The Challenge of Economic and Monetary Union: Lessons from Italy's Experience*

Wyzwania Unii Gospodarczej i Walutowej: wnioski z doświadczeń Włoch

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Abstract

This article briefly reviews Italy's economic performance and policies prior to Economic and Monetary Union (EMU) membership and, in particular, their reliance on exchange rate depreciations to maintain competitiveness at the cost of accelerating inflation. The tightening of the exchange rate policy following membership in the European Monetary System (EMS) did bring down inflation but also led to the financial and exchange rate crisis of September 1992, with its silver lining of finally spurring adjustment in the public finances. It is now clear that the insistence on nominal convergence only and the consequent focus on the Maastricht criteria detracted from attending sufficiently to needed structural reforms to improve a growth potential that was already faltering. In fact, Italy's potential growth has declined significantly since the mid-1990s to just over 1 per cent a year in this decade entirely as a result of a decline in total factor productivity. This in turn has resulted in a significant appreciation of the real exchange rate of a magnitude comparable to that that led to the 1992 crisis. Similarly, five years of profligate public finances since 2000 have by now undone most of the progress made in the 1990s. Since membership in the euro area precludes the reoccurrence of such a crisis, what will spur adjustment now? The lesson to be drawn for new candidates to euro membership, such as Poland, is to concentrate on structural adjustment and not only on nominal convergence and avoid a dash towards membership.

Keywords: monetary union, monetary policy, Italy, Poland.
JEL: E42,E52, E58, F36

Streszczenie

W artykule dokonano przeglądu wyników gospodarczych Włoch oraz polityki prowadzonej przed przystąpieniem do Unii Gospodarczej i Walutowej, a w szczególności jej uzależnienia od deprecjacji kursu walutowego w celu utrzymania konkurencyjności za cenę rosnącej inflacji. Zaostrzenie polityki kursu walutowego po przystąpieniu do Europejskiego Systemu Monetarnego zmniejszyło inflację, ale również doprowadziło we wrześniu 1992 r. do kryzysu finansowego i walutowego. Pozytywnym skutkiem tego zjawiska było wprowadzenie korekt w finansach publicznych. Obecnie oczywiste jest, że naleganie jedynie na konwergencję nominalną, a co za tym idzie koncentrowanie się na kryteriach z Maastricht, spowodowało, że w niewystarczającym stopniu zajmowano się potrzebnymi reformami strukturalnymi, które zwiększyłyby słabnące już wtedy możliwości rozwoju. Potencjał rozwojowy Włoch zmniejszył się znacznie od połowy lat 90. do niewiele ponad 1% rocznie w ciągu dekady, tylko i wyłącznie w wyniku spadku całkowitej produktywności czynników produkcji. To z kolei skutkowało istotną aprecjacją realnego kursu walutowego w wysokości porównywalnej z tą, która doprowadziła do kryzysu w 1992 r. Podobnie pięć lat rozrzutności w finansach publicznych od 2000 r. unicestwiło większość postępu, który dokonał się w latach 90. Ponieważ członkostwo w strefie euro wyklucza ponowne wystąpienie takiego kryzysu, co teraz stanie się bodźcem dla dostosowania? Wnioski, które nowi kandydaci do członkostwa w strefie euro, tacy jak Polska, powinni wyciągnąć, to skoncentrowanie się na dostosowaniu strukturalnym, a nie tylko na nominalnej konwergencji. Powinni również unikać zbytniego pośpiechu w dążeniu do członkostwa.

Słowa kluczowe: unia walutowa, polityka pieniężna, Włochy, Polska.

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1. Introduction

Barely a decade and a half after the introduction of the 1990 Stabilization and Reform Programme, Poland has become a full-fledged market economy, member of the EU and on the way to adopt the euro. If this is not an „economic miracle", what are miracles then? For Italy too, joining Economic and Monetary Union (EMU) at its start on January 1, 1999 represented a miracle (let's call it Mr. Ciampi's miracle[1])! But this achievement is beginning to be questioned and doubts are being raised on its sustainability. It is therefore appropriate to review now Italy's experience in EMU with a view to draw from it some lessons for future candidates in general, and Poland in particular. While this paper will concentrate on Italy, it must be noted from the outset that similar problems are also being faced by Portugal, Greece and – to some extent – also Spain. The next two sections will briefly review Italy's policies and performance prior to joining EMU, while the fourth section will discuss performance since then. The last section will present some lessons for Poland and conclude the article.

2. Italy's performance and policies before EMU membership: A bird's eye view

The fundamental cost of belonging to a currency union is the loss of monetary policy independence which itself entails the loss of the exchange rate instrument to deal with idiosyncratic shocks. In the three decades that preceded the monetary union, Italy had been subject to several such shocks which had necessitated the frequent active use of the exchange rate instrument. Domestically, in the late 1960s and 1970s, a strong wage push, the adoption of a restrictive labor code and full and automatic indexation of wages to consumer prices led to considerable increases in labor costs. Externally, the demise of the Bretton Woods regime of fixed exchange rates and the major oil shocks of 1973–74, all contributed to exchange rate instability and increases in costs that adversely affected competitiveness. The resulting exchange crisis of 1976 exhausted the Bank of Italy's external reserves and obliged Italy to borrow from the International Monetary Fund, the European Commission and Germany. Inflation rose into the double digits and remained high until well into the 1980s. With inflation in Italy exceeding significantly and persistently that of its trading partners, the lira exchange rate was repeatedly allowed to depreciate in order to restore competitiveness. These were turbulent years characterized by political instability and stop-go policies. In unison with the rest of Europe, from the mid-1970s the unemployment rate rose steadily to over 10 per cent, doubling in a few years.

In this period, a vicious circle was allowed to develop between wage indexation, inflation and exchange rate depreciation. As inflation accelerated, automatic wage indexation resulted in higher wage costs which adversely affected competitiveness and were in turn offset by lira depreciation. The knowledge that exchange rate depreciation would bail out exporters (and others) led employers to give in more easily to demands for wage increases. Whatever the initial shock, these interactions between wages, prices and exchange rate depreciation pushed inflation to rates well above 20 per cent in the late 1970s and early 1980s. At this level inflation became politically unsustainable and led the authorities to renew their stabilization efforts. Accordingly, fundamental changes in exchange rate and monetary policies were gradually introduced, in keeping with Italy's decision to join the European Monetary System (EMS).

Membership in the EMS and its Exchange Rate Mechanism (ERM) was hotly debated in the country. The Bank of Italy feared fixing the exchange rate, especially vis-à-vis the Deutsche Mark, which had acquired a "refuge" currency role internationally and enjoyed a much lower and stable rate of inflation. It therefore insisted and obtained a wider band of fluctuation for the lira (±6 per cent instead of ±2.25 per cent for the other members). In line with the consensus that gradually emerged among EMS members, the exchange rate and the Deutsche Mark became progressively an anchor for a monetary policy aimed at price stability. Consistently with this decision, the Bank of Italy was relieved of the obligation to be the lender of last resort of the Treasury (the so-called "divorce"). After some softening of wage indexation and the introduction of forward looking incomes policies in 1982–84, the way was open for the central bank to gear monetary policy to reducing inflation. As an integral part of this effort, the real exchange rate was allowed to appreciate and interest rate to become positive in real terms. This policy brought inflation steadily down to around 5 per cent by 1986, but not much further below this floor for another decade. Even so, Italy had to devalue its currency within the ERM seven times, more than any other member, and was able to join the narrow band only in 1990.

Stabilization policies were not successful in addressing another major imbalance which had been allowed to grow to dangerous levels. I refer here to the large and growing government budget deficits which

[1] Mr. Carlo Azeglio Ciampi was Treasury Minister in the Italian Government from April 1996 to March 1999.

Table 1. *Maastricht criteria and Italy, 1995-98*

	1995	1996	1997	Feb. 97-Jan. 98
HICP Inflation				
Actual	5.4	4.0	1.9	1.8
Reference value	2.7	2.5	2.7	2.7
Long-term interest rate				
Actual	12.2	9,4	6.9	6.7
Reference value	9.7	9.1	8.0	7.8
General government borrowing				
Actual	7.1	6.7	2.7	2.5*
Reference value	3.0	3.0	3.0	3.0
Government debt to				
GDP ratio				
Actual	124.2	124.0	121.6	118.1
Reference value	60.0	60.0	60.0	

* Refers to the full year 1998.
Sources: EMI (1996; 1998) and Bank of Italy.

caused an explosion of the public debt, especially after the tightening of monetary policy turned interest rates around from largely negative in the 1970s to positive (at relatively high levels) in the 1980s. In a vicious circle, the public debt rose from less than 40 per cent of GDP in 1970 to about 100 per cent in 1990 and reached a peak of 125 per cent in 1994, creating serious problems of credibility and significantly constraining monetary policy. The limits of a policy of real exchange rate appreciation to combat inflation coupled with persistent and large fiscal imbalances came to the fore in September 1992, when a major exchange crisis led Italy to lose – once again – virtually all its exchange reserves and to exit from the ERM, less then two years after joining the narrow band.

The exchange crisis of September 1992 represented a major defeat for the Italian authorities; however, it also proved to be cathartic. In its wake, fiscal policies that had proven infeasible until then were adopted, despite the climate of political instability then prevailing (three general elections were held between 1992 and 1996 and five governments installed two of which so-called "technical" ones, headed one by the former governor of the Bank of Italy and the other by the former deputy governor). A major correction took place in the public finances (with the primary balance rising from 0 to 2 per cent of GDP in 1992 and over 4 per cent in 1995 and 1996, thus halting the continuous increase in the public debt to GDP ratio). However, the vicious interaction between high debt levels and increased interest rate premia (which rose to a peak of over 500 basis points in the winter of 1995) continued to swell the overall budget deficit. The existing system of wage indexation was abolished and replaced in 1993 by forward looking indexation based on the government's official inflation target. Monetary policy, after losing the exchange rate anchor, began to aim directly at achieving and maintaining price stability, without the Bank of Italy, however, adopting a formal inflation target framework. These policies gradually restored confidence in the financial markets and prevented an acceleration of inflation in the wake of the two large nominal depreciations of 1992 and 1995. This atypical outturn (by past standards) permitted a durable restoration of the competitiveness of Italian exports, in contrast with the experience of the 1970s and 1980s. Despite this progress, however, Italy in 1996 was still far from meeting the Maastricht criteria for membership in EMU (Table 1).

3. The dash to EMU membership

The general elections of the spring of 1996 brought to an end the last "technical" government and gave the opportunity to a center-left coalition, headed by Romano Prodi, to govern for the entire term of the legislature. One of the first tasks of the new government was to decide the timing of Italy's membership in EMU: Together with the other founders on January 1, 1999 or at a later date to allow for a more gradual adjustment. In fact, performance in 1995 and the forecasts then available for 1996 showed that Italy was still far from meeting the Maastricht entry criteria virtually in all areas.

The initial position of the new government was revealed in the *Economic and Financial Planning Document* (DPEF) issued in June 1996 (MEF 1996). The DPEF showed that the 1997 targets for the public finances were incompatible with meeting the Maastricht criteria. Since the decision on the countries fit to participate in EMU on January 1, 1999 was to be taken in mid-1998 based on performance in 1997, this implied that Italy would have not sought entry at the start. Politically, however, this position became quickly untenable as Spain refused to join Italy in a delayed entry. Thus, the budget for 1997, adopted in October 1996, contained strong measures to bring the deficit below 3 per cent of GDP. They consisted mostly of increases in taxation (with many one-off measures, including a special temporary "tax for Europe") that brought the primary surplus in 1997 to almost 7 per cent of GDP thus permitting a significant decline also in the debt to GDP ratio. Helped by a continued fall in inflation and interest rate premia, as markets became convinced of its early entry, Italy was thus able to meet all the Maastricht criteria in 1997. The high level of public debt and related interest burden, which in periods of crisis had greatly contributed to the expansion of the overall budget deficit, proved helpful in the final effort, transforming the earlier vicious circle into a virtuous one. Between 1994 and 1997, Italy's fiscal adjustment totaled 6.6 per cent of GDP, of which 4.6 percentage points was primary adjustment and 2.0 percentage points came from the decline in interest rates. EMU entry produced a clear immediate benefit for the budget, making the adjustment more sustainable, despite the significant contribution of one-off measures to the effort.

The fiscal adjustment permitted a reduction in the public debt ratio from its peak of 125 per cent in 1994 to less than 122 per cent in 1998, but at this level it still represented a serious vulnerability. Accordingly, the 1998 European Monetary Institute *Convergence Report* concluded: "Notwithstanding the efforts and the substantial progress made towards improving the current fiscal situation, there must be an ongoing concern as to whether the ratio of government debt to GDP will be "sufficiently diminishing and approaching the reference value at a satisfactory pace" and whether the sustainability of the fiscal position has been achieved; addressing this issue will have to remain a key priority for the Italian authorities. Significant and persistent overall fiscal surpluses are rapidly needed to be able to forcefully reduce the debt ratio to 60 per cent of GDP within an appropriate period of time" (EMI 1998, p. 19).

With the benefit of hindsight, it is now clear that the insistence on nominal convergence only and the consequent focus on the Maastricht criteria detracted from attending to needed structural reforms to improve a growth potential that was already faltering, as we shall see shortly.

4. Italy's performance in EMU

Compared to the experience of the 1970s and 1980s (which, after all, had been years of inflation and repeated attempts at stabilization) Italy's growth performance since the establishment of EMU has been, to say the least, very disappointing. GDP growth has exceeded the average for the euro area only in two years (2000 and 2001) out of seven and by only a small margin. In all the other years, Italy's growth has been significantly lower, both in total and in per capita terms (Table 2). After 2000, consumption and

Table 2. *Italy's economic performance, 1999-2005*

	1999	2000	2001	2002	2003	2004	2005
				(per cent change)			
GDP growth	1.9	3.6	1.8	0.3	–	1.1	–
Private consumption	2.5	2.4	0.7	0.2	1.0	0.5	0.1
Gross fixed investment	3.6	6.4	2.5	4.0	-1.7	2.2	-0.6
Exports	-0.4	8.3	1.6	3.2	-1.9	3.2	0.5
Consumer prices	1.6	2.6	2.3	2.5	2.7	2.2	1.9
Unemployment rate	10.9	10.1	9.1	8.6	8.4	8.0	8.1
Public finances*				(in per cent of GDP)			
Revenue	46.7	45.8	45.7	45.3	46.0	45.2	44.8
Expenditures	48.4	46.6	48.8	48.1	49.2	48.5	49.2
Primary balance			3.4	3.0	2.1	1.9	0.6
Overall balance	-1.7	-0.8	-3.2	-2.7	-3.2	-3.2	-4.3
Debt/GDP	115.6	111.3	110.9	108.3	106.8	106.5	108.2

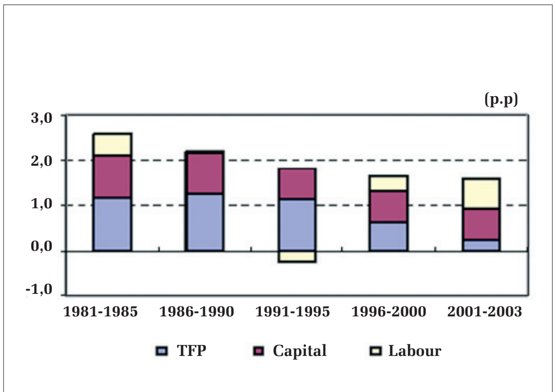
* In per cent.

Sources: IMF (2005) and Bank of Italy.

investment growth have remained very subdued, despite significant increases in employment. This lackluster performance cannot be ascribed to excessively tight fiscal and monetary policies in Italy; indeed, the latter was the same as for the rest of the euro area and budget deficits increased. It reflects instead a continued loss of competitiveness which resulted in a notable negative contribution of net exports to GDP growth (2 percentage points over 2001–2005). Despite relative stagnation, Italy's employment performance was much better than that of France or Germany thanks in part to measures to increase labor market flexibility. The rate of unemployment fell from almost 11 per cent in 1999 to 8 per cent in 2005. However, the combination of slow output growth and increased employment has had also a negative side: the implied decline in labor productivity.

Monetary union, and in particular the common monetary policy per se, cannot be held responsible for this poor performance which indeed has its roots in deep structural problems that predate EMU. Since the early 1990s, Italy's pace of economic expansion has slowed down visibly. While this experience is shared by some other European countries and reflects, in part, the end of a process of "catching up", the slowdown in Italy has been more marked and signals the beginning of a process of "divergence" from its European partners and even more so from the USA (Faini and Sapir 2005). Estimates by the EU Commission show that Italy's potential growth has progressively declined from 2.6 per cent per year in the first half of the 1980s to 1.5 per cent in the second half of the 1990s and the first three years of the current decade. Other estimates, arrived at independently by the OECD and the IMF, reach similar conclusions and are even lower. There is therefore no doubt that Italy's growth potential has declined over the 1990s in both absolute and relative terms and is likely to remain low for the rest of the

Figure 1 *Potential output growth. Contributions from factors of production*



Source: Larch (2004, p. 2).

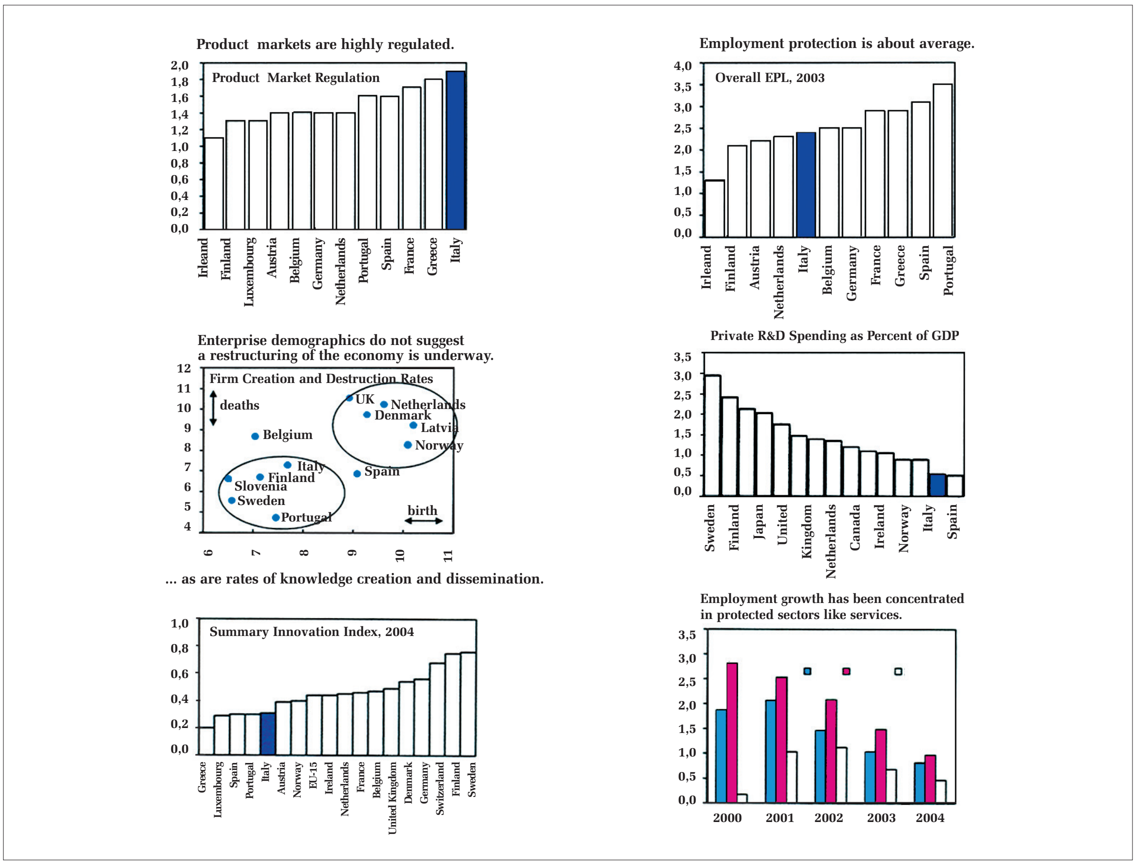
decade. The *2005 Stability Programme* update shows potential output growth at 1.2 per cent a year for 2004-2008 hopefully rising to 1.6 per cent in 2009. A simple growth accounting exercise shows that the decline in potential growth is to be entirely attributed to a fall in total factor productivity, especially since the mid-1990s (Figure 1).

There is by now an ample literature on the likely causes of this decline.[2] I would like briefly to recall here a few recent studies and examine in more detail the question of external competitiveness, which, in my view, is more directly related to the issue of monetary union. There is broad agreement among economists that rigidities and inefficiencies throughout the economy are at the heart of Italy's difficulties (Figure 2). These range from excessively regulated product markets and insufficient competition that increase costs, distort incentives and set barriers to market entry and innovation, to low R&D expenditures both by the private and public sectors. The prevalence of small, family owned firms and a surprisingly low level of FDI also discourage the introduction of new technologies. As in other EU countries, legislation protecting the labor market, while made more flexible in recent years, remains an obstacle to structural shifts. Moreover, the education level of the labor force is lower (and the gap is increasing) than in other European countries and in the U.S., discouraging the shift toward higher technology industries. These rigidities have resulted in an unfavorable product specialization of the Italian economy which, unlike Germany and France, has not significantly changed over the past decades in response to global economic developments. Thus, the Italian economy remains strong in traditional low-skilled labor intensive sectors for which global demand is expanding below average and competition from emerging markets producers has increased strongly.

Unfavorable product specialization and low productivity growth explain in large measure the slow and decelerating growth of exports and the net negative contribution of the external balance to GDP growth, especially in the last few years. While monetary union is clearly not the cause of these longer-term problems, the advent of the common currency has brought these structural rigidities into sharper focus. As noted before, in the past losses of competitiveness due to idiosyncratic shocks had been corrected – at least for some time – by nominal and real exchange rate depreciation, the last two occurring in 1992 and 1995. Within a monetary union, this is no

[2] See for instance: Brandolini and Cippolone (2001), Ciocca (2003), Faini (2003), Faini and Sapir (2005), Larch (2004), Larch (2005), Nicoletti (2002), Pagano and Schivardi (2003), Rossi (1998), Signorini and Visco (1997), Visco (2003).

Figure 2 *Italy: Market rigidities*



Source: IMF.

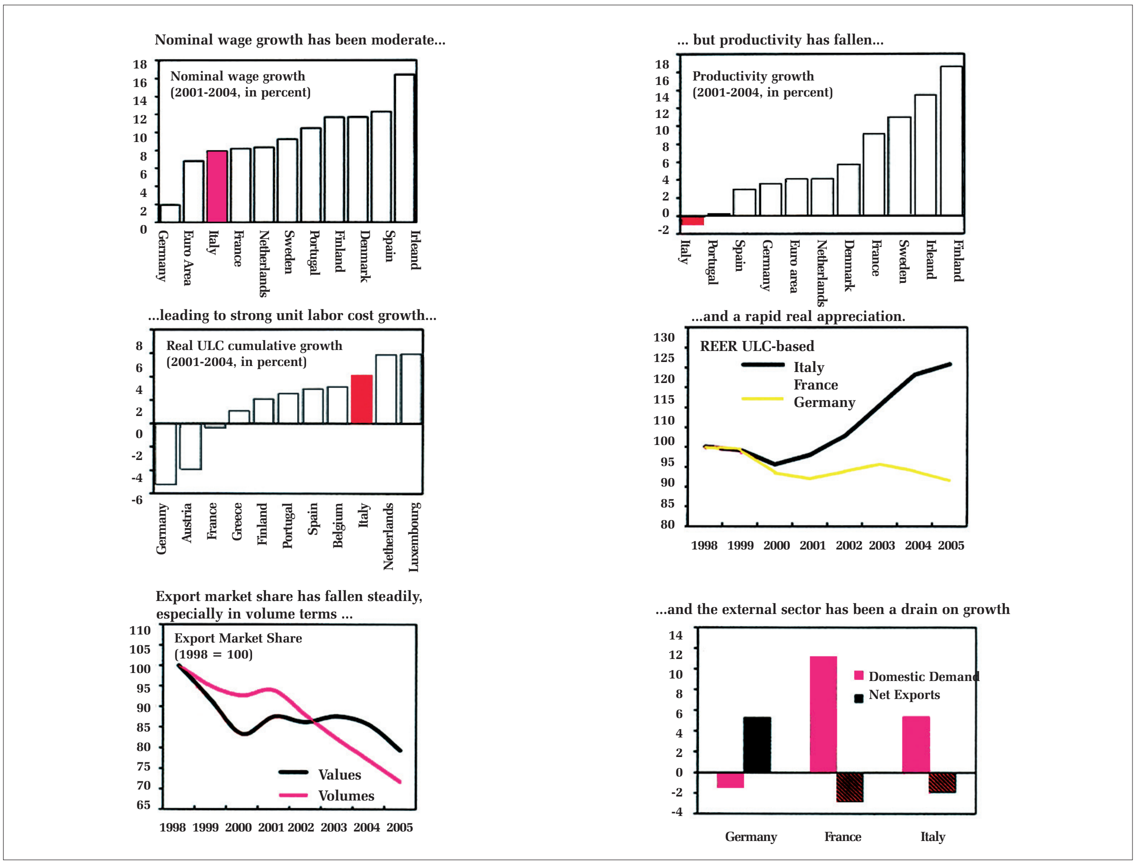
longer possible. Losses of competitiveness are again occurring, this time less because of excessive wage growth and more because of the lack of productivity increases (Figure 3). By 2005 the appreciation of Italy's real effective exchange rate (ULC based) was not very different from that which had occurred in 1992 and had led to the exchange rate crisis of September 1992 (Figure 4). This time, however, the „cathartic" effect of that crisis will not occur since no such event is possible in a monetary union. What then will prompt the necessary adjustment in the real economy and in the public finances?

The years 1992 and 1995 had also witnessed the risk of a financial melt down and the resulting very high risk premia in interest rates had helped spur fiscal adjustment. This, too, is absent now, with the spread of Italian bonds over German ones at very low levels despite the deterioration in the fiscal position. By 2005 the large primary surplus, which had been generated for EMU entry, has virtually disappeared and the public debt to GDP ratio has begun to rise again. The inability or unwillingness of financial markets so far to differentiate more among euro area participants with regard to default risks is, to say the least, perplexing, as noted recently by a high ECB official. It is probably due to the fact that, based on past experience, financial markets give much more weight to exchange rate risks than to default risks in the case of industrial countries.

Table 2 referred to above shows the deterioration of the fiscal position in recent years and the renewed increase in the debt to GDP ratio from already very high levels. Coupled with the stagnation of output and exports because of low productivity growth, it is not surprising that these developments are beginning to generate public discussions on the sustainability of Italy's membership in EMU. These discussions started some time ago with a shouting match in Davos between then Italian Minister Tremonti and the New York University economist Nouriel Roubini and have continued in recent months, for instance in the *Financial Times* and *The Economist*.[3] Since leaving EMU is clearly not an option in the foreseeable future and would be extremely costly, will the slow deterioration – we have described – be able to spur the required structural adjustments? This has been the case only in a limited way with the center-right government of Mr. Berlusconi, despite its large

[3] See also Roubini (2006).

Figure 3 *Italy: Competetiveness*



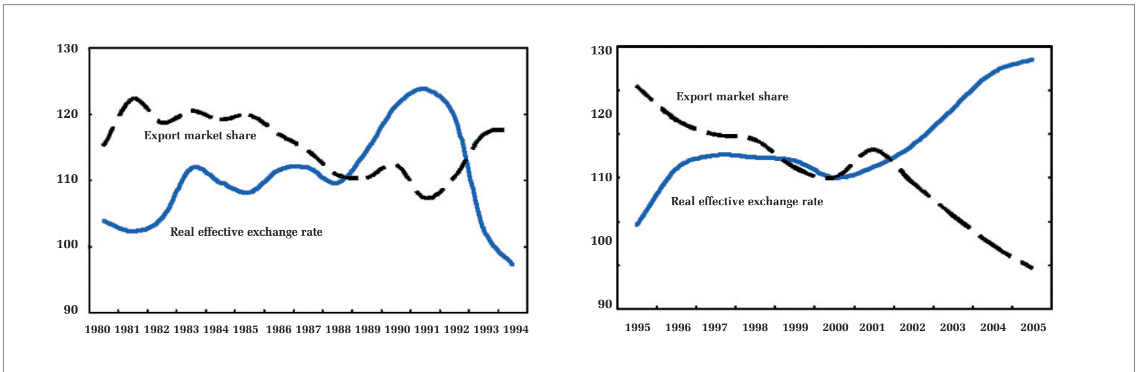
Source: IMF.

majority in Parliament. Will it be possible with the center-left government elected in April 2006 with a very small margin and made up of such a heterogeneous coalition? These questions will, of course, be answered in time and recent pronouncements by Minister Padoa-Schioppa augur well[4]. However, the main lesson to be drawn now is that EMU has brought to the fore structural weaknesses, but has not been able so far to generate sufficient political will to address them fully. In the meantime, the costs of insufficient action mount and doubts on Italy's future membership begin to be raised.

These conclusions are in line with those of a recent paper prepared for an ECB workshop on what effects EMU is having on the euro area and its member countries. This paper looks in particular at the impact of EMU on structural reforms in labor and product

[4] See for instance the article on *Corriere della Serra* of June 14, 2006.The DPEF 2007 – 11, published in July 2006, presents an analysis similar to that developed here and proposes a significant fiscal adjustment for 2007 to bring the fiscal deficit below 3 per cent of GDP (MEF 2006).

Figure 4 *Italy: Export market share and REER, 1980-94, 1995-2005 (2000 = 100)*



Source: IMF.

markets (Duval and Elmeskov 2006). Its findings are somewhat disappointing, especially for those who had hoped that the loss of an independent monetary policy would have spurred structural adjustment. There are two basic reasons for this expectation: (1) the TINA argument – There Is No Alternative – and (2) the fact that the greater transparency created by the single currency would expose more clearly the costs of structural rigidities and introduce greater market competition. On the other hand, other arguments point to EMU possibly weakening the incentive for structural reforms mostly because the up-front costs may be larger with a common currency coupled with restrictions on the use of fiscal policy, as is the case in EMU. Which argument will prevail is therefore an empirical question. This study finds that there is little evidence that EMU has facilitated the reform process and concludes as follows: "The upshot of the analysis is that many of the usual suspects [indeed do] seem to determine the pace of structural reform such as going through an economic crisis and more broadly experiencing high unemployment" (Duval and Elmeskov 2006, p. 37).

Before concluding the story of Italy in EMU, there is a final tale that warrants noting. I refer to the impact on consumer prices of the introduction of euro notes and coins to replace the lira. This process lasted a few months starting on January 1, 2002 or three years after the establishment of EMU. Between 1999 and 2002, the euro and the lira had been both legal tender but the euro was only used in bank transactions. Prices were required to be shown in both currencies at the official conversion rate of 1 euro = 1,936.27 Italian lira. Despite this rather long period of adjustment there is a widespread belief in the Italian public (and also in some other countries) that in many cases prices of some goods and services were increased significantly by using de facto a different conversion rate (in some extreme cases even doubling, i. e. converting at 1 euro = 1,000 Italian lira). This phenomenon, of course, has given scope for criticism and discontent that has not gone unexploited by some politicians. How much truth is in it? Studies carried out by the Bank of Italy, the Italian statistical office ISTAT and academic economists do not show any significant effect (in December 2002 consumer prices were 2.8 per cent higher than a year earlier compared with 2.4 per cent in 2001). However, monthly consumer surveys on past inflation (carried out by ISAE and euro barometer) show a sharp rise in perceived inflation far exceeding officially recorded price changes in Italy as well as in the rest of the euro area. This difference between consumer perceptions and officially observed prices has not so far been explained and a recent comprehensive econometric study concluded: "Overall, the extensive empirical evidence we gathered does not lend support to the contention that the cash changeover led to a generalized price flare up" (Zecchini and Ventura 2005, pp. 339-340). While Italy may have been an extreme case due to the conversion rate, the unfamiliarity with the use of cents, lack of competition in local markets and among small shops, etc., the issue remains relevant for other candidate countries too (and is now worrying Slovenia). It calls for a very careful changeover, with a long period of double pricing and clear explanations of the process by the authorities. The other challenges of a more fundamental policy nature just discussed are already difficult enough to compound them with issues of perception.

Italy's dash to EMU membership achieved its immediate goal, but the issue of sustainability has remained. As foretold in the EMI 1998 *Convergence Report* (EMI 1998), the high level of public debt is a serious fragility, especially in a situation of slow growth and increasing budget deficits above the limits imposed by the Growth and Stability Pact. This unfavorable combination of outcomes not only limits the use of fiscal policy but also brings to the fore the insufficiency of structural reforms, raising serious questions as to the sustainability of membership. These are the basic lessons from Italy's experience for new candidates to the euro area. How relevant are they for Poland?

5. The challenge for Poland

The main message for Poland from Italy's experience is clear and simple: do not rush and adopt the euro only when the public finances are well under control and the main structural problems have been addressed to, i. e. do not rely on TINA argument. There are, however, sufficient differences and similarities between the two countries briefly to turn now our attention to the challenges facing Poland more specifically.

On May 1, 2004, Poland became a member of the European Union, with a derogation from adopting the euro as its currency. The issue facing the country therefore is not whether to join the euro area, but only when. In this endeavor economic policies in Poland (as in almost all the other new members of Eastern and Central Europe) will have to address two major challenges: (1) To reduce the large income gap that still exists vis-à-vis the older EU members through a process of real convergence (Poland's per capita income in purchasing power standards at about half the EU 25 average is one of the lowest); and (2) to achieve the degree of nominal convergence needed to qualify for entry in the third stage of EMU, i. e. to adopt the euro (Schadler et al. 2005).

The first objective requires rapid GDP growth on a durable basis, through continued productivity increases, higher domestic savings and large capital inflows to sustain investments and import technology. The second will need stability oriented macroeconomic policies. While these two objectives are not mutually exclusive and, in point of fact, even reinforce each other in the longer run, in the period immediately ahead the task of reconciling them may not prove easy. Poland's current economic situation, characterized by a very high rate of unemployment and serious structural weaknesses, is not amenable to a "dash" for meeting the Maastricht criteria as Italy did in 1997, rather it requires the steady and prolonged pursuit of reforms together with stabilization.

No official date has been set by the current Polish government for entry in the euro area. In the past, however, 2009-10 had been indicated as a possible target. This would have implied membership in ERM2 sometime in 2007 and meeting all the other Maastricht criteria already in 2008. Currently a later date is envisaged and the Prime Minister is reported to have said that 2009 would see the start of discussions for euro adoption.[5] The January 2006 update of the *Convergence Programme* states that the intention „is for Poland to meet the Maastricht criteria within the present term of the Parliament" (Republic of Poland 2006, p. 6). Accordingly, economic policies will aim at strong growth and employment gains as well as at budget consolidation, with the emphasis seemingly placed on the former. These objectives, however, must be pursued together as a stable public debt and less dissavings by the Government are needed to achieve faster growth. With this in mind, the Government also wants to strengthen absorptive capacity to benefit fully from EU transfers.

The first convergence reports issued by the ECB (ECB 2004a) and the EU Commission (EC 2004a) in October 2004 had concluded that, in the reference period September 2003 – August 2004, Poland had not met any of the entry criteria. By now significant progress has been made and both the inflation and interest rate criteria are being met. This is also the case for the government debt criterion although more recently the debt to GDP ratio has resumed increasing because of the still unsatisfactory budgetary situation. There are questions concerning the criterion on central bank independence which the current law does not fully meet, let alone changes to that law currently under discussion.

Over the last five years, general government deficits have consistently exceeded the 3 per cent reference limit, not only in actual terms but also, according to available estimates, on a cyclically adjusted basis. There have been improvements in 2005 and foreseen for 2006, thanks in part to the impact of the Hausner Plan, but available independent forecasts (e. g. Goldman-Sachs) show the deficit remaining above 4 per cent also in 2007, against the targets of 2.6 per cent for 2006 and 2.2 per cent for 2007 set in the update of the Convergence Progamme just mentioned.[6] These targets, if achieved, would represent real progress, but there is little specificity in the Programme as to how this will be done and clear doubts in the markets as to their feasibility. Moreover, this planned performance should not only be compared with the reference value of the Maastricht Treaty but also, from a medium-term sustainability point of view, to the objective for Poland of a deficit not exceeding 1 per cent of GDP called for by the European Commission under the Stability and Growth Pact. This would create enough room for the automatic stabilizers to play a role in case of need and for mitigating some of the costs of future structural reforms. Furthermore, past deficits have been achieved at relatively high levels of tax revenue and expenditure (in terms of GDP) when compared to other countries with similar levels of per capita GDP and to the need to sustain high rates of GDP and employment growth. The distance therefore to be made good in the area of public finances is still considerable.

Despite these shortcomings, there is no doubt that if the Government were to decide to join the euro area soon, the required additional effort could be made with one-off measures or similar action, as Italy did. Indeed, when compared to Italy at a similar phase prior to joining, Poland's situation in meeting the Maastricht criteria is considerably more favorable even though little if any contribution could be expected in the case of Poland from lower interest rates. But this is not the lesson that one should draw from the Italy's experience: Poland should look beyond the legal requirements of the Maastricht Treaty and concentrate on the issue of sustainability and growth. Then the main question becomes: are reforms likely to be made easier by being in the currency union soon or does sustainability require a much sounder fiscal position, well below the Maastricht reference limit, and the implementation of as many reforms as possible prior to joining?

Also with regard to structural reforms Poland has so far made considerable progress, but the unfinished agenda is still heavy. It shares with Italy and other EU members the need to reform product markets and the labor market. In its 2005 *Annual Report on Structural Reforms* (EC 2005b), the EU Economic Policy Committee calls for reducing the share of the state in

[5] See for instance the *Financial Times* of May 16, 2006.

[6] These targets include the surplus of the second tier pension fund.

the economy through further privatizations (in particular in the coal and energy sector), improving infrastructures, strengthening competition (especially in telecommunication services) and incentives, and for encouraging private R&D expenditure and innovation, etc. In the labor market, in addition to its own high rate of unemployment resulting from the transition process, Poland shares with Italy low participation rates, a high tax wedge, the need for regional wage differentiation to reflect different levels of productivity and unemployment, the need to improve the skills of the labor force, especially of young workers, and to increase the flexibility of labor contracts.

An unfavorable demographic profile (very similar to the Italian one) and measures to alleviate the impact of transition have created a major pension imbalance that Poland has, however, addressed more decisively than other EU countries and Italy in particular. The 1999 reform established a mixed private-public system which in Italy will only become effective in 2008 (EC 2006). It represented a major effort toward restoring the long-term stability of public finances, but less favorable than envisaged developments since then have resulted in less progress than targeted. Moreover, the transition costs of these reforms have been high and underscore the need for a solid underlying budgetary balance.

Of course, not all these reforms must be completed prior to adopting the euro, but priority should be given to those aimed at improving the working of product and labor markets. Only in this way the necessary flexibility to respond to asymmetric shock, once in the euro area, will be found. It is delays in these reforms and the insufficiency of the measures so far adopted that are now considered responsible for the slow productivity growth in Italy, raising the question of sustainability. Fortunately, Poland's reserves of productivity increases are considerable, but so is the need for real convergence to the rest of the EU.

A resilient financial system and a strong supervisory system are essential for the good operation of monetary policy and an efficient transmission mechanism once in the euro area. There is also the risk of a credit explosion that could fuel consumption and/or an asset bubble as the experience of Portugal shows. This is more the responsibility of the National Bank of Poland and improvements in this area are being carried out in a timely manner.

Once the decision to join the euro area is taken, an immediate challenge will be the management of the exchange rate within ERM2. In this respect, Poland's situation differs considerably from that of Italy in 1997. Poland is now successfully following a strategy of formal inflation targeting and flexible exchange rate which has served it well judging by the very low inflation and relatively low long-term interest rates. In addition, Poland, as an emerging market, has experienced large capital flows and the flexible exchange rate has proven a useful cushion. Moreover, the exchange rate needs to be steered to a level that is sustainable (and reasonably competitive) in the longer run. Meeting these requirements and managing a successful non-inflationary monetary policy will be a major challenge for the National Bank. So far the official pronouncements from the ECB have called for a strict application of the exchange rate stability criterion, namely participation in the narrow band without devaluing the zloty at Poland's request for two years prior to qualification.[7] It would be more desirable to apply a „wide" normal band and/or a shorter period of membership in ERM2 so as to preserve the price stability so far achieved and at the same time meet this entry requirement.

At a 2004 ECB conference on EMU enlargement (ECB 2004b), members of the ECB Executive Board insisted on the need for nominal convergence and a very strict application of the entry criteria (The recent decision on Lithuania is an extreme example!).[8] However, the experience of Italy shows that the fundamental message for both the old and new members should be "sustainability". Nominal convergence will not be sustained without real convergence. Low fiscal deficits, even if achieved, will not prove durable without productivity growth and lower unemployment, which will in turn require well functioning product and labor markets in both the old and new members. These objectives should be more the focus of the *Convergence* or *Stability Programmes* than is the case now. The programs presented by both Italy and Poland show a reasonable path of adjustment, but the measures to realize them are not specified and past experience shows that these plans are too often revised and the targets missed. An old Italian proverb says: "Tra il dire e il fare c'é di mezzo il mare", which can be translated as follows: "Between promising and delivering there is an ocean to cross!" Let us wish to both Italy and Poland a safe crossing and agree with the ECB executive board member that at the same conference expressed the hope that as EU membership had proved a major incentive for reforms in transition countries, so the new members should spur the older ones to implement more forcefully structural reforms.

[7] But in the case of Italy it was interpreted as two years prior to fixing permanently the exchange rate of the lira.

[8] Lithuania application to join the euro area was rejected by the Commission on May 16, 2006 on the ground that its inflation rate at 2.7 per cent exceeded the reference value (2.6 per cent) and was likely to remain above it in the forecast period. All other criteria had been met by a large margin.

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