2007

Monetary and Fiscal Policy in Poland During the EU Accession

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6. Monetary and fiscal policy in Poland during EU accession

Lucjan T. Orlowski*

6.1 INTRODUCTION

The main objective of this chapter is to review the fiscal and monetary policies of Poland for EU accession and to extract their guiding precepts. Only the most essential aspects of fiscal and monetary convergence are examined, with some attention to institutional convergence. An in-depth analysis of institutional convergence falls beyond the boundaries of this study, as its main focus is on the systemic foundations of macroeconomic stabilization policies during the economic transition and in the course of preparations for EU accession. The chapter also examines policy options for the post-accession macroeconomic policy strategy which will focus on preparations for adopting the euro.

This chapter underlines the importance of imposing and preserving fiscal discipline and political stability on the road to Poland’s accession to the EU which took place on 1 May 2004, and to the future adoption of the euro. Special attention is drawn to fiscal restructuring and bringing about compliance with the European System of National Accounts. In addition, the implications of the expected net transfers from the EU budget are examined.

The evolution of Poland’s monetary policy, which is marked by a passage from a simple policy framework based on a hard peg to a modern, complex regime based on direct inflation targeting (DIT) is examined. With respect to the tasks related to monetary convergence to the euro, the main analytical hypothesis is that the current strict DIT regime is not conducive to adopting the euro. It needs to be more flexible, that is, to incorporate the objective of stabilizing the exchange rate, which, in essence, means the lowering of the exchange rate risk premium. However, it is advised that the central bank’s main commitment to the low inflation target is preserved until the very end of the euro convergence.

As this study focuses on the systemic foundations of macroeconomic stabilization policies it does not provide a detailed account of the actual record of real and nominal convergence in Poland. The gradual advancement of
Poland's monetary policy has been so far consistent with the task of laying down solid foundations for a functioning market economy that is capable of withstanding competition within the EU. At the final stage of convergence to the euro, Poland's monetary policy needs to be focused on achieving the convergence benchmarks embodied in the Maastricht criteria. In general terms, this means embracing an appropriate policy framework and a sequence of policy adjustments that will be most conducive to achieving price stability and securing a smooth currency convergence. A proposal for such policy adjustments is outlined in section 6.5 on the sequencing of monetary policy for euro adoption.

The analysis begins with a brief description of the stabilization policies in the early 1990s which established an effective springboard for convergence to the EU/EMU. Next, fiscal policy considerations are discussed, followed by the overview of systemic changes in Poland’s monetary policy framework. Subsequently, alternative policy proposals for convergence to the euro are presented. A synthesis of the key policy prescriptions concludes this chapter.

6.2 ADVANCING MACROECONOMIC POLICY: FROM TRANSITION TO EU ENTRY

Policies for the accession of Poland to the EU constitute an extension of stabilization strategies that were enacted at the start of the country’s swift transition from central planning to a market economy in the early 1990s. At that time, the initial infusion of economic stability posed a particularly serious challenge to the Polish economy which was plagued by a severe crisis stemming directly from the pitfalls of the communist central planning. Among the most severe rigidities of the previous system were highly regulated prices set at ceilings far below market equilibrium, monopoly structures in the financial and industrial sectors, the execution of the central plan as the main business objective, non-convertible currency, and the arbitrarily-imposed trade ties with the former Soviet bloc (Bruno, 1992).

In order to underpin a decisive departure from the inefficiencies of central planning, the now democratically elected, independent Polish Government instituted a radical programme of reforms in January 1990. The so-called Bajcerowicz Plan was aimed at dismantling the most obstructive foundations of the former command economy system (Bruno, 1992; Sachs, 1993). The main precepts of this radical reform programme included far-reaching price liberalization, full currency convertibility on current account, trade liberalization, fiscal consolidation and monetary policy discipline to be achieved through the hard peg of the Polish zloty to the US
dollar. As a consequence of massive price liberalization and the incomplete decomposition and privatization of state-owned monopolies, producer and retail prices quickly rose to market equilibrium levels, which spurred a short-lived corrective inflation that on the CPI-basis reached 640 per cent in 1989 and declined below the annual rate of 50 per cent only in 1992.

The early ‘shock therapy’ programme in Poland was based on the reformers’ notion of ‘extraordinary politics’, that is, that the collapse of the old system created a unique window of opportunity that provided the government with the special mandate to proclaim such reforms. Consequently, strong political will and commitment led to the establishment of the foundations of macroeconomic stability and, later, to the pursuit of macroeconomic reforms for EU accession. Polish society, having vivid memories of the inefficiencies and high social costs of central planning, has strongly endorsed the reform programme and supported the government’s commitment to laying down foundations for a functioning market economy capable of withstanding competition within the EU. However, social endorsement has not always been unequivocal as the transition to a deregulated and privatized economy has carried considerable welfare costs, such as the gradual increase in (mostly structural) unemployment that reached a monthly average of 19.8 per cent in the peak year of 2002. (Table 6.1)

The early macroeconomic stabilization policies brought about considerable progress in economic stability in the late 1990s during the more advanced stage of transition and active preparations for the EU accession. This progress is reflected by the set of indicators presented in Table 6.1.

The real economy and financial sector annual data show that Poland’s monetary authorities have been able to contain inflation while avoiding economic recession. Yet, in the post-accession period, there is still a need to improve fiscal discipline and enact long-term labour market reforms to ease persistently high unemployment.

As shown in Table 6.1, between 1997–2004 the CPI-based inflation fell from double digits to a low single digit level that in the last three reported years was roughly commensurate with the Maastricht price stability benchmark qualifying for accession to the euro. Yet the ambitious disinflation effort succeeded only by applying very high real interest rates which undoubtedly contributed to a significant slowdown of economic growth in 2001–02. In that period, the inflation adjusted short-term credit refinancing rate was maintained at extremely high levels by the National Bank of Poland (NBP). This rate, which serves as the policy reference rate for NBP, reached its peak of 9 per cent in 2001. Having contained inflation at a sustainable ‘safe’ level through such highly restrictive monetary policy, the NBP was able to reduce the real short-term interest rate to 2.1 per cent by 2004. Most importantly, high real interest rates helped establish a necessary degree of
Table 6.1  Selected measures of real and financial stability in Poland, 1997–2004

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP growth rate</td>
<td>6.8</td>
<td>4.8</td>
<td>4.1</td>
<td>4.0</td>
<td>1.0</td>
<td>1.4</td>
<td>3.8</td>
<td>5.5</td>
</tr>
<tr>
<td>Unemployment rate</td>
<td>10.9</td>
<td>10.2</td>
<td>13.4</td>
<td>16.4</td>
<td>18.5</td>
<td>19.8</td>
<td>19.2</td>
<td>19.1</td>
</tr>
<tr>
<td>(ILO def.)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CPI-inflation rate</td>
<td>14.9</td>
<td>11.8</td>
<td>7.3</td>
<td>10.1</td>
<td>5.5</td>
<td>1.9</td>
<td>0.8</td>
<td>3.5</td>
</tr>
<tr>
<td>PPI-inflation rate</td>
<td>12.5</td>
<td>7.5</td>
<td>5.8</td>
<td>7.9</td>
<td>3.1</td>
<td>0.5</td>
<td>1.6</td>
<td>7.0</td>
</tr>
<tr>
<td>Real compensation per employee (whole economy)</td>
<td>21.0</td>
<td>16.0</td>
<td>13.2</td>
<td>11.9</td>
<td>8.0</td>
<td>2.6</td>
<td>4.2</td>
<td>4.8</td>
</tr>
<tr>
<td>Labour productivity (% growth)</td>
<td>3.9</td>
<td>2.4</td>
<td>7.0</td>
<td>6.4</td>
<td>1.7</td>
<td>3.7</td>
<td>16.6</td>
<td>6.1</td>
</tr>
<tr>
<td>Unit labour cost (% growth)</td>
<td>16.5</td>
<td>13.2</td>
<td>5.8</td>
<td>5.2</td>
<td>11.5</td>
<td>-1.6</td>
<td>-9.7</td>
<td>-2.2</td>
</tr>
<tr>
<td>Govt. budget deficit (% GDP)</td>
<td>-4.0</td>
<td>-2.1</td>
<td>-1.4</td>
<td>-0.7</td>
<td>-3.8</td>
<td>-3.6</td>
<td>-3.9</td>
<td>-5.6</td>
</tr>
<tr>
<td>Govt. total debt (% GDP)</td>
<td>n.a.</td>
<td>n.a.</td>
<td>40.1</td>
<td>36.8</td>
<td>36.7</td>
<td>41.1</td>
<td>45.4</td>
<td>47.2</td>
</tr>
<tr>
<td>Real short-term int. rate (avg. monthly)</td>
<td>8.4</td>
<td>7.7</td>
<td>6.0</td>
<td>7.1</td>
<td>9.0</td>
<td>6.7</td>
<td>4.8</td>
<td>2.1</td>
</tr>
<tr>
<td>Bank lending (avg. m. growth rate)</td>
<td>33.8</td>
<td>27.0</td>
<td>26.7</td>
<td>17.6</td>
<td>7.4</td>
<td>4.0</td>
<td>n.a.</td>
<td>7.1</td>
</tr>
<tr>
<td>M3 (avg. m. growth rate)</td>
<td>27.9</td>
<td>24.7</td>
<td>20.1</td>
<td>11.9</td>
<td>9.2</td>
<td>-2.0</td>
<td>8.8</td>
<td>9.4</td>
</tr>
<tr>
<td>Current account (% GDP)</td>
<td>-3.7</td>
<td>-4.1</td>
<td>-7.6</td>
<td>-6.0</td>
<td>-2.8</td>
<td>-2.6</td>
<td>-2.2</td>
<td>-1.5</td>
</tr>
<tr>
<td>PLN-per-EUR (ECU) (avg. monthly rate)</td>
<td>3.54</td>
<td>3.92</td>
<td>4.23</td>
<td>4.01</td>
<td>3.67</td>
<td>3.86</td>
<td>4.40</td>
<td>4.53</td>
</tr>
<tr>
<td>Consumer confidence index*</td>
<td>416</td>
<td>751</td>
<td>681</td>
<td>606</td>
<td>406</td>
<td>550</td>
<td>730</td>
<td>n.a.</td>
</tr>
<tr>
<td>New job offers in '000b</td>
<td>103</td>
<td>100</td>
<td>85</td>
<td>80</td>
<td>75</td>
<td>76</td>
<td>77</td>
<td>n.a.</td>
</tr>
</tbody>
</table>

Notes:

a. Ratio of optimistic to pessimistic consumers periodically compiled and reported by *Rzeczpospolita Daily.*
b. Reported by search firms.

Sources: Central Statistical Office, Warsaw; Eurostat; Ministry of Finance, *Macroeconomic Survey* (various issues); *Rzeczpospolita* (various editions).

Policy credibility that contributed to declining inflation expectations, which subsequently suppressed wage demands in both the public and the private sector, as reflected by the parallel to inflation decline in real compensation per employee. At the same time, a combination of large direct investments from domestic and foreign sources coupled with a squeeze on wage demands from high unemployment led to the accelerated growth of labour productivity outpacing the growth of labour compensation. As a result, unit labour costs that were still rising during the 1997–2001 period began to recede over
the following three years. Along with the monetary easing that has been evident over the recent two-year period, the bank lending and the M3 money aggregate returned to higher growth rates reinvigorating investment and real GDP growth. As a consequence, the declining unit labour costs along with a brisk demand for credit and rising investment have recently contributed to the growth of industrial production and exports. They have also reduced unemployment, albeit at a very slow pace.

As shown in Table 6.1, the macroeconomic stability conditions are strongly correlated with consumer confidence and job market conditions. High unemployment along with a wage squeeze is not conducive to raising consumer confidence and promoting growth in consumption. In fact, the recently renewed economic recovery is mainly driven by the increase in private investment and to some extent by sharply rising exports to the EU. These spending components contribute to a recognizable job creation, as reflected by new job offers, and to a significant improvement in the current account position. Nevertheless, a sustainable economic recovery is likely to depend on higher consumer spending, which is yet to materialize. As a matter of fact, it may take some time for consumer to recover from the recent drop in confidence about future economic conditions. One may hope that the stimulus of the EU accession-related income transfers along with the continuous commitment to a macroeconomic stability that no longer needs to be supported by excessively restrictive policies may ultimately improve this situation.

The disciplined economic policies of the centre-right coalition government pursued prior to 2001 did not help Poland's now-notorious political instability. After losing the 2001 election, the Solidarity government was replaced by a coalition of left-wing parties that was initially less inclined to maintaining fiscal discipline. However, the required commitment to a sound fiscal policy, which is a pillar of the post-EU accession strategy and its focus on convergence to the euro, forced the new socialist government to outline a budget-balancing strategy in its April 2004 Convergence Programme in a way conducive to euro convergence. Nonetheless, unpopular budget cuts cannot immediately improve the confidence of the general public in the economy.

In retrospect, both the pre- and the post-EU accession strategies can be viewed as a logical extension of the macroeconomic policies pursued during the economic transition of the 1990s. The process of navigating the macroeconomic convergence becomes increasingly challenging in Poland due to unfavourable demographic dynamics and the high social costs of disciplined policies.

One may further argue that in order to be successful and sustainable, the convergence strategy in Poland must be highly transparent. Since the
EU/EMU accession entails certain short-run costs, while its benefits are likely to materialize only in the long-run, there is a serious risk that the net social costs will outweigh the benefits in the near future, which may erode public endorsement of the convergence programme. Thus, to sustain social endorsement, the government must fully explain the detailed aspects of the convergence strategies and the expected social costs. Therefore, a high transparency of the convergence programme is a key prerequisite for its overall success.

6.3 FISCAL CONVERGENCE

The main aim of fiscal policy adjustments in Poland in the course of preparations for EU accession included laying the ground for a sustainable fiscal discipline, developing compliance with the European System of National Accounts and reforming the tax system in congruence with Chapter 10 (Taxation) of the EU acquis communautaire. Accordingly, Poland had to develop institutional capacity in the area of taxation and in aligning its legislation with that of EU. A number of changes were made in the area of indirect taxation, including VAT and excise duties. In general terms, without resorting to the complexity of the detailed tasks, special attention had to be paid to the scope and definition of VAT rates, particularly the extensive use of zero-rating, as well as to the vast tax exemptions. New taxes were introduced with regard to direct taxation, such as a 20 per cent tax on interest income and a temporary 2 per cent tax on outward capital movements by residents only. Still, on EU entry in May 2004, Poland had to raise VAT and excise taxes on a number of products (including construction materials, tobacco, mineral oils and so on), which induced a short-lived jump in inflation.

As a member of the EU, Poland is obliged to provide the European Commission with a detailed report on fiscal stance, including general government deficit and debt statistics, in accordance with the European System of National Accounts (ESA'95). In preparation for such reports, the Polish Government has redesigned its budgetary process by distinguishing between three basic subsectors of public finance: central government, local government and social security funds. This distinction has proven to be very helpful for enacting appropriate fiscal reforms aimed at decentralizing the budget, streamlining funds to their main intended recipients and broadening the tax base.

Furthermore, in order to develop compliance with the EU budgetary procedures, the Polish Government has enacted a series of legislative documents, including the ‘Medium Term Public Finance Strategy’ of September 2003,
the ‘Programme of Consolidation of Public Expenditures’ of January 2004 and ‘The Convergence Programme’ of April 2004. A driving force behind the ongoing fiscal consolidation is the officially declared plan to adopt the euro in the unspecified future. Accordingly, the fiscal authorities are now facing the challenge of maintaining fiscal discipline as stipulated by the EU Stability and Growth Pact (SGP). They are compelled to demonstrate efforts to bring the budget deficit down to 3 per cent in relation to GDP. In fact, the SGP has been used extensively by the authorities as a politically convenient excuse for maintaining fiscal discipline. Aspirations to enter the eurozone provide a compelling justification for the government to reduce budgetary expenditures and, at the same time, to maintain taxes at a level low enough to promote growth and high enough to balance the budget. For instance, in response to the deteriorating budgetary situation, the government adopted an expenditure rule (in 2002) according to which central government spending was limited to an annual rise of 1 per cent above the inflation rate. The need to undergo further fiscal consolidation is quite apparent. As evidenced by the data in Table 6.1, there is a propagation of the general government budget deficit to the degree exceeding the maximum allowed benchmark of 3 per cent of GDP and an increase in public debt getting closer to the maximum of 60 per cent of GDP stipulated by the Maastricht Treaty.

The pronounced acceleration of the general government budget deficit over the past three years poses a serious problem to the implementation of fiscal consolidation. Yet, there are some optimistic developments. The expected increase in economic growth is likely to ease pressure on the deficit and to stabilize the level of indebtedness. Taking into account the faster economic growth that has been recently driven by high investment and exports, the projected decline of the deficit from 4.2 per cent of GDP in 2005 to 1.5 per cent in 2007, as specified in the Polish Government Convergence Programme (Republic of Poland, 2004) appears to be realistic. In order to achieve this ambitious goal, the government needs to reduce expenditures on public administration and on selected social programmes. While it is reasonable to expect reduced costs of debt servicing due to steadily declining interest rates, spending cuts on public administration and social programmes will have to be decisively administered. However, spending cuts on social programmes may pose a major challenge as they are politically unpopular and risky.

Major challenges to a successful implementation of fiscal consolidation can be detected by analysing recent budgetary developments and projections within the three basic subsectors of the budget, as defined by ESA’95 (Table 6.2).

Large central government expenditures that are allocated predominantly to social programmes and public administration constitute the primary
Table 6.2  General government budget balance and public debt in Poland (ESA’95) (% GDP)

<table>
<thead>
<tr>
<th>Year</th>
<th>General government budget balance</th>
<th>Central government</th>
<th>Local government</th>
<th>Social security funds</th>
<th>General government debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>-1.8</td>
<td>-1.9</td>
<td>-0.5</td>
<td>+0.6</td>
<td>36.6</td>
</tr>
<tr>
<td>2001</td>
<td>-3.5</td>
<td>-4.2</td>
<td>-0.3</td>
<td>+1.0</td>
<td>36.7</td>
</tr>
<tr>
<td>2002</td>
<td>-4.0</td>
<td>-4.6</td>
<td>-0.3</td>
<td>+0.9</td>
<td>41.2</td>
</tr>
<tr>
<td>2003</td>
<td>-4.1</td>
<td>-5.6</td>
<td>-0.2</td>
<td>+1.7</td>
<td>45.3</td>
</tr>
<tr>
<td>2004</td>
<td>-5.7</td>
<td>-6.4</td>
<td>-0.2</td>
<td>+0.9</td>
<td>49.0</td>
</tr>
<tr>
<td>2005</td>
<td>-4.2</td>
<td>-5.5</td>
<td>-0.4</td>
<td>+1.8</td>
<td>51.9</td>
</tr>
<tr>
<td>2006</td>
<td>-3.3</td>
<td>-4.8</td>
<td>-0.4</td>
<td>+1.9</td>
<td>52.9</td>
</tr>
<tr>
<td>2007</td>
<td>-1.5</td>
<td>-3.4</td>
<td>-0.1</td>
<td>+2.0</td>
<td>52.3</td>
</tr>
</tbody>
</table>

Note: Ministry of Finance forecasts are indicated in italics.


area of concern within the consolidated budget. In the 2004 budget, the consolidated expenditures in relation to GDP reached 23.5 per cent for social transfers, 15.1 per cent for public administration, 9 per cent for public consumption and only 2.9 per cent for interest on public debt (Republic of Poland, 2004, p. 26). Since the central government conducts the majority of spending on social programmes and public administration, its deficit level reached 6.4 per cent while the local government deficit was only 0.2 per cent of GDP. Needless to say, the success of fiscal consolidation projected in Table 6.2 will depend on the government’s ability and determination to reduce spending in these politically sensitive areas. The local level, the major accession-related task for governments is to improve their absorptive capacity to dispose the EU transfers related to common agricultural policy (CAP) subsidies as well as structural and cohesion funds.

A serious challenge to fiscal consolidation stems from rising transfers related to the ageing population. The need to foster EU tax coordination and to restructure the public finances in order to prepare for the budgetary consequences of the ageing population was emphasized in the 1999 Commission report on economic and structural reform in the EU (Cardiff II). The gravity of the ageing problem in Poland can be illustrated by the ratio of retired to working age population, which is expected to rise from the recently reported level of 62 per cent in 2002 to the projected 69 per cent in 2010 and 94 per cent in 2050. The large share of retirees, along with the negative growth of the country’s total population will impose a serious rigidity on social spending programmes.

Within the next several years, the social security fund is expected to show a rising surplus (Table 6.2). This projected surplus stems from the ongoing
contributions to the special ‘open retirement funds’ by the insured persons, while the first payments from these funds are scheduled to take place only in 2009 (the intended year for adopting the euro!). The changes adopted by the EU Council of Ministers at its March 2005 meeting which now allow for accounting contributions to these funds as budget revenues are of crucial importance for Poland, as their inclusion may help the country meet the Maastricht budget deficit criterion by the time of examination for the euro entry.

In addition to reforming government expenditures, policymakers face the challenge of determining an optimal level and pragmatic rules of taxation. The efforts in this direction pursued by the Polish Government are encouraging. Since 1999, the Ministry of Finance has reduced corporate income taxes from 27 to 19 per cent, closing at the same time many of the existing tax loopholes. It also allowed for accelerated depreciation allowances and established a special fund for restructuring the budgetary obligations of some firms with serious liquidity problems. Personal income taxes have been also significantly reduced. In spite of these reductions in tax rates, tax revenues have been growing steadily. The 2006 Budget Proposal introducing a linear flat tax of 18 per cent (submitted in March 2005 by the Ministry of Finance), if passed by the parliament, should further contribute to higher tax revenues as it will likely translate into accelerated income growth. In addition, tax revenues should also benefit from the existing institutional improvements in tax administration and in the collection system.

It should be further noted that the official programme of fiscal consolidation (Republic of Poland, 2004) will materialize only in the absence of serious threats to financial stability. Among these might be the possibility of a significant depreciation of the Polish zloty (PLN) as well as the danger of renewed inflationary expectations that would have to be restrained by the NBP with higher interest. These would contribute to higher debt service payments. Other dangers include a possible propagation of political risk stemming from the recent corruption scandals involving government officials. In addition, the erosion of public support for the government due to its inability to reduce rampant unemployment may further exacerbate the political risk.

Poland’s membership of the EU is likely to improve the state of public finance due to the injection of net transfers from the EU budget. The main components of estimated transfers and contributions to the EU budget are shown in Table 6.3. It should, however, be noted that the presented data are only estimates based on the results of accession negotiations at the December 2002 Copenhagen Summit and do not necessarily reflect actual appropriations and payments which are yet to be disclosed.
Table 6.3 EU appropriations for Poland (EUR million in 1999 prices)

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total transfers to Poland</td>
<td>2983</td>
<td>5068</td>
<td>5498</td>
</tr>
<tr>
<td>Pre-accession assistance</td>
<td>970</td>
<td>823</td>
<td>509</td>
</tr>
<tr>
<td>Agriculture (total):</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. market measures</td>
<td>135</td>
<td>350</td>
<td>377</td>
</tr>
<tr>
<td>2. direct payments</td>
<td>0</td>
<td>557</td>
<td>675</td>
</tr>
<tr>
<td>3. development of rural areas</td>
<td>290</td>
<td>605</td>
<td>882</td>
</tr>
<tr>
<td>Structural actions (total):</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. structural funds</td>
<td>860</td>
<td>1776</td>
<td>2107</td>
</tr>
<tr>
<td>2. cohesion funds</td>
<td>834</td>
<td>1482</td>
<td>1578</td>
</tr>
<tr>
<td>Internal policies (total):</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. existing policies</td>
<td>285</td>
<td>407</td>
<td>499</td>
</tr>
<tr>
<td>2. institutions building</td>
<td>154</td>
<td>266</td>
<td>359</td>
</tr>
<tr>
<td>3. Schengen instrument</td>
<td>38</td>
<td>48</td>
<td>46</td>
</tr>
<tr>
<td>Special cash-flow facility</td>
<td>93</td>
<td>93</td>
<td>94</td>
</tr>
<tr>
<td>Total contributions by Poland to EU budget</td>
<td>-1579</td>
<td>-2454</td>
<td>-2520</td>
</tr>
<tr>
<td>Traditional resources</td>
<td>-123</td>
<td>-213</td>
<td>-214</td>
</tr>
<tr>
<td>VAT resource</td>
<td>-194</td>
<td>-304</td>
<td>-310</td>
</tr>
<tr>
<td>GNI resource</td>
<td>-1114</td>
<td>-1707</td>
<td>-1752</td>
</tr>
<tr>
<td>British rebate</td>
<td>-148</td>
<td>-230</td>
<td>-244</td>
</tr>
<tr>
<td>Net appropriations balance</td>
<td>1404</td>
<td>2614</td>
<td>2978</td>
</tr>
</tbody>
</table>


Among the receipts, structural funds are the largest initial component, followed by CAP subsidies. Structural funds are designated mostly for infrastructural projects thus the data in Table 6.3 reflect mostly granted funds, which may take longer to be actually transferred. The assistance to the agricultural sector is expected to rise in proportion to other receipt items during the years following formal EU entry. CAP payments to Polish farmers will reach respectively 55, 60 and 65 per cent of the level of corresponding subsidies in the incumbent EU member states during the first three years of membership (Kawecka-Wyrzykowska, 2004). This is because full-scale assistance would be extremely expensive for the EU, given the large size of Polands' agricultural employment, which comprised 19.6 per cent of total employment in 2002, while the sector's value added was merely 3.1 per cent of total value added in the economy (European Commission, 2003). Direct payments to farmers are expected to be the fastest growing component among all transfer categories. In contrast, the assistance aimed at strengthening internal policies will rise at a slower rate. These funds are particularly
needed in the early stage of membership as they are aimed at strengthening institutions indispensable for the implementation of Community legislation and for reinforcing border controls (the Schengen Instrument). In addition, Poland will receive large direct cash transfers (the Special cash-flow facility) designated to improve absorptive capacity and to cushion the fiscal burden of the initially large contributions to the EU budget.

Poland’s contributions to the EU budget will come from three main sources: (1) traditional resources (mainly revenues from import duties and agricultural duties); (2) value added tax (VAT) revenues; and (3) resources based on gross national income (GNI). Along with other EU member states, Poland is also obliged to contribute to the ‘British rebate’, or special VAT refund scheme granted by the EU to the United Kingdom.

In summary, Poland is expected to be a net recipient of sizeable funds from the EU, estimated at 0.8 per cent of GDP for 2004, gradually increasing to 1.3 per cent for 2005 and 1.4 per cent for 2006. However, the large scale of these net transfers is not automatically guaranteed, as some delays in CAP subsidies due to bureaucratic hurdles have already been reported. In addition, some structural fund appropriations that have already been granted may take some time to materialize.

There is still another important dimension of the necessary fiscal reform, that is, the determination of an appropriate type of fiscal governance. Following a proposal made by Hallerberg et al. (2004), fiscal policies can be bound by rules, thus following a contract approach, or they can be based on a high degree of finance ministry discretion, consistent with the delegation approach to budgetary decisions. These authors show empirically that, based on the EU experience, coalition governments are more likely to employ the contract approach, while single or majority party governments are likely to delegate the budgetary decision-making power to finance ministers in order to alleviate the coordination problem that is inherent in the fiscal policy process. One may reasonably assume that these findings will also hold for Poland in the near future. Therefore, the design of a fiscal policy framework that is consistent with the delegation approach seems to be a viable option, since a majority party government is likely to prevail in the future, after the recent wave of consolidation of major political parties in Poland.

6.4 MONETARY CONVERGENCE

Concurrently with fiscal reforms, Poland’s monetary policy regime had to undergo equally challenging changes during the course of preparations for the EU accession. The general objective of these adjustments was to ensure
a sustainable degree of financial stability in the spirit of one of the three Copenhagen EU accession criteria, namely, the task of establishing a well-functioning market economy. In order to generate a stable financial environment, the NBP faced the task of devising a proper monetary policy framework that would, at minimum, effectively contain inflation, mitigate exchange rate risk, and help establish a solid record of policy credibility.

Defining such a policy framework turned out to be an intricate task at the early stage of preparations for the EU accession. The exchange rate anchor had to be given up relatively early, as the combination of currency peg and high, double-digit inflation led to real currency appreciation, which in turn exacerbated Poland's current account deficit and deteriorated the risk structure of capital inflows (the move toward short-term and away from long-term capital inflows). The evolution of the country's exchange rate system is synthesized in Table 6.4.

The hard peg to the US dollar was instrumental in the elimination of the corrective inflation and the diffusion of the monetary overhang in the early 1990s. Once an acceptable degree of financial stability appeared in sight, the monetary authorities enacted a soft peg in the form of the crawling devaluation with a 7 per cent symmetric band around the parity rate on 16 May 1995. A further notable move toward greater flexibility coincided with the official inception of direct inflation targeting in January 1999. DIT is a monetary policy framework that is based on the assumption of long-term price stability as the official policy goal through designation of the official

Table 6.4 Evolution of Poland's exchange rate regime

<table>
<thead>
<tr>
<th>Exchange rate regime (Classification)*</th>
<th>Currency basket</th>
<th>Tolerance band</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Jan. 1990–17 May 1991 hard peg (2)</td>
<td>9500 PLZ/USD</td>
<td></td>
</tr>
<tr>
<td>17 May 1991–30 Apr. 1993 crawling peg (5)</td>
<td>USD</td>
<td>+/- 1%</td>
</tr>
<tr>
<td>1 May 1993–15 May 1995 crawling peg (5)</td>
<td>5-currency basket</td>
<td>+/- 1%</td>
</tr>
<tr>
<td>16 May 1995–24 Feb. 1998 crawling band (9)</td>
<td>basket</td>
<td>+/- 7%</td>
</tr>
<tr>
<td>1 Jan. 1999–11 Apr. 2000 crawling band (9)</td>
<td>EUR 55%</td>
<td>+/- 15%</td>
</tr>
<tr>
<td>12 Apr. 2000–present free float (13)</td>
<td>USD 45%</td>
<td></td>
</tr>
</tbody>
</table>

Note: * The exchange rate classification number is based on the 'fine course' determined by Rogoff et al. (2003, p. 55), and it ranges from the least flexible (no separate legal tender = class 1) to most flexible exchange rate arrangements (free float, class 13; freely falling, class 14, and dual market in which parallel market data is missing, class 15).

Source: Own compilation based on IMF Annual Report on Exchange Rate Arrangements and Restrictions (various editions).
target ranges for the inflation rate (Orlowski, 2000). DIT focuses directly on achieving the predetermined inflation target and by this virtue it differs from alternative monetary policy regimes that may aim at lowering inflation in an indirect way, for instance by focusing first on exchange rate stability objective.

With the inception of DIT, the exchange rate band was effectively widened to 15 per cent around the central parity, which in essence denoted abandonment of the exchange rate based monetary regime. Once price stability became the predominant objective of monetary policy, the crawling devaluation mechanism could no longer be maintained since the forced currency weakening promulgated inflation via the active exchange rate channel of policy transmission. In recognition of this threat to price stability, Poland’s monetary authorities finally embraced a free float in April 2000.

After abandoning the exchange rate anchor in May 1995, the NBP was prompted to search for alternative regimes that would uphold the necessary policy discipline. As a consequence, it carried out several, rather ineffective policy experiments, beginning with interest rate targeting in 1996. This option proved to be flawed in the presence of sizeable capital inflows which induced large shocks to market interest rates in a continuously vulnerable financial system. For this reason, the NBP moved to monetary base targeting in 1997 and M2 money growth targeting in 1998. These alternatives proved to be ineffective as well, particularly in the presence of some contagion effects from the Asian and Russian financial crises which infused large shocks to money balances. In addition, monetary targeting was not practical in an economy undergoing fast-paced monetization, as reflected by the overall growth of the M2 to GDP ratio from 15 per cent in 1991 to 43 per cent in 2002. As a result, money balances grew at a much faster rate than GDP, contributing to a large instability of income elasticity of money demand, which in turn made monetary targeting entirely implausible (Orlowski, 2004a).

Under such circumstances, inflation targeting appeared to be the only viable option for Poland as it could offer an effective disciplinary anchor for monetary policy which got lost after departing from the currency peg; it could also underpin the authorities’ commitment to disinflation (Jonas and Mishkin, 2003; Eichengreen, 2005; Orlowski, 2005a). However, the inception of the DIT framework in January 1999 took place at the earliest possible time or, as argued by Christoffersen and Wescott (1999), even slightly prematurely, since inflation was still running at double-digit levels and a prior record of price stability had not yet been established. In spite of the violation of some prerequisites for the DIT inception specified as essential by Mishkin (2000), the DIT framework was embraced by the NBP as it entailed important benefits, which prevailed over the possible costs of
missing overly optimistic inflation targets (Orlowski, 2001b, 2005a). Among the important DIT benefits is the explicit commitment to achieve ambitious and transparent inflation goals. An additional DIT advantage that is particularly pertinent to convergence to a common currency system is its ability to insulate the economy from balance of payments shocks. For this reason, DIT is an attractive policy option for Poland since inflation fluctuations there are predominantly influenced by nominal supply-side shocks, rather than real exchange rate and balance of payments shocks, as is empirically proven by Diboğlu and Kütan (2005). In hindsight, it is well-established in the literature that inflation targets must be believable in order to be effective; therefore, DIT could be introduced in Poland only when a minimum degree of ‘foundational credibility’ was in place.

Due to the key strategic objective of reducing inflation from double-digits to a low, sustainable level, a strict variant of DIT (as defined by Svensson, 1999) with year-end, narrowly defined targets appeared to be a viable policy option. As summarized in Table 6.5, the early variant of DIT was based on a strict CPI-inflation target of 6.6–7.8 per cent specified for December 1999. It seemed to be quite ambitious, considering the fact that the average monthly inflation in 1998 was 11.8 per cent (as shown in Table 6.1). The initial actual target realization was far from being satisfactory, as December 1999 inflation was 2 per cent higher than the upper bound of the

**Table 6.5** Evolution of direct inflation targeting in Poland

<table>
<thead>
<tr>
<th>Type of DIT</th>
<th>Main target(s)</th>
<th>Actual annualized CPI inflation</th>
<th>Corresponding exchange rate regime</th>
<th>Policy transparency</th>
<th>Formal plan for euro adoption</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jan. 1999</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current regime</td>
<td>Strict, single target</td>
<td>CPI inflation trajectory: midpoint 2.5%, +/- 1% tolerance 'band</td>
<td>Dec. 2004: 4.4%</td>
<td>Pure float</td>
<td>High, published: inflation projection, reports and policy assumptions</td>
</tr>
<tr>
<td>(2005)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

operating target. It should also be noted that a similar mismatch was
repeated in the second year of DIT. The target for December 2000 was set
at 5.4–6.8 per cent, while actual inflation reached 8.5 per cent. In response
to such prolonged target overshooting, the NBP took decisive policy steps
to contain inflation to the degree commensurate with its ambitious target.
It applied an extremely restrictive course of monetary policy as reflected by
the average monthly real short-term (three months T-bill) interest rate,
which reached 8.48 per cent during the January 1998–December 1999
period, and an even higher rate of 8.60 per cent between January 2000 and
June 2001. As a result, actual inflation at the end of 2001 fell to 3.6 per cent,
well below the target of 6–8 per cent, and at the end of 2002 it fell to 1.9 per
cent, also considerably below the 4–6 per cent target. In essence, it took
approximately two and a half years to bring inflation down to the desired
level, or in other words, to align private sector inflation expectations with
the central bank forecast. Needless to say, the NBP was successful in estab­
lishing a solid ground for policy credibility and price stability, but it did so
by applying an extremely restrictive course of monetary policy, which,
without doubt, entailed certain welfare costs and contributed to the eco­
nomic slowdown in 2001–02.

Once a satisfactory degree of financial stability was achieved, the NBP
altered the DIT strategy by replacing year-end operating targets with the
trend consistent linear inflation trajectory. By doing so, it has improved the
transparency and credibility of the DIT regime, in line with the arguments
introduced to the literature by King (1996). The trajectory approach is
believed to be superior to the year-end target specification for several
reasons. The stable linear target allows for expanding the time horizon of
low inflation expectations, thus it contributes to lower long-term interest
rates and promotes private sector long-term borrowing and investment.
Moreover, the linear trajectory is also beneficial for resisting political pres­
sures on the central bank, which is not the case of year-end targets. In prin­
ciple, the trajectory maintains a steady course that is not subject to
negotiations, while year-end targets are annually adjusted, which leaves
them exposed to potential pressures.

The current linear inflation trajectory in Poland is formulated in consis­
tency with the precepts of monetary convergence to the euro. The midpoint
is set at 2.5 per cent – the rate roughly corresponding with the anticipated
Maastricht reference rate. It is surrounded by the symmetric tolerance
band of 1 per cent that allows for accommodating possible temporary
shocks. In addition, the current DIT policy is highly transparent, as the
NBP regularly publishes quarterly and annual inflation reports and dis­
closes its inflation projection to the general public. However, the current
strict DIT framework is not fully consistent with the key objectives of
monetary convergence to the euro as it focuses exclusively on the inflation target and does not incorporate an exchange rate stability objective. The NBP is continuously committed to the pure float, perhaps due to the technical difficulties in determining a long-run sustainable market equilibrium rate of PLN in EUR terms that could serve as a targeted reference rate.

Modifications of Poland's and other new EU member states' monetary regimes on the final passage towards the euro will have to take into account a number of potential risks (Masson, 1999; Schadler, 2004). Chief among them are risks attributed to asymmetric shocks. In order to mitigate such risks, a clear and transparent monetary policy framework needs to be in place as it will be imperative to explain how disruptions to financial conditions will be dealt with. The effective absorption of exogenous shocks becomes particularly important upon entry to ERM II. Fiscal and monetary policies need to provide capacity to support the limits on exchange rate volatility imposed by this interim mechanism preceding euro adoption. Monetary policy in particular needs to embrace a mechanism of responding to contagion effects of possible future financial crises. For this reason, a continuous commitment to inflation targeting would offer a necessary cushion for absorbing such effects.

It should be noted at this juncture that there is a compelling historical record of Poland's effective responses to international financial crises. Two particular episodes underscore this claim:

1. the policy of counteracting possible contagion effects of the August/September 1998 Russian financial crisis, and
2. the strategy of dealing with the May 2004 'accession syndrome'.

The Russian moratorium on repayment of foreign currency debt declared on 29 August 1998 triggered a wave of contagion effects to international financial markets. Poland dealt with the shock relatively well as the government launched the so-called 'de-coupling' from Russia (Orlowski, 2001a). Empirical research on this subject proves that such a strategic approach was indeed successful. There were only mild contagion effects from Russia to Poland (as oppose to the Czech Republic or Hungary) in the aftermath of the crisis (Linne, 1999), particularly with respect to eurobonds (Gelos and Sahay, 2001). This is because the PLN and the Russian ruble displayed a limited co-movement at the time, which was not the case with other Central and East European currencies. In addition, depreciation of PLN in USD terms was considerably milder relative to the fall of other currencies in the region, which might have stemmed from the NBP decision to cut interest rates at that time, while other central banks were forced to raise them in order to prevent capital outflows (Orlowski,
In an effort to insulate the Polish financial market from Russia’s troubles, the NBP, by cutting interest rates, sent a ‘signalling effect’ to international markets, underpinning the country’s systemic resilience to external nominal shocks. In sum, thanks to its strong policy base, Poland weathered relatively well the shocks from the Russian financial crisis (as well as from the 1997–98 Asian crisis) that reverberated across the international financial markets, while many other countries fell victim to recession. Its currency remained strong, capital inflows continued and the banks were not imperilled.

Another noteworthy incidence of asymmetric shocks is related to the May 2004 EU accession. However, that was much easier to deal with than the 1998 disturbance, as Poland’s economic policy base and its systemic foundation had become considerably stronger, resulting in the overall nominal shock being milder. The scope of the accession-related real and nominal disturbance is reflected by changes in the selected macroeconomic variables shown in Table 6.6.

Table 6.6 The impact of Poland’s EU accession on selected macroeconomic variables

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004 1st Q</th>
<th>2004 2nd Q</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real GDP</td>
<td>3.8</td>
<td>6.9</td>
<td>6.1</td>
</tr>
<tr>
<td>Private consumption</td>
<td>3.1</td>
<td>3.9</td>
<td>3.8</td>
</tr>
<tr>
<td>Public consumption</td>
<td>0.4</td>
<td>1.3</td>
<td>2.5</td>
</tr>
<tr>
<td>Gross fixed capital formation</td>
<td>-0.9</td>
<td>3.5</td>
<td>3.6</td>
</tr>
<tr>
<td>Exports</td>
<td>14.7</td>
<td>16.0</td>
<td>11.3</td>
</tr>
<tr>
<td>Imports</td>
<td>9.3</td>
<td>11.3</td>
<td>8.3</td>
</tr>
<tr>
<td>Real industrial output</td>
<td>8.6</td>
<td>18.7</td>
<td>16.6</td>
</tr>
<tr>
<td>Real labour productivity</td>
<td>11.4</td>
<td>19.6</td>
<td>17.0</td>
</tr>
<tr>
<td>Average nominal wage in industry</td>
<td>3.0</td>
<td>6.6</td>
<td>4.8</td>
</tr>
<tr>
<td>Unit labour cost of industry (nominal)</td>
<td>-7.5</td>
<td>-10.9</td>
<td>-10.5</td>
</tr>
<tr>
<td>Unemployment rate (ILO definition)</td>
<td>19.6</td>
<td>20.7</td>
<td>19.1</td>
</tr>
<tr>
<td>HICP inflation</td>
<td>0.7</td>
<td>1.8</td>
<td>3.4</td>
</tr>
<tr>
<td>Broad money growth rate (nominal)</td>
<td>1.5</td>
<td>5.3</td>
<td>7.1</td>
</tr>
<tr>
<td>Net domestic bank credit growth rate (nom.)</td>
<td>5.2</td>
<td>6.2</td>
<td>4.6</td>
</tr>
<tr>
<td>PLN per EUR (period average)</td>
<td>4.40</td>
<td>4.78</td>
<td>4.69</td>
</tr>
</tbody>
</table>

Notes:
- Year-on-year percentage change (period average).
- Including foreign currency deposits.

The real economy effects directly related to the EU accession included the acceleration of real GDP and industrial production in the first quarter of 2004. This phenomenon has been labelled by Polish economic analysts as ‘the accession syndrome’, which was based on a switch in industrial activity from the second to the first quarter, in anticipation of strong demand following EU entry. Other real effects included a strong increase in investment, a surge in exports of mainly industrial and food products, and a decline in imports. Notably, exports of food products rose significantly, contrary to prior warnings from some politicians and economists about a possible influx of less expensive Western food products following the accession. These fears were entirely unfounded. It should also be noted that in April 2004, on the eve of the accession, exports rose at the annual rate of 41.6 per cent, while imports fell by 58.4 per cent, primarily due to the alignment of tariffs with the common EU rates.

In addition to shocks in the real sphere, EU accession triggered a mild inflation shock, caused mainly by higher VAT rates and excise taxes now aligned with the EU norms. The inflation effect was additionally exacerbated by the decline in domestic supply of certain food products and construction materials which became unexpectedly popular among the buyers in other EU countries. In consequence, HICP inflation rose from the average rate of 0.7 per cent in 2003 to 3.4 per cent in the second half of 2004. Broad money balances showed a proportional increase to inflation.

Without doubt, EU accession augmented economic growth in Poland, primarily through a surge in industrial production, investment and exports. This is a welcome development for monetary authorities because the national income acceleration helps reduce welfare losses stemming from the restrictive DIT policy. As a consequence, the EU accession shocks did not have to be curtailed with active monetary policy responses.

Looking ahead, monetary policy during the final stage preceding euro adoption will have to rely on the continuous commitment to disinflation, but also incorporate the task of lowering the exchange rate risk. Therefore, the strict variant of DIT is no longer a viable policy option during the active preparations for the euro adoption.

6.5 SEQUENCING OF MONETARY POLICY FOR THE EURO ADOPTION

There is a common understanding in the literature that the adoption of the euro means relinquishing monetary autonomy of the candidate countries, but clearly there is no uniform ‘one-size-fits-all’ policy prescription. The ongoing debate on this subject includes a variety of proposals
ranging from calls for a leap to unilateral euroization to a gradual convergence relying on an extended application of flexible DIT. One may however notice that with the passage of time the difference between an early euroization and a gradual policy adjustment becomes increasingly irrelevant. The bottom line is that Poland as well as other new member states will enter the euro system as soon as they complete the fiscal, monetary and institutional convergence prescribed by the Maastricht criteria and go through the two-year minimum quarantine imposed by the ERM II rules.

The proponents of an early adoption of the euro, including Bratkowski and Rostowski (2001), Buiter and Grafe (2002) and Begg et al. (2003) have identified a number of benefits from such a bold move. They include elimination of exchange rate risk, lower transaction costs, a more favourable climate for foreign direct investment and a clear framework for macroeconomic policy discipline. However, a rush to a common currency may also entail large costs, particularly if the institutional convergence is far from complete (Nuti, 2002), making the domestic financial system vulnerable to default risk. In addition, the country entering a common currency automatically relinquishes its monetary autonomy and the option to use exchange rates as a tool for countering nominal (mostly demand-side) shocks. In essence, an early euroization by itself is unlikely to resolve the remaining problems related to the institutional fragility of the real economy and the financial system; neither will it guarantee a necessary fiscal discipline. This is because the institutional deficiencies have much deeper roots than simply the monetary regime, and fiscal problems are a function of more than just the availability of seigniorage revenues (Eichengreen, 2005). For these reasons, the timing of formal euro adoption should matter less than having in place well-coordinated monetary, real and institutional convergence policies. A few more years of monetary independence combined with disciplined fiscal policies may allow enough time for the necessary completion of institutional reforms.

The qualified reservations against a premature euroization along with the Maastricht due process prescribed by the EU authorities have motivated researchers to seek more gradual policy solutions to euro convergence. In general terms, the gradualist proposals are based on various degrees of departure from the current strict DIT regimes. They infuse greater flexibility to various degrees by placing more or less balanced weights on inflation and exchange rate stability targets. It becomes clear that the two extreme solutions, namely a hard peg versus a full flexibility, which have been dismissed in the literature as viable policy options (Fischer, 2001) cannot work for the eurosystem accession programme. This is because the euro convergence necessitates a dual focus on price stability and the
exchange rate stability. Thus flexibility becomes pragmatic in order to avoid extreme solutions. A critical task is to cope with the exchange rate risk as well as the interest rate risk, which entails an inflation risk premium when adjusted to real interest rates (Orlowski, 2003; Holtemöller, 2005).

An extreme solution assigning preference to the exchange rate stability is proposed by Bofinger and Wollmershäuser (2001, 2002) who advocate adopting a monetary regime based on flexible exchange rate targeting. In their policy scenario, exchange rate stability becomes the key policy objective, while price stability plays a secondary role, as it is presumed to be derived from less volatile exchange rates. However, their scenario implies a significant regime switch which might prove to be too costly for those new member states that follow DIT policies, including Poland, the Czech Republic and, to a lesser degree, Hungary. This is because the primary commitment to the exchange rate stability objective may entail frequent and costly foreign exchange market interventions, particularly if financial markets continue to be vulnerable to large nominal shocks. In addition, it is highly uncertain whether the monetary regime focusing on exchange rate stability (even in a stricter form than the one allowed by the ERM II) will actually contribute to price stability. This is because the exchange rate channel of monetary policy transmission in the larger NMS such as Poland is rather unstable (Orlowski, 2003). Therefore, a smooth transmission of a more stable exchange rate into low inflation is not automatically guaranteed upon assigning a strong priority to the exchange rate stability.

A more balanced weighting of inflation and exchange rate stability targets is examined by Jonas (2004). His analysis focuses on the ‘dual target—one instrument’ policy scenario as an extension of the present DIT regimes, which assigns equal importance to the inflation and exchange rate stability targets. A central bank uses interest rates as a single policy instrument to hit these, at times conflicting, targets. Possible conflicts between them may arise in the presence of a simultaneous currency appreciation and high inflation, when both are triggered by large capital inflows. In such a case, a deliberate lowering of the domestic currency value requires an interest rate cut, which in turn may jeopardize realization of the inflation target. Also, higher interest rates aimed at containing inflation are likely to aggravate currency appreciation and promulgate exchange rate volatility. The conflicts between the targets are particularly severe in the presence of the Balassa-Samuelson effect. A number of studies have argued that such an effect is prevalent and contributes to high inflation in transition economies (Buiter and Grafe, 2002; Begg et al., 2003; Mihaljek and Klau, 2004; De Graauwe and Schnabl, 2005). Others, particularly Égert et al. (2003), show that this effect has now evaporated. A compelling empirical study by Blaszkiewicz et al. (2004) shows that the Balassa–Samuelson
effect in Poland has been negligible since 1999, while before that it was quite pronounced, contributing between 1.5 and 2 per cent to annual inflation. With the expiration of this effect, the potential conflicts between inflation and exchange rate stability targets have little merit; so do the arguments for an early euroization that are derived on the basis of this effect. The strongest weight on inflation targets is assigned in yet another scenario of gradual policy adjustments proposed by Orlowski (2005b) who introduces the monetary policy framework based on relative inflation forecast targeting (RIFT). This operational framework is a forward-looking extension to the DIT regimes pursued currently by Poland as well as by several other new member states. It constitutes a viable solution for the final passage towards the euro as it is likely to facilitate monetary convergence and ensure a smooth entry to the euro system. Stating briefly, RIFT is based on targeting the differentials between the candidate country and the eurozone inflation forecasts, thus, in essence it is an advanced variant of DIT, which in principle focuses on domestic inflation only. Therefore, RIFT allows for combining a decisive commitment to disinflation with an effective price convergence. In this advanced policy framework the inflation forecast differential becomes the key operating target of monetary policy, while exchange rate stability is treated only as one of the main indicator variables, and not as an auxiliary operating target. RIFT enables policymakers to focus exclusively on price stability as the main objective of monetary convergence. It therefore assigns priority to lowering inflation when a possible conflict between disinflation and exchange rate stability arises.

To underpin a successful monetary convergence to the euro, the proposed RIFT framework assumes a perfect identity between the long-term inflation targets of the candidate country and the eurozone. Therefore, in practical terms, the candidate’s inflation based on HICP (harmonized index of consumer prices) can reasonably be expected to converge to less than 2 per cent by the time of the euro adoption. Instrumentalization of RIFT is based on the ‘instrument dichotomy’, that is, on interest rate adjustments in response to changes in the differential between domestic and eurozone inflation forecasts, while exchange rate stability is secured with foreign exchange market interventions. Thus, in essence, RIFT is an elaborate combination of a forward-looking DIT and a managed float. Shocks to the exchange rate can be curtailed with higher interest rates only if they are destabilizing (elevating the exchange rate risk premium) and potentially threatening to realization of the inflation target. It seems plausible and necessary to modify the current Polish monetary regime based on strict DIT and the pure float by introducing solutions consistent with the proposed RIFT strategy. The NBP is presently well
Monetary and fiscal policy in Poland during EU accession

equipped to consider such regime adjustment as it has developed an advanced inflation forecasting methodology, as well as the ability to apply efficiently indirect instruments of monetary policy implementation. In addition, the RIFT framework is unlikely to interfere with the ramifications of ERM II, since it also incorporates the precept of lowering the exchange rate risk premium. Nevertheless, the operational viability of such a complex monetary policy framework is yet to be tested.

In sum, the current strict DIT in Poland needs to be modified by incorporating the exchange rate stability objective. The same is required of other DIT countries pursuing monetary convergence to the euro (Jonas and Mishkin, 2003; Jonas, 2004; Orlowski, 2005b). Regardless of the selected direction of DIT modification, Poland can and should avail itself of the exchange rate flexibility afforded by ERM II, providing that the ‘standard’ plus-minus 15 per cent band of currency fluctuations will be upheld, rather than the ‘normal’ band of 2.25 per cent prescribed originally by ERM I. It is, however, likely that the future band surrounding the official reference rate to the euro will be asymmetric, that is, wider on the appreciation side and much narrower (perhaps only 2.25 per cent) on the depreciation side. Under such circumstances, a tighter than normal stance of monetary policy will be required in order to accommodate the prevalent exchange rate risk premium within the short-term interest rate target. Moreover, frequent interventions will be called for in the presence of even relatively mild shocks to the exchange rate. Due to these constraints, remaining in the ERM II beyond the required two-year minimum period is not advisable.

Reformulation of Poland’s monetary policy upon entry to ERM II will take into consideration a proper choice of the PLN per EUR reference rate. This choice is critically important. In principle, the official ‘de jure’ reference rate should correspond with the ‘de facto’ rate that is technically perceived as a sustainable long-run equilibrium rate as determined by the financial markets. Mis-specification of the official rate at a level considerably different from the market rate may lead to a number of destabilizing consequences. These can be encapsulated as follows:

1. A considerably stronger official rate than the market rate may precipitate short-term capital inflows, exacerbating inflation. The unfavourable risk structure of capital inflows may result from expectations of an official devaluation.
2. A weaker official rate is likely to inflate the domestic value of foreign currency debt and raise the default risk.
3. Mis-specification of the official rate may effectively narrow the exchange rate tolerance band, as its perceived percentage boundaries
will surround the long-run equilibrium market rate, not the official rate. This scenario will necessitate more frequent, seemingly asymmetric foreign exchange market interventions.

(4) A mis-specified official rate may function as a magnet, pulling the market rate in a wrong, suboptimal direction (Schadler, 2004) that may in turn threaten realization of the inflation target.

(5) In general terms, the greater gap between the official rate and the market equilibrium rate is likely to exacerbate exchange rate risk (volatility) as its choice will appear to be less credible and expectations of rate resetting will arise. This risk will be greater if the official rate is too weak, as the markets are likely to expect either resetting of the official rate or an easing of monetary policy in an effort to adhere to its actual level. The easier policy stance will be suboptimal as it will clearly jeopardize realization of the inflation target.

Considering the serious dangers of the official rate mis-specification, its careful and thorough estimation and determination becomes a critical task. So far, the attempts to determine the long-run equilibrium rate for Poland have produced mixed and rather inconclusive results. Steady-state equilibrium conditions modelled by Golinelli and Rovelli (2005) have arrived at some suggestions. In contrast, Johanssen cointegration tests employed by Orlowski (2004a) have not produced conclusive results due to frequent regime changes, a high exchange rate risk premium and unstable key monetary variables applied in cointegrating equations.

There is a further complexity in the determination of the appropriate reference rate. This stems from the prevalent risk premia that are built into the equilibrium exchange rate (Orlowski, 2004b). Uncertainties about fiscal discipline and political stability may bring down the perceived market rate and demand a much tighter monetary policy stance, that is, higher interest rates encapsulating such exogenous risk premia. Needless to say, the choice of the official rate must take into account the political risk and the fiscal policy outlook. In order to accommodate these risks, the official rate might be set at a slightly higher level than the long-run equilibrium rate perceived by the market.

The process of selecting the appropriate official ERM II reference rate for PLN will require the application of correct procedures and robust formulas. It is imperative not to determine the reference rate too soon (as appears to be the case in Hungary) in order to alleviate the above-listed serious dangers of its mis-specification.

To reiterate, it is advisable for Poland to continue the reliance of its monetary policy on inflation targeting to the very end of the euro convergence
process. Yet, DIT needs to become more flexible in order to incorporate the exchange rate stability objective into the framework that will preserve the NBP commitment to price stability. The proposed RIFT framework appears to be viable for accomplishing these tasks.

6.6 A SYNTHESIS: IMPLICATIONS FOR FUTURE EMU ACCESSION

Several important prescriptions for successful EU accession and an effective pursuit of convergence to the euro have emerged from the Polish experience. At the forefront is the ability to maintain fiscal discipline, which is a function of the authorities' resilience to political pressures on government spending. Equally important is the development of a simplified, transparent tax system, ultimately leading to adoption of a flat linear tax set at a low rate that is competitive within the EU.

With respect to adjustments to the monetary regime, the objective of disinflation and price stability plays a critical role for balancing the attainment of long-term economic growth and convergence to the euro. A flexible DIT framework is believed to be conducive to achieving such balance. At the initial stage of convergence to the EU and EMU, a strict DIT supported with high real interest rates was effective for lowering inflation to a manageable, single-digit level. Yet, a strict DIT is not conducive to convergence to the euro, as the task of achieving exchange rate stability, or more precisely, lowering the exchange rate risk will have to be incorporated in the DIT framework.

Following Orlowski (2005b), this study advocates, for the final passage towards the euro, the RIFT framework which prioritizes realignment of the inflation forecast of the candidate and the eurozone and incorporates the exchange rate stability objective (within the ERM II) as the policy indicator variable. Adherence to the relative inflation forecast is achieved primarily by adjusting the differential between domestic and eurozone interest rates, while exchange rate stability is secured with cautiously applied foreign exchange market interventions.

In general terms, a successful completion of the EU/EMU convergence process necessitates enacting policies that would reinforce resilience to various types of financial risk. Among others, disciplined fiscal and monetary policies need to be in place in order to mitigate the exchange rate risk. In the case of Poland, such policies are entirely possible providing that a stable political climate, free of populist claims and pressures, is preserved.
NOTES

* I thank Ali M. Kutan and Jürgen von Hagen for valuable comments and suggestions. I remain, however, solely responsible for the views presented in this chapter and for all possible errors and omissions.

1. The Maastricht inflation convergence requirement calls for a euro-candidate country to achieve sustainable inflation not exceeding 1.5 per cent above the average of the three lowest inflation EU members. The benchmark rate specified in the October 2004 ECB Convergence Report was 3.4 per cent.

2. Specifically, the Ministry of Finance had to introduce equal taxation of goods irrespective of their origin, as well as special VAT schemes concerning travel agents, second-hand goods, investment in gold, and farm products. Special tax provisions had to be granted for intra-Community transactions (European Commission, 2003). During the course of accession negotiations, Poland was granted a number of derogations on VAT adjustments for residential housing, selected goods and periodicals (until the end of 2007), as well as a large number of food products (until the end of April 2008).

3. Yet, the ability to cut spending will pose a major challenge. Following argument by von Hagen et al. (2001), fiscal adjustments are successful if they are based on cuts in transfer payments, rather than on tax increases or cuts in government consumption and investments. Due to unfavourable demographic developments and strong political pressures, there is currently little chance of reducing transfer payments in Poland.

4. Own estimates based on Ministry of Finance data.

5. For instance, in June 2004 domestic prices of beef rose by 13.8 per cent, poultry 13.4 per cent, butter 7 per cent and sugar 48.5 per cent (additionally triggered by hoarding purchases), relative to their level from the year before. Prices of building materials rose 11.4 per cent.

6. A similar recognition of the exchange rate stability target is presented by Natalucci and Ravenna (2003).

7. A more optimistic view is presented by Golinelli and Rovelli (2005) whose empirical tests indicate a seemingly robust channel of monetary policy transmission in the Central European countries, including Poland.

8. The Balassa–Samuelson effect is based on the argument that there is a productivity shock in the tradable goods sector in an open economy, which in turn drives up wages of non-tradables and subsequently contributes to chronic inflation.

9. The debate on designing an optimal monetary policy framework for convergence to the euro focuses mainly on relative importance of low inflation versus exchange rate stability targets. However, equally challenging, yet inadequately addressed, are issues of appropriate choices of policy instruments. The advocated separation of interest rate adjustments in response to the inflation target, and market intervention aimed at stabilizing the exchange rate seems to be in opposition to the calls for integrating both instruments presented by the proponents of using the monetary conditions index (MCI) as an instrument rule. Such a rule is, for instance, endorsed for Turkey by Us (2004). Yet, its implementation might be technically very difficult, if not impossible, at least in the case of Poland. Because the MCI rule-based policy may send conflicting signals about the policy stance, it may inhibit central bank credibility.

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