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The European fiscal reform and the plight of the Euro

Abstract: The paper presents the background of the American crisis in 2007–2008 that later spread into the global crisis. It distinguishes and discusses four phases of the crisis: subprime mortgage crisis, soaring dollar and the Lehman Brothers fiasco, US and global recession, and, finally, European debt crisis. In the above context, the benefits and costs of joining the Eurozone are presented, particularly from the Polish perspective. The need of fiscal reforms and concerns regarding Eurozone institutions are addressed.

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1. The background of the American crisis

Since 1982 the U.S. has had three long periods of expansion. The first one was the 1982–1990 period, so-called "seven fat years", in which President Ronald Reagan came to office and took the ideas of myself and Arthur Laffer (1983) to slash the tax rates. In that period the tax rate in the highest bracket moved from 70%[1] down to

[1] The 70% tax rate in the highest bracket was in effect from 1971 to 1981. The top bracket tax rates were even higher in the preceding years. The table below shows the tax rate in the highest bracket in the period 1929–1970:

1929	1930–1931	1932–1933	1934–1935	1936–1939	1940	1941	1942–1943	1944–1945	1946–1947
24%	25%	63%	63%	79%	81.1%	81%	88%	94%	86.45%
1948–1949	1950	1951	1952–1953	1954–1963	1964	1965–1967	1968	1969	1970
82.13%	84.36%	91%	92%	91%	77%	70%	75.25%	77%	71.75%

Source: Internal Revenue Service.

28% in 1989, when Reagan left office. The year 1990 was the beginning of a three-quarter recession.

The expansion that began in 1982 was fed partly by the Reagan tax cuts and partly by the Silicone Valley high-tech revolution. The latter essentially led not only to 1982–1990 expansion, but also to doubling of the U.S. growth rate in the second half of the 1990's. It happened during the longest boom in American history, which started in the spring of 1991 and lasted until 2001 - throughout the George H. W. Bush administration and the Bill Clinton administration periods. Like most periods of expansion, it overshot and led to the dot-com recession in 2001–2002.

Three "lows": low tax rates, low interest rates and low U.S. dollar value, marked the end of the 2001–2002 recession and set the recovery going. The Clinton administration had raised tax rates to 39.6% in the highest bracket and then George W. Bush lowered them to 35%[2]. The Federal Reserve led by Alan Greenspan kept the interest rates low for quite a long time. A series of interest cuts initiated in autumn of 2001 brought down the Federal Funds effective rate below 2% in December 2001 and then was running at about 1% for 12 months beginning in July 2003 to gradually increase above 2% only in December 2004. The expansionary monetary policy contributed to the 2002–2008 boom with a great housing expansion at its center. This housing expansion was extraordinary in American history and ultimately overshot into a bubble.

The housing expansion peaked in the first quarter of 2006 and was followed by a series of remarkable events such as the beginning of the sub-prime mortgage crisis, the Lehman Brothers crisis, the recession and, finally, the European debt crisis. All these phenomena are mixed up together and they will be the subject of discussion in the following sections.

American mortgage market and innovations in the market

The total size of the mortgage market in the United States is about 10 trillion dollars. Federal National Mortgage Association (FNMA or Fannie Mae) and Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), the two government-sponsored institutions, count for about half of the whole market in the United States, and the rest is covered by private banks. Fannie Mae and Freddie Mac supported to large extent "the American dream" of home-ownership, which was subscribed to by both Republicans and Democrats.

[2] The Bush tax cuts had a ten-year horizon and if they are not renewed, the tax rates will go up. At the end of 2010 the Bush tax cuts expire and there will be an upsurge in tax rates, which may be the biggest tax increase in American history.

One of the incentives for home-ownership are the tax benefits - deducting the mortgage payments for the first house bought. The Clinton administration was particularly pushing for easier lending conditions. That created a paradoxical situation: many people, who could not afford to buy houses, could not afford not to buy them – they felt – because of the advantages. There were also many innovations in the mortgage market going on in this period, that eventually turned out to make troubles:

- concessionary mortgage lending, which originated in the sub-prime assets;
- securitization of mortgages, originated by the Italian banker named Lewis Ranieri in a form of asset-backed securities, who created the way of bundling together mortgages and putting them in some security form that could be held by the regular capital market[3]. This was a great innovation, which globalized the supply of mortgage finance, but it also had the great downside related to asymmetry of information and insufficient knowledge of assets inside those bundles;
- derivatives and leverages caught insurance napping;
- credit default swaps, which are a kind of insurance and proved that insurance was woefully underpriced;
- mark-to-market accounting rules, introduced after collapse of Empire Savings and other Savings&Loans in Texas in the 1980s. It was discovered then that a lot of the banks' assets were vastly overpriced, because they had not downgraded them. In order to avoid similar situations in the future, the regulators insisted upon mark-to-market accounting rules, so as soon as the market price of an asset went down, the asset had to be marked down on the books of the banks. Mark-to-market accounting in every session means assets are marked down immediately as their market prices go down, although they may come up again. That created tremendous problems of lack of capital and revealed necessary of striking a medium;
- variable-rate mortgages made house equity a function of interest rates and were supported by the chairman of the Federal Reserve Board, Alan Greenspan.

The boom ended when the house prices passed the peak and began to fall. When house prices fell below mortgage costs, homeowners walked away. In most European countries, in contrast to the U.S., if the value of a house goes down below the mortgage, the homeowner can walk away, but he has to pay the difference. If the bank sells the house for less than the value of the mortgage, the homeowner still owes the bank the difference between the value of the house and the value of the mortgage. In the US it is different and falling sub-prime mortgage assets created holes in balance sheets. The banks were left holding the bag, which is a uniquely American phenomenon.

[3] In November 2004 Business Week presented Lewis S. Ranieri as one of the greatest innovators of the past 75 years (McNamee 2004).

2. Four phases of the crisis

In the spring of 2007 Secretary of Treasury Henry Paulson said he had never seen the world economy in such fine shape. The world economy: every big economy and every emerging market economy, was doing great – a tremendous expansion was going on. At the Singapore meetings the IMF had to ask for more money for funds, because nobody needed to borrow. They were awash with liquidity as the U.S. deficit was supplying dollars.

2.1. Phase one: sub-prime mortgage crisis

Already in March 2007 Bill Rhodes, Citibank Chairman, President and CEO published the article in "Financial Times" warning that the sub-prime mortgages could threaten the financial system as a whole (Rhodes 2007). The mortgage market in the US had eventually turned in the summer of 2007. The banks started to get into trouble and suddenly, the fall in the mortgage markets and the capital needs caused by mark-to-market accounting rules created a necessity for them to fill holes. That resulted in a big demand for liquidity, unprecedented since the Great Depression.

The banks tried to borrow money everywhere. The European Central Bank was hit first, because the European market opens 6 hours before the American one. They supplied this liquidity, offering to lend unlimited amounts at 4%, and in one day, on August 9, 2007, they lent 95 billion euro (about 130 billion dollars). The same day the Federal Reserve and other banks came in. Never before such an amount of high-powered money came into the system within one day. The total money lent in two days, August 9–10, 2007, was about 300 billion dollars. Toxic assets remained on the balance sheet, but infusion of central bank liquidity let work them off slowly.

Injections by European Central Bank and Federal Reserve Banks in August 9–14, 2007 (billions of dollars)

	Thursday August 9	Friday August 10	Monday August 13	Tuesday, August 14	Total
European Central Bank	130	84	65	34	313
Federal Reserve Banks	24	38	2	-	64

Source: (Cecchetti 2007).

Due to heavy involvement of Bear Stearns in the mortgage field, which was commonly known, they went under and were eventually sold by May 2008 at 10 dollars a share to JP Morgan Chase.

2.2. Phase two: soaring dollar and the Lehman Brothers fiasco

The big question is why it took 13 months for the financial crisis next year to hit. What was so special about the summer of 2008 that weakened Lehman Brothers, Fannie Mae, Freddie Mac and then the American Insurance Group (AIG) who was the biggest insurer in the world and held credit default swaps? It was not until September 15, 2008 that Lehman Brothers failed. If this was still part of the mortgage crisis, why did not it happen a few months after that, anytime in the same year? But before the bankruptcy of Lehman Brothers came the quasi-bankruptcy of Fannie Mae and Freddie Mac, which were bailed out by 80 billion dollars from the U.S. Treasury. They did not immediately collapse, but then Lehman Brothers did collapse.

The economic growth in the first quarter of 2008 was very low, then in the second quarter of 2008 the economy showed the annual GDP growth of 4.1%, which suggested that the recovery was coming. But all the liquidity that had been injected into the markets by the central banks over this period, created – according to inflation hawks – a threat of inflation. The Federal Reserve started to listen to the inflation hawks and began to tighten up credit without changing interest rates. The money multiplier, i.e. the ratio of the total supply of money to the base of the money supply (monetary reserves), fell in half, because there was a big increase in the base of the money supply. People expected that if that was unleashed, it would create a surge in money supply, causing inflation.

There are four measures that prove market was tightening. It should be noted here that interest rates were still kept at a very low level of 1%. The first of the indications

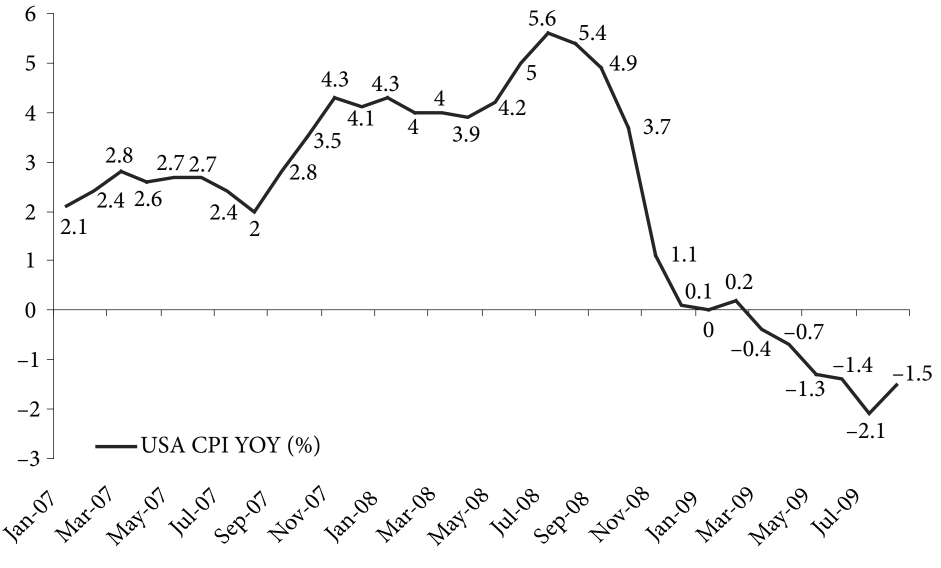

Figure 1. Consumer price index in the United States in 2007–2009

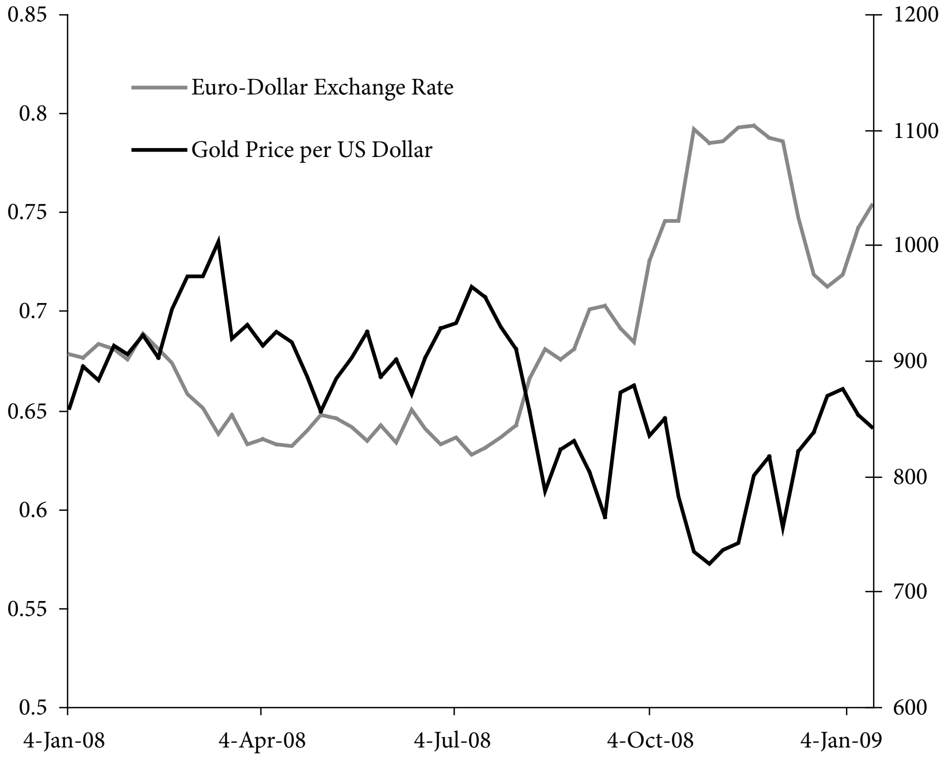

Figure 2. Euro-dollar exchange rate and price of gold (in USD) in 2008

of the tightness on the market was that the inflation rate, which in June 2008 had amounted to 5.5%, then within six months had fallen to 0 and went down to negative values on an annualized basis. The second one was the fall of the price of gold. On July 15, 2008 it was USD 980 per ounce and it fell to USD 720 on October 27, 2008. The third one was plummeting oil price: while on July 11, 2008 Brent was traded at a record level of USD 147 a barrel, then just four months later on December 21, 2008, oil was trading at less than one fourth of the peak price, USD 34 a barrel. The fourth factor was that the dollar soared against the major currency in the world, the euro: from 0.63 on July 15, 2008 to 0.80 on October 27, 2008.

According to Milton Friedman (1968), the long and variable lag in the effect of monetary policy was between 2 and 6 quarters. However, that result was based on the data from the Bretton Woods world of fixed exchange rates. Under fixed exchange rates the monetary policy in one country has to bring the whole currency area with it, while under flexible exchange rates, monetary policy brings about immediate adjustments in forward and spot exchange rates. In 2008 in a period of just three and a half months, between the middle of July and the end of October, the US experienced an appreciation of its currency of the magnitude of 27% – the biggest appreciation ever in its history. This was caused by an increase in the global demand for the dollar and the Federal Reserve was not supplying it. This broke the back of the Lehman Brothers and created the quasi-bankruptcy of two housing institutions.

2.3. Phase three: US and global recession

The first part of the crisis was the sub-prime mortgage crisis, and the second - the soaring dollar and the Lehman Brothers crisis. The US and global recession was the third part of the crisis as the strong dollar weakened the economy. Never before in American history one could hear General Motors screaming „we're going bankrupt!". General Motors was one of ten biggest corporations in the world, one of the most successful ever, with the revenues exceeding 180 billion USD in 2008. Other world biggest corporations, General Electric (12th) and Ford (13th), were also in bad shape. They were all thinking they would go bankrupt because of this sudden 27% appreciation of the dollar, which was overvaluing assets. In the housing markets, appreciation is always deflationary, so it was driving down house prices even more than before, aggravating the weakness of bad housing assets. So that was the problem of disinflation.

When was there a similar situation in American history that the dollar had soared and the economy had gone into recession? And why did the US allow a strong appreciation of its currency in the midst of one of the greatest crises in history? The best analogy to it would be beginning of the 1980s, in spite of differences. In 1980, the US inflation rate was allowed to get up to 13% – in a peacetime year! Then Ronald Reagan was elected President of the US with programs for a tax cut and then the Paul Volcker presidency of the Fed, tightened the tax cuts and the dollar soared. Dollar doubled against the Deutsche Mark in the next four years and inflation rate was brought down to 4%. It created the steep recession of 1982, that was similar to what Bernanke did in the third quarter of 2008.

2.4. Phase four: European debt crisis

The US and global recession was not, however, the last part of the crisis so far. The 2009–2010 part is the European debt crisis. The questions were raised on this occasion whether this European debt crisis was a euro crisis, whether the euro was safe etc. The year 2009 was the 10th anniversary of the European currency and at that time the euro was assessed as an unqualified success despite of some problems with the economy. Only in 2010, with the European debt crisis particularly sponsored by Greece, the euro was blamed. There were a lot of people calling for deconstructing the euro, breaking up the Eurozone into different parts - getting Greece, or maybe get all the PIIGS,[4] out of the Eurozone.

The European debt problem is severe, but the euro was not the main cause. If there is any complicity of the European currency, it is due to increase in fiscal spendings that was detached from changes in productivity. A distinct example is Greece, which started to increase their fiscal spending, and especially pensions, imitating Germany in this respect. A Greek teacher at 60 would get a pension of EUR 28,000 per annum for the rest of his life, which is the amount comparable to Germany, while Greece had a third of the German per capita income and just could not afford it. If the Greeks had done this when the drachma was there, it would have caused a financial crisis, which they would have to quickly correct. But because the euro was there, people thought that the Community was not going to let Greece fail. The rating institutions did not downgrade Greece, what they should have done after 2005 or 2006, so their ratings were not helpful in predicting the crisis.

The fiscal crisis of some Eurozone countries should not be called the euro crisis. The fiscal rules were not strong enough and the growth and stability pact was not being kept to and enforced. The socialist governments went into a fiscal binge under the protection of the euro. There is definitely a need for enforceable fiscal rules or else debt unification combined with the removal of fiscal sovereignty from national governments.

3. Benefits and costs of joining the Eurozone

The euro was a spectacular success: when it came on, it replaced the yen as the number two currency in the world. The bottom line for countries outside the Eurozone, including Poland, is whether they should join the Eurozone now. Like any normative question in economics, it has to be addressed in terms of benefits and costs.

There are 16 benefits of joining the Eurozone:

1. Obtaining a world-class currency which is on par with the dollar in this area.
2. Price stability as there are no inflation problems in the Eurozone.
3. Reduction, if not elimination, of destabilizing speculation. Nobody speculates on devaluation or revaluation of the European currency.
4. Policy stability. There is no confusion about the shape of policy of the largest Eurozone members, like Germany or France, as the element of the exchange rate policy is ruled out. The only thing the Eurozone members have to do is to maintain fiscal balance and credibility of fiscal solvency. There is no other good

[4] An acronym referring to the Eurozone economies with troubled sovereign debt markets: Portugal, Italy, Ireland, Greece and Spain.

policy and any surprise inflation and devaluation, which is a source of instability, is taken out.

5. Enhanced wage discipline. In the Eurozone a country is not able to change the exchange rates. Thus when a labor union makes claims of, for example, 10% wage increase, when productivity growth is only 2–3%, they know it will result in instant unemployment and bankruptcies of companies. Impossibility of depreciation causes the labor unions moderate their demands. It was seen in the last 10 years as there were no labor crises of a major scale in the Eurozone.
6. Expanded trade. With the certainty of exchange rates trade will occur as it does within the borders of a single country.
7. Lower nominal interest rates. Interest rates are lower in the Eurozone, because there is no inflation prospect.
8. Reduced transaction costs in the trade between countries of the Eurozone as there is no need for currency exchange.
9. Improved price information system as the prices are quoted in the same currency over the whole Eurozone.
10. More efficient continent-wide resource allocation as sudden shifts back and forth due to changes in exchange rates are ruled out.
11. Elimination of speculative currency tax. Poland is not immune to the experience of big banks speculating against or in favor of the zloty and creating discrepancies.
12. The euro debt instruments, which are a safer method of saving for the people.
13. Enhanced status, prestige, reputation, power in the EU. Poland is the biggest economy on the continent of Europe outside the Eurozone and being part of the Eurozone would make the country an insider in terms of policy.
14. Integration with richer neighbors as most of Poland's neighbors in the Eurozone would be richer, which is a benefit in numerous ways.
15. Automatic monetary policy, which results in the exact correct rate, since there is no alternative rate for a country in the Eurozone.
16. Political security. If you look at Poland's history over a thousand years, it is hard to find long periods when it was stable, independent and prosperous at the same time. Now Poland is in fortunate situation, having a stable democratic zone right next to it. Being a part of this zone would be a big advantage.

There are some arguments against joining the Eurozone.

1. Loss of discretion over the exchange rate. Of course, up until 1971, when the U.S. unilaterally terminated convertibility of the dollar to gold, countries did not have discretion over the exchange rate. Through all the periods of the gold standard (when the price of gold was fixed) or the bi-metallic era (when currency was based on gold or silver, or both) there was no change over the exchange rate. Britain from Elizabethan era up until the 1930's did not change the exchange rate. Even though Britain had the ability to change the exchange rate under the

gold standard by changing the price of gold, the British found the phrase "don't tamper with gold" a widely obeyed imperative.

Although some people consider the exchange rate a policy instrument that can be used on a day-to-day or week-to-week basis, the loss of discretion may not be a cost. Discretion over the exchange rate creates uncertainty about it and speculation. Because poor countries never appreciate their currencies – there is no such an example in history, the discretion is always asymmetrical - if they are going to change the exchange rate, the expectation is that it will be downward. They will devalue their currency, not appreciate, leading to higher interest rates. If Poland joins the Eurozone, it will effectively have no influence over the exchange rate – that is going to be a given factor, an equilibrium exchange rate.

2. Loss of control of the inflation rate. The loss of control over inflation would be a very important cost if Poland was joining an unstable anchor currency area, for example the Ruble zone 20 years ago. Russia experienced price increase of more than 2,500% in 1992, which was tremendous instability, and no one would want to be part of that. But it would be hard to think that the Eurozone is going to become an inflation area – there is rather a tendency for it to be under the shadow of the Bundesbank in Frankfurt. All the signs indicate that the European Central Bank, located in Frankfurt, will maintain price stability, as, indeed, is mandated in the European Central Bank Treaty.
3. Loss of ability to inflate away real wages. This is an important factor for Keynesian economists, who worry about the rigidity of money wage rates causing unemployment, and the need for the central bank to inflate the real value of money wage rates away. Keynes himself thought that if his type of policy was followed, the economic future would involve a race between trade unions and central banks, however the wage price inflation would not be good at all.

   The European Central Bank under its first President, Wim Duisenberg, renounced the idea of surprise inflation to maintain employment. The problem became irrelevant and disappeared because trade unions have taken the rigidity of exchange rates into account in wage negotiations. That loss should not be weighted too highly, because the expectations of trade unions are changed when a central bank tries to compete with them over price increase. It is better to keep a firm control over the expectations of trade unions.
4. Inflating away the public debt. In view of the debt crisis, a country can inflate away the public debt if it has its own currency. Almost everybody knew that when Italy joined the euro area in 1999, right at the beginning, it had a debt to GDP ratio of 120%, although it was supposed to have 60% maximum. But other countries had violated that criterion, too, and Italy was such an important economy that it was allowed in. What was another policy option? Suppose Romano Prodi, who was the Prime Minister of Italy until October 1998 – before Italy entered the Eurozone, suddenly launched a big inflation to inflate away Italian public debt. It

would create tremendous chaos and might take 10 years before Italy would live that down and get down to prove stability.

When did inflating away public debt occur in history? One example is France in the 1920's. Before World War I the value of the French frank was 19.3 US cents, and then, after the War, France went down to a 4.9 cent frank. This was a way of wiping out 70% of the French public debt. Keynes recognized it and appreciated. Another example, the US in 1946, after the World War II, had a debt to GDP ratio of 121% - the magnitude of Italy in 1999. But there was the post-war inflation of the cumulative magnitude of 60%, not unconnected to the debt, so that by 1960 the US debt to GDP ratio got down to 55%.

Another way to inflate away public debt, raised by some people, might be to impose a capital levy. Imagine a country had USD 100 billion worth of bonds out there and it imposed an 80% capital levy on those – that would be equivalent to slashing away the value of these bonds to USD 20 billion. Governments could do this in the face of force majeure, like a big war, but not in ordinary circumstances. Inflating away public debt is concerned immoral in some circles, but it is probably no more immoral than bankruptcy brought on by insolvency. The best case that could be made says that if the public debt is too high, it should be dealt with before joining the Eurozone. Poland is in such a fortunate situation that someone made this ingenious, good idea early on that the debt to GDP ratio could not, by law, be more than 60%. Every country should have done similar protection against too heavy indebtness.

5. National patrimony. Nostalgia for the national currency is particularly significant in the UK. It can be thought of as a heritage that should be preserved. On the other hand the Netherlands and France, both countries with a certain degree of nationalism, who used to have their national currencies for over a thousand years (the Dutch currency goes back to the 8th century), gave them up for the sake of the common European currency. Germany had the best currency in Europe, nevertheless they gave it up for the sake of the euro. So if the economic and political case for the euro is good enough, it is sufficient to overcome objections on this ground.
6. Irrevocability. Is is not clear whether entry in the Eurozone is reversible or not. Under force majeure, like fierce riots in the street or other symptoms indicating that the whole country wants to get out, a process for getting out of the Eurozone could probably be arranged. Members of a common currency area should also share common values, expectations and defense commitments, so Poland should not enter the Eurozone if it disagrees with the member countries on those issues. A currency area has to be a security zone: the fact is that most of the countries are members of NATO[5]. Summarizing the above discussion, irrevocability is not an important issue.

[5] The Eurozone countries that do not belong to NATO are Austria, Cyprus, Finland, Ireland and Malta.

My verdict is that the benefits outweigh the costs by a large margin. Poland should join the Eurozone, assuming a political agreement to do this, as soon as fiscal balance can be achieved. If a deficit smaller than 5% can be fulfilled, Poland should enter the Eurozone, if it cannot - that should be a top priority of a government that wants to go into the Eurozone.

4. Eurozone institutions

The next issue concerns Eurozone institutions: what new institutions are needed in Europe as the growth and stability pact turned out to be not working. This weekend in Italy I am going to discuss with a group of 40 political scientists the next steps Europe should take to solve this issue.

In 1792 Alexander Hamilton pioneered the idea of the US dollar in 13 colonies that later formed the United States. He argued that there was a good case for lumping together all the public debts of the 13 colonies. People objected, arguing that some colonies had high debts per person, while debts in the others were low, so it would not be fair. Hamilton argued that all the colonies were in the same boat and most of these debts were created during the revolutionary war with a common pur-

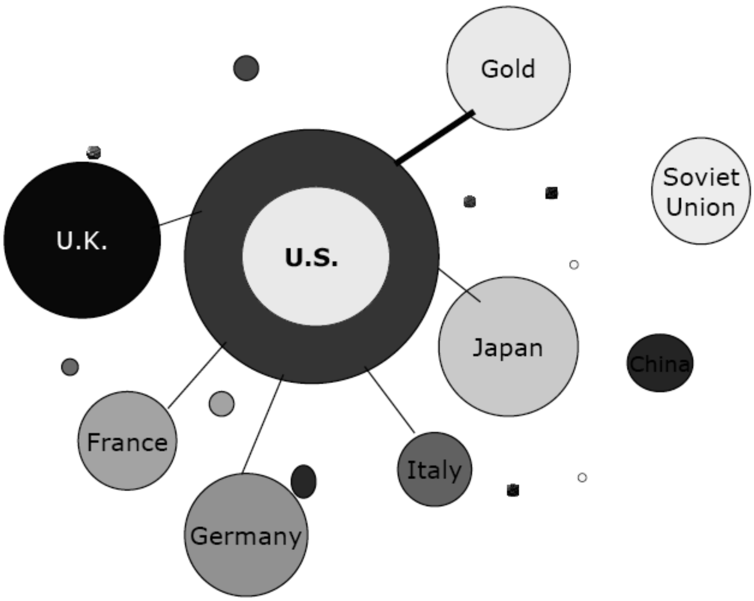

Figure 3. Bretton Woods System

pose. Now, if Europe could find a common purpose for amalgamating the debts, it would be a good step forward.

Of course, it would not be enough just to amalgamate the debts and pull all the debts of all the Euro area countries together. Possibility of building up more debt by any country would have to be cut off as responsibility has been removed from that. However, that would create another kind of slippage since preventing countries from making further debts would mean taking away a further element of their sovereignty. That is an issue that has to be really thought about and worked out.

In my opinion creation of the Euro area made a fundamental difference to the way the international monetary system worked. Before 1971, the Bretton Woods system was based on dollar, which was in turn anchored to gold at USD 35 an ounce since 1946. The other countries fixed their exchange rates to the dollar. That scheme was asymmetrical, but working, because it allowed for the fact that there was one super-economy in the system. Finally, that fixed exchange rate system broke down, but not because there was anything wrong with fixed exchange rates. It broke down because there was no mechanism for keeping the price of the currencies in line with the price of gold.

The price of gold had been fixed in 1934 by the United States at USD 35 an ounce. By 1971 the world price of gold had tripled, but the price of gold expressed in US dollars had stayed constant. The United States in 1948 had 70% of the world's monetary gold – 700 million ounces. It sold 400 million ounces to Europe until 1971, getting its own stock down to 300 million ounces. Then President Nixon took the

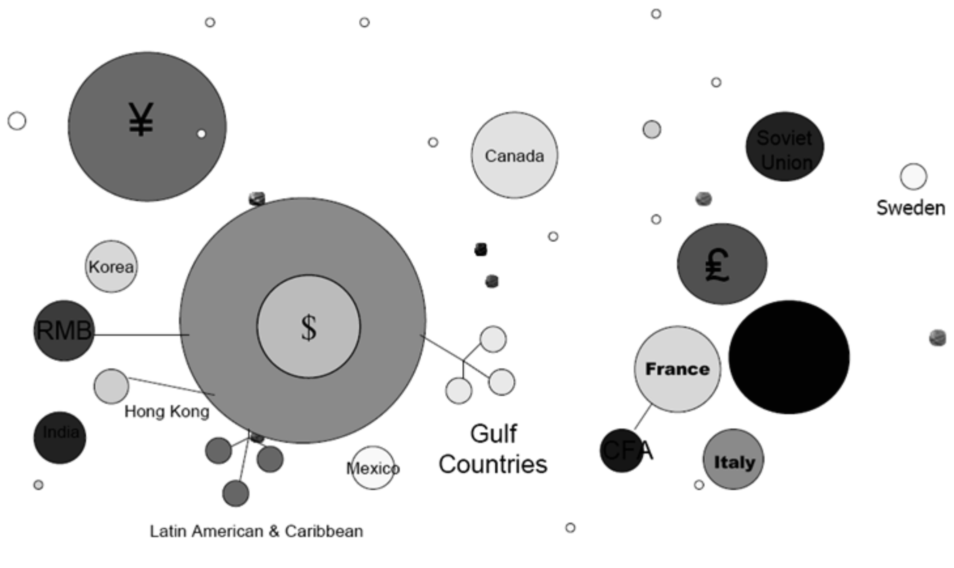

Figure 4. Flexible Exchange Rates in 1973–1999

dollar off gold, and because the dollar was no longer a convertible currency, the European countries took their currencies off the dollar. In that way the international monetary system moved on to flexible exchange rates. Then there was a return to a pure-dollar standard for a year and a half, but that broke up in 1973.

The idea of flexible exchange rates in the economic system is a monstrosity. If there were 200 countries in the world and they were all about equal in size, we would end up with 19,900 exchange rates. Imagine an attempt to price things around the world to find the best bargains. That would require checking through 19,900 different ways of doing a transaction. Of course, that could be limited by choosing transactions in terms of one country without worrying about cross-country transactions, but it would still quickly turn into a tremendous chaos. Then imagine what would happen to stock markets if 200 currencies were in use. In that flexible exchange rates scheme the dollar became the dominant unit of accounting for everybody to price their currencies in.

The dollar represented, to a large extent, the mainstream of the world's economy from 1971 until 1999. But after the euro came into being in an area almost as big as the area of the dollar – and if the UK had come into the Eurozone, it would have been bigger than the dollar – this mainstream was split, dividing the core of the world economy in half. This is a monstrous thing, which multiplied enormously the magnitude and the systemic importance of big swings in the dollar/euro exchange rate. And that is what calls to action.

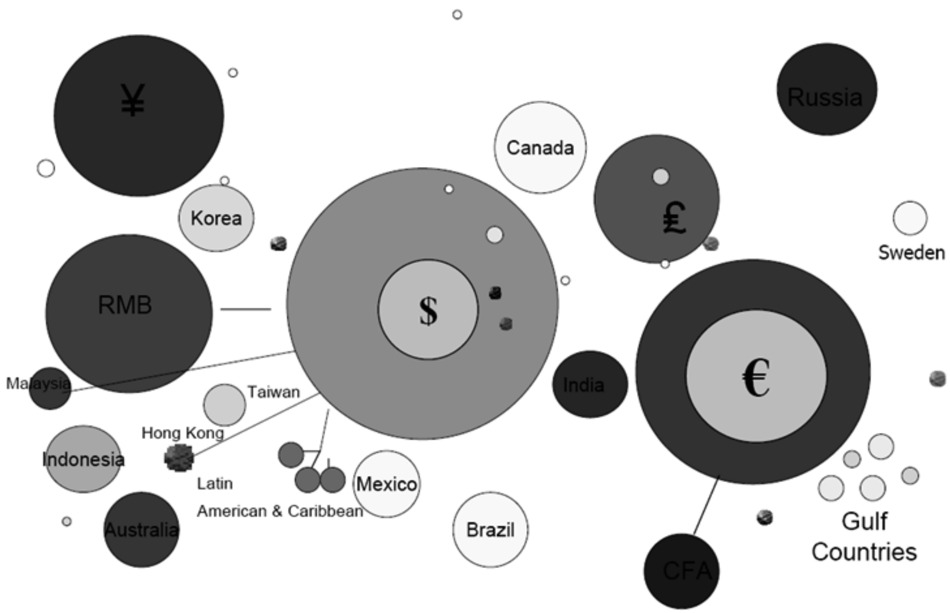

Figure 5. The International Monetary System in 2010

Figure 6. Euro-dollar Exchane Rate in January 1999–June 2010

There is much talk about having the special drawing rights and similar ideas, but the only thing that can make a global system out of today's monetary system is to stabilize the dollar/euro exchange rate, or keep it within very small differences. The euro started off at USD 1.18 and within less than two years it went down 40% – to 82 cents. Then it went up by 67% – to USD 1.36 at the end of 2004. Later the exchange rate level of USD 1.17 per euro was observed in November 2005, then 1.60 in July 2008 and it went down to USD 1.19 just in the beginning of June 2010. Those huge swings are splitting the world. Think what is happening to the countries in North Africa, which use both the dollar and the euro. This creates enormous problems. Imagine what it does to, for example, the price of air fares of two airlines in the same club: Air China and Lufthansa – you get a USD 5,000 difference in the price of their air tickets.

Conclusions

Stabilizing the dollar/euro exchange rate would create a core base for a global monetary system again. I am afraid we are quite far away from getting to such a system as no signs of consensus building for this can be seen in the United States – although the main economic advisor to President Obama, Paul Volcker, the former Chairman of the Federal Reserve, insists that a global economy needs a global currency. It is going to be politically hard to achieve, unless we get a good, deep cooperation between the United States and Europe. Poland would be much better off if the dollar/euro rate was fixed and so would Britain, which would find it easier to come into the Eurozone if the rates were fixed. At the present time, the best bet for Poland is to go into the Eurozone as soon as it can achieve fiscal stability.

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