Poland to Float Zloty in Step Toward Goal of Joining EU

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WARSAW -- Poland's central bank announced Tuesday it will fully float the zloty, the country's national currency, as of Wednesday.

The move, a key part in Poland's bid to join the European Union and eventually, convert to the euro, was long anticipated. Though the announcement came after foreign exchange markets in Warsaw closed, traders said that in London trading the zloty strengthened by 1.5% in the hours after the central bank's announcement.

Nonetheless, economists and traders expect that while the float may result in a temporary strengthening of the zloty, big swings are unlikely.

The zloty has so far been fixed to a basket consisting of the dollar and the euro, and devalued at a rate of 0.3% a month. It had been allowed to fluctuate within plus or minus 15% of a parity rate set daily by the central bank.

The announcement from the National Bank of Poland followed approval of the decision by Poland's government and the bank's Monetary Policy Council. Late last year, the central bank had
recommended that the zloty be allowed to float, but required the approval of the government to take that step.

Krzysztof Rybinski, chief economist at ING Barings in Warsaw, noted that the central bank seemed to be contemplating an imminent zloty float last June. "But this has been a very smooth transition that didn't bring about any speculative buying, and signals good cooperation between Poland's fiscal and monetary authorities," he said. "I do expect some rock and roll tomorrow, but don't expect anything more than slight strengthening."

More interesting, economists say, is that in the absence of the currency basket, the market will for the first time decide what will be the major exchange rate used by foreign-exchange markets: dollar-zloty or euro-zloty.

Mr. Rybinski says that in the beginning dollar-zloty based transactions should dominate, but as Poland moves closer to European Union, which it plans to enter in 2003, a euro-zloty mentality will increasingly prevail. Either way, Wednesday the market must choose.

Traders say that any extreme volatility is highly unlikely. "There's always fear of central bank intervention, and they will intervene if the zloty moves in too volatile a direction," one Warsaw dealer said. "The float doesn't mean that the [central bank] won't step in. They reserve the right to do that."

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Polish Currency, Zloty, Surges On First Day of Floating Free

By CHIP CUMMINS
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LONDON -- The zloty's surge Wednesday during its first day as a free-floating currency foreshadows more volatility ahead, but for now at least, the risk remains on the upside.

Economists and currency analysts say the zloty's sudden strength is a sign of confidence in Poland and eastern Europe as a whole, but the currency may be in for a few weeks of sharp ups and downs as market players try to come up with a fair value for the currency. With capital flows unlikely to slow, however, the zloty is expected to come to rest significantly higher than its pre-float exchange rates.

"In some sense, all bets are off," said Sonja Gibbs, an economist at Nomura International in London. "The zloty will be moved by capital flows even more" than it was before Wednesday's float, and that means gains for the currency, she said.

Late Tuesday, the National Bank of Poland said it would allow the zloty to float freely starting Wednesday. The announcement came
after Warsaw markets had closed, but London traders bid up the currency against the dollar and euro.

While the central bank had hinted strongly that it would soon unleash the zloty, the timing of the announcement was a surprise to the market.

By late Wednesday morning in London, the dollar was buying 4.103 zlotys, up from its low of 4.065 zlotys but still 1.3% lower than Warsaw's Tuesday closing of 4.1565 zlotys. The euro was trading at 3.9309 zlotys, down from 3.9383 zlotys late Tuesday.

Local corporate buyers bought cheap dollars soon after the U.S. currency hit its low, according to one Warsaw dealer. Polish businesses looking for hard currency, especially dollars, will keep the zloty from surging out of control, the dealer said.

After initial steep gains, the currency will spend a few sessions seeking out "a new sort of equilibrium," said Krzysztof Rybinski, an economist at ING Barings in Warsaw.

"This strength is irrational," he said. "It is not backed up by any fundamental reasons."

The country is running a large current-account deficit which will only get worse as the currency appreciates. But the risk that such a deficit could pose longer-term structural problems for the economy hasn't yet become a consideration for currency markets.

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Poland took a step closer to European Union membership by floating its currency, the zloty, this week. It's a decision that at least makes Polish monetary policy more consistent.

The dismal scientists -- economists -- have reached a consensus since the Asian crisis. Central banks have two choices: They either fix their currency by adopting a currency board or joining a monetary union, or they let their currencies float freely. Any other currency regime is just "an accident waiting to happen," especially if accompanied by loose fiscal policy or by imprudent banking practices. So Poland's decision was wise, but it is one that will have both benefits and costs for the Polish economy.

By deciding on Tuesday to drop the nine-year-old crawling peg mechanism, Poland decided to adopt the second option, a float, as it waits to adopt the first, joining the euro.

By a statement following the float, the National Bank of Poland made its intentions clear. "A full flotation of the zloty is essential to completely and effectively meet the inflation target. It is also a necessary step on Poland's road to enter the EU and the EMU." It means, therefore, that Poland will try to keep the floating exchange rate regime until it joins the European Union and the zloty joins the Exchange Rate Mechanism-2.

In the meantime, Poland will have to manage its own monetary strategy. This strategy is based on direct inflation targeting, with the goal of bringing inflation below 4% in 2003 from above 10% at
present. Direct inflation targeting can be effective in reducing inflation from moderate to low levels with relatively small costs to the real economy.

Strict inflation targeting was not possible, however, under the crawling-peg regime, as a central bank cannot target an inflation rate and an exchange rate at the same time. Under the crawling-peg regime, the central bank would be forced to sacrifice its inflation target in order to fulfill the exchange-rate commitment if the zloty moved toward one end or the other of the band. With the zloty fully floating, this inconsistency is gone, which should result in a more credible monetary policy.

In the last two years, the zloty has been among the most volatile currencies in the region. Large swings of the nominal exchange rate imply large volatility of the real exchange rate, which in turn results in large costs to the real economy.

Volatile terms of trade could also harm the much-needed development of the export sector, as the majority of Polish firms do not hedge their foreign-exchange risk at all. In order to stabilize the exchange rate, Poland will have to change the current unsustainable policy mix of tight monetary and loose fiscal policy, and would have to eliminate the public finance sector deficit. In 1999, the public finance sector deficit widened from 3.5% to around 4%. This relaxation of the fiscal policy forced a sharp tightening of monetary policy. Loose fiscal policy and high interest rates continue to invite more and more short-term investments to Poland. In March the total volume of short-term foreign capital has approached 60% of the foreign-exchange reserves held by the central bank. This is less than 100% and still five times less than in countries such as Russia and Korea, that suffered severe currency crises. However, this is enough to trigger a significant currency depreciation should the market sentiment change rapidly.

Polish authorities have set up a very ambitious plan to join the EU and ERM-2 in 2003 and to join the EMU in 2005-2006. However, this target, as well as Poland's economic stability, could be jeopardized should Poland fail to tighten fiscal policy. The upcoming election cycle, with presidential elections this year and general elections next, will provide a test of the politicians' will to proceed with much-needed fiscal tightening. The markets will be watching, and we can expect the newly floated zloty to suffer if Poland does not appear to be headed towards a credible long-term policy mix.

--From The Wall Street Journal Europe