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CONTROVERSIES OVER COSTS AND BENEFITS OF POLAND'S MEMBERSHIP IN THE EUROPEAN MONETARY UNION

It was on May 1, 2004 that Poland – together with Cyprus, Estonia, Czech, Lithuania, Latvia, Malta, Slovenia, Slovakia and Hungary – became a legal member of the European Union. Poland's membership in the EU-25 has been closely connected with the declaration of entering the Euro zone, as well as participation in the common monetary policy within the framework of the Economic and Monetary Union (EMU).¹ Poland, together with its membership in the European Union, acquired the incomplete status of a member-country of the EMU and was granted derogation.² This legal status imposes the obligation for Poland to fulfill nominal convergence criteria fixed in *The Treaty of Establishing the European Community*. After satisfying the criteria, Poland is formally prepared to enter the Euro zone. It is worth underlining that *The Treaty* does not force any EU member-country to submit a definite date of either its nominal convergence or its joining the EMU. Prior to being eligible to join the EMU, the member-states are required to enter the European Monetary System (EMS), and participate in the Exchange Rate Mechanism, the so-called ERM II, for at least two years. The mechanism aims at maintaining the stability of the exchange rate in relation to the Euro. A new mechanism

¹ Joining the EMU is not compulsory according to relevant Protocols to Maastricht Treaty. Great Britain and Denmark hold special status, and they are not obliged to enter the EMU. Moreover, these EU members declared that they did not intend to adopt a common currency. Sweden has not been admitted to the EMU because of the failing to satisfy the conditions of the European Monetary System participation. Greece was accepted as a EMU member until January 1, 2001, because its economy had not converged with the strategic criteria of convergence.

² "Derogation" is a juridical term which means an abrogation of the power of a law and replacement of it by another law. A derogation can be removed/withdrawn/ if the country with derogation fails to satisfy the agreed criteria *i.e.* Maastricht convergence criteria.

was put into practice on January 1, 1999, replacing the old European Monetary System [Królak-Werwińska, 2005, 28–29]. The new mechanism focuses mainly on the reduction of excessive fluctuation of exchange rates in relation to the administratively fixed rate of exchange. After two years of ERM II participation and meeting the Maastricht convergence criteria, candidate countries would be approved as legal members of the Euro zone (EMU).

In the light of the *Convergence Report* delivered by the European Commission, none of the countries admitted on May 1, 2004 (except Estonia and Lithuania), did fulfill all convergence criteria (Table 1).

Table 1. Indicators of economic convergence (except the exchange rate criterion) in 2003

Member country	Inflation %	Long – term interest rate,%	Budget deficit (–), % GDP	Public deficit, % GDP
Czech Republic	1.8	4.7	–5.0	37.9
Estonia	2.0	–	0.3	4.8
Cyprus	2.1	5.2	–5.2	72.6
Latvia	4.9	5.0	–2.0	14.7
Lithuania	–0.2	4.7	–2.6	21.4
Hungary	6.5	8.1	–5.5	59.9
Malta	2.6	4.7	–5.2	73.8
Poland	2.5	6.9	–5.6	47.2
Slovenia	4.1	5.2	–2.3	30.8
Slovakia	8.4	5.1	–3.9	44.5
Reference value	2.4	6.4	–3.0	60.0

Source: *Convergence Report 2004*. The European Central Bank, Frankfurt am Main, Germany 2004

The *Report* says that only five countries: the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, met the inflation criterion. Poland fulfilled the inflation criterion only in the period between August 2002 and April 2004. The HICP (harmonized index of consumer prices) was only 0.7% in 2003, and soared to 3.6% in 2004 [ECB, *Monthly Bulletin*, 2005, 68–69]. In the first half of 2005, the HICP reached around 4.5%, being far above the reference value.

The *Stability and Growth Pact* establishes the reduction of budget deficits below 3% of GDP. The criterion was satisfied only by Estonia, Latvia, Lithuania, Slovenia. The budget deficit stood in the Czech Republic at 12.6% of the GDP, 6.2% in Hungary, 9.6% in Malta and 3.9% in Poland. The public deficit as a portion of the GDP, exceeded 60% of that just in two countries, *i.e.* in Malta (73.8%) and Cyprus (72.6%). Six of the countries analyzed above were the members of ERM II – Cyprus, Estonia, Lithuania, Latvia, Malta and Slovenia [www.europa.eu.int/euro].

Compliance with the criteria mentioned above seems to be out of Poland's reach by the end of the current decade at least, the main cause of the lag being the crisis of the public finances in Poland, which causes the country to fail to meet the budget deficit criterion. Moreover, it is clearly visible that some of the EU countries are unwilling to welcome new members in the Euro zone very soon.

There are a range of scenarios of Poland's accessing the EMU described in the Polish literature. The most optimistic version predicts Poland's joining the EMU in the period 2008–2010. The most feasible option, however, seems to be in the years 2012–2014 [Małecki, 2004, 142–143].

The synthetic balance of benefits and costs of Poland's joining the Euro zone

The fundamental decision to give up the national currency and to join the Euro zone is a challenge of historical importance for the Polish society at the beginning of the 21st century. The following analysis focuses on economic costs and benefits of an early EMU entry that are pivotal for the further process of Polish integration with the EU.³ There are a lot of controversies over the issue. It is necessary to underline here that a complete assessment of costs and benefits of Poland's EMU membership is not only difficult, but even impossible, given that a lot of elements needed for such an analysis are immeasurable.⁴ Some of the costs and benefits are highly prospective. Hence, the balance of Poland's membership in the Euro zone brings closer the probable costs of integration and expected benefits.

Benefits of the membership in the Euro zone

Expected benefits of Poland's membership in the Euro zone are linked most of all to the increase in microeconomic rationality, which may offer an impulse to increase macroeconomic efficiency, economic growth and greater economic welfare. There exists a general agreement on the sources of the aforementioned efficiency benefits. The first one stems from the disappearance of transaction costs relating to the exchanges of national currency (abolition of the Zloty/Euro exchange rate). The second cause of the effectiveness accumulation is the

³ Additionally, implementation of a common currency and resignation from an independent monetary policy that are tightly connected to specific costs and benefits of political and social nature, in short-term as well as in long-term, will not be taken into consideration in this paper.

⁴ There is a lot of subjectivism in the economic analyses depending on the authors' political biases.

elimination of the exchange rate risk. The exchange rate and risk premium that are cut out to the members of the Euro zone should result in lower interest rates. The benefits will now be discussed in more detail.

The most evident and measurable benefits – sometimes called *direct benefits* – of joining the common currency is the abandonment of transaction costs when exchanging the Zloty to the Euro and *vice versa*. Although these costs are small indeed – from 0.25 to 0.5% of the EU's GDP, they affect the costs of production activities of enterprises [de Grauve, 2001, 70]. The estimations of the direct costs in Poland are around 0.14% of the GDP [Borowski, 2003]. Transaction costs are deadweight losses, as the customer gets nothing for the expenditure incurred. The transaction costs include direct financial costs, which put a wedge between a purchase and sale of foreign currency, fees and insurance costs. Moreover, there are also administrative costs such as exchange rate risk management costs, financial administrative costs, etc.

The elimination of this “shoe leather cost” (the additional time and energy spent on currency exchange transactions) and “menu cost” (the cost of alteration of tables with exchange rates, advertisements, calculations, stock exchange quotations) will result in social and economic benefits of much importance, although they are difficult to assess. This will lead to increased efficiency in the allocation of scarce resources – especially the human factor – and will accelerate the economic growth. The National Bank of Poland estimates the elimination of transaction cost to generate the economic growth in Poland of about 0.21% [*Convergence Report*, 2004, 47].

The benefit of pivotal importance is the disappearance of currency conversion risk in relation to the Euro and the reduction of insurance costs.

Currency risk stems from the fluctuation of the exchange rate, in particular, unexpected devaluation or revaluation – which lead to the diminution of assets value or the increase in the value of obligations translated into national currency in relation to its expected value. Economic units may generate losses as an effect of exchange rate change between the moment of entering a transaction and the moment of finalizing a transaction or in effect of exchange rate alteration between the invoicing and receiving the payment (transaction risk) [Bajer, Grzelak, Zabielski, 1993].

Poland's membership in the Euro zone will minimize investment risk. This alone should generate a flow of foreign direct investment. A stable exchange rate will stimulate the development of commercial exchange with the EU-15 countries, greater capital accumulation, and in effect – through the multiplier mechanism – an augmentation of the GDP and economic welfare.⁵

⁵ Estimations of the IMF indicate the impulse to foreign commerce of about 15% to 30% and 20% to economic growth in the period of 20 years, as the result of entering the Euro zone.

The reduction on national interest rates is perceived as one of the greatest benefits of Poland's membership in the Euro zone. Exchange rate risk is one of the three elements determining the level of national interest rate. The lower the risk, the greater will be the reduction of interest rates. The reduction of exchange rate risk premium included in interest rates enables economic units to get more money resources at a lower price (interest rate). Research conducted by the National Bank of Poland indicates the reduction of long-term interest rates of about 1.5–2.0 percentage points after Poland joins the European Monetary Union. The level of the interest rate – relatively low in the opinion of the author of the paper – reflects the premium of exchange rate risk estimated under the assumption that Poland would not become a member of the EMU at all [see de Grauwe, 2004; Lutkowski; Krajewski, 2003; Tchorek, 2004; *The Accessing...*, 2004; Czyżewski *et al*, 2003].

It is worth noticing that some economists point to the reduction of exchange rate risk as a factor eliminating, to a large extent, the uncertainty of the entrepreneur, hence increasing their profits. This refers particularly to managers who are risk-averse. Notwithstanding, the assertion is repealed. Along with the theory of risk-preferring entrepreneur, significantly augmented profits are feasible only when the exchange rate fluctuates considerably. Parallel arguments can be made about the behavior of consumers. When there is price uncertainty consumer surplus is higher than when price is certain. Consumers increase their demand when a price is low and stable and *vice versa* [de Grauwe, 2001, 73–74].

Poland's accession to the Euro zone, which would cause an alteration of the environment of economic units' activity, is expected to initiate a numerous adjustment processes. The adjustment is to produce particular benefits that would be visible no sooner than in a long perspective time, and many of them may not emerge or be of significant importance.

Substantial benefits of the reduction of exchange rate risk are foreseen in the area of prices. Many economists expected the elimination of the risk to foster the effectiveness of the price mechanism and consequently increase the rationality of the resource allocation within national as well as integrated economies. The introduction of the Euro was expected to result in a convergence of price differences within the European Monetary Union.⁶ Significant variations in prices of the same goods in member-countries reflect market ineffectiveness and force consumers to suffer shoe-leather cost when searching for markets where goods are relatively (to disposable income) or absolutely cheaper. Moreover, a common currency makes comparability of prices pos-

⁶ This assertion proved to be untrue as prices rose by about 0.5–2.0 percentage points after implementing the Euro in the EMU countries. The phenomenon of price soaring in catching-up countries is explained in Balassa-Samuelson effect.

sible, which, on the one hand, increases supply-side competition, and, on the other one, increases the size of the market. The prices in the Euro, being more transparent, rationalize the choices of suppliers and recipients, facilitate the economic calculations and – probably – increase competition on the supply-side, which should produce greater utility to consumers.

Poland's membership in a common financial market enables Polish economic agents to access wider and cheaper financial resources. This will improve capital allocation through greater risk diversification. Intensified competition is expected in the domestic market. This alone should bring the financial service costs down in Poland.

When eliminating exchange rate risk, uncertainty and, thus, the risk of running a business should consequently decrease. This may result in increasing entrepreneurship and innovation, especially in those companies that previously were risk-averse [de Graue, 2001, 73–74].

It has been commonly accepted in the theoretical arguments that the deletion of exchange rate uncertainty exerts a positive effect on the dynamics of GDP. Lower exchange risk has a twofold outcome: it lowers real interest rate – which, through the multiplier effect, induces economic growth and increases the rate of return on investment. The relation interest rate – national income growth is analyzed within IS-LM model by Hick and Hansen. However, numerous research into the relation of the dynamics of the exchange rate, economic growth, investment and foreign trade in the EMU countries showed that the relationship was not statistically significant.⁷ Therefore, the strength of the argument for automatic acceleration of Poland's economic growth after joining the EMU is fading away.

There is no doubt that there is a wide range of theoretical potential stemming from Poland's membership in the EMU in the long run. However, it is hard to distinguish all of the long-term development determinants in practice.

Summing up, it needs to be stated that the probability of credible benefits of Poland's membership in the Euro zone – lower transaction costs, improved effectiveness of price mechanism, more transparent prices, bonuses from common financial market participation – are highly feasible.

⁷ Compare P. de Graue [2001, 79–81] and the IMF research. In such a settled context, there are immense doubts both of methodical and essential provenience emerging from the official statements of the National Bank of Poland. Declarations that “the access to common monetary union will make a stable medium-term economic growth of about 0.21–0.42 percentage point, and higher GDP by around 5.6–11.8% in 2030 in relation to the base scenario” and “the medium-run growth of individual consumption will soar by 0.16–0.37 percentage points after Poland's joining the EMU, and in 2030 the level of consumption in relation to base scenario will be higher by around 4.4–10 percentage points” [Report, 2004, 75] are strikingly authoritarian. It is worth mentioning that the EMU countries have recorded the lowest economic growth within a few recent years.

Costs of Poland's entering the Euro zone

The costs of a common currency are mainly those affecting macroeconomic effectiveness of an economy.

The transference of sovereignty in monetary and exchange rate policy is the fundamental cost of joining the Euro zone. The National Bank of Poland loses its independence to influence freely the level of money supply, the interest rate and the exchange rate. These powers are transferred to the European Central Bank (ECB). The monetary policy is "common" and run by the ECB. The direction of monetary and exchange rate policy in the Euro zone is based on indicators of the EMU area as a whole. Member-countries of the Euro zone do not influence directly the policy (they get indirectly involved in the monetary policy decision making).

But, economic situations in member-countries and regions vary significantly in the case of asymmetric shocks.⁸ Therefore, introducing monetary policy instruments to neutralize the shock is, in principle, impossible. The burden of the adjustment processes falls on the member-countries concerned. The package of stabilizing actions is a combination of labor market adjustment tools and fiscal policy. The effectiveness of the actions depends heavily on the elasticity of prices and wages (in particular, the downward elasticity), as well as on the deregulation of the labor market. The lack of efficient anti-shock mechanisms and the tendency for expansionary fiscal policy (particularly, the increase in the government expenditure) do lead to high adjustment costs in the case of asymmetric shocks [see Fahrholtz, Mohl, 2003].

It should also be noted that particular countries differ in the bundle of economic aims, and especially in preferences for the level of inflation and unemployment. One group of countries is sensitive to inflation, another group is focused on unemployment. In terms of a centrally adopted monetary and exchange rate policy, economic aims of the EMU are not necessarily in line with national interests of particular member-countries. The EMU prefers stability of prices rather than lower unemployment. Therefore, the European Central Bank faces a dilemma of choice of monetary instruments. If we assume that, for instance, there is high inflation in Italy and excessive unemployment in

⁸ The term 'asymmetric shocks' embraces unexpected and impetuous disturbance of real processes in economies of integrated countries spreading with uneven intensity in the particular countries. These kinds of perturbation result in chronic trade and monetary surpluses in some group of countries and persistent trade and monetary shortage in another group of countries. Moreover, asymmetric shocks mean lack of convergence of business cycles in particular regions of monetary union – economic boom in some area and recession in another [Lutkowski, 110–111]. And, symmetric shocks affect economies of monetary union all in the same direction and with similar magnitude. In this case the instruments of the common monetary policy are potent in macroeconomic stabilization of an economy.

Germany, it raises a concern for the use of the same monetary tool – interest rate – to achieve the contradictory aims, *i.e.* reduced demand in Italy and stimulated demand in Germany. As Friedman M. rightly ascertained, the same monetary policy run by the ECB for countries in different phases of the business cycle is mistaken. It is worth adding that shaping the same monetary policy for countries of a different level of socioeconomic development is highly difficult, the last thesis being of crucial importance as Poland's level of economic development in the GDP *per capita* is merely 40% of the EU-15 GDP (before expansion, May 10, 2004) and 19% of the unemployment rate is the highest in the EU.

Moreover, joining the EMU means a loss of the exchange rate as the instrument of business cycle stabilization in case of asymmetric shocks in Poland. The value of the alternative cost⁹ of losing the independence of monetary and exchange rate policy depends *inter alia* on the choice of alternative adjustment mechanisms¹⁰ that would neutralize the results of potential demand and supply shocks [*Convergence Report*, 2004, 89–90]. The risk of immense, in particular, external, shocks when no monetary sovereignty exists may result in enormous costs, which are very tough to assess.

An overvalued exchange rate of the Zloty before entering the EMU is of great danger. The benefits of higher competitiveness of Polish export through a depreciation of the domestic currency are to be forgone in the European market if Poland joins the EMU.

Summing up, the comparative analysis performed by Western and Polish economists indicates that the balance of Polish membership in the EMU is positive in the long run. Poland's road to the Euro zone seems to be complicated due to the lack of nominal and real convergence, as well as significant resistance within the society.

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⁹ The microeconomic costs of EMU membership are administrative costs, costs of institutional modification, costs of introducing new computer systems of operational processes, costs of training, and other adaptation costs.

¹⁰ That is automatic stabilizers and discretionary fiscal policy.

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3. Labor market policy and employment policy

...The issue of the relationship between the labor market policy and the employment policy or the economic policy has often been discussed in the literature. In general, it is usually remarked that the employment policy, with "full employment" as its priority, is just one of the types of the economic policy [Jarmolowicz, 2005; Jarmolowicz, Ważniak, 2003a, 2003b].

...The employment policy focuses on the determination and explanation of the power of connection of the economic development process with demographic and social processes. It means revealing particular employment goals along with methods, means and ways of their implementation. The employment policy also influences the formation of directions and pace of development of employment [Op. 1990, 23].

...Among the goals of the employment policy the following are mentioned most frequently: full and rational employment; substitution of actions in the area of the employment growth to the maximization of the growth of social product; restriction of unemployment or partial employment; as well as equitable and efficient distribution of the emerging surplus of labor force [Op. 1990, 23].