Poland – The Green Island Sinking into a Sea of Red

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November 2011: *"I do not hide the fact that the aim is to stabilise the financial situation of Poland. This is positive for the reputation of Poland and connected to the security of our bonds".*

October 2012: *"The world and Poland face another difficult year. The primary goal before the government is to protect people from the consequences of the crisis".*

(PM Donald Tusk speaking in Parliament)

Introduction

Although the global economic crisis severely affected most countries in Central Eastern Europe (CEE), Poland enjoys the status of being the only EU member state not to have undergone a recession over the past few years. This led the government to claim that Poland was a green island in a sea of red. Nevertheless, there are now signs that Poland's positive economic performance is waning and that many of the factors that drove its growth are beginning to dissipate. Moreover, despite continued economic growth, many socio-economic indicators have worsened in recent years, particularly in the labour market, which shows that the benefits of the country's economic growth have not been felt evenly throughout society.

This article considers the effects of the economic crisis on Poland; the reasons that it was able to avoid a recession; the factors behind its recent slowdown and the future prospects for its economy.

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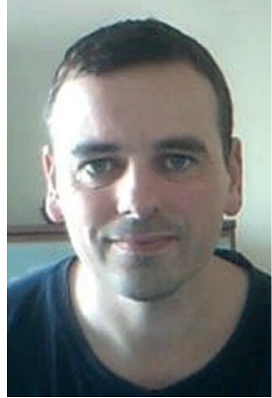
Surviving the crisis



Poland's GDP rose on average by 3.7 percent between 2008 and 2011, with growth slowing to just 1.6 percent in 2009 (see Table 1). This is down from an average of 5.5 percent in the years after joining the EU and before the outbreak of the economic crisis (i.e. between 2004 and 2007). In the context of the severe downturns experienced by other CEE countries, this represents a significant success for the Polish economy.

Despite avoiding an economic contraction, the slowdown did lead to a worsening situation in the labour market. Unemployment had significantly reduced after Poland joined the EU, falling from over 19 percent in 2004 to 7.5 percent in 2007. However, in the wake of the economic crisis, unemployment rose to 10 percent by the end of 2011. Unemployment only reveals part of the difficulties in the Polish labour market. Poland has the highest amount of workers of any EU country employed on the basis of temporary, insecure contracts; a figure that increased from just 5.8 percent of all employees in 2000 to almost 27 percent in 2011 (the EU average is 14.1 percent).

The slowdown in economic growth, the increase in unemployment, reduced government revenues (see below) and sustained public spending contributed to a worsening of the country's public finances. Yet these remained manageable when compared to those in many other EU countries. The budget deficit stood at – 5.1 percent of GDP in 2011, after growing from – 1.9 percent in 2007 to – 7.8 percent in 2010. Meanwhile although public debt has risen steadily over the past few years, its level of 56.3 percent in 2012 was still well below the EU average of 82.5 percent. These relatively healthy public finance figures have allowed the government to increase its spending and investment and help offset the worst effects of the economic crisis.

Why no recession?

Poland was able to avoid an economic recession due to a unique combination of internal and external fac-

Table 1

Basic economic indicators (%)

	2004	2005	2006	2007	2008	2009	2010	2011	2012
GDP growth	4.3	3.6	6.2	6.8	5.1	1.6	3.9	4.3	2.4
Unemployment	18.3	16.9	12.3	8.6	7.0	8.8	9.6	10.0	10.4
Budget deficit	– 5.4	– 4.1	– 3.6	– 1.9	– 3.7	– 7.4	– 7.8	– 5.1	– 5.0
Public debt	45.7	47.1	47.7	45.0	47.1	50.9	54.8	56.3	–

Source: Eurostat.

tors. Firstly, the country suffered no significant collapse in its banking and financial sectors. Personal debt in Poland was relatively low, mainly due to the fact that base interest rates had remained in double figures up until 2003 and therefore the credit bubble was only inflated for a short period of time. The banking sector in Poland was also relatively well regulated compared to many other European countries (Leven 2011).

Secondly, Poland was not as dependent on the inflow of private credit and capital as some other small economies in CEE, such as those in the Baltic States. As the largest country in CEE, the Polish economy is more diversified and reliant upon internal demand and therefore did not suffer so much as international capital flowed out of the region. Poland was also not so heavily reliant upon exports, and in particular not dependent upon one export industry, as is the case in the small export-led countries, such as Slovenia and Slovakia, which have well-developed car industries. It therefore did not suffer as much as other countries from collapsing demand in Western Europe.

Thirdly, Poland had not joined or tied its currency to the euro and therefore could retain some competitiveness through a devaluation of its currency. Although the devaluation of the *zloty* negatively affected those who had taken out credits in foreign currencies, it benefited many export industries.

Finally, throughout the crisis, the Polish government continued to increase its spending, particularly by raising public investment through utilising the money gained from an inflow of EU structural and cohesion funds.

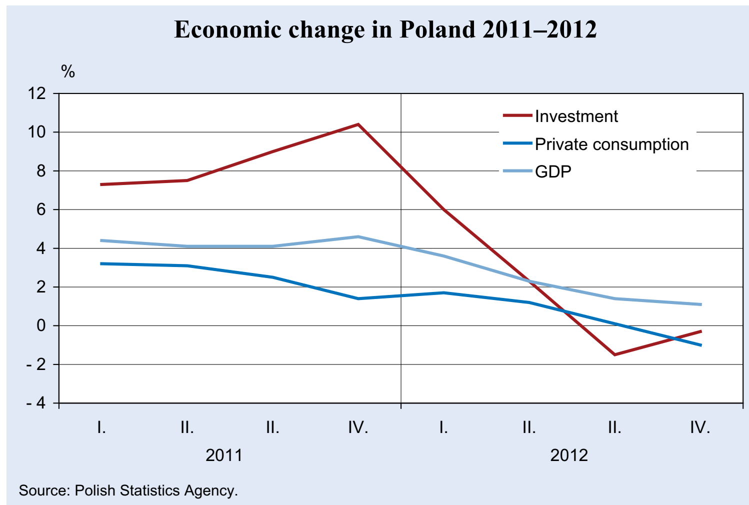
This last point is of particular importance when understanding Poland's on-going growth. Government expenditure continued to increase in Poland throughout the crisis, rising from 15.1 billion euros in 2008 to 16.5 billion euros in the first quarter of 2012. The level of government expenditure in Poland is slightly above the EU average, standing at around 49 percent of GDP. One of the most important actions of the government was to increase public investment by utilising available EU funds. Poland was the single largest recipient of EU funds from the 2007–2013 budget, as it was liable to receive up to 67 billion euros in structural and cohesion funds. This sum increased to 82 billion euros once the designated national government funds were added. This helped the government to instigate large investments in the country's infrastructure, particularly in preparation for the Euro2012 football championships. As a share of overall investment, public investment increased from 35 percent to 43 percent between 2005 and 2010. This has ensured that although private investment fell sharply throughout the crisis, Poland's overall investment rate only declined slightly (by 0.08 percent) in 2009, whilst in other years it continued to rise. The biggest increase in investment has been in the area of buildings and infrastructure, which increased from 1.8 billion euros in 2005 to 3.1 billion euros in 2010.

Slowing growth

Despite Poland's comparatively impressive growth throughout the period of the economic crisis, this has begun to slow down significantly over the past year (see Figure 1). After expanding by over 4 percent in the fourth quarter of 2011, GDP growth slowed to 1.1 percent in the fourth quarter of 2012. A decrease in personal consumption and investment was mainly responsible for this slowdown in economic growth. The very sharp fall in the rate of investment was primarily due to a decline in public investment, as the large construction projects related to preparations for the Euro2012 football championships came to an end. Private investments did not compensate for the decrease in government investment, with private companies themselves suffering from many public investment projects ending. This led to a deterioration in the situation in the Polish industrial sector. In February 2013 the Purchasing Managers Index (PMI) declined for the eleventh month in a row, with pro-

duction, new orders and employment in the sector falling.[1]

Figure 1



Another important contributory factor to Poland's slowdown was the drop in personal consumption. The rate of increase in personal consumption slowed steadily throughout 2011 and 2012, before actually falling in the fourth quarter of 2012. The collapse in the rate of investment means that the situation in the labour market is worsening, which is also having its effect on salaries. According to the calculations of the Polish government, unemployment rose to 14.2 percent in January 2013 up from 13.4 percent in December 2012.[2] Personal consumption is also being squeezed by declining real salaries, which in January 2013 were 1.4 percent below the level of a year earlier.[3] This is of particular significance as it is the first time that real salaries have declined in the country since the early 1990s when Poland was emerging from Communism. The worsening situation in the labour market has meant that poverty (that had declined after Poland joined the EU) has been rising once again since 2010.[4]

Positive economic growth in Poland has been maintained over the past year, primarily through the continual expansion of exports, which rose by 6 percent between January and October 2012. Polish exports tend to involve manufacturing products that are cheaper for many target countries to import, rather than to produce themselves. Furthermore, Poland's floating exchange rate has allowed for a real depreciation in the value of the *zloty* that has helped to boost its exports. Nevertheless, the continual growth in Polish exports will largely depend upon whether the crisis in the eurozone countries can be contained and economic growth in Poland's main export markets in Western Europe maintained. For example, around 31 percent of all Polish exports go to Germany and France. In the final quarter of 2012 the French economy contracted by 0.3 percent and the Germany economy by 0.6 percent. The outlook for these economies is uncertain and their fate (particularly of Germany) will have a great influence upon Poland's future economic outlook.

Sink or swim

The main question for the Polish economy is whether its present downward trend will continue and lead towards its first economic recession since the early 1990s. This slowdown in economic growth has had a significant impact on shaping public debate around the economy and has led to some change in emphasis in the government's present economic policy.

When PM Donald Tusk's Citizens' Platform (PO) was re-elected in October 2011, it seemed as though his new administration would come more into line with the politics of economic austerity and reduced government spending, being pursued by many EU countries. During his inaugural speech to parliament Tusk pledged to bring the budget deficit down to 1 percent and public debt to 42 percent of GDP by the end of his government's term in office. He announced a series of government spending cuts designed to achieve

[1] Spowolnienie w sektorze przemysłowym trwa nadal, Interia Business, http://tinyurl.com/cz59sm9.

[2] The manner in which the Polish government and Eurostat measure unemployment differs greatly, with the former always calculating a higher rate of unemployment than the latter.

[3] http://ww Dalszy spadek realny płac, Rzeczpospolita, 18 February 2013, http://tinyurl.com/c788eyl.

[4] This rise in poverty has been exacerbated by government policies on social benefits. Only around 1/7 of the unemployed receive any benefit. Until October 2012, low income benefits were also accessible for a family (2 adults and 2 children) whose income did not exceed 1,404 *zloty* and for a single person whose income was not above 477 *zloty*. These limits are set by the government every 3 years, yet in 2009 the government did not raise it from the position established in 2006. This ensured that large numbers of people were pushed out of the benefits system, with an estimated 1 million children losing their right to benefits over the past 8 years. In fact, for the first time in 2012, the percentage of those living in households below the statutory poverty line was actually greater than those receiving benefits. From October 2012 the government raised the threshold to 1,824 *zloty* for families and to 542 *zloty* for single people. This was set according to prices existent in 2010, and therefore, as the rate of inflation increases, by 2015 some of those living below the absolute poverty line may not even be eligible to claim social benefits (see *Some Notes on poverty in Poland,* Beyond the Transition, 09 August 2012, http://tinyurl.com/c24qwfc).

these aims and reduce the amount of government spending in the economy.

The attempt to reduce social spending and reform the tax system has met with the social and political obstacles usually faced by such reform programmes. However, a further major problem for the Tusk administration was that the recent decline in public investment was not accompanied by a corresponding increase in private sector investment. Furthermore, with funds from the EU's present budget coming to an end – and the impetus given to the public investment programmes given by Euro2012 having come to an end –the government found it difficult to sustain its previous policy of raising public investment.

In November 2012, Tusk once again addressed the Polish parliament, and announced new plans for a new programme of public investment in an attempt to stave off an economic recession. He pledged large public spending on areas such as highways, rail modernisation, the army, power plants, a natural gas terminal and new pipelines. He announced that over the next few years Poland would spend around 220 billion *zloty* (= 70 billion US dollars), although some of this was recommitting the government to previous spending plans.

The major part of the funding for this investment programme will come out of funds gained from the next EU budget, that comes into force as of 2014 (see below), with the rest of the money gained from financial institutions, the state budget and private and state companies. Importantly, the government has announced that it will bridge the gap before these funds from the EU begin to arrive by increasing public investment in 2013. It plans to use the state-owned BGK bank to set up a 40 billion *zloty* investment fund, which will be supported by the largest state controlled companies. This will be used in order to encourage private sector lending for big infrastructural projects and it is hoped that over the next six years it can be leveraged up to 90 billion *zloty*.[5]

The ability of the Polish government to maintain large public investments is heavily dependent upon the amount of funds it receives from the EU's 2014–2020 budget. Although for the first time in its history the EU's budget was actually reduced in size, Poland has managed to increase the absolute amount of money it will receive from this budget. Poland remains one of the poorest countries inside the EU, with many of its regions (particularly in the east of the country) having levels of GDP per capita far below the EU average. This ensures that it is liable to receive significant funds through the EU's structural and cohesion funds that are designed to help develop the poorest regions inside the EU. Poland will have access to around 500 billion euros (adjusted for inflation) from the next EU budget, which will equal around 1,890 euros per head, 82 euros more than the amount that it received out of the 2007–2013 budget. Importantly, the Polish government also managed to negotiate that the level of EU money used to finance an investment project will remain at 85 percent; and that the EU will continue to cover the VAT paid on any EU financed investment project.

The relative success of the Polish government in negotiating an increase in EU funds potentially provides the means for the government to increase its level of investment in the economy. The positive hope for the Polish economy is that it can ride out the present downturn over the next few months and then gain access to new sources of EU funds to once again raise investment levels and invest in parts of its underdeveloped infrastructure, thus boosting economic growth and employment. However, a number of factors could hinder this aim. The government's commitment to bringing down its deficit and debts could mean that there are fewer resources available for new investment projects. The Polish constitution states that public debt cannot exceed 60 percent of GDP and the government has voluntarily signed up to the eurozone's fiscal pact that demands increased fiscal discipline and a reduction in deficits.[6] There is therefore not that much room for the government to increase its own spending. This is exacerbated as the government's policy of deficit reduction is being pursued partly through local governments, which are the government bodies most responsible for managing EU funded investments, which have been required to balance their income and current expenditure as of 2011.[7] Furthermore, the priorities for investments funded by money from the EU's next budget have altered. The structural and cohesion funds from the 2007–2013 budget were focused upon infrastructural projects. In the run up to the Euro 2012 football championships

[5] *Poland: Bye Bye Austerity*, BeyondBrics, 12 October 2012, http://tinyurl.com/czyu5lg.

[6] The Polish constitution (adopted in 1997) limits public debt to 60 percent of GDP, meaning that the government cannot take on any financial obligations if it exceeds this level. In order to ensure that this is not breached, Poland has a self-imposed threshold of 55 percent of GDP and if this threshold is crossed then the government has to take action to balance the budget.

[7] Local governments have been required to balance their income and current expenditure from 2011.

in Poland, there were large investments carried out in areas such as transport and constructing facilities such as stadiums. In the 2014–2020 budget the priority has shifted to raising innovation and it remains to be seen what impact this will have on the rate of investment and whether it can continue to boost economic growth in Poland.

If the rate of investment cannot be increased and if there is not a significant upturn in the European and international economies then the outlook for the Polish economy could be grim. Presently industrial production is falling, unemployment rising and real wages declining. This economic slowdown has encouraged the Monetary Policy Council (RPP) to aggressively cut interest rates during recent months. In March 2013, interest rates were reduced by 50 base points, which was the fifth month in a row when interest rates have fallen. This has occurred during a time when inflation has stood at its lowest level throughout the whole of the post-communist period. In January 2013 inflation stood at just 1.7 percent, after remaining at around 4 percent for most of 2012. These declining interest rates and falling real wages have contributed to an increase in personal debt. The level of personal debt increased by 11 percent in 2012, reaching a total sum of 38.29 billion *zloty*. At present 2.26 million Poles are unable to meet their debt payments on time, an increase of 170,000 compared to 2011.[8] This rise in personal debt has to some degree offset the decline in consumption caused by rising unemployment and falling real wages. However, this is an unsustainable way of maintaining domestic demand and the growth in personal credit has decreased as economic growth has slowed (in 2011 personal debt grew by 40 percent).

Conclusion

The Polish economy presently stands at a crossroads. After being the EU's best performing economy, in the initial years following the outbreak of the global economic crisis, its economy has begun to slow, which is having an increasingly negative effect on the labour market and living standards. Although exports remain strong, these are heavily dependent upon continual growth in the major Western European economies; and as a large diversified economy these exports cannot fully compensate for declines in other parts of its economy. Poland was able to avoid an economic recession for a number of reasons, but mainly thanks to its ability to maintain investment rates. This was achieved primarily through raising public investment, which was boosted by a large flow of EU funds. The major question now is whether the Polish government will be able to repeat this performance and effectively use the EU funds available in the 2014–2020 budget (both in terms of quantity and quality) and thus help to drive economic growth, modernize its infrastructure and raise activity in its labour market.

Reference

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[8] Zadłużenie Polaków wzrosło w 2012 r. o 3,9 mld zł' Gazeta Wyborcza, 09 January 2013, http://tinyurl.com/avqu6p7.