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Poland on International Financial Markets, with the Focus on the Accession to EMU

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The process of economic transformation in Poland has been visibly dependent on external financing. During the 1990's Poland regained an access to international financial markets and has been using external funds for the strengthening macroeconomic stabilisation and for the structural change. In the coming years an accession to EMU and the adoption of the Euro remain critical opportunities as well as challenges for Poland's economy. Therefore an appropriate strategy of the Euro adoption, including the speed and sequencing of the process, has to be worked out.

Poland on International Financial Markets – A Retrospective

In 1990 Poland launched the process of the transformation of its economy with the major objective to catch up with industrialised countries in terms of per capita income levels and economic welfare. The process involved two essential components: macroeconomic, including financial, stabilisation as well as structural and institutional change. It is commonly assumed that both components are designed to underpin medium- and long term growth and, therefore, to stimulate the catching up process vis-à-vis mature market economies.

From the very beginning of Poland's economic transformation it was clear that the achieving of the strategic catching up objective requires **seeking for the external financial support.** In general terms, seeking for external financing rests with the notion that the integration of a developing country with world financial markets can enhance its economic growth and welfare through various channels. External financing allows for the augmentation of investments and for closing domestic savings – investments gap. Through increased availability of a world – wide pool of financial instruments external financing can help to diversify risks, distribute them more efficiently, reduce equity – risk premium and lower borrowing costs. The inflow of

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foreign capital in the form of foreign direct investments is usually associated with the spillover of more efficient technology and management practises. The exposure of a developing economy to the more demanding discipline of international financial markets is augmenting efficiency as in those circumstances reasonable economic policies are more swiftly rewarded whereas inappropriate policies – more severely punched.

Both components of the transformation of Poland's economy were significantly dependent on external financing.

In 1990 **macroeconomic stabilisation** was most pressing task for Poland to be performed as the economy was heavily unbalanced, both domestically and externally. On the domestic front, macroeconomic disequilibrium was reflected in high inflation and in the dramatic deterioration in general government finances. External financing was badly needed to overcome domestic savings – investment gap and domestic credit constraint. On the external front, the economy felt an acute shortage of foreign exchange reserves as in the 1980"s exports have visibly deteriorated while external debt has strongly accumulated, to c.a. 80% of GDP. Poland has not been fully servicing its official as well as commercial debt. Already in the early 1990's the country has experienced a remarkable reorientation of its external trade from Eastern to the West of Europe and the need for foreign currency reserves was increasingly felt by the economy.

Throughout the whole process of transformation the economic stability has been gradually, although not evenly, strengthening. Inflation rate has remarkably gone down, from near hyperinflation levels in 1990 to less than the EU average today. During 1990's the general government deficit has been gradually decreasing alongside with stronger economic growth whereas in the early 2000's it has again increased with the economic slowdown and structural reform weakness in the background. Current account balance, on the other hand, was negatively linked to the growth rate. The deficit on the current account has been increasing with the robust growth in the late 1990's (reaching the level of 8,3% of GDP in March 2000) while in early 2000's, with slowing growth, it visibly went down, to c.a. 3% of GDP. The amount of foreign currency reserves has been gradually increasing and currently is covering the value of 7 months' imports while the servicing of external debt remains on schedule.

Macroeconomic balances of Poland's economy were exposed to pressures from the wave of financial crises in several important emerging economies, particularly from the meltdown in Russia in 1998. Due to reasonably restrictive monetary and fiscal policies the economy was largely resilient to external financial risks and recorded only some negative impacts felt mainly by companies exporting to Russia. The overall

GDP growth rate in 1999 and 2000 remained at reasonably high 4% range while inflation rate (8,5%) was lower than targeted.

Institutional and structural change provides the ground for the catching up mainly through increasing the ability of the EU candidate to cope with competitive pressures on international markets, including single EU market. In 1990 Poland embarked on a program of economic restructuring which included privatisation and industrial restructuring, strengthening competition, reforming financial sector and public services and developing infrastructure.

Polish government applied a multi - track approach to privatisation as the privatisation program was based on different avenues, including both mass privatisation (through National Investment Funds) and capital (indirect) as well as direct privatisation.[2]

Simultaneously, the authorities created intermediary financial and capital markets required for the modern market economy. The program of industrial restructuring has progressed relatively slowly. The program of bank restructuring was quite successful. Transition – related portfolio problems of big commercial banks have been largely resolved as banks were recapitalised and that paved the way to their privatisation, mainly to foreign investors.

Although at the end of 1990's Poland's score on the progress in structural and institutional reforms was relatively strong (according to EBRD classification Poland was second – high on the list of accession countries and scored 3,5 in the scale of 1 to 4), there was, nevertheless, a common feeling among economists and policy makers that reforms have to be strongly accelerated. In the late 1990's the government responded to that feeling with the implementation of four big reforms ("second wave of reforms") covering pension system, healthcare services, education and administration. The reforms were designed to increase efficiency and quality of public services and, consequently, competitiveness and ability of the economy to create new jobs. Simultaneously, shifts in budgetary expenditures – in favour of development related items (such as infrastructure) – were declared.

Under Poland's economic circumstances, progress in both areas of the transformation, i.e. on stabilisation and structural change, was strongly dependent on external financing. Therefore, the access to **international financial markets** remains a significant component of the transition process. It was absolutely crucial in restoring

2 L.Ebrill (and others): „Poland: the Path to Market Economy", Occasional Papers 113/94, International Monetary Fund, Washington DC. 1994, p. 61-62.

external equilibrium of the economy, particularly its debt service capacity. The process of privatisation as well as the need to build – clearly capital-intensive – **infrastructure** of the market economy also augmented the demand for external funds.

Within the period 1990-1994 external financing has been provided to Poland almost exclusively from official sources. The country had on its records the suspension of the full service of its external debt and, therefore, private creditors cut off their new credits.

Financing from the IMF as well as from bilateral governments has been instrumental in the gradual restoring of macroeconomic stabilisation in Poland. The significance of the IMF support goes much beyond direct financing, to Fund's surveillance and a catalytic role. First, the loans were conditional on performing the program designed to stabilise the economy. Secondly, the agreements with the IMF were also the condition for the access to further financing from other official sources.

The Paris Club agreement signed in 1991 with government creditors was the spectacular action designed to support externally the move towards restoring external financial equilibrium of Polish economy. It gave Poland a two-stage 50% reduction in net present value terms of the official debt (amounting to 33 billion dollars) and helped lower external debt from the level of approximately 80% of GDP in 1990 to 65% in 1991 and further to 56% in 1993.

The agreement with the IMF was also crucial for the decision of seventeen Western governments to create the stabilisation fund totalling to one billion dollars and designed to support the convertibility of the Polish currency. Poland was also supplied with bilateral credits guaranteed by governments of industrialised countries.

During the first half of 1990's international development banks have largely supported **structural and institutional reforms** in Polish economy. World Bank had supplied Poland with loans totalling to 3,9 billion dollars of which the significant part was designed to finance investment projects in infrastructure (including transportation, energy, environmental protection, banking, healthcare, housing construction) as well as to support privatisation and restructuring. European Investment Bank was initially an institution co-financing World Bank projects with a particular bias to projects promoting European integration in infrastructure (e.g. within TEN —Trans European Network). Financing obtained by Poland from European Bank for Reconstruction and Development as well as form International Finance Corporation was heavily focused on privatisation and restructuring of state owned enterprises and banks.

Since 1995 Poland turned to private investors who have been becoming the dominant source of external financing of the economy. In late 1994 the government managed to sign – on a comparable basis with the Paris Club agreement – a deal on old 14 billion dollars commercial debt ("London Club agreement"). This deal helped further decrease the external debt – GDP ratio to 45% at the end of 1994. Consequently, Poland shifted from being a heavily to moderately indebted economy, strengthened its creditworthiness and regained an access to international financial markets.

In 1995 Poland has repaid its outstanding commitments to the IMF, stopped applying for new resources from the Fund and continued to receive loans from international development banks. However, the relative importance of external official financing has been decreasing as it was gradually replaced with private financing. After 1995 total annual private capital inflows usually exceeded 10 billion dollars.

In the middle of 1995 Poland has placed its first international issue of government bonds. This issue has met a strong demand and was followed by other issues, almost 20 up to now. The issues were denominated largely in EUR (totalling to over 6,5 billion), USD (3 billion), GBP (400 million) and JPY (25 billion). The list and main characteristics of the selected issues are included in table1.

Table 1. Selected issues of Poland's government bonds, 1995-2004

Year of issue	Currency	Nominal value (million)	Spread to benchmark (bp)
1995	USD	250	-
1997	USD	300	-
2000	EUR	600	82
2001	EUR	750	80
2002	EUR	750	75
2002	USD	1000	158
2002	GBP	400	115
2003	EUR	250	61,8
2003	EUR	800	62,6
2003	JPY	25000	-
2003	USD	1000	96
2004	EUR	1500	46,2

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Table 1 also shows that, over time, spreads of Poland's bonds to the benchmarks have been gradually, although not evenly, decreasing. This evolution of spreads reflects the improving perception of Poland's creditworthiness. Those improving assessments are also witnessed by increasing ratings obtained by Poland from professional rating agencies, e.g. from Standard and Poor's the country received in 1995 a sub-investment grade whereas today it has an investment grade of BBB+.

It is expected that also in coming years Poland will strongly draw resources from international financial markets.

EMU Membership and the Euro Adoption – an Opportunity and Challenge for Poland

The accession to EMU and the adoption of the Euro belong to major medium-term instruments for Poland in the process of catching up with mature economies. Formally, EMU membership is the natural extension of the accession of Poland to the EU that is taking place in May 2004. In economic and social terms, joining the monetary union has a strong potential of bringing significant net gains in terms of increased trade and investment, higher growth and, ultimately, catching up in standards of living.

In particular, advantages from adopting the Euro include:

- intensified trade activities with the Euro-zone arising from the elimination of foreign exchange rate risk and reduced transaction costs;
- faster interest rates convergence with the Euro-zone, which should yield higher investment rates;
- elimination of exchange rate and interest rate risk should also augment foreign direct investment;
- increased efficiency due to additional competitive pressure in domestic market stemming from augmented trade and from price comparability.

It is necessary to emphasise that – according to the optimal currency area concept – those potential benefits have more chances to be materialised when the joining economy becomes similar, in terms of structure, to the economies which are already in the monetary union. Thus, reaping those benefits depends on the pace of **real convergence.** The larger the structural differences between two sides the stronger exposure of the acceding country to external asymmetric shocks. As adopting of the Euro is also associated with some disadvantages, such as the loss of the independent monetary and exchange rate policy, cushioning the effects of external shocks implies the disproportionate burden on the side of growth and employment, especially if domestic prices and wages show signs of rigidity.

To sum up, achieving the real convergence with the monetary union economies and enhanced resilience to possible future shocks depends on the scope and pace of progress in the implementation of the structural reform agenda aiming at achieving the more competitive labour, product and capital markets.

The adoption of the Euro is also formally conditional on achieving by the EMU candidate economy **nominal convergence,** i.e. on fulfilling fiscal, monetary and exchange rate targets[3] that imply macroeconomic stability. In the medium- and long term, sound macroeconomic conditions and policies are a prerequisite for supporting the catching up process and for reaping gains from the adoption of the Euro which by no means should be taken for granted. However, in the short term macroeconomic stability and structural cohesion, i.e. nominal and real convergence, may not be fully compatible, may imply several trade-offs and, therefore, pose serious challenges and dilemmas to economic policy in the acceding country.

There are several examples of such trade-offs. Speeding up nominal convergence and the adoption of the Euro implies swifter giving up monetary and exchange rate policy - instruments which can support GDP growth, restructurings, competitiveness and cushioning of the consequences of shocks. Speeding up nominal convergence implies also more restrictive macroeconomic policy that may dampen current GDP growth. It is, however, broadly recognised that when growth is strong, doing big restructurings is economically and politically more feasible. Fulfilling EMU exchange rate stability criterion requires that the currency of the acceding country remains a least two years inside the corridor with limits on exchange rate movements. However, the exposure to speculation is thus increasing[4] as the risk for speculators is lower than with the full floating system.

All those examples show that caution and reasonability are necessary with regard to the speed of nominal convergence as some interference with the catching up process may be involved. This interference, however, may also be other way round as e.g. big restructurings imply shifting resources to modern sectors (where the prices are usually higher) and increasing average price levels which is not compatible with nominal convergence inflation criterion.

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3 So called Maastricht criteria refer to: inflation rate, long term bond yields, general government balance, public debt and to thestability of the exchange rate. They are specified in the Maastricht Treaty of 1992.

4 R.A. Feldman, C.M.Watson „Into the EU. Policy Frameworks for Central Europe", Washington DC. 2000, p.133

Those issues require from EMU candidate countries a careful strategy of the adoption of the Euro, i.e. reasonable decisions on the speed and the sequencing of the process. In particular, it is necessary to decide on several issues: when to adopt single currency; when and at which level of exchange rate to enter ERM2; how long to stay at ERM2; whether, upon ERM2 entry date, other nominal convergence criteria have to be met or not; what should be sequence and speed of economic restructuring.

The above general, EMU-related issues are also clearly exhibited in the context of **Poland's economy** and its objective to adopt the Euro.

The official path for Poland's monetary integration with the EU includes three stages. In the first stage Poland, upon entering the EU, will become a member of EMU with a derogation, i.e. it will have ultimately to adopt the Euro, unlike UK or Denmark who have an opt-out clause. In the second stage Poland will have to join, at her convenient moment, the exchange rate mechanism ERM2 and to fulfil the convergence criterion on the exchange rate. In the third stage Poland will adopt the Euro upon fulfilment of all convergence criteria.[5]

In terms of **real convergence,** catching up process has not been so far in Poland consistently strong and visible gaps vis-à-vis EMU economies still exist. Poland's GDP per capita amounts to 40% of the EU average and, according to EU Economic Policy Committee base scenario, 50 years would be needed to reaching 75% of the EU average (in the optimistic scenario this period is reduced to 37 years).[6] Current remarkable recovery of Poland's GDP (in the range of 4% – 5%) does not – so far – affect the unemployment rate which persistently remains at high level of 20%. Several old sectors of the economy are still maintained and substantial regional differences in economic and social development exist inside the country. Relatively weak R&D activities and low university education enrolment ratios restrict international competitiveness of Polish products. To alleviate those lags a substantial push to the restructuring process is badly needed, particularly on two areas: reducing traditional, inefficient industries and strengthening public finances, through reducing social and administrative expenditures as well as improving tax policy.

In terms of **nominal convergence** Poland currently fulfils four out of five criteria. According to Ministry of Finance data and estimates, inflation rate in Poland amounted in 2002 to 1,9% and in 2003 further decreased to 0,9%, much below EMU reference

[5] B. Egert, T. Gruber , T. Reiniger „Challenges for EU Acceding Countries' Exchange Rates After EU Accession and Asymmetric Application of the Exchange Rate Criterion" in: Focus on Transition 2/ 2003, National Bank of Austria, Vienna 2003, p. 153, 154.

[6] Economic Policy Committee Working Group on Enlargement „Key Structural Challenges in the Acceding Countries", Brussels 2003, p.9, 10.

level (2,9%). Long-term interest rates (yields on 10 years bonds) came in 2003 under the reference level of 6%. Public debt ratio amounted in 2003 to 45% and in coming years is expected to further increase but, conditionally on the implementation of fiscal reform, not to exceed the reference value of 60%. Exchange rate fluctuations didn't exceed +/-15% band towards previous central parity.

Serious problems and challenges are recorded on the area of fiscal policy, where the central government deficit remains high (over 5% of GDP) and is expected to go below the reference value of 3% in 2007 only provided strong fiscal consolidating reforms are implemented. Social resistance as well as negative impact of EU accession on central government balance during the early stage of EU membership are complicating factors here.

Specific decisions falling within the strategy of adopting the Euro in Poland will affect the speed and sustainability of both nominal and real convergence while trade-offs exist between them. Therefore **managing the Euro entry process** is a very challenging task that aims to maximise benefits from the enlarged monetary union and minimise associated risks. In this context there are several policy recommendations which may be considered.

First, strong and sustainable growth should remain the major priority as it helps Poland catch up, restructure, increase competitiveness and – therefore – alleviate fiscal pressures. Strong economic growth is also instrumental in reducing unemployment and increasing resilience towards external shocks.

Second, and related to the former, the strategy of adopting the Euro should emphasise achieving visible progress in real convergence because the more similar is the economy to those of EMU the more sustainable growth is and less vulnerability to shocks is ensured. Staying outside the Euro allows the retention of independence of monetary and exchange rate policies that help Poland absorb consequences of shocks and defend growth.

Third, consolidating public finances remains the most burning issue for Polish policy makers in the short and medium term. Without strong and swift fiscal adjustment external financial markets will not be convinced to the sustainability of Poland's growth and to successful EMU accession. Consequently, conditions of external financing will become worse and public debt ratio will further increase.

Fourth, policies designed to implement fiscal adjustment should be introduced clearly prior to entering ERM2. As the stay at ERM2 implies increased vulnerability to capital account volatilities it is better to enter the mechanism only when the appropriate macroeconomic policy is in place and the restructuring process is well advanced.

Fifth, due to ERM2 – related risks it may be argued that the stay in the mechanism should be short rather than extended beyond two years with policies gradually adjusted to the Euro area policy framework.

Sixth, Poland should aim at wide exchange rate band while being in ERM2. The narrow band, particularly with the capital controls being removed, would strongly encourage speculative attacks to test stability of Polish currency, which also will be under the persistent pressure on its real exchange rate.

Seventh, getting the appropriate level of the central parity remains the other important component of managing the Euro entry process.[7] Ideally, the central parity should be as close to the equilibrium rate as possible that would preserve the role of the central rate as a guiding anchor for exchange rate and inflation expectations. It is not, however, easy to find the equilibrium rate. Furthermore, during the stay of Polish currency in the interim regime of ERM2 convergence – related real appreciation pressures will have to be accommodated. There are negative effects of getting the parity and conversion rate level too low (these effects include inflation and overheating) as well as too high (slowdown of growth and increase in unemployment). However, the latter risks are likely more disruptive and that suggests a modest bias towards lower levels of exchange rate.

It has to be emphasised that in the process of the Euro adoption two sides participate. It is therefore important that both Poland and the European Central Bank keep positive and co-operative approach to the process. It is equally significant that Poland closely monitors and draws conclusions from the internal EMU problems (such as those with the Stability and Growth Pact) as well as from strategies applied by other countries on their way towards the Euro.

7 For the review of issues related to the nominal euro conversion rates see: L. Rawdanowicz „The EMU Enlargement and the Choice of Euro Conversion Rates: Theoretical and Empirical Issues", Studies and Analyses No 264/2003, Center for Social and Economic Research, Warsaw 2003.