

Poland and the Transition from Planned Economy to European Union Membership

Table of Contents

Part 1

1. Overview of Poland
2. Trade Composition and Direction
3. Balance of Payments and Investment Flows
4. Foreign Exchange and the Overall Balance of Payments
5. Foreign Debt and Debt Service

Part 2

1. Growth Strategy
2. Trade Policies and Protections
3. Foreign Exchange Policies
4. Privatization of State Owned Enterprises

Summary

Appendices

1. General Information
2. Recent Economic Indicators
3. Real GDP Growth

Part 1

1. Overview of Poland

Poland is one of the largest states in Central European. It has a population of over 38 million people, and a total land area of 313,000 square kilometers. This makes it by far the largest of the former Soviet-bloc states currently slated to join the European Union (EU) on May 1, 2004. In fact, Poland has over half of the total land area, population, and GDP of this slate of EU accession states. Poland's GDP for 2003 was estimated at \$207 billion USD, giving the state a per capita GDP of \$5416 USD¹. This number is particularly impressive when one considers that Poland had an estimated unemployment rate of 20% for 2003, and that a significant percentage of the Poland's population—roughly 2.6 million people—lived on small, inefficient, family-owned subsistence level farms during that same year². Moreover, Poland has maintained consistent GDP growth since 1999 without the debilitating wealth re-allocations common to many transition states; whereas many states have seen their income distribution gap (as measured by the Gini coefficient) widen dramatically, Poland has maintained a relatively even dispersal of wealth, more in line with what one might expect from the US or UK rather than a former Soviet Bloc state³. Poland has managed this relatively successful period of transition by implementing over ten years of effective economic policies designed to encourage foreign investment, liberalize monetary policy, improve productivity, and establish a competitive market economy.

Poland's economy is far from perfect however. It currently carries a substantial budget deficit due to costs associated with joining the EU, unproductive spending caused by the necessity of providing a social safety net in a nation with high unemployment, and a general reduction of its corporate tax rates to levels that are competitive with Western nations. Additionally, Poland's high unemployment rate is likely to continue to climb because of the number of workers who will be dislocated from subsistence level farming as Poland's economy becomes more integrated with Europe

¹ Australian Department of Foreign Affairs and Trade, Poland. www.dfat.gov.au.

² Rawi Abdelal and Kimberly A. Haddad, "A Wider Europe: The Challenge of EU Enlargement," Business Economics: GBBE 7251. Fordham University: 2003, p. 8-9.

³ Michael P. Keane and Eswar S. Prasad, "Poland: Inequality, Transfers, and Growth in Transition," Finance and Development, Volume 28, March 2001. www.imf.org/external/pubs/ft/fand/2001/03/keane.html.

and Poland's farmers are forced to compete with the modern and efficient farms of the West. This hidden unemployment is likely to be a significant drag on economic growth in the future. However even with these problems, Poland successfully weathered the economic downturn that struck Europe during 2001 and 2002 without a single year of negative GDP growth. As a nation it is currently on pace to grow its GDP at a rate of 4.3% annually for 2004⁴, and government projections expect even faster growth as the decade continues. This recent history compares favorably with that of almost any transition economy one might study.

2. Trade Composition and Direction

As it approaches its entry into the EU, Poland is in a strong position to develop economically through increasing exports to the nations of Western Europe. For example, in the first half of 2002, Polish exports to the countries of the EU were nearly \$13 billion USD, and since that time, they have grown as the economy in Europe has improved. Poland's exports come predominantly from six major product groups⁵: Electromechanical products, Base metals and metal products, Fabrics and textiles, Furniture, lighting and toys, Chemical industry products, and Mineral products. This trend is not surprising considering that Poland has very large reserves of coal and other metals and minerals such as copper and sulfur⁶. Additionally, as a former Soviet bloc country, Polish workers command low wages by European standards, and so a lot of labor-intensive manufacturing processes, such as those seen with furniture and textile manufacturing, have moved into Poland, and the country has developed significant exports based on this situation.

Poland's largest trading partner is its next-door neighbor Germany. In 2001, Poland exported \$12.4 billion USD worth of goods and services to Germany, and it imported \$12.06 billion. This figure represents roughly one third of both Poland's imports and exports. On a global scale, Poland exported over \$72 billion USD worth of goods and services during 2003. Poland typically targets industrialized countries for its

⁴ Australian DFAT.

⁵ Market Access Working Group, "Country Profile Fact Sheet - Poland," December 2002, p9-11. europa.eu.int.

⁶ Yahoo! Finance, Poland Country Fact Sheet, p. 1-2. <http://biz.yahoo.com/ffc/pl.html>.

exports⁷ where it has a distinct wage advantage, and it imports a number of commodities, such as oil and other raw materials, as well as many high-tech finished goods. However, its reliance on foreign technology and efficiency is gradually decreasing as foreign investment and increasing competition develop the efficiency of Poland's manufacturing processes. Light industrial manufacturing in particular has improved dramatically since 1999⁸. Poland still imports a significant amount of goods and services, but its exports have risen dramatically to cover the cost of these imports.

3. Balance of Payments

In 2003, Poland ran an overall current account deficit of \$4 billion USD. This deficit is composed of a significant shortfall in Goods (\$5.7 billion), but it is largely balanced by a net inflow from Services and Current Transfers. This is likely due to Poles living in other countries in order to perform service tasks but sending a significant portion of their earnings home, and overall services made up approximately 60% of Poland's overall GDP in 2001⁹. Moreover, Poland's current account deficit has grown smaller every year since 1999 when it was \$12.5 billion¹⁰ as Polish industry and efficiency has improved, but much of this improvement has come through foreign investment. This fact caused has caused Poland's Balance on Income to be negative – it was -\$3.1 billion USD in 2003¹¹ - because foreign companies can easily repatriate earnings from Polish subsidiaries back to their home countries.

Poland's Capital Account has gone from a net positive to a net negative since 2001 as Polish citizens and enterprises have begun to acquire foreign currency and assets. This has also served to slightly devalue Poland's currency, but in general financial asset and currency transactions do not make up a significant portion of Poland's Balance of Payments (BOP). Moreover, Poland's government is known for its reluctance to intervene in the foreign exchange markets.

Poland's Financial Account is a very significant contributor to its BOP, providing over \$8 billion USD in 2003. In general, foreign companies have invested heavily in

⁷ Market Access Working Group, P. 12-14.

⁸ Market Access Working Group, P. 12.

⁹ Market Access Working Group, P. 14.

¹⁰ National Bank of Poland, Poland: Balance of Payments, p. 1. www.nbp.pl.

¹¹ National Bank of Poland, p. 1.

Polish industry since 1995 in order to take advantage of cheap Polish labor and of Poland's close relationship to the EU countries. Once Poland becomes a full member of the EU, it will be able to export freely into the EU states, and this makes it a prime target for foreign direct investment (FDI). Companies can build factories in Poland and use them to produce goods that will be sold tariff-free throughout Europe. In 1998, Poland's financial account reached a peak level of over \$13 billion USD incoming. Over \$6 billion of this was FDI and another \$5.5 billion worth of these inflows came from portfolio investment and government borrowing. Although this investment has declined since that time as recession has gripped the EU and monetary crises have affected several of the former Soviet client states, it remains a strong force. FDI rebounded in 2002 to over \$4 billion, and in 2003 it was just over \$4.2 billion. Portfolio investments into Poland have been a smaller but still a significant source of the Financial Account as well. In 2003 Poland received over \$3.7 billion USD on portfolio investment.

Poland lost approximately \$2.7 billion to illicit and unreported activity in 2003, and this was up from 2002. This is somewhat discouraging because it indicates that Poland is likely importing illegal substances - such as narcotics - and this trade appears to be on the rise as Poles develop sophisticated tastes and the financial wherewithal to indulge them. Poles seeking to deposit money illegally overseas in order to avoid government taxes or controlled exchange rates are another potential source for this outflow, but this motive seems unlikely given that Poland has established and maintained relatively loose fiscal controls and allows its money to be exchanged easily in order to encourage foreign investment.

4. Foreign Exchange and the Overall Balance of Payments

Poland ran a slightly positive overall Balance of Payments in 2003, just under \$1.2 billion USD¹². This means that Poland's foreign currency reserves grew by that amount, and that the government did not intervene significantly in order to keep Poland's currency, the Zloty, trading within its targeted trading band. However, the fact that the country ran a balance at all means that the currency did not trade completely freely. Under those conditions, the overall Balance would have equaled zero, and the

¹² National Bank of Poland, p. 1.

difference would have come from an inflow in the Capital Account likely causing a slight rise in the value of the Zloty. This is significant because Poland maintains a “ tradition - verging on an implicit commitment - of abstaining from intervention in the foreign exchange market.”¹³ This policy is designed to deal with volatile currency market conditions and to protect the National Bank of Poland from speculation, and it is one of the main reasons why Poland was able to weather the financial crises of 1997 and 1998 without serious damage to the National Bank of Poland and without depleting its foreign currency reserves.

5. Foreign Debt and Debt Service

Throughout the 1990's, Poland held to a firm policy of tight monetary and fiscal discipline. This was relatively easy to do while Europe and the United States were experiencing rapid economic expansion that was in turn driving large investments into Poland, but by 2001, Poland could no longer support these policies¹⁴. In September of 2001, a new socialist government was elected, and since that time, the government has run large budget deficits that currently approach 6.6% of GDP¹⁵. A significant portion of this is related to Poland's coming accession to the EU, but a larger portion is due to Poland's inability to cut social spending in the face of lingering unemployment. Poland specifically has identified three “Black Hole Sectors:”¹⁶ coal mining, health care, and railway operations. These sectors add huge expenditures and therefore large contributions to the national budget deficit and overall national debt. With such large deficits having been run over an extended period of time, Poland's total debt level has risen significantly. The government of Poland owed over \$69.7 billion USD to foreign institutions¹⁷. Added to this, Polish Banks owe an additional \$11 billion USD, and Polish corporations owe at least \$48 billion in various inter- and intra-company loans from foreign corporations seeking to establish operations in Poland¹⁸.

¹³ International Monetary Fund, “Poland - Concluding Statement of the IMF Staff Mission,” Warsaw, November 20, 2003. <http://www.imf.org/external/np/ms/2003/12003.html>.

¹⁴ Yahoo! Finance, p. 2-3.

¹⁵ Kancelaria Prezesa Rady Ministrow, “Poland: 2004 Budget and Medium-Term Fiscal Reform Package,” p. 1. www.kprm.gov.pl.

¹⁶ KPRM, p. 4.

¹⁷ The Economist Intelligence Unit, “Economic Structure,” Country Briefings: Poland, p.1. www.economist.com/countries/Poland.

¹⁸ National Bank of Poland, Poland: External Debt. www.nbp.pl.

This level of debt has some adverse effects on Poland's economy and overall budget. As yet, Poland's national debt service is still manageable, but its Debt/Service Ratio has risen to 28.8%¹⁹, and its national deficit is much higher than the 3% allowed for states within the Euro Monetary Zone (EMU). While Poland will join the EU on May 1, it will not be eligible for inclusion into the EMU for some time

Part 2

1. Growth Strategy

Poland has primarily used an export development strategy to generate economic growth, but in many ways this strategy has been hampered by Poland's desire to join the EU and therefore meet the EU's accession standards. In a typical export development strategy, the growth country targets specific industries for developmental protections and then provides government investments into the target industry in order to help reduce some of the barriers to entry for its major domestic companies seeking to enter international competition. Poland does have some industries that it has tried to support and develop, such as steel manufacturing, light machine manufacturing and agriculture, but its efforts have been hampered by its inability to raise any trade barriers against EU member countries, especially with respect to agriculture. Thus Poland might successfully raise barriers to imports from the US or from Asian countries, but it cannot protect its infant industries from the fierce competition provided by German companies and subsidized farms. This is especially devastating when one considers that Germany accounts for approximately one third of all imports into Poland.

However, this very weakness is also Poland's primary source of strength. As a member of the EU, Poland will be immune to the EU's import tariffs, and therefore Poland has been very successful in attracting FDI. It has done this by amending laws to make foreign ownership of Polish companies both legal and legally equal to domestic ownership, and it has lowered Poland's corporate tax rate to 19% from 27%²⁰. Additionally, international companies that set up factories in Poland will benefit from

¹⁹ The Economist Intelligence Unit, p.1.

²⁰ Jennifer Kane, "Poland – Emerging into a New Market," [Export America](http://www.export.gov/exportamerica/MarketBrief/mb_poland_0104.html), p. 1-2.
www.export.gov/exportamerica/MarketBrief/mb_poland_0104.html.

both Poland's relatively inexpensive labor and its ability to trade unrestricted with the larger markets of Western Europe. This strategy is similar to the one that is currently being pursued by China, and it has had similar results. Like China, Poland often pursues FDI by encouraging joint venture companies with formerly state-owned enterprises²¹. Both Poland and China are currently growing their manufacturing and export capacity, and both are currently gaining large foreign investment in domestic production capacity. This has led to large foreign currency reserves for both nations as well. The export development model has served to modernize some of Poland's industries via FDI, but as with China, not all of the formerly state owned enterprises have been reformed to a point where they are competitive with Western concerns. These industries, coal mining, railroad operations, and health-care among others, continue to provide a significant drain on Poland's economy. Additionally and perhaps not coincidentally, both Poland and China have large peasant farming populations, and one of the largest economic concerns in either country is how to move this large heretofore-unreformed economic sector into the twenty-first century.

2. Trade Policies and Protections

Poland has moved gradually towards meeting the EU's collective tariffs over the past decade, and while there were still serious differences as late as 2002²², Poland is at this point essentially in line with the EU. Poland has two serious issues outstanding with the EU, but neither will prevent accession. First is agriculture, and second is labor mobility. In agriculture, Polish farmers are understandably desirous of receiving the same level of government support and protection as farmers receive throughout Western Europe. Western European farmers receive substantial governmental subsidies, and they also enjoy significant protection from overseas food imports, primarily in the form of a ban on all genetically modified organisms (GMOs) of the type common in North American food production. Polish farmers already receive the protection from genetically engineered food, but the vast majority will never receive any additional subsidies. As has been mentioned, a significant portion of Poland's population still lives on subsistence level farms, and the sheer number of these farms

²¹ Kane, p. 4-5.

²² US Department of Commerce, "Poland – Foreign Trade Barriers," 2002, p.1.

makes providing government subsidies to these farmers simply unworkable. Additionally, most of these farms are not productive enough to compete with Western farms, and the Polish government does not really want to have its population remain on them indefinitely. However at the present time, Poland has not generated enough industry to support these farmers with other work. As a consequence, unemployment in Poland has been rising since the end of the Communist era even as industry has also been expanding due to the increasing displacement occurring throughout Poland's agricultural sector.

A potentially more difficult problem with Poland's accession into the EU is the freedom of mobility that is supposed to go with entrance into the Union. Many Western labor unions rightly fear unrestricted mobility for Polish labor because they believe that many Poles will simply leave Poland to go to other parts of Europe where work is more plentiful. With an increase in the labor supply without a corresponding increase in overall product demand, this would drive wages down throughout Europe, and most Western European governments have little interest in allowing this to happen. Thus despite the EU's basic rules allowing free passage throughout Europe, many Western European countries have recently moved to restrict mobility to prevent mass waves of immigration from accession members.

As a accession member of the EU, Poland has very low trade barriers overall, and currently Poland is one of the easiest places for US companies to do business outside of North America²³. American companies exported a significant amount of goods and services to Poland in 2003. This number has grown over the past decade and will likely continue growing. In particular, Poland is in need of high-technology products dealing with computers and computer services, the defense industry, the automotive industry, and water and waste treatment. Additionally, Poland has proven to be a profitable market for foreign franchises such as US coffee and fast food chains²⁴. As with all EU countries, Poland's largest trade barriers are in the realm of agriculture. At the current time, Poland continues to support its farmers with a disproportionate amount of its resources given that this sector only generates 4% of the country's GDP,

²³Kane, p. 2.

²⁴ Kane, p. 4-5.

and it continues to have tariffs on food imports and an outright ban on genetically engineered food.

3. Foreign Exchange Policies

Poland moved its currency exchange policy to a crawling peg in 1995, and since that time the state government has shown a commitment to avoiding intervention in foreign exchange markets. This policy served Poland well in the late 1990s by serving to insulate the central bank from the currency shocks that hit Russia, the Czech Republic, and several developing countries of Asia. Currently Poland is trying to meet the requirements for joining the EMU by 2008-2009²⁵. Poland's primary obstacle is its budget deficit. The Polish government has proposed using a portion of its foreign currency reserves to pay down its international debt and therefore lower its budgetary obligations going forward. It did this in 2001 using its reserves of US dollars to pay off its debt to Brazil²⁶. This step, in addition to projected growth above 5% and reductions in state spending, will hopefully help Poland reduce its overall budget deficit to the 3% allowed by the EMU within the planned timeframe.

Once Poland joins the EMU, it will no longer have control over its own interest rates or monetary policy since it will no longer have its own unique currency, but using the Euro will greatly aid international trade throughout the EMU and likely throughout the rest of the world. The Euro is fully convertible with international currencies and is allowed to float freely, and using the Euro allows goods and services to pass freely throughout the EMU. Additionally, using the common currency allows companies operating and trading within the EMU to conduct trade without worrying about additional risks to profitability caused by changes in the various exchange rates between European countries between which goods and services flow.

4. Privatization of State Owned Enterprises

By mid-2003, Poland had largely completed privatization, having privatized over 8500 formerly state owned enterprises²⁷. It did this by selling many of its state owned

²⁵ KPRM, p. 3.

²⁶ Embassy of the Republic of Poland, "NBP must decide how to lower hard currency reserves," 2003 News Bulletins. www.polandembassy.org/News/Builetyny_news/p2003-07-09.html.

²⁷ Kane, p. 2.

businesses to foreign companies and individuals and by encouraging foreign companies to partner with domestic Polish businesses as they moved into the private sector. This succeeded in many ways, but it had some drawbacks as well. It succeeded because it did successfully lead to privatization for most businesses, and it did this in such a way that these businesses are now well run and increasingly profitable. Foreign companies operating for profit have a strong motive to increase productivity, and they also have the capital necessary to carry out reforms and modernization. However, this strategy also leads to widespread foreign ownership, and this has a serious downside. Foreign companies have the most resources to purchase their choice of enterprises, and so many of the best assets went to overseas owners. This means that future profits from these businesses will also go overseas, and that it will be very difficult for domestic Polish concerns to compete with these already powerful interests in the future. Moreover, from a nationalistic standpoint, many Poles do not like having their best assets owned by foreigners, and it is doubtful that this method was fair in any case. The people of Poland theoretically owned these formerly state owned enterprises, but it is doubtful that many of these people will gain materially from their sale or future operations. Additionally, with the best assets sold, the government of Poland is left with only the worst performers – the “Black Hole” sector mentioned earlier. This sector continues to eat Polish resources at an astounding rate while providing little benefit or possibility for reform.

Summary

In many ways, the “Black Hole” sector is a microcosm of Poland’s economic problems as it moves from a planned economy to a free market economy. As a nation Poland has made great strides towards becoming a liberal state: largely successful privatization, free monetary convertibility with little intervention into the market’s workings, and strong growth driven by FDI and exports. However, Poland has a few serious problems remaining, and these problems are typified by this one lagging sector. Poland was unable to completely privatize because no foreign investor wanted to take over Poland’s inefficient coal mining or healthcare systems, and it still has a significant agrarian population which it cannot easily integrate into the new economy. These

problems have led to systemically high unemployment and, in turn, large budget deficits and debt levels. The state has had little choice about taking on more and more of the burden of supporting an increasingly displaced workforce. In a few weeks, Poland will join the EU, and this change can only help Poland in the long run. However, the state still has some severe problems to deal with before it can reap the full benefits of free trade and full membership in Europe.

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