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POLISH ECONOMIC OUTLOOK

TRENDS • ANALYSES • FORECASTS

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Persistent challenges

Moving forward, but slowly

3Q02 saw plenty of speculation on an economic recovery, with each new month bringing more contradictory information on industrial production, exports and retail trade. According to our estimates, GDP growth indeed accelerated (to 1.8%, as opposed to below 1% in the previous quarters), driven by consumption, exports and accumulation of inventories. Investments contracted despite real interest rates on loans to enterprises dropping by close to 3 p.p. since the beginning of 2001. This tends to support the opinion that interest rate reductions have limited impact on capital decisions, as over half of all investments are financed from companies' own resources.

Private consumption has been maintained more by a falling savings rate than by real income growth. We estimate that revenues from self-employment were the main source of income growth. The labour fund kept

Table 1.1. CASE Outlook, 2002–2004

	2000	2001	*2002*	*2003*	*2004*
GDP (change in %)	4.0	1.0	*1.3*	*2.3*	*3.2*
Domestic demand	2.8	-1.9	*0.9* ↗	*2.4* ↘	*4.3*
Individual consumption	2.7	2.1	*3.2* ↗	*2.6* ↘	*3.5*
Investment	2.7	-9.8	*-6.6* ↘	*3.0* ↘	*9.7*
Unemployment rate (%)	15.1	17.5 ↗	*18.3* ↘	*18.2* ↘	*17.3*
CPI (average, %)	10.1	5.5	*2.0* ↘	*1.8* ↘	*2.1*
Trade balance (USD billion)	-13.2	-11.7	*-10.2* ↗	*-11.9* ↗	*-13.6*
Current account balance (USD billion)	-10.0	-7.2 ↘	*-6.8* ↘	*-7.8* ↘	*-9.0*
Current account balance (% GDP)	-6.3	-4.1 ↘	*-3.7* ↘	*-4.0*	*-4.5*
Central budget balance (PLN billion)	-15.4	-32.4	*-43.4* ↘	*-43.3* ↘	*-51.3*
Public sector balance (% GDP)	-2.6	-5.2 ↗	*-7.5* ↘	*-7.6* ↘	-
Exchange rate (average)					
PLN/USD	4.35	4.09	*4.09* ↘	*4.03* ↘	*4.15*
PLN/Euro	4.01	3.67	*3.86*	*4.00* ↘	*4.17*
Broad money supply M3 (change in %)	11.3	9.2	*-1.1* ↘	*4.6* ↘	*4.1*
Interest rate of NBP (28-day reference rate)	19.00	11.50	*6.50* ↘	*5.50* ↘	*4.25*
WIBOR 3M	19.61	12.30 ↘	*7.30* ↘	*6.51* ↘	*4.86*

Source: Data – CSO, NBP, forecasts – CASE.
Note: Arrows point the direction of changes compared with the previous outlook.

falling – employment reductions have been faster than growth in the average wage. Moreover, as the indexation rate for social transfers is close to zero they have run out of momentum somewhat.

Higher imports, stimulated by consumption and foreign demand, were heavily offset by strong exports. This was largely due to good performance in Central and Eastern Europe and non-EU developed countries.

In 4Q02, we expect continuation of the above trends: strong household demand, accumulation of inventories and stable exports. We have upheld our previous forecast of GDP growth in 2002 of 1.3%.

Perspectives for 2003 and 2004 are slightly better. Up to mid-2003 consumption demand and net exports are likely to be the main engines of growth, with investments then taking over. We forecast private consumption to grow more slowly in 2003 than in 2002, despite income dynamics slightly accelerating. To date, household consumption has been largely immune to signals of economic slowdown and increasing unemployment. We estimate further, that the possibilities for further consumption growth at the cost of a lower savings rate will be small. If foreign demand trends remain stable in 2003 (weak demand from the EU compensated by higher orders from Poland's eastern neighbours) maintaining current export dynamics is realistic. Imports, on the back of higher demand, are expected to grow even faster, with net exports ceasing to contribute positively to GDP growth. This would deepen the current account deficit, however it is expected to oscillate around moderate level of 4% of GDP. We maintain our previous forecast of 2.3% GDP growth for 2003.

Further investment recovery and acceleration of consumption are forecast to lead to an acceleration of domestic demand in 2004. Growth in capital expenditures should result from domestic factors such as higher profitability of enterprises, improvement in economic sentiment and lower interest rates. The impact of structural funds from the EU will not most likely be observed in the first year after accession (assuming that to be 2004) due to high requirement procedures attached to using the funds. An inevitable growth in imports is expected to weaken the effect of stronger domestic demand and exports, and GDP growth would be moderate (3.2%).

The big unknown is the PLN exchange rate against US$ and euro (we maintain our forecast of the dollar-euro exchange rate fluctuating around parity: 1:1). The economy's macroeconomic fundamentals are good and any problems (e.g. with fiscal policy) have been pinpointed and are being monitored by the financial markets. It is speculative factors that are expected to play the key role, in particular during Poland's accession to the EU. They could put continuous pressure on a nominal appreciation of the zloty. Such trends were observed in all previous candidate countries in the process of joining the EC/EU, either in the run up to or directly after accession. In our forecasts, we expect nominal zloty appreciation in the next three quarters and further cuts in interest rates.

How much depends on EU membership?

Our limited optimism on economic growth over the next two years stems from structural features of the economy. As we outlined in our previous outlook, there are many micro- and macroeconomic question marks in Poland that undermine the possibility of achieving dynamic and stable growth. Firstly, the public sector – less profitable than the private sector – still plays an important role in the economy: in terms of employment (nearly 50% of employees in enterprises with over 9 persons), and sales (25% among enterprises with over 49 employees). Government policy has been doing little to radically change this. Secondly, privatisation has become got bogged down in the search for strategic, sector-based, solutions (in the case of steel, mining and energy) and facing opposition from a strong anti-privatisation lobby. Budgetary units tolerate growing tax arrears accumulated by inefficient sectors, thus de facto widening inequalities in the tax burden among enterprises. Another problem is the labour market. The president recently signed into law various, largely cosmetic, changes to the Labour Code. Further revisions are not likely in the near future. High unemployment mainly reflects structural unemployment, which cannot be absorbed through cyclical recovery (see, *The natural rate of unemployment in Poland*...). This will remain an important barrier for demand growth, as well as a burden on the budget (either through unemployment benefits or social assistance).

The key macroeconomic problem is the budget. First up, there are doubts about this year's deficit again.

Budget revenues slowed in 3Q02, and this could lead to a gap of around PLN 3.4 billion by the end of the year. This gap could hit PLN 4.6 billion in 2003, as we forecast GDP growth at a lower level than has been assumed in the budget law. There are also several doubtful items on the revenue side (e.g. restructuring fees). However, even if shifts in 2003 budget expenditures (for example, to the following year or outside the central budget) may provide some relief, the situation in public finances in 2004 is expected to be far more serious. New EU-membership expenditures, as well as expenditures put off from previous years, may push the budget deficit up to around 6% of GDP. Poland would then fail to meet the last Maastricht convergence criteria (it has met the other three criteria: inflation, public debt and long-term interest rates). Given that a budget deficit of below 3% of GDP will be crucial at the moment of entering ERM-2 (planned for 2006), already now Poland is bearing the costs of fiscal imbalances. A strengthening of the crowding out effect is also visible and the structure of budget expenditures is worrying. Administrative expenses and subsidies to two public pension funds crowd out education expenditures and investments, for example, which is not conducive to creating favourable conditions for economic growth. The high share of fixed expenditures, furthermore, and limited determination of the government does not engender great hope for rapid changes in this area in the near future.

For Poland to join the EU on time (that is, in 2004) it has to pass through several stages, many of which are already behind us. The next stages (final negotiations, the Polish referendum and ratification of the agreements in the EU member parliaments) are not easy, though do not appear to be a threat to the accession timeframe. Instead, we foresee a problem that goes beyond the horizon of the nearest few quarters: the effectiveness and competitiveness of the Polish economy within the EU. Most of the key factors here lie in the sphere of fiscal policy. Aside from the poor prospects of transforming what is essentially a socio-administrative budget into a pro-development budget, attempts are underway in fact to fix high fiscal imbalances over a much longer perspective. Poland's finance minister at the ECOFIN forum (finance ministers meeting in Brussels) already now proposed changes to fiscal discipline – „averaging" budget deficits within the EU. This reveals an underlying attempts at fiscal loosening. The fact that several countries have already broken the Stability and Growth Pact this year in respect to budget deficits only serves to underpin this rhetoric. Moreover, EU directives aimed at liberalisation are often ignored. An example is the situation on the energy and telecom markets, and state aid. Such lack of discipline does nothing to push decisions on structural reforms in Poland. In this context, Poland's domestic micro- and macroeconomic policy is of crucial importance, both before and after EU accession. EU membership and the inflow of structural funds will never compensate for lack of responsible policies, which should be creating the fundamentals for stable growth.

Economy in 3Q02

Economic growth

Katarzyna Piętka

GDP and demand factors

• Slow recovery of domestic demand

Official figures on GDP growth in 2Q02 show we hadn't been far out in our earlier estimation (0.8% compared with our 1.0% estimate). While on the positive side, both domestic demand and exports appeared to grow faster, these were offset by high imports. Household consumption continued to grow strongly, public consumption was stable and inventories built up.

We estimate an acceleration of GDP growth to 1.8% in 3Q02. According to our estimates, the real dynamics of household incomes were slightly lower than in the previous quarter. Nevertheless, we see household consumption growing faster, on the back of an again falling yoy savings rate. This lower savings rate reflects a reduction in net banking deposits. During 3Q02 households withdrew deposits of PLN 2.8 billion, while the stock of credits increased by PLN 2.8 billion. On the other hand, we estimate that the increase in savings outside of the banking sector was higher (including investments in private building). This did not, however, compensate for the drop in net monetary savings.

According to our estimate, investments dropped in 3Q02 by over 6%, which means a small improvement. The most downward trend was registered in building investments, which were however partly offset by a dynamic growth in individual housing (over 20%). Registered growth in machinery and transportation imports, as well as their domestic production, indicates that purchases of these investment goods stopped falling. However, the substantial increase in production of machinery and transportation may not be entirely related to investments, since as the exports of these goods were rising steeply as well. There was a moderate improvement in enterprises' financial results, which we believe should also indicate less negative dynamics in investments. Net credits for enterprises, however, grew less than in 3Q01 (by PLN 0.7 billion compared with PLN 1.1 billion).

We also observed an increase in inventories – due to the good harvest and higher turnover in retail sales. This meant that total accumulation fell less than in the previous quarter.

Our pessimism about export potential turned out to be premature. We estimate export volume dynamics at a level of 6.1% in 3Q02. Enterprises faced with poor economic performance in the EU are effectively using growth in Central and Eastern Europe. Higher exports led, however, to higher imports. Moreover, higher domestic demand is also pushing import growth. Despite this, net exports fell in real terms and contributed positively to GDP growth.

Katarzyna Piętka

Real sector

- **Growth in industrial production**
- **Smaller falls in construction**

In 3Q02, manufacturing sales grew for the first time in many months. This growth was enough to cover falls in mining and energy, and kept overall industrial production growing. A clear majority of manufacturing sectors registered higher sales. Falls were experienced in tobacco manufacturing (tobacco exports plummeted drastically in 3Q02), coke and petroleum products, as well as the production of specialised equipment (like medical and precision instruments, or transport equipment other than vehicles and trolleys).

Dynamic growth in individual housing has been taking place in parallel to falls in other investments in buildings. As a result, we estimate that drops in overall construction sales were deeper than the figures for companies with over 9 employees indicated.

According to our estimates, growth in value added in market services accelerated to 4.1% in 3Q02. This was reflected in higher of retail and wholesale turnover. Volumes of goods transportation were also on the rise. The number of new telecom lines increased quite rapidly. On the other hand, however, passenger transportation and other market services were contributing negatively to the overall growth in services.

Since the beginning of the year, net indirect taxes have been falling in real terms or growing negligibly. At the same time, they have been increasing in nominal terms dynamically (especially in 2Q02), and this was in line with actual budget revenues. As a consequence, the indirect tax burden over value added increased. This is most likely the result of rising excise and VAT rates on some goods at the beginning of the year, as well as a one-off effect of extending the VAT repayment period (described in the previous issue of PEO). We estimate that the indirect tax deflator was not as high as in the previous quarter. This, together with less dynamic budget revenues from indirect taxes, brought about the same level of net indirect taxes in real terms. This means that with gross value added growing by 1.9%, GDP increased by 1.8%.

Anna Myślińska

Enterprise finances

- **Improved sales results, but gross financial results still weak**
- **Decrease in loans for big enterprises**

2Q02 was the third quarter in a row to see a yoy improvement in financial results from the sale of the products, goods and materials in enterprises employing over 49 people. The results, though, are still lower (in nominal terms) than two years ago. This recovery stems from a slight reduction in costs, accompanied by stable revenues. Over half of the financial results (profits minus losses) are from the manufacturing sector. The biggest rate of increase in the financial results was achieved in trade. Construction made a small loss.

Gross financial results of enterprises were exceptionally low in 2Q02, amounting to PLN 1.8 billion, or almost two and a half times less than in 1Q02 and over two times less than in 2Q01. The difference between financial results from sales and gross financial results has increased drastically (qoq as well as yoy). In other words, results from other operating activity, on financial operations and extraordinary events have significantly worsened. This may have been caused either by an exceptionally difficult financial situation in 2Q02 (the need to sell non-financial fixed assets at a loss, receivables written-off as a result of bankruptcy procedures, paying off expensive loans, foreign exchange losses incurred because of unexpected for many firms strengthening of the zloty) or by creative accounting. Following the decline in gross results, net financial results decreased, dropping below zero. Surprisingly enough, the share of profitable enterprises (in terms of net profits) in all enterprises increased to 57.4% (in comparison with 54.7% in 2Q01 and 52.4% in 1Q02). This can be explained by the remarkable asymmetry in ownership structure. The private sector[1], consisting of numerous small firms, achieved almost PLN 1 billion in profits, whereas the public sector showed losses amounting to over PLN 1 billion.

The profitability rate of gross turnover increased in comparison with 2Q01, though was still lower than in 1Q02, mainly due to weakened indicators in the public sector (0.3%). The private sector saw a slight decrease in profitability (to 1.8% from 2.1% in 1Q02). Poorer profitability in the public sector is connected with the dramatic decline of sold industrial production (1H02 was 20% worse yoy). Despite worsening indicators, the public sector continues to have a higher rate of wage growth than the private sector.

Big enterprises surveyed by the CSO (Central Statistical Office) significantly decreased their demand for loans in 2Q02. Any decline in loans (and one as big as this – by 2.3% qoq) has not been seen for a long time. The behaviour of small enterprises was quite different. NBP data (covering loans extended to all enterprises) show a yoy increase in loans (2.6%) as well as a seasonal rise (4.8% percent qoq). However, analysis of the NBP data can indicate a degree of entrepreneurs' wariness – deposits made by firms were growing considerably faster (both the increase and growth rate were bigger). As a result, net credits declined. Foreign loans continued to rise briskly – trade credits as well as loans incurred by sectors other than government and banks increased. Enterprises seem to be looking for cheaper, non-domestic, sources of financing.

One should expect 3Q02 indicators, soon to be published by the CSO, to show a slight improvement in the financial state of enterprises. This expectation stems from the observation of falling wage bill on the one hand, and increasing production sold in industry accompanied by a rise in production prices, on the other. Increases in business trends indicators noted by the CSO in 3Q02 would also appear to point towards recovery. Overall, the economic climate appears to be far more favourable, even in construction.

Mateusz Walewski

Labour market

- **Unemployment growth slows**
- **Lower pace of heavy industry restructuring**
- **Stable real wages**

Unemployment

At the end of 3Q02, the number of unemployed was 3,112,600 – 21,700 more than at the end of 2Q02 and 192,200 more than at the same time in 2001. The unemployment rate reached 17.6% – that is 1.3 p.p. more than a year ago. However, although unemployment is still increasing, plenty of signals appear to indicate an upcoming – albeit slight – improvement on the labour market. Above all, the rate of growth in unemployment is decreasing: in September 2001 there were 391,600 more unemployed than in September 2000; while in September 2002 the number of unemployed was only 192,000 more than in September 2001. This falling rate began in 2Q02 and continued in 3Q02, suggesting it may be sustainable.

The weakening rate of unemployment growth is mainly influenced by increased numbers of people quitting the unemployment register, a process that had already started in 1Q02. The number of job offers is also increasing. On average during 3Q02 there were as many as 23% more job offers than in 3Q01. The average quarterly numbers of people signing on as unemployed has been stable for the last two years.

[1] The public sector is comprised of state and local government administration enterprises. The private sector consists of privately owned units, both domestic and foreign. In the case of enterprises with "mixed" ownership the dominance of either private of public stakes is the key determining criterion for statistical classification purposes.

The number of unemployed who lost jobs due to group dismissals is also decreasing, though not by much. However, this – combined with the decreasing number of group dismissals planned by enterprises – may indicate that this positive trend will continue.

There are no clear effects yet of the government's program „A First Job”. The number of graduates signing on at labour offices has stabilised at about 150,000 every month.

President Kwaśniewski in August 2002 signed into law the amendments to the Labour Code that had been voted by Parliament in July. Some of the amendments come into force as early as November 2002, the rest at the start of 2003. The majority of the changes are aimed at loosening regulations governing work schedules, decreasing the administrative burden for enterprises with less than 20 employees and expanding the possibilities of using fixed-term employment contracts. These are all good news for advocates of increased labour market elasticity as they cut some red tape surrounding the employment process, especially for small enterprises.

Doubts have been raised, however, as to the amended rules for defining employment relationships. The changes were designed to limit the possibilities of using Civil Code agreements instead of employment contracts. From the legal point of view, definitions of labour relationships were not changed in the amendments. The rule making employers not obliged to pay for employees' first day of sick leave if the leave is shorter than 7 days may simply become ineffective. Some have expressed serious doubts, also, on the new rule obligating employers to grant a 4-day „emergency leave” to employees even if they have applied for it on the same day as the leave starts. The large number of such sick leaves may paralyse the work of some enterprises, especially smaller ones.

The results of the 2002 Labour Force Survey (LFS) partially confirm the positive trends observed on the labour market in 3Q02. According to the LFS, the number of unemployed in 2Q02 was 3,432,000 – 224,000 more than in 2Q01. This indicates less dynamic unemployment growth – in the analogous period of 2001 the number of unemployed increased by 383,000. According to the LFS, unemployment in 2Q02 stood at 19.9%.

Employment

The widely held expectation that the situation on the labour market will improve is based on a weakening of falling employment trends over the last 6 months. This weakening is partially the result of a decrease in the pace of restructuring in heavy industry and mining. Since the beginning of 2002, employment in metallurgy and mining has fallen by 3,000 in each. In the analogous period of 2001, employment cuts were, respectively, 12,000 and 7,000 and, in 2000, 18,000 and 16,000.

Employment has risen more dynamically in the trade and repairs sectors. It has also risen (though less strongly) in real estate services and business services. Falling employment in the communal services has been stopped. Employment in construction is still declining. This results from poor trends in the sector. Employment in construction at the end of 3Q02 was 53,000 (or 11%) lower than a year earlier.

Unlike the data on registered unemployment for 3Q02, LFS data for 2Q02 do not indicate any increase in labour demand. The number of employed is decreasing faster in 2002 than in 2001. In 2Q02, the number of employed was 13,821,000 – 431,000 less than a year earlier. This decline is bigger than in 2001, when it was only 266,000. Consequently, the activity rate (that is the share of employed and unemployed in the total population over the age of 15) is also decreasing. In 2Q02, the activity rate was only 55.6%, more than 1 p.p. less than a year earlier. The activity rate decrease in 2002 is the highest for the last 3 years. This may indicate that improvements on the labour market that are based on data on registered unemployment may be partially the result of disincentives for the unemployed to look for work, and quitting the register.

Wages

The downward trend of nominal wages is stable. In 3Q02 the annual increase in nominal wages reached on average 3.6%. This lower increase is not as big as the decrease in inflation, which means that the increase in real wages has stabilised at an annual rate of 1.9% since the beginning of the current year.

Mining has one of the highest wage growth trends. This is a further reflection of the restructuring slowdown in the sector. The average wage for the first nine months of 2002 was 7.1% higher than in the analogous period of 2001. The average wage in the entire enterprise sector grew in the same period by only 4.1% and in manufacturing by 3.6%.

Prices

Mariusz Jarmużek

Main price indices

• Stable disinflationary factors

In 3Q02, the CPI dynamics continued to decline, whereas the PPI slightly accelerated. This was due to still weak domestic demand and favourable supply factors.

In 3Q02 the depreciation of the zloty against the basket comprising the dollar and euro (inflationary pressure) was compensated by a continued output gap (deflationary pressure), which did not allow for an adequate response from domestic prices to the change in the exchange rate. It should also be stressed that both PPI and CPI dynamics have reached similar levels, which could be related to lower profit margins and lack of pressure on the CPI. Nominal wages dynamics remained at a low level, indicating lack of wage pressure in the economy. This stemmed from the situation on the labour market.

There were no monetary-driven inflationary impulses in 3Q02. The majority of supply factors in fact had a disinflationary effect. This year's harvests are estimated at a similar level to previous years. And this, along with inventories from the past few years, allowed oversupply to build up. A similar situation was seen on the meat market, where retail prices did not alter over the analysed period. Lower cost-pushing factors – and the decline in inflationary expectations related to it – were also supported by energy prices, which rose by 6.5% yoy. This was substantially less than previously assumed by the Energy Regulatory Office. Crude oil prices experienced an upward trend and oscillated in the range assumed by OPEC. This was reflected in domestic fuel prices, which slightly increased in September.

The PPI rose slightly in comparison with 2Q02. This was partially the result of zloty weakening against the basket by 7%. However, the unclosed output gap, along with increasing competition on the domestic market, created a situation in which depreciation of the domestic currency was only partially passed on to prices. The main factors behind the increase in prices remained rises in sectors such as electricity, gas and water supply and to a lesser extent than in the past, mining and quarrying. Prices in the former sector increased by 6.9%, a lot more than the aggregated index. This reflected the ineffective structure of the economy where monopolies distort production costs.

Katarzyna Zawalińska

Agricultural commodity prices

• Surprisingly low prices of agricultural commodities

In 3Q02, prices of the most important agricultural commodities were substantially lower than the June forecasts made by CSO and the previous month's average (procurement wheat prices were 8.4% lower, rye 14% lower, beef 3% lower and pork prices stayed unchanged, though they usually seasonally increase in 3Q02).

Grain surpluses continued – total supply of grain in the 2001/2002 season amounted to 30.3 million tons (against total domestic consumption of 26.6 million tons). The surplus was also 2.4 million tons larger than in the previous season. Thus, grain imports were very limited in 2002, amounting to only 840,000 tons, what resulted also from low domestic grain prices (relative to foreign markets). As a result, the current season began with increased opening stock (for the first time in two years), which in July was estimated at 3.6 million tons, i.e. 1 million tons higher than in the previous season.

Crops in 2002 were 0.6% lower than in 2001, though, due to the increase in opening stocks, total domestic supply in the 2002/2003 season may yet stay at a similar level to last season or may even grow – it is estimated to come in at 30.0–30.5 million tons. Despite expectations for higher demand this season (domestic consumption is estimated at 27.6 million tons) grain surpluses are likely to remain. Grain imports are estimated at between 0.9 to 1.4 million tons, higher than last season's. This results from the high level of European export surpluses and comparative prices that don't tend to favour Poland. The level of grain procurement prices in Poland and the EU set for 2002, added to the current euro exchange rate, means that grain imports are more profitable not only within quota-free agreements, but also within the WTO contingent with 25% tariff rate *ad valorem*.

Increasing profitability of swine production (due to low feed prices) triggered an upward trend in hog production – in July its level increased by 9.4% yoy – which caused an increase in already high surpluses of pork. In 3Q02 downward pressure on the price was stopped thanks to seasonal decline in its supply. It is expected that the falling pork price trend that started at the beginning of this year will continue due to the further expected increase in hog production in 2H02 (the annual rate of increase is estimated at 10%) and the positive balance of pork trade (the first for seven years). According to CSO, pork prices in 4Q02 will decline on average by about 4.6% compared to 3Q02.

Beef prices have been quite stable for a longer time, though declined in 3Q02 – by a negligible 3%. This despite CSO's announcement that consumer confidence in beef had been restored, and despite growing exports (in 1H02 exports were twice as high as in 1H01). The reason behind the fall in beef prices, however, was the sale of stocks accumulated by the Agricultural Market Agency (ARR). In 4Q02, beef prices should stay at a similar level, or may increase insignificantly (by up to 20 groszy) over their level in 3Q02, assuming exports are further supported by the actions of ARR and demand remains weak.

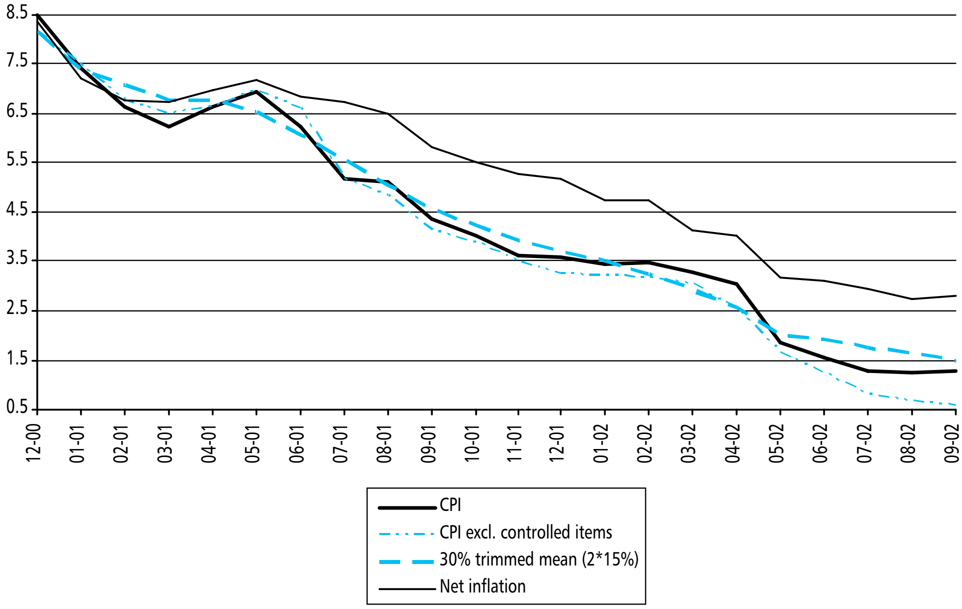
Przemysław Woźniak

Core inflation

The core inflation trends that were observable during the proceeding few months continued in 3Q02. All NBP-calculated indices fell sharply, while the alignment of most core series against the headline inflation series remained unchanged. Net inflation (calculated without the prices of food and energy) still significantly exceeds headline inflation, however, the distance between both inflation measures rose a few months ago to stabilise recently at a relatively high level of about 1.5 p.p. This indicates that food and energy jointly continue to constitute a strong disinflationary factor. In the case of the food aggregate, disinflationary pressure stemmed mainly from falling prices of staple food products: flour (a 5.4% drop on an annual basis in September), meat (5.3%), vegetables (5.5%) and sugar (10%). Overall, in September 2002, the total food aggregate was 2.2% cheaper than last year (in October 2002 – 2.1% cheaper), which, considering its 30% share of total consumption basket, translates into a significant lowering of the headline inflation trend. The outlook is different for fuels' prices which are also eliminated from the net inflation index. For several months now, prices of fuel have been gradually rising, contributing to the reversal of the annual trends. August 2002 saw positive annual fuel price moves for the first time since February 2001. Recent data confirm this trend – since September fuel price inflation has exceeded headline inflation (in October annual fuel price growth amounted to 4.1% vs. 1.1% CPI growth). In the near future this tendency is likely to narrow the distance between the net and headline inflation measures. With low food prices prevailing, this will amount to lowering disinflationary pressures from the 'food and fuel' aggregate.

Administered prices registered on average higher price dynamics than the general price level. This is reflected in the lower (compared to headline inflation) annual dynamics of core inflation excluding administratively controlled prices, which fell to a record low level of a mere 0.5% in September. For a couple of months now we have been observing a widening of the deviation between the two inflation measures, suggesting a stronger role being played by controlled

Chart 2.1. Core inflation, 2001–2002 (% changes, yoy)



Source: CSO, NBP, and CASE.

prices on inflation. In this sector, the biggest price hikes (as of September) were registered by electricity and gas (annual price growth of over 6%), hot water supply (over 7.9%), as well as public tv and radio subscription fees (11.9%) and state administration fees (20.6%). Prices of telecommunication services remained at an unchanged level against 2001. Over the next couple of months the growth of prices of controlled goods is likely to be dampened by a cut in the rate of the alcohol excise tax. This should contribute to a slowing of alcohol price dynamics and, consequently, impact on the price dynamics of the entire aggregate of controlled items.

The 15% trimmed mean performs best in filtering out reversible shocks that destabilise headline inflation (see chart 2.1). The two indices have been running roughly parallel for the past 12 months, which suggests that disinflationary processes encompass many sectors and are relatively comprehensive. Recent months have not brought about any changes with respect to the nature of disinflation, leading us to predict that the trimmed mean and headline inflation will exhibit similar trends in future months.

Strong disinflationary tendencies present in the economy are also confirmed by the remaining two core inflation measures calculated by the NBP: core inflation excluding the most volatile prices as well as core inflation excluding the most volatile prices and the price of fuel (not represented in the chart). Both measures indicate developments for the most stable (exhibiting lowest price variance) groups of consumer goods. In line with other core inflation indices, these two series have pointed to consistent disinflation stretching beyond sectors prone to supply shocks for several months now.

External sector

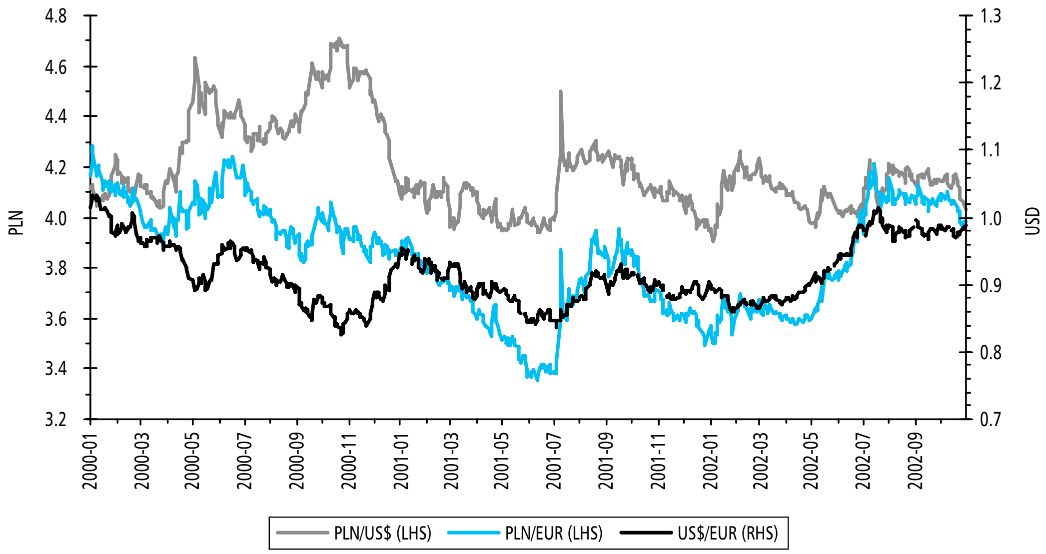
Rafał Antczak

Exchange rates

- **Quarterly weakening of the zloty**

During 3Q02, the zloty weakened on average by 2.6% against the dollar and by almost 10% against

Chart 2.2. Exchange rates, 2000–2002



Sources: NBP.

the euro (by 7% against the currency basket). Depreciation against the euro also took place on yearly basis (5.1% at end-September), but the zloty still strengthened against the dollar (appreciating by 2.1% in end-September). The weakening during 3Q02 to maximum level of 4.23 PLN/US$ and 4.18 PLN/euro (on July 9) resulted from the change of finance minister and speculation surrounding the plans of new minister, Grzegorz Kołodko. After this period, the zloty's exchange rate revealed fluctuations in the range of 4.02–4.21 against the dollar and 3.95–4.21 against the euro.

Zloty fluctuations during 3Q02 were also affected by minor changes in dollar-euro exchange rates in the range of 0.96–1.01, or by 4.5%. Stabilization of the euro against the dollar around parity was in line with our expectations.

The cuts in the NBP's interest rates by a combined 100 basis points during 3Q02, with inflation unchanged, led to lower real interest rates (to around 6%). However, this did not stem the inflow of portfolio capital, whose net balance amounted to US$ 571 million (US$ 2.4 billion from the beginning of the year). Investors were mostly attracted by Treasury papers, and investments amounted to US$ 1.1 billion in 3Q02 (US$ 3.7 billion from the beginning of 2002, which resulted in an over 170% increase against the same period of 2001). The foreign sale of Polish government T-bills for US$ 400 million in September was responsible for the one-third leap in portfolio investments during 3Q02. There was, however, a drop in investments in stocks, whose balance was almost US$ 250 million lower in 3Q02 than in 2Q02 (and US$ 585 million lower than at the beginning of 2002). The strong inflow of portfolio investment was accompanied by negligible privatization revenues and a decline in FDIs, whose total amount was down from US$ 4.1 billion to US$ 2.5 billion after three quarters of 2001 and 2002, respectively. The surplus in the balance of other investments resulted from a strong decline in Polish receivables abroad, mostly cash and deposits, by US$ 2.1 billion in 3Q02 (by US$ 2.8 from the beginning of the year) and also decline in Polish payables abroad (respectively, by US$ 567 million and US$ 1.1 billion). In the latter case, this was a result of repayment of capital to the Paris Club of US$ 603 million. Withdrawal of deposits from banks abroad may reflect a decline in exchange rate risk in the eyes of domestic financial institutions. As a result, the capital and financial balance totalled US$ 2.7 billion in 3Q02, which, with a current account deficit of US$ 913 billion (and small deficit in errors and omissions), increased the NBP's reserve assets by US$ 1.1 billion to US$ 29.3 billion.

Macroeconomic data have not had a sustained effect on the forex market and the zloty exchange rate, as neither have significantly differed from average market expectations or were unclear, as was the case in the flux of data on monthly industrial production. The most significant were political factors, which strongly influenced the zloty exchange rate both at the beginning of 3Q02 and 4Q02.

Łukasz Rawdanowicz

Foreign trade

- **Positive developments in exports**
- **Higher exports to CEECs**
- **Favourable terms of trade sustained**

The currently available data point to sustained positive trends in Polish exports. According to the balance of payments data, the annual pace of growth in nominal exports accelerated from 6.3% in 2Q02 to 16.7% in 3Q02. In addition, in 2Q02, the volume of exports (based on customs statistics) and real growth in exports (according to the national accounts definition, covering goods and services), recorded high rates of growth – significantly higher than we expected. This situation indicates that Polish exporters have managed to maintain their competitiveness and position on foreign markets. This took place in spite of rather weak demand in the EU – Poland's main trading partner. Having said that, two facts should be noted. First, changes in the zloty exchange rate were conducive to growth in exports. In 2Q02 and 3Q02 the zloty's real effective exchange rate depreciated on an annual basis. This stemmed not only from the nominal depreciation of the zloty against the euro (and in 2Q02 also against the dollar), but also from a significant slowdown in inflation in Poland – the CPI was lower than in the euro zone. Second, the increase in the volume of exports in 1H02 was mainly driven by trade with CEECs, in particular Russia, Ukraine as well as the Czech Republic. Although the share of exports to CEECs in total turnover is not very high (below 20% of total exports, against approximately 70% in the case of exports to the EU), the rapid growth took its toll on the growth in total exports.

It should be stressed that growth in exports to particular EU members was uneven across the board. In January-August nominal exports to Sweden, Denmark and France increased on an annual basis substantially, whereas exports to Germany remained almost unchanged and to Italy actually declined. This picture is consistent pretty well with the differences in the pace of growth among EU members.

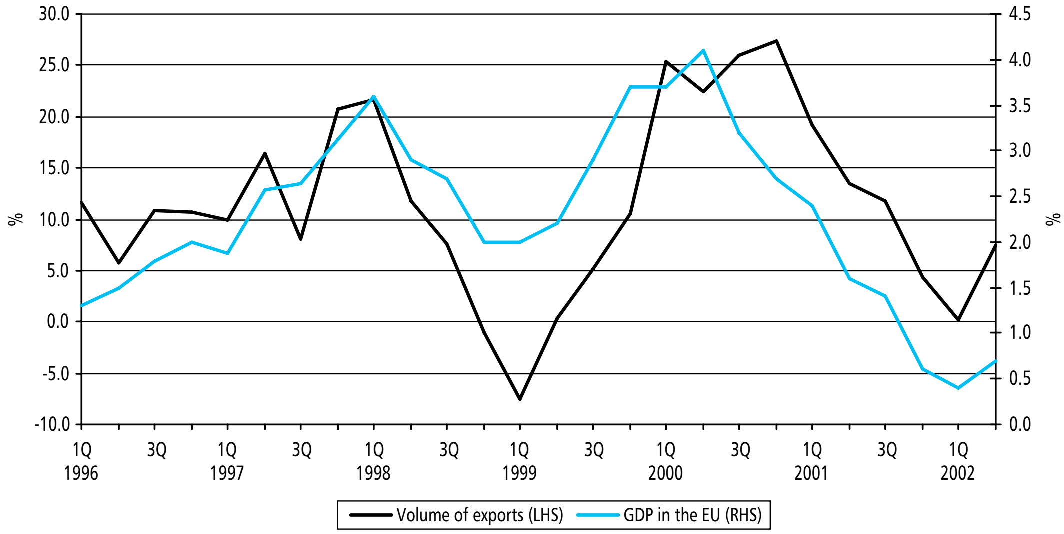
According to data for 1H02, the highest expansion in export volume to CEECs was recorded in the following SITC categories: crude materials, inedibles, except fuels; chemicals and related products; manufactured goods classified chiefly by material; machinery and transport equipment; as well as miscellaneous manufactured articles. In the case of exports to the EU, volumes of exports in almost all categories of the SITC declined except for exports of machinery and transport equipment and commodities and transactions not classified elsewhere in the SITC.

Against this positive picture in exports one should note, however, that growth in export volumes both to the EU and CEECs was lower than a year ago. This applies primarily to exports to the EU – in 1H02 the volume increased by 1% yoy, whereas in 1H01 it rose by 17.1% yoy.

2Q02 and 3Q02 also saw higher growth in imports. Although in 2Q02 imports declined (in nominal dollar terms and according to balance of payments statistics), the real growth in the national accounts accounting as well as import volume actually increased, by 7.9% yoy and 10.0%, respectively. In 3Q02, nominal imports expanded by 8.8%, fuelling expectations of a significant increase in import volume – even if world prices of imported goods increase. In our view, import demand has been driven primarily by higher activity in industrial production and robust household consumption. According to 1H02 data, imports of intermediate commodities comprised nearly 60% of total imports and consumer goods approximately 22% (in current prices).

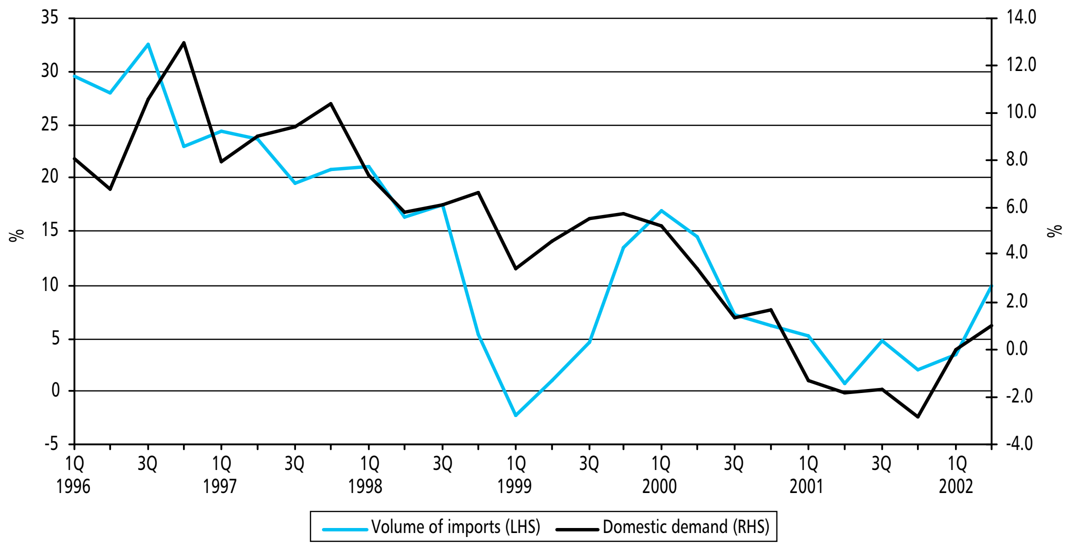
2Q02 experienced high growth in import volume of investment and consumer goods. Higher imports of consumer goods are no surprise in the light of strongish household consumption, but higher imports of investment goods are somewhat surprising. Figures

Chart 2.3. Volume of exports and GDP growth in the EU, 1996–2002 (% change, yoy)



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

Chart 2.4. Volume of imports and domestic demand growth, 1996–2002 (% change, yoy)



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

on total fixed investment point to a significant contraction in 1H02, although investment in transport equipment declined at the slowest pace and it was imports of industrial transport equipment that recorded such unprecedented growth. In 1H02, they expanded by 70% yoy in nominal terms, against a decline in 1Q02 of 10.4% yoy. Among consumer goods, the highest growth in import volume was recorded for cars and semi-durable goods.

In 2Q02, the terms of trade remained above 100 and were favourable to the Polish economy. The 105.2 reading was only slightly lower that in 1Q02. Export prices denominated in zlotys increased on the back of zloty depreciation against the euro and dollar. On the other hand, import prices responded to exchange rate changes more modestly. This stemmed from the decline in world prices of imported goods (especially those denominated in euro). In 3Q02 the trend in export prices could have been expected to be maintained, but import prices increased due to rising world commodity prices (for instance, in 3Q02 the price of Brent oil rose on average by 6.6% yoy – in 2Q02 it declined by 7.7% yoy). Against this backdrop, we expect that the terms of trade deteriorated in 3Q02.

Łukasz Rawdanowicz

Balance of payments

- **Record low current account deficit**
- **Low merchandise trade deficit and high unclassified current transactions surplus**
- **Still small FDI inflows**

The current account deficit dropped in 3Q02 to a record low of US$ 911 million since 1998. This positive development is primarily attributable to the narrowing of the merchandise trade deficit (only US$ 2.4 billion). This was slightly higher than in the previous quarter, but was still a good result by historic standards. It was not a great surprise given weak domestic demand and positive trends in exports. On the other hand, the surplus in unclassified current transactions came in higher than we expected. As such, the concerns we raised in the previous issue of the Polish Economic Outlook about structural changes in the underlying trend appear to have been unjustified, on this occasion.

In 3Q02, the net inflow of FDI amounted to some US$ 600 million, lower than in the two previous quarters, both of which were already regarded as very poor in this respect. This stemmed not only from the slowdown in privatisation (as mentioned in the previous issue of the Polish Economic Outlook), but also from the general downward trend in international investment activity. Due to sluggish growth in the world economy foreign firms have less capacity and are thus less willing to invest in other countries. This factor is especially important in the view of poor economic performance in the EU. Almost 70% of total FDIs comes from this area.

In relation to the portfolio capital balance, 3Q02 saw a continuation of a trend marked by outflows of capital invested in the stock market and inflows of capital invested in debt papers. On balance, 3Q02 saw a net inflow of portfolio capital to the tune of US$ 578 million. It should be also mentioned at this point that in July US$ 1.4 billion was withdrawn from abroad in the form of cash, current account or time deposits. This augmented the positive net financial account in the balance of payments.

At the end of September gross reserve assets increased as compared to the end-June level, amounting to US$ 29.3 billion – sufficient to cover the equivalent of over 8 months of average imports.

Małgorzata Markiewicz

Public finances

- **High tax revenues**
- **Change in assumptions for 2003 budget**

After nine months of 2002, 71.5% of annual budgetary revenues, 72.1% of expenditures and 74.4% of the planned annual deficit had been executed. On the revenue side, previous trends were maintained, although tax revenue dynamics weakened. In 3Q02 indirect tax revenues were 3.7% higher in real terms than for the same period of the previous year; CIT revenues were 0.5% higher; while PIT revenues dropped by 7.7%. The NBP transferred PLN 2.6 billion-worth of profits to the budget, PLN 620.4 million more than it had been planned. The transfer of NBP profits and the execution of 84.6% of the plan of state budget unit revenues led to high collection of non-tax revenues. In the context of low privatisation receipts (15% of the plan) the deficit was financed mainly by growing public debt (principally on the domestic market). In September 2002, Parliament approved amendments to the Teachers Charter, that would see implementation of a third stage of teacher wage increases starting October 1. According to the 2002 budget law, this was to be conditioned on high VAT collection rates. The increase in teachers' salaries will cost PLN 487 million in budget expenditures in 2002.

FUS

After three quarters, the Social Security Fund had received 71.3% of planned endowments (the amount planned for 2002 is PLN 27.3 billion). ZUS has transferred only PLN 6.9 billion (60% of the annual plan) to the pension funds. In the 2003 budget bill, the expected transfer to the pension funds for 2002 have been lowered by PLN 1.7 billion.

Local governments

In 1H02, local governments recorded a surplus of PLN 2.3 billion and increased their public debt insignificantly. Notwithstanding this, the Finance Ministry revised down its forecast for local government financial results in 2002, increasing the expected deficit by more than PLN 1 billion to PLN 6 billion. The higher deficit of local budgets may be due to low allocations from the state budget, which grew by only 1.9% in 2002.

2003 Budget

In the process of preparing the 2003 budget, the macroeconomic assumptions approved by the government at the beginning of June were revised. GDP growth rate was increased from 3.1% to 3.5%. All budgetary figures were changed: revenues grew by PLN 5.2 billion, expenditures by PLN 0.9 billion. As a result, the deficit decreased by PLN 4.3 billion. Revenue grew due to: (1) PLN 1.3 billion from restructuring fees, (2) PLN 600 million from tax abolition, (3) PLN 1.5 billion from an increased tax collection rate and (4) NBP profits increased by PLN 1 billion. On the other side, the rule of expenditure growth of 1% in real terms over the next few years was broken. As the finance minister, Grzegorz Kołodko, said, budget expenditures in real terms should not grow faster than GDP. According to this rule, as projected in the 2003 budget law, expenditures are expected to grow by 2.2%. The second reading of the legislation is to take place on November 21 and the third on November 23, 2002. The law on tax abolition was sent by president to the constitutional court, which is expected to present its opinions by the end of November. As such, budgetary revenues from abolishing taxes are somewhat risk-laden. Other doubts on the revenue side also exist. According to preliminary figures, restructuring fees may reach only PLN 800 million, and increased tax collection rates are not based on any institutional or legal changes which might lead to greater efficiency in tax collection.

The government has assumed significant legal changes which have budgetary consequences:

- According to a Finance Ministry decree the excise duty on alcohol was cut by 30% starting October 1.
- Along with the draft 2003 budget law, amendment to the CIT law were submitted to Parliament and approved on October 30. The corporate tax rate will be equal to 27% in 2003 (previously it was supposed to drop from the current 28% to 24% in 2003). There are no plans to lower the 27% CIT rate in the future.
- The government approved a project for changing the Law on Common Health Insurance and the Law on the National Health Fund. Due to the adopted changes, people over 65 (a group comprising 4.5 million people) would be able to buy some medicines for 1 zloty. The list of these medicines is supposed to be presented at the end of this year. This proposition could lead to uncontrolled growth in expenditures on refunding expenses for medicines to the Health Funds. The creation of a privileged group here may lead to moral hazard, as was the case when people combat-veterans were allowed to get medicines free of charge. This led to huge numbers of abuses and changes in the Law on Common Health Insurance. Experts say this proposition is not consistent either with the constitution or EU regulations.

– The government decided that average wages in the public sector in 2003 will grow by 4%, and pensions and disability pensions will increase by 3.7%, which means – taking into account the level of inflation of 2.3% assumed in the budget – a real growth of 1.7% and 1.4%, respectively. Revision of these indicators means growth of expenditures on public sector wages by PLN 250 million and growth on pensions by PLN 1 billion over the previously assumed figures. The Finance Ministry did not use these figures in the 2003 budget act, due to the fact that the work on changes in indexation rules was undertaken by the Labour Ministry. It proposed indexing these payments to the rate of inflation recorded in the previous year, instead of the existing rule based on the expected inflation rate.
– The second stage of increasing the salaries of those employed in higher education was supposed to happen in September 2002, but in the process of preparing the budget it was frozen for a year. This means these expenditures will grow starting as of September 2003.
– In 2003, the state-based system of medical life-savings will not be launched. The government proposed delaying this law to 2005.

From next year the government will introduce toll payments for using the country's main roads. The expected revenue is estimated at PLN 1.2–1.5 billion annually. This amount will be transferred to General Directorate of Highway Construction (GDHC), which is to be transformed into a joint stock company, Management of Domestic Roads. GDHC's financial plans envisage revenues of PLN 800 million from this new tax, set to be implemented starting from the beginning of 2003. The Finance Ministry said these payments should be taxed at the 22% VAT rate.

Rafał Antczak

Monetary policy

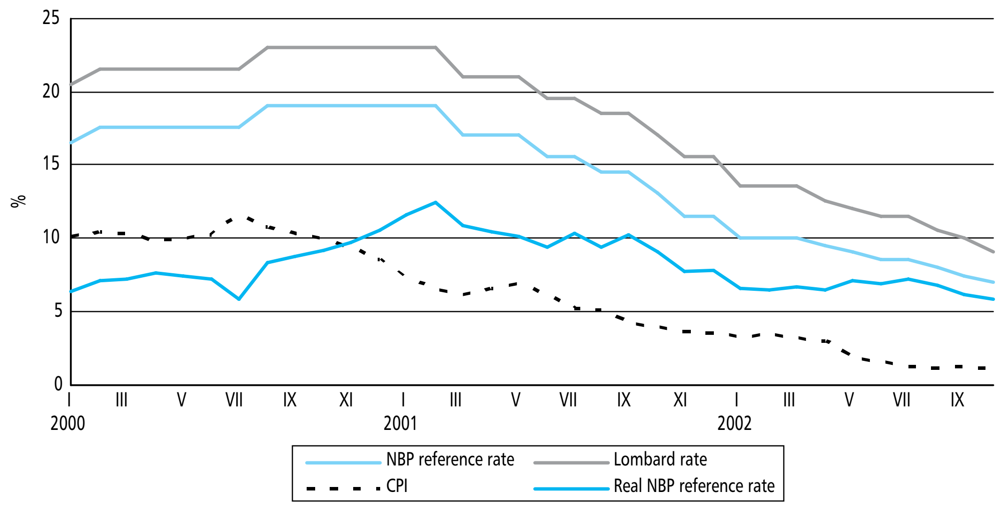
- **Strategic change in interest rate tuning**
- **Situation in the banking sector worsens**

The MPC clearly in our view over-compensated for the rise in real NBP interest rates in 2Q02 by lowering rates by 100 basis points in 3Q02 and by 50 basis points in October. This was in the context of inflation stable at 1.1–1.3% yoy. As a result, the real NBP reference rate was about 6% yoy in 3Q02. Such large rate cuts resulted from the MPC's lessened anxiety about meeting inflation targets for 2002 and 2003. At the same time, our expectations that the instruments for loosening monetary policy away from interest rates would be altered to reserve requirements have not materialised. The MPC fundamentally changed its position on the latter issue, as well as on the fight to reduce over-liquidity in the banking sector, which was outlined in „Monetary Policy Assumptions to 2003" (see, *Monetary policy – forecast*).

The drop in base money by PLN 2.2 billion after three quarters resulted from a decline in the component of domestic assets, which resulted from a decline in government indebtedness in Treasury papers held by the NBP and from an increase in government sector deposits at the NBP. It had become something of a tradition that any decline in government sector debts towards the NBP were accompanied by increases in debts towards commercial banks. Because of the decline in refinancing credits (to PLN 5.2 billion) and open market operations (to PLN 5.6 billion), NBP credits to the financial sector have also declined. During 3Q02, in contrast to the previous two quarters, there was a significant rise in the component of net foreign assets. This resulted in an increase in reserves in 3Q02, stronger than the effect of the zloty depreciation (through the valuation adjustment).

Currency in circulation kept growing during 3Q02, maintaining the yearly average rate from the previous quarter (over 17%) and significantly higher than the average from earlier periods. A drop in the supply of broad money during 3Q02 resulted in a decline of monetization of the Polish economy to the level of 43.4% – this for the first time since 1995, when quarterly data on GDP was first published. This resulted from both a decline in M3 components and GDP growth. The decline seemed to strongly support the rate cuts in September-October, with an attempt to increase the supply of components in M3.

Chart 2.5. Monetary policy instruments, 2000–2002



Source: NBP and CASE.
Notes: The real NBP reference rate is calculated as a difference between NBP reference rate and CPI inflation.

Table 2.1. Contribution to money supply dynamics, 2001–2002 (cumulative, %)

Period	2001				2002		
	I	II	III	IV	I	II	III
Reserve money (RM)	-1.0	-0.5	-1.0	22.4	-2.8	5.1	-3.7
Net foreign assets (NFA)	-1.5	-12.2	-25.3	-11.9	-9.8	-9.8	9.1
Net domestic assets (NDA)	-5.9	-3.3	-7.3	5.6	-33.0	-22.3	-41.1
Net claims on government (NCG)	-6.7	-4.8	-11.7	7.7	-15.9	-16.6	-30.7
Claims on deposit money banks (CDMB)	0.8	1.5	4.4	-2.1	-17.1	-5.8	-10.4
Other items net (OIN)	6.5	15.2	31.5	28.8	40.1	37.3	28.3
Broad money (M3)	2.9	4.6	8.3	9.0	-2.6	-1.7	-2.1
Net foreign assets (NFA)	1.0	-1.5	-4.5	1.9	-3.4	-3.9	-2.3
Net domestic assets (NDA)	-0.1	0.0	4.1	2.4	-2.4	-0.3	-0.5
Net claims on government (NCG)	-0.8	0.2	0.4	4.4	-2.0	-1.0	-2.8
Claims on deposit money banks (CDMB)	0.9	0.0	2.9	-3.1	-0.4	0.4	1.7
Other items net (OIN)	2.0	6.1	8.7	4.7	3.3	2.6	0.6

Source: NBP and CASE.
Note: Contributions to money supply dynamics are calculated using the following formula: $\Delta M/M_{-1} = \Delta NFA/M_{-1} + \Delta NCG/M_{-1} + \Delta CDMB/M_{-1} + \Delta OIN/M_{-1}$ cumulative in the current year. Net foreign assets were re-estimated (valuation adjustment) using the average exchange rate of the currency basket (0.6 euro and 0.4 US\$) for a given period.

Table 2.2. Calendar of the most important events in the NBP's monetary policy, 2002

Source	Date of the resolution	Events
J. NBP No. 6	March 15	Changes in system of calculation and maintaining required reserves (in compliance with ECB standards)
J. NBP No. 7	April 25	Rediscount rate 11.0% Lombard rate 12.5% Refinancing rate 12.5/13.5% Interest rate on NBP current deposits 6.5% Reference rate at min. 9.5%
J. NBP No. 8	May 29	Rediscount rate 10.5% Lombard rate 12.0% Refinancing rate 12.0/13.0% Interest rate on NBP current deposits 6.0% Reference rate at min. 9.0%
J. NBP No. 9	June 26	Rediscount rate 10.0% Lombard rate 11.5% Refinancing rate 11.5/12.5% Interest rate on NBP current deposits 5.5% Reference rate at min. 8.5%
J. NBP No. 11	August 28	Rediscount rate 9.0% Lombard rate 10.5% Refinancing rate 10.5/11.5% Interest rate on NBP current deposits 5.5% Reference rate at min. 8.0%
J. NBP No. 14	September 25	Rediscount rate 8.5% Lombard rate 10.0% Refinancing rate 10.0/11.0% Interest rate on NBP current deposits 5.0% Reference rate at min. 7.5%
Monitor Polski No. 54	September 25	Monetary policy for 2003, direct inflation target of 3 percent at the end 2003, with a deviation band +/- 1 p.p.
J. NBP No. 16	October 24	Rediscount rate 7.75% Lombard rate 9.0% Refinancing rate 9.0/10.0% Interest rate on NBP current deposits 5.0% Reference rate at min. 7.0%

Source: Journal of the NBP, Monitor Polski and own compilations.

The banking system and broad money

The majority of components in M3 fell after three quarters, resulting in a decline in the M3 aggregate by 2.1% yoy. The net foreign assets component declined because of the withdrawal of deposits of domestic banks from banks abroad and repayment of credits. The decline in domestic assets came from a fall in government sector debts towards the banking system, resulting from a stronger increase in government deposits (by PLN 13.7 billion after 3Q02) than debts and payables. Government debts towards commercial banks also grew (by PLN 1.4 billion) as did the issuance of Treasury papers (by PLN 5.5 billion) after 3Q02. Consequently, the share of credits to the public sector decreased, but still amounted to over half (54%) of total credits to enterprises.

Credits to the private sector, which have been increasing at a pace close to 2Q02, were an important growth factor in the M3 aggregate during 3Q02. An improvement in business outlook and further decline in credit rates (from January 2001 to September 2002 by 970 basis points for enterprises with a PPI decline by 530 basis points and by 700 basis points for households with a CPI decline by 720 basis points) caused an increase in credits. Higher demand for credits was also affected by cheaper offers of credits in foreign currencies, mostly mortgage loans, which went up by PLN 2.5 billion in 3Q02 compared to 2Q02 and their overall share in mortgage loans reached 65%.

However, the decline in credit rates was generally lower than deposit rates, both for enterprises as well as households. As a result, the interest rate spread increased to a level of 640 basis points for enterprises and 1080 basis points for households at end-September, compared to 620 and 990 basis points in March, respectively. This higher and still growing spread is a result of the worsening quality of credit portfolios of banks (and establishing reserves on impaired debts), but also the high costs of banking activities, including maintaining over 2-times higher reserve requirements in Poland than in the EU and other Central European countries. The report of the Banking Supervision Inspectorate from October 2002 indicates an increase in the share of impaired debts to 21% at end-June, which constitutes a 100 basis point rise compared to end-March 2002. This share has been increasing more strongly in receivables from enterprises than from households. Disaggregating impaired debts, there was a faster growth of doubtful and lost receivables in 1H02, with the latter reaching half of all impaired debts (and 9.9% of total receivables). Consequently, the capital adequacy of banks fell to an average level of 13.7% at end-June compared to 15.1% at end-2001. Banks have also increased their involvement in derivatives, whose value went up by 12.5% at end-June against end-2001. This increase resulted from speculative transactions, especially on interest rates, which grew by 50% compared to end-2001.

A decline in deposit rates also caused deposits in banks to fall by PLN 10.1 billion yoy in September. This was caused in turn by a drop of deposits of households. Deposits of enterprises showed an increase of PLN 4.9 billion in the same period. However, the inflow of funds to financial institutions other than banks did not compensate for an outflow of deposits from banks.

Rafał Antczak

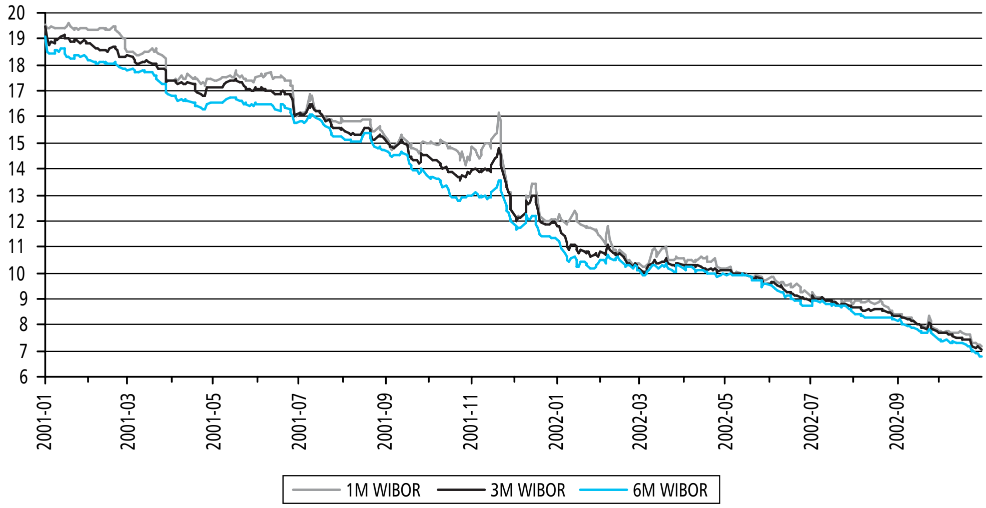
Financial markets

- **Increase in supply and price of T-bills**
- **High demand for T-bonds, lower supply**
- **Convergence of long-term interest rates**

Short-term interest rates

Since the beginning of July, interest on interbank deposits and currency swaps on all maturities slightly increased, reflecting markets' uncertainty over political events – the government reshuffle and change in the post of finance minister. Stabilization on the market lasted until the end of July, after which – alongside no cuts in interest rates – there were growing expectations of rate cuts in August. The market clearly expected a rate cut of 25 basis points, as a 50 basis point cut had been discounted after the announcement of the MPC decision in August. In September, markets began

Chart 2.6. 1-month, 3-month, and 6-month WIBOR, 2001–2002 (daily quotations, %)



Source: NBP.

more accurately anticipate rate cuts – a reduction of 50 basis points was discounted in the middle of the month. Market certainty as to the inevitability of lower interest rates was reflected in the drop in long-term rates. This was also influenced by publication of data on the falling rate of inflation to historically low levels and lack of clear signals of recovery in Poland and abroad. However, short-term rates (1M WIBOR) rose before and during the September MPC meeting, reflecting sizeable uncertainty as to the council's final decision.

During 3Q02, the Finance Ministry sold T-bills worth PLN 11.5 billion compared to PLN 8.5 billion in 2Q02. As a result, after nine months, the supply of bills was over 62% higher (PLN 3.6 billion) than the budget plan for 2002. The higher supply of T-bills, together with higher-than-expected foreign financing of the budget deficit (by over 175%, or PLN 2 billion) fully compensated for the missing privatization revenues (PLN 5.6 billion). Irrespective of the large supply of bills, high demand exceeded supply threefold, resulting in a decline of average yield to maturity (and a price increase) from 8.603% in June to 7.240% in September. Moreover, this decline was higher than rate cuts by the NBP in 3Q02 (by 100 basis points).

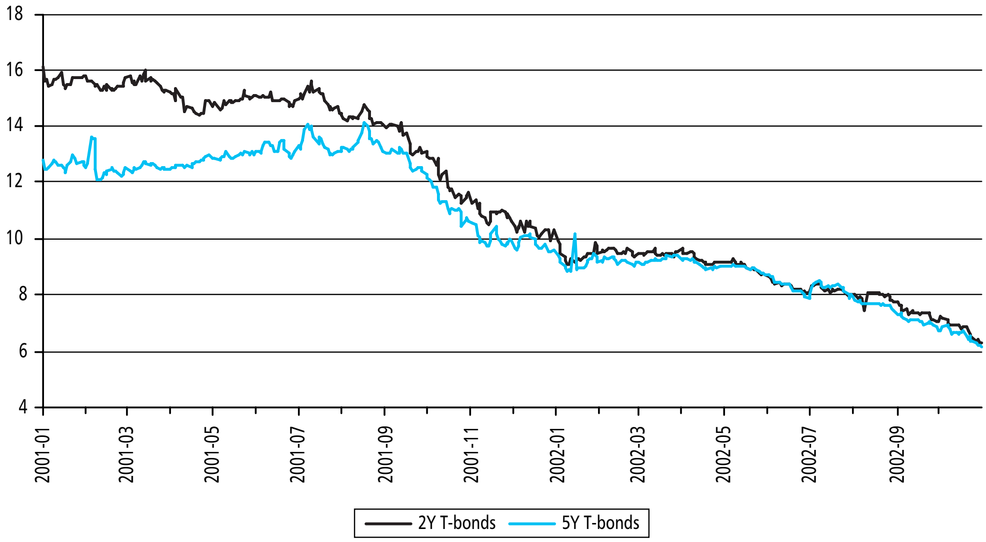
Further rate cuts by the NBP were expected at the beginning of October. As in September, a smaller cut was expected (by 25 basis points), which passed on a yield to long-term papers. It would appear that the MPC's timing and scale of rate cuts has been baffling the markets for some time now.

Alongside the financial needs of the budget in 3Q02, the NBP limited the supply of central bank bills, irrespective of 2-4-times higher demand, avoiding competition with the Ministry of Finance. Consequently, PLN 25.2 billion of NBP bills were sold, compared to PLN 37 billion in 2Q02 and PLN 53.1 billion in 1Q02.

Long-term interest rates

The supply of T-bonds differed from that of T-bills. In 3Q02 the Finance Ministry sold bonds worth of PLN 10.6 billion with threefold higher demand, against PLN 11.1 billion and twofold higher demand in 2Q02. After July uncertainty, in September-October significantly higher demand was observed from foreign investors, who mostly bought 2-year bonds (zero-coupon) and the share of bonds in purchases by non-residents exceeded 12% at end-July (compared

Chart 2.7. Yield to maturity of 2Y and 5Y Treasury bonds, 2001–2002 (daily quotations, %)



Source: NBP.

to 4% at end-June). Foreign investors stayed away from the second issuance of 20-year bonds, though the issuance was a success – supply increased 2.5-times (up to PLN 1 billion) against the first issuance in April, and on twofold higher demand.

The high demand in 3Q02 allowed the Finance Ministry to lower the yield on short- and long-term debt instruments by more than cuts in the NBP rates. July was an exception to the rule, when prices offered by investors missed the expectations of the Finance Ministry. However, with a record high level of budgetary resources deposited in the NBP (PLN 12.4 billion), the ministry was not constrained to accept unfavourable offers. This choice of strategy seem to be vindicated by the results of the first half of October, when the higher supply of bonds (PLN 5.3 billion) met higher demand with lowering yields on 2- and 5-year bonds.

At the turn of 3Q02 and 4Q02, a convergence of long-term interest rates in Poland to EU rates took place. The average yield of 10-year bonds (DS1110) was lowered from 7.560% in July to 6.224% (DS1013) at the beginning of October, and 20-year bonds from 7.215% in April to 6.219% in September. Together with yields on 10- and 20-year bonds in three EU countries with the lowest inflation at a level of around 4.4%, long-term bonds in Poland were in the bracket of up to 200 basis points above the average rate in the EU. This means Poland's fulfilment of the third (after inflation and public debt) of four convergence criteria set in the Maastricht Treaty.

In September, the Polish government issued bonds for US$ 400 million on the US market. This was a supplement to the issuance of June (US$ 1 billion). In line with market expectations, the obtained resources were spent on redemption of Brady bonds (PDI) for US$ 1.3 billion and a face value of US$ 2.46 billion, announced at the end of October. The ministry obtained additional resources for this operation from the issuance of 8-year bonds for £400 million made at the beginning of November. After the fourth redemption of Bradys, US$ 4.48 billion are left on the market. Their existence is a reminder to Poland of its default in 1981, still relatively burdensome for the financial accountability of the state. The Finance Ministry will therefore continue redeeming Bradys until autumn 2003. At the beginning of 2004, the high concentration of foreign debt repayments of interest and capital would require a rollover of debts at the lowest yield possible.

Outlook for the economy in 2002–2004

Łukasz Rawdanowicz

Economic growth

GDP and demand factors

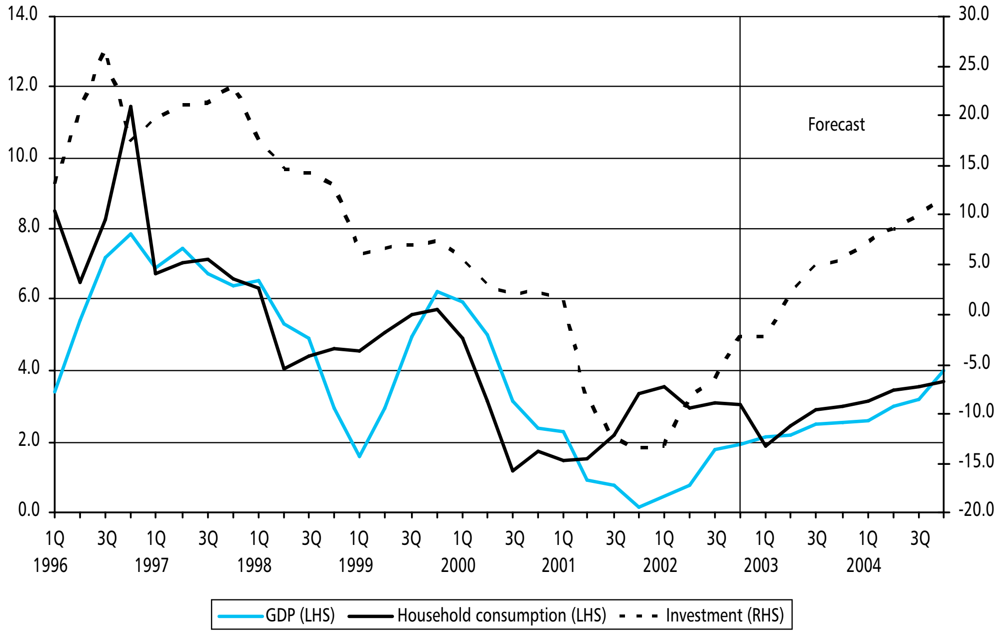
• Gradual recovery in domestic demand

The recovery of the Polish economy is a fact, though its pace is still slow. GDP growth in 3Q02 approached 1.8% yoy, from below 1% yoy in the previous five quarters. 3Q02 was also the second quarter in a row in which domestic demand increased. On the basis of data for the first three quarters of 2002, we can see fairly clearly already what the annual pace of GDP growth will turn out to be. In particular, growth in 4Q02 should not be greatly different from 3Q02. The last three months of the year should see stable household consumption and smaller contraction in investment. Consequently, domestic demand growth should accelerate, but at the same time net exports deteriorate. Against this background, we maintain our forecast of 1.3% expansion in 2002 as a whole.

In the face of a deteriorating outlook for the global economy, in particular in Germany (see, *Global Economy*), economic growth in 2003 in Poland is likely to be largely dependent on domestic demand rather than on external factors. Data for the most recent quarters indicate a low sensitivity of household consumption to the economic slowdown and rising unemployment. The decline in wages and social benefits dynamics was offset by a lower propensity to save as well as by higher incomes of the self-employed. In this context, our current forecast of household consumption in 2003 seems rather conservative, as we anticipate improvement in the consumption determinants. 2003 should see higher growth in real wages due to higher growth in real average wages and the slowdown in employment contraction. Also, self-employed income should expand at least at this year's pace, boosted by better economic activity in the manufacturing, services sector and household construction. For the moment, there are also no reasons to expect the savings rate to increase next year. The relative stabilisation in unemployment and inflation in 2003 should bolster consumer confidence. On the other hand, social benefits will experience significantly lower growth in 2003.

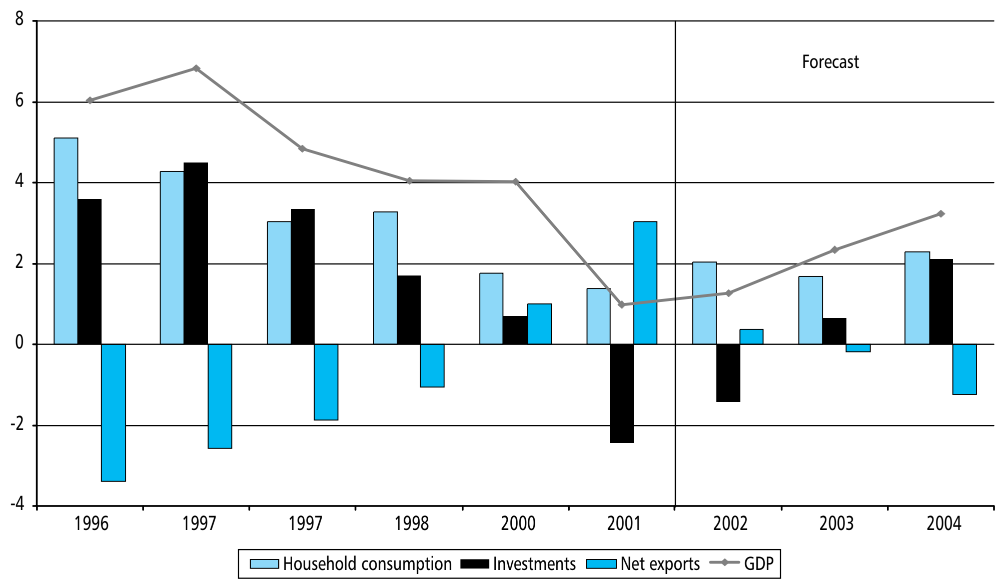
As far as investment is concerned, although we have lowered our forecast, we still expect the investment climate to improve. In January-September the financial results of enterprises improved in comparison to the same period of last year and a lowering in interest rates took place. If these trends are sustained in 2003, they should boost investment activities.

Chart 3.1. GDP, domestic demand and investment, 1996–2004 (% change, yoy)



Source: CSO and CASE.
Note: CASE forecasts starting from 4Q02.

Chart 3.2. Contribution to GDP growth, 1996–2004 (%)



Source: CSO and CASE.
Note: CASE forecasts starting from 4Q02.

The acceleration in domestic demand growth in 2003 should result in a widening of the trade gap and thus in a higher negative contribution of net exports to GDP. It should be stressed that in spite of lower domestic demand forecast as compared to the previous forecast, GDP growth in 2003 as a whole could be sustained at 2.3%. This is possible due to the smaller negative contribution of net exports than we thought last time.

2004 should see further acceleration in domestic demand growth. Investment is expected to be the main driver. In an environment of relatively stable prices, sustained growth in household consumption, lower interest rates as well as a better performance in the EU, higher investment is almost certain. EU membership will play a significant role in this respect. New financial sources from the EU will contribute to higher investment, though the impact on 2004 GDP growth could be muted due to the need to go through formal procedures to use EU funds. EU membership is also expected to lower investment risk. This may lead to higher inflows of FDI and consequently higher investment in the private sector.

In 2004, the improving economic condition of the EU (see, *Global Economy*) is expected to stimulate export performance. This should be crucial in compensating for high import dynamics (at least to some extent). Nonetheless, export growth should not be high enough to prevent the foreign trade deficit widening in the face of very strong domestic demand. The negative contribution of net exports to GDP is expected to be higher than in 2003.

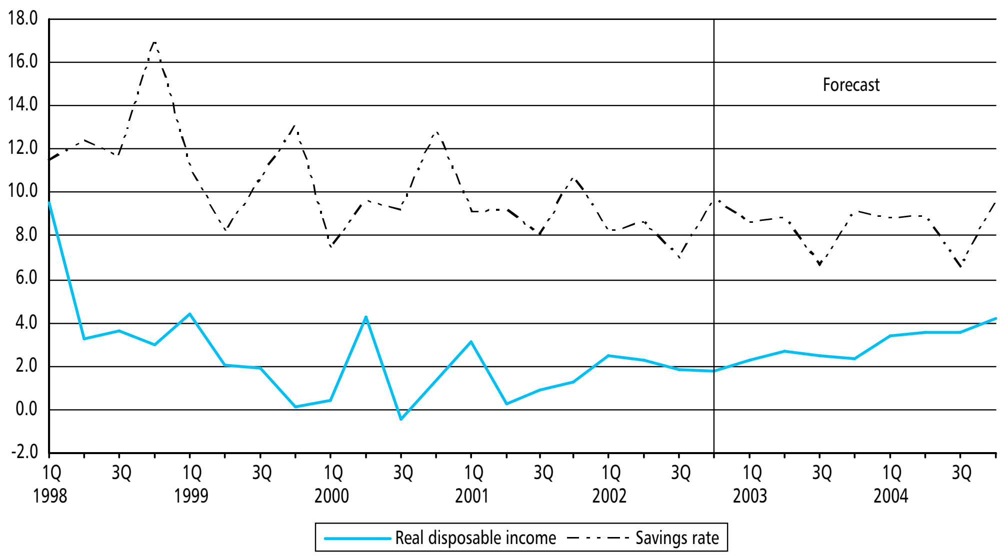
Real sector

• Slower recovery in the construction sector

2003 and 2004 are expected to see gradual acceleration in industrial production growth. This should be driven by stronger domestic demand (household consumption and primarily investment) and also by gradual improvement in foreign demand.

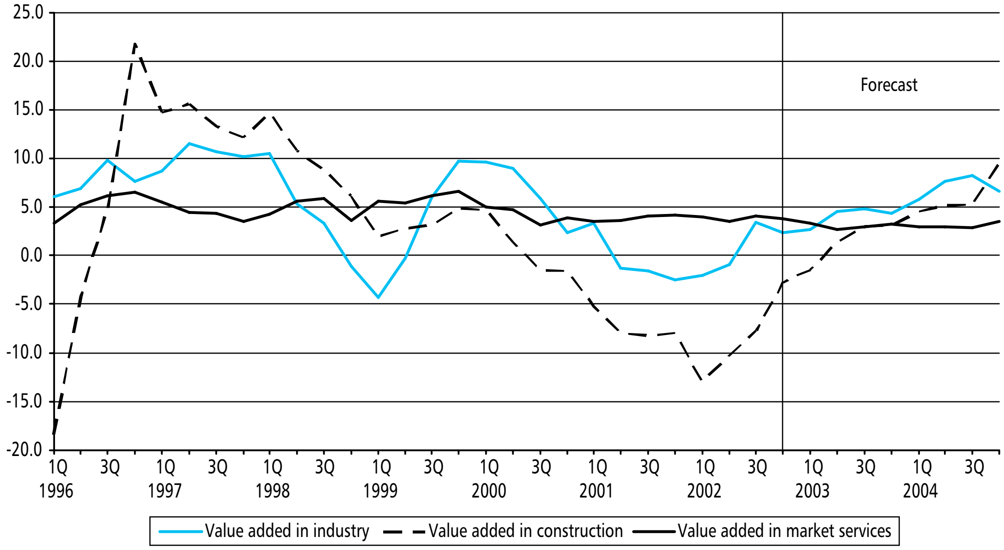
On the back of the more muted and delayed recovery in investment we have revised downwards our forecast for construction output. This lowering

Chart 3.3. Change in real household disposable income and the savings rate, 1998–2004 (%)



Source: CSO and CASE.
Note: CASE forecasts starting from 4Q02.

Chart 3.4. Value added in major sectors of the economy, 1996–2004 (% change, yoy)



Source: CSO and CASE.
Note: CASE forecasts starting from 4Q02.

stems not only from weaker investment in general but also from the change in its structure. For the moment, we anticipate that the fastest recovery will take place primarily in machinery and transport equipment investment and not in construction. Such a structure should largely fuel industrial production and import growth. Against this background, a better outlook for the construction sector will materialise no earlier than in 2004. Finally, it should be noted that the discrepancy in the performance of large construction enterprises and small ones operating in the household construction sub-sector will probably be sustained (at least in 2003).

Mateusz Walewski

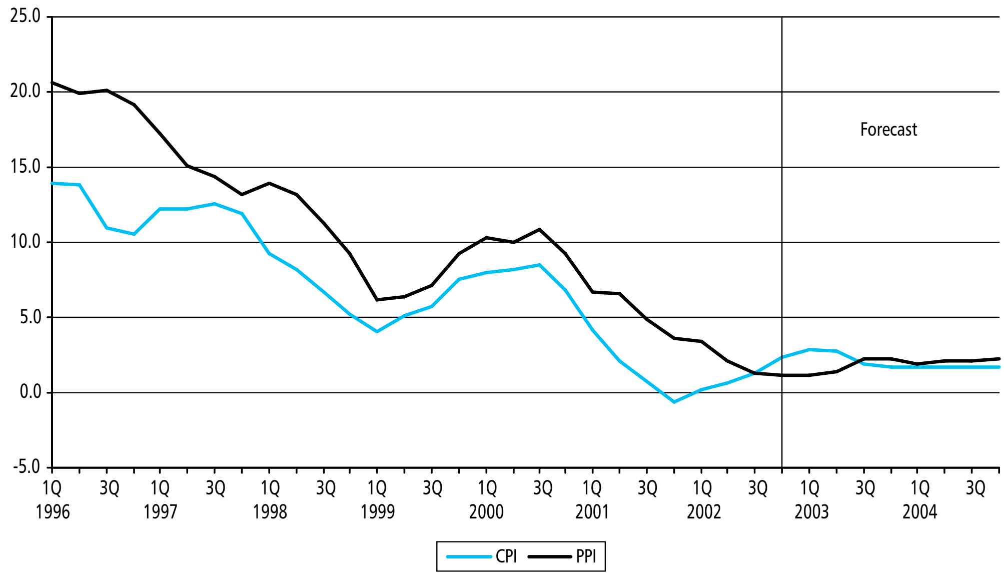
Labour market

- **Stable unemployment level**

Despite positive trends suggesting a possible improvement on the labour market we do not expect unemployment to fall before the end of 2002. This is mainly due to seasonal factors – unemployment usually rises in the winter. The positive signals have resulted, however, in us correcting downward our unemployment rate forecast for the end of 2002, from 18.9% to 18.3%.

While we do not expect unemployment to fall at the end of 2003 as against the end of 2002, if compared to the last 3 years – when unemployment rose constantly – this would have to be seen as some kind of improvement. The stabilisation of unemployment should result mainly from the slow emerging shoots of economic growth, but also from restructuring slowdown in some sectors – not a positive phenomenon, especially from the point of view of long-term growth perspectives. However, we believe that these processes, together with the slight economic recovery, are not enough to lower unemployment over the next year.

Chart 3.5. CPI and PPI, 1996–2004 (% change, yoy)



Source: CSO and CASE.
Note: CASE forecasts starting from 4Q02.

Mariusz Jarmużek

Prices

- **Stable inflation around 3%**

We forecast stable inflation trends, as measured by the CPI, until 1H03, before a slight rise in 3Q03. Over the next year we predict stable inflation trends. This situation should stem from a gradual recovery in domestic demand and the results of previous interest rate cuts that underpinned it. We envisage an alternating harvest and a further relaxing in monetary policy. However, the latter will be significantly less than in 2001–2002. We also believe the Energy Regulatory Office will accept an increase in electricity tariffs of 4–5% in 2004. We see PPI and CPI trends moving closer together, which should support any improvement in enterprises' financial results. The improvement in economic activity should also have a more significant impact on inflation than the exchange rate.

External sector

Rafał Antczak

Exchange rates

- **Irish referendum a turning point**
- **Fundamentals versus speculation, continued...**

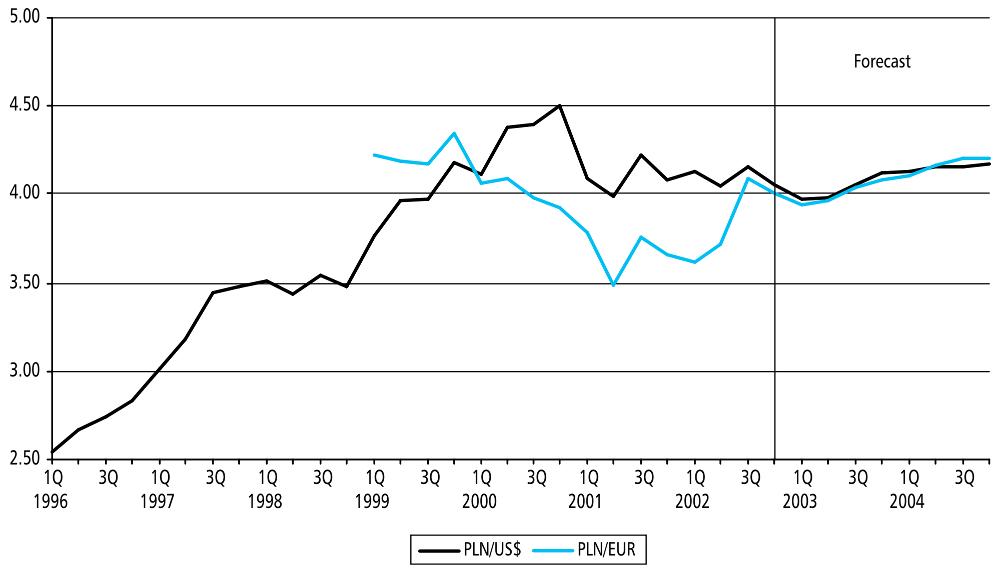
After the positive result of the Irish referendum on October 20 on EU enlargement the zloty began to strengthen against both the dollar and the euro (respectively, by 3.3% and 1.8% up to the end of October). The referendum was the first of three potential political obstacles to the process of the EU enlargement (the other two are closure of all negotiation chapters by end-2002 and the referendum in Poland in spring 2003). The positive outcome in Ireland and pressure on nominal appreciation of the zloty may indicate a break in investors' – both Polish and non-Polish – psychological tendency to think in terms of political obstacles to Poland's EU accession.

During 4QO2, as in 3Q02, we believe the economic situation in Poland will not improve sufficiently to lower unemployment or reduce the budget deficit. In addition, systematic recovery in 2H02 will not negatively influence, at least during the two consecutive quarters, the nation's external balance or increase inflation above the MPC's target. Therefore, the above forecasts indicate the positive (or neutral) influence of economic fundamentals on the exchange rate. A more realistic scenario for Poland's accession to the EU in 2004 would appear to lead to lower political, exchange rate risk as well as interest rate, risk. Consequently, this increases the attractiveness of the zloty and puts pressure on its appreciation. As such, our forecast for the zloty against both the euro and the dollar has changed. We now envisage a nominal appreciation of the zloty to mid-2003, followed by a minor depreciation on the back of macroeconomic factors such as increases in the current account deficit, inflation and especially problems with the next budget. One cannot rule out that pressure for a nominal appreciation of the zloty in 2H03 may be stronger than weak economic fundamentals and the zloty will strengthen further.

Implementing fiscal policy in 2003 and its shape for 2004 are the biggest risk factors for the zloty. This risk also applies in the EU and to the euro. Exceeding the EU budget deficit level in Germany and France, or a continuation of current discussions on further „loosening" of the Maastricht criteria at a time of possible deflation, may hit the euro as hard as the „creative accounting" scandals in the USA hit the dollar. Economic fundamentals in the USA and the EU are not very clear at the moment, but certainly do not indicate a strong recovery in 2H02. However, further cuts in interest rates by the Fed would lead to negative rates in real terms in the USA and in the case of the ECB, to a dispersal of inflation patterns among countries in stagnation (Germany, France, Italy) and fast-growing economies (Spain, Ireland). The interest rate disparities of the dollar and the euro will impact on short-term appreciation of the latter currency.

A potential conflict with Iraq will have rather short-term consequences on weakening the dollar against the euro. It is not, however, certain if weakening of the euro in the long-term would result either from fundamental factors (breaking the Maastricht criteria)

Chart 3.6. Basic exchange rates, 1996–2004



Source: NBP and CASE.
Notes: CASE forecasts starting from 4Q02.

or how it would influence the zloty. The zloty may strengthen – as happened during pre- and post-accession periods in Ireland and Spain, or it may weaken – as the currency of a country with permanently loose fiscal policy lacking real chances for any change on that front over the next few years.

Łukasz Rawdanowicz

Foreign trade and balance of payments

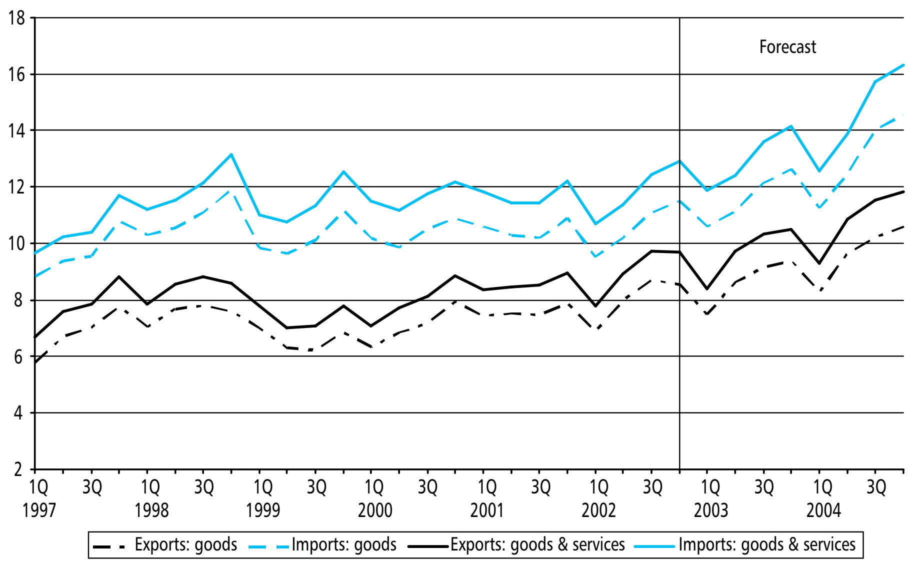
- **Gradual widening of merchandise trade and current account deficits**
- **Problems forecasting the balance of payments in 2004**

In 2002, we forecast a current account deficit of US$ 6.8 billions – i.e. 3.7% of GDP. In 2003 and 2004 the deficit is expected to be widen on annual basis, reaching 4.0% of GDP in 2003 and 4.5% in 2004. The higher merchandise trade deficit is likely to be primarily to blame for this. Export growth consistent with our assumptions on GDP performance in Poland's trading partners is not expected to be high enough to compensate for import growth boosted by strongish domestic demand – especially in 2004.

According to our forecast for this year, the net inflow of FDI will nearly square with net inflow of portfolio capital. This is the first time Poland is likely to have such a negative current account deficit financing structure. In subsequent years we expect this trend to reverse. Given slightly lower portfolio capital inflows, the net inflow of FDI should increase. A better economic outlook in Poland and in the global economy (especially in Germany and the US) as well as Poland's accession to the EU should be conducive to FDI inflows, in particular in 2004.

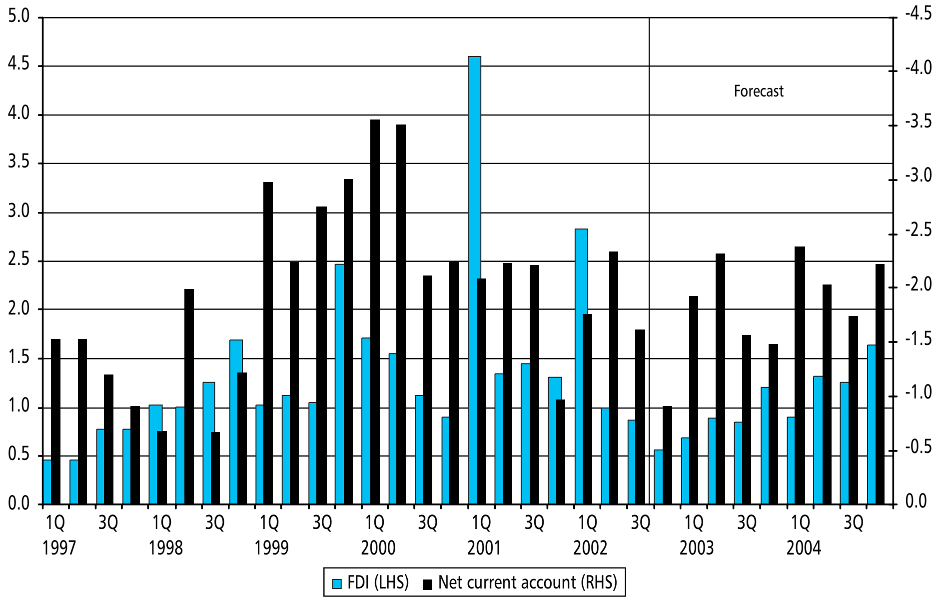
One should bear in mind that the balance of payments forecast for 2004 is subject to large uncertainty. This stems primarily from Poland's accession to the EU and related transfers of various funds, as well as the sentiment factor influencing investor behaviour. As not all negotiation chapters have been closed and the final decisions regarding various financial flows from the EU (cohesion funds, subsides to agriculture) and to the EU (budget contributions and other European bodies, and

Chart 3.7. Exports and imports, 1997–2004 (US$ billion)



Source: NBP and CASE.
Note: CASE forecasts starting from 4Q02.

Chart 3.8. Balance on the current account and FDI, 1997–2004 (US$ billion)



Source: NBP and CASE.
Note: CASE forecasts starting from 4Q02.

customs duties) have not yet been made, it is difficult to forecast the net transfers. Even if the detailed sums of these transfers were known, the real and planned flows could still be wide of mark. This is due to formal procedures for transfer administration.

Małgorzata Markiewicz

Public finances – forecast

- Revision of 2002 forecast
- High uncertainty over 2004 budget

3Q02's results have obliged us to revise our last forecast for 2002. High budgetary revenues in 2Q02 were not maintained and, as a result, we have lowered our forecast to the one similar to two quarters ago. We now estimate a budget deficit in 2002 PLN 3.4 billion higher than the PLN 40 billion envisaged in the budget law. This means expenditure cuts will be necessary at the end of the year, although by less, due to some savings on debt servicing payments (of about PLN 200 million).

On the revenue side, on the basis of 3Q02's results, we expect PLN 250 million more than planned revenues on duties. Changes implemented in the PIT law in November 2001 seem to be overoptimistic. Revenues from capital tax, instead of the PLN 1.35 billion assumed in the budget, will be equal to about PLN 800 million. Excise tax on electricity should bring in PLN 1.3 billion, instead of PLN 2.3 billion assumed in the budget.

We estimated revenues in 2003 PLN 4.6 billion lower than assumed in the budget. The collection of PLN 1.3 billion from restructuring fees is doubtful (according to preliminary figures, enterprises have to date applied for PLN 5.3 billion in restructuring taxes of an expected PLN 10.1 billion). PLN 600 billion from the abolition of certain taxes would also appear to be somewhat unrealistic. In the opinion of many experts, there is a high probability that the law on tax abolition will be rejected by constitutional court. All these factors will lead to a deterioration of the budget in 2003 and gradual growth recovery is unlikely to help resolve any of these problems.

Fiscal policy problems in 2004

After the recent rejection of previous finance minister, Marek Belka's, rule that budget expenditures should grow 1% in real terms it is difficult to judge how 2004 budget will be constructed. According to estimation at the beginning of November 2002, we know that:

- If Poland joins the EU in 2004 expenditures will grow by about euro 2.4 billion in the first year of membership due to the membership fee; by euro 1 billion due to the obligation to finance projects from the budget; by euro 232 million due to the so-called British rebate, and by the number of enrolments to EU institutions (e.g. the European Investment Bank), which is today difficult to estimate.
- On the revenue side import duties will be lost, but we may expect advances in the first year of membership equal to 16.33% of structural funds planned for 2004–2006 (about euro 1.58 billion) and 20% of funds devoted to the Cohesion Fund (about euro 800 million). These amounts will be available if Poland prepares and approves its National Development Plan. Moreover, some inflows to the budget for the financing of agriculture expenditures, other than direct payments, may be forthcoming, although it is difficult to evaluate the amount today.
- Without legal changes to fixed expenditures, which in 2003 will be equal to almost 70% of state budget expenditures, they will continue to grow at the previous rate.

If one takes into account revenue forecasts and presented assumptions to date, one comes up with a rough idea of the state budget deficit for 2004. Lack of fiscal reform in 2003, which could change the structure of budget expenditures and relaxation of fixed obligations, would lead to a growth in the deficit to 6.2% of GDP. Growth in fiscal imbalances increases the risk of changes in the sentiments of portfolio investors. Therefore, we believe that in the face of the risk of macroeconomic disequilibria brought by growth in the public sector deficit, the government will decide to make some necessary reforms in 2003.

Rafał Antczak

Monetary policy

- **Monetary policy for 2003 means...**
- **...Further loosening?**

The government's plan, „Monetary policy assumptions for 2003", establishes an inflation target of 3% +/-100 basis points by end-2003. This is in line with the „Medium-term monetary policy assumptions for 1999–2003", which specified lowering inflation below 4% in 2003. In the document for 2003, the inter-dependence of the direct inflation targeting strategy with a floating exchange rate regime was underlined. The MPC implicitly believes this should be maintained until Poland's accession to ERM-2. A further loosening of monetary policy would depend on lowering the budget deficit. Judging by the restrictiveness of fiscal policy as based on the level of economic deficit, in 2003 there is very unlikely to be a loosening in fiscal stance by the MPC. At the same time, any delay in the privatization process would lead to a higher supply of Treasury papers and increase the crowding-out effect, alongside appreciation pressure on the zloty. However, the MPC has definitely resigned from reducing operational liquidity in the banking sector (i.e., the NBP's short-term indebtedness towards commercial banks) due to the potential threat of competition with large supply of papers offered by the Finance Ministry. Moreover, the reduction of over-liquidity has been a part of the MPC's strategy since 1999. In the document for 2003, the MPC conditioned lowering reserve rate requirements in banks (though did not specify a level, for example 2%, as was in the assumptions for 2002) on structural liquidity in the banking sector (i.e., NBP short- and long-term indebtedness towards banks). Simultaneously, it announced a continuation of the unconditional sale of converted bonds and redemption of NBP bonds indexed to inflation issued in 1999. Purposefully this should lead to a reduction in structural liquidity while maintaining operational over-liquidity in the banking sector.

What is likely come out of such mixed signals from the MPC? The MPC seems to be determined to introduce Poland as quickly as possible to ERM-2, to exchange the zloty with the euro. For this reason, it would attempt to fulfil those parts of the Maastricht criteria that lie in the hands of the NBP. That is, maintaining inflation at a level not exceeding 2.5% and long-term interest rates (10-year) at a level of around 6%. These criteria have already been fulfilled by Poland. In this case, one may expect to see MPC pressure on the government to fulfil the other convergence criteria – lowering the budget deficit to 3% of GDP and limiting the public debt-GDP ratio to below 60%. Fulfilment of the latter criterion, at least with a help of „creative accounting", was prepared by the Finance Ministry (see, *Co-ordination of monetary and fiscal policies*).

As a result, one may expect further cuts in interest rates by about 200 basis points in November 2002–December 2003 and by about 125 basis points in 2004. The two big unknowns in monetary policy for 2003 are exchange rate performance and the scale of rate cuts by the ECB in 2003 in the context of further cuts in the Fed rates and the threat of stagflation in some EU countries. If the zloty nominally strengthens deeper rate cuts could be expected, irrespective of the fiscal policy stance.

Rafał Antczak, Małgorzata Markiewicz

Co-ordination of fiscal and monetary policies

- **Battle over the exchange rate?**
- **Fiscal over monetary policy – nothing new**

For the rest of 2002 and all of 2003, the biggest problem in co-ordinating monetary and fiscal policies may be the zloty exchange rate. Pressure on strong zloty appreciation during the pre-accession period is nothing extraordinary, bearing in mind trends in the exchange rates of the peseta or escudo (after 1985) or the Irish pound (after 1972), that is a year and a half before the accession of Spain, Portugal, and Ireland to the European Community, respectively. During these periods, the nominal appreciation of national currencies in the above countries reached 20% before accession and, combined, 30–40% in the first three years after accession. The Czech koruna has been already experiencing a strong appreciation in real and nominal terms, gaining about 15% in real terms from the beginning of 2000 to November 2002 (the real effective exchange rate in Poland appreciated by about 6% in the same period). This pressure cannot be prevented with interventions on the forex market by the CNB. Fears of appreciation of the currency of another candidate country – the Lithuanian lit, which is pegged to the euro – have led to the passing of an amendment to the foreign currency law and the introduction of dual-currency system (the lit and the euro) in cash transactions in Lithuania since November. Lithuania this becomes the first country fulfilling the concept of unilateral euroization.

Published in October, the communiqué of a joint NBP-finance ministry team on a strategy for euro-zone accession did not signal any compromise on either the date of accession or the central parity of the exchange rate. The NBP prefers the market rate, while the ministry prefers a „corrective" devaluation of the zloty. In the case of GDP growth significantly below 3% in 2003 (the government plan assumes GDP growth of 3.5%) and build up of more problems in enterprises in the state sector, one cannot rule out the possibility of conflict between the government and the MPC over the exchange rate, similar to the one over the level of interest rates in mid-2002.

The attitude of the Finance Ministry to fulfilment of the convergence criteria is found in „Strategy for managing public sector debt, 2003-05". The simple change in the methodology for calculating public sector debt from the domestic to the EU's one means a planned increase of debt, together with pledges and guarantees to lower it from 54.2% of GDP to only 46% of GDP in 2004. Consequently, an expected rise in payments of pledges and guarantees of PLN 7.2 billion during 2003-05 would not worsen the debt-ratio in Poland. However, irrespective of multiple attempts already undertaken in 2002 to change the methodology of calculating public finance deficit, it will be impossible to lower it from 5–6% to 3% of GDP (see, *Public finance – forecast*).

*Łukasz Rawdanowicz**

Global economy

- **Faltering global recovery**
- **Downward revisions of forecast growth**
- **Threat of a double-dip recession in the US**
- **Sluggishness of recovery in the euro zone**
- **Inflation broadly stable**
- **Monetary policy in the US and euro zone on hold**

3Q02 brought deterioration in economic sentiment in the global economy, in particular in the US and the EU. Leading indicators deteriorated and the sustained falls in stock markets and the political uncertainty surrounding a potential conflict with Iraq impacted negatively on household and business sentiment. Concerns about the pace and sustainability of the global recovery are surfacing and downside risks emerging. Consequently, the outlook for most economies has been downgraded, though a general forecast of recovery has been sustained. The recovery is now expected to be more uneven and modest than earlier expected.

Preliminary data for 3Q02 in the US showed that despite declines in retail sales and consumer confidence, private consumption remained the main engine of GDP growth. Growth of the recovery in the US economy is expected to moderate in 2H02. In the event of a war with Iraq and soaring oil prices, the scenario of a double-dip recession cannot be ruled out. On the other hand, declining long-term interest rates, a weaker dollar, and sustained productivity growth may offset the negative effects in the business sector.

In the euro zone monthly data for 3Q02 indicate growth momentum moderation with the main drag coming from weaker external demand. So far, consumer spending in France and Germany has been quite resilient. At the same time, household and business confidence has deteriorated. Against this background and the grimmer world outlook, growth momentum is expected to slow before picking up in 2H03. Most forecasting institutions have revised downwards their forecasts for 2002 and 2003. The recovery is expected now to take a more muted path that earlier thought. In particular, sluggish economic activity in Germany overcasts the general outlook for the area.

The major risks to the global economy are: the health of the US economy and whether it can lead a global upturn; threats of surging oil prices in the event of a war with Iraq and the fallout on declining equity markets.

Previous global forecasts stressed the importance of a US for recovery in the global economy. US demand was expected to trigger upturns in other major economies. Today, as fears about a weaker-than-previously-expected US recovery start to emerge and there are no clear signs of robust economic performance, outlook for other regions has been downgraded. Given the general slackness of domestic demand in most of the industrialised and emerging market economies, the double-dip scenario for the US could be damaging for their recoveries. So far, only Asia (excluding Japan) appears to be less dependent than had been expected on the US economy, performing relatively well on the back of strongish domestic demand.

The negative impacts on household consumption and business investment stemming from the falls in stock markets have been increasingly pervasive. In 2Q02 the declines in stock indices were triggered largely by accounting scandals, but in recent months this factor ceased to operate. The falling indices were attributable to worse financial results of enterprises as well as to problems with liquidity and ensuing credit ratings downgrades, especially in Europe. According to the IMF, the strength of the impact differs from one country to the next: it is higher in economies with

* The text based on the ***Global Economy 4/2002*** (7) (http://www.case.com.pl/index.php3?page=pgtopge&lang=pl). ***Global Economy*** is a CASE quarterly publication (only in English) broadly covering the current world economic situation and outlook.

Table 3.1. GDP in selected countries, 1996–2004 (% change, yoy)

	1996	1997	1998	1999	2000	2001	2002f	2003f	2004f
OECD	3.1	3.4	2.7	3.2	3.8	0.8	*1.6*	*2.6*	*3.2*
USA	3.6	4.4	4.3	4.1	3.8	0.3	*2.4*	*3.1*	*3.6*
Japan	5.0	1.6	-1.1	0.7	2.4	-0.2	*-0.8*	*1.1*	*1.5*
European Union	1.7	2.6	2.8	2.6	3.3	1.7	*0.9*	*2.0*	*2.6*
Germany	0.8	1.4	2.1	2.0	2.9	0.6	*0.3*	*1.6*	*2.4*
United Kingdom	2.6	3.5	2.6	2.1	2.9	2.0	*1.8*	*3.1*	*3.3*
Russia	-3.5	0.8	-4.9	5.4	8.3	5.0	*4.0*	*3.5*	*3.5*

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

Table 3.2. Inflation in selected countries, 1996–2004 (% change, yoy)

	1996	1997	1998	1999	2000	2001	2002f	2003f	2004f
USA	2.9	2.3	1.6	2.1	3.4	2.8	*1.5*	*2.2*	*2.1*
Japan	0.1	1.8	0.7	-0.3	-0.7	-0.7	*-1.2*	*-0.8*	*-0.3*
European Union	2.1	1.8	1.8	1.2	2.5	2.5	*1.9*	*1.9*	*1.7*
Euro area (HICP)	2.2	1.6	1.2	1.1	2.4	2.5	*2.1*	*1.9*	*1.8*
Russia	22.0	11.0	84.4	85.7	20.8	21.6	*16.0*	*13.0*	*8.0*

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

Table 3.3. The euro and yen exchange rate vs. the US dollar, 1996–2004

	1996	1997	1998	1999	2000	2001	2002f	2003f	2004f
Euro	1.270	1.134	1.121	1.066	0.924	0.896	*0.939*	*0.991*	*1.008*
Yen	108.8	120.9	130.6	113.8	107.7	121.3	*122.0*	*114.0*	*114.0*

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

market-based financial systems (like the US, UK, Canada) than in bank-based economies (like the euro zone and Japan). On the positive side, the declines in stock markets are offset to some extent by a decline in long-term interest rates.

In 3Q02, the oil price increased by above 7% yoy and 8% qoq. A war against Iraq could see prices surge and derail global recovery, especially aggravating the economic problems in the US. Despite the recent increases in the oil price, inflation pressures around the globe have remained broadly contained, with industrialised countries experiencing relatively stable price dynamics. Japan continues to suffer from deflation aggravated by yen appreciation. Strong disinflation is observed in the emerging markets of Central and Eastern Europe – recently the CPI reached historic lows in several countries in the region. On the other hand, inflation has raised its head in many Latin American countries, largely stimulated by currency depreciations. The election results in Brazil and Argentina as well as announcements of changes in economic policy and default on interest payments by Argentina led to financial markets' tensions that could spillover to other emerging markets.

The softening of recovery growth in the US and UE as well as subdued price developments allowed central bankers to continue their accommodative monetary policy, with no hikes in interest rates in 3Q02. Given the uncertainty surrounding recovery, a continuation of such a policy should be expected for the next couple of months as the macroeconomic situation clears up. However, if economic activity surprises on the downside, further monetary easing cannot be ruled out – especially in the US and UK, but also in the euro zone. In Central Europe, the Czech National Bank further loosened its monetary policy – interest rates were cut by 75 basis points in July, falling below levels observed in the euro zone. In 3Q02 the CNB intensified interventions against the strengthening of the koruna. It intervened several times without incurring sterilisation costs. On the other hand, the National Bank of Hungary raised interest rates by 50 basis points in July in spite of declining inflation. The main concern of the NBH is the large budget deficit.

On the exchange rate market front, the US dollar continued to lose against the euro and the yen. In the former case the pace of the depreciation abated, while strengthening in the latter. The Hungarian forint has been appreciating against the dollar and the euro, both in nominal and real terms. Similar developments took place also in the Czech Republic. The strong nominal appreciation (in July the Czech koruna hit a record low of 28.9 for the euro) determined the real appreciation of the koruna despite the fact that inflation was very low in comparison to other countries. Macroeconomic fundamentals do not yet provide clear indications on possible future directions in the major currency exchange rates. We think that current trends are likely to remain broadly unchanged.

Sluggish growth and/or fiscal stimuli in many countries have led to deterioration in government budget balances. Japan, which has pursued accommodative fiscal policies and introduced many fiscal packages in recent years, ran up a budget deficit of over 6% of GDP and this situation is expected to continue this year as well. Consequently, Japan's public debt reached over 130% of GDP. The US, which loosened its fiscal policy recently (among other things due to tax cuts and higher military spending) to boost economic growth, is expected to see a budget deficit to the tune of 1.5% of GDP in the current fiscal year. In 2001, the US recorded a budget surplus of 1.3% of GDP. According to the US Congressional Budget Office forecast, the deficit will continue to 2005. On the other hand, economies in the euro zone have been restrained to some extent in their pursuit of accommodative fiscal policy by the Stability and Growth Pact. This year however, Germany, Portugal and possibly France and Italy are expected to breach the 3% of GDP budget deficit level. Widening budget deficits are attributable primarily to growth slowdown and political tensions (election year and difficult labour market situation). In the current economic context, the rigidity of the Pact has sparked a row over budgetary rules in the UE and many critical opinions have been voiced. High budget deficits are also a common characteristic of many CEECs, where fiscal policies have been very lax recently. Given the nearing EU and EMU membership of some CEECs, such policy will have to be changed soon and some governments (for instance in the Czech Republic and Hungary) have already announced plans to reform public finances with this in mind.

Early warning crisis indicator

3Q02 deteriorated somewhat in comparison to the previous quarter, although its 3.90-point reading is still subdued, indicating low risk of currency crisis.

Among positive trends one should note above all the depreciation of the zloty's real effective exchange rate, which was also seen in 2Q02. The improvement in monetary and financial indicators is also important. For the moment, we anticipate lower inflation over the next four quarters as compared to the previous forecast. Due to cuts in nominal interest rates – higher than the drop in inflation – the real WIBOR has declined. Monetary expansion in relation to M3 and short-term foreign debt in relation to liquid reserve assets diminished. On top of this, GDP growth in the upcoming four quarters should be higher.

The high budget deficit still impacts negatively on our indicator. This time we have changed the horizon for the budget deficit forecast form the current year to 2003. Nevertheless, deficits in both years are more than likely to exceed 5% of GDP, which is a worrisome trend. Also on the negative side, a higher current account deficit forecast and higher unemployment should be noted, though the deterioration in these variables is not that severe.

Table 3.4. Early warning crisis indicator

	weights	1Q00	2Q00	3Q00	4Q00	1Q01	2Q01	3Q01	4Q01	1Q02	2Q02	3Q02
1. Annual GDP for 4 consecutive quarters	0.10	4	4	6	6	4	4	6	6	4	6	4
2. Annual unemployment rate (end of quarter)	0.05	10	4	6	10	10	4	6	10	6	0	6
3. Annual average CPI forecast for 4 consecutive quarters	0.06	4	4	4	0	0	6	0	4	4	0	0
4. Government deficit forecast as a % of GDP	0.10	5	5	5	6	6	10	10	10	10	10	10
5. CA balance forecast for 4 consecutive quarters as a % of GDP	0.15	10	0	4	4	6	0	4	0	10	0	6
6. Real effective exchange rate	0.15	6	6	6	6	10	10	6	6	6	0	0
7. Credit expansion as a % of M3 (end of quarter)	0.07	6	6	6	4	4	6	6	6	6	6	4
8 Polish foreign short term debt as a % of liquid reserves (end of quarter)	0.15	6	4	6	4	4	6	6	4	6	4	4
9. Total Polish foreign debt as a % of GDP	0.07	6	6	6	6	6	6	6	6	6	6	6
10. Real 3M WIBOR	0.10	4	6	6	6	6	4	6	4	0	6	0
Indicator		6.18	4.28	5.48	5.10	5.80	5.60	5.74	5.08	6.08	3.64	3.90

Source: CASE.
Notes: 1. The methodology of indicator calculation is available at CASE web site: http://www.case.com.pl/index.php3?page=pgtopwsk&lang=pl&submenu=6
2. The annual forecast for the budget deficit in a given year is introduced in every fourth quarter of the previous year.
3. Changes in the historical values of the indicator due to official data revision.

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The natural rate of unemployment in Poland
– introductory analysis and an attempt at estimation

Theoretical introduction

The constitutions of many countries state that full employment is one of the main objectives of economic policy. Nevertheless, even during the best of economic times there are always groups of the population who are not able to find a job regardless of their best efforts and therefore unemployment rate is never zero. This unemployment rate depends on the structural characteristics of a given economy and is called the „natural rate of unemployment".

Milton Friedman is the author of the idea of a natural rate of unemployment. In an article in 1968 he defined it in the following way: „The natural rate of unemployment is the level that would be ground out by the Walrasian system of general equilibrium equations, provided that there is imbedded in them the actual structural characteristics of the labour and commodity markets, including market imperfections, stochastic variability of demands and supplies, the cost of gathering information about job vacancies and labour availabilities, the cost of mobility, and so on."[2] This sentence, although quite simple to understand, does not help economists who would like to test it empirically. In order to calculate the natural rate of unemployment exactly matching this definition one has to design and solve a general equilibrium model taking into account all the described and also not described (that problematic „and so on…") market imperfections. This appears, however, to be practically impossible, which is why the natural rate of unemployment has tended to be estimated by proxies such as: NAIRU, structural unemployment or „steady state" unemployment.

The most popular method is based on the Phillips Curve augmented by the inflation expectations – most commonly adaptive ones. The expected wage is the function of the real wage in the previous period and of the situation on the labour market. Hence we obtain the relationship between the inflation and unemployment rate enabling us to estimate the rate of unemployment not resulting in inflation and this rate is called NAIRU, (Non Accelerating Inflation Rate of Unemployment).

The next method, much less common, is based on the negative relationship between the number of unemployed and the number of vacancies, so called Beveridge Curve. The number of unemployed that could fill vacancies in a given period is called the structural unemployment. If the number of vacancies is bigger than the number of unemployed the entire unemployment is treated as structural – resulting from the mismatch on the labour market.

The third proxy for natural rate of unemployment is the „steady state unemployment". It is calculated as the theoretical unemployment rate in the given period where the

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[2] Friedman M. *„The role of Monetary Policy"*, American Economic Review t. 58, pages. 1-17.

unemployment inflows would be equal to unemployment outflows – i.e. the number of persons finding a job would be equal to the number of persons loosing their jobs. The basic advantage of this method is the simplicity, it is very easy to calculate as soon as there exist the suitable data. Additionally it enables us to decompose the unemployment dynamics to such factors as: demographic changes, job destruction and job creation. The basic disadvantage is, that it is not fully independent from the cyclical fluctuation and it means it does not satisfy one of the important characteristics of the Friedman's natural rate definition.

In our analysis due to simplicity of calculations we will use the last proxy for natural unemployment rate. We will utilise three different formulas to calculate the steady state unemployment. We hope our analysis will help to better understand the situation on the Polish labour market in the recent period.

The ways of calculating of the steady state unemployment rate

The first formula we use may be found in the work of Alogoskufis et al issued by CEPR in 1995. They used the formula to calculate the 'steady state' unemployment rate in several OECD countries. Consequently, our results will be comparable to their results for other countries.

Steady state unemployment is described by the following formula:

$$u^* = \frac{s+z}{s+h+n} \quad , \quad (1)$$

where:

u^* – steady state unemployment rate,

s = $(EU+EN)/E$ – separation rate – the probability of losing a job in a given period,

z = $(NU\text{-}UN\text{-}EN)/(E+U)$ – the demographic factor – part of the difference between the number of entrants on the labour market, (graduates a.s.o.) and the number of leavers, (discouraged unemployed, retirees a.s.o.), increasing the number of unemployed,

h = UE/U – hiring rate – the probability of an unemployed person finding a job,

n – percentage increase of the labour force,

E – employment,

U – unemployment,

N – the number of inactive persons,

EU – the number of persons who in the period t changed their status from „employed" to „unemployed" – the flow from employment to unemployment. All the other flows are defined respectively.

This formula enables us to break down unemployment's dynamics into various economically meaningful factors. Thus, the separation rate can be interpreted as the indicator of restructuring processes, the hiring rate as the indicator of cyclical fluctuations and also of mismatches on the labour market (skills mismatch, geographical mismatch a.s.o.). The meanings of the demographic factor and labour force growth seem to be obvious.

The second formula is very similar to the first. It does not take into account the demographic factor or labour force growth. It is based on a very friendly – due to its simplicity – mathematical model of the labour market. It also reminds us how important for the situation on the labour market is the possibility of those who are not able to find a job of leaving it. It shows us the steady state unemployment rate without such a possibility. This formula may be found in Hall's article (1979).[3]

$$u^* = \frac{s}{s+\frac{h}{1-h}} \quad , \quad (2)$$

where all rates are defined as in equation (1).

The third formula comes from Ehrenberg and Smith (1994)[4] and the steady state unemployment rate is calculated as follows:

$$u^* = \frac{1}{1+\left[\frac{(ne+nu)ue+(ne)(un)}{(ne+nu)eu+(nu)(en)}\right]} \quad , \quad (3)$$

where $ne = NE/N$ and is a rate of flow from inactivity to employment. All the other flow rates are defined respectively and there is always a starting point in the denominator. This formula is clearly the most comprehensive of all the three

[3] Hall R.E. „The theory of the natural unemployment rate and the duration of unemployment", *Journal of Monetary Economics 5 (1979 p. 153-169).*
[4] Ehrenberg R.G., Smith R.S. „Modern labor economics: theory and public policy", *The American Prospect*, spring 1995.

since it takes into account all the possible flows. Neither the first nor the second formula takes into account the flow from inactivity straight into employment, for example graduates who find jobs immediately. The disadvantage of this formula is that it disenables us from analysing the factors determining unemployment's dynamics.

Results of estimations and commentaries

The data from table 4.1 and graph 4.1 show how complicated it is to estimate a proxy of the natural unemployment rate, and how imprecise the proxies are. The results of the calculations are extremely sensitive to the method used. One should bear in mind that all the methodological formulae used here estimate the steady state unemployment rate, therefore „belong to the same family".

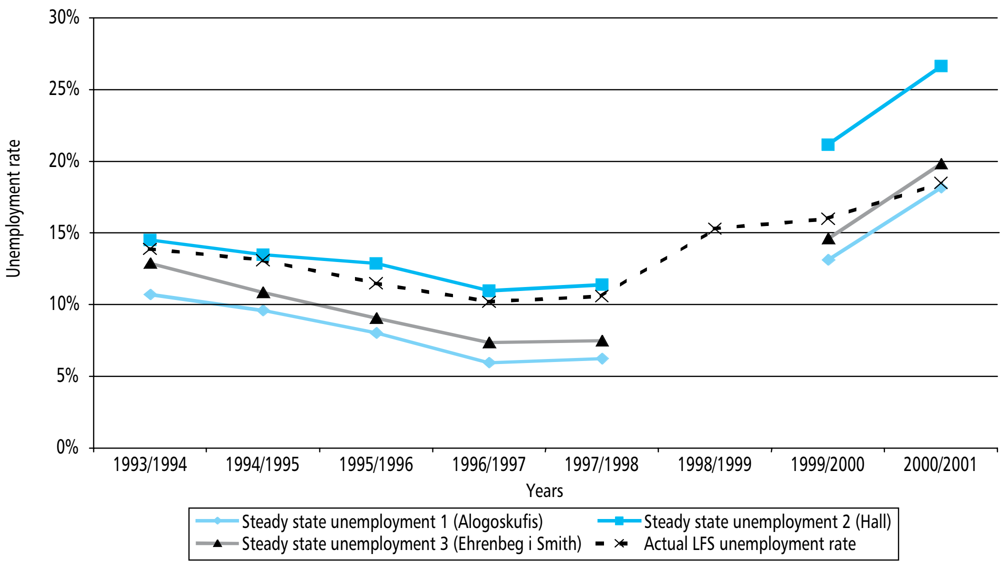
This analysis proves the importance of flows between the labour force (*E+U*) and inactivity. The steady state unemployment rate without these flows (formula 2) is much higher than for other formulae and is already above 20%. Steady state unemployment in the last two years is growing much faster than the actual unemployment rate. This contradicts the theoretical expectation that during an economic slowdown actual unemployment dynamics

Table 4.1. Steady state unemployment rates and actual unemployment rate in Poland, according to the LFS in the period 1993–2001

	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99*	1999/00	2000/01*
Formula 1 (Alogoskufis)	10.7	9.6	8.0	6.0	6.2		13.1	18.2
Formula 2 (Hall)	14.5	13.5	12.9	11.0	11.4		21.2	26.7
Formula 3 (Ehrenbeg and Smith)	12.9	10.9	9.1	7.4	7.5		14.6	19.8
LFS unemployment rate	13.9	13.1	11.5	10.2	10.6	15.3	16.0	18.5

Source: Own calculations based on LFS data.
** It was not possible to apply the flow-based calculations for the period 1998/99. The LFS was broken for two quarters of 1999.*

Chart 4.1. Steady state unemployment rates and actual unemployment rate in Poland, according to the LFS in the period 1993–2001



Source: Table 4.1.

would originate mainly from cyclical factors. It may indicate that during the period of fast economic growth, for various reasons, enterprises retained redundant workers.

Increase of the steady state unemployment rate according to formula 2 (not taking into account the flows between the labour force and inactivity) is the most apparent. It follows an increase in the separation rate, combined with a serious decrease in the hiring rate (table 4.2). This is a result of the economic slowdown and real appreciation of the currency in the period 1999–2001, which resulted in the forced acceleration of the restructuring process in Polish enterprises. Outflows from the labour force cushioned somewhat the negative effects of this process on labour market statistics. Steady state unemployment rates calculated according to formulae 2 and 3, taking these flows into account, did not rise as much either.

The data in table 4.2 show that the significance of demographic factors (*z*) in unemployment dynamics in Poland is slightly decreasing. This factor is less negative, thus further aggravating the situation on the labour market. It results from the growing inflow of graduates onto the labour market in the last period and also of the recent limitations on pre-retirement schemes. It is also clear that labour force growth hardly influences unemployment dynamics at all.

Chart 4.2 presents a break down of steady state unemployment dynamics into various factors. It simulates steady state unemployment rate changes, holding selected factors at their 1993 levels.

One can clearly notice the effect of the hiring rate fall in the recent period. If the hiring rate had been stable since 1993 the steady state unemployment would still not be higher than 10%. This simulation indicates the growing importance of job creation policies in the subsequent years.

If the separation rate were stable, steady state unemployment would currently be much higher than 20%. Although in the period 1999–2001 the separation rate started to increase as a result of accelerated restructuring it seems that following expected governmental financial support for enterprises this trend will not continue.

It is also clear that in 1993 the demographic situation was much more comfortable. Steady state unemployment would be much lower if the demographic factor had not changed over the last few years. One should note, however, that the earlier deactivating schemes, although having positive effects in the short run, are very dangerous from the long-term point of view. They lead to an increase in the social burden of labour costs, consistently raising them, which results in higher unemployment in the long run.

Conclusions

- The faster growth of steady state unemployment than the actual unemployment rate during the economic slowdown contradicts theoretical expectations. It proves that in spite of the serious employment reductions in the second half of 1990s, in 1999 there was still serious over-employment in Polish enterprises.

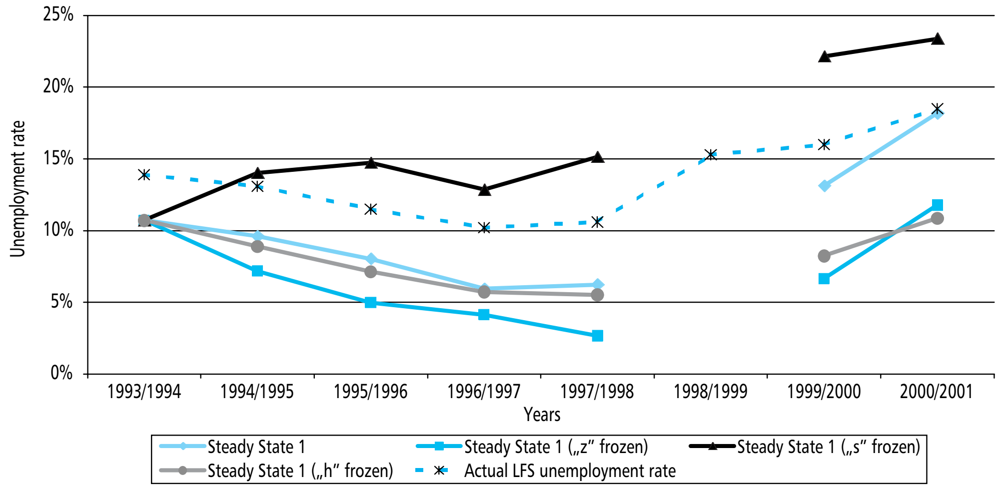
- The level of productivity in manufacturing enterprises has been constantly growing over recent years. Even assuming increasing economic growth in the nearest future they will not increase employment accordingly.

Table 4.2. Factors influencing steady state unemployment, according to formula 1 (Alogoskufis et.al), 1993–2001

	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99*	1999/00	2000/01
Separation rate (*s*)	10.6%	8.4%	7.4%	7.2%	6.4%		7.3%	8.7%
Demographic factor (*z*)	-5.3%	-4.3%	-4.1%	-4.5%	-3.9%		-3.5%	-3.5%
Hiring rate (*h*)	38.5%	35.1%	33.3%	36.7%	33.2%		21.3%	19.3%
Labour force growth (*n*)	0.3%	-0.5%	0.5%	0.1%	0.6%		0.5%	0.5%

Source: Own calculations based on the LFS data.
** It was not possible to apply the flow-based calculations for the period 1998/99. The LFS was broken for two quarters of 1999.*

Chart 4.2 Simulations of steady state unemployment rate dynamics, according to formula 1 (Alogoskufis et.al) with frozen elements of the formula, 1993–2001



Source: Own calculation based on data from the LFS.

This conclusion is based on analysis of the permanent decrease in the hiring rate since 1993.

– An improvement in the economic situation may come, however, from an increase in labour demand from the small and medium enterprises, especially from the services sector. From the point of view of the labour market, it is much more important to facilitate and support the development of the small and medium enterprises than to limit dismissals in the larger manufacturing enterprises.

– The economic slowdown of recent years resulted in the „panic" dismissals of superfluous labour. This has increased labour productivity and may help to competition during Poland's while integration to the EU common market.