

Currency Regimes in Poland During European Integration Process

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Abstract

The article analyses the currency regime in Poland during the transition process. The analysis starts with the beginnings of transition process when so called internal convertibility was introduced in Poland. But the main part of the article refers to present and possible future solutions in the field of currency regime in Poland. Poland should access European Monetary Union (EMU). The key decisions in that process are analyzed.

Key words

Currency regime, Poland, Exchange rate, Free float, Adjustable peg, Crawling Band, European Monetary Union (EMU), Euro, European Central Bank (ECB), Exchange Rate Mechanism II (ERMII).

1 Preface

Exchange rate and currency regime are key factors of equilibrium in balance of payment as a result of central bank's credibility. Trade balance and capital movement as the most important parts of balance of payment are very sensitive to exchange rate and credibility of a country. The currency regime could be described as all solutions undertaken in the country in order to determine the exchange rate and to achieve the equilibrium in balance of payment.

There are various possible regimes for a country. The most frequently used classification the one distinguishing regimes into fixed pegs and floating pegs.

2 The currency regimes

Among fixed pegs regimes there are regimes with fixed peg vis-à-vis single currency and with fixed peg against a basket consisting of currencies of major trade partners and / or international currencies (i.g. SDR). The market exchange rate may fluctuate in very narrow band ($\pm 1\%$) against official exchange rate. The fixed parity is kept thanks to market intervention and / or excessive use of monetary instruments. The monetary policy is subordinated to maintenance exchange rate regime.

On the other end of possible solutions there are floating regimes. Country can apply free floating. This regime means that exchange rate is determined by currency market demand and supply. Central bank assumes no market intervention, no influence on the currency market. Market intervention could not be justified. Monetary policy and exchange rate policy are independent.

There are also a managed floating exchange rate policy. In this case central bank influence exchange rate by the currency market intervention and the monetary policy. The central bank's adjustments are not automatic. The central bank takes into account in decision making process such factors as balance of payment position, foreign currency reserves or developments on international currency market.

Numerous intermediate regimes can be put into effect. The horizontal band for an exchange rate means that the exchange rate may fluctuate around the fixed central rate within

determined margin (at least $\pm 1\%$). The central bank declares to defend the regime with central rate and the band. Instruments enabling to do so are market intervention and the monetary policy.

Other solution can be taken into account in case of inflation difference between country and their main partners. The one is called crawling peg. It means that central (official) rate is adjusted at regular intervals. The other regime is a Central European countries solution. It is the crawling band. The currency rate fluctuates within margins around central rate. The central rate is adjusted (even on a daily basis) to inflation difference.

3 The regimes in Poland in transition to market economy

Before 1990 Polish currency was an unconvertible currency with fixed rate. There were so called black market and because of hyper inflation citizens and private companies used foreign currencies to settle their assets and liabilities. In this situation on the 1 January 1990 internal convertibility and fixed exchange rate was introduced. Internal convertibility means that it wasn't allowed to use Polish currency abroad. Also firms weren't allowed to have currency accounts. The rate was fixed at 9 500 zloty for US dollar – much less than price on so called black market. The fixed rate was intended as an anchor against inflation and an stabilizer of economy. It was intended to be maintained for only first quarter of 1990. But in fact it existed until may of the next year.

There was a stabilizing fund of 1 billion dollars organized by International Monetary Fund. The government was feared that demand for foreign currency could be too high. The fund was intended to secure additional supply of dollars and other currencies. But in the matter of fact the fund wasn't used for that purpose. So called parallel market was introduced. It was organized by exchange offices. On this market was in force free exchange rate. But in comparison to the official rate the difference was surprisingly small.

The exchange rate was intended to fulfill two conditions. The first one was to facilitate inflation reduction. The other one was to make Polish export profitable. But what was primarily acceptable by exporter, shortly became an object of criticism. Inflation and fixed rate made export less and less profitable. In this conditions a first change was introduced on 17 May 1991. Devaluation of Polish zloty took place. The new US dollar price was set at 11 000 Polish zloty. Simultaneously another change took place. The Polish zloty was based on a basket consisting of US dollar (45 percent of a basket), German mark (35%), British pound (10%) and French and Swiss francs (5% each). The currencies in the basket was set according to payments received by Polish exporters.

Another significant change took place on 14 October 1991. A crawling peg was introduced. Primarily zloty was losing 1,8% of its value to the basket. Every day central bank was announcing new rate. The basket was gaining 9 zloty every day against Polish zloty. Until next important alternation took place there were several adjustments done as the inflation in Poland lowered.

The next important change took place on 16 May 1995 when crawling band was introduced to the Polish currency regime. The band primarily was set at $\pm 7\%$ in relation to central rate. Several adjustments to the value of basket took place. The band was widened. The Polish currency regime since that was based on three elements:

- Central rate announced by central bank on a daily basis,
- Band (primarily $\pm 7\%$),
- Currency fixing for two currencies: US dollar and German mark.

Table 1 Polish currency regime Since 1990

Date	Decision
1st Period — fixed rate 01.01.1990 - 13.10.1991	
01.01.1990	Polish zloty based on US dollar: 1 USD = 9 500 PLZ
17.05.1991	devaluation 1 USD = 11 100 PLZ (about 15%) basket composed of five currencies: USD — 45%; DEM — 35%; GBP — 10%; FRF — 5%; CHF — 5%
2nd Period – crawling peg 14.10.1991 15.05.1995	
14.10.1991	PLZ devaluation 1.8% monthly (9 PLZ daily)
26.02.1992	Single devaluation 12%
27.08.1993	Single devaluation 8%, PLZ devaluation 1.6% monthly
13.09.1994	PLZ devaluation 1.5% monthly
15.11.1994	PLZ devaluation 1.4% monthly
01.01.1995	Denomination in Poland 1 PLN = 10 000 PLZ
16.02.1995	PLN devaluation 1.2%
3rd Period — crawling band 16.05.1995 - 11.04.2000r.	
16.05.1995	Introduction of crawling peg towards central rate (-/+ 7%)
01.06.1995	Zloty becomes convertible according to 8th Article of the IMF Statute
22.12.1995	Single devaluation 6%
08.01.1996	PLN devaluation do 1% monthly
14.02.1998	PLN devaluation 0.8% monthly
26.02.1998	Band width $\pm 10\%$.
17.07.1998	PLN devaluation 0.65% monthly
10.09.1998	PLN devaluation 0.5% monthly
29.10.1998	Band width $\pm 12.5\%$.
01.01.1999	Basket change: USD – 45%, EUR – 55%.
25.03.1999	PLN devaluation 0.3% monthly Band width $\pm 15\%$.
7.06.1999	New principles of the average exchange rate
4th Period — free float 12.IV.2000r.	
12.04.2000	Free float introduced: no central rate, no band, no monthly devaluation

Source: PUSZER B.: *Kurs walutowy jako instrument oddziaływania na polski eksport w latach 1997-1999. Praca doktorska.* Akademia Ekonomiczna w Katowicach. Katowice 1999. p. 83 and Polish Central Bank.

The fixing allowed central bank's clients to close a deal with central bank on conditions set – let say – auction. The Polish Central Bank declared to the International Monetary Fund to fulfill requirements of the 8th Article of the IMF Statute effective since 1 June 1995. This way zloty become an convertible currency. In the beginning of 1999 Euro replaced all currencies except US dollar in Polish zloty basket. The new basket consisted of US dollar (55%) and Euro.

Late nineties is a time of currency crises in several countries. Polish Central Bank observes other central banks (mainly in far east) losing their currency reserves. Bank is afraid of own reserves. Polish zloty and Polish exchange market are rather stable. The band is now +/- 15% wide. Inflation lowers enabling to devalue zloty only 0,3% against basket. In this conditions another important change to the Polish currency regime was introduced.

On 12 April 2000 free float was introduced. The Polish National Bank reluctantly intervene on the foreign exchange market. Since that market volume increases. Exchange risk for companies increases so they are more interested in managing that risk.

4 The decisions to come

Poland was among 15 new European Union members. EU member states are generally obliged to adopt Euro. To fulfill this obligation country has to meet the requirements of convergence criteria. They are presented in the table number two.

Table 2 Convergence criteria

1.	inflation shall not be higher then exceeded by 1,5 percentage point the average level of inflation in those three EU countries that observe the lowest inflation,
2.	budgetary deficit shall not excide 3% GDP of the country,
3.	government debt shall not be higher than 60 % of GDP,
4.	long term interest rate (10 years government bonds) shall not excide by more than 2 percentage points the average interest rate of those EU countries that observe the lowest level of inflation,
5.	exchange rate should be stable for at least two years.

Source: European Central Bank

Among convergence criterias there are one that refers to the exchange rate. This criteria mean that a country before adopting Euro should adopt European Exchange Rate Mechanism (ERM, currently second version). This mechanism actually means that country has to introduce horizontal $\pm 15\%$ band. For Poland it means that central bank will have withstand the fears leading to free float.

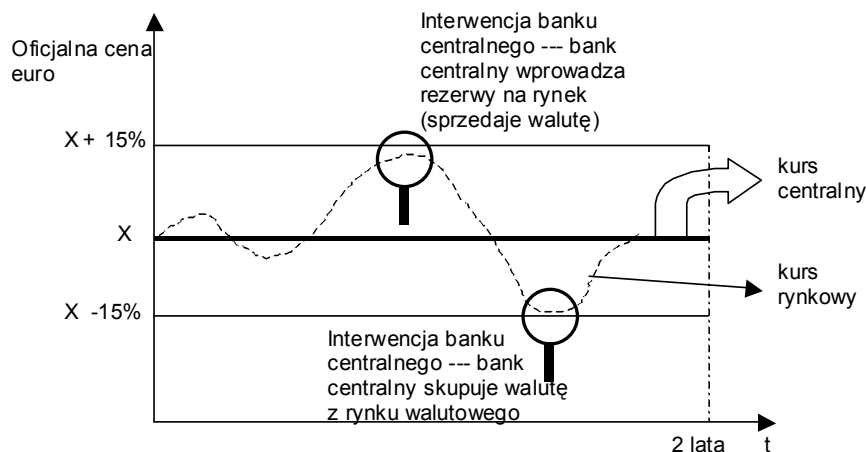


Chart 1 Exchange Rate Mechanism (ERM)

Thus adopting Euro in Poland (and other non-EMU EU countries) require to adopt horizontal band and keep this system for at least two years. There was in Poland proposals to take a short cut. One of them was so called euroization. It means that a legal tender becomes Euro and domestic currency is withdrawn. Another proposition for Poland was so called currency board. It requires not only to replace domestic currency with euro but also it means to limit money circulation to the amount of foreign assets held by the central bank. The European Commission and the European Central Bank objected to this solutions arguing that it would be against Treaties and unfair for other EMU countries. The present EMU countries

had to fulfill all the requirements of convergence criteria. In present those solutions are passed over.

The only way to European Monetary Union leads through convergence criteria. In 2004 two important publications that analyses Poland's fulfillment of the convergence criteria were released. The first one was the one of The Polish Central Bank¹. The central bank opts for quick EMU access. Poland fulfils most of the criteria (only budgetary deficit is to high). Authors underline that there are more advantages than disadvantages of Polish membership in EMU that Poland should as quickly as possible fulfill the remaining criteria and take advantages of EMU membership. Europe's (Commission and ECB) answer to this report was to warn Poland against quick EMU membership. There were opinions that Europe may change for some EU countries ERM principles, e.g. narrow band of only $\pm 2.25\%$ or extend the time when country will have to stay in the ERM.

The other publication is the one published by European Central Bank². This report is not so good for Poland. It is also more important because ECB assesses the fulfillment of the convergence criteria by potential new EMU members. According to this report Poland meets the requirement of only one of the criteria: public debt. In all other cases Polish performance is to weak. According to mentioned report Polish debt in comparison to GDP equals 47%. In case of budgetary deficit the criterion is 3% of GDP. Poland noted 5,6%. Inflation for three best countries exceeded by 1,5% reached 2,4%. ECB noted for Poland 2,5% — bit above criterion. The interest rate criterion was 6,4% and ECB for Poland noted 6,9%³. Poland hasn't introduced European Rate Mechanism so doesn't fulfill the Exchange rate criterion.

There are opinions in Poland for quick EMU access (these comes mainly from central bank), others want to postpone the moment of EMU accession. Some reasons for quick and slow accession are presented.

Poland can try to EMU access because has well-developed foreign exchange market. There are term instruments that can be used to reduce currency risk. The turnover increases. The central bank — as he claims — has reserves high enough to defend the zloty in ERM. EMU membership may allow exporters to perform better. Two-third of Polish export goes to EU, two-third of import comes from EU. No need of currency change will facilitate trade and reduces risk for long term decisions. EMU membership may facilitate foreign investors to make a decision to invest in Poland. This should mean for them low labor costs and full EU market access.

Against EMU membership at all is the fact that this is a one-way road. There are no exit from the EMU. If anything goes wrong — in may be very harmful for Poland. Exporters are very afraid of an exchange rate set at the beginning of two – year ERM membership. The stronger zloty means the less profitable export. Theoretically the rate can be changed just before EMU membership. But till now practice shows that rate set at the beginning of the ERM membership is used to convert all prices into Euro.

Another dangerous factor for EMU access may be effects known as the Balassy – Samuelson Effect. The economy which quickly opens to the foreign markets especially noticeable increases the effectiveness. Of course some of the sectors are more experiencing this process – these which have to compete on the market with foreign products. In other the competition with foreign products is not so high. In the first group of sectors increases profitability and salaries. The other sector's employees after a while have to increase salaries but it isn't an effect of better performance. Thus it may cause inflation. Strong commitment to reduce inflation- as required by the nominal convergence – may cause regression and

¹ Raport na temat korzyści i kosztów przystąpienia Polski do strefy euro. Narodowy Bank Polski. Warszawa 2004.

² Convergence Report. European Central Bank. Frankfurt a/Main 2004.

³ Convergence Report. European Central Bank. Frankfurt a/Main 2004. p. 21

problems in real convergence. Too strong commitment to reduce inflation may cause problems for the domestic economy in the EMU. The enlarged EMU may not create an optimal currency area.

European Monetary Union is a fact. Poland and other new EU countries have to access EMU. This may bring them many advantages. But the process of adopting EMU is quite complicated and many important decisions must be taken. As the real convergence is one of the most important factors of sound EMU membership, countries shouldn't hurry.

Literature

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Summary

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