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Poland : challenges ahead of EU and EMU accession

Before dwelling on the challenges, let me first touch briefly on the results of the Polish transition process over the last twelve years.

I. The results of twelve years of macroeconomic and structural reforms are striking :

A. Macroeconomic stabilization is an ongoing process :

1. Inflation has been brought down to very moderate levels :

After the rather bumpy developments following the five first years of the transition process (where inflation hovered around 30 % for a number of structural reasons), inflation in Poland has gone down continuously over the last seven years. It's rate is now below 1 %. The central bank's new medium-term target of 2,5 % is consistent with the Maastricht criteria under present assumptions. This is a remarkable achievement.

2. Growth has been robust :

After the adjustments of the period 1990-1992, where output actually reduced, Poland has been back on the road to growth since 1992-93. In 2002, GDP was nearly 30% higher than it's level of 1990. The Polish rate of growth has significantly outpaced that of the main other transition countries. Nonetheless, growth has decelerated since 2001 (GDP's rate of growth has been around 1 % to 1,5 % over the last two years) and an upward movement to 2,5 %-3% is forecast for 2003 and 3,5-4 % in 2004 driven mostly by exports.

3. But a number of imbalances have to be tackled :

- On the macroeconomic side, there has been a widening of the fiscal deficit since 2001. Whilst the general government deficit as a percentage of GDP remained between 2,5 to 3,5 % until 2000, it has reached 5 % in 2001 and more than 6,5 % in 2002-2003. This entails a rise of public debt, albeit at levels (52 %) still below the Maastricht limits.

- On the structural side, with the slowdown of growth, the unemployment rate has increased from 16 % to 19 %.

B. <u>Structural changes have been remarkable :</u>

1. <u>The structure of the economy has profoundly changed :</u>

If one looks at the evolution of the added value of the different sectors of the Polish economy one can observe that :

- in 1990, agriculture represented 7,1 % of the total added value of the economy, but only 3,8 % in 2000 ;
- in 1990, industry accounted for 43,6 % and 34,9 % in 2000 ;
- while services have seen their share go up from 49,3 % in 1990 to 61,3 % in 2000.

These are huge changes in a period of ten years.

2. <u>The structure of foreign trade has been radically transformed :</u>

The EU share of Polish exports has gone from 38 % in 1990 to 70 % in 2000. Furthermore, exports with a high degree of technological contents have dramatically increased, moving from 10 % in 1995 to 20 % in 2000.

3. <u>The GDP per capita catching up process is engaged :</u>

The increase in per capita real GDP has been remarkable over the years (from 1997 to 2001, $ per capita GDP went up form 3.727 to 4.736 $).

Now, the Polish GDP per capita represents about 40 % of the EU average.

Wages have increased and working conditions are gradually catching up towards EU standards.

If one looks at some technical standards, like the use of telephone lines, of PC's and internet, one observes that Poland is now between 30 to 50 % of the UE average.

4. Productivity has increased strikingly :

Labor productivity in the private sector has increased dramatically. These annual increases are higher than the figures of Spain and Portugal the year before their entry into the Union.

II. The challenges ahead of EU and EMU accession :

The key factor is not the gap between Polish per capita GDP and the EU average. The real challenge is to have in place the macroeconomic and structural settings that will allow and foster domestic savings and investment.

A. Macroeconomic stabilization is a continuous challenge :

1. Inflationary expectations are now, and should remain, subdued :

With headline inflation falling to 0,8 % (year on year) in December 2002, inflation should remain subdued in 2003 and well within the medium terms target range of the Monetary Policy Council. The hard won achievements of anti-inflationary policies geared to price targeting are paying off. They have allowed gradual, but significant, cuts in interest rates over the last two years and a welcome easing of the zloty. As long as wage moderation persists, and fiscal policy gets under control, inflationary expectations should remain moderate which will give more room for monetary ease.

In this respect, the combination of prudent monetary and fiscal policies in the framework of the floating exchange rate regime, is probably the best solution for a country like Poland whose joining the EMU is dependent on price stability, on labor market flexibility and a competitive exchange rate.

2. Fiscal consolidation is an important element of macroeconomic stability and future growth :

Budget deficit is particularly sensitive to the cyclical downturn, but also to the increasing requirements of agricultural agencies and social security funds.

One of the major tasks of fiscal policy is to cope with EU membership costs and to allow co-financing of structural funds[1]. This requires significant changes in current expenditures and cuts in social spending.

In this respect, the recent fiscal consolidation program presented by the Minister of Finance intends to reform the tax system (with elimination of exemptions, loopholes and a reduction of rates) in a neutral way. The program will also address the issue of the necessary curtailment of current spending.

In this regard, the issue of desindexation of entitlements and other commitments is of high importance. Now that inflation is under control, the agreement on wage increases and social transfers has resulted (because of actual inflation being lower than projections) in real increases that outpace the rise in contributions. So it would seem appropriate, as the Minister has suggested, to move towards deindexation.

The earlier expenditure reforms will be implemented, the more likely will be the virtuous "crowding in" process and the greater the room for tax and interest rate cuts and a resumption of investment and activity.

B. <u>The structural challenges :</u>

1. <u>The nature of the challenge :</u>

As I said earlier, the challenge is not so much the catching up of GDP per capita as such (it could take a generation as Mr. Kolodko said). It is to allow, through appropriate structural reforms, the economy to grow faster, to promote savings and to attract foreign direct investment.

2. <u>The type of structural measures that are of the essence :</u>

I shall cite a few in no specific order :

- progress in the privatization and restructuring of state owned enterprises (including in the financial sector) ;
- increasing labor markets efficiency and mobility ; in particular reducing benefits, which are relatively high compared to minimum wage, would tend to increase structural employment ;
- addressing inefficiences in the agricultural sector (including the farmers social security scheme) ;

[1] The program presented by the Minister of Finance aims to take advantage of PLN 62 billion that the EU will make available to Poland, after accession. These funds could add 0,7-0,8 % of GDP annually to Polish growth in the first three years of membership.

- tackling the reform of pension and social benefits, (addressing abuses of Poland's social entitlements).

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In conclusion, I would like to make a few remarks.

Enlargement is now closer with the signing of accession treaties at the April 16 Summet in Greece. National referendums are taking place. The Polish vote will be on June 8. In late 2003, the Commission will issue it's final assessment report and in June 2004 we will have the European elections.

1. The impact of accession -and of EU transfers- on the eight "first" Central and Eastern European countries to join EU has been estimated by the Commission as significant. In the 2000-2004 period, annual growth rate in the candidate countries would reach an average of 4 % (instead of 3,1 % assuming no accession). The figures in the period 2005-2009 would be 4,6 % (against 2,9 % with no accession).[2]

In the same vein, employment and investment and total factor productivity would exceed by 1 % (annually) the figures calculated with no accession. These projections are not scientific, but give an idea of the orders of magnitude involved.

2. The key to the success of this process is investment and productivity growth :

In this respect, the euro accession has considerable merits. It will accelerate and confirm the interest rate convergence towards lower EU levels. This will reduce significantly the cost of funding and investment.

Adopting the euro should also promote trade and technological transfer and, by eliminating exchange rate risk, foster FDI.

This "virtuous" process will be dependant on two major factors :

- the pursuit of ongoing macroeconomic stability policies, the reining in of budget deficits, and the progress in structural reforms ;
- the increase in labor productivity.

These major factors are perhaps even more crucial and urgent that was the case in prior enlargements : indeed, the per capita GDP of Spain, Portugal and

[2] Cf. European Commission : "The Economic Impact of Enlargement" (June 2001).

Ireland was significantly higher (60-70 % of EU average) than is the case in the Central European Countries (less than 50 % at accession date).