The monetary and fiscal policy mix in Poland

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1. A short history of the monetary and fiscal policy mix

Since 1998 monetary and fiscal policies in Poland have been formulated by distinct and independent monetary and fiscal authorities. The history of cooperation between them allows an appreciation of the relevance of the policy mix for the composition of final demand and output, and for interactions between monetary and fiscal policies.

In Poland, the policy mix has largely been determined by monetary and fiscal authorities' perceptions of each other's credibility. Increased uncertainty about the fiscal stance resulting from unexpected fiscal relaxation led to a conservative, tight monetary policy. Combining that with a significant increase in government expenditures suggests that a sub-optimal policy mix is one of the factors that have hampered economic growth in Poland. Such a state of affairs has its source in the past.

Monetary policy determinants

Since 1999 the National Bank of Poland (NBP) has based its policy on direct inflation targeting, thus strengthening its commitment to the price stability goal. Although unforeseeable circumstances meant that short-term goals were not realised, it seems highly probable that the medium-term inflation target set for the end of 2003 will be achieved. This, in turn, should enhance the central bank's credibility. Notwithstanding this achievement, the NBP has often been accused of conducting too tight a monetary policy, and paying insufficient attention to other economic developments, and so keeping interest rates too high. The monetary stance, however, has been determined by a loose fiscal policy to the extent that it has affected the ability of the NBP to attain its inflation target, thereby enforcing further tightening of monetary policy, leading to the sub-optimal policy mix.

Fiscal policy turmoil

From early 1998 the NBP's monetary policy committee relaxed monetary stance by lowering interest rates. It was a natural response aimed at reviving economic growth, which had been hampered by the Russian crisis. The response was "natural" because the central bank's decisions appeared to pose no risk to the desired disinflation trajectory. However, the sequence of events that followed did not correspond with expectations and impinged on relations between the monetary and fiscal authorities for the next few years, leading to a deteriorating policy mix in Poland. The underlying cause of the fiscal turmoil in 1999 was the Social Security Fund breakdown, an event resulting from the temporary loss of control over the inflow of social security contributions. According to the European Commission (2002, p 121), Poland's structural deficit in 1999 increased to above 5% of GDP. Consequently, an unexpected increase in fiscal expenditure, combined with earlier relaxation of the monetary stance, poor external demand and negative supply shocks, led to a surge in inflation and deterioration of the current account deficit.

Under these circumstances, the NBP adopted a very cautious attitude towards the conduct of monetary policy, reflected in a series of interest rate increases and a subsequent series of careful reductions. The Monetary Policy Committee's conservative strategy came in for severe criticism, which further fuelled mutual distrust between the fiscal and monetary authorities. Subsequent events did not facilitate the relaxation of the monetary stance. Insufficient fiscal consolidation, and fiscal policy relaxation, led to an additional contraction in the monetary stance, thus resulting in a far from optimal

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combination of too loose fiscal and too tight monetary policies. Two revisions to the budget in 2001 further weakened the credibility of the fiscal authorities. The 2003 budget does not seem to bring much change in this respect either. Of particular concern is an increasing share of government expenditure in GDP, which hampers long-run economic growth. All in all, the emerging picture is that of an unfavourable policy mix that has constrained the development of the Polish economy.

2. The policy mix given frictions between real and nominal convergence

EMU challenges

Having recognised the underlying causes of the policy mix imbalances and their adverse influence on the Polish economy, one should not underestimate the significance of an adequate mix of policies. Current challenges facing Poland further strengthen the need to improve the combination of monetary and fiscal policies. Poland is on the point of joining the European Union. Soon afterwards it will aim at entering the ERM II and subsequently the euro area. Poland, however, has to fulfil the Maastricht nominal convergence criteria before becoming eligible for euro zone membership. In October 2002, representatives of both the NBP and the Polish government declared that they would aim to fulfil the Maastricht criteria in 2005. However, the most recent statements made by government officials seem to indicate that their commitment may not be maintained. By contrast, in the currently published *Monetary policy strategy for after year 2003*, the NBP has reinforced its stance on euro zone accession.

Fiscal tightening and policy mix adjustments

The most challenging convergence criterion for Poland will be the budget deficit. It should be stressed here that the 3% budget deficit ceiling not only determines eligibility for euro zone membership, but also constitutes a requirement imposed by the Stability and Growth Pact (SGP), which Poland will have to respect from the time it enters the EU. Unfortunately the SGP is all stick and no carrot.

Both the pursuit of nominal convergence and the stringency of the SGP will require a significant tightening of fiscal policy in the near future. Moreover, bearing in mind that no significant steps have been undertaken in this direction in the budget for 2003, the fiscal stance may be expected to be even more restrictive in subsequent years. In the light of the current economic downturn, high unemployment and continuing lack of clear-cut signs of economic revival, such a tightening may entail - according to neo-Keynesian theory - significant costs in terms of economic growth and social expenditures. In this context, choosing a quick path towards the achievement of nominal criteria may conflict with real convergence in the short-run. However, some economists have claimed that these costs could be compensated for by a parallel relaxation of monetary policy in the form of a cut in interest rates, which would make up for the fiscal policy contraction. In this way, fulfilling the nominal Maastricht criteria would not constitute an obstacle on the real convergence path. The question that arises here is whether such an approach would work in Poland.

On this reasoning, having completed the disinflation process, and having achieved lower than expected inflation (in March 2003 the annual inflation rate amounted to 0.6%), monetary policy could provide some stimulus on condition that a corresponding fiscal contraction takes place. Therefore, an agreement between the NBP and the government might result in a common strategy consisting of fiscal tightening and a simultaneous relaxation of monetary policy. However, the crucial factor in such a cooperative process is the credibility of the respective authorities. Assume that the monetary authority decides to lower interest rates, basing its decision on the fiscal authorities' commitment to tighten their policy. If fiscal decision-makers reneged on their promise and loosened their stance, then the central bank could lose credibility, regardless of what steps it took, because the assumed economic outcome would not materialise and inflation would increase. In addition, such swings from too loose to too tight a policy mix could increase the volatility of output. To a certain extent, developments in Poland have been marked by such a sequence of events. Returning the policy mix to balance requires regaining credibility first. This process, however, is a long one, for it is conditional on the pace of the "memory decay". In addition, any slippage sets it back considerably.

The foregoing implies that a proper adjustment in the policy mix can take place only with credible commitments by both fiscal and monetary authorities. Such an adjustment would also moderate the costs incurred due to sharp fiscal tightening necessary to fulfil the nominal criteria. Looking at the historical experience, it is clear that the credibility of the monetary and fiscal authorities in Poland still needs to be enhanced before a credible deal, as advocated by some economists, may take place.

Providing a "credibility anchor" - the role of the Stability and Growth Pact

The factor that significantly limits the fiscal authorities' credibility in Poland is the lack of any nominal/real anchor, that would constitute a constraint on the excessive fiscal relaxation, thus improving the transparency and predictability of the fiscal stance. One attempt to implement such an anchor was the "inflation plus one" rule, which aimed to limit the expenditure growth rate to 1 percentage point above inflation. This rule, though praiseworthy, would require further development, as it was unclear whether the constraint would refer to the central budget or the entire public sector. In the latter case, it would hardly be feasible to fulfil such a commitment, for a significant proportion of public sector expenditure remains beyond the control of the central fiscal authorities. Notwithstanding these shortcomings, giving up the "inflation plus one" rule, which is reflected in the assumed level of expenditures in the 2003 budget, certainly did not enhance the credibility of fiscal policy. A new Minister of Finance announced a new fiscal rule, according to which increases in central budget real expenditures should not exceed real GDP growth. However, as long as no formal commitment has been made by the fiscal authorities, these rules will be perceived as subject to change. If the rules were indeed changed, this could prove counterproductive in terms of the credibility of fiscal policy.

In this context, the commitment to fulfil the Maastricht criteria in 2005, if stood by, might in a way "anchor" expectations as to the stance of fiscal and monetary policies in the allotted time, thereby enhancing transparency of the respective policies. Fulfilling the budget deficit criterion, however, may not necessarily be equivalent to limiting the structural deficit. The target deficit can be achieved through a cyclical improvement, while it is the structural deficit that determines the shape of the policy mix.

Against this background, the SGP could be of considerable value as a vehicle for fostering the credibility of fiscal policy and – consequently – improving the quality of the policy mix in Poland. In particular, the surveillance procedure of the SGP represents a nominal anchor, for it allows tracking of the budgetary stance of EU member states and, should the need arise, enforces the 3% budget deficit limit via the threat of introducing the excessive deficit procedure. Although the penalty for EU members not participating in the euro area is limited, the Council of the European Union may reduce its allocations from the Cohesion Fund to a member country that overspends. Therefore, after joining the European Union, any relaxation of the fiscal policy not justified by a sudden and unfavourable change of macroeconomic environment, and resulting in a breach of the 3% reference value, may entail significant costs. The SGP, by providing a stick, influences expectations as to the limit of the prospective budget expenditures. Moreover, because of the continuous nature of surveillance, the SGP imposes fiscal discipline over the long run, fostering the long-term credibility of fiscal policy. Upholding the announced commitment of the fiscal and monetary authorities to fulfil the Maastricht criteria would only add to that positive process.

3. Concluding remarks

The enhanced cooperation between the government and the NBP, combined with the credibility imposed by the SGP, should improve the policy mix in Poland. However, it seems inevitable that some costs will be incurred when fiscal policy is sharply tightened in order to fulfil the nominal criteria. Temporary frictions between the nominal and real convergence processes may nevertheless be moderated by an adequate adjustment of the policy mix. This, however, will largely be conditional on the credibility of the respective institutions. Against the background of recent disputes and distrust between monetary and fiscal authorities, which may not be forgotten quickly, regaining confidence may be a lengthy process in Poland. Latest statements, questioning the government's commitment to fulfil the Maastricht criteria in the allotted time, may still protract it. Importing a "credibility anchor" in the form of the SGP, however, should shorten that process significantly. Improved credibility will facilitate coordinated shifts towards tightening of the fiscal policy and loosening of the monetary policy, which in turn should improve the macroeconomic situation and contribute to lasting and balanced economic growth in Poland.

Reference

European Commission, Directorate-General for Economic and Financial Affairs (2002): "Public finances in EMU 2002", *European Economy*, no 3/2002.