



MONETARY AND FISCAL POLICY RELATED ISSUES  
REGIONAL INPUT POLAND

Katarzyna Żukrowska  
Dominik Sobczak (eds.)

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**Jean Monnet Centre of Excellence**

Freie Universität Berlin  
Innestr. 22, 14195 Berlin, Germany  
Phone: +49 (30) 838 – 54966  
Fax: +49 (30) 838 – 52357

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## Monetary and Fiscal Policy Related Issues

### Regional Input Poland

The study comprises several contributions on monetary and fiscal policy problems in Central and Eastern Europe, starting with “Fiscal aspects of EU accession – Poland and Czech Republic” by *Marcin Żogała*, then *Tomasz Jędrzejowicz* looks at “The Maastricht-induced fiscal consolidation in EMU Member States – conclusions for accession countries”. The third chapter is delivered by *Jolanta Zombirt* “Monetary and fiscal policies in Poland and Czech Republic in the perspective of EMU accession”. Finally, and more strictly from a monetary perspective, *Marek Rozkrut and Tomasz Chmielewski* focus on Exchange-rate movements and the Maastricht ‘challenges’ in their contribution: “Monetary policy in Poland in perspective of accession to the EMU”.

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Katarzyna Żukrowska; Dominik Sobczak

International Security Department  
Warsaw School of Economics  
ul. Wisniowa 41 lok. 63  
02-520 Warsaw  
Poland

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## **Eastward Enlargement of the Eurozone Monetary and Fiscal Policy Related Issues**

*Regional Input: Poland*

*Katarzyna Żukrowska, Dominik Sobczak (eds.)*

Warsaw School of Economics

### **I. Fiscal aspects of EU accession – Poland and Czech Republic**

Contribution by Marcin Żogała\*

#### **Introduction**

For the ten Central and Eastern European countries a long way towards EU accession is coming to a successful end. Since the early years of transition, the prospects of EU membership has been a landmark of reforms targeted at building an economy based on free market principles. In the free market economy sound public finances play an important role in bringing about a stable macroeconomic environment that is conducive to a sustained growth and employment creation.

There are further reasons for candidate countries to pay particular attention to public finance. Given the limited progress achieved so far in real convergence, the role that fiscal policy should play in supporting the catching-up efforts appears to be particularly important. Moreover, the candidate countries apply for membership in a club where strict constraints are imposed on budgetary policy. Some time after accession to the

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\* International Department of the National Bank of Poland. The views expressed in this paper are those of the author only and do not necessarily reflect those of the National Bank of Poland.

EU, new Member States will be required to adopt the euro and give up autonomous monetary policy. This prospects call for efficient fiscal policy that will be ready to take over as the only macroeconomic instrument to stabilise the economy.

On the other hand, the dangers of missing the above target are significant. The fiscal requirements coming from the transition and accession are likely to be challenging to a considerable period after accession. The problems with maintaining sound fiscal policy in the euro area countries raise question about feasibility of the EU fiscal rules.

This paper reviews fiscal developments in Poland and the Czech Republic, and medium-term prospects against a broader background of candidate countries. An extensive part of the paper is devoted to EU fiscal rules. The reason for that is that the rules, which will soon apply to the candidate countries, are heavily criticised now.

### **Fiscal developments in candidate countries**

The budgetary situation in the accession countries shows significant differences. Deficit ratios to GDP vary between a balanced budget (Bulgaria and Estonia) and a considerable deficit (Hungary, the Czech Republic). But still some general observations can be made. Deficits (in % of GDP) in the Central European countries (with the exemption of Slovenia) are clearly higher than those of the Baltic countries. Moreover, the phase of buoyant growth in recent years was not used for reducing deficit to GDP ratios in the Central Europe. In fact, deficits in most Central European countries were unchanged or on the rise in the period implying that the positive cyclical impact was offset or even overcompensated by a worsening of structural balances. This contrasts with the developments in the Baltic countries. The Baltic countries faced a rapid increase in deficit ratios in 1999 attributable to the shock caused by the Russian crisis. Although the Russian crisis led to substantial slowdown, fiscal positions were brought under control very quickly as growth re-gained momentum. Whereas the Central European countries followed obviously a pro-cyclical fiscal stance, this has not been the case for the Baltic countries.

Current national debt levels in the candidate countries depend very much on initial levels. The countries which started with high debt levels (Poland) are still heavily indebted. On the other hand, the countries with a low level at the beginning of transformation have kept a lower indebtedness (the Czech Republic). Although in some countries, notably in the Czech Republic, debt ratios started to rise.

The recent slowdown in the world economy took its toll on both Poland and the Czech Republic. It is hardly surprising since both countries could be classified as small open economies although Poland to much smaller extent than the Czech Republic. Since 2000 the fiscal deficits in all the Central European countries have risen markedly. In Poland the deficit reduction was one of economic policy priorities in the 1990-s and the deficit of the public sector continually diminished since the middle of the decade. The trend came to a halt in 2001 when a drastic deterioration of economic situation occurred. In 2000 the government deficit amounted to 3.6% of GDP and in the following year 3.9% of GDP<sup>1</sup>. In 2002 the deficit deteriorated further to 4.1% of GDP. The deterioration was exacerbated by the fact that the slowdown was caused mainly by falling domestic demand. Along with falling demand the tax base shrank contributing to a deterioration of budget revenues. Polish authorities estimate that 0.61 percentage points of the 2002 deficit was a cyclical component. It could be expected that when growth resumes, automatic stabilisers will improve the situation in government sector.

The situation in the Czech Republic is slightly different. The government deficit deteriorated significantly in 2000 and it reached 4.3% of GDP. In the two consecutive years it deteriorated further to 6.4% of GDP in 2002. A growth performance of the Czech Republic was far better than that of Poland. However, the growth was, at least

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<sup>1</sup> Analysing the situation of public finance in the accession countries encounters significant data problems. The countries have been using various national methodologies as well as IMF's GFS 86 methodology. Currently, the transition to ESA 95 is underway, but the data series are limited and vary between the countries. Efforts have been made to use the data consistent with ESA 95 methodology presented by the accession countries in their PEPs, European Commission and Eurostat.

to some extent, supported by a massive fiscal stimulus, which on the other hand contributed to a fiscal deterioration.

The cyclical component of a large Czech deficit is assumed to be much smaller than it is the case in Poland, which makes the overall deficit stubborn even during periods of fairly rapid growth. The main culprit of this structural deficit is the expenditure side of the government sector and the growing share of mandatory social expenditures.

The size of the government sector was dramatically reduced at the beginning of transformation in all candidate countries. In fact, the candidate countries have had just ten years to develop from the basis a public finance system. Today the size of the government sector is on average higher in the candidate countries than in most emerging economies, however, this can be explained by underlying economic factors, such as income, trade openness, government debt and demographic structure. Upon those variables the European Commission (2002c) finds out that the actual size of the public sector in the accession countries is generally close to projected values. The largest discrepancy is found for Poland, where the actual level of government expenditure is more than 5 percentage points of GDP above the predicted one. In the Czech Republic, on the other hand, actual level is below the predicted one.

In the Czech Republic the expenditures of the government sector amount to around 47% of GDP. In Poland the relation of public sector expenditures to GDP was generally declining since 1994 (with the exception of 1999) and fell to less than 43% in 2000. In 2001 and 2002 the expenditures were on a rise and reached almost 47% in 2002.

Government expenditure in the accession countries are affected mainly by four group of factors: social spending, infrastructure spending, bad debt and cost of implementation of the *acquis communautaire*.

The social security spending are large both in Poland and the Czech Republic. In Poland social transfers are planned to amount 19.4% of GDP in 2003. In the Czech Republic social transfers to households in 2002 have been estimated at 14.9% of GDP.

The accession countries, similar to current EU members, are facing similar pressures for higher spending on pensions due to an ageing population. However, economic transformation puts a pension system under additional strain. Both Poland and the Czech Republic inherited mature pay-as-you-go schemes with rather generous benefits that were confronted with pressures on both the expenditure and the revenue side due to economic transition. In order to contain a serious escalation in the number of unemployed and to ease the social and political costs of restructuring state-owned enterprises many countries resorted to early retirement programs. At the same time, the contribution base shrank due to a decline in labour force participation, the rise in unemployment and the expansion of the shadow economy. Many countries, among them Poland and the Czech Republic, have since then introduced reforms and set up voluntary private pension funds. Additionally, Poland introduced mandatory pension system modelled on Latin American funds. The partial switch to the funded system entails considerable transition costs in the short run, which are borne by the state budget.

The Polish system seems to be very well designed in order to cope with the issue of ageing population. Although in comparison to EU standards Polish population is fairly young, yet it has already developed symptoms of adverse changes in the demographic structure. The new pension system is thought to be flexible enough to adjust to growing demographic demands but ageing population pose challenges also to other policies, specifically health care systems and education.

In 2001 the Czech Republic tightened the conditions for early retirement what caused temporary slowdown of the growth of social expenditures. In 2002, however, the social transfers rose again. The reform of pension system is crucial in view of fiscal risks stemming from ageing population. According to calculations of the Czech

Government, if the current legal provisions stay in place, the balanced contribution rate will increase by 2 percentage points by the year 2005 and by another more than 2 points by 2010. Afterwards the impact of ageing population on the economy will be even more pronounced with a significant impact on the general government.

**Table 1**

**Projected financial performance of the public pillar following reforms approved through end-2001**

(Percent of GDP)

	2000	2005	2010	2030	2050
<b>Czech Republic</b>	-0.9	-0.9	-1.3	-4.7	-8.7
<b>Poland<sup>1</sup></b>	-2.3	-2.2	-1.2	-2.2	-2.2

<sup>1</sup> Excluding the costs of the Farmers' Pension Programme

Source: Funk (2002)

The second area of important public spending is connected with infrastructure, particularly of the environment and transport. The underlying reason for that is quite a large degradation of capital stock in those countries. If the governments want to remain attractive for FDIs they need to give high priority for infrastructure spending. The total public capital expenditure amounted to 3.1% of GDP in 2002 in Poland and 6.4% of GDP in the Czech Republic.

The main part of infrastructure investment in the Czech Republic is carried out by the State Fund of Transportation Infrastructure. Its expenditures are financed by shared indirect taxes revenues and privatisation revenues. Also other indirect instruments are used for financing infrastructure, such as development loans provided by the European Investment Bank.

Some types of expenditure come from the period of early transformation. Improper state policy or just connections between (state owned) banks and companies caused unreasonable financing coming from banks to companies. Loans were given on the basis of administrative decisions not on economic calculations. This behaviour caused a pile of bad debts, which governments have to acknowledge at some time. Although

problems with bad debts occurred in all transition economies, the Czech case was the most difficult one. The Czech government consolidated huge bad debts in banking system into the Debt Consolidation Agency (CKA). In each of the past two years the government transferred funds equivalent to 2.5% of GDP to CKA in partial settlements of outstanding losses (the write-off of accumulated losses is counted as government expenditure according to ESA 95 methodology). The still outstanding losses are worth about 4.5% of GDP, which the government will have to eventually pay to CKA. As long as the losses persist they will be counted as deficit according to ESA 95, but once they have been fully written off, fiscal deficit will fall. Backe et al. (2002) quotes a study of Tang et al. (2000) that estimate the cumulative fiscal cost of bank restructuring in the Czech Republic between 1991 and 1998 at 25.4% of GDP. The Czech Government expected the costs of bank restructuring to peak in 2002 at approximately 3.5% of GDP. This indicates that fiscal risks resulting from potential future banking sector failures seems to be rather limited and costs in this area related to transition will diminish in the future.

Poland, on the other hand, suffers from severe costs of restructuring state-owned lagging behind industries. Main sectors that require continuation and intensification of reforms are coal mines and steel industry. According to Funk (2002), the latest programme of reforms in coal mines introduced in 1998 cost 1.8% of the 1998-GDP. The reforms in the steel industry are supposed to cost 40 million PLN in 2002 and 2003 respectively.

A significant part of fiscal burden consists of costs of implementation of the *acquis communautaire* in the run-up to the EU membership. Such costs however will not disappear once the accession countries join EU. The applicants negotiated a bulk of transition periods which allow them to spread the necessary adjustments over longer periods. This means that the impact on budget will be felt longer. The Polish Ministry of Finance estimates that the transfers from the central government budget to the EU will amount to about 1.7 to 1.8% of GDP per year. Poland will be net recipient but many of the EU payments require contributions from the national budget. Moreover,

some EU financial instruments require that a payment has to be made primarily from national budget and later, after obtaining approval from an eligible EU institution, is reimbursed to the country. Such a mechanism, characteristic of the Common Agricultural Policy, could pose an additional pressure on the central budget in the first years of the EU membership.

The general government revenue as a share of GDP has been on a declining trend in the 1990-ties. Transition-accession countries had to set a new tax policy and build tax administration along with introducing a variety of new taxes and to develop systems for classifying new categories of tax payers and new forms of economic activities. Today the composition of revenues resembles those in other EU countries. They have introduced corporate income taxes and a system of personal income taxation. Value added taxes have generally replaced complex turnover taxes.

Although the tax systems are broadly in line with the EU average, some important differences exist. The contribution of personal income taxes is relatively low compared with the respective EU average, whereas social security contributions are a relatively more important component than the personal income taxes with respect to taxes on labour income. This revenue mix could have adverse consequences for the cost of labour and therefore for the demand for labour. Thus reforming the structure and composition of taxes should be a part of the medium-term agenda of those countries (Backe et al. 2002).

The personal income taxation in the candidate countries is a particular sensible area for reforms. They are characterised by high rates, progressive structure and numerous deductions and exemptions through which the effective tax collection is low compared to the EU.

A corporate tax differs significantly among the accession countries. Broad differences in company taxation partly reflect different strategies to attract FDI, as some governments favour special treatments and non-tax incentives. According to IMF calculations

effective tax rates have been much lower than statutory rates (in the Czech Republic about 10%, 22% in Poland).

Indirect taxation has been generally aligned with the EU norms. The VAT system follows the EU guidelines but the standard rates exceed the EU average. Excise taxes are partly above and partly below the EU rates.

**Table 2**  
**Main tax rates in the Czech Republic and Poland**  
 (Percent)

	Personal income taxes				Corporate income tax	Value Added Tax	
	Number of tax thresholds	Lowest rate	Highest rate	Bank deposits		Lower	Standard
<b>Czech Republic</b>	5	15	40	15	31	5	22
<b>Poland</b>	3	19	40	20	27	7	22

Source: Compiled from Backe at al. (2002) and Polish Ministry of Finance.

### EU fiscal rules

From 1 May 2004 onwards the current accession countries will become members of a club where fiscal policy is subject to strict supranational rules. The rules that did not exist prior to Maastricht, were introduced in the Treaty together with plans of launching of the single currency. EMU and the euro have completely changed the economic environment in the EU countries. Monetary policy and exchange rate policy are formulated at the Community level, other policies, mainly fiscal policy remain in national hands. The monetary policy and fiscal policy are the only available economic instruments of influencing aggregate demand and hence main instruments of economic policy. Thus when the monetary policy cannot respond to country-specific shocks the importance of fiscal policy increases.

The external effects of national fiscal policy affecting other monetary union's participants call for co-ordinating national fiscal policies in a monetary union. Outside the monetary union, when a government runs unreasonable fiscal policy pushing up deficits and debt, markets will price in higher risk premium in government's bills. Higher interest paid on debt require larger budget expenditures and further build up of the debt. When markets assess the debt as unsustainable they could sell off their holdings and withdraw from the country. If such a feeling is shared by many market participants this could result in a downward pressure on the currency, and in the extreme, in a currency crisis.

This does not happen in a currency union. The size of the union financial market is far larger than that of an individual country. Consequently, the impact of an increasing debt level on refinancing condition of the individual county is much smaller that in the absence of monetary union (European Central Bank 2003). One currency and an integrated financial market mean that greater recourse to capital markets by national governments to finance an increasing debt level will ultimately affect financial market conditions in the whole currency area. Those so-called spill-over effects are generally transmitted to the whole area via long-term interest rates. Expansionary fiscal policy in one country drains the union-wide private savings and put pressure on the cost of long-term finance in all constituent countries.

Such fears were familiar to the draftsmen of the Maastricht Treaty. In order to prevent national government from running unsound fiscal policy in the Economic and Monetary Union, several specific provisions concerning public finance were included in the Treaty. First and foremost, "sound public finances" were raised to one of the "guiding principles" of all the economic activities of the Community (Article 4). This provision is more of a political declaration than a specific policy rule but further articles make this general declaration more practical.

In order to prevent from unsustainable build up of a debt and a "free rider" behaviour, a "no bail-out clause" was included in the Treaty. Article 103 stipulates that neither the

Community nor a Member State is responsible for liabilities of any other Member State. Monetary financing of the debt has also been excluded in Article 101. Hence any acquisition by the ECB or any other central bank of government liabilities is forbidden. This rule is a basic element of the fiscal discipline and of the central bank independence. The provisions of the Treaty go much further. Not only is the direct financing by the central bank prohibited but merely a “privileged access” of any public institution to financial institutions. This provision complements the prohibition of central bank financing, imposes market discipline in public sector borrowing, reinforces freedom of capital movements and gets rid of the distortions in the allocation of financial resources towards the public sector.

The most prominent provision, however, was introduced in Article 104 as the so-called “excessive deficit procedure”. This Article requires all Member States to hold their deficits below 3% of GDP and their debts below 60% of GDP. Subject to some exception, when a Member State fails to obey the rules, the Council can introduce the procedure, described in the Article, which, in extreme case, can result in fines.

When the start of stage III of EMU was approaching, some Member States (mainly Germany) felt that those provisions of the Treaty are not sufficient to ensure sound public finance that would not endanger the stability of the common currency. After a long debate a consensus was reached at 1997 Amsterdam European Council which on 17 June 1997 adopted a *Resolution on the Stability and Growth Pact*. Based on that political agreement the Council adopted two regulations, which together with the above *Resolution* form the Stability and Growth Pact. The Pact took effect in full only after the euro was launched in January 1999. The three documents consisting the Pact correspond to its three main functions:

- preventive function - Council Regulation (EC) 1466/97 reinforcing the multilateral surveillance of budget positions and the co-ordination of economic policies;
- dissuasive function - Council Regulation (EC) 1467/97, accelerating and clarifying the implementation of the excessive deficit procedure;

- political commitment - contained in the Resolution of the Amsterdam European Council – that all parties involved in the implementation of the Pact (Commission, Member States, Council) will endeavour to implement the budget surveillance process in a full and timely manner according to the clearly defined responsibilities. The political commitment included in the Resolution should not be undervalued. Although it has no legal power, the budgetary process is of political nature and hence the political commitment is important.

The controversies about SGP has surged lately when some Member States broke the reference value of budget deficit. The discussion escalated when the President of the Commission called the Pact “stupid”. Professor Paul de Grauwe, Belgian statesman and economist wrote in Financial Times: *“The stability pact is a vote of no confidence by the European authorities in the strength of the democratic institutions in the Member countries. It is quite surprising that EU countries have allowed this to happen, and that they have agreed to be subject to control by European institutions that even the International Monetary Fund does not impose on banana republics”* (Financial Times 2003).

Are such restrictions really necessary?

The benefits of budgetary discipline are obvious:

- sound public finance help maintain low interest rates which foster investment and growth,
- together with monetary policy they stabilise inflation expectations,
- by reducing the interest burden, help to restructure public spending and reduce taxation,
- allow an increase in public saving in order to cope with adverse economic consequences of ageing population,
- create room for manoeuvre in case of adverse economic disturbances and asymmetric shocks.

In spite of those clear benefits, not many countries succeeded in achieving balance budgets. Between 1970 and 1990 the balance of general government in 15 EU countries

recorded an average deficit of nearly 3% of GDP. The deficit even widened to 5.1% of GDP in the years 1991-1995 and only thanks to efforts connected to fulfilment of the Maastricht criteria fell to 1.6% over the next five years. The history shows clearly that the deficit bias of fiscal policy exists. There are many features of fiscal policy that contribute to the bias. The process of formulating fiscal policy is particularly spread over time. The period between the decision on application of certain measures and its impact on the economy could be long. During this period the cyclical situation may change and hence the applied measures may have a pro-cyclical effect. The decisions once taken by the Parliament and introduced in the law are very hard to reverse, which can have a negative impact in the long run, when the economic environment changes. Fiscal policy is also to much extent subject to political constraints. Because of the political cycle which is determined by elections, the fiscal measures are sometimes based on political rather than economic rationale.

As it was shown above, in a monetary union there are even greater incentives to keep the public finance in the red. The cost-and-benefits calculus of running a deficit is evidently positive for the individual country, while for the union as a whole – negative. Consequently, some restrictions had to be applied in order to prevent EMU, from falling apart. Excessive deficit procedure and SGP were, as P. de Grauwe pointed it, “a vote of no-confidence” of Member States to one other, but the lack of trust was underpinned by the historical evidence, that many European countries failed to keep their houses in order.

Current fiscal developments in EMU countries support, not diminish the importance of SGP as it is sometimes considered by its critics. If, in the presence of SGP - its objectives, rules and sanctions - some countries did break the deficit limits, how it would be in case of absence of any rules?

Most of arguments against SGP invoke keynesian effects of fiscal policy in times of growth slowdown and argue that the Pact prevents the working of fiscal automatic stabilisers. However, the fact is that the 3% limit on deficit was not provided for a

discretionary fiscal policy but just for automatic stabilisation in times of normal growth fluctuation. In times of adverse economic shocks and severe recessions the SGP allows for wider deficits. It is unfortunate that the slowdown in Europe occurred before all Member States brought their budgets to balance but this is not a charge against the Pact but against the lack of sufficient consolidation in EMU countries.

The European Commission indicates (Public Finance 2002) that euro area countries missed the opportunity to exploit favourable growth conditions of the years 1999 and 2000 and to consolidate their public finance. In the euro area as a whole cyclically-adjusted primary balance deteriorated in 2000 and 2001. Taking into account positive output gap during those years the conclusion is that the policy in the euro area was procyclical. Failure to consolidate public finances in times of rapid growth constitutes the main reason of inadequate room for automatic stabilisers and rapidly deteriorated budgetary stance in consecutive slowdown. The current troubles with SGP point out to a failure of enforcement mechanism based on peer pressure rather than of rule-based fiscal policy strategy. Moreover, fiscal policy could learn a lot from monetary policy, where rule-based strategies have been successfully applied for at least a decade.

The questions whether the quantitative rules provided by SGP are adequate for all Member States are, however, justified. The numbers of 3% and 60% concerning deficit and debt levels, as well as 2%, which determines the amount of growth fall justifying the breach of deficit limit, seem arbitrary. Nevertheless, this should not overshadow the usefulness of the whole fiscal policy framework proposed by the Treaty, and Stability and Growth Pact.

## **Fiscal prospects for candidate countries**

At the beginning of their EU membership, the accession countries will have the status of a Member State with a derogation. This means that they will participate in fiscal policy co-ordination in lesser extent than the Member States which have introduced a common currency. First and foremost, they will not be subject to sanctions provided for by the SGP. As the worst “institutional” consequence (meaning the consequence stemming from the SGP) of having an excessive deficit, the Council will be able to address recommendations to a country concerned and as the next step of the procedure, make the recommendations public.

All other provisions of the Pact will apply to new Member States, together with its core objective to keep the fiscal position “close to balance or in surplus” in the medium term. They will also participate in all co-ordination procedures, specifically they will be expected to submit medium-term macroeconomic programmes in form of convergence programmes (eurozone countries present stability programmes). Convergence programmes provide an essential basis for price stability and for a strong sustainable growth contributing to employment creation. They should specify the medium-term objective for the budgetary position of close to balance or in surplus and the adjustment path towards this objective; the expected path for the general government debt ratio; and set out the medium-term monetary policy objectives and their relationship with price and exchange rate stability<sup>2</sup>.

Fiscal rules that govern EU policies were set to improve transparency and predictability of fiscal policies. It could be argued that this kind of features are especially valuable for transition economies with short history of functioning of market economy. Large benefits should also come from improved investors’ confidence. Although all accession countries are functioning market economies, their status as “emerging markets” has fully disappeared. This makes the capital in those countries highly volatile and sensitive. When fiscal tensions arise, those countries can witness rapid shifts in capital flows

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<sup>2</sup> Council Regulation (EC) No. 1466/97

which can result in currency crises. This is particularly dangerous in light of expected participation in ERM 2 and plans of early adoption of the euro.

There could be, however, arguments against too early implementation of the EU fiscal rules in the candidate countries. The required transparency for fiscal policy is not created by a simple quantitative rule itself. A rule, like 3% of excessive deficit, could be an incentive to shift fiscal operations off budget or introduce one-off measures which makes the situation even more blurred<sup>3</sup>. Moreover, for the countries with large investment needs, the requirement of “close to balance or in surplus” could be a too rigid constraint. This may be appropriate for the countries with high debt levels but it could be questioned in case of some candidate countries like the Czech Republic where there is enough room before the debt reference value is reached. It is important that the budget constraint do not disturb necessary structural reforms and investment plans. This issue relates also to EU Member States and is included in the Commission proposal of reforms of SGP, but is of much higher importance in the accession countries.

The EU membership does not bring only new fiscal policy rules but it also has important direct and indirect effects on the fiscal positions of the accession countries. On the one hand the EU membership implies substantial additional expenditure. They are primarily related to a membership contribution to the EU budget. Other costs are connected with implementation of the *acquis*. A significant problem for at least some accession countries will be related to co-financing of structural funds and regional development fund. The accession countries will also have to finance the completion of the transition – so called “second-generation reforms”.

On the other hand, debt servicing costs will diminish. This will be connected with convergence of interest rates to the EU level as well as to better access to European

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<sup>3</sup> The scope of creative accountancy which is at least potentially available, is shown by the example of Portugal. The official figures released at the beginning of 2002 by the government showed the fiscal deficit of 2.2% of GDP. Because the quality of the data were questioned by the opposition party, only after elections the new cabinet set a group of experts under the chairmanship of central bank's president to audit the government accounts. Apparently the deficit widened to 4.1% of GDP.

financial market. However, full benefits of this kind will materialise only after joining the euro zone.

**Table 3**  
**Summary of fiscal effects of EU membership<sup>1</sup>**  
 (% of GDP)

	Czech Republic	Poland
<b>Direct effects</b>		
Contribution to EU budget	-1.25	-1.25
Structural Fund transfers <sup>2</sup>	-1.5	-1.5
Cohesion Fund transfers	0.5	0.5
Reform of public administration <sup>3</sup>	-1.5	-1.5
Phase-out of production subsidies	1.0	2.0
Realignment of customs duties <sup>4</sup>	-0.5	-0.5
Tax harmonisation	0	0.25
Infrastructure expenditures	-1.5	-1.5
<b>Indirect effects</b>		
Structural reforms	+	+
Tax competition	-	-
Tax revenue windfall	+	+
Decline in interest rates	+	+

<sup>1</sup> Annual effect on the fiscal balance over the medium term, following accession.

<sup>2</sup> National contribution.

<sup>3</sup> Including legal approximation.

<sup>4</sup> Including liberalization commitment under WTO.

Source: Kopits and Szekely (2002)

In order to prepare to the future membership requirements, the candidate countries participate in a voluntary initiative called the Pre-accession Fiscal Surveillance Procedure (PFSP) which is composed of three elements – the fiscal notification, the pre-accession economic programme and the multilateral dialogue. The PFSP is designed to prepare the prospective Member States for the EU policy co-ordination and surveillance mechanisms. It aims to strengthen the technical, statistical, analytical and institutional capacity of each candidate country. In addition, it provides an opportunity for the candidate countries to present their economic policies in a multilateral context similar to that applying for the examination of the Member States' convergence/stability programmes, although with no binding character. The PFSP started in the spring 2001.

The first element of the PFSP is the fiscal notification. The candidate countries are asked to submit to the Commission an annual notification of general government budgetary positions in the same format as the one used by the current Member States. The Commission services evaluate the notifications, by monitoring countries' fiscal positions, determining compliance of the data with ESA 95 standards. This evaluation plays an important role in identifying remaining weaknesses, and helps targeting any technical assistance that may be required to ensure the production of adequate statistical data by the time of accession.

Secondly, each candidate country submits a Pre-Accession Economic Programme (PEP) on an annual basis. Similarly to the stability and convergence programmes, PEPs are expected to play a key role in setting the framework for policy-making in the candidate countries. Unlike the stability and convergence programmes, PEPs focus on the economic requirements needed in the period running up to the accession. They, therefore, concentrate predominately on the Copenhagen criteria, rather than the Maastricht convergence criteria. Each PEP consists of a review of recent economic developments, a detailed macroeconomic framework, a discussion of public finance issues and an outline of the structural reform agenda. The Commission services evaluate each programme, focussing on the institutional and analytical preparations for future participation in EMU and assessing whether the outlined policies are adequate to prepare a country for the accession.

Finally, the Pre-accession Fiscal Surveillance Procedure explicitly envisages a multilateral dimension. This was requested by the ECOFIN Council in order to establish a regular in-depth dialogue between candidate countries and Member States, at various levels. To this end, members of the Economic and Financial Committee and their counterparts from the candidate countries meet to discuss the result of the pre-accession procedure. These high level meetings also serve to prepare the economic dialogue at a ministerial level.

A short look at the medium-term fiscal frameworks presented in 2002 PEPs gives a picture of fiscal restraint and consolidation: countries with modest deficits intend to preserve their positions or even improve to full balance. On the other hand, most countries with higher deficits plan to reduce their deficits till 2005. However, the two analysed countries are exceptions to this general observation. The Czech Republic aims only at a moderate reduction of the deficit and Poland intends to reduce the deficit only towards the end of the framework period. The Czech authorities plan to reduce the deficit to 5.5% of GDP in 2005. The Polish PEP, prepared in the mid-2002 envisaged the reduction of the deficit from 4.1 % of GDP in 2002 to 2.2 % of GDP in 2005. However, the budget law, prepared just some month later, revised the figures towards more ambitious consolidation – from 4.4% of GDP in 2002 to a target ratio between 2.0 and 1.0% of GDP in 2005.

The 1.9 percentage points fall of deficit ratio between 2002 and 2005, projected in the Polish PEP, is to be reached by improvement of structural balance by 1.25 percentage points, cyclical component by around 1 percentage point and by a limited negative contribution of the interest rate component. In the Czech Republic the structural primary deficit is planned to fall from 4.8% of GDP in 2002 to 3.7% of GDP in 2005. The cyclical component improves only marginally and the interest rate component worsens. In addition the Czech PEP contains sensitivity analysis of public finance balance. It is argued that an improvement of the GDP growth rate by 1 percentage point improves the budget balance by around 0.3 percentage points. These calculations prove that the budget deficit is mainly of a structural nature.

Medium term economic programmes presented in PEPs present only general overview of measures affecting government expenditures and revenues. Nevertheless it seems quite clear that those countries do not intend to increase expenditures in order to close their budget gaps. In Poland the share of revenues to GDP is expected to fall by about 1.4 percentage points in 2003, before rising again through 2005. As an exception to almost all candidate countries, in the Czech Republic the government forecasts

revenues remaining flat as a percentage of GDP in 2003, before rising marginally in 2004.

**Table 4**

**Deficit and debt developments in the Czech Republic and Poland**

	2001	2002	2003	2004	2005
<b>Czech Republic<sup>1</sup></b>					
Deficit	-5.0	-6.4	-6.0	-5.7	-5.5
Debt	23.7	25.6	27.8	31.3	34.7
<b>Poland<sup>2</sup></b>					
Deficit	-3.5	-4.1	-3.9	-2.6 – -2.1	-2.0 – -1.0
Debt	38.7	41.8	44.7	44.6 – 46.0	42.7 – 45.4

<sup>1</sup> Pre-Accession Economic Programme

<sup>2</sup> Data for 2001 - Pre-Accession Economic Programme, data for 2002 – the Ministry of Finance, forecasts for 2003-2005 – budgetary law for 2003

Given the high tax rates, changes to the revenue side will likely be focused rather on broadening the tax base and improving tax collection efficiency. The Polish PEP points to increasing arrears in tax payments and proposes measures improving tax collection. Tax legislation is generally in line with the EU standards with only fine-tuning required. The planned harmonisation of indirect taxes should contribute to a small increase of tax revenues in the Czech Republic. In order to reduce tax evasion, on 31 December last year the Czech Republic increased the lower VAT rate from 5% to 7%, while the upper VAT rate was cut from 22% to 21%. In 2001 Poland introduced interest gain tax in amount of 20% as well as excise tax on energy.

The major part of consolidation process will require restructuring expenditures. Expenditure strategy in the Polish PEP is based on a rule “CPI + 1%” meaning that annual growth in expenditure at central government level should not exceed the forecasted CPI by more than 1 percentage point. However, in the budget law for 2003 the expenditures are set to increase by 2.2% in real terms which means that the “CPI + 1%” has been abandoned and in fact never applied.

Poland plans to reduce public investment expenditures substantially to very low levels – 2.5% in 2005. This significant cut may raise doubt whether this is feasible in the context of accession and catching-up process. In the Czech Republic public investment expenditures relative to GDP are projected to remain comparatively high (4.7% of GDP in 2005). This figure, on the other hand, rises question of whether spending plans in this area would not deserve to be reviewed for potential savings in order to contribute to a more forceful fiscal consolidation.

The high rate of growth of social transfers, exceeding the growth rate of social contributions and tax revenues, is considered as a major risk for the government expenditures in the Czech Republic. A new system of remuneration of public administration employees will also affect public spending. Poland targets at a reduction of overall social and welfare expenditures in relation to GDP, from an initially high level, which is to be achieved by keeping real growth of such expenditures below real GDP growth. Most of the adjustments, however, will come only in 2004 and 2005.

Most candidate countries expect a gradual reduction of the debt ratio, in line with decreasing deficits. Both Poland and the Czech Republic are major exceptions to this trend<sup>4</sup>. The debt to GDP ratio is supposed to rise by 9.1% of GDP in the Czech Republic and by 2.3% of GDP in Poland between 2002 and 2005. There are, however, significant differences in debt ratio in the two countries: at end-2002 Polish debt-to-GDP ratio stood at 41.8%, whereas the Czech one at 25.6%. Additionally, the Polish PEP gives estimates for the impact of change in interest rates on the government debt service. It is supposed that a rise of domestic (foreign) interest rate by 1 percentage point would amount to a rise of debt service expenditure by 0.4% (1.4%). The estimated elasticity for currency depreciation is 0.2.

The interest payments on national debt constitute another important item of the expenditure side in both countries, although the burden differs along with the difference in debt ratio. For 2003 the interest payments are expect to amount to 1.1% of

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<sup>4</sup> Other two cases are Latvia and Romania.

GDP in the Czech Republic and 3.5% of GDP in Poland. The difference in debt servicing cost stem from different stock of debt but also form different interest rates paid on national debt.

Therefore, countries like Poland where the debt and interest rates are high will enjoy big fiscal savings as interest rates and borrowing costs converge to the eurozone levels. Consequently, Poland has every incentive to join the eurozone as soon as possible. This would lead to a sharp reduction in domestic interest rates towards the euro levels and to big fiscal savings on domestic debt service. On the other hand, the Czech Republic, where benchmark government bonds are currently trading at or even through the euro curve, will not likely enjoy any fiscal savings from an interest rate squeeze. Fiscal benefits of early joining the eurozone will be thus much smaller. A rough estimate of the fiscal saving in the long run can be easily calculated assuming no future changes in the eurozone interest rates. According to data of *Credit Suisse First Boston* (CSFB, 2003), the Czech Republic can expect no further savings on debt servicing costs from the eurozone entry. However, it could be argued that unless a radical finance reform takes place, the debt levels are likely to rise sharply in the coming years as well as the yields on government bonds. In this case the expenditure on debt servicing is posed to rise sharply. On the other hand, Poland's gain from the eurozone entry could be as large as 0,7% of GDP if it were able to pay interest rates around the euro level on its national debt.

Those differences are well mirrored in the above countries' plans for the eurozone entry. In Poland the discussion on when to introduce the euro is more advanced among academics than among politicians but official position included in the PEP is "the sooner, the better". Last year an agreement between the Ministry of Finance and the National Bank of Poland was reached on general principles of Polish strategy of entry to the eurozone. Those institutions committed themselves to pursue a policy which would eventually lead to fulfilment of the Maastricht criteria in 2005. Since the inflation rate is already very low, interest rates are close to the Maastricht criteria and a safe margin on debt ratio exists, the budget deficit will be the key variable. If the path of

reducing the deficit presented in the PEP (2.2% of GDP in 2005) or budgetary law for 2003 (1-2% of GDP) is accomplished, the agreed strategy will enable to introduce the euro as soon as 2007.

The Czech Republic evidently hesitated to release any clear intentions as far as the timetable of euro introduction is concerned. Only in December last year a comprehensive official strategy was published. Although the document is much longer than the Polish one, the conclusions are much more concise. The presented assessment of potential risks and benefits allows the Czech authorities conclude that the “fast entry” to the eurozone will be beneficial for that country. Consequently, the economic policy should be pursued in such a way as “not to rule out the possibility of joining the eurozone sometime around 2007”. This evasive wording means that the Czech authorities are aware of the risks embedded in fiscal policy stance. In spite of cautious formulation it seems that the year 2007 is too optimistic. In order to introduce the euro in that year the deficit criterion should be fulfilled by 2005, yet according to the PEP the actual deficit will exceed the reference value by 2.5% of GDP. In case of lack of any thorough public finance reform it is very unlikely that the deficit will fall quickly after 2005, because of its rigid structural nature. Meanwhile, the long expected and urgently needed reform has been postponed. The reform should take form of significant and sustainable expenditure cuts, especially mandatory social spending. Old-type PAYG pensions system needs re-arranging and development of a second pillar. Also health policies are not fiscally sustainable in the medium term, which was addressed in the latest OECD survey (OECD 2003).

A proposal of a reform package for the public finance has been recently announced in Poland. The package includes reform of the farmer’s pension system, liquidation of some state agencies and funds and further decentralisation of the public finance system. The critics, however, point to the proposed abolition of most personal income tax relief, which together with maintaining current tax rates will mean a larger tax burden. The government has already approved the general assumptions of the programme but the details have to be consulted with social partners and the central bank. The National

Bank of Poland is to be consulted in view of a controversial intention to make use of a revaluation reserve which has been established according to new accountancy methods in the central bank. Full details of the strategy will be revealed in the middle of the year, probably after accession referendum (scheduled for 8 June) and the implementation should start from 2004 onwards.

## **Conclusions**

Fiscal policy in both the Czech Republic and Poland face similar challenges, stemming from completion of transition on the one hand and UE accession on the other. Successful answer to those challenges will require substantial improvements in the public finance system. The medium-term goal of the reforms should be to make public finance contribute to real and nominal convergence, which will allow the candidate countries to fulfil the Maastricht criteria and introduce the euro. At a later stage fiscal policy will need to be prepared to take over as the only available instrument to cope with country-specific shocks. On the other hand the flexibility of fiscal policy will be constrained by strict fiscal rules of the Treaty and Stability and Growth Pact. In the long run the accession countries, together with the current EU members, will encounter the fiscal costs of ageing population.

There are some similarities in the current fiscal situation of the Czech Republic and Poland. The budget deficits have risen markedly in recent years in face of slowing growth. The Czech deficit, however, seems to be more of a structural nature than that of Poland. Both countries require substantial re-arranging of government expenditures. Most important item on the expenditure side is social spending with pension obligations displaying significant fiscal risks in the Czech Republic. Although social transfers are also important position in the Polish expenditures, pension system in this country is better prepared to cope with ageing population. A significant burden for both countries are costs related to restructuring of the economy. In the Czech Republic

these mainly concern banking sector yet in Poland the heavy industry. As far as national debt is concerned, the situation is more favourable in the Czech Republic with moderate debt level and low interest rates. The Czech government seems to take advantage of its low debt and do not intend to reduce the deficit until 2005. Poland, in face of significant debt burden, sets ambitious deficit path in its PEP 2002. Deficits levels will be the main constraint on the time of EMU entry. Although both countries opt for fast path to EMU, it seems to be more likely that Poland will be first to introduce the euro.

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## II. The Maastricht-induced fiscal consolidation in EMU Member States – conclusions for accession countries

Contribution by Tomasz Jędrzejowicz\*

### Introduction

On May 1, 2004 ten new Member States shall join the European Union. This shall be a historical milestone for the EU and in particular its new members, who shall reap many benefits. However, their effort to become fully integrated with one of the world's largest single markets will not be over by then. That road shall be concluded in a few more years' time, when they join the Economic and Monetary Union and adopt the single European currency. In order to complete this final step, EU members are required to meet the Maastricht convergence criteria, which ensure that economies joining the euro-zone are ready to participate in one currency and one monetary policy. Although majority of the acceding countries were centrally-planned economies barely 15 years ago, they have completed a remarkable transformation process and are now conducting sound economic policies allowing them to converge to their Western European counterparts. They have instituted modern, independent central banks, which have effectively fought high inflation experienced by these countries in the first years of transition. At present they are in a very good position to meet the monetary criteria of the Maastricht Treaty and enter the Exchange Rate Mechanism (ERM) en route to adopting the euro.

However, the Treaty also places obligations regarding fiscal policy on EMU candidates. For some of them this could prove to be a tougher challenge, as reduction of budget deficits is always politically unpopular and especially so in adverse macroeconomic conditions, which some of the candidate countries are experiencing in the period of run up to EU accession. The fiscal criterion was also the biggest challenge for many of the current EMU members. The Europe-wide fiscal consolidation process of the mid-1990s can thus be a valuable lesson for EU accession countries, who can draw conclusions on different retrenchment strategies pursued. They can also draw comfort from the fact that all countries aiming to meet the Maastricht criteria have in fact managed to achieve this

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\* Public Finance Division, Macroeconomic and Structural Analysis Department, National Bank of Poland. The views expressed in this paper are those of the author and shall not be attributed to NBP.

objective (although Greece did so a year later than the other EMU countries) and their citizens now have euros in their wallets.

This paper is aiming to examine the European fiscal consolidation experience of the 1990s and to draw implications for accession countries, some of whom will have to conduct similar consolidation in order to qualify for EMU.

## **1. The rationale behind EMU fiscal rules**

One of the vital features of the institutional framework of the EMU is strong fiscal discipline. This is meant to support the independent monetary authority European Central Bank (ECB) in its mandate of preserving price stability. The authors of the Treaty were particularly concerned about preventing a repeat of fiscal policy failures, which occurred in Europe in the 1970s and 1980s (Buti and Giudice, 2002). These years were an era of rapidly rising share of the general government sector in the economy. In countries belonging to the euro area, the relation of government expenditures to GDP had risen from 36% in 1970 to a high of over 52% in 1993 (European Commission, 2000). Government revenues also increased very significantly during that time, but not quite as fast as spending. As a result, net borrowing of euro area countries grew from almost nil in 1970 to a range of 4%-5% in the 1980s. This had inevitably resulted in a quickly rising stock of public debt, which in late 1970s totalled less than 30% of GDP, but by early 1990s its relation to GDP had more than doubled. Growing debt had in turn fuelled a further rise in expenditure in the form of interest payments, which by 1990 amounted to around 4% of GDP.

To make matters worse, fiscal policy in Europe in the 1970s and 1980s has tended to be pro-cyclical. This means that government budgets did not help to dampen cyclical fluctuations of the economy as they could and should have, but instead have contributed to amplifying output swings. The budget should be anti-cyclical primarily through the working of automatic stabilisers. In a situation of a cyclical downturn, tax revenues are lower, while unemployment-related and social spending tends to be higher, resulting in a higher deficit and helping the economy come out of recession. Meanwhile, during an upturn, tax revenues are buoyant, fewer citizens require social assistance of the state and the deficit is thus automatically reduced. However, this was not the case in the period in question. Deficits did not fall as expected during economic upturns, implying that rather than allow for automatic stabilisers to work, policymakers opted for tax cuts or spending

increases in periods of boom. This has in turn forced them to tighten fiscal policy in times of recession, as they could not let the deficit and public debt rise indefinitely.

There are two main conclusions to be drawn from these developments, which imply that a radical change in fiscal policy was required. The first one is that policies carried out in the 1970s and 1980s were simply unsustainable, as evidenced by the rapid growth of public debt. The second is that such pro-cyclical policies would have been much more dangerous in a monetary union, where an excessively lax fiscal policy stance in one country cannot be countered by restrictive monetary policy, which is the same for all countries. Similarly, if one country conducted a restrictive fiscal policy during a downturn, because its public debt had risen to extremely high levels already, a single monetary authority could not focus on reviving the economy of that one particular country.

## **2. Fiscal criteria of the Maastricht Treaty**

The fiscal story of the 1970s and 1980s, outlined above, was an important factor in the design of the rather rigid fiscal framework of the Maastricht Treaty and, consequently, the Stability and Growth Pact, which is meant to ensure fiscal prudence within the euro zone. There are two basic types of fiscal rules, which can help enforce fiscal discipline: (Buti and Giudice, 2002)

- a) Numerical targets, namely explicit constraints on fiscal variables, such as spending, deficit and debt or their growth
- b) Procedural measures conducive to formulation of disciplined fiscal policy

Numerical targets are simple to implement and monitor, provided there are good fiscal accounting standards. The drawback of tight numerical rules is that they enforce strict discipline also during economic downturns, which can lead to procyclical fiscal policy, if policymakers are not prudent enough to lower the deficit during a boom. A possible solution to this problem would be using numerical targets for structural budget balances, but this is methodologically difficult, as it would involve a numerical target based on an unobservable variable – the output gap. Another important drawback of numerical targets is that they encourage using one-off measures or even creative accounting measures in order to attain the right figure on paper. Such measures are not conducive to prudent fiscal policy and thus do not comply with the objectives which fiscal rules are supposed to achieve in

the first place. As shown later on in this discussion, such measures were in fact employed by some EMU candidates to attain an illusory improvement in their fiscal position.

Procedural measures are aimed at creating “hierarchical” budgeting procedures, in which the supreme fiscal authority has strong power to maintain spending limits set. At supra-national level, a supra-national body is assigned the power to assess the fiscal position of national governments and sanction them for failure to meet numerical targets.

The institutional framework of the Maastricht Treaty is a combination of numerical and procedural measures. On one hand, the Treaty stipulates that Member States shall attain a high degree of sustainable convergence in order to be admitted to a monetary union. One of the elements of this convergence is sustainability of the government financial position, specified as a deficit below 3% of GDP and public debt not higher than 60% or in case of higher debt, it should be approaching the reference value at a satisfactory pace.

On the other hand, the European Commission is granted the right to verify the financial position of governments of Member States and prosecute them in case of failure to meet the numerical targets. In such a situation, the Commission can launch a procedure aimed at correcting excessive deficits. This procedure can culminate with sanctions in the form of non-interest bearing deposits and fines.

### **3. Budgetary adjustment in the 1990s**

The Maastricht Treaty was a powerful stimulus for European Union countries to consolidate their budgets. The role of the Treaty and the ‘carrot’ of future EMU membership is particularly evident, when considering the unfavourable economic climate of the early 1990s in spite of which a remarkable fiscal consolidation has been achieved (European Commission, 2000). All 11 future members of the EMU,<sup>1</sup> had embarked on a fiscal consolidation path, although for example Ireland need not have done so, since it had already reduced its budget deficit significantly in the late 1980s. This means that there are at least 11 interesting cases of fiscal retrenchment to analyse.

Considering that each of these 11 countries began its consolidation process from a different starting point, in a different economic and political setting, there is no surprise in the fact that they have pursued very diverse strategies. There are different ways of classifying these

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<sup>1</sup> Luxembourg is being excluded from this analysis due to its unique features as a micro state.

strategies, with the most common division being that into revenue- and expenditure-based retrenchment strategies. The European Commission distinguished also a third path – the “switching’ strategy in which countries first resort to revenue adjustments and then switch to expenditure cuts.

However, another classification can be offered, one which relates to the numerical nature of Maastricht Treaty targets. As mentioned earlier, these can also be attained through superficial measures. We would therefore propose to divide the consolidation strategies into three groups:

- expenditure-based consolidations,
- revenue-based consolidations,
- mixed strategies featuring one-off measures and in some cases creative accounting.

### **Expenditure-based consolidations**

#### **Austria**

Following the failure of Austria’s first EMU-aimed budgetary retrenchment effort in 1995, when the deficit turned out at 5.1% of GDP, a comprehensive reform package was introduced in the following year. Consolidation measures were introduced for most categories of revenues and expenditure, however, the bulk of the adjustment occurred on the spending side. Expenditure decreased by 2.8 percentage points of GDP between 1994 and 1997. The cuts were focused in such areas as public administration wages, family allowances, other welfare transfer payments, unemployment benefits, subsidies to the business sector, reduction of health care costs. Furthermore, early retirement options were restricted. In spite of the need to reduce the deficit within a short period of time, the Austrian government implemented several systemic measures, rather than resorting to temporary tax increases or spending cuts. Taxes were also adjusted, through elimination of some concessions and allowances, mainly in the area of direct taxes. These measures allowed Austria to lower its deficit to 1.7% in 1997, comfortably meeting the Maastricht deficit criterion.

#### **Finland**

At the beginning of the 1990s, Finland was undergoing quite pronounced economic difficulties, caused by the breakdown of trade with the former Soviet Union and a banking

crisis. As a result, the country ran a high budget deficit, exceeding 5% of GDP. However, in 1995 a determined fiscal consolidation strategy was implemented, leading to quick reduction of the deficit in subsequent years and achievement of a budget surplus in 1998. This strategy involved radical measures on the expenditure side, as public spending decreased by 12 percentage points between 1992 and 1999. The government undertook firm measures to lower social transfers and intergovernmental transfers. The pension system had undergone a comprehensive overhaul, including lowering accrual factors, less favourable calculation of pensionable wage and lower indexation. Access to unemployment benefits was tightened and the policy of subsidising industries altered. Thanks to such extensive measures on the expenditure side of the budget, the government was able to not only attain a budget surplus, but also to lower social security contributions, with the aim of promoting employment.

### **Ireland**

The “Irish miracle” is a well-established phrase in economic literature, which says a lot about Ireland’s macroeconomic performance over the past two decades. The country has achieved a spectacular turnaround by implementing a host of bold structural reforms, one of which was a major overhaul of public expenditure, conducted already back in the 1980s. This made Ireland the only EU country meeting the Maastricht fiscal deficit criterion on the day the Treaty was signed. However, prior to its spending reforms, Ireland’s fiscal policy was very lax and public debt soared to levels in excess of 100% of GDP. The government was therefore intent on maintaining prudent fiscal policy, so as to facilitate a steady reduction of the debt level, while at the same promoting employment. At the beginning of the 1990s, additional fiscal adjustment took place, but this time on the revenue side of the budget, primarily through broadening of the corporate tax rate. However, between 1994 and 1999 public spending was further lowered by 5.9 percentage points of GDP. This was attained thanks to a reduction in wage compensation of public employees, agreed with trade unions, as well as lower transfers. As a result, Ireland attained a budget surplus of 2% of GDP in 1999, while reducing its debt level to 43.9%, half of what it was barely five years earlier.

## Netherlands

Although the budget deficit of Netherlands exceeded the Maastricht reference value only by a marginal 0.1 of percentage point of GDP in 1993, in the following years the deficit deteriorated, reaching 4.2% in 1995, as a result of an economic downturn. However, already in 1994 the government accepted a fiscal consolidation strategy focused on reducing real expenditure by 0.7% per year on average, with the bulk of the adjustment coming in the area of social security. A health care financing reform was undertaken and a law introduced to limit the number of disability claimants. Unemployment eligibility was then tightened and social assistance structure simplified. As a result of these measures, primary expenditure decreased by more than 5 percentage points of GDP between 1992 and 1999. Meanwhile, the tax burden had increased in 1993, but in the subsequent years personal income taxes for the lowest earners were lowered, as were social security contributions, both with the aim of promoting employment. Some of the ensuing revenue loss was offset by an upward adjustment of indirect taxes. From 1997 onwards the consolidation effort was additionally supported by a decrease in interest payments.

## Spain

The Spanish consolidation effort was somewhat delayed, in comparison to other euro area countries. At the beginning of the 1990s the country's macroeconomic situation deteriorated, leading to shortfalls in tax revenues and causing the government to undertake discretionary measures to counter the crisis, such as higher transfers to social security funds and public companies. This had resulted in a high budget deficit, which peaked at 7% of GDP in 1995, with just two years to meet the Maastricht target of 3%. However, in 1994 the government initiated its expenditure-based fiscal consolidation, aimed at meeting the reference value. Retrenchment measures had been undertaken in several spending categories, including agreements on wage moderation and a public employment freeze, agreement on containing growth of health care spending, restricting access to unemployment benefits, adjustments in the pension system, causing lowering of replacement rates. As a result of these steps, primary expenditure declined by more than 5 percentage points of GDP between 1993 and 1999. On the revenue side, indirect tax rates were raised, while social security contributions and direct taxes decreased as a proportion of GDP.

## **Revenue-based consolidations**

### **Belgium**

The European Commission classified Belgium's consolidation effort as an example of a so-called "switching" strategy, in which tax increases are followed by expenditure restraint (European Commission, 2000). The Belgian authorities provided the following explanation for such a strategy – hard measures on the revenue side would stabilise market expectations and thus facilitate the ensuing expenditure restraint. This rationale was particularly valid for Belgium, which had accumulated a stock of public debt exceeding 120% of GDP, meaning that market expectations about the success of the consolidation strategy had important implications for debt servicing costs. However, for the purpose of this classification, Belgium is included among countries pursuing revenue-based consolidation, as revenue measures outweighed those on the expenditure side, in terms of adjustment in relation to GDP.

At the beginning of the previous decade, Belgium introduced hard measures on the revenue side, causing all major tax categories to increase as a proportion of GDP. Corporate taxes were raised by limiting deductions and depreciation write-offs. Taxes on pension and life insurance payments were introduced and indexation of personal income tax thresholds suspended. Indirect taxes were also raised. However, after 1994, the government introduced some tax lowering measures, aimed at long-term creation of unemployment. Contributions to social security were thus reduced, particularly for lowest earners, young unemployed and sectors most exposed to international competition. The government also introduced some short- and long-term expenditure restraint measures. The latter initiatives were focused in the areas of health care financing, unemployment benefits, as well as the growth of wage compensation.

### **Greece**

In the first half of the 1990s, the situation of Greek public finances was one of the worst in Europe, casting serious doubt over the country's ability to meet the Maastricht criteria. Throughout that period, the public sector deficit exceeded 10% of GDP, leading public debt to rise above 100%. Interestingly enough, despite a radical increase in taxes, enacted at the beginning of the decade, the deficit remained above 10% until 1995. This was due to a

moderate increase in public expenditure and rising costs of servicing the piling public debt. The revenue-raising effort included excise tax increases, VAT harmonisation, and several measures aimed at limiting tax evasion, as well as introduction of new principles of taxing farmers. Tax deductions and exemptions in corporate income taxation had been abolished or limited. As a consequence of these sweeping tax changes, the current revenue to GDP ratio expanded from 31.9% of GDP to 48% of GDP. Expenditures were reduced only modestly after 1995, although some of this adjustment had been achieved by moving public investment off budget (Von Hagen et al., 2001). These steps, combined with significantly reduced interest payments, have allowed Greece to stabilise its deficit well below the 3% reference ratio towards the end of the 1990s.

### **Portugal**

This is another example of a country with a high budget deficit of over 6% at the beginning of the Maastricht consolidation process. In 1992 the first fiscal consolidation programme was implemented, with several measures aimed at raising tax revenue, such as changes in income taxes, VAT rates and efforts to improve tax administration. However, these steps did not yield a lasting fiscal improvement, as in 1993 the government increased public spending in reaction to an economic crisis, raising subsidies to farmers, exporters and enacting a programme of low cost housing loans. A second wave of revenue-based consolidation began in 1994, supported by moderate expenditure reduction in the form of wage and transfer moderation. However, these measures were soon reversed, as the spending policy yet again became expansionary. In spite of this, the government did manage to effectively lower the fiscal balance to -2.6% of GDP in 1997, thanks to strongly falling interest rate payments from 1995 onwards.

### **Mixed consolidation strategies featuring one-off measures**

As mentioned previously, the numerical nature of the Maastricht fiscal deficit criterion can cause attempts to satisfy it using superficial measures, rather than firm and lasting fiscal consolidation strategies. In case of some of the euro area countries, it can be argued that the desire to meet the Maastricht criteria and join the EMU was stronger than the desire to actually attain a sustainable improvement of the fiscal position. This inconsistency of objectives manifested itself in resorting to emergency measures and in some cases even

creative accounting in order to show a sufficiently low deficit in 1997. Although emergency measures appeared in several countries, which had to curb high deficits, perhaps the three countries outlined below relied on them to greatest extent.

### **France**

At the beginning of the 1990s France's fiscal policy was an expansionary one, which, coupled with unfavourable economic conditions, has led to a general government deficit of 6% in 1993. The government proposed an expenditure-based consolidation strategy, but it has not been successful, as evidenced by the deficit of 5.5% of GDP in 1995. This is because long-term spending reduction measures such as the pension reform of 1994, were accompanied by various subsidies granted to specific sectors of the economy and new social security benefits. At the same time, indirect taxes were raised, but the effects of this step were offset by introduction of a tax scheme supporting small and medium sized businesses. Since the deficit remained excessive, the government resorted to emergency short-term measures to meet the Maastricht criteria. These included blocking appropriations, temporary freezing of wages, introducing a social security debt repayment levy and raising the corporate tax rate on larger firms. Finally, the government took on the pension obligations of France Telecom, in return for a one-time payment equal to 0.5% of GDP, which improved the budget balance in 1997. As a result, France managed to meet the reference value for the deficit. (Milesi-Ferretti, 2000).

### **Germany**

Although Germany showed relatively low budget deficits at the beginning of the 1990s, the true picture of fiscal stance was obscured by several special funds and semi-governmental entities which provided off-budget unification support to East Germany. The government initiated a consolidation effort in 1993, but it turned out not to be very effective, due to conflicting objectives. The government did not want to lower social transfers, which would affect particularly the Eastern part of the country, but at the same time it sought to reduce tax burden on businesses, which had increased in previous years in order to finance the unification process. Furthermore, economic conditions were not conducive to achieving a reduction in the deficit. This had pushed policymakers to resort to emergency measures, such as spending restraints, in order to meet the Maastricht target in 1997.

## Italy

At the beginning of the 1990s, the fiscal picture of Italy was one of the most troublesome in all of Europe, with a deficit close to 10% of GDP and public debt higher than the GDP. A tremendous consolidation effort appeared necessary and the Italian government began with a revenue-based retrenchment, as a result of which revenues increased from 41.7% of GDP in 1990 to 48.3% in 1993. However, these measures were mostly of a short-term nature and ended in 1994, following which revenues fell sharply. This is when decisive efforts were undertaken to lower expenditures, including a health care reform and a second pension reform, after the previous attempt did not succeed in significantly lowering spending. Expenditure decreased by 2.5 percentage points of GDP, but as the initial deficit had been very high, by 1996 it had only been reduced to 7.1% of GDP – more than double the Maastricht reference value. Facing the need to achieve an improvement in the budget balance of 4 percentage points of GDP in one year, the government resorted to numerous emergency measures. Spending restraints were introduced on intergovernmental transfers, access to early retirement benefits postponed and indexation of high pensions suspended. Limits were introduced on health care expenses, particularly on pharmaceuticals. On the revenue side, some of the tax deductions had been abolished and property, corporate, VAT taxes and social security contribution rates were all raised. The previously introduced extraordinary tax on firm assets had been extended. In 1997 as special one-year, progressive “Euro” tax had been introduced, with rates varying from 1.5% to 3.5%. Interestingly, the tax was partly reimbursed in 1999. Measures, which could be considered creative accounting, were also employed in Italy. For example court-ordered payments of pension outlays, which were made in 1997-2000, were retroactively imputed back to the years when the liabilities were incurred (1993-1995) leaving the deficit in 1997-2000 unchanged (Milesi-Ferretti,2000).

### Fiscal consolidation in the 1990s - recapitulation

The table below shows the remarkable improvement in the budget balances of the 11 members of the EMU.

**Table 1. Budget balances (in % of GDP) of EMU countries in the 1990s**

	1993	1994	1995	1996	1997	1998
Austria	-4,2	-4,8	-5,1	-3,8	-1,7	-2,3
Belgium	-7,3	-5,0	-4,3	-3,8	-1,9	-0,9
Finland	-7,3	-5,7	-3,7	-3,2	-1,5	1,3
France	-6,0	-5,5	-5,5	-4,1	-3,0	-2,7
Germany	-3,1	-2,4	-3,3	-3,4	-2,7	-2,1
Greece	-13,8	-10,0	-10,2	-7,4	-4,0	-2,5
Ireland	-2,3	-1,7	-2,2	-0,2	0,7	2,1
Italy	-9,4	-9,1	-7,6	-7,1	-2,7	-2,8
Netherlands	-3,1	-3,6	-4,2	-1,8	-1,1	-0,7
Portugal	-6,1	-6,0	-4,6	-4,0	-2,6	-1,9
Spain	-6,7	-6,1	-7,0	-4,9	-3,2	-2,6

Source: IMF World Economic Outlook, 2001

The Maastricht Treaty turned out to be a very effective impulse leading to successful reversal of the 25-year deterioration in the public finances of EU countries. The deficit of the euro area fell by 3.5 percentage points of GDP between 1993 and 1997 to reach a level below the 3% of GDP threshold. Was this a sufficient adjustment? It may appear so considering that all countries except for Greece, attained a deficit below 3% of GDP in 1997. This means that EMU countries consolidated their budgets sufficiently to enter the EMU.

However, it is important to note that after EMU candidates meet the entrance criteria and join the Union, they need to continue to maintain fiscal discipline. In fact, they are bound by even stricter rules of the Stability and Growth Pact (SGP). The Pact was adopted by the European Council in 1997 as a means of ensuring budgetary discipline inside of the EMU. It includes measures to strengthen surveillance of budgetary positions as well as detailed regulations on the excessive deficit procedure of the Maastricht Treaty. Moreover, as far as the numerical target for the deficit is concerned, the SGP constitutes a very important interpretation of the Maastricht reference criterion. The Pact states that Member States should achieve a medium-term budget position “close to balance or in surplus.” This is crucially important, because it means that the 3% of GDP limit is not a target, but an absolute ceiling, which may not be violated, except for exceptional situations. The SGP therefore imposes the following fiscal strategy on Member States: their budgets should be

close to balance or in surplus when their economies grow at the trend rate. This would ensure, that the deficit does not breach the 3% of GDP level during normal cyclical downturns.

Aside from an economic downturn which could undermine the newly improved budgetary positions of EMU countries, another key issue is the quality of the consolidation strategies. For example, if an adjustment is attained through short-lived measures such as introduction of special temporary taxes or suspension of indexation of public sector wages for one or two years, the budget position is likely to deteriorate after these measures are revoked. Therefore, it is important to look at the quality of the fiscal adjustment achieved in EMU countries.

#### 4. Fiscal developments in EMU following the consolidation period

The fiscal position of EMU countries in the years following their consolidation effort is a telling indicator of the quality of the fiscal adjustment. The fiscal imbalance of most euro area countries deteriorated between 1998 and 2002 and in some cases it is expected to deteriorate further by 2004. To some extent, this is due to negative cyclical developments. However, those countries which have consolidated their budgets to reach a position close to balance or in surplus in the late 1990s, shall have no problem maintaining their deficit within the 3% of GDP limit, even during an economic downturn.

Let us examine the fiscal situation in EMU countries, divided into the same three groups as above – according to their consolidation strategies.

**Table 2. Post-consolidation budget balances (in % of GDP) of countries which pursued expenditure-based retrenchment strategies**

	1998	1999	2000	2001	2002	2003	2004
Austria	-2,4	-2,0	-1,5	0,1	-0,6	-1,1	-0,4
Finland	1,3	2,3	6,7	5,1	4,7	3,3	3,0
Ireland	2,1	2,0	2,4	1,2	-0,3	-0,6	-0,9
Netherlands	-0,8	0,5	1,3	0,2	-1,1	-1,6	-2,4
Spain	-2,5	-1,1	-0,4	0,0	-0,1	-0,4	-0,1

Source: European Commission (2000, 2001, 2002, 2003)

Note: excluding UMTS revenues

As the above table shows, the improvement of fiscal positions in this group of countries appears to be quite permanent. In 2001 none of the countries from the group recorded a public finance deficit. In the following years their balances have deteriorated somewhat due to the economic downturn, however, none of them has, or is expected to breach the 3% of GDP reference value for the deficit.

**Table 3. Post-consolidation budget balances (in % of GDP) of countries which pursued revenue-based retrenchment strategies**

	1998	1999	2000	2001	2002	2003	2004
Belgium	-1,1	-0,9	0,0	0,2	0,1	-0,2	-0,1
Greece	-2,5	-1,8	-0,8	-0,4	-1,2	-1,1	-1,0
Portugal	-2,1	-2,0	-1,7	-4,2	-2,7	-3,5	-3,2

Source: European Commission (2000, 2001, 2002, 2003), OECD Economic Outlook (for Greece in 1998-2000 period)

Note: excluding UMTS revenues

The fiscal situation in this group of countries is diverse. Belgium and Greece continued to reduce their deficits following the pre-EMU consolidation period and are expected to maintain low deficits until 2004. Meanwhile, Portugal's fiscal balance slipped considerably in 2001. Although the deficit was initially forecasted to be under 3% in that year, it actually turned out above 4%. Portugal quickly took measures, partly of one-off nature, to reduce it in the following year, but according to European Commission forecasts, the situation was not fixed permanently and further problems are expected in 2003 and 2004. It is worth pointing out, that while all of these countries relied mainly on raising revenues to lower their deficit in the 1990s, their behaviour on the expenditure side differed. Belgium supported its consolidation effort by a moderate cut in spending. Greece allowed its expenditure to rise, but only by a modest 2 percentage points between 1989 and 1999. Meanwhile, Portugal's public spending grew by well over 5 percentage points between 1991 and 1998. This could help explain why the consolidation effort of that country proved to be insufficient to permanently keep the deficit under 3% of GDP.

**Table 4. Post-consolidation budget balances (in % of GDP) of countries which pursued mixed retrenchment strategies, including one-off measures and creative accounting**

	1998	1999	2000	2001	2002	2003	2004
France	-2,7	-1,8	-1,4	-1,5	-3,1	-3,7	-3,5
Germany	-1,8	-1,1	-1,0	-2,7	-3,6	-3,4	-2,9
Italy	-2,8	-1,9	-1,5	-2,6	-2,3	-2,3	-3,1

Source: European Commission (2000, 2001, 2002, 2003)

Note: excluding UMTS revenues

The present fiscal picture of this group of countries is the most troubling. All three countries are expected to breach the Maastricht deficit criterion at some point in the 2002-2004 period. This casts a doubt over the quality of their adjustment effort.

## **5. Quality and macroeconomic effects of European fiscal consolidations**

The conclusions which can be drawn from the European fiscal consolidation of the 1990s are broadly in line with a considerable body of literature investigating fiscal retrenchments and the factors which can determine their success or failure.

The first such factor is size and persistence of budgetary adjustments. Large and sustained consolidations strategies can have positive effects for demand, offsetting the negative demand effect of reduction in the deficit. Such expansionary effects of fiscal consolidations have been called non-Keynesian, with the Irish consolidation process of the 1980s a flagship example of a major fiscal contraction, which has served as boost for the economy. These effects operate through several channels, with credibility of the adjustment being the common link. One of the reasons why lower government demand does not necessarily have to cause a contraction in the economy, is that it can be offset by an increase in private demand, caused by anticipation of lower taxes in the future. Credible fiscal policy may also affect the behaviour of labour market participants. (European Commission, 2000, Giavazzi and Pagano, 1995)

However, probably the most important factor for the success of a fiscal consolidation is its composition. Numerous studies have found that expenditure-based adjustments are much more likely to be successful and lasting, particularly if they are concentrated in politically sensitive areas such as social transfers and public wage expenditure. An important channel

here is the supply-side impact of fiscal policy on labour costs and competitiveness. Conversely, revenue-based adjustments usually have a negative effect on labour costs. Alesina and Perotti (1996) cite the example of the Danish adjustment of 1983-1986. The consolidation effort was radical and credible and the cyclically adjusted budget balance improved by more than 11% as a result. However, Alesina and Perotti found that the increase in personal income taxes, which was part of the adjustment, negatively affected labour costs and thus the competitiveness of the Danish economy. Following the consolidation process, Denmark entered a recession.

The European experience of the 1990s appears to confirm these findings. The five countries which undertook comprehensive measures to reduce their public spending, managed to achieve a lasting improvement in their budget balances, maintaining a safe margin from the Maastricht reference value even during an economic downturn. Three countries pursued revenue-based consolidation strategies and each of their cases should be considered separately. Belgium raised taxes significantly, but at the same time it had reduced spending, using not only one-off measures, but also some systemic changes in such areas as health care and unemployment benefits. The overall consolidation effort certainly met the first criterion in that it was determined and credible. Therefore, it is hardly surprising that the consolidation turned out to be a lasting one. The case of Greece was different, as the entire adjustment effort was on the revenue side. However, that revenue raising effort was also very determined and permanent and may have thus been perceived as a credible. This was not the case in Portugal, where two waves of tax raising measures occurred, but both were followed by expansionary policy on the expenditure side. This implies that the Portuguese consolidation effort may have lacked the decisiveness and resolve necessary for economic agents to perceive it as lasting.

Judging by post-consolidation performance, the adjustment efforts of the countries pursuing a “mixed” strategy appears to have been the least successful. This is fully in line with the theory outlined above. The reliance of these countries on one-off measures and creative accounting implies that they did not have determined and consistent strategies to achieve an improvement in the budget balance of the necessary size. Therefore, they were not able to benefit from positive credibility effects.

## 6. Fiscal perspectives in EU accession countries

It is as yet too early for definite declarations regarding future euro adoption by the accession countries. However, all of these countries, with the single exception of the Czech Republic, intend to meet the Maastricht Treaty fiscal criteria by 2005 (European Commission, 2003). In cases of some of them, a considerable adjustment shall be required, but overall, their fiscal situation is better than that of current EMU members at the beginning of their consolidation process.

**Table 5. General government balances in accession countries (% of GDP)**

	2001	PEP forecasts		
	Turnout	2002	2004	2005
Cyprus	-3,0	-2,6	-0,6	-0,3
Czech Republic	-5,5	-6,4	-5,7	-5,5
Estonia	0,5	-0,2	0,0	0,0
Hungary	-4,2	-5,7	-3,0	-2,5
Latvia	-1,9	-1,8	-2,2	-2,0
Lithuania	-2,3	-1,9	-1,6	-1,5
Malta	-7,0	-5,2	-3,9	-3,1
Poland	-3,1	-4,1	-3,3	-2,2
Slovakia	-5,4	-7,8	-3,8	-2,0
Slovenia	-2,5	-1,8	-1,0	-0,8

Source: European Commission (2003)

None of the ten accession countries, except for Malta, has a public debt to GDP ratio exceeding 60%. Furthermore, the three Baltic states and Slovenia had a deficit below the Maastricht reference value already in 2002. The pre-accession programme of Cyprus also forecast a deficit under 3% of GDP for 2002 (and its further reduction in the following year), although the European Commission expects the reference deficit level to be exceeded in 2003 and 2004. On the other hand, the four Central European accession countries – Czech Republic, Hungary, Poland and Slovakia, have let their fiscal positions deteriorate considerably in recent years. Three of those countries – Hungary, Poland and Slovakia – are aiming for a deficit reduction in the next few years. Their consolidation strategies are

outlined in their Preaccession Economic Programmes (PEPs). It would thus be interesting to consider how these strategies compare to those employed by EU countries in the 1990s and how likely they are to succeed in attaining a lasting improvement in the budget balance.

### **Hungary**

The budget deficit of Hungary was, next to that of Slovakia, the largest among the all accession countries in 2002. The deficit target in the 2002 PEP was 5.7% of GDP, but the turnout could well have been considerably higher. By 2005, the government of Hungary intends to reduce the deficit to 2.5% of GDP. The proposed consolidation strategy is entirely expenditure-based, as revenues are actually forecasted to decrease by around 2-3 percentage points of GDP between 2002 and 2005. Part of the spending reduction will come from lower interest payments. The PEP lists three possible other solutions to lower expenditure: improving efficiency of management of public funds, reduction of the rate of growth of government investments and reforming the system of subsidies to the corporate sector. At the same time, the government apparently intends to increase its spending on health care, education, public administration and public security, in particular by raising public wages.

The strategy presented in Hungary's PEP does not include any sweeping measures to significantly reduce public spending. Instead, it promises higher spending in some areas. Such formulation of the consolidation strategy casts a doubt over feasibility of attaining the target of a reduction in public expenditure equal to 6 percentage points of GDP. Combined with a pledge to cut several categories of taxes, the deficit target also appears to be rather ambitious.

### **Poland**

According to Poland's PEP, the public finance deficit was 4.1%<sup>2</sup> of GDP in 2002, indicating that a relatively small adjustment was required to reduce it below 3%. The deficit appears to be particularly moderate when considering that Poland is in a much different macroeconomic situation, than other Central European accession countries. GDP growth

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<sup>2</sup> According to Polish authorities' interpretation of ESA 95 accounting rules. This interpretation is still subject to consultation with Eurostat.

was only 1.3% in 2002, the lowest out of all accession countries. This implies, that if the economy begins to recover in the coming years, as the government is expecting it to, the budget balance shall improve automatically. However, the PEP does specify some measures on the expenditure side of the budget, facilitating a reduction of the deficit to 2.2%. Spending is set to decrease by 2.5 percentage points of GDP between 2002 and 2005. This includes such measures as consolidation of some of the public sector entities, such as funds and agencies, tightening eligibility for benefits from the former social security scheme, change in the formula for indexation of benefits.

If the economy does indeed recover and spending is restrained as the government proposes, Poland should be able to meet the reference value for the budget deficit. However, the example of some EMU countries shows that it may not be sufficient to lower the deficit to barely less than 3% of GDP when economic growth is buoyant, as this implies an excessive deficit during a recession.

### **Slovakia**

As mentioned previously, Slovakia is also facing a high general government deficit, reaching almost 8% of GDP in 2002 (European Commission, 2003). Similarly as in the case of Hungary, the target deficit for 2005 is 2.6% of GDP. Slovakia also intends to pursue an expenditure-based consolidation strategy, with revenues expected to decrease in relation to GDP by 1.6 percentage points, almost exclusively due to lower social security contributions. In order to achieve the deficit target, spending will therefore have to be reduced by around 6 percentage points of GDP. Slovakia's PEP calls for numerous measures to help achieve this goal. They include balancing of the health care budget and rationalisation of social benefits via improved control over these transfers and consolidation of the various institutions, which are paying out the benefits. Education is to be reformed through increasing the role of the private sector in its financing. Above all, Slovakia is pursuing a significant public finance management reform, including measures to improve control and auditing of public spending, implementation of programme budgeting, new classification of the budget and establishment of the State Treasury, coordinating and supervising disbursement of public funds.

The government of Slovakia is therefore pursuing several systemic measures to limit public spending.

## **7. Fiscal consolidation strategies of accession countries – summary evaluation**

Having examined the cases of three Central European accession countries looking to consolidate their budgets in order to meet the Maastricht criteria for EMU membership, the positive conclusion is that all three are planning to rely on spending reductions, rather than raising taxes, to achieve this goal. As evidence of consolidations in EU countries in the 1990s shows, such strategies are more likely to succeed. However, another important factor determining the success of fiscal consolidations is their size and persistence. Half-hearted measures, particularly those based on one-off measures, are likely to only cause a short-term contraction of demand and then be reversed. Considering these arguments, the fiscal consolidation plans of Hungary may be a cause for concern. The strategy calls for reduction of some spending, but at the same time for increases in other categories and sweeping tax cuts. This raises doubts whether a considerable adjustment will actually be attained.

The strategy outlined in the Polish PEP also does not fully satisfy the criteria of a successful fiscal consolidation. The strategy relies to some extent on the anticipated cyclical upturn to attain an improvement in the budget balance. Meanwhile, the presented forecast of public expenditure suggests that the adjustment on the expenditure side will occur more in the form of small steps, than an extensive overhaul. Although this may be sufficient to lower the deficit below 3% of GDP, the improvement may prove not to be lasting.

Out of the three consolidation programmes presented above, that of Slovakia appears to be the closest to the model approach. It includes several systemic measures aimed at lowering expenditures. If these measures are bold enough, the consolidation strategy could well attain the objective of a lasting reduction in the deficit together with all its positive consequences seen in those euro countries where such a strategy had succeeded.

### **Conclusions**

The introduction of a single currency in Europe had very significant implications not only for monetary policy of Member States, but also for their fiscal policies. During the two decades preceding the decision to create a single currency, these have been pro-cyclical and overly expansionary, leading to a build up of public debt. Continuation of such policies

would have undermined the macroeconomic stability of the euro area and ability of the European Central Bank to fulfil its mandate.

The states willing to join EMU were thus obliged by the Maastricht Treaty to consolidate their budgets and attain deficits below the reference value of 3% of GDP. A remarkable Europe-wide consolidation process ensued. Varying strategies were pursued to correct public finance imbalances, which in some cases were extremely high. In the end, all countries seeking to reduce their deficits had succeeded, but as the following years showed, the quality of the fiscal adjustment varied. Those countries, which lacked decisiveness and determination in their consolidation effort, resorting to temporary and one-off measures instead of systemic reforms, have found their low deficit positions not to be lasting. Meanwhile, those countries which relied on extensive expenditure cuts, reached a budget position close to balance, meaning that they were not in a danger of exceeding the 3% of GDP limit even during an economic downturn.

The 2004 expansion of the European Union means that quite soon as many as ten new countries may be willing to join the EMU. Although their overall fiscal position is better than that of EU countries at the beginning of the 1990s, some of the accession countries will have to undertake fiscal adjustments of similar size as those of current EMU members. They are planning to pursue expenditure-based retrenchment strategies, which is a good sign, but does not guarantee success. In order to attain a lasting improvement in the budget balance, such as required by the Stability and Growth Pact, bold and decisive measures are necessary. The example of current EMU members shows that this effort is well worth taking.

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### III. Monetary and fiscal policies in Poland and Czech Republic in the perspective of EMU accession

Contribution by Jolanta Zombirt

Such an exceptional event as the creation of the EMU and the euro has not had happened never before. The most common challenges concerning EMU and the euro are: fiscal policy making, monetary policy making, euro area being a non-optimal currency area and the political legitimacy of EMU. It is worthwhile stressing that economic policies – except from monetary policy – are still framed by the individual member states or by coordination with others. Still, “experiment called euro starts to have effects on practically every area of economic policy – making in Europe: it will influence the allocation of resources, the distribution of income, stability and growth, as well as the formal and informal institutions on labour, products and financial markets within the euro area”.<sup>1</sup>

It is than of the utmost importance to define what are the chances for the euro to preserve its influence and to combat inflation after accession of ten new member states. We will try to begin with the assessment of four areas mentioned above, drawing some comparison from history.

#### *Fiscal policy-making.*

Legal framework in this area, i.e. the absence of central co-ordination within EMU, implies that EMU will not be able to respond to asymmetric shocks and disturbances in a satisfactory way<sup>2</sup>. This framework will also contribute to some pro-cyclical fiscal behaviour, completely in a different way that it is prescribed in Keynesian advises. Will – if the member states are not ready to decide on the co-ordination of fiscal policies in the euro area. What, however, should be extend of this co-ordination, nobody can answer at this stage. It seems that the first step to some harmonisation of the fiscal policy within the euro

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<sup>1</sup> EMU and the euro – the first 10 years, Economic Papers, European Commission, Directorate – General for Economic and Financial Affairs, February 2002

<sup>2</sup> Brunila A., Buti M., Franco D., The Stability and Growth Pact. The Architecture of Fiscal Policy in EMU, Palgrave, Houndmills and New York, 2001.

area has been already done: the national fiscal authorities do not have access to national central banks, nor the right to force them to issue money.

#### *Monetary policy-making*

It is too early to evaluate and to make any guidelines for the monetary policy in the euro area. It is an unprecedented experiment summing up the experience of the member central banks. European Central Bank, during the first years of operations, has showed some weaknesses, for example, being too slow with reduction of its main interest rates.

#### *EMU as a non-optimal currency area*

The EMU and the euro have been established on the base of political will to expand and deepen European integration. It means that politicians have ignored the theoretical preconditions encompassed in optimal currency area approach. Ironically, the prospects and a short history of the euro show that this single currency, circulating freely from January 2002, strengthens credibility of EMU.

#### *The political legitimacy of EMU*

At the roots of EMU we can find two political powers, i.e. France and Germany. However, their influence on other member states was so polarised that it could be unwise to say that any other countries are marginalized. As long as all member states and their inhabitants, including newly accepted, will be of the opinion that the benefits of the euro in broad political and economic terms exceed the costs, EMU will maintain the political backing. Thus, it is important when predicting the fate of the legitimacy of the EMU – project to forecast an economic and then political environment for future Europe. So, although fundamentals of EMU have apparently replaced the Keynesian orthodoxy, they seem to be palatable from the political point of view. These fundamentals have gathered together the views of policy-makers (central bankers and ministers of finance), theories of macroeconomic policy being conducted in member states and the institutional framework (mainly European Central Bank and European System of Central Banks).

## Institutional arrangements

An obvious example of the joint concern about stability of EMU, its success in monetary and fiscal field, was an imposition of specific ceiling on the public debt and deficits for the member states and an agreement called the Growth and Stability Pact, assisting to preserve a tight fiscal discipline. A sustainability of all the convergence indicators, as a whole, is also regarded the key issue for the candidate countries. However, accession to the Eurozone has to be, and it is in fact, preceded by required adjustments. In particular, the adjustments are necessary in the sphere of monetary, exchange rate and fiscal regimes. It is also related to the formation of a proper policy mix under constraints of the integration stages<sup>3</sup>.

As the exchange rate stability is concerned it is necessary to maintain for at least two years a currency of a candidate state applying to EMU (but being already a member of the EU) within a exchange rate mechanism called ERM II. It implies the fixing of a central parity vis-à-vis the euro and the establishment of a band around it. It is then of the utmost importance to have a central parity properly defined because it – in most cases – would be a rate to convert a national currency into euro. A proposal of a level of a central parity is passed to European Ministers of Finance. Then, together with ECB, the final parity is fixed on the base of a thorough evaluation of the specific features of convergence (i.e. purchase parity power of a given national currency), potential volatility and the interaction between central parity and the market exchange rate. In the “in-between” period it requires in-deep preparations to the concurrent introduction of the euro and a change in credit and currency risk management procedures in the financial sectors of the candidate states.

The other very important convergence criterion strictly connected with the requirement of the ERM II membership is a fiscal test, i.e. ceilings for budget deficit and state indebtedness. Article 104 of the Treaty establishing the European Community sets forth that member states must avoid excessive government deficits. The decision on whether an excessive deficit exist is made by the European Council based on a report

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<sup>3</sup> As it has been stated in the project realised by the Czech National Bank titled “Priorities in four research areas”.

presented by the European Commission. When the existence of an excessive deficit is decided, the Council makes recommendations to a member state concerned with a view to bring that situation to an end. It is worthwhile stressing that under the Stability and Growth Pact financial sanctions may be imposed on EMU member state in the form of either a non-interest bearing deposit or - after two years of the decision to impose sanctions, unless the excessive deficit has been reduced - a fine. It is obvious that fixing the exchange rate and giving up an independent monetary policy requires solid and healthy fundamentals of a given economy. Monetary policy needs frequent interactions with fiscal policy and financial sector development. That is why the channels of monetary transmission should be efficient and the response from the fiscal decision-makers should be clear and responsible.

An inflation test has to be passed but also a monetary policy has to be adjusted to the conditions in the ESCB. For the candidate countries it is then required to evaluate the state and a range of the monetary instruments in possession of their central banks, and also their inflation targeting approach, to be able to exist in the broadened EU in the “in-between” period and then, to pass smoothly to EMU.

The pre-EMU economic policy system turns out to be a monetary dominance regime, in which monetary authorities in the member states apply an “*active*” (counter-inflationary) monetary policy, whereas fiscal policy is “*passive*”<sup>4</sup>. In particular, fiscal authorities react to debt accumulation by increasing primary surpluses, thereby guaranteeing fiscal solvency. Interestingly, the macroeconomic institutional architecture of EMU can also be categorised as a monetary dominance regime. Still, one could observe some apparent differences. The most important is that the variability of fiscal-policy shocks rather common during pre-entry period has to be reduced by an active fiscal policy in order to maintain the 3% reference level. However, such volatility in the stable

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<sup>4</sup> Has EMU shifted policy?, *Economic Papers*, European Commission, Directorate – General for Economic and Financial Affairs, February 2002

environment tends to be much lower after joining the Eurozone. It is the result of a fact that the member states governments tend to apply a counter-cyclical fiscal policy.

A policy regime is defined by a specific combination of fiscal and monetary policy behaviour. Since monetary and fiscal policy are closely connected, any positive or normative conclusion about one branch of policy depends on assumptions about the behaviour of the other branch. So, fiscal policy can be called “passive” or “Ricardian” if its primary aim is to preserve solvency. It is the case of all the economies trying to achieve Maastricht criteria. A “passive” fiscal policy has been observed during the period preceding the single currency among the member states of the EU. Similarly, this kind of a fiscal policy is being conducted in a majority of the candidate states, more or less depending of the extend of the independence of their central banks.

The after-EMU policy regime tends to strengthen the relations between an “active” monetary policy and a “passive” fiscal policy. It is an effect of an institutional framework within the Eurozone<sup>5</sup>. On one side, a single independent bank, the ECB, is in charge of conducting monetary policy with a strong mandate of preserving price stability, explicitly defined as an inflation rate below 2% over the medium term. On the other side, the Stability and Growth Pact constrains the behaviour of the various independent national governments in conducting fiscal policy. In other words, the Pact calls for fiscal policy to be “passive” in member states.

For all the candidate countries, the future compliance with the EMU requirements implies a definition of a common macroeconomic policy for all member states<sup>6</sup>. Based on the Treaty, three distinct phases for the adoption of the EMU *acquis* by accession countries has to be specified, namely:

- The pre-accession period
- The period from accession to the adoption of the euro
- Euro area phase after adopting the euro.

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<sup>5</sup> *ibidem*

<sup>6</sup> The macroeconomic policy framework for EU membership and euro area participation – the role of budgetary policy, European Commission, Directorate General, Economic and Financial Affairs, Brussels, May 2002.

The pre-accession countries, being already at the edge of entering EU seem to have completed the requirements included in the first period mentioned above. Apart from the famous and rather general criteria formulated at the Copenhagen Summit in 1993 (the existence of a market economy and the capacity to cope with competitive pressures and market forces within the Union), they have already implemented the required EMU legislation to be able to have the status of “member state with a derogation” as regards the adoption of the euro (Art.122), i.e.:

- Completion of the orderly liberalisation of capital movements (Art. 56)
- Prohibition of any direct public sector financing by the central bank (Art. 101)
- Prohibition of privileged access of the public sector to financial institutions (Art. 102)
- Alignment of the national central bank statutes with the Treaty, including the independence of the monetary authorities (Art. 108 and 109).

After accession, the new member state will have the statute of “member state with a derogation” granted in the accession treaty. It will have to show adherence to the aim of economic and monetary union and compliance with the relevant parties of title VII of the EC Treaty and the other EMU *acquis*. These are:

- Treatment of exchange rate policy as a matter of common interest and, eventually, participation in the exchange rate mechanism – ERM II (Art. 124)
- Treatment of economic policies as a matter of common concern and co-ordination of economic policies between the member states through participation in Community procedures (Art. 98 and 99)
- Avoidance of excessive government deficits and adherence to the relevant provisions of the stability and growth pact (Art. 104)
- Further adaptation of the national central bank’s statutes with a view to integration in the ESCB (Art. 109)
- Progress towards the achievement of a high degree of sustainable convergence (Art. 121)

With accession, the common macroeconomic policy framework gets more constraining, with a strong reinforcement of fiscal discipline and the integration of other economic policies. Budgetary policy and outcomes become subject to the excessive deficit procedure and the non-punitive parts of the Stability and Growth Pact. The new member states will also have to obey the rules of common exchange rate policy. This implies that they will try to avoid excessive fluctuations of the exchange rate and in due time, perhaps rather soon after accession, they will participate in ERM II. Economic policies of these countries will become an element of policy co-ordination and multilateral surveillance procedures.

At the moment the public discussions are held whether to enter the ERM II as soon as at the accession to the EU, or postpone this decision. An issue on an optimal path and a speed of the changeover into euro, as it seems, is not agreed yet in the particular candidate countries. However, a prompt entrance to ERM II prevails. It means a fulfilment of the exchange rate and other Maastricht criteria in first two years after accession. It is then worthwhile noting that the Maastricht Treaty does not specify any mandatory timetable for that. Conversely, it leaves that decision to a given member state depending on its assessment of a state of preparation of all the economy. So, the first years after accession should be devoted for completion and consolidation of the integration in the internal market as well as the implementation of the relevant parts of EMU's macroeconomic framework.

The new member states will meet a much stricter environment that during the pre-accession period. The macroeconomic policy options compatible with above framework of the new "member state with a derogation" could be severely limited, in particular if the country aims at a prompt adoption of the euro<sup>7</sup>. A member state will be of course still free in its monetary and fiscal policy. However, the aspiration to adopt the euro will push the national central bank to define price stability as its overriding goal in order to meet the Treaty criteria on inflation and interest rate. Fiscal policy, under these constrains could become unduly restrictive, in order to avoid an excessive deficit while still having to bear

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<sup>7</sup> *ibidem*

the burden of any adjustments necessary to catch up process, external imbalances, external shocks or simply reversible capital movements.

It is then apparent that the most important period for any candidate country will start just after its accession but will not finish automatically after adoption the euro. The attempts to comply with the EMU *acquis* can imply substantial changes in the institutional macroeconomic framework in majority of candidate countries. We can say that the budgetary policy will play a crucial role in this process. Fiscal adjustment will be the key instrument to contain internal and external imbalances given the freedom of capital flows, the aim of the independent monetary authorities towards price stability and the progressive reduction in the flexibility of exchange rate policy. In this context, the Stability and Growth Pact will play a crucial role in the policies of these countries.

The Pact strengthened the Treaty provisions on fiscal discipline in EMU, even for “member states with a derogation”. According to Art. 121, while qualifying for euro adoption requires only a sustainable reduction of the fiscal deficit below 3% of GDP, the candidate country should also plan to reach a budgetary position meeting the Pact’s requirements in the medium term.

The Pact also envisages the annual submission and evaluation of medium-term macroeconomic programmes or updates<sup>8</sup>. It means that a candidate country will be expected to submit a convergence programme to the Commission. Then, based on a Commission recommendation and within the multilateral surveillance framework, the Council will perform the examination on a level of medium-term budget deficit but also – whether the programme facilitates the closer co-ordination of economic policies and is consistent with the broad economic policy guidelines envisaged by Art. 99.

According to the declaration in the Pact, when examining and monitoring the stability or convergence programmes, the Council should take into account the relevant cyclical and structural characteristics of the economy of each member state. It means that:

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<sup>8</sup> *ibidem*

- The monitoring of budgetary trends should rely on both nominal and cyclically-adjusted budget figures
- A distinction between what is required to meet “close-to balance or in surplus” requirement and what would be most appropriate. Accordingly, member states can go beyond reaching a budget position that only provides a safety margin for cyclical economic developments
- When determining their medium-term fiscal target, member states should also take into account the need to cope with unforeseen budgetary risk, run down high debt ratios at a fast pace, prepare for the budgetary impact of ageing populations, and create room for appropriate discretionary fiscal policy.

Appropriate fiscal policy will remain a challenging task for candidate countries after the accession. The public finances of the new member states will have to cope with substantial expenditure pressures. It will result in the following outcomes<sup>9</sup>:

- Participation in the process of EU multilateral surveillance will considerably strengthen the external discipline imposed upon accessing countries’ policy-makers. By providing a credible mechanism for the establishment, assessment and monitoring of medium-term policy commitments, the EU surveillance procedures will offer to the acceding countries a useful device to support the implementation of the complex structural reforms needed, to provide an anchor to market’s expectations, and to adjust to shocks within a medium-term horizon. However, although imposing such discipline is beneficial in general, one could consider whether EU budgetary rules, under some conditions, might impose too tight a set of constraints, in the first years after accession.
- It can be argued that the Pact’s medium-term objective of budgetary positions close to balance or in surplus is too demanding for countries where a certain amount of deficit financing would seem unavoidable, given the size of expected reforms or unanticipated shocks and higher volatility of output. The excessive deficit ceiling might be regarded as too hard to achieve. A higher vulnerability to shocks and the ensuing need for frequent fiscal policy adjustments would violate the deficit ceiling

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<sup>9</sup> *ibidem*

and make it more difficult to respect multi-annual fiscal deficit commitments, even though a multi-annual cyclically adjusted planning will be the best option.

- The above consideration could suggest that, for some time after accession, the strict application of the Pact would require a structural surplus of some magnitude in some new member states, in order to stay within the 3% ceiling, or a rather long definition of the “medium-term” to attain the targets. Implementing the EU framework for budgetary surveillance taking into account the specific needs and circumstances of some accession countries will be the responsibility of the EU multilateral surveillance and policy co-ordination actors.

Table 1.  
General government net borrowing (-) / lending (+) of the candidate countries

% GDP	1998	1999	2000	2001
Cyprus	-4,9	-4,5	-3,1	-3,0
Czech Republic	-4,5	-3,2	-3,3	-5,5
Estonia	-0,4	-4,0	-0,4	0,2
Hungary	-8,0	-5,3	-3,0	-4,1
Latvia	-0,7	-5,3	-2,7	-1,6
Lithuania	-3,1	-5,6	-2,7	-1,9
Malta	-10,8	-8,3	-7,0	-7,0
Poland	-2,3	-1,5	-1,8	-3,9
Slovakia	-4,9	-6,4	-12,8	-5,6
Slovenia	-2,3	-2,3	-3,2	-2,5

The above table gives a comparison of a deficit level in all the candidate countries. We can see that Estonia is the only accession country that has managed to work out a budgetary surplus. Having in mind that the accession countries will have to accelerate their pace of growth it is also known that the growth enhancing expenditure strategy should focus on education, transport network and environmental programmes but also on social systems. These are the preconditions jeopardising the aim of meeting the 3% ceiling. They also force the national governments to even stricter fiscal policy and deficit planning. For example, the Polish government has started to increase expenditure annually by the level of a projected inflation rate + 1% above the inflation level. The design of the state budget takes into consideration the economic conditions and does not focus exclusively on a deficit target. The efforts are made also to attract the private capital to finance the projects formerly of the exclusive responsibility of the central government.

The way to consolidation of the state budgets within EU prior to the euro seemed, however, equally difficult. The prevailing budget deficit in all the countries has been corrected in several ways. Four countries (Belgium, Ireland, Austria and Portugal) have relied essentially on tax increases. The Nordic countries and the United Kingdom carried out their fiscal consolidation through sizeable cuts in government spending, with either very limited increases in tax revenue or even with reduction in taxation. In Finland and Sweden the pronounced cut in spending followed an expansionary policy during the period 1991 – 93. Therefore, the spending cuts helped to restore “normal” spending levels. In the rest of the countries, a kind of “switching” strategy prevailed. Their consolidation period consisted of two phases. The first one – the substantial increase in taxation with rather limited reduction in spending (or even increase). In the second phase of the adjustment, substantial expenditure cuts were implemented, while tax revenue grew much less or even declined. The achievements of the EMU countries bring us to the conclusion on the unsustainability of further tax increases and on the need to put public spending firmly under control. The observation can be supported with other conclusion: the better and quicker budget consolidation depends directly from the state of the development of national capital markets easing the burden of financing from the government budget.

The Maastricht Treaty offers no special provisions for the monetary policies of the selected countries during the interim period between EU accession and adoption of the single currency. As is the case throughout so called the second stage (stipulated in the Treaty) the member states still treat their exchange rate policies as a matter of common interest (Art. 109 m), but the monetary policies of the participating countries formally remain the responsibility of the national authorities. However, it is necessary to stress that in the central banks’ policy formulation, the weight of “common interest” increases, relative to domestic considerations, during the final run-up to EMU.

The need for closer co-ordination arises from several reasons. First, the market will closely observe any of serious disagreements about the appropriate direction of monetary policy what could destabilise exchange rates during the final period. Second, it is very important to have an exchange rate of any pre-EMU country on the level very close to the

desirable from EMU perspective. That is why the pre-accession countries have to consider carefully all the pros and cons of joining quickly the Eurozone and its impact on their economy. From the technical point of view, they have to make the examination on the similarities and discrepancies in the following areas:

- Exchange rate regime or regulations in capital flows. A fixed exchange rate regime limits substantially the effectiveness of monetary policy. Conversely, in a floating rate regime changes in interest rates will give rise to capital flows and to exchange rate movements. Regulations or other barriers to capital flows may modify the above relationships and would have the negative repercussions for the economy.
- Financial structure. Among the most important characteristics that can influence the impact of monetary policy are: the degree of competition within the banking system and between banks and other financial institutions; the share of bank credit in total financing; the development of modern financial techniques as securitisation; the credit maturity; the relationship between the banking system and the corporate sector; the ownership in the banking system; the degree of internationalisation of the banking system and foreign currency holdings; households' access to the credit market; the existence of credit access constraints for certain agents; the balance sheet configurations of financial and non-financial agents, the financing of the public sector and the maturity structure of public debt.
- Labour market structure. The effectiveness of monetary policy is higher the quicker a given final target (typically price stability) is achieved and the less it costs in terms of output losses. In other words, different degrees of flexibility in labour market can account for a different impact of monetary policy.
- Sectoral composition of output. Differences in this area may account for a significant part of the measured differential effects of monetary policy.

As stated at the EU summit in Nice in 2000, the assumed time horizon for EU enlargement is the year 2004. It is then worthwhile to analyse the present state and the prospects for the economies of future member states – Czech Republic and Poland. An integral part of these countries' accession to the EU is the obligation of subsequently joining the Eurozone. What will be the effects for the new member states and the “old” ones after full adoption of the single currency?

The Economic and Monetary Union was implemented in three stages on the basis of Maastricht Treaty. In 1999, eleven countries satisfied the conditions for adopting the single currency and consequently established the Eurozone. When they join the EU<sup>10</sup>, the new member states will automatically participate in the third stage of EMU. As it has been stated above, they will acquire the status of “member state with a derogation” regarding the adoption of the euro. Upon UE accession, the central banks of new member states will become members of the European System of Central Banks. After they adopt the euro, these central banks will become parts of the Eurosystem.

Under the EU legislation, prior to adopting the euro any candidate state must be an EU member state and must have fulfilled the Maastricht convergence criteria, including compatibility between their legal rules and EU law on EMU. The convergence required for entering the Eurozone is assessed according to the procedure laid down in the Treaty establishing the European Community. The final decision is subsequently made by a summit of EU member states acting on the recommendation of the ECOFIN Council<sup>11</sup>. Those member states whose economic conditions are assessed as a potential threat to the maintenance of price stability in the Eurozone will not join the monetary union and will retain the status of member state with derogation.

The criterion on exchange rate stability requires two-years participation in the ERM II. The central parity and fluctuation band of the exchange rate regime within the ERM II will – after being agreed upon between a central bank of a given member state and its government – be discussed with the ECB and the Commission and subsequently approved by the ECOFIN Council. Staying in the ERM II for longer than the minimum required period is not deemed desirable.

The positive effects of a particular member state entry into the Eurozone are as follows:

- It will be a completion of the country’s integration into European monetary structures.
- The new member states in the Eurozone will be able to participate fully in formulating

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<sup>10</sup> The Czech Republic and the Euro – Draft Accession Strategy, Czech National Bank, December 2002

<sup>11</sup> ECOFIN Council – the Councils consisting of ministers of finance of the member states.

and implementing the single European monetary and exchange rate policy, which aims to strengthen macroeconomic stability in Europe.

- It should have positive impacts on domestic economic policy, since the key elements of the system are a requirement for balanced public budgets in the medium term and a requirement to undertake structural reforms supporting sustainable economic growth.
- Fiscal policy implemented in accordance with the Stability and Growth Pact, coupled with a decline in the risk premium, will lead to stabilisation of long-term interest rates at a low level. Corporations and households will profit not only from the low interest rates but also from access to the deeper, more liquid and more transparent Eurozone capital markets.
- The irrevocable fixing of the currency within EMU will increase the stability of the financial sector and reduce the risks of monetary turbulence.
- The domestic enterprise sector in particular will profit from the elimination of exchange rate risks vis-a-vis the Eurozone countries, which are the most important trading partners of the new member states. These benefits will show up as a decline in transaction and hedging costs and a reduction in investment uncertainty. The household sector will profit from greater price transparency that stimulates competition.
- These positive effects will foster a more stable environment for entrepreneurship, more efficient allocation of resources and subsequently higher economic growth. Eurozone membership will thus further speed up the real convergence of the new member states' economies towards the EU average.

On their way to the Eurozone, however, the new member states should also take some possible barriers and risks into consideration. These risks are connected primarily with the response of the economy to economic disturbances under the irrevocably fixed exchange rate within the Eurozone. In the event of insufficient cyclical and structural alignment of the new member states' economies and their financial sectors with the Eurozone economies, economic shocks may have unequal and asymmetric impacts in different regions. The cessation of an independent monetary policy able to respond flexibly to such shocks constitutes a challenge for fiscal policy and for the functionality of natural

adjustment mechanisms, especially on the labour market. The barriers to fast entry into the Eurozone may thus be as follows:

- Insufficient alignment of the new member state's economy with the Eurozone economies in the real and financial spheres – the characteristics of the accessing economies are gradually converging towards those of the EU member states. Trade with the EU in both countries accounts for about two-thirds of their total foreign trade, and the inflow of foreign direct investment from the EU (although somehow slowing down in Poland) constitute an important part of all the investments flowing to their economies. It is however apparent that the cyclical development of their economies is less aligned with the cyclical trend in the Eurozone than is that of the average Eurozone member state.
- Low fiscal policy flexibility – the large budget deficits in both countries, together with the built-in trends towards a further structural widening of those deficits and inadequate conditions for the symmetrical functioning of automatic stabilisers, represent a serious barrier to effective fiscal stabilisation policy. The aim of fiscal consolidation must be not only to fulfil the Maastricht criteria but also to achieve in the medium term balanced public finance budget facilitating the effective action of automatic stabilisers and flexibility of discretionary expenditure. In the future absence of an autonomous monetary policy, fiscal policy will – given the irrevocably fixed exchange rate within the Eurozone – be the key element of macroeconomic stabilisation. An insufficiently consolidated public finance system could have exceptionally adverse effects during these countries' participation in the ERM II and during the first years after they join the Eurozone. During this period, the probability of their economic cycles diverging from that elsewhere in the Eurozone will be higher than during the later stage of integration. Moreover, given the unified nominal interest rates, the expected positive inflation differential between Poland and Czech Republic from one side and the Eurozone average from other, in this period will result in lower real interest rates which could trigger excessive growth in domestic demand. Therefore, in the years immediately following their entry into the Eurozone, prudential fiscal policy will be a key condition for maintaining stable economic growth.
- Insufficiently flexible labour market. Like the EU labour market, the Polish and Czech labour markets are characterised by relatively low mobility and flexibility of the labour

force. Moreover, for several years following accession, restrictions on the free movement of labour from new member states will have to be reckoned with. To strengthen the adjustment mechanisms on the labour market, steps must be taken to increase the flexibility of the labour market and real wages not only in the institutional area but also in areas such as transport infrastructure and the housing market.

## **The Czech Republic**

In its 2001 Regular Report, The European Commission found that *“The Czech Republic is a functioning market economy. Provided it makes further progress towards medium-term fiscal consolidation and completes the implementation of structural reforms, it should be able to cope with the competitive pressure and market forces within the Union in a near term”*<sup>12</sup>.

While the Czech Republic is called a good pupil among the accession countries it is still far from reaching the average indicators of the EU member states. The most apparent is lack of the real income convergence. In 2001 the average per capita income in purchasing power standards amounted to 57% of the EU average.. The economic activity rate has been at relatively high levels of around 71-72%. The unemployment rate was 8% in 2001 what was somehow above the EU average.

The country has a well functioning market economy. Its efficiency is being supported by a well-developed financial sector and the absence of any significant barriers to market entry and exit. Policy co-ordination between the government and the Czech National Bank (CNB) works broadly well and the independence of the CNB has finally been enshrined.

Prior to the recovery regained firmly in 2001 the economy had to go through its first post-transition crisis that has been provoked by macroeconomic imbalances coupled with substantial shortcomings on the microeconomic reform agenda. After

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<sup>12</sup> Progress towards meeting economic criteria for accession: The assessment from the 2002 regular report, European Economy, European Commission, Directorate General for Economic and Financial Affairs, October 2002

implementation of an austerity package beginning from 1999 the economy started to grow with the average yearly rate of 2.4%.

Since 1998 the current account deficit has been financed by high inflows of foreign direct investments. Inflation targeting was introduced in 1998, with net inflation serving as the reference until 2001. With its “Setting of the Inflation Target for the Period 2002 to 2005”, the CNB has embarked upon headline inflation targeting which helps ensure that the public accepts the targets. The inflation target is set as a band that should fall continuously to 2% to 4% in December 2005. Since its sharp depreciation in 1997, the Czech crown has shown an appreciating trend against the euro. In the light of the strong upward move of the exchange rate the government and the CNB agreed on a joint strategy to prevent a further strengthening of the Czech crown. This strategy aims at withholding foreign currency denominated public revenues, in particular privatisation receipts, from the market.

Overall monetary policy has been accommodating since 1998. Policy rates have been cut several times. The real short-term interest rate for example has significantly been falling from around 11% to 0.5% in 2001. Monetary conditions reflect the low inflationary environment and the strong rate of the Czech currency.

The state of the country public finances does not seem satisfactory. The general government deficit has averaged 3.8% of GDP from 1997 to 2001. In 2001 the deficit reached 5.5% of GDP and the end of 2002 this level was already around 6.6%. Mandatory and quasi mandatory expenditures of the state budget have increased by roughly 10 percentage points of GDP since 1995 and account for about 80% of state budget spending. To cope with it the government has announced that in 2003 it will give priority to tax increases and to discretionary expenditure cut backs. However, without a completion of far reaching comprehensive reform this problem is unlikely to be solved in a medium term.

General government debt ratio is low in “European terms”, i.e. 23.6% of GDP at the end of 2001 but the direction of its changes causes a concern – in 1998 it was only 13.7%. Good progress has been made towards greater fiscal transparency and better fiscal

management with the introduction of new budgetary rules in 2001. Still, however, because of the reforms needed a final fiscal position seems to be rather unpredictable.

Because of the fact that the fiscal policy has become increasingly expansionary, the monetary policy, with the consensus between CNB and the government, has undertaken stronger efforts to secure macroeconomic stability. So, the macroeconomic policy mix is broadly adequate and the continuous high inflows of foreign capital – of which by far the majority is medium to long-term capital – seem to the convincing prove of it.

Almost all measures leading to the open market economy have been already performed. The majority of prices for goods and services and the trade and foreign exchange regimes have been liberalised in the first half of 1990s. The private sector is firmly established and accounts for the overwhelming part of the economy. The privatisation process is close to completion apart from some strategic enterprises in the corporate sector waiting for a change of ownership. Market entry and exit mechanisms are already in place, while they have to be improved in order to make economy more efficient. Property rights are established and transferable.

Privatisation and consolidation have laid the foundations for a solid financial sector that is able to fulfil its intermediation role. This sector consists mainly of banks and the overall health in the banking sector has been improved substantially over time. However, over the last years, the credit-to-GDP ratio declined from 58.5% at the end of 1998 to 47.5% at the end of 2001. The decline in business lending can partly be explained statistically by the transfer of bad assets from the banking sector to the state's bail out institution, but it is also due to the implementation of stricter risk assessments thereby putting an end to the past lending activities of banks not always fully based on through commercial considerations. In Czech banking sector a foreign capital predominates with more than 90% of total assets in all banking sector.

The non-bank financial sector is still relatively small but stands ready to play a bigger role in intermediation. However, there are signs of the marginalisation of Czech capital markets due to disadvantageous economic conditions: market capitalisation of the

equity market plunged from roughly 29.5% of GDP in 1997 to a mere 15.7% of GDP in 2001. The development of this market is hampered by low liquidity reflecting both demand and supply shortcomings on the domestic equity markets. The bond market has developed better and comprises a sizeable volume of corporate bonds and government bonds, Capitalisation in this market amounted to 14.9% of GDP in 2001, up from 10.4% of GDP in 1997<sup>13</sup>. Commercial banks represent by far the biggest group of investors in the bond market.

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<sup>13</sup> *ibidem*

Table 2.

Selected Macroeconomic and Financial Indicators for the Czech Republic<sup>14</sup>

	1998	1999	2000	2001
<b>I. Real Sector</b>				
Real GDP growth (in %)	-1.2	-0.4	2.9	3.6
Real growth of exports of goods and services (in %)	10.7	6.3	17.1	12.0
Investment (in % of GDP)	29.0	27.9	28.3	28.0
Unemployment rate	5.9	8.7	8.8	8.3
Inflation (CPI, period average, annual change in %)	10.7	2.1	3.9	4.7
Real exchange rate against the euro (change in %)	9.2	-2.5	3.1	7.0
<b>II. External Sector</b>				
Current account balance (in % of GDP)	-2.4	-2.9	-5.6	-4.7
Foreign direct investment inflows (net, in % of GDP)	6.3	11.4	8.7	8.5
Portfolio investment (in % of GDP)	1.9	-2.5	-3.5	1.6
Other investment – short term (in % of GDP)	1.6	1.7	1.6	-3.0
Gross external debt (in % of GDP)	39.1	43.1	41.0	37.0
Gross external debt (in % of exports of goods and services)	66.7	70.8	59.0	51.0
Short-term gross external debt (in % of total gross external debt)	37.8	38.8	42.0	41.0
Gross official reserves (in months of imports of goods and services)	4.1	4.7	4.0	4.0
Gross official reserves (in % of gross short-term debt)	138.8	146.2	145.0	161.0
<b>III. Fiscal Sector</b>				
General government balance (in % of GDP)	-4.5	-3.2	-3.3	-5.5
General government debt (in % of GDP)	13.8	14.5	17.0	23.7
<b>IV. Monetary and Financial Sector</b>				
Bank assets (in % of GDP)	120.2	122.8	128.1	130.0
Deposits (in % of GDP)	63.8	64.1	64.5	69.2
Domestic credit to private sector (in % of GDP)	57.0	53.0	49.2	36.1
Nominal domestic credit growth (in % over the last 12 months)	-4.7	-4.4	-3.7	-19.6
Share of majority state-owned banks in total bank assets (in %)	18.6	23.1	28.2	3.8
Share of majority foreign-owned banks in total bank assets (in %)	25.7	28.1	65.5	90.1
Aggregate capital adequacy of banks (in %)	12.1	13.6	14.9	15.6
Non-performing bank loans (in % of total bank loans)	26.4	32.2	29.8	21.6
Pre-tax bank profits (in % of total bank loans)	0.2	0.2	0.5	0.9
Foreign-currency denominated assets (in % of foreign-currency denominated liabilities)	110.1	117.5	114.4	124.1
Foreign-currency denominated credits (in % of foreign-currency denominated liabilities)	54.4	51.1	47.0	39.5

<sup>14</sup> Report on macroeconomic and financial sector stability developments in candidate countries by Directorate-General for Economic and Financial Affairs, April 2002

Sharp fluctuations in the exchange rate present a significant threat to a small open economy in an environment of liberalised capital flows. Coupled with some imbalances in monetary and fiscal policy such an environment could be a threat of serious shocks. However, certain circumstances could serve as assistance in a way to the eurozone. The pace of growth is here a key element. The medium-term macroeconomic scenario has suggested that if there are no substantial changes, particularly in foreign demand, then the Czech economy will fluctuate within an economic growth trajectory of 3% to 4%, with a slight acceleration tendency.

In the medium horizon, the inflation rate is expected to fluctuate around 4%. Having in mind that the more intense dialogue between the Czech central bank and the government has improved the conditions for forming a desirable mix of monetary and fiscal policy, it should have a positive effect on inflation expectations and costs' reduction of anti-inflationary policy.

The steps of the process of consolidation of public finances should be implemented gradually over time without having negative effects on the performance of the Czech economy or on its real convergence. In addition to standard policies (adjustments on the expenditure and revenue side of general government budget) fiscal policy also bears the costs of completing the transformation process and creating conditions for the real convergence of the Czech economy and the pre-accession costs of harmonising policies and institutions. This combination of factors limits the rate at which government expenditures to GDP are reduced.

In the medium term, subsidies to transformation institutions will gradually decrease. The general government deficit excluding net lending is supposed to decrease over time from 8.9% of GDP in 2002 to 3.9% of GDP in 2004.

## **Poland<sup>15</sup>**

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<sup>15</sup> Progress towards meeting economic criteria for accession: The assessment from the 2002 regular report, European Economy, European Commission, Directorate General for Economic and Financial Affairs, October 2002

In its Regular Report from 2001 the Commission has expressed a similar opinion about Poland as about Czech Republic cited above: *Poland is a functioning market economy. Provided that it continues and intensifies its present reform efforts in a consistent policy environment, it should be able to cope with the competitive pressure and market forces within the Union, in the near term.*

As in the Czech Republic, in Poland the impressive track record of economic growth since the mid-1990s has been interrupted by the sharp slowdown in activity experienced since 2001. The positive side-effect of the slowdown has been the correction of a number of macroeconomic imbalances that had arisen as a result of strong domestic demand. With the downturn, high unemployment and inactivity have become the main imbalances in the Polish economy.

Prior to the 2001 downturn, Poland was slowly but steadily catching up with the EU in terms of income. GDP per head in purchasing power standards now represents around 40% of the EU average. At present, because of slowing economic activity the employment rate has fallen from around 59% in 1997 to 53,8% in 2001.

Similarly as in the case of Czech Republic, Poland also has already performed a majority of steps necessary to create an open market economy. One, however, can see some barriers for the further smooth pace of development. In the recent years the consensus on macroeconomic policies has weakened. There has been an increasing divergence of views between the monetary authorities and the government that has led to a sub-optimal macroeconomic mix and a further breakdown in co-operation. This situation is being mirrored in weakening investor confidence and the decreasing attractiveness of the Polish economy.

The downturn starting in the second half of 2000 led to a weak growth rate of just 1.1% in 2001 and 0.5% in the first quarter of 2002. The current account balance has been showing continuous deficits of at least 4% of GDP, which have been increasingly financed by FDI inflows. Inflation has been on a falling trend. Whereas annual inflation in 1997 still

amounted to 15%, it has fairly continuously fallen over the past years. Headline inflation dropped to 3.5% at end-2001.

Poland has switched its exchange rate regime from a crawling peg prevailing until 2000 to a regime of free float since then. Since the exit of the crawling peg in April 2000, Poland has been maintaining a monetary and exchange rate policy framework combining a floating exchange rate with direct inflation targeting. Implementation of direct inflation targeting is proving difficult, in particular because of the uncertainties and lags surrounding the monetary policy transmission mechanism, given the state of development in the financial sector. Since the flotation of the zloty, the monetary authorities refrained from direct intervention in the foreign exchange market, as this would probably have brought little effect on the currency's real value and could only have been undertaken at the cost of higher inflation.

Poland's efforts of fiscal consolidations cannot be described as a big success because of a slowdown in growth and the reluctance of the Polish authorities to undertake a deep restructuring of public expenditures. General government net borrowing dropped from 4.3% of GDP in 1997 to levels of around or below 2% in the subsequent three years but has widened significantly in last years, parallel to the slowdown of economic activity. Most of the deterioration of the fiscal accounts is attributable to the deficit of the central government budget. Reforms in health care and pensions, which were initiated in 1999, have still not been completed.

After a policy mix in mid nineties that enabled economic growth and stability, this policy mix has become less supportive since 1999. After a sharp easing of monetary policy in 1999 and a rapid pick up in inflation and in the current account deficit, macroeconomic policies were considerably tightened in 2000. Since then, the relaxation of monetary policy has been lagging while the deterioration of the fiscal stance in the course of 2001 has gone beyond cyclical factors and reflects a discretionary relaxation of policy. The lack of transparency in the fiscal accounts is also an obstacle to the appropriate setting of monetary policy.

Poland has conducted a liberalisation of most of the prices very early in the transition. Trade liberalisation has been guided by WTO and EU accession-related commitments that have enabled a fall in Poland's effective trade-weighted average tariff from 5.8% in 1997 to 2.6% in 2001.

There are no significant legal or institutional barriers to the establishment of new firms in Poland. The main remaining problem is the implementation of bankruptcy procedures and the exit of insolvent firms but the new law is due to be implemented later in 2003.

The financial sector is maturing slowly. The government maintains ownership in only 7 institutions compared to 15 in 1997 but the role of the former state savings bank – PKO BP – remains significant. The market is also fairly concentrated, with the largest 10 banks accounting for more than 70% of assets. Polish banking intermediation remains characterised by a lack of effective competition. However, the sector seems stable and well capitalised. Efficiency of banking intermediation, measured in terms of interest rate spreads remains low and is improving only slowly.

The non- banking financial sector is relatively small, but growing rapidly. The Polish equity market is still very small with a capitalisation of less than 15% of GDP. The corporate bond market (as well as other fixed income markets) is also small but should now develop in parallel with the growth of institutional investors. The commercial paper market is expanding rapidly and becoming an alternative source of financing for the biggest firms.

Table 3.

Selected Macroeconomic and Financial Indicators for Poland<sup>16</sup>

	1998	1999	2000	2001
<b>I. Real Sector</b>				
Real GDP growth (in %)	4.8	4.1	4.0	1.1
Real growth of exports of goods and services (in %)	9.4	2.0	25.3	13.3
Investment (in % of GDP)	25.1	25.5	25.3	20.1
Unemployment rate	10.6	13.9	16.1	18.2
Inflation (CPI, period average, annual change in %)	11.9	7.3	10.1	5.5
Real effective exchange rate (towards EU-15 and 8 other industrialised countries (change in %)	5.8	-3.8	11.1	12.9
<b>II. External Sector</b>				
Current account balance (in % of GDP)	-4.3	-7.5	-6.1	-4.0
Foreign direct investment inflows (net, in % of GDP)	4.0	4.7	5.2	3.7
Portfolio investment (in % of GDP)	0.8	0.5	1.6	1.1
o/w inward portfolio investment (net, in % of GDP)	0.9	0.7	1.6	1.0
Long-term investment (net, in % of GDP)	1.0	1.3	0.9	-1.2
Other investment – short term (net, in % of GDP)	2.3	-1.0	-3.0	-1.7
Gross external debt (in % of GDP)	37.4	41.5	40.3	56.3
Gross external debt (in % of exports of goods and non-factor services)	65.9	64.9	57.2	n.a.
Short-term gross external debt (in % of GDP, remaining maturity)	6.2	7.2	6.0	7.7
Gross official reserves (in months of imports of goods and services)	7.7	7.8	7.7	6.6
Gross official reserves (in % of gross short-term debt, remaining maturity)	29.8	38.8	33.2	n.a.
<b>III. Fiscal Sector</b>				
General government balance (in % of GDP)	-2.4	-2.1	-3.5	n.a.
General government debt (in % of GDP)	42.9	44.4	40.9	n.a.
<b>IV. Monetary and Financial Sector</b>				
Bank assets (in % of GDP)	57.5	59.0	62.8	61.3
Deposits (in % of GDP)	33.9	36.0	37.0	33.4
Domestic credit to private sector (in % of GDP)	25.0	28.6	30.2	30.6
Nominal domestic credit growth (in %, annual, end-period)	22.2	20.4	13.9	7.2
Share of majority state-owned banks in total bank assets (in %)	36.7	22.1	21.1	24.2
Share of majority foreign-owned banks in total bank assets (in %)	16.6	47.2	69.6	68.4
Aggregate capital adequacy of banks (in %)	15.0	16.6	15.5	14.4
Non-performing bank loans (in % of total bank loans)	10.9	13.7	14.6	16.4
Pre-tax bank profits (in % of total bank loans)	0.7	1.0	1.3	1.6

<sup>16</sup> Report on macroeconomic and financial sector stability developments in candidate countries by Directorate-General for Economic and Financial Affairs, April 2002

Before entering the Eurozone both countries have to fulfil certain preconditions to ensure that the positive effects really materialise and the potential risks of Eurozone membership are minimised. In the ERM II exchange rate regime and after the subsequent adoption of the euro, when the analysed countries will give up their autonomous monetary policy, sufficient alignment of their economies with the Eurozone economies in the real and financial spheres, flexible fiscal policy and a well-functioning labour market will be of key importance for the smooth functioning of their economies.

In Poland we can find a lot of academics and the representatives of central institutions suggesting that the only Polish way to the Eurozone could be so called “euroization”. This term describes one-side replacement of the Polish currency by the euro during the interim period preceding the full adoption of the single currency. Technically, it will be performed in a way of buying the euro coins and banknotes in the market and all the invoices, bonds, banking accounts etc. would be converted into euro in a due time. Supporters of such a solution argue that it would further attract the foreign capital, reduce the costs of transactions and the final effect would be an augmentation of manufactory volumes and a stabilisation of prices.

One-side euroization is not, however, a process supported by the EU representatives. High level of deficit precludes a success of euroization. Poland would not be able to conduct an independent monetary policy with the aim of curbing inflation. Poland would then become a victim of so called Balassa – Samuelson effect<sup>17</sup>. Having a fixed exchange rate vis-à-vis the euro Poland would experience the inflation rate higher than in the Eurozone. At present, having a floated exchange rate Poland can rather easily fight with the B-S effect, for example by permitting zloty to appreciate as a result of restrictive monetary policy and – in this way – meet the inflationary criterion. Conversely, having a fixed exchange rate means that all the process of combating inflation would have to be conducted by government. In the light of the known problems with the central budget consolidation it seems to be impossible.

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<sup>17</sup> In a country where a productivity growth rate is very high, the prices of services grow much quicker than the prices of tradable goods.

In the document „Partnership for the accession in the EU” agreed with the representatives of the European Union in spring 1998 and describing priorities to be executed by Poland in the pre-accession period, one could find also recommendations on preparation of Poland to the membership in the Eurozone. It was stated that “Poland will not enter the Eurozone immediately after gaining the membership in the EU. Conversely, it will conduct policy with an aim to achieve a real convergence with European goals on macroeconomic and social cohesion as well as a nominal convergence leading to the single currency”.

Programme „Agenda 2000” published in December 1997 stresses that to the aim of effective monetary policy within EMU, Poland has in advance to conduct and conclude necessary reforms that would eliminate factors hindering an execution of the efficient monetary policy, i.e. for example lack of a level playing field in the banking sector and low degree of the financial market development. In „Agenda 2000” it was also emphasised that it would be of the crucial importance for Poland to meet convergence criteria and to conduct a policy to obtain a stabilisation of the exchange rate.

### **Conclusions**

The future member states, in particular first five: Poland, Hungary, Czech Republic, Slovenia and Estonia meet already better the convergence criteria that it was the case of the Southern member states in 1999.

The governor of the National Bank of Poland supports the view that the Polish way to the single currency should be preceded by structural reforms, changes in tax regime, liberalisation of the labour code, budget discipline, restructuring of some industrial sectors, development of the transport networks, completion of the privatisation process and changes in social security system.

Frequently cited Reports of the Commission stress that it takes a lot of time before the new member states will catch the EU standards of living. They present the opinion that the countries entering the EU in 2004 should not insist on a prompt adoption of the single

currency. The euro should not be treated as a priority for the countries lagging for some 20 years with reaching the same average of economic indices as it is the case of the present EU member states. The European Central Bank strongly displays its opposition. It shows a concern that too rapid implementation of the euro in these countries could threaten a stability of the single currency. European Commission recommends that these countries should take as a priority a diminishing of a distance in their development, not a restrictive exchange rate and monetary policy resulting from standards in Eurozone. Daniel Gros, director of Centre for European Policy Research in Brussels states that „it is necessary to assume that Central and East European countries at a moment of entering the Eurozone will be in average more poor than those of European Union. However, having in mind the experience of Portugal, Greece and Spain is it possible that the growth rate of CEE countries will accelerate when they become the new member states of EMU. In this way these countries will also accelerate the average growth rate in all the Eurozone. In other words, it means that the broadened Eurozone in, say, 2006 with the participation of some ECC countries should be more dynamic than would justify higher interest rates. These two elements, higher growth rate and higher interest rates will result in the stronger euro. So, the euro should strengthen after bringing some new countries to the Eurozone, assuming that those new countries will have a high growth rate and a strong fiscal position”.

It is very difficult to predict the effects of any shocks that could happen in any of the three distinct phases: the pre-Maastricht phase, the Maastricht phase and the enlargement after the accession of ten countries. These effects depend on whether they are symmetric or country-specific<sup>18</sup>. If supply shocks are symmetric, the response of inflation and output in the enlarged currency area is very similar to that of the euro area before enlargement, while the response in accession countries is sensitive to the slope of the Philips curve.

In the pre-accession phase, as it was described above, a stable state inflation in any accession country depends on the monetary policy framework. With a floating exchange rate inflation will be higher, the less credible the monetary policy framework and the

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<sup>18</sup> The admission of accession countries to an enlarged monetary union: a tentative assessment, European Central Bank, Working Paper Series, February 2003.

flatter the Phillips curve, Still, there is more room to manoeuvre for the policy mix. With a currency anchored to, say, the euro inflation is partly imported from the Eurozone and partly determined by the process of real exchange rate appreciation (B – S effect).

In the Maastricht phase and some requirements resulting from both internal (within a given country) and external (the EU conditions) environment the inflationary expectations start to be formed in a dramatically different way leading to the nominal convergence objective. During this phase one can observe however some upward pressures on the nominal exchange rate.

What is there going to happen with a steady state inflation after a given country enters the third phase? It seems that after a new member state adopts the convergence monetary policy, the inflationary impact should be negligible. Similarly, the real exchange rate appreciation will have in a long run a small, if any, influence on aggregate inflation in the Eurozone. Its impact can be felt, however, in the short term. That impact will depend on a real appreciation and on a size of a given country.

Summing up, time series observed in the accession countries are not of the appropriate length to serve as an evidence of the desirable development of the results of policy mix implemented in these countries. The flood in the Czech Republic, political uncertainty in Poland, prolonged downturn in all candidate countries could be recalled as an explanation of difficulties in any predictions. Still, it seems to be rather apparent that at the present stage – at the edge of accession – the candidate countries should concentrate firmly on a fiscal side of their policy mix. They have already reached a satisfactory level of inflation, even better than in some Eurozone member states. It is then the final and the only period for them to consolidate their budget deficits, even at the slight cost of inflation. As long as there are some discrepancies between the overall state of their economies and the ones of the Eurozone, the candidate states should not insist on an early access to the ERM II, still trying to harmonise their monetary policies with that conducted by ESCB.

As it has been stated at the beginning of this report, the Eurozone cannot be called an optimal currency zone in theoretical terms. Notwithstanding, because of some practical

evidence, the enlarged monetary union in Europe will work well provided the continuous fiscal and monetary discipline in participating countries. The longer it exists, the more apparent will be the positive effects of its creation: strengthening economic cohesion, reduction in risk premia, facilitation foreign direct investments and encouraging technological progress.

## IV. Monetary policy in Poland in perspective of accession to the EMU

Contribution by Marek Rozkrut and Tomasz Chmielewski

### Introduction

Poland is on the eve of joining the European Union, an event that over time should greatly contribute to the development of the Polish economy. Having achieved that goal gives rise to another challenge to be faced up to, namely meeting the requirements of eligibility for prospective euro-zone membership. Focusing on this aim will largely determine the monetary policy conduct in the forthcoming years. And thus, in light of various changes the European integration entails with respect to the real economy and simultaneous necessity to meet the Maastricht nominal criteria, an effort to assess the potential impact of new economic conditions on the monetary policy performance is by all means desirable. Therefore, this paper makes an attempt to scrutinize distinct factors that might influence policy makers' decisions.

The structure of the paper is as follows. At the very beginning, a quick glance at the path of the disinflation process is given. It provides a reader with a rough overview of developments that impinged on the relationships between the monetary and fiscal authorities, and thus influenced the monetary policy conduct. This constitutes a starting point for the analysis of the rationale behind the current strategy of the Monetary Policy Council (MPC), which is discussed next. This, in turn, gives rise to the development of the most important phenomena that might have an impact on the monetary policy conduct in the early stage of Poland's membership in the European Union. At this stage, a particular emphasis is placed on the Balassa-Samuelson effect and the way it may influence inflation targeting. Moving forward, as participation within the ERM II framework constitutes a prerequisite for euro-zone membership, the ins and outs of this mechanism, and - more generally - of the quasi-fixed exchange rate regimes, are brought to light. While developing potential sources of capital movements experienced by the accession countries (ACs), the issue of convergence play is touched upon. Setting the pros and cons of the ERM II against those of the floating exchange rate system provides support for the MPC's decision to maintain the current regime. Further, the relationship between the nominal and real exchange rate is discussed, with particular stress laid on the importance of setting the

central parity within the ERM II at the level consistent with the real equilibrium exchange rate. Next, an overview of the Maastricht criteria challenges is made in parallel with focusing on the potential trade-off between the real and nominal convergence. Then, the authors make an attempt to refute various allegations quoted by the opponents of Poland's early entry into the euro-zone. Finally, envisaged sequence of events subsequent to Poland's euro-zone memberships is fleshed out, with an emphasis put on the potential threat related to the overheating phenomenon.

### **1. From disinflation path to the stage of stabilizing inflation – the Polish experience**

The year 2003 completes the stage set by the *Medium term monetary policy strategy for the years 1999-2003* and gives rise to another one, whose framework has been determined in the recently published *Monetary policy strategy beyond 2003*. The new strategy also marks a shift from the disinflation path to stabilizing inflation at the low level. This is not to say, however, that the process of reducing inflation from a high level of 8.6% (YoY) in December 1998 to 0.4% in May 2003 has been carried out smoothly with no tensions encountered over time.

It is enough to go back to the fiscal turmoil in 1999, whose underlying cause was the Social Security Fund breakdown, an event resulting from the temporary loss of control over the inflow of social security contributions<sup>1</sup>. Consequently, an unexpected increase in fiscal expenditure (structural deficit increased to above 5% of GDP in 1999 – European Commission, 2002a), combined with earlier relaxation of the monetary stance, poor external demand and negative supply shocks, led to a surge in inflation (Figure 1) and deterioration of the current account deficit. This event impinged on the relationships between the central bank and fiscal authorities for the next few years. The *policy-mix* improvement was further protracted by insufficient fiscal consolidation and fiscal policy relaxation reflected, *inter alia*, in two revisions to the budget in 2001 or a continuing increase in government expenditure relative to GDP. Mutual distrust between the fiscal and monetary authorities have further been fuelled by government officials' critical comments

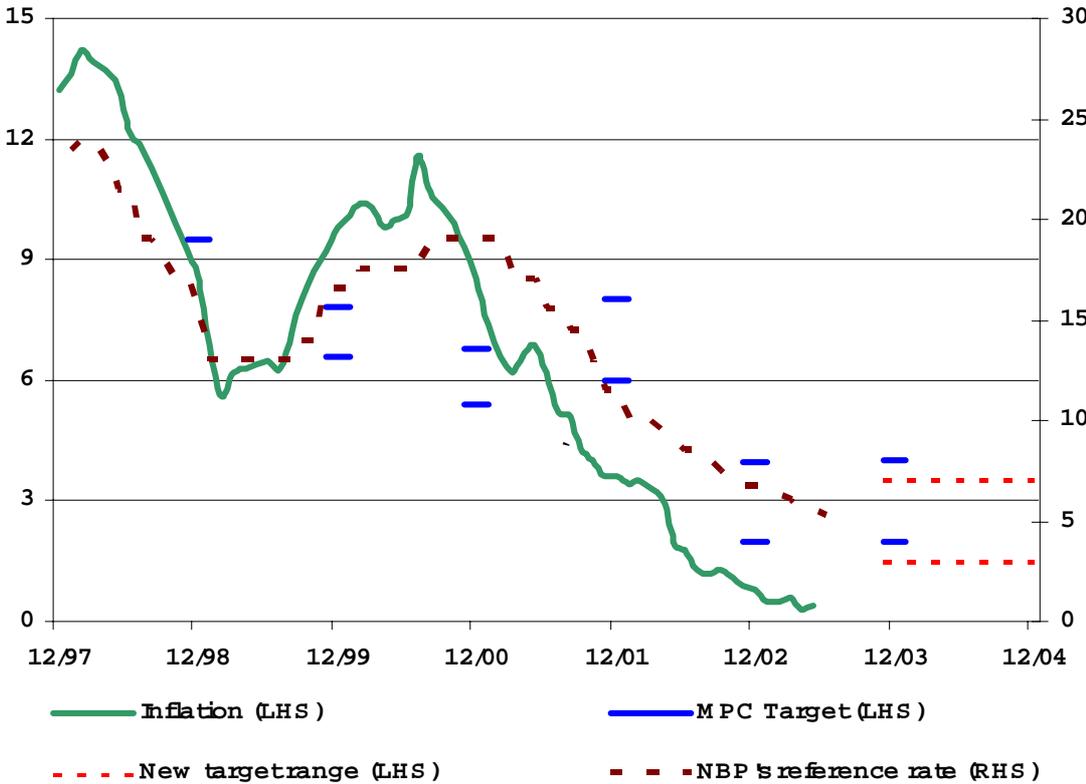
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<sup>1</sup> This and the following paragraph largely draw on Rozkrut (2003b)

on the monetary policy conduct, or pressures exerted on the NBP to release resources classified as for exchange-rate risk provisions.

The above-outlined circumstances seem to justify, at least to a certain extent, a cautious attitude adopted by the MPC towards the conduct of the monetary policy, reflected in a series of interest rate increases and a subsequent series of careful reductions (Figure 1). The NBP’s conservative strategy, however, came in for severe criticism, reinforced by the fact that since 1999 all the inflation goals have been either overshoot or undershot (Figure 1). Notwithstanding that, fulfillment of the medium-term inflation target of below 4% at the end of 2003 can almost be taken for granted, which in turn should enhance the NBP’s credibility. All in all, the completion of the disinflation path should not be underestimated, although one might have reservations about the way it has been attained.

**Figure 1. Disinflation and NBP’s reference rate paths, and MPC targets (%)**



Source: NBP

**2. Towards the euro-zone – monetary policy strategy**

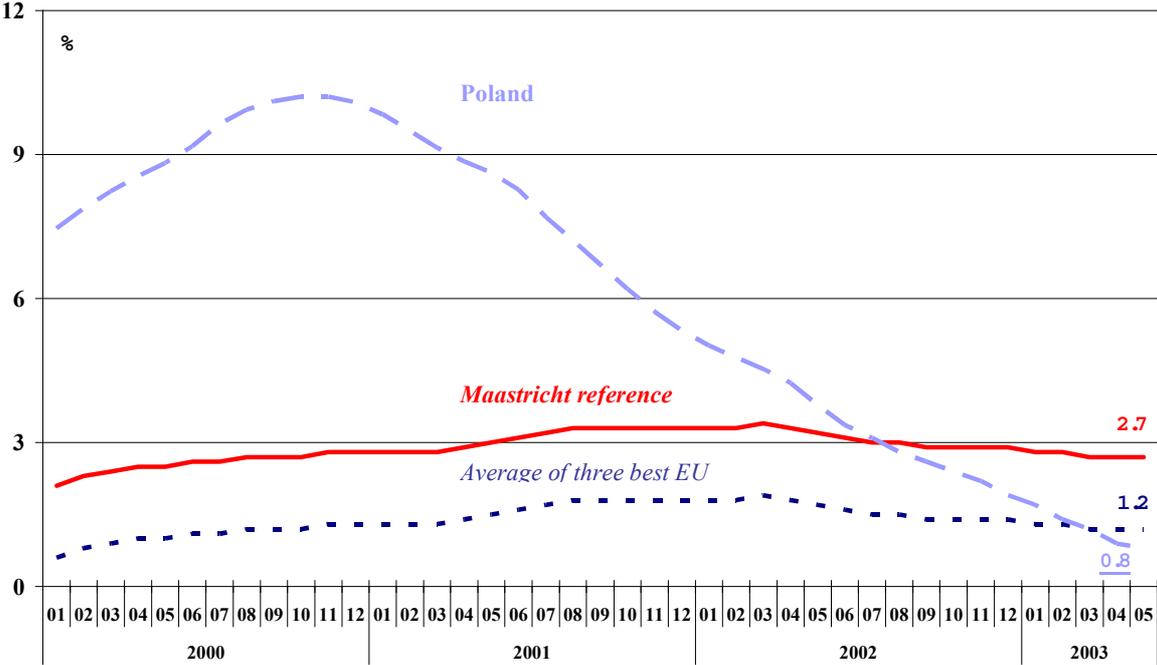
In the *Monetary policy strategy beyond 2003* the Monetary Policy Council (MPC) have taken a stand that direct inflation targeting (DIT), remaining at the core of the NBP's policy since 1999, should be continued. An increasing number of countries adopting inflation targeting (IT) (Mishkin and Schmidt-Hebbel, 2001; Fracasso et al., 2003) seems to support the virtues of the policy conduct based on that strategy. First of all, it enhances transparency of the monetary policy by presenting the monetary policy goal in an explicit and understandable manner. Secondly, its openness allows public verification of monetary policy directions and effectiveness of the policy conduct. Furthermore, under IT strategy a central bank, provided that it possesses sufficient credibility, may influence significantly inflationary expectations, one of the crucial factors that determine the actual inflation path. Last but not least, IT provides a central bank with a greater flexibility for the use of monetary instruments that may be tailored to the specific nature of the shock that might jeopardize the achievement of the inflation target.

A new medium-term inflation target has been defined in the *Monetary policy strategy beyond 2003* (NBP, 2003a) as a CPI year-on-year increase of 2.5% +/- 1 p.p. As distinct from the so-far inflation targets verified once a year in December, the new one is to be scrutinized on a permanent basis. It is a corollary of the completion of the disinflation process and movement to the stage of stabilizing inflation at the low level. According to the MPC, the such defined inflation target should both go in parallel with a dynamic economic growth and enable fulfillment of the Maastricht inflation criterion. The CPI is the inflation measure best identified by and clearly communicated to the society. Moreover, the structure of the Polish CPI index is similar to that of the HICP. Finally, stabilising inflation at the low level limits deviations of the annual average from the YoY inflation increase. As a result, the measure of inflation target adopted by the MPC should be roughly consistent with the way the Maastricht criterion is determined, i.e. by HICP 12-month moving average.

One might complain, however, that the MPC have not justified the level of the chosen inflation target, not least why it is to be consistent with a rapid economic growth. Taking into account the information available at the moment of the strategy's release (February 2003), one might come up with the following rationale.

While defining the inflation target the MPC might assume that the ECB’s monetary policy was based on the YoY inflation growth, being in check on a permanent basis and ranging between 0-2% (European Central Bank, 1999). On this reasoning, taking 1% inflation growth as the ECB’s medium-term target would seem to be fairly logical. Adding to that the estimated value of circa 1.5 p.p. (Chmielewski, 2003) for the Balassa-Samuels effect in Poland (see also discussion on the Balassa Samuelson effect in section 3), the 2.5% +/- 1 p.p. inflation target set by the MPC would seem fully justified. However, the current level of inflation in the euro-zone, and, more importantly, the recent revision of the ECB’s strategy that it is to aim at stabilizing inflation *below but close to 2%*, undermine the above-outlined reasoning and would call for setting the inflation target at the higher level.

**Figure 2. Poland’s performance on the (HICP) inflation criterion**



Source: Eurostat database, own calculations

On the other hand, however, raising the inflation target might imply high costs related to the Maastricht criterion fulfillment. In the period of 1998 to May 2003 the reference value ranged between 1.8% and 3.4%, while between January 2000 and May 2003 it amounted on average to 2.9%<sup>2</sup>. Since August 2002 Poland has fulfilled the Maastricht inflation criterion

<sup>2</sup> own calculations based on the Eurostat data

and in May 2003 the HICP 12-month moving average for Poland equaled 0.8%, less than for any other EU country (Figure 2). In May 2003, the reference value amounted to 2.7%, and it has not gone below 2.5% since March 2000 (2.4%). The important issue is that since EU enlargement the reference group of three countries will be chosen not from current 15, but from already 25 EU members. This bears the risk that the value for the inflation criterion may plummet. Such a view is supported by the fact that in May 2003, apart from Poland (0.8%), the other two countries the reference group would comprise might be<sup>3</sup>: Lithuania (-0.9%) and the Czech Republic (-0.1%), and, consequently, the inflation criterion would reach the low-record value of 1.4%<sup>4</sup>.

Under such circumstances, the need to reduce the inflation from above 2.5% to the reference value in the short period of time would require a radical monetary policy tightening, which in turn would entail significant social costs. Alternatively, not fulfilling Maastricht criterion on schedule would set back euro-zone membership significantly, and thus the benefits it would otherwise entail.

In this context, bearing in mind that the ECB conducts monetary policy for the euro-area exclusively, and not the whole EU, it seems that the reference group should comprise euro-zone members only. It is little justified why a non-euro member, not least with a negative price growth, should constitute a 'model' reference country<sup>5</sup>.

### 3. The Balassa-Samuelson effect

The Balassa-Samuelson (BS) effect often constitutes an important part of the framework for analysing the accession process. The model, originally formulated by Balassa (1964) and Samuelson (1964), explains persistent, of structural nature, deviations of an exchange rate from the value implied by the purchasing power parity. According to the model, the source of the BS phenomenon stems from higher productivity growth in the home tradable

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<sup>3</sup> Provided that a member where deflation has taken place is to be numbered among the reference countries. Although some statements seem to exclude such a possibility, no formal decision has made it clear so far. Nevertheless, even if the reference group did not comprise a country with negative price growth, still it might include other EU members with close to but above zero inflation growth. Moreover, a formerly deflation country can get back to the positive price growth, thus becoming a new reference country, which might reflect in a plummet of the reference value. In this latter case the inflation criterion would become a very volatile figure, thus increasing uncertainty as to the eligibility of an AC for euro-zone membership.

<sup>4</sup> own calculations based on the Eurostat data

<sup>5</sup> see footnote 3

sector in relation to the home non-tradable sector as well as to both sectors of the foreign economy. Such a feature constitutes part and parcel of the catching-up process the accession countries (ACs) still experience.

And thus, in the foreseeable future the ACs are expected to follow the real convergence progress. This implies that these countries should on average grow faster than the incumbent EU members. Moreover, it is widely recognized (and empirical evidence for Poland supports this view – see below) that it is the tradable sector that accounts for the driving force behind the economic growth. Foreign competition that this sector faces both on domestic and foreign markets provides a powerful stimulus to its accelerated productivity improvement. It reflects in the ACs' productivity dynamics outpacing that of developed countries, the relationship compounded by the initial low starting point in terms of the ACs' productivity, a legacy of the former command economy. Another factor explaining higher productivity growth in the tradable sector in relation to the non-tradable sector is concentration of foreign direct investments, which provide know-how and new technologies, in the former. By contrast, the non-tradable sector, consisting mostly of services, tends to be more regulated (reflected e.g. in prices being set administratively below the market level) and thus less attractive for foreign investors than the tradable sector.

The difference in productivity growth influences the relationship between prices of tradable and non-tradable goods on the domestic market. It operates through development in wages. In the long run wages in both sectors tend to equalise. This might take place because of labour mobility between sectors or due to the strong position of labour unions<sup>6</sup>. As the tradable sector remains subject to international competition and capital is assumed to be internationally perfectly mobile, the rate of wages growth reflects improvements in productivity in the tradable sector<sup>7</sup>. The productivity growth in the non-tradable sector is lower than in the tradable sector, so the equal level of wages in the whole economy implies that non-tradable goods in terms of tradable goods have to become more expensive. If there

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<sup>6</sup> It should be stressed that a high unemployment rate can to a certain extent influence the described effect. In particular, two issues should be focused on. First, unemployment does not have to influence the relative rate of wages growth in both sectors (unemployment is sometimes wrongly considered as a factor that works against sectoral wages equalisation). On the other hand, it can be a source of economy-wide downward pressure on wages. It is, however, very difficult to quantify and not so far has not been taken into account in the empirical literature of the subject.

<sup>7</sup> This is the condition for equality (in terms of chosen currency) of the price of the tradable goods in the home country and abroad and therefore also for the international competitiveness of the home tradable sector.

are no productivity differentials between these sectors in the foreign economy, then straightforward implication of this reasoning will be the real appreciation of the currency of the faster growing country. This, in turn, usually reflects in the non-tradable goods inflation in the fast growing country.

The most important issue for the assessment of a possible significance of the Balassa-Samuelson effect are changes in relative productivities<sup>8</sup>. Figure 3 illustrates developments in productivity in distinct sectors. Industry represents an approximation of the tradable sector, while services account for an approximation of the non-tradable sector<sup>9</sup>. Productivity is measured as the average product of labour (seasonally adjusted by X-11 method). Figure 3 provides some evidence that the Balassa-Samuelson effect might be at work in Poland. For most of the analysed period, productivity increases in industry were higher than in market services.

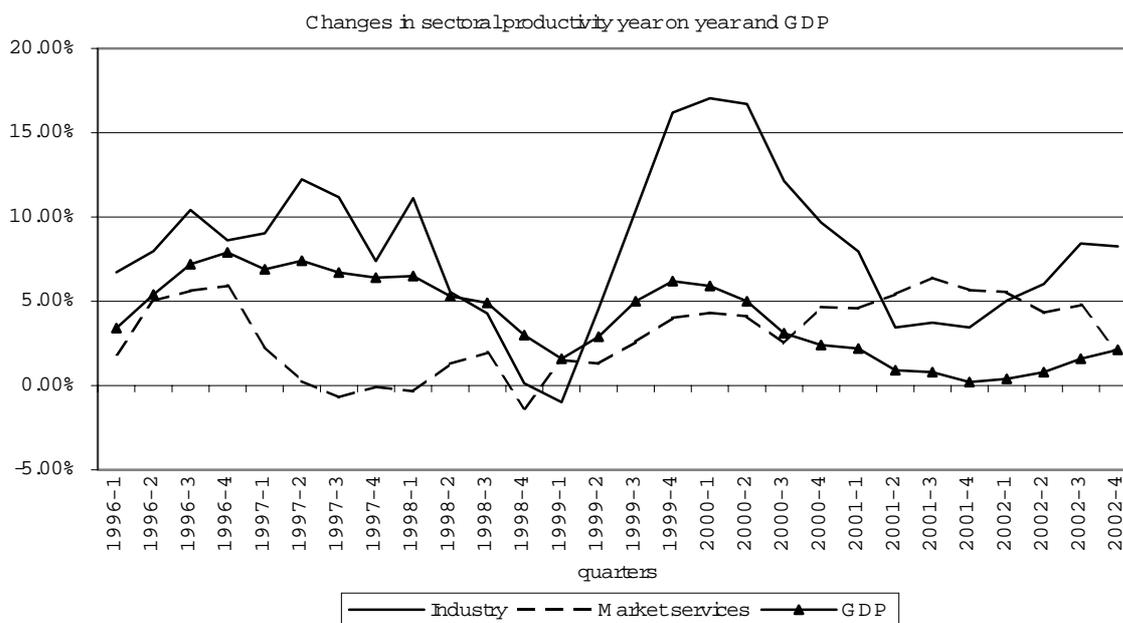
Empirical literature dealing with the Balassa-Samuelson effect in the transition countries has recently expanded. The so far evidence, however, offers quite varying estimations of the Balassa-Samuelson effect, even for the same countries (cf. Halpern and Wyplosz, 2001; Égert, 2002a and 2002b; Backé et al., 2002; Sinn and Reutter, 2001). The underlying causes are mostly: distinct time periods considered, differences in assumptions and models specifications, differences in data-sets construction and even distinct econometric techniques applied. Recent empirical results for Poland (Chmielewski, 2003) suggest that the probability of the Balassa-Samuelson effect being on average larger or smaller than 1.5 percentage point is symmetrical. For policy-making purposes it can be estimated that a size of the Balassa-Samuelson effect could, on average, fluctuate in the range between 1 and 2 percentage points.

**Figure 3. Changes in sectoral productivity, year on year, seasonally adjusted, and GDP growth**

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<sup>8</sup> A distinct and very important problem for empirical research is how to define the tradable and non-tradable sectors, in a way that would be consistent with available data.

<sup>9</sup> This is a common practice in the literature dealing with the Balassa-Samuelson effect.



Source: Central Statistical Office and own calculations.

The crucial point for the coming years is to assess possible developments in sectoral productivities. As can be derived from Figure 3 changes in productivity in industry (i.e. the tradable sector) is much closely correlated with GDP growth than changes in productivity in market services (i.e. the non-tradable sector). Therefore, as economic conditions improve (a rise in GDP growth), the difference between the rates of productivity changes in both sectors widens. There is not a clear-cut answer to the question whether such a development will continue to exist in the future. The difficulty to a large extent stems from the fact that accession to the EU will constitute a very significant regime change and therefore the Lucas critique<sup>10</sup> may apply.

First, assume that observed relationship will be still in place. As it is generally reflected in the recently published forecasts (e.g. IMF, 2003; European Commission, 2003), outlook for the Polish economy is improving. The rate of GDP growth will increase as a result of cyclical adjustment (a revival of the economy is expected subsequent to shifting from the period of a slowdown to the next stage of the economic cycle) and improving international conditions. First benefits of EU accession can also materialise soon. In such a case widening of the gap between sectoral productivity changes might be expected. It will lead to

<sup>10</sup> Lucas in his famous critique argued that in the case of significant structural change in an economy, economic agents (policy makers included) might start to behave dissimilarly to the period before the change. This might cause changes in the parameters values of any structural econometric model. Therefore, basing policy makers' reasoning on the estimation results from the period before the structural break, may lead to drawing erroneous inference about the period after that break.

increasing pressure on relative domestic non-tradables inflation and appreciation of the real exchange rate. Given the stability of nominal exchange rate, this would imply international differentials in inflation rates. This issue is discussed in more details in the latter part of this paper where implications of the Maastricht criteria and ERM II membership are developed.

It should be stressed that the Balassa-Samuelson effect will not cease to exist in a few years time. It is a phenomenon of structural nature and will probably remain at work, although with diminishing strength, as long as the process of real convergence has not been over. It is straightforward then that the BS effect will be of importance to monetary policy-makers in Poland until their prerogatives have been fully transferred to the ECB.

It has been mentioned above that the accession to the EU may make extrapolation of relationships observed so far an improper forecasting tool. As far as sectoral productivities are concerned, it can take place because of e.g. shift in the pattern of foreign direct investment and changes in the competition structure of the Polish market. Expanding foreign retail chains in Poland may serve for an example of the former (it also qualitatively changes competition environment for many retailers). Offering services without establishing strong physical presence in a country, for example offering and selling products via internet, might be an unusual challenge for some entities operating already on the Polish market. It might be particularly the case for banking and insurance industries (one can ask, however, whether these services are still non-tradable), but also, for instance, in tourism industry.

The Balassa-Samuelson effect is one of the possible structural factors that may affect inflation and real exchange rate during the early stage of membership in the EU and the euro-zone. Their overall impact, however, is very difficult to be assessed *ex ante*. Therefore, the economic and, in particular, monetary policy makers should be aware of the degree of uncertainty. In such conditions it is reasonable to pose a question about the possible outcome of policy makers' mistakes or misperception of some developments.

It might happen that policy-makers' assumptions about the strength of the Balassa-Samuelson effect and of other structural factors, inherently related to the real convergence process, may diverge from their actual impact on inflation. The light is to be cast on how

such a misjudgement may result in a suboptimal policy framework. Assuming the stability of the nominal exchange rate, in the presence of the Balassa-Samuelson effect and effects alike, two components of the inflation rate can be distinguished (Schardax, 2001). The first can be referred to as a “bad inflation”. “Bad inflation” is by definition unwelcome in the economy and diminishing it constitutes a target for the monetary policy authorities. By contrast, the second type of inflation, a “good inflation”, is the result of structural adjustments in the economy (i.e. the real convergence process). Sectoral productivity differentials may serve for an example. The “good” inflation accounts for the influence of the Balassa-Samuelson effect and of similar factors on the inflation rate. Attempts to reduce the second type of inflation<sup>11</sup> would result in a slowdown in the real convergence because of creating too restrictive stance of the economic (and in particular – monetary) policy. It should be stressed that it is not only a short-run trade-off between inflation and growth that is observed during almost every disinflation process. The inflation rate permanently lower, even if it is stable, than the rate of “good inflation” implies costs for the real side of the economy in terms of growth being below the potential level.

Restrictive monetary policy would deteriorate companies’ ability to raise the productivity level via less favourable investment conditions. Figure 3 supports for Poland the assumption that productivity growth in the non-tradable sector is rather low. Therefore, possible deterioration in the productivity growth would take place mostly in the tradable sector and, consequently, the difference in the productivity growth between sectors would be lower. It would then result in a lower pressure on inflation, but also in a slower growth of the economy. The real convergence would therefore be deferred.

Similarly, misperception of the size of structural, convergence-related factors influencing the inflation rate and the real exchange rate may also impinge on ensuing economic developments. First, consider a situation when the policy makers assume that the impact of the Balassa-Samuelson effect (and other similar effects in terms of their impact on inflation) is significant, but, that the actual productivity differential is lower than assumed. Under such circumstances, monetary policy might not be restrictive enough. Prospects of the higher inflation would not lead to tightening of the monetary policy, for policy makers would perceive the inflation increase as a natural corollary of structural adjustments. On

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<sup>11</sup> Assumption about stability of the nominal exchange remains valid.

this reasoning, the rise in inflation would not be damaging, because the observed additional price growth would predominantly pertain to the “bad inflation” category.

One might also consider the opposite situation when the estimated size of the Balassa-Samuelson effect is smaller than the actual one. In such circumstances, the monetary authorities would attempt to subdue the “good inflation”. The price growth that would in fact stem from the Balassa-Samuelson effect, would then be perceived in terms of the “bad inflation”. Therefore, monetary policy would be too restrictive and have adverse effects on the rate of the real convergence. The slowdown in the real convergence would thus be the ultimate outcome of underestimating the size of the Balassa-Samuelson effect.

The existence of the Balassa-Samuelson effect in the economy and the commitment to meet the nominal convergence criteria should influence the way inflation targets are set. The need to comply with the Maastricht criterion implies that the inflation target should not exceed an average of three lowest forecasted inflation rates of the EU members by more than 1.5 p.p.

If the projected magnitude of the Balassa-Samuelson effect exceeded allowed inflation differential against three best performing countries, the only reasonable inflation target would be that consistent with the inflation criterion. In this scenario, either restrictive economic policy (e.g. in the form of (additional) monetary or fiscal policy tightening) should be conducted temporarily to slow down the productivity growth in the tradable sector and diminish the size of the “good inflation” or the nominal appreciation should be allowed (the appreciation resulting from the convergence play may serve for an example). Undertaking these measures would stem from the need to fulfil the Maastricht criteria. Consequently, pursuing nominal convergence might in this particular case entail the cost of a temporal decline in output. Such a growth restraining policy, however, would not have to be long-lasting, for it would be necessary only as long as it could influence nominal variables in the reference period against which the convergence assessment is made.

#### **4. Prospects for the exchange-rate policy – from the Zloty to the euro**

According to the *Monetary policy strategy beyond 2003*, the floating exchange rate system is to be maintained until the moment of entering the ERM II. Bringing to light the ins and outs of the quasi-fixed exchange rate regime seems to provide credentials for the NBP's decision.

First and foremost, under liberalized capital movements volatility of both currency and money markets has increased significantly (Garber and Spencer, 1995). Moreover, financial innovations have provided market participants with a wide range of instruments that, by facilitating leveraged speculation, may exacerbate the risk of exchange rate turbulence (Papaioannou, 2002). Vast evidence suggests that of various exchange rate regimes it is soft peg arrangements that turn out to be the least immune to the above-outlined potential sources of currency crisis, as it was particularly the case in the ERM 1992-93 crisis (Eichengreen and Wyplosz, 1993; Eichengreen, Rose and Wyplosz, 1995; McKinnon, 1997).

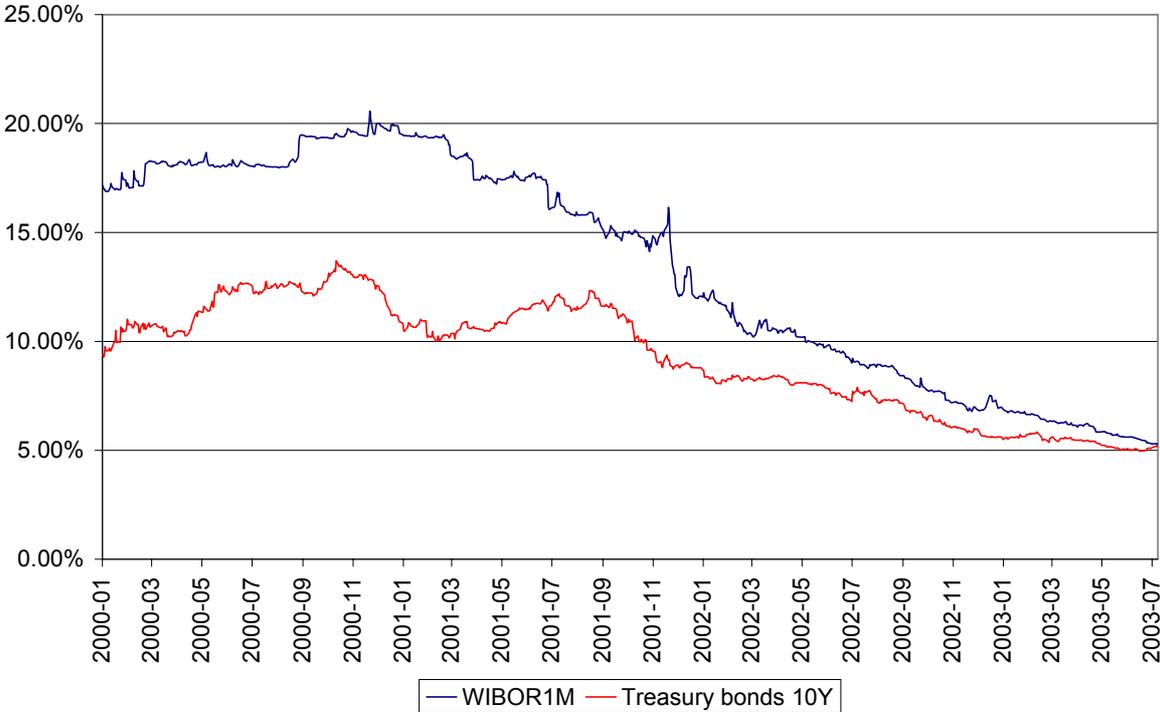
The foregoing should be of special interest to the ACs, for during the period preceding their euro-zone membership they are likely to face massive capital movements, which may stem from various factors. And thus, catching up economies, with relatively low domestic savings, usually offer prospects of higher returns on investment, which should encourage capital inflows. Moreover, to the extent that EU membership holds out the prospect of joining the euro-zone, enhanced credibility and reinforced expectations of interest rates convergence and exchange rate stability may boost consumers' spending and attract further capital influx. Furthermore, an improved access to global financial markets would add to that process. In addition, incomplete privatization would lure still more foreign investment in a limited time span (Koronowski and Rozkrut, 2003). Last but not least, the necessity to maintain relatively high interest rates, implied by levels of natural interest rates in the ACs (Brzoza-Brzezina, 2003), and the need to stabilize inflation expectations at a low level, would encourage further capital inflows.

While fleshing out the issue of capital movements in the ACs, one should touch upon a phenomenon dubbed "convergence play". It accounts for foreign portfolio capital inflow ensuing from expectations of nominal interest rates reduction. The convergence play is usually considered as a potentially important factor that should be taken into account in the policy formulation process in the ACs. It provides investors with a capital profit on

changes of the bills and bonds prices<sup>12</sup>. As long as there are possibilities of realising significant gains without a meaningful risk, one can expect that foreign capital will continue to inflow into the Polish financial markets, exerting the appreciation pressure on the nominal exchange rate. The question that arises is whether such opportunities will still exist after joining the EU and, subsequently, the euro-zone.

As of today, it seems that in Poland there is not much room left for further reductions in nominal interest rates, with the NBP's reference rate being now slightly above 5%. It reflects the completion of the disinflation process (see section 1). Moreover, estimates of the natural interest rate for Poland at the level of 4-6% (Brzoza-Brzezina, 2003) should also temper expectations of further interest rates reductions. The conclusion to be drawn is that in the first stage of EU membership this type of convergence play will be of small magnitude.

**Figure 4. Short- vs long-term interest rates in Poland**



<sup>12</sup> Other possibility of realising such a gain is to use syntetic instruments replicating government bonds pay-off profile, such as FX swaps.

*Source: NBP*

There is, however, a possibility that a new type of convergence play will come to the forefront in Poland before euro-zone membership takes effect. It could be referred to as a “yield curve convergence play”. In Poland, the yield curve has still inverted shape. It is the combined result of relatively high short term interest rates and lower long term rates, the latter determined mostly by expectations of a successful catching-up process and short term interest rates prospective reductions as euro-zone membership approaches. When the yield curve is about to switch from inverted to the normal shape, taking opposite position in long- and short-term papers would generate arbitrage-like profits.

The above-outlined scenario of capital inflows to the ACs should lead to their currencies appreciation. Real exchange rate appreciation can take place either through nominal exchange rate appreciation, when inflation rates in the home country and abroad are similar, or through international inflation differentials, with the stable nominal exchange rate. In what way it will take place will largely depend on the economic policy pursued. Were nominal appreciation preferable to inflation growth, then under a quasi-fixed exchange rate regime it might result in approaching the ceiling of the pre-determined fluctuation bands. In such circumstances the scope for monetary policy tightening would be limited, for interest rates rise would attract still more capital inflows, thus exacerbating currency appreciation pressures. Therefore, if faced with the need to subdue inflation, resorting to the parity revaluation might turn out the only viable solution, a view often supported by lower efficiency of the interest rate channel relative to the exchange rate with respect to their influence on the inflation<sup>13</sup>.

By and large, the above-outlined sequence of events might lead to a domestic currency appreciation, most likely in parallel with current account deterioration, a state that would not have to be consistent with economic fundamentals. If the positive market sentiment, boosted by the overall optimism, persisted, it might lead to a prolonged overvaluation and excessive fluctuations of the exchange rate (Papaioannou, 2002).

Moreover, in the quasi-fixed exchange rate system, such as the ERM II, tacitly implied exchange rate guarantee, set by the width of the fluctuation bands around the parity level,

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<sup>13</sup> For more on that see: Koronowski and Rozkrut (2003); for interest rate tool insufficiency: Bank of Greece (2001) or Garganas and Tavlas (2001); for exchange rate vs interest rate transmission mechanism: Łyziak (2001), Przystupa (2002).

constitutes a source of a moral hazard problem (Burnside et al., 1999). This, in turn, may incline market participants to underestimate the growing balance of payments problem and lead to the negligence of hedging against exchange rate risk.

Consequently, in the event of the investors' sentiment turnaround and subsequent financial markets turbulence, a significant depreciation pressure could be exerted on the national currency, which might eventually make the parity devaluation inevitable<sup>14</sup>. In the presence of the above-stated recklessness of the market participants, such an abrupt currency plummet might lead to exacerbating economic costs due to unmatched foreign exchange composition of their assets and liabilities. Under a floating exchange rate regime, lack of any exchange rate guarantee forces market participants to hedge against currency turbulence, which also increases the cost of potential speculations.

Another issue to be stressed here is that the ACs are not entirely immune to the risk of contagion effect, for they are still pigeonholed as the "basket countries". Therefore, any financial disturbances in one AC may be perceived as foreshadowing similar events in other candidate countries. As a result, investors may withdraw their funds, thus exerting depreciation pressure on the ACs' currencies. In the era of liberalized capital movements, massive outflows of capital may not be withstood, thus entailing necessary parity realignment (CEPR, 2003). In addition, the potential impact of contagion may largely be reinforced by the shallowness of the ACs' financial markets. Therefore, even reasonably strong macroeconomic fundamentals and prudential supervisory arrangements may not rule out the above-outlined sequence of events, leading to the breakdown of the quasi-fixed exchange rate arrangement.

It should also be emphasized that any attempts to maintain the exchange rate at the level considered by the market as being in variance with fundamentals often turn out futile and lead to currency crisis (Papaioannou, 2002). In particular, it was the case in the Czech Republic where persistent high inflation and simultaneous rigidity of the exchange rate, whose fluctuations were limited to the predetermined bands, led to overvaluation of the Czech Koruna. In the aftermath of the speculation attack, the Czech currency was floated in May 1997.

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<sup>14</sup> For factors that may contribute to the U-turn of the investors' sentiment and foreign capital hasty retreat see: A. Koronowski and M. Rozkrut, *Towards the euro-zone through the ERM II. Countering fallacies*, mimeo, 2003

Realignment of the central parity might offset the above-outlined harmful scenario. This, however, would weaken the parity credibility as a “nominal anchor”, for such a decision might trigger further speculations based on the “history repeats itself” belief. In addition, empirical evidence indicates that changing parity both at the right time and in proper dimension is hardly an easy task (CEPR, 2003).

Focusing more closely on the particular quasi-fixed exchange rate regime, the ERM II, this framework is said to provide its members with a seemingly wide scope for exchange rate movements within +/- 15% bands. Such flexibility, therefore, should mitigate the above-outlined risks that the quasi-fixed exchange rate regimes are exposed to. In fact, this is a mistaken picture, for the maintenance of one’s currency within wide fluctuation bands does not guarantee fulfillment of the exchange rate stability criterion. Such a conclusion can be drawn from the convergence reports expounding the position of the EC (European Commission, 2002b) and, to a lesser extent and in a more ambiguous way, of the ECB (European Central Bank, 2002) on the exchange rate stability assessment<sup>15</sup>. The stance adopted by the European authorities seems to imply that breaching the 2.25% depreciation band constitutes a “severe tensions” yardstick, thus entailing failure in the exchange rate stability test. Therefore, taking advantage of the above-extolled flexibility of the ERM II framework may stay in contradiction with the eligibility for euro-zone membership (Koronowski and Rozkrut, 2003). By contrast, judging by the experience of Ireland or Greece, appreciation of one’s currency, no matter whether far from or close to the upper band, would not run counter to the Maastricht criterion fulfillment (Rozkrut, 2003a). Such an asymmetric nature of the ERM II is even more pronounced when taking into account the permissible upward realignment of the parity, whereas resorting to the central rate devaluation is forbidden (“Agreement of ...”, 1998).

The advocates of the ERM II stress that flexibility of this framework, though questionable – as argued above, will greatly facilitate the task of “finding” the equilibrium exchange rate. The available evidence, however, seems to undermine the foregoing view, for the experience teaches that, no matter the width of fluctuation bands, massive flows of capital and subsequent exchange rate shifts not strictly related to fundamentals may be possible (Koronowski and Rozkrut, 2003). In particular, *the experience of Greece has shown that rather than a*

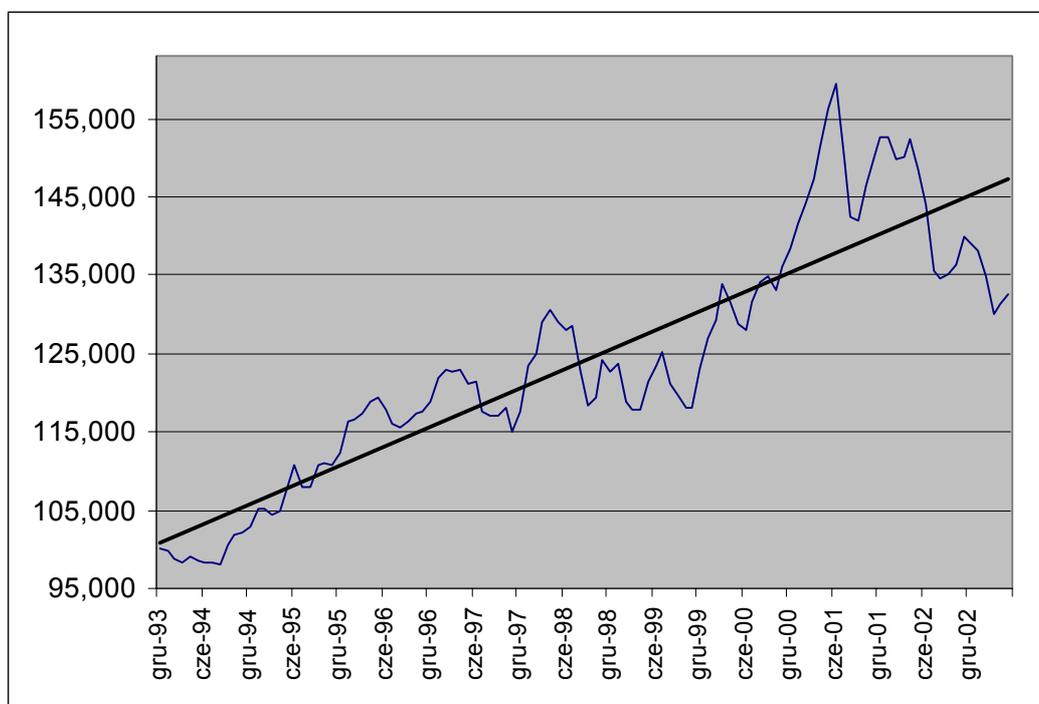
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<sup>15</sup> For more on the asymmetric nature of the ERM II arrangement see: Borowski et al. (2003)

useful test the ERM 2 gives rise to a convergence play in which short term capital flows are affected by expectations on the final parity chosen (Coricelli, 2001).

Another argument quoted by the advocates of the ERM II is that the credibility of this framework is greatly enhanced by the ECB's support. In fact, the only extra facility the members of the ERM II are provided with is the ECB's aid in the foreign exchange conduct. Yet even this measure is subject to numerous constraints and ambiguities<sup>16</sup>. And thus, daily ceilings are imposed on the unilateral use of the ACs' own resources in the foreign exchange intervention conduct. These limits may formally be exceeded only after the prior assent of the ECB. Moreover, drawing on very short term facilities (VSTF) within margins is limited to the extent that any recourse to that source of financing is of little, if any, help. For Bank of Greece and Danmarks Nationalbank these limits were set at the level of EUR 300mln and EUR 520mln respectively. For Poland they have been estimated at circa EUR 450mln (Bofinger and Wollmershauser, 2002). It is enough to set the latter number against the NBP's EUR 28bln foreign reserves to get a picture of the usefulness of the ECB's support within margins of the ERM II framework.

**Figure 5. Zloty real effective exchange rate (CPI deflated) and line trend**



<sup>16</sup> The issue on foreign exchange interventions within the ERM II is developed in: A. Koronowski and M. Rozkrut (2003)

*Source: NBP, own calculations*

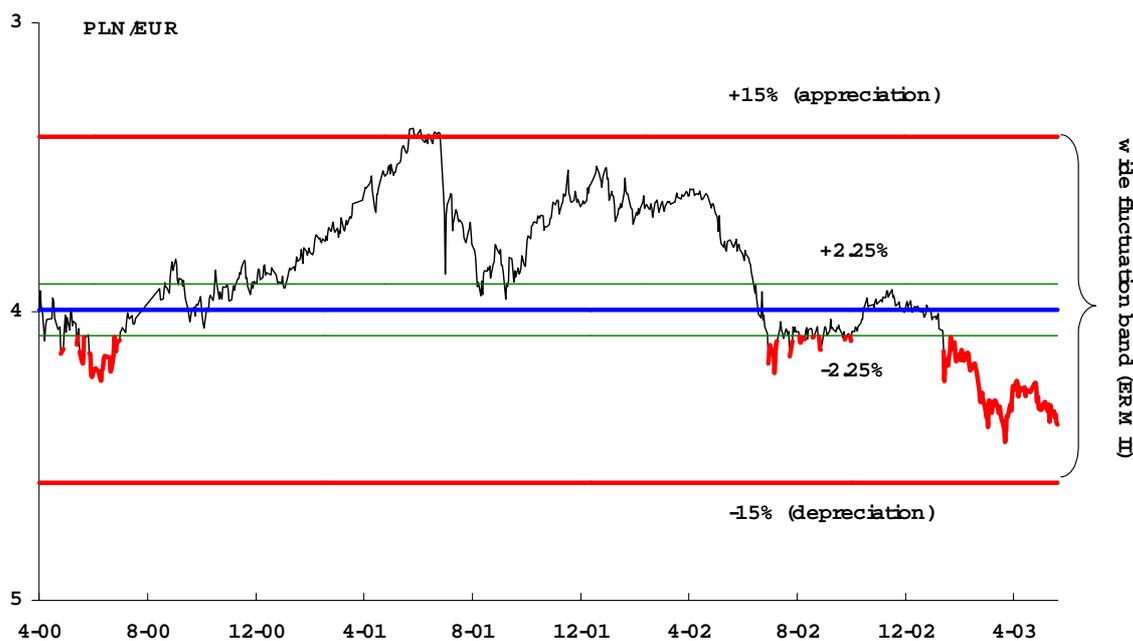
As for the interventions at the margins, the ECB's unlimited and automatic financing might seem to largely contribute to the credibility of the ERM II. One might argue, however, that the foregoing view is somewhat exaggerated, when set against the following rationale. Firstly, foreign exchange interventions may offset only short-term pressures exerted on the domestic currency. In this respect, the NBP's foreign reserves seem to be far in excess of their reasonable use for this purpose. Secondly, when faced with exchange rate misalignments, i.e. when fundamental factors underlie the inappropriateness of the parity level, the attempts to defend the currency through foreign exchange interventions may become nothing but useless and costly waste of resources. Under such circumstances the ECB could not help much either (Koronowski and Rozkrut, 2003). In addition, drawing on VSTF, be it at or within the margins, is limited by maturity constraints. Last but not least, foreign exchange intervention rules are so vague that number of issues still needs to be cleared up<sup>17</sup>.

While juxtaposing the quasi fixed against floating exchange rate regime, it should be emphasized that the former is fully consistent with the DIT strategy, which is at the core of the NBP's policy. By contrast, an eclectic policy based on both the exchange rate and inflation targets pursued simultaneously at some point may lead to inconsistencies, which have recently been observed in Hungary. Consequently, the just-outlined trade-off may be harmful to the credibility, and thus stability, of the system and give rise to financial markets turmoil (Rozkrut, 2003a).

#### **Figure 6. PLN/EUR exchange rate movements**

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<sup>17</sup> see footnote 16



Source: NBP, for the figure's description – see text.

Finally, flexibility of the floating exchange rate regime is by definition higher than that of the quasi-fixed exchange rate system and, therefore, provides more scope for the market forces to “look for” an equilibrium exchange rate. In this case, however, significant volatility of the zloty, not least since it was floated (Figure 5), calls for an extreme caution when establishing the parity. In terms of fulfilling the Maastricht criterion, zloty movements against the euro should be an issue of particular concern. Figure 6 depicts the Polish currency movements against the euro, and more precisely – around the parity established, for instance, at the level of 3,9937 PLN per euro (as of the moment of the zloty being fully floated in April 2000). Two hypothetical fluctuation bands of various widths,  $\pm 15\%$  (red lines) and  $\pm 2.25\%$  (green lines), are presented.

According to what Figure 6 illustrates, and on the assumption that  $-2.25\%$  “severe tensions” benchmark holds, three distinct periods (red colored) when the Polish currency breached the narrow depreciation band can be distinguished. Whether these infringements would entail the negative assessment of the exchange rate stability seems to be a matter of judgement on the European authorities’ side. As of today, however, it is anybody’s guess what the criteria for the exchange rate stability appraisal really are (Koronowski and Rozkrut, 2003).

## 5. Proper central parity – a prerequisite for successful ERM II membership

Therefore, maintenance of the exchange rate within the “right”, may it be  $-2.25\%$  /  $+15\%$ , fluctuation bands may constitute a real challenge. To a large extent, it will hinge on the appropriateness of the level of the parity chosen. And thus, the asymmetric nature of the ERM II implies a bias for a depreciated central rate (Coricelli, 2001). Provided that market rate would follow an undervalued parity, initial boost to export competitiveness would be short term only, for a weaker domestic currency would give rise to the subsequent increase in inflation. If monetary authorities were credible enough, i.e. their commitment to maintain the parity were unquestionable, adaptive inflationary expectations might be reinforced to a larger extent within the ERM II than would otherwise be the case under the floating regime. The more these expectations were manifested in the wage pressure, and subsequently – in the price growth, the larger real appreciation of the domestic currency would be, and the sooner the initial improvement of the economy’s competitiveness would be subdued. In these circumstances the monetary tightening, reflected in the interest rates increase, would be required to contain inflationary pressures. The necessity to fulfil another Maastricht criterion would imply raising the volume of costly sterilized interventions in order to stifle appreciation pressures stemming from the interest rates increase. As a result, tightening of the monetary policy, combined with lower NBP’s profits, and thus the government’s income, would constrain economic growth and put under threat another Maastricht requirement - fulfillment of the budget deficit criterion.

Similarly, establishment of the parity at too high a level is not free of dangers either. Strong domestic currency would impinge on the competitiveness of exporters and – consequently – might lead to current account deterioration, which is one of the chief factors taken into account in the economy’s stability assessment. At some point, conviction of the zloty’s overvaluation might give rise to the market turnaround and thus, depreciation pressures. However, sharp plummet of the zloty, let alone devaluation of the parity, would run counter to the Maastricht criterion on the exchange rate stability (Borowski and Woreta, 2002).

Therefore, setting the parity at a level inconsistent with economic fundamentals, be it overvaluation or undervaluation of the exchange rate, might restrain economic growth and

lead to failure in fulfilling the Maastricht criteria. The latter would in turn delay Poland's entry into the euro-zone, with all the benefits it would otherwise entail.

As the zloty may be expected to appreciate in real terms during Poland's stay in the ERM II, it may complicate the process of designing the optimal policy on the accession path. The source of this difficulty stems from a potential inconsistency between nominal and real variables. The central parity within the ERM II and – subsequently - an exchange rate of entry to the euro-zone are set and assumed to be constant in nominal terms. This implies, however, that in case of the catching up economies, they will most likely appreciate in real terms. As it has already been argued, real appreciation of the exchange rate accounts for the real convergence process and if the magnitude of both is closely related, the international competitiveness of the Polish economy will not be hampered. A difficulty may stem from the fact that the just-outlined relationship between the real appreciation and real convergence progress may not hold in the short-term. And thus, persistent nominal rigidities in the economy (e.g. already mentioned incomplete pass-through of nominal exchange rate changes into domestic prices) may lead to real appreciation not being in line with the pace of real convergence. It takes time for all adjustment processes in the economy (e.g. monetary transmission mechanism) to operate fully. Therefore, it stresses the need of proper policy actions well before the beginning of the reference period.

As it has been mentioned in the discussion on the potential impact of the Balassa-Samuelson effect, in case of very rapid economic growth, especially during the reference period, it might be necessary to resort to the nominal exchange rate tool to adjust domestic tradable goods prices in order to meet the inflation criterion. Therefore, it implies the need that projected developments (trend) in the nominal exchange rate, not least in the first year of participation in the ERM II, should be taken into account when establishing the level of the central parity. The underlying rationale is that for some time the nominal exchange rate may deviate from the path consistent with the equilibrium real exchange rate.

It may be assumed that the central parity will be perceived by market participants as a reference point for the ultimate conversion rate. This belief will be based on the monetary authorities' commitment to maintain the parity. Moreover, the nearer euro-zone entry, the

more credible that central rate will be<sup>18</sup>. This, combined with expectations about the inflation rate, should make possible calculation of the expected real exchange rate of entry. However, any deviations of the actual inflation from the projected path would change the value of the parity in real terms. If the source of such a shock to the inflation differential stemmed from the relative productivity growth (i.e. reflecting the pace of the real convergence), the deviation of the real exchange rate from the expected path would be fully justified and with no harm to the competitiveness of the economy<sup>19</sup>. However, the unexpected real exchange rate change may also result from the shocks of nominal nature. These can be related to some nominal rigidities in the home economy and asymmetric reactions to large swings on international markets. Such developments may call for the realignment of the expected entry rate to the euro-zone.

Lack of knowledge about the exact value of the equilibrium real exchange rate constitutes a real challenge for the policy makers, not least in light of the above-outlined consequences of setting the parity at the level inconsistent with fundamentals. Coming up with precise point estimates of the equilibrium real exchange rate, however, is hardly feasible, even for most developed economies (MacDonald and Stein, 1999). This uncertainty should be taken into account in the policy formulation before and during the period of participation in the ERM II.

One may conclude from the foregoing that there is prevailing uncertainty with respect to the future strength of factors that may influence the real exchange rate development. Moreover, various shocks of different nature, which can influence the level of the long term equilibrium real exchange rate, may take place. It would therefore seem to be preferable to establish the central parity within the ERM II at the level that would leave some scope for potential realignments. This, combined with an asymmetric nature of the ERM II framework (see section 4), seems to strengthen the bias for undervaluation of the parity. Such a downward inclination seems to be reinforced by the fact that, once in the monetary union, it is easier to correct the real exchange rate misalignments when the entry

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<sup>18</sup> If the market participants expect a different entry rate, then nominal exchange rate will deviate in a systematic way from the parity.

<sup>19</sup> Provided that inflation deviation would exactly reflect changes in the relative productivity growth

rate has been too weak (in such a case inflation rate above that for euro-zone average is needed)<sup>20</sup>.

Above-outlined hypothetical approach of the policy makers towards the central parity establishment might affect the behaviour of the foreign exchange market participants. According to the advocates of the ERM II, one of its virtues is anchoring expectations of the nominal exchange rate to the central parity. It is generally true, given the proper level of the central parity, in case of an exchange rate between economies growing on average at the same pace. The Maastricht criteria framework, however, gives rise to the risk of biased expectations as to the expected parity movements. The underlying rationale is as follows. The authorities' potential incentive to set the central parity somewhat below the level the fundamentals would call for would not escape the market participants' attention. In this respect, credibility of any announcements regarding the commitment of the policy makers not to revalue the parity might be undermined. It is an illustrative example of the time-inconsistency problem.

Policy makers would try to convince the market participants that they have set the parity according to their best assessment of the equilibrium real exchange rate and, therefore, would not change the central rate. However, the policy makers, not least in the ACs, like Poland, with unstable relationships in the economy and short available time series for econometric analyses, cannot be very certain *ex ante* that their assessment of the real exchange rate is appropriate. In the course of time new information may come to light, allowing better assessment of the equilibrium exchange rate – in either direction – appreciation or depreciation. In such a situation the authorities might decide to realign the central parity (mirroring their expectations of the proper exchange rate of entry to the euro-zone). For policy makers, the expected shift of the central parity in the indefinite future, in terms of expected value, is equal to zero. If it were not for the asymmetry of the Maastricht exchange rate criterion, the above sequence of events should indeed reveal policy makers' true assessment of the equilibrium exchange rate. However, given their commitment to meet the Maastricht criteria, they should maintain some room for

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<sup>20</sup> The correction of the overvalued real exchange rate within a monetary union implies that, for a given monetary union's subarea, lower inflation than in the rest of the union is necessary. If the rest of the union experiences low inflation rates then even deflation might be necessary to correct the misalignment.

manoeuvre. This, in turn, implies that the central parity might diverge from its optimal level on the downward side.

The above-outlined reasoning might give rise to speculations based on the conviction that the central parity *will* be revalued, which would add to the appreciation pressures. Unless the central bank intervened, it might lead to a serious overvaluation of the currency<sup>21</sup>. And the more discord among the policy makers, the more probable such a scenario would be. This is particularly the case in Poland where exchange rate policy has been a bone of contention between the National Bank of Poland and Ministry of Finance. And thus, recent events have shown that divergence of opinions about the optimal level of the exchange rate might be significant.

The foregoing stresses the necessity for a very high level of transparency in policy formulation, especially as far as setting the central parity in the ERM II is concerned. It seems to be the only way to assure the markets that policy makers are going to reveal their true expectations. Otherwise, speculation pressures may arise, attracting even more short-term portfolio capital influx and, therefore, lead to the foreign exchange market turmoil.

The already emphasized potential divergence of opinions among the policy makers gives rise to another concern, closely related to the potential misjudgement in assessing the proper level of the exchange rate. Suppose that policy makers are not that much politically committed to enter the euro-zone “as soon as possible”. Assume also that there is a significant overvaluation of the real exchange rate that is damaging to the competitiveness of the tradable sector<sup>22</sup>. Under such circumstances, policy makers might consider the costs for the real economy, stemming from the overvalued exchange rate, as higher than the costs of postponing euro-zone membership, subsequent to sharp depreciation or devaluation of the parity. In such a situation, they might withdraw from their vow to meet the nominal convergence criteria. As it would alter expectations about the future path of interest rates changes, a hasty retreat of the capital, previously attracted by the perspectives of gains from the convergence play, might ensue. The ultimate outcome would be abrupt depreciation of the exchange rate, with all the consequences the currency turmoil entails.

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<sup>21</sup> A speculative attack against a currency on which appreciation pressure is exerted is not just a theoretical concept as illustrated by the Hungarian forint turmoil in January 2003.

<sup>22</sup> The overvaluation might in this case be considered as a result of an earlier mistake in assessing the level of the equilibrium real exchange rate.

Therefore, two goals should be achieved simultaneously: setting the parity at the “right” level and make the markets believe that it is indeed the right one. These tasks, although prerequisites, still do not guarantee successful membership within the ERM II. Apart from the above-outlined risks inherently associated with the adoption of the quasi-fixed exchange rate regime, there is another factor that one should focus on more closely. It is fiscal discipline that constitutes “the must” before a decision on the ERM II entry is taken. Fiscal imbalance will imply the necessity to contain additional inflationary pressure so that the Maastricht price stability criterion is fulfilled. Current research on the transmission mechanisms suggests that it is through exchange rate channel rather than central bank’s interest rate shifts that inflation may be influenced more efficiently in the short span.

Resorting to nominal exchange rate as an adjustment tool, however, is of limited use. The reason for this is incomplete and delayed pass-through from changes in the nominal exchange rate to changes in domestic prices. In case of Poland the pass-through from nominal exchange rate to domestic prices of the tradable goods in one-year time is equal to 0.5 (Przystupa, 2002) – i.e. one percentage change in nominal exchange rate after a year will result in a half percentage change of the PPI (the producer price index that consists mostly of tradable goods)<sup>23</sup>. Therefore, subduing inflation through exchange rate channel would require additional nominal appreciation, thus resulting in excessive real appreciation. This, in turn, would hamper economy’s competitiveness. Moreover, fluctuation bands, even if relatively wide, might not contain the required dimension of nominal appreciation. On this reasoning, shortage of alternative efficient disinflation measures implies the necessity of fiscal policy tightening within the ERM II framework.

On the above-outlined reasoning, it comes to light that potential risks associated with ERM II membership by far outweigh those few and still questionable advantages that this mechanism entails. Consequently, the ERM II should be perceived as a “waiting room” rather than a “useful framework”. Therefore, Poland’s membership within this framework should be shortened to the minimum required period of time. The moment of entry, however, should largely hinge on the viability of the disciplined fiscal policy conduct and certainty that other Maastricht criteria will be fulfilled in time. Until these prerequisites

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<sup>23</sup> The impact of change in nominal exchange rate on the CPI, consisting of both tradable and non-tradable goods is even smaller. It is the CPI that should be of interest to the ACs because the Maastricht criteria are set in terms of the HICP, which is roughly consistent with the CPI index (see section 2).

have not been fulfilled, it is the floating exchange rate system that seems to fit the best the realm of the Polish economy. Against this background, the MPC's decision to maintain the current regime is the second best to none.

## 6. Maastricht challenges – real vs nominal convergence

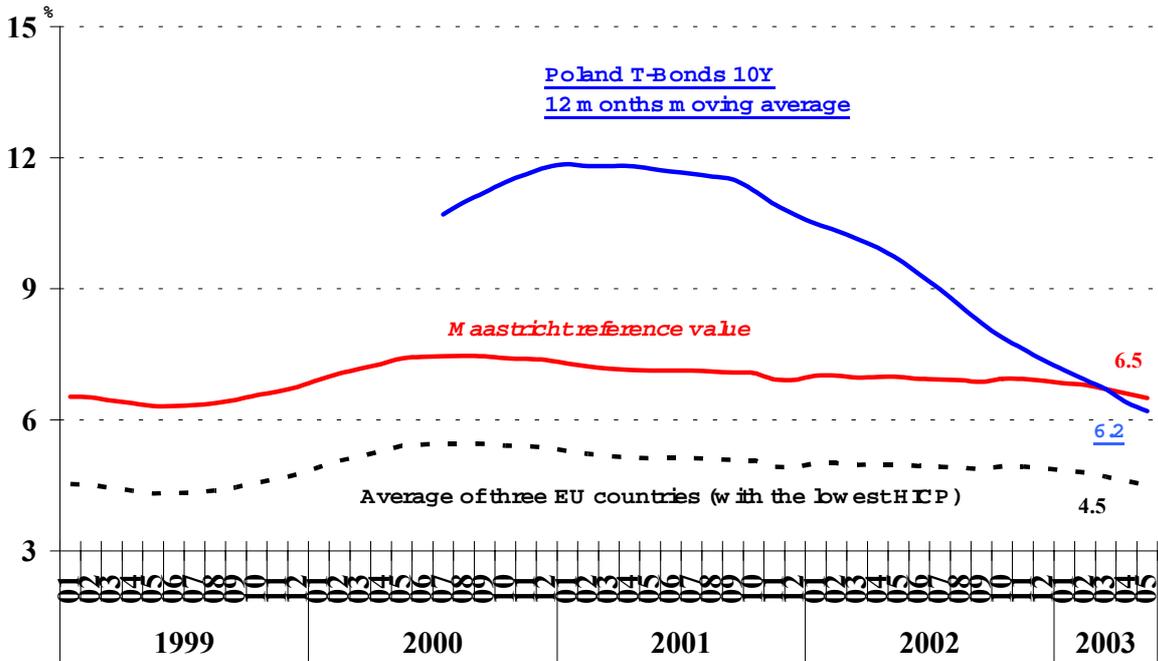
Eligibility for euro-zone membership will hinge, *inter alia*, on the fulfillment of the Maastricht criteria. With public debt largely secure and long term interest rates criterion already fulfilled (Figure 7) and being closely related to the inflation performance and credibility of the macroeconomic policy, it is other criteria that should be focused on more closely. Of these, the exchange rate stability assessment has already been developed. And thus, the most concerning issue seems to be that pertaining to the general government deficit, for swinging commitments and worse and worse updates of fiscal projections give rise to a quite gloomy perspective in Poland. In addition, without fiscal discipline the necessity to contain inflationary pressures within the ERM II will imply resorting to measures that may be inconsistent with other Maastricht criteria, as outlined above (see section 5). As for the inflation criterion, though now well below the reference value (Figure 2), various factors, such as economic revival, supply shocks, or still growing fiscal expenditures may lead to the price growth rebound. And the bigger downward realignment of the reference value subsequent to EU enlargement is, the more challenging the inflation criterion will be (see section 2).

The above-outlined analysis points out that in the short run there might be a trade-off between the real and nominal convergence. If paths of some nominal variables (i.e. the inflation rate, the nominal exchange rate) are subject to exogenous restrictions (e.g. the nominal convergence criteria) that do not take into account changes in the structure of the economy, situation in the real sector of the economy can deteriorate. In other words, the optimal path of the real convergence process may imply such developments in some nominal quantities that run counter to the nominal convergence criteria. A critical question is, therefore, whether imposed nominal convergence criteria provide enough room for adjustment for catching-up economies. This issue is discussed in what follows.

While inflation should be stabilised at a low level, at the same time it should be prevented from going below some optimal level. In case of a catching-up country this optimal level is equal to the rate that wards off the threat of deflation increased by the “good inflation” components. Assume that the average inflation rate of “three best performers” among the EU members accounts for an approximation of that “deflation immune” ingredient<sup>24</sup>. For the accommodation of the nominal effects of the real convergence there would remain 1.5 percentage point allowed by the Maastricht Treaty plus the extent to which the inflation might be contained by nominal exchange rate appreciation (see section 3).

As outlined above, so far observed relationships in Poland allow estimating the impact of the Balassa-Samuelson effect on average in the range of 1-2 percentage points. If relationship between sectoral productivity differentials and GDP growth continues, it could be advisable that the reference years fall in a period of economic slowdown, because the then-impact of the Balassa-Samuelson effect would be of limited magnitude. Nevertheless, according to the provided estimates, even a sharp boost to economic growth would not pose a significant trade-off between real and nominal convergence, for potential additional contribution of the BS effect would still be small enough, and thus relatively easily offset via nominal exchange rate appreciation of reasonable size.

**Figure 7. Long term interest rates in Poland with respect to the Maastricht criterion**



<sup>24</sup> This assumption obviously excludes “deflation” reference countries – see footnote 3

*Source: Eurostat database, own calculations*

In addition to numerous challenges to be faced before joining the monetary union, still more spokes are put in the ACs' wheel on their road to the euro-zone<sup>25</sup>. And thus, allegations are addressed to, *inter alia*, still underdeveloped and insufficiently integrated financial markets (Kroger, 2002). Since October 2002, however, Poland has fully liberalized capital flows and there remain no formal stumbling blocks to the unconstrained both domestic and cross-border flows of capital. Moreover, transactions turnover on the forex market in Poland exceeds several times that of Greece or Ireland in the period preceding their accession to the euro-zone. Finally, well developed inter-bank derivative markets (e.g. FX Swap, FRA, and IRS) in Poland are in fact an integral part of the international financial market (Koronowski and Rozkrut, 2003). Yet, as nitpickers may persist, the argument about the financial market shallowness cannot be entirely parried. Having admitted that, however, should not serve for an argument against fast enlargement of the euro zone. It is due to the fact that although EU membership will precipitate the process of financial integration with the EU internal market (though itself still not completely integrated), the introduction of the euro should provide most powerful impetus for the desired development in this area (Galati and Tsatsaronis, 2001).

Another allegation concerns seemingly high share of bad loans in the ACs' banking sector (Kroger, 2002; European Commission, 2002c). Despite the high level of the NPL ratio in Poland, it should be borne in mind that it is largely due to implementing a much stricter definition for classifying a particular loan as a non-performing one. And thus, in Poland the NPLs are fully covered by reserves. Accordingly, they do not cause an erosion of the banks' capital base (Koronowski and Rozkrut, 2003), which is reflected in the capital adequacy ratio for the Polish banking sector (15%; NBP, 2002) exceeding the EU average (12.04%; European Central Bank, 2003).

Others reproach the ACs for their run to the euro-zone pointing out their insufficient structural convergence, related to meeting the preconditions determined by the OCA theory: real and financial openness, mobility of factors of production, high share of common trade, etc. (Gaspar, 2001). Therefore, the opponents of fast enlargement take a

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<sup>25</sup> The following constitutes a rough overview of the arguments presented in A. Koronowski and M. Rozkrut (2003).

position that the OCA criteria should be taken into account while assessing the ACs' suitability for euro-zone membership (European Commission, 2002c).

The foregoing, however, seems to overlook the fact that *a number of the ACs appear to have reached a high degree of cyclical co-variation with the euro-area, which exceeds in some cases that of the less integrated current members of the euro-area* (European Commission, 2002c). And thus, comparative analysis shows a relatively high and moderate cyclical convergence in industrial production and GDP respectively between Poland and the euro area (Borowski and Woreta, 2002). Against this background, Poland's susceptibility to asymmetric shocks should be limited. On the other hand, the intensity of intra-industry trade between Poland and the euro-zone, which reflects the sustainability of cyclical convergence, is relatively low (Bratkowski and Rostowski, 2001; Borowski, 2001). Such a weak performance stems from the structural nature of Poland's trade deficit with the euro-area. Nevertheless, the share of intra-industry trade in the overall Polish trade with the euro zone has been increasing continuously and the observed trend is predicted to persist in the forthcoming future. Strengthening cyclical convergence, and thus reducing susceptibility to asymmetric shocks, will largely hinge on the FDI inflows, which should be encouraged by a proper macroeconomic policy (Borowski, 2001).

Furthermore, when measured by the share of the exports of goods to the EU countries in the overall export volume, Poland's convergence with the EU (69.2%) exceeds that of the most of the incumbent EU members, let alone the EU average (61.9%) (Eurostat/Comext 2002).

Moreover, in many EU countries labor markets are more rigid than they are in Poland. Such a view is supported, *inter alia*, by setting the EPL ratio for Poland (2.0) against those, e.g. for Germany, France, Italy, or Portugal, which amount to 2.6, 2.8, 3.4, and 3.7 respectively (Knogler, 2002). Notwithstanding that, low propensity to migration, as measured by intensity of intrinsic migration in Poland (Borowski, 2000), would call for another adjustment mechanism in order to contain the potential effects of asymmetric shocks. As yet low real wage flexibility, however, cannot compensate sufficiently for the lack of labor mobility in Poland (Borowski, 2002). Therefore, removal of persistent labor rigidities should be numbered among the priorities of the macroeconomic policy in the nearest future.

Furthermore, as the ACs are predominantly perceived as small and open economies, it might be stated that foregoing an independent monetary policy should not constitute too big a sacrifice for them (De Grauwe, 1997; Mundell, 2000). Last but not least, the above-outlined allegations downplay the hypothesis about endogenous nature of the OCA criteria, according to which membership within a monetary union endogenously accelerates the process of generating the conditions, which are determinants for a successful participation in the common currency area (see; Rose, 2000; Frankel and Rose, 1998; Fidrmuc, 2001; Maurel, 2002).

The opponents of fast euro-zone enlargement reach out for still more arguments to postpone the ACs' entry into the monetary union<sup>26</sup>. Lots of them, however, lack substance. And thus for an illustrative example may serve the attempts to prevent the candidate countries from joining the euro-zone on the basis of their insufficient real convergence, understood as a persisting income gap between the ACs and the EU average (Kroger, 2002). Such an approach is groundless, for on both the theoretical and empirical ground the real income level cannot serve for an argument against entering the monetary union.

## **7. Convergence progress within the Eurozone**

As the real convergence will be a long-lasting phenomenon, the Ballassa-Samuelson effect, though of uncertain strength, will remain at work also during the early stage of Poland's membership in the euro-zone. Its influence, however, might by then have differed from what can be observed now, mostly because of two factors: firstly, the impossibility of any adjustment via the nominal exchange rate and, secondly, Poland being fully subject to the common monetary policy of the ECB in the aftermath of foregoing monetary policy independence.

Changes in the real exchange rate after joining the monetary union will reflect changes in the relative prices between Poland and the rest of the Euroland. Once in the monetary union, the inflation rate would not be subject to restrictions imposed by any type of a nominal convergence criterion. Provided that shifts in the real exchange rate would fully

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<sup>26</sup> For more on that see: Koronowski and Rozkrut (2003)

mirror developments in the relative sectoral productivity and that Poland entered the euro-zone with the exchange rate at the equilibrium level, this would imply that, at least on the theoretical grounds, the real exchange rate would remain on the equilibrium path.

The ACs' GDP, let alone Poland's, accounts for only a small fraction of that of the euro-area. Therefore, the ECB's interest rates will be set predominantly on the basis of inflation developments in large economies of the euro-zone. At the beginning of membership in the euro-area, due to existence of higher inflation stemming from the Balassa-Samuelson effect, the real interest rates in Poland would be lower than in most of the Euroland. As long as various asymmetries between incumbent and new members of the euro-zone persist, the common monetary policy might remain too loose for the fast growing catching-up economies.

The other argument supporting such a view is related to the issue of the already mentioned natural interest rates. As long as the natural interest rate for Poland exceeds that for the rest of the euro area, the neutral policy stance of the ECB will turn out to be expansionary for Poland. The question that arises is for how long such differences will persist<sup>27</sup>.

Lower nominal and real interest rates, as a corollary of joining the euro-zone, might trigger the rise of the domestic demand that may potentially pose a threat to the stability of the economy. Demand for credit from enterprises and households would probably rise significantly. This would reflect the increase in investment, encouraged by low real interest rates, and a consumption boom financed by banking credit. Simultaneously, low real interest rates will decrease propensity to save.

Basing on the experience of Portugal in the years 1990-2000, one may foreshadow that the Polish banks will probably be forced to seek financial resources abroad. It would imply an abrupt shift in the banking sector environment. So far the Polish banking sector has experienced liquidity surplus. The bank financing of the economy is less than it could be, and excessive liquidity has to be absorbed by the NBP. It generates additional costs for the central bank and makes monetary policy conduct more difficult. If consumption rises and propensity to save decreases, the excessive liquidity of the banking sector will spread out as

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<sup>27</sup> It is closely related to the issue of optimality of a currency area. The more the enlarged euro area resembles the model optimal currency area, the smaller divergences in the impact of the common monetary policy on specific regions of the euro-zone will be. The hypothesis about the endogenous nature can precipitate that process (see section 6).

there will be higher demand for credit and lower supply of deposits. Such a development might take place already before joining the euro-zone. In these circumstances, effectiveness of the Polish monetary policy might increase because banks will be more sensitive to the shifts in short-term interest rates.

The above-outlined scenario of a very rapid growth of consumption and demand for credit has been accounted for by real interest rates reduction. Two more effects should be brought to light here. The first refers to the changes in the collateral value, being in possession of companies and private persons. Lower nominal interest rates increase the collateral value (and also perceived wealth) and via this channel have an additional impact on the increase in demand for credit. The second possible effect is the nominal illusion that assumes lack of rationality of some individuals. It is reinforced by the fact that the Polish economy experienced relatively long period of high inflation and, consequently, of high nominal interest rates. This bears the risk that reduction in nominal interest rates may be perceived as decrease in real interest rates of similar size. In these circumstances, demand would be additionally boosted.

A very high rate of credit growth might pose a threat to the banking sector stability. An increase in demand for credit bears the risk that banks may pursue less prudential lending policies. It might particularly be the case if banks strive for either retaining or increasing their market share. Bank managers can consider such a situation as a good opportunity to win new customers or sell other products to the current clients. If lending policies turned out to be too lax and loan applications not properly scrutinized, it would result in the subsequent deteriorating of the quality of the banks' loans portfolio. Incurring inevitable large credit losses would be the price for too large an appetite of the banking sector for the market share.

Higher domestic demand and the growth of borrowing requirements of the economy would lead to the current account deterioration. The long lasting current account deficit leads to accumulation of foreign debt, thus increasing the costs of its servicing. Were it not compensated for by the appropriate growth of income, at some point creditors might cut off further supply of funds. The Maastricht fiscal criteria and the Stability and Growth Pact impose restrictions on the level of public debt. Poland might be quite close to those limits so an increase in the economy-wide debt level will reflect increase in companies and

households borrowing. In a similar situation growing foreign debt of companies in the South-East Asia was a major factor that led to currency crises. Although monetary union membership rules out the possibility of the currency turbulence, it does not entirely protect against dangers ensuing from external imbalances. Such problems might only be postponed, but not eliminated. If foreign debt were allocated in the economy via the banking sector (i.e. banks refinanced domestic lending activity abroad), then the cut-off of supply of foreign financing (being the result of the higher risk resulting from too high debt and current account deficit levels) would hit the home banks in the first order. The banks would then try to overcome such a difficulty by curtailing their lending activities. As a result, a boom and bust cycle might occur.

Therefore, economic policy should be tightened before the moment of joining the euro-zone and remain moderately tight for some time afterwards in order to prevent excessive rise in the consumption and credit demand. Once in the euro-zone, when the conduct of the monetary policy will be “transferred” to the ECB, the only way to do so will be to tighten fiscal policy.

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Current stage of Poland’s economic development marks a significant shift in the environment within which the monetary authorities operate. On the one hand, completion of the disinflation path seems to make the central bank’s job relatively easy. On the other hand, however, requirements to be met on the road to the euro-zone are very challenging. Moreover, the process of approaching the monetary union will be accompanied by precipitated, due to EU membership, changes in the Polish economy. This, in turn, may distort the so far observed relationships in the economy and thus make policy conduct more difficult.

In terms of the Maastricht criteria, it is that pertaining to fiscal requirements that should be of particular concern. Fiscal imbalance would also impinge on the fulfilment of other criteria, not least on those related to the price and exchange rate stability. Successful membership within the ERM II framework will largely hinge on the appropriateness of the

central parity chosen. Nevertheless, this mechanism entails so many risks of currency turbulence that even prudential macroeconomic policy combined with the parity consistent with the equilibrium exchange rate may not rule out the nightmare scenario. Numerous drawbacks of the ERM II by far outweigh its advantages and, therefore, it should be perceived as a “waiting room” rather than a “useful framework”. Adding to that potential trade-off between nominal and real convergence as well as vagueness of the rules on which the assessment of one’s eligibility for euro-zone membership is based, one might come to the conclusion that the path to the monetary union will be beset with numerous difficulties.

Sound and transparent monetary policy and establishment of the parity at the level consistent with the equilibrium exchange rate should help to mitigate the effects of potential obstacles. However, it is fiscal discipline that will constitute the crucial factor in the successful accession process. In addition, not only would it mitigate a threat of the currency crisis within the ERM II, but it might also counteract the risk of overheating subsequent to joining the euro-zone.

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