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Jarosław Kundera
University of Wrocław

PREPARATION OF POLISH ACCESSION INTO EURO ZONE IN THE TIME OF FINANCIAL CRISIS

Summary: Taking into consideration economic arguments the introduction of euro still brings more advantages then disadvantages for Polish economy. The impulse for additional growth from euro adoption would come mainly from: the intensification of trade with the EU member countries, the increase of competition on Polish market, the elimination of risk of rate of exchange, the increase of attractiveness of Polish market for international direct investment and new opportunities for Polish economic agents to finance their activities on European Single Market. The economic costs may occur in the long run which is related to the fact that economic structure of Polish economy is not perfectly similar to the EU core states and there is low flexibility of wages in Poland.

Key words: euro, convergence criteria, inflation, budgetary deficit, public debt.

Poland has been a member of the European Union since 1 May 2004 and adoption of the euro by Poland is an integral part of our Treaty of Accession. From the legal point of view Poland is already a member of the Economic and Monetary Union (EMU) but because has not completed the third stage of the EMU, still has its use own currency – Polish zloty.

On 17 January 2006 Polish Finance Minister Zyta Gilowska said in an interview that Poland would not adopt the euro before 2010, adding that 2011 was an achievable deadline. In October 2006 Polish President Lech Kaczyński said in an interview with Spanish El Mundo that euro entry should be a subject submitted to a referendum, which would take place at the end of his legislature, which ends in 2010[1]. Polish Prime Minister Donald Tusk said during the economic forum in Krynica that Poland would adopt euro in 2011 a year before the European football championship organized together by Poland and Ukraine. In November 2008 Polish government accepted so called a road map to introduce euro by 2012. Firstly, Polish zloty should join the ERM 2 system which was planned for the middle of 2009. Secondly, after the accomplishment of convergence criteria in 2011 Poland is going to fix the permanent exchange rate between Polish zloty and euro. Thirdly, the introduction of euro and the withdrawal of Polish zloty is previewed on 1 January 2012. The prices on Polish

[1] "Rzeczpospolita" 18.07.2006, Warszawa, Poland.

market are going to be presented in two currencies (Polish zloty and euro) during six months. However, before Poland decides to join the euro, the Polish Constitution has to be amended to give the European Central Bank the right to print and distribute euro as Polish national currency. In connection with the world financial crises and sudden devaluation of Polish zloty most economists agree that the government plan of euro introduction in Poland is too rushed and not realistic and the adhesion of zloty into ERM 2 system should be delayed.

Article 109j of the Maastricht Treaty contains five criteria which any candidate, also Poland, must fulfill before entering into euro zone:

1. Achieving a high degree of price stability, which according to the protocol of Maastricht says: a Member State eligible to the monetary union has a price performance that is sustainable and an average rate of inflation observed over a period of one year before the examination, that does not exceed by more than 1.5% point that of, at most, the three best performing EU Member States in terms of price stability[2]. The assessment of price stability and inflation convergence shall be measured by means of the harmonized consumer price index (HICP).

2. Achieving a sustainable financial position: at the time of the examination the Member State cannot be the subject of a Council decision that excessive deficit exists. Because inflation is typically the result of large budget deficit, budget deficit under the Maastricht should not exceed in market prices the 3% limit of GDP. A deficit above 3% may be regarded as acceptable if it is something unusual or something transitory. According to so called German golden rules the budget deficit to this limit may be allowed as a source of economic growth and additional income especially if it corresponds to public investment spending on roads, telecommunications and other infrastructures (German golden rule)[3].

3. The total outstanding government debt must not exceed 60% in market prices of the GDP. However, the 60% limit on debt may not apply where: the ratio is sufficiently diminishing over time and approaching the reference value at a satisfactory pace (article 104c.2). The 60% debt limit can be seen as compatible with a deficit debt ceiling of 3% of GDP.

4. Applicant country should have joined the exchange-rate mechanism (ERM II) under the European Monetary System (EMS) for two consecutive years, which means that the Member State has respected without severe tensions the normal fluctuation margins (firstly 2.25%, next enlarged to 15%). In particular, the Member State shall not have devalued its currency rate against euro on its own initiative for this period.

5. Achieving a long term interest rate of durable convergence that means over a period of one year before the examination applicant country to euro zone has an

[2] Protocol on the Convergence Criteria Referred to in Article 109j of the Treaty Establishing the European Community.

[3] R. Baldwin, Ch. Wyplosz, *The Economics of European Integration*, Berkshire 2004, p. 382.

average nominal long-term interest rate that does not exceed by more than 2% points that of, at most, the three best performing EU Member States in terms of price stability. Long term interest rate mostly reflects markets' assessment of long term inflation. The assessment of the criterion is based on the interest rates on comparable 10-year benchmark bond, using an average rate over the latest 12 months.

The theory of optimal currency area stresses the need to labour market flexibility and labour mobility as a precondition of forming a successful monetary union. On the other hand the Maastricht Treaty stresses the importance of macroeconomic convergence prior to adhesion to the euro zone. In connection with the conversion criteria the question arises what the Polish economy macroeconomic situation is. Does Poland qualify to respective Maastricht criteria taking into consideration the level of yearly inflation, budgetary deficit, public debt, long term interest and currency rates?

Table 1. Polish macroeconomic situation in view of Maastricht criteria

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
1. Inflation rate	10.1	5.5	1.9	0.8	3.5	2.1	1.4	2.2	4.1	3.5+
2. Budget deficit							–3.7	–3.1	–3.9	–6.4+
3. Public debt						51.1	49	44.9	45.2	51.2+
4. Long term interest rates							5.6	5.84	4.25	4.00+

Source: GUS Portal Informacyjny, January-July period, prognosis.

Since the beginning of 2004, the National Bank of Poland (NBP) has pursued a continuous inflation target at the level of 2.5% with a permissible fluctuation band of ±1%. The NBP maintains interest rates at a level consistent with the adopted inflation target. As we see from table 1 Poland was a high inflation country at the beginning of the XXI century and after restrictive and long lasting deflationary policy was able to reduce inflation rates to 0.8% in 2003 and 1.4% in 2006. In 2006 Poland was among three EU member states indicating the lowest rates of yearly inflation. In the period 2005-2007 Poland qualified without any problems to the inflation criteria fixed by the Treaty of Maastricht: 2.7% in 2006 and 2.9-3.0% in 2007 having inflation rates distinctly lower then the calculated limit. However, in the year 2008 Poland was affected by the recurrences of inflation processes, and in March was not able to keep inflation within the Maastricht bounds and surpassed it by 0.1%. In the first half of that year, in comparison to the corresponding period of 2007 year, the growth of prices of consumer goods and services amounted to 4.2%. It was previewed that at the end of 2008 inflation in Poland would reach the level of 4.8%. But after financial crises inflation pressure in Poland was reduced and its rate decreased at the end of the year to a lower level then the preview of about 4.1%. Economic crisis and an economic slowdown will bring down the inflation rate further more in the following years: according to the prognosis by Polish Monetary Council to 2.9%.

If Poland enters the euro zone, the rates of inflation must be nearly equal with partner's countries. If this is not the case, inflation in Poland occurs to be higher then in euro zone, Poland will increasingly lose its competitive position. However, a high-inflation country might decide that it is in its interest to join the monetary union despite the asymmetric shocks to reduce inflation and interest rate. Although in the long run countries cannot really choose between inflation and unemployment, it is said that the short-run Philips curve is still alive. If Poland decides to reduce inflation too fast, it will most probably be faced with a temporary increase in the unemployment rate. Moreover, as we know from Balassa-Samuelson effect the Member States with lower productivity face mechanical pressure to appreciate their real exchange rate after joining the monetary union[4].

As we see from table 2 inflation growth in Poland in 2007 and 2008 was due mainly to the growth of prices of non-alcoholic and alcoholic beverage, tobacco, milk, cheese, vegetables, electricity, oil and gas. Prices of food and non-alcoholic beverage, as well as goods related to housing were rising the most. In manufacturing prices grew slower then in total industry, in construction and assembly prices grew by 6.5% during the first half of this year. To all these around the world effects imported from abroad we must also add our internal reasons, namely the increase by 7.4% of the purchasing power of average monthly gross wages and salaries in the enterprise sector during the first half of this year, which gave also the pressure to the growth of local demand. The growth of prices was not fully recompensed by the reduction of prices of clothes, household equipment, or telecommunications fees and recreation and culture. We expect more and more slower growth of inflation in the next 2009 mainly due to the slower growth of domestic and foreign demand and the drop of prices of oil and gas on the world market.

After the credit crunch crises which started in the US in October 2008 economists asses that commodities prices would plunge all around the world. In theses circumstances the inflation risk will be reduced not only in the US but also in the EU and Poland as well. The statistical data in September-November 2008 confirms that the inflation growth trend slowed down. The Polish Ministry of Finance has announced that inflation will be around 4% in December in 2009. With assets prices plummeting and economies shrinking not inflation pressure but the reduction of production and the growth of unemployment may be the biggest worry in 2009--2010.

EU hit Poland with the procedure of excessive budget deficit shortly after the adhesion in May 2004 because deficit in Poland exceeded the 3.0% rule. Three years later the European Commission called on Poland's partners to drop disciplinary action: the Commission said that Poland had brought its fiscal shortfall well below the limit and estimated it would stay in line. It should be underlined that Polish

[4] A.B. Benbassy-Quere, B. Coeure, *Economie de l'euro*, Paris 2002, p. 88; P. De Grauwe, *The Economics of Monetary Integration*, Oxford 1997, p. 52.

Table 2. Changes of prices in percentage of some goods and services in Poland in the period 2006-2008

Goods	December 2006	December 2007	Jan-May 2008
1. Food, non-alcoholic and alcoholic beverages, tobacco			6.9
2. Bakery goods	6.4	11.8	3.3
3. Meat products	0	4.2	1
4. Fish	1.6	2.1	1.4
5. Milk	1.1	16.2	1.8
6. Cheese	0	18.5	–2
7. Vegetables	10.9	–2.6	12
8. Clothes	–6	–5.8	–3.2
9. Housing, water, electricity, gas and other fuels			7.5
10. Rooms' rent	4.1	6.2	2.7
11. Electricity	4.2	1.6	11.5
10. Gas	15.8	4.8	10.9
11. Household equipment	–1.8	–1	–0.6
12. Pharamacutics	0.8	3.1	1.4
13. Oil	–6.3	18.1	0.7
14. Transport			5.7
15. Bus transport	1.3	2.4	2.8
15. Telecommunication	1.8	–2	0.3
16. Communication			–1.7
17. Recreation and culture			–2.0
18. Education			3.1
19. Restaurants and hotels			5.5
20. Miscellaneous goods and services			1.7

Source: "Rzeczpospolita" 24 July 2008; GUS Statistics 2008.

government was serious about the commitment to medium-term convergence programme and it is planning to drastically cut its budget deficit. Finance Minister Jacek Rostowski said that the budget deficit would be cut to 18.2 billion zlotys (8.2 billion US dollars) from 27 billion (12 billion US dollars). During the first half of 2008, the revenue of the state budget amounted to 127 572.9 million Polish zloty, while the expenditure was at 131 029.2 million Polish zloty, so the recorded state budget resulted in a small deficit of 3456.3 million[5]. If the positive tendency had continued and low deficit target programme succeeded, the overall government deficit in Poland might have even dropped to 1.9% in 2008 and 1.0% in 2009 in relation to the GDP. But at the end of the 2008 the economic slowdown hit the state budget, and in a situation where revenues were less than foreseen, the public sector

[5] "Poland Monthly" No. 80, October 2008, p. 10; "Poland Monthly" No. 81, November 2008, p. 10.

deficit grew to 3.9% in relation to the GDP. In the growing public deficit it was natural to limit expenditure. Expensive health care, education, state administration systems present the main barrier on the way to lower budget deficit. To rescue the budget balance in 2009 Polish government declared the saving programme to reduce the budget spending by 19.7 billion zloty, which encompasses several ministers: Ministry of Defense (1.95 billion zloty), Ministry of Internal Affairs and Administration (1.21 billion zloty), Ministry of Health (1.89 billion zloty), Ministry of Science and Higher Education (0.87 billion zloty), Ministry of Justice (0.59 billion zloty), Ministry of Finance (0.53 billion zloty). However, in the conditions of slower economic growth the pressure would arise to enlarge the budget deficit, so it might be difficult to sustain budget much lower then the limit of 3% of GDP. After the financial crisis and slowing down the economic growth tax take is falling, exposing unreformed Polish public finances. With the huge weight of fixed expenditure of about 75% of the budget, the government by law can only reduce the spending from the position covering the rest 25%. In 2009 we have the budget expenditure for about 321 billion zloty and about 80 billion is the so called flexible part of the budget. According to an opinion of economists the 2009 budget was based on completely unrealistic assumptions. Although economists have long dismissed the risk of Poland falling into turmoil caused by the financial crisis, GDP growth has since been downgraded and many have now taken a more pessimistic view of the Polish economy over the next years. Ministry of Finance predictions for 2009 of 3.7% growth of GDP has been roundly criticized and revised into 1.25-1.7% GDP growth[6]. With slower economic growth, lost jobs, less export and import, increasing conservatism in credits, the budget deficit would be definitely bigger than previewed. According to government prediction it may grew to the level of 6.4% in relation to GDP in 2009 and about 7.5% in 2010 and 2011.

It should be stressed that the policy of budgetary restraining is being questioned in the face of financial crisis which reaches also Polish economy. If economic growth turns out to be clearly lower, the budgetary income will be lower than the assumed budgetary plan. Production drop and the rise of unemployment is imposing a new task on public policy for additional spending. It would be difficult to keep the budget under control if we had an economic slowdown. Critics say that budget deficit should have been left on the same unchanged level as one year before or even increase to offset consumption decrease and that in 2009 there will be necessity of fiscal policy revision. The shortfall is not likely to reach a few billion zloty, but tens billion. There is pressure from the opposition to enlarge the budget deficit above 3% of GDP to 3.6% in 2009 as a means to fight against growing unemployment. This deficit will be out of Maastricht limit in 2009, but still lower than forecast by the IMF for France – 5.5%, UK – 7.2% and the United States 12%[7]. Without loosing the rules of

[6] GUS selected indicators regarding the economic situation of the country, Warszawa, July 2008.

[7] "The Economist" 14-20 March 2009, p. 29.

Maastricht criteria the increasing budget deficit means that Poland would have to give up its intention to join the euro zone in 2012. In the time Poland will act in compliance as many EU states normally do in recession, if the lower spending needed to satisfy the entry criteria is not the choice. However, with the growing budget deficit one can forget euro accession in 2012, and the 2013-2014 scenario will depend on the prospect for economic growth.

In November 2008 the Commission elaborated a comprehensive 200 billion euro recovery plan (0.5% of Unions GDP) which complements financial markets and is mostly funded at the national level (170 billion)[8]. Because exceptional times call for exceptional measures, there is also a question about the application of Stability and Growth Pact to the euro zone Member States in the time of fighting against financial crises. Fiscal policy would likely lead not only new Member States countries of the EU, but also some euro zone partners to breach the 3% of the GDP Maastricht deficit threshold.

Poland meets also Maastricht public debt criteria. According to estimates by states office GUS public debt has been diminished from more then 50% in reference to GDP in 2005 to 45.2% of the GDP in 2008. Polish government tried to do the best to curb the growth in public debt to make it safe for financing and to limit huge financing that is currently being spent on debt servicing. But sudden depreciation of Polish zloty has made covering the interest rate from foreign debts more and more difficult. In 2008-2009 Poland was struck by the financial crisis as other economies of the EU and all around the world. While there was an economic slowdown, rising unemployment and dropping export, the financial system avoided falling down completely like in Iceland, Ukraine, Baltic's states or Hungary. The banking sector in Poland is still underdeveloped in comparison to other well developed countries, what is minimizing the impact of any negative fallout from the global financial turmoil. For example, the amount of assets held by Polish banking sector in relation to GDP is about 60%, whereas in Iceland, which was seriously damaged by the crisis it is approximately 900%[9]. Despite the fact that Poland is trying to restrict the size of public deficit, the cost of its serving is becoming more and more increasing. Although international financial markets have continued to have confidence in the euro zone states and the US, they do not have they confidence in Central-European emerging economies. If the government decided then to abandon euro in 2012 and to increase the budget deficit, on the other hand it could lead to a large increase at the cost of serving public debt and further growth of budget deficit.

In the past large differences in the interest rates between Poland and the euro zone created large disturbances in Polish capital market due to the inflow of foreign speculative capital and the appreciation of Polish zloty. In order to limit this Polish interest rates should be nearly the same as the euro zone rates taking into consideration

[8] European Economy, European Commission, January 2009 No. 12, p. 6-7.

[9] "Poland Monthly" No. 80, October 2008, p. 10.

the differences in the inflation rates on the day of adhesion. On 25 June 2008 Polish central bank (NBP) hiked its key reference rate by 25p to 6%. The hike comes as the Polish economy continued to grow due to domestic demand, wages grew strongly and inflation was expected to come to 5%. However, the monetary tightening cycle in Poland has drawn to close after the global financial crises. In November 2008 Polish Monetary Council changed the approach to monetary policy from restrictive to neutral preparing the ground to postpone monetary tightening. So just after that Council of Monetary Policy in Poland reduced interest rates by 0.25 points to 5.75 and in December 2008 by 0.75 points to 5%, and to 4.25 in January 2009. In February 2009 it reduced the rate of interest by 0.25 to 4.00. To fulfil the condition by Poland to follow the EU example and reduce even more its interest rates requires the stabilization on the currency markets. In case of stopping and reversal tendency of devaluation of zloty in 2009-2010 Poland can stick to the Maastricht criteria regarding long term interest rates without much trouble.

Meeting the exchange rate stability criterion is one of the conditions of joining the euro zone. Since April 2000 the zloty exchange rate has been a floating exchange rate that is not subject to any restrictions. Therefore before the adoption of the euro, the zloty exchange rate against the euro remains fixed for at least two years within the ERM II (Exchange Rate Mechanism II), which means that the NBP will maintain the market exchange rate against the euro within the permissible range ±15% with regard to the set central parity. However, there are the risks of entering the ERM II where currency will be put under the exchange rate test without fiscal and external payments deficits under control. Some economists think that it would not be desirable to enter the ERM II when currency markets are so shaky. From the day of adhesion of Poland to the EU to the middle of 2008 zloty became a more and more stronger currency, 40% stronger in relation to euro. However, in November 2008 after the global crises zloty lost its value due to sudden devaluation by 20% from 3.2 zloty to euro to 3.97 zloty to euro and in December even to 4.20 by more then 30% and next up to 4.5 zloty per one euro. The situation was not calmed down following a declaration by the National Bank of Poland that the macroeconomic fundamentals remain strong and stable. An the beginning of 2009 the rate of exchange reached the level of 4.82 zloty per one euro. February 2009 was a month of crisis for the Polish currency, with zloty hitting 4.899 for one euro. Exchange rate against US dollar was 3.82 and Swiss franc 3.26. The depreciation of Polish zloty was especially dangerous in reference to Swiss franc, because some 30% of Polish mortgage holders are estimated to hold them in this currency. It is a common opinion that the weakening of zloty is not longer linked to the economic situation, but it has become a result of speculation games.

After this financial turbulence we can expect the recurrence of new equilibrium on the financial market. In 2008-2009 the fight of short term capital, the reduction of repatriated funds from migrant workers and a continuing trade deficit were causing deep devaluation of Polish zloty. Because zloty is treated by foreign investors as one of Central European currencies, as long as other countries of the region pass serious economic crisis there is not a chance for the zloty to strengthen considerably. Economists generally believe that zloty is greatly undervalued. In the view of some of them the optimal rate of exchange between euro and zloty should be lower then actual rate in the range of 3 to 3.5 zloty for euro. On the other hand taking into consideration lower competitiveness of Polish economy than euro zone partners the other economists think that the optimum exchange rate of Polish zloty should be nearer 4 zloty then 3 zloty for one euro around 3.65-3.7 zloty against euro[10]. Currently the exchange rates of Polish zloty are not much the macroeconomic criteria of Polish economy. A central parity should not be stipulated at a level which does not reflect fundaments of Polish economy. Most economists think that Poland should enter the ERM II system with the rate of exchange about 4 zloty per one euro. This rate seems strategically profitable for the long term competitiveness of Polish economy[11].

Whereas the cost of a common currency has much to do with the macroeconomic management of economy, the benefits are mostly related to the microeconomic level[12]. In the theory of economic integration it is said that European Monetary Integration (EMU) is needed to safeguard the benefits from an internal market. The alternative to EMU might be widely floating exchange rates with the pronounced realignments that lead to competitive devaluations and new trade barriers. Then what are the main benefits and costs from the monetary integration? What benefits and costs can expect Polish economy with the adhesion to the euro zone? It should be underlined that benefits and costs accompanying a monetary integration are pretty well detected and analysed by the theory of international integration.

1. After 10 years of functioning the euro zone has become a pole of stability for Europe. Therefore the adaptation of euro by Poland is recommend as soon as possible to guarantee the stabilization for money and our monetary policy. The adaptation of euro is going to be related first and foremost with the disappearance of speculation pressure against zloty due to the international importance of euro as a world currency. From its participation in euro zone Poland also expects to become a more credible state with more predictable macroeconomic policy and sound structure of economic governance. With low inflation, restricted budget deficit and solid common currency Poland may be treated as a solid partner on the international scene. The worst scenario for Poland is to abandon the plan to join euro in the foreseeable future. The resignation from euro with a economic slowdown and ballooning budget deficit may cause investors to withdraw from Poland and further slide of Polish zloty.

2. The elimination of cost of exchanging zloty to euro is certainly the most visible gain of adhesion of Poland to the euro zone. There are two sources of savings connected directly with so called transaction costs: firstly, bid-ask spreads plus other commission charged by banks, secondly, in-house costs that arise because Polish

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[10] "Wprost" 22.02.2009, p. 62-63.

[11] D. Gros, N. Thygesen, *European Monetary Integration,* Longman, New York 1998, p. 262.

[12] EC Commission, *One Market One Money*, European Economy 44.

enterprises have to maintain separate foreign currency expertise. The EU Commission estimated these gains for first euro zone member states at a number between 13 and 20 billion euro per year, which represented from one quarter to one-half of one per cent of Community GDP. Direct gains from common currency come from the elimination of transaction costs of exchanging Polish zloty into euro in Polish banks and bureaus de changes. According to Emerson the total savings from a common currency are estimated to be about 0.4% of the GDP of the EU 12[13]. These gains may be a little bit higher for Polish economic agents taking into consideration noticeable difference in the price of buying and selling euro in Polish banks and bureaus de changes. The transaction costs for all Polish economy is assessed at about 3 billion zloty (about one billion dollars). The difference in rates in buying and selling euro to zloty accounts is now about 6%. Additionally it may also be expected that after adopting euro the transaction costs will be lower in Polish trade with third countries then when using the national currency as a means of exchange.

3. The theory of integration asserts that the true gains from the introduction of a common currency are much larger then the apparent savings in transaction costs. The continuing existence of national currencies can lead to indirect costs if it allows firms to engage in price discrimination on the home market. Using zloty as a national currency is difficult for consumers when comparing prices on Polish market with the euro zone and it is also difficult for foreign consumers and enterprises from euro zone while comparing prices in zloty with their prices. National currency allows firms to obtain some local monopoly power. They can charge higher prices in the local market than abroad. At present it is estimated that prices in Poland are the 53% of the average level in the euro zone. Some prices on the agricultural products and services are much lower in Poland than in the EU, but the technologically advanced products have lower prices in the euro zone in comparison with our country. Prices discrimination is only possible because national markets are still segmented, and as a result euro will reduce the scope for price discrimination between Poland and euro zone Member States. Consumers and Polish firms will be able to compare prices across European single market in the same currency. The accession of Poland to the euro zone will provide – as is expected – better price clearance between Polish and euro zone market where even a small difference can be detected. This can bring about the movement towards equalization of prices with some prices growing and some prices dropping on the Polish market to adjust them to the euro zone level.

4. Introducing euro in Polish economy will eliminate the exchange rate risk connected with Polish zloty. Therefore it will lead to more efficient working of price mechanism. Economic agents base their business decisions on the information that the price system provides for them. Because exchange rate uncertainty may introduce uncertainty about the future prices of goods and services, the quality of these decisions

[13] M. Emerson, D. Gross, A. Italianer, J. Pisani-Ferry, H. Reichenbach, *One Market, One Money*, Oxford 1991.

in the system of national currency might be less then in the system of common currency. The system of common currency price would become a better guide to make the right decisions regarding investment and consumption as far as international transactions are concerned. Savings are likely to be greater for Polish small and medium sized enterprises (SME) than for large multinational corporations which hold diversified currency portfolios and support treasury department to manage exchange risk. The elimination of risk in currency rates can reduce the amount of risky projects. The exchange rate changes are dangerous instruments in the hands of politicians. In the euro zone the exchange rate realignments that periodically disturbed the European economies have become a thing of the past. Market mechanism becomes of course more reliable as a mechanism to allocate national resources. All these efficiency gains are difficult to quantify for Polish economy. The experience of some countries illustrates that when devaluations are used too often, they will lead to more inflation without gains in terms of output and employment. They can lead to macroeconomic instability as economic agents continuously tend to expect future devaluations.

5. It is argued that an additional dynamic effects will arise after the adhesion of Poland to euro zone because EMU reduces the risk premium attached to foreign investments. Risk-averse investors exporting capital abroad require a higher premium to compensate them for the increased riskiness of currency rates fluctuation. A reduction in this risk premium and more stable Polish macroeconomic policy would stimulate foreign investments and Poland expects additional inflow of foreign investment by about 50% in comparison with so called "anti monde scenario". These new investments may come not only from the euro zone members, which are the main investors in our economy, but also from non–European states wanting to invest in Europe and planning to open their factories in Poland as a country which belongs to the euro zone. It is worth noticing that in 2008 intra-euro zone foreign direct investments (FDI) stand at one third of GDP' Member States as compared to one fifth before establishing the monetary union. European Commission suggested that up to two thirds of this increase importance of FDI in the Member States economies can be attributed directly to the creation of the single currency[14].

6. It is obvious that the accession of Poland to euro zone should lead to a fall in the real interest rate. The reduction of Polish interest rate after the adhesion to the euro zone should raise investment in Poland, as well as consumption and increase output over time as the capital stock increases. In the neoclassical growth model the reduction of the interest rate in Poland due to the acceptation of lower interest rate fixes by the European Central Bank would increase the rate of growth of our GDP. For example the interest rate managed by Polish Central Bank in November 2008 was 6% but then of the European Central Bank was 3.0%, a half lower. At the

[14] *EMU and 10. Successes and challenges after 10 years of Economic and Monetary Union*, European Economy 2008, No. 2, Brussels, p. 4.

beginning of 2009 the interest rate in Poland was at 5% and in euro zone at 2.5%, also a half lower. Higher interest rates and rapidly changing rates of Polish zloty struck against the competitiveness of Polish export. If Poland wants to remain competitive within the EU, it must lower its key interest rates to the levels closer to its European neighbors. Therefore as a result of our adhesion to the EMU and lower interest rate Polish economy may invest more and accumulate more capital. This would raise productivity, output per worker and export and may place Polish economy on a permanently higher growth path.

7. The accession of Poland to the euro zone could lead to an increase in trade with the euro zone member states. The elimination of the transaction costs of zloty to euro and uncertainty connected with the zloty exchange rate and Polish monetary policy could stimulate additional trade and other exchange transaction on the European single market. There would be fewer problems from uncertain and variable exchange rate which causes important difficulties for Polish companies which do export. The exchange rate stability which encourages greater trade should result in higher growth and employment. The question then is: how large would be the increase in cross-border transactions stimulated by euro. The analysis said that the effects would be similar to the abolition of non tariff barriers under the single market programme. Intra-area trade flows in the euro zone accounted for one third of the area's GDP, up from one quarter in 1998. According to European Commission the elimination of exchange rate volatility can explain up to half of this increase[15]. The adaptation of euro by Poland could also increase the volume of our mutual trade with the euro zone partners by at least about 50%.

8. The adaptation of euro is also recommended to avoid negative consequences of tendency of zloty fluctuation and changing its rate of exchange. Rapidly changing rate of exchange is striking against export, competitiveness of many industries and services and it is inciting the inflow of speculative capital. From late June until July this year the euro fell against zloty by over 14 grosz and the dollar fell by 12 grosz. Zloty had not strengthened on this scale since October 2007. From the time of Polish accession to the EU zloty had appreciated by about 40% in relation to euro. Thousands of Polish firms went bankrupt when zloty had become overvalued. Some branches of Polish industry, like shipbuilding and furniture were on the verge of bankruptcy due to loss of profit in export market The appreciation of Polish zloty had reduced also the value of aid from structural funds and forced our regions to modify their development plans. But in October 2008 zloty suddenly lost 20% of its value and in December value of zloty deceased further by 10%. In 2009 the reduction of repatriated funds from migrant workers and a continuing trade deficit have weakened zloty further to euro to about 4.5 zloty per one euro. Such sudden devaluation struck also foreign contracts of Polish firms which were wrongly calculated and insured. If on one hand the appreciation of zloty benefited consumers and importers, cooling down

[15] Ibidem, p. 4.

inflation, on the other hand the depreciation of Polish zloty was to export advantage but to import disadvantage and boosted inflation. It seems that from the long term perspective euro will give Polish economy more stable fundament for growth and competitiveness and reduce negative consequences of circulation of speculative capital.

9. There may be some structural consequences for Polish capital market, which will become more liquid, deeper in many segments and more diverse in terms of the range of instruments. For Polish companies issuing debt and equity euro implies lower capital costs. Bonds emission on the European market can increase with the introduction of the joint currency. Hardouvelis estimated a reduction of 2% in the cost of capital due to the process of European integration[16]. Equity market has integrated fast after introducing euro with the share of equity held in other states from the euro zone rising from 20% to 40%[17]. For all Polish capital sector the increased competition might bring about its modernization, greater pressure to perform and greater expansion for foreign markets. All this will help to bring lower interest rates.

10. There is also a problem of savings through lower official international reserves. As long as zloty subsists, Polish national central bank has to keep large foreign exchange reserve (50 billion US dollars) to be able to defend the exchange rate. Because in the euro zone the European Central Bank, overseeing a common currency, keeps the common reserves of the member states at lower level (only 50 billion euro from the reserves of the 12 member states by 200 billion euro) such a large Polish reserve ceases to be useful. It is expected that only 5% of Polish currency reserve will be moved to ECB after the adhesion of Poland to the euro zone. Some of this reserve could be used then for another goals for example to retire Polish public debt (domestic or international). However, we are not expecting large economic gains from these savings because the Polish central bank's reserves are having opportunity costs as they are actually invested in the interest – bearing assets.

On the other hand we expect some default coming from our adhesion to euro zone which is related to:

1. The accession of Poland to the euro zone is connected with the fact that our central bank will loose its real power. It means that it will not be able any more to change the price of Polish zloty or to determine the quantity of the national money in circulation. In the euro zone it will be impossible for Poland to carry our independent monetary policy on the national level. For each member state the adhesion to euro zone means transferring to the European Central Bank in Frankfurt their previous national bank's competencies regarding the emission of currency and fixing the rate of interest. Poland in the euro zone structure will not be able to change individually the rate of exchange to act against negative balance of payment tendencies or against

[16] G. Hardouvelis, D. Malliaropulos, R. Priestley, *EMU and European stock market integration*, CEPR DP 2124, April 1999.

[17] *EMU and 10. Successes...*, p. 4.

the unexpected growth of import or drop in export. Poland will not be able to modify individually the rate of interest against the inflation growth or to boost economic activity. If Poland would be hit by an economic shock that does not affect the euro zone partners, it has to fight it with one hand tied behind its back mainly by the fiscal policy means.

2. Fears of growth of prices is the principle reason of lack of enthusiasm in Poland regarding accepting euro as a national currency. Although the statistical data said that in the 15 member states of euro zone there was moderate growth of inflation after accepting the common currency, we observe the divergence of opinion between economic analysis and the perception of Polish society. Polish citizens fear that after the accession to euro zone the prices for the primary goods will growth substantially and it will strike the standard of living of people with the lowest income. The accession of Poland into euro zone will reduce the scope for price discrimination between Poland and the euro zone markets. On average the prices in Poland are at 53% of average level of prices in the EU 15 Member States. Such prices discrimination is only possible because Polish and EU member states markets are still segmented. It is worth adding that Polish National Bank in its report foresees the moderate growth of prices in Poland after the accession to euro zone by 0.53% in the least pessimistic scenario to 2.56% in the most[18]. Although in the short run this will cause the growth of prices and rates of inflation in Poland, then in the long run it may bring about the growth of competition and pressure to reduce the inflation and level of prices. This would bring benefits for consumers in Poland, especially in cases of the sectors composed of imported goods and services in which prices of local producers are relatively high.

3. After the accession to euro zone, as I said before, Poland may profit from the reduction of interest rates to the level of the ECB. However, in the long run the interest rates on the bonds market in Poland might be higher then in the EU partner countries. Before the credit crunch in Germany bounds yielded for ten years nearly the same profits as in the other euro zone partners, for example only 0.2% less than in Italy. After the crisis the spread has widened in case of Ireland, Spain, Greece and Portugal, which faced serious difficulties to finance their debts. The sharp rise in bonds spread for Greece, Italy, Ireland and Portugal showed that capital market became less forgiving of higher debt and rising budget deficit[19]. The same situation would meet Poland after the adhesion into euro zone, however, it is possible that borrowing cost would be higher when Poland stood outside euro zone then if it decided to join in.

4. Market mechanism in Poland and in other post communist countries is relatively young and has been functioning correctly for no longer than 15-20 years.

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[18] *Efekty zaokrągleń cen w Polsce po wprowadzeniu euro do obiegu gotówkowego*, Narodowy Bank Polski, Warszawa 2008.

[19] "The Economist" 7-13 February 2009, p. 23-24.

According to the institutional economics the institutions play fundamental role in each economy for market regulation, stabilization, movement of production factors, etc. Because of the "infancy of the market institutions" the risk of the destabilization of the market seems to be more important in Poland than in better developed euro zone states. The necessity of keeping "une marge de manoevre" is particularly essential in case of controlling inflation, economic growth and unemployment and in carrying out the policy of restructuring. Polish politics is afraid that after the adoption of euro the country would be deprived of the monetary instrument more adequate for the regulation of Polish economy than more mature economics of euro zone.

Poland is likely to adopt euro few years later than 2012. There are still a number of problems to get over. The country already meets most of the EU's Maastricht criteria, with low inflation and public debt running at under 60 GDP. But budget deficit surpassed the level of 3% of GDP in 2008 and it may last out of the Maastricht criteria in 2009 and 2010 because of economic crisis. Moreover, there is still the issue of currency stability after sudden devaluation of zloty in October 2008 and being a member of the ERM 2 system for at least two years. Zloty collapse had come primarily because the currency had been targeted by speculators. In view of zloty exchange rate fluctuation it became clear that euro was a great idea and we missed the best moment to do so. The government has now two alternatives to choose from. If it tries to limit budget deficit under the Maastricht criteria to make severe cuts, this policy may occur to be politically hard to sustain. On the other hand if government decides to enlarge budget deficit, we would have higher public debt, zloty would drop in value, and all these may delay the euro project by several years.

Overall, we can conclude that the elimination of monetary frontier between Poland and euro zone will bring about more advantages than disadvantages for Polish economy. While the benefits from Poland participation in euro zone will be moderate, cumulative and reasonably uncontroversial, the costs seem to be much more uncertain, possibly widely exaggerated and diminishing with the passage of time. In sum the standard analysis shows that the adhesion of Poland to euro zone is comparable to the elimination of non tariffs barriers under the single market framework and will give additional moderate impulse to the economic growth by 0.4-0.5% of Polish GDP each year during 20 year period. This additional growth would come mainly from: the intensification of trade with the EU member states, the increase of competition on Polish market, the elimination of risk of exchange rate of Polish zloty and transaction costs, the increase of attractiveness of Polish market for international direct investment, new possibilities for Polish economic agents to finance their activities on the European single market.

In the short run Poland may expect the economic profit from its participation in euro zone. The economic costs may occur in the long run which are related with the fact that the economic structure of Polish economy is not perfectly similar to the EU so called core countries and with low flexibility of wages. From five criteria of optimum currency area Poland has accomplished only three, hence in the face of asymmetric shock it would face the problems of structural unemployment. The importance of costs bearing from the functioning of common currency in Poland would be related to further structural changes in the economy, the growth of productivity and the reforms of the labour market.

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PRZYGOTOWANIE POLSKI DO CZŁONKOSTWA W STREFIE EURO W CZASACH KRYZYSU FINANSOWEGO

Streszczenie: Najważniejszym obecnie celem polityki rządu jest walka ze stagnacją gospodarczą poprzez zwiększanie wydatków, stąd polityka deficytu budżetowego odracza nasze przystąpienie do strefy euro poza rok 2012. Wciąż aktualne są jednak korzyści płynące dla gospodarki polskiej z przyjęcia wspólnej waluty: eliminacja kosztów transakcyjnych oraz spekulacji kursem waluty, większa przejrzystość cen, dodatkowy napływ bezpośrednich inwestycji zagranicznych, spadek realnych stóp procentowych, wzrost obrotów międzynarodowych, oszczędności z tytułu mniejszych rezerw banku centralnego. Z drugiej strony, po przyjęciu euro możemy się spodziewać pewnych kosztów związanych z utratą realnych kompetencji naszego banku centralnego w zakresie prowadzenia polityki kursowej i ustalania stopy procentowej oraz możliwości wyższej inflacji.