Analysis of Poland’s Macroeconomic Indicators and Suggested Policy Recommendations

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I. Introduction
The first country in Central Eastern Europe to undergo radical market-oriented reforms, Poland also was the first to witness positive results from its new economic policies. Poland entered the transformation process in 1989, sharing all the characteristics of a centrally planned economy; lack of the institutional infrastructure of a market economy, with a poor banking system and no capital markets; domination of state property; and a low level of international trade. Its program of economic transformation in 1989 consisted of three elements:

1) The macroeconomic stabilization plan referred as the “big bang”, or “shock treatment”, aimed at restoring the budget and keeping down inflation;
2) Institutional reform aimed at the privatization of the economy and building a modern capital market;
3) The microeconomic liberalization or “deregulation” aimed at eliminating the price controls and restrictions on foreign trade.

Poland experienced an immediate backlash to the implementation of the new policies. In 1990 and 1991, GDP dropped by large amounts, while inflation and unemployment soared to all-time highs. GDP began to rebound in 1992, however, and the economic situation in Poland steadily improved over the next decade. Poland is now one of the fastest growing post-socialist countries of Central and Eastern Europe along with Hungary. Poland has served as a leader in the political and economic transition of the region. Poland joined OECD in 1996 and NATO in 1999, and began to negotiate entry to the European Union in 1998, with aims to be ready for entry by the end of 2002. For Poland, the challenges of transition and EU accession are similar. There is still work to be done in infrastructure and in the privatization of inefficient state owned companies. The Polish economy, despite several problems and unresolved issues, is considered to be an example of a successful transition from the central planned economy to a market economy.

This paper analyzes the current macroeconomic situation in Poland and recommends policies anticipated to be effective in continuing successful growth, while avoiding potential economic downturns.

II. Macroeconomic Policy in Poland
Monetary policy has taken center stage in Poland’s successful transition over the past decade to a market economy. As previously discussed, Poland experienced substantial growth relative to other post-socialist countries of Central and Eastern Europe. Real GDP in Poland steadily increased throughout the 1990’s by an average rate of 5.5 percent per year. However, Poland found itself contending with some negative repercussions of its 1989 economic transformation, including extremely high inflation and unemployment. As a result, Poland’s central bank, the Monetary Policy Council (RPP), has played a much more prominent role in its macroeconomic strategy over the past decade than has the Polish government.

The primary focus of Poland’s RPP has been to reduce inflation. Through a tightening of the money supply, particularly in the last three years, Poland has experienced a steady decline in inflation throughout the 1990’s, from as high as 35 percent in 1993 to a record low of 5.5 percent in mid-1999. Determined to keep inflation at a manageable level, the RPP has set a short-term goal of 6.8 percent for the year 2000 and a mid-term goal of less than 4 percent by 2004. However, the RPP’s

1 International Monetary Fund, “IMF Concludes Article IV Consultation with Poland”, March 31, 2000.
policy of fighting inflation “at any cost” has come under much scrutiny recently because of its potentially harmful effects on Poland’s economy.

In an attempt to offset the restrictive monetary policy and maintain growth in output, the Polish government increased its spending over this same time period. Fiscal expansion was marked by a strong increase in public sector wages, pensions and social benefits, as well as financial support to loss-making sectors. Consequently, the country’s budget deficit has increased from 3.1 percent of GDP in 1995 to nearly 4 percent in 1999.

Due to the tightening of the money supply, and the consequent increase in government spending, interest rates remain relatively high, although there has been a slight decline over the past several years. High interest rates have led to an inflow of capital and an appreciation of the Polish currency, the zloty. With Polish goods becoming more expensive, its exports have dramatically declined. The result has been an increase in Poland’s current account deficit to $6,901 million, or 7.6 percent of GDP, a level far exceeding the commonly accepted safety level of 5 to 6 percent. Poland’s exports have further been hindered by the Russian crisis and the stalled economies of the European Union (EU) countries.

At the same time Poland’s current account deficit is reaching dangerous levels, its capital account, which should be large enough to offset the deficit, is at its lowest point in years. This decline may be attributed to foreigners’ lack of confidence in the Polish economy due, in large part, to the overvaluation of the zloty, as well as the government’s budget deficit. With the current account deficit at an all-time high, and the capital account at an all-time low, Poland may inadvertently be setting the stage for a financial crisis similar to the one experienced by Mexico in the mid-1990s.

Like Poland, Mexico’s economy in the early 1990’s was growing, inflation had been shrinking, foreign investment was increasing, and the central bank reported billions of dollars in reserves. Additionally, with the proposal to eliminate trade barriers between the U.S. under NAFTA, forecasters predicted a positive economic outlook for Mexico’s future. However, also similar to Poland’s current situation, Mexico’s current account deficit grew during this time, from 2.8 percent of GDP in 1989 to an average of more than 7 percent from 1992 to 1994. While the Mexican government felt the growth in the current account deficit was a positive reflection of current policy reforms stimulating capital inflow into the country, experts were concerned with the overvaluation of the peso. Despite growing reserves, Mexican goods were relatively more expensive than U.S. goods, encouraging residents to buy more imported goods which, consequently, discouraged exports due to the rising real exchange rate. Mexico operated under a system of a crawling peg exchange rate against the dollar within a narrowly defined crawling peg band. Similarly, Poland operates on a crawling peg exchange rate against the dollar and the Euro. Although the zloty has recently been relaxed from its peg, it is still defined within band of Κ= +/-12.5.

The Mexican economy crashed in December of 1994 due, among other things, to a sudden devaluation of the peso. The result was a financial crisis that sent the Mexican economy into a recession. While there are a number of additional factors that played an important role in Mexico’s economic meltdown and ensuing financial crisis, there are lessons Poland can learn from the past. Poland, too, is facing an appreciation of its currency, “catastrophic” levels of exports due to an

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appreciated real exchange rate, and a lack of awareness on the part of some of its government officials as to the severity of the problem. Poland is primed to repeat what happened in Mexico if it does not take immediate steps to correct these potential problems.

While there are a number of economic factors which could be addressed to improve Poland’s current situation, the most critical of these is reducing the current account deficit. Poland faces two immediate dangers by running a current account deficit of its size. First, Poland is next in line to join the EU in 2002. Prior to its accession, Poland must meet the Maastricht Criteria, which includes deficit ceilings on the current and capital accounts. Too large of a current account deficit may delay Poland’s joining the EU. The second danger is the possibility that the zloty will experience a sudden depreciation, causing tremendous capital flight. Poland already has seen some capital flow out of the country, signaling that investors are becoming wary of the zloty’s overvaluation, and this effect could be magnified if Poland were to encounter some unexpected circumstances, i.e. shocks. While, interestingly, some polish officials disagree with this assessment based on the fact that the current account presently is being financed by foreign direct investment, their optimism may be unwarranted. In light of the current slowing of foreign investment and the free flow of capital mobility in today’s global markets, it would be imprudent for Poland to rely on continued high levels of foreign investment to offset its current account deficit.

III. Recommended Policy

It is recommended that Poland take a conservative course of action utilizing both monetary and fiscal policy to reduce the current account deficit by increasing net exports and increasing the capital account through domestic investments. It is important for the RPP to maintain a restrictive monetary policy aimed at getting inflation to its target rate. Such a policy will help keep inflation expectations low, which, in turn, will assist in the effort to reach the target. However, critical to the overall strategy of reducing the current account deficit is a tightening of fiscal policy aimed at lowering interest rates, depreciating the zloty and balancing the budget. The RPP is well aware of the detrimental economic impact of having only been employing a limited macroeconomic strategy over the past several years, “[These side effects] are the costs we have to pay for trying to meet the inflation target figure.” This strategy was shortsighted. The cost has become too great and it is time for the Polish government to take action.

A reduction in government expenditures must play a role in the adjustment of the real interest rates. The decrease in government spending needs to be sufficient enough to offset the monetary contraction in order to obtain lower rates. Lower interest rates would cause a decline in the real effective exchange rate and, therefore, increase exports. This also will lead to a necessary devaluation of the zloty. As was learned through the Mexico crisis, using currency devaluation as a policy tool proactively, instead of reactively or as a last resort, may be very effective in bringing Poland to a soft versus hard landing, particularly when skepticism from investors and local residents may already run high.

The aforementioned policy is recommended as an attempt to save Poland from a potentially crippling financial crisis, as well as to prepare it for accession into the EU. It is put forth as a short-term strategy for decreasing the underlying source of much of Poland’s economic problems, the enormous current account deficit. Such a strategy will have some immediate, short-term, negative effects on

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6 For the purpose of this paper we recommend only decreasing government spending; changes in the tax rate are not considered.
Poland’s economy, i.e., hindered growth due to lowered output, and increased unemployment. However, the benefits to Poland of enduring these short-term hardships far outweigh the cost of delaying action.

**Effects of the policy on Poland’s economic indicators:**

*Net Exports:*

The combination of the monetary and fiscal policies will result in lower interest rates. The decreased interest rates will cause an increase in nominal exchange rates and, therefore, a depreciation of the zloty. Such depreciation would need to be gradual as to avoid alarming investors and risking extreme capital flight, as was the case in Mexico. We assume that relative prices are sticky, therefore the increase in the nominal exchange rate will cause a decrease in the real exchange rate. Polish exports will become cheaper relative to other countries’ goods and, as a result, Polish exports will increase. The upturn in other European economies also should contribute to stronger exports. Additionally, recent real wage increases and a boom in consumer credit has helped to revive domestic demand, which should decrease imports. Together, the increase in exports and the decrease in imports should work to bring the current account into balance despite the slowing of foreign direct investment.

*Investment:*

The decreased interest rates for lending will boost domestic investment. This is especially important as Poland attempts to privatize formerly state-owned enterprises. Lower interest rates will encourage domestic investors to take out loans to purchase state-owned enterprises. If investment increases, the rate of domestic savings needs to increase as well. If we do not increase savings, the disequilibrium between the two will give rise to the danger of excessive inflow of foreign capital, resulting in an appreciation of the zloty. It must be emphasized that the decrease in the interest rates may cause a decrease in foreign direct investment in the short run, though it is unclear whether this is guaranteed. In the long run, a depreciation of the zloty would cause an even further decrease in foreign direct investment. A decrease in the interest rate is good for domestic investment and, furthermore, suggests lower risk, which means an interest rate drop will not necessarily dry up foreign investment.

*Capital Flows and Exchange Rate:*

Poland has succeeded in creating attractive investment conditions so far. However, there is need for the Polish government to create a stable currency. Currently, according to the Big Mac Index, the zloty is overvalued. With appropriate macroeconomic policies and strong political support, Poland can maintain a real exchange rate that will contribute to a stable and strong currency. Since interest rates and expectations about changes in capital markets drive exchange rates, allowing for a depreciation of an overvalued zloty will therefore make the zloty more stable. With a stable and properly market-valued zloty, the recommended policy will:

a) Create stable conditions and build confidence in citizens to keep their money in the Polish banks, and invest it at home.

b) Increase savings by making sure that Poles do not hold large deposits in foreign banks. These are investments that can be very useful at home.

c) Rebuild confidence in the future of the Polish economy. This requires price stability.

d) Increase confidence in foreign investors by sending positive signals to Wall Street and foreign investors.

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7 The Economist, April 12, 1997. Price of a Big Mac in Poland was $4.30 when the predicted price was $1.78 and the actual price was $3.10 (predicted and actual exchange rate prices are for U.S. dollars).
e) Contribute, in the long run, to a smooth transition of the zloty to the Euro when Poland joins the EU.

**Inflation:**
Poland’s Central Bank has done a satisfactory job of lowering inflation over the past decade, which is a good indicator that they can keep inflation down in the future. While this is an unclear issue, there is some evidence that a lower real exchange rate will lead to higher prices and a higher expected inflation. However, there is no reason to believe this will happen in Poland given the effectiveness of the RPP in lowering inflation up to date.

**GDP/ Output Decrease:**
The fiscal and monetary contraction will lead to a decrease in real output. When designing economic strategy, it is sometimes worthy to restrain high rate of growth for the sake of increasing the share of investments in GDP. In return, the increase in domestic investment should result in an increased output in the long run. Domestic investment also may increase domestic consumption and exports, both of which would increase the GDP.

**Unemployment:**
The recommended policy most likely will cause an increase in the unemployment rate. Poland already has a high rate of unemployment, although it has been falling in recent years. Recognizing that increased unemployment is a concern for the government, it can be justified by the overall positive effect that the recommended policy will have on Poland's economy in the long run. If Poland decreases its current account deficit, increases exports and raises domestic investment, the potential growth in GDP may help bring down the unemployment rate.

**IV. Conclusion**
“Poland’s economic performance during the past decade of transition has been outstanding”, according to the IMF\(^8\), and there is reason to believe that Poland will continue to thrive in the European Union in 2002. However, this will only be the case if Poland takes immediate steps to address its growing economic concerns. With the uncanny similarities in Poland’s current economic situation to that of Mexico’s in the early 1990s, the Mexico crisis provides Poland with a valuable lesson. Had Mexico directed its attention to indicators such as currency overvaluation, appreciated exchange rates, and its large current account deficit, all of which emerged as potential problems well before the devaluation of 1994, the government may have been able to lessen the impact of the crisis and subsequent recession. Poland has the unique opportunity to learn from Mexico’s mistakes.

The proposed recommendation is a short-term strategy aimed at helping Poland avoid such a crisis, as well as prepare it for its entry into the EU. To this end, it is critical that Poland stabilize its current and capital accounts, as well as its exchange, interest and inflation rates, even at the expense of a temporary decrease in growth and increase in unemployment. Knowing that a policy advocating growth reduction and increased unemployment will be politically unpopular, it is further recommended that the Polish government express the policy in terms of its necessity in keeping Poland from being denied entry into the EU.

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\(^8\) International Monetary Fund, “IMF Concludes Article IV Consultation with Poland”, March 31, 2000.
Appendices