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Internal and External Factors of Economic Growth in Poland

Abstract

The focus of the paper is to develop and evaluate factors influencing the economic growth in Poland. The factors are divided into two major groups: external and internal factors. The paper provides the analysis of relationships between the magnitude of particular factors and the rate of economic growth in the country. It is stated that although external environment did not create favorable conditions for the economic growth, the internal factors, however, were of the most importance for the rate of economic growth in Poland. The paper ends up with some concluding remarks on the analyzed problems.

1. Introduction

The year 2001 was unfavorable for the global economy. This was due to negative economic developments in majority of the countries. The significant reduction in the rate of global GDP growth, from 4.7% to 2.6%, applied to all major countries. For example, in the United States the GDP growth was no more than 1% in 2001. The GDP in the European Union grew only 1.8%, compared to 3.4% in 2000. Central and East economies and the Baltic States slowed down in 2001, but not dramatically. Their collective GDP growth rate stood at 3.5% compared to 3.8% in the previous year.

In this context Poland's economic situation was unfavorably. Its GDP grew only 1.1% in 2001, much less than in 2000 and below the EU figures. This was a manifestation of a general trend that began earlier. In 2001, Poland lost its leadership in the region in terms of reforms, and was rated the lowest among the 10 EU candidates in Central Europe. This means a widening gap in relation to the EU and may become a factor hampering integration process.

2. Macroeconomic performance

After nine years of economic growth, Poland found itself on the brink of recession in 2001. Some sectors (including industry and construction) experienced a reduction of output for at least two quarters. In 2001, GDP growth amounted to 1.1%, compared to 4.1% in 1999 and 4% in 2000. It was also below the level targeted in the budget law (5.1%). While in the first three months of 2001 the growth rate accounted for 2.3%, in the next three quarters it dropped to 0.9%, 0.8% and 0.3% respectively. Poland's 2001 GDP approached 176 billion USD, translating into 4570 USD per capita, up from 4100 USD in 2000.

Poland was the first transition country that regained (in 1996) and exceeded its pre-transformation GDP level. In 2001, the growth surplus amounted to 28%, implying that – despite a slowdown in 2001 – the Polish economy was the fastest-growing among all transition countries in the 1990–2001 period.

Personal consumption rose 2.1%, compared to 2.6% in 2000 and 5.2% in 1999. This slowdown resulted from two factors: stagnation of real disposable incomes and adverse impact of monetary constraint on the availability and cost of consumer credit.

Gross fixed investment decreased in real terms by 10.2%. This was mostly due to shrinking investment demand in the Polish corporate sector. Four major factors seem to be responsible for this trend. The first was the poor financial standing of both public and private firms. The second factor was the monetary restraint imposed by the Monetary Policy Council (RPP) and the resulting excessive cost of corporate borrowing. Thirdly, the slump in private investment can be partly explained by the crowding out of private capital by public expenditures. Finally, a year 2001 also witnesses considerable deterioration in the business climate.

Basic macroeconomic indicators in Poland 1995–2001 (% growth rates)

	1995	1996	1997	1998	1999	2000	2001
Real GDP • Previous year =100 • 1989 = 100	 7.0 98.5	 6.0 104.5	 6.8 111.6	 4.8 117.0	 4.1 121.9	 4.0 126.8	 1.1 128.2
Personal consumption	3.3	8.3	6.9	4.8	5.2	2.6	2.1
Gross fixed investment	16.9	19.7	21.7	14.2	6.8	2.7	-10.2
Government spending	2.9	3.4	3.2	1.6	1.0	0.8	-4.0
Exports	16.7	9.7	13.7	9.4	2.0	15.3	14.0
Imports	20.5	28.0	22.0	14.6	4.4	7.4	3.6
Industry • production sold • value added	 9.7 10.4	 8.3 7.6	 11.5 10.3	 3.5 4.3	 4.8 3.0	 6.8 6.5	 -0.2 -0.6
FDI inflow (US bn)	1.1	2.8	3.1	5.9	6.3	8.2	6.5
Budget deficit (% GDP)	-2.7	-2.5	-2.6	-2.4	-2.0	-2.2	-4.4
CPI inflation (Dec./Dec., %)	21.6	18.5	13.2	8.6	9.8	8.5	3.6
Unemployment rate (%)	14.9	13.6	10.3	10.4	13.1	15.1	17.4

Source: Poland – International Economic Report, Warsaw School of Economics, Warsaw 2002.

The Polish economy in 2001 experienced a trade-off between the slowdown of economic growth and some improvement in its macroeconomic equilibrium. First of all, in 2001 there was an improvement in the external balance. Exports expanded by 14% in constant domestic prices, while imports rose by 3.6%. Export expansion in 2001 occurred despite the drop of foreign demand caused by economic slowdown in most Western economies, including Poland's key trading partners. The fastest growth of Polish exports was recorded towards Eastern and Central European countries, while trade with the EU significantly slowed down. Surprisingly enough, Poland's exports did not suffer from the real appreciation of the zloty that took place both towards the dollar and all major European currencies.

Industry was a major sector that was hit by recession. Its output shrank in 2001 by 0.2% (production sold) and 0.6% (value added) respectively. This industrial performance unfavorably compares with the previous period: in 1998–2000 industrial output (value added) expanded by 4.3%, 3.0% and 6.5% respectively.

One of the most spectacular events in the global economy in 2001 was the Argentinean crisis. The direct repercussions for Poland were rather marginal due to weak economic ties between the two countries. However, its indirect consequences may be more important. Investors treat all emerging markets as a kind of a monolith and withdraw themselves from them even if a crisis appears only one market. Lower inflow of FDI to Poland in 2001 proves to such a behavior (see Table). A second lesson for Poland from the Argentinean crisis is that it confirms the need to follow a sensible macroeconomic policy, especially as both countries have similar problems. In both countries, economic policy was subordinated to anti-inflationary target and in both Poland and Argentina, recession contributed to a deteriorated condition of public finance.

There are some internal factors determining the macroeconomic condition of the country. They can be generally named as the stabilization policy and include a mix of fiscal and monetary policy. In 2001 the policy-makers assumed that the desired stabilization policy should include a tightened fiscal policy accompanied by a more relaxed monetary policy.

The fiscal policy was to remain essentially unchanged, compared to the previous few years. It was directed toward short-term, mostly redistributive objectives. Many economists consider that the state budget spends too much money for social goals and that these expenditures should be radically cut. The problem is, however, that the society got used to this source of incomes and it would not accept any cuts. Policy-makers realize that there exists clearly visible social barrier against the rationalisation of public finance. What is more, the government failed to simplify the tax code and make it more business-friendly. The only exception was a cut, from 30% to 28%, in the corporate income tax. However, its potential positive impact on the corporate sector was offset by a parallel rise of VAT. This means that one of the weaknesses of fiscal policy was its emphasis on redistributive goals rather than on fostering self-sustained long-term growth. In 2001, as for most of the 1990s, fiscal policy makers failed to create positive conditions for business, such as increased support for domestic R&D, human capital and physical capital infrastructure. This tendency finds its expression in reduction of pro-development expenditures, namely for R&D and education (in 2001 R&D expenditures were cut by 20%). This in turn negatively affects the long-term perspectives of development.

The implementation of fiscal policy in 2001 caused unprecedented problems. The budget law had to be amended. This brought about a widening of the budget deficit from 2.7% of GDP to 4.5%. This was mainly due to:

However, at the same time the inflow of FDI to Poland was again the largest in the region and amounted to 6.5 bn USD.

One of the key dimensions of the internal equilibrium involves the fiscal stance of the government. In July 2001, a threat of financial crisis unexpectedly emerged. The budget law had to be amended twice. As a result the budget deficit widened from the target level of 2.7% of GDP to 4.5% of GDP.

2001 was a success story in the long-lasting battle to stifle inflation. The point-to-point CPI inflation decreased to a record low 3.6%. Due to fast disinflation, in 2001 Poland ranked among the best-performing transition economies in this area.

The most worrisome situation took place on the labor market. The slowdown of economic growth, in addition to the reduced growth in global trade, resulted in growing unemployment. At the end of 2001, the number of the unemployed rose to 3,115,000. The unemployment rate went up from 15.1% to 17.4%. Unemployment has become the chief economic, social, and political problem in Poland.

3. Factors of economic growth in Poland

There are some factors responsible for the economic performance of the country. Factors influencing the rate of economic growth in Poland may be divided into two groups: external and internal factors.

One of the external factors hampering the economic growth in Poland were conditions in the international environment in 2001 that were less favorable for the Polish economy than in previous years. Leading industrialized countries including the United States and Poland's key economic partners in the European Union experienced a substantial slowdown. Additionally, Poland suffered from significant negative external supply shocks (the prices of oil and other basic raw materials increased considerably in international markets).

Some economists state that the Russian crisis, or, to be more precise, Far East crisis also slowed down the economic growth in Poland. In fact, exports to Russia dropped, but on the other hand trade with Russia was not of much importance in the Polish trade balance. Moreover, Russia, having problems with selling its oil and gas in the Far East, had to decrease its prices, which positively affected also the Polish economy.

- reluctance of the previous government to implement a deep reform of public finance;
- a shortsighted behaviour of the previous government and the Parliament. In the face of upcoming parliamentary elections, the Parliament passed a dozen of new bills, which caused a dramatic increase in public expenditures (mostly redistributive in nature), not matched by a parallel rise in budget revenues;
- a tendency to maximise the politicians' personal gains at the expense of efficiency goals;
- unexpected recessionary trends in Poland that reduced the expected level of budget revenues;
- poor financial performance of the entire state-owned enterprises sector, translating into an effective loosening of the hard budget constraint, both directly (lower tax revenues from state-owned firms) and indirectly, due to budget subsidies to inefficient firms.

In strictly macroeconomic terms, the lack of fiscal discipline can be partly blamed for the excessive level of both nominal and real interest rates in Poland in 2001. The unplanned softening of the hard budget constraint led to a situation in which monetary policy makers tighten their policy. The combination of an expansionary fiscal policy and a restrictive monetary policy tended to discourage private investment and adversely affected long-term growth.

For 2001, the Monetary Policy Council (RPP) set the inflation target at 6–8%, at a higher level than in 2000. This was because the RPP expected continued inflationary pressure and was afraid that it might overshoot its target again (as it happened twice before). At the same time the RPP stressed that such a target resulted from supply factors beyond its control and was burdened with a high level of uncertainty. Setting the target for 2001, the RPP failed to predict that conditions in the economy would be considerably different from the predictions. The RPP assumed that GDP would grow about 5%, with the current-account deficit at approximately 7% of GDP and public finance sector deficit at 1.6% of GDP. In these conditions, the RPP was concerned that inflationary pressure would continue to be strong in 2001, which called for keeping or even stepping up the restrictive monetary policy.

The implementation of monetary policy in 2001 was determined by factors connected with overall economic trends. They were the following:

- slow GDP growth;
- a significant rise in unemployment;
- a major drop in the current-account deficit;
- the appearance of a hole in the national budget;
- a strong zloty.

It is not easy to determine to what extent these developments were provoked by earlier macroeconomic (and monetary) policy, and to what extent resulted from external shocks. However, it seems that the strong deterioration in economic trends in Poland in 2001 was largely due to a more restrictive monetary policy in 2000. This policy proved effective in reducing demand, probably far more effective than the RPP expected. Despite the strong zloty, lower demand contributed to a reduction in the current-account deficit.

In the first several months of 2001, a growing number of experts and politicians began to warn against the risk of recession unless interest rates were reduced fast and markedly. Critics also blamed high interest rates for the influx of capital, leading to the appreciation of the zloty and threatening the competitiveness of Polish business, due to lower exports and higher imports. As usual, the RPP responded with its argument that first the government should limit the budget deficit as a precondition for a looser monetary policy.

In order to avoid overshooting the target for the third time, the RPP made monetary policy more restrictive. The result was a major undershooting of the target this time. Inflation at the end of the year reached 3.7%. Real interest rates reached 10% and were more than 2 percentage points higher than in 2000. At the same time the zloty appreciated 8% in real terms and was the strongest since 1992.

In response to the rapidly falling rate of inflation and clearly narrowing current-account deficit, the RPP started to cut interest rates. Over the year, the RPP made six cuts, as a result of which interest rates were reduced by a total of 7.5 percentage points. However, according to most Polish observers and international organizations (IMF, EU and OECD) these reductions came too late to soften a deterioration of the economic growth rate in Poland.

High interest rates were one of the reasons for low investment activity in the economy. In order to gain high rate of economic growth, the real rate of investment growth should be higher than the rate of GDP growth. However, in 2001 gross investments declined by over than 10%. Apart from high interest rates, this resulted mainly from poor financial standing of many Polish firms, as well as from drop in investors' trust for development perspectives in the economy (due to huge budget deficit). Therefore suitable conditions for investments have to be created: low inflation, low interest rates, reduction in taxes, investment reliefs, accelerated depreciation of fixed assets and improvements in infrastructure (transportation, highways, telecommunication, etc.). The problem is that both the state budget and the economic agents suffer from lack of financial sources. In such a situation stimulation of investments should be based on fulfilling other criteria: stabilization of economic policy and improvement in public administration activities (clear criteria of taking decisions, elimination of corruption, etc.)

Successful implementation of investment processes needs also adequate level of domestic savings. To avoid expansion of current-account deficit, increase in investments should be based on adequate growth in domestic savings. However, since the beginning of the nineties the rate of savings in Poland has been rather stable and has amounted to 25–26% of GDP. Any trials to increase this level have failed. This means that Poland will have to accept lower rate of investments growth (negatively affecting the GDP growth) or higher current-account deficit. The second possibility can not be accepted, so Poland will have to attract foreign capital, especially transfers from the European Union. However, Poland has to collect its own financial sources in order to absorb the EU funds and this may be very problematic (supplementary sources will have to reach a sum of 10 bn euro).

One of the weaknesses of the Polish economy is insufficient restructuring of the industry chiefly due to lack of capital, especially for restructuring of the so called "problem sectors', such as coal mining, metallurgy, textile industry, shipbuilding, power processing sector, parts of chemistry sector, etc. These sectors need huge financial sources and there is lack of investors interested in them.

4. Concluding remarks

The comparison of Poland's situation with that of the global economy points to an essential change from previous years. Previously, the weaknesses of the Polish economy included high inflation and high current-account deficit. Strengths included a high rate of growth, decreasing unemployment and a relatively stable situation in public finance. In 2001, Poland joined the group of countries with low inflation and a safe current-account deficit. However, this occurred at the expense of slower economic growth and increased unemployment, accompanied by a high budget deficit.

The Polish economy has created a background for implementation of the market economy conditions' relatively early. Since the years 1994/95 it has been undergoing the business cycle characteristic for the market economy, so the policy-makers can use typical stabilization instruments in order to stifle excessive fluctuations. At the moment the economy finds itself in a period of recession.

Overall, the international environment did not create a favorable climate for economic growth in Poland in 2001. This was both due to extraordinary events, and, primarily, the low rate of global GDP growth and global trade.

However, internal factors were of the most importance for the rate of economic growth in Poland. Policy-makers paid too little attention to the long-term development interventionism (R&R, education, creation of infrastructure). Additionally, restructuring processes were slowed down. This referred chiefly to large state-owned and privatized enterprises and to the so called "problem sectors". Situation in agriculture was especially difficult.

There was still lack of cohesive short-term macroeconomic policy. Fiscal policy was excessively relax (too high social expenditures, high budget deficit, weakness of instruments stimulating the economic growth). All this caused excessive tightening of the monetary policy. Monetary policy-makers, being afraid of the inflationary pressure, tried to keep interest rates high. This in turn provoked appreciation of the zloty and drop in exports and growth in imports.

Weakness of both the long-term development policy and the short-term macroeconomic policy together with insufficient restructuring may cause that the Polish economy will not be able to reach a 5–6% self-sustained long-term growth rate and will be more exposed to fluctuations of growth compared to most of European economies.

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