

Economic Survey of Poland, 2001

What have been the driving forces behind Poland's impressive growth performance?

Have the threats of high inflation and a large current account deficit been dealt with?

What would be an appropriate policy mix at this critical juncture?

What are the medium-term prospects for output and the labour market?

How to foster job creation, fight unemployment and reduce poverty?

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Summary

Poland has achieved an impressive economic performance in the second half of the 1990s and is well positioned for a relatively rapid output growth in the medium term. However, signs of overheating that emerged from 1999 were replaced by a rapid weakening of activity towards the end of 2000. Real GDP growth has declined severely, unemployment has surged, and inflation has declined, which set the stage for a relaxation of monetary policy. Achieving low inflation and a lower current account deficit in the medium term remain nonetheless difficult challenges. This will require that monetary policy increasingly focus on multi-year inflation objectives. It is equally important that the budget be set in a medium-term framework, a first objective being to reach a general government surplus by 2003. Implementing ambitious labour market reforms is essential to foster job creation and absorb the hugely under-utilised labour resources. At the same time, the authorities should re-affirm that they intend to relinquish the control over state enterprises through speedy privatisation, including in sensitive sectors. Regulatory reform that fosters restructuring in large network industries, such as railways, telecommunications and electricity, should be pursued in a pro-competitive way. Poland also needs to adopt a long-term strategy for structural changes in agriculture and to further integrate this sector with international markets. Despite the great progress made to reduce environmental damage from heavy industries, more needs to be done to eliminate perverse incentives. In particular, environmentally-related taxes would help achieve a higher quality of air in inner cities and reduce Poland's contribution to global warming. These reforms will be essential to achieve sustainable growth in the medium term, as well as reach the authorities' medium-term goal of an orderly integration into the European economy. ■

This Policy Brief presents the assessment and recommendations of the 2001 OECD Economic Survey of Poland. The Economic and Development Review Committee, which is made up of the 30 Member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

What have been the driving forces behind Poland's impressive growth performance?

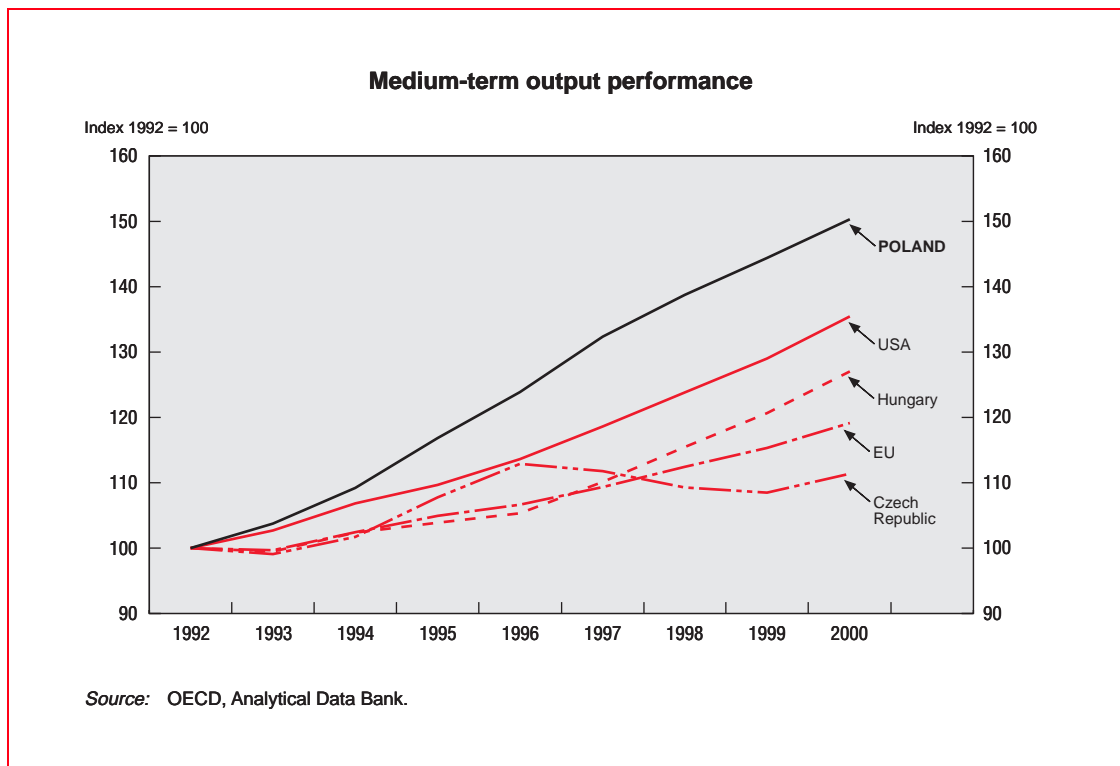
Poland's economic performance was impressive during the second half of the 1990s. Real GDP grew on average by 5½ per cent per annum, inflation was sharply reduced and average living standards improved considerably. This outcome reflected the persistent efforts made by both the government and the private sec-

tor to lay the foundations for lasting growth. Many firms were privatised, restructured and modernised. Foreign direct investment inflows reached the equivalent of 20 per cent of GDP cumulatively during 1996-99, bringing much needed capital and know-how to large companies. Two million small and medium-sized enterprises made a remarkable contribution to economic growth. Even the traditionally bloated state enterprises appear to be stepping up their adjustment efforts – in particular the coal mining sector which is undergoing a sweeping adjustment. In many respects, therefore, Poland has been

one of the most successful transition economies. Nonetheless, the unemployment rate has been for some time one of the highest in the OECD and remains therefore an outstanding challenge. ■

Have the threats of high inflation and a large current account deficit been dealt with?

Furthermore, after several years of strong performance, the economy



showed signs of imbalances starting in mid-1999. Consumer price inflation temporarily increased above 10 per cent and ran over the targets established by the National Bank of

Poland (NBP) for two years in a row. Another sign of imbalance was the increase in the current account deficit, which temporarily exceeded 7 per cent of GDP, in part due to

soaring world energy prices, but also because of high real import growth. In reaction to these growing imbalances, the Monetary Policy Council (MPC) of the NBP raised its

leading interest rates in several steps. These moves were initially in close parallel with inflation, but towards the end of 2000 interest rates rose in real terms and liquidity conditions tightened, restraining credit expansion and investment. Another moderating factor throughout the year was the erosion in real income growth and the downtrend in consumer confidence, which led to a sharp fall in retail sales. Output thus lost considerable momentum during the second half of 2000 and, by the fourth quarter, real GDP growth had declined to only 2.4 per cent year-on-year. Meanwhile, the unemployment rate had increased to a record high of 15 per cent. Nevertheless, these developments have helped stabilise macroeconomic imbalances. At the end of the year, inflation had fallen back to 8½ per cent and the current account deficit had shrunk to about 6 per cent of GDP.

Even though the recent deceleration is sharp, the official projection is for real GDP growth of 4½ per cent in 2001, which would require a significant pick-up of activity. There is a large degree of uncertainty, nonetheless, as to the short-term robustness of activity. Real household income will be boosted by compensation payment to pensioners, transfers related to world war II forced labour, and a possible “disinflation surprise”. But forces in the international economy, including in the European Union, appear to be less supportive than expected, which may affect export growth in the near future. The sharp increase in unemployment is having a negative impact on private consumption, and business surveys indicate that confidence has weakened. Import volumes have virtually stopped increasing, suggesting sluggish domestic demand growth. ■

What would be an appropriate policy mix at this critical juncture?

Should the risk of prolonged economic weakness become significant, a relaxation of the monetary policy stance would be appropriate. The two cuts in official interest rate by 1 per cent each in March were justified by the emergence of several disinflationary factors: domestic demand was weak, unemployment had sharply increased, unit labour costs were growing very slowly, oil prices had fallen and the exchange rate was strong. Any further relaxation, should it become necessary, has to be cautious in order not to jeopardise the medium-term inflation goal of less than 4 per cent, which the MPC intends to achieve by 2003. Indeed, inflationary pressures are likely to keep some strength in years ahead because the convergence towards higher income levels will push wages up in the non-tradables sector. Several lessons ought to be drawn from the experience of countries that moved from moderate to low inflation levels. First, a sound fiscal policy matters. Second, central bank credibility also matters to influence inflationary expectations, which appear to have been driven by past trends. This would require that government officials refrain from making public comments on monetary policy ahead of MPC meetings, especially during the current credibility-building stage. Third, given the long and unpredictable transmission mechanisms, the MPC should increasingly focus on multi-year inflation objectives. Fourth, monetary policy should be more explicitly forward-looking. In this context the NBP's effort to foster

its forecasting capacity is a welcome step. Finally, opening markets to competition is important to tame inflation – including for private services, utilities and farm products. Such reforms would facilitate the conduct of monetary policy over the medium term.

In a similar vein, fiscal policy should also be guided by medium-term objectives. Fiscal slippages occurred in the last two years, which resulted in a higher-than-expected general government deficit in 2000. These slippages resulted in part from tax revenue shortfalls and from the ongoing “teething” problems associated with the reform of the pension, education and public administration systems. Implementation of the health care reform has also been more difficult than expected, with financing difficulties widespread in the public hospital sector and growing patient discontent. These have delayed the planned consolidation of public finances. Admittedly, the state budget deficit partly reflects spending related to the new pension system, which is not inflationary because it contributes to higher individual savings. Nonetheless, the authorities should concentrate on getting the budget back on a medium-term path of consolidation and aim at a general government budget surplus by 2003. There are many good reasons to do so. First, tighter public finances should contribute to higher national savings and hence to a lower current account deficit. Although the current account deficit has declined in 2000, it remains excessively large and will become increasingly difficult to finance in the future as privatisation inflows are projected to dry up. Second, a bunching of debt service obligations will need to be faced

soon when the grace period associated with sovereign debt rescheduling agreements comes to an end. Third, large public investments will have to be made in the run-up to and after accession to the EU. Hence, there is little choice other than tightening public finances. The 2001 budget, which aims at reducing the general government “economic” deficit to 1.8 per cent of GDP, would make a contribution in this direction. It is of utmost importance that the authorities avoid new slippages and keep consolidation going, not only for the state budget, but also more broadly for the general government. A greater degree of transparency in the government accounts would help in this respect, including for the social security administration (ZUS) and health care funds. ■

What are the medium-term prospects for output and the labour market?

Beyond the immediate economic slowdown, prospects for growth are bright. Over the years, the Polish economy has demonstrated its resilience and its capacity to rebound. The ongoing efforts to preserve macroeconomic stability and undertake structural reforms bode well for future output growth. The new old-age pension system, which is very close to actuarial neutrality, will substantially reduce pension liabilities overtime and contribute to improved long-term growth potential. Prospects for net job creation are unfortunately much less promising. The social model that has been promoted in the 1990s by the coalition governments has many features that are not employment-

friendly. Employment protection is widespread, resulting in a rigid labour market. Wage indexation mechanisms and the non-differentiated minimum wage lead to high labour costs that crowd out the low-skilled. Generous early-retirement and disability pensions have led to huge increases in social security contributions. Policies to cut labour supply have failed to achieve their intended goal because many recipients have remained active. In addition, they have been narrowly focussed on the short-term target of reducing unemployment figures, and failed to recognise labour resources as a development factor. Finally, public employment services do not foster active job search, and there is virtually no individual follow-up of the unemployed. In the circumstances, it is likely that structural unemployment has already reached a high level. A particularly worrying feature is the low employment rate among school leavers, with inevitable social implications. Thus, without major reform in labour market policies, Poland may suffer from the chronically high unemployment that confronted other OECD countries in the past. ■

How to foster job creation, fight unemployment and reduce poverty?

Regrettably, little reform of labour market policies has been undertaken since the last *Survey*. Lessons should therefore be drawn from the experience of countries that have had greater success in reducing persistent and high unemployment. An important step is to lower the tax wedge, so as to reduce labour costs. The recent pension reform has helped in this respect, because it transformed old-age pension contributions from taxes to savings, and abolished widespread

early retirement schemes. But it will take time for people to internalise these reforms and adjust to new incentives. In the meantime, cutting ZUS contributions at the minimum wage level and slightly above it would be particularly important in raising the employability of low-skilled workers. Disability pension contributions could also be reduced from their presently high level, with both a tightening of eligibility criteria and a shift of financing to indirect taxes, for instance environmentally-related taxes, as suggested below. Lowering the personal income tax rate would also be important to alleviate the tax burden of the low-paid and make work pay. Another important step would be to make working time more flexible, so that companies can adjust work schedules to their activity peaks and troughs and avoid paying large overtime premia. A concrete measure in this direction would be to promote the annualisation of working time. Labour offices need to become more pro-active and make the labour market function better. This would involve a greater degree of co-operation with employers to better assess their specific needs. Labour offices should also draw up individual plans with each unemployed person that would chart strategies to re-enter the labour market, including through retraining. This effort should focus first on young unemployed persons so as to leverage their human capital and encourage participation in the labour market because, for them, the transition from school to employment seems particularly difficult.

Active labour market policies will however take time to work, and many persons are likely to remain unemployed in the near future. This will increase poverty which, although not widespread, is not negligible in selected areas. The authorities’ decisions to establish

universal coverage for the pension and health care systems were important to shelter these persons. Nonetheless, the challenge is to prevent large groups of disadvantaged persons from staying in poverty and remaining unable to adjust to the new society. For those individuals and families who are unable to adjust, social benefits will need to be better targeted to the needs. ■

Which structural reforms could be undertaken to foster output and employment growth?

High unemployment should not be a reason to retain state controls over the enterprise sector. Poland has been well served by its ambitious privatisation and restructuring efforts and should continue to implement its agenda. For 2001, the government projects privatisation proceeds of Zł 18 billion, arising notably from the sales of additional blocs of shares in TPSA (telecoms), PZU (insurance) and LOT (airlines), which seem difficult to achieve. The privatisation process has been disrupted temporarily by the authorities' actions to regain control over a partially privatised company (PZU), which has created some disarray among foreign investors. To restore confidence, they should make it clear that they accept the loss of control over enterprise management after privatisation. Such a statement is all the more necessary because the state's presence in the economy remains excessively large. The share of value added generated by the private sector in Poland is among the lowest in transition economies. There is no evidence that the authorities are

about to achieve their own goal of selling 70 per cent of state enterprises' assets by the end of 2001. Hence, achieving the privatisation goals remains a high priority. The authorities should also take concrete actions to move forward with privatisation in sensitive sectors, such as coal mining, steel and defence. In some of these sectors, the authorities envisage to suspend market mechanisms during the adjustment period, for instance by organising recession cartels. Such state intervention should be transparent, strictly limited in time, and adopted after receiving the published views of the Office for Competition and Consumer Policy. It should also comply with EU prohibitions against cartels, so as to ensure benefits to consumers.

In the electricity sector, privatisation and regulatory reform are being pursued by vertically separating power plants, regional distribution companies and the transmission grid. An Energy Regulatory Authority is entitled to grant energy licences to new entrants, to approve electricity tariffs and large customers are authorised to select their suppliers. An Electricity Exchange is set up to clear next-day market transactions. Due to inherited institutional arrangements, however, long-term procurement contracts between power plants and large customers prevail at pre-established prices, which makes actual competition impracticable. As a result, at the end of 2000, only 1 per cent of the electricity trade took place on the Electricity Exchange. The government decided to implement a compensation payment mechanism to alleviate the resulting cost burden on electricity users. Steps to enhance transactions in the Electricity Exchange would indeed be useful to advance reform, including price liberalisa-

tion, and privatisation in the sector. Care is needed, however, in designing a regulatory framework that preserves incentives for long-term capacity development and supply security in the face of unpredictable prospects for demand.

In the coal mining sector, restructuring programmes are well underway. They involve sizeable reductions in operating costs and should help restore some degree of financial viability. The significant employment reduction has been accompanied by a number of measures to mitigate the social impact and help facilitate the re-training of younger workers. With respect to iron and steel, downscaling and privatisation have occurred throughout the decade, but a hard core of problems remains in the two biggest production sites, which together generate more than 50 per cent of the industry's output. The government has introduced a restructuring programme for the sector, and commercial partners are actively sought to help implement it. All these operations will need to find a balance between avoiding political deadlocks and keeping budgetary costs under control.

Another challenge for the authorities is to reform the railways sector. This is all the more important given the potential of rail transportation across the flat Polish territory, the need to relieve congestion on the road network and the desire to reap environmental benefits. Several steps are intended to restructure the railway monopoly PKP: financial rescue via guaranteed restructuring bonds; vertical separation of infrastructure, passenger and freight activities; and a gradual opening of services to competition. It is important that the reform effort just launched not

be stalled again by vested interests, and that all potential participants in the long-term development of the railways be given reinforced investment incentives.

The rapid privatisation and deregulation of the economy should lead to important welfare and efficiency gains. Improved corporate governance, *inter alia* through the strengthening of scrutiny by minority shareholders, is among the key ingredients. The stock market does not yet play a significant role in the funding of the corporate sector, and domestic institutional investors (mostly pension funds) are not insisting on high standards of corporate governance. Primary equity issues are sparse, only a minority of shares are traded for most companies, and controlling stakes remain with their strategic and stable investors, including the Treasury. This ownership pattern explains the limited number of mergers and acquisitions taking place on the market. In such circumstances, certain aspects of corporate governance remain unsatisfactory with minority investor rights lacking representation commensurate with their ownership, in particular in major reorganisation decisions. A new commercial code due for application in 2001 should contribute to strengthening the stock exchange and the quality of corporate governance. The new code would ban the utilisation of stocks with multiple voting rights and increase the powers of supervisory boards and annual shareholder meetings. The take-over law also needs to be revised to promote a transparent market for corporate control. These legal efforts should be supported by collective actions from the investor community to define guidelines for desirable corporate governance practices expected

from corporations listed on the stock exchange. ■

How can reforms be pursued in the rural areas?

The agriculture sector has to an important extent remained outside the vast efforts of restructuring and modernisation. Agricultural policy has attempted to protect farmers' incomes through price support and by limiting their exposure to international competition. This has not prevented the gradual decline in farm earnings over the past decade. High unemployment in rural areas also slowed down productivity enhancing restructuring and modernisation in farms. Agricultural policies should aim at promoting competitive activities and employment. Changes in policy will in any case be required by accession to the European Union, which will involve dismantling intra-EU trade protection – while possibly increasing import protection from third countries. Future policies should as much as possible depart from market distorting interventions and aim at an integrated, sustainable rural development strategy, which ought to be cross-sectoral and reach beyond farming. With an appropriate entrepreneurial environment and well-adapted labour and social policies, rural areas should be able to expand based on their own specific assets, including organic agriculture, rural food industries and green tourism. The focus should also be on rural education, because the present level of education puts farmers at strong disadvantage on labour markets. Pre-accession assistance available from the European Union may help promote these efforts. ■

What can be done to strengthen Poland's environmental policies and improve the quality of ambient air and the water system?

One strength of Polish agriculture is its respect for the environment. Substantial progress has also been made outside the farm sector in dealing with the heavy environmentally-unfriendly legacy from the past. Emissions released into the air by the industrial and energy sectors – especially the worst pollution from heavy industries – have been cut back. Withdrawal of water has been reduced to more reasonable levels. The situation in pollution “hot spots” that were dangerous for the population's health has improved. Although a great deal of pollution retrenchment has been achieved, the authorities now have to deal with more costly and complex tasks. The main challenge in this process will be to formulate sustainable development policies that are both environmentally effective and market friendly. This requires avoiding over-reliance on certain “command and control” solutions, such as compulsory technical standards, which would impose excessive costs on the economy. Instead, for the most ambitious environmental targets, Poland should develop compliance programmes that would focus on rapid improvement in environmental quality.

In addition, Poland should further develop the type of economic instruments that it has used so effectively in the last decade. For example, for certain pollutants, a system of tradable emission permits, in parallel to firm-specific integrated per-

mits, would bring a market-friendly approach to emission reduction and would inject a dose of flexibility in the otherwise rigid permit system. In addition, the existing system of piecemeal earmarked environmental fees and product charges should be streamlined and focussed on the few really important charges. Excise taxes on energy should also be redesigned so that they provide neutral incentives in terms of carbon content, which would require the introduction of a tax on coal consumption, even though this may in the short-term add to the difficulties of the coal extraction sector. This would streamline the environmental tax system and pave the way towards a genuine system of unearmarked environmentally-friendly taxes. Such a reform should be designed in a revenue neutral way, for instance by lowering social security contributions at the same time as environmental taxes are raised. This would adequately shift the tax burden away from under-utilised resources (labour) to scarce natural resources.

Large public investments need to be made in the context of EU accession to clean up the environment. These investments are important to pro-

vide a degree of environmental protection and health safety to the entire population, but they need to be designed in a cost effective manner, which would require focussing on clear ecological objectives. For instance, the focus should first be put on improving water quality in rivers and lakes. For this purpose, the river-basin integrated management approach should be extended to encompass the management of water related financial resources. It makes sense for the installation of costly sewage systems and water treatment plants in small villages to be postponed until a later stage, as requested by the Polish government in the accession talks. These investments should be increasingly financed by raising the fees for using the environmental infrastructures, such as water and wastewater tariffs, which would also provide incentives to economise water usage. Currently, private operators are discouraged from investing in environmental protection area, unlike in other countries. Regulatory reforms are needed to encourage private sector participation in environmental protection.

The role of the Environment Funds needs to be reconsidered. These

Funds have played an important role in the period of transition in establishing an environmental finance system. However, market-based private sources of financing are now becoming available for well-designed environmental protection investments, and Environment Funds, which receive tax resources, are therefore unfairly competing with private sources in some segments of the market. Hence, their role needs to be reconsidered. A wide range of options is available for their future, including closure or transformation into commercial institutions. Their last important public role may be to help with the implementation of investment-heavy environmental Directives of the European Union. This would require defining fewer and clearer objectives and targeting expenditure accordingly. A great deal of improvement is also needed in the area of transparency and accountability. ■

For further information

Further information on the *Survey* can be obtained from Patrick Lenain (e-mail: patrick.lenain@oecd.org, tel.: 33-1-45.24.88.07).

For further reading

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- **Economic Outlook No. 69,** June 2001. A preliminary edition is published on the OECD Web site approximately one month prior to the publication of the book: www.oecd.org/eco/out/Eo.htm.

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Where to contact us?

FRANCE

OECD Headquarters
2, rue André-Pascal
75775 PARIS Cedex 16
Tel.: 33 (0) 1 45 24 81 81
Fax: 33 (0) 1 45 24 19 50
E-mail: sales@oecd.org
Internet: www.oecd.org

GERMANY

OECD BERLIN Centre
Albrechtstrasse 9/10
D-10117 BERLIN
Tel.: (49-30) 2888353
Fax: (49-30) 28883545
E-mail:
berlin.contact@oecd.org
Internet: www.oecd.org/deutschland

JAPAN

OECD TOKYO Centre
Landic Akasaka Bldg
2-3-4 Akasaka, Minato-Ku
TOKYO 107
Tel.: (81-3) 3586 2016
Fax: (81-3) 3584 7929
E-mail: center@oecdtokyo.org
Internet: www.oecdtokyo.org

MEXICO

OECD MEXICO Centre
Av. Presidente Mazaryk 526
Colonia: Polanco
C.P. 11560
Mexico, D.F.
Tel.: (00.52.5) 281 3810
Fax: (00.52.5) 280 0480
E-mail:
mexico.contact@oecd.org
Internet: www.rtn.net.mx/ocde

UNITED STATES

OECD WASHINGTON Center
2001 L Street N.W.,
Suite 650
WASHINGTON D.C. 20036-4922
Tel.: (1-202) 785 6323
Fax: (1-202) 785 0350
E-mail:
washington.contact@oecd.org
Internet: www.oecdwash.org
Toll free: (1-800) 456 6323

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