October 2006
IMF Country Report No. 06/391

Republic of Poland: 2006 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 2006 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 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 22, 2006, 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 August 23, 2006. 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 September 29, 2006 updating information on recent developments;

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its October 4, 2006 discussion of the staff report that concluded the Article IV consultation; and

- a statement by the Alternate 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.

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

Copies of this report are available to the public from

International Monetary Fund • Publication Services
700 19th Street, N.W. • Washington, D.C. 20431
Telephone: (202) 623-7430 • Telefax: (202) 623-7201
E-mail: publications@imf.org • Internet: http://www.imf.org

Price: $18.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

REPUBLIC OF POLAND

Staff Report for the 2006 Article IV Consultation

Prepared by the Staff Representatives for the
2006 Consultation with the Republic of Poland

Approved by Michael Deppler and Adnan Mazarei

August 23, 2006

The discussions for the 2006 Article IV consultation were held in Warsaw during May 8–22, 2006. The mission met the Ministers of Finance, Labor and Social Policy, and Regional Development, the chairperson of Parliament's Public Finance Commission, the President of the National Bank of Poland (NBP), members of the Monetary Policy Council (MPC), other senior officials, and private sector representatives and academics.

The staff team comprised Ms. Schadler (head), Mr. Klingen, Mr. Lissovolik, Ms. Tamirisa, and Ms. Allard (all EUR). Messrs. Raczko (Alternate Executive Director), Piątkowski (Advisor to the Executive Director), Rosenberg (Senior Regional Representative), and Sierhej (Regional Representative's office) participated in some of the discussions.

The mission overlapped with an FSAP update mission, the findings of which were discussed with the authorities during the Article IV consultation.

The authorities released the mission's concluding statement and intend to publish this staff report. Last year's Article IV staff report was published as IMF Country Report No. 05/263 following the IMF Executive Board Meeting on July 22, 2005.

Poland's statistical database is adequate for surveillance. The quality of quarterly national accounts and general government statistics needs improvement.

Poland has accepted the obligations of Article VIII and maintains an exchange system free of restrictions on payments and transfers for current international transactions. In accordance with UN Security Council resolutions and EU Regulations, Poland maintains exchange restrictions for purposes of national and international security specified in Appendix I.

Contents Page

EXECUTIVE SUMMARY

Background: In the last five years, economic performance failed to live up to the promise of Poland's early reform record. This reflected a second wave of enterprise restructuring, a large government sector, lagging openness to trade—along with less measurable factors such as insufficient competition, a relatively large farming sector, poor infrastructure, and ructious policies. Nonetheless, since mid-2005, cyclical factors, the benefits of EU membership, and the impetus from earlier enterprise restructuring have been producing an economic upswing.

Outlook: Barring policy missteps or a change in the global economic outlook, prospects for this year and next are strong, with growth projected at 5 and 4½ percent, respectively. The improved outlook for western Europe, reduced labor shedding from enterprise restructuring, strong profits, and the many benefits from EU membership should maintain the momentum of the economy. Resource constraints are not binding with inflation at around 1 percent, still high unemployment, and the current account deficit hovering around 2 percent of GDP. However, it is unclear whether there is political support for an economic reform agenda that would lock in strong economic performance for the medium term.

Policy Discussions

Public finances remain a challenge in many regards (vulnerabilities from high and rising public debt, large fiscal deficits clouding euro adoption prospects, and high tax rates distorting incentives). The authorities intend to meet the challenge by capping the headline state budget deficit at PLN 30 billion while reducing tax rates. Staff pushed for more ambitious consolidation—a goal that can be achieved sustainably only if social entitlements and administrative costs are tackled, revenue losses from tax reform contained, and populist spending pressures resisted.

Monetary policy needs no tightening well into the upswing, since inflation is projected to continue to run below target until end-2007, staff and most Monetary Policy Council (MPC) members agreed. Some, however, were concerned about a possibly quicker rebound of inflation as one-off factors dissipate and wage pressures build.

Structural reforms and improvements of Poland's poor business environment are key to underwrite strong medium-term performance. The authorities and staff agreed that full and efficient use of increasingly available EU funds, reductions of payroll taxes, and lowering tax compliance costs were priorities. Staff pushed for broadening the agenda to also include privatization, steps toward enhancing product market competition, and improving incentives to work through targeting social benefits better. The authorities expressed some reluctance about diminishing the state's role in the economy or cutting benefits.

The financial sector was found in good health by the overlapping FSAP update mission, although rapid growth of foreign currency mortgages required monitoring. Staff expressed grave concern about the planned reorganization of financial sector supervision that risked politicizing its operations. The government pressed ahead regardless, with severely deficient draft legislation meanwhile passed by the Lower House of Parliament.

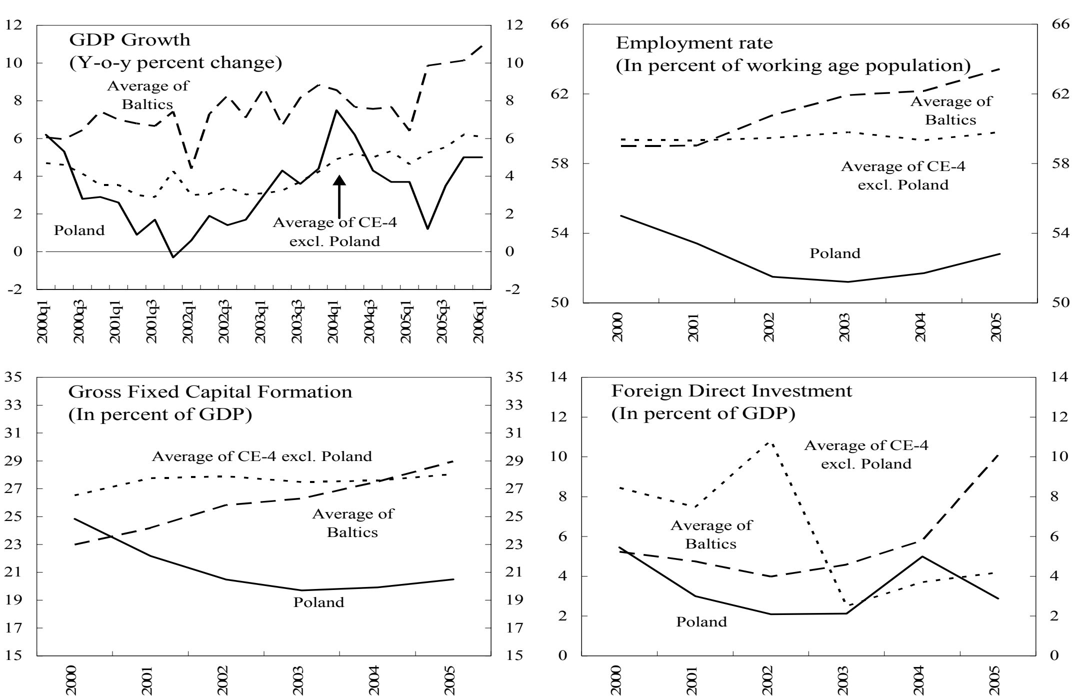
I. INTRODUCTION

1. **Benefiting from EU accession and improving growth prospects for western Europe, Poland is rebounding from a half decade of subpar growth**. Barring policy missteps or a change in the global economic environment, the near-term outlook for growth, inflation, and the external position is favorable. Beyond 2006-07, however, a decisive break with past underperformance is likely to hinge on the government's ability to maximize gains from EU membership (particularly to use EU transfers fully and efficiently and attract complementary private investment) and move ahead with macroeconomic, structural, and institutional reforms. Early euro adoption, with strong supporting policies, could also significantly bolster growth prospects.

2. **The political support for such an agenda is unclear**. The Law and Justice Party that won last fall's parliamentary and presidential elections campaigned on a platform of social justice, anticorruption, traditional Polish values, and skepticism about free-market efficiency. Following a short-lived attempt to run a minority government, it formed a coalition in April with two smaller parties—Self-Defense and League of Polish Families. Economic policy and prospects for reform remain uncertain, as the government tries to straddle conflicting objectives amid high turnover of key policy makers. A major reshuffle of government, in which the Prime Minister and Finance Minister changed, occurred after the mission. The new authorities have committed to the existing policy program.

II. BACKGROUND

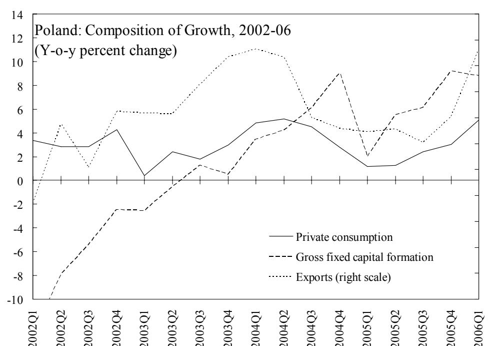
3. **From 2001 to 2005, economic performance has not lived up to the promise of Poland's early reform record**. In the 1990s, growth surpassed that in other transition countries, but since then has disappointed. In part, this has reflected the costs of a second wave of restructuring, particularly in the export-oriented manufacturing sector, and attendant job destruction and wage moderation. But lagging openness to foreign trade, slow growth in

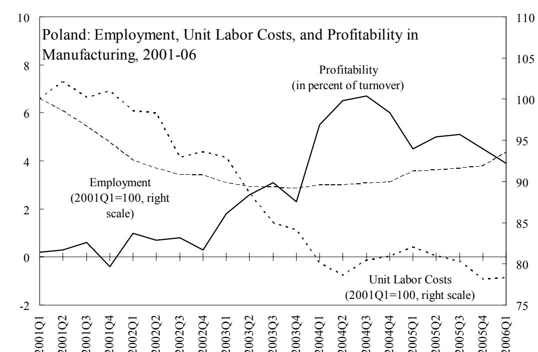


Sources: Eurostat, and WEO.

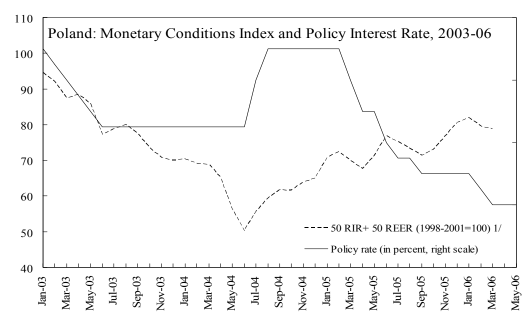
trading partners, and a large government also held back performance.[1] Less measurable features—policies that stifle competition (especially sizable state ownership and a still-developing legal system), a large, low-productivity farming sector, poor infrastructure, and ructious politics—probably also played a role. Thus, while benefiting from successful disinflation and protected from key external vulnerabilities by small current account deficits, a floating exchange rate, and sizable external reserves, Poland trailed most other NMS in income convergence, investment (including FDI), and employment.

4. **Nevertheless, by mid-2005, cyclical influences alongside the benefits from EU accession and impetus from the restructured manufacturing sector produced an economic upswing**. Output has expanded at an annualized rate of almost 6 percent since mid-2005 despite restrictive macroeconomic policies. Following a pickup in investment growth in early 2004, export growth has strengthened on the back of solid competitiveness and improving prospects in the euro area and in countries to the east. And, as prolonged net labor shedding ended, private consumption picked up with a short lag. Supply-side developments have been particularly strong in the externally exposed manufacturing sector. There, employment is rising strongly, profitability is robust, and exports are steadily climbing the technology ladder.[2]





5. **Monetary and fiscal conditions were contractionary last year and have been broadly neutral thus far in 2006**:



1/ 50% weight given to the real interest rate, and 50% weight given to the REER interest rate.

- **During March 2005-March 2006, the MPC cut policy rates by 250 bps, to 4 percent**. Nonetheless, overall monetary conditions tightened during 2005 as the zloty appreciated and falling inflation added to real interest rates. With the weakening of the zloty in 2006, monetary conditions have stabilized.

---

[1] See Schadler and others (*Growth in the Central and Eastern European Countries of the European Union*, Occasional Paper 252, forthcoming) on growth in the new member states (NMS) of the EU.

[2] See accompanying multi-country Selected Issues paper on export structure and credit growth.

- **Public finances were a positive surprise**. The general government deficit fell to 3.9 percent of GDP (2.4 percent of GDP according to ESA95).[3] Expenditure growth was contained marginally below GDP growth, even after adjusting for 2005 being an off-year for the biennial pension adjustment. As there were no major tax policy changes, buoyant taxes, partly reflecting strong profit growth, drove deficit reduction. This buoyancy appears to extend into 2006, and, with spending on track, fiscal policy has been neutral so far this year.

Poland: General Government Accounts, 2000-05
(In percent of GDP)

	2000	2001	2002	2003	2004	2005
Revenue	36.5	37.0	36.6	38.3	37.8	39.2
Expenditure	39.7	42.2	42.7	43.9	43.7	43.1
Balance 1/	-3.3	-5.2	-6.1	-5.6	-5.9	-3.9
of which : central government 1/	-2.1	-4.2	-4.9	-4.4	-5.7	-4.2
according to ESA95 2/	-1.8	-3.7	-3.2	-4.7	-3.9	-2.4
Underlying balance 3/	-4.1	-4.8	-4.7	-4.5	-5.2	-4.0
Public debt	37.7	38.8	43.6	48.5	46.8	47.7
according to ESA95 4/	…	35.9	39.8	43.9	41.8	41.9

Sources: Ministry of Finance and IMF staff calculations.
1/ National definition but including pension reform costs.
2/ Excludes pension reform costs.
3/ Adjusted for cyclical and one-off effects.
4/ Excludes government debt held by second-pillar pension funds.

6. **Resource constraints have not been tested**. Domestic savings are low by regional standards, but investment, even with the recent pickup, is lower still, and the current account deficit hovers around 2 percent of GDP. Labor market slack still appears substantial: only 53 percent of the working age population is employed, a sizable share of the approximately one million Poles working abroad could return as employment opportunities arise, and the working-age population is growing by about ½ percent annually. Thus, although the fall in ULCs during 2002-04 has ended, wage costs remain contained. The threats to watch are sector specific—workers in the state-controlled mining sector negotiated sizable bonus payments and conditions in health and construction may be tightening. Also, measures of physical capacity utilization are reaching high levels but in a changing economic structure may not be very accurate.

7. **Vulnerability indicators are generally favorable**. The biggest risk stems from high and rising public debt (48 percent of GDP, or 42 percent of GDP according to ESA95) with an annual rollover rate of 22 percent.[4] The authorities, however, improved the structure of debt in 2005, lengthening the average maturity by one year, repaying the Paris Club early, and increasing the share of euro-denominated foreign debt. Other vulnerabilities are modest by regional standards. The moderate current account deficit is more than fully financed by FDI, and, helped by zloty appreciation, the external debt ratio fell to 43 percent of GDP in 2005. Standard indicators of competitiveness put the zloty in an equilibrium range, given structural features of the economy and the macro policy mix. Official reserves are equivalent to short-term debt (by remaining maturity), a satisfactory coverage given the generally clean float. Although rapid expansion of foreign currency mortgages is a concern, overall growth of bank credit to the private sector, at 13 percent in 2005, is modest by regional standards, and banks—largely foreign owned—are well capitalized. EU membership appears to impart a substantial degree of confidence to markets, reflected in low measures of risk premiums.

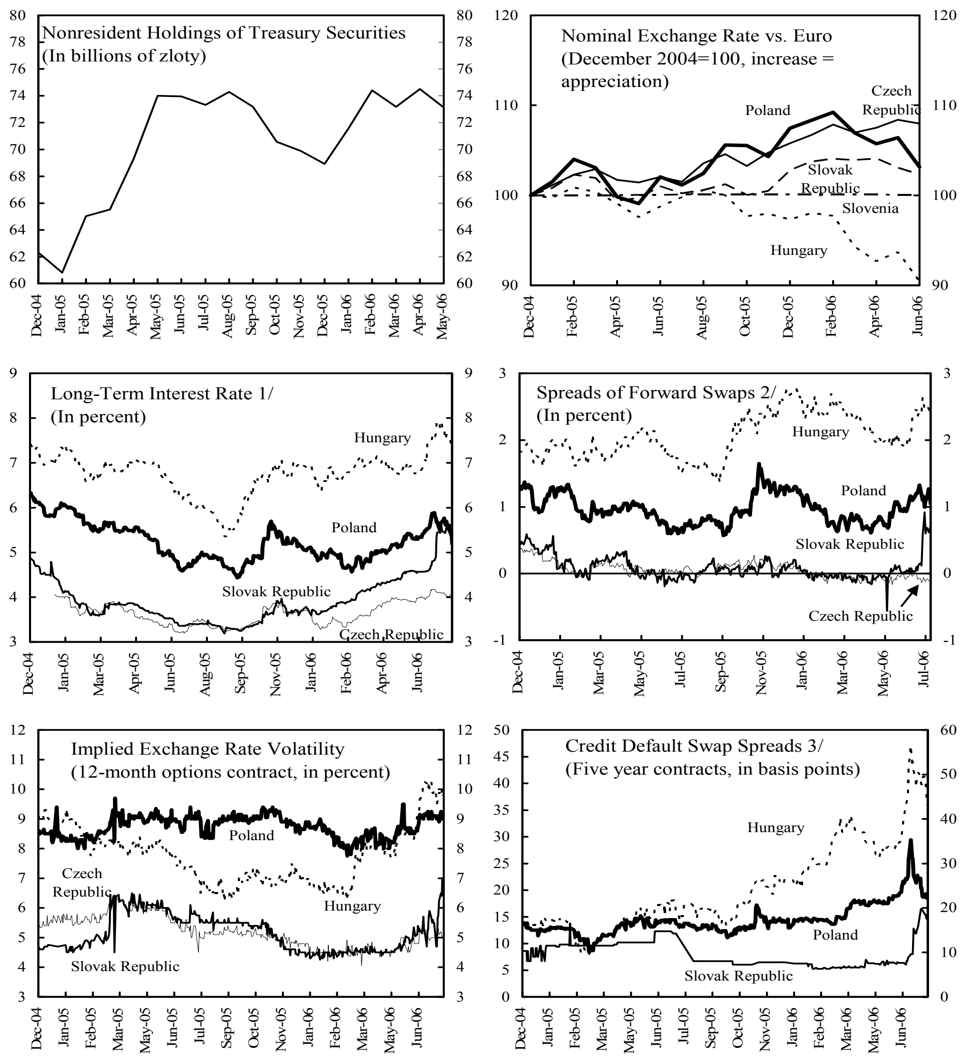
---

[3] Under Eurostat rules, Poland is allowed to report deficits excluding the costs of pension reform until March 2007. For purposes of the Excessive Deficit Procedure, pension reform cost can be partially excluded until 2010 if the European Commission considers the deficit close to 3 percent of GDP and falling.

[4] Redemptions, excluding early Paris Club repayments (US$5½ billion), as percent of public debt.

8. **Nevertheless, after a smooth ride in 2005, Poland has been buffeted recently by turmoil in emerging markets** (Figure 1). During 2005, equity markets surged, the zloty appreciated by about 5 percent in nominal effective terms, and zloty yields fell by 75 basis points to below 5 percent. Issuing US$12 billion in sovereign debt last year (almost half for early Paris Club repayment), Poland was the largest emerging market issuer. The two subsequent waves of emerging market turmoil—in March and June 2006—affected Poland far less than emerging markets on average, but rather strongly by regional standards. Since March, the zloty has fallen by 4 percent, bond yields are up by 70 bps, and credit default swap spreads rose by over 10 bps before falling back. As most of these changes were partial reversals of run-ups in 2005, they do not threaten economic performance. They indicate, however, that good vulnerability indicators and EU membership do not insulate Poland from market unrest.

Figure 1. Selected Countries: Financial Market Indicators, 2004-06



Sources: Bloomberg; Haver; and IMF staff estimates.
1/ 10-year government bond yield.
2/ Spread of 5-year local currency interest rate forward with settlement 5 years from date versus euro-denominated interest rate forward.
3/ Credit default swap (CDS) is an over-the-counter contract whereby the buyer pays the seller a periodic fee in return for a contingent payment by the seller upon default of the issuer of a credit instrument. Spreads are calculated versus the U.S.

9. **Implementation of IMF policy recommendations has been uneven** (Box 1).

Box 1. Implementation of Past IMF Recommendations

Last year's macroeconomic forecast for a gradual revival of growth through 2005 alongside low inflation and a small external deficit was on the mark. Interest rate cuts since early 2005 have been consonant with staff's inflation projections and views.

In the fiscal area, the authorities engaged staff in efforts to build support for a fiscal responsibility law and ambitious deficit and debt reduction based on entitlement reform. However, political support for such reforms could not be garnered. Unexpected tax buoyancy, rather than entitlement reform, produced sizable consolidation last year. Tax reform efforts are now moving in the recommended direction with government proposals to cut payroll taxes and flatten the income tax schedule.

The new government is keeping the question of the timing of euro adoption under review and is reserved toward bringing privatization to a rapid conclusion, two issues on which the staff has urged stronger commitment.

III. Report on the Discussions

10. **The authorities' confidence was buoyed by the economic upswing**. They were confident that the economy would expand strongly at rates above official forecasts over the policy horizon. They saw robust profits, rising investment supported by anticipation of a sharp increase in absorption of EU transfers, and competitive wages as sources of near- and medium-term strength. In their view, the immediate outlook for strong growth, low inflation, and modest current account deficits was solid. They recognized, however, the importance of improving public finances and addressing impediments to business.

11. **Nevertheless, economic policies face conflicting objectives**. The government's commitment to a nominal ceiling on the state budget deficit will be hard to square with promised tax cuts and continued pressure on social spending. The objective of strengthening business conditions and investment may clash with reservations about privatization, unease about foreign control of companies, and proposals that could weaken banking supervision. The desire to reduce interest rates is complicated by lingering unease over euro adoption. The economic upswing and unexpected buoyancy of tax revenues have gone some way toward easing the trade-offs, but difficult choices still lie ahead.

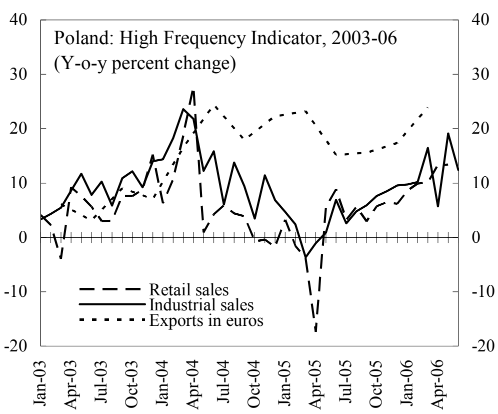
12. **The discussions focused on the tensions between these objectives in seeking a lasting renewal of growth and protection from any further deterioration in emerging market conditions**. The authorities and staff agreed that efficient use of the forthcoming substantial transfers from the EU was critical. They also agreed on the importance of reforming public finances, improving the business environment, and making the economy more flexible, but debated how to achieve these goals. This year's FSAP update facilitated in-depth analysis of financial sector developments, including a controversial proposal to reorganize financial sector supervision. The mission emphasized the benefits of euro adoption for trade, investment, and growth.

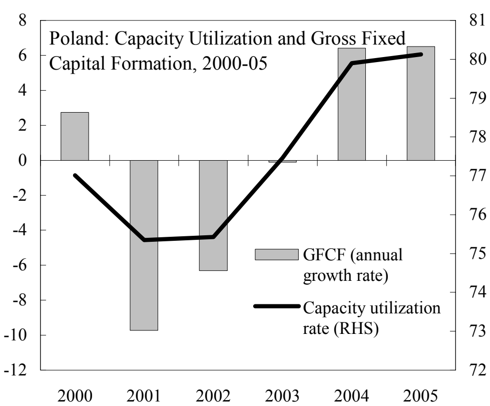
A. Economic Outlook

13. **The economic outlook for 2006-07 is strong**. Staff projections for a pickup in growth, to almost 5 percent this year and 4½ percent next, are in line with government and consensus forecasts. Private consumption should benefit from labor market improvements over the last 18 months, as well as the biennial pension adjustment in March 2006. Increasing rates of capacity utilization and additional EU funds should spur investment. Although export volumes should grow in the double digits, the external contribution to growth is expected to turn slightly negative as strong domestic demand lifts imports, widening the current account deficit moderately. Macroeconomic policies will ease: the fiscal deficit is projected to widen from its better-than-budgeted 2005 outturn, and currency depreciation has loosened monetary conditions. High-frequency data confirm the momentum of the economy.

Poland: Growth Projections, 2005-07
(In percent)

	2005	2006	2007
	Actual	Projection	
IMF (July)	3.4	4.9	4.5
Polish Ministry of Finance (May)	3.4	4.6	4.6
OECD (May)	3.4	4.4	4.6
European Commission (Spring)	3.4	4.5	4.6
EIU (June)	3.4	4.8	4.6
Consensus Forecast (July)	3.4	4.9	4.7





14. **In the medium term, the goal of rapid income convergence will pose several tests**. The authorities and staff agreed that higher investment and employment would be key. The authorities viewed the wage differential with western Europe as a virtual guarantee of reasonably rapid convergence, but also pointed to the importance of structural reforms such as reducing payroll taxes and simplifying access to EU funds. The mission felt that broader structural reform including downsizing the public sector, lowering disincentives to work from poorly targeted social benefits, increasing competition in product markets, and clarifying a timetable for euro adoption would also be important. Staff agreed that the large forthcoming transfers from the EU—up to 4 percent of GDP on average per year under the 2007-13 Financial Perspectives—will be a significant impetus to growth if efficiently used. The prospect of reasonably efficient absorption warranted an upward revision of potential growth, to 4 percent relative to the 3¾ percent envisaged in previous staff reports (Box 2).

15. **Staff's medium-term scenario occupies a middle ground in the range of possible outcomes**. With improvements in conditions for investment and efficiency gains, growth could move to a substantially higher plateau; a retreat to fiscal populism and failure to address structural weaknesses, however, could lower growth and increase vulnerabilities to a less favorable external environment. The central scenario assumes unchanged fiscal policy and structural reform that provides modest support for growth. Substantially higher

investment would be financed by increased national savings (bolstered by growing transfers from the EU) and higher recourse to foreign savings (Table 5). The increase in the current account deficit to about 4½ percent of GDP would be easily covered by FDI and portfolio inflows, with external debt remaining at about 40 percent of GDP (Table 3). Stress tests on external debt indicate that, barring a sharp depreciation of the exchange rate, external debt is reasonably robust to most shocks of plausible size (Table 7).

Box 2. Implications of EU Transfers

Sizable EU transfers offer an opportunity to accelerate income convergence with minimal strain on competitiveness, the balance of payments, or public finances. Staff's medium-term scenario assumes that EU transfers (net of Poland's contribution to the EU budget) rise from ½ percent of GDP in 2005 to 2½ percent by 2011. This is conservative, implying substantial back-loading in absorption.

- **Economic growth**. In the short term, given existing unutilized capacity, the direct demand effect of increased spending on nontraded goods would boost GDP by about 1/8 percentage point per year. In the longer term, supply-side effects would be stronger, considering Poland's underdeveloped infrastructure. Potential output could well rise in excess of ¼ percentage point a year. Model-based projections calibrated by the Ministry of Regional Development suggest larger gains.
- **Exchange rate**. Using empirical estimates from the aid literature, appreciation is likely to be modest—about 2 percent within a year and 13 percent cumulatively over a five-year period.[1] This could well be within the margins of productivity gains resulting from efficient use of transfers.
- **Current account**. EU funds are recorded in the balance of payments partly above the line (current transfers) and partly below (capital grants). Assuming that the transfers are eventually fully reflected in imports, the current account deficit should widen by the amount of capital transfers.
- **Public finances**. Growing EU transfers worsen the fiscal balance only through the higher cofinancing requirements for projects carried out by public entities. The fiscal burden will be mitigated by smaller cofinancing shares required under the 2007-13 Financial Perspective.

[1] Prati A., R. Sahay, and T. Tressel, 2003, "Is there a Case for Sterilizing Aid Inflows?," IMF, unpublished; July http://www.imf.org/external/np/res/seminars/2003/lic/pdf/tt.pdf.

B. Fiscal Policy

16. **Reform of public finances remains a prime challenge**. Although public finances have lately benefited from tax buoyancy, the underlying deficit is still excessive: on unchanged revenue and expenditure policies, general government deficits would rise to 5 percent of GDP and public debt to 55 percent of GDP over the next five years. This leaves debt dynamics vulnerable to a growth slowdown—a repeat of the 2001-02 slowdown would add more than 10 percentage points of GDP to the debt stock after five years. Public finances, however, would weather shocks to the exchange rate or interest rate relatively well (Table 6).

17. **The authorities intend to meet the challenge by capping the state budget deficit at PLN 30 billion while reforming the tax system.** The 2006 budget, already subject to this cap, had been formulated on the assumption of continued tax buoyancy and general expenditure compression without any specific policy initiatives. With the reversal of one-off improvements in fiscal positions in 2005 at other levels of government, the 2006 general government deficit is expected to rise to about 4½ percent of GDP. While revenues had indeed been close to budget projections in the first half of the year, staff pressed for efforts to contain expenditure below budgeted levels to provide a cushion should revenues prove less buoyant than budgeted later.

18. **The authorities agreed that adhering to the cap in 2007 and beyond would be difficult**. Plans for administrative reform were under discussion, but no significant savings were expected. Reform of social transfers and subsidies was not under consideration; indeed, pressures were in the other direction. Staff cautioned against building optimistic assumptions about tax buoyancy into the 2007 budget. Buoyancy could peter out as the effects of the large increase in profits during the past few years subside. The authorities suggested that buoyancy might also reflect increasing formalization of the economy. Staff saw this as a possibility, but noted the absence of such buoyancy elsewhere in the region despite similar formalization.

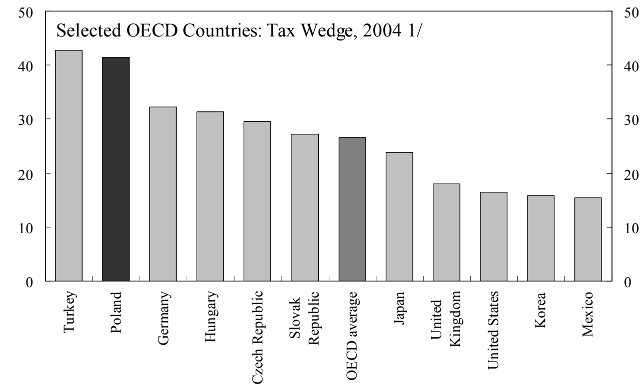
19. **Staff advocated more front-loaded adjustment and ambitious medium-term consolidation**. Reiterating its message of recent years, staff advocated a medium-term deficit target of no more than 2 percent of GDP—consistent with a gradual reduction of public debt ratios. This could be achieved, even allowing for some revenue loss from tax reform, if real expenditure growth were slowed to 3½ percent (against 5½ percent in staff's no-policy-change scenario). Large and poorly targeted social transfers, high spending on state aid, and overlaps in public administration were prime areas for rationalization. Targeting a deficit of 4 percent of GDP in 2007 (rather than the 4.3 percent implied by the PLN 30 billion cap) would be a good first step, given the strong economy.

Poland: General Government Accounts, 2003-11
(In percent of GDP)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Staff's no-policy-change scenario 1/									
Revenue	38.3	37.8	39.2	39.6	40.1	40.1	40.3	40.4	40.4
Expenditure	43.9	43.7	43.1	44.2	44.4	44.9	44.9	45.5	45.5
Balance 2/	-5.6	-5.9	-3.9	-4.5	-4.3	-4.8	-4.6	-5.1	-5.0
of which : central government 2/	-4.4	-5.7	-4.2	-4.1	-3.9	-4.2	-4.2	-4.5	-4.3
of which : central government, excl. transfers to open pension funds	-3.2	-4.5	-2.9	-2.9	-2.8	-3.1	-3.1	-3.4	-3.1
Public debt 3/	48.5	46.8	47.7	48.8	49.8	51.3	52.4	54.0	55.3
Authorities' scenario 4/									
Central government balance, excl. transfers to open pension funds	-3.2	-4.5	-2.9	-2.9	-2.7	-2.5	-2.4	-2.2	-2.1
Staff's reform scenario 5/									
Revenue	38.3	37.8	39.2	39.6	39.6	39.6	39.6	39.6	39.7
Expenditure	43.9	43.7	43.1	44.2	43.5	43.3	42.5	42.4	41.7
Balance 2/	-5.6	-5.9	-3.9	-4.5	-4.0	-3.7	-2.9	-2.8	-2.0
of which : central government 2/	-4.4	-5.7	-4.2	-4.1	-3.6	-3.2	-2.6	-2.4	-1.6
of which : central government, excl. transfers to open pension funds	-3.2	-4.5	-2.9	-2.9	-2.4	-2.0	-1.5	-1.3	-0.5
Public debt 3/	48.5	46.8	47.7	48.8	49.5	49.8	49.4	48.7	47.3

1/ Tax reform plans under discussion by the government are not taken into account.
2/ National definition but with open pensions classified outside the public sector.
3/ National definition. Excludes risk adjustment for government guarantees and sureties.
4/ Constant nominal budget cap at PLN30 billion.
5/ Reduction of annual expenditure growth by 2 percentage points and cut of social security contributions in 2007 and 2009 costing a total of 0.7 percent of GDP.

20. **The authorities were eager to finalize a tax reform package, which subsequently went to Parliament**. The reform, which the authorities viewed as revenue neutral, would ease tax compliance costs, reduce payroll taxes by 4.6 percentage points, raise some excise taxes, and, from 2009, cut personal income tax rates. Staff agreed on the desirability of the envisaged measures but expected they would lose up to 0.8 percent of GDP in revenue in 2007 and more after the 2009 personal income tax cuts. Thus, staff advocated offsetting measures starting in the 2007 budget, preferably on the spending side.



Source: OECD.
1/ Tax in percent of labor costs for married worker with two children earning average production wage

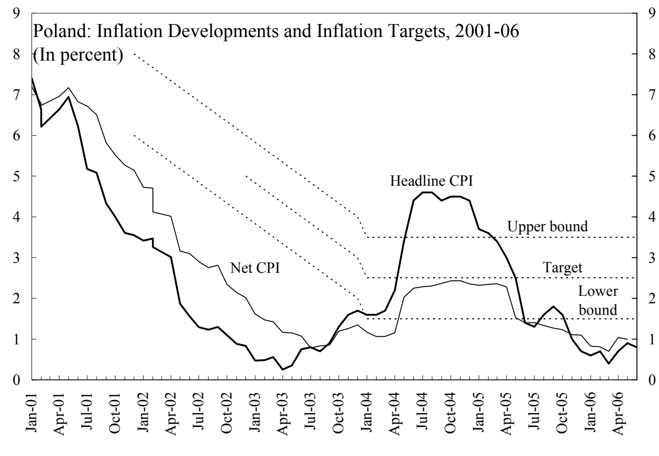
21. **Poland's public finances are set to weather aging better than those of most other EU countries**. The 1999 pension reform was key to this favorable outlook, but commitment to two aspects of reform—maintaining the indexing of pensions to inflation and moving benefits of occupational groups with hitherto preferential treatment to the treatment prescribed in the reform—will be tested in the next year. Serious challenges on both these issues are in train: miners have already secured wholesale exemption from the pension reform, and the government has pledged to reintroduce a wage component into pension indexation.

C. Monetary and Exchange Rate Policies

22. **A combination of one-off and more permanent factors has kept inflation below the central target over the past year**. The monetary authorities saw several factors as having played a role: import bans by Russia and Ukraine on Polish agricultural products, a limited pass-through of rising global energy prices due to excise cuts and margin compression by distributors, exchange rate appreciation, integration with the EU, and globalization. The consensus view was that the current level of interest rates, at 4 percent, was appropriate. Inflation would return to the central target rate by end-2007, considering the economic upswing, waning scope for easy productivity gains, and diminished prospects for zloty appreciation in the global monetary tightening cycle. Nevertheless, views varied: some MPC members underscored the importance of one-off factors in holding inflation down and saw mainly upside risks to the inflation projection; others thought there was ample time to assess the permanence of the various factors before changing interest rates, especially since low ULCs and high profits created space for some pickup in wages before effects on inflation would be a problem.

23. **In the mission's view, risks were skewed toward undershooting the inflation target**. One-off factors had indeed dampened inflation in recent months but core inflation had also remained below the target for headline inflation for five years running, reflecting falling unit labor costs in a high-unemployment setting and effects of globalization (Box 3). Various forecasting approaches of staff consistently conclude that it is likely to take over 20 months for inflation to return to target. They incorporate staff's growth projections and assume a pickup in ULC growth to 2 percent annually, a constant nominal effective exchange

rate, and further sizable increases in domestic energy prices. Moreover, staff's structural model suggests that it would take much larger shocks for inflation to exceed the upper tolerance limit than to undershoot the lower one. Nonetheless, the mission agreed that interest rates should be kept on hold: the cyclical position hardly called for stimulus, and keeping rates constant would minimize the risk of a policy reversal should the global tightening cycle continue or have a larger-than-anticipated effect on Polish financial markets. That said, in current conditions, the start of any tightening cycle could be delayed until well into the upswing.



Box 3. Inflation in Poland—How Much Can Globalization Explain?

Poland's inflation rate is currently one of the lowest in the EU. Extending recent IMF research on globalization for industrialized countries (WEO, April 2006), Chapter I of the Selected Issues paper analyzes how much globalization contributed to declining inflation and relative manufacturing prices in the NMS since the mid-1990s.

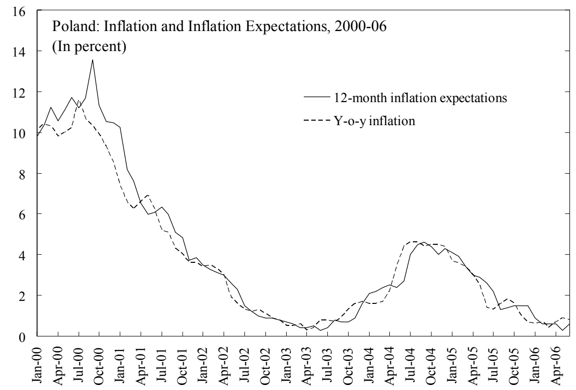
Disinflation in NMS over 1997-2005 is evident in all components of the CPI, pointing to the influence of monetary policy and productivity gains. But the relatively more pronounced disinflation of highly tradable goods, such as textiles and housing equipment, suggests that globalization was also a factor.

At the aggregate level, estimation of an "augmented" Phillips curve during 1996-2004 for the eight NMS finds that inflation has become less sensitive to economic shocks. Due to increased trade penetration, the output elasticity of inflation declined to 0.7, from 0.9 ten years ago. Thus, globalization has indirectly affected inflation, through better consumption smoothing, increasingly severe sanctioning of imprudent policies, and the consequent shift of monetary policy targets toward lower inflation.

At the micro level, increasing trade openness is likely to have curbed domestic production prices because of tougher global competition. Using disaggregated data in the manufacturing sector, panel data analysis over 1996-2003 for the four central European NMS suggests that globalization could have shaved off between ½ and 1 percentage point annually from Polish inflation since the middle of the 1990s, as firms cut markups.

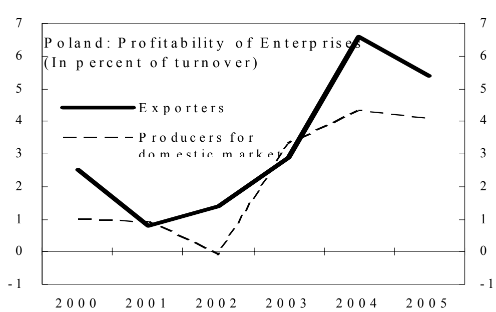
With trade openness likely to advance more slowly going forward, the sectoral effects of globalization seem set to diminish somewhat. However, the larger role of foreign determinants exhibited in the augmented Phillips curve should endure and hold inflation down.

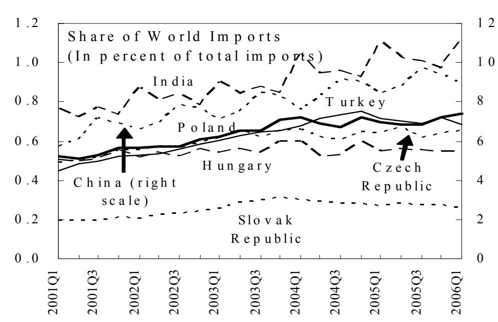
24. **A better anchoring of inflation expectations at the central target is a challenge for the MPC**. Despite successful disinflation, inflation expectations remain highly adaptive. Staff encouraged the monetary authorities to communicate consistently to the public that they target the central rate with symmetric risks around it, as some statements could be construed as attaching more concern to overshooting than undershooting the target. The authorities stressed that centering inflation at the target over the policy horizon was enshrined in the Monetary Policy Guidelines but saw scope to communicate this better to the public, including perhaps through publication of MPC minutes.

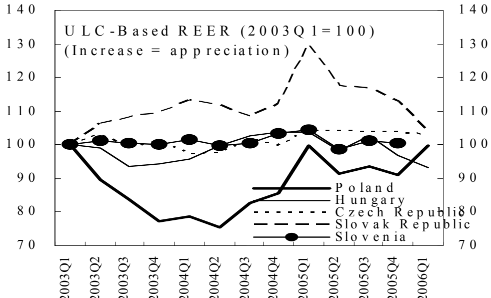


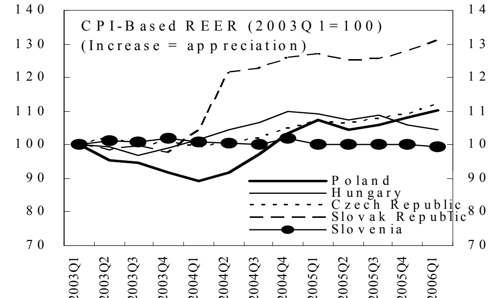
25. **The NBP accumulated significant foreign exchange reserves last year**, in contrast with recent years. The authorities explained that the increase mainly reflected receipts of EU transfers and other smaller factors—not discretionary intervention, which the NBP continued to eschew. Unlike in 2004, contributions to the EU budget were made in zlotys rather than euros in 2005 and therefore did not offset inflows of EU funds. However, even with the return to normal practice, the possibility of sizable reserve accumulation called for a reconsideration of the reserve accumulation policy. The NBP will consider this issue in the broader context of reserve needs for ERM2 and eventual euro adoption. For now when the zloty would continue to float, staff and the authorities agreed that reserves were at comfortable levels.

26. **Staff (using model-based and heuristic indicators) and the authorities saw the exchange rate as within an appropriate range**. Nevertheless some officials felt that it was at the strong end of this range, and others that it was at a very competitive level. Staff noted that large exporters were highly profitable, and overall export market share was growing.









The effects of the 2004 appreciation had been mitigated by productivity gains and, for large-scale exporters, offsetting savings on imported inputs. Only some small-scale exporters—who did not use imported inputs—were seen as moderately affected, and for them the recent zloty depreciation should have provided relief.

27. **The government wanted to make more progress toward meeting the Maastricht criteria before setting a target date for euro adoption**. Ministry of Finance officials were discouraged by the EU Commission's decision not to endorse Lithuania's request for entry (because of a small breach of the inflation criterion) and by the extra fiscal adjustment that would be required, relative to their expectation before Eurostat's decision to phase in an exclusion of second-pillar pension funds (which are in surplus) from the deficit calculation. Nevertheless, while not seeing great urgency in setting a schedule for application, the government intends to meet the fiscal requirements by 2009. Staff stressed the parallel steps needed to make the economy more flexible. It urged the authorities to set a schedule for adoption to reinforce the resolve for reform and to take the earliest advantage possible of the opportunities in euro adoption for reducing exchange risk, lowering interest rates, and boosting trade and growth.

D. Financial Sector

28. **Poland's financial sector is generally in good health**. The joint IMF-World Bank FSAP update mission and the authorities agreed that banks were well capitalized, resilient to shocks, and profitable. Banks' capital adequacy and ROE are above the EU average. Credit

Poland: Core Financial Soundness Indicators for the Banking Sector, 1998-2005
(Ratios in percent)

	1998	1999	2000	2001	2002	2003	2004	2005
Capital adequacy								
Regulatory capital to risk-weighted assets	11.7	13.1	12.9	13.5	14.2	13.8	15.4	14.5
Regulatory Tier I capital to risk-weighted assets 1/	14.0	14.7	14.1	14.1	14.2	13.9	15.3	14.4
Classified loans net of provisions to capital 2/	33.2	54.3	59.4	58.9	63.6	68.7	36.8	21.4
Nonperforming loans net of provisions to capital 3/	...	...	...	...	...	31.1	22.5	11.9
Asset composition and quality								
Classified loans to gross loans 2/	10.5	13.3	15.0	17.9	21.1	21.2	14.9	11.0
Nonperforming loans to gross loans 3/	...	...	...	...	...	10.4	9.2	7.7
Sectoral distribution of loans to total loans								
Loan to households 4/	33.8	37.0	39.7	42.4	41.4	43.7	48.0	52.3
Loans to nonfinancial corporations 4/	66.2	63.0	60.3	57.6	58.6	56.3	52.0	47.7
Earnings and profitability								
Return on average assets (after tax)	0.6	0.9	1.1	0.9	0.5	0.5	1.4	1.6
Return on average equity (after tax)	9.1	13.2	15.4	12.4	6.1	5.8	17.1	20.7
Interest margin to gross income 5/	70.3	63.7	60.8	53.3	54.4	55.7	56.4	57.7
Noninterest income (net) to gross income 6/	29.7	36.3	39.2	46.7	45.6	44.3	43.6	42.3
Noninterest expenses to gross income 7/	68.0	70.1	67.9	68.6	71.5	78.9	77.1	72.3
Liquidity								
Liquid assets to total assets (liquid assets ratio) 8/	28.8	15.6	17.0	17.8	24.1	26.1	26.2	26.2
Liquid assets to borrowed funds 8/	32.7	17.7	19.2	20.2	27.4	29.5	29.8	29.6
Sensitivity to market risk								
Net open positions in foreign exchange to capital	...	-1.5	5.3	2.1	1.1	0.3	1.5	2.5

Source: National Bank of Poland.
1/ Tier 1 capital consists of core capital reduced by a shortfall in specific / impairment provisions.
2/ The definition of classified loans was changed in 2004.
3/ Nonperforming loans defined as arrears over 90 days (as recommended in the *FSI Compilation Guide).*
4/ Definition of the sectors changed in 2002.
5/ No deductions of income from other deposit takers.
6/ No deductions of expenses paid to other deposit takers.
7/ Noninterest expenses comprise fees and commission costs, other operating costs, depreciation, personnel costs, and other general expenses.
8/ Liquid assets comprise cash, balances at the NBP accounts, placements at banks maturing in up to one month, debt securities admitted to public trading, securities admitted to public trading, and units in open-ended investment funds. Borrowed funds are all liabilities other than provisions, capital, and earnings.

growth is picking up, following many years when weak domestic demand and a rise in non-performing loans had slowed financial deepening.[5] The FSAP update noted progress in supervision: newly-gained authority to conduct consolidated supervision; a shift toward risk-focused supervision; better cooperation with foreign supervisors; and modernization of the legal framework with the adoption of the *acquis communautaire* (Box 4).

Box 4. FSAP Update

This follow-up of the 2001 FSAP focused on stress testing, banks' preparedness for a pickup of credit growth, and nonbank financial institutions. It found good progress in implementing previous recommendations. Most remaining issues are developmental.

A set of stress tests found the banking system resilient to shocks, confirming strong soundness indicators. A 30 percent deprecation of the zloty, a 4 percent contraction of aggregate demand, or classification of 10 percent of housing loans would leave the system capital adequacy ratio above the regulatory minimum. Only a few nonsystemic banks would dip below the minimum in some scenarios. Bank resilience benefited from sharply improved profitability in 2004-05, although room remains for further reduction of operating costs.

Banks and supervisors are generally well positioned to handle the recent pickup of credit growth from the modest pace of the past few years. But early warning indicators and foreign currency lending need to be closely monitored, as risk management is inherently difficult in banks with short lending histories. Information systems on credit histories and real estate prices still have room for improvement, and the enforcement of creditor rights needs strengthening.

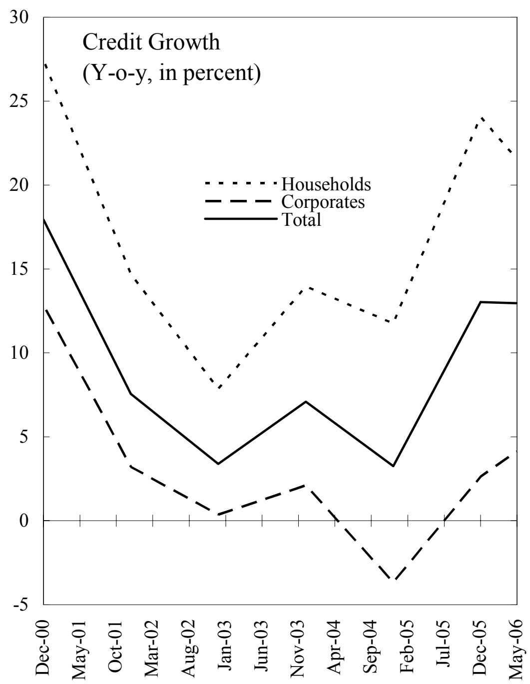
Private pension funds, which hold assets worth 9 percent of GDP, have generated high returns at costs that are low compared to systems at a similar stage of development in other countries. The main challenges are to move to more risk-based supervision, ensure greater portfolio diversification, and prepare the regulatory framework for the payout phase, to commence in 2009.

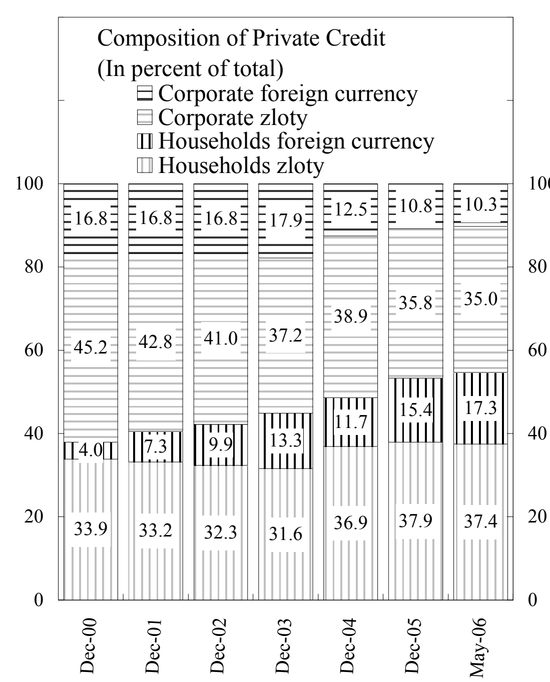
Many companies in the small insurance sector are not profitable and rely on support from stakeholders. However, solvency and capital levels of the sector are satisfactory. Consolidation seems likely, and loss-making companies require supervisor's continued attention.

Growth of the equity market has been impressive, both in terms of market capitalization and IPOs. The corporate bond market remains in its infancy.

[5] See Chapter II of the Selected Issues paper on credit growth and foreign currency mortgages.

29. **Banking supervisors were concerned about the rapid growth of foreign currency mortgages**. In response, they had hiked capital charges for housing loans in 2005 and issued guidance in 2006 with a view to strengthening risk management practices and to improving risk disclosure to customers. They were leaning toward following up with more direct lending controls later in the year. Staff welcomed the market-based measures but stressed that more direct intervention was prone to circumvention and would be heavy-handed in the circumstances. Mortgages correspond to less than 6 percent of GDP and 20 percent of private credit. Total credit growth of 13 percent is moderate by regional standards.





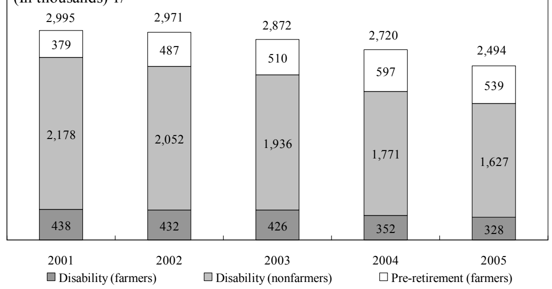
30. **Staff and the FSAP update mission warned against weakening the governance structure of banking supervision**. A draft law on financial supervision under consideration during the mission would unify financial-sector supervision in a new agency, replacing the roles of the NBP vis-à-vis banks, and separate supervisors for capital markets and insurance companies/pension funds. The agency's independence is not guaranteed in the law, and the appointment and dismissal procedures for its management risk politicizing its operations. The authorities argued that unification was in line with what they perceived as an international trend and would save administrative costs. Since the mission, a little-improved version of the draft law was passed by the Sejm and awaits discussion in the Senate.

E. Structural Policies

31. **There was broad agreement that structural reform was key to improving economic performance**. The authorities plan to cut red tape in tax administration, lower the tax wedge, and ease onerous requirements for using EU funds. They did not envisage reforms in other key areas, as they would conflict with campaign promises to maintain a strong government presence in the economy and generous social transfers.

32. **Social benefit reform to spur labor force participation is not under consideration**. Staff noted studies showing poorly targeted benefits contributed to low employment. Previous governments had tightened vetting procedures and eligibility under the disability and early retirement schemes; this had curtailed inflows but was reducing the number of beneficiaries only gradually. Some 2½ million people (9½ percent of the working-age population) are still covered by these schemes. The authorities do not intend to take further steps in this area—on the contrary, the momentum is for increasing the generosity of family benefits, pension indexation, and access to early retirement schemes. Improvement of work incentives could, however, come from the planned cut of payroll taxes.

Poland: Beneficiaries Under Disability and Pre-Retirement Schemes, 2001-05
(In thousands) 1/



Sources: Ministry of Labor and Social Affairs; Social Security Administration; and IMF staff calculations.
1/ Corrected for estimated number of beneficiaries above the statutory retirement age.

33. **The government expressed reservations about further large privatization**. Ministry of Treasury officials supported the objective of privatization but wished to proceed cautiously to ensure the integrity of the process. With concerns about privatized firms tending to come under foreign control, the state failing to maximize proceeds when privatizing unrestructured firms, and union opposition, they had put many large-scale privatizations on hold, most notably in the coal sector and, pending the creation of vertically integrated larger entities, the energy sector. They do not intend to relinquish state control of bank PKO BP, copper giant KGHM, or insurance company PZU (the outcome of the legal proceedings with a foreign shareholder allowing). The 2006 target for privatization proceeds had been lowered to PLN 3.1 billion (0.3 percent of GDP) from PLN 5.5 billion. Staff questioned whether even this level could be achieved, as four medium-sized chemical companies seem to be the only larger items on the agenda. It also pointed out that the rather large share of value-added produced by state-controlled enterprises (some 20 percent) detracted from product market flexibility.

34. **The authorities took issue with Poland's low ratings in business environment surveys**. The mission presented evidence that Poland had fallen back relative to peers in terms of structural flexibility, the costs of doing business, and trade openness (Box 5).[6] This was reflected in a slowdown of structural change and TFP growth, and poor ratings in business environment

Selected Countries: Business Climate Indicators

World Bank Doing Business		WEF Growth Competitiveness		WEF Business Competitiveness		IMD World Competitiveness		ICRG Institutional Quality		Heritage Foundation Economic Freedom	
Ireland	11	Estonia	20	Ireland	19	Ireland	12	Ireland	9	Ireland	3
Lithuania	15	Portugal	22	Spain	25	Estonia	26	Portugal	21	Estonia	7
Estonia	16	Ireland	26	Estonia	26	Czech Republic	36	Spain	25	Czech Republic	21
Latvia	26	Spain	29	Czech Republic	27	Hungary	37	Slovenia	27	Lithuania	23
Spain	30	Slovenia	32	Portugal	30	Spain	38	Greece	30	Portugal	32
Slovak Republic	37	Czech Republic	38	Slovenia	32	Slovak Republic	40	Latvia	36	Spain	33
Czech Republic	41	Hungary	39	Hungary	34	Portugal	45	**Poland**	**38**	Slovak Republic	35
Portugal	42	Slovak Republic	41	Slovak Republic	39	Greece	50	Czech Republic	39	Slovenia	38
Hungary	52	Lithuania	43	Greece	40	Slovenia	52	Estonia	40	Latvia	39
Poland	**54**	Latvia	44	Lithuania	41	**Poland**	**57**	Hungary	41	Hungary	40
Slovenia	63	Greece	46	**Poland**	**42**	Latvia	--	Lithuania	49	**Poland**	**41**
Greece	80	**Poland**	**51**	Latvia	48	Lithuania	--	Slovak Republic	55	Greece	57
OECD average	28	**OECD average**	**25**	**OECD average**	**23**	**OECD average**	**25**	**OECD average**	**23**	**OECD average**	**25**
EU average	32	**EU average**	**25**	**EU average**	**23**	**EU average**	**28**	**EU average**	**25**	**EU average**	**28**

Sources: The World Bank, World Economic Forum, IMD, International Country Risk Guide, and Heritage Foundation. Data relate to 2006 or latest available observation.

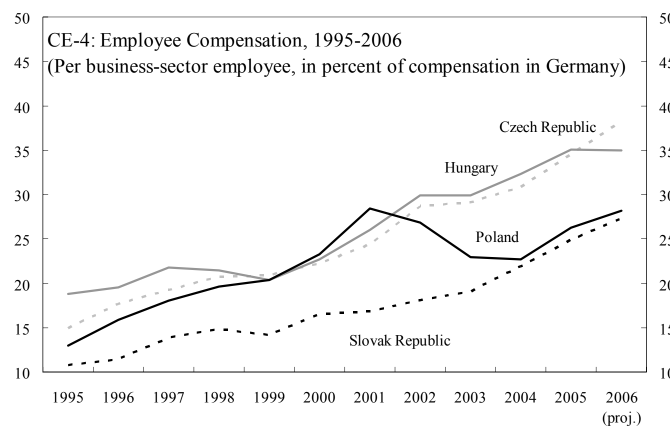
[6] Chapter III of the Selected Issues paper assesses structural conditions.

surveys. The authorities did not share this view and felt that the mission's assessment sat oddly with the upbeat mood in the business community. They pointed to some recent surveys by business consultancies that identified Poland as an attractive destination for global outsourcing and investment.

Box 5. Openness of the Polish Economy

Poland has the lowest ratio of trade to GDP among central and eastern European countries (63 percent during 2003-05). This would not be a concern so long as it were explained by the relative bigger size of its economy and population. However, a cross-country regression, controlling for size, along with distance to trading partners, per-capita GDP, etc., shows that actual trade falls some 20 percentage points of GDP short of model predictions.

35. **Staff noted that these views are not necessarily contradictory**. Poland's reemerging attractiveness could be grounded in low labor costs and the availability of low-priced land, rather than a supportive environment for business. From this perspective, several priorities for boosting potential growth exist: (i) simplifying regulation, lowering capital requirements for enterprises, and reforming self-regulation of professions to cut market entry costs would bolster product market competition; (ii) expanding opportunities for asset-backed financing, improving contract enforcement, and introducing spatial development plans to facilitate real-estate development would spur investment; and (iii) better targeting out-of-work benefits and differentiating minimum wages regionally would increase incentives to work.



Sources: OECD Economic Outlook Database (June 2006); and IMF staff calculations.

IV. Staff Appraisal

36. **The current cyclical upswing underscores the potential of the Polish economy in the wake of EU accession and in the face of favorable global growth prospects**. After five years of underperformance relative to many regional peers, the upswing reflects balanced growth across consumption, investment, and exports alongside a pickup in employment and strong competitiveness in the export-oriented manufacturing sector. These are the fruits of recent restructuring in the open parts of the economy, which have positioned Poland to take advantage of EU accession and the strength of global demand. Also, resource constraints are not yet binding, and the economy has absorbed energy price increases without second-round effects. The MPC appropriately cut interest rates during the past year and is now positioned to delay a tightening cycle until prospects for reaching the inflation target over the policy horizon are clear. Overall, the underpinnings for near-term growth are strong.

37. **The current juncture offers good opportunities to lock in improved economic performance**. The global outlook is strong, EU grants will be a boon to the economy, and a base of rising employment and incomes is being established. External vulnerabilities, though tested in the recent episode of financial market turbulence, remain low, helped by the strong reputation of the NBP and a solid record of low inflation. But these favorable conditions could be fleeting without efforts to address several key impediments to sustained high growth.

38. **Perhaps most important in the near term is allaying uncertainties about the commitment to reducing the deficit and stabilizing public debt**. Despite beneficial effects of recent tax buoyancy on the deficit, public debt remains on an upward trajectory and public spending, at 43 percent of GDP, is too high. The government's tax reduction plans are commendable but unfinanceable unless expenditure savings can be found by better targeting social transfer programs and tackling high administrative costs. As a first step, the government should present a strong 2007 budget ideally reducing the deficit by at least ½ percent of GDP—a solid step toward consolidation during the upswing. This could be achieved under the government's PLN 30 billion deficit target for the state budget only if deficits in the rest of the general government remain contained and the state budget overperforms. Beyond 2007, the authorities should move toward a sustainable general government deficit of about 2 percent of GDP while pressing ahead with tax reforms and adhering to the long-term goals of the 1999 pension reform.

39. **Looking further out, the restructuring over the past few years in industries exposed to foreign competition needs to be expanded to the economy more generally**. The productivity gains in manufacturing have been impressive and, having turned the corner on employment growth, the sector will increasingly contribute to higher incomes. But with Poland's openness to trade and foreign competition still lagging its income level and economic size, further efficiency gains from increased competition should be within reach. This will require pressing ahead with privatization and institutional reform to lower the costs of doing business and attract investment.

40. **Increasing labor usage will be another prerequisite for higher output**. At just over 50 percent of the working-age population, employment is too low, with obvious effects on both aggregate supply and demand. Proposals to cut payroll taxes will help but need to be supplemented by strengthening incentives to work through better targeting of social benefits. Improving the business environment and ensuring full and efficient use of EU funds will be critical to increasing labor demand.

41. **In the financial sector, strong and independent supervision needs to be protected**. The conclusions of the FSAP update—that the resiliency, capitalization, and profitability of banks are solid, financial supervision is sound, and the main issues in the financial sector are developmental—attest to the accomplishments of the supervisory system. In this context, the draft law to create a unified financial supervisor is a concern because of deficiencies in laying out a governance structure protected against politization. Supervisors will face increased challenges if, as seems likely, bank credit growth rises to rates in regional peers. The consequences of any weakening of supervision could therefore be severe. Already, a pickup in foreign currency lending to households subjects banks to growing credit

risk, although stress tests indicate that banks could absorb the direct effects of even rather large shocks to exchange and interest rates. While this assessment should be kept under review, it argues for continued reliance on careful bank-by-bank supervision of risk assessment systems rather than a move to direct controls, which anyway have not had lasting effects in other countries.

42. **With a reform agenda in place, euro adoption would be an additional impetus for trade, investment, and growth**. In developing its strategy for euro adoption, the government should bear in mind that Poland already benefits from markets' anticipation of euro adoption—reflected in reduced risk premiums, some insulation from financial market turbulence, and expanding trade and growth. Should markets' perceptions of the government's intentions on euro adoption slip significantly, Poland would not only lose an important anchor for policies, but might even forgo these anticipatory benefits. Indeed, the somewhat larger spillovers to Poland than to some regional peers from recent financial market turbulence are a reminder of the risks of delaying action to address policy weaknesses and eliminate impediments to euro adoption.

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

Table 1. Poland: Selected Economic Indicators

	2001	2002	2003	2004	2005	2006 Proj.	2007 Proj.
Activity and prices							
GDP (change in percent)	1.1	1.4	3.8	5.3	3.4	4.9	4.5
Domestic demand growth	-1.4	0.9	2.7	6.0	2.2	5.4	5.0
Private consumption growth	2.1	3.3	1.9	4.2	2.0	4.3	3.8
Public consumption growth	2.7	1.3	4.9	3.1	4.9	2.7	2.9
Domestic fixed investment growth	-9.7	-6.3	-0.1	6.4	6.5	10.0	9.5
Net external demand (contribution to growth)	2.6	0.5	1.1	-0.8	1.1	-0.5	-0.5
CPI inflation (change in percent)							
Average	5.5	1.9	0.8	3.5	2.1	0.8	2.0
End of period	3.6	0.8	1.7	4.4	0.7	1.4	2.0
Unemployment rate (average period) 1/	18.2	19.9	19.6	19.0	17.7	17.0	16.1
Gross domestic saving (ratio to GDP) 2/	18.0	16.1	16.6	16.3	17.9	19.3	20.2
Gross domestic investment (ratio to GDP)	20.8	18.6	18.8	20.1	19.0	20.6	21.7
Public finances (percent of GDP) 3/							
General government revenues	37.0	36.6	38.3	37.8	39.2	39.7	40.0
General government expenditures	42.2	42.7	43.9	43.7	43.1	44.2	44.4
General government balance	-5.2	-6.1	-5.6	-5.9	-3.9	-4.5	-4.4
Public debt 4/	38.8	43.6	48.5	46.8	47.7	48.9	50.0
Money and credit (change in percent)							
Private credit (12-month change in percent)	9.2	5.0	8.0	-0.4	12.6	. . .	. . .
Broad money (12-month change in percent)	9.2	-2.0	5.6	8.7	11.6	. . .	. . .
Money market rate (eop)	11.7	6.7	5.5	6.5	4.6	. . .	. . .
13-week t-bill rate (eop)	11.2	6.1	5.3	6.3	4.3	. . .	. . .
Policy Rate 5/	11.5	6.8	5.3	6.5	4.5	. . .	. . .
Corporate lending rate (1 year)	. . .	11.4	7.3	7.6	6.8	. . .	. . .
Balance of payments							
Current account balance (transactions, millions U.S. dollars)	-5,376	-5,009	-4,599	-10,522	-4,314	-5,644	-7,274
Percent of GDP	-2.8	-2.5	-2.1	-4.2	-1.4	-1.7	-2.1
C/A balance plus net FDI and capital account balance, percent of GDP	0.3	-0.6	-0.2	1.0	1.1	1.1	0.8
Exports of Goods (millions U.S. dollars)	41,663	46,742	61,007	81,862	95,846	110,859	122,451
Export volume growth	3.1	4.8	14.2	14.0	8.1	11.8	10.3
Imports of Goods (millions U.S. dollars)	49,324	53,991	66,732	87,484	98,540	116,282	130,182
Import volume growth	-5.3	2.7	9.3	15.2	4.9	12.9	11.4
Net oil imports (millions U.S. dollars)	3,530	3,602	4,297	5,644	. . .	. . .	. . .
Terms of trade (index 1995=100)	94.4	94.2	93.6	96.7	97.7	96.7	96.4
FDI, net (in percent of GDP)	3.0	2.0	2.0	4.8	2.2	2.3	2.3
Official reserves (millions U.S. dollars)	26,564	29,794	34,168	36,783	42,571	48,358	54,201
months of imports	6.5	6.6	6.1	5.0	5.2	5.0	5.0
Total external debt (percent of GDP)	37.8	42.9	49.3	50.9	42.9	42.3	42.1
Exchange rate							
Exchange rate regime				Floating			
Present exchange rate (July 14, 2006)				PLN 3.186 = US$1			
Zloty per US$, period average	4.1	4.1	3.9	3.7	3.2	. . .	. . .
Zloty per Euro, period average	3.7	3.9	4.4	4.5	4.0	. . .	. . .
Real effective exchange rate (INS, CPI based)	142.8	136.9	122.0	121.9	136.0	. . .	. . .
percent change	12.7	-4.1	-10.9	-0.1	11.6	. . .	. . .

Sources: Polish authorities; and IMF staff estimates.
1/ Using Labor Force Survey data (BAEL).
2/ Derived as total savings minus the current account minus capital transfers.
3/ Assumes unspecified savings of PLN 2.2 billion to meet the 2006 state budget deficit.
4/ Excluding second-pillar pension funds.
5/ Yield on the 7-day National Bank of Poland money market bills.

Table 2. Poland: Monetary Survey, 2000-05
(In millions of PLN, end-of-period)

	2000	2001	2002	2003	2004	2005
Net international reserves	131,761	132,565	132,118	135,888	143,223	170,451
(in billions of U.S. dollars)	27.5	26.6	29.8	34.0	36.8	42.6
Net domestic assets	212,320	259,982	260,806	279,699	302,276	326,917
Credit to central government, net	56,081	69,208	65,949	70,158	69,329	63,434
Credit to nongovernment	218,624	238,726	250,586	270,569	269,433	303,300
Other items, net	-62,385	-47,951	-55,729	-61,028	-36,485	-39,818
Broad money	300,757	328,434	321,961	340,049	369,484	412,346
Memorandum items (in percent)						
Broad money growth (12-month)	11.9	9.2	-2.0	5.6	8.7	11.6
Real broad money growth (12-month)	3.1	5.5	-2.8	3.9	4.1	10.8
Nominal growth of credit to nongovernment	17.3	9.2	5.0	8.0	-0.4	12.6
Real growth of credit to nongovernment	8.8	5.6	4.1	6.3	-4.8	11.9
Share of foreign currency deposits in broad money	13.8	15.3	14.5	13.7	12.6	11.3

Sources: National Bank of Poland; and IMF staff estimates.

Table 3. Poland: Balance of Payments on Transaction Basis, 2002-11
(In millions of US$)

	2002	2003	2004	2005 Est.	2006 Proj.	2007 Proj.	2008 Proj.	2009 Proj.	2010 Proj.	2011 Proj.
Current account balance	-5,009	-4,599	-10,522	-4,314	-5,644	-7,274	-9,444	-12,075	-16,046	-20,295
percent of GDP	-2.5	-2.1	-4.2	-1.4	-1.7	-2.1	-2.5	-3.1	-3.8	-4.5
Trade balance	-7,249	-5,725	-5,622	-2,694	-5,423	-7,731	-10,316	-13,635	-17,615	-21,950
percent of GDP	-3.7	-2.6	-2.2	-0.9	-1.7	-2.2	-2.8	-3.5	-4.2	-4.9
Exports										
percentage change in unit values	10.4	27.1	32.1	17.5	15.7	10.5	8.9	8.7	8.8	9.7
percentage volume growth	4.8	14.2	14.0	8.1	11.8	10.3	9.4	9.1	9.2	9.0
export market growth	2.8	6.3	10.5	7.7	8.1	6.5	5.6	5.2	5.4	5.1
Imports										
percentage change in unit values	8.4	22.5	29.2	12.8	18.0	12.0	10.3	10.4	10.6	11.2
percentage volume growth	2.7	9.3	15.2	4.9	12.9	11.4	10.8	10.8	10.9	10.6
growth in domestic demand	0.9	2.7	6.0	2.2	5.4	5.0	4.8	4.7	4.9	5.0
Terms of trade percentage change	-0.2	-0.6	3.3	1.0	-1.0	-0.4	0.0	0.0	-0.1	0.1
Services balance	851	527	1,005	1,957	1,930	1,881	1,774	1,579	1,317	1,067
Credit	10,037	11,174	13,465	16,186	18,721	20,679	22,518	24,476	26,633	29,228
Debit	9,186	10,647	12,460	14,229	16,791	18,798	20,743	22,897	25,317	28,162
Net Income	-1,889	-3,637	-11,539	-10,529	-10,044	-10,189	-10,379	-10,092	-10,315	-10,368
Net transfers	3,278	4,236	5,634	6,952	7,893	8,765	9,477	10,073	10,567	10,957
o/w EU receipts				3,902	4,655	5,304	5,777	6,121	6,339	6,429
o/w payment to EU				-3,031	-3,217	-3,439	-3,676	-3,927	-4,201	-4,499
Capital and financial account balance	7,173	8,640	9,313	15,875	11,431	13,117	14,392	16,503	19,997	24,036
Capital account balance	-7	-46	998	993	1,429	2,135	2,973	3,944	5,047	6,287
o/w net EU transfers				1,012	1,552	2,273	3,111	4,081	5,187	6,429
Financial account balance	7,180	8,686	8,315	14,882	10,002	10,981	11,418	12,559	14,949	17,750
Foreign direct investment (net)	3,901	4,284	12,079	6,716	7,649	8,017	8,873	10,372	12,735	15,568
by nonresidents	4,131	4,589	12,873	8,241	9,149	9,517	10,373	11,872	14,235	17,068
o/w privatization	414	138	197	31	700	700	400	400	400	400
Portfolio investment (net)	1,894	2,444	9,282	12,645	8,734	8,944	9,099	9,214	9,328	9,431
by non-residents	3,051	3,740	10,612	15,133	11,968	12,502	13,013	13,519	14,063	14,641
o/w equities	-545	-837	1,660	1,317	1,317	1,317	1,317	1,317	1,317	1,317
Other investment	2,283	2,828	-13,255	-4,724	-6,380	-5,979	-6,554	-7,028	-7,113	-7,250
Assets	1,887	-493	-11,897	-2,497	-3,931	-3,285	-3,590	-3,767	-3,527	-3,304
Liabilities	396	3,321	-1,358	-2,227	-2,450	-2,695	-2,964	-3,261	-3,587	-3,945
Financial derivatives	-898	-870	209	245	0	0	0	0	0	0
Errors and omissions	-1,529	-2,846	1,999	-3,426	0	0	0	0	0	0
Overall balance	635	1,195	790	8,135	5,787	5,843	4,948	4,428	3,951	3,742
Financing										
Reserve assets	-635	-1,195	-790	-8,135	-5,787	-5,843	-4,948	-4,428	-3,951	-3,742
Memorandum items:										
Official reserves	29,794	34,168	36,783	42,571	48,358	54,201	59,149	63,577	67,528	71,270
in months of imports	6.6	6.1	5.0	5.2	5.0	5.0	4.9	4.8	4.6	4.4
Ratio of reserves to short-term debt 1/	123.1	105.6	106.2	103.4	101.1	130.3	128.4	134.9	144.4	152.7
Total external debt (percent of GDP)	42.9	49.3	50.9	42.9	42.3	42.1	42.0	41.7	41.3	40.8
Total external debt (percent of exports) 2/	149.5	147.8	135.0	116.0	106.6	102.5	99.7	97.0	94.1	90.4
External debt service (percent of exports) 2/ 3/	23	24	27	22	24	19	21	21	20	18
Gross FDI inflows (percent of GDP)	2.1	2.1	5.1	2.7	2.8	2.7	2.8	3.0	3.4	3.8
Net FDI inflows (percent of GDP)	2.0	2.0	4.8	2.2	2.3	2.3	2.4	2.6	3.0	3.5

Sources: National Bank of Poland; and IMF staff estimates.
1/ By remaining maturity.
2/ Exports of goods and services.
3/ Excluding repurchase of debt.

Table 4. Poland: General Government Revenues and Expenditures, 2000-07
(In percent of GDP)

	2000	2001	2002	2003	2004	2005 Est.	2006 Proj.	2007 Proj.
General government revenue	36.5	37.0	36.6	38.3	37.8	39.2	39.6	40.1
Taxes	19.2	18.5	19.2	19.2	18.6	19.8	20.3	20.5
Social security contributions	11.4	11.6	10.9	11.1	11.9	12.0	12.0	12.0
Other taxes and nontax	5.8	6.8	6.5	8.0	7.4	7.4	7.3	7.6
General government expenditure 1/ 2/	39.7	42.2	42.7	43.9	43.7	43.1	44.2	44.4
Goods and services	12.8	14.8	14.4	15.4	15.3	17.6	17.3	17.9
Transfers and subsidies	21.7	22.0	22.6	22.9	22.8	19.8	20.5	20.1
Interest payments	2.4	2.7	3.0	2.9	2.4	2.5	2.7	2.5
Capital and net lending	2.8	2.7	2.7	2.7	3.2	3.1	3.8	3.9
General government balance 1/ 2/	-3.3	-5.2	-6.1	-5.6	-5.9	-3.9	-4.5	-4.3
Financing	3.3	5.2	6.1	5.6	5.9	3.9	4.5	4.3
Domestic	0.3	5.8	5.3	4.4	4.5	2.4	4.0	3.8
External	-0.7	-1.5	0.5	0.8	0.3	1.2	0.3	0.3
Privatization	3.6	0.8	0.2	0.4	1.1	0.3	0.3	0.3
Memorandum items:								
Structural balance 3/	-3.9	-5.1	-5.3	-4.8	-5.7	-3.6	-4.6	-4.6
Underlying balance 4/	-4.1	-4.8	-4.7	-4.5	-5.2	-4.0	-4.4	-4.7
Primary balance	-0.8	-2.5	-3.1	-2.7	-3.5	-1.3	-1.9	-1.8
ESA95 deficit with OFEs inside general gov.	-1.8	-3.7	-3.2	-4.7	-3.9	-2.4	…	…
ESA95 deficit with OFEs outside general gov.	-2.8	-4.8	-5.0	-6.4	-5.6	-4.3	…	…
State balance	-2.1	-4.2	-4.9	-4.4	-5.7	-4.2	-4.1	-3.9
Rest of government balance	-1.2	-1.0	-1.2	-1.2	-0.2	0.3	-0.4	-0.4
Public debt	37.7	38.8	43.6	48.5	46.8	47.7	48.8	49.8
ESA95 public debt with OFEs outside general gov.	…	36.7	41.7	46.8	45.9	47.3	…	…
ESA95 public debt with OFEs inside general gov.	…	35.9	39.8	43.9	41.8	41.9	…	…

Sources: Polish authorities; and IMF staff estimates and projections.
1/ Polish definition, but including pension reform costs by classifying the budgetary compensation to the social security fund (FUS) for its transfers to second-pillar pension funds (OFEs) as expenditure.
2/ Assumes unspecified savings of 0.2 percent of GDP to meet 2006 state budget target.
3/ Actual balance corrected for economic cycle.
4/ Actual balance corrected for economic cycle and one-off/special effects.

Table 5. Poland: Savings and Investment Balance-Baseline Scenario, 2001-11

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
				Est.				Proj.			
						(In percent of GDP)					
Consumption	82.9	84.8	83.8	81.9	81.3	80.5	80.0	79.5	79.0	78.5	78.0
Non-government	64.9	66.8	65.5	64.2	62.8	62.3	61.9	61.6	61.1	60.7	60.3
Government	18.0	18.0	18.3	17.7	18.5	18.2	18.1	17.9	17.9	17.8	17.7
Investment	20.8	18.6	18.8	20.1	19.0	20.6	21.7	22.8	24.1	25.3	26.7
Fixed capital	20.7	18.7	18.3	18.1	18.2	19.3	20.3	21.2	22.2	23.2	24.2
Non-government	17.3	15.3	14.9	15.2	14.7	15.4	16.4	17.2	18.2	19.5	20.7
Public sector	3.4	3.4	3.3	2.9	3.5	3.9	3.9	4.0	4.0	3.7	3.4
Change in inventories	0.1	-0.1	0.5	2.0	0.9	1.2	1.4	1.6	1.9	2.2	2.5
Total savings	20.8	18.6	18.8	20.1	19.0	20.6	21.7	22.8	24.1	25.3	26.7
Domestic savings	18.0	16.1	16.6	16.3	17.9	19.3	20.2	21.1	22.0	22.7	23.5
Non-government	20.4	19.5	19.5	19.0	18.7	20.0	20.7	21.9	22.5	23.5	24.1
General government	-2.5	-3.3	-2.8	-2.7	-0.8	-0.8	-0.5	-0.8	-0.5	-0.8	-0.5
Foreign savings 1/	2.8	2.5	2.1	3.8	1.1	1.3	1.5	1.7	2.1	2.6	3.1
						(In percent)					
Memorandum items:											
Real GDP growth	1.1	1.4	3.8	5.3	3.4	4.9	4.5	4.1	3.9	4.0	4.1
Private consumption											
Real growth	*2.1*	*3.3*	*1.9*	*4.2*	*2.0*	*4.3*	*3.8*	*3.7*	*3.5*	*3.7*	*3.7*
Contribution to GDP growth	1.4	2.2	1.3	2.8	1.3	2.7	2.4	2.3	2.2	2.3	2.2
Public consumption											
Real growth	*2.7*	*1.3*	*4.9*	*3.1*	*4.9*	*2.7*	*2.9*	*2.5*	*2.5*	*2.5*	*2.5*
Contribution to GDP growth	0.5	0.2	0.9	0.6	0.9	0.5	0.5	0.5	0.4	0.4	0.4
Fixed investment											
Real growth	*-9.7*	*-6.3*	*-0.1*	*6.4*	*6.5*	*10.0*	*9.5*	*9.0*	*9.0*	*9.0*	*9.0*
Contribution to GDP growth	-2.3	-1.3	0.0	1.2	1.2	1.8	1.8	1.8	1.9	2.0	2.1
Change in inventories											
Contribution to GDP growth	-1.0	-0.2	0.6	1.6	-1.1	0.4	0.2	0.3	0.3	0.4	0.4
External balance											
Contribution to GDP growth	2.6	0.5	1.1	-0.8	1.1	-0.5	-0.5	-0.8	-0.9	-1.1	-1.1

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

Table 6. Poland: Public Sector Debt Sustainability Framework, 2001-11
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2001	2002	2003	2004	2005			2006	2007	2008	2009	2010	2011	
								I. Baseline Projections						**Debt-stabilizing primary balance 1/**
Public sector debt 2/	38.8	43.6	48.5	46.8	47.7			**48.9**	**49.8**	**51.2**	**52.3**	**53.8**	**55.0**	**-0.8**
o/w foreign-currency denominated	12.7	13.5	15.3	12.2	13.0			13.3	13.5	13.9	14.2	14.6	14.9	
Change in public sector debt	1.1	4.9	4.9	-1.7	0.9			1.2	0.9	1.3	1.1	1.5	1.2	
Identified debt-creating flows (4+7+12)	2.1	4.0	3.1	-2.3	1.8			1.4	0.8	1.3	1.1	1.5	1.3	
Primary deficit	2.5	3.1	2.7	3.5	1.3			1.9	1.8	2.1	1.8	2.3	2.0	
Revenue and grants	37.0	36.6	38.3	37.8	39.2			39.6	40.1	40.1	40.2	40.3	40.4	
Primary (noninterest) expenditure	39.5	39.7	41.0	41.3	40.5			41.5	41.9	42.3	42.1	42.6	42.5	
Automatic debt dynamics 3/	0.4	1.1	0.7	-4.7	0.9			-0.2	-0.7	-0.6	-0.5	-0.5	-0.6	
Contribution from interest rate/growth differential 4/	1.0	1.6	1.1	-1.8	-0.2			-0.1	-0.7	-0.6	-0.5	-0.6	-0.6	
Of which contribution from real interest rate	1.4	2.1	2.7	0.5	1.3			2.1	1.4	1.3	1.3	1.4	1.4	
Of which contribution from real GDP growth	-0.4	-0.5	-1.6	-2.3	-1.5			-2.2	-2.1	-1.9	-1.9	-1.9	-2.0	
Contribution from exchange rate depreciation 5/	-0.6	-0.5	-0.3	-2.9	1.1			-0.1	0.0	0.0	0.1	0.1	0.1	
Other identified debt-creating flows	-0.8	-0.2	-0.4	-1.1	-0.4			-0.3	-0.3	-0.3	-0.2	-0.2	-0.2	
Privatization receipts (negative)	-0.8	-0.2	-0.4	-1.1	-0.4			-0.3	-0.3	-0.3	-0.2	-0.2	-0.2	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3)	-1.0	0.9	1.8	0.6	-0.9			-0.1	0.1	0.1	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 2/	104.8	119.3	126.6	123.9	121.7			123.3	124.2	127.5	129.9	133.3	136.2	
Gross financing need 5/	17.7	20.3	21.8	23.0	18.7			15.2	14.4	14.5	14.0	14.2	13.9	
in billions of U.S. dollars	33.7	40.3	47.1	58.2	56.7	10-Year Historical Average	10-Year Standard Deviation	49.4	50.2	53.8	55.6	60.1	62.6	Projected Average
Key macroeconomic and fiscal assumptions														
Real GDP growth (in percent)	1.1	1.4	3.8	5.3	3.4	4.2	1.9	4.9	4.5	4.1	3.9	4.0	4.0	4.1
Average nominal interest rate on public debt (in percent) 5/	7.5	8.0	6.8	5.5	5.8	7.5	1.3	5.9	5.4	5.6	5.7	5.8	5.9	5.7
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	4.0	5.7	6.4	1.4	3.0	0.6	4.9	4.7	3.2	3.0	2.9	2.9	2.9	3.0
Nominal appreciation (increase in US dollar value of local currency, in percent)	3.9	3.8	2.6	25.1	-8.3	-2.0	12.8	1.0	0.2	0.0	-0.4	-0.4	-0.4	-0.2
Inflation rate (GDP deflator, in percent)	3.5	2.2	0.4	4.1	2.7	6.9	5.7	1.2	2.2	2.6	2.8	2.9	3.0	2.7
Growth of real primary spending (deflated by GDP deflator, in percent)	7.0	1.9	7.3	5.9	1.5	4.9	3.1	7.6	5.5	5.0	3.5	5.3	3.6	4.6
Primary deficit	2.5	3.1	2.7	3.5	1.3	1.3	1.5	1.9	1.8	2.1	1.8	2.3	2.0	2.0
								II. Stress Tests for Public Debt Ratio						**Debt-stabilizing primary balance 1/**
A. Alternative scenarios														
A1. Key variables are at their historical averages in 2006-10 8/								**48.9**	**48.3**	**47.7**	**47.2**	**46.7**	**46.2**	**-1.8**
A2. No policy change (constant primary balance) in 2006-10								**48.9**	**49.9**	**51.0**	**52.2**	**53.3**	**54.4**	**-0.8**
B. Bound tests														
B1. Real interest rate is at baseline plus one standard deviations								**48.9**	**50.9**	**53.4**	**55.7**	**58.5**	**61.0**	**0.5**
B2. Real GDP growth is at baseline minus one-half standard deviation								**48.9**	**50.6**	**53.2**	**56.0**	**59.5**	**63.2**	**-0.3**
B3. Primary balance is at baseline minus one-half standard deviation								**48.9**	**50.6**	**52.7**	**54.6**	**56.8**	**58.8**	**-0.8**
B4. Combination of B1-B3 using one-quarter standard deviation shocks								**48.9**	**51.0**	**53.5**	**55.8**	**58.6**	**61.1**	**0.1**
B5. Onetime 30 percent real depreciation in 2006 9/								**48.9**	**56.0**	**57.3**	**58.3**	**59.8**	**61.0**	**-0.9**
B6. 10 percent of GDP increase in other debt-creating flows in 2006								**48.9**	**59.8**	**61.0**	**62.1**	**63.5**	**64.6**	**-0.9**

1/ 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.
2/ General government gross debt.
3/ Derived as $[(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp))$ times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
4/ 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.
5/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).
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/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 7. Poland: External Debt Sustainability Framework, 2001-11
(In percent of GDP, unless otherwise indicated)

	Actual							Projections							
	2001	2002	2003	2004	2005			2006	2007	2008	2009	2010	2011		
								I. Baseline Projections							**Debt-stabilizing non-interest current account 1/**
External debt	37.8	42.9	49.3	50.9	42.9			**42.3**	**42.1**	**42.0**	**41.7**	**41.3**	**40.8**		**-3.3**
Change in external debt	-2.7	5.0	6.4	1.6	-8.1			-0.6	-0.2	-0.2	-0.3	-0.4	-0.5	0.0	
Identified external debt-creating flows (4+8+9)	-4.4	-1.1	-4.0	-7.0	-8.7			-3.2	-2.3	-1.9	-1.7	-1.4	-1.2	0.0	
Current account deficit, excluding interest payments	1.4	1.2	0.8	2.7	-0.3			-0.3	-0.1	0.3	0.8	1.5	2.2	3.3	
Deficit in balance of goods and services	3.6	3.4	2.6	2.1	0.2			1.1	1.7	2.3	3.1	3.9	4.7		
Exports	27.0	28.7	33.3	37.7	36.9			39.7	41.2	42.1	43.0	43.9	45.2		
Imports	30.6	32.1	35.9	39.8	37.2			40.8	42.8	44.4	46.1	47.8	49.8		
Net non-debt creating capital inflows (negative)	-3.2	-2.1	-2.4	-4.1	-1.6			-1.8	-1.8	-1.9	-2.2	-2.6	-3.1	-3.1	
Automatic debt dynamics 2/	-2.7	-0.2	-2.4	-5.6	-6.8			-1.0	-0.4	-0.3	-0.2	-0.2	-0.2	-0.2	
Contribution from nominal interest rate	1.4	1.3	1.3	1.5	1.7			2.0	2.2	2.3	2.3	2.3	2.3	2.3	
Contribution from real GDP growth	-0.4	-0.5	-1.5	-2.2	-1.4			-2.0	-1.8	-1.6	-1.5	-1.6	-1.6	-1.5	
Contribution from price and exchange rate changes 3/	-3.6	-1.0	-2.2	-4.8	-7.0			-1.1	-0.8	-0.9	-1.0	-1.0	-1.0	-1.0	
Residual, incl. change in gross foreign assets (2-3)	1.7	6.1	10.4	8.6	0.6			2.6	2.2	1.8	1.4	1.0	0.7	0.0	
External debt-to-exports ratio (in percent)	140.0	149.5	147.8	135.0	116.0			106.6	102.4	99.7	97.0	94.1	90.4		
Gross external financing need (in billions of US dollars) 4/	35.6	37.7	46.7	62.3	64.1			73.2	70.0	77.5	81.9	86.3	90.9		
in percent of GDP	18.7	19.0	21.6	24.7	21.2	10-Year Historical Average	10-Year Standard Deviation	22.4	20.1	20.9	20.8	20.5	20.3	For debt stabilization	Projected Average
Key macroeconomic assumptions															
Real GDP growth (in percent)	1.1	1.4	3.8	5.3	3.4	4.2	1.9	4.9	4.5	4.1	3.9	4.0	4.0	4.0	4.1
Exchange rate appreciation (US dollar value of local currency, change in percent)	6.2	0.4	4.9	6.4	13.0	-2.4	9.9	1.4	-0.3	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
GDP deflator in US dollars (change in percent)	9.9	2.6	5.3	10.8	16.1	4.0	7.4	2.7	1.9	2.2	2.4	2.5	2.6	2.6	2.3
Nominal external interest rate (in percent)	3.8	3.5	3.3	3.5	4.1	4.0	0.9	5.1	5.6	5.7	5.8	6.0	6.0	6.0	5.8
Growth of exports (US dollar terms, in percent)	11.0	10.4	27.1	32.1	17.5	12.7	12.3	15.7	10.5	8.9	8.7	8.8	9.7		9.3
Growth of imports (US dollar terms, in percent)	1.9	9.0	22.5	29.2	12.2	13.1	9.1	18.0	12.0	10.4	10.4	10.6	11.2		10.9
Current account balance, excluding interest payments	-1.4	-1.2	-0.8	-2.7	0.3	-2.2	1.9	0.3	0.1	-0.3	-0.8	-1.5	-2.2		-0.9
Net non-debt creating capital inflows	3.2	2.1	2.4	4.1	1.6	3.0	1.1	1.8	1.8	1.9	2.2	2.6	3.1		2.3
								II. Stress Tests for External Debt Ratio							**Debt-stabilizing non-interest current account 1/**
A. Alternative Scenarios															
A1. Key variables are at their historical averages in 2006-10 5/								**42.3**	**41.9**	**41.1**	**39.9**	**38.4**	**36.6**		**-4.5**
B. Bound Tests															
B1. Nominal interest rate is at baseline plus one-half standard deviation								**42.3**	**42.3**	**42.3**	**42.3**	**42.1**	**41.7**		**-3.2**
B2. Real GDP growth is at baseline minus one-half standard deviations								**42.3**	**42.5**	**42.7**	**42.8**	**42.8**	**42.6**		**-3.1**
B3. Non-interest current account is at baseline minus one-half standard deviations								**42.3**	**43.1**	**43.9**	**44.6**	**45.1**	**45.5**		**-3.4**
B4. Combination of B1-B3 using 1/4 standard deviation shocks								**42.3**	**42.9**	**43.5**	**44.0**	**44.3**	**44.5**		**-3.1**
B5. One time 30 percent real depreciation in 2007								**42.3**	**62.1**	**61.7**	**60.9**	**59.7**	**57.9**		**-4.9**

1/ 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.

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

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

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.

Table 8. Poland: Indicators of External Vulnerability, 2001-06
(In percent of GDP, unless otherwise indicated)

	2001	2002	2003	2004	2005	2006 Proj.	Date of Observation
Financial indicators							
Public sector debt (in percent of GDP) 1/	38.8	43.6	48.5	46.8	47.7	48.9	*Proj. for 2006*
Broad money (percent change, 12-month basis)	9.2	-2.0	5.6	8.7	11.6	9.6	*Apr-06*
Private sector credit (percent change, 12 month basis)	8.7	4.4	7.9	2.9	12.6	11.3	*Apr-06*
Domestic credit to GDP	33.4	32.3	33.2	32.7	33.3	...	
13 week T-Bill rate 2/	11.2	6.1	5.3	6.3	4.3	4.2	*Jan-06*
13 week T-Bill real rate 3/	7.4	5.2	3.5	1.8	4.3	4.2	*Jan-06*
External Indicators							
Exports (percent change, 12-month basis in US$)	11.0	10.4	27.1	32.1	17.5	15.7	*Proj. for 2006*
Imports (percent change, 12-month basis in US$)	1.9	9.0	22.5	29.2	12.2	18.0	*Proj. for 2006*
Current account balance	-2.8	-2.5	-2.1	-4.2	-1.4	-1.7	*Proj. for 2006*
Capital and financial account balance	1.7	3.6	4.0	3.7	5.2	3.5	*Proj. for 2006*
o/w: Inward portfolio investment (debt securities etc.)	0.6	1.5	1.7	4.2	5.0	3.7	*Proj. for 2006*
Other investment (loans, trade credits etc.)	0.3	0.2	1.5	-0.5	-0.7	-0.8	*Proj. for 2006*
Inward foreign direct investment	3.0	2.1	2.1	5.1	2.7	2.8	*Proj. for 2006*
Net Foreign Assets (NFA) of commercial banks (in billions of US$)	33.3	33.8	35.8	46.3	52.4	...	
Official reserves (in billions US$)	26.6	29.8	34.0	36.8	42.6	48.5	*May-06*
Official reserves in months of imports of goods	6.5	6.6	6.1	5.0	5.2	5.0	*Proj. for 2006*
Reserve money to reserves (Ratio)	0.6	0.5	0.5	0.6	0.5	0.5	*Apr-06*
Broad money to reserves (Ratio)	3.0	2.6	2.6	2.7	3.0	...	
Reserves to total short term external debt (in percent) 4/	132.6	123.1	105.6	105.6	103.4	101.1	*Proj. for 2006*
Total external debt (in billions of US$)	72.0	84.9	106.7	128.7	130.0	138.2	*Proj. for 2006*
o/w: Central and local government debt (in billions of US$)	29.3	35.7	44.0	57.7	58.9	...	
Ratio of short-term external debt to total external debt (in percent)	15.5	16.3	18.4	18.9	19.6	...	
Exchange rate (per US$, period average)	4.1	4.1	3.9	3.7	3.2	3.18	*Jul-06*
REER depreciation (-) (12-month growth, period average) 5/	12.7	-4.1	-10.9	-0.1	11.6	2.7	*Apr-06*
Financial Market Indicators							
Stock market index (WIG)	13,922	13,845	20,820	26,636	35,601	40,817	*Jul-06*
Foreign currency debt rating							
Standard and Poor's 6/	BBB+	BBB+	BBB+	BBB+	BBB+	BBB+	*Jul-06*
Moody's 7/	Baa1	A2	A2	A2	A2	A2	*Jul-06*
Spread, JP Morgan's EMBI index	195	185	76	69	62	69	*Jun-06*

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 remaining 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.

Appendix I
POLAND—Fund Relations
(As of June 30, 2006)

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

II. **General Resources Account**:

	SDR Million	Percent Quota
Quota	1,369.00	100.0
Fund holdings of currency	1,258.35	91.92
Reserve position in Fund	110.65	8.08

III. **SDR Department**

	SDR Million	Percent Allocation
Holdings	57.09	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 Zl 1 equaling old Zl 10,000. The central parity of the zloty was adjusted under a crawling peg policy at a pre-announced 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 PLN 4.08 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 July 12, 2005 (Country Report No. 05/263). In concluding the consultation, Directors congratulated the Polish authorities on a successful first year in the European Union, but urged them to implement further fiscal and structural reforms to ensure long-term sustainability of public finances, enhance the flexibility of the economy, particularly in the labor market, and improve the business climate. They concluded that these steps should help secure a favorable setting for Euro adoption.

IX. Technical Assistance, 1992–2006

Department	Subject/Identified Need Counterpart	Action	Timing	
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 exercise visits	Expert	Late 1995	NBP
FAD	Tax administration (VAT) short-term assignments of field experts	Nine October 1994	August 1992–	MoF
FAD	Tax administration	Mission	November 1992	MoF

Department	Subject/Identified Need Counterpart	Action	Timing	
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 Mission	Follow-up	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 MoF/Local	Mission	October 1999	
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

Department	Subject/Identified Need Counterpart	Action	Timing	
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 2001)	Mission	October 2003	
IMF/IBRD	FSAP Update	Mission	April/May 2006	MoF NBP

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.

Appendix II
POLAND—World Bank Activity

44. 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 2005 eleven projects are under implementation, with an undisbursed balance of US$180 million.

45. 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$100 million) which aim at supporting the government’s Coal Reform Program (2003–06), specifically by mitigating the negative effects associated with the further reduction of employment levels, and supporting closure of uneconomic production capacity in a safe and environmentally sound manner, respectively; a EUR 100 million loan for Rehabilitation and Maintenance of Roads , fully implemented in calendar year 2004, a follow-up loan signed in 2005 (EUR 100 million) and the Post Accession Rural Support Loan for the amount of US$ 88 signed on April 7, 2006. Smaller institutional development grants are currently financing activities to strengthen the processes of land administration and registration and accounting and auditing.

46. 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 reducing poverty, encouraging social inclusion and bringing employment closer to the Lisbon targets.

47. 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 FY06 and FY07 include support for road infrastructure and flood prevention in the Odra river basin.

48. 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. The World Bank was 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 three 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.

49. The following non-lending activities identified in the CPS are under implementation:

ESW

- EU8 Cross-country Public Finance Reform (the first of three annual reports has been completed in early 2006; the second report is currently under preparation and is expected to be completed by the end of the fiscal year)
- EU8 Quarterly Economic Reports
- EU8 Cross-country Labor Market Report
- Legal Barriers to Contract Enforcement (This report was originally prepared with NBP as our counterpart, but following the elections it has been adopted by the Ministry of Justice and further assistance has been requested for implementation of some of its recommendations in FY07 and beyond)

Technical Assistance

- Health Reform Implementation
- Railway Reform Implementation
- IDF Grant for Accounting and Auditing Reform
- ROSC Updates (Accounting & Auditing and Corporate Governance modules)
- Policy Dialogue on the National Development Plan 2007-13
- Financial Services Policy Notes (*with NBP as counterpart*)
- Energy Policy Dialogue
- Energy Efficiency (ESMAP)
- Development of Secondary Legislation for PPPs
- PPPs for Roads (Spanish Trust Fund)

CGE Model Building (with NBP, MOF and MOEL as counterparts)

Appendix III
POLAND—Statistical Issues

50. 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 data to the Fund that are adequate for surveillance. Data on the core indicators are available on a timely basis (see the attached Table of Common Indicators Required for Surveillance). Consistent with its commitment to provide 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

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

52. 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 the production and expenditure approaches 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 have been delayed. In addition, seasonal adjustment on relatively short period leads to frequent and large backward revisions.

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

54. The producer price index (PPI) is based on the *1993 SNA* concepts and definitions for recording and valuation of product prices and weights. Its scope includes mining and quarrying, manufacturing and electricity, gas and water supply. Output price indices are also

calculated for agriculture, construction, and business services such as transport, storage, and communication. Since 2000, the index is classified by the Polish Classification of Activities based on the General Industrial Classification of Economic Activities within the European Communities, first revision (NACE, Rev.1), the Classification of Products by Activity, and the List of Products of the European Communities. The PPI does not include any estimation for missing prices or quality and seasonal adjustments.

Government finance statistics

55. The Ministry of Finance provides detailed monthly state budget data on its website, compiled on a cash basis. Fiscal data for other levels of government are published or provided to IMF missions on a less frequent basis. Consolidated general government data are published only on an annual basis, at the time of the budget, as an estimated outturn at the time of the preparation of the next budget, and as the final outturn in late spring of the following year. The limited breakdown of expenditure by category hinders fiscal analysis and identification of priority areas for fiscal consolidation; consequently they play a very limited role in the public policy debate, although non-state budget expenditure accounts for a large share of general government expenditure.

56. Data for inclusion in the *Government Finance Statistics Yearbook* are reported to the Fund on a regular basis and, since 2004, according to the framework of *GFSM 2001*. The authorities provided comparable data, compiled on an accrual basis, for 2001–03. Monthly data on consolidated core operations of the central government are reported in *IFS.* The Central Statistical Office also produces fiscal data according to the ESA95 methodology for submission to the EU and use in Poland's Stability Programs. However, GFS and ESA95 data, while providing a superior classification of revenues and expenditure, traditionally became available with long lags and only on an annual basis, diminishing their value for surveillance purposes. Detailed bridge tables between high-frequency cash data and ESA95 data are not yet available.[7]

Monetary statistics

57. The National Bank of Poland (NBP) regularly reports analytically useful data 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) for the compilation of monetary statistics; data compiled from March 2002 onward are generally consistent with the ECB framework, and previously released data have been revised back to December 1996.

[7] STA and Eurostat are working on bridging ESA and GFS data for all EU countries.

58. The mission that prepared the data module of the Report on the Observance of Standards and Codes (ROSC) 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 is not at market prices. The first three practices differ from the *MFSM* guidelines, but are in conformity with the ECB framework.

59. In addition, the data presented on the balance sheets of the NBP and other depository corporations provide insufficient breakdown of the claims on, and liabilities to, the government and other resident sectors. It is impossible to derive net claims on general government or central government on a consistent basis from the published data. Similarly, interbank positions between the NBP and other depository corporations cannot be identified. There are material differences between government finance statistics, financing data and the corresponding monetary data. The data 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

60. 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 further 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. Also, the coverage and reporting of the stock of external debt, especially at maturities up to one year, could be improved.

61. The 2003 data ROSC mission recommended that Poland include interest on an accrual 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 JULY 21, 2006

	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	7/21/2006	7/21/2006	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	6/2006	7/2006	M	M	M		
Reserve/Base Money	5/2006	6/14/2006	M	M	M	O, LO, O, LO	O, O, O, O, O
Broad Money	5/2006	6/14/2006	M	M	M		
Central Bank Balance Sheet	5/2006	6/14/2006	M	M	M		
Consolidated Balance Sheet of the Banking System	5/2006	6/2006	M	M	M		
Interest Rates[2]	7/21/2006	7/21/2006	D	D	D		
Consumer Price Index	6/2006	7/14/06	M	M	M	O, O, O, O	O, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2005	5/31/06	A	A	A	LO, O, O, O	O, O, O, O, NA
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	6/2006	7/19/06	M	M	M		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	5/2006	7/20/06	M	M	M		
External Current Account Balance	5/2006	7/13/06	M	M	M	O, O, O, LO	O, O, O, O, LO
Exports and Imports of Goods and Services	5/2006	7/13/06	M	M	M		
GDP/GNP	Q1/2006	6/30/06	Q	Q	Q	O, LO, O, O	LO, LO, O, O, LO
Gross External Debt	Q1/2006	6/30/06	Q	Q	Q		

[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 2006 Article IV Consultation

Supplementary Information

Prepared by the European Department

Approved by Alessandro Leipold and Adnan Mazarei

September 29, 2006

1. This supplement reviews political and economic developments since the preparation of the staff report for the 2006 Article IV consultation and provides a brief staff assessment. It also updates the PIN. The thrust of the staff appraisal remains unchanged.

V. Political Developments

2. **Political uncertainty has increased**. On September 22, Prime Minister Kaczynski ended the coalition with Samoobrona, one of the junior partners in government for the last five months, leaving this government short of a parliamentary majority. Among other issues, disagreements over the 2007 budget seem to have triggered this decision. The Prime Minister is now trying to secure a new majority with parliamentarians from a number of small parties and Samoobrona defectors. The outcome is hard to predict at this stage.

VI. Economic Developments and Outlook

3. **Recent data releases underscore the strong cyclical momentum of the economy**. According to newly available national accounts for the second quarter, the economy expanded at a year-on-year real rate of 5.4 percent in the first half of 2006, around ½ percentage point faster than anticipated in the staff report. Strong growth of private consumption, underpinned by a pickup of year-on-year enterprise employment growth to 3½ percent in August, and briskly expanding investment augur well for a continuation of the upswing. High-frequency indicators also remain strong, with growth of retail sales, industrial sales, and export volumes all in the double digits.

4. **Consequently, staff now expects somewhat faster growth than at the time of the staff report**—5.2 percent in 2006 and 4.7 percent in 2007, compared to 4.9 and 4.5 percent, respectively, in the staff report. The strength of domestic demand, and particularly investment, entail higher imports. However, as export prospects have also improved, projected current account deficits remain moderate. At 1.9 percent of GDP in 2006 and 2.3 percent of GDP in 2007, they are 0.2 percentage point wider than anticipated in the staff report.

5. **Inflation is picking up somewhat faster than expected from the very low levels early this year**. In August twelve-month inflation was 1.6 percent, compared to rates of below one percent throughout the first half of this year. Part of the pickup is due to a drought-related spike of food prices, which should be largely transitory and offset as easing oil prices are reflected in the CPI. More importantly, core inflation has been running at somewhat higher rates than anticipated, prompting staff to raise its inflation projection to 1.8 percent for end-2006, compared to 1.5 percent in the staff report, and to 2½ percent for end-2007. Nonetheless, core inflation (1.4 percent in August) remains well below the inflation target of 2½ ±1 percent, and productivity growth in industry still exceeds the rise in real wages. Staff therefore remains of the view that present interest rates are appropriate pending evidence that the economy will close in on resource constraints over the policy horizon.

6. **Public finances are also benefiting from the strong economy**. Buoyant tax collections through August suggest that the government's ambitious revenue target for 2006 is within reach. Also, expenditures are below plan so far, partly reflecting investment delays related to amendments of the public procurement law in May. But the government expects a full catch-up to meet budgetary allocations in the remainder of the year. Staff now projects the 2006 general government deficit at 4.3 percent of GDP (including pension reform costs), against 4.5 percent of GDP in the staff report.

7. **The preliminary 2007 draft budget suggests a small consolidation and no significant change in the structure of expenditure**. The budget is due for submission to Parliament by end-September. In line with the government's long-standing pledge, the preliminary draft keeps the central government deficit constant in nominal terms, implying a reduction of the deficit relative to GDP of 0.2 percentage point. Key elements of the government's earlier tax reform plans—payroll tax cuts and excise tax harmonization—have been dropped, although the indexation of personal income tax brackets, the restoration of gasoline excises to pre-September 2005 levels, and a number of other measures remain under consideration. Cyclically robust revenues are envisaged to fund expenditure growth of 6½ percent in real terms. EU-related expenditure, social benefits, and discretionary spending are the principal drivers.

8. **Financial markets have calmed since the emerging market sell-off in spring, and have taken the recent political developments in stride**. Between the trough in June and late September financial market indicators have improved substantially. Foreign currency interest spreads and credit default swap spreads, which had spiked during the emerging market turmoil, have fallen back to the levels of the beginning of the year. The stock market index has gained some 15 percent and is now up 10 percent year-to-date. The nominal effective value of the zloty has appreciated by some 3 percent and is now roughly back to its level at the beginning of the year. However, the 5 year–5 year interest spread seems to have

settled on a higher level[8]. This might be a first indication that Poland's waning enthusiasm for early euro adoption is starting to affect interest rate differentials.

9. **The new law on financial sector supervision took effect in September**. The governance provisions for the new unified supervisory agency were little improved in the legislative process and continue to fall short of best practice. With the independence of the agency insufficiently anchored in the legislation itself, implementation of the law will be key to determining the effectiveness of the new body.

VII. Staff Assessment

10. **The government's resistance of pressures to raise the deficit in 2007 is commendable, but the improving economic outlook strengthens staff's view that more ambitious consolidation should be targeted**. It is also regrettable that expenditure savings have not been found to accommodate earlier government plans to reduce taxes. While the remaining tax reform measures for 2007 are a step forward, they fail to address the key problem of Poland's excessively high payroll taxes. Looking ahead, efforts to rein in excessive administrative spending and poorly targeted social transfers should be a priority. This would make room for more aggressive deficit reduction and cuts in the tax wedge.

11. **Under the new legal framework for financial sector supervision, the scope for political interference remains a major concern**. It will now be critical that implementation of the law dispel any concerns in this regard from the outset, and that the early work of the agency send a strong signal of commitment to the high standards for supervision that have characterized the experience of recent years.

[8] It measures market expectations about the interest spread of zloty-denominated 5-year bonds over bunds in five years time. It thus reflects expectations about interest rate convergence, and by extension, euro adoption prospects.

Table 1. Poland: Selected Economic Indicators, 2001-07

	2001	2002	2003	2004	2005 Est.	2006 Proj.	2007 Proj.
Activity and prices							
GDP (change in percent)	1.1	1.4	3.8	5.3	3.4	5.2	4.7
Domestic demand	-1.4	0.9	2.7	6.0	2.2	5.8	5.2
Private consumption growth	2.1	3.3	1.9	4.2	2.0	4.8	4.1
Public consumption growth	2.7	1.3	4.9	3.1	4.9	1.8	2.9
Domestic fixed investment growth	-9.7	-6.3	-0.1	6.4	6.5	12.0	10.0
Net external demand (contribution to growth)	2.6	0.5	1.1	-0.8	1.1	-0.6	-0.6
CPI inflation (change in percent)							
Average	5.5	1.9	0.8	3.5	2.1	1.1	2.4
End of period	3.6	0.8	1.7	4.4	0.7	1.9	2.4
Unemployment rate (average, according to Labor Force Survey	18.3	19.9	19.6	19.0	17.7	15.9	15.0
Gross domestic saving (ratio to GDP) 1/	18.0	16.1	16.6	16.3	17.9	19.0	20.2
Gross domestic investment (ratio to GDP)	20.8	18.6	18.8	20.1	19.0	20.5	21.8
Public finances (percent of GDP) 2/							
General government revenues	37.0	36.6	38.3	37.8	39.2	39.9	40.0
General government expenditures 3/	42.2	42.7	43.9	43.7	43.1	44.2	44.2
General government balance 3/	-5.2	-6.1	-5.6	-5.9	-3.9	-4.3	-4.2
according to ESA95 and excl. pension reform costs	-3.7	-3.2	-4.7	-3.9	-2.4	…	…
Public debt 3/	38.8	43.6	48.5	46.8	47.7	48.4	49.4
according to ESA95 and excl. pension reform costs	35.9	39.8	43.9	41.8	41.9	…	…
Money and credit							
Private credit (12-month change)	9.2	5.0	8.0	-0.4	12.6	. . .	. . .
Broad money (12-month change)	9.2	-2.0	5.6	8.7	11.6	. . .	. . .
Money market rate (eop)	11.7	6.7	5.5	6.5	4.6	. . .	. . .
13-week t-bill rate (eop)	11.2	6.1	5.3	6.3	4.3	. . .	. . .
Policy Rate 5/ 6/	11.5	6.8	5.3	6.5	4.5	. . .	. . .
Corporate lending rate (1 year) 6/	. . .	11.4	7.3	7.6	6.8	. . .	. . .
Balance of payments							
Current account balance (transactions, millions U.S. dollars)	-5,376	-5,009	-4,599	-10,522	-4,314	-6,290	-7,844
Percent of GDP	-2.8	-2.5	-2.1	-4.2	-1.4	-1.9	-2.2
C/A balance plus net FDI, percent of GDP	0.2	-0.6	-0.1	0.6	0.8	0.6	0.2
Exports of Goods (millions U.S. dollars)	41,663	46,742	61,007	81,862	95,846	114,732	128,161
Export volume growth	3.1	4.8	14.2	14.0	8.1	13.3	10.6
Imports of Goods (millions U.S. dollars)	49,324	53,991	66,732	87,484	98,540	119,017	135,425
Import volume growth	-5.3	2.7	9.3	15.2	4.9	15.0	11.9
Net oil imports (millions U.S. dollars)	3,530	3,602	4,297	5,644	…	…	…
Terms of trade (index 1995=100)	94.4	94.2	93.6	96.7	97.7	98.2	97.5
FDI, net (in percent of GDP)	3.0	2.0	2.0	4.8	2.2	2.5	2.4
Official reserves (millions U.S. dollars)	26,564	29,794	34,168	36,783	42,571	45,080	47,963
months of imports	6.5	6.6	6.1	5.0	5.2	4.5	4.3
Total external debt (percent of GDP)	37.8	42.9	49.3	50.9	43.2	41.8	40.5
Exchange rate							
Exchange rate regime			Floating				
Present exchange rate (September 19, 2006)			PLN 3.125 = US$ 1				
Zloty per US$, period average	4.1	4.1	3.9	3.7	3.2	. . .	
Zloty per Euro, period average	3.7	3.9	4.4	4.5	4.0	. . .	
Real effective exchange rate (INS, CPI based)	142.8	136.9	122.0	121.9	136.0	. . .	
percent change	12.7	-4.1	-10.9	-0.1	11.6	. . .	. . .

Sources: Polish authorities; and IMF staff estimates.

1/ Derived as total savings minus the current account minus capital transfers.

2/Assumes expenditure savings of 0.2 percent of GDP relative to preliminary draft budget in 2007.

3/ National definition but including pension reform costs.

4/ Yield on 7-day NBP money market bills.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 06/116
FOR IMMEDIATE RELEASE
October 13, 2006

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

IMF Executive Board Concludes 2006 Article IV Consultation with the Republic of Poland

On October 4, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of Poland.[9]

Background

In the last five years, economic performance has not lived up to the promise of Poland's early reform record. In the 1990s, growth surpassed that in other transition countries, but since then has disappointed, in part reflecting a second wave of restructuring, particularly in the export-oriented manufacturing sector, lagging openness to foreign trade, slow growth in trading partners, and a large government sector. Less measurable features—policies that stifle competition, a large, low-productivity farming sector, poor infrastructure, and political tensions—probably also played a role. Thus, while benefiting from successful disinflation and protected from key external vulnerabilities by small current account deficits, a floating exchange rate, and sizable external reserves, Poland trails most other new member states of the EU in per capita GDP, investment, and employment.

---

[9] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the October 4, 2006 Executive Board discussion based on the staff report.

Nevertheless, by mid-2005, cyclical influences alongside the benefits from EU membership and the impetus from manufacturing sector restructuring produced an economic upswing. Output has expanded at an annualized rate of almost 6 percent since mid-2005 despite restrictive macroeconomic policies. Following a pickup in investment growth in early 2004, export growth has strengthened on the back of solid competitiveness and improving prospects in the Euro Area and in countries to the east. As prolonged net labor shedding ended, private consumption picked up with a short lag. Supply-side developments have been particularly strong in the externally exposed manufacturing sector. There, employment is rising strongly, profitability is robust, and exports are steadily climbing the technology ladder.

Monetary and fiscal conditions were contractionary last year and have been broadly neutral thus far in 2006. During March 2005-March 2006, the MPC cut policy rates by 250 bps, to 4 percent. Nonetheless, overall monetary conditions tightened during 2005 as the zloty appreciated and falling inflation added to real interest rates. With the value of the zloty little changed since end-2005, monetary conditions have now stabilized. Public finances were a positive surprise. The general government deficit fell to 3.9 percent of GDP in 2005 (2.4 percent of GDP according to ESA95 and excluding pension reform costs), two percentage points less than in 2004. Deficit reduction was driven by buoyant taxes, partly reflecting strong profit growth, while expenditure growth was contained marginally below GDP growth. Revenue strength extends into 2006, and, with spending so far below plan, fiscal policy was contractionary in the first eight months of the year.

The upswing has not tested resource constraints. Although domestic savings are low by regional standards, investment, even with the recent pickup, is lower still, and the current account deficit hovers around 2 percent of GDP. Labor market slack appears substantial with only 54 percent of the working-age population employed. Wage costs thus remain contained, although the fall in unit labor costs during 2002-04 has ended and sector-specific threats are to be watched (in state-controlled mining, health care, and construction).

Vulnerability indicators are generally favorable. The modest current account deficit is more than fully financed by FDI, and, helped by zloty appreciation, the external debt ratio fell to 43 percent of GDP in 2005. Official reserves fully cover short-term debt. Overall growth of bank credit to the private sector is modest by regional standards (13 percent in 2005) and banks are well capitalized, although rapidly expanding foreign currency mortgages require close monitoring. Poland’s weak spot remains high and rising public debt (48 percent of GDP or 42 percent of GDP according to ESA95 and excluding government debt held by second-pillar pension funds) with a sizable rollover rate of 22 percent, despite recent improvements of public debt management. More generally, EU membership appears to impart a substantial degree of confidence to markets, reflected in low measures of risk premiums. Nevertheless, after a smooth ride in 2005, Poland has been buffeted recently by turmoil in emerging markets.

Executive Board Assessment

Directors welcomed the upswing in the Polish economy that has been developing since mid-2005, and noted that prospects for this year and next are broadly favorable. The upswing has been well-balanced between consumption, investment, and exports, and underpinned by strong employment growth and enterprise profitability. Directors called on the Polish authorities to secure the momentum of the recent strong growth and maximize the benefits from EU membership by pressing ahead with fiscal and structural reforms.

Directors noted that the upswing is unlikely to run into resource constraints in the near term, as inflation remains subdued, the current account deficit is moderate, and the labor market still has substantial slack. In these circumstances, they considered that past monetary policy decisions had been appropriate and felt that rates could be kept on hold longer, pending evidence that the economy is closing in on resource constraints over the policy horizon. Nevertheless, it will be important for the central bank to remain vigilant against possible emerging inflationary pressures. Directors noted the volatility of inflation. They urged the Monetary Policy Council to make further efforts to anchor expectations at the central target rate by clearly communicating their aim of targeting this rate with symmetric deviations. Overall, they considered the monetary policy framework to be sound, and pointed to the vital role an independent central bank has played in maintaining stability.

Directors saw the exchange rate as within a range appropriate to ensure external competitiveness. Exports are gaining market share, relative unit labor costs are not rising, and exports have moved up the technology ladder.

Directors regretted that the general government outturn for 2006 is unlikely to improve over 2005, despite strong growth and buoyant revenue collections. With respect to the 2007 budget, they acknowledged that spending pressure has been resisted by sticking to the PLN 30 billion anchor for the central government deficit. They regretted, however, that because of insufficient expenditure savings, earlier tax reform plans could not be financed and had to be largely abandoned. In Directors' view this underscores the need to tackle poorly-targeted and high social spending as well as large administrative expenditures to reduce the deficit, while also making room for tax cuts, particularly on labor. They therefore felt that a more ambitious fiscal target, possibly supplemented by an expenditure ceiling, would help focus attention on the critical need for stronger expenditure based adjustment to stabilize the government debt and meet the Maastricht criteria. They also emphasized that adhering to the objectives of the 1999 pension reform would be critical for long-term fiscal sustainability.

Directors encouraged the authorities to move decisively to increase the flexibility of the economy. They stressed that improvements in Poland's low-rated business environment would be critical for extending the strong performance of the competitive export sector to the economy more generally. In this context, Directors expressed concern about the stalling privatization process. They underscored that Poland's still-low employment rate points to the need to make labor markets more flexible, especially by lowering the tax wedge and strengthening incentives to work. Moreover, Directors saw full and efficient use of EU funds as a priority and a welcome opportunity to raise productivity.

Directors agreed with the conclusions of the Financial System Stability Assessment (FSSA). They welcomed the finding that the banking system is well-capitalized, profitable, resilient to shocks, and soundly supervised. Noting Poland's limited progress in financial deepening in previous years, Directors viewed the recent pickup of credit growth as a generally positive development. However, the potential risks of a high concentration of credit growth in foreign currency housing loans require careful monitoring by supervisors, and Directors welcomed recent market-based steps that supervisors had taken in response.

Directors expressed concern about the new law on financial sector supervision. They noted that the governance provisions in the legislation for the establishment of a new unified financial sector supervisory agency fall short of best practice, providing insufficient assurances of the agency's independence and leaving scope for a politicization of its operations. Directors emphasized that it will be essential for the authorities—through effective implementation of the legislation—to send a strong signal of their commitment to the high standards of supervision that have characterized the experience of recent years.

Directors stressed that euro adoption will be an important opportunity to provide an impetus to trade, investment, and growth. They expressed concern that a slippage in the timeline for measures supporting euro adoption could result in a weakening of an important anchor for domestic reform and adversely affect market confidence. Directors agreed, however, that careful preparation for this important step, especially by reducing the fiscal deficit, increasing the flexibility of the economy, and ensuring broad political support, is essential for its success.

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: Selected Economic Indicators

	2001	2002	2003	2004	2005
Real economy			(Change in percent)		
Real GDP	1.1	1.4	3.8	5.3	3.4
Real domestic demand	-1.4	0.9	2.7	6.0	2.4
CPI (end of period)	3.6	0.8	1.7	4.4	0.7
Unemployment rate (in percent, period average)	18.3	19.9	19.6	19.0	17.7
Gross national savings (percent of GDP) 1/	18.0	16.1	16.6	16.3	17.9
Gross domestic investment (percent of GDP)	20.8	18.6	18.8	20.1	19.0
Public finance			(In percent of GDP)		
General government balance 2/	-5.2	-6.1	-5.6	-5.9	-3.9
According to ESA95 and excl. pension reform costs	-3.7	-3.2	-4.7	-3.9	-2.4
Public debt 3/	38.8	43.6	48.5	46.8	47.7
According to ESA95 and excl. debt held by second-pillar pension funds	35.9	39.8	43.9	41.8	41.9
Money and credit			(End of period, percent)		
Private sector credit (12-month change)	9.2	5.0	8.0	-0.4	12.6
Broad money (12-month change)	9.2	-2.0	5.6	8.7	11.6
Money market rate (end of period)	11.7	6.7	5.5	6.5	4.6
Balance of payments					
Trade balance (in percent of GDP)	-4.0	-3.7	-2.6	-2.2	-0.9
Current account (in percent of GDP)	-2.8	-2.5	-2.1	-4.2	-1.4
Official reserves (in billions of U.S. dollars)	26.6	29.8	34.2	36.8	42.6
Reserve cover (months of merchandise imports)	6.5	6.6	6.1	5.0	5.2
Total external debt (percent of GDP)	37.8	42.9	49.3	50.9	43.2
Fund position			(In millions of SDRs)		
Quota					1,369.00
Fund holdings of currency (June 30, 2006)					1,258.35
Holdings of SDRs (June 30, 2006)					57.09
Exchange rate					
Exchange rate regime			Floating		
Present exchange rate (September 25, 2006)			PLN 3.107 = US$1		
Zloty per U.S. dollar (period average)	4.1	4.1	3.9	3.7	3.2
Appreciation (+) of real effective exchange rate (CPI based, in percent)	12.7	-4.1	-10.9	-0.1	11.6

Sources: Central Statistical Office; data provided by Polish authorities; and IMF staff calculations.
1/ Includes capital and current transfers from the EU.
2/ Polish definition, but including pension reform costs.
3/ Polish definition.

Statement by Andrzej Raczko, Alternate Executive Director for the Republic of Poland October 4, 2006

We are grateful to the staff for its insightful report and constructive recommendations. Our authorities highly value the quality of the staff's analysis and its contribution to the domestic economic debate.

Recent Economic Developments and Prospects

Poland's accession to the European Union in May 2004 substantially improved the economy's long-term fundamentals and increased the potential growth rate. This is due to the fully gained access to the EU market in line with the principles of free movement of goods, capital, and—increasingly—labor, institutional convergence, increased credibility, and rising inflows of EU funds. After a temporary slowdown, caused by a delayed investment expansion, the economy in mid-2005 entered a period of economic upswing characterized by booming foreign trade, fast growth in private fixed investment, increasing FDI, burgeoning inflows of EU funds, robust productivity growth, and growing employment.

The long-awaited spurt in fixed investment (14.4 percent growth rate in the second quarter of this year), driven by high utilization of production capacity, cyclical rebound, high corporate profits, falling interest rates, stable unit labor costs in the industrial sector and strong investors' confidence is particularly promising. The growth in fixed investment should be increasingly supported by the absorption of EU cohesion and structural funds (estimated at up to 13 billion euro in 2004–06 and up to 91 billion euro in 2007–13). According to model-based estimates of the Ministry of Regional Development, EU funds contributed 0.86 percent of GDP in 2005. Their contribution to growth is projected to exceed 1 percentage point in 2006 and thereafter.

Given that the current expansion takes place in an unusually auspicious environment of low inflation (projected at 1.1 percent y-o-y in 2006), low external imbalances, a satisfactory fiscal situation, and an improved outlook for western Europe, the prospects for sustained growth in the medium term seem to be well grounded. Broadly in line with the staff, our authorities project GDP growth to reach 5.2 percent in 2006, 4.6 percent in 2007 and roughly 5 percent onwards.

The external position is comfortable. Owing to robust growth in exports, the current account in 2006 is expected to stabilize at the level of 1.7 percent of GDP. It will be fully financed by inflows of portfolio capital, FDI and EU funds. The current account deficit is projected to remain below 3 percent of GDP in the medium term.

My authorities were intrigued by the staff's scenario of increasing the potential growth rate by accelerating the absorption of foreign savings. We agree with the staff that a higher current account deficit of roughly 4.5 percent of GDP would be easily financed by FDI, stable portfolio investment, and EU capital transfers. However, use of additional foreign savings would depend not only on the improvement of the business climate, but also on the appropriate policy mix. This is not always easy to achieve. In the late 1990s, booming domestic investment widened the current account deficit to over 7 percent of GDP. To curb the deficit—in absence of fiscal measures—monetary policy was significantly tightened. Such a policy mix halted growth and increased unemployment for a number of years. That costly and painful maneuver had to be implemented because fiscal policy was not flexible enough, mostly due to the fixed structure of budgetary expenditures. More intensive use of foreign savings can thus be considered only if the flexibility of the fiscal policy improves.

Fiscal Policy

Since Poland implemented a fundamental pension reform in 1999, the staff needs to provide two sets of data on deficit and public debt with pension funds placed inside and outside of the general government. The general government deficit with pension funds classified outside the government's sector is some 1.8–2.0 percentage points higher than the one based on the common EU's methodology ESA-95 (the difference reflects the government's transfers to open pension funds (OFE) and exclusion of income from pension funds' assets). According to the Fund's estimates, the general budget deficit amounted to 4.6 percent of GDP in 2005; according to ESA-95, the deficit was much lower and amounted to only 2.5 percent of GDP. If the former measure of deficit is used to analyze the macroeconomic impact, i.e. the one with pension funds outside the general government, it is hard to explain how in 2005 such a high deficit (4.6 percent) may co-exist with 0.7 percent inflation. This misleading interpretation may be avoided if the latter is used. Since budgetary transfers to pension funds increase savings rather than expand consumption, the fiscal stimulus is limited and does not contribute to additional inflationary pressures. Thus, from a macroeconomic standpoint, any analysis of deficits should take into account the impact of the pension reform. The European Council partially shared this view since it decided to consider the impact of the pension reform on the general government deficit in five consecutive years.

My authorities believe that the level of inflation and the size of the public debt do not require any drastic fiscal adjustment, as it could undermine the ongoing economic expansion. The current political situation does not allow for any significant cuts in social expenditure. Nonetheless, the government is committed to reducing the budget deficit to below 3 percent, in line with Poland's commitments under the EU's Stability and Growth Pact.

To achieve this goal, the government established a simple fiscal rule based on a PLN 30 billion nominal cap on the state budget deficit in 2006, 2007 and onwards. It also committed itself to base the budget projections on conservative assumptions and—when tax revenues overperform—save the surplus. This was already the case in the past years. Robust growth also improved the financial position of local governments. As a result, they achieved a small fiscal deficit in 2005 and are likely to have roughly balanced budgets in 2006.

My authorities continue to gradually implement the agenda of structural reforms in the fiscal sector. The new minister of finance reiterated her commitment to enacting a new Public Finance Law, which would liquidate a number of extra-budgetary funds, incorporate the EU funds into the budget, and increase overall transparency of the public sector. The government is also working on the introduction of a performance-based budgeting aimed at enhancing the effectiveness of public spending and improving absorption of EU funds.

The deficit and public debt are easily financed both domestically and internationally. The public debt-to-GDP ratio remained stable between 2004 and now, and at the end of 2005 reached 41.9 percent (OFE within the general government sector), 47.3 percent (OFE outside the general government sector), owing to faster growth, lower yields, and the appreciating zloty. At the end of 2006, the public debt-to-GDP ratio shall reach 49.3 percent of GDP (OFE outside the general government sector). During the next three years, the pace of growth of public debt-to-GDP ratio should be lower and at the end of 2009, the ratio is expected to stabilize at the level of 52 percent (42 percent—OFE within the general government sector).

My authorities also took advantage of the favorable external environment to substantially lengthen the average maturity and duration of debt. During 2005, Poland also partially prepaid its Paris Club debt and is considering further early repayments and other active debt management measures.

While risks to the public debt seem to be contained, we nonetheless agree with the staff that the last temporary turmoil in emerging markets shows that Poland is better insulated from market turbulence than before. The impact of the turmoil was significantly lower than in emerging markets. Given that Poland's debt market is by far the largest and most liquid in the region, it is hard to compare Poland with other Central European countries, except perhaps Hungary. JP Morgan's Emerging Market Bond Index (EMBI) shows that during May–June the change in spreads on Polish and Hungarian debt was similar (spreads rose by 12 and 16 basis points, respectively). The increase in spreads was lower than in all emerging markets (38 basis points change) and European emerging market (36 basis points change).

As regards tax reforms, the government is considering the reduction of the high tax wedge by lowering contributions to the Labor Fund. The government is committed to implement this reform as a package with additional measures which allows to ensure budget neutrality.

Monetary Policy

In 2005, headline inflation reached only 0.7 percent (end-year) and was one of the lowest in the EU. This was due to lagged effects of the interest rates increases in 2004 aimed at preventing the emergence of second-round effects of the post-accession price shock and high oil prices, strong credibility of the central bank, slow growth in wages, an appreciating zloty and the effects of globalization.

A low growth rate of inflation continued in 2006. This allowed the central bank to lower the reference interest rates in the first quarter of the year to 4 percent, the lowest level in the history of modern Poland. Although inflation has currently reached the lower band of the continuous inflation target of 2.5 percent +/- 1, our authorities agree with the staff that for now they should refrain from further monetary easing, as risks to inflation are on the upside. This is mostly due to the future consequences of the accelerating wage growth, driven by fast GDP growth, and robust mortgage credit growth. The National Bank of Poland (NBP) projects that inflation will return to the target by the end of 2007.

My authorities agree with the staff that they should target the central rate with symmetric risks around it to better anchor expectations and further increase the credibility of monetary policy. The NBP is currently working on a communication strategy aimed at further improving the quality of information on its assessment of inflation risks provided to financial markets and to the public.

As regards the euro adoption, my authorities are convinced of its potential positive effects on growth through lower transaction costs, lower interest rates, and higher trade and investment. However, they are also aware of the risks of entering the euro zone without sufficient preparation in terms of fiscal and structural reforms. While the authorities have never officially announced a target date for the euro adoption, this date should be set while being on the sustainable path towards meeting the relevant Maastricht criteria, which are supposed to be fulfilled in 2009 at the latest according to the Convergence Program agreed with the EU. Meanwhile, the government wants to place emphasis on strong economic growth facilitating job creation and ensuring stable public finance. The decision on the date of Poland's entry into the Euro zone needs to be preceded by detailed analyses and should be taken after the achievement of an appropriate degree of real convergence of the Polish economy with the euro area. The process to fulfill the Maastricht criteria therefore should take place gradually and with respect to the government's priorities in the field of economic growth and social solidarity.

Structural Reforms

Since fundamental reforms have largely been completed in the run-up to the EU accession, in the past year the government has focused on areas where Poland lags behind its peers. The government continued the reform of the judiciary system by streamlining procedures, improving management of case flow, and implementing information systems. This should help improve the enforcement of bank collateral, which the staff pinpointed as one of the main barriers to wider access to bank financing. The re-established telecommunications regulator was substantially strengthened. Access to legal professions has been made much easier. In order to simplify access to EU funds, the government reformed the procurement law and cut red tape. The authorities also initiated collaboration with the World Bank on improving corporate governance. Last, but not least, the parliament established a new institution - the Central Anti-Corruption Bureau - to combat corruption.

My authorities also strongly supported structural reforms within the EU, including those concerning the financial and services markets. As to the latter, my authorities contributed to the adoption of the new Services Directive, even though its final shape fell short of our expectations.

We welcome the interesting staff paper on the flexibility of the Polish economy. We note, however, that most of the presented source data dates back to before EU accession and thus seems to be less relevant. For instance, product market flexibility has significantly improved upon entering the EU (the OECD data cited by the staff is for 1998 and 2003) thanks to the removal of barriers to trade and cross-border investment, converged legislation, strengthened EU-wide competition watch and elimination of unauthorized discretionary public subsidies to enterprises. In a similar vein, since the EU accession, the economy's openness increased by almost 10 percentage points of GDP thus closing a large part of the gap relative to its peers, when adjusted for size. Lastly, the fact that wage growth continues to substantially lag productivity growth seems to imply that the labor market is much more flexible than what the staff's paper suggests.

Continued structural reforms, fast GDP growth, and emigration to Western Europe contributed to a faster-than-expected decrease in unemployment. As of the end of August, the unemployment rate went down to 15.5 percent, 2.2 percentage points lower than a year earlier. The government estimates that unemployment will decrease further to about 14 percent by the end of 2007.

Despite falling unemployment, wage growth continues to be moderate (5.3 percent yoy in the corporate sector in August 2006). Given the dynamic labor productivity growth in manufacturing (10.1 percent yoy in August 2006), moderate wage growth (5.9 percent yoy in August 2006) led to lower unit labor costs and stronger competitiveness. The latter was reflected in double-digit growth rates in exports and continued increase in the global export share.

Financial Sector and FSSA

My authorities welcome the FSSA report. We broadly share the staff's opinion and appreciate the positive assessment of the soundness of the financial sector and of the progress in implementing recommendations from the 2001 FSAP. While detailed remarks to FSSA recommendations were delivered directly to the staff, additional comments clarifying my authorities' position vis à vis the staff's recommendations are needed.

EU accession has recently been the key driving force behind the financial sector's development, as it enhanced competition, spurred the emergence of new products, and contributed to improvements in the regulatory framework. EU accession has also led to a growth in the level of sophistication of financial products and a growing number or cross-border operations. To face the new challenges and contain increasing risk, the domestic financial supervision needed to be strengthened. My authorities decided to consolidate all supervisory institutions into one integrated financial sector regulator. Although the government's decision was not supported by the central bank, the new bill amending supervision law was approved by the parliament and signed by the president. In the government's view, the new law guarantees the new regulator's independence and professionalism. To ensure a smooth transition period and uninterrupted preparations for the introduction of the Basel II regulations, the integration of banking supervision into the new regulator is planned only for 2008. Until then the newly established Financial Supervision Authority will supervise the securities market, insurance sector and pension funds.

My authorities share the staff's view that the collateral and insolvency regimes are the key elements to reduce credit risk. In 2004, the new Financial Collateral Act provided a flexible non-judiciary mechanism for collateral enforcement. At the same time, the mortgage registry was reorganized and transferred to an electronic database to accelerate enforcement of property rights.

As regards the staff view's that the current list of financial instruments available to pension funds is not sufficient, the government believes that the degree of diversification of pension funds' assets is not a direct consequence of limitations imposed by regulators but it depends on the level of competition and development of the financial market.

Finally, the problem of voting rights and board representation for minority shareholders, like other corporate governance issues, will be addressed by the new EU directive on shareholders' rights—currently under consideration.