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Meeting the nominal and legal convergence criteria of the euro area by Poland*

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Abstract

Under the Treaty on Poland’s accession to the UE, the country is obliged to introduce the euro. By that date Poland has a status of a country with derogation from the euro zone.

Due to the significant uncertainty concerning the time horizon in which the requirements for the safe adoption of the common currency can be met, as well as because of lack of strong public opinion support in the country, Polish government at present is not specifying a target date for the euro adoption.

In view of the improving economic situation in 2014 and a lot of measures undertaken by the government in several recent years in order to exit the excessive deficit procedure, Poland seems to be ready to meet economic convergence criteria in 2015. The best situation is as regards meeting the public debt criterion which has risen steadily over the past few years but the level has been all the time well below the 60% of GDP ceiling and is expected to decrease in the next few years.

Successive yearly convergence programmes prepared by Poland (in the framework of coordination of macroeconomic policies of EU Members) have outlined in an integrated manner the fiscal consolidation efforts, the key structural reforms and the reforms that underpin macroeconomic stabilisation.

An additional factor, apart from Council’s recommendations and Polish convergence program, stimulating activities towards fiscal improvement should be Poland’s participation in a strengthened economic governance architecture recently introduced in the EU.

The uncertain situation in the euro zone on one hand, and lack of strong public opinion support for the idea of the euro adoption have, however, postponed adoption of a clear timetable of joining the euro zone. The final decision will depend much not only on the improvement of the domestic macroeconomic situation but also on the evolution of the situation in the euro area.

Even more important element affecting the organizational and legal preparations (but not the efforts to improve the economic situation) for the euro adoption will be the new political situation in Poland after the 2015 parliamentary elections.

Key words: nominal convergence (Maastricht) criteria, fiscal stabilization, Poland’s budgetary situation, EU economic governance, Economic and Monetary Union (EMU).

JEL: E61, E62, F33,
• **Introductory remarks**

The adoption of the euro by Poland is an integral part of country’s Treaty on accession to the EU in 2004. As Poland was not prepared to adopt the euro in 2004, it declared to conduct a policy aimed at fulfillment of necessary criteria. The date of future entrance to the euro area has not been set up. From a legal point of view Poland has been a member of the Economic and Monetary Union (EMU) since accession, but it uses its own currency, as it has not yet entered the third stage of the EMU yet. These countries are called “Member States with a derogation” (art. 139 of TFEU). Thus, in the case of Poland the question is not whether but when Poland should join the euro currency area.

The difficult situation in the euro zone since the financial crisis of the late 2008 itself doesn’t make the decision easy for any applicant country, even if all entrance criteria are met. Adoption of the euro is, however, still an important objective declared by Polish government.

The objective of this paper is to reflect on, when Poland will be ready for the euro adoption and what are the main obstacles to achieve this goal. Also, we want to see whether progress (in terms of meeting convergence criteria as formulated in the Maastricht Treaty) has been achieved in recent years and if so, how solid it is. The answer is relevant not only from the point of view of Poland’s ability to join the euro zone but also from the point of view of the stability of the country’s economic foundations and prospects for further economic growth. The analysis covers in general the period 2008 - mid 2014, it is the year before economic slowdown in Poland (2009) and the next years for which full-year statistics exist or actions have been started to improve the situation.

The thesis is that despite recent efforts Poland has not met all economic convergence criteria. Even more important problem is a challenge to comply with legal adjustments.

We do not analyze costs and benefits: the general effects of the euro adoption are commonly known. Estimates of concrete types of costs and benefits were made in Poland in the end of the previous decade, in a different economic situation, and most of them are not relevant for the present period. ¹

The paper starts with a short information on Poland’s legal status with regard to the EMU and to criteria of convergence with the euro area. Next, the recent efforts to meet each of those criteria are presented and possible changes of the situation in the next years are elaborated on. Reflections on the importance of the real convergence follow the assessment of meeting the nominal convergence criteria. The paper concludes with assessment of the main problems on Poland’s road to the euro area.

¹ According to a report commissioned by NBP in 2004, long term effects of euro implementation on GDP were estimated at 6-12%: Raport na temat korzyści i kosztów przystąpienia Polski do strefy euro, 2004. More specific effects, following concrete legal and economic changes as a result of the euro adoption were estimated by: T. Daras, J. Hagemejer,2008.
The legal status of Poland with regard to the EMU and to convergence criteria

Under the Accession Treaty, Poland – like all other Member States which accredited to the EU in 2004 and 2007 and in 2013 (we will use for them the abbreviation NMS – New Member States, despite the fact that they are not the “new Members” any more) - became members of the Economic and Monetary Union (EMU). None of them entered the euro zone on the day of EU accession. All of them committed themselves in their Accession Treaties to adopt the euro in the future, after having fulfilled the required criteria and obligations, including the so called Maastricht criteria (nominal convergence criteria). Apart from those criteria, candidate countries have to ensure full independence of the national central banks and to adjust respective domestic laws.

Given that at the time of the EU accession, the NMS did not fulfill these criteria, they obtained the so called status of EMU “Member States with a derogation”. The condition for lifting the derogation was the fulfillment of the above mentioned nominal convergence (Maastricht) criteria. The adoption of the common currency implies, above all, that applicant countries should apply disciplined macro-economic policy which enables both, their sustainable development and brings them forward towards meeting the convergence criteria. Nominal economic convergence criteria involve several types of requirements to be met by countries aspiring to the euro zone:

- (a) two fiscal criteria [low budget deficit and gross government (public) debt],
- (b) three monetary criteria (low inflation and interest rate, stable exchange rate of domestic currency).

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2 Even more important is the real convergence of the economy which we refer to in the end of this paper.
3 In conformity with art. 140 of TFEU (former art.121 and 122 of the TEC).

The Maastricht criteria are criticized because they concentrate on sanctions and numerical thresholds, and not on solving structural problems. Convergence criteria formally seemed to be a good idea with a view to stabilizing the fiscal equilibrium of countries. They assumed that members of the euro areas operate broadly at the same level of efficiency. The financial crisis has revealed that the biggest problems with sticking to the Maastricht criteria appeared in the least stable and least competitive countries. Therefore the countries that enter the euro area should take into consideration not only public debt and inflation, but also long term the competitiveness of their economies (real convergence). This principle is in line with the assumptions of Optimum Currency Area which were much neglected at the time of EMU creation. Fulfillment of the Maastricht criteria on the day of accession does not mean keeping hold during times of economic downturn. Unsustainable budgetary positions leading to the default of one or several member states seem to be a major threat to the overall monetary stability. Long term fiscal discipline in all partners is a vital component of the EMU.
Apart from them, there are also institutional criteria as required by the Treaty of Maastricht (now TFUE).\(^5\)

The degree of fulfillment of convergence criteria is subject to ECB and European Commission (EC) periodic evaluation. Also, the final assessment of country’s readiness for membership in the euro area is based on Commission and EBC reports. The fulfillment of those criteria allows to recognise the economy of a given EU country as sound and competitive, which, in the future, will not constitute a burden for the remaining euro area members.

There is no deadline for the euro adoption. In early September 2008, Poland’s Prime Minister Mr. D. Tusk, announced that the country would be ready to join euro zone in 2011. It was bad timing to announce such a date, as just a few days later the Lehman Brothers collapsed and the government had to drop its previous timing target. Since this announcement, no new date has been set. The government has not, however, dropped the preparations for euro zone accession. Respective actions have been taken to speed up the country’s fulfillment of the Maastricht criteria. At the same Poland says that the euro zone has to be prepared for enlargement. It means also that euro adoption in Poland has become highly conditional on the enforcement of the economic governance enhancements in the EU, which are of utmost importance for boosting the stability of the euro area as a whole.

**Institutional criteria**

The adoption of the euro requires full comparability of the domestic legislation with the EU treaties and the statute of the ESCB and the ECB. Some of such adjustments are of technical character, but some involve important economic and political implications. It’s first of all the question of competences in the field of monetary policy. In this area, the Constitution of Poland and the Act on the National Bank of Poland are not fully compatible with art. 130 and 131 TFEU and the ESCB/ECB Statue. Article 227 of the Constitution provides that “The central bank of the State shall be the National Bank of Poland. It shall have the exclusive right to issue money as well as to formulate and implement monetary policy. The National Bank of Poland shall be responsible for the value of Polish currency.” Adoption of the euro needs change of this provision to make monetary policy conducted by the ECB.

\(^5\) Also, the applicant country has to prepare the economy for the euro adoption from the technical and organisational points of view. So far, Polish authorities have adopted two key documents: *Strategic Guidelines for the National Euro Changeover Plan*, approved by the Council of Ministers in 2010, and *the National Euro Changeover Plan*, approved by the European Affairs Committee in 2011. The second document has to be updated in order to take into account the significant changes introduced in recent years in the EU which aimed at the stabilization of the euro area. These changes will have impact on Poland’s euro adoption strategy and on the national balance of costs and benefits arising from introduction of the common currency.
However, neither the coalition currently ruling the country nor, most probably, any cabinet formed after the next parliamentary election (due in 2015), will have a majority in the parliament, which is necessary to change the Constitution. Therefore, also changes of other legal acts to adjust them to the TFUE requirements cannot be introduced or changes would be meaningless (see more further).

- **The issue of real convergence**

  Meeting the nominal criteria of EMU is not a sufficient condition to benefit from the membership in a single currency area. Benefits are guaranteed first of all when real convergence is met. It is usually understood as an ability of a given country to cope – in the framework of the monetary union – with possible economic shocks without excessive social costs. It is usually analyzed in terms of convergence of incomes (tendency towards the equalization of income and development levels – income level or growth convergence) or of conformity of business cycles (cyclical convergence). Such convergence takes place when certain conditions are met, mainly among homogeneous groups of countries. When countries have very different economic patterns and levels of development, convergence is rather absent. In other words, in order to reap the full benefits of the single currency in the absence of a national monetary policies and under the irrevocably fixed exchange rates, economic policy has to ensure the proper functioning of internal adjustment mechanisms to safeguard stability. In particular, adequate labor and product market flexibility as well as sound fiscal policy are usually listed as the main challenges with regard to euro preparedness.

  Treaties do not mention the concept of real convergence. It is however, a very important aspect of preparations to entering the euro area. For Poland aspiring for the euro zone and having at the same time less competitive and different pattern of economy, meeting of real convergence is of crucial importance. After entering the euro zone Poland will not have any more the possibility to improve its competitiveness by devaluation of the national currency or to use other national instruments of monetary policy. Therefore, the country has to be well prepared to adjust to internal and external challenges by changes in the real economy (e.g. to adjust to a decrease of production and of employment).

**Meeting the fiscal criteria**

Sustainable public finances are key for macroeconomic stability and, in consequence, for the long-term economic growth. That’s why budgetary deficit (general government

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6 Real convergence is measured usually by such indicators, as GDP per capita (in terms of PPP standard), level of productivity of capital and of labor, pattern of production and employment, quality of regulatory institutions.

7 This part of the paper draws on the paper: E. Kawecka-Wyrzykowska, 2013.
deficit) and public debt are important criteria of assessing the situation of applicant countries to the euro zone.

According to the Treaty (art. 126 of TFEU) “Member States shall avoid excessive government deficits”. The Commission examines compliance with budgetary discipline on the basis of the following two fiscal criteria: ratio of government deficit to GDP and ratio government debt to GDP. The reference values for both indicators were specified in the Protocol on the excessive deficit procedure annexed to the Maastricht Treaty (now TFEU) - art. 126 of TFEU. Countries should also respect in their budgetary policies the procedures of the Stability and Growth Pact (SGP) of 1997 (as revised later in the Six-Pack). Poland, as a country aspiring to the euro zone, must regularly present convergence programmes serving for the assessment of the implementation of its policies of approaching the euro zone (euro zone members have to present stability programs). It means, that Poland is subject to periodical reviews conducted by the European Commission and the ECB from the point of view of fulfillment of the nominal convergence criteria and the degree of alignment of national legislation with respect to the ECB and EU requirements. Convergence reports address the requirements of the SGP (multilateral surveillance procedure and excessive deficit procedure).

- **Budgetary deficit**

According to Art. 1 of the Protocol on excessive deficit procedure (Protocol 12 of the TFEU), the reference value referred to in Article 126(2) of the TFEU with regard to of the deficit amounts to 3% for the ratio of the planned or actual government deficit to gross domestic product at market prices.\(^9\)

In the period of economic slowdown (2009-2010), sharp increase of budget deficit was recorded in Poland (from minus 3.7% of GDP in 2008 to minus 7.4% in 2009 and minus 7.9% in 2010) – table 1. The increase of imbalance of the Polish public finance sector (of the budget deficit and also of the debt) resulted from an exceedingly expansive fiscal policy aimed at supporting low rate of economic growth\(^10\) and from international commitments to finance infrastructure for Euro 2012 football championship. Public investment increased from 35% to 43% of overall investment between 2005 and 2010. This ensured that although private investment fell sharply throughout the crisis, Poland’s overall investment rate only declined slightly (by 0.08 per cent) in 2009, while in other years it has continued to rise (Finanse

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\(^8\) According to the TFEU, such reports are prepared “at least once every two years” (art. 140 of TFEU).

\(^9\) According to the same Protocol, "government means general government, that is central government, regional or local government and social security funds, to the exclusion of commercial operations, as defined in the European System of Integrated Economic Accounts” (Art. 2 of the Protocol).

\(^10\) Unfortunately, the accelerated economic growth in 2008 was not used to improve the public finance sector situation and reduce the deficit. The budget adopted for 2008 did not provide for adjustments, on the contrary – was characterized by expansionary fiscal policy.
An important part of public investments in 2008-2011 was related to buildings and infrastructural projects (mostly roads of nationwide and local character) implemented to speed up Poland’s convergence with other EU countries. A big part of the projects was directly linked to football championships to be organized in Poland in 2012. Such big investment wouldn’t be possible without substantial financial support from the EU budget in form of structural funds and the Cohesion Fund. Let’s make clear, however, that EU funds are not included into the assessment of the budget situation. Only national co-financing created a part of the increased deficit.\footnote{The influence of EU funds on the general government deficit is neutral, i.e. the general government revenues from the EU are shown in the amount of the sector expenditure financed from EU funds, irrespective of the cash flows. They are registered in a separate sub-budget of EU funds. However, Polish contributions to the EU budget are included (like co-financing of EU funds); see: Ustawa, 2009.}

Increased expenditures (including direct and indirect effects of EU funds) helped reduce negative implications of the fall of demand on export markets for Polish goods and services.

Of course, Poland’s worsening of the public finance situation was not exceptional among the EU countries. The deficit in turbulent 2009 and during the low recovery in 2010 increased also in all other EU countries, except for Estonia and Malta (table 1).

Table 1. Changes in government deficit of Poland and of other EU Member States in 2008-2013 (% of GDP)

<table>
<thead>
<tr>
<th>Country</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU 27</td>
<td>-2.4</td>
<td>-6.9</td>
<td>-6.5</td>
<td>-4.4</td>
<td>-3.9</td>
<td>-3.3</td>
</tr>
<tr>
<td>Belgium</td>
<td>-1.0</td>
<td>-5.5</td>
<td>-3.8</td>
<td>-3.8</td>
<td>-4.1</td>
<td>-2.6</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>1.7</td>
<td>-4.3</td>
<td>-3.1</td>
<td>-2.0</td>
<td>-0.8</td>
<td>-1.5</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>-2.2</td>
<td>-5.8</td>
<td>-4.8</td>
<td>-3.2</td>
<td>-4.2</td>
<td>-1.5</td>
</tr>
<tr>
<td>Denmark</td>
<td>3.2</td>
<td>-2.7</td>
<td>-2.5</td>
<td>-1.9</td>
<td>-3.8</td>
<td>-0.8</td>
</tr>
<tr>
<td>Germany</td>
<td>-0.1</td>
<td>-3.1</td>
<td>-4.1</td>
<td>-0.8</td>
<td>0.1</td>
<td>0.0</td>
</tr>
<tr>
<td>Estonia</td>
<td>-2.9</td>
<td>-2.0</td>
<td>0.2</td>
<td>1.1</td>
<td>-0.2</td>
<td>-0.2</td>
</tr>
<tr>
<td>Ireland</td>
<td>-7.4</td>
<td>-13.9</td>
<td>-30.9</td>
<td>-13.1</td>
<td>-8.2</td>
<td>-7.2</td>
</tr>
<tr>
<td>Greece</td>
<td>-9.8</td>
<td>-15.6</td>
<td>-10.7</td>
<td>-9.6</td>
<td>-8.9</td>
<td>-12.7</td>
</tr>
<tr>
<td>Spain</td>
<td>-4.5</td>
<td>-11.2</td>
<td>-9.7</td>
<td>-9.6</td>
<td>-10.6</td>
<td>-7.1</td>
</tr>
<tr>
<td>France</td>
<td>-3.3</td>
<td>-7.5</td>
<td>-7.1</td>
<td>-5.2</td>
<td>-4.9</td>
<td>-4.3</td>
</tr>
<tr>
<td>Italy</td>
<td>-2.7</td>
<td>-5.4</td>
<td>-4.5</td>
<td>-3.7</td>
<td>-3.0</td>
<td>-3.0</td>
</tr>
<tr>
<td>Cyprus</td>
<td>0.9</td>
<td>-6.1</td>
<td>-5.3</td>
<td>-6.3</td>
<td>-6.4</td>
<td>-5.4</td>
</tr>
<tr>
<td>Latvia</td>
<td>-4.2</td>
<td>-9.8</td>
<td>-8.1</td>
<td>-3.5</td>
<td>-1.3</td>
<td>-1.0</td>
</tr>
<tr>
<td>Lithuania</td>
<td>-3.3</td>
<td>-9.4</td>
<td>-7.2</td>
<td>-5.5</td>
<td>-3.2</td>
<td>-2.2</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>3.2</td>
<td>-0.8</td>
<td>-0.8</td>
<td>0.2</td>
<td>0.0</td>
<td>0.1</td>
</tr>
<tr>
<td>Hungary</td>
<td>-3.7</td>
<td>-4.6</td>
<td>-4.4</td>
<td>4.3</td>
<td>-2.1</td>
<td>-2.2</td>
</tr>
<tr>
<td>Malta</td>
<td>-4.6</td>
<td>-3.9</td>
<td>-3.6</td>
<td>-2.7</td>
<td>-3.3</td>
<td>-2.8</td>
</tr>
</tbody>
</table>
The good 2010 economic growth was not used to reduce the budgetary deficit. Only in 2011 the government undertook consolidation measures which have led to positive changes (see more later). After reducing the general government deficit in 2011-2012 by 4 percentage points of GDP, as compared to 2010, the deficit in 2013 reached again a level higher than last year, i.e. 4.3% of GDP (against 3.9% of GDP in 2012). The growth of the deficit resulted mainly from the decline in revenue in relation to GDP by 0.8 percentage points of GDP, as compared to the previous year. Similar to 2012, the consolidation was mainly achieved on the expenditure side. Significant decrease of expenditure in the central government sub-sector resulted mainly from lower infrastructural expenditure executed by the National Road Fund under the Programme for Construction of National Roads for the years 2011-2015 (Convergence Programme 2014, p. 22-23).

The forecasts of the European Commission published in February 2014 indicate that Poland will achieve its budgetary target for 2014.  

- **Poland under excessive deficit procedure**

Poland has suffered from deficits which exceeded the Maastricht criterion ceiling since its entry in the European Union. The high deficit in excess of the prescribed reference value of 3% of GDP made that the European Commission recommended Council to start the excessive deficit procedure upon Poland’s accession in May 2004. The deficit reduction efforts on the part of the Government aided by high economic growth proved successful: deficit gradually decreased from 6.3% in 2003 down to 2% in 2007 when the original deadline to eliminate

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excessive deficit was established by the Council. It allowed the EU to drop the procedure in

In 2009 the ECOFIN Council (Economic and Finance Ministers of the EU Member
States) established the excessive deficit in Poland once again. The argument was the 3.7%
deficit in 2008, exceeding the Maastricht ceiling at 3.0% of the GDP.

Box no 2. Excessive Deficit Procedure (EDP)
At the time when the Excessive Deficit Procedure (EDP) was adopted, the assumption was that this procedure
should be an essential element preventing “excessive” deficits and public debts and ensuring sound EU fiscal
framework. Practice showed that this was not the case. The enforcement appeared to be extremely weak.
Budget deficit ceiling was exceeded many times by Member States but no single fine was introduced. Public
deficit never was examined under SGP as a serious criterion. Deficits and debts increased, not decreased in
majority of EU Members and in some of them became a reason for serious economic troubles.
On 13 December 2011, a new set of rules entered into force under the so called “Six-Pack”. Their main purpose
is to enforce the SGP mechanism. The new rules affect both arms of the SGP, it is the preventive arm and the
corrective arm of the pact (the EDP). New enforcement mechanisms, including fines, were drawn up for non-
compliant euro-area Member States in order to make the SGP more effective. Also, it is now possible to open
an EDP on the basis of the debt criterion.

Source: E. Kawecka-Wyrykowska (2013), Enhanced Economic Governance In the EU: Alternative To A
Political Union?, International Journal of Management and Economics, Warsaw School of Economics,
Warsaw. No. 37.

At that time, the ECOFIN Council recommended that the deficit be brought below 3%
of GDP in 2012 at the latest. In 2012 economic growth slowed down and it appeared that this
target could not be achieved. The reason was mostly a marked deterioration of the economic
situation in Poland’s external environment followed by a slowdown in domestic economic
activity. Consequently, in June 2013, the ECOFIN Council postponed the deadline for
elimination of the excessive deficit by 2 years, i.e. until 2014.

In November 2013 the European Commission recognized (European Commission
(2013)), based on a report received from the Polish Government (Information on measures,
2013)\(^{13}\) that the country had not taken effective action to implement the Council
recommendation of June. Taking into account those circumstances, the European Commission
found it necessary to define a new deadline for the correction of the excessive deficit. As a
consequence, the ECOFIN Council adopted new recommendation for Poland on 10 December
2013 (Council Decision of 10 December 2013 ), postponing the deadline for bringing an end

\(^{13}\) This information was prepared in accordance with The Stability and Growth Pact which requires countries
subject to the excessive deficit procedure to provide the EU institutions with and publish reports on measures
undertaken in connection with the ECOFIN Council recommendations.
to the excessive deficit situation to 2015. In accordance with the new recommendations, Poland should reduce the deficit to 3.9% GDP in 2014 (from the level of 4.8% GDP forecast at that time for 2013) and to 2.8% GDP in 2015, excluding the impact of the assets transfer of the pension reform in 2014. The ECOFIN Council also stated that the achievement of the budgetary targets would require an improvement of the structural balance (i.e. this part of the nominal deficit the government may directly influence through the policy implemented)\(^\text{14}\) of 1% of GDP for 2014 and 1.2% GDP in the following year.

Following the existing procedure, in the end of April 2014 Poland adopted and later forwarded to the European Commission and the Council the updates of both National Reform Programme. Europe 2020. Update 2014/2015 and Convergence Programme. Update 2014. The update of the Convergence Programme (2014) contained information on measures taken by Poland in response to the Council recommendation of 10 December 2013. On the basis of the analysis of these documents and Commission’s proposal, the ECOFIN Council has issued modified recommendations for the economic policy in Poland in the next period (European Commission (2014). Very few new elements have been introduced into this document as compared with the assessment of the previous year, except for one thing. A new element is a proposal for a Tax Council. Such tax councils exit in several UE members but are not foreseen by EU law. The debate started in Poland on the usefulness of such a body, its functions, effectiveness etc. Also, the Commission deleted the recommendation to introduce the stabilising expenditure rule on a permanent basis as this proposal was introduced by Poland in 2013 (see more later).

- Reform policies to reduce fiscal imbalances undertaken by Polish Government and prospects of exiting excessive deficit procedure

In order to assess the credibility of meeting the new deadline for correction of the budgetary deficit in the next few years it’s good to review briefly on the earlier attempts to correct the deficit and reasons for earlier failures.

As a result of the economic slowdown in 2009 and related worsening of public finances situation, the government undertook a number of measures to reduce the fiscal imbalance. Its efforts concentrated first on spending cuts which could be introduced in a relatively short time. Also, some measures on the revenue side were announced and later introduced, the most important being a VAT increase by 1 percentage point – from 22% to

\(^{14}\) A structural budget deficit is the unequilibrium between higher expenditure and lower revenue, which occurs when the economy is operating at full capacities. Rather than comparing actual outlays to actual receipts, the structural deficit looks at their balance that would occur when the economy would be at full employment. If the economy is expanding and real GDP is above its potential, the government may easily increase taxes or cut its spending to prevent the economy from overheating.
23%, to be effective since 1 January 2011 (the reduced rates were also increased in line), and increases in excise taxes.

As mentioned above, they appeared to be insufficient and in 2011 the government started consolidation of public finances which aimed at eliminating the excessive deficit in 2012. The measures appeared to be insufficient to reduce the deficit below 3% of GDP ceiling. Faster improvement of public finances has proved impossible mostly because of procyclical nature of the deficits (slowdown of economic growth from 4.5% in 2011 to 2.9% in 2012 and to 1.6% in 2013). In this situation, more radical spending cuts in 2013 would threaten the economic growth in 2014 and pose a significant risk of recession, an even deeper downturn of tax revenue and a continued increase in the general government deficit (Convergence Program Update 2014, Information on measures). As a result, the objective of meeting the budgetary ceiling of 3% of GDP was postponed till 2015. In its 2014 Convergence programme, the Polish government confirmed this objective. Additional measures were undertaken to achieve the 2015 objective (Information on measures).

The most important reform, which will bring about substantial effects for the economy and probably the most long-lasting effects, albeit in the medium- and long run was undoubtedly the decision to gradually increase of the retirement age. A uniform retirement age of 67 years for men and women was decided upon, meaning an increase from 65 and 60, respectively, starting from 2012 and to be completed until 2020 (men) and 2040 (women). This change shall, on the one hand, increase the future pensions and, on the other hand, improve the balance of the public pension fund, limiting the imbalance of public finance. Moreover, raising of the statutory retirement age will influence the increase in the labour supply which, in turn, shall foster the economic growth, as a consequence of which the improvement of the financial situation should be visible in all institutional sectors, including the public finance sector (Convergence Programme Update 2014).

In 2014 an abrupt improvement of the general government budget (a surplus) is expected. It will be however a one off situation, resulting from the changes in the pension system: transfer of part of the pension rights of the insured, expressed by The State Treasury bonds, from the Open Pension Funds (OFE) to the Social Insurance Institution (ZUS). The transfer of assets from OFE and the transfer due to the so-called “safety slider” will not be classified as revenues in accordance with the ESA2010 methodology which will replace in 2015 the present ESA95 methodology.
Increase of new expenditures will be controlled by the expenditure rule which was established on 28 December 2013 pursuant to the amendment of the Act on Public Finance. This rule replaced the temporary disciplinary expenditure rule and introduced new regulations applicable after the state public debt exceeds 50 per cent in relation to GDP. The mechanisms replaced referred to much narrower fraction of the general government than the new rule.\textsuperscript{16} The compliance with the stabilising expenditure rule shall result in bringing the excessive deficit procedure to an end, followed by further reduction of the general government deficit and, consequently, the reduction of public debt and maintaining these categories at safe levels. The aim of the rule is the stabilisation of the general government balance in the medium-term at a level of a medium-term objective (MTO). The effectiveness of the new rule will, however, depend on how it is actually implemented, in particular in view of frequent changes to the fiscal framework introduced in the past.

- **Public debt criterion**

According to the said Art. 1 of the Protocol on excessive deficit procedure (Protocol 12 of the TFEU), the reference value referred to in Article 126(2) of the TFEU with regard to the public debt amounts to 60 % for the ratio of government debt to gross domestic product at market prices.

In recent years (in fact – in the whole period since the EU accession) the gross government (public) debt has been under control in Poland - well below the Maastricht-prescribed 60\% of GDP threshold and that of the euro zone (some 62-83\% in EU 27 in recent years)\textsuperscript{17} – see table 2.

Table 2. Changes in government debt situation of Poland and in other EU Member States in 2008-2013 (% of GDP)

<table>
<thead>
<tr>
<th>Country</th>
<th>General government gross debt</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2008</td>
<td>2009</td>
<td>2010</td>
<td>2011</td>
<td>2012</td>
<td>2013</td>
</tr>
<tr>
<td>EU 27</td>
<td>62.2</td>
<td>74.6</td>
<td>80.0</td>
<td>82.5</td>
<td>85.5</td>
<td>87.4</td>
</tr>
<tr>
<td>Belgium</td>
<td>89.2</td>
<td>95.7</td>
<td>95.5</td>
<td>99.2</td>
<td>101.1</td>
<td>101.5</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>13.7</td>
<td>14.6</td>
<td>16.2</td>
<td>16.3</td>
<td>18.4</td>
<td>18.9</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>28.7</td>
<td>34.2</td>
<td>37.8</td>
<td>41.4</td>
<td>46.2</td>
<td>46.0</td>
</tr>
</tbody>
</table>

\textsuperscript{16} The rule does not apply to the expenditure of European funds budget and this part of expenses which are financed with non-refundable EU and EFTA aid shall be excluded. It is justified by the fact that the impact of UE funds on the deficit (calculated in accordance with ESA95 and ESA2010) is neutral, i.e. the revenue of the sector from the EU is always indicated at a level of expenditure of the sector, financed from the EU funds, irrespective of the cash register flows. See more: Convergence Programme 2014 Update, p. 62.

\textsuperscript{17} Let’s notice that although following Eurostat’s calculations (so called Maastricht definition) public debt already exceeds 55\% of GDP, but according to the national definition (Polish government’s methodology) it has remained recently below 55\%.
Public debt has been, however, increasing year by year since the level of 45% of GDP in 2007 – to slightly more than 56% of GDP in 2011 but was still lower than the 60% Maastricht criterion. The main factor triggering its increase seems to be the constitutional ceiling at 60% of the debt-to-GDP ratio and related executive acts which encourage the government to control effectively the public finances situation (box 1). The other strong factor inducing the government to control the public finances situation is the EDP (via the mechanism of government’s deficit reductions).

Box no. 1. Constitutional ceiling for public debt in the EU Member States.
As already mentioned, the 60% debt-to-GDP ceiling in written into Polish Constitution which entered into force in 2007. The main reason for this decision at that time was to prepare faster Poland for joining the EU.
(accession negotiations started only at the beginning of 2008) and in particular to show EU-15 how much Poland was committed to adjust domestic laws to the EU membership requirements.

In 2009 the German Constitution was amended to introduce a balanced budget provision, or *Schuldenbremse* [debt brake]. Starting in 2016 the German federal government will be constrained to a deficit ceiling of 0.35% of GDP; from 2020 the Länder will not be permitted to run any deficit at all. An exception can be made for emergencies such as a natural disaster or economic crisis.

Let’s add that strengthened financial requirements were introduced under the Six Pack which entered into force in December 2011. They provide not only for easier and earlier possibility of financial sanctions (or suspension of the Cohesion Fund in the case of non euro-zone members) but also for stricter application of national fiscal rules. The Six Pack ensures stricter application of the fiscal rules by defining quantitatively what constitutes a “significant deviation” from the *Medium Term Objective* (MTO). The MTO is the required structural balance which will ensure sustainability of the public finances, set out in the SGP.18

The most recent articulation of EU fiscal rules is the Fiscal Compact (the main part of the *Treaty on Stability, Coordination and Governance*, TSGC), which requires countries to ensure convergence with their respective MTOs. It introduces a more explicit budget rule, whereby all States must strive for budgetary balance and achieve a structural deficit of no more than -0.5% of GDP. Importantly, the Fiscal Compact requires that both budget rules must be implemented in national law, preferably in the constitution, that compliance is monitored by independent institutions and that an automatic correction mechanism is put in place to correct divergences from these rules.

Let’s notice, that a debt ceiling written into the constitution cannot by itself guarantee the fiscal discipline. In fact, achieving this goal will depend much on the political culture of EU Member States. Constitutional ceiling can, however, be more efficient in disciplining Member States than the European law.

Some other EU Members, than Poland and Germany, decided to work on the including of debt ceiling into their national constitutions. In autumn 2011 Slovakia passed the respective law which includes automatic sanctions that are triggered when the debt level passes the 50% threshold. Also Spain decided to enact a respective law in 2012, but it will not come into force until 2020.


**Strengthened economic governance in the EU**

The financial and economic crises revealed a weak enforcement of the Maastricht convergence criteria.19 The original rules of the Economic and Monetary Union (EMU), as

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18 Throughout 1999-2004 the Stability and Growth Pact (SGP) had outlined a common mid-term objective (hereinafter – MTO) for all Member States, which was “to achieve a budgetary position of close to balance or in surplus over a complete business cycle”. After the reform in 2005, MTOs were calculated to reflect country-specific values according to “the economic and budgetary position and sustainability risks of the Member State”, based upon the state's current debt-to-GDP ratio and long-term potential GDP growth, while the overall objective over the medium term was still the same.” Later on, Member States and the European Commission completed a joint work elaborating a methodology for computing MTOs that renders operational the MTO determination criteria.

19 The crises confirmed also that the monetary union of the EU was sub-optimal from the theoretical point of view and did not meet all criteria necessary to conduct single monetary policy addressing properly the needs of all parts (member states) of the single currency area. In particular, the conditions of flexibility of the labour market (via reduction of real salaries in case of worsened competitiveness or via increased outflow of
specified in the Maastricht Treaty of 1992 and later elaborated in the Stability and Growth Pact (SGP) of 1997, were adopted under the assumption that governments would conduct responsible economic policies. Surveillance and the risk of fines were expected to be sufficient to force countries to ensure fiscal discipline. Practice has shown that such an idealized approach has not been working. The financial crisis that started in fall 2008, followed by a sovereign debt crisis and deep recession in many countries in subsequent years, has revealed major macroeconomic imbalances, including huge – sometimes - budgetary deficits and public debts in the EU economies.

An important role in increasing the deficits was due to the poor enforcement of Maastricht rules (or rather the Stability and Growth Pact rules) before the crisis. It appeared that Maastricht criteria, which were breached more than 100 times till those crises, never resulted in implementation of the restrictive provisions of the Stability and Growth Pact (imposition of financial fines on countries which exceeded the deficit ceiling). In fact, the rules of the Pact were made less restrictive under the March 2005 Conclusions of the European Council.

In view of increasing public debts and unrest on financial markets, EU leaders took a number of decisions to reduce fiscal imbalances and increase the confidence of investors. Among the most important institutional measures one should mention adoption of so called Six-Pack, of Two-Pack and entering into force of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union – TSCG (the fiscal part of the TSCG is referred to as a "fiscal compact" but sometimes the whole Treaty is referred to as a "fiscal compact"). It entered into force on 1 January 2013. The main elements of those documents can be summarized in the following way:

(a) Stronger preventive action. Member states are required to make significant progress towards country-specific, medium-term budgetary objectives (MTO) for their budgetary balances to ensure public finance sustainability. The new rules define a new “expenditure benchmark” to help assess progress towards these MTOs. This expenditure benchmark places a cap on the annual growth of public expenditure according to a medium-term rate of growth.

unemployed workers) and use of fiscal transfers to address problems have not been met (R.A. Mundell, 1961, p.657-665).

20 In one of its recent Communications, the European Commission has admitted “The SGP was insufficiently observed by the member states and lacked robust mechanisms to ensure sustainable public finances. The enforcement of the preventive arm of the SGP, which requires that member states maintain a strong underlying budgetary position, was too weak and member states did not use periods of steady growth to pursue ambitious fiscal policies. At the same time, the debt criterion of the treaty was not rendered operational in practice in the corrective arm of the SGP” (Communication from the Commission, 2012, p. 2).
For member states that have not yet reached their MTO, the rate of growth of expenditure should be below the reference rate in order to ensure adequate progress.\textsuperscript{21}

(b) Stronger restrictive actions towards fiscal sustainability. Excessive Deficit Procedure can be now opened, both on the basis of a budget deficit as well as of debt criterion. New rules (including fines) have been introduced regarding the planning and calculation of the budgets. The budget expenditure of the Member States should be linked to the mid-term GDP growth rate.\textsuperscript{22} If a country fails to reduce budgetary deficit or public debt, the Commission shall recommend to the Council to impose a sanction in the form of a non-interest bearing deposit of 0.2\% of GDP, unless a qualified majority of Members States vote against it (the so called reverse qualified voting procedure). The assumption is that “reverse qualified majority” voting procedure will make the enforcement of the rules stricter and more automatic, therefore more dissuasive and credible.

Under the Fiscal Treaty, the budget rules shall be implemented into the national laws through provisions of “binding force and permanent character, preferably constitutional”. The Court of Justice of the EU (CJ) may impose financial sanction (0.1\% of GDP) if a country does not properly implement the new budget rules in national law and/or fails to comply with a CJ ruling that requires it to do so.

Also, a permanent stability mechanism – European Stability Mechanism (ESM) – was established with the aim to provide financial assistance (under strict conditionality) for countries experiencing or threatened by severe financing problems.\textsuperscript{23} The European Stability Mechanism acts as an intergovernmental organization under public international law. It was inaugurated on 8 October 2012 following ratification by all 17 euro area Member States.

**Price stability criterion**

This criterion of the Maastricht Treaty deals directly with inflation and it requires aspiring member states to achieve a high degree of price stability. According to the protocol attached to the TFUE: a member state eligible for the common currency area has a price

\textsuperscript{21} The medium-term objective (MTO), as defined in the revised SGP under the Six-Pack, provides for a low limit of the so called structural deficit (cyclical effects and one-off measures are not taken into account) – only at 0.5\% of GDP. When such criterion is met, the budgetary position of the general government of a contracting party is considered to be balanced or in surplus. The contracting parties “shall ensure rapid convergence” towards their respective medium-term objective. A higher structural deficit of at most 1\% is only allowed if the government debt-to-GDP ratio is significantly below 60\% and risks to long-term fiscal sustainability are low. The balanced budget rule must include a correction mechanism, which is automatically triggered in the event of significant observed deviations from the MTO or from the adjustment path towards it. Escape clauses for exceptional circumstances are provided for (see more: E. Kawecka-Wyrzykowska, 2013).

\textsuperscript{22} Fiscal part of the TSCG requires contracting parties to respect/ensure convergence towards the country-specific medium-term objective (MTO), as defined in the revised SGP, with a lower limit of a structural deficit (cyclical effects and one-off measures are not taken into account) of 0.5\% of GDP.

\textsuperscript{23} On the text of the Treaty see: \url{http://www.esm.europa.eu/pdf/esm_treaty_en.pdf}.
performance that is sustainable, that means an average rate of inflation that does not exceed by more than 1.5 percentage points (p.p.) that of, at most, the three best performing EU Members States. The price stability must be observed over a period of one year before the examination. 

Taking into calculation the rate of inflation of the three member countries with the lowest rates of inflation means in practice that only countries with very low inflation may accede to the euro area. Although it is said that this convergence criterion might have also been calculated as a medium rate of inflation of all members’ states, doing so would probably have been harmful to the partner countries with low inflation. Buiter and Sibert consider the proper interpretation of “best performing in terms of price stability” as the inflation rate of the three partners of that area that are closest to the ECB inflation goal, but below 2%. (W.H. Buiter, A.C. Sibert, 2006). Higher inflation may reflect a weaker position of common currency.

It is worth noticing that the convergence criterion does not take into consideration the processes opposite to inflation, namely deflation, that is very probably now in few the EU member states. Deflation of prices has as many negative consequences for an economy as inflation has. Suppose, a given member country were to exhibit deflation processes, it is unclear that country’s data would or would not be used to calculate the average rate of inflation of the three best performing member states. Sticking strictly to the letter of the law, this country ought to be excluded from calculation of the convergence criterion, as the relevant treaty article only mentions low inflation countries. Perhaps it is possible to envisage taking into consideration one country with dropping prices and two countries with growing prices to calculate the average inflation rates among three partners. The real problem would arise, if there were three UE countries with deflation rates more than 1.5 p.p. In this case, the calculation of the Maastricht criterion would mean that candidate countries were obliged to follow deflationary policy. The Maastricht Treaty did not consider this scenario and fortunately this situation has not yet arisen.

The ECB monetary policy concentrates on the euro area partner countries but the convergence criteria shall be calculated on the basis of yardsticks all members of the EU. It is possible that the average inflation rate of the three best performing UE countries may be lower than that of the euro area average of three partners with lowest inflation and lower than the 2% price stability definition of the European Central Bank. Such was the case in 2006 when inflation rates in Poland and Sweden were taken into calculation of the reference value. The rates of those countries decreased by 0.2 p.p. the average inflation rate if it was

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calculated for Finland, Netherlands and Austria, the three the best performing countries of euro area that year. Margin of 1.5 p.p. among inflation rates is not big in relation with three low inflation countries, but it does allow also for some differences in the rate of inflation. This margin level was chosen because it was not possible to determine with precision what should be the maximum inflation rates differential in the framework of monetary union. The idea is that the countries with higher inflation growth must squeeze it to the nearly the same level as is the inflation rate in the three best performing countries. It should be noted that an inflation differential of 1-2 p.p. can also observed between regions of large federal states. Small differences in inflation rates do not constitute a threat to the cohesion of monetary union and leave some “room of manoeuvre” for economic policy, if they do not persist for a long time.

Although integration process help to equalize prices on the single market, the consumer’s price level in wealthier partners’ countries might be higher than the price level in the partners with lower GDP. The consumers price index is made up of tradable goods that have the nearly the same prices on the single market and of local goods with differentiated prices that are more expensive in relation to tradable goods in richer partner countries. According to the Balassa-Samuelson hypothesis countries undergoing the catching up process may show higher growth in prices increases resulting from relative productivity gains in the tradable sector against the non-tradable goods sector. Since an increase in growth of productivity and wages in tradable sectors spreads across the economy as a whole, there is a rise in relative prices in the non-tradable sector, where productivity has not grown at the same pace. So countries with rapidly growing economies tend to have appreciation of real exchange rates, which result from differences in relative productivity growth. Real appreciation of the currency has two channels: inflation differentials and nominal rate appreciation. The necessity to fulfill the criterion on exchange rates stability could put in such circumstances additional pressure on the disinflationary policy of euro area candidate country. As some countries have to meet the convergence criteria in the catching up framework, the European Economic Advisory Group advices in its report to introduce a “Balassa-Samuelson rebate” (maximum 1 percentage point) for the inflation criterion; this rebate would provide more elasticity to reach reference rate for countries with lower level of economic development (EEAG 2007).

The level of inflation in the EU should be of course measured by index which is comparable between member countries. To this goal the EU obliged member states to use a harmonized consumer price index (HICP) that provides a better and more comparable basis for the assessment than national consumer’s price indices. The HICP covers the same categories of goods and services in the partner’s countries and is based on the consumer
expenditure weight applicable for 2010. In connection with the required harmonization the member states are obliged to provide common coverage and common classification of goods and services, using comparable formula for calculating prices changes, minimum standards for procedures of quality adjustment (The Monetary Policy of the ECB, 2011).

Overall, the Maastricht inflation criterion is directed to keep very low inflation in the euro area. As it is a moving target changing year by year, than the Maastricht criterion may be associated with some uncertainty. For some countries it may be difficult to formulate the right economic policy in order to reach the required yardstick. There is no margin of tolerance which means that the limit is strictly supervised by the European Commission on the basis of economic data. Lithuania surpassed the inflation yardstick by only 0.1 p.p. in 2006 but that was sufficient to eliminate is as a candidate country for the euro area. It should be taken into account that the Maastricht goal of curbing inflation needs first and foremost a proper policy mix of monetary and fiscal policy. On the one hand, a lack of fiscal tightening requires pursuing a more restrictive monetary policy; on the other hand, limited government spending would allow a reduction of inflation to the reference level without a significant tightening of monetary policy.

Poland was a high inflation country in the 1990s. Nevertheless, after a restrictive and long lasting deflationary policy Poland was able to reduce inflation rates to 0.8% in 2003, and 1.4% in 2006. The inflation rate in Poland remained below the reference value of the Maastricht Treaty from an autumn 2005 to early 2008. Unfortunately Poland saw a return to growth of inflation from 2.2% in 2007 to 4.1% in 2008 (see table 3). After the financial crisis economists predicted that commodities prices should have plunged all around the world. In 2009 the rate of inflation was assessed in Poland at 2.9%. However that was higher than the 1.8% HICP reference inflation rate in the euro area.

Table 3. Polish inflation rate in the period 2008 -2014

<table>
<thead>
<tr>
<th>Year</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inflation rate</td>
<td>4.1</td>
<td>2.9</td>
<td>2.6</td>
<td>4.0</td>
<td>3.7</td>
<td>0.7</td>
<td>1.0*</td>
</tr>
<tr>
<td>Reference rate</td>
<td>2.6</td>
<td>1.8</td>
<td>2.2</td>
<td>3.0</td>
<td>3.1</td>
<td>1.8</td>
<td>1.2*</td>
</tr>
</tbody>
</table>

* first quarter 2014.

25 Goods account for 58% of HIPC (food 19.2 %, energy 9.6%, industrial goods 29.3% ) and services for 42% (housing 10.2%, transport 6.6%, recreation and personal services 14.9%).
However, the inflation rate grew again in Poland to 4% in 2011 and 3.7% in 2012. The increase in inflation was driven by a 1 p.p. growth in the VAT rate effective starting 1 January 2011. There was also a sudden rise of prices of energy as well as of gas and fuel imported from third countries which brought about higher imported inflation. Poland’s rising inflation rate started to create pressure on the labour market to demand higher wages. Increase in prices of goods and services throughout the year 2013 in relation to the years 2010 was only 0.7% and it was the lowest since 2003.

Since the beginning of 2004 the National Bank of Poland has pursued a continuous inflation target at the level of 2.5% with a permissible fluctuation band of +/- 1 percentage point. The Monetary Policy Council (MPC) - a decision making body of the NBP - fixes the basic interest rates at a level consistent with the adopted inflation target. To fight inflation the MPC changed many times interest rates. On 25 June 2008 Monetary Policy Council hiked its key reference rate by 0.25 p.p. to 6%, but just after that the MPC reduced interest rates in Poland by 0.25 p.p. to 5.75%, in December 2008 by 0.75 p.p. to 5%, and to 4.25% in January 2009. After the breaking up of the global crises, the NBP had changed the approach to monetary policy from restrictive to neutral. In 2009 the MPC reduced the rate of interest by 0.25 p.p. in February to 4.00 and in June to 3.5%. Later, to keep inflation down, it raised its reference rate up to 4.75% in May 2012. However, because of slower economic growth, the MPC decided to reduce three times interest rates by 25 p.p. up to 4% in January 2013. In 2013, the Monetary Policy Council continued the series of interest rate reductions. During this period, the NBP interest rates have been reduced by 2.5 p.p. to 2.50 % and, therefore, to the lowest level in history. In 2014, the big drop in inflation puts pressure to further cuts in rates, but whether this will take place deepens also on the prospect of economic growth.

In the period 2005 - 2007 Poland qualified without any problems to the inflation criterion provided for by the Treaty of Maastricht. However, in the year 2008 Poland was affected by recurrences of inflationary processes, and since March of that year was not able to keep inflation within the Maastricht bounds. Due to the growth of inflation in all EU members countries in 2009-2012 the gap between the 12 month average HICP in Poland and the Maastricht reference value was no more than 1 p.p. Energy and food prices have been major components of inflation growth because these categories of products have large shares in the HICP basket. They are mostly imported (oil and gas) and Polish government has not instruments to control them. From 2013 the economy of Poland has fulfilled the convergence criterion of inflation. However, keeping low inflation rates in Poland is not only a question of limiting it by one year policy action but keep it low in a long term. To fight inflation permanently Poland must carry out some structural reforms to change its economy to make it
more competitive. Much depends also on the correct policy of the Central Bank in reference with money supply and rates of interest.

**Interest rate criterion**

The other criterion of entering the common currency area is achieving low interest rates. Low interest rate means average nominal long-term interest rate that does not exceed by more than 2 percentage points that of, at most, the three best performing EU Member States in terms of price stability. The assessment of the criterion is based on the interest rates on comparable 10-year benchmark bonds, using an average rate over the latest 12 months.\(^{26}\)

The bonds are certificates acknowledging a debt that someone has borrowed money and promises to pay it back in the future. Governments purchase and sale bonds to finance budget deficits and to change the level of national debt. Central banks buy bonds to increase bank reserves and sell bonds to reduce bank reserves. In doing so the central bank can increase or decrease the money supply in an economy. For example, by buying bonds a central bank pumps additional reserves into the banking systems. Holders of the bonds can of course sell them via the bonds market and bonds like stock markets are located in all the major financial centres.

The current market price of such bonds is determined by demand and supply and interest rate. The interest rate reflects mainly the market rate paid for bonds at the time when the bonds are issued. When countries borrow money in international financial markets, they do not face the same interest rate. Like individuals, riskier countries face higher interest rates, which include a risk premium to cover the possibility of default. For example, at the beginning of the euro area the public debts of partner countries gained nearly the same reputation (differences in rate of interest for 10 years bonds in Germany and Greece were less than 0.5% ), but after the crisis spread between German and Greek bonds grew even to above 30%. The rate of interest on a new loan is referred to as the nominal interest rate. The interest rate on 10 years bonds not only reflects market conditions, but also the markets’ assessment of long term inflation and the risk of default. Hence the nominal rate of interest has three components. One is the expected rate of inflation, second - risk of default, and a third component is the real rate of interest. However, in practice it is not possible to assess correctly the risk of default and expected rate of inflation. Speculative capital may deviate the rate of interest from real rate of interest.

There are different theories concerning rates of interest payable for bonds. According to the expectation theory market participants are indifferent to whether bonds are long-term

\(^{26}\) In the case of Estonia this criterion was not applied because this country did not issue the 10 years bond in the time of accession to the euro area.
or short term. Market participants used to have “perfect foresight”, so long-term investments in securities is equivalent to a series of short-term investments with rates expected to remain constant in the future. On the other hand, long terms bonds are less liquid than bills and the short-term bonds. They are hard to sell because the price for which they could be sold and the amount of money they could generate are more uncertain. The relative riskiness of investment in long term debt means that they should offer a higher yield to induce investors to hold them (liquidity preference theory). According to market segmentation theory the yields on each “term to redemption segment” are determined independently by supply and demand. The relative riskiness of investment in long term debt means that they should offer a higher yield to induce investors to hold them The higher the current market rate of interest (in ceteris paribus risk of default and inflation), the lower the market price of existing bonds will be. It is common to say that governments cannot go bankrupt in paying debts because they have “unlimited power” to impose taxes. But if a government in managing a big debt heavily increased the level of taxation it would plunge the economy into a deep and long recession. Thus governments do face limits in raising tax rates to meet the burden of the debt. Beyond a certain point governments must redirect budget spending from public investments, social protection, public services to servicing only the bonds. Without sufficient taxes receipts governments with their own currencies may also print additional money and lend it to avoid default, but this mechanism does not work in the framework of monetary union. Heavily indebted countries at last sometimes look to resolve debt problems by rescheduling (creditors may prefer to get some money back over a longer period), but doing so decreases the trustworthiness of the country and makes borrowing in the capital market more difficult.

The inclusion of interest rates criterion into the Maastricht criteria seems to be connected with the desire to ensure stability of low inflation and debt credibility of partner countries. The Maastricht price stability criterion helps member countries to avoid short term inflation and criterion concerning rates of interest helps them to avoid long term inflation. Low interest rates speak also about the partner country solvency and its possibilities of paying back the debts. Because interest rate on 10 years bonds reflects market condition of supply and demand and assessment of inflation, a low long term interest rate is able to convince the financial markets that the inflation rate will also remain low. Low interest rates are a proof that the EU partner countries are stable, trustworthy, carrying out responsible fiscal policy, and are able to borrow money by selling bonds, paying interest and buying them back.

Spreads between rates of interest become the indicator of doubts about public finances and differences in countries competitiveness. The Polish 12 month average long
term interest rate stayed below the Maastricht reference value from 2005 to 2007. It started to rise gradually in mid-2007 from a relatively low level of about 5%. In 2009 it increased above the reference value to 5.9% (see table 4). In 2010 the reference value in the euro zone was fixed at 5.0%, while the 12 month average of the yield on ten year Polish benchmark bonds stood at 6%. In 2011 the Polish 10 years bonds interest rate was still a little higher than the reference rate of 0.5%. As economic crisis developed a long term interest rate was in Poland at 5.478% in 2012, in Greece at 35%, in Spain surpassed 7%, but in Germany 10 years bonds hit a record low of 1.39%, lower than in UK - 1.81% and US Treasuries – 1.69%.27

Table 4. Interest rates of Polish 10 years bonds in 2008 – 2014

<table>
<thead>
<tr>
<th>Year</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long term interest rate</td>
<td>6.29</td>
<td>5.9</td>
<td>6.0</td>
<td>5.88</td>
<td>5.4</td>
<td>4.0</td>
<td>4.1*</td>
</tr>
<tr>
<td>Reference rate</td>
<td>4.25</td>
<td>4.0</td>
<td>5.0</td>
<td>5.33</td>
<td>4.17</td>
<td>5.4</td>
<td>5.5*</td>
</tr>
</tbody>
</table>

* first quarter 2014.


In December 2013 Poland fulfilled the criterion of interest rates. The average long-term interest rate over the past 12 months had not significantly changed (4.0%) and was about 1.4 percentage points below the reference value, which stood at 5.4%. Reference value fluctuations in 2013 were primarily due to changes in the reference countries group. The basis for the calculation of the reference value of this time were the two EU countries with the most stable prices (Latvia and Bulgaria). Also in March 2014, Poland performed the interest rate criterion. The average long-term interest rate over the past 12 months amounted to 4.1%, thereby was by 1.4 percentage points below the reference value which stood at 5.5%.28

As one can see from table 5, in June 2014, 10 years bond interest rate in Poland amounted to 3.508% and was higher than in Germany, France, the Netherlands (1.25; 1.60 and 1.49 respectively) but was close to the level of interest rates of bonds in Portugal - 3.59, and lower than in Greece - 5.94 and in Hungary - 4.5%. The interest rate on the 10 years bonds was in Poland close to the level of bond interest rates in Lithuania-3.20 which wants faster than Poland join the euro zone. It is worth to add that at the beginning of 2014, Poland

sold 10-year bonds with a value of 2 billion euros, with profitability of 3,032 percent and these bonds were bought mainly by investors from the EU.29

Table 5. The interest rate on 10 year bonds in EU countries in June 2014 (in %)

<table>
<thead>
<tr>
<th>Country</th>
<th>Interest rate</th>
<th>Country</th>
<th>Interest rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>1.675</td>
<td>Greece</td>
<td>5.94</td>
</tr>
<tr>
<td>Belgium</td>
<td>1.798</td>
<td>Hungary</td>
<td>4.500</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>3.299</td>
<td>Netherlands</td>
<td>1.490</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>1.654</td>
<td>Ireland</td>
<td>2.418</td>
</tr>
<tr>
<td>Croatia</td>
<td>4.173</td>
<td>Italy</td>
<td>2.700</td>
</tr>
<tr>
<td>Denmark</td>
<td>1.437</td>
<td>Latvia</td>
<td>2.696</td>
</tr>
<tr>
<td>Finland</td>
<td>1.611</td>
<td>Lithuania</td>
<td>3.200</td>
</tr>
<tr>
<td>France</td>
<td>1.600</td>
<td>Germany</td>
<td>1.250</td>
</tr>
<tr>
<td>Portugal</td>
<td>3.590</td>
<td>Spain</td>
<td>2.591</td>
</tr>
<tr>
<td>Poland</td>
<td>3.508</td>
<td>Slovenia</td>
<td>2.985</td>
</tr>
<tr>
<td>Romania</td>
<td>4.611</td>
<td>United Kingdom</td>
<td>2.710</td>
</tr>
</tbody>
</table>


The large differences in the interest rates between Poland and other EU member states created large disturbances in the Polish capital market due to the inflow of foreign speculative capital and appreciation of the Polish zloty. After 2004 Polish interest rates were within the Maastricht limit up to the financial crisis, but even in this period deviated from reference rates only a little. The temporary increase of interest rates in Poland was connected to risk aversion among foreign investors associated with buying the assets of emerging markets’ and an expected tightening of monetary policy connected with an anticipated growth in inflation. However, Poland avoided financial crisis and a situation of Polish economy was much better than that of highly indebted countries like Greece, Portugal or Spain. In 2013 the profitability of Polish 10 years bonds fell to about 4% and at the beginning of 2014 to about 3%. The decline in yield on Polish bonds indicated that investors treated Poland as a country relatively stable. It seems that with a policy focused upon reducing the budget deficit and limiting public debt Poland can satisfy this criterion.

- **Stability of currency criterion**

Before accession to the euro area an applicant country is obligated to participate in the exchange-rate mechanism for two consecutive years. The ability to keep the exchange rate at a stable level is treated as precondition to enter into euro area because having those

29 Rzeczpospolita, Warszawa 8.01.2014.
ability shows that economic shocks are not frequent or that the adjustment mechanism is effective in managing the rate of exchange. Stable exchange rate means there are normal fluctuation margins of a currency’s rate of exchange, without severe tension. This expression of “normal fluctuation margins” is of course not very precise.

It is worth to add that the phenomenon of severe tension includes not only the breach of the permitted range of devaluation or revaluation of the candidate country’s central parity currency against the euro, but also the policy measures aimed at defending the parity. Such severe tension cases were demonstrated by Latvia’s negative assessment in the 2010 convergence report in connection with bank intervention in the foreign exchange market and strong increase of interest rates (M. Belka, 2013).

Meeting the exchange rate stability criterion is connected with functioning of floating exchange rates. Since April 2000 the Polish Zloty exchange rate has been a floating exchange rate that is not subject to any restrictions. In the opinion of P. Grauwe, the exchange rate requirement with +/-15% band has become quite soft among the Maastricht criteria and candidate countries easily accomplish this condition (P. De Grauwe, 1997, p. 135). The main motivation for keeping the ERM II mechanism for candidate countries is not only to show the stability of their national currencies but indirectly also to keep the balance of payments equilibrium. A stable exchange rate for the zloty means that demand and supply shock may be accommodated by changes in prices and wages, migration, or production rather than devaluation or revaluation. Appreciation of candidate country’s currency is rarer phenomenon than depreciation. One can imagine the situation in which candidate country would try to depreciate the value of its currency before accession to the euro area in order to improve its competition position afterwards and in doing so a country is limited only by a 15% band.

From the day of accession to the EU to the middle of 2008 the strength of the zloty has increased. Polish currency became 40% stronger against the euro what caused the financial difficulties for many Polish companies exporting goods to the single European market. However, in 2008 after the financial crisis, the zloty lost its value due to a sudden devaluation of 20% falling from 3,2 zloty per euro to 3,97 zloty per euro. In 2009 the rate moved by more than 30% to 4,5 zloty per euro. The situation did not calm down following an announcement by the National Bank of Poland that the macroeconomic fundamentals remained strong and stable. February 2009 was a month of crisis for the Polish currency, with zloty hitting 4.899 per euro. The exchange rates against the US dollar was 3.82 zloty per dollar and against the Swiss franc 3,26 zloty per franc. Depreciation of the Polish zloty was especially dangerous with regard to Swiss franc because some 30% of Polish mortgage were estimated to be held in francs. Such frequent and important changes of the zloty’s rate of
exchange did not help Polish firms to get long term contracts. It is a common opinion that the weakening or strengthening of the zloty was no longer linked to the economic situation, but instead was a result of speculation games.

In 2011 the rate of exchange of the zloty to the euro fluctuated in range between 4 zloty and 4.5 zloty per euro. At the beginning of 2012 the rate of the zloty against the euro decreased to 4.2 and in the middle of this year to 4.08 zloty per one euro. In January 2013, one euro costed 4.1369 zloty while in June - 4.2865 zloty. In January 2014, one euro costed 4.1776 zloty and in June - 4.1528 zloty. In the second half of 2014 the Polish zloty rate to the euro is expected to heading down to the level close to 4 zloty for one euro.

In 2008 - 2009 and again in 2011 the flow of short term capital and panic on the financial markets caused a deep devaluation of zloty. Because the zloty is treated by foreign investors as one of the Central European currencies, as long as other countries in the region have had difficulties in overcoming economic crisis, there are no chances for the zloty to strengthen considerably.

Economists generally believe the zloty was greatly undervalued during the economic crisis. In the view of some of them the optimal rate of exchange between euro and the zloty should have been lower than the actual rate. On the other hand taking into consideration the lower competitiveness of the Polish economy against its euro zone trading partners, other economists think that the optimum exchange rate of the Polish zloty should have been in the range of 4- 4.5 zloty rather than below 4 zloty for one euro.

There are opinions that Poland should hold elastic rate of exchange up to the end of crisis in euro area. Floating exchange rate involves some economic costs but may be the best instrument of growth policy in the time of economic downturn.

• **When Poland could adopt the euro?**

As already mentioned, in the new circumstance after the financial and economic crises, Polish government has not decided to set up a date for the euro adoption. From the formal point of view, even if Poland meets nominal convergence criteria (e.g. in 2015), two years more are needed to declare the ERMII rules entrance and their enforcement.

In order to take a decision to enter the ERMII, the government should take into account not only the compliance with nominal criteria, but also the real convergence of the Polish economy to the euro area members.

Another requirement is the adjustment of legal rules to the euro area laws. It’s a question of the respective changes in Polish Constitution which require the 2/3 majority of the Members of the Parliament. At present there is no possibility to get such a support. Therefore,
restoration of a public opinion support it necessary to reverse the present reluctance of great part of the society to the euro and get to support to changes in the Constitution.

The situation is even more complicated as the strongest political party in opposition (PIS - Law and Justice ) to the ruling coalition [Civic Platform (PO) and PSL] has argued from a long time that they want to have first the referendum on the euro adoption. They do not accept the argument that Poland has already committed itself to the euro adoption under the Accession Treaty. Taking into account this strong negative approach to the euro on the part of political opposition (according to public poll from the beginning of July 2014, the main opposition party PIS had 32% support while the governing Civic Platform was supported only by 24% of respondents) on one hand, and the parliamentary elections in autumn 2015, nobody can forecast reliably the evolution of the situation. None of the two biggest political parties (PO and PIS) is nowadays and probably will be in the nearest future able to achieve 2/3 majority in the Parliament.

An open question is whether Poland should set up the possible date of the euro adoption, even if it is a distant goal. The main argument is that dates always mobilize decisions makers and all institutions to do every effort to keep the deadlines established. The deadline also shows what is necessary to do in order to achieve the objective set up. One can argue, for example, that without a clear timetable of three stages of the EMU creation provided for in the Maastricht Treaty of 1992, the EMU would not be established. The reason was that in the late 1990s the economic situation and resulting political support for EMU were much weaker than at the beginning of the decade. Dates show also how much time we need to bear the necessary adjustment costs, before we can enjoy benefits of the common currency adoption. On the other hand, setting a deadline of the euro adoption (and of successive formal and legal preparations) will not have much meaning without a strong involvement of the public institutions into a broad public debate on the euro in Poland. Formally, a good occasion for that might be the political debates before the above mentioned parliamentary elections in Poland to be held in autumn 2015. Political realities say however, that politicians will not risk so “hot” and unforeseeable topic. Thus, in practical terms, we should not expect a deep discussion on the timetable of the euro adoption in Poland before the end of 2015.

- Conclusions

The only convergence criterion that Poland has met since the beginning of EU accession has been public debt. There are good prospects to meet the deficit criterion till 2015 as declared by Poland in Convergence Programme 2014. Let’s stress, that achieving sound fiscal policy in Poland is a major pre-requisite for respecting all Maastricht criteria. The consolidation of public finances shall lower inflation pressure, contribute to reducing the
volatility of the currency and favour the convergence of interest rates, while offsetting their expansionary impact on activity at the same time.

Price criterion and interest rate criterion depend, first of all, on the conduct of Polish economic policy, but also on the situation in the three best performing countries of the EU which are the basis of reference values. The recent experiences and forecasts show that these criteria will also be met by Poland in 2015. The decline in yield on Polish bonds indicated that investors treat Poland as a relatively stable country. The decision to enter the ERMII is more risky as exchange rate changes will depend not only on domestic economics and politics but also on external developments.

Let’s stress that meeting Maastricht criteria is important (and required) even if a country does not aspire for euro zone as they are criteria (especially fiscal criteria) of sound economic policy: low deficit and public debt are usually beneficial for the economy.

Meeting nominal Maastricht criteria is not enough. The higher the real convergence of the Polish economy on the day of the euro adoption, the more stable and secure situation of the economy will be in the next period. Poland should be able to remain competitive without nominal exchange rate depreciation even in the event of large adverse shocks. Without a possibly close economic convergence of Polish economy to the best developed EU countries there is a risk of a number of problems including a risk of strong Balassa-Samuelson effect and loss of price competitiveness of Polish products and services.

Thus, in the medium- and long term, the key role will be played by structural reforms, going much beyond the public finance sector. They include first of all increased flexibility of labour market, improved business environment, improvement of transport infrastructure, increased role of innovations in economic growth etc. Such reforms are necessary to ensure sustainable growth and longer term competitiveness of the economy.

Also, institutional and legal changes have to be introduced in Poland to make the country ready for the euro adoption. The biggest challenge in this context is the change of the Polish Constitution in order to adjust competences of the national – at present – monetary policy – to the requirements of the euro area. However, neither the coalition currently ruling the country nor, most probably, any cabinet formed after the next parliamentary election (due in 2015), will have a majority in the Parliament to do that.

In this situation, an important task for the government which takes the decision to include Poland into the euro area is the necessity of preparing the society for the euro adoption. Without restoration of a public opinion support it will not be possible to reverse the present situation and get the support to changes of the Constitution. Also, it’s impossible to imagine preparations for the euro adoption in case, an important part of the society is against it: they could risk de-stabilization of the domestic political situation.
Adopting the euro and benefiting from full membership of the Economic and Monetary Union has been still among top priorities of the Polish government's economic policy. However, after the recent financial and economic crisis Poland is "less enthusiastic" about introducing the euro: the benefits of euro area seem to be smaller. Since that, Poland has stressed that it can derive maximum advantage from joining the euro zone only if there is sound situation in the euro zone itself. Taking into account uncertainty as regards the date of meeting all criteria of the euro adoption and improving the situation in the euro area, Poland’s present government does not declare any more any concrete timetable of the euro adoption. Altogether, the domestic political situation and recent turbulences in the EU and in the world as have caused that the euro adoption remains a distant prospect.

As a final conclusion, let’s say that in the present context, preparations for euro adoption, including proper economic policy to meet Maastricht criteria are more important than the concrete date of the euro area entry.

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