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Economic Developments

Economic growth accelerates

After dismal economic performance since the late 2000, the Polish economy finally appears to be recovering. Polish output grew 3 % in 1H03 and 4 % in 3Q03. The government is expecting that the economy will grow by 3.5 % for the all of 2003. Industrial production grew 12 % y-o-y in October and 8 % in the first ten months of the year.

The economic recovery seems to be broadly based, since domestic consumption and exports are growing, and the sharp decline in investments has also ceased. Household consumption grew 3.9 % y-o-y in the second quarter, while retail trade rose 9.7 % in September and 6 % in the first nine months of 2003. New car sales were up 12.5 % y-o-y in the first ten months of 2003.

Investments, which decreased by 9 % and 7 % in 2001 and 2002, declined 2.6 % in the first half of 2003. Even construction showed slight positive growth in September, although the sector was still down 9 % y-o-y for the first nine months of the year. The decline or slow recovery in construction and investments reflect the high real interest rates in Poland in 2000–2003.

Recent data also shows that the profitability of Polish enterprises is improving. The total gross profit of enterprises with more than 49 employers increased to PLN 24.6 billion during the first nine months from PLN 10.6 billion last year. The share of enterprises showing positive net profits in June 2003 increased to 61.4 %, compared to 57.4 % last year. Enterprises involved in mining, construction and hotel industries remain unprofitable.

It is expected that the growth of Polish economy will continue. The consensus forecast carried out in September expects Polish GDP growth to come in at 3.1 % for 2003 and climb to 4.1 % in 2004. The government is expecting 5–6 % growth during 2004–2006.

Exports rise, current account deficit narrows

Thanks in part to the zloty's depreciation, exports grew 6 % in euro terms and about 20 % in zloty terms during the first nine months of the year. Growth of Polish exports was particularly strong to France (10 % y-o-y) and Italy (7 %). The largest market for Polish exports is Germany (32 % of exports), where exports increased 4 % y-o-y.

Imports in the first nine months of 2003 decreased slightly in euro terms, which lowered Poland's current account deficit to €2,7 billion, or about 2.4 % of GDP. For September, Poland recorded its first current account surplus in five years.

Unemployment still high, but declining

The unemployment rate according to the statistical office was 17.4 % in October. This is slightly lower than in October last year, and clearly lower than in February 2003 when the unemployment rate peaked at 18.8 %. According to an LFS survey, the unemployment rate was 19.4 % in June. Employment picked up strongest in private firms (4 % growth from the previous year). New employment was created especially in temporary jobs, which grew 12 % y-o-y. (Data includes economic entities employing more than nine persons.)

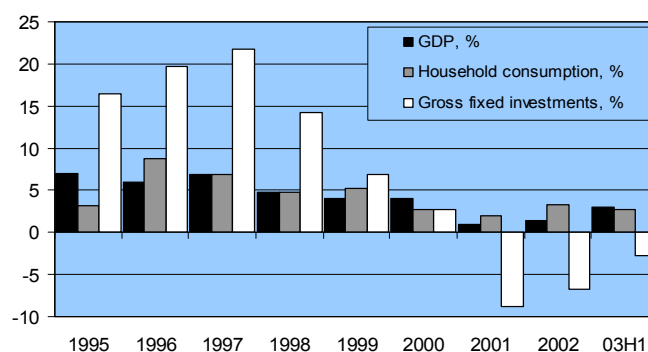
Nevertheless, the growth of employment is clearly insufficient. About 3.1 million Poles were out of a job at the end of June, and only 7.6 million were employed.

Rising wages in the public sector have increased the average wage. In the second quarter, the average wage was up 3.3 % y-o-y in real terms, which is the highest growth since 1999. Public sector wages were up 7 % y-o-y.

Poles vote yes in EU referendum

In last June's referendum (June 7–8), Polish voters were 77.5 % in favour of EU membership, compared to 22.5 % against. Voter turnout was 59 %. Together with the nine other accession countries, Poland is set to join EU on May 1, 2004.

Components of GDP, y-o-y growth from 1995 to 2003



Source: CSO

ECONOMIC INDICATORS	1995	1996	1997	1998	1999	2000	2001	2002	2003	As of
GDP, %	7.0	6.0	6.8	4.8	4.1	4.0	1.0	1.4	3.0	H1/03
Sold production of industry, %	9.7	8.3	11.5	3.5	3.6	6.7	0.6	1.4	8.4	1-10/03
Household consumption, %	3.2	8.7	6.9	4.8	5.2	2.7	2.0	3.3	2.7	H1/03
Gross fixed investments, %	16.5	19.7	21.7	14.2	6.8	2.7	-8.8	-6.8	-2.6	H1/03
Registered unemployment, % (end of period)	14.9	13.2	10.3	10.4	13.1	15.1	17.4	18.1	17.4	10/03
Average monthly gross wages, EUR*	220	259	288	314	401	472	557	553	488	Q3/03
Exports of goods, EUR billion	17.7	19.5	24.1	26.9	24.7	30.8	33.8	34.7	26.81	Q1-3/03
Imports of goods, EUR billion	19.2	26.1	34.1	39.0	38.3	45.0	46.8	45.7	33.19	Q1-3/03
Current account, % of GDP	4.2	-1.0	-3.0	-4.3	-7.4	-6.3	-4.1	-3.6	-2.6	H1/03

Source: CSO, NBP

* From 1999, the average gross monthly wages and salaries are increased by the mandatory contribution for social security.

The 2003 budget on target

For the first ten months of this year, the central government deficit was PLN 35 billion. The 2003 budget assumes a deficit of PLN 38.7 billion for the entire year. Thus, as revenues traditionally increase at the end of the year, the deficit should only slightly exceed the budget plan. The deficit would amount to about 5 % of GDP for all of 2003.

Privatisation revenues have been running below the 2003 budget plan, which was originally anticipated to reach PLN 9 billion this year. As of end-June, the government had received only PLN 1.5 billion in privatisation revenues. Many privatisation projects have been cancelled or postponed. The Polish treasury still holds either a majority or a controlling stake in about 2,100 firms.

The privatisation process may be reviving, however. In October, the government sold Polish Steel Mills (PHS) to Britain-based LNM, the world's second largest steel producer. PHS produces around 70 % of Polish steel. Under the deal, LNM will pay around PLN 6 million for an approximately 70 % stake in PHS, as well as contribute an additional PLN 800 million to PHS's capital, PLN 990 million immediately for debt payments and invest about PLN 2.4 billion through 2009. This month, the treasury sold a 7.5 % stake in national telecom operator TP SA. The privatisation was carried out on the Warsaw stock exchange and the treasury received PLN 1.64 billion from the sale. France Telecom, a major shareholder in TP SA, refused to confirm whether it had taken part in the operation.

2004 budget draft still foresees deficit of 5 – 6 % of GDP

In October, the government submitted its 2004 budget draft to the parliament. The budget bill passes in its first reading. The parliament will work with the budget draft until January when president is expected to approve it. The draft assumes expenditures of PLN 198 billion (23.3 % of GDP) and revenues of PLN 152.7 billion (17.7 % of GDP). If transfers to the pension system (OFE) are included as budget expenditures (as in previous years), expenditures would increase by 6 % in real terms compared to the 2003 budget, whereas revenues would diminish. The rise in expenditures is partly explained by the cost of EU membership. The drop in revenues are caused by planned tax cuts.

In November, the lower-house Sjem reduced the corporate income tax from 27 % to 19 % and abolished many tax exemptions. Also small enterprises and their owners will now be taxed at the 19 % rate. The government also wants to broaden the tax base and standardise VAT rates (currently 22 % and 7 %).

The government expects the budget deficit in 2004 to widen to 5.6 % of GDP. The deficit will amount to 6.6 % of GDP when contributions to the pension fund are included. According to EU methodology (ESA 95), the deficit is expected to be 5.7 % of GDP. The budget draft further assumes GDP growth of 5 % and an annual average exchange rate of PLN 4.25 to the euro (currently PLN 4.71 to the euro).

The government assumes that the public debt level will be 54.8 % of GDP next year and 59.3 % of GDP in 2005. Thus, the debt level would stay just below the constitutional ceiling of 60 % of GDP. Many analysts see the budget's growth and exchange rate assumptions as overly optimistic, and expect the debt to exceed 55 % next year and 60 % in 2005. The public debt is currently ca. PLN 400 billion or 50% of GDP.

Markets reacted negatively, government seeks cuts

In October, several analysts started to question the sustainability of the budget deficit and became anxious about the burgeoning public debt level. The liquidity position of the government was also called in question. At the end of September, the cash reserves of the central budget were only PLN 1.1 billion. As a result, interest rates rose slightly and the zloty lost value. As of end-October, the cash reserves of the central government had increased to PLN 8.3 billion.

To keep the debt level below the constitutional limit and calm the markets, the government rolled out a plan to cut the budget expenditures. The plan, written by the deputy prime minister Jerzy Hausner, seeks to cut PLN 18 billion in public administration costs and PLN 12 billion savings in welfare spending by 2007. Several analysts have commented that the planned cuts are neither sufficient nor feasible for a minority government to push through the parliament.

In early November, the European Commission criticised Poland's fiscal policy stance in its final monitoring report on Poland's preparations for EU membership. The Commission's report claims, "the reform path has nearly come to a halt since last year's report." In particular, the Commission criticised the reluctance of the Polish authorities to cut budget expenditures and their aspirations at undermining the independence of the central bank. The report added that Poland's efforts at restructuring of heavy industries, energy distribution and agriculture have been modest, and that privatisation has stalled this year.

Another finance minister resigns

In June, finance minister Grzegorz Kolodko resigned over a disagreement on the budgetary process. Andrzej Raczko was named as the new finance minister, while minister of economy Jerzy Hausner was named as deputy prime minister responsible for overall economic questions. In June 2002, finance minister Marek Belka resigned over a disagreement about fiscal policy.

Central government budget 2002-2004, PLN bln

	2004		2003		2002	
	budget	% of GDP	budget	% of GDP	actual	% of GDP
Revenues	153	17.7	155	18.7	143.9	18.7
Expenditures	198	23.3	194	23.4	183.0	23.8
Deficit	45	5.6	39	4.7	39.4	5.1

Source: MinFin

PUBLIC SECTOR	1995	1996	1997	1998	1999	2000	2001	2002	2003	As of
Total revenue of public finance sector, % of GDP	43.3	42.8	42.0	41.1	41.1	38.1	38.5	27.9*	27.8*	8/03
Total expenditure of public finance sector, % of GDP	46.1	46.1	45.2	43.6	44.3	41.0	43.6	32.6*	32.8*	8/03
Balance of public finance sector, % of GDP	-2.9	-3.3	-3.2	-2.6	-3.2	-2.9	-5.1	-4.7*	-5.1*	8/03
Balance of the state budget, % of GDP	-2.4	-2.4	-1.2	-2.4	-2.0	-2.2	-4.5	-5.1	-5.3	10/03
Total debt of public finance sector, % of GDP	54.3	47.8	46.9	42.9	44.4	39.3	40.2	45.8	50	8/03

Source: CSO, Ministry of Finance, CASE. *The figures for 2002-2003 include public finances only at the consolidated central level, and are calculated according to the IMF methodology.

Zloty falls on budget worries

Since the start of the year zloty has depreciated 17 % against the euro and 5 % against the dollar. The largest drops in the zloty's external value occurred mainly in September and October.

On November 5, the international rating agency Standard & Poors downgraded Poland, cutting its rating of long-term local currency sovereign credit from A to A minus and its rating for short-term debt from A1 to A2. The agency cited the country's high budget deficits and the rapid increase in government indebtedness as reasons for the downgrade. S&P estimates that the budget deficit in 2004 will balloon to 8.3 % of GDP and then diminish to 7 % of GDP in 2005-2007. On the previous day (Nov. 4), Fitch Ratings upgraded its long-term foreign currency ratings for seven accession countries, including Poland (BBB+).

MPC sets inflation target at 2.5 %

Polish consumer prices in October were 0.7 % higher than at the start of the year and 1.3 % higher than in October last year. Producer prices in October were up 2.7 % y-o-y.

On June 25, the Monetary Policy Council (MPC) lowered its benchmark 28-day reference rate to 5.25 %. Since January, reference rates have been lowered 1.5 percentage points. Lower inflation and reduced reference rates have helped push down market interest rates. The 3-month interbank rate (WIBOR), still 12.5 % in December last year, fell to 5.1 % in September. In November, the rate has climbed to 5.7 %. Average lending rates are still quite high in Poland. The average interest rate on one-year zloty denominated corporate loan in September was 8.2 %.

In September, the MPC released its monetary policy guidelines for 2004. Starting January 2004, the inflation target of the MPC and the National Bank of Poland (NBP) is 2.5 % with a permissible deviation band of ± 1 % percentage points. The exchange rate regime will continue to float. According to the report, Polish government and NBP plan to initiate negotiations with the European Commission and ECB on Poland's joining of ERM II. In the opinion of the MPC, the fluctuation band for the exchange rate should be as wide as possible and for a period as short as possible, i.e. two years in the ERM II.

Warsaw stock exchange rises

After poor developments in 2001 and in 2002, the Warsaw stock exchange's main index, the WIG, has risen 30 % since the start of the year. The market capitalisation is currently about PLN 120 billion (15 % of GDP). There have been discussions about integrating the Warsaw exchange with foreign bourses and trading systems.

In the market for government bonds has seen mixed performance. Due to unfavourable market conditions, the government cancelled issues of zloty-denominated bonds in several times in October and November. However, during the

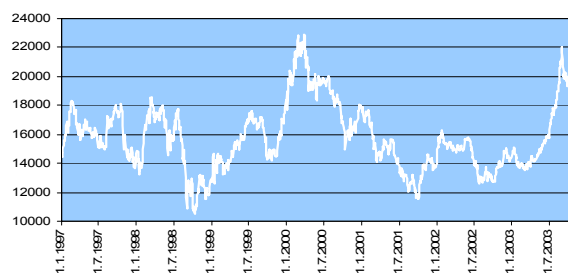
first nine months of the year, altogether almost forty tenders were successful, raising a total nominal value of about PLN 40 billion. On November 19, the government also sold successfully a four-and-a-half-year zloty-denominated bond issue with an average yield of 6.7 %. Earlier this year Poland issued successfully eurobonds worth of almost 3 billion euros.

In October, Poland bought back nearly \$400 million worth of Brady Bonds. The buy-back is part of Poland's medium-term strategy of cutting its exposure on more expensive debt instruments, while expanding the longer-term market for debt.

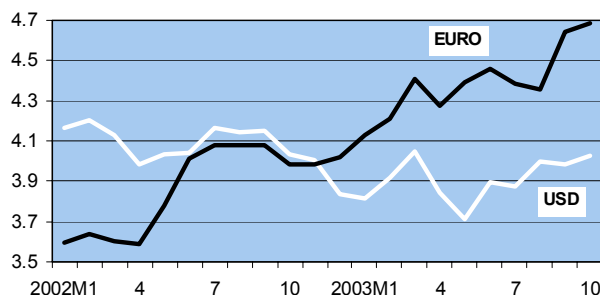
Discussions on ERM, EMU entry

NBP head Leszek Balcerowicz has expressed on several occasions the intention that Poland should target membership in EMU as early as possible (even 2007). The government has, however, indicated that it will be impossible to meet the Maastricht fiscal criteria before 2007, which means that the earliest date of possible membership in EMU would be in 2009. In November, ECB executive board member Gertrude Tumpel-Gugerell warned accession countries about the dangers of rapid adoption of the euro. She mentioned that financial markets in accession countries are still vulnerable and that these countries may still need time before entering ERM II.

Poland's Stock Market Index (WIG) 1997-2003



Exchange rates 2002-2003



Sources: Bloomberg, NBP

MONETARY INDICATORS	1995	1996	1997	1998	1999	2000	2001	2002	2003	As of
Inflation (CPI), annual average, %	27.8	19.9	14.9	11.8	7.3	10.1	5.5	1.9	0.7	1-10/03
M2, annual average growth, %	37.8	32.7	30.3	25.8	23.2	14.9	13.4	1.5	3.5	10/03
Interest rates										
-reference rate, % end of period	-	-	-	15.5	16.5	19.0	11.5	6.75	5.25	10/03
-deposit rate*, %	19.5	17.0	18.0	11.0	9.0	9.0	2.5	4.1	2.7	10/2003
-lending rate**, %	24.0	20.5	22.5	15.5	14.4	19.7	12.5	9.9	8.3	10/2003
Forex reserves, USD billion	14.96	18.22	21.40	28.28	27.31	27.47	26.57	29.79	33.78	10/03
PLN/EUR, end of period	-	-	-	4.09	4.17	3.85	3.52	4.02	4.68	10/03
PLN/USD, end of period	2.47	2.88	3.52	3.50	4.15	4.14	3.99	3.84	4.02	10/03

Source: CSO, NBP

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

Focus: Zloty could rebound nicely

by Karl Hansen*, Nordea

The zloty's depreciation over the past year mainly reflects market concerns about fiscal policy, especially the central government's ability to balance the budget. The budget deficit this year will likely amount to 5–6 % of GDP.

The government's draft budget, approved in October its first reading in the Sejm, foresees a deficit of 5.3 % of GDP in 2004 (PLN 45.5bn). The government hopes to be able to trim the deficit to just over 2 % of GDP by 2007. Should it succeed, the public debt ratio (public debt to GDP) would peak at 59.5 % in 2006 and then decline to just over 58 % in 2007.

The recent demise of the zloty also reflects the political situation. Prime minister Miller, who leads a minority government, has not even always been able to count on the votes of his fellow Social Democratic party members. On several occasions there has been a significant risk of an early election (the next election is scheduled in 2005), but each time the small parties or independent MPs have come to the government's rescue; they know they will be ousted from the Sejm in the next general election.

Fears of Polish deficit overdone

Investor fears relating to the Polish budget deficit might be overdone. If the government's budget assumptions can be relied on, the budget deficit should not give rise to major concerns. The public debt of the present EMU members on average exceeds 60 % of GDP (despite the requirements of the Growth and Stability Pact) – a level Poland will not reach under the government's budget assumptions.

It is more likely that the financial markets have pounded the zloty's external value for the government's overly optimistic 2004 budget assumptions. For example, the government assumes GDP will grow at a rate of 5%. If that target is missed, the budget deficit could quickly grow. Moreover, uncontrollable budget overspending would delay Poland's EMU membership and hence the convergence of Polish interest rates towards the euro-area level.

On the other hand, the Polish constitution stipulates that the debt ratio may not exceed 60 % of GDP. When the debt ratio is at 55%, the government must introduce measures to stabilise the debt ratio. True, with the incumbent government's relatively optimistic and weak budget proposals, there is a great risk that it may violate these constitutional provisions. The reason the government even dares take this course of confrontation is that it is far from certain that it will survive long enough to have to clean up the mess and introduce the fiscal austerity measures required by law. The budget deficit and the debt ratio for 2004 will only be known when the process for the 2005 budget is over. This means that any fiscal tightening would not have to be implemented until 2006, i.e. after the general election.

The markets, however, have interpreted the government's lenient fiscal policy as a sign that the government believes it does not have to comply with the constitutional provisions on public debt. Eventually, however, countervailing forces may compel it abide by the rules.

True, one can argue that this foggy political landscape makes it difficult to muster a majority for fiscal tightening before the debt thresholds are reached. But then, it will be

even more difficult to muster a majority in favour of abolishing the debt rules (this requires a constitutional amendment supported by at least two-thirds of the parliament). On balance, we believe that the constitutional provisions on the debt ratio and the Poland's upcoming EU membership will keep the country on track towards EMU membership and prevent the debt ratio to get out of hand.

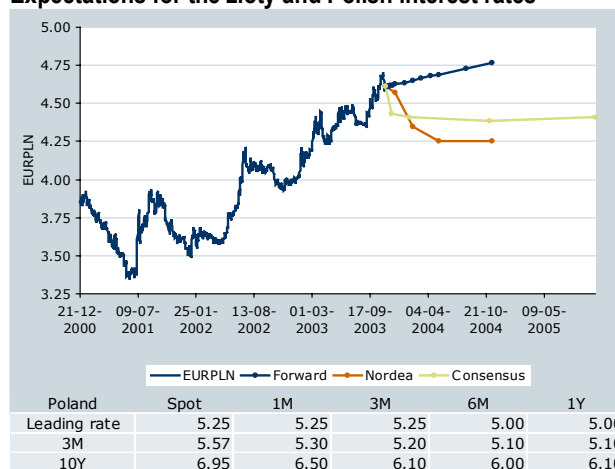
Note also that the Polish economy is on a steady up-trend, a situation that will make it both politically and economically easier to win support for reforms. The expected upswing in the German economy, in particular, should provide a significant boost to the Polish economy. Polish exports are already soundly stimulated by the weak zloty and confer an excellent international competitiveness. Against this backdrop, investor confidence should return, causing the zloty to strengthen over the coming year or so. It could start to appreciate as soon as the 2004 budget is in place.

Monetary policy on hold

Over the past few months the financial markets have witnessed a turnaround, moving from widespread expectations of further rate cuts by the central bank to expectations of a rate hike – by and large as a consequence of the zloty weakening.

The market may have overreacted to the negative sentiment. The central bank will thus probably keep its key policy rate unchanged during the autumn and winter until February, when all the members except the chairman of the monetary policy council, the RPP, will be replaced. The reason is that the RPP, which heroically resisted the government's pressure for monetary policy easing, does not want to challenge the government right now. A tightening of monetary policy may provoke the government to appoint its own monetary doves to the RPP. The government and parliament have already voiced plans to change the size and the composition of the RPP, i.e. to increase their political influence and tame the monetary hawks. Thus, there is every reason for the RPP to keep a low profile for the time being. A rate hike is not in the cards.

Expectations for the zloty and Polish interest rates



Spot rates: November 10, 2003

*The author is a Senior Analyst at Nordea Markets Research, which is part of the Nordea Group (Nordea AB).

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