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POLISH ECONOMIC OUTLOOK

TRENDS • ANALYSES • FORECASTS

Contents

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From the editor

Dear readers,

On the behalf of our research team I would like to thank Andrzej Bratkowski very much for his efforts in improving our quarterly bulletin and for his fruitful co-operation. The current issue of PEO has been prepared and edited by the whole team.

Our expectations with regard the rebound in economic activity in Poland this year proved somewhat over-optimistic. The decline in investment in 2Q01 took us by surprise and we estimate that the negative trend in investment continued into 3Q01. The atmosphere of stagnation and recession is prevailing across the economy. Industry and construction continue to contract. This is partly reflected in the rising unemployment rate. In addition, the condition of public finances is appalling. Due to insufficient cuts in budgetary expenditures and low revenues, as well as lower-than-planned privatisation proceeds the problem of financing the budget gap has not been solved. The domestic situation is aggravated by increasingly pessimistic news from the world economy. The risk of recession in the US is on the upside and the performance of the largest economies in the EU is surprising on the downside. Consequently, weakening external demand leads to slower export growth.

Thus, if the question is 'are we dealing with dwindling optimism' the answer is most definitely 'yes,' though we see a chance for a rebound next year. Currently, we believe the situation in the EU will be strong enough to secure growth – though very moderate – in Polish exports. This, coupled with a gradual recovery of domestic demand, will make higher GDP growth possible. Lower interest rates and improved business confidence in 2H02 will boost investment activities and stable growth in income and the drop in the savings rate will underpin moderate growth in household consumption. This scenario is based on optimism – in the current situation – regarding external developments. However, given the high level of global uncertainty we cannot rule out a more pessimistic scenario. In the event of a decline in foreign demand, the impaired condition of exporters would make a rebound in investment, wages and employment less likely. Under this scenario in 2002, GDP growth would level off or even decline in comparison to this year.

Regardless of growth developments in 2002, Poland still has to face serious challenges in the area of economic reforms. In the current situation a profound reform of public finances with an emphasis on the expenditure side is absolutely essential. This issue in the context of the new government's economic plan is addressed in the first article. The fight against unemployment – due to its high economic and social costs – is also a top priority. Moreover, given the approaching date of Poland's entry to the EU, harmonisation processes should be accelerated. If the government pursues only temporary and superficial measures it may turn out that costs of postponed but necessary reforms will be significantly higher.

In the current issue, we present for the first time our forecast for 2003. All estimates and forecasts are based on official statistical data available up to 31 October 2001. One should note that changes of data stem from releases of new official data and revisions in official statistics.

Łukasz Rawdanowicz

Rafał Antczak, Małgorzata Markiewicz

Center for Social
and Economic Research

All on one card

After twelve years of transition the Polish economy is at the crossroads. Public sector finances are in a mess, economic growth is declining, investments are falling, and the number of non-profitable enterprises is growing as is unemployment. External conditions are deteriorating due to the growing risk of recession in the US and a slowdown in economic growth in the EU. This situation creates challenges for the economic policy of the new government, especially if negotiations on EU accession are to be concluded. Our purpose here is to evaluate the economic program of the new government and the chances for its implementation.

The new government's economic program

The economic strategy of the SLD-UP-PSL government has been stated in two official documents: the coalition agreement and Prime Minister Leszek Miller's inaugural speech to Parliament. The new government outlined three sets of goals: short-term (the first one hundred days), medium-term (first year) and long-term (the entire parliamentary term). The short-term goal, namely the creation of a sound basis for economic growth, is to be achieved by: stabilisation of the state's finances (cuts in current year expenditures), a deficit gap of 40 billion zlotys in 2002 and growth in expenditures no higher than the inflation rate, amendments to the law on personal income tax, fixing of salaries in the state administration, limiting the operating costs of local governments, revival of dialogue between government, employers and labour unions, and changes in the criteria for assessing social allowance eligibility.

In one year perspective government aims at improvement of environment for small and medium size enterprises (instruments were not given), plans to amend law on public finances and tax law (increase in taxes to boost budget revenues), to increase discipline in public sector expenditures, limit the number of agencies and extra-budgetary funds, introduce limits on transfer of profits abroad by private sector entities. The basic goal is to conclude negotiations with the EU in 2002.

Over the span of the four-year parliamentary term the government has said it wants to bring down unemployment, mainly by introducing incentives to employ graduates, the introduction of tax preferences, a relaxation of the labour code by cancellation of limits on labour time, and by support for active measures to deal with unemployment. Its next goal are improvements in agriculture via increasing financial support for the sector and the imposition of limits on imports. The government has also committed itself to a revision of expenditure on health, the public sector, justice, education and science, infrastructure and modernisation of the armed forces. Achieving these long-term goals will mean higher public expenditures.

A policy for accelerating economic growth

In theory, there are two possible strategies for accelerating economic growth in Poland: either stimulating domestic absorption or undertaking structural reforms (any combination of the two may also be examined).

The purpose of structural reforms is growth in the competitiveness of an economy by decreasing its costs of functioning. This requires reforms of public finances, labour market, deregulation of the economy and privatisation of public enterprises.

In general, reform of the public sector is aimed at reducing the redistributive role of the state, especially of central government (measured as the proportion of GDP taken up by the public sector). Given the assumption that the private sector functions more efficiently, wherever possible public sector activities are transferred to the private sector. When public sector expenditures are limited or revised then a reform of government revenues is also possible – e.g., a decline in corporate income tax and payroll taxes (health insurance, pension collection and others). A fall in labour taxation requires an increase in labour market elasticity: cancellation of nominal salary rigidity, diversification of salaries among regions, shorter paid sick leave (which are fully covered by the state), cuts in unemployment benefits, regional diversification of unemployment benefits and minimal wages, increase in the pension age, including cancellation of branch privileges. It is also important to decrease the costs of the state administration by abolishing state offices and lowering public sector employment at the central and local levels. The next step is a public control over state finances, which would be achieved by the introduction of transparent rules and access to information. The day when a public sector clerk could arbitrarily interpret regulations should go for good as it may lead to corruption. Finally, loss-making state-owned enterprises in "strategic sectors" of the economy could be liberalised and privatised, not excluding the engagement of foreign capital.

Domestic absorption can be boosted by monetary and fiscal policy instruments. On the budget revenue side, this goal can be achieved via lowering taxation and the propensity to save through increases in taxes on savings. On the expenditures side, it means support for investments by increasing central government and other public sector expenditure. Such policy leads to a growth of the fiscal deficit financed with public debt and a drop in domestic savings. Private investments are determined by demand and the level of interest rates on domestic and foreign markets. The interest rate policy of the banking sector may be reflected in the level of investments. However, the impact of monetary policy should not be overestimated when there are no restrictions on capital flows.

The current situation

Fixing the state budget deficit at 40 billion zlotys (about 5% of GDP) in 2002 is expected to be achieved mainly by higher revenues and keeping budgetary expenditures unchanged in real terms. This would not be sufficient in the case of a crisis in public sector finances. Expenditure cuts were limited only to those where the president used his veto on laws which would have led to an increase in budgetary spending and to the freezing of wages and salaries in the public administration. There is no visible consistent strategy on the revenue side of the budget. A low effective VAT rate and high rates of CIT and PIT, together with existing progressions, indicate the distorted structure of the present tax system. According to our estimations, the effective VAT rate was equal to 9.4% in 2000, which in comparison with the basic rate of 22%, indicates that there are many exemptions, especially in the agriculture sector, as well as outright tax avoidance. This then also indicates the possibility of increasing revenues from VAT by adjusting the system.

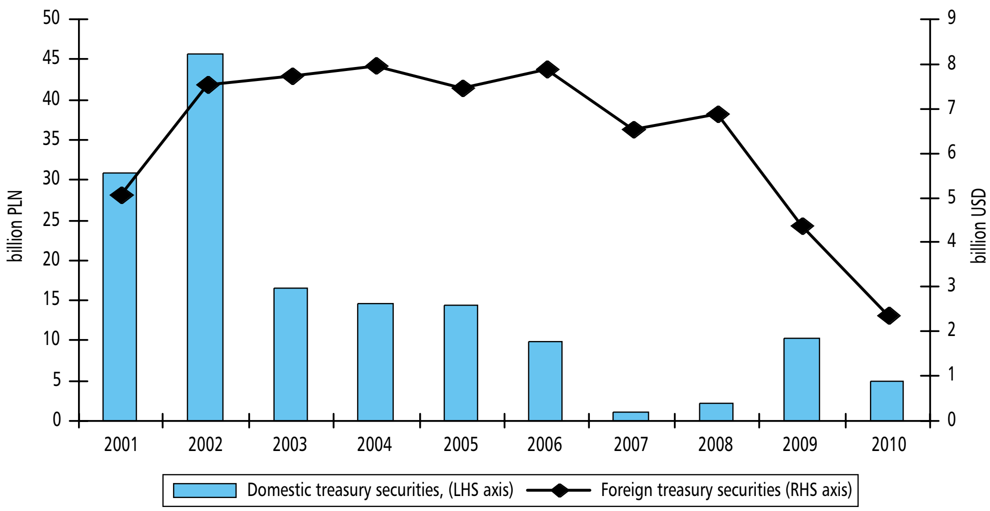
The government's tax proposals concentrate on growth in PIT taxation by freezing tax bands in nominal terms for two years, the introduction of a capital tax, the cancellation of tax exemptions connected with outlays on housing, cancellation of exemptions on private health expenditures with an increase in contributions for health care insurance. The Ministry of Finance estimates additional revenues to the budget due to proposed changes in PIT taxation at over 4 billion zlotys. In our opinion it would be more reasonable to introduce a flat tax rate, especially when the effective rate of PIT has been below 16% over the last two years.

The new government's policy of growing fiscal pressure is not in line with EU conditions for accession countries, and more importantly is not consistent with trends in EU countries. In 2003–2005 most EU countries will balance their budgets by cutting expenditure and economic growth will be stimulated by lowering taxation. Germany, for example, has declared its wish to cancel capital tax and lower direct taxes from 2002.

The state budget deficit is expected to be 4–5% of GDP in 2001–2002. If this relatively high deficit becomes permanent, then, when the means for financing it such as privatisation revenues are exhausted, there is likely to be a significant growth in public debt (domestic and/or foreign). As a result debt-servicing costs will increase. The state public debt, augmented by expected payments due to guarantees, will grow in 2001–2002 faster than the GDP growth rate, leading to an increase in the debt-to-GDP ratio of 46.0–48.6% in 2004 and growth of debt servicing payments from about 2.9% of GDP in the previous year to 3.4–3.6% of GDP in 2002–2004 (the Ministry of Finance's forecast). Due to the growth of public sector borrowing requirements over the next several years it will not be possible to achieve the basic goals of the strategy of public debt management such as lowering debt servicing costs and limit exchange rate risk. A growth in the ratio of the public debt to GDP will be accompanied by maintenance of the present structure of domestic debt maturity on average equal to 2.7[1] years and by growth in non-residents' share and/or growing share of foreign liabilities, which increases the risk of a sharp depreciation of the zloty. A considerable depreciation of the zloty (over 20% during one year) would see a breaking of the safety margins of public debt to GDP (50, 55 and 60% of GDP). Healing measures would then have to be applied to public finances or changes to the law and constitution would have to be introduced. In 2004–2009 this would cause additional problems due to the need to cover the rollover of new short-term debt with huge repayments of earlier accrued foreign debt.

A continuation of lax fiscal policy would finally require relaxation of monetary policy and a sharp decrease in NBP interest rates. It is widely assumed that if lax fiscal policy is combined with tight monetary policy, one of them has to adjust. When fiscal policy dominates, then at some stage monetary expansion will take place in order to satisfy public sector borrowing requirements (so called "unpleasant monetary arithmetic"). It happens as a result of pressure on the central bank when there is a recession or debt crisis.

Chart 1. Maturity of the public debt, 2001–2010



Source: NBP and Ministry of Finance.
Note: Foreign debt as of end-1H01, debt in domestic treasury securities (bills, bonds – tradable and non-tradable, savings bonds) as of 31 May 2001.

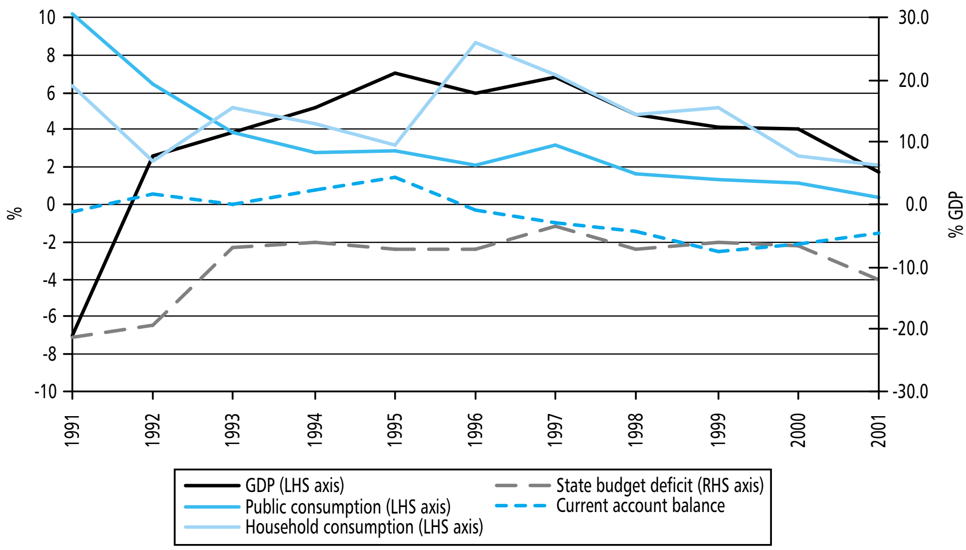
[1] An increase in average debt maturity is unrealistic along with a sharp increase in public sector borrowing requirements mainly due to low liquidity on the domestic market and existing level of inflationary expectations. Moreover, extending debt maturity would lead to growth of debt servicing costs and distortions in the revenue curve.

The current disinflation trend has been influenced by favourable conditions on the domestic food market, by a fall in domestic demand as a result of monetary policy, by an appreciation of the zloty largely influenced by a growth of public sector borrowing requirements and by lack of unfavourable external factors. In 2001, the NBP for the first time will undershoot its inflation target (inflation will be about 4.4% in comparison with the planned 6–8%). Over the last two years the opposite situation has been the case: the inflation target was overshot as a result of unfavourable domestic and external factors. Monetary policy assumptions for 2002 imply an inflation target of 4–6%, which allows for a growth in the inflation rate in 2002. At the same time, the medium-term target of inflation below 4% in 2003 has been maintained. However, the need of fiscal deficit financing, along with government pressure for a drop in NBP interest rates, and amendments to the tax law may significantly change the situation on the financial markets, complicating the co-ordination of monetary and fiscal policies. Since the beginning of the transition in Poland, public consumption has fallen consistently. At the same time the growth in individual consumption has led to an increase in the current account deficit. The period 1993–1997, when domestic demand was higher than GDP growth, is a good example. As a result of growing domestic demand the current account deficit was over 6% of GDP in 1999–2000, which, according to IMF standards is a safe margin for balance of payments disequilibrium. A favourable structure of financing from privatisation revenues, long-term foreign direct investment (equal to 60–70% of all inflows) and tight monetary policy directed at controlling credit expansion have meant an avoidance of a currency crisis. This situation may change in 2002–2003. A high fiscal deficit and relaxation of monetary policy creates the risk of growing inflation and the current account deficit.

Threats

The success of the new government's economic strategy is conditioned on several factors. The first is the assumption that real interest rates will drop and, as the fiscal deficit will be 4–5% of GDP, this would not lead to a growth in domestic consumption (as in 1993–1997) and a surge in inflation. The second assumption is that Poland will join the EU in 2004–2005, which would improve the country's credit rating and could lead to lower debt costs and an

Chart 2. Macroeconomic indicators, 1991–2001



Source: IMF Institute Database, NBP, and CSO.
Notes: CASE forecasts for 2001.

Table 1. Household savings and the domestic savings gap, 1996–2001

	1996	1997	1998	1999	2000	2001
Household savings (% of GDP)[1]	11.5	9.1	9.5	9.5	7.7	6.9
Household net monetary savings (% of GDP)	23.1	24.3	25.4	25.3	25.2	26.5
Savings rate (% of disposable income)[2]	16.0	12.8	13.1	13.2	10.8	9.8
Domestic savings gap (% of GDP)	1.1	3.6	4.2	5.6	n/a	n/a

Source: NBP, data until 1999 – CSO, estimates – CASE : 2000–1H01.
Notes: 1. Household savings include monetary savings, other financial savings and household investments.
2. Savings rate is a ratio of total household savings and disposable income.

increase in foreign investments or at least in transfers from the EU. Therefore, in spite of the relatively high fiscal deficit, the lack of structural reforms and increase in public debt in 2002–2004, control over public finances could be preserved. These assumptions are risky due to the existence of factors difficult to forecast such as the external situation or the political environment. As a result, if the government's program is realised this would appear to be at least partly predicated on the absence of unfavourable economic or political "reserves," or errors in forecast, which in transition countries are quite common.

In our opinion the political situation in Poland in 3–4 years will be highly unfavourable due to the appointment of new Monetary Policy Council members (February 2004) and presidential and parliamentary elections in 2005. In 2006 elections to the European Parliament will take place. For Poland, as an accessing country, this will also matter. On this basis we suggest it would be reasonable to undertake the necessary reforms, including those of the fiscal sector, within the next two years.

Center for Social and Economic Research

The economy in 3Q01

Katarzyna Piętka

Economic growth

GDP and demand factors

- **Further stagnation of the economy**
- **Continued decline in investments**

The boost in economic growth which had been expected since the beginning of the year has not materialised. According to our estimates, GDP growth in 3Q01 was only slightly better than in the previous quarter (1.2% compared with 0.9%).

The significant drop in investments in the previous quarter (not registered for at least six years, as the quarterly national accounts are only available from 1995) was reflected in the recent data. Serious declines in building investment were accompanied by falls in the purchases of machinery and a slowdown in acquisitions of transportation equipment. For 3Q01, we also estimate falls in investments – albeit not as steep as in the previous quarter. The following factors support our forecasts: on the one hand, continued recession in construction and a 20% drop in sales of transportation products (as well as a very limited increases in imports); on the other hand, growth in sales of machinery, equipment and electrical machinery, as well as increases in imports. All of the above allows us to expect a drop in investment less steep than in 2Q01.

A further indication of falling investment are estimates of enterprises' means to finance investments. Increases in net corporate credits (credits minus deposits) were much smaller than in 3Q00 (by 70%). In addition, we estimate that the profitability of enterprises deteriorated (their own resources were not as big as a year ago). Lower profitability is implied by massive drops in CIT collection (by 20% on an annual basis), unfavourable relative prices for manufacturers – on the one hand a drop in the prices of their products, on the other hand faster growth of input prices, such as transportation, storage and telecommunications (by 6%) and energy (by 11%). Also, ongoing falls on the stock exchange do not encourage raising capital through new offers.

On the one hand, we estimate that this year's harvest was large and that farming inventories increased. On the other hand, producers facing weak demand have limited accumulation of inventories. Therefore, we believe that the overall increase in inventories was smaller than in 3Q00. This contributes to steeper falls in accumulation.

Such negative investment dynamics have not been compensated enough by rises in consumption.

As a result, domestic demand dropped for the third consecutive quarter.

Growth in household demand was fuelled by the positive real growth in disposable incomes and a lower propensity to save (compared to the previous year). The total sum of pensions and other social transfers were the most dynamic (increasing 14% yoy in nominal terms) despite the fact that the number of pensioners slightly decreased. This is the result of the current as well as delayed last year's indexation which in the case of Poland takes place in the middle of the year. On the downside, the wage bill again registered weak dynamics. As average salaries grow employment falls heavily. We estimate that the positive dynamics of mixed incomes diminished the effect of low growth in the wage bill.

Moderate growth of incomes forced households to lower their net monetary savings (compared with 3Q00) for the first time in the last four quarters. Taking into account our estimates of other savings, we believe that the overall savings rate was lower than a year ago.

Ongoing sequestration of budget expenditures leads us to estimate that the dynamics of government consumption were close to zero.

Suppressed domestic demand led to very poor import dynamics. Exports experienced single-digit growth, despite the worsening economic situation of our main trading partners and the strong zloty. Thus, net exports are still the driving force of the economy and compensate for falls in domestic demand.

The real sector

- **Deepening recession in construction and industry**

Annual industrial production in 3Q01 experienced a steeper fall than in the previous quarter (1.2% against 0.9%), hit by suppressed domestic demand and lower foreign demand. It is worth noting, however, that the recession in manufacturing has not deepened. Continued growth in the energy sector, however, did not compensate for the sharper fall in mining.

3Q01 was the sixth consecutive quarter of negative growth in construction – this time by a massive 11.7% yoy. Diminished investments in buildings and installations are responsible for the recession in the sector.

As in 2Q01, negative trends in industrial and construction sectors were offset by growth in market services' value added. Slight improvements in consumption improved retail and wholesale turnover. In addition, passenger transportation registered higher demand. On the negative side, goods transportation continued to fall. Taking into account the recession in construction and lower profitability of enterprises, we estimate that value added growth in real estate, renting, business activities and other services remained at the same level as in the previous quarter. We evaluate that value added in market services has grown therefore by 4.3% yoy.

The agriculture sector registered significant increases in crop output (in particular, cereals and fruit) and small increases in animal output. Therefore we forecast significant growth in agriculture value added in 3Q01, following big falls in the previous quarters of the year.

External sector

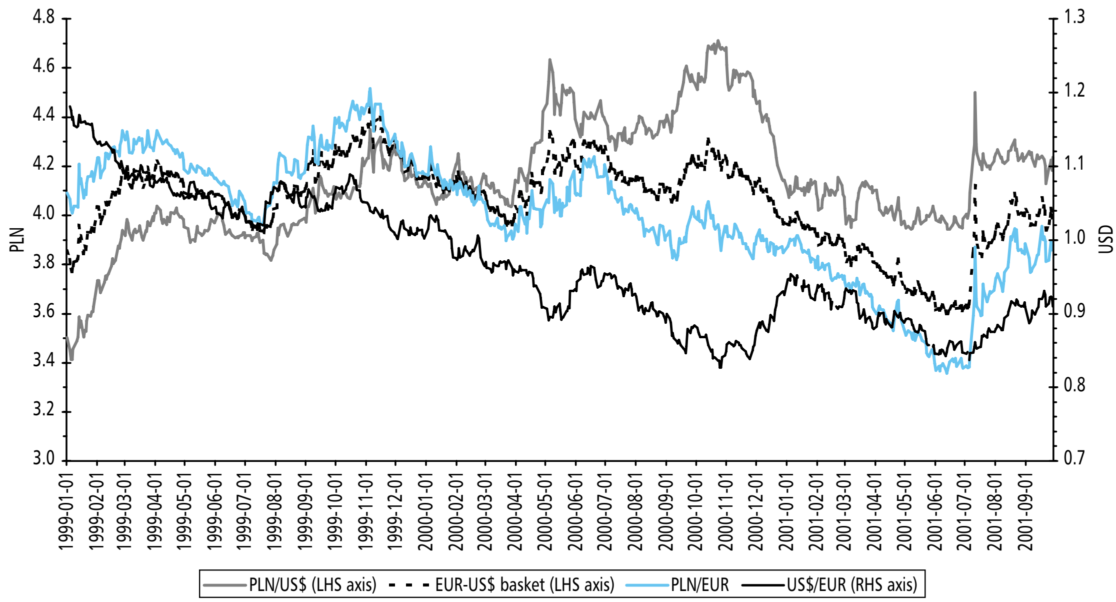
Rafał Antczak

Exchange rate

- **Correction of zloty exchange rate at the start of 3Q01**
- **Pressure on nominal zloty appreciation continued**

From end-2000 to September 2001 the zloty appreciated by 1.6% against the dollar and 1.5% against the euro. In the course of 3Q01 the zloty depreciated by 6.3% against the dollar and 13.4% against the euro. From the end of June until July 11, the zloty's average exchange rate at the NBP depreciated by almost 13% against the dollar, reaching its highest level (4.5004 PLN/US$) since end-November

Chart 2.1. Zloty exchange rates against the dollar, euro and the currency basket, 1999–2001



Sources: NBP.
Note: The currency basket: the euro (60%) and the US dollar (40%).

2000. From mid-July to end-September the zloty oscillated at the level of 4.20–4.25 PLN/US$. The significant depreciation of the zloty against the euro in 3Q01 resulted also from appreciation of the euro against the dollar, which rose from 0.85 euro/US$ in mid-July to 0.92 euro/US$ in the second half of September.

The zloty's correction since July has been based on economic fundamentals, with an almost doubling of the central budget deficit from a planned level of 2.5% of GDP to approximately 4.6% in 2001. However, the forex market's reaction was in line with traditional responses to budget crises – increase in government borrowing, together with high interest rates, results in high capital volatility. The outcome is high zloty volatility, which – along with appreciation – increases the profitability of portfolio investments in Poland. While foreign portfolio investments declined by US$952 million during 2Q01, they went up by US$203 million from July to August to drop again by US$267 million in September. After three quarters portfolio investments were lower by over US$1 billion than in the same period of last year. The share of foreign investors on the T-bonds primary market was on average 15.3% from January to May, before declining in June to 8.4%, to zero in July, up again to 28.7% in August, before finally dropping in September to 5.9%. Significant fluctuations in the share of foreign investors in the Treasury papers market during uncertain periods tend to result in shifting to derivatives, which provide a similar rate of return to Treasury papers but at lower liquidity risk.

Movements in portfolio capital would have had a stronger impact on the market if not for the generally positive outlook of the political-economic situation in 3Q01, especially the decline in the current account deficit and – irrespective of difficulties of realising privatisation revenues – a growth in foreign direct investments after three-quarters of US$1.3 billion, compared to US$902 million in the previous year. Restrictive monetary policy also had a positive impact on the market in the face of an unexpected worsening of the fiscal situation.

Łukasz Rawdanowicz

Foreign trade

- **Stabilisation of the merchandise trade deficit**
- **Waning export growth**
- **Import growth stops**

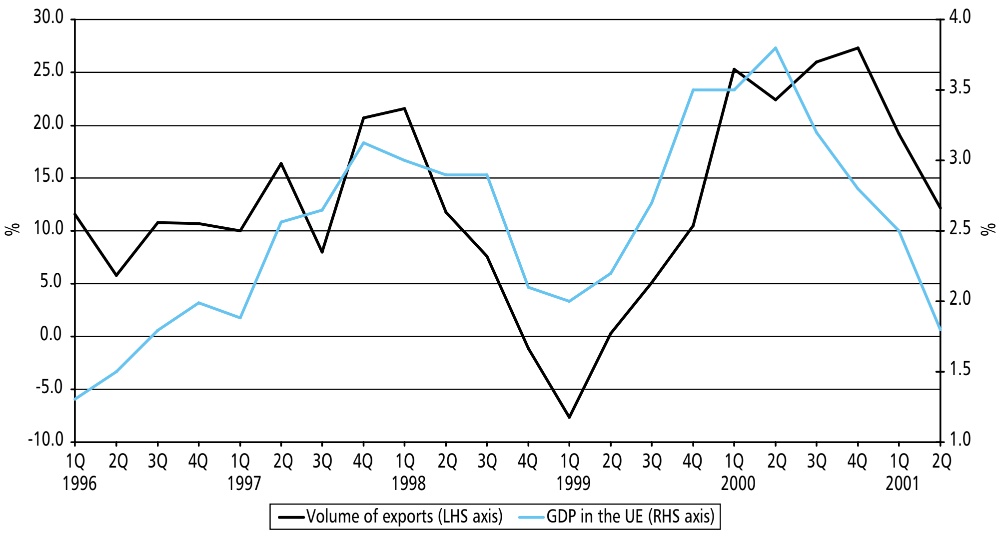
In 3Q01, the situation in foreign trade mirrored the contraction in domestic demand. Despite declining export growth, the merchandise trade deficit in the balance of payments stayed at an almost unchanged level in comparison to 2Q01.

In Germany the GDP growth forecast has once again been revised downwards. The growth rate is now expected to be under 1% in 2001. Other large economies in the EU, such as France and Italy, are also slowing down more seriously than was expected in 1H01. Despite these factors Polish exports in dollar terms are still on the rise, though at a slower pace. This is evident both in CSO and NBP quarterly data. The September export figures in the balance of payments are especially symptomatic of the export slowdown. Also the CSO data on export volume paint a similar picture – 12.2% yoy growth in 2Q01 against 19.2% yoy growth in 1Q01 (data for 3Q01 are not available yet). The crowding-out effect due to weak domestic demand was still at work.

On the import side, adjustments are far greater, with import growth cooling off significantly. According to preliminary NBP data, 3Q01 saw a nominal decline in imports of 2.5% yoy. This should not be surprising given the dramatic decline in investment, slow growth in household consumption and waning exports.

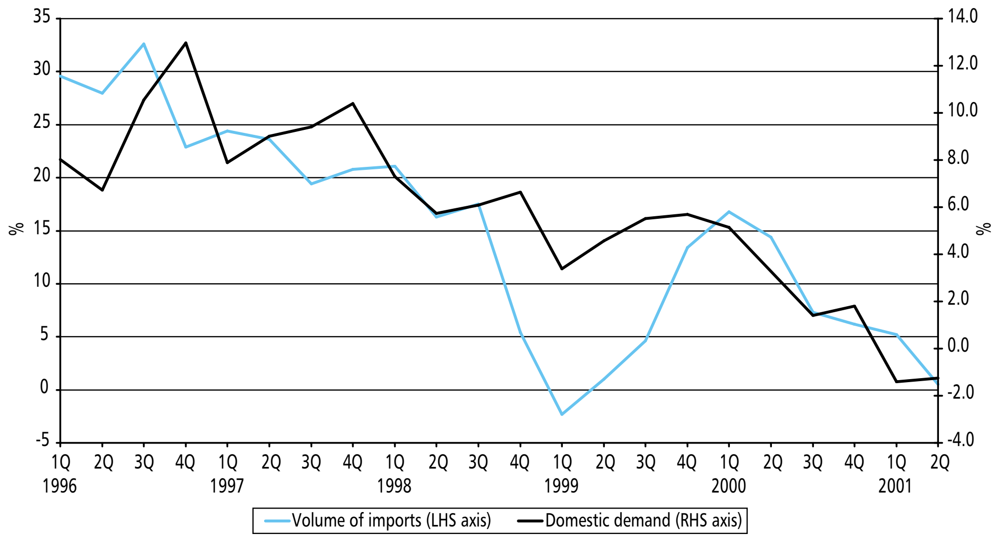
In 2Q01, the terms of trade stayed above 100, though deteriorated in comparison to 1Q01. Import prices were declining faster than export prices. The contraction in prices, denominated in zlotys, stemmed primarily from the appreciation of the zloty against the dollar and the euro. However, it should be noted that the drop in export prices in 2Q01 was smaller than the nominal appreciation of the zloty. Hence, export prices, denominated in foreign currencies, were rising.

Chart 2.2. Volume of exports and GDP in the UE, 1996–2001 (% change, yoy)



Source: CSO and Eurostat.
Note: Volume of merchandise exports only.

Chart 2.3. Volume of imports and domestic demand, 1996–2001 (% change, yoy)



Source: CSO and Eurostat.
Note: Volume of merchandise imports only.

Łukasz Rawdanowicz

Balance of Payments

- **Unprecedented improvement in the current account deficit**

According to preliminary NBP data, the deficit on the current account amounted to US$1 billion – a record low (in absolute terms) since 1998. The cumulated deficit over 4 quarters dropped to 4.35% of annual GDP.

The improvement both in comparison to 2Q01 and 3Q01 (over US$1 billion) was underpinned by several factors. Firstly, the merchandise trade deficit remained almost unchanged from 2Q01 and on annual basis declined by almost US$0.5 billion. Secondly, a higher-than-expected surplus in unclassified current transactions was recorded. It increased by 27% yoy, not only due to the higher balance of turnover in exchange bureaus, but also due to the higher surplus in transactions on foreign currency accounts. It should be noted that the former item constitutes less than 20% of the total surplus in unclassified current transactions. Unclassified current transactions are generally treated as a proxy for 'suitcase trade,' though most of these transactions are classified as trade in services – in 2000 only 24% of the surplus in unclassified current transactions was classified as merchandise trade in the balance of payments on the transaction basis. This classification is in line with the third factor, after the lower current account deficit – the deficit in trade in services. This saw a low not recorded since 1998 (in absolute terms). Fourthly, transfers were higher and the income deficit lower. In September only a part of the usual amount of interest payments was transferred. Thus, we will have the same situation as last year – with these payments being postponed until October. Due to this the current account turned out lower by around US$300 million.

At the end of 3Q01, official reserve assets stood at US$28.3 billion, a move up by a notch from the end of June. They remain at a comfortable level sufficient to offset 8 months of average monthly imports.

Małgorzata Markiewicz

Public finances

- **Mid-year budget revision**
- **New government decides on expenditure cuts**
- **Revealing the 2002 fiscal gap**

In 3Q01 the budget experienced problems with revenue collection. The depreciation of the zloty at the beginning of July led to an improvement in indirect tax collection rates, which after falling in nominal terms began to grow in real terms. The slowdown in economic growth is reflected in CIT budget revenues, which have seen the lowest execution rates in terms of the plan of all-tax budgetary revenues.

Expenditures have been strictly controlled, with an execution rate of 74.9% of the plan after the first nine months of the current year. Public sector entities made their decisions on expenditures on the basis of the revised budget law (amendments to the budget law on 2001 implied a drop in expected revenues by 8.6 billion zlotys and an increase in the budget deficit by the same amount, expenditures remained unchanged). In the context of low tax collection rates in 3Q01, either budget expenditures had to be cut or the budget revised again. The new government in October decided on expenditure cuts of 8.5 billion zlotys. According to our estimates, revenues will drop by more than 12 billion zlotys, which implies that the amount of expenditure cuts is insufficient. The Minister of Finance has admitted that there is a possibility of the budget revision before the end of the year. Amendments would consider the repayment of outstanding government liabilities due the pension funds and PKO BP bank (due to so called 'dwelling books') of 8 billion zlotys, which would cause a widening of next year's budget deficit. It is possible that the central government deficit will be kept under control at the expense of other public sector entities' finances. The previous government's budget act for 2002 included such a solution: the central government deficit executed according to the budget law accompanied by a growth in economic deficit. There is also the possibility of transferring some expenditures (mainly investments) to next year.

The budget deficit was financed from domestic sources. Foreign financing was negative i.e. more payments were made than new obligations accrued. Privatisation revenues remained modest (6.6 billion zlotys as of mid-October out of 18 billion zlotys assumed for the whole year). Revenues from PZU's privatisation of 2.774 billion zlotys will come in when the Ministry of Internal Affairs and Administration approves the sale contract. It appears that no more privatisation revenues will be collected this year. Therefore, rather than the 18 billion zlotys assumed in the budget law, only about half of this will reach the state coffers. Thus, the government will have to increase public debt by this amount, leading to a rise in debt servicing payments of over 1 billion zlotys next year.

In the middle of August 2001, the former Minister of Finance estimated an expected budget deficit for 2002 at 88 billion zlotys. On September 23 a team of independent experts was brought in to evaluate the Ministry of Finance's estimates. Despite confirming the ministry's figures on September 27 the Minister of Finance was dismissed the following day. The fiscal gap for 2002 arose as a result of a revenue drop of 11 billion zlotys against planned revenues for 2001 (due to the new tax law (3.5 billion), liberalisation of duties (0.9 billion), decrease in NBP profit (2.2 billion) and limiting one-time payments for UMTS licenses (4.6 billion)) and growth in expenditures by 45 billion zlotys (due to payment of outstanding liabilities (8.2 billion), indexation (8.9 billion), increase in debt servicing payments (5.1 billion), execution of liabilities caused by preferential treatment of branches e.g. 'teachers card' (4.3 billion), approval of a new law creating additional cost for the budget (15.2 billion) and other factors (3.1 billion)). As a result the budget deficit calculated for the next budget was expected to equal 88 billion zlotys.

The budget for 2002 will be determined by political decisions. At present it seems to have been decided that the central government deficit will not be higher than 40 billion zlotys and expenditures, according to the coalition agreement, will not grow in real terms (when the agreement was made it was decided that budget expenditures would be 183 billion zlotys). Next year's expenditures were also restricted with the president's decision to veto a law that would have lead to the increas in expenditures of 11 billion zlotys next year. Limiting the fiscal deficit to 40 billion zlotys was presented as a success for the new government. However, it means a growth in the central government deficit to over 5% of GDP, an increase in the economic deficit and acceleration of public debt accumulation.

Local governments

The budget law for 2001 assumed a local government deficit of 5.6 billion zlotys. The financial results announced in the middle of the year noted a surplus of 2.7 billion zlotys. These results were not interpreted optimistically. In budget draft for 2002, local government financial results in 2001 were assumed to be 4.8 billion zlotys. An improvement in the results led to a drop in local government liabilities from 9.4 billion zlotys at the end of 2000 to 7.6 billion zlotys in the middle of 2001. However, local government debt is expected to growth to 15.8 billion zlotys by the end of 2001. This will mainly be due to the inclusion (for the first time) of data on the debts of entities controlled or managed by local governments in the measure of overall local government debt.

The Social Insurance Board (ZUS)

The payroll tax collection rate remained high. To the end of September 2001 central government transferred only 57.2% of total payments to FUS. This was reflected in the amount transferred to OFE (the open pension funds). As of 30 September only 6.8 billion zlotys had been transferred. This is a small amount given the annual plan was 14.1 billion zlotys, including 3.25 billion zlotys of outstanding liabilities accrued during 1999−2000. It is realistic to assume that not all of outstanding liabilities will be transferred this year. Moreover, this amount will likely grow due to the accumulation of new arrears. Central government's financial problems may be reflected in the FUS deficit, increasing from 0.3 billion zlotys in 2000 to 2.8 billion zlotys in 2001 (this number was applied in the budget draft for 2002 based on preliminary budget estimates for 2001).

Piotr Bujak

Labour market

- **Further increase in unemployment, deepest cut in employment not seen for eight years**
- **Ongoing lack of desired changes in labour code**
- **Drop in enterprise sector wage bill**

Unfortunately, no major changes in labour market trends were recorded in 3Q01, with the situation progressively deteriorating. Unemployment figures were up, while employment continued to fall, at its rate highest since 1H93.

The election of the new parliament and appointment of the new cabinet calls for a summary of the fight against unemployment. Despite serious administrative problems at the outset, the introduction of comprehensive pension system reform can certainly be considered a success of the out going cabinet. In contrast however, attempts to lower the costs of labour and to increase short-term flexibility of the labour market are far from success stories. Over six months ago the cabinet endorsed a 'Timetable of actions targeted at supporting enterprise and creating new jobs.' However, it is already evident that most of the scheduled actions have not been implemented. It is worth mentioning here the stated priorities: a lowering of the fiscal burden, especially that affecting small businesses, and the enhancement of flexibility in the labour market. The lack of success in either area will certainly not make the fight against unemployment any easier. Instead of voting the desired amendments to the employment law, the previous parliament carried motions that merely contributed to lower competitiveness in the Polish labour market. Among the regulations approved over the last year, that have led to an increase in labour costs in Poland, was undoubtedly the introduction of a 40 hour / 5 day working week (passed in May 2001). In 3Q01, parliament amended the labour code with the aim of bringing Polish regulations in line with those in the EU and to harmonise the different terminology of the labour code and bills passed in the context of the Social Security system reform. The alterations included restrictions on the conduct of commercial activities on Sundays and the extension of paid leave. The president subsequently vetoed the bill and it seems increasingly unlikely that a new proposal will be endorsed in the near future.

Reducing unemployment is a top priority for the new cabinet. Among the actions its plans are: support for the SMEs; a preferential tax system; the use of privatisation as means of economic stimulation; implementation of large infrastructural projects; government schemes for graduates and government aid for companies engaging in the creation of jobs. Despite the government's determination to introduce such a range of undoubtedly desirable solutions, any actions it takes are now way behind schedule and unemployment is likely to rise further in the coming months.

Without doubt, all the last government's structural and institutional changes aimed at improving the efficiency of the labour market are vital. However, they are unlikely to result in long-expected cuts in labour costs or an acceleration of the job creation process unless accompanied by an appropriate macroeconomic policy mix. A reduction of both the budget deficit and the share of government spending in GDP are top priorities. Changes in the structure of budget expenditures, especially ineffective social security spending, are also necessary. A reduction in the budgetary imbalances could create space for further interest rate cuts and could in turn contribute to a stimulation of economic activity. This could take place mainly via a reversal of the negative investment trends and could lead to an increase in employment. In order to allow such an expansion of employment, the necessary reforms of labour code are essential.

Unemployment

Registered unemployment reached 2920.4 thousand by the end of September 2001, marking a quarterly increase of 71.2 thousand and annual increase of 391.6 thousand. As a result, registered unemployment at the end of September was 16.3% – a 2.3 percentage points increase yoy. The number of unemployed entitled to unemployment benefits decreased again. However, in contrast to 1H01, the number of entitled to unemployment benefit in 3Q01 increased substantially yoy. This triggered an increase in the bill for unemployment benefit. Similarly, expenditure on health insurance for the unemployed without the right to unemployment benefits as well as pre-pension payments increased, contributing to a deterioration of the financial situation of the Work Fund.

Evidence of increasing unemployment is also supported by the results of a CSO survey. According to Labour Force Survey data (BAEL), the unemployment rate was 18.4% (a 0.2 percentage point increase qoq and a 2.1 percentage points increase yoy). Unemployment rose to 3208 thousand. These figures contribute to the grim picture on the Polish labour market – in the past the rate of unemployment tended to fall qoq in the second quarter.

An analysis of the structure of unemployment also shows persistent negative trends: no change in the regional differentials in unemployment and a continued rise in the rate of unemployment in the 15–24 age bracket. At the same time, unemployment rose across all degrees of education. As many as 73.1% of the unemployed now come from the private sector. The average employment search time is now longer and a substantial increase in the number of long-term unemployed has been recorded.

Among the causes of rising unemployment are: the ever-increasing numbers of entrants onto the labour market and ongoing restructuring in the enterprise sector. The latter is indicated by the rising share of individuals who lost employment and immediately started looking for new employment as well as by the rising numbers of group redundancies encompassing an ever-larger number of employed.

Employment

The CSO data shows a continuing fall in employment in the enterprise sector. In September 2001, employment decreased by 4% yoy (3.8% yoy on average in 3Q01). These figures mark the most pronounced decreases since 1H93.

A significant adverse shift in the demand for labour in the 2Q01 is also evident in the BAEL survey. 2Q01 brought a fall in the number of employed by 1.8% yoy to 14,525 thousand. Accompanying this was a reduction in the average weekly work time. In addition, 2Q01 was the second subsequent quarter in which the share of the employed in the service and manufacturing sectors deteriorated. The falling demand for labour in non-agricultural sectors is a result of a slowdown in economic activity and employment restructuring in companies formerly tied in to the social security commitments agreed during the privatisation process. In addition to demand side constraints, the high level of labour costs and the difficulties with geographical and cross-qualification reallocation of labour contributed to the reduction in the number of firms increasing employment.

Wages and salaries

In September the average wage in the enterprise sector increased by 6.2% yoy. The equivalent average increase in 3Q01 was 7.0% yoy. The purchasing power of wages in 3Q01 was on average 2.2% higher yoy. In line with our predictions, the rate of growth of real wages increased, albeit almost entirely due to falling inflation. Due to rapidly falling employment, however, 3Q01 recorded a 1.9% fall in the wage bill measured in real terms. 3Q01 was the fourth consecutive quarter that saw a fall in the real wage bill calculated on an annual basis. After three quarters, despite lower inflation, growth in real wages is lower than that for the corresponding period of 2000.

In contrast, in 2001 the purchasing power of disability and old-age pensions was considerably higher in comparison to the figures for last year. The underlying reason was the increase in the indexation rate due to an underestimated rate in 2000.

Mariusz Jarmużek

Prices

- **Acceleration of disinflation process in 3Q01**
- **Inflationary exchange rate impulse compensated by low domestic demand**

3Q01 saw a substantial acceleration in the disinflation process. Both inflation measures (CPI and PPI) recorded considerable falls in growth. The underlying reasons were: the substantial appreciation of the zloty in 1H01 tight monetary policy, the slowdown of domestic demand growth and favourable trends in inflationary factors on the supply side.

The depreciation of the zloty in July 2001 was short enough not to lead to an increase in inflation in conditions of weak domestic demand. Producers and importers, facing the problems of falling sales and increasing inventories of imported products, respectively, could not fully pass the depreciation-related increase in costs on to consumers.

Monetary policy remained tight, undermining the absorption capacities of the Polish economy. The relatively low growth rate of wages reflected the weakening of demand for labour and diminishing inflationary expectations.

Among other factors contributing to disinflation were positive developments on the supply side in 3Q01. World oil prices, excluding a short period just after the 11 September events in the US, remained in the lower band assumed by OPEC – with a positive effect on domestic fuel prices. Sizeable stocks of unsold cereals and tariff free imports contributed to the unusual stability of cereal prices in the pre-harvest period. Good weather conditions contributed to a high harvest, which, according to the advanced CSO estimates, was 21.9% higher than in 2000. Moreover, the September interventions by the ARR (Agriculture Market Agency) stabilised pork carcass prices, which led to negligible growth in the retail price of meat.

In 3Q01, contrary to earlier warnings by the PGNiG (Polish Oil and Gas Company), gas prices remained unchanged. This was after two rejections by the URE (Energy Administration Office) of PGNiG's proposed price hikes of almost 10%. The settlement of accounts for both individual and corporate clients is still according to the old tariffs. It is worth stressing that the decrease in inflation in 3Q01 was also the product of decreasing prices of telecommunications services – in September by 7.1% – as a result of increased competition in the telecommunications market.

The annual growth in the PPI fell to its lowest level since the beginning of the transformation process (0.6% yoy), with the underlying reasons being the weakening of domestic demand and the persistent strength of the zloty. Attention should be paid to the fact that the PPI in manufacturing fell as a result of serious difficulties with sales.

Katarzyna Zawalińska

Agricultural commodity prices

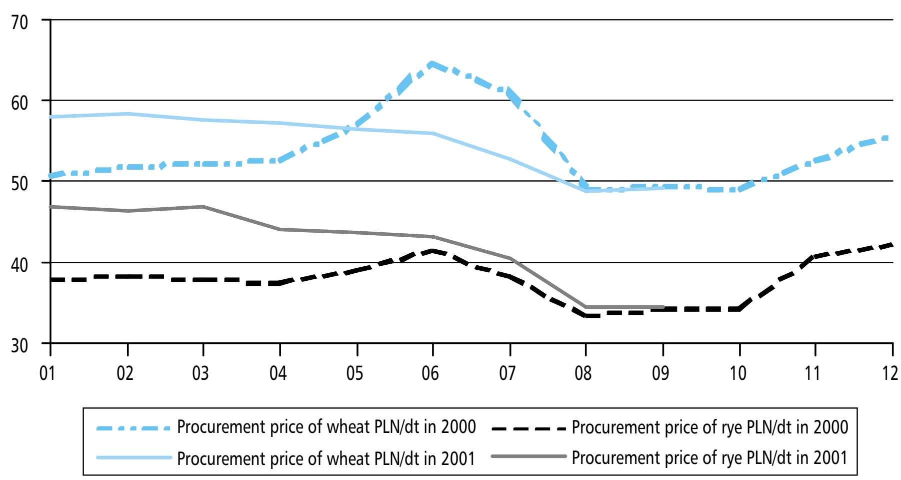
According to the estimates of the Institute of Agricultural and Food Economics (IERiGŻ), in the season 2001/2002, grain supply from domestic sources (consisted of grain stocks and grain crops) totalled about 29.7 million tons – 16.6% more than in the previous season and 4% more than the 1996–2000 average.

The growth was mainly attributed to better-than-expected harvests of basic grains, which totalled 25.8 million tons, and to record high harvests of maize (about 1.4 million tons). Total grain production is estimated at 27.2 million tons, 8% higher than the 1996–2000 average and 22% higher than last year's level. This resulted from growth in production of all types of grains, including 10.5% growth in wheat production and 22.9% growth in rye production. This production growth was mainly attributed to increased grain yields accompanied by a small increase in grain acreage. The increased production and yields in 2001 were due to good weather conditions during the growing period which compensated for the short rainfall period during the harvest. However, rainfalls in September-October may negatively influence winter grains, which may harm yields in 2002.

While the last season was characterised by excessive grain demand over supply, in the season 2001/2002 the grain balance is reversed because a significant growth in grain supply is accompanied by only a minor growth in demand. Increase in domestic grain utilisation is estimated at about 5%, which means growth by 1.4 million tons in comparison to last year's utilisation of 25.3 million tons. This growth is attributed to increased grain use for feeding purposes and for processing.

Thanks to the good grain harvest in the season 2001/2002, the oversupply of grains (above the utilisation level) will approach 0.5 million tons. Such a situation was last seen in 1993/1994. According to IERiGŻ, this will cause a 60% decrease in grain imports, compared to the previous season, to the level of 0.9 million tons. However, compensatory grain imports will continue, especially of high quality wheat, rye and malting barley. Moreover, Poland is obligated to continue importing under the WTO quota agreements (388 thousand tons of wheat) and tariff-free quotas under an EU agreement (440 thou-

Chart 2.4. Prices of main agricultural commodities, 2000–2001



Source: Based on CSO and Agricultural Markets Agency (ARR).

sand tons of wheat). There is also a threat that if the minimum price for grains in Poland is held at the current high level, the imports of cheap grains from countries such as Ukraine, Russia or Kazakhstan – which have significantly increased production and exports of grains this year – will become more attractive.

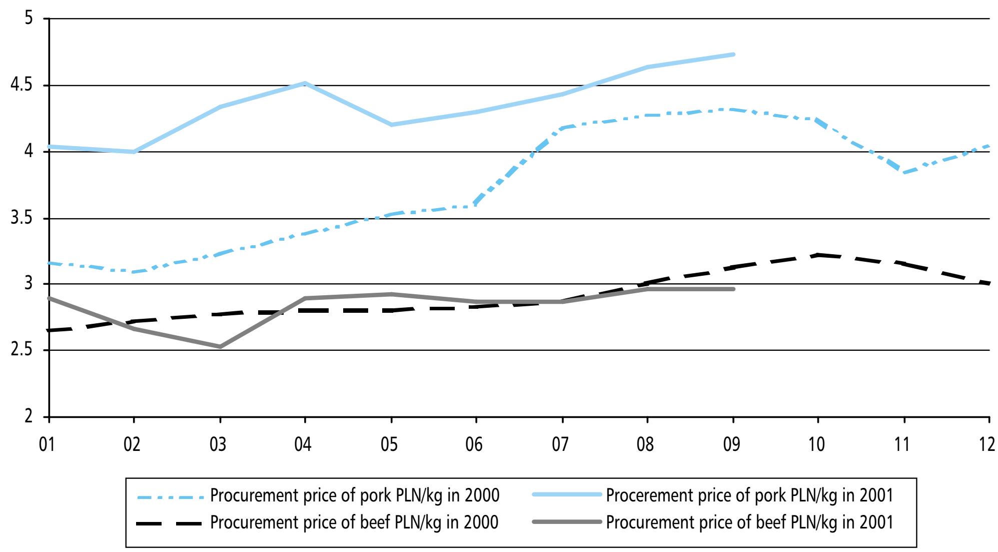
Slower growth of demand (5.4%) than of supply (16.6%) will exert a downward pressure on grain prices. A downward trend was already apparent in 3Q01, when wheat procurement prices dropped by 7% (to 49.11 zł/dt) and rye prices by 14% (to 34.54 zł/dt). In 4Q01 we can expect an increase in prices of only high quality wheat and rye, to the level estimated by IERiGŻ of 62 zł/dt and 43 zł/dt respectively.

According to IERiGŻ estimates, in 2001 total production of meat will be lower by 2–3% yoy. Production of pork will be 5% yoy lower and beef 6–8% yoy. The production of poultry, on the other hand, will be about 10% yoy higher. Therefore, in 2001 lower production of processed meat is expected. Since the beginning of this year pork prices have remained high (in 1H01 the average procurement price was 27% higher than during the same period of 2000). This resulted from limited supply (caused by deteriorating profitability of production over the last few years) and increased demand. However, good grain harvests and the ensuing lower grain prices contribute to improvement in profitability of pork production. Therefore, a 5% increase in swine production from June in to 2002 is expected. The forecasted price for 2H01 is 4.5 zł/kg, 10% higher than for the same period of last year. This is mainly because of record high procurement prices of pork in 3Q01.

Exports of pork significantly decreased in 2H01 due to much higher prices in dollar terms (1.13 US$/kg versus 0.74 US$/kg in 1H00). The main target market for Polish pork remained the CIS, including Russia. Imports of pork also decreased in 2H01. A slight recovery in pork imports is expected in 1H02, but exports of pork and pork processed products is expected to remain unchanged as compared to 1H01.

Against previous expectations, the crisis on the beef market continued into 3Q01. Despite the fact that no cases of BSE were found in Poland, the demand for beef dropped significantly, but not accompanied by a decrease in beef supply sufficient

Chart 2.5. Prices of main agricultural commodities, 2000–2001



Source: Based on CSO and Agricultural Markets Agency (ARR).

to meet the decline in demand. Therefore the market suffered from oversupply. However, beef prices were fairly stable. In nominal terms they were almost at last year's level. At the end of this year beef prices should be similar to last year's level in the same period, pork prices should stay high until next year when production is expected to recover. IERiGŻ's forecast for meat production in 2002 is optimistic, and predicts a 4–5% increase in overall meat production, of which 5% would come from growth in pork production and 7% in poultry production. Beef production is, however, expected to decrease by 6–8%.

Przemysław Woźniak

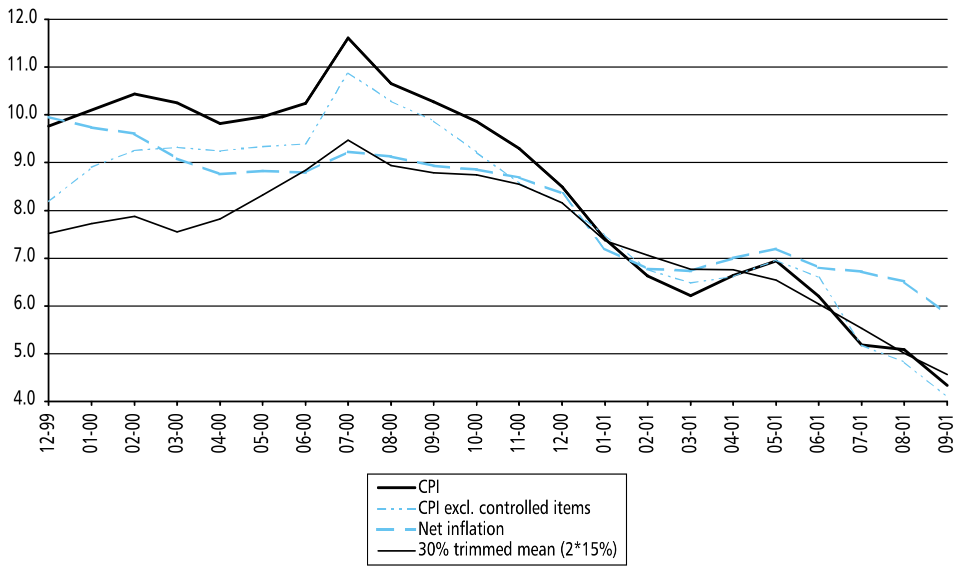
Core inflation

In 3Q01, after a period of stabilisation or even slight increase in 2Q01 (which we pointed out in the previous edition of PEO) core inflation indices registered a pronounced drop. This drop, however, was not equal across all indices: trimmed mean and core inflation excluding administratively controlled prices fell at the pace of headline inflation, while net inflation fell almost 1.5 percentage points more.

Net inflation eliminating food and fuels from the consumer basket dropped to 5.82% at the end of September. This index has been exceeding core inflation since the beginning of the year and the deviation between the two indices is widening systematically (it amounted to 1.5 percentage points at the end of September). This clearly points to changes in the inflation process which is no longer dominated by food and fuel inflation, as was the case last year. A significant fall in the price of fuels (11.5% on an annual basis as of end-September) and many staple foodstuffs (butter – 14%, flour – 8% and eggs – 7%) brought strong disinflation in the combined food-and-fuel aggregate and consequently 'lifted' net inflation above headline inflation.

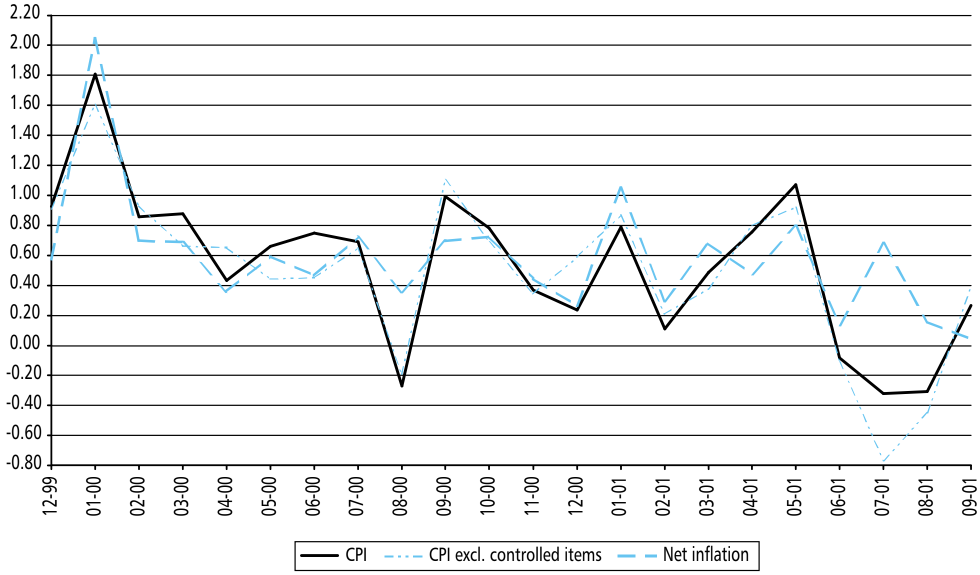
Another core inflation index calculated by the NBP, the 15% trimmed mean (eliminating 15% of the highest and 15% of the lowest price changes), has been moving roughly in line with headline inflation since the beginning of the year. This indicates that the acceleration of the disinflation process that we have witnessed in recent months, has not been brought about by short-term, reversible supply-side phenomena (their effect is eliminated from the trimmed mean), but is soundly grounded and

Chart 2.6. Core inflation, 1999–2001 (% changes, yoy)



Source: CSO, NBP, and CASE.

Chart 2.7. Core inflation, 1999–2001 (% change, mom)



Source: CSO, NBP, and CASE.

encompasses all prices. The rate of growth of the trimmed mean (4.56%) confirms the strong disinflationary trends across the economy and its proximity to rate of growth of headline inflation (4.33%) suggests that these trends will prevail in the coming months.

The core inflation index calculated without administratively controlled prices reached 4.09% in September 2001 and was slightly higher than headline inflation. Consumer items excluded from this measure include alcohol, tobacco products, fuel, certain municipal and telecommunications services, as well as other services whose prices are subject to administrative control. In the past 12 months the rate of growth of this index has not deviated from that of headline inflation, which points to a diminution in the inflationary role of administered price increases that were an important short-term inflation-shaping factor up to 1999. Currently, controlled prices are growing on average at the same pace as the remaining consumer prices. This does not mean, however, that price adjustments in sectors controlled by the state have come to a halt: the price of gas has grown by 15% over the past 12 months, electricity by 14% and hot water by almost 10% (as of end-September). The concurrence of the rate of growth of core inflation without controlled prices and headline inflation should be ascribed to a nominal plunge in prices of products treated as administratively regulated: fuel – by more than 14% and the telephone installation fee – by more than 35%. However, treating prices of, for example telecommunication services, as administratively controlled is increasingly less convincing as are calls for a revision of the elements, comprising the group excluded from the index (which remains unchanged since 1999!).

Rafał Antczak

Monetary policy

- **Fiscal expansion and monetary easing – continued**
- **Undershooting inflation target in 2001**

Notwithstanding very difficult state of public finance, the MPC cut the NBP's reference interest rates by 100 basis points in August, based on a main-

Table 2.1. Assumptions, targets and their fulfilment in monetary policy, 1997–2003

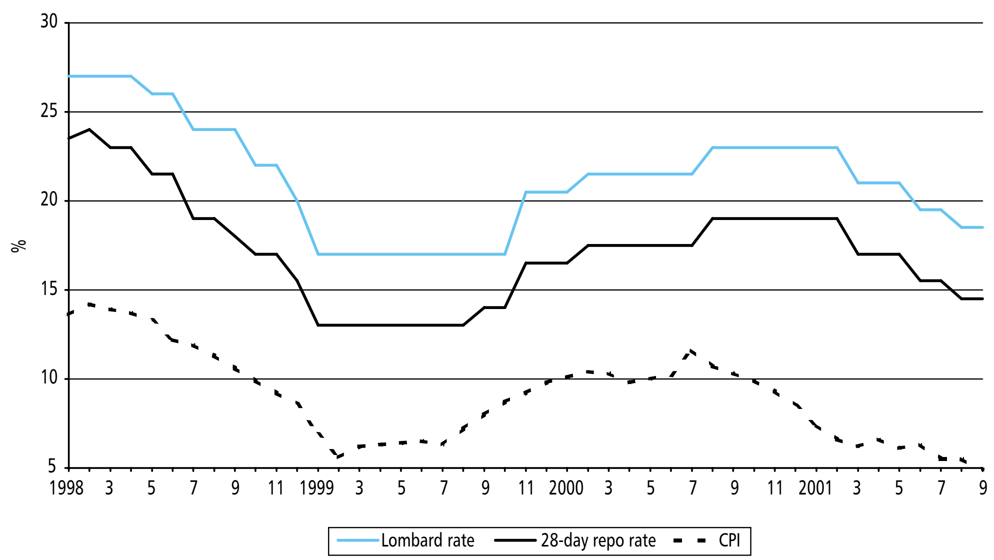
	Inflation target, %[1]		Supply of M2, increases in %[2]	
	Assumption	Fulfilment	Assumption	Fulfilment
1997	13.0	13.2	20.3-21.2	30.9
1998	9.5	8.6	16-20	25.1
1999	8-8.5	9.8	15.4-18.6	19.4
2000	5.4-6.8	8.5	14.7-18.2	11.8
2001	6-8	4.5[3]	13.6-15.6	14.2[3]
2002	4-6		n.a.	
2003	below 4			

Source: NBP and CASE.
Notes: 1. CPI inflation.
2. NBP forecast.
3. CASE forecast.

tained disinflation trend. As a result, the NBP's reference interest rates were lowered by 450 basis points by the end of 3Q01, while CPI inflation on a yearly basis dropped by 420 points, which left real interest rates at their end-2000 level.

The reserve money supply up to the end of 3Q01 was lower by over 1% against the end of the previous year, which resulted from a decline in the net foreign assets component due to nominal appreciation of the zloty against the dollar as well as a decline in the domestic credit component, especially credit to the government. At the end of 3Q01, the decline in net claims on government was over 5.7 billion zlotys and resulted from a repayment of the budget debt towards the NBP on Treasury papers (conversion of

Chart 2.8. Monetary policy instruments, 1998–2001



Źródło: NBP i CASE.

Table 2.2. Components of the reserve money supply, 1998–2001 (cumulative % change)

		Reserve money (RM)	Net foreign assets (NFA)	Net domestic assets (NDA)	Net claims on government (NCG)	Claims on deposit money banks (CDMB)	Other items net (OIN)
1998	1Q	4.82	25.37	-7.00	-5.31	-1.69	-13.55
	2Q	17.54	36.32	-10.22	-8.74	-1.48	-8.56
	3Q	17.50	48.85	-4.39	-6.35	1.96	-26.94
	4Q	26.78	63.44	-0.90	2.95	-3.85	-35.75
1999	1Q	0.44	-0.78	-0.57	-0.50	-0.07	1.79
	2Q	10.20	14.07	1.54	2.10	-0.57	-5.42
	3Q	-13.94	6.15	-3.65	-2.79	-0.87	-16.45
	4Q	-1.57	18.50	-4.75	-3.71	-1.04	-15.34
2000	1Q	-14.44	15.29	-1.91	-1.57	-0.34	-27.81
	2Q	-1.83	-2.97	9.15	9.82	-0.67	-8.02
	3Q	-3.20	12.66	0.98	1.53	-0.55	-16.84
	4Q	-7.64	22.90	-9.48	-9.08	-0.40	-21.05
2001	1Q	-1.03	-4.46	-5.93	-6.69	0.76	9.45
	2Q	-0.48	-14.83	-5.28	-4.85	-0.43	19.71
	3Q	-1.02	-25.28	-12.63	-11.74	-0.90	36.95

Source: The NBP Bulletin and authors' calculations.

Note: The shares of components of reserve money are calculated using the following formula: $\Delta RM/RM_{-1} = \Delta NFA/RM_{-1} + \Delta NCG/RM_{-1} + \Delta CDMB/RM_{-1} + \Delta OIN/RM_{-1}$ cumulative in the current year. Net foreign assets were re-estimated (valuation adjustment) using the average exchange rate of the currency basket for a given period to account for fluctuations in the exchange rate of the zloty.

Table 2.3. Components of the broad money supply, 1998–2001 (cumulative % change)

		Broad money (M2)	Net foreign assets (NFA)	Net domestic assets (NDA)	Net claims on government (NCG)	Claims on private sector (CPS)	Other items net (OIN)
1998	1Q	2.25	3.76	0.85	-2.85	3.70	-2.36
	2Q	8.97	4.79	5.25	-2.60	7.86	-1.08
	3Q	15.35	4.33	13.76	0.86	12.90	-2.74
	4Q	25.12	9.72	20.60	3.42	17.18	-5.20
1999	1Q	4.30	-0.53	5.74	1.18	4.55	-0.91
	2Q	7.01	2.35	9.59	1.77	7.82	-4.93
	3Q	11.42	2.45	13.19	0.14	13.06	-4.23
	4Q	19.36	6.43	18.45	1.51	16.94	-5.53
2000	1Q	-0.58	4.93	-0.54	-3.62	3.08	-4.97
	2Q	8.11	1.10	8.14	-2.30	10.44	-1.13
	3Q	6.48	4.05	8.12	-2.57	10.69	-5.68
	4Q	11.76	10.59	6.27	-5.27	11.54	-5.10
2001	1Q	2.22	0.44	-0.26	-1.82	1.57	2.03
	2Q	4.46	-1.97	2.01	-0.49	2.50	4.42
	3Q	9.13	-4.69	7.56	0.83	6.73	6.25

Source: The NBP Bulletin and authors' calculations.

Note: The share of broad money components are calculated using the following formula: $\Delta M2/M2_{-1} = \Delta NFA/M2_{-1} + \Delta NCG/M2_{-1} + \Delta CPS/M2\text{-}1 + \Delta OIN/M2_{-1}$, cumulative in the current year. Net foreign assets were re-estimated (valuation adjustment) using the average exchange rate of the currency basket for a give period to account for fluctuations of the exchange rate of the zloty.

debt from 1999). Resources to debt repayment came from government borrowing in commercial banks. Both the money multiplier and with velocity of money did not change, amounting, respectively, to 6.7 and 2.7 at the end of 3Q01.

A lowering of the NBP reference interest rates by 450 basis points up to end 3Q01 was not transferred into credit rate cuts by the commercial banks. While the average weighted rate on individual deposits went down by 380 basis points (from 14.4% at end-2000 to 10.6% in August 2001), and by 300 basis points for companies (from 14.2% to 11.2% in the respective period), the average weighted rate on credits to companies was lowered by 280 basis points (from 21.1 at end-2000 to 18.3% in August 2001) and to individuals only by 70 basis points! As a result the interest rate spread in commercial banks increased by 120 basis points and amounted to 840 basis points at end-August. This is probably the outcome of an increase in costs to commercial banks, including the amount from debtors facing problems

Table 2.4. Calendar of the most important events in the monetary policy of the NBP, 2000–2001

Source	Date of the resolution	Events
J NBP No. 1	February 23, 2000	NBP rediscount rate 20% Lombard rate 21.5% Refinancing rate 21.5/22.5% 28–day repo rate at least 17.5%
J NBP No. 2	February 25, 2000	Interest rate on NBP current deposits 6.45%
J NBP No. 6 and Monitor Polski No. 11/231 and 232	April 11, 2000	Abolition of crawling peg of the zloty and the permissible exchange rate fluctuation band
J NBP No. 13	August 30, 2000	NBP rediscount rate 21.5% Lombard rate 23% Refinancing rate 23/24% 28–day repo rate at least 17.5%
J NBP No. 14	September 4, 2000	Interest rate on NBP current deposits 6.9%
Monitor Polski No. 31	September 20, 2000	Release of the monetary policy guidelines for 2001, inflation target for end-2001 set as the range of 6-8%
J NBP No. 3	February 28, 2001	Interest rate on NBP current deposits 6.6%
J NBP No. 3	February 28, 2001	NBP rediscount rate 20.5% Lombard rate 22% Refinancing rate 22/23% 28 – day repo rate at least 18%
J NBP No. 4	March 28, 2001	NBP rediscount rate 19.5% Lombard rate 21% Refinancing rate 21/22% 28–day repo rate at least 17%
J NBP No. 5	March 30, 2001	Interest rate on NBP current deposits 6.3%
J NBP No. 8	June 28, 2001	NBP rediscount rate 18.0% Lombard rate 19.5% Refinancing rate 19.5/20.5% 28–day repo rate at least 15.5%
J NBP No. 9	July 2, 2001	Interest rate on NBP current deposits 5.85%
J NBP No. 12	August 23, 2001	NBP rediscount rate 17.0% Lombard rate 18.5% Refinancing rate 18.5/19.5% 28–day repo rate at least 14.5%
J NBP No. 13	August 27, 2001	Interest rate on NBP current deposits 5.55%
Monitor Polski	October , 2001	Release of the monetary policy guidelines for 2002, inflation target for end-2002 set as 5% +/- 1percentage point

Source: Official Journal of the NBP, various issues. Authors' compilation.

paying on time. Given the apparent unwillingness of the commercial banks to lend to individuals we can assume that the problem of doubtful debts is still relevant to this group of debtors.

Since 1999, the NBP has pursued a strategy of a direct inflation targeting and a medium-term target of CPI inflation below 4% in 2003 was established. The MPC, when setting yearly inflation targets, also takes into account the medium-term target. Up to the end of last year, the NBP regularly overshot its yearly inflation targets – the exception being 1998 when there was a positive supply shock on the food market after the Russian crisis.

2001 may be the first year in which, due to the lack of negative external shocks, the inflation target could be higher than actual inflation. It is noticeable that during 1997–1999 the NBP missed its broad money supply targets. The main reasons were unrestrained growth of the credit to the private sector component, reinforced by a growth of the net foreign assets component. The trend towards increasing credits to the private sector has been continued during the current year, and only a negative contribution of the net foreign assets component, resulting from the nominal appreciation of the zloty, will mean that the broad money supply target will be met. Therefore, simple monetary indicators (e.g., the Fisher equation) show that the dynamics of broad money supply under the current level of inflation and GDP growth are double what they should be (14.5% against 6–7%). Excessive monetary expansion is neutralised by a growth in deposits. However, a reversal in that trend (e.g., resulting from the introduction of tax on interest rate gains) may cause purely monetary-driven inflation growth in 2H02.

The supply of broad money increased after three-quarters by over 9% (14.5% on a yearly basis) due to an increase in domestic credit, especially credit to the private sector. Credit to the government also increased, both in commercial banks' positions "receivables from the government" and due to the purchases of Treasury papers (rollover of converted NBP T-bonds). The share of the net foreign assets component was negative due to nominal appreciation of the zloty, though assets have increased in dollar terms. In 3Q01 the main area of growth in domestic credit were claims on individuals by over 20% on a yearly basis, irrespective of the high real interest rates. The rate of growth of individuals' deposits within the banking sector was similar, indicating the stable preferences of creditors and depositors given the current level of interest rates. The banks claims on companies have been increasing at a lower rate up to the end of 3Q01 than in the respective period of the previous year (an increase by 8.7% compared to 13.8% in 2000). During 3Q01, there was a drop in the zloty deposits of companies, especially current deposits in favour of an increase in foreign currency deposits. Also individuals increased foreign currency deposits, whose share in the total deposits of individuals increased to almost 18% in September compared to 16.6% in June.

Piotr Bujak, Mariusz Jarmużek

Financial markets

• Increasing expectations of cuts in interest rates

Short-term interest rates

The beginning of July saw a temporary increase in interest rates as a result of the turmoil in the currency market. The underlying reason was the financing of short zloty sales. When the market returned to its previous levels in mid-July, the inter-bank rates deteriorated gradually. On the deposit market the 3 and 6-month rates recorded the most notable falls. The FRA market rates also decreased with the most notable fall in 5-month contracts. These developments were the product of increasing expectations of NBP rates cuts after the publication of grim figures on trends in manufacturing in June and favourable trends in foodstuff prices in the same month. The highest yields on the yield curve recorded for contracts up to 6 months suggested that the market has already priced in NBP rates cut before the end of 2001 – though expectations of similar cuts in the longer term have weakened.

In the middle of August, with the announcement of the budget assumptions for next year by the

Ministry of Finance, market rates picked up. All deposit rates, irrespective of maturity, increased and the slope of the yield curve changed most in the 1–9 months period. This illustrates that expectations of an interest rate cut for horizons beyond 1-month decreased. The same was suggested by an increase in rates on the FRA market. Deposit rates decreased again shortly before the August MPC meeting and, yet again, after the MPC's decision to cut the NBP rates.

After the events of the 11 September in the US the inter-bank rates initially rose, before subsequently falling together with both the FRA and swap rates. This was to a large extent the result of a series of rate cuts performed by numerous central banks in industrialised countries. After 20 September the market speculated there would be a cut even before the end of the month. One factor contributing to such expectations was the publication of low GDP growth in 2Q01. After the announcement of no change in the NBP rates market interest rates increased. This temporary increase concerned mainly the O/N and T/N rates and was connected to the liquidity problems of banks due to speculative purchases of NBP money market bills in anticipation of the cuts in interest rates.

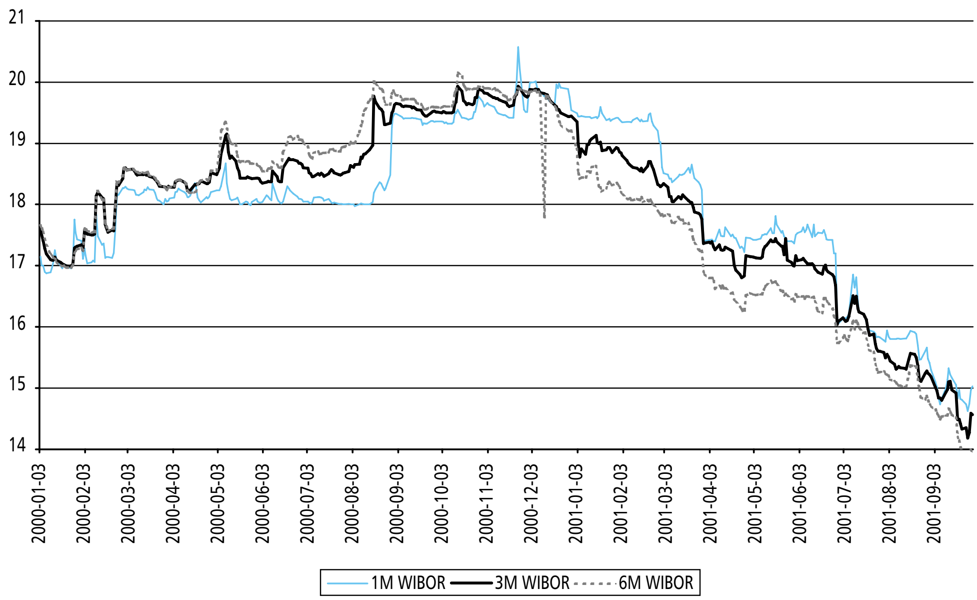
The Treasury debt securities market

The yields on all kinds of treasury debt securities fell gradually until the beginning of August causing a parallel downward shift of the yield curve. Such an increase in the price of bonds was triggered by expectations of NBP rates cut and a lowering of exchange rate risk after the correction in early July. The same period saw a reduction of prices of 2 and 5-year bonds which contributed to their attractiveness in successive periods. On the other hand, budgetary problems and the implied uncertainty with respect to the scale of additional issuance put downward pressure on bond prices.

Similar to the money market, bond yields increased in the middle of August. The increase was more visible on the long end of the yield curve due to the announcement of budgetary assumptions for 2002. The relative stability of the short end of the yield curve was implied by persistent expectations of a future cut in NBP rates at the August MPC meeting.

After the MPC's decision to reduce the national bank's base rates the yields started falling, with 2 and

Chart 2.9. 1-month, 3-month, and 6-month WIBOR, 2000–2001 (daily quotations)

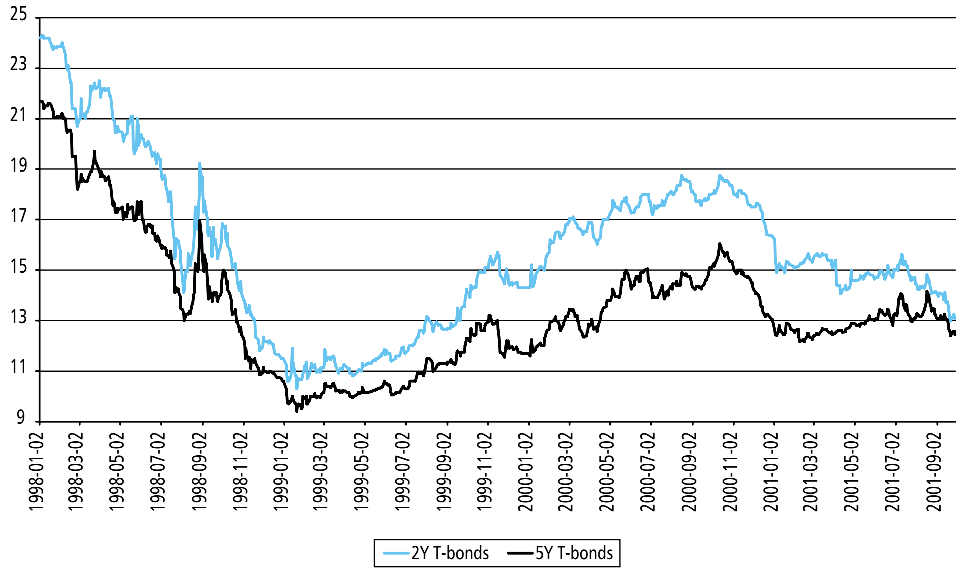


Source: NBP.

5-year bonds recording the most pronounced falls. This resulted in a flattening of the yield curve.

A further decrease in the prices of bonds occurred in September due to growing expectations of further cuts in the NBP rates. In the middle of September, after the terrorist attack on the World Trade Centre, the trading in the bonds market came to a standstill. Hence, the yields did not fully reflect fundamentals. Extraordinary expectations about the reduction of NBP rates at the September MPC meeting arose after the release of official figures on inflation and GDP in 2Q01 on 20 September. After a decision was made to hold the current rates market, expectations increased again.

Chart 2.10. 2Y and 5Y treasury bonds, 1998–2001 (daily quotations)



Source: NBP.

Outlook for the economy in 2001–2003

Łukasz Rawdanowicz

Dwindling optimism?

The current mood prevailing among economists all over the world is pessimism. Japan is entangled in recession, the US exhibits early signs of recession and the EU has lost steam. These developments depress any optimism in macroeconomic forecasts. Any faith there may have been in the soft-landing scenario in the US and its modest impact on the performance of the EU have disappeared abruptly. The IMF, OECD, World Bank, as well as investment banks have been gradually downgrading their forecasts over the course of this year and Polish economists have followed suit in their assessment of the domestic market. Are they right?

The latest macroeconomic indicators do not appear encouraging – industry and construction continued to contract, investment dropped, unemployment increased, and public finances remain in a poor state. And there are no reasons to expect a significant rebound before the end of the year. The GDP growth rate in 4Q01 will be only slightly higher than in previous quarters and 2001 as a whole will see 1.7% growth. This is a marked deterioration in comparison to previous years. Even in the aftermath of the Russian crisis Poland did not record such low growth. The question is whether Poland is on a downward path with next year only getting worse? It seems to us that the answer is "no", though we have also been downgrading our forecasts for this year and next. However, there are no sound arguments that we are doomed to stagnation or even a further slowdown next year.

Domestic demand – a growth hope

Is it possible that domestic demand will continue to decline next year? In our view, it is not. Investment, which in 2001 contracted for the first time since 1991, should recover gradually next year. It should be noted that in 1H01 the greatest declines in investment were in the public sector. This sector appears less able to accommodate to unfavourable conditions. This is evident in terms of its remuneration and employment policies. In contrast, the private sector – exposed to higher competition from imports in the domestic market as well as in foreign markets – has undertaken faster and more successful restructuring. Due to flexible wages and salaries (according to data from 1H01), employment has not been declining so fast and profitability rates have remained almost unchanged from 1H00. Therefore, given further NBP interest rates cuts and an improving external environment in 2H02, there are chances for a rebound in investment – especially in the private sector. In addition, the current restructuring in the public sector – induced by tough economic conditions – will leave this sector in a better condition.

We also do not see reasons for growth in household consumption to slow down further. High

Table 3.1. Main macroeconomic indicators, 1998–2003

		1998	1999	2000	2001	2002	2003	2001 I	2001 II	2001 III	2001 IV	2002 I	2002 II	2002 III	2002 IV
					Forecast						*Forecast*				
GDP	% growth	4.8	4.1	4.0	1.7	2.4	4.2	2.3	0.9	1.2	2.3	2.1	1.9	2.0	3.7
Domestic demand	% growth	6.4	4.8	2.8	-0.3	2.9	5.7	-1.4	-1.2	-0.4	1.4	2.0	2.0	2.7	4.6
Budget deficit	%of GDP	-2.4	-2.0	-2.2	-4.0	-5.1	-4.1	-9.1	-2.2	-1.7	-3.5	-8.0	-6.8	-3.5	-2.9
Unemployment rate	%	10.4	13.1	15.1	17.2	18.5	18.8	16.1	15.9	16.3	17.2	17.8	17.5	17.9	18.5
Balance on current account	% of GDP	-4.3	-7.5	-6.3	-4.1	-5.0	-5.7	-5.3	-5.2	-4.3	-4.1	-4.2	-4.1	-4.7	-5.0
Balance on merchandise trade	US$ billion	-13.7	-14.4	-13.2	-11.7	-13.2	-14.9	-3.1	-2.8	-2.8	-3.0	-3.0	-3.1	-3.5	-3.7
M2	PLN billion	220.8	263.5	294.4	333.1	363.3	396.1	301.0	321.4	321.4	333.1	337.5	343.5	353.6	363.3
CPI	%	11.8	7.3	10.1	5.6	4.6	4.5	6.7	6.6	4.9	4.2	4.8	4.3	4.5	4.8
Exchange rate against US$	zloty/US$	3.5	4.0	4.3	4.1	4.3	4.5	4.1	4.0	4.2	4.2	4.3	4.3	4.4	4.4
Exchange rate against euro	zloty/euro		4.2	4.0	3.7	4.1	4.3	3.8	3.5	3.8	3.8	3.9	4.0	4.1	4.2
Lombard rate	%	20.0	20.5	23.0	16.5	15.0	13.0	21.0	19.5	18.5	16.5	16.5	16.0	15.0	15.0

Source: Data – CSO and NBP; forecast – CASE.

growth in social benefits (due to indexation) will remain in place until the middle of 2002. On the other hand, growth in wages and salaries as well as in mixed incomes will gradually accelerate. In addition, we expect a decline in the savings rate. It is unlikely that the increased tax burden – expected to affect primarily wealthier households – will impact negatively on consumption. It is more likely that higher-income households will tend to first lower their savings and then consumption, especially given the possibility of an introduction of a tax on capital earnings.

Exports?

Over last two years in the face of waning domestic demand, exports have been the main driving force of economic growth in Poland. Will it be different next year? Definitely yes, although export performance will be still essential for growth stability – especially during the period of recovery in domestic demand in 1H02. The exact path of export growth will hinge on two factors: growth developments in the EU and the ability of Polish exporters to sustain their competitiveness in foreign markets.

The outlook for the EU, and Germany in particular, is rather bleak. Recent economic forecasts for the EU point to a far-reaching slowdown across the whole region. 2002 is expected to see even slower growth than this year. This will be a drag on external demand for Polish exports, although given positive growth in the EU – so far a recession is unlikely – Polish exports should still expand. To some extent the unfavourable developments in the EU can be alleviated by dynamic growth of exports to Poland's southern neighbours and Russia. It appears that the Czech Republic and Hungary will be on a firm footing despite the slowdown in the EU. Russia is again one of Poland's top 10 export markets and its macroeconomic outlook for next year is favourable.

With regard to the second factor we remain optimistic. Disregarding the strong appreciation of the zloty since the end of 2000 and the weakening performance of the EU, exports in the balance of payments remained almost unchanged for three quarters in a row. This seems to suggest that Polish exporters have been successful in accommodating to the exchange rate shock via a reduction in their costs. Thanks to this, they have been able to save their positions in foreign markets. Although the relation of producer prices in the EU and Poland favoured Polish companies – the real appreciation of the zloty against the euro deflated by PPI was not as strong as that deflated by the CPI – this trend should not reverse promptly. In addition, we expect the zloty to gradually depreciate next year, contributing positively to the profitability of exporters.

Aware of risks related to the external environment and bearing in mind the arguments presented above we believe that exports will prop up GDP growth in 2002, though their growth will decline. As soon as data for 4Q01 and 1Q02 are known we will find out if we were right. This period will be crucial for the growth perspective of Polish exports.

Nevertheless, risks are on the downside...

Our current macroeconomic forecasts for next year may seem optimistic when compared to the market consensus, but should be treated as a highly plausible scenario. However, we are aware of the downside risks, especially those related to the uncertain external situation. It is hard to predict the duration and depth of a potential recession in the US and its spillover effects in the EU. If the growth rate in the EU stays close to zero for longer than two quarters or even declines, Polish exports could contract. In this case, the private sector would be most affected, as it is to a greater degree exposed to foreign markets. Consequently, confidence and the financial condition of producers could deteriorate – taking their toll on investment activities. Also, growth in wages and salaries would not be as high as in our baseline scenario. In addition, in this scenario, if the loss of foreign markets is not offset by recovering domestic demand, things could be even worse – growth in wages and salaries would slow down and unemployment increase. This would in turn impact on consumer confidence and household consumption. The contribution of government consumption to GDP growth would also be lower, as the budget would see lower tax revenues. In such a black scenario growth next year would level off or even decline in comparison to this year. We cannot rule out entirely such a scenario, though in our view its chances remain low.

Aside from growth developments in 2002, Poland will still face serious economic, political and social challenges over the next 2–3 years. Most importantly, unless a profound reform of public finances with an emphasis on the expenditure side is undertaken and the current patching up of the budgetary gap is limited only to increases in taxes, a rise in State Treasury debt will be unavoidable. As a result, the costs of debt servicing and the tax burden will mount and this will be a drag on growth potential over a longer horizon. In this context, it should be stressed that households keep on lowering their propensity to save and the proposed changes in the tax system for next year are only enhancing this trend. Lower domestic savings coupled with the higher borrowing requirements of the budget sector, boost imports of savings. This in turn may increase external imbalances. The ensuing higher exchange rate risk would hinder access of Polish business to foreign financial resources. Consequently, given low domestic savings, investment is bound to slow down.

Faced with a forecasted unemployment rate of over 18% in the next two years, the development of a favourable environment for creating new jobs becomes a top priority. Such high unemployment will have serious economic and social implications (e.g., increase in budgetary expenditures on unemployment benefit and social insurance for the unemployed). Thus, structural legal changes, aimed at lowering labour costs and making the labour market more flexible, are essential. Raising labour qualification and fostering the development of small and medium-sized enterprises also needs to be boldly addressed. The unemployment problem may escalate when Poland joins the EU. The high costs of adopting EU regulations may dampen labour demand. The tough situation on the labour market may give rise to social discontent and falling support for European integration. Further delays in Poland's entry to the EU could also shake foreign investor confidence and complicate debt issues as well as cut off sources of financing new investment.

Poland's EU integration will not only entail challenges with regard to the adoption of EU regulations, but also macroeconomic policies. Under the current exchange rate regime potential large inflows of pre-accession funds, FDI (e.g., in the form of green field investment) or portfolio capital will cause a strong appreciation of the zloty. This will take its toll on the competitiveness of Polish enterprises. Fiscal policy will be also subject to serious strains. After joining the EU Poland will be obliged to comply with the Stability and Growth Pact, which stipulates member states achieving sound budgetary positions close to balance or in surplus. Given the fact that a number of EU projects will require co-financing on the Polish side, achieving this goal will entail tough and prudent expenditure policy. Thus, the current difficult macroeconomic situation cannot serve as an excuse for postponing pending structural reforms. The less time is left, the more difficult they will become to implement. Waiting for an economic recovery that may smooth reforms will only increase their costs.

*Łukasz Rawdanowicz**

External conditions

- **The global economy on the verge of recession**
- **US economic outlook mired in uncertainty**
- **Euro zone on a very slow track**
- **Japan and several emerging economies in Asia contracting**
- **Inflationary pressures on the decline**
- **Oil prices expected to remain relatively low**

At the end of 3Q01 the situation on global markets has become decidedly more complicated. A high degree of uncertainty prevails alongside a gloomy outlook for the global economy. Expectations of a bottoming out of the US economy in the middle of the year have turned out to be somewhat premature. The deteriorating conditions in the EU appear to be more acute than expected and with far reaching consequences for growth potential next year. Japan, as expected, is embroiled in recession. The concerted slowdown in the largest economies has impacted negatively on other countries, especially in Asia and Latin America. Asian economies like Hong Kong, Singapore and Taiwan have been hit by the global investment downturn and their growth this year is expected to become negative. Mexico and Argentina are facing a similar plight. The negative developments in 2H01 will definitely have an adverse impact on growth potential next year. The IMF, OECD and investment banks have already forecast an even worse performance for the global economy next year.

So, does the global economy stand on the verge of a recession? The answer is 'yes,' though we remain optimistic and believe it will not slide further. In our baseline forecast, only a few countries in Asia (including, foremost, Japan) and in Latin America will experience GDP contraction. In the case of Japan the picture is clear. Japan already finds itself in a fully-fledged recession. The GDP contraction recorded in 2Q01 should continue in 3Q01. This estimate is consistent with many economic indicators (rising unemployment, continued deflation, an increase in corporate bankruptcies, falling exports) and recent Tankan survey results. This means that Japan has experienced four recessions in the last 10 years. A rebound is most likely to occur around mid-2002. The room for manoeuvre in the policy sphere is limited both on the fiscal and monetary sides. Without fundamental structural changes, Japan's authorities can only pursue a weak yen policy to alleviate some of the impact of a decline in external demand.

Our earlier expectations of a recovery in the US in 3Q01 have proved over-optimistic. Before September, the signals of a severe downturn were mixed. On the one hand, the contraction in industry continued, corporate profits were revised downward, stock exchanges indices were falling, but on the other hand consumer confidence, and thus spending, remained relatively robust. Still, as inflation did not ease significantly, unemployment rose and bearish stock markets reduced the wealth effect and consumer confidence has been gradually eroded. A final – and powerful – blow came in the aftermath of the terrorist attack on 11 September. As the US takes on a war footing, the political and therefore also the econom-

* The text based on the ***Global Economy 4/2001*** (http://www.case.com.pl/index.php3?page=pgtopge&lang=en). ***Global Economy*** is a CASE quarterly publication (only in English) broadly covering the current world economic situation and outlook.

ic situations have become highly uncertain. After the attack, added to a hike in unemployment, consumer confidence collapsed further. Future developments in the war in Afghanistan, as well as possible future terrorist attacks, have increased uncertainty in the short-term outlook. The advance GDP estimate for 3Q01 turned out very low (0.8% yoy) and risk of recession increased. There are now no doubts that the economy is in serious trouble and the recessionary moods are deep-rooted. On the positive side, recent aggressive monetary easing, combined with already introduced and planned future fiscal packages, allow one to expect a short-lived downturn. The US, after recording growth close to zero in 2H01 and at the beginning of next year, will start to recover in the course of 2002.

In Europe the situation is less dramatic but still far from satisfactory. Domestic structural weaknesses have coincided with the global slowdown and reduced the positive stimulus from external demand. The external environment has become more damaging to growth than previously expected. This – as well as higher inflation – has dented consumer confidence and led to a slowdown in domestic demand. Growth momentum declined significantly in 2Q01 – the annual GDP growth rate came down from 2.4% in 1Q01 to 1.7%. Various economic indicators for separate member countries point to even lower dynamics in 3Q01. In addition, leading indicators do not paint a rosy picture for the next couple of months, especially in the corporate sector – in September the Ifo index dropped to 85 points, a level not seen since 1993. This should be reflected in investment contraction. Household consumption is moderate, despite the fact that the drain on confidence from high inflation is fading – inflation has been on the decline. However, the deteriorating situation on labour markets is making consumers more cautious. Also, the terrorist attacks in the US and the on-going war in Afghanistan have taken their toll on confidence.

Given internal structural weaknesses in the euro zone and the bleak global outlook, a rapid recovery from the current doldrums is rather unlikely. In the short term there is little scope for fine-tuning of macroeconomic policy. A further easing in monetary policy is difficult when inflation remains above target. Still, weakening demand, a moderation in wage growth and a favourable (in this situation) outlook for energy prices give hope for waning inflationary pressures. Furthermore, any significant fiscal expansion is restrained by the Stability and Growth Pact, which require a balanced or in-surplus budget position.

Against this background, 2H01 and 1H01 should see a weakening of growth momentum in the euro zone. The turning point should be seen at the latest around the middle of 2002 with a pick-up in domestic and external demand. However, the present protracted slowdown may turn out so deep that GDP growth next year will be lower than in 2001. At this point it should be stressed that the risk of recession for euro zone members is negligible. Contrary to the US, the euro zone will expand in a more stable manner. Both in 2001 and 2002 the growth rate in the euro zone should surpass that of the US.

Hungary and the Czech Republic seem to be surprisingly resilient to the economic slowdown in particular in Germany. Their growth prospects remain favourable, given the pick-up in domestic demand. Remarkably, stable and firm economic growth in Russia continues despite the global downturn. Domestic demand is still the driving force of the expansion. It results in rapidly expanding imports. The outlook for growth in 2001 and 2002 remains optimistic, while on the inflation front not much progress is expected.

In Latin America external shocks emanating from the US have coincided with a wide range of serious internal problems. As a result, growth prospects for 2001 and 2002 have worsened significantly since the summer. The region's growth is expected to fall below 1% in 2001, with only a limited improvement forecast for 2002.

The significant economic cooling around the world, as well as stable oil prices – which have recently held around the lower end of the OPEC band – have helped to rein in inflationary pressures. After recent peaks in CPI in developed countries around mid-year, inflation rates came down somewhat. In Japan deflation continued. Due to the lower economic activity reduced international trade volumes are visible. Oil prices should remain relatively low provided the war on terrorism brings no major dis-

Table 3.2. GDP in selected countries, 1996–2003 (% change, yoy)

	1996	1997	1998	1999	2000	*2001f*	*2002f*	*2003f*
OECD	3.1	3.4	2.7	3.2	4.2	*1.0*	*1.3*	*2.9*
USA	3.6	4.4	4.4	4.2	5.0	*1.0*	*1.3*	*3.1*
Japan	5.0	1.6	-1.1	0.8	1.2	*-0.5*	*-0.4*	*1.5*
European Union	1.7	2.6	2.8	2.6	3.3	*1.6*	*1.5*	*2.4*
Germany	0.8	1.4	2.1	1.6	3.0	*0.7*	*1.1*	*2.9*
France	1.1	2.0	3.5	3.0	3.3	*2.0*	*1.7*	*3.1*
Italy	1.1	1.8	1.5	1.4	2.9	*1.5*	*1.6*	*2.8*
United Kingdom	2.6	3.5	2.6	2.3	3.0	*2.0*	*1.8*	*2.7*
Russia	-3.5	0.8	-4.9	5.4	8.3	*4.5*	*4.0*	*3.0*

Source: Data – OECD, IMF, statistical agencies; forecast (f) – market consensus and CASE.

Table 3.3. Inflation in selected countries, 1996–2003 (% change, yoy)

	1996	1997	1998	1999	2000	*2001f*	*2002f*	*2003f*
USA	2.9	2.3	1.6	2.1	3.4	*3.0*	*1.9*	*2.7*
Japan	0.1	1.8	0.7	-0.3	-0.7	*-0.6*	*-0.4*	*0.6*
European Union	2.1	1.8	1.8	1.2	2.5	*2.5*	*1.3*	*1.4*
Euro area (HICP)	2.2	1.6	1.2	1.1	2.4	*2.6*	*1.4*	*1.4*
Russia	22.0	11.0	84.4	36.5	20.8	*23.0*	*18.0*	*13.0*

Source: Data – OECD, IMF, statistical agencies; forecast (f) – market consensus and CASE.

Table 3.4. The euro and yen exchange rate vs. the US dollar, 1996–2003

	1996	1997	1998	1999	2000	*2001f*	*2002f*	*2003f*
Euro	1.270	1.134	1.121	1.066	0.924	*0.902*	*0.937*	*0.969*
Yen	108.8	121.1	131.0	113.7	107.8	*121.8*	*119.3*	*110.3*

Source: Data – ECB; forecast (f) – market consensus and CASE.

ruptions in the main Islamic oil producing countries. This favourable forecast stems from the significant weakening of economic activity around the globe. Even if OPEC adjusts its production to meet lower demand there should not be any pressure for higher prices, at least until the middle of next year.

As economic performance has surprised on the downside and inflation pressures have eased there has been another round of interest rate cuts in many countries in the Americas and Europe. The US Fed is leading the easing with cuts totalling 400 basis points since the end-2000. In October, real interest rates even entered negative territory.

Against the current backdrop global economic growth should bottom out somewhere at the turn of 2001 and 2002. 1H02 will see some stabilisation, though at a low level, especially in the US and the EU. Only in 2H02 – when the cyclical slowdown comes to an end and the lagged effects of monetary and fiscal stimulus materialise – should more vigorous economic activity be expected. Nonetheless, the overall performance in 2002 as a whole will not be better than this year.

Given the subdued growth in developed countries the inflation outlook is positive. Unless there is a rally in oil prices, 4Q01 and 1Q02 should see rapidly declining inflation rates in the US, the euro zone and the UK. However, when growth picks up after the substantial monetary easing, inflationary pressures should mount in the course of 2H02.

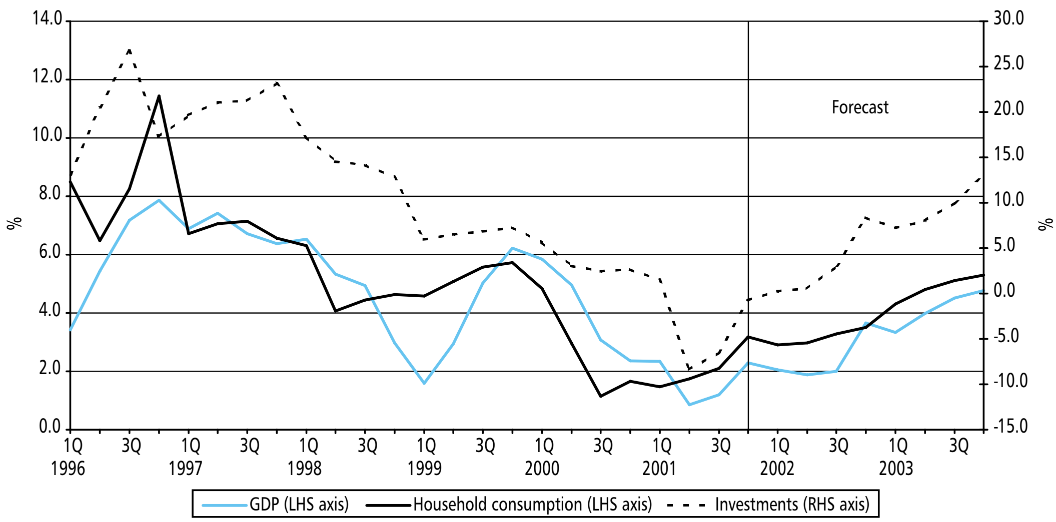
Łukasz Rawdanowicz

Economic growth

The official GDP data for 2Q01 and selected information on the economy in 3Q01 have again inclined us to revise our forecast for this year and next. The marked decline in investment in 2Q01 and in turn in domestic demand took us by surprise. According to our estimates, investment also headed down in 3Q01. It seems it was not interest rates (which were declining), but business confidence that influenced investment activities. In our view, such a perception will not change until the middle of next year. Growth in fixed investment in the next three quarters will be close to zero.

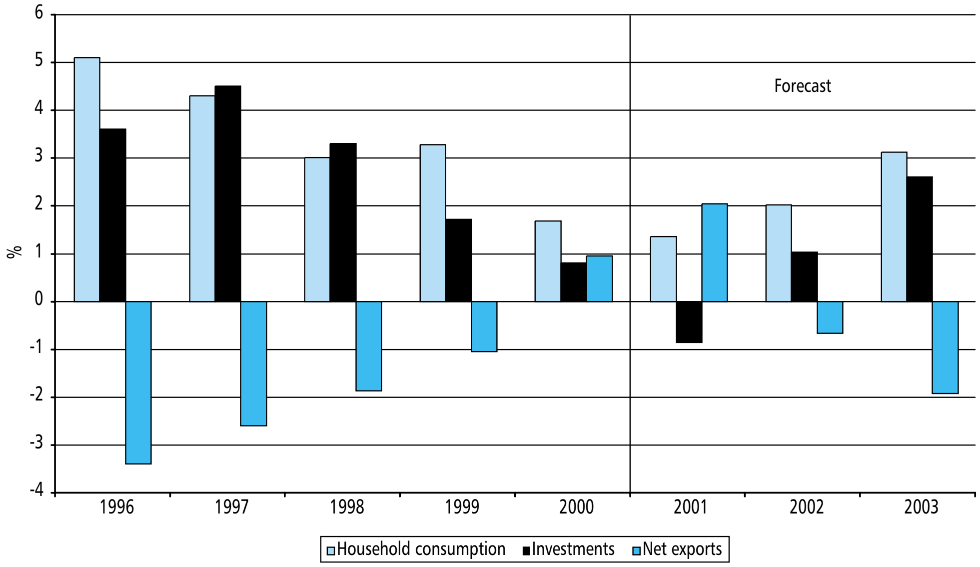
Starting from 3Q01, growth of household consumption will start to accelerate gradually. The moderate pace of growth will be the result of various factors. Slow wage and salary dynamics due to weak labour demand and undermined consumer confidence on the back of high unemployment will act as a drag on household consumption. On the other hand, high growth in social benefits and in mixed income (this will accelerate along with the rebound in overall economic activity) will boost consumption. Also, in our view, the higher tax burden planned for next year will mostly affect the more affluent. They are more likely to limit their savings first than reduce consumption. Taxes on profits from savings will

Chart 3.1. GDP, domestic demand and investment, 1996–2003 (% change, yoy)



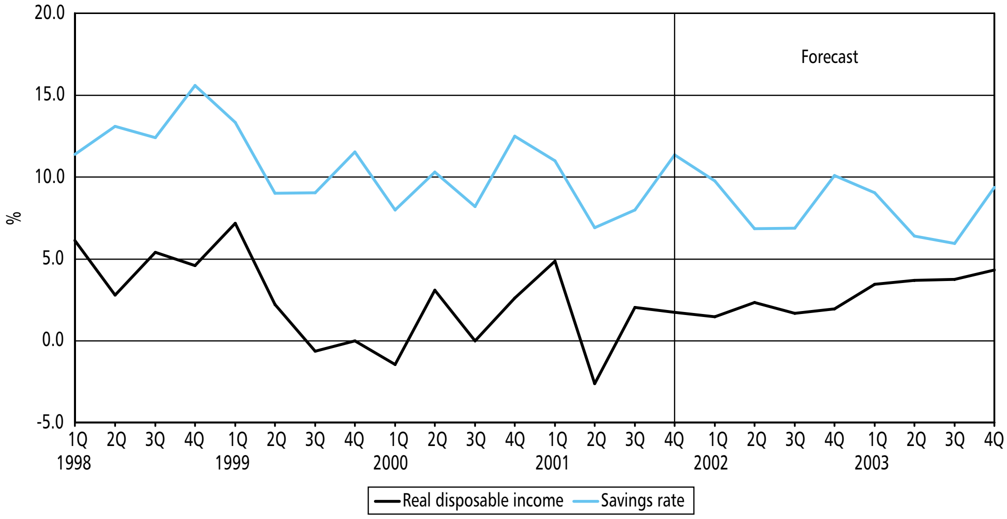
Source: CSO and CASE.
Note: CASE forecasts starting from 4Q01.

Chart 3.2. Contribution to GDP growth, 1996–2003 (%)



Source: CSO and CASE.
Note: CASE forecasts starting from 2001.

Chart 3.3. Change in real household disposable income and savings rate, 1996–2003 (%)



Source: CSO and CASE.
Note: CASE forecasts starting from 4Q01.

strengthen such a trend to some extent, though it may turn out that wealthier people find ways to dodge the taxes. In addition, given moderate income growth and lowering interest rates, we anticipate a fall in the savings rate. Against this background, we see scope for household consumption to remain moderate in 1H02 and then to accelerate.

Up to the end of this year and in the course of 2002 government consumption growth will slow significantly due to the tough budget situation. Despite the widening of the budget deficit next year, expenditures on debt servicing will grow fastest.

The worsening economic conditions in the EU and the stronger zloty in 2H01 will certainly dampen external demand. Consequently, growth in exports will lose steam in 4Q01 and in 1H01. As at the same time imports will accelerate, net exports will gradually cease to contribute positively to GDP growth, although in 2001 as a whole the contribution will be still positive.

Against this backdrop, we forecast GDP growth at 1.7% this year (0.7 percentage points lower than our forecast a quarter ago) and 2.4% next year.

In 2003, household consumption will be the main driving force behind GDP growth. Stronger domestic demand will drive imports higher. As a result in 2003 net exports will increasingly act as a drag on GDP growth. The rebound in exports – due to the expected business cycle in the EU – will not suffice to offset soaring imports.

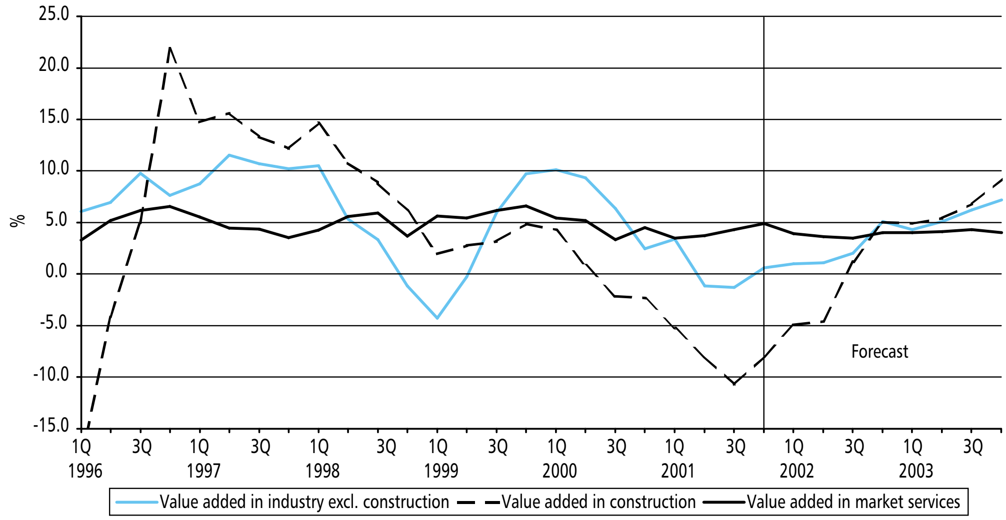
The real sector

The contraction in the real sector in the last two quarters and the revisions of the outlook for 4Q01 and all of 2002 have taken their toll on the forecast of economic activity in industry and construction.

4Q01 will not see the rebound we forecast earlier – the industrial production index will grow only by 0.8% yoy. The lack of a strong recovery in household consumption and investment as well as waning external demand are the underlying factors. In 2002 we forecast only a moderate improvement.

The situation in the construction sector is far bleaker. The cutbacks in building investment will continue to depress the performance of the entire

Chart 3.4. Value added in major sectors of the economy, 1996–2003 (% change, yoy)



Source: CSO and CASE.
Note: CASE forecasts starting from 4Q01.

sector. Any recovery will be possible only in 2H02. A marked improvement will be seen in 2003, ending an almost 2-year recession in the construction sector.

External sector

Rafał Antczak

Exchange rate

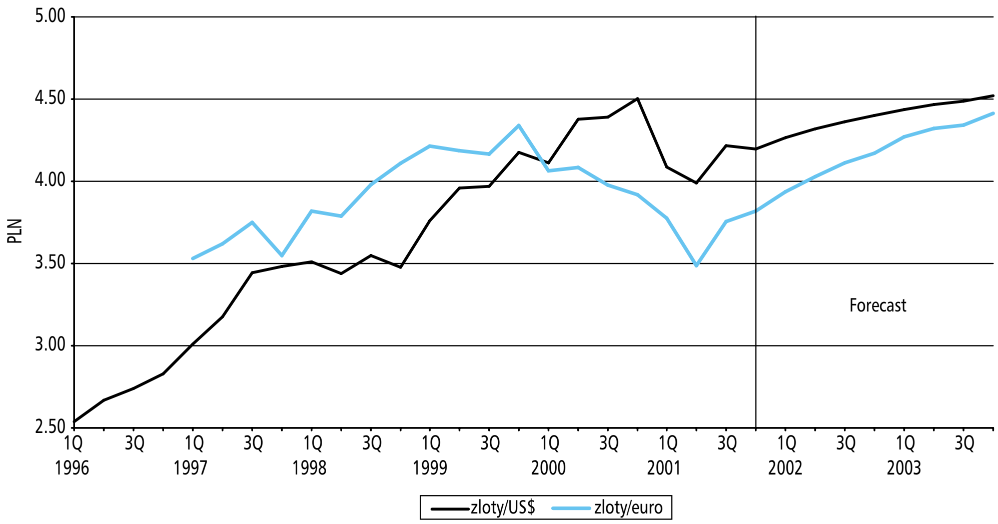
- **Short-term perspective – nominal appreciation**
- **Long-term perspective – increase in currency risk**

In the short-term (4Q01 and 1Q02) the decisive factors influencing the zloty exchange rate will be: investor speculation related to the level of real interest rates, the government's financial needs and how much of this year's privatisation revenues will be realised. A decline in CPI in September-October left real interest rates on Treasury papers at 9–10% on a yearly basis. The market-anticipated cut in the NBP's reference interest rates before end-year has also intensified speculative inflows. On the other hand, there would be an increase in the supply of Treasury papers to finance growth in the budget deficit. The gap depends also on the realisation of privatisation revenues, which, according to the government's plan, were to reach 18 billion zlotys this year. By mid-October privatisation revenues amounted to 6.6 billion zlotys, or 37% of the plan. In the same period of last year the figure was over 130% of the annual plan. Statements from representatives of the government SLD-UP-PSL governing coalition on postponing the privatisation of "strategic" sectors (oil, banks, and insurers), indicate that it will not be feasible to fulfil the annual privatisation plan. This would imply a shortfall of 8–9 billion zlotys in deficit financing in 2001. We expect a nominal appreciation of the zloty until the end of 2001.

The Ministry of Finance's foreign currency deposits from privatisation revenues were equal to 261 million zlotys (set to increase to approximately 4 billion zlotys by end-October), which should satisfy the needs of foreign debt payments until the end of 2001.

Preliminary declarations suggest the budget deficit in 2002 will not to be higher than 40 billion zlotys, from which 10 billion zlotys was to be financed from privatisation revenues and 30 billion

Chart 3.5. Basic exchange rates, 1996–2003 (in zlotys)



Source: NBP and CASE.
Notes: CASE forecasts starting from 4Q01.

zlotys from the issuance of Treasury papers (most probably via issuance abroad in eurobonds). Maintaining the budget deficit at 4–5% of GDP would lead to higher debt and an increase in the debt/GDP ratio to about 48% as early as 2003. Moreover, as 40% of debt is foreign debt, its increase together with an increase in currency risk could lead to a situation in which the limit starts approaching a 50–55% debt/GDP ratio, where, according to the law on public finance, automatic stabilisers are introduced sequestrating budget expenditures. The 60% debt/GDP ratio cannot be surpassed without breaking the respective constitutional stipulations and violating one of the Maastricht criteria.

Łukasz Rawdanowicz

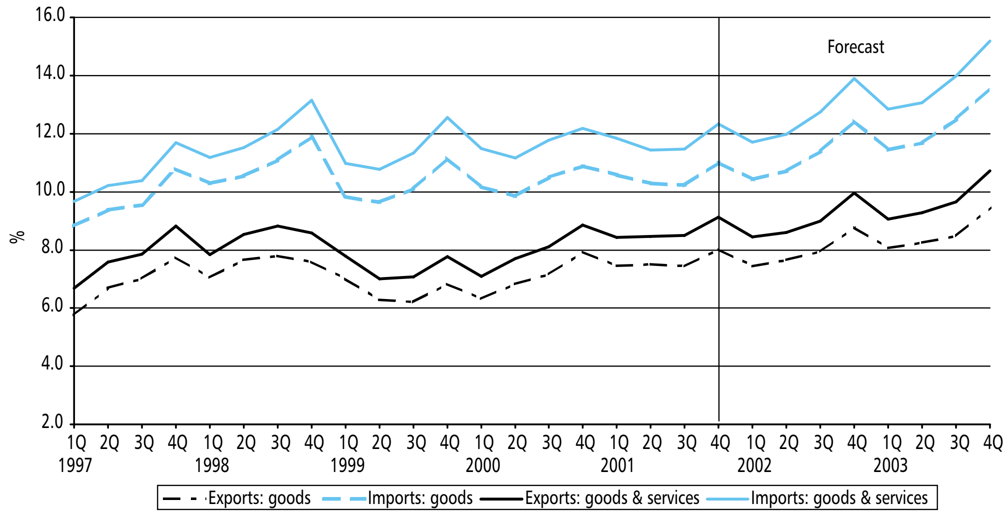
Foreign trade

- **Worse export prospects**
- **Still weak imports**

Due to changes in our growth forecast for 2001 and 2002, as well as amendments to assumptions on the external environment in particular in the EU, we have modified our foreign trade projections accordingly. As far as exports are concerned, corrections for the remainder of 2001 are not substantial. Despite a significant slowdown in the EU in 4Q01, exports will continue to expand, albeit at a slower pace than in 1H01. The crowding-out effect will play a major role here. Still, prospects of a prolonged weakening of EU growth have made us lower our export growth projections for 2002 compared to the previous quarter. Export growth in 2002 will not match the 2001 figure, despite the revival that should be observed in 2H02. A gradual depreciation of the zloty will help exports in 2002. In 2003 external demand is likely to bounce back along with a significant rebound in the EU economy.

The alterations in our import forecasts are more significant than in the case of exports. Contrary to what we previously expected, there will be no improvement in economic performance in 4Q01 and thus the cutback in domestic demand growth, and especially in demand for imports will be more pronounced. A rebound in investment demand that is likely to materialise after mid-2002 and stronger private consumption oblige us to anticipate faster growth in imports in 2002 and 2003.

Chart 3.6. Exports and imports, 1997–2003 (US$ billion)



Source: NBP and CASE.
Note: CASE forecasts starting from 4Q01.

Łukasz Rawdanowicz

Balance of payment

- **Major improvement in the current account balance**
- **Prospects of deterioration in external equilibrium in 2002 and 2003**
- **Lower FDI inflows**

Along with a more pronounced imports adjustment to lower domestic demand and the muted response of exports to a worsening external economic performance, Poland's external position is set to improve significantly in 2001. The current account deficit will shrink to 4.1% of GDP, the lowest figure since 1998.

In the following years, faster growth in domestic demand will lead to a strong upsurge in import demand. Imports are expected to expand stronger than exports, resulting in a deterioration in the trade balance and consequently also in the current account balance. The current account deficit is set to grow in the next two years to 5.7% of GDP in 2003.

On the financial account front, in 2002 FDI inflows are likely to decrease on the back of lower intensity of privatisation processes and a worsening of the political climate (the new government announced that 'there would be no selling-off of national property'). On top of this, weaker growth prospects in 2002 may also discourage FDI inflows.

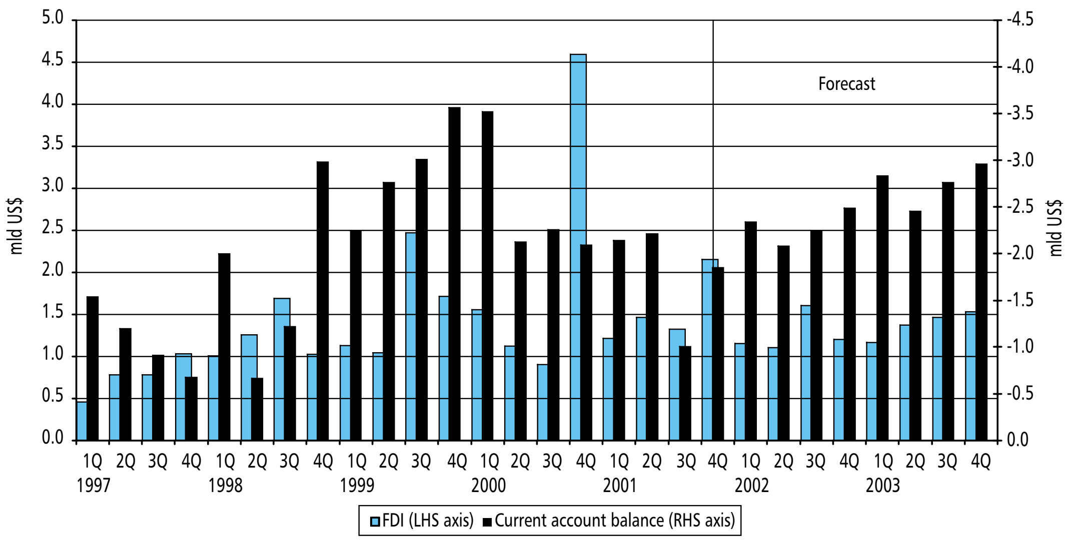
Małgorzata Markiewicz

Public Finances

- **Expenditure cuts or a second revision of the budget at the end of 2001 will be necessary**
- **Transfer of central government imbalances to other public sector entities**

Our previous forecast of public sector balances was based on the assumption that all expenditures planned in the budget law would be executed. However, the government controlled budgetary out-

Chart 3.7. Net FDI and the current account balance, 1997–2003 (US$ billion)



Source: NBP and CASE.
Note: CASE forecasts starting from 4Q01.

lays, in line with received revenues and the budget deficit, were lower than our previous estimations. Our current forecast is based on a different assumption: that budgetary expenditures will be executed at an amount equal to the collected revenues increased by the planned deficit.

In our forecast for 2001 (Appendix 10) we previously presented what the central government deficit would be if expenditures were executed according to the budget law. In this issue we show the financial position resulting from the budget law – expenditures are the adjusting item. Data on the financial results of the other segments of the public sector are taken from the budget draft for 2002. Budget execution means transfer of imbalances to other public sector entities. This approach does not change the general government budget balance in 2001.

The directly forecast variable is revenue. Recorded results for the first nine months of 2001 have led us to correct our projections due to a higher-than-expected fall in CIT revenues and non-tax revenues (official data does not provide information on the sources of drops in non-tax revenues). Corrections in macroeconomic assumptions, mainly in domestic demand, have influenced the budget forecast. In line with our outlook, 2001's budget revenues will be lower than assumed in the revised budget by over 12 billion zlotys.

On October 23 the government decided on expenditure reductions of 8.5 billion zlotys in 2001. The gap between the estimated shortfall in revenues and the planned reduction in expenditures may be partly covered by unused reserves and savings on debt servicing costs. It is possible that further amendment to the budget will be introduced at the end of the year. There are two possible scenarios:

- a second amendment of the budget law undertaken at the end of the year increasing the deficit by about 3.8 billion zlotys. The central government deficit would then be equal to 4.5% of GDP and the economic deficit would rise. This is a rather unlikely solution due to the limited possibilities of increasing debt by this amount in such a short period, especially when the public sector borrowing requirements will grow due to the shortfall in privatisation receipts.
- no budget amendment or revision related only to the payment of outstanding liabilities. In this case, one might expect the central government deficit to equal 29.1 billion zlotys (according to mid-year amendments), expenditures to be limited by 8.5 billion zlotys, and the outstanding shortfall to be transferred to other public sector entities, increasing their debts, or would be shifted to next year. In this case the economic deficit would rise.

The fiscal forecast for 2002 is even more difficult to predict. In line with our projections, central government revenues will be about 142 billion zlotys. Only macroeconomic factors are considered, with the assumption that real GDP growth will be 1.7% in 2001 and 2.4 in 2002. If budget expenditures are planned to equal 183 billion zlotys in 2002 (growth in real terms) this will mean a budget deficit of 40 billion zlotys may be feasible. However, if there is no recovery and if economic growth is below the assumed level the budget would not be executed. The forecast for 2003 is based on the assumption of a stabilisation in expenditures in real terms and a growth in revenues due to an acceleration of economic growth.

Piotr Bujak

Labour market

- **Unemployment at record highs in 4Q01**
- **Unemployment projected to increase further in 2002**

Unemployment

We project strong growth in unemployment in 4Q01 and in the course of 2002 due to labour adjustment processes in enterprises. These processes are driven by low dynamics of demand for goods and services and the weak financial condition of firms. CSO data show increasing numbers of companies announcing further layoffs. In particular, the railway monopoly PKP, national airliner LOT, as well as automotive firms that have found themselves in difficult conditions are planning job cuts. Further labour restructuring is also expected in the mining and steel industries. The downward trend in employment is expected to reverse in 4Q02, when economic activity is projected to rebound. This will help to weaken the trend of rising unemployment. However, demographic pressure will be on the rise in 2002 and the following years.

In 2002–2003, we forecast unemployment growth to slow gradually, though still rising due to the expected only moderate economic growth. Even in the case of a stronger economic rebound, employment growth will be limited by high labour costs. The difficult state of public finances will limit the scope for a reduction in these costs.

Mariusz Jarmużek

Prices

- **Transitory increase in inflation at the beginning of 2002**
- **Acceleration in the PPI**

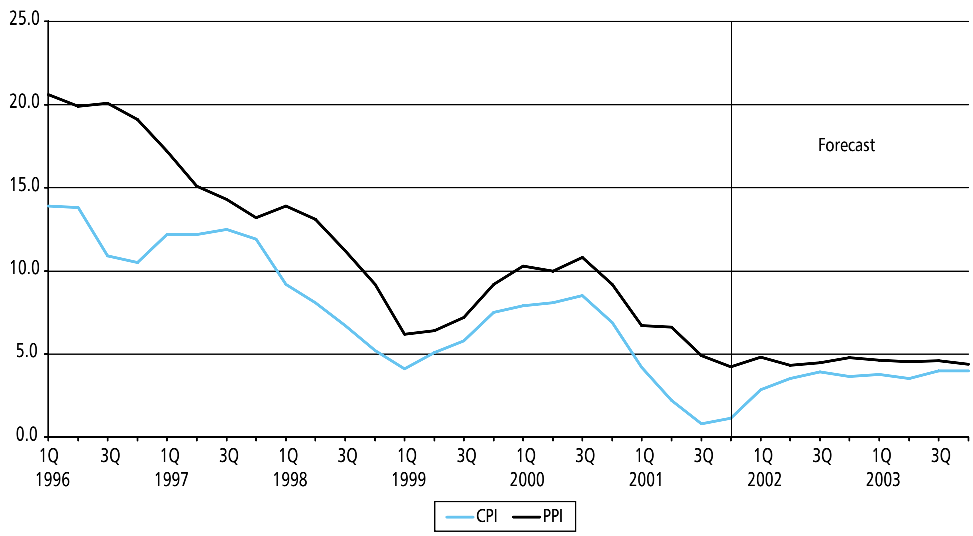
Due to the effect of a low statistical basis, the slow recovery of domestic demand and the gradual depreciation of the zloty we forecast an increase in the annual inflation rate starting in the period November 2001– March 2002. This increase will also be reinforced by factors on the supply side.

In our view, the depreciation of the exchange rate in July and August 2001 cannot be expected to impact proportionally on the inflation rate in 3Q01. Domestic demand remains weak, which rules out any increases in importers' prices equal to the recorded depreciation of the zloty. Moreover, the zloty appreciated at the beginning of October which, in the context of commercial contracts that span several months, suggests a stabilisation of import transaction prices.

We expect monetary policy to be loosened only to a limited degree in the period 2002–2004. This in turn will cause only a moderate increase in monetary aggregates and will contribute to persistent disinflationary pressure on the economy.

Our baseline scenario for the period 2002–2003 assumes a gradual depreciation of the zloty with ref-

Chart 3.8. CPI and PPI, 1996–2003 (% change, yoy)



Source: CSO and CASE.
Note: CASE forecasts starting from 4Q01.

erence to the dollar/euro basket. This should contribute to an increase in import transaction prices (and hence consumer and producer prices) in the context of a forecasted steady revival of domestic demand.

Due to a favourable harvest in 2001 foodstuffs prices are not expected to contribute to inflationary pressure in 2002. Low prices of cereals have triggered increased interest in the expansion of livestock (both swine and cattle). Such developments are expected to neutralise the effect of the currently low levels of livestock, especially of swine. Cereal preserve prices are expected to remain stable in 2002 as a result of high harvests in 2001. Expansion of swine and cattle livestock should prevent substantial increases in meat prices. It is possible, however, that the prices of ground vegetables will pick up in 2002 as the harvests are estimated to be 5% lower yoy. We assume a leap cycle of crops for the period 2002–2003.

The situation in those sectors with administered and quasi-administered prices remains unclear. It is uncertain when exactly the new PGNiG gas tariff will be approved by the URE. December 2001 is the earliest realistic date. The extent and the timing of any future increases in electricity prices also remain unknown. For both price growth rates of 5–6% above inflation are assumed.

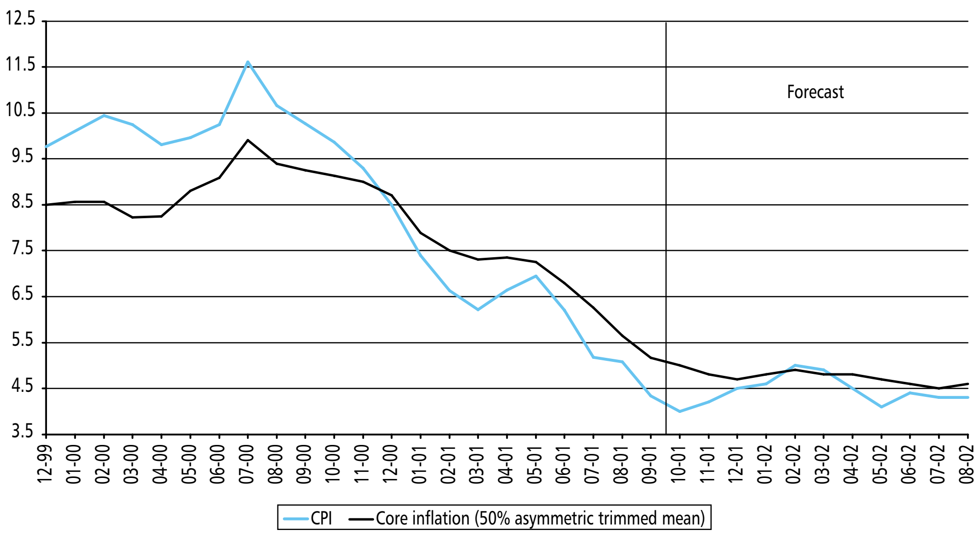
We forecast a marked acceleration in growth in the PPI. In addition to the statistical effect the revival of domestic demand and the depreciation of the zloty in 2002 will play a decisive role.

Przemysław Woźniak

Core inflation

We base our core inflation forecast on the 50% asymmetric trimmed mean, which has proved to have better forecasting properties than the symmetric 30% trimmed mean used by the NBP. In the figure we present the rate of growth of this index along with the rate of growth of the conventional CPI. We predict that during the next several months the trimmed mean will continue to follow a downward trend, albeit if the pace of the decline will be markedly slower than in 2Q01 and 3Q01. We forecast a decrease in the rate of growth of the trimmed mean from about 5% currently down to 4.5% by end-2002. The deviation of the trimmed

Chart 3.9. Core inflation, 1999–2002



Source: CSO and CASE.
Note: CASE forecasts starting from 4Q01.

mean from headline inflation will narrow further as inflationary pressures die out in subsequent sectors of the economy.

We back our expectations of a gradual decrease in core inflation on favourable signals from the market for foodstuffs (good harvests and a stabilisation in the meat market), for fuels and on extensive disinflationary pressures in the tradables market as a consequence of the strong zloty. At the same time we believe that the increase in the growth rate of the CPI that we forecast for early 2002 will not extend to core inflation due to its transitory (mostly statistical) character.

Rafał Antczak

Monetary policy

• Accommodation of loose fiscal policy

The October 150 basis point cut in the NBP's reference interest rates is a compromise between the bold cuts expected by the government and precautionary cuts, that is small reductions in interest rates in the coming months. Under such conditions it is difficult to predict the size of the NBP's reference interest rate cuts. Due to the budget problems we expect one more cut before end-2001 (50–100 basis points) and 150 basis points during 2002, which would result in real interest rates of 6–7% on a yearly basis at end–2002. Over the subsequent several years interest rate cuts should be insignificant with a possibility of increasing them.

A loosening of monetary policy implies an accommodation of lax fiscal policy – the economic deficit in 2002 would be the same or higher than in the current year (4.5–4.7% of GDP). Securatisation of budget debts towards OFE (Open Pensions Funds) should not have negative effects. However, if budget debt payments towards non-budget entities, like pension funds, or budget entities, like the health care sector, become the norm – with the exception of debt expansion (in the case of OFE) – it would result in growth in the money supply by the Ministry of Finance. Such a policy was pursued in Russia during 1996–1997 and ended in the debt crisis of 1998. Besides, abandoning half of the privatisation revenues in 2001 and planned lower revenues from privatisation in 2002 (10 billion zlotys) means an increase in the issuance of Treasury papers on domestic and/or foreign markets. Lower nominal and real interest rates together with the imposition of tax on Poles' capital gains may have negative impacts on the savings rate and demand for Treasury papers, which would lead to borrowing from external sources or from non-residents. This would impact on currency risk.

The document "Assumptions for monetary policy in 2002," published in September 2001, fixes the CPI inflation target at 5% +/-1 percentage point at end-2002. The realisation of the medium-term inflation target at end-2003 (CPI inflation below 4%) and accommodation of loose fiscal policy during 2002 implies the acceptance of a temporary hike in inflation in 2002. Higher uncertainty in realisation of the 2002 inflation target results from external developments (world financial markets), supply factors (prices of oil, foodstuffs) and the degree of public finance sanation. However, the MPC underlines the importance of the medium-term inflation target which has started to serve as an anchor for inflationary expectations. Therefore, without agreement between the government and MPC on the appropriate policy mix, any pressure to revise the medium-term target could have very negative implications.

Early warning crisis indicator

3Q01 saw a worsening of our indicator as compared to 2Q01, pointing to a higher risk of crisis occurrence. Almost all components deteriorated, albeit the scale was moderate. A further weakening in the state of public finances was the most destructive development. We project the central budget deficit to reach 5.1% of GDP in 2002, compared to 4% in 2001.

The behaviour of individual components of the indicator mirrors well the protracted economic slowdown – GDP growth and unemployment prospects deteriorated, while an improvement was recorded in inflation and the current account.

As far as monetary components of the indicator are concerned, inflation moderation was the only positive factor. Credit expansion and Poland's foreign debt increased. The zloty continued its real appreciation in 3Q01, though the pace was slower than in 2Q01 due to some nominal depreciation and lower inflation. The latter led to an increase in the real WIBOR rate.

Table. Early warning crisis indicator

	weights	3Q99	4Q99	1Q00	2Q00	3Q00	4Q00	1Q01	2Q01	2Q01
1. Annual GDP	0.10	6	4	4	4	6	6	4	4	6
2. Annual unemployment rate	0.05	6	10	10	4	6	10	10	4	6
3. Annual average CPI forecasts for 4 consecutive quarters	0.06	10	6	4	4	4	0	0	6	0
4. Government deficit forecast for 2002 as a % of GDP	0.10	5	5	5	5	5	6	6	10	10
5. CA balance forecast for 4 consecutive quarters as a % of GDP	0.15	6	6	10	0	4	4	6	0	4
6. Real effective exchange rate	0.15	0	0	6	6	6	6	10	10	6
7. Credit expansion as a % of M2 (end of quarter)	0.07	4	4	4	6	6	4	4	6	6
8. Polish foreign short term debt as a % of liquid reserves	0.15	6	6	6	10	6	4	4	4	6
9. Total Polish foreign debt as a % of GDP	0.07	6	6	6	6	6	6	6	4	6
10. Real 3M WIBOR	0.10	6	10	4	6	6	6	6	4	6
Indicator		**5.10**	**5.26**	**6.04**	**5.18**	**5.48**	**5.10**	**5.80**	**5.30**	**5.74**

Source: CASE.
Note: The forecast for budget deficit is changed every forth quarter of a year.

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Session III
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