August 2002

THE BLEYZER FOUNDATION

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The Case of Poland

Poland has been in the international news recently given its current economic difficulties: low economic growth, high unemployment, large trade deficits and political unrest. Many observers are now blaming economic liberalization and reforms as the cause of the current malaise.

However, Poland is **not** a case that shows that economic reforms are ineffective. In fact, Poland is a case that validates the importance of sound measures as described in the IPCTF Economic Policy Framework. In fact, with relatively good policies since 1992, Poland was able to secure positive economic results. Unfortunately, in the last couple of years, the country became complacent and the willingness to continue sound economic policies declined. As a result, the country exhausted its sources of growth and now has low GDP growth, low exports, high current account deficits and high unemployment.

This note reviews the history of reforms in Poland as well as the current situation.

The Early Economic Reform Program

In the early 1980s, Poland faced economic stagnation, large fiscal deficits and hyperinflation. In the mid-1980's, the first non-communistic government started the move towards a market economy. The initial reforms included:

- price and external trade liberalization
- adoption of a new legal framework with guarantees to investors, and a new law on bankruptcy
- cancellation of financing by the central bank of the State budget
- establishing a fixed exchange rate to the US dollar
- opening the economy for foreign investors

These policies, though significant, were insufficient to foster confidence and revive economic growth.

It was only in the early 1990's that the economy started its recovery, when the Government undertook a comprehensive program, including among others, measures to stabilize the economy through

In 1999, SigmaBleyzer initiated the International Private Capital Task Force (IPCTF) in Ukraine. Its objective was to benchmark transition economies to identify best practices in government policies that improve the investment climate and attract private capital. An Action Plan was developed and presented to the Ukrainian government, which identified the economic policy actions necessary to improve the investment and business climate in Ukraine, attract additional flows of private capital to the country; support economic growth, and improve the quality of life for their citizens. In 2001, this effort was expanded to all countries of the FSU, and IPCTF ratings for all 15 countries of the FSU were developed. They are available from SigmaBleyzer and The Bleyzer Foundation.

The Bleyzer Foundation was established in 2001 in order to promote the IPCTF framework and help countries implement the policies necessary to successfully complete transitions to market economy.

The Foundation's Managing Director is Mr. Victor Gekker, who is supported by a team of economists and business analysts. The Advisory Board of The Bleyzer Foundation is chaired by Dr. Edilberto Segura and provides advice and guidance to the activities of the Foundation.

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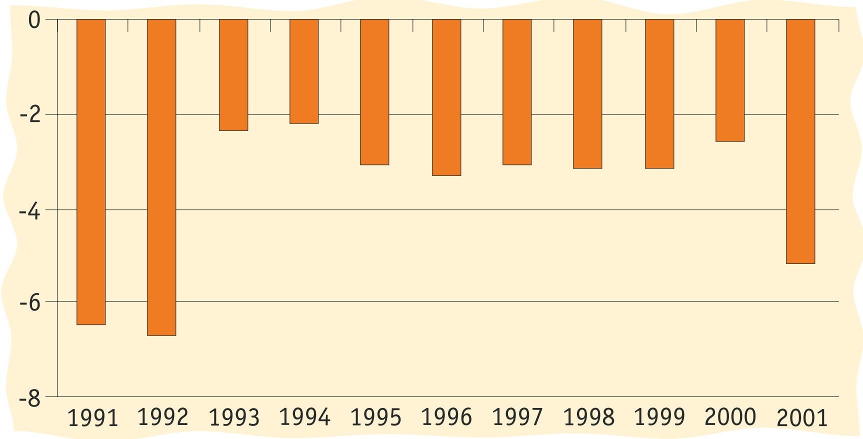
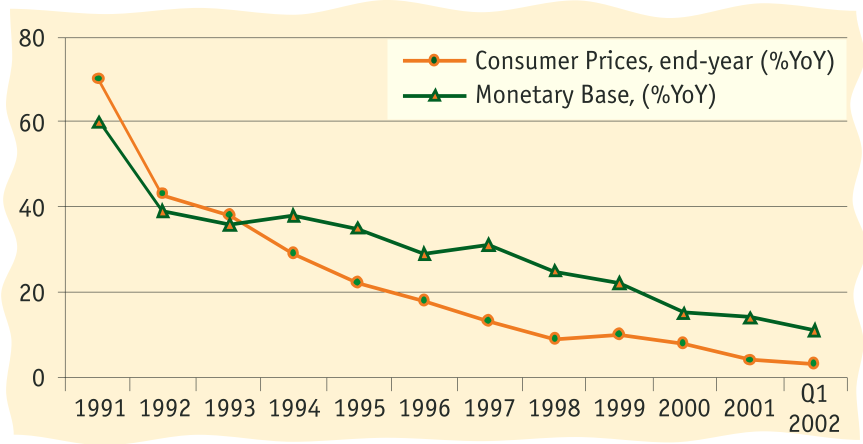
tight fiscal and monetary policies, liberalize the economy, improve the legal environment, and improve public and corporate governance. The fiscal budget deficits in 1991 and 1992 were running at over 6% of GDP, which was not sustainable. Starting in 1992, the fiscal deficit was reduced to a level of 2% to 3% of GDP, consistent with available financing. But in 2001, the fiscal budget deficit exceeded 5% again

Fiscal Deficit/GDP in Poland, 1991-2001, %



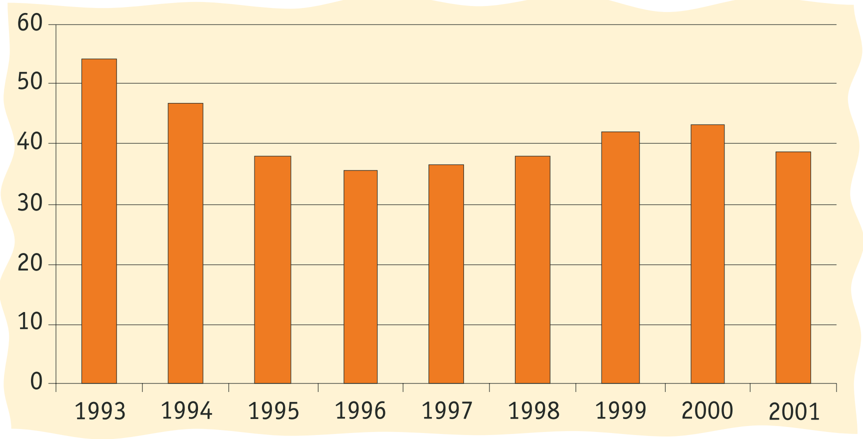
Before 1992, monetary policy was expansionary, in part to finance the large fiscal deficits. In 1991 alone, the monetary base grew by 60%, which led to an inflation rate of 70% for the year. But lower fiscal deficits after 1992 led to tighter monetary policies (including higher interest rates), which led to a reduction in the rate of growth of money supply, as noted in the chart below. These monetary policies led to a gradual reduction in inflation, to 8.6% in 1998, and to less than 5% in 2002.

CPI and Monetary Base growth in Poland, 1991-2002



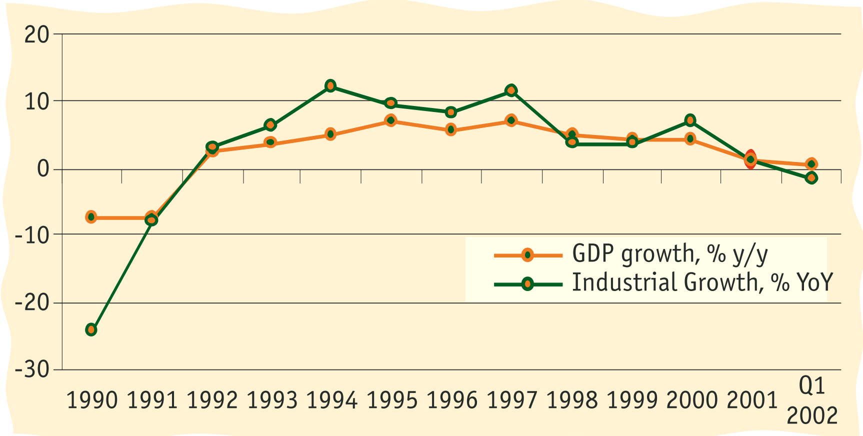
After 1992, with lower financing requirements for the fiscal deficit, Poland's level of external debt to GDP declined. In 1994, external debt to GDP declined below the "threshold" of 50%, bringing more confidence in the country's creditworthiness.

External debt/GDP in Poland, 1993-2001, %



The economic reforms implemented after 1992 bore their fruits: economic growth recovered, and inflation and unemployment started declining. In addition, these measures spurred the creation of a large number of small and medium businesses (over 2 million small enterprises were created between 1992 and 1995). These enterprises provided the basis for reasonable GDP growth for a number of years. In 1992, real GDP grew by 2.6%, making Poland the first country of the former Eastern bloc to reach a positive rate of economic growth after a deep economic recession. In 1995, GDP growth reached 7%, driven by a 10% rate of industrial production growth. Similar rates of GDP growth were experienced in 1996, 1997 and 1998.

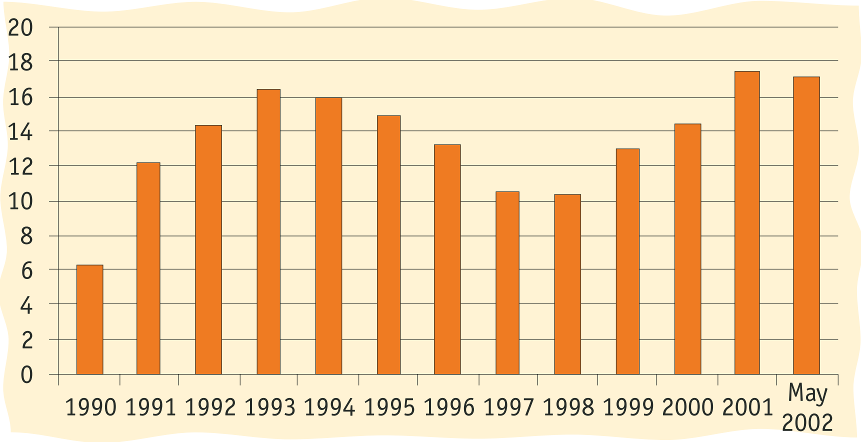
GDP and Industrial Growth in Poland



However, the industries created during the 1990's were principally for import-substitution purposes. Very few export oriented industries emerged. Even FDI was oriented toward import-substitution industries. Domestic consumption could no longer provide the basis for sustainable growth. In 2001, the rate of GDP growth declined substantially to about 1%, as noted in the chart above.

Though the country made progress in the implementation of a number of reforms during the 1990's, there remained serious economic bottlenecks — particularly labor rigidities — that kept unemployment at rather high levels. Starting in 1994, the level of unemployment decreased for several years, to a low of 10.4% in 1998. But since then, unemployment has continued to increase, to about 17% in early 2002, as noted in the chart below.

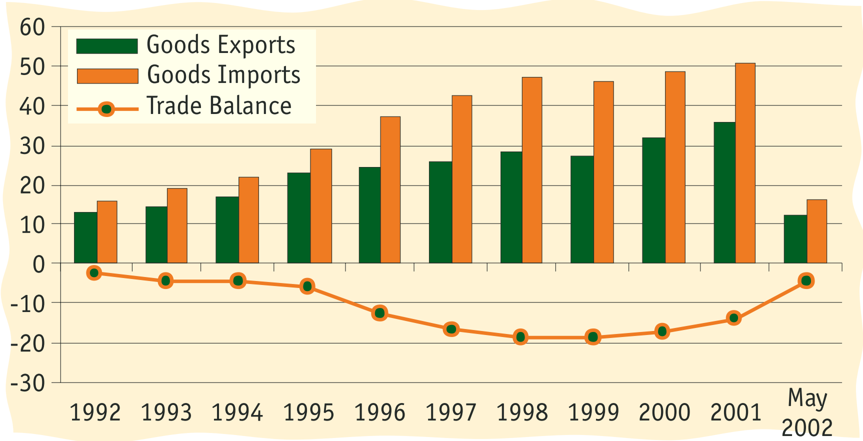
Unemployment in Poland in 1990-2002, %



Given labor rigidities and an import-substitution strategy, the level of Poland's exports has been below imports. In 1995, with imports still growing at a high pace and with more limited exports, the foreign trade deficit started widening, as noted below.

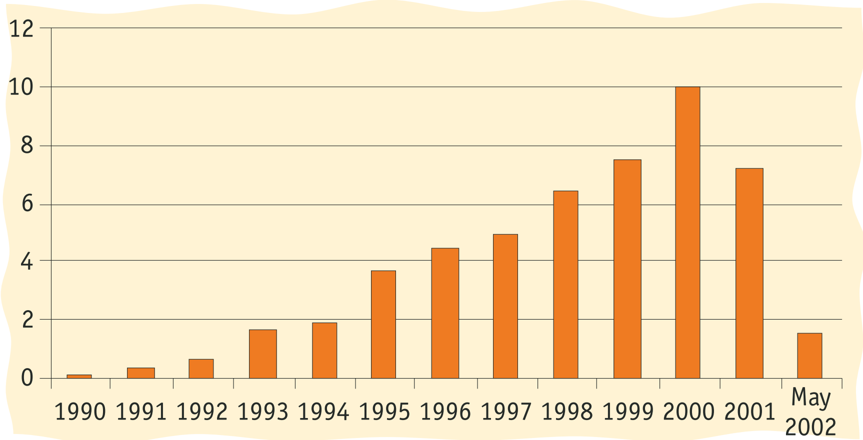
Over the 1992-1998 period, foreign trade had been an important source of economic growth in Poland. Since 1992, merchandise exports grew by about 11.6% per annum and totaled $36 billion in 2001. During the same period, merchandise imports increased by 13.8% per annum to $51 billion in 2001. During this whole time, Poland has had a trade deficit. The merchandise trade deficit widened from $2.7 billion in 1992 to $18.9 billion in 1998, a result of growth in domestic demand and import stimulating investments. Although the deficit was reduced to $13 billion in 2001, the ongoing size of the trade deficit continues to be a major concern to private investors.

Merchandise Trade Growth, USD bn



The level of Foreign Direct Investments (FDI) in Poland was rather modest until 1991. Following three years of economic growth, FDI began to increase rapidly in 1994, reaching $3.7 billion in 1995. FDI reached a peak of $10 billion in 2000 (of which $4 billion was accounted for by the sale of the Telekomunikacja Polska to France Telecom). However, following the deterioration of economic conditions since 2000, the level of FDI has continued to decline, as noted below.

FDI inflows in Poland, USD bn



During the 1990s, FDI inflows had a significant role in financing the current account deficits. They also led to restructuring and improvements in corporate governance. Overall, FDI was largely dominated by privatization-related transactions.

Economic Developments in 2001 and 2002

After peaking at 6.9% in 1997, real GDP growth in Poland fell to only 1.1% in 2001, the lowest rate for the last ten years. The growth rate for 2002 is not likely to be much better than 1.1%. In the first quarter of 2002, Poland's GDP grew by 0.5% year-on-year, while industrial production declined by 1.4% year-on-year. In May 2002, industrial output fell by 4.1% year-on-year, significantly below earlier expectations of a 1.8% decline.

In May 2002, the Consumer Price Index was only 1.9% over May 2001. In the context of favorable food prices, there are no demand-driven factors that could create inflation risk in the near term. The persistent low prices in Poland are a result of a slowdown in GDP growth and stifled consumer demand.

One of the causes of the current slowdown of economic growth in Poland lies in the fiscal and monetary policies of the Government. As noted under the IPCTF Framework, one of the preconditions for investments and growth are sound fiscal and monetary policies. Unfortunately, the Polish Government has not satisfied these conditions in the last couple of years. As noted earlier, the fiscal deficit for 2001 reached 5.2% of GDP, with a similar figure anticipated for 2002. These numbers are too large to be sustainable over the long term.

Furthermore, many international analysts believe that the Government's fiscal strategy is unclear and confusing. The Polish Parliament enacted a fiscal budget with a deficit of 5.2% of GDP. This number was already high. But then, Parliament introduced a number of amendments increasing the spending side. They proposed additional revenue measures, which are unrealistic and may be difficult to collect.

The Government privatization strategy is also confusing. The 2002 budget assumed that privatizations would amount to 1% of GDP. But then the Government announced that some of the key privatizations would be delayed beyond this year (public insurance, state banks). This will require additional adjustments in fiscal spending that are not identified.

The Polish Central Bank itself has been quite critical of the Government's fiscal budget stance. For this reason, in the last quarter of 2001 and the first quarter of 2002, the Central Bank followed very tight monetary policies. As should be anticipated, these policies resulted in high interest rates and a decline in investments.

There is also confusion on the foreign exchange rate policy. Last month, the Government made a formal proposal to abandon the floating exchange rate regime (again trying to use Government intervention to deal with inadequate policies). But this proposal was turned down by the Monetary Policy Council, which decided to keep the current regime.

All these matters have cast doubts on the adequacy of the policies of the Government and its commitment to sound market oriented policies.

International analysts do not believe that Poland can just blame the current worldwide slowdown for its problems in securing growth and better export performance. This is because, in spite of the current situation, other neighboring countries are doing much better, including the Czech Republic, Hungary and Slovakia. Poland is forecast to grow by 1.1% this year, compared to 3.3% to 3.6% in the other three countries.

Poland's poor performance is due both to the cracks in fiscal policies and to the number of structural deficiencies that the government has not been able to address. In fact, the Government has not moved into the implementation of a second stage of economic reforms needed to remove structural deficiencies that are hindering growth. In particular, they have not created the environment to stimulate export-oriented industries.

The first structural deficiency is that labor rigidities have become more binding. The second is that the level of business taxation has deteriorated in Poland in relation to other countries that have taken stronger taxation relief measures. This has led to growth in the informal economy, reversing earlier trends. Finally, because of these weaknesses, Poland has not been able to attract export-oriented foreign investments.

A recent IMF report states that a return to strong growth in Poland in 2003 will be "very difficult" unless certain preconditions are met (the IMF was commenting on the government's forecasts of 3% GDP growth in 2003, and 5% in 2004.) In its report, the IMF said that "an improvement in Poland's medium-term economic situation will be impossible without changes in fiscal policy, as has already become clear in 2001". Unless rapid changes are made downwards in public spending, public debt will rise to an alarming level of 60 percent of GDP, up from the current 43 percent. A fiscal slackening would immediately hamper corporate borrowing, preventing a rise in capital spending. "Without working out a proper financial policy that would ease pressure on the exchange rate, without greater labor market flexibility and swifter privatization, achieving such strong growth rates will be very difficult," says the IMF report.

All of these economic uncertainties have diminished confidence in the Polish economy. But it is clear that the country has the resources and the capacity to move forward, provided that the political will is in place to deal with the fiscal deficit and undertake tough labor and other policy reforms.

Poland is in fact a good example of what can happen to a country when it fails to address its economic issues in a timely manner. The same happened to Mexico in 1994. In the decade before 1994, Mexico did almost everything right — low fiscal deficits, good monetary policies, great liberalization of business activities, and so on. But they failed to follow a consistent foreign exchange policy by fixing the exchange rate. This led to high imports, high current account deficits and a major financial crisis in December 1994.

Argentina had the same problem. They did almost everything right, except that the fiscal budget deficit was not under control. This led to excessive public debt that caused the current crises.

On the other hand, there are ample examples of countries that have been able to follow consistent policies for an extended period of time. Chile is a good example, and the country has benefitted from this.

For other emerging countries, all this means that reforms cannot be carried out halfway. The countries must be continuously seeking improvements without backtracking. For example, when one source of growth is exhausted (such as import substitution), the strategy must be to deepen reforms in other areas to attract export-oriented industries. This may require labor reform and a tax system that would entice investors to convert the country into a supply-center for other countries.

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