
Poland – the EU's Large New Member State¹

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Poland is the EU's large new member state – and Denmark's neighbour. Poland has a population of 39 million living in an area seven times the size of Denmark. Although as yet the economy is only 2-3 times larger than Denmark's, Poland is a member state that will gain in importance. The development over the last 15 years has been fast in some areas, but not quite so fast in others. Poland has had a relatively difficult starting point. A number of structural economic problems have been ignored, and in some respects the macroeconomy is faring worse than in several of the other new EU member states, which have seen equivalent economic restructuring. Poland's problems are exacerbated by a prolonged vacuum in relation to economic-policy decisions due to a government crisis and parliamentary and presidential elections. The government that recently took office is thus faced with a huge task in relation to the economy. This article seeks to disclose where the necessary decisions are most urgently required.

INVESTMENTS, GROWTH AND EMPLOYMENT

The reform process in the 1990s changed Poland into an emerging market economy with high growth, a large current-account deficit and considerable capital inflows in the form of foreign direct investments (FDI). In general, the new member states have become attractive FDI targets since their payroll costs are less than one fourth of the level in the old EU member states (EU 15). This also applies to Poland, where FDI in 2004 was 7.9 billion dollars, corresponding to 14 per cent of the total foreign investments in the central and eastern European countries, including Russia.²

Much of the foreign direct investment in Poland comes from western enterprises wishing to produce goods for export. Approximately 60 per cent of Poland's exports are generated by enterprises under foreign ownership.³ Compared with other new member states, the average rate

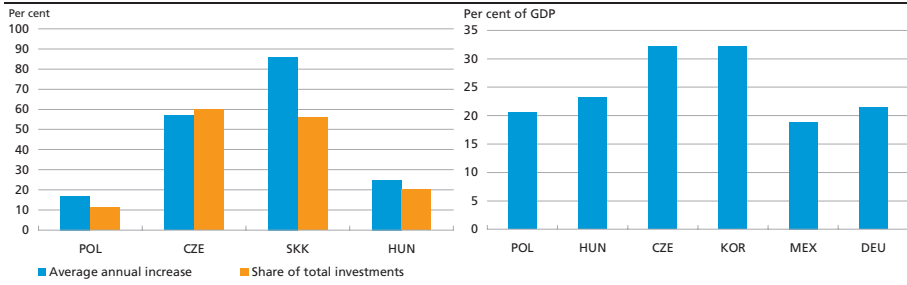
¹ This article was written after a visit to the National Bank of Poland in Warsaw on 8 June 2005.

² Polish Information & Foreign Investment Agency (2004).

³ Wojciech Mroczek, Michal Rubaszek (2004), p. 13.

FDI 1994-2002 (LEFT) AND INVESTMENT RATIO 1993-2005 (RIGHT)

Chart 1



Note: POL = Poland, CZE = Czech Republic, SKK = Slovakia, HUN = Hungary, KOR = Korea, MEX = Mexico and DEU = Germany. Share of total investments relates to 2002.

Source: OECD (2004b), p. 54, and OECD (2005).

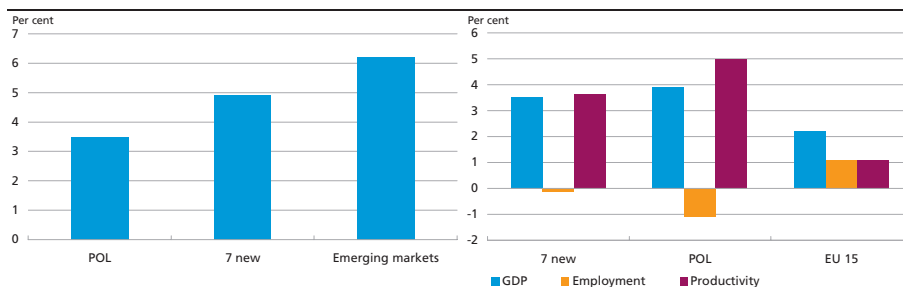
of increase in FDI since the onset of the reform process has, however, been low, as have investments from abroad as a ratio of total real investments, cf. Chart 1 (left-hand side). The investment ratio has been around 20 per cent, which is not particularly high compared with other new EU member states, emerging market economies or even industrialised countries, cf. Chart 1 (right-hand side).

Poland's largest trading partner is Germany, which receives 30 per cent of its exports. Much trade with Germany comprises intermediate goods and parts and components, particularly for machinery and means of transport, and 80-90 per cent of these exports are generated by foreign-owned enterprises. Exports to Germany correlate closely with the development in German exports, e.g. in the automotive industry. There is also considerable trade in car components between Poland, the Czech Republic and Hungary. 4 per cent of Poland's exports go to Russia, and a proportion of the foreign direct investments in Poland come from western enterprises manufacturing for the Russian market.

In terms of income per capita, Poland is in the lower half of the new member states. The level has risen from 40 per cent of the EU average in 1995 to 47 per cent in 2004, but progress has been slower in Poland than in most other new member states, and also slower than in the most successful emerging market economies, cf. Chart 2 (left-hand side). This is partly attributable to the relatively poor employment situation in Poland. Unemployment is far higher, and employment has grown at a slower rate, than in the other new member states. Overall employment has only recently begun to increase slightly, while employment rose far earlier in the other new member states. On the other hand, productivity growth has been higher in Poland, cf. Chart 2 (right-hand side). Seen over the past 10 years, employment elasticity in relation to GDP growth has therefore been relatively low in Poland compared to e.g. the Czech

GDP PER CAPITA 1999-2004 (LEFT) AND PRODUCTION, EMPLOYMENT AND PRODUCTIVITY 1995-2003 (RIGHT), AVERAGE ANNUAL INCREASE

Chart 2



Note: "7 new" are the new member states except Cyprus, Malta and Poland. "Emerging markets" are the top 25 per cent of emerging market economies excluding the new member states. POL = Poland. EU 15 = the old EU member states.

Source: IMF (2005), Peter Havlik (2005), p. 14, Eurostat and own calculations.

Republic and Hungary. Keeping employment at an unchanged level within the existing economic structure has required average annual growth in GDP of around 6 per cent in Poland, compared to 3 and 4 per cent, respectively, in Hungary and the Czech Republic, and even higher growth rates have been required in the manufacturing sector.¹

A breakdown of the productivity increases, based on productivity data for subsectors, shows that less than 10 per cent is attributable to a "structural bonus" that is achieved by transferring employment from – in relative terms – low-productivity to high-productivity sectors of the economy. The rest, i.e. by far the greatest part, is attributable to a general increase in productivity within the individual sectors. In this respect Poland lags a little behind Hungary and Slovakia.² Poland has seen relatively high productivity increases within virtually all subsectors, but has only to a limited extent managed to replace low-productivity jobs in agriculture in particular, cf. below, with high-productivity jobs. The level of productivity per employee is also relatively low, at just over 50 per cent of the EU 15 level in terms of purchasing power parity, compared to 55-65 per cent in other new member states. Since working hours are longer in the new member states, including Poland, than in EU 15, output per working hour is even lower, cf. Chart 3 (left-hand side).

On average, employees work three weeks more per year in the new member states than in the old ones. Poland tops the list of EU member states with 1,956 working hours per employee per year, against e.g. 1,475 hours in Denmark. The EU average is 1,655 hours.³ On the other hand, the employment ratio is low in the new member states, particu-

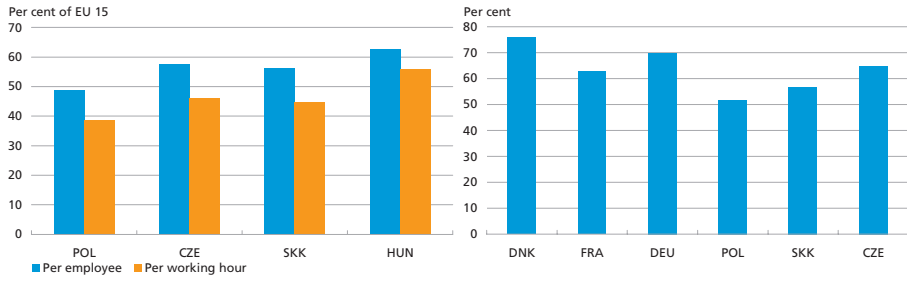
¹ Peter Havlik (2005), p. 24.

² Cf. Havlik (2005), Table 2. See also Michael Peneder (2002).

³ OECD (2004a).

PRODUCTIVITY LEVEL 2002 (LEFT) AND EMPLOYMENT RATIO 2004 (RIGHT)

Chart 3



Note: Productivity is GDP in terms of purchasing power parity. The employment ratio is the proportion of 15-64-year-olds in employment. POL = Poland, CZE = Czech Republic, SKK = Slovakia, HUN = Hungary, DNK = Denmark, FRA = France and DEU = Germany.

Source: Kolasa (2005) and OECD (2005).

larly in Poland where only just over half the population of working age is in employment, compared with e.g. 69 per cent in Germany, cf. Chart 3 (right-hand side).

AGRICULTURE AND SOCIAL CONDITIONS

Total employment is approximately 14.5 million, of which agriculture accounts for 19 per cent, against 5-7 per cent in most other new member states, and 11 per cent in an emerging market economy such as Korea, cf. Chart 4 (left-hand side). In contrast to the other new member states, the percentage employed in agriculture has not declined in Poland in recent years, and the difference between the employment structures has therefore been accentuated. In view of the percentage employed in agriculture, it is remarkable how little added value is generated, cf. Chart 4 (right-hand side).

The fact that so many people contribute so little to added value compared with other countries is an indication that a large proportion of the registered employment in Polish agriculture is actually hidden unemployment. For instance, Poland differs from most other new member states by having more part-time employment (11 per cent, compared to 2-3 per cent in the Czech Republic, Slovakia and Hungary),¹ and part-time employment is indeed prevalent in agriculture.

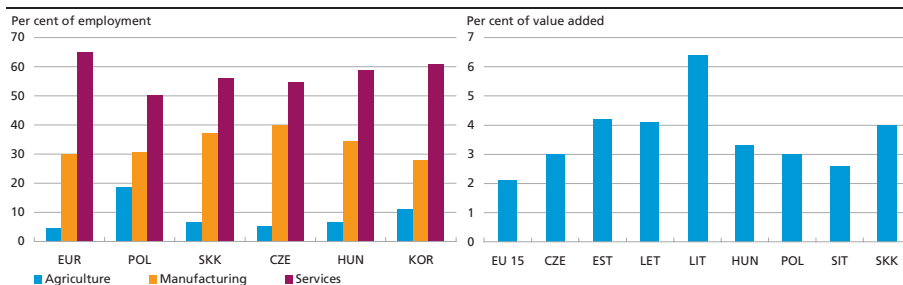
Registered unemployment is substantially higher in Poland than in the other new member states, except Slovakia,² and particularly since 1999 the labour market has deteriorated. Long-term and youth unemployment are generally high in all new member states, but in Poland youth unemployment is a particular problem, standing at more than 40 per

¹ OECD (2004a).

² The problem in Slovakia especially relates to the Roma (Gypsies).

EMPLOYMENT STRUCTURE 2000 (LEFT) AND GROSS VALUE ADDED IN AGRICULTURE 2003 (RIGHT)

Chart 4



Note: EUR = euro area, POL = Poland, SKK = Slovakia, CZE = Czech Republic, HUN = Hungary, KOR = Korea, EU 15 = old EU member states, EST = Estonia, LET = Latvia, LIT = Lithuania and SIT = Slovenia.

Source: OECD (2004b) and Eurostat.

cent, compared with 10-20 per cent in Slovenia, the Czech Republic and Hungary, cf. Chart 5 (left-hand side). In the new member states, unemployment is generally high among people with little education or training, but again Poland is the exception since unemployment in this group does not differ from EU 15.¹ The reason is that these people are employed in the relatively large agricultural sector. On the other hand, unemployment among the better educated is relatively high.

In spite of the progress made, agriculture is the Achilles' heel of the Polish economy. There are 1.8 million farms, many of which are small. The average size is only 10 hectares. In 2003, Poland became a net exporter of food, and in 2004 – the year when Poland joined the EU – agricultural exports rose by 40 per cent. EU membership entailed large increases in producer prices for e.g. sugar and meat and consequently higher incomes for the 1.5 million farms receiving support from the EU.² Rural consumer confidence soared, and land prices rose from approximately 4,000 zloty (just over 1,000 euro) per hectare before EU membership to 5,000 zloty after. It is generally believed that more efficient agriculture would benefit the entire Polish economy. For instance, the OECD assesses that an agricultural reform whereby farms are merged into larger units to enhance productivity, and labour is released for employment in other sectors of the economy, would increase the potential growth rate of the Polish economy by 1 per cent annually over 10-15 years.³ A higher potential growth rate is necessary to speed up the convergence process.

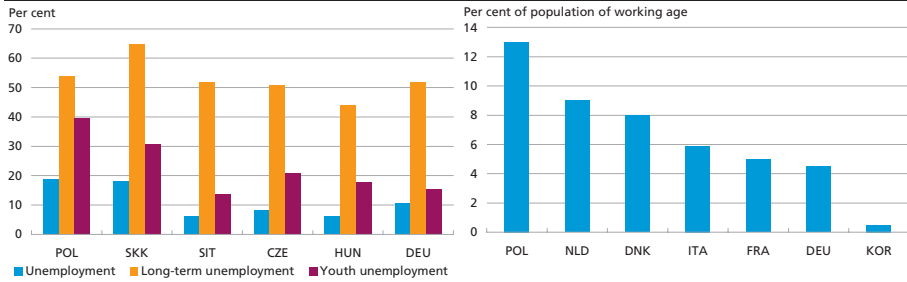
¹ Cf. Michael Landesmann, Hermine Vidivic, Terry Ward (2004).

² They receive 25 per cent of normal agricultural support, rising to 100 per cent in 2013.

³ OECD (2004b). However, the Polish agricultural structure also has its advantages. It is more environmentally friendly since the cultivation methods are less intensive. Compared with the rest of the EU, Polish farmers use only one third of the volume of chemical fertiliser and one seventh of the volume of pesticides. The number of organic farms has more than quadrupled since 1999.

UNEMPLOYMENT STRUCTURE 2004 (LEFT) AND POPULATION RECEIVING SOCIAL PENSIONS 1999 (RIGHT)

Chart 5



Note: Long-term unemployment as a percentage of total unemployment. Youth unemployment comprises 15-24-year olds as a percentage of the labour force, December 2004. POL = Poland, SKK = Slovakia, SIT = Slovenia, CZE = Czech Republic, HUN = Hungary, DEU = Germany, NLD = Netherlands, DNK = Denmark, ITA = Italy, FRA = France and KOR = Korea.

Source: Gruber (2004), Eurostat and OECD (2004b).

The restructuring of the agricultural sector is impeded by the social security system. Owing to the structure of the system, a large group of the population is retained in rural areas and the size of the farms remains small. Farmers have a special government-financed Agricultural Social Insurance Fund (KRUS) where benefits depend on the size of the land owned. To qualify for social benefits in rural areas, it is necessary to own a farm or smallholding of at least one hectare or to be a member of a household that makes its living from agriculture. The benefits are administered by a governmental Social Insurance Institution (ZUS) and financed by a public Social Security Fund (FUS) or by KRUS. The unique aspect of KRUS is that the own contribution to the scheme is much lower than in the public system. Membership of KRUS is steadily rising, and the system operates with a substantial deficit. Expenses now equate more than 2 per cent of GDP, while earnings cover only a negligible part. Altogether rural social security benefits are 95 per cent subsidised.¹

Only 15 per cent of the unemployed, equivalent to just over half a million people, receive unemployment benefits. The compensation rate is around 20 per cent of the average wage. Instead, many people receive social benefits, especially disability pension, where the compensation rate is 75 per cent of the average wage. Disability pensions and other social pensions are disbursed to 3.2 million people, corresponding to 13 per cent of the population of working age. This is by far the highest ratio in any OECD member state and more than twice the OECD average, cf. Chart 5 (right-hand side). Early retirement pension also ensures a compensation rate of 75 per cent of the average wage. Since the social and unemployment benefits are determined in relation to the statutory

¹ OECD (2004b), p. 98.

minimum wage, it is particularly favourable to receive social benefits in rural areas where the wage level is relatively low. This is an important reason why approximately 40 per cent of the population live in rural areas. Surveys shows that the rural population therefore demands relatively high wages in exchange for their labour.¹

The most important type of income support for those out of work is therefore not unemployment benefit, but rather social pensions, primarily disability pension. The high compensation rate under disability and early retirement pension schemes compared to earned wages is important to explaining why almost half the population of working age is not employed, or is employed in the black economy. Surveys of wage elasticity with regard to unemployment and expected inflation show that elasticity matches that of the euro area.² In an economy that needs to implement changes of the scope required in Poland, greater flexibility in the labour market would be expected. It has also been found that if unemployment exceeds 14 per cent, the situation since 1999, wages are not affected.³

ECONOMIC POLICY

The structural problems in the Polish economy are also reflected in fiscal policy in the form of a consistently high budget deficit. Since the mid-1990s the deficit has been around 3 per cent of GDP, rising to 5.4 per cent in 2004. As in most of the new member states, a large proportion of this deficit is structural, cf. Chart 6 (left-hand side), but Poland stands out by having a large cyclical element in the deficit compared to other new member states. Calculations show that the elasticity of government expenditure with respect to changes in economic activity is relatively high in Poland. For instance, when the economy weakens, government expenditure rises relatively substantially.⁴ The challenge of managing expenditure is primarily related to the public and semi-public funds FUS and KRUS, whose deficits are covered by the government. These funds account for 35 per cent of total government expenditure, including pensions.

The earlier government's "Hausner" plan was an ambitious attempt to bring the funds' expenditure under control. The target was an overall budget improvement by 5.2 per cent of GDP in 2005-07. Three quarters of the measures were aimed at cutting costs in sensitive social areas, particularly early retirement pension, social security for farmers, and

¹ OECD (2004b).

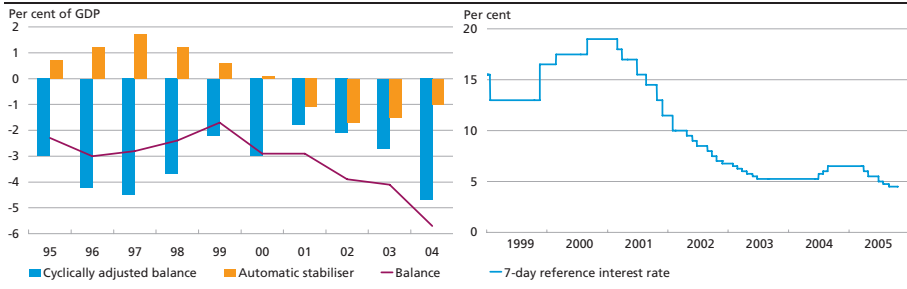
² Thomas Gruber (2004), pp. 96-121.

³ Yamaguchi (2005).

⁴ Cf. Girouard, André (2005), p. 19, Table 8.

BUDGET DEFICIT 1995-2004 (LEFT) AND OFFICIAL INTEREST RATE (RIGHT)

Chart 6



Source: OECD (2004b) and EcoWin.

indexation of social benefits. The planned savings in these areas totalled 3.1 per cent of GDP. The remainder of the savings related to increased efficiency in government administration, a broader tax base, etc. Only just over one third of the measures, equivalent to 1.6 per cent of GDP, were implemented by the adoption of the necessary legislation in February 2004. Among other things, early retirement pensions and pension indexation are affected, but not the farmers' social security system.

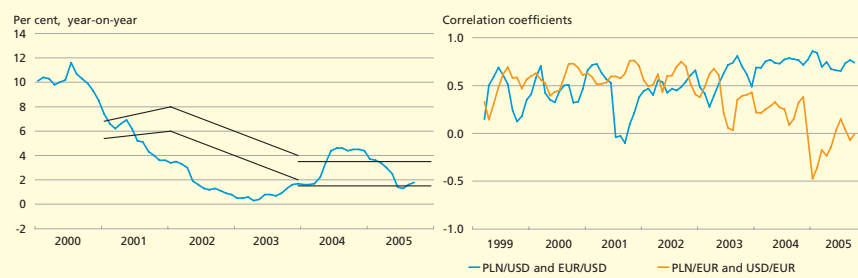
At the end of 2004, the next, now retired, government proposed further budget improvements of around 1.5 per cent of GDP, e.g. via higher income from corporate taxation and VAT. However, parliament rejected several of the government's proposals, and around half of the measures aimed at reducing the budget deficit to around 4 per cent of GDP in 2005 were not realised. At present it is uncertain what the new government intends to do in this area. It appears that most of the plan has been abandoned. The failure of the Hausner plan not only generates uncertainty as to the sustainability of fiscal policy, but may also influence the timing of Poland's euro area membership. Poland's monetary-policy strategy and strategy for euro area membership are described in Box 1.

The economic policy was previously characterised by tension between the government and the National Bank of Poland. During the subdued growth in 1999-2001 the central bank maintained its tight monetary policy on the grounds that fiscal policy was too weak. On the other hand, the government called for relaxation of monetary policy. In 2001, the National Bank of Poland shifted to an inflation target for managing monetary policy. The falling rate of inflation, which was very low in 2002-03, allowed the National Bank of Poland to lower its reference interest rate up to 2003, and the tension concerning monetary policy has gradually receded, as reflected in further lowering of the interest rate in 2005, cf. Chart 6 (right-hand side). The recent interest-rate reductions have taken place with reference to ongoing structural changes in the

Since 1999, the zloty has floated freely, and from 2001 monetary policy has been based on an inflation target. The target is determined by the Monetary Policy Council, whose 10 members are the President of the National Bank of Poland and nine members appointed by the Polish president and the two chambers of parliament (the Sejm and the Senate). The Council also makes decisions concerning adjustments of official Polish interest rates. Since 2004 the monetary-policy target has been an increase in the Harmonised Index of Consumer Prices, HICP, by 2.5 per cent +/- 1 per cent. This is an ongoing target. For a brief spell in 2004, inflation exceeded the target interval, cf. Chart B1 (left-hand side), but this was attributable to temporary circumstances related to EU membership, including restructuring of taxes.

INFLATION (LEFT) AND CORRELATION OF ZLOTY EXCHANGE RATE (RIGHT)

Chart B1



Note: Narrow lines in the left-hand Chart indicate the inflation target. Inflation is calculated on the basis of HICP. The correlation coefficients in the right-hand Chart are calculated as quarterly moving correlations in the overnight exchange-rate fluctuations.

Source: EcoWin, National Bank of Poland and own calculations.

Poland is the only new EU member state not to have any official target date for euro area membership. The new president has announced that he expects a referendum on euro area membership to be held towards the end of his current term of office, which expires in 2010.

Previously, the zloty has tended to fluctuate with the dollar rather than the euro. If it continues, this could constitute a problem in ERM II, but there are signs of a closer correlation with the euro since Poland joined the EU, cf. Chart B1 (right-hand side). It is seen that the overnight fluctuations in the zloty vis-à-vis the dollar increasingly match the overnight fluctuations in EUR/USD, while the overnight fluctuations in the zloty vis-à-vis the euro to a lesser extent mirror the USD/EUR overnight fluctuations. The correlation between zloty and euro is, however, still substantially lower than for the Slovak and Czech koruny, which also float freely.

economy that give net exports a larger share of added value. According to the Monetary Policy Council it is now more likely that long-term inflation will fall below the target of 2.5 per cent.

CONCLUSION

It has undoubtedly boosted confidence in monetary policy that Poland's EU membership is now a fact, since Poland must in the long term join ERM II and the euro. The nominal convergence process has been successful, so that fiscal consolidation in particular is crucial to preventing further uncertainty regarding the Polish economy. Real convergence plays a role in this respect, and Poland has not done too well. The main task for the new government will be to gain control of fiscal policy and reduce the budget deficit. At the same time it is very important to solve some of the structural problems that affect the Polish economy and entail that so far the convergence process in relation to the old EU member states has been relatively slow.

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