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"Poland: fit for the future?"

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2014 will be a year to remember for us Europeans. It marks a modest and cautious recovery from the crisis, as a well as a turning point in European politics, with the parliamentary elections just around the corner. It is thus a year which provides us with a good opportunity to stop for a while and reflect about our past and consider our future.

It is certainly worth looking at the European and global context that Poland is operating in.

As we look at the factors shaping Poland today, we are on the one hand struck by a Europe that is radically different to what it was in 2004, but not only. We are also struck by a radically different Europe to that of five years ago. The Union has been completely transformed, not only by the crisis, but also by the unprecedented reform effort ignited by it.

From economic governance to financial sector reforms, from a harsh lesson in austerity to a gradual shift towards growth friendly measures, Europe today is a different Union. And we can be safe to assume that more changes will be coming our way over the next few years. Poland being fit for the future is directly connected on Europe being fit for the future.

Looking beyond European borders, we are also struck by the image of an increasingly globalised world, which over the past few decades has blurred borders and brought onto the world stage new players. Globalisation is no longer built around a transatlantic consumer and a Chinese producer. Gradually, a demand driven growth model in emerging economies generates new demands from millions, if not billions, of new consumers coming to the world market. Consumption habits change in Europe, they change across the world. If Poland is to remain competitive in the world of today, it will have to keep its windows open and measure its competitiveness against the global backdrop.

Thus, today, Poland needs to think of itself as belonging to an evolving and different European and global context. Poland has to wisely internalize these changes and see how it can best mitigate the risks they bring along. Most of all however, it will have to make smart use of the opportunities that these changes create and avoid petrifying old patterns of growth.

Over the coming minutes, I would like to have a look at where Poland stands today and would also like to illustrate some of its specificities which bring along risks as well as opportunities. They include Poland's status as an emerging economy, its back row seat in the euro area reform and its susceptibility to a middle-income trap.

What are the characteristics of Poland's economy today?

Poland has over the past few years been one of Europe's best performing economies. It has weathered the crisis without a recession (having experienced its latest downturn back in 1992, before some of you were born), has accumulated more than 50% in terms of GDP since 1990 and sustained a modest growth rate over the recent years. Moreover, the country has recently had its credit rating affirmed by one of the main credit rating agencies (S&P, 'A-/A-2' foreign currency and 'A/A-1' local currency sovereign credit rating), sending the signal that its economy has kept in place robust fundamentals and a strong growth potential. Economic growth is expected to reach 3% of GDP by 2015.

We have been very proud of how our banking sector proved to be resilient to the crisis. Banks moreover still remain strongly profitable. We must remember at the same time however that the financial sector remains shallow, that banks still rely mostly on short-term deposits and we have yet to develop deep capital markets.

Looking at public finances, government debt amounts to 58%, still below the 60% EU threshold, and low if compared to the 93% average level in the euro area and 87% in the EU.

Poland's public finances will be impacted by the recent pension system reform, which will see the transfer of assets from the private to the public pension pillar. The measure will improve deficit figures, which had reached 3.9% in 2012, and is expected to deliver a surplus of 4.6% in 2014. This is only a one off measure and, while it will reduce the deficit in 2014, it will not count towards deficit reduction in 2015. This is due to the fact that one-off measures will be disregarded under new accounting rules due to enter into effect from the autumn of 2014. Thus the deficit is expected to reach 3.3% by 2015 (we are under the excessive deficit procedure).

Behind growth, there are not only external factors. Poland's economy today has also been enjoying a gradual pick-up in private consumption and investment, with public investment in particular driven by a considerable inflow of EU funds. All of these factors combined promise good prospects for growth in Poland in the short and medium term.

How does Poland fit into the group of emerging economies and how is it doing relative to its peers?

Poland's recent growth rate however is less impressive if put in the context of the group of economies which the country belongs to: that of catching-up, emerging economies. Its growth should thus not be compared only to that of France or Germany, but also to that of fellow emerging markets, such as Turkey, Brazil, India or China. Once we do that, a growth rate of 1.5% might seem less impressive.

There are various ways to define emerging economies. Generally, they are understood to be developing countries, experiencing rapid growth and promising higher profits to investors, inhabited by young populations with consumption demands similar to those of the West, sound public finances and business friendly environments. Promises of higher returns for investments come however with potentially higher risks. They are generated by these economies being underdeveloped from a regulatory point of view, suffering from political instability, domestic infrastructure problems, currency volatility, restricted equity opportunities and a limited availability of liquid markets on local stock exchanges for outside investors. These risks have to some extent materialized over recent decades. We have seen emerging economies being exposed to social protests and political shocks. North Africa, Turkey, Russia, Brazil and Peru are cases in point. We have also witnessed a wave of economic and financial crises with an important political component.

While risks and higher expectations in terms of growth trajectories are certainly common themes among emerging economies, we must take a step back and realize that emerging economies have gone through big changes over the years and have become more and more heterogeneous. You can see that Poland does not share many of those features.

Emerging economies are certainly more resilient today than they were in previous crises (such as the 1997 Asian episode). In the past, they used to be heavily dependent on cheap capital from abroad, which made the sudden stop of capital flows even more of a shock and rendered previously experienced growth rates unsustainable. This is less the case today.

Differentiations among emerging markets are also much more prevalent today. Investors strongly distinguish between economies such as Poland or Mexico, with strong fundamentals, and more vulnerable ones, such as Turkey or Thailand. Stronger emerging economies have built up emergency cash buffers and are less reliant on foreign currency. Moreover, they are less susceptible to inflation risks. Consumer prices, in particular in Central and Eastern Europe, have fallen dramatically over the last year.

Of course inflation developments need to be kept under control. Maintaining interest rates at excessively low levels at a time when the Federal Reserve may be tapering its bond purchase more aggressively than markets expect it to, risks undermining the credibility of CEE central banks. Excessively loose monetary policy should also be avoided in virtue of the fact that countries such as Poland or Hungary still have a very high share of foreign holdings of local currency debt.

The outlook for more resilient emerging markets ultimately hinges on investors' willingness to differentiate among developing markets. This requires on the one hand that risks from more vulnerable emerging markets are contained. As long as vulnerabilities continue to be seen as country-specific, this will probably be the case.

On the other hand however, it also implies that Poland, like other more promising emerging economies, must not take its privileged status for granted and instead fight to retain it and fully capitalize on its growth potential as a catching-up economy. Over the years to come, it will have to move in this direction and show its determination to shift onto new innovation frontiers.

How is Poland currently positioned relative to the euro area and how should it position itself in the future?

A year from now, the eurozone will count 19 members, two thirds of the EU member states. From the group of the 2004 accession to the Union, only Poland, the Czech Republic and Hungary will remain outside the single currency. This is an issue which politicians do not dare raise.

Whether we like it or not, we have to face up to the changing realities of European integration. We are clearly confronted nowadays with a Union focused on the reform of its single currency area. There is no reason to assume that this eurocentric trend will come to an end. We have in fact reasons to assume that after the European elections, Europe will be focused even more strongly on further integrating the common currency area.

The challenge for the post-election Union will be the identification of Union-wide strategic goals which push the EU forward.

Multi-tier Europe is here to stay. This is not only reflected by the euro/non-euro divide, but also in the case of the Ukraine and Turkey challenge. The two will most likely not become members of the Union in the mid-term. However, in a future Treaty revision, we may design a new type of membership for them. This illustrates how the EU's variable geometry is a reality which is clearly acquiring new dimensions.

Taking into account this changing landscape, the statement most often heard from politicians in Poland these days is that Poland should not join the euro and the debate focuses on risks of joining the euro. Instead, I think we should focus on the risks of staying outside. This is due to the fact that staying outside the common currency comes with big risks, let me mention a few of them.

What are the risks of staying outside the euro for too long?

One is a lack of impact in the decision-making process. Remaining outside the eurozone, we will not be effective in influencing the reconstruction of the eurozone. As a player on the inside, our impact could be decisive. Waiting for the eurozone to fix all its problems before we can join is an unacceptable argument. I would like to see us participating in the fixing process.

Moreover, by staying on the outside, the only way we can get on board current and future new institutional mechanisms, which are created, is by opting-in. The opt-in status is however an uncertain one. A number of policies are put on the table with the a form of opt-in option already incorporated into the proposal (for instance the first pillar of the banking union, the single supervisory mechanism allows non-euro member states to opt-in, or the six-pack of economic governance applies selectively also to non-euro member states), for other pieces of legislation, non-euro member states need to fight to be included around the debating table with their ideas on opt-in mechanisms (they are for instance excluded from the ESM and two-pack). Even if we manage to create an opt-in status, as was the case for instance in the context of single supervision of the banking union, we receive a decision-making backstop, but no fiscal backstop. The opt-in status effectively delivers limited benefits in terms of impact, with potentially prohibitive costs. A fully-fledged membership of the eurozone would come with some costs, but would certainly offer a higher number of benefits (access to a fiscal backstop, to the ECB non-standard monetary policy measures, such as the Long Term Refinancing Operations and to ECB supervision, which can be attractive for market confidence etc.), if compared to the opt-in status.

Additionally, staying outside could risk making us a different category of EU membership, which would impact the way we are perceived by investors and would weaken the confidence markets place in us. Our membership in the eurozone financial sector reforms is crucial here, with the banking union reform standing out in particular. While for a regular consumer, the membership of a country in the banking union would probably not be decisive for where he or she opens a bank account, banking union membership can be pivotal for bank bond market investors. We cannot ignore this consideration.

As more member states join the euro, the internal market becomes more and more dominated by euro area concerns. Lower transaction costs linked to the use of one common currency may put countries outside the euro area at a disadvantage when it comes to trade. The internal market will not be a level playing field anymore.

Let me also mention the monetary policy issue. The conventional line on this is that the use of the exchange rate tool can help increase competitiveness. We often hear that the loss of monetary policy independence is a major drawback when a country joins a currency union. I would like to reverse this argument. Monetary policy independence can be a risky tool in a member state that has to build its long-term competitiveness and go through deep structural reforms, especially if a government is tempted to use exchange rate policy to compensate for structural weaknesses.

If we accept this, then joining the euro area could actually bind us in a positive way and determine us to push towards deeper, genuine reforms, as opposed to relying on short-term fixes. We will need to look out for new growth factors and genuinely boost our competitiveness.

Additionally, the single currency can also cushion the danger of speculative attacks on national currencies, as these currencies might not be sufficiently strong to resist such episodes on their own.

Staying outside the euro area, at this stage of our development, given also our status of an emerging economy, when many factors, especially those related to the global world, can impact our competitiveness and stability, can lead to many risks. Globalisation is bringing new superpowers onto the world stage and exposing us to the new waves of threats of global competition. The eurozone could shelter us from emerging risks and offer more stability.

The previous concerns are very important for the medium and long-term. Looking at the short-term horizon, our preparation for euro area accession is pivotal.

In this context, a very important decision when it comes to joining the euro area is the issue of timing. In particular, the time must be ripe for us to join the ERM II. This entails entering the ERM II at a moment when the risks of speculative attacks, which may force devaluations of the national currency, are at a minimum. We must avoid a devaluation episode during the ERM II phase. We could also consider committing to a narrower fluctuation band, than the standard one of +/- 15%.

Thinking about what we need to do, it is clearly desirable for Poland to join the on-going reforms of the Union, which up to now, have been and will continue to be largely euro-centred.

While the euro area is often perceived solely as a monetary union, the trend of current reforms is clearly taking us further, into the realm of fiscal, financial and political union. Not joining the reform bandwagon must be a well thought through political choice.

The banking union reform comes to mind as a key reform. Also important are economic governance related policies, an example of such a choice is the competitiveness and convergence instrument, currently under discussion. The instrument would be based on a contract between the Member State and the European Commission and would cover some of the costs related to structural reforms.

Taking non-euro member states on board current reforms remains a constant struggle. The Commission largely puts forward eurocentric policy proposals. While the Council shows some concern for member state states outside the euro being taken on board, there has been lately a tendency also to reach out to intergovernmental agreements which exclude non-euro members (for instance the ESM). The Union is still missing a concrete blueprint for an opt-in mechanism. One option to consider in the future could be the enhanced cooperation tool offered by the Treaty.

In brief, for the time being we can actively endorse the participation of non-euro member states in euro area reforms, while communicating on the benefits of eurozone membership and carefully preparing our entry into the ERMII, which would eventually lead to our accession to the single currency area.

We cannot afford to be a mere observer.

As our entrance into the ERMII and the euro area later on will unfortunately take some time, we will have to start thinking carefully about how to mitigate other risks coming our way. One of them is the middle-income trap.

It is legitimate to ask whether Poland is susceptible to the middle income trap

Poor countries tend to grow faster than rich ones, largely because imitation is easier than invention. This does not however imply that every poor country of five decades ago has caught up. Data shows that most countries which were middle income in 1960 remained so in 2008. This reality brings to the fore the so-called "middle income trap."

The trap refers to growing economies which end up stagnating at middle-income levels and fail to graduate into the ranks of high-income countries. Economies often get stuck in between as they do not have access to the best technologies (reserved to rich economies) and over time also lose the advantage of lower wages (reserved to the poorest ones). This is where Poland is today.

It is important however to distinguish between growth slow-downs related to middle incomes and slowdowns provoked by other factors. The economic climate of the time is one key factor upon which growth hinges. For instance, the 1970s economic climate was particularly challenging for global growth, specifically the oil-price shock years, 1973 and 1979, stand out. This reminds us that the global conjecture can be as important as an individual country's level of development when it comes to growth. Thus one must be careful before labelling an economy as suffering from the middle-income trap. It might just be that the economy in question is only feeling the strain of the global environment. This holds particularly true in the current economic context, when slow global growth is a fact.

At the same time however, this should not make policymakers complacent about the threat of a middle income trap, which is slowly being discussed in the context of Central and Eastern Europe.

Typically, such a trap materializes after the growth benefits of labour and capital productivity are exhausted and the focus should shift more on innovation and does not. And it is indeed the case that since the 90s, countries such as Poland, the

Czech Republic, Slovakia and Hungary have used labour and capital productivity increases as their main growth drivers.

The worry now is that these countries may slowly exhaust the benefits derived from traditional growth drivers and may need to make the leap onto new innovation frontiers. The risk however is that they may not be ready for this leap, lacking adequate innovation capacity and resources.

The worry of the trap materializing is also accentuated by an ageing population, by low private sector confidence and consequently low investment.

One more caveat must be kept in mind before concluding that an economy is at risk of falling into a middle-income trap, namely that often economies undergoing rapid structural change face a concomitant risk of slowdowns. During the process of economic development, surplus labour typically moves from the agricultural and services sector to formal employment in the newly expanding industrial sector. As agriculture and services shrink in relative terms, industry expands and modern growth ensues. This process however can create risks of a growth slowdown which would not occur in an economy trapped in a low-equilibrium with no structural transformation and no growth.

Whether Poland is actually at risk of a middle-income trap, going through a rapid restructuring with negative growth side-effects or simply feeling the burden of a difficult global environment, we cannot deny the importance of kick-starting growth based on new factors.

How can Poland avoid falling into the middle income trap and promote sustainable growth?

New member states can be seen as having at their disposal two options for growth. One is growing convergence in living standards. A second is working on a home-grown growth model with different measurements and stronger incentives for progress. A tailor made, home-grown plan is likely to be more successful in avoiding the middle-income trap.

What kind of home-grown model could we expect to have in Poland?

To understand this model, it is useful to look at the evolution of the transition economies ever since the fall of communism. When 25 years ago, individuals and societies of Central and Eastern Europe embarked on the grand change towards democracy and market economy, they found themselves in a new democratic reality with their enormous consumption ambitions based largely on very traditional patterns coming from the West.

But also, we inherited an economy where investment had never cared about the environment, about resource efficiency, about energy efficiency or quality of life. The first years of transition were years of a dramatically deep recession, of sky rocketing inflation, of inequalities growing between winners and losers of transition. Those societies moved quickly on catching up, with higher growth rates than in countries around, growing income and consumption hunger with all its consequences. Even today still many people believe in this path for change, where first you grow and later you go green, and sustainable, and start caring about the externalities of growth.

We do face however gradually a growing individual and collective feeling of responsibility for sustainability of development and of solidarity with future generations and this is increasingly linked to the desire of looking anew at our own life quality.

The current economic crisis has added a new dimension to the growth challenge and to the middle-income trap. More specifically, with increased pressure on the sustainability of public finances, additional strain is put on individuals for ensuring their own prosperity. This will partially be achieved through education and skills which enable social mobility.

Thinking of a home-grown growth models to be pursued by Poland in the future, we can certainly envisage a strategy focused on quality of life, sustainability, education, knowledge and innovation.

The home-grown model should exploit a country's competitive advantages, while also bearing in mind the policies identified by researchers and policymakers up until now as helping against the middle income-trap.

These policies all relate to a holistic outlook on competitiveness, which includes a number of factors. One is given by efficient institutions. Governments need to build and operate successful institutions, with adequate property rights, economic freedom and effective enforcement. Good quality institutions can stimulate an entrepreneurial culture, combining good quality institutions with an entrepreneurial culture, which nurtures and protects innovators. Another is given by good quality infrastructure.

A good macroeconomic environment also plays an important part. Prudential regulation to limit the build-up of excessive capital inflows is important and can cushion the impact of a sudden stop. Such inflows are usually conducive to growth and allow capital to be allocated wherever its marginal product is highest. However significant capital inflows can also be followed by sudden stops. Moreover, high reliance on cross-border banking flows can have negative spillovers in the case of a downturn.

If the endeavour to boost growth is to succeed however, all of the above policies will have to be placed in the global context, as discussed earlier. National and European level competitiveness can ultimately only be measured against the global background.

Looking ahead, if Poland is to remain fit for the future, it will really need to capitalize on its privileged dual status, as a catching-up economy which is at the same time an EU member state. The catching-up element gives us dynamism and a competitive advantage in terms of growth potential, while the EU membership comes with many opportunities. Poland now needs to fully leverage this potential in a smart way.