

Economics of the EU

Country chosen for assignment: Poland

Word Count: 1495

(LABELS AND HEADINGS EXCLUDED)

Poland became a member of the European Union in May 2004 and thus the EU single market. The National Bank of Poland (NBP) has now become a member of the European System of Central Banks (ESCB). There are various stages that the NBP will go through to join the Euro zone. Firstly the Polish currency will be included in the Exchange Rate Mechanism II (ERM II), alongside fulfilling the Maastricht convergence criteria. Then they can adopt the Euro as their domestic currency. There are also objectives of the NBP that need to be included within the process of monetary union, in order to stabilise its economy¹.

Objectives of the Central Bank of Poland within 2004-2006:

- Monetary Stability – Preparing the Polish currency for participation in the ERM II. Providing an adequate level of the State's financial security, providing liquidity and quality of cash operations by issuing and putting domestic currency into circulation and enhancing credibility of the NBP. Also aiming to lower inflation.
- Financial system stability – Achieving the objective of stability of the financial system of the NBP; security to the payment system through its regulatory and supervisory functions, security of the banking system, exchange information with supervisory institutions.
- Technical preparedness for ESCB membership – Fulfilling the obligations set for the central banks of countries which have adopted the common currency euro, implementation of the European standards where needed, technically help entry into the ERM II.
- Assuming the status of a major academic centre involved in economic research in Poland and within ESCB – ensure reliability of statistical data, conduct scientific research.

- Raising economic awareness- increasing knowledge of central banking operations and the entire economy as well as of global economic processes, helping them become credible.

To achieve the above objectives and also have an efficient institution the NBP must be operating efficiently. To do this the NBP will need to enable transparency of operations with the use of auditing and have clear strategic plans alongside good project management.¹ Poland is the only country that has not set an official target date to join the Euro. However the Polish Prime Minister Kazimierz Marcinkiewicz feels that setting a time would be “unrealistic”, however he does feel that it is necessary to join within the next four years ⁶.

The Maastricht Treaty sets out various convergence criteria that need to be met as the final stage of monetary union. I am going to take each one and analyse the progress towards fulfilling the criteria for Poland, to see whether Poland is ready for Euro zone membership.

- General government deficit not exceeding 3% of GDP (expected to decline continuously)

Table 1. Forecast deficit and debt in Poland versus the Maastricht fiscal criteria

(according to ESA95 methodology as % of GDP)

Item	2003	2004	2005	2006
General government deficit	4.2	5.7	3.9	2.8
General government debt	44.8	47.6	51.4	51.3

Source: *The Supplementary Document of The Budget Law for 2004*

The above table shows that in 2006 Poland should have reduced its deficit to 2.8%. This would be below that of 3% and therefore should be able to meet these criteria by the end of 2006.

- Public debt not higher than 60% of GDP (should diminish sufficiently)

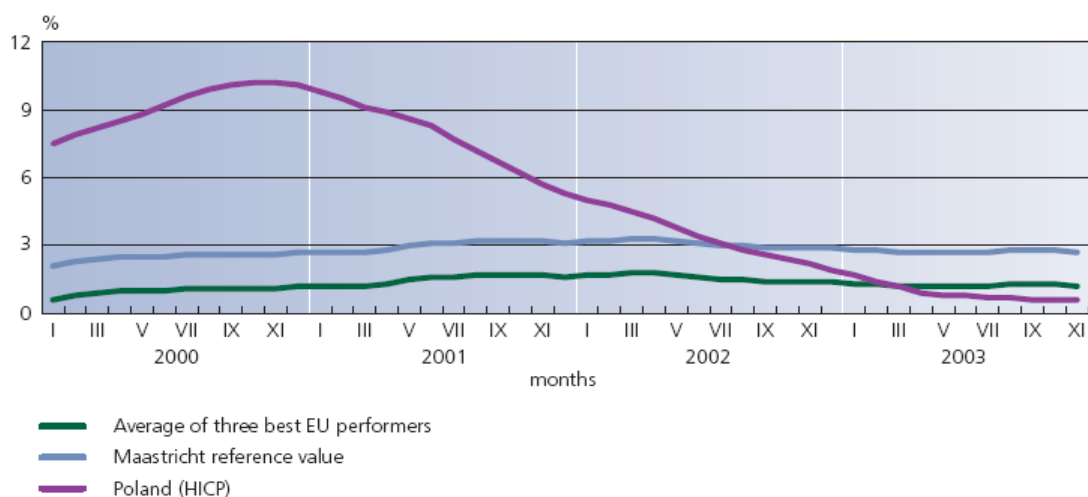
Table 1 also shows that the government debt is below that of which is required.

However it does show an increase from 2003 to 2005 and then a 0.1% decrease expected for this current year.

- The inflation rate – rate of inflation not exceeding by more than 1.5% than the average inflation of the three best-performing EU countries.

The graph below shows the figures for 2000 up to 2003 of which Poland's Inflation overall inflation reduced from 2001 onwards. Starting at 7.5% at the beginning of 2000 and was as low as 0.5% in 2003.

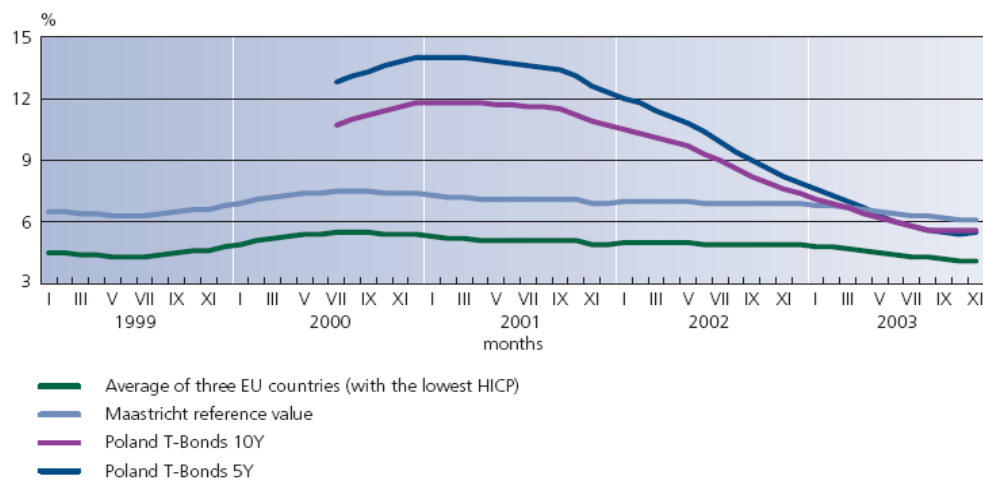
Fig.1 – Inflation in Poland and the Maastricht reference value¹



Source: NBP estimates based on the Central Statistical Office and Eurostat data.

- The interest rate – nominal long-term interest rates not exceeding by more than 2% of the average of such interest rates of the three best-performers

Fig.2 – The long-term interest rates in Poland and the Maastricht reference value ¹



Source: NBP and Eurostat

The above graph shows that long-term interest rates declined significantly towards the end of 2000 till the end of 2003. This is a good indication that interest rates have stabilised to that of the three EU countries who are best performers.

Low long-term interest rates show that inflation is stabilizing which can be seen in similar patterns on the above graphs. This can help us to say that Polish financial markets are standing by to adopt the Euro.

- The exchange rate – has joined the ERM II for more than 2 years and has not experienced a devaluation (fluctuation band against the central parity is +/- 15%) ^{2,3}

Fig.3 – PLN/EUR exchange rate levels from April 12, 2000 till November 28, 2003. ¹



Source: NBP

Exchange rates have fluctuated from 2000 up to the end of 2003, from where they have begun to decline. The graph shows that exchange rate levels were 3.9 (PLN) in 2000 down to 4.7 (PLN) in 2003. This means that the Polish Zloty declined in value against the Euro. The current figure is 3.84 (PLN) on 21 February 2006. Poland has voted in favour of the ERM II (77%)². “Poland, the Czech Republic and Hungary will most likely wait until at least 2007 to join ERM II.”⁷

I then went on to find more up to date figures for inflation and found that the NBP are more optimistic with future predictions as official values are not as good.

Fig 4. Progress towards Maastricht (2004/2005 data) for the 10 new members⁵

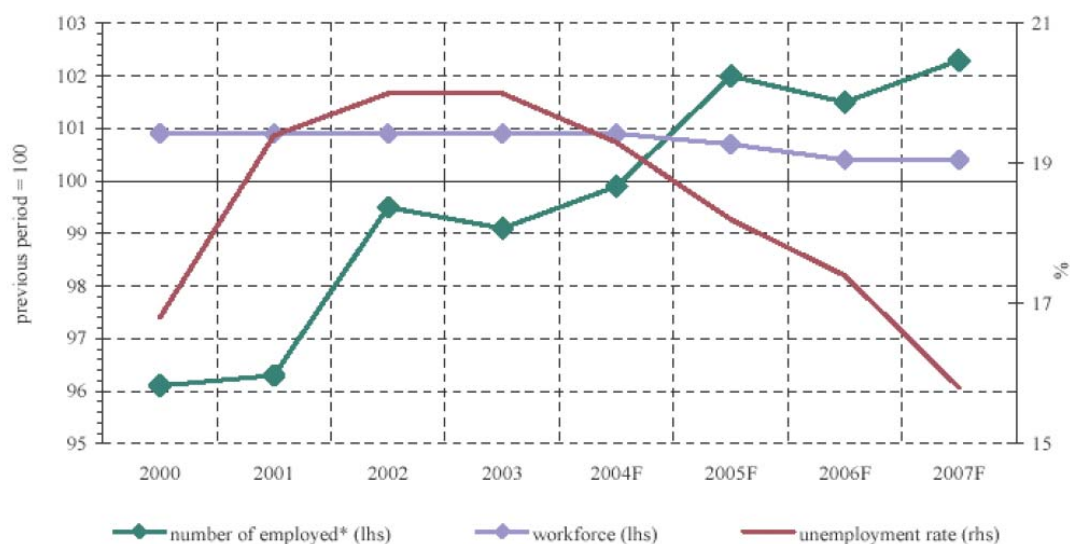
(Sources: Eurostat and Fitch Ratings)

Country	Inflation rate (June 2004- June 2005)	Government deficit (% of GDP)	Government debt (% of GDP)	Maastricht criteria met
<i>Maastricht reference value</i>	2.3	-3.0	60.0	
Cyprus	2.5	-4.1	71.9	0
Czech Republic	2.1	-3.0	37.4	4
Estonia	4.1	+1.8	4.9	3
Hungary	5.0	-5.4	60.4	0
Latvia	7.0	-0.7	14.3	3
Lithuania	2.7	-2.5	19.7	3
Malta	2.4	-5.2	75.0	1
Poland	3.8	-6.8	47.7	1
Slovakia	4.5	-3.3	43.6	2
Slovenia	3.0	-1.9	29.4	3

It can be seen that Poland had only met one criterion in 2004/2005. In order for Poland to be accepted for the Euro, Poland needs to address areas such as high deficits immediately. The average inflation in 2004 was 3.6%, with 3.2% projected for 2005. Government deficit was 5.4% in 2004, with 4.1% predicted for 2005. Government debt figures: 45.4% of GDP in 2003, 45.9% of GDP in 2004, and 47.6% of GDP in

2005 (projection)⁵. The main problem is cutting government spending and as elections are coming up this is unlikely to be adjusted⁵.

Fig 4. Unemployment for Poland 2000 to 2007²



The economy is currently undergoing restructuring and privatisation. These are ways of improving areas of which the government cannot spend time and money on, as a result can be made efficient by other bodies e.g. coal and steel. Poland currently has the highest unemployment in the EU at 18.3%⁴.

When a country enters monetary union, they become bound and therefore do not have power over their currency as much as when independent. Therefore fiscal policy measures are used to adjust factors such as unemployment e.g. reducing taxation. The Polish government introduced a package to cut spending by \$17 billion through 2007⁴; however this will slow down changes within the economy. Alongside indirect costs, during the changes of currency Poland will experience, short term direct costs, e.g. menu costs.

The theory of optimum currency area includes three points to consider; Intra-EU trade, degree of rigidities and degree of asymmetry of shocks. In 2002 Poland only

traded 14.8% of GDP as exports with other EU members; this means that there is a lot of scope to increase this figure. Last years figures show that Exports are up by nearly a quarter in Euro terms and should rise further⁷. Poland is expected to benefit from higher food prices and booming exports when using the Euro, due to increases in economies of scale. Poland will also benefit from trade integration, this will reduce asymmetric shocks in demand, causing only symmetric shocks to occur between trading countries.

There are many benefits of having a common currency such as, the elimination of exchange rate risk, reduction in transaction costs, welfare gains from uncertainty and many benefits from the openness of countries. The EC Commission estimated gains of up to 20 billion euros per year (1990)³. Transparency enables consumers to make better price comparisons and therefore should help in increasing competition. By this we would expect prices and price discrimination to decrease, but currently this is not the case, as figures show a 30% price differential between EU countries³. Exchange rate uncertainty will be removed once Poland takes the Euro and therefore will increase firm's profits. If we take a look at the development of the country as a whole we would expect foreign direct investment to rise, and therefore economic growth to increase. This is because other EU countries will now begin to move or expand to the more appealing cheaper EU countries due to the elimination of exchange rate risk and greater credibility of their financial market. If the UK was to invest in Poland this will not only create jobs but will also bring more skills into their labour force making labour markets more flexible and therefore decreasing rigidities.

The Polish economy is known to have low capital to labour ratio and shortages in domestic savings, all the points I have mentioned above should not only increase the output of Poland but also make it more productively efficient and therefore help them

to catch up to the more developed countries within the EU. In turn this should then make the Zloty more competitive with the Euro.

In conclusion joining the Euro should accelerate Poland's economic growth. Although Poland have not met the convergence criteria, in the theory of OCA and from the advantages and disadvantages that I have mentioned I feel that Poland should join as soon as possible to enable them to reach the standards set by the western EU countries.

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Appendix

GDP (purchasing power parity) - \$489.3 billion (2005) (4)

GDP (real growth rate) – 3.3% (2005)

GDP - per capita -purchasing power parity - \$12,700 (2005 est.)

Table1. Foreign currency flows between Poland and abroad (bln USD0 in 1988-2002

		1998	1999	2000	2001	2002
Current account	Inflows	37.5	33.8	36.2	39.5	41.9
	Outflows	50.4	48.9	50.2	47.6	52.6
Capital account	Inflows	402.3	526.5	884.3	1629.1	2157.8
	Outflows	391.2	518.3	876.8	1625.8	2151.7
Including:						
Direct investments	Inflows	8.3	9.5	11.2	9.6	7.5
	Outflows	3.4	3.2	3.0	2.7	3.7
Portfolio investments	Inflows	18.7	22.5	43.7	68.3	116.4
	Outflows	17.0	21.7	41.1	67.2	114.7
Other investments	Inflows	360.9	438.7	643.6	1013.6	1213.8
	Outflows	356.0	438.1	647.1	1018.0	1212.3
Financial derivatives	Inflows	14.4	55.8	185.8	537.6	820.1
	Outflows	14.8	55.3	185.6	537.9	821.0

Note: The data include only cash flows. They do not include transactions registered on a memorial basis, including: interest capitalisation, restructuring of principal and interest, conversion of principal and interest. This means that the data shown in the table are not in line with the officially published data on the balance of payments on the cash basis.

Source: The National Bank of Poland.

Table 2. GDP projection in the years 2004 – 2030 for various dates of joining the euro zone (annual average growth rate,%)

GDP projection	Scenario ^a			Comparison of scenarios (difference of results)	
	B	A2007	A2010	A2007 - B	A2010 - B
GDP	3.88	4.11	4.09	0.23	0.21
Total consumption	3.42	3.61	3.57	0.19	0.15
Private consumption	3.75	3.96	3.91	0.21	0.16
Investment	4.80	5.35	5.30	0.55	0.50
Exports	5.21	5.37	5.37	0.16	0.16
Imports	4.86	5.19	5.13	0.33	0.27

^aScenario:

B – baseline scenario, i.e. without accession to the euro zone within the projection horizon,

A2007 – scenario of accession in 2007,

A2010 – scenario of accession in 2010.