THE OECD ECONOMIC SURVEY OF POLAND 2010

Introductory remarks by Andrew Dean,
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Warsaw, 8 April 2010

It is a great pleasure to be here today to present the latest *OECD Economic Survey of Poland* in the presence of Deputy Prime Minister Pawlak, together with my colleagues Hervé Boulhol and Rafal Kierzenkowski who were instrumental in producing the report. The key messages are as follows:

- Poland's economic performance in 2009 was strong, given the global downturn. Indeed, Poland recorded the best real GDP growth outcome in the OECD in 2009, and growth is expected to pick up steadily over the next two years.

- Yet, the crisis has taken a heavy toll on public finances, thus threatening the fulfilment of the constitutional ceiling on public debt in the near future. As a result, ensuring credible and sustained fiscal discipline is one of the prime objectives facing Polish policy makers seeking to satisfy the conditions for a balanced recovery.

- The Survey also highlights a number of issues that should be addressed to strengthen Poland's position in a globalising world and to ensure sustainable growth in the context of future euro adoption.

Let me elaborate on these issues:

Why has Poland done so well?

Poland's strong relative performance during the crisis is due to a combination of factors:

- First, resilient final domestic demand was supported by pre-crisis tax cuts. In fact, significant excess demand at the outset turned out to be helpful in the downturn.

- Significant depreciation of the zloty then cushioned the downturn.

- Relative to other countries, the financial system was solid, notably with a protective role played by foreign-owned banks.

- Limits on excessive borrowing in foreign currency have been in place since 2006; and the Financial Supervision Authority (KNF) encouraged financial firms to retain profits.

- External imbalances were smaller than in other Eastern European countries.

- Major infrastructure investments related to EU funds and the 2012 European football championships that are underway have also underpinned demand.

- Finally, the policy response was appropriate:

  - Official interest rates were cut swiftly and combined with unconventional measures to ensure liquidity.

  - The flexible credit line agreed with the IMF helped to restore capital-market confidence.

  - On the fiscal side, despite an already weakened fiscal position, automatic stabilisers were allowed to operate and there was a small anti-crisis package.

Now that recovery is in train, how should policy be set? The number one priority is that macroeconomic stimulus should be withdrawn in a measured way.

- Implementing a credible fiscal consolidation is the main challenge. The exceptional pre-crisis expansion was not used to improve the fiscal position in a sustainable way, which resulted in the need to use privatisation receipts to reduce public debt during the recent period of lower stock prices.

- Some of the consolidation measures presented recently by the authorities are broadly in line with our recommendations, but their success will depend on the degree of ambition shown in the implementing legislation. Yet it is disappointing that the main part of the effort is back-loaded to 2012, which calls into question the determination to retrench and risks delaying the informal euro adoption plans of the authorities.

- Ensuring sound and sustainable public finances will require structural reforms in three ways set out in the *Survey*.

  – First, <u>the pension reform should be continued</u> by:

    1) Changing the overly generous special social security system for farmers and pension schemes for soldiers, police officers and miners, with the long-term objective to align them with the general regime;

    2) Increasing employment rates at older ages, which are among the lowest in the OECD. The bridge pension reform and the “Programme 50+” go in the right direction; in addition the statutory retirement age for women should converge steadily with that for men, which should itself be indexed to life expectancy; and

    3) Avoiding shifting back part of the contribution to open pension funds into the social security’s first pillar. As this would undermine the commitment to the reformed pension system, such a shift should be shelved definitively.

  – Second, <u>the tax base should be broadened through</u>:

1) An improvement of the VAT treatment of certain professional services in order to enhance tax collection;

2) Restrictions to the option of choosing to pay lump-sum income tax without keeping accounting books;

3) Making farmers liable for the income tax rather than the lump-sum agriculture tax;

4) Better administrative enforcement.

– Third, tax receipts should be raised in less distortionary ways by reforming property taxes and introducing a carbon tax.

The withdrawal of monetary stimulus will also need to begin soon, especially if fiscal policy is not tightened significantly in the immediate future.

- It would be best if fiscal policy were tightened decisively without delay. However, should early fiscal consolidation not be forthcoming and given the projected pick-up in growth, it would fall to monetary policy to tighten at an early stage so as to head off a re-acceleration of inflation in 2011 and 2012.

Looking forward, the ground for euro adoption must be prepared

- Although exchange-rate and interest-rate flexibility have supported the economy during the crisis, net long-term gains can be expected from euro adoption. However, the benefits of the euro are conditional on an appropriate policy framework and the implementation of structural reforms to increase the capacity of the economy to adjust to shocks.

- Maximising the gains from euro adoption will thus depend on policy reforms in a number of areas:

  – Fiscal policy will be at the centre of macro stabilisation and should be conducted through more transparent and effective rules, aimed at achieving a greater degree of counter-cyclicality.

  – The current fiscal framework could be strengthened in four ways: First, a rule specified in terms of the structural general government deficit of no greater than 1% of GDP; second, a complementary rule capping general government expenditure; third, an independent fiscal council to monitor and assess the implementation of these rules; and last, more transparency by referring explicitly to the Maastricht definition of the deficit and debt. For example, the consolidated public debt should include the National Road Fund.

  – Structural reforms in labour and product markets will be key to achieving greater flexibility of the economy. One of the main ways to do so is to reduce wage rigidities. In that regard, the minimum-to-average wage ratio should not be increased further. Also, given the strong regional disparities in unemployment rates, the authorities should consider introducing differentiated regional minimum wages based on local labour-market conditions.

- In the run-up to the monetary union and then as a member, a catching-up country such as Poland faces the risk of a boom-bust scenario, as much lower real interest rates and rapid credit creation boost real estate investment and domestic consumption.

- Policies must therefore be set to contain the risk of such a boom-bust cycle. Measures should be taken to strengthen macro-prudential regulation and to prevent the build up of an oversized real estate sector through:

  – dynamic provisioning for banks;

  – higher capital requirements;

  – stricter limits on both loan-to-value and loan-to-income ratios;

  – removal of support for housing demand;

  – more competition in construction; and

  – property taxes based on market values.

Poland has made tremendous progress in increasing linkages with the global economy but a wide range of reforms are needed to benefit more extensively from globalisation:

- The privatisation process should be reinvigorated and its credibility strengthened, given that Poland is the OECD country with the tightest grip of the state on the economy.

- Administrative burdens should be reduced. Compliance costs are still too high for starting a company, obtaining construction permits and registering properties.

- Stringent product-market regulations are restraining competition, notably in network industries, retail distribution and professional services. Public ownership in the potentially competitive segments of network industries should be phased out and regulations on educational requirements and licensing in professional services should be eased.

- Developing infrastructure is also important to reduce trade costs. Regarding transport infrastructure, a key priority is to absorb EU funds efficiently by:

  – enhancing co-ordination between all public and private parties involved in the process;

  – systematically defining project priorities based on cost-benefit analysis; and

- facilitating the issuance of temporary permits for foreign workers to avoid future labour shortages.

- The gap between the skills needed by firms and those provided by the education system has grown despite rising educational attainment. Science and technology education should be encouraged, and a comprehensive and flexible lifelong-learning strategy developed.

- Investment in R&D is low and could be boosted by:

  - increasing tax credits so long as there is adequate monitoring and evaluation of their efficiency;

  - intensifying efforts to concentrate the public funding of research in order to help the best centres to reach a critical mass; and.

  - encouraging researchers to move in and out of the business sector;

- The foreign investment agency, PAIiIZ, should be strengthened via expanded financial capacity and by turning it into an independent body. Also, export promotion activities could be rationalised and supported by a creation of a separate agency.

- Finally, the fragmentation of SME-support policies should be reduced and public support should aim at increasing financial management, accounting and marketing skills in SMEs.

Strengthening economic performance

- To sum up, let me again emphasise the good performance of the Polish economy during the current crisis. It is now important for macroeconomic policy to be adjusted so as to put the economy on a more sustainable path and for structural reforms to be aimed at stepping up competition and enhancing flexibility. Advancing both macroeconomic and structural reforms in this way will enable the country to prepare the grounds for a safe adoption of the euro and to maximise the benefits from increasing connections with the world economy.