

**What is the optimum ERM II Central Parity for the Polish Zloty?
Fundamental Equilibrium Exchange Rate approach.**

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The studies of the development tendencies of the Polish economy in the late '90s and at beginning of this millennium cannot neglect the influence of the foreign sector on the economic situation of the country. In this period Polish current and capital accounts have been fully liberalized. The Polish economy has become more open: the volumes of imports and exports have multiplied five and three times, respectively (Mroczek, Rubaszek, 2003 and 2004). As a consequence, the impact of exchange rate fluctuations on Polish economy has risen considerably.

In May 2004 Poland joined the European Union and is thereby committed to introduce the euro in the forthcoming years. Among the benefits of joining the Monetary Union, which are discussed in Borowski (2004), one can number lower costs of borrowing, elimination of the exchange rate risk, higher access to foreign capital and lower transaction costs. These advantages of one currency seem to exceed the major cost, i.e. loss of monetary policy independence. The balance of costs and benefits of the euro adoption also depends on the decision of the Polish and European authorities concerning the level of central parity in the ERM II, and subsequently the conversion rate of the zloty. More precisely, inappropriate determination of the entry rate may invoke severe consequences for the real sector of Polish economy. On the one hand, an overvalued parity leads to a loss of competitiveness of domestic producers and hence forces them to limit their output or even drives them bankrupt. If prices are sticky and the adjustment is slow, an overvalued conversion rate may dampen domestic output for a prolonged period of time. On the other hand, an undervalued parity causes ineffective allocation of capital as the companies that are not competitive can develop their activity. Moreover, the purchasing parity of domestic wages is subdued, which might not optimize consumers' welfare. Finally, weak currency invokes inflationary pressure, which in the environment of externally set nominal interest rates may lead to an unsustainable consumption boom. The other disadvantage of a misaligned central parity in the ERM II is that it may entail speculative attacks that would lead to severe problems with maintaining the zloty within the fluctuation bands. The above considerations lead us to the conclusion that the entry rate should equal the equilibrium exchange rate of the zloty to maximize the net gain of adopting the euro.