Country focus

How competitive is Poland?

Over the past decade, the Polish economy has generally retained its external competitiveness, and, overall, exports have boomed. But movements in the real exchange rate have not made for a smooth path, and substantial structural changes have left the country with high and persistent unemployment. A recent IMF study took a closer look at Poland's competitiveness and its implications for policymakers.

In terms of several frequently used yardsticks, Poland's external competitiveness in 2004 was broadly comparable with its position in the mid-1990s when the country's external current account deficit was low and export growth strong. Judged by Poland's real effective exchange rate vis-à-vis its trading partner countries (based on consumer price indices and producer price indices), the country saw an appreciation of 2 to 3 percent a year between end–1994 and mid–2004. A real appreciation can be expected during transition periods, and it need not imply a deterioration in competitiveness to the extent that there are "equilibrium effects"—that is, faster productivity growth in the tradable than in the nontradable sector. The average 2 percent a year depreciation of the real effective exchange rate based on unit labor costs during the same period supports this view.

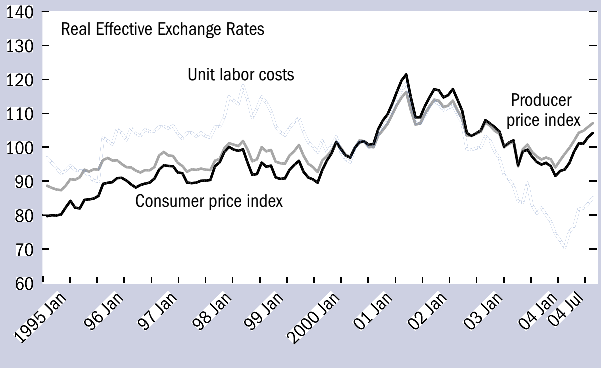
Moderate average movements in real effective exchange rates, however, mask a number of bumps in the road since the mid-1990s (Chart 1). During 1995–2001, Poland experienced a sizable real appreciation across all measures of competitiveness, and this took a toll on exports, output, and employment.

Chart 1

A bumpy road

Real effective exchange rates vis-à-vis Poland's trading partners are rising again

(2000=100)



Data: UN, Comtrade database; and IMF, staff calculations. The classification of exports is based on Peneder (1999 and 2001).

Subsequently, wage moderation together with nominal depreciation restored lost competitiveness, but Poland saw this trend reversed in the second quarter of 2004 when the real effective exchange rate again began to appreciate.

Export growth and profitability

Poland's export performance since 1995 had followed a similarly uneven path, reflecting swings in competitiveness and external shocks. Robust real growth of exports in the mid-1990s confirmed adequate or even strong initial levels of competitiveness, but export growth took a hit in 1999 when the country's export markets in Russia and the Commonwealth of Independent States (CIS) collapsed and in 2001 when demand declined as a result of an economic slowdown in the European Union (EU).

Export growth has recovered since late 2002, as Poland's currency, the zloty, weakened against the euro and the consequent nominal effective exchange rate depreciation has helped improve competitiveness. Foreign direct investment (FDI) inflows in the late 1990s also began to bear fruit. In response to all of these factors, Poland's export-to-GDP ratio has increased (albeit starting from a very low base) by 11 percentage points since 1993. While sizable, this increase has been substantially smaller than those recorded in some other central European countries, notably Hungary and Slovakia, which have seen their export ratios increase by 36 and 23 percentage points, respectively.

Not surprisingly, profitability has mirrored developments in competitiveness and overall export performance. Various measures of profitability suggest that Polish exporters squeezed profit margins during the periods of deteriorating competitiveness in an attempt to preserve market shares. Since 2002, export profitability has strengthened considerably, benefiting from both the industrial restructuring in the late 1990s and the depreciation of the zloty through early 2004. Overall, the export sector has been a driving force of economic growth in the past few years.

Poland has succeeded in expanding its market share in the EU. While it has not kept pace with some other central European countries and China, it has outperformed most non-European competitors. Poland has made little progress, however, in expanding its share in other major markets, such as the United States. These patterns may reflect, at least in part, factors other than changes in competitiveness. The rapid increase in China's export share, for example, may also be due to Asia's growing "vertical integration in production"—that is, components made, for example, in Southeast Asia but assembled in China and considered Chinese exports. And Poland's present edge over non-European competitors, such as Mexico, may reflect the benefits of free trade agreements that it was able to enter into with the EU in the early and mid-1990s. Non-European competitors have since entered into similar EU arrangements but have not yet fully realized their benefits.

Product changes and labor shedding

Poland's export sector has had to adapt to remain profitable. Underlying structural changes in the economy, compounded by external factors, have significantly changed the product composition of exports. Like other transition economies, Poland in the early 1990s inherited a large industrial sector and an underdeveloped service sector. Its past participation in the Council for Mutual Economic Assistance (CMEA) heavily influenced Poland's export composition. As a CMEA member, it chiefly provided manufactured goods to the CIS in exchange for raw materials. With liberalization, the share of industry in output and employment declined, with ramifications for the export potential of different sectors. The permanent loss of export markets in the CIS countries following the 1998 Russia crisis exacerbated these underlying trends. Poland subsequently and successfully reoriented its exports toward EU markets, but this has necessitated demand-driven changes in the product structure of exports.

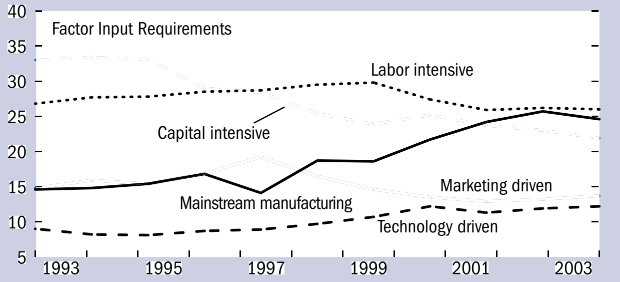
FDI inflows, too, have been instrumental in altering the product structure of Poland's exports. In the beginning of the transition period, much of the country's existing stock of capital was not up to the task of expanding exports to advanced countries. Subsequently, FDI inflows—for acquiring privatized existing firms and setting up new operations—have played a crucial role in upgrading technology, improving organizational capacity and product quality, expanding new production, and creating export capacities. The impact of FDI on export composition is evident at the sectoral level. Poland's machinery and transport equipment sector, which received the largest share (one-fourth) of FDI in manufacturing between 1993 and 2003, also recorded the largest increase in the share in total exports.

The changing product structure of exports has had implications for inputs, notably for capital, employment, and labor-skill levels. While the share of capital-intensive exports in total exports has declined quite rapidly, the share of labor-intensive exports remained broadly stable through 1999 but diminished thereafter (Chart 2). The share of mainstream manufacturing exports has increased rapidly since 1998, while the share of technology-driven exports has increased only slightly. Similarly, the labor-skill requirements of exports have also changed dramatically. The most striking result is the sharp fall, since 1993, in the share of exports requiring low-skill labor and the increase in the share of medium-skill labor-intensive exports. The low and stable share of high-skill labor exports appears consistent with the modest increase in the share of technology-driven exports.

Chart 2

Export composition is changing

The structure of Poland's exports is increasingly converging to that of advanced countries



Data: IMF, Information Notice System, *International Financial Statistics*, and staff calculations; and UN, Common Database and Comtrade.

Unit labor costs in labor-intensive and low-skill industries rose faster than in other sectors between 1999 and 2003. It is likely that the increased costs contributed to the weakening competitiveness and poor export performance of these industries. Producers responded by shedding workers in an attempt to limit rising labor costs. This process was exacerbated by a minimum wage that constrained downward wage movements. Skill mismatches, in turn, may have hindered the absorption of the unemployed in higher productivity sectors. Beginning in 1999, Poland saw the falling share of labor-intensive and low-skill exports contribute to a rapid economywide decline in employment. By 2003, employment in export-oriented firms had decreased by 31 percent compared with a 13 percent increase in nonexporting firms.

Challenges for policymakers

While non-export sectors have taken up some of Poland's displaced workers, particularly in the past one to two years, the reabsorption has not been complete. Unemployment remains high at almost 19 percent. While this may reflect temporary frictions in the transition, it is likely that skill mismatches and insufficient wage flexibility have contributed. In this environment, it will be important to provide adequate training and to minimize labor market rigidities. With estimates of structural unemployment of about 15 percent, visible improvement may, however, be gradual. ■

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Copies of *Republic of Poland: Selected Issues*, IMF, Country Report No. 04/218, are available for $15.00 each. See page 32 for ordering information.