



BETWEEN CRISIS AND INNOVATION

European Policies through
National and Transnational Perspectives

Krzysztof Łobos, Peter Schiffauer (eds)

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 CEDeWU.PL

Reviewer: prof. dr hab. Marek Szydło, Uniwersytet Wrocławski

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Contents

Foreword.....	13
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Part I Perspectives on National, European and Global Economy

Chapter 1	
Macro-prudential Policy and Stability of the Financial System in Poland	
– <i>Marian Noga</i>.....	19
1.1. Introductory remarks	19
1.2. The macro-prudential policy should be targeted at financial stability	21
Conclusion	26
Bibliography	27

Chapter 2	
Transparency of Monetary Policy vis-à-vis Risks for the Financial Stability	
– <i>Agnieszka Tomczak</i>.....	29
2.1. Genesis and character of the monetary policy transparency	30
2.2. Information instruments	31
2.3. Message addressees	32
2.3. Financial 2007-2008+ crisis and communication policy in the euro area.....	34
Conclusions.....	41
Bibliography	42

Chapter 3

Alternative Trading Systems in European Capital Market as an Unregulated Market for Financial Instruments Trading – *Marek Kopyściański,*

<i>Tomasz Kopyściański</i>	45
3.1. Introduction	45
3.2. Origin of alternative systems of trading in financial instruments	46
3.3. Alternative trading systems vs. regulated markets	49
3.4. Role of alternative trading systems in the economy	54
Summary	57
Bibliography	57

Part II

EU Membership as a Stimulus for Emerging Economies – Polish Experience

Chapter 4

Financing Innovative Undertakings from the European Union

Structural Funds – <i>Joanna Wieprow</i>	61
4.1. Introduction	61
4.2. The concept and types of innovation	62
4.3. The significance of innovation	65
4.4. Financing innovation projects from the structural funds in the years 2007-2013	66
4.5. Examples of the implementation of innovation projects	69
4.6. Financing innovation under the 2014-2020 financial perspective	71
Conclusion	72
Bibliography	73

Chapter 5

Innovativeness of the Polish Service Sector as Well as of the Whole Economy in Comparison with Chosen Countries of Central and Eastern Europe

– <i>Waldemar Gajda</i>	75
5.1. Introduction	76
5.2. Innovations in the history of economic thought	77
5.3. The analysis of activity of the Polish service sector	78
5.4. Innovativeness of the Polish economy in comparison with the chosen countries of Central and Eastern Europe	79
5.5. Barriers of innovativeness of the Polish service sector	82
5.6. Barriers connected with education and knowledge	83
5.7. Barriers connected with the weakness of the academic and R&D sphere	83
5.8. Economic and financial barriers	84

5.9. Barriers connected with R&D financing	84
5.10. Market barriers	85
5.11. Barriers of political nature	85
5.12. Legislative barriers	86
Conclusion	86
Bibliography	87

Chapter 6

Irregularities in the Process of Implementation of Projects Co-Financed from EU Funds under the 2014-2020 Financial Perspective – Analysis of Article 24 of the “Implementation Act” – Jarosław Odachowski	89
6.1. Introduction	90
6.2. The essence of irregularity	93
6.3. The analysis of Article 24 of the Implementation Act	94
Conclusion	105
Bibliography	106

Chapter 7

The Impact of EU Funds on Indebtedness of Polish Companies – Anna Motylska-Kuźma	109
7.1. Introduction	109
7.2. EU Funds and their applicability in Poland	110
7.3. Procedures and resources expenditure	113
7.4. the use of EU Funds and company indebtedness	114
Summary	117
Bibliography	117

Chapter 8

Poland's Membership in the European Union – an Opportunity Seized? – Izabela Jędrzejowska-Schiffauer, Adam Hetmańczyk	119
8.1. Introductory remarks: Towards the accession	119
8.2. Balance of financial flows between the EU and Poland	120
8.3. Poland's economic growth in the European context	123
8.4. Poland's overall economic development in the context of EU membership	124
8.5. Reform imperative in the face of the crisis	125
8.6. Consequences of Poland's remaining outside the Single Currency	127
8.7. EU perspective on Poland's economic policy: a smooth or bumpy way forward?	129
8.8. Concluding Remarks	131
Bibliography	132

Part III

Political Dimension of European Integration

Chapter 9

Political Rights and Liberties in the European Union: an Ideal Dating Back to the Enlightenment? – <i>Hélène Palma</i>	137
9.1. The central importance of the notion of inalienable individual rights and liberties for Europe.....	138
9.2. The invention of natural individual rights and liberties	139
9.3. Locke's conception of natural individual rights and liberties	140
9.4. How locke's views travelled throughout Europe and how the concept of natural individual rights and liberties spread to the whole continent ...	142
9.5. The French <i>Déclaration des droits de l'homme et du citoyen</i> : first public formulation of the notion of human rights, later endorsed by international organizations such as the European Union.	146
Bibliography and webography	147

Chapter 10

Are there really European Values? – <i>Piotr Napierała</i>	149
10.1. Introduction: Two parts of the west	149
10.2. Mistrust of religion/ state.....	151
10.3. America as the future of Europe	153
10.4. What does it mean to be European?	154
10.5. Divisions within the EU and the USA	157
Conclusions.....	157
Bibliography	158

Chapter 11

Europeanisation as a Constitutional Process: a Double-Edged Effect of Political Transformation – <i>Izabela Jędrzejowska-Schiffauer</i>	159
11.1. Introducing the Concept of Europeanisation	160
11.2. Europeanisation as a constitutional process – the transformation of Central and Eastern European states	161
11.3. Constitutional adaptation process at the EU-level.....	162
11.3.1. Further EU enlargements and the composition of the Commission.....	163
11.3.2. The European Parliament	164
11.3.3. EU enlargement process and the decision-making in the European Council and the Council	165
11.4. Western-European States and their resistance to change	168
11.5. Europeanisation and crisis management: EU beyond the main stream of integration?.....	169
Conclusions.....	171
Bibliography	172

Chapter 12

A New Role for European Parties? – <i>Bengt Beier</i>	175
12.1. The role and function of political parties	176
12.2. The position of political groups in the European Parliament.....	177
12.3. The development of European party law	179
12.4. European parties in law: the current rules	181
12.5. European political parties now: taking stock	183
12.5.1. European funding.....	185
12.5.2. A closer look at the parties	186
12.6. Key findings	195
Bibliography	197

Chapter 13

George Friedman's Geopolitical Forecast for Poland and Europe until the mid-21st Century – <i>Józef Michał Soroka</i>	199
13.1. Introduction.....	200
13.2. The nature, functions and types of forecasts in international relations	201
13.3. Forecasting methods.....	203
13.4. The Personality of Friedman, and the characteristics of the Stratfor analytical institute	205
13.5. Friedman's geopolitical forecast for Poland and Europe	207
Conclusions.....	210
Bibliography	211

Part IV**Social and Linguistic Aspects of European Policies****Chapter 14**

L'Arche Community as an Example of Social Capital – <i>Bojana Bujwid-Sadowska</i>	215
14.1. Introduction.....	216
14.2. L'Arche foundation.....	216
14.3. The mission of L'Arche.....	218
14.4. 'De-institutionalization process' project	219
14.5. "Changing the World Heart by Heart" project.....	220
Conclusions.....	223
Bibliography	224

Chapter 15

Senior Tourism Supported Financially by European Union Funds as a Way of Socio-economic Activation of Elderly People

– <i>Małgorzata Starczewska</i>	225
15.1. Introduction.....	226
15.2. Tourism consumption by seniors – its motivations and constraints.....	226
15.3. Role of the European Union Funds in the development of the seniors' tourism.....	228
15.4. Benefits from implementation of European Union programmes financially supporting the development of senior tourism.....	234
Conclusions.....	236
Bibliography.....	237

Chapter 16

Changes in English Language Teaching and Assessment at Polish Higher Education Institutions and Subsidiaries of Multinational Corporations after Poland's Accession to the European Union – *Ewa Bułat*

16.1. Introduction: <i>Do you speak business?</i>	240
16.2. English language assessment	242
16.3. The challenge – a teacher's perspective	243
16.4. English language teaching – a practical approach.....	245
16.5. Social skills and cross-cultural awareness as important elements of any ESP curriculum	246
Conclusions.....	249
Bibliography	249

Chapter 17

The Change of Modal Attitudes of the Addressees in Legal Discourse on the Example of EU Directive 2014/41/EU on the European Investigation Order in Criminal Matters – *Katarzyna Gęborys*.....

17.1. Introduction.....	252
17.2. On the concept of discourse within linguistic approaches	252
17.3. The typology of discourse	255
17.4. The language of law.....	258
17.5. Strategies of enforcing modal attitudes	260
17.6. Final remarks.....	264
Bibliography	264

EPILOGUE

Constitutional Challenges for European Integration beyond the Crisis	
– <i>Peter Schiffauer</i>	269
1. Stable framework and need for reform.....	270
2. Governance of the Eurozone.....	274
3. Stimulate sustainable growth.....	277
4. Joint action in foreign policy.....	279
5. Internal security	279
6. Functioning of the institutions	280
Bibliography	289
List of Tables.....	292
List of Figures.....	293

Foreword

After centuries marked by wars, foreign domination and manifold sufferance the peoples of Europe are experiencing since the middle of the twentieth century an unprecedented historical experience which from a small initial nucleus has spread out to cover the major part of the continent. Since it is unprecedented in history, historians, political scientists, economists and lawyers encountered significant difficulties when trying to qualify the emerging polity called European Union. Evidently this polity cannot be identified with a fix model because it was a process in the making without a predetermined finality since it came into being. Its *constitutional process* does not aim at substituting and has by no means substituted the existing European States which remain sovereign subjects in the sense of the international law, while being legally committed to exercise jointly a tangible part of their sovereign rights. The Union may perhaps be described as a polity which overarches sovereign States and places their sovereign will under the command of a common legal order without affecting their sovereign power. The impact of this process on human society does not stimulate a development towards unification of a homogeneous society of continental scope and pyramidal shape. It necessarily requires, however, integration¹ of existing diversity in society, in a sense that allows the individuals to recognise in *the different other* the fraternal being sailing on the same boat, with whom we need to share tolerance and solidarity if we want to reach a safe haven.

Integration of societies does not happen spontaneously, it is not an automatic reflex in society caused by the setting up of a transnational legal order. Economic integration requires entrepreneurial intelligence to seize new opportunities, followed by the courage and initiative to make use of them. It is stimulated by increased understanding of neighbouring societies and their difference, inducing

¹ The concept of integration was developed by Rudolf Smend (*Verfassung und Verfassungsrecht*, Duncker & Humblot, München 1928) as a basic feature for the existence and survival of a State. It may well fit for a transnational political entity which, taking the integration achieved by and within its Member States as a basis, seeking to unify them in their diversity.

awareness that beyond the own country's borders one is not on enemy's territory. Such experience, too, is a process in time. Patience and the capability to overcome misunderstandings is required for the growing together of societies which, while living under a common legal framework, wish to maintain their diversity. Integration may be considered as achieved where the difference is understood as equivalence and solidarity is flowing from reference to a common identity. Essential precondition for a process of this kind is the readiness and capability to communicate. Integration can only be successful where a dense network of well-functioning communication paves its way.

This is the reason why efforts of the academic world to analyse and to discuss all aspects of the European integration process are of paramount importance. As long as the dimension of the single European market and of the European Union citizens' rights has not become a normal feature of daily business, the academic institutions have not fully complied with their task to be, through training the coming generations, a central communicator for a society of information and science. There is a widespread view that nearly ten years after the most significant enlargement of the European Union, the Member States which adhered in 2004 were not yet finding themselves on a fully equal footing within the European Union. Some progress may have recently been achieved, including on the highest political level. The commemoration of ten years EU-membership has frequently given rise to stocktaking. In times of economic and financial crisis the European Union cannot simply be identified with economic growth, higher welfare and improved social benefits. But how would such crisis have possibly developed in the absence of a stabilising economic power like the European Union and its single currency? Have its financial instruments been efficiently used? And what is the best way forward for those presently outside the Euro area? What about the sustainability of future economic development without the Union's intervention? What about the security of energy supply?

The contributions assembled in this volume are examining a widely spread spectrum. In its first part we are proposing selected analyses of national, European and global economic issues, ranging from macro-prudential policy over the transparency of monetary policy to alternative trading systems in European capital markets. The second part of the volume looks more closely at the Polish experience accumulated during the first decade of its European Union membership. It demonstrates the stimulating effect of this membership for an emerging economy, analysing in particular the innovativeness of the domestic economy, the financing of innovative undertakings through EU structural funds and the impact of such funds on indebtedness in Poland. It also addresses the settling of irregularities encountered during the implementation of projects co-financed by EU funds and gives an overall assessment of the benefits drawn by the domestic economy. In its third part the volume proposes miscellaneous contributions dealing with the political dimension of European integration. The common tradition of individual rights and liberties is

traced back to an ideal developed in the times of enlightenment, while from an outside perspective it is questioned whether there are really European values. The process of Europeanisation is presented in a new light focussing on the dialectics of its development, affecting the East as well as the West, the founding as well as the adhering Member States. The political nature of the European polity is focussed by an analysis of the due role for European political parties and, from an outside perspective, a geopolitical forecast for Poland and Europe is given. The forth part of the volume underlines the importance of societal cohesion and communication for every project of integration. It proposes case-studies of the activities by the “Arche” –community and of EU-funded tourism of seniors as a way for activation of elderly people. Tribute to the paradigmatic role of language for any kind of integration is paid by contributions that examine the changes in English language teaching after Poland’s adhesion to the European Union and the legal language of EU legislation on the basis of concepts which were developed in the field of linguistics. The volume is closed by an epilogue addressing constitutional challenges faced by the European Union beyond the crises and options to cope with them.

Having regard to such a broad range of subjects and to the variety of the authors’ scientific disciplines, professional functions and personal background it goes without saying that there is not and cannot be any theoretical or methodical link common to all the contributions published in this volume. Hence their contents is the sole responsibility of the authors. The contributions are put together with the aim to provide a lively platform of debate at a crucial stage of the European integration process where more than a decade after the biggest EU enlargement its benefits can be seriously assessed, while at the same time the European Union is faced with a crisis threatening to put its very existence into question. The narrative of maintaining peace and freedom through the European success story merits to be maintained against voices which in short-sighted defence of national interests endeavour to dismantle the historical innovation of a political architecture allowing to settle conflicts through negotiations and compromise peacefully, albeit in a cumbersome and tiring manner, but excluding the use of mere power, violence and domination. Resolute defence of the European project does not exclude, however, strong criticism towards errors, mismanagement and other undesirable developments which affect European integration alike any other social reality. Only by taking up such criticism in measured and balanced reforms will the European Union and its institutions prove the strength to achieve the noble objectives solemnly proclaimed in its founding Treaties.

Wroclaw, July 2015 the Editors

Part I

Perspectives on National, European and Global Economy

Chapter 1

Macro-Prudential Policy and Stability of the Financial System in Poland

*Marian Noga**

Abstract

The recent economic crisis has revealed not only deficiencies in the state micro-prudential policy but in fact the lack of a macro-prudential policy of the state. The author of the paper defines precisely the structure of the Polish financial system, its stability and usefulness to activities of the micro-prudential and macro-prudential policy. The paper also presents institutional frameworks of activities of the macro-prudential policy in Poland and the world.

Key words: macro-prudential policy, stability of the financial system.

1.1. Introductory remarks

Reduction of the systemic risk and limitations of pro-cycles of a financial system should become an important target of the macro-economic policy to be dealt with by the macro-prudential policy¹. As opposed to the former supervisory policy with a micro-prudential perspective, the main impact area is not the stability of particular financial institutions but of the entire financial system and its influence on the other sectors of the economy. I would like to remind here that the financial system is

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¹ P. Bańbuła, *Polityka makroostrożnościowa: przesłanki, cele, instrumenty i wyzwania*, NBP, Instytut Ekonomiczny, Materiały i Studia, Warsaw 298/2013, p. 55.

a part of the economic system which allows money to circulate in the national economy consisting of:

- a) households and enterprises operating in the financial market,
- b) regulations of the financial system,
- c) regulations of the European Union,
- d) infrastructure of the financial system,
- e) financial institutions including the Central Bank,
- f) investment funds,
- g) open pension funds,
- h) insurance companies,
- i) entities running brokerage activities,
- j) financial markets.

In simple terms, the financial system may be presented as a network of legal norms and financial institutions whose task is to collect, share and spend pecuniary resources.

The financial system understood this way may be analysed from various points of view:

- a) as a financial sector in the economy divided into a market financial sector and a public financial sector,
- b) as sub-systems of the financial system, i.e.
 - a budgetary subsystem (of the state budget and local self-governments),
 - a banking subsystem (including operations of the Central Bank),
 - a financial and insurance subsystem,
 - a financial subsystem of economic subjects,
 - a financial subsystem of the population defining the source of pecuniary resources of individuals.

Even such a rough analysis of the financial system shows its complexity and its impact on the entire economy. First of all, this system may be disturbed by a systemic risk, a structural, legal and economic risk of the worldwide range. That is why, we need the stabilization of the financial system by means of defined tools such as a macro-prudential and micro-prudential policy. The following mistakes have been made so far regarding the macro-economic policy:

- a) an overzealous focus on the stability of particular institutions;
- b) insufficient examination of particular institutions in critical situations. It was only after the outbreak of the crisis that stress tests were applied;
- c) feedbacks between financial institutions were left aside which contributed to deepening of the crisis;
- d) systemic risk got out of control of institutions dedicated to securing stability because of a simple reason – nobody was authorised to limit it. Even if central

- banks prepared appropriate analyses, they were not followed by any actions as there was no institution having an appropriate authorization and tools;²
- e) the public debt crisis in Greece could have been stopped *in statu nascendi* because it did not exceed the value of 360 billion euro at the beginning of 2009. However, indolence of the European Commission and the lack of a European authority reducing the systemic risk brought about “spilling over” the crisis onto the entire EU and even beyond the Atlantic Ocean;
 - f) regulations of capital adequacy turned out imperfect as they did not include mechanisms limiting the systemic risk concerning counter-cyclicality and eliminating excessive concentration. Banks maintained inadequate capitals compared to the scale of the risk incurred. In order not to allow a lot of banks go bankrupt, the public sector had to inject capital into banks in the amount of 2.35% of GDP on average (Ireland 30% of GDP, Belgium 5.7%, the UK 4.89%)³.

All deficiencies listed above occurring until the outbreak of the economic crisis led to a necessity of designing and carrying out the macro-prudential policy consistently.

1.2. The macro-prudential policy should be targeted at financial stability

The National Bank of Poland defines financial stability as a state where a financial system performs its roles in a continuous and effective way even in case of unexpected and unfavourable significant disturbances. It is worthwhile emphasising that the macro-prudential policy must not only strengthen resistance to shock but must prevent arising imbalance and systemic risk in the economy. It is extremely important as according to supporters of Keynes it is in fact impossible to attain an equilibrium in the market due to numerous objective, subjective, historical and psychological factors etc. The previous concept of running a monetary policy by central banks aiming at the balance between demand for money and supply of money and a struggle with inflation always centred around diminishing a gap in demand and employment as well as in the balance of payments etc.⁴

The paper aims to evaluate the mechanism of forming and designing a macro-prudential policy from the author's point of view as a member of the Monetary Policy Council (2nd tenure of the MPC over the years 2004-2010) being one of the

² C.A.E. Goodhart, *The Macro-Prudential Authority: Powers, Scope and Accountability*, OECD Journal: Financial Market Trends, Volume 2011 – Issue 2, OECD, Paris 2011.

³ P.J. Szpunar, *Rola polityki makroostrożnościowej w zapobieganiu kryzysom finansowym*, NBP, Warszawa, Materiały i Studia, Zeszyt no. 278, 2012, p. 6.

⁴ Por. M. Noga, *Dylematy polityki pieniężnej związane z wystąpieniem luki popytowej*, [w:] M. Noga, M.K. Stawicka (red.), *Narodowa i ponadnarodowa polityka monetarna*, CeDeWu, Warsaw 2009.

most important elements of the financial system in Poland, *eo ipso*, reducing the systemic risk.

The literature describes a macro-prudential policy by means of the following dimensions:

- a) an aim – reduction and counteraction to the systemic risk and thus contributing to the financial stability;
- b) the scope comprising the entire financial system;
- c) instruments consisting mostly of former micro-prudential instruments used from the point of view of the system perspective⁵.

I will in short refer to the objectives of the macro-prudential policy:

- a) Total reduction of the systemic risk is impossible thus it is necessary to limit the part of the systemic risk which originates from failure of the market mechanism. The point is to limit and eliminate negative external effects e.g. pensions related to the risk taken by financial institutions on the expense of customers and to diminish system's vulnerability to the failure of particular entities⁶.
- b) Market failure authorises us to establish a macro-prudential supervision which would coordinate regulations limiting and eliminating the scale of negative external effects.
- c) The next objective should aim to decrease vulnerability of the system to mistakes in evaluating the risk. One cannot give up quantitative models in favour of heuristic ones or limiting oneself to a narrow number of model classes. The Bank for International Settlements (BIS) in Basel as an association of world central banks establishing capital recommendations for the banking sector, the level of reserves, principles of foreign currency exchange etc. set up in 1930 is in favour of harmonising methods and models of evaluating risk. However, there is no ideal solution and the International Monetary Fund or the Financial Stability Board as a European macro-prudential supervision should provide recommendations for applying methods and model evaluating risk. I would like to emphasize the fact that this problem was considered as the first one by G-20. The international financial crisis over the years 2007-2008 revealed a lot of defects of the world financial system and national financial systems. That is why, G-20 at its 2008 summit in Petersburg decided to carry out an international reform of the international financial architecture [IFA]. Namely, they decided to transform the previous G-20 body called the Financial Stability Forum into G-20 Financial Stability Board to include new tasks. The FSB G-20 was established in April 2009 and the following fundamental tasks were assigned:
 - defining and monitoring capital requirements for banks adequate for a current economic situation in the country, region and the world,

⁵ P. J. Szpunar, *Rola polityki makroostrożnościowej...*, *op. cit.* footnote 4.

⁶ P. Bańbuła, *Polityka makroostrożnościowa...*, *op. cit.* footnote 2.

- establishing institutions important from the system point of view to the financial system,
 - defining frames of activities, control and monitoring of parallel banking, namely shadow banking,
 - reform of international accounting standards,
 - defining principles of functioning rating agencies and conditions of establishing new rating agencies,
 - applying compensating practices of financial institutions,
 - determining regulations and monitoring over-the-counter [OCT] derivative instruments. Recommendations of FSB G-20 were accounted for in activities of European institutions dealing with financial stability and most importantly these recommendations were included in the proposal for a legislative act (henceforth a draft Act) that is being elaborated with regard to establishing a Systemic Risk Council in Poland. From the institutional point of view IFA reforms in Poland and the world are delayed as compared to recommendations of FSB G-20. However, regulations are executed according to FSB G-20 recommendations, for example with regard to monitoring capital requirements and the so called stress tests for banks.
- d) Then the macro-prudential policy should aim to counteract financial imbalances in the economy which, in turn, transform into disequilibrium in the real economy.
- e) The previous risk evaluation in central banks is based on DSGE models – dynamic stochastic general equilibrium models. DSGE models base on the theory of rational expectations of:
- households,
 - a company sector,
 - a public sector (representing monetary authorities in the model)⁷.

Clearly, there is no financial sector here and it is desirable that DSGE models were included in the financial sector. Moreover, according to the selected literature, people do not behave pursuant to the rational expectations theory as human behaviour is adaptive⁸. That is why DSGE models should take into account adaptive rather than rational behaviour. Inclusion of these changes into DSGE would be favourable for apt risk evaluation.

Mistakes in evaluating systemic risks may be avoided by applying not only DSGE models but also by:

- bounded rationality models,
- models based on imperfect models,
- models of connections network of financial institutions,
- models of making decisions under risky circumstances and uncertainty.

⁷ *Makroekonomia ze szczególnym uwzględnieniem polityki pieniężnej*, M. Noga (ed), CeDeWu, Warsaw 2012, p. 156.

⁸ P. Bańbuła, *Polityka makroekonomiczna...*, *op. cit.* footnote 2.

These aims in measurable terms are included in the report on financial stability of the National Bank of Poland⁹.

On 16th July 2014 the NBP published the “Report on stability of the financial system”. The report recommends that the Systemic Risk Council should be quickly established in Poland, which would implement the 2010 Directive of the European Union.

The aforementioned draft Act was ready on 23rd May 2013. The Act in question stipulates that:

- a) The objective of the Systemic Risk Council as a body for macro-prudential supervision involves:
 - identifying,
 - monitoring,
 - reducing systemic risk and thus supporting sustainable growth.
- b) Systemic risk denotes a possibility of occurring trends in the functioning of the financial system which may lead to increasing an excessive macro-prudential imbalance threatening stability of the economic growth or cause other significant negative effects for the national economy.
- c) The Council will be able to issue warnings and recommendations addressed to entities in the national financial system, the Bank Guarantee Fund and the Financial Supervision Authority.
- d) The Council will be able to express opinions about macro-prudential tools. According to the said Act, macro-prudential tools will in fact constitute:
 - a systemic capital buffer
 - countercyclical capital buffer aiming to reduce systemic risk resulting from the excessive supply of credits related to the economic cycle.

The systemic capital buffer aims to reduce systemic risk of non-cyclical nature.

The Council will be entitled to define operation time for these buffers.

- e) According to the draft Act, the Systemic Risk Council will consist of seven members. “The President of the NBP will be the chairman whereas the Finance Minister and an NBP Board member appointed by the President of the NBP will be deputies. Moreover, the Council members will comprise:
 - The Chairman of the Financial Supervision Authority,
 - The President of the Bank Guarantee Fund Board,
 - Two representatives specializing in issues belonging to Councils’ tasks (one appointed by the Minister of Finance, the other appointed by the Prime Minister).

⁹ *Raport stabilności systemu finansowego*, NBP, Warsaw, July 2014.

The President of the Main Statistical Office will be participating in Council meetings as an adviser.

The NBP will be in charge of handling the functions for the Council. "The leading role of the NBP in the Council on the national level secures coherence with the European Systemic Risk Council where the key role is played by central banks."¹⁰

In my view, the assumptions about the Systemic Risk Council presented above require comments:

Firstly, the work on this draft Act takes too long and it should have been adopted sooner.

Secondly, specific solutions proposed in the Act do not evoke any reservations so such a long process is not justified.

Thirdly, the leading role of the NBP anticipated by the Act originates not only from the leading role of central banks in the European Systemic Risk Council. Since 1997 the NBP has won a reputation of a constitutional body of great independence in Poland, which makes decisions not always popular and necessary for the development of the Polish economy¹¹. Publications of the International Monetary Fund, the Bank for International Settlements and G-30 group gave rise to formulation of a set of recommendations concerning institutional organization of the prudential policy.

Recommendation 1

The macro-prudential policy should be assigned to a central institution or a formal collective body of guaranteed independence. Formal independence is necessary in situations when an institution in charge of the macro-prudential policy is to make unpopular decisions in a short period (e.g. requiring banks to reduce risk in a growing phase of the economic cycle) in order to secure financial stability in the long-term.

Recommendation 2

The Central Bank should have a secured influence on developing a macro-prudential policy, either by taking on a formal responsibility for the policy or by a significant number of votes in the collective body.

¹⁰ The proposal for a legislative act dated 29th May 2013 concerning macro-prudential supervision over the financial system, Ministry of Finance, Warsaw 2013.

¹¹ P. J. Szpunar, *Rola polityki...*, *op. cit.*, pp. 31-35.

Recommendation 3

An institution responsible for the macro-prudential policy should have a clear mandate and appropriate competences. It is indispensable if its decisions are to be legally binding.

Recommendation 4

The mandate for the macro-prudential policy should be combined with an adequate set of instruments/tools used for its execution. These instruments with their simple design may be used for other purposes (e.g. micro-prudential policy) and implemented on the operational level by other institutions (e.g. the financial supervision office).

Recommendation 5

Providing an institution responsible for a macro-prudential policy with independence requires establishing rules of liability and an appropriate level of transparency in its activities.

Recommendation 6

An institution in charge of the macro-prudential policy should have access to information and data necessary to identify risk for financial stability as well data concerning individual financial subjects.

Recommendation 7

Such an institution should possess appropriate analytical facilities. The basis should be given by information and analytical tools used so far for the purposes of drawing up stability reports by central banks. Relevant analysing techniques should be further developed (Polityka makroostrożnościowa, mimeo, NBP 2011).

According to these recommendations, the NBP should play a leading role in the Systemic Risk Council in Poland which should favour stability of the financial system.

Conclusion

The considerations presented above with regard to shaping and executing the macro-prudential policy incline me to draw the following conclusions:

The mission of the National Bank of Poland should be modified and have the following wording:

The mission of the NBP is to manage inflationary expectations of all market participants [actors] as well as to act in order to reduce systemic risk by shaping and designing an effective macro-prudential policy strictly coordinated with micro-prudential and macro-economic policies. Such activities of the NBP should secure stability of the Polish financial system and the growth of social wealth.

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