rules, despite a certain strengthening of the role of the European Commission, remains in the hands of the Council for Economic and Financial Affairs (ECOFIN). At the same time, the departure from the no bailout principle and the introduction of

solutions based on mutualisation of national macroeconomic risks (ESM, OMT) could partly weaken the effectiveness of fiscal policy disciplining via the financial markets.

- **The current model of fiscal integration in the euro area is not fully adapted to the strong integration of financial markets.** Taking into account the incompleteness of the banking union under implementation, including the absence of a fiscal backstop for the Single Resolution Fund and the mutualisation of risk related to deposit guarantees (see above), there still exists a risk of negative bank-sovereign feedback loops as well as the risk of fragmentation of the financial markets. This may significantly hinder the effectiveness of the common monetary policy, particularly in crisis conditions. The above-mentioned problems could be reduced not only by the creation of a full banking union, but also by the mutualisation of national debt of the euro area and the issuance of common government securities, which would increase the effectiveness of such nonstandard instruments of monetary policy as government bond purchases in crisis conditions and in the face of looming deflation.
- **The absence of a fiscal capacity, which would help mitigate the costs of adjustment to asymmetric shocks, translates into a higher volatility of GDP and employment over the business cycle and hinders the formulation of an appropriate policy mix in the euro area.** In the case of shocks, the countries must rely on their own stabilising fiscal policy, whose room for manoeuvre is dependent on the public finance discipline of the previous years. As the experience of recent years shows, a fiscal capacity would be useful in the case of large shocks, when the alleviation of the adverse developments with the help of national fiscal policy could threaten the stability of the public finance sector. The potential benefits of implementing a fiscal capacity are now also increased by the fact that for many years highly-indebted euro area countries will not have sufficient room to conduct counter-cyclical fiscal policies.

The need for a fiscal capacity may be limited by measures that enhance alternative mechanisms of adjustment to macroeconomic shocks: the creation of a full banking union, the strengthening of the national frameworks for budget policy, the reduction of a home bias among investors in the case of equity assets, facilitating labour force mobility and improving the effectiveness of resource reallocations, and also further development of the single market for services.

The strengthening of disciplinary mechanisms for fiscal policy should be the condition for deeper financial integration of the euro area through the creation of fiscal capacity or mutualisation of debt. In particular, it seems of key importance to restore the credibility of the no bailout clause or increase the powers of the central institutions to control the national fiscal policy, while simultaneously increasing the level of democratic control and accountability of these institutions.

The deepening of fiscal integration between euro area countries would be beneficial for Poland as a future member state, provided, however, that the solutions in this respect are suitably designed. The creation of a fiscal capacity and mutualisation of the debt of euro area countries could improve the functioning of the currency union. However, for Poland it is important that the solutions deepening fiscal integration in the euro area have the greatest possible capacity to stabilise the business cycle. They should, at the same time mitigate the risk of moral hazard and reduce the scale of any possible permanent transfers from the Polish economy to other economies, or – if such types of transfers are to occur – they should guarantee a high level of democratic control and accountability of the institutions managing such mechanisms.

At the same time, the necessity to harmonise rules related to the further deepening of fiscal integration in the euro area may translate into reduced cost competitiveness of the Polish economy. This increases

the necessity of preceding the euro area membership with a strengthening of structural competitiveness of the Polish economy.

Economic integration

As in the case of fiscal integration, the changes implemented in the area of economic governance only modify the mode for formulating and coordinating economic policy in the euro area which was in force before the crisis. The changes in the area of economic governance in the euro area that were implemented in response to the crisis are, above all, aimed at reducing the risk that the national authorities will not react to growing imbalances that threaten macroeconomic or financial stability. In comparison to the solutions in force before the crisis, an important change is the enhanced possibility of the European Commission and the Council of the European Union to influence the economic policy of those countries facing significant macroeconomic imbalances, including financial imbalances.

Although at the moment it is difficult to ascertain definitely whether the changes introduced will – as assumed – effectively reduce the threats related to macroeconomic imbalances in the euro area countries, one can list the following doubts regarding such an assumption:

- Solutions in the field of economic policy coordination, applicable to euro area countries – similarly to those functioning before the financial crisis – assume *a priori* existence of strong market incentives for the national authorities to undertake reforms, ownership of the recommendations of the EU institutions and high efficiency of such mechanisms of influence on economic policy such as peer pressure or the pressure of public opinion. However, the experience of the functioning of the euro area indicates the insufficient effectiveness of such mechanisms.
- In the euro area there are no effective solutions in place to encourage euro area countries to introduce significant changes in their economic policy before macroeconomic imbalances occur or before financial stability of these economies is significantly threatened.
- A key challenge for economic policy in the euro area is the strong structural heterogeneity of its member states. This issue has been addressed only to a small extent by changes in the economic policy governance framework that were introduced in the wake of the economic crisis. As a result, the euro area economies respond differently to common shocks which poses a risk of a permanent income divergence between member states.

The proposed responses to some of the above-mentioned weaknesses of the current model of economic governance are as follows:

- ***Ex ante* coordination of plans of the major reforms.** This instrument, which was supposed to take the form of a discussion at an EU level of plans for reforms of significance for the functioning of the euro area, will most probably not solve the fundamental problems related to the current model of economic policy coordination. The evaluation and discussion of major economic reforms will not reduce significantly the risk of their asynchronous implementation being a source of asymmetric shocks in the euro area countries. Moreover, considering the challenges related to identifying reforms, which should be covered in the coordination process, spillovers induced by their implementation and the best practices in a particular field, as well as the natural divergence of interests between member states, this procedure should not be expected to have a significant impact on the shape of the planned economic re-

forms and the functioning of the currency union. Thus, the implementation of this instrument will not have a major significance from the point of view of the balance of opportunities and threats related to Poland's adoption of the euro.

- **Multilaterally agreed contractual agreements and the accompanying solidarity mechanism.** This instrument would establish incentives for sufficiently early adjustments to economic policy. The introduction of this instrument is desirable, above all, in the context of the absence of a fiscal capacity in the euro area. This is related to the need to improve business cycle stabilisation in those countries of the region which are characterised by significant structural weaknesses and a high level of public debt, and thus are at risk of permanent divergences. For this instrument to become a tool reducing the risk of income divergence and structural heterogeneity of the euro area economies, it would be desirable – contrary to the earlier plans – to ensure the possibility for the countries under macroeconomic adjustment programmes to make use of this instrument. In addition, the forms of granting assistance should take into account the fact that countries in which the application of this instrument would be most desirable post a high level of public debt, and are at the same time characterised by an unfavourable structure of production. Nevertheless, even if properly designed, contractual agreements, supported by a solidarity mechanism, will only be able to moderately reduce structural divergence between member states of the euro area. Therefore, their implementation would change only slightly the balance of opportunities and threats related to Poland adopting the euro. Joining the mechanism of contractual agreements, supported by a solidarity mechanism, in the period prior to Poland's membership of the euro area could, however, accelerate measures aimed at increasing the structural competitiveness of the Polish economy.

In view of the limited opportunities to deepen economic integration among member states of the euro area through stronger coordination of their policies, and also assuming that the areas covered by common policy are not extended, it may be desirable to accelerate harmonisation of rules in areas which have a significant impact on the functioning of currency union. This would be desirable, in particular, in those areas which have an impact on labour and capital mobility between countries and the ability to relocate resources. The above-mentioned postulate has been reflected in the Single Market Act II, aimed at a faster completion of the single market for services. Also the labour market institutions may require deeper harmonisation across euro area countries. Their diversity translates into significantly asymmetric reactions of the economies to common shocks.

Financial integration

The crisis has also triggered substantial institutional and regulatory changes in the financial system, which aim at increasing harmonisation and integration of the supervisory system, proportionally to the degree of single market integration, i.e. limiting the powers of the financial safety net at the national level in favour of an increased role of European institutions. This was achieved through the following measures:

- **the establishment of the European Supervisory Authorities,** responsible for setting common standards and regulatory and supervisory practices for the EU financial sector as well as the resolution (through mediation) of conflicts between the national competent authorities.
- **the establishment of the European Systemic Risk Board,** i.e. the introduction of macro-prudential supervision as a new element of the financial safety net, **as well as – in accordance with its recommendation – the creation of authorities responsible for macro-prudential policy at the national level.**

- **the harmonisation of** crisis management **regulations** (with respect to restructuring and resolution of banks) as well as the functioning and financing of deposit guarantee funds in the EU.
- **the creation of a banking union,** consisting of a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM).

The banking union should be recognised as a historic venture and a key element – after the creation of the currency union – in the construction of a full Economic and Monetary Union. The banking union is an attempt to limit the following pre-crisis weaknesses of the financial safety net:

- **the discrepancy between the cross-border banking model in the EU and the allocation of supervisory powers at the national level.** During the financial crisis this resulted in a negative bank-sovereign feedback loop in particular countries. Moreover, national supervisory policy actions taken in response to the crisis were not always appropriate (unwillingness to reveal capital needs of banks).
- **insufficient effectiveness of coordination of the activities** carried out by individual member states to safeguard financial stability and manage the crisis on the EU scale.

The banking union was created relatively quickly since the project was introduced as a response to the crisis. The need to proceed rapidly excluded the possibility of implementing reforms by way of treaty changes, which would have allowed to strengthen the legal foundations of the functioning of the SSM/SRM and address the need to ensure equal rights and obligations of euro area countries and those non-euro area countries which decide to join the SSM/SRM on a close cooperation basis. Establishing the banking union in such a way resulted in rather complex institutional structures and decision-making processes, both in the SSM and the SRM, which may hinder their day-to-day functioning, and above all, be an obstacle in effective crisis management. As regards the first pillar of the banking union, i.e. the single supervisory mechanism, the following may be highlighted:

- an important condition to ensure the smooth functioning of the SSM will be to precisely define cooperation mechanisms between the ECB and national supervisory authorities in practice. This is important in order to avoid duplication of work, reduce the risk of conflicts of competencies, as well as gaps, and ensure an appropriate division of resources between the ECB and the national authorities.
- it is important to resolve the issue of the actual division of work on macro-prudential decisions between the Supervisory Board and the Governing Council of the ECB. Decision-making powers are in the hands of the Governing Council of the ECB, which, supported by the Financial Stability Committee of the ECB, has greater experience in the field of analysis and actions taken to ensure stability of the financial system as a whole than the Supervisory Board, which is a micro-prudential authority composed of representatives of national supervisory authorities.
- the establishment of the SSM will require strengthening the role and independence of the ESRB. The ECB in its supervisory capacity will – in accordance with its legal mandate – focus on the banking sector of SSM countries. Meanwhile, the strengthening of the ESRB will foster the adoption of a cross-sectoral approach and identification of systemic risk in the medium- and long-term perspective with respect to the whole EU.

As regards the second pillar of the banking union, i.e. the single resolution mechanism, the following weaknesses may be identified:

- **Effectiveness of the decision-making process:** the decision-making process on activation of resolution procedures is multi-staged and involves many institutions, which makes it complex and time-

consuming. As a result, it may weaken the possibility to respond rapidly in a crisis situation and may have an adverse impact on the conducting of the whole resolution process.

- **Financing of the resolution process.** Having in place – even in the transitional period – a model which allows simultaneous functioning of national compartments and a mutual fund constitutes a departure from the original idea behind the banking union. This is inconsistent with the transfer to the European level of decision-making powers in the field of supervision and resolution and weakens the possibility to break the negative bank-sovereign feedback loop of individual member states. Furthermore, this may also generate conflicts of interests between decision-makers at the national and central level.

An important element of the banking union should also be a Single Deposit Guarantee Scheme (SDGS). In a situation in which the supervision over the banking sector in the euro area and in countries that establish close cooperation is exercised by the central authority – the ECB – the responsibility for the safety of bank deposits should also be centralised and thus separated from the local deposit guarantee fund and ultimately, from the fiscal situation of the member state concerned. The lack of a single deposit guarantee scheme should be recognised as a major inconsistency of the banking union, weakening the possibility to achieve its aims. The fact that the creation of the third pillar of the banking union was abandoned means that fiscal responsibility for the costs of a banking crisis will still to a great extent rest on the member states.

From the perspective of a non-euro area country, including Poland, the weaknesses of the banking union negatively impact the cost-benefits analysis of establishing close cooperation with the ECB. In particular, unequal positions of countries participating in the banking union, depending on their euro area membership, result in a lack of cohesiveness of the pan-European mechanisms and limited influence of opt-in countries on the decision-making process within the SSM as well as a lack of access to capital support from the ESM. In addition, an open issue is the limitation of risk for opt-in countries with respect to the potential centralisation of capital and liquidity management within the SSM. As indicated earlier, the gradual mutualisation of the resolution fund and the abandonment of the creation of a single deposit guarantee scheme are additional shortcomings of the banking union.

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ESRB Recommendation (2013), Recommendation of the European Systemic Risk Board of 4 April 2013 on intermediate objectives and instruments of macro-prudential policy, ESRB/2013/1, Official Journal of the European Union C170 of 2013.

Regulation (EU) No 1022/2013 of the European Parliament and of the Council of 22 October 2013 amending Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority) as regards the conferral of specific tasks on the European Central Bank pursuant to Council Regulation (EU) No 1024/2013.

Part II. Strengthening the potential of the Polish economy

Introduction

Analyses conducted at NBP before the onset of the financial crisis show that the benefits of adopting the euro outweigh the costs. In the *Report on full membership of the Republic of Poland in the third stage of the Economic and Monetary Union* (NBP 2009) it was shown that in the case of Poland, the adoption of the euro should lead to a pick-up in economic growth and consequently, increased welfare. The reasoning was as follows: the adoption of the single currency through a reduction of transaction costs in foreign trade, elimination of risk resulting from exchange rate fluctuations of the zloty in relation to the euro, the fall in interest rates and the increase in macroeconomic stability and credibility of the country will lead to trade intensification and growth in investment, both domestic and foreign, and consequently a rise in the level of GDP per capita. The main cost would be the loss of independent monetary policy, carrying the risk of a credit boom and the loss of competitiveness as a result of the excessive growth of prices and wages. To sum up, the results of the NBP report, presented in the Strategic Guidelines for the National Euro Changeover Plan (Ministry of Finance 2010), stated that the cost-benefit analysis clearly shows that "*The benefits outweigh the costs of euro adoption, both in the short and long term*".

However, the experience of the recent crisis shows that the scenario of accelerated GDP growth should be treated rather as an opportunity associated with the adoption of the single currency. It has turned out that due to the fragmentation of the financial markets, increasing the costs of public debt servicing and impeding access of households and firms to bank finance, a number of euro area countries have experienced an increased amplitude of business cycle fluctuations. Moreover, an analysis of the trends observed since the establishment of the euro area shows that integration of the financial markets and the fall in interest rates after adoption of the euro bears the risk of a build-up of macroeconomic imbalances, e.g. in the form of real estate bubbles. The above observations show that the estimates of the benefits and costs balance of euro adoption are subject to much greater uncertainty than it was thought before the crisis (see also Ministry of Finance 2014). In this context, the scenario of accelerated growth after adoption of the single currency should be treated as an opportunity which one should know how to seize.

In light of the above, the main aim of this part of the report is to analyse the experience of individual euro area states in order to draw conclusions on how to prepare the Polish economy to function properly in the common currency area. In particular, on the basis of fifteen years of experience of the functioning of the euro area, an attempt has been made to determine which structural features of the member states economies have increased the likelihood of the scenario of accelerated economic growth, and which have increased the risk of the build-up of macroeconomic imbalances and higher amplitude of cyclical fluctuations. In this sense, this part of the report does not constitute a comprehensive analysis of the effects of euro adoption on the Polish economy. It presents only a discussion aimed at preventing a situation in which Poland would repeat the mistakes made by other countries which decided to adopt the euro in the past. It deals with neither the political effects of adopting the euro, the importance of which (it seems) has grown in the recent period, nor the broader spectrum of macroeconomic effects. It focuses exclusively on the challenges, and in that sense it constitutes a checklist of things that need to be done before adopting the euro.

In particular, the following four areas have been classified to constitute a potential challenge in the context of the smooth functioning of Poland in the euro area:

- the process of nominal and real convergence,
- cost-price and structural competitiveness,
- structural diversification of the economies forming the euro area,
- the effectiveness of preventive and adjustment mechanisms.

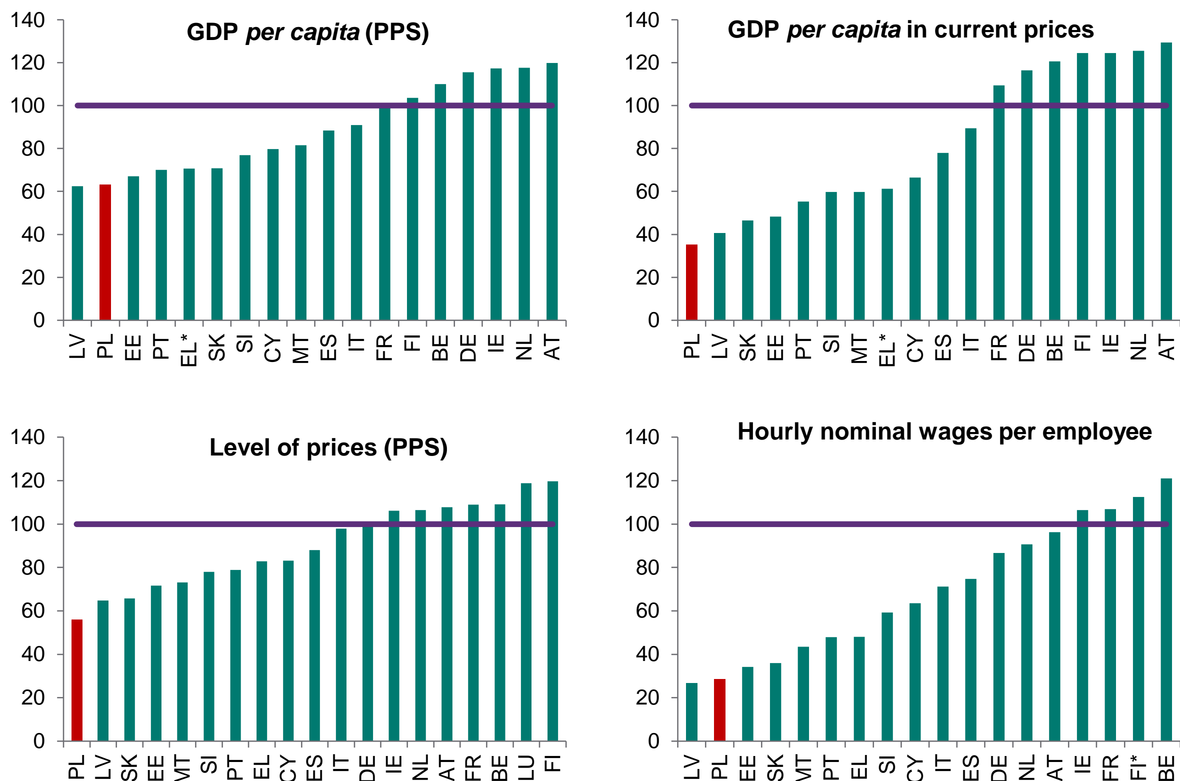
Each of the discussed areas constitutes the subject of each successive chapter of this part of the report.

The analyses show that the adoption of the euro should be preceded by structural adjustment of the Polish economy so that it is prepared to seize the opportunities associated with its membership in the euro area and, at the same time, not exposed to the risk associated with the adoption of the single currency. The adoption of the euro is an opportunity to accelerate GDP growth and increase the welfare of Polish society. However, it is necessary to know how to seize this opportunity. Otherwise, as the experience of the recent crisis has shown, the single currency could increase the risk of the build-up of imbalances and raise the amplitude of cyclical fluctuations, which could slow down the economic development of the country temporarily or even permanently. This part of the report analyses the experiences in the field of heterogeneity of economic structures as well as the development of the macroeconomic situation in euro area countries in order to determine which factors could underlie the success or failure after Poland's adoption of the single currency. The results of the analysis show that the condition necessary to ensure macroeconomic stability and success in the euro area is support for a programme of reforms aimed at strengthening the economic fundamentals, as well as adjusting the structure of the Polish economy to the characteristics of the euro area.

Chapter 1. Real convergence

The level of GDP *per capita* in Poland is lower than in the euro area, which is reflected in the lower level of prices and wages. In 2013 GDP *per capita* in purchasing power standards was 37% lower in Poland than in the euro area (Figure 1, top left-hand panel). The results of calculations of prices of comparable baskets of goods, which is carried out under the *International Comparison Program*, show that countries with a low level of GDP *per capita* are usually characterised by a lower level of prices than highly-developed countries. According to Eurostat data, in 2013 the level of prices in Poland was 44% lower than the euro area average (Figure 1, bottom left-hand panel). With both these two factors combined, Poland's development gap in relation to the euro area, measured in terms of GDP *per capita* in current prices, amounted to 65% in 2013 (Figure 1 top right-hand panel). It is also worth noting that wages in Poland are significantly lower than in the euro area: in 2013 hourly rates in Poland stood at only 29% of the average wages received by employees in the euro area (Figure 1, bottom right-hand panel).

Figure 1. Real and nominal convergence with the euro area in 2013 (euro area = 100)



Notes: * data for 2012.
Source: Eurostat, AMECO.

Along with Poland's gap narrowing in relation to the euro area, measured in terms of GDP *per capita*, one can expect a convergence in the level of prices and wages[1], i.e. an appreciation of the real exchange rate. The appreciation of the real exchange rate in economies experiencing relatively rapid economic growth, which has been described by Isard (2007) as the *Penn effect*, can be considered a stylised fact. The most well-known explanation of this phenomenon was proposed (in separate studies) by Balassa and Samuelson. In the Balassa-Samuelson model, the difference in the level of prices between countries arises exclusively from the differences in prices in the sector of goods that are not traded internationally, which in turn, result from different levels of wages at home and abroad. However, the level of wages is determined by the productivity of the employees in the sector of goods that are traded internationally, so that for these goods the law of one price still holds. Consequently, as less developed countries close their development gap, which is related to relatively faster growth in productivity in the tradable goods sector, the real exchange rate appreciates.

After joining the euro area, pressure on the appreciation of the real exchange rate, resulting from real convergence, will be manifested in higher inflation. Real appreciation may take place through the appreciation of the nominal exchange rate or higher inflation. In a country belonging to a currency union, the real appreciation of the exchange rate in relation to partners of the same currency area may take place only through the adjustment of prices. For these reasons, the convergence of GDP per capita, due to the appearance of the *Penn effect*, may be expected to exert additional inflationary pressure in Poland.

Table 1. The scenario of convergence of price levels

Assumed rate of price level convergence	1%	2%	3%
Relative price level	56.0%	56.0%	56.0%
Additional inflationary pressure in the first year	0.8 pp	1.6 pp	2.4 pp
Relative price level after 5 years	58.2%	60.2%	62.2%
Additional inflationary pressure after 5 years	0.7 pp	1.4 pp	1.9 pp
Relative price level after 10 years	60.2%	64.1%	67.5%
Additional inflationary pressure after 10 years	0.7 pp	1.2 pp	1.5 pp

Source: own calculations.
Notes: Additional inflationary pressure is the calculation of the *Penn effect* on inflation.

The scale of additional inflationary pressure – which depends on the assumed rate of real convergence – may range from 0.8 to 2.4 percentage points. A review of the literature analysing the pace of real convergence indicates that the rate at which the poorer countries close the income gap relative to richer countries is in the range between 1 and 2% annually (Islam 2003). In turn, the estimates of the European Commission (2004) based on the 1960-2003 data for the EU15 countries show that this rate was slightly over 2%. Indeed,

[1] Since joining the European Union (EU) in 2004, Poland's development gap in relation to the euro area measured in terms of GDP *per capita* in PPS has diminished by 17 percentage points, the difference in the level of prices has fallen by 9 percentage points, while the level of hourly labour costs in relation to the average level in the euro area has increased by 7 percentage points.

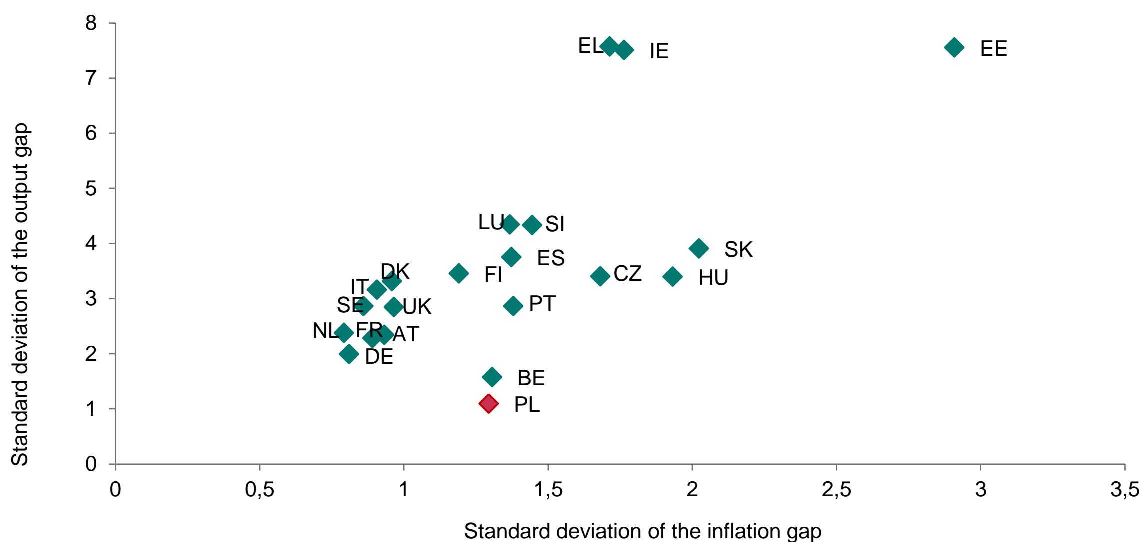
the past experience of Poland and the remaining Central and Eastern Europe economies indicates that the rate of convergence after the adoption of the euro may be higher than 2%. Let us further assume that the rate of price levels convergence is the same as the rate of real convergence. In such a case the achievement of the average level of GDP *per capita* prevailing in the euro area would lead to an equalisation of price levels. With the above assumptions, we can calculate the predictable additional inflationary pressure arising from the *Penn effect* after the adoption of the euro. The results, presented in Table 1, show that in the base scenario (2% convergence rate) the rate of appreciation of the real exchange rate, hence the additional inflationary pressure, may be expected to reach 1.6 percentage points annually. In the alternative scenarios this value is 0.8 and 2.4 percentage points respectively for the slow and fast convergence rate. It should be stressed that as the convergence process proceeds and the differences between the price levels disappear, the additional inflationary pressure associated with the *Penn effect* will slowly fade away (see the successive rows of Table 1).

Figure 2. Difference between the real interest rates in Poland and the euro area (percentage points)

Notes: Real interest rates are calculated by adjusting the nominal 3-month interest rates of the money market by the annual HICP inflation rate.
Source: Eurostat

The natural interest rate in Poland is probably higher than in the euro area. The natural interest rate, which is defined as the real interest rate guaranteeing stable inflation and a rate of economic growth at the level of its potential, is an unobservable variable. Therefore, it is difficult to determine with certainty whether and by how much it is higher in Poland than in the euro area. However, on the basis of selected studies (e.g. Brzoza-Brzezina 2006 and NBP 2009) it can be argued that its level in Poland is higher than in the euro area. For example, the estimates presented in the NBP report (2009) show that the natural interest rate in Poland is approx. 4%, while in the euro area it is approx. 2%. Historical data also show that since joining the EU, real interest rates in Poland have been on average 1.8 percentage points higher than in the euro area (Figure 2). Moreover, the analysis of macroeconomic volatility of the Polish economy indicates that the level of the real interest rate was well suited to its fundamentals. As Figure 3 shows, the variability of the output gap and inflation in Poland were among the lowest of the EU countries.

Figure 3. Internal balance of the EU countries in the years 2004-2013



Source: own calculations on the basis of Eurostat and OECD data.

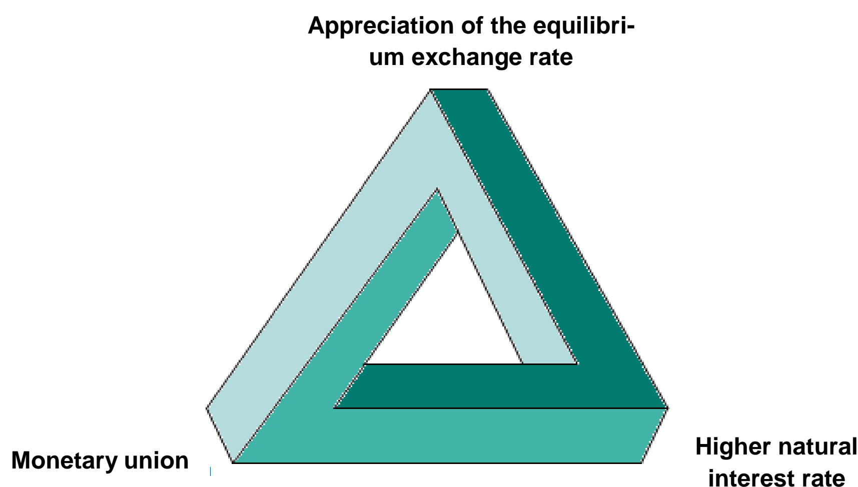
The above considerations suggest that the interest rates set by the ECB will most likely be too low in relation to the needs of the Polish economy. The difference in the level of natural interest rates together with additional inflationary pressure arising from the *Penn effect* could result in the ECB's monetary policy being not well suited to Polish conditions. Accepting the estimates from the previous points, it can be calculated that the nominal interest rates set by the ECB can be on average 2-3 percentage points below the equilibrium level for the Polish economy. However, it should be stressed that the above calculations are based on a series of assumptions, hence their reliability could be low. In addition, in the context of the discussion on the challenges posed by the adoption of the single currency, the difference in levels of the natural interest rate in Poland and the euro area should be considered in dynamic terms, i.e. taking into account its possible reduction as real, nominal and structural convergence progresses.

The long-term persistence of the real interest rate below its equilibrium level increases the risk of excessive credit expansion and the appearance of real estate bubbles. The low cost of capital after joining the euro area (arising from the fall in the real interest rate), combined with excessively optimistic expectations of income growth, increases the risk of inefficent capital allocation, i.e. such allocation that is not increasing the economic potential (Sławiński 2010). This can be manifested in excessive consumer credit expansion and a build-up of bubbles in the real estate sector. For example, Angello and Schuknecht (2009), on the basis of the panel data for 18 economies in the years 1982-2007, show that the level of short-term interest rates (along with changes in the level of income *per capita* and global liquidity) are one of the most important factors explaining the likelihood of the real estate bubble. OECD (2010) also shows that the low level of the real interest rate was the main factor behind the creation of the real estate bubble in Spain and Ireland.

The risk of a real estate bubble is greater in countries with an underdeveloped private rental market. Cuerpo et al. (2014), on the basis of a set of panel regressions for 15 EU countries and years 1970-2011, show that regulations promoting the development of the private rental market reduce the semi-elasticity between the interest rate and real estate prices. For example, ensuring the availability of housing for rent to low income households (including young people) in the phase of real estate bubble build-up could reduce de-

mand pressure and limit price growth, thus limiting the scale of later adjustment. In the case of Poland, the share of households living in appartments rented on the private market stood at 4% in 2012, which is 18 percentage points less than in the euro area (compared to Germany the difference is much greater – 35 percentage points). Therefore there is a danger that the underdevelopment of the private rental market in Poland could be an element reinforcing the response of the Polish economy to a fall in interest rates after adopting the euro, hence increasing the risk of building-up macroeconomic imbalances (a wider discussion on the real estate market is presented in Chapter 3).

Figure 4. Trilemma in the case of a country passing through the process of real and nominal convergence when joining a currency union



Source: own work.

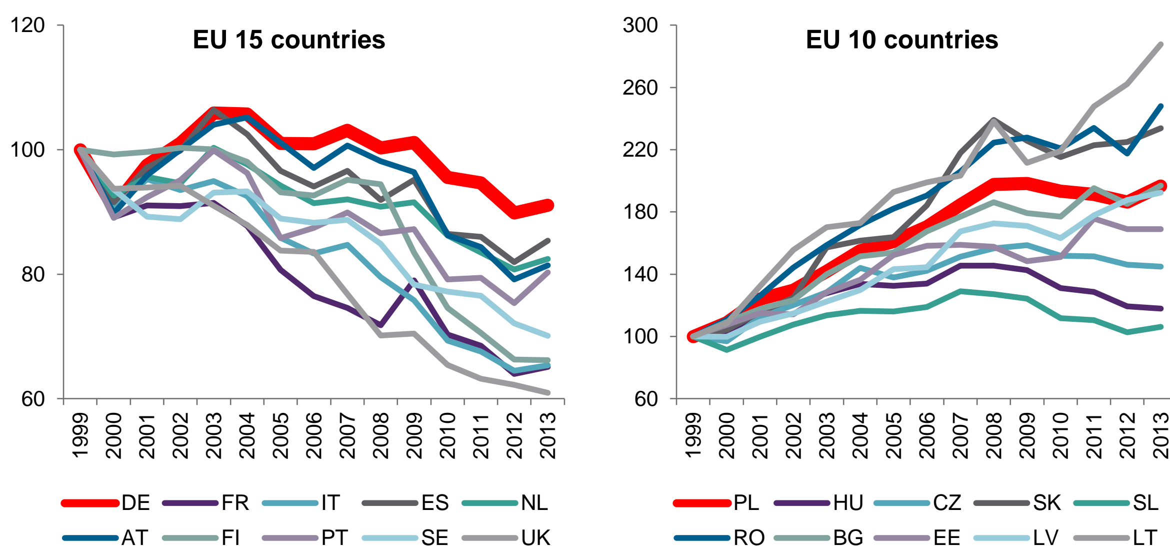
The above considerations can be illustrated with the help of a trilemma showing that in a country characterised by the appreciation tendency of the real exchange rate and a relatively high natural interest rate, there is a high risk of macroeconomic imbalances build-up after joining a currency union (Figure 4). Firstly, the real appreciation of the exchange rate, associated with price convergence, may occur only through higher inflation than in the euro area. Secondly, the euro area is a group of countries characterised by a higher degree of economic development than Poland; therefore the level of the natural interest rate is most likely to be lower there. Thirdly, after the adoption of the single currency, the level of nominal interest rates of the central bank will be the same in Poland as in the remaining euro area countries. As a result, the real interest rate in Poland is likely to run below the equilibrium level, increasing the risk of excessive credit expansion, the occurrence of real estate bubbles, and the growth of macroeconomic imbalances. The experience of the recent crisis in the euro area shows that when the real estate bubble bursts, a return to equilibrium entails the necessity to implement painful adjustments.

Chapter 2. Structural competitiveness

A very important challenge after the Eurozone accession will be to maintain the competitiveness of the Polish economy on the international markets. Poland's accession to the euro area means the loss of the possibility to adjust the nominal exchange rate (in relation to partners from the currency union) in response to changing economic conditions. Consequently, the adjustment of relative prices and costs, requiring a depreciation of the real exchange rate against the euro, could be made only through the internal devaluation channel, i.e. through a fall in wages, costs of production and relative prices. The experience of selected euro area countries shows that this may be accompanied by an increased amplitude of economic fluctuations and a temporary increase in the unemployment rate. Therefore, it can be argued that a very important element in the preparations for participation in the euro area is to guarantee that the competitiveness of the Polish economy has strong fundamentals.

Since the creation of the euro area, a strong heterogeneity has been observed in export market share (EMS) dynamics of individual EU economies. In the years 1999-2013 the loss of export markets by the old EU countries (EU15) was observed and, at the same time, the New EU Member States (EU10) were increasing their presence on the international markets. The heterogeneity was also noticeable within the EU15 and EU10 groups: among the EU15 countries, the largest falls were recorded by the United Kingdom, France and Italy, while Germany recorded the smallest decline. Among the EU10 countries, the highest growth was recorded by Lithuania and Romania, while the smallest was recorded by Slovenia and Hungary. It is worth noting that in the analysed period the growth of EMS in Poland was relatively high compared to the countries of the region and amounted to 97% (Figure 5).

Figure 5. Export market share of goods and services (1999=100)

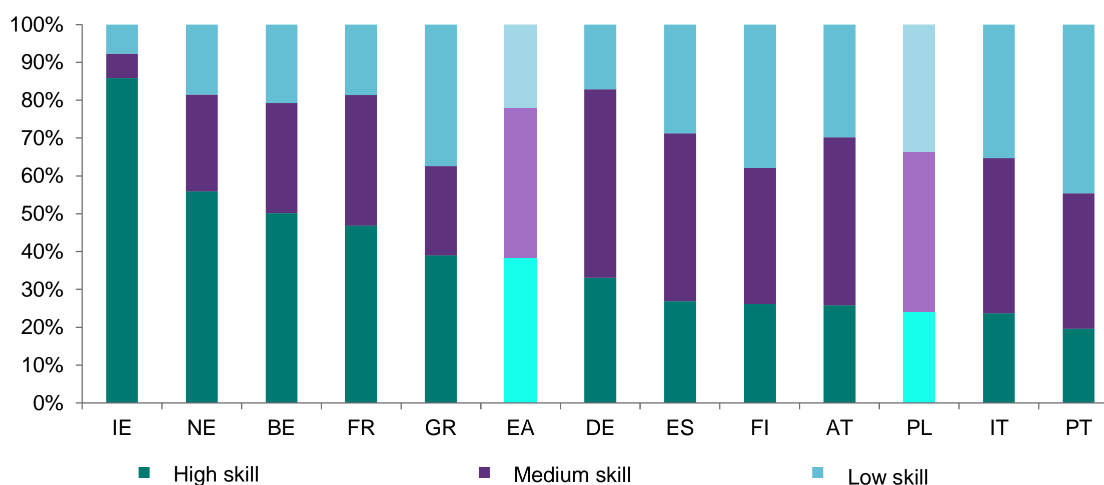


Source: Eurostat.

There are two dimensions of international competitiveness: cost-price and structural. The literature distinguishes two groups of factors determining the competitiveness of manufactured products of a country on the international markets. The traditional measure of competitiveness is the relative costs of production and the price of manufactured goods at home and abroad, which is measured by the real exchange rate. In accordance with traditional economic models, the appreciation of the real exchange rate, causing an increase in prices of the country's products, should lead to a fall in world demand for the country's goods. An alternative measure is non-price competitiveness, in other words structural competitiveness, which affects the quality and diversity of the country's export offer. In this case there is not one universally accepted measure. However, it is pointed out that structural competitiveness depends on the institutional environment of business as well as human and social capital, among others, through the influence of these factors on the innovativeness of the economy.

In the long term, success on international markets depends, above all, on structural competitiveness, and to a lesser degree on cost-price competitiveness. Kaldor (1978), on the basis of observations of many economies, showed that in the long term countries gaining export market share, contrary to traditional economic models, are characterised by an appreciating tendency of the real exchange rate. Attempts to explain this dependence, which is described in the literature as *Kaldor's paradox*, are as follows: the countries that were able to increase supply and improve the quality of goods offered on foreign markets, i.a. through advances in structural competitiveness, were also the countries which experienced a real and nominal convergence process, hence the appreciation of the real exchange rate (Fagerberg 1996). It should be noted that Kaldor's paradox provides a good description of changes that have occurred in Poland and selected countries of Central and Eastern Europe for the last fifteen years.

Figure 6. Degree of technical sophistication of exports



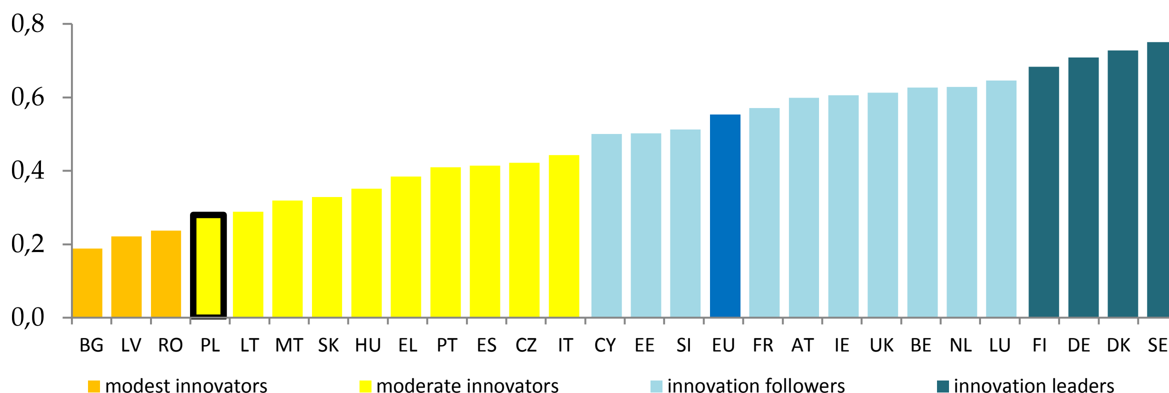
Source: Own calculations on the basis of UNCTAD.

Structural competitiveness is particularly important in technology-intensive sectors. The relative importance of structural competitiveness and cost-price competitiveness varies depending on the sector of the economy. The results of panel regressions on sectoral data for many economies show that cost-price competitiveness is more important for low-skill and technology-intensive sectors, while structural competiveness is more important for high-skill and technology-intensive sectors (e.g. Magnier and Toujas-Bernate 1994, Wakelin 1998, Montobio and Rampa 2005). In this respect, it is worth noting that, despite progress in recent years, the technological sophistication of Polish exports still remains below the average level for the euro area. In 2012 the share of high-skill and technology-intensive manufactures in Polish exports was 24%, compared to 38% in the euro area, while the share of low-skill and technology-intensive manufactures was 34% compared to 22% in the euro area (Figure 6). This is a sign of lower structural competitiveness of the Polish economy compared to the euro area. Moreover, this is a factor increasing the risk that Polish exports will be more sensitive to changes in relative manufacturing costs compared to other euro area economies.

Low structural competitiveness increases the risk of macroeconomic imbalances after adoption of the euro. Regardless of participation in the euro area, the structural weakness is a factor lowering the economic potential and slowing down the rate of real convergence. It is reflected in the lower level and slower growth of total factor productivity (TFP), a lower level of domestic savings, as well as smaller inflow of foreign direct investment. However, after adoption of the single currency, due to the lack of possibility to adjust the nominal exchange rate and the resignation of an independent interest rate policy, subdued structural competitiveness could have additional adverse effects. In particular, the experience of recent years shows that in the case of selected euro area countries, adjustment to the gradual growth in macroeconomic imbalances in the form of current account deficit and the accumulation of foreign debt, as well as the loss in the export market share, occurs later than in the case of countries outside the currency union. In this way the scale of accumulated imbalances is higher, while the adjustment process become more painful. For these reasons, it is very important to ensure high structural competitiveness of the economy before adopting the single currency.

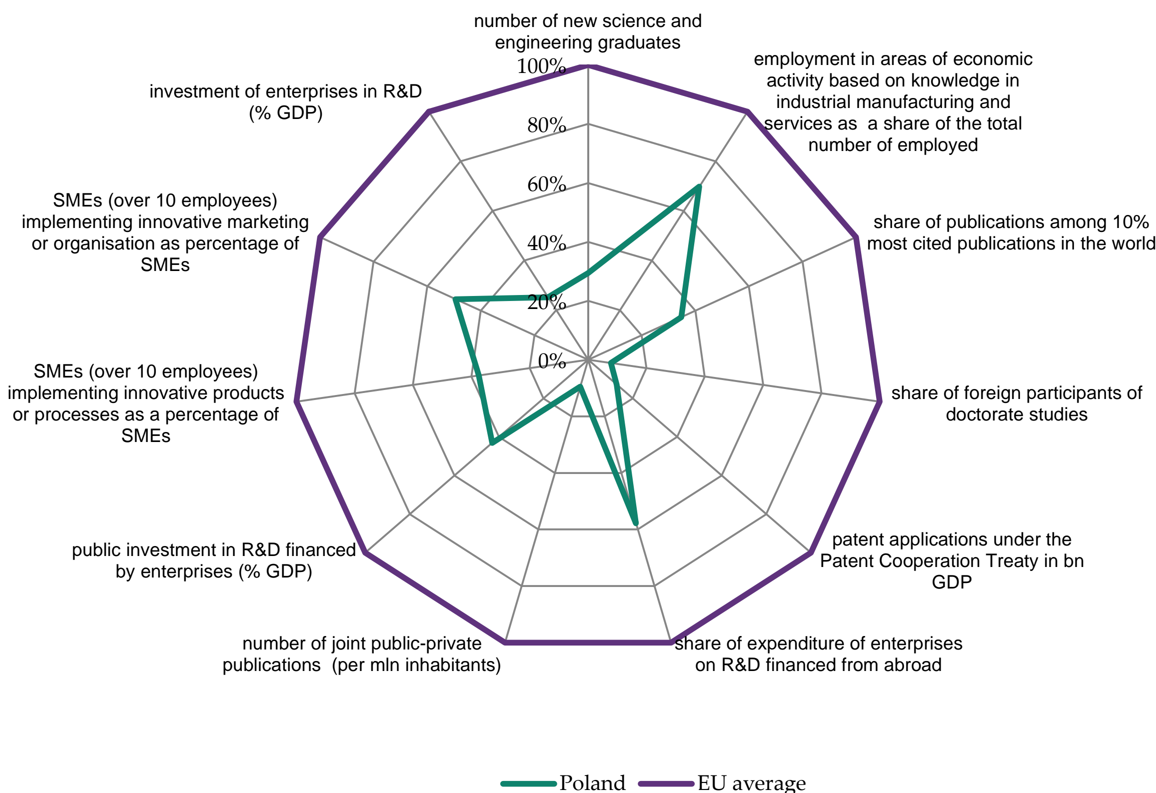
Compared to euro area countries, Poland is assessed as a country with a moderate degree of innovation, which may suggest problems with structural competitiveness. According to the Innovation Union Scoreboard indicator developed by the European Commission, in 2014 Poland was assessed relatively low compared to the remaining 26 EU countries: only Romania, Latvia and Bulgaria had worse results (Figure 7). Many factors contributed to this result. One of them was the situation of Polish education, measured, among others, by the number of publications in refereed international journals or the share of foreign students on doctoral studies. The second factor is the low effectiveness of cooperation between the public and private sectors. Thirdly, according to the European Commission, the character of the Polish system of innovation is based to a greater degree on the absorption of foreign technology than on internal R&D. It is also worth pointing to the relatively high percentage of companies that do not report any research and development activity (Figure 8).

Figure 7. Innovativeness of EU countries according to the Innovation Union Scoreboard 2014



Source: European Commission, Innovation Union Scoreboard 2014.

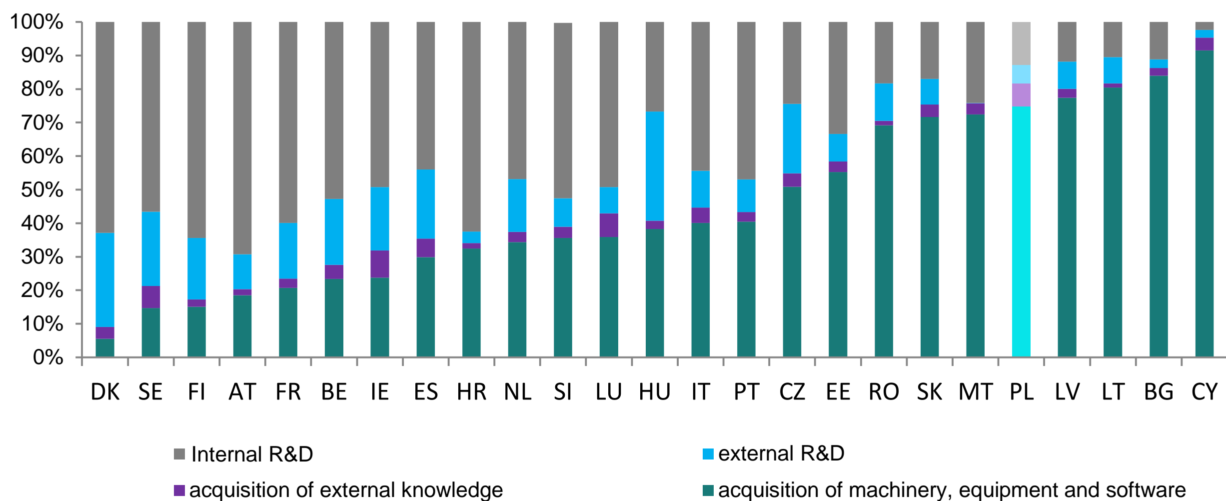
Figure 8. Poland in relation to the EU28 according to the main indicators of innovativeness in 2014.



Source: European Commission, Innovation Union Scoreboard 2014.

From the macroeconomic perspective, the relatively low innovativeness is partly a result of the low level of investment in R&D and the unfavourable structure of this investment. In 2012 the ratio of expenditure on R&D to GDP was merely 0.9% in Poland, i.e. less than half of what it was in the euro area (2.1%). The structure of this investment is also unfavourable. The share of the private sector is low in the total expenditure on research and development (32% in Poland in 2012, compared to 56% in the euro area in 2011). Moreover, in the case of enterprises, in 2010 as much as 75% of the financial resources on innovation was allocated for the purchase of machines, equipment and software, while only 13% of expenditure was allocated on internal R&D. This is clearly a much lower percentage than in main euro area countries (Figure 9).

Figure 9. Structure of enterprises' expenditure on R&D in 2010.

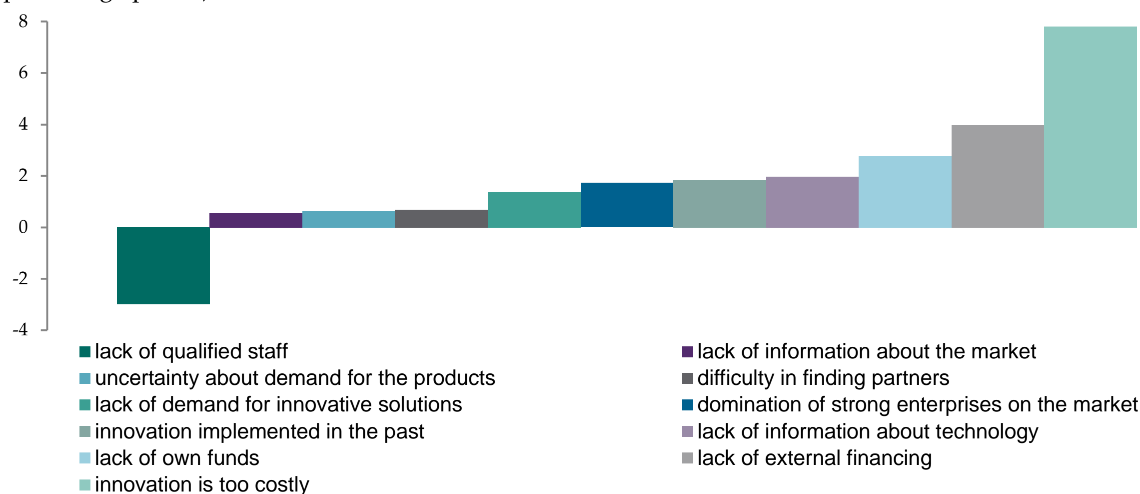


Source: Eurostat.

From the microeconomic perspective, an important barrier for the development of innovativeness in Poland is the high cost of innovation, combined with problems with access to external finance. The following barriers to the growth of innovativeness can be distinguished: (i) financial barriers, (ii) low effectiveness of public assistance mechanisms, (iii) lack of cooperation between enterprises and scientific institutions, and (iv) insufficient level of human capital. In the case of the innovative activities of Polish enterprises, the results of the *Community Innovation Survey* of 2010 show the important role of financial factors. Compared to companies from other countries of the EU, Polish enterprises often declare that the barrier to creating innovation is its high cost, combined with the lack of access to external finance and insufficient own funds. These problems are partly related to the shape of the state's innovation policy, among others, the limited possibilities to make tax reductions on expenditure incurred for research and development and the relatively low level of assistance in the form of grants from public sources[2]. However, it is worth noting that the lack of qualified staff is a relatively less important barrier for Polish enterprises than for companies from the remaining EU countries, which is evidence of the high level of human capital in Poland (Figure 10).

[2] According to OECD (2013) data, only 22% of Polish companies from the manufacturing sector that were introducing innovations declared that they had received support in the form of grants. In comparison, these values were 26%, 29%, 32% and 53% correspondingly for Germany, Spain, Italy and France.

Figure 10. The main barriers to innovative activity of enterprises (the difference between the share of enterprises declaring the importance of individual factors in Poland and the average in the EU countries in percentage points).



Source: Eurostat.

In the past, the development of innovativeness was limited by the low effectiveness of the use of European funds granted under the innovation support programmes. The World Bank's evaluation of the Innovative Economy Operational Programme implemented in 2007-2013 identifies the following weaknesses (Kapil et al. 2012):

- excessive support for large enterprises at the cost of SMEs and start-ups,
- excessive support for technology of a low and average level of technological advancement,
- excessive amount of resources (as much as 56%) allocated for supporting the research and development process at a later stage of research (commercialisation), in other words, at the moment when the risk of failure of the supported project is already relatively low,
- excessive support of low risk projects in the form of non-repayable grants (instead of loans). In the opinion of the World Bank, non-repayable loans should be applied rather in the case of risky projects, i.e. at an earlier stage of the research process,
- excessive focus on the formal side of projects and a preference for the services sector in the process of awarding grants,
- the low level of evaluation of grant programmes.

Despite its low innovativeness, Poland has experienced a significant increase in export market share. Poland, like selected countries of the region, is an interesting case of a country which is characterised by relatively good historical results (a clear increase in EMS) in conditions of low innovativeness. There are two possible explanations for this phenomenon. Firstly, as Montobbio and Rampa (2005) indicate, in the case of developing countries an alternative to developing internal innovations is to import the existing foreign technologies[3]. Secondly, labour costs in Poland stood at a very attractive level (Chapter 1), which has

[3] "Innovation as such is not crucial for the technological upgrading of developing countries. Imitation activities, adaptation to the local context of imported technologies, small incremental improvements, and learning-by-doing are more important. The

been increasingly exploited by foreign and domestic producers, along with the liberalisation of trade and the removal of barriers to foreign investment.

The convergence of wages after accession to the euro area will require a strengthening of structural competitiveness. The basic opportunity arising from accession to the euro area is the prospect of an acceleration in the rate of real convergence, including a growth in the relative incomes of households. However, this means an increase in the relative wages, hence a fall in cost-price competitiveness. **Therefore, in order to take advantage of the opportunity of faster economic growth and avoid an increase in external imbalances, it is necessary to ensure that prior to euro adoption the underlying fundamentals of international competitiveness are strong.** An additional challenge is that the current methods for improving non-price competitiveness, among others in the form of the import of foreign technology, could prove to be increasingly ineffective as the convergence process proceeds.

priority for firms competing on international markets is the diffusion and mastering of existing technology, not the creation of new ones." (Montobbio and Rampa 2005)

Chapter 3. Diversity of structures and institutions

Structural and institutional diversity may be a source of asymmetric shocks and the resulting divergent business cycles in the euro area countries. Due to the differences in economic institutions and structures, euro area states are vulnerable to asymmetric shocks. Since the effects of such shocks cannot be fully mitigated by the common monetary policy, reducing the costs of adjustment in the economy after their appearance requires smoothly functioning adjustment mechanisms (Chapter 4). In the case of the limited effectiveness of such mechanisms, there is a risk of cyclical divergence among euro area countries, which could be further reinforced by the common monetary policy. This mechanism was described by Walters (1990), who showed that a common monetary policy will be expansive (restrictive) in countries in which inflation and GDP growth are higher (lower) than on average in the euro area. As a result, the common monetary policy will deepen the divergence of the cyclical position and inflationary differences between member countries, hence destabilise their economies. This mechanism is currently described as *Walter's Critique*.

The heterogeneity of the institutions and structures of the economies of the euro area countries increases the likelihood of their different responses to common shocks. The differences between euro area countries in terms of their economic structures and institutions are important for the transmission of common macroeconomic shocks (including changes in the parameters of the common monetary policy) and can be a source of cyclical divergence in the currency union, with potential consequences similar to those mentioned above in the case of asymmetric shocks. In particular, as Guiso et al. (1999) show, one of three conditions to ensure effectiveness of monetary policy in a currency union is the lack of differences in the functioning of the monetary policy transmission mechanism. Such differences make it difficult to take effective decisions on interest rates, and so the common policy could be inadequate to the macroeconomic situation in individual economies of the currency union.

The risk of macroeconomic instability associated with structural and institutional diversification between euro area countries is greater than in other currency unions due to its incomplete integration model. In Part 1 of this report, which describes institutional changes in the euro area, it is shown that structural and institutional diversification between countries forming a currency union need not be a negative phenomenon in and of itself. Differences between individual states of the United States are on a scale not much smaller than those observed in the euro area. However, the negative consequences of these differences are mitigated by the higher level of mobility of factors of production and by the fact that between the states there is a political and fiscal union as well as a high degree of integration of capital markets. The scale of mitigation of the impact of shocks on consumption and incomes in individual regions is therefore greater due to the existence of risk sharing mechanisms between regions such as fiscal transfers and interregional ownership of equity. In the absence of deeper integration between euro area countries in the areas mentioned above, institutional and structural differences between Poland and the main economies of the euro area will therefore be a challenge for the smooth functioning of the Polish economy after the adoption of the single currency.

Selected characteristics of the Polish economy generate the risk that the transmission of common shocks will be significantly different than in the euro area. The research on the structural conditions of the transmission mechanism of macroeconomic shocks in the economy, including research on countries which are part of a currency union, points to a series of factors that have an impact on the form and rate of response of the economy to disturbances. These factors are the level of price and wage rigidity, the structure of aggregate demand, the degree of openness or the structure and functioning of the financial sector (Guiso et al. 1998 and Kokoszczyński et al. 2002). This chapter will address only two structural and institutional characteristics of the Polish economy, which in our opinion are the most important in the discussion on the heterogenous response to common shocks. These characteristics relate to the institutions determining the functioning of the labour market as well as the structure of the financial and real estate sector.

3.1. Labour Market

Labour market adjustments (extensive, intensive and nominal) are important determinants of the transmission mechanism of macroeconomic shocks. Labour market institutions have an influence on the degree to which changes in demand for labour will have an extensive (changes in the number of employed and unemployed), intensive (changes in the number of hours worked) or nominal character (changes in wages). Selected institutional structures may block the intensive and nominal channels and stimulate the extensive one, increasing the risk that the majority of adjustments to shocks are made through a change in the level of employment. This type of situation was observed during the recent crisis in Spain, where the unemployment rate surged from 8.2% in 2007 to 26.1% in 2013. One can argue that in many cases, i.e. in those not requiring permanent reallocation of employees between companies or sectors, extensive adjustments are socially less desirable, since their costs fall overwhelmingly on a narrow group of people, who lose their jobs.

There are marked differences among euro area countries (and between euro area countries and Poland) in terms of institutions defining the functioning of the labour market. There is differentiation between euro area countries in the case of the majority of institutional factors that influence the level of wage rigidity and determine the scale of labour market flows. Clear differences are observed in relation to all of the most important areas such as the following:

- the design of the unemployment insurance system[4] (Table 2),
- trade union density (Table 3),
- the model of wage negotiations (Table 3),
- regulations determining downward wage rigidity (Dickens et al. 2009),
- the level of the minimum wage (Table 3),
- mechanisms of wage indexation (Table 3),
- the scale of expenditure on an active labour market policy[5] (Figure 11),

[4] The high level of benefits in relation to wages in the economy or the long period of payment of benefits could adversely affect the attempts of the unemployed to find work, undermining the effectiveness of labour market adjustments (see Boeri and von Ours 2008). If this effect is not mitigated by other factors (e.g. in the field of active labour market policy), it will result in reduced flows into employment.

[5] Active labour market policies (ALMP) cover, above all, expenditure on public employment services, career counselling and guidance, training and internships, employment subsidies and other expenditure aimed at supporting employment. Taking into account the fact that their aim is to lower the costs of searching and increase the likelihood of finding employment for the un-

- the scale of employment protection legislation[6] (EPL) and the difference in the level of regular employment protection (permanent contracts) and more flexible forms of employment (temporary contracts, civil contracts; Figure 12),
- solutions encouraging the use of part-time forms of employment, as well as allowing the adjustment of working hours to the business cycle.

It is worth stressing that the impact of individual characteristics of the labour market on the functioning of extensive, intensive and wage channels should be analysed in a systemic way, i.e. taking into account the interdependences occurring between various institutions.

Table 2. Selected characteristics of unemployment insurance systems in euro area countries

	Net replacement rate*		Maximum length of claiming benefits in months	People receiving benefits and other allowances for the unemployed (% of unemployed according to LFS)	Indicator of the strictness of eligibility criteria for people claiming unemployment benefit**
	Initial period of unemployment	First five years of unemployment			
IT	73	9	8	50	3.6
GR	44	11	12	42	2.9
SK	72	16	6	11	4.3
EE	64	20	12	18	3.6
ES	76	36	24	49	3.6
FR	72	44	24	96	2.8
PT	81	36	28	46	4.4
DE	74	42	12	119	2.7
BE	74	65	without limit	170	3.0
SI	81	20	9	37	3.6
AT	69	59	9	127	2.6
FI	69	46	23	107	2.6
NL	77	30	22	163	3.0
LU	87	24	12	78	3.4
IE	65	61	12	135	3.3
MT	53	48	6	88	3.8
LV	84	11	9	19	no data
EA* **	**73**	**35**	**16**	**92**	**3.1**
PL	**57**	**15**	**6**	**20**	**3.0**

Notes: The three least (most) generous unemployment insurance systems in a given category are marked in yellow (orange). *The net replacement rate is the average amount of benefits in relation to the last wage for the unemployed with four family types (single, married, with or without children) and reaching two wage ceilings in recent work (67% and 100% of the average wage in the economy) . Data on replacement rates and people in receipt of unemployment benefits for 2012, with the exception of Greece (2010), and Luxembourg, Spain, Ireland and Malta (2011). ** This index, developed by Venn (2012), is a synthetic measure of restrictiveness of requirements for the unemployed in receipt of unemployment benefits. Four categories of requirements are taken into account: eligibility criteria for benefits (such as length of employment and contribution period), willingness to accept a job offer or participation in ALMP programmes, monitoring the effort to look for work, sanctions for non-acceptance of an offer, or participation in ALMP programmes. Higher index values mean more restrictive requirements. The index was constructed based on the information for 2011. *** EA = weighted average of the share of the number of employed in the country (according to Labour Force Statistics).

Source: Own calculations based on data from the OECD, Eurostat, Venn (2012) and Esser et al. (2013).

employed (by improving the suitability of their qualifications to the requirements of the market), they play an important role in determining the intensity of flows into employment.

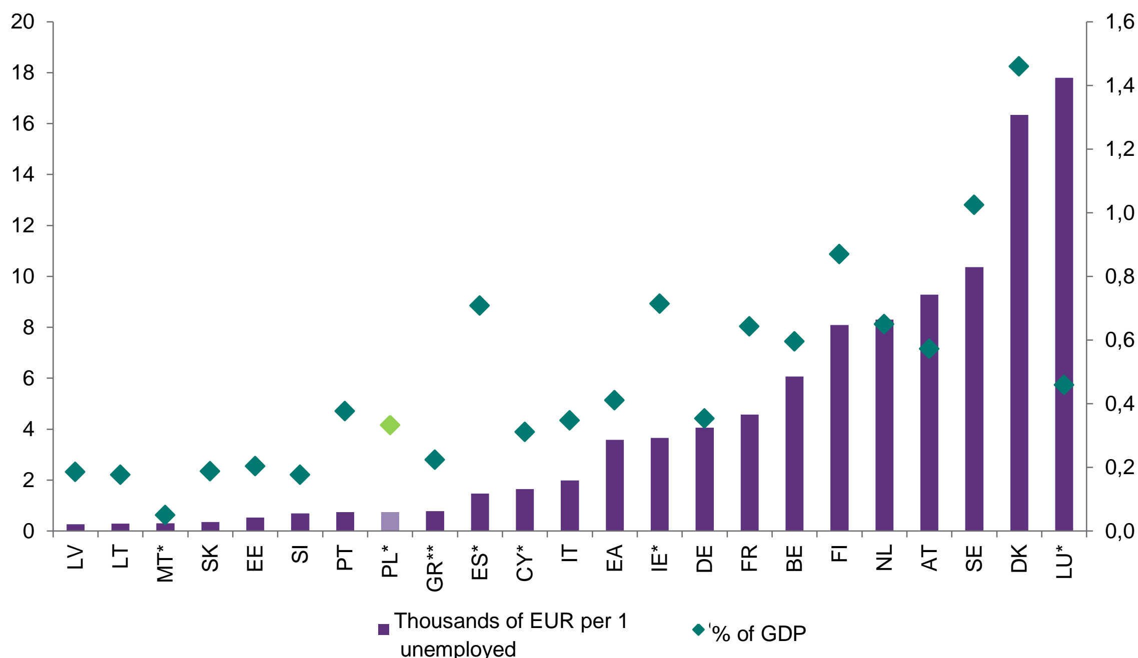
[6] The degree of legal protection of employees is important from the point of view of redundancy costs. The high cost of redundancies curbs employers' willingness to dismiss employees and at the same time – by increasing the average cost of the contract – to recruit new employees.

Table 3. Selected characteristics of collective bargaining systems in euro area countries

	Trade union density*	Collective bargaining coverage*	Minimum wage (% median gross salary)*	Wage indexation mechanisms in collective bargaining
AT	28	99	None	None
BE	50	96	50.7	Universal wage indexation mechanism
DE	18	62	None **	None
FR	8	90	61.5	None
ES	16	84	44.2	Indexation within collective bargaining
IT	36	80	None	None
NL	18	82	46.9	None
LU	37	58	42	Universal wage indexation mechanism
FI	69	90	None	Indexation within collective bargaining
SI	24	92	59.5	Indexation within collective bargaining
SK	17	40	47	None
PT	19	45	57.7	None
GR	25	65	43.4	None
IE	30	44	47.6	None
EE	8	19	35.7	None
EA* **	**21**	**76**	**-**	**-**
PL	**15**	**38**	**46.5**	**None**

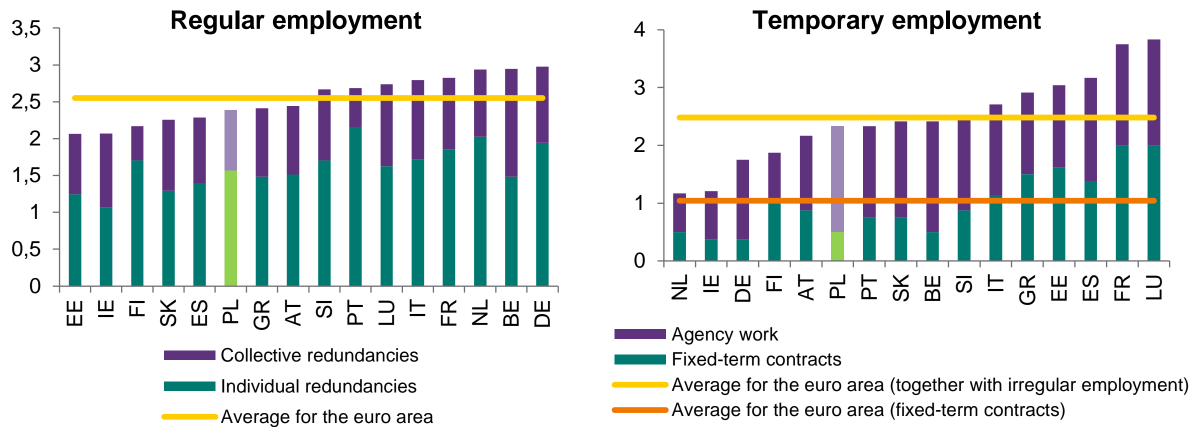
Notes: * Data for the trade union density for 2011, with the exception of data for France, Spain, Portugal, Estonia and Poland (2010), Luxembourg (2008) and Ireland (2013). Data on collective bargaining coverage in 2008, with the exception of Austria (2010), Germany, Italy, Slovenia, Slovakia, Portugal and Estonia (2009) and Finland (2007). Data for the minimum wage for 2012. ** Starting from 2015, the minimum wage will apply in Germany. *** EA = weighted average of the share of employment in the country (according to Labour Force Statistics).
Source: Own calculations based on OECD and Eurostat data, and Mongourdin-Denoix and Wolf (2010).

Figure 11. Expenditure on active labour market policy (2012)



Note: * indicates the countries for which data are presented for 2011. ** correspondingly for 2010.
Source: Eurostat, own calculations. Number of the unemployed according to the Labour Force Surveys.

Figure 12. Employment protection legislation



Source: OECD. Data for 2013.

Institutional characteristcs of the labour market affect its structure: in the case of Poland, special attention should be paid to the high number of people employed on fixed-term contracts. By influencing the behaviour of enterprises and households in the process of labour market matching, as well as subsequent interactions between employees and employers, institutional conditions influence the dynamics and structure of employment as well as the level of wages. The diversification of the employment protection level for different types of contracts, the relatively high share of young people among the economically active population as well as the size of the tax wedge for various forms of employment[7] are the key factors explaining why currently Poland has the highest level of dualism in the labour market among EU countries (Figure 13). It is worth mentioning that euro area countries with a high share of employees employed on fixed-term contracts, i.e. Spain, Greece and Portugal, are characterised by a higher volatility of the unemployment rate and fluctuations of GDP than the remaining euro area countries.

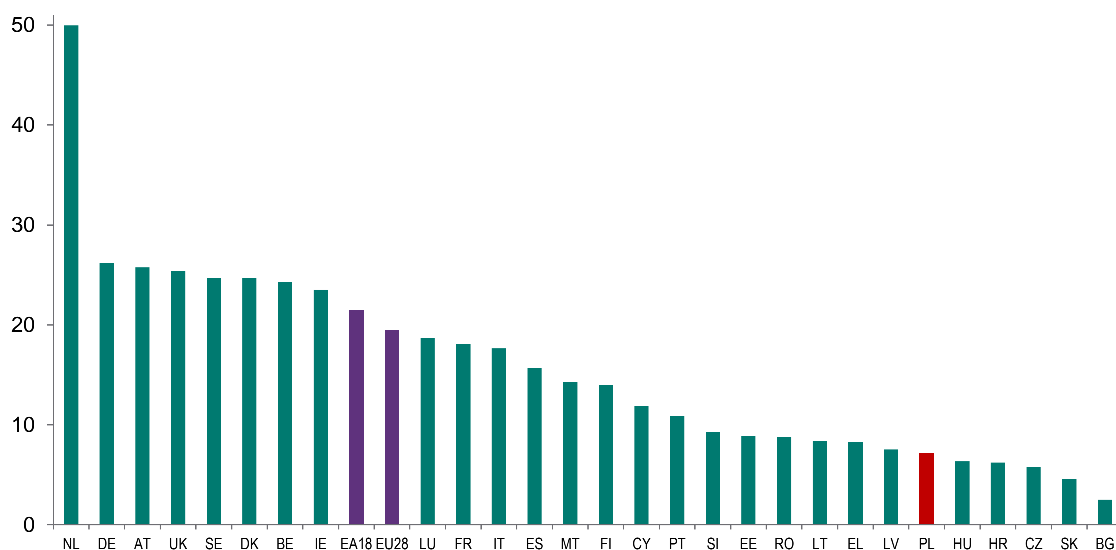
Figure 13. The share of self-employed* and employees on fixed-term contracts in total employment (%, 2013)

Note: * Self-employed workers without employers (people running their own businesses employing at least 1 person). **Source:** Own calculations based on Eurostat data.

[7] In particular, the possibility of reducing the tax wedge through the conclusion of a civil contract and self-employment increases the attractiveness of this form of employment.

Poland also has a low share of part-time employees. In 2013 in Poland only 7% of people employed worked part-time, compared to 21% in the euro area (Figure 14). In the long term, the opportunity to employ part-time gives companies a greater possibility to match the level of employment to the business conducted, while giving employees the possibility to adjust working hours to their preferences[8]. This could boost economic activity and improve the structural competitiveness of the economy. As the experience of Germany in recent years shows, the adjustment of working hours can also be an important element in the absorption of temporary macroeconomic shocks (Brenke et al. 2011). Therefore, the following question becomes important: what is the degree of asymmetry in the possibilities of intensive adjustments to shocks (of working hours) between Poland and the euro area? Analysis of Figure 14 would indicate that it is relatively large. However, this conclusion should be treated with caution as the high share of people employed on civil contracts provides the employer with greater possibilities to adjust working hours to changing demand than in the case of people employed on permanent contracts.

Figure 14. Percentage of part-time employees in total employment (%, 2013)



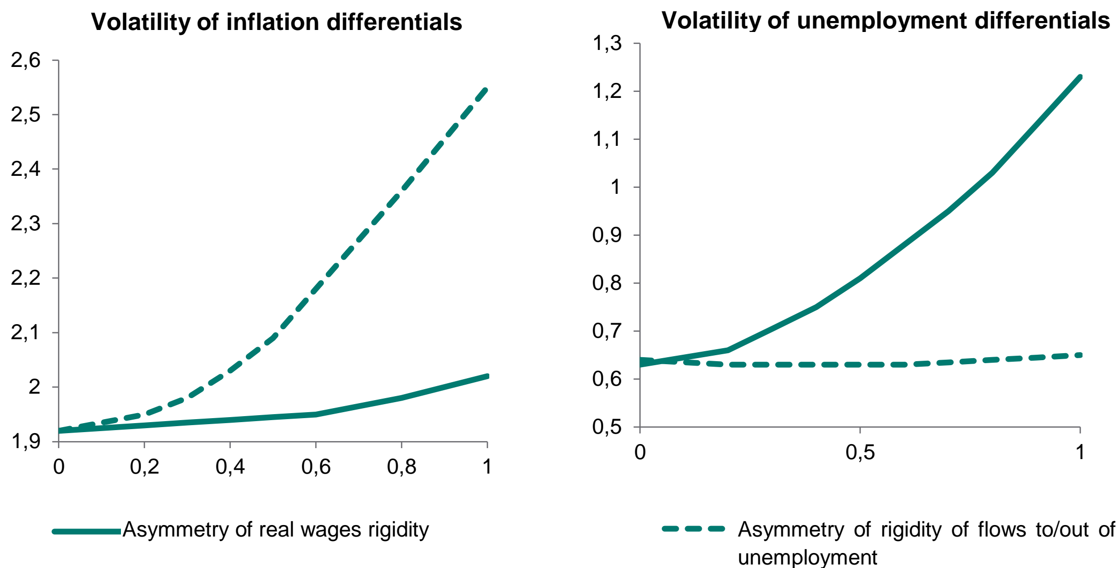
Source: Eurostat.

Differences in wage rigidity in countries forming a currency union hinder the possibility to make adjustments to common shocks. The heterogeneity of euro area countries in terms of wage rigidity is one of the most frequently indicated sources of asymmetric response to common shocks, including those associated with a common monetary policy. Abritti and Mueller (2012) – using a two-country DSGE model – show that a consequence of this type of asymmetry in a currency union is much greater variability of differences in the level of unemployment and inflation in its member countries (Figure 15). The logic of the model is as follows: in an economy with high wage rigidity and high employment flexibility, the response to changes in demand takes the form of significant fluctuations in the level of employment and the unemployment rate, whereas the response of wages and inflation is moderate. On the other hand, in an economy characterised by high employment rigidity and flexible wages, demand fluctuations are reflected in high volatility of

[8] In 2013 in the euro area, 36% of women were employed part-time, while the figure for men was just 10%.

wages and inflation, while the response of employment is small. In both cases, asymmetry reduces the effectiveness of a common monetary policy and welfare in comparison to the hypothetical situation in which asymmetry between countries of a currency union did not exist.

Figure 15. Differences in volatility of inflation and the unemployment rate between two countries forming a currency union depending on the asymmetry of labour market institutions



Note: The horizontal axis represents the asymmetry index, which takes the value 0 if there are no differences between the countries in the two aspects of labour market rigidities: wages and flows into and out of unemployment. With the increase in the value of the index, there is an increase in diversity between the countries (the average level of rigidity in the labour market does not change). The vertical axis is the standard deviation of inflation differentials and differences in the level of unemployment between countries.
Source: Abbritti and Mueller (2012).

The symmetry of reaction of currency union countries to common shocks is also reduced by diversification of institutions influencing the intensity of flows on the labour market. The above-mentioned two-country model of Arbritti and Mueller (2012) shows that in a currency union between countries of respectively high and low rigidity of flows on the labour market, much higher volatility of inflation differentials and unemployment may be expected than in a union in which there is no such asymmetry. As a result, in a heterogeneous currency union in terms of restrictions to flows on the labour market, one can expect a lower effectiveness of adjustments to common shocks. In this context it is worth paying attention to empirical studies which show that the diversity of employment protection legislation, which has an impact on the process of job creation and destruction, is an important factor explaining the differences in volatility and sustainability of changes in the unemployment rate, the output gap and inflation observed between countries in the euro area (Merkl and Schmitz 2011; Jaumotte and Morsy 2012). Furthermore, empirical studies also show that the differences in the level of segmentation of the labour market (resulting from differences in employment protection depending on the type of contracts) in the euro area countries translates into volatility of unemployment and the output gap differentials. In particular, as previously mentioned, they partly explain the relatively high volatility of the unemployment rate and output gap (compared to the euro

area as a whole) in such countries as Spain, Greece and Portugal, which are characterised by a high level of dualism in the labour market.

High flexibility of the labour market need not necessarily be desirable in the case of joining a currency union characterised by a high level of rigidities. High flexibility of the labour market, which strengthens market-based adjustment mechanisms (Chapter 4), is often perceived as a factor increasing macroeconomic stability after joining a currency union. The main argument is the positive relationship between the flexibility of the labour market and the capacity of the economy to absorb asymmetric shocks. However, in the case of joining a currency union characterised by high rigidity of the labour market, the flexibility may prove to be undesirable. Dellas and Tavlas (2005) and Campolmi and Faia (2012) – based on models of heterogeneous currency unions in terms of wage rigidity – show that countries with a relatively flexible wages lose after joining a currency union characterised by high rigidity of the labour market, among others due to increased volatility of the business cycle. This is because wage flexibility – firstly – weakens the stabilising properties of a common monetary policy: in response to monetary policy tightening, wages and prices in a flexible economy fall more dramatically than in a rigid economy. This leads to a deterioration in the terms of trade in a flexible economy and an associated increase in demand for goods that it produces, which weakens the stabilising influence of increased interest rates. Secondly, wage flexibility strengthens the effects of supply shocks (also through its influence on the terms of trade). As a result, when joining a currency union characterised by a rigid labour market, the following dilemma arises: high flexibility of the labour market strengthens market adjustment mechanisms, but at the same time enhances the divergence of labour market institutions from those of the remaining countries of the union.

The characteristics of the Polish labour market are significantly different from the characteristics of the labour market of the main euro area countries. The main differences are as follows:

- **Low generosity of its unemployment benefit system compared to the euro area countries** (Table 2). Compared to euro area countries, in Poland benefits for the unemployed are claimed by a relatively small percentage of all the unemployed. The replacement rate is much lower than in the euro area countries. The basic features of the unemployment benefit system in Poland show that it is probably less able to mitigate the influence of macroeconomic shocks on household consumption and aggregate demand than on average in the euro area countries. At the same time, it can be estimated that the low level of generosity of the unemployment benefit system reduces wage rigidity (weakening the bargaining power of employees in wage negotiations) and rigidity of flows to the labour market (the benefit system in Poland is not a factor weakening the incentive of the unemployed to look for employment).
- **Low level and effectiveness of the active labour market policy** (Figure 11). Expenditures on the active labour market policy are generally lower in Poland than in euro area countries. In 2012, on average 3.8 times more euros were spent on activating one unemployed person in the euro area than in Poland. The effectiveness of this expenditure is also low compared to the euro area countries. This is confirmed, among others, by the low percentage of vacancies reported to the labour offices which, according to the NBP (2013) survey, is only about 15%. As a result, the costs of labour market matching, both for the unemployed and enterprises, are high, which increases the risk of the unemployment rate persisting at an elevated level.
- **The high level of dualism in the labour market** (Figure 13). Compared to euro area countries, Poland is characterised by the highest share of people on temporary contracts and self-employed in total em-

ployment. As shown earlier, this translates into lower wage rigidity compared to the euro area countries. However, at the same time a consequence of this type of segmentation of the labour market after Poland joins the euro area could be a stronger response of employment, the unemployment rate and the output gap to common shocks than in the case of the other euro area countries.

- **The low level of coordination and regulation of wage bargaining** (Table 3). Wage bargaining systems in most of the euro area countries are much more coordinated by trade unions than in Poland. The low level of trade union density and collective bargaining coverage compared to euro area countries, combined with the absence of collective wage indexation mechanisms, are one of the reasons behind the low – compared to the euro area countries – wage rigidity in Poland. Noteworthy is the fact that Poland is characterised by a high proportion of additional remuneration components, which is a factor increasing wage flexibility within the business cycle.

The clear difference in the characteristics of the Polish labour market compared to the main economies of the euro area creates a risk that wage and employment adjustments in response to shocks will be different from those in the euro area. Available analyses indicate that the scale of flows in the labour market (from unemployment to employment and in the opposite direction) is greater than on average in the euro area countries (Ward-Warmedinger and Macchiarelli 2013 and NBP 2013). This is mostly due to the relatively high rate of job destruction. This phenomenon can be correlated with two factors. Firstly, with the low generosity of the unemployment insurance system and the high dualism of the labour market, which increase flows on the labour market. Secondly, with the low level and effectiveness of expenditure on the active labour market policy, which limits the flows from unemployment to employment. At the same time, Poland is characterised by lower downward wage rigidity than in the case of the euro area countries (see below), which could also be attributed to the relatively low level of unemployment benefit and the popularity of flexible forms of employment, and also to the low degree of coordination of wage negotiations. Moreover, Figure 14 suggests that intensive adjustments, i.e. through a change in the number of hours worked, play a smaller role in Poland than on average in euro area countries[9]. To summarise, compared with the euro area countries, Poland is characterised by the following:

- relatively high wage flexibility,
- relatively high possibilities for extensive adjustments (changes in the level of employment), but in conditions of low effectiveness of labour market matching mechanisms,
- relatively low effectiveness of the intensive channel (the number of hours worked).

After joining the euro area, these differences of the Polish economy would probably result in its asymmetric response to common shocks. In particular, considering the high level of dualism of the labour market, one could expect increased volatility of employment and short-term unemployment, and taking into account the low effectiveness of the matching mechanism (among others, due to the low effectiveness of the active labour market policy) – a higher rate of long-term unemployment.

3.2. The financial system and the real estate market

The different structure of the financial system could be a source of asymmetric transmission of macroeconomic shocks between countries of a currency union. The financial system is key from the point of view

[9] However, one should remember the high percentage of people employed on civil contracts, where the possibilities for intensive adjustment are relative large.

of influence of the central bank's monetary policy on the economy. Therefore, one can expect that differences between the structure of financial systems in euro area countries – like in the case of labour market and product market institutions – will lead to differences in the impact of ECB interest rate changes on the level of economic activity in the euro area countries (Cecchetti 1999). Important from this point of view are such factors as, among others, the level of development of selected segments of the credit and capital markets, competition in the banking sector, the quality of banks' balance sheets, the structure of financial assets of economic entities and the extent to which variable and fixed interest rates are used in credit agreements. The structure of the financial system also has a big influence on the likelihood of the occurrence and transmission of financial shocks. As Hubrich et al. (2013) show, there are clear differences between euro area countries in terms of the importance of financial shocks and their different types[10] for the situation in the real economy. According to the authors, the source of these differences are institutional factors.

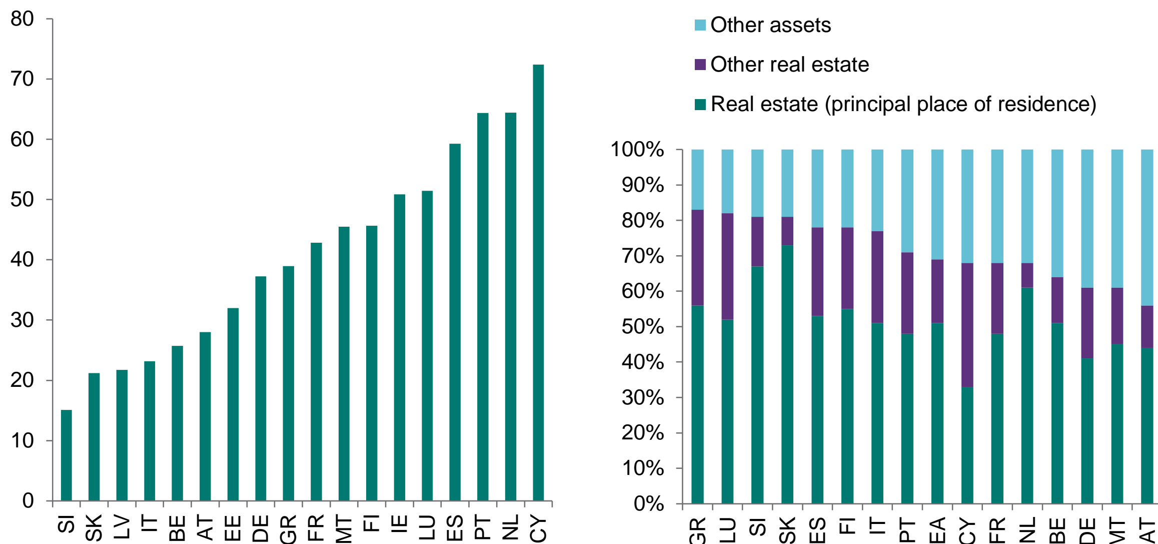
A potentially very important source of asymmetric response of currency union economies to common shocks is the housing loans segment. The housing market plays an important role in the monetary policy transmission mechanism. This is because of the following factors:

- *Housing loans are the dominant part of the liabilities and assets of households.* In the euro area on average 64% of total loans taken out by households are housing loans (Figure 16). The share of housing in households' gross assets amounts to almost 70%. Changes in the interest rates of housing loans as a result of changes in the central bank's interest rates will therefore have a significant impact on consumption and investment demand of households by influencing the size of interest payments and the possibility of refinancing existing debt as well as through their influence on housing prices, and therefore on the value of collateral for loans and the value of households' assets. In fact, as Muellbauer (2008) shows, changes in housing prices have a greater impact on household consumption than changes in the prices of other assets.
- *Housing loans are a large part of banks' credit portfolio.* In the euro area they account on average for 13% of all monetary assets of financial institutions. This is why it can be expected that changes in the central bank's interest rates, changes in the possibility of financing lending in this market segment and changes in the financial situation of borrowers will have a significant impact on the aggregate credit supply in the economy. The relatively high share of mortgages in the assets of the banking sector also shows the importance of the situation on the housing market for financial stability. This is confirmed by the experience of Spain and Ireland, where the bursting of the real estate bubble threatened the financial and macroeconomic stability of these economies.
- *The growth of housing loans is of major importance to the situation in the construction sector.* In countries where construction investment is elastic with respect to demand and housing prices, the rate of lending in the housing loans sector has a significant influence on the growth of housing investment and the activity of the construction sector, causing a strong reaction of the real economy to monetary policy impulses. A negative consequence of this process could be the excessive allocation of resources in the construction sector in periods of rapid growth in housing prices and the ensuing weakening of economic competitiveness (both cost and structural). The importance of the impact of this channel on the real economy is shown, among others, by the experience of Spain, where the boom in the housing

[10] The analysed shocks include unexpected changes of real housing prices, real share prices, the maturity structure of interest rates and two indicators of financial leverage (of credit for the private sector in relation to GDP and the output gap).

loans segment resulted in strong fluctuations in production and employment in construction. Taking the above into account, differences between euro area countries in the functioning of the housing loans segment and the housing market may be expected to cause differences in the responses of these economies to symmetric shocks. At the same time it should be noted that in countries with a rigid supply of new housing, changes in demand may be expected to have a stronger influence on their prices.

Figure 16. Household debt from housing loans in 2013 (% of GDP, left-hand panel) and the share of real estate in gross household assets (right-hand panel)



Source: the authors' own study on the basis of ECB data (left panel) and Arrondel et al. (2014; right-hand panel).

The housing market features which could translate into differences in the transmission of common shocks in a currency union are as follows:

- the level of housing debt and the share of housing in household assets,
- the share of foreign exchange loans, i.e. denominated in another currency than the euro, in total loans,
- the share of housing loans in banks' portfolios,
- characteristics of loan agreements,
- the way in which banks finance lending in this segment of the market,
- factors influencing the response of construction investment to changes in housing demand (e.g. spatial planning regulations),
- the development of the private rental market.

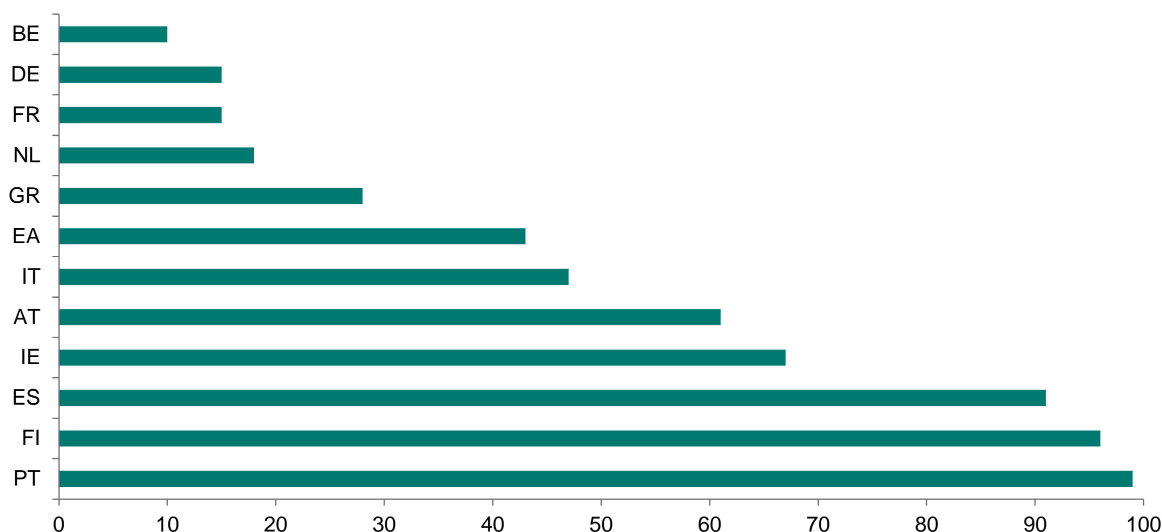
Euro area countries show significant differentiation in the level of housing loan debt. As a result of the credit booms observed in selected euro area countries before the financial crisis, currently strong differences are seen in the housing debt to GDP ratio, which ranges from 15% in Slovenia to 72% in Cyprus. There is also a big difference in terms of the share of housing debt in the total household debt. The lowest level is recorded in Belgium (46%), while the highest is in Latvia (89%). From a theoretical point of view, it is not clear how differences in the level of debt will translate into the functioning of the transmission mechanism. A lower level of household debt implies, on the one hand, a lower sensitivity of demand to interest rate changes, which weakens the effectiveness of stabilisation of the business cycle with the help of a common

monetary policy. On the other hand, to the extent that it is the result of restrictions in credit supply arising from the underdevelopment of the financial system, it indicates that there are fewer opportunities to smooth consumption than in economies with more developed financial markets (Guiso et al. 1998), and thus a higher sensitivity of demand to changes in monetary policy parameters. In the case of euro area countries, the credit booms, which were observed in selected economies, were a significant source of differences in housing debt levels. Assuming that these booms brought excessive growth of household debt, the economies may be expected to be generally more sensitive to changes in monetary policy parameters than the rest of the euro area.

Euro area countries also differ significantly in terms of the importance of housing in household assets. According to the survey of the Household Finance and Consumption Network, real estate (as the main place of residence of the household as well as remaining real estate) amounts to approx. 55% of the gross household assets in Austria, compared to approx. 84% in Greece. In the latter country, one can therefore expect a considerably stronger response of household consumption to changes in housing prices than on average in the euro area, among others, due to the greater scale of the effect of the assets. Heterogeneity among the euro zone countries is also seen in the importance of the housing segment for the banking sector: the mortgage portfolio accounts for 7% of the total assets of the sector in Malta, compared to 30% in Estonia. Also in this respect one can therefore expect differences in the influence of developments in the housing market on the performance and stability of the banking sector of the euro area countries.

An important aspect are the differences between euro area countries in terms of the type of interest rates on housing loans (fixed vs. variable). The ECB (2009) shows that the characteristics of housing loans are important for the transmission of monetary policy, while the differences between euro area countries as regards these characteristics translate into the heterogeneity of transmission of symmetric shocks. One of the most important aspects of this diversity is the type of interest on loans, i.e. whether it is fixed or variable. In economies with a large share of mortgages with variable interest rates one can expect a stronger propagation of shocks than in economies with a dominant share of loans with fixed interest rates. Rubio (2011), who formalized this argument within the DSGE framework, shows that in the case of a variable interest rate, changes in interest rates have a stronger impact on the level of interest payments and, consequently, on consumption of indebted households. Moreover, in conditions of a variable interest rate on housing loans, one can expect a stronger response of the credit supply to changes in the central bank's interest rates. This is because the reaction of housing prices (and consequently the value of the loan collateral) as a result of changes in the central bank's interest rates is stronger in economies dominated by variable interest rates on housing loans. In this context it is worth noting that euro area countries differ significantly as far as the share of loans with variable interest rates is concerned (Figure 17). This variation seems to be driven by both demand factors (e.g. the differences in risk aversion and the planning horizon of consumers) and supply (e.g. the availability of liquid markets of debt instruments with long maturities; ECB 2009).

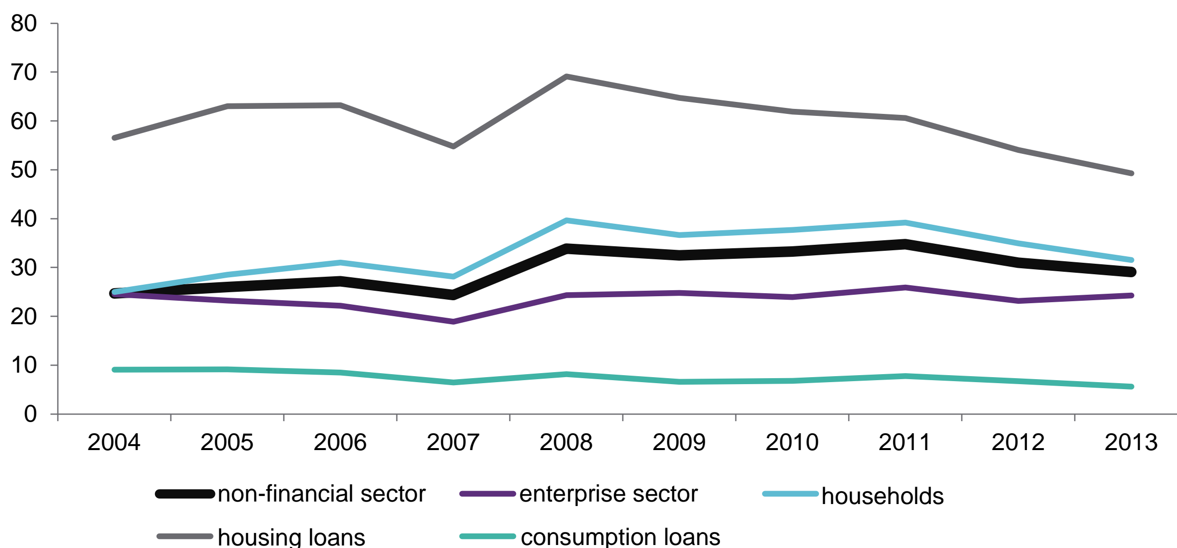
Figure 17. The share of housing loans with variable interest rates in newly-granted housing loans



Source: own study on the basis of ECB (2009).

Asymmetric transmission of common monetary policy may also be strengthened by differences in the currency structure of loans. In the years preceding the crisis, loans denominated in foreign currency played an important role in the financing of home purchases in the majority of Central and East European countries, including Poland. This concerned, in particular, the segment of housing loans denominated in Swiss Francs. As shown in Figure 18, in Poland the share of foreign currency loans in the monetary assets of financial institutions from the non-financial sector has fluctuated at around 30% for the last decade, while in the case of housing loans the share was 49% at the end of 2013. In the case of the major euro area economies, the share of foreign currency loans is negligible and stands at below 10% (Yesin 2013). Differences in the popularity of foreign currency denominated loans in member states of a currency union may represent a challenge for the conduct of a common monetary policy for three reasons. Firstly, expenditure and assets of economic agents with debts in a foreign currency are sensitive to changes in the exchange rate and foreign interest rates. This increases the likelihood of asymmetric shocks. Secondly, interest payments of economic agents with debt in a foreign currency are less sensitive to the parameters of national monetary policy, above all in the case of loans with a variable interest rate. Thirdly, as Brzoza-Brzezina et al. (2010) shows, the opportunity to take out loans denominated in a foreign currency leads to the so-called substitution effect. In particular, the influence of a tightening of the national monetary policy on lending is limited by the growing importance of newly-granted foreign currency loans. However, it is worth stressing that the importance of the substitution effect in Poland has weakened significantly in recent years, among others, on account of the policy of the banks and the recommendations of the Polish Financial Supervision Authority. This is reflected in the negligible share of newly-granted foreign currency denominated loans, as well as in the falling share of such loans in the total housing loans (Figure 18).

Figure 18. The share of foreign currency loans in monetary assets of financial institutions from the non-financial sector in total (%)



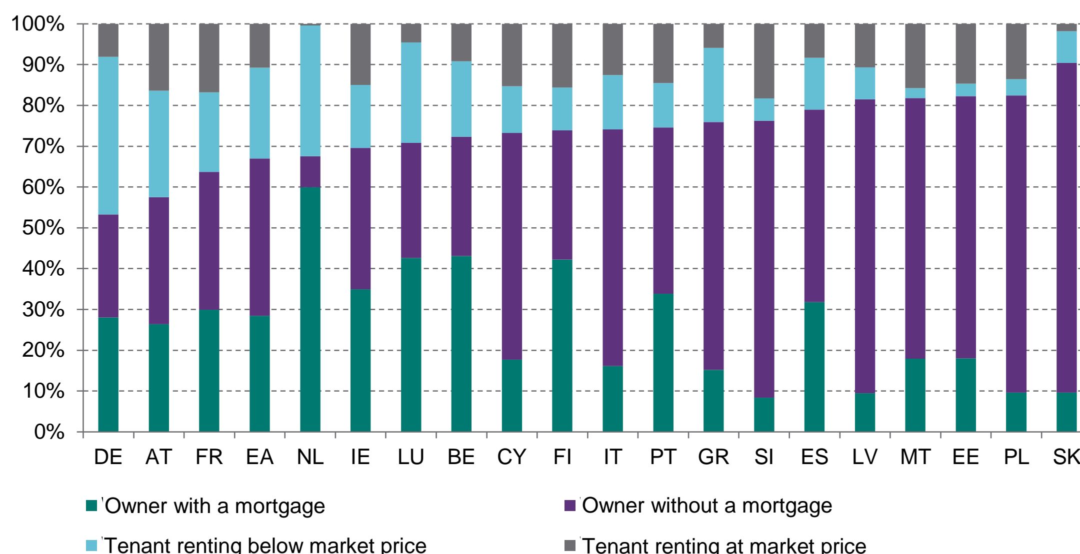
Source: own study on the basis of NBP data.

The differences in the level of development of the private rental market are also a potentially important source of asymmetric transmission mechanism of monetary policy. A well-developed private rental market, providing households with an alternative possibility to acquire housing services in comparison to home ownership, could limit the impact of changes in housing demand on home prices. As shown by the analysis of Cuerpo et al. (2014), which was mentioned in Chapter 1, regulations regarding the rental market influence the strength of response of housing prices to interest rate changes: estimated semi-elasticity declines from 3 in countries with restrictive regulations of the rental market, to 0.75 in countries in which regulations support the development of the rental market. The existence of an effective rental market may also have important implications for financial stability. This is because low income households are relatively more sensitive to adverse income changes in the business cycle, and therefore the possibility for this group of consumers to rent housing (instead of purchase it with credit) will limit the scale of adjustment in home prices in the case of the bursting of speculative bubbles and the associated risk for the financial system. Taking into account these factors, one can expect that differences between euro area countries in the development of the private rental market will be reflected in the asymmetry of monetary policy transmission. Indeed, as the simulations carried out by Rubio (2014) based on the DSGE model show, countries with a low share of the rental market may be expected to experience higher volatility of GDP and inflation. Monetary policy in such countries is therefore less effective in stabilising business cycle fluctuations, since changes in housing prices have a stronger influence on economic activity than in economies with a large rental market.

The differences in the developments in the rental market are also important for the transmission of other macroeconomic shocks. The absence of a liquid, effective and transparent rental market limits spatial mobility, thus adversely influencing the effectiveness of adjustment to both symmetric and asymmetric shocks in individual economies. This is confirmed by the results of studies conducted by Caldera-Sanchez and Andrews (2011), who proved that there is a significant relationship between mobility and housing

status. According to the authors' estimates, the probability of changing the residence during one year is from 7 to 20 percentage points lower in the case of owners than in the case of tenants. As Kierzenkowski (2008) indicates, the lack of a developed private rental market can therefore preserve the differences in the level of unemployment in individual regions. In this context, heterogeneity in the development of the private rental market observed in the euro area countries can be considered as undesirable. The share of housing rented at market price in the housing stock ranges from 2% in Malta to 39% in Germany (Figure 19).

Figure 19. Ownership structure of housing in euro area countries and Poland



Source: own elaboration on the basis of Eurostat data.

Different characteristics of the housing loans segment and the underdevelopment of the private rental market increase the sensitivity of demand and supply of credit in Poland with respect to monetary policy impulses. This can lead to a higher amplitude of cyclical fluctuations and increases the risk of a credit boom after the adoption of the euro (more detail in Chapter 1). Taking into account the above discussion on the importance of the housing market for economic fluctuations, it should be noted that certain features of the Polish housing market could pose a challenge after the adoption of the single currency. In particular, the risk of excessive amplitude of fluctuations in activity in the construction sector and the likelihood of housing bubbles are increased by the following:

- *The difference in the dominant type of interest on housing loans (fixed vs. variable) between Poland and the euro area.* Housing loans constitute 59% of all loans in the Polish banking system granted to households and 38% of loans to the non-financial private sector (compared to 74% and 36% respectively in the euro area[11]). While in the largest euro area economies credit agreements in the mortgage segment are overwhelmingly based on fixed interest rates (Figure 17), mortgages granted in Poland are based on variable interest rates only. After joining the euro area, these differences will lead to higher average sensitivity of aggregate demand in Poland to changes in the parameters of the common monetary policy.

[11] According to data on monetary assets of financial institutions at the end of June 2014.

- *The high share of foreign currency denominated loans in total loans.* Due to the growth of availability of foreign currency denominated loans and the differences in the level of interest rates in the interbank market, in the years preceding the crisis there was a dramatic increase in the value of housing loans denominated in foreign currencies, particularly in Swiss Francs (Figure 18). After the adoption of the euro this will pose a challenge on account of the growing vulnerability of the Polish economy to asymmetric shocks in the form of fluctuations in the EUR/CHF exchange rate and changes in the interest rate in Switzerland, as well as the weakening of the income channel of changes in ECB interest rates.
- *The underdevelopment of the private rental market.* The sensitivity of demand for housing loans to interest rate changes is highly dependent on the availability of other alternative forms of acquiring housing services to ownership, which in turn depend on the level of development of the rental market. Compared to euro area countries, Poland has a relatively low share of rented apartments in its housing stock (Figure 19). In 2012 only approx. 4% of housing units in Poland were rented at market price, while for the euro area this figure stood at 22%, and in Germany at 39%. The underdevelopment of the rental market in Poland is partly associated with households' preferences, but also with the ineffectiveness of solutions related to the protection of tenants' and landlords' rights. Empirical research confirms that countries that are characterised by lower effectiveness of the judicial system generally also record a lower share of rented housing (Casas-Arce and Saiz 2010). The underdevelopment of the private rental market in Poland compared to the euro area strengthens the asymmetric reaction of the Polish economy to changes in ECB interest rates after joining the euro area, as well as increases the risk of the formation of bubbles in the real estate market.

As a consequence it can be expected that the higher (than the euro area average) sensitivity of supply and demand for housing loans to interest rate changes would generate stronger cyclical fluctuations in the Polish economy than in the euro area.

Chapter 4. Mechanisms of prevention and adjustment to shocks

The discussion in the previous chapters shows that there are two main threats to the stability of the Polish economy after adopting the euro: the build-up of macroeconomic imbalances and divergence in business cycles. The first threat is mainly associated with the fact that the long-lasting persistence of low interest rates of the central bank may lead to an excessive expansion of credit and the emergence of bubbles in the housing market. This, in turn, through a gradual appreciation of the real exchange rate and a loss of cost-price competitiveness, combined with weak structural competitiveness, could lead to growing external imbalances in the form of a high current account deficit and growing net foreign debt (Chapters 1 and 2). The second risk is that as a result of the occurrence of asymmetric shocks or an asymmetric reaction to common shocks, there could be a divergence in the business cycle (Chapter 3).

In order to reduce the risk of the accumulation of macroeconomic imbalances it is necessary to design preventative mechanisms. The build-up of macroeconomic imbalances is spread over time results in stock disequilibrium, i.e. it leads to an increase in debt (domestic and foreign), ineffective capital allocation and a loss of export markets. The liquidation of imbalances is also a long-term process, entailing the necessity of deleveraging, permanent reallocation of resources, and even changes in the main parameters of economic policy. This means that before joining the euro area it is necessary to develop preventative mechanisms that would reduce the risk of the accumulation of macroeconomic imbalances. This could consist in implementing structural changes (including boosting innovativeness or the development of the private rental market) or implementing an active macro-prudential policy. The first section of this chapter discusses the main issues concerning the second of the above-mentioned solutions.

The scale of divergence in business cycles may, in turn, be limited by developing alternative adjustment mechanisms. The divergence in business cycles has a flow-like character, i.e. it leads to differences in the level of inflation, the unemployment rate, the output gap, etc. The liquidation of divergences could therefore take place relatively rapidly, particularly if effective adjustment mechanisms are developed. After joining the euro area mechanisms alternative to changes in interest rates and the nominal exchange rate have to be strengthened, such as, for example, an active fiscal policy. In this area the effective functioning of the labour and product markets is also very important. These issues are discussed in the second section of the chapter.

4.1. Preventive mechanisms – macro-prudential policy

The experience of euro area countries has shown that the creation of a single financial market increased the scale of capital flows, which led to the accumulation of macroeconomic imbalances. The euro area countries participated in the single financial market to an asymmetric degree; some countries were mainly importers of capital while others were exporters. An important role in the emergence of this phenomenon was played by differences in economic and financial development. These differences, amidst deepened financial integration and the growing ease of making cross-border transactions, resulted in long-term flows of capital from countries with a surplus of savings to countries with a deficit of savings. It is worth stressing

that these flows were made overwhelmingly in the form of interbank loans and investment in bonds, and to a lesser extent in the form of cross-border purchases of equity securities (Part 1 of the report). The long-term inflow of capital was one of the factors leading – in the receiving countries – to the emergence of housing bubbles, overheating of their economies, excessive growth of wages and prices, and as a result, loss of cost-price competitiveness. Taking into account the current differences in the level of economic and financial development between Poland and the euro area countries, there is a risk of similar phenomena occurring in Poland after the adoption of the single currency (Chapter 1).

The build-up of macroeconomic imbalances between the euro area countries was driven by a growing divergence in financial cycles. The financial cycle can be defined as fluctuations of a series of financial variables, such as the level and growth of credit, housing prices, or equity prices. Drehmann et al. (2012) show that the financial and business cycles differ in many respects – among others, the financial cycle is much longer and has a greater amplitude than the business cycle. The average length of the business cycle is from 6 quarters to 8 years, while the financial cycle lasts between 10 and 20 years. The above characteristics of the financial cycle show that the build-up of macroeconomic imbalances, particularly in the real estate markets in the peripheral countries, could be linked to financial cycles. During the crisis, the differences in the financial cycles were additionally enhanced by an asymmetric functioning of the monetary policy transmission mechanism.

Macro-prudential policy offers a series of tools to reduce the risk of growing financial imbalances and the effects of adjustments, hence it reduces the amplitude of fluctuations in the financial cycles. The global financial crisis showed that the ratio of the financial system assets to GDP, which was growing dynamically in recent decades, increased the dependence of macroeconomic stability on financial stability. Therefore, it is justified to broaden the area of interest of economic policy to include issues related to the role of the financial system. This task is to be fulfilled by macro-prudential policy, which, based on an analysis of the financial system and its relations with the real economy, is charged with identifying and responding to threats to the stability of the financial system and thus of the whole economy (a description of the origins of macro-prudential policy can be found in Borio 2009).

The character of tools is also another strong argument for the application of macro-prudential policy as a preventive rather than an adjustment mechanism. Both the process of decision-making and the impact of macro-prudential tools on the economy are spread over time. On the one hand, the introduction of some of the tools needs to be announced fairly long in advance. For example, pursuant to art. 136 of the Capital Requirements Directive (CRD IV), raising the level of the countercyclical buffer must be announced 12 months in advance (a shorter period is allowed only in exceptional circumstances). The relatively long period for their implementation and the structural character of some of them make the frequent adjustment in the level of selected instruments difficult. At the same time, the results of preliminary analysis show that the transmission mechanism for macro-prudential tools could be longer than in the case of monetary policy instruments (Wdowiński 2011). Nevertheless, some of the macro-prudential instruments, such as the restrictions on the loan-to-value and debt-to-income ratios, could be introduced without advance announcement and almost immediately restrict or increase the number of potential new borrowers. Some of the instruments could therefore be applied more flexibly, reducing credit restrictions during a crisis, but this does not change the basic preventive character of macro-prudential policy.

Macro-prudential policy, particularly in its cyclical aspect, should be implemented on a national level. Since the factors influencing the financial cycle, such as regulations of the real estate market and mortgages, are overwhelmingly of a national character, macro-prudential policy should also be conducted on a national level (Houben and Kakes 2013). Brzoza-Brzezina et al. (2013) – using a DSGE model for two economies in a currency union – also show that macro-prudential policy can play an important role in reducing the amplitude of the financial cycles. However, the condition is that this policy is implemented on a national level: simulations that have been carried out show that countercyclical macro-prudential policy on a supranational level is ineffective[12]. Moreover, countercyclical macro-prudential policy on a national level should increase the resilience of the banking sector to adverse shocks. According to simulations of the IMF (2013), an active macro-prudential policy in Ireland and Spain would have reduced considerably the fiscal costs of the recent crisis. If the macro-prudential policy framework that is now being implemented (specifically: the countercyclical capital buffer) had functioned in these economies in the 1990s, banks would have been obliged to increase the capital buffer in the period preceding the global financial crisis. An additional capital buffer, increasing the resilience of banks, could have significantly reduced the fiscal costs of restructuring the financial sector (in Ireland by one quarter and in Spain almost completely). Moreover, since it could have been difficult for some banks to raise additional capital, it would probably have prevented them from excessively increasing their lending activity. This could have prevented the build-up, or at least mitigated the size, of the credit boom and the real estate bubble.

A number of macro-prudential tools were introduced in the EU in the package of regulations including the Capital Requirements Directive (CRD IV) and the Capital Requirements Regulation (CRR). The CRD IV/CRR package harmonises and regulates a series of aspects related to the use of capital requirement tools (including the required level of own funds, the way of introducing the capital conservation buffer, the countercyclical buffer and the systemic risk buffer, as well as their levels, see next paragraph). This package also expands the possibilities for action to be taken by prudential authorities in response to the threat of a build-up of speculative bubbles in the real estate market, including through risk-weight adjustments for bank exposures related to the real estate market, or by keeping the limits on the loan-to-value and debt-to-income ratios among the instruments available to national prudential authorities – CRD IV/CRR neither regulates the use of these instruments nor places any restrictions on them (Bańbuła 2013).

The Capital Requirements Directive (CRD IV) regulates the rules allowing national macro-prudential authorities to set – with certain restrictions – the ceiling of the countercyclical capital buffer and the systemic risk buffer in their subordinate jurisdictions as well as to impose the obligation to maintain a capital conservation buffer. These buffers are added on top of standard capital requirements.

- *The countercyclical capital buffer* is variable over time: the buffer is increased in the growth phase of the financial cycle and lowered in the downturn phase. The objective of the buffer is to slow down bank lending during the expansion phase of the financial cycle and at the same time increase banks' capital base and resilience to possible losses in the downturn phase. In the case of setting a buffer to the level

[12] However, this does not concern the structural aspect of macro-prudential policy, i.e. the regulation of rules of functioning of the financial system. In this scope the pan-European approach is most needed due to the character of cross-border activities of financial groups in the EU.

of 2.5% of risk-weighted assets, the principle of reciprocity is automatically applied[13]; above 2.5%, the mutual recognition of the imposed buffer by the authorities of other countries is, however, voluntary.

- *The systemic risk buffer* is fixed in time and enables the national authorities to increase the capital requirements for banks in their jurisdictions in the case of long-term risk to financial stability which could have serious consequences for the financial system and the real economy. In the case of the systemic risk buffer, the principle of reciprocity does not apply automatically; however, national authorities may request the ESRB to issue appropriate recommendations addressed at other member states. The directive sets the minimum buffer at a level of 1% of risk-weighted assets. The imposition of a systemic risk buffer at a level higher than 3% of risk-weighted assets (and from 2015 above 5%) requires the agreement of the European Commission. With a buffer at a level ranging from 3% to 5%, in the case of a negative opinion of the Commission, the national authorities should follow the recommendation or explain the reasons for their refusal to do so (Brzozowski 2014).
- *Capital conservation buffer.* The directive imposes on banks in the EU the obligation to maintain an additional capital conservation buffer at the level of 2.5% of risk-weighted assets.

The regulation (CRR) allows national authorities the possibility to introduce additional (stricter) national measures, including those regarding the level of own funds, the level of the capital conservation buffer and the risk weights assigned to specific assets. Pursuant to art. 458 of the regulation (under the so-called flexibility clause), it is possible when the national authorities determine "…changes in the intensity of macroprudential or systemic risk[14] in the financial system with the potential to have serious negative consequences to the financial system and the real economy in a specific Member State…". However, the introduction of national measures is subject to a number of constraints:[15]

- national authorities must justify that other available tools cannot adequately address the observed risk;
- the introduction of measures may be challenged and rejected by the Council of the European Union on a proposal of the European Commission;[16]
- other EU member states are not obliged to apply the principle of reciprocity; however, national authorities may apply to the ESRB to issue an appropriate recommendation addressed at other states.

Moreover, the CRD IV and the CRR mention the leverage ratio as a supplementary tool[17]. The introduction of harmonised regulations on the leverage ratio within the EU is not planned until 2018. Until that time, member states have the possibility to apply the ratio in a way that they consider to be appropriate. As noted by NBP (2014), the possibility to set the threshold for the leverage ratio should remain one of the tools

[13] Reciprocity means that the authorities of other countries are required to apply the same buffer to financial institutions in their jurisdiction that have exposures in countries introducing the buffer (this concerns in particular the imposition of the same capital buffer on branches of banks in the country in which the buffer has been introduced). The principle of reciprocity is aimed at limiting the possibility of regulatory arbitrage by circumventing more restrictive national regulations through the transfer of lending activity to (associated) foreign entities that are not subject to national jurisdiction (more on this subject by Brzozowski 2014).

[14] Systemic risk is defined in the CRD IV/CRR package as a risk of disruption in the financial system, which can have serious negative consequences for the financial system and the real economy. The package does not contain a definition of macroprudential risks. In the opinion of the ESRB (2014a) there is no clear difference in the meaning of these terms.

[15] Stricter national measures can be introduced initially for a maximum period of two years. The period of applying national measures can be extended each time for one year, within the same procedure.

[16] This restriction does not apply to the increase of the risk weights for targeting asset bubbles in the residential and commercial property sector or intra financial sector exposures by 25%.

[17] The leverage ratio is calculated as the relation of all the bank's assets (not risk weighted), including off-balance sheet items, to equity, in other words, the bank's capital.

of macro-prudential policy at a national level, and the room for regulatory arbitrage should be restricted through the principle of reciprocity, similar as in the case of the countercyclical capital buffer.

Apart from changes related to capital requirements, the CRD IV and the CRR also introduce principles of liquidity risk management. The mismatch between the maturity structure of assets and liabilities and the reliance on wholesale financing was one of the causes of the scale of the current crisis (Brunnermeier 2009). The introduction of harmonised regulations on the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) is supposed to reduce the risk of crises in the future. As in the case of the leverage ratio, the final shape of these measures is still being consulted and their implementation within the EU is scheduled for 2018. The current proposals for EU acts include plans to set the minimum threshold for both measures; however, national authorities would have the possibility to set it at a higher level.

The results of analyses of the impact of increasing capital requirements on the economy show that the increase in the capital adequacy ratio leads to an increase in interest rates on loans and a decline in the effective demand for credit (MAG 2010). This means that an increase in the capital requirements could potentially be used to limit the fall in interest rates on loans after Poland joins the euro area, thus reducing the risk of a build-up of a credit bubble. According to the analysis of MAG (2010), raising capital requirements by 1 percentage point (gradually over 2 years) leads in the analysed countries to an increase in credit margins of, on average, 5-25 basis points (after 18 quarters). Similar calculations for Poland show that raising capital requirements by 2.5 percentage points would cause an increase in the interest rate on household loans by 41-56 basis points (in the fourth year of the simulation; Wdowiński 2011). Therefore it seems that Poland is one of the countries where the influence of capital requirements on the interest rate on loans for the private sector is relatively strong. Therefore, raising the interest rate on loans in Poland by 100 basis points would require, theoretically, an increase of capital requirements by 5-6 percentage points. The raising of capital requirements to such an extent would cause, theoretically, a fall in the effective demand for consumer credit by 6.5% and for housing credit by 19%.

In the case of Poland, the effectiveness of capital requirement tools in reducing the risk of an accumulation of macroeconomic imbalances could be limited by restrictions in the CRD IV/CRR package and a high level of capital adequacy of the banking sector. From a technical point of view, an increase in capital requirements that would completely neutralise the too low level of interest rates in the interbank market in relation to the needs of the Polish economy (Chapter 1) would most likely have to be so significant that it would be challenged and rejected by the European Commission or the Council of the European Union. Moreover, the effectiveness of the above-mentioned requirements would be reduced by a lack of reciprocity in their application (lack of the principle of reciprocity). In the case of the threshold for the leverage ratio, the possibility of its application is dependent on further agreement in the EU. From a practical point of view, the effectiveness of raising capital requirements could also be limited by the high level of capital adequacy of the banking sector in Poland. The average capital adequacy ratio of the banking sector in March 2014 was 15.6% (NBP 2014), compared to the requirements at the level of 8%[18]. It is not clear whether in the case of an increase of the capital requirements in Poland banks will maintain their current voluntary buffer above the regulatory minimum or simply reduce it – in this second case the effectiveness of the capital re-

[18] It is worth noting that the maintenance of a relatively high capital adequacy ratio by the banking sector in Poland could partly be explained by the currently relatively high credit margins (e.g. for housing loans) compared to countries in the euro area.

quirements as a macro-prudential instrument would be low. The Polish banking sector is also characterised by a low level of financial leverage: the average leverage ratio in domestic commercial banks as of March 2014 was 10.9. This is a level approx. three times lower than that proposed in Basel III (Bańbuła 2013).

Limits on the loan-to-value and debt-to-income ratios may be applied in the attempt to reduce the risk of growing bubbles in the real estate market (ESRB 2014b). Both ratios are standard prudential measures used by banks and micro-prudential supervision, except that the debt-to-income ratio is also widely used for loans other than mortgage loans. The setting of limits for both indicators in the framework of macro-prudential policy should reduce the scale of credit expansion in the growth phase of the financial cycle. Their effectiveness is demonstrated by empirical research, which shows that tightening the limits for the loan-to-value and debt-to-income ratios can slow down the growth rate of mortgage credit as well as reduce the number of transactions and the growth rate of prices in the real estate market (IMF 2013). Since there are currently no plans for the harmonisation of the use of these indicators within the EU, it can be expected that national authorities will have greater discretion in using this instrument. However, the lack of obligatory principles of reciprocity could lower their effectiveness through allowing the possibility of regulatory arbitrage. Another argument in favour of the active use of these macro-prudential policy tools in Poland is the fact that Poland has positive experience in applying some of them (*Recommendation S* and *Recommendation T*).

The effectiveness of macro-prudential policy tools after Poland joins the euro area may be limited by excessive harmonisation of regulations. An example are the restrictions that are placed on the possibility to apply stricter national prudential requirements under the CRDIV/CRR package. According to the ESRB (2014a), such restrictions could make it difficult for the national authorities to use these tools effectively. Therefore, the ESRB suggests increasing the flexibility in the application of selected tools, e.g. the possibility for national authorities to impose more than one level of the systemic risk buffer in order to limit various risk factors. The ESRB also recommends a strengthening of the regulations regarding the application of the principle of reciprocity, which seems to be more appropriate from the point of view of the effectiveness of applying macro-prudential policy tools than the pursuit of excessive harmonisation of requirements in order to avoid market disruptions and regulatory arbitrage.

The creation of the banking union may limit the possibilities to conduct macro-prudential policy at a national level. The introduction of a Single Supervisory Mechanism (SSM) implies the delegation of a significant part of micro-prudential powers in relation to banks in the euro area to the ECB. This means that after joining the euro, the banking sector will be subject to the direct or indirect supervision of the ECB. This could make it more difficult to introduce stricter macro-prudential policy measures in order to reduce the risk of a divergence of financial cycles. Moreover, the Regulation establishing the SSM provides for a transfer of certain macro-prudential policy powers to the ECB. In particular, the ECB has the possibility to tighten macro-prudential policy in member states, subject to close coordination with the national authorities. However, the precise design of the mechanism of taking due account of mutual opinions in applying macro-prudential tools remains an open question (more on this in part I of the report).

To summarize:

- Macro-prudential policy seems to be more effective as a preventive mechanism, reducing the risk of a build-up of financial imbalances, rather than as an adjustment mechanism, reducing the adverse effects of asymmetric shocks. Therefore, it should not be expected that macro-prudential policy is capable of replacing the lack of autonomy of monetary policy after adopting the euro.
- Due to the national character of factors influencing the financial cycle, macro-prudential policy should be implemented at a national level.
- The limits on the loan-to-value and debt-to-income ratios could potentially be the most effective macro-prudential tools after Poland joins the euro area. The advancing institutional integration and concentration of powers (e.g. in the framework of the ECB) as well as an excessive pursuit of harmonisation could, however, result in limiting the effectiveness of macro-prudential policy.

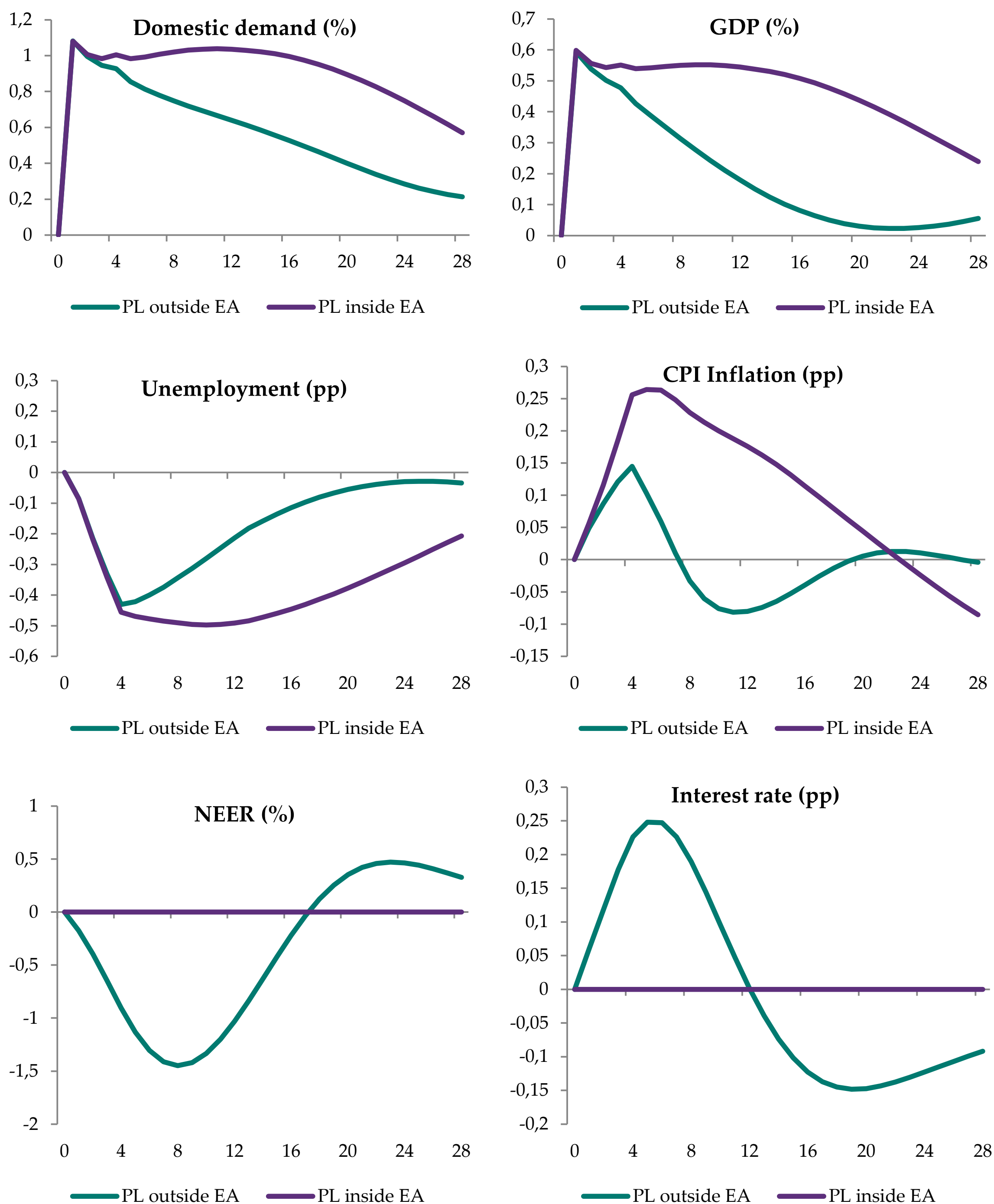
4.2. Adjustment mechanisms

In the absence of the possibility for national authorities of countries forming the currency union to use such instruments of economic policy as the nominal exchange rate and nominal interest rates, there is a risk that after joining the euro area the amplitude of fluctuations in economic activity will be higher. In analyses of macroeconomic adjustments in the currency union, the following market-based adjustment channels are distinguished: the real interest rate channel and the real exchange rate (competitiveness) channel. An asymmetric demand shock, causing an increase in inflation in only one of the regions, leads to opposing effects:

- *destabilisation* of the economy through a decline in real interest rates, which is conducive to a further increase in inflation (real interest rate channel),
- *stabilisation* of the economy through the gradual appreciation of the real exchange rate, leading to a worsening of external competitiveness and a reduction in export growth as well as a subsequent reduction in domestic demand and prices (real exchange rate channel).

Due to the dominant role of the real interest rate channel, particularly in the initial period after the occurrence of the shock, there is a risk that joining the euro area will amplify the cyclical fluctuations in the Polish economy.

Figure 20. The response of the Polish economy to asymmetric demand shock



Source: own calculations.

This is confirmed by the results of the simulation conducted on the basis of the NECMOD model of the Polish economy[19]. They show that if Poland conducts an independent monetary policy, the response of the economy to a demand shock is smaller than when Poland is in the euro area. In the simulation the influence of an unexpected disturbance to domestic demand was tested in two variants: Poland being "inside" and "outside" the euro area. A simplifying assumption was adopted that the relative size of the Polish economy is so small that a shock will not affect the remaining euro area countries. Therefore, there is no reaction of the common interest rate to the disturbance affecting only Poland. Moreover, it was assumed that alternative adjustment mechanisms (e.g. discretionary fiscal policy) are the same in both scenarios. The results of the simulations, which are presented in Figure 20, show that if Poland conducts an independent monetary policy the level of GDP converges gradually to the path of the baseline scenario, while annual CPI inflation grows to a maximum of 0.14 percentage points, returning, after 6 quarters, to the level observed before the disturbance. In the variant of joining the euro area, the scale of influence of the shock on inflation is greater (growth of 0.26 percentage points). The expiry rate of this disturbance is also slower. The difference is mainly due to the absorption of the shock by the response of monetary policy and the exchange rate – in the case of an independent monetary policy the central bank raises the interest rate by 0.25 percentage points, while the exchange rate strengthens by 1.4%.

Due to the low degree of centralisation of economic policy in the euro area (compared to other currency unions) alternative adjustment mechanisms are growing in importance. When deciding that the fiscal and economic policy is to be conducted by national authorities, the designers of the euro area institutional setup assumed that market-based adjustment mechanisms combined with countercyclical fiscal policy at the national level would allow the effective stabilisation of the business cycle in member states. It was also implicitly assumed that the stabilising real exchange rate channel would prevail in the medium to long term over the destabilising real interest rate channel, thus ensuring effective stability of the business cycle in the absence of autonomous monetary policy and floating exchange rates. This section will discuss the alternative (in relation to interest rates and the exchange rate) adjustment mechanisms, namely, fiscal policy instruments and market-based mechanisms related to the functioning of the labour and product markets.

4.2.1. Fiscal policy

In a country belonging to a currency union, fiscal policy is particularly important as the main instrument of stabilisation policy. Countercyclical fiscal policy may work through two channels. The first of these are spontaneous changes in the balance of public finances in response to cyclical fluctuations, in other words, the so-called automatic stabilizers. Their operation results from the dependence of tax revenues and certain categories of public expenditure (e.g. unemployment benefit) on the business cycle. The second channel is discretionary fiscal policy, in other words, intentional government measures aimed at increasing the deficit and stimulating the economy in the slowdown phase and tightening policy in the recovery phase. The use of this second tool potentially allows to increase the countercyclical impact of economic policy. However, it has weaknesses resulting from imperfections in the assessment of the current position in the business cycle and the lag in introducing fiscal measures, driven, among others, by the duration of the legislative process.

[19] A detailed description of the NECMOD model is available in Budnik et al. (2009).

Therefore, it is assumed that automatic stabilizers should be used to smoothen typical cyclical fluctuations, while discretionary policy should be applied only in the case of exceptionally large shocks. However, for automatic stabilizers to fulfil their role, discretionary policy should not act in the opposite direction, i.e. it should not be pro-cyclical.

In practice fiscal policy often acts asymmetrically over the business cycle, which constitutes an obstacle for its effective use as an instrument stabilising the economy. During a slowdown of the economy, the fiscal authorities willingly allow an increase in the public finances deficit arising from the operation of automatic stabilizers or even increase the deficit themselves. However, in conditions of an economic upturn, there is pressure not to assign growing tax revenues to deficit reduction, but to transfer them to the citizens in the form of lower taxation or increased spending. In addition, during periods of boom this is often supported by overestimated growth prospects of the economy, giving the impression that a loosening of fiscal policy does not lead to excessive growth of the debt to GDP ratio. The lack of public finance discipline during good times means that once the downturn comes, stimulation of the economy through increased deficit becomes too risky from the point of view of financing it. What is more, in a situation of rapidly increasing public debt, the pressure of the financial markets can force the government to immediately implement fiscal cuts in order to maintain credibility. The effect is a pro-cyclical fiscal policy having a destabilising impact on the economy. In order to avoid such a policy, it is necessary to maintain public debt and structural deficit of public finances at an appropriately low level so that it is possible to safely increase the nominal deficit during an economic downturn.

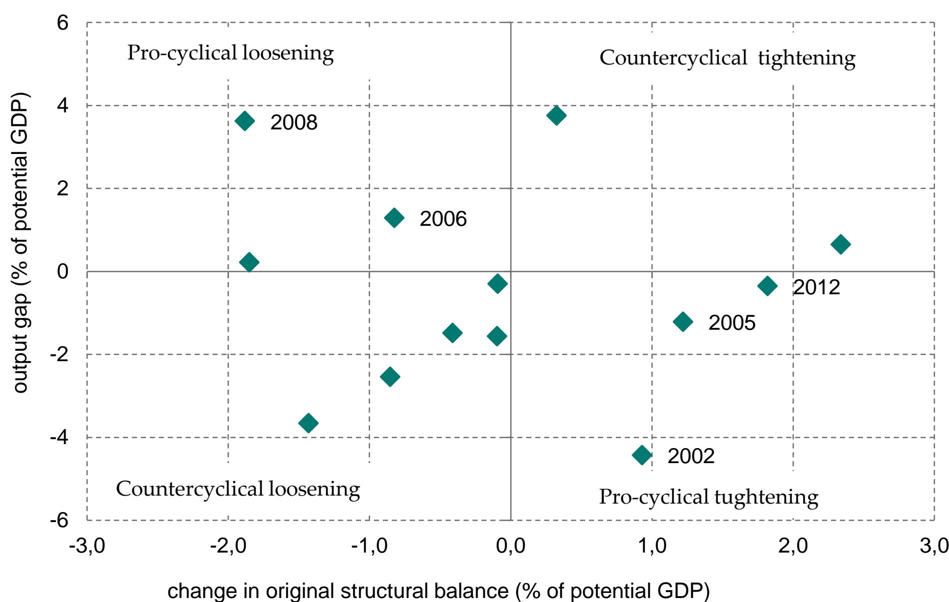
The effective use of fiscal policy as a stabilizing instrument can be supported by appropriate fiscal procedures. These allow the management of public finances in a way that takes into account the medium and long-term conditions, without being subject to *ad hoc* political pressure, which often leads to pro-cyclicality (Alesina et al. 2008). A key element of such fiscal procedures is the centralisation of the budget process, aiming to take into account in the decision-making all their benefits and costs and consciously chose expenditure priorities (Harden and von Hagen, 1995). Hallerberg et al. (2007) show that centralisation could be achieved in two ways – through the delegation or a contract approach. In the delegation approach, which is usually used by one-party governments, coordination of decisions in the framework of the budget process is entrusted to a single entity, usually the minister of finance, who plays a special role in this process. In the contract approach, typical for a multi-party coalition, centralisation takes place through the adoption of binding expenditure limits at the beginning of the budget process, and next their allocation in accordance with the agreed priorities. It is desirable that the limits are multi-annual in order to maintain an appropriate perspective of budget decisions. Effective centralisation of the budget process is favourable to the transparency of public finance, thanks to which the fiscal authorities and citizens have a full picture of the decisions taken.

Fiscal rules also affect the possibility to apply countercyclical policy, wherein the effect can be both positive and negative, depending on the form of the rules adopted. In recent years, the use of fiscal rules has become widespread – according to IMF data, as many as 81 countries apply them. While the aim of all the rules is to discipline public finances, their influence on the possibility to conduct countercyclical fiscal policy is indeterminate and depends on the form of the adopted solutions. The most important rules disciplining public finances in the upturn phase, and thus limiting the pro-cyclicality of fiscal policy, are expenditure and structural balance rules. On the other hand, the rules limiting the nominal level of the deficit

and debt or their relation to GDP do not produce this effect. With favourable economic conditions and high growth in tax revenues, these rules can be easily fulfilled without taking any tightening measures, but with the advent of an economic slowdown, pro-cyclical adjustments may be required in order to fulfil the rules.

Fiscal policy conducted in Poland in recent years has often been pro-cyclical. During periods of downturn or directly after them, it was necessary to take action to limit the deficit – this was the case in 2002 and in the years 2011-2013. These adjustments made it difficult for the economy to come out of the downturn phase. On the other hand, during the strong upturn of 2006-2008, the parliament decided to significantly loosen fiscal policy by lowering the tax burden, without offsetting this by expenditure reductions (Figure 21).

Figure 21. Cyclicality of fiscal policy in Poland in the years 2000-2013



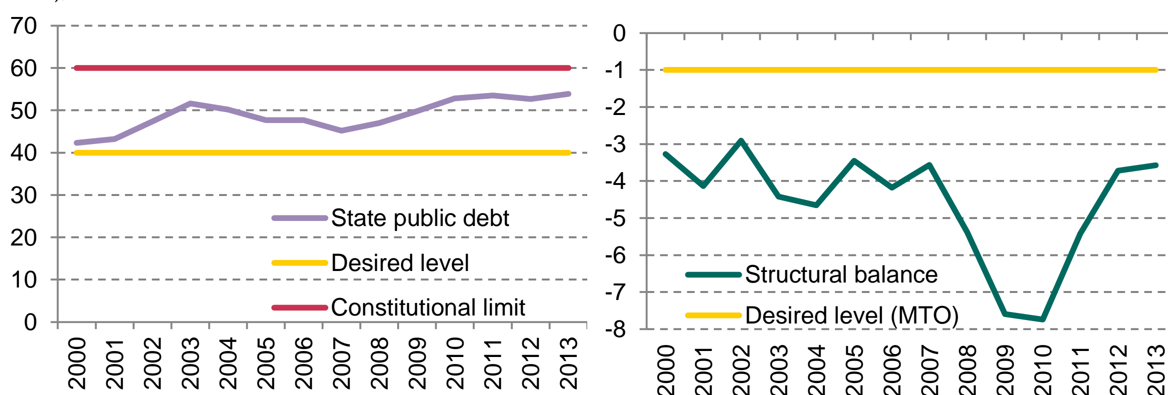
Source: own calculations on the basis of results of projected inflation and GDP of July 2014.

The form of budget procedures in Poland does not seem to be optimal from the point of view of conducting countercyclical fiscal policy. Hallerberg and von Hagen (2006) found that in comparison to other European countries, the budget process in Poland is centralised only to a small degree. Neither of the requirements are met, namely the strengthened role of the minister of finance, recommended for countries with a delegation approach to centralisation, or the requirement of expenditure limits, typical for countries with a contract approach to centralisation. Also the transparency of public finances was assessed by the authors as low. Poland has no binding multi-annual expenditure framework in force either. Since 2010 Multiannual Financial Plans have been drafted by the government, but the limits contained therein are not binding (OECD 2011).

The fiscal rules in force have most likely contributed to the pro-cyclical fiscal policy in Poland. A public debt limit of 60% of GDP, enshrined in the Constitution of the Republic of Poland has been in force since

1998; since 1999 it has been supplemented with the so-called prudential debt thresholds, amounting to 50% and 55% of GDP, provided for in the Public Finance Act. Should these thresholds be exceeded, the provisions of the Act will enforce the launch of adjustment measures. Experience with the use of this institutional framework confirms the above-mentioned risk of pro-cyclical impact of rules limiting the public debt. So far, the 50% of GDP threshold for public debt has been exceeded on two occasions with a risk of exceeding the 55% of GDP threshold – in 2003[20] and 2010. In both cases the economy was in a downturn phase (the output gap was negative in these years) and in both cases the functioning of the rules was an impulse to undertake adjustment measures which had a pro-cyclical effect. Meanwhile, during the pre-crisis boom of 2006-2008, the debt to GDP ratio declined, thanks to which the decision to increase the structural deficit of public finances did not seem to jeopardise the fulfilment of the debt rules. Apart from the national rules, since 2004 fiscal policy in Poland has been subject to European rules, enshrined in the Stability and Growth Pact (SGP), as described in the first part of the report. During the period preceding the sovereign debt crisis of the euro area, the system of rules enshrined in the SGP also had a pro-cyclical effect and did not prompt member states to observe fiscal discipline during the upturn.

Figure 22. State public debt[21] (left-hand panel) and the structural balance of public finances (right-hand panel), % of GDP



Source: Ministry of Finance (left panel) and own calculations on the basis of the results of projected inflation and GDP as of July 2014 (right panel).

Despite the existence of national and European fiscal rules, in recent years public debt and the structural deficit have persisted at too high a level to be able to provide room for a countercyclical fiscal policy. The indicator for the desired size of the structural balance is the medium-term objective (MTO) adopted by Poland and set at -1% of GDP. Meanwhile, in the period 2000-2013, the structural deficit regularly exceeded 3% of GDP (Figure 22, right-hand panel). In turn, the constitutional threshold of 60% of GDP is of key importance for the public debt. Since this amount is the absolute limit which cannot be exceeded even during a recession, the level of debt which should be maintained in "normal times" should be sufficiently low. As shown by the analysis of public debt in the euro area after the outbreak of the global economic crisis, the

[20] Data on the public debt exceeding the 50% of GDP threshold was published in 2004. Since then GDP has been revised. According to currently available data, as a result of these revisions, since the prudential debt thresholds were put in place up to 2010 the public debt remained below 50% of GDP.
[21] Data published by the Ministry of Finance in May next year, without taking into account subsequent revisions of GDP – assuming that the revisions were unexpected – such data is more reliable in terms of their impact on the current decisions taken by the fiscal authorities.

median increase in the ratio of debt to GDP in these countries amounted to approx. 20 percentage points. This could suggest that a safe target for the public debt to GDP ratio in Poland would be approx. 40%. In the years 2000-2013 the size of the state public debt announced each year by the Ministry of Finance always exceeded this level (Figure 22, left panel).

The stabilizing expenditure rule (SER) adopted in 2013 should significantly facilitate the conduct of countercyclical fiscal policy in the future. This rule, which for the first time will be applied while preparing the draft budget law for 2015, limits the growth of public expenditure to the medium-term GDP growth, additionally adjusted downwards when the public debt to GDP ratio exceeds 43%, or the general government deficit to GDP ratio exceeds 3%[22]. Such a design of the rule should help discipline public finances over the business cycle. Moreover, the SER, aimed at keeping the debt-to-GDP ratio at a level close to 40% of GDP, should provide effective protection against exceeding the constitutional limit. Whilst welcoming the adoption of the SER mechanism, it should be added that at the moment it is too early to say whether the adoption of this rule is sufficient to bring about fundamental changes in Polish public finances and permanently reduce the level of the structural deficit and public debt to levels that would allow the government to conduct a countercyclical fiscal policy.

Similarly, changes to the Stability and Growth Pact adopted after the outbreak of the crisis should help to conduct a countercyclical fiscal policy. As shown in the first part of the report, the so-called Six Pack aims, among others, to enforce the preventive arm of the SGP more rigorously, including to improve fiscal policy discipline in the upturn phase. The compulsory implementation of these regulations into national legislation in the case of the euro area countries, in accordance with the requirements of the Fiscal Pact, will further strengthen these regulations.

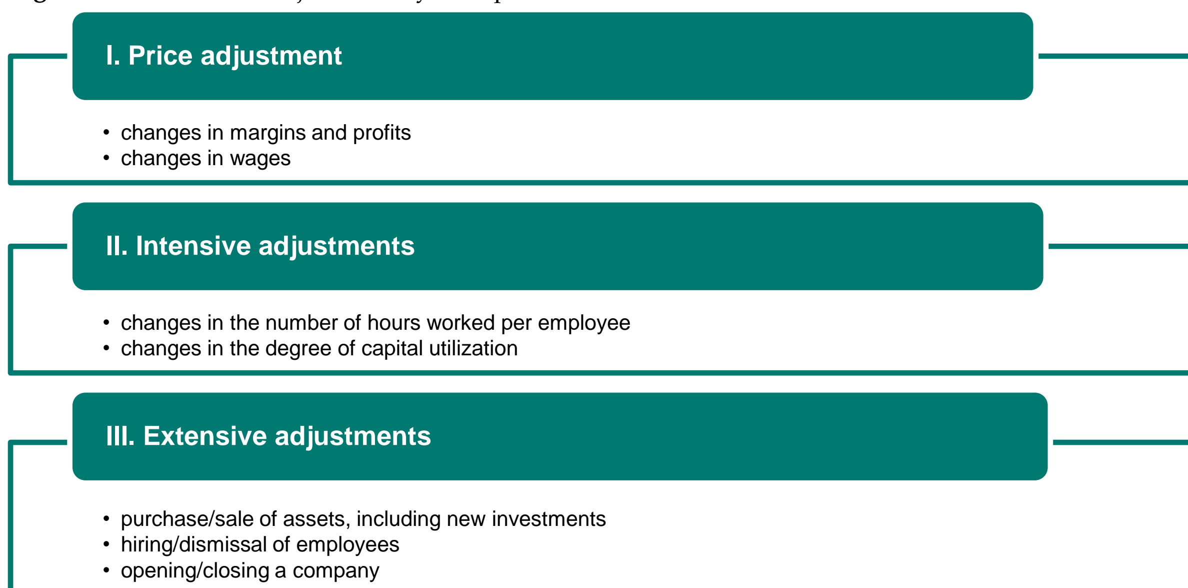
To summarize, in order to be able to use fiscal policy to smoothen the business cycle after joining the euro, two basic conditions have to be met. Firstly, in order to be able to use fiscal expansion to support the economy, the condition of public finances must be in a position to allow that. Secondly, discretionary fiscal policy must resist the temptation to act pro-cyclically, particularly during periods of favourable economic conditions. The experience of recent years shows that in Poland neither of these conditions was generally met. Neither the national procedures and fiscal rules in force in Poland nor the European Stability and Growth Pact supported the meeting of these conditions. During the last three years, the European, and even to a greater extent, the national fiscal rules, have been fundamentally changed. The amendments aimed at strengthening public finance discipline and discouraging pro-cyclical policies. However, it should be noted that the amended rules have not yet been put to the test, budget procedures still deviate from best practices, and the level of the structural deficit and public debt still clearly exceed the desired values. Thus it is still too early to say whether Poland will be able to effectively conduct a countercyclical fiscal policy thanks to the above-mentioned changes.

[22] In addition, upward or downward revisions of the rate of growth of spending are possible depending on the status of the so-called control account, which records deviations from the level of the MTO noted in the past general government balance, i.e. -1% of GDP.

4.2.2. Market mechanisms

Market-based adjustment mechanisms, which are determined by the functioning of the product and labour markets, are the second most important factor – after fiscal policy – determining how fast the economy of a currency union country returns to equilibrium after the occurrence of macroeconomic disturbances. The transmission of a shock leading to an increase in demand and inflation in one of the regions of a currency union is made through the destabilising real interest rate channel and the stabilising real exchange rate channel. Just as the action of the first channel can be neutralised by countercyclical fiscal policy (see the previous point), the real exchange rate channel can be strengthened by effectively functioning labour and product markets, which determine the market-based adjustment mechanisms. In particular, in a currency union institutions that enable the rapid reallocation of resources between and inside sectors are desirable, as well as those that increase the ability of companies to respond to changing price and demand conditions.

Figure 23. Channels of adjustment by enterprises to disturbances



Source: own work.

Market-based adjustment mechanisms can be divided into price, intensive and extensive adjustments. The response of companies to changing demand conditions can be made through three channels, whose effectiveness depends on the shape of the institutions that determine the functioning of the labour and product markets (Figure 23). In order to illustrate this, let us consider a situation of a fall in demand for products of a given company. The possible responses are as follows:

i. reduction in product price (through a fall in wages or profits) until the demand returns to the original level, while leaving production at an unchanged level (price adjustment),
ii. adjustment of the size of production to of the new, lower demand through a reduction in working hours or the intensity of capital utilization (intensive adjustment),
iii. reduction of the size of production to the new level of demand through dismissal of employees and the sale of fixed assets of the company (extensive adjustment),

iv. a combination of (i.), (ii), and (iii.).

The effectiveness of the intensive channel is important in the case of temporary disturbances, while the extensive channel is important in the case of permanent shocks. The response of companies to shocks depends on the expectations on how persistent the shocks are.

- In the case of a *temporary fall in demand*, taking into account the fixed costs of hiring and dismissing employees, an optimal response of companies is a temporary reduction in the intensity of production factors utilization. Brenke et al. (2011) show that considerable possibilities to change the working hours during the recent crisis significantly limited the growth of the unemployment rate in Germany and also resulted in companies being prepared for a rapid increase in production when demand started to pick up.
- In the case of a *permanent fall in demand*, it is optimal to reduce the activity (through dismissing employees, selling assets or not making new investments) or arrange its closure. Disturbances requiring a reallocation of productive resources between sectors, such as the bursting of a housing market bubble, require a high effectiveness of the process of dismissing and hiring employees as well as an effectively functioning bankruptcy law and effective regulations supporting the creation of new companies.

The effectiveness of market-based adjustment mechanisms after joining the euro area depends on the effectiveness of the price, intensive and extensive channels. This is why before Poland joins the euro area it is necessary to ensure that the range of possible responses of enterprises to macroeconomic disturbances is as wide as possible. The effectiveness of the price channel, associated with price and wage flexibility, is important in the case of aggregate shocks requiring adjustment of the exchange rate (in the currency union changes to the real exchange rate in relation to partners of the currency area can be made only through changes in relative prices and wages). An example of this type of shock could be the deterioration in the terms-of-trade. The effective functioning of the intensive channel plays a large role in the absorption of temporary fluctuations in demand. An example of this type of shock could be a short-term decline in world trade. In turn, the effectiveness of the extensive channel is crucial in the case of shocks that require the reallocation of productive resources. An example of this type of shock could be the bursting of a real estate bubble.

The characteristics of the Polish labour market indicate a high effectiveness of the price and extensive channels. Analyses presented in Chapter 3 show the following:

- high wage flexibility,
- considerable freedom of Polish enterprises in determining the level of employment, among others, by resorting to civil law and temporary contracts,
- low effectiveness of the matching process, associated with the low resources invested in an active labour market policy,
- low share of part-time employees.

The above characteristics show that market-based adjustment mechanisms operating through changes in the labour market in the majority of cases should work properly. There could be some concerns as to what degree the low effectiveness of the matching process in combination with low costs of dismissing employees would lead to an excessive and long-term increase in the unemployment rate in periods of adjustment

requiring a permanent reallocation of resources between sectors. Moreover, the low share of employees with part-time contracts could signal that the effectiveness of the intensive channel is limited[23]. In the context of the considerations presented in Chapter 3, it is worth noting that due to the rigidity of the labour market in the euro area countries, the high flexibility of the labour market in Poland, despite leading to a strengthening of market-based adjustment mechanisms, can increase the amplitude of business cycle fluctuations due to the asymmetric reaction to common macroeconomic shocks.

The flexibility of the Polish labour market is based on the high share of employees employed on fixed term contracts and the low level of state activity. The flexibility of the Polish labour market is determined by, among others, two factors: the low level of activity of the state, manifested by the relatively small expenditure on passive and active labour market policies, and the freedom of enterprises in setting wage and employment levels, especially by resorting to civil law and fixed-term contracts. This means that the costs of adjustments to changes in demand for labour are borne mainly by the employees, and in particular by employees with temporary contracts, and to a lesser degree by enterprises or the state. An alternative solution ensuring high flexibility of the labour market is the *flexsecurity* system. In this system the enterprise has many possibilities to adjust to changing demand conditions; however, the burden of the adjustments of the economy to changes in labour demand is covered to a large degree by the state. A comparison of the experience of Spain and Ireland, i.e. two economies which experienced a collapse in demand in the housing market during the recent crisis, would indicate that the effectiveness of the *flexsecurity* system proved to be greater than the system based on the dualism of the labour market[24].

In the case of the product market, there are a series of factors that limit the effectiveness of the price and extensive channels. One can hypothesize that the functioning of the product market will be a factor limiting the effectiveness of market-based adjustment mechanisms. In the later part of this section we will discuss the factors that prove the correctness of this hypothesis, such as the following: the level and variability of margins, the statistics measuring the allocative effeciency within sectors as well as selected elements related to the dynamics of the establishment and liquidation of economic activity.

At the sectoral level, margins in Poland are high, while their variability is low in comparison with the main economies of the euro area. The data presented in the left-hand panel of Figure 24 suggest that for the majority of sectors, the margins in Poland are at a level exceeding the average value for the main economies of the euro area[25]. This result is confirmed by studies using the firm-level data. According to Bottini and Molnár (2010), the margins in the construction and services sector enterprises in Poland are among the highest in the OECD countries, while their relatively high level in manufacturing is confirmed by the analyses of Gradzewicz and Hagemejer (2007). It should be noted that high margins in the intermediate goods sectors lead to elevated costs of final goods, hence reduce the international cost-price competitiveness (more on this in Allegre et al. 2004 and Forlani 2010). Therefore, after joining the euro area this may increase the risk of growing imbalances, particularly in the case of low structural competitiveness (more on this in Chapter 2). In turn, the low variability of margins (Figure 24, right-hand panel) limits the effectiveness of

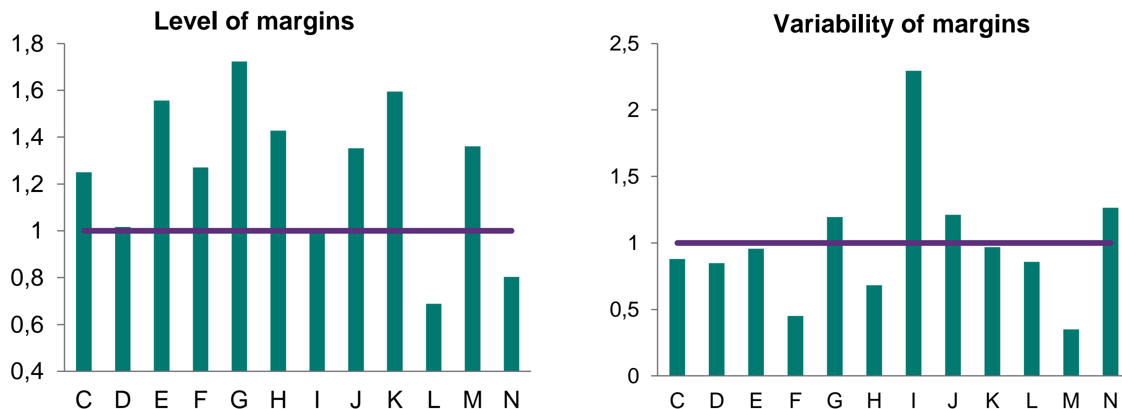
[23] As mentioned in Chapter 3, the intensive channel is most likely to be effective in the case of people employed on civil law contracts.

[24] However, it is worth mentioning that wage adjustment played a much greater role in Ireland than in Spain.

[25] It should be stressed that a comparison of the values of margins between the main countries of the euro area and Poland is difficult, among others due to the relatively high share of zero-employees companies in our country.

market-based adjustment mechanisms through the price channel. It is worth noting that the relative rigidity of margins is particularly noticeable in construction. This could pose a challenge should Poland experience a real estate bubble, since there is a risk that potential adjustments will be made through a fall in production and employment in this sector and to a lesser degree through adjustment of construction firms' margins.

Figure 24. Average level and variability of margins in Poland and EA4 countries (Germany, France, Italy, Spain) in the years 2000-2012 (average EA4=1)



Note: The level of margins is calculated using the following formula: margin = (value added – wages)/production

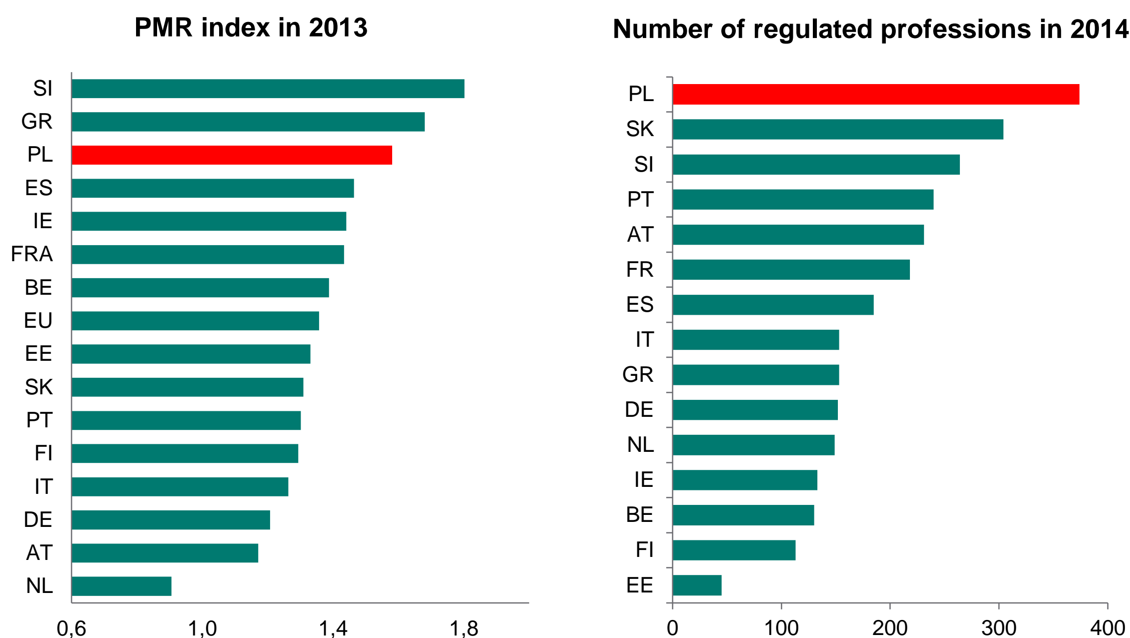
Legend: C – Industrial manufacturing; D – Production and supply of electricity, gas, steam and air to air conditioning systems; E – Water supply, sewage and waste management and restoration and rehabilitation activities; F – Construction; G – Wholesale and retail trade; repair of motor vehicles and motorcycles; H – Transportation and warehouse management; I – Activities related to accommodation and gastronomic services; J – Information and communication; K – Financial and insurance activities; L – Activities related to real estate services; M – Professional, scientific and technical activities; N – Administrative and support services.

Source: own calculations based on Eurostat data.

The relatively high level and low variability of margins could be related to excessive regulation, strengthening the monopolistic power of firms. High margins and their low variability are often symptoms of a highly monopolistic market, which, among others, might be related to the presence of barriers for the competition. It is worth mentioning two statistics. First, the numer of regulated professions is relatively high in Poland in comparison to other EU countries (Figure 25, right-hand panel). In this regard, however, one can expect changes leading to an increase in competition in the sector of professional services thanks to the reform prepared by the Ministry of Justice under the title "Deregulation of the access to professions"[26]. Secondly, numerous indicators describing the functioning of the product market, among others, the PMR index elaborated by the OECD, point to the excessive level of regulation of the Polish economy. Despite a clear decline in recent years, its value is still higher than the average level in EU or OECD countries (Figure 25, left-hand panel). In particular, it is worth emphasising the high level of regulation of the energy market, which can reduce competition and lead to an inadequate level of investment. This, in turn, will be reflected in higher costs of final goods production.

[26] The first two instalments of the reform came into force during the preparation of this report, while the third instalment was the subject of a meeting of the Sejm (the Polish parliament), and the Ministry of Justice gathered information on further professions to which access should be simplified.

Figure 25. Index of regulation of the product market in Poland compared to euro area countries



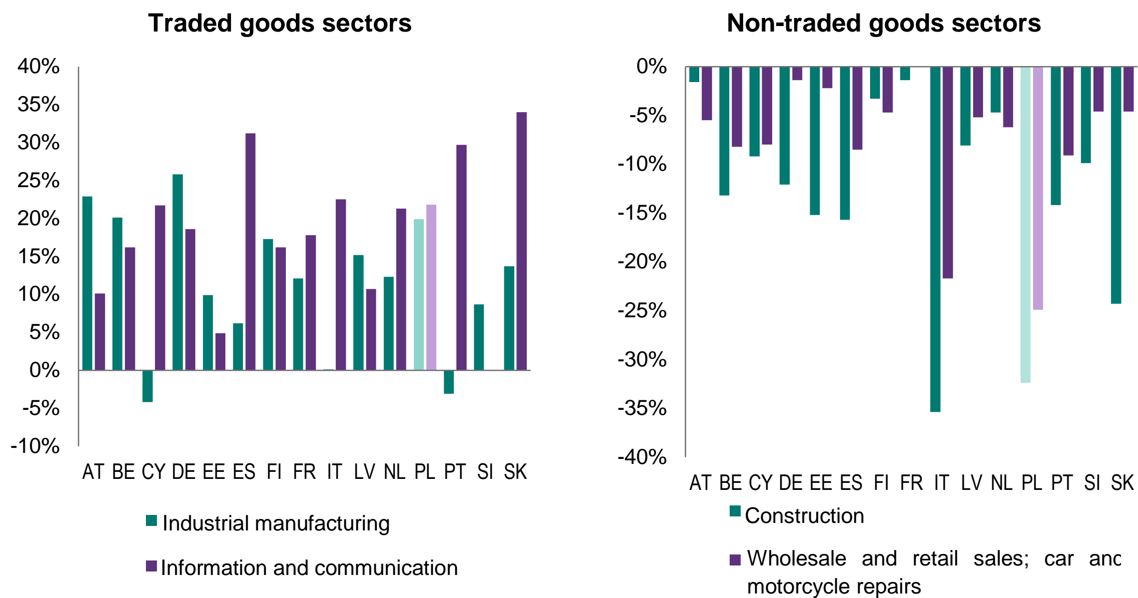
Source: OECD, European Commission.

The effectiveness of the extensive channel at the product market can be illustrated by the allocative efficiency index proposed by Olley-Pakes. Efficient allocation of resources depends on the well-functioning selection mechanisms. High productivity enterprises should theoretically increase the use of production factors and increase their share of the market. At the same time, the role of low-productivity companies should diminish, whereas the weakest entities should fall out of the market, freeing resources for newly-created rivals. The most common method of evaluating allocative efficiency is the Olley-Pakes' (1996) decomposition, which serves to check whether more productive companies have a relatively larger share of the market (or higher use of production resources) than their less productive competitors. The value of the allocative efficiency index above zero means that the aggregate productivity of a given sector of the economy is higher than if the shares of each of the companies were the same.

Compared to euro area countries, allocative efficiency in the Polish economy is relatively low in the services sector and high in manufacturing. International comparisons show a clear difference in allocative efficiency among countries. For example, the allocative efficiency index in manufacturing is approx. 50% in the USA, approx. 20-30% in Western Europe and only 0-10% in Central and Eastern Europe (Bartelsman at al. 2013). Against this background, the allocative efficiency of resources in Polish manufacturing sector is comparable to the most productive countries of the euro area (Figure 26, left-hand panel). However, the value of the allocative efficiency index is well-below zero and below the levels observed in euro area countries[27] for the majority of services sectors. This indicates that a significant part of the production factors is employed in enterprises with a lower-than-average productivity for the given sector (Figure 26, right-hand panel). This would suggest that the possibility to rapidly relocate resources in the services sector is limited.

[27] The allocative efficiency index in services sectors is usually lower than in manufacturing.

Figure 26. Allocative efficiency index in Poland compared to selected euro area countries

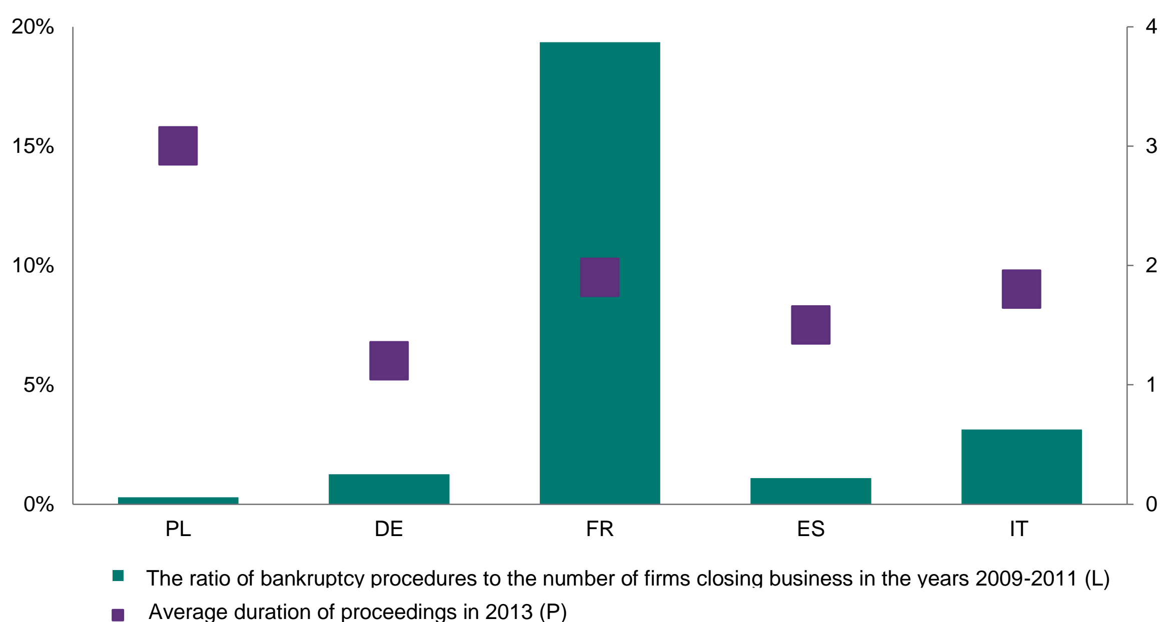


Note: data for 2010. Simplified breakdown, calculations based on data on productivity and share in employment for groups of enterprises employing 2-9; 10-19; 20-49; 50-249 and 250 or more employees.
Source: European Commission (2014).

The ability to relocate resources between sectors (extensive channel) might be limited by inefficient bankruptcy law. An efficient bankruptcy law is important because in a market economy failure and/or bankruptcy is a rule rather than an exception[28]. Therefore it is important that resources that are freed as a result of the termination of economic activity are used as quickly as possible and to as great a degree as possible in other enterprises. Unfortunately, in this respect Poland falls far behind the major euro area countries. Attention shold be drawn to the relatively long duration of the proceedings, translating into a lower rate of recovered assets and a slower transfer of fixed assets to other companies. The ineffectiveness of bankruptcy institutions in Poland is also demonstrated by the very low ratio of formal court proceedings to the actual number of companies that wind up their business (Figure 27). Moreover, there is a high number of dismissed bankruptcy applications due to insufficient value of assets of the enterprise to cover the costs of the proceedings, as well as the lack of will to carry out the restructuring proceedings. As a result, the bankruptcy law insufficiently supports illiquid enterprises threatened with bankruptcy, but which have a chance to continue economic activity after regaining liquidity. In other words, it insufficiently differentiates between culpable and non-culpable liquidity problems of enterprises (PTE 2013). The answer to the above problems is the draft of the Restructuring law[29] prepared by a team at the Ministry of Justice. However, it will be possible to evaluate the effectiveness of the reforms only after several years after their entry into force.

[28] According to Eurostat data for the years 2008-2011, approx. 60% of newly-created enterprises in EU countries are not able to survive for the first three years.
[29] The draft law was submitted for social consultation on 09.05.2014.

Figure 27. Indicators on bankruptcy proceedings in Poland compared to selected euro area countries

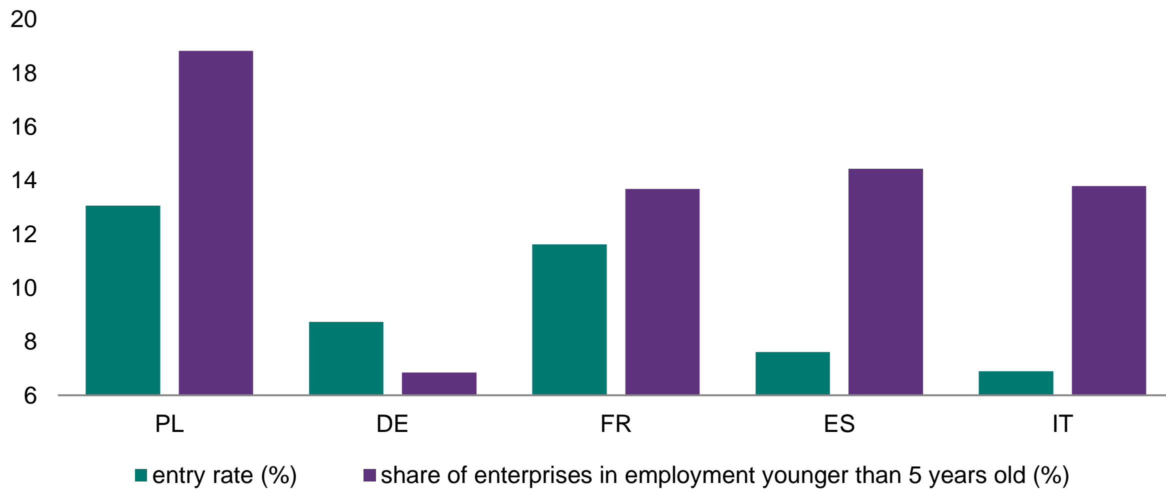


Source: Creditreform (2014), Eurostat, Doing Business.

Apart from weakening market-based adjustment mechanisms, the restrictive character of the bankruptcy law (the lack of a "second chance policy") can weaken the structural competitiveness of the economy. Andrews and Criscuolo (2013) indicate that the disproportion in the protection of the creditors' and debtors' rights, as well as excesively restrictive policy towards entrepreneurs who have failed, could reduce the willingness to invest in innovations, which by their nature bear higher risk. This leads to a permanently low supply of innovations, hence a smaller number of start-ups, patents and lower investment in research and development. The importance of these issues is discussed more widely in Chapter 2.

Despite the high degree of regulation of the product market, data on enterprise demography show that for the last decade the scale of extensive adjustments has been relatively large compared to the majority of the euro area countries. The entry rate in Poland, i.e. the ratio of the number of enterprises created in a given year in relation to the number of existing enterprises, stood at a significantly higher level than in the main euro area countries. The relatively high rate of business start-ups and wind-ups is also confirmed by the data on the share of young companies in the total population of companies (Figure 28). However, the interpretation of the indicators should be cautious since in the case of Poland their value could be inflated by the restructuring of the economy and the high share of self-employment. As convergence of the Polish economy proceeds, taking into account the greater regulatory burden than in the euro area countries and the relatively lower quality of institutional environment of doing business, it is difficult to expect that the currently high rate of business start-ups and wind-ups will be sustained in the medium-term perspective.

Figure 28. Indicators of enterprise demography in the years 2008-2011 in Poland compared to selected euro area countries



Source: Eurostat.

To summarize, the effectiveness of market-based adjustment mechanisms seems to be supported by a high flexibility of the labour market and a limited rigidity of the product market. The main challenges associated with the functioning of market-based adjustment mechanisms after Poland joins the euro area should include the following:

- high degree of regulation of the product market, leading to monopolisation and excessive margins;
- ineffective bankruptcy law;
- low effectiveness of matching mechanisms in the labour market.

It is also worth recalling that the high flexibility of the Polish labour market is obtained by allowing for an extensive use of civil law and fixed-term contracts, and not thanks to an active and effective state policy.

Summary Part II

The presented considerations indicate that Poland's accession to the euro area currently involves the following challenges:

1. *The convergence process*. Poland is a country with a relatively low level of GDP *per capita* and prices. After joining the euro area, the level of interest rates set by the ECB could prove to be too low in relation to the needs of the Polish economy. This will pose the risk of building-up macroeconomic imbalances, among others, in the form of a real estate bubble. The risk of the real-estate bubble is increased by the underdevelopment of the private rental market.
2. *Moderate structural competiveness.* Currently, the competitiveness of the Polish economy is based predominantly on low labour costs. Wage convergence means the need to develop non-price sources of competitiveness, among others, through increased investment in innovations.
3. *Different structure of the economy.* The structure of the Polish economy differs from the structures of the major euro area economies. This concerns mainly the labour market (among others its high flexibility, partly based on dualism) and the housing market (among others, the underdevelopment of the private rental market and the prevalence of loans with variable interest rates). As the experience of the peripheral countries shows, this type of heterogeneity could lead to a situation in which the common monetary policy will not be adequate to the cyclical situation in the country.
4. *Insufficient effectiveness of selected adjustment mechanisms.* For a euro area country it is important to develop alternative mechanisms of adjustments to macroeconomic disturbances. In this regard, the challenge is that the current level of public debt and structural deficit limits the possibility to conduct a countercyclical fiscal policy, while the excessive level of selected regulations reduces the speed of reallocation of production factors.

Macro-prudential policy will not replace an autonomous monetary policy. Both the decision-making process and the impact of macro-prudential policy on the economy are more spread over time than in the case of monetary policy. Thus macro-prudential policy should be treated as a preventive mechanism in reducing the risk of a build-up of financial imbalances, and not as a substite for monetary policy. Moreover, the presented considerations on the effectiveness of macro-prudential policy suggest that it should be implemented at a national level.

The decision on joining the euro area should involve a set of structural reforms strengthening the fundamentals of the Polish economy. The analyses presented in this report, based to a large extent on the experience of euro area countries over the last fifteen years, suggest that the ability to seize the opportunities of the euro adoption, which are in the form of higher economic growth and increased welfare, depends on how well prepared the Polish economy is to function within the framework of a common monetary policy. **For this reason, the decision to join the euro area should be preceded by a well-elaborated reform programme aimed at strengthening the fundamentals of the Polish economy and, at the same time, adjusting its structure to the characteristics of the euro area.**

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