Central Europe Digest

Center for European Policy Analysis

November 5, 2013

More Credit, More Money: Poland and the Euro-zone

By Steve H. Hanke

Money matters — it's a maxim of Prof. Milton Friedman that I repeat often in my columns, and to my students in class. Since the Northern Rock bank run of 2007 — the "opening shot" of the recent financial crisis — the money supply, broadly measured, in Poland and the rest of Europe has taken a beating. In the Euro-zone, money supply growth is anemic and becoming weaker, while private credit continues to contract. In Poland, the money supply has seen a recent slight recovery, but remains relatively weak. This is cause for concern, because the quantity of money and nominal gross domestic product are closely related.

When it comes to measuring the money supply, we must heed the words of Sir John Hicks, a Nobelist and high priest of economic theory: there is nothing more important than a balance sheet. These sentiments were recently echoed by my Parisian friend, former Governor of the Banque de France Jacques de Larosière, in his April 17th lecture at Sciences Po.

Components of the money supply appear on a bank's balance sheet as liabilities. The money supply is simply the sum of the deposits and various other short-term liabilities of the financial sector. On every balance sheet, the sum total of assets must equal total liabilities. In consequence, the money supply (short-term liabilities) must have either an asset or longer-term liability counterpart on the balance sheet (see Figure 1).

Figure 1: The Balance Sheet of Monetary Financial Institutions

The Balance Sheet of Monetary Financial Institutions

Assets	Liabilities
Credit to the Private Sector	Deposits and other Short-Term Liabilities
Credit to the Public Sector	Longer-Term Liabilities
Net External Assets and Other Counterparts	

Notes: All cells highlighted in blue are credit and the cell highlighted in green is the money supply. The non-highlighted cells are non-credit counterparts of the money supply.
The Money Supply (Deposits and other Short-Term Liabilities) = (Credit to the Private and Public Sector) + (Net External Assets + Other Counterparts) - (Longer-Term Liabilities).

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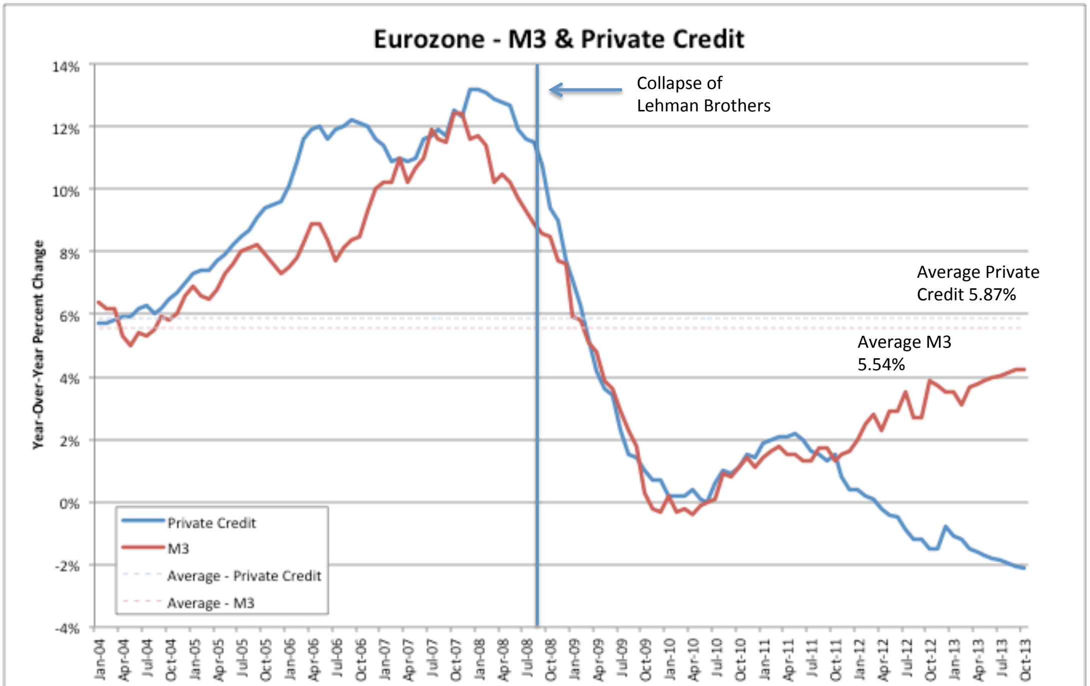
One of these counterparts is known as credit, and it includes various financial instruments such as private loans, mortgages, etc. Money and credit are often confused as synonyms, but they are not the same thing — credit is a counterpart to money. Any economist worth his salt should have the money supply on his dashboard. But, it is also important to look at what the financial sector is doing with these deposits — are they lending this money back out to the economy, and if so, to whom? There is one very important counterpart of the money supply that is particularly worth looking at — loans to private individuals and businesses, known as "private credit."

In the Euro-zone, the growth rate of the money supply has historically moved in the same direction as private credit growth. Recently, however, this relationship has reversed. Despite a very modest rebound in the annual growth rate of the money supply (2.3 percent), growth in private credit has been contracting for over a year, indicating a severe credit crunch (see Figure 2).

How can Europe's money supply (M3) be growing while private credit is shrinking? First, it is necessary to determine where on the asset side of the balance sheet this increase in the money supply (deposits) is going. As it turns out, a whopping 40.8 percent of the growth in M3 over the last year has gone to bank lending to governments.

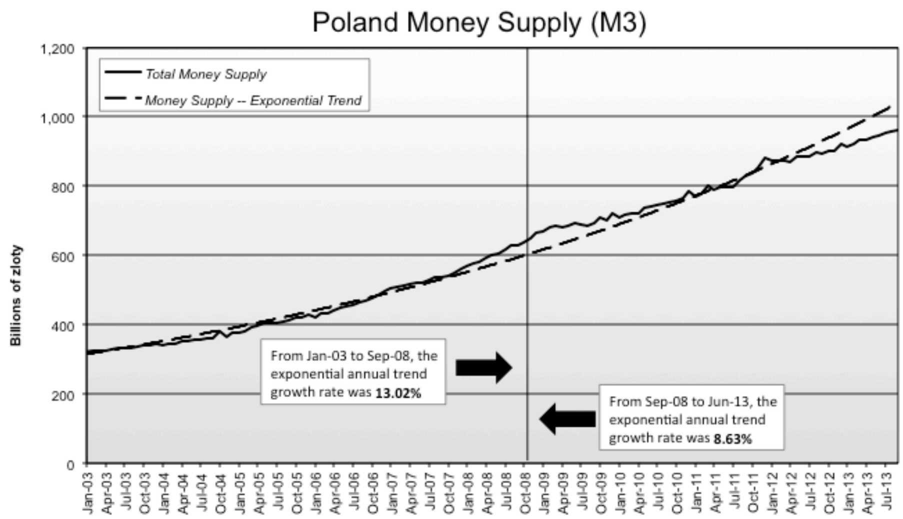
Back on the liability side of the balance sheet, we will also find that 30.7 percent of this growth in

Figure 2: Euro-zone Money Supply and Private Credit



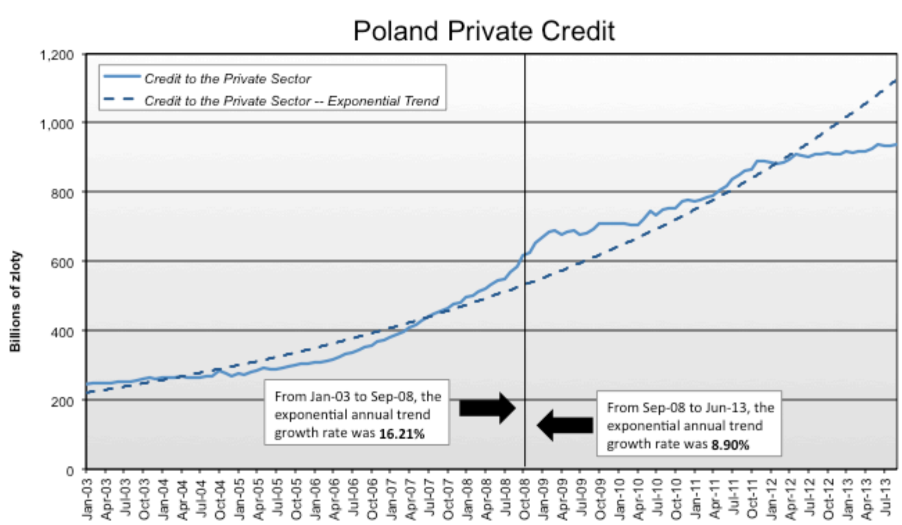
Source: ECB and author's calculations. *Note: The annual growth rate averages are calculated from January 2004 to the most recent data point.*

Figure 3: Poland Money Supply



Sources: National Bank of Poland and calculations by Prof. Steve H. Hanke, The Johns Hopkins University.
Note: The trend line for the money supply and private credit are calculated over the period from Jan-03 to Sep-13.The trend line used is an exponential trend line -- an exponential trend line has a constant growth rate over time in percentage terms in contrast to a linear trend line, which has constant incremental change over time in nominal terms. For example, this exponential trend line for private credit grows at 16.49% per year but a linear trend line would grow by 6.55 billion zloty per year.

Figure 4: Poland Private Credit



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M3 has come from a decrease in banks' long-term liabilities. To understand how this would increase the money supply, consider the following example: If I own a long-term bank bond, and the bank then retires that bond, I will take the money I receive as a result of this transaction and put it into my bank account. Hence, the money supply (deposits) increases.

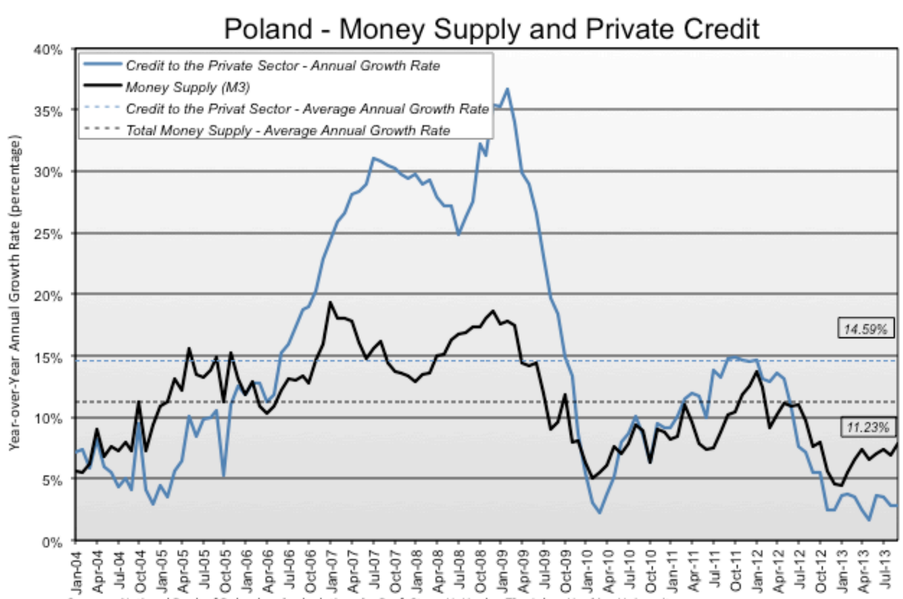
In short, the money is going to government borrowing, and the restructuring of the liability side of bank balance sheets is modestly pumping up the Euro-zone money supply. Meanwhile, private credit remains in the doldrums.

And things are not much better in Poland, where annual growth in private credit and the money supply has been below its trend level for quite some time (see Figures 3 and 4) .

Following the collapse of Lehman Brothers in September 2008, private credit, in particular, took a beating (see Figure 5) – the annual trend growth rate dropped from 16.21 percent to 8.90 percent, leaving private credit currently well below its trend level.

The main factor hampering broad money and private credit growth in the Euro-zone and the "Zloty-zone" alike is, not surprisingly, the government-created squeeze that has been put on banks as a result of the Basel III's capital-asset ratio hikes. By requiring banks to hold more capital per dollar of risk assets (read: loans), the regulators have put a constraint on banks' balance sheets, which limits their ability to lend (create private credit). In consequence, money supply and private credit growth has been slower than it would have otherwise been.

Figure 5: Poland Money Supply and Private Credit



Sources: National Bank of Poland and calculations by Prof. Steve H. Hanke, The Johns Hopkins University.

Note: The annual growth rate averages (14.59% for private credit and 11.23% for M3) are calculated from January 2004 to September 2013.

Even the International Monetary Fund (IMF) and the Paris-based Organization for Economic Cooperation and Development (OECD) quietly acknowledge that this will hamper GDP growth and raise lending rates. But, thus far, they have failed to fully assess the negative impact of raising capital requirements during an economic slump. The problem is that analysts at the IMF and OECD are not properly focused on private credit and the money supply. Indeed, when viewed in terms of money and private credit, the picture comes into sharp relief.

PARADOXICALLY, THE DRIVE TO DELEVERAGE BANKS IN THE NAME OF MAKING THEM SAFER, DESTROYS MONEY BALANCES AND CREATES A CREDIT CRUNCH.

So, paradoxically, the drive to deleverage banks and to shrink their balance sheets, in the name of making them safer, destroys money balances and creates a credit crunch. This, in turn, dents company liquidity and asset prices. It also reduces spending relative to where it would have been without higher capital-asset ratios. In the end, economic activity remains weak and unemployment continues to climb, which makes banks less safe.

Clearly, central bankers around the world have misdiagnosed the patient – a reread of Prof. Friedman on money, as well as Prof. Hicks and Mr. de Larosière on the importance of balance sheets, is much needed. Alas, the contradictory monetary policy mix – loose state money and tight credit – shows no sign of letting up anytime soon.

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Poland Redux

By Edward Lucas

Radosław (Radek) Sikorski and Carl Bildt make a formidable double act. In recent weeks they have been crisscrossing the continent's eastern borderlands to drum up support for the Eastern Partnership — the European Union's (EU) attempt to woo six ex-Soviet republics away from Moscow's orbit.

It is hard to imagine Sweden's foreign minister staying quietly at home. But it is now also hard to imagine any other country than Poland providing his travelling companion and counterpart. No Western European country would have the connections. No other "Eastern" European country would have the clout. Poland has, over the past 10 years, become the indispensable country in post-Communist Europe.

As Marcin Piatkowski argued recently in a powerful new paper, Poland is enjoying the best 20 years in its economic history, after 500 years of persistent misadventure (see Figures 1 and 2).

And the best is yet to come. Poland is already the largest economy of the ten "new member states" (a term that is now increasingly redundant). Measured in nominal terms, its Gross Domestic Product (GDP), at $520 billion, makes up a third of the region's output. It is the sixth-largest economy in the EU when measured by purchasing-power parity (which takes into account price differences in measuring the value of national income). Warsaw, by European standards, is already a rich city. The World Bank already counts Poland as a "high-income country."

The future Polish growth rate is one of the most important questions for Europe's future. If Poland can converge on (and exceed) European levels of income, it will have overcome the historic division of the continent into an advanced western half and a backward east. It will no longer be the junior partner to Sweden, say, but a paid-up member of the big-countries club. It will be able to afford defense spending on a level that helps regional security — especially to the north, where the smaller countries around the Baltic Sea face decades of uncertainty as Russia frays and flails. It will be an Atlanticist anchor on issues such as transatlantic free trade.

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Rather too much attention has been paid to Poland's slowdown in growth this year. It coincided with a trough in support for Civic Platform (PO), the main party in the governing coalition. But the opposition Law and Justice (PiS, in its Polish acronym) has blown its chances, pursuing conspiracy theories rather than highlighting the real shortcomings in the government's record. The latest figures show growth accelerating again and Donald Tusk's party regaining its popularity.

Instead attention should focus on the long-term constraints and spurs to growth in the country. If Poland can grow at three percent for the next 25

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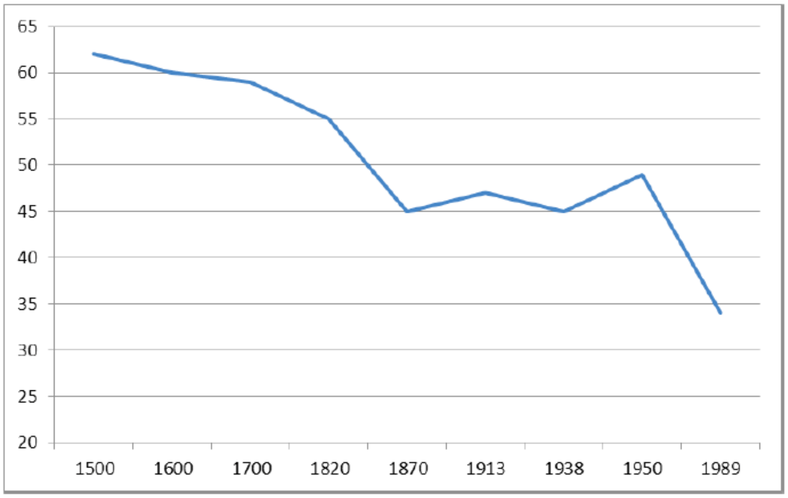
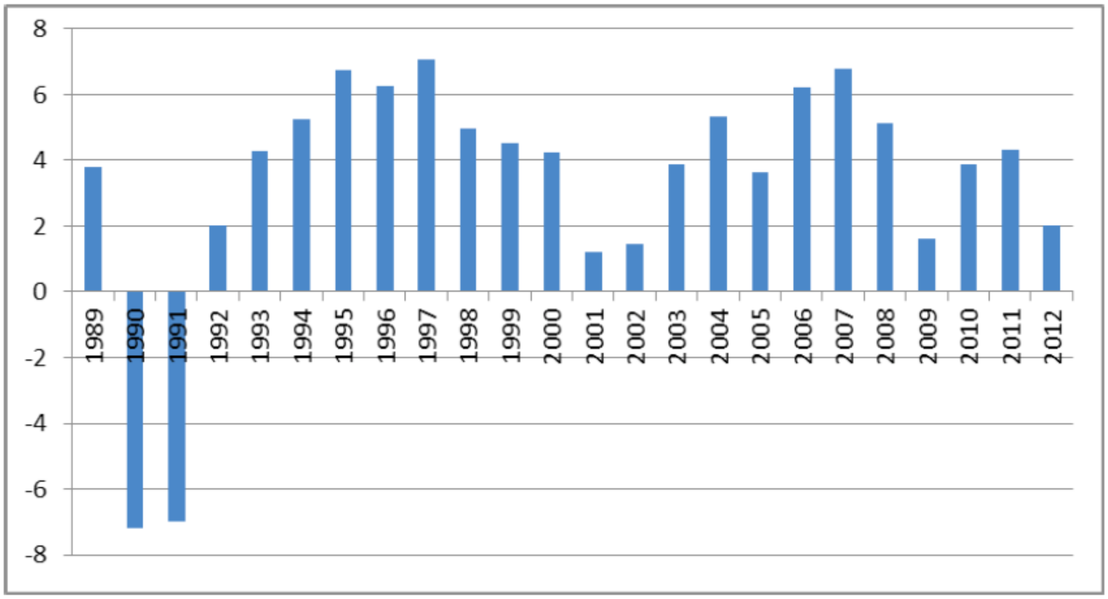
Figure 1: GDP per Capita in Poland, 1500-1989, Western Europe = 100



Note: Data for 1500, 1600, 1700 and 1820 based on an average for Albania, Bulgaria, Czechoslovakia, Hungary, Poland, Romania, and Yugoslavia. Data for Poland only starting in 1870. See Maddison (2010) for definition of Western Europe (12 economies).

Source: own calculations based on Maddison (2010).

Figure 2: GDP Growth Rates in Poland, 1989-2012



Source: own calculations based on the IMF World Economic Outlook, October 2012.

years, it will double the size of its economy. If the growth rate is only 1.5 percent, then GDP will rise by less than half.

The first task is to attract more people. The demographic dividend of the 1980s is fading into history. It is aggravated by emigration. Poland needs to attract back home its two million-odd sons and daughters who have sought a new life abroad. It cannot rely on higher wages alone acting as the magnet. Poles who live in Western Europe have become accustomed to high-quality public services: health, education, public transportation, criminal justice, garbage collection and many other bits of modern life. Many of these have improved hugely in Poland in the past 20 years. But they still have a long way to go to meet the standards of, say, Germany. Polite, honest, efficient public servants are not a luxury: they are part of national economic security.

Poland can also do more to attract foreigners. By European standards, the number of foreign-born residents is remarkably low. For Ukrainians, Belarusians, Moldovans and Russians, Poland is a good cultural fit — and a beacon of economic opportunity (and in some cases, of political freedom). But Poland could compete harder in the global talent market too. The new software and IT cluster in Kraków, for example, is a natural home for ambitious geeks from all over the world. Sadly, they do not always find the Polish bureaucracy welcoming them with open arms. It is high time for Poland to work out a serious national migration policy aimed at attracting and integrating legal migrants of a quality and quantity that will suit its needs.

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Solving the "human factor" also means raising the labor participation rate, which is one of the lowest in Europe. This is chiefly because too many Poles retire too early. Raising the retirement age and lowering the overly generous disability benefits is politically unpopular. But Poland cannot afford a rich-world scatter-gun approach to social spending until it can afford it — and preferably, not even then. And it should not neglect its education system. Poland already scores highly on reform of the school system. It needs to approach higher education with the same zeal.

A second big priority is to seize the historic chance offered by $100 billion in European structural funds over the next seven years. Poland did a brilliant job in negotiating its budget deal. It has yet to show similar brilliance in spending the money. Road-building in particular has been plagued by bureaucratic rigidity, leading to howls of protest from contractors — and in some cases bankruptcy. Poland should not be seen as an easy target when it comes to bidding for public procurement contracts. But it risks deterring bidders by seeming too zealous and inflexible. Cracking the infrastructure constraints should bring huge benefits. As Mr. Piatkowski notes in his paper, Poland's huge economic success during the past 20 years has come despite bottlenecks in transportation and other crucial services. Imagine what Polish business could do if it was operating in a friendlier environment.

Third, Poland needs to pursue European integration. Completing the single market in services would allow Polish firms to compete far more effectively abroad. So too would the completion of the digital single market. Joining the Euro would add between 0.3 and 0.7 percentage points to annual GDP growth. An emphatic focus on solving the continent's problems will help a Polish candidate win one of the top jobs in the EU or NATO — Sikorski is a front-runner to succeed Catherine Ashton as the EU High Representative for Foreign Affairs and Security Policy.

Catching up with the West will be a marathon, not a sprint.

There are of course plenty of other constraints to growth, such as low spending on research and development, a poor record on innovation, and low rates of saving and investment. But to my mind these are better seen as symptoms rather than core problems. Poland will save and invest more as people get richer. Innovation will come when innovative people have the physical, financial and legal conditions that encourage them to unleash their talents. Labor, capital, and know-how flow freely in the single market.

Perhaps the biggest obstacle of all has nothing to do with economics or government policy: it is the low level of social trust in Poland. The deepest wound left by the history of past centuries is not the flattened cities or murdered millions, but the scars on the psyche of generations of survivors and their descendants. As Mr. Piatkowski points out, catching up with the West will be a marathon, not a sprint. For a sustained effort over another decade or two, the cooperation of all Poles will be necessary.

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