

Republic of Poland: 2003 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Poland

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with the Republic of Poland, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **March 10, 2003**, with the officials of the Republic of Poland on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on May 16, 2003.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff supplement updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its June 9, 2003 discussion** of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for the Republic of Poland.

The document(s) listed below have been or will be separately released.

Report on Observance of Standards and Codes Update
Selected Issues Paper

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INTERNATIONAL MONETARY FUND

REPUBLIC OF POLAND

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the 2003 Consultation
with the Republic of Poland

Approved by Michael Depler and Liam P. Ebrill

May 16, 2003

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- Article IV consultation discussions were held in Warsaw during February 25–March 10, 2003. The mission met the Deputy Prime Minister and Minister of Finance, President of the National Bank of Poland (NBP), Minister of Treasury, members of the Monetary Policy Council (MPC) and the Sejm, and other senior officials.
- The staff team comprised Ms. Schadler (Head), Mr. Estevao, Ms. Murgasova, and Mr. Székely (all EU1), and was assisted by Messrs. Sassanpour and Sierhej (Resident Representative's office). Mr. Szczuka, Alternate Executive Director for Poland, participated in the discussions.
- Poland's statistical base is adequate for surveillance. In January, a ROSC data module mission concluded that Poland meets the SDDS specifications for coverage, periodicity, and timeliness of data, except for timeliness of general government operations, using the flexibility option.
- In the last consultation in June 2002, Directors welcomed the success in lowering inflation and the current account deficit, but pressed for a more balanced policy mix—particularly fiscal consolidation. Since then, monetary policy has been further eased, but the 2003 budget did not introduce measures to address structural overspending.
- The Polish Peasants' Party (PSL) departed from the 16-month old ruling coalition in March, leaving the Democratic Left Alliance (SLD) and the Labor Union (UP) with a minority government. The EU Accession Treaty was signed in April and a referendum on EU membership is scheduled for June 7–8, 2003. EU entry is expected on May 1, 2004.
- Poland has accepted the obligations of Article VIII, Sections 2, 3, and 4 and maintains no restrictions on current transactions.
- Poland has indicated willingness to provide debt relief to Mozambique and Nicaragua and to seek a solution with Tanzania once the nature of claims is established.

I. BACKGROUND

1. **In 2002, the economy began to recover from the sharp weakening of growth during 2000–01, but the recovery was fragile (Figure 1 and Table 1).** Private consumption picked up gradually, fueled by the jump in fiscal transfers in 2001, easing monetary policy and a drop in the savings ratio. Exports outpaced rather weak market growth as competitiveness improved, domestic market growth disappointed, and exporters moved aggressively into rising CIS markets. In other respects, the recovery reflected more a lessening of negative influences than the emergence of sources of strength: a sharp drop in inventories ended, and the contraction of fixed investment lessened. Without signs of a leading force behind the recovery, its robustness remains in doubt. Investment appears to be weighed down by an overhang from the late-1990s, rising unemployment and moderating wage increases threaten consumption growth, and weak European markets constrain the scope for exports. Recent retail sales, construction activity and confidence surveys reinforce these doubts.

2. **The slack in the economy remained evident (Figure 2).** Consumer price inflation fell below 1 percent. Falling food prices played a role, but more important were moderating cost, especially wage, increases. Employment continued to drop, and, even with falling labor force participation, the unemployment rate rose to almost 19 percent. The external current account deficit remained moderate by transition country standards (Table 2).

3. **Macroeconomic policies were eased.** Since early 2001, monetary policy in particular was deliberately and substantially relaxed, and by April 2003, the main policy interest rate had fallen cumulatively by 1,325 basis points to 5.75 percent (Figure 3). With inflation falling, real interest rates dropped more gradually—but still by a substantial 6 percentage points. Also, lower interest rates (together with political uncertainties and the need to attract sharply higher portfolio and other capital inflows as FDI slowed to a trickle) contributed to a welcome 15 percent depreciation of the real effective value of the zloty since early 2002. Nevertheless, credit growth to enterprises was low reflecting banks' caution in the face of rising non-performing loans and weak demand as enterprises delayed investments (Table 3).

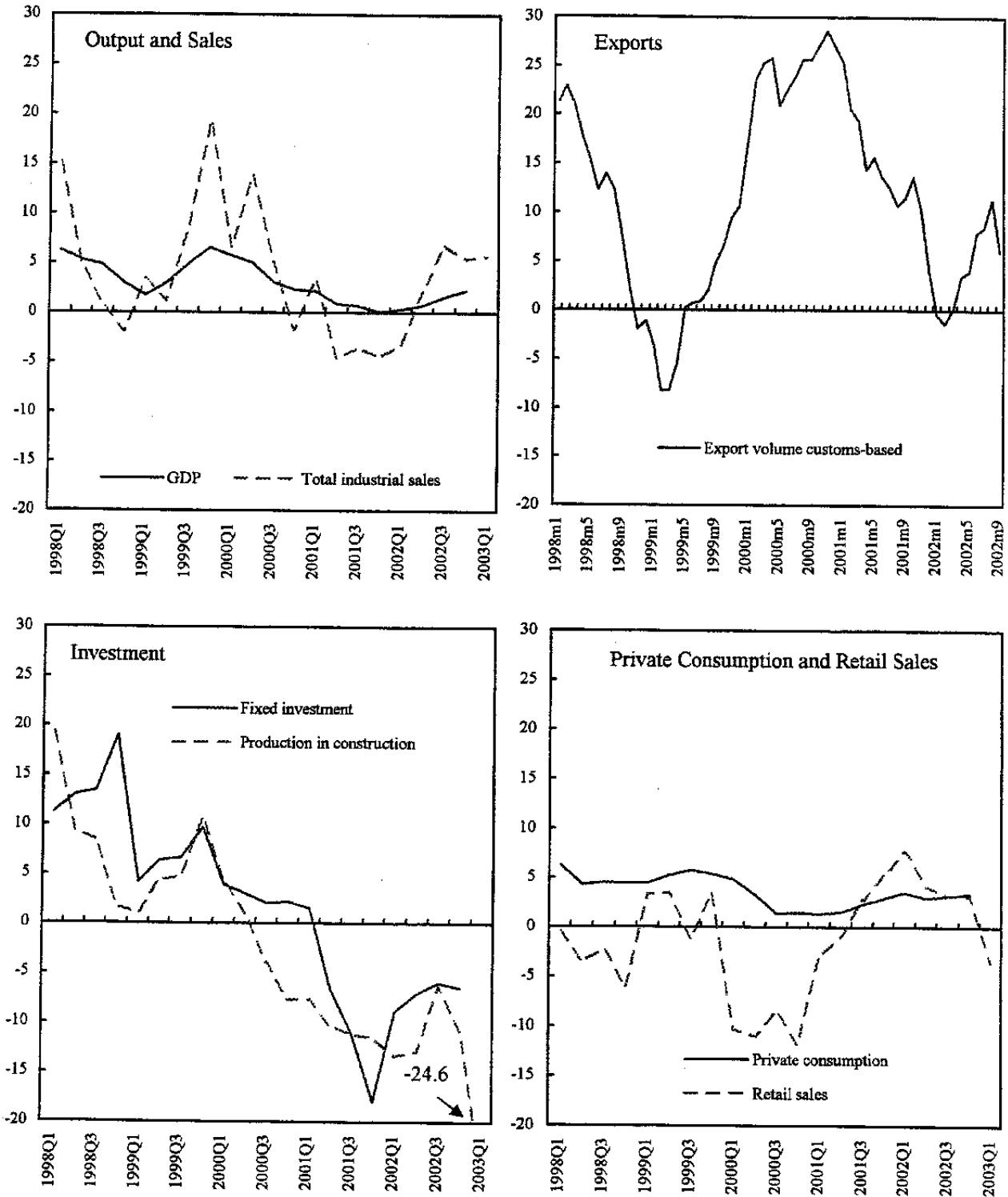
4. **After a large injection of fiscal stimulus in 2001, the fiscal stance in 2002 was neutral (Table 4).** Financial plans of the general government for 2002 aimed for a withdrawal of stimulus of around 2/3 percent of GDP. In the event, lower-than-expected economy-wide wage increases cut into the tax

	Fiscal Outcome, 2002					
	2001 Outcome		2002 Budget		2002 Staff estimate	
	Zł billion	Percent of GDP	Zł billion	Percent of GDP	Zł billion	Percent of GDP
State government						
Revenue	140.5	18.8	145.1	18.4	143.9	18.7
Expenditure	172.9	23.1	185.1	23.5	183.0	23.8
Non-interest	152.0	20.3	159.4	20.3	158.9	20.7
Balance	-32.4	-4.3	-40.0	-5.1	-39.1	-5.1
General government						
Balance ^{1/}	-40.5	-5.4	-48.9	-6.3	-51.3	-6.7
Structural balance	-36.0	-4.8	-31.6	-4.0	-39.1	-4.9
Privatization receipts	6.6	0.9	6.6	0.8	2.0	0.3
Average inflation (in percent)	5.5	...	4.5	...	1.9	...
Real GDP growth	1.0	...	1.0	...	1.3	...
Gross general government debt	302.1	40.3	...	...	353.8	46.0

Sources: Polish authorities; and staff calculations.

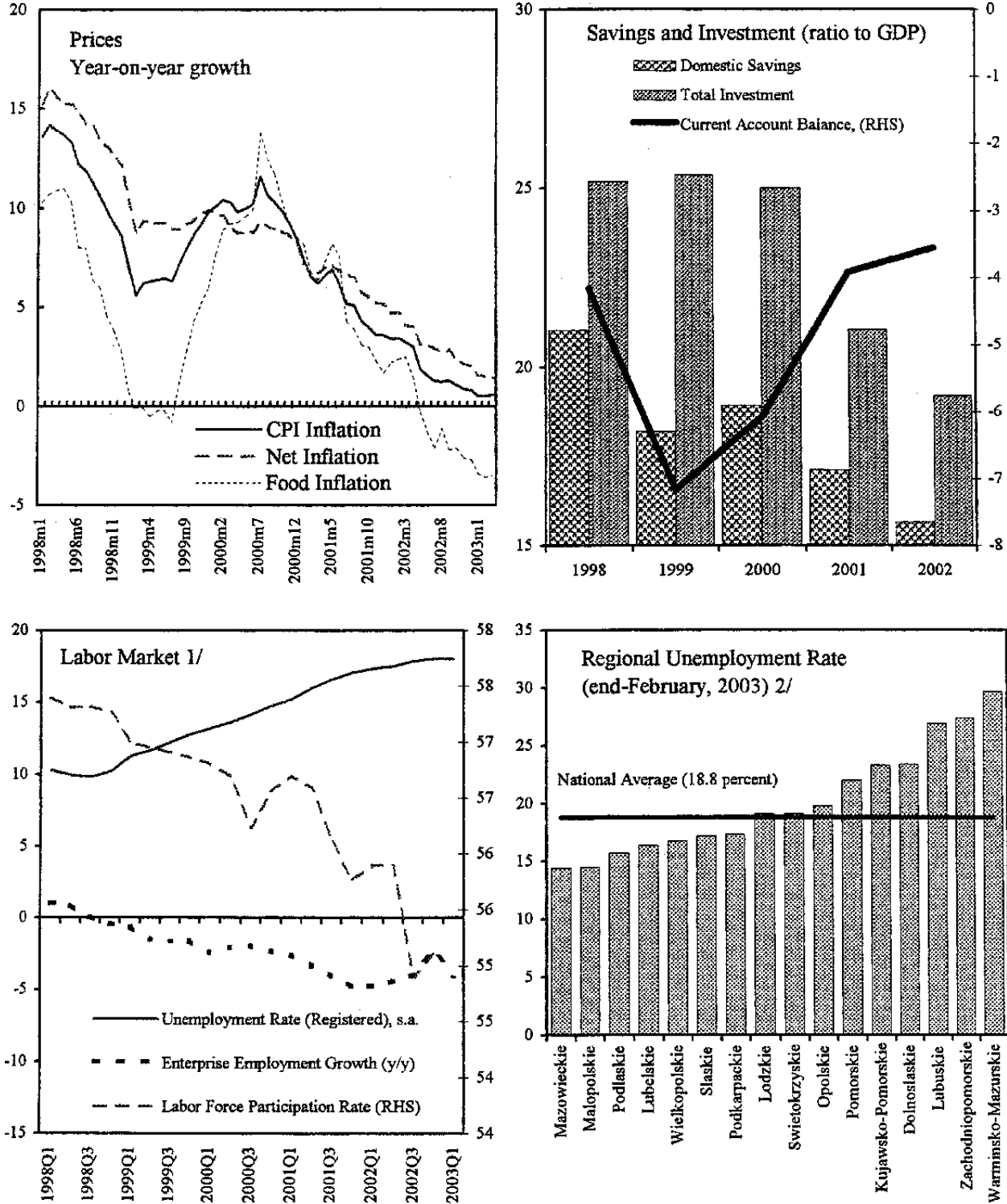
^{1/} General government overall balance on a cash basis including payments in compensation for insufficient indexation in the 1990s.

Figure 1. Poland: Activity and Demand, 1998-2003
(Year-on-year real growth, in percent)



Sources: Polish authorities and staff calculations.

Figure 2. Poland: Indicators of Economic Slack, 1998-2003
(In percent)

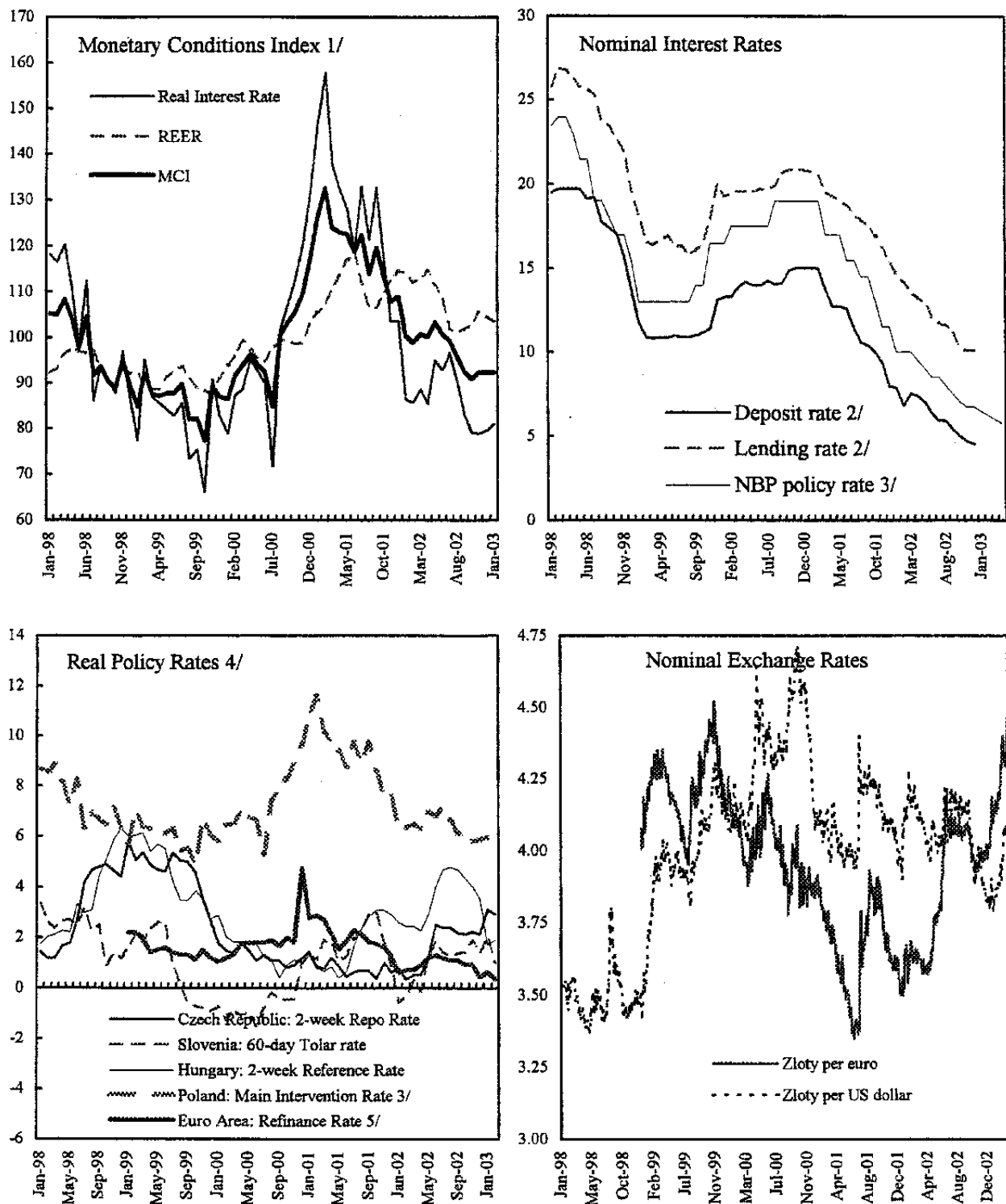


Sources: Polish authorities, Labor Force Survey, and staff calculations.

1/ The quarterly Labor Force Survey was not undertaken in Q2 and Q3 of 1999.

2/ The Mazowieckie region encompasses Warsaw.

Figure 3. Poland: Indicators of Monetary Policy, 1998-2003
(In percent, except where indicated)



Sources: Polish and other country authorities, International Finance Statistics, and staff estimates.

1/ The real interest rate and the REER have weights of 50 percent; Jan 1998-Oct 2002 = 100.

2/ Since end-March 2002, rates reflect revisions of monetary accounts.

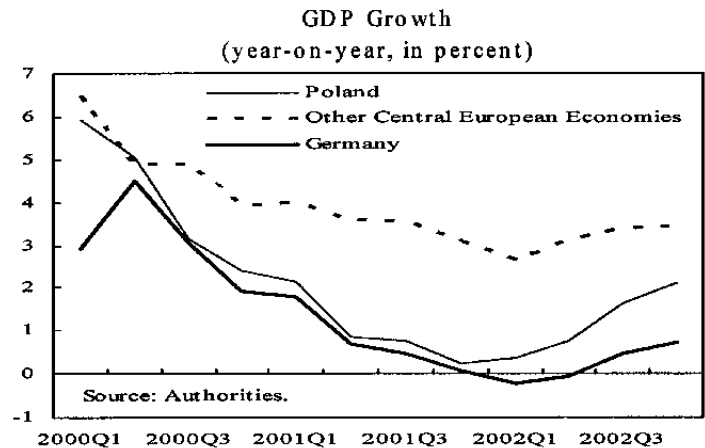
3/ 28-day intervention rate through end-2002; 14-day intervention rate thereafter.

4/ Policy rates deflated by the percentage change in CPI over the previous 12 months.

5/ ECB fixed rate until July 2000; minimum bid rate thereafter.

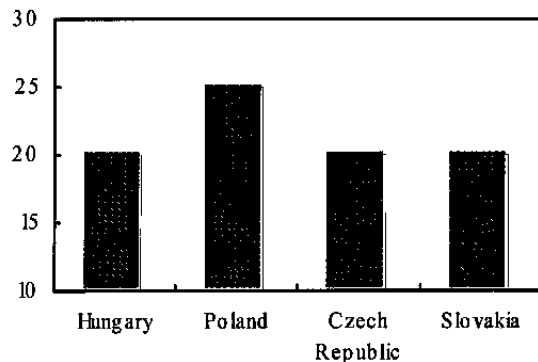
and contribution base while expenditures—most significantly, transfers to households and public sector wages—could not be reduced commensurately with lower-than-expected inflation. Thus, the structural fiscal deficit rose slightly to 4.9 percent of GDP, the actual deficit widened from 5½ to over 6½ percent of GDP, and public debt rose sharply.

5. **The origins of the weakness in economic activity in 2000–01 were complex, and a robust recovery will await corrections on several fronts.** Global cyclical influences do not tell the whole story. That the slowdown was substantially more severe than in Poland's relatively more open transition neighbors points to the importance of other influences.



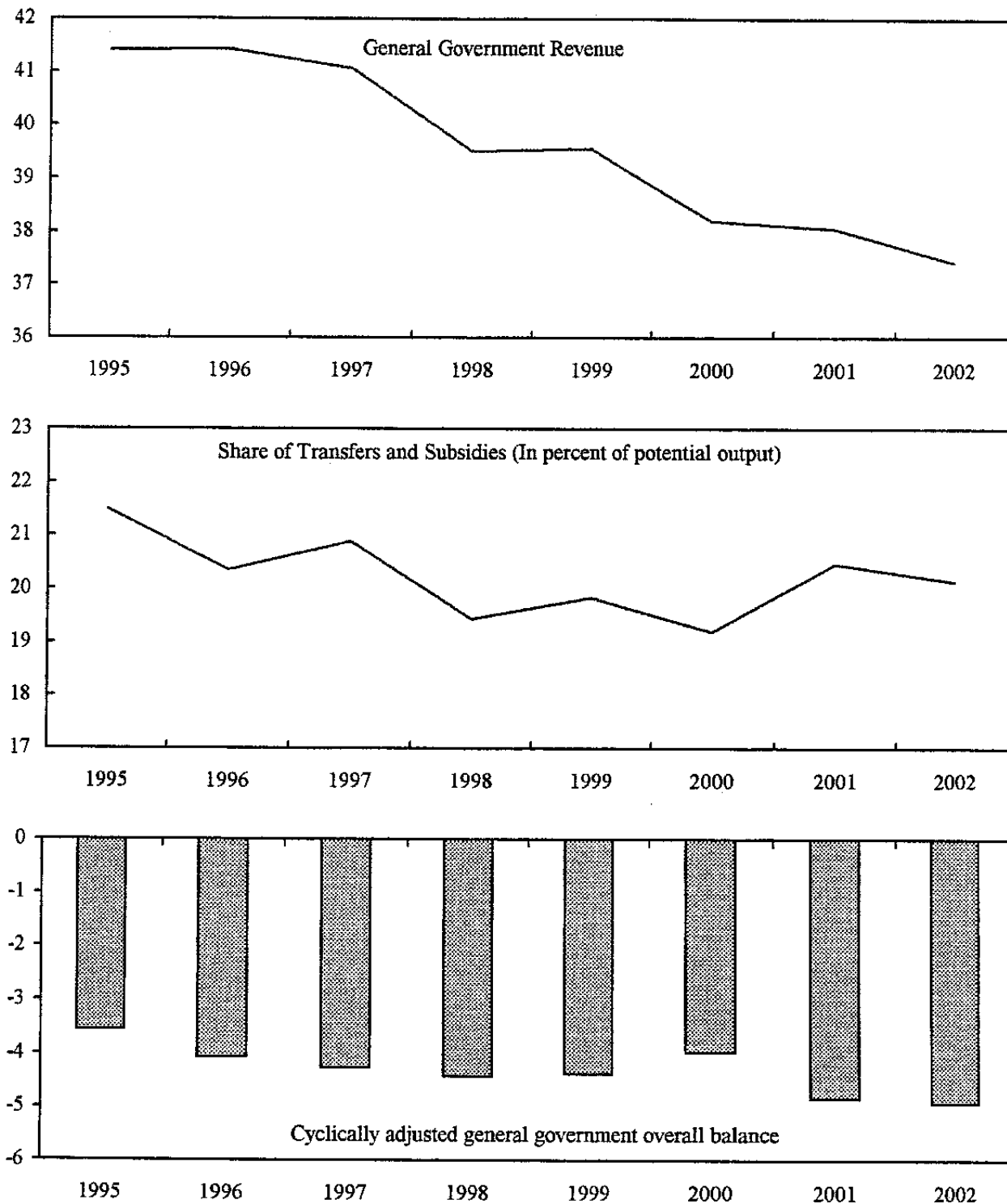
- **At the heart of the slowdown was a long slide in investment growth as the torrid pace of early-transition investment cooled.** Combined with restructuring after the Russia crisis, this slide contributed to a radical shift from employment creation to employment destruction. External cyclical influences and the severe tightening of monetary policy in 2000 played a role, but with an investment overhang also likely to have been a factor, the recovery could be slow.
- **The fiscal-monetary policy mix remains a problem.** Efforts since the mid-1990s to address excessive spending, especially on social transfers, have met strong political resistance. Moreover, revenue reductions largely absorbed the limited success in curtailment and better targeting spending (Figure 4). As the structural deficit and public debt climbed, monetary policy was left to curb current account and inflation pressures, producing a policy mix that put pressure on interest rates and the exchange rate. More recently, even as monetary policy has eased, the risk of a tightening if fiscal adjustment is delayed creates market uncertainty.
- **Privatization largely ground to a halt in 2002, and progress was slow in redressing the problems of state enterprises where privatization prospects are remote.** Subsidies continue to burden the budget, and low

Share of GDP Produced in the Public Sector, 2001 (Percent)



Source: EBRD's Transition Report, 2002.

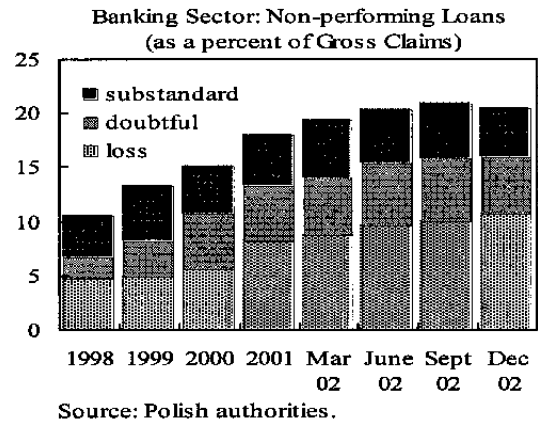
Figure 4. Poland: Fiscal Indicators, 1995-2002
(In percent of GDP, except where indicated)



Sources: Polish authorities and staff calculations.

productivity in public enterprises weighs on growth. The share of GDP produced by the public sector remains above that in other advanced transition economies.

- **The banking system, which is well supervised and largely foreign-owned, was strained by the slowdown.** Bank profits dropped as nonperforming loans rose, the value of banks' equity holdings fell, and lending decelerated. While the drop in profitability is probably largely cyclical, at least the early stages of the recovery will be affected by banks' reluctance to lend, particularly to small and medium-sized enterprises.



6. **Political uncertainties also cloud the situation.** Falling popularity of the government and the recent breakup of the coalition have created a difficult environment for structural reform and legislative changes needed for EU entry. The President and Prime Minister have called for a general election, originally scheduled for late-2005, in June 2004; speculation about an earlier date is rife. Relations between the NBP and the government remained strained, owing to a new conflict about use of the revaluation reserve of the NBP. The need to reconstitute the MPC in early 2004, when the terms of all current members (excluding the President) expire, adds to the uncertainty.

7. **Notwithstanding these weaknesses, the economy enters this upturn with distinct strengths.** EU accession opens an era of policy coordination with Europe through potentially powerful channels for speeding income convergence. This, and modest external indebtedness, prompted declining spreads and an upgrade in Moody's ratings of external debt to A2 in November 2002 (Table 6). The structural revamping of private industry after the Russia crisis, when firms had to cut costs and turn to Western markets, left it leaner and more competitive. Slowing domestic demand reinforced these tendencies. Wages proved responsive to developments in the labor market (although continuing high unemployment may require an even stronger response), while the zloty depreciation in 2002 further bolstered export profitability (Figure 5). Reforms to the labor code introduced since mid-2002 should stimulate labor demand once the recovery takes hold. And inflation expectations have been tamed. With a moderate current account deficit and a floating exchange rate, these developments have diminished important sources of vulnerability.

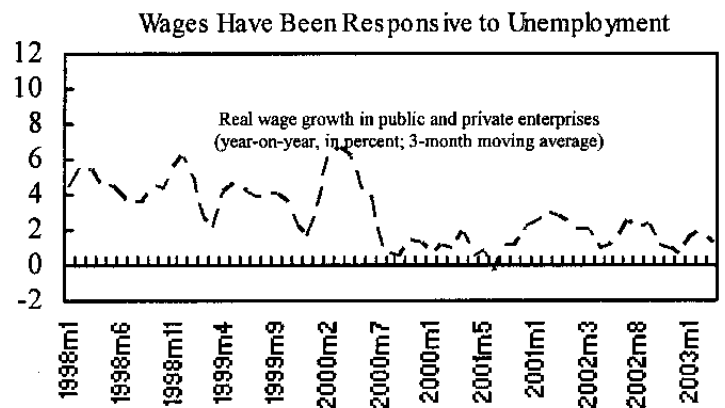
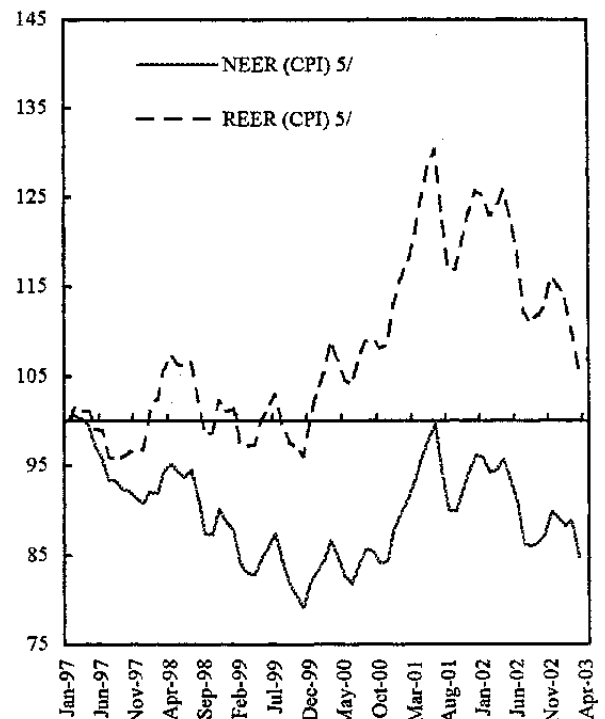
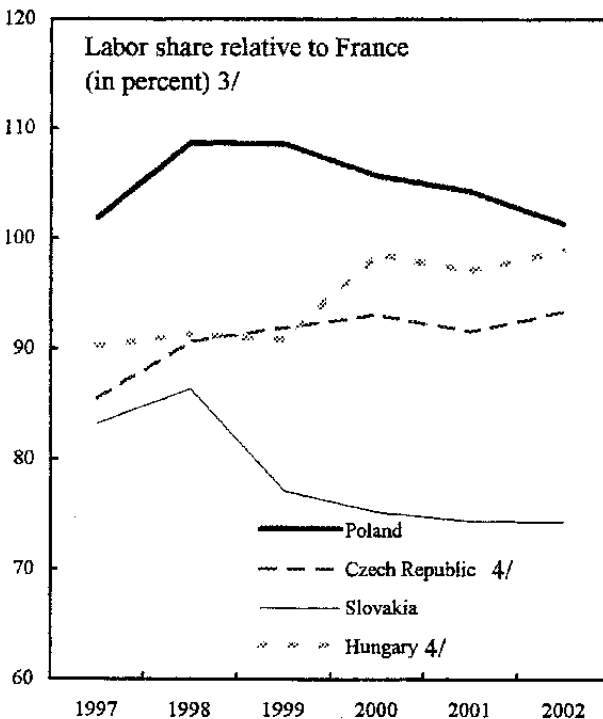
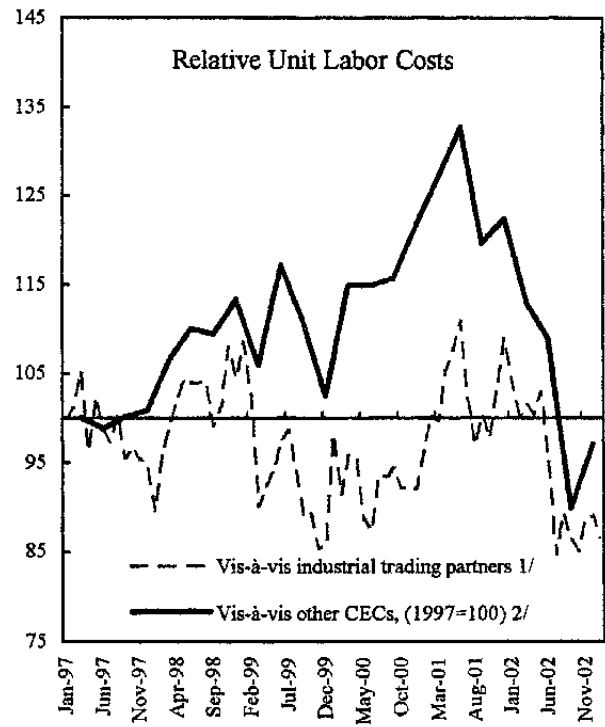
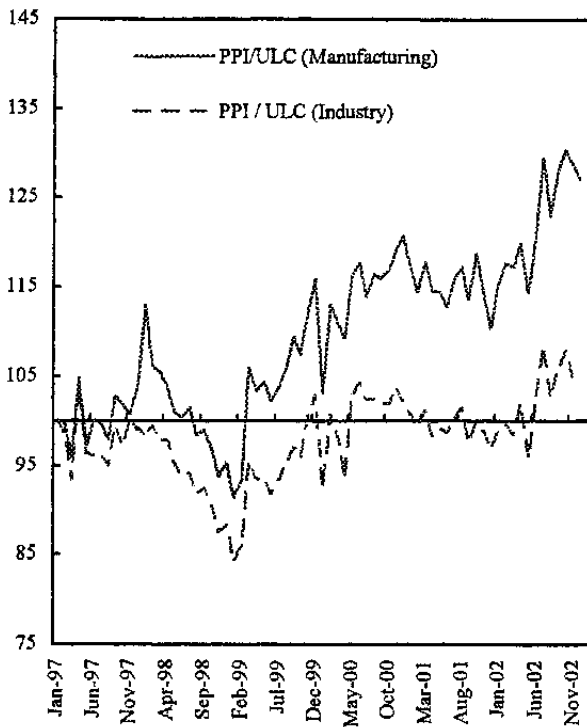


Figure 5. Poland: Indicators of Wage Costs, Profits and Competitiveness, 1997-2003
(January 1997=100, unless otherwise indicated)



Sources: Polish authorities, Information Notice System, OECD Analytical database, and staff calculations.

1/ Trade weights for 1999 for Austria, Belgium, Denmark, Finland, France, Germany, Italy, Japan, Netherlands, Norway, Spain, Sweden, Switzerland, United Kingdom, and United States.

2/ US dollar ULC in Poland relative to US dollar ULC in Hungary, Czech Republic, and Slovakia, weighted by share of average exports of goods and services in 1995 and 1996.

3/ Wage bill per employee in the manufacturing sector as ratio to value added per employee, relative to the same ratio in France. A higher ratio implies less favorable profitability, other things being equal.

4/ Using IMF staff estimates for total employment.

5/ NEER and REER data for February and March 2003 are approximated by a basket of euro (60 percent) and dollar (40 percent) against the zloty.

II. REPORT ON THE DISCUSSIONS

8. **Discussions focused on policies to build on the nascent recovery and return to a path of high growth.** Fiscal and structural reforms, policies to prevent an undue increase in inflation, and plans for euro adoption were the main issues.

9. **The authorities were optimistic about growth prospects and reaffirmed their commitment to fiscal adjustment and structural reform.** They noted, however, that after several failed attempts to introduce substantive fiscal reforms and with the recent split in the majority coalition, the political challenges were daunting. Renewed efforts would be based on a cooperative approach drawing all segments of the government into the process. They were concerned about falling investment and rising unemployment, but believed that the cyclical recovery, structural reforms, and positive effects of EU accession would improve the situation. They were confident about the soundness of the banking system, despite the weakening of banks' performance during the past two years.

10. **The authorities intend to enter ERM2 and adopt the euro on the most compressed schedule possible.** They concurred with ongoing staff analysis indicating that Poland meets optimum currency area criteria (synchronization of business cycles and economic integration) by the standards of many existing euro-area members. The Ministry of Finance (MoF) and NBP agreed that adopting the euro would bring substantial benefits and plans for early adoption would help mobilize support for needed fiscal adjustment—the most challenging Maastricht criterion for Poland. They therefore aimed to meet the Maastricht criteria by 2006 so as to be able to adopt the euro in 2007. Dissent, even within the government, would make the timetable a challenge. The authorities were eager for clarification of some aspects of ERM2 and the Maastricht criteria: most importantly, whether the exchange rate would need to remain within wide or narrow bands for two years prior to euro adoption and the definition of the deficit against which the fiscal criterion would be measured.

A. Economic Outlook

11. **Near-term, the recovery is likely to remain gradual and fragile.** Strengthening corporate profits, diminishing excess capacity, and a recovery in Western Europe will boost investment, but with no signs yet of a decisive turnaround, timing is highly uncertain. Staff expected that private consumption would decelerate slightly in 2003 as the effects of the 2001 fiscal stimulus wore off, unemployment rose, wage growth remained slow and the terms of trade weakened (Tables 1 and 4). Export growth was likely to fuel the recovery, although external factors—German growth in particular—would be critical. Thus, staff saw growth rising to 2.6 percent in 2003 (in line with consensus) and to 4 percent in 2004. The authorities broadly agreed with this assessment, although, expecting an earlier rebound in investment, felt the budget forecasts for GDP growth of 3½ percent in 2003 and 4.9 percent in 2004 were still feasible.

12. **Pressures on inflation and the current account should remain subdued.** The output gap, which staff estimates at 2.6 percent of potential output in 2002, will widen through 2004.

Even with some drop in unemployment in 2004, labor market conditions should constrain wage growth. Staff therefore concurred with the authorities that inflation would be below 2 percent in 2003 and, even with some easing of interest rates, remain well within the target range of 1.5–3.5 percent in 2004. Although imports will rise when investment recovers, strong export growth should keep the current account deficit at about 4 percent of GDP through 2004.

13. For the medium term, assuming the initiation of structural fiscal reforms and some further easing of interest rates, prospects for growth are good. Estimates of the capital stock and trend productivity suggest that with a cyclical increase in employment, output growth should rebound to 5–5½ percent as the output gap closes during 2005–08, before falling to potential of 4¼ percent (Table 5). The scenario underlying the new medium-term fiscal program of the MoF was more optimistic. Envisaging stronger investment growth than in the staff scenario, it sees growth rising to 5½–6 percent by 2005–06. Taking into account the large fiscal adjustments needed, staff saw this as feasible only with decisive structural reform through privatization, improving the functioning of labor markets and incentives to work, and strengthening fiscal expenditure and tax frameworks. Moreover, staff emphasized that without improvements to the policy mix, growth prospects could be significantly worse than envisaged in its own scenario. Staff and the authorities agreed that increases in public savings were essential for containing current account pressures and crowding in private investment, including FDI. External and public debt dynamics remain manageable under most stress tests, but in some public debt would exceed the constitutional limit of 60 percent of GDP (Tables 7 and 8).

B. Fiscal Policy

14. The authorities explained that several broad objectives drove their plans for fiscal adjustment. Recent increases in the general government deficit needed to be reversed immediately to avoid exceeding the constitutional limit on the debt ratio within the next few years.¹ Also needed was an improvement in the structure of taxes, which, with high rates and numerous and generous exemptions, was a drag on growth, savings and investment. The authorities pointed to the problem of unduly high social transfers and expressed their frustration with the automaticity of pervasive formula-driven adjustments that prevented needed discretionary changes. Moreover, because adjustments related to projected inflation were corrected only for underprojections but not for overprojections of inflation, the system imparted an upward bias to expenditures, particularly during disinflation. The authorities noted that fiscal adjustment consistent with these objectives was essential for meeting the Maastricht criteria and restructuring fiscal priorities to ensure adequate funds for co-payments to realize EU grants.

¹ The constitution limits public debt to 60 percent of GDP. The Public Finance Act defines corrective actions (including on new guarantees) once debt exceeds 50 percent of GDP.

15. **Staff strongly supported these objectives.** In its view, macroeconomic and refinancing risk from the large fiscal deficit (discussed in the accompanying selected issues paper) required immediate adjustment. Agreeing strongly that reductions in social spending should be the nub of adjustment efforts, staff also noted that too-generous social benefits created disincentives for work and employment as well as distortions in spending decisions. Staff noted that if early euro adoption is pursued, structural expenditure reform should be sufficient to ensure deficits low enough to offset the substantially easier monetary conditions of the euro area and allow room for automatic stabilizers to work after adopting the euro. With respect to revenues, staff urged that alongside tax reform, tax administration should be strengthened and made more transparent. Staff welcomed improvements in debt management and the authorities' intention to include collective action clauses in its international bonds fully by next year.

16. **The 2003 budget should produce a slight tightening of fiscal policy although it does not include initiatives to cut future structural spending.** The budget, which reportedly hastened the resignation of the previous finance minister when it did not conform to his target of constraining expenditure growth to the increase in the projected CPI plus one percent, was designed to reduce the general government deficit relative to GDP by about

Fiscal Outlook 2003						
	2002 Staff Estimate		2003 Budget		2003 Staff Projection	
	Zl billion	Percent of GDP	Zl billion	Percent of GDP	Zl billion	Percent of GDP
Revenue	143.9	18.7	155.7	19.1	152.5	19.0
Expenditure	183.0	23.8	194.4	23.9	191.3	23.9
Noninterest	158.9	20.7	167.3	20.6	166.0	20.7
Balance	-39.1	-5.1	-38.7	-4.8	-38.7	-4.8
General government						
Balance 1/	-51.3	-6.7	-51.6	-6.3	-55.6	-6.9
Structural balance	-39.1	-4.9	...	...	-38.6	-4.6
Privatization receipts	2.0	0.3	7.4	0.9	5.0	0.6
Average inflation (in percent)	1.9	...	2.3	...	1.1	...
Real GDP growth	1.3	...	3.5	...	2.6	...

Sources: Polish authorities; and staff calculations.

1/ General government overall balance on a cash basis including payments in compensation for insufficient indexation in the 1990s.

½ percentage point. With nominal GDP likely to be well below budget projections, revenues and contributions will be short of target for the second year running. The authorities indicated that the expected revenue shortfall of the state budget will be offset with expenditure cuts, although staff projected larger shortfalls for the social security funds that could probably not be offset. Thus, staff projected a general government cash deficit of 6.9 percent of GDP, compared to the official estimate of 6.3 percent. With a sizable shortfall expected in privatization receipts, public debt would rise to about 52 percent of GDP. Staff regretted the absence of structural expenditure reforms to ensure adjustment over the medium term, but the authorities insisted that the budget could not have been any more ambitious in the political environment.

17. **For the medium term, the Minister of Finance recently proposed a public finance reform program intended to meet the government's fiscal objectives.** The program defines

a fiscal path that would keep public debt below 55 percent of GDP; reduce general government net borrowing below 3 percent of GDP (on the government's interpretation of ESA95 including second-pillar pension funds in the general government) by 2006; and provide for net EU-related spending (which staff estimates at ½-1 percent of GDP per year during 2004-06). It specifies measures that, with the authorities' optimistic growth projections, would go halfway toward achieving these targets. The gap between the targeted and projected deficit is about 1 percent of GDP a year over 2004-2006. For 2004, it is proposed that transfers from the revaluation reserve account of the NBP close the gap. Revenues measures, excluding tax expenditure reductions, are broadly revenue-neutral and geared toward improving supply-side conditions: PIT and CIT rates would be lowered, a 20 percent capital gains tax established, VAT rates and excise duties harmonized, and EU-related tax administration reforms introduced. Elimination of many rebates and exemptions would reduce tax expenditures. The design of expenditure reforms had been constrained by legal and political problems in previous attempts to curb social transfers. Thus, instead of specific reforms recommended by previous Fund technical assistance and the World Bank PEIR, they proposed eliminating many rule-based adjustments to entitlements and wages ("de-indexing") and many revenue earmarking practices. Temporary nominal freezes on selected expenditures could then be imposed to correct substantial unintended real increases of the past two years. Some extrabudgetary funds and special accounts of ministries would be eliminated to enhance transparency and efficiency. Reforms of health care, education and research financing were envisaged, but not specified.

18. Staff welcomed key parts of the program, but projected larger gaps than the authorities. Staff agreed that the proposed tax measures would eliminate distortions, reduce untargeted and inefficient tax expenditures and subsidies, and facilitate tax administration. Staff also thought that "de-indexation" would permit

Fiscal Adjustment Program					
	2002	2003	2004	2005	2006
	Staff Est.	Proj.	Proj.	Proj.	Proj.
(In percent of GDP, unless otherwise specified)					
MoF program 1/					
Gen. govt. balance (GFS) 2/ 3/	-6.7	-6.3	-5.7	-5.4	-5.1
Gen. govt. net borrowing (ESA95) 4/	-4.0	-4.1	-3.8	-3.4	-2.9
Structural balance (GFS) 5/	-4.9	-4.7	-3.9	-4.1	-4.3
Public debt	47.6	51.2	52.6	53.0	52.7
Real GDP growth (in percent)	1.3	3.5	4.9	5.4	6.0
Staff projections based on MoF program 6/					
Gen. govt. balance (GFS) 3/	-6.7	-6.9	-6.1	-5.9	-5.6
Gen. govt. net borrowing (ESA95) 4/	-4.0	-4.2	-3.9	-3.8	-3.5
Structural balance (GFS)	-4.9	-4.6	-3.9	-4.1	-4.3
Public debt 7/	47.6	52.0	55.1	56.5	58.0
Real GDP growth (in percent)	1.3	2.6	4.1	5.3	5.3
Staff projections of fiscal path needed to keep public debt below 55 percent of GDP 8/					
Gen. govt. balance (GFS) 3/	-6.7	-6.9	-6.1	-5.4	-4.7
Gen. govt. net borrowing (ESA95) 2/	-4.0	-4.2	-3.9	-3.3	-2.7
Structural balance (GFS)	-4.9	-4.6	-3.9	-3.7	-3.4
Public debt	47.6	52.0	54.6	54.6	54.7
Real GDP growth (in percent)	1.3	2.6	4.1	5.3	5.3

Sources: MoF, and staff projections.

1/ Based on the MoF assumptions on GDP growth. Assumes that measures which have not yet been identified will be implemented in time to produce the planned savings in 2004-06.

2/ Staff estimates based on information provided by the authorities.

3/ General government overall balance on a cash basis including payments in compensation for insufficient indexation in the 1990s.

4/ With second-pillar pension funds included in general government.

5/ Based on staff potential output estimates and MoF nominal expenditure pattern.

6/ Based on staff macroeconomic framework, but assuming structural adjustment implied by MoF program proposals, including those measures that are to be identified for 2004-06.

7/ In line with authorities' plans, privatization receipts are assumed to be Zl 22 billion over 2004-06.

8/ The fiscal path advocated by staff also assumes an acceleration of privatization so that privatization receipts are assumed to be Zl 34 billion over 2004-06.

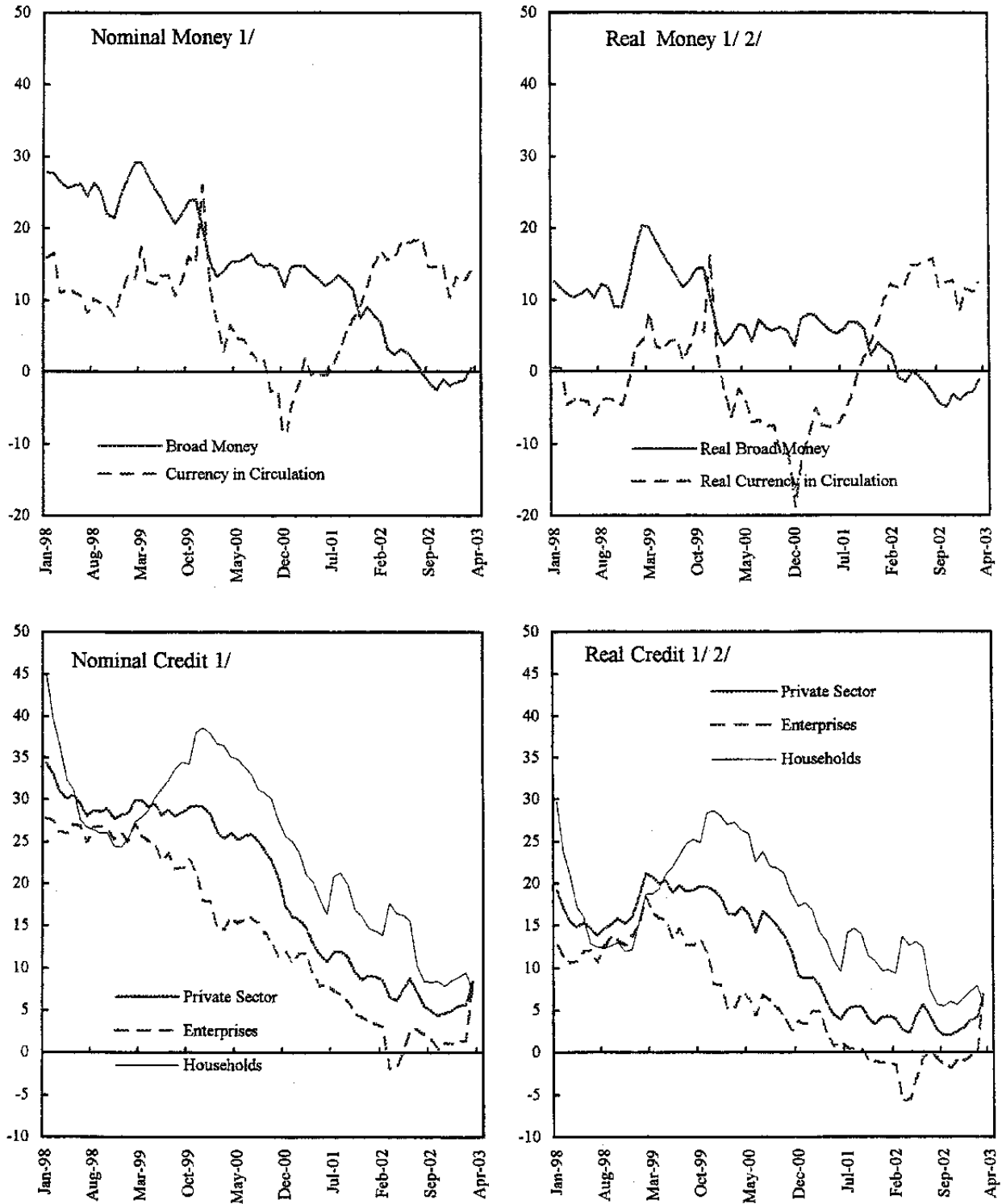
needed discretionary spending adjustments, but was less sure that wage and entitlement freezes could be sustained, even with low inflation. Staff calculated, however, that using its more cautious growth assumptions the program measures would achieve only about one-third of the adjustment needed to stabilize the public debt ratio below 55 percent of GDP by 2006. And if Eurostat decided against including second-pillar pension funds in the general government, even stronger measures would be needed to meet the Maastricht deficit criterion by 2006. Apart from any benefits for debt service costs, staff viewed the proposed transfer from the NBP as little more than window-dressing; in any event, it would go below the line in ESA95. Staff therefore pressed for reforms to pension and social benefits—including, equalization and increases of mandatory retirement ages for men and women, tightening eligibility for disability pensions, reforms to farmer pensions and support programs, and reductions in subsidies and public employment—that would institutionalize medium-term adjustment. The authorities pointed out that political pressures to water down the program even in its present form were strong.

C. Monetary Policy

19. **The MPC considered that monetary policy over the past year had successfully reduced inflation expectations.** They saw the gradual interest rate cuts in 2002 as suitable given the uncertainty about growth, food prices, and the impact of earlier cuts. An unexpected drop in food prices—a temporary shock which had not warranted additional easing—had been a major factor in the undershooting of the 2002 inflation target. Although the NBP did not deny that high interest rates in late 2000 had contributed to the slowdown, they did not believe that faster monetary easing in 2002 would have improved growth prospects, which were constrained by the external environment and overinvestment in the 1990s. They viewed the monetary stance as having been supportive, especially taking into account the depreciation. Staff agreed that given uncertainties about the effects in the pipeline of past interest rate cuts, the cautious approach in 2002 had been appropriate.

20. **The MPC saw room for further gradual interest rate cuts.** Interest rate decisions would be guided by inflation prospects for 2004, which appeared benign. Some upward pressure could be expected as food prices stabilized and the recent depreciation and oil price increase fed through. But as the NBP projected growth of about 2½ percent in 2003 and little improvement in the unemployment rate, wage increases should remain low. Broad money was declining and credit growth remained historically weak (Figure 6). NBP staff did not see scope for deflation, particularly in view of the depreciation of the zloty. A major concern for the outlook was fiscal policy. While welcoming the reforms in the government's fiscal package, the MPC considered that the program did not go far enough to forestall crowding out and current account pressures as the economy recovered. Taking these considerations together, the MPC expected to continue its policy of small interest rate cuts as needed, and, since the mission, has cut the policy rate twice by a total of 50 basis points. Particularly because of uncertainties about the effects still in the pipeline of large interest rate cuts, staff supported this approach. It encouraged the MPC to avoid excessive caution in assessing inflation pressures and to be responsive to credible improvements in fiscal policy.

Figure 6. Poland: Indicators of Money and Credit, 1998-2003
(Year-on-year growth, in percent)



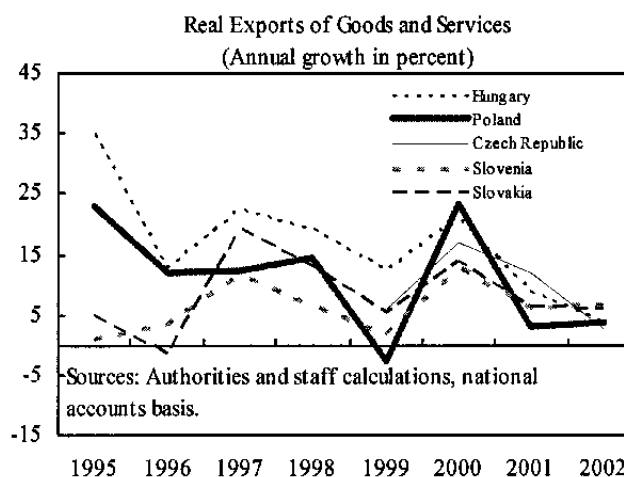
Source: Polish authorities.

1/ Data for June 2000 are corrected for the effect of a privatization bid.

2/ Deflated using CPI excluding food and fuel.

21. **The MPC pointed out that the task of monetary policy had shifted from reducing to stabilizing inflation.** They thought the anti-inflation record of the MPC would help this process. The newly announced medium-term monetary policy strategy, which will guide decisions in 2003 but will not be binding for the new MPC, targets inflation of 2.5 percent from 2004 onwards. Staff questioned whether the target was too low given that Balassa-Samuelson effects are estimated at 1–2 percent. The MPC insisted that the target would be consistent with the Maastricht inflation criterion. Staff welcomed the introduction of a continuous inflation target, but wondered if a wider band than ± 1 percent would be appropriate in light of the significant supply shocks to which Poland was prone. The authorities thought that the range was adequate and widening it would reduce the credibility of the MPC and the inflation target. Staff also questioned the MPC's decision to lower the end-year inflation target (from 5 percent to 3 percent) in June 2002 when it became obvious that inflation would substantially undershoot the target. The MPC defended the change as solidifying market expectations of disinflation. They saw room, however, to improve the strategy for communicating with the public when the inflation target is missed.

22. **The government and NBP were satisfied with the recent depreciation of the zloty.** They saw it as the result of falling zloty interest rates and the weakening of the dollar (with which the zloty had moved closely). The turmoil in the Hungarian market in January had also contributed. The authorities believed that the current level of the zloty was conducive to long-term growth. Relative unit labor costs and indicators of export profitability had returned to the levels of the high export growth period of 1997–98



(Figure 5). While welcoming this improvement, staff noted that export growth had been weaker than in other CECs since 2001 and felt it would be necessary to see sustained stronger export performance before concluding that current competitiveness was appropriate for the medium term. The NBP and staff agreed that improving the macroeconomic policy mix would be crucial to avoiding undue appreciation of the zloty.

23. **The MPC intends to continue the policy of nonintervention in foreign exchange markets.** They considered that a pure float was the best exchange arrangement for inflation targeting and helped protect Poland from external vulnerabilities. They believed that the current level of foreign exchange reserves was appropriate relative to imports and external debt. Staff supported the nonintervention strategy, pointing to well-established market understanding of the policy and its promotion of adequate hedging. The high level of international reserves was probably a strength with ERM2 on the horizon.

24. **In line with the objective of early adoption of the euro, the current plan is to enter ERM2 soon after EU accession.** While accepting ERM2 as an essential step in adopting the euro, the authorities saw risks in an exchange rate band if it needed to be sustained for longer than the minimum two-year period. In the authorities' view, critical questions about ERM2 concern the choice of a central parity, the fluctuation band, and the monetary framework during ERM2. Both the NBP and MoF expected that the central parity would be set close to the market rate just prior to ERM2 entry. They shared staff's concern that a significant appreciation before establishing parity would risk setting an overvalued rate. On the monetary strategy during ERM2, the MPC saw a continuation of inflation targeting as desirable and feasible: some of the existing euro-area members had successfully inflation-targeted during ERM, and fluctuations in the value of the zloty in the past two years have not exceeded ± 15 percent of the average rate.

25. **The NBP and the MoF have discussed whether part of the revaluation reserve of the NBP could be transferred to the budget.** The recent fiscal package envisages transfer of at least a third of the account, which carries unrealized gains on foreign exchange reserves of some $3\frac{1}{2}$ percent of GDP, to cover expenditure of EU accession—a proposal the NBP has firmly resisted. Staff saw value in a transfer only if it improved the management of public assets and liabilities, including those of the NBP, but none if it merely reduced government debt issue and delayed fiscal adjustment. Drawing on international best practices, staff pointed to a number of issues—appropriate capitalization and foreign exchange reserve holdings of the NBP, details of NBP accounting procedures, and the scope for and cost of sterilization operations—that would have to be addressed before any decision is made. Staff stressed that preserving the ability of the NBP to conduct monetary policy independently should be paramount in any decision.

D. Financial Sector Risk and Vulnerability

26. **Despite a difficult 2002, the authorities believed that the current and prospective state of the banking system was sound.** They noted that the overinvestment of the late-1990s and the subsequent slowdown of growth had led to an increase in classified bank loans since 1999. They emphasized, however, that Poland's unusually rigorous loan classification system—loans are put in a doubt category when the sector to which the loan is made weakens—put developments in the worst light possible. They also provided assurances that nonperforming loans are fully provisioned and collateral valuation is conservative. Nevertheless, the deteriorating financial situation was reflected in a decline in banks' return on assets to 0.5 percent from about 1 percent in 2001. Banks had responded by cutting employment, increasing provisions, and restricting credit. Despite losses incurred by some banks, the authorities believed that the overall stability of banks was not at risk owing to high capital adequacy and financial support from strategic owners. They also pointed to one-off factors—specifically the bankruptcy of the Szczecin Shipyard—that contributed to the rise in classified loans in 2002. The leveling off in the last quarter of 2002 was both expected and encouraging.

27. **Staff agreed that banks' response to the difficult financial situation had been appropriate.** However, staff thought the loan quality deterioration was not over. The increase in bank credit last year was almost entirely in foreign-currency loans to households, which were likely to continue to deteriorate faster than the overall portfolio, particularly given the recent large zloty depreciation, without a strong rebound in income growth.

Indicators of Soundness of the Banking System					
	1998	1999	2000	2001	2002 1/
ROA 2/	0.7	0.9	1.1	1.0	0.9
ROE 3/	9.2	12.9	14.5	12.8	9.9
Risk-based capital ratio 4/ 5/	11.7	13.2	12.9	15.1	14.5
NPL ratio 5/ 6/	10.5	13.3	15.0	17.9	20.5
Of which: loss 5/ 6/	4.7	4.8	5.5	8.2	10.7

Staff welcomed the development of a credit information database, following the recommendation of the 2001 FSAP. Overall, staff thought that pressures on banks' earnings were likely to

Source: National Bank of Poland.

1/ As of June 2002.

2/ Net earnings as percent of average total assets for commercial banks.

3/ Net earnings as percent of average core capital for commercial banks.

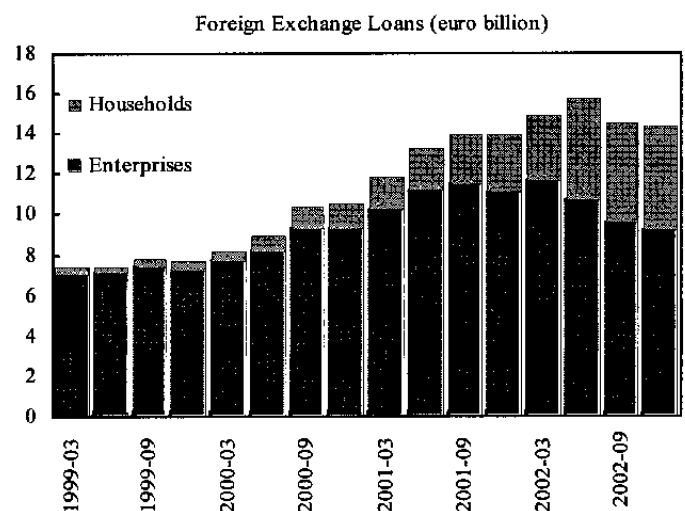
4/ Average for all commercial banks.

5/ Values for 2002 are as of end-2002.

6/ Ratio of irregular claims to gross claims on non-financial customers for the banking sector.

remain strong in 2003. The authorities agreed that weak economic growth could produce poor financial results and a further shift in bank assets from credit to government securities. However, they thought it more likely that weak banks would be recapitalized and the recovery would reinvigorate credit growth. They were concerned about banks whose foreign owners faced financial difficulties, which could lower the likelihood of Polish subsidiaries receiving financial assistance from them in case of need. The authorities pointed to challenges associated with EU accession, when possible cross-border offers and new foreign bank branches in Poland could stiffen bank competition and put pressure on margins.

28. **The rapid increase in foreign exchange-denominated credit since mid-2000 reversed in late-2002.** The authorities observed that the recent depreciation of the zloty against the euro and the narrowing spreads between zloty and foreign interest rates had reduced foreign currency borrowing. Staff questioned whether the decline in foreign currency loans might prove transitory if expectations of zloty appreciation strengthen. Since the last Article IV consultation when credit risk associated with foreign exchange-denominated lending had been discussed extensively, the NBP had formed a unit to monitor this and other external vulnerabilities.



Source: Polish authorities.

E. Structural Policies

29. **The authorities planned to speed up privatization and enterprise restructuring, which had largely stalled in 2001–02.** Privatization startups in 2002 were the lowest since the early-1990s, and receipts, at 0.3 percent of GDP, were well below target. The authorities argued that the slowdown partly reflected delays as they screened projects initiated by the previous government and their preference for the “restructure-first, privatize-later” approach. They expected to speed up privatization, eliminate government’s share in about 200 enterprises in 2003 and raise about 20 billion zloty in privatization revenue over 2003–05. But the privatization process should aim at maximizing receipts and minimizing social consequences of restructuring and downsizing, rather than meeting arbitrary deadlines. Staff welcomed the intentions to pursue privatization more forcefully. Staff noted reports of frictions between government agencies or with foreign investors that could detract from Poland’s position as a good location for foreign investment and urged their early resolution. Staff cautioned against restructuring nonviable enterprises, where cost efficiency was unlikely to be achieved and recommended their liquidation. The authorities thought that some restructuring was unavoidable, especially when the future of entire sectors was at stake. In this spirit, they had introduced in late 2002 regional guarantee funds for small- and medium-sized enterprises and programs to restructure tax and contribution arrears of large, financially distressed enterprises. Results in their view had been good.

30. **The authorities were concerned about high and still-increasing unemployment.** They believed that cyclical developments, and perhaps rising grey market employment, had been important causes. The staff thought that structural factors, such as regulations inhibiting labor demand, skill mismatches, benefits that are relatively high compared to the minimum wage, and low labor mobility—aggravated by industry-specific shocks originating especially from the Russian crisis and the currency appreciation—had also played a role. Changes to the Labor Code introduced since mid-2002, aimed at lowering costs and easing restrictions on employers, had been an important response to these developments. Measures included liberalizing restrictions on lay-offs, working hours, and employment conditions, and differentiating the minimum wage for young first-time jobholders. Staff welcomed these changes and agreed that their effects should be particularly evident in a cyclical upturn.

31. **Nevertheless, because of the severity of the unemployment problem—the worst among OECD countries—staff urged consideration of action on other fronts, such as disincentives to work.** Reflecting analysis in the accompanying selected issues paper, staff questioned whether the large tax wedge and high benefits replacement rates, mainly after some individuals migrated from unemployment insurance to social assistance, demotivated job search and weakened downward pressure on wages. Staff suggested—consistent with OECD recommendations—consideration of an earned income credit to low-wage earners or the possibility of retaining social transfers temporarily after accepting a job. Scaling down social transfers was also an option. To support fiscal consolidation, such changes should be expenditure neutral. The staff also emphasized that job placement by employment agencies should be strengthened. The authorities thought negative incentives to work could be a

problem, but preferred to improve administration of social transfers before embarking on new schemes.

32. **EU accession should have a positive impact on trade.** The authorities expect harmonization of the tariff structure with the EU to reduce the average tariff, though by less on a trade-weighted basis. Exports to third countries should also grow, owing to favorable EU agreements with those countries. Adoption of EU non-tariff barriers, however, may increase the effective protection of some domestic producers.

33. **Restructuring of agriculture is crucial to improve resource allocation.** With about 22 percent of the labor force producing only 3 percent of GDP, productivity of agriculture is one-seventh of that in the rest of the economy. The authorities explained that the low profitability of farmers will be improved with the EU accession-related investments in infrastructure and support for product diversification. Agricultural producers have shown some discontent about low prices and income support, and the government had responded with more pro-active price support. Complaints had arisen about the average transfer from the EU, which, together with the topping up, will be up to 55 percent of the level received by an average EU farmer in 2004. The authorities acknowledged that serious structural problems in agriculture will need to be addressed to close the productivity gaps vis-à-vis the rest of the economy and Europe. To speed up restructuring, the authorities are planning programs to provide alternative jobs, credit guarantees, noninterest bearing loans, and training for people leaving farms. Staff emphasized that reforms to farmers' pension and support programs, especially to work toward actuarially fair social security contributions and lower subsidies, alongside general labor market reforms are key to attracting labor away from agriculture.

34. **2002 saw progress in fiscal transparency and combating bribery, money laundering and financing terrorism.** Many issues identified in the 2001 fiscal ROSC had been addressed over the last two years, particularly those related to improving the coverage and public availability of fiscal information and strengthening communication with financial markets.² Still, a number of areas identified by the 2001 ROSC require further progress: improving the periodicity and timeliness of fiscal data outside the state budget, harmonizing accounting standards across the general government, and developing a medium-term budget framework. New ministry-specific surveillance offices have enhanced monitoring of official bribery. Efforts to fight money laundering and terrorist financing had focused on enforcing regulations on tracking information on transactions in financial institutions.

III. STAFF APPRAISAL

35. **Turning a nascent recovery into durable growth will be a major challenge for Poland.** The upturn starts from a base of some distinct strengths. EU accession is on track for mid-2004, inflation expectations have been tamed, firms have become leaner and more

² These and other initiatives are discussed in the accompanying fiscal ROSC update.

competitive, and wages have responded to rising unemployment. But other ominous developments—weakness in Germany, a steep deceleration in investment, a high and rising unemployment rate, stalled privatization, and a doggedly high structural fiscal deficit born of excessive and poorly targeted social transfers and subsidies—threaten Poland's growth prospects and ultimately its standing among the advanced transition economies. With no power to influence the strength of the German recovery or the legacy of an investment overhang, Poland must act forcefully in the areas it can control if it is to deliver growth adequate to absorb a rising labor force, while closing the income gap with western Europe.

36. The strengthening cyclical position and imminent EU entry create a good environment for such actions. The authorities should waste no time in tackling the two key macroeconomic policy challenges: reigniting structural reform, particularly privatization, and undertaking structural expenditure reform so as to stabilize public debt and create room for significantly easier monetary policy. The goal of adopting the euro as soon as possible, beyond permitting timely realization of the substantial potential benefits, should be a constructive rallying point for these needed policy changes.

37. Recently-proposed fiscal reform, if enacted, would be a long-overdue first step toward budget consolidation. By reducing distortions in the tax system and improving the flexibility of budgeting, it would improve incentives for investment and employment, pave the way toward redressing the sizable, unintended real public sector wage and transfer increases during disinflation, and permit expenditure restructuring needed to absorb EU funds. Full political support for these reforms, which as yet is uncertain, is essential for the credibility of intentions to cut the structural deficit. Indeed, more extensive measures will be needed to ensure that public debt remains within constitutional limits and the Maastricht fiscal criterion is reached. Measures should focus on reforms to pensions and social benefits (including farmer pensions and support), reductions in subsidies, cuts in public employment, and widening the tax base while further improving tax administration. The scope for savings in these areas is ample for reaching Maastricht criteria while raising infrastructure investment.

38. Rejuvenating structural reform is at least as critical. The authorities' intention to push ahead with privatization is absolutely key in this respect. However, the recent replacement of the Minister of Treasury and reports of conflicting views within the government about privatization have raised doubts about this intention. Early steps in the form of concrete progress with specific projects would go a long way toward erasing these doubts. The authorities also need to be mindful of large costs associated with restructuring unviable enterprises; closures may create social tensions, but do alleviate pressures on the overstretched budget. Action on the unemployment problem, which will be challenging, should rather focus on improving the functioning of labor markets. Recent labor market reforms are an excellent step in this direction. While further efforts to root out remaining rigidities are needed, improving incentives to work, possibly even through in-work benefits, should also be considered. Similarly, agriculture reform, which has yet to be tackled, is key to raising efficiency and increasing growth. Reform of farm pensions would combine benefits for resource allocation with fiscal consolidation.

39. **Monetary policy, having won the hard fight against inflation, must now secure inflation in the target range.** The new medium-term monetary policy framework, continuing inflation targeting, and a floating exchange rate, are well suited to this task. The continuous inflation target of 2½ percent \pm 1 percent will anchor expectations, while the floating exchange rate—ideally with no direct intervention in the foreign exchange market—will remain a hallmark of Poland’s strategy for addressing risks associated with large and volatile capital flows. The strategy has been helped by the recent zloty depreciation, which brought a welcome improvement in competitiveness. However, with Balassa-Samuelson effects estimated at 1–2 percent, the inflation target is low and likely to result in renewed nominal appreciation. Improving the macroeconomic policy mix—tightening fiscal while easing monetary policy further—will be key to preventing appreciation from exceeding equilibrating amounts, a particularly important goal before the central parity for ERM2 is set. As the complete reconstitution of the MPC early next year could provoke volatility and speculation about changes in monetary policy, the authorities should take every opportunity to signal their commitment to low inflation.

40. **Operating monetary policy within this framework in 2003 will probably allow further easing.** A still-widening output gap and high unemployment should keep core inflation pressures subdued in 2003–04 even with some reduction in interest rates in the near term. Nevertheless, in light of the uncertainties about budgetary intentions and the impact of large cumulative interest rate reductions, a cautious strategy of small cuts seems desirable.

41. **It is regrettable that plans to improve the policy mix are being marred by unproductive tensions between the government and NBP** over the use of the NBP revaluation reserve. Consideration of this issue should be driven by careful consideration of optimal public debt management, the appropriate capitalization of the NBP and the level of foreign exchange holdings—not by budgetary exigencies. Any decision must ensure the unfettered ability of the NBP to conduct monetary policy.

42. **Banks weathered considerable strains last year and are likely to face a difficult financial situation in 2003.** Cyclical influences and the depreciation of the zloty contributed to a large increase in nonperforming loans and a drop in profitability. Banks responded appropriately by restructuring operations, increasing provisioning, and adopting more cautious lending practices. This caution will continue to constrain potential borrowers, especially small- and medium-sized firms, until a cyclical upturn improves bank asset quality. Nevertheless, with the share of housing loans, particularly those denominated in foreign currency, rising, high unemployment and the recent zloty depreciation may cause further deterioration in loan portfolios. More reassuring, however, is the drop in foreign currency-linked corporate borrowing, which should help contain banks’ credit risk.

43. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. Poland: Selected Economic Indicators, 1998-2003 1/
(In percent, except where indicated)

	1998	1999	2000	2001	2002 Est.	2003 Proj.
Activity and prices (growth rates)						
GDP	4.8	4.1	4.0	1.0	1.3	2.6
Domestic demand	6.4	4.8	2.8	-1.7	0.8	2.2
Private consumption growth	4.8	5.2	2.8	2.0	3.3	2.8
Public consumption growth	1.4	1.0	1.1	0.4	1.4	2.5
Domestic fixed investment growth	14.2	6.8	2.7	-8.8	-7.2	1.1
Net external demand (contribution to growth)	-1.8	-1.2	1.3	3.1	0.6	0.4
CPI inflation						
Average	11.8	7.3	10.1	5.5	1.9	1.1
End of period	8.6	9.8	8.5	3.6	0.8	1.9
Unemployment Rate (registered, end year)	10.4	13.1	15.1	17.5	18.1	18.3
Gross Domestic Saving (ratio to GDP) 2/	21.0	18.2	18.9	17.1	15.6	16.6
Gross Domestic Investment (ratio to GDP)	25.2	25.4	25.0	21.0	19.2	20.3
Public Finances (percent of GDP)						
State Government Revenues	22.0	19.7	19.1	18.8	18.7	19.0
State Government Expenditures	24.3	21.6	21.2	23.1	23.8	23.9
State Government Balance	-2.3	-1.9	-2.1	-4.3	-5.1	-4.8
General Government Revenues	39.5	39.6	38.2	38.1	37.4	37.8
General Government Expenditures	42.7	42.8	41.7	43.6	44.1	44.8
General Government Balance	-3.2	-3.3	-3.5	-5.5	-6.7	-6.9
General Government Net Borrowing (ESA95) 3/	...	...	...	-3.5	-4.0	-4.2
General Government Net Borrowing (ESA95) 4/	...	...	...	-4.8	-5.5	-6.0
General Government Debt 5/	41.3	42.7	39.4	40.3	46.0	50.9
Public debt 6/	...	...	40.7	41.6	47.6	52.0
Money and credit						
Private Credit (12-month change)	28.0	29.1	17.3	9.2	4.9	...
Broad Money (12-month change)	24.7	20.1	11.9	9.2	-2.1	...
Money market rate (eop)	15.2	17.9	19.2	11.7	6.7	...
13-week t-bill rate (eop)	13.5	16.4	16.8	11.2	6.1	...
Balance of Payments						
Current account balance (in millions U.S. dollars)	-6,841	-11,553	-9,952	-7,166	-6,700	-7,513
percent of GDP	-4.2	-7.2	-6.1	-3.9	-3.6	-3.7
C/A balance plus FDI, percent of GDP	-1.1	-3.2	-1.1	-0.1	-1.5	-1.6
Exports (millions U.S. dollars)	30,120	26,349	28,255	30,275	32,945	38,482
Export volume growth	10.4	-8.1	16.6	5.9	5.6	8.0
Imports (millions U.S. dollars)	43,840	40,728	41,423	41,950	43,297	50,289
Import volume growth	17.2	-0.6	6.0	1.8	-1.1	4.8
Terms of trade (index 1995=100)	100.7	102.5	98.2	99.9	98.6	96.2
Official reserves (millions U.S. dollars)	28,275	27,314	27,466	26,564	29,794	30,952
months of imports	7.7	8.0	8.0	7.6	8.3	7.4
Total external debt (percent of GDP)	35.9	40.5	42.4	39.2	43.4	42.0
Ratio of short term debt to gross reserves	29.8	41.1	34.8	41.8	43.1	43.0
Fund Relations (March 31, 2003)						
Fund holding of currency (in percent of quota)					65.0	
Holding of SDRs (in percent of allocation)					n/a	
Quota (SDR million)					1369.0	
Exchange rate						
Exchange rate regime						
Present exchange rate (April 25, 2003)						
Zloty per US\$, period average	3.5	4.0	4.3	4.1	4.1	...
Zloty per Euro, period average	3.9	4.2	4.0	3.7	3.9	...
Real effective exchange rate (INS, CPI based)	120.4	115.6	125.2	138.4	133.9	...
percent change	4.8	-4.0	8.3	10.5	-3.2	...

Sources: Polish authorities and staff estimates.

1/ GDP series for 2000-2002 are based on the authorities' new methodology introduced in late 2002. GDP series prior to 2000 are staff estimates of the new methodology, using growth rates from the old methodology. This applies to all tables and figures of the staff report.

2/ Derived as a difference between total savings and current account.

3/ With second pillar pension funds part of general government.

4/ With second pillar pension funds outside general government.

5/ Data for 1996-98 covers central government debt only.

6/ Including risk weighted stock of outstanding guarantees.

Table 2. Poland: Balance of Payments, 1998-2007
(In millions of US dollars)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
					Est.	Proj	Proj	Proj	Proj	Proj
Current account balance	-6,841	-11,553	-9,952	-7,166	-6,700	-7,513	-8,924	-10,365	-12,903	-14,730
percent of GDP	-4.2	-7.2	-6.1	-3.9	-3.6	-3.7	-4.0	-4.3	-4.9	-5.1
Trade balance	-13,720	-14,379	-13,168	-11,675	-10,352	-11,807	-12,672	-13,738	-15,912	-16,819
Exports	30,120	26,349	28,255	30,275	32,945	38,482	42,619	47,135	52,367	58,708
percentage change in unit values 1/	0.2	-4.8	-8.1	1.2	3.1	8.2	1.1	1.0	1.0	1.0
percentage volume growth 1/	10.4	-8.1	16.6	5.9	5.6	8.0	9.5	9.5	10.0	11.0
export market growth 1/	7.5	5.4	12.2	2.5	1.5	4.7	6.1	6.8	6.6	6.5
Imports	43,840	40,728	41,423	41,950	43,297	50,289	55,291	60,873	68,279	75,528
percentage change in unit values 1/	-3.0	-6.5	-4.0	-0.5	4.4	10.8	1.2	1.3	1.8	2.1
percentage volume growth 1/	17.2	-0.6	6.0	1.8	-1.1	4.8	8.6	8.7	10.2	8.3
growth in domestic demand 1/	6.5	5.0	2.6	-2.0	0.6	2.2	4.3	4.8	4.9	5.0
Terms of trade percentage change 1/	3.3	1.8	-4.2	1.7	-1.2	-2.4	-0.1	-0.3	-0.8	-1.1
Services balance	-488	-1,631	-1,686	-976	-1,005	-915	-989	-1,099	-1,319	-1,578
Credit	3,683	3,298	3,505	3,988	3,992	4,519	4,850	5,231	5,634	6,059
Debit	4,171	4,929	5,191	4,964	4,997	5,434	5,839	6,330	6,953	7,638
Net Income	-569	-795	-759	-896	-1,588	-1,035	-1,840	-3,101	-3,951	-4,902
Net transfers	1,941	1,614	1,681	1,986	2,180	2,444	2,790	3,805	4,510	4,768
Net unclassified current transactions	5,995	3,638	3,980	4,395	4,065	3,799	3,786	3,769	3,768	3,802
Capital and financial account balance	10,991	8,241	7,658	2,980	6,622	8,187	9,273	10,609	13,055	14,689
Financial account balance	10,919	8,191	7,645	2,981	6,630	8,147	9,233	10,569	13,015	14,649
Foreign direct investment (net)	4,969	6,352	8,169	6,928	3,789	4,264	5,099	6,105	8,170	9,372
by nonresidents	5,130	6,474	8,293	6,995	4,119	4,564	5,449	6,505	8,670	9,871
o/w privatisation	2,023	3,377	3,500	1,500	476	1,026	1,449	1,668	700	700
Portfolio investment (net)	1,694	867	2,591	1,109	1,671	1,739	1,887	2,110	2,407	2,743
by non-residents	1,824	1,414	2,676	1,066	2,824	2,984	3,232	3,563	3,975	4,437
o/w equities	951	882	866	-306	-545	-634	-686	-809	-948	-1,111
Other investment	4,618	400	-3,382	-4,715	2,050	3,024	3,128	3,234	3,319	3,414
Assets	2,168	-2,698	-2,920	-3,500	3,092	1,832	1,867	1,903	1,939	1,975
Liabilities	2,450	3,098	-462	-1,215	-1,042	1,192	1,260	1,331	1,380	1,438
o/w Short-term	-43	441	143	-91	448	466	485	504	524	545
Errors and omissions	1,787	3,479	2,970	3,763	723	0	0	0	0	0
Overall Balance	5,937	167	676	-423	645	674	349	244	152	-41
Financing	-5,937	-167	-676	423	-645	-674	-349	-244	-152	42
Reserve assets	-5,928	-158	-621	440	-633	-674	-349	-244	-152	41
Exceptional financing	-9	-9	-55	-17	-12	0	0	0	0	0
Memorandum items										
Current account balance, excl. net oil related imports 2/	-5,423	-9,649	-6,191	-4,412	-3,861	-3,500	-6,117	-8,184	-10,963	-12,885
In percent of GDP	-3.4	-6.2	-3.9	-2.4	-2.0	-1.8	-2.9	-3.6	-4.3	-4.6
Official reserves	28,275	27,314	27,466	26,564	29,794	30,952	31,323	31,579	31,768	31,757
in months of imports	7.7	8.0	8.0	7.6	8.3	7.4	6.8	6.2	5.6	5.0
Ratio of short-term debt to reserves	29.8	41.1	34.8	41.8	43.1	43.0	44.1	45.3	46.7	48.4
Total external debt (percent of GDP)	35.9	40.5	42.4	39.2	43.4	42.0	41.2	40.2	38.8	37.5
Net external debt (percent of GDP) 3/	13.2	15.5	17.2	15.5	19.3	18.7	18.5	18.2	17.7	17.4
External debt service (in percent of exports) 4/	14.0	16.8	19.8	21.4	21.7	17.7	21.6	25.2	25.2	24.8
Gross FDI inflows (percent of GDP)	3.1	4.0	5.0	3.8	2.0	2.2	2.5	2.7	3.3	3.4

Sources: NBP and staff estimates.

1/ Based on WEO calculations.

2/ Net oil related imports are defined as net imports of mineral fuels, lubricants, and related materials (SITC section 3), using customs data.

3/ Defined as external liabilities minus external assets, both exclusive of equity portfolio and direct investment.

4/ Excluding debt buyback.

Table 3. Poland: Monetary Survey, 1998-2002
(In millions of zloty, end-of-period)

	1998	1999	2000	2001	2002
Net International Reserves (in billions of U.S. dollars)	95,891 28.3	110,559 27.3	131,761 27.5	132,565 26.6	132,023 29.8
Net domestic assets	155,647	193,903	212,320	259,982	260,265
Credit to nongovernment	144,370	186,347	218,624	238,726	250,494
Credit to government, net	64,934	68,201	56,081	69,208	65,934
Other items, net	-53,657	-60,645	-62,385	-47,952	-56,163
Broad Money	223,913	268,868	300,757	328,434	321,555
Memorandum items (in percent)					
Broad money growth (12-month)	24.7	20.1	11.9	9.2	-2.1
Real broad money growth (12-month)	16.1	10.3	3.4	5.6	-2.9
Nominal growth of credit to nongovernment	28.0	29.1	17.3	9.2	4.9
Real growth of credit to nongovernment	19.4	19.3	8.8	5.6	4.1
Share of foreign currency deposits in broad money 1/	15.0	11.3	14.3	16.1	15.2

Sources: National Bank of Poland and staff estimates.

1/ As of September 2002.

Table 4. Poland. General Government Revenues and Expenditures, 1998-2003
(In percent of GDP)

	1998	1999	2000	2001	2002 Staff Est.	2003 Proj.
General government revenue	39.5	39.6	38.2	38.1	37.4	37.8
Direct taxes	25.4	24.2	23.4	23.4	23.0	...
Indirect taxes	11.2	11.7	11.2	11.0	11.7	...
Other taxes and nontax	2.9	3.7	3.6	3.7	2.7	...
General government expenditure (comm. basis)	42.7	42.8	41.7	43.6	44.1	44.8
Goods and services (inc. arrears)	17.8	17.6	16.8	16.9	16.9	17.1
Transfers and subsidies	18.5	19.2	19.3	21.0	21.2	21.3
Interest payments	3.1	2.9	2.5	2.8	3.1	3.2
Capital and net lending	3.5	3.1	3.1	2.9	2.9	3.2
General government balance (cash) 1/	-2.5	-2.9	-3.1	-5.4	-6.7	-6.9
General government bal. (commitment) 1/	-3.2	-3.3	-3.5	-5.5	-6.7	-6.9
Financing	2.5	2.9	3.1	5.4	6.7	6.9
Domestic	1.8	1.0	0.1	6.0	6.1	5.9
External	-0.6	-0.2	-0.7	-1.5	0.3	0.4
Privatization	1.2	2.1	3.8	0.9	0.3	0.6
Memorandum items:						
Structural Balance	-4.4	-4.4	-4.0	-4.8	-4.9	-4.6
ESA95 deficit with OFEs inside general government	...	...	...	-3.5	-4.0	-4.2
ESA95 deficit with OFEs outside general government	...	...	...	-4.8	-5.5	-6.0
General government primary balance (cash)	-0.1	-0.3	-0.9	-2.6	-3.5	-3.9
State balance (cash)	-2.3	-1.9	-2.1	-4.3	-5.1	-4.8
Rest of government balance	-0.2	-1.0	-1.0	-1.1	-1.6	-2.1

Sources: Polish authorities and staff estimates and projections.

1/ General government overall balance on a cash basis including payments in compensation for insufficient indexation in the 1990s.

Table 5. Poland: Savings and Investment Balance, 2002-2007

	2002 Est.	2003 Proj.	2004 Proj.	2005 Proj.	2006 Proj.	2007 Proj.
(In percent of GDP)						
Consumption	84.2	84.3	83.2	82.3	81.3	80.4
Non-government	65.4	65.3	64.8	64.4	64.0	63.6
Government	18.8	19.0	18.4	17.9	17.3	16.9
Investment	19.2	20.3	21.7	22.6	23.5	24.6
Fixed capital	19.2	20.0	21.3	22.2	23.1	23.9
Non-government	15.7	16.1	17.3	17.6	17.9	18.8
Government	3.5	3.9	4.0	4.6	5.2	5.1
Inventories	0.0	0.3	0.3	0.4	0.5	0.7
Domestic Savings	15.6	16.6	17.6	18.2	18.6	19.5
Non-government	18.1	18.9	19.1	19.1	18.5	18.9
Current Account Balance 1/	-3.6	-3.7	-4.0	-4.3	-4.9	-5.1
NAIRU	15.0	15.0	14.8	14.6	14.4	14.2

Sources: Polish authorities and staff estimates.

1/ BOP basis.

Table 6. Poland: Indicators of External Vulnerability, 1999-2003
(In percent of GDP, unless otherwise indicated)

	1999	2000	2001	2002 Est.	Latest 2003	Date of Observation
Financial indicators						
Public sector debt 1/	42.7	39.4	40.3	46.0	50.9	Proj. for 2003
Broad money (percent change, 12-month basis)	20.1	11.9	9.2	-2.1	-1.2	Feb
Private sector credit (percent change, 12 month basis)	29.1	17.3	9.2	4.9	5.7	Feb
Domestic credit to GDP	30.3	29.8	34.7	33.7	31.2	Proj. for 2003
13 week T-Bill rate 2/	16.4	16.8	11.2	6.1	5.7	Mar-03
13 week T-Bill real rate 3/	6.0	7.6	7.3	5.2	5.1	Mar-03
External Indicators						
Exports (percent change, 12-month basis in US\$)	-12.3	7.1	7.9	7.8	11.8	Feb
Imports (percent change, 12-month basis in US\$)	-4.9	2.1	0.6	2.9	6.8	Feb
Current account balance	-7.2	-6.1	-3.9	-3.6	-3.7	Proj. for 2003
Capital and financial account balance	5.1	4.7	1.6	3.5	4.0	Proj. for 2003
o/w: Inward portfolio investment (debt securities etc.)	0.9	1.6	0.6	1.5	1.5	Proj. for 2003
Other investment (loans, trade credits etc.)	0.2	-2.1	-2.6	1.1	1.5	Proj. for 2003
Inward foreign direct investment	4.0	5.1	3.8	2.2	2.2	Proj. for 2003
Net Foreign Assets (NFA) of commercial banks (in billions of US\$)	26.7	31.8	33.3	34.3	34.3	Mar
Official reserves (in billions US\$)	27.3	27.5	26.6	29.8	31.0	Mar
Official reserves in months of imports of goods	8.0	8.0	7.6	8.3	7.4	Proj. for 2003
Reserve money to reserves (Ratio)	0.5	0.4	0.6	0.5	0.5	Feb
Broad money to reserves (Ratio)	2.3	2.5	3.1	2.9	2.6	Feb
Total short term external debt to reserves (in percent) 4/	41.1	34.8	41.8	43.1	...	2002 Q4
Total external debt (in billions of US\$)	65.4	69.5	71.8	81.9	...	2002 Q4
o/w: Public sector debt (in billions of US\$)	32.1	29.2	27.5	35.7	...	2002 Q4
Ratio of short-term external debt to total external debt (in percent)	17.2	13.7	15.5	15.7	...	2002 Q4
Exchange rate (per US\$, period average)	4.0	4.3	4.1	4.1	4.0	Mar
REER depreciation (-) (12-month growth, period average) 5/	-4.0	8.3	10.5	-3.2	-4.6	Jan
Financial Market Indicators						
Stock market index	18,084	17,848	13,922	14,367	13,759	31-Mar-03
Foreign currency debt rating						
Standard and Poor's 6/	BBB	BBB+	BBB+	BBB+	BBB+	31-Mar-03
Moody's 7/	Baa1	Baa1	Baa1	A2	A2	31-Mar-03
Spread, JP Morgan's EMBI index	212	241	195	185	176	31-Mar-03
Spread of benchmark bonds (basis points, end of period) 8/	...	83	55	48	52	31-Mar-03

Sources: Bloomberg, Polish authorities, and staff estimates.

1/ Data for 1999 and beyond covers general government debt; data for earlier years includes central government debt only.

2/ End-of-period.

3/ Backward-looking with actual CPI.

4/ By original maturity.

5/ CPI based, using 1999 trade weights.

6/ In Standard & Poor's rating system BBB- is investment grade whereas BB+ is below.

7/ In Moody's rating system Baa is investment grade whereas Ba is below.

8/ Spread on Polish bond expiring 03/2010 with a 6 percent coupon and German bond expiring 07/2010 with a 5 1/4 percent coupon.

Table 7. Poland: External Debt Sustainability Framework, 1997-2007
(In percent of GDP, unless otherwise indicated)

	1997	1998	Actual		2001	Projections					
			1999	2000		2002	2003	2004	2005	2006	2007
I. Baseline Medium-Term Projections											
1 External debt	33.2	35.9	40.5	42.4	39.2	43.4	42.0	41.2	40.2	38.8	37.5
2 Change in external debt	1.4	2.7	4.7	1.8	-3.2	4.2	-1.4	-0.8	-1.0	-1.4	-1.2
3 Identified external debt-creating flows (4+8+11)	-5.5	-4.5	-1.1	-3.8	-1.7	0.8	0.3	-0.9	-1.1	-1.4	-1.2
4 Current account deficit, excluding interest payments	1.6	2.2	5.5	4.2	2.3	2.4	2.0	1.5	0.9	1.3	1.5
5 Deficit in balance of goods and services	7.4	8.6	9.9	9.1	6.9	6.0	6.2	6.2	6.2	6.5	6.4
6 Exports	20.7	20.5	18.4	19.4	18.7	19.5	20.9	21.5	21.9	22.0	22.4
7 Imports	28.0	29.1	28.3	28.4	25.6	25.5	27.1	27.7	28.1	28.6	28.8
8 Net non-debt creating capital inflows (negative)	-2.5	-3.7	-4.5	-5.6	-3.6	-1.6	-1.8	-2.0	-2.2	-2.8	-2.9
9 Net foreign direct investment, equity	2.1	3.1	4.0	5.1	3.8	2.0	2.1	2.3	2.5	3.1	3.2
10 Net portfolio investment, equity	0.4	0.6	0.4	0.5	-0.2	-0.4	-0.3	-0.3	-0.3	-0.4	-0.4
11 Automatic debt dynamics 1/	-4.7	-3.0	-2.1	-2.5	-0.4	0.0	0.1	-0.4	0.3	0.0	0.2
12 Contribution from nominal interest rate	1.3	1.9	1.7	1.8	1.6	1.2	1.7	2.5	3.4	3.6	3.6
13 Contribution from real GDP growth	-2.2	-1.5	-1.5	-1.6	-0.4	-0.5	-1.0	-1.6	-1.9	-1.9	-1.9
14 Contribution from price and exchange rate changes 2/	-3.8	-3.5	-2.3	-2.7	-1.6	-0.7	-0.5	-1.3	-1.3	-1.7	-1.6
14 Residual, incl. change in gross foreign assets (2-3)	6.9	7.2	5.7	5.6	-1.5	3.3	-1.8	0.1	0.1	0.0	0.0
External debt-to-exports ratio (in percent)	160.4	174.9	220.5	218.7	209.5	222.2	200.7	191.7	183.7	175.8	167.4
Gross external financing need (in billions of US dollars) 3/	10.0	13.5	22.3	24.5	20.5	22.2	25.1	27.9	30.4	33.7	36.3
in percent of GDP	6.7	8.2	13.8	14.9	11.2	11.7	12.2	12.6	12.7	12.8	12.5
Key Macroeconomic and External Assumptions											
Real GDP growth (in percent)	6.8	4.8	4.1	4.0	1.0	1.3	2.6	4.1	5.0	5.3	5.3
Exchange rate appreciation (US dollar value of local currency, change in percent)	-17.8	-6.1	-11.9	-8.7	6.2	0.4	4.6	0.9	0.7	1.8	1.8
GDP deflator in US dollars (change in percent)	-6.3	5.0	-6.0	-2.3	10.5	2.1	6.0	3.2	3.2	4.4	4.3
Nominal external interest rate (in percent)	4.0	6.5	4.5	4.6	4.2	3.1	4.3	6.4	9.1	9.8	10.3
Growth of exports (US dollar terms, in percent)	11.2	9.2	-12.3	7.1	7.9	7.8	16.4	10.4	10.3	10.8	11.7
Growth of imports (US dollar terms, in percent)	15.8	14.4	-4.9	2.1	0.6	2.9	15.4	9.7	9.9	11.9	10.5
II. Stress Tests for External Debt Ratio											
1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2003-2004	43.4	40.1	37.0	34.0	31.1	28.3					
2. Nominal interest rate is at historical average plus two standard deviations in 2003 and 2004	43.4	42.9	42.2	41.1	39.7	38.5					
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004	43.4	42.8	43.4	42.4	41.0	39.7					
4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2003 and 2004	43.4	51.3	59.7	58.8	57.4	56.2					
5. Non-interest current account is at historical average minus two standard deviations in 2003 and 2004	43.4	47.3	52.3	51.3	49.9	48.7					
6. Combination of 2-5 using one standard deviation shocks	43.4	49.3	55.1	54.1	52.7	51.5					
7. One time 30 percent nominal depreciation in 2003	43.4	42.0	41.2	40.2	38.8	37.5					
Historical Statistics for Key Variables (past 10 years)											
	Historical Average	Standard Deviation	Average 2002-07								
Current account deficit, excluding interest payments	1.1	3.1	1.6								
Net non-debt creating capital inflows	2.5	1.8	2.2								
Nominal external interest rate (in percent)	3.8	1.3	7.1								
Real GDP growth (in percent)	4.5	1.9	3.9								
GDP deflator in US dollars (change in percent)	4.3	8.5	3.9								

Sources: Polish authorities and staff calculations.

1/ Derived as $[r - g - \rho(1+g) + \alpha e(1+r)] / (1+g+p+g)$ times previous period debt stock, with r = nominal effective interest rate on external debt; p = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \alpha e(1+r)] / (1+g+p+g)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($e > 0$) and rising inflation (based on GDP deflator).

3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

Table 8. Poland: Public Sector Debt Sustainability Framework, 1997-2007
(In percent of GDP, unless otherwise indicated)

	Actual					Projections					
	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
I. Baseline Medium-Term Projections											
1. Public sector debt 1/ o/w foreign-currency denominated	45.2	41.3	42.7	39.4	40.3	46.0	50.9	53.8	55.7	57.1	58.3
2. Change in public sector debt	-0.9	-3.9	1.5	-3.4	0.9	5.7	4.9	2.9	1.9	1.4	1.2
3. Identified debt-creating flows (4+7+12)	0.0	-3.5	2.4	-2.5	2.8	5.1	5.4	2.9	1.8	1.2	0.7
4. Primary deficit	-0.3	0.1	0.0	-0.6	2.6	3.5	3.8	3.1	2.7	2.5	1.9
5. Revenue and grants	41.1	39.5	39.6	38.2	38.1	37.4	37.8	37.0	36.6	36.1	35.8
6. Primary (noninterest) expenditure	40.8	39.6	39.5	37.6	40.7	41.0	41.6	40.0	39.3	38.5	37.6
7. Automatic debt dynamics 2/	0.3	-3.6	2.4	-1.9	0.2	1.6	1.7	-0.2	-0.9	-1.2	-1.2
8. Contribution from interest rate/growth differential 3/	-4.9	-3.5	-1.2	-1.8	0.8	2.1	1.4	0.0	-0.8	-1.0	-0.9
9. Of which contribution from real interest rate	-2.4	-1.6	0.3	-0.3	1.2	2.6	2.6	1.9	1.9	1.8	1.9
10. Of which contribution from real GDP growth	-2.6	-1.9	-1.5	-1.5	-0.4	-0.5	-1.2	-2.0	-2.6	-2.7	-2.8
11. Contribution from exchange rate depreciation 4/ Denominator = $1+\pi+\pi+\pi$	5.2	-0.1	3.6	0.0	-0.7	-0.5	0.2	-0.1	-0.1	-0.3	-0.3
12. Other identified debt-creating flows	1.2	1.2	1.1	1.1	1.1	1.0	1.0	1.1	1.1	1.1	1.1
13. Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
14. Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
15. Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
16. Residual, including asset changes (2-3)	-0.9	-0.3	-0.9	-0.9	-1.9	0.6	-0.5	0.0	0.0	0.2	0.5
Public sector debt-to-revenue ratio 1/	110.0	104.5	108.1	103.1	105.9	122.9	134.6	145.5	152.2	158.3	163.1
Gross financing need 5/ in billions of U.S. dollars	10.0	9.0	9.3	9.2	10.9	11.2	11.9	11.4	11.4	11.2	10.9
	15.0	14.9	15.1	15.1	20.0	21.1	24.4	25.1	27.2	29.5	31.4
Key Macroeconomic and Fiscal Assumptions											
Nominal GDP (local currency)	490.8	575.2	639.6	712.3	749.3	769.4	799.7	851.6	919.2	992.1	1070.8
Real GDP growth (in percent)	6.8	4.8	4.1	4.0	1.0	1.3	2.6	4.1	5.3	5.3	5.3
Average nominal interest rate on public debt (in percent) 6/	8.8	8.1	7.9	6.6	7.5	8.0	7.2	6.4	6.4	6.1	6.2
Average nominal interest rate on forex debt (in percent) 6/	8.8	8.1	7.9	6.6	7.5	8.0	7.2	6.4	6.4	6.1	6.2
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-5.3	-3.7	1.1	-0.5	3.3	6.5	5.9	4.1	3.9	3.6	3.7
Exchange rate (LC per US dollar)	3.5	3.5	4.1	4.1	4.0	3.8	3.9	3.9	3.8	3.8	3.7
Nominal depreciation of local currency (LC per dollar)	22.3	-0.4	18.4	-0.1	-3.8	-3.7	1.6	-0.9	-0.7	-1.8	-1.7
Exchange rate (US dollar per LC)	0.3	0.3	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Nominal appreciation (increase in US dollar value of local currency, in percent)	-10.3	0.4	-15.5	0.1	3.9	3.8	-1.6	0.9	0.7	1.8	1.8
Inflation rate (GDP deflator, in percent)	14.1	11.8	6.8	7.1	4.2	1.4	1.3	2.3	2.5	2.5	2.5
Growth of real primary spending (deflated by GDP deflator, in percent)	6.1	1.7	4.0	-1.1	9.3	2.0	4.1	0.2	3.4	3.3	2.9
II. Stress Tests for Public Debt Ratio											
1. Real GDP growth, real interest rate, and primary balance are at historical averages in 2003-2007						46.0	38.4	32.3	27.3	23.3	20.2
2. Real interest rate is at historical average plus two standard deviations in 2003 and 2004						46.0	56.1	66.0	67.7	68.8	69.8
3. Real GDP growth is at historical average minus two standard deviations in 2003 and 2004						46.0	53.6	60.5	62.6	64.2	65.5
4. Primary balance is at historical average minus two standard deviations in 2003 and 2004						46.0	50.6	53.9	55.8	57.2	58.4
5. Combination of 2-4 using one standard deviation shocks						46.0	48.2	50.6	50.5	50.0	49.4
6. One time 30 percent real depreciation in 2003 7/						46.0	57.3	60.2	61.9	63.3	64.3
7. 10 percent of GDP increase in other debt-creating flows in 2003						46.0	60.9	63.7	65.5	66.7	67.7
8. Impact on debt-to-GDP ratio if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04						46.0	52.2	55.5	57.3	58.7	59.9
8a. Impact on debt-to-revenue ratio if revenue-to-GDP ratio is at historical average minus two standard deviations in 2003-04						122.9	142.8	151.8	156.8	162.7	167.5
Historical Statistics for Key Variables (past 10 years)											
		Historical Average	Standard Deviation					Average 2002-07			
Primary deficit		0.3	1.6					2.9			
Real GDP growth (in percent)		3.6	3.1					4.0			
Nominal interest rate (in percent) 6/		7.4	1.4					6.7			
Real interest rate (in percent)		-13.5	15.5					4.6			
Inflation rate (GDP deflator, in percent)		20.9	14.8					2.1			
Revenue to GDP ratio		40.9	2.2					36.8			

Sources: Polish authorities and staff calculations.

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as $[(r - \pi(1+\pi)) - \alpha + \alpha\pi(1+\pi)] / (1+\pi+\pi+\pi)$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; α = share of foreign-currency denominated debt, and $\alpha\pi$ = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+\pi)$ and the real growth contribution as $-\pi$.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\pi(1+\pi)$.

5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

POLAND: FUND RELATIONS
(As of March 31, 2003)

I. Membership Status: Joined 6/12/86; Article VIII

II. General Resources Account

	SDR Million	Percent of Quota
Quota	1,369.00	100.0
Fund holdings of currency	890.14	65.02
Reserve position in Fund	478.86	34.98
Financial transactions plan transfers (net)	46.00	

III. SDR Department

	SDR Million	Percent Allocation
Holdings	31.15	N/A

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements:

	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	8/05/94	3/04/96	333.30	283.30
Stand-By	3/08/93	4/08/94	476.00	357.00
EFF	4/18/91	3/08/93	1,224.00	76.50

VI. Projected Obligations to Fund: None

VII. Exchange Rate Arrangement

Poland accepted the obligation of Article VIII, Sections 2, 3, and 4 on June 1, 1995. The exchange system is free of restrictions on the making of payments and transfers for current international transactions. Since April 12, 2000, the zloty has floated freely. Prior to that, the zloty had been pegged to a currency composite made up of the U.S. dollar, deutsche mark, pound sterling, French franc, and the Swiss franc. As of January 1, 1999, the currency composite was changed to a basket comprised of 55 percent euro and 45 percent U.S. dollar. From January 1, 1995, the zloty was redenominated, with new Zl 1 equaling old Zl 10,000. The central parity of the zloty was adjusted under a crawling peg policy at a preannounced monthly

rate. On May 16, 1995, a band of ± 7 percent was introduced around the central rate. Following the implementation of the new system, the zloty initially appreciated by about 5 percent above the central rate. In September 1995, the exchange rate was allowed to appreciate a further 1 percent within the band. In December 1995, the central parity was raised by 6 percent, and at the same time the authorities allowed the actual exchange rate to appreciate by 22 percentage points. On January 8, 1996 the monthly rate of crawl was reduced to one percent. On February 26, 1998, with the zloty pushing towards its upper limit, the newly-formed Monetary Policy Council (RPP) widened the fluctuation band from ± 7 percent to ± 10 percent. At the same time, the rate of crawl was reduced from one percent to 0.8 percent per month. On July 17, 1998, the crawling peg's monthly rate of depreciation was cut from 0.8 percent to 0.65 percent. On September 9, 1998, the monthly rate of depreciation was reduced further to 0.50 percent. On October 29, 1998, the zloty's trading band was widened to ± 12.5 percent. On March 1, 1999, the zloty's trading band was widened to ± 15 percent, and the rate of crawl was lowered to 0.3 percent per month. On December 31, 1999, the official rate was Zl 4.08 per US\$1. On April 12, 2000, the crawling band regime was abolished and the zloty has since floated freely.

VIII. Article IV Consultation

The last Article IV consultation was concluded on June 7, 2002. In concluding the consultation, Directors welcomed the success in lowering inflation and narrowing the current account deficit, but pressed for a more balanced policy mix—particularly a sustained fiscal consolidation which would halt the increase in public debt. They also underlined the importance of safeguarding central bank independence.

IX. Technical Assistance, 1992–01

Department	Subject/Identified Need	Action	Timing	Counterpart
MAE- Coordinated	Periodic visits by experts from central banks cooperating in providing technical assistance to the NBP under the coordination of MAE	Experts' visits	1992–94	NBP
MAE	Payments system, banking supervision, monetary research and analysis	Mission	May 1992	NBP
MAE	Review of progress in the modernization of operational functions	Mission	Oct. 1992	NBP

MAE	Resident expert–Advisor to President of NBP		Nov. 1991–92	NBP
FAD	Tax administration (VAT)	Nine short-term assignments of field experts	August 1992–October 1994	MoF
FAD	Tax administration	Mission	November 1992	MoF
STA	Framework for monetary statistics	Mission	February 1993	NBP
STA	Framework for monetary statistics (follow-up)	Mission	November 1993	NBP
MAE	Additional steps in the modernization process of the NBP	Mission	April 1993	NBP
MAE	Monetary programming and operations, and payments system.	Mission	Nov. 1993	NBP
MAE	Central bank modernization	Mission	August 1994	NBP
MAE/LEG	Review of the exchange and payments system	Mission	February 1995	NBP/ MoF
MAE	Exchange rate system	Mission	March 1995	NBP
MAE	Review of government securities market, payments system and public debt management	Mission	August 1995	NBP/ MoF
MAE	Asset consolidation exercise	Expert visits	Late 1995	NBP
STA	Government finance Statistics	Mission	August 1995	NBP/ MoF
STA	Data Standards	Mission	November 1995	CSO

STA	Money and banking statistics	Mission	January 1996	NBP
STA	Government finance statistics	Mission	July 1996	NBP/ MoF
STA	Balance of payments statistics	Mission	November 1996	NBP/ MoF
STA	Balance of payments statistics	Follow-up Mission	April 1997	NBP/ MoF
STA	Review of progress in implementing the SDDS	Visit	February 1998	
FAD	Public expenditure management	Mission	April 1998	MoF
MAE	Operational aspects of monetary and exchange rate policy	Mission	September 1998	NBP
FAD	Tax administration	Mission	October 1998	MoF
FAD	Examination of impact on revenues of proposed tax reform	Mission	November 1998	MoF
FAD	Discussion of tax administration	Mission	March 1999	MoF
FAD	Tax administration seminar	Mission	April 1999	MoF
STA	Government Finance Statistics	Mission	October 1999	MoF/Local
FAD	Tax administration—introduction of expert	Mission	November 1999	MoF
FAD	Administering Social Security	Mission	March 2000	MoF
IMF/IBRD	FSAP	Mission	May & Sept 2000	MoF NBP
FAD	ROSC, Fiscal Transparency Module	Mission	May & Nov. 2000	MoF
MAE	Monetary Operations	Mission	July 2001	NBP
STA	Data Template on International Reserves and Foreign Currency	Mission	November 2001	NBP

	Liquidity			
FAD	Expenditure restructuring	Mission	December 2001	MoF
MAE	Stress testing	Mission	January 2002	NBP
STA	Data ROSC	Mission	January 2003	CSO/ MoF/ NBP

X. Resident Representative

Mr. Sassanpour, the Resident Representative, took up his duties in Warsaw in September 2000.

POLAND—WORLD BANK ACTIVITY

1. Poland rejoined the World Bank in 1986 and World Bank lending to Poland started in 1990. Since then the Bank has committed loans totaling US\$5.4 billion equivalent. Total loans outstanding and disbursed amount to US\$2.5 billion as of April 2003. At present eleven projects are under implementation, with an undisbursed balance of US\$360 million. In addition, the World Bank is administering three Global Environmental Facility operations totaling \$33 million in commitments, with US\$8.5 million undisbursed.

2. Since 1990, the Bank has financed projects in a variety of areas including in agriculture, coal sector restructuring, enterprise and financial restructuring, environment, energy, forestry development, health, housing, railway sector restructuring, ports, roads, and rural development. More recent loans include the Second Hard Coal Sector Adjustment Loan (US\$100 million), which aimed at assisting the continuing restructuring of this sector and to improve its financial sustainability; a Krakow Energy Efficiency project (US\$15 million, also cofinanced by the Global Environmental Facility (GEF)), which aims at improving energy efficiency of the city's district heating systems and end-users; a Railway Restructuring loan (US\$101 million), which is financing restructuring of the Polish State Railways' (PKP) to increase efficiency, improve finances, and privatize selected activities within a sound regulatory framework; a Rural Development Project (US\$120 million), which has the objective of rural restructuring and employment creations through promotion of non-farm rural activities, strengthening of local governments and other institutions, financing infrastructure investments, and improving rural education; and the Szczecin-Swinoujscie Seaway and Port Modernization Project (US\$38.5 million), which aims to promote Poland's trade by developing an efficient administrative/managerial structure and improving physical facilities. Other ongoing projects being financed by the World Bank are for rural environmental protection, flood management, roads, Gdynia and Gdansk ports, power transmission, water supply and development of geothermal resources. Smaller institutional development grants are currently financing activities to strengthen the processes of land administration and registration and to strengthen budget management.

3. The World Bank in consultation with the Polish government has recently prepared a Country Assistance Strategy (CAS) with three focuses; promoting a rebalancing of macroeconomic policies through fiscal reform, assisting the Government to strengthen the effectiveness of public expenditures and programs, and enhancing private sector-led growth and employment creation. The Bank's Executive Directors discussed the Country Assistance Strategy in December 2002. As indicated in the CAS, total lending in 2003–05 could total as much as US\$1.4 billion. Areas for potential lending during this time include support for road infrastructure, coal sector restructuring, rural development, health sector reform, and education sector reform.

4. In addition to its lending program, over the years of its involvement in Poland the Bank has prepared a series of economic and sector work reports and policy notes that provide advice on various poverty-related, institutional and structural reform issues. Most recently, a Public Expenditure and Institutional Review has been prepared with the Government in

January 2003. World Bank staff are continuing work with Government and non-Government counterpart teams to prepare a Living Standards Assessment to help measure the status of poverty reduction in Poland and advise on policy programs to achieve this objective, an Anticorruption Update, an Investment Climate Assessment, a Knowledge Economy Assessment, next stages of implementation of pensions reform, and social aspects of energy policies. Other work which has been completed in the past couple of years includes a development policy assessment (2001), health and social sector reviews and policy notes (1999–2001), a labor market review (2001); rural land, labor and capital markets (2001), and a study on trade and foreign direct investment (2000). In 2000, a Financial Sector Assessment on the Poland financial system was carried out under the joint IMF/World Bank Financial Sector Assessment Program.

POLAND—STATISTICAL INFORMATION

1. Poland has a comprehensive database on macroeconomic statistics that has been improving in recent years. The authorities publish a full range of economic and financial statistics, and cooperate fully in providing information to the Fund. Data on the core indicators are available on a timely basis (see the attached table on core statistical indicators). Consistent with its commitment to providing a comprehensive set of high quality data, in an open and timely manner, Poland subscribes to the IMF's Special Data Dissemination Standard (SDDS), and its metadata are posted on the Fund's Dissemination Standards Bulletin Board.

Real Sector Statistics

2. The Central Statistical Office (GUS) compiles a wide range of real sector statistics, most of which are published promptly in the monthly Statistical Bulletin. The main problems for users include (i) the short span of comparable Polish data series, reflecting the upheavals associated with transition to a market economy (ii) inconsistencies between annual and higher frequency data, reflecting differences in weights and differences in coverage, and (iii) lack of easy electronic retrieval of these data.

3. The national accounts follow the concepts and definitions of the *European System of Accounts 1995 (ESA 95)*, which is based on the *System of National Accounts 1993 (SNA 1993)*. The CSO compiles annual and quarterly GDP estimates by production and expenditure approach in current and constant prices, a full sequence of accounts by institutional sectors, supply and use tables, input/output tables, annual financial accounts and regional accounts. The statistical techniques are basically sound. The constant price estimates are compiled in average prices of the previous year, using deflation techniques that generally follow international standards. However, national accounts data still have some problems - the subannual data are collected on a cumulative rather than on a discrete basis and plans to introduce proper benchmarking and chain-linking techniques have been delayed.

4. The concepts and definitions of the CPI follows the *ESA 95* standards and Eurostat's requirements for the Harmonized Consumer Price Index. Polish CPI does not cover the shelter prices faced by household owner-occupants. The weights for the index are obtained

from the average annual expenditures primarily taken from the national Household Budget Survey (HBS) of the previous calendar year, and are updated annually. From 1999 onwards, the national classification is based on the Classification of Individual Consumption by Purpose (COICOP). The scope of the index covers all resident households, except those in some rural areas. Historical series are constructed using a chain method. Time series data are available for the index with reference periods of 1990 and 1998.

5. The producer price index (PPI) is based on the *1993 SNA* concepts and definitions for recording and valuation of product prices and weights. Its scope includes mining and quarrying, manufacturing and electricity, gas and water supply. Output price indices are also calculated for agriculture, construction, and business services such as transport, storage, and communication. Since 2000, the index is classified by the Polish Classification of Activities based on the General Industrial Classification of Economic Activities within the European Communities, first revision (NACE, Rev.1), the Classification of Products by Activity, and the List of Products of the European Communities. The PPI does not include any estimation for missing prices and quality and seasonal adjustments.

Government Finance Statistics

6. The authorities provide detailed state budget data to the Fund every month. In addition, government finance statistics are reported to the Fund on a regular basis. The classification of transactions in the official data still needs improvement. In the meantime, the staff makes adjustments to the official data.

7. The annual consolidated central and local government data are available in the *Government Finance Statistics Yearbook*. Monthly data on consolidated core operations of the central government are reported in *IFS*.

Monetary Statistics

8. The National Bank of Poland (NBP) reports analytically useful data on a regular and timely basis to the Fund with minimal delay. High-frequency data (every ten days) on the central bank balance sheet and the monetary survey are also available with minimal delay.

9. As an accession country to the European Union, Poland is in the process of adopting the recommendations of the European Central Bank (ECB) in the compilation of its monetary statistics. The monetary statistics from March 2002 are generally consistent with the ECB framework. The authorities have also revised the historical data to December 1996. Other changes adjusting the monetary statistics to be fully consistent with the ECB standards will be introduced starting January 2004..

10. The concepts and definitions used by

the NBP to compile monetary statistics, barring a few exceptions, are in broad conformity with the guidelines outlined in the *Monetary and Financial Statistics Manual*. Nevertheless, in adjusting the scope and presentation of the main monetary aggregates to conform to ECB standards, deviations from *IFS* presentation and concepts arise in some cases such as net claims on general government and interbank positions.

11. There are some material differences in data on financing based on government finance statistics financing and on the corresponding monetary data. These discrepancies

between the government finance statistics and the monetary data should be investigated and reconciled, on an on-going basis, by the Ministry of Finance and the NBP.

External Sector Statistics

12. While improvements have been made in the balance of payments data, some issues need to be addressed. Payments from the kantor market remain reported as a separate item on the current account and are not allocated across their current account components. While there are valid differences in definitions between the customs (GUS) and payment-based trade data compiled by the NBP, the two data sources need to be cross-checked for broad consistency. The NBP now reports net foreign assets (NFA) rather than the net international reserves (NIR) previously shown in the monetary survey. In contrast to NIR, NFA includes less liquid foreign assets and liabilities. Finally, the coverage and reporting of the stock of external debt, especially at maturities up to one year, could be improved.

Poland: Core Statistical Indicators
(As of April 30, 2003)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Central Government Balance	GDP	Public External Debt/ Debt Service
Date of Latest Observation	18-Apr	March	Dec. 2002	February	February	18-Apr	March	February	February	March	2002, Q4	December
Date Received	18-Apr	4-Apr	Feb. 24	31-Mar	31-Mar	18-Apr	14-Apr	31-Mar	31-Mar	15-Apr	14-Mar	15-Feb
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Bi-monthly	Quarterly	Quarterly
Source of Update	Bloomberg	NBP	NBP	NBP	NBP	Bloomberg	GUS	NBP	NBP	MOF	GUS	MOF
Mode of Reporting	On-line	Internet	Mail	Mail	Mail	On-line	On-line	Mail	Mail	Email/ fax	Email	Mail
Confidentiality	None	None	None	None	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly

INTERNATIONAL MONETARY FUND

REPUBLIC OF POLAND

**Staff Report for the 2003 Article IV Consultation
Supplementary Information**

Prepared by the European I Department

Approved by Susan Schadler

June 3, 2003

1. This statement reviews development in Poland since the preparation of the staff report for the 2003 Article IV consultation. The additional information does not change the thrust of the staff appraisal.
2. Recently-released data for April show a continuation of the recovery in output with low inflation but high unemployment.
 - Industrial sales were up by 8.3 percent (year-on-year, compared to 5.5 percent in March). Construction continued to decline (by 13.5 percent year-on-year), but considerably less than in March (when it declined by 25.3 percent).
 - The seasonally adjusted unemployment rate remained unchanged at around 18 percent.
 - Headline CPI inflation dropped to 0.3 percent (year-on-year, from 0.6 percent in March). Net inflation (excluding food and fuel) fell to 1.2 percent.
3. Macroeconomic policies have seen two new developments. First, the Monetary Policy Council further reduced the key policy interest rate by 25 basis points at end-May. Second, the government reviewed the fiscal reform program at a meeting in mid-May, but no decision on its final form was made. Separately, the Minister of Finance announced that the state budget for 2004 would include a transfer of realized gains on the National Bank of Poland's (NBP) foreign exchange holding of some Zl 9 billion (1.1 percent of GDP). This transfer would close the gap between targeted and projected deficits in 2004 in the program. On the other hand, the President of the NBP has mentioned only a possibility of lending foreign exchange to the government to retire foreign debt, a transaction that would not realize holding gains.
4. Some revisions to official GDP forecasts and estimates have occurred. The Ministry of Finance revised downward its projection for GDP growth in 2003 to 3 percent (from 3.5 percent in the budget), but left its revenue projections unchanged. The Central Statistical Office (GUS) revised its GDP estimate for 2002 to 1.4 percent (up from 1.3 percent in the

preliminary estimates). This revision would modify several of the ratios used in the tables and text, but only marginally, and not in a way that would modify the analysis and conclusions of the staff report.

**Statement by Wiesław Szczuka, Alternate Executive Director
for the Republic of Poland
June 9, 2003**

The documents prepared by the staff for today's discussion present a comprehensive picture of recent developments and trends in the Polish economy, and of the numerous challenges still facing the policy makers in my country. In line with the already well-established tradition, the Polish authorities consent to the publication of all these documents. My authorities broadly share most of the staff's conclusions and are very grateful for the staff's effort to provide sound policy advice. The challenge, as always, is to find a way of implementing such recommendations in a given political and social environment.

This Board's discussion on Poland takes place at a very important moment for my country, just one day after the referendum on accepting the EU Accession Treaty. While the outcome of this referendum is not yet known at the time of submitting this statement, my authorities certainly hope that it will be overwhelmingly positive, and will pave the way to Poland's full EU membership starting from May 1, 2004. Joining the EU can be considered the crowning moment in Poland's economic and political transition that started almost 14 years ago. My authorities needed to invest a lot of their energy in concluding the complex negotiations process and ensuring a successful result of the referendum, but they are firmly convinced that the full integration with the EU remains the best option for Poland's future. However, the forthcoming EU membership also opens several new challenges for the economic policymaking in my country. Among the most important ones are certainly the need to simultaneously pursue the real and nominal convergence objectives, to ensure the most efficient use of the EU funds, and to select the most appropriate path to joining the euro zone.

Recent developments and prospects: recovery long in coming.

Last year's staff report referred to a „nascent recovery” that could prove „strong and durable”. In this year's report, staff again uses the same term (with more stress on risks and fragilities) which may suggest that this expected upturn has an unusually long „incubation” period. The delayed and hesitant global recovery, and in particular the weak economic conditions in Europe, certainly contributed to this unfavorable outcome, but the ongoing slump in investment as well as some other domestic factors also played an important role. Several developments, however, suggest that the last year has brought some further improvement, and that the Polish economy, gradually but steadily, has been gaining strength and reducing its vulnerabilities. The quarterly GDP growth rate increased from 0.4 percent in the first quarter of 2002 to an estimated 2.2 percent in the first quarter of this year, and - according to official projections - the growth rate for the whole 2003 can still reach about 3 percent. Private consumption continues to be relatively strong and the recent exports performance is quite encouraging. After increasing, in US dollar terms, by 13.6 percent in 2002, the Polish exports expanded by an annualized rate of 23.6 percent in the first quarter of 2003. Improved competitiveness of the Polish producers, declining unit labor costs and some real depreciation of the zloty contributed to such favorable outcomes, but the indicated growth rates have also been somewhat inflated by the recent weakness of the US currency.

While it would not be appropriate to read too much from some short term indicators, the April data on industrial and retail sales (+8.3 percent and + 11 percent, respectively) as well as the recent improvement in business sentiment can also be seen as encouraging signals. The enterprise profitability and the labor productivity have been improving as well, while the real wage growth remained moderate. The still declining, albeit at a slower pace, investment and the depressed construction sector continue to be the weakest spots and the biggest drag on overall activity. The unacceptably high level of unemployment, even after its recent small decline, and the very low labor participation ratio remain the source of major concern, and there is rather little ground to expect a rapid improvement in this area.

My authorities agree that it would be premature to speak of a robust recovery, but they also see a number of positive developments and share the staff's view that the Polish economy has some „distinct strengths” to support the long-awaited upturn. These include, among others, the absence of inflationary pressures, a significantly improved external position and a more competitive private enterprise sector. The approaching EU membership, the somewhat weaker zloty and the lower interest rates, as well as more moderate global energy prices should also improve the prospects for the Polish economy. However, the strength of the upturn and the sustainability of the future growth will crucially depend on the success in introducing the envisaged major reform of public finances, on the acceleration of structural reforms and on the timing, scale and durability of the recovery of Poland's major trading partners.

Addressing the fiscal challenges

My authorities are fully aware of the need to implement a decisive fiscal adjustment in order to significantly reduce the fiscal deficit and prevent an excessive increase in public indebtedness. This is not an easy task for any government, but in the current Polish circumstances it is additionally complicated by such factors as low level of economic activity, very inflexible structure of the budget (with at least 2/3 of expenditures, not counting public sector wages, being considered mandatory), the need to accommodate a large increase in EU-related spending and the minority character of the present government. Fortunately, both the external pressures resulting from the EU integration process and the constitutionally-set public debt ceiling, reinforced by two lower thresholds stipulated by the Public Finance Act, provide very strong incentives for the government to resolutely address the fiscal problem.

What has been achieved in 2002, and what largely continues with this year's budget, is the stabilization of Poland's fiscal position after it was brought to the verge of collapsing by the pre-election spending euphoria in 2001. The most recent data indicate that the 2002 fiscal results very closely match the original budget assumptions, which may imply an unchanged, or even slightly improved, structural position. This is a rather welcome achievement given the weakness of the cyclical position and the much lower than expected level of inflation. The 2002 general government deficit, when estimated using my authorities' understanding of the ESA95 rules (with open pension funds considered part of the government sector), has reached 3.9 percent and is projected to only slightly increase (to 4.1 percent) in 2003.

However, the unadjusted deficit levels (6.3 and 6.5 percent, respectively) are much higher and, if left unaddressed, would imply an unsustainable fiscal position, soon leading to breaching the legal debt ceiling. While the implementation of the 2003 budget is proceeding broadly as planned, this year's budget was not yet meant to bring a decisive turnaround in the overall fiscal position. This extension of the consolidation phase reflects both the political reality and the current budget's broader objectives of establishing the foundations for the acceleration of growth, protecting the employment level and advancing Poland's preparations to the EU accession.

To address the medium-term fiscal challenges, the Ministry of Finance has prepared a comprehensive fiscal reform program with a key objective of creating conditions for achieving a high and sustainable growth while reducing the budget deficit to below the 3 percent Maastricht criterion by 2006. The initial version of this program has been outlined in the staff report and broadly welcomed by the staff. The reform program also aims at rearranging the structure of Poland's public finances in order to both release the resources needed to meet Poland's obligations towards the EU and to ensure the most efficient absorption of the funds expected from the EU. Some key measures proposed to achieve these broad growth and adjustment objectives include streamlining the tax system by eliminating most tax reliefs and exemptions and selectively reducing some tax rates, enhancing the flexibility of public expenditures by eliminating the still-pervasive indexation and valorization rules, and increasing fiscal transparency (and achieving some savings) by liquidating a large number of special accounts as well as some extrabudgetary funds and public agencies. At this stage it is still not possible to present the detailed content of the program, because it has yet to be formally approved by the government. The implementation of the program would also require the adoption by the parliament of a large number of new laws and/or amendments to existing regulations. The draft of the reform program itself has also been already amended as a result of an extensive series of public consultations. Some of the newly proposed measures include a deeper reduction of the corporate tax rate (to 19 percent) to stimulate investment demand, the introduction of an additional, lower personal income tax bracket, and the introduction of a uniform tax rate of 19 percent for all forms of capital income (including capital gains). The revenue impact of some of these measures is still being evaluated.

Monetary policy

The recent inflationary trends and prospects allow to declare already today that the Polish monetary authorities have achieved their medium-term target (set in 1998) of reducing inflation to below 4 percent by 2003. The headline CPI inflation recorded in April was negligible (0.3 percent year-on-year) while two out five core inflation measures calculated by the National Bank of Poland (NBP) have even shown negative values. Staff expects the end-2003 inflation to reach almost two percent, but this projection may prove too cautious (as it happened last year when the actual inflation of 0.8 percent was significantly below staff's 3.6 percent estimate). While I recognize the difficulty with forecasting inflation in Poland, such too conservative projections could prove problematic if they were to guide staff's advice on the stance of monetary policy. The NBP does not publish any official inflation forecasts but

one of the members of the Monetary Policy Council recently suggested that the end-year inflation figure could be in the range of 1 to 1.5 percent.

The NBP has continued implementing its policy of gradual interest rate reductions. Through a series of nineteen cuts the main reference rate has been reduced from 19 percent in February 2001 to the current level of 5.5 percent. The real interest rates have also been reduced but at a somewhat slower pace. The NBP justified these reductions by pointing to low and declining headline and core inflation indicators, significantly reduced inflation expectations, broadly favorable developments in monetary aggregates, wage moderation and weak external conditions. In turn, the main factors constraining the pace of monetary easing have been identified by the NBP as concerns about the developments in private savings, uncertainty regarding the actual and future stance of fiscal policy, depreciation of the zloty in the course of 2002 and the lagged effects of the earlier implemented nominal rates cuts. The relatively tight monetary policy not only resulted in bringing inflation much below the relevant Maastricht criterion, but also helped to reinforce the central bank's anti-inflationary credentials and contributed to a substantial reduction in the external current account imbalance. However, the progress in reducing inflation coincided with a significant slowdown in economic activity and with a large rise in unemployment. The nature of the relation between these developments remains the subject of an extensive public debate in Poland. The critics of the NBP policies would point to the fact that, even after the recent declines, the real interest rates in Poland remain much higher than in most other European countries and should be reduced further. The question of the link between the disinflation process and performance of the real economy is not merely of academic relevance since it may also determine the risk of renewed inflationary pressures, if and when the long-awaited recovery materializes. Fortunately, with subdued inflation expectations, large unemployment (reducing the risk of any major wage pressures), and the obvious necessity of ultimately improving the fiscal position (in view of the envisaged euro adoption), the near- to medium-term outlook for inflation in Poland appears to be relatively benign.

With inflation brought down to a very low level, the NBP decided to adopt a new medium-term strategy focusing on stabilizing instead of further reducing inflation. The NBP is convinced that the direct inflation targeting framework is best suited to achieving this objective. The new strategy envisages that this framework would also be implemented after the entry into the ERM-2, provided, of course, that the fluctuation bands are not set too narrowly. Starting from 2004, the NBP proposes to adopt a new, continuous inflation target of 2.5 +/- 1 percent. This relatively ambitious target (expressed, as before, in a headline CPI measure) has been set at this level, among others, in order to facilitate the fulfillment of the relevant Maastricht criterion. The NBP has already started adjusting the instruments of its monetary policy to the rules and practices adopted by the Eurosystem, and this process will continue under the newly-approved strategy.

Moving towards the euro

The questions of when to enter the ERM-2, when to adopt the euro, and how to approach the issue of choosing the level of central parity are certainly among the biggest dilemmas facing

not only Poland, but also all remaining accession countries. In the process of deciding on these issues we count on good cooperation with our future EU partners, with the Commission and with the ECB. What is needed is full clarity regarding „the rules of the game”, and in particular the width of the ERM-2 fluctuation band and the method of assessing the observance of the exchange rate stability criterion. In the Polish case, of great importance is also the pending Eurostat decision on our request to consider the open pension funds as part of the general government sector. The rejection of the Polish method of calculating the ESA95-conform fiscal deficit would significantly complicate the task of meeting the relevant Maastricht criterion, and could lead to delaying the timing of adopting the euro. My authorities also count on being able to benefit from the Fund’s advice on how to approach the issues of entering the ERM-2 and adopting the euro. After all, by its very nature, the IMF should aspire to be a „center of excellence” for exchange rate policy matters.

Poland’s preliminary official position on the euro zone entry has been specified in October 2002 by the joint Ministry of Finance and NBP working group on Poland’s integration with the EMU. The declared policy is to aim at joining the EMU at the earliest possible date while paying due attention to macroeconomic conditions and to the need to accelerate the process of real convergence. The initial intention was to be able to meet the Maastricht convergence criteria by 2005 (without prejudging the date of the actual switch to euro). My authorities recognize, however, that this tentative target may no longer be feasible and should not be forced if the process of fiscal and structural reforms does not advance as currently envisaged, and/or if the macroeconomic conditions turn unfavorable. The zloty’s central parity to be negotiated with the EU partners prior to the ERM-2 entry should take into account the market rate in a selected reference period, and should be set at a level that creates conditions for a sustained economic growth without exchange market pressures. The new monetary policy strategy approved by the Monetary Policy Council (MPC) has also embraced the objective of striving for an early adoption of the euro, possibly in 2007. The MPC is convinced that the benefits from joining the euro zone significantly outweigh the costs of losing monetary policy independence.

Structural reform agenda

The staff report puts a lot of stress, and rightly so, on the need to accelerate structural reforms. My authorities fully share the view that without further advancing the structural transformation of the Polish economy it will not be possible to sustain a high growth rate, reduce unemployment and fully benefit from the ongoing EU integration process. Among the most important structural reform measures is undoubtedly the long-awaited relaxation of labor market regulations. The changes to the Labor Code introduced in 2002 aim at increasing the flexibility of employing and laying-off workers and lowering costs for the employers. One of the potentially very important measures is the differentiation of minimum wage for first-time jobholders. The legislative changes have been accompanied by several other measures to improve the situation on the labor market, including training, public works and the “First job” program promoting employment of young graduates. While the introduction of the earned income tax credit for employees, as suggested by the staff, is not currently being considered (among others, in view of the current fiscal situation) a somewhat

similar measure in form of a tax credit for new small enterprises maintaining at least an unchanged level of employment has been approved in October 2002. The large program to support enterprise restructuring, based on a set of new laws approved in 2002, benefited more than sixty thousand mostly small enterprises and also contributed to protecting the level of employment.

The staff suggests that the pace of privatization has recently slowed down in Poland. While it may be confirmed, in part, by the lower level of revenues from selling the state assets, it also reflects the less attractive and/or more complex nature of the remaining enterprises which are slated for privatization, and a reduced interest on part of both foreign and domestic investors. My authorities, however, intend to proceed with the implementation of their medium-term privatization strategy which envisages that after the completion of the divestment process by 2005, Poland would have an ownership structure broadly similar to other European countries. The recent examples of the ongoing efforts to reduce the state ownership include the continuing negotiations with two investors bidding for the large steel conglomerate Polskie Huty Stali and the tender for the privatization adviser for the largest (and one of the few remaining) state-owned banks (PKO BP).

Anti-money laundering and preventing terrorism financing activities

In February 2003 Poland formally ratified the 1999 UN Convention on the Suppression of Terrorist Financing. However, many of the stipulations of this Convention had already been implemented earlier, including through changes to the penal code and through the adoption of the Act on Counteracting Introduction into Financial Circulation of Property Values Derived from Illegal or Undisclosed Sources. In 2002, the General Inspector of Financial Information (GIF) notified the public prosecutor's office of more than one hundred suspected transactions with a total of more than 100 million zlotys. It also ordered suspension of 26 transactions with a value of over 32 million zlotys. In the coming months the Polish regulations will be further revised to make them fully conform with the relevant directive of the European Union. In July 2004 the GIF intends to start operating the specialized IT system registering all transactions exceeding 15000 euro.



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700 19th Street, NW
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IMF Concludes 2003 Article IV Consultation with the Republic of Poland

On June 9, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Poland.¹

Background

During 2002, the economy began to recover from the sharp weakening of growth in 2000–01, but the recovery is fragile. Private consumption picked up gradually, fueled by rising real fiscal transfers, easing monetary policy and a drop in the savings ratio. Exports outpaced rather weak market growth as competitiveness improved. The recovery also reflected a lessening of negative influences: a sharp drop in inventories ended, and the contraction of fixed investment lessened. However, without signs of a leading force behind the recovery, its robustness remains in doubt. Investment appears to be weighed down by an overhang from the late-1990s, rising unemployment and moderating wage increases threaten consumption growth, and weak European markets constrain the scope for exports. The slack in the economy remained evident. Consumer price inflation fell below 1 percent. Falling food prices played a role, but more important were moderating cost (especially wage) increases. Employment continued to drop and, even with falling labor force participation, the unemployment rate rose to almost 19 percent. The external current account deficit remained moderate by transition country standards.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Monetary policy was deliberately and substantially relaxed. The interest rate easing cycle that began in early-2001 continued, and as of April 2003 the main policy interest rate had fallen by a cumulative 1325 basis points to 5.75 percent, but with falling inflation, real interest rates dropped more gradually. In addition, falling interest rates, together with political uncertainties and the need to attract sharply higher portfolio and other capital inflows as foreign direct investment slowed to a trickle, contributed to a welcome 15 percent depreciation of the real effective value of the zloty since early 2002. Nevertheless, credit growth, particularly to enterprises was low reflecting banks' caution in the face of rising non-performing loans and weaker demand as enterprises delayed investment plans.

Fiscal policy also eased slightly, though unintentionally. Financial plans of the general government for 2002 aimed for a withdrawal of stimulus of around 2/3 percent of GDP. In the event, lower-than-expected economy-wide wage increases cut into the tax and contribution base while expenditure commitments—most significantly transfers to households and public sector wages—could not be reduced commensurately with lower-than-expected inflation. Thus, the structural fiscal deficit rose slightly to 5 percent of GDP, the actual deficit widened from 5½ to over 6½ percent of GDP, and the public debt rose sharply.

The origins of the recent weakness in economic activity are complex and a robust recovery will await corrections on several fronts. At the heart of the slowdown was a long slide in investment growth as the torrid pace of early-transition investment cooled. The fiscal-monetary policy mix remains a problem—even as monetary policy has eased, the risk of a tightening, if the fiscal adjustment is delayed, creates market uncertainty. Privatization and redressing the problems of state enterprises where privatization prospects are remote, largely ground to a halt in 2001–02. The banking system, which is well supervised and largely foreign-owned, was strained by the slowdown. Political uncertainties also cloud the situation. The President and the Prime Minister have called for a general election, originally scheduled for late-2005, in June 2004, and speculation about an earlier date is rife. The need to reconstitute the Monetary Policy Council (MPC) in early 2004 when the terms of all current members expire adds to the uncertainty.

Notwithstanding these weaknesses, the economy enters this upturn with distinct strengths. The recent signing of the agreement on EU accession opens an era of policy coordination with Europe with potentially powerful channels for speeding income convergence. This, together with modest external indebtedness, prompted declining spreads and an upgrade in Moody's ratings of external debt to A2 in November 2002. The structural revamping of private industry following the Russia crisis, when firms had to cut costs and turn to Western markets, left it leaner and more competitive. Wages proved responsive to developments in the labor market, while the zloty depreciation in 2002 further bolstered export profitability. Reforms to the labor code introduced in mid-2002 should stimulate labor demand once the recovery takes hold. And inflation expectations have been tamed. With a moderate current account deficit and a floating exchange rate, these developments have diminished important sources of vulnerability.

Executive Board Assessment

Executive Directors noted that the strong upturn in industrial output, the continued decline in inflation and the strengthening of the external position create favorable conditions for a cyclical recovery of the Polish economy notwithstanding a difficult external environment. Particularly encouraging is the strong increase in productivity, which together with wage moderation and the depreciation of the zloty, have resulted in a welcome strengthening of export competitiveness.

Notwithstanding these improvements, Directors cautioned that turning the nascent recovery into durable growth will be a major challenge, and will require decisive action to address Poland's problems of high unemployment, insufficient progress in structural reform, and a persistently high structural fiscal deficit. They therefore urged the authorities to use the opportunity provided by the improving cyclical position and imminent EU accession to further strengthen macroeconomic policies and speed up structural reforms. Directors welcomed in this regard the strongly positive outcome of the national referendum on Poland's accession to the EU, which they hoped will help create a new momentum in the reform effort.

Directors stressed the need for a substantial fiscal adjustment, in particular a deep reform of public expenditure policies, to reverse the recent deterioration in public finances and contain the rapid increase in public debt. They welcomed the recent fiscal reform proposals which, if fully implemented, would be an important first step toward budget consolidation. By improving the flexibility of budget formulation, the proposed measures would help redress recent real public sector wage and social transfer increases and permit expenditure restructuring needed to absorb EU funds. The reforms of the personal and corporate income taxes would reduce distortions in the tax system and lower poorly targeted tax expenditure.

Looking ahead, Directors emphasized that more extensive measures will be needed soon to ensure that public debt remains within constitutional limits, reduce the vulnerability of public finances, and create further room for significantly easier monetary policy. They urged the government to build the required political and social support for a well-structured fiscal reform agenda, based on prudent growth assumptions, and focusing on pensions and social benefits, including farmer pensions and support, further reductions in subsidies, and cuts in public employment. Directors noted that substantial savings in these areas, along with measures to widen the tax base and further improve tax administration, will be key to containing the fiscal deficit while at the same time creating room for raising infrastructure investment.

Directors commended the National Bank of Poland (NBP) for achieving price stability and continuing to ease monetary conditions as inflationary expectations subside. With a still widening output gap, high unemployment and continued wage discipline in the corporate sector, they saw scope for further interest rate cuts without jeopardizing the inflation target. In light of the uncertainties about the effects still in the pipeline of past interest rate cuts, Directors considered the NBP's approach of small cuts appropriate, but urged against excessive caution in assessing inflationary pressures. The recent depreciation of the zloty has resulted in a welcome improvement in export competitiveness, but Directors noted that, to secure this gain

and avoid undue appreciation of the zloty in the coming years, it will be crucial to continue to improve the macroeconomic policy mix, in particular through sustained fiscal consolidation.

Directors welcomed the authorities' intention to continue with inflation targeting after 2003 when the current target expires. They regarded the continuous inflation target of 2½ percent ± 1 percentage point as broadly adequate, although a number of Directors considered that a somewhat higher target and wider band would be advisable given the scope for price shocks and structural influences on inflation. Directors also generally supported the NBP's strategy of not intervening in the foreign exchange markets and felt that it helped address the risks associated with large capital flows.

Directors urged the authorities to work towards a satisfactory solution of the dispute between the NBP and the government over the use of the NBP's revaluation reserve. Drawing on international best practices, they emphasized that in dealing with this issue, careful consideration should be given to optimal debt management, the appropriate capitalization of the NBP, and a prudent level of foreign exchange reserves, particularly as participation in ERM2 approaches. Directors stressed the importance of ensuring the unfettered ability of the NBP to conduct monetary policy independently, and avoiding any delay in fiscal adjustment.

Directors welcomed the prudent way in which the Polish banks have responded to the difficult economic environment of the past few years, including the pressure on earnings resulting from the increase in classified loans. Continued vigilant supervision will nevertheless be needed, in particular, since the pressure on bank earnings might continue, and foreign currency-denominated housing loans remain sizeable. The formation of a special monitoring unit at the NBP was therefore welcome. Directors also welcomed the authorities' decision to include collective action clauses in international sovereign bond issues not later than upon joining the EU. They supported ongoing efforts to further strengthen the capacity to combat money laundering and the financing of terrorism.

Directors noted the authorities' objective of early adoption of the euro. While recognizing that decisions in this regard will be taken based on the rules and procedures within the competent European fora, Directors stressed that, to realize the benefits of adopting the euro, Poland will need to undertake major expenditure reforms and speed up the structural reforms that are key to strengthening its growth and employment prospects. Some Directors observed that, in view of the still considerable challenges ahead, Poland may need time to achieve greater convergence with the EU before adopting the euro.

Among priorities for structural reform, Directors highlighted in particular the importance of labor and product market reforms, stepped up privatization, and agriculture reform. They welcomed the recent changes to the Labor Code, but, in light of Poland's very high unemployment rate, saw a need for further steps to eliminate remaining rigidities, improve incentives to work, and enhance regional mobility and job training. Directors viewed with concern the slowdown of progress with privatization, and urged the authorities to push ahead with delayed privatization projects.

While Poland's statistical base is adequate for surveillance, Directors encouraged the authorities to improve the periodicity and timeliness of fiscal data for the general government. They welcomed the significant progress made in improving fiscal transparency, but highlighted the importance of a transparent recapitalization of loss making state-owned enterprises.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

POLAND: MAIN ECONOMIC INDICATORS

	1998	1999	2000	2001	2002
Real economy (change in percent)					
Real GDP	4.8	4.1	4.0	1.0	1.3
Real domestic demand	6.4	4.8	2.8	-1.7	0.8
CPI (end-year)	8.6	9.8	8.5	3.6	0.8
Unemployment rate (in percent)	10.4	13.1	15.1	17.5	18.1
Gross national saving (percent of GDP) 1/	21.0	18.2	18.9	17.1	15.6
Gross domestic investment (percent of GDP)	25.2	25.4	25.0	21.0	19.2
Public finance (in percent of GDP)					
General government balance (commitment)	-3.2	-3.3	-3.5	-5.5	-6.7
Public debt 2/	...	...	40.7	41.6	47.6
Money and credit (end of period, percent change)					
Private credit (12-month change)	28.0	29.1	17.3	9.2	4.9
Broad money (12-month change)	24.7	20.1	11.9	9.2	-2.1
Money market rate (end of period, in percent)	15.2	17.9	19.2	11.7	6.7
Balance of payments in convertible currencies					
Trade balance (in percent of GDP)	-8.3	-8.9	-8.0	-6.4	-5.5
Current account (in percent of GDP)	-4.2	-7.2	-6.1	-3.9	-3.6
Official reserves (in billions of U.S. dollars)	28.3	27.3	27.5	26.6	29.8
Reserve cover (months of merchandise imports)	7.7	8.0	8.0	7.6	8.3
Total external debt (percent of GDP)	35.9	40.5	42.4	39.2	43.4
Fund position (in millions of SDRs)					
Quota					1,369.0
Fund holdings of currency (March 31, 2003)					890.14
Holdings of SDRs (March 31, 2003)					31.15
Exchange rate					
Exchange rate regime				Floating Rate	
Present rate				Zl 3.898 per US\$1 (April 28, 2003)	
Zloty per U.S. dollar					
(period average, in percent)	3.5	4.0	4.3	4.1	4.1
Appreciation (+) of real effective exchange rate					
(relative CPIs, in percent)	4.8	-4.0	8.3	10.5	-3.2

Sources: Central Statistical Office; data provided by the authorities; and IMF staff estimates.

1/ Derived as a difference between total savings and current account.

2/ Including risk weighted stock of outstanding guarantees.