July 2005
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Republic of Poland: 2005 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Poland

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 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 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on April 28, 2005, with the officials of the Republic of Poland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 30, 2005. 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 20, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 22, 2005 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for the Republic of Poland.

The document listed below has been or will be separately released.

Selected Issues Paper

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

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INTERNATIONAL MONETARY FUND

REPUBLIC OF POLAND

Staff Report for the 2005 Article IV Consultation

Prepared by the Staff Representatives for the 2005 Consultation
with the Republic of Poland

Approved by Michael Deppler and Ambroise Fayolle

June 30, 2005

- Article IV consultation discussions were held in Warsaw during April 14–28, 2005. The mission met the Prime Minister, Minister of Finance, President of the National Bank of Poland (NBP), Minister of Treasury, members of the Monetary Policy Council (MPC), leaders and advisors to the largest opposition parties, and other senior officials.

- The staff team comprised Ms. Schadler (Head), Ms. Choueiri, Ms. Murgasova, and Mr. Székely (all EUR). Mr. Raczko (Alternate Executive Director), Mr. Piątkowski (Advisor to the Executive Director), Mr. Rosenberg and Mr. Sierhej (both Regional Resident Representative's office) participated in some of the discussions.

- The last consultation was concluded on July 12, 2004 (http://www.imf.org/external/pubs/ft/scr/2004/cr04217.pdf).

- Poland's statistical base is adequate for surveillance, but the quality and timeliness of quarterly national accounts and the general government accounts need improvement.

- Poland has accepted the obligations of Article VIII and maintains an exchange rate system free of restrictions. In accordance with UN Security Council resolutions, Poland maintains restrictions on and imposes sanctions against individuals, groups, and organizations associated with terrorism.

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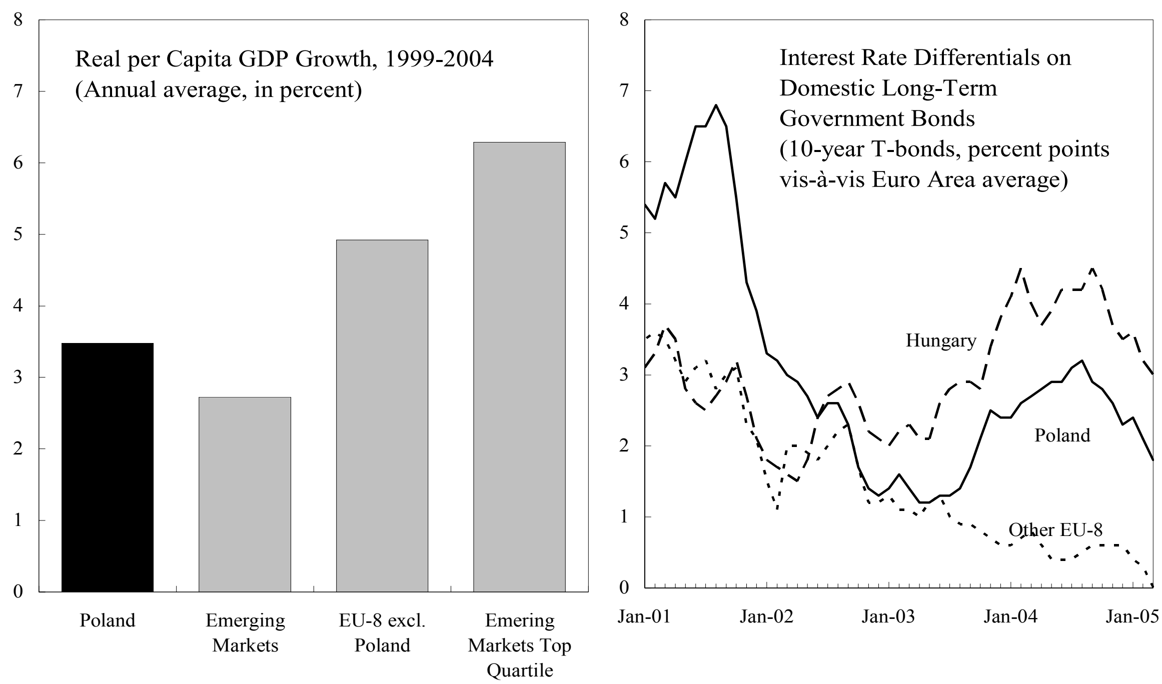
I. INTRODUCTION

1. **In its first year in the European Union, Poland has shown its mettle.** Export growth remained buoyant and FDI picked up sharply—rendering a solid external position stronger. Policymakers successfully coped with accession-related price and demand shocks. And international financial markets, helped by ample global liquidity, reacted positively: market access improved; spreads on external debt narrowed, and the zloty appreciated. Looking ahead, the prospect of euro adoption promises to provide an anchor for economic policies. The convergence plan should make macroeconomic policies more forward-looking and strengthen the medium-term orientation of fiscal policy. Access to structural funds and agricultural subsidies should enhance growth potential and reduce large regional differences by upgrading infrastructure and modernizing agriculture.

2. **Nevertheless, overall economic performance remains disappointing relative to the promise of the early transition years and the most dynamic emerging markets.** Economic growth has slowed significantly since the Russia crisis, employment has fallen, and, under the burden of rising fiscal deficits, public debt has increased sharply. Thus, despite low inflation, the local currency risk premium on the zloty is higher than on most other EU8 currencies (Text Figure 1). This, together with a falling investment ratio and employment rate over the period, suggest investor concerns about policies and structural impediments to growth

Text Figure 1. Poland and Other Emerging Market Economies



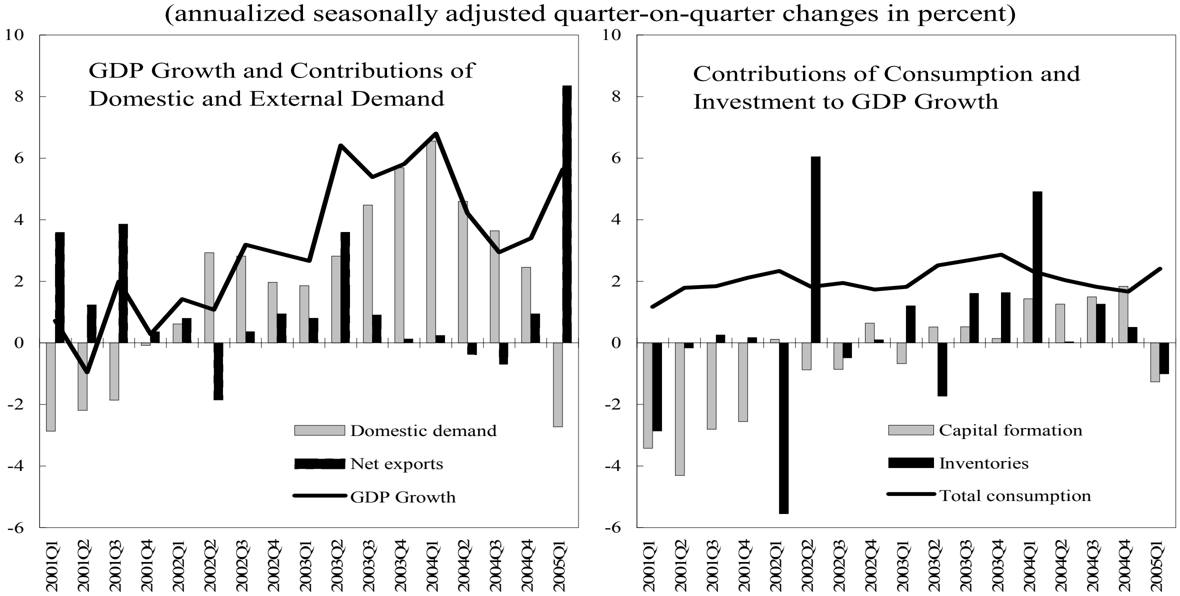
Sources: JP Morgan; Bloomberg; and Eurostat.
Note: EU-8 countries are the new Central and Eastern European EU members.

3. **Fragmented politics have been largely responsible for repeated failures of reform efforts and market uncertainties.** The disintegration of the senior party in the ruling minority coalition has continued since the resignation of the Miller government in May 2004. Prime Minister Belka, who then formed a government to bridge to general elections due by fall 2005, submitted his resignation in May to prompt early elections. But President Kwaśniewski rejected the resignation, opting for elections in September. Polls put two center-right parties—which plan to form a coalition and have broadly pro-reform, though not fully convergent, economic policy agendas—in the lead, but are unclear on whether they will secure a majority. Populist parties with significant support generally oppose public finance reforms and euro adoption. The mission held discussions with leaders and economic advisors of the leading opposition parties.

II. Background

4. **A surge in growth in the run-up to EU accession dissipated in the second half of 2004.**[1] One factor behind this profile was a bunching of inventory accumulation prior to tax and regulatory changes accompanying accession in May (Text Figure 2). Nevertheless, and despite the fact that annual growth reached almost 5½ percent, the sharp deceleration of GDP in the second half of the year dampened hopes of pushing growth potential up to 5 percent in the ongoing recovery (Table 1). Both domestic and external demand contributed to the slowdown. Whereas consumption and inventory accumulation had supported output growth

Text Figure 2. Poland: GDP Growth and Its Composition, 2001-05
(annualized seasonally adjusted quarter-on-quarter changes in percent)



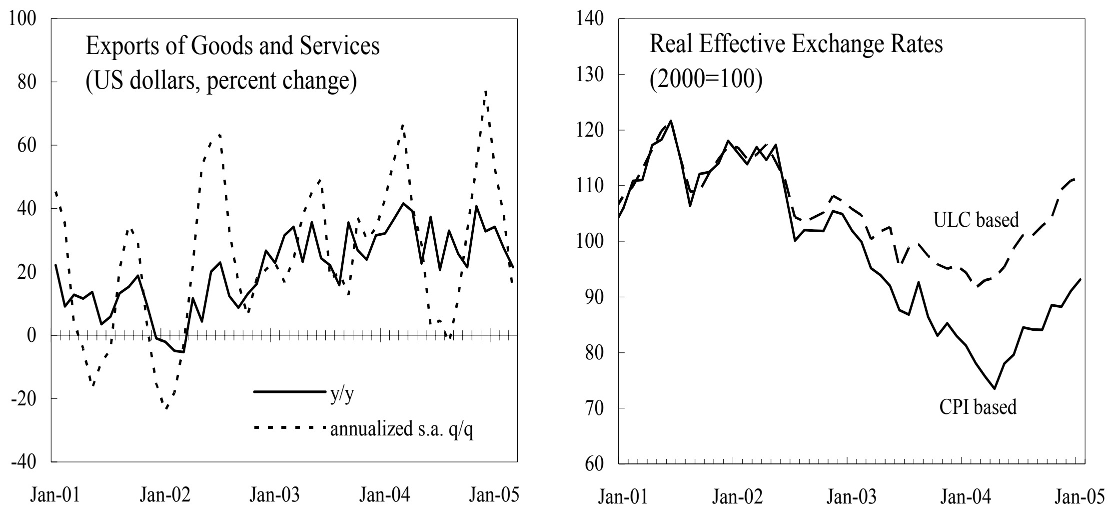
Source: Polish Central Statistical Office.

[1] Weaknesses in quarterly national accounts data hinder analysis of within-year developments.

as the contribution of net exports diminished, by mid-2004 these sources of demand growth also slackened. Preliminary data for the first quarter of 2005 show falling domestic demand—mostly owing to drops in inventory accumulation and highly import-intensive investment—but with some rebound in output growth as net exports recovered sharply.

5. **Even as the contribution of net external demand fell in 2004, exports had remained strong.** Export growth, which led the recovery, hit a soft spot in mid-2004, but by end-year had rebounded to rates of about 40 percent (quarter-on-quarter annualized) (Text Figure 3). This pick-up was particularly impressive in view of slackening demand in Western Europe and the appreciation of the zloty during the second half of the year. Exporters appeared strongly motivated to price to market, especially as domestic demand softened.

Text Figure 3. Poland: Export Growth and Real Effective Exchange Rates, 2001-05

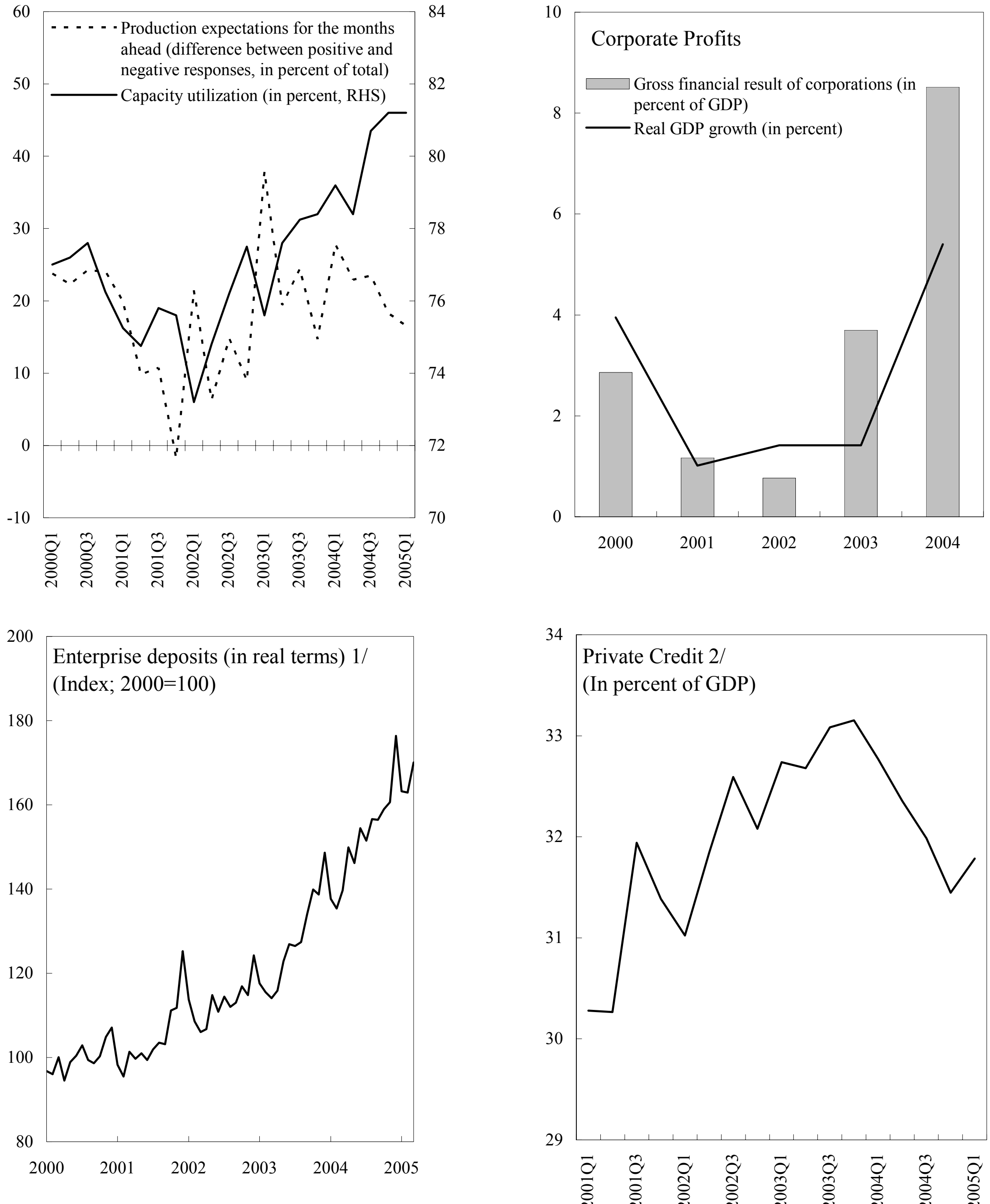


Sources: Polish authorities; IMF Information Notice System; and IMF staff calculations.

6. **Private fixed investment has lagged the cycle, indicating that potential investors remained cautious**. Staff analysis (see Selected Issues) shows that corporate fixed investment growth has been significantly lower than model-based projections since 2000. This is corroborated by a rather steady increase of capacity utilization since early-2002 to historical highs by early 2005 (Figure 1). Thus, strong corporate profitability since 2002 translated mostly into an accumulation of financial assets, while bank credit to the corporate sector fell—indicating a considerable unrealized capacity to invest (Table 2). A slow recovery of fixed investment during 2004 lost pace in early 2005.

7. **The recovery has started to produce jobs, but the employment rate remains low owing to structural rigidities and demographic changes**. The Russia crisis and the large appreciation of the zloty in 2001 created two waves of job destruction just as a baby-boom generation entered the labor market. Job creation was stymied by supply side problems—

Figure 1. Poland: Factors Influencing Corporate Investment, 2000-05

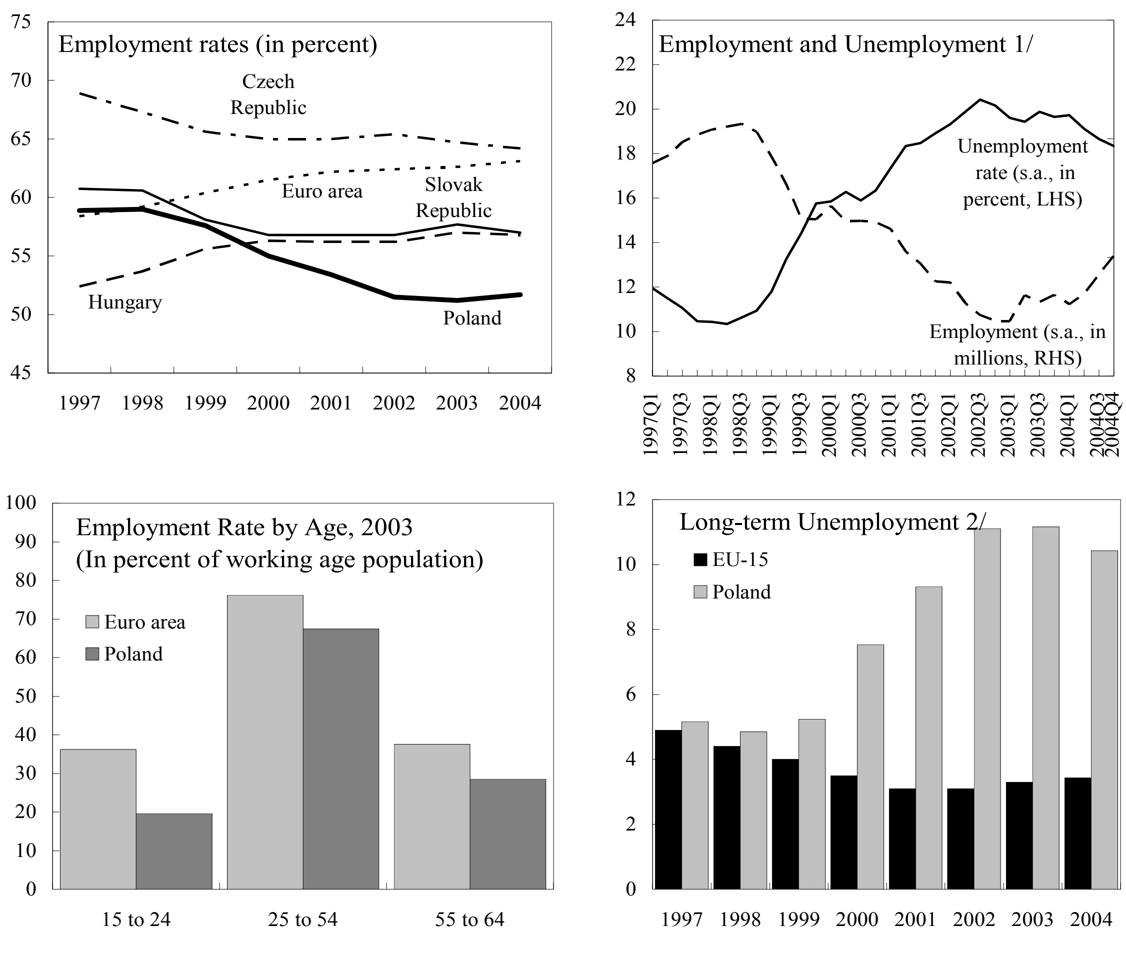


Source: Polish authorities; and Eurostat.

1/ Deflated by PPI.
2/ Decline in 2004 was partly due to valuation effects from zloty appreciation.

skill mismatches, immobility between regions, and disincentives to work—while demand was weakened by the cycle, poor infrastructure particularly in high unemployment regions, and high non-wage costs of employment. Thus, the employment rate, which was close to the euro area average in 1998, is now 52 percent—the lowest in the EU. The gap is particularly large for young workers while the long-term unemployment rate is one of the highest in the EU (Text Figure 4). These developments have their counterpart in impressive productivity gains during the recovery and, as high unemployment has kept wage growth low, falling unit labor costs.

Text Figure 4. Poland and Selected EU Countries: Labor Market Indicators, 1997-2004



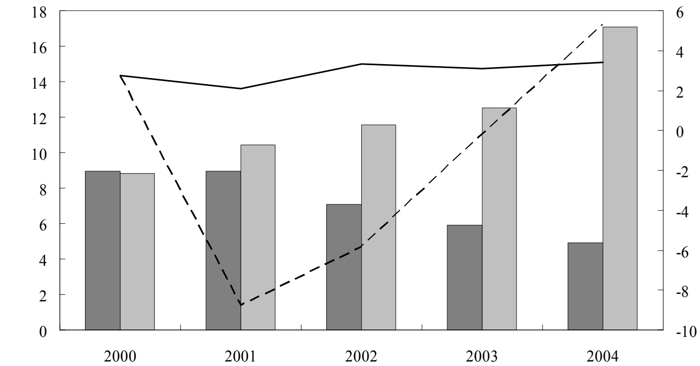
Sources: Polish authorities; Eurostat; European Commission; and OECD.

1/ The quarterly Labor Force Survey was not undertaken in Q2 and Q3 of 1999, and observations in these quarters are extrapolated.

2/ Share of unemployed over one year in total labor force in percent. Annual average.

8. **These developments suggest sluggish interplay between consumption and investment since the recovery began in mid-2002**. With slow job creation and low wage growth, household incomes have grown modestly. By late 2004, even with falling savings rates, strong consumption growth could not be sustained (Text Figure 5). In contrast, corporate savings have risen rapidly without a commensurate increase in investment. Corporate bank deposits have escalated, but banks continue to hold a large share of assets in government bonds. With limited scope for further cuts in household savings rates, future growth will depend on stronger investment in job-creating capacity both to push up household incomes and to ease potential supply constraints.

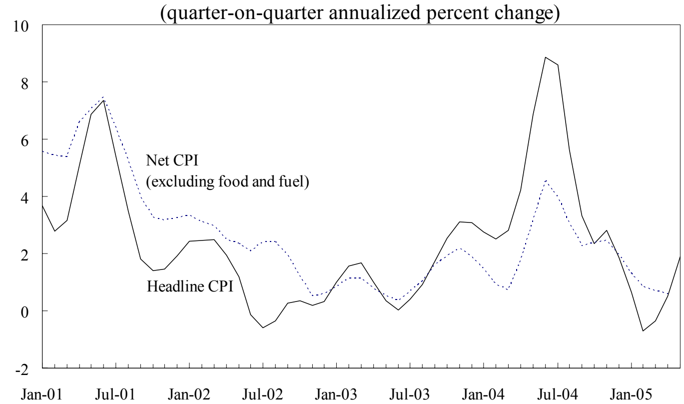
Text Figure 5. Poland: Savings, Consumption, and Investment, 2000-04



Sources: Polish authorities; and IMF staff calculations.

9. **Thus far, however, resource constraints have not been evident in inflation or the current account.** A pickup in nominal wage growth, rising oil prices, and an increase in food prices as agricultural exports were liberalized created mid-year price pressures (Text Figure 6). Monetary policy reacted swiftly with cumulative 125-basis point interest rate hikes during June-August. This, together with a deceleration of demand, contained inflation and wage increases. Meanwhile the current account deficit narrowed: for the year as a whole, export growth was strong, while import growth picked up modestly with investment (Table 3).

Text Figure 6. Poland: Inflation, 2001-05
(quarter-on-quarter annualized percent change)



Sources: Polish Central Statistical Office; and The National Bank of Poland.

10. **Fiscal policy continued to drift in 2004.** Adding EU-accession related spending to a cut in the corporate tax rate and upward drift in non-discretionary spending resulted in a procyclical (though lower-than-initially projected) rise in the general government deficit (Text Table 1 and Table 4). Despite strong efforts of the Belka government to secure Parliamentary approval of fiscal reforms (Hausner Plan), only about a third (in terms of potential savings) of the plan was implemented. Some key reforms—to limit coverage of the farmer pension scheme, close social security contribution loopholes and better target disability programs—were not implemented, although pre-retirement benefits were reined in and pension indexation rules were changed. Notwithstanding the large deficit, a renewal of

the privatization program, the zloty appreciation and strong growth resulted in the first drop in the debt ratio in four years.

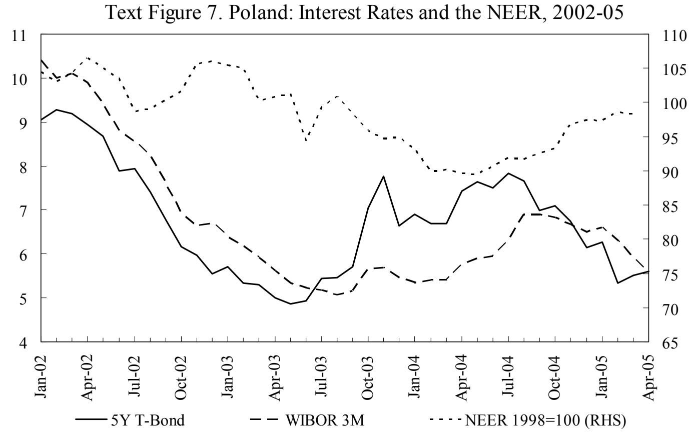
Text Table 1. Poland: Fiscal Trends, 2000-04

	2000	2001	2002	2003	2004
	(in percent of GDP)				
General government balance (cash)	-3.4	-5.3	-6.2	-5.9	-6.1
Structural balance	-4.2	-4.9	-4.9	-4.7	-5.4
Public debt	...	41.0	46.7	51.5	50.2

Sources: IMF staff calculations, Polish authorities.

11. **Financial markets turned strongly positive during 2004.** Despite low inflation, long-term interest rates had risen sharply in mid-2003 and a two-year depreciation of the zloty persisted following the announcement of an expansionary 2004 budget (Text Figure 7). But EU accession, formation of the pro-reform Belka government, and signs of stronger-than-expected budgetary developments (including privatization) prompted a mid-2004 turnaround while the equity market also surged. Despite narrowing interest rate differentials vis-à-vis the euro and the dollar, the zloty appreciated through early 2005.

Text Figure 7. Poland: Interest Rates and the NEER, 2002-05



Sources: IMF Information Notice System; and Bloomberg.

12. **The authorities thought that past IMF policy recommendations had been apt, although political constraints had hindered their full implementation (Box 1)**.

Box 1. Implementation of Previous Recommendations

Despite the government's efforts, fiscal reforms, long supported by staff, have been slow. However, the government used a window of opportunity immediately after its formation last year to accelerate privatization, also a longstanding staff recommendation. Staff views on monetary policy have been well received and were seen as on the mark in managing the price shock last year. Similarly, the NBP and its supervisory arm have acted forcefully, also consistent with staff views, to step up prudential regulation and supervision of foreign exchange-denominated loans. Staff's concerns about the changes in the regulation on loan classification, however, turned out to be unnecessary as the changes have had the benign effects the authorities expected.

III. REPORT ON THE DISCUSSIONS

13. **After a successful first year in the EU, the authorities were for the most part confident about the medium term.** Pointing to potential gains from EU membership for FDI and institutional and infrastructural development, most expected growth to increase to 5–5½ percent in 2006–07. They were puzzled about why investment had not taken off in 2004, but felt that underlying conditions (competitiveness, preparations for absorbing EU funds, and high capacity utilization) were conducive to a significant strengthening in 2005. They acknowledged, however, the importance of an electoral outcome that would give a strong base to a pro-reform government. Reversing the rising public debt ratio, reining in social transfer spending, and reducing and simplifying taxes would be key for a favorable growth scenario.

14. **Job creation, a special focus of this year's consultation discussions, was seen as critical for raising growth, easing strains on the pension system, and reducing poverty (Box 2).** Analyses by government, opposition advisors, and staff (see Selected Issues), identified many influences constraining job growth, with no obvious ranking of importance. The discussions therefore explored a variety of possible actions. Views on the likely response of job creation to policy change, however, differed. The more optimistic expected a sharp rise in employment and indeed foresaw pockets of labor shortages over the medium term. Others felt that high and persistent structural unemployment was a legacy of the transition in which social transfer schemes had been used to effectively remove many affected by restructuring from the labor force. On either view, the authorities were concerned that long-term unemployment and persistent regional differences in employment were depriving many of the benefits of Poland's prosperity.

15. **Preparations for euro adoption were another focus of the discussions.** The government had targeted euro adoption in 2009–10. Formally, this would require entering ERM2 by mid-2006-mid-2007 and meeting the Maastricht criteria by mid-2008-mid-2009. The authorities viewed the major hurdle as reducing the fiscal deficit and aimed to get it significantly below the Maastricht criterion of 3 percent of GDP. The criteria for inflation (below about 2½ percent) and general government debt (below 60 percent of GDP) were viewed as well within reach. Looking beyond the Maastricht criteria, the authorities were also examining structural aspects of the economy—such as the flexibility of the labor market, structural characteristics that influence monetary transmission, and any challenges for bank supervision—that could impact the success of euro adoption. Staff welcomed the ambitious policy goals and underscored that fiscal and structural reforms needed to secure strong growth were also critical for a safe journey to euro adoption.

A. Economic Outlook

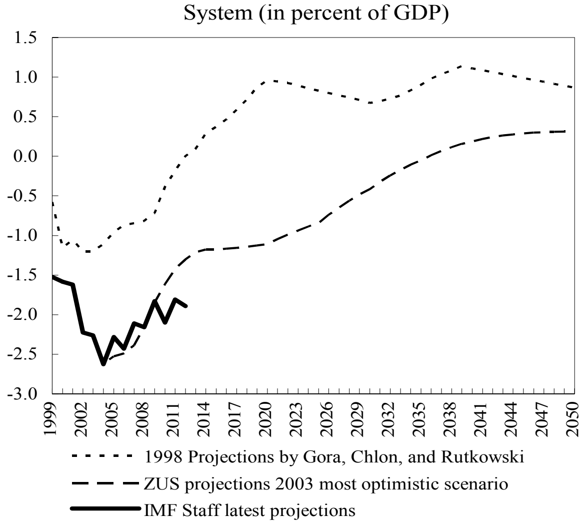
16. **All forecasts envisaged a pick-up in growth from the low end-2004 rates, but views on its strength differed.** Staff saw several influences that would constrain the rebound. Weak demand in Western Europe and the zloty appreciation should slow exports.

Box 2. The Interactions of Labor Market, Fiscal, and Poverty Trends

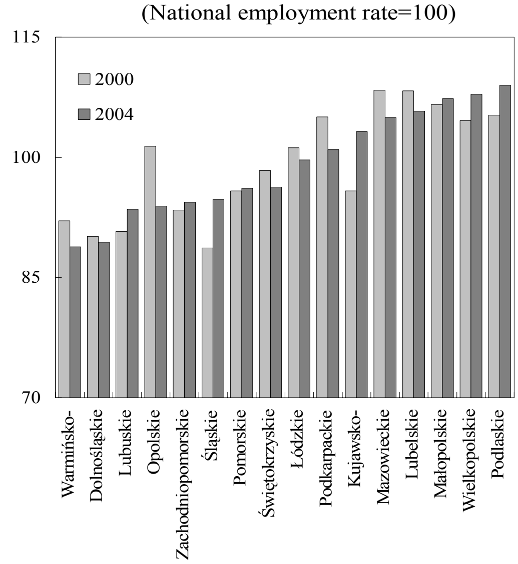
Negative employment trends have contributed importantly to a deterioration of the financial position and coverage of the pension system (see Selected Issues). Projections in 1999 (when a pay-as-you-go system was replaced by a three-pillar mixed private-public scheme) showed a small, transitory deficit followed by long-term sustainability of the state-managed first pillar. However, owing to unfavorable labor market developments, combined with changes in the parameters, and generous pension indexation since 1999, official projections now show a significant deterioration relative to the 1999 projections. Declining employment has also limited the accumulation of savings in the privately managed second pillar, increasing the likelihood of future claims on the budget to support those who will not accumulate sufficient pension rights. The authorities were discussing the possibility of setting up a National Actuary Office to safeguard the pension system. Staff welcomed this plan.

Long-term joblessness, persistent regional differences in unemployment and poorly targeted social benefits have marginalized an increasing part of society. The share of people living below the existence minimum rose from 5.6 percent in 1998 to 11.7 percent in 2003. Social spending relative to GDP is among the highest in the OECD, but the social support system is uneven and poorly targeted (Table 5). Almost 30 percent of social benefit recipients live in deep poverty, while families headed by old-age pensioners have one of the highest per capita incomes.

Box Figure 1. Poland: Projected Balance of the State-Managed Part of the Old-Age Pension System (in percent of GDP)



Box Figure 2. Poland: Regional Differences in Employment Rates (National employment rate=100)



Sources: IMF staff projections and calculations, Polish authorities, and Chłon, A., M. Góra, and M. Rutkowski, "Shaping pension reform in Poland: Security through diversity", Social Protection Discussion Paper Series No. 9923, The World Bank, August 1999.

Moderating export growth and political uncertainties are likely to delay a full-scale recovery of investment—a projection supported by the drop in Q1 2005 investment reported after the mission. The planned withdrawal of fiscal stimulus in 2005, mostly from postponement of pension indexation, should counterbalance the impact of increasing employment on private consumption. Staff, thus, projects growth of 3.7 percent in 2005, with the current account deficit staying at about 1½ percent of GDP. Risks to these forecasts were evenly balanced: export growth could continue to surprise on the upside, while political uncertainty could lower investment growth. The authorities, especially the NBP, were more optimistic on investment and labor income growth and therefore expected growth of about 4 percent.

17. **Staff saw a range of possible medium-term outcomes, depending on the resolution of uncertainties about the political situation, economic policies, and timing of euro adoption.** The authorities and staff agreed that, supported by strong fiscal and structural policies and a competitive parity, euro adoption would be a significant impetus to investment, trade, and growth. With a strong coalition after the elections committed to early euro adoption and the required reforms—most importantly expenditure-reform-based fiscal adjustment—average growth should be above 5 percent. Without fiscal reforms, however, staff projected growth to stay at 3½–4 percent (Table 6): market concerns about the deficit could produce persistently high interest rates and modest investment, locking the economy into a sub-par growth equilibrium characterized by moderate current account deficits, but low employment and sluggish private consumption. The authorities saw the danger in continued postponement of reforms and agreed that investment would be crucial for rapid income convergence.

B. Fiscal Policy

18. **The authorities viewed the 2005 budget as a first step toward rapid fiscal consolidation.** Parts of the Hausner Plan that had been implemented—particularly a shift from annual pension indexation to indexation only in years after cumulative inflation reached 5 percent and reductions in defense spending and support to employers of disabled people—would contribute to the projected cut in the general government deficit from 6.1 percent of GDP in 2004 to 5.7 percent in 2005. In fact, the authorities hoped that tight expenditure control, lower-than-assumed interest rates, and higher-than-planned dividends would reduce the deficit below target. Staff agreed with the assessment of revenue and interest costs, but felt that these would just compensate for the loss from elements of the Hausner plan that had not received parliamentary approval but had been assumed in the budget. Looking ahead, staff questioned the basis for assuming further adjustment. Indeed, in view of the need to index pensions for 2005 and 2006 inflation, staff projected that without new measures the general government deficit would rise above 6 percent of GDP in 2006.

19. **Building on the envisaged reduction in the deficit in 2005 the authorities planned to leave the next government an ambitious 2006 budget proposal.** A new strategy, termed

Plan B, would reduce the deficit in 2006 to 4.6 percent of GDP and in 2007 to below 3 percent.[2] The authorities explained that the strategy, still in early stages of definition and obviously subject to post-election changes, would rely on the initiative of spending units to identify savings and efficiency gains, entailing an array of small measures. Also, an overhaul of cash management was expected to generate savings relative to GDP of up to 1 percentage point. Tax reform was another key element. A central plank also of the opposition's platform, the new tax regime would have a uniform-rate (provisionally set at 18 percent) PIT, CIT, and VAT phased in over three years. The authorities stressed that these changes would be revenue neutral and would provide an impetus to growth through the elimination of distortions.

20. **Staff welcomed the ambitious fiscal targets and tax reform plan, but doubted the durability of fiscal consolidation without fundamental expenditure reform.** As concrete steps to rein in spending had not been developed, it was not possible to assess the feasibility of the targets. Nevertheless, in staff's view, such ambitious fiscal targets would require measures to reduce poorly-targeted social transfer spending—the root of the fiscal problem. These would cut the deficit not only directly, but also indirectly by strengthening incentives to work and raising employment. Measures to improve cash and expenditure management could be important supplements, but savings would accrue over time and with large investments in information systems. Noting that the simplification of the tax system would strengthen enforcement capacity and nurture a compliance culture, without major negative distributional effects, staff supported a move to single-rate taxes carefully designed to ensure revenue neutrality.

21. **In discussions with the government and opposition leaders, staff focused on the immediate post-election opportunity for introducing fiscal reforms**. It emphasized that under present policies and historical average growth rates, public debt would continue to grow and public finances would become more vulnerable to shocks (Table 7, Box 3). Indeed, with such debt dynamics, assuming growth at the historical average would be optimistic, and dynamics could look even worse. Staff therefore urged four immediate post-election initiatives for fiscal policy.

- **Establishment of targets for reducing the public debt ratio and for deficits consistent with this goal.** Based on an analysis of fiscal risks and distribution of fiscal burden across generations (see Selected Issues), staff suggested that public debt be reduced below 40 percent of GDP. To achieve this level in the medium-term, the general government deficit should be reduced to about 2 percent of GDP by 2008. This would also support exchange rate stability in ERM2 and allow Poland to adopt the euro from a strong position.

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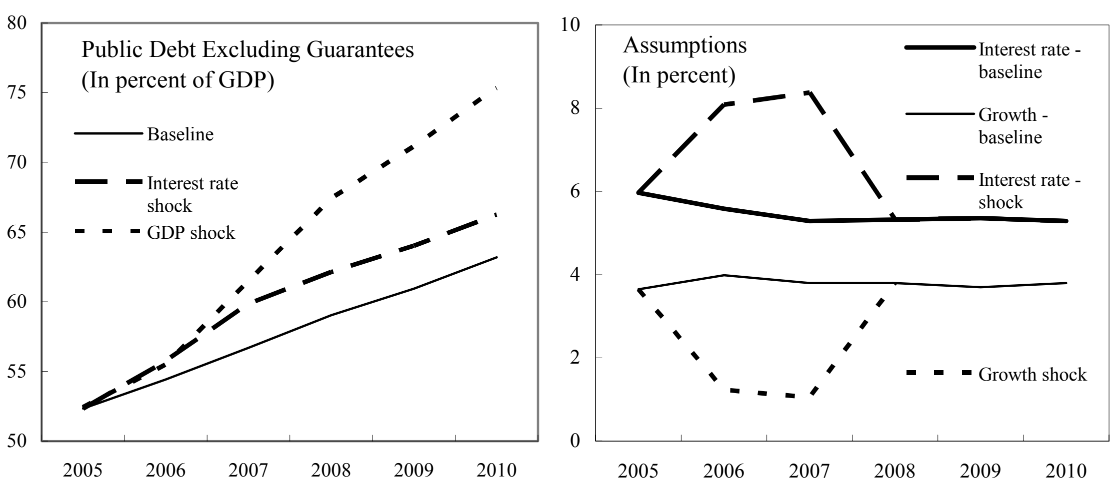
[2] These targets refer to ESA95 deficits (excluding privately-managed pension funds), the measure for the Maastricht deficit criterion. Because historical differences between cash (GFS) and accrual (ESA95) deficits will not persist, staff projections for the two are identical.

Box 3. Debt Sustainability Analysis

Although favorable developments in 2004 lessened immediate concerns about public debt, medium-term trends remain worrisome. After a ten-percentage point increase in 2002-03, public debt (excluding guarantees) relative to GDP fell in 2004 owing to zloty appreciation, strong growth, and large privatization receipts. In staff's baseline scenario, however, without a sizable cut in the deficit and with average output growth of 3¾ percent, public debt rises to 63 percent of GDP in 2010 and stabilizes at above 65 percent after 2014.

More importantly, with staff's projected debt profile, the vulnerability of public finances to shocks would be high. As detailed in previous staff analysis (Country Report No. 03/187), real shocks pose a major risk: a two-year slowdown in output growth in 2006 similar to that in 2001–02 (a 2¾ percentage point-drop), reversed in 2008, would push public debt to 75 percent of GDP by 2010 (Box Figure). An increase of this magnitude could lead to strong market reactions and, thus, necessitate a large procyclical fiscal adjustment—further exacerbating the negative impact of the real shock (Table 8). A 300 basis-point increase in the average interest rate on public debt in 2006–07 (returning to the baseline afterwards) would increase public debt relative to GDP by some 3¼ percentage points only.

Box Figure. Poland: Debt Sustainability Analysis, 2005-10



Source: IMF staff calculations presented in Table 8.
Note: For a description of the shocks, see the text and Table 8.

Macroeconomic risks from external debt are much smaller. Although the gross external debt ratio has risen in the past few years, much of the increase was due to increased non-resident holding of the stock of domestically issued public debt. Under the baseline assumption, a current account deficit of 2–3 percent of GDP over the next five years, external debt would remain below 50 percent of GDP—leaving an ample safety margin for

- **Formulation of a plan for reducing spending on social transfers focused on improved targeting.** Measures included in the Hausner plan needed to be pressed again and supplemented by further reforms of agricultural and disability pensions and containment of the wage bill, particularly in education. The reforms should be adequate to both achieve deficit targets and create scope for cuts in the tax wedge.

- **Implementation of a tax reform,** moving to single rates in a revenue neutral manner.

- **Introduction of a Fiscal Responsibility Law (FRL)** with three elements. First, as a standard for discipline and message to markets, a fiscal rule should be established. The difficulty of calculating structural balances and the aim of avoiding procyclical behavior argued for a rule in the form of annual current expenditure ceilings for a 4-year electoral cycle. Expenditure management should also be strengthened to support medium-term budgeting. Second, to enhance transparency, the law should introduce expert independent assessment of macro assumptions and fiscal projections in annual budgets and the medium-term framework Third, to ensure efficient planning, the law should mandate detailed rolling 3-year budget projections alongside each annual budget.

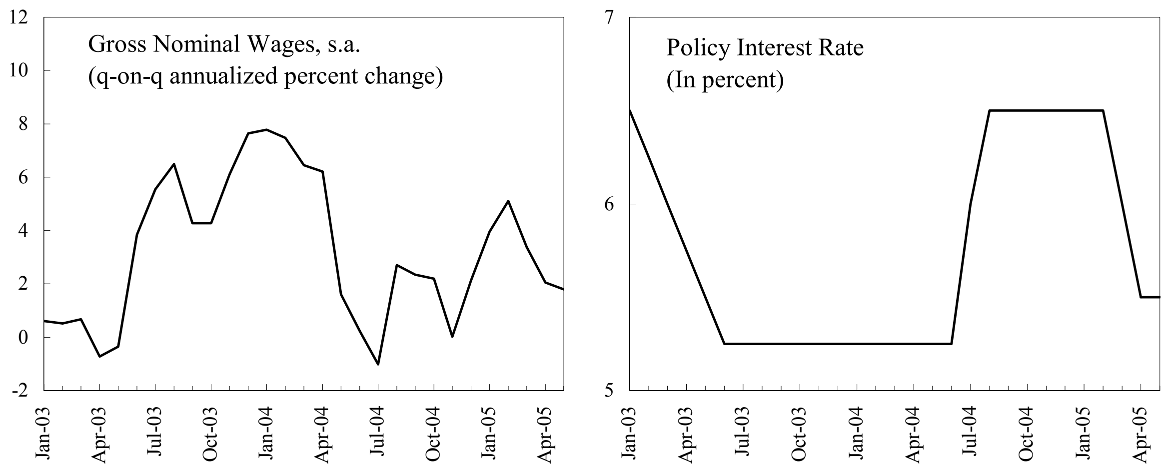
22. **The authorities and opposition leaders and experts saw merit in these recommendations.** All parties to the discussion supported deficit reduction. The objective of lowering debt to 40 percent of GDP, while seen as ambitious, commanded attention. The government, fresh from a bruising battle over the Hausner Plan, was not optimistic about the chances for reform of social transfers. Some of the key opposition experts, however, viewed such reforms, particularly to disability pensions, as essential for a lasting fiscal adjustment. Some were concerned, however, that this may create room for populist fiscal policies later on. Tax reform had become a common goal and questions centered on phasing and selection of rates. Both the authorities and opposition experts saw the merits of a FRL.

C. Monetary Policy

23. **The MPC considered that the monetary policy response to the inflation upturn in 2004 had been appropriate.** The combination of brisk output growth and a strong pickup in wage growth, followed by oil and EU accession-related price increases had called for preemptive interest hikes in mid-2004 to avert second-round effects and anchor expectations (Text Figure 8). The second-round effects had, in fact, been contained—a development some MPC members attributed to the rapid policy response and others also to increased credibility of monetary policy. Staff queried whether last year's success had made inflation expectations more forward-looking and better anchored to the target. The MPC was not unanimous on this issue; some saw expectations as still highly adaptive and others felt they were becoming better anchored. The strong appreciation of the zloty following the rate hikes surprised some

MPC members and was viewed as a factor that helped lower inflation faster than they had expected. Staff felt that the credibility of monetary policy had been reinforced, and this should allow future price shocks to be handled with smaller interest rate changes.

Text Figure 8. Poland: Wages and Policy Rate, 2003-05



Sources: The National Bank of Poland; and Polish Central Statistical Office.

24. **The NBP and MPC thought that the inflation outlook was benign but leaned toward a cautious approach to policy in the run-up to the elections.** Together with staff they expected inflation to drop to the lower half of the target range (2½ ± 1 percent) (temporarily perhaps even below that) in the rest of the year and revert toward the target in 2006. In the discussions (prior to the second 50-basis point cut in April) MPC members thought that a benign inflation outlook provided room for further rate reduction. But views on the extent of possible future rate cuts differed. Some MPC members thought, and staff agreed, that a sizable estimated output gap, low projected inflation, falling inflation expectations, and risks of speculative inflows if interest rate differentials remained sizable, left ample room for reductions: others saw several risk factors. The MPC cut the policy rates again at its April meeting by 50 basis points and adopted a neutral stance, widely interpreted as indicating that the easing cycle might have ended or that future changes would be small.

25. **The monetary authorities viewed the uncertainties surrounding future fiscal policies as the main medium-term risk for inflation.** They welcomed indications that the next government would pursue fiscal consolidation. But they felt that a connected monetary policy response would need to await evidence of commitment to the necessary structural fiscal reforms.

26. **The monetary authorities felt that approaching ERM2 and euro adoption also warranted caution.** As the Maastricht inflation reference rate was likely to be 2½ percent or lower, some advocated an effort to stay consistently below that rate. Noting the increased credibility of monetary policy, however, staff cautioned against an asymmetric approach to the 2½ percent policy target, which would put undue upward pressure on the exchange rate and risk misalignment approaching ERM2. Thus far, the authorities did not hold firm views

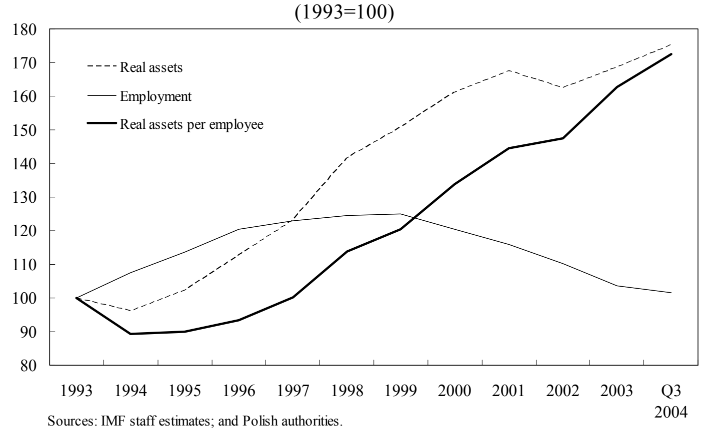
on the appropriate parity or the best method for determining it. For the immediate future, staff and the authorities agreed that export and profitability developments suggested that the zloty was in a satisfactory range. Staff noted, however, that empirical work focusing on the medium to long term was turning up a wide range of views, few suggesting that the zloty was undervalued and more that it was either appropriately- or over-valued. Staff underscored the importance, for investment and income catch-up, of entering ERM2 and adopting the euro at a competitive rate.

27. **The authorities felt that inflation targeting would serve Poland well until ERM2 entry.** Noting that market participants were concerned about policy surprises and conflicting signals from MPC members, staff asked the MPC whether they saw a need for changes in the way future policies were signaled. Staff also asked whether the MPC could better communicate views on future inflation through a fanchart endorsed by the MPC rather than the statement of a policy bias. The authorities felt that the current arrangement—whereby the inflation projections and the associated fanchart were given by the NBP staff—was appropriate and that the policy bias was an effective way to communicate future policy intentions. With an eye to ERM2, the authorities were developing capacity for foreign exchange market intervention, but agreed with staff that it should not be used as an active policy instrument before ERM2 entry.

D. Financial Sector Risk and Vulnerability

28. **The authorities viewed recent developments and prospects in the banking sector as favorable.** Since the late 1990s the number of banks had fallen by about a third and employment by about 20 percent, while real assets had increased sharply (Text Figure 9). Helped by the recovery, loan quality had improved significantly lowering the need for provisioning. This, together with strong interest and non-interest earnings, had contributed to an average ROE of about 17½ percent in 2004 (Text Table 2). Expecting further improvements in loan quality, the authorities thought that banks would maintain high profitability in 2005. They assessed that about two-thirds of the decline in the share of classified in total loans, from 22.2 percent in 2003 to 15½ percent in 2004, resulted from improved loan quality. The change in the loan classification rules played only a minor role; moreover, owing to changes to the rules for collateral valuation, the banks had not released any sizable amount of previously accumulated provisions.

Text Figure 9. Poland: Productivity of Polish Commercial Banks
(1993=100)



Sources: IMF staff estimates; and Polish authorities.

Text Table 2. Poland: Financial Soundness Indicators for Commercial Banks, 1998-2004

	1998	1999	2000	2001	2002	2003	2004
	(in Percent)						
Regulatory capital to risk-weighted assets 1/ 2/	11.7	13.2	12.9	15.1	13.8	13.7	15.5
Regulatory Tier I capital to risk-weighted assets 1/ 2/ 3/	10.7	12.3	12.2	14.2	12.7	12.7	14.3
Regulatory capital to assets 2/	7.0	7.1	7.1	8.0	8.7	8.2	7.9
Nonperforming loans to total gross loans 4/	10.9	13.7	15.5	18.6	22.0	22.2	15.6
Nonperforming loans net of provisions to capital	50.0	70.2	78.3	83.2	91.4	94.7	64.3
Provisions to nonperforming loans 5/	45.4	39.1	40.5	42.6	46.7	47.4	61.9
ROA (After-tax)	0.7	0.9	1.1	1.0	0.5	0.5	1.4
ROE (After-tax)	9.2	12.9	14.5	12.8	5.2	5.4	17.4
Interest margin to gross income 6/	69.7	63.0	60.9	51.6	53.3	55.0	55.7
Liquid assets to total assets	…	…	…	…	31.3	31.7	33.8
Liquid assets to short-term liabilities 7/	…	…	…	…	53.6	53.4	56.9
Net open positions in foreign exchange to capital 8/	…	6.9	6.5	4.4	3.2	0.7	1.8
Foreign currency loans to total loans 9/	23.4	21.2	22.8	25.9	28.8	34.0	26.6
Foreign currency deposits to total deposits 10/	19.2	19.7	18.2	19.5	18.7	18.5	16.7

Source: Polish authorities.

1/ Including off-balance sheet commitments. Since 2002 except credit risk including market risk and other kinds of risk.
2/ Since 2004 excluding branches of credit institution.
3/ Core capital (Tier 1) does not include all the obligatory deductions referring to regulatory capital.
4/ Share of irregular claims in gross claims on non-financial customers.
5/ General and specific provisions to irregular claims on non-financial customers.
6/ Net interest income to net income from banking activity.
7/ Liquid assets to liabilities 3M.
8/ Overall net position to regulatory capital.
9/ Loans to non-financial customers.
10/ Deposits from non-financial customers.

29. **The authorities pointed to risks inherent in a strong cyclical upturn and institutional weaknesses as challenges for the financial sector.** Although the share of foreign exchange-denominated and -indexed loans declined in 2004, the authorities thought that borrowers' foreign exchange risk remained significant owing to the large stock of such loans. Regarding cyclical risks, the authorities had detected some signs of banks relaxing credit standards to maintain market shares, mostly in the fastest-growing mortgage lending market. To address this issue and strengthen foreign exchange risk assessment, banking supervisors had issued new recommendations on mortgage lending and focused on- and off-site inspections on assessing such loans. On institutional weaknesses, they thought that the inefficiency of the commercial court system seriously hindered banks' capacity to call loan collaterals and, thus, made collateral valuation uncertain and banks potential losses higher. The NBP had initiated a project with the World Bank to address this problem. Staff agreed that legal reforms to speed up case resolution and improve contract enforcement were essential, also to improve the overall business climate. The mission stressed that bank supervision should address any sign of excessive easing credit standards during the upturn.

E. Structural Policies

30. **The authorities had taken several measures to reduce unemployment but results were mixed.** Recognizing that young and old-age workers, particularly with low skills, were the most vulnerable to joblessness, the authorities had concentrated their efforts on these groups. The most successful initiative of the First Job program, which started in 2002 and

aimed to strengthen incentives for labor market entrants to seek employment, was a traineeship program: about 40 percent of participants had found permanent jobs. Information centers set up in municipalities to promote regional mobility had also been effective, but more were needed. Other efforts had been less effective. The authorities regretted that the 50+ program, which started in 2004 and offered financing to projects by labor offices and NGOs to raise the labor force participation of old-age workers, had had little success. More generally, the authorities were pleased with the 2002 Labor Code revision, which they felt had eliminated most administrative barriers to job creation. Moreover, the recent rapid growth of temporary employment, subject to less strict regulation than permanent employment, had introduced additional flexibility.

31. **The government was preparing a number of initiatives to amplify the beneficial effects of the cyclical upturn on the labor market.** They explained that proposals were being prepared to provide tax relief to low wage-earning new labor market entrants and to freeze the minimum wage for two years. They, however, were uncertain about the prospects for parliamentary approval, especially in light of a recent proposal by MPs to raise the minimum wage by 50 percent over three years. The authorities also had plans to provide incentives to bring grey economy employment into the legal economy. They projected an unemployment rate of 16½ percent by 2006.

32. **Staff commended the authorities for their efforts to raise employment but emphasized that stronger efforts were needed on all fronts to achieve a breakthrough.** Staff agreed that reducing the tax wedge, particularly for low-skill and young workers, lowering the minimum wage relative to the average, and reducing disincentives to work for young people would be beneficial. Based on its analysis (see Selected Issues), however, staff stressed that reforms should also aim to differentiate the minimum wage across regions and for young workers; increase the flexibility of regular labor contracts; improve public education, particularly vocational training; increase regional mobility; and reduce regional differences in infrastructural development. Such initiatives would also be crucial for a successful experience in the euro area. Staff acknowledged that the flexibility of Poland's labor market compared well with most euro area countries but emphasized that large labor market imbalances necessitated exemplary flexibility.

33. **The authorities reiterated their commitment to rapid privatization.** Receipts had reached 1.2 percent of GDP in 2004, significantly above the target. The successful IPO of PKO BP (the largest commercial bank), originally planned for 2001, also gave a strong impetus to capital market development and foreign investment. The authorities felt that privatization was the only way to secure the viability of most public companies in the competitive environment since EU accession. They thought that state-ownership should be confined to a handful of activities where the private sector cannot operate efficiently. Privatization was also important to provide quality investment opportunities for pension funds. They, therefore, thought that privatization should progress on many fronts, including the energy sector, the railroad company, and the postal service. Staff welcomed the achievements in 2004, strongly supported the authorities' strategy, and urged swift

completion of privatization, including of PKO BP and PZU, during the term of the next government.

IV. Staff Appraisal

34. **Poland's first year in the EU was a success.** Businesses met the challenge of increased competition inside the EU, and the MPC successfully stabilized inflation expectations following an increase in prices. Markets reacted positively to these accomplishments and to the government's efforts to gain Parliamentary approval of fiscal reforms, resurrect privatization, and improve debt management. Domestic interest rates fell toward euro area levels, albeit with some delay and to a smaller extent than in some other new members of the EU. Reflecting positive market sentiment, greenfield and privatization-related FDI increased, offering critical support for future growth.

35. **Indeed, EU membership adds to other attributes that should stand Poland in good stead for strong growth.** The current account deficit is small, and low inflation commands increasing credibility. External debt is modest, although public debt, having risen sharply in recent years, could become a source of vulnerability to changing market sentiments if allowed to rise further. High corporate profitability, modest wage growth, and ample corporate liquidity suggest strong investment potential. A large and young labor force, combined with an institutional framework strengthened by EU membership, should sustain foreign investors' attraction to Poland. EU transfers promise to promote an upgrading of infrastructure and modernization of agriculture.

36. **The stalling of growth momentum in recent months, however, suggests remaining impediments to growth.** Insofar as underlying conditions remain broadly favorable, the recent slowdown is likely to be temporary—the result of a bunching of demand prior to accession, a dip in EU growth, and a delayed investment response. Helped by the recent reductions in policy interest rates, GDP growth should rise through 2005 alongside low inflation and only a small increase in the current account deficit. But the loss of momentum from the heady growth rates of a year ago cooled hopes that Poland had entered a period of substantially higher investment and output growth, sufficient to make a serious dent in its strikingly low employment rate. Rather, such a shift is likely to require the resolution of uncertainties about political leadership and a commitment to fiscal conservatism and structural policies to strengthen incentives to work and invest.

37. **The immediate post-election period offers a window of opportunity for consolidating public expenditure and reversing the increase in public debt.** The most important macroeconomic challenge for the next government will be to set clear goals in these areas and secure political support for them. This will involve, first, committing to sound targets for public debt (ideally about 40 percent of GDP) and associated general government deficits (falling to about 2 percent of GDP). Second, a strategy should be articulated for reducing the deficit, focusing on poorly-targeted social transfers, the key excess in the fiscal accounts. Third, a tax reform to simplify the system would contribute to

reducing administrative costs and eliminating distortions. Consideration of single-rate personal and corporate income and value-added taxes is a good starting point for reforms.

38. **Backing these commitments with the enactment of a fiscal responsibility law would buttress political resolve and bring forward beneficial effects.** Such a law should encompass a fiscal rule—ideally in the form of a multi-year ceiling on primary current spending—to supplement the current constitutional limit on debt; a requirement to supplement annual budgets with rolling 3-year budget projections; transparency requirements including norms for expert independent assessment of macroeconomic assumptions and fiscal projections in the annual budgets and medium-term projections. Such laws, with sufficient political support, have proved effective elsewhere in accelerating the medium-term benefits of fiscal adjustment—lower interest rates, higher investment, and stronger confidence.

39. **Alongside fiscal reform, a multi-pronged approach to job creation is essential to realize output potential and ensure that all parts of the population benefit from higher growth.** Fiscal actions encompassing a revenue-neutral tax reform that reduces the tax wedge and social benefit reforms to remove disincentives to work, particularly for those receiving disability and pre-retirement benefits, would be an important first step. Other important initiatives include infrastructure improvements in regions with low employment; education reforms, particularly in vocational schools, focused on equipping workers with marketable skills; and regulatory reforms. Although the OECD ranks labor market regulation in Poland relatively favorably, addressing the low employment rate will require exemplary regulatory conditions. In this vein, freezing the minimum wage to make it less binding for low-skill workers, differentiating the minimum wage across regions and for young workers; and eliminating remaining impediments to job creation (particularly undue regulation of regular labor contracts) would help increase labor demand. Labor offices should focus on improving job matching and the flow of labor market information among regions.

40. **The next government should also complete privatization.** With limited scope for state-aid and more intense competition in the EU, this is the only way to ensure the long-term viability of most public companies. Setting a timetable for the full privatization of PKO BP and PZU is of particular importance.

41. **Credible commitment to early euro adoption could amplify the potential benefits of these policies.** Provided the fiscal deficit is well below the Maastricht limit, the conversion rate affords strong competitiveness, inflation is low, and labor market flexibility has been improved, euro adoption should bring substantial benefits for trade and output growth. But the risk of moving ahead without adequate preparation could be substantial. The new government, therefore, should work closely with social partners and the NBP to reach an agreement on a timetable for euro adoption and secure broad support for required reforms.

42. **Strong monetary policy credibility and a sound policy framework provide a good basis for euro adoption.** The decisive monetary response to the inflation fillip in 2004 was effective, and the inflation outlook is now benign. The MPC has appropriately reduced

the policy rate and shifted its policy bias to neutral. Developing capacity for foreign exchange intervention is an important preparation for ERM2, but continuing to avoid such intervention in the interim is appropriate. Looking ahead, the MPC should avoid any temptation to aim for inflation in the bottom half of the target range as an insurance against missing the Maastricht inflation criterion. Rather, gearing interest rate decisions toward keeping inflation within a symmetric band around the 2½ percent inflation target will help limit any undue upward pressure on the zloty in the approach to ERM2. Near-term considerations indicate that competitiveness is in an acceptable range, but careful assessment of the medium-longer term outlook, including growth potential and the evolution of competition in global markets, will need to feed into the ongoing assessment of competitiveness.

43. **Recent improvements in banking sector performance are welcome, and prospects for their continuation are encouraging.** The fruits of restructuring and consolidation since the late-1990s together with the cyclical upturn are apparent in strengthening bank profits and loan portfolios. Also, lower zloty interest rates and zloty depreciation have stopped the trend rise in foreign currency lending—a key concern in recent years. Potential problems to watch for are easing lending standards and a renewal of foreign currency lending—issues which the NBP seems well-prepared to monitor and address.

44. **Although EU accession brought many improvements in statistics, further efforts are needed to strengthen quarterly national accounts and fiscal accounts for the general government.**

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

Table 1. Poland: Selected Economic Indicators, 2001-05
(In percent, except where indicated)

	2001	2002	2003	2004 Est.	2005 Proj.
Activity and prices (growth rates)					
GDP	1.0	1.4	3.8	5.4	3.7
Domestic demand	-1.6	0.8	2.6	5.0	2.6
Private consumption growth	2.1	3.3	3.1	3.4	2.9
Public consumption growth	0.6	0.6	0.2	1.4	1.3
Domestic fixed investment growth	-8.8	-5.8	-0.2	5.3	2.3
Net external demand (contribution to growth)	2.6	0.5	1.1	0.3	1.0
CPI inflation					
Average	5.5	1.9	0.8	3.5	2.4
End of period	3.6	0.8	1.7	4.4	1.6
Unemployment rate (registered, end year)	19.4	20.0	20.0	19.1	18.6
Gross domestic saving (ratio to GDP) 1/	17.8	16.2	16.7	19.0	19.4
Gross domestic investment (ratio to GDP)	20.7	18.9	18.9	20.0	20.2
Public finances (percent of GDP)					
General government revenues	38.2	38.3	38.5	38.2	38.4
General government expenditures	43.6	44.6	44.4	44.3	44.1
General government balance 2/	-5.3	-6.2	-5.9	-6.1	-5.7
General government net borrowing (ESA95) 3/	-3.9	-3.6	-4.5	-4.6	-4.2
General government net borrowing (ESA95) 4/	-5.3	-5.5	-6.2	-6.4	-5.8
Public debt 5/	41.0	46.7	51.5	50.2	53.5
Money and credit					
Private credit (12-month change)	9.2	5.0	8.0	2.9	. . .
Broad money (12-month change)	9.2	-2.0	5.6	8.7	. . .
Money market rate (eop)	11.6	6.7	5.5	6.7	. . .
13-week t-bill rate (eop)	11.1	6.1	5.3	6.3	. . .
Policy Rate 6/ 7/	11.5	6.8	5.3	6.5	5.5
Corporate lending rate (1 year) 7/	. . .	8.7	7.0	8.2	7.2
Balance of payments					
Current account balance (transactions, millions U.S. dollars)	-5,376	-5,011	-4,599	-3,585	-3,627
Percent of GDP	-2.9	-2.6	-2.2	-1.5	-1.3
C/A balance plus net FDI, percent of GDP	0.2	-0.6	-0.3	0.7	1.0
Exports (millions U.S. dollars)	41,663	46,742	61,007	81,596	94,878
Export volume growth	3.1	4.8	14.2	10.2	8.5
Imports (millions U.S. dollars)	49,324	53,991	66,732	87,180	101,552
Import volume growth	-5.3	2.6	9.3	8.7	5.2
Terms of trade (index 1995=100)	94.3	94.0	93.4	94.2	91.1
Official reserves (millions U.S. dollars)	26,564	29,794	34,168	36,783	37,522
months of imports	6.5	6.6	6.1	5.1	4.4
Total external debt (percent of GDP)	38.7	44.3	50.5	52.3	46.6
Ratio of short-term debt to gross reserves	41.9	46.6	59.7	63.2	62.4
Exchange rate					
Exchange rate regime			Floating		
Present exchange rate (June 8, 2005)			Zl 3.3 = US$1		
Zloty per US$, period average	4.1	4.1	3.9	3.7	...
Zloty per Euro, period average	3.7	3.9	4.4	4.5	...
Real effective exchange rate (INS, CPI based)	138.0	133.6	120.5	120.9	...
percent change	13.8	-3.2	-9.8	0.3	...

Sources: Polish authorities; and IMF staff estimates.
1/ Derived as total savings minus the current account minus capital transfers.
2/ General government overall balance on a cash basis including payments in compensation for insufficient indexation in the 1990s.
3/ With second-pillar pension funds part of general government.
4/ With second-pillar pension funds outside general government. Fiscal notification to the European Commission will be on this basis from March 2007.
5/ Polish definition of debt including risk weighted stock of outstanding guarantees and excluding second-pillar pension funds.
6/ Yield on the 7-day National Bank of Poland money market bills.
7/ Data for 2005 are actual as of April.

Table 2. Poland: Monetary Survey, 2000-04
(In millions of zloty, end-of-period)

	2000	2001	2002	2003	2004
Net International Reserves	131,761	132,565	132,118	135,888	143,232
(in billions of U.S. dollars)	27.5	26.6	29.8	34.0	36.8
Net domestic assets	212,320	259,982	260,806	279,699	302,237
Credit to central government, net	56,081	69,208	65,949	70,158	69,394
Credit to nongovernment	218,624	238,726	250,586	270,569	278,412
Other items, net	-62,385	-47,952	-55,729	-61,027	-45,570
Broad Money	300,757	328,434	321,961	340,049	369,470
Memorandum items (in percent)					
Broad money growth (12-month)	11.9	9.2	-2.0	5.6	8.7
Real broad money growth (12-month)	3.1	5.5	-2.8	3.9	4.1
Nominal growth of credit to nongovernment	17.3	9.2	5.0	8.0	2.9
Real growth of credit to nongovernment	8.1	5.6	4.1	6.3	-1.4
Share of foreign currency deposits in broad money	13.8	15.3	14.5	13.8	12.2

Sources: National Bank of Poland; and staff estimates.

Table 3. Poland: Balance of Payments on Transaction Basis, 2001-10
(In millions of US$)

	2001	2002	2003	2004 Est.	2005 Proj.	2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.	2010 Proj.
Current account balance	-5,376	-5,011	-4,599	-3,585	-3,627	-5,021	-6,036	-7,353	-9,495	-12,551
percent of GDP	-2.9	-2.6	-2.2	-1.5	-1.3	-1.6	-1.9	-2.1	-2.6	-3.2
Trade balance	-7,661	-7,249	-5,725	-5,584	-6,674	-8,319	-9,962	-11,920	-14,628	-18,124
percent of GDP	-4.1	-3.8	-2.7	-2.3	-2.3	-2.7	-3.1	-3.4	-4.0	-4.6
Exports										
percentage change in unit values	11.0	10.4	27.1	31.6	16.3	9.9	11.6	11.0	10.9	10.9
percentage volume growth	3.1	4.8	14.2	10.2	8.5	9.8	11.4	10.5	9.9	9.6
export market growth	3.2	3.1	6.0	10.5	7.6	6.2	6.5	6.0	5.8	5.8
Imports										
percentage change in unit values	1.9	8.4	22.5	28.8	16.5	10.9	12.2	11.7	11.9	12.1
percentage volume growth	-5.3	2.6	9.3	8.7	5.2	10.2	12.3	11.6	11.1	11.0
growth in domestic demand	-1.5	0.9	2.6	5.0	2.6	4.2	4.2	4.3	4.3	4.6
Terms of trade percentage change	0.0	-0.3	-0.6	0.8	-3.2	-0.5	0.3	0.3	0.2	0.2
Services balance	786	849	527	893	1,012	972	987	973	877	701
Credit	9,753	10,035	11,174	13,364	15,539	17,078	19,052	21,157	23,454	26,017
Debit	8,967	9,186	10,647	12,471	14,527	16,106	18,066	20,183	22,578	25,316
Net Income	-1,390	-1,889	-3,637	-4,556	-4,729	-5,002	-4,849	-4,683	-4,515	-4,425
Net transfers	2,889	3,278	4,236	5,662	6,764	7,328	7,788	8,277	8,771	9,297
Capital and financial account balance	3,249	7,173	3,504	1,476	4,366	5,333	6,588	8,048	9,807	12,311
Financial account balance	3,173	7,180	3,550	478	3,066	3,933	5,118	6,505	8,186	10,593
Foreign direct investment (net)	5,804	3,901	3,927	5,353	6,431	7,092	8,007	9,063	10,349	11,680
by nonresidents	5,714	4,131	4,123	6,159	6,931	7,592	8,607	9,663	10,849	12,180
o/w privatization	1,528	414	138	197	1,000	700	700	400	400	400
Portfolio investment (net)	1,115	1,894	2,444	9,635	10,684	11,844	13,115	14,511	16,038	17,741
by non-residents	1,067	3,051	3,740	10,885	11,959	13,182	14,507	15,959	17,544	19,307
o/w equities	-307	-545	-837	1,918	1,918	1,918	1,918	1,918	1,918	1,918
Other investment	-3,410	2,283	-1,951	-14,764	-14,049	-15,003	-16,003	-17,069	-18,200	-18,828
Assets	-4,072	1,887	-1,249	-11,913	-11,484	-12,180	-12,898	-13,654	-14,443	-14,696
Liabilities	662	396	-702	-2,851	-2,566	-2,822	-3,105	-3,415	-3,757	-4,132
Financial derivatives	-336	-898	-870	254	0	0	0	0	0	0
Errors and omissions	1,691	-1,527	2,290	2,899	0	0	0	0	0	0
Overall balance	-436	635	1,195	790	739	313	552	695	312	-240
Financing										
Reserve assets	436	-635	-1,195	-790	-739	-313	-552	-695	-312	240
Memorandum items:										
Official reserves	26,564	29,794	34,168	36,783	37,522	37,835	38,387	39,082	39,393	39,153
in months of imports	6.5	6.6	6.1	5.1	4.4	4.0	3.6	3.3	3.0	2.7
Ratio of short-term debt to reserves	41.9	46.6	59.7	63.2	62.4	62.3	61.8	61.2	61.1	62.0
Total external debt (percent of GDP)	38.7	44.3	50.5	52.3	46.6	46.6	46.7	46.8	47.3	48.0
Total external debt (percent of exports) 2/	140.0	149.5	146.8	133.4	121.5	117.5	112.3	108.2	104.8	101.6
External debt service (percent of exports) 2/ 3/	27	23	24	20	17	21	15	18	18	16
Gross FDI inflows (percent of GDP)	3.1	2.2	2.0	2.5	2.4	2.5	2.6	2.8	2.9	3.1
Net FDI inflows (percent of GDP)	3.1	2.0	1.9	2.2	2.2	2.3	2.5	2.6	2.8	3.0

Sources: National Bank of Poland; and staff estimates.
1/ Defined as external liabilities minus external assets, both exclusive of equity portfolio and direct investment.
2/ Exports of goods and services.
3/ Excluding repurchase of debt.

Table 4. Poland: General Government Revenues and Expenditures, 2000-05
(In percent of GDP)

	2000	2001	2002	2003	2004 Est.	2005 Proj.
General government revenue	37.5	38.2	38.3	38.5	38.2	38.4
Direct taxes	20.7	20.1	19.5	19.4	19.2	19.5
Indirect taxes	11.0	10.8	11.5	11.7	11.4	12.2
Other taxes and nontax	5.7	7.3	7.3	7.5	7.6	6.7
General government expenditure 1/	40.9	43.6	44.6	44.4	44.3	44.1
Goods and services	17.0	17.7	18.0	15.8	16.5	16.6
Transfers and subsidies	18.6	20.4	20.6	22.6	21.6	21.1
Interest payments	2.6	2.9	3.2	3.1	2.7	2.7
Capital and net lending	2.7	2.6	2.7	2.9	3.6	3.7
General government balance (cash) 2/	-3.4	-5.3	-6.2	-5.9	-6.1	-5.7
Financing	3.4	5.3	6.2	5.9	6.1	5.7
Domestic	0.4	6.0	5.5	4.7	4.6	4.9
External	-0.7	-1.5	0.5	0.8	0.4	0.4
Privatization	3.7	0.9	0.3	0.4	1.2	0.5
Memorandum items:						
Structural balance	-4.2	-4.9	-4.9	-4.7	-5.4	-4.9
Corrected structural balance 3/	-4.2	-4.9	-4.9	-4.7	-5.4	-5.3
Primary balance	-0.9	-2.5	-3.0	-2.7	-3.4	-3.0
ESA95 deficit with OFEs inside general government	-1.8	-3.9	-3.6	-4.5	-4.6	-4.2
ESA95 deficit with OFEs outside general government	-2.8	-5.3	-5.5	-6.2	-6.4	-5.8
State balance (cash)	-2.1	-4.3	-5.0	-4.5	-5.9	-4.9
Rest of government balance	-1.3	-1.1	-1.2	-1.3	-0.3	-0.8
Public debt (including guarantees) 4/ 5/	…	41.0	46.7	51.5	50.2	53.5
Public debt (excluding guarantees) 4/	…	39.7	45.1	50.1	48.8	52.3

Sources: Polish authorities and staff estimates and projections.
1/ In 2004, the transfer to the FUS (Social Security Fund) to compensate for contributions paid to the OFEs is treated as an expenditure.
2/ General government overall balance on a cash basis including payments in compensation for insufficient indexation in the 1990s.
3/ The improvements in the overall an structural balances in 2005 are in large part due to the postponement of the indexation of pensions to 2006. The corrected structural balance nets this effect out.
4/ Polish definition of public debt.
5/ Including the risk-weighted stock of outstanding state guarantees.

Table 5. Public Social Expenditure in OECD Countries, 2001
(In percent of GDP)

	Total public social expenditure	Pensions (old age and survivors)	Income support to the working age population	Health	Total Cash	Total Services	Active Labor Market Programs	Spending Relative to the Size of Old-Age Population	
								Pension	Health
Australia	18.0	4.3	5.5	6.2	9.9	7.7	0.4	0.4	0.5
Austria	26.0	12.9	6.0	5.2	18.9	6.5	0.5	0.8	0.3
Belgium	27.2	11.2	6.6	6.4	17.8	8.1	1.3	0.7	0.4
Canada	17.8	5.3	2.8	6.7	8.0	9.4	0.4	0.4	0.5
Czech Republic	20.1	7.6	4.8	6.7	12.4	7.5	0.2	0.6	0.5
Denmark	29.2	6.5	8.7	7.1	15.2	12.5	1.5	0.4	0.5
Finland	24.8	8.0	7.3	5.3	15.4	8.5	0.9	0.5	0.4
France	28.5	11.9	6.0	7.2	17.9	9.2	1.3	0.7	0.4
Germany	27.4	11.2	4.5	8.0	15.6	10.6	1.1	0.7	0.5
Greece	24.3	13.4	3.1	5.2	16.5	7.7	0.2	0.8	0.3
Hungary	20.1	7.7	5.3	5.1	13.0	6.6	0.5	0.5	0.3
Iceland	19.8	4.7	3.8	7.5	8.4	11.3	0.1	0.4	0.6
Ireland	13.8	3.2	4.4	4.9	7.5	5.5	0.7	0.3	0.4
Italy	24.4	13.8	3.3	6.3	17.1	6.9	0.5	0.8	0.3
Japan	16.9	7.6	1.5	6.3	9.1	7.5	0.3	0.4	0.4
Korea	6.1	1.3	1.0	3.2	2.3	3.6	0.3	0.2	0.5
Luxembourg	20.8	8.0	6.5	4.8	14.5	6.2	0.1	0.6	0.3
Mexico	11.8	7.6	0.4	2.7	8.0	3.7	0.1	1.6	0.6
Netherlands	21.8	6.4	6.9	5.7	13.3	6.9	1.5	2.6	2.3
New Zealand	18.5	4.9	6.7	6.1	11.6	6.4	0.5	0.4	0.5
Norway	23.9	4.8	6.8	6.8	11.6	11.5	0.8	0.3	0.4
Poland	**23.0**	**10.6**	**7.3**	**4.4**	**17.9**	**5.0**	**0.1**	**0.9**	**0.4**
Portugal	21.1	9.1	4.2	6.3	13.2	7.3	0.6	0.6	0.4
Slovak Republic	17.9	6.6	5.3	5.0	11.9	5.6	0.4	0.6	0.4
Spain	19.6	8.7	4.1	5.4	12.8	6.0	0.8	0.5	0.3
Sweden	28.9	7.4	7.0	7.4	14.4	13.2	1.4	0.4	0.4
Switzerland	26.4	13.1	5.1	6.4	18.2	7.8	0.5	0.8	0.4
Turkey	13.2	6.3	2.6	3.9	8.9	4.1	0.1	1.1	0.7
United Kingdom	21.8	8.3	5.9	6.1	14.1	7.3	0.3	0.5	0.4
United States	14.8	6.1	1.8	6.2	7.9	6.7	0.2	0.5	0.5
OECD Average	**20.9**	**8.0**	**4.8**	**5.8**	**12.8**	**7.6**	**0.6**	**0.7**	**0.5**

Source: OECD (2004), Social Expenditure database 1980-2001.

Table 6. Poland: Savings and Investment Balance-Baseline Scenario, 2000-10

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
					Est.			Proj.			
					In percent of GDP						
Consumption	81.9	82.9	84.5	83.6	81.9	81.8	81.6	81.0	80.4	80.0	79.6
Non-government	62.9	64.0	65.4	65.0	63.7	63.8	63.9	63.7	63.4	63.1	62.9
Government	19.0	19.0	19.1	18.6	18.2	18.0	17.6	17.3	17.0	16.9	16.7
Investment	24.7	20.7	18.9	18.9	20.0	20.2	20.8	21.8	22.7	23.8	24.8
Fixed capital	23.5	20.7	19.0	18.4	18.3	18.3	19.0	19.9	20.9	21.9	22.9
Non-government	20.0	17.2	15.4	15.0	15.2	14.7	14.9	15.8	16.7	17.7	19.0
Public sector	3.5	3.5	3.6	3.4	3.1	3.7	4.1	4.1	4.2	4.2	3.9
Change in inventories	1.1	0.1	-0.1	0.5	1.8	1.8	1.9	1.9	1.9	1.9	1.9
Total savings	24.7	20.7	18.9	18.9	20.0	20.2	20.8	21.8	22.7	23.8	24.8
Domestic savings	18.7	17.8	16.2	16.7	19.0	19.4	19.7	20.4	21.1	21.6	22.0
Non-government	17.8	19.4	18.6	18.5	22.0	20.8	21.1	20.6	21.8	21.2	22.4
General government	0.9	-1.6	-2.4	-1.8	-3.1	-1.5	-1.4	-0.2	-0.7	0.4	-0.4
Foreign savings 1/	6.0	2.9	2.6	2.2	1.1	0.8	1.2	1.4	1.7	2.1	2.8
						In percent					
Memorandum items:											
Real GDP growth	4.0	1.0	1.4	3.8	5.4	3.7	4.0	3.8	3.8	3.7	3.8
Private consumption											
Real growth	*2.8*	*2.1*	*3.3*	*3.1*	*3.4*	*2.9*	*3.9*	*3.5*	*3.5*	*3.5*	*3.8*
Contribution to GDP growth	1.8	1.3	2.1	2.0	2.2	1.8	2.5	2.2	2.2	2.2	2.4
Public consumption											
Real growth	*1.6*	*0.6*	*0.6*	*0.2*	*1.4*	*1.3*	*1.5*	*1.5*	*1.5*	*1.5*	*1.5*
Contribution to GDP growth	0.3	0.1	0.1	0.0	0.3	0.2	0.3	0.3	0.2	0.2	0.2
Fixed investment											
Real growth	*2.7*	*-8.8*	*-5.8*	*-0.2*	*5.3*	*2.3*	*7.4*	*9.0*	*9.0*	*9.0*	*9.0*
Contribution to GDP growth	0.6	-2.0	-1.2	0.0	1.0	0.4	1.3	1.7	1.8	1.9	2.0
Change in inventories											
Contribution to GDP growth	0.6	-1.0	-0.2	0.6	1.7	0.1	0.1	0.1	0.1	0.1	0.1
External balance											
Contribution to GDP growth	0.6	2.6	0.5	1.1	0.3	1.0	-0.2	-0.4	-0.5	-0.7	-0.8

Sources: Polish authorities; and IMF staff estimates and calculations.
1/ BOP basis current account deficit less capital transfers.

Table 7. Poland: Medium-Term Fiscal Developments, Baseline Scenario 2004-10 [1/]

	2004	2005	2006	2007	2008	2009	2010
	(In percent of GDP, unless otherwise indicated)						
Budget deficit							
Primary revenue	38.2	38.4	38.6	38.6	38.6	38.5	38.5
Primary expenditure	41.6	41.5	42.0	41.5	41.8	41.0	41.2
Primary balance	-3.4	-3.1	-3.4	-2.9	-3.2	-2.5	-2.6
Interest costs	2.7	2.7	2.6	2.6	2.7	2.9	2.9
Overall balance	-6.1	-5.7	-6.1	-5.4	-5.9	-5.3	-5.6
Debt sustainability indicators							
Public debt (Polish definition) [2/]	50.2	53.6	55.7	58.1	60.5	62.4	64.9
Public debt excluding guarantees (Polish definition) [2/]	48.8	52.3	54.4	56.7	59.0	60.9	63.2
Assumptions							
Real growth (ppa)	5.4	3.7	4.0	3.8	3.8	3.7	3.8
90-day T-bill rate (ppa)	6.0	4.4	4.7	4.9	4.9	5.0	5.0
Rate of real appreciation (CPI based, ppa)	7.0	5.0	0.0	0.0	0.0	0.0	0.0
GDP deflator (percentage change)	3.0	2.7	2.8	2.8	2.8	2.8	2.8

Sources: Data provided by the authorities; and Fund staff estimates and projections.
1/ The general government.
2/ The definition of public debt in Poland includes the risk-weighted stock of outstanding government guarantees and the debts of some public institutions that are outside the general government.

Table 8. Poland: Public Sector Debt Sustainability Analysis, 2000-2010
(In percent of GDP, unless otherwise indicated)

	Actual							Projections					
	2000	2001	2002	2003	2004			2005	2006	2007	2008	2009	2010
								I. Baseline Projections					
1 **Public sector debt 1/**	38.7	39.7	45.1	50.1	48.8			**52.3**	**54.4**	**56.7**	**59.0**	**60.9**	**63.2**
o/w foreign-currency denominated	0.0	13.0	14.0	15.8	12.7			13.9	13.3	13.5	13.6	13.6	13.6
2 Change in public sector debt	-3.2	1.0	5.4	4.9	-1.2			3.5	2.1	2.3	2.3	1.9	2.3
3 Identified debt-creating flows (4+7+12)	-4.9	2.6	4.5	3.2	-1.8			2.5	2.2	1.7	2.0	1.5	1.8
4 Primary deficit	0.4	2.5	3.0	2.7	3.4			3.0	3.3	2.7	3.1	2.4	2.6
5 Revenue and grants	37.5	38.2	38.2	38.5	38.2			38.4	38.6	38.6	38.6	38.5	38.5
6 Primary (noninterest) expenditure	37.9	40.7	41.3	41.3	41.6			41.4	41.9	41.3	41.7	40.9	41.1
7 Automatic debt dynamics 2/	-1.6	1.0	1.7	0.8	-4.3			0.0	-0.4	-0.6	-0.7	-0.7	-0.8
8 Contribution from interest rate/growth differential 3/	-1.6	1.0	2.2	1.2	-1.2			0.0	-0.4	-0.6	-0.7	-0.7	-0.8
9 Of which contribution from real interest rate	-0.1	1.4	2.7	2.8	1.3			1.7	1.6	1.3	1.3	1.4	1.4
10 Of which contribution from real GDP growth	-1.5	-0.4	-0.5	-1.6	-2.5			-1.7	-2.0	-1.9	-2.0	-2.1	-2.2
11 Contribution from exchange rate depreciation 4/	0.0	0.0	-0.5	-0.4	-3.1			...	...	...	...	...	...
12 Other identified debt-creating flows	-3.7	-0.9	-0.3	-0.4	-0.9			-0.5	-0.7	-0.4	-0.4	-0.2	0.0
13 Privatization receipts (negative)	-3.7	-0.9	-0.3	-0.4	-0.9			-0.5	-0.7	-0.4	-0.4	-0.2	0.0
14 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
15 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
16 Residual, including asset changes (2-3) 5/	1.7	-1.6	0.9	1.7	0.6			1.0	-0.1	0.5	0.3	0.4	0.5
Public sector debt-to-revenue ratio 1/	103.4	103.9	118.0	130.0	127.8			136.3	141.0	146.9	152.9	158.3	164.1
Gross financing need 6/	3.0	5.3	6.3	5.9	6.1			5.7	6.1	5.4	5.9	5.3	5.6
in billions of U.S. dollars	4.9	9.9	12.0	12.3	14.8			16.5	18.6	17.7	20.5	19.7	21.9
Key Macroeconomic and Fiscal Assumptions						10-Year Historical Average	10-Year Standard Deviation						
Real GDP growth (in percent)	4.0	1.0	1.4	3.8	5.4	4.1	1.9	3.7	4.0	3.8	3.8	3.7	3.8
Average nominal interest rate on public debt (in percent) 7/	6.8	7.8	8.4	7.2	5.9	7.2	1.0	6.0	5.6	5.3	5.3	5.4	5.3
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.0	3.8	5.6	5.0	3.0	2.7	1.5	3.7	3.3	2.7	2.6	2.6	2.6
Nominal appreciation (increase in US dollar value of local currency, in percent)	0.1	3.9	3.8	2.6	25.1	0.3	13.3	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	6.7	4.0	1.3	0.7	2.9	7.3	6.1	2.2	2.3	2.6	2.7	2.7	2.7
Growth of real primary spending (deflated by GDP deflator, in percent)	0.6	8.6	2.9	3.7	6.2	5.2	3.9	3.1	5.3	2.4	4.6	1.7	4.3
Primary deficit	0.4	2.5	3.0	2.7	3.4	1.4	1.5	3.0	3.3	2.7	3.1	2.4	2.6
								II. Stress Tests for Public Debt Ratio					
A. Alternative Scenarios													
A1. Key variables are at their historical averages in 2006-10 8/								**52.3**	**52.2**	**53.1**	**53.7**	**54.6**	**55.8**
A2. No policy change (constant primary balance) in 2006-10								**52.3**	**54.2**	**56.8**	**59.1**	**61.7**	**64.5**
A3. Country-specific shock in 2006, with reduction in GDP growth (relative to baseline) of 2 3/4 percent for two years								**52.4**	**55.5**	**61.5**	**67.4**	**71.2**	**75.3**
A4. Selected variables are consistent with market forecast in 2005-10								**52.0**	**53.5**	**55.8**	**58.1**	**60.0**	**62.3**
B. Bound Tests													
B1. Real interest rate is at historical average plus two standard deviations in 2006 and 20067								**52.3**	**55.8**	**59.8**	**62.1**	**64.0**	**66.2**
B2. Real GDP growth is at historical average minus two standard deviations in 2006 and 20067								**52.3**	**57.9**	**65.4**	**70.8**	**75.7**	**80.9**
B3. Primary balance is at historical average minus two standard deviations in 2006 and 2007								**52.3**	**55.5**	**59.4**	**61.7**	**63.5**	**65.8**
B4. Combination of B1-B3 using one standard deviation shocks								**52.3**	**55.5**	**59.7**	**62.0**	**63.9**	**66.1**
B5. One time 30 percent real depreciation in 2006 10/								**52.3**	**61.0**	**63.2**	**65.5**	**67.3**	**69.4**
B6. 10 percent of GDP increase in other debt-creating flows in 2006								**52.3**	**64.4**	**66.6**	**68.7**	**70.5**	**72.6**

1/ Public sector gross debt (Polish definition, excluding the risk-weighted stock of guarantees).
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/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ Derived as nominal interest expenditure divided by previous period debt stock.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ The implied change in other key variables under this scenario is discussed in the text.
10/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
11/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table 9. Poland: External Debt Sustainability Framework, 2000-10
(In percent of GDP, unless otherwise indicated)

	Actual 2000	2001	2002	2003	2004			Projections 2005	2006	2007	2008	2009	2010	
								I. Baseline Projections						Debt-stabilizing non-interest current account 6/
1 **External debt**	41.7	38.7	44.3	50.5	52.3			**46.6**	**46.6**	**46.7**	**46.8**	**47.3**	**48.0**	**-2.9**
2 Change in external debt	2.0	-3.0	5.6	6.2	1.8			-5.7	0.0	0.1	0.2	0.5	0.6	
3 Identified external debt-creating flows (4+8+9)	0.2	-3.5	0.6	-3.0	-7.8			-2.5	-2.3	-1.9	-1.6	-1.2	-0.7	
4 Current account deficit, excluding interest payments	4.3	1.5	1.3	-0.3	-0.8			-0.9	-0.6	-0.4	0.0	0.5	1.1	
5 Deficit in balance of goods and services	6.5	3.7	3.3	2.5	1.9			2.0	2.4	2.8	3.2	3.7	4.4	
6 Exports	27.8	27.7	29.7	34.4	39.2			38.4	39.6	41.5	43.3	45.2	47.2	
7 Imports	34.3	31.4	33.0	36.9	41.1			40.3	42.0	44.3	46.4	48.9	51.6	
8 Net non-debt creating capital inflows (negative)	-5.9	-2.9	-1.6	-1.6	-3.0			-2.9	-2.9	-3.0	-3.1	-3.3	-3.4	
9 Automatic debt dynamics 1/	1.7	-2.1	0.8	-1.1	-4.0			1.3	1.3	1.5	1.5	1.6	1.6	
10 Contribution from nominal interest rate	2.2	2.2	2.0	2.7	2.8			2.9	3.0	3.1	3.2	3.3	3.3	
11 Contribution from real GDP growth	-1.6	-0.4	-0.5	-1.5	-2.4			-1.6	-1.7	-1.7	-1.7	-1.6	-1.7	
12 Contribution from price and exchange rate changes 2/	1.1	-3.9	-0.6	-2.4	-4.4			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	1.8	0.6	5.0	9.1	9.6			-3.2	2.2	2.0	1.8	1.7	1.3	
External debt-to-exports ratio (in percent)	150.0	140.0	149.5	146.8	133.4			121.5	117.5	112.3	108.2	104.8	101.6	
Gross external financing need (in billions of US dollars) 4/	28.5	27.6	28.0	33.4	37.7			39.9	46.4	43.1	50.3	55.1	58.9	
in percent of GDP	17.1	14.9	14.6	15.9	15.5			13.9	15.2	13.2	14.5	14.9	15.0	
Key Macroeconomic Assumptions						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	4.0	1.0	1.4	3.8	5.4	4.1	1.9	3.7	4.0	3.8	3.8	3.7	3.8	3.8
GDP deflator in US dollars (change in percent)	-2.6	10.4	1.6	5.6	9.5	2.6	6.4	14.6	2.3	2.6	2.7	2.3	2.3	4.5
Nominal external interest rate (in percent)	5.7	5.8	5.3	6.8	6.3	5.9	0.7	6.5	6.9	7.1	7.3	7.4	7.5	7.1
Growth of exports (US dollar terms, in percent)	20.5	11.0	10.4	27.1	31.6	12.1	12.9	16.3	9.9	11.6	11.0	10.9	10.9	11.8
Growth of imports (US dollar terms, in percent)	9.8	1.9	8.4	22.5	28.8	13.1	9.6	16.5	10.9	12.2	11.7	11.9	12.1	12.5
Current account balance, excluding interest payments	-4.3	-1.5	-1.3	0.3	0.8	-2.1	2.3	0.9	0.6	0.4	0.0	-0.5	-1.1	0.1
Net non-debt creating capital inflows	5.9	2.9	1.6	1.6	3.0	3.4	1.4	2.9	2.9	3.0	3.1	3.3	3.4	3.1
								II. Stress Tests for External Debt Ratio						Debt-stabilizing non-interest current account 6/
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2005-09 5/								**46.6**	**48.2**	**49.6**	**50.9**	**51.9**	**52.5**	**-3.9**
A2. Country-specific shock in 2005, with reduction in GDP growth (relative to baseline) of one standard deviation.								**46.6**	**46.6**	**46.7**	**46.8**	**47.3**	**48.0**	**-2.9**
A3. Selected variables are consistent with market forecast in 2005-09								**46.6**	**46.6**	**46.7**	**46.8**	**47.3**	**48.0**	**-2.9**
B. Bound Tests														
B1. Nominal interest rate is at historical average plus two standard deviations in 2005 and 2006								**46.6**	**46.7**	**46.8**	**47.0**	**47.5**	**48.1**	**-2.9**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**46.6**	**48.3**	**50.1**	**50.3**	**50.9**	**51.4**	**-3.1**
B3. Change in US dollar GDP deflator is at historical average minus two standard deviations in 2005 and 2006								**46.6**	**53.2**	**60.9**	**61.2**	**61.7**	**62.2**	**-3.8**
B4. Non-interest current account is at historical average minus two standard deviations in 2005 and 2006								**46.6**	**54.0**	**61.2**	**61.5**	**62.2**	**63.0**	**-2.7**
B5. Combination of B1-B4 using one standard deviation shocks								**46.6**	**55.4**	**64.6**	**64.9**	**65.6**	**66.5**	**-3.3**
B6. One time 30 percent nominal depreciation in 2005								**46.6**	**66.8**	**67.1**	**67.3**	**67.9**	**68.3**	**-4.1**

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, ε = nominal appreciation (increase in dollar value of domestic currency), and α = 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/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 10. Poland: Indicators of External Vulnerability, 2000-05
(In percent of GDP, unless otherwise indicated)

	2000	2001	2002	2003	2004	2005 Proj.	Date of Observation
Financial indicators							
Public sector debt (in percent of GDP) 1/	...	39.7	45.1	50.1	48.8	52.3	*Proj. for 2005*
Broad money (percent change, 12-month basis)	11.9	9.2	-2.0	5.6	8.6	11.0	*Apr-05*
Private sector credit (percent change, 12 month basis)	17.3	9.2	5.0	8.0	2.9	5.3	*Apr-05*
Domestic credit to GDP	29.3	34.2	33.4	34.3	34.1	...	
13 week T-Bill rate 2/	16.8	11.2	6.1	5.3	6.3	5.4	*Apr-05*
13 week T-Bill real rate 3/	7.6	7.4	5.2	3.5	1.8	2.3	*Apr-05*
External Indicators							
Exports (percent change, 12-month basis in US$)	20.5	11.0	10.4	27.1	31.6	16.3	*Proj. for 2005*
Imports (percent change, 12-month basis in US$)	9.8	1.9	8.4	22.5	28.8	16.5	*Proj. for 2005*
Current account balance	-6.0	-2.9	-2.6	-2.2	-1.5	-1.3	*Proj. for 2005*
Capital and financial account balance	6.2	1.7	3.7	1.7	0.6	1.5	*Proj. for 2005*
o/w: Inward portfolio investment (debt securities etc.)	2.1	0.6	1.6	1.8	4.5	4.2	*Proj. for 2005*
Other investment (loans, trade credits etc.)	0.7	0.4	0.2	-0.3	-1.2	-0.9	*Proj. for 2005*
Inward foreign direct investment	5.6	3.1	2.2	2.0	2.5	2.4	*Proj. for 2005*
Net Foreign Assets (NFA) of commercial banks (in billions of US$)	31.8	33.3	33.8	35.8	46.3	...	
Official reserves (in billions US$)	27.5	26.6	29.8	34.2	36.8	40.8	*Apr-05*
Official reserves in months of imports of goods	6.8	6.5	6.6	6.1	5.1	4.4	*Proj. for 2005*
Reserve money to reserves (Ratio)	0.4	0.6	0.5	0.5	0.6	0.5	*Apr-05*
Broad money to reserves (Ratio)	2.5	3.0	2.6	2.6	2.7	...	
Total short term external debt to reserves (in percent) 4/	34.8	41.9	46.6	59.7	63.2	62.4	*Proj. for 2005*
Total external debt (in billions of US$)	69.5	72.0	84.9	105.9	126.7	134.2	*Proj. for 2005*
o/w: Central and local government debt (in billions of US$)	33.0	29.3	35.7	44.0	57.7	...	
Ratio of short-term external debt to total external debt (in percent)	13.7	15.5	16.4	19.3	18.4	...	
Exchange rate (per US$, period average)	4.3	4.1	4.1	3.9	3.7	3.3	*May-05*
REER depreciation (-) (12-month growth, period average) 5/	8.4	13.8	-3.2	-9.8	0.3	8.2	*Feb-05*
Financial Market Indicators							
Stock market index	17,847	13,922	13,845	20,820	26,636	27,425	*8-Jun-05*
Foreign currency debt rating							
Standard and Poor's 6/	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+	*1-Jun-05*
Moody's 7/	Baa1	Baa1	A2	A2	A2	A2	*1-Jun-05*
Spread, JP Morgan's EMBI index	241	195	185	76	69	57	*8-Jun-05*

Sources: Bloomberg; Polish authorities; and IMF staff estimates and calculations.
1/ Polish definition of public debt excluding the risk-weighted stock of guarantees.
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.

POLAND: FUND RELATIONS
(As of May 31, 2005)

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	970.63	70.90
Reserve position in Fund	398.37	29.10

III. **SDR Department**

	SDR Million	Percent Allocation
Holdings	49.97	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.

Poland maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for the exchange restrictions imposed by Poland solely for the preservation of national or international security that have been notified to the Fund pursuant to Executive Board Decision No. 144–(52/51). Those exchange restrictions are contained in the following legal instruments:

- Council Regulation (EC) No. 2488/2000 of November 14, 2000, as amended (freezing of funds and economic resources of former Yugoslav President Slobodan Milosevic and certain other natural persons).

- Council Regulation (EC) No. 2580/2001 of December 28, 2001, as amended (freezing of funds and economic resources of certain persons, groups and entities with a view to combating terrorism).

- Council Regulation (EC) No. 881/2002 of May 29, 2002, as amended (freezing of funds and economic resources of persons and entities associated with Osama bin Laden, the Taliban and Al-Qaida).

- Council Regulation (EC) No. 1210/2003 of July 8, 2003, as amended (freezing of funds and economic resources of certain persons and entities in respect of Iraq).

- Council Regulation (EC) No. 314/2004 of February 24, 2004, as amended (freezing of funds and economic resources in respect of Zimbabwe).

- Council Regulation (EC) No. 798/2004 of April 28, 2004, as amended (freezing of funds and economic resources in respect of Burma/Myanmar).

- Council Regulation (EC) No. 872/2004 of April 30, 2004, as amended (freezing of funds and economic resources of persons and entities associated with Liberia's former President Taylor).

- Council Regulation (EC) No. 1763/2004 of October 14, 2004, as amended (freezing of funds and economic resources of certain persons indicted by the International Criminal Tribunal for the former Yugoslavia).

- Council Regulation (EC) No. 560/2005 of April 14, 2005 (freezing of funds and economic resources of certain persons who constitute a threat to the peace and national reconciliation process in Côte d'Ivoire).

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 modernization of operational functions	Mission	Oct. 1992	NBP
MAE	Resident expert-Advisor to President of NBP		Nov. 1991–92	NBP
MAE	Additional steps in the modernization process of the NBP	Mission	April 1993	NBP
MAE	Monetary programming and operations, and payments system	Mission	Nov. 1993	NBP
MAE	Central bank modernization	Mission	August 1994	NBP
MAE/LEG	Review of the exchange and payments system	Mission	February 1995	NBP/ MoF
MAE	Exchange rate system	Mission	March 1995	NBP
MAE	Review of government securities market, payments system and public debt management	Mission	August 1995	NBP/ MoF
MAE	Asset consolidation exercice	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. Christoph Rosenberg, the Senior Regional Resident Representative for Central and Eastern Europe, took up his duties in Warsaw in February, 2005.

POLAND—WORLD BANK ACTIVITY

46. 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$1.9 billion as of the end of 2004. At the end of 2004 eleven projects are under implementation, with an undisbursed balance of US$297 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.

47. 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$101 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 flood management, roads, Gdynia and Gdansk ports, water supply and development of geothermal resources. More recent loans include the Hard Coal Social Mitigation Loan (US$200 million), and a companion Coal Mine Closure Loan (US$100 million) which aim at supporting the government’s Coal Reform Program (2003–06), specifically by mitigating the negative effects associated with the further reduction of employment levels, and supporting closure of uneconomic production capacity in a safe and environmentally sound manner, respectively; a EUR 100 million loan for Rehabilitation and Maintenance of Roads almost fully implemented in calendar year 2004, and a follow-up loan approved by the Board of the World Bank on March 29, 2005 (EUR 100 million) for implementation mostly during calendar year 2005. Smaller institutional development grants are currently financing activities to strengthen the processes of land administration and registration and accounting and auditing.

48. The World Bank in consultation with the Polish government prepared in 2005 a Country Partnership Strategy (CPS) with three key priority areas; promoting fiscal adjustment and reversing negative debt dynamics through restructuring of expenditures; promoting convergence through an improved investment climate and enhanced competitiveness; and *r*educing poverty, encouraging social inclusion and bringing employment closer to the Lisbon targets.

49. The Bank's Executive Directors discussed the Country Partnership Strategy in March 2005. The CPS is open-ended in terms of duration, and flexible in terms of its lending and non-lending program, which is defined in annual business plans. As indicated in the CPS, yearly lending is expected to be in the US$350–400 million range in the earlier years of the strategy with amounts to be determined in the above mentioned annual business plans. Areas for potential lending during FY05 and FY06 include support for road infrastructure, flood prevention in the Odra river basin and rural development.

50. 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. In 2004 World Bank staff prepared with Government and non-Government counterparts a Living Standards Assessment, a Knowledge Economy Assessment and an Investment Climate Assessment. Preparation of Quarterly Economic Reports for the 8 new EU members in Central and Eastern Europe (EU8) started in March 2004. Work has also started in the preparation of two multi-country (covering EU8 countries), multiyear reports focusing on public finance reform and on labor market issues. The World Bank is also cooperating with Polish authorities in the process of review and consultation of the National Development Plan 2007–13. Other work which has been completed in the past couple of years includes a Public Expenditure and Institutional Review (2003), 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

51. 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

52. 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 data series, reflecting the upheavals associated with the 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.

53. 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 techniques have been delayed.

54. The concepts and definitions of the CPI follow the *ESA 95* standards and Eurostat's requirements for the Harmonized Consumer Price Index. Polish CPI does not cover the services related to owner-occupants dwellings. 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 chaining method. Time series data are available for the index with reference periods of 1990 and 1998.

55. 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 Statistical Classification of Economic Activities within the European Community, first revision (NACE, Rev.1), the Statistical Classification of Products by Activity in the European Community, and the List of Products of the European Community. The PPI does not include any estimation for missing prices and quality and seasonal adjustments are not made.

Government finance statistics

56. 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. Data, recently submitted for inclusion in the 2005 *Government Finance Statistics Yearbook* (GFSY), were for the first time compiled according to the framework of *GFSM 2001*. The authorities provided comparable data, compiled on an accrual basis, for 2001–03. This submission followed the creation of a General Government Statistics Working Group (GGSWG), comprising officials of the Ministry of Finance, the Central Bank, and the Central Statistical Office. This working group has the responsibility to implement the European System of Accounts 1995 and harmonization with fiscal data presented in the framework of *GFSM 2001*. Although the classification of transactions in the official data still needs improvements, a recent STA mission in February 2005 noted many advancements in fiscal data compilation. However, several areas need further development to fully comply with international guidelines. In the meantime, the staff makes adjustments to the official data.

57. The annual consolidated general, central and local government data are available in the GFSY. Monthly data on consolidated core operations of the central government are reported in *IFS.* The main weaknesses in data reporting are the following: (i) high frequency data have only partial coverage of units of central government. All the extrabudgetary units at central government level, and a part of the social security sector are left out. GFS data on the missing entities are only available either on semi-annual or annual basis and at timeliness from three to 10 months; (ii) fiscal source data for state budget and local authorities are reported on a cash basis. Calculations and estimates are therefore needed to adjust the data to an accrual basis; (iii) the budgetary classification does not institute concepts and systems focused on economic balances; (iv) the sectorization of the general government sector is not yet finalized, with the treatment of both the Open Pension Funds and the public health care institutions still under consideration; and (v) the reporting of annual fiscal data on the general government sector is sometimes incomplete due to delays in reporting of data on certain entities such as health care and cultural institutions.

58. Work on the implementation of *GFSM 2001* framework is well under way, although full implementation may take several years. The work done by the GGSWG will in future improve the transparency of compilation methods and improve the quality and consistency of reported data. Similarly, the development of electronic accounting and reporting systems within the MOF could improve the compilation and availability of fiscal statistics.

Monetary statistics

59. 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.

60. The data module of the Report on the Observance of Standards and Codes (ROSC) mission to 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 (MFSM)*. Nevertheless, the following concepts and principles underlying valuation and classification of financial instruments deviate from the *MFSM*: (i) financial derivatives are indistinguishably recorded under other assets/other liabilities; (ii) accrued interest on loans and deposits are included as part of other assets/other liabilities, but not with the respective underlying instruments; (iii) similarly accrued interest on securities other than shares issued by the depository corporations are included as part of other liabilities; (iv) loan-loss provisions are classified as *special reserves* under *capital accounts and reserves*; and (v) 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 fact that the first three practices noted above differ from the *MFSM* guidelines, the compilation of monetary statistics are in conformity with the ECB framework.

61. The data presented on the balance sheets of the NBP and other depository corporations provide an 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

62. While improvements have been made in the balance of payments data, some issues need to be addressed. While there are valid differences in definitions between the customs (GUS) and payment-based trade data compiled by the NBP, the two data sources need to be cross-checked for broad consistency. 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.

63. 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.

POLAND: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

AS OF JUNE 17, 2005

	Date of latest observation	Date received	Frequency of data[6]	Frequency of reporting[6]	Frequency of publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality Accuracy and reliability[8]
Exchange Rates	6/16/05	6/16/05	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]							
Reserve/Base Money	4/2005	5/31/05	M	M	M	O, LO, O, LO	O, O, O, O, O
Broad Money	4/2005	5/31/05	M	M	M		
Central Bank Balance Sheet	4/2005	5/31/05	M	M	M		
Consolidated Balance Sheet of the Banking System							
Interest Rates[2]	6/16/05	6/16/05	D	D	D		
Consumer Price Index	5/2005	6/14/05	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]						LO, O, O, O	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government							
Stocks of Central Government and Central Government-Guaranteed Debt[5]							
External Current Account Balance	3/2005	5/31/05	M	M	M	O, O, O, LO	O, O, O, O, LO
Exports and Imports of Goods and Services							
GDP/GNP	Q1/2005	6/13/05	Q	Q	Q	O, LO, O, O	LO, LO, O, O, LO
Gross External Debt							

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extrabudgetary funds, and social security funds) and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D); Weekly (W); Monthly (M); Quarterly (Q); Annually (A); Irregular (I); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC published in October 2003 and based on the findings of the mission that took place during January 8–22, 2003 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning (respectively) concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[8] Same as footnote 7, except referring to international standards concerning (respectively) source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

INTERNATIONAL MONETARY FUND

REPUBLIC OF POLAND

Staff Report for the 2005 Article IV Consultation Supplementary Information

Prepared by the European Department

Approved by Susan Schadler

July 20, 2005

1. This statement reviews developments in Poland since the preparation of the staff report for the 2005 Article IV consultation. The additional information does not change the thrust of the staff appraisal.

2. **Economic developments continue to present a mixed and rather difficult to interpret picture.**

- The deceleration of exports of goods and services (in US$) continued in May. Exports increased at a seasonally adjusted annualized (quarter-on quarter) rate of 3.7 percent in the three months through May (down from 13.9 percent in April), while imports grew at 8.1 percent (on the same basis). The slowdown in exports is somewhat more pronounced than projected by staff.

- Industrial sales (in real terms), however, picked up strongly in the three months through June, increasing at a seasonally adjusted annualized (quarter-on quarter) rate of 11.4 percent (up from -1.4 percent in May). Manufacturing sales and construction activity showed similar rebounds.

- CPI inflation was 1.6 percent in the three months through June (seasonally adjusted annualized quarter-on quarter), slightly lower than projected by staff.

- Labor costs in the corporate sector jumped in recent months, but it is too early to tell if this is due to one-off effects, delayed adjustment to decelerating inflation and production (until May), or genuine wage pressures. Nominal unit labor costs in manufacturing increased at a seasonally adjusted quarter-on quarter annualized rate of 12.2 percent in the three months to May, up from about 7 percent in the three months to March. Nominal wages in the enterprise sector rose at a seasonally adjusted quarter-on-quarter annualized rate of 5 percent in the quarter to June, up from 2.7 percent in the quarter to May.

- Unemployment continued to fall in May, dropping to 18.4 percent (seasonally adjusted). Seasonally adjusted employment in the enterprise sector, however, remained unchanged during February through June.

3. **In June, the MPC cut policy rates by 50 basis points for the third time this year and adopted an easing bias.** The central policy rate now stands at 5 percent. Despite the cut, the zloty remained broadly stable against the euro. Financial markets are pricing in further reduction in interest rates amounting to about 75 basis points by the end of 2005.

4. **In a pre-election environment, several pieces of legislation have been passed by one of the houses of Parliament and if they survive the rest of the legislative process, they would have negative economic and fiscal implications.** Legislative actions initiated by MPs, and opposed by the government, would: change the formula for indexing the minimum wage with the aim of gradually raising the minimum wage to half of the average wage; cap the interest and other costs lenders can charge on loans, despite opposition from the NBP; postpone the planned curtailment of access to early retirement (official estimates put the total cost to the budget of this change in 2007-10 at about 1½ percent of GDP); and allow individuals to reclaim part of the VAT paid on construction and refurbishment materials to compensate for the increase in the rate following EU accession (the MoF estimates that the total cost of this legislation would be about ½ percent of GDP in 2006-2009, when the refunds could be claimed). None of these pieces of legislation has entered into force pending approval by both houses of Parliament and the President.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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

IMF Executive Board Concludes 2005 Article IV Consultation with the Republic of Poland

On July 22, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Poland.[1]

Background

In 2004 annual growth reached 5½ percent, with a surge in growth in the run-up to EU accession dissipating in the second half of 2004. Both domestic and net external demand contributed to the slowdown. Consumption and inventory accumulation had supported output growth as contribution of net external demand diminished, but by mid-2004 these sources of demand growth slackened. Private fixed investment has lagged behind the cycle, indicating that potential investors remained cautious. Strong corporate profits thus translated mostly into an accumulation of financial assets and a reduction in bank credit to the corporate sector. Export growth, which led the 2002–03 recovery, hit a soft spot in mid 2004, but by end-year had rebounded to annual rates of about 40 percent despite the slackening demand in Western Europe and the appreciation of the zloty during the second half of the year. Preliminary official data for the first quarter of 2005 show flat domestic demand, mostly owing to a decline in highly import intensive investment and inventory—with little immediate negative effect on domestic production.

The recovery has started to produce jobs, but the employment rate remains low owing to structural rigidities and demographic pressures. The Russia crisis and the rapid appreciation of the zloty in 2001 created two large waves of job destruction as a baby-boom generation

[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.

entered the labor market. Job creation was stymied by supply side problems—skill mismatches, immobility between regions, and disincentives to work—while demand was weakened by the cycle, poor infrastructure particularly in high unemployment regions, and high non-wage costs of employment. Thus, the employment rate, which was close to the euro area average until 1998, is now 52 percent—the lowest in the EU. These developments have their counterpart in impressive productivity gains during the recovery, and, as high unemployment has kept wage growth low, falling unit labor costs.

Resource constraints have not been evident in either inflation or the current account. A pickup in nominal wage growth combined with a sizable upward shift in food prices resulting from the full liberalization of agricultural exports and high oil prices created price pressures. Monetary policy reacted swiftly with a cumulative 125-basis point rate hike during June-August. This, together with apparently tame inflation expectations, a deceleration of demand, contained inflation and wage increases. Meanwhile the current account deficit narrowed for the year as a whole. Against export growth which on average was strong, import growth picked up modestly with investment.

Fiscal policy remained adrift in 2004. Adding EU-accession related spending to a cut in the corporate tax rate and upward drift in non-discretionary spending resulted in a sizable (though lower-than-initially projected) procyclical rise in the general government deficit . Despite strong efforts of the Belka government to secure Parliamentary approval of fiscal reforms (Hausner Plan), about a third (in terms of potential savings) of the plan was implemented. Some key reforms—reform of the farmer pension scheme, closing social security contribution loopholes and reining in disability programs were among the unsuccessful—though pre-retirement benefits were reined in and pension indexation rules were changed. Notwithstanding the large deficit, a renewal of the privatization program alongside the zloty appreciation and strong growth resulted in the first drop in the debt ratio in four years.

Despite low inflation, long-term interest rates rose sharply in mid-2003 and a two-year depreciation of the zloty persisted following the announcement of an expansionary 2004 budget. But the simultaneous EU accession, formation of the pro-reform Belka government, and signs of stronger-than expected budgetary developments (including privatization) turned financial markets strongly positive during 2004. Thus despite narrowing interest rate differentials vis-à-vis the euro and the dollar, the zloty appreciated through early 2005.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. They congratulated the Polish authorities on a successful first year in the European Union. They noted the positive market reactions to the government's efforts to contain the budget deficit and gain parliamentary approval of fiscal reforms, reinvigorate privatization, and improve debt management. Directors agreed that the many strengths of Poland's macroeconomic position provide a basis for sustained high growth in the future.

At the same time, Directors noted that the stalling of growth momentum since mid-2004 might reflect remaining impediments to growth. While the slowdown from the heady growth rates a year ago is likely to be temporary if underlying conditions remain broadly favorable, it had dampened hopes that Poland had entered a period of substantially higher investment and growth sufficient to make a serious dent in its strikingly low employment rate. Directors therefore emphasized that more needs to be done to enable the economy to achieve its full potential, building on the steps already taken in recent years. This requires a strong commitment to fiscal and structural reforms aimed at ensuring long-term sustainability of public finances, enhancing the flexibility of the economy, particularly in the labor market, and improving the business climate. These steps should also help secure a favorable setting for euro adoption.

Directors felt that the immediate post-election period offers a window of opportunity for fiscal consolidation and expenditure reform. They encouraged the authorities to consider further steps to keep the fiscal deficit and the public debt ratio on a downward track, while protecting investment plans envisaged in the convergence program. In this regard, Directors stressed that the most important macroeconomic challenge for the next government would be to set clear medium-term fiscal policy goals and secure parliamentary support for them. Achieving these targets in a manner that would enhance growth potential requires a well-formulated fiscal strategy, focused on a restructuring of poorly-targeted social transfers, as well as the reform of the farmers' pension scheme and the disability program. The positive economic impact of such reforms could be further supported by a well-designed tax reform, aimed at simplifying the tax system in a revenue-neutral manner. The proposals for single-rate personal and corporate income and value-added taxes from both sides of the political spectrum provide a good starting point. Directors urged the authorities to resist the adoption of recent pre-election legislative initiatives that would hinder fiscal consolidation in the medium term.

Directors agreed that a fiscal responsibility law would help buttress political resolve and bring forward the beneficial effects of fiscal consolidation. Such a law should encompass a fiscal rule, ideally an expenditure rule, to supplement the current constitutional public debt limit; a requirement to supplement the budget with rolling three-year budget projections; and transparency requirements, including norms for independent assessment of macroeconomic assumptions and fiscal projections.

Directors emphasized that a multi-pronged approach to job creation is essential to address Poland's persistently high unemployment rate. On the fiscal front, Directors stressed the importance of reducing the tax wedge on labor and reforming the social benefit system to remove disincentives to work. In the labor market, Directors called on the authorities to further enhance flexibility and increase labor participation, particularly by making the minimum wage less binding for low-skill and young workers, differentiating it across regions, and removing unduly restrictive regulation of regular labor contracts. In this context, they expressed concern about the recent legislative initiative to increase the minimum wage relative to the average wage.

Directors considered it imperative that the new government complete the process of privatization, particularly for the financial and energy sectors, to ensure the long-term viability of companies within the competitive environment of the EU. They welcomed the progress made in privatizing the largest commercial bank and attached particular importance to setting a timetable for its full privatization.

Directors felt that a credible commitment to early euro adoption could amplify the potential benefits of fiscal consolidation and structural reforms. They also agreed that euro adoption would bring substantial benefits for trade and output growth, provided that the budget deficit remains well below the Maastricht limit, the conversion rate affords strong competitiveness, inflation is low, and labor market flexibility improves. Directors stressed that the new government should work closely with the social partners and the National Bank of Poland to reach an agreement on a timetable for euro adoption and secure broad support for required reforms.

Directors commended the authorities for their timely action to stabilize inflation expectations following the inflation fillip in 2004. Given the benign inflation outlook, they considered the recent interest rate cuts as appropriate. Looking ahead, Directors agreed that the inflation targeting framework continues to serve Poland well until ERM2 entry. They encouraged the authorities to gear interest rate decisions toward keeping inflation within a symmetric band around the inflation target to limit undue upward pressure on the zloty in the approach to ERM2. The Monetary Policy Council was also advised to improve the communication of its views and future policy intentions to markets. Directors noted steps to develop capacity for foreign exchange market intervention in preparation for ERM2, but stressed that such intervention should be avoided in the interim period. While agreeing that Poland's competitiveness is not a problem for the near term, Directors underscored the importance of basing ongoing assessments of competitiveness on a careful analysis of the medium- to longer-term outlook.

Directors welcomed the recent improvements in banking sector performance and noted the encouraging prospects for their continuation. They also welcomed the halt in the trend increase in foreign currency lending. To preserve these achievements, they encouraged the authorities to continue to carefully monitor trends in foreign currency lending and banks' lending policies and to take early action if necessary. Efforts to address institutional weaknesses, including in the commercial court system, should also help improve the soundness of the financial sector.

Notwithstanding the improvements EU accession had brought about in statistics, Directors encouraged the authorities to make further efforts to strengthen quarterly national accounts and fiscal accounts for the general government.

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.

Poland: Main Economic Indicators

	2000	2001	2002	2003	2004
Real economy (change in percent)					
Real GDP	4.0	1.0	1.4	3.8	5.4
Real domestic demand	2.8	-1.6	0.8	2.6	5.0
CPI (end-year)	8.5	3.6	0.8	1.7	4.4
Unemployment rate (in percent)	16.1	19.4	20.0	20.0	19.1
Gross domestic saving (percent of GDP) 1/	18.7	17.8	16.2	16.7	19.0
Gross domestic investment (percent of GDP)	24.7	20.7	18.9	18.9	20.0
Public finance (in percent of GDP)					
General government balance 2/	-3.4	-5.3	-6.2	-5.9	-6.1
Public debt 3/	...	41.0	46.7	51.5	50.2
Money and credit (end of period, percent change)					
Private credit (12-month change)	17.3	9.2	5.0	8.0	2.9
Broad money (12-month change)	11.9	9.2	-2.0	5.6	8.7
Money market rate (end of period, in percent)	19.2	11.6	6.7	5.5	6.7
Balance of payments in convertible currencies					
Trade balance (in percent of GDP)	-7.4	-4.1	-3.8	-2.7	-2.7
Current account (in percent of GDP)	-6.0	-2.9	-2.6	-2.2	-1.5
Official reserves (in billions of U.S. dollars)	27.5	26.6	29.8	34.2	36.8
Reserve cover (months of merchandise imports)	6.8	6.5	6.6	6.1	5.1
Total external debt (percent of GDP)	41.7	38.7	44.3	50.5	52.3
Fund position (in millions of SDRs)					
Quota					1,369.00
Fund holdings of currency (April 30, 2005)					942.91
Holdings of SDRs (April 30, 2005)					47.57
Exchange rate					
Exchange rate regime			Floating		
Present exchange rate (June 8, 2005)			Zl 3.3 = US$1		
Zloty per U.S. dollar (period average, in percent)	4.3	4.1	4.1	3.9	3.7
Appreciation (+) of real effective exchange rate (relative CPIs, in percent)	8.4	13.8	-3.2	-9.8	0.3

Sources: Central Statistical Office; data provided by Polish authorities; and IMF Staff estimates.

1/ Derived as the difference between total savings and current account deficit less capital transfers.

2/ General government overall balance on a cash basis including payments in compensation for insufficient indexation in the 1990s.

3/ Polish definition of debt including risk weighted stock of outstanding guarantees and excluding second-pillar pension funds.

Statement by Andrzej Raczko, Alternate Executive Director for the Republic of Poland and Marcin Piatkowski, Advisor to Executive Director
July 22, 2005

We would like to thank staff for the high quality report and background papers and for the excellent cooperation with our authorities. We share staff's opinion that the first year of Poland's membership in the European Union was a success. Economic growth returned to the long-term path, exports surged, inflation – aside from the one-off post-accession spike – was low, unemployment went down, and FDI went up. As a result, the past year significantly contributed to advancing the income convergence with the EU. Nonetheless, our authorities are aware that the long-term convergence will crucially depend on maintaining macroeconomic stability and implementing further structural reforms. Broadly in line with staff's recommendations, the authorities are hence committed to pursue further fiscal adjustment, continue structural reforms, increase employment, and accede to the euro zone as soon as the preconditions have been met.

Recent economic developments and prospects

After the economic slowdown in 2001-02, in 2004 the recovery further strengthened. Despite weaker growth in the euro zone, GDP expanded by 5.4 percent thanks to buoyant exports, rising private consumption, and growth in gross capital formation. The first half of last year was particularly strong, as enterprises accumulated inventory in anticipation of price increases upon EU accession. However, growth slowed in the second half of the year owing mainly to lower growth in inventory accumulation.

The modest pace of GDP growth continued in the first quarter of 2005 due to slower-than-expected acceleration in growth of fixed investment. Given the historically high capacity utilization, high corporate profitability and accumulated savings, declining interest rates, and lower corporate tax burden, the behavior of fixed investment remains somewhat of a puzzle. Nonetheless, we agree with staff that the growth in fixed investment should significantly strengthen in the second half of 2005 because of a reduction in political uncertainty upon the formation of a new government, decline in interest rates, more stable exchange rate, increasing FDI, and continued improvement in relative unit labor costs. As noted by staff, growth in fixed investment should also be helped by the cyclical rebound after the period of underinvestment in 2000-02, the launching of infrastructure projects supported by EU structural and cohesion funds, and the new law on public-private partnerships.

Growth in fixed investment, complemented by a steady increase in private consumption and the continuation of double-digit growth in exports, is projected to contribute to a GDP growth rate for the whole year 2005 of slightly below 4 percent. Going forward, a robust growth rate exceeding 4 percent a year is projected for 2006 and 2007. It will be underpinned by rising private consumption and growing fixed investment. Private consumption, which has held a remarkably stable 3 percent growth rate since 1999, will be additionally stimulated by increasing employment, rising real wages, and growing consumer borrowing spurred by historically low interest rates and low level of household debt. The contribution of net exports is projected to gradually decline, as recovery in fixed investment will stimulate imports.

However, the current account deficit will remain low at below 3 percent of GDP in 2005-06. It is projected to be fully financed by inflows of FDI, portfolio capital, and EU funds. Official foreign reserves in 2005-06 will remain at a sufficient level, covering more than four months of imports. Comfortable external position is underpinned by an easy access to international capital markets, best evidenced by several successful bond transactions in the first half of 2005 (for a total value of about USD10 billion), including the recent placement of a 50-year EUR500 million bond yielding only 38 bps over mid-rate euro swaps.

Fiscal policy

While the headline general government deficit (according to ESA-95) increased from 4.5 in 2003 to 4.6 percent of GDP in 2004, this increase mainly reflected the direct budgetary impact of EU accession, i.e. the contribution to the EU budget and co-financing for EU funded projects, which added almost 1.2 percent of GDP to the overall deficit. The budget deficit in 2004 turned out to be lower than projected thanks to the economic recovery but also due to such factors as strict control over the expenditures, simplification of the tax system, improved debt management, and lower payments on state guarantees. Lower deficit has been achieved despite large uncertainty as to the impact of EU accession-related change in the VAT settlement, loss of customs revenue, and the implementation of significant tax reforms (reduction of the corporate income tax rate from 27 to 19 percent and extension of the flat CIT rate to business income earned by individuals).

In 2004, the authorities succeeded in implementing a number of fiscal measures stipulated in the Hausner Plan. These measures resulted, among others, in the reduction of costs of public administration and lower spending on defense. The Program also improved long-term fiscal sustainability by reforming disability payments and implementing an important change in the pension indexation formula by linking it to the increase in CPI. The implementation of the Hausner Plan, although falling short of the government's expectations due to insufficient political support, has contributed to stabilizing public debt and helped advance the fiscal adjustment that is indispensable to allow Poland to exit from the EU's excessive deficit procedure and thus meet the relevant Maastricht criterion by 2007. Despite somewhat less favorable macroeconomic environment, the implementation of the 2005 budget is broadly on track thanks to the continued spending discipline and lower costs of public debt, rising corporate tax revenue, and higher revenue from dividends. Based on the performance of budget revenues and expenditures so far in the year, it is even likely that the deficit for the whole year will be by about 0.2 percent of GDP lower than budgeted. This is noteworthy given the political pressures of the election year.

The assumptions for the 2006 budget set the state budget deficit in the range of 28-34 billion zloty, down from the 35 billion zloty budgeted for 2005. This translates into a decrease in budget deficit by 0.3 to 0.9 percent of GDP, keeping Poland on the fiscal adjustment path stipulated in the Convergence Program.

The public debt to GDP ratio declined between 2003 and 2004 thanks to faster growth, revenues from privatization, and appreciation of the zloty. In 2005, public debt is projected to reach about 53 percent of GDP (based on the very conservative Polish definition of the debt). According to the Public Finance Law, when the public debt exceeds 50 percent of GDP, the government is obliged to submit a budget with a ratio of the budget deficit to revenues that is not higher than in the preceding year. The assumptions for the 2006 budget fully meet this requirement. If the public debt exceeds 55 percent, in line with the fiscal rule imposed by the Public Finance Law additional fiscal measures would have to be implemented to reach a de facto primary budget surplus. The ensuing fiscal adjustment would stabilize public debt below the 60 percent threshold stipulated in the Polish Constitution.

Nonetheless, the authorities are aware of the vulnerability of public debt to shocks, as shown in the staff report. The DSA scenario, however, is based on assumed shocks whose probability of occurring is low given the economic outlook. The assumed 2.75 percent drop in the growth rate in 2006-07 does not seem probable. Also, the staff's projections do not take into account the expected positive impact of the convergence process on the interest rates and the authorities’ response to a potential breaching of the 55 percent debt threshold.

Our authorities welcome the staff’s recommendations for the medium-term budgeting framework, which would strengthen the existing fiscal rules and make fiscal policies more predictable over time but the decision whether to implement such recommendations will need to be taken by the new government.

Monetary policy

After a significant decline in 2003, inflation accelerated in the first half of 2004 due to a temporary impact of EU accession, which resulted in increasing food prices, higher indirect taxes, and stronger domestic demand. This effect was additionally boosted by increasing oil prices. To mitigate the risk of second round effects on inflation, the Monetary Policy Council raised interest rates in the second half of the year by cumulative 1.25 percentage points. As a result of the dissipation of the EU accession price shock, timely intervention of the MPC, and strong appreciation of the zloty, inflation declined significantly and recently moved even below the continuous inflation target of 2.5 percent +/- 1.

In response to slower economic growth in the first half of 2005, and in view of the benign inflation outlook, the MPC cut interest rates by a total of 1.5 percentage point and adopted an easing bias. The inflation rate in the remaining months of 2005 and for the whole of 2006 is expected to stay below the target of 2.5 percent.

With regard to joining the EMU, since 2004 the Working Group established by the Ministry of Finance and the NBP has been working on a strategy for joining the ERM-II and the euro area. The feasibility of joining the EMU will largely depend on implementing fiscal consolidation in line with the Convergence Program. This may require adopting some additional fiscal adjustment measures, in particular in view of the expiration of the transition period for the classification of the open pension funds that is envisaged for March 2007. It is also worth emphasizing that the authorities do not view the Maastricht criteria as objectives in themselves, but rather as useful tools in ensuring fiscal sustainability and sound long-term growth prospects.

Structural reforms

Poland continues to make progress in structural reforms. Thanks to the full adoption of EU regulations, implementation of the Economic Freedom Act, which substantially cut administrative burden on enterprises, and reduction in corporate taxes, the business climate improved. The World Bank's "Doing Business in 2005" survey classified Poland among the top 10 reformers in 2003.

Nevertheless, a number of structural challenges remain to be resolved. These in particular relate to the high structural unemployment and the low employment ratio. We broadly share staff's assessment of the situation in the labor market and their recommendations for policy actions. In fact, during the last couple of years the authorities have undertaken a number of initiatives, as described in staff's papers, which are closely aligned with staff's recommendations. Along with faster growth, these initiatives contributed to the decline in unemployment from 20.0 percent in 2003 to 19.1 percent in 2004, and to projected 17.5 percent by the end of this year.

Going forward, the authorities aim to follow up on the recent initiatives by strengthening the 50+ Program to increase labor participation of older workers and ease labor market entry for the youth by expanding the successful First Job program. In addition, earlier this month the lower chamber of the parliament adopted a new bill that should increase employment by significantly reducing the tax wedge on newly registered self-employment. However, any further reduction in the tax wedge will be subjected to the overarching goal of achieving the planned fiscal consolidation.

As a result of these initiatives, the unemployment rate is projected to decrease to 16.5 percent in 2006 and to 15.0 percent in 2007, while the employment ratio should exceed 53 percent. These trends will be helped by the improving quality of human capital (between 1991 and 2004 the tertiary scholarization ratio almost quadrupled from 13.1 to 47.0 percent and exceeded the EU average), fading of the demographic boom (labor supply will decline to 100 thousand in 2006 versus 215 thousand on average per year between 2000 and 2005), slowing labor shedding in restructuring enterprises, EU-funded improvements in infrastructure, which should enhance labor mobility, and higher spending on active labor market policies. Reduction in the access to pre-retirement and disability benefits adopted within the framework of the Hausner Plan should further add to increasing employment.

The pension reform implemented in 1999, which replaced the earlier pay-as-you-go system (PAYG) with a three-pillar scheme, should also gradually improve the situation in the labor market by providing incentives for longer working life. In turn, raising employment is crucial to improve the sustainability of the new pension system, as shown in the excellent Selected Issues paper. While the projected deficits of the first pillar will last longer than originally projected, it needs to be borne in mind that without the reform the fiscal position under the old PAYG pension system would only deteriorate with time thus undermining the long-term fiscal sustainability and growth prospects. Contrary to this, the new system promises to start generating surpluses rather than deficits after 2040. Moreover, the pension reform enhances transparency of the long-term fiscal position by clarifying future public pension liabilities, provides opportunities for higher return on accumulated pension assets, and contributes to the development of financial markets and thus – indirectly – to economic growth.

Financial sector

Our authorities welcome staff’s largely favorable assessment of the domestic financial sector. In 2004, the banking sector’s profitability increased sharply, capital position strengthened, and loan quality improved. With regard to the issue of household foreign currency borrowing, in 2004 the share of foreign currency borrowing in total lending decreased for both the household and corporate sector. Notwithstanding this improvement, banking supervision encouraged banks to adopt higher collateral requirements for foreign currency denominated loans, particularly in mortgage lending, and strengthen credit risk analysis. Together with declining interest rates on borrowing in domestic currency, these measures should contribute to a further reduction in the share of foreign currency loans in total lending.

Recent legislation of the Parliament

As the staff’s Supplement informs, the Parliament has recently debated a number of its own legislative initiatives, currently in various stages of the parliamentary approval process, which could negatively affect fiscal and economic policies. At this stage, given the uncertainty concerning the final approval of these initiatives by both chambers of the Parliament and by the President, it is still not possible to assess their fiscal consequences. The government is strongly against all new legislative proposals that would have large fiscal consequences and tries to use all available legal means to prevent their final adoption.