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Beyond convergence: Poland and Turkey en route to high income☆

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ABSTRACT

This paper compares and contrasts the policy reform experiences of Poland and Turkey en route to high income. For both countries, globalization has presented unprecedented opportunities to catch up, unleased by integration into European and global markets and the establishment of macroeconomic discipline. These opportunities were reinforced by the creation of economic institutions to strengthen competition and support private entrepreneurship, catalyzed by the convergence process with the European Union. Both Poland and Turkey have shown resilience following the 2008 global crisis, but continued success will require renewed structural reform measures. Dealing with the challenging of aging while at the same time finding a way to sustain productivity growth through greater domestic innovation is shaping Poland's policy agenda. Turkey's structural and demographic potential as well as its strategic location between the markets of Europe and Asia offers attractive value proposition to investors, which could be further enhanced with improvements in business regulations and economic governance.

1. Introduction

The decade before the global economic and financial crisis saw unprecedented convergence in incomes between advanced and emerging market economies. Based on the adoption of prudent macroeconomic policies, emerging markets benefited handsomely from accommodating global liquidity conditions. Thanks to a track record of economic liberalization and structural reforms many middle income countries became attractive destinations for foreign investment and emerged as serious players in the global economy, accelerating a shift in global economic power that had begun in the early 1980s.

This short paper compares the experience of two such emerging markets: Poland and Turkey. The main argument of the paper is that seen against the broader backdrop of globalization and convergence, the stories of Poland and Turkey are surprisingly similar. In Section 1 we argue that the process of economic transition in Poland can be seen as a process of economic liberalization and integration typical of emerging markets, only of broader scope and condensed in time. Turkey started the process of opening up its economy a decade earlier, but Poland achieved the faster convergence thanks to the scope and depth of its reform efforts launched after 1989. As Section 1.2 elaborates, a key driver of the pace of change in Poland was EU membership, achieved in 2004, just a year before Turkey formally began accession negotiations with the European Union. European integration was critical to Turkey's reform process and resulting economic ascent, too, but the impact was less pervasive and Turkey's convergence was slower than Poland's.

Overall, the message from our analysis is that globalization presents unprecedented opportunities for emerging markets to catch-up, if they open their economies, keep macroeconomic discipline, and reform their economic institutions to strengthen competition and support private entrepreneurship. And these opportunities are compounded for countries on the periphery of the European Union that are offered the prospect of accession, because European institutions function like a “tractor beam” for institutional reform in accession countries allowing confidence to build long before the process of institutional reform has been completed.

The paper closes by casting a look ahead. Both Poland and Turkey have shown resilience during the post-crisis period, but are facing more moderate growth prospects in a less forgiving global environment. Which country has better prospects to converge to

☆ The views in this paper are those of the authors and do not in any way constitute the official position of the World Bank.

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the standards of living of the “old” EU members? Drawing on the “middle income trap” literature, the paper comes out with a balanced assessment. Poland's strengths lie in its higher degree of openness, its stronger economic and political institutions, lower degree of inequality and somewhat stronger capacity for innovation. Poland also benefits from less macroeconomic vulnerability, thanks in part to decisive anti-inflation policies around a decade ago. Poland's challenge is to safeguard these achievements and to deal with aging and reform social security arrangements accordingly. Turkey's strengths lie in favorable demographics and the greater remaining potential for gains from the reallocation of labor from agriculture to industry and services. Turkey's challenge is to attract investment and create enough productive jobs to benefit from the demographic dividend. Both countries are likely to see growth above EU averages over the coming decade. Which country will converge faster depends on which country moves more decisively to address its most pressing structural challenges.

The year 2014 is a historic and symbolic year to be writing about Poland's and Turkey's transition experiences. The two countries this year celebrate 600 years of diplomatic relations. Poland also celebrates 25 years of transition from Communism, and 10 years of membership in the European Union. Turkey can look back to over 30 years of experience with economic liberalization, with current account convertibility achieved in 1984. 2015 marked the 20th anniversary of the Customs Union agreement with the European Union and 10 years from the formal start of accession negotiations.

This paper is in no way an attempt to do justice to these very important milestones and achievements. Rather we draw on the large literature summarizing the lessons of the transition experiences in Poland and other countries in Central and Eastern Europe (see for instance World Bank, 1996; Blanchard, 1997; Roland, 2014; EBRD, 1999, 2010; World Bank, 2009; IMF, 2014; Lipton, 2014), and a recent World Bank study on Turkey's own transition from a state controlled to a market based economy (Raiser and Wes, 2014; see also Öniş and Webb, 1992; Canevi, 2014).[1] The purpose of this paper is not to evaluate Poland's and Turkey's experiences in their own right, but rather to explore their commonalities. In this vein, the paper also draws on the study of European convergence present in Gill and Raiser (2012).

2. Unleashing the private sector: economic liberalization and the roots of convergence in Poland and Turkey

Poland's economic transformation from a centrally planned to a market based economy has been among the most successful of all former communist countries. Poland's GDP in Euro terms rose sixfold since 1990, its GDP per capita in constant prices more than doubled over the same period as economic growth averaged slightly more than 4 percent. Some would say not since the days of the Polish-Lithuanian Commonwealth, when Poland and Turkey first established diplomatic relations, has Poland felt so confident, have its national aspirations been backed by a clear rise in economic prowess. Turkey is among the more successful emerging market economies that began opening up to the world economy in the early 1980s (China did so in 1978, India in 1991, Latin America also largely abandoned import substitution strategies and multiple exchange rate practices during the 1980s and 1990s). Its GDP has also grown at around 4 percent since the 1980s (and around 3 percent per capita), with acceleration in the first decade of the 2000s, when GDP in Euro terms tripled. Both Poland and Turkey have thus converged to European Union income levels, standing in 2013 at 68 and 55 percent respectively of the EU average in purchasing power parity terms (Fig. 1). In this section, we trace the roots of convergence back to a common set of basic economic reforms: price, trade and foreign exchange liberalization, sound macroeconomic policies, and a gradual retreat of the state from direct involvement in production.

2.1. A dynamic private sector

The motor of economic convergence in both Poland and Turkey was the same: a dynamic private sector, with a particularly important role played by domestic SMEs. Gomulka (2014) points to the strength of Poland's domestic private sector as a key factor behind the country's shallower transition recession. The rise of a new generation of Turkish entrepreneurs in the growing inland cities of Anatolia has been associated with Turkey's recent economic success and socio-economic transformation (Atiyas and Bakış, 2013). As a result, Polish and Turkish enterprises delivered among the highest productivity and export growth rates among a group of emerging market peers (Fig. 2).

2.2. Structural change drives productivity growth

Private entrepreneurship was also the driver behind dramatic structural changes in Poland's and Turkey's economies. However, the nature of structural change was quite different in the two cases. In Poland's case, workers moved from unproductive state-owned enterprises in the industrial sector to service sector jobs (and some manufacturing jobs created by new private enterprises). The reallocation of workers from unproductive to productive enterprises is shown by EBRD (2013) to have been a major driver of the high rate of Total Factor Productivity (TFP) growth in Poland and other transition economies of Central and Eastern Europe. By contrast, TFP in Turkey – whilst also rapid – was driven mainly by the reallocation of labor from agriculture to industry and services. In other words, while within sector labor reallocations were at the core of productivity gains in the transition from communism, in Turkey the transition was from an agrarian to an urban economic structure. Indeed, among a group of peers, Turkey is the only country that saw an increase in employment in industry since 1990 (Fig. 3). As of 2014, Poland and Turkey had a similar share of employment in manufacturing (around 20 percent), but Poland had a larger services sector, and Turkey still had around 30 percent of employment in agriculture.

2.3. A rapid opening of the economy raised new challenges for macroeconomic and financial sector management

The catalyst of all this dynamic, private sector driven structural change was the move to an open foreign trade regime and the abolition of domestic price controls, ensuring that market signals were allowed to work effectively. The story for Poland is well known – as of January 1990 the vast majority of prices were liberalized, as was foreign trade and a floating exchange rate was introduced (see Gomulka, 2014). What is perhaps less well known today is the extent to which Turkey's economy in the 1970s was hampered by price controls, closed to foreign competition, and riddled with state intervention. In 1980, Turkey's total exports were a mere US$ 3 billion, multiple exchange practices abounded, and the government controlled the prices of a substantial number of consumer goods (particularly agricultural products, fuel and imported manufactures). With Turgut Özal's economic reform package introduced in January 1980, Turkey embarked on a more

[1] Martin Raiser and Marina Wes both worked at the EBRD in the mid-1990s and were involved in several of the EBRD's Transition Reports, which since 1994 have provided an annual update of reform progress in the region, including Turkey since 2011, when the country became an EBRD country of operations.