The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of the Bank of Finland.
Economic Developments

Modest recovery in production

After dismal economic developments in 2001 and the first half of 2002, the Polish economy recovered in the second half of the year, when industrial output rose more than 3 % y-o-y. Industrial output was up 5.1 % y-o-y in December. The return of healthy growth seems to continue as industrial output also grew by 4.2 % in January.

Industrial output was up only 1.5 % overall for 2002. Preliminary figures also indicate modest GDP growth of 1.3 % for the year (1 % in 2001). Estimates for 2003 GDP growth vary between 2.3 % and 3.5 %. The finance ministry used an assumption of 3.5 % GDP growth in preparing the 2003 budget.

Exports and consumer spending, which increased 9 % and 3 %, respective, drove growth in 2002. Investments, however, decreased 5.8 % last year (-9.8 % in 2001). The slump in construction also continued: -10.5 % (-9.9 %).

Current account deficit narrows

With a robust increase in exports (9 % in USD terms), Poland’s current account deficit diminished slightly to $6.7 billion (3.6 % of GDP) in 2002. The current account deficit was $7.1 billion (4.0 % of GDP) in 2001. Imports increased 3.2 % in 2002.

The flow of foreign direct investment into Poland slowed considerably last year. National Bank of Poland statistics indicate FDI in 2002 amounted to just $3.7 billion, down from $6.9 billion in 2001. The falling trend will apparently continue as Poland recently lost two major automotive investments from the Japanese Toyota and the French PSA. Reasons investors cite for their reluctance to invest in Poland are frustration with the tax system and corruption, as well as lower costs in nearby Russia and Ukraine.

Sluggish demand in Germany has also forced Polish enterprises increase their exports to other markets. Last year Polish exports to France, Sweden and Russia rose between 26 % and 32 %, while exports to Germany grew only 4 %. However, last year 32.5 % of total exports still went to Germany, which remains Poland’s largest export partner.

Unemployment situation still sticky

Although the Polish economy started to recover in the last half of 2002, unemployment continues to increase. At the end of January 2003, the unemployment rate stood at 18.7 %. This corresponds to 3.32 million registered unemployed persons – about 104,000 more than in December 2002 and 206,000 more than in December 2001.

Along with high unemployment, the employment rate (ratio of employed people to total population) has become a major worry for the Poles. By 4Q02, the employment rate had fallen to 44.1 % (CSO statistics). In August 1998, the ratio was still 51.9 %. Thus Poland shares honours with Bulgarias for the lowest employment rate among applicant countries and current EU members. Unemployment is concentrated in rural areas, where more than 40 % of the unemployed live, and in regions close to Germany.

High unemployment also provoked the government to amend the Labour Code last August. The changes affect recurring work contracts and group layoffs, as well as simplify rules governing small employers. According to an OECD study, these amendments will lower the EPL index, which measures the rigidity and the degree of regulation of labour markets, by approximately 16 %.

Balance of Payments, USD bln

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current account</td>
<td>-6.734</td>
<td>-7.166</td>
</tr>
<tr>
<td>Merchandise trade balance</td>
<td>-10.294</td>
<td>-11.675</td>
</tr>
<tr>
<td>Exports</td>
<td>32.998</td>
<td>30.275</td>
</tr>
<tr>
<td>Imports</td>
<td>43.292</td>
<td>41.950</td>
</tr>
<tr>
<td>Service balance</td>
<td>-1.029</td>
<td>-0.976</td>
</tr>
<tr>
<td>Investment income net</td>
<td>-1.662</td>
<td>-0.896</td>
</tr>
<tr>
<td>Current transfers balance</td>
<td>2.186</td>
<td>1.986</td>
</tr>
<tr>
<td>Unclassified flows balance</td>
<td>4.065</td>
<td>4.395</td>
</tr>
<tr>
<td>Capital and financial account</td>
<td>7.105</td>
<td>2.980</td>
</tr>
<tr>
<td>Foreign direct investment net</td>
<td>3.700</td>
<td>6.928</td>
</tr>
<tr>
<td>Portfolio investment net</td>
<td>1.698</td>
<td>1.109</td>
</tr>
<tr>
<td>Other investment balance</td>
<td>2.095</td>
<td>-4.715</td>
</tr>
<tr>
<td>Errors and omissions</td>
<td>0.273</td>
<td>3.763</td>
</tr>
<tr>
<td>Total</td>
<td>0.644</td>
<td>-0.423</td>
</tr>
</tbody>
</table>

Note: On cash basis
Source: National Bank of Poland
EU negotiations finalised

Ten countries, including Poland, successfully concluded their accession negotiations at the Copenhagen summit in December 2002. If the European parliament, the parliaments of EU incumbents and accession countries ratify the agreements, these countries will become members in EU on May 1, 2004. The Polish referendum has been scheduled for the June 8, 2003.

Poland will be a net receiver from the EU budget. During 2004–2006, Poland is eligible for up to €19.2 billion, of which a maximum of €13.6 billion would come directly from the EU budget. During the same period, Poland would only contribute €6.5 billion to EU coffers.

Although these figures look favourable, EU membership also imposes a substantial cost burden on Poland’s state budget. If Poland uses the maximum €3.68 billion from the structural fund and €1.06b from the cohesion fund in 2004–2006, the government must find approximately €1 billion to co-finance these projects. Similarly, while maximum subsidies to Polish farmers in 2004–2006 amount to €4.6 billion, only €2.9 billion will come from the EU. The remainder must come from the state budget. On the other hand, the EU agreed in the final days of negotiations to grant Poland special subsidies in the amount of €1.44 billion to improve budget liquidity (of this sum €1 billion will be transferred from the structural fund) during 2004–2006.

The Poles seem satisfied with the negotiation result. In a poll conducted in December 2002 after the agreement, 76 % of voters said they favoured Poland’s EU accession.

2002 budget on target, debt increased

State finances closely followed the 2002 budget plan. Revenues totalled PLN 144 billion (18.7 % of GDP) against expenditures of PLN183 billion (23.8 % of GDP). Also the public sector deficit according to EU standards (4.2% of GDP, ESA95) is estimated to be higher than the 3 % limit allowed by the Maastricht Treaty and is especially large when compared to state revenues (i.e. 28 % of total revenues).

The deficit was financed mainly through domestic and foreign bond issues. Between December 2001 and September 2002, consolidated central government debt increased from PLN 291 billion to PLN 342 billion. Including regional debt, total public debt amounted to PLN365 billion (47.5 % of GDP) in September 2002. Including later borrowing, Polish public debt is close to 50 % of GDP – the initial ceiling in the Act on Public Finance. While the Polish constitution limits public debt to 60 % of GDP, the Act on Public Finance imposes restrictions on future deficits as soon as public debt exceeds 50 %. Further restrictions are imposed if debt exceeds 55 % of GDP. Finance Minister Grzegorz Kolodko declared that the ratio was only about 45 % at the end of December when calculated according to EU standards (ESA 95).

The many extra-budgetary funds in Poland muddy the overall picture of public sector finance. An OECD study found over 300 extra-budgetary funds and establishments at the central level, as well as over 3,000 at regional and local levels. The most important include the social insurance fund, the farmers’ insurance fund and the labour fund. Such extra-budgetary funds are only partially reflected in the state budget. While the deficits of these funds are estimated to be less than 1 % of GDP, they create sizeable contingent liabilities. The 2002 budget act estimates the maximum liabilities or outstanding guarantees at PLN 38.5 billion (5 % of GDP). Due to extra-budgetary funds, some estimates assess the actual public sector deficit (or economic deficit) at between 5.5 % and 5.8 % of GDP in 2002.

2003 budget - deficit still 4.7 % of GDP

The 2003 budget act assumes 3.5 % GDP growth. It estimates budget revenues of PLN 155 billion (18.7 % of GDP), expenditures of PLN 194 billion (23.4 % of GDP) and a deficit of PLN 39 billion. The finance ministry estimates the deficit will amount to 4.7 % of GDP this year.

The growth of budget revenues, 6.7 % y-o-y in nominal terms and 4.3 % in real terms, reflects projections for GDP growth, improved tax collection and higher out-of-profit payments from the NBP. Budget spending, up 4.5 % in nominal terms and 2.2 % in real terms, should be driven by higher unemployment, increases in public salaries and expenditures related to the recent Act on Common Health Insurance and the National Heath Fund. The high growth in spending violates a former rule that limited expenditure growth to 1 % in real terms.

The 2003 budget is expected to take in about PLN 430 million from restructuring fees paid by enterprises seeking relief from tax debts. Last August, the government introduced a debt-restructuring program, whereby viable firms were able to receive debt write-offs owed to state institutions. In January, the finance ministry announced that out of 60,673 applicants, tax officials granted relief to 55,270 firms. Some 98 % of applicants were small firms, employing fewer than 250 people. The total amount of overdue taxes to be written off is estimated at about PLN 5.7 billion (€1.38b).

Central government budget 2003, PLN bln

<table>
<thead>
<tr>
<th></th>
<th>2003 budget</th>
<th>% of GDP</th>
<th>2002 actual</th>
<th>% of GDP</th>
<th>2002 budget</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>155</td>
<td>18.7</td>
<td>143.5</td>
<td>18.7</td>
<td>145.1</td>
</tr>
<tr>
<td>Expenditures</td>
<td>194</td>
<td>23.4</td>
<td>183.0</td>
<td>23.8</td>
<td>185.2</td>
</tr>
<tr>
<td>Deficit</td>
<td>39</td>
<td>4.7</td>
<td>39.4</td>
<td>5.1</td>
<td>40.0</td>
</tr>
</tbody>
</table>

Note: 2003 figures are according to the Ministry of Finance’s revision in January
Markets

Interest rate cuts continue
The Monetary Policy Council (MPC) cut its reference rates again in January by 25 basis points. The main 28-day reference rate now stands at 6.5 %. Since January 2002, when the reference rate was still 11.5 %, the MPC has cut its reference rates nine times. The MPC justified the recent rate cut as a response to sluggish domestic demand, a lack of improvement in the global economy and falling inflation.

Consumer price inflation (CPI) for the all of 2002 was 1.8 %, while producer price inflation (PPI) was 1 %. December consumer prices were 0.8 % higher y-o-y. Among key sectors, prices fell only in food, alcohol and tobacco, where prices were down 2.8 % y-o-y in December.

The inflation target for last year was lowered in June 2002 and at the same time the target for 2003 was set to 3 % (within a tolerance band of ±1 %). Thus, the CPI undershot the lowered inflation target by 1.2 % last year.

Since December 2001, the zloty has depreciated 19 % against the euro. During January and February this year, it fluctuated between 4.0 and 4.19 zlotys to the euro. Currency depreciation and low inflation have thus improved the competitiveness of Polish enterprises and helped spur export growth.

The monetary policy debate has heated up again. In early February, finance minister Grzegorz Kolodko criticised the NBP on monetary policy and high real interest rates. Noting that annual inflation was only 0.5 % in January, Mr. Kolodko warned 6 % real interest rates were “suicidal for Poland’s economy.” NBP governor Leszek Balcerowicz, in turn, has repeatedly criticised the government and the finance ministry for high budget deficits.

Despite the interest rate cuts, the broad measures of money supply have shown little change. The narrow measure of money supply, M1, was 15.2 % higher y-o-y in December 2002, while the broader M3 decreased 2.1 % from last year. This shift reflects a general decision by Polish households to decrease savings. Bank deposits and other bank liabilities were down 12.6 % y-o-y in December.

New MPC members will be elected in early 2004, when the president, lower-house Sejm and the Senate will each choose three MPC members. NBP governor Leszek Balcerowicz will remain on the MPC.

NBP plans early EMU entry
Last December, NBP governor Leszek Balcerowicz announced that Poland should target the entry into EMU no later than the beginning of 2007 and, if possible, already in 2006. Under the Maastricht Treaty, applicant countries must participate in the ERM two years before joining EMU. As soon as Poland becomes an EU member in May 2004, it is eligible for ERM participation.

Finance minister Kolodko last month announced that Poland might miss its timetable of meeting the Maastricht criteria on budget deficit by 2005. According to Kolodko, the ministry’s optimistic, but achievable, scenario assumes the budget deficit will fall to 3.2 % of GDP in 2005, which is still slightly above the 3 % ceiling allowed under the Maastricht Treaty.

New bond issues in 2003
The budget act assumes this year’s projected PLN 39 billion (€9.4 billion) budget deficit will be financed mainly through new debt issues. In addition to several domestic bond issues, the finance ministry is planning to issue at least $1 billion on the US market, ¥20-30 billion on the Japanese market and several fresh issues on European markets. The budget sets the total value of foreign bond issues at $2.8 billion, although the government has permission to issue as much as $6 billion this year.

The finance ministry has had mixed success with its bond issues this year. On January 28, the ministry responded to strong market demand by raising the amount of its eurobonds issue from a planned €750 million to €1.5 billion. The bonds sold at 0.45 percentage points above the referent eurobonds.

On February 12, however, the finance ministry rejected all bids on a 20-year, 1 billion zloty (€240million) domestic bond issue. The ministry rejected all bids, as none of the offered prices met the ministry’s minimum expectations. Analysts said the threat of impending war in Iraq and the ministry’s large borrowing needs dampened investor interest. On February 19, the Ministry successfully sold out a five-year domestic bond issue, worth a total of 2 billion zlotys (€483 million).

Inflation and reference rate in 1998-2002

<table>
<thead>
<tr>
<th>Inflation (CPI), annual average, %</th>
<th>1995</th>
<th>1996</th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>As of</th>
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<tr>
<td>M2, annual average growth, %</td>
<td>37.8</td>
<td>32.7</td>
<td>30.3</td>
<td>25.8</td>
<td>23.2</td>
<td>14.9</td>
<td>13.4</td>
<td>1.5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rates</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-reference rate, % end of period</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>15.5</td>
<td>16.5</td>
<td>19.0</td>
<td>11.5</td>
<td>6.75</td>
<td>6.5</td>
<td>1/03</td>
</tr>
<tr>
<td>-deposit rate*, %</td>
<td>19.5</td>
<td>17.0</td>
<td>18.0</td>
<td>11.0</td>
<td>9.0</td>
<td>9.0</td>
<td>2.5</td>
<td>4.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-lending rate**, %</td>
<td>24.0</td>
<td>20.5</td>
<td>22.5</td>
<td>15.5</td>
<td>14.4</td>
<td>19.7</td>
<td>12.5</td>
<td>9.9</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Forex reserves, USD billion</td>
<td>14.96</td>
<td>18.22</td>
<td>21.40</td>
<td>28.28</td>
<td>27.31</td>
<td>27.47</td>
<td>26.57</td>
<td>29.79</td>
<td></td>
<td></td>
</tr>
<tr>
<td>PLN/EUR, end of period</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>4.09</td>
<td>4.17</td>
<td>3.85</td>
<td>3.52</td>
<td>4.02</td>
<td>4.13</td>
<td>1/03</td>
</tr>
<tr>
<td>PLN/USD, end of period</td>
<td>2.47</td>
<td>2.88</td>
<td>3.52</td>
<td>3.50</td>
<td>4.15</td>
<td>4.14</td>
<td>3.99</td>
<td>3.84</td>
<td>3.82</td>
<td>1/03</td>
</tr>
</tbody>
</table>

Source: National Bank of Poland

*lowest interest on 6 month deposit; **lowest interest on 1-year loan

Source: CSO, NBP
Focus: Poland’s arduous road to EMU

by Małgorzata Markiewicz, CASE*

The Polish state budget has run substantial deficits since 1999. This deterioration is due in part to cyclical changes and in part to political factors. Relatively minor budget cuts in the face of rising budgetary expenditures in real terms seem to be setting up a permanent imbalance. Expenditures in 2001 and 2002 grew in real terms 9% and 3.9%, respectively.

The finance ministry now denotes obligatory budget expenditures, which can be changed only by amending the law, as “fixed expenditures.” There are now 14 groups of such expenditures, including debt servicing payments, transfers to local governments, social transfers and endowments to the social security fund, the farmers’ pension fund and the labour fund. Many interest groups attempt to “fix” their expenditure items by law. Every year new items are added to this list. This year, the nominal increase in fixed expenditures will exceed the growth of total expenditures. In this light, the government’s claim that budget expenditures are overly rigid is a bit strange, especially given that a majority government can get changes in the law implemented by parliament.

Weak budget revenues also hurt Polish budget balance. For the past three years, state budget revenues have undershot their targets. Some of this can be attributed to the global economic slowdown, but it also reflects overly optimistic assumptions about tax collection and economic growth. This year the finance ministry seems to have the most optimistic forecast on GDP growth and domestic demand. The ministry estimates Polish GDP will grow by 3.5% in 2003, which is well above the 2.7% consensus forecast.

2004 budget and EU accession

Poland’s EU accession in 2004 will alter the budgetary process. The list of fixed expenditures will also have to include Poland’s EU membership fee (€1.56 billion). There will further be other new expenditure items such as co-financing of structural projects from the budget, the British rebate and enrolments in EU institutions (e.g. European Investment Bank and the European Central Bank). These will raise budget expenditures by about €1.35 billion. Moreover, if Poland supports agriculture up to the 55% limit, it will cost the budget about €400 million in 2004.

On the revenue side, certain income from duties and tariffs will be lost with EU accession. These include customs fees on the eastern border and possibly some VAT revenues (since taxes will no longer be collected at the border).

Obviously, Poland is a net gainer from the EU’s budget; advances in the first year of membership will include 10% of the structural funding planned for 2004–2006 (approx. €967 million in 2004), as well as advances to the Cohesion Fund (about €800 million). Poland will also receive a special payment of €443 million to support the budget in the first year of membership and an additional €100 million for control of the eastern border.

Simply taken from the budget perspective, the net effect of accession on the 2004 budget should be negative. Moreover, given the burden of fixed expenditures, the fiscal deficit may worsen. Thus, if the government does not undertake fiscal reform directed at fixed obligations, this could increase the budget deficit to 5.5% of GDP in 2004. It also clarifies finance minister Kolodko’s recent remark that Poland’s budget deficit in 2005 may exceed the 3% of GDP ceiling set down in the Maastricht Treaty.

When and how to enter EMU?

To join EMU by 2007, Poland has to comply with the criteria on inflation, interest rates, exchange rate and public finance in 2005. There is presently no consensus in Poland how these criteria will be met or the timing of EMU membership.

Poland already fulfils the criteria on inflation and interest rate – the fiscal record is the big problem. How much adjustment is needed? The Maastricht criterion of 3% fiscal deficit relates to the general government measure calculated on an accrual basis according to ESA95 standards. The budget deficit approved by parliament only concerns the state budget and amounts to 50% of the general government sector expenditures. Control over other items is therefore limited. The finance ministry presented the results of fiscal deficit on ESA95 standards to the European Commission (see table). Outsiders will find it impossible to calculate this measure, as components are not published in official statistics.

Further methodological problems include whether open pension funds (OFE) should be included inside the general government sector. While Polish authorities include them, Eurostat has yet to issue a final opinion. The Commission has already provisionally agreed that Poland will incorporate OFE into the public finances’ sector once in the EU. Classification of these funds outside the general government sector would diminish the declared deficit by 1.3% of GDP last year.

Incorporating OFE into general government sector has shortcomings as well. The low on public finances, which lists public institutions, excludes OFE. Incorporation of these funds into the public sector might thus increase political pressure in these institutions. Moreover, information on public debt will be blurred when accumulated debt of the central budget towards OFE vanishes.

Clearly, Poland’s path to the EMU membership will be a rocky one.

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003f</th>
</tr>
</thead>
<tbody>
<tr>
<td>State budget deficit</td>
<td>-2.4</td>
<td>-2.0</td>
<td>-2.2</td>
<td>-4.3</td>
<td>-5.1</td>
<td>-4.9</td>
</tr>
<tr>
<td>Economic deficit</td>
<td>-</td>
<td>-</td>
<td>-2.9</td>
<td>-2.1</td>
<td>-4.7</td>
<td>-5.8</td>
</tr>
<tr>
<td>Net borrowing (ESA95)</td>
<td>-2.3</td>
<td>-1.5</td>
<td>-1.8</td>
<td>-3.9</td>
<td>-4.2</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Note: Net borrowing is based on data presented by the Polish Government to the European Commission. The 2002 deficit will be revised slightly downwards, as GDP figures were altered due to changes in methodology applied by the state statistical office. 2003 figures are author’s estimates.

* CASE is an independent private research institution based in Warsaw.
2001
No 2 Tuuli Koivu ja Ikka Korhonen: Talouskasvu riepeästi Baltiassa vuonna 2000
No 3 Jouko Rautava: Suomen Venäjän-kauppa 2000 - Epävakaa toimintaympäristö rajoittaa kauppaa
No 4 Ikka Korhonen: EU-kandidaatit ja rahaliitto
No 5 Pekka Sutela: Venäjän talouden kasvunäkymät
No 6 János Gács, Ikka Korhonen and Mare Randveer: The Impact of EMU’s Third Stage on Estonian Economic Development, 1999-2000
No 7 Jouko Rautava: Venäjän reformistratet: rakennreuudistukset vs. liberalisointi
No 8 Tuuli Koivu: Current issues in pension reform in the Baltics
No 9 Jaana Rantama: Baltic pankkijärjestelmät
No 10 Pekka Sutela: Venäjän talouspolitiikka ja talouden näköalat lokakuussa 2001
No 12 Tarja Kauppila: Puolan talouskasvu hidastuu
No 13 Katja-Leena Klemola: Siirtymätalouksien tutkimuslaitoksen lukijatutkimus
No 14 Katja-Leena Klemola: Survey of readers of BOFIT publications, spring-summer 2001
No 15 Michael Funke: Determining the taxation and investment impacts of Estonia’s 2000 income tax reform
No 16 Merja Tekoniemi: Venäjän maatalouden kehitys ja uudistaminen 1990-luvulla
No 17 Jian-Guang Shen: China’s Exchange Rate System after WTO Accession: Some Considerations

2002
No 1 Juhani Laurila: Determinants of transit transports between the European Union and Russia
No 2 Tarja Kauppila: Polish Economic Review 1/2002
No 3 Tuomas Komulainen: Elokuun 1998 talouskriisi
No 4 Laura Solanko - Merja Tekoniemi: Fiskaalifederalismi Venäjällä
No 5 Jian-Guang Shen: China’s Macroeconomic Development in 2001
No 6 Tuuli Koivu: Vuosi 2001 Baltiassa
No 7 BOFIT: Näkökulmia Venäjän talouteen - BOFIT-seminaari 13.5.2002
No 8 Pekka Sutela: Combining the incompatibles: fixed exchange rate, liberalisation and financial development in Estonia
No 9 Tarja Kauppila: Polish Economic Review 2/2002
No 10 Ikka Korhonen: Selected Aspects of Monetary Integration
No 11 Tuuli Koivu: Banking and Finance in the Baltic Countries
No 12 Filippo Ippolito: The Banking Sector Rescue in Russia
No 13 Antje Hildebrandt: What is Special about Enlarging the European Union towards the East? A Comparison with the Southern Enlargement

2003
No 1 Marco Fantini: An evaluation of draft legislation on Russian deposit insurance
No 2 Jian-Guang Shen: China’s Economic Development in 2002
No 3 Komulainen, Korhonen I, Korhonen V, Rautava, Sutela: Russia: Growth prospects and policy debates
No 4 Tuomas Komulainen: Polish Economic Review 1/2003