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Poland's joining the euro zone: the challenges ahead

The overall assessment of costs and benefits speaks for Poland's joining the euro zone. The most important benefits will be derived from a permanent reduction of the country risk premium and from the enlarged scale of the foreign trade[2]. Nonetheless, there are the two challenges left. The first is the necessity to pass the stability test of the ERM2. The second is to minimize potential costs of resignation from an independent monetary policy after joining the euro zone.

The paper analyses risk factors related to Poland's joining the euro zone. Section 2 highlights the factors behind the Polish zloty moderation during the last two years and underlines the importance of central bank credibility for passing the stability test of the ERM2. Section 3 focuses on the potential costs related to the possible procyclical influence of the ECB monetary policy on the Polish economy. Section 4 highlights the costs of postponing the date of the entry into the Euro zone. Section 5 offers concluding remarks and highlights the importance of structural reforms.

2.Exchange rate policy before joining the euro zone

During the last couple of years there were two things that are important for the prospects and timing of Poland's joining the euro zone. The first was zloty moderation. The second are the experiences of neighbouring countries stabilizing their currencies.

2.1.The factors behind the zloty moderation

In 1999-2004, the zloty was fluctuating widely. The NBP worried that meeting the Maastricht exchange rate stability criterion would be a serious challenge for Poland. However, in 2005-2007 the volatility of the zloty became much lower. The scale of zloty moderation was

[1] English version of the paper prepared for Congress of Polish Economists. Author expresses his gratitude to Mariusz Jarmużek, Krzysztof Rybiński, and Edward Stuart for their valuable comments. The paper expresses author's own views.

[2] *A Report on Costs and Benefits of Poland's Adoption of the Euro,* (ed. J. Borowski), (2004) National Bank of Poland, Warsaw. M. J. Bun, F. J. G. M. Klaasen, (2002) "Has the Euro Increased Trade?", *Tinbergen Institute Discussion Paper*, University of Amsterdam.

unexpected. Previously the NBP had worried that the volatility of the zloty might be the result of several factors. One of them was the level of the development of the Polish FX market. It had become liquid enough to attract large foreign investors, but not deep enough to dampen the impact of their transactions on the zloty. The second factor was the institutional changes in the global financial markets. The dealing rooms of large banks and the mushrooming hedge funds became more active on the global FX market.

The moderation of the zloty was expected, but not to such an extent. The experiences of the Czech Republic were a source of hope that disinflation in Poland and the lowering of interest rates might help to stabilize the zloty. The example of the Czech koruna illustrated that the lowering of interest rate differentials might reduce that scale of the *carry trade*. Moreover, it could create a positive feedback between the fall in the volatility of the exchange rate and the scale of the carry trade[3].

The factors that contributed to the moderation of the zloty included Poland's joining the EU which brought about important changes in the Polish FX market. Before joining the EU, the transaction currency on the Polish FX market was the US dollar. After Poland's accession to the EU, the transaction currency became the euro. The zloty started to be priced by the FX dealers not in dollars but in euros. The cross dollar-euro rate ceased to be a source of the volatility of the zloty-euro rate.

The other factor that contributed to the lower volatility of the zloty was the growing integration of the Polish economy with the EU. The EU share in Poland's foreign trade exceeds 80%. Thus, the FX dealers perceive the zloty as a currency tied with the euro. This appears to have a dampening effect on the volatility of the zloty.

The moderation of the zloty does not exclude the risk of an increase in its volatility during periods of turmoil in the global financial market. As in the case of other emerging currencies, the volatility of the zloty is correlated with the volatility of the S&P500[4]. The correlation is the product of globalisation. Once global investors take profits in the US capital market, they buy all the assets that are in their global benchmark portfolios. This produces a rise in many different asset prices including emerging markets currencies. The reverse situation produces a fall in investors' risk appetite and the resulting fall in exchange rates of emerging currencies.

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[3] G. Galati, M. Melvin (2004). „Why has FX trading surged? Explaining the 2004 Triennial Survey". *BIS Quarterly Review* (December). http://www.bis.org/publ/qtrpdf/r_qt0412f.pdf

[4] P. Bańbuła (2007) "Wpływ globalizacji na kurs złotego" (The influence of globalisation on the exchange rate of the zloty), NBP, Warsaw 2007, mimeo

Lately the zloty started to appreciate due to the free fall of the dollar, which triggered also appreciation of the zloty against the euro. Now, it is impossible to say, if this increase the volatility of the zloty. Nonetheless, taking into account the severity of the turmoil on financial markets, the zloty is getting through amazingly well. The other potential risk is that crisis in the Collaterised Obligation Market affected European banking sector, which forced the EBC to break the tightening cycle, which was expected to continue. In the face of agflation this may produce widening of the interest rate disparity between Poland and the euro zone, which might influence the zloty. Nonetheless, the experiences of the last two years give a hope that the increasing economic integration will make the zloty similarly stable agaisnt the euro as it is the case with the British pound and the Swedish crone.

2.2.The importance of central bank credibility for passing the ERM2 stability test

It is a quite common conviction that the prospects of joining the euro zone requires the conduct of a tight monetary policy in Poland. Such a belief is largely unfounded. In 2005-2007 the Maastricht inflation criterion has been always higher than the NBP inflation target (2.5%).

On the other hand, however, the prospects of entering the ERM2 do influence monetary policy in Poland. The experiences of Slovakia, Hungary and Czech Republic illustrate that the central bank should conduct monetary policy in such a way that gives it a necessary scope of manoeuvre. The experiences of the East European countries show that speculative short-term capital flows may be provoked when financial market find that the central bank has a limited scope of manoeuvre for its interest rate policy.

The ERM2 system seems not to be adjusted properly to the economic situation of the recent accession countries and to the increased mobility of international capital flows[5]. The method of conducting monetary policy may augment the risks related to the ERM2.

One illustration is the experience of Slovakia which entered the ERM2 with a relatively high rate of inflation. Financial markets assumed that Slovakia might be forced to accept a Slovak koruna (SKK) revaluation in order to secure fulfilment of the Maastricht inflation criterion. Probably such an assumption was behind the speculation in the Slovak FX market which resulted in the National Bank of Slovakia decision to revalue the SKK by 8%.

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[5] W. H. Buiter (2004)*"*An Attendant Godot? Financial instability risk for countries targeting Eurozone membership*"*, CEPR/ESI 8th Annual Conference: *EMU Enlargement to the East*, Hungarian National Bank,

It is worth remembering that the target of speculation in the FX market may be not only the exchange rate level but also the level of interest rates[6]. In 2003, Hungary, having an ERM-like exchange rate regime, was forced to raise interest rates under the pressure of speculation against the Hungarian forint (HUF)[7].

The experiences of the Czech Republic are interpreted often in a simplistic way. It is argued that the Czech koruna (CZK) has been relatively stable during the last several years, because of the relatively low level of interest rates, which enabled a reduction in the scale of short-term capital flows. The low interest rate level itself could not be sufficient to secure the relative stability of the Czech koruna, i.e. the situation in which the CZK was appreciating more or less in accordance with the appreciation of the equilibrium rate. The main factor behind the koruna's relative stability was the credibility of the Czech National Bank (CNB) in its commitment to stabilise inflation.

The general conclusion which stems from the experiences of the East European countries, is that the NBP should stabilise the CPI on the target that enables the zloty to pass successfully through the Maastricht ERM2 stability test. The NBP anti-inflationary credibility is necessary to maintain the scope of manoeuvre for reacting to unfolding events.

An even more important factor, which speaks for stabilising the CPI close to the inflation target, is the necessity to stabilise the REER (*real effective exchange rate*) whose movements might adversely effect the competitiveness of Poland's economy.

3.Potential costs of joining the euro zone

The possible costs of joining the euro zone are related mainly to the risk that the ECB monetary policy may exert a pro-cyclical influence on the economies of the EMU member countries. The argument is called „Walters critique" after the name of Margaret Thatcher's economic adviser[8].

If business cycles within a monetary union are not sufficiently synchronized, the differences in expected rates of inflation may produce differences in the real level of interest

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Budapest. W. H. Buiter, (2004) "To Purgatory and Beyond: When and How Should the Accession Countries from Central and Eastern Europe become Full Memebers of EMU?", *CEPR Discussion Paper*. No. 4342

[6] P. Krugman (1999) *The Return of Depression Economics*, The Penguin Press, s. 118-136

[7] M. Rozkrut, K. Rybiński, L. Sztaba, R. Szwaja, „Quest for central bank communication: Does it pay to be talkative?", *European Journal of Political Economy*, vol 23, 2007, p. 190

[8] A. Walters (1994), „Walters Critique". W: K. Matthews (ed.) *The Economics and Politics of Money: The Selected Essays of Alan Walters*, U.K. Elgar.

rates. This may, in turn, produce a pro-cyclical influence of the common monetary policy on the economies of the monetary union.

3.1.The risk of a procyclical influence of the EBC monetary policy

The ECB monetary policy turned out to be pro-cyclical in some member countries[9]. The excessive expansion produced a large increase in ULC (unit labour cots), the REER appreciation, and the following economic slowdown. The real problem is the risk that the period of regaining competitiveness by a given country may be long, because a devaluation in not a viable option. The process of regaining competitiveness is long when the rate of growth in productivity is low. The other factor, which makes the adjustment process long, is the low downward elasticity of wages. Under these circumstances, the process of regaining competitiveness needs a long period of relatively low economic growth, which might bring about a sufficient decrease in unit labour costs. Such a situation was characteristic for the German economy and now it can be observed in Italy.

The differences in REER dynamics among the euro zone countries are often treated as an important factor explaining the differences in their economic situation[10]. This poses a question. Will the ECB monetary policy be pro-cyclical in the case of Poland?

There are factors that reduce the risk. Above all, Poland, similar to other accession countries enjoys a high rate of productivity growth which would shorten the period of recovering productivity after a period of REER appreciation. The other important factor is that the disinflation of the Polish economy is completed. The CPI and the interest rate level are very similar as in the euro zone. Poland's entry into the euro zone would not bring about such a large fall in interest rate level, as was the case in Portugal, Greece, Spain and Italy[11].

The risk of a procyclical influence of ECB monetary policy may be, of course, reduced by accelerating the process of structural reforms fostering product market deregulation and flexibility in the labour market.

3.2.The risk of asymmetric shocks

[9] Blanchard, O. (2006) „Portugal, Italy, Spain, and Germany. The implications of a suboptimal currency area", WEL-MIT meeting, NYC http://econ-www.mit.edu/faculty/dowload_pdf?id=1344

[10] P. De Grauwe (2006). "What have we Learnt about Monetary Integration since the Maastricht Treaty?", *Journal of Common Market Studies*, vol. 44, no. 4.

The potential costs of entering a euro zone monetary union stem also from the fact that Poland might not be able to use monetary policy in order to neutralize the impact of asymmetric shocks[12].

The risk is not hypothetical. The Italian economy experienced an adverse asymmetric shock resulting from the growth in Asian exports to Europe. The strength of this shock was enlarged by the appreciation of the euro against the dollar. The consequences for the Italian economy were so painful that Italian politicians started to talk about a withdrawal from the euro zone. The costs of such withdrawal would be so high that such an option is not viable [13]. Nonetheless, Italy is probably facing a long period of lower economic growth and structural reforms, as previously was the case in Germany. The importance of structural reforms is illustrated by the fact that the fall in Italy's share of world exports started in the mid 1990s, before this country joined the euro zone[14].

Is Italy's experience relevant for Poland? It is, but to a limited extent. Poland economy went through the shock produced by imports from China and other Asian countries and this was during a period of quite substantial zloty real appreciation.

One has to take into consideration also the fact that the most probable factor producing adverse asymmetric shocks are large movements of the exchange rate[15]. Robert Mundell came to such conclusion after the collapse of the Bretton Woods system, when exchange rate fluctuations turned out to be largely disconnected from fundamentals. Mundell's general conclusion was that joining a monetary union should not be perceived only in terms of the costs of resigning from an autonomous monetary policy, but also the gains from eliminating the risk of adverse exchange rate movements[16].

Despite the Polish zloty moderation (section 2.3), there is always a risk of an increase in exchange rate volatility, which might trigger a trend pushing the zloty far away from its

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[11] Blanchard, O. (2006) "Adjustment within the euro. The difficult case of Portugal http://econ-www.mit.edu/faculty/dowload_pdf?id=1295

[12] K. Rybiński (2007) "The Euro adoption: assessing benefits and costs", NBP, Warszawa, www.nbp.pl/publikacje/wyklady/SEPA140307.pdf

[13] N. Roubini, "What Happens if Italy Dumps EMU and the Euro? Devaluation", Default and Lira-lization of Euro Debts!, www.regmonitor.com/blog/archive/2005-07/

[14] "Macroeconomic Adjustment in the Euro Area: The Cases of Ireland and Italy", *The EEAG Report on the European Economy 2007*, op. cit. s. 67

[15] P. De Grauwe (2006). "What have we Learnt about Monetary Integration since the Maastricht Treaty?", *Journal of Common Market Studies*, vol. 44, no. 4, s. 714

[16] Mundell, R. (1973) "Uncommon Arguments for Common Currencies". W: Johnson, H., and Swoboda, A. (eds) *The Economics of Common Currencies*, Allen & Unwin, London

equilibrium level. The risk that other factors might produce asymmetric shocks will be shrinking with Poland's growing economic integration with the euro zone[17].

4.The costs of being outside the euro zone

As underlined in the previous sections, in the case of Poland, the risks related to joining the euro zone are relatively small, because the relatively high rate of productivity growth would limit potential appreciation of REER. This would shorten the period of recovering competitiveness if it deteriorated due to a rise in unit labour costs.

What would be the cost of extending the period outside the euro zone? In order to answer this question, one has to take into consideration the costs of having a floating exchange rate and the diminishing scope of monetary policy autonomy under the growing mobility of international capital flows.

4.1.The risk of exchange rate movements disconnected from fundamentals

High productivity growth in the accession countries enables them to improve the competitiveness of their economies. However, for those having fixed exchange rates, such as the Baltic states, this is a mixed blessing producing a conflict between nominal and real convergence. The main culprit is the Balassa-Samuelson effect, which emerges in the countries enjoying high rates of productivity growth.

A high rate of productivity growth enables the corporate sector to raise wages without raising export prices. However, the growth in wages spills over the whole labour market which pushes up wages in the services sector, where the rate of productivity is relatively low. This brings about a higher rate of inflation[18]. The Balassa-Samuelson effect is the most important factor behind *catching-up inflation*, which it is characteristic for the countries going through the real convergence[19].

In the literature there is a consensus that the best solution for the conflict between nominal and real convergence is an appreciation of a currency at a rate reflecting (more or

[17] J. Frankel, A. K. Rose (1998) „The Endogeneity of the Optimum Currency Area Criteria", *Economic Journal*, 108, s. 1009-1025. M. Bieć, (2007), „Od recesji do boomu. Wahania cykliczne polskiej gospodarki 1990-2007", www.sgh.waw.pl/instytuty/irg/konferencje/20lecie/referaty
[18] B. Balassa, „The Purchasing Power Parity Doctrine: A Reappraisal", *Journal of Political Economy*, 1964
[19] R. Dobrinsky (2006) "Catch-up inflation and nominal convergence", *Economic Systems* no. 30

less) the rate of appreciation of the equilibrium exchange rate[20]. In 2005-2007, the Polish zloty did appreciate roughly in accordance with the estimates of its equilibrium rate. The growth in productivity enabled wages to grow, but the appreciation of the zloty helped to keep inflation in check.

The main problem with a floating exchange rate is that there is always a risk that it might deviate for a long period of time from its equilibrium level. The risk cannot be neutralized by central bank interventions in the foreign exchange market. There are situations when intervening in the foreign exchange market might be effective. Nonetheless, usually interventions are expensive and bring about short-lived results[21]. Thus, the important cost of being outside the euro zone is the risk that the movements of the zloty might depart from its equilibrium rate.

One might assume that the most probable scenario is that Poland will enjoy quite a long period of relatively high productivity growth[22], which will be the result of the real convergence[23]. Thus the high rate of productivity growth would neutralize the adverse effects of a possible zloty appreciation. Nonetheless, the problem is that it is impossible to assess the risk of a less optimistic scenario, of which the experiences of the Baltic states are an uncomfortable reminder.

4.2.The diminishing scope for monetary policy autonomy

The growing mobility of international capital flows reduces the scope for independent monetary policy even in countries having floating exchange rates. Central banks in emerging economies usually take into consideration the impact of their interest policy on the movements of exchange rates. They simply try not to provoke exchange rate volatility which might have an adverse impact on the real economy[24]. The risk of triggering such movements of exchange rates increases with the growing scale of the *global carry trade*.

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[20] P. De Grauwe, G. Schnabl (2005) "Nominal versus Real Convergence – EMU Entry Scenarios for the New Member States", *Kyklos*, vol. 58, no. 4

[21] S. Studi (2006), "Is foreign exchange intervention effective? Some micro-analytical evidence from Czech Republic". *Temi di discussione*, Banca D'Italia, no. 579. M. Losoncz (2003) "Speculative Attack Against the Hungarian Forint. Preliminary Lessons and Conclusions", *Intereconomic*s, no. 5-6

[22] M. Kolasa (2005) "What Drives Productivity Growth in the New EU Member States? The Case of Poland", *ECB Working Paper Series*, no. 486.

[23] *The EU-KLEMS Productivity Report*. (2007), Issue 1, www.euklemsnet/index.htlm

[24] G. A. Calvo, C. M. Reinhart (2000) "Fear of floating", *NBER Working Paper Series*, www.nber.org/papers/w7993

In theory, a flexible exchange rate should secure full autonomy of monetary policy. In textbooks, a rise in expected inflation produces exchange rate depreciation. However, such reasoning describes the relationships which are long-term. In the real world the *global carry trade* is a short-term speculation. If a country keeps its interest rates at a relatively high level, it usually attracts large short-term capital flows[25].

This has a repercussions for exchange rate policy. In the 1970s and the 1980s, a devaluation might be an effective tool to regain competitiveness of a given economy when it was combined with sufficient tightening in monetary and fiscal policy. However, at that time the mobility of capital flows was much smaller. Nowadays, under the much increased mobility of international capital flows, a large number of countries have floating exchange rates.

Due to the rise in the mobility of international capital flows, much larger current accounts are easily financed without resulting in a substantial increase in the country (default) risk. Quite often, even large current account deficits do not automatically produce currencies depreciations. Conversely, once the deterioration on the current account is caused by increased inflation, a rise in interest rates often brings about an exchange rate appreciation.

What are the factors behind the growing scale of the *global carry trade*? Of course, the main reason is globalization resulting from financial liberalization and technological progress. *Carry trade* enables the export of liquidity from one country to another[26]. There are two sources adding to the supply of liquidity in the global market. The first is the low level of interest rates in Japan. The second is the sterilization of Asia's and oil producers' mammoth foreign exchange reserves[27].

The illustration of the consequences of the growing scale of the *carry trade* are the trade-offs which have been faced by the Reserve Bank of New Zealand Bank during the last couple of years. The RBNZ was raising interest rates in order to contain speculation in the domestic mortgage market. However, the interest rate hikes attracted short-term capital flows, which inflated domestic banks deposits. New Zealand banks could increase the supply of mortgage loans. Under the circumstances, the RBNZ was forced to raise interest rates to a level that was much higher than justified by the expected rate of inflation[28].

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[25] „Interest Rates, Carry Trades, and Exchange Rate Movements", Federal Reserve Bank of San Francisco, *Economic Letter*, 17 November 2006

[26] "When all boats floated", HSBC, *Global Research*, February 2007, s. 7-9

[27] JPMorgan, B. Kasman, J. Loeys, D. Hensley, J. Lupton, N. Panigirtzoglou, *So much depends upon a grand experiment. Central banks test the limits of noninflationary growth*, July 10, 2007, s. 15

[28] HSBC, *Global Economics*, 03 2007: "Inflated reality", s. 18

Did the floating rate make it easier for the RBNZ to conduct its interest rate policy? Quite the contrary. It complicated the RBNZ monetary policy, as the capital inflows, which were attracted by the high level of interest rates, produced a substantial exchange rate appreciation. In 2007, the RBNZ was intervening in the foreign exchange markets, in order to increase the risk of the carry trade[29].

The experiences of the RBNZ provides an illustration that the growing mobility of international capital flows narrows the scope for autonomous monetary policy also in the countries that have floating exchange rates. Poland's experiences from 2000-2001 illustrate the same phenomenon[30].

5.Concluding remarks

A few month ago Poland's situation seemed to be clear. The nominal convergence in Poland was almost completed. The only task left, before joining the euro zone, was to fulfil the fiscal Maastricht criterion. Now, the situation is more complicated as the world-wide agflation may be a transitional challenge for the monetary policy, but the credibility of the central bank and the narrowing of the fiscal deficit still secure favourable prospects for Poland's fulfilling Maastricht criteria.

Nonetheless, Poland's joining the euro zone poses the two questions: How to pass the stability test of the ERM2? How to minimize the potential costs of resignation from monetary policy autonomy.

The first challenge would not be difficult, it the zloty continued to be as stable as it was during the last couple of years. Since 2004, the volatility of the zloty has been substantially lower than in previous years, which resulted largely from the process of nominal convergence and the reduction of country risk after Poland's joining the European Union. The experiences of the other accession countries illustrate that the necessary factor enabling a smooth passing the ERM2 stability test is the strengthening credibility of the central bank.

In the case of Poland, potential costs of resignation from independent monetary policy seem to be relatively small. The real convergence process will probably bring about a long period of relatively high rates of productivity growth, which would reduce the

[29] *Financial Times*, June 22 2007, Peter Garnham, "NZ bank resolve tested as kiwi climbs", p. 26

[30] W. Orłowski (2003) „Wpływ członkostwa w strefie euro na konkurencyjność polskich przedsiębiorstw"(The impact of the EMU membership on the competitiveness of the Polish corporate sector). In: *Gospodarka Polski przed wejściem do Unii Europejskiej* (*Polish economy before joining the European Union*), Polish Economic Society, PWE, Warszawa

appreciation of the REER, if such a risk materialized. The other factor which reduces the probability of a boom-bust cycle is nominal convergence which pushed the CPI and interest rates down in Poland close to euro zone levels. Joining the euro zone will not bring about a substantial fall in interest rate levels which might trigger excessive economic expansion as was the case in Portugal, Greece and Spain.

Nonetheless, the experiences of the Baltic countries illustrate that a substantial REER appreciation may produce a serious problem even for economies enjoying high rates of productivity growth. The research on the functioning of the euro zone shows that the divergences between actual and neutral level of interest rates may be a problem especially for the smaller member countries[31]

It is necessary also to take into consideration that it was nominal appreciation, which neutralized conflict between nominal and real convergence in today's candidate countries. They are small open economies with relatively high pass-trough of the exchange rate on inflation. The permanent fixing of the exchange rate might increase a potential procyclical impact of the EBC monetary policy.

What might be the hedge against the potential costs of joining the euro zone? The answer has been known for a long period of time. The solution lies in structural reforms, which might enhance mobility of resources and competition in the domestic economy. The stellar economic performances of the Swedish and the Finish economies resulted mainly from structural reforms that enabled increased expenditures on education, research and development and the deregulation of product markets[32].

The important challenge is to increase flexibility of fiscal policy. One may find the tempting recipe for creating a better medium-term fiscal framework in the budding literature on the potential virtues of establishing independent fiscal policy councils[33]. Nowadays monetary policy is conducted in many countries by collegial independent bodies; i.e. monetary policy councils. A creation of a fiscal policy council would enable to lengthen the decision-making horizon for fiscal policy, as was the case with monetary policy[34]. Official advisory bodies in the field of fiscal policy were established in Denmark, Belgium and

[31] G. Flaig, T. Wollmershaeuser, T. (2007) "Does the Euro-Zone Diverge? A Stress Indicators for Analyzing Trends and Cycles in Real GDP and Inflation", CESifo *Working Paper* No. 1937, www.CESifo-group.de
[32] "Scandinavia Today: An Economic Miracle?" *The EEAG Report on the European Economy 2007*, s. 82-120
[33] Ch. Wyplosz (2005) Fiscal Policy: Institutions versus Rules, *National Institute Economic Review No. 191*
[34] L. Calmfors (2003) "Fiscal Policy to Stabilise the Domestic Economy in the EMU: What Can We Learn from Monetary Policy", CESifo *Economic Studies*, Vol. 49

Germany[35]. The lengthening of the decision-making horizon would make it much easier to implement structural reform and improve flexibility of fiscal policy. This might increase possibilities to use fiscal policy as a stabilisation policy tool after joining the euro zone[36].

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