

NBP

Narodowy Bank Polski

# Recent Developments in the European Union

## Polish Experiences

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# Emerging Europe is not homogenous

- Dimensions
  - EU membership
  - Euro zone membership
  - Exchange rate regime
  - Monetary policy framework
  - Financial sector ownership
  - Size of the domestic financial sector
  - Historical background
- Polish case
  - EU member since May 2004
  - Obligation of euro adoption
  - Free float exchange rate regime (since 2000)
  - Inflation targeting (since 1999)
  - Over 70 percent of financial sector belongs to the foreign private investors
  - Highly liquid TB market, developed stock market, shallow commercial debt market
  - Former centrally planned economy (experience of high dollarization and hyperinflation)

## Capital flows

- Forms of capital flows
  - Foreign direct investments (special role of intra-company debt)
  - Refinancing of foreign currency denominated mortgages
  - Portfolio capital (TB and equity)
  - EU funds
- Phases of capital flows
  - Pre-accession period – phase I (1990-1998)
    - FDI (privatization)
    - Large scale foreign investments
    - Limited portfolio investments (elements of capital controls)
  - Accession period – phase II (1998-2003)
    - Inter-firm credit for large companies (debt instruments)
    - Portfolio investments on Warsaw Stock Exchange (blue chips)
  - EU membership – phase III (since 2004)
    - Refinancing of mortgages by foreign currency deposits
    - Large portfolio investments into TB

## Absorption of foreign savings

- Phase I - limited impact on growth and crucial for structural changes
  - Domestic savings growing in line with foreign capital
  - New know-how (financial sector)
  - Financial support for structural reforms
- Phase II – accelerated development of selective branches
  - Domestic savings still growing in line with foreign capital
  - Selective branches (high revenue to capital ratio) financed by inter-firm credit
- Phase III (pre-crisis period) – growing risk of overheating
  - Loans growing faster than liabilities of the banking sector (refinancing mortgages mechanism)
  - Excessive current account deficit
  - A bubble in housing market

## Capital flows in a right direction

- Key explanations
  - Risk-adjusted returns to capital
  - Growing total factor productivity
  - Responsible macroeconomic policy
- Conservative risk premium assessment
  - Historical background
  - Slow improvement of ratings
  - High exchange risk
  - Limited liquidity
- Build-in mechanism of total productivity growth
- Institutional development – clear agenda
  - Balcerowicz plan – a stabilization package
  - Accession agenda
  - Euro adoption declaration

## Accelerated growth and vulnerability in pre-crisis period

- Building up external vulnerability (2006-2008)
  - Widening current account deficit (appreciation trend)
  - Growing unit labor cost faster than productivity
- Limited impact of the counter-credit monetary policy
  - Invert impact of tight monetary policy in the case of foreign currency mortgages
  - Weak interest rate channel of monetary policy
- Relaxation of fiscal policy
  - Lack of public expenditure reform (non discretionary expenditure)
  - Excessive tax cuts (PIT and contribution to social security system)
- Delay of euro adoption

## Rebalancing economy during the crisis

- Limited outflow of foreign capital
  - Short-term outflow of foreign capital from TB
  - Open Pension Funds as a stabilizer of Warsaw Stock Exchange
  - Vienna initiative
- Double effect of depreciation of Polish zloty
  - Rebalancing current account
  - Foreign liquidity mismatches
  - Liquidity problems addressed by central bank (NBP)
- Contained credit risk due to former prudential regulations
- Fiscal impulse financed by EU funds
  - Lack of public expenditure reform (non discretion expenditure)
  - Excessive tax cuts (PIT and contribution to social security system)

## Managing vulnerability in the post crisis era

- How to limit the outflow of foreign capital from the banking sector
  - Decoupling of the mother-bank's deleveraging process from the financial standing of local subsidiary
  - Foreign liquidity safety-net
- Prudential regulation
  - Elimination of regulatory arbitrage in the EU
  - Flexible system of capital buffers
  - Norms on liquidity mismatches
- Households
  - General credit risk norms (LTV, LTI, etc.)
  - Limitation of the f/x risk for unhedged customers
  - Information policy about potential risks
- Governments – solvency vs. liquidity
  - Sustainable threshold for public debt
  - Fiscal policy framework (debt sustainability law)
  - Liquidity safety-net