# Poland's road to the euro: A review of options[1]

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## Long-term economic benefits of adopting the euro

Euroization is an important part of what appears to be a new general tendency in the world economy, one towards fewer but better monies (Dornbusch, 2001).

The main arguments in favour of the European Union (EU) countries' adopting a common currency may be divided into three categories: (a) those related to international trade and static efficiency gains, (b) those related to stability, and (c) those related to growth. Although these arguments are well known, I should like to recall them briefly, in order to make the point that while (a) applies to all countries, (b) and (c) apply mainly to the least developed members and candidates of the EU.

**Trade and efficiency**: The elimination of an exchange rate risk within a common currency area (CCA) reduces the transaction cost in international trade and therefore stimulates the integration of national markets for traded goods. This in turn creates opportunities to reduce costs through economies of scale and increased competition. The efficiency gains of this kind should be enjoyed by all CCA countries, but especially those which trade a great deal with other EU countries.

**Stability**: The arguments in this category note that the countries whose record of stability was poor in the past stand to improve significantly the credibility of their macroeconomic policies. Credibility gains in those countries would result in lowering inflation expectations, which in turn would lower both current interest rates and the cost of keeping the inflation rate at a low level. Further implications would be a lower cost of servicing the public debt and smaller speculative and destabilising capital inflows. Benefits of this kind have been already enjoyed by some EMU countries, notably Italy, Spain, Portugal and Greece. However, credibility gains would be particularly strong for new EMU members belonging to the group of emerging market economies (EMEs), such as Poland or Turkey. The credibility of macroeconomic policies in all EMEs is relatively low, the group having suffered from the macroeconomic instabilities which in the past were concentrated in those economies.

**Growth**: Some EMEs, including Poland, also suffer from low domestic savings. In China and the Southeast Asian countries, prospects of rapid growth have in the past tended to stimulate domestic savings. During the period 1960–2000, the savings rates in those countries increased from about 15–20% of GDP to levels in the range of 30–50% of GDP. But in those countries public expenditures, and hence tax burdens, have been very low by European standards. The private sector was then in a position to respond to investment opportunities by increasing its own savings. In Poland, parallel tendencies were likewise observed during the 1990s: a lowering of the tax burden and an increase of the domestic savings rate, produced changes in savings and investment of around 5% of GDP. However, the domestic savings rate is still only 20–22% of GDP. This is much lower than what is needed to support growth at a rate of 6–7%, which may be the potential rate of growth in the current decade. Judging by the experience of successful EMEs, the investment rate required to support 6–7% GDP growth over a long period of time is about 30 to 35% (Gomulka, 2000).

*The Strategy for Poland* (Government of Poland, 1999) was designed specifically to close the gap between this required total investment and the supplied domestic savings by increasing the latter by some 8% of GDP and by adopting policies that would maintain the inflow of foreign savings at the present level of around 5% of GDP. However, the central components of this strategy related to public expenditures (other than public investments) and domestic savings seem to have failed. As a result, public expenditures are unlikely, in the medium term, to decrease (significantly) in relation to GDP, so that domestic savings are unlikely to show a (significant) increase. This would be no problem whatsoever if Poland were already a member of EMU. In that case Polish enterprises would have direct access to the savings pool of the entire Euro area at low interest rates with no exchange rate risk. An increase of the savings

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inflow to Poland by 8% of Poland's GDP would represent only about 0.2% of the Euro area's GDP. Such an increase, while large for Poland, would require practically no adjustments in EU interest rates and the euro/dollar exchange rate.

While the potentially large impact of euroization on the supply of savings is well understood by economists, a point little stressed so far, though of general political interest, should be made with respect to the parallel impact on investment. Namely, foreign savings could and probably would be used above all by Polish-owned enterprises to supplement their profits in financing their own investments. Under the present floating exchange rate mechanism this is not the case, for the exchange rate risk associated with borrowing euros is particularly high for enterprises which supply predominantly domestic markets, and these enterprises tend to be Polish owned. Euroization would thus remove this form of credit discrimination. This, in turn, would mean that the utilisation of foreign savings would no longer be tied to the size of foreign direct investment.

## Medium-term concerns in selecting a euro strategy

While the long-term gains from euroization are large enough to favour the choice of a fast-lane approach, in the medium term the potential risks and net costs vary substantially among the different possible strategies. Of particular concern is the impact of any chosen strategy on developments in three areas: (1) the rate of inflation – and hence the risk of not meeting the Maastricht criteria on inflation and interest rates, (2) the current account deficit and (3) the size of the foreign debt, the risk being that both the current account and the debt may become excessive. Other causes of concern are supply-side and demand-side negative shocks – that they may be excessive if changes in the zloty exchange rate are too fast and too large. I shall discuss these concerns in general terms in this section and in a somewhat greater detail in the following two sections.

### Inflation and interest rates

While Poland's failure, to date, to reform public finances has increased the attractiveness of an early euroization strategy, it has also increased the risk that Poland will not be able to meet, in the near future, the Maastricht criteria regarding budget deficit and interest rates. There are essentially three possible policy responses to these conflicting implications:

(A) One response is to adopt unilateral euroization as early as feasible on purely internal practical grounds, e.g. soon after joining the EU (probably January 2004).

(B) The second response is to adopt policies explicitly aimed at meeting the Maastricht criteria by about 2005, with a view to join EMU in 2006 or 2007, which is probably the earliest feasible accession date .

(C) The third response is to delay the entry to EMU on the grounds that the costs of meeting the entry requirements are so large that they must be spread over a longer period, e.g. 8 to 10 years.

Strategy (A) offers the benefits of an early entry, in particular much lower interest rates, while finessing the cost obstacle by shifting to a later date the question of meeting the Maastricht criteria, especially on the budget deficit and interest rates. The risks associated with this option are discussed in the next section.

Strategies (B) and (C) are variants of what may be called the standard approach, one which presupposes full co-operation with the European Central Bank (ECB) and the EU authorities.

### Current account and foreign debt

A high-growth strategy in the circumstances of low domestic savings presupposes the acceptance of a high current account deficit. In order to lift the investment rate to a level of about 30% of GDP, the deficit would have to increase from the present level of about 3 to 5% of GDP, to a level possibly in the range of 8 to 10% of GDP.

Foreign direct investment and transfers from the EU may amount to 4 to 6% of GDP. Therefore foreign borrowing by banks and enterprises would have to amount to some 4 to 6% of GDP as well. Given the currently low level of the country's foreign debt, increasing it by about 5% of GDP annually would be acceptable for the several years of the transition period. If the prospect of Poland's joining EMU in about four years were credible, Poland's total foreign borrowing could yet increase substantially without any significant risk to macroeconomic stability. If the official international reserves of the National Bank of Poland are kept comfortably above the short-term debt, augmented by portfolio capital and annual debt amortisation, the maximum safe level of total foreign debt could be some 70% of GDP, which is double the present level of about 35% of GDP. An additional debt of 20% of GDP above the present level would still keep the total comfortably below that maximum and yet be sufficient to finance an additional current account deficit of some 5% of GDP for four years. The debt constraint may therefore be binding for strategy (C), but need not be binding for strategy (B).

**Supply-side and demand-side shocks**

The euroization of the Polish economy would deprive it of the ability to respond flexibly to external shocks through a suitable change of the zloty exchange rate. The associated cost is known, however, or at any rate believed to be relatively small. A much greater potential problem for the real economy is that, during transition to the euro, the zloty exchange rate may become highly volatile, causing significant supply-side shocks for importers, demand-side shocks for exporters, and cash-flow shocks for holders of foreign debt. This exchange rate volatility would be particularly high when the current account deficit is significantly larger than at present. Moreover, an increasing current account deficit under strategies B and C presupposes some persistent real appreciation of the zloty . Such appreciation should also be expected to inflict costs on the supply side. In theory, the cost of the shocks due to high volatility of the exchange rate could be curbed by the ERM-2 arrangement. In practice, the (15% band would have to be shifted under strong market pressure.

## The unilateral euroization strategy

The idea of adopting unilaterally a major world currency, such as the US dollar, the euro or the yen, as a national currency has been proposed or revisited for several countries. This idea has been typically presented as an improvement over a currency board arrangement, and as an even bigger improvement over the standard fixed peg exchange rate policy.

Bratkowski and Rostowski have modified this idea for Poland and some other EU applicant countries (Rostowski, 2001a,b). The modification stipulates that unilateral euroization is just a transitory policy to be followed by full membership of EMU.

**Key advantages**

The unilateral euroization strategy offers two closely related advantages: immediate access to large foreign savings and substantially lower interest rates. These advantages are therefore tailormade for a country, such as Poland, where domestic savings are, and are likely to remain, low for reasons of culture and politics, while the pool of highly profitable investment projects is large due to earlier reforms and the availability of entrepreneurial capital.

**Key risks**

Unfortunately, the risks associated with this strategy are also formidable. The primary risk is that, due to the impact of the Harrod-Balassa-Samuelson effect, Poland will be unable to meet the Maastricht criterion on inflation for a very long time. Sinn and Reutter (2001) calculated that this effect would be much greater in Poland than in Germany with the result that, under the fixed zloty-euro exchange rate, inflation in Poland would be 4.2% higher. This calculation is based on the empirically supported assumption that labour productivity growth in Poland is 10.3% in the traded goods sector and 3.9% in the non-traded goods sector. It is also assumed that nominal wages grow at the same rate in both sectors. Even if the HBS effect is significantly lower than the Sinn-Reutter estimate, it would still pose a risk for an early entry to the official Euro zone.

It is conceivable that the EU countries may be persuaded to modify the Maastricht criterion on inflation for those countries which adopt the euro unilaterally. But the probability that they will keep the criterion in place is too close to 100% for the risk to be ignored. This risk would be priced in by money markets, and this pricing would be reflected in higher interest rates on Poland's foreign debt. If that risk is high, the potential advantages of a unilateral euroization would be much diminished, or even wiped out altogether.

Another risk is that adoption of this strategy would lower pressure on fiscal and other structural reforms. That risk would also be priced in by the financial markets, reducing further any potential advantages of the unilateral euroization strategy.

Finally, until Poland joins the EMU, there would be the standard risk associated with a fixed exchange rate, namely that foreign borrowing by corporations could explode, as it did in the Czech Republic in 1995 (Dedek, 2001).

## The standard strategy: a fast lane variant

### A broad outline and timetable

This option is, I believe, still the current official strategy. Its central theme states that: "*[i]n view of the large benefits which an early entry to the EMU would bring about, Poland will offer to submit its exchange rate policy to the rigours of the ERM-2 soon after joining the EU*" (Government of Poland, 1999, p. 26). If Poland were to join the EU on 1 January 2004, this statement proposes to join ERM-2 sometime during 2004, and to join EMU two years later or soon afterwards.

### Initial conditions and macroeconomic policies

The initial conditions of transition to EMU must be carefully noted, since they will have a large impact on economic policies, the macro-financial risks and the growth performance during the transition period. The standard euroization strategy will be helped by the currently low stock of foreign debt and the high rate of unemployment. As noted earlier, the low level of debt provides room for a sizeable increase of the current account deficit from the present 3–5% of GDP. Such an increase would serve two purposes. It would provide room for some real appreciation of the zloty and it would permit a high rate of economic growth. The high unemployment rate will keep the growth of nominal wages low, and this should help to stabilise inflation at a rate close to the currently very low level. Low inflation would permit the central bank to keep interest rates on a declining trend. This latter is needed to meet the Maastricht criterion on interest rates. Lower rates would also stimulate bank borrowing by companies. This borrowing remains low by international standards, which is another favourable initial condition of the Polish economy. Bank credits would be funded to a greater extent than at present by foreign borrowing. This borrowing would be encouraged by the expectation that, during the transition, the zloty will rather appreciate than depreciate. But any appreciation should be moderate. Kawalec and Krzak (2001) warn that the current policy of pure floating may cause excessive appreciation which could stifle economic growth. They advocate a policy of 'controlled appreciation'. Although agreeing that a rapid appreciation should be avoided, this aim can and must be achieved while keeping the economy on the targeted low inflation path. Hence the balanced policies proposed here: little growth of public expenditures, much lower budget deficits of the general government as a result of faster growth, lower real interest rates, higher current account deficit, fuller labour market liberalisation, official reserves kept above short-term debt, the long-term debt of corporations allowed to increase more sharply.

It is interesting, though perhaps not surprising, that the current theoretical debate on exchange rate policies has revealed sharp disagreements between supporters of fixed and floating exchange rates (Reinhart 2000, Obstfeld and Rogoff, 2000), prompting Williamson (2000) to argue against any 'corner solutions'. In fact, monetary authorities and governments in most countries have tended to practice the Williamson doctrine (Calvo and Reinhart, 2000). The intended adoption of ERM-2 by Poland would mean embracing this doctrine for a while with respect to the euro. Following the entry to EMU, Poland will have a fixed peg for transactions within the Euro area and fully floating rates for transactions outside the area. This arrangement, though a combination of two corner solutions, will be a kind of intermediate solution.

An important feature of the initial conditions in Poland is a severe 'reform deficit' in the areas of public finance. Large and increasing unemployment have already induced a substantial liberalisation of the labour code, and this, in turn, will keep both the growth of nominal wages and the natural rate of unemployment low. A reform of the public finances is, however, still needed to release resources for investment and growth. This redistribution of resources requires a restructuring of public expenditures away from social transfers. If such a restructuring does not take place, which is a possible development during the transition period, the unemployment rate will continue to be very high. Although this outcome could increase social tension, it should also help to keep the economy on the targeted low inflation path.

The only necessary fiscal requirement is the Maastricht criterion of keeping the deficit below 3% of GDP. But this EMU entry requirement can probably be met without substantial fiscal reforms. The Maastricht stability and growth pact would require Poland, after joining EMU, to have a balanced budget on average and a budget surplus in years of rapid growth. However, meeting this post-entry requirement would be eased by lower debt servicing costs, the EU net transfers to the budget and some 4–5 years of GDP growth between now and the entry date.

### Macroeconomic risks

There will be considerable risks associated with this fast lane variant of the standard euroization strategy. These risks have five ultimate causes: excessive and poorly structured public expenditures, low domestic savings, an economy capable of fast productivity growth and high returns to investment, hence high investment demand, high growth of the labour supply, and a large pool of poorly educated labour. The first two causes are interrelated. Attempts to remove these two causes have so far been largely unsuccessful. But if domestic savings continue to be low, then in view of the high growth potential, we have a range of possibilities between the following two extreme scenarios.

One such scenario is that which we have already begun to observe in the years 2000–2001: a moderate current account deficit, a low increase in foreign debt, extremely high real interest rates and, as a result, a costly recession in industry and construction, and very high and still increasing unemployment. Under this scenario, the risk of a macroeconomic instability is indeed close to nil. However, the rate of unemployment could reach a socially unsustainable level, affecting very seriously some parts of the country and some segments of the population. This experience of rapid and prolonged poverty growth rather than economic growth is bound to put into question the underlying policies. The other extreme scenario is the one outlined above: a high current account deficit, a moderately rapid increase in the foreign debt of corporations, much lower real and nominal interest rates, rapid growth of GDP, and stable or declining unemployment. Under such a policy, the zloty may appreciate moderately in real terms, and this appreciation, along with high unemployment and labour market reforms, would help to meet the Maastricht criteria on inflation and interest rates. The risk of a macroeconomic instability would be clearly higher than at present, might well become significant, rising together with the size of the foreign debt in relation to GDP. However, as was argued earlier in this paper, this risk need not be excessive if the projected entry date to EMU, the years 2006–2007 were credible. The conditions required to keep this risk acceptable are that the debt increase is smooth and takes place at a moderate rate, the debt's maturity composition is heavily skewed in favour of post-entry dates, and official reserves are kept comfortably above short-term payment obligations. The main intellectual and policy innovation of the fast growth variant of this standard euroization strategy lie in the acceptance of high current account deficits already during the transition to EMU.

Intermediate cases are those which lie between the two extreme strategies.

## The standard strategy: a slow lane variant

The losses associated with a delayed entry to EMU are self-evident. But are there any substantial gains? Can the costs and the risks associated with a fast lane variant of the standard strategy be reduced significantly by postponing the entry for several years?

Let us recall that the costs and the risks of that strategy are interrelated. The former are associated first and foremost with the expected real appreciation of the zloty, while the latter are associated with a projected high current account deficit and an increasing level of foreign debt. Given the large size of the HBS effect, some real appreciation may be needed to support a low-inflation policy, while in view of the low level of domestic savings, the current account deficit will be required to support a high growth policy.

These costs and risks can be reduced if strong reforms are undertaken to increase both domestic savings and the flexibility and competitiveness of domestic markets, especially the labour market. It may be argued that although the Buzek-Balcerowicz attempted reforms of this kind have failed, in the new circumstances of very high unemployment, the need for such reforms could become more evident to political leaders and the general public. The recent implementation of a more flexible labour code is a clear expression of that need.

However, one cannot rule out the scenario that the much needed fiscal reforms will not be undertaken during this current decade. In the medium term there might, indeed, be some regress in this area of the public finances, beginning with the adverse fiscal developments in 2001. Does this mixed reform scenario provide a case for adopting a slow lane variant of the standard euroization strategy?

The answer depends on the magnitude of risk which it would be sensible to accept. If regress in the public finances were to be considerable, then the risk of macro-economic instability associated with an attempt to implement the fast-lane variant would increase sharply, making it at some point a sub-optimal strategy.

## Concluding remarks

The unilateral euroization strategy, if adopted, would bring about the substantial benefits which Poland stands to reap by adopting the euro as its national currency. However, the strategy involves the risk that the date of official entry to EMU will be highly uncertain, possibly much delayed. Therefore this strategy could and should become a serious candidate for consideration only if the Maastricht criteria on inflation and interest rates can be renegotiated. As things stand now, the choice is, effectively, between different variants of the standard strategy. The costs and risks associated with a fast lane variant of this strategy are considerable. However, the initial conditions and potential net gains are such that Poland should and is likely to attempt to implement that variant.

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