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POLAND ON THE PATH TO EUROPEAN MONETARY UNION

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Grzegorz W. Kolodko

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Warsaw 1997

1. European Union membership is an indisputable objective of Polish foreign policy. This is an aim both favoured by society and supported by the country's political elite.

Primary efforts are directed toward obtaining support for our application from leaders of member nations. At the same time, the arduous task is underway of adapting the legal and institutional system to that accepted by the Union (aquis communautaire). This requires Poland to accept membership obligations, particularly those related to the free flow of: goods, services, capital and labour. Organizational and material preparations are also underway for the commencement of negotiations.

However, the activities so far undertaken urgently need to be supplemented by structural undertakings that will be directed not so much at mere membership, but rather at also ensuring the international competitiveness of the Polish economy and thus its strong position in a unified market.

For this reason, our acceptance into the European Union should not be viewed, both in the public opinion and the activities of the State, so much as a desirable and fortuitous event that will be brought about merely by active diplomacy, but rather as an important step in the long, complex and exacting process of integration, whose success largely depends on our concerted efforts.

2. Membership status is neither the start nor end of the integration process. This is, among other reasons, because the European Union is not a static formation. From the moment the European Economic Community was founded it has been a process of dynamic expansion and development, leading to a gradual deepening of the integration process. Just as once the custom union was transformed into a common market and the European Exchange Rate Mechanism was established, so the unified market is presently becoming part of the Monetary Union, whose clear symbol is to be the joint currency – the Euro.

A timetable has been precisely established: in 1998 a common central bank will be appointed, in January 1999 the European Monetary Union will start functioning and in 2002, Euro coins and bills will replace the currency of those countries which have met the criteria agreed upon at the Maastricht Treaty and become members of the Monetary Union. In line with the criteria, the Union is to be made up exclusively of countries with stable, strong economies and it is they that will set the pace and direction of further European Union development. It is therefore understandable why particular countries have undertaken definite action to meet the Maastricht criteria to the greatest extent possible.

3. These criteria can be divided into two groups:

- two fiscal criteria, relating to the levels of (A) the budget deficit and (B) public debt and
- three monetary criteria, relating to the levels of (C) the inflation rate, (D) the interest rate and (E) stability of the exchange rate.

Criterion A means that the budget deficit should not be more than 3 per cent of the GDP. The Maastricht Treaty permits this threshold to be exceeded for short periods and, as long as the deficit level is clearly and consistently falling, even for longer periods. The Stabilization and Growth Pact recently signed in Dublin lays down the consequences to be taken by any country that is unable – on joining the Monetary Union – to maintain the deficit below this threshold. The pact also defines the additional conditions under which it is permissible to exceed this threshold (automatically, in the case of a more than 2 per cent fall in GDP; or as a result of negotiation, if the fall ranges from 0.75 – 2.0 per cent).

Criterion B means, that public debt should not exceed 60 per cent of GDP. The Maastricht Treaty permits a larger debt level, as long as this is falling at a satisfactory rate.

Criterion C means, that the inflation rate over the course of a year may not be more than 1,5 points over the average rate of price increases in the three European Union countries with the most stable prices.

Criterion D means that the long–tern interest rate over the course of a year may not be more that two points over the average interest rate in the three European Union countries with the most stable prices.

Criterion E means that the country in question must participate in the European Currency System (ECS) for at least two years and in this connection, maintain its exchange rate within the limits of permissible deviations from the central rate established jointly by the member nations. The current permissible deviation range stands at ±15 per cent, with the exception of Germany and Holland which only permit deviations to a maximum level of ±2.25 per cent. (Data showing the meeting by EU countries of Maastricht criteria – table 1).

4. Analysis of data indicates that in principle the Polish economy meets the fiscal criteria for convergence, while it still has some way to go to meet the monetary criteria (charts 1, 2, and 3).

Thanks to the strict and effective fiscal policy conducted since 1993, the budget deficit does nor exceed the 3 per cent of GDP threshold. In line with the proposed budget bill that the government has presented to parliament, this will also be true for 1997. Although in principle this has no significance for the indicator registered in Poland, it should be noted that the European Union applies a different method for determining the deficit, where it is calculated as nominal net growth in the entire budget sector' debt. In our case, such a formulation would require taking into particular consideration the increase in public debt resulting from conversion of foreign debt from foreign currencies to Zloties. Furthermore, pursuant to budget accounting rules as followed in the EU, income from privatization is not counted in deficit calculations.

Since 1995 public debt has not exceeded 60 per cent of GDP. In line with the proposed budget bill, this will amount to 49.7 per cent in 1997. Likewise in the case of this indicator, a somewhat different calculation method must be followed in the EU, but its application would raise the level registered in Poland by less than 2 percentage points. Nevertheless, it is essential that in both cases the calculation methodology used in EU countries be adopted (Appendix 1).

Despite considerable achievements in combating inflation, its level continues to be high and clearly deviates from that accepted in the Union, and especially from the levels in the best performing nations (in September 1996 these were: Finland 0.8 per cent, Holland 1.2 per cent, Germany 1.3 per cent; giving an average of 1.1 per cent). The proposed budget bill foresees an average 15 per cent inflation in Poland for 1997, while to meet the convergence criteria it should be less than 2.6 per cent. This best shows the scale of the problem. According to the program STRATEGY FOR POLAND: PACKAGE 2000 adopted by the government in the middle of 1996, it should be possible to lower inflation to about 5 per cent by implementing consistent and well–coordinated fiscal threshold. In line with the proposed budget bill that the government has presented to parliament, this will also be true for 1997. Although in principle this has no significance for the indicator registered in Poland, it should be noted that the European Union applies a different method for determining the deficit, where it is calculated as nominal net growth in the entire budget sector' debt. In our case, such a formulation would require taking into particular consideration the increase in public debt resulting from conversion of foreign debt from foreign currencies to Zloties. Furthermore, pursuant to budget accounting rules as followed in the EU, income from privatization is not counted in deficit calculations.

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5 and CHF – 5 per cent) is flexible within a creeping band, which means ±7 per cent around the central exchange rate that is systematically nominally devaluated at a monthly rate of 1 per cent. As a consequence of additional nominal revaluations, in 1995 the Zloty was devaluated, but only by 3 per cent on the dollar. The average nominal devaluation was accelerated in 1996 but still remains considerably lower than would result from differentiation of domestic and foreign inflation rates. Maintaining the competitiveness of the Polish economy may require further devaluation, in order to absorb the effects of higher inflation in Poland than among competitors.

It ensues that likewise in this case, meeting the convergence criteria will only be possible after several years of concentrated efforts, on the one hand to strengthen the economy's presence and competitiveness on international markets, and on the other hand to consolidate and develop financial markets, including the foreign exchange market. It will also be necessary to decide on paths, for this period, for Zloty attachment to the European Currency System.

It seems that the simplest way to carry this out would be by:

– a first phase: gradual linking of the Zloty exchange rate to the ECU, instead of the present linkage to the basket of five currencies. To begin with, the four other currencies from the basket other than the dollar could be replaced by the ECU at a level equivalent to 55 per cent;

– a second phase: gradual stabilization of the central exchange rate by reducing the monthly devaluation rate to zero. At the same time, use should be made of the full scope of the Zloty's liquidity within the accepted band, even by the application of an additional, single devaluation of the central rate, but only if the need to maintain the competitiveness of the Polish economy so demanded; (and possibly)

– a third phase: gradual reduction of the permissible fluctuation range from 7 to 2.25 per cent (current currency fluctuations in the European Currency System – chart 4).

By thus shaping its policy, NBP would enhance the credibility and strength of the Polish currency and in time, ensure the Zloty's entry into ECS, requiring no additional efforts at that time, other than agreement with member countries concerning the Zloty's initial exchange rate.

5. To maturely examine the issue of whether and when Poland should aspire to membership of the European Currency Union, it must be appreciated how great a distance the Polish economy must still go to meet the Maastricht criteria on a permanent basis. For this reason, the benefits and costs associated with this venture have to be honestly evaluated.

Remaining outside the Monetary Union will undoubtedly mean that some of the benefits ensuing from economic integration will be unobtainable. **If a domestic currency were to function in Poland, with the Euro being used in most EU countries, our ability to increase international economic competitiveness – and, as a result, to develop it – would be limited.** However, even without being a member of the Monetary Union, Poland could still use the Euro in international transactions. There is no reason why bank accounts in Ecus could not be opened today. The opening of such accounts would have not only financial but educational and symbolic meaning.

Participation in the Monetary Union will ensure us a place in the structure of the European central bank and permit the use of the Euro in all transactions. One may expect the following benefits to ensue:

– lowered transaction costs,

- lowered exchange risks, and as a result reduction in costs and associated reserves,
- lowered interest rates,
- strengthened macro–economic stability resulting from the stronger discipline maintained by the new monetary institutions,
- greater stability in real terms – production and employment.

Thus, in practice, producers, exporters and importers will not be entangled in settlements involving exchange rate variations nor involved in exchange risks. Small and medium–sized businesses in particular will be able to secure cheaper and more reliable information on market conditions and their potential development. All citizens, receiving income in Euros, will be able to use that currency domestically and internationally without the need for exchange and consequently, increased costs. A greater flow of foreign capital will result, especially in the most beneficial form of direct investment. Inflation, as it is understood today, will cease to be a problem. In principle, it will be just the same and equally low throughout the Monetary Union. The advantage arising from Euro introduction that will be most noticeably felt by citizens will be price stability for most goods, creating an additional incentive to savings and investment.

Joining the Monetary Union will be accompanied by certain limitations and challenges. This will mean relinquishing an important economic policy instrument, namely the exchange rate, which constitutes a kind of buffer in situations of internal or external economic pressure. On the other hand, flexibility would remain in the form of the liquidity of the Euro's exchange rate against the currencies of non–Union countries.

The State will then forego the possibility of conducting a monetary policy, but rather will have to strengthen and explore other attributes of autonomy. However this should not make bother us, since countries such as France or Germany, with their much stronger currencies, are making this decision. Furthermore, in the case of a country like Poland, where the central bank enjoys considerable independence, this change, from the government's point of view, has no fundamental meaning: the rights of the independent central national bank will be taken over by an independent central European bank, whose shareholders will be all the member nations. On the national scale however, while losing influence on our own monetary policy, we shall in this way gain a share in the control of money throughout the Union.

The largest challenge – besides the need to stamp out inflation – to be met before joining the European Currency Union will be structural reforms. Restructuring industry and agriculture will have to be accelerated, as well as completion of the privatization process and reform of the retirement and disability pensions system and social services. However, these reforms will be conducted regardless of whether we aspire to the Union. The national budget will not be able to support for long the weight of subsidies to ineffective enterprises of agricultural production, nor subsidy payments to the ZUS and KRUS social insurance programs, nor maintain the income indexing system presently in force in many spheres.

6. It therefore ensues that if Poland wants to fully benefit from membership in the European Union, it must at the same time attempt to participate in its tightest form of international integration, namely the Monetary Union. For this reason, the answer to the question „whether?" seems to be a clear affirmative.

However, the answer to the question „when?" is much more difficult. It cannot be reduced to a formal statement of when we may by accepted, that is, when we will meet the fiscal and monetary convergence criteria. This is because, essentially, these are the criteria of a stable and strong economy – one that is competitive in the international arena. So in our case, the question „when?" actually means „how?", or „on the basis of what strategy?"

In answering these questions it is important to define the scope and schedule of structural reforms that are essential if the Polish economy is to be stable and strong and have a real chance of integration. To answer the question „how?" in practice means selecting the critical path of necessary structural reforms, taking into consideration:

- their logical, professionally coherent sequence;
- the benefits from participation in the European Currency Union and the limitations resulting therefrom;
- the economic and social outlays needed to achieve the reform program that will be essential for meeting convergence criteria on a permanent basis.

7. Acknowledging the above arguments leads to the conclusion that in the process of Poland's European integration, two primary orientation points that are used presently should remain:

- the first, associated with obtaining membership of the European Union,
- the second, associated with obtaining membership of the European Currency Union.

The National Strategy for European Integration should therefore define the two primary steps, both of which will lead to the appropriate program of structural reforms. The first involves undertaking and conducting activities that will increase our opportunities and limit the threats ensuing from participation in a unified market. On the other hand, completion of the second program of activities should ensure that the Polish economy achieves relatively quickly – already in unified market conditions – the capacity to meet Maastricht criteria on a permanent basis.

8. Only such definition and construction of the National Strategy for European Integration will create opportunities adequate to the scale of the problem and the chance for a participant to play an active role in the integration process, without losing sight of domestic interests.

9. Considering the present state of the Polish economy, the forecasts for its development and the progress made so far in achieving the government's primary economic programs, particularly the STRATEGY FOR POLAND, it can be rationally assumed that the country will be able to meet the requirements associated with membership in the European Union by the year 2002 and likewise with membership in the European Currency Union about 2006, that is, in about ten years time.

10. Achievement of a thus oriented National Strategy for European Integration, leading to Polish membership in the European Currency Union by 2006, will mean completion and culmination of the economic transformation process within the next 10 years, and would confirm the formation in our country of a mature and modern market economy.

There is no reason to treat as rigid either the date relating to Poland's admission to the European Union, or the desired date for membership of the European Currency Union. These dates merely mark the primary orientation points in Poland's European integration process and it would seem, from the current standpoint, that it will be possible to meet them. Whether this happens depends largely, but not only, on us. These dates are thus a conscious marking of the time limits for achieving the two steps of the National Strategy for European Integration. Obviously, it could turn out that the superior objectives contained in this strategy may only be achieved slightly later. However, it is certain that we will not reach them at all if they are not clearly defined now.

The present clear establishment of these objectives and their consistent achievement will later provide us – after extensive evaluation of the Monetary Union's functioning – with the actual ability to make a decision on whether to join. The future selection of one of these two options will be possible only if we consciously and resolutely begin now to create the conditions that will permit such a choice. If we want to make an autonomous decision in a few years' time, we have to start creating the foundation for it today.

[redacted] [redacted]

Table 1

Achievement of Maastricht criteria by European Union member countries (percentage)

	Consumer price index			Deficit of the public finance sector (general government) in relation to GDP			Public debt in relation to GDP			Long term interest rate
	1995	1996	1997	1965	1966	1967	1995	1996	1997	(August 1996)
Austria	2.2	2.1	1.9	6.2	4.5	3.0	69.4	72.3	73.8	6.4
Belgium	1.5	2.0	2.0	4.1	3.2	3.0	133.5	132.3	129.6	6.6
Denmark	2.1	1.6	1.9	1.6	1.3	1.0	72.0	70.9	69.5	7.3
Finland	1.0	1.0	2.0	5.2	2.9	1.8	59.4	61.6	61.8	7.1
France	1.8	2.1	1.6	5.0	4.0	3.0	52.9	56.2	57.3	6.4
Greece	9.3	8.4	6.6	9.2	7.6	6.0	111.7	108.2	106.2	14.2
Spain	4.7	3.4	3.1	6.9	4.6	3.4	65.7	67.1	67.1	8.9
Holland	2.0	2.5	2.9	3.8	3.1	2.5	79.0	78.4	77.3	6.3
Ireland	2.5	2.3	2.5	2.1	2.4	2.3	84.8	78.9	76.3	7.3
Luxembourg	1.9	1.8	2.0	0.4	0.4	0.4	6.3	6.7	6.8	6.6
Germany	1.8	1.6	1.7	3.5	4.0	3.0	58.1	60.8	61.9	6.3
Portugal	4.1	3.3	3.0	5.2	4.0	3.8	71.7	71.3	70.7	8.7
Sweden	2.5	1.6	2.3	8.1	5.0	3.0	78.7	80.1	78.5	8.1
Great Britain	2.8	2.7	2.4	5.5	4.4	3.3	47.2	49.5	50.8	7.8
Italy	5.2	3.9	3.0	7.1	6.7	5.5	124.9	124.3	122.8	9.5
Criteria	2.9	2.9	3.2	3.0	3.0	3.0	60.0	60.0	60.0	9.2

Source: World Economic Outlook – October 1996, IMF.

Chart 1

National budget deficit in relation to GDP in the period 1992-2006

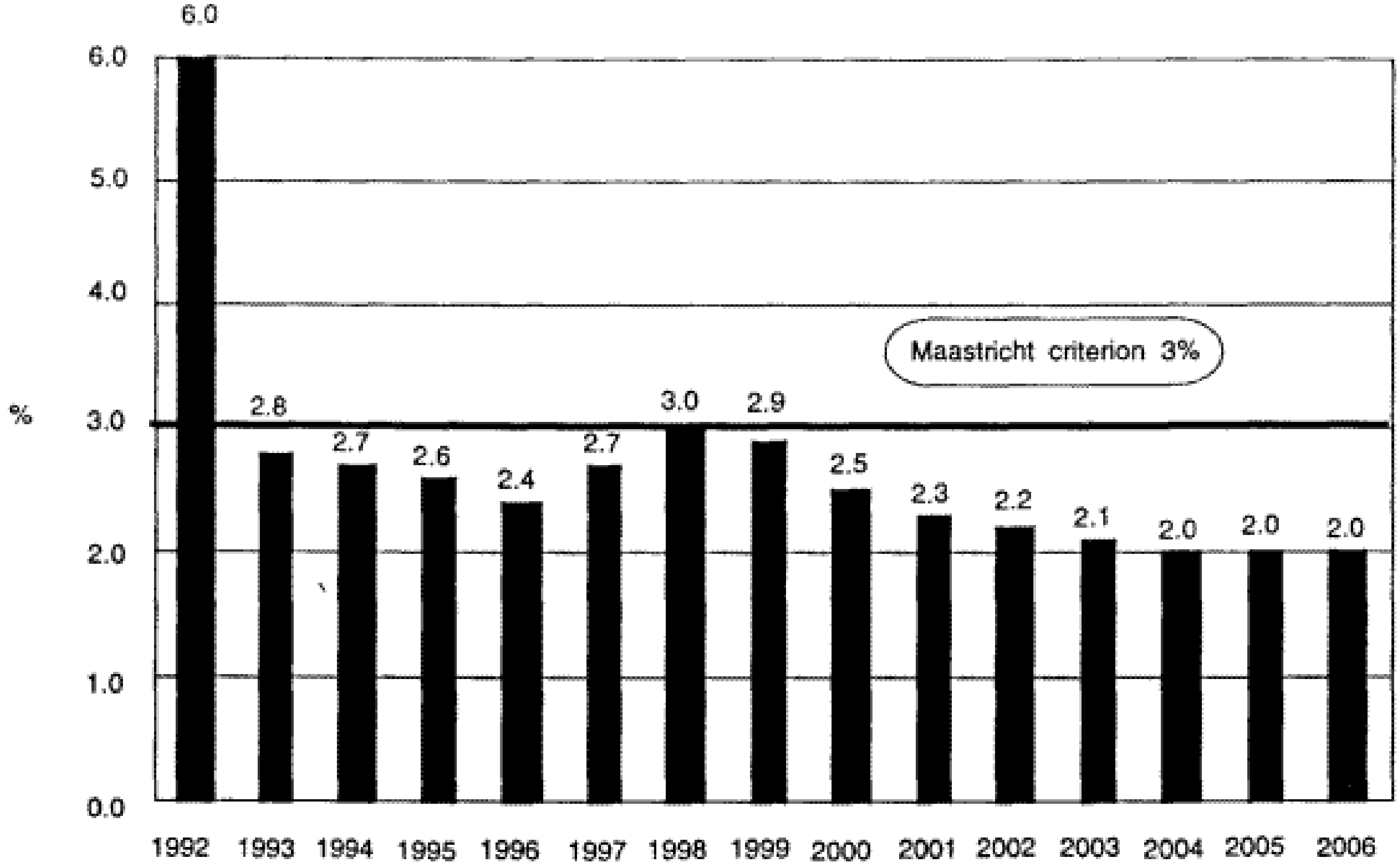


Chart 2

Public debt in relation to GDP in the period 1992-2006

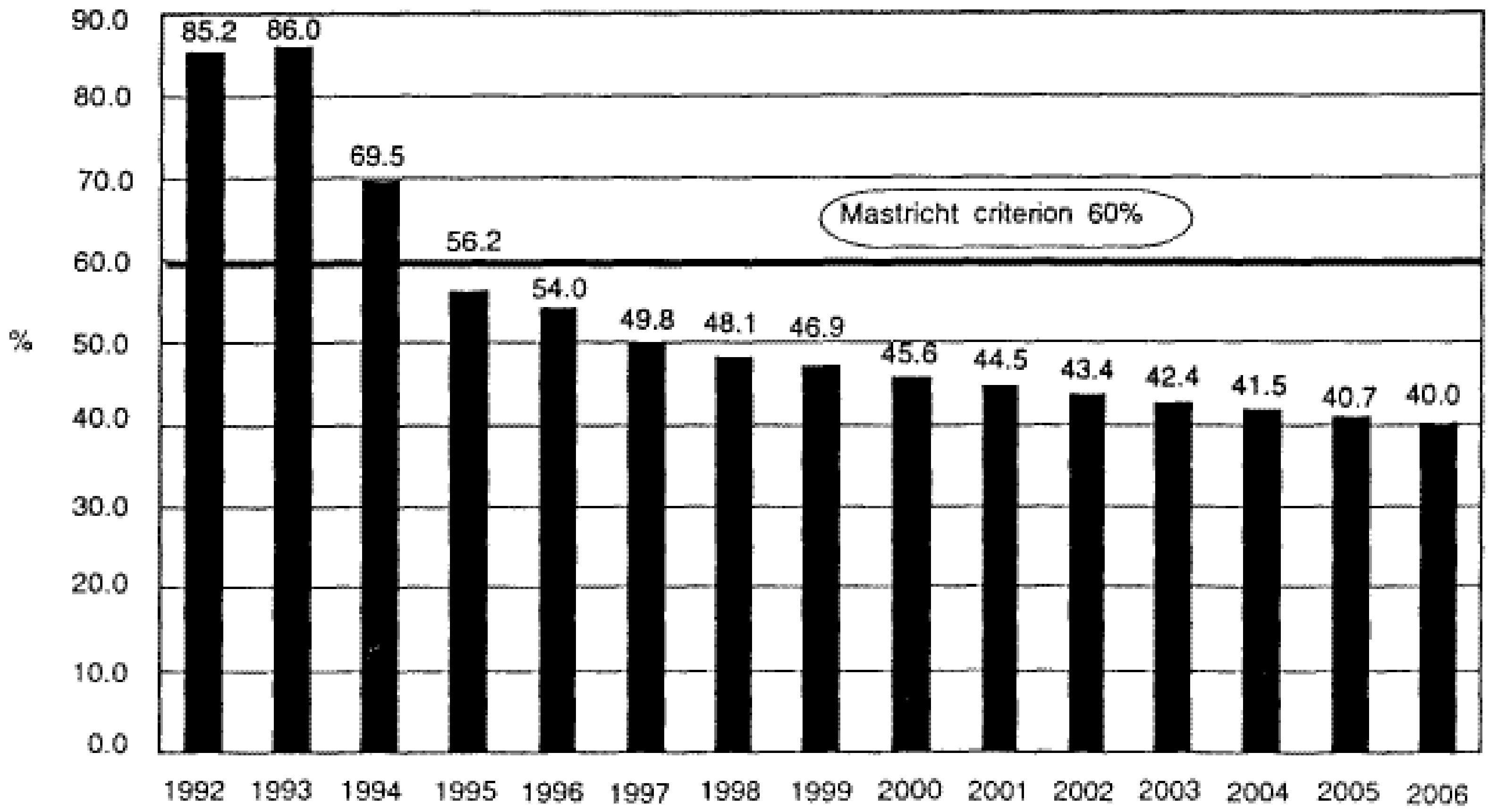


Chart 3

Inflation in the period 1991-2006 (XII/XII)

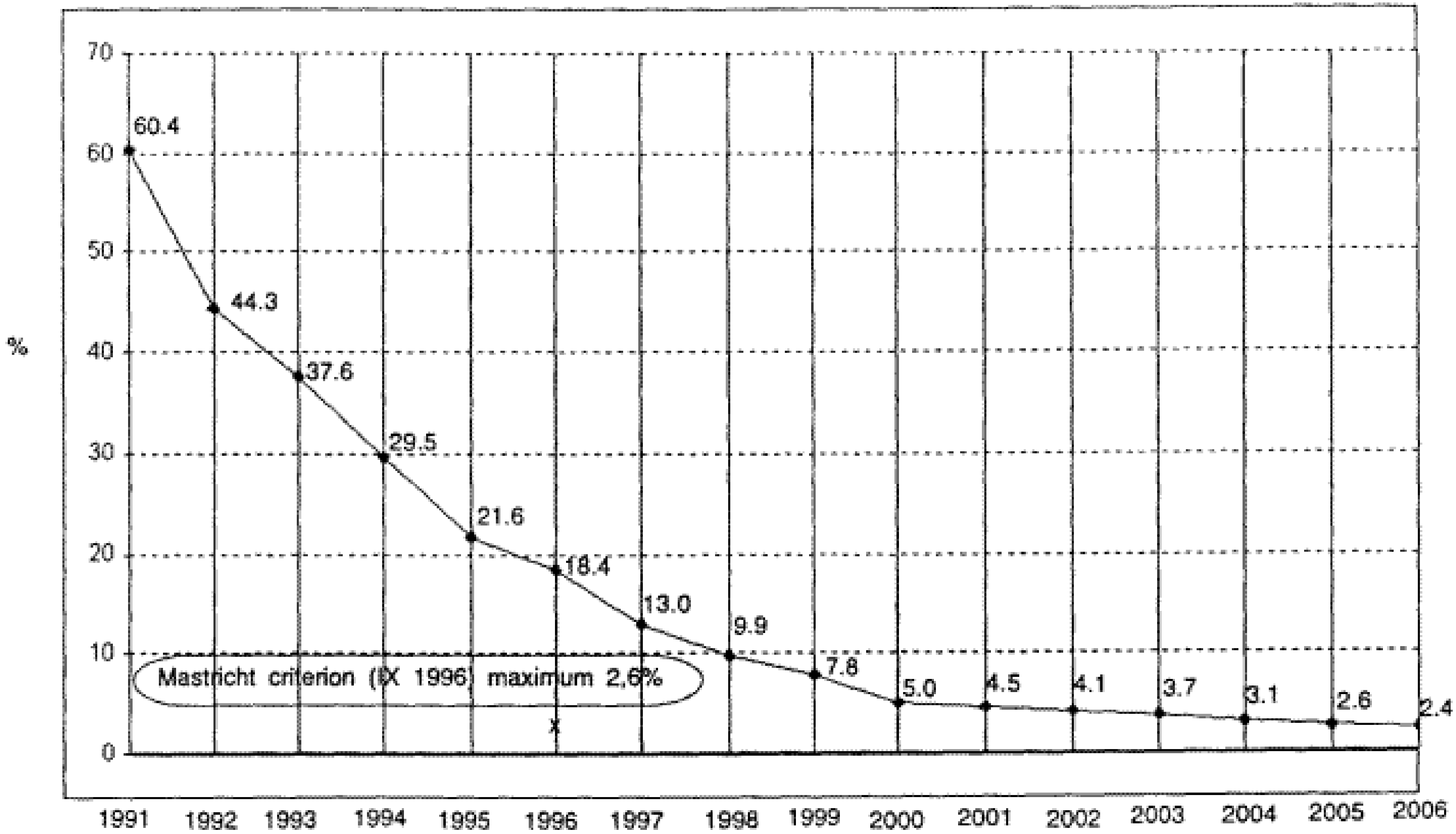
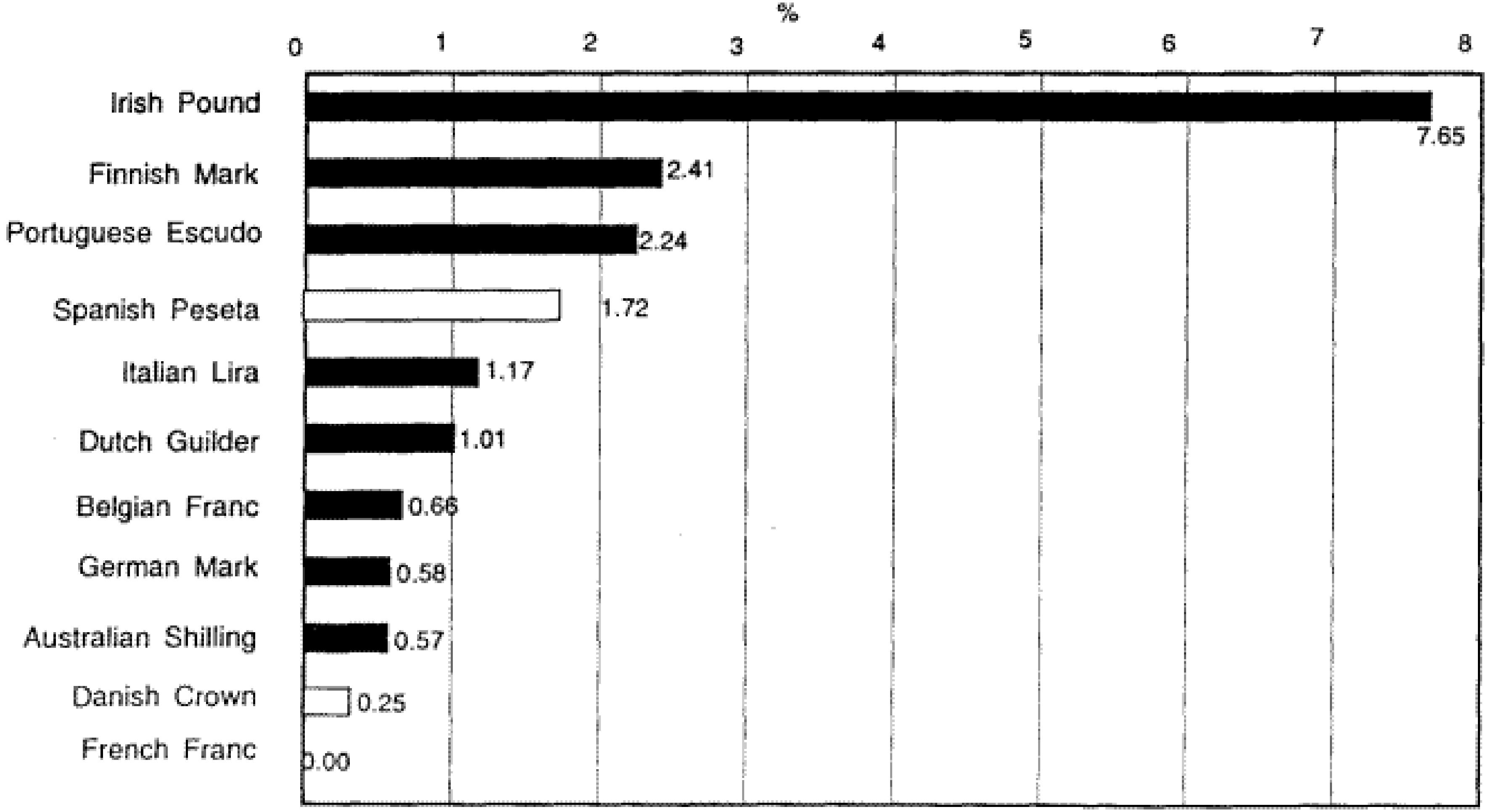


Chart 4

Currency fluctuation levels in the European Currency System 16.12.1996



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