EUROPEAN COMMISSION
European Research Area
SEVENTH FRAMEWORK PROGRAMME
Funded under Socio-economic Sciences & Humanities

AUGUR

Challenges for Europe in the World in 2030

Project no. SSH-CT-2009-244565

Collaborative Project

SP1-Cooperation

DELIVERABLE D8.1 (WP 8)

Hypotheses and trends on major political issues

Due date of deliverable:	**30 April 2010**
Actual submission date:	**20 October 2010**
Start date of project:	**1. October 2009**
Duration:	**36 months**
Lead contractor:	**KU-TIGER**
Revision:	**2**

Project co-funded by the European Commission within the Sixth Framework Programme ('02-'06)		
Dissemination Level		
PU	Public	
PP	Restricted to other programme participants (including the Commission Services)	
RE	Restricted to a group specified by the consortium (including the Commission Services)	
CO	Confidential, only for members of the consortium (including the Commission Services)	**x**

Jacek Tomkiewicz
Grzegorz W. Kolodko

The Prospects for Europe and the World in the Next 20 Years – the Institutional Framework of Economic Policy

The general aim of the research area is to look for an answer to the following question: How do economic policies of specific countries and an economic policy carried out at the supranational level change as a result of long-term economic, social, and cultural trends?

Structure of the text is as follow: first we discuss general approach to economic policy. In the next part we present critical role of institutions in policy making and we also analyse quite new phenomena which we call "Gray Sector" in politics.

In the later part of the article we analyse current situation of global economy and situation in thr EU special in the context of contemporary financial crisis.

Means and ends of economic policy

Incidentally, the question of identifying means and ends in the context of development processes deserves further serious debate.

From a purely economic standpoint, it should be obvious that the goal is socio-economic development, part of which is economic growth *per se*. Such categories and processes as budget, inflation, privatization, rates of exchange, interest rates, taxes *etc.* are merely instruments facilitating the attainment of this supremegoal. Confusing these two things in economic policy is quite costly, as the Poles have had a chance to learn over the past 15 years, although, luckily, on a smaller scale than some other countries in the region. In a broader context — bearing in mind that freedom and democracy are autonomous values — dilemmas arise around the question of what should be subservient

and subordinate to what. Amartya Sen appears to be free from doubt on that score as he declares that «Freedoms are not only the primary ends of development, they are also among its principal means» (Sen, 2000, p. 10). This is the right approach, for it emphasizes the positive feedback between freedom and development. The problem is that this synergy only manifests itself in the long-term or even very long-term perspective. Once again, one needs to be very patient.

However, as the biological clock is ticking away, not everyone will be able to enjoy the fruits of their patience. Is it then possible, or, differently put, is it worthwhile to subordinate freedom and democracy to the requirements of an efficient economic policy and rapid output growth, which brings about an outcome of vast importance: an improvement in the living standards? This seems to be the prevailing approach, for instance, in China and Vietnam, where sensible development policies have been pursued for many years, in the context of rather limited democratic arrangements, but not so in Uzbekistan or Turkmenistan, where such policies have been lacking. Or is it, perhaps, better to cherish freedom and democracy, even if they stand in the way of implementing an effective pro-growth policy? This has been the case in Poland, among other places, where the institutional weakness of a young political democracy and civil society hampers the pursuit of a sensible pro-growth policy and affects the functionality of the painstakingly constructed institutions of market economy.

It is not enough to win majority support for one's views: these need to be the right views in the first place. But the reverse is also true: in a democracy, being right is not enough, one needs majority support besides. And political practice shows unequivocally that what is right on substantive grounds may not come across to the majority and win its understanding and approval. Not least because an influential, opinion making minority can make use of various democratic institutions, such as the media, to impose their priorities on others. This is the paradoxical case of a democratically endorsed, yet erroneous policy. Such a policy has to be continued until the majority comes round to the right way of thinking or, conversely, those who are right become a majority. Once again, this requires not only knowledge and culture, but also time and patience. And the latter is likely to run out with some people or at certain times.

The main problems of interest for us are the rate of economic growth, the structure of the increments of global output and their absorption over time, as well as the distribution of growth effects among various social, occupational and income groups, and their allocation to various types of goals. When analyzing these problems, one must not abstract away from the regional aspect of income creation and distribution. The policy of GDP redistribution in time and space (construed in social as well as geographical terms) is more likely to stir up controversy than the issue of output dynamics itself. In some cases more social and economic problems arise in times of relatively faster growth, because it is accompanied by increased redistribution. As a result, grievances about perceived inequitable division of the fruits of growth are more acute than at a time of weaker economic dynamics.

Undoubtedly, this syndrome can be observed in present post-socialist economies which experienced quiet successful economic progress, but significant part of society (possibly even a majority) still fails to benefit from this growth. Worse still, there are groups of households and entrepreneurs who experience a continuing, painful drop in real incomes. For them, the growth of output, which has already attained substantial proportions, signifies a "loss". This generates resentment which not only prevents reaching the level of social contentment that would be attainable assuming a different distribution of income, but also affects growth in the long run (Tanzi, Chu and Gupta, 1999). Thus an inequitable distribution of income (or, more precisely, of the effects of its real increase) is harmful not only from a social point of view, but also for purely pragmatic reasons, for such a policy hinders efficiency and growth, so after a while it turns against its former beneficiaries. Interestingly, the latter of- ten fail to understand this, also in Poland, as is attested to by the never-ending controversies over tax rates applicable to the relatively richer sectors of society.

Institution building – crucial approach to the systemic change

Both the collapse in the early 1990s and the great transitional depression that followed proved beyond any doubt that the one sided orientation towards liberalization (of prices, trade, business entry and exit) and privatization, neglecting the importance of

institution building for the efficient functioning and development of market economy, came at a heavy price for all (well, nearly all) of us. Such a recipe is certainly not sufficient to create a dynamic, expanding market economy (North, 1997). Worse still, lost output is unrecoverable, while social costs in terms of massive unemployment and exclusion are enormous.

Today, however, no one calls into question the role of institutions any more; just the opposite — it has been heavily emphasized for the last couple of years, even by the former advocates of a naive, neoliberal approach subscribing to the unrealistic notion that the mythical invisible hand of the market would now replace the old institutions, which were rightly being eliminated, such as state ownership, central planning, administrative controls on prices, inconvertible currency or subsidies. In most cases it is not that simple: the old institutions must indeed be dismantled or die away, but new ones must emerge in their place.

The latter is a tedious process, requiring constant involvement of the state — itself one of the most essential institutions in the process of fundamental change (Kornai, 2001).

The popularity of the term institutions towards the end of the first 15 years of transformation is comparable to that of "liberalization" and "stabilization" at the beginning of this period, or other buzzwords, such as "privatization" and "deregulation" slightly later. Nowadays, terms such as institutions, institution building, institutional structure of the market or institutional order are household words in many languages, not only English, but also Russian or Chinese. Luckily, in Polish, too. A review of the relevant literature worldwide, including the weighty publications of such organizations as the World Bank or, especially, the International Monetary Fund, would reveal a striking contrast between the absence of these notions from earlier works, published in the early 1990s, and their very frequent use nowadays (World Bank, 2002; IMF, 2003).

What, then, are institutions? In a narrower sense, institutions comprise the rules of the economic game — in this case, the market game — made up by the law and organizations that enforce compliance with these rules on the part of all economic entities, using incentives, rewards and penalties ("carrot and stick"). The quantifier all used in this context includes the government and non-governmental organizations,

enterprises from the vanishing state sector and expanding private sector, internal and external agencies operating in an open market economy, financial and capital-market intermediaries, as well as households. Incidentally, it should be noted that some confusion arises due to the fact that the word institution is quite often used in the economic jargon in the sense of an organization or structure — one speaks, for instance, of financial institutions or state institutions — whereas the institutions that we discuss here organize, control and shape economic processes to ensure their sufficiently smooth progress, with due respect to the interests of all the partners in the social reproduction process. Just like traffic regulations, which govern the use of public roads, apply to pedestrians, drivers and the police alike, to streets and parking spaces, by day and by night. A car or scooter may be privately owned, but its use, in view of its external effects, is a matter of not only personal, but also public concern. Therefore, it must be subjected to some restrictions and regulated in ways the actors understand and are obliged to respect in the public interest, as well as for their own good. To continue this simile, institutions include both a speed limit and a ticket for breaking this limit, as well as a delinquency fee for its late payment; likewise, institutions comprise traffic regulations and the applicable enforcement measures.

By the same token, market institutions include both a contract between entrepreneurs and arbitration or court proceedings; both the price of a commodity or service, agreed upon between the buyer and the vendor, and the right to make a complaint about a faulty product, as well as consumer organizations which strengthen the market position of buyers *vis-à-vis* manufacturers and vendors. To sum up, institutions comprise:

1) the procedures and rules of conduct sanctioned by the law
or by custom;

2) the applicable laws and regulations, promulgated in order
to protect the interests of market entities;

3) the organizations and administrative/political structures that serve the needs of various market entities — from the government and central bank to capital-market agencies and anti-monopoly authorities (expected to compel economic entities to follow specific norms defined by the applicable laws in the interest of the entire socio-economic system) to commercial banks and commodity exchanges;

4) and last — which extends the scope of our definition —institutions in the broad sense of the term also include market culture and mentality.

In this perspective, institutions are not only built, promulgated or decreed, but also understood and learnt. Besides, it is (or should be) obvious that this learning process, even if very actively pursued, must be gradual and lengthy. Also in the case of the unique, unprecedented process of reunification of Germany, the fourth, institutional dimension — "learning the market" — had to be protracted and could not follow a "shock" formula, because no single political act would have effected a radical transformation of a culture and mentality rooted in the socialist system and planned economy into their capitalist, market based counterparts.

To be able to follow the rules of the market game, one needs an adequate knowledge, which may not always be acquired from textbooks or from other actors, but must be learnt by experience.

One also has to form specific habits and characteristics, which were often unnecessary or poorly developed under the previous system. Now the old habits — so to speak, the "old, non-market culture" — become a liability of which one has to be freed, in particular, by successively learning market economy. It is an instance of learning by doing, which takes time. It is thus a lasting process which, however, requires much less time to complete in those countries where market reforms had reached an advanced stage already by 1989 in comparison with those which embarked on a systemic transformation with institutions that followed more closely the socialist orthodoxy. This explains to some extent why the transitional recession was much shorter in Poland and Hungary than, for example, in Romania and Ukraine.

The Gray Sector in Politics

As has been said, institutions are vital, and so is policy; institutions are not a substitute for it, but they facilitate or hamper its efficient implementation from the point of view of economic dynamics.

We construe policy, in this context, in various ways, concentrating in most cases on its overt, public aspects. However, just like the economy has its gray sector (so-called

shadow economy), hard to observe and control, so a gray sector exists in politics (shadow politics). It has been even less studied than its economic counterpart.

The reason is that the scientific community and so-called independent media are all but paralyzed with fear when it comes to a systematic investigation of "gray politics". And yet many decisions, sometimes of key importance for economic growth, are taken in the gray sector and only then transferred to the sphere of overt policy at officially recorded cabinet meetings, sessions of the Parliament and its committees, or proceedings of the independent central bank and its monetary policy council.

The actual decisions are taken after informal discussions that take into account political arrangements and the position of various interest groups, whereas official politics serves only as a formal and public instrument to implement settlements made elsewhere.

Elaborating on the simile between politics and economics, one can venture to say that the proportion of decisions made de facto in the political gray sector to those that are taken entirely through official channels is higher than the ratio of unrecorded and untaxed gray-sector turnover to registered economic transactions.

Any analysis and evaluation of current policies should take into account this phenomenon, particularly in connection with recommendations on desired policy directions. It is fairly obvious that the scope for gray sector politics depends on the maturity of the institutions of a democratic state and civil society on the one hand, and the market economy on the other.

What, then, is economic policy? It should be seen as an ability to solve mass-scale social problems on economic grounds. To put it differently, it is a capacity to engage in a specific kind of game with all the actors involved in the liberalized market economy.

In the context of the present discussion, it is a game which should lead to expanded macroeconomic reproduction. Its object is to maintain the highest growth rate possible and distribute its effects in an equitable, that is, socially acceptable, manner. For it is social sentiment, rather than the judgment of some economists or political leaders, that decides what is equitable and what is not.

Ultimately, decisions on such matters must be taken in the parliament, through the adoption of laws, budget acts and other arrangements relating to the tax system, financial transfers, and social policy.

However, such public decisions are often secondary to decisions taken in private in government offices or party caucuses, since many persons involved view politics differently: as a matter of who supports whom against whom and for what kind of money.

On such an interpretation, it is likewise a game, but one of a negative and often harmful character, oriented towards destroying political enemies and advancing particularistic interests of one's own and one's political clientele. In other words, politics — and especially the better part of gray-sector politics — does not have to be subordinated to the common good and public interest, and hence does not have to promote economic growth. Sometimes it may even impede it.

One might ask why the growth rate in Poland plunged form 7.5% in the second quarter of 1997 to a stagnant 0.2% in the fourth quarter of 2001. After all, it was hardly a consequence of external shocks. Neither was it a case of institutional retrogression, for the maturation process in this area went on uninterrupted.

Privatization and liberalization were continued; openness to the global economy was increasing; integration with the European Union was in progress. But the state was being weakened and the economic policy was being misdirected through a harmful combination of liberal and populist ideas.

Furthermore, the power struggle aspect of politics is present at all times. Some attempt to stay in power, others to gain power, usually affecting in the process the dynamics of the economy by obstructing decisions that foster development and hindering growth-promoting structural reforms. In this approach to politics, the yardstick is the "effectiveness" of a policy from the point of view of its proponents' interests, which translate in many cases into weakening authority, rather than enhancing growth tendencies.

World Economic Policy

The first assumption to be made consists in deciding whether in 20 years' time, the world politics will be dominated by a major national actor or maybe there will be no specific leader.

The course of events in recent years shows that the US will become less important in both economy and politics. Of course, the analysis of the world politics will still take into account the role and interests of the US for many years to come; however, there are numerous signs indicating that the US is not very likely to maintain its dominant position held at the turn of the century. Another obvious question is whether the US will be replaced by another superpower that will dominate the world politics for many years. Economic history shows that the fall of a world superpower is usually accompanied by the rise of a new leader. It is doubtful, however, as shown by political and economic trends, that China (it is the very country that is most frequently referred to as the next world superpower) may dictate the terms of the world economic policy in the future. The importance of China will certainly be growing and there is rather no doubt about the heavy dependence of a large part of the so-called emerging markets on decisions made in Beijing. However, on the other hand, it is difficult to imagine other areas of the world, such as the US, the EU or Russia, to be dominated by China. Of course, the economic situation of the US or the EU will become increasingly affected by information from China, but there are no grounds for believing that the latter will be able to impose its will on the governments of highly-developed countries.

There is ample evidence that weighs in favour of the opinion that in 20 years' time, the world will become a place lacking one specific leader. A thesis can be proposed that in 20 years, the world will be, to a larger extent than it is nowadays, the place where several strong regional groups, having their own local leaders, will operate. It is and will undoubtedly be the US that is and will be such a leader in North America. As for Europe and North Africa, the European Union will be its hub, South-East Asia will be dominated by China even more than it is at present, while the area of the former USSR (apart from the Baltic States) will, to a large extent, be influenced by Russia's economic policy. Africa still will be dominated by former colonial powers but influence of China in the region is going to be bigger and bigger.

Another, not less important, question is whether in the lack of an outright leader, the task of setting basic standards will be undertaken by supranational organisations, such as the UN in politics or the IMF in economy. In recent years, quite a reversed trend can be observed – the IMF's economic importance has been rather declining than growing. It is small wonder that the line-up in international organisations has obviously lagged behind changes in the world economy. Therefore, it is rather doubtful whether decisions made, for instance, by the IMF on financial market regulations can be effectively imposed on the whole world.

The present phase of globalisation allows for asking fundamental questions about the efficiency of regulations, as it is clear that there is a wide range of opportunities to 'evade' imposed regulations by, for example, registering business activity at a place that is beyond the jurisdiction of specific regulatory bodies. The financial market provides an excellent example of that phenomenon. It has created instruments allowing for evasion of, for instance, capital requirements concerning banks, while the most profitable areas of activity have been located in the so-called tax havens, which has made it possible to reduce public law dues to a minimum.

As there is no national leader and the efficiency of international organisations is doubtful, a question arises whether it is possible to coordinate economic policy at the international level – that is the most important issue in the discussion about global policy making. It is obvious that fundamental problems of contemporary economy, such as global warming or the threat of financial markets destabilisation, may not be solved without a consensus reached by major economies. Recent developments indicate that the situation seems to be ambiguous in that respect. G-20 forum (countries of it represents 85% of global GDP) is very interesting initiative – we should look at its development.

On one hand, the climate summit in Copenhagen has shown that there is such a conflict of interests among the countries that it is virtually impossible to work out a compromise.

On the other hand, however, the reaction of governments and central banks to the outbreak of the financial crisis has indicated that macroeconomic policy should and can be coordinated. The best example was provided by the coordinated policy of the main central banks that strongly reduced interest rates, increasing the efficiency of national

monetary policies as well as preventing the wave of speculative capital movement caused by interest rate differences.

The recommended necessary stronger supervision over and regulation of financial markets will become a true test for international institutions and countries. New regulations will make sense only if they are applied and effectively enforced in a substantial part of the world economy.

Another major doubt concerning future economic policy is connected with the likelihood of carrying out efficient economic policy on a national and international basis. Several processes can be shown that lead to the impairment of the state's economic role.

The information and telecommunications revolution has, to a large extent, removed limits on the mobility of productive factors. As it is so easy to move capital or labour to new places in the world, governments are losing its efficiency in enforcing tax dues because it is ever easier to show profits where they are lightly taxed or not taxed at all and, thus, deprive states of their revenues. Due to the growing role of the so-called fiscal termites, major instruments of economic policy, i.e. taxes, become less and less effective and budget revenues go down, which makes active policy extremely difficult to carry out.

An abrupt increase in states' debts due to aggressive anti-crisis policy will certainly entail high costs of public debt service in the future. As it is necessary to bear considerable costs of debt service and there is little opportunity to increase public revenues (see comments above), states are more and more limited in their financing of active policy in specific areas.

Big public debts have another significant consequence. Governments' borrowing needs are huge and will remain as such in years to come, which makes governments, to an increasing extent, hostages of financial markets. A situation that could often be seen in the so-called emerging markets, i.e. the financial sector's refusal to finance the state's borrowing needs, which usually leads to a deep financial crisis and destabilisation of the whole economy, is very likely to occur even in highly-developed countries nowadays - as experienced by Greece recently. Dependence on the moods of the financial markets considerably limits the elbowroom in economic policy – implementation of otherwise

rational solutions, such as the strengthening of regulations or increasing (or introducing new taxes) may be impossible because markets will take a negative attitude to that.

Another process that undermines the efficiency of the state institutions' actions is the growing power of huge supranational corporations. Today, reactions of big corporations have to be taken into account not only by governments of small and poor countries as even the economic policies of highly developed countries are considerably influenced by opinions issued by large companies' executives. We could see a lot of examples of that phenomenon last year – for instance, numerous decisions on spending huge public funds were made not with the national interest in mind, but rather considering the situation of some private corporations. By the way, it is a very interesting issue related to sociology and political science: we all believed that the bankruptcy of a bank was not the problem of its shareholders or managers who had caused that critical situation, but rather the collapse of a privately owned company was a national tragedy and, thus, the state should, without hesitation, use taxpayers' money to save private enterprises. That problem cannot be solved without the comprehensive analysis of the media's role in the political and economic play.

When faced with the declining importance of the state and the growing one of huge, supranational corporations, one should, first of all, ask what factors most significantly affect decisions made by people managing large enterprises. The growing importance of the media has to be mentioned at that point, as in the world where the quantity of information is immense, the media performs a decisive role in shaping consumers' opinions and these ultimately determine the situation of economic entities.

Another process that deserves attention is the growing importance of non-governmental organisations (NGOs), whose voice is increasingly heard in a public debate. An especially interesting issue is the establishment and development of international non-governmental organisations, that are institutions bringing together people supporting an idea irrespective of the national divisions. An excellent example is that of Greenpeace, without which it is difficult to imagine any serious debate on the environmental protection issues. Therefore, NGOs have become an equal partner for governments or official international organisations.

To sum up, the world economic policy will certainly be different in 20 years' time. As for now, several processes can be identified that will shape the institutional system of making decisions in the area of economic policy:

- it is highly probable that there will be no undisputed leader of the world in 20 years;
- international organisations will not significantly grow in importance;
- along with the increasing globalisation, processes of regional integration around strong economies will intensify;
- the position of the state as the regulator and major decision maker in economic issues will rather become weaker;
- large privately owned international corporations will rise in importance;
- the media and non-governmental organisations closely cooperating with them will exert ever greater influence on decisions at the national and international level.

Economic Policy in the EU

A natural starting point is to examine the institutional framework of the European Union, taking into account Europe's resistance to the economic crisis. It is equally important to ask a question whether the EU has at its disposal instruments of economic policy that would respond to challenges resulting from the international financial crisis.

Crisis and the EU Economy

Despite the fact that the crisis has obviously been caused by a series of structural imbalances in American economy, adverse effects of the collapse of financial markets have spread beyond the US. Much to one's surprise, the scale of the economic collapse is even greater in the EU than it is in the US – the GDP is estimated to have dropped by 4.2% in the EU in 2009, while the recession in the US has reached the level of a 'mere'

2.7% this year.[1]. The situation is similar in the labour market – the EU's unemployment rate reached 9.9%[2] as compared with 9.3% in the US. It is interesting that, despite obvious structural difficulties of the American economy, estimations show that it will be the US that will 'deal with' the crisis quicker than the EU – in 2010, the US economic growth is expected to reach 1.5%, whereas in the EU, we can only count on very slight economic recovery at the level of 0.5%.

The course of the crisis in the EU and the US may come as a surprise as factors, which were specified to be the causes of the present financial crisis, have been much more noticeable in the American than in the European market.

Firstly, as opposed to the US, the EU economy is practically externally balanced – the current account deficit accounted for 1% of the whole EU GDP in 2008, while the US had to import capital accounting for as much as about 5% of the GDP every year. Of course, there are countries with high current account surpluses (Germany with its surplus of 6.4% of the GDP in 2008) or economies that are deeply dependent on importing capital, such as the Baltic States or Bulgaria. However, that does not change the fact that the EU as a whole (the same can be said about the euro zone) is externally balanced and the majority of the international movement of goods and capital takes place within the territory of the European Union.

Secondly, the role of the financial sector in the EU economy (about 25% of the GDP) is also less than that in the US (about 30% of the GDP), and that is an unrestrained increase in financial assets blamed for the present occurring problems. Also, the extent of the financial market collapse seems to be less in the EU than it is in the US. That can be proven by differences in '*spreads*' (3-month LIBOR versus the profitability of 3-month treasury securities) in financial markets or the assessment of risk (evaluation of the so-called CDSs). The risk (and, thus, the extent of distrust) in the EU financial market was estimated at the time of the greatest uncertainty, i.e. at the end of 2008, to be about 250 base points lower than in the US[3].

---

[1] All data and estimations in this part of the text are extracted from the IMF World Economic Outlook database.

[2] It is Spain, that is a record holder with its unemployment rate of 18.2% at the end of 2009.

[3] Another interesting method of assessing the condition of the financial sector is the so-called Financial Stress Index – details can be found in: the Global Financial Stability Report, Chapter 3, October 2009.

Considering the data provided above, a fundamental question arises: is the EU economy able to adapt to the quickly changing reality? On the other hand, it should be considered whether instruments at the disposal of the EU governments and institutions are suitable to meet the current challenges.

Economic Policy – the Euro Zone

The analysis of economic policy can be carried out taking several issues into account. In the case of the EU, along with the traditional division of economic policy into fiscal, monetary and structural policy, instruments of economic policy ought to be analysed to take into consideration a decision maker. Are those instruments at the disposal of national or supranational bodies?

As for the monetary policy, the issue seems to be easy in the EU – the majority of the EU economy (measured by its share in the EU GDP) is the euro zone, and thus, it is the European Central Bank, that is an active subject of monetary policy. As for now, it is difficult to state without a doubt whether the common currency provides favourable conditions for tackling the crisis; however, there are more arguments for a thesis that, without the common currency, and thus, the common monetary policy, it would be more difficult.

First of all, due to structural problems similarly encountered by specific national economies, it is necessary to coordinate interest rate policies. A lack of coordinated interest rate policies may pose a threat to macroeconomic stability due to the uncontrolled movement of speculative capital that incessantly looks for short-term differences in profitability and evaluation of financial instruments. The above-mentioned coordination does not merely include the coordination of monetary policies in the EU, but has an importance on a global scale, i.e. it is important for the world's major central banks to be able to cooperate. Without a doubt, the present situation, where there is one European Central Bank instead of a dozen or so national central banks, greatly facilitates coordination both at the European and world level.

Besides the interest rate policy, that is common for the whole euro zone, the exchange rate policy is equally important. A slump in exports triggers a standard reaction

of trying to affect the exchange rate in order to lower it and, thus, make a national economy more competitive at the international level. If there were still national currencies used in the majority of the EU economies, there would certainly be numerous attempts at manipulating exchange rates in order to improve exports profitability. However, it should be remembered that the interest rate works always 'in both ways' – i.e. devaluation of one currency against the other means revaluation from the point of view of the other, and such a situation is an obvious reason for conflicts between the countries, which could weaken the European integration. Therefore, a thesis can be put forward that, thanks to the use of euro, we avoid numerous conflicts concerning exchange rates of such currencies as the German mark/French franc, lira/peseta, etc.

There is another merit of the fact that it is impossible to devaluate the currency in order to improve the economy's competitiveness, i.e. it is necessary to look for ways of improving competitiveness other than manipulating the exchange rate. Microeconomic factors (mainly costs of businesses' operations) become much more important than macroeconomic ones (exchange rate), which is rather a good sign for the competitiveness of the whole European economy – enterprises realise that they cannot count on a bonus in the form of a more favourable exchange rate; therefore, in order to remain competitive, they have to strictly control their costs[4].

Of course, there are also some adverse effects of the euro zone. Today, it can be clearly seen that the present problems of many euro zone countries (Spain, Greece, Ireland) result - to a large extent - from earlier economic 'overheating', which was indicated, for example, by abnormally high dynamics in the real estate market. That situation was caused, to a large extent, by the low interest rates of the European Central Bank and an opportunity to use external financing – while in 'normal' conditions, a current account deficit accounting for 10% of the GDP is a straight path to monetary crisis.A member of a monetary union avoids such a threat and may enjoy the very high dynamics of consumption, financed by the inflow of external capital.

Nevertheless, it is difficult to prove a thesis that the euro zone membership is a reason for problems faced by Greece nowadays, although a rise in interest rates in Greece

---

[4] Of course, those remarks concern exchange rates within the euro zone, while the issues of exchange rates such as USD/euro, yen/euro, GBP/euro still exist. However, there are no strong opinions expressed about an intention to abandon the system of floating exchange rates in respect of major world currencies.

or Ireland could have worked wonders at a proper time. The example of Greece indicates rather that, as there are no monetary instruments at the national level, instruments of fiscal and structural policies should grow in importance and, thus, those are mistakes made in that area that the Greeks ought to take a closer look at.

The course of the crisis in the EU has not compromised the principles, on which the function of the common currency zone is based. Of course, there are opinions that the euro zone will soon go to pieces, but they seem to be unreliable. The majority of Europeans do not even imagine the comeback of national currencies and Greece's problems prove that the macroeconomic policy at the European level requires more coordination, i.e. institutions of the European fiscal policy, such as the EU budget and provisions of the Stability and Growth Pact, need to be strengthened.

Monetary policy is seen in a completely different way by the EU member states, that do not belong to the euro zone. A duty to strive at membership in the area of the common currency[5] is a basic factor shaping the EU countries' macroeconomic policies. What is interesting, the present financial crisis has fundamentally changed the perception of the exchange rate policy as an instrument of macroeconomic stabilisation. Not long ago, it could seem that fixing the exchange rate (by means of the mechanism of the currency board or a fixed peg in relation to the euro) is an obvious step towards the euro zone membership and abandoning the floating exchange rate constitutes an important element of the economic stability, which allows, for example, the use of external financing of economic development to a large extent.

The course of the financial crisis has shown that monetary policies of the Baltic States or Bulgaria, that used to be their strength, are their fundamental problem now. Heavy dependence on external capital, when faced with a dramatic slump in international financial flows, has to result in a heavy slump in economic dynamics. A measure, that would seem to do wonders in such a case, i.e. currency devaluation, cannot rather be adopted for at least two reasons.

Firstly, introducing the floating exchange rate of, for example, the Latvian lat (or devaluation and re-fixing of the rate at a lower level) would be a strong inflationary

[5] There are exceptions to that rule, i.e. countries that retained the right to make a unilateral decision on entering the euro zone (the so-called *opt-out* clause), e.g. Great Britain.

impulse, which could result in the uncontrolled giving of impetus to the so-called inflationary spiral.

Secondly, in the case of fixed interest rate, it has been a common practice to incur liabilities denominated in foreign currencies[6] (lower interest rates accompanied by a lack of exchange rate risk). Therefore, devaluation of national currency would entail a wave of bankruptcies among businesses and households, which is difficult to accept. By the way, there is an unanswered question whether drastic measures (major budget expenditure cuts, an increase in outlay taxes) taken in the Baltic States in order to save macroeconomic stability are not more severe in their consequences for the economy and society than the currency devaluation would be.

Thus, it is difficult to come up with a good solution to Latvia's and Lithuania's problems. The only way to solve them seems to be a painful adaptation through deep recession, increased unemployment, and reduced incomes, which will allow to achieve balance at a new and, regrettably, lower level. Of course, theoretically, the best solution would be to let those countries join the euro zone, irrespective of the Maastricht criteria; but such a decision is difficult to imagine as it would amount to an obvious violation of the law and principles of the EU policy.

Countries that have opted for the floating exchange rate policy (Poland, the Czech Republic, Hungary) experienced deep depreciation of their national currencies in relation to the euro[7], which, taking into account a considerable decrease in demand for exports to the countries of Western Europe, proved to be a godsend and, to a large extent, was a decisive factor that made their economic slowdown relatively mild.

The present crisis has clearly shown that the time has come to reconsider conditions of joining the euro zone, that are contained in the so called Maastricht criteria. Even in the past, some powerful arguments were put forward stating that the Maastricht criteria are incompatible with the situation of the new EU members. The crisis has made

[6] Also in the countries with floating exchange rates, loans denominated in foreign currencies were taken out, but that practice was not so common. In 2008, the share of foreign exchange loans accounted for about 10% of all the private sector loans in the Czech Republic and 35% in Poland, while those indicators in the Baltic States were much higher – 65% in Lithuania, 85% in Estonia, and 90% in Latvia, respectively (the National Bank of Poland, 2009).

[7] In the period from July 2008 to February 2009, Poland's, the Czech Republic's, and Hungary's currencies lost 50, 30, and 35% of their value in relation to the euro, respectively – data of the National Bank of Poland.

those arguments more convincing. Inflationary and fiscal criteria concerning the level of the admissible public finance sector deficit can come in for the most severe criticism.

The inflationary criterion is very difficult to meet by the so-called catching-up countries that are doomed to a structurally higher level of inflation (the Balassa-Samuelson effect), so the requirement of maintaining low inflation entails the necessary restrictive monetary policy that must adversely affect economic dynamics. Deep recession and, thus, the considerable weakening of the inflationary pressure (even the occurrence of deflation) in Western Europe, which means that the reference value for the inflationary criterion is decreased (the average for three EU countries with the lowest inflation plus 1.5 percentage points), making the required level of price dynamics much more difficult to achieve by the countries of Central Europe, the more so as the currency devaluation has led to increased inflation. Thus, eventually meeting the inflationary criterion by a country, such as Poland, is exceptionally difficult now.

The requirement of maintaining the public finance sector deficit below the level of 3% of the GDP may also be severely criticised. On one hand, the present euro zone members do not submit to the public finance discipline (it was a common practice even before the crisis). Thus, it can be said that countries applying for the membership in the common currency zone are discriminated against.

Secondly, it is very difficult (virtually impossible) to impose the necessary reduction of budgetary imbalance at the time of a slowdown and, first of all, such a policy would be unreasonable. Fiscal tightening (a rise in taxes, expenditure cuts or the combination of both those measures) is bound to decrease the dynamics of development even more because during crisis, there is no hope that the so-called non-Keynesian effects of fiscal policy changes, i.e. the replacement of public demand by elements of private demand – consumption, investment or net export, will occur.

To sum up, the existence of the common currency zone can be considered to be a favourable factor, taking into account the dealing with the economic crisis. First of all, it is easier to coordinate monetary policies at the European and world level. Thanks to the common currency, it is possible to avoid conflicts related to exchange rates between EU countries, which would otherwise threaten the unity of the EU. From the point of view of countries applying for membership in the common currency zone, the euro provides an

excellent opportunity of protection against macroeconomic destabilisation caused by changes in financial flows and, thus, considerable fluctuations of nominal exchange rates. It seems that a serious discussion ought to begin on the revision of the Maastricht criteria, which would mean a step towards the full membership of the Central European countries in the economic and monetary union.

Fiscal Policy in the EU

The level and structure of public revenue and spending in the EU countries result from numerous factors, making the institutional environment of carrying out the fiscal policy in the EU member states more complicated than elsewhere.

Firstly, in principle, the level of public revenue and expenditure depends on decisions of national authorities.

Secondly, the stream of public means in the EU countries is supplemented with those being available from the Community's budget.

Thirdly, the framework of fiscal policy is specified in supranational regulations such as the Stability and Growth Pact or EU directives harmonising fiscal policy principles.

The states' response to the present crisis undeniably indicates that, despite the increased European integration, the fiscal policy is still shaped mainly by national states. Those were national budgets that bore the highest costs of tackling the consequences of the crisis.

The EU common budget has a rather marginal importance, which arises from two fundamental issues. Firstly, the Community's budget accounts for a mere 1% or so of the GDP of the whole EU; therefore, expenditures made from the EU common budget do not considerably affect the level of economic activity[8].

Secondly, by virtue of the law, the EU budget has to be balanced, so there is no place for fiscal expansion within the meaning of the Keynesian system.

[8] Of course, in the case of specific countries, financial means from structural funds or the Cohesion Fund may affect the level of economic activity. That is the case, for example, in Poland, where in the near future, expenditures connected with EU means may account for as much as 5% of the GDP and, thus, constitute a considerable source of demand in the economy.

Despite plans for reform both in the area of revenue and that of expenditure in the Community budget, it is rather not likely that the European Commission or Parliament will have more means at their disposal. First of all, the fiscal condition of the largest payers (high budgetary deficits in Germany, France or Italy) indicates that attempts at limiting the Community financial means should rather be expected, instead of the considerable expansion of the EU budget.

However, a lack of possibility to conduct discretionary fiscal policy at the level of the EU budget should not rather be seen as the weakness of the Community. Taking into account complicated procedures of making decisions related to EU expenditure or revenue, and thus, a considerable delay between the occurrence of a problem and implementation of a solution, there are serious doubts about the efficiency of the current discretionary measures. Therefore, it seems to be a better idea to maintain the current system, i.e. current tasks of the state are performed by national systems of public finance, while the Community budget finances mainly long-term development objectives.

Undoubtedly, the establishment of the common currency zone – the euro – is among the greatest achievements of the European integration. From the point of view of carrying out macroeconomic policy, common monetary policy ought to be accompanied by the international coordination of fiscal policy. In the event fiscal policy is not coordinated, common monetary policy may be non-optimal from the point of view of specific members of the monetary union. For instance, a large budgetary deficit in one country and, thus, increased inflationary pressure make it necessary to increase interest rates, which may adversely affect the economy of another country with more restrictive fiscal policy.

Due to the small size of the Community's budget, the EU common finance may not be regarded as an instrument of policy coordination in the area of public finance. Thus, the only solution is to set rules of carrying out the fiscal policy, that would be binding on all members of the monetary union. Such rules are contained in the Stability and Growth Pact, which expressly specifies admissible levels of budgetary deficit and public debt. It is obvious that the Pact draws on the assumptions of the neoclassical concept, stating that the aim should be to achieve a balanced budget and the level of deficit (and, thus, public debt) ought to be limited by the law. Today, it can be easily seen

that, when faced with the crisis, fiscal conservatism is on the retreat both in the ideological and practical fields, which is proven by a very expansive fiscal policy to be an answer to the economic slump. It is evident that provisions of the Stability and Growth Pact are not effective. Taking into account the fact that major EU members (Germany and France) did not observe the limits of admissible deficit even before the crisis, and that with impunity, in the situation where it is necessary to tackle the crisis, limitations on conducting fiscal policy are all the more disregarded by member states.

The situation described above is quite puzzling. On one hand, the obvious failure to comply with the set rules is definitely not a kind of behaviour that strengthens the EU institutional system. On the other hand, however, a strict requirement that budgets be balanced at the time of economic slump would be impracticable and extremely harmful both from the macroeconomic point of view (limiting aggregated demand by expenditure cuts or tax increases) and the point of view of the states' duties to provide public goods of appropriate quality.

There is no doubt, however, that it is necessary to, first and foremost, coordinate fiscal policy at the EU level due to the existence of the common currency zone. It seems that the Stability and Growth Pact needs revision, that has to be based on two assumptions. Firstly, it seems to be rational to abandon the requirement of the restrictive fiscal policy, which is ineffective and, most importantly, may be unreasonable from the point of view of development policy. Secondly, a mechanism ought to be created, that would actually allow for coordinating fiscal policies of specific EU members.

Another important area of the gradual evolution of the economic policy is the transfer of powers of governments and parliaments (central authorities) to the local level, which increases along with the market's growing role in controlling the economy. Self-governments will continue to grow in importance – with all consequences for the reform of public finance. That requires the establishment of an appropriate institutional structure as well as the evolution of political methods and a change in the political culture of member state societies.

In the context of the EU membership, that issue takes on an added importance in connection with the role of regional policy coordinated throughout the EU. Moreover, the development of the institution of euro regions is crucial for member state economic

policies as it requires a regular improvement in the countries' cooperation and striving to coordinate their regional development policies.

As for politics, the European Union has still a far way - or actually infinite one - to go to carry out institutional changes. The acceptance of the Lisbon Treaty solves some problems, while others will be created by solutions contained in the Treaty itself. There is no doubt that more and more problems will be resolved in the European Union - not under the pressure of national states, but under that of political parties operating on another basis, social movements (including in particular NGOs (*non-governmental organisations*)), interest groups, the media. That will require more flexibility and organisational skills of the EU structures and IGOs (*inter-governmental organisations*).

To sum up, the European Union's economic policy will be determined by two fundamental groups of factors. On one hand, the situation in the EU will follow the world trends covered in the first part of the text. On the other hand, the ever greater economic and political integration will definitely transfer the making of important decisions to the supranational level.

References:

ÅSLUND A., *How Russia Became a Market Economy*, Washington (DC), Brookings Institution, 1995.
2003.
EUROPEAN COMMISSION, *Perception of Living Conditions in Enlarged Europe*, Luxembourg- Dublin, European Foundation for the Improvement of Living and Working Conditions, 2000
EUROPEAN COMMISSION *EMU@10: successes and challenges after 10 years of Economic and Monetary Union*, European Commission, 2008
IMF, «*World Economic Outlook* 2000», chapter III: *Transition: Experience and Policy Issues*, Washington (DC), International Monetary Fund, September, 2000, pp. 127-201, (*www.imf.org/extarnal/pubs/ft/weo/2000/02/pdf/chaptre3.pdf*).

IMF, *World Economic Outlook. Growth and Institutions*, Washington (DC), International Monetary Fund, April, 2003.

IMF (2007) *World Economic Outlook*, International Monetary Fund

IMF (2009a) *Euro Area Policies: Selected Issues***,** IMF Country Report No. 09/224, International Monetary Fund

IMF (2009b) *World Economic Outlook*, International Monetary Fund

IMF (2009c) *Global Financial Stability Report*, IMF October 2009

KEYNES J.M., *A Tract on Monetary Reform*, London, Macmillan, 1924.

KOLODKO G.W. *From Shock to Therapy. Political Economy of Postsocialist Transformation*, Oxford-New York, Oxford University Press, 2000

KORNAI J., «The Role of the State in a Post-Socialist Economy», Warsaw, Leon Kozminski Academy of Entrepreneurship and Management, *Distinguished Lectures, Series*, no. 6, 2001 (*www.tiger.edu.pl/publikacje/dist/kornai.pdf*).

LIN J. - CAI Y.F. - LI Z., *The China Miracle. Development Strategy and Economic Reform*, Hong Kong, Chinese University Press, 2003.

NORTH D.C., «The Contribution of the New Institutional Economics to an Understanding of the Transition Problem», Helsinki, *WIDER Annual Lectures*, no. 1, March, 1997, The United Nations University World Institute for Development Economics Research (WIDER) (*www.wider.unu.edu/publications/publications.htm*).

NORTH D.C., «Understanding Economic Change and Economic Growth, Warsaw, Leon Kozminski Academy of Entrepreneurship and Management, *Distinguished Lectures, Series*, no. 7, 2002 (*www.tiger.edu.pl/publikacje/dist/nortg.pdf*).

PISANI-FERRY J. *Euro-area Governance: What Went Wrong? How to Repair It?* Bruegel Policy Contribution, Issue 2010/05CONTRIBUTION

SEN A., *Development as Freedom*, New York, Alfred A. Knopf, 2000.

STIGLITZ J.E., «More Instruments and Broader Goals: Moving Towards the Post-Washington Consensus», Helsinki, United Nations University World Institute for Development Economics Research (WIDER), *WIDER, Annual Lectures*, no. 2, January, 1998 (*www.wider.unu.edu/events/annuell1998.pdf*).

TANZI V. - CHU K. - GUPTA S. (eds.), *Economic Policy and Equity*, Washington (DC), International Monetary Fund, 1999.

WORLD BANK, *Building Institutions for Markets. World Development Report 2002*, Washington (DC), World Bank, 2002.