July 2004
IMF Country Report No. 04/217

Republic of Poland: 2004 Article IV Consultation—Staff Report; Staff Supplement; and Public Information Notice on the Executive Board Discussion

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 2004 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 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on April 7, 2004, with the officials of Republic of Poland on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on June 17, 2004.** 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 supplement of **July 8, 2004** updating information on recent economic developments.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its July 12, 2004 discussion** of the staff report that concluded the Article IV consultation.

The documents listed below have been or will be separately released.

Selected Issues Paper
Report on the Observance of Standards and Codes—Fiscal Transparency Module—Update

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF POLAND

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives for the 2004 Consultation
with the Republic of Poland

Approved by Alessandro Leipold and Liam P. Ebrill

June 17, 2004

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- Article IV consultation discussions were held in Warsaw during March 25–April 7, 2004. The mission met the Prime Minister designate, the Deputy Prime Minister, the Minister of Finance, President of the National Bank of Poland (NBP), Minister of Treasury, members of the Monetary Policy Council (MPC) and the Sejm, and other senior officials.
- The staff team comprised Ms. Schadler (Head), Ms. Choueri, Ms. Murgasova, Mr. Székely (all EUR), and Ms. Mitchell-Casselle (MFD), and was assisted by Messrs. Sassanpour and Sierhej (Resident Representative's office). Mr. Szczuka, then-Alternate Executive Director for Poland, and Mr. Tomasz Skurzewski then-Advisor to the Executive Director participated in the discussions.
- In the last consultation in June 2003, Directors commended the authorities for achieving price stability and welcomed the government's fiscal reform proposal, but urged the authorities to use the improving cyclical position to embark on a substantial fiscal adjustment and accelerate structural reforms.
- Poland's statistical base is adequate for surveillance.
- Poland has accepted the obligations of Article VIII, Sections 2, 3, and 4 and maintains no restrictions on current transactions.

I. Background

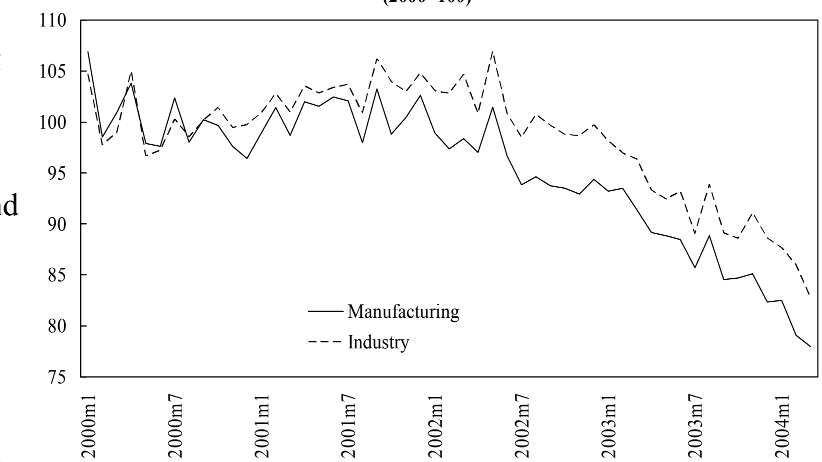
1. **Poland is in a challenging economic situation.** Although a strong recovery is underway, private investment is still flat and financial markets are jittery. This paradox is the legacy of several years of weak policies which produced an unsustainable fiscal position and, together with slow growth, worsened a rising unemployment problem. Exacerbated by uncertainty about the strength of the recovery in Western Europe, Poland's principal export market, these setbacks continue to strain political stability and market confidence even as the recovery takes off. While the government has proposed a comprehensive program to tackle the fiscal and structural problems, political support needed to implement it has wavered. Thus, Poland, a star performer in the 1990s, entered the EU with substantive economic and social problems and a weak government.

2. **Throughout the past year, a recovery strengthened, but it is not yet fully entrenched.** With strong exports, robust consumption, and a leveling off of the drop in investment, GDP growth picked up gradually, reaching 4.7 percent (year-on-year) in the last quarter of 2003 (Table 1, Figure 1). Continued high export growth and accelerating retail sales suggest that the recovery strengthened substantially in early 2004, but still without any indication of investment growth (Figure 2). Although the fiscal stance in 2003 was slightly restrictive, a considerable easing of monetary conditions since 2001 supported the recovery:

policy rates were massively reduced between early 2001 and mid-2003, while falling interest differentials and unsettled politics contributed to a 20 percent real effective depreciation of the zloty in the past two years (Figure 3). With strong gains in the service sector, employment has grown modestly in the past year, for the first time since 1997. This, combined with accelerating wages and rising social transfers, kept consumption growth robust.

3. **Slack in the economy is diminishing but without signs yet of excessive demand pressure.** The output gap narrowed slightly in 2003, but at over 2 percent of potential GDP, was still sizable. The unemployment rate of 20 percent is well above the estimated structural rate of 15 percent (Figure 4). Falling unit labor costs and, in turn, strong increases in profit margins have been key to containing current account and inflation pressures during the upswing. The strong increase in corporate savings, while investment fell, pushed the current account deficit down to 2 percent of GDP in 2003 (Table 2); and, in the absence of domestic cost push and with an unusually small pass-through of the zloty depreciation by profit-rich firms, net inflation (excluding food and fuel) was steady at 1–1½ percent. A rise in headline inflation to 2.2 percent in April (still below NBP's 2½ percent target) was mostly due to food and oil price increases.

Poland: Unit Labor Costs
(2000=100)

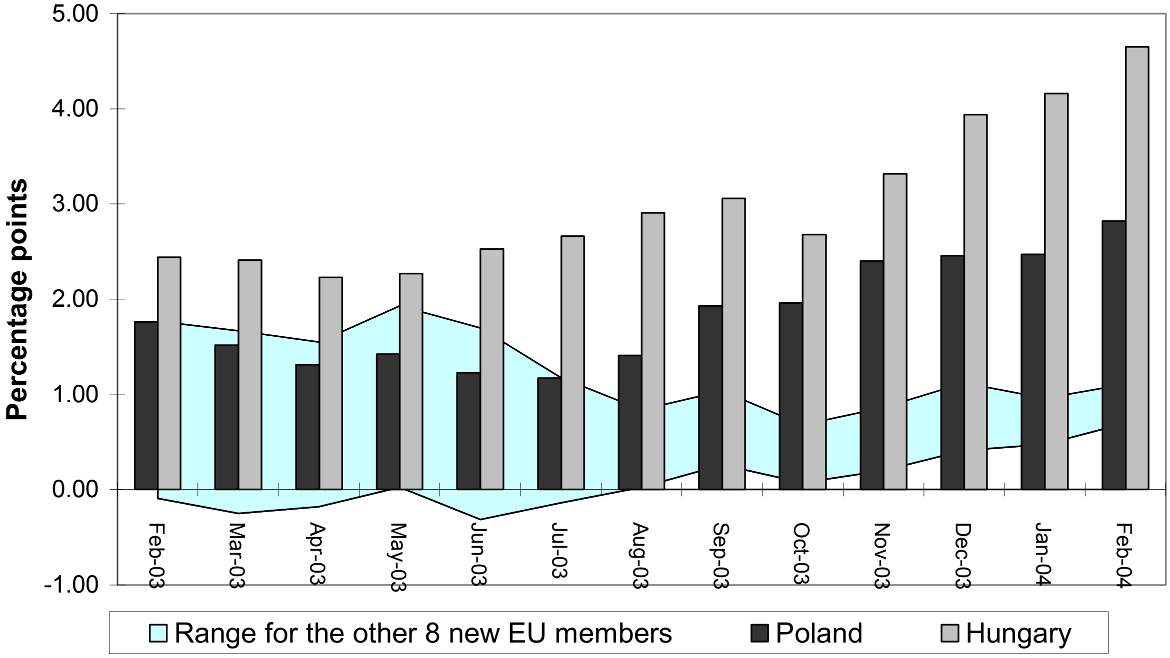


Sources: Polish authorities and staff calculations.

4. **Financial markets have been unsettled.** Despite low inflation, long-term interest rates have risen since mid-2003, in response initially to the announcement of an expansionary 2004 budget and more recently to unsettled politics (Figure 5). Unlike in most other new EU countries, the domestic spread over the 10-year euro yield has more than doubled since mid-2003. Pointing to weak political and fiscal fundamentals, S&P and Fitch downgraded Poland's domestic debt and the outlook on its foreign debt in the past year.

5. **The weak responses of investment and employment raise concerns about fundamental impediments to the recovery.** Uncertainties about the recovery in Western Europe are likely playing a role. But investment and employment growth remain substantially weaker than in other central European countries facing the same markets (Figure 6). And while excess capacity may still be a factor in some sectors, it seems likely that policy weaknesses during the past several years are influencing investor confidence and employment trends.

Spreads in New EU Members
(10-year domestic currency yield over 10-year euro reference rate)

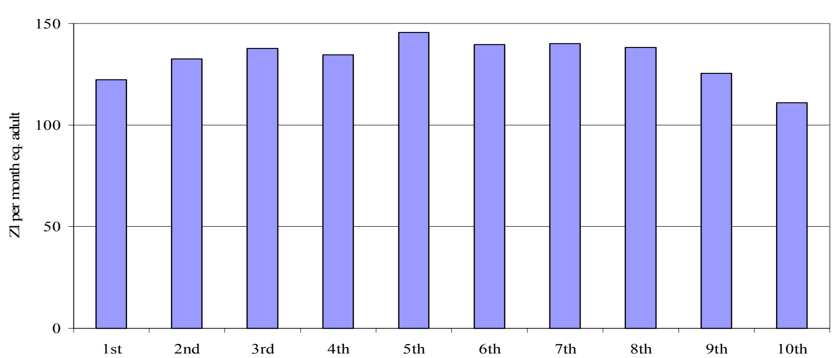


Sources: Eurostat, Bloomberg, and IMF staff

- **A weak fiscal situation inherited from the 1990s has been allowed to drift.** With a widening output gap, the headline deficit doubled during 1999–2002 and narrowed only slightly last year. As a result, public debt increased from below 40 percent of GDP at end-2000 to 51½ percent by end-2003 (Figure 7). Repeated fiscal reform efforts have failed in the face of vested interests and fractious politics (Box 1).

- **As fiscal reform attempts failed, social expenditure remained excessive and poorly targeted.** According to the World Bank, half of the 6.3 percent of GDP social spending (excluding old-age pension) in 2002 was paid to non-poor families or in excess of what was necessary to keep families above the poverty line.

Poland: Social Transfers per Capita by Consumption Deciles in 2002



Source: The World Bank.

Box 1. Fiscal Reform Attempts in Poland, 1999–2004

The authorities realized as early as 1999 that public finances needed to be strengthened to enhance Poland's growth potential and fully benefit from EU accession. Excessive current, mainly social, expenditure was diagnosed as the root of the fiscal problem. Since then a series of fiscal reform attempts have failed, reflecting vested interests and inadequate political cohesion around reforms. Each year since 2000, the finance minister resigned when his effort to incorporate reforms in the budget met political resistance and the government temporarily gave into the pressure. The Fund has supported these efforts and provided technical assistance to help design them.

The Balcerowicz strategy

The 1999 fiscal strategy—building on previous fiscal reforms and an ambitious reform agenda—aimed to reduce the general government deficit below 1 percent and public debt below 30 percent of GDP by 2003 (IMF Country Report No. 01/56). The strategy addressed the crux of the fiscal problem by aiming to restrain high current expenditure. As growth slowed in mid-2000, fiscal slippages emerged, political support for reforms faded, and the ruling center-right coalition lost its majority in 2000.

The Bauc period

Election politics got the upper hand in 2001, the structural deficit rose relative to GDP by ¾ percentage point and fiscal reforms were halted.

The Belka rule

After the 2001 election, Finance Minister Belka attempted to introduce a fiscal rule limiting central government expenditure growth to the CPI inflation rate +1 percent. To make this rule sustainable, the MoF started preparations for fiscal reforms to reduce social expenditure. Staff supported the plan and called for extending the rule to the general government (IMF Country Report No. 02/127).

The Kolodko package

The consolidation plan in 2003 focused on eliminating widespread formulaic expenditure adjustments. Welcoming the plan, staff called for structural fiscal reforms and warned that more needed to be done to restore fiscal sustainability (IMF Country Report No. 03/187).

The Hausner plan

The plan, proposed in 2003, aims to reduce social expenditure, streamline government, and accelerate the restructuring of ailing public companies. Deputy Prime Minister Hausner has accompanied well-specified proposals with a major outreach effort to gain public support, PM-designate Belka has endorsed the plan, but its fate remains uncertain.

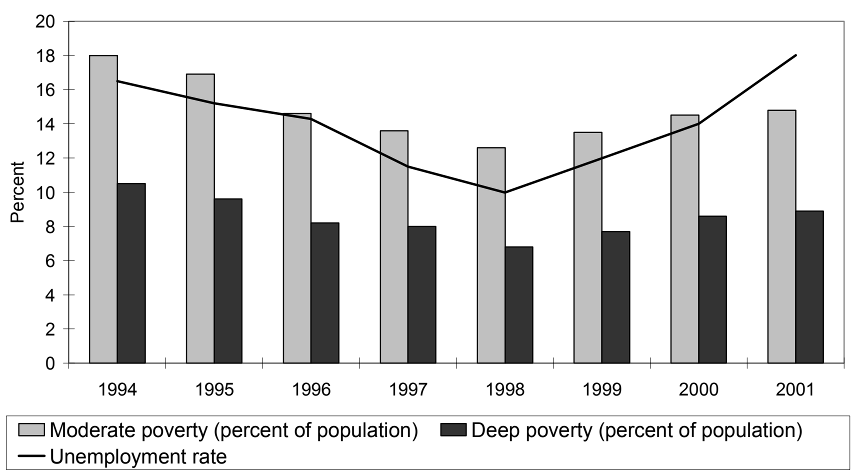
The large fiscal problem Poland is facing now could have been avoided if past plans had been implemented. For example, had the augmented Belka rule been followed from 2003 onward the deficit would now be well-positioned to drop below 3 percent of GDP by 2006, and public debt would have been stabilized below 50 percent of GDP.

- **An increase in unemployment owing to the cycle and enterprise restructuring was aggravated by policy-induced disincentives in the labor market.**[1] A large tax wedge and high minimum relative to average wage for low-skilled workers hindered wage adjustment where it was needed most. In addition skill mismatches persisted, and the social transfer system created benefit traps. By 2002, the share of long-term unemployed had risen to over half of the total.

- **With considerable rigidities in the labor market and poorly targeted social transfers, the economic slowdown worsened poverty.** Rising (particularly long-term) unemployment was the prime source of the increase in poverty. Poorly targeted fiscal transfers meant that even high social spending was less effective in addressing this problem than it should have been.

- **Lax fiscal policy left the burden of responding to a large current account deficit and rising inflation in the late-1990s to monetary policy.** Excessive tightening and a simultaneous large real appreciation (more than 25 percent during mid-1999–mid-2001) produced a sharp, though short-lived, diminution in price competitiveness (Figure 3). This contributed to a deep decline in investment in 2001–02 and, as it was most severe in labor-intensive industries, to massive lay-offs (Box 2).

Poverty and Unemployment in Poland, 1994-2001



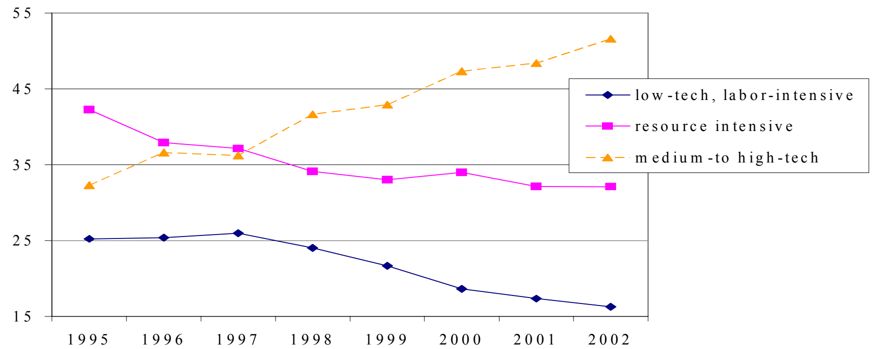
Sources: The World Bank and the authorities.

[1] See IMF Country Report No. 188 for a staff study on the structural, cyclical, and institutional contributions to unemployment.

Box 2. The Changing Structure of Exports and Labor Demand

Substantial changes in the product structure of Polish exports have had a strong impact on labor markets. As the accompanying selected issues paper shows, the share of low-tech and labor intensive exports declined rapidly following the Russia crisis, while medium-to-high-tech exports rose rapidly. As a result, employment in export industries fell by 25 percent between 1998–2003, accounting for most of the decline in employment in the corporate sector. Low-skilled jobs were likely lost to competition from other emerging markets.

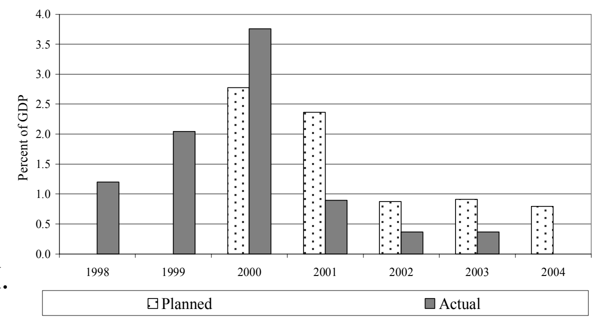
Poland-Structure of exports, 1993-2002
(in percent of total)



Source: UN Comtrade and IMF staff calculations.

- **Privatization slowed sharply and the environment for private investment has not improved.** Several of major companies slated for privatization in 2001 have still not been sold. Slowing privatization, the deteriorating economic climate, and stronger competition from neighboring countries lead to a rapid decline in FDI.

Poland: Privatization Receipts, 1998-2004



Sources: The authorities and IMF staff calculations.

6. **High unemployment, controversy over a fiscal reform plan, and scandals linked to the ruling coalition destabilized the political situation.** Prime Minister Miller resigned in May, and the President asked former Finance Minister Belka to form a new government. The first-round confidence vote failed to deliver the needed majority and ongoing negotiations will determine whether a government can be formed or early elections (ahead of the 2005 schedule) must be held. Prospects for implementing the previous government's fiscal reform plan are uncertain.

II. Report on the Discussions

7. **The discussions focused on policies needed to foster a pick-up in investment and employment growth so as to secure the recovery.** On the fiscal side, the Hausner plan and debt dynamics were the main issues. For monetary policy, keeping inflation within the target range in the face of rising oil prices and several temporary shocks was viewed as a major challenge. The discussions about longer term goals centered on the adoption of the euro.

8. **The authorities were confident that growth in 2004–05 would be strong and provide a robust foundation for containing the fiscal deficit.** They saw the Hausner plan as well-targeted at Poland's central fiscal problems and were determined to see it through to full implementation. While they expected that it would be sufficient to stabilize debt below the constitutional limit of 60 percent of GDP, they acknowledged that additional measures could be needed should growth disappoint. Staff shared the authorities' positive assessment of short-run economic trends, but cautioned on vulnerability to policy slippages.

9. **Despite previous ambitious plans, early euro adoption is unlikely.** The depth of the conviction about the benefits of early adoption varies within policy-making circles, but most accept that gains for trade and growth could be substantial. The authorities thought that achieving the necessary fiscal adjustment would be the most difficult hurdle to overcome.[2] Staff emphasized that a strong fiscal position—a structural deficit of 1–2 percent of GDP—before entering ERM2 would provide scope for automatic stabilizers to operate and minimize the risk of speculative attacks in ERM2. Inflation, on the other hand, was low and meeting the Maastricht criterion should be feasible. The monetary authorities were concerned about market stresses on the exchange rate in ERM2, depending on how limiting it would be, but agreed with staff that a stay limited to two years would be manageable.

10. **The authorities thought that staff's past policy recommendations had served Poland well, although political constraints had hindered their implementation.** They acknowledged that inadequate political support had prevented fiscal reforms (Box 1), and frequent changes in privatization strategies reflecting political resistance had delayed restructuring. Regarding monetary policy, the authorities thought that the policy of non-intervention—on which there had been an agreement with staff since the move to the float in 2000—had been a critical aspect of risk management.

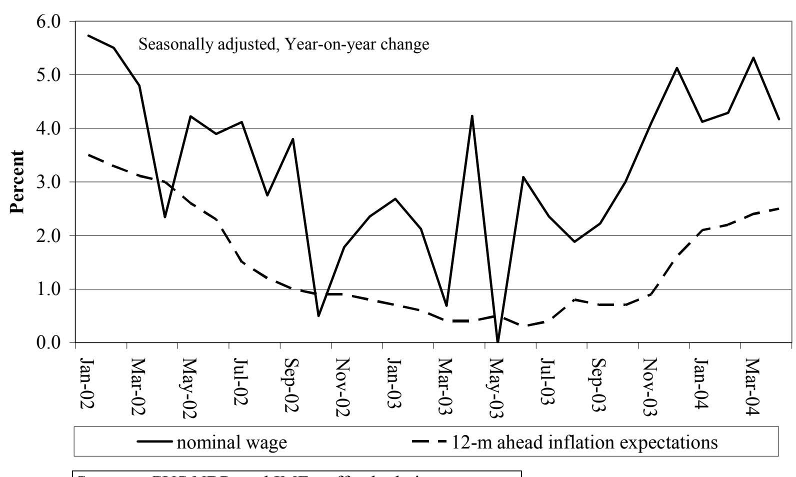
[2] The Maastricht deficit limit is for the general government net borrowing (ESA95), which differs from the general government cash deficit (GFS86) shown in this report. Depending on how the Eurostat decision on pension funds is applied to Poland, the ESA95 deficit was 0.3 (with pension funds outside the general government) or 1.9 (with pension funds in the general government) percent of GDP lower than the GFS86 cash deficit in 2003 (Table 4).

A. Economic Outlook

11. **Short-run prospects are favorable.** A modest recovery in Europe and improved competitiveness will help maintain high export growth, but political and fiscal uncertainties could keep a recovery of fixed investment gradual. Fiscal stimulus, mostly through accelerating public investment, will boost domestic demand. Reflecting job creation and some acceleration in real wages, private consumption growth should increase. Thus staff project growth rising to 5 percent in 2004, with an external current account deficit of 2.3 percent of GDP. Indications of strong growth in early-2004 suggest risks for full-year growth are on the upside, although some doubt remains about whether the robust first half reflected a bunching of consumer demand before EU accession. The authorities broadly agreed with staff's assessment, though NBP staff were less optimistic on growth and expected that higher domestic demand would lead to a faster deterioration in the external current account balance.

12. **Though core inflation should be low, headline inflation is likely to increase this year due to one-off factors.** Staff expect CPI inflation in 2004 to rise, perhaps briefly above the 2½–3½ percent target range, due to a closing output gap and temporary shocks—rising oil prices, possible effects of EU accession, and the pass-through from depreciation. Yet even rising inflation expectations and, in turn, wage growth are consistent with the center of the target range. Assuming expectations increase no further, staff expect headline inflation to revert to the central target in 2005 as the one-off factors dissipate. While trends so far are no cause for concern, the authorities viewed a further increase in inflation expectations—which, if translated into further wage acceleration, could turn a temporary increase in inflation into a more lasting one—as a major risk.

Poland: Corporate Wage Dynamics and Inflation Expectations, 2002-04



Sources: GUS,NBP, and IMF staff calculations.

13. **The authorities were optimistic about the medium-term.** They expected growth to increase, to 5½ percent in 2006–07, driven by a sharp upturn in investment and gradually rising consumption growth owing to confidence effects from the Hasuner plan. They projected a small deterioration in the current account deficit.

14. **Staff pointed to substantial risks to the recovery without structural and fiscal reforms.** Assuming a partial implementation of the Hausner plan in their central scenario, staff projected GDP growth to return to around 4¼ percent in 2005 and slightly below 4 percent in the longer run (Tables 6 and 7). Staff stressed that with only tepid fiscal adjustment—which would keep financial markets unsettled and interest rates increasing—the recovery of private investment would be slow—stabilizing the external current account deficit below 4 percent of GDP, but limiting job creation and private consumption growth. Staff emphasized that a higher growth path would require ambitious fiscal reforms (Table 8). External debt remains manageable under most stress tests (Table 9), but public debt continues to grow under the staff's central scenario (Table 10). In this scenario, a sudden depreciation of the zloty, especially if combined with a substantial increase in international capital market yields, would increase public debt sharply and would threaten required rollovers.

B. Fiscal Policy

15. **The authorities acknowledged that the 2004 budget was expansionary and added to the ultimate adjustment burden**. Prepared in the wake of the resignation of the previous finance minister, the budget had prioritized investment promotion and fully utilizing available EU funds. They stressed that the deterioration in the fiscal deficit was mostly due to the CIT rate cut from 27 to 19 percent, implemented in one step in 2004, and increased EU-related spending. The authorities were confident that the required financing could be secured and that a strong recovery would allow them to reduce the deficit later. Staff argued that, with a strong recovery in train, a fiscal expansion was unwarranted in 2004 and that with a reprioritization, an increase in spending relative to GDP could have been avoided. While recognizing the pressure from CIT-rate cuts in neighboring countries, staff emphasized that, without expenditure reform, the budget could not afford a large revenue loss. Moreover, as private investment was not hindered by inadequate internal funds or low profit margins, the rate cut would have limited immediate effects on corporate investment. Pointing to the increase in gross financing requirements, staff argued that the 2004 budget had substantially increased the vulnerability of public finances.

16. **To address the growing debt, Deputy Prime Minister Hausner had put forward a medium-term fiscal consolidation plan.** The plan aims to reduce the general government deficit relative to GDP (from an official baseline) by about 2 percentage points by 2007 (text table), thereby stabilizing public debt below the constitutional limit on the debt ratio—60 percent of GDP. Savings are from three areas: social benefit reforms, broadening the tax base, and administrative measures including public enterprise restructuring. Social measures, accounting for almost half of the planned total savings, include a change in the pension indexation rule, a streamlining of the pension scheme for farmers (KRUS), a tightening of pre-retirement benefits, and a reassessment of disability pensions. These are among the measures recommended in recent years by the IMF and the World Bank. Tax measures aim to broaden the tax base by eliminating preferential income tax and social contribution treatment for farmers, the disabled, and the self employed. Administrative measures

concentrate on reducing defense spending, strengthening tax administration, streamlining extra-budgetary funds, and restructuring public companies.

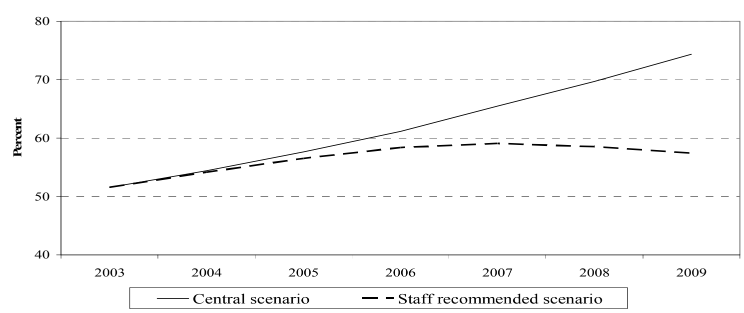
The Hausner Plan: Expected Budgetary Savings

	2004	2005	2006	2007	2004-07	Share in total
	In percent of GDP					percent of total
Social transfers						
Authorities estimates	0.1	0.6	1.0	0.8	2.5	46.2
Staff estimates	0.1	0.2	0.3	0.3	0.9	44.1
Revenue measures						
Authorities estimates	0.0	0.3	0.3	0.3	0.9	16.2
Staff estimates	0.0	0.1	0.2	0.1	0.4	20.8
Administrative measures and SOEs restructuring						
Authorities estimates	0.0	0.7	0.7	0.7	2.1	37.6
Staff estimates	0.0	0.2	0.2	0.3	0.7	35.2
Total						
Authorities estimates	0.1	1.6	2.0	1.8	5.5	100.0
Staff estimates	0.1	0.5	0.7	0.7	2.1	100.0

Sources: The authorities and staff calculations.

17. **The authorities emphasized that the Hausner plan addressed the crux of the fiscal problem and were confident that parliamentary support could be secured.** They explained that the plan aimed to redefine the role of government, increase the efficiency of public spending, and promote growth and employment. Planned reforms would reduce excessive social spending while making it more pro-poor and eliminating disincentives to work. The authorities also emphasized that the successful restructuring of the targeted public companies—recipients of substantial budget support—would improve efficiency and reduce the burden on the budget in the longer run. The first package of legislative amendments was submitted to Parliament in March 2004. Two others would follow shortly and all key measures were to be in place before the 2005 budget.

Poland: Public Debt-to-GDP Ratio, 2003-2009



Source: IMF staff calculations.

18. **Staff strongly supported the Hausner plan and urged its full implementation.** Social benefit reforms which would reduce expenditure and improve the efficiency of benefit schemes were especially welcome. Staff were concerned, however, by reports that two measures, the change in pension indexation rules and KRUS reform—over half the savings from social measures—risked being substantially watered down during Parliamentary approval. Applauding the long-term benefits of restructuring public sector companies, staff pointed out that it was unlikely to produce significant savings soon. Taking

into account this, the absence of identified measures to increase revenue, and the likelihood that pension indexation, pre-retirement benefit, and KRUS reforms would be watered down, staff estimated the total annual saving from the Hasuner plan at 0.7 percent of GDP by 2007, around one third of the official estimates (text table, Table 7). About half of the 1.1 percentage points difference between the authorities' and staff's estimates reflects staff's more conservative assessment of the yields of tax and administrative measures, particularly where measures are not clearly identified. The rest reflects staff's expectation that social measures would be implemented only partially. Moreover, staff scenarios with more conservative growth projections than in the official projections suggested that even full implementation of the Hausner plan would not stabilize debt below 60 percent of GDP.

19. **Staff argued that a decisive fiscal adjustment based on full implementation of the Hausner plan and follow-on structural measures was needed to restore fiscal sustainability and enhance growth.** Staff advocated further trimming and better targeting social benefits and streamlining public administration. Staff pointed out that an adjustment of about 1¾ percent of GDP in the structural deficit by 2007 compared to its central scenario—about 1 percent of GDP more than full implementation of identified measures in the Hausner plan would produce—was needed to stabilize public debt below the constitutional limit. Additional measures should aim to achieve savings in 2004 and keep the deficit on a declining path in 2005 (Table 8). The authorities agreed, but doubted whether the necessary political support could be secured.

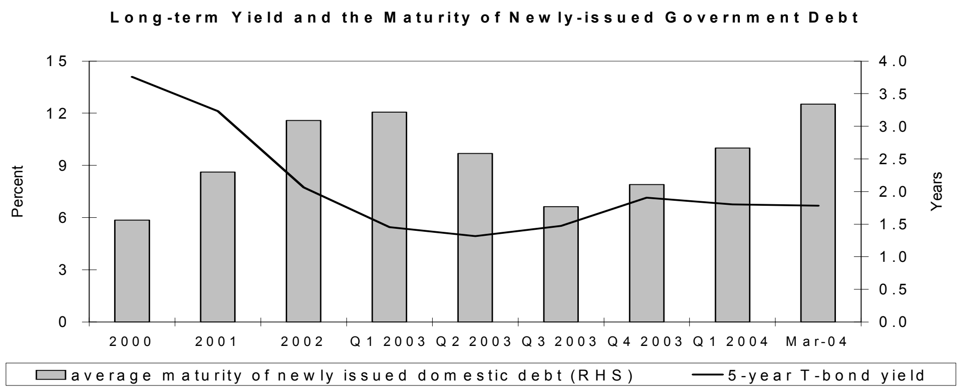
20. **Staff emphasized that steady debt management would be key to securing budget financing and the stability of domestic financial markets.** High gross public financing requirements combined with uncertainties about fiscal reforms and political developments created potential for episodic financing difficulties. Reflecting on the market turbulence last fall (Box 3), the authorities agreed on the importance of steady debt-management, including the maintenance of adequate government reserves. They also realized the role foreign investors had played in stabilizing the T-bond market in the past few months and described plans to improve market access by including non-resident financial institutions among primary dealers. Staff commended the authorities for stabilizing the T-bond market and urged that the foreign investor base be strengthened by issuing new liquid benchmark T-bonds.

C. Monetary Policy

21. The MPC, which was fully reconstituted early this year, considered monetary policy had been appropriately supportive during the past year. Some MPC members thought that deeper cuts in the policy rate in 2003 would have provided more scope for an early increase in rates as the recovery gained steam, but they did not consider interest rates had hindered recovery. Staff pointed out that the success of the previous MPC in achieving low inflation

Box 3. Turbulence on the Domestic T-Bond Market and the Role of Foreign Investors

Responding to deteriorating fiscal trends, long-term yields started to increase in mid-2003. In an attempt to stem the consequent increase in interest costs, the Ministry of Finance (MoF) reduced T-bond issue: in September two auctions were cancelled or declared unsuccessful because yields demanded by investors were deemed too high. This triggered a period of market turbulence, when long-term rates continued to increase and the average maturity of newly issued debt dropped. MoF subsequently improved communication with the market and returned to the practice of accepting market pricing. By March 2004, it managed to stabilize the market and increase the maturity of newly issued debt back to its mid-2003 profile.



Sources: The authorities and IMF staff calculations.

An accompanying selected issues paper shows that foreign investors played an important role in stabilizing the T-Bond market during this period. From September, when the turbulence began, through December they substantially increased their holding of domestic T-bonds. This suggests that, in their absence, the fluctuation in long-term yields would have been larger with potentially severe consequences for other financial markets.

was a helpful legacy although the new MPC would need to establish its credibility. Staff complimented the new MPC for quickly establishing a clear anti-inflationary stance and for successfully managing the take-over.

22. **The MPC saw an increasing number of factors weighing on the side of tightening their policy bias.** They attributed the recent pickup in headline inflation to supply side shocks from agriculture and oil; also, a possible short-run price hike caused by EU accession was a risk specific to this year. They would keep a careful eye on these effects on inflation expectations which they saw closely influencing wages. Thus far the effects had been benign, and no policy reaction had been required; but any change would call for a tightening of their bias. They viewed the weak fiscal position and increased uncertainty surrounding the Hausner plan, however, as more fundamental threats to price stability. Staff agreed with this assessment. Reflecting the analysis in the selected issue paper, it emphasized that the pass-through from the depreciation of the zloty during the past year had been less than experience of the past few years would suggest. While wide profit margins and strategic pricing by

importers might explain this, the strong recovery could produce a catch-up of the pass-through.

23. **The authorities felt that inflation targeting with no intervention in the foreign-exchange market would continue to serve Poland well until ERM2 entry.** They thought that exchange rate flexibility had for the most part helped the economy adjust to external and internal shocks in the past four years. Staff emphasized that in a low inflation environment and with limited downward wage flexibility, preserving this adjustment mechanism would help ensure that exchange rate is well-aligned upon ERM2 entry. More importantly, staff noted that the float had promoted prudent risk management which strengthened Poland's capacity to withstand volatile capital flows. Regarding the inflation targeting framework, MPC members thought that the medium-term inflation target of 2.5±1 percent set by the previous MPC remained suitable. Given the importance of continuity, staff agreed, though pointed out that a slightly higher target could better accommodate the Balassa-Samuelson effect, estimated at 1–2 percent per year.

24. **The tension over the use of the NBP revaluation reserve had dissipated.** The fiscal authorities confirmed that they would leave the decision on this matter to the central bank and emphasized that any part of the reserve released should be used to redeem expensive foreign debt. Welcoming the positive developments, staff stressed the importance of carefully considering the appropriate capitalization of the NBP and the level of foreign exchange holding when discussing the options.

25. **The authorities attributed the weakness of the zloty to political uncertainties.** They thought that an appreciation a more stable environment would bring about would not significantly harm competitiveness, but it would keep public debt in check. They argued that, while the depreciation of the zloty helped exporters, corporate restructuring was the main factor explaining strong corporate profits and rapid export growth in the past year. Staff broadly agreed, but stressed that, given high unemployment and the abundance of low-skilled labor, export competitiveness not just overall but also in labor-intensive products was important. Structural and labor market reforms as well as training were essential for addressing these problems, although an appropriate macroeconomic policy mix would help maintain a supportive exchange rate.

D. Financial Sector Risk and Vulnerability

26. **The authorities were confident that the banking system was well-capitalized and fully provisioned for irregular loans.** Based on the old loan-classification system, the share of irregular loans started to decline in mid-2003 reflecting the improved liquidity and profitability of the corporate sector. The rapid growth of foreign exchange-denominated housing loans had slowed significantly in the last quarter of 2003 as zloty interest rates declined and households became more careful about unhedged borrowing. Nonetheless, about half of the outstanding stock of housing loans was still foreign exchange-denominated or indexed. Based on their empirical analysis, the authorities thought that risks to the banking system originating from these loans were small.

Poland: Financial Soundness Indicators for Commercial Banks

	1998	1999	2000	2001	2002	2003
	(in Percent)					
Risk -based capital adequacy ratio	11.7	13.2	12.9	15.1	13.8	13.6
Capital to assets 1/	7.0	7.1	7.1	8.0	8.7	8.2
Nonperforming loans to total gross loans 2/	10.9	13.7	15.5	18.6	22.0	22.0
Provisions to nonperforming loans 3/	45.4	39.1	40.5	42.6	46.7	47.3
Pre-tax ROA	1.7	1.5	1.5	1.3	0.8	1.0
Liquid assets to total assets	…	…	…	…	31.3	31.7
Foreign currency loans to total loans 4/	23.4	21.2	22.8	23.8	28.8	34.0
Foreign currency deposits to total deposits 5/	19.2	19.7	18.2	19.5	18.7	18.5

Source: National authorities.
1/ Total capital base (regulatory capital).
2/ Share of irregular claims in gross claims on non-financial customers.
3/ General and specific provisions to irregular claims on non-financial customers.
4/ Loans to non-financial customers.
5/ Deposits from non-financial customers.

27. **The authorities felt the new loan classification system would enhance banks' competitiveness without substantially increasing risks.** Staff agreed that many elements of the new system had brought Poland in line with international best practice (Box 4). Staff, however, recommended keeping provisions freed up as a result of the changes in a special account until the full impact of the changes could be assessed. On more specific aspects of the change, staff called attention to a provision in the new regulation that automatically assumed or solely relied on the strength of a foreign guarantor when classifying loans. In staff's view this alone was insufficient for judging the quality of a loan; the capacity of the local borrower to repay should also be taken into account. Staff was concerned about the new rules for classifying consumer loans because they had the potential to delay the timely

identification of problems. Regarding mortgage products, staff recommended uniform standards for all types of banks. Staff also emphasized the importance of maintaining a database on foreign exchange-denominated or linked loans that would allow supervisors to assess risks—including built-in options for conversion—of this type of product.

Box 4. Changes to the Loan Classification and Provisioning Regulation (LCP)

The new regulation, introduced in 2004, was motivated by the authorities' perception that Poland's classification regulation was more exacting that that in most other countries. The change extends the period of non-servicing that triggers automatic classification, limits the value of the real estate collateral that can be considered for reducing the provisions for non-performing loans and sets specific timeframes for writing down the value of underlying collateral to zero. It also allows some high quality collateral (mainly guarantees) to be used to determine the severity of loan classification. At this stage, there is no available estimate of the impact of these changes on the stocks of classified loans and provisions.

E. Structural Policies

28. **The government planned to speed up privatization, but implementation is uncertain.** After a sizable underperformance last year, a relatively ambitious target—0.8 percent of GDP—was set for privatization receipts in 2004. Treasury officials, however, pointed to several factors hindering privatization, including political resistance to foreign ownership in financial services and other strategic sectors. Staff emphasized the importance of privatization in promoting corporate restructuring and FDI and urged the authorities to speed up implementation. Staff also argued against extensive restructuring prior to privatization, stressing that it had been costly and led to major delays without achieving significant improvements. The authorities planned to sell a 30-percent stake in PKO BP through an IPO. Staff emphasized the urgency of moving ahead with this long–delayed project.

29. **The government is planning comprehensive reforms in health financing, delivery and organization.** The authorities explained that the reforms, formulated with World Bank technical support, aimed to control costs, channel scarce resources to cost effective and clinically efficient procedures, enhance service quality, foster competition among service providers, and improve efficiency in the production and delivery of health care. Services to be covered by the public health insurance system are being established in a basic benefits package. These reforms are an integral part of the new legislation on health insurance, and the authorities were aiming for parliamentary approval of this bill by September 2004. Staff agreed that controlling health care costs is critical to avoid a rapid increase in public health care expenditure in the coming years.

30. **The authorities expected a marked decline in unemployment with the cyclical upturn and new initiatives to promote job creation.** They projected that the

unemployment rate could drop to 16–17 percent by end-2006. They expected the new law on employment promotion in the Hausner plan to enhance job creation during the upturn by promoting active labor market programs for high-risk groups (e.g., long-term unemployed and low-skilled people). They also emphasized that the law would create incentives for old-age people to re-enter the labor force. They thought that the changes to the Labor Code had helped create employment. Staff commended the authorities for their renewed efforts to reduce high structural unemployment and agreed with the overall strategy of focusing on low-skilled and long-term unemployed, and creating work incentives for old-age workers. The reform of the Labor Code had been an important step forward, but the re-introduction of restrictions on temporary contracts was likely to reverse some gains. Staff stressed that reforms needed to reduce the large tax wedge particularly for low-skill workers and eliminate the disincentives of poorly-targeted social assistance. The authorities thought that EU accession would not be conducive to making Polish labor market more flexible and they did not expect significant labor migration to other EU countries.

31. **The authorities expected EU entry to increase competitive pressure in several sectors, even though the overall level of trade protection would decline only slightly.** Significantly lower tariffs on light industrial and consumer electronics products and cars would have the strongest impact, while changes in antidumping and safeguard rules would have a negative impact on metallurgy production. In agriculture, the authorities expected increased competition from the other new EU members following elimination of high tariffs among these countries.

III. Staff Appraisal

32. **Poland is in the midst of a strong recovery with an uncertain future.** The immediate outlook is for an unusually favorable combination of strong growth, low inflation and a small current account deficit. Much of the recent and prospective success is due to a cyclical rebound accompanied by modest wage growth and strong corporate profits. Sustaining the recovery, however, will require more. Most importantly, confidence that steady and sustainable policies will be pursued is essential to reignite investment and employment demand. To this end, the damaging drift in fiscal and structural polices during the past few years must give way to purposeful reform.

33. **The 2004 budget illustrates the problems Poland will face in this process.** Formulated in the aftermath of the fourth resignation of a finance minister in four years, the budget was another in a series that failed to address the formula-driven structure of spending inherited from the era of central planning and first years of transition—characterized by poorly-targeted and excessive social transfers and subsidies. While commendable initiatives were taken—the corporate income tax rate was cut and co-financing for a sizable increase in EU funds was provided—the reprioritization of budget spending needed to make such policies sustainable was not. Moreover, coming as the recovery gained steam, the budget injected a pro-cyclical stimulus that is likely to hasten the need for a restraining monetary policy response. Any windfall revenues from higher-than-predicted growth in 2004 should therefore be saved. The adverse market reaction to the announcement of the 2004 budget is

an example of the difficulties Poland will face if the unsustainable fiscal trends are not addressed.

34. **The Hausner plan, if fully implemented, would be a central step in this process.** Its thrust—streamlining social transfers, restructuring state-owned enterprises, and broadening the tax base—targets the most acute fiscal excesses. It would not only improve the fiscal balance, but also address several unfinished aspects of transition—particularly a poorly-targeted social welfare system with disincentives to work and cumbersome state-enterprises. The political obstacles to implementation are onerous; passing a watered-down version of the reform legislation offers a politically appealing escape that would probably satisfy markets for the short-term. Further postponing a decisive fiscal consolidation, however, would make public finances vulnerable to shifts in market sentiment, and, in turn, limit the recovery in private investment. Longer-term prosperity demands that this option be resisted. Indeed, barring exceptionally favorable external and domestic conditions over the next decade, steps beyond the Hausner plan will be needed to stabilize debt below the constitutional limit (and Maastricht criterion) of 60 percent of GDP. Such efforts should focus on further streamlining social benefits and public administration and improving revenue administration.

35. **A second priority for the new government will be to reinvigorate economic restructuring.** The urgency of this issue is reflected in the share of Poland's GDP produced in the public sector, which remains the largest among the new EU members, while the political commitment to privatization has all but disappeared. Longstanding discussions on privatizing several large financial institutions, in particular the country's largest bank, and major companies in the energy, chemical and petrochemical industries need to move onto implementation; progress in downsizing and restructuring in the coal industry needs to be replicated in other sectors; and the government should divest minority shareholdings in privatized enterprises. The drain of inefficient state enterprises should not be allowed to drag down Poland's competitiveness as it enters the EU.

36. **Labor market reform is a third task for the new government**. The recovery should lead to a cyclical decline in unemployment, but efforts are needed on several fronts to lower structural unemployment. Labor market reforms should focus on increasing employability, in particular of low-skilled workers. Changes to social benefits—some already included in the Hausner plan and others expanding the effort, for example, to in-work benefits for the recently unemployed—should increase incentives to work. Also on the fiscal side, savings need to make room for reducing the tax wedge.

37. **Fiscal and structural reform will be critical for future monetary policy**. Poland's exceptionally low inflation will rise over the next year, in the first instance owing to one-off supply side influences: as the recovery strengthens, these one-off effects could be incorporated in expectations and self-perpetuate. The new MPC has therefore appropriately signaled its concern—and thereby taken the first step toward establishing its anti-inflation credentials—by shifting to a tightening bias, while holding off on any increase in interest rates until the risk of one-off factors influencing expectations is clearer. A continuation of the

strong recovery, especially without full and early implementation of the Hausner plan, would likely call for the Council to act on its bias.

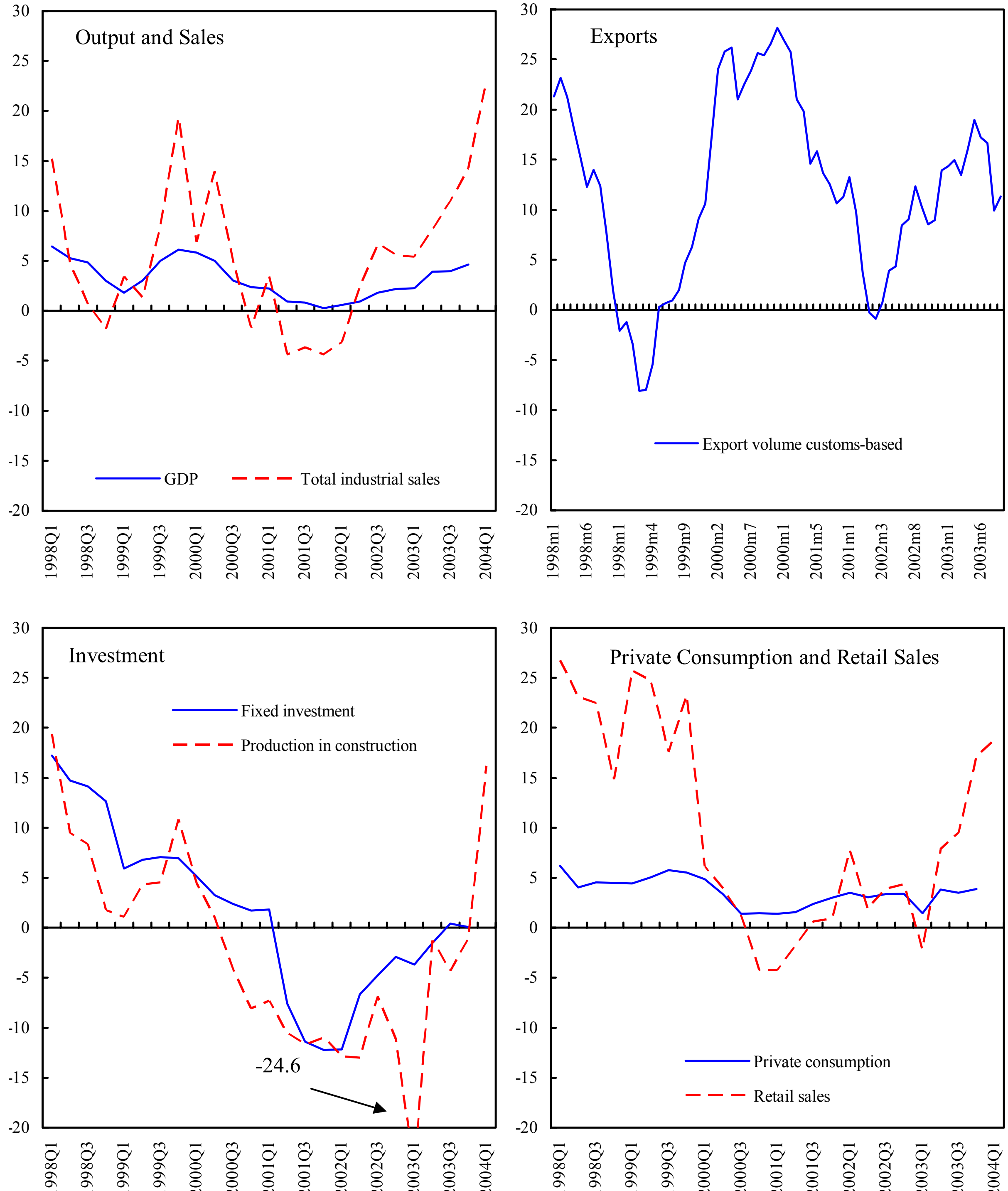
38. **A flexible exchange rate continues to serve Poland well.** The large depreciation since mid-2001 has restored profitability contributing forcefully to the strength of exports and activity. The new MPC has appropriately signaled its support for continuing a policy of non-intervention, which, by placing the costs of capital account volatility on market participants and eliminating the scope for the official sector getting stuck on one side of the market, offers Poland substantial protection from the risks of zloty volatility. Indeed, the fact that balance sheets have absorbed the large depreciation without excessive strains is testimony to the strengths of this regime. In this setting, questions about the need for NBP reserve holding equivalent to over 180 percent of short term debt might be asked, but the case against such holdings must take into account prospects for participation in ERM2.

39. **Having weathered the slowdown in activity and the deprecation of the zloty, the financial sector must now prepare for the challenge of rapid growth of bank credit to the private sector.** After sharp deteriorations until mid-2003, the share of non-performing loans has stabilized, and bank profitability has strengthened. Bank credit to the corporate sector remains stagnant but credit to households is increasing strongly. Such expansion is expected when bank credit accounts for only one third of GDP, but the health of banks must be watched closely in these circumstances, even though most banks are subsidiaries of foreign banks. A preliminary assessment of the new loan classification system suggests that it probably moves Poland's system closer to that in neighboring countries and does not unduly ease oversight or free provisions excessively. Nevertheless, experience over the next year will be critical in solidifying this assessment, and the authorities must be ready to act if experience suggests undue easing of provisioning.

40. **Poland's potential for a rapid catch-up to EU incomes levels is substantial, but a decisive shift to pro-growth policies is essential to realize it.** Such policies would also pave the way to early euro adoption—another channel for speeding up the catch-up and locking in a commitment to policy discipline. To this end, not only must fiscal policy be reined in quickly, but also labor and product markets must demonstrate the flexibility to ensure efficient adjustment in the absence of an independent monetary policy, and financial sector supervision must be exemplary. The government has not committed to a timetable for euro adoption—understandably, in light of the current political turmoil. But once a new government with a multiyear mandate is in place, it would be well-advised to summon the political support to prepare the economy expeditiously for euro adoption

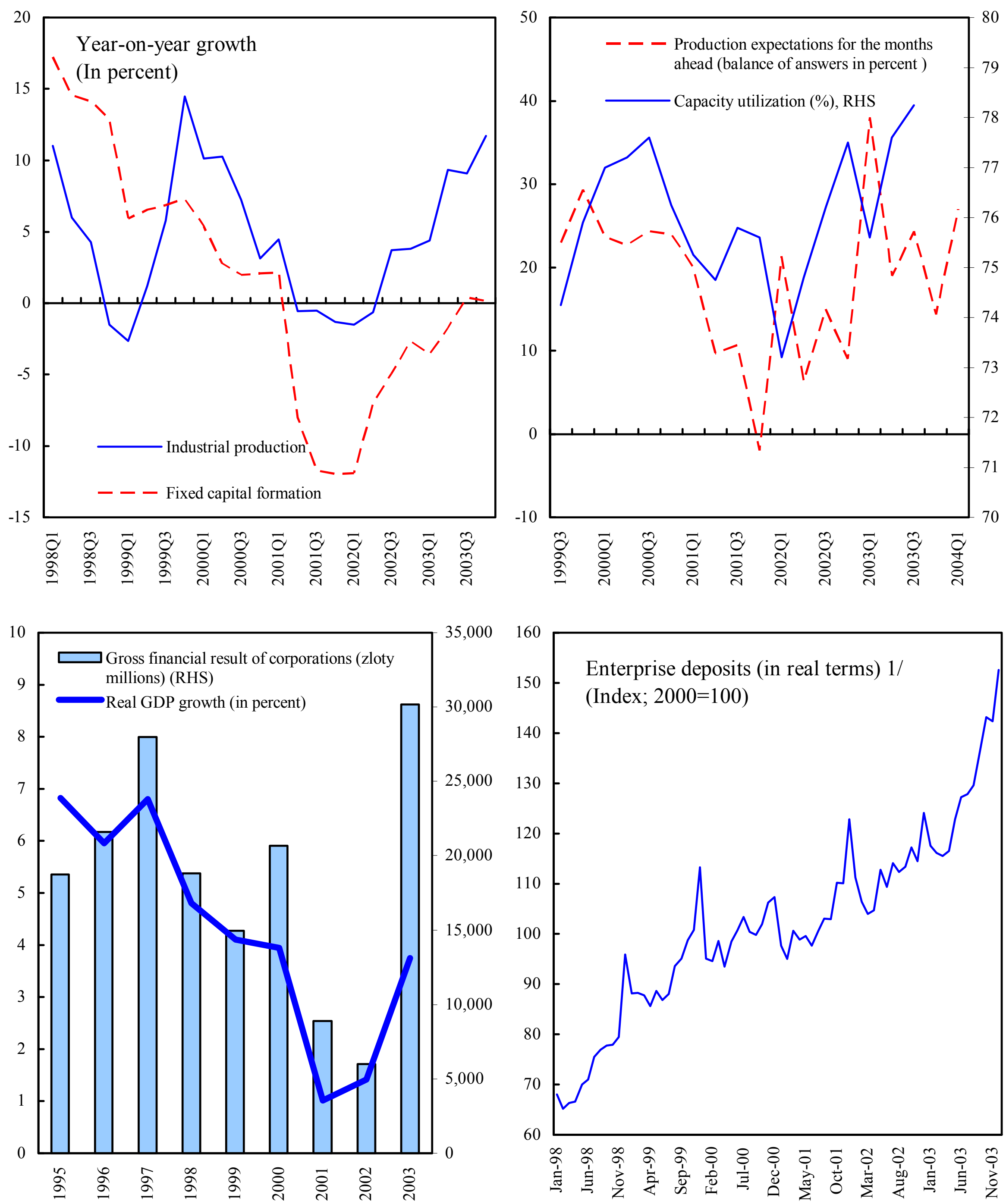
41. **It is recommended that the next Article IV consultation be held on the standard 12-month cycle.**

Figure 1. Poland: Activity and Demand, 1998-2004
(Year-on-year real growth rates, in percent)



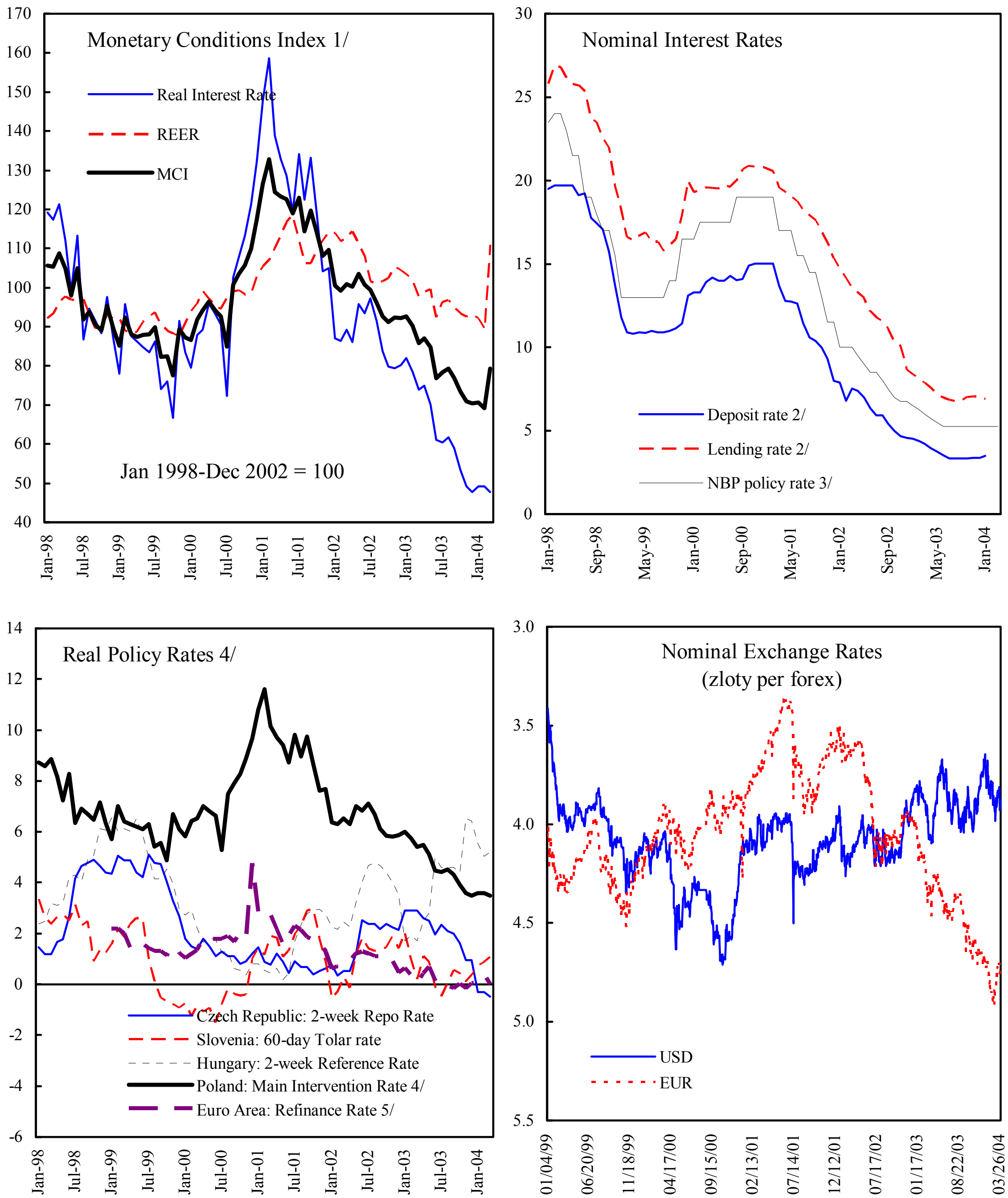
Sources: Polish authorities; and staff calculations.

Figure 2. Poland: Indicators of Investment Climate, 1998–2004



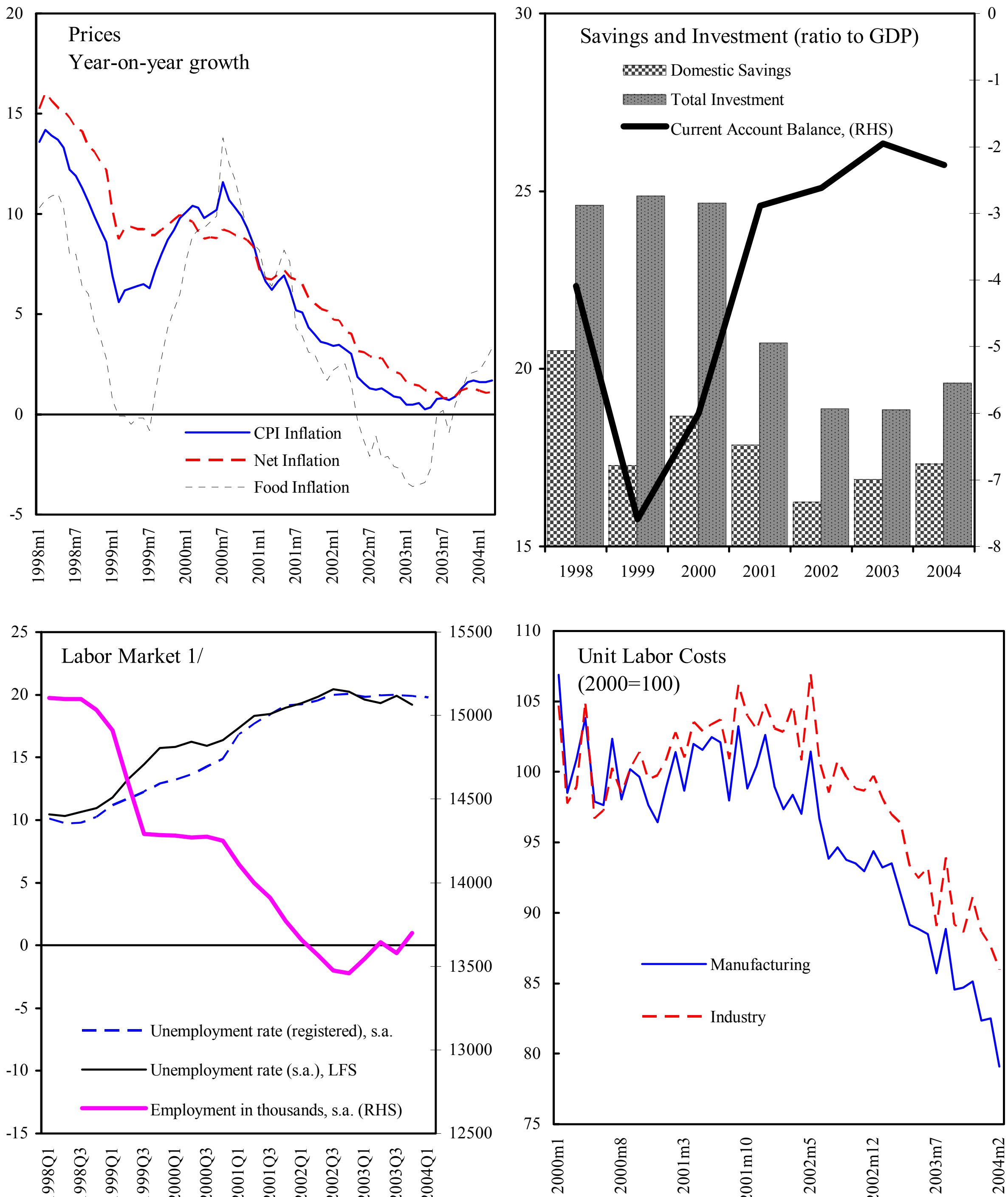
Sources: Polish authorities; and staff calculations.
1/ Deflated by CPI.

Figure 3. Poland: Indicators of Monetary Policy, 1998-2004
(In percent, except where indicated)



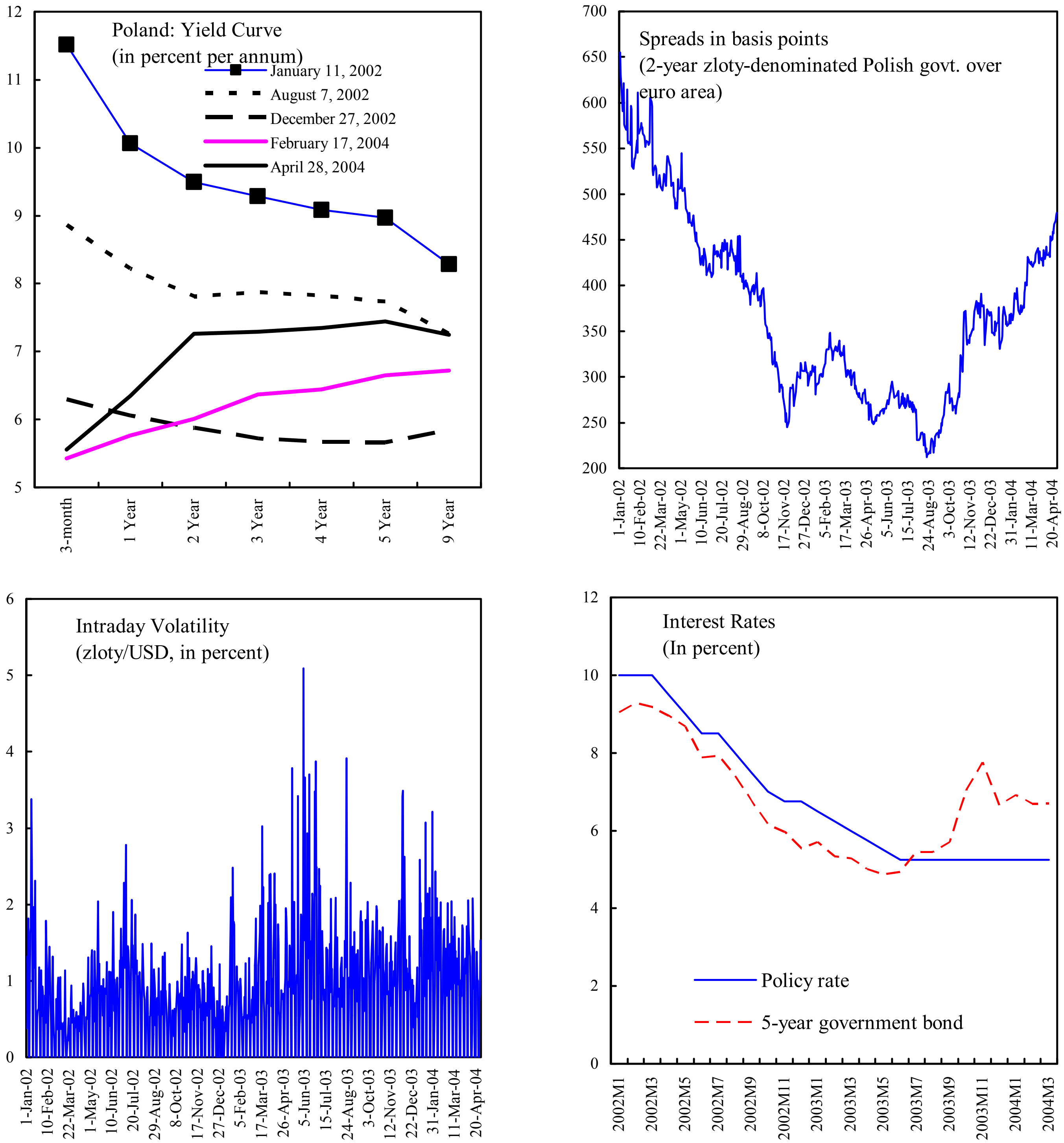
Sources: Polish and other country authorities; International Finance Statistics; and staff estimates.
1/ The real interest rate and the REER have weights of 50 percent.
2/ Since end-March 2002, rates reflect revisions of monetary accounts.
3/ 28-day intervention rate through end-2002; 14-day intervention rate thereafter.
4/ Policy rates deflated by the percentage change in CPI over the previous 12 months.
5/ ECB fixed rate until July 2000; minimum bid rate thereafter.

Figure 4. Poland: Indicators of Economic Slack, 1998-2004
(In percent, unless otherwise indicated)



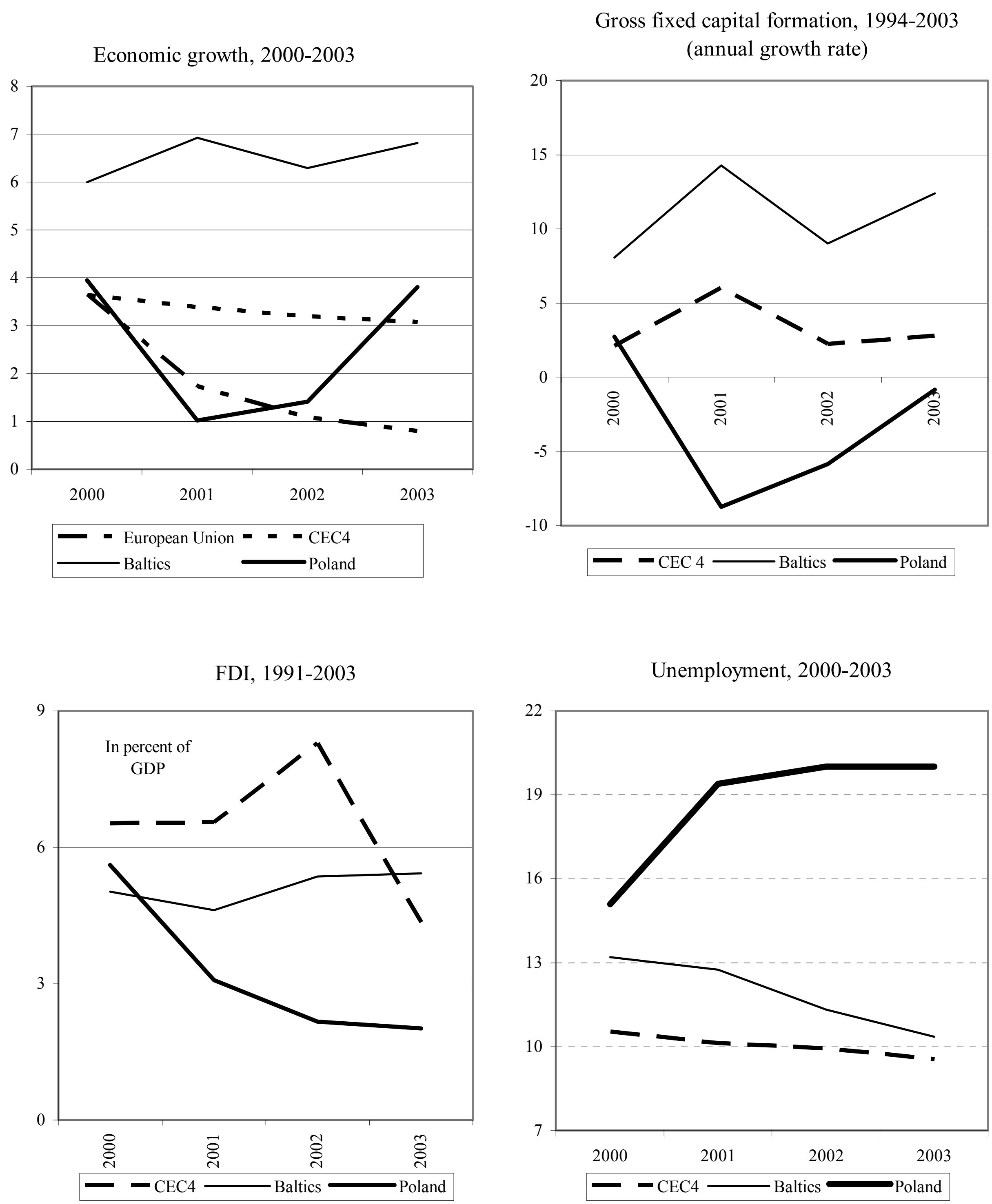
Sources: Polish authorities; Labor Force Survey; and staff calculations.
1/ The quarterly Labor Force Survey was not undertaken in Q2 and Q3 of 1999, and observations in these quarters are extrapolated.

Figure 5. Poland: Indicators of Market Sentiment, 2002–04



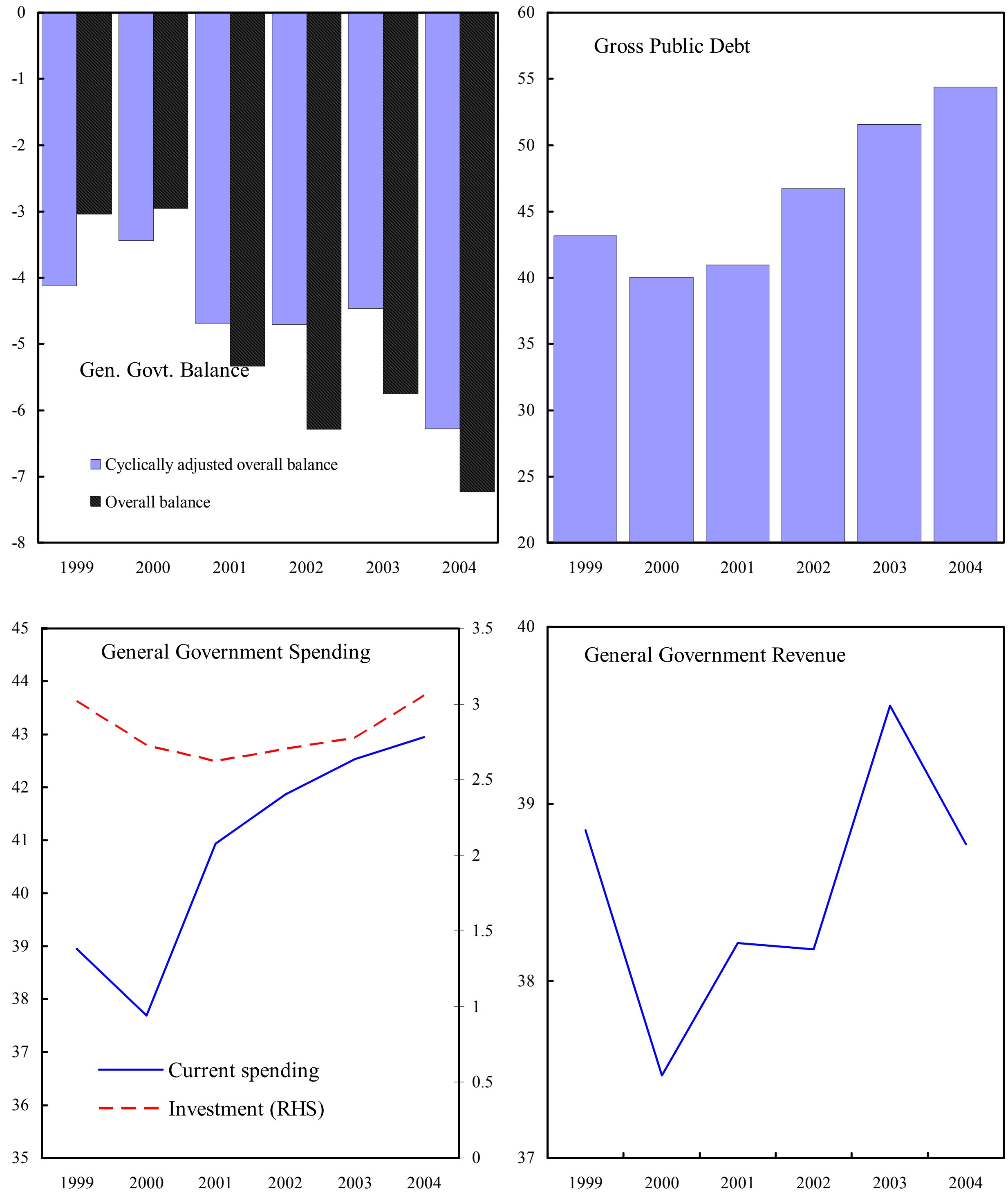
Sources: Bloomberg; and staff calculations.
1/ The ten-year bond was discontinued in early 2002 and reinstated in 2003.

Figure 6. New EU Members: Growth, Investment, and Unemployment, 2000-2003



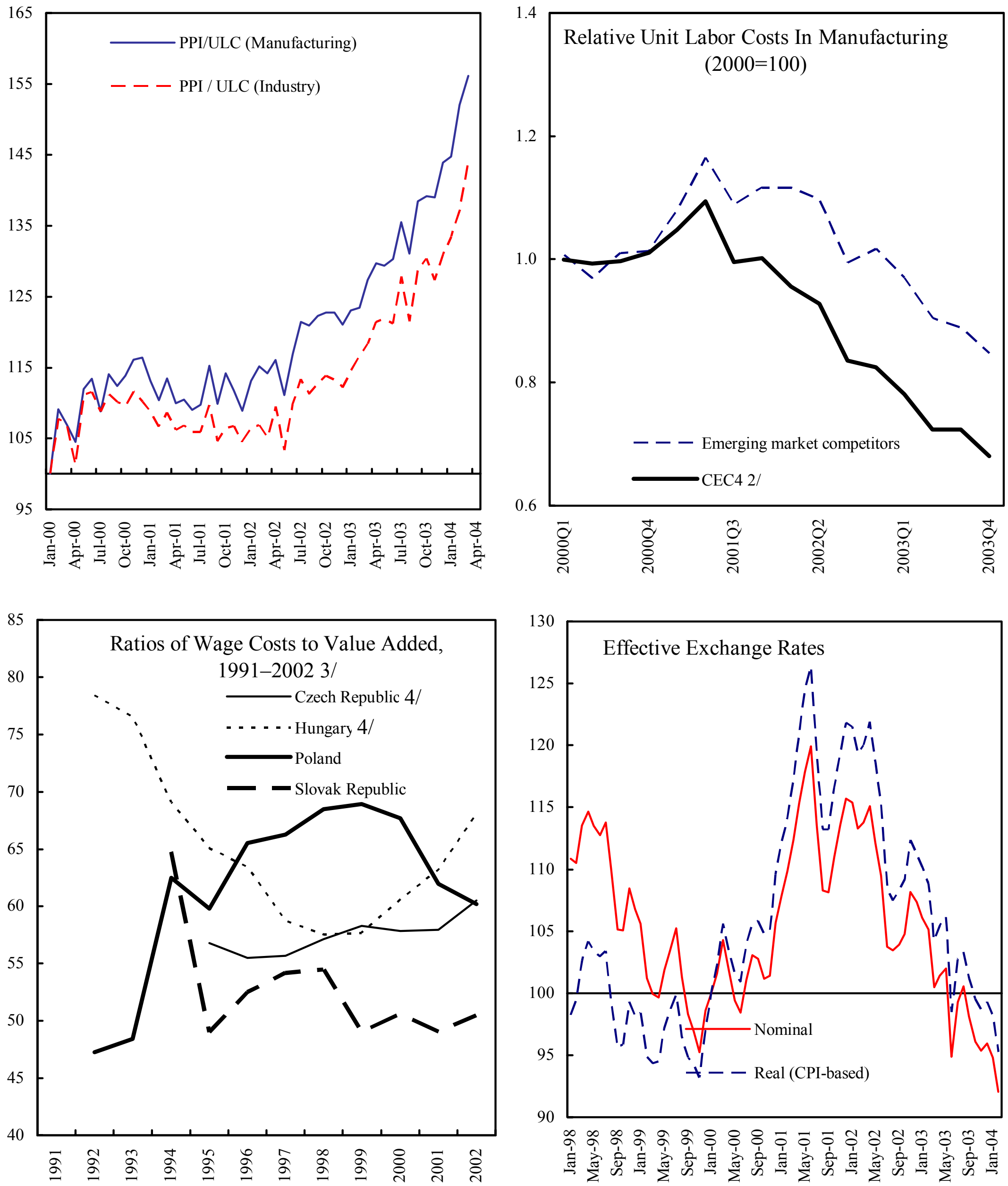
Source: WEO

Figure 7. Poland: Indicators of Fiscal Policy, 1999–2004 1/
(In percent of GDP)



Sources: Polish authorities; and staff calculations.
1/ Data for 2004 are staff projections.

Figure 8. Poland: Indicators of Wage Costs, Profits and Competitiveness, 1997-2004
(January 2000 =100, unless otherwise indicated)



Sources: Polish authorities; Information Notice System; OECD Stan databse; OECD Analytical database; and staff calculations.

1/ Trade weights for 1999 (exports plus imports) for Australia, Austria, Belgium, Denmark, Finland, France, Germany, Italy, Japan, Netherlands, Norway, Spain, Sweden, Switzerland, United Kingdom, and United States.

2/ US dollar ULC in Poland relative to US dollar ULC in Hungary, Czech Republic, and Slovakia, weighted by share of average exports of goods during 1997-2001 to the US, Canada, Australia, Euro area, Norway and Sweden.

3/ Wage bill per employee in manufacturing, as ratio of value added per person employed.

4/ Using IMF staff estimates for total employment.

Table 1. Poland: Selected Economic Indicators, 1999-2004 1/
(In percent, except where indicated)

	1999	2000	2001	2002	2003	2004 Proj.
Activity and prices (growth rates)						
GDP	4.1	4.0	1.0	1.4	3.8	5.0
Domestic demand	4.7	3.1	-1.5	0.9	2.4	5.5
Private consumption growth	5.2	2.8	2.1	3.3	3.1	5.1
Public consumption growth	2.1	1.6	0.6	0.9	0.4	3.5
Domestic fixed investment growth	6.8	2.7	-8.8	-5.8	-0.9	7.4
Net external demand (contribution to growth)	-0.9	0.6	2.6	0.5	1.3	-0.5
CPI inflation						
Average	7.3	10.1	5.5	1.9	0.8	2.7
End of period	9.8	8.5	3.6	0.8	1.7	2.9
Unemployment Rate (registered, end year)	12.0	15.1	19.4	20.0	20.0	19.4
Gross Domestic Saving (ratio to GDP) 2/	17.3	18.7	17.9	16.2	16.8	17.0
Gross Domestic Investment (ratio to GDP)	24.9	24.7	20.7	18.9	18.7	19.4
Public Finances (percent of GDP)						
State Government Revenues	19.3	18.8	18.4	18.4	18.7	...
State Government Expenditures 3/	21.2	20.9	22.7	23.4	23.2	...
State Government Balance 3/	-1.9	-2.1	-4.3	-5.0	-4.5	...
General Government Revenues	38.9	37.5	38.2	38.3	39.6	38.8
General Government Expenditures	42.0	40.4	43.6	44.6	45.3	46.0
General Government Balance	-3.0	-3.0	-5.3	-6.3	-5.8	-7.2
General Government Net Borrowing (ESA95) 4/	-1.5	-1.8	-3.5	-4.0	-3.9	-5.2
General Government Net Borrowing (ESA95) 5/	-2.0	-3.3	-5.0	-5.9	-5.5	-6.7
General Government Debt	40.5	36.9	40.2	45.1	50.1	53.2
Public debt 6/			41.0	46.7	51.6	54.4
Money and credit						
Private Credit (12-month change)	29.1	17.3	9.2	5.0	7.9	. . .
Broad Money (12-month change)	20.1	11.9	9.2	-2.0	5.6	. . .
Money market rate (eop)	17.9	19.2	11.7	6.7	5.5	. . .
13-week t-bill rate (eop)	16.4	16.8	11.2	6.1	5.3	. . .
Balance of Payments						
Current account balance (transactions, in mill.$US)	-12,487	-9,998	-5,357	-5,007	-4,085	-5,337
percent of GDP	-7.6	-6.0	-2.9	-2.6	-1.9	-2.3
C/A balance plus FDI, percent of GDP	-3.2	-0.4	0.2	-0.6	-0.1	-0.5
Exports (millions U.S. dollars)	30,060	35,902	41,664	46,742	61,007	73,263
Export volume growth	2.0	25.3	11.8	8.3	14.1	11.0
Imports (millions U.S. dollars)	45,132	48,210	49,324	53,991	66,732	80,380
Import volume growth	4.4	10.8	3.2	7.3	4.9	12.0
Terms of trade (index 1995=100)	90.5	88.1	97.4	100.1	103.5	104.2
Official reserves (millions U.S. dollars)	27,314	27,466	26,564	29,794	33,975	34,338
months of imports	7.3	6.8	6.5	6.6	6.1	5.1
Total external debt (percent of GDP)	39.7	41.7	38.7	44.3	49.6	48.5
Ratio of short term debt to gross reserves	41.1	34.8	41.7	46.7	55.6	55.5
Fund Relations (January 31, 2004)						
Fund holding of currency (in percent of quota)				60.7		
Holding of SDRs (in percent of allocation)				n/a		
Quota (SDR million)				1369		
Exchange rate						
Exchange rate regime			Floating			
Present exchange rate (March 4, 2004)			zl 4.0 = US$1			
Zloty per US$, period average	4.0	4.3	4.1	4.1	3.9	. . .
Zloty per Euro, period average	4.2	4.0	3.7	3.9	4.4	. . .
Real effective exchange rate (INS, CPI based)	112.0	121.2	137.7	133.3	120.0	. . .
percent change	-4.1	8.2	13.7	-3.2	-10.0	. . .

Sources: Polish authorities; and staff estimates.
1/ GDP series for 2000-2002 are based on the authorities' new methodology introduced in late 2002. GDP series prior to 2000 are staff estimates of the new methodology, using growth rates from the old methodology. This applies to all tables and figures of the staff repo
2/ Derived as a difference between total savings and current account.
3/ Including the full amount of transfers to social security fund.
4/ With second pillar pension funds part of general government.
5/ With second pillar pension funds outside general government.
6/ Including risk weighted stock of outstanding guarantees.

Table 2. Poland: Balance of Payments on Transaction Basis, 2000-09
(In millions of US$)

	2000	2001	2002	2003 Est.	2004 Proj	2005 Proj	2006 Proj	2007 Proj	2008 Proj	2009 Proj
Current account balance	-9,998	-5,357	-5,007	-4,085	-5,337	-7,367	-9,524	-10,809	-11,487	-11,392
percent of GDP	-6.0	-2.9	-2.6	-1.9	-2.3	-3.0	-3.7	-3.9	-4.0	-3.7
Trade balance	-12,308	-7,660	-7,249	-5,725	-7,117	-8,715	-10,156	-11,643	-13,285	-15,231
percent of GDP	-7.4	-4.1	-3.8	-2.7	-3.1	-3.6	-3.9	-4.2	-4.6	-5.0
Exports										
percentage change in unit values	20.5	11.1	10.4	27.1	20.1	10.8	9.8	11.1	10.8	10.9
percentage volume growth	25.3	11.8	8.3	14.1	11.0	9.8	9.6	10.3	9.7	9.8
export market growth	12.0	3.2	1.7	4.5	6.3	6.1	5.3	6.1	5.9	5.9
Imports										
percentage change in unit values	9.8	1.9	8.4	22.5	20.5	11.8	10.4	11.5	11.2	11.3
percentage volume growth	10.8	3.2	7.3	4.9	12.0	11.6	10.4	10.8	10.3	10.3
growth in domestic demand	3.1	-1.5	0.9	2.4	5.5	4.9	4.5	4.3	4.3	4.3
Terms of trade percentage change	-2.6	10.5	2.8	3.4	0.6	0.7	0.2	0.2	0.2	0.1
Services balance	1,393	804	849	519	585	516	472	468	457	427
Credit	10,387	9,755	10,035	11,166	13,409	14,860	16,312	18,128	20,089	22,276
Debit	8,994	8,951	9,186	10,647	12,825	14,344	15,840	17,660	19,632	21,848
Net Income	-1,463	-1,390	-1,887	-3,112	-3,390	-4,765	-7,289	-8,803	-10,140	-11,214
Net transfers	2,380	2,889	3,280	4,233	4,586	5,596	7,450	9,170	11,481	14,625
Capital and financial account balance	10,234	3,248	6,947	8,015	5,700	6,584	8,553	9,871	11,423	11,683
Financial account balance	10,202	3,173	6,954	8,061	5,700	6,584	8,553	9,871	11,423	11,683
Foreign direct investment (net)	9,322	5,803	3,901	3,839	4,274	4,866	5,661	5,861	6,524	6,232
by nonresidents	9,340	5,713	4,131	4,225	4,674	5,266	5,861	6,461	7,124	6,732
o/w privatisation	3,500	1,500	476	588	1,000	1,000	700	700	400	400
Portfolio investment (net)	3,333	1,113	1,669	2,444	2,110	2,887	3,665	4,377	5,225	5,733
by non-residents	3,422	1,067	2,826	3,740	3,536	3,314	3,964	4,736	5,656	6,168
o/w equities	447	-307	-545	-837	-837	-837	-837	-837	-837	-837
Other investment	-2,722	-3,407	2,282	2,647	-684	-1,169	-773	-368	-326	-281
Assets	-3,870	-4,071	1,887	-1,700	-2,857	-3,125	-2,925	-2,735	-2,812	-2,891
Liabilities	1,148	664	395	4,347	2,174	1,956	2,152	2,367	2,485	2,610
Financial derivatives	269	-336	-898	-869	0	0	0	0	0	0
Errors and omissions	382	1,672	-1,306	-2,735	0	0	0	0	0	0
Overall Balance	618	-437	634	1,195	363	-783	-971	-939	-64	292
Financing										
Reserve assets	-618	437	-634	-1,195	-363	783	971	939	64	-292
Memorandum items										
Official reserves	27,466	26,564	29,794	33,975	34,338	33,555	32,583	31,645	31,580	31,872
in months of imports	6.8	6.5	6.6	6.1	5.1	4.5	3.9	3.4	3.1	2.8
Ratio of short-term debt to reserves	34.8	41.7	46.7	55.6	55.5	57.2	59.4	61.7	62.4	62.4
Total external debt (percent of GDP)	41.7	38.7	44.3	49.6	48.5	48.1	47.7	47.9	48.4	49.1
Total external debt (percen of exports)	150.1	139.8	149.3	143.8	127.3	121.3	117.0	112.1	108.1	104.1
External debt service (in percent of exports) 1/	19	27	23	24	21	20	26	21	24	24
Gross FDI inflows (percent of GDP)	5.6	3.1	2.2	2.0	2.1	2.2	2.3	2.4	2.5	2.2

Sources: NBP; and staff estimates.
1/ Excluding repurchase of debt.

Table 3. Poland: Monetary Survey, 1999-2003
(In millions of zloty, end-of-period)

	1999	2000	2001	2002	2003
Net International Reserves	110,559	131,761	132,565	132,118	135,551
(in billions of U.S. dollars)	27.3	27.5	26.6	29.8	34.0
Net domestic assets	193,903	212,320	259,982	260,806	279,994
Credit to central government, net	68,201	56,081	69,208	65,949	70,122
Credit to nongovernment	186,347	218,624	238,726	250,586	270,414
Other items, net	-60,645	-62,385	-47,952	-55,729	-60,542
Broad Money	268,868	300,757	328,434	321,961	340,111
Memorandum items (in percent)					
Broad money growth (12-month)	20.1	11.9	9.2	-2.0	5.6
Real broad money growth (12-month)	9.4	3.1	5.4	-2.7	3.9
Nominal growth of credit to nongovernment	29.1	17.3	9.2	5.0	7.9
Real growth of credit to nongovernment	19.3	8.8	5.6	4.2	6.2
Share of foreign currency deposits in broad money	14.4	13.8	15.3	14.5	13.8

Sources: National Bank of Poland; and staff estimates.

Table 4. Poland. General Government Revenues and Expenditures, 1999-2004
(In percent of GDP)

	1999	2000	2001	2002	2003 Est. 4/	2004 Proj.
General government revenue 1/	38.9	37.5	38.2	38.3	39.6	38.8
Direct taxes 2/	23.3	22.6	22.6	22.2	21.6	21.3
Indirect taxes	11.4	11.0	10.8	11.5	11.7	11.4
Other taxes and nontax	4.2	3.8	4.8	4.5	6.3	6.0
General government expenditure 1/	42.0	40.4	43.6	44.6	45.3	46.0
Goods and services	17.2	16.5	17.6	18.0	17.6	19.5
Transfers and subsidies	18.8	18.6	20.4	20.6	21.9	20.2
Interest payments	2.9	2.6	2.9	3.2	3.1	3.2
Capital and net lending	3.0	2.7	2.6	2.7	2.8	3.1
General government balance (cash) 3/	-3.0	-3.0	-5.3	-6.3	-5.8	-7.2
Financing	3.0	3.0	5.3	6.3	5.8	7.2
Domestic	2.0	0.0	6.0	5.5	4.6	6.2
External	-0.2	-0.7	-1.5	0.5	0.8	0.3
Privatization	1.2	3.7	0.9	0.3	0.4	0.8
Memorandum items:						
Structural Balance	-4.1	-3.4	-4.7	-4.7	-4.5	-6.3
ESA95 deficit with OFEs inside general government	-1.5	-1.8	-3.5	-4.0	-3.9	-5.2
ESA95 deficit with OFEs outside general government	-2.0	-3.3	-5.0	-5.9	-5.5	-6.7
General government primary balance (cash)	-0.2	-0.3	-2.4	-3.1	-2.7	-4.0
State balance (cash)	-1.9	-2.1	-4.3	-5.0	-4.5	-6.4
Rest of government balance	-1.1	-0.8	-1.1	-1.3	-1.2	-0.9

Sources: Polish authorities and staff estimates and projections.
1/ Revenue and expenditure exclude non-returnable resources from the European Union.
2/ Including social security contributions.
3/ General government overall balance on a cash basis including payments in compensation for insufficient indexation in the 1990s.
4/ The estimates for other budgetary units are preliminary and may be subject to revisions.

Table 5. Poland: Indicators of External Vulnerability, 2000-04
(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004 latest	Date of Observation
Financial indicators						
Public sector debt 1/	36.9	40.2	45.1	50.1	53.2	*Proj. for 2004*
Broad money (percent change, 12-month basis)	11.9	9.2	-2.0	5.6	5.7	*Mar-04*
Private sector credit (percent change, 12 month basis)	17.3	9.2	5.0	7.9	5.9	*Mar-02*
Domestic credit to GDP	29.3	34.2	33.4	34.4	...	
13 week T-Bill rate 2/	16.8	11.2	6.1	5.3	5.2	*Mar-04*
13 week T-Bill real rate 3/	7.6	7.4	5.2	3.5	3.5	*Mar-04*
External Indicators						
Exports (percent change, 12-month basis in US$)	20.5	11.1	10.4	27.1	20.1	*Proj. for 2004*
Imports (percent change, 12-month basis in US$)	9.8	1.9	8.4	22.5	20.5	*Proj. for 2004*
Current account balance	-6.0	-2.9	-2.6	-1.9	-2.3	*Proj. for 2004*
Capital and financial account balance	6.1	1.7	3.6	3.8	2.5	*Proj. for 2004*
o/w: Inward portfolio investment (debt securities etc.)	2.1	0.6	1.5	1.8	1.6	*Proj. for 2004*
Other investment (loans, trade credits etc.)	0.7	0.4	0.2	2.1	1.0	*Proj. for 2004*
Inward foreign direct investment	5.6	3.1	2.2	2.0	2.1	*Proj. for 2004*
Net Foreign Assets (NFA) of commercial banks (in billions of US$	31.8	33.3	34.3	34.3	...	
Official reserves (in billions US$)	27.5	26.6	29.8	34.0	34.3	*Mar-04*
Official reserves in months of imports of goods	6.8	6.5	6.6	6.1	5.1	*Proj. for 2004*
Reserve money to reserves (Ratio)	0.4	0.6	0.5	0.5	0.4	*Mar-04*
Broad money to reserves (Ratio)	2.5	3.0	2.6	2.6	...	
Total short term external debt to reserves (in percent) 4/	34.8	41.7	46.7	55.6	55.5	*Proj. for 2004*
Total external debt (in billions of US$)	69.5	71.9	84.7	103.8	110.4	*Proj. for 2004*
o/w: Public sector debt (in billions of US$)	29.2	27.5	35.7	44.0	...	
Ratio of short-term external debt to total external debt (in percent)	13.7	15.4	16.4	18.2	...	
Exchange rate (per US$, period average)	4.3	4.1	4.1	3.9	4.0	*Apr-04*
REER depreciation (-) (12-month growth, period average) 5/	8.2	13.7	-3.2	-9.8	-9.8	*Apr-04*
Financial Market Indicators						
Stock market index	17,847	13,922	13,845	20,820	23,245	*24-May-04*
Foreign currency debt rating						
Standard and Poor's 6/	BBB+	BBB+	BBB+	BBB+	BBB+	*24-May-04*
Moody's 7/	Baa1	Baa1	A2	A2	A2	*24-May-04*
Spread, JP Morgan's EMBI index	241	195	185	76	82	*24-May-04*

Sources: Bloomberg; Polish authorities; and staff estimates.
1/ Data for 1999 and beyond covers general government debt; data for earlier years includes central government debt 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.
7/ In Moody's rating system Baa is investment grade whereas Ba is below.

Table 6. Poland: Savings and Investment Balance-Central Scenario, 1999-2009

	1999	2000	2001	2002	2003 Est.	2004 Proj	2005 Proj	2006 Proj	2007 Proj	2008 Proj	2009 Proj
					In percent of GDP						
Consumption	81.1	81.9	82.9	84.5	83.8	83.5	83.3	83.2	83.3	83.4	83.5
Non-government	62.3	62.9	64.0	65.4	65.0	64.8	64.9	65.0	65.2	65.4	65.6
Government	18.8	19.0	19.0	19.1	18.7	18.7	18.5	18.2	18.1	17.9	17.9
Investment	24.9	24.7	20.7	18.9	18.7	19.4	20.1	20.5	20.8	21.1	21.3
Fixed capital	24.0	23.5	20.7	19.0	18.3	18.7	19.3	19.6	19.8	20.0	20.1
Non-government	20.5	20.0	17.2	15.5	14.4	14.6	14.4	14.2	14.3	14.4	14.5
Public sector	3.5	3.5	3.5	3.5	3.9	4.1	4.8	5.4	5.4	5.5	5.6
Inventories	0.9	1.1	0.1	-0.1	0.4	0.6	0.8	0.9	1.0	1.1	1.2
Total Savings	24.9	24.7	20.7	18.9	18.7	19.4	20.1	20.5	20.8	21.1	21.3
Domestic Savings	17.3	18.7	17.9	16.2	16.8	17.0	17.0	16.8	16.9	17.1	17.6
Non-government	17.5	17.9	18.6	18.5	18.5	20.3	19.6	19.5	20.1	20.6	21.0
General Government	-0.2	0.7	-0.7	-2.3	-1.7	-3.3	-2.6	-2.7	-3.3	-3.5	-3.4
Foreign Savings 1/	7.6	6.0	2.9	2.6	1.9	2.3	3.0	3.7	3.9	4.0	3.7
Memorandum items:											
Real GDP growth	4.1	4.0	1.0	1.4	3.8	5.0	4.2	4.0	3.9	3.9	3.9
Private consumption											
Real growth	*5.2*	*2.8*	*2.1*	*3.3*	*3.1*	*5.1*	*4.5*	*4.4*	*4.4*	*4.4*	*4.4*
Contribution to GDP growth	3.3	1.8	1.3	2.1	2.0	3.3	2.9	2.9	2.9	2.9	2.9
Public consumption											
Real growth	*2.1*	*1.6*	*0.6*	*0.6*	*0.4*	*3.5*	*3.0*	*2.5*	*2.5*	*2.5*	*2.5*
Contribution to GDP growth	0.4	0.3	0.1	0.2	0.1	0.6	0.5	0.4	0.4	0.4	0.4
Fixed Investment											
Real growth	*6.8*	*2.7*	*-8.8*	*-5.8*	*-0.9*	*7.4*	*7.3*	*6.0*	*5.0*	*5.0*	*5.0*
Contribution to GDP growth	1.5	0.6	-2.0	-1.2	-0.2	1.4	1.4	1.2	1.0	1.0	1.0
Change in inventories											
Contribution to GDP growth	-0.2	0.6	-1.0	-0.2	0.6	0.3	0.2	0.2	0.2	0.2	0.2
External Balance											
Contribution to GDP growth	-0.9	0.6	2.6	0.5	1.3	-0.5	-0.9	-0.6	-0.6	-0.6	-0.6

Sources: Polish authorities and staff estimates.
1/ BOP basis.

Table 7. Poland: Medium-Term Debt Dynamics-Central Scenario 2002-09 /1

	2002	2003	2004	2005	2006	2007	2008	2009
	(In percent of GDP, unless otherwise indicated)							
Budget deficit								
Primary revenue	38.2	39.6	38.8	38.8	38.8	38.8	38.7	38.6
Primary expenditure	41.3	42.3	42.7	42.5	42.5	42.5	42.3	42.2
Primary balance	-3.1	-2.8	-4.0	-3.8	-3.6	-3.6	-3.6	-3.5
Interest costs	3.2	3.1	3.2	3.3	3.6	4.0	4.5	5.0
Overall balance	-6.3	-5.8	-7.2	-7.1	-7.3	-7.7	-8.1	-8.5
Debt sustainability indicators								
General government debt (end of year stock)	45.2	50.2	53.1	56.4	59.9	64.1	68.2	72.7
Public debt (Polish definition, end of year stock)	46.7	51.6	54.4	57.6	61.1	65.5	69.7	74.3
Savings-Investment balance								
Investment	18.9	18.7	19.4	20.1	20.5	20.8	21.1	21.3
Domestic savings	16.2	16.7	17.0	17.0	16.8	16.9	17.1	17.6
Foreign savings	2.6	2.0	2.3	3.0	3.7	3.9	3.9	3.7
Assumptions								
Real growth (ppa)	1.4	3.8	5.0	4.2	4.0	3.9	3.9	3.9
Average effective nominal interest rate on general government debt (ppa)	8.9	9.0	7.7	7.1	7.4	7.8	8.1	8.4
90-day T-bill rate (ppa)	7.4	5.5	5.7	6.5	7.3	7.8	7.8	7.8
Rate of real appreciation (CPI based, ppa)	-0.3	3.5	1.5	0.0	0.0	-0.5	-1.0	-1.0
GDP deflator (percentage change)	1.2	0.5	3.2	2.8	2.7	2.7	2.7	2.8

Sources: Data provided by the authorities; and Fund staff estimates and projections.
1/ General government .

Table 8. Poland: Medium-Term Debt Dynamics-Staff Recommended Scenario 2002-09 /1

	2002	2003	2004	2005	2006	2007	2008	2009
	(In percent of GDP, unless otherwise indicated)							
Budget deficit								
Primary revenue	38.2	39.6	38.8	38.7	38.9	39.0	38.9	38.8
Primary expenditure	41.3	42.3	42.6	42.2	41.4	40.4	39.2	38.0
Primary balance	-3.1	-2.8	-3.8	-3.5	-2.6	-1.4	-0.3	0.8
Interest costs	3.2	3.1	3.2	3.3	3.4	3.4	3.5	3.4
Overall balance	-6.3	-5.8	-7.0	-6.7	-6.0	-4.8	-3.7	-2.6
Debt sustainability indicators								
General government debt (end of year stock)	45.2	50.2	52.9	55.3	57.1	57.7	57.1	55.9
Public debt (Polish definition, end of year stock)	46.7	51.6	54.1	56.5	58.4	59.1	58.5	57.4
Savings-Investment balance								
Investment	18.9	18.7	19.4	21.0	22.6	23.7	24.4	25.1
Domestic savings	16.2	16.7	17.0	17.5	17.4	18.1	19.2	20.6
Foreign savings	2.6	2.0	2.3	3.5	5.2	5.6	5.2	4.5
Assumptions								
Real growth (ppa)	1.4	3.8	5.0	3.9	4.1	4.9	5.0	5.1
Average effective nominal interest rate on general government debt (ppa)	8.8	9.0	7.7	7.1	7.2	7.1	7.1	7.2
90-day T-bill rate (ppa)	7.4	5.5	5.7	5.8	5.8	5.8	5.5	5.5
Rate of real appreciation (CPI based, ppa)	-0.3	3.5	1.5	1.5	1.5	0.0	0.0	0.0
GDP deflator (percentage change)	1.2	0.5	3.2	2.7	2.6	2.6	2.7	2.6

Sources: Data provided by the authorities; and Fund staff estimates and projections.
1/ General government.

Table 9. Poland: External Debt Sustainability Framework, 1997-2008
(In percent of GDP, unless otherwise indicated)

		Actual							Projections				
		1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
	I. Baseline Medium-Term Projections												
1	**External debt**	32.3	35.1	39.7	41.7	38.7	44.3	49.6	48.5	48.1	47.7	47.9	48.4
2	Change in external debt	1.4	2.7	4.7	2.0	-3.0	5.5	5.3	-1.0	-0.5	-0.4	0.1	0.6
3	Identified external debt-creating flows (4+8+11)	0.3	-5.4	5.8	-4.0	-3.5	-0.7	-1.5	-3.2	-1.8	-1.2	-0.5	-0.2
4	Current account deficit, excluding interest payments	2.5	2.2	6.0	4.2	1.3	1.4	1.2	1.5	1.4	1.7	1.8	2.0
5	Deficit in balance of goods and services	4.3	5.1	8.3	6.6	3.7	3.3	2.5	2.9	3.4	3.7	4.1	4.4
6	Exports	25.8	25.7	23.4	27.8	27.7	29.7	34.5	38.1	39.6	40.8	42.7	44.8
7	Imports	30.1	30.8	31.7	34.3	31.4	33.0	36.9	41.0	43.0	44.5	46.8	49.2
8	Net non-debt creating capital inflows (negative)	-3.6	-4.6	-4.3	-5.9	-2.9	-1.6	-1.5	-1.6	-1.7	-1.9	-1.9	-2.0
9	Net foreign direct investment, equity	3.2	3.6	4.4	5.6	3.1	2.0	1.8	1.9	2.0	2.2	2.1	2.3
10	Net portfolio investment,equity	0.4	1.0	-0.1	0.3	-0.2	-0.4	-0.31	-0.29	-0.27	-0.25	-0.24	-0.23
11	Automatic debt dynamics 1/	1.4	-3.0	4.1	-2.3	-1.9	-0.6	-1.1	-3.1	-1.5	-0.9	-0.4	-0.1
12	Contribution from nominal interest rate	1.2	1.8	1.7	1.6	1.6	1.2	0.9	0.8	1.5	2.1	2.3	2.4
13	Contribution from real GDP growth	-2.1	-1.3	-1.5	-1.4	-0.4	-0.5	-1.6	-2.3	-1.9	-1.8	-1.7	-1.7
14	Contribution from price and exchange rate changes 2/	2.3	-3.5	4.0	-2.5	-3.1	-1.2	-0.5	-1.6	-1.1	-1.2	-1.0	-0.8
14	Residual, incl. change in gross foreign assets (2-3)	1.1	8.2	-1.1	5.9	0.5	6.3	6.8	2.1	1.3	0.9	0.7	0.7
	External debt-to-exports ratio (in percent)	125.2	136.5	170.1	150.1	139.8	149.3	143.8	127.3	121.3	117.0	112.1	108.1
	Gross external financing need (in millions of US dollars) 3/	15846.0	20449.0	32117.0	30763.0	25974.0	29978.0	36881.0	43270.1	45603.3	48075.4	49689.1	50708.1
	in percent of GDP	10.3	12.1	19.5	18.5	14.0	15.7	17.6	19.0	18.8	18.6	18.1	17.5
	Key Macroeconomic and External Assumptions												
	Real GDP growth (in percent)	6.8	4.8	4.1	4.0	1.0	1.4	3.8	5.0	4.2	4.0	3.9	3.9
	Exchange rate appreciation (US dollar value of local currency, change in percent)	-18.3	0.4	-15.5	0.1	3.9	2.0	0.5	0.2	-0.5	0.0	-0.5	-1.0
	GDP deflator in US dollars (change in percent)	-6.9	12.0	-10.2	6.9	8.1	3.2	1.1	3.3	2.3	2.7	2.1	1.7
	Nominal external interest rate (in percent)	4.0	6.5	4.5	4.6	4.2	3.2	2.2	1.9	3.3	4.7	5.1	5.4
	Growth of exports (US dollar terms, in percent)	6.3	9.2	-11.3	20.5	11.1	10.4	27.1	20.1	10.8	9.8	11.1	10.8
	Growth of imports (US dollar terms, in percent)	12.4	12.2	0.4	9.8	1.9	8.4	22.5	20.5	11.8	10.4	11.5	11.2
	II. Stress Tests for External Debt Ratio												
	1. Real GDP growth, nominal interest rate, dollar deflator, non-interest current account, and non-debt inflows are at historical average in 2004-2008								50.1	49.8	49.1	48.2	47.3
	2. Nominal interest rate is at historical average plus two standard deviations in 2004 and 2005								50.7	50.1	49.7	49.9	50.4
	3. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005								50.7	50.1	49.7	49.9	50.4
	4. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2004 and 2005								60.4	59.6	59.0	59.1	59.6
	5. Non-interest current account is at historical average minus two standard deviations in 2004 and 2005								53.7	53.1	52.6	52.7	53.3
	6. Combination of 2-5 using one standard deviation shocks								60.5	59.7	59.1	59.2	59.7
	7. One time 30 percent nominal depreciation in 2004								48.5	48.1	47.7	47.9	48.4

Historical Statistics for Key Variables (past 10 years)	Historical Average	Standard Deviation	Average 2004-08
Current account deficit, excluding interest payments	2.9	1.9	1.6
Net non-debt creating capital inflows	4.1	1.1	1.8
Nominal external interest rate (in percent)	4.6	1.3	3.7
Real GDP growth (in percent)	4.4	2.0	4.3
GDP deflator in US dollars (change in percent)	2.0	9.8	2.6

Sources: Polish authorities and staff calculations.

1/ Derived as [r - g - ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (based on GDP deflator).

3/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

Table 10 Poland: Public Sector Debt Sustainability Framework, 1999-2009
(In percent of GDP, unless otherwise indicated)

	Actual							Projections					
	1999	2000	2001	2002	2003			2004	2005	2006	2007	2008	2009
								I. Baseline Projections					
Public sector debt 1/	41.9	38.7	39.7	45.1	50.1			**53.1**	**56.4**	**59.9**	**64.1**	**68.2**	**72.7**
o/w foreign-currency denominated	19.9	16.7	13.0	13.9	15.7			15.9	17.8	18.2	18.5	18.8	19.1
Change in public sector debt	1.6	-3.2	1.0	5.4	5.0			3.0	3.3	3.5	4.2	4.1	4.6
Identified debt-creating flows (4+7+12)	-0.7	1.1	2.6	5.3	3.3			3.5	3.6	3.7	4.0	4.1	4.4
Primary deficit	0.3	0.9	2.7	3.2	2.8			4.0	3.8	3.6	3.6	3.6	3.5
Revenue and grants	38.9	37.6	38.2	38.3	39.6			38.8	38.8	38.8	38.8	38.7	38.6
Primary (noninterest) expenditure	39.2	38.5	40.9	41.5	42.4			42.8	42.6	42.5	42.5	42.2	42.1
Automatic debt dynamics 2/	-1.0	0.2	-0.1	2.0	0.5			-0.4	-0.1	0.1	0.3	0.6	0.9
Contribution from interest rate/growth differential 3/	-1.0	-1.7	0.9	2.1	1.1			-0.7	-0.2	0.1	0.3	0.6	0.8
Of which contribution from real interest rate	0.5	-0.1	1.3	2.6	2.8			1.6	1.9	2.2	2.5	2.9	3.3
Of which contribution from real GDP growth	-1.5	-1.5	-0.4	-0.5	-1.6			-2.3	-2.1	-2.1	-2.2	-2.3	-2.5
Contribution from exchange rate depreciation 4/	0.0	1.8	-1.0	0.0	-0.7			0.3	0.0	0.0	0.0	0.0	0.1
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes (2-3)	2.3	-4.3	-1.6	0.1	1.8			-0.5	-0.4	-0.3	0.3	0.0	0.1
Public sector debt-to-revenue ratio 1/	107.8	103.0	104.0	117.8	126.5			136.8	145.3	154.1	165.0	176.3	188.5
Gross financing need 5/	15.2	14.9	16.9	19.3	20.2			25.1	25.4	26.7	28.4	30.2	32.1
in billions of U.S. dollars	25.1	24.8	31.4	36.9	42.3			55.8	60.3	67.8	76.9	87.3	98.5
Key Macroeconomic and Fiscal Assumptions						10-Year Historical Average	10-Year Standard Deviation						
Real GDP growth (in percent)	4.1	4.0	1.0	1.4	3.8	4.4	2.0	5.0	4.2	4.0	3.9	3.9	3.9
Average nominal interest rate on public debt (in percent) 6/	7.9	6.6	7.5	8.0	7.1	7.9	0.9	6.9	6.6	6.9	7.2	7.6	7.8
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.6	-0.1	3.4	6.8	6.4	3.7	2.9	3.6	3.9	4.3	4.6	4.9	5.3
Nominal appreciation (increase in US dollar value of local currency, in percent)	-11.9	-8.7	6.2	0.4	4.9	-7.0	8.8	-1.8	-0.3	0.0	0.0	0.0	-0.4
Inflation rate (GDP deflator, in percent)	6.4	6.7	4.0	1.2	0.7	13.4	12.8	3.3	2.7	2.6	2.6	2.6	2.6
Growth of real primary spending (deflated by GDP deflator, in percent)	5.4	2.4	5.3	1.4	1.5	2.8	3.7	6.4	3.7	4.1	2.9	3.1	3.4
Primary deficit	0.3	0.9	2.7	3.2	2.8	0.7	1.6	4.0	3.8	3.6	3.6	3.6	3.5
								II. Stress Tests for Public Debt Ratio					
A. Alternative Scenarios													
A1. Key variables are at their historical averages in 2005-09 7/								**53.1**	**53.1**	**53.2**	**53.8**	**54.1**	**54.6**
A2. No policy change (constant primary balance) in 2005-09								**53.1**	**56.6**	**60.4**	**64.9**	**69.5**	**74.5**
A3. Country-specific shock in 2005, with reduction in GDP growth (relative to baseline) of one standard deviation								**53.0**	**57.5**	**61.1**	**65.5**	**69.7**	**74.5**
B. Bound Tests													
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006								**53.0**	**59.0**	**65.4**	**69.6**	**73.8**	**78.5**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**53.0**	**59.9**	**68.7**	**76.2**	**83.6**	**91.6**
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006								**53.0**	**56.5**	**60.4**	**64.6**	**68.7**	**73.4**
B4. Combination of 2-4 using one standard deviation shocks								**53.0**	**57.2**	**61.5**	**65.8**	**69.9**	**74.5**
B5. One time 30 percent real depreciation in 2005 8/								**53.0**	**63.9**	**67.4**	**71.6**	**75.8**	**80.6**
B6. 10 percent of GDP increase in other debt-creating flows in 2005								**53.0**	**66.3**	**69.8**	**74.1**	**78.3**	**83.0**

1/ Gross public debt after consolidation excluding risk weighted stock of outstanding guarantees, based on Polish methodology.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

POLAND: FUND RELATIONS
(As of March 31, 2004)

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	850.16	62.10
Reserve position in Fund	518.85	37.90

III. **SDR Department**

	SDR Million	Percent Allocation
Holdings	36.89	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**

Poland accepted the obligation of Article VIII, Sections 2, 3, and 4 on June 1, 1995. The exchange system is free of restrictions on the making of payments and transfers for current international transactions.

Since April 12, 2000, the zloty has floated freely.

Prior to that, 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 Zl1 equaling old Zl10,000. 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 22 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 zlotys 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 Zl4.08 per US$1. On April 12, 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 June 9, 2003 (EBM/03/54). In concluding the consultation, Directors commended the authorities for achieving price stability and welcomed the government's fiscal reform proposal, but urged the authorities to use the improving cyclical position to embark on a substantial fiscal adjustment and speed up structural reforms.

IX. **Technical Assistance, 1992–2004**

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 supervision, monetary research and analysis	Mission	May 1992	NBP
MAE	Review of progress in the	Mission	Oct. 1992	NBP

	modernization of operational functions			
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 statistics (follow-up)	Mission	November 1993	NBP

STA	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
MAE	Monetary Operations	Mission	July 2001	NBP
FAD	Expenditure restructuring	Mission	December 2001	MoF
MAE	Stress testing	Mission	January 2002	NBP

STA	Data ROSC	Mission	January 2003	CSO/ MoF/ NBP
STA	Government finance Statistics (GFSM 2003)	Mission	October 2003	

X. **Resident Representative**

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

POLAND—WORLD BANK ACTIVITY

1. Poland rejoined the World Bank in 1986 and World Bank lending to Poland started in 1990. Since then the Bank has committed loans totaling US$5.4 billion equivalent. Total loans outstanding and disbursed amount to US$2.5 billion as of April 2003. At present eleven projects are under implementation, with an undisbursed balance of US$360 million. In addition, the World Bank is administering three Global Environmental Facility operations totaling US$33 million in commitments, with US$8.5 million undisbursed.

2. Since 1990, the Bank has financed projects in a variety of areas including in agriculture, coal sector restructuring, enterprise and financial restructuring, environment, energy, forestry development, health, housing, railway sector restructuring, ports, roads, and rural development. These include the Krakow Energy Efficiency project (US$15 million, also co-financed by the Global Environmental Facility (GEF)), which aims at improving energy efficiency of the city's district heating systems and end-users; a Railway Restructuring loan (US$110 million), which is financing restructuring of the Polish State Railways' (PKP) to increase efficiency, improve finances, and privatize selected activities within a sound regulatory framework; a Rural Development Project (US$120 million), which has the objective of rural restructuring and employment creations through promotion of non-farm rural activities, strengthening of local governments and other institutions, financing infrastructure investments, and improving rural education; and the Szczecin-Swinoujscie Seaway and Port Modernization Project (US$38.5 million), which aims to promote Poland's trade by developing an efficient administrative/managerial structure and improving physical facilities. Other ongoing projects being financed by the World Bank are for rural environmental protection, flood management, roads, Gdynia and Gdansk ports, power transmission, water supply and development of geothermal resources. More recent loans include the Hard Coal Social Mitigation Loan (US$200 million), which aims at supporting the government’s Coal Reform Program (2003–06), specifically by mitigating the negative effects associated with the further reduction of employment levels (a companion Coal Mine Closure Loan is scheduled for Board approval at the end of June 2004 and should provide between US$80–100 million for supporting closure of uneconomic production capacity in a safe and environmentally sound manner); and a EUR 100 million loan for Rehabilitation and Maintenance of Roads. Smaller institutional development grants are currently financing activities to strengthen the processes of land administration and registration and to strengthen budget management.

3. The World Bank in consultation with the Polish government prepared in 2002 a Country Assistance Strategy (CAS) with three focuses; promoting a rebalancing of macroeconomic policies through fiscal reform, assisting the Government to strengthen the effectiveness of public expenditures and programs, and enhancing private sector-led growth and employment creation. The Bank’s Executive Directors discussed the Country Assistance Strategy in December 2002. As indicated in the CAS, total lending in 2003–05 could total as much as US$1.4 billion. Areas for potential lending during this time include support for road infrastructure, coal sector restructuring, rural development, health sector reform, and education sector reform.

4. In addition to its lending program, over the years of its involvement in Poland the Bank has prepared a series of economic and sector work reports and policy notes that provide advice on various poverty-related, institutional and structural reform issues. A Public Expenditure and Institutional Review has been prepared with the Government in January 2003. Most recently, World Bank staff prepared with Government and non-Government counterpart teams a Living Standards Assessment to help measure the status of poverty reduction in Poland and advise on policy programs to achieve this objective, an Anticorruption Update, an Investment Climate Assessment, and a Knowledge Economy Assessment. Other work which has been completed in the past couple of years includes a development policy assessment (2001), health and social sector reviews and policy notes (1999–2001), a labor market review (2001); rural land, labor and capital markets (2001), and a study on trade and foreign direct investment (2000). In 2000, a Financial Sector Assessment on the Poland financial system was carried out under the joint IMF/World Bank Financial Sector Assessment Program.

POLAND—STATISTICAL ISSUES

1. Poland has a comprehensive macroeconomic database that has been improving in recent years. 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 table on core statistical indicators). Consistent with its commitment to providing a comprehensive set of high quality data, in an open manner, Poland subscribes to the IMF's Special Data Dissemination Standard (SDDS), and its metadata are posted on the Fund's Dissemination Standards Bulletin Board.

Real sector statistics

2. The Central Statistical Office (GUS) compiles 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 these data.

3. The national accounts follow the concepts and definitions of the *European System of Accounts 1995 (ESA 95)*, which is based on the *System of National Accounts 1993 (SNA 1993)*. The GUS compiles annual and quarterly GDP estimates by production and expenditure approach in current and constant prices, a full sequence of accounts by institutional sectors, supply and use tables, input/output tables, annual financial accounts and regional accounts. The statistical techniques are basically sound. The constant price estimates are compiled in average prices of the previous year, using deflation techniques that generally follow international standards. However, national accounts data still have some problems—the subannual data are collected on a cumulative rather than on a discrete basis, and plans to introduce proper benchmarking and chain-linking techniques have been delayed.

4. The concepts and definitions of the CPI follows the *ESA 95* standards and Eurostat's requirements for the Harmonized Consumer Price Index. Polish CPI does not cover the shelter prices faced by household owner-occupants. The weights for the index are obtained from the average annual expenditures primarily taken from the national Household Budget Survey (HBS) of the previous calendar year, and are updated annually. From 1999 onwards, the national classification is based on the Classification of Individual Consumption by Purpose (COICOP). The scope of the index covers all resident households, except those in some rural areas. Historical series are constructed using a chain method. Time series data are available for the index with reference periods of 1990 and 1998.

5. The producer price index (PPI) is based on the *1993 SNA* concepts and definitions for recording and valuation of product prices and weights. Its scope includes mining and quarrying, manufacturing and electricity, gas and water supply. Output price indices are also calculated for agriculture, construction, and business services such as transport, storage, and communication. Since 2000, the index is classified by the Polish Classification of Activities

based on the General Industrial Classification of Economic Activities within the European Communities, first revision (NACE, Rev.1), the Classification of Products by Activity, and the List of Products of the European Communities. The PPI does not include any estimation for missing prices and quality and seasonal adjustments.

Government finance statistics

6. The authorities provide detailed state budget data to the Fund every month. In addition, government finance statistics are 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.

7. The annual consolidated general, central and local 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

8. The National Bank of Poland (NBP) reports analytically useful data on a regular and timely basis to the Fund with minimal delay. High-frequency data (every ten days) on the central bank balance sheet and the monetary survey are also available with minimal delay. As a member of the European Union, Poland is in the process of adopting the recommendations of the European Central Bank (ECB) in the compilation of its monetary statistics. The monetary statistics from March 2002 are generally consistent with the ECB framework. The authorities have also revised the historical data to December 1996.

9. The data module of the Report on the Observance of Standards and Codes (ROSC) mission that visited Warsaw in January 2003 found that the concepts and definitions used by the NBP to compile monetary statistics were in broad conformity with the guidelines outlined in the *Monetary and Financial Statistics Manual*. Nevertheless, the following concepts and principles underlying valuation and classification of financial instruments deviate from the *MFSM*: (1) financial derivatives are indistinguishably recorded under other assets/other liabilities; (2) accrued interest on loans and deposits are included as part of other assets/other liabilities, but not with the respective underlying instruments; similarly accrued interest on securities other than shares issued by the depository corporations are included as part of other liabilities; (3) loan-loss provisions are classified as *special reserves* under *capital accounts and reserves*; and (4) valuation of shares and other equity on the asset side of the balance sheets of the NBP and other depository corporations are not in market prices. Notwithstanding the first three practices noted above differ from the *MFSM* guidelines, they are in conformity with the ECB framework.

10. The data presented on the balance sheets of the NBP and other depository corporations provide insufficient breakdown of the claims on, and liabilities to, the government and other resident sectors. It is impossible to derive net claims on general government or central government on a consistent basis from the published data. Similarly,

interbank positions between the NBP and other depository corporations cannot be identified. There are material differences between government finance statistics financing data and the corresponding monetary data. The data module ROSC mission recommended that the NBP, in cooperation with the Ministry of Finance, reconcile monetary and government finance statistics and carry out the reconciliation exercise on a regular basis.

External sector statistics

11. Some improvements have been made in the balance of payments data. Payments from the kantor market are reported separately, but are allocated into current account components. The NBP compiles the balance of payments on transaction basis with monthly and quarterly frequency, including trade in goods. The trade data are fully consistent with the national accounts data prepared by GUS. Despite these improvements, some additional issues need to be addressed. The NBP now reports net foreign assets (NFA) rather than the net international reserves (NIR) previously shown in the monetary survey. 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.

12. The 2003 data module ROSC mission recommended that Poland move to a transaction-based monthly balance of payments, include interest on an accrued basis, make explicit the legal requirement that the NBP disseminate balance of payments statistics, separate insurance from transportation when making the c.i.f./f.o.b. adjustment, publish on a regular basis a reconciliation table between international merchandise trade statistics and "goods" in the balance of payments, and undertake periodic revision studies. Since 2004, the transaction-based balance of payments is compiled and published monthly (though the interest payments remain on a cash basis), and the reconciliation between the international merchandise trade statistics and goods in the balance of payments is published quarterly.

Poland: Core Statistical Indicators
As of June 3, 2004

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Central Government Balance	GDP	Public External Debt/ Debt Service
Date of Latest Observation	4-May	March	March	March	March	4-May	April	March	March	March	2003, Q4	February
Date Received	4-May	10-April	10-April	10-April	10-April	4-May	June	31-May	31-May	28-April	7-March	15-April
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Bi-monthly	Quarterly	Quarterly
Source of Update	Bloomberg	NBP	NBP	NBP	NBP	Bloomberg	GUS	NBP	NBP	MOF	GUS	MOF
Mode of Reporting	On-line	Internet	Internet	Internet	Internet	On-line	On-line	Internet	Internet	Email/ fax	Email	Internet
Confidentiality	None	None	None	None	None	None	None	None	None	None	None	None
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly	Monthly

INTERNATIONAL MONETARY FUND

REPUBLIC OF POLAND

Staff Report for the 2004 Article IV Consultation
Supplementary Information

Prepared by the Staff Representatives for the 2004 Consultation
with the Republic of Poland

Approved by Michael Deppler and Liam P. Ebrill

July 8, 2004

1. This supplement reviews developments in Poland since the preparation of the staff report for the 2004 Article IV consultations and provides a staff comment.

I. Recent Economic and Political Developments

2. **The recovery continues to be strong, while inflation has risen faster than expected.** Real GDP growth reached 6.9 percent year-on-year (2.8 percent quarter-on-quarter seasonally adjusted) in the first quarter of 2004, substantially faster than the 4.7 percent year-on-year (1.2 percent quarter-on-quarter) growth in Q4 2003. Most of the pick-up in growth was attributable to a rapid inventory accumulation, though fixed investment growth also rose. The current account deficit rose in the first quarter of 2004, but, owing to a strong pick-up in service exports, was less than staff expected. CPI inflation increased in May to 3.4 percent (year-on-year) mainly due to food and oil price increases. Nevertheless, inflation expectations are steady at about 2½ percent (year-on-year) and nominal wage growth fell to 4.4 percent (year-on-year) in May. Retail sales, export, import and industrial sales remained robust through May. Employment growth, however, is still weak.

3. **Prime Minister Belka's government was approved by Parliament in a second round confidence vote in June.** The economic team, including Deputy Prime Minister Hausner, of the previous government remains in place. To secure the support of the new social democratic party (SDPL), the ruling coalition had to agree to a no-confidence vote in October which could lead to early elections in late 2004 or early 2005. Mainstream opposition parties strengthened their positions and the support for populist parties diminished in the European elections.

II. Economic Outlook

4. **Recent data releases support the projections in the staff report of a reasonably strong recovery with a modest current account deficit; inflation in the near term, however, is likely to be higher than projected.**

- Staff have revised GDP growth projections for 2004 slightly upward, from 5 to 5.3 percent, reflecting expectations of somewhat stronger investment growth and a smaller negative contribution from net exports than in the staff report.

- The relatively small upward revision, despite a far stronger than expected outcome in the first quarter, reflects the staff's assumption that some pick-up in final domestic demand over the balance of the year will be largely met by drawing down the large inventory accumulation in the first quarter.

- In spite of the stronger-than-expected current account outcome in the first quarter, the staff's projection for the year remains unchanged because higher oil and commodity price projections suggest a smaller terms of trade gain than previously expected.

- Reflecting a stronger-than-expected pick-up in food prices, staff has increased its projection for the average inflation rate in 2004 from 2.9 to 3.5 percent.

III. Fiscal Policy

5. **The fiscal outlook for 2004 has improved somewhat.** With stronger growth and higher tax revenue so far this year than previously expected, staff projects the general government deficit at 7 percent of GDP, down from 7.2 percent indicated in the staff report. Assuming the appreciation of the zloty since mid-May holds, public debt should remain below 55 percent of GDP by year-end.

6. **The new government has committed itself to the implementation of the key elements of the Hausner plan.** Although a number of social benefit reform measures in the Hausner plan have been abandoned, staff estimates of annual savings in 2005–07 fall by only 0.1 percent of GDP.

IV. Monetary Policy

7. **The MPC increased the policy rate by 50 basis points on June 30 and maintained a restrictive bias.** As analysts expected a 25 basis point-increase, the MPC's decision surprised the market. In its statement, the MPC pointed to strengthening domestic demand and the increase in inflation expectations that had taken place already before the high CPI inflation for May was released as the main inflation risk factors.

V. Staff Appraisal

8. **The resolution, at least for now, of recent political uncertainties and the new government's commitment to renew the effort to implement the Hausner plan are welcome.** The government should seize this opportunity to press the fiscal reform agenda vigorously. Early statements provide some hope that the government will attempt to do so. While part of the Hausner plan appears to have been abandoned, what remains is still a critical mass that should be implemented in time for the 2005 budget. This will be a critical

test of the government's will to arrest the damaging fiscal deterioration of the past few years and reposition the government's role in the economy.

9. **The increase in the policy rate in June signaled concerns about the impact of rising prices on inflation expectations and future wage demands.** The recent jump in inflation—due to one-off factors, which now seem to be stronger than previously expected by staff and market participants—combined with an expansionary budget and a strong rebound in economic activity made a case for a policy response. Going forward, it will be important to ensure that the policy response to supply side influences remains measured. In its future decisions, therefore, the MPC should take into account that—as long as inflation expectations continue to be contained and nominal wage demands do not accelerate—inflation should revert toward the middle of the target range when temporary shocks dissipate in 2005. While the output gap seems to be closing faster than staff previously expected, the modest nominal wage increase so far suggests that high unemployment continues to impose wage discipline. Nonetheless, nominal wage developments and changes in inflationary expectations will have to be closely monitored in the coming period. Setting, early on, a nominal wage growth target in the budget that is in line with longer-term inflation trends would help with anchoring expectations at this stage.

Table 1. Poland: Selected Economic Indicators, 1999-2004 1/
(In percent, except where indicated)

	1999	2000	2001	2002	2003	2004 Proj.
Activity and prices (growth rates)						
GDP	4.1	4.0	1.0	1.4	3.8	5.3
Domestic demand	4.8	2.8	-1.6	0.8	2.4	5.5
Private consumption growth	5.2	2.8	2.1	3.3	3.1	5.1
Public consumption growth	2.1	1.6	0.6	0.6	0.4	3.5
Domestic fixed investment growth	6.8	2.7	-8.8	-5.8	-0.9	7.7
Net external demand (contribution to growth)	-0.9	0.6	2.6	0.5	1.3	-0.4
CPI inflation						
Average	7.3	10.1	5.5	1.9	0.8	3.5
End of period	9.8	8.5	3.6	0.8	1.7	4.5
Unemployment Rate (registered, end year)	13.1	15.1	19.4	20.0	20.0	19.4
Gross Domestic Saving (ratio to GDP) 2/	17.3	18.7	17.9	16.2	16.8	17.1
Gross Domestic Investment (ratio to GDP)	24.9	24.7	20.7	18.9	18.7	19.4
Public Finances (percent of GDP)						
State Government Revenues	19.3	18.8	18.4	18.4	18.7	...
State Government Expenditures 3/	21.2	20.9	22.7	23.4	23.2	...
State Government Balance 3/	-1.9	-2.1	-4.3	-5.0	-4.5	...
General Government Revenues	38.9	37.5	38.2	38.3	39.6	39.3
General Government Expenditures	42.0	40.4	43.6	44.6	45.3	46.4
General Government Balance	-3.0	-3.0	-5.3	-6.3	-5.8	-7.0
General Government Net Borrowing (ESA95) 4/	-1.5	-1.8	-3.5	-4.0	-3.9	-4.9
General Government Net Borrowing (ESA95) 5/	-2.0	-3.3	-5.0	-5.9	-5.5	-6.4
General Government Debt 6/	41.9	38.7	39.7	45.1	50.1	53.0
Public debt 7/	43.2	40.0	41.0	46.7	51.6	54.2
Money and credit						
Private Credit (12-month change)	29.1	17.3	9.2	5.0	7.9	. . .
Broad Money (12-month change)	20.1	11.9	9.2	-2.0	5.6	. . .
Money market rate (eop)	17.9	19.2	11.7	6.7	5.5	. . .
13-week t-bill rate (eop)	16.4	16.8	11.2	6.1	5.3	. . .
Balance of Payments						
Current account balance (transactions, in mill.$US)	-12,487	-9,998	-5,357	-5,007	-4,085	-5,226
percent of GDP	-7.6	-6.0	-2.9	-2.6	-1.9	-2.3
C/A balance plus FDI, percent of GDP	-3.2	-0.4	0.2	-0.5	-0.1	-0.4
Exports (millions U.S. dollars)	30,060	35,902	41,664	46,742	61,007	73,710
Export volume growth	2.0	25.3	11.8	8.3	14.1	10.0
Imports (millions U.S. dollars)	45,132	48,210	49,324	53,991	66,732	80,902
Import volume growth	4.4	10.8	3.2	7.3	4.9	10.7
Terms of trade (index 1995=100)	90.5	88.1	97.4	100.1	103.5	103.8
Official reserves (millions U.S. dollars)	27,314	27,466	26,564	29,794	33,975	34,463
months of imports	7.3	6.8	6.5	6.6	6.1	5.1
Total external debt (percent of GDP)	39.7	41.7	38.7	44.3	49.6	48.6
Ratio of short term debt to gross reserves	41.1	34.8	41.7	46.7	55.6	55.2
Fund Relations (January 31, 2004)						
Fund holding of currency (in percent of quota)				60.7		
Holding of SDRs (in percent of allocation)				n/a		
Quota (SDR million)				1369		
Exchange rate						
Exchange rate regime			Floating			
Present exchange rate (March 4, 2004)			zl 4.0 = US$1			
Zloty per US$, period average	4.0	4.3	4.1	4.1	3.9	. . .
Zloty per Euro, period average	4.2	4.0	3.7	3.9	4.4	. . .
Real effective exchange rate (INS, CPI based)	112.0	121.2	137.7	133.3	120.0	. . .
percent change	-4.1	8.2	13.7	-3.2	-10.0	. . .

Sources: Polish authorities; and staff estimates.
1/ GDP series for 2000-2002 are based on the authorities' new methodology introduced in late 2002. GDP series prior to 2000 are staff estimates of the new methodology, using growth rates from the old methodology. This applies to all tables and figures of the staff report.
2/ Derived as a difference between total savings and current account.
3/ Including the full amount of transfers to social security fund.
4/ With second pillar pension funds part of general government.
5/ With second pillar pension funds outside general government.
6/ Public debt after consolidation excluding risk weighted stock of outstanding guarantees based on Polish methodology.
7/ Including risk weighted stock of outstanding guarantees.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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Washington, D. C. 20431 USA

IMF Concludes 2004 Article IV Consultation with the Republic of Poland

On July 12, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Poland.[1]

Background

Since mid-2002 a recovery has taken shape, but it is not yet fully entrenched.
With strong exports and robust consumption, GDP growth picked up gradually, reaching 6.9 percent (year-on-year) in the first quarter of 2004. Nevertheless, investment growth remains moderate. Although the fiscal stance in 2003 was slightly restrictive, a considerable easing of monetary conditions since 2001 supported the recovery: policy rates were massively reduced between early 2001 and mid-2003, while falling interest differentials and unsettled politics contributed to a 20 percent real effective depreciation of the zloty in the past two years. With strong gains in the service sector, employment has grown modestly in the past year, for the first time since 1997. This, combined with accelerating wages and rising social transfers, kept consumption growth robust.

Slack in the economy is diminishing but without signs yet of excessive demand pressure. The output gap narrowed slightly in 2003, but at over 2 percent of potential GDP, was still sizable. The unemployment rate of 20 percent is well above the estimated structural rate of 15 percent. Falling unit labor costs and, in turn, strong increases in profit margins have been key to containing current account and inflation pressures

[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.

during the upswing. The strong increase in corporate savings, while investment fell, pushed the current account deficit down to 2 percent of GDP in 2003; and in the absence of domestic cost push and with an unusually small pass-through of the zloty depreciation by profit-rich firms, net inflation (excluding food and fuel) was steady at 1-1½ percent. A rise in headline inflation to 3.4 percent in May (still within National Bank of Poland's 2½ percent ±1 percent target) was mostly due to food and oil price increases.

Financial markets have been unsettled. Despite low inflation, long-term interest rates have risen since mid-2003, initially in response to the announcement of an expansionary 2004 budget and more recently to unsettled politics. Unlike in most other new EU countries, the domestic spread over the 10-year euro yield has more than doubled since mid-2003. Pointing to weak political and fiscal fundamentals, S&P and Fitch downgraded Poland's domestic debt and the outlook on its foreign debt in the past year.

The weak responses of investment and employment raise concerns about fundamental impediments to the recovery. Uncertainties about the recovery in western Europe likely play a role. But investment and employment growth remain substantially weaker than in other central European countries facing the same markets. And while excess capacity may still be a factor in some sectors, it seems likely that policy weaknesses during the past several years are influencing investor confidence and employment trends.

A weak fiscal situation inherited from the 1990s has been allowed to drift. Repeated fiscal reform efforts have failed in the face of vested interests and fractious politics, and social expenditure remained excessive and poorly targeted. An increase in unemployment owing to the cycle and enterprise restructuring was aggravated by policy-induced disincentives in the labor market. With considerable rigidities in labor market and poorly targeted social transfers, the economic slowdown worsened poverty. Lax fiscal policy left the burden of responding to a large current account deficit and rising inflation in the late-1990s to monetary policy. Excessive tightening and a simultaneous large real appreciation (more than 25 percent during mid-1999–mid-2001) produced a sharp, though short-lived, diminution in price competitiveness.
This contributed to a deep decline in investment in 2001–02 and, as it was most severe in labor-intensive industries, to massive lay-offs.

Privatization slowed sharply in the past years. Several major companies slated for privatization in 2001 have still not been sold. Slowing privatization, and stronger competition from neighboring countries led to a decline in foreign direct investment (FDI). The recently adopted Economic Freedom Act was an important first step to improve the investment climate.

Executive Board Assessment

Executive Directors welcomed Poland's accession to the European Union on May 1, 2004, which sets the stage for faster economic growth and income convergence based on stronger policy coordination with Europe. They noted that the Polish economic conjuncture is favorable, with a strong cyclical recovery alongside a small current account deficit and low underlying inflation. Improved overall competitiveness underpinned by modest wage growth and a large depreciation of the zloty have supported the recovery. The near-term economic outlook is also positive, with the prospect of strong growth in exports and output being supported by an improved external environment, strong profitability of enterprises, and domestic fiscal stimulus.

At the same time, Directors noted that the response of employment and investment to the pickup in activity has thus far been modest and that unemployment and public debt remain high. Furthermore, Poland remains vulnerable to policy slippages stemming from political uncertainty and a lack of consensus for adjustment and reform, factors that have deterred private investment by weakening market confidence and increasing the cost of financing.

Against this background, Directors urged the Polish authorities to seize the opportunity provided by the current favorable conditions to implement ambitious fiscal and structural reforms. A durable recovery will require a sustained increase in investment and fiscal consolidation consistent with the provisions of the Stability and Growth Pact. In addition, tackling deep-rooted structural weaknesses will require building a political consensus for reform. Decisive actions in these areas will help secure a balanced and lasting recovery into the medium term, and demonstrate that the authorities are embarked on a clear agenda of policies to reap the full benefits of EU membership and to move ahead with the adoption of the euro.

Directors expressed concern about the steady worsening of the fiscal position during the past several years and the attendant threat to keeping the debt-to-GDP ratio within the constitutional limit. Although pension reform has mitigated an important part of potential difficulties related to population aging, costs will still be significant, particularly in the health care sector; this strengthens the case for timely fiscal consolidation. Directors were therefore disappointed that the 2004 budget introduced an undesirable fiscal stimulus and is likely to further increase the debt ratio. While welcoming the initiatives that have been taken to reduce the corporate income tax rate and co-finance the sizable increase in EU funds, Directors regretted that the opportunity to reprioritize budget spending to make such policies sustainable was missed. They therefore urged that, at a minimum, any windfall revenues from higher-than-predicted growth in 2004 be saved and used to lower the government debt.

Directors welcomed the Hausner plan for fiscal reform and felt that its full implementation would be a major step in the process of medium-term fiscal consolidation. They agreed that its key reforms—aimed at streamlining social transfers, restructuring state-owned enterprises, and broadening the tax base—would target Poland’s most acute fiscal excesses. Directors urged that the 2005 budget reflect full implementation of the plan. They also encouraged the authorities to begin consideration of measures beyond the Hausner plan, which will be necessary to stabilize the debt ratio, minimize the vulnerability of public finances to shifts in market sentiment, and support the recovery in private investment. Such measures should focus on further streamlining social benefits and public administration and reducing mandated public spending, while also improving revenue administration.

Directors agreed with the view that the authorities' inflation targeting framework has served the country well. In the immediate future, headline inflation will remain at elevated levels owing to one-off influences. Directors stressed that the new Monetary Policy Council (MPC) should continue to ensure that these influences do not feed into expectations and become entrenched in an inflationary process, and they welcomed, in this context, its cautious approach—whereby the MPC first shifted to a tightening bias and subsequently raised interest rates as the risk of one-off factors influencing expectations increased. Looking ahead, Directors considered that the still sizeable amount of slack in the economy will help inflation revert toward the middle of the target range as temporary shocks dissipate in 2005.

Directors underscored the importance of fiscal and structural reform for monetary policy. They felt that decisive measures to ensure a strong supply-side response to rising demand will be the best insurance against pressure on interest rates through the recovery. Directors also agreed that an improved policy mix—with tighter fiscal policy avoiding the need for monetary tightening as the recovery proceeds—should provide maximum protection for Poland's currently strong external competitiveness.

Directors agreed that a flexible exchange rate continues to serve Poland well, both as a shock-absorber and as assurance that the zloty is well-aligned upon Poland's entry into ERM2. They commended the MPC for signaling its support for continuing a policy of non-intervention in the foreign exchange market. Directors noted Poland's comfortable reserve cushion, which they considered a strength for attracting and maintaining the confidence of international capital markets. They cautioned that any decisions about the optimal level of central bank reserves should take into account both the role played by this cushion and needs associated with prospective participation in ERM2.

Directors noted that the banking system had adjusted well to the slowdown in activity in 2001–02 and the depreciation of the zloty. They welcomed the slowdown since late 2003 of the previously rapid growth in foreign exchange-denominated credit. Going forward, Directors urged the authorities to continue to monitor the health of the banking system closely, as credit growth to the private sector, and households in particular, is likely to remain strong. Directors noted that the new loan classification system adopted in January 2004 moves practices in Poland closer to those in other countries in the region. Although Directors were reassured that the changes to the system would not ease oversight unduly or free provisions excessively, the authorities should be ready to act if developments during the next few months created any room for doubt.

Directors urged the new government to give high priority to reinvigorating economic restructuring and reducing the size of the public sector. They cautioned that inefficient state enterprises could impede Poland's competitiveness, and called on the authorities to speed up privatization and divestment of the government's minority shareholdings in privatized enterprises. They welcomed the recent adoption by Parliament of the Economic Freedom Act aimed at reducing red tape and simplifying procedures for setting up new enterprises. Directors noted that Poland's structural unemployment problem is attributable in part to the shifts in the industrial structure in response to changes in competitiveness. In this context, they emphasized the importance of pursuing labor market reforms, measures to reduce skill mismatches, and changes to social benefits in order to increase incentives to work and lower structural unemployment.

Poland's statistical database is adequate for surveillance. Directors noted the progress in improving fiscal transparency, and encouraged the authorities to further reduce budget fragmentation and emphasized the importance of transparent recapitalization of loss making state-owned enterprises.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The Staff Report for the 2004 Article IV Consultation with Poland is also available.

POLAND: MAIN ECONOMIC INDICATORS

	1999	2000	2001	2002	2003
Real economy (change in percent)					
Real GDP	4.1	4.0	1.0	1.4	3.8
Real domestic demand	4.8	2.8	-1.6	0.8	2.4
CPI (end-year)	9.8	8.5	3.6	0.8	1.7
Unemployment rate (in percent)	13.1	15.1	19.4	20.0	20.0
Gross domestic saving (percent of GDP) 1/	17.3	18.7	17.9	16.2	16.8
Gross domestic investment (percent of GDP)	24.9	24.7	20.7	18.9	18.7
Public finance (in percent of GDP)					
General government balance (commitment)	-3.0	-3.0	-5.3	-6.3	-5.8
Public debt 2/	43.2	40.0	41.0	46.7	51.6
Money and credit (end of period, percent change)					
Private credit (12-month change)	29.1	17.3	9.2	5.0	7.9
Broad money (12-month change)	20.1	11.9	9.2	-2.0	5.6
Money market rate (end of period, in percent)	17.9	19.2	11.7	6.7	5.5
Balance of payments in convertible currencies					
Trade balance (in percent of GDP)	-9.2	-7.4	-4.1	-3.8	-2.7
Current account (in percent of GDP)	-7.6	-6.0	-2.9	-2.6	-1.9
Official reserves (in billions of U.S. dollars)	27.3	27.5	26.6	29.8	34.0
Reserve cover (months of merchandise imports)	7.3	6.8	6.5	6.6	6.1
Total external debt (percent of GDP)	39.7	41.7	38.7	44.3	49.6
Fund position (in millions of SDRs)					
Quota					1,369.0
Fund holdings of currency (May 31, 2004)					850.15
Holdings of SDRs (May 31, 2004)					40.77
Exchange rate					
Exchange rate regime			Floating Rate		
Present rate			Zl 3,6590 per US$1 (July 7, 2004)		
Zloty per U.S. dollar (period average, in percent)	4.0	4.3	4.1	4.1	3.9
Appreciation (+) of real effective exchange rate (relative CPIs, in percent)	-4.1	8.2	13.7	-3.2	-10.0

Sources: Central Statistical Office; data provided by the authorities; and IMF staff estimates.
1/ Derived as a difference between total savings and current account.
2/ Including risk weighted stock of outstanding guarantees.