Spring Update for Poland

Spring has arrived in Poland, and with it the question of "whence the Polish economy?" There are signs that the economy may be turning around, somewhat, as well as signs that such a conclusion is premature and overly optimistic.

As for the energy business, our *raison d'etre*, Spring has not yet sprung. Energy, as for the total story about privatization and liberalization in Poland, is mired in government tinkering and tampering. The future of privatization is seriously in doubt; there is a big question mark over what the present government intends versus what it says.

THE ECONOMY

The Polish economy is in a difficult situation at the moment. In short:

- GDP growth in 2001 was 1.1%
- unemployment stands at over 18% and is increasing
- the government's budget deficit is over 4% of GDP
- foreign direct investment is shrinking
- industrial output is stagnant
- little growth in real incomes
- real interest rates well over 10% p.a.

A new, socialist-oriented, government was elected in September on generally populist and socialists planks.[1] The new government has, as would any new government in such a position, blamed the past government for all the problems, and continues to do so. It also has taken a very confrontational stance with the National Bank of Poland (the central bank, which makes monetary policy decisions) over the high rates of interest. The rates of interest are high due to a focus on fighting inflation. The government has taken the position that the high rates of interest have killed the economy, that those rates need to be brought down immediately, and that if the (independent) central bank does not do that the government will introduce legislation into the parliament stripping the National Bank of some of its independence. So far this has been only a war of words.

The National Bank (monetary policy committee) response to this is that it is premature to drop interest rates as the fight against inflation is not over yet, although inflation (February, year on year) stands at a very low 3.5%. It has also pointed out that there would be some severe negative implications for the economy if interest were to be dropped too fast. This fight is not over yet.

While we believe it may be true that high interest rates have hurt the economy some, it is not the main cause of the recession in Poland.

According to some economists that we tend to think have it right, the Polish recession results from the coincidence of three influential factors: a worldwide recession, especially in Europe; Poland's own normal business cycle compounded by the fact that this is the first "normal business cycle" Polish business and government leaders have experienced in post-Communist Poland; and finally some very serious structural problems within Poland itself.

In short, the structural problems include:

- poorly and partially implemented privatization and restructuring of basic industries;
- inflexibility of the Labor Code;
- very high social costs imposed on employers (estimated at 80% of payroll);
- high level of social transfer payments as a percentage of the total government budget (~40%);
- crumbling services and infrastructure (schools, health care, transportation);
- already high levels of taxation (especially personal income taxes and VAT);
- crushing bureaucracy.

In every direction the government turns, it seems to run into insoluble problems. It also seems to have a knack for proposing solutions that make things worse.

The government's own priorities seem a bit confused as well. Its stated policy goals are:

- contain the crisis (and it is a political crisis about which the Prime Minister has expressed considerable fears[2]);
- complete preparations for Poland's accession to the European Union (EU) in (they hope) 2004 and prepare for a public referendum on joining;
- adopt economic programs that will engender sustainable economic growth in the range of 5% to 7% p.a. after 2004.

The problem is that many of the actions being taken to contain the crisis are not consistent with programs needed to foster long term, sustainable growth.

Unemployment appears to be a very serious social problem that has, so far, defied correction. That problem is aggravated by the entrance at present of a "baby boom" leaving school and entering the work force. The decline of Poland's schools has resulted in the level of education of many of those entering work force to be less than the market wants.[3]

The most recent attempt to reduce unemployment has prompted a number of questions from many and outrage from a not inconsiderable portion of the Polish population. The government proposed (then partially backed down in response to public reaction and questions regarding constitutionality) to deprive by law the right of pensioners to work. The general reaction, however, seems to be "if that's the best they can come up with, we're really in trouble."

There are signs that the economy may be starting to recover, as we said earlier. Some economists (notably Krzysztof Rybiński, Chief Economist of Bank Zachodni/WBK and Prof. Stanisław Gomułka, London School of Economics and independent economic advisor to the Polish government) see signs of an upturn in spending on new plant and equipment and an increase in consumer spending.[4] But other economists are not so optimistic and look for major reforms from this government before they believe real economic recovery will begin.

In conclusion we would comment that this is a sad state of affairs. During the 1990s, when the western world was flush with cash, good intentions, and the will to help, the Poles were standoffish. The result is that going on 13 years after the fall of Communist rule in Poland, the infrastructure has deteriorated, restructuring and privatization is still being debated, and the average Pole feels no better off than he was in 1990. This is a recipe for serious social problems.

And, to make matters worse, investors have drawn into their shells reducing the prospects for foreign direct investment below what even this government would hope for.

PRIVATIZATION AND THE ENERGY SECTOR

Although privatization in Poland is not limited to the energy sector by any means, the two are closely related. The Polish government is struggling with conflicts stemming from:

- a continuing sense in the general public that selling state owned assets is "giving away the family silver;"
- the natural tendencies of governments not to want to relinquish control;
- the budget imperatives to raise money;
- the assumption that privatized companies will reduce the number of employees (not an unreasonable assumption) aggravating already bad relations with unions and adding to the unemployment problem;
- the apparent personal agenda of some government officials to "run the show;"
- promises made during the elections to put political operatives into lucrative corporate jobs;
- the unrecognized reality that a small, underpaid and sparsely qualified ministry staff cannot exercise effective corporate governance control over thousands of state-owned companies.

Since taking control in October, the new government has given confusing signals on completion of major privatizations, in the energy sector and outside. There have been stop and start signals on the Group of Eight (8 electricity distribution companies, bundled into one privatization package initiated by the previous government) and on STOEN (the electricity distribution company in Warsaw city). Although the Skawina power plant was "sold" to PSEG Global, and the deal closed, the buyer has yet to obtain the vital permissions needed from the Ministry of the Interior to take actual control of their shares. Other privatization initiatives have been stopped. It was recently announced in the press that the giant Bełchatów power plant would not be privatized after all, but would be bundled with another lignite fired giant, Turów, and the large Opole power station (creating a holding called "BOT").

This latter action to create BOT seems consistent with the general preference of this government to combine companies in a sector to make one big state holding. Also recently, the government backed off any plans to privatize the biggest chemical companies and decided rather to create a state holding company to embrace many of them, especially the big fertilizer producers. A similar initiative regarding pharmaceutical manufacturers has also been suggested.

In part, we see this as a return to "old habits." And, in part we see this as a reaction to the general presence of "national champions" in many EU countries. Such consolidations are necessary, the argument goes, if Poland is to avoid being swamped by national champions from other EU countries after accession. There may be some truth to that.

Any plans to restructure and privatize either Polish Oil & Gas Company (PGNiG) or any of the coal mines have been set aside for the "moment."

Also troubling for investors has been this government's apparent willingness to interfere for political reasons in the management structures of state-owned and partially state-owned companies. The well publicized Eureko - PZU affair is only one case in point. Perhaps more upsetting was the recent arrest by internal security forces of the CEO of the Polish oil refining and distribution company, PKN Orlen, in a blatant action to force his resignation so that someone else could take the position. A court subsequently decided that the arrest was "unnecessary," but the damage was already done.[5] These are chilling messages to foreign investors.

The end result is that not much is on offer for an investor at this point. For investors in the power sector the choices are pretty sparse. Some smaller projects are still possible: industrial and municipal CHPs. But, the recession calls into question the ability of either a municipal or an industrial CHP host to pay for heat or electricity at prices anywhere near economic sustainability.

But then, the sparsity of investment opportunities in Poland is matched by a sparsity of investors ready to come into Poland (or anywhere else, for that matter). So, now is a time of wait and see.

References:

1. See our report on the September elections on our website.

2. See interview Prime Minister Leszek Miller with *Reuters* published by the *New York Times* on April 7th: ***Polish PM Fears Economic Gloom will Spark Unrest.***

3. ***Why Poland isn't Working,*** *Poland Monthly* magazine, April 2002,

4. Comments made by both economists during a panel discussion hosted by the *American Chamber of Commerce in Poland* on April 10th.

5. ***A Tale of Cronyism, State Meddling.. And time behind Bars,*** *Poland Monthly magazine*, op cit.