10 Economic Performance in Poland under Fixed and Flexible Exchange Rate Regimes

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INTRODUCTION

During the last decade, Europe has experienced a remarkable increase in the integration of economic, political and social structures. In the European Union, this process of integration culminated in the Economic and Monetary Union (EMU). EMU formally started on 1 January 1999 with the replacement of national currencies by a common currency, the euro, and the replacement of national monetary policy autonomy by a common monetary policy implemented by the European Central Bank (ECB). The introduction of the euro and the so-called Eastern Enlargement of the EU – first outlined in the Treaty of Copenhagen in 1993 and further developed in the EU Council Meeting in Madrid in 1995 and the recent Agenda 2000 – offers economies in transition in Central and Eastern Europe (CEEC countries) the possibility to embark upon a process of integration and convergence that should lead in the end to their accession into the current EU 15.

A comprehensive overview of macroeconomic design in Poland during the period 1990–98 is given by Durjasz and Kokoszczynski (1998) and Gomulka (1998). The adjustment in monetary and fiscal policy, exchange rate management and capital mobility are analysed. Since October 1991 the exchange rate policy of a pre-announced crawling peg is in place which seeks to strike a balance between containing inflationary pressure and to maintain competitiveness. Both the rate of crawling and the bandwidth have been adjusted several times to adjust to changes in nominal and real developments in the Polish economy. An important issue in this period has been the increasing capital inflow with considerable repercussions for monetary and exchange rate management. Foreign direct investment and net portfolio investment led to recent surges in capital flows and reserve accumulation. Successive liberalization of capital in and outflows also contributed to larger capital flows. Sterilization attempts were ineffective and abandoned in 1995 when exchange rate and interest-rate policy were instead explicitly directed at containing...
capital inflows. Since 1997 the current-account balance turned into a deficit given a strong surge in consumption and investment and only a modest export performance. Throughout the period the fiscal policy has been mildly expansionary with fiscal deficits around 2.5–3.0 per cent of GDP.

Poland’s way towards the EU will have a strong effect on its present and future macroeconomic policies and vice versa. In particular, we will focus on the effectiveness of two polar types of exchange rate management – fixed and flexible exchange rates – for Poland during adjustment towards the EU. The two exchange rate regimes differ significantly in the transmission of monetary and fiscal policies conducted in Poland and of macroeconomic disturbances in the EU into the Polish economy. Therefore, the choice of the exchange rate regime of the zloty versus the euro will be of crucial importance for the Polish economy during its convergence process. The policy of the fixed zloty/euro exchange rate would imply, for example, a drastic move from the current exchange rate policy that prescribes a target zone for the zloty against a basket of major currencies. Assuming the euro to be strong, pegging the zloty to the euro – if credible – will provide monetary discipline that is likely to provide considerable benefits. That was experienced earlier by small EMS countries while pegging their currencies to a strong deutsche mark. Inflexibility in case of asymmetric shocks, domestic policy impulses and disturbances in the EU are likely, however, to bring considerable adjustment costs to the Polish economy at the cost side. Since it is very likely that the Polish economy will operate under the fixed exchange rate regime in the future, we regard the flexible exchange rate regime as an opportunity exchange rate system.

This chapter studies the problem of a macroeconomic policy in a transition economy – Poland – that considers future accession into the EU and EMU. We analyse the most important interactions between the Polish and EU economies and the impact of a further integration and convergence process. To analyse the implications of a given policy we propose a stylized model of the Polish economy. Especially, the relations for the demand for goods and the balance of payments all include parameters for a transition economy. The parameters enable us to analyse the effects of the macroeconomic policies and foreign shocks on the development of output, prices and the exchange rate within a framework of the transition process. The effects of macroeconomic policies are studied where the focus is on three traditional macroeconomic policy instruments: (i) fiscal policy, (ii) monetary policy and (iii) exchange rate management. Moreover, we analyse effects of interactions between the Polish economy and the EU economy. We study macroeconomic policy dilemmas that are likely to arise during the adjustment process towards entrance into the EU and EMU.

The analytical solution of the model allows for simulation analysis. Different scenarios can be defined: alternative monetary and fiscal policies, as well as shocks to foreign interest rate, prices and demand. The chapter is structured as follows: in