The "Soaring Eagle" :
Poland's economic performance and challenges

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10 years of Polish membership in the OECD

Warsaw
23 November 2006

It is an honour and a pleasure to take part in the celebration of Poland's first decade as an OECD member. Back in 1995, when I joined the OECD myself and was assigned to work on Poland, the mood in Warsaw was buoyant. The favourite metaphor of the Polish economy of the then Minister of Finance was that of "the soaring eagle of Europe". And indeed, the opening sentence of the last OECD Survey of Poland before it completed its journey to full OECD membership read: "In many ways, Poland stands out as one of the most successful transition countries".[1]

Today, 2½ years after EU accession, growth is also running strong enough to again warrant flattering metaphors. However, Poland's growth performance during the first half of this decade has been disappointing. This has led our IMF colleagues to recently lament that "In the last five years, economic performance has failed to live up to the promise of Poland's early reform record"[2] and our colleagues in Brussels to write that "real convergence, so far, has been slow".[3]

Now that activity is soaring anew, the challenge is to ensure that the upswing turns into a sustained catch-up. This requires a number of reforms, many of which are spelled out in the most recent OECD Economic Survey of Poland, released this summer.[4]

Catching up

Since Poland joined the OECD, real GDP growth has on average exceeded 4% per annum (**Slide 1**), as against 2¾ per cent OECD-wide, 3¾ per cent for the other new EU member states and barely over 2% for "Old Europe", understood as the EU15. As a result, income per capita, valued at purchasing power parity, rose from below 40% of the OECD average in the mid-1990s to almost 50% today (**Slide 2**).

While the income gap has narrowed, it remains wide. Upon OECD accession, Poland was the third poorest OECD member, ahead of Mexico and Turkey and today, this ranking is unchanged. In fact, while Poland did catch up during the 1990s, it subsequently lost momentum, especially when

[1] See *OECD Economic Survey of Poland*, November 1996 and M. de Broeck and V. Koen, "The 'Soaring Eagle': Anatomy of the Polish Take-Off in the 1990s", IMF Working Paper No. 00/6, January 2000.

[2] *IMF Country Report* No. 06/391, October 2006.

[3] *Growth and Competitiveness in the Polish Economy: The Road to Real Convergence*, European Economy, Occasional Paper No. 27, November 2006.

[4] *OECD Economic Survey of Poland*, June 2006.

compared with some of the other, smaller new EU countries, where convergence has been making faster headway.

The current upswing

However, since mid-2005 or so, the Polish economy has been expanding at its potential rate or even a bit faster and this newfound dynamism is not expected to falter over the near term. Encouragingly, investment is booming, following a protracted spell of much-deplored under-investment. Equally spectacular and at least as welcome is the stunningly rapid decline in unemployment over the past few quarters. Several factors are at work here, some more transient than others.

First, Poland has been benefiting from the dynamism of the global economy and from the long-awaited recovery in the larger economies of the euro area. This year, Polish export volumes are estimated to be up by around 16%. As they have a high import content, but also because domestic demand is buoyant, imports are rising at a similar pace, meaning that Poland is also contributing to growth elsewhere.

The export boom is benefiting substantially from the revival of the German economy. Indeed, across the Oder, activity is on course to grow by 2½ per cent this year, a rate last witnessed at the peak of the exuberance of the turn of the millennium. Well over one quarter of Poland's exports are directed to its Western neighbour, and Polish exports to Germany are up by close to 30% this year.[5]

This good news, however, is partly cyclical. The world economy has been enjoying an unusually long and vigorous expansion, with growth averaging 4½ per cent over the past five years and 5% since 2004. But the US locomotive has slowed quite sharply since the beginning of this year, as a result of the drag exerted by a cooling housing market (**Slide 3**). Going forward, global growth may hence be somewhat less strong, despite the continued dynamism in Asia and the acceleration in the euro area, and even if the US economy regains momentum over the next few quarters. Moreover, growth in Germany is not expected to continue quite as rapidly as in the first three quarters of 2006.

In addition, there are risks surrounding the global outlook, notably as concerns energy prices and long-term interest rates. Oil prices have eased substantially from their August highs, but at close to \$60 per barrel of crude, they remain high (**Slide 4**). And with small margins of spare capacity, a supply disruption or demand shock could quickly push them back up. Bond yields remain intriguingly low, even if they have trended up since 2005 (**Slide 5**). If they were to rise more than currently expected, this would hold back consumption and investment – not least, in residential construction.

A second factor that should support Polish growth for some time relates to EU membership. Investment is already and will be boosted by the infusion of EU funds. Initially, Poland's absorption capacity with respect to these inflows was limited, but it has started to improve. This source of finance, together with private FDI flows, should help relieve capacity constraints, lift potential growth and contribute to job creation.[6] It will be important to use this large source of funding to the fullest and as efficiently as possible.

Turning to the labour market, recent developments are encouraging. Indeed, after hovering for five years between 18 and 20%, the unemployment rate has plummeted since late 2005. Its level remains the highest among OECD countries (**Slide 6**) but it is projected to decline further. Granted, emigration,

[5] Based on Bundesbank data for the first eight months of 2006, and in nominal euro terms.

[6] Model-based estimates of the Ministry of Regional Development suggest that from 2006 onwards EU funds may add one percentage point or even more to GDP growth.

early retirements and a growing number of full-time students are helping. But the improvement also reflects a strong pick-up in employment, which is now expanding faster than ever since Poland joined the OECD. To some extent, this is the pay-off of the painful restructuring and labour shedding that took place during the lower-growth and high-joblessness years.

Even though apparent labour market slack is rapidly diminishing, inflation has stayed very subdued, well below the mid-point of the National Bank of Poland's 1½ to 3½ per cent target range. In fact it is low – if somewhat volatile – by OECD standards (**Slide 7**), by EU standards and especially in comparison with other catch-up economies. Inflation is expected to rise somewhat, however, as resource utilisation increases and in the wake of this year's poor harvest. But over the near future, it is not projected to exceed the 2½ per cent mark by much, if at all.

Fiscal worries

Another pleasant surprise this year has been the faster-than-expected decline in the fiscal deficit (**Slide 8**). Like in many other OECD countries, revenues have come in more abundantly than foreseen. At the same time, local government capital spending has fallen behind, reflecting administrative difficulties with the absorption of EU monies. Hence, the general government deficit is set to shrink to around 2% of GDP this year (or 4% if private pension funds are counted as private sector entities, as will be the case from Spring next year). While this constitutes an improvement, it is partly cyclical, and it is not sufficient.

With a gross public debt ratio that is far below the OECD average (**Slide 9**), with a major pension reform successfully implemented back in 1999, and given the government's intention to bring down the deficit below the Maastricht threshold by 2009, some question the need for more rapid fiscal adjustment.

Yet, on current policies, even with growth of around 5% per annum, the public debt ratio is set to rise, because of the spending pressures. In addition, an adverse shock to growth of a magnitude similar to the one witnessed half a decade ago would push it up much further.

Another important reason to aim for a lower deficit pertains to the macroeconomic policy mix and has in fact been quite conspicuous in recent years. For a given inflation target, if the fiscal stance is overly loose, monetary policy has to be tighter than would otherwise have been the case, to the detriment of private-sector led investment and growth. This is particularly so in a catch-up economy contemplating euro adoption at some point down the road.[7]

To achieve lasting and better fiscal consolidation, the Zł 30 billion, nominal state budget deficit ceiling used as an anchor by the government should be complemented by a multi-year framework spelling out expenditure priorities, with limits on overall public spending. The latest OECD Survey devoted a whole chapter to this issue. Besides the need for more of a medium-term approach and for more transparency, its key recommendations included the following general orientations.

First, it concluded that spending on social transfers ought to be reduced so as to make room for other priorities, notably health and long-term care, child care, education and active labour market measures. Mainstreaming the social security regime for farmers is one of the recommendations, and should be easier now that the rural sector receives substantially more income from the EU Common Agricultural Policy.

[7] See J.-P. Cotis and V. Koen, "The political economy of strong fiscal adjustments in aspiring euro area countries", Presented at a National Bank of Poland and Magyar Nemzeti Bank conference, Warsaw, 30 June - 1 July 2005.

Second, it emphasised the need to simplify the tax system and to reduce administration costs. As part of the streamlining, the tax base should be broadened as much as possible, by curtailing special provisions and exemptions.

Third, it stressed the importance of bringing down the very high tax wedge (**Slide 10**), especially for low income earners, so as to reduce the disincentives to take up a job. The governmental package involving a cut in payroll taxes sent to Parliament a few months ago was a step in this direction.

In addition, a number of more specific recommendations were spelled out, of which the need to reduce the total number of administrative public-sector employees, while paying more for those who are highly skilled; the need to reconsider the special pension treatment granted to certain groups and to resist the creation of new exceptions; and the need to phase out early retirement schemes.

Obviously, most of these measures are easier to preach than to push through parliament and to implement, but they are no less worthy.

Reforming to raise living standards

The same holds for structural policy reforms more generally, which are needed to raise living standards and speed up convergence with the wealthier OECD countries. These reforms are described in depth in the successive OECD Surveys of the Polish economy, with a special focus in the latest one on education. They are also presented, more compactly, in the context of the OECD's multilateral structural surveillance.[8] In this framework, Poland's income gap can be decomposed into a labour resource utilisation gap and a productivity gap (**Slide 11**).

Focusing briefly on some of the main economic reforms areas that aim at raising labour utilisation and/or at boosting productivity, let me single out the following ones: the tax and benefit system, geographical mobility, education and training, product market regulation and privatisation.

As mentioned already, Poland's sizeable tax wedges hurt employment, translating into comparatively low employment rates (**Slide 12**). On the benefit side, disincentives to take up work arise from the unemployment and disability benefit schemes, whose cost also magnify the tax wedges. Action has in fact been taken: access to disability benefits has been restricted, which has reduced the number of new claimants, even if the stock of beneficiaries of permanent disability pensions remains high. That said, there is scope to further improve the link between the degree of work incapacity and the level of disability benefits. Besides, there is also room to enhance the incentives faced by the unemployed to accept jobs or training by further tightening work-availability and job-search requirements in the unemployment benefit system.

Another important avenue to raise labour utilisation is to promote internal geographical mobility – international mobility is already remarkably high. This can be achieved by continuing to upgrade transport and communications, and by improving the national integration of the public employment service. A more fluid housing market would also help: to stimulate the supply of rentals, there is scope to reduce the level of tenant protection whilst retaining safeguards against abusive landlord behaviour.

Turning to human capital, a number of education reforms were introduced during the 1990s. Partly as a result thereof, the quality of compulsory education as measured by OECD PISA scores has improved, but from comparatively modest levels. One way to make further progress would be to encourage the pre-schooling of the children under six.

[8] See OECD, *Going for Growth*, 2005 and 2006. The third in this series is to be published in February 2007.

Tertiary education has expanded tremendously over the past 15 years, from 400 000 students, all in the public sector, to 2 million, with many in private institutions. This surely helps lift productivity, but problems of coordination and mismatch of resources endure, both between public and private institutions and among students. A state body has been created to monitor the quality of higher-education institutions. This makes for more transparency and better quality. However, quality control and information dissemination need to be reinforced. Equity and efficiency would both benefit if tuition fees for full-time students in public higher-education institutions were introduced, alongside improved systems of means-tested grants and student loans with income-contingent repayments. Furthermore, careers in tertiary education should be made more attractive: for the moment, promotion does not depend closely enough on teaching ability or research results. Facilitating links between academic researchers and companies would also help attract or retain top researchers.

Adult training is key in a rapidly changing economy, but Polish firms are less active in that respect than in most other OECD countries, and a large share of the training is financed by the employees themselves. Moreover, training is in practice mostly benefiting younger and more educated persons. In contrast, training of the unemployed is limited, in part because passive social benefits absorb such a large amount of resources. Local labour offices should be encouraged to pilot innovative training projects.

Productivity can also be boosted through better product market regulation and intensified competition. Much has been done in this regard in Poland, not least in the context of EU accession. But there remains room to further bring down regulatory and administrative barriers to entrepreneurship. One dimension of the problem is corruption, or the perception thereof, as evidenced in international comparisons. The efforts underway to eradicate it are important, since it holds back potential investment, both domestic and foreign.

Last but not least, productivity could be raised by reducing public ownership further. It remains very high compared with the other OECD countries, at the expense of investment in R&D and physical capital. True, the process of privatisation continues, but slowly – including with respect to the objectives set out in the budget. Moreover, many social and “strategic” elements get woven into deals, undermining the potential efficiency gains. The OECD’s advice is therefore to step up privatisation and to eliminate most remaining state controls in the form of residual shareholdings kept in privatised companies. It is also to refrain from imposing side conditions on employment and investment in privatisation deals. Finally, and this holds for some countries in Western Europe as well, it is to step back from the temptation of “economic patriotism”, which tends to dress up what are in effect incumbent producers’ private interests as public or security concerns.

Concluding remarks

To sum up, convergence may have been slower than in some of the other catch-up countries so far, but it has certainly been very real. Moreover, it is set to continue, all the more rapidly so as the necessary reforms are enacted. A number of these reforms will in fact facilitate preparations for euro adoption, but all of them will boost overall living standards and deserve to be pursued irrespective of any euro timetable. Lastly, the current auspicious economic environment and comfortable external position of the Polish economy make it the best of times to push through the more ambitious reforms.

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Poland's Economic Performance and Challenges

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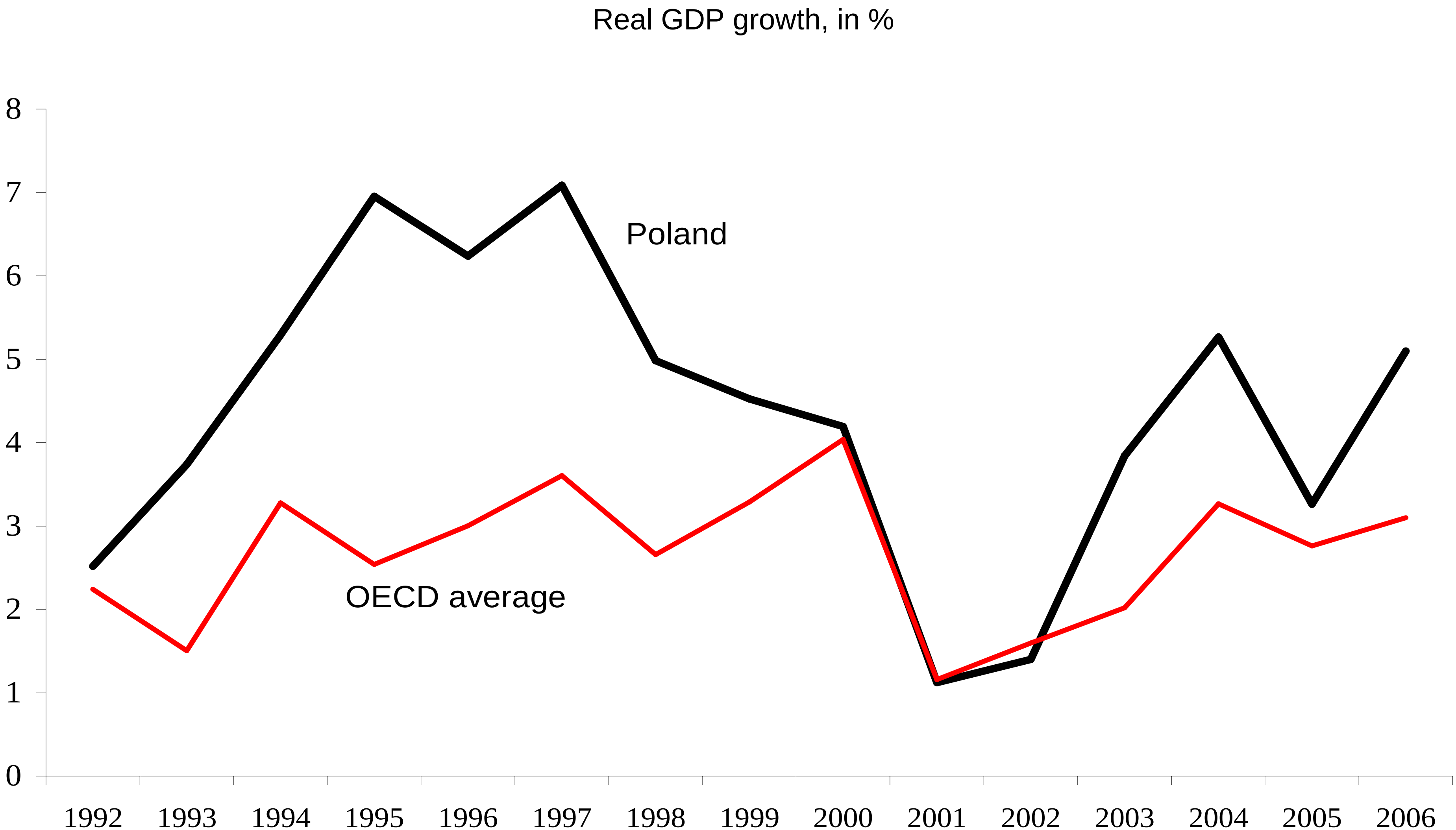
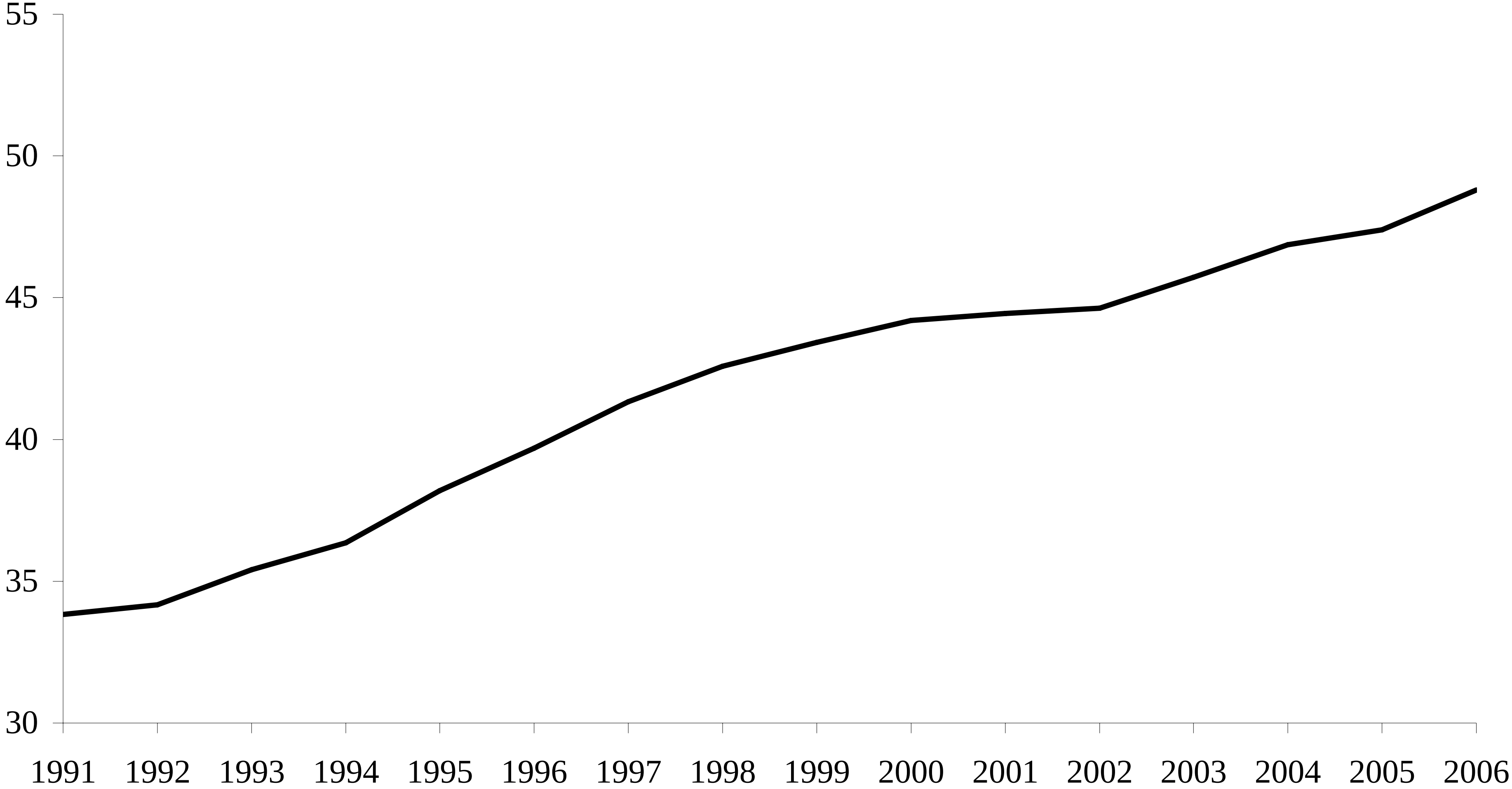
Poland's growth performance in perspective



Source: OECD.

Catching up

Real GDP per capita, in % of OECD average, purchasing-power adjusted



Source: OECD.

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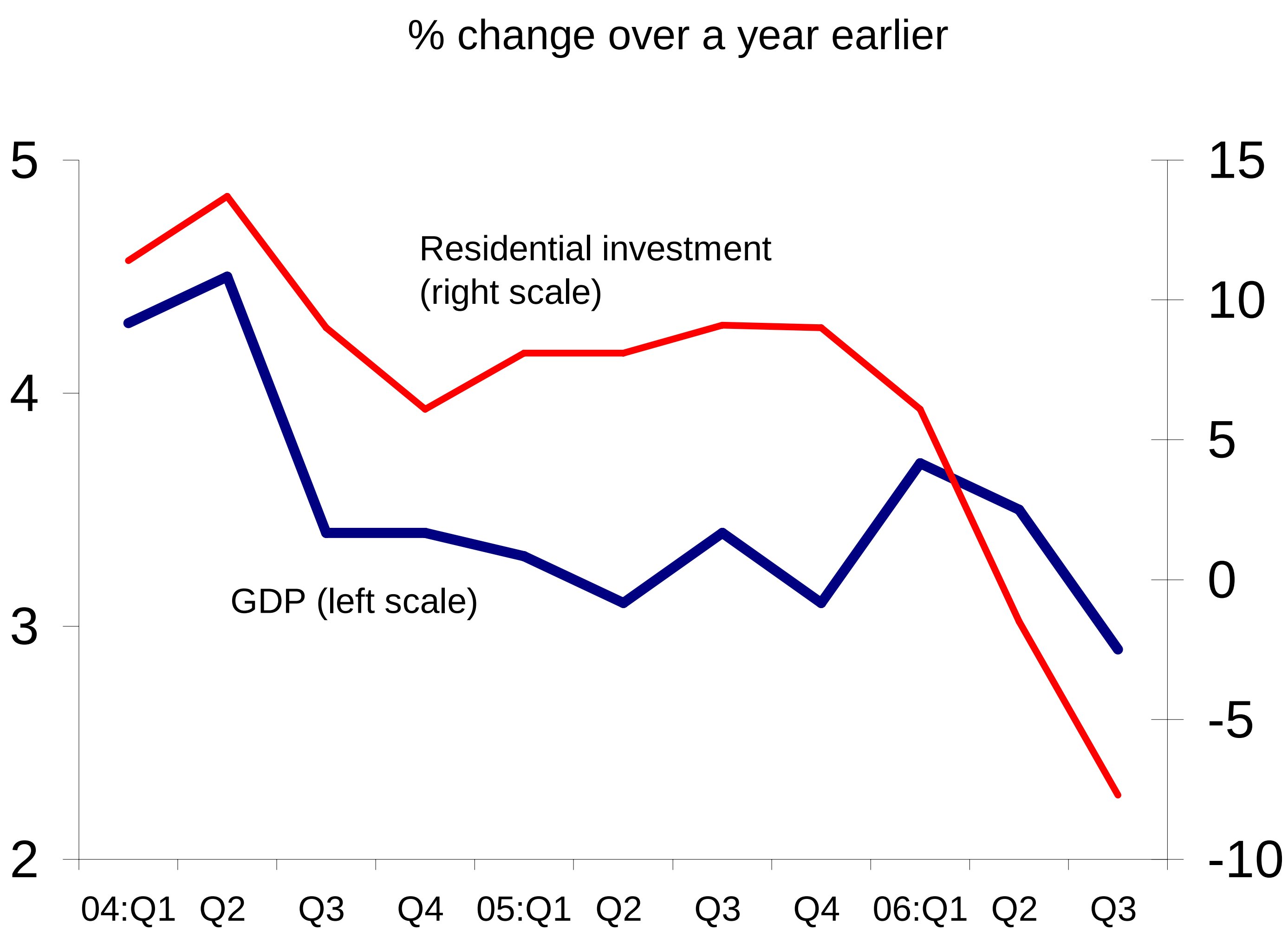
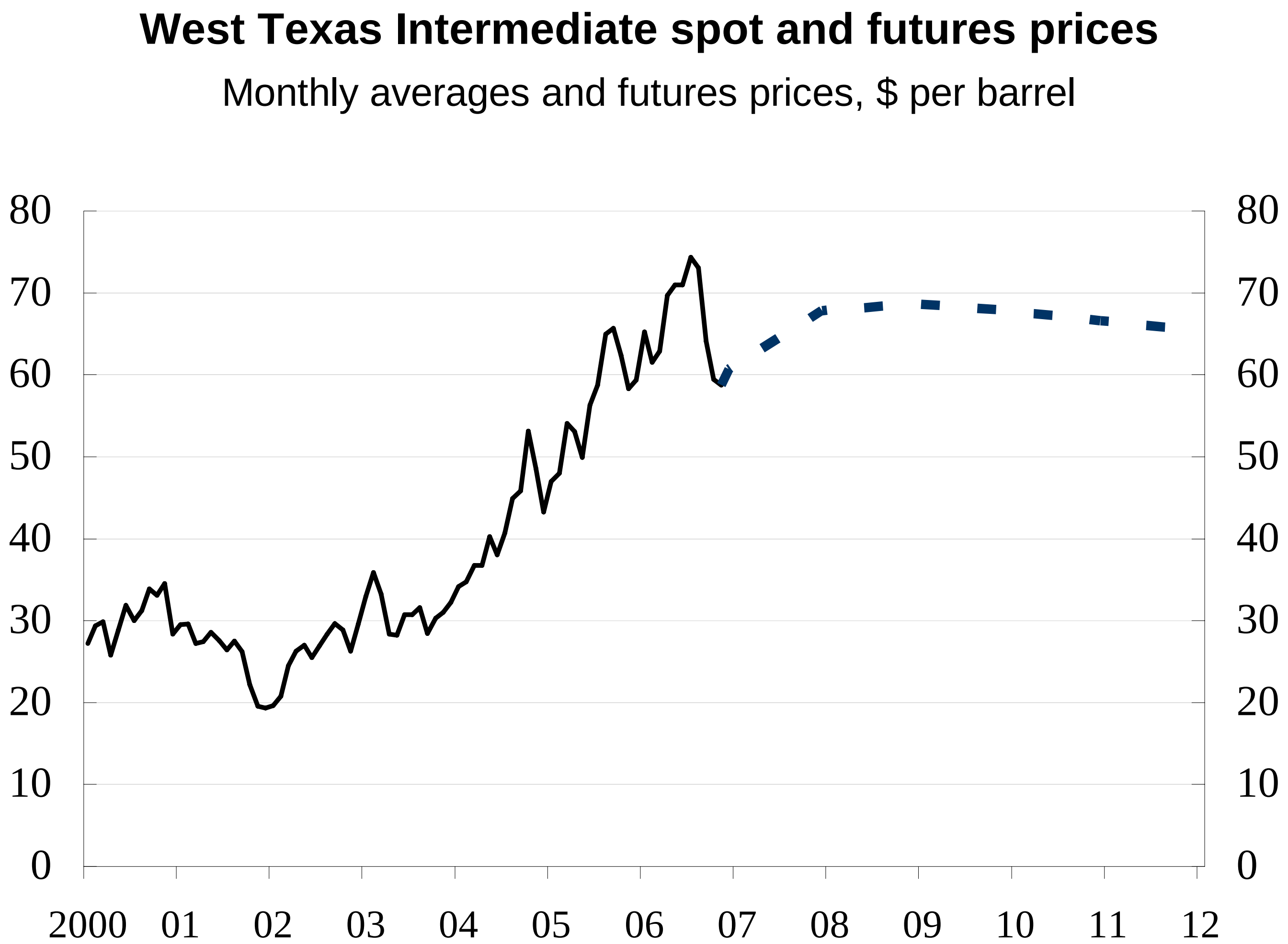
Housing is slowing the US expansion



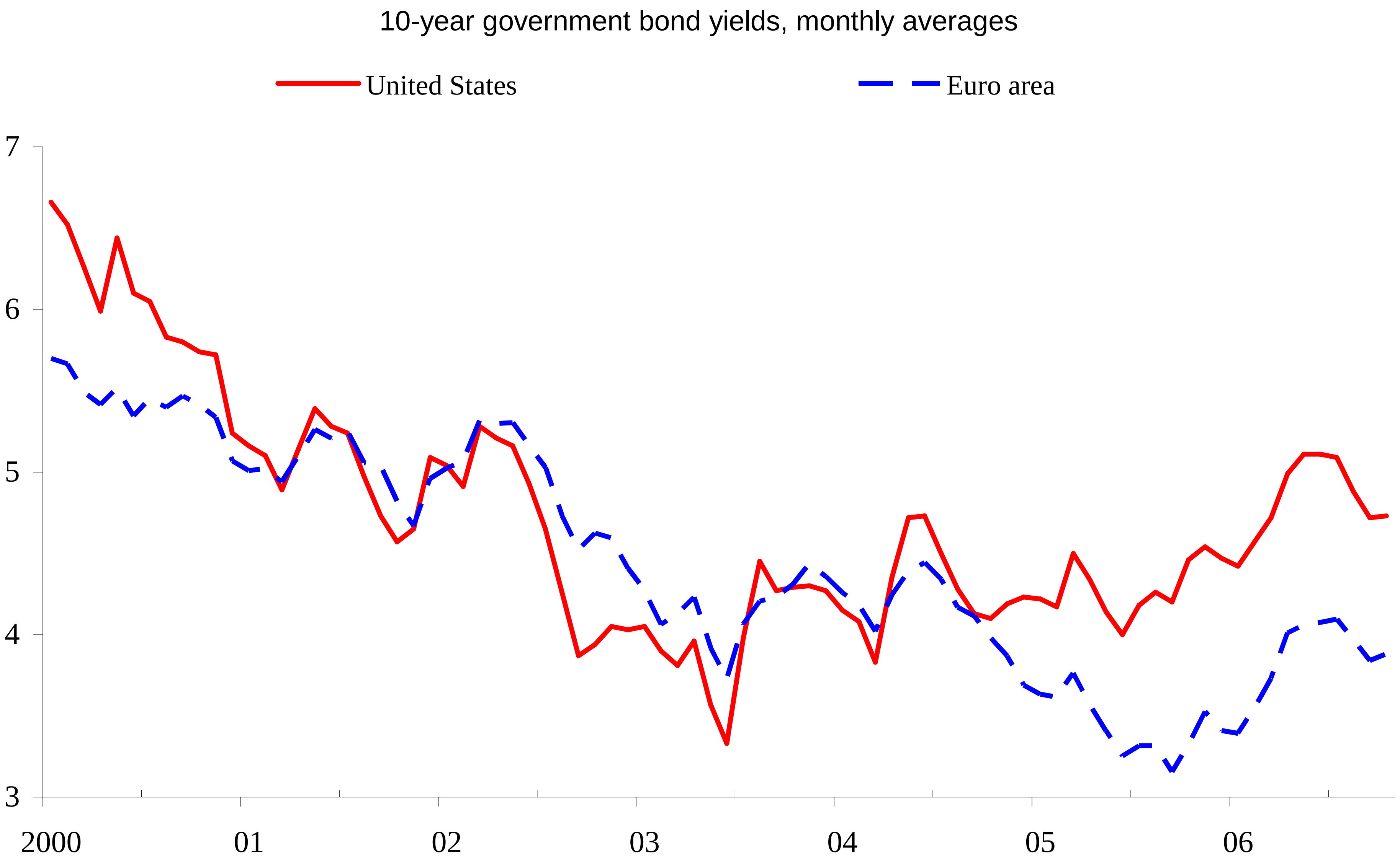
Source: OECD.

Oil prices remain high and are not expected to decline



Source: Datastream.

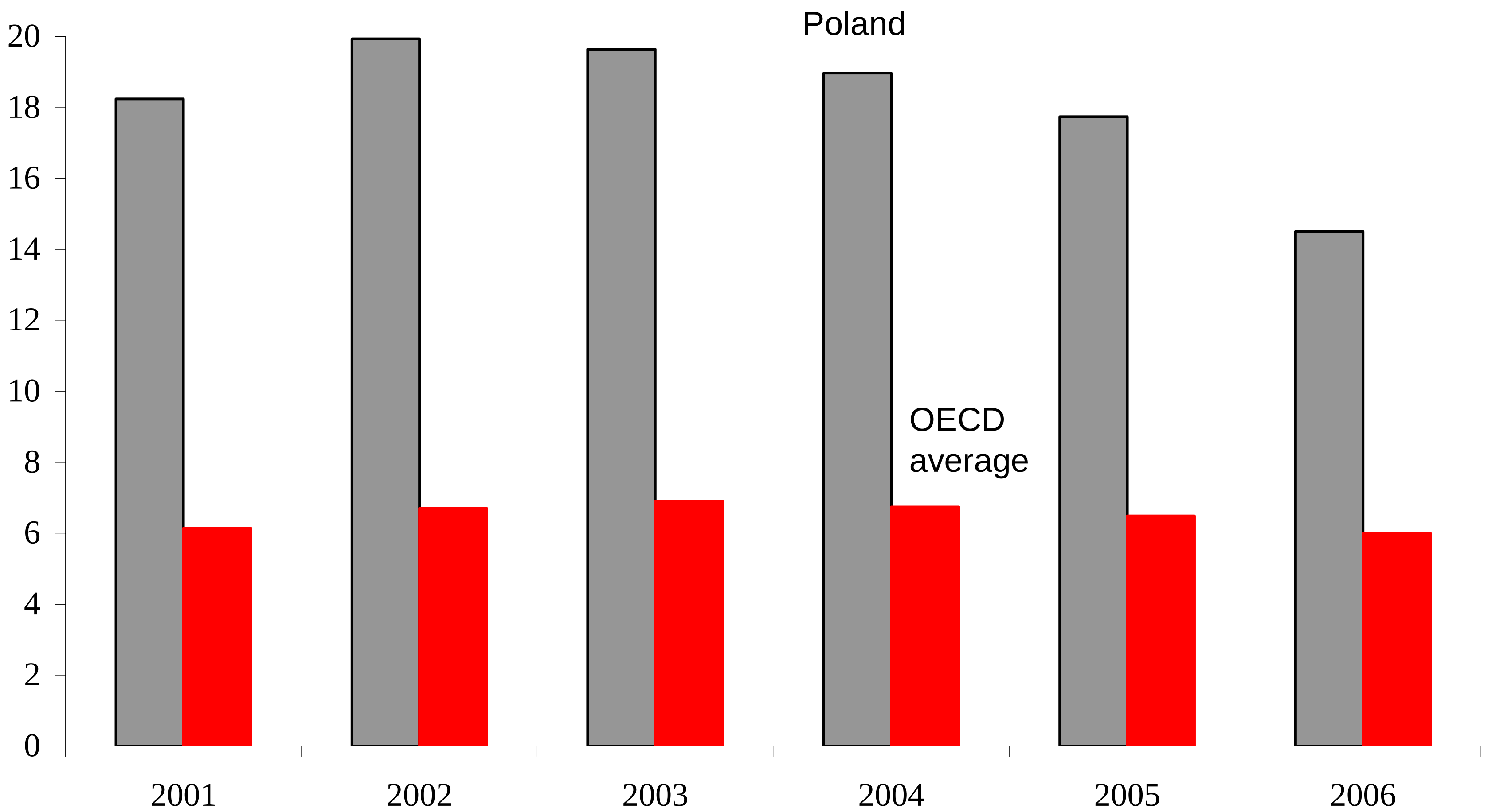
Long-term interest rates are still fairly low



Source: ECB, Federal Reserve Board.

Unemployment is retreating but remains very high

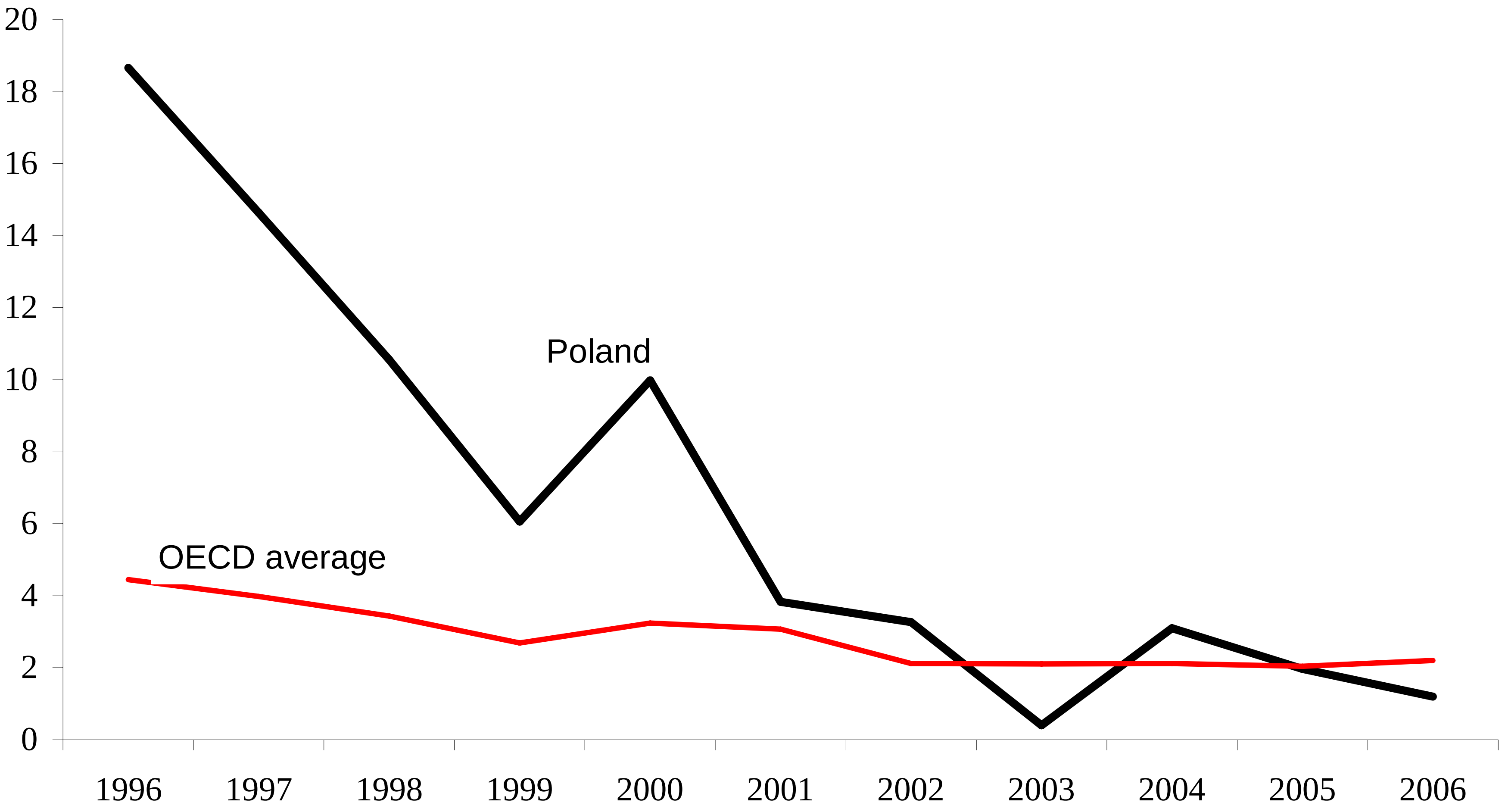
Standardised unemployment rate, in % of the labour force



Source: OECD.

Inflation is now low

Annual % change in the private consumption deflator



Source: OECD.

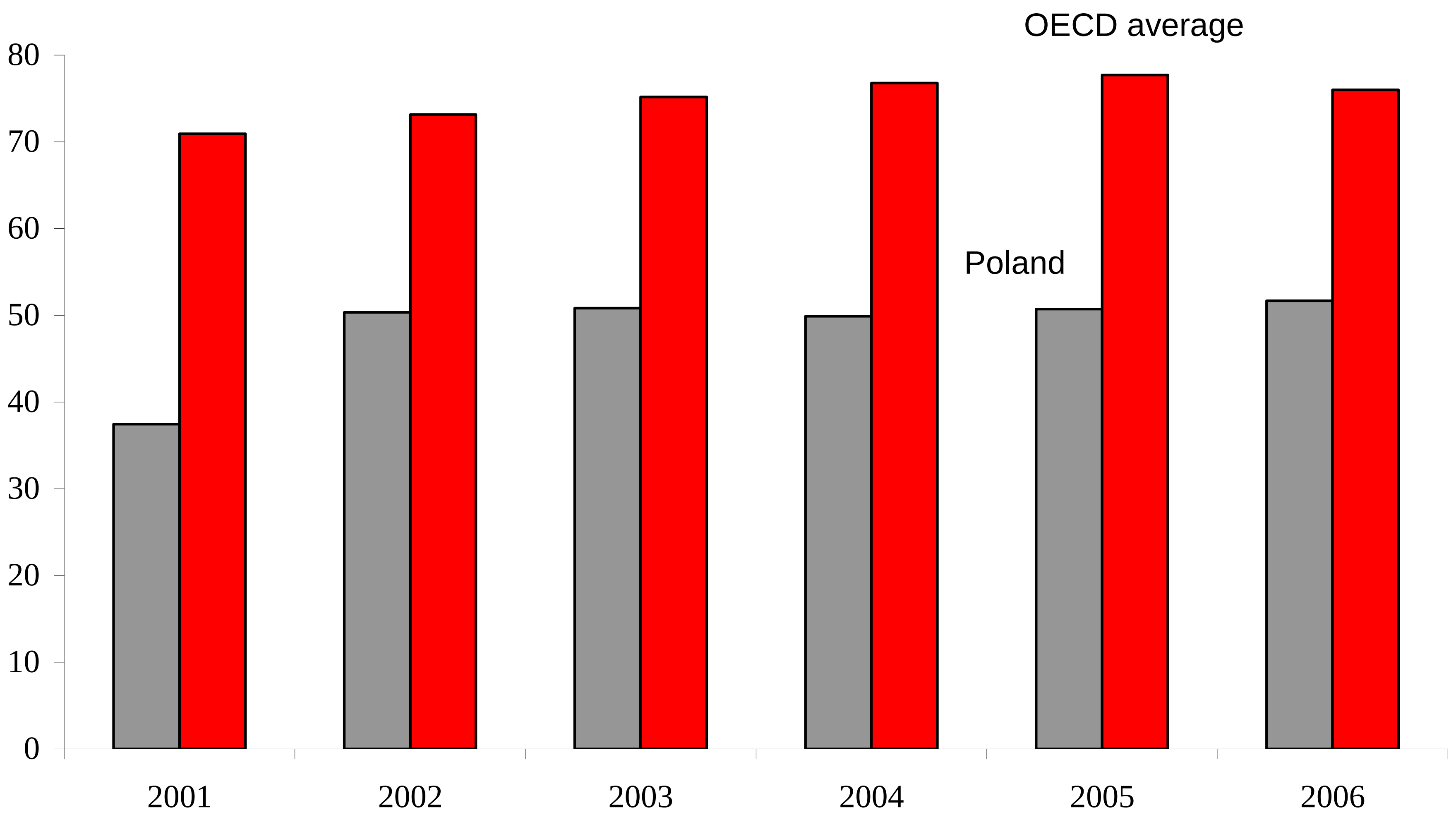
Fiscal outcomes have been better than foreseen

		2004	2005	2006
Convergence Programme (CP) May 2004	Deficit outcome/target	−5.7	−4.2	−3.3
	With pension reform costs	**−7.3**	**−5.8**	**−4.9**
CP Jan. 2006	Deficit outcome/target	−3.8	−2.9	−2.6
	With pension reform costs	**−5.6**	**−4.7**	**−4.6**
Fiscal notification Oct. 2006 and budget bill 2007	Deficit outcome/target	−3.9	−2.5	−2.1
	With pension reform costs	**−5.7**	**−4.4**	**−4.1**

Source: European Commission, 14 November 2006.

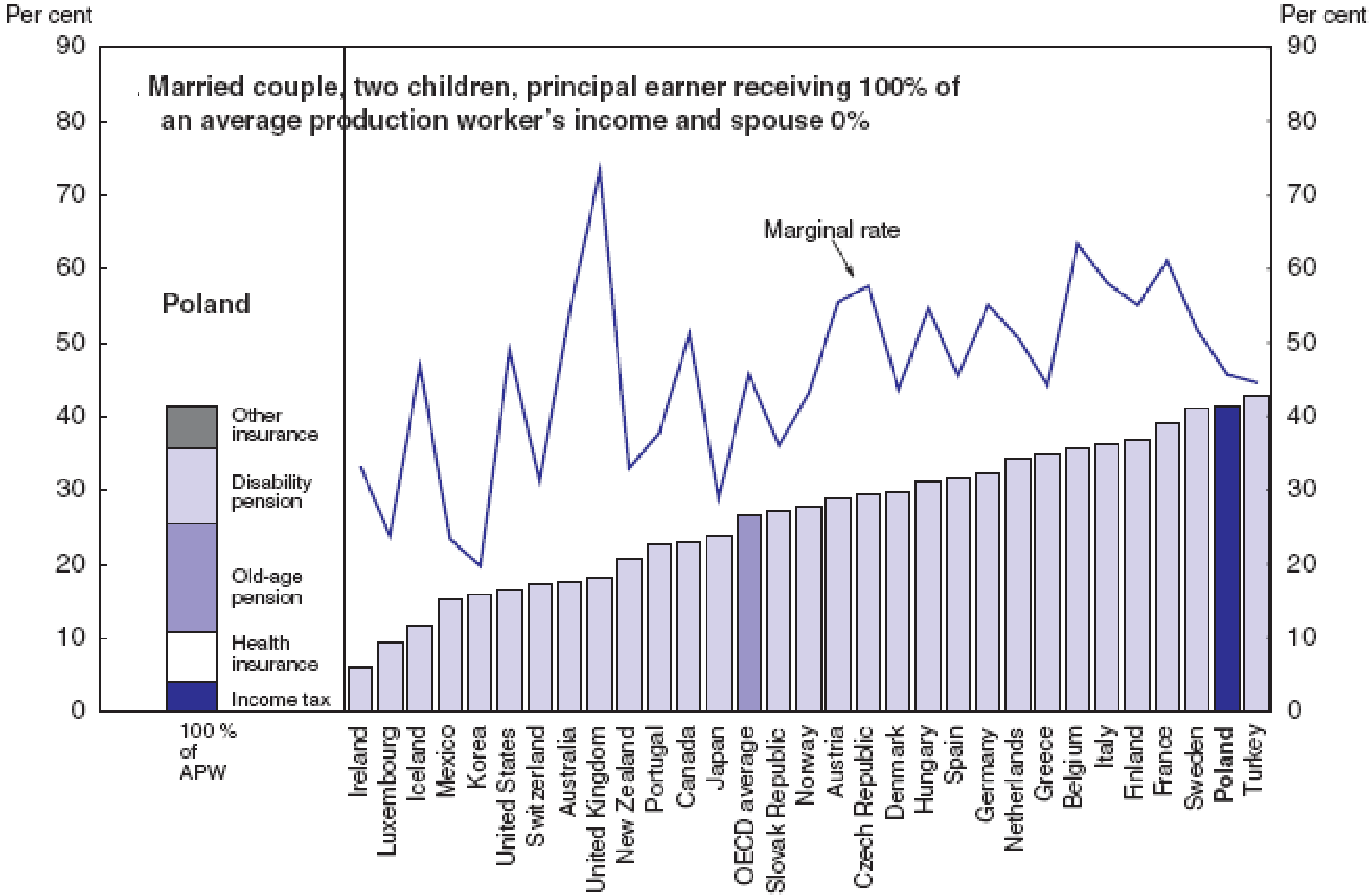
Public debt is below the OECD average but edging up

in % of GDP



Source: OECD.

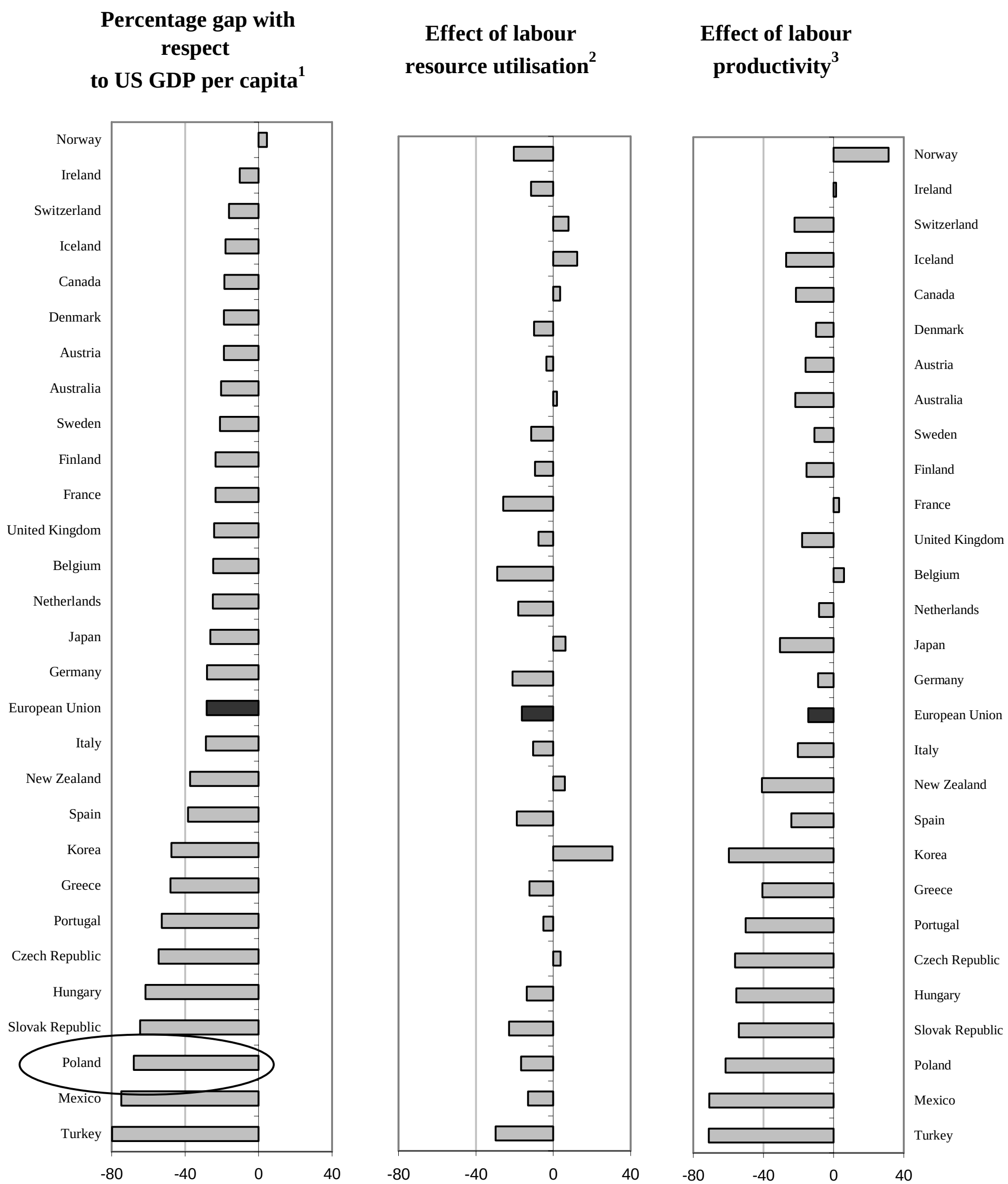
The tax wedge is among the highest in the OECD



1. The average wedge is the sum of employees' and employers' social security contributions and personal income tax as a percentage of gross labour costs, i.e. gross wages plus employers' social security contributions. The marginal tax wedge is the percentage of gross labour costs represented by increased employees' and employers' social security and income tax contributions, following a rise in net wages.

Source: OECD.

The two dimensions of the income gap

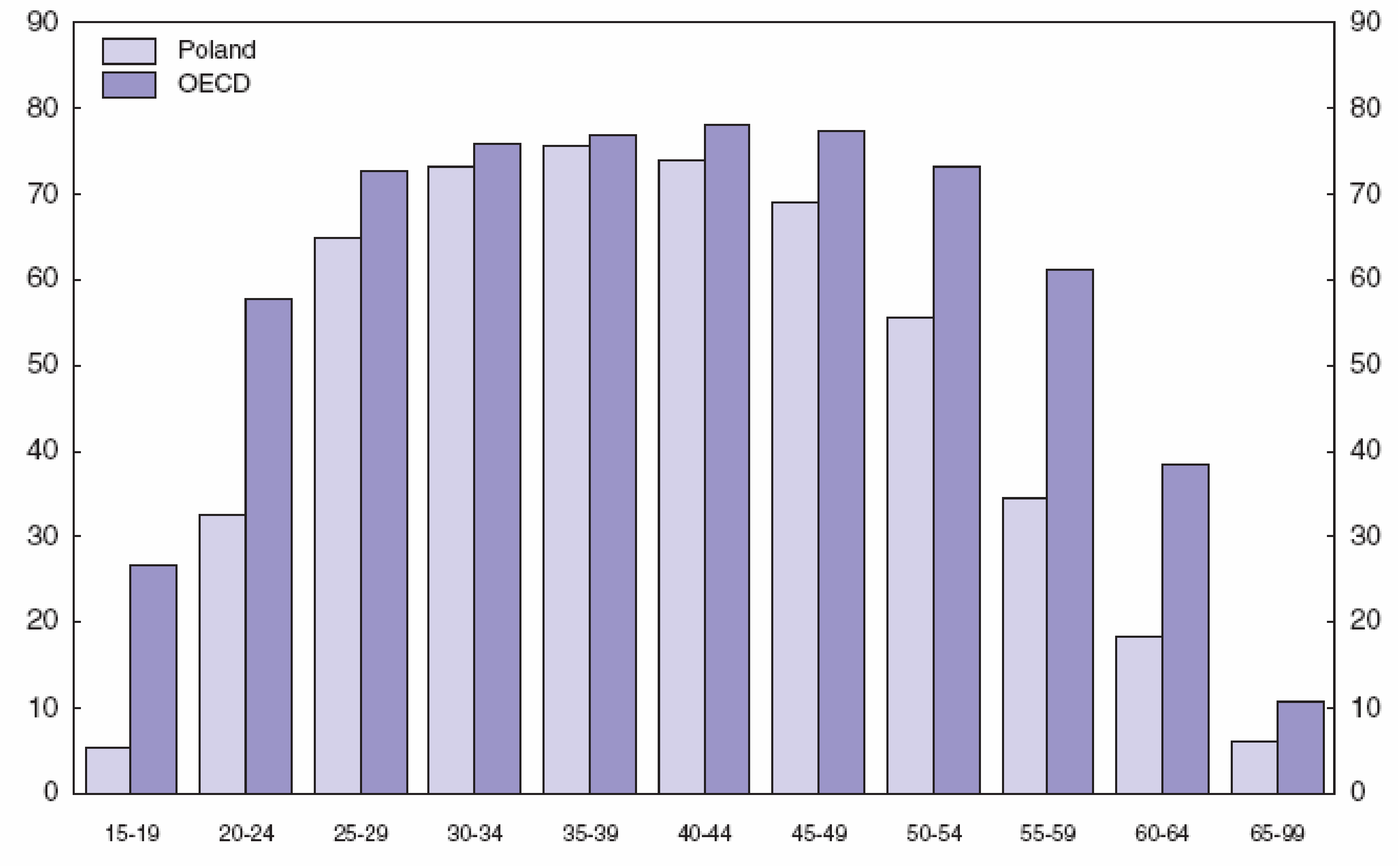


1. Based on year 2000 purchasing power parities (PPPs).
2. Labour resource utilisation is measured as total number of hours worked divided by population.
3. Labour productivity is measured as GDP per hour worked.

Source: OECD, *National Accounts of OECD Countries,* 2005; OECD *Economic Outlook,* No. 78; and OECD, *Employment Outlook,* 2005.

Employment rates are especially low for older individuals

As of 2004



For further details

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Economic Outlook

No. 80

forthcoming on

28 November 2006