

Structural Reform and Economic Growth in 2002–2003

The Opening and Closing Balance

In the fall of 2001, the Polish economy was in a crisis and although the policy conducted by the government in the next eight months averted the danger of its escalation, the economy in mid-2002 was still marked by stagnant output, a profound decline in investment and increasing pessimism of both consumers and entrepreneurs. The danger of a further increase of budget deficit was very real, while important structural reforms, particularly in the area of public finance, were at a standstill. The negotiations concerning the financial and budget aspects of Poland's membership in the European Union were behind schedule and the position of Poland on international financial markets was weakening. As the government had no comprehensive and coherent vision of its socio-economic policy, such detrimental trends and processes were likely to persist.

In contrast, the socio-economic processes observed in the second half of 2002 and the first half of 2003 indicate that the economy is returning to a rapid growth path. Despite the unfavorable external market conditions, the negative tendencies were soon clearly reversed, mainly due to enterprise debt cancellation, an increased depreciation allowance and a consistent financial policy, including, especially, the preparation and implementation of the budget for 2003, focused on stabilization and development. What was also significant for an accelerated output growth and the creation of new jobs was the weakened exchange rate of the zloty, which, additionally, fosters the expansion of exports. At the same time the character of the growth processes is changing: from a feeble, import-driven growth, we are moving towards a dynamic, export-propelled growth.

Thanks to this policy, industrial output has been growing in the second quarter of 2003 at a rate of 9.1 percent in real terms, whereas a year ago it dropped, in absolute terms, by 0.4 percent. While GDP grew last year at a mere 0.5 percent in the first quarter and 0.8 percent in the second, it is now increasing at a rate of 3.8 percent. Consequently, the number of the unemployed is shrinking – recently by as much as 50,000 a month. The current account balance shows a substantial improvement: its deficit has dropped from 4.0 percent at the end of the second quarter of 2002 to 2.9 percent at the end of the first half of 2003 – the lowest level in seven years.

Despite this acceleration, inflation is kept at a record-breaking low: as measured by the consumer price index, it stood at just 0.4 percent in May 2003. The central budget and the local government budgets are executed without any major tensions. The central budget deficit, measured in accordance with the European Union methodology, does not exceed 4 percent of the GDP this year, which is about 0.5 percentage point less than in 2002. At the same time resort to fiscalism has been reduced, as the ratio of budget expenses to GDP has been decreasing. Due to these circumstances, and in view of the improved microeconomic competitiveness and profitability of enterprises, optimism is growing among entrepreneurs and investors, as well as consumers. Poland's rating on the international financial scene, among global banks and investors, is also improving.

Even so, we have not yet fully overcome the negative tendencies observed in 2000–2001 and in the first half of 2002, caused initially by the unnecessary overcooling of the economy and a faulty financial policy, especially in its monetary aspect, and then, in addition, by the delay in the implementation of certain structural reforms, also by the present government, which by the early summer of 2002 had not yet worked out an effective economic growth program. At present, the reinforcement of the positive tendencies which have been observed for a year requires more intense and focused reform efforts – including

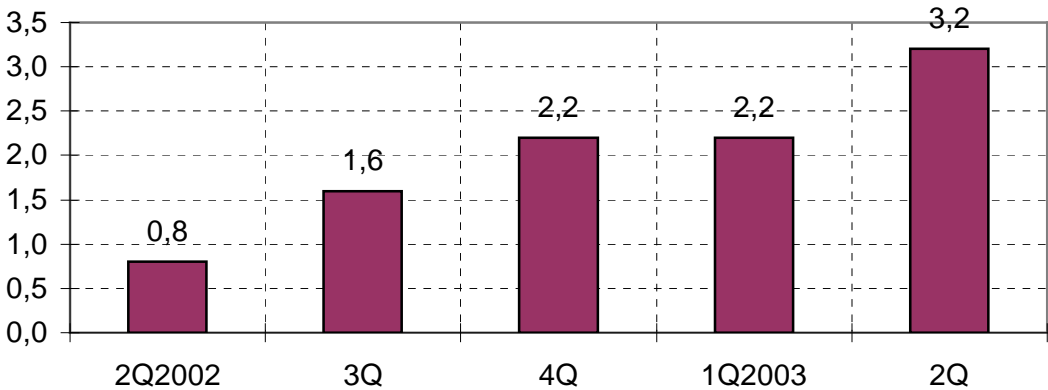
changes in the area of the privatization and management of state property – as well as new measures, especially in the field of public finance. In a social market economy, the systemic and redistributive role of such reforms is twofold: to ensure the efficient functioning of the state and its institutions, and to guarantee a stable socio-economic growth.

Under the present circumstances, of special importance is the necessity to adjust the public finance system in Poland to the requirements of the approaching European Union accession and to foster the development of the institutions of civic democracy through genuine reinforcement of local government. Important changes have occurred in this field over the past year, also in the legislative sphere, through the adoption of many new laws. Special mention is also due to the favorable financial and budget package negotiated in the accession process, crowned by the agreements reached at the Copenhagen summit and confirmed by the corresponding provisions in the Accession Treaty signed in Athens. However, further progress, continued rapid growth and taking full advantage of European Union membership will not be possible without perseverance in the implementation of the guidelines and tasks set out by the *Public Finance Recovery Program* – a comprehensive socio-economic strategy for Poland for the coming years.

1. GDP growth dynamics

Thanks to the increased volume of economic activity in specific sectors – especially in industry and market-oriented services as well as a major recovery in exports – GDP growth increased in the second quarter of 2003 to ca. 3.8 percent, as compared to 0.8 percent a year ago and 1.0 and 1.4 percent, respectively, in 2001 and 2002. This allows one to expect an annual GDP growth of about 3.8 percent in 2003, consistent with the budget assumptions and more than three times the rate of 2001.

GDP growth (%)

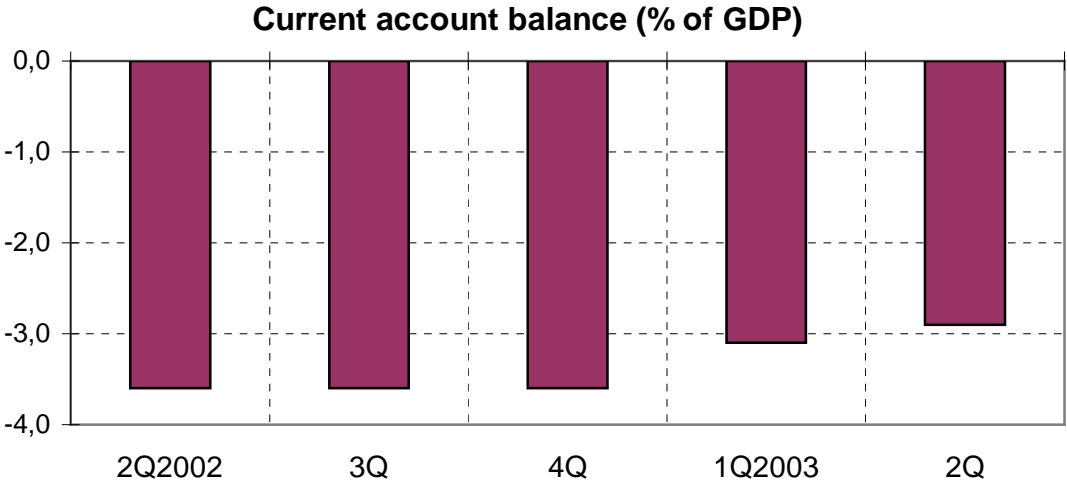


2. Foreign trade volume and economic expansion

In spite of the weak global markets – particularly in the case of our main trade partners from the European Union and the United States – and a strong appreciation of the real exchange rate from the fourth quarter of 1999 to the second quarter of 2002, the second half of previous year brought a significant improvement of the foreign trade figures. As the exports increased faster than the imports, the goods trade balance improved, cutting down the deficit by ca.

\$1.3bn over 2001. The current account deficit has also been noticeably reduced: from nearly \$7.2bn in 2001 to \$6.7bn a year later. As a result, the current account deficit as a proportion of GDP was brought down to 3.6 percent in 2002 from 3.9 percent in 2001.

In the first half of 2003, export growth dynamics was still very high, despite the unfavorable developments affecting our main trade partners, especially Germany. This demonstrates the increasing capacity of Polish enterprises to adjust their supply potential and product offer, as the zloty has been losing to the euro. From January to April 2003, export revenues exceeded \$12.2bn, a staggering increase of 27.7 percent over the same period last year, while import expenditures amounted to nearly \$15.5bn, up 19.6 percent over the previous year. As a result, current account deficit dwindled to \$1.95bn, from \$2.98bn in the same months a year before. The preliminary figures for May and June 2003 confirm this tendency. Obviously, such an expansion of exports has its beneficial effect on the overall profitability of the enterprise sector and, especially, on output and employment levels.



The high exports dynamics is predominantly a consequence of the increasing competitiveness of Polish enterprises, which operate ever more successfully on foreign markets. The relatively weak foreign demand forces exporters to restructure, reduce costs and improve efficiency. These are very favorable developments which help enhance our production potential.

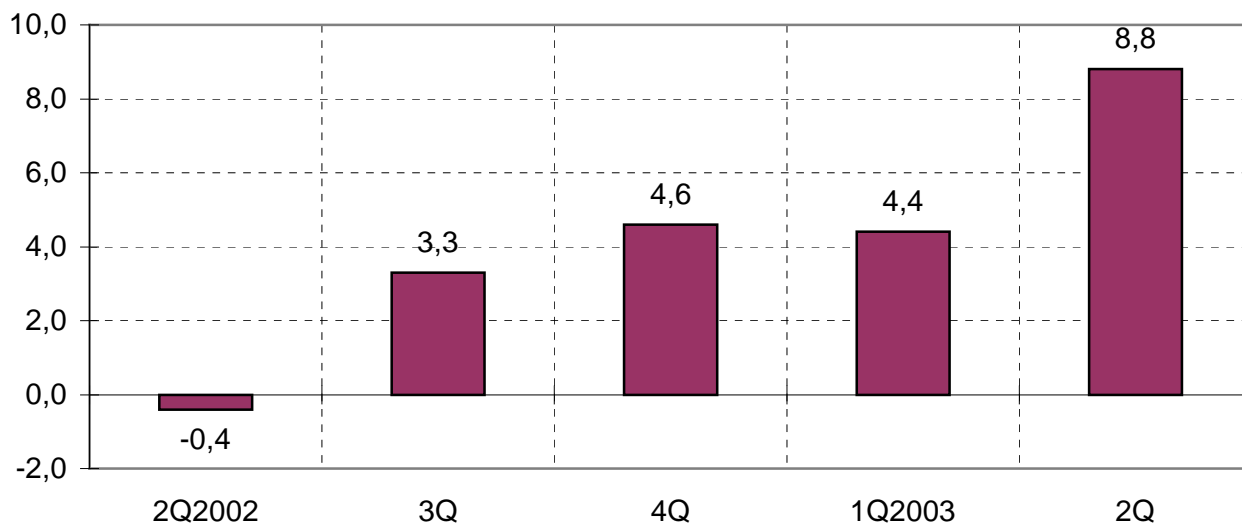
3. Industrial output: reversing the downward trend

In May, industrial output sold soared in real terms by 11.7 percent and in the first five months of the year it showed an increase of more than 6 percent over the same period of 2002. Its high dynamics persists in June. Thus although industrial output, measured in absolute terms, dropped in the second quarter of 2002 by 0.4 percent, in the second quarter of 2003 it is higher than a year ago by 9.1%.

This implies a qualitative change, which is mainly influenced by four factors. First, effective financial restructuring and enterprise debt cancellation under the “Anti-crisis Package” prepared last summer: almost 60,000 enterprises underwent restructuring; more than 98 percent of these were small and medium-size private businesses, which otherwise faced inevitable bankruptcy. In the process, some 210,000 jobs were saved. Second, a non-inflationary increase in internal demand, which increases the opportunity to sell products on

the domestic market, as a consequence of the successful implementation of the adopted income policy, including the financial ratios stipulated by this year's budget. Third, the expanding opportunities to sell on foreign markets, resulting, among other things, from the increased profitability of manufacturing activities due to the weakening of the zloty to the euro. The fourth and final point – which may be the most important – is the improving quality of enterprise management, combined with better marketing skills of the executives.

Industrial output growth (%)



Besides, following several years of deep recession, the downward trend in housing construction has been reversed, as is shown by the increasing turnover of companies preparing building sites, which has more than doubled in recent time. This is one of the factors behind the recent growth in investment.

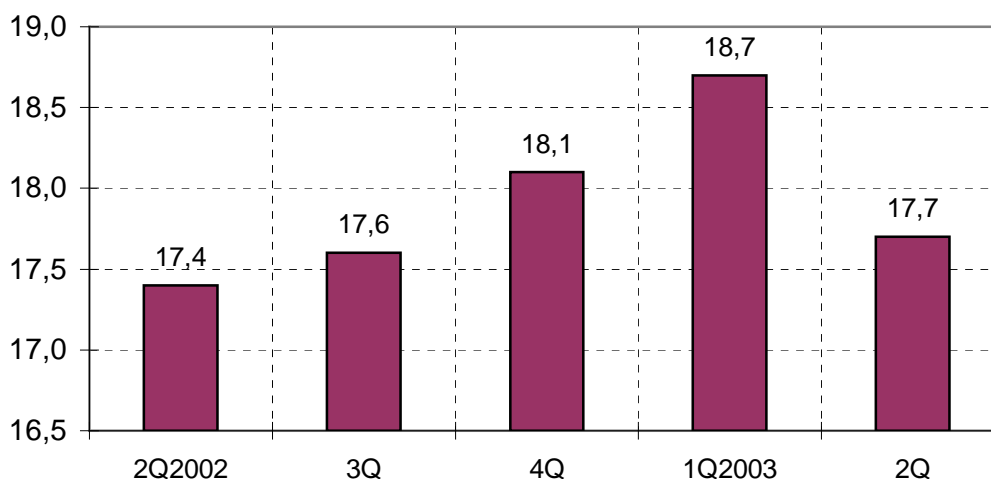
4. Increasing employment and reduced joblessness

Towards the end of 2002, there were 3,217,000 unemployed seeking work, registered at job centers, and unemployment rate stood at 18.1 percent. As a result of the baby boomers of the 1970s and 1980s entering the labor market and the insufficiency of the anti-unemployment and alternative job creation measures of the government, unemployment rose even further, reaching the record level of 18.8 percent at the end of February this year. The situation on the labor market is aggravated by the excessive costs of labor, kept high by the lack of the needed reform, and by the persistently low spatial and occupational mobility of the unemployed.

A combination of structural factors, an accelerated growth rate and the excellent results of the “Anti-crisis Package” implementation – together with factors related to the seasonality of unemployment – brought the unemployment rate down to 17.7 percent at the end of the first half-year, while the number of the unemployed has decreased by about 200,000 as compared with the highest level of a few months ago. In order to keep up this favorable trend – which has its obvious, beneficial consequences for the reduction of poverty

and exclusion – it will be necessary to maintain high output dynamics and take active anti-unemployment measures.

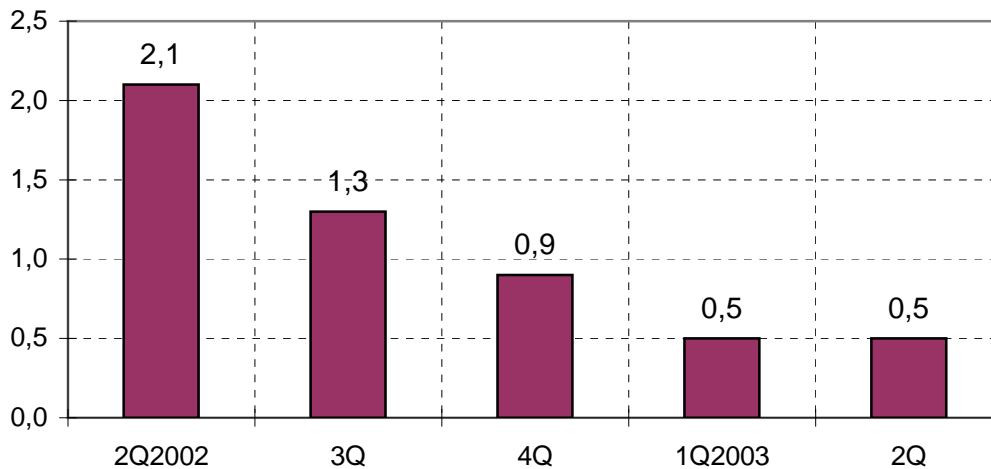
Unemployment rate (% at end of period)



5. Reduced inflation rate

A distinct tendency for inflation to decline has continued right through the middle of the current year. The average annual inflation rate has decreased from 5.5 percent in 2001 to 1.9 percent in 2002 and a record-breaking low of 0.3 percent in April and 0.4 percent in May 2003. Such a significant drop in inflation was mainly the effect of a systematic reduction of inflation expectations resulting from the strengthening competition on the markets of consumer and manufacturing goods and services, the relatively low domestic demand dynamics, surpluses of food products in some sectors of the market, and a very high level of real interest rates. Unfortunately, the last-mentioned factor not only suppressed inflation, but to an even greater degree limited the attainable growth of output and employment.

Inflation (consumer price index %)



6. Budget priorities: stabilization and development

“Inflation plus one percentage point” was the buzz-phrase a year ago. What it meant was that the central budget expenditure should increase in 2003, nominally, by not more than the projected inflation rate (estimated back then at as much as 3 percent) increased by one percentage point. Under such assumptions, deliberately accepted by the government before detailed work was commenced on the stabilization and development budget, the expenditure in current year should reach about PLN 193bn, while the deficit should not exceed PLN 40bn. But the actual gap between the projected expenditure and revenues ran up to PLN 60bn, as the expenditure planned by the ministers and other administrators of the budget were about PLN 16bn higher than assumed, while the revenues were about PLN 4bn below the finally accepted level. With a tremendous adjustment effort, involving mainly the rationalization of expenses, the threat of such a huge deficit was dispelled, as it was finally reduced to PLN 38.7bn, which was 0.5 percent of the GDP less than a year before. It can be seen that at an early stage of work on the 2003 budget, the “inflation plus one percentage point” formula was replaced for the time being by “inflation plus nine percentage points”.

The 2003 budget – the only one in the 15 years’ history of the Polish transformation (1989–2003) to be adopted on time, that is, before the beginning of the new year – has been executed in the first half of the year without problems. After the first five months of the year, revenues reached PLN 56.7bn, or 36.4 percent of the annual budgeted revenues. Compared with the same period of the previous year, revenues were nominally 5.9 percent higher, which translates into a real increase by 5.3 percent. Apart from the general improvement of the economic situation, this was made possible by increased indirect tax revenues, generated especially by VAT and the excise tax. The expenditure in the same five months amounted to 41.1 percent of the annual budgeted amount and does not deviate from the plan. Accordingly, this year’s budget is being successfully implemented and there are no significant threats to its execution.

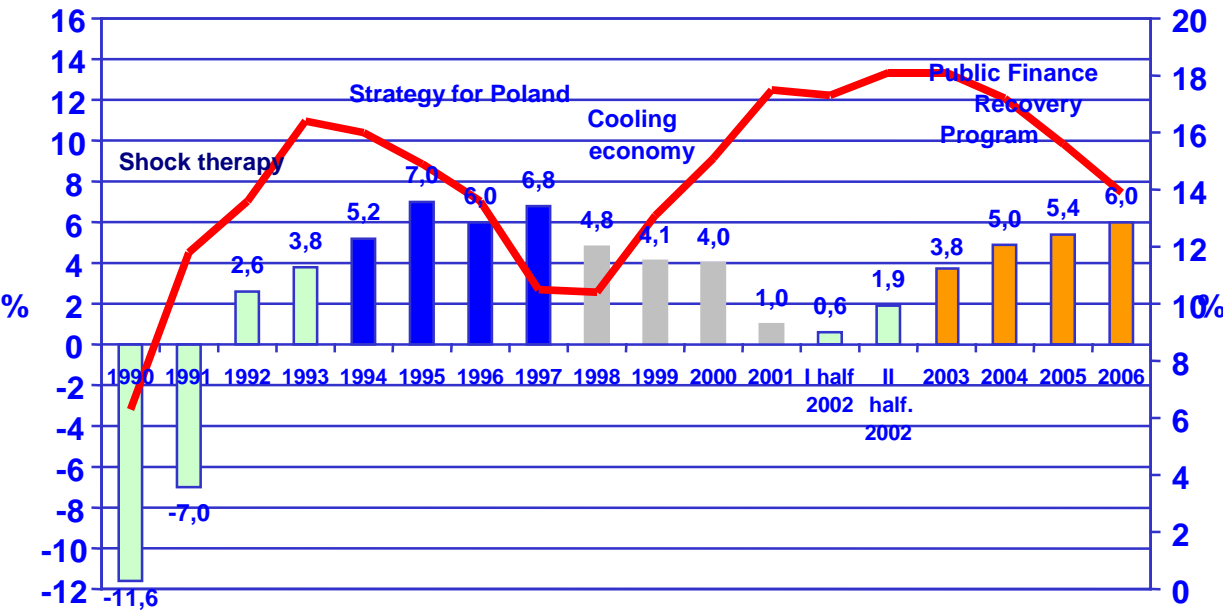
7. Growing optimism of consumers, entrepreneurs and investors

Early in June this year, the consumer optimism index improved by another 4 points, reaching a level of 81 points. This was undoubtedly due not only to an increase, by more than 3

percent, of consumption financed by the personal income of the population over the past 12 months, but also to the growing conviction that this increase may evolve into a lasting tendency in the coming months and years. At the same time the economic climate index was up 7 points. The barometer indicator published by the *Rzeczpospolita* daily – comprising a weighted average reflecting the mood and expectations of both manufacturers and consumers – rose above the psychological barrier of 1000 points (from 992.5 points at the beginning of the year). This increase is mainly accounted for by the “better economic outlook perceived by entrepreneurs and the brighter consumer mood”. Besides, the Pengab banking sector climate indicator moved up by 3.1 points in June, reaching 16.1 points.

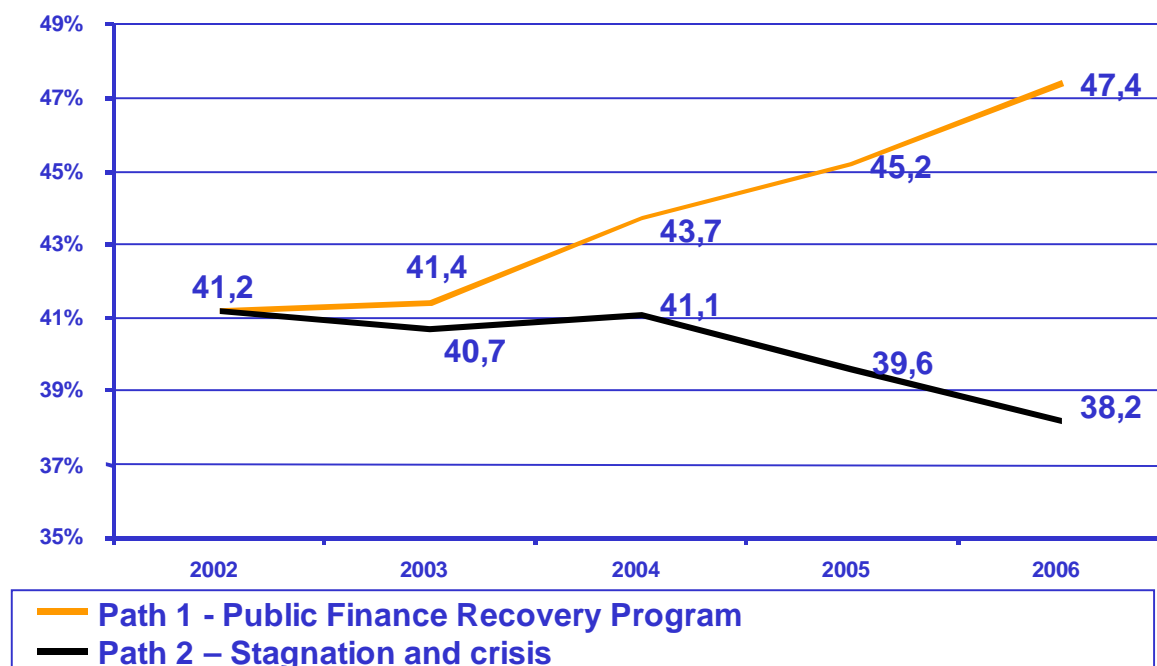
All these developments are related, on the one hand, to the ever more widespread perception of accelerated output growth and, on the other, to the expectations for an appropriate development strategy and a continuation of the structural reforms outlined in the *Public Finance Recovery Program*, including a simplification of the tax system and a qualitative reduction of the tax burden, particularly for corporate entities, by as much as 8 percentage points: from 27 to 19 percent. This may be a hopeful sign for the future, provided that the strategy of accelerated growth, initiated in mid-2002, is continued and that the main objectives of the *Program* are further pursued. If so, per capita GDP may increase in Poland in 2004–2007 by a further 24 percent.

GDP dynamics and unemployment rate in Poland in 1990–2007



It is possible to stay on a rapid growth path and the way to attain such growth dynamics – with special emphasis on the potential benefits of Poland’s forthcoming membership in the European Union – has been outlined in the *Public Finance Recovery Program*. If effectively implemented, it will allow Poland, gradually but perceptibly, to narrow the economic distance to the rich European Union countries.

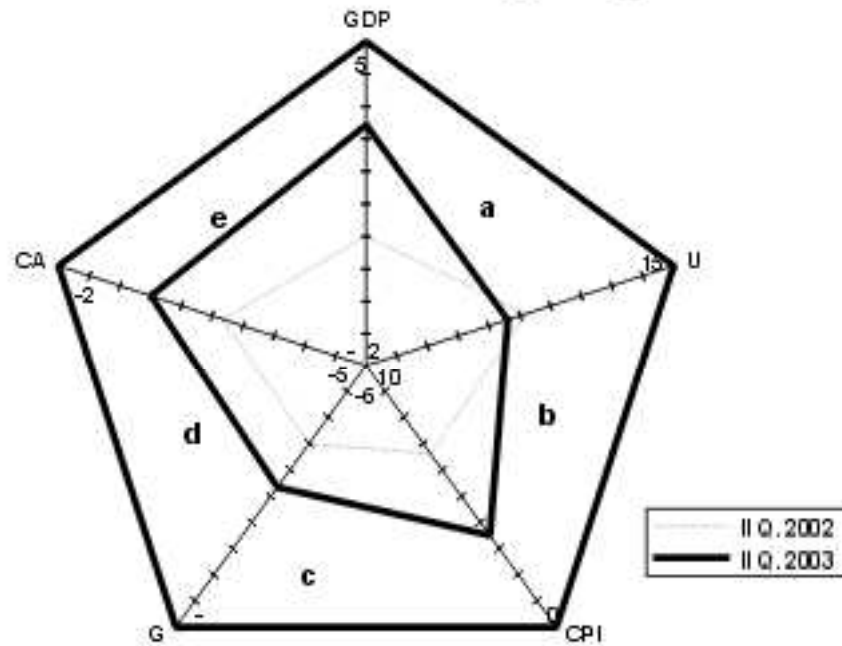
Per capita GDP in Poland (adjusted for purchasing power parity) as a percentage of the European Union average



If, however, the reforms stipulated by the *Program* are not effectively and consistently implemented, it will be hard to maintain optimism and – most importantly – it will not be possible to keep the economy on a path of sustained rapid growth, on which we already moved when implementing the *Strategy for Poland* in 1994–7, increasing in the process per capita GDP by as much as 28 percent. The past year has opened up a chance to return to such a path. Hopefully, this chance will be turned to good advantage.

Warsaw, June 24, 2003

Macroeconomic stabilization pentagon



datas	II Q. 2002	II Q. 2003
GDP	0,8	3,2
CPI**	2,1	0,3
U	17,4	17,7
G	-6,1	-4,8
CA	-3,6	-2,9

square	II Q. 2002	II Q. 2003
a	0,099	0,162
b	0,084	0,142
c	0,048	0,144
d	0,067	0,155
e	0,089	0,247
sum	0,388	0,862

GDP - Gross Domestic Product
 U - Unemployment Rate
 CPI - Consumer Price Index
 G - Government Budget Balance / GDP
 CA - Current Account Balance / GDP