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Stabilization of Zloty Within the Exchange Rate Mechanism II (ERM II) as an Alternative for the Floating Exchange-Rate Regime and the Unpopular Idea for Introducing Euro in the Polish Society

Key words: Eurozone, European Exchange Rate Mechanism II, exchange rate arrangements.

Introduction

The Eurozone currently includes 19 out of 28 European Union countries. Thus, Poland is in the minority of the EU countries that do not have euro. If one takes into consideration Bulgaria (currency board) and also Denmark (officially it is an exchange-rate with very low fluctuation margin towards euro $\pm 0.25\%$) provides a fixed exchange-rate towards euro it turns out that Poland is in a small group of only six EU countries – Great Britain, Sweden, the Czech Republic, Hungary, Romania and Croatia whose economies, citizens and economic entities are in danger of everyday exchange rate fluctuation and costs resulting from such a state. It must be noted that it is 15 years since Polish economy transferred to the floating exchange-rate regime on the 12th of April, 2000. In practice it means everyday potentially limitless changeability of zloty's rate as its level is decided on by the market. If the interest in zloty is bigger, it causes its appreciation, whereas if it is lower it leads to its depreciation.

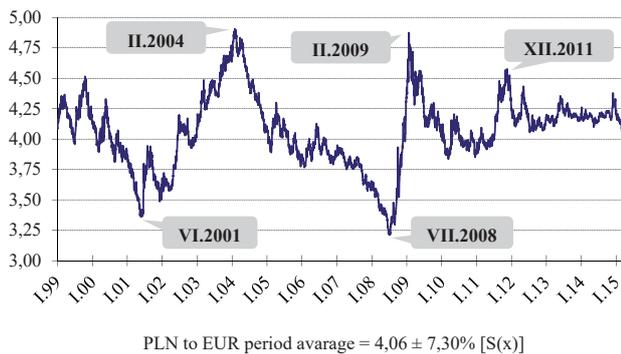
Aside from multi-dimensional analysis of advantages and costs of implementing euro which is not the subject of this overview, it must be noted that economic entities from Eurozone countries have been in better

competitive position for over 16 years. This allows them functioning on a shared EU market. It is especially important in the case of Polish economy. Its currency was either very strong (2001 and 2008) or very weak (2003–2004 and 2008–2009) – chart 1. For example, two-and-half-year period of the zloty's weakening towards euro lasting from the half of 2001 till the beginning of 2004 (for about 46% in the case of medium rate from the level of 3.36 PLN to 4.90 PLN for EUR), and then the almost five-year period of strengthening (for about 34% up to the level of 3.21 for EUR in July 2008) introduced Polish entrepreneurs (exporters and importers) as well as debtors (in foreign currency) to completely different conditions of functioning.

It led, for example, to losses in the case of some contracts, issues with fluctuation or even insolvency and later on to limits in expansion on foreign markets, refraining from entering such markets and, as a result, to employment reduction or shortage of new work places, limiting consumption and investment with all spectrum of consequences for the country's economic situation, level of affluence and financial situation of the country.

Thus, the question about the accuracy of the floating exchange-rate regime as the best solution for Polish economy seems natural. That is why the main aim

Chart 1. The exchange-rate level of zloty to euro in the period from January 1999 to April 2015.



Source: self-reported data on the basis of Oanda, *Historical Exchange Rates* (www.oanda.com – accessed 10.04.2015).

of this overview is to point out an alternative option and its advantages – an option that could possibly be not noticed at first glance, but would rapidly provide benefits and at the same time be a compromise towards strong and growing antipathy for Poland joining the Eurozone. According to the CBOS polling conducted in October 2014, 68% of respondents were against the euro introduction in Poland (only 24% were for introduction). Extra support for introducing euro is dropping systematically every year (it only rose at the time of the biggest crisis in 2008/2009). It must be noted that 12 years ago in 2002 64% were for introducing euro¹.

The European Exchange Rate Mechanism II

The European Exchange Rate Mechanism II is a system of stabilizing exchange rates. It was established on the 1st of January, 1999 for EU countries which did not enter Eurozone. The system is used for maintaining stability of a country's own currency towards euro. At the same time, it supports stabilization and development of the country's and Europe's economy. The participation in it is voluntary but, at the same time, it conditions entering into Eurozone. ERM II is the successor of the European Monetary System in which, from the 13th of March, 1979 up to the end of 1998, EU countries stabilized their exchange rates towards the European

¹ Centrum Badań Opinii Społecznej, *Narastanie obaw związanych z wprowadzeniem euro*, Komunikat z badań CBOS Nr 151/2014, Warszawa, listopad 2014 (cbos.pl – accessed 20.04.2015). The research was conducted with the method of direct and computer-support interviewing in the period of 9th–15th October, 2014 on the group of 919 adult inhabitants of Poland.

Currency Unit. A few decades ago West Europe noticed that the advantages of rate stability compensate for the costs of stabilization – particularly in the case of European economies integrating with each other, which are characterized by high and growing level of openness and mutual trading exchange above the average level.

The ERM II participation includes the duty of maintaining the rate of one's currency within the established range. However, the standard range is broad and amounts to $\pm 15\%$ towards the central rate². It must be underlined that participation in the system provides a very measurable advantage in the form of guarantee of help from the European Central Bank in preserving stability should any tensions in the exchange rate occur³. Such help is automatic and limitless at the end of the range⁴; intervention inside the range would be, in the case of Poland, limited up to around 1.94 billion euros⁵. Such guarantee is an important factor which preserves stability and credibility of the economy.

Due to lack of support and more precise plans in case of Poland in Eurozone, the membership in the ERM II may be treated, only as an action ensuring safety and stabilization in Polish economy. In the future, it could be used for discussion on narrowing the fluctuation range meaning the stronger position of zloty and maybe even the means for accelerating the process of euro implementation should any will or need appear. Eurozone membership must be supported with at least two-year period (at the moment of checking requirements) of membership in ERM II mechanism (without any major disturbances or devaluation of the central exchange-rate)⁶.

² Sec. 2.1, *Resolution of the European Council on the establishment of an exchange-rate mechanism in the third stage of economic and monetary union*, Amsterdam, 16th June 1997, Official Journal of the European Communities No 97/C 236/03.

³ Art. 6 and Art. 4, *Agreement of 16 March 2006 between the European Central Bank and the national central banks of the Member States outside the euro area laying down the operating procedures for an exchange rate mechanism in stage three of Economic and Monetary Union*, Official Journal of the European Union No 2006/C 73/08.

⁴ *Ibidem*, Art. 7–8.

⁵ Attachment to the *Agreement of 13 November 2014 between the European Central Bank and the national central banks of the Member States outside the euro area amending the Agreement of 16 March 2006 between the European Central Bank and the national central banks of the Member States outside the euro area laying down the operating procedures for an exchange rate mechanism in stage three of Economic and Monetary Union*, Official Journal of the European Union No 2015/C 64/01.

⁶ Art. 140 par. 1, indent 3, *Treaty on the Functioning of the*

As ERM II does not require entering Eurozone and it enables preserving fluctuation of the exchange rate (hence, it does not require frequent rate intervention) as well as it also gives the help guarantee of EBC with, at the same time, offering the increase of one economy's credibility, it sounds reasonable to implement zloty into ERM II – especially if relatively long periods of weak (or weakening) and strong (or strengthening) zloty in relatively short period of time from the point of view of a single entrepreneur or debtor are taken into consideration. It is not about obvious advantages for the economy coming from better stability of the exchange rate in the form of better predictability, stability, extended scope of planning, improvement in concurrence or the economy's credibility, but it is also about testing if Polish economy is able to develop and cope with crisis at the chosen level of exchange rate towards euro, i.e. at the level to which one does not have to hold on too much (and, within the allowed range of fluctuation, it could steer the rate) and one which, in case there is any need, could be corrected or leave the system. Such possibility does not exist if zloty is to be introduced to ERM II at the last moment before introducing euro – due to time pressure and the will of fulfilling the exchange rate criteria. What is more important, it all may be done under the supervision and guarantee of help of the European Central Bank (such help serves as additional protection in the case of speculation attacks on zloty). Indeed, the exchange-rate stabilizing (whether it is within the currency system or not) may provoke speculations. It needs to be remembered that the floating exchange-rate regime absolutely does not serve as protection against such attacks. Western financial institutions possess such big capital that they are capable of destabilizing of every economy, not only of a developing economy, but also of an economy with the floating exchange-rate. On the other side, credible exchange-rate policy of the central bank enables the transfer of the weight of intervention onto the very participants of the currency market. Introducing zloty into the ERM II would provide with one more advantage, it would enable the choice of the level of currency conversion into euro that would be attractive from the perspective of the Polish economy. It is crucial due to the importance of economic interests of both, supporters of the lower or stronger conversion rate. One must be aware of the fact that making a deci-

sion of supporting anyone's interest is, in the case of Poland, particularly difficult. Poland is still a developing economy that aims at catching up with Western countries. Hence, supporting concurrence seems essential. However, if we take into consideration immense dependence on import (not only raw materials) as well as the issue of innovation, the choice of the compromise rate becomes really difficult.

If Poland intends to stay a full-right decision-maker, participant and beneficiary of the development of Europe's economy, sooner or later it will have to join the Eurozone, which is mainly because staying on the lower margin of Europe will generate bigger costs (the network effect⁷). Thus, using the present lack of pressure, economical consequences resulting from the floating exchange-rate, preserving zloty on different levels towards euro (very strong, strong, medium, weak, very weak) and eventual stabilization of zloty towards euro should be analyzed substantially, also publicly for the purpose of educating citizens and receiving support from some of them. A debate should also be held on a possibility of introducing zloty to the ERM II. The membership in ERM II is one of the criteria of convergence conditioning joining the Eurozone. However, it does not appear as a declaration of fast joining the Eurozone or any other pressure for deciding in the case. It is confirmed best by the situation of Danish krone which has been successfully stabilized towards euro within the system since its beginning, that is from the 1st January 1999. Despite that, up to this day, Denmark has not accepted euro.

The experience of other EU countries

Some of the new EU members that already belong to the Eurozone, had implemented their currencies into the ERM II system long before joining the Eurozone (table 1).

Lithuanian litas has been in the ERM II system for more than 10 years, Latvian lats for more than 8 years and Estonian kroon for more than 6 years before transferring to the euro. Economic entities had many years to check if their economies will cope both in the period of good economic situation from 2008 and also in the

⁷ Narodowy Bank Polski, *Raport na temat pełnego uczestnictwa Rzeczypospolitej Polskiej w trzecim etapie unii gospodarczej i walutowej*, Warszawa 2009, p. 26 and Narodowy Bank Polski, *Mechanizmy funkcjonowania strefy euro*, Warszawa 2013, pp. 59 i 179.

European Union (consolidated version), Official Journal of the European Union No 2012/C 326/15; Art. 3 of *Protocol (No 13) on the convergence criteria* attached to this Treaty.

Table 1. Comparison of the entire time of being in the ERM II by currencies of countries taking part in it.

country	the date of entering ERM II	the date of entering Eurozone	the time of being in ERM II
Slovenia	28 th of June 2004	1 st of January 2007	2,5 years
Cyprus	2 nd of May 2005	1 st of January 2008	2.5 roku
Malta	2 nd of May 2005	1 st of January 2008	over 2.5years
Slovakia	28 th of November 2005	1 st of January 2009	over 3 years
Estonia	28 th of June 2004	1 st of January 2011	6.5 years
Latvia	2 nd of May 2005	1 st of January 2014	8.5 years
Lithuania	28 th of June 2004	1 st of January 2015	10.5 years
Greece	1 st of January 1999	1 st of January 2001	2 years*
Denmark	1 st of January 1999	–	over 16 years** (so far)

* Greek Drachma took part in previous ERM from the 16th of March, 1998 to the 31st of December, 1998 which equals almost 3 years.

** Danish krone took part in the first ERM from its beginning, that is from the 13th of March, 1979; at the moment of implementing euro it automatically became the member of ERM II system and it still is a member of the system. Denmark has been stabilizing its currency towards euro and, before that, towards ECU for more than 36 years.

Source: self-reported data on the basis of European Central Bank, *Estonian kroon included in the Exchange Rate Mechanism II (ERM II)*, Press Release, 27th June 2004, European Central Bank, *Lithuanian litas included in the Exchange Rate Mechanism II (ERM II)*, Press Release, 27th June 2004, European Central Bank, *Slovenian tolar included in the Exchange Rate Mechanism II (ERM II)*, Press Release, 27th June 2004, European Central Bank, *Latvian lats included in the Exchange Rate Mechanism II (ERM II)*, Press Release, 29th April 2005, European Central Bank, *Cyprus pound included in the Exchange Rate Mechanism II (ERM II)*, Press Release, 29th April 2005, European Central Bank, *Maltese lira included in the Exchange Rate Mechanism II (ERM II)*, Press Release, 29th April 2005, European Central Bank, *Slovak koruna included in the Exchange Rate Mechanism II (ERM II)*, Press Release, 25th November 2005, Danmarks Nationalbank, *Foreign-Exchange-Rate Policy and ERM 2*, 13th March 2014, www.nationalbanken.dk [12.04.2015], Z. Kontolemis, *Exchange rates are a matter of common concern: policies in the run-up to the euro?* Economic Papers N° 191, September 2003, p. 31.

situation of extreme financial-economical issues resulting from the financial crisis of 2008. In the case of three economies, this test was especially unique as all of these countries, out of their own initiative, used the fixed peg regime towards euro (Latvian lats was pegged to euro with a very low range of fluctuation +/-1%). The example of Denmark is also worth mentioning: Danish currency has been in the ERM II system since its beginning, that is from the 1st January 1999 and before that, since 1979 it has been stabilized towards ECU within the previous system of stabilizing – the European Monetary System. It must be also noted that Denmark, out of its own initiative, officially maintains the peg of its currency on much narrower range than the standard one +/-15%, namely in the range of +/-2.25% from the central rate towards euro. The ERM II allows for stronger stabilization of the exchange rate⁸. In practice, the rate of Danish krone is yet more stable towards euro – with the fluctuation range of only around +/-0.5%⁹. Thanks to that, Danish

economy, although without euro, is not endangered with continuous fluctuations and uncertainty. This places its economic entities in much better position than, for example, Polish entities. At the same time, the ERM II membership strengthens the stability and trust towards the Danish economy and its economic policy thanks to the guarantee of help coming from the European Central Bank in case of any rate tensions.

Currently, 8 currencies of EU countries which remain outside of the Eurozone and the ERM II system are: Poland, Great Britain, Sweden, the Czech Republic, Bulgaria, Hungary, Romania and Croatia.

The costs of stabilizing and destabilization of the exchange-rate

Indeed, being a part of the exchange-rate system is associated with certain responsibilities, costs and risk-similarly as to staying out of it. Accepted 30% amplitude of fluctuation in ERM II is a very broad channel, especially in the context of a discussion about the need to stabilize the exchange-rate of zloty towards euro. Thus, keeping zloty in wide range should not generate any high stabilization

⁸ Sec. 2.4., *Resolution of the European Council on the establishment of an exchange-rate mechanism...*

⁹ Danmarks Nationalbank, *Foreign-Exchange-Rate Policy and ERM 2*, 13th March 2014, www.nationalbanken.dk, [12.04.2015].

costs. In fact, if one were to decide on stronger stabilization (as currently Denmark and before that Latvia, Lithuania, Estonia, Cyprus, Malta), such costs would be bigger and would require intense activity from the central bank on a country's currency market. It must be noted that higher costs of functioning of the central bank mean the decrease of its profit or the risk of such occurrence, which is especially important for the Poland's budget as 96% of NBP's profit for the previous year goes into this year country's budget¹⁰. Here lies the answer for the question about the lack of interest on the side of governments on the change of the exchange-rate regime in Poland.

Consequences of stabilizing and destabilizing should be pointed out. On such basis, a decision about the floating exchange-rate regime should be made. Negative consequences of unpredictability and continuous, strong fluctuations of zloty have been visible in Polish economy since the moment of introducing floating exchange-rate regime 15 years ago. The costs of stabilizing the exchange-rate mean lower income from the NBP's profit into the country's budget (or complete lack of such) as an effect of higher costs of NBP's actions. That would mean cutting expenditure and/or either higher taxes or bigger budget deficit. Hence, the dilemma appears again: which interest is more important from the perspective of the future economic development of the country? It must be noted that, although for the economy each of these solutions brings certain costs, for the politicians the first option is much more convenient, namely the lack of stabilization of zloty thanks to which NBP does not generate costs of stabilizing the exchange-rate. Thus, it achieves better financial results that generate income of the country's budget and simplify maintaining economic policy. The amounts are not small. NBP's profit in the last 14 years has amounted to almost 50 billion zloty – table 2.

Once, in 2007, the loss of 12.43 billion occurred, which equals a positive financial result of NBP in the period 2000–2013 in the amount of 37.49 billion. In this period, the country's budget received from NBP 47.63 billion¹¹ which equals for example 17.1% of budget income planned for 2014 (according to the budget act for 277.8 billion)¹² or 5.8% of the national Polish

Table 2. The net profit level of NBP and the amount of payment from its profit into the country's budget for the given year* (in billions of zloty).

	the NBP's profit (in bln PLN)	the payment from the NBP's profit into the country's budget for the given year (in bln PLN)
2013	0	0
2012	5,54	5,26
2011	8,64	8,21
2010	6,53	6,20
2009	4,17	3,96
2008	0	0
2007	-12,43	0
2006	2,61	2,48
2005	1,22	1,16
2004	4,39	4,17
2003	4,27	4,06
2002	4,84	4,68
2001	2,70	2,58
2000	5,01	4,87
	37,49	47,63

* the payment from the profit for the given year comes to the budget for the following year – for example, the payment from the profit in 2012 = 5.26 billion PLN came into the country's budget in 2013.

Source: self-reported data on the basis of Narodowy Bank Polski, *Raport roczny*, Warszawa, selected issued for the period 2000–2013 (www.nbp.pl – accessed 14.04.2015) and Ministerstwo Finansów, *Sprawozdanie z wykonania budżetu państwa (roczne)*, issued for the period 2000–2013, www.mf.gov.pl [14.04.2015].

debt (amounting at the end of 2014 as 827 billion)¹³. It is interesting, however, that despite the accumulated financial result of NBP in this period on the level of 37.49 billion, the country's budget received from NBP's profit 47.63 billion, i.e. over 10 billion more. A more detailed analysis of NBP's financial situation reveals that it was possible thanks to the fact that the high loss of NBP in 2007 (12.43 billion) has not been fully covered up by now and, at the end of 2013, NBP's balance shows 11.46 billion in the place of loss from the previous years¹⁴.

¹⁰ Art. 69 par. 4 and Art. 62 *Ustawa z dnia 29 sierpnia 1997 o Narodowym Banku Polskim*, Dz. U. 1997 Nr 140 poz. 938.

¹¹ Ministerstwo Finansów, *Sprawozdanie z wykonania budżetu państwa (roczne)*, issued for the period 2000–2013, www.mf.gov.pl [14.04.2015].

¹² *Ustawa budżetowa na rok 2014 z dnia 24 stycznia 2014 r.*, Dz. U. z 2014 r., poz. 162.

¹³ Ministerstwo Finansów, *Zadłużenie sektora finansów publicznych IV kw/2014*, Warszawa, 31 marca 2015, www.finance.mf.gov.pl [14.04.2015].

¹⁴ Narodowy Bank Polski, *Raport roczny 2013*, Warszawa 2014, www.nbp.pl [14.04.2015], p. 119.

Conclusion

The issue of whether to enter or not the Eurozone may be discussed for another 15 years, but it is a better solution to get to work, namely to publicly analyze all consequences of zloty's instability and its eventual stabilization in order to educate the society on the specificity of Polish economy in the face of the Eurozone expansion as well as in the context of available solution in the form of ERM II. Perhaps it will enable for better understanding of issues connected with the choice of a desired level of zloty's rate towards euro from the perspective of Polish economy as a whole, as well as understanding the importance of the stabilization of zloty and introducing zloty into ERM II – without any declaration of transferring onto euro in order to use available tools for testing the chosen level of exchange-rate and competitiveness of Polish economy in this respect as well as a crucial element supporting its stability and credibility. Economic stabilization that will be given once continuous fluctuations of the zloty's exchange rate are eliminated, should contribute to the growth of support for integrating with the Eurozone. Even if it does not happen, at least we will function in more stable economic reality, while having additional support from the European Central Bank.

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