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The Risk of Currency Crisis in Poland[1]

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The Risk of Currency Crisis in Poland

Summary

In the 1990's, a wave of currency crises swept the emerging countries. Despite many traits common to all these crises, a great diversity of causes that had led to them could be observed. A part of them clearly did not fit in with the hitherto adopted theory that, consequently, had to be modified.

In this paper, the most important lessons learned from crises in the emerging economies were presented. The conclusions drawn served to assess the risk of currency crisis outbreak in Poland.

The Risk of Currency Crisis in Poland

Contents

Introduction

The subject of this paper is the possibility of currency crisis outbreak in Poland, with special regard to the risk induced in this respect by short-term capital flows.

So, the following problems will be discussed: the mechanics, effects and causes of currency crises (section I); the role of short-term capital flows in currency crises (section II); lessons from the currency crises of the 1990's (section III); as well as the risk of currency crisis in Poland (section IV). The most important conclusions, with special consideration given to the risks brought about by short-term capital flows, will be presented in the Summary.

I. Currency crises: mechanics, effects and causes

A currency crisis occurs as a result of a severe crisis of confidence in the stability of a given currency. Then, the following phenomena appear:

- rapid outflow of a considerable part of the foreign capital that had earlier flown into the given country;
- the residents' flight from the domestic currency (including beforehand buying of foreign currencies needed for repayment of outstanding foreign exchange loans);
- speculative attack on the given country's currency, mainly by non-residents.

If the given country uses any kind of fixed exchange rate, the drop in international reserves can be so drastic that, at a certain moment, any further defence of the domestic currency becomes impossible. Then, it turns out necessary either to carry out a deep devaluation or to make a substantial modification in the exchange rate regime (a considerable extension of the allowed fluctuation band or complete flotation of the exchange rate). Much more rarely, provided that the given country had applied a floating exchange rate of its currency already before the crisis, the depreciation can be very deep and, in addition, a drop in the international reserves can take place if, at any moment, the monetary authorities try to counteract the depreciation by means of foreign-exchange market interventions.

The currency crises arouse so many fears above all because of their numerous and serious repercussions. The considerable fall in the exchange rate of the domestic currency and the unavoidable in such conditions tightening of the macroeconomic policy (including an often drastic increase in interest rates) mostly result in the spread of the crisis to the remaining financial markets and, in particular in the occurrence of:

- a banking crisis (as a result of rapid outflow of foreign capital, difficulties in the access to foreign sources of financing and, above all, sudden deterioration in the financial performance of enterprises as a consequence of drop in the exchange rate of the domestic currency and increase in the interest rates;

- a stock exchange crisis;
- a real estate market crisis;
- a debt crisis.

Finally, after a certain delay, the crisis extends to the real sphere of the economy, assuming the form of a more or less deep and lasting recession.

The basic question about the causes of crises of confidence in certain currencies has not yet been univocally answered by the economic theory [Calvo G.A., 1995], [Flood R.P. and Marion N.P., 1998]. The early attempts at modelling the mechanics that led to currency crises appeared at the turn of the 1970's in response to the crises in some developing countries such as Mexico (1982) and Argentina (1978-1981). These models, now called first-generation models or canonic models, were developed by economists such as Paul Krugman and Robert Flood and Peter Garber. These models presented the currency crises as a consequence of inconsistency between the fixed exchange rate regime and the excessively expansionary macroeconomic policy (of which, especially, high money emission-financed fiscal deficits).As soon as the above inconsistency became obvious to the financial market participants, a speculative attack and currency crisis took place. Thus, the first-generation models explained the currency crisis as a consequence of errors in the country's macroeconomic policy and, in particular, of the chronic budgetary imbalance [Krugman P., 1979], [Flood R.P. and Marion N.P., 1998].

The next group of models, so-called second-generation models, already assumed a much greater elasticity of action of both the government and the central bank. In the face of the threat of crisis they were able to tighten their policy (fiscal or monetary policy, respectively). However, even in such circumstances, a speculative attack on the given country's currency could take place if, at a certain moment, the financial market players came to the conviction that the country's authorities, in pursuit of another economic goal, might after all, in a not-too-distant future, give up the exchange rate stability and allow depreciation of the domestic currency. Such goal can be: stimulation of the economy and reduction in unemployment through growth in exports, erosion of the domestic public debt considered too high, or reduction in real wages [Obstfeld M., 1994], [Rybiński K. and Szczurek M., 1998)

The following, third group of models interpreted the currency crises rather in terms of self-fulfilling expectations, "herding behaviours" and other psychological factors, than in terms of macroeconomic fundamentals [Krugman P., 1997], [Rybiński K. and Szczurek M., 1998].

However, because of the limited usefulness of all the above-mentioned models trying to explain the majority of the currency crises that took place in the 1990's, still other possible causes of currency crises began to be taken into consideration. And so, attention was drawn to the weak points in the microeconomic sphere, to the structural and institutional shortcomings of the economy, as well as to different kinds of the phenomenon known as "moral hazard" -

all of them making the economies in question highly vulnerable to speculative attacks and currency crises.

II. Role of short-term capital flows in currency crises

Of course, the short-term capital flows play a key role in the development of the currency crisis, once it has already set in. Then, firstly, an outflow of the foreign capital earlier invested in the domestic instruments (bank deposits, short-term securities, derivative instruments) takes place. Here, it is however to be noted that even that part of the foreign portfolio investment which formally is of long-term nature (purchase of domestic bonds and equities) can in practice be withdrawn equally easily as the short-term capital; and this is what really happens soon after a serious crisis of confidence in the given currency occurs. Secondly, as well the residents' flight from the domestic currency (especially for its part that assumes the form of capital export) as the speculative attack on the domestic currency (at least for its part that is carried out by non-residents) are tantamount to the outflow of short-term capital.

It is however worth noting that already prior to the crisis the inflow of short-term capital plays a substantial role in making the given economy vulnerable to currency crisis. As to the above-mentioned foreign capital investment in various domestic financial instruments, once it is known that this capital is capable of flowing out equally easily as it has flowed in, its massive inflow should give rise to justified apprehension about the stability of the domestic currency. In turn, an excessive foreign currency indebtedness of domestic economic agents can threaten the given economy with a liquidity crisis. It is therefore that investors pay great attention to a variety of indicators of which the most important ones will be presented below.

The first one is the ratio of the short-term foreign debt of domestic economic agents to the international reserves. The level of this ratio permits to assess the degree of the liquidity crisis risk.

The second indicator is the ratio of the sum of the short-term foreign exchange debt and the foreign capital invested in domestic short-term financial instruments to the international reserves. This indicator serves to assess the ability of the monetary authorities to defend the exchange rate of the domestic currency in the case of a confidence crisis. It is worth noting that, to obtain a fully correct value of the numerator of the quotient in question, one should take into account also that part of the foreign portfolio capital invested in long-term instruments which is of speculative nature. In practice, its estimation is rather difficult, which will still be discussed later on.

The third indicator is the share of short-term capital flows (together with portfolio capital of speculative nature) in financing the current account deficit. This indicator, in turn, conveys an idea of the likelihood of occurrence of difficulties in financing this deficit.

In the last years, still another relationship is more and more often stressed, namely that between the capital flows and vulnerability of the given economy to currency crisis. And so, it is being claimed that in the conditions of the modern world economy the magnitude of the capital inflow to the given country depends, in the first place, on decisions made by private investors who assess the attractiveness of such a country from the point of view of investing their capital in it. Whereas the host country's influence on the scale of the inflow of foreign capital is rather limited. This leads to the conclusion that the inflow of foreign capital rather than financing the current account deficit is generating it itself.

There are at least several channels through which the inflow of foreign capital influences the current account balance. However it is one of them that is considered to be decidedly the most important. Under the fixed exchange rate regime its mechanics are as follows: the inflow of foreign capital leads to increase in international reserves, monetary base and money supply, which, after a certain time, entails increase in the inflation rate, appreciation of the real exchange rate of the domestic currency and, consequently, deterioration in the international competitiveness of the given economy. Under the floating exchange rate regime the ultimate result is similar, although here the appreciation of the real exchange rate is a result of an increase in the nominal exchange rate (on a scale exceeding the drop in the inflation rate) rather than a consequence of increase in inflation rate, as is the case under the fixed exchange rate regime.

Of course, the above-mentioned mechanics concern all the kinds of foreign capital, inclusive of short-term capital. What is more, in the case of the short-term capital the long-term advantages normally expected of the inflow of foreign capital are least certain, so the adverse impact on the current account balance can prove particularly lasting.

III. Lessons from currency crises of the 1990's

In the 1990's, the currency crises affected, in the first place, a number of the so-called emerging markets. These were in succession: Mexico in 1994, Thailand, Czech Republic, Malaysia, Indonesia, Philippines and South Korea in 1997, Russia in 1998, as well as Brazil in 1998-1999. From among all those crises, only the Russian one, by the way showing a great similarity to the Argentinian crisis of 1981, could be well explained by means of the traditional theory of currency crises (in this particular case, the so-called first-generation models). The remaining crises showed many common features.

1) The countries in which the crises occurred had somewhat earlier carried out a radical external liberalization, and that not only with respect to trade but equally to capital flows.

2) Such countries used different kinds of the fixed exchange rate regime, this being motivated by the wish to suppress the still always relatively high inflation and/or by the choice of a development strategy based on export expansion.

3) In their economic policies the countries in question achieved undeniable successes and so were perceived by foreign investors. In particular, the following developments were recognized as success: the way in which the liberalization (and in the case of Czech Republic,

the systemic transformation) and stabilization of their economies had been carried out and, in particular , their achievements in the spheres of economic growth (especially in the South East Asian countries), reduction in the rate of inflation (in this respect, the most spectacular results were obtained by some Latin American countries, in the first place Brazil), and balancing the public finance (South East Asia, Czech Republic, Mexico). As a result, these economies were considered by investors from industrial countries as attractive places of investment for their capital.

4) Despite the above-mentioned undeniable successes, the economies of these countries were characterized by a number of substantial structural and/or institutional shortcomings.

a) In a part of these countries (Czech Republic, the majority of South East Asian countries and, to a certain degree, Brazil), there was no proper restructuring on the microeconomic level. What was more, this was often accompanied by the presence of informal links between the sphere of economy and that of politics. In the longer run, these phenomena exerted a decidedly adverse influence on the international competitiveness of the economies in question.

b) The majority of the countries that were affected by crises (the countries of South East Asia, Czech Republic, Mexico) had inefficient and inadequately supervised banking sectors. These shortcomings became particularly dangerous in conditions of a massive inflow of foreign capital, leading to its far-from-optimal allocation and to excessive credit expansion.

c) In spite of the above-mentioned achievements in fighting the inflation, in practically all those countries the inflation persisted on a level higher than in the industrialized countries. As a rule, to combat this residue of the inflation high interest rates were used that, however, especially in combination with fixed exchange rates, were a factor that strongly attracted the foreign portfolio and short-term capital and encouraged the domestic economic agents to contract debt abroad.[Lutkowski K., 1999].

d) In the countries under review, except the South East Asian ones, the rate of domestic saving was relatively low (and in the case of Mexico even very low). Thus, to reach a relatively high pace of economic growth, a very substantial inflow of foreign savings was indispensable. Even in the South East Asian countries (where the domestic saving rate was much higher) the demand for foreign savings was not lower, this time because of the very high capital intensity of these countries' economic growth.

e) In the majority of the countries under review, the quality of published statistical data on the country's financial position was unsatisfactory. Particular reservations were aroused by considerable delays in the disclosure of certain key data. Here, the examples of Mexico, Thailand and South Korea can be considered the most characteristic. In these countries, data on the drop in international reserves and/or increase in short-term foreign debt were disclosed only after their level had become alarmingly low or high, respectively, which was bound to throw the investors into a panic. If the investors had been earlier informed about the accumulation of such adverse trends, their reaction could have been much more moderate.

f) Even where very ambitious reforms were implemented they were not free of serious omissions. These concerned, for example, the lack of pension system and tax system reforms in Brazil, the delay in proper regulation of the financial market in Czech Republic, and the lack of reform (or, practically, non-existence) of social security systems in the South East Asian countries.

It is to be stressed that all the above-mentioned shortcomings of the emerging economies were getting particularly dangerous just in conditions of radical external liberalization of these economies, this making them highly vulnerable to currency crises. It is also worth noting that for a very long time this risk remained, if not completely ignored, then in any case underestimated, and that as well by the domestic authorities as by foreign investors.

In the 1990's, the countries that were carrying out a far-reaching foreign exchange liberalization and opening their economies to external markets had to perform these processes in conditions much more difficult than those that had prevailed in earlier periods. This was caused by the ongoing globalization of the world economy, and in particular the financial markets, as well as by the structural changes taking place in those markets. To-day, the international financial market is capable of generating streams on a scale that in one day exceeds the total of international reserves of all the central banks of the world. In addition, it is no more the commercial banks that are the main "actors" in this market. This role has been taken over by investment banks and, above all, investment funds of different kinds, including the famous hedge funds that are guided almost exclusively by short-term arbitrage and speculative considerations and ready to take very high risks. The way of operating of these main participants in to-day's financial markets favours the occurrence of very violent movements of capital: from its massive inflow driven by financial euphoria to sometimes panicky outflow often quite unrelated to economic fundamentals of the given country [Lutkowski K., 1999]. Of course, the above-mentioned conditions equally regard all the countries. Nonetheless, they represent a particular challenge just to the emerging economies because of the relative shallowness of their financial markets and the above discussed structural and institutional shortcomings of those economies.

To sum up, the process of integration of the emerging economies with the world economy has turned out more difficult than expected still at the beginning of the 1990's. The severe currency crises (together with all their further consequences), were an external manifestation of the serious inconsistency between:

- on the one hand, the radical external liberalization and the fixed exchange rate policy as a rule consistently pursued by those countries;

- on the other hand, the still always numerous structural and institutional shortcomings of the economies in question, as well as the processes going on in the world financial markets.

In such circumstances, the implementation of the otherwise right strategy of accelerating the economic growth through ample use of foreign savings (which, among other things, was the purpose of integration with the international financial market) proved highly hazardous because of difficulties in controlling both the level of the current account deficit and the structure of its financing.

This deficit was growing because of factors of both internal and external natures. The former included the still always low international competitiveness and the low domestic saving rate (or high capital intensity of the economic growth) of the emerging economies. Whereas the main external cause was the inflow of foreign capital on a scale that exceeded not only the existing financing needs of the current account deficit, but even the given economy's capability to absorb this capital. Such capital inflow, boosted by often overoptimistic assessments of the given economy's prospects, together with high interest rates and seemingly reliable assurances of the domestic authorities about maintenance of a stable exchange rate, contributed in turn to a further deepening of the current account deficit (according to the mechanics described in section II of this paper).

In addition, the economies in question, strongly committed to attraction of development-oriented investment, became the place of large-scale inflow of short-term capital too. In some cases (as for example in South Korea and Brazil) the disadvantageous structure of the foreign capital inflow was also a result of the erroneous sequence of the foreign exchange liberalization steps: almost full liberalization of short-term capital inflow with simultaneous maintenance of far-reaching restrictions on the inflow of long-term capital (of which, especially, direct investment).

The conditions for outbeak of a currency crisis were already present as soon as the current account deficit had exceeded the level generally recognized as still safe (this limit is generally situated somewhere between 5% and 7% of the GDP) and a balance of payments deficit had already appeared (understood as that part of the current account deficit which is funded not by inflow of foreign capital related to normal economic activities but by inflow of short-term capital, speculative portfolio capital and/or by decrease in the international reserves [Sławiński A., 1999]). It was the more so as soon as the total of the foreign exchange debt of the given economy and the foreign capital invested in marketable domestic financial instruments had already begun to top the level of the international reserves.

However, this was by no means tantamount to immediate outbreak of the crisis. As a rule, there was still need for some "detonators" in the form of certain additional internal or external factors, or a coincidence of both. The most frequent ones among the internal factors turned out to be a marked slowdown in the economic growth and/or political destabilization. Whereas among the external factors the one decidedly placed first was the effect of "contagion" with another country's crisis. This effect was strengthened by the way of functioning of numerous investment funds operating on global scale. Very often, in response to losses in one emerging market, a considerable portion of investments in the remaining emerging countries was almost automatically liquidated so as to compensate the losses. Thus, capital was being withdrawn even from countries very distant from the one affected by the crisis and hardly economically connected with the latter.

During the period immediately preceding the outbreak of the crisis, the authorities of the majority of the countries under review (in particular those of Mexico and Thailand) committed in their economic policy serious errors whose avoidance could have permitted, if not to escape the crisis, then at least to considerably mitigate its effects. Faced with accumulation of the above-mentioned evident prerequisites of the outbreak of crisis, the authorities did not settle upon an adequate correction of their macroeconomic policy, especially the exchange rate policy (an adequately deep devaluation or flotation of the exchange rate) while they still had at their disposal considerable foreign exchange reserves and there was still no panic in the market. This behaviour most probably resulted from underestimating the degree of the currency crisis risk and, therefore, giving priority to different internal and/or external policy considerations over the need to make some difficult and unpopular decisions.

So, it can be said that a far-reaching foreign exchange liberalization carried out without meeting all the conditions traditionally considered indispensable for its success [Pietrzak E., 1996], in particular those which have a bearing on the country's international competitiveness, as well as an appropriately low level of inflation, has turned out a risky undertaking. The price that had to be paid by many countries that, in the 1990's, had chosen such a strategy assumed the form of currency crisis with all its further effects. However, in the conditions of the progressing economy globalization it would have been difficult to recommend an alternative development path that could have guaranteed better results. It was so because, as was shown above, on the one hand the global financial markets augmented the risk normally inherent in the radical external liberalization, while on the other hand they rendered practically impossible the earlier practised careful, gradual foreign exchange liberalization, since the huge majority of the hitherto applied foreign exchange restrictions had proved to be utterly ineffective in such conditions. Meanwhile, one could hardly consider a full autarchy to be an optimum solution.

IV.The risk of currency crisis in Poland

Over the whole past decade, the Polish economy showed a remarkable immunity to currency crisis. This immunity was not seriously shaken by any of the crises of the 1990's discussed in section III above. It is only since the latter half of 1999 that the currency crisis risk has become a matter of serious consideration under the influence of the following factors:

- steadily deepening current account deficit having reached a level generally considered as already dangerous;

- deterioration in the financing structure of this deficit to a degree that has already led to emergence of a balance of payments deficit;

- quickly growing short-term foreign exchange indebtedness of Polish enterprises.

As is known from our earlier discussion, it is just the above developments that belong to the most important symptoms of an imminent currency crisis. Therefore, it is they that will be shortly commented here. Later on, a more detailed analysis will be carried out according to the scheme presented in section III so as to ascertain which of the features recognized as typical of the to-day's currency crises are already present in Poland and, if so, to which extent.

The current account deficit appeared in Poland first in 1996 and, then, was steadily growing. In relation to the GDP, it amounted to 1.0 % in 1996, 3.2 % in 1997, 4.3 % in 1998, 7.6 % in 1999 and, according to preliminary data, 6.2 % in 2000[3]. The sources of this deficit will be discussed somewhat later on and, for the time being, let us focus on its level that has already become undoubtedly dangerous. The majority of the currency crises discussed in section III occurred with a current account deficit level ranging between 7.0 % and 9.0 % of the GDP, and that not later than a dozen-or-so months after the deficit had reached such a level. There also were crises (e.g. in Brazil, South Korea and Indonesia) with a much lower level of the current account deficit. On the other hand, however, examples could be adduced of countries (such as Estonia, Latvia, Lithuania, Slovakia) that for a certain time succeeded to "get away" with an equally high (or even higher) deficit.

Till 1998 inclusive, Poland's current account deficit was fully (and sometimes even with a certain surplus) funded by the inflow of long-term capital, i.e. direct investment and long-term loans. *The balance of payments deficit*, understood according to its definition adopted in this paper, appeared first in 1999. However, its precise estimation hits two barriers. The first one is the relatively high surplus in the item "errors and omissions" (1.5 % of the GDP) whose real structure is by assumption unknown. The second barrier is the difficulty in classifying the portfolio capital inflow. As already mentioned above, from the technical point of view this capital can be rapidly withdrawn, irrespective of in which instruments it has been invested. In turn, when trying to analyze the motives by which the investors are guided, it probably can be assumed that, in the case of an economy such as the Polish one, practically the totality of the portfolio investment in debt securities as well as a substantial part of such investment in equity securities are still always of speculative nature [S³awiñski A., 1999].

If the above assumption is adopted and if, with the current account deficit in the amount of 7.6 % of the GDP, the surplus in the direct investment balance was 4.3 % of the GDP, the surplus in the long-term credits balance amounted to 1.2 % of the GDP and the surplus in the

[3] Somewhat earlier, namely after the first quarter of 2000, the current account deficit reached the record level of 8.3 % of the GDP.

portfolio investment balance was equal to 0.7 % of the GDP (of which that related to investment in debt securities 0.4 % of the GDP and that related to investment in equity securities 0.3 % of the GDP), then the 1999 balance of payments deficit can be estimated at about 2 % of the GDP. However, preliminary data for 2000 show a considerable improvement in this respect. The current account deficit amounting to 6.2 % of the GDP was in over 90 % funded by the inflow of foreign direct investment, which, upon taking into account also the long-term loans balance (for which no data is available yet), suggests that there was no balance of payments deficit in 2000.

The foreign exchange indebtedness of Polish enterprises is a relatively new phenomenon, but has been increasing rather fast. According to the National Bank's of Poland data, it amounted to USD 8.5 billion by the end of 1996, to USD 10.7 billion by the end of 1997, USD 17.6 billion by the end of 1998, USD 21.9 billion by the end of 1999, and somewhat over USD 25 billion by the end of the former half of 2000. Short-term liabilities made only about 1/3 of the total debt and, at the end of 1999, amounted to USD 7.3 billion. This made 29 % of international reserves, compared to 22 % a year earlier. On the one hand, the level of this indicator still always is one of the lowest among the emerging economies but, on the other hand, it is growing at the fastest pace in this group of countries. In turn, according to ING Barings, at the end of 1998 the cumulative amount of the short-term foreign exchange debt and the foreign capital invested in marketable instruments of the Polish financial market could be estimated at USD 15 billion, i.e. about 60 % of international reserves. This indicator, too,. is not alarming, however its growing trend can be a matter of concern because, as shown by the experience of countries such as Mexico or South Korea, the above-mentioned indicators are capable of growing with giant strides as soon as the first prerequisites of a currency crisis appear to be met.

And here is how the Polish economy is to be assessed from the point of view of the remaining features typical of the contemporary currency crises:

1) *The degree of external liberalization of the economy.* The external liberalization of the economy, especially the foreign exchange liberalization, was being carried out in Poland somewhat more circumspectly than in the majority of the remaining emerging economies. It is only since June 1995 that the Polish zloty has enjoyed the status of convertible currency by international standards, but its actual external convertibility came much later - only in January 1999. Whereas with respect to short-term capital flows certain restrictions still always continue to be in force. In particular, they concern the non-residents' zloty deposits with Polish banks, contraction of zloty-denominated short-term loans by non-residents, as well as short-term investments by foreign residents. Also, certain restrictions are imposed on contraction of short-term foreign loans by Polish residents.

According to the schedule of foreign exchange liberalization agreed by Poland at the moment of its accession to the OECD, all these foreign exchange restrictions had to be abolished at the beginning of 2000. However, because of the difficult position of the country's balance of payments, further liberalization was deferred till an undefined date (the earliest date indicated is 2001).

The maintenance of the above-mentioned foreign exchange restrictions was long enough considered to be a factor to a certain extent protecting the Polish economy from currency crisis. In particular, they were supposed to secure Poland against excessive inflow of short-term capital and against possible speculative attack on the Polish currency by non-residents. However, as a result of the dynamic development of derivative instruments and the transformation of the Polish zloty into externally convertible currency, the restrictions ceased to be effective. More and more frequently opinions are being expressed that all the transactions can already be carried out, if not by normal methods, then by means of derivative instruments, and that already now the Polish market is perceived by foreign investors as open to free capital flows. In these conditions, a possible full liberalization will, in practice, make already no difference at all [Rzeczpospolita, 2000], [Rybiñski K., 2000].

Maybe, however, a slightly more circumspect opinion would be nearer to reality, as those restrictions have still kept a certain, though already minimal, effectiveness. Firstly, there are certain categories of investment funds that on principle (or because of legal restraints) do not at all invest in the countries that apply foreign exchange restrictions. Secondly, such restrictions can still always be effective with respect to a limited group of smaller investors who do not take advantage of the benefits of the financial engineering. Thirdly, such restrictions can, at least to a certain extent, slow down the increase in the foreign indebtedness of the Polish economic agents.

2) *The exchange rate regime used*. The exchange rate policy pursued in Poland was more flexible than in the countries that were affected by the currency crises of the 1990's. To be sure, this also was a kind of fixed exchange rate regime, but from May 1995 it was a "crawling band", from the very beginning relatively wide (14 %) and, then, gradually still more widened (up to 30 %). Finally, since 12 April 2000, the exchange rate has been fully floating.

The decision to introduce the floating exchange rate seems right for a number of reasons. The one on which we will focus below is reduction in the currency crisis risk. In the situation in which, as was shown above, it is hardly to be expected that the flows of speculative capital can be limited by means of foreign exchange restrictions, this function must be taken over by the exchange rate policy. At the same time, it is well known that it is just the floating exchange rate regime that creates conditions least suitable for foreign exchange speculations. What is more, however, in the existing conditions the exchange rate policy must shoulder the still more far-reaching task of reversing in the short or even medium run the adverse trends in the current account balance evolution. Despite all the well-known reservations in this respect [McKinnon R.I., 1996], [Gotz-Kozierkiewicz D., 1999], it is again the floating exchange rate that can better than any other exchange rate regime assure an adequate and rather smooth adjustment of the exchange rate level to the so-called economic fundamentals, including the balance of payments position.

Although it is still too early for ultimate conclusions, already the first months of the functioning of the new exchange rate regime seem to show that such expectations can materialize. The foreign exchange market participants, lacking in points of reference such as the scale of crawling devaluation, deviation from the parity exchange rate and deviation from the limits of the band of allowed fluctuations, seem to attach a much greater importance to the above-mentioned fundamentals[4].

Meanwhile, it seems to be an error on the part of the Monetary Policy Council that it obstinately rejects the possibility of intervening in the foreign exchange market and that some of its members even declare the Council's complete lack of interest in shaping the exchange rate. Maybe, the US Federal Reserve can afford such declarations (although even in its case they never have been quite true), but certainly not the central bank of a country like Poland. Of course, under the regime of managed floating exchange rate the choice of the time and way of foreign exchange interventions is a difficult art that the central bank has still to learn. Besides, this instrument must in no case be used too freely, which however does not mean that one can afford an outright renunciation of the manifold possible uses of such interventions.

3) *Successes in the economic policy*. The successes of the Polish economic policy achieved during the last decade are much better appreciated abroad than in Poland itself. Foreign investors and international economic organizations particularly well assess Poland's achievements in transforming and stabilizing the economy as well as in the maintenance of a relatively high rate of economic growth. Naturally enough, such assessments find a measurable reflection in the decisions of foreign investors to place their capital in Poland, as well as in the terms on which Polish economic agents can borrow abroad. However, keeping in mind the experience of the countries affected by crises in the 1990's, it is to be remembered that such assessments by foreign investors are very volatile and not always well-founded. At first, they perceive only the strong points of the given economy, to go then suddenly to the opposite extreme.

4) *Structural and institutional shortcomings of the economy*

a) <u>Insufficient restructuring on the microeconomic level as a factor affecting the international competitiveness of the economy</u>

This probably is the most serious shortcoming of the Polish economy and the main cause of the fast growth in the current account deficit. The above conclusion is prompted by a number of facts.

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[4] However it is the big privatization transactions that remain a factor that distorts the level of the exchange rate. Contrary to government announcements, the bulk of the foreign exchange proceeds from this source gets into the foreign exchange market instead of being remitted directly to a special foreign currency account of the Treasury.

Firstly, over the last years the foreign trade deficit was increasing as a result of the slow growth (and sometimes decline) in export rather than as a result of a very fast growth in import. By the way, a similar trend was present in the invisible trade, too.

Secondly, the Polish export responded relatively weakly to improvement in the business climate in the European Union countries being Poland's main export outlets. This strikingly contrasted with the quick and strong reaction of exports of countries such as Czech Republic and Hungary.

Thirdly, the sometimes expressed view that it is the public sector borrowing requirement that makes the main source of the current account deficit does not seem true. According to the most recent data, the deficit of the entire public sector, understood in a way really meaningful from the point of view of the current account balance (i.e. calculated as the borrowing requirement when the proceeds from privatization are included in budget revenues), amounted to 1.3 % of the GDP in 1998 and 1.1 % in 1999 [Wernik A., 2000 (a)], [Wernik A., 2000 (b)]. This permits to frame two important conclusions:

- one can hardly recognize the deficit of the public sector as the main source of the current account deficit now that only about 1/7 of the latter is generated by the public sector borrowing requirement and the remaining 6/7 by the demand for foreign financing of the private sector;

- in 1999, the public sector deficit was even slightly reduced, so it can not be recognized as the cause of the considerable growth in the current account deficit over that year.

Fourthly, it also does not seem that it was the inflow of foreign capital that played a deciding role in deepening the current account deficit. Despite a certain role undoubtedly played by factors such as the high import intensity of foreign investment and the effect of the foreign capital inflow on deterioration in the income balance, there was, at least in 1999, no sign of functioning of the mechanics described in section II of this paper as the most important factor that might lead to deterioration in the international competitiveness of the economy. The above proposition was corroborated by the fact that in 1999, thus in the year in which the growth in the current account deficit was so drastic:

- the total inflow of foreign capital was smaller than in the preceding year;

- there was no real appreciation of the Polish zloty;

- no increase in international reserves took place;

- the increase in the monetary supply came from growth in the domestic component of the monetary base.

Thus, even if in certain periods the role of the foreign capital inflow in generating the current account deficit might have been greater than in 1999, this does not shake the conclusion framed above.

So, which are the main causes of the low international competitiveness of the Polish economy? Firstly, the slow progress with the restructuring, demonopolization and privatization of a number of strategic economy sectors (power industry, mining, the fuels sector, telecommunications, post, railways). Secondly, because of the relatively large size of the Polish domestic market, the foreign capital hitherto invested in Poland was largely directed just towards satisfying the internal demand. Hence, among other things, the pro-export effect of such investment was weaker than in other countries such as Hungary and Czech Republic. Thirdly, many small and even medium-sized Polish enterprises produced until quite lately for the needs of the so-called cross-border trade for which the competitiveness requirements were much lower than for the normal exports. Fourthly, the financial infrastructure77 (inclusive, for example, of venture-capital investment funds) remains poorly developed, while a better financial infrastructure could help the development and restructuring of the small and medium business. Whereas the question of lack of an active official industrial policy is more controversial, since the opinions on the advisability of such a policy remain extremely divided.

b) Condition of the banking sector and the quality of banking supervision

In this respect the situation in Poland is decidedly better than in almost all the emerging economies affected by crises in the 1990's. Thus, in this case one can hardly speak of a shortcoming of the Polish economy.

c) Rate of inflation

In contrast, in this particular respect the situation in Poland is relatively unfavourable. The threat of currency crisis emerged when the inflation rate was not only relatively high (over 10 % yearly), but even slightly rising. To be sure, later the rate of inflation dropped to 8.5 % by the end of 2000, but such a level of inflation is still always a matter of concern.

In this connection it has become evident that the chosen strategy of strong commitment to the possibly fastest economic growth at the expense of slower reduction in the rate of inflation has not only merits, but drawbacks too. In the conditions of progressing liberalization of capital flows, the necessity to maintain high nominal and real interest rates is a factor that strongly stimulates the inflow of short-term and portfolio capital with all its adverse effects discussed in detail above. What is more, with an unhappy coincidence such a not fully suppressed inflation always threatens with recurrence, and that at the least opportune moment.

d) Rate of domestic saving

Like the remaining emerging economies Poland suffers from scarcity of own savings, which compels it to make use of foreign savings. Admittedly, the level of the domestic saving rate is now somewhat higher than that in Mexico and Brazil before the outbreak of crisis, but lower than that in the Asian countries and even in Czech Republic on the eve of crisis.

e) Quality of statistical data

Poland was recently recognized as one of the six emerging countries that, over the last two years, had made the greatest progress in rendering available reliable, complete and up-to-date data on the financial position of their economies. So, this factor can hardly be considered as a shortcoming of the Polish economy.

f) Omissions in the programme of economic reforms

Again, in this respect Poland looks relatively well, which, of course, does not mean that there have not been any such omissions or delays. The delays in the restructuring, demonopolization and privatization of certain strategic economy sectors were already discussed above. Some other omissions and delays to be added here are: lack of determination to continue the tax system reform, delay in implementation of some structural reforms (reforms of the pension system and the health service system) that later led to disadvantageous simultaneous piling up of a number of reforms, and, finally, lack of reform of the labour law and the judiciary.

Summary

As a consequence of a marked improvement in the balance of payments in the latter half of 2000, as well as of a reduction in the rate of inflation, now, at the beginning of 2001, the currency crisis risk in Poland is rather generally assessed as considerably less serious than still a dozen-or-so or even several months ago. Such an assessment might be accepted but, in the light of the analysis made earlier in this paper, it requires to be looked at with some nuance. This is the more necessary as the level of some indicators that have improved (the current account balance, the rate of inflation) can still hardly be considered satisfactory and, at the same time, some disquieting developments have taken place such as drop in the rate of economic growth and appreciation of the Polish currency (even in nominal terms).

Theoretically, a currency crisis can occur at any moment, however, in practice the probability of such an event during the year 2001 is very insignificant. This results from the high level of international reserves, and that as well in absolute terms as, above all, in relation to the total of the short-term debt and the foreign capital amount that might be withdrawn from Poland in a short time. Therefore, there is no risk of liquidity crisis and the participants in the foreign exchange market must take into account the possibility that a speculative attack on the Polish currency may fail and such awareness will radically diminish the likelihood of such an attack. It is however to be kept in mind that in the conditions of the already considerable vulnerability of the economy to currency crisis, such a crisis can nonetheless break out if certain particular internal developments (e.g. a severe political crisis) or external events (e.g. a massive outflow of capital from all the emerging economies) occur, and all the more so in the case of coincidence of both the kinds of circumstances.

However, in the medium run, the currency crisis risk seems more serious. It may materialize especially if the above-mentioned advantageous tendencies in the current account balance and in the rate of inflation are checked (and the more so if they are reversed). A coincidence (well-known from crises in the other countries) of gradually diminishing confidence in the country's currency with very high interest rates might, in a relatively short time, lead to drastic deterioration in the structure of the foreign capital inflow and in the ratio of the short-term foreign exchange debt together with the foreign capital invested in marketable zloty-denominated instruments to the international reserves. Then, the outbreak of currency crisis will be just a matter of time.

However, there is a good chance that such a "black scenario" will not materialize, this owing first of all to the floating exchange rate, and secondly to the improvement in at least some of the structural factors that have a bearing on the current account balance. The floating exchange rate of zloty should, by adjusting to the level of the balance of payments, prevent a serious deterioration in the current account balance. In addition, by increasing the exchange rate risk, it can discourage the inflow of speculative capital to Poland and weaken the inclination of the Polish economic agents to assume debts abroad. Later on, a growth in exports can be expected as a result of a larger and larger scale of inflow of foreign direct investment of which at least a part is, after all, invested in the export sector. Finally, in the somewhat longer run, an increase in the domestic saving rate can be expected (in the first place as a result of implementation of the pension system reform), as well as a progress in the restructuring of the economy on the microeconomic level.

In turn, a factor of key importance for materialization of the above optimistic scenario will be the quality of the country's economic policy, especially as (because of the already practically complete opening of the Polish economy to capital flows) it is the anonymous forces of the global financial market that will de facto be the supreme judge of the quality of this policy. Therefore, its reliability must be based on a solid foundation, and this requires a persistent continuation of structural reforms and, in addition, since the confidence is never given for good, the macroeconomic policy must always be consistent, steady and reliable.

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