

**Republic of Poland: 2000 Article IV Consultation—Staff Report; Staff Statement;
Public Information Notice on the Executive Board Discussion; and Statement by the
Authorities of the Republic of Poland**

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2001 Article IV consultation with the Republic of Poland, the following documents have been released and are included in this package:

- the staff report for the 2000 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **January 26, 2001**, with the officials of the Republic of Poland on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on February 14, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of **March 9, 2001**, updating information on recent economic developments.
- the Public Information Notice (PIN), which summarizes the **views of the Executive Board as expressed during its March 9, 2001, discussion** of the staff report that concluded the Article IV consultation.
- a statement by the authorities of the Republic of Poland.

The document(s) listed below have been or will be separately released.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF POLAND

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives for the
2001 Consultation with the Republic of Poland

Approved by Michael C. Deppler and Liam P. Ebrill

February 14, 2001

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1. The 2001 Article IV consultation discussions with Poland were held in Warsaw during November 30–December 13, 2000, and during January 24–26, 2001 in meetings conducted by the Resident Representative.¹ The mission met with: Finance Minister Bauc; outgoing National Bank of Poland (NBP) President Gronkiewicz-Waltz, incoming President Balcerowicz, and several members of the Monetary Policy Council (MPC); senior officials in government ministries, the NBP, the Council of Ministers, and the office of the President; Parliamentary leaders from the main opposition party; and representatives of the financial institutions, labor, and research institutions. Mr. Szczuka, Alternate Executive Director for Poland, participated in many of the meetings.

2. Poland formally accepted the obligations of Article VIII, Sections 2, 3, and 4 of the Articles of Agreement of the Fund as from June 1, 1995, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions.²

3. In concluding the 1999 Article IV consultation on March 11, 2000, Directors praised Poland's decade-long strong economic performance. Though external developments had adversely affected performance during 1999—with inflation and the external current account deficit rising and growth slowing—the consequent midyear fiscal tightening and increases in interest rates were welcomed. Still, Poland was vulnerable to changes in market sentiment if the external current account deficit did not decline, and hence fiscal adjustment in 2000 and beyond was critical. Sustained public expenditure restraint and an effective mechanism to monitor local government finances would also be necessary. Several directors encouraged early abolition of remaining short-term capital controls, but others recommended delay until the current account deficit had begun to fall.

4. The unpopular “rightist” coalition collapsed in early June, when Mr. Balcerowicz (Deputy Prime Minister and Finance Minister) resigned over various issues, including the budget and labor market reform measures. The government continues without a parliamentary majority. Elections must be held by September 2001.

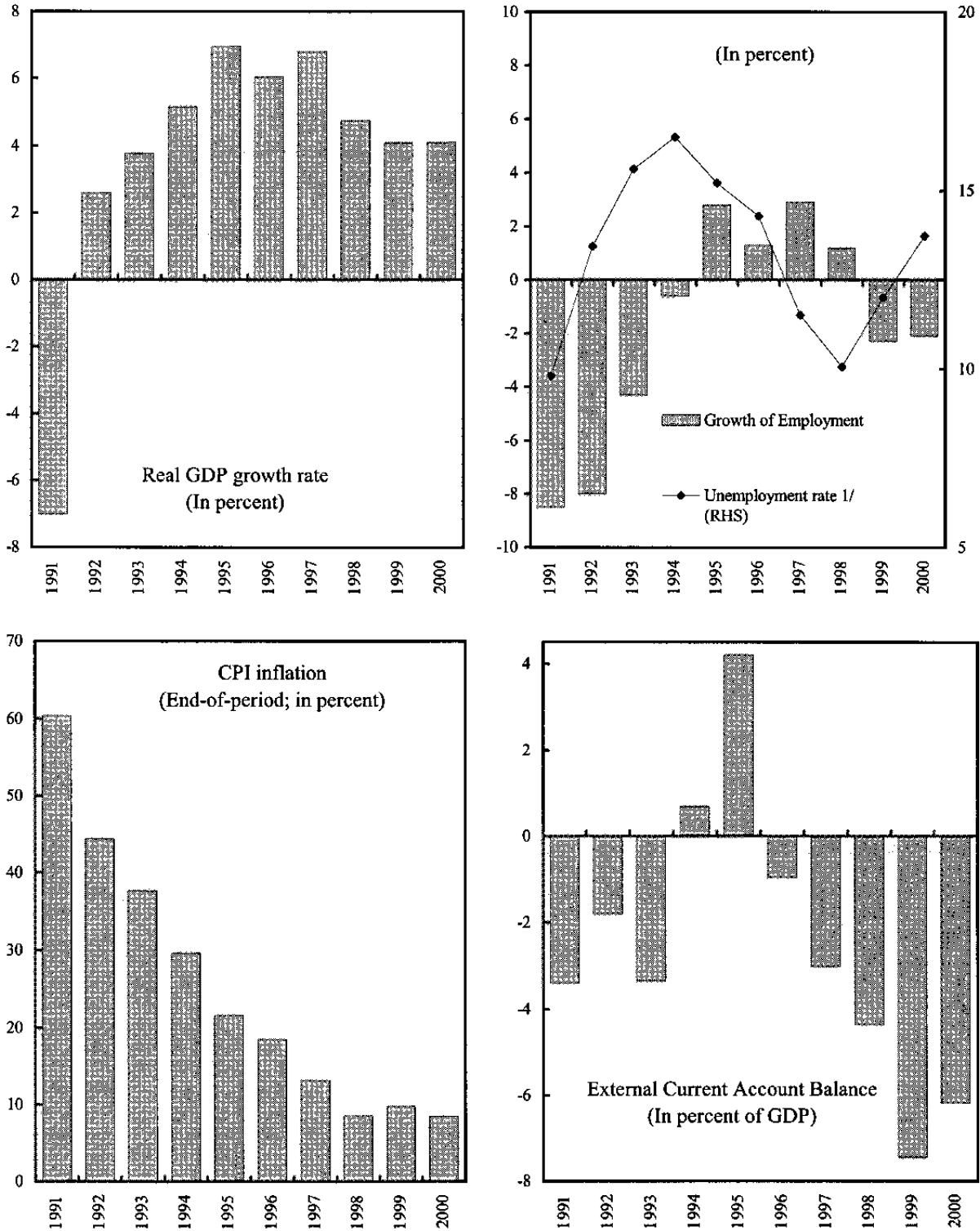
I. ECONOMIC BACKGROUND

5. **In the past two years, Poland's outstanding economic performance has come under strain.** Output growth dropped to about 4 percent in 1999–2000 from an average of 5½ percent during 1993–98 (Figure 1 and Table 1). Total employment has fallen by 6 percent since mid-1998, largely reversing increases since 1994. Longstanding downward trends in

¹ The mission comprised Ms. Schadler, Ms. Daseking, and Messrs. Doyle and Selassie (all EU1), Mr. Kell (FAD), and Ms. Riggle, Assistant (EU1), and was assisted by Mr. Sassanpour and Mr. Sierhej in the Resident Representative's office. Mr. Quintyn (MAE) visited Warsaw during December 7–13 to continue discussions for the FSSA.

² Poland maintains United Nations-based exchange restrictions against Libya and Iraq, which have been approved pursuant to Decision No. 144–(52/51).

Figure 1. Poland: Selected Economic Indicators, 1991-2000



Sources: Polish authorities, and staff estimates.
1/ Registered unemployment.

unemployment and inflation have been broken: unemployment has risen back to 15 percent while headline inflation, which troughed at 6½ percent in early 1999, increased back to 10-11 percent in mid-2000. And notwithstanding decelerating activity, the external current account deficit rose to 7½ percent of GDP in 1999. However, it has declined since early 2000 with inflation following suit later in the year.

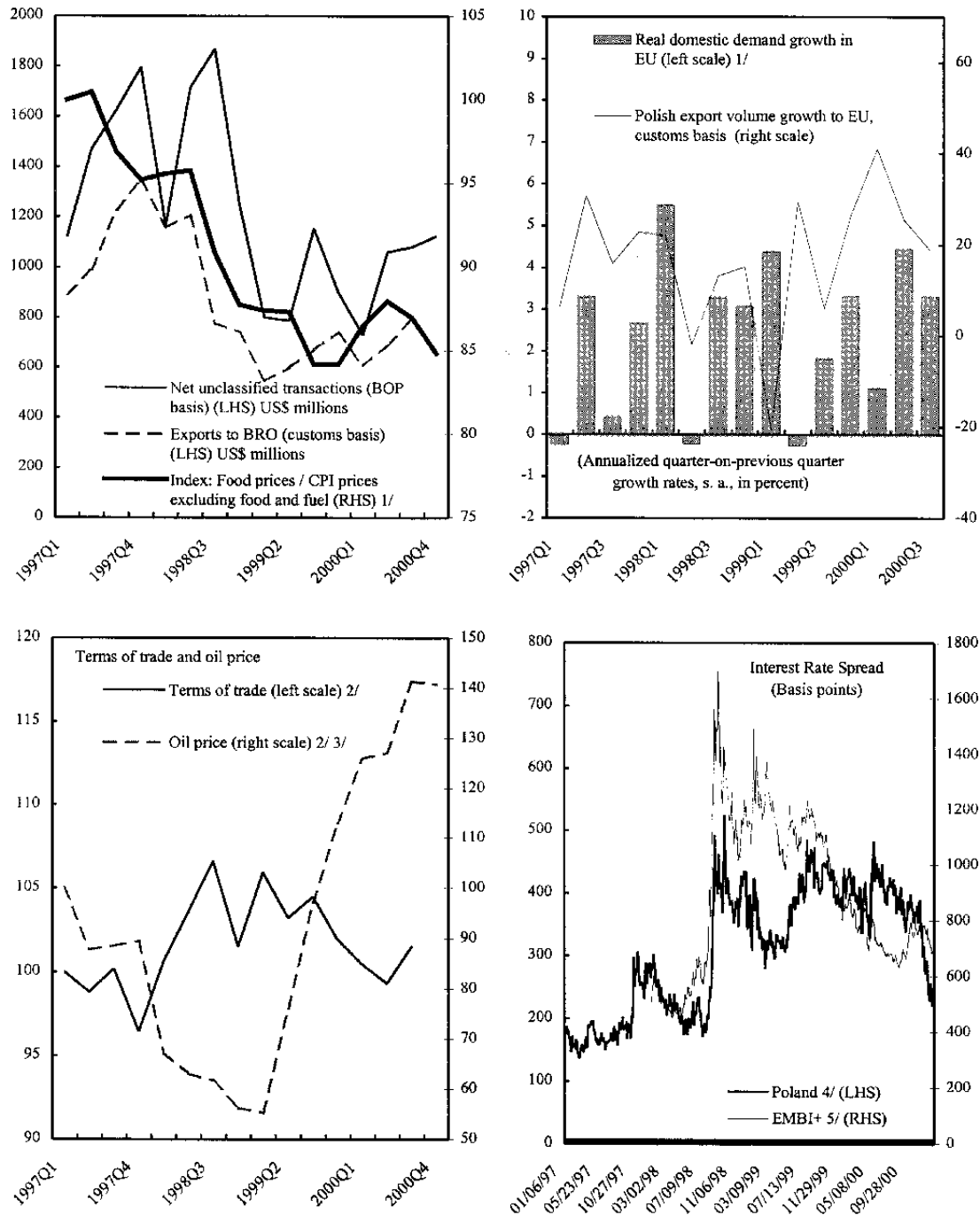
6. Several factors combined to produce this outcome in 1999 and 2000: adverse external shocks; a related new wave of enterprise restructuring; and a deterioration in the policy mix.

7. External shocks weakened the current account balance, output growth and employment and caused considerable volatility in inflation. The Russia crisis in mid-1998 eliminated much of Poland's eastern export market and halved an active suitcase trade (net unclassified transactions) (Figure 2). To a large extent, the loss of these markets has proved lasting: a strong recovery of exports began only with the rebound in demand in western Europe in mid-1999 and reflected a significant change in the structure of exports and export markets. The collapse of food exports to eastern markets also caused a sharp drop in food relative to nonfood prices in 1999 and thereby, a fall in inflation. Increases in food import tariffs in 1999 together with poor weather partly reversed this in 2000, and, along with rising oil prices, boosted inflation. International spreads on Polish bonds largely followed those of emerging markets until September 1999 when concerns over Poland's widening current account deficit pushed up the Polish spread.

8. Partly spurred by these shocks, a new round of labor shedding began, boosting unemployment. Since mid-1998, employment has fallen by over 4 percent in enterprises and by 8 percent in manufacturing (Figure 3). These job losses reportedly reflect layoffs from firms losing sales to Russia, from coal companies which have shed 80,000 jobs since 1998 under a World Bank-supported program, and from privatized firms as job guarantees expired. Even with marked drops in labor force participation, unemployment rates rose from mid-1998 with much regional variation. Job losses and rising unemployment, along with higher-than-anticipated inflation in 2000 (the so-called "inflation surprise"), moderated private sector real wage growth.

9. Shifts in the policy mix made matters worse. In 1999 and again in 2000, a substantial fiscal tightening was planned to lower the external deficit and inflation, while setting the stage for an easing of monetary conditions that would promote the strongest possible competitiveness (Figure 4, Box 1 and Tables 1 and 2). But slippages in both years, owing to both structural and cyclical factors, undermined this strategy. Overall, the fiscal deficit was unchanged in 1999 and, according to staff estimates, narrowed by 0.5 percentage points of GDP in 2000 on a commitments basis (0.4 percentage points of GDP on a cash basis), less than half the targeted adjustment. Prompted by concerns about these developments, rising inflation and the external deficit, the Monetary Policy Council (MPC) raised the central intervention rate by 600 basis points in four steps between September 1999 and August 2000 to 19 percent, and maintained a tightening bias until December 2000 when they reverted to a neutral bias. Banking interest rates followed suit, taking real borrowing

Figure 2. Poland: Indicators of the External Environment, 1997-2000



Source: Polish Authorities, Bloomberg and Staff Calculations.

1/ Includes Germany, France, Italy, and the UK (weighted by Polish export shares in 1999), accounting for about three-quarters of total Polish exports to the EU. Source.

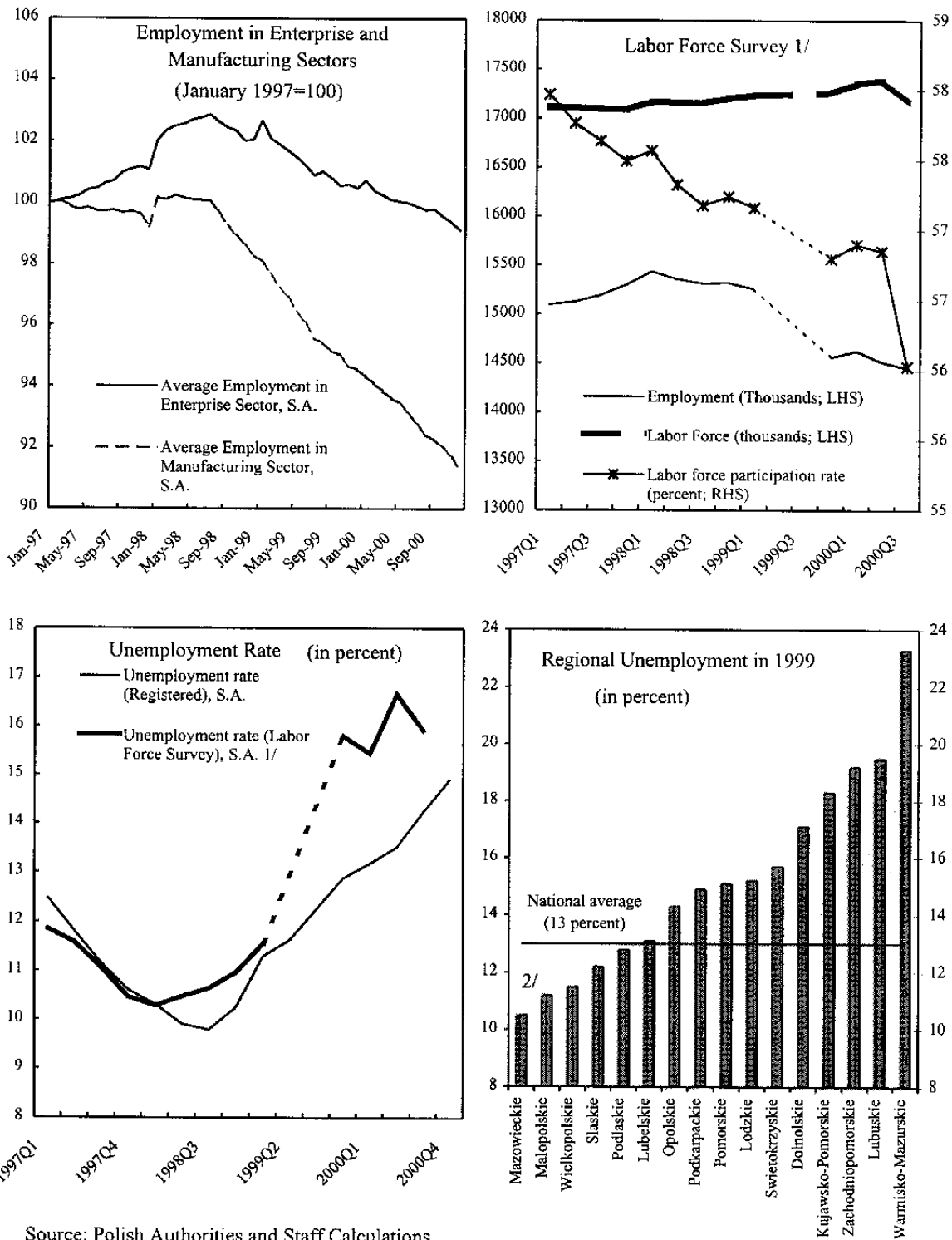
2/ 1997Q1=100

3/ Index of the simple average of spot prices for U.K. Brent, Dubai, and West Texas Intermediate.

4/ Spread on US\$ denominated 30 year bond and Republic of Poland US\$ bond maturing in 10/2024.

5/ Emerging Markets Bond Index.

Figure 3. Poland: Indicators of Employment and Unemployment, 1997-2000

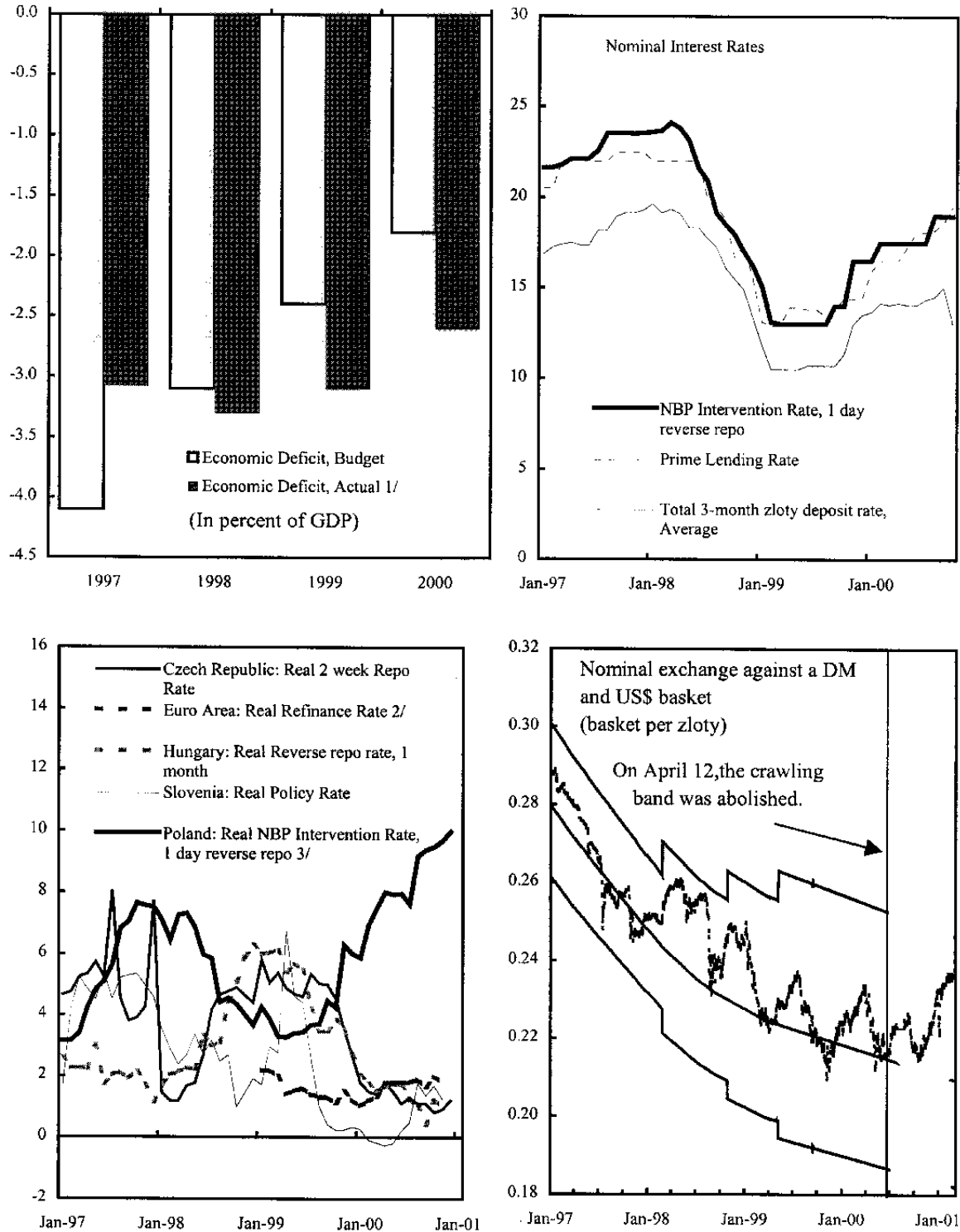


Source: Polish Authorities and Staff Calculations.

1/ The quarterly Labor Force Survey was not undertaken in Q2 and Q3 of 1999.

2/ The Mazowieckie region encompasses Warsaw.

Figure 4. Poland: Indicators of Fiscal and Monetary Policy, 1997-2000
(In percent unless otherwise indicated)



Source: Polish Authorities.

1/ On commitment basis.

2/ ECB Fixed rate until July 2000, after that minimum bid rate is used.

3/ Deflated using CPI Inflation excluding food and fuel.

Box 1. Fiscal Slippages in 1999 and 2000

General Government Economic definition ^{1/} (In percent of GDP)	1998	1999		2000	
	Outturn	Budget	Outturn	Budget	Outturn ^{2/}
Total Revenue	41.1	41.7	41.6	42.9	40.4
<i>Of which:</i> State budget	22.9	20.6	20.5	20.8	19.4
Social security (FUS)	11.4	11.0	10.3	10.2	9.8
Total Spending	43.6	43.6	44.4	44.7	42.7
Goods and services	15.9	19.2	19.5	19.1	17.9
Transfers and subsidies	20.9	18.5	18.6	19.4	19.4
Interest	3.2	3.3	3.1	2.8	2.6
Investment and net lending	3.6	2.6	3.2	3.4	2.8
Economic balance (cash)	-2.6	-1.9	-2.7	-1.8	-2.3
Net change in arrears	0.7	0.4	0.4	0.0	0.4
Economic balance (commitments)	-3.3	-2.4	-3.1	-1.8	-2.6
Real GDP growth	4.8	5.1	4.1	5.2	4.1
Nominal GDP (zł billion)	554	627	616	677	699

^{1/} The economic basis adds to General Government revenue, transfers to the funded private pillar of the pension system, excludes receipts from mobile phone licenses from revenues, and adds to spending court-ordered compensation payments to wage earners for inflation in the early 1990s.

^{2/} Staff estimate. Compared to the authorities, staff estimate a lower deficit for local government and for the social security administration, but also some accumulation of spending arrears in 2000.

In 1999, despite a number of difficulties with revenue, fiscal slippage largely reflected spending overruns. Weaker than projected growth lowered state budget revenues and teething problems in the reforms to the pension system lowered social security contributions. However, these revenue shortfalls were offset by a midyear increase in excise rates and higher-than-projected revenues of local governments and some extrabudgetary funds. On the expenditure side, state budget spending was cut to meet the state budget deficit target, but local governments and extrabudgetary funds spent their unexpected revenue gains, taking overall spending over projected levels.

In 2000, a broader array of factors undermined the fiscal outturn. Cyclical factors include unexpectedly weak employment and wages, which hurt social security contributions, PIT receipts, and consumption-based taxes. Rising unemployment increased labor fund spending slightly. These factors were partially offset by strong CIT receipts, the result of strong profit share as wages and employment weakened. On the structural side, the loss of management information for 1999 in the social security system impeded the preparation of projections for 2000, which turned out to be overoptimistic; the partial recovery of the relative price of food shifted consumption towards relatively low VAT-rated goods; and anticipated arrears clearance by restructuring public enterprises failed to materialize (Table 2). Additional allocations were also required to meet education costs which had been under-budgeted, partly offset by savings on interest expenditure. To meet the state budget deficit target, even given savings on debt service of Zł 1 billion, it was necessary late in the year to postpone around Zł 1 billion of capital expenditure until 2001, and to find a further Zł 3 billion of largely ad hoc cuts to nonwage current spending; this process was expected to result in additional arrears of at least Zł 0.5 billion.

rates into double digits for nonprime borrowers, by far the highest among advanced transition countries. Influenced by privatization inflows and rising domestic interest rates, the CPI-based real effective exchange rate of the zloty appreciated by 9 percent in 2000.

10. **In this context, domestic demand weakened sharply from early 2000 and inflation began to decline.**³ Personal consumption growth fell markedly, reflecting slow growth of

wages, falling employment, and a 4 percent terms of trade loss (a tax equivalent of 0.5 percent of GDP). Fixed investment growth held steady through 1999, but influenced at least in part by rising

	1999				2000		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Real GDP	0.8	1.7	2.3	1.4	0.6	0.9	0.2
Real domestic demand	-0.2	1.8	2.3	1.6	-0.6	0.1	0.3
Private consumption	1.1	1.3	1.7	1.4	0.2	-0.6	-0.1
Fixed investment	-0.2	2.5	2.5	2.4	-1.8	0.0	1.7
Real credit to corporates ^{2/}	4.7	2.6	2.2	2.5	1.2	3.1	1.4
Real credit to households ^{2/}	6.7	7.1	10.3	8.6	8.1	6.0 ^{3/}	5.5 ^{3/}
Industrial sales	0.7	3.9	3.8	5.5	-2.8	3.5	1.1

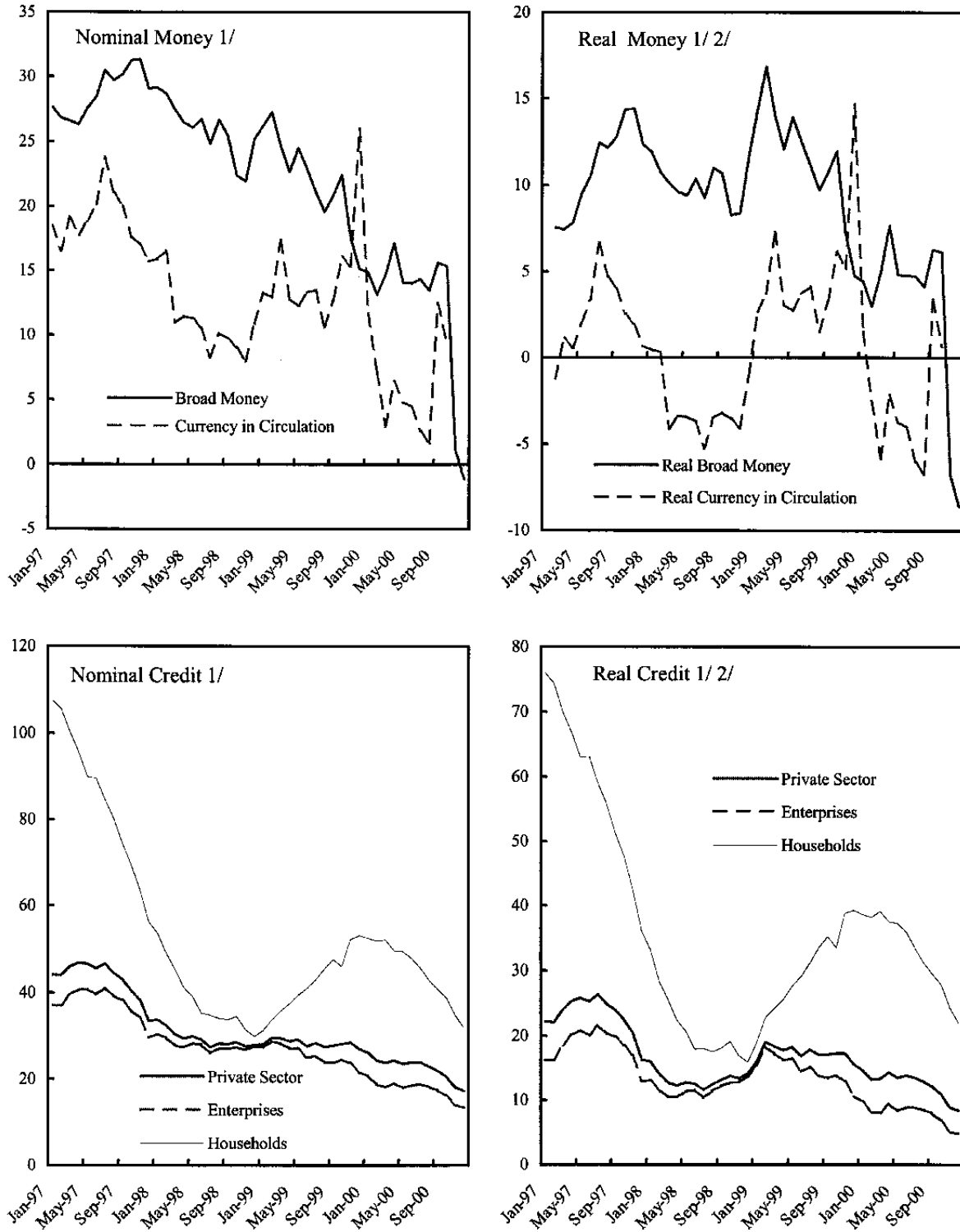
^{1/} Growth rates for national accounts series calculated by staff from official national accounts data.
^{2/} Deflated using inflation excluding food and fuel prices.
^{3/} Credit data exclude household borrowing to finance privatization bids in June 2000.

interest rates, slowed decisively in the first quarter of 2000, before recovering somewhat. Money—notably currency in circulation—and credit growth also slowed (Figure 5 and Table 3). Headline inflation has declined markedly since mid-2000 largely reflecting movements in food and fuel prices (Figure 6). Core inflation, measured by the CPI excluding food and fuel, has responded more moderately to weak demand during 2000; it stood at 8.2 percent in December 2000. In addition, the PPI has been on a moderate downward trend towards the end of the year.

11. **After a large improvement during 1999, cost competitiveness was maintained in 2000, at the expense of employment.** Average economy wide unit labor costs in 2000 rose some 4 percent, while output prices rose some 8–10 percent. Even allowing for increases in fuel prices and interest rates, this suggests a shift to profits, evident also in strong corporate income tax receipts and corporate surveys. Higher frequency data for manufacturing suggest that profits rose strongly through 1999 and leveled off during 2000 (Figure 7). This is also true of the export sector, where unit labor costs fell in 2000 while export prices rose

³ The authorities do not collect constant price quarterly national accounts data and report only year-on-year growth rates for quarterly national accounts series. Staff have used these year-on-year growth rates to calculate seasonally adjusted quarter-on-quarter growth rates, as reported in the text and the text table.

Figure 5. Poland: Indicators of Money and Credit, 1997-2000
(12-month growth)

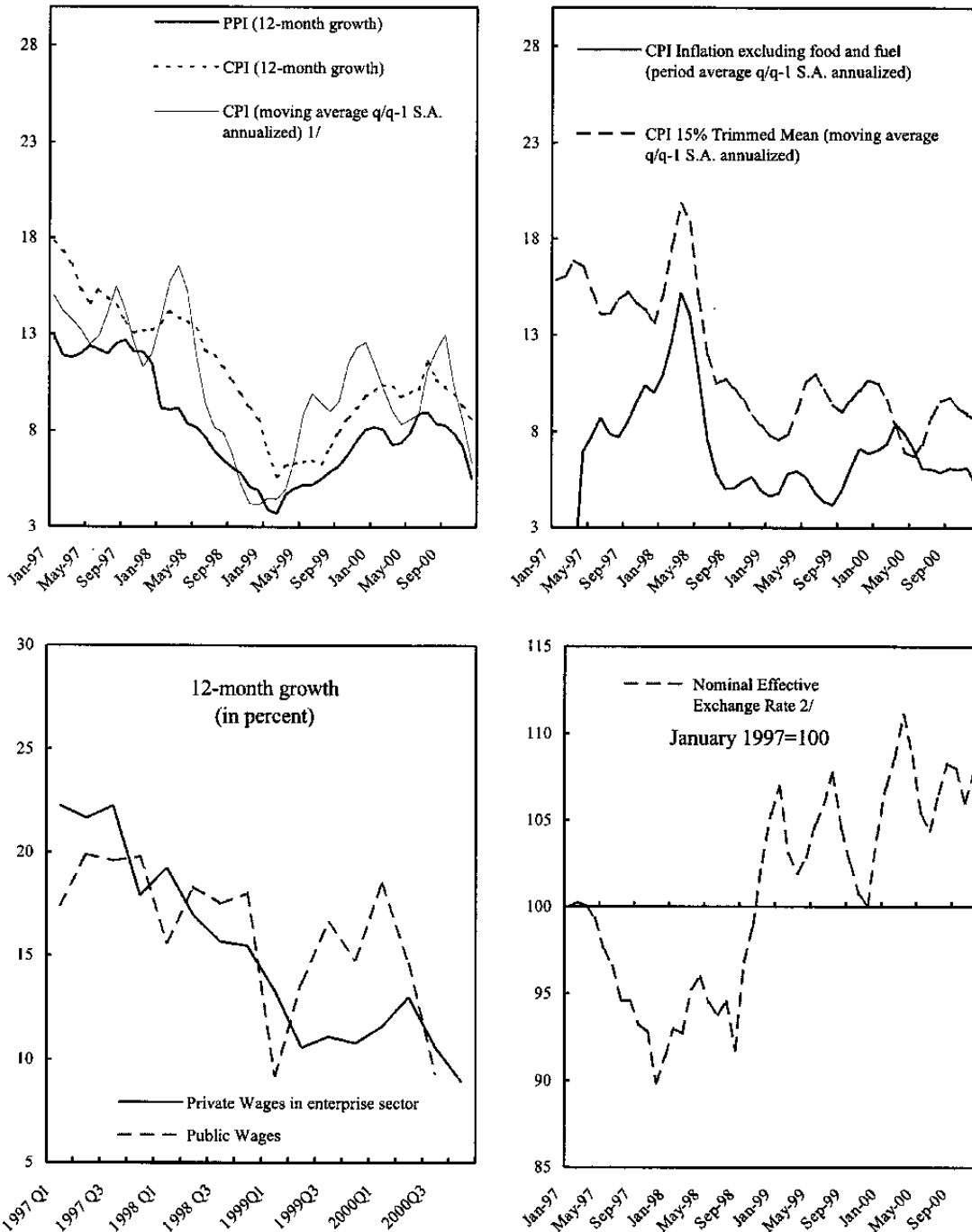


Source: Polish authorities.

1/ Data for June 2000 are corrected for the effect of a privatization bid.

2/ Deflated using CPI excluding food and fuel.

Figure 6. Poland: Indicators of Inflation, 1997-2000

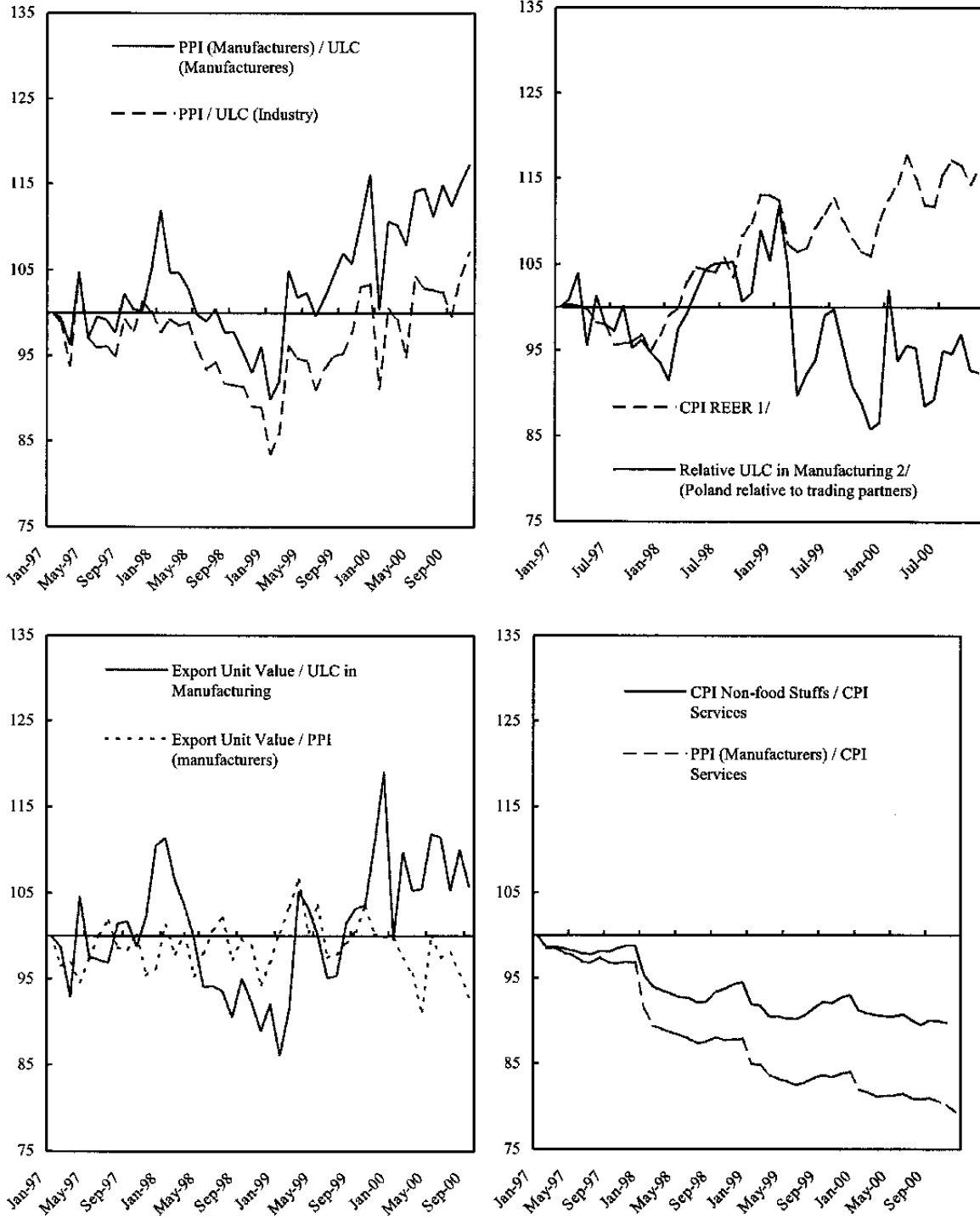


Source: Polish Authorities.

1/ This is a 3 month moving average rate. Thus, the data for December 2000 are the seasonally adjusted average for October, November and December divided by the average for July, August and September, and annualized.

2/ Trade weights for 1999 for Austria, Belgium, China, Czech Republic, Denmark, Finland, France, Germany, Hungary, Italy, Japan, Netherlands, Norway, Russia, Slovakia, Spain, Sweden, Switzerland, Taiwan, UK and USA.

Figure 7. Poland: Indicators of Profits and Competitiveness, 1997-2000
(January 1997=100)



Sources: Polish authorities, Information Notice Systems and Staff Calculations.

1/ Trade weights for 1999 for Austria, Belgium, China, Czech Republic, Denmark, Finland, France, Germany, Hungary, Italy, Japan, Netherlands, Norway, Ukraine, Russia, Slovakia, Spain, Sweden, Switzerland, United Kingdom and United States.

2/ Trade weights for 1999 for Austria, Belgium, Denmark, Finland, France, Germany, Italy, Japan, Netherlands, Norway, Spain, Sweden, Switzerland, United Kingdom and United States.

2½ percent. The 9 percent appreciation of the CPI-REER in 2000 thus largely seems to reflect a sharp decline of tradeable relative to nontradeable prices arising from differential productivity growth—the Balassa-Samuelson effect. This is evident in the appreciation of the CPI-REER whilst relative unit labor costs were unchanged, and in the trend decline in nonfoodstuffs and manufacturing PPI prices deflated by the prices of services. But the strength of profit share and the successful maintenance of competitiveness in export markets came at a high price: loss of jobs. The competitiveness of firms and exporters has strengthened, but labor has lost ground.

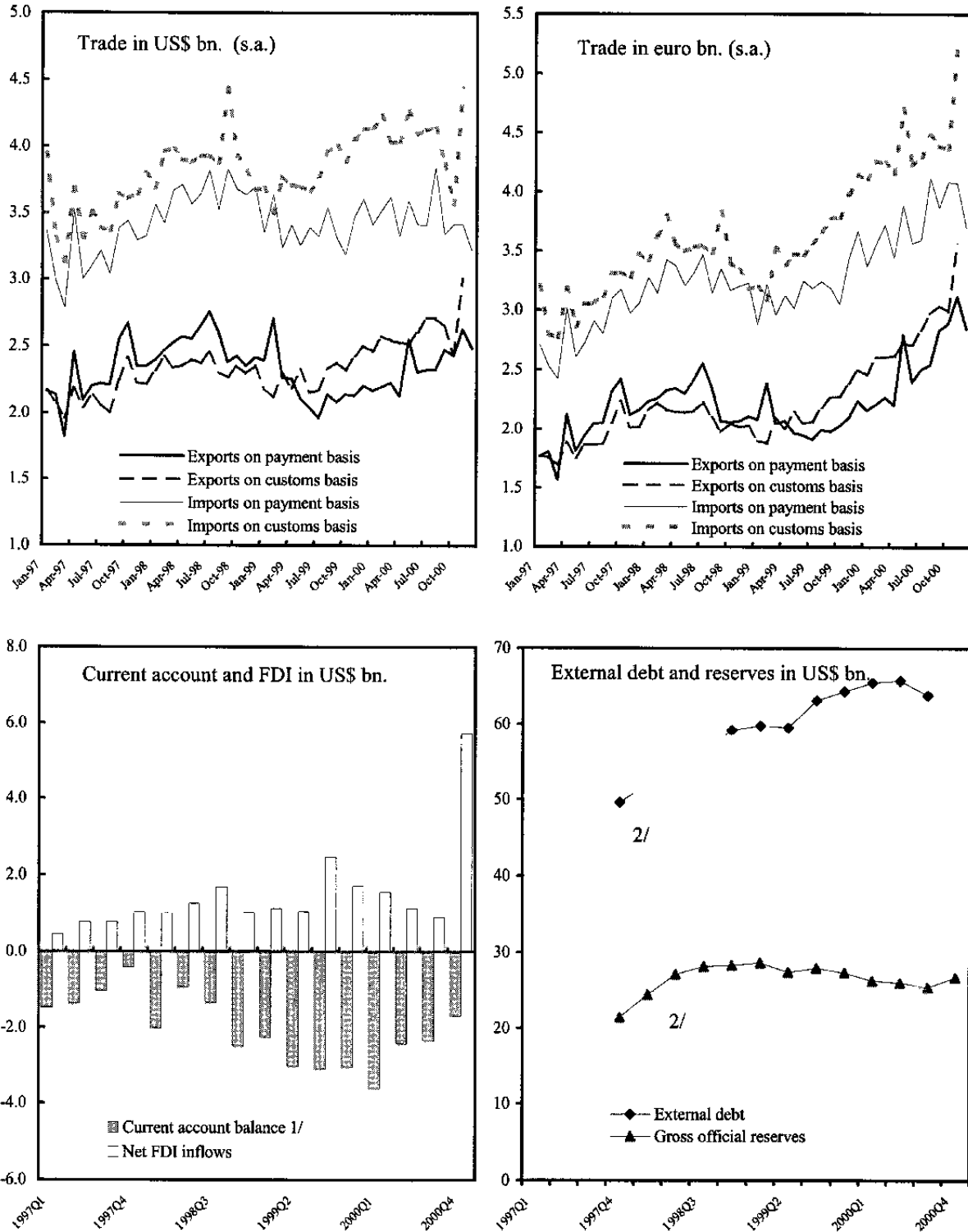
12. **With the weakening of domestic demand, the external current account strengthened during 2000.** New export capacity came on stream, some firms switched sales from weak domestic to stronger foreign markets, and non-oil imports slowed along with domestic demand (Figure 8 and Table 4). These external trends, along with the lagged effects of the improvement in competitiveness in 1999, buoyed activity and overshadowed the effect on the current account of increased international oil prices: for 2000 as a whole, the deficit shrank to 6.1 percent of GDP. Almost all of this deficit was funded by FDI inflows, the bulk of which were privatization-related, while moderate portfolio inflows were more than matched by outflows of other long-term capital. There was no disturbance to capital flows ahead of or following the abolition of the crawling exchange rate band in April 2000 and the shift to a pure floating exchange rate regime. Gross international reserves provided 7½ months of import cover throughout the year.

13. **Since mid-October, the zloty has appreciated against the U.S. dollar and the euro by 12 and 5 percent, respectively, and Polish international spreads have fallen sharply.** These developments reflect a variety of factors including: continued declines in the current account deficit, notably in November 2000; an easing of political tensions which facilitated the appointment of National Bank President, Mr. Balcerowicz, and improved the prospects for passage of the 2001 budget and its accompanying legislation; the consequent increased likelihood that the minority administration will survive till the end of its term in September 2001; expectations (now borne out) that long term zloty interest rates would fall with the drop in inflation; and the 100 bp reduction in US official interest rates in January 2001.

II. REPORT ON THE DISCUSSIONS

14. **The authorities and staff agreed that priorities for policy were to reduce the current account deficit, secure progress towards inflation below 4 percent by end-2003, and create conditions for strong employment growth.** These goals were framed within the overarching objective of accession to the EU at the earliest possible date. In this context, some of the recent headline macroeconomic numbers were encouraging: inflation and the current account deficit were falling; exports were booming and FDI inflows remained strong; and all of these were reflected in the recent strength of the zloty. But consumption, fixed investment, and output were weakening unexpectedly rapidly, real interest rates remained at historical and regional highs, and the fall in employment had yet to stop. Moreover, job losses had been necessary to maintain labor and export competitiveness since 1998, and the strengthening of the zloty compounded these strains.

Figure 8. Poland: Balance of Payments Indicators, 1997-2000



Sources: NBP and staff estimates.

1/ Derived on the basis of seasonally adjusted exports and imports.

2/ Quarterly data are available only from 1999 for external debt, and from 1998 for gross official reserves on the current official definition of reserves.

15. **The discussions focused primarily on the balance of risks in the macroeconomic outlook and on two key operational issues for policy arising from those risks.** The first was the extent to which fiscal stabilizers should be allowed to operate in 2001, in light of weak activity, recent fiscal slippages, the persistence of inflation, and the need for medium-term fiscal consolidation. The corresponding implications for monetary policy in 2001 were also explored. The second was broader medium-term fiscal and structural policies—and particularly the requirements for generating employment to address recent job losses, the growth in the working age population, and the prospective large-scale shift of labor out of agriculture.

16. **Since the mission, the authorities have revised their macroeconomic framework and their budget deficit target for 2001 (Text Table).** The revisions largely reflect newly released data, notably an unexpectedly weak outturn for GDP in the third quarter of 2000. This report reflects discussions held with the authorities since the mission on the revised macroeconomic projections and economic deficit target.

Authorities' macro framework	<u>2001</u> Original	<u>2001</u> Revised
Real Growth Rates:		
GDP	5.1	4.5
Personal Consumption	4.2	3.9
Fixed Investment	8.5	5.8
Inflation (p.a.)		
Unemployment (e.o.p.)	14.9	15.4
In percent of GDP		
Current Account Deficit	6.7	5.9
Economic deficit	1.6	1.8

A. Macroeconomic Outlook for 2001 and the Medium Term

17. **The macroeconomic framework underlying the 2001 budget projects output growth at 4.5 percent in 2001,** a further strengthening of the external current account balance, and a decline in inflation (Text Table). Following the adjustments to the framework in the revised budget for 2001, staff still expect weaker output growth than do the authorities. But the difference is within the margin of error surrounding both projections. The assessment that the external deficit and inflation will fall is shared, though magnitudes differ somewhat.

18. **External factors on balance favor activity growth in 2001—the key uncertainties are domestic.** The WEO projects international oil

	Macroeconomic Framework 2000–2001			
	<u>2001 Budget</u>		<u>Staff</u>	
	2000	2001	2000	2001
Real GDP	4.2	4.5	4.1	4.0
Real domestic demand	2.4	4.0	2.3	2.7
Private consumption	2.0	3.9	2.0	2.9
Gross capital formation	4.1	5.5	3.4	4.5
Fixed investment	2.5	5.8	3.0	4.6
Current Account Balance (in percent of GDP)	-6.2	-5.9	-6.2	-5.4
Consumer inflation (p. a.)	10.0	7.0	10.1	7.0
Real wage growth (p.a.)	2.8	2.0	0.8	2.0
Employment growth (p.a.)	-2.3	0.2	-2.5	-0.5

prices to ease, Poland's terms of trade to improve by ½ percent, and the euro to strengthen. But export market growth is projected to almost halve, to 7 percent. On the domestic side, the authorities and staff anticipated that household consumption would rise due to modest real wage growth, including some catch up after the "inflation surprise" in 2000, the improvement in the terms of trade (tax equivalent of 0.1 percent of 2000 GDP), and one-off transfers—automatically due to pensioners for higher than anticipated inflation in 2000, court-ordered to households for loss of real incomes in 1991, and from Germany for war compensation. The authorities and staff also agreed that investment, buoyed by recent strong export growth, a firm medium-term policy framework, and prospective EU accession, would increase somewhat more strongly than in 2000, especially if interest rates fell as expected. But staff projected lower annual growth than the authorities for consumption, investment, and activity in 2001, in part because the effects of the spate of recent negative external shocks, restructuring, and the monetary tightening in 1999–2000, could continue to dampen activity in 2001. And the recent appreciation of the zloty, if sustained, would likely weaken exports and activity further.

19. The authorities were confident that inflation was set to fall to within the target range of 6–8 percent for 2001. Tight monetary policy during 2000 and into 2001, the strength of the zloty, muted growth of unit labor costs, the deceleration of money and credit aggregates already underway, the projected fiscal tightening in 2001 and falling international oil prices all presaged a continuation of the recent decline in inflation. Exogenous shocks could disturb this outlook—in either direction—and the authorities were leery of a larger-than-expected rebound of nominal and real wage growth after the 2000 inflation surprise; but the deceleration in monthly consumer prices late in 2000 augured well. Staff were somewhat more optimistic, pointing out that even modest decelerations in monthly inflation during 2001 would suffice to bring the consumer price index to the bottom end of the target range for 2001. In addition, all the factors pointing to disinflation had begun to be reflected in the core inflation measures late in 2000.

20. Looking beyond 2001, the key question is whether output can grow fast enough to absorb the currently unemployed and likely growth of the working age population without undue strains on the external accounts (Table 5). Assuming strong policies—notably incorporating fiscal consolidation and ensuring flexibility in the labor market—staff suggested that GDP growth could revert to the 5–7 percent range (Box 2). This would stem from total factor productivity growth of about 3 percent, together with employment growth sufficient to reduce the unemployment rate to 8 percent by 2005, and fixed investment at between 25–30 percent of GDP. The fiscal authorities anticipated growth in the lower end of the staff's range, and the monetary authorities, while not ruling out this scenario, stressed the critical role of fiscal and labor market policies in supporting rapid growth. They also noted that during the 1990s, such growth rates had been achieved only alongside sharp and unsustainable deteriorations in the external balance, and that recent lower growth rates may indicate underlying potential. Staff noted that rising fixed investment had been key to the weakness of the external current account since the mid-1990s and that exogenous shocks together with an inappropriate mix of macroeconomic policies, rather than constraints

Box 2. How Fast Can Poland's Output Grow?

Output growth has recently decelerated from 5–7 percent between 1993–97 to 4–5 percent in 1998–2000. Though adverse exogenous factors played a role in this deceleration, does it also reflect a deceleration of growth to potential, after a post-1990–92 surge?

Rapid structural change and uncertainty about the “productive” capital stock complicate conventional approaches to estimating potential output growth in a transition country. Nevertheless, a simple Cobb-Douglas type growth accounting framework offers useful insights. This framework decomposes output growth into growth of factor inputs (labor and capital) and growth of total factor productivity (TFP).

For this exercise, the elasticities of output with respect to capital and labor are (as commonly) assumed, $1/3$ and $2/3$, respectively. Employment growth is assumed to equal the growth of the working-age population growth, projected at $1/2$ percent, plus a further $1\frac{1}{2}$ percentage points arising from a reduction in unemployment. This is sufficient to lower unemployment rates to 8 percent by 2005 from 14 percent in 2000. The appropriate measure of the capital stock is, however, far from clear—much of the pre-transition stock may now be redundant and this significantly affects estimates of the rate of depreciation. For this exercise, Poland's reported capital stock has been used alongside various depreciation and fixed investment rates, ranging between 5–10 and 25–30 percent respectively. Estimated TFP growth is based on an equation reported by Benhabib and Spiegel (1994) for a panel of many countries. It indicates that TFP depends on countries' income gap with the U.S. and average years of schooling. Entering the values for these variables for Poland into the equation yields predicted TFP growth of 3 percent. On these assumptions, potential output growth would range between 5–7 percent.

Key elements of this calculation are the level of investment and TFP growth, but the transition context and the prospect of a large medium-term structural shift of labor out of agriculture make projections hazardous. The experience of Italy and Spain, which underwent similar agricultural transformation from the mid-1960s to early 1970s, can provide a guide. In Italy, GDP growth in the 1960s averaged 6 percent, while the investment and capital output ratios remained broadly constant over the decade. The investment ratio averaged around 28 percent. Two-thirds of Italy's growth originated in TFP with the rest coming from growth of the capital stock. Spain's transformation process was more capital intensive: $3/4$ of output growth originated in capital accumulation between 1964–73 when the share of agriculture in employment dropped by 10 percentage points to 25 percent. Spain's output growth averaged $6\frac{1}{4}$ percent in this period.

Thus, for Poland, potential growth may be below the highest annual growth rates in 1993–97, but may well be at the average achieved for those years. Margins of error in such estimates are, of course, considerable.

stemming from the economy's potential, were probably the key influence on the recent drop in growth.

21. **Staff anticipated that fixed investment ratios would likely remain high, with unchanged private savings ratios.** Fiscal consolidation, structural reforms and prospective EU accession would maintain the strength of investment.⁴ But the domestic private savings ratio, long broadly stable, showed little prospect of rising: economic growth could boost savings ratios, but the prospect of higher permanent income due to prospective EU entry and financial sector reform were likely to offset this effect. Falling unemployment could also dampen the precautionary motive for savings. This underpinned the need for medium-term fiscal consolidation to contain the external imbalance and make room for investment. In this context, the outlook for financing current account deficits was good: FDI inflows boosted by privatization receipts should amount to over half of the projected current account deficits in 2001; thereafter as privatization-related FDI inflows decline, portfolio inflows are likely to take up the slack. Assuming an improvement in the fiscal-monetary mix, however, these should remain below levels that would worsen debt ratios.

B. Fiscal Policy

22. **The authorities are targeting an economic deficit of 1.8 percent of GDP in 2001.**

On the official estimate of the 2000 outturn, this implies an adjustment of 0.9 percentage points of GDP on a commitment basis.⁵ In their view, this adjustment would contribute significantly to reducing

	General Government, economic basis, 1999–2001 ^{1/}				
	(in percent of GDP)				
	1999	2000		2001	
		Off. Est.	Staff ^{2/}	Budget ^{3/}	Staff
Revenue	41.6	40.3	40.4	41.9	41.1
Expenditure	44.4	43.0	42.7	43.7	43.6
Economic deficit (cash)	2.7	2.7	2.3	1.8	2.5
Ch. in arrears	0.4	0.0	0.4	0.0	0.0
Economic deficit (commitment)	3.1	2.7	2.6	1.8	2.5
GDP growth	4.1	4.1	4.1	4.5	4.0
GDP Zl billion	616	699	699	782	782

^{1/} Data for revenue and expenditure reported on the same basis as for the economic deficit.
^{2/} Staff provisionally estimate that the deficits of social security and local government were respectively 0.4 and 0.1 percent of GDP lower than officially estimated, but that spending arrears rose by 0.4 percent of GDP during 2000.
^{3/} Budget presented to parliament in January 2001.

⁴ Chapter III of the Selected Issues paper discusses medium-term external current account issues.

⁵ The economic deficit is the General Government cash balance, net of transfers to the funded private pillar of the pension system, court-ordered compensation payments to wage earners for inflation in the early 1990s, and receipts from mobile phone licenses.

inflation and the current account deficit and would move toward the objective of balance in the medium term. These benefits outweighed the possible costs of a large withdrawal of fiscal stimulus when output growth was almost certain to be below potential.

23. **The budget envisages that nontax revenues will rise significantly, funding the bulk of the projected increase in spending.** The main sources of additional nontax revenue are: an increase in the transfer from the NBP and receipts of interest on deposits funded by foreign exchange privatization receipts; proceeds from the sale of assets formerly held as collateral for Brady bonds; and the proceeds from an anticipated auction of arrears to the social security system. Tax revenue is projected to rise slightly relative to GDP, assuming an increase in VAT due to improved collection of current liabilities and arrears. On the spending side, nonwage current expenditure in the state budget is lowered relative to GDP, and the stock of arrears is projected unchanged in 2001, making room to fund the compensation to pensioners for the overshoot of inflation in 2000. The authorities argued that recent data and administrative improvements in the social security administration greatly lessened the risks of a third year of under-performing revenues.

24. **The authorities were confident that their revised estimates were well supported by initiatives to strengthen tax administration and maintain effective expenditure control.** They argued that their target would be met despite recent weaknesses in VAT, the fact that adjustments to nonwage current state budget spending are not yet specified, and spending postponed from 2000—which staff estimated could sum to 0.4 percent of GDP.⁶ The improved financial position of the mining and railways sectors and proposals to strengthen enforcement (currently with Parliament) would buttress revenue collection. Spending adjustments were largely within the purview of the spending ministries which would make them in light of reduced resources, and 2000 spending shifted forward into 2001 would be offset by similar switching between 2001 and 2002. Furthermore, an increase in health insurance contributions effective in 2001 and tighter financial monitoring of autonomous health care facilities would strengthen the financial position in the health sector. The authorities noted, however, that logistical hurdles confronting the sale of arrears to the social security administration were still being assessed by external financial advisers.

25. **Staff projected a larger deficit than the authorities.** Even assuming the authorities' macroeconomic projections and their estimates for yields from improved tax administration, staff projected lower VAT receipts and felt that the schedule for selling arrears was overly ambitious. Staff argued that these revenue shortfalls should be acknowledged promptly. In addition, staff projected weaker activity, with consequent effects on the budget outturn. Taking account of both factors, staff projected that revenue policies and spending estimates would yield an economic deficit in 2001 of 2½ percent of GDP, a slippage of 0.7 percent of GDP from the official target (Table 2).

⁶ A total of Zl 4 billion in spending approved for the 2000 state budget was either cancelled or postponed into 2001 in order to meet the state budget target for 2000, given weaker-than-expected revenues. It is unclear how much of the Zl 4 billion was cancelled and how much was postponed.

26. **How to respond to growth, and by extension revenues, weaker than official projections would be a critical question for policy in 2001.** The budget revision in January had responded to a lowering of the revenue projection by 0.3 percentage points of GDP by increasing the deficit target from 1.6 to 1.8 percent of GDP and cutting spending allocations. But the authorities said that they would resist a further increase in the deficit target if, early in the year, revenues looked likely to fall short of the revised target. The staff understood the authorities' reluctance to let the deficit target slip, but emphasized that the response to a shortfall of revenues should place primacy on strictly adhering to nominal spending ceilings—given that the cyclical effects on spending are minimal—and ensuring complete transparency in all budget transactions. In that context, the staff suggested that stabilizers should be allowed to operate even beyond the amount in the budget revision in January. The authorities noted that midyear increases in the state budget deficit ceiling—which would require legislative amendment—could elicit strong political pressures for additional spending, so that allowing further scope for stabilizers to operate risked damaging the credibility of the authorities' commitment to fiscal adjustment. Accordingly, revenue developments would be monitored closely and spending or revenue would be adjusted if the prospect of shortfalls emerged sufficiently early.

27. **The authorities reaffirmed their commitment to improved transparency, and welcomed the fiscal transparency module of the Report on Observance of Standards and Codes.** They intended to publish monthly data on the social security deficit and the transfer of funds to the second pension pillar, and quarterly data on revenue and spending of local governments. These steps would anticipate a comprehensive reporting system for the public sector due to be operational in 2002. Staff supported these proposals, emphasizing that they would improve transparency and would help strengthen the coordination between monetary and fiscal policy. The authorities welcomed the commendation in the Fiscal Transparency Report of progress in strengthening fiscal transparency, including the implementation of a modern budget process and clearly defined boundaries between the public and private sectors, and the significant clarification of the roles of different levels of government in the 1998 Act on Public Finances. They would address the remaining shortfalls, notably the need to provide timely data on the economic deficit, to integrate the extrabudgetary funds fully into the state budget and to strengthen the accounting treatment and reporting of arrears. The authorities will publish the report with the staff report for the 2001 Article IV consultation.

28. **For the medium term, the authorities repeated their commitment to eliminating the economic deficit by 2003, to make room for private investment without straining the current account.** Additional savings of 1–2 percent of GDP were also needed for the domestic counterpart of EU grants anticipated over the medium term. Endorsing this goal, staff urged that the medium term strategy include steps to reduce the burden of taxation, which is high, especially on labor. But even if the overall tax burden were held stable, as envisaged, the adjustment would have to come from expenditure cuts, which would require technical preparation. The authorities agreed that taxation was high and that adjustment would have to focus on spending. They indicated that there is scope to reduce social security expenditure by cutting back on early retirement, reforming agricultural pensions, and

introducing a wealth test for certain social benefits. Staff agreed that social spending, which is high relative to other advanced transition countries, and the public wage bill were obvious candidates for reform and stressed that medium term planning was essential for effective expenditure restraint.⁷ The authorities had set up a working group to address this issue. On local governments, the authorities argued that most were proving to be financially prudent, and, for the small proportion in deficit, the legal limits on borrowing were either already binding or likely to become so soon. Nonetheless, the authorities would seek to improve the incentives for efficient resource utilization by local authorities, especially in education. Staff welcomed this proposal, adding that improved guidance on the level of resources from central government and a tightening of local government borrowing limits would help to ensure that local government budgetary positions were consistent with medium term fiscal objectives.

C. Monetary and Exchange Rate Policies

29. **Having overshoot the 1999 and 2000 inflation targets, the monetary authorities emphasized the absolute priority they placed on meeting the target of 6–8 percent by December 2001 as a prerequisite to reducing inflation below 4 percent by end-2003.** In their view, this priority had already been decisively reflected in the increases in official interest rates since late 1999—a necessary response to headline inflation running above target, buoyant domestic demand and fiscal slippage in 1999 and again in 2000. This priority had also been reflected in the specification of the target range for 2001: it had been widened to 2 percentage points from 1.4 percentage points to better reflect the volatility in inflation and the virtual absence of satisfactory models of inflation in Poland; also, it had been raised to 6–8 percent from 5.4–6.8 percent in 2000 to reflect the reality of the overshoot of the 2000 target.⁸ But if food and fuel prices were more favorable than expected, then the MPC would aim for an inflation outturn in 2001 below the target range. Further substantive changes to the formal inflation targeting framework would be delayed at least until the 2001 target had been met lest such changes compound skepticism in some quarters about the integrity of the framework.

30. **The authorities felt that their commitment to disinflation had been reflected in market expectations, but that residual uncertainties remained among households and businesses.** They noted that while the whole yield curve had risen since end-1999, it remained inverted: financial markets still expected inflation to decline over the medium term, but from a higher starting point. This expectation was also reflected in the monthly Reuters survey of inflation expectations of bank economists in Poland. But the monetary authorities noted that long yields remained above levels prevailing at end-1999, indicating that even the MPC's much-criticized interest rate increases may not have been sufficient to eliminate renewed inflationary expectations. This was compounded by household surveys

⁷ Chapter IV of the Selected Issues paper looks at this issue in the context of the recent local government reforms.

⁸ Chapter II of the Selected Economic Issues paper discusses modeling inflation in Poland.

which, perhaps surprisingly, anticipated further increases in inflation in 2001. Nevertheless, MPC members pointed to the deceleration of domestic demand, credit and money, as well as the recent appreciation of the zloty as indications of the resumption of disinflation.

31. **In this context, the authorities regarded the key question as when and how interest rates should be lowered.** The first step was taken after the mission in December when the MPC shifted from a tightening to a neutral bias. The next step would be to lower nominal interest rates in line with reasonable estimates of inflation expectations. MPC members underscored, however, that they would be cautious in interpreting evidence on expectations and on whether the economy was set to achieve the short- and medium-term inflation targets. A full range of indicators of potential inflationary pressures would be taken into account in decisions on interest rate cuts, but MPC members were particularly concerned about the risks of adverse supply shocks and excessive budget slippages.

32. **In weighing the risks of excessive delays in lowering nominal interest rates against those of premature reductions,** the monetary authorities emphasized the gains to credibility from greater certainty that inflation would be close to the 2001 inflation target floor against the costs to economic activity which would largely be short term.

33. **While acknowledging the case for caution and for the primacy of structural reforms as the engine of growth in the medium-term, staff pointed to the risks of undue delay in significantly easing the stance of monetary policy.** Staff, like market participants, were increasingly confident that inflation would fall: nominal wage growth remained moderate, the lagged effects of the 1999–2000 monetary policy had yet to fully work through, fiscal policy if operated counter-cyclically would overshoot its target but would not compound inflationary risks, and inflation was already running at annual rates which, without further significant reduction, would yield inflation at most at the lower end of the target band by end-2001. This assessment was eliciting strong capital inflows and boosting the zloty because markets felt that rate cuts would be delayed. In turn, this was producing a marked tightening of monetary conditions when activity and inflationary pressures were already relatively weak.

34. **The NBP intended to continue to refrain from intervention in foreign exchange markets—a position staff strongly supported.** Staff agreed with the authorities that the volatility of the exchange rate continued to encourage responsible hedging. The establishment in 2000 of a special account in the NBP into which some privatization receipts are placed to finance future debt service also insulated NBP reserves from public debt service, and the account had been used to fund a US\$943 million buy-back of Brady bonds in August 2000. But staff reiterated concerns that markets had little advance notice about how much would be placed in the account, and no formal commitment had been made to restrict withdrawals solely to external debt service. The authorities agreed that the account should not be perceived as an implicit tool of intervention, and noted that the balances in the account are posted monthly on the Ministry of Finance web site. Staff also suggested that in time, the NBP should consider beginning a program of purchases of foreign currency so as to maintain appropriate ratios of reserves to short-term debt and imports. If this program was

preannounced, the principle of abstention from discretionary intervention would be preserved.

D. Financial and Macroeconomic Vulnerabilities

35. **Drawing on the conclusions of the FSAP mission, staff and the authorities agreed that major financial risks were not apparent.** The banking system had weathered recent increases in interest rates and structural changes in the economy: portfolio quality and profitability had reflected the pressures, but overall remained resilient. In addition, banking interest rates had responded appropriately to increased official rates, albeit with some lags, and banks had been able to absorb fluctuations in the zloty without undue difficulty.

36. **Staff and the authorities agreed that the main risk factor remained the size of the current account deficit, despite recent falls.** Poland scores well on vulnerability indicators (Table 6). Gross reserves cover 8 months of imports and 300 percent of short-term debt. This level strikes an appropriate balance between the cost of holding reserves and the need to signal financial strength. Poland's robust performance on other indicators of vulnerability, including the ratio of reserves to broad money and external debt, shelter it from some concerns that the large current account deficit might otherwise elicit. The FSAP had, however, highlighted a number of concerns as well as areas where progress was needed in order to fully meet international standards (See Box 3).

37. **In the context of limited vulnerabilities, the authorities intended to abolish the remaining controls on capital flows when the external current account balance is stronger and when processes for monitoring of flows have been strengthened.** Apart from restrictions on purchases of real estate, the controls require prior NBP approval of nonbank short-term capital flows. Staff noted that sizeable offshore spot and forward markets in the zloty alongside unfettered access for residents to foreign currency deposits and credits from domestic banks meant that the controls on short-term flows did not constitute much of an impediment to speculative pressures on the zloty or the accumulation of foreign debt, an assessment endorsed by the recent FSAP mission. Abolition would, however, promote the development of domestic financial markets, improve monitoring of foreign exchange transactions, and facilitate hedging. Given the strengthening of the current account deficit, further delays in abolition of the controls on short term flows seemed unwarranted. Since the mission, the authorities have indicated that they intend to proceed with abolition soon.

E. Unemployment

38. **The authorities acknowledged that unemployment had become an increasingly urgent challenge.** If the job losses inherent in past and prospective structural adjustments were not to translate into permanent increases in unemployment, it was essential that macroeconomic policies make room for private investment and that labor market conditions encourage job creation. Growth of the working age population by about 1 percent per annum and the prospective shift of labor out of agriculture made these goals all the more critical.

Box 3. Stability in the Financial System

The Financial Sector Assessment Program for Poland (initiated in July 2000) concluded that there are no major immediate issues of systemic stability. Nonetheless, the banking system and its regulatory and supervisory framework need to be further strengthened, and with the financial system likely to continue to grow rapidly from a low base, vigilance over possible developmental problems will be needed.

Financial sector restructuring has accelerated significantly recently. The sector has become diversified and foreign participation is up in key sectors (70 percent of bank equity and 53 percent of insurance companies' equity is foreign controlled). Both developments have contributed to the stability of the sector and the quality of its services. Transition-related bad debt problems in the banking system have largely been resolved, and the 1997 banking law brought the regulatory system and supervisory practice closer to international standards.

There are areas of possible concern for financial stability, however.

The exposure of the financial sector to exchange rate risks is unclear. Direct exposure of the banking system on average is small, but an informal assessment suggests some trouble spots, and corporate exposure is not known. It is important that the authorities improve data collection on these exposures to facilitate monitoring while markets for hedging deepen.

Profitability in the banking sector is declining as competition stiffens, and consequently consolidation will be necessary, through mergers and closures, especially among the small and weaker banks.

The banking system is well capitalized (on average 16 percent of risk-weighted assets). But following the Russian crisis, the increase in domestic interest rates, the decline in activity growth, and the boom in lending to households in recent years, portfolio quality has declined. Credit risk is now the greatest risk to the banking system.

Restructuring and privatizing the largest retail bank should be accelerated. Even though the bank does not pose a systemic threat, because it is publicly owned, it should be privatized to reduce the burden on the budget and enhance competition.

The banking regulatory and supervisory framework needs further strengthening. Supervision and reporting should move to a consolidated basis given the expansion of group structures. Corporate governance also needs to be strengthened, both through changes in the law and through restructuring of small private banks. Enforcement powers need to be augmented to facilitate more timely and effective action to address problematic banking practices uncovered in the supervisory process. The new banking law—currently before Parliament—addresses several of these issues, introducing important improvements in the regulatory framework, and its implementation should not be delayed.

A fundamental theme cutting across all parts of the financial sector is the need to strengthen corporate governance. The difficulties in this area largely emanate from the transition, but as competition deepens, it becomes increasingly important to address this issue as it may threaten the stability and soundness of the sector over time.

For this reason, the authorities have resisted steps—including proposed changes to the definition of the work week—that could compromise labor market flexibility. They have constituted a high-level inter-ministerial team to examine how to meet the challenge of unemployment.

39. **Staff agreed that the issue was critical and that its remedies were not yet entirely clear.** Declining employment alongside falling labor share raised concerns that labor was becoming overpriced. But the roots of any possible problem remained somewhat obscure—wages largely appear to be flexible; union pressures are, by international standards, limited; and in most areas, the legal framework for the labor market is relatively flexible. There was, however, evidence that the minimum wage was harming job creation in Poland.⁹ The ratio of the minimum to the average wage is high compared with other regional EU-accessant countries and there is a marked spike in the distribution of wages at the minimum wage, notably for the relatively unskilled, labor market entrants, and in high unemployment regions (Figure 9). This evidence suggests that the minimum wage binds. Thus, a reduction in the ratio of the minimum wage to average wages, particularly in high unemployment regions and for labor market entrants, could play a part in job creation. Still, it was unclear how much of the overall unemployment problem reforms of this nature would address. The authorities emphasized that such a change would also need to be supported by training initiatives and steps to improve labor mobility, including improved access to housing for migrants. They stressed that a more efficient labor market will combat unemployment and greatly improve the environment in which macroeconomic policies operate.

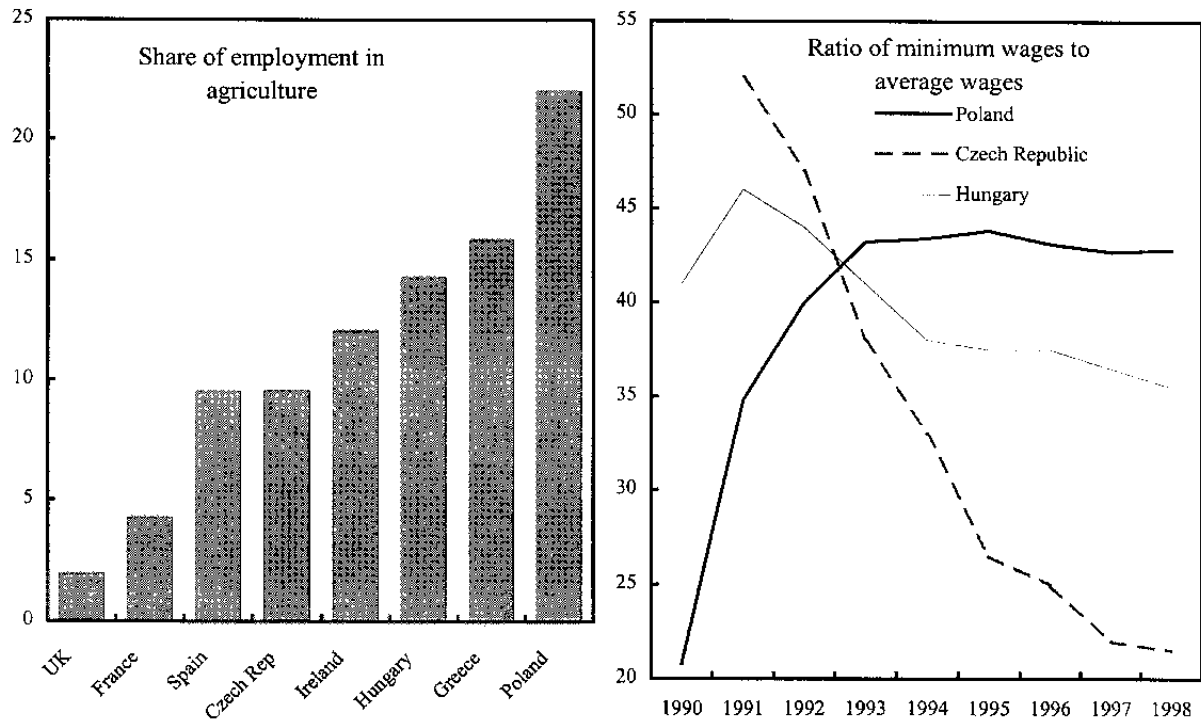
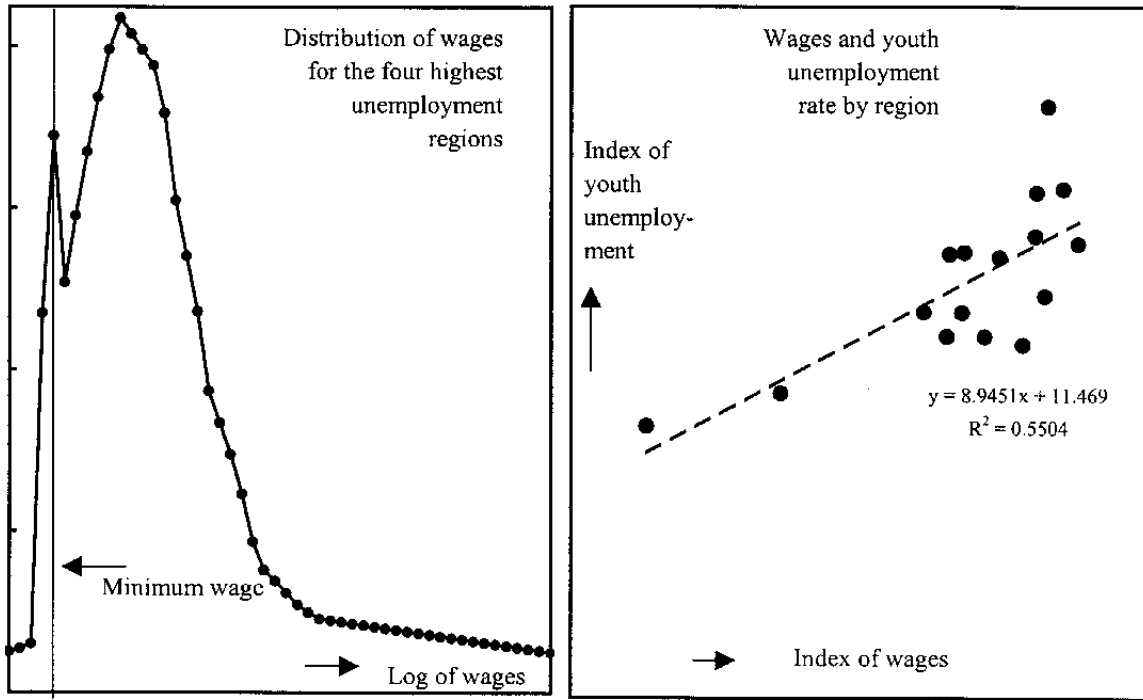
F. Structural Policies

40. **The authorities emphasized that other structural reforms, building on progress so far and in the context of EU accession, are also essential to achieve Poland's medium-term goals.** With almost half of the accession chapters closed, EU negotiations were on track. Difficult issues lay ahead, notably in agriculture, but the streamlined process adopted for implementation of necessary legislative changes was operating effectively.

41. **Privatization continues at a rapid pace.** The 2001 budget conservatively anticipates Zl 18 billion (3 percent of GDP) in receipts. Key projects anticipated for 2001 include further sales in telecommunications and various defense, steel and sugar companies. For steel, the authorities hoped that allowing investors to buy only those parts of firms they want will accelerate overall progress. Ten companies in energy generation and distribution will be put up for sale early in 2001. The government's objective remained to privatize more than 70 percent of the total value of its 1998 assets by 2002. State ownership would be limited to mostly minority stakes in strategic sectors, including defense, energy, transportation, and postal services. A dispute between the authorities and the buyers of PZU, an insurance company, had concerned the investor community, but the dispute was being resolved through

⁹ Chapter I of the Selected Issues paper examines the minimum wage and other labor market issues.

Figure 9. Poland: Indicators of the Minimum Wage, 1999



Source: Country authorities, UN FAO and staff calculations.

standard legal procedures in the courts. Preparations were also being made to privatize the remaining state-owned banks.

42. **The restructuring program for the coal sector also continues.** This aims for further significant reductions in production capacity and employment, leading ultimately to privatization. Additional mine closures and redundancies are expected. The sector as a whole has reduced its losses, but still accrues arrears on tax and social security contributions.

43. **Trade liberalization continues to be guided by commitments to the WTO and the EU, and will require further progress.** Poland plans to adjust all tariffs to non-EU members to EU external rates over the coming 2 years. This implies a reduction in unweighted average MFN tariffs from 16 to 7 percent, though the bulk of Polish trade in nonagricultural goods will be unaffected as it is already covered by free trade area agreements with the EU and CEFTA. This will be accompanied by the abolition of all tariffs on trade within the EU by the time of accession. To ensure a smooth transition, agricultural trade with the EU will be covered by a “double-zero” agreement. Under this, Poland and the EU commit to abolish tariffs on products with already low tariffs and to steadily increase preferential quotas and lower tariffs for more sensitive products (e.g., meat, milk, and sugar), while the EU will unilaterally open preferential quotas on a third group of products (e.g., cucumbers, cherries, and juice).

III. STAFF APPRAISAL

44. **Poland has been hard hit by shocks in recent years—from the Russia crisis in 1998 to the surge in oil prices in 2000—but has weathered them well.** Growth has slowed to about 4 percent, below most estimates of potential in Poland but satisfactory by the standards of most other countries. Disinflation stalled at around 10 percent, but now appears to be back on track. Employment has fallen sharply and, though this raises considerable short- and medium-term concerns, it appears largely to reflect a new wave of restructuring that will boost output, incomes, and employment in the medium-term. The current account deficit peaked briefly at over 8 percent of GDP but has headed decisively back into safer territory for a year, on the back of booming exports. Throughout this difficult period, Poland maintained access to international markets on excellent terms. This record is testimony to the economy’s resilience under fire, the legacy of years of deep structural reform and a commitment to macroeconomic stability.

45. **Nevertheless, the past two years leave challenging legacies.** Output growth and investment weakened sharply through 2000, consensus forecasts do not envisage an early rebound, and there is significant uncertainty about near-term prospects. The current account deficit, while narrowing rapidly, remains vulnerable to the needed recovery in domestic demand. In this setting the policy mix has been problematic. Slippages in meeting fiscal deficit targets have placed an undue burden on monetary policy for reining in the current account deficit and lowering inflation: consequently, real interest rates have been very high and the zloty has appreciated. Perhaps most fundamentally, the drop in employment during the last two years needs to be reversed. These issues will need to be addressed during an historic sprint to complete reforms for early EU accession.

46. **Adjusting the fiscal-monetary policy mix will be difficult in 2001 when growth is likely to be well below most estimates of potential.** Fiscal policy will need to find a balance between moving toward medium term balance in the fiscal accounts and avoiding an undue withdrawal of fiscal stimulus. The recent revision to the proposed budget, lowering spending by a fraction of the downward revision in revenue estimates, was appropriate while improving the credibility of the budget targets. Looking ahead, even if the authorities' growth projections are realized, a revenue shortfall seems likely; this shortfall should be acknowledged promptly in the spirit of transparency. But if growth is significantly weaker—a clear possibility given the uncertainties in projections for 2001—more difficult fiscal decisions will be needed. Two main principles should guide them: nominal spending plans should be strictly observed, and all monthly and quarterly data on the economic deficit should be published as soon as they are available, in line with the recommendations of the fiscal transparency report, so that fiscal developments are readily apparent to markets. If these principles are strictly adhered to, however, there is a case for allowing stabilizers to operate: with growth of 4 percent or lower and continued favorable developments in inflation and the external current account, some of the revenue shortfalls should be allowed to carry over into a higher deficit than is now targeted. In fact, since staff projections for output assume fiscal stabilizers, activity would be weaker still if offsetting fiscal actions were taken.

47. **At the same time, the underlying momentum towards medium-term fiscal consolidation needs strengthening.** The external current account deficit is large, especially in light of weak domestic demand, and fiscal support to secure inflation targets will be needed when domestic demand recovers. Thus, the authorities' target of eliminating the economic deficit by 2003 is appropriate—assuming a return to growth of 4½–5½ percent. But the evidence of recent years, when deficit reduction proved elusive, underscores that adjustment on this scale will require fundamental policy decisions, notably on social spending—which is high for the region—and on the public wage bill. Following the devolution of spending in 1999, the support of local authorities for these objectives will need to be marshaled. This would be facilitated by improving guidance on the volume of resources they can expect to receive from the central government over the medium-term, and tightening the rules governing their borrowing, which in most cases do not yet bind. Substantial expenditure reforms will be necessary if the deficit reduction is to be achieved without any increase in the tax burden, a key requirement for increasing the dynamism of the private sector.

48. **The recent and prospective easing of inflation presents an opportunity to lower high interest rates.** The inflation target of 6–8 percent in 2001 is appropriate. With output growth likely to be weak, and absent further adverse supply shocks, an outturn much above the floor of this range would raise doubts about prospects for meeting the end-2003 target of inflation below 4 percent. Given the need to rebuild credibility, the weakness of models of inflation in Poland, the risk of supply shocks and noncyclical fiscal slippage in 2001, it is understandable that the Monetary Policy Council is risk-averse in cutting interest rates. But an undue delay in lowering official interest rates would pose risks to activity and exports, particularly in light of the recent appreciation of the zloty and the drop in dollar interest rates. For the short term, policy interest rates should be lowered along with reasonable estimates of

inflation expectations so as to prevent passive increases in real interest rates and further loss of competitiveness. And if wage moderation persists alongside fiscal policy as outlined above, the groundwork would be laid for reductions in interest rates. Once the end-2001 target is comfortably met, adjustments to the inflation targeting framework should be considered—a further widening of the inflation target band, so as to better reflect the incidence of supply shocks and the state of inflation forecasting, and the specification of a rolling three-year ahead band.

49. **Poland should continue to abstain from discretionary intervention on the foreign exchanges and should end remaining controls on short-term capital flows.** Since the elimination of the exchange rate band in April 2000, exchange rate volatility has remained manageable and appears to be promoting hedging. Funding official foreign debt service from the special account for privatization receipts has removed the NBP even further from intervention activity. Operation of the account would be strengthened by giving markets more advance notice of its transactions and reassurance that it will not be used for discretionary intervention. The recent decision to proceed soon with capital account liberalization promises to bolster market mechanisms and transparency. With already active on- and off-shore zloty markets, the move should have little effect on the value or vulnerability of the zloty, yet it should promote sound financial market development.

50. **The FSAP found that the financial sector is sound, but a variety of steps would strengthen it further.** Restructuring and privatization of the remaining state-owned commercial banks would improve efficiency, competition, and the operation of the transmission mechanism. Also, as competition among smaller banks increases, consolidation and improved governance will be essential. Early passage of the draft Banking Act would bring regulation more fully in line with the Basle Core Principles. Moves to strengthen monitoring of currency exposures in the corporate sector should be accelerated.

51. **With registered unemployment at 15 percent, sizeable hidden unemployment, a growing working age population, and prospective agricultural and industrial restructuring, reversing the drop in employment of the last two years is paramount.** Of course, more rapid growth, fostered by a rebalancing of the fiscal-monetary policy mix and continued progress with industrial restructuring and privatization, will be critical. But persistently high unemployment and declining labor force participation are indications of rigidities in the labor market itself. Research into the nature of these rigidities is at an early stage, but some results are emerging. Reform of the minimum wage—at a regionally high 40 percent of average wages—is likely to be important. Beyond this, the authorities' resistance of direct interventions such as reductions in the work week, import protection, and export subsidies is right.

52. **Poland's statistical base is adequate for surveillance.** The authorities should continue to improve the quality of macroeconomic data, notably by taking steps to produce and publish constant price quarterly national accounts data and monthly data on the economic deficit of the general government. These should accompany ongoing efforts to provide transaction-based balance of payments data on a more timely basis and improve the

transparency of fiscal data. Poland has subscribed to the Special Data Dissemination Standard and its metadata are posted on the Data Standards Bulletin Board and data on reserves, foreign currency liquidity, and external debt conform to the established benchmarks for the provision of data to the Fund.

53. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Table 1. Poland: Selected Economic Indicators

	1996	1997	1998	1999	Estimate 2000	Projection 2001
Real economy (percent growth)						
GDP	6.0	6.8	4.8	4.1	4.1	4.0
Domestic demand	9.6	9.4	6.5	5.0	2.3	3.4
<i>Contribution to GDP growth</i>	9.4	9.5	6.7	5.3	2.4	3.5
Private consumption growth	8.6	6.9	4.9	5.4	2.0	3.0
<i>Contribution to GDP growth</i>	5.3	4.4	3.1	3.4	1.3	1.9
Public consumption growth	2.0	3.1	1.4	1.0	1.5	3.2
<i>Contribution to GDP growth</i>	0.3	0.5	0.2	0.2	0.2	0.5
Domestic fixed investment growth	19.7	21.7	14.2	6.5	3.0	4.6
<i>Contribution to GDP growth</i>	3.7	4.6	3.4	1.7	0.8	1.2
CPI						
Average	19.9	14.9	11.8	7.3	10.1	7.0
End of period	18.5	13.2	8.6	9.8	8.5	6.0
Unemployment Rate	14.3	11.5	10.1	12.0	13.9	15.2
Average wage growth	...	...	16.7	11.5	10.9	9.0
Gross National Saving (ratio to GDP)	20.9	21.6	21.9	18.9	20.1	20.7
Gross Domestic Investment (ratio to GDP)	21.9	24.6	26.2	26.4	26.3	26.0
Public Finances (percent of GDP)						
State Government Revenues	24.7	24.0	22.9	20.5	19.4	20.2
State Government Expenditures	28.3	26.6	25.9	23.0	22.0	23.2
State Government Balance	-3.5	-2.6	-3.0	-2.5	-2.6	-3.1
General Government Revenues	43.0	42.8	41.4	40.2	39.4	39.6
General Government Expenditures	46.4	45.8	44.6	43.9	42.6	43.2
General Government Balance	-3.3	-3.1	-3.2	-3.7	-3.2	-3.6
Economic Balance				-3.2	-2.6	-2.5
General Government Debt 1/	47.9	46.9	42.9	44.5	42.5	40.0
Money and credit						
Domestic Credit (12-month change)	31.1	26.5	22.1	20.5	6.9	...
Broad Money (12-month change)	29.5	27.3	25.2	19.3	11.8	...
Money market rate (eop)	21.6	24.8	15.9	16.4	18.9	...
13-week t-bill rate (eop)	18.8	23.5	13.6	16.2	16.8	...
Balance of Payments						
Current account balance (in mill. U.S. dollars)	-1,371	-4,312	-6,858	-11,569	-9,892	-9,491
percent of GDP	-1.0	-3.0	-4.3	-7.5	-6.1	-5.4
C/A balance including FDI, percent of GDP	1.0	-0.9	-1.2	-3.4	-0.4	-1.4
Exports (in mill. U.S. dollars)	24,453	27,229	30,122	26,347	28,276	31,311
Export volume growth (percent)	10.0	21.7	10.4	-8.1	14.9	10.0
Imports (in mill. U.S. dollars)	32,632	38,549	43,842	40,727	41,421	44,344
Import volume growth (percent)	32.1	29.0	17.2	-0.6	4.6	6.8
Terms of trade (1995=100)	97.5	97.5	100.7	102.5	98.5	98.9
Official reserves (in mill. U.S. dollars)	18,220	21,403	28,275	27,314	27,464	28,844
in months of cover	6.7	6.7	7.7	8.0	8.0	7.8
Total external debt (percent of GDP)	33.1	34.5	37.3	41.5	40.3	38.3
Ratio of short term debt to gross reserves	27.3	23.9	29.8	38.8	39.1	38.1
Exchange rate						
Zloty per US\$, period average	2.7	3.3	3.5	4.0	4.3	...
Zloty per Euro, period average	...	...	3.9	4.2	4.0	...
Real effective exchange rate (INS, CPI based)	113.0	114.9	120.4	115.6	124.9	...
percent change	13.0	1.7	4.8	-4.0	7.3	...

Sources: Polish authorities and staff estimates.

1/ Data for 1999 on cover general government; data for earlier years are for central government only.

Table 2: General Government Finances 1998-2001

	in Zloty billion					in percent of GDP				
	Outturn 1998	Outturn 1999	Staff projection 2000	Amended draft budget 2001	Staff projection 2001	Outturn 1998	Outturn 1999	Staff projection 2000	Amended draft budget 4/ 2001	Staff projection 2001
State revenue	126.6	125.9	135.7	161.1	157.7	22.9	20.5	19.4	20.6	20.2
Taxes	120.0	118.3	124.9	142.5	139.8	21.7	19.2	17.9	18.2	17.9
Direct taxes	49.5	38.2	39.8	43.2	43.4	8.9	6.2	5.7	5.5	5.6
Indirect taxes	70.5	80.1	85.1	99.3	96.4	12.7	13.0	12.2	12.7	12.3
Non-tax revenue 1/	6.5	7.6	10.8	18.5	17.9	1.2	1.2	1.5	2.4	2.3
State expenditure	139.7	138.4	151.1	181.6	181.6	25.2	22.5	21.6	23.2	23.2
Current expenditure	131.8	133.4	146.3	172.8	172.8	23.8	21.7	20.9	22.1	22.1
Transfers to households	12.7	12.0	13.3	14.9	14.9	2.3	1.9	1.9	1.9	1.9
Other transfers and subsidies	42.7	66.8	82.0	101.9	101.9	7.7	10.9	11.7	13.0	13.0
Debt service	17.9	18.8	18.0	22.2	22.2	3.2	3.1	2.6	2.8	2.8
Other current expenditure	58.5	35.8	32.9	33.8	33.8	10.6	5.8	4.7	4.3	4.3
Capital and net lending	7.9	5.0	4.8	8.8	8.8	1.4	0.8	0.7	1.1	1.1
State budget balance (cash) 2/	-13.2	-12.5	-15.4	-20.5	-23.9	-2.4	-2.0	-2.2	-2.6	-3.1
Net change in arrears	3.9	2.2	2.5	0.0	0.0	0.7	0.4	0.4	0.0	0.0
State budget balance (comm)	-17.1	-14.7	-17.9	-20.5	-23.9	-3.1	-2.4	-2.6	-2.6	-3.1
FUS balance	-0.8	-6.5	-1.0	0.0	-2.2	-0.1	-1.1	-0.1	0.0	-0.3
Labor fund balance	0.3	-0.1	-0.9	-0.6	-0.9	0.1	0.0	-0.1	-0.1	-0.1
Health funds balance	0.0	-0.8	-0.5	0.0	0.0	0.0	-0.1	-0.1	0.0	0.0
Other funds balance	0.8	0.9	0.2	1.2	1.2	0.1	0.2	0.0	0.2	0.2
Local authorities balance	-1.4	-1.0	-2.1	-3.1	-2.4	-0.2	-0.2	-0.3	-0.4	-0.3
General government balance (cash)	-14.3	-19.9	-19.7	-23.0	-28.2	-2.6	-3.2	-2.8	-2.9	-3.6
General government balance (comm)	-18.2	-22.1	-22.2	-23.0	-28.2	-3.3	-3.6	-3.2	-2.9	-3.6
Financing	18.2	22.1	22.2	23.0	28.2	3.3	3.6	3.2	2.9	3.6
Domestic (net)	17.6	21.1	24.7	24.8	30.0	3.2	3.4	3.5	3.2	3.8
o/w Privatization	7.1	8.0	26.7	18.0	18.0	1.3	1.3	3.8	2.3	2.3
Foreign	-3.3	-1.2	-5.0	-1.8	-1.8	-0.6	-0.2	-0.7	-0.2	-0.2
Change in arrears	3.9	2.2	2.5	0.0	0.0	0.7	0.4	0.4	0.0	0.0
Adjustments										
Transfer to 2nd pillar	0.0	3.1	7.6	14.4	14.4	0.0	0.5	1.1	1.8	1.8
Compensation payments	0.0	0.0	-3.4	-2.5	-2.5	0.0	0.0	-0.5	-0.3	-0.3
UMTS	0.0	0.0	0.0	-3.1	-3.1	0.0	0.0	0.0	-0.4	-0.4
Special payments from MoT	0.0	0.0	-0.4	0.0	0.0	0.0	0.0	-0.1	0.0	0.0
Economic revenues	227.3	256.3	282.7	327.7	321.1	41.1	41.6	40.4	41.9	41.1
Economic spending (cash)	241.6	273.1	298.6	342.0	340.4	43.6	44.4	42.7	43.7	43.6
Economic spending (comm)	245.5	275.3	301.1	342.0	340.4	44.3	44.7	43.1	43.7	43.6
Economic deficit (cash) 2/	-14.3	-16.8	-15.9	-14.3	-19.4	-2.6	-2.7	-2.3	-1.8	-2.5
Economic deficit (comm)	-18.2	-19.0	-18.4	-14.3	-19.4	-3.3	-3.1	-2.6	-1.8	-2.5
<i>Memo item: Nominal GDP</i>	553.6	615.6	699.1	781.7	781.6					
<i>Memo item: General government debt 3/</i>	237.4	274.0	297.2	314.8	312.8	42.9	44.5	42.5	40.3	40.0

Sources: MoF, NBP, and staff estimates.

1/ Authorities' projection for 2001 includes an estimated zł 0.6 bn capital gain on the sale of Brady Bond collateral, which staff records as financing

2/ Additional measures of Zł 3.4bn would be required to meet the authorities' target for the state budget deficit in 2001. If these were implemented, the economic deficit would be 2.1 percent of GDP in 2001.

3/ For 1998, this covers state debt only; from 1999 onwards, this includes debt of local governments and extrabudgetary funds

4/ Budget presented to parliament in January 2001.

Table 3. Poland: Monetary Survey, 1995-2000
(in billions of zlotys)

	1995	1996	1997	1998	1999	2000Q1	2000Q2	2000Q3	2000Q4
Net International Reserves	50.4	62.3	82.8	96.3	110.7	115.5	122.3	122.4	132.0
(in billions of U.S. dollars)	20.1	21.7	23.5	27.5	26.7	27.9	27.9	27.0	31.9
Net domestic assets	53.8	74.4	93.6	124.5	152.8	146.5	162.6	158.2	162.4
Credit to nongovernment	56.2	81.1	108.3	138.5	175.9	184.0	203.4	204.1	206.3
Credit to government, net	41.8	48.2	55.3	61.3	64.7	55.1	58.6	57.9	50.9
Other items, net	-44.5	-55.0	-70.0	-75.4	-87.8	-92.7	-99.5	-103.8	-94.7
Money and quasi money 1/	104.2	136.7	176.4	220.8	263.4	262.0	284.9	280.6	251.4
Zloty money	83.0	113.3	145.6	187.1	223.8	219.8	240.4	239.5	34.1
Foreign currency deposits	21.2	23.4	30.8	33.6	39.7	42.2	44.4	44.8	43.0
Memorandum items (in percent)									
Broad money growth (12-month)	83.9	31.2	29.1	25.2	19.3	13.8	20.6	14.1	11.8
Real broad money growth (12-month)	10.9	9.3	14.0	15.4	8.7	3.2	9.4	3.4	3.0
Real growth of credit to nongovernment	11.2	20.3	18.0	17.7	15.7	12.3	18.5	10.6	8.1
Share of foreign currency deposits in broad money	20.4	17.1	17.5	15.2	15.1	16.1	15.8	16.0	14.6

Sources: National Bank of Poland, and Fund estimates and projections.
1/ There was a break in this series at the end of 1996.

Table 4. Poland: Balance of Payments, 1997-2005
(in millions of US\$)

	1997	1998	1999	Est 2000	Proj 2001	Proj 2002	Proj 2003	Proj 2004	Proj 2005
Current account balance	-4,312	-6,858	-11,569	-9,892	-9,491	-9,656	-9,874	-10,051	-9,936
percent of GDP	-3.0	-4.3	-7.5	-6.1	-5.4	-5.0	-4.7	-4.4	-4.0
Trade balance	-11,320	-13,720	-14,380	-13,145	-13,033	-12,544	-12,726	-17,333	-18,303
On customs basis	-16,556	-18,825	-18,504						
Exports	27,229	30,122	26,347	28,276	31,311	34,880	38,400	42,274	46,540
percentage change in unit values	-8.5	0.2	-4.8	-6.6	0.7	1.3	1.0	1.0	1.0
percentage volume growth	21.7	10.4	-8.1	14.9	10.0	10.0	9.0	9.0	9.0
export market growth	8.9	6.1	4.9	11.8	6.9	6.5	6.3	6.3	6.3
Imports	38,549	43,842	40,727	41,421	44,344	47,425	51,126	59,607	64,843
percentage change in unit values	-8.4	-3.0	-6.5	-2.8	0.2	1.2	1.0	1.1	1.1
percentage volume growth	29.0	17.2	-0.6	4.6	6.8	5.6	6.7	15.3	7.6
growth in domestic demand	9.4	6.5	5.0	2.3	3.4	3.8	4.3	4.6	4.9
Services balance	305	-509	-1,624	-1,689	-2,101	-2,322	-2,581	-2,864	-3,178
Credit	3,724	3,677	3,310	3,524	3,649	3,937	4,228	4,539	4,873
Debit	3,419	4,186	4,934	5,213	5,749	6,259	6,809	7,403	8,051
Net Income	-458	-567	-804	-730	-930	-1,174	-1,450	-1,746	-2,072
Net transfers	1,150	1,942	1,604	1,681	2,794	2,618	3,151	8,195	9,953
Net unclassified current transactions	6,011	5,996	3,635	3,991	3,779	3,766	3,732	3,697	3,663
Capital and financial account balance	4,868	10,993	8,253	7,922	10,748	11,444	11,521	10,880	11,061
Financial account balance	4,778	10,921	8,206	7,896	10,698	11,369	11,446	10,805	10,986
Foreign direct investment (net)	3,041	4,966	6,348	9,299	7,092	7,262	6,130	4,987	4,700
by nonresidents	3,077	5,129	6,471	9,422	6,892	7,562	6,430	5,287	5,000
o/w privatisation	1,993	2,023	3,377	6,154	3,085	2,788	666	287	0
Portfolio investment (net)	2,098	1,330	1,449	2,841	2,706	3,120	4,123	4,562	4,962
by non-residents	1,283	1,510	1,437	2,498	2,806	3,225	4,233	4,678	5,083
o/w equities	599	952	885	635	1,016	1,401	2,299	2,541	2,954
Other investment	-361	4,625	409	-4,244	900	988	1,192	1,255	1,324
Assets	-872	2,213	-2,691	-2,851	-688	-723	-759	-797	-836
Liabilities	511	2,412	3,100	-1,393	1,588	1,711	1,952	2,052	2,160
Long-term	416	1,669	2,056	190	403	465	621	652	684
Short-term	592	-46	440	139	225	243	277	291	307
Other	-497	789	604	-1,722	960	1,003	1,053	1,109	1,170
Errors and omissions	2,487	1,801	3,484	2,643	0	0	0	0	0
Overall Balance	3,043	5,936	168	673	1,257	1,788	1,647	829	1,125
Financing	-3,043	-5,936	-168	-643	-1,257	-1,788	-1,647	-829	-1,125
Reserve assets	-3,044	-5,926	-159	-588	-1,202	-1,733	-1,592	-774	-1,070
Credits from IMF	0	0	0	0	0	0	0	0	0
Exceptional financing	1	-10	-9	-55	-55	-55	-55	-55	-55
Memorandum items									
Current account balance, excl. net oil related imports 1/	-2,320	-5,440	-9,665	-6,170	-6,415	-6,831	-7,297	-7,461	-7,331
In percent of GDP	-1.6	-3.4	-6.2	-3.8	-3.6	-3.5	-3.5	-3.3	-3.0
Official reserves of the NBP	21,403	28,275	27,314	27,464	28,818	30,603	32,243	33,060	34,148
in months of imports	6.7	7.7	8.0	8.0	7.8	7.7	7.6	6.7	6.3
Ratio of short-term debt to reserves	23.9	29.8	38.8	39.1	38.1	36.7	35.7	35.7	35.4
Total external debt (percent of GDP)	34.5	37.3	41.5	40.3	38.3	36.9	35.6	34.5	33.3
Net external debt (percent of GDP) 2/	12.8	13.7	16.1	14.6	13.9	13.3	12.9	12.5	12.1

Sources: NBP and Staff Estimates.

1/ Net oil related imports are defined as net imports of mineral fuels, lubricants, and related materials (SITC section 3), using customs data.

2/ Defined as external liabilities minus external assets, both exclusive of equity portfolio and direct investment.

Table 5. Poland: Medium-Term Macroeconomic Framework

	1996	1997	1998	1999	Est 2000	Proj 2001	Proj 2002	Proj 2003	Proj 2004	Proj 2005
In percent of GDP										
Consumption	79.7	79.8	79.0	80.0	78.3	77.6	76.5	75.5	74.5	73.7
Non-government	63.3	63.7	63.6	64.6	63.3	62.7	62.0	61.5	61.1	60.9
Government	16.4	16.0	15.4	15.4	15.0	14.9	14.6	14.0	13.4	12.7
Investment	21.9	24.6	26.2	26.4	26.3	26.0	26.0	26.2	26.4	26.5
Fixed capital	20.7	23.5	25.1	25.5	25.1	24.9	25.0	25.2	25.4	25.5
Non-government	16.8	19.3	21.0	21.7	21.4	20.7	20.7	20.7	20.8	20.7
Government	3.9	4.2	4.2	3.7	3.6	4.2	4.3	4.5	4.6	4.8
Inventories	1.1	1.1	1.0	0.9	1.2	1.2	1.0	1.0	1.0	1.0
Total Savings	21.9	24.6	26.2	26.4	26.3	26.0	26.0	26.2	26.4	26.5
Domestic Savings	20.9	21.6	21.9	18.9	20.1	20.7	21.0	21.5	22.0	22.5
Non-government	21.6	21.6	22.1	20.4	21.3	21.5	20.9	20.5	20.6	20.6
General Government	-0.6	0.0	-0.3	-1.5	-1.1	-0.9	0.1	1.0	1.4	1.9
Foreign Savings	1.0	3.0	4.3	7.5	6.1	5.4	5.0	4.7	4.4	4.0
Memorandum items:										
Real GDP growth	6.0	6.8	4.8	4.1	4.1	4.0	4.5	5.0	5.3	5.5
General government revenues	43.0	42.8	41.4	40.2	39.4	39.6	38.5	37.5	39.0	38.8
General government expenditures	46.4	45.8	44.6	43.9	42.6	43.2	40.6	39.0	40.4	39.7
Balance	-3.3	-3.1	-3.2	-3.7	-3.2	-3.6	-2.1	-1.4	-1.4	-0.9
Economic Balance 1/	...	...	...	-3.2	-2.6	-2.5	-1.5	-0.5	-0.2	0.4
Net external debt 2/	13.6	12.8	13.7	16.1	14.6	13.9	13.3	12.9	12.5	12.1

Sources: Polish authorities and staff estimates.

1/ Commitment basis

2/ Defined as external liabilities minus external assets, both exclusive of equity portfolio and direct investment.

Table 6. Poland: Indicators of External Vulnerability
(In percent of GDP, unless otherwise indicated)

	1996	1997	1998	1999	2000/01	Date of Latest Observation
					Latest Observations	
Financial indicators						
Public sector debt 1/	47.9	46.9	42.9	44.5	42.6	September
Broad money (percent change, 12-month basis)	29.5	27.3	25.2	19.3	11.8	December
Private sector credit (percent change, 12 month basis)	42.5	33.6	27.9	27.0	17.3	December
Domestic credit to GDP	33.3	34.8	36.1	39.0	36.8	December
13 week T-Bill rate 2/	18.8	23.5	13.6	16.2	16.8	December
13 week T-Bill real rate 3/	0.2	9.1	4.6	6.8	8.0	December
External Indicators						
Exports (percent change, 12-month basis in US\$)	6.9	11.4	10.6	-12.5	7.2	Jan-Dec.
Imports (percent change, 12-month basis in US\$)	31.6	18.1	13.7	-7.1	2.1	Jan-Dec.
Current account balance	-1.0	-3.0	-4.3	-7.5	-6.1	Jan-Dec.
Capital and financial account balance	3.3	3.4	6.9	5.3	4.9	Jan-Dec.
o/w: Inward portfolio investment (debt securities etc.)	0.0	0.9	1.0	0.9	1.8	Jan-Dec.
Other investment (loans, trade credits etc.)	1.1	-0.3	2.9	0.3	-2.6	Jan-Dec.
Inward foreign direct investment	1.9	2.1	3.2	4.2	5.9	Jan-Dec.
Net Foreign Assets (NFA) of commercial banks (in billions of US\$)	6.5	7.8	4.1	7.9	10.9	December
Official reserves (in billions US\$)	18.2	21.4	28.3	27.3	27.5	December
Official reserves in months of imports GS	6.7	6.7	7.7	8.0	8.0	December
Reserve money to reserves (Ratio)	0.7	0.6	0.6	0.4	0.4	December
Broad money to reserves (Ratio)	2.8	2.5	2.2	2.3	2.2	December
Total short term external debt to reserves (in percent) 5/	27.3	23.9	29.8	38.8	33.2	September
Total external debt (in billions of US\$)	47.5	49.6	59.2	64.4	63.8	September
o/w: Public sector debt	36.3	34.4	34.1	32.1	32.4	September
Ratio of short-term external debt to total external debt (in percent)	10.5	10.3	14.2	16.5	13.2	September
Exchange rate (per US\$, period average)	2.7	3.3	3.5	4.0	4.3	Jan-Dec.
REER depreciation (-) (period average) 6/	13.0	1.7	4.8	-4.0	9.3	Jan-Nov.
Financial Market Indicators						
Stock market index	14343	14668	12796	19470	16830	7-Feb-01
Foreign currency debt rating 7/	BBB-	BBB-	BBB-	BBB	BBB+	15-May-00
Spread of benchmark bonds (basis points, end of period) 8/	35.0	77.0	102.0	47.1	...	...
Spread of benchmark bonds (basis points, end of period) 9/	...	...	...	...	78.1	7-Feb-01
Spread of brady bonds (basis points, end of period) 10/	148	174	198	199	186	7-Feb-01

Sources: Polish authorities and staff estimates.

1/ Data for 1999 on cover general government; data for earlier years are for central government only.

2/ End-of-period.

3/ Backward-looking with actual CPI.

4/ By original maturity.

5/ CPI based, using 1999 trade weights.

6/ In Standard & Poor's rating system BBB- is investment grade whereas BB+ is below. Date of latest observation refers to date of latest change.

7/ Spread on Polish bond 7 3/4 coupon expiring 07/2000 and US Treasury 5 7/8 coupon expiring 06/2000.

8/ Spread on Polish bond 6 coupon expiring 03/2010 and German bond 5 1/4 expiring 07/2010

9/ Spread on Polish brady bond PDI 10/2014 and US Treasury coupon 11/3/4 maturing 11/2014.

POLAND: FUND RELATIONS
(As of December 31, 2000)

I. **Membership Status:** Joined 6/12/86; Article VIII

II. **General Resources Account:**

	SDR Million	Percent Quota
Quota	1,369.00	100.0
Fund holdings of currency	1,196.74	87.4
Reserve position in Fund	172.26	12.6
Financial transactions plan transfers (net)	72.00	

III. **SDR Department**

	SDR Million	Percent Allocation
Holdings	13.60	N/A

IV. **Outstanding Purchases and Loans:** None

V. **Financial Arrangements:**

	Approval Date	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
Stand-By	8/05/94	3/04/96	333.30	283.30
Stand-By	3/08/93	4/08/94	476.00	357.00
EFF	4/18/91	3/08/93	1,224.00	76.50

VI. **Projected Obligations to Fund:** None

VII. **Exchange Rate Arrangement**

The zloty had been pegged to a currency composite made up of the U.S. dollar, deutsche mark, pound sterling, French franc, and the Swiss franc. As of January 1, 1999, the currency composite was changed to a basket comprised of 55 percent euro and 45 percent U.S. dollar. From January 1, 1995, the zloty was redenominated, with new Zl 1 equaling old Zl 10,000. The central parity of the zloty was adjusted under a crawling peg policy at a preannounced monthly rate. On May 16, 1995, a band of ± 7 percent was introduced around the central rate. Following the implementation of the new system, the zloty initially appreciated by about 5 percent above the central rate. In September 1995, the exchange rate was allowed to appreciate a further

1 percent within the band. In December 1995, the central parity was raised by 6 percent, and at the same time the authorities allowed the actual exchange rate to appreciate by 2½ percentage points. On January 8, 1996 the monthly rate of crawl was reduced to one percent. On February 26, 1998, with the zloty pushing towards its upper limit, the newly-formed Monetary Policy Council (RPP) widened the fluctuation band from ±7 percent to ±10 percent. At the same time, the rate of crawl was reduced from one percent to 0.8 percent per month. On July 17, 1998, the crawling peg's monthly rate of depreciation was cut from 0.8 percent to 0.65 percent. On September 9, 1998, the monthly rate of depreciation was reduced further to 0.50 percent. On October 29, 1998, the zloty's trading band was widened to ±12.5 percent. On March 1, 1999, the zloty's trading band was widened to ±15 percent, and the rate of crawl was lowered to 0.3 percent per month. On December 31, 1999, the official rate was Zł 4.08 per US\$1. On April 11, 2000, the crawling band regime was abolished and the zloty has since floated freely.

VIII. Article IV Consultation

The last Article IV consultation was concluded on March 20, 2000 (EBM/00/26). In concluding the 1999 Article IV consultation, Directors commended the authorities for Poland's decade-long strong economic performance. Though external developments had adversely affected performance during 1999—with inflation and the external current account deficit rising and growth slowing—the consequent mid-year fiscal tightening and increases in interest rates were welcomed. Poland was nevertheless still vulnerable to changes in market sentiment if the external current account deficit did not decline and hence fiscal adjustment in 2000 was critical. This mid-year fiscal tightening and the commitment to balancing the budget over the medium-term would render the inflation goals achievable but sustained public expenditure restraint and an effective mechanism to monitor local government finances would be necessary. Several directors encouraged early abolition of remaining short-term capital controls, but others recommended delay until the current account deficit had begun to decline.

IX. Technical Assistance, 1992–00

Department	Subject/Identified Need	Action	Timing	Counterpart
MAE-Coordinated	Periodic visits by experts from central banks cooperating in providing technical assistance to the NBP under the coordination of MAE	Experts' visits	1992–94	NBP
MAE	Payments system, banking	Mission	May 1992	NBP

	supervision, monetary research and analysis			
MAE	Review of progress in the modernization of operational functions	Mission	Oct. 1992	NBP
MAE	Resident expert—Advisor to President of NBP		Nov. 1991–92	NBP
MAE	Additional steps in the modernization process of the NBP	Mission	April 1993	NBP
MAE	Monetary programming and operations, and payments system.	Mission	Nov. 1993	NBP
MAE	Central bank modernization	Mission	August 1994	NBP
MAE/LEG	Review of the exchange and payments system	Mission	February 1995	NBP/ MoF
MAE	Exchange rate system	Mission	March 1995	NBP
MAE	Review of government securities market, payments system and public debt management	Mission	August 1995	NBP/ MoF
MAE	Asset consolidation exercise	Expert visits	Late 1995	NBP
FAD	Tax administration (VAT)	Nine short-term assignments of field experts	August 1992– October 1994	MoF
FAD	Tax administration	Mission	November 1992	MoF
STA	Framework for monetary statistics	Mission	February 1993	NBP
STA	Framework for monetary	Mission	November 1993	NBP

STA	statistics (follow-up) Government finance statistics	Mission	August 1995	NBP/ MoF
STA	Money and banking statistics	Mission	January 1996	NBP
STA	Government finance statistics	Mission	July 1996	NBP/ MoF
STA	Balance of payments statistics	Mission	November 1996	NBP/ MoF
STA	Balance of payments statistics	Follow-up Mission	April 1997	NBP/ MoF
STA	Review of progress in implementing the SDDS	Visit	February 1998	
FAD	Public expenditure management	Mission	April 1998	MoF
MAE	Operational aspects of monetary and exchange rate policy	Mission	September 1998	NBP
FAD	Tax administration	Mission	October 1998	MoF
FAD	Examination of impact on revenues of proposed tax reform	Mission	November 1998	MoF
FAD	Discussion of tax administration	Mission	March 1999	MoF
FAD	Tax administration seminar	Mission	April 1999	MoF
STA	Government Finance Statistics	Mission	October 1999	MoF/Local
FAD	Tax administration—introduction of expert	Mission	November 1999	MoF
FAD	Administering Social Security	Mission	March 2000	MoF
IMF/IBRD	FSAP	Mission	May & Sept 2000	MoF NBP

X. Resident Representative

Mr. Sassanpour, the Resident Representative, took up his duties in Warsaw in September, 2000.

WORLD BANK ACTIVITY POLAND¹

1. World Bank lending

As of December 31, 1999, loans totaling US\$4.9 billion equivalent had been approved, the most recent being the Rural Development Program Loan which was approved in April 2000. This followed the approval of the Hard Coal Sector Adjustment loan in November 1999. As of September 2000, thirty-four out of the 48 loans approved have closed.

The Bank's current assistance strategy for Poland was reviewed in the Country Assistance Strategy Progress Report approved by the Board in September, 1999. The CAS Progress Report provides an update on political and economic development and reviews the implementation and strategies of the 1997 CAS. The CAS's assessment is that Poland continues to make good progress in pursuing its political and economic transition agenda. Overall economic performance remains strong, with the preparation and implementation of additional structural reforms, as well as the legal and policy changes needed for EU membership, continuing to move forward. The country's democratic political framework is functioning well and was strengthened by the introduction of new elected councils at the regional level. Regarding the implementation of the 1997 CAS, the Bank's program remains consistent with the CAS objectives, but the program content has evolved substantially in light of the reforms being pursued by the current Government. The program is now much more sharply focused on the structural reform agenda, especially as it relates to some of the key reforms needed for EU accession. In next three years, the Bank's lending will support the reform of the hard coal sector and the railways, both of which relate directly to EU accession, and contribute toward progress in rural development and in social programs critical for the sustainability of reform and the continuation of Poland's rapid growth.

2. Economic and sector work

Recent reports include:

Poland: Trade and Foreign Direct Investment Study, June, 2000.

Corruption in Poland: Review of Priority Areas and Proposals for Action, October 1999.

Poland: Education Opportunity Pilot Project, World Bank Technical Paper No. 454, August 1999.

Poland: Tax Reform In The Light of EU Accession, July 1999.

¹ Prepared by World Bank staff.

Poland: Decentralization in Poland: Building Capacity For Sound Governance and EU Integration, June 1999.

Poland: Strategic Priority for the Transport Sector, No. 19450, June 1999.

Poland: Complying with EU Environmental Legislation, April 1999.

Poland: Financial Report, December 1998.

Competitiveness Employment, A Framework for World Development in Poland, Report No. 17708, August 1998.

Country Economic Memorandum; Reform and Growth on the Road to the EU, Report No. 16858-POL, July 15, 1997.

Urban Transport Review, Report No.12962-POL, September 1995.

Understanding Poverty in Poland, July 1995 (red cover).

Poland-Policies for Growth with Equity, December 1994 (red cover).

Municipal Water and Wastewater Sector Study, Report No. 12660-POL, December 1993.

Transforming the State: Issues in Public Administration Reform, Report No.11797-POL, June 1993.

Private Sector Assessment, Report No. 11285-POL, January 1993.

Income Support and the Social Safety Net During the Transition, Report No. 11592-POL, January 1993.

POLAND—STATISTICAL INFORMATION

1. Poland has a comprehensive and improving economic database. The authorities publish a full range of economic and financial statistics, and cooperate fully in providing information to the Fund. Data on the core indicators are available on a timely basis (see the attached data matrix). Consistent with its commitment to providing a comprehensive set of high quality data, in an open and timely manner, Poland subscribes to the IMF's Special Data Dissemination Standard (SDDS), and its metadata are posted on the Data Standards Bulletin Board.

Real sector statistics

2. The Central Statistical Office (GUS) issues a wide range of real sector statistics, most of which are published promptly in the monthly Statistical Bulletin. The main problems for users include (i) the short span of comparable Polish data series, reflecting the upheavals associated with transition to a market economy (ii) inconsistencies between annual and higher frequency data, reflecting differences in weights and differences in coverage, and (iii) lack of easy electronic retrieval of such data.

3. National accounts data still have some problems, particularly in the measurement of unrecorded cross-border trade, and in the treatment of changes in inventories. However, progress has been made. Most notably, the Central Statistical Office has started to issue quarterly national accounts statistics that now include estimates by expenditure category.

Government finance statistics

4. The authorities provide detailed state budget data to the Fund every month. In addition, government finance statistics are now reported to the Fund on a regular basis. The classification of transactions in the official data still needs improvement. In the meantime, the staff makes adjustments to the official data.

5. The annual consolidated central government data are available in the *Government Finance Statistics Yearbook*. Monthly data on consolidated core operations of the central government are reported in *IFS*.

Monetary statistics

5. The National Bank of Poland (NBP) reports good quality data on a regular and timely basis to the Fund. High-frequency data (every ten days) on the central bank balance sheet and the monetary survey are available with minimal delay.

External sector statistics

6. While improvements have been made in the balance of payments data, some areas still need to be addressed. Payments from the kantor market remain reported as a separate item on the current account and are not allocated across their current account components. Differences in definitions remain between the customs (GUS) and payment (NBP) based trade data.

7. In the monetary survey the NBP now reports net foreign assets (NFA) rather than the net international reserves (NIR) previously supplied. In contrast to NIR, NFA includes less liquid foreign assets and liabilities. Finally, the coverage and reporting of the stock of external debt, especially at maturities up to one year, could be improved.

Poland: Core Statistical Indicators

As of February 7, 2001

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP	Public External Debt/ Debt Service
Date of Latest Observation	6-Feb	26-Jan	26-Jan	26-Jan	26-Jan	6-Feb	December	November	November	October	Q3	September
Date Received	6-Feb	6-Feb	6-Feb	6-Feb	6-Feb	6-Feb	15-Jan	10-Jan	10-Jan	December	October	Decemebr
Frequency of Data	daily	every 10 days	every 10 days	every 10 days	every 10 days	daily	monthly	monthly	monthly	quarterly	quarterly	monthly
Frequency of Reporting	daily	every 10 days	every 10 days	every 10 days	every 10 days	daily	monthly	monthly	monthly	quarterly	quarterly	monthly
Source of Update	Reuters	Reuters	Reuters	Reuters	Reuters	Reuters	Reuters	NBP	NBP	MOF	GUS	MOF
Mode of Reporting	on-line	on-line	on-line	on-line	on-line	on-line	on-line	fax	fax	letter to IMF	fax	published report
Confidentiality	no	no	no	no	no	no	no	no	no	yes	no	no
Frequency of Publication	daily	monthly	monthly	monthly	monthly	monthly	monthly	monthly	monthly	quarterly	quarterly	monthly

Statement by the IMF Staff Representative
March 9, 2001

1. This statement highlights economic and policy developments in Poland since the circulation of the staff report for the Article IV consultation (SM/01/55, February 16, 2001). This additional information does not change the broad thrust of the staff appraisal.

- January data confirmed the downward trend in inflation. The 12-month rate of consumer price inflation was 7.4 percent, a decline from 8.5 percent in December. Data necessary for the calculation of core inflation measures in January have not yet been released, but the decline partly reflects falling international oil prices and changes in the seasonality of adjustments of administered prices. Subject to these caveats, the one month seasonally adjusted growth of consumer prices in January was -0.4 percent. The 12-month producer price inflation declined to 4.8 percent in January, from 5.5 percent in December: month on month seasonally adjusted, producer prices fell by 0.4 percent in December. Although the current account deficit rose in January, it remained consistent with the staff's projection of 5.4 percent of GDP for 2001 as a whole. In January, the current account deficit amounted to US\$0.9 billion, about US\$70 million more than December 2000. Export growth remained strong, but import growth picked up somewhat from recent months.
- Industrial sales remain sluggish. In January, they were 10 percent higher than a year earlier. However, this reflects a very weak base in January 2000; the seasonally adjusted one month growth rate was 0.5 percent. Enterprise sector employment fell a further 0.3 percent from December, and the registered unemployment rate continued its upward trend, reaching 15.5 percent in January from 15 percent in December 2000.
- The State Budget deficit outturn for January was equivalent to 1/5 of the target deficit (excluding receipts from the sale of mobile phone licenses) for 2001. This is considerably higher than accounted for by normal seasonality of spending and revenue, after adjusting for identified one-off factors. The outturn largely reflects non-interest spending above projections, though revenues from indirect taxes were also below target.

2. The Monetary Policy Council (MPC) lowered all official interest rates by 100 basis points with effect from March 1, 2001. It retained its neutral bias. The MPC emphasized declines in headline and core inflation, inflation expectations, the external current account deficit, and in the growth of money and credit in explaining the reductions. But it also noted continued risks in the fiscal area and concerning wages and private consumption. The Zloty strengthened further on the action. Local stock market indices weakened somewhat, partly reflecting trends in international stock markets.

3. The zloty exchange rate has remained strong. Supported by large foreign exchange inflows, the zloty now trades at around 4 per U.S. dollar and 3.7 against the Euro—up 13.7 percent and 8.7 percent respectively from end September 2000.



INTERNATIONAL MONETARY FUND

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April 10, 2001

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes Article IV Consultation with Poland

On March 9, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Poland.¹

Background

In the past two years, Poland's outstanding economic performance has come under strain. Output growth has dropped to about 4 percent in 1999-2000 from an average of 5½ percent during 1993-98. Total employment has fallen by some 6 percent since mid-1998, largely reversing the trend increase since 1994. Longstanding downward trends in unemployment and inflation have been broken: unemployment has risen back to 15 percent; headline inflation, which dropped to 6½ percent in early 1999, rose back to 10-11 percent in mid 2000; and the external current account deficit rose to 7½ percent of GDP in 1999.

Several factors combined to produce this outcome in 1999 and 2000. Adverse external shocks, starting with the Poland's loss of eastern export markets and most recently oil price rises weakened the current account balance, output growth and employment. Partly spurred by these shocks a new round of labor shedding ensued, raising unemployment.

Shifts in the policy mix made matters worse, and combined with the shocks have weakened domestic demand. Both in 1999 and 2000 significant fiscal tightening was planned to lower the external deficit and inflation, while setting the stage for an easing of monetary conditions. But slippages in both years undermined this strategy. Overall, the fiscal stance was little changed in 1999 and, according to staff estimates, was tightened by 0.2 percentage points of GDP last year on a commitments basis—less than a third of the targeted adjustment. Prompted by concerns

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the March 9, 2001 Executive Board discussion based on the staff report.

about these developments, rising inflation and the external current account deficit, the Monetary Policy Council raised the central intervention rate by 600 basis points between September 1999 and August 2000. Banking interest rates followed suit. These factors have combined to weaken domestic demand from early 2000.

Poland has, however, weathered these shocks well. Growth of 4 percent is low only by recent Polish standards, and would be satisfactory by almost any other. Inflation is again trending downwards. The current account has also strengthened. While to some extent this reflects weakening activity, new export capacity coming on stream has also contributed significantly. Financing, moreover, has never been in doubt with the still sizable deficit in 2000 (6.1 percent) being entirely financed by FDI. There was no disturbance to capital flows ahead of or following the abolition of the crawling exchange rate band in April 2000 and the shift to a pure floating exchange rate regime. The banking system had also weathered recent increases in interest rates without sizeable decreases in portfolio quality or profitability.

On the structural front, progress continues but some new challenges are also evident. The most pressing among the new challenges is unemployment, which has risen considerably. The roots of the problem remain somewhat obscure, though there is some evidence that wage flexibility may be hampered by a binding national minimum wage. Privatization continues at a rapid pace, and is conservatively expected to generate 3 percent of GDP in receipts for the budget in 2001. The restructuring of the coal sector also continues, as is evident in the reduction of losses and arrears to social security contributions.

Executive Board Assessment

Executive Directors commended the authorities for the progress made in reducing the external current account deficit and inflation in the past year in the face of a difficult external environment. They considered that the authorities' commitment to pursue these goals further, alongside deepening structural reforms, will strengthen medium-term economic performance and place Poland in a strong position to secure accession to the EU.

Directors noted that Poland's economic performance in the past two years has been robust in the face of external shocks. In particular, growth was a creditable 4 percent, and while the fall in underlying inflation has been interrupted, it has not reversed. Further, the bulk of the external deficit has been funded by foreign direct investment and Poland has retained access to international capital markets on keen terms. Nevertheless, strains have emerged: notably, output growth has fallen below most estimates of potential, unemployment rates have risen to worrisome levels, and fiscal and inflation targets have been overshot. In addition, fiscal slippages have placed an undue burden on monetary policy. Thus, while the immediate outlook is for continued reductions in inflation and in the current account deficit, output growth is likely to remain modest.

In this context, Directors noted that fiscal and monetary policies for 2001 would have to strike a difficult balance between securing progress toward medium-term targets and avoiding an unduly tight policy stance in the short term when growth is below potential. In this light, they

welcomed the authorities' decision early this year to lower their fiscal revenue target in response to a reduction in projected growth and to offset only part of this adjustment through lowering spending. This represented an appropriate use of fiscal stabilizers given that inflation and the external current account balance are on a downward track. Even accepting the authorities' revised growth projections, Directors noted that there were uncertainties in the budget estimates—notably with respect to the impact of spending carried forward from 2000, VAT receipts (assuming improved collection), and the anticipated auction of arrears of social security contributions. Should these expected sources of revenue not materialize, Directors agreed that contingency measures should be taken to secure the integrity of the budget.

In the event that GDP growth is weaker than the authorities projected, several Directors argued that the fiscal deficit should be allowed to exceed the target, on condition that inflation and the current account deficit remain on track, that existing nominal spending allocations are strictly observed, and that data on the fiscal deficit outturn are published in a timely manner. By responding in this way, Directors believed that the authorities would be maintaining the momentum towards the goal of fiscal balance in 2003, while also supporting activity in the short term. A number of Directors suggested that the authorities should monitor carefully vulnerability indicators before allowing automatic stabilizers to operate, cautioning that the room for maneuver was limited by the medium-term fiscal targets. In addition, it was noted that should the slowdown in growth remain protracted, then monetary policy action might be more appropriate. A few Directors also expressed understanding of the authorities' view that changing the officially adopted state deficit target would be difficult in Poland's current legal and political environment.

Directors welcomed the authorities' objective of achieving fiscal balance in the medium term as it would provide essential room for further private investment, especially if growth of domestic demand picks up and output growth returns to potential. Directors underscored the need to strengthen initiatives to restructure public expenditure in the medium term in order to secure the balanced budget target. They emphasized that further reform of welfare and of the public wage bill warrants a high priority. Such initiatives would be crucial, especially if consolidation is to be secured alongside the reduction in the burden of taxation on the economy that is needed to spur private sector activity and employment.

Directors welcomed the preparation of the fiscal transparency module of the ROSC, progress made in many areas covered by the IMF code on Fiscal Transparency, and the authorities' commitment to secure greater adherence to the code. They identified as priority areas the timely publication of the components of the economic deficit, the authorities' plans for improved data reporting by all parts of general government (including extra budgetary funds), and the reporting of expenditure arrears. Given the uncertainties in the decision-making process, a few Directors suggested that the authorities should adopt multi-annual ceilings for expenditure.

Directors welcomed the recent reduction in official interest rates. With inflation now back on a downward track towards the 2001 and medium-term targets, Directors generally agreed that there appears to be room for further interest rate reductions. However, they acknowledged that these steps would have to strike a balance between the uncertainties about the determinants of

inflation in Poland, the risks of supply shocks and structural fiscal slippages, on the one hand, and concerns about the weakness of output, on the other. Directors also noted that real interest rates remain high, even after the recent reduction in nominal rates, as reflected in the strong upward pressure on the zloty in recent months. In this context, they were concerned that undue delays in lowering interest rates could jeopardize short-term output prospects and may slow the much needed strengthening of the current account. Some Directors felt that it would be appropriate to consider further adjustments to the inflation targeting framework once the 2001 inflation target has been secured.

Directors commended the authorities for the strengths of the Polish financial system as reported in the Financial Sector Stability Assessment. Its strength has been a key factor sustaining capital inflows to Poland in recent years, despite external shocks. Areas of concern have been highlighted, however, including the exposure of the non-financial sector to foreign currency risk and in bank credit risk, especially if activity decelerates further. Regarding the latter, a few Directors pointed out that in light of the falling bank profitability indicators, close monitoring of credit risk is warranted.

Directors supported the authorities' intention to continue to abstain from intervention in the foreign exchange market, a policy which has served Poland well. The volatility of the exchange rate has been manageable and has promoted responsible hedging. Several Directors welcomed the authorities' intention to deepen the process of capital account liberalization by abolishing the remaining controls on short-term capital flows.

Directors noted with concern the sharp increase in unemployment in the past two years. While part of this appears to be the result of the slowing of growth and much-needed restructuring of industry, certain labor market institutions may also be playing a role in impeding job creation, notably the minimum wage. Given high unemployment and the prospect of a large inflow of new entrants to the labor force, Directors urged early and active consideration of reform of the minimum wage structures, continued reform of the labor code without imposing rigidities on employers, and efforts to encourage internal labor migration and worker retraining. Directors praised the authorities' commitment to rapid completion of industrial restructuring and privatization. These reforms would ultimately spur employment and would contribute to the preparation for EU accession.

While noting that Poland has subscribed to the Special Data Dissemination Standard and its statistical base is adequate for surveillance, Directors urged the authorities to continue to improve the quality of macroeconomic data, in particular, by reporting quarterly national accounts in current and constant prices, and strengthening monthly fiscal and balance of payments data.

Poland: Main Economic Indicators

	1996	1997	1998	1999	<u>Estimate</u> 2000
Real economy (change in percent)					
Real GDP	6.0	6.8	4.8	4.1	4.1
Real domestic demand	9.6	9.4	6.5	5.0	2.3
CPI (end-year)	18.5	13.2	8.6	9.8	8.5
Unemployment rate (in percent)	14.3	11.5	10.1	12.0	13.9
Gross national saving (percent of GDP)	20.9	21.6	21.9	18.9	20.1
Gross domestic investment (percent of GDP)	21.9	24.6	26.2	26.4	26.3
Public finance (in percent of GDP)					
General government balance 1/	-3.3	-3.1	-3.3	-3.1	-2.6
Public debt 2/	47.9	46.9	42.9	44.5	42.5
Money and credit (end of period, percent change)					
Domestic credit (12-month change)	31.1	26.5	22.1	20.5	6.9
Broad money (12-month change)	29.5	27.3	25.2	19.3	11.8
Money market rate (end of period, in percent)	21.6	24.8	15.9	16.4	18.9
Balance of payments in convertible currencies					
Trade balance (in percent of GDP)	-5.7	-7.9	-8.7	-9.3	-8.2
Current account (in percent of GDP)	-1.0	-3.0	-4.3	-7.5	-6.1
Official reserves (in billions of U.S. dollars)	18.2	21.4	28.3	27.3	27.5
Reserve cover (months of merchandise imports)	6.7	6.7	7.7	8.0	8.0
External debt (end of period, percent of GDP)	33.1	34.5	37.3	41.5	40.3
Fund position (in millions of SDRs)					
Quota					1,369.0
Fund holdings of currency (end-December 2000)					1,196.7
Holdings of SDRs (end-December 2000)					13.6
Exchange rate					
Exchange rate regime	Floating Rate				
Present rate	Zl 3.9837 per US\$1 (March 8, 2001)				
Zloty per U.S. dollar (period average, in percent)	2.7	3.3	3.5	4.0	4.3
Appreciation (+) of real effective exchange rate (relative CPIs, in percent)	13.0	1.7	4.8	-4.0	7.3

Sources: Central Statistical Office; data provided by the authorities; and staff estimates.

1/ Economic balance, on a commitment basis.

2/ Data for 1999 and 2000 cover general government; data for earlier years are for central government only.

**Statement by Wieslaw Szczuka, Alternate Executive Director
for the Republic of Poland
March 9, 2001**

This year's Board discussion on Poland is unprecedented in at least one respect. Never before had the Executive Directors been provided with such an impressive set of documents providing not only a very thorough assessment of the recent macroeconomic developments and prospects but also a comprehensive review of Poland's structural, institutional and regulatory features. This is the result of Poland's voluntary and willing participation in the FSAP and ROSC programs. The teams of experts from the Fund, the World Bank and from the cooperating central banks have X-rayed the Polish economy, the financial system and the regulatory environment from almost every angle. My authorities are very grateful for the efforts of all staff members participating in these projects and highly appreciate the quality of the produced reports. My authorities also note with satisfaction that this comprehensive review confirmed that the Polish economy and the financial system are in a reasonably good health and that Poland has made good progress in improving fiscal transparency and in adopting many international codes and standards with relevance to various sectors of the financial system. The fact that both the FSSA and the fiscal transparency report have identified some areas where further improvements could be made can be considered encouraging, because not only the authorities had been given guidance on what to focus their future activities but also the usefulness of the whole FSAP/ROSC exercise had been proven. My authorities also appreciate the advice provided by the staff in the process of the traditional Article IV consultation and broadly share the staff appraisal, even if some of the recommendations may prove difficult to implement in Poland's current legal and political environment. I am very pleased to inform the Board that as an expression of Poland's traditional and growing commitment to transparency my authorities have given their consent to publish the Article IV Staff Report, the ROSC module on fiscal transparency and, as the first member country making use of Fund's new policy on publication, the whole FSSA report.

Macroeconomic developments and challenges

The standard set of macroeconomic indicators for 2000 provides a rather mixed and perhaps also a little misleading picture of economic developments in Poland in the course of the last year. Several of such indicators point to some degree of stabilization with the continuation of the GDP growth at the same level as in 1999 (4.1 percent, based on preliminary data), with an almost unchanged fiscal balance, with some decline in the year on year inflation measure (from 9.8 to 8.5 percent) and with a somewhat more pronounced improvement in the external position (reduction in the current account deficit from 7.5 to about 6.3 percent of GDP). Such data, at least on the surface, would not corroborate staff's claim (par. 5 of the Report) that "Poland's outstanding macroeconomic performance has come under strain". This claim, which extends also to developments in 1999, could however find some justification in the very significant increase in the unemployment rate (from 13.1 percent in 1999 to 15.6 in January 2001) and in the quarterly GDP and domestic demand data, which indicate quite substantial deceleration in economic activity during 2000 (drop in

quarterly GDP growth from 6 percent in the first quarter to an estimated 2.5 percent in the last quarter). However, comparing to the annual indicators, the disaggregated (monthly) as well as the more recent data also show a much stronger progress in fighting the evils of inflation and external imbalance. The annual, CPI-measured inflation declined from a peak of 11.6 percent in July 2000 to 7.4 percent in January of this year. This very favorable trend (inflation in February is expected to be close to 7 percent on an annual basis) indicates that this year's inflation target of 6-8 percent may not be seriously threatened. Booming exports and much weaker import demand helped to bring the annualized current account deficit from a peak of about 8.3 percent of GDP in March 2000 to only slightly above 6 percent in January 2001 with good prospects for further improvement in the course of this year.

Despite the very important setback in form of rising unemployment, my authorities are of the opinion that on balance both the results achieved in 2000 and most of the current trends in the economy should be viewed positively, in particular when assessed from the perspective of securing the medium-term sustainability. The decent growth rate of above 4 percent has been achieved despite the unfavorable supply shocks resulting from the increase in oil prices and from the second year in a row of below-normal conditions in agriculture. The external vulnerability has been significantly curtailed despite the very unfavorable terms of trade, continued weakness of the main settlement currency (euro) and sizable appreciation of the zloty. Even more consequential, however, is that Poland is still well on the way to reaching its two most important medium-term targets of balancing the fiscal accounts and reducing inflation to below 4 percent. This is considered essential for both creating the basis for a sustainable long-term growth of the Polish economy and for strengthening Poland's competitive position in the run-up to the expected accession to the European Union.

Fiscal policy

As noted in the Staff Report, the Polish authorities remain committed to eliminating the "economic" deficit of the general government by 2003. Moving in this direction and ultimately achieving this target should provide the needed support to the disinflation effort, stimulate private domestic saving and investment, and help in reducing external imbalance and in strengthening the confidence of foreign investors. While the actual reduction in the fiscal deficit in 2000 was smaller than initially assumed, largely on account of structural and cyclical factors, the general orientation of fiscal policy remained unchanged and further progress was made in improving the fiscal transparency. This progress has also been acknowledged in the ROSC module on fiscal transparency. In reaction to much weaker than expected direct and indirect tax revenue (with the exception of the corporate income tax which performed strongly despite further reduction of the nominal tax rate) the authorities had to keep spending below the budgeted levels in order to stay within the legally binding deficit ceiling. Thanks to some improvement of the situation in the social security fund and to the continuation of fiscal prudence at the local governments level the overall "economic" deficit of the public sector remained almost unchanged at the level of about 2.7 percent. My authorities prefer to focus on the changes in the level of the "economic" deficit because in their view this measure (which, i.a., subtracts from expenditure the equivalent of transfers to

the newly created private pension funds) better reflects the actual demand pressures stemming from the public sector in the period of transition to a completely revamped social security system. The very significant costs associated with the ongoing implementation of four fundamental reforms initiated in 1999 should also be taken into account when assessing the overall progress in fiscal consolidation during the last two years. These reforms, and in particular the pension reform, while costly at the start should nevertheless significantly contribute to securing the medium-term sustainability of Poland's fiscal position.

The 2001 budget, which was formally approved by the parliament on March 2, 2001 and now only awaits the President's signature, envisages further tightening of the fiscal stance that should lead to a reduction in economic deficit from 2.7 to 1.8 percent of GDP. This is fully in line with the medium-term fiscal target and should create some room for the very much-needed relaxation of monetary policy. Staff take some issue with the authorities' assumptions regarding the improvement in fiscal revenue in 2001 and, based on their own revenue projections, expect a somewhat larger economic deficit. At the same time, staff advise that such a counter cyclical widening of the deficit should not be resisted in case of a weaker than projected output growth. Staff also see, however, the need to stay on the path of the medium-term fiscal consolidation and even urge to reduce the burden of taxation. The Polish authorities continue to believe, based on the macroeconomic assumptions and on the expected results of new tax regulations and improved tax collection, that the projected level of revenue can be achieved. My authorities would also see some practical, and perhaps not only practical, difficulties with the implementation of staff's advice with regard to the operation of fiscal stabilizers in the current legal and political environment in Poland. In accordance with the Polish law, any increase in the nominal deficit of the state budget would require the parliament's approval of an amendment to the just adopted budget bill. Securing such an approval in the period just ahead of the parliamentary election would be a very difficult task for the current minority government. Given that GDP growth is projected to stay at an acceptable level, while inflation and current account deficit are still much too high, my authorities prefer to stick to their medium-term fiscal consolidation plan and somewhat reduce the burden on the monetary policy. Nevertheless, it can be expected that the fiscal developments will provide some additional, albeit limited, support to the economic activity in the first half of the year in result of the traditional, but this time somewhat more pronounced, concentration of large expenditures at the beginning of the year (as already indicated by the unusually high level of budget deficit in January). The authorities are fully aware of the need to deal with the twin problem of weaker activity and rising unemployment, but in their view it can best be addressed by an acceleration of structural reforms (including in the crucial area of labor market regulations) and by some relaxation of monetary conditions, if and when justified by the fall in inflationary expectations and by other monetary indicators.

Monetary policy and exchange rate developments

The recent lowering of interest rates (all the basic policy rates had been reduced on February 28 by 100 basis points) and the ensuing, but probably only partially related, further appreciation of the zloty are the "themes of the day" in Poland. Market participants eagerly

anticipate further decisions of the Monetary Policy Council (RPP) while the economic analysts try to evaluate the risks stemming from the unprecedented strength of the zloty. It is undisputed that the interest rates exceeding 10 percent in real terms are very high not only by the OECD but also by most emerging markets standards. However, when assessing the current stance of the monetary policy and before suggesting any changes there is a need to look at the sources of the present situation and define the conditions that could lead to any further relaxation. The series of interest rates increases implemented since September 1999 were the natural reaction to rising demand pressures, which negatively affected the price developments and contributed to the deterioration in the external position. The National Bank of Poland (NBP) is legally obliged to aim at maintaining the price stability. Given the way the inflation target is specified (i.e. in CPI terms) and the strong impact of headline inflation on inflationary expectations, the NBP felt compelled to maintain a tight monetary stance throughout the rest of the last year when confronted with supply shock induced increases in nominal prices. Even though the core inflation remained broadly stable, the NBP saw also the need to prevent any negative spillover effects of these strong supply shocks. The NBP considers the reduction in inflation as an investment benefiting the long-term development of Poland's economy. The unavoidable cost of such an investment would be lower if the fiscal and structural policies could equally contribute to the disinflation process. Unfortunately, in the situation when these policies, by their very nature, are strongly dependent on reaching the consensus of political forces while the monetary authorities enjoy full independence, there is some sort of asymmetry in the whole system which results in a tendency to shift the larger part of the burden of fighting inflation on the shoulders of the central bank. When deciding on interest rates policy, the NBP looks not only at the recent trends in inflation and inflationary expectations, at credit growth and at the developments in basic monetary aggregates but also at a broad array of other macroeconomic indicators, at the stance of fiscal policy, at the progress in structural reforms and at the external environment. While several of such factors contributed to the recent lowering of interest rates (with a particularly important role played by the visible decline in inflationary expectations, reductions in headline inflation and in the current account deficit as well as the recent government decision to establish a duty free quota for the imports of cereals) the NBP claim that it must proceed with caution because the absolute level of inflation is still excessive, the credit growth – though significantly decelerating – remains quite high in nominal terms, and there are several sources of uncertainty (originating, among others, from the fiscal and structural side) which could potentially derail or slow the disinflation process. This, in part, may explain why the RPP decided to maintain the neutral bias when announcing the recent interest rates reductions.

The operation of the monetary policy framework based on the inflation target has been strengthened by the last year's decision to abandon the former crawling band regime and to move to an independent floating of the Polish currency. This orderly exit from the soft peg regime proceeded very smoothly with only a relatively brief period of increased exchange rate volatility. However, in view of the stance of monetary policy, continuation of large, mainly privatization-related foreign capital inflows and the generally favorable assessment of Poland's economic fundamentals (as reflected, i.a. in a further upgrade of Poland's external credit rating in May 2000), the zloty remained under the appreciation

pressure throughout most of the recent period. Following its long-standing policy, which has been endorsed also by the staff, the NBP refrained from intervening in the foreign exchange market. The establishment of the government's foreign exchange account at the central bank has also helped the NBP to significantly reduce its passive market interventions, which result from supplying the government with foreign exchange needed to service its foreign debt obligations.

The results of the Financial Sector Stability Assessment

The FSSA results indicate that Poland's financial sector appears to be in a generally good health and is relatively well regulated and supervised. As indicated in the report, the authorities are already in the process of either implementing or preparing measures, which will remove many, if not most, of the remaining shortcomings and imperfections. This is particularly true for the situation in the banking sector, because several of staff's recommendations have already been included in the drafts of the amended Banking Act and Act on the NBP, which are currently being considered by the Polish parliament. These amendments, which among others provide for the introduction of consolidated supervision, will further adjust the Polish banking regulations to the requirements of the EU law, and in particular to the EU Directive No 2000/12/WE. The staff recommended consolidation of financial institutions is already proceeding in a market driven and gradual manner, as manifested, i.a., by the recent mergers between several Polish subsidiaries of foreign banks and the Polish banks which had been taken over by the parent companies of such foreign banks. Care should be taken, however, that the consolidation process (which is proceeding also in the insurance and pension fund sectors) does not lead to an excessive increase in the already high concentration ratios in the various subsectors of the Polish financial system. While my authorities agree that there is a need to better monitor the exchange rate risk exposure of the corporate sector, staff's statement that such an exposure is not known seems to be too strong. Both the general and the banking statistics, as well as the balance of payment data, provide information on the (still quite limited) scale of the indebtedness of the corporate sector, while surveys conducted by the NBP indicate the scope of the use of hedging techniques. There is also some evidence for the growing popularity of hedging the exchange rate risk, in particular since the switch to the floating exchange rate regime. In their general comments on findings included in the ROSC modules, the Polish supervisors agreed on the need to further improve the existing regulations but also stressed that in most cases they already have sufficient powers to effectively perform their duties (which also includes, at least in case of the banking supervision, the right to issue prudential regulations).