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# Poland's Accession to the EMU

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# Contents

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## Abstract

This paper is focused on the development of a proper macroeconomic strategy in the process of Poland's accession to the European Monetary Union. It is argued that due to legal and political considerations Poland may not opt out from EMU participation. The country will however command net gains from participation in the eurozone, mainly due to reduced macroeconomic and microeconomic uncertainty. In order to achieve even higher gains it is necessary to reduce price and wage rigidities, eliminate constraints on free movement of labor, further promote trade links with EU and its diversification. Loss of monetary and exchange rate instruments will require responsive but generally conservative fiscal policy. Particularly, as Poland might experience major economic upturn at the outset in the EU membership, the country should achieve positive budget balance by this time. It will allow for fiscal expansion in case of future negative asymmetric shock or recessions. Fiscal policy should be therefore assigned to improve saving-investment balance and consequently current account, so that direct inflation targeting is well placed to achieve fulfillment of Maastricht price stability criterion. Real exchange rate is not an independent instrument to target current account, as real appreciation of domestic currency is unavoidable due to rapid productivity gains in Poland. Finally, the accession to EMU should follow promptly the accession to EU. Unilateral introduction of Euro is too risky for banking and real sectors. Slower process of joining EMU would hamper credibility of macroeconomic adjustment commitment.

# 1. Introduction

Poland, the most advanced reformer has major difficulties in responding to the consequences of its own success, i.e. intensive capital inflows and dynamics of consumption and investment that are above the supply side capacities. Existing imbalances are consequently reflected in persisting relatively high rate of inflation, budget deficit and growing current account deficit.

Many problems central to these developments can be solved only by measures improving efficiency of the government structures and competitiveness of Polish firms. Many unfinished structural reforms put a limit on the sustainable rate of growth. It should be underlined that good macroeconomic policies may not be viewed as substitute for structural reforms. Opposite, however is also true: adjustment in real sector may not take place without good macroeconomic framework. Consequently, this paper is focused on macroeconomic policies with special attention paid to problems of proper coordination and changing roles of fiscal and monetary policies. The most controversial issue of the correct path of exchange rate regime is also discussed.

This paper evaluates policies in the medium term perspective that is in the context of the future participation in the European Monetary Union [1]. This context limits considerably – due to international obligations – the pool of possible policy actions but also poses new problems to the policy makers. Therefore, question "How well policies formulated today fit the accession challenges" should be increasingly important in the decision taking process. For that reason, this paper deals with issues that are expected to become crucial after full integration of Poland with the European institutions and during the process of integration. In line with such a "backward induction" approach, characteristics of post-accession situation are first considered (terminal conditions or quasi steady-state analysis), and then considerations about transition period follow (path of changes). Finally, policy recommendations on "How to get from here to there" are drawn.

[1] This paper was prepared during the Applied Economic Policy Course 3 in Joint Vienna Institute under supervision of Angel Antonaya and Johann Schulz.

# 2. Integration into European Monetary Union

## 2.1. Decision about Participation in EMU

European Economic and Monetary Union (EMU) is widely recognized as an extension to the single market emergence. More profoundly EMU is a major political project aimed at pushing European integration forward and making it even more irreversible. Similarly, Poland's accession to EMU is logical consequence of EU membership and needs to be viewed as the last stage of integration. As such, a decision about joining EMU has predominantly political and not economic character. Failure to qualify for EMU would probably lead to a deep political crisis with unknown consequences. On the other hand, convergence to the Maastricht criteria might increase the bargaining power of Poland's negotiators during EU accession process.

Accordingly, Copenhagen criteria of June 1993 – that summarize major preconditions for EU membership – require applicant countries to have "the ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union". EU Commissioner for Economic and Monetary Affairs gave recently rather simple interpretation of this criterion: "EMU is part of "Community Patrimony" which those countries that have applied for membership must adopt to be allowed to join. So it is probable that new Member States will take part in EMU from the outset, with a derogation for the adoption of the Euro" [2]. Consequently, Poland immediately after accession will have to adopt the *acquis communautaire* related to the stage 2 of monetary union (i.e. parts of Stability and Growth Pact). It includes the obligations on liberalization of capital movements, principles of independent central banking, prohibition of the central bank financing of public sector deficit and privileged access to financial institutions. Coordination of macroeconomic policies is also explicitly mentioned. Last but not least, Poland, as a member country, will have to become a party to the second European Exchange Rate Mechanism (ERM2), as it is discussed below.

The economic rationale for joining EMU will be therefore of limited importance while the decision is made. Still European Commission expects that "it is unlikely that applicants will be able to join the Euro area immediately upon accession". Because of these considerations, economic case for participation in eurozone is discussed below

[2] European Commission (2000), Infeuro, No. 14.

rather briefly – there is no really "opt out" alternative – while more attention is given to considerations about EMU accession process.

## 2.2. Benefits and Costs from Participation in EMU

Although creation of monetary union in Europe and future membership of Poland in the monetary union is a result of political rather than economic process, economic effects of EMU will be significant and will be more far reaching than only deepening of the single market. It is therefore important to assess benefits and costs of introducing of the single currency in Poland. Such evaluation will make the discussion of optimal accession strategy better informed.

Among main benefits from EMU membership it is possible to name:

– trade creation,

– reduced transaction costs,

– reduced costs of exchange rate volatility and hedging,

– reduced risk premium and therefore real interest rates (especially: no fear of devaluation),

– import of low inflation, therefore reduced uncertainty and low nominal interest rates,

– discipline in macroeconomic policies – through obligations of the Stability and Growth Pact (S&GP),

– disappearance of asymmetric financial market and money shocks.

All of these effects should lead to the increase in investment, trade and competitiveness of markets. As a result a higher rate of growth of production and employment might be expected. Additionally, Poland's participation in the EMU may:

– give Polish policy makers some control on decisions made by the European Central Bank (ECB) that have impact on Polish economy anyway (especially under non-flexible exchange rate regimes).

On the other hand, Poland will face significant costs of EMU membership:

– loss of monetary policy to cope with country specific disturbances (as at least in short-term money is not neutral),

– possible pro-cyclical policy of ECB due to different business cycles in Poland and core eurozone countries,

– no exchange rate offset to possible asymmetrical shocks and loss of exchange rate as early signal of such shocks,

– double fiscal tightening: S&GP budget deficit requirements at the time of costs of single market accession being incurred,

– possible S&GP obligations of fiscal tightening at the time of an economic downturn (when scope of recession is not significant enough for safeguards measures),

– low seigniorage (however due rather to the lower inflation than participation in the union itself),

– high output-inflation "sacrifice ratio" unless price and wage rigidities removed,

– risk of "core and periphery" model of development.

Gains and costs of the participation in EMU can be further assessed within the framework of the Optimal Currency Area (OCA) theory formulated in early sixties by Robert Mundell (1961).

**Table 1. Factors of success for participation in OCA**

<table>
<tr><th>Factor</th><th>Importance</th></tr>
<tr><td>Small relative size of the country</td><td rowspan="3">Danger of asymmetrical shocks<br>Scope of reduction in transaction cost and uncertainty</td></tr>
<tr><td>Deeper economic and political integration</td></tr>
<tr><td>Similar structure of economy</td></tr>
<tr><td>Public indebtedness</td><td>Risk premium reduction</td></tr>
</table>

On the more operating level key success factors for countries forming (joining) OCA may be represented as follows:

– openness to trade,

– diversity of production,

– mobility of factors of production,

– flexibility of prices and wages,

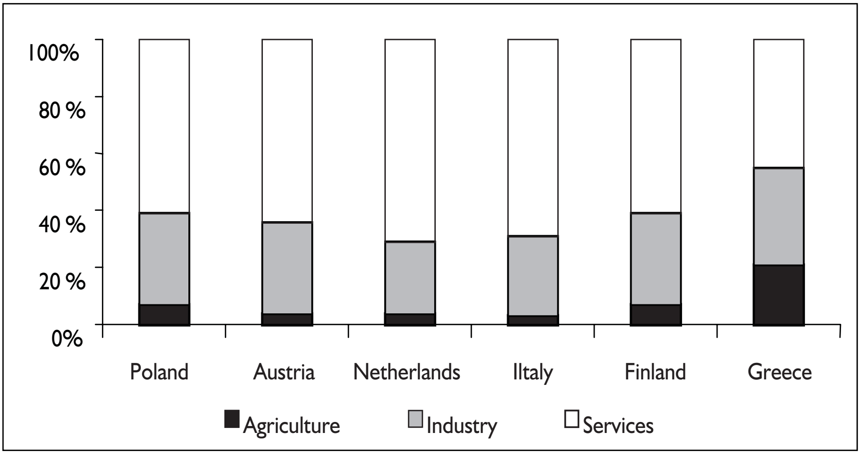
– coordination of fiscal policies.

The general picture that emerges from various studies shows that only a subset of current eurozone countries can be qualified today as forming the optimal currency area. Economic research into the degree of correlation of business cycles of countries participating in EMU shows that some peripheral countries may face additional volatility of output due to the relegation of monetary policy to the European Central Bank [Bayoumi and Eichengreen, 1993, Pautola, 1998 offer an overview]. Importance of exchange rate as shock absorber is also often underlined [Dornbusch, 1996]. On the other hand examinations of past exchange rate movements sometimes indicate that real shocks were seldom determining nominal rate movements and thus the adjustment role was limited [Flood and Rose, 1995;

Conzoneri et al., 1996]. It would suggest that the loss of the exchange rate instrument is not so important.

Similar uncertainty characterizes discussions about consequences of Poland's accession to EMU, although general consensus is that Polish economy is not fundamentally worse prepared for joining monetary union than some of present members [Kopits, 1999]. Indirect evidence on business cycle in Poland (as direct analysis is not possible due to short time series) suggests relatively high convergence with core eurozone countries (especially Germany). Also the structure of the Polish economy is not significantly different from this of EMU participants (see: Figure 1). The Polish economy is open with approximately 70% of trade with the EU countries (see: Figure 2). Further on, most of trade between Poland and EU is rather intra-industry and not inter-industry. This means that trade takes place in diversified varieties of products rather then in various products with different factor contents. Such characteristic limits substantially the risk of asymmetrical shocks.

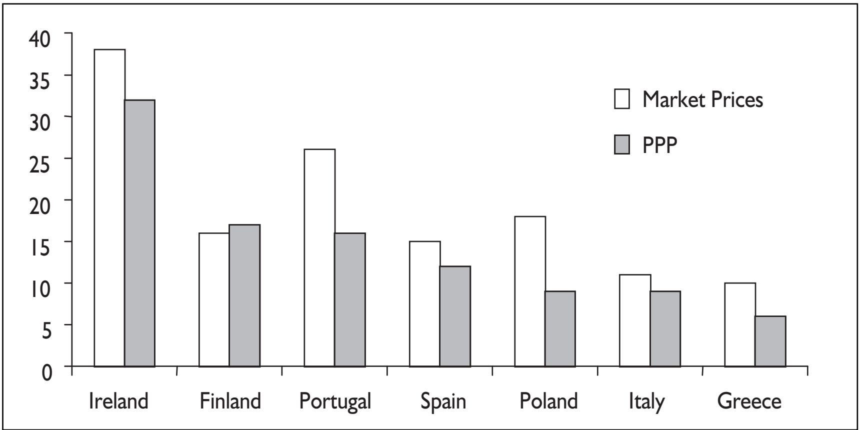
**Figure 1. Structure of GDP by Sectors (%), 1997**




Source: Kopits (1999)

One consideration that cannot be skipped is the endogeneity of the economic convergence: once the country participates in the common system, the convergence of economic cycles becomes more rapid – mainly through the higher intensity of trade. On the other hand, there might be concerns about the risk of higher concentration of production after full integration in the European economy. Due to fall in transaction costs and presence of economies of scale, agglomeration effects may build up with clusters of specific industries

**Figure 2. Trade with EU as % of GDP, 1997**




Source: Kopits (1999)

locating increasingly in specific countries. In such a situation the risk of asymmetrical shocks will be increased. Intra-national regional problems serve here as important warning.

It is the structure of labor market that is of particular importance for the successful participation in monetary union. Firstly, flexibility in wages together with the freedom of migrations is essential for adjustment for negative asymmetrical shocks. Secondly, more successful introduction of forward-looking wage bargaining instead of existing indexation mechanisms is necessary. Analysis of historical exchange rate movements suggests that real exchange rate, calculated on the unit labor costs basis remained broadly constant since 1993 [Kopits, 1999]. Throughout the period changes in nominal exchange rates reflected a rise in the domestic currency denominated unit labor costs (which almost doubled due to wage dynamics higher than productivity growth). Therefore, if Polish industry is to remain competitive under single currency, wage inflation must be significantly reduced and that requires elimination of backward looking wage formation mechanisms. The government may therefore have significant role to play by reforming labor institutions in order to reduce wage (but also price) rigidities.

## 2.3. Macroeconomic Policies under EMU

The key challenge for eurozone countries' governments now, and for Polish government in the future, is to position macroeconomic and structural policies in such a way as to deal with country specific problems while maintaining coordination with other union members. Unfortunately, even after more than a year since the introduction of common currency, fundamental questions about the macroeconomic policy regime under EMU remain open. Indeed, the only exception is the strong commitment of the European Central Bank to the single target, i.e. price stability (what is widely understood as mean inflation below 2% annually). Fiscal prop for macroeconomic stabilization in the eurozone is far behind, both in conceptual and institutional terms. The difficulties arise exactly from problems of merging nation- and union-wide interests. As Poland will share similar dilemma in the future it is useful to show considerations about various policy outcomes [cf. IMF, 1998].

National policy makers see fiscal adjustment as the only remaining tool at hand to protect interests of their economies at times of economic distress, while they do not pay enough attention to more flexible income policies. For that reason national authorities are extremely reluctant to give up the autonomy of fiscal policy making. However, externalities that fiscal adjustment in one country might have on situation in other countries constitute major economic rationale for policy coordination. Spillovers of benefits and costs are stronger; the stronger are financial and trade links among countries. Under a single market, and especially monetary union, issues of coordination are of a special concern [Catenaro, 1997]:

– Heavy borrowing by one member of the Union raises interest rates in all Union by:
  - increasing the burden of debt for other countries,
  - crowding out investments,

– Heavy borrowing by one country increases the uncertainty and increases the fears about possible default that other countries would have to bail out,

– Impact of domestic policies on Euro exchange rate that affects all member countries,

– Heavy borrowing may increase inflationary pressures in all countries.

These effects may be very strong, because countries may lock themselves in the sort of the "prisoner's dilemma" situation. Fiscal policies in the monetary union are very effective (compare: fiscal policy under Mundell-Flemming fixed exchange rate regime) and especially smaller countries may tend to neglect impact of these policies on overall fiscal situation in the monetary union. Accordingly, member countries perceive that the impact of domestic policy on the credibility of inflation target is much lower in the Union then at the national level. If consequently all countries engage in anticyclical fiscal policies, ECB (although probably having stronger relative position than national central banks have) will be under significant pressure for more accommodating monetary policy. For that reasons some authors suggest that inflation in the monetary union might be higher than it will be on average for its member countries [Goodhart, 1992].

These considerations generate strong support for fiscal rules in the eurozone and formulation (at the initiative of Germany) of Stability and Growth Pact (S&GP) in 1997 as the follow up for Maastricht Criteria. S&GP imposes a permanent 3% cap on budget deficit (unless country is in serious economic downturn) for eurozone members supported by the system of penalties for non-compliance. Confidential and then public reprimands, if inconsequential, are followed by financial penalty of 0.25% of GDP for every percentage point of deficit above 3% threshold. Moreover, countries are requested to sustain a near zero balance budgets and are advised to have a surplus in economic upturns. S&GP is regarded as very controversial:

– the penalty itself will increase the deficit even further,

– fear of penalties may generate creative accounting and reduce the transparency,

– penalties may lead to the political backlash against Union,

– cuts in expenditures necessary to achieve more strict fiscal policy have, according to studies, strong negative effects on output (even 1:1) – risk of vicious circle: cuts-recession-cuts [McAdam and Hallet, 1998].

Real controversy focuses, however, on the issue of:

– credibility and flexibility of fiscal policies under S&GP [see: Catanero, 1997 for overview].

The economic rationale behind S&GP is to limit the deficit to values close to zero in order to allow for the room for anticyclical fiscal policy, when countries are in the economic downturn [Goodhart, 1996]. However, in order to contain fiscal deficit at 3% it would be anyway often necessary to depress the working of automatic stabilizers: studies show that 3% deficit during historically big downturns corresponds to a policy with 1% deficit at the full employment level of output. While the main principle of S&GP is right, it might be to simplistic to have the same target established for all countries and for every period in the business cycle – the threshold should be rather cyclically adjusted. As a matter of fact, S&GP represents a rather imperfect substitute for fiscal federalism and it explicitly calls for a stability council to coordinate fiscal policies. In any case, there are hopes that S&GP will put an end to pro-cyclical, and therefore, destabilizing fiscal policies of the 80's and 90's that focused on actual rather then cyclically adjusted deficits. It should also help governments to simply establish most sustainable fiscal policy in longer time perspective, decrease the level of indebtedness and save some government programs, especially pension schemes from bankruptcy [Artis and Winkler, 1997]. Similarly it was argued that Maastricht Criteria formed consistent policy framework necessary to keep indebtedness of

Member States unchanged with inflation and real GDP growths forecast at 2.5% annually. Sometimes it is also suggested that Maastricht and S&GP obligations are simply derived from the German golden rule: the government can borrow just to finance investments (that are usually 3% of GDP), while 60% is just average of debt in the participating countries [Wyplosz, 1997].

### 2.4. Lessons for Fiscal Policies in Poland

What is probably the most important policy constraint for Poland in its entry into EMU is the future permanent obligation to contain the fiscal deficit to 3% of GDP. Furthermore, the Polish authorities will need to have some room for spending economy out of economic downturns that may follow negative asymmetrical shocks, that are likely to happen (as discussed above) because of imperfect business cycle convergence with core European economies. Fiscal policy should be, therefore, carefully planned, being responsive to negative developments but generally very conservative to have sufficient room for maneuver at times of downturn. While contractionary convergence towards Maastricht targets among the first members took place during an economic recession, joining EMU will mean for Poland simultaneous fall in the risk premium and boost for investment and consumption. If accession to EMU will coincide with economic upturn in Poland, the country should run at the time budget surplus. Therefore, Maastricht criteria (see: Table 2) may provide helpful, however not sufficient fiscal commitment during the process of integration to EMU. While Maastricht fiscal criteria are probably not restrictive enough, Poland may have fundamental difficulties in meeting simultaneously target on

**Table 2. Maastricht Criteria (for joining eurozone)**

| | |
|---|---|
| Total public debt | no higher then 60% of GDP (or proved convergence towards this level) |
| Public sector deficit | not higher than 3% |
| Inflation | not higher than 1.5% above the average inflation in three Member States with lowest inflation |
| Long term interest rates | not higher than 2 percentage points above average rate in three Member States with lowest rates |
| Exchange rates | volatility must remain within +/-15% band around base rate |

Source: Maastricht Treaty

inflation and exchange rate. The following section is therefore focused on the path of accession to EMU.

# 3. Path of Integration into Eurozone

## 3.1. Policy Challenges

Ultimate goal of the Polish macroeconomic policy in the medium term (3 to 10 years) should be fulfillment of Maastricht criteria and successful participation in the eurozone. Membership has to be preceded with the 2-year long participation in the ERM2. During this period exchange rate should be floating, however as a precondition for joining the Eurozone, it should remain within a +/-15% band around base rate. This might be difficult to achieve due to volatile inflows and outflows of short-term capital, largely because of the convergence play and rapidly falling rates of inflation. Excessive dynamics of absorption might also spoil the quality of macroeconomic stabilization and make it impossible to meet Maastricht targets. Such negative development would lead to the prolongation of the transition period and would make markets more skeptical on any future commitment.

There are two major possible risks to achieving the goal of ERM2 criteria:

– inappropriate macroeconomic policies, high inflation inertia and need for exchange rate adjustment,

– excessive capital inflows destabilizing otherwise sound macroeconomic environment.

Basic recommendation to reduce these risks is a conservative policy both in fiscal and monetary sphere, with latter requiring *inter alia* more effective instruments to absorb excess liquidity. This would lead not only to reduced deficits and inflation but also reduced uncertainty. Also continuation of structural reforms, as it was stated in the introduction, is the must for achieving real stabilization. Estonia serves as a good example in this context. Wage flexibility, restructuring and fiscal discipline made the Estonian currency board arrangement immune from any pressures from market sentiments even during the Asian and Russian crises. There are however many issues that might require attention even if the basic requirement of sound policies is fulfilled.

### 3.2. Policy Targets and Instruments

The case for close coordination of macroeconomic policies is very strong during the period preceding integration with eurozone. During this period Poland will have to be member of ERM2, targeting at Maastricht criteria. Neither fiscal nor monetary policy could alone achieve these goals. On the contrary, each instrument of macroeconomic policies should be assigned to target variable that is relatively most sensitive to this instrument. Therefore, what is essential for macroeconomic policy, it is to establish:

– policy goals and targets,
– appropriate policy instruments,
– optimal assignments among policy goals, targets and instruments.

This paper argues that fiscal policy should be assigned to achieve desired internal saving-investment and therefore also current account balance while monetary policy should be focused on targeting monetary developments and the overall external balance (level of foreign reserves). As it was noted above the accession process is likely to be accompanied with investment and consumption boom (that arguably has been already started). This expansion should be compensated by fiscal contraction that would allow achieving the internal equilibrium and sustainable current account. If there is no adequate fiscal response, monetary policy is forced to make up for this failure. However internal adjustment through monetary contraction has strong destabilizing effect on external balance and monetary aggregates. High interest rates generate substantial capital inflows, as international financial markets are more responsive to increased interest rates in comparison to domestic absorption. Capital inflow leads in turn to real appreciation either through nominal appreciation or higher inflation. It is crucial to note that in such policy setting real exchange rate is therefore not an independent instrument to target current account. The latter real appreciation channel works in the following way: if bank chooses to intervene in order to prevent nominal appreciation, overall surplus of balance of payment (BOP) is likely to emerge. Increasing stock of foreign reserves then leads to the growth in money stock and therefore increases inflationary pressures. Sterilization of interventions might in longer run be ineffective and also very costly.

### 3.3. Macroeconomic Policy Stance in 2000

Indeed, absorption rather than exports have fueled the economic growth in Poland in the last two years. This has to constitute the major concern for policy makers as the trade balance and current account are deteriorating with the latter in the thrilling deficit above 7% of GDP. The case for more conservative fiscal policy is therefore evident.

The situation in the public finance with unexpectedly high deficits generated by reformed extra-budgetary schemes, as pensions and health care, is especially worrisome is. It is true that at times fiscal policy relaxation during transition is justified, if it reflects the budgetary costs of transition. On the other hand, hard budget constraint is the necessary requirement for the microeconomic adjustments and in the medium term ability to achieve nearly balanced fiscal position is the best reflection of the quality of reforms. Branson et al. (1998) suggest introduction of stronger commitment mechanism to fiscal targets at the pre-accession process in order to improve fiscal performance. Also more transparency in public finance is a necessity, not only to meet EU regulations, but also in order to set good policy goals [Kosterna, 1998].

Without proper fiscal policy, monetary and exchange rate policies in Poland in recent years are driven by two, sometimes contradictory targets: disinflation and sustaining external competitiveness. Previously this situation was reflected in the double-anchor monetary policy, that targeted both monetary aggregate and exchange rate crawl. Competitiveness considerations are, however, in the contradiction with the logic of present official central bank's strategy of direct inflation targeting (introduced in order to speed up disinflation process). High interest rates to reduce inflation attract substantial inflow of short-term investments that put pressure on appreciation of the Polish currency as described above. Appreciation makes the public concern about high current account even more pronounced. That introduces a lot of uncertainty into financial markets and may prompt investors to speculate against the Polish currency. So far such speculations are unsuccessful mainly because of lack of instruments, as short-term capital movements are still not fully liberalized. As remaining capital controls will be abolished when Poland joins ERM2, fundamentals (mainly fiscal policy) will have to be substantially improved.

Meanwhile the exchange rate regime in Poland under transition evaluated from fixed exchange rate towards more flexible regimes. Firstly, crawling peg was introduced, followed by crawling band with changes towards decreasing the rate of peg (to help disinflation) and widening of the band (to stem capital inflow). Finally, fully floating exchange rate regime was introduced in April 2000. However, regardless of the regime, the exchange rate in the last years was (due to capital inflow) always close to the upper band. This situation was changing only temporarily for short spells following Asian and Russian crisis. Policy makers actually welcomed such weakening of the Polish currency, as it alleviated them from dealing with an uneasy inflation-current account deficit dilemma. Floatation should allow for a higher uncertainty for speculative investors and can facilitate inflation targeting as a means for meeting criteria of ERM2. It is interesting that during the integration to EMU the trend towards flexibility will be reversed towards eventual establishment of – this time irreversible – fixed exchange rate regime (common currency). However this transition should be especially carefully planned as it may even aggravate current difficulties.

### 3.4. Strategic Options

As it is stated above, joining the eurozone is the unquestionable primary policy objective. However, policy makers have the responsibility to choose the right path and speed of integration to the single currency area in the macroeconomic setting as described in the previous section. Three possible options might be considered [cf. CASE, 1999]:

– accession to EU preceding EMU by many years,
– joint accession to EU and EMU,
– unilateral introduction of Euro.

One obvious policy option is simply a delay in the accession to the eurozone. Apart from all political costs of such decision (worse position in the accession negotiations, second category membership) it may probably not make later adjustment easier. On the other hand, maximal acceleration of the process (as a result, joining Euro zone could coincide with EU enlargement) could have positive impact on the stabilization efforts (especially budget deficit and inflation)."Deadline pressures" were arguably the necessary element of introducing Euro in the present member countries. Additionally, economic costs of not joining eurozone and participation in ERM2 may be high by preserving difficult choices between price and current account targets, what always poses a risk of a currency crisis.

The third policy options is to introduce Euro unilaterally and in a single step. Polish foreign currency reserves are sufficient to provide for conversion of the money stock into Euros. Such radical action could eliminate credibility problems associated with gradual transition (no possibility of devaluation) and therefore would make the economy less vulnerable to financial turbulence. Accordingly, policies would not have to be so strict. On the other hand, such a policy would mean irreversible loss of exchange and monetary instruments in the process of stabilization of output during real shocks. However, the real sector in Poland is not prepared yet to this change: what can be expected is the overheating of the economy due to rapidly falling interest rates with the falling competitiveness of enterprises. Another costs of this solution are the loss of seigniorage revenues and lender of the last resort abilities of the central bank (although this function can be also played by foreign commercial banks). This solution would also take economic agents by surprise and would not allow for the "learning" of the new macroeconomic environment. Lastly, such policy will receive rather unsupportive reaction from ECB and European Commission. Therefore, it is suggested that the policy option of immediate euroisation is too risky and should be rejected.

### 3.5. Recommended Exchange Rate Policy

While assessing three options, one basic observation needs to be made. It is not possible to escape fundamental Balassa-Samuelson effect, as the successful accession to European structures must be combined with high productivity growth, supported by further structural reforms. Consequently, if rate of productivity growth in Poland is higher than in EU countries, Polish currency has to appreciate in real terms. The real question in the medium term period is simply whether to allow this process to take place through the nominal appreciation of the currency (more flexible exchange rate regimes) or rather through inflation under the fixed exchange rates (introduction of Euro). It should be noted that competitive devaluation might not solve any problems in the longer-term perspective, as it would cause even higher inflation to follow. Some politicians choose however to promote devaluation strategy and to ignore the argument that current account deficit should be tackled through the promotion of domestic savings, especially through a reduced budget deficits.

After assessing various options the most recommended one is that of maximally short period of restrictive macro-policies under ERM2 with accession to EMU, following promptly the accession to EU. This option will generate disciplinary framework for macroeconomic policies. This would leave some space for compensation for productivity growth through initial exchange rate movement. Fiscal contraction with possible revaluation of currency would help the disinflation process and convergence to Maastricht inflation target. At the same time, productivity growth should be as high as possible, to further decrease inflationary pressures when the convergence with Maastricht criteria are evaluated.

Additionally, there are ways of reducing the volatility of the forex market without involving central bank in costly rate-defending operations during participation in ERM2. The central bank may, for example, establish a rule of restoring the exchange rate to the parity value shortly after major market turbulence. France used this rule in the period preceding introduction of Euro to improve credibility of its policy commitment. Such arrangement is superior to capital controls, which are not in line with EMU regulations, and moreover are non-market based and highly distortionary.

## 4. Summary – Policy Recommendations

This paper was focused on the development of good macroeconomic strategy in the process of joining European Monetary Union. Therefore recommendations listed below do not address explicitly structural measures, irrespective of how essential they might be for the successful integration into European structures. At the same time macroeconomic policy adjustments suggested below will be impossible to implement unless based on fundamental structural and institutional changes.

EMU participation:

– Poland may not opt out from EMU participation due to political considerations and the logic of European integration;

– Poland will command net gains (expressed in economic growth rates) from participation in the eurozone, mainly due to reduced macroeconomic uncertainty;

– It is necessary to reduce price and wage rigidities, eliminate constraints on free movement of labor, further promote trade links with EU and its diversification.

Fiscal policy under EMU:

– Fiscal and structural policies need to deal with country specific problems though coordinated with other union members;

– Loss of monetary and exchange rate instrument will require responsive but generally conservative fiscal policy;

– As Poland might experience major economic upturn at the outset in the EU membership, it should achieve positive budget balance in order to be prepared for fiscal expansion in case of negative asymmetric shock or recession.

Macroeconomic policies before joining EMU:

– Fiscal policy should be assigned to improve internal (saving-investment) balance and therefore also acceptable level of current account deficit. Fiscal policy needs to be tightened in order to meet these goals;

– Monetary policy should be targeting domestic credit and overall external balance that conditions level of foreign reserves and therefore money stock. Direct inflation targeting is well placed in this setting for future fulfillment of Maastricht criteria;

– More successful introduction of forward-looking wage bargaining instead of indexation mechanisms is necessary for successful disinflation process;

– Real exchange rate is not an independent instrument to target current account and real appreciation of currency is unavoidable due to rapid productivity gains;

– Accession to EMU should follow promptly the accession to EU. Unilateral introduction of Euro is too risky for banking and real sectors. Slower process of joining EMU would hamper macroeconomic adjustment commitment;

– In order to limit speculative attacks central bank should establish a rule of restoring the exchange rate to the parity value short after major market turbulence;

– Full capital liberalization without significant tightening of fiscal policy and further improvements in soundness of banks would probably lead to a financial crisis.

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