Should Poland Join the Euro?

An Economic and Political Analysis

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Graduate Policy Workshop
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About the WWS Graduate Policy Workshop

At some point, Poland will need to confront the question whether it should adopt the euro or not. Legally, Poland has an obligation to do so, but like the Czech Republic, Poland could keep saying, 'yes, but not now.' The Woodrow Wilson School at Princeton University provides an opportunity for graduate students in the Master in Public Affairs program to participate in a professional workshop during the second year of the degree. Led by Professor Ashoka Mody and Professor Marzenna James, seven graduate students spent the fall semester of 2015 addressing the question of Polish euro adoption.

In addition to academic research (based on scholarly writings and analysis of economic and poll data), the workshop members travelled to Warsaw, Poland; Bratislava, Slovak Republic; and Prague, Czech Republic. There, they conducted interviews with representatives from central banks, finance ministries, as well as government and non-government organizations.

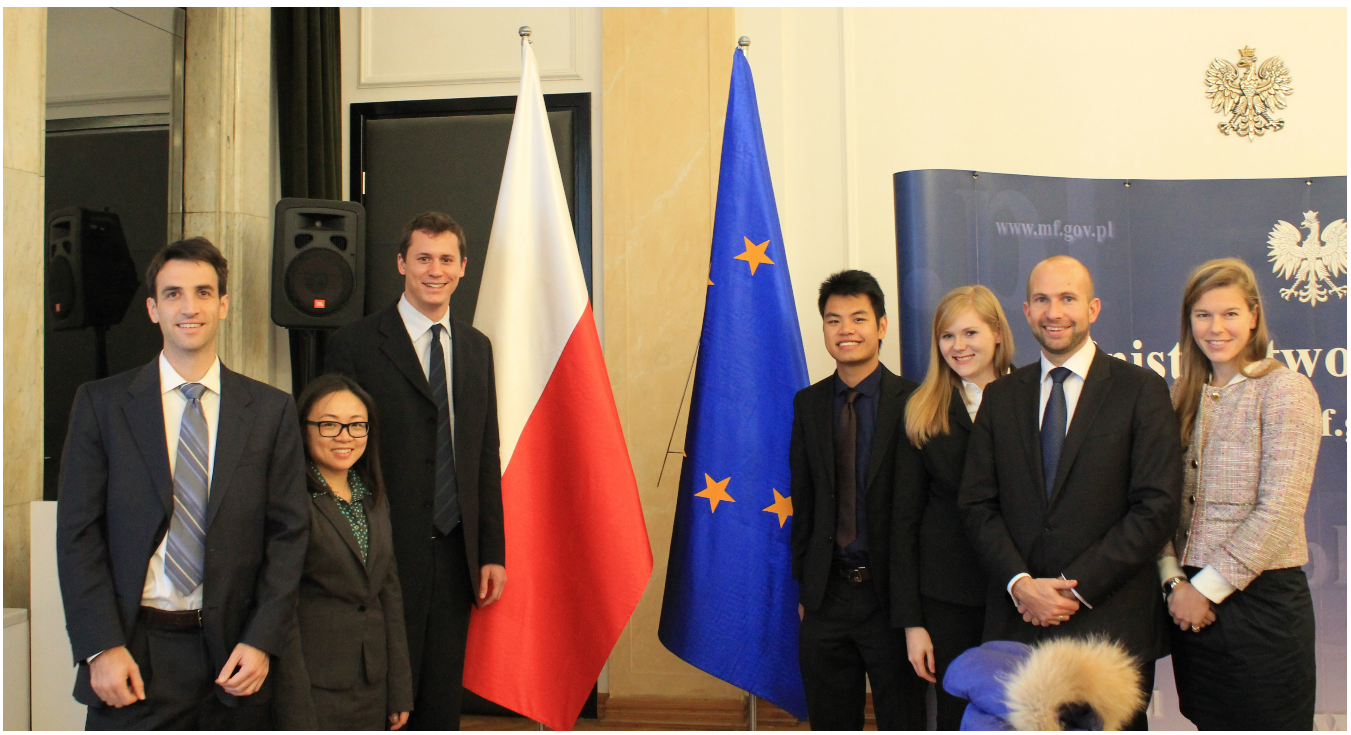


Photo credit: Marzenna James

The workshop team at the Ministry of Finance in Warsaw, Poland on 2 November, 2015.
From left to right: Conor Carroll, Iris Chan, Michael Carlson, Duc Tran, Kelsey Montgomery, Geoff Cooper, Vanessa Lehner.

Executive Summary

Poland committed to joining the euro when it joined the European Union in 2004, although no specific deadline was set for its entry into the currency union. There was widespread popular and political support for joining the euro at the time. The accepted view, both in Poland and across international institutions, was that joining the currency union would yield net economic benefits and speed up Poland's development. It would also forge a closer relationship with Europe. That view was dealt a blow by the global financial and euro crises. Adopting the euro became seen as a source of macroeconomic instability while delivering limited benefits in enhancing trade or lowering borrowing costs.

Prior to the crises, Poland experienced strong 'catch-up' growth and was on a balanced and sustainable growth path. Its inflation performance was no worse than the average among members of the euro area. Poland then performed particularly well during the crisis, in part because of its flexible exchange rate regime. Since the crises, Poland has resumed its strong catch-up growth.

By contrast, those on a fixed exchange rate regime, especially the Baltics, attracted more 'hot' money inflows before the crisis, which fueled a rapid rise in domestic credit growth and inflation. The higher inflation lowered real interest rates, making it more attractive for residents of those countries to borrow. The higher inflation also caused the real exchange rate to appreciate, making it attractive for foreign investors to lend to them since borrowers' ability to repay had improved in the short term. Thus the cycle of capital inflows, more domestic credit growth, and inflation continued. Current account deficits, financed by short-term flows, increased quickly.

A flexible exchange rate helped Poland avoid a similar build-up of imbalances ahead of the crises and limited the subsequent need to reverse them. A sharp depreciation in its real exchange rate improved Poland's net export position during the crises. Moreover, fiscal and monetary policy were able to play a counter-cyclical role to a greater extent than for the comparator countries in the euro area, and effective banking supervision also helped to prevent the build-up of imbalances. As a result, Poland's economic performance clearly surpassed that of the others both during the crises and afterwards, despite not having the 'external anchor' of the euro.

The diminished economic appeal for Poland to adopt the euro is likely to continue. Poland has benefited from high productivity growth as part of economic convergence, and its growth potential has been reinforced by structural reforms that have raised educational standards. Moreover, Poland's trade share with the euro area has been declining as the rest of the world has grown faster. Therefore, there appears to be little economic incentive to join the euro as long as Poland continues to prudently manage its economy.

The political case for euro adoption is similarly weak. First, the argument that euro adoption could provide Poland with greater influence in the 'fast lane' of further integration should be considered in light of Poland's successful domestic policy track record versus the distant prospect of a fully functioning monetary union. Second, the geopolitical and security argument for joining ignores Poland's NATO membership—a much better deterrent to security threats—and the many differences between Poland and the Baltics. Third, public support for adopting the euro has declined markedly and persistently since the early 2000s. This will, at the very least, complicate the legislative process within Poland, which requires a high degree of political support for euro adoption. Finally, Poland would not violate its legal obligation to join the currency union by delaying its entry. These factors all suggest that Poland should delay entry for as long as the economic and political costs of joining exceed the limited benefits from it.

1 Introduction

Poland's decision to join the European Union (EU) on 1 May 2004 came with a commitment to adopt the euro.

The decision was taken after a national referendum in which 77.4 percent of Poles approved accession.[1] A temporary derogation for euro adoption was given.[2] Poland agreed to eventually cede national monetary policy to the European Central Bank (ECB) and adopt the euro at some time in the future. But the timeline was nonspecific, and an obligation without deadline was easily deferrable. Poland continues to issue zloty as a member of the European Union without breaking any legal agreement.

When Poland joined the European Union, the eventual commitment to join the euro was conceivably blurred with perceived advantages of closer European association. Almost certainly, there was little public understanding of the economic and political implications of the euro. It was perhaps accepted because it would firmly anchor Poland in Europe, and Europe was regarded then—and continues to be regarded now—as a force for economic and political development. In policy circles, euro adoption was seen as providing an effective external anchor, helping to enforce domestic policy discipline. In addition, it could be a source of prosperity, lowering transaction costs and generating trading opportunities with rich euro area countries.

This early Polish view corresponded with policy advice from international institutions and economic literature. In particular, the International Monetary Fund (IMF) was a forceful advocate of early euro adoption because of its anticipated effects on trade creation, enhanced policy credibility, and reduced borrowing costs. Together, these benefits were thought to speed up Poland's economic convergence. The Deputy Director in the IMF's European Department wrote in 2004, "[…] euro adoption could raise GDP by up to 10 percent over 20 years in Poland."[3] Such views were supported by economic literature. Rose (2000) found that two countries sharing a currency would trade three times as much as with different currencies[4]. While there was some ambiguity as to the channels through which shared currency increases trade, common reasons put forward include lower transaction costs, price transparency, and exchange rate certainty. Poland, the IMF, and economic literature had a clear and consistent message: Poland should prepare for euro adoption with speed.

The global financial crisis was an inflection point. Public support for the euro may well have begun to diminish before the crisis, but Polish institutions, the IMF, and academia certainly began to rethink euro adoption following large asymmetric shocks within the Eurozone. Opinions began to change when details on crisis transmission were exposed, with exchange rate regimes at the epicenter. Many fixed exchange rate regimes (such as those in the Baltics) experienced large credit booms, stoking inflation, and lowering real interest rates. Consequently, capital inflow continued to climb along with credit growth, funded by 'hot' money. This generated real exchange rate appreciation, exacerbating current account deficits. The combination of growing inflation, and low interest rates created large asset price bubbles that

1 Ralph Clem and Marek Jan Chodakiewicz, "Poland Divided: Spatial Differences in the June 2003 EU Accession Referendum", *Eurasian Geography and Economics* 45, no. 7, (2004): 482.

2 National Bank of Poland, *A Report on the Costs and Benefits of Poland's Adoption of the Euro*, March 2004, 10.

3 Susan Schadler, "Charting a Course Towards Successful Euro Adoption," *Finance & Development*, June 2004, 29–33.

4 Andrew K. Rose, "One Money, One Market: The Effect of Common Currencies on Trade," *Economic Policy* 15, no. 30 (2000): 8–45.

ended in prolonged periods of unemployment and low growth.

Flexible exchange rates can break this loop through the nominal exchange rate, which adjusts to changes in international capital flows or higher inflation. Poland's flexible exchange rate helped restrict credit growth prior to the crisis and afforded Poland the option to adjust to the crisis via exchange rate depreciation. This allowed for the effective deployment of countercyclical policy and obviated the need for painful internal devaluation. In the midst of these events, the 2009 IMF review of Poland's economy recommended delayed euro adoption, concluding that joining the euro area was advisable only in the medium term[5]. The National Bank of Poland (NBP) agreed, emphasizing preparation rather than speedy adoption.[6]

By 2015 these positions had firmed. Trade and borrowing cost benefits were revised to almost zero by the IMF and recommendations to adopt the euro were removed from subsequent reports[7]. Similarly, the National Bank of Poland demonstrated concern for euro adoption recently.[8] This reflects the role that monetary policy, together with effective banking supervision and regulation, played in Poland's economic performance before, during, and after the euro crisis. These economic policies contributed to Poland avoiding recession. It was the only country in the European Union to do so.

A range of new academic papers informed these changing views. The Rose (2000) paper, purporting large trade benefits to currency unions, sparked considerable research. Follow up studies found problems with Rose's initial econometric approach, and estimated much smaller effects. Baldwin (2006) surveyed the existing literature and predicted that the euro may increase intra-EU trade by around 5 to 10 percent; Santos and Tenreyro (2010) found benefits of close to zero; and Rose (2015), in a follow-up paper, found only a "mildly stimulating effect at best."[9] Lower trade effects associated with euro adoption likely reflect the already deep integration of EU trade that was not controlled for in earlier work.

The attraction of euro adoption has diminished for two broad reasons. First, the external anchor argument now carries little credibility. Poland has demonstrated more effective banking supervisory and regulatory systems than the Eurozone, and its monetary policy has been more effective in supporting sustainable economic growth. We have undertaken analysis comparing Polish economic performance with countries of the Eurozone and some European countries not in the European Economic and Monetary Union (EMU). We find that exchange rate flexibility, combined with sound macroeconomic management, has worked well for Poland. Second, the benefits of euro adoption associated with trade, reduced borrowing costs, and lower transaction costs were vastly overstated.

The politics of euro adoption has similarly evolved since the initial 2003 referendum on EU membership.

A 2002 CBOS survey found that 64 percent of Poles either definitely or probably supported euro adoption. By 2014, this trend reversed, with just 24 percent of Poles in both of these categories.

Today, the political constituency for euro adoption appears weak. In the wake of the euro crisis,

5 International Monetary Fund, "Republic of Poland: 2009 Article IV Consultation—Staff Report." IMF, 2009.

6 National Bank of Poland, *Report on Full Membership of the Republic of Poland in the Third Stage of the Economic and Monetary Union*, February 2009.

7 International Monetary Fund, "Central and Eastern Europe: New Member States (NMS) Policy Forum," IMF, 2015, 7.

8 National Bank of Poland, *The Economic Challenges of Poland's Integration with the Euro Area*, March 2015.

9 Andrew. K. Rose and Reuven Glick, "Currency Unions and Trade: A Post-EMU Mea Culpa," NBER Working Paper No. 21535, September 2015.

support for the euro has fallen substantially, across almost all age groups.

Two political arguments are sometimes offered for early euro adoption: geopolitical security and a seat at the table in Europe's 'fast' lane. But these do not stand up on closer examination. Europe has a commitment to Poland, and euro adoption would not change this. Joining the faster European integration track is sensible if it pays dividends. Rather than influencing European policy, however, there is a real risk that Poland is caught in protracted discussions with no guarantee of successful resolution. Analyzing this evolution is key to understanding the current conversation.

The answer to the normative question asked in this paper—'Should Poland Join the Euro?'—requires an assessment of the economic as well as political outlook.

The outlook not only conditions the rationale for the policy action but also shapes the likelihood of the policy action being taken and implemented. Our analysis leads to the conclusion that Poland has used—and can continue to use—its policy independence to achieve growth with stability. This independence is valuable, particularly during crises or when the economy faces idiosyncratic shocks. The economic case for euro adoption is weak, and will remain so as long as Poland implements effective domestic economic policy. Moreover, with the inevitable shift in trade towards emerging economies outside the Eurozone, the case for joining the euro area becomes weaker.

The political assessment similarly relies on the political outlook. The diminishing popular support for the euro and the large political capital needed to make the necessary constitutional changes make it difficult to see where a political constituency for euro adoption would emerge. Poland has gained enormously from joining the European Union, a fact that is mirrored in the Polish support for Europe. But this is not the same as Eurozone membership. Poland can—and should—remain a valued member of the European Union while remaining outside of the Eurozone.

2 The Evolution of Polish Thought on Euro Adoption

Poland has witnessed profound historical evolution over the last 30 years, from its transformation from a communist state to a new European Union member state, to the further integration with and multiple recent crises within the Eurozone. As the political and historical systems evolved, Polish thought on accession to the EMU has changed greatly since the end of the Soviet Union. Analyzing this evolution of thought surrounding euro adoption is key to understanding the current conversation around the topic and how the current list of costs and benefits of adoption has developed.

2.1 Pre-EU membership reforms

In the 1990s, integration of the Central and Eastern European (CEE) countries into the EU was seen as a distant prospect. As Visvizi and Tokarski (2014) explain, "In the early 1990s and before the December 1997 European Council decision to launch the accession negotiations with the CEE countries, the possibility of them adopting the euro, not least them joining the EU, was approached either with distrust and irony or in the best case as a really long-term scenario."[10] At this time, euro adoption and EU membership were seen as one and the same. Visvizi and Tokarski go on to explain that academics began to see the accession of these countries in the early 2000s as "a risky, yet a viable option."[11] As a post-communist state, Poland had to prove to the Western European countries that it could reform and meet the standards of EU membership.

Politically, Poland and its elites made EU accession an aim of their post-communist reform process to break from the country's communist history. Economic leaders like Leszek Balcerowicz thought that a rapid transition from a planned to market economy would give Poland the greatest growth. Visvizi and Tokarski say, "this external anchor served as a tool of mobilizing the reformist elite in Poland to continue the reform process and as a beacon highlighting the path to follow."[12] These entrenched goals influenced the actions of Polish leaders and the public for many years to come. As EU accession was realized, the next goal of Eurozone membership replaced it in many minds. However, domestic political hurdles—like the requirement to amend the Polish constitution, which requires a two-thirds majority of parliament—remained.

A single currency could provide an additional 'external anchor' to Polish economic policies. By giving up monetary independence, it was argued, CEE countries could import prudent, sound monetary policy. The ECB, based on the Bundesbank, was expected to resolutely guard against inflation. Joining the monetary union also required implementing sound but potentially unpopular policy measures, including tight fiscal discipline. Reform-minded leaders could use the accession criteria to help steer domestic policy in a direction otherwise unachievable.

2.2 After EU Accession

When Poland joined the European Union in 2004, the official view was that it was only a matter of time before Poland adopted the euro. In voting to join the EU, the Polish public had voted to join the Eurozone. The next questions were how could Poland reform to join, and when the country would be ready to adopt the euro. At the same time, in part because the goal of EU

10 Anna Visvizi and Paweł Tokarski, "Poland and the Euro: Between Lock-in and Unfinished Transition," *Society and Economy* 36, no. 4 (2014): 447.

11 Visvizi and Tokarski, "Poland and the Euro": 447.

12 Visvizi and Tokarski, "Poland and the Euro": 454.

membership had driven reforms before 2004, support for continued reforms dwindled. Polish political elites could now postpone other reforms and the costs of euro adoption. This backsliding received more credence when the financial and euro crisis began, particularly when Poland weathered the storm with remarkable economic growth.

A 2004 NBP study concluded that euro adoption would have positive value for the domestic economy.[13] The report advocated that the sooner the Maastricht criteria were met and the euro was introduced with the support of an appropriate economic policy, the greater the benefits for Polish economic growth. Meeting the Maastricht criteria was considered as opening the way to the euro. Joining the euro area was in turn believed to eliminate the costs related to zloty/euro exchange rate transactions, the exchange rate risk between Poland and the euro area, and the risk of a currency crisis. Euro adoption would spur investment, foster long-term capital inflow, and expand foreign trade and related benefits, including technology transfer. The NBP believed the pros of euro adoption outweighed the cons, and anticipated positive effects of adoption on Polish GDP, consumption, and welfare.

2.3 Crisis years

With the global financial and Eurozone crises, the costs of joining the Eurozone became clearer. Multiple euro area countries required bailouts. The stability of the Eurozone itself was and still is in question, and the costs and benefits of accession were permanently changed. New Member States, including Poland, began to re-consider the benefits of monetary union and the probability of EMU reform.

In its 2009 report, the NBP confirmed the potential long-term benefits of euro adoption, but it emphasized that Poland needed considerable preparation to be ready.[14] There was no longer an incentive to adopt the euro as soon as possible, as there had been in 2004. The report argued that the better-prepared Poland was, the more Poland could benefit from euro adoption. The NBP still agreed that the long-term result of membership in the euro area would be positive if the Polish society and economy were well prepared for integration. This report also gave more weight to permanent costs associated with the introduction of the euro, including the risk of accompanying price effects and the costs of tightening macroeconomic policy.

In the wake of the financial crises, the NBP was much less optimistic about the benefits of euro adoption, and was especially worried about the impact of the euro on macroeconomic stability.

The NBP claimed that participation in the Eurozone would not guarantee effective protection against turmoil in the world economy. It also stated its concerns about the negative effects of the loss of autonomous monetary policy, and the spread of a crisis within a currency union whose members had not achieved real economic convergence.

2.4 Post-crisis assessment

After the Ukrainian crisis, there was a revival of security arguments for joining the Eurozone. Some Polish political leaders like former prime minister Donald Tusk argued that adopting the euro would bring Poland closer to Europe, increase diplomatic relations with Europe, and make Poland more secure. This reasoning drew on the experience of the Baltic States that joined the EMU to protect themselves from outside threats. However, as will be discussed in Section 4.2, Poland's geo-strategic situation differs significantly from the Baltics' because Poland is much larger and more integrated with Europe. Poland's NATO membership is also a much more

13 National Bank of Poland, *Report on the Costs and Benefits of Poland's Adoption of the Euro.*

14 National Bank of Poland, *Report on Full Membership of the Republic of Poland.*

effective deterrent against security threats than EMU membership would be.

Poland's strong economic performance before and after the crisis decreased the need for an 'external anchor'.

The external anchor argument calls for the importation of prudent monetary and fiscal policy. However, in the years since the initial EMU debates, Poland has shown strong macro-economic governance. Inflation has generally matched the levels in the euro area, and Poland has had manageable fiscal deficits (see Chapter 3).

After the worst of the crisis had subsided, the NBP's 2014 report expressed serious concerns about the benefits and prospect of early euro adoption.[15] It implied that Poland would put EMU accession on hold without a specific target date until Poland is politically and economically prepared for euro adoption, and the Eurozone is institutionally reformed to benefit Poland. This strategy has been called 'get ready and see.' The report emphasized the necessity of an improvement in the institutional set-up of the euro area, and of structural reforms strengthening the fundamentals of the Polish economy. It also argued that the sovereign debt crisis revealed numerous weaknesses in the institutional set-up of the euro area in the field of fiscal, economic, and financial integration. The NBP strongly emphasized the need for deeper fiscal and banking integration between euro area countries and claimed that such integration would benefit Poland as a future Member State. The IMF, too, revised its understanding of the costs and benefits of euro adoption for Poland and other new EU member states (see Box A).

In addition to criticizing the institutional design of the euro area, the NBP also expressed more concerns about Poland's preparedness for adopting the euro than in 2009. It emphasized that Poland should focus on improving its economy's fundamentals while the country observes reforms in the Eurozone. According to the NBP, the introduction of the euro would reduce the level of interest rates in Poland and could cause macroeconomic imbalances. The NBP also stressed other challenges for Poland that include its low level of innovation in the domestic economy, the high duality of the labor market, the underdevelopment of the private rental market, and Poland's limited ability to conduct countercyclical fiscal policy.

2.5 Present

Poland now faces what Visvizi and Tokarski describe as a 'mismatch' between prior policy agreements and domestic political incentives.[16] With the EU accession vote, the country had agreed to adopt the euro at some time; yet the economic and political costs have outweighed the benefits to date. As Visvizi and Tokarski say, "lock-in, institutional resistance, and increased transaction costs create a situation where 'neither reform nor Eurozone entry' is in sight."[17] Polish political elites have considerable power in the current situation, despite their legal requirements to adopt the euro, and have strong incentives to delay adoption for years to come.

15 National Bank of Poland, *Economic Challenges of Poland's Integration with the Euro Area*, March 2015.

16 Visvizi and Tokarski, "Poland and the Euro", 458.

17 *Ibid*, 461.

Box A: The IMF's evolving view on euro adoption for New Member States

In 2005, the IMF outlined the benefits and challenges of euro adoption for EU New Member States (NMS).[18] Trade creation and enhanced policy credibility, leading to lower interest rates (the risk premium), were emphasized. Euro adoption would also create challenges, namely the need to mitigate asymmetric demand shocks, large and volatile capital inflows, and higher inflation. While these would test the NMS, each was manageable, owing to ongoing economic convergence and business cycle synchronization. The NMS could cope with asymmetric shocks through fiscal and labor market flexibility.

By 2009, the global financial crisis had sparked. Heightened market uncertainty instigated a nuanced change in IMF advice, with a preference for independent monetary policy in the short term. Euro adoption in the medium term would "on balance" remain beneficial, with labor and product market flexibility sufficient for mitigating future idiosyncratic shocks.[19]

In 2015, there was a striking reversal.[20] Trade benefits were revised down from 10–25 percent of real GDP over 20 years[21] to a range of zero to 2–3 percent.[22] While trade remains an important benefit for EU accession, it is deemed likely immaterial to euro adoption. Benefits associated with the risk premium were now estimated at close to zero, owing to greater differentiation of sovereign debt by private markets. Moreover, far from being a benefit, any risk premium could be a source of future instability. Risk pooling can conceal deep vulnerabilities, with cheap credit contributing to large fiscal and external imbalances.

While benefits were reduced, costs were revised upwards. Independent monetary policy was given new importance in light of large asymmetric demand shocks. Countries outside the Eurozone (like Poland) benefitted significantly from tighter monetary policy before the crisis and expansionary policy after it. The resulting currency depreciation stimulated economic activity. Additionally, institutional solutions to the euro crisis, such as the European Stability Mechanism, were found to carry additional costs not previously considered.

While there is discussion of the euro helping to prevent foreign currency retail borrowing, and the subsequent problems relating to currency mismatch, taken as a whole the IMF appraisal of euro adoption has significantly eroded over time. This is most visible in the changing conclusions. The 2005 report predicts substantial net gains for euro adoption; the 2009 report recommends adoption in the medium term only; the 2015 report makes no recommendation for euro adoption.

18 Susan Schadler et al., "Adopting the Euro in Central Europe: Challenges of the Next Step in European Integration," IMF Occasional Paper 234, 2005.

19 International Monetary Fund, "Republic of Poland: 2009 Article IV Consultation—Staff Report." IMF, 2009.

20 International Monetary Fund, "Central and Eastern Europe: New Member States (NMS) Policy Forum," IMF, 2015. See also related Selected Issues Paper.

21 These estimates were based on Jeffrey A. Frankel and Andrew K. Rose, "The Endogeneity of the Optimum Currency Area Criteria," *The Economic Journal* 108, no. 449 (1998): 1009–25 and Rose, "One Money, One Market".

22 Updated estimates from Richard Baldwin, "The Euro's Trade Effects," *European Central Banking Working Paper Series* No. 594: March 2006 and Tomas Havranek, "Rose Effect and the Euro: Is the Magic Gone?" *Review of World Economics* 146, no. 2 (2010): 241–261.

3 Why Has Poland's Economy Done So Well?

This chapter examines Poland's economic performance in the context of the performance of other European countries. Cross-country variation in economic performance cannot be attributed exclusively to policy decisions. However, comparative analysis is still a useful tool to highlight the commonalities among countries with stronger economic performances. It is in this context that the current chapter will consider Poland along with several comparator countries in the same region. Specifically, we will focus on the role played by the prevailing currency regime in our countries of interest as summarized by Figure 1.

Figure 1

Currency Regimes of Selected European Countries

Country	Current currency regime	Date of joining euro area	Previous exchange rate regime
Estonia	Member of the euro area	2011	Pegged to DM/EUR
Latvia		2014	Pegged to EUR since 2004 and SDR previously
Lithuania		2015	Pegged to EUR since 2002 and USD previously
Slovak Republic		2009	Float with a 15% band since 2005 with repeated parity adjustments; free floating previously
Slovenia		2007	Pegged to EUR since 2004; floating previously
Bulgaria Croatia	Pegged to the euro	-	-
Czech Republic Hungary Poland Romania	Floating*	-	-

* 'Free floating' for Poland and 'other managed arrangement' for the Czech Republic
Source: adopted from International Monetary Fund, "Central and Eastern Europe: New Member States (NMS) Policy Forum," IMF, 2015

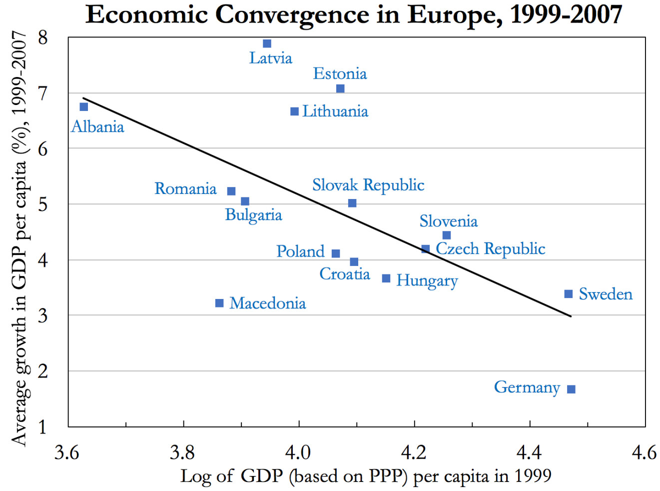
3.1 Poland before the crisis: sustainable and balanced growth, limited inflation and limited imbalances

3.1.1 Poland experienced strong 'catch-up' growth

Poland's economy grew solidly before the crisis (Figure 2). Poland's pre-crisis GDP growth outpaced that of the more advanced European economies, in line with the process of economic convergence.[23] However, Poland was clearly growing at a slower pace than the Baltics. These differences in growth are partly attributed to overheating in the Baltics, which—as will be discussed—could be partly explained by differences in the exchange rate regime adopted.[24]

Figure 2

Economic Convergence in Europe, 1999-2007



Source: IMF WEO database; author's calculations

23 Convergence, or 'catch-up growth', is the phenomenon that poorer countries have higher potential economic growth, and hence typically faster growth, than richer countries because more developed countries face greater diminishing returns to capital.

24 For instance, the rapid expansion of credit has been assessed as a major factor for Latvia's divergence from a balanced and sustainable growth path: International Monetary Fund, "Statement by IMF Mission to Latvia on 2007 Article IV Consultation Discussions," Press Release No. 07/87, May 2007.

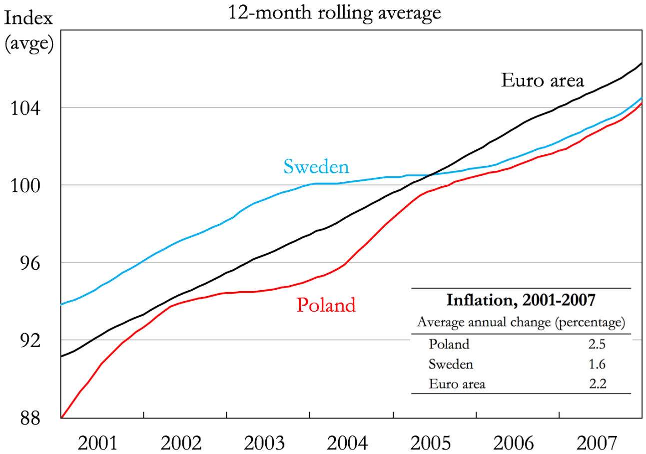
3.1.2 Having a flexible exchange rate has not been associated with higher inflation

Inflation performance in Poland and other countries with flexible currency regimes has been no worse than those with fixed regimes. Over the seven years to 2007, core inflation in Poland amounted to 2.5 percent – slightly above the 2.2 percent in the euro area (Figure 3).

Figure 3

CPI Index

12-month rolling average



Source: OECD

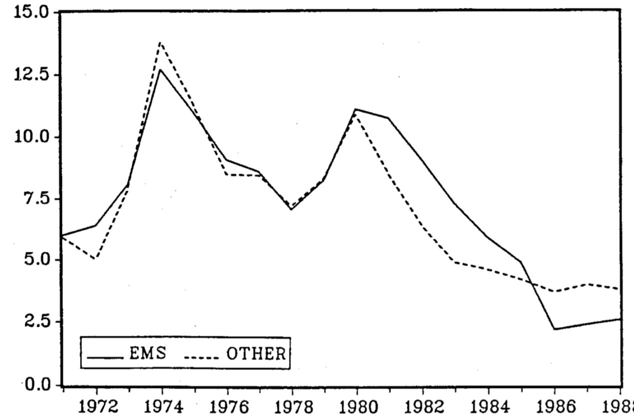
Indeed, the National Bank of Poland has been judged to have a credible and well-functioning monetary policy framework even when tested by the recent crisis.[25] Poland's inflation experience is not an outlier. It is consistent with the finding that, on average, fixed exchange rate regimes do not lead to lower inflation.[26] In fact, countries with fixed exchange rates appear to be more prone to inflationary bursts. This runs counter to the argument that better inflation outcomes could be achieved by deferring to the ECB.

Membership in the EMU or its predecessor does not appear to influence inflation outcomes.

Eichengreen (1992) showed that the inflation trend in countries in the European Monetary System during the 1970s and 1980s was nearly identical to the trend in non-member countries (Figure 4).

Figure 4

Inflation for Members and Non-members of the European Monetary System

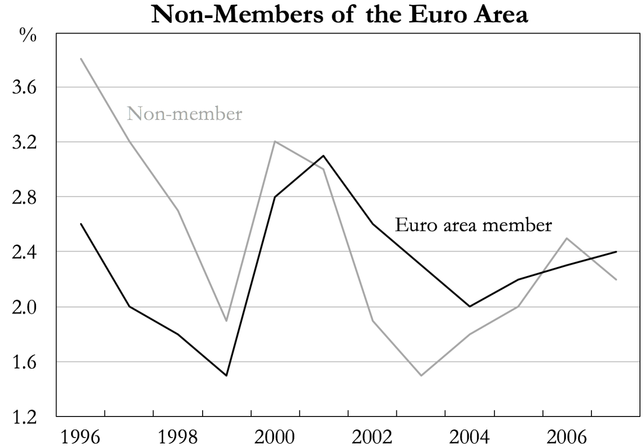


Source: Eichengreen (1992), p. 6

Recreating his analysis for the Eurozone during the late 1990s and 2000s reveals a similar finding (Figure 5).

Figure 5

Inflation for Members and Non-Members of the Euro Area



Source: OECD

Using panel data on 24 countries over the period of 1995 to 2007, we also estimated the effect of adopting the euro on inflation, controlling for GDP growth and growth in money supply. Our

25 International Monetary Fund, "Republic of Poland: 2010 Article IV Consultation—Staff Report," IMF, 2010, 28.

26 Eichengreen, Barry, "Should the Maastricht Treaty Be Saved?" Princeton Studies in International Finance, December 1992.

regression revealed a negative but statistically insignificant relationship (Figure 6).

Figure 6

Regression Results: The Effect of Eurozone Membership on Inflation

Variables	Fixed Effects	Random Effects	Dynamic Panel xtabond	Dynamic Panel xtabond2
Lagged inflation	0.423 ***	0.485 ***	0.358 ***	0.494 ***
	(6.55)	(8.04)	(5.35)	(4.98)
Twice-lagged inflation	0.134 ***	0.114 **	0.168 ***	0.103 *
	(2.64)	(2.46)	(3.22)	(1.94)
Money growth	0.053 **	0.055 ***	0.049 *	0.045
	(2.35)	(3.33)	(1.89)	(1.26)
GDP growth	-0.114 **	-0.091 **	-0.080	-0.079
	(-2.27)	(-2.11)	(-1.33)	(-1.34)
Lagged GDP growth	0.207 ***	0.224 ***	0.272 ***	0.220 ***
	(4.31)	(5.22)	(4.96)	(3.81)
Eurozone	**0.405**	**0.201 ***	**0.712**	**-0.719**
	(1.50)	**(1.70)**	**(1.64)**	**(-0.44)**
Constant	-0.170	-0.120		-0.183
	(-0.47)	(-0.53)		(-0.73)
Observations	*264*	*264*	*240*	*262*
R-squared	*0.648*			
Number of countries	*24*	*24*	*24*	*24*

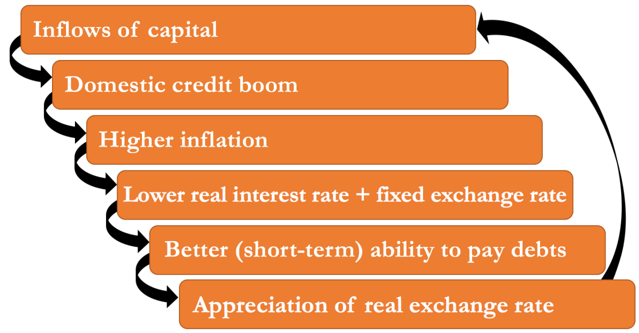
Source: OECD; authors' calculation

3.1.3 Fixed exchange rate regimes could lead to an 'overheating' feedback loop

This section explains the mechanics of overheating before proceeding to discuss the differences in macroeconomic imbalances in Poland and other CEE countries. The process by which fixed exchange rate regimes could lead to overheating is summarized in Figure 7.

Countries running current account deficits must finance the deficits via international capital inflows. Such inflows can take the form of 'hot' capital flows, which are invested for short periods of time. In international financial data, these flows would be included in 'other' or 'bank' flows, as opposed to foreign direct investment (FDI) or portfolio inflows.

Figure 7



Having access to cheap, short-term 'hot' capital is strongly related to domestic credit booms,[27] and credit booms are more commonly associated with fixed and managed exchange rate regimes than floating regimes.[28] Lane and McQuade (2013) found that large net debt inflows are strongly associated with credit booms. Mendoza and Terrones (2012) found that three-quarters of credit booms happened in countries with fixed or managed exchange rates across industrial and emerging countries, and often followed surges in capital inflows.

Credit booms can lead to higher inflation, capital inflow, and credit growth in countries with fixed exchange rates. Credit booms are associated with consumption or investment booms, which place upward pressure on prices and wages. In a fixed exchange rate regime (whether with a peg or within a currency union), higher inflation leads to lower real interest rates, making it more attractive for domestic borrowers to borrow. Higher inflation also leads to real exchange rate appreciation, all else being equal. Bruno and Shin (2014) found evidence that this effect leads short-term investors to invest even more hot money into the country.[29] Consequently, local currency

27 Philip R. Lane and Peter McQuade, "Domestic Credit Growth and International Capital Flows," ECB Working Paper Series No. 1566, July 2013.

28 Enrique G. Mendoza and Marco E. Terrones, "An Anatomy of Credit Booms and Their Demise," NBER Working Paper No. 18379, September 2012.

29 Valentina Bruno and Hyun Song Shin. "Cross-Border Banking and Global Liquidity," BIS Working Paper No. 458, August 2014.

appreciation is associated with more leverage in the banking sector.

Further capital inflows drive further inflation, further real exchange rate appreciation, and bigger current account deficits. The process repeats. Eventually, when short-term investors pull out, domestic borrowers are left over-leveraged and unable to rollover their loans, leading to a contraction in credit, stress on private and public sector balance sheets, and a potential contraction in output.

In countries with flexible exchange rate systems, this feedback loop is broken by the nominal exchange rate, which adjusts in response to changes such as increases in international flows or higher inflation. The literature provides strong evidence that flexible exchange rates can help prevent the build-up in international imbalances and serve as a stabilizing mechanism given economic shocks. Hussein, Mody, and Rogoff (2004) found that emerging economies with flexible currency regimes experience fewer crises, while more developed economies with such policies benefit from greater durability and slightly faster growth.[30] Berglöf et al. (2009) examine the performance of emerging European economies during the recent financial crisis and find that 'hard peg' regimes are associated with large, statistically significant output declines.[31]

There is a relationship between credit booms and negative effects on the real economy. Lane and McQuade (2013) found the size of recessions to be related to the magnitude of domestic credit growth and current account balances. More generally, Mendoza and Terrones (2012) found a systematic relationship between credit booms and boom-bust cycles, asset prices, real exchange rates, capital inflows, and external deficits.[32]

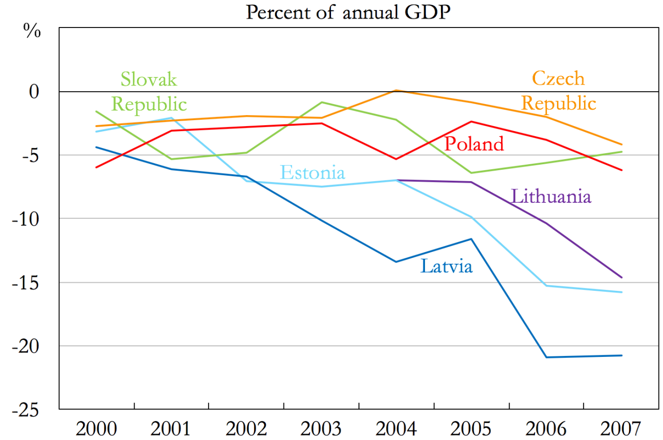
3.1.4 Flexible exchange rate regimes are associated with smaller current account balances and less 'hot' money flows

Current account deficits revealed overheating in countries with pegged currencies. Figure 8 shows the trends in the current accounts of six countries in the years leading up to the crisis—three Baltic countries with fixed exchange rate regimes (Estonia, Latvia and Lithuania) and three with floating regimes (Czech Republic, Poland and the Slovak Republic). All six countries consistently ran deficits over the period, but during 2006 and 2007 the deficits in countries with fixed exchange rates ballooned. Latvia's deficit grew to over 20 percent of GDP in 2007.

Figure 8

Current Account Balance

Percent of annual GDP



Sources: IMF, BoP Statistics; World Bank GDP estimates; OECD GDP estimates; Poland Central Statistical Office (pre 2006 data.)

The current account deficits of the Baltics were financed more heavily by 'hot' money flows. Short-term loans are a fickle source of capital, as they can quickly dry up during crises. By contrast, investments with longer time horizons (such as foreign direct investment) tend to be a more stable source of funding. Figure 9 examines

30 Aasim M. Husain, Ashoka Mody, and Kenneth S. Rogoff, "Exchange Rate Regime Durability and Performance in Developing Countries Versus Advanced Economies," NBER Working Paper No. 10673, August 2004.

31 Erik Berglöf et al., "Understanding the Crisis in Emerging Europe," EBRD Working Paper No. 109, November 2009.

32 The Latvia example is discussed in Blanchard, Olivier J., Mark Griffiths, and Bertrand Gruss, "Boom, Bust, Recovery: Forensics of the Latvia Crisis," *Brookings Papers on Economic Activity*, no. 2 (2013): 325–88.

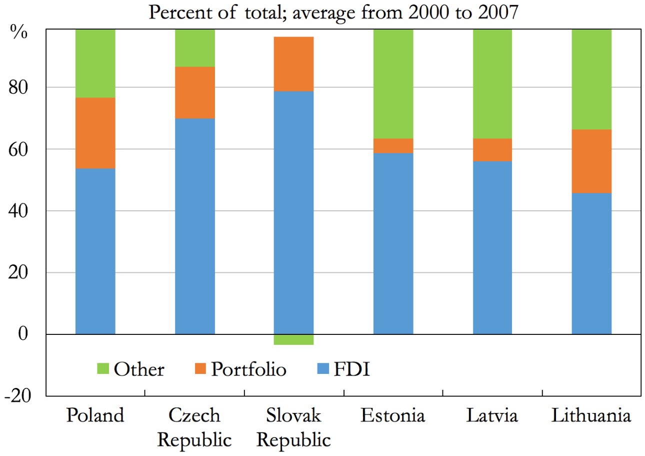
how current account deficits were financed in the same six countries from 2000 to 2007.

Consistent with the reasons described in Section 3.1.3, the fixed exchange rate regimes of the Baltics facilitated more short-term financing (a major component of 'other' flows) than did the countries with more flexible regimes, including Poland. 'Other investment' flows amounted to nearly 40 percent of Latvia's inflows during the period of interest.

Figure 9

Composition of Financial Account

Percent of total; average from 2000 to 2007



Sources: IMF International Financial Statistics; Poland Central Statistical Office (pre 2006 data.)

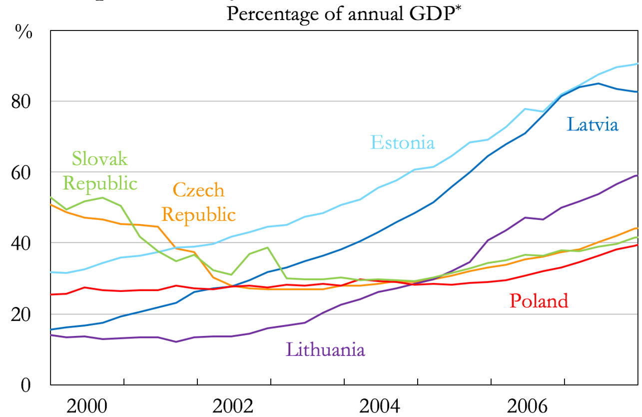
3.1.5 Credit booms were also limited in the countries with flexible exchange rate regimes

Poland experienced a relatively limited build-up in domestic credit in the lead-up to the crisis. Poland's domestic bank credit to the private sector grew at a relatively moderate pace, from around 30 percent of GDP in 2004 to around 40 percent by the end of 2007 (Figure 10). The Czech Republic and the Slovak Republic—both countries with a similarly flexible exchange rate in that period—had comparable credit growth. This is in direct contrast to the Baltics, where domestic bank credit as a share of GDP increased by around 20 percentage points. This difference is in line with the literature suggesting that credit booms are much more frequent in the presence of fixed or managed exchange rates.[33] Consistent with the earlier discussion on the mechanics of overheating, lower real interest rates played a role in Latvia's credit boom while the narrow exchange rate band limited the Latvian central bank's ability to effectively tighten monetary policy.[34]

Figure 10

Deposit Money Banks' Claims on Private Sector

Percentage of annual GDP*



* Quarterly GDP summed on a rolling basis

Sources: IMF IFS (22D___XDC and NGDP_XDC); author's calculations

Domestic financial supervision also played a part in tempering Poland's credit growth.

Poland's financial sector entered the crisis in better health than in some other European countries. Polish banks were well-capitalized, resilient to shocks, and held above-EU-average capital adequacy and return on equity.[35] Moreover, they were less reliant on international funding than others in the region, and foreign subsidiaries continued to receive funding from parent institutions as the crisis unfolded.[36] Supervisors were well-positioned to handle the pickup in credit

33 Mendoza and Terrones, "Anatomy of Credit Booms".

34 This is because a larger interest differential would induce further foreign-currency borrowings. See International Monetary Fund, "Republic of Latvia: Staff Report for the 2005 Article IV Consultation—Staff Report, IMF, 2005, [20] and Box 4.

35 IMF, "Poland 2006 Article IV Consultation", [27] and Box 4.

36 IMF, "Poland 2010 Article IV Consultation", Box 2.

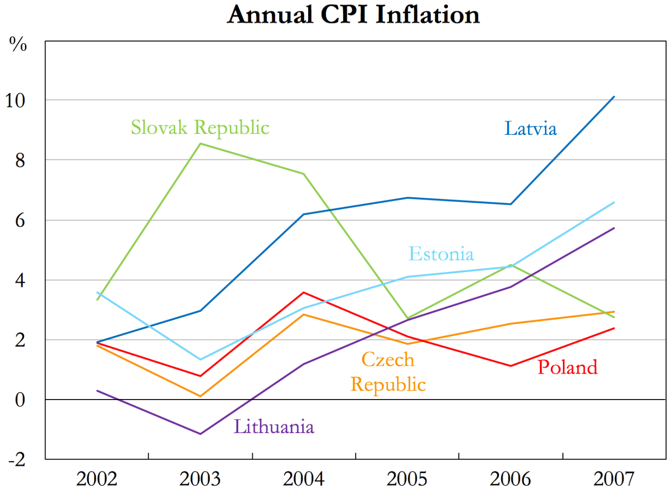
growth, and took steps to curb the growth of foreign-currency mortgages.[37] Besides limiting the boom, these factors also added to Poland's financial sector resilience during the crisis, contributing to a strong recovery.[38]

3.1.6 Inflation was limited in countries with a flexible currency regime but accelerated for the Baltics

Inflation in the Baltics accelerated into the crisis, consistent with the mechanics of overheating. CPI inflation in Latvia was high, although stable at around 6 percent for several years, but by 2007 had accelerated to 10 percent (Figure 11).

Figure 11

Annual CPI Inflation



Source: IMF International Financial Statistics

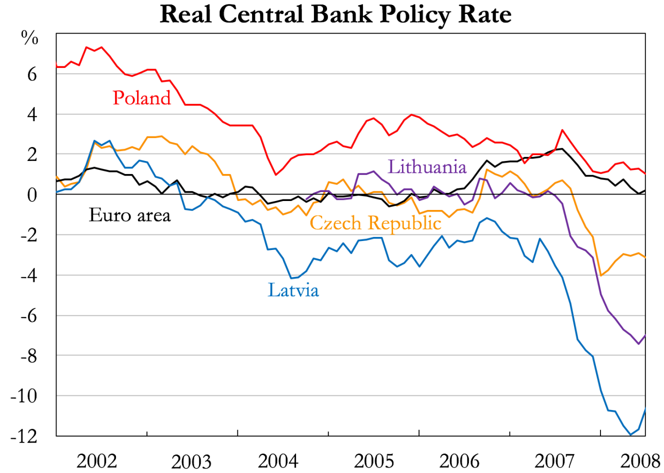
Estonia and Latvia experienced similar, albeit less severe increases in prices. Although elevated inflation in Eastern Europe partially reflected convergence (as productivity growth in tradable sectors led to higher wages and prices),[39] this acceleration is consistent with the process of overheating described earlier. Having fixed currency regimes, the Baltics were unable to raise policy rates to combat inflation and overheating. In fact, inflation would have made it easier for domestic borrowers to repay their domestic currency-denominated loans, making lending to these borrowers more attractive to foreign investors, and thereby further fuelling the credit boom and inflationary pressures.

3.1.7 Real interest rates fell in countries with fixed exchange rates, thereby contributing to further overheating

Higher inflation contributed to lower real interest rates in the Baltics, in effect loosening monetary policy even as inflation was accelerating (Figure 12).

Figure 12

Real Central Bank Policy Rate



Source: International Financial Statistics (accessed via Global Insights); authors' calculation

By contrast, central banks in the countries with flexible exchange rates were able to raise policy interest rates, with tightening cycles of more than 100 bps during 2006 and 2007 in Poland, the Czech Republic, and the Slovak Republic.[40] This, along with stable inflation in the period, meant that Poland did not experience any considerable falls in its real interest rate. This was in direct contrast to the Baltics. Lower real interest rates provided

37 IMF, "Poland 2006 Article IV Consultation", [29].

38 IMF, "Poland 2009 Article IV Consultation", Box 3.

39 Dubrav Mihaljek and Marc Klau, "Catching-up and Inflation in Transition Economies: the Balassa-Samuelson Effect Revisited," BIS Working Paper no. 270, December 2008.

40 International Monetary Fund, "Nominal Central Bank Policy Rates," IMF IFS Data, accessed via Global Insights.

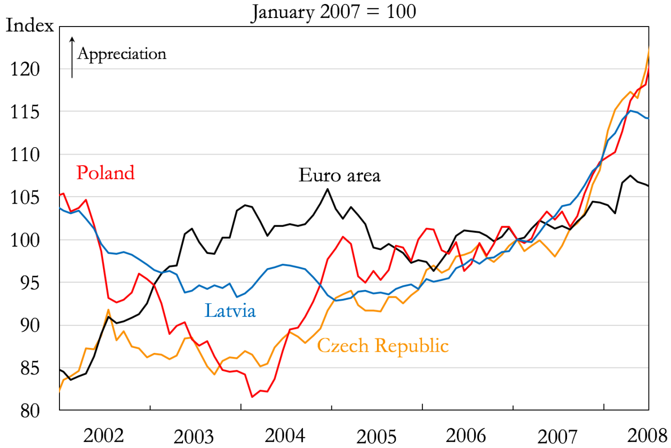
another reason for providing more cross-border credit to the countries with fixed regimes.

There was real appreciation across our comparator countries in the lead-up to the crisis, but this coincided with nominal appreciation in Poland (Figures 13 and 14). In Latvia, the real effective exchange rate appreciation was caused by high inflation rather than a nominal appreciation.

Figure 13

Real Effective Exchange Rate

January 2007 = 100

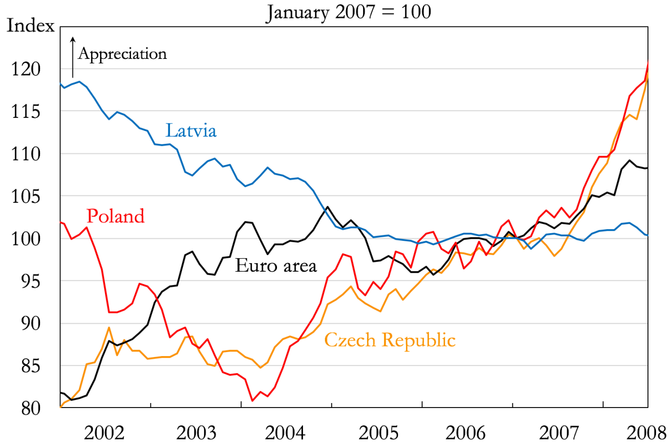


Source: BIS effective exchange rate Real (CPI-based), Broad Indices

Figure 14

Nominal Effective Exchange Rate

January 2007 = 100



Source: BIS Nominal Effective Exchange Rate, Broad Indices

3.1.8 Overheating gives the illusion of fiscal health

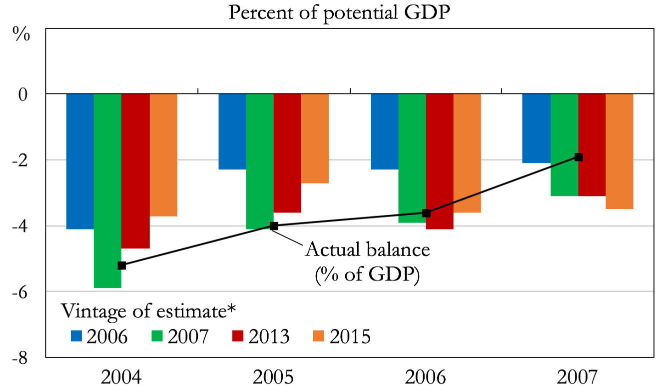
Estimated 'structural', or cyclically adjusted, fiscal balances can be distorted by overheating. For an economy growing at potential, actual and structural balances would be the same. For an overheating economy, the actual budget balance would be higher than the structural measure. For instance, cyclically adjusted tax receipts would only make up a portion of actual receipts if some of the government's revenue stemmed from an asset price bubble (e.g. capital gains tax). Such a measure would also be affected by whether estimates of an economy's potential are accurate.

Poland's growth was close to potential before the crisis. This can be shown by the relatively close alignment of actual and structural balances as estimated by the European Commission. This assessment of Poland's economy has not changed materially since the crisis, as illustrated by the lack of significant changes from successive 'vintages' of the estimated structural balances (Figure 15).

Figure 15

Poland - Cyclically Adjusted Fiscal Balances by Selected Vintage of Estimate

Percent of potential GDP



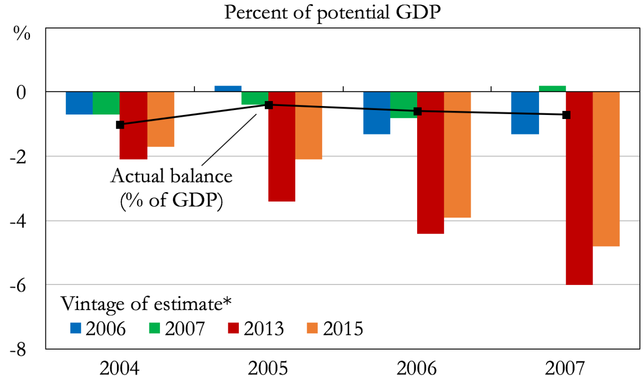
* Estimates as at October; based on the production function approach
Source: European Commission, *Cyclical Adjustment of Budget Balances*

By contrast, Latvia's economy began to overheat from 2005 into the crisis (Figure 16) Comparing estimates across vintages also makes clear that the extent of Latvia's overheating was evident only in hindsight.

Figure 16

Latvia - Cyclically Adjusted Fiscal Balances by Selected Vintage of Estimate

Percent of potential GDP



* Estimates as at October; based on the production function approach
Source: European Commission, *Cyclical Adjustment of Budget Balances*

3.2 Outperformance during and after the crisis: limited reversal of imbalances, real exchange rate depreciation, and counter-cyclical fiscal policy

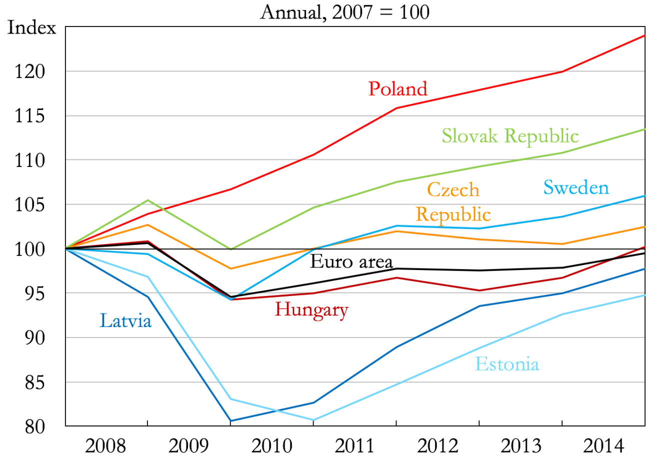
3.2.1 Poland's economic performance clearly surpassed that of the comparator countries

Poland was able to preserve its strong economic performance through the crisis and afterward. From 2007 to 2014, Poland's GDP did not fall in real terms, leading to cumulative growth of almost 25 percentage points in the seven years to 2007 (Figure 17).

Figure 17

Real GDP

Annual, 2007 = 100



Source: IMF WEO database

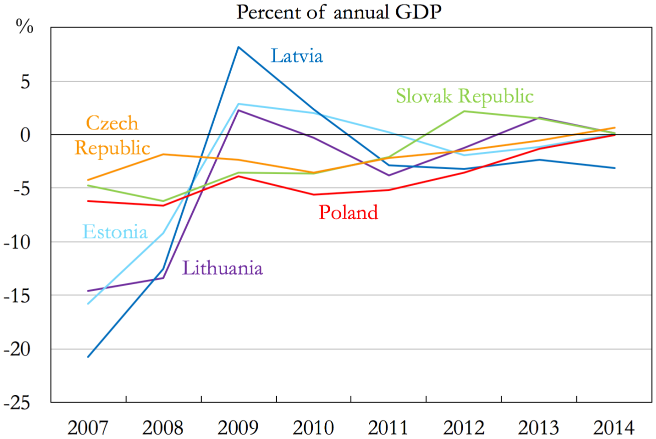
3.2.2 Poland had less need to reverse imbalances given that these were limited before the crisis.

When the crisis struck, capital inflows reversed suddenly. Countries with large imbalances, such as the Baltics, could no longer finance large current account deficits and had to adjust sharply (Figure 18).

Figure 18

Current Account Balance

Percent of annual GDP



Sources: IMF, BoP Statistics; World Bank GDP estimates; OECD GDP estimates; Poland Central Statistical Office (pre 2006 data.)

By 2009, Latvia ran a current account surplus—a change of close to 30 percentage points from 2007—and Estonia and Lithuania had similarly sharp corrections.

Without exchange rate flexibility, those with fixed exchange rate regimes were forced to undergo painful internal devaluations. Real GDP fell by nearly 20 percent from 2007 in the Baltic countries, and had yet to recover by the end of 2014. Poland, which had a much smaller current account deficit, did not require a sharp adjustment. Moreover, the ability for the zloty to depreciate allowed Poland to wind down its relatively small current account deficit more gradually.

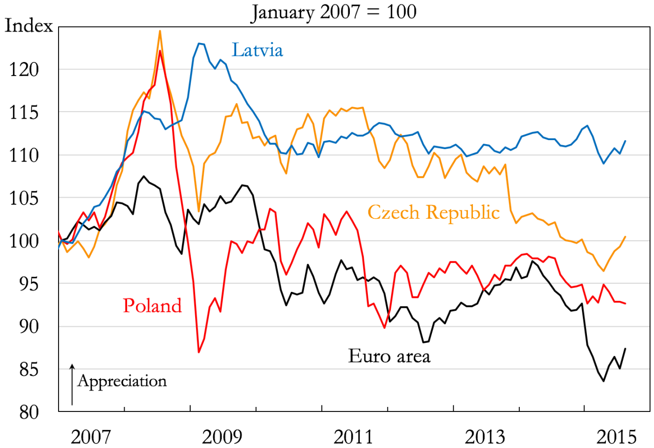
3.2.3 Poland's sharp real exchange rate depreciation played a stabilization role

During the crisis, Poland's flexible exchange rate regime allowed for a large real exchange rate depreciation (Figure 19).

Figure 19

Real Effective Exchange Rate

January 2007 = 100

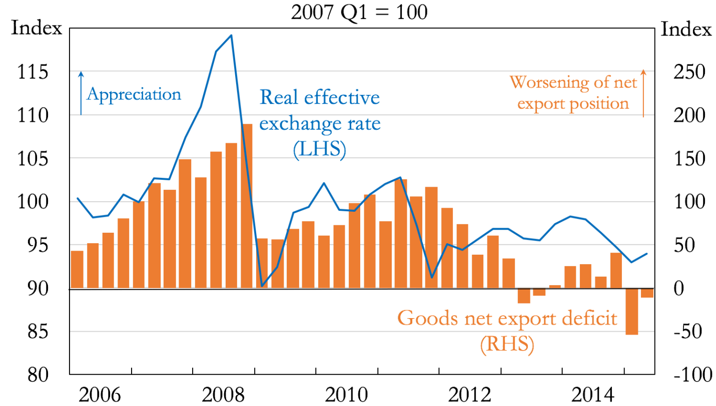


Source: BIS effective exchange rate Real (CPI-based), Broad Indices

Figure 20

Real Effective Exchange Rate and Goods Net Export Deficit

2007 Q1 = 100



Sources: chart based on Agnieszka Stążka-Gawrysiak's presentation on 4 Nov 2015; net exports data from National Bank of Poland; BOP statistics and exchange rate data from BIS effective exchange rate Real (CPI-based), Broad Indices; authors' calculations.

Poland's real effective exchange rate fell to a level lower than before the period of pre-crisis appreciation. In Latvia, with its fixed exchange rate, real depreciation—from internal devaluation—began later than in Poland and the Czech Republic. Latvia eventually achieved a depreciation of more than 10 percent from its peak, leaving it still much above the pre-crisis level.

The zloty's depreciation improved Poland's net export position.

During the pre-crisis tightening of monetary policy, the zloty's real appreciation initially led to a widening of Poland's deficit in the net exports of goods. Once the large depreciation began during the crisis, the deficit declined substantially, significantly improving Poland's net export position (Figure 20). This contributed to Poland's strong economic performance, along with resilience in domestic consumption that reflected a large domestic market.[41]

3.2.4 Fiscal policy also played a counter-cyclical role

Counter-cyclical fiscal policy contributed to Poland's strong economic performance during and after the crisis. In particular, tax cuts passed before the crisis (in 2007) had come into effect with a delay (in 2008). These tax cuts were the driver behind fiscal stimulus amounting to 1.75 percent of GDP in 2008 and 2.5 percent of GDP in 2009.[42] The government also refrained from executing a sizeable planned cut in expenditure in 2009 that, together with the tax cuts, has been recognized as a major reason that Poland did not fall into a recession.[43] It is also clear from Figure 21 that Poland's fiscal stimulus was larger as a proportion of GDP than those of other countries in the region and the euro area, despite the longer-term fiscal consolidation undertaken by Poland and despite being subject to the EU's Excessive Deficit Procedure for a number of years until exiting in June 2015. As threats from the crisis abated, the Polish authorities tightened fiscal policy beginning in 2010.

41 For instance, see IMF, "Poland 2010 Article IV Consultation", [1].

42 IMF, "Poland 2010 Article IV Consultation", [5].

43 *Ibid.*

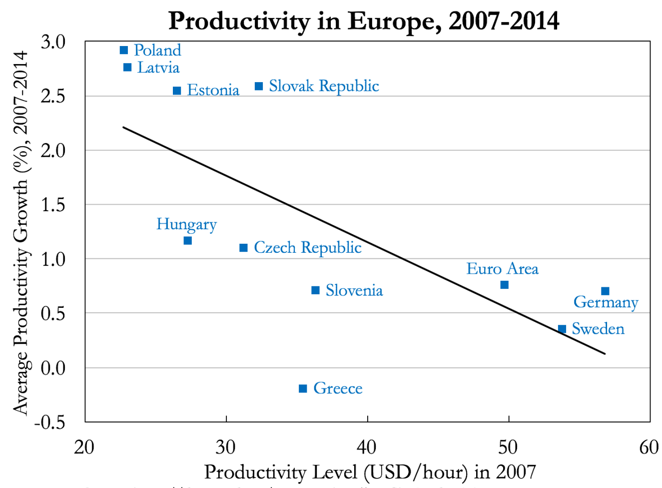
Figure 21

Average Annual Change in Structural Balance
Average percentage point change in share of potential GDP

	2000-2007*	2008-2009	2010-2013
Czech Republic	-0.04	-1.46	1.42
Estonia	N/A	N/A	N/A
Latvia	-0.03	-0.62	0.33
Lithuania	-0.53	-1.15	1.18
Poland	**0.04**	**-2.26**	**0.96**
Slovak Republic	0.19	-1.13	1.27
Euro area	-0.14	-1.21	0.84

* 2004-07 for Latvia and 2001-07 for Lithuania due to data availability
Source: IMF WEO database; author's calculations

Figure 22



Source: https://data.oecd.org/economy.htm#profile-Productivity

3.3 Looking ahead: strong growth potential from rising productivity and better education, a shift in Poland's trade away from Europe, and limited benefits from joining the euro area

3.3.1 Productivity growth is rising as convergence continues

Poland's economy has benefited from rising productivity growth. In 2007, Poland's labor productivity level was among the lowest of the EU New Member States (Figure 22).

Since then, Poland has steadily increased its productivity at 3 percent annually. This has largely been the result of structural reforms and further integration with European supply chains, with further productivity gains expected from reforms in the pipeline.[44] This has made Poland one of the most appealing investment destinations in Central and Eastern Europe, which can potentially facilitate faster income convergence.

3.3.2 Reforms have lifted Poland's educational performance and potentially raised the productivity of its workforce

Polish education reform reinforces Poland's strong economic growth potential. Poland began its ongoing educational reforms in 1999, and has successfully improved the quality of its education system. The 1999 reform set two important changes: delaying the choice of a vocational track by one year (to when students reach the age of 15), and expanding the supply of schools within the tracks while making them more homogeneous.[45] These reforms appear to have lifted Poland's educational performance, as measured by its average PISA scores from 2006 to 2012 (Figure 23).

This improvement in the strength of the future Polish workforce is another potential contributor to faster convergence.

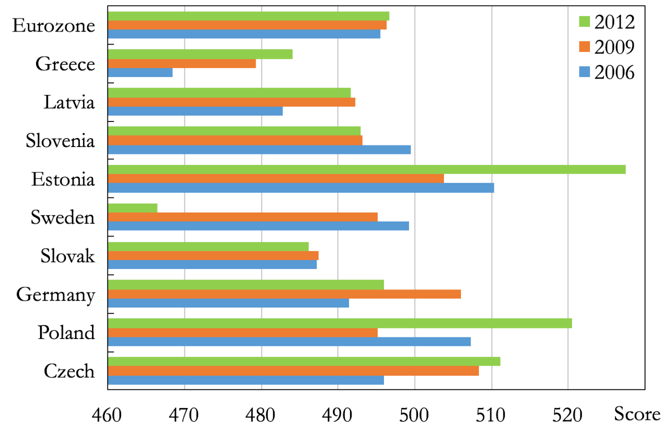
44 IMF, "Poland 2015 Article IV Consultation", [32].

45 World Bank, "Successful Education Reform: Lessons from Poland," *World Bank Knowledge Brief* vol. 34 (2014).

Figure 23

Education in Europe

Average PISA Scores



Source: https://nces.ed.gov/surveys/pisa/

3.3.3 The trade benefits of joining the euro area have been overstated, and Poland's trade shares with the Eurozone are decreasing as the rest of the world grows faster than Europe

Benefits accruing from trade creation were identified as a key reason for Poland's accession in 2004. The National Bank of Poland described trade benefits arising from increased specialization and a growing scale of production, technological and knowledge spillovers, and capital accumulation contributing to productivity and economic growth.[46] The prediction that euro adoption would generate increased trade with EMU countries was consistent with empirical estimates at the time. Rose (2000) found that two countries sharing a currency would trade three times as much as with different currencies.[47] Deciphering the precise cause of these large effects was largely left to speculation. Trade may increase due to some combination of lower transaction costs, price transparency, exchange rate certainty, a long-term political commitment to integration, or greater financial integration.[48]

Estimates of trade benefits from euro adoption have been revised downward since this time. Baldwin (2006) reports that the euro may have increased intra-EU trade by around 5 to 10 percent. Santos and Tenreyro (2010) find that the euro's effect on trade has been close to zero.[49] In 2015, The IMF revised earlier estimates of benefits of up to 25 percent down to zero to two or three percent. Rose (2015) himself concluded in a follow-up paper that euro adoption "has a mildly stimulating effect at best."[50] The trade effect within the Eurozone is lower than other currency unions more generally since Eurozone members consist of middle and high income countries, with already large tradable sectors. In addition, these countries were already deeply integrated, so the effect of a currency union is diminished.

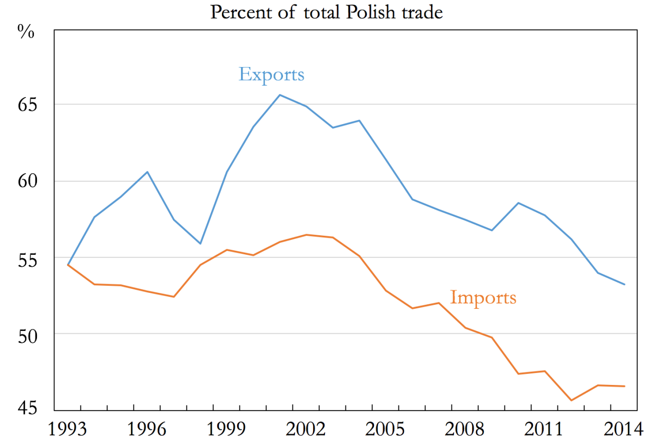
Poland should distinguish between trade creation and trade diversion.

While trade creation carries benefits, trade diversion to the Eurozone may not be desirable. Trade benefits arise through an increase in trade volume. If Poland increases intra-euro trade through euro adoption at the expense of non-Eurozone trade, Poland may not be better off. Indeed, Poland's trade with the Eurozone has been falling since the early 2000's (Figure 24).

Figure 24

Poland's Trade with the Euro Area

Percent of total Polish trade



Source: World Bank, World Integrated Trade Solutions

46 National Bank of Poland, *Report on the Costs and Benefits of Poland's Adoption of the Euro*, 50.

47 Rose, "One Money, One Market".

48 *Ibid*: 23.

49 João M. C. Santos Silva and Silvana Tenreyro, "Currency Unions in Prospect and Retrospect," *Annual Review of Economics* 2, no. 1 (2010): 54.

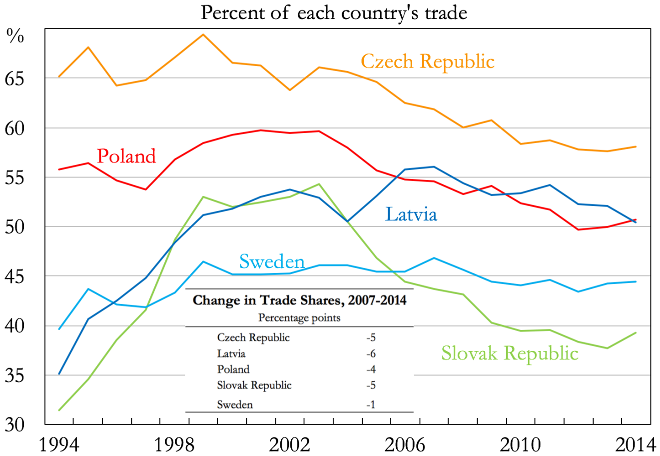
50 Rose and Glick, "Currency Unions and Trade", 1.

The Polish case is not an exception: trade shares with the Eurozone have fallen for a number of countries (Figure 25).

Figure 25

Trade with the Euro Area

Percent of each country's trade



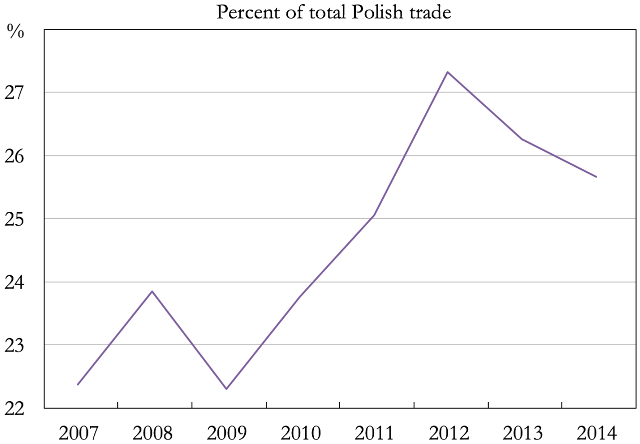
Source: World Bank, World Integrated Trade Solution database

While some of this decline is surely associated with the recent euro crisis, the decline began much earlier, suggesting a deeper trend. This likely reflects global changes in trade patterns as non-European emerging economies experience faster growth. Moving forward, shifting trade further toward these more dynamic non-European countries could be an important source of growth for Poland (Figure 26).

Figure 26

Poland's Trade with Middle/Low-income Countries

Percent of total Polish trade



Source: World Bank, World Integrated Trade Solution database

3.4 Conclusion: there might be limited economic benefits to adopting the euro, but there are considerable costs in terms of macroeconomic stability

Poland's economic outperformance in the past decade-and-a-half has been facilitated by the flexibility of its exchange rate regime and prudent economic management.

Indeed, having a fixed exchange rate regime – either through a peg or euro area membership – has been associated with destabilizing capital flows and limited policy options for other CEE countries, resulting in a costly adjustment process. These costly episodes appear not to be outliers, but may instead be inherent to the mechanics of a fixed currency regime. Although the recent shift toward 'macro prudential' policies might limit the future build-up of imbalances within the euro area, these policies have not yet been widespread enough or in place long enough to make an assessment.

At the same time, benefits to joining the euro appear to be limited. First, the oft-cited benefits from increased trade have not materialized for other euro area members. Second, Poland's policy framework to date has proven itself to have enough credibility without the 'external anchor' of the euro, allowing for Poland's solid economic performance despite the recent crisis.

Reforms to date have placed Poland in a good position to continue the process of convergence with its European neighbors. Structural reforms that have raised productivity and educational attainment have been achieved without the anchor of the euro. These reforms have made Poland a likely beneficiary of increased investment flows, which could facilitate faster income convergence, despite not having adopted the euro.

Therefore, the economic case for euro adoption in Poland is weak, provided Poland continues implementing effective domestic economic policy.

4 The Political Case for Euro Adoption

The decision to adopt the euro is not just an economic one. Political factors can override a weak economic case. This section describes the following four issues frequently raised in political considerations of euro adoption:

1. Euro adoption moves Poland into the fast lane of a 'two-speed' Europe.
2. The euro acts as insurance against external threats to sovereignty.
3. Public preference for euro adoption.
4. A legal obligation.

This section finds a weak case on all four factors. Poland is not disadvantaged by remaining outside the Eurozone since the Eurozone is catching up to Poland's fiscal and financial sector policies. Security benefits of euro adoption appear minimal due to Poland's membership in NATO. Public support for the euro has eroded since the global financial crisis, with just 24 percent of Poles supporting euro adoption. Since euro adoption would require a two-thirds majority vote in Parliament to change the constitution, it is difficult to see political capital being spent on the issue. And while Poland's EU accession came with a temporary derogation on euro adoption, Poland only agreed to join at some time in the future. No promises are violated through continued delay. This frees Poland to fully consider the current preferences of the Polish electorate, the post-2008 experience of the European common currency, and new advice from the IMF, NBP, and various other sources, all of which suggest caution.

4.1 Two-speed Europe

European leaders have signaled political intent for deeper integration. Integration efforts are focused on the weaknesses highlighted by the euro crisis. This places Eurozone members at the core of integration efforts. Since Poland remains outside the Eurozone, it is peripheral to these integration efforts. The contrast in integration speed between Eurozone members and European Union members is commonly described as 'two-speed' Europe. This form of integration creates a 'core' and a 'periphery'.

Eurozone accession could theoretically strengthen the Polish voice with deeper European integration. Euro adoption would bring Poland into the core and provide greater opportunity for Eurozone influence. Poland could influence the Eurozone agenda and actively participate in institutional and policy settings. To the extent that Polish authorities view this as a benefit, it creates a catch-22 for Poland. Were Poland to join the Eurozone, its authorities could be a more effective advocate for institutional reforms that would make the EMU better suited to deal with economies in crisis. Such reforms include automatic stabilizers, appropriate Europe-wide budgets, fiscal transfer mechanisms, and deeper banking integration. But without those measures, Poland would be joining a project marked by deep institutional fragilities.

The 'two-speed' Europe and 'seat-at-the-table' argument has existed for as long as the Eurozone. The 1997 Swedish report on Eurozone adoption states:[51]

> "The main political argument for participation in the monetary union concerns the possibilities for the influence within the EU. It is likely that the countries that participate in the currency union will have a leading role in overall EU cooperation and greater possibilities to influence the political agenda. Being a part of this group could

51 Lars Calmfors et al., *EMU: A Swedish Perspective*, Dordrecht: Kluwer Academic, 1997, 32.

be especially important for a small country, with few possibilities to influence the agenda if it acts alone."

As demonstrated by Sweden's choice to remain outside of the Eurozone, this is not decisive for euro adoption. Sweden's absence from the Eurozone table does not appear to have hurt it. One explanation is that Europe-wide policymaking has important limitations. For instance, Darvas and Leandro (2015) show that European Semester decisions are only sometimes implemented by Member States. Only 40 percent of decisions in the European Semester had been implemented by Member States in 2011. By 2014 this had fallen to 29 percent.[52] The authors argue that preferences for national sovereignty will increasingly place limitations on Eurozone policymaking. If such limitations on Europe-wide policy dominate, the value of a seat-at-the-table is in jeopardy.

The cachet from being in the European 'fast lane' should not influence euro adoption since integrating with the Eurozone could be costly to macroeconomic stability. During the crisis, Poland's monetary policy was tailored to its needs, which would not have been the case if Poland were under ECB's monetary policy. Poland's fiscal management allowed for counter-cyclical policy; Poland has the necessary supervisory infrastructure to support a banking sector dominated by foreign banks; and banking regulation is appropriately conservative and widely considered to be amongst the best in Europe.

4.1.1 Poland has effective fiscal policy while the Eurozone does not

The euro crisis exposed numerous institutional weaknesses in EMU fiscal oversight. Public finances that appeared sustainable were later revealed unsustainable, fueled only through asset bubbles. The fiscal rules set out in the Stability and Growth Pact were enforced inconsistently and sometimes counterproductively. For example, the Czech Republic faced pressure to unwind its fiscal stimulus early because they were placed in Excessive Deficit Procedure.

Eurozone efforts to overcome these problems look inadequate. Additional measures include the Six Pack, Two Pack, and the European Semester. These policies emphasize public debt and fiscal discipline throughout the business cycle; the European Stability Mechanism provides loans during times of crises. Despite these measures, however, EMU fiscal policy ultimately looks remarkably similar to that in place pre-crisis.

In contrast to the Eurozone, Poland has the capacity to implement effective counter-cyclical fiscal policy. Because of rigid numerical rules, European fiscal policy tends to be pro-cyclical. Poland ran a government surplus in the years leading up to the crisis and was able to run a large fiscal expansion during the crisis. Following this, it has returned to surplus. Counter-cyclical fiscal policy helps to smooth consumption and create a sustainable growth path.

4.1.2 Poland has effective banking supervision and regulation while the Eurozone does not

Further progress on a European banking union faces political constraints. Many European political leaders have opposed fully funding capital backstops for the banking union because of the possibility of cross-national transfers. If these challenges turn out to be insurmountable and Europe continues without adequate and timely resolution mechanisms, capital backstops, and a common deposit guarantee fund, then the system will continue to pose serious risks to its members. This would represent a large step backward for Poland.

Contributing to a European Deposit Guarantee Scheme (DGS) could be costly and duplicative. Poland already has a deposit insurance fund. Joining the Eurozone may require contributions to a European DGS that exceed the

52 Zsolt Darvas and Alvaro Leandro, "The Limitations of Policy Coordination in the Euro Area under the European Semester", Brugel Policy Contribution, Issue 2015/19, November 2015, 2.

cost of a domestic scheme, with Poland having limited say in how these funds are used.

Poland's banking supervision and regulation is among the best in Europe. Poland entered the euro crisis with a strong banking sector, which had limited credit growth and the formation of property bubbles. It is not clear how Poland would do better if it became part of the euro supervision and regulatory system. Indeed, Poland could lose control over domestic banking supervision upon euro adoption.

Poland benefits from having its own bank capitalisation rules. The Polish Financial Supervision Authority (KNF) requires that Polish subsidiaries of foreign-owned banks are properly capitalized. This further improves domestic financial stability, particularly since over half of the Polish banking system is foreign-owned. Eurozone rules on capital management might prevent Poland from keeping this additional layer of protection.

The continued dominance of national sovereignty makes a fully functioning monetary union a challenge that will remain hard to overcome.

In particular, the requirement of ceding considerable proportions of fiscal responsibility to a supranational authority, which will inevitably transfer resources to other nations, remains a barrier that member states are not able to breach. The success of the Eurozone's new initiatives therefore appears uncertain, irrespective of Poland's influence upon euro adoption. Adopting the euro for the purposes of a stronger European voice should not dominate the goal of having macroeconomic stability.

4.2 Geopolitical and security considerations are not critical to euro adoption

For some, euro adoption would provide additional insurance against future threats. In March 2015, Poland's former president and Nobel laureate Lech Wałęsa summoned Poland to join the euro, stating, "this is the last move to make Poland's security complete."[53] Poland's proximity to the recent Ukraine-Russia conflict has reinvigorated this argument,[54] where euro adoption is seen as a way to lock Poland tightly to Europe's core, giving further protection.

The Baltic countries emphasized security concerns in their euro adoption decision. Euro membership is seen as advantageous since a foreign threat may compel European involvement. The particular emphasis on security comes about from two factors. First, the small size of the Baltic countries, both in GDP and territory, magnifies geopolitical concerns. Second, the Russia-bordering Baltic states—Estonia, Latvia, and Lithuania—have large populations of ethnic Russians[55] and are dependent on Russia energy resources.[56] The Aspen Institute summarizes the argument by stating that "[t]he closest possible integration with the core of the European Union enables the Baltic states to distance themselves geopolitically from Russia."[57]

However, Poland differs greatly from the Baltics. Poland was never a region of the Soviet Union, does not have a large ethnic Russian population, and is a much larger country in terms

53 "Poles Reject Euro, as Nobel Laureate Wałęsa Calls for Adoption ASAP," Polskie Radio Dla Zagranicy, Radio Poland, 26 March 2013.

54 Karolina Slowikowska, "Poland Will Join the Euro but Not for 'several Years': PM Tusk," Ed. Toby Chopra. Thomson Reuters, 9 Apr 2014.

55 There are significant Russian minority populations in all three Baltic countries, which Russia has previously capitalized on to destabilize political situations. For example, in the spring of 2012, Russian representation in Latvia rallied Russian minorities to force the country to hold a referendum to make Russian the second official language in Latvia.

56 In 2013, Russia's Gazprom was in control of Latvia's natural gas reserve (the only one in the Baltics). Thus, Russia could directly manipulate gas and heating prices in the Baltics.

57 Martin Ehl, "The Baltic States and the Euro: Protection from the Global Crisis (and Russia)," Aspen Institute, January 2013.

of population, territory, and economy. As Kerry Longhurst points out, "Poland has the largest armed force in the Central European region and is the biggest spender in both real and proportional terms on [defense]."[58]

Poland's NATO membership is a much more effective deterrent against security threats than Eurozone membership can ever be. NATO and Poland are firmly committed to their relationship. Following the Ukrainian crisis, NATO has increased its commitment to Poland by deploying heavy weaponry to the country, by establishing a NATO command center in Poland, and by initiating the Readiness Action Plan to more quickly deploy NATO forces.[59] Warsaw is scheduled to host the NATO Summit in 2016.

Poland's NATO membership, not EMU membership, will be the mechanism to deter security threats.

EMU membership would do little, if anything, to sway NATO to fulfill Poland's policy objectives. For instance, several influential NATO members are not even NATO members and likely have little interest in Poland's euro adoption.

4.3 Public opinion does not support adoption

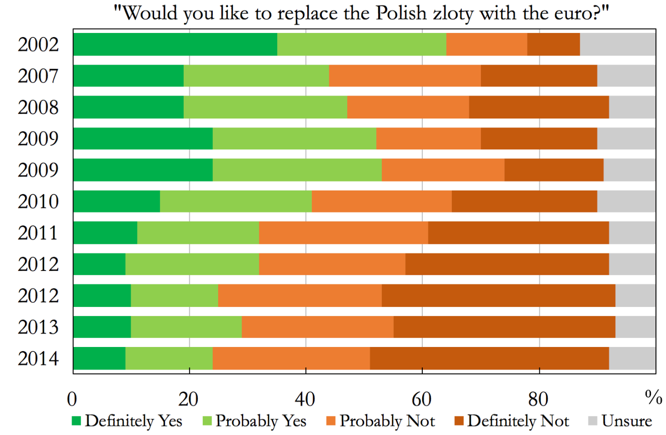
In the early 2000s, there was majority support for euro adoption. In a 2002 CBOS survey, 64 percent of Poles either definitely or probably supported euro adoption (Figure 27).

This may have reflected some optimism about the bold new European project as many of those not in the first wave began preparations to join the Eurozone. A national referendum on joining the European Union and Eurozone was held at this time, with 77.6 percent of Poles supporting accession and euro adoption.[60] It is unclear whether the reasons to join the euro were well

Figure 27

Support for the Euro

Percent of respondents answering the question,
"Would you like to replace the Polish zloty with the euro?"



Source: CBOS (2014), *Heightened Awareness with the Introduction of the Euro*, November

understood at the time, or at least distinguished from joining the European Union. Europe was regarded then—and continues to be regarded now—as a force for economic and political development. In any case, perceptions of euro adoption were almost certainly blurred with perceived advantages of closer European association.

Since this time, there has been a marked and persistent decline in euro support. Support began to wane in 2007 and accelerated after 2010. By 2014, just 24 percent of Poles either definitely or probably supported euro adoption. While the precise reasons for decline are hard to pinpoint, problems in the Eurozone together with a relatively strong Polish economy surely played a part. The blurring of European Union and Eurozone membership preferences has disappeared. While euro adoption has fallen out of favor, support for the European Union increased throughout the early 2000s, peaked in 2007, and remains steady at just above 80 percent (Figure 28).

58 Kerry Longhurst, "Where from, Where to? New and Old Configurations in Poland's Foreign and Security Policy Priorities," *Communist and Post-Communist Studies* 46, no. 3 (2013): 363.

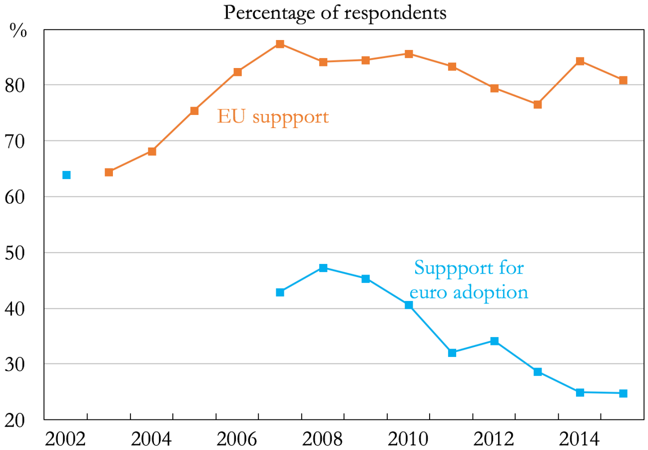
59 Thomas Barrabi, "NATO Won't Establish Permanent Military Bases In Poland Amid Russia Tension, US Diplomat Says," *International Business Times*, 22 July 2015.

60 CBOS raw data, (2015).

Figure 28

Support for the EU vs. Supprt for Euro Adoption

Percentage of respondents



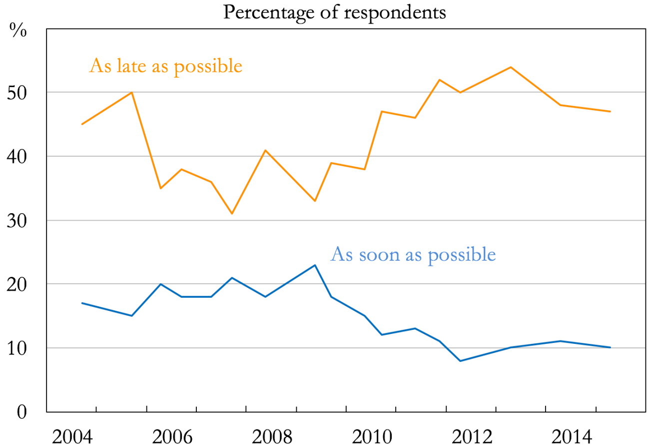
Source: CBOS

In line with an overall decrease in euro support, there is also clear preference to push euro adoption to as late as possible (Figure 29). Interestingly, Poles have long preferred later adoption, but this began to intensify in 2005.

Figure 29

Desired Adoption Timeframe in Poland

Percentage of respondents



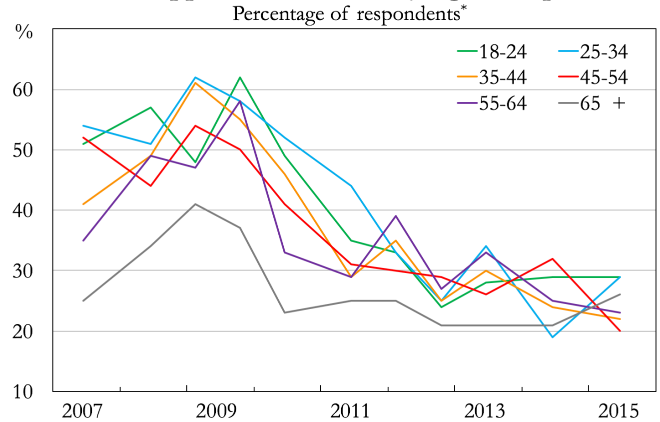
Source: Flash Eurobarometer

Disapproval for euro adoption is broad based, occurring at almost all age groups, with the exception of 65 and over (Figure 30).

Figure 30

Support for the Euro by Age Group

Percentage of respondents*



* Respondents replying yes to the question, "Would you agree to replace the Polish currency (PLN) with one common to many EU countires - the euro?"

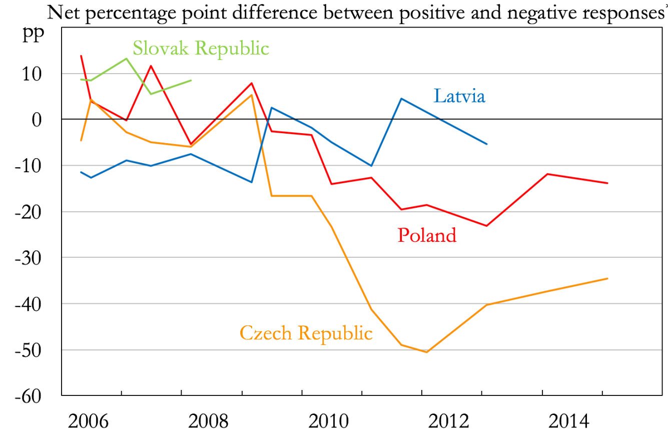
Source: CBOS

In comparison to neighboring countries, Polish pessimism about joining the Eurozone is exceeded only in the Czech Republic (Figure 31).

Figure 31

Support for the Euro by Country

Net percentage point difference between positive and negative responses*



* From the question, "Do you think the introduction of the euro would have positive or negative consequences for you personally?"

Source: Flash Eurobarometer, 'Introduction of the Euro in the Member States that have not yet adopted the Common Currency'

The legislative process for euro adoption requires significant political cooperation. Euro adoption involves changing Poland's national constitution. This requires a two-thirds majority in Parliament, a majority in the Senate, and approval from the President.[61] An optional referendum can

61 Richard J. Hunter and Leo V. Ryan, "Poland, the European Union, and the Euro: Poland's Long Journey to Full European Integration." *Global Economy Journal* 9, no. 2 (2009): 1–20.

be called by either body of the legislature or the President within 45 days after the amendment is approved by the Polish Senate. As Visvizi and Tokarski write, this process "drives the stakes of the political power game high and effectively limits the Polish government's capacity to proceed with politically costly reforms."[62] Successfully navigating this process demands broad based political support, and involves cooperation of the two biggest parties, Law and Justice (PiS) and Civic Platform (PO). Effectively, therefore, changing the constitution likely requires a substantial reversal in public preference for euro adoption. Given current polling statistics and the high bar for constitutional change, the legislative path for euro adoption seems prohibitively difficult.

4.4 A legal obligation does not generate urgency

It is commonly argued that Poland has already made a decision on euro adoption following the 2003 referendum, and that Poland should fulfill this obligation quickly.

While EU accession did create a legal obligation to join the euro, the obligation lacked an enforceable timeline.

As such, Poland does not violate any promises by continuing to delay. In fact, Poland would do well to consider the preferences of the Polish electorate, the post-2008 experience of the European common currency, and new advice from the IMF, NBP and various other sources, all of which suggest caution.

62 Visvizi and Tokarski, "Poland and the Euro".

5 Conclusion

European integration is an important source of prosperity for Poland. Economic integration from free trade and labor mobility, together with security integration, is non-controversial among economists. Poland has benefited greatly from these policies in the form of faster convergence and better overall standards of living. Such policies represent best practice the world over.

But while Poland benefits from such integration, it also draws strength from national policy. Poland was the only country in the European Union to avoid recession during the euro crisis. This is not a coincidence, but reflects the value of monetary flexibility together with a strongly regulated banking sector. These policies proved decisive in Poland's recent economic performance.

Euro adoption would increase risk to the Polish economy without providing any meaningful benefit. While the IMF and NBP stop short of explicitly advising against euro adoption, the evidence both from these institutions and the economic literature more broadly support this view. Poland should not join the Eurozone for the foreseeable future.

Instead of joining the Eurozone, effort should focus on prudent macroeconomic policy, supported by strong domestic institutions and good governance. Doing so will maintain policy credibility and remove the need to import monetary policy from a European institution. The macroeconomic levers to Poland's economic aspirations are best wielded by Poles themselves.

Integration-at-all-costs is no path to prosperity. Instead, a judicious approach to European integration is best. None of this prevents Poland from continuing as a strong and reliable partner of the European Union; indeed, Poland's own economic strength is the best way it can support Europe.

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Acronym Glossary

CBOS	Centrum Badania Opinii Społecznej (Centre for Public Opinion Research)
CBR	Council for Budget Responsibility
CEE	Central and Eastern Europe
CNB	Czech National Bank
DGS	Deposit Guarantee Scheme
ECB	European Central Bank
EMU	Economic and Monetary Union
ESM	European Stability Mechanism
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IMF	International Monetary Fund
KNF	Polish Financial Supervision Authority
LEWIATAN	formerly Polish Confederation of Private Employers Lewiatan
MPC	Monetary Policy Council
NATO	North Atlantic Treaty Organization
NBP	National Bank of Poland
NBS	National Bank of Slovakia
NMS	New Member States
OPZZ	Ogólnopolskie Porozuminie Związków Zawodowych (All-Poland Alliance of Trade Unions)
PAN	Polish Academy of Arts and Sciences
PiS	Prawo i Sprawiedliwość (Law and Justice Party)
PO	Platforma Obywatelska (Civic Platform)
REER	Real Effective Exchange Rate
SRM	Single Resolution Mechanism
SSM	Single Supervision Mechanism
WSE	Warsaw School of Economics

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Photo credit: Duc Tran

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