© 2002 International Monetary Fund

June 2002
IMF Country Report No. 02/127

Republic of Poland: 2002 Article IV Consultation—Staff Report; Staff Statement; 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 2002 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 2002 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **March 14, 2002,** 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 17, 2002.** 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 statement of **June 7, 2002** updating information on recent developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its June 7, 2002 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.

Selected Issues and Statistical Appendix papers

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to Publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

REPUBLIC OF POLAND

Staff Report for the 2002 Article IV Consultation

Prepared by the Staff Representatives for the
2002 Consultation with the Republic of Poland

Approved by Michael Deppler and Liam P. Ebrill

May 17, 2002

- The Article IV consultation discussions were held in Warsaw during February 27–March 14, 2002. The mission met with the Ministers of Finance, Treasury and the Economy, the Speaker of the lower house of Parliament, the President of the National Bank of Poland (NBP) and other senior officials, including members of the Monetary Policy Council (MPC).

- The staff team comprised Ms. Schadler (Head), Messrs. Hoffmaister and Selassie (all EUI) and Mourmouras (PDR) as well as Sassanpour and Sierhej from the Resident Representative's office. Mr. Gillingham (FAD) joined the mission during March 4–11 to follow up on FAD TA recommendations for rationalizing public expenditures.

- Poland's statistical base is adequate for surveillance.

- At the conclusion of the last consultation in March 2001, Directors welcomed the decline in inflation and the current account deficit, but were concerned about low growth and rising unemployment. They endorsed the operation of fiscal stabilizers but emphasized the need to keep to budget spending totals to retain fiscal credibility. Directors welcomed interest rate cuts and felt there was room for further action. Along with stronger growth, further labor market flexibility, notably on minimum wages, would boost jobs.

- The former Solidarity Electoral Action (AWS) administration lost all of its seats in last September's general elections. The victorious Democratic Left Alliance (SLD)—Labor Union (UP) fell just short of an overall majority, and formed a coalition government with the Polish Peasant Party (PSL). The leadership is committed to early EU accession. To date agreement has been reached on 23 chapters out of 30, including: labor mobility (with Polish access being delayed for up to 7 years after entry) and EU residents' ability to acquire land in Poland being delayed for up to 12 years.

Contents Page

I. Background ... 3

II. Report on the Discussions ... 13

A. Outlook for 2002 and the Medium-Term ... 13
B. Fiscal Policy ... 16
C. Monetary Policy ... 19
D. Financial Sector Risk and Vulnerability ... 20
E. Structural Policies ... 23

III. Staff Appraisal ... 24

Text Boxes
1. Public Expenditures in Poland ... 17
2. Temporary Supply Shocks and Inflation in Poland ... 21

Figures
1. Selected Economic Indicators, 1991–2001 ... 4
2. Indicators of Fiscal and Monetary Policy, 1997–2002 ... 5
3. Balance of Payments Indicators, 1997–2001 ... 6
4. Spreads and Yield Curves, 1997–2002 ... 8
5. Indicators of Inflation, 1997–2002 ... 9
6. Indicators of Money and Credit, 1997–2002 ... 10
7. Indicators of Profits and Competitiveness, 1997–2002 ... 11
8. Indicators of Employment and Unemployment, 1997–2002 ... 12
9. Unit Labor Costs for Advanced EU Accession Countries, 1995–2001 ... 14

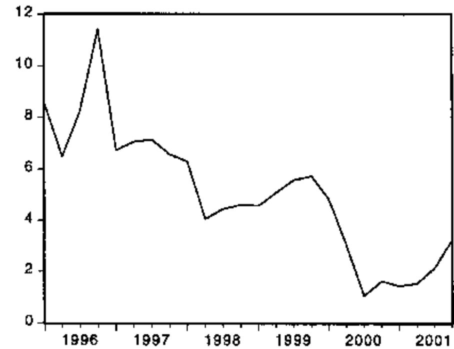
Tables
1. Selected Economic Indicators ... 27
2. Balance of Payments, 1997–2005 ... 28
3. General Government Revenues and Expenditures ... 29
4. Monetary Survey, 1996–2001 ... 30
5. Savings and Investment Balance, 1997–2006 ... 31
6. Indicators of External Vulnerability ... 32

Appendices
I. Fund Relations ... 33
II. World Bank Activity ... 38
III. Statistical Information ... 39

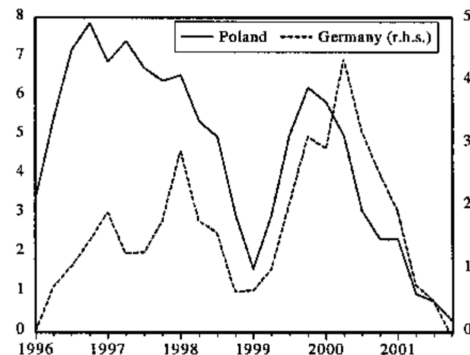
I. BACKGROUND

1. **Poland has weathered a difficult two years.** Following exogenous shocks (Russia crisis and oil prices), an aggressive policy response to rising consumption growth in 1999 and early 2000, and a downturn in Germany, output growth slumped from 4 percent in 2000 to 1 percent last year (Figures 1–2, and Table 1). The slowdown has taken a toll: lay-offs, coupled with a surge in school leavers, have raised the unemployment rate back to the high teens; the fiscal deficit has widened sharply; and the stock of non-performing bank loans has risen. The accompanying progress in lowering inflation and the current account deficit—the threats to prosperity of yesteryear—has done little to improve sentiment. Frustration is evident in the complete wipeout of Solidarity Electoral Action (the majority coalition partner) in last September's elections. And, playing off this frustration as well as genuine concerns about high real interest rates especially in late 2000 and early 2001, fierce attacks have been made on the MPC, through a Parliamentary censure and threats to alter the structure of the MPC.

Poland: Year-on-Year Growth in Real Private Consumption, 1996-2001 (in percent)



Year-on-Year Real GDP Growth (in percent)



2. **At the heart of the slowdown was a collapse in investment (Figure 3).** This largely reflected postponement and cancellation of projects by enterprises due to high borrowing costs, decelerating demand and low profitability. But even before its recent plunge, investment growth had weakened ahead of the domestic and external downturn, probably reflecting a slowing of post-transition obsolescence and the high ratio of investment to GDP. With non-privatization FDI remaining strong (Table 2), it appears that domestic investors are the ones holding back.

3. **By 2001, weakening growth was cushioned by a considerable easing of fiscal and monetary policies.** The general government deficit widened sharply in 2001, reflecting both automatic stabilizers and an increase in the structural deficit. State (central government) primary expenditures (excluding one-off transfers) rose relative to GDP by 1 percentage point, notwithstanding cutbacks late in the year. Two factors accounted for this rise: significant increases in transfers and subsidies to households, agriculture and state enterprises, as well as wages in an

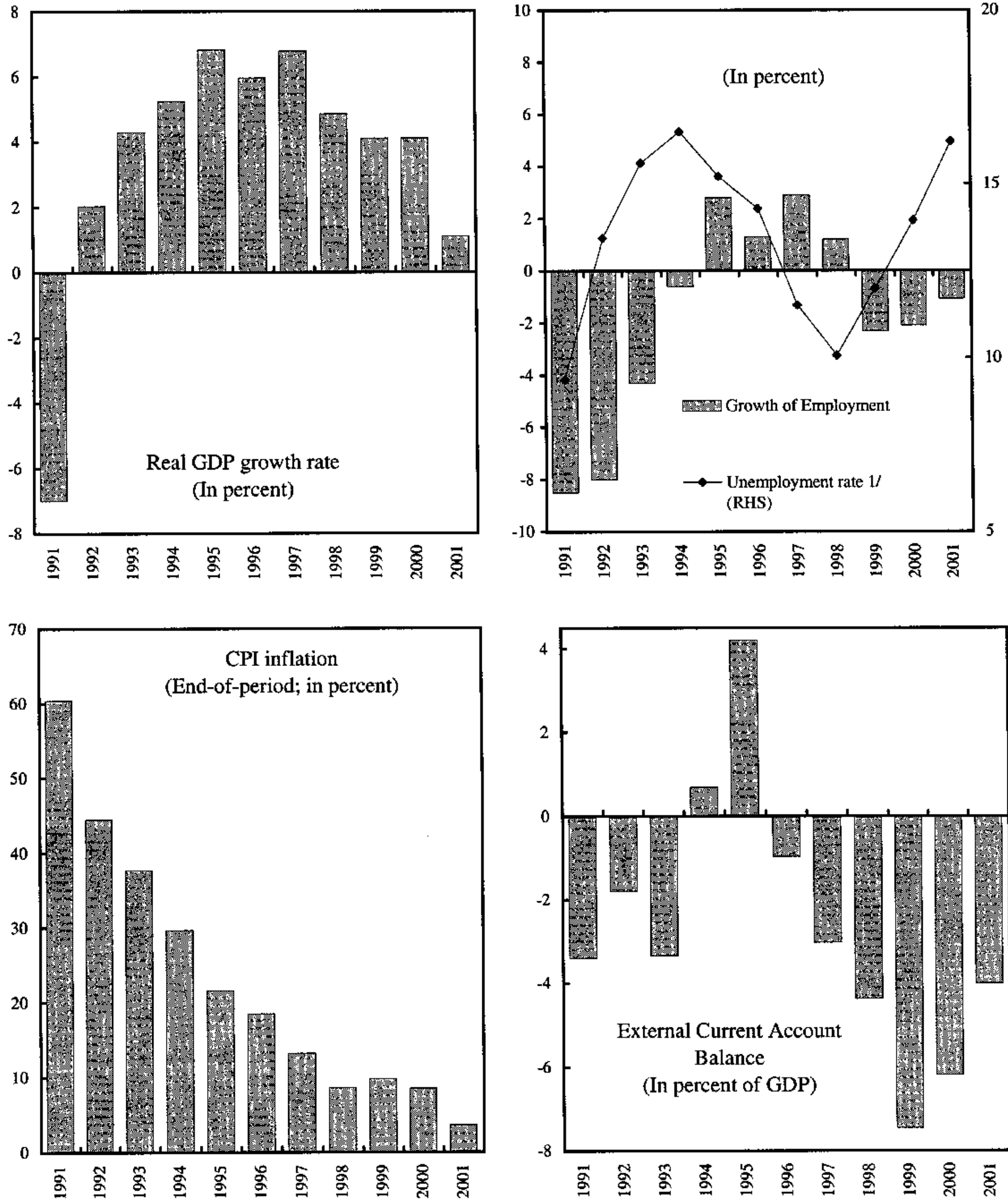
Fiscal Developments 2001-2001

	2000 Outturn	2001 Budget		Estimate	
	Percent of of GDP	Zl Bn	Percent GDP	Zl Bn	Percent of GDP
State budget					
Revenue	19.8	161.1	20.6	140.5	19.5
Expenditure	22.0	181.6	23.2	172.9	24.0
excl. interest	19.4	159.4	20.4	152.0	21.1
Balance	-2.6	-20.5	-2.6	-32.6	-4.5
Gen. Govt Economic balance 1/	-2.6	-14.1	-1.8	-35.0	-4.8
Gen. Govt. balance 1/ 2/	-3.1	-23.0	-2.9	-38.4	-5.3
Est Structural balance	-2.3	-19.0	-2.5	-21.2	-2.9
Privatization receipts	3.9	18.0	2.3	6.5	0.9
Nominal GDP (Zl billion)	686	782		722	

1/ For 2001, cash basis.

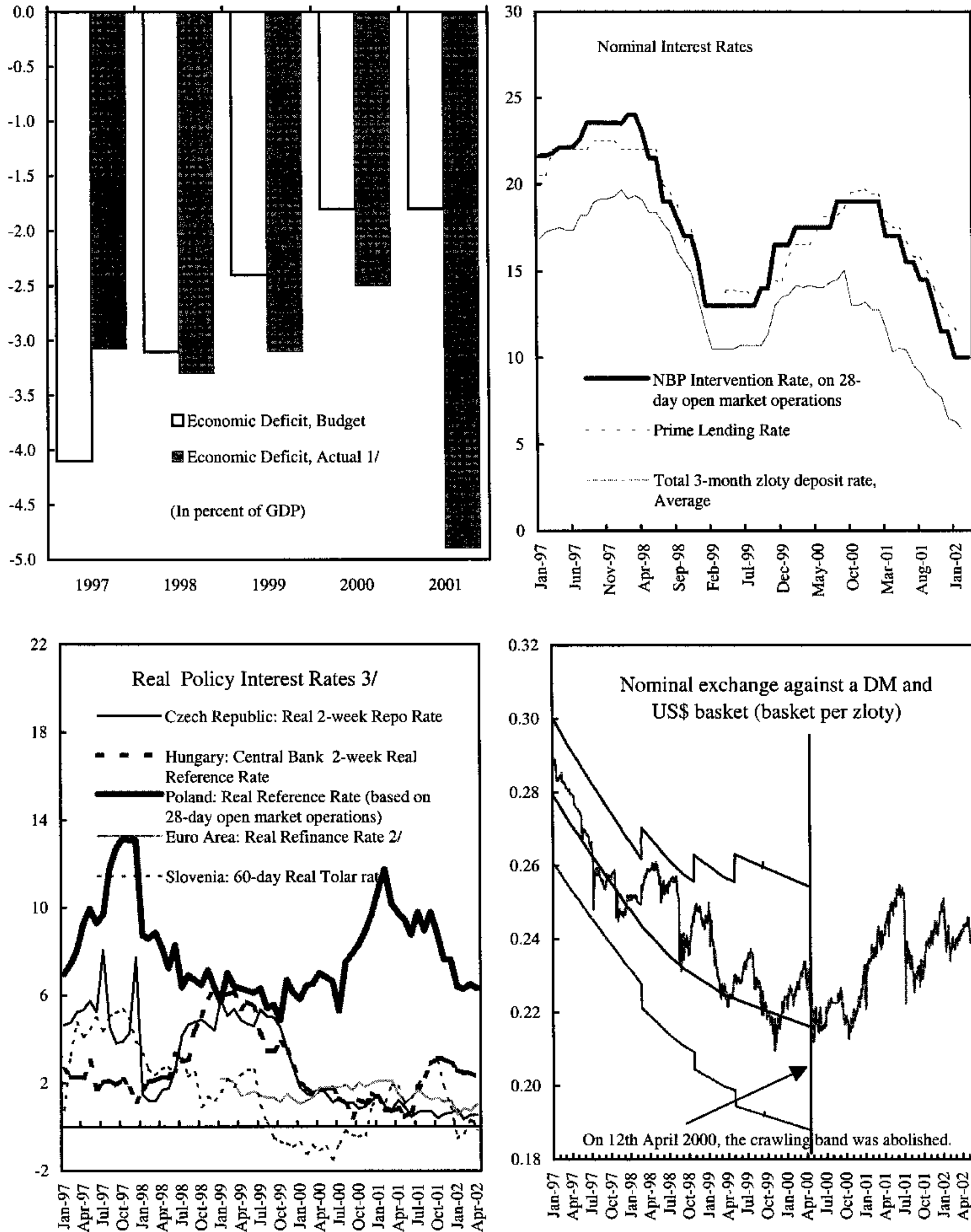
2/ PSBR corresponds to general government balance less privatization proceeds.

Figure 1. Poland: Selected Economic Indicators, 1991-2001



Sources: Polish authorities and staff estimates.
1/ Registered unemployment, annual averages.

Figure 2. Poland: Indicators of Fiscal and Monetary Policy, 1997-2002



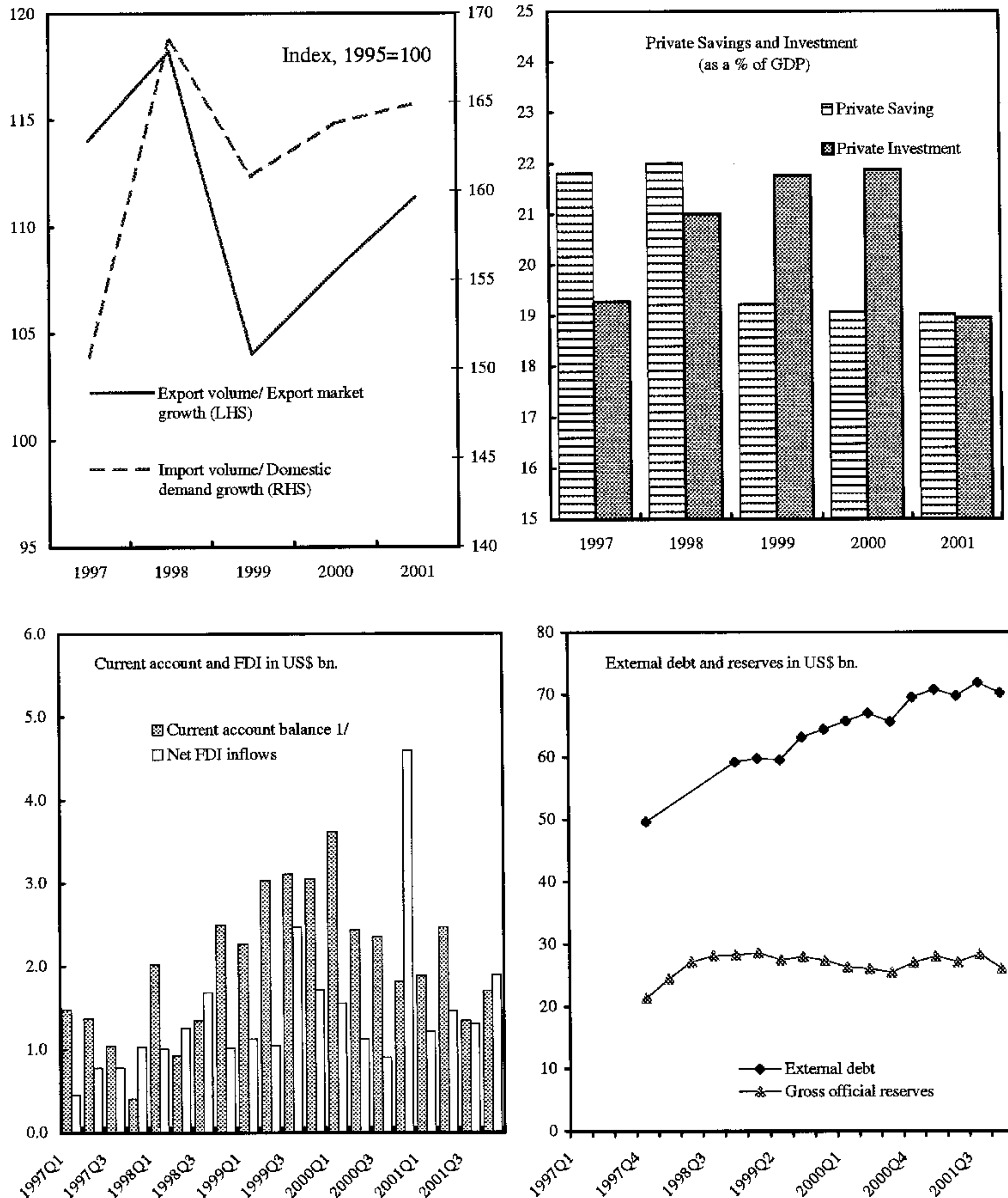
Source: Polish Authorities.

1/ On commitment basis.

2/ ECB fixed rate until July 2000, after that minimum bid rate is used.

3/ Policy rate deflated by inflation over the past 12 months.

Figure 3. Poland: Balance of Payments Indicators, 1997-2001



Sources: National Bank of Poland, the Central Statistical Office and staff estimates.

1/ Derived on the basis of seasonally adjusted exports and imports. Defined as the deficit.

2/ Quarterly data are available only from 1999 for external debt, and from 1998 for gross official reserves on the current official definition of reserves.

election year; but also outcomes for inflation and growth that were far below budget projections. Together with a cyclical slowing of revenues, this led to a general government economic deficit provisionally estimated by the staff at just under 5 percent of GDP, up from 2.6 percent of GDP in 2000 (Table 3).[1]

4. **Falling inflation and inflation expectations permitted deep cuts in interest rates (Figure 4).** Headline inflation dropped from 11½ percent year-on-year in mid-2000 to 3½ percent at end-2001, well below the target range of 6–8 percent and indeed the end-2002 target of 5 percent, ±1 percentage points (Figure 5). Seasonally adjusted inflation in the first quarter of 2002 was less than 1 percent. A favorable harvest and declines in international oil prices last year helped; but inflation excluding those prices was some 4 percent year-on-year, and -0.5 percent in the first quarter of 2002. After some hesitation, monetary policy has been eased significantly: the key policy interest rate has been cut by 950 basis points since February 2001. However, with inflation having fallen sharply, real policy interest rates (deflated by either current or projected one year ahead inflation) at some 6 percent are high. Credit growth remains anemic (Table 4, Figure 6).

5. **Despite the interest rate cuts, the real exchange rate has appreciated considerably, heightening vulnerability to shifts in market sentiment.** The CPI-based real effective exchange rate has appreciated by some 25 percent since end-1999 (Figure 7), of which at most 6 percentage points can be attributed to Balassa-Samuelson effects. Also, despite labor shedding and wage moderation, relative unit labor costs have risen markedly. Beyond threatening further export volume expansion, the strong zloty and wide interest rate differentials have promoted a rapid rise in household foreign currency borrowing from domestic banks. With little evidence of hedging, this has heightened banks' credit risk.

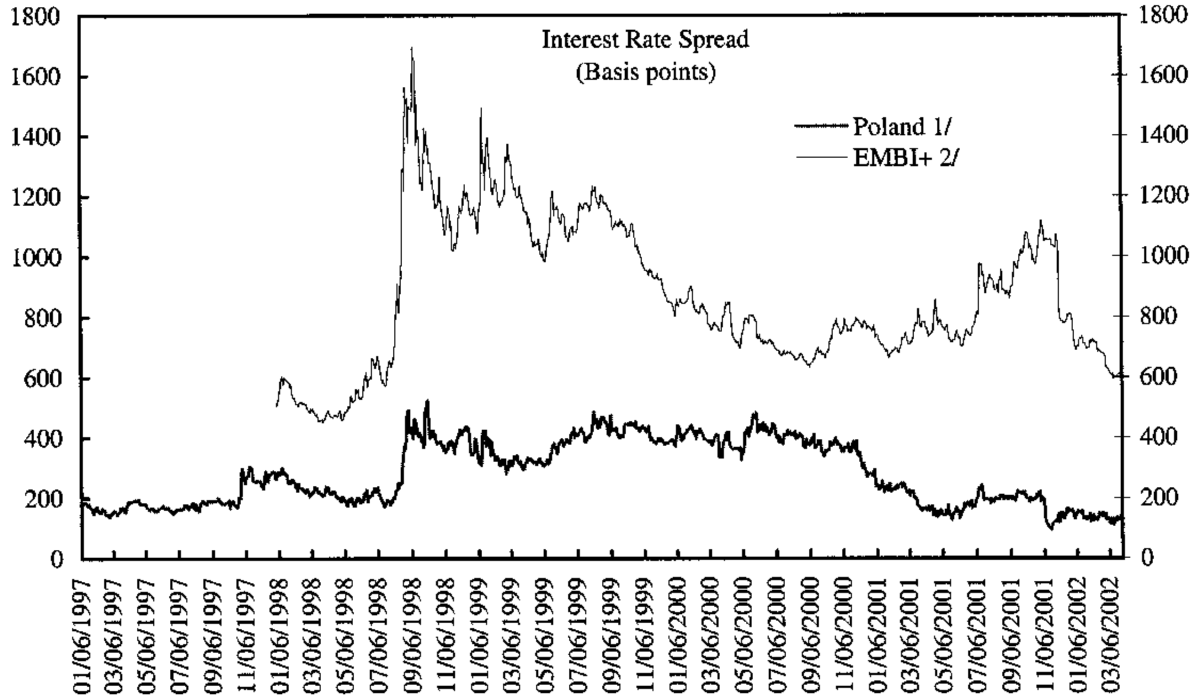
6. **The slide in investment coupled with resilient private savings cut the current account deficit.** Despite the appreciating zloty and weakening external demand, export volumes expanded by 6 percent in 2001, well ahead of export market growth. Enterprises have accepted lower profitability to maintain market share. With activity subdued, import growth was weak, allowing the current account deficit to narrow to 4 percent of GDP.

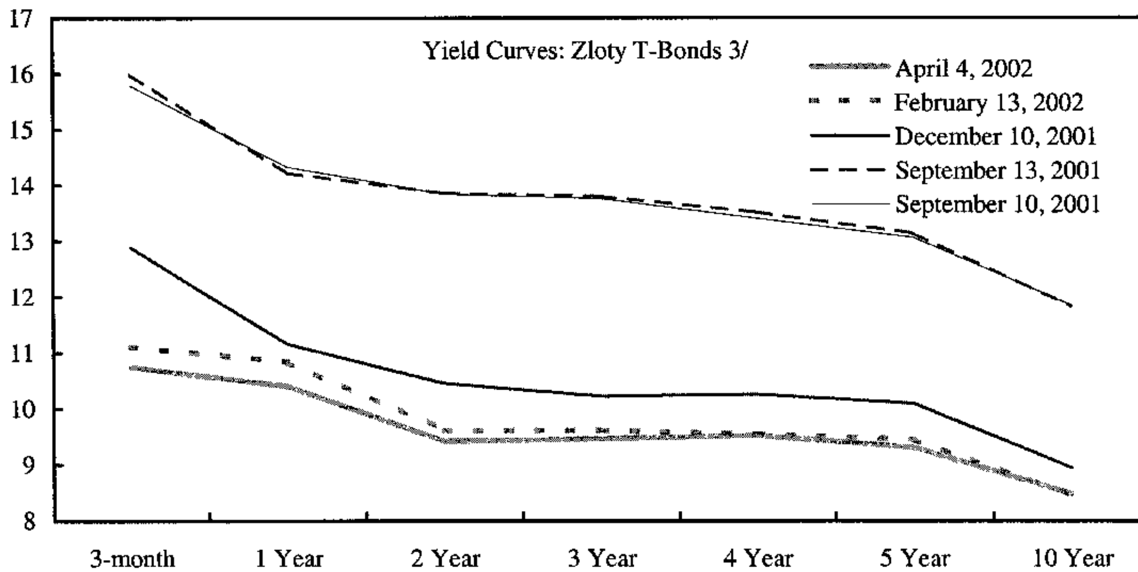
7. **Unemployment in Poland is among the highest in the OECD, reflecting structural and cyclical factors.** After dropping to 10 percent in mid-1998, unemployment has risen to some 18 percent (Figure 8). In contrast, the unemployment rate is 8 percent in the Czech Republic (where labor force participation is much higher) and 6 percent in Hungary (though its participation rate is lower). Demographic factors have contributed to the rise in unemployment in Poland, with the working age population increasing by around ¾ million (close to 3 percent) since 1998. But more important was an 8 percent drop in employment

---

[1] The economic balance adds transfers to the private pension pillar to revenues and some off-budget payments to spending and subtracts receipts from the sale of third generation phone licenses from revenues.

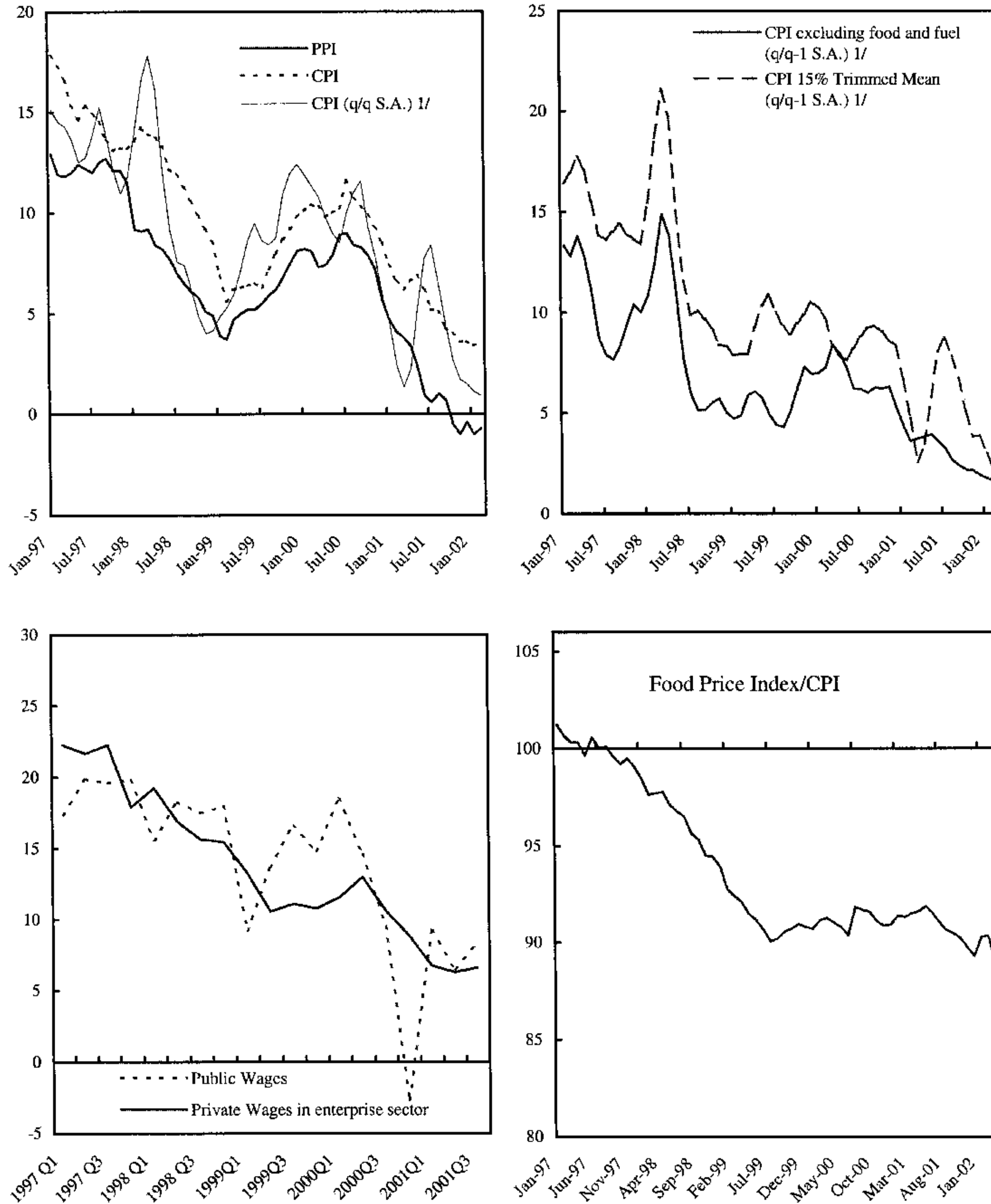
Figure 4. Poland: Spreads and Yield Curves, 1997-2002





Source: Bloomberg.
1/ Spread on US$ denominated 30 year bond and Republic of Poland US$ Brady bond maturing in 10/2024.
2/ Emerging Markets Bond Index.
3/ Nine-year bond yields used in 2002 instead of 10-yr yields.

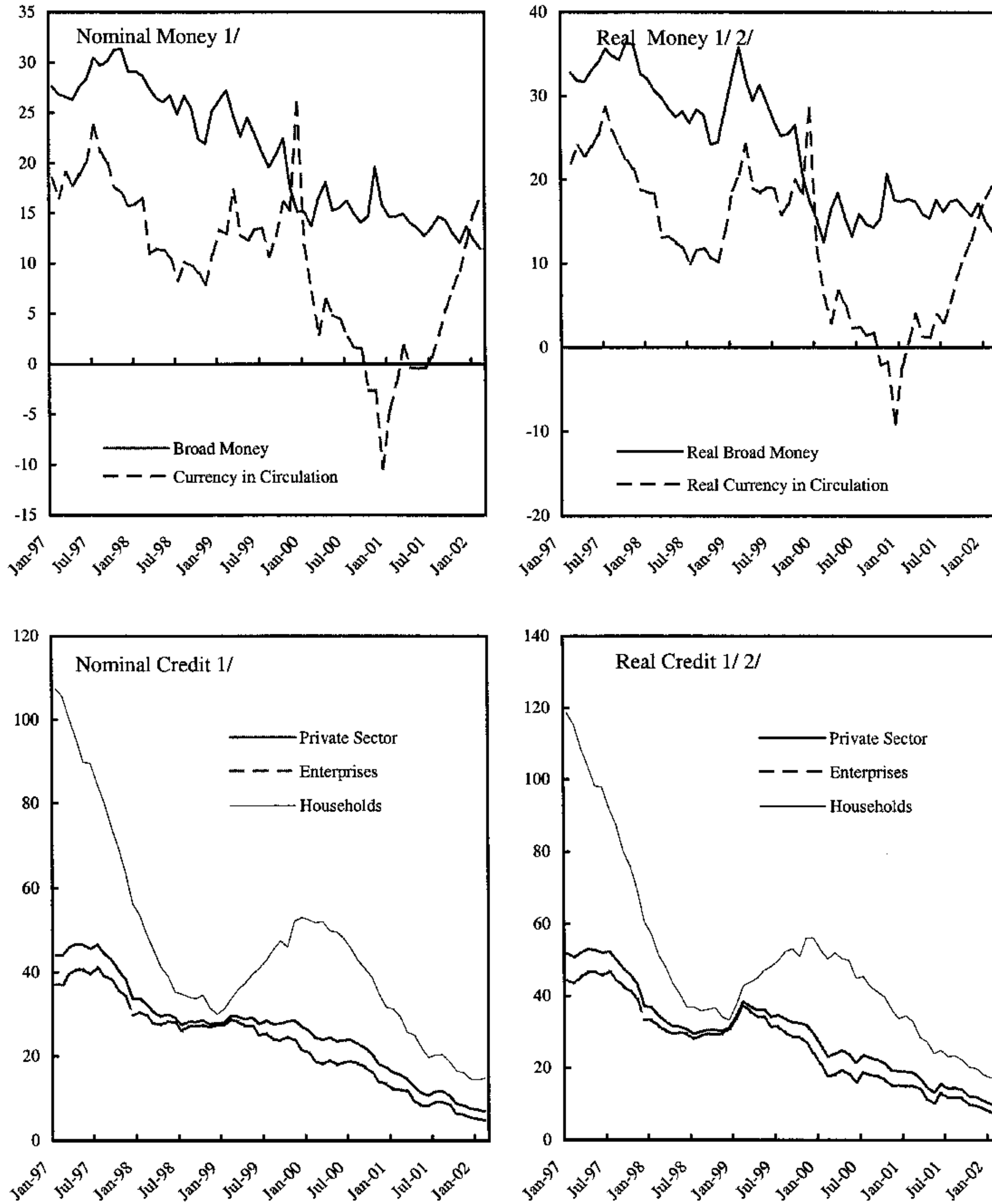
Figure 5. Poland: Indicators of Inflation, 1997-2002
(12-month growth, in percent, unless otherwise stated)



Source: Polish Authorities.

1/ Three-month moving average annualized.

Figure 6. Poland: Indicators of Money and Credit, 1997-2002
(12-month growth)

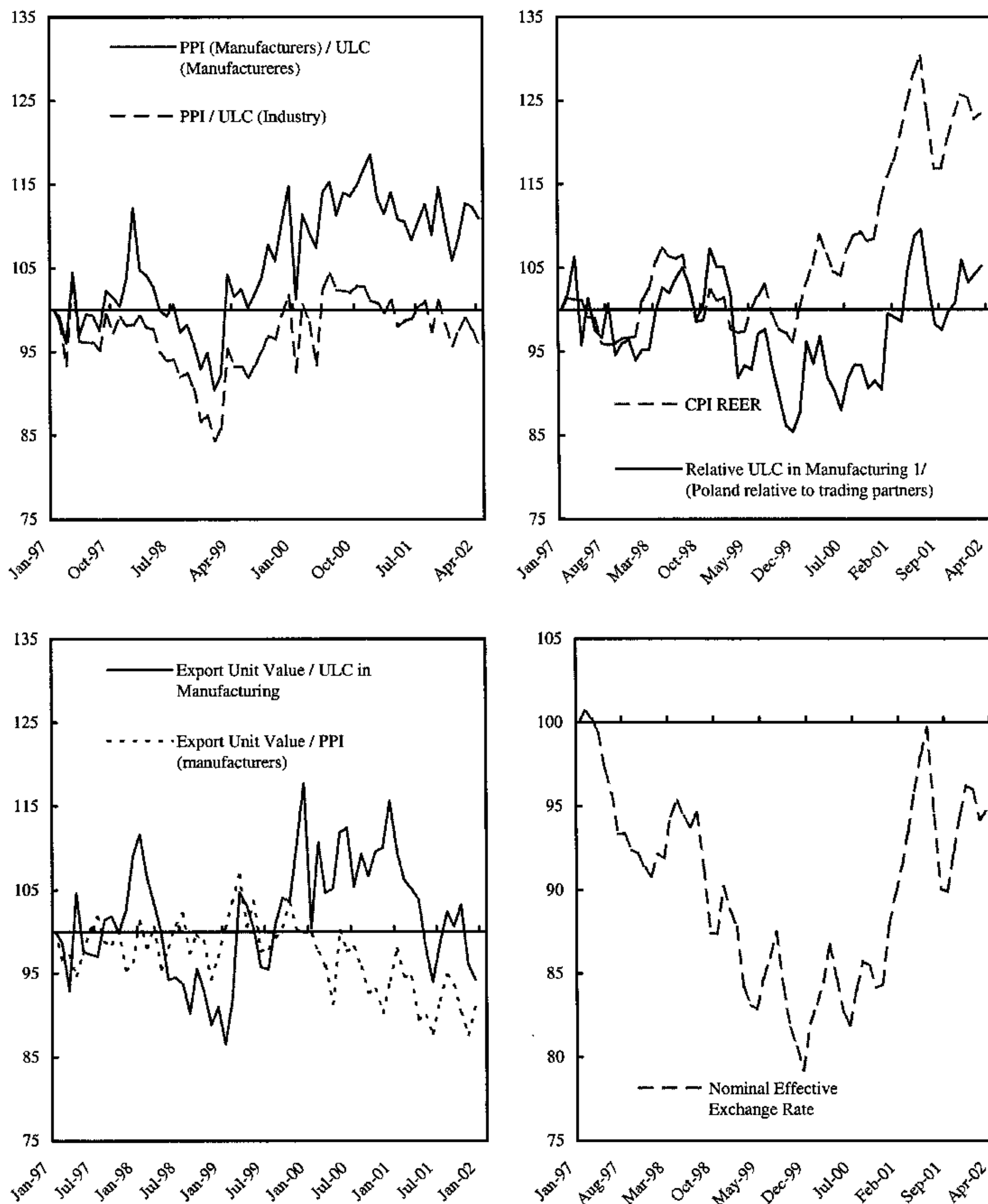


Source: Polish authorities.

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

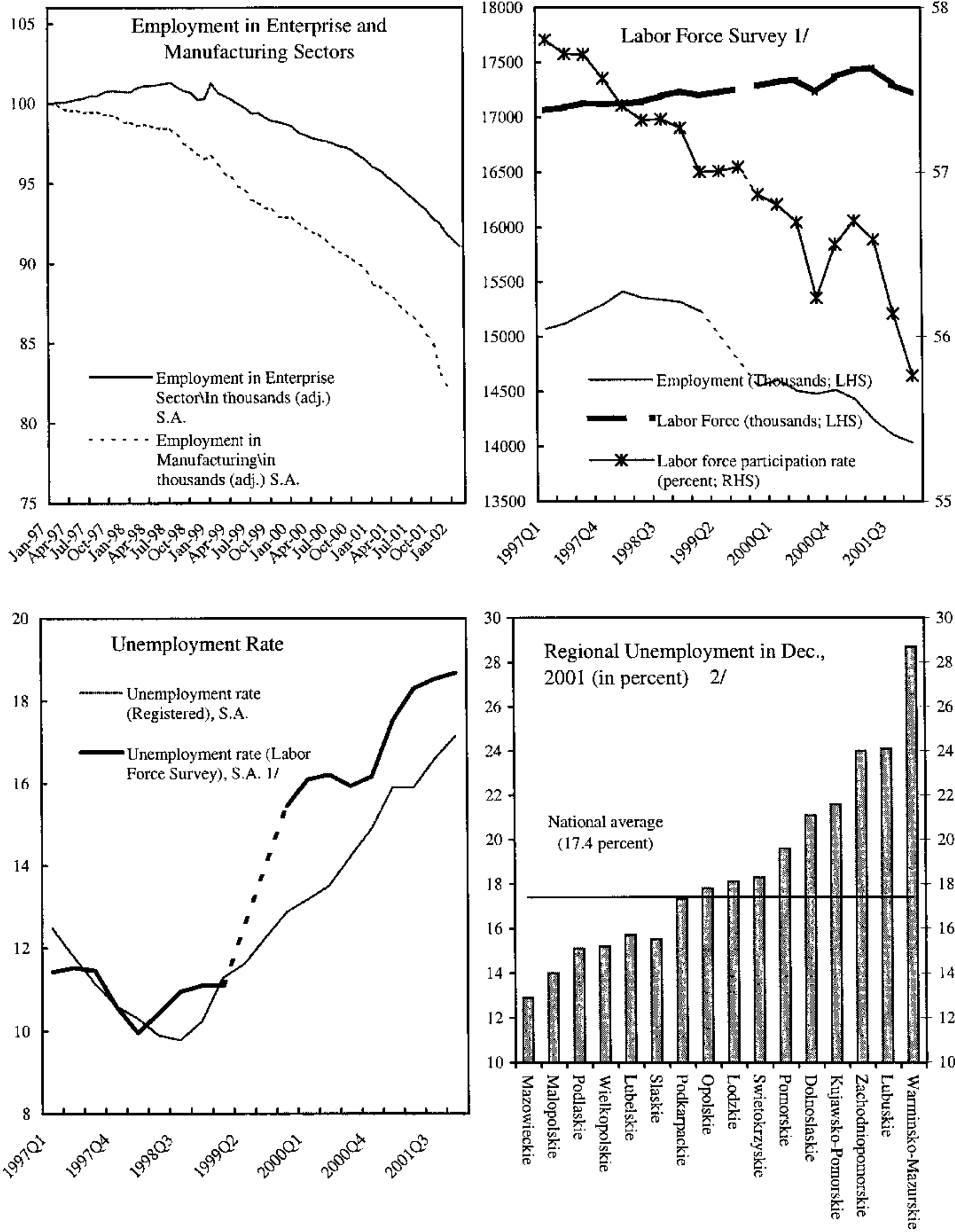
2/ Deflated using CPI excluding food and fuel.

Figure 7. Poland: Indicators of Profits and Competitiveness, 1997-2002
(January 1997=100)



Source: Polish authorities, Information Notice System, and Staff Caluculations.
1/ Trade weights for 1999 for Austria, Belgium, Denmark, Finland, France, Germany, Italy, Japan, Netherlands, Norway, Spain, Sweden, Switzerland, United Kingdom and United States.

Figure 8. Poland: Indicators of Employment and Unemployment, 1997-2002



Sources: Polish Authorities and Staff Calculations.

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

2/ The Mazowieckie region incompasses Warsaw.

since end-1998—a loss of more than a million jobs. The slowdown in activity, labor shedding by privatized enterprises after employment guarantee periods and the shakeout following the Russia crisis all have contributed. At the margin, high wage costs probably also are pricing workers out of jobs: whereas unit labor costs have trended downwards in other accession countries, they have remained high in Poland (Figure 9).

II. REPORT ON THE DISCUSSIONS

8. **The authorities confirmed the priority the new government attaches to regenerating growth and cutting high unemployment.** Like many observers, they saw Poland's annual growth potential at 4–5 percent, a rate that if sustained over time would rekindle job creation. They were committed to adjusting macroeconomic policies to preserve underlying gains in inflation and the current account deficit. Central to this effort was a rule limiting spending increases in future budgets, cutting to the quick of Poland's fiscal problem—excessive spending and high taxation. The authorities also pointed to their medium-term plan for structural reform ("Entrepreneurship-Development-Jobs") as key to their strategy for regenerating growth: the wide-ranging plan was a blueprint for eliminating institutional impediments to job-creation and growth of small and medium-sized enterprises, spearheading infrastructure development, and reining in social transfers. Considerable tension attached to further reductions in interest rates, which the government viewed as essential to support their program, and the MPC on balance viewed as risky for inflation. The new administration was skeptical about the benefits of further large-scale privatization and preferred to give priority to enterprise restructuring. While targeting a reduction in public ownership by half to 10–15 percent of GDP by 2005, the authorities expected to sell shares in enterprises selectively and mainly outside the financial sector.

9. **The new government has firmly embraced the goal of early EU accession.** The authorities were confident that EU accession by early 2004 was feasible and are directing considerable effort toward putting in place the institutional infrastructure to absorb EU funds. Internal debate had started on a schedule for adopting the Euro, and the authorities were considering how to mesh policies with the Maastricht criteria.

A. Outlook for 2002 and the Medium-Term

10. **Recent indicators suggest that Poland is poised for a recovery.** Lagged effects of the stimulus from fiscal and monetary policies last year and the anticipated pick-up in Germany should cement a recovery in the second half of the year. Nevertheless, with a weak first half expected, the authorities and staff agreed that average output growth for this year would only be at or somewhat above last year's 1.1 percent, while unemployment would rise. Even with a pick-up in demand in the second half, pressures on the

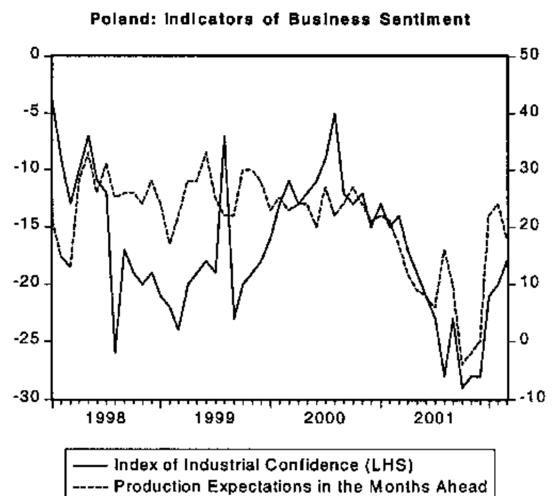
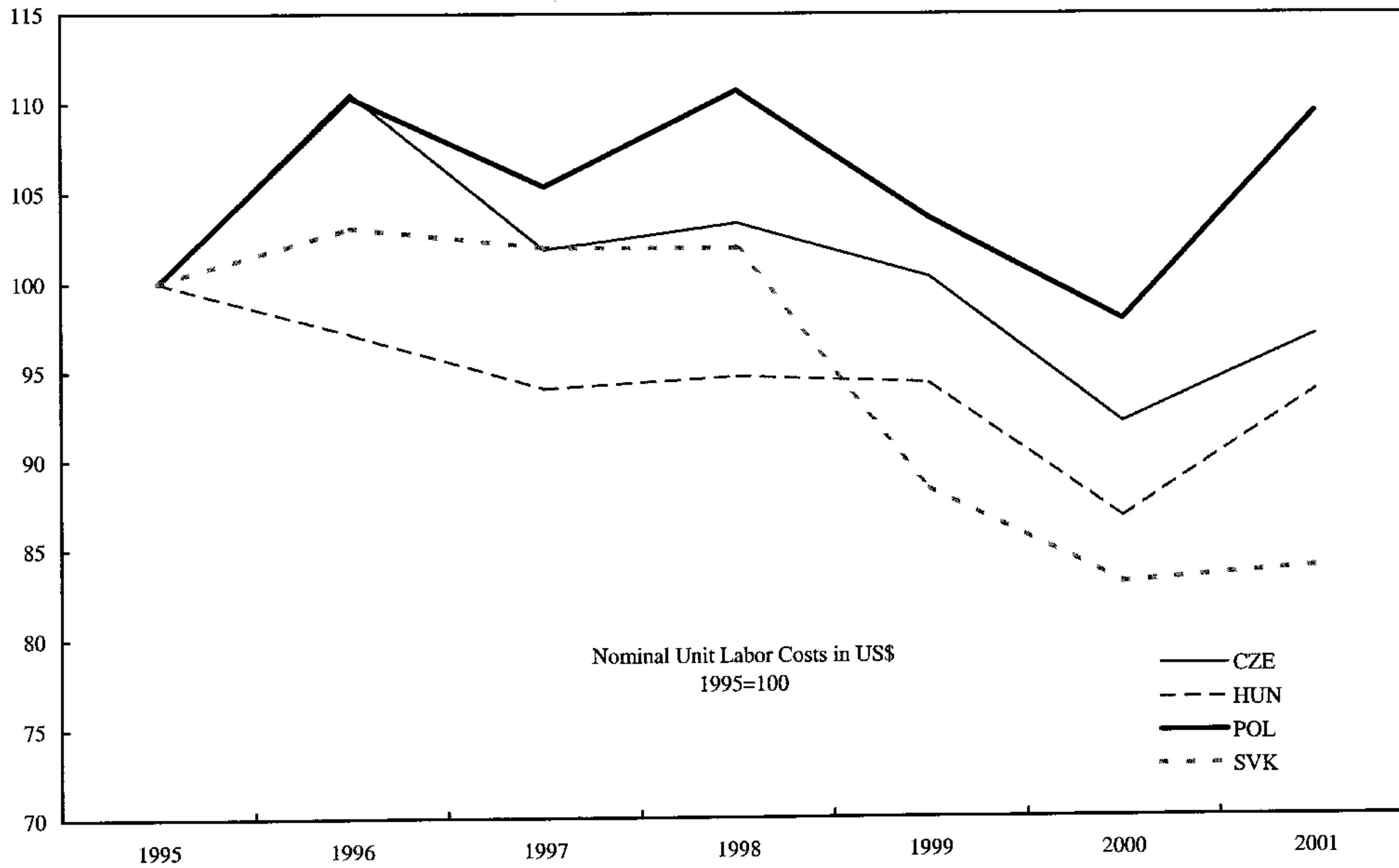


Figure 9. Poland: Unit Labor Costs For Advanced EU Accession Countries, 1995-2001



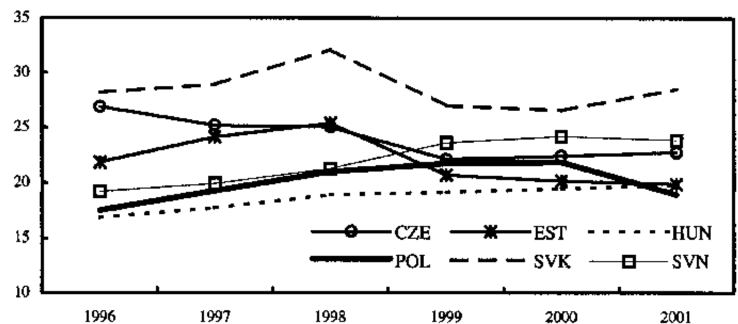
Source: OECD.

current account should be limited. Views diverged on the outlook for inflation. The authorities expect end-year inflation to be above 4 percent, reflecting a pick-up in demand pressures as well as food and fuel prices. Staff noted, however, with seasonally adjusted inflation now running at about 1 percent, a considerable acceleration of inflation would still leave year-end inflation closer to 3 percent.

11. **Beyond 2002, Poland's growth prospects are strong, though much depends on the forceful implementation of reforms.** The authorities' medium-term program envisages growth rising to 3 percent next year and 5 percent in 2004, driven by sharp increases in investment. Staff was somewhat less bullish (Table 5). Growth has been well below potential—which the staff estimates at 4–4½ percent—since mid-2000, and considerable slack now existed. Yet, staff felt that without a more pronounced rebalancing of the policy mix to lessen pressure on the real exchange rate, greater flexibility in labor markets and an acceleration of privatization, returning to potential would be slow.

12. **This debate underscored the high uncertainty about the outlook for investment and, ultimately, the current account.** At 19 percent of GDP, private fixed investment in Poland is the lowest among the leading EU accession countries. There was consensus that some pick-up in investment from last year's depressed levels is likely, as enterprises will, at a minimum, invest to upgrade product quality and remain competitive. Beyond that, views differed somewhat. The authorities' program envisages gross investment increasing to 27 percent of GDP by 2006. Reflecting rising incomes, they expect private savings also to grow, allowing the current account deficit to fall below 2½ percent of GDP. Staff projections show a more gradual recovery in private fixed investment to the levels of the late 1990s. This takes into account currently low capacity utilization and the TFP-driven nature of Poland's past growth. Staff also argued that higher enterprise savings, as profits recover against the backdrop of a weak bargaining position for labor, are likely to be matched by a deterioration in household savings as prospects for permanent income rise with EU accession. With considerable increases in the private investment-saving imbalance, shrinking government deficits would be essential to curbing an increase in the current account deficit.[2]

Private fixed investment in select CEE accession countries in percent of GDP



[2] Chapter 1 in the selected issues paper looks at external financing prospects.

B. Fiscal Policy

13. **The discussion centered on the need to tackle the long-elusive fiscal adjustment.** The sharp deterioration in public finances in 2001 has heightened the urgency of this adjustment. The authorities acknowledged that unless the PSBR is reduced, public debt would quickly rise to the 60 percent of GDP constitutional limit, from the present 43 percent. Staff stressed that failure to curb the deficit could impede credit growth to the private sector or, should private investment take-off, unleash a renewed widening of the current account deficit. The authorities and staff agreed that a successful fiscal adjustment absolutely required reining in the high level of spending, particularly on transfers to households (Box 1).

14. **The 2002 State (central government) budget curbs spending growth, but the PSBR will remain high**. The authorities pointed out that, given the time constraint, their draft State budget, submitted to Parliament in November, had merely sought to re-shape the draft submitted by the outgoing government at end-September. State primary expenditure growth was limited to some 4 percent, compared with last year's estimated 14 percent. Numerous measures—including a public sector wage freeze, cuts in some benefits, and delays in introducing new spending initiatives—contributed to limiting spending growth. New taxes (notably, an excise on electricity and a tax on interest income) were introduced, and the coverage of other taxes was broadened. Considering the Ministry of Finance's revenue projections overly pessimistic, Parliament subsequently increased State expenditures by Zl 1 billion (0.15 percent of GDP). For the general government, the authorities envisage an economic deficit of 4.9 percent of GDP. Staff considered the 2002 budget reasonable, and even thought a lower economic deficit likely on the basis of higher (State) revenue projections. It, however, noted that local government spending increases would need to fall from 14 percent last year to under 3 percent. The authorities argued that most government spending comprised wages and the wage freeze would facilitate the projected moderation. Staff estimates show that, if implemented strictly, the 2002 budget should more than reverse last year's structural slippage.

Fiscal Outlook 2002

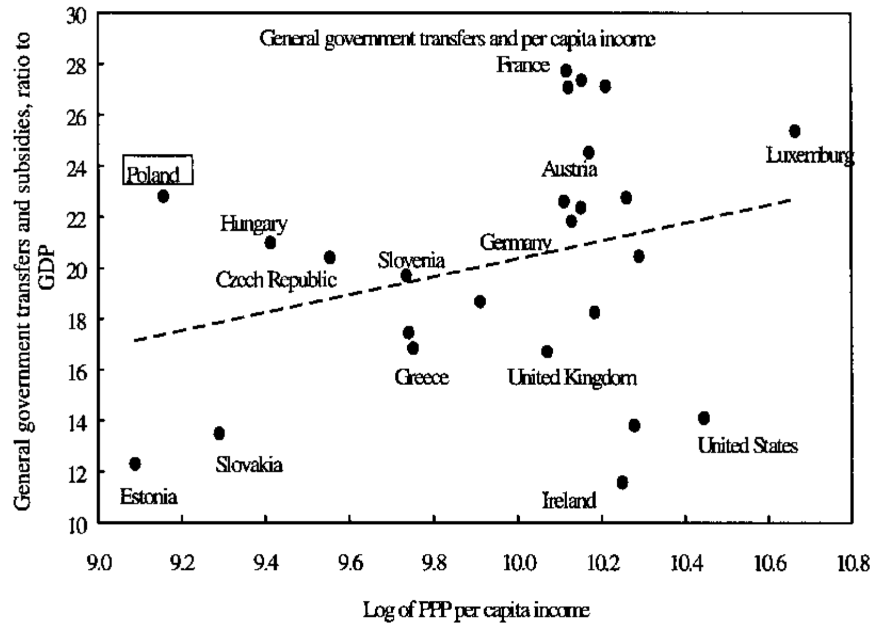
	2001 Staff Est.		2002 Budget.	
	Zl Bn.	Percent of GDP	Zl Bn	Percent of GDP
State budget				
Revenue	140.5	19.5	145.1	18.8
o/w Income taxes	36.7	5.1	40.4	5.3
Consumption taxes	82.4	11.4	90.7	11.9
Expenditure	172.9	24.0	185.1	24.1
Non-interest expenditure	152.0	21.1	159.4	20.7
Balance	-32.6	-4.5	-40.0	-5.2
Gen. Govt Econ. balance 1/	-35.0	-4.8	-37.2	-4.9
Gen. Govt balance 1/ 2/	-38.4	-5.3	-45.9	-6.0
Est Structural balance	-21.1	-2.9	-16.1	-2.0
Privatization receipts	6.5	0.9	6.6	0.9

1/ For 2001, cash basis.
2/ PSBR corresponds to general government balance less privatization proceeds.

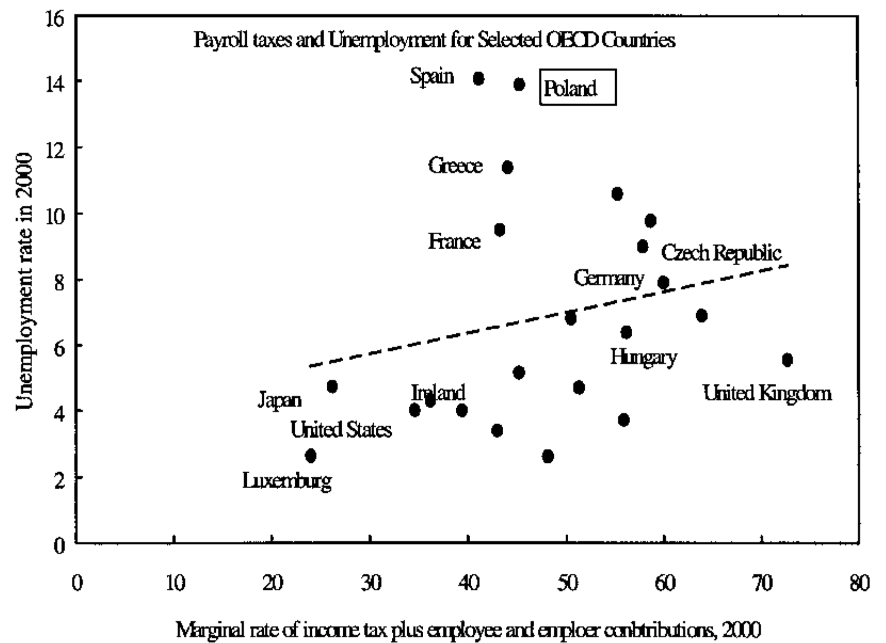
15. **For subsequent years, the authorities have announced their intention to limit total State spending increases to the projected increase in the CPI plus 1 percent—a rule that (though without legal force) will be the anchor for public finance**. Previous medium-term frameworks in Poland focused on targeting reductions in the general government economic deficit. This objective had not been realized because of unexpected weakness in the economy as well as poor expenditure control. Against this backdrop, the authorities argued that the expenditure rule focused on Poland's essential fiscal problem—high and rising public spending—and on a policy variable that could be controlled through

Box 1. Public Expenditures in Poland

The level of public expenditures and, in particular, social transfers in Poland, is high. In part, this is a legacy of socialism: Begg and Wyplosz (1999) show that government transfers and consumption for many transition countries are higher than the OECD average, as suggested by the correlation of government transfers and per capita income (top panel, see also Christou and Daseking, 2000).[1] Even by transition country standards, however, transfers in Poland are higher.



Elevated expenditure levels have implied high taxes. Given the difficulty in taxing capital, this burden has tended to fall on labor income. Payroll taxes in Poland are close to the OECD average—not where a country with Poland's unemployment rate should be, given the positive correlation between taxes and unemployment (lower panel). The figure also makes it clear, however, that high unemployment in Poland is not due merely to the tax wedge.



Source: OECD and WEO.

[1] David Begg and Charles Wyplosz, "How Big a Government? Transition Economy Forecasts Based on OECD History," mimeo, September, 1999 and Costas Christou and Christina Daseking, "Balancing Fiscal Priorities: Challenges for the Central European Countries on the Road to EU Accession," forthcoming, 2002.

the cycle. Moreover, provided growth picked-up, it would deliver increased public savings. Staff agreed with this assessment and welcomed the "CPI plus 1 percent" rule. But it also suggested some technical changes to improve the framework, including committing to an explicit nominal spending path to prevent expenditure base drift in the event inflation were overpredicted. The authorities acknowledged that the framework could be improved, but stressed that an important consideration in designing the rule had been simplicity and the ease with which it could be explained to the public.

16. **The mission questioned whether the "CPI plus 1 percent" rule had a broad enough coverage.** Staff agreed that with unchanged tax policies and even quite conservative assumptions on growth, successful application of the rule should reduce the fiscal imbalance sufficiently to stabilize the debt ratio (albeit at about 50 percent of GDP) and preserve a manageable current account position. Nevertheless, it questioned whether a more ambitious approach would not be better. Baseline simulations assumed that spending by non-State government entities (accounting for ½ of general government spending) would grow, as in recent years, by just over 3 percent in real terms. But extending the "CPI plus 1 percent" rule to spending outside the State sector would have three advantages. First, it would eliminate the risk that the rule could be subverted by shifting spending from State to local authorities. Second, it would deliver a stronger reduction in the PSBR and debt, even leaving room for tax cuts accounting for some 2 percentage points of GDP. Third, it would be a more even-handed approach to reining in overall government spending. However, the authorities felt that extending the rule to local government spending would be difficult in light of the lumpiness of some local government spending and would unduly complicate an otherwise simple rule. They preferred to rely on the existing constraints on local government—ceilings on debt and debt servicing—to restrain their spending.

Poland: Alternative Medium-term Fiscal Scenarios, in percent of GDP

	2001	2002	2003	2004	2005	2006
CPI +1% Rule for the State Budget from 2003						
General government revenue	40.6	40.3	40.2	40.1	40.1	40.2
General government expenditures	46.0	46.0	45.5	45.0	44.4	43.8
Implied real growth	*7.2*	*2.2*	*2.8*	*3.4*	*3.6*	*3.9*
General Government Balance (commitment)	-5.3	-5.7	-5.4	-4.9	-4.3	-3.6
Economic balance	-4.8	-4.5	-3.8	-3.3	-2.8	-2.1
General Government Debt	43.4	46.8	48.7	49.6	49.8	49.1
CPI +1% Rule for the State and Local Government Spending from 2003						
General government revenue	40.6	40.3	40.0	39.5	38.8	38.3
General government expenditures	46.0	46.0	44.8	43.2	41.5	39.8
Implied real growth	*7.2*	*2.2*	*1.0*	*1.0*	*1.0*	*1.0*
General Government Balance (commitment)	-5.3	-5.7	-4.8	-3.7	-2.7	-1.5
Economic balance	-4.8	-4.5	-3.2	-2.1	-1.2	0.0
General Government Debt	43.4	46.8	48.1	47.8	46.5	44.0
Real GDP Growth	1.1	1.4	3.2	4.0	4.2	4.5

17. **The authorities acknowledged that the success of the "CPI plus 1 percent" rule would depend critically on streamlining social transfers, where poor targeting is a problem.** Staff questioned if the 2003 budget would adhere to the "CPI plus 1 percent" rule in light of possible delays in difficult legislative changes and the need to reverse the stop gap measures used to limit spending in 2002. The authorities explained that working groups had been formed to review the efficacy and efficiency of public expenditures. They would shortly report their findings, and legislative proposals would be formulated. The groups were examining many aspects of public finance, including pension benefits, eligibility for

disability payments and public sector employment.[3] The authorities confirmed their commitment to securing the legislative changes in programs as needed to stick to the spending rule. Staff noted that cuts of this nature would be essential in light of plans to increase future infrastructure spending.

C. Monetary Policy

18. **Monetary policy discussions were complicated by on-going threats to amend the NBP's mandate and the structure of the MPC**. In the event, Parliament has passed a non-binding resolution blaming the MPC for the growth slowdown and high unemployment and calling on the Council to support the government's economic policies. More intrusive legislation remained under discussion following the MPC's decision not to cut rates in March. The mission expressed strong concerns about these developments. It stressed that the results of the hard-fought battle to tame inflation would be imperiled unless the principle of non-interference in the NBP and MPC, particularly with regard to setting interest rates, were placed beyond question. Staff also called for the traditional channels of communication between the government and the NBP to remain open for constructive dialogue. Aside from a vociferous group of Parliamentarians urging large interest rate cuts, the mission found that the debate on monetary policy had shifted to what scope remained for modest rate cuts.

19. **The authorities and staff agreed that monetary policy decisions should be based on the end-2003 target of inflation below 4 percent**. Neither the authorities nor staff saw any reason to reflate back to the targeted mid-point of the 4-6 percent range for end-2002. The authorities argued that the sharp deceleration in inflation last year owed much to the weak economy, strong zloty, and favorable supply-side influences: most expected inflation to rise back to 4–5 percent in 2002 as the economy recovered. Nevertheless, they were pleased by how well inflation expectations had responded to monetary policy. Some MPC members, pointing to the absence of demand pressures and the benign inflation outlook, were inclined to see some scope for further reduction in interest rates. Others felt that lower inflation expectations were not yet fully secure. In this view, threats to the inflation outlook included: (i) a possible rebound in food and fuel prices; (ii) recent declines in household bank deposits (though it was unclear whether this reflected an incipient consumption boom or a shift to alternative financial instruments induced by the new tax on interest income); (iii) a rapid increase in cash holdings; and (iv) uncertainties regarding fiscal policy in 2003. In April, after the mission, the key policy rate was cut by 50 basis points.

20. **The staff was more sanguine about the inflation outlook but argued that any rate changes should be made cautiously to avoid an overshoot**. The large cuts over the past year and their cumulative effects needed to be assessed carefully. But staff also noted that threats to inflation were modest and counterbalanced by the likely persistence of a sizable output gap for sometime. Temporary supply shocks could be in either direction and policy should neither anticipate nor react to them. Staff analysis shows that such price shocks in Poland, typically to food and fuel, have transitory effects on headline inflation (Box 2).

[3] The World Bank is assisting the authorities in this effort. An FAD TA last year helped identify measures that can be taken in the short-run to rationalize public expenditures.

Beyond the outlook for inflation, staff felt that other effects of high interest rates should not be overlooked. Specifically, rate differentials vis-à-vis industrial countries together with the persistent strength of the zloty were leading to unhedged foreign currency borrowing from domestic banks that was subjecting banks to heightened credit risk.

21. **A new medium-term inflation target and changes to tailor the IT framework to a low inflation environment would be considered alongside the broader issue of adopting the Euro.** Informal views of the monetary authorities tended toward early adoption of the Euro in order to reap the benefits of aligning Poland with a low-inflation and disciplining policy environment. Finance Ministry representatives were more concerned about the implications of the current value of the zloty, which they viewed as too strong for an early entry. In any event, the monetary authorities and staff agreed that a new medium term inflation target (to replace the current one which extends only through 2003) of 3 percent would be appropriate; it would likely be consistent with the Maastricht criteria while allowing room for ongoing relative price adjustments. Staff argued for wide bands—even ± 2 percentage points around the central rate—and for replacing the end-year target with a continuous one. The MPC agreed, but preferred bands closer to the current ±1 percentage point as wider bands would undermine usefulness of the target.

22. **The MPC intended to continue refraining from direct intervention in the foreign exchange markets.** They felt that the strength of the zloty owed as much to the drop in the current account deficit as to the tight monetary stance. They pointed to the continued strength of the currency, despite the near halving of the interest differential vis-à-vis the euro and U.S. dollar. While concerned about the implications of the strength of the zloty for competitiveness, they thought cyclical changes in productivity growth, which would be reversed with a recovery, had also influenced enterprise profitability. They did not believe that direct intervention could change the value of the zloty in a lasting way. While agreeing, staff felt that a rebalancing of the policy mix to tighter fiscal and easier monetary conditions so as to reduce pressure on the zloty would also be important for exporters' profits. Staff supported the policy of non-intervention, noting that some degree of exchange rate volatility was desirable to discourage open foreign currency positions. Recently, the government has spoken out in favor of direct intervention and would like to come to an agreement on this matter with the MPC.

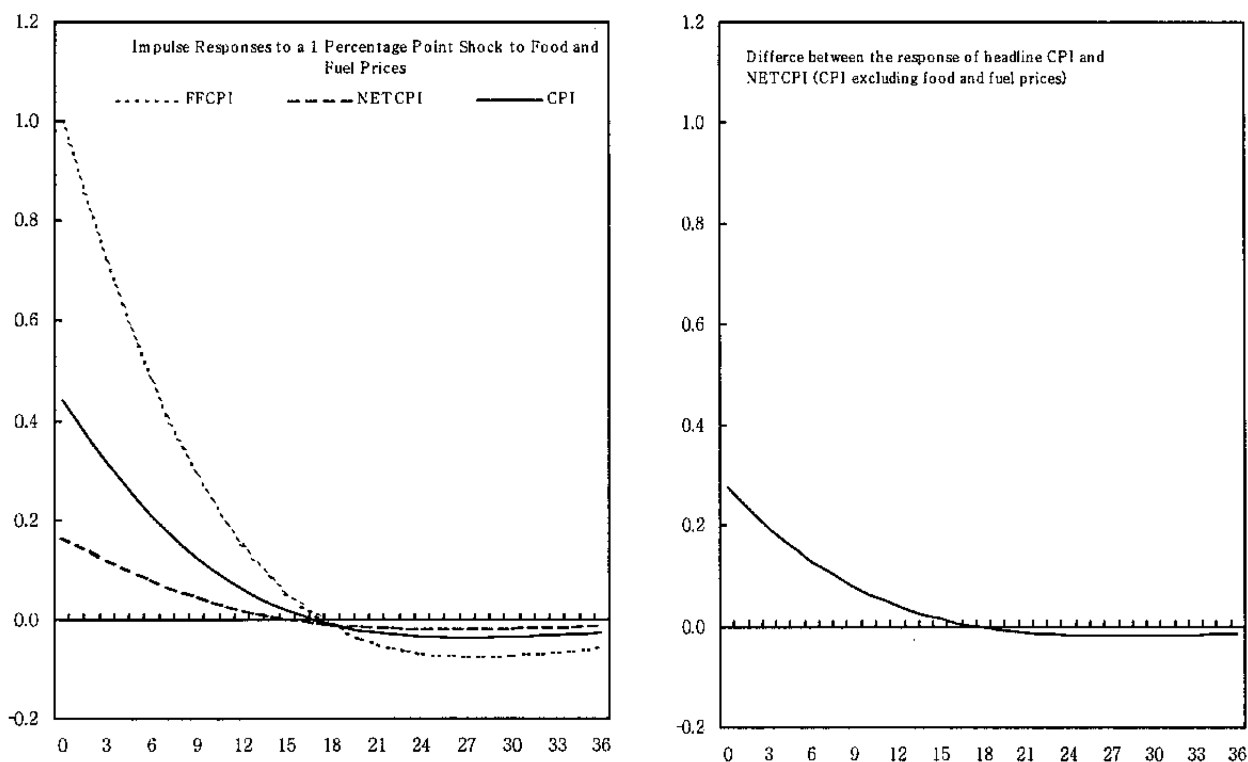
D. Financial Sector Risk and Vulnerability

23. **The decline in the current account deficit has attenuated vulnerability, but other risks have emerged.** The reduction in the current account deficit to some 4 percent of GDP—even less if part of the large positive errors and omissions inflows reflect current transactions—has reduced Poland's net reliance on foreign creditors. Further, at US$27 billion, reserves continue to cover 7½ months of imports and 280 percent of

Box 2. Temporary Supply Shocks and Inflation in Poland

A persistent concern in Poland is the effect of food and fuel prices on headline inflation. Shocks to these prices over the last two years have been a source of significant upward and more recently downward pressures on the headline CPI, which the authorities target. Thus, gauging the impact and duration of shocks to these prices on headline inflation is important. These can be quantified with the aid of a VAR model comprising headline CPI, NETCPI (the headline index excluding food and fuel prices) and FFCPI (the food and fuel price index) (Hoffmaister, 2001).[1] The response of headline inflation to a shock in food and fuel prices is then discerned by comparing its evolution with and without a shock.

Staff estimates show that shocks to food and fuel prices have a significant impact on headline inflation only in the short-run. Specifically, a 1 percentage point shock to food and fuel prices raises headline inflation by about 0.4 percentage point after 1 month and this effect dies out quickly, disappearing within about a year (Figure, left panel). The price level, however, remains commensurately higher or lower depending on the direction of the shock. The approximate first-round impact of the shock is gauged by comparing the response of CPI to that of NETCPI (Figure, right panel). This suggests that to the extent monetary policy in Poland focuses on inflation 12 or more months ahead, the effect of food and fuel supply shocks can be largely discounted.



[1] Hoffmaister, Alexander, "Inflation Targeting in Korea: An Empirical Exploration," IMF Staff Papers, Vol. 48, No. 2, 2001, pp. 317–43.

short-term debt (Table 6). Discussion focused on other sources of vulnerability that have emerged, particularly in the banking system.

24. **Staff and the authorities agreed that the banking system is generally sound.** The authorities noted that non-performing loans (NPLs) had risen from some 13 percent of total loans at end-1999 to 17½ percent at end-2001 in response to the economic slowdown. They pointed out, however, that the classification of NPLs in Poland—requiring banks to mark as non-performing loans to creditors whose "economic" conditions have deteriorated even if they continue to service the loans on time—was more stringent than in many other countries. Excluding this class of impaired loans, the ratio had risen from 8 to almost 13 percent since end-1999. Moreover, they emphasized that the banking system is profitable and strongly capitalized with an average risk-weighted capital adequacy ratio of 15 percent, up from 13 percent at end-2000.

25. **The mission asked about recent increases in banks' foreign currency loans (FCL) to the private sector and whether the authorities were satisfied that they were adequately hedged.** Total FC and FC-linked loans stood at US$14½ billion or some 8 percent of GDP at end-2001, up from US$11 billion at end-2000.[4] The authorities noted that most of the new FCLs are long-term—typically for housing, but also for consumer durables or small enterprises. While the authorities acknowledged that FCLs to households are probably infrequently hedged, clauses that permit changes in currency denomination for a small fee constitute a built-in "safety-valve" for borrowers. The authorities expected demand for such loans to decelerate with falling interest differentials. Staff noted that the share of such loans in Poland is relatively high. In the event of an unexpected exchange rate change large-scale switches in currency denomination would shift exchange risk to banks. It is critical that banks appropriately price this risk. The NBP, already strengthening its stress testing capabilities with MAE technical assistance, decided to form a working group to examine these concerns.

Foreign Currency Loans (FCL), in percent

		FCL ratio	
		GDP	Private Credit
Poland	December, 2001	8.1	28.5
Hungary	May, 2001	8.8	27.2
Czech Rep	January, 2001	6.0	15.7
Israel	Average, 2001	26.5	25.3
Chile	March, 2001	9.8	13.8
Mexico	December, 2000	2.3	19.6
Argentina	February, 2001	14.3	62.6

Sources: Authorities, and Barajas and Morales (2002).

26. **The authorities have decided to remove remaining controls on short-term capital flows with other OECD countries from October 2002.**[5] Originally planned for 1999, the removal of the controls on holdings—by non-bank residents and non-residents—of assets and liabilities with an original maturity of less than one year has already been delayed once. Staff welcomed the plan, agreeing that the effectiveness of controls has been limited; residents already have full access to FX credits through domestic banks and fairly liquid short-term zloty markets in major financial centers exist.

[4] Chapter 2 of the selected issues papers discusses FCLs in Poland.

[5] The controls are also being removed for countries with whom Poland has concluded agreements on mutual protection of investments and capital.

E. Structural Policies

27. **The authorities attributed the high level of unemployment to cyclical, structural and policy-induced factors in about equal parts**. Attaching considerable concern to the latter, the new government has put before Parliament a legislative program to revise the labor code to make it easier for employers to use fixed-term contracts, permit more flexibility in working hours, and cut overtime pay. In addition, the authorities are considering lowering the minimum wage for first-time labor market entrants. Plans are also afoot to exempt employers from their share of social security contributions (some 20 percent of gross salary) for up to one year for hiring school leavers. Staff welcomed the proposals to amend the labor code and differentiate the minimum wage for the young, but was skeptical about the benefit of a time-limited exemption of employers from social security contributions. Also, it noted that distortions in the labor market reportedly stemming from myriad detailed regulations and urged that further efforts to identify and change them be made. As the regional disparity in unemployment is large, it pressed for differentiating the uniform national minimum wage across regions, possibly on the basis of local unemployment levels. The authorities agreed that fully addressing labor market rigidities was an ongoing job.

28. **With most of the easy-to-sell enterprises already disposed of, the authorities emphasized that most of the remaining state owned enterprises would be less likely to attract buyers absent further restructuring**. Accordingly, the authorities intend to pursue a sector-specific restructuring and privatization strategy. In the heavily indebted and loss-making steel sector as well as mining, they intended to address the difficulty of finding buyers for individual enterprises in the current environment, by bundling individual entities into conglomerates, cutting costs, and making them available for privatization. Staff, however, questioned whether there were synergies that would help cost rationalization, and feared the strategy might even make the newly created entities less flexible and thus less attractive to buyers. More generally, the authorities raised questions about the economic benefits of privatization, beyond helping finance the fiscal deficit. They noted that privatized entities had tended to replace domestic suppliers with foreign ones, adding to the unemployment burden. In the telecom sector, the state owned company had been sold to a foreign public owned company. Staff noted the authorities' concerns about the tendency for privatized enterprises to switch suppliers, and wondered whether it might not be a short-term dislocation from privatization. It advocated strong regulatory controls over any domestic or foreign-owned monopoly.

29. **In banking, in view of the already high foreign ownership (70 percent of total assets), the authorities do not envisage any further privatization**. They hoped that the state-owned banks would help advance the government's economic program, by facilitating lending to small- and medium-scale enterprises and for housing, and infrastructure development. Staff cautioned against using publicly-owned banks, some of which are already burdened by high levels of NPLs, for quasi-fiscal objectives. More generally, the mission questioned whether, absent privatization in the banking and insurance sectors, the targeted ½ percent of GDP annual privatization proceeds over the next four years could be realized. But the authorities were confident that the sale of non-financial sector assets would allow them to meet their privatization revenue targets.

30. **Trade liberalization, guided by WTO and EU commitments, remains on track.** Notwithstanding pressure, the authorities have refused to rely on import surcharges as a tax handle. Accordingly, the weighted average MFN tariff is projected to decline from 2.6 percent in 2001 to 2.3 percent this year, though the bulk of imports will be unaffected as they are already covered by trade agreements.

III. STAFF APPRAISAL

31. **After two difficult years, signs of a recovery are emerging.** As yet these are mainly improving confidence surveys, while the slump in growth is just leveling off. But with supportive policies and a recovery in Poland's main trading partners, growth should revive during the second half of the year. Poland approaches this juncture from a position of strength in some important respects: inflation is low and the fruits of the hard-fought battle to tame inflation expectations will bolster growth; the modest current account deficit leaves room for a pick-up in imports; and enterprises, having adapted to highly competitive conditions, are leaner and more efficient than before. With EU accession in sight, a recovery should prove strong and durable.

32. **To realize this potential, however, policies need to shift toward sustaining the nascent recovery.** Several challenges are emerging. The unfettered ability of the NBP to conduct monetary policy must be put beyond question. Only then will the time-proven benefits of low inflation and investor confidence be secured. Second, the policy mix must shift. Public spending must be curtailed to achieve a sizeable reduction in the fiscal deficit, a halt to the rising public debt ratio and significantly lower real interest rates. And, third, policy-induced distortions in the labor market need to be eliminated if firms are to have the flexibility to respond aggressively to new opportunities and create jobs. While addressing these domestic issues, Poland must finalize negotiations for EU accession and ensure that institutions for absorbing EU funds are in place.

33. **With the 2002 budget, the new government has started the process of reining in the fiscal deficit and public spending.** Withdrawing fiscal stimulus in a weak economy is less than ideal but nonetheless necessary since this year's PSBR is likely at the limit of what can be financed without putting pressure on interest rates. Moreover, the consolidation creates conditions for the recent and possible further monetary easing. It is regrettable that the budget relied heavily on expenditure freezes and postponement, but this was perhaps unavoidable given the limited time for budget preparation after the election.

34. **The real test for fiscal policy, however, will be to endow the "CPI plus 1 percent" expenditure rule with the necessary medium term credibility.** The "CPI plus 1 percent" rule limiting state spending appropriately focuses on Poland's central fiscal problem—revenue and expenditures are too high for its level of development—in an easily understood framework. And with even a modest rebound in growth, it should steadily lower deficits. Nevertheless, in implementing the rule, the authorities will need to address two critical questions. First, is it enough to rein in deficits and reverse rising debt dynamics? If growth failed to rise as envisaged, more stringent expenditure limits would have to be adopted. Also, the authorities will need to adapt the rule should spending drift, owing to possible overprojections of inflation or excessive local government spending. Second, will legislative changes to current spending programs be forceful enough to meet the ceilings without undue

compression of public investment? Areas where the scope for achieving the greatest savings by better targeting social transfers—limiting enrollment in the agricultural pension fund, trimming public employment, equalizing retirement ages for men and women, raising the early retirement age, and tightening eligibility for disability benefits further, to name a few—are well known but require building a social consensus for change.

35. **The scope for monetary policy action has greatly narrowed**. After the 950 basis point cuts during the past year, the scope for further reductions is small and must be judged against an assessment of the easing effects already in the pipeline. But with indications that fiscal policy will be guided by lasting spending restraint and that wage pressures remain subdued, a case exists for meeting market expectations for further small cuts: expectations seem benign auguring for inflation below target even for 2003, a substantial output gap is likely to persist for some time, the zloty remains at the top of the manageable range; and incentives for unhedged FX borrowing would well be further reduced. Any changes should be made cautiously and in small steps to minimize the risk of overshooting.

36. **Refraining from direct intervention in the foreign exchange market remains highly advisable**. Direct intervention is unlikely to curtail upward pressure on the zloty significantly except at the cost of higher inflation, and this would yield little effect on the zloty's real value. Moreover, volatility of the zloty, which has not been excessive, encourages hedging of foreign exchange risk. Resisting upward pressure would best be accomplished through a steady reduction in the fiscal deficit while monetary policy is eased.

37. **The monetary policy framework needs to be adapted to the new low inflation environment**. Poland has reached the stage where a more symmetrical inflation targeting framework, giving equal weight to deviations in either direction from the central target, is needed. A continuous single inflation target, with relatively wide bands to accommodate volatility of headline inflation would serve this purpose. These changes should be made soon for the benefit of the Council that will take office in 2004. More urgently, the MPC should announce a new medium-term inflation target, as the current one only extends to end-2003. While decisions on the adoption of the Euro have not been made, adopting an inflation target broadly consistent with Maastricht criteria would be appropriate and leave the timing of entry open.

38. **Poland's banking system is generally sound, but rising NPLs and foreign currency loans need to be monitored closely**. NPLs are high, but as they are fully provisioned they do not now hamper the effectiveness of the banking system. The sharp increase in foreign currency borrowing, most of which is assumed to be unhedged, poses another challenge. While these loans are not a systemic threat, they could add to the already high NPLs in the event exchange market sentiment shifted adversely. To mitigate this possibility, supervisors should encourage banks to ensure that the risk weighting of foreign currency loans to households and unhedged enterprises is appropriate.

39. **Structural reforms and privatization need to be accelerated.** The authorities' concern about the impact of action in these areas on short-run demand is evident, but should be balanced against the fiscal and other costs of labor and product market rigidities and of sustaining loss-making state enterprises. The government's legislative proposals to remove some restrictions on hiring and worker compensation are welcome. But the much-needed

impetus to employment from the recovery will need to be supported by continuing efforts to identify and address hindrances to labor market flexibility—including restrictions on hiring and firing and the minimum wage, which should be lowered for new labor market entrants and differentiated across regions for others. On privatization, the authorities face hard choices with many remaining state-owned enterprises unattractive to the market and downsizing or liquidation difficult given high unemployment. Nevertheless, in the interest of redeploying resources to the highest priority uses, the government should reinvigorate privatization so as to reduce its ownership in the real and financial sectors. Of particular concern are proposals to halt financial sector privatization and to use the largest state bank for quasi-fiscal projects.

40. **The authorities' have steered a steady course in maintaining open markets**. The planned removal of remaining capital controls, which probably afford little protection, recognizes the existing near-full capital mobility. The decision not to heed popular calls for import surcharges to bridge the fiscal deficit was appropriate. Draft legislation to bring Poland's ability to combat money laundering to international standards has been prepared, and this should be approved soon. The authorities should also consider completing the ROSC on data quality at their earliest convenience. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. Poland: Selected Economic Indicators

	1997	1998	1999	2000	2001 Est	2002 Proj	2003 Proj
Real economy (percent growth)							
GDP	6.8	4.8	4.1	4.0	1.0	1.4	3.2
Domestic demand	9.4	6.5	5.0	2.8	-1.9	0.2	2.8
Private consumption growth	6.9	4.9	5.4	2.7	2.1	4.5	3.3
Public consumption growth	3.1	1.4	1.0	1.5	0.6	0.4	1.0
Domestic fixed investment growth	21.7	14.2	6.5	2.7	-9.8	1.0	6.7
CPI							
Average	14.9	11.8	7.3	10.1	5.4	3.2	3.2
End of period	13.2	8.6	9.8	8.5	3.5	3.6	3.2
Unemployment Rate	11.5	10.1	12.0	13.9	16.3	17.1	16.2
Average wage growth	...	16.7	11.5	10.9	7.2	4.5	5.2
Gross National Saving (ratio to GDP)	21.6	21.9	18.9	19.8	17.5	18.9	19.0
Gross Domestic Investment (ratio to GDP)	24.6	26.2	26.4	26.1	21.6	23.1	23.5
Public Finances (percent of GDP)							
State Government Revenues	24.0	22.9	20.5	19.8	19.4	19.2	...
State Government Expenditures	26.6	25.2	22.5	22.0	24.0	24.2	...
State Government Balance	-2.6	-2.4	-2.0	-2.2	-4.5	-5.0	...
General Government Revenues	42.7	41.0	41.1	39.7	40.6	40.2	40.0
General Government Expenditures	45.8	44.3	44.5	42.8	46.0	45.9	45.4
General Government Balance	-3.2	-3.3	-3.4	-3.1	-5.3	-5.7	-5.4
Economic Balance (commitments basis) 1/	...	...	-3.0	-2.6	-4.8	-4.5	-3.8
General Government Debt 2/	46.9	42.9	44.5	38.9	43.4	46.8	48.7
Money and credit							
Private Credit (12-month change)	33.6	27.9	27.0	17.3	7.6	...	...
Broad Money (12-month change)	29.3	25.2	15.1	15.9	13.7	...	...
Money market rate (eop)	24.8	15.9	16.4	19.2	11.9	...	...
13-week t-bill rate (eop)	23.5	13.6	16.2	16.2	11.8	...	...
Balance of Payments							
Current account balance (in mill. U.S. dollars)	-4,312	-6,858	-11,569	-9,978	-7,010	-7,263	-8,333
percent of GDP	-3.0	-4.3	-7.5	-6.3	-4.0	-4.2	-4.5
C/A balance plus FDI, percent of GDP	-0.9	-1.2	-3.4	-1.1	-0.3	-2.0	-2.3
Exports (in mill. U.S. dollars)	27,229	30,122	26,347	28,256	30,310	31,666	34,450
Export volume growth (percent)	21.7	10.4	-8.1	16.6	6.0	5.0	7.5
Imports (in mill. U.S. dollars)	38,549	43,842	40,727	41,421	41,967	42,625	46,043
Import volume growth (percent)	29.0	17.2	-0.6	6.0	1.8	2.4	6.9
Terms of trade (1995=100)	97.5	100.7	102.5	98.2	99.9	100.2	100.4
Official reserves (in mill. U.S. dollars)	21,403	28,275	27,314	27,464	26,248	26,675	29,013
in months of cover	6.7	7.7	8.0	8.0	7.5	7.5	7.6
Total external debt (percent of GDP)	34.5	37.3	42.2	44.0	39.5	42.1	41.9
Ratio of short term debt to gross reserves	24.0	29.8	41.1	34.6	35.5	35.0	32.7
Exchange rate							
Zloty per US$, period average	3.3	3.5	4.0	4.3	4.1	...	...
Zloty per Euro, period average	...	3.9	4.2	4.0	3.7	...	...
Real effective exchange rate (INS, CPI based)	114.9	120.4	115.6	125.2	138.4	...	...
percent change	1.7	4.8	-4.0	8.3	10.5	...	...

Sources: Polish authorities and staff estimates.

1/ For 2001, cash basis.

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

Table 2. Poland: Balance of Payments, 1997-2005
(In millions of US dollars)

	1998	1999	2000	2001 Est	2002 Proj	2003 Proj	2004 Proj	2005 Proj	2006 Proj
Current account balance	-6,858	-11,569	-9,978	-7,010	-7,263	-8,333	-10,982	-14,020	-15,892
percent of GDP	-4.3	-7.5	-6.3	-4.0	-4.2	-4.5	-5.5	-6.5	-6.8
Trade balance	-13,720	-14,380	-13,165	-11,657	-10,959	-11,593	-13,920	-17,327	-19,072
Exports	30,122	26,347	28,256	30,310	31,666	34,450	37,926	41,753	45,965
percentage change in unit values	0.2	-4.8	-8.1	1.2	-0.5	1.2	1.0	1.0	1.0
percentage volume growth	10.4	-8.1	16.6	6.0	5.0	7.5	9.0	9.0	9.0
export market growth	6.5	4.4	12.5	2.7	3.2	6.7	6.7	7.0	6.9
Imports	43,842	40,727	41,421	41,967	42,625	46,043	51,846	59,080	65,037
percentage change in unit values	-3.0	-6.5	-4.0	-0.5	-0.8	1.0	0.8	1.1	1.0
percentage volume growth	17.2	-0.6	6.0	1.8	2.4	6.9	11.7	12.7	9.0
growth in domestic demand	6.5	5.0	1.8	-1.7	0.2	2.8	4.5	5.1	4.3
Services balance	-509	-1,624	-1,684	-828	-625	-632	-684	-737	-819
Credit	3,677	3,310	3,516	4,079	4,188	4,523	4,874	5,267	5,687
Debit	4,186	4,934	5,200	4,907	4,814	5,155	5,558	6,004	6,506
Net Income	-567	-804	-796	-888	-733	-1,242	-1,740	-2,193	-2,764
Net transfers	1,942	1,604	1,680	1,969	1,152	1,313	1,577	2,486	3,046
Net unclassified current transactions	5,996	3,635	3,987	4,394	3,902	3,821	3,785	3,751	3,716
Capital and financial account balance	10,993	8,253	7,745	3,538	7,812	10,603	12,789	14,394	15,499
Financial account balance	10,921	8,206	7,732	3,540	7,772	10,563	12,749	14,354	15,459
Foreign direct investment (net)	4,966	6,348	8,168	6,497	3,760	4,140	5,644	6,571	6,911
by nonresidents	5,129	6,471	8,291	6,584	3,960	4,440	5,994	6,971	7,411
o/w privatisation	2,023	3,377	3,500	1,500	1,000	1,079	994	500	400
Portfolio investment (net)	1,330	1,449	2,769	1,996	3,456	3,914	4,269	4,579	4,925
by non-residents	1,510	1,437	2,497	1,919	3,348	3,800	4,150	4,454	4,794
o/w equities	952	885	634	70	476	595	649	746	859
Other investment	4,625	409	-3,205	-5,271	1,023	2,510	2,836	3,204	3,623
Assets	2,213	-2,691	-2,877	-3,463	789	868	955	1,051	1,156
Liabilities	2,412	3,100	-328	-1,808	233	1,642	1,881	2,154	2,467
o/w Short -term	-46	440	139	-174	0	153	168	185	204
Errors and omissions	1,801	3,484	2,907	2,980	0	0	0	0	0
Overall Balance	5,936	168	674	-492	549	2,270	1,807	374	-393
Financing	-5,936	-168	-661	492	-549	-2,270	-1,807	-374	393
Reserve assets	-5,926	-159	-605	509	-549	-2,270	-1,807	-374	393
Credits from IMF	0	0	0	0	0	0	0	0	0
Exceptional financing	-10	-9	-56	-17	0	0	0	0	0
Memorandum items									
Current account balance, excl. net oil related imports 1/	-5,440	-9,665	-6,211	-4,254	-4,788	-6,070	-8,947	-12,013	-13,912
In percent of GDP	-3.4	-6.2	-3.9	-2.4	-2.8	-3.3	-4.5	-5.6	-6.0
Official reserves	28,275	27,314	27,464	26,248	26,675	29,013	30,887	31,296	30,980
in months of imports	7.7	8.0	8.0	7.5	7.5	7.6	7.1	6.4	5.7
Ratio of short-term debt to reserves	29.8	41.1	34.6	35.6	35.0	32.7	31.3	31.4	32.4
Total external debt (percent of GDP)	37.3	42.2	44.0	39.5	42.1	41.9	41.4	41.0	40.5
Net external debt (percent of GDP) 2/	13.7	16.1	17.9	15.0	15.8	16.0	16.3	16.6	16.8
Gross FDI inflows (percent of GDP)	3.2	4.2	5.3	3.7	2.3	2.4	3.0	3.2	3.2

Sources: NBP and Staff Estimates.

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

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

Table 3. Poland. General Government Revenues and Expenditures
(In Percent of GDP)

	1998	1999	2000	2001 Est.	2002 Proj.
General government revenue	41.0	41.1	39.7	40.6	40.3
Direct taxes	26.4	25.1	24.3	24.5	24.8
Indirect taxes	11.6	12.1	11.6	11.4	11.9
Other taxes and nontax	3.0	3.9	3.7	4.7	3.6
General government expenditure (comm basis)	44.3	44.5	42.8	46.0	46.0
Goods and services (inc arrears)	18.5	18.3	17.4	18.5	18.3
Transfers and subsidies	19.2	19.9	19.5	21.5	21.1
Interest payments	3.2	3.1	2.6	2.9	3.4
Capital and net lending	3.6	3.2	3.2	3.1	3.3
General government balance (cash)	-2.6	-3.0	-2.8	-5.3	-5.7
General government bal. (comm.) 1/	-3.3	-3.4	-3.1	-5.3	-5.7
adj for pension switching	...	0.4	1.1	1.2	1.5
adj for compensation payments	...	...	-0.5	-0.3	-0.4
adj for payments from MoT	...	...	-0.1	0.0	0.0
adj for UMTS	...	...	...	-0.4	0.0
adj for Demographic reserve fund	...	...	...	...	0.0
Economic deficit (cash)	-2.6	-2.7	-2.2	-4.8	-4.5
Economic deficit (comm) 1/	-3.3	-3.0	-2.6	-4.8	-4.5
General government primary balance	-0.1	-0.4	-0.5	-2.4	-2.3
Privatization Proceeds	1.3	2.2	3.9	0.9	0.9
State balance (cash)	-2.4	-2.0	-2.2	-4.5	-5.0
State balance (comm.)	-3.1	-2.4	-2.6	-4.5	-5.0
Rest of government balance	-0.4	-1.0	-0.5	-0.8	-0.7
Local authorities	-0.2	-0.1	-0.5	-0.7	-0.7
Funds	-0.1	-0.8	-0.1	-0.1	-0.1
FUS	-0.1	-0.9	-0.2	-0.2	-0.1
KRUS	0.0	0.0	0.0	0.0	0.0
Labor fund	0.1	0.0	-0.2	0.0	0.0
Health fund	0.0	-0.1	0.0	0.1	0.0
Alimony fund	0.0	0.0	0.0	0.0	0.0
Fund for rehabilitation	0.1	0.0	0.0	0.0	0.0
Environment fund	0.1	0.1	0.1	0.0	0.0
Other extrabudgetary funds	-0.2	0.1	0.2	0.0	0.0

Sources: Polish authorities, and Staff estimates.
1/ For 2001, cash basis.

Table 4. Poland: Monetary Survey, 1996-2001
(In billions of zlotys)

	1996	1997	1998	1999	2000	2001Q1	2001Q2	2001Q3	2001Q4
Net International Reserves	62.3	82.8	96.3	110.7	132.0	137.1	128.2	140.1	134.7
(in billions of U.S. dollars)	21.7	23.5	27.5	26.7	31.9	33.4	32.1	33.1	33.8
Net domestic assets	74.4	93.6	124.5	152.8	162.4	163.9	179.4	180.6	200.0
Credit to non-government	81.1	108.3	138.5	175.9	206.3	211.0	213.5	225.9	221.9
Credit to government, net	48.2	55.3	61.3	64.7	50.8	45.4	49.4	53.6	67.9
Other items, net	-55.0	-70.0	-75.4	-87.8	-94.7	-92.4	-83.6	-98.9	-89.7
Money and quasi money 1/	136.7	176.4	220.8	254.1	294.5	301.0	307.5	320.7	334.7
Zloty money	113.3	145.6	187.1	223.8	251.5	254.9	261.6	269.6	281.7
Foreign currency deposits	23.4	30.8	33.6	30.4	43.0	46.1	45.9	51.1	53.0
Memorandum items (in percent)									
Broad money growth (12-month)	31.2	29.1	25.2	15.1	15.9	14.9	8.0	14.3	13.7
Real broad money growth (12-month)	9.3	14.0	15.2	4.8	6.8	8.2	1.6	9.6	9.7
Real growth of credit to nongovernment	20.3	18.0	17.8	15.7	8.1	7.9	-1.2	6.1	3.8
Share of foreign currency deposits in broad money	17.1	17.5	15.2	11.9	14.6	15.3	14.9	15.9	15.8

Sources: National Bank of Poland, and Fund estimates and projections.
1/ There was a break in this series at the end of 1996.

Table 5. Poland: Savings and Investment Balance, 1997-2006

	1997	1998	1999	2000 Prel	2001 Est	2002 Proj	2003 Proj	2004 Proj	2005 Proj	2006 Proj
					In Percent of GDP					
Consumption	79.8	79.0	80.0	78.7	79.2	81.1	80.9	81.4	81.6	81.3
Non-government	63.7	63.6	64.6	64.1	64.6	66.6	66.7	67.5	68.1	68.2
Government	16.0	15.4	15.4	14.6	14.6	14.4	14.1	13.8	13.5	13.1
Investment	24.6	26.2	26.4	26.3	22.5	23.1	23.5	23.9	24.9	25.5
Fixed capital	23.5	25.1	25.5	25.1	22.0	21.9	22.5	23.3	24.2	24.8
Non-government	19.3	21.0	21.7	21.9	19.0	18.9	19.3	20.1	20.8	21.3
Government	4.2	4.2	3.7	3.2	3.0	3.0	3.2	3.2	3.4	3.5
Inventories	1.1	1.0	0.9	1.2	0.5	1.2	1.0	0.6	0.7	0.7
Total Savings	24.6	26.2	26.4	26.3	22.5	23.1	23.5	23.9	24.9	25.5
Domestic Savings	21.6	21.9	18.9	19.9	18.5	18.9	19.0	18.4	18.4	18.7
Non-government	21.6	22.0	19.2	19.2	19.5	20.1	19.7	18.9	18.5	18.3
General Government	0.0	-0.1	-0.3	0.8	-1.1	-1.1	-0.7	-0.5	-0.1	0.4
Foreign Savings	3.0	4.3	7.5	6.3	4.0	4.2	4.5	5.5	6.5	6.8
Memorandum items:										
Real GDP growth	6.8	4.8	4.1	4.1	1.1	1.4	3.2	4.0	4.2	4.5
General government revenues	42.7	41.0	41.1	39.7	40.6	40.2	40.0	39.9	40.0	40.0
General government expenditures	45.8	44.3	44.5	42.8	46.0	45.9	45.4	44.8	44.2	43.6
Balance	-3.2	-3.3	-3.4	-3.1	-5.3	-5.7	-5.4	-4.9	-4.3	-3.6
Economic Balance 1/	...	...	-3.0	-2.6	-4.8	-4.5	-3.8	-3.3	-2.8	-2.1
General Government Debt	46.9	42.9	44.5	38.9	43.4	46.8	48.7	49.6	49.8	49.1
Net external debt 2/	12.8	13.7	16.1	17.9	15.0	15.8	16.0	16.3	16.6	16.8

Sources: Polish authorities and staff estimates.

1/ Commitment basis. See footnote on page 4 for definition.

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

Table 6. Poland: Indicators of External Vulnerability
(In percent of GDP, Unless Otherwise Indicated)

	1998	1999	2000	2001	2002 Latest Observations	Date of Latest Observation
Financial indicators						
Public sector debt 1/	42.9	44.5	38.9	43.4	46.8	*proj. for 2002*
Broad money (percent change, 12-month basis)	25.2	19.3	15.9	13.7	6.6	*March*
Private sector credit (percent change, 12 month basis)	27.9	27.0	17.3	7.5	5.5	*March*
Domestic credit to GDP	25.0	28.6	30.1	27.7	29.1	*March*
13 week T-Bill rate 2/	13.6	16.2	16.2	11.2	9.6	*May*
13 week T-Bill real rate 3/	4.6	5.8	7.1	7.3	5.9	*May*
External Indicators						
Exports (percent change, 12-month basis in US$)	10.6	-12.5	7.3	-7.7	-5.2	*March*
Imports (percent change, 12-month basis in US$)	13.7	-7.1	1.6	-9.5	-10.6	*March*
Current account balance	-4.3	-7.5	-6.3	-4.0	-4.1	*March*
Capital and financial account balance	6.9	5.3	4.9	2.0	2.3	*March*
o/w: Inward portfolio investment (debt securities etc.)	1.0	0.9	1.6	1.1	0.9	*March*
Other investment (loans, trade credits etc.)	2.9	0.3	-2.0	-3.0	-2.2	*March*
Inward foreign direct investment	3.2	4.2	5.3	3.7	3.6	*March*
Net Foreign Assets (NFA) of commercial banks (in billions of US$)	4.1	7.9	11.3	15.3	14.8	*December*
Official reserves (in billions US$)	28.3	27.3	27.5	26.2	27.1	*March*
Official reserves in months of imports GS	7.7	8.0	8.0	7.5	7.6	*March*
Reserve money to reserves (Ratio)	0.6	0.4	0.4	0.6	0.5	*March*
Broad money to reserves (Ratio)	2.2	2.3	2.5	3.2	3.0	*March*
Total short term external debt to reserves (in percent) 4/	29.8	41.1	34.6	35.6	...	*December*
Total external debt (in billions of US$)	59.1	65.4	69.5	69.7	...	*December*
o/w: Public sector debt	34.1	32.1	29.2	27.5	...	*December*
Ratio of short-term external debt to total external debt (in percent)	14.2	17.1	13.7	13.4	...	*December*
Exchange rate (per US$, period average)	3.5	4.0	4.3	4.1	4.1	*April*
REER depreciation (-) (period average) 5/	4.8	-4.0	8.3	11.1	1.7	*February*
Financial Market Indicators						
Stock market index	12,796	19,470	17,847	13,922	14,877	*14-May-02*
Foreign currency debt rating 6/	BBB-	BBB	BBB+	BBB+	BBB+	*14-May-02*
Spread of benchmark bonds (basis points, end of period) 7/	102.0	47.1	...	...	...	...
Spread of benchmark bonds (basis points, end of period) 8/	...	...	83	47	61	*14-May-02*
Spread of brady bonds (basis points, end of period) 9/	198	199	197	185	155	*13-May-02*

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. Date of latest observation refers to date of latest change.
7/ Spread on Polish bond 7 3/4 coupon expiring 07/2000 and US Treasury 5 7/8 coupon expiring 06/2000.
8/ Spread on Polish bond 6 coupon expiring 03/2010 and German bond 5 1/4 expiring 07/2010
9/ Spread on Polish brady bond PDI 10/2014 and US Treasury coupon 11/3/4 maturing 11/2014.

POLAND: FUND RELATIONS
(As of March 31, 2002)

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

II. **General Resources Account:**

	SDR Million	Percent Quota
Quota	1,369.00	100.0
Fund holdings of currency	1,002.16	73.20
Reserve position in Fund	366.84	26.80
Financial transactions plan transfers (net)	40.00	

III. **SDR Department**

	SDR Million	Percent Allocation
Holdings	22.18	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 2½ 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 March 9, 2001 (EBM/01/--). In concluding the consultation, Directors welcomed the declines in inflation and the external current account deficit, but were concerned at low growth and rising unemployment. In this context, they endorsed the operation of fiscal stabilizers but emphasized the need to keep to budget spending totals to retain fiscal credibility. Fiscal consolidation would be needed in the medium-term if fixed investment recovered strongly and should be led by expenditure rationalization. Directors welcomed interest rate cuts and felt there was room for further action. Along with stronger growth, further labor market flexibility, notably on minimum wages, would boost jobs.

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
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
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
STA	Government finance statistics	Mission	August 1995	NBP/ MoF
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
MAE	Monetary Operations	Mission	July 2001	NBP

FAD	Expenditure restructuring	Mission	December 2001	MoF
MAE	Stress testing	Mission	January 2002	NBP

X. **Resident Representative**

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

POLAND—WORLD BANK ACTIVITY[1]

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 amounts to US$2.2 billion as of March 31, 2002. At present 13 operations are under implementation, with an un-disbursed balance of US$454 million.

2. Since 1990, the Bank has financed a variety of loans in the following areas: agriculture, coal sector restructuring, enterprise and financial restructuring, environment, energy, forestry development, health, housing, railway sector restructuring, road and transport and rural development. More recent loans include: the second Hard Coal Sector Adjustment Loan (August 2001, US$100million), which aims to improve the financial sustainability of the hard coal sector; Krakow energy efficiency project (June 2001, US$15million), which aims at improving the efficiency of the city's district heating (DH) systems, decrease heat energy consumption by improving energy efficiency at the end-user level, and, develop knowledge-based mechanisms to finance energy efficiency projects; the Railway restructuring loan (May 2001, US$101million), which aims to restructure Polish State Railways' (PKP) to increase efficiency, improve finances, and privatize selected activities within a sound regulatory framework. Other projects under implementation are e.g. rural development project, which focuses on the design of sustainable rural development programs, to include the promotion of non-farm rural activities, through the strengthening of local governments, and institutions, developing selective infrastructure investments, and focusing on education; Szczecin-Swinoujscie seaway and port modernization project, which aims to promote Poland's trade by developing an efficient administrative/managerial structure and improving physical facilities in the main ports of Gdansk, Gdynia, and Szczecin-Swinoujscie.

3. The World Bank is in the process of preparing the next Country Assistance Strategy (CAS) with a proposed focus on assisting the Government in improving its effectiveness of the public sector and public resource management, social protection, education, health, and anti corruption. The Board approved the last Country Assistance Strategy Progress Report in September 1999. Over the years, the Bank has prepared a series of policy notes that provide advice on various poverty related, social economic and structural reforms issues such as a development policy assessment and health and social sector reviews. The Bank also prepared a report on the functioning of the labor market (June 2001); rural factor markets (June 2001) and a study on trade and foreign direct investment (June 2000). In October 2000, a Financial Sector Assessment on the Poland financial system was carried out under the joint IMF/World Bank Financial Sector Assessment Program. The Bank currently is advising the Government on a variety of issues that are related to structural impediments and budget management of which the latter is expected to cumulate into a Public Expenditure and Institutional Review.

---

[1] Prepared by World Bank staff.

POLAND—STATISTICAL INFORMATION

1. Poland has a comprehensive and improving economic database. 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 data matrix). 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) issues 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 such data.

3. National accounts data still have some problems, particularly in the measurement of unrecorded cross-border trade, and in the treatment of changes in inventories. However, progress has been made. Most notably, the Central Statistical Office has started to issue quarterly national accounts statistics that now include estimates by expenditure category.

Government Finance Statistics

4. The authorities provide detailed state budget data to the Fund every month. In addition, government finance statistics are now 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.

5. The annual consolidated central 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

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

External Sector Statistics

6. While improvements have been made in the balance of payments data, some areas still 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. Differences in definitions remain between the customs (GUS) and payment (NBP) based trade data.

7. In the monetary survey the NBP now reports net foreign assets (NFA) rather than the net international reserves (NIR) previously supplied. 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 May 14, 2002

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	Public External Debt/ Debt Service
Date of Latest Observation	14-May	April	April	April	March	February	March	March	March	February	Q4, 2001	Q4, 2001
Date Received	14-May	May	May	May	April	April	May	May	May	April	March	April
Frequency of Data	daily	monthly	monthly	monthly	monthly	monthly	monthly	monthly	monthly	quarterly	quarterly	quarterly
Frequency of Reporting	daily	monthly	monthly	monthly	monthly	monthly	monthly	monthly	monthly	quarterly	quarterly	quarterly
Source of Update	NBP	NBP	NBP	NBP	NBP	NBP	GUS	NBP	NBP	MOF	GUS	NBP
Mode of Reporting	on-line	on-line	on-line	on-line	on-line	on-line	on-line	on-line	on-line	letter to IMF	fax	on-line
Confidentiality	no	no	no	no	no	no	no	no	no	yes	no	no
Frequency of Publication	daily	monthly	monthly	monthly	monthly	monthly	monthly	monthly	monthly	quarterly	quarterly	quarterly

Statement by the IMF Staff Representative
June 7, 2002

1. This statement reviews developments in Poland since the preparation of the staff report for the 2002 Article IV consultation (SM/02/152, 5/17/02). The additional information does not change the thrust of the staff appraisal. Nonetheless, in light of the deterioration in the problematic relationship between the government and the National Bank of Poland (NBP) and further threats to the autonomy of the Bank, staff again urges the authorities to prevent differences on policy for the short-run from giving rise to changes in institutional structures that are likely to have long-term damaging consequences.

2. **Economic Developments**

- **Evidence of a strong economic recovery remain few and far between.** Exports, imports and tax revenues picked-up considerably in April. But the up-tick in industrial production was more muted (0.5 percent in seasonally adjusted terms). Credit growth also remained anemic (4 percent, year-on-year). Further, confidence surveys, which had improved sharply in the first quarter, have more recently leveled off. These data points are not inconsistent with the staff's projections of 1.4 percent output growth for 2002, which assumed a weak first-half.[1]

- **Unemployment appears to have peaked.** According to the broadest measure, the quarterly labor force survey, seasonally-adjusted unemployment fell from 19 in the last quarter of 2001 to 18.7 percent in the first quarter of this year. Registered unemployment, however, continues to rise, to 17.5 percent in April in seasonally adjusted terms, although its rate of increase has moderated in recent months.

- **Headline inflation fell to 3 percent in April—a new post transition low.** Moreover, virtually all of the core inflation measures are now below the end-2003 target. These developments are consistent with the staff's inflation projections for 2002 of an average rate of 3.2 percent and an end-year rate of 3.6 percent—below the end-year target of 5 percent with a ±1 percentage point band.

- **The 2001 fiscal deficit has been revised down marginally (0.2 percent of GDP).** Reflecting the availability of final numbers for local governments' deficit, which were 0.3 percent of GDP lower than projected, and central government expenditure

[1] The statistical agency has revised GDP growth in both 2000 and 2001 downwards by 0.1 percentage points, to 4 and 1 percent respectively. These revisions do not alter the staff's assessment of recent economic developments.

- over -

arrears, which amounted to 0.1 percent of GDP, the 2001 general government economic deficit is now estimated by the staff at 4.6 percent of GDP.[2]

- **The zloty has strengthened in recent weeks**: appreciating from around Zl 4.15–4.20 to the U.S. dollar earlier in the year to around Zl 4.05 to the U.S. dollar in recent days. Coupled with the lack of firm evidence of a robust economic recovery, this has prompted the government to seek changes to the exchange rate regime. To date markets have been unperturbed by these and other developments (see below).

3. **Policy Developments**

- **The Monetary Policy Council (MPC) cut interest rates further in April.** Reflecting the fall in inflation and subdued demand conditions, the key policy rate was cut by another 50 basis points in April, to 9 percent. This brings the cumulative cut in rates since the start of the easing cycle in February 2001 to 1000 basis points. Real policy interest rates remain of the order of 6 percent.

- **Troubled by frailty of the economy, the government has been pressing for deeper interest rate cuts and changes to the exchange rate regime**. A Cabinet Council, a joint meeting between the Council of Ministers and the President convened for matters of importance, is expected to meet in the coming days to discuss monetary policy issues. In parliament, parallel to government proposed revisions to the National Bank Law to make it consistent with EU requirements, a group of parliamentarians have submitted a number of amendments—including, a provision for adding six new members to the MPC and expanding the mandate of the NBP to include economic growth and employment objectives—that would change institutional arrangements in a way that would most likely lead to an easing of monetary policy. Both drafts have been sent to a parliamentary committee for further consideration. After the report of the committee, further votes in the lower house, upper house and ratification by the President would be required for the amendments to be adopted. The President has generally indicated that he would not sign such legislation and/or refer it the constitutional court—although a veto could be overridden by a 60 percent majority in parliament.

[2] See page 7 of the Staff Report (SM/02/152) for a definition of the economic deficit.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 02/65
FOR IMMEDIATE RELEASE
June 26, 2002

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2002 Article IV Consultation with the Republic of Poland

On June 7, 2002, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Poland.[1]

Background

Poland has weathered a difficult two years. Under the weight of exogenous shocks, an aggressive policy response to rising consumption growth in 1999 and early 2000, and a downturn in Germany, output growth slumped from 4.1 percent in 2000 to 1.1 percent last year. And the slowdown has raised the unemployment rate back to the high teens, hit investor confidence and caused non-performing loans in the banking system to rise. At the same time, inflation has declined sharply (from 11½ percent in mid-2000 to some 3¼ percent in the first quarter of 2002) and the current account deficit has narrowed considerably (from 6¼ percent in 2000 to some 4 percent last year).

The fiscal deficit widened sharply in 2001, reflecting both automatic stabilizers and a ½ percent increase in the structural deficit. State (central government) primary expenditures (excluding one-off transfers) rose relative to GDP by 1 percentage point, notwithstanding cutbacks late in the year. Two factors accounted for this rise: significant increases in transfers and subsidies to households, agricultural and state enterprises, as well as wages; but also outcomes for inflation and growth that were far below budget projections. Together with a cyclical slowing of revenues,

[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. This PIN summarizes the views of the Executive Board as expressed during the Executive Board discussion based on the staff report.

this led to a general government economic deficit (cash basis) provisionally estimated by the staff at just under 5 percent of GDP, up from 2.2 percent of GDP in 2000

Monetary policy was eased significantly in 2001. The sharp declines in inflation and inflation expectations made deep interest rate cuts possible. Accordingly, the key policy interest rate has been cut by a cumulative 1000 basis points since February 2001, and reserve requirements were lowered from 5 to 4½ percent. But with inflation having fallen sharply, real policy interest rates (deflated by either current or projected one year ahead inflation) remain at some 6 percent.

The interest rate cuts have done little to stem the continuing appreciation of the zloty. The CPI-based real effective exchange rate has appreciated by some 25 percent since end-1999, of which at most 6 percentage points can be attributed to Balassa-Samuelson effects. Notwithstanding the strength of zloty, export volume growth remained strong in 2001—expanding by 6 percent, well ahead of export market growth. Coupled with weak import growth, this contributed to the improvement in the current account deficit.

Partly spurred by the easing of policies last year, signs of an economic recovery are now appearing. Further, the expected recovery in Germany, Poland's main trading partner, should cement this recovery in the latter part of this year. While the weak first half will leave growth this year at or somewhat above last year's 1 percent, prospects for growth beyond this year are strong. And Poland approaches this juncture from a position of strength in some important respects: inflation is low and the fruits of the hard-fought battle to tame inflation expectations will be conducive to growth; the modest current account deficit leaves room for a pick-up in imports; and enterprises, having adapted to highly competitive conditions, are leaner and more efficient. With EU accession in sight, Poland has the potential to do well.

But realizing this potential will require addressing the policy challenges that have emerged. A first requirement is to put the unfettered ability of the National Bank of Poland (NBP) to conduct monetary policy beyond question. Only then will the time-proven benefits of low inflation and investor confidence be secured. Second, public spending must be curtailed if private investment and exports are not to be crowded out and lead to the reemergence of a large current account deficit. And third, policy-induced distortions in the labor market need to be eliminated if firms are to have the flexibility to respond aggressively to new opportunities and create jobs.

Executive Board Assessment

Executive Directors noted that Poland has had a long and well-established track record in building the institutions and pursuing the policies for a successful transition to a market economy. In the past two years, the Polish economy has weathered a difficult period against the background of a weaker external environment. Economic growth has decelerated markedly, reflecting a sharp drop in investment, while unemployment has risen rapidly. Positive developments, however, include the decisive lowering in inflation and inflation expectations, and the reduced vulnerability to changes in investor confidence resulting from the sharp, if partly

cyclical, drop in the current account deficit. Looking forward, Directors welcomed the emerging signs of a recovery, to which the upturn in the world economy should add welcome support.

To realize the potential of sustained high growth and make the most of impending EU accession, Directors considered that Poland faces several important challenges that will require prompt and resolute policy responses. Key among these are a sustained fiscal consolidation effort to set the stage for an improved policy mix and reverse rising debt dynamics, as well as the vigorous pursuit of labor market and other structural reforms that will be crucial for regenerating growth and job creation.

For the immediate future, Directors underlined the importance of preserving the institutional integrity and independence of the NBP. They were concerned that a continuation of the present debate, which has perpetuated perceptions of interference in the organization and role of the NBP, would have adverse short and long-term consequences, by diminishing investor confidence in Poland's commitment to sound policies and raising inflation expectations. Although differences in views on policy choices are quite natural, Directors urged the government and NBP to restore a constructive dialogue on monetary policy and to work expeditiously toward resolving their differences through dialogue and open communication. Directors also urged the government to oppose the amendments to the National Bank Law now before parliament that would curtail the central bank's unfettered ability to conduct monetary policy.

Directors welcomed the restraint on public expenditure growth in the 2002 budget as a first, important step toward correcting the widening fiscal imbalances. While recognizing that the budget entails a sizeable withdrawal of stimulus in a setting of weak growth, Directors considered this to be unavoidable, given the large size of the deficit and the need to pave the way for further monetary easing. They urged the authorities to ensure that the expenditure moderation expected of the local governments is achieved.

Directors stressed that sustaining fiscal consolidation in the coming years will be key to prevent general government debt from rapidly rising to the constitutional limit of 60 percent of GDP. They commended the government's decision to limit the rate of growth of State spending to the projected increase in the "CPI plus one percent", as a key first step, and urged its strict implementation to ensure a gradual lowering of the fiscal deficit and stabilization of the public debt ratio. Most Directors encouraged the authorities to broaden the coverage of the "CPI plus one percent" rule by extending, in due time, its application to the spending of local government and extra-budgetary funds. They considered that this would help ensure that fiscal consolidation goals are more safely achieved, thereby creating some welcome scope for tax cuts. Some Directors also suggested that the rule should be enacted by law and combined with explicit nominal spending ceilings to ensure its effectiveness.

Beyond lowering the fiscal deficit, Directors underscored the importance of re-orienting public expenditure to more productive uses. Directors noted that better targeting of social transfers, which at present account for close to half of total public spending, will be essential both for achieving the required fiscal consolidation as well as for releasing resources for much-needed

infrastructure investment. They encouraged the government to build the required social consensus in favor of reforms in this area.

Directors commended the NBP for its effective conduct of monetary policy, which has reduced inflation and brought about cumulatively quite large interest rate cuts during the past year. Looking ahead, considering the generally benign inflation outlook, the likely persistence of a sizeable output gap, and the strength of the zloty, Directors saw some scope for further interest rate cuts. Directors generally supported the recent cautious approach of cutting by small amounts in view of the uncertainties about the effects still in the pipeline from the large cuts during the past year. However, a few Directors pointed out that the lagged effects of the zloty appreciation would suggest that there is scope for somewhat more ambitious easing.

Directors welcomed the continued improvements to the inflation targeting framework, which will be further enhanced with improved overall coordination of macroeconomic policies and information dissemination. They noted that, in the current environment, it would be appropriate to make the framework more symmetrical, by setting a single continuous inflation target with relatively large bands. They encouraged the authorities to adopt a new medium-term inflation target soon to help guide policies beyond 2003.

Directors considered that the freely floating exchange rate regime has served Poland well, and that the current strength of the zloty is a by-product of the macroeconomic policy mix combined with the normal tendency toward appreciation in the transition. Noting that direct market intervention to engender a depreciation is unlikely to yield any lasting benefit, Directors generally emphasized that concerns about competitiveness should be addressed through a reduction of the fiscal deficit and an acceleration of structural reforms that would permit a more substantial easing of monetary policy than would otherwise be possible.

Directors noted that Poland's financial system appears to be generally sound. They considered that the substantial increase in non-performing loans should not be a systemic concern, as banks have fully provisioned against them, and they expected this problem to subside as growth recovers. Directors noted, however, that a sizable increase in foreign exchange denominated or linked borrowing by households has heightened the risks to the banking system from a sudden exchange rate depreciation. While recognizing that the attraction of those loans would likely decline with falling interest differentials, Directors urged the NBP to ensure that banks are clearly aware of the credit risk embodied in foreign currency loans to unhedged borrowers, and are pricing this risk appropriately. They welcomed the NBP's intention to monitor closely the evolution of foreign currency loans, and stressed the importance of improving data coverage in this area.

Directors commended the authorities' commitment to further structural reforms aimed at improving economic efficiency and promoting business opportunities and job creation. They urged the authorities to undertake extensive labor market reforms to ensure that the economic recovery will be job-rich, and, in particular, to relax the regulations governing the hiring and firing of workers. Many Directors also supported measures to differentiate the uniform national minimum wage for labor market entrants and across the regions. Directors encouraged the

authorities to deepen public enterprise reform so as to reduce the fiscal cost of sustaining these enterprises and remove the economic inefficiency that they entail for the economy at large. They also urged the authorities to reinvigorate privatization, including in the financial sector, and to refrain from using publicly-owned banks for quasi-fiscal objectives.

Directors welcomed the authorities' decision to remove the remaining controls on capital flows in the context of a sufficiently strong regulatory framework. They looked forward to the early enactment of draft legislation to further strengthen the framework for combating money laundering and the financing of terrorism.

Poland subscribes to the Special Data Dissemination Standard and its statistical base is adequate for surveillance. Directors encouraged the authorities to improve the timeliness of the compilation and dissemination of monthly fiscal data for the general government. Directors welcomed the authorities' decision to complete the Report on Standards and Codes on data quality in the coming year.

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. The Staff Report for the 2002 Article IV Consultation with the Republic of Poland is also available.

Poland: Main Economic Indicators

	1996	1997	1998	1999	2000	Estimate 2001
Real economy (change in percent)						
Real GDP	6.0	6.8	4.8	4.1	4.0	1.1
Real domestic demand	9.6	9.4	6.5	5.0	1.8	-1.7
CPI (end-year)	18.5	13.2	8.6	9.8	8.5	3.6
Unemployment rate, average (in percent)	14.3	11.5	10.1	12.0	13.9	16.3
Gross national saving (percent of GDP)	20.9	21.6	21.9	18.9	19.9	18.5
Gross domestic investment (percent of GDP)	21.9	24.6	26.2	26.4	26.3	22.5
Public finance (in percent of GDP)						
General government balance 1/	-3.3	-3.2	-3.3	-3.6	-3.0	-5.3
Public debt 2/	47.9	46.9	42.9	45.8	42.3	43.2
Money and credit (end of period, percent change)						
Domestic credit (12-month change)	31.1	33.6	27.9	27.0	17.3	7.6
Broad money (12-month change)	29.5	29.3	25.2	15.1	15.9	13.7
Money market rate (end of period, in percent)	21.6	24.8	15.9	16.4	19.2	11.9
Balance of payments in convertible currencies						
Trade balance (in percent of GDP)	-5.7	-7.9	-8.7	-9.3	-8.3	-6.6
Current account (in percent of GDP)	-1.0	-3.0	-4.3	-7.5	-6.3	-4.0
Official reserves (in billions of U.S. dollars)	18.2	21.4	28.3	27.3	27.5	26.2
Reserve cover (months of merchandise imports)	6.7	6.7	7.7	8.0	8.0	7.5
External debt (end of period, percent of GDP)	33.1	34.5	37.3	42.2	44.0	39.5
Fund position (in millions of SDRs)						
Quota						1,369.0
Fund holdings of currency (February 28, 2002)						1,002.2
Holdings of SDRs (February 28, 2002)						22.2
Exchange rate						
Exchange rate regime	Floating Rate					
Present rate	Z14.0284 per US$1 (April 26, 2002)					
Zloty per U.S. dollar (period average, in percent)	2.7	3.3	3.5	4.0	4.3	4.1
Appreciation (+) of real effective exchange rate (relative CPIs, in percent)	13.0	1.7	4.8	-4.0	8.3	10.5

Sources: Central Statistical Office; data provided by the authorities; and IMF staff estimates.
1/ On a commitment basis through 2000; cash-basis for 2001.
2/ Data for 1996-98 covers central government debt only.

Statement by Wieslaw Szczuka, Alternate Executive Director for the Republic of Poland June 7, 2002

As usual, the staff has prepared for the Board's annual discussion on Poland an interesting set of papers, which provide many valuable insights into the recent economic developments and the current policy debates in my country. My authorities broadly share the staff's assessment and agree with most of the recommendations contained in the staff report. The Polish authorities highly value the continued policy dialogue with the IMF and confirm their willingness to participate in various Fund activities and initiatives, including through an expanding participation in the financial transactions plan, contributions to the HIPC Initiative and the recently expressed interest in completing a ROSC on data quality.

The lost growth puzzle

By the time of the last year's Board discussion on Poland most economic experts, including the Fund staff, expected that the Polish economy would grow in 2001 by about 4 percent. The actual outcome was a disappointing 1 percent, and a similar, low figure is expected for this year. Concurrently, unemployment increased to a staggering level of 17.4 percent and grew even slightly further in the first quarter of 2002. On the positive side, inflation declined to the current level of about 3 percent and the current account deficit dropped to a more sustainable 4 percent. While Poland is certainly not a unique case of a missed growth projection for 2001, there is clearly a need to try to find an explanation for this large, and largely unexpected, first cyclical downturn in Poland's so far very successful transition experience. The most obvious culprit – the global slowdown – certainly contributed to Poland's recent worries, but it does not offer a full explanation for at least two reasons. First, it was mainly the decline in domestic demand that caused last year's slowdown in activity, while the contribution of net exports remained positive (exports for the whole year expanded, in dollar terms, by a healthy 14 percent, but its dynamic turned negative by the end of 2001). And second, Poland's growth performance last year was markedly different from most other European transition countries, which either recorded much smaller downturns or, in some cases, even managed to increase their growth rates despite the global slump.

Looking for more Poland-specific factors, the staff rightly identified the collapse in investment as being at the heart of the GDP slowdown. This collapse, in turn, has been explained by such factors as weakening demand conditions, low profitability and high borrowing costs. However, a somewhat more detailed analysis of the causes of the profits and demand decline, and of other factors holding back investment decisions, would be warranted in order to both assess the prospects for a recovery in investment and to find out, which areas of the economic policy making contributed the most to the large decline in the propensity to invest, and thus should be corrected in the first place. In looking for answers to such questions, it would also be important to try to assess more thoroughly which groups of investors (domestic, domestic but foreign controlled, new FDIs) reduced their outlays the most, because each of these groups can be expected to react differently to such factors as changes in domestic interest rates and external demand. Staff's claim that it was mostly

domestic investors may not be very precise, because a more detailed breakdown of investments shows significant declines in many sectors with a large participation of foreign capital. Also worth noting is that public investments declined strongly last year despite a significant increase in total fiscal spending. This is telling a lot about the need to adjust the structure of public expenditures.

My authorities do not deny that past mistakes in macroeconomic policies contributed to the current slowdown in growth. The new government identified the wrong mix of relaxed or inconsistent fiscal policy and tight monetary policy, mistakes in introducing major structural reforms and the tendency to postpone painful decisions as important sources of the recent decline in economic activity. Some experts also see the roots of the current problems in the failure to use the period of relative prosperity in the second half of the last decade to stronger promote domestic savings, including by more decisively reducing the public sector imbalance. This failure left Poland with no other choice but to significantly tighten macroeconomic policies in order to constrain the demand pressures and reduce the fast expanding current account deficit. The issue at stake is thus not whether Poland had to restore macroeconomic balance and seek the long-term benefits of price stability, but if the "sacrifice" – in terms of lost output and employment – for achieving these objectives had to be as large as experienced in the last two years.

The developments recorded in 2000 indicate that not only the inadequacy of the policy mix, which is so strongly emphasized by the staff, but also the excessive overall tightness of the whole set of macroeconomic policies may have contributed to the last year's slump. While this view is not shared by the NBP, some analysts claim, with the benefit of hindsight, that given the much better than expected results of the general government in 2000 (economic deficit of 2.1 percent), the monetary policy in the second half of 2000 could have been somewhat easier. Unfortunately, the Polish monetary authorities had to act under the conditions of imperfect information (lack of timely data for consolidated public sector and delays in the detection of the incipient global slowdown) and preferred to adopt a cautious stance, given their price stability mandate and the still high at that time, and even slightly rising in the third quarter, level of core inflation. Tight monetary conditions, together with strong FDI inflows, contributed to a sizable appreciation of the zloty, which intensified by the end of 2000 and continued for most of 2001. This, in turn, negatively affected the profitability of the Polish exporters and may provide yet another partial explanation for last year's investment and output collapse.

Prospects for a recovery in economic activity and the strategy of the new government

Staff is quite optimistic as to the prospects of a relatively early and strong recovery in Poland. My authorities would be ill-advised not to share this optimism, but they are also concerned that the signs of the emerging improvement in economic activity are still fairly weak and fragile, and thus need to be reinforced through an appropriate policy action. While, until recently, the expectations of an incipient recovery were mostly based on the improving results of the business and consumer confidence surveys, these expectations received a welcome support in the form of some favorable statistical data reported for April. The first in many months increases in exports and import (by 9.4 percent and 7.9 percent

respectively) may suggest some improvements in both external and domestic demand, while the improved profitability of enterprises slightly brightens the outlook for an ultimate revival of investments. The continued, albeit at a more moderate pace, increase in sales and some decline in inventories are also welcome developments. Last but not least, among recent positive news one should also point to some more encouraging signs of an emerging recovery in Germany and the rest of Western Europe. However, the relatively poor production data for April, the absence of credible signs of a recovery in investments and the still very difficult situation on the labor market clearly indicate that the Polish economy is not yet out of the woods. Also, the decline in real and nominal wages in the enterprise sector recorded in April does not augur well for the future evolution of domestic demand.

My authorities are fully aware that the efforts to revive the domestic demand should also be complemented by well-designed policy actions aimed at strengthening the supply response of the economy. To achieve these goals, and to ensure Poland's return on the path of a sustainable and strong growth, they continue working on ensuring a smooth and efficient implementation of the comprehensive medium-term program "Entrepreneurship-Development-Work", which was adopted by the government in February 2002. This three-pillar economic policy framework for 2002-2006 aims at promoting growth, stabilizing public finances and preparing Poland for the EU membership. Economic policies are geared towards a gradual return to an annual growth rate of about 5 percent. It is to be achieved by improving business environment, increasing infrastructure spending, efficient use of the EU funds, strong FDI inflows and mobilization of the domestic savings, including through a further strengthening and development of the banking system and the capital market.
The program includes many new laws designed to lower labor costs, boost employment and spur business development. The process of privatization and enterprise restructuring will be continued and should be completed by 2005, leaving Poland's ownership structure similar to that of the EU members. The government is fully aware that enhancing the supply side response can significantly contribute to accelerating the real convergence with the EU income levels. Structural reforms are also designed to increase efficiency of the public finances and thus to provide more flexibility in macroeconomic policy.

Monetary policy stance

As reported by the staff, the questions, what should be the appropriate stance of monetary policy and whether, and to what extent, the past policy actions in this area contributed to provoking and/or extending the current economic slowdown are the subject of a very intense public debate in Poland. While some of the arguments and instruments used in this debate may not be considered ideal, or even appropriate, this discussion reflects some legitimate concerns. To some extent it can also be seen as part of a much broader dispute, whether the priority should be given to the real or to the nominal convergence with the EU.

Looking only at the bare facts, one could observe that in Poland over the last two years the large decline in economic activity and the large increase in unemployment coincided with relatively high interest rates and a strong appreciation of the currency. As noted in one of the staff's interesting background studies, in this respect, and also in the duration of the deceleration of the domestic demand, Poland differed somewhat from its peers. This situation

may lead to posing a question about the causal link between the monetary policy stance and the real sector developments. Both the economic theory and the experience of many other countries indicate that some price, in terms of a decline in output, has to be paid for reducing the excess demand pressures and regaining a sustainable external position. There also is considerable evidence that this price tend to be higher when the main burden of constraining the demand pressures has to assumed by the monetary policy, without an adequate support from the fiscal side. However, even after acknowledging the existence of an imperfect policy mix, a question can be asked, whether the level of the so-called sacrifice ratio in Poland has been influenced by the specific conduct and stance of the monetary policy chosen by the NBP's authorities, and whether some other factors had an even stronger impact on the cost of stabilizing the economy.

While both sides of the Świętokrzyska Street, which separates the central bank from the ministry of finance, agree that there was a need to ease the monetary policy in line with falling inflationary expectations, the views differ as to timing, scale and method (or strategy) of introducing the interest rates cuts. This latter issue is also of a considerable importance, because several economic analysts claim that the Monetary Policy Council's (MPC) decision to follow a gradual path of relatively small reductions in its policy rates contributed to the continuation of strong appreciation pressures by inducing foreign portfolio inflows motivated by profits to be realized ahead of the next expected interest rate cut. This view is not accepted by the MPC, which points to the evidence that purchases of medium-term government bonds are the main channel of portfolio capital inflows. The general position of the MPC is quite firm and points to both its constitutional mandate, and to the benefits of price stability, which is usually seen as the single most important contribution monetary policy can make to promoting medium-term growth. The MPC puts a lot of emphasis on the importance of structural reforms and on the need to create room for further real interest rates cuts by reducing the public sector borrowing requirements. In this context, the MPC stresses that the near collapse of public finance in the middle of last year significantly limited the options available to monetary authorities. The MPC also emphasizes the importance of reaching their medium-term inflation target (below 4 percent by the end of 2003) which, in its view, may still be at risk given the possibility that the lagged effects of the recent substantial reductions in nominal interest rates will appear at the time of the expected pick up in external and domestic demand. The decision to move in small steps is being justified by the MPC, among others, by both the negative experience with a more decisive move at the beginning of 1999 and the need to gradually reduce the inflationary inertia, given Poland's history of high inflation, the still considerable scope of indexation and the relative importance of the so-called nominal illusion.

With both sides having some strong and valid arguments, the debate on the stance of monetary policy in Poland remains unresolved, even if its actual importance has somewhat diminished given the much more reduced scope for any further easing. While my authorities do not expect the Fund to become an arbiter in this dispute, they certainly count on the staff's frank and professional advice. Although the staff appears to show some reluctance to provide a clear-cut assessment of the past conduct of monetary policy, it nevertheless quite firmly indicated in the report that a case existed for cautiously introducing some further small interest rate cuts. This advice has already been followed by the MPC, which on May 29

decided to reduce all NBP's policy rates by another 50 bps, bringing the cumulative reduction since February 2001 to 10 percentage points and the main intervention rate to 9 percent. However, the MPC also maintains that the publication of Fund's, and other international institution's, suggestions as to the recommended direction of monetary policy does not remain without an impact on market expectations.

Given the importance of properly assessing the inflationary trends and the actual stance of monetary policy I believe that the staff could have devoted a little more attention to analyzing these issues. Relatively little attention has been paid in the report to the various measures of core inflation calculated by the NBP, while the PPI developments are only reflected by a single graph. It is quite obvious that the PPI (with the value of this index having declined below zero by the end of last year) has a strong bearing on the profitability of enterprises, and on the assessment of the real cost of their borrowing. The report also does not include any formal presentation of the evolution of a monetary conditions index (MCI). Absence of such analysis and data makes the assessment of the actual stance of monetary policy somewhat more difficult.

The exchange rate policy

The declines in exports observed since November 2001 (with the welcome exception of last April) and the continued appreciation pressures brought a renewed attention to the issue of the exchange rate. According to staff's calculations, zloty's real effective exchange rate has appreciated since end-1999 by about 25 percent, with only less than 6 percentage points being attributable to the Balassa-Samuelson effects. This situation, as well as the realization that a somewhat weaker zloty would not put at risk the achievements of this year's inflation target, prompted the government to propose some changes to the current exchange rate policy, including the option of resuming discretionary market interventions. The NBP, supported by the staff, has so far rejected the idea of official intervention claiming that it would be largely ineffective and could prove very costly as well as inconsistent with the monetary policy framework. In NBP's view the fully flexible exchange rate regime has served Poland well and does not require any change at this moment. It claims that a significant part of upward pressures on the zloty results from the so-called convergence play and such pressures cannot be effectively reversed by market intervention. The NBP also claims that the latest data do not point to any strong upward movement of the zloty, in particular after the recent appreciation of the euro. To resists or constrain future appreciation pressures staff recommends a steady reduction in the fiscal deficit which, in turn, would create conditions for easing of monetary policy. While this certainly is the best way to follow, the government is concerned that the implementation of this recommendation takes time, while it sees the current strength of the currency as an increasingly acute short term problem, with implications for both the level and profitability of exports and the broader prospects of the recovery in economic activity. Also, the government points out that some categories of large (and often bulky) foreign currency inflows (such as those related to privatization, "greenfield" FDIs and transfers from the EU) are to a large extent insensitive to the interest level. Taking all of this into account, the government presents the view that even if it would not offer any long-term solution, some limited intervention could be worth

trying. The government has also declared its readiness to indirectly assume the costs of such intervention, seeing this as a means of providing a temporary respite to the Polish exporters. The exchange rate issue needs also to be evaluated in the broader context of Poland's ultimate membership in the EMU. My authorities count in this respect on the Fund playing the role of an active advisor on how to conduct the exchange rate policy before the final conversion of the zloty into the euro.

Central bank's independence

The recent discussion on the central bank law is an unfortunate by-product of the broader debate on the role of monetary policy. This discussion resulted in several legislative proposals that have been submitted to the parliament. A draft bill prepared by the Polish Peasant Party and the Labor Party (two junior parties belonging to the ruling coalition) proposing to expand both the mandate of the central bank and the number of members of the MPC has already been preliminary discussed by the Sejm (lower chamber of the parliament) and sent for further elaboration by a parliamentary committee. The government, even though at times openly critical of the NBP's policies, has not officially endorsed this proposal and instead submitted its own draft bill introducing such amendments to the NBP law, which would make it fully conform with the EU standards. This draft has also been discussed by the Sejm and sent to one of its committees. The government's proposal, in its current form, has been fully supported by the NBP itself, which sees in it a further reinforcement of its already very strong legal and operational independence. While the outcome of the parliamentary debates on these two largely opposing draft bills is difficult to predict, there is quite a significant probability than any new legislation materially limiting the central bank's independence would be vetoed by the president, and/or challenged in the Constitutional Court. The recent intensification of direct contacts between the government, parliament and the NBP should also help in reducing tensions and promoting better understanding of each side's position. I certainly agree with the staff's view that the central bank's independence should be considered one of the most important achievements of Poland transition process and should not be put in question because of any short term policy discussions.

Fiscal developments and plans

It would be rather difficult to disagree with staff's critical assessment of the fiscal policy implemented in Poland in 2001. The election year budget prepared by the previous minority government provided for a large increase in expenditures and was based on a very unrealistic revenue projection. This lack of realism was reflected in both assuming excessively high rates of growth and inflation, and projecting a very significant improvement in tax collection. The actual state budget revenue was by more than 12 percent lower than assumed in the original budget bill. To make things worse, in the course of the year the parliament introduced several legislative initiatives providing for a very large increase in public spending. After an alarm bell was sounded by the outgoing minister of finance that a "hole" in the next year's budget could exceed 10 percent of GDP, the government, the president and the newly elected parliament took a coordinated action, that helped to avert such a fiscal disaster by blocking and cutting many expenditure items, and by rejecting or postponing most of the new spending initiatives. Despite these last minute efforts, the "economic" deficit

of the general government increased in 2001 to about 4.8 percent of GDP, as compared to 2.1 percent the year before. As often stressed by the NBP, the inability to effectively control public expenditure, the very uneven implementation of fiscal policy and the large degree of uncertainty as to the actual stance of fiscal policy significantly complicate the task of monetary authorities.

However, what Poland really needs in the area of fiscal policy is not some short term measures to avoid a next calamity, but a comprehensive reform effort aiming at both restoring fiscal equilibrium and adjusting the structure of expenditures in order to free additional resources for spending on development. Such objectives underpin the new public finance strategy, which was adopted by the current government as part of its comprehensive economic program. At the center of this strategy is the "CPI + 1" rule which, by limiting the real growth in expenditure, should allow Poland to gradually grow out of the fiscal deficit and keep the public debt to GDP ratio below the constitutionally mandated 60 percent ceiling. While the implementation of the "CPI + 1" rule has yet to be tested, in particular at times of a faster GDP growth, my authorities are quite confident that they will be able to stick to this clear and transparent rule. They are also somewhat less concerned than the staff that the implementation of this rule could be undermined by systematically assuming too high rates of inflation (which, in a sense, would be against the nature of any minister of finance) or by a lack of spending discipline outside of the state budget. This latter risk is indirectly controlled by strict (even if not yet fully binding) limits on indebtedness of local authorities and can be further reduced by the current effort to reduce the number of extra budgetary funds. While the current year's budget was drafted before the adoption of the new fiscal rule, it can be seen as an intermediate step towards this new regime. Even though, as reported in the staff report, the parliament decided to slightly increase both the expenditure and the revenue levels proposed by the government, a major part of this additional spending is conditional on the materialization of the assumed higher VAT revenue. The implementation of this years budget proceeds quite smoothly and there appears to be no significant risk of exceeding the admittedly still quite high state budget deficit of 5.4 percent.

In order to achieve the second main objective of the new fiscal strategy, namely a decisive change in the composition and level of expenditures, the government has initiated a comprehensive review of public spending and already started the process of consolidating and/or eliminating several of the too numerous state agencies, extra budgetary funds and other public sector institutions. Several other measures envisaged under the new strategy, including those aimed at rationalizing or better targeting social transfers have either already been approved or are under preparation.

While the current fiscal position does not allow for any significant reduction in the tax burden and some additional revenue measures had to be introduced for this year's budget (like the tax on capital income and a new excise tax on electricity) the authorities intend to proceed next year with the planned reduction of the corporate tax rate from 28 to 24 percent and to introduce some additional tax incentives for the small and medium size enterprise sector.