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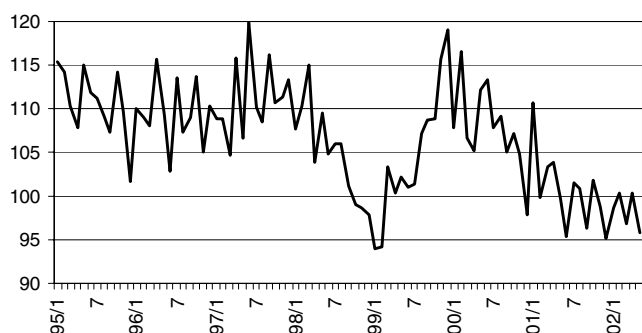


Economic Developments

Economy still weak

Recent figures for industrial output confirm the Polish economy is still weak. Compared to last year, industrial output in unadjusted terms was down 4.1 % in May and 1.4 % for the first five months of 2002. Industrial output declined last year for the first time in ten years (-0.2 %).

Industrial output, % change y-o-y



GDP grew 0.5 % y-o-y in the first quarter, or slightly more than the revised 0.2 % growth in the fourth quarter of 2001. The revised growth figure for all of 2001 was 1.0 %. The consensus forecast for GDP growth is 1.3 % in 2002 and 3.2 % in 2003.

Inflation hits record low in May

Figures released by the Central Statistical Office show inflation continued to slow in May, reaching an all-time low rate of 1.9 % y-o-y. For the period January-May, consumer prices increased 3.0 % y-o-y. The deceleration of inflation has been notable across the board, and particularly in food and transport prices. Clothing and footwear prices also strongly reflected weak domestic demand. Producer price inflation decelerated even faster than consumer prices. Industrial producer prices rose only 0.3 % y-o-y during the first five months of this year. The consensus forecast for consumer price inflation in 2002 is 3.7 %.

Worrisome unemployment situation

Poland's Central Statistical Office reports that the total registered unemployment rate peaked at 18.1 % in March then declined to 17.2 % in May, bringing the number of people registered unemployed in May to about 3.1 million. The unemployment rate is expected to rise again as school-leavers enter the labour market later this year.

Poland's unemployment rate has climbed rapidly as economic growth has slowed. However, unemployment was increasing even in 1999 and 2000 when economic growth was still around 4 %, possibly reflecting the structural and long-term character of Polish unemployment.

According to a Labour Force Survey (LFS), total unemployment in the first quarter of 2002 was 20.3 %, or about 3.5 million jobless persons. The LFS reveals that unemployment was a bit higher among females than males and higher in urban areas than in rural areas. Among 15-24 year-olds, unemployment is highest – 45.5 %. Regionally, unemployment figures are highest in Voivodships along the German border and in the northeast along the Belarussian border. The LFS found that nearly half of the unemployed had been without job for over a year and that only about 13 % of all unemployed received unemployment benefits.

To address labour market problems, the government is preparing a package of amendments to labour code and tax regulations. These amendments, if implemented, would make the labour market more flexible and make it easier to hire and fire employees. The Labour Ministry has also announced that it will spend PLN 330 million (about €85 million) on its "First Job" program, which aims at reducing unemployment among recent graduates.

Indeed, unemployment may currently be Poland's most serious economic and social problem. Despite the proposed measures by the government, unemployment is expected to rise further before the recovery in output and possible changes in labour regulations help the situation.

Consensus forecasts, % change y-o-y

	2002	2003
GDP	1,3	3,2
Industrial production	1,4	4,5
Gross fixed investment	-2,1	4,9
Consumer prices	3,7	4,0

Source: Eastern Europe Consensus Forecasts May 2002

ECONOMIC INDICATORS	1995	1996	1997	1998	1999	2000	2001	2002	As of
GDP, %	7.0	6.0	6.8	4.8	4.1	4.0	1.0	0.5	1-3/02
Sold production of industry, %	9.7	8.3	11.5	3.5	3.6	6.7	-0.2	-1.4	1-5/02
Household consumption, %	3.2	8.7	6.9	4.8	5.2	2.7	2.1		
Gross fixed investments, %	16.5	19.7	21.7	14.2	6.8	2.7	-9.8		
Registered unemployment, % (end of period)	14.9	13.2	10.3	10.4	13.1	15.1	17.4	17.2	5/02
Average monthly gross wages, EUR**	220	259	288	314	401	472	562	595	1-3/02
Exports of goods, EUR billion***	16.8	18.9	23.8	27.1	24.7	30.6	33.8	11.1	1-4/02
Imports of goods, EUR billion***	18.2	25.2	33.7	39.4	38.2	44.9	46.9	14.8	1-4/02
Current account, % of GDP	4.6	-1.0	-3.0	-4.4	-7.5	-6.3	-4.0	-5.3*	1-4/02

Source: CSO, NBP

*own calculation, ** From 1999, the average gross monthly wages and salaries are increased by the mandatory contribution for social security. Indices are calculated in comparable conditions.

***based on USD and converted with the average exchange rate USD/EUR

Finance minister Belka resigned

On July 2 finance minister Marek Belka resigned after the government approved a 2003 fiscal deficit of PLN 43 billion (\$10.7 billion), which is above the PLN 40 billion provisional target. Professor Grzegorz Kolodko was named the country's new finance minister. He held the same post from 1994 to 1997.

EU negotiations embark on final, and toughest, chapters

Poland has now closed 25 of 30 accession chapters of the *acquis communautaire*. In the first half of this year, Poland wrapped up negotiations on free movement on capital, fisheries, transport and taxation. The chapter of free movement of capital was provisionally closed with a 12-year transitional period for agricultural and forest land. Also the taxation and transport chapters were accepted with some transitional arrangements. The fisheries chapter was closed after Poland agreed to allow the EU countries' large fishing vessels to work in Polish waters.

The two remaining chapters, which were planned for closure in the first half, are competition policy and justice and home affairs. In the justice and home affairs chapter, the problem concerns ensuring strict control at Poland's eastern border, which will be the EU's eastern border, and introducing visas for Poland's eastern neighbours. In the competition chapter, the problematic topic is public aid to entrepreneurs in Polish special economic zones and subsidies to Poland's troubled steel sector.

The toughest negotiation chapters – agriculture, budget and finances and regional policy and structural funds – remain ahead. Under the EU's enlargement timetable, up to ten countries (Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia) could finish accession talks by the end of this year and become members in 2004. Lithuania and Cyprus lead the negotiations with 28 chapters closed.

Agricultural headaches

Poland faces especially tough talks over the scale of EU aid to its large and inefficient agriculture sector. Polish agriculture is a mix of large privatised farms of over 1000 hectares, medium-sized commercial enterprises and numerous small-scale farmers. Of about two million farms in Poland, approximately half are small farms that produce mainly or exclusively for themselves (self-supplying families).

The main points of contention in agriculture negotiations between the EU and Poland are direct payments to farmers and setting quotas for agricultural production. The EU decided in June to delay the decision of its common position on direct aid to farmers in new member states while opening all other aspects of the agriculture chapter up for negotiation. The European Commission has proposed direct payments to be gradually increased during a ten-year period starting from a level of 25 % of current member subsidies.

Germany and several other EU members consider the proposal overly generous and refuse to agree to the extension of direct payments without a promise that the common agricultural policy (CAP) will be scaled back overall. On the other hand, the candidate countries, especially Poland, see the Commission's proposal as unfair and discriminatory. The situation in Poland has increased support for a radical farmer's group called Self Defence. This EU-critical group won 53 seats in Poland's 460-seat lower-house Sejm in the last election.

Tension over central bank law

Politicians and monetary policymakers are locked in a heated dispute over interest rates and foreign exchange policy. The government blames tight monetary policy and an overvalued zloty for the economic slowdown.

Efforts by politicians to limit the independence of the National Bank of Poland entered a new stage in May, when legislative measures to change the central bank charter received official readings. Two small coalition partners in Poland's left-wing government, the Polish Peasants' Party (PSL) and the Union of Labour (UP), drafted a controversial bill obliging the Monetary Policy Council (MPC) to promote economic growth and employment in addition to ensuring price stability. The draft bill would also expand the Council from 10 to 16 members so that the lower and upper houses of parliament and the president would each elect two additional members to the MPC.

The changes to the Council's policy goals, in particular, are generally seen as attempts to limit the independence of the central bank. The European Central Bank has voiced concern that Poland could endanger its accession to EU if measures curbing central bank independence were passed.

The government, however, did not support the draft bill submitted by the two small parties. Instead, it put forward another draft bill, which would avoid some of the controversial provisions in the first draft and modify the central bank law to EU requirements. Both draft bills are now in the parliamentary Finance Committee for further work. President Alexander Kwasniewski said he will defend the independence of the central bank and veto or send bills to Constitutional Tribunal for legal review if they seem unconstitutional.

Dispute over exchange rate regime

The finance ministry also put pressure on the central bank to devalue the Polish zloty, arguing that Poland should shift to a managed float regime instead of the current free float. The MPC strongly favours the free float regime in the near term, but says it is ready to discuss Poland's long-term exchange rate strategy. Constitutionally, the government and the MPC should jointly decide on exchange rate policy.

Upon EU accession, Poland will join EMU as a country with a derogation (article 122 of the EC Treaty). Poland must also participate in ERM2 if it wants to join the euro-zone. Under ERM2, the zloty may fluctuate for two years against the euro within the range of 15 % on either side of central parity.

PUBLIC SECTOR	1995	1996	1997	1998	1999	2000	2001	2002	As of
Total revenue of public finance sector, % of GDP	44.4	44.0	43.7	41.1	41.2	39.7	40.1		
Total expenditure of public finance sector, % of GDP	46.1	46.1	45.2	43.6	44.4	42.7	45.3		
Balance of public finance sector, % of GDP	-1.7	-2.1	-1.5	-2.6	-3.2	-3.0	-5.3		
Balance of the state budget, % of GDP	-2.4	-2.4	-1.2	-2.4	-2.0	-2.2	-4.5	-7.6	1-5/02
Total debt of public finance sector, % of GDP	54.3	47.9	46.9	42.9	43.0	38.9	41.9		

Source: CSO, *own calculation

Markets

Interest rate cuts continue

The Monetary Policy Council (MPC) cut its main 28-day rate again in June by 50 basis points. This main market rate is now 8.5 %. Rates were cut by equal amount also in April and May. Rate cuts were based on falling inflation and dropping inflationary expectations. The margin between current inflation and reference rate is still 6.5 %. The MPC has, however, argued for caution in monetary policy due to the high public deficit and a fall in the growth of household deposits. The MPC also cautioned that earlier substantial rate cuts have yet to exert their full effect on the real economy. In June, the central bank cut its 2002 inflation target from 4-6 % to 2-4 %.

Zloty weakens slightly against the euro

The government continues to blame the strong zloty for weak exports this year. In May and June, the zloty actually depreciated against the euro by about 10 % from around 3.6 to nearly 4.0 in the end of June. On 5th of July the zloty traded at 4.06 per euro. About 70 % of Poland's exports go to the EU. Most trade transactions are denominated in euros.

Nordea seen boosting its presence in Polish banking sector

The Nordic banking group Nordea has advanced its plans to purchase Polish LG Petro Bank, which is among Poland's 20 largest banks. Nordea signed a conditional share purchase agreement in May with Korea's LG Bank, which holds 54.3 % of LG Petro Bank's shares. Nordea will launch a tender offer for all outstanding shares in LG Petro Bank and plans to merge the LG Petro Bank with the Nordea Bank Polska as soon as possible. Under the plan, the merger would take place before the end of 2002. The deal is subject to several conditions, including approvals from authorities in Poland and Sweden and the acceptance of tender by 90 % of LG Petro Bank's current shareholders. The remaining shares are owned by the Polish oil company PKN Orlen (20 %), Belchatow coal mine (12 %), power company Energetyka Poznanska (4.5 %) and by a number of small shareholders.

Nordea Bank Polska is a merger of two Polish banks, Bank Komunalny, which Nordea bought in 1999 and BWP-Unibank, which Nordea acquired last year. A merger with LG Petro Bank would substantially increase Nordea's presence in Poland.

Foreign investors now dominate the Polish banking sector. As of end-2001, 46 of 69 commercial banks were controlled by foreign investors and 69 % of sector's total assets belonged to foreign-controlled banks. Western strategic investors control seven of the ten biggest banks. For example, number-two Bank Pekao SA is majority owned by

UniCredito Italiano. The Polish banking sector is rather concentrated with five biggest banks accounting for about half of the total assets and the ten biggest banks controlling about three-quarters of total assets. The largest bank is state-owned savings bank PKO BP with assets of almost PLN 80 billion (€23 billion).

Last year was a tough year for the Polish banking sector. Total banking sector assets to GDP went slightly up from 62.1 % in 2000 to 66.1 % last year and stood at 477 billion zlotys (€136 billion) at the end of 2001. Both loan and deposit growth slowed down and the share of non-performing loans rose to about 18 % of total loans.

State budget debt grows

State budget debt accounts for over 90 % of public debt. The rest belongs mainly to local governments and to the Social Insurance Agency. Poland's public debt started to climb again last year along with the rising budget deficit. At end-2001, the state budget debt was nearly 40 % of GDP. During January-February 2002 state budget debt increased by about PLN 20 billion (€5.5 billion).

At the end of February, two-thirds of the debt was domestic. This was mostly marketable bonds, typically two- and five-year bonds, which have become a substantial component of total state debt since the end of 2000. The share of short-term (maturity under a year) treasury bills has also increased. Foreign debt decreased last year when Poland bought out its Paris Club debt from Brazil for 74 % of its nominal value. It financed the buyout by issuing dollar-denominated bonds. Major part of the foreign debt still consists of loans from the Paris Club.

State budget debt and its components, by place of issue

	Dec 2000	Feb 2002*
State budget debt	PLN 266,8	PLN 302,2
	billion	billion
% of GDP	38,9	41,9
Domestic debt, % of total	48,3	65,8
Treasury bills	7,8	13,3
Treasury bonds	31,1	43,6
Others	9,4	8,9
Foreign debt	40,0	34,2
Treasury bonds	7,5	8,1
Loans**	32,5	26,1

*preliminary data

** includes debt to Paris Club

Source: Ministry of Finance

MONETARY INDICATORS	1995	1996	1997	1998	1999	2000	2001	2002	As of
Inflation (CPI), annual average, %	27.8	19.9	14.9	11.8	7.3	10.1	5.5	3.0	1-5/02
M2, annual average growth, %	37.8	32.7	30.3	25.8	23.2	14.9	13.4	11.9	2/02
Interest rates									
-reference rate, % end of period	-	-	-	15.5	16.5	19.0	11.5	8.5	6/02
-deposit rate*, %	19.5	17.0	18.0	11.0	9.0	9.0	2.5	2.5	2/02
-lending rate**, %	24.0	20.5	22.5	15.5	14.4	19.7	12.5	10.9	2/02
Forex reserves, USD billion	14.96	18.22	21.40	28.28	27.31	27.47	26.57	27.52	5/02
PLN/EUR, end of period	-	-	-	4.09	4.17	3.85	3.52	4.01	6/02
PLN/USD, end of period	2.47	2.88	3.52	3.50	4.15	4.14	3.99	4.04	6/02

Source: CSO, NBP

*lowest interest on 6 month deposit; **lowest interest on 1-year loan

The Sustainability of Poland's Fiscal Policy

By Tarja Kauppila and Tuomas Komulainen*

As EU negotiations enter the most difficult chapters, the economic situation in the largest accession candidate, Poland, is near standstill and the budget deficit has risen to dangerously high levels. Whether this will make accession to EU more difficult for Poland and perhaps for other candidates is unclear.

During the last decade, Poland ran moderate budget deficits. Last year, the state budget deficit increased to 4.5 % of GDP and public sector deficit stood at 5.3 % of GDP. This year the state budget deficit is planned to be PLN 40 billion (5.3 % of GDP). In January-May 2002, the budget deficit reached nearly 60 % of the annual plan and was over 7 % of GDP. Although the measures of deficit used in Poland do not exactly match EU methodology, the budget deficit is far above the 3 % ceiling a country needs to be eligible to join the euro-zone.

Earlier deficits were, to a large extent, financed by privatisation receipts. Since last year, deficit financing has relied heavily on domestic bond issues. At the end of last year, Poland's public finance sector debt increased to 41.9 % of GDP and when including payments for guarantees the debt stood at 43.3 % of GDP. Polish constitution sets the top limit of debt at 60 % of GDP. Whether this ceiling is remote is debatable.

Economic program perhaps insufficient

As a solution to the current economic woes, Poland's parliament approved a four-year economic program in March aimed at returning to the 5 % GDP growth path in 2004 and improving employment. While the program frankly admits the country's economic troubles, the proposals – even if they are good in themselves – may well be insufficient to solve them. These proposals include stimulating the activity of enterprises mainly by liquidating bureaucratic barriers, making the Labour Code more flexible and developing infrastructure by constructing highways and housing.

One part of the program is the reform of public finances. The program limits the annual growth of public spending to 1 % in real terms.¹

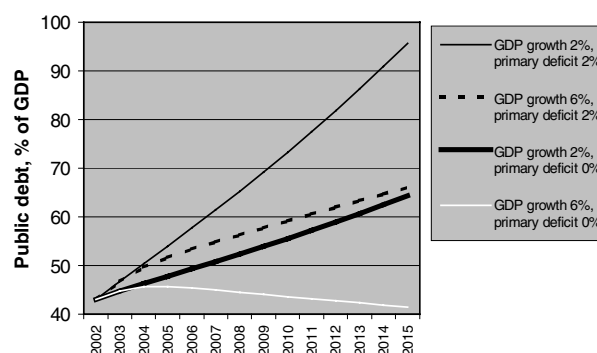
The economic strategy presents three alternative scenarios for economic growth and budget deficit. In the worst-case scenario, GDP growth never exceeds 2 % and state budget deficit remains above 5 % of GDP in 2002-2006. In the most positive scenario (the "development scenario"), economic growth follows a 1-3-5 % path in 2002-2004 and remains above 5 % after that. The state budget deficit still remains in the range of 3.9 – 5.3 % of GDP during the period. The plan notes there is actually no alternative to the development scenario.

A threat of growing public debt

One major shortcoming in the economic program is that it does not pay much attention to present or future public debt levels. To look at what the continuation of present policies of high public deficits could mean for the public debt develop-

ment, we present some simple calculations based on alternative scenarios of GDP growth, real interest rates and primary deficit (deficit without interest payments on government debt). As starting points, we specify that at end-2001 public debt of 43 % of GDP, the primary deficit was about 2 % of GDP and real interest rates were high (5 %).

According to our calculations, the present stance of fiscal policy is unsustainable except under conditions of rapid and sustained GDP growth. If economic growth remains at 2 % level, public debt will quickly grow to over 90 % of GDP. But if the primary deficit would be cut to zero, indebtedness could be sustainable even with slow 2 % GDP growth. In the simulation, the real interest rate is assumed to be 5 % (see Chart).



Indebtedness of Poland's public sector (chart)

If the real interest rate decreases to 3 % by 2009 (when euro-zone membership might occur) and GDP grows 6 % a year, the debt to GDP ratio could stabilise at about 60 % even with a 2 % primary deficit.

So why worry about the public indebtedness of Poland? The chief reason is that, many financial crises in recent years, notably Russia and Argentina, were precipitated by public sector indebtedness. These simple calculations show that if the budget deficit is not reduced, the situation of indebtedness, liquidity crisis and capital outflows might well occur in Poland.

Granted, the debt-to-GDP ratio depends to a certain extent on real interest rates, but it nevertheless mainly depends on the primary deficit. If the real interest rate is 3 %, but primary deficit remains at 2 % and GDP growth is slow, the debt level quickly reaches almost 80 % of GDP.

Given that the principal goal of the Polish government is EU membership, it should be very concerned about the effects rapid indebtedness of the public sector. Current EU members might have low enthusiasm for admitting a new member state whose public debt is rising above 60 % of GDP – and violating both the Maastricht Treaty convergence criterion and its own constitution. It may also be politically difficult to accept new members but leave Poland to the waiting room. Hopefully the government will implement tough measures against its high budget deficits and growing debt levels.

¹ This year's state budget already violates the principle.

*The authors are economists at BOFIT.

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