Poland’s Achilles’ Heel: The Budget Deficit

by Alexander Hartmann

While the financial crises in Argentina and Japan dominate the news, the global economic depression threatens to unleash a financial implosion of Poland. But as yet, no politician in Poland dares say this. The last one who did, then-Minister of Finance Jaroslav Bauk, was immediately fired by then-Prime Minister Jerzy Buzek.

Bauk had warned that Poland’s budget deficit in fiscal year 2002 may reach 88 billion zlotys (some $21 billion), and that 40% of the budget was not covered by revenues. A hasty investigation proved Bauk right, but he was fired anyway, because he had warned of the payment crisis “too late.”

That occurred last August. The Buzek government is gone, but the problems remain. Apparently, there is an agreement to not speak about the upcoming crisis. Nevertheless, nervousness is rampant, as the government’s unprecedented demand that the National Bank of Poland lower rates by at least 5% within three months, attests.

The background to this is, that the current very high interest rates—they are at 11.5%—prevent Poland’s industries from investing. Thus, the demand that interest rates be lowered, is absolutely justified. The other argument is, that the high interest rates drive the zloty up, crippling the competitiveness of Poland’s exporters, and this drives Poland’s exports down.

Indeed, Poland’s exports are going down. Polish exports to Russia have essentially vanished, while Poland still needs to import Russian oil and gas. As a consequence, Poland’s trade deficit, both in 1999 and in 2000, was more than $13 billion, creating a current account deficit of $11.5 billion in 1999, and of slightly less than $10 billion in 2000.

Foreign Investment Drying Up

This deficit was covered by a massive inflow of foreign capital. According to the UN Conference on Trade and Development’s World Investment Report, foreign investors directly pumped more than $7 billion into Poland in 1999, and about $10 billion in 2000. Mostly, this money bought former state properties and companies, when they were privatized. In other words, Poland sold its silverware, in order to pay for its imports.

But this source of money is in the process of drying up. First of all, there are not that many state enterprises left that could be privatized. Second, the international “investors” have run out of money, being in a crisis themselves. Poland will be lucky, if these investors are not forced to pull their money out to pay their debts elsewhere. On the other hand, those who have invested in Poland in the past, want to see returns—creating an outflow of funds.

In the meantime, the monthly trade deficit has come down, mostly because of the low oil prices in recent months. But, it is not only the import volume that shrinks—exports are going down, too, because of the economic crisis in Western Europe, especially in Germany. Many factories in Poland are part of the “production chain” of Western multinationals, and when these cut production, they buy less from their affiliates or suppliers in Poland. Hence, unemployment in Poland has risen to 17.4%, a record in the post-Communist era. That Germany’s imports from Poland have gone down less than German imports from Western countries, is little of consolation, under these circumstances.

This will soon affect tax revenues—which will serve to exacerbate the budget deficit. At the end of 2000, public debt amounted to $76.4 billion, of which some $33 billion was foreign debt.

With a budget deficit of 40%, and sinking tax revenues, Poland’s government will not be able to finance its debt; it is in a debt trap. If the zloty stays high, tax revenues will shrink, if the zloty weakens, the foreign debt will rise by the same factor. This, of course, will not only affect the government’s debt, it will also affect the $39 billion in private foreign debt, and aggravate the internal economic crisis in Poland.

This is the reason why this favorite recipe of the International Monetary Fund (IMF)—devaluation of national currencies—has ended in a failure, wherever it has been applied. In fact, the aim of this medicine was not so much to increase the ability of the affected countries to pay, but to provide ever-cheaper imports for the formerly industrialized countries in the West, to ease living conditions there.

Last Autumn, Argentina was in the same situation. President Fernando de la Rúa and his Finance Minister Domingo Cavallo tried to manage the crisis by imposing ever more brutal austerity measures, cutting pensions and salaries of state employees to finance the debt, at an accelerating tempo. This, in turn, destroyed the domestic market. In the end, it did not work: Despite (or because of) several IMF bailout packages, the government was forced to admit it was bankrupt. The devaluation of the peso, in January, has made matters worse, despite the debt moratorium declared by then-President Adolfo Rodríguez Saá.

Poland’s government is moving along the same path. Once the government can no longer pay its debt, foreign investors will pull out. Once this avalanche is triggered, the zloty will collapse, with catastrophic consequences.

The only move which can prevent this scenario from playing out, is to turn away from the monetarist credo. The question arises: Are Poland’s elites more courageous than those of Argentina, who deserted President Rodríguez Saá, when he wanted to do just this?