

# Poland's Economy Prior to EU Accession

Poland will join the European Union on 1 May 2004. Membership of the EU is expected to promote stable growth and thus convergence in real GDP and living standards. With a growth rate of real GDP of 3.7% in 2003, Poland has recorded a remarkable recovery after two years of near stagnation. This report, which has been compiled in cooperation with the Center for Social and Economic Research Foundation (CASE) in Warsaw, provides an overview of the current economic situation and a forecast of trends for this year and next. In addition, it addresses the difficulties Poland faces in preparing its participation in the European monetary union, which are largely rooted in the substantially deteriorated state of public budgets.<sup>1</sup>

## Strong Recovery in 2003

In 2003, Poland's real gross domestic product (GDP) rose by 3.7%; in the fourth quarter, economic performance actually stood 4.7% above the previous year's level. Following two years of economic stagnation, this marks a strong recovery (cf. figure 1). In the 1990s, Poland has already demonstrated strong economic growth, thus reducing the income lag per inhabitant compared with the European Union and Germany. In 2001 and 2002, however, economic growth fell substantially, due in particular to a restrictive monetary policy stance in the face of great foreign trade imbalances.

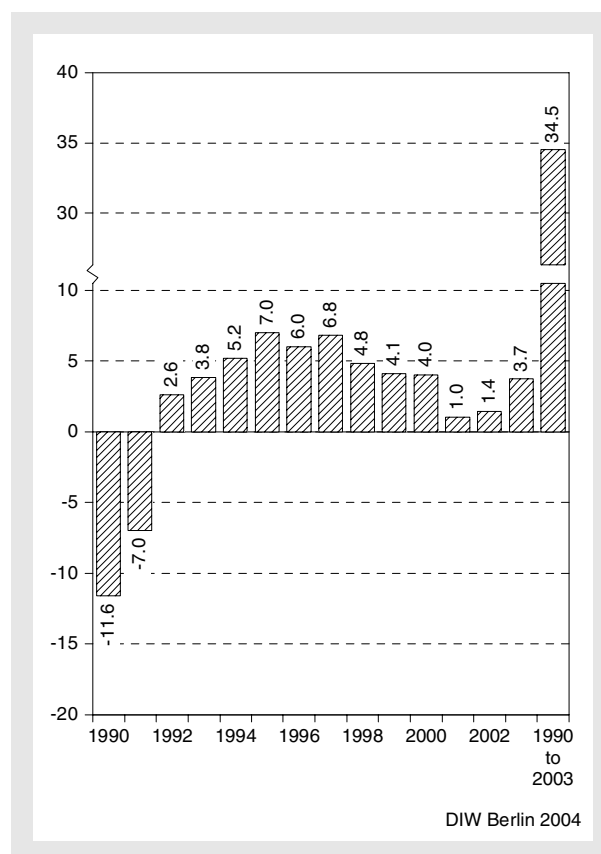
In the meantime, the monetary policy stance has been relaxed. From January 2003 to January 2004, the zloty devalued by 16% in nominal terms against the euro, while price trends in Poland and Germany were very similar. There are several reasons for the strong devaluation of the zloty: real interest rates have fallen substantially – from their highest level of 12.4% at the beginning of 2001 to 3.6% in December 2003 (central bank refinancing rate). In addition, the devaluation of the US dollar against the euro also led to a devaluation of the zloty against the euro, since a large share of financial transactions is effected in US dollars. Moreover, the uncertain fiscal future is also likely to have played a part in the currency's devaluation: the government's attempts, since mid-2003, to implement a consolidation programme have, to date, been unsuccessful.

<sup>1</sup> The forecast in the paper is based on CASE: *Polish Economic Outlook*, 2004/1, Warsaw, 2004.

The recovery in 2003 is the result, in particular, of the strong expansion of exports and of continuously high private consumption. Thus, for example, private consumption contributed 2 percentage points to growth, while foreign trade accounted for 1.3 percentage points. Calculated in zloty, between January 2003 and November 2003 exports were up 21.6% over the corresponding value the previous year; calculated in euro, this was still an increase of 6.8%. A similar increase was registered in exports to Germany, which accounts for a third of Polish exports.

The continuously robust increase in private consumption is due especially to the strong expansion of income from self-employment. In Poland, persons engaged in self-employment constitute more than 30% of the active workforce.<sup>2</sup> In 2003, according to estimates, income from self-employment, from property, and from

Figure 1  
Poland's GDP, 1990 to 2003  
Change on previous year (%)



Source: Statistical Office (GUS).

<sup>2</sup> The ratio of self-employment in Poland is higher than in Germany in all sectors of the economy; it is especially high in agriculture, where it stands at 95%.

work in the shadow economy rose by more than 7% in real terms. The unemployment rate fell only slightly last year, from 19.7% in December 2002 to 19.1% in November 2003.<sup>3</sup> Real wages were stagnant, and, on an annual average, the overall wage bill actually fell as a result of the declining number of employed persons. The increase in nominal disposable income was estimated at approximately 4.7%; social transfers (including pensions) rose at approximately the same speed (4.4%). Compared with 2002, the savings ratio of private households rose slightly.

Investment in fixed assets generally stabilised throughout 2003. After falling during the two previous years, by 8% and 6%, respectively, they decreased by only 1% in the past year.<sup>4</sup> In this area, however, the difference between the private and public sectors is considerable: investment activity in the public sector<sup>5</sup> fell sharply (during the first three quarters by 12% in nominal terms), while the private sector recorded an increase (of almost 10%). This was the case in particular in companies that generated a substantial income from exports.

The inflation rate has been below the EU average since mid-2002; in 2003 prices rose by only 0.8%. Economic downturn contributed to speedy disinflation; in addition, falling food prices, whose weight constitutes 30% in the Polish consumer price index (cf. figure 2), helped lower the rate of inflation. The most recent acceleration in price increases is, to a large degree, also due to food price trends.

### Moderate upturn this year and next

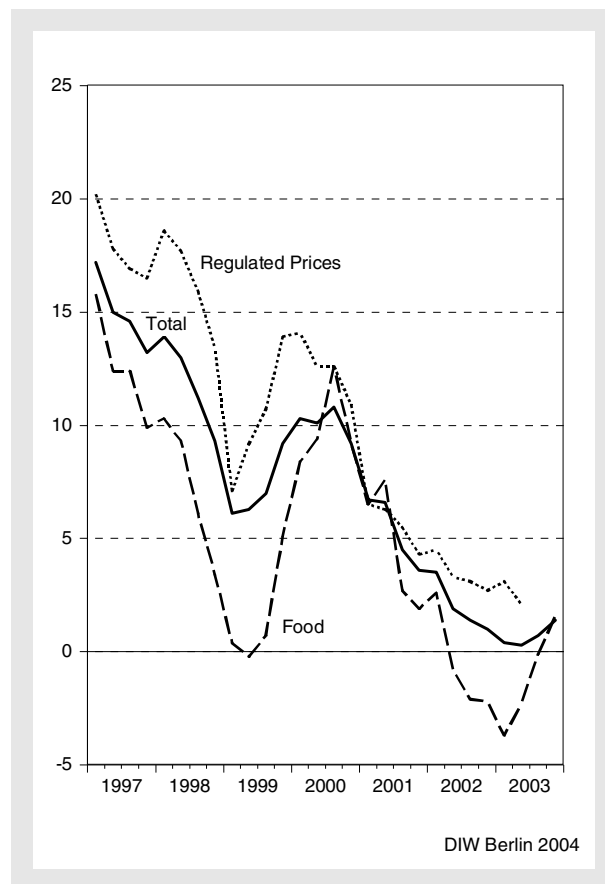
For 2004 and 2005, GDP growth of 4.2% and 3.8%, respectively, is forecast (cf. table 1). Exports and private consumption remain the driving forces of expansion. Real disposable income will rise by 3.2% and 4.3%, respectively. In addition to income from self-employment, the aggregate wage bill will rise again. Nominal wages will increase strongly in both years (by a good 6% each year); in addition, the number of employed persons is forecast to increase again, and unemployment to fall slightly. Income from EU transfers (both through new administrative capacities and through transfers to farmers) will further stimulate private consumption.

<sup>3</sup> Standardised unemployment rate, seasonally adjusted.

<sup>4</sup> Due to the short time series of the quarterly national accounts statistics, official seasonally adjusted figures have not yet been published. Consequently, it is extremely difficult to evaluate the dynamism within one year.

<sup>5</sup> This includes not only investment in public infrastructure, but also investment of state-owned companies (e.g., steel works and coal mines).

Figure 2  
Poland's Consumer Price Index, 1997 to 2003,  
by Selected Components  
Change on previous year (%)



Sources: Eurostat; Narodowy Bank Polski (NBP).

Net exports are also expected to remain a key growth factor. Gains in export markets achieved in the past two years will pay off in the next few years; furthermore, the recovery in the world economy, including in the EU and Germany, will increase demand for Polish products. An additional factor stimulating export sales in 2004 is the forecast further weakening of the zloty, which is due primarily to uncertainties in fiscal policies. With a change in the exchange rate trend in 2005, the rate of export growth will weaken. Imports will grow at a lower rate than exports, owing to the only modest recovery in investments and the depreciated exchange rate. The (still negative) gap between exports and imports will thus be further reduced, as will the current account deficit.

The increase in private investment will accelerate given the improving financial situation of companies as well as strong domestic and foreign demand. The most recent monetary policy measures – the reduction of the

Table 1  
Forecast for Selected Economic Indicators  
for Poland

Change on the previous year (%)

	2002	2003	2004	2005
GDP, real	1.4	3.7	4.2	3.8
Domestic demand	0.9	2.3	3.5	3.9
Private consumption	3.3	3.1	3.5	4.1
Fixed assets	-5.8	-0.9	6.2	5.1
Unemployment rate (%)	19.8	20.0	19.4	18.9
Inflation rate (Consumer price index)	1.9	0.8	2.5	2.3
Government budget deficit (as % of nominal GDP)	-6.0	-4.6	-6.5	.

Source: Center for Social and Economic Research Foundation (CASE).

required minimum reserve ratio and a relaxation of the restrictive regulations on risk provision to EU standards – should make a more active credit policy possible on the part of commercial banks. On the assumption that Poland would use at least 35% of the EU-related transfers, investment should also gain an additional boost every year of around 5% of the total value of investments in 2003. Nevertheless, the weak zloty will have a dampening effect on investment activity. Since more than one-third of company debt is in foreign currency, the costs of international debt are on the increase. In addition, the uncertain situation of public finances and the government's high requirements for spending are likely to have negative effects on interest rates. Thus, despite the upturn, investment as a whole is likely to expand by only 6% this year and 5% next year.

The most serious source of uncertainties about future development is fiscal policy. Although the budget deficit seems to have been slightly lower in 2003, with 4.6% of GDP, consolidation efforts must be intensified in the years to come. On the one hand, being a member of the European Union, Poland has to prepare for membership in the monetary union by achieving nominal convergence as stipulated in the Maastricht Treaty. This implies that current budget deficits must not exceed 3% of GDP and overall state debt 60% of GDP. On the other hand, the limit for the state debt of 60% is also fixed in the Polish constitution. This year, public debt – based on the current state of budgetary planning

– is expected to reach 55% of GDP. According to the legal provision on public finances, when a debt level of 60% of GDP is reached the government is obliged to balance central government and local authority budgets within the next two years.

The great dynamism in the development of the deficit is partly structurally conditioned; in this context, three aspects in particular must be considered: rapid growth of fixed expenditures (i.e., debt servicing, transfers to local authorities, and social spending), the cost of implementing structural reforms, and EU accession. The share of legally fixed spending as part of total spending has consistently risen in the past years (from 46% in 1998 to roughly 70% in 2003). Half of the remaining spending goes on wages for state employees; despite the economic slowdown, these have risen in real terms even in recent years. In addition, the state budget has been burdened with the costs of structural reforms undertaken in recent years (i.e. reforms of the pension, health care, administrative and education systems). Because of the introduction of a capital accumulation pillar, the current 'pay-as-you-go' system requires that the state budget finances the gap created by the shift of a part of the current contributions to private pension funds. Pressures are also occurring because of slow progress in the agriculture and coal mining sectors, the latter of which continues to be primarily state-run. In addition, transfers following EU accession will not remove pressures on the government budget: although, on balance, Poland may be a net recipient of EU funding, the government budget will not benefit as it will have to take on the co-financing of EU funds.

Last year, the necessity of reducing statutory spending induced the government to develop a fiscal consolidation programme (the so-called Hausner Plan<sup>6</sup>). However, no agreement could be achieved on this, and on 27 February 2004 the government put forward an amended version of the programme. According to this plan, no substantial reduction in spending is anticipated for this year; between 2005 and 2007, however, considerable spending cuts are to be undertaken.<sup>7</sup> This situation has led to rising uncertainty about the fiscal perspective. This is true in particular for the 2004 budget plan; moreover, owing to the insufficient controls over public expenditure not directly controlled by the budget, for example, in the health care sector, it is likely that government debt will rise to 55% of GDP by the year end.

The trends in the exchange rate are also causing uncertainty. Even with no further increase in foreign

<sup>6</sup> Programme to adjust and limit public spending, Warsaw, October 2003.

<sup>7</sup> In 2004, these are estimated at approximately 5% of planned income and 4% of planned spending.

Table 2

## Maastricht Criteria: Situation of Poland in Comparison with the European Union

	Inflation rate change on previous year (%)		Long-term interest rates (%) (government securities, 10 years)		Debt level, as % of GDP <sup>1,2</sup>		Budget deficit, as % of GDP	
	2002	2003	2002	2003	2002	2003	2002	2003
Poland	1.9	0.8	7.3	5.8	47.4	50.5	-6.0	-4.6
EU-15	2.1	2.0	4.9	4.2	62.5	64.1	-1.9	-2.7

The Maastricht criteria are:

- The inflation rate may exceed the rate of the three countries with the lowest rate within the EU by a maximum of 1.5%.
- Long-term interest rates may exceed the rates of the three countries with the lowest rate by a maximum of 2%.
- The current budget deficit may not exceed 3% of GDP; total government debt must be below 60%.
- The exchange rate against the euro must be fixed for at least two years within the framework of the ERM-II Exchange Rate Mechanism; the maximum fluctuation bandwidth is  $\pm 15\%$ . During this two-year period, the exchange rate may not be exposed to any pressure that would necessitate strong central bank intervention or a devaluation of the currency (change in central parity).

1 2003 value: estimate. — 2 The debt level of Poland's government budget is calculated based on Polish public finance law. If the European ESA 95 standard were applied, the figures could be lower by up to 5 percentage points.

Sources: CASE; Eurostat.

debt, the devaluation of the zloty implies rising government debt; new indebtedness abroad will increase this risk even further. On the one hand, the government's financing requirements can therefore lead to an increase in interest rates; on the other hand, the danger of reaching the upper 60% threshold is a consistent source of uncertainty. The risk therefore remains that Poland may find itself in a budget crisis that can considerably curtail growth. Even in the case of implementing the consolidation programme, growth in 2005 will still be lower than this year due to the more restrictive fiscal policy.

## Poland on its way towards Monetary Union

Membership of the European Union implies that Poland must, at some point in the future, introduce the common European currency. Although the new member states do not have the option of completely refusing to introduce the euro (as, for example, Denmark and the United Kingdom are able to do) the actual date on which the euro is introduced depends on certain conditions. Most importantly these include the convergence criteria stipulated in the Maastricht Treaty. Currently Poland does not fulfil all of them (cf. table 2 and figure 3).

During the preparation phase for monetary union, and in the decision on the time of accession, Poland is faced with questions similar to those that faced the current member states before monetary union was estab-

lished. Membership of monetary union implies certain benefits and costs. For Poland, the benefits of monetary union are, foremost, a lower interest rate, a lower risk premium, and easier access to financing for investments.<sup>8</sup> Moreover, lower transfer costs and greater price transparency will have positive effects on economic growth.

The costs of participating in monetary unions are linked primarily to relinquishing independent monetary policy. Up to now, the Polish Central Bank, Narodowy Bank Polski (NBP), has been pursuing monetary policy within the framework of inflation targeting; the central bank does not influence the development of the exchange rate. Economic and Monetary Union (EMU) membership, just like the fixing of the exchange rate in the exchange rate mechanism (ERM-II), will lead to considerable changes in the economic conditions – and ultimately to relinquishing independent monetary policy. Since its liberalisation in May 2000, the exchange rate of the zloty against the euro has fluctuated substantially. This could indicate that the exchange rate is an important instrument in cushioning exogenous shocks. The change in the exchange rate would bring about the needed change in relative prices and hence work

<sup>8</sup> Detailed discussion on the benefits and costs of participating in monetary union were recently published by Poland's National Bank, the NBP. Cf.: NBP: 'Raport na temat korzyści i kosztów przystąpienia Polski do strefy euro'. Warsaw 2004. A summary has also been published in English: 'A Report on the Costs and Benefits of Poland's Adoption of the Euro'. ([www.nbp.pl](http://www.nbp.pl))

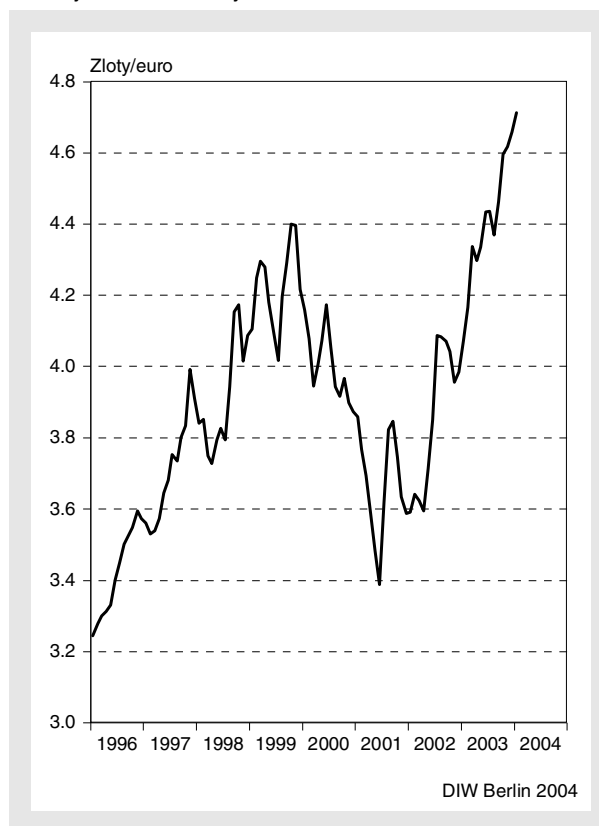
towards internal and external equilibrium more swiftly than other policy areas, mainly the labour market including wage policies and fiscal policies. Whether a country is prone to asymmetric shocks or not is – with reference to optimum currency area criteria – most often measured on the basis of the importance of foreign trade for a country and the amount of mutual trade with other members of the monetary union. The share of external trade (total of exports and imports) in GDP stood at about 63% in 2002. Hence, Poland is a marginally less open economy than Germany. On the other hand, 70% of all exports are directed to other EU member states, with a further 10% of exports going to countries acceding to the EU in May; this exceeds the corresponding EU-15 value. Similarly, the increasing significance of intra-industrial trade reduces the probability of asymmetric shocks, so that the significance of exchange rate fluctuations will continue to decrease in the course of convergence.

At the same time, large exchange rate fluctuations can be an asymmetric shock in themselves, because the exchange rate developments may be driven by other than real factors, which impedes the efficient functioning of price signals. The large exchange rate swing in the past three years is most likely to be connected with the disinflation policies of the NBP, i.e. temporary restrictive policies to adjust the Polish economy to a low-inflation environment, and later on with uncertainties about the fiscal outlook and thus the development of the financial market in the years to come.

The examination of nominal convergence in the run-up to participation in the monetary union is aimed at determining whether or not fixing the exchange rate can imply costs for the country concerned in terms of lower growth or employment. A high budget deficit prevailing for a number of years is regarded as an imbalance that may require a change in the real exchange rate. Similarly, inflation rates well above those of other countries in the monetary union may indicate a loss of competitiveness. This could be corrected more easily by a change in the nominal exchange rate than by price developments depressed below the average in the monetary union, implying real interest rates dampening domestic demand.

Our forecast signals an increase in the inflation rate this year. Reasons for this are the increase of a number of indirect taxes, the devaluation of the zloty, and the revving up of the economic cycle. These factors alone should not, however, lead to missing the NBP's inflationary target of 2.5% ( $\pm 1\%$ ) in place since 2004. Nonetheless, it is debatable whether this inflationary target is the best choice to prepare Poland for monetary union, or whether the ECB target of 2% would not be more appropriate. By choosing the 2% target, the NBP would have

Figure 3  
Zloty-Euro Exchange Rate  
January 1996 to January 2004



Source: Eurostat.

been able to lend greater credibility to the aim of rapid introduction of the euro. It would also lessen the probability that, in the years to come, further monetary restriction would become necessary to meet the Maastricht criteria. Moreover, this choice would strengthen the credibility of the exchange rate targets, since steady real appreciation at fixed exchange rates increases the danger of a loss of competitiveness.

## Conclusion

Since the beginning of 2003, Poland's economy has been growing more strongly again. This is due in part to the weak currency, which is stimulating foreign demand. Private consumption, too, is strongly on the increase. By contrast, investments, which provide the foundation for a catch-up growth process, have been developing with restraint. At present, the factor representing the greatest uncertainty for future development is fiscal policy: on the one hand, a continuation of the current spending

course threatens to drive government debt above 60% of GDP; on the other, the implementation of the consolidation programme will induce a dampening effect on growth. However, even under these conditions, the national economy will expand at rates of approximately 4% this year and next.

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