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Economic Developments

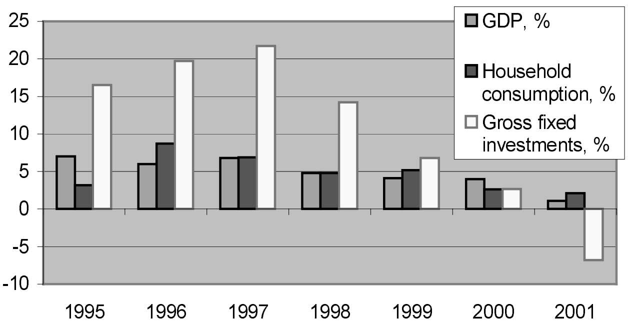
GDP growth continues to slow

Poland's economic growth continued to decline throughout the second half of 2001. Preliminary estimates indicate GDP growth fell to 1.1 % in 2001 (4.0 % in 2000).

Industrial output, which accounts for about 20 % of GDP, decreased 0.2 % y-o-y in 2001. Construction activity (7 % of GDP) fell 9.9 %, due largely to a sharp drop in investments – the driving force of economic growth in previous years. Investment growth began to slow in 1998, but remained positive until the second quarter of 2001. During the first three quarters of last year, investments decreased 6.8 % (see figure). While low profitability of enterprises and high credit costs played a role, some analysts say the major reason for the decline is the pessimistic economic outlook. Domestic demand as a whole decreased 2 % in the first three quarters, mainly reflecting lower investment levels.

In contrast, market services, which account for over 40 % of GDP, grew about 4 % in the first three quarters of 2001. Private consumption accelerated slightly, reaching almost 2 % y-o-y growth in January-September. This was mainly due to hikes in retirement and disability pensions. Unemployment, however, continued to increase. The unemployment rate climbed to an all-time high of 17.4 % in December.

Components of GDP, y-o-y growth from 1995 to 2001



Source: Central Statistical Office (CSO) of Poland

Current account deficit shrinks

Despite the strengthening of the zloty and the slowdown in EU economic activity, Polish exports rose over 10 % y-o-y in euro terms in 2001 (see NBP balance-of-payments data below). Low producer price inflation compensated for the appreciation of the zloty. Import growth remained weak (just over 4 % in euro terms), mainly due to low domestic demand. The trade deficit was still nearly 7 % of GDP. However, exports decreased on-year in November and December, most likely a reflection of the global economic slowdown. Almost three-quarters of total Polish exports went to EU countries.

The current account deficit declined substantially to EUR 7.9 billion (4 % of GDP) in 2001 (over 6 % of GDP in 2000). Higher export revenues, falling imports and improvements in the service balance reduced the deficit. Poland's current account breakdown includes a component for unclassified current transactions, i.e. unregistered cross-border trade. These transactions constitute the second largest component of the current account after the trade balance.

Foreign direct investment inflows accounted for nearly 4 % of GDP last year and were sufficient to cover over 90 % of the current account deficit. For the year, FDI declined to about EUR 7.4 billion (EUR 9 billion in 2000). Factors contributing to the FDI shortfall included the postponement of the second stage of privatisation of PZU, the state insurance company, and power distributor PKN Orlen.

Balance of payments 1999 – 2001 (EUR billion[1])

	1999	2000	2001
Current account	**-10.84**	**-10.77**	**-7.86**
Trade balance	**-13.49**	**-14.26**	**-13.04**
Exports	24.72	30.59	33.81
Imports	38.21	44.85	46.85
Services: net	**-1.52**	**-1.82**	**-0.94**
Credit	3.11	3.81	4.55
Debit	4.63	5.63	5.49
Income: net	**-0.74**	**-0.82**	**-0.99**
Credit	1.76	2.44	2.97
Debit	2.51	3.27	3.96
Current transfers: net	**1.51**	**1.82**	**2.20**
Credit	2.07	2.34	2.94
Debit	0.57	0.52	0.73
Unclassified transactions: net	**3.41**	**4.32**	**4.91**
Capital and financial acc.	7.73	8.29	4.17
Direct investment: net	5.96	8.85	7.26
Portfolio investment: net	0.81	2.80	2.25
Other investment: net	0.38	-3.67	-5.90
Financial derivatives net	0.53	0.29	0.56
NET ERRORS AND OMISSIONS	3.28	3.21	3.14
OVERALL BALANCE	**0.16**	**0.73**	**-0.55**

Source: NBP

[1] Based on USD and converted at the average USD/EUR exchange rate for the period.

ECONOMIC INDICATORS	1995	1996	1997	1998	1999	2000	2001	As of
GDP, %	7.0	6.0	6.8	4.8	4.1	4.0	1.1^{e}	
Industrial production, %	10.4	7.6	10.3	4.3	3.0	6.5	-0.2	
Household consumption, %	3.2	8.7	6.9	4.8	5.2	2.6	1.7	1-9/01
Gross fixed investments, %	16.5	19.7	21.7	14.2	6.8	2.7	-6.8	1-9/01
Unemployment, % (end of period)	14.9	13.2	10.3	10.4	13.1	15.1	17.4	
Average monthly gross wages, EUR	220	259	288	314	401	472	555	1-9/01
Exports, EUR billion	16.8	18.9	23.8	27.1	24.7	30.6	33.8	
Imports, EUR billion	18.2	25.2	33.7	39.4	38.2	44.9	46.9	
Current account, % of GDP	4.6	-1.0	-3.0	-4.4	-7.5	-6.3	-4.0^{e}	

Source: CSO, NBP

Government presents economic recovery plan

Poland's three-month-old leftist government recently unveiled its economic program for the next four years. The program has three parts: reform of public finances, a business reform package and reforms in infrastructure. The plan limits annual growth of public spending to 1 % in real terms. It estimates that public debt level will rise, but will stay below the constitutional limit of 60 % of GDP (the EMU criterion). Poland's total debt rose slightly in 2001 and corresponded to about 43 % of GDP. The program makes no mention of privatisation of state monopolies such as the national railways, gas networks and national power grid.

Budget deficits increase

Finance ministry data indicate that the Polish central government budget deficit stood at 4.5 % of GDP in 2001. This was slightly below twice-revised estimates (in July and in December). The larger public sector measure - the "economic deficit"[1] - increased to 3.8 % of GDP in January-September (2.3 % of GDP in 2000). It will likely exceed 5 % of GDP for 2001 (the EMU ceiling on public deficits is 3 % of GDP).

The parliament is expected to discuss the final draft of the 2002 state budget this month. The 2002 draft budget fixes expenditures at PLZ 184 billion (24 % of GDP) and budget deficit at PLZ 40 billion (5.3 % of GDP). Under Poland's constitution, the parliament is prohibited from adding to a budget deficit proposed by the government.

Central government budget (PLZ billion, % of GDP)

	2001	2002 (proposed)
REVENUES	**140.30 (19 %)**	**143.97 (19 %)**
Tax revenues	119.03	131.07
-indirect taxes	82.37	90.70
-corporate income tax	13.27	13.83
-personal income tax	23.39	26.54
Non-tax revenues	21.27	12.90
EXPENDITURES	**172.88 (24 %)**	**183.97 (24 %)**
Budget deficit	**32.58 (4.5 %)**	**40.00 (5.3 %)**

Source: Ministry of Finance

The 2002 draft budget assumes that GDP will grow 1.0 % in 2002 and unemployment will climb to 18.6 % of the labour force by the end of this year. Average consumer price inflation is projected to be 4.5 % and the average exchange rate of the zloty is assumed to be 3.95 to the euro (4.22 to the dollar). The current account deficit is projected to reach 4.8 % of GDP, export growth 4.1 % and import growth 3.6 %.

Some savings approved

Analysts have criticised the 2002 draft budget for doing little to address the structural weaknesses of the Polish economy. Social expenditures are the biggest expense item of the budget, constituting over 40 % of public spending. Most expenditures are fixed by law, which makes them difficult to change. The single largest cut in the draft budget removes some PLZ 2.1 billion in defence spending so that defence will now receive only about PLZ 9 billion (5 % of public expenditures). The reduction is part of the army's six-year reform program. Certain public sector wages will also be frozen.

The government aims at increasing revenues through amendments to tax regulations. Perhaps the most notable change is the introduction of a 20 % tax on interest income. The tax would come into force on 1 March. Concerning personal income taxation, tax thresholds have been frozen and some exemptions eliminated. The government also wants changes in VAT and excise taxes for fuel, cigarettes, and electricity. Some of these changes still await parliamentary approval.

Government wants faster progress in EU negotiations

Poland is among the ten countries that the European Commission gives a realistic chance of acceding to the EU in the first wave of enlargement, which could happen as soon as 2004. Poland has preliminarily closed just 20 of the 29 chapters in the *acquis communitaire*. Slovenia presently leads in its accession talks with 26 closed chapters. Poland's new government has actively pushed to accelerate negotiations. The largely positive assessment of Poland in the progress report issued by the European Commission in November has given new hope to Poland's negotiations.

Under its new government, Poland has completed negotiations on three chapters – environmental policy, company law and the free movement of labour. Perhaps the most important was the acceptance of EU's position on the movement of labour. Poland accepted a seven-year transition period for employment of Poles in other EU countries. Moreover, the government has reduced the transition period for purchases of agricultural land by foreigners from 18 years to 12 years.

Poland has an ambitious plan to close six chapters in the first half of 2002 and leave the three most difficult chapters (agriculture, regional policy and budget and finance) for the second half of the year. Agriculture is considered the most controversial chapter. The European Commission recently presented its proposal for funding agriculture, whereby the scale of subsidies would rise gradually over a 10-year transition period before they reach parity with current EU members. The proposal was widely criticised in Poland. Last year Poland had to give up part of its EU regional and infrastructure aid due to inadequate administrative facilities.

A poll commissioned by Poland's CBOS Institute and taken last December found that 60 % of Poles support EU membership, while 22 % oppose it. The institute noted that the level of support was the highest in three years.

[1] The "economic deficit" is the most prominently used budget balance in Poland. The difference between the general government balance and the economic deficit is that the economic deficit comprises not only state and local budgets and extra-budgetary funds but also compensations, transfers to pension funds and revenues from the sale of licences for third-generation wireless networks (UMTS). The economic deficit has been used since 1999.

PUBLIC SECTOR	1993	1994	1995	1996	1997	1998	1999	2000	2001	As of
Revenues, % of GDP	49.8	45.9	44.5	43.3	42.8	41.5	41.4	41.6		
Expenditures, % of GDP	49.9	50.5	49.2	49.3	48	44	44.7	44.9		
Balance, % of GDP	-2.4	-2.2	-3.1	-3.3	-3.1	-3.2	-3.3	-2.6	-3.8*	1-9/01
Debt, % of GDP	88.7	72.4	57.9	51.2	49.8	43.2	44.5	42.5		

**) Economic deficit* — *Source: EBRD, OECD*

Markets

2001 inflation below target

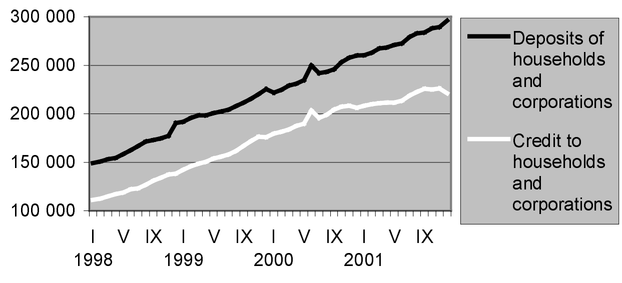
Polish consumer price inflation in December was 3.6 % y-o-y, compared to 8.5 % a year earlier. The National Bank of Poland's year-end inflation target was in the range of 6 to 8 %. The year-end inflation was the lowest in the post-communist period. Polish consumer prices were up 5.5 % on average in 2001, compared to 10.1 % in 2000.

The lower-than-expected inflation mainly reflects weakening domestic demand, tepid food price growth (due to abundant harvests last year), lower fuel prices and a strong zloty. December prices of CPI categories for food, beverages and tobacco rose only 2.2 % y-o-y. Prices for housing services were up 7.4 % y-o-y, due mainly to hikes in rates for electricity, heat and hot water. Transport prices fell 2.5 % on year, reflecting the decline in fuel prices. Producer prices decreased 0.3 % y-o-y in December, mainly reflecting a drop in prices of manufactured goods.

Interest rates decrease, real rates still high

The growth of credits and deposits by households and enterprises was slower than during earlier years. The rate of credit growth fell from over 17 % in December 2000 to 7 % in December 2001. Deposits increased nearly 14 % in December y-o-y. The stock of zloty deposits grew more slowly than foreign currency deposits, but still represented nearly 80 % of the total. Towards the end of 2001, the slowing growth in deposits may have been a response to lower commercial bank deposit interest rates and the announcement of a 20 % tax on savings income (which comes into force on 1 March). Total deposits represented some 40 % of GDP at the end of 2001. The credit-to-GDP ratio was around 30 %.

Deposits and credits (PLZ million)

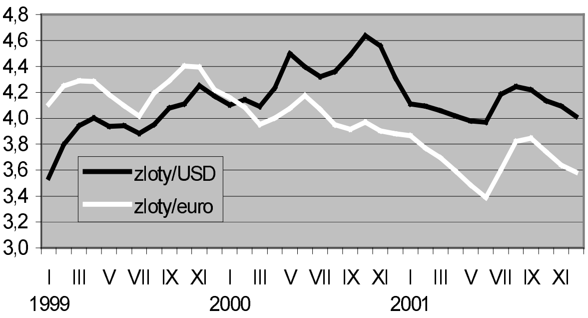


Source: NBP

The Monetary Policy Council cut its key interest rate six times last year, altogether lowering by 750 basis points. At the end of January, the rate was cut another 150 basis points to 10 %. NBP data indicate that average weighted interest rates on zloty deposits decreased in January-November by 5 percentage points, while the weighted average interest on zloty loans fell by 3.7 percentage points. Due to low inflation, however, real interest rates are presently among the highest in Europe. The interest rate spread in 2001 was still high (on average nearly 8 %).

High real interest rates and the increase in the supply of Treasury papers to finance growth of the budget deficit have slightly increased foreign capital inflows to Polish debt securities. This has helped keep the zloty strong. The zloty appreciated 9 % against the euro and 4 % against the dollar last year.

Basic exchange rates, 1999-2001



Source: NBP

Equities lost ground in 2001

Foreign investments in equities, however, declined substantially in 2001 (see table). As a whole, the Warsaw Stock Exchange's WIG index lost 22 % of its value in 2001. The index ended the year at 13,922 – its lowest level since 1998. Poland's economic slowdown, its strong currency and high interest rates were the main factors undermining investor confidence. The best performers in 2001 were financial institutions, including the largest publicly traded financial institution, Bank Pekao. Polish equity market capitalisation is still low – less than 15 % of GDP last year (nearly 20 % in 2000).

Foreign portfolio investment in Poland in 1999-2001
(EUR billion[1])

	1999	2000	2001
Foreign portfolio investment	**1.33**	**2.90**	**2.14**
Equity securities	0.83	0.94	0.08
Debt securities	0.50	1.96	2.06

Source: NBP

[1] Based on USD and converted at the average USD/EUR exchange rate for the period.

MONETARY INDICATORS	1995	1996	1997	1998	1999	2000	2001	2002	As of
Inflation (CPI), annual average, %	28.1	19.9	15.0	11.9	7.3	10.1	5.5		
M2, annual average growth, %	37.8	32.7	30.3	25.8	23.2	14.9	13.4		
Interest rates									
-reference rate, % end of period	-	-	-	15.5	16.5	19.0	11.5	10.0	1/02
-deposit rate, %1)	19.5	15.5	16.5	11.0	7.5	9.0	2.5		
-lending rate, %2)	24.0	20.5	22.5	15.5	12.9	15.9	12.5		
Forex reserves, USD billion	14.96	18.22	21.40	28.28	27.31	27.47	26.57		
PLN/EUR, end of period	-	-	-	4.09	4.17	3.85	3.52	3.59	1/02
PLN/USD, end of period	2.47	2.88	3.52	3.50	4.15	4.14	3.99	4.16	1/02

1) lowest interest on 6 month deposit; 2) lowest interest on 1-year loan *Source: CSO, NBP*

The monetary policy dilemma

Playing the Polish version of chicken

During recent months, the National Bank of Poland and the finance ministry have disputed the need to curtail inflation. The government has blamed the central bank for overly strict monetary policy. In response, the central bank has called for reduced public spending before it will consider a looser monetary policy stance.

Polish real interest rates are among the highest in Europe. In the finance ministry's view, interest rates need to be cut further, because they hamper economic activity. Preliminary estimates indicate that in 2001, GDP growth was just 1.1 % compared to 4.0 % growth in 2000. Investments, in particular, declined sharply. One factor may be high credit costs.

The ministry is also worried that high interest rates attract foreign portfolio investment, which further strengthens the zloty and causes difficulties for Polish exporters. The zloty, a freely floating currency since April 2000, appreciated last year 9 % against the euro and 4 % against the dollar. Exports, however, increased over 10 % in the same period, but a closer look reveals that growth slowed gradually over the year.

The Monetary Policy Council[1] (MPC) determines monetary policy guidelines in Poland. Its task is limited to ensuring price stability. Since 1999, the MPC has used a strategy of inflation targeting. Now the MPC is worried that loose fiscal policy may threaten this year's inflation target of 4 to 6 %, as well as the end-2003 target of 4 %. The "economic deficit," a measure for the total public financing deficit, likely reached almost 6 % in 2001 – a huge jump from slightly over 2 % in 2000. The economic deficit is further expected to remain above 5 % of GDP for the next two to three years.

The central bank also claims high deficits will lead to increasing indebtedness and push up debt service costs at a time when privatisation receipts are dwindling. The finance ministry shares this worry, but claims interest rates need to fall or debt-servicing costs will become a problem. Poland's debt-to-GDP ratio was about 43 % last year. It is expected to grow to between 50 and 60 % (the EMU ceiling on public debt is 60 % of GDP). Share of foreign debt declined to about a third last year (about 50 % in 2000).

What determines Polish inflation?

Early macroeconomic literature often considered inflation as a purely monetary phenomenon. Recent researchers (e.g. Woodford 2001), however, suggest that maintaining price stability requires not just appropriate monetary policy, but also appropriate fiscal policy.

The handful of studies that analyse Polish inflation in the transition period share a common perception that Polish monetary policy has been relatively ineffective. Welfe (2000) argues that the increase in wages was a dominant factor in generating inflation in Poland in 1991–1996. Brada and Kutan (1999) claim that Polish inflation has been determined largely by past inflation and foreign prices. Kim (2001) finds that labour markets and external sectors overwhelmingly determined Polish inflation in the period 1990–1999.

Thus, the Polish experience does not support inferences that inflation is purely monetary in nature. While fiscal evidence of Polish inflation is also scarce, there is perhaps enough to support an idea that the MPC and the finance ministry need to reach a compromise on fiscal policy and inflation targeting.

Fearing the return of high inflation

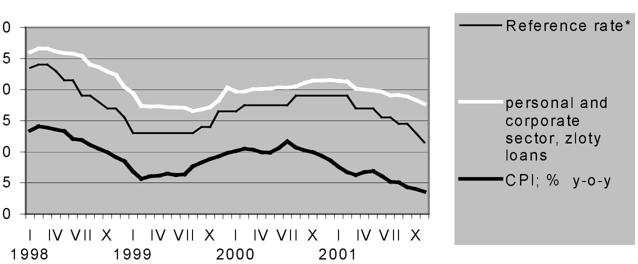
In fact, the Monetary Policy Council has loosened its monetary policy stance. It cut its key reference rate six times last year by a total of 750 basis points. At the end of January, it cut the rate again by 150 basis points to 10.0 %. Inflation, however, fell last year by almost 5 percentage points and thus, real interest rates remain high. In 2001, the total money supply increased 13 %.

The central bank has not forgotten what happened several years ago. The 1998 victory over inflation seemed real and led the central bank to decrease interest rates dramatically. Instead, the imbalance in public finances deepened together with supply shocks to the fuel and food markets, and inflation bounded back to double-digit figures. This forced the MPC to take a restrictive monetary policy stance in 2000.

Polish inflation is at its lowest level since the start of transition. Consumer prices increased only 3.6 % y-o-y in December last year (see figure). This was well below the year-end target range of 6-8 %. However, base inflation, which excludes food and fuel prices, was still 5.3 % in December. Many analysts have also pointed out that last year's low inflation was largely a seasonal aberration, driven particularly by food and fuel prices. Thus, it cannot be ruled out that inflation may rebound this year. Inflation could also be boosted by increases in certain regulated prices, e.g. the new excise taxes on fuel and tobacco introduced at the start of this year.

The MPC must therefore worry that large rate cuts now may have to be taken back within one or two years as interest rate changes impact the real economy only after a considerable time lag. The impact of nine percentage points in cumulative rate cuts, in other words, may have yet to feed through to the economy.

Inflation, reference rate and average weighted interest rate on zloty loans in 1998-2001



*Rate on 28-day open market operations

[1] The Monetary Policy Council is chaired by the President of the NBP. Other nine members are appointed in equal numbers by the President of the Poland, the Sejm and the Senate.

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