

Poland: How Robust is Economic Growth?

Poland can point to significant progress in the transition to a market economy. Its success is reflected primarily in impressive rates of economic growth, dynamic investment and rising employment. Inflation is falling, although it remains yet at two-digit levels. In contrast to the Czech Republic and Hungary, Poland has so far been spared a second transition crisis. Yet there are factors currently calling into question a continuation of this success story. Poland's current account deficit is widening seriously. While such a development need not necessarily be seen as negative – a current account deficit may be seen as a necessary condition for accelerated development in transition economies – this does not apply when the increase in the current account deficit results from a real appreciation of the currency and thus a deterioration in competitiveness.

Do higher real interest rates pose a threat to investment?

The Polish economy has been growing extremely strongly for several years now (cf. figure 1). This is due primarily to dynamic investment growth, not least investment from abroad. However, it is necessary in this context to recall the low initial level of investment. Following the collapse of investment in the course of the transition shock at the end of the 1980s and the start of the 1990s, two-digit rates of growth have been recorded since 1995 (cf. figures 2 and 3). The data available so far for 1998 suggest that investment growth in the current year will be just as strong as in recent years. This success is due not least to the fact that economic policy-makers have successfully dampened down inflation in a "controlled" way, and have minimised the risk of exchange rate fluctuations for foreign investors with the help of a crawling peg.

Yet since 1996 developments have set in that place a question-mark over a continuation of the investment boom in the coming years: Poland's current account has moved dramatically into the red. In response the Polish National Bank pushed up real interest rates. At more than 15% at times, the real rate of interest on bank loans has risen to an extremely high level (cf. figure 4).¹

¹ The real interest rate is defined as the nominal rate adjusted for the inflation rate, i.e. the rate of increase of consumer prices.

Fighting inflation with a crawling peg

The exchange rate of the zloty was fixed until 1991. Yet costs and prices were rising rapidly. In 1991, for instance, the inflation rate was still at around 80%, so that the real external value of the zloty rose by almost 60%.² This represented a serious weakening of the competitiveness of the Polish economy. Yet inflation cannot be brought down overnight, but only gradually. An economic policy instrument that covers the external-economic flank of a policy of successively reducing inflation is the crawling peg exchange rate regime introduced in Poland in 1991: the exchange rate of the zloty against a basket of currencies³ depreciates from month to month at a rate that is announced in advanced for a certain period of time and that is supposed to reflect the differential between the inflation rate in Poland and the (lower) weighted average of inflation rates in the countries constituting the currency basket. The pre-announced monthly depreciation rate has been steadily cut from the initial level of 1.8% to the current rate of 0.8 per cent.⁴ Inflation has gradually been brought down, from almost 80% in 1991 to its current level of around 10%.

However, for the strategy to be successful collective wage bargainers and the monetary authorities must pursue a course that is compatible with the exchange rate policy. Yet this has not been achieved to the required degree. Although the Polish National Bank has increasingly oriented its monetary policy towards price stabilisation, in most years, and particularly in 1994 and 1995, the trade unions have won pay increases that were not compatible with the crawling peg policy as practised. The rise in unit labour costs and consequently in the rate of inflation exceeded, allowing for the rate of inflation abroad, the level compatible with the announced and realised devaluation of the zloty (cf. figure 5). As a result the real external value of the currency, calculated on the basis of consumer prices, rose substantially from 1991 to 1997, namely by 36% in all and an annual average of more than 5% (cf. figure 6).

As a result of the real appreciation, Polish exports have become more expensive, while imports have become cheaper. Although there is considerable disagreement on the actual extent of Poland's current account deficit, there is no denying the serious increase

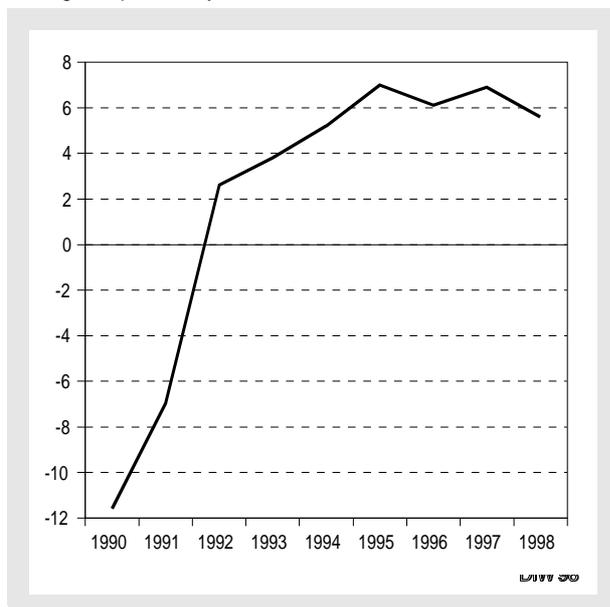
² The inflation rate differential and the appropriate rate of depreciation are not identical. An inflation rate differential of 25% compared with the rest of the world implies a depreciation rate of 20%.

³ The composition of the basket of currencies has remained unchanged since 1991: 45% US-dollar, 35% D-Mark, 10% pound sterling, 5% French franc, 5% Swiss franc.

⁴ Since 25 February 1998.

Figure 1
Poland's GDP

Change on previous year in %



Sources: OECD, Economic Outlook No. 63; NBP, Preliminary Information No. 5; DIW estimates.

in the deficit since 1996 (cf. table).⁵ This trend continued in the first eight months of 1998.

Interest and exchange rate policy dilemma

A current account deficit is not always a bad thing. Particularly in the economies of central and eastern Europe, where much of the capital stock was devalued at the start of the transition process, such a deficit can be interpreted as a necessary condition for the economic development process. This is particularly the case when imports, financed by foreign capital, primarily serve the transfer of know-how and the formation of real capital. Precisely the reverse applies, however, when the deterioration of the current account position is due to real appreciation of the currency. In such a case the current account deficit may reflect a lack of international competitiveness. In such a situation there is a danger that the current account deficit will become entrenched leading to rising foreign debt.

⁵ This trend also emerges from the "adjusted" current account calculated by the Polish National Bank. It differs from the "official" figure in the way currencies exchanged in currency exchange offices are recorded. In the adjusted current account the currency transactions by exchange bureaux are set off against corresponding exports and imports. In the "official" balance of payments statistics these transactions are classified as short-term capital inflows.

Table
Current Account Position

As a % of GDP

1994	1995	1996	1997
1.1	0.7	-2.5	-4.4

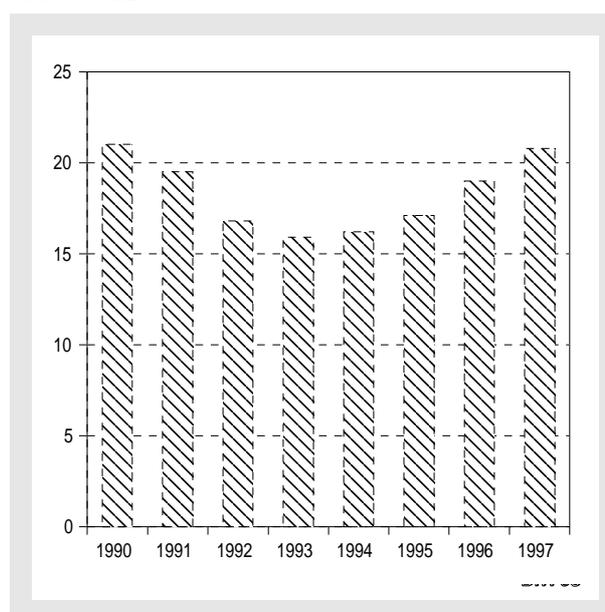
Source: OECD.

Under such circumstances the Polish National Bank may feel obliged to tighten its restrictive stance further.⁶ This would have serious consequences. A further increase in the real cost of borrowing would make it more difficult to finance investment, posing a threat to the continuation of the still strong investment dynamic. Moreover, if the real interest rate is excessively high, the National Bank would face an influx of foreign capital. In order to maintain the exchange rate envisaged and the high interest rate, it would increasingly be forced to purchase foreign exchange and then to "sterilise" the increased liquidity this implies by restrictive measures.

⁶ The Central Bank Law that came into force in 1998 emphasises the independence of the central bank. Its prime task is seen as ensuring the stability of the value of money. The supreme body in the central bank is the central bank council, which met for the first time in February 1998.

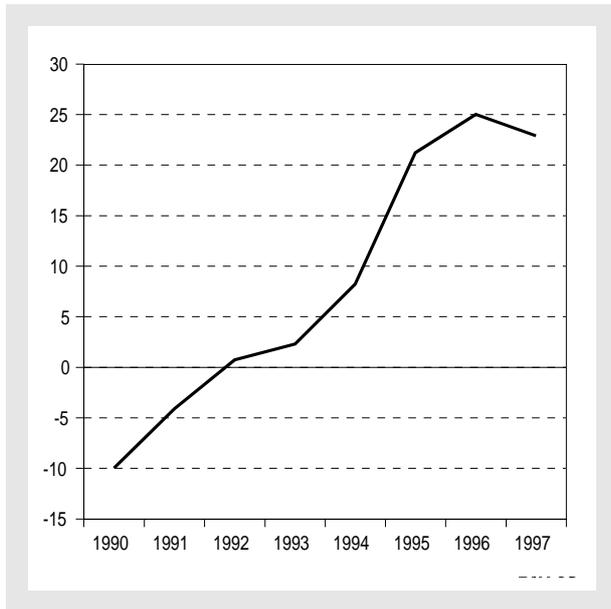
Figure 2
Poland's Gross Investment Share

As a % of GDP



Sources: IWF, International Financial Statistics; Central Statistical Office (Warsaw), Statistical Bulletin; DIW calculations.

Figure 3
Poland's Gross Fixed Capital Formation
 Change on previous year in %



Sources: National statistics; DIW calculations.

Signs of an increasing inflow of foreign money have been observed for one to two years now.

The Polish National Bank has recognised the dangers resulting from the combination of real appreciation and a high-interest-rate policy. First, during its last revision of the monthly depreciation rate to 0.8% it increased the band width around the central rate within which the currency is allowed to fluctuate from $\pm 7\%$ to $\pm 10\%$. The aim of this measure was to restrict the influx of speculative capital, i.e. that available only for a short time, by increasing the exchange rate risk. Yet in doing so it acted in a way that ran counter to the desired effects of the crawling peg, namely to reduce the risk of exchange rate fluctuations. Second, in view of the continued decline in inflation, central bank interest rates were cut; the Lombard rate is now at 24%, the discount rate at 23.5%. Yet real interest rates remained high even after this cut, and there has been no change in the basic constellation of high real interest rates and restrictive domestic lending.

Restrictive lending

Of central importance for financing investment are the conditions under which the financial sector operates. In Poland these are determined largely by two factors. As mentioned above, the Polish National Bank is pursuing an extremely restrictive monetary policy, with central

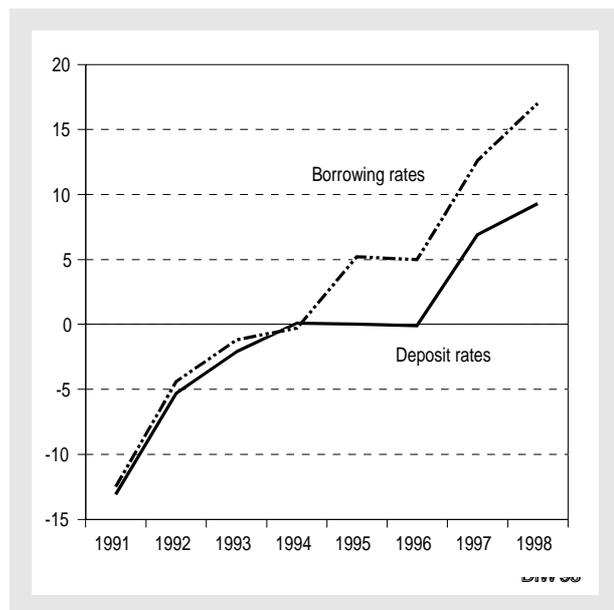
bank rates around 10 percentage points above the inflation rate. The central bank aims to reduce lending and restrain buoyant domestic consumer demand.

At the same time the institutional parameters for lending have tightened. Initially the banking sector, which is partly still state owned, had to undergo a restructuring phase in which the problems of bad loans inherited from its centrally planned past had to be solved. Between 1995 and 1997 the banks' non-performing loans were, it is claimed, reduced by half. Following this step it seems that the banks are pursuing a lending policy that takes greater account of risk than previously. At the prevailing market interest rates lending is being rationed to a greater extent than previously. At the same time interest rate margins are being increased to cover the increased risk of non-repayment of loans. As a result of higher interest rates and credit rationing, lending growth declined slightly in 1997 to 32% from 37% in 1996. The decline in the rate of growth of lending to the business sector is unlikely to have been greater; at least this is suggested by the fact that consumer loans, which account for significantly less than one fifth of total lending, expanded at a far more than proportional rate.

Outlook

In recent years Poland has recorded impressive rates of economic growth; the economic dynamic will be main-

Figure 4
Real Interest Rates in Poland



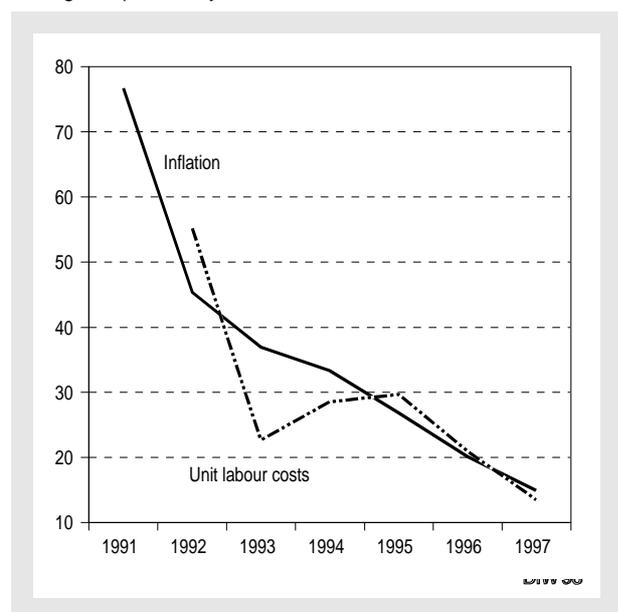
Sources: IWF, International Financial Statistics ; NBP; DIW estimates.

tained in 1998. This has been associated with rapid investment growth, partly financed on international capital markets. The combination of high real interest rates and a pre-announced depreciation rate practised in Poland is attractive to foreign investors. The sharp deterioration in the current account position since 1996 is to be seen largely as a consequence of the declining competitiveness of Polish products due to the real appreciation of the zloty. Inflation rates have consistently been higher than the announced depreciation rates. Such a constellation is similar to that in Asia prior to the crisis there. Many Asian currencies had also appreciated significantly in real terms and their current account moved sharply into the red. The origins of the crisis in Asia are, however, also due in large measure to the way in which the financial intermediaries lend money. Here very little similarity emerges between the Asian and the Polish situation. Polish financial intermediaries are seemingly much more risk averse.

Whether Poland can avoid a further deterioration in its current account and debt situation depends essentially on whether fiscal policy and, above all, wage growth can be subordinated to the exchange rate target, so as to avoid further real appreciation. One positive fact is that in the wake of the crisis in Russia the Polish currency came under pressure only briefly; the band width set by the exchange rate regime was fully utilised, miti-

Figure 5
Inflation and Unit Labour Costs in Poland,
1991 to 1997

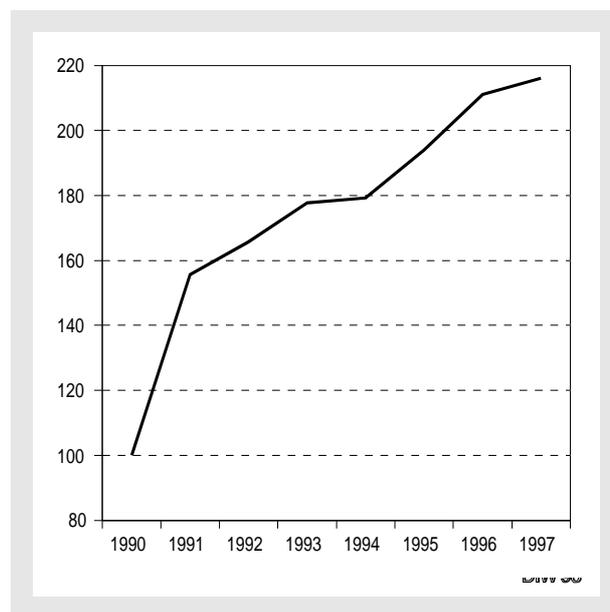
Change on previous year in %



Sources: IWF, International Financial Statistics; OECD, Economic Outlook; DIW estimates.

Figure 6
Real External Value of the Polish Zloty

Index: 1990 = 100



Sources: IWF, International Financial Statistics (Real Effective Exchange Rate).

gating the trend towards real appreciation. This external shock offered the chance of making a necessary adjustment without departing from the pre-announced path. Whether or not a currency and banking crisis can be avoided in future, however, will depend decisively on the extent to which the banking sector maintains a risk-oriented lending policy. This will be determined not least by the view taken of lending behaviour by the banking supervisory authorities.

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