Quarterly 2/2001 (9)

POLISH ECONOMIC OUTLOOK

TRENDS • ANALYSES • FORECASTS

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From the editor

Dear readers,

Economic developments in 1Q01 did not differ much from our previous forecasts. Growth turned out slightly lower than we expected. This was due to consumer caution. Facing a tough situation on the labour market consumers were inclined to save rather than spend. Enterprises have demonstrated a greater elasticity in accommodating to tough market conditions than we expected. Thanks to this, exports have compensated for lower growth in domestic demand, irrespective of the further appreciation of the zloty. Against this background, the risk of seeing our alternative, black, scenario – presented in the previous issue – coming to life is very low, especially given that the chances of recession in the US are much lower now than three months ago.

Nevertheless, the pace of recovery will be slightly lower than we previously expected. However, low growth is not the main problem facing economic policy, as is commonly perceived. The reason for this is that the public sector, as opposed to consumers and enterprises, proved little able to accommodate, if it was able at all. The public sector's financial stance fully mirrors its economic condition. The mounting budget deficit points to increasing risks of macroeconomic turmoil.

At present, the biggest threat to the economy is a belief among some politicians that structural adjustments in the public sector can be avoided by stimulating growth. Despite this, restrictive monetary policy has minimised the chances of our alternative, black scenario being realised. This scenario projected deepening budget imbalances impacting the whole economy. Thanks to this restrictiveness, budget imbalances which have set back some positive changes (with slower disinflation and postponed prospects of a recovery), do not directly pose a threat of recession. However, without consolidation of public finance it is not possible to put the economy back on a fast track. We should also bear in mind that if public sector adjustments are exchanged for monetary loosening, we could see a severe economic meltdown. The preconditions for such a scenario are elaborated in our forecasts and analyses.

Andrzej Bratkowski

Małgorzata Markiewicz

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Fiscal consolidation – for now only on paper

The state budget deficit in 1999–2000 was about 2% of GDP and the consolidated budget deficit above 3%. The economic deficit, reflecting the impact of the budget deficit on national savings (calculated as a consolidated deficit of the public sector augmented by compensation for public sector employees and revenues from the sale of UMTS licenses and lowered by funds transferred by ZUS to Open Pension Funds) stood at 2.7% of GDP for two years. There was neither fiscal adjustment nor growth in fiscal imbalances. The budget deficit would seem to be moderate, especially in comparison with other countries in the region and could be explained by the financial costs of restructuring the economy and the effects of high real interest rates on the domestic market which have increased public debt servicing expenditures.

However, fiscal imbalances are higher than appeared at first glance. The nominal overall deficit rule which applies to the central government budget does not allow for any increase in the deficit above the level set in the budget act. In the case of dropping revenues the budget act must either be amended or expenditures have to be sequestrated. There is also a possibility of hidden expenditures. Last year, the state budget extended loans to extra-budgetary funds and return payment was suspended. However, debt cancellation was permitted after parliament approved the realisation of the budget act. These activities are remembered only by economists, and – judging by parliamentary commission reports – also by some members of parliament.

What was the scope of these operations? If it hadn't been for the following loans the state budget deficit would have been higher by 0.8% of GDP in 1999 and 0.4% of GDP in 2000: an 800 million zloty loan extended to the Regional Health Funds in 1999 (payment was actually cancelled) and a 1 billion loan in 2000 (the Ministry of Finance suspended payment in 2001–2002), added to a 4 billion zloty loan to FUS (Social Insurance Found) in 1999 (payment was planned for 2001, but there is no such amount in FUS's financial plans) and a 2 billion zloty loan in 2000.

The Ministry of Finance appears to make arbitrary decisions influencing fiscal balances. For instance, the consolidated budget deficit would be higher if compensation paid to public sector employees for the non-increase in salaries and pension payments in 1991–1992 had been recorded "above the line". Shifting obligations to the future is an effective method for decreasing deficits: immediate expenditures would increase the deficit, while in the future they would be classified as debt and repayment would be classified "below the line" as negative financing. Official fiscal statistics do not reveal contingent liabilities which might assign budget expenditure in the future (for example: the indebtedness of public health sector institutions was about 3 billion zlotys at the end of 2000 and the indebtedness of the Open Pension Funds was for two years adding to the budget). These obligations might, but do not have to increase expenditures; they could be classified as compensation to public sector employees. The overall degree of central bank independence is evaluated as high, though the central bank still finances operations which should be included in government accounts. For example, in 2001 the central bank will finance restructuring of the state bank PKO BP. Hence, revenues from defence sector privatisation collected in 2001 will not be included in financing items, but will be used by the defence sector to cover (extra-) budget expenditures. Finally, funds from the sale of UMTS licenses will be treated as revenue. This one-time revenue should be recorded "below the line" on the same basis as are privatisation proceeds.

The budget deficit is therefore actually higher than official data suggests and public debt is higher than indicated by the public sector borrowing requirements. Some revenues are one-offs and some financing sources will be exhausted within the next few years. Next year, privatisation revenues are expected to equal about 5 billion zlotys, and will be negligible thereafter. The fall in privatisation revenues will limit budget deficit financing sources and the possibilities of covering imbalances in extra-budgetary funds with loans extended by the government. The choice will be between fiscal retrenchment and an increase in debt. However, a growth in public debt would lead to an increase in debt servicing expenditures and would contradict the Maastrich Treaty's convergence criterion concerning central government bond yields with around 10 years' residual maturity. The difference today between these rates in Poland and Euro-zone countries is about 7%. Fiscal, not monetary, policy is responsible for the persistence of high interest rates. Monetary policy that limits inflationary expectations influences long-term interest rates. A faster drop in national bank interest rates would lead to an increase in long-term rates.

The size of the consolidated public sector deficit in Poland is higher than the EU average. Members states have been exerting efforts to consolidate fiscal balances over the last few years (see: table). Such a tendency is observable also in the US where a policy of fiscal consolidation enabled economic growth lasting a decade.

Fiscal deficits in Poland are not connected with business cycles and distort the effects of automatic stabilisers. One could talk of the transitional character of deficits at the beginning of transformations in Poland, but not today when the private sector contribution to value added is over 60%. Economic growth did not contribute to budget deficit reduction. If in a growing economy the fiscal deficit was equal to 2-3% of GDP it might be expected that during a slowdown in growth the fiscal deficit would increase. The slowdown in economic activity currently being observed is already reflected in a drop in budgetary revenues. According to our estimates, these revenues will be lower than planned by more than 10 billion zlotys. This means either a sequestration of expenditures or amendments to the budget law. However, the government may decide to limit the budget deficit with creative accounting measures – those mentioned above are just examples. For instance, the government may decide not to transfer funds to cover ZUS's outstanding debt to the Open Pension Funds – in that case the owners of the accounts would finance the deficit. The transactions to pay back Brady bonds before maturity seem to be a good way to decrease current expenditures and decrease public debt. These operations allow the government to sell collaterals, which are partly classified as financing items and partly as budget revenues. If the operation of paying back Brady bonds was financed by

Table. Consolidated public sector deficits as a percent of GDP

	Euro zone	US
1991	-4.7	-4.5
1992	-4.8	-4.7
1993	-5.7	-3.9
1994	-5.0	-2.9
1995	-5.0	-2.2
1996	-4.3	-1.4
1997	-2.6	-0.3
1998	-2.1	0.8
1999	-1.2	1.4
2000	-0.7	2.4

Source: European Central Bank and Congressional Budget Office.
Note: negative figures indicate a deficit.

the issue of new bonds it would not lead to a decrease in public debt, but could be a source of extraordinary budget revenues.

The Law on Public Finances allows for the transfer of unrealised expenditures to the next budgetary year (in 2000 expenditures of 580 million zlotys were transferred to this year and 177 million zlotys of expenditures were financed with foreign credits and grants). This is also a way to hide expenditures. At the end of the year some expenditures may be delayed and the recorded fiscal deficit is smaller. This may cause higher imbalances in the future, but budgetary revenues may be planned with greater confidence. If expenditures are not executed due to a fall in revenues they may be shifted to the next year.

The lack of determination in fiscal adjustment is explained by the rigidity of public expenditure. It is assumed that such outlays are equal to about 80% of all expenditures. Debt servicing payments are a good approximation of the cost of the lack of fiscal contraction. In 2000 they were equal to 12% of all expenditures. Social insurance expenditures increased from 15% of all outlays in 1991 to 24.4% in 2000. Most public expenditures are directed for consumption. Only 4.9% of outlays set investment expenditures.

Some politicians have called for an increase in the budget deficit and a cut in interest rates in order to accelerate growth and decrease unemployment. Recently observed growth in the rate of unemployment has heightened expectations towards the budget. In such a situation a critique of current fiscal policy and proposals for fiscal retrenchment appear less than popular.

This proposal is based on the results of empirical economic research that proves that persistent fiscal deficits in the long run reduce economic growth through the reduction of domestic savings and the crowding out of domestic investment (increase in cost and accessibility of funds). Ricardian theory concerning the lack of influence of public dissavings on domestic savings has yet to be proven in the sample of transition countries. Admittedly, in an open economy the private sector undertakes some measures weakening the relation between budget deficit and domestic savings. As a result of budget deficits, domestic savings decrease, which leads to a drop in investment and/or growth in the current account deficit. As a consequence, the rate of economic growth decreases. Growth in domestic savings observed in Poland during the last decade was too low to stimulate a high rate of economic growth.

In the case of a high tax burden, any calls for fiscal adjustment mean cuts in expenditure. Economic research confirms the persistence of fiscal adjustment when undertaken alongside expenditure cuts. An increase in revenue does not lead to sustainable fiscal adjustment. Therefore, the idea of an increase in the tax burden would not lead to an improvement in public finances for longer than one parliamentary term.

It should be stressed that the lower the inflation rate the smaller is the real depreciation of public debt. Therefore, the financial results of cuts in interest rates should not be directed towards current expenditures, but should be aimed at solving some structural problems of the budget (deficit or tax burden reduction).

Today, the most popular method of expenditure reduction is sequestration. It seems to be necessary to create a realistic budget and limit outlays with legal provisions. The source of savings could be the activity of extra-budgetary funds, which manage 30% of public sector funds and more than half of funds redistributed at the state level. There are some additional factors weakening pressure on budget expenditures: the numbers of pupils in primary schools and pensioners are falling: a drop in real interest rates could also be expected.

Creative accounting blurs the fiscal sector but does not solve any real problems. On the contrary, it may lead to their accumulation in the future. Such practices make answering questions concerning necessary fiscal adjustment measures more complicated.

Łukasz Rawdanowicz

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Early warning crisis indicator

This article presents the modified methodology of our early warning crisis indicator. The experience gathered after just under a year of using the previous indicator, combined with a wide range of research on currency crises carried out by CASE, inclined us to do some fine tuning. We invite you to visit the CASE web site (www.case.com.pl) where you will be able to download papers on currency crisis – a detailed list is provided at the end of this article. The new methodology of our indicator will be also available on the web site.

The recent wave of financial crises in the 1990s has led to a resumption of studies aimed at developing a universal set of indicators serving as early warning signals against crises. As yet, no such set has been successfully developed since no consensus has been reached on the theoretical fundamentals and practical problems concerning the availability and quality of data. In addition, each country – due to its specific problems – may be characterised by variables describing its economic stability which vary from country to country. One must bear in mind that all quantitative indicators used in warnings against crises are imperfect and do not provide a sufficient basis for a full assessment of any given country's financial and macroeconomic stability.

Our indicator does not provide an ex-post measure for the occurrence of a currency crisis. Rather it points to trends that may lead to one. The indicator includes 10 differently weighted macroeconomic and financial variables. Based on changes in the variables (magnitudes or levels) and their signs a certain score is attributed (see Table). The lower the value of the indicator, the lower the threat of a currency crisis. The indicator values range between 0 and 13.

After almost a year of publishing our early warning crisis indicator for Poland we have decided to modify the methodology of its compilation. Firstly, we have introduced weights for particular variables in order to reflect their ability to impact the economy and raise the probability of a crisis. In our view, the most important variables are as follows: the current account deficit as a percentage of GDP, the real effective exchange rate, and Polish foreign short-term debt as a percentage of liquid reserves (weights: 0.15). The second most important variables are GDP growth, the government budget deficit as a percentage of GDP, and the real 3-month WIBOR (weights: 0,10) – see Table below. In addition, we have changed the thresholds of the scoring system.

Secondly, from now on developments in variables related to the government budget deficit and total Polish foreign debt and their influence on macroeconomic stability will be assessed based on their actual levels rather than their percentage changes, as was the case previously. In three cases – government budget deficit, current account deficit and total foreign debt – critical thresholds have been set. If they are exceeded, additional points are added (the inverse of the corresponding weight).

Thirdly, for the GDP forecast, current account deficit and CPI we have introduced a "crawling horizon". These variables will be calculated based on forecasts for the

Table 1. Composition of the early warning crisis indicator

Variables	Magnitude and sign of a change	Points
1. Annual GDP growth rate forecast for 4 consecutive months – % change to the analogous forecast of the previous quarter		
Weight: 0.1	Below -2.5 of standard deviation	10
	From -2.5 to 0	6
	no change	5
	From 0 to 2.5 standard deviation	4
	Above 2.5 standard deviation	0
2. Actual unemployment rate (end–quarter) – % change qoq		
Weight: 0.05	above 1 standard deviation	10
	from 1 standard deviation to 0	6
	no change	5
	from -1 standard deviation to 0	4
	below -1 standard deviation	0
3. Average annual CPI forecast for 4 consecutive quarters – % change to the analogous forecast of the previous quarter.		
Weight: 0.06	above 1 standard deviation	10
	from 1 standard deviation to 0	6
	no change	5
	from -1 standard deviation to 0	4
	below -1 standard deviation	0
4. Government budget deficit forecast in 2001 (as % of GDP) – each 4Q forecast for the following year is adopted.		
Weight: 0.1	above 1 standard deviation	10
	from 1 standard deviation to 0	6
	no change	5
	from -1 standard deviation to 0	4
	below -1 standard deviation	0
	If deficit below -6% GDP	additional 10
5. Forecast of the current account deficit as a % of GDP (sum of 4 consecutive quarters) – % change to the analogous forecast of the previous quarter.		
Weight: 0.15		
	above 1 standard deviation	10
	from 1 standard deviation to 0	6
	no change	5
	from -1 standard deviation to 0	4
	below -1 standard deviation	0
	if deficit below -8% GDP	additional 6.67
6. OECD real effective exchange rate weighted with CPI – deviation from a 3-year average		
Weight: 0.15	appreciation above 2.5 standard deviation	10
	appreciation from 1 to 2.5 standard deviation	6
	appreciation up to 1 standard deviation and depreciation	5

7. Credit expansion as a % of M2 (end–quarter) – % change yoy		
Weight: 0.07	above 2.5 standard deviation	10
	from 0 to 2.5 standard deviation	6
	no change	5
	from -2.5 standard deviation to 0	4
	below -2.5 standard deviation	0
8. Polish foreign short–term debt to liquid reserves ratio (end of previous quarter – data available with one–quarter lag) – % change yoy		
Weight: 0.15	above 1 standard deviation	10
	from 1 to 0 standard deviation	6
	no change	5
	from -1 to 0 standard deviation	4
	below -1 standard deviation	0
9. Total Polish foreign debt as a % of GDP (end of previous quarter – data available with one–quarter lag)		
Weight: 0.07	above 60%	10
	from 30% to 60%	6
	below 30%	0
	if the debt is over 100% of GDP	additional 14.29
10. Real 3–month WIBOR (average for the last month of a quarter) – % change qoq		
Weight: 0.1	above 2 standard deviation	10
	from 0 to 2 standard deviation	6
	no change	5
	from -2 to 0 standard deviation	4
	below -2 standard deviation	0

Source: CASE.

4 immediately consecutive quarters. As such, the GDP growth rate will be a weighted sum of quarterly rates; the CA deficit will be calculated as the sum of deficits in the 4 following quarters divided by nominal GDP in the corresponding 4 quarters expressed in US dollars; and the CPI as an average of average quarterly CPI over the next 4 quarters.

We hope that our improved indicator will be useful in assessing Poland's economic situation and the potential threat of a currency crisis. We are fully aware that the choice of variables, the system of scoring and weights may be subject to criticism. However, all indicators of this kind suffer some deficiencies. We would like to point out that the values provided by the indicator should be interpreted with caution, and should be based on other available information. This indicator is not an absolute and infallible tool used as a warning signal against crises.

1Q01 saw an increase in our early warning crisis indicator up to 5.80. This signifies a deterioration in the macroeconomic situation. Among growing imbalances one should most clearly note the further real appreciation of the zloty in effective terms, something that has been observed for five quarters. In addition, forecasts for the budget deficit and current account as a percentage of GDP as well as the total foreign debt as a percentage of GDP increased. Finally, the continued rise in the rate of unemployment also had a negative impact.

On the positive side, short-term foreign debt as a percentage of liquid reserves, credit expansion as a percentage of M2, as well as higher GDP in the coming four

Table 2. Early warning crisis indicator

	weights	3Q99	4Q99	1Q00	2Q00	3Q00	4Q00	1Q01
1. Annual GDP	0.10	6	4	4	4	6	6	4
2. Annual unemployment rate	0.05	6	10	10	4	6	10	10
3. Annual average CPI forecasts for 4 consecutive quarters	0.06	10	6	4	4	4	0	0
4. Government deficit forecast for 2001 as a % of GDP	0.10	5	5	5	5	5	6	6
5. CA balance forecast for 4 consecutive quarters as a % of GDP	0.15	6	6	10	0	4	4	6
6. Real effective exchange rate	0.15	0	0	6	6	6	6	10
7. Credit expansion as a % of M2 (end of quarter)	0.07	4	4	4	6	6	4	4
8. Polish foreign short term debt as a % of liquid reserves	0.15	6	6	6	10	6	4	4
9. Total Polish foreign debt as a % of GDP	0.07	6	6	6	6	6	6	6
10. Real 3M WIBOR	0.10	6	10	4	6	6	6	6
Indicator		**5.10**	**5.26**	**6.04**	**5.18**	**5.48**	**5.10**	**5.80**

Source: CASE.

quarters were all positive developments. On top of this disinflation was maintained.

The overall internal and external macroeconomic situation is relatively well balanced. Slower economic growth and rising unemployment is offset by lower inflation and the stable current account deficit. Over the year the broad picture of the Polish economy should not change considerably. Faster GDP growth and weaker global economic activity will worsen the current account deficit (see chapter on forecasts), but not to such extent that it will fundamentally impact the economy. In addition, given the floating exchange rate regime, rising unemployment should not add significant risk of a crisis – similar to the one experienced in the UK in 1992.

The current exchange rate of the zloty both against the dollar and the euro remains our main concern. The longer the zloty remains strong, the higher the risk of a sudden depreciation. In the near future, the zloty may weaken in the event of an abrupt outflow of portfolio capital. However, in the face of high real interest rates such a possibility is rather unlikely. Moreover, even in the case of portfolio outflow, this could be offset with an inflow of foreign currency cash, current accounts, and time deposits held abroad by banks in Poland. Thus, the extent of the possible depreciation could take various paths.

At this point, it should be underlined that there is no unique definition of a crisis, especially in the case of economies with floating exchange rates, as the degree of depreciation commensurate with a crisis is also floating. The exchange market pressure index (EMP) approach has recently became very popular in economic literature. This is largely due to the work of Eichengreen, Rose, and Wyplosz (1996) ["Contagious currency crises", NBER Working Paper 5681, June]. The

EMP index measures crises not only with reference to changes in the nominal exchange rate but also changes in foreign reserves and interest rates. The inclusion of the latter two variables is believed to be more appropriate if crises are understood as a drop in confidence in a given currency. The weighted sum of the variables – comprising the overall index – is then related to a threshold, based on standard deviation. A such the index tends to define a crisis in a rather mechanical way.

In our view, a better definition of a crisis is one that includes some negative process in the real sphere. Without doubt, crises take place when depreciation – caused by a sudden increase in corporate debt – triggers a banking or debt crisis. So far such a severe crisis is not a real threat for Poland. On the other hand, it seems appropriate to speak about a crisis if depreciation on its own is not enough to restore investor confidence, and other policy measures are needed – like consolidation of the budget, lowering inflation or external financial aid (e.g. IMF guarantees). This term also is suitable when the weakening of the domestic currency leads to GDP contraction (directly – if export price elasticity is low and insufficient to offset the drop in domestic demand – or indirectly via higher interest rates needed to curb inflation).

Against the current economic setting, the two latter cases of crisis cannot be ruled out and this is reflected in our early warning crisis indicator. For more information on our exchange rate and capital flows forecast, please read the chapter on forecasts.

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The economy in 1Q01

Anna Myślińska, Katarzyna Piętka

Economic growth

GDP and demand factors

- **Further slowing of growth**
- **Export driven growth along with weak domestic demand**

The slowdown in the Polish economy evident throughout 2000 continues – according to our estimates, GDP grew 2% yoy in 1Q01, compared with 2.4% yoy in 4Q00. At the same time, net exports remain a key growth driver, as domestic demand registered only a 0.5% increase yoy (which is less than GDP).

The stagnation in domestic demand stems from flat dynamics of all its components. According to our estimates, government consumption increased 1.6% yoy. However, the key element here was suppressed household consumption. A negligible expansion reflected both income and saving factors. The real dynamics of wages and social transfers (which in 1Q01 were stimulated only by partially paid compensation for last year's higher-than-expected inflation), were quite modest despite lowering inflation. Thus, according to our estimates, the pace of growth in real disposable incomes deteriorated to 1.2% yoy. However, despite slowing dynamics of incomes and high interest rates, households' propensity to save remained high (around 10% of nominal incomes). Only net banking deposits increased – by over 11 billion zlotys.

In our assessment, investments in fixed assets grew by a mere 1% yoy. This represents layouts on capital goods other than buildings; which are still falling. Taking into account modest investment and, on the other hand, a drop in enterprises' net savings by 9.4 billion zlotys, one can expect a worsening of enterprises' financial situation.

Weak domestic demand limited import growth, which in 1Q01 was stimulated mainly by exports. Foreign demand, however, was restrained compared with 2000, and may be already reflecting the worsening economic climate in Germany – our main trade partner. Nevertheless, the pace of export growth exceeds that of imports and thus continues to contribute positively to GDP growth.

Value-added

- **Slight acceleration in industrial production**
- **Continuing recession in construction**

Persistently strong export growth (above 10% yoy) stimulated industrial production. It grew 4.1% yoy in 1Q01, which in our assessments, translates into a 3.7% yoy value-added increase. Services related to household consumption demand, such as trade or transport, were stagnant. Other branches, which provide services mainly to firms, witnessed a moderate growth; hence, the slowdown in overall market services was marginal.

Contrary to earlier expectations of improvement in building works, construction output contracted for the third consecutive quarter. The drop reached 9% yoy, or 4.3% yoy compared to 4Q00 after seasonal adjustments, in spite of warm winter.

External sector

Rafał Antczak

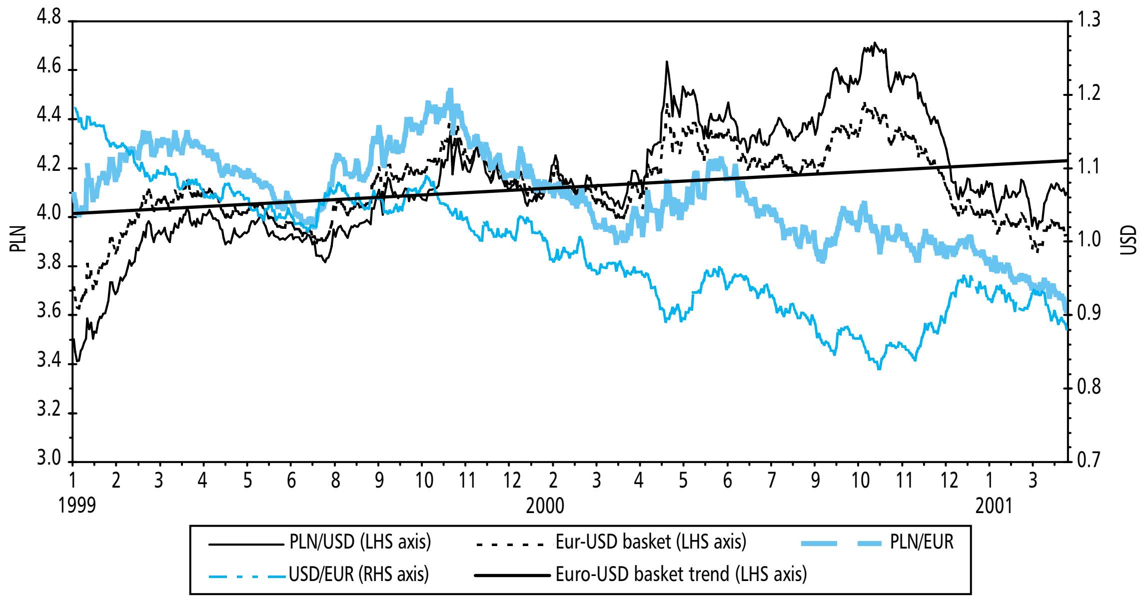
Exchange rate

- **Continued appreciation of the zloty in 1Q01**
- **Stabilisation of the dollar-euro exchange rate**

In previous quarters the volatility of the zloty against the dollar resulted to some extent from changes in dollar-euro cross rates. However, in 1Q01 the zloty appreciated both against the dollar and the euro. Improvements in macroeconomic indicators, including a decline in inflation and the current account deficit, foreign budgetary borrowing (eurobonds) and high interest rates caused an increase in the net inflow of portfolio capital of US$2.1 billion in 1Q01 compared to US$2.4 billion in 1Q00. The fluctuation of cross-rates resulted in an average appreciation of the zloty against the dollar of 5.9% and against the euro of 4.8% during 1Q01, though on an end-quarter basis (1Q01 to 4Q00) the zloty against the dollar appreciated in nominal terms by 1% and against the euro by over 6% (respectively, from 4.1432 PLN/US$ to 4.10 PLN/US$ and from 3.8544 PLN/euro to 3.617 PLN/euro). Irrespective of low turnover on the foreign currency spot market (still at roughly US$1 billion), derivative currency contracts are growing in importance.

Since the zloty was floated in April 2000, the NBP's only direct influence on the exchange rate has been possible via market interventions. Such interventions reveal reference rates (exchange rate levels that lead to interventions) which lower the risks of investor speculation. Hence, they may lead to an intensification of speculation and limit the effectiveness of central bank interventions. Indirect measures, such as sterilisation of privatisation revenues with debt-service payments on the NBP's and Ministry of Finance's common account or

Chart 2.1. Average exchange rates of the zloty against the dollar, euro and the euro-dollar currency basket, 1999–2001



Source: NBP.

increasing the costs – through higher reserve requirements – for foreign banks taking foreign currency positions, have not stemmed two inter-related inflows on to the forex market. The first comes from movements of foreign capital as a result of domestic and foreign interest rate disparities. The second results from the needs of the Ministry of Finance offering Treasury papers on domestic and foreign (eurobonds) markets. The share of foreign investors on the primary bond market amounted to 35% in January, 7% in February, and 12% in March.

Łukasz Rawdanowicz

Foreign trade

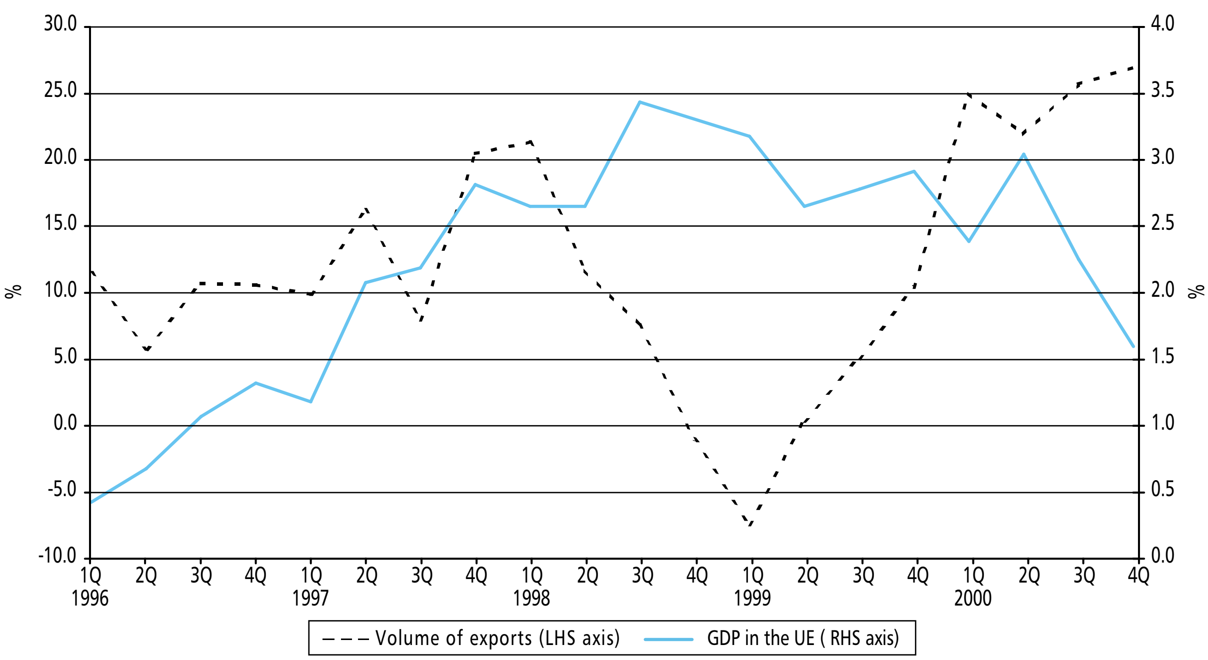
- **High exports maintained**
- **Shifts in import payments from 4Q00 to 1Q01**
- **Continued unfavourable terms of trade**

The favourable developments in Polish exports – observed since 2Q00 – have been sustained in 2Q01. 2Q01 figures came as a surprise in the face of the mounting appreciation of the zloty over the subsequent months and indications of weaker activity in the EU. Exports in the balance of payments reached US$7.5 billion – only US$450 million lower than in 4Q00. The strengthening of the zloty is partially offset by a rapid growth in labour productivity in the industry sector. This, however, was achieved at the cost of lower employment. Consequently, the rise in unit labour costs has been moderate. It should be also noted that movements in the exchange rate feed through with some lag. We maintain the opinion that weak domestic demand contributes positively to exports.

2000 saw no significant changes in the geographic structure of exports. Exports to eastern markets, in particular to Russia, have been growing gradually. Over 2000 as a whole, Russia was ranked 9th in terms of Poland's biggest export markets. Nevertheless, exports in 2000 in dollar terms constituted only 55% of those recorded in 1999. After the first 2 months of this year, Russia remained outside the top 10 export markets.

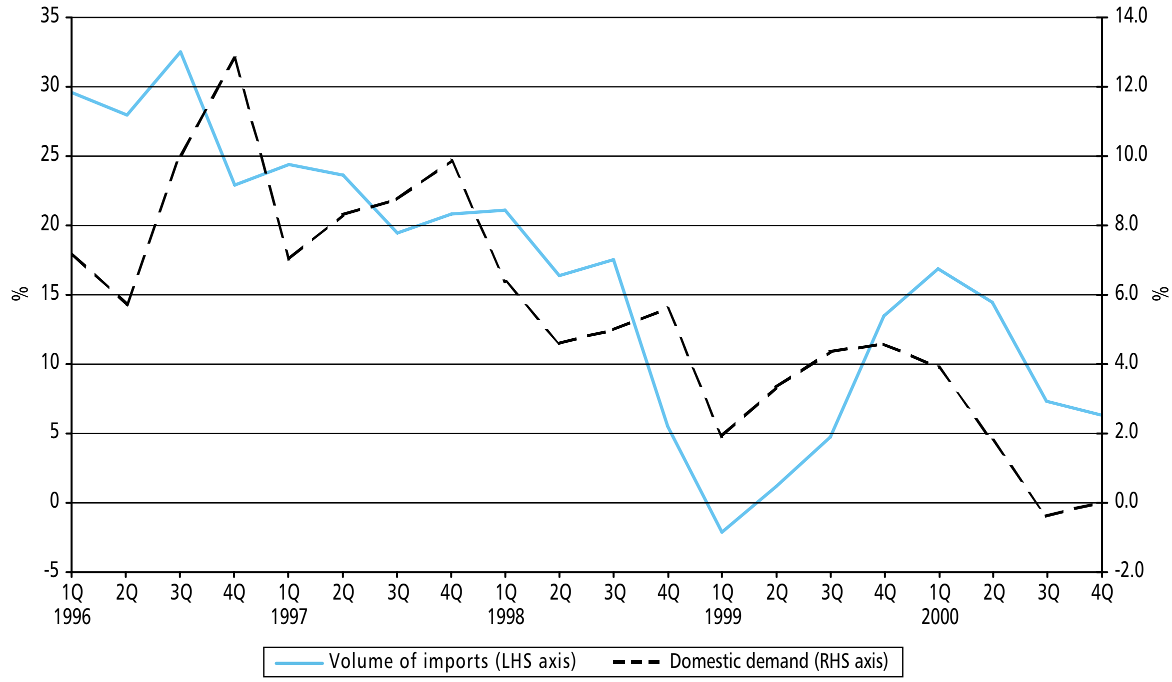
Continued weak domestic demand dampened import growth. According to preliminary estimates of the balance of payments, imports amounted to US$10.6 billion. The January figure came in higher than the December figure and imports in both 4Q00 and 1Q01 were roughly at the same level. In previous years

Chart 2.2. Volume of exports and GDP in EU, 1996–2000 (% change, yoy)



Source: CSO and Eurostat.
Notes: Volume of merchandise exports only.

Chart 2.3. Volume of imports and domestic demand, 1996–2000 (% change, yoy)



Source: CSO and CASE.
Note: Volume of merchandise imports only.

there was usually a seasonal decline in 1Q. This can be partially explained by stronger activity in the industry sector (a 4.1% yoy rise in 1Q01 against 2.6% yoy in 4Q00). Also some shifts in import payments from December to January took place.

Over 2000 as a whole, Poland's terms of trade remained below 100. High growth in import prices – mainly due to high world oil prices – was to blame for such a situation during the first three quarters. As the trend reversed in 4Q01, import price growth waned. A similar result is expected in 1Q01. In addition, enforced stronger exports during 2000 as a result of weak domestic demand have effectively dampened the growth of export prices. This has not helped to improve the terms of trade.

The situation of exporters deteriorated in 4Q00 and, according to our estimates, also worsened in 1Q01 on the back of the zloty's appreciation and the ensuing drop in export prices expressed in zlotys. The maintenance of such a trend will hurt corporate profits. However, on the other hand, this will enforce a lowering of costs and boosting of productivity. Consequently, Polish competitiveness may see gains in the future.

Łukasz Rawdanowicz

Balance of payments

- **Stable current account deficit**
- **Further outflow of foreign currency cash held by banks in Poland**

Preliminary results for 1Q01 show a merchandise trade deficit of US$3.1 billion. This, combined with the meagre deficit in services trade (US$274 million), a surplus in unclassified current transactions (US$730) and a surplus in income (for the first time since 1Q97), added up to a US$2.1 billion deficit in the current account. This result broadly indicates a stabilisation of the deficit over the previous four quarters and can be treated as a positive sign.

A lack of large privatisation deals in 1Q01 was behind the rather low inflows of FDI, which totalled US$1.3 billion. The quarter also saw a US$2.4 billion net inflow of portfolio investment. Foreign capital was mainly invested in government debt securities (roughly US$2 billion). These inflows contributed to the strengthening of the zloty.

Moreover, after a halt in transfers of foreign currencies held by banks located in Poland to time and savings accounts abroad in January and February, the trend reversed in March. In 1Q01 US$821 million of this kind of capital flowed out of Poland. This was related to an increase in corporate foreign currency time deposits.

Overall, the financial and capital account in the balance of payments recorded a surplus of US$2.1 billion, a figure that was almost able to meet the current account deficit. As for the end of March, official gross reserves amounted to US$28 billion, only a small increase (US$534 million) in comparison to end-2000. The increase is primarily attributable to the appreciation of the euro against the US dollar (roughly by 1.4% from end-4Q00 to end-1Q01). The end-March level is sufficient to cover 8 months of average imports.

Małgorzata Markiewicz, Artur Radziwiłł

Public finances

- **Budget deficit reaches 73% of the planned annual amount**
- **Tax revenues decline by more than could be explained by slowdown in economic activity**
- **Improvement in ZUS's tax collection rate**

At the beginning of 2001 the government introduced amendments to the budget law changing all macroeconomic assumptions. The real GDP growth rate was lowered from 5.1% to 4.5%, the average annual inflation rate from 7.2% to 7% and the average exchange rate from 4.66 to 4.45. There were some changes resulting in a relaxation of fiscal policy and lowering the transparency of fiscal accounts. For instance, revenues from selling licenses for UMTS were classified as revenues (not as financing items) and directed towards an increase in expenditures for education. Additionally, transfers to the second pillar of the pension system were lowered by 250 million zlotys. Instead of paying back the debt due to pension funds this money will be directed to the Labour Fund and spent on alleviating unemployment, in line with labour market policy.

The results for 1Q01 are worse than expected, mainly due to low rates of tax collection. The lowest are revenues from CIT (17.4% of the annual plan), PIT (18.2%) and indirect taxes (20.2%). These revenues are lower than in 1Q00 in nominal terms. Considering inflation, this indicates a significant decline in real revenues in conditions of positive economic growth. The drop in indirect tax revenues is greater than in previous years and cannot be fully explained by a slowdown in domestic demand (exports are taxed at a 0% VAT rate) or seasonality.

These poor results were recorded at the same time as the tax base was being extended – the amount of annual turnover qualifying for VAT payments fell (from 80 to 40 thousand zlotys), the excise tax rate for petrol, liquid gas for cars and cigarettes increased. It is likely the main reason behind a lowering of indirect tax revenues was rapid disinflation and the nominal appreciation of the zloty which led to a drop in revenues from excise and VAT taxes imposed on imported goods.

State budget expenditures were 46.6 billion zlotys, slightly exceeding the amount forecasted in the previous issue of PEO. This can be attributed to high debt servicing expenditures (the result of debt management policy) and the growing subsidy to the Labour Fund, reflecting the increase in unemployment. Furthermore, in 1Q01 payments were made to pensioners to compensate for the underestimation of inflation in 2000 (over 2 billion zlotys), and in March payments to the budgetary sector caused by the lack of increases in salaries during 1991–1992 began to be paid off.

The state budget deficit in 1Q01 reached 73% of the planned annual figure, financed mainly from domestic sources. Privatisation revenues were negligible (1.1 billion out of 18 billion zlotys assumed for the whole year). The budget deficit was financed by 9.3 billion zlotys of funds transferred over from 2000, which made it possible to limit the issue of treasury securities at the high interest rates prevailing in the market.

Social Insurance Board (ZUS)

In 2000 ZUS's efficiency of operations improved. The collection rate of contributions increased from the 96.9% assumed in the plan to 98% actually executed. ZUS was able to increase the transfer of contributions to the Open Pension Funds, however there are still outstanding debts accrued in 1999–2000. Parliament's decision to decrease the subsidy in order to pay off outstanding debts by 250 million zlotys will delay a reduction in this debt. In 2000 ZUS took legal steps to receive 7 billion zlotys of outstanding contributions (the previous year it was 3 billion). As a result, 3.3 billion zlotys were recovered, more than twice regained the previous year. However, ZUS's outstanding debt remains high, estimated at 17 billion zlotys, out of which 10 billion is from the biggest debtors (mainly railway and mining industries). The chances of getting back these debts are low.

In 2001, Open Pension Funds' liabilities did not grow. A high collection rate enabled the transfer of 2.4 billion zlotys in contributions with interest (from the beginning of the year till April 18), which is equal to the amount transferred during the whole of 1999. Furthermore, ZUS's debts to commercial banks have been falling. The average level of these debts is 500 million zlotys, far below the 3 billion allowed for in the budget act.

Local government

Local governments' financial results in 2000 were better than expected. The overall deficit was 3.1 billion zlotys (0.5% of GDP, against the 5 billion zlotys expected), and debt growth was moderate. At end–2000 local government debt was 9.4 billion zlotys, with the majority being long-term debts (87%). Threats to local government finances are rooted in the accumulation of public health sector debts, which, according to rough estimations, may be higher than 3 billion zlotys.

Piotr Bujak

Labour market

- **Continued increase in unemployment**
- **Restructuring of enterprises continues to dampen labour demand**
- **Decreasing inflation caused acceleration of real wages growth?**
- **Real wages growth is still lower than growth in labour productivity**

Unemployment

1Q01 saw a further deterioration in the labour market. The rate of registered unemployment increased to 15.9% and the number of unemployed increased by 196,1 thousand (7.8% yoy) to 2898,7 thousand. This means a continuation in the upward trend in unemployment.

The structure of registered unemployment slightly changed compared to end-2000. Those unemployed who had not previously been working constituted at end-March 23.13% of all unemployed, a 0.8 percentage point more than the previous year. The number of graduates among the total unemployed rose by only a 0.25 percentage point to 6.29% compared to 1Q00. Preliminary official data on the structure of unemployment indicates an inflow of young people onto the labour market. This is partly due to the fact that the number of unemployed who had previously been working also increased considerably. The other main reason – as we pointed out in the previous issue of PEO – is that many young people sought to improve their chances in the tight labour market via further education. This is reflected in LFS data, according to which, the number of economically inactive people due to a return to education or training rose.

The number of those who had previously been working fell to 76.9% in the overall unemployment figures in 1Q01. This is mainly caused by a decrease to 6.6% in the number of those laid-off for reasons internal to enterprises – 2.8 percentage points lower than in 1Q00. This data appears at first glance to indicate that enterprise restructuring has become a less important cause of unemployment. Unfortunately, this stands in contrast to plans for group layoffs in the framework of employment restructuring that have been announced by a number of enterprises (among others, in the auto manufacturing sector). The layoffs are mainly in those enterprises that were earlier unable to do so due to privatisation agreements or those that could have laid off workers but chose not to for other reasons.

According to LSF figures, 4Q00 and 2000 as a whole were marked by a significant increase in unemployment. The number of unemployed, according to the definition of the International Labour Organisation, amounted to 2760 thousand. It increased by 85 thousands qoq (i.e. 3.2%) and by 119 thousand yoy (i.e. 4.5%). The unemployment rate in 4Q00 stood as high as 16.0%.

Over the year unemployment increased most among people aged 15–24 (by a 1.6 percentage point). Young people's situation on the labour market again worsened. As in the structure of registered unemployment this fact was also not highlighted in LFS data on the causes of unemployment. First-time employment was sought by 21.5% of all unemployed (1 percentage point less than last year). Of these, 25.6% were graduates entering the labour market. The highest number of unemployed remains people who lost jobs and immediately began to look for new ones. Their share in the total number of unemployed increased by 1.3 percentage points to 51.8%. Simultaneously, the main cause of job losses in 4Q00 (concerning 44.7% of those who had previously been working – an increase of 0.3 percentage points) was liquidation of place of work or enterprise. The next second most important reason (concerning 16.5% of laid-off workers – an increase of 2.1 percentage points) was expiry of contracts. Among the causes of unemployment enterprise restructuring dominates. In the current situation of declining economic activity this is an even more important factor than the inflow of young people onto the labour market.

A more important element in the overall structure of unemployment is now the private sector. The proportion of unemployed who had previously worked in this sector rose 3.3 percentage points yoy to 67.3%. The share of services sector and industry sector unemployed of those who had previously worked was 48.0% (an increase of 2.1 percentage points) and 46.7% (a decrease by 2 percentage points) respectively. This means that restructuring had a greater impact on the services sector than it before.

In 4Q00, the number of long-term unemployed (those looking for a job longer than one year) was 1135 thousand, a rise of 307 thousand, or 37% yoy. This meant an overall increase in the proportion of long-term unemployed from 31.3% (4Q99) to 41.1% (4Q00), indicating that unemployment in Poland may have wider-reaching social consequences. Getting people back to work will be also more difficult.

Processes on the labour market reinforce this trend, changing the differentiation in unemployment rates in terms of education. The only group, which did not register an increase in unemployment, was graduates (4.8% in 4Q00). Unemployment rose most and was the largest in the case of those with standard or lower levels of education. Unemployment in this group, after an increase of 1 percentage point, was 20.2% in 4Q00.

Employment

Employment in the enterprise sector in March was 5169,7 thousand, a fall of 2.6% yoy. In 1Q01 it dropped by 2.4% yoy. A further decrease in labour demand is also indicated by LFS data. The number of employed in 4Q00 was 14540 thousand, a drop of 187 thousand, or 1.3% qoq and 33 thousand, or 0.2% yoy. The employment indicator also fell compared to the previous quarter and also compared to 4Q99 (by 0.6 percentage points). A decrease in both of these indicators partly reflects seasonal factors. However, yearly comparisons show a downward trend in labour demand. This is confirmed by a shortening of working hours. In 4Q00 the average working week was 40,5 hours, 0.5 hour less than in 4Q99. A similar conclusion can be made in the growth of part-time workers (to 304 thousand) and their share in total employed (to 2.1%). Compared to 4Q99 the number of part-time workers increased in 4Q00 by 3 thousand (i.e. 1.0%). Data on those working in more than one enterprise yields similar results. Their number in 4Q00 was 1126 thousand, or 7.7% of total employment, indicating a fall of 100 thousands (8.2%) compared to 4Q99.

The lack of positive changes in the labour market is also reflected in the structure of work. In 4Q00, the number of hired workers was 10550 thousand, a fall of 80 thousand yoy (or 0.8%) and their share in total employment was 72.6%. The number of employers and self-employed also decreased by 10 thousand yoy (or 0.3%), to 3254 thousand. This indicates that self-employment failed to compensate for the decrease in the number of hired workers. Furthermore, we cannot assume that small and medium enterprises would be in a position to offer jobs to those laid-off from large companies.

On 6 March, the government set out its "Plan for supporting enterprises and creating jobs". This included: lowering tax burdens, especially for small business, by amending the fiscal law on CIT; unification of reporting for fiscal and accounting purposes; moves to improve the flexibility of the labour market by changing the labour code; intensification of exports, which could be via amending the law governing treasury guarantees and pledges. The plan also foresees the launch of four programmes designed to support small businesses, the development of tourism, the development of new branches and improving infrastructure necessary for enterprise growth. According to the document, a project aimed at fighting unemployment was to be introduced to parliament before the end of March, though unfortunately this date turned out to be unrealistic.

With growing unemployment and the on-going restructuring of mining, metallurgy and Polish Rail, the measures should be more radical, though it is far from certain that the planned changes will gain sufficient political support to go ahead.

Wages

In March 2001, nominal wages and salaries in enterprises totalled 2149,13 zlotys, 7.9% higher by yoy. Accounting for inflation, average real wages in March rose 1.5% yoy. With stabilising trends in nominal wages, the decrease in inflation causes an increase in real wages (but the rate of growth in this case is still low). High unemployment dampens wages pressure. The real wage trend is still lower than the rate of labour productivity.

Mariusz Jarmużek

Prices

1Q01 saw continued disinflation helped by the zloty's appreciation and restrictive monetary policy. The latter resulted in low growth in the money supply, consumer credits and wages and salaries that suppressed aggregate demand. The zloty gained 7% against the euro-dollar currency basket. This caused a fall in import prices and contributed to lower CPI and PPI rates. According to our estimates, aggregate demand remained weak in 1Q01 – a meagre increase of 0.1% yoy. This is also reflected in retail trade figures. Supply side factors also worked in favour of lower inflation – fuel prices declined, and the prices of cereal and cereal products and meat rose only moderately.

We would like to underline the importance of the substitution effect in also contributing to lower inflation. The high growth in foodstuff prices the previous year pushed down households spending on non-food items and consumer services.

Foodstuff prices continued to decline in 1Q01, rising only 6.6% yoy. The decision to allow imports of cereals dampened the growth of cereal products and bread prices. On top of this, the rise in meat prices was low for two reasons. First, the prices of beef fell dramatically as a result of so-called Mad Cow Disease. Second, moderate demand on the retail market and low exports to CIS countries subdued growth in prices of other kinds of meat (see next paragraph).

Controlled prices saw a rise in 1Q01. In March, prices of gas rose 8.1% and of energy 4.2%. On the other hand, the prices of services related to flat maintenance declined.

The PPI fell significantly in 1Q01 to 4.3% yoy. Prices in manufacturing rose by only 2.0% yoy. This was the fifth month in a row when growth declined. This resulted from weak domestic demand, the strong zloty and falling fuel prices. Low domestic demand was reflected in the lower growth of household consumption and declining new orders to industry, visible since July 2000.

Katarzyna Zawalińska

Agricultural commodity prices

After last year's drought, the main problem this year is the outbreak of BSE and foot-and-mouth diseases in Western Europe. Poland was one of the first countries to introduce severe restrictions on the imports of livestock and animal products. This exposed its manufacturing sector to significant losses due to the limited access to necessary production inputs from abroad.

Nevertheless, the European Union Veterinary Committee placed Poland in the group of higher-risk countries. This decision has serious consequences. First, it means a decrease in exports of Polish meet, since exports of some beef products will be banned. Second, it means unexpected budgetary expenses due to the costly examinations of each unit of cattle over 30 months old (most probably as of June). Such regulation raises the cost of meat exports as well as price of meat traded on the domestic market, since the same rules will also refer to internal trade.

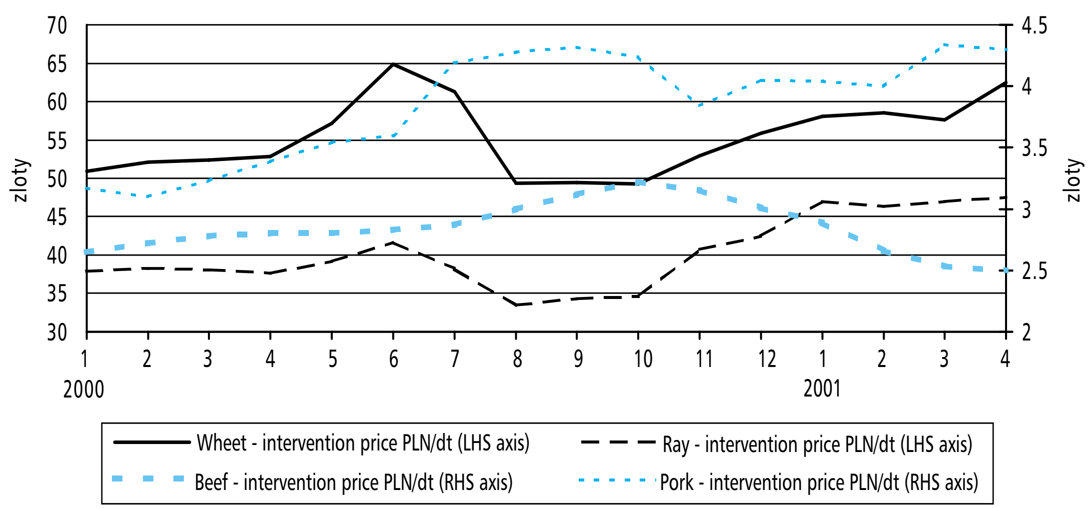
The consequences of the existing situation were reflected in prices during 1Q01, as indicated in Chart 2.4. Due to sluggish demand for red meat, especially beef, deep drops in beef intervention and market prices were visible. What is more, since mid-March, a substitution effect was visible – consumers switched partly to pork, reversing a two-month downward trend in pork prices. According to the Chief Veterinary Inspectorate, during January and February Polish exports of pork and processed meat products decreased. At the same time, exports of beef increased, indicating a short-term crowding-out effect in response to the decrease in domestic demand. Pork prices in the EU increased significantly because of decreasing supply (pig slaughters) on the one side, and higher demand (due to the substitution effect) on the other. At the same time beef prices decreased despite shrinking supply.

There was a somewhat better situation in crop markets. In March, rye intervention prices recovered, though market prices remained virtually the same. The opposite was true in the case of wheat, where the intervention price dropped in March after a four-month rise, and market prices increased a little. According to the Chamber of Crop Feed, this year's cereal production will reach about 24.6–26.0 million tonnes, between 2–3.5 million above the 2000 figure. However, cereal consumption is forecast to be higher, estimated to come in at 26.5–27.0 million tonnes. Despite relatively high cereal stocks at the beginning of 1Q01 – about 70% higher than the same time the year before – they remain quite low, at about 2 million tonnes. Therefore, approximately 1–2 million tonnes of cereal imports to Poland are expected (depending on the harvest this year).

In this situation, positive news is that wheat prices are on a downward path on Western commodity exchanges, for example in the USA and Argentina. Wheat prices on German exchanges also reached their lowest level for three months.

On 20th December 2000, the cabinet decided to introduce import tariff-quotas on some agricultural products (Dziennik Ustaw No 120, December 29th, 2000). In line with this, during the first half of the year imports of 526.5 thousand tonnes of cereals and

Chart 2.4. Prices of basic agricultural products, 2000–2001



Source: CSO and Agricultural Market Agency (ARR).

75.6 thousand tonnes of cereal products is possible under preferential tariff rates. Wheat, which dominates imports, could be imported up to the following levels: 210 thousand tonnes at zero tariff rate within the framework of liberalisation agreement with the EU; up to 194 thousand tones at 25% and 20% tariff rates within the WTO agreement; and within the framework of international contracts with the Czech Republic and Hungary – up to 45 thousand tonnes at 15% tariff rates.

However, imports of wheat from the EU may be limited for cost reasons. First, according to the agreement it will not be subsidised by the EU (to assure fair competition), which means its price will be higher than the world price. Besides this, the recent strengthening of the euro against the dollar made these imports even less attractive. Since the amount of cereal imports this year is significant, it would be reasonable to plan them for a period when the zloty is strong and world cereal prices low, as they are now.

Since 1st January 2001 a new agreement between Poland and the EU has been in force. It liberalised 75% of trade in agricultural products and scheduled the further liberalisation of remaining agricultural trade through increasing duty-free quotas by 10% each year until the entire trade becomes free. It is hoped that as a result of this, there will follow greater integration and liberalisation of agricultural commodities exchanged on the Warsaw Board of Trade with those quoted on world commodity exchanges. So far – due to significant price interventions, market inefficiencies and high risk – Polish wheat prices seem not to be correlated with those on world exchanges (CBOT and LIFFE).

So far, the most important prices are domestic intervention prices. Based on forecasts from the Team of Independent Experts qualified by ARR (Agricultural Markets Agency), they are expected to show moderate average growth. Compared to February 2001, by end-June the wheat intervention price may increase about 6.8%, rye intervention price by 2.6%, and pork products by 7.5%. The most uncertain situation is on the beef market – the beef intervention price is forecast to either increase by about 1.5% or decrease by about 6%. Prices of milk, butter and milk powder are also expected to drop.

Przemysław Woźniak

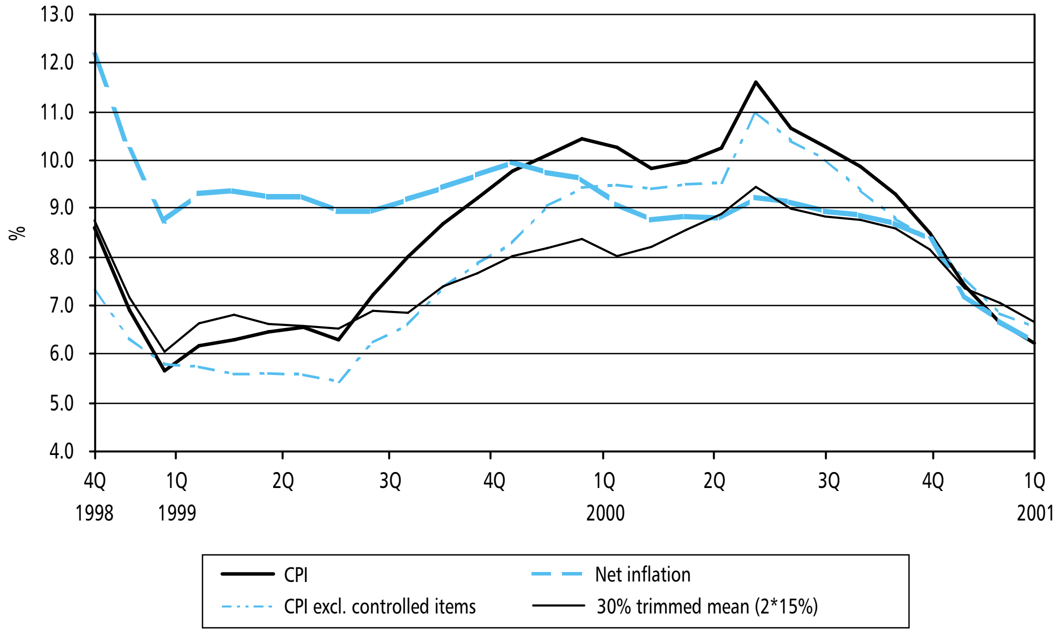
Core inflation

Core inflation trends were calculated according to the methodology employed by the NBP. This yielded the same results for baseline price changes as those used by the Monetary Policy Council (MPC) in its monitoring of inflationary pressures in the economy. Thus, examining these core inflation series can be of substantial help in predicting the MPC's chosen degree of monetary policy restrictiveness at its monthly meetings.

The analysis of core inflation in this section includes 3 core inflation series: (1) core inflation excluding prices of administratively controlled items, (2) "net inflation" excluding prices of food and fuel and (3) a 15% trimmed mean. Series 1–2 are obtained by permanently excluding certain categories of goods and services from the consumption basket – as a weighted average of the remainder of the basket. Series 3 is computed without the lowest 15% and highest 15% price changes in individual CPI components each month. All 3 series have exhibited similar falling trends since August 2000. At the beginning of 2001 the gap between core inflation measures and headline inflation was virtually zero. Currently, the trimmed mean and core inflation excluding prices of administratively controlled items slightly exceed headline inflation.

Core inflation excluding prices of administratively controlled goods and services amounted to 6.54% in March 2001. This was slightly higher than headline inflation (6.21%). Items excluded from this index range from, among other things, alcohol and tobacco products to various municipal services and other services with partially administratively regulated prices. Core inflation trends calculated with the use of this index did not differ significantly from that of the CPI (headline inflation) during the past 12 months. This points to a diminishing pro-inflationary role played by administrative price increases, which until 1999 significantly shaped short-term inflation. Moreover, administrative prices have grown slower than free-market prices from the start of 2001. Given that the prices of many of these goods and services are still seriously undervalued compared to world prices this indicates that adjustment processes in the government-controlled sector have slowed.

Chart 2.5. Core inflation, 1998–2001



Source: NBP and CASE.

Net inflation (introduced by the NBP in late 2000 – excluding food and fuel, which have more than 30% of the consumption basket) exhibited a relative stability throughout 1999 and 2000, fluctuating within a narrow band of 8.5–10% and since December 2000 has been falling at an almost identical pace to headline inflation. In March 2001, it reached 6.23% against 6.21% for headline inflation. Balancing the trends of net and headline inflation indicates that, on average, food and fuel price changes did not diverge from price changes of the other consumer goods and services.

The trimmed mean is obtained by eliminating extremely high and low price changes from the index. This is based on the view that they are unrepresentative of general price changes. The 15% trimmed mean, calculated by the NBP, excludes the biggest 15% and smallest 15% price changes (the percentage rate refers to the share of each in the consumption basket). After a several-month period in which the NBP's trimmed mean had a lower rate than the CPI, January 2001 saw a reversal of this trend. The deviation of the trimmed mean from headline inflation is not large (amounting to a 0.5 percentage point in March), though is rising consistently. In our view, this process will be in place throughout 2Q01 and 3Q01 due to the fact that the observed slowdown in headline inflation was fuelled mainly by price decreases in only a few products, most of which registered significant hikes in 2000. As they are extreme and unrepresentative they will be eliminated in the trimmed mean calculation, which will result in a higher trimmed mean compared to the CPI.

Rafał Antczak

Monetary policy

- **Monetary policy still restrictive, problems with policy-mix remain**
- **Exchange rate complications**

Two cuts in the NBP's reference interest rates at the beginning and end of March (200 basis points together) has not changed the restrictive monetary policy as comparing to 4Q00. Similarly, as in the previous quarter, greater restrictiveness followed the decline in inflation of 230 basis points and nominal appreciation of the zloty, reaching over 5% against the dollar and almost 3% against the euro. On the other hand, irrespective of stabilisation of reserve money growth, the supply of broad money has been growing at almost

15% on an annual basis (and domestic broad money at almost 16% per annum).

The MPC decision to cut interest rates after the decline in inflation had an adaptive character. The fact that there were two cuts in one month resulted from a move to inhibit foreign investors from shifting short-term money into Polish banks and to stem appreciation pressure on the zloty.

Interest rates in commercial banks have followed the MPC's decisions. From December 2000 to March 2001 average weighted interest rates on credits to firms declined by 250 basis points, and for individuals roughly by 130 basis points. Average interest rates on deposits went down by 110 basis points for individuals and by 120 basis points for firms. Therefore, the decline of interest rates for deposits was smaller than for credits. Money market interest rates dropped by 100 basis points in 1Q01 (see, financial markets).

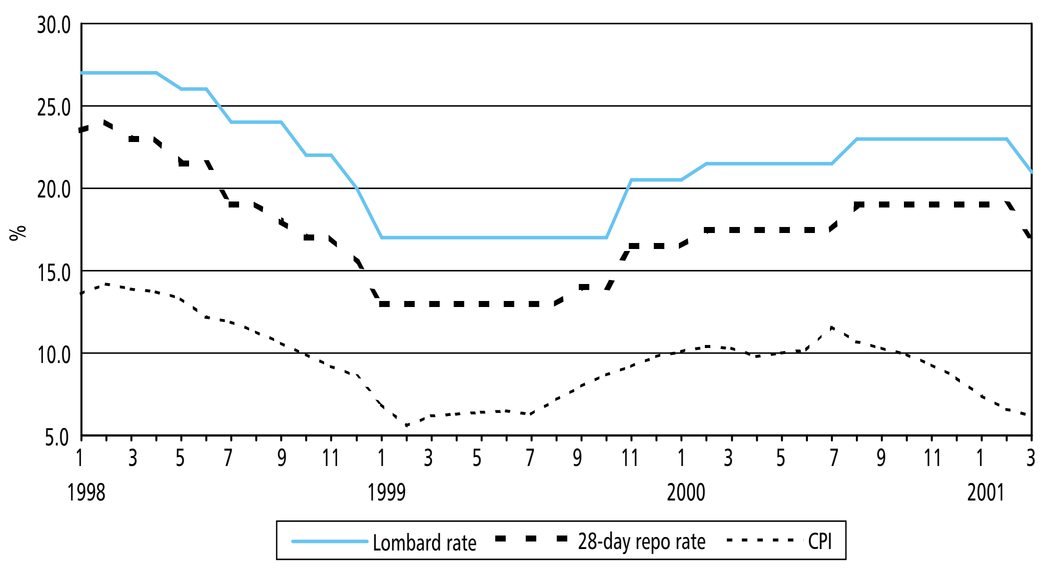
Public finances were the main factor influencing monetary policy in 1Q01. The budget deficit after the first quarter amounted to 73.3%, causing the money multiplier to increase. In an attempt to prevent this, the NBP was forced to restraint credit growth by maintaining very high interest rates. However, high interest rates attract foreign portfolio investors and this results in capital inflows and further appreciation of an already strong zloty.

In 1Q01, the supply of reserve money dropped by 1% against 4Q00 (and below 7% March-to-March) as a result of a decline in credits to the budget, credits to banks, and appreciation of the zloty, though valuation adjustment in respect of appreciation lowered the increase in reserve assets. In dollar terms, NBP reserve assets went up by US$530 million to US$28 billion.

The banking system and broad money

Irrespective of high interest rates in 1Q01 credit to firms increased by 2.8%. The growing demand on credits from companies together with the financial needs of the budget keep deposit interest rates high, causing their fast growth. As a result, despite a decline in the reserve money supply, broad money supply increased by 2.1% in 1Q01. Even taking into account seasonal effects, this growth is significant. On an annual basis the supply of broad money stayed at 14.6-14.8%. Such high supply resulted from an increase in individual domestic currency deposits and foreign currency deposits of companies. In March, compared to end-February, foreign currency claims to companies hiked by almost 23% (or 2.3 billion zlotys). As exchange rate

Chart 2.6. Monetary policy instruments, 1998–2001



Source: NBP and CSO.

Table 2.1. Components of the reserve money supply, 1998–2001 (cumulative % change)

		Reserve money (RM)	Net foreign assets (NFA)	Net domestic assets (NDA)	Net claims on government (NCG)	Claims on deposit money banks (CDMB)	Other items net (OIN)
1998	1Q	4.82	25.37	-7.00	-5.31	-1.69	-13.55
	2Q	17.54	36.32	-10.22	-8.74	-1.48	-8.56
	3Q	17.50	48.85	-4.39	-6.35	1.96	-26.94
	4Q	26.78	63.44	-0.90	2.95	-3.85	-35.75
1999	1Q	0.44	-0.78	-0.57	-0.50	-0.07	1.79
	2Q	10.20	14.07	1.54	2.10	-0.57	-5.42
	3Q	-13.94	6.15	-3.65	-2.79	-0.87	-16.45
	4Q	-1.57	18.50	-4.75	-3.71	-1.04	-15.34
2000	1Q	-14.44	15.29	-1.91	-1.57	-0.34	-27.81
	2Q	-1.83	-2.97	9.15	9.82	-0.67	-8.02
	3Q	-3.20	12.66	0.98	1.53	-0.55	-16.84
	4Q	-7.64	22.90	-9.48	-9.08	-0.40	-21.05
2001	1Q	-1.03	-24.03	-7.01	-6.69	-0.32	30.10

Source: The NBP Bulletin and authors' calculations.
Notes: The shares of components of reserve money are calculated using the following formula: $\Delta RM/RM_{-1} = \Delta NFA/RM_{-1} + \Delta NCG/RM_{-1} + \Delta CDMB/RM_{-1} + \Delta OIN/RM_{-1}$ cumulative in the current year.Net foreign assets were re-estimated (valuation adjustment) using the average exchange rate of the currency basket for a given period to account for fluctuations in the exchange rate of the zloty.

Table 2.2. Components of broad money,1998–2001 (cumulative %)

		Broad money (M2)	Net foreign assets (NFA)	Net domestic assets (NDA)	Net claims on government (NCG)	Claims on private sector (CPS)	Other items net (OIN)
1998	1Q	2.25	3.76	0.85	-2.85	3.70	-2.36
	2Q	8.97	4.79	5.25	-2.60	7.86	-1.08
	3Q	15.35	4.33	13.76	0.86	12.90	-2.74
	4Q	25.12	9.72	20.60	3.42	17.18	-5.20
1999	1Q	4.30	-0.53	5.74	1.18	4.55	-0.91
	2Q	7.01	2.35	9.59	1.77	7.82	-4.93
	3Q	11.42	2.45	13.19	0.14	13.06	-4.23
	4Q	19.36	6.43	18.45	1.51	16.94	-5.53
2000	1Q	-0.58	4.93	-0.54	-3.62	3.08	-4.97
	2Q	8.11	1.10	8.14	-2.30	10.44	-1.13
	3Q	6.48	4.05	8.12	-2.57	10.69	-5.68
	4Q	11.76	10.59	6.27	-5.27	11.54	-5.10
2001	1Q	2.15	-3.17	-0.26	-1.83	1.57	5.58

Source: The NBP Bulletin and authors' calculations.
Notes: The share of broad money components are calculated using the following formula:. $\Delta M2/M2_{-1} = \Delta NFA/M2_{-1} + \Delta NCG/M2_{-1} + \Delta CPS/M2_{-1} + \Delta OIN/M2_{-1}$, cumulative in the current year.Net foreign assets were re-estimated (valuation adjustment)using the average exchange rate of the currency basket for a give period to account for fluctuations of the exchange rate of the zloty.

Table 2.3. Calendar of the most important events in the monetary policy of the NBP, 2000–2001

Source	Date of the resolution	Events
J NBP No. 1	February 23, 2000	NBP rediscount rate 20% Lombard rate 21.5% Refinancing rate 21.5/22.5% 28 – day repo rate at least 17.5%
J NBP No. 2	February 25, 2000	Interest rate on NBP current deposits 6.45%
J NBP No. 6 and Monitor Polski No. 11/231 and 232	April 11, 2000	Abolition of crawling peg of the zloty and the permissible exchange rate fluctuation band
J NBP No. 13	August 30, 2000	NBP rediscount rate 21.5% Lombard rate 23% Refinancing rate 23/24% 28 – day repo rate at least 17.5%
J NBP No. 14	September 4, 2000	Interest rate on NBP current deposits 6.9%
Monitor Polski No. 31	September 20, 2000	Release of the monetary policy guidelines for 2001, inflation target for end-2001 set as the range of 6-8%
J NBP No. 3	February 28, 2001	Interest rate on NBP current deposits 6.6%
J NBP No. 3	February 28, 2001	NBP rediscount rate 20.5% Lombard rate 22% Refinancing rate 22/23% 28 – day repo rate at least 18%
J NBP No. 4	March 28, 2001	NBP rediscount rate 19.5% Lombard rate 21% Refinancing rate 21/22% 28 – day repo rate at least 17%
J NBP No. 5	March 30, 2001	Interest rate on NBP current deposits 6.3%

Source: Official Journal of the NBP, various issues. Authors' compilation.

changes were minimal in that period, overall growth reflects an increase in foreign currency deposits and there were growing expectations among domestic entities that the zloty would weaken.

The high level of interest rates (and the resulting opportunity cost of holding cash), especially after the rate hike in August 2000, caused a decline in cash in broad money from 18.2% to 14.1% in end-February, which is positive (a decline in the velocity of narrow monetary aggregates). However, the resulting growth in deposits from one side and purchases of Treasury papers by banks (higher liquidity of assets diminishing demand on cash) from the other side increased the money multiplier. Therefore, despite stabilisation of the nominal amount of reserve money, broader monetary aggregates kept growing. The velocity of broad money has not changed and was at 2.8 at the end of March, while monetisation of GDP reached over 41%.

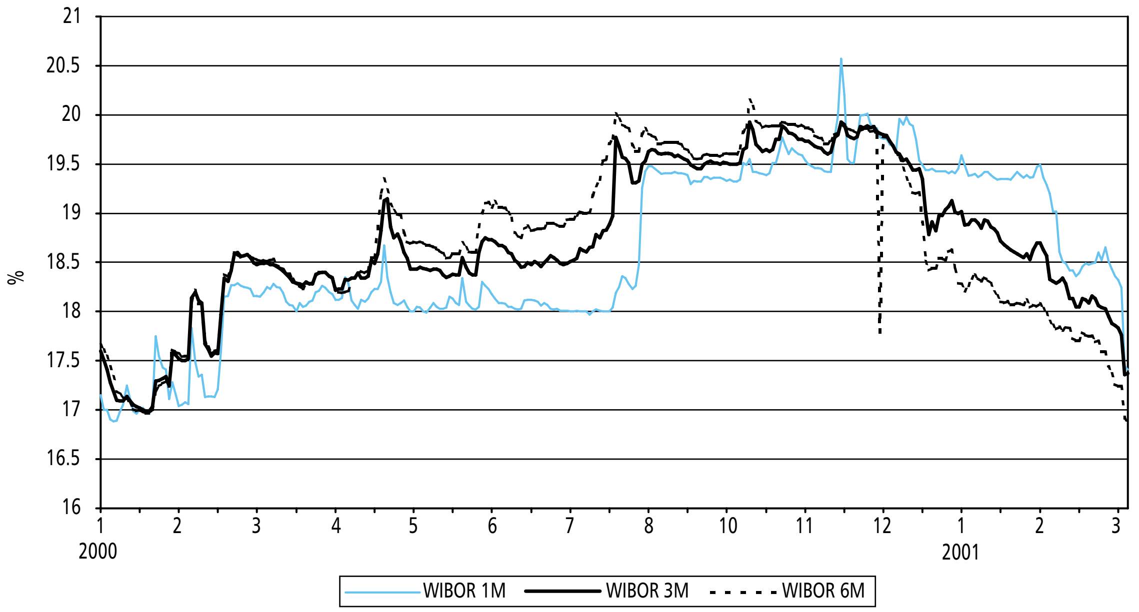
Piotr Bujak, Mariusz Jarmużek

Financial markets

Interbank deposit market

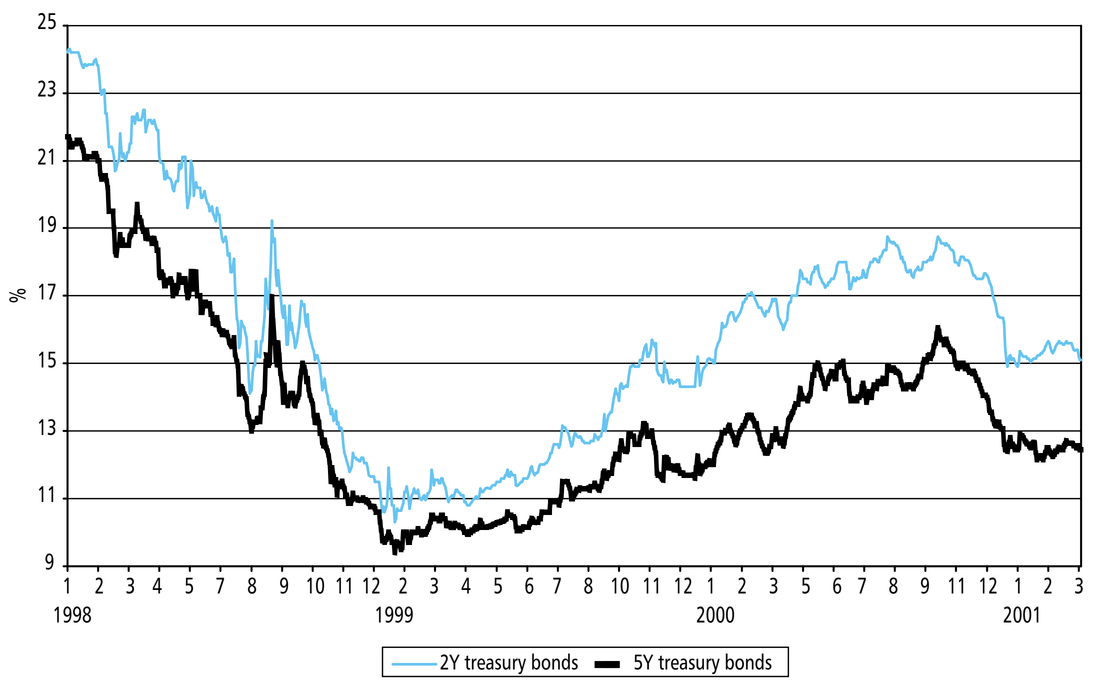
In 1Q00, the situation on the interbank money market was dominated by widespread expectations of cuts in NBP's reference interest rates. This was reflected in changes to 3- and 6-month interest rates, which decreased gradually in relation to 28-day interest rates. Rates offered on the interbank market tracked news on falling inflation and lower industrial economic activity. In January, commercial banks anticipated moderate cuts in NBP rates, so the scale of the drop in interest rates on the deposit market was similar to that on the FRA market. At the same

Chart 2.7. 1M, 3M and 6M WIBOR, 2000–2001 (daily quotations)



Source: NBP.

Chart 2.8. 2Y and 5Y treasury bonds, 1998–2001 (daily quotations)



Source: NBP.

time the expectation of further cuts in the course of the year has strengthened.

In February a downward trend of 3- and 6-month interest rates on the interbank market was continued. Only the turmoil in Turkey in the middle 10-day period of February caused a temporary outflow of short-term capital. Consequently, short-term interest rates temporarily increased and the zloty depreciated. However, the IMF's support for the Turkish government's policies forestalled any serious contagion effects on to other emerging markets. In the last ten days of March, market rates continued to decrease, especially short-term loans, which caused a flattening of the yield curve. After the MPC decision to cut NBP's reference interest rates, WIBOR quotations decreased again, most in the case of the 1-month rate.

The Treasury market

At the beginning of January 2001, after the release of good current account figures for November 2000, larger foreign demand for T-bonds drove prices up. Prices were then reinforced by news on declining inflation. Only financial turmoil in Turkey caused a drop in prices. After a moderate cut in NBP's rates in February, the prices of 2-year bonds rose slightly and of 5-year bonds decreased. News on the drop in industrial production and prices in February increased the odds – in the view of market participants – of further rate cuts. However, this was not reflected by larger bond purchases. The NBP's interest rate cut in March again did not surprise the market, causing only a slight increase in bond prices.

Center for Social and Economic Research

Outlook for the economy in 2001 and 2002

Andrzej Bratkowski

Defusing the exchange rate bomb

Monetary and fiscal policies will shape the economic situation in the next quarters. In our view, monetary policy will remain relatively tight. The extent of its restrictiveness will strictly depend on developments in fiscal policy. How the government moves in response to lower budget revenues will be of key importance. If the government decides not to reduce expenditures, restricting its activities to the budget act amendment which allows for a higher deficit, moves towards a reduction in interest rates will be very cautious. This would leave real interest rates high, or if changed, then only by a notch. However, if the government decided on more radical measures and cut expenditures significantly, interest rate reductions could be more radical. We believe that the most probable outcome is somewhere between the two extremes, with a bias towards the budget act amendment. Thus, cuts in budget expenditures as well as interest rates will be moderate.

Against the background of such a policy mix, purchases of treasury bonds by foreign investors would still remain high, sustaining pressure on zloty appreciation. However, the current situation – the strengthening of the zloty and stable foreign trade balance – cannot last indefinitely. In the coming months, a strong zloty would set back growth of exports and lead to an increase in the current account deficit. The same effect would be exerted if there was a slow recovery in domestic demand triggered by interest rate cuts. As a result, the deteriorating merchandise trade deficit will finally deter capital inflows and lead to a depreciation of the zloty. How this latter process pans out is crucial. A gradual depreciation would allow the current account deficit to stabilise and would facilitate economic growth. In addition, if domestic demand also sees a gradual rise, the CPI could still decrease, although at a slower pace than currently. However, in the event of an abrupt zloty depreciation, a significant rise in the CPI would be inevitable. In this case there would need to be a renewal in the fight against inflation – interest rates would have to go up and domestic demand would be dampened again. The longer the zloty appreciates the greater chances of a sudden capital outflow and a strong exchange rate correction.

Thus, the development of fiscal policy is of critical importance. If fiscal discipline is loosened any further the growing budget borrowing requirements and high interest rates would attract even greater capital inflows, strengthening the zloty and leading to a wider foreign trade deficit. The zloty's correction would in this case be more severe and would be certain to lead to a hike in inflation. Higher inflation, heralding interest rate increases, would be a signal for the withdrawal of foreign capital. This, in turn, would contribute to an even further depreciation of the zloty and possibly a currency crisis.

Depreciation of the zloty is the most probable scenario for fiscal adjustment and in our view should begin

Table 3.1. Main macroeconomic indicators, 1996–2002

							forecast		forecast 2001			
		1996	1997	1998	1999	2000	2001	2002	I	II	III	IV
GDP	% growth	6.0	6.8	4.8	4.1	4.1	2.9	4.3	2.0	2.4	2.8	4.1
Domestic demand	% growth	9.7	9.2	6.4	4.9	2.8	2.7	5.0	0.5	2.4	3.1	4.3
Budget deficit	%of GDP	-2.4	-1.3	-2.4	-2.0	-2.2	-4.4	-4.1	-9.0	-3.7	-2.9	-2.8
Unemployment rate	%	13.2	10.3	10.4	13.0	15.0	16.6	17.7	15.9	15.6	15.9	16.6
Balance on current account	% of GDP	-0.9	-3.0	-4.3	-7.5	-6.3	-5.7	-5.9	-5.2	-5.3	-6.9	-5.2
Balance on merchandise trade	US$ billion	-8.2	-11.3	-13.7	-14.4	-13.2	-13.7	-14.7	-3.1	-3.6	-3.8	-3.6
M2	PLN billion	134.8	176.4	220.8	263.5	294.4	332.3	368.7	300.8	309.5	318.4	332.3
CPI	%	19.9	14.9	11.8	7.3	10.1	5.6	5.2	6.7	6.1	5.0	4.7
Exchange rate against US$	zloty/US$	2.7	3.3	3.5	4.0	4.3	4.22	4.41	4.09	4.11	4.29	4.38
Exchange rate against euro	zloty/euro				4.2	4.0	3.91	4.29	3.78	3.81	3.97	4.09
Lombard rate	%	25.0	27.0	20.0	17.9	23.0	18.5	17.0	21.0	19.5	19.5	18.5

Source: CSO, NBP and CASE.

relatively soon. It should take a less dramatic course – given the modest widening of the current account deficit high interest rates will hold back foreign capital outflows. Therefore, we do not expect a one-off abrupt devaluation of the zloty, but rather several periods of capital outflow and their relatively quick return as the zloty depreciates. Consequently, the volatility of the exchange rate will be high, as in the previous year, though the depreciation trend will be benign.

Moderate depreciation of the zloty will impede fast growth in exports and high real interest rates will have the same effect on domestic demand. Thus, the pace of economic recovery will be modest.

In the longer-term, the favourable – in our view – situation in the global economy and the policies of a new government formed after this year's elections will have a greater influence on the Polish economy. We believe that economic policy will remain broadly unchanged. The tight monetary stance will still be opposed to passive structural polices and the reluctance to consolidate fiscal policy will result in a continued high budget deficit. In such a scenario NBP cuts in interest rates in 2002 will be only slightly more aggressive than this year. Consequently interest rates will remain higher than in developed countries, attracting foreign portfolio capital and hampering the zloty's depreciation.

*Łukasz Rawdanowicz**

External conditions

- **Risks of global slowdown have not disappeared**
- **Odds of V-recovery in the US increase**
- **EU growth – slower but firm**
- **Japan performs poorly**
- **Visible slowdown in economic activity in Russia**
- **Developments in Argentina loom over Latin American prospects**
- **Fed surprises with a second intermeeting cut**
- **Strengthening of the dollar versus major currencies**
- **Forecast of fairly stable crude oil prices in 2001**

* The text based on the ***Global Economy 2/2001*** (www.case.com.pl/pgtopge.html). ***Global Economy*** is a CASE quarterly publication (only in English) broadly covering the current world economic situation and outlook.

Table 3.2. GDP in selected countries, 1997–2002 (% change, yoy)

	1997	1998	1999	2000e	*2001f*	*2002f*
Global	4.1	2.6	3.4	4.1	*2.2*	*3.2*
OECD	3.4	2.7	3.0	3.7	*2.3*	*3.0*
USA	4.4	4.4	4.2	5.0	*2.1*	*3.0*
Japan	1.6	-2.5	0.2	1.7	*1.0*	*2.0*
European Union	2.6	2.7	2.4	3.4	*2.4*	*2.9*
Germany	1.4	2.1	1.6	3.1	*2.2*	*2.8*
France	2.0	3.2	2.9	3.2	*2.8*	*3.1*
Italy	1.8	1.5	1.4	2.9	*2.4*	*3.2*
United Kingdom	3.5	2.6	2.1	3.0	*2.5*	*2.9*
Russia	0.9	-4.9	3.2	7.7	*4.0*	*3.3*
China	8.8	7.8	7.1	8.0	*7.5*	*7.0*

Source: IMF, CASE and market consensus.
Notes: e – estimates, f – forecasts.

1Q00 has not reduced the uncertainties of a global slowdown that started last year. With Japan stagnated on the verge of recession and a downward growth revision in the EU, developments in the US remain the key element of the current global economic situation. While business confidence in the US appears to have improved slightly, a deterioration in household confidence may be yet to come. Expected higher unemployment and recent declines in equity prices may reduce household wealth and in turn lower demand. This was the Fed's major concern when it decided to cut interest rates on April 18 – for the fourth time this year and the second time between the regular scheduled meetings. This proves that the downside risks to the US economy are still to come, though such an aggressive easing give hopes of a V-recovery in 2H01. 2Q01 should tell us if the US economy is bottoming out or experiencing a recession. Furthermore, while the aggressive cuts lower the probability of recession in the near term, they may actually increase risks of a recession later on.

The prospects for the EU are less rosy than a quarter ago, especially in Germany. Many research institutes have since then downgraded German growth forecasts from almost 3% to 2% for 2001. The ECB's tight policy has so far not given any boost to the economy. This, coupled with structural limitations, makes a prompt acceleration in economic activity infeasible. In this respect, our forecast of a shift in leadership in the global economy, presented in the previous issue, now looks less probable. If the US manages rapidly to recover from the present slowdown the growth gap between it and the EU will widen again. In turn, calls for the removal of structural rigidities in the European markets will be raised.

The biggest economies of CEE have not suffered so far (in terms of weaker exports) from the slowdown in the EU and Germany in particular. However, the lower activity in the region will definitely spillover on to the CEECs in the months ahead. Thus, growth this year will be lower. In addition, Poland and the Czech Republic are embroiled in problems with domestic demand. They also face structural rigidities, in particular in labour markets.

Asian and Pacific economies are expected to experience less severe spillover effects from the US slowdown than previously predicted, according to the Asian Development Bank. Growth for the region is predicted to reach 5.3% versus 7.1% in 2000. However, the newly industrialised economies like Hong Kong, Korea, Singapore and Taiwan will be hurt hardest, with growth slowing from 8.4% in 2000 to 4.3% this year. China is expected to undergo only a minor slowdown, to 7.3% from last year's 8%. The recovery of those countries hit by the 1997/98 financial crisis remains volatile and the prospects for this group are poor, with growth slowing to less than 4% from last year's 6.8%. Japan is still entangled in problems related to the banking sector, labour market and trade policies. The prospects for this year are therefore rather bleak, with growth expected at around 1% and a recession looming.

Latin America's prospects are determined by the situation in the US and Argentina. While the impact of the US slowdown is already clearly visible in Mexico (a sharp reduction in the growth rate), most of the region's economies seem to be maintaining a solid pace of growth. Fed easing provides a positive stimulus. The situation in Argentina poses the major downside risk for the region's outlook. Devaluation and debt default, a scenario that cannot be ruled out completely, would have a significant effect on the growth prospects for the whole region. However, unless this threat materialises the outlook is positive, with regional growth slowing only slightly from last year's 3.9%.

With global oil prices remaining fairly stable and the advanced economies entering a slowdown phase in the business cycle, inflation is in check. Only the euro-zone is still experiencing high inflation. This is mainly the lagged effect of high oil prices and the still weak euro. Over the longer-term, a further lowering of inflation in developed countries may be difficult on the back of monetary easing and the high costs of energy. Oil prices are forecast to remain broadly stable at around US$25 per barrel, but end-user prices are expected to go up in the summertime. Emerging markets in Central Europe continue to fight inflation.

The declines in stock prices in the US, EU, and Japan that started as early as September 2000 led to lower business optimism and lower investment. Stock declines in recent weeks were driven by news of lower profits of big companies. Even though this trend started to reverse at the beginning of 2Q01 it has already hurt business confidence and consequently also investment plans.

Exchange rate developments in 1Q01 were mainly influenced by uncertainties related to global growth, changes in monetary policies, and losses on equity markets. In general, 1Q01 saw a steady appreciation of the US dollar against the euro as well as the yen. The euro lost ground against the dollar despite the interest rate

Table 3.3. CPI in selected countries, 1997–2002 (% change, yoy)

	1997	1998	1999	2000	*2001f*	*2002f*
USA	2.3	1.5	2.2	3.4	*2.9*	*1.8*
Japan	1.7	0.6	-0.3	-0.6	*-0.5*	*-0.1*
European Union	1.8	1.3	1.2	2.3	*2.2*	*1.5*
Euro zone	1.6	1.1	1.1	2.3	*2.2*	*1.4*
Russia	14.7	27.7	85.9	20.7	*23.0*	*18.0*
China	2.8	-0.8	-1.4	0.3	*0.8*	*0.9*

Source: IMF, CASE and market consensus.
Notes: f – forecasts.

Table 3.4. Long-term interest rates in selected countries, 1997–2002 (%)

	1997	1998	1999	2000	*2001f*	*2002f*
USA	6.3	5.3	5.7	6.1	*4.8*	*5.0*
Japan	2.3	1.5	1.8	1.7	*1.3*	*1.3*
Euro area	5.7	4.7	4.6	5.4	*5.0*	*5.0*
United Kingdom	7.0	5.5	5.0	5.3	*4.7*	*5.0*
LIBOR (US$/year)	5.9	4.8	5.4	6.5	*5.3*	*5.3*

Source: IMF, CASE and market consensus.
Notes: f – forecasts.

Table 3.5. Dollar exchange rate vs. the euro and the yen, 1997–2002

	1997	1998	1999	2000	*2001f*	*2002f*
Euro			1.07	0.92	*0.927*	*0.973*
Yen	121.0	130.9	113.9	108	*116*	*120*

Source: IMF, CASE and market consensus.
Notes: 1. f – forecasts.
2. Annual averages.

disparity changing in favour of the euro-zone. The average euro-dollar exchange rate dropped from 0.938 in January to 0.910 in March. Consequently, the euro depreciated in effective real and nominal terms, though comparing 1Q01 and 4Q00 one notes appreciation. The slippage of the yen against the dollar was driven by the poor performance of the Japanese economy and outlook for a recession this year. If there is no change in sentiment, underpinned with news of better performance of the Japanese economy, the yen will remain weak against the dollar for at least two consecutive quarters.

Exchange rates seem to be less dependent on flows related to interest rate differentials. FDI and M&A flows that are contingent on growth prospects tend to play an important role. Consequently, exchange rate forecasts are prone to higher uncertainty. In the current international setting there is some potential for the euro to appreciate against the dollar in 2Q01 and 3Q01, but it will definitely not reach parity with the dollar by the end of year.

Oil prices in 1Q01 were fairly stable despite two rounds of OPEC output cuts. The markets reacted calmly on the news of crude oil production cuts by the largest oil exporter – OPEC accounts for 60% of the world's crude exports. After the 1.5 million bpd cut in January, the price increased in February on average by US$1.85/bbl (compared US$25.88/bbl average in January) but in March it dropped below the initial level, reaching US$25.51/bbl on average. After the second oil output cut, by 1 bpd million in March, the price fell further at the beginning of April, dropping below US$25/bbl, before rising slightly soon after.

Most commodity analysts agree that IPE Brent crude oil prices should range between US$22.75/bbl and US$27/bbl in 2001. OPEC's output cuts by a total 2.5 million barrels per day and its subsequent declaration that it will keep discipline over production limits prevented a seasonal build-up in world stocks and may keep prices high. However, there are also good reasons to believe that oil prices may drop below their above-mentioned level this year. This may happen because of lower-than-expected demand growth due to a slowdown in the US, doubts over OPEC's ability to stick to output limits because of a pressure from spare capacity, and an expected increase in non-OPEC oil supply by about 1 million bpd this year (including exports from Kazakhstan via the newly opened Novorossiisk route: first loadings should begin in June).

According to FAO (Food and Agriculture Organisation of the United Nations), global cereal output in 2001 will reach 1.89 billion tonnes, 2% above the 2000 level, mainly due to the rise in coarse grain production by almost 4%. At the same time the FAO forecasts global cereal output utilisation to be higher than output (1.91 billion tonnes), which will lead to a further depletion in world cereal stocks, which are forecast to fall by 4%, to 646 million tonnes during 2001.

United States

- **The worse may be yet to come**
- **Developments in the household sector a key factor behind recessionary or nonrecessionary path**
- **Fed's aggressive easing boosts odds of a V-recovery in 2H01**

The advanced GDP figure for 1Q01 indicated a growth of 2% yoy, i.e. higher than in 4Q00. It came as a surprise, in particular the fact that household consumption was the main driving force. Despite this, imports declined and the trade deficit improved from the recent high levels. In March it reached US$27 billion. Investment growth was very moderate. The unemployment rate saw a minor rise – only a 0.3 percentage point higher than at end-2000. However, a further deterioration in the labour market is to come. This may hurt household confidence and dent household spending. Industrial production increased 0.4% yoy in March – the first rise since September 2000.

Big drops in equity prices in 1Q01 have appeared on the verge of rebounding recently, especially after the second cut in interest rates announced between the regular meetings of the Fed. March 20, 2001 marked the third cut of 50 basis points in Fed interest rates this year. The Federal Reserve continues to be concerned about economic slowdown and pursued an aggressive easing, manifested in a second intermeeting reduction of 50 basis points on April 18. This illustrates the determination of the Fed authorities to push the economy promptly ono the fast track and counteract the expected deterioration in the household sector. Given the stable path of inflation and profound Fed concern for the state of the economy further cuts are yet to come, possibly even as early as June.

Against this background, the ominous scenario of a severe recession in the US is less likely, though downside risks have not disappeared – especially on the household side. 2Q01 should bottom out and 2H01 will see growth acceleration. A V-shape or U-shape recovery will depend on the strength and speed the lower interest rates feed through the economy and their ability to boost consumer and business confidence. Inflation in the US remains in check so far but upside risks are mounting. First, the aggressive easing of monetary policy may take its toll on prices and second, the prices of gasoline and energy are forecast to increase in the summertime.

At this point it is worth considering the possible longer-term implications of the Fed's strategy. There is some risk that if the current slowdown is quickly reversed thanks to the aggressive easing – which would boost the confidence of households and business – the underlying imbalances will not be cleared. Consequently, lower interest rates and stronger domestic demand would drive inflation and the trade deficit up. The Fed would then be forced to reverse its monetary policy and adopt a tightening bias. Given the short period of adjustment in the economy during the current slowdown, this could prompt an even sharper recession than the one looming now.

European Union

- **Growth – slower but firm**
- **Inflation pressures will slowly fade away**

4Q00 GDP figures for the EU and the euro-zone proved slightly higher than previously expected – 2.9% and 3.0% respectively. Consequently, 2000 saw impressive growth – by the standards of the last 10 years – of 3.4% for both the EU and euro-zone. This growth was driven mainly by domestic demand, though the positive contribution of net exports was considerable. In the face of a world-wide slowdown this year growth is expected to decrease to around 2.5%. This would still constitute a decent result. According to the ECB, it would be in line with growth potential. Domestic demand will continue to act as an important driving force.

Inflation has diminished recently, though the improvement has not been that impressive. Despite lower oil prices, inflation in the euro-zone remained at 2.6% in March (in the EU at 2.3%), i.e. at an unchanged level from December 2000. The second-round effect of earlier high oil prices (that fed through the PPI) and exchange rate developments (a general weakness of the euro) are mainly to blame. On top of this the recent high volatility of unprocessed food prices related to foot and mouth disease added to inflation. These effects should fade away gradually, but no prompt easing of inflationary pressure should be expected in 2Q01. Over the longer perspective, the inflationary outlook is more positive providing there are moderate wage rises. One should also note very high CPI rates in some economies of the euro-zone (Ireland – 4.1% in March, the Netherlands – 4.9%, and Portugal – 5.1%) that push up the overall CPI index for the region.

In the face of high inflation in the euro-zone (2.6% in March – i.e., above the reference level of 2.5%), the ECB is reluctant to cut its interest rates. Moreover, M3 3-month average growth reached 4.8% (still above the 4.5% reference level) in February but has been on the decline. It would seem that the bank's officials are now more concerned about price stability than growth. Leaving interest rates unchanged may hamper economic activity in particular in the biggest economies of the euro-zone, though real short-term and long-term interest rates are not high by historic standards. Besides, the ECB authorities claim that the euro-zone is currently above its growth potential. Thus, lowering rates will be seen only in the event of a rosier inflation outlook and this will probably happen no earlier than around mid-year.

The unexpected good performance of industrial production in the euro zone stands in contrast to confidence surveys. For instance the Ifo index for western Germany (allegedly a good leading indicator for the euro-zone as a whole) declined for three consecutive months from 96.8 in December 2000 to 93.9 in March 2001. On the other side, consumer confidence remained high in 1Q01 on the back of ongoing job creation and easing of oil prices. The unemployment rate in the euro zone remained flat at 8.7% over the period December 2000 – February 2001, though the number of unemployed actually declined.

Germany

The world-wide slowdown and a lack of interest rates cuts by the ECB inclined many forecasting institutes to revise downwards their GDP forecasts for Germany this year. The consensus points now to something around 2%, against almost 3% three months ago. This is a considerable revision though does not pose major threats. The IP figure for February came as a surprise against the forecast based on leading indicators. Retail sales recorded a decline both in January and February, providing a body of evidence that the effects of tax cuts, that were expected to boost consumer confidence, have not materialised so far. The declining rate of unemployment that was observed from mid-1999 has halted and the number of unemployed has actually been on the rise in 1Q00. Given the weak euro and expected stronger growth in the US in 2H01 the external environment for Germany should improve in the course of the year.

Russia

Recent available data on activity in the five main production sectors of the economy (3.6% growth yoy) suggest that 1Q01 will witness a visible slowdown after a stunning performance last year. We expect that GDP growth will remain relatively constant over the coming quarters and may reach around 4% this year. In 1Q01 industrial production expanded by a mere 3.3% yoy, compared to 6.5% for 4Q00 and 9% for the whole of 2000. The slowdown was visible in all sectors.

Central Bank of Russia (CBR) preliminary data for 1Q01 indicate that both the strong trade surplus and current account surplus were sustained (US$14.5 and US$11.5 billion, respectively). Merchandise exports have actually risen by 3.6% over 1Q00 (mainly due to oil and gas exports). A slower-than-expected rate of reduction in world oil prices might help to sustain the 2001 current account surplus at a very high level, although some decline from an astonishing US$46.3 billion, or 19.2% of GDP, last year seems certain.

Fast growth of money aggregates in 2000 combined with some administrative price hikes has deteriorated the inflation outlook. The CPI rose by 7.1% qoq in 1Q01. The official 12–14% inflation target seems to be out of reach and it is likely that 2001 may actually end with inflation higher than in 2000.

The issue of foreign debt payments to Paris Club creditors has been solved for this year and there is no threat of falling short of current obligations. Russia is still trying to negotiate the rescheduling (citing large repayment due in 2003). We do not expect any serious problems with realisation of this year's budget even if there is no debt restructuring deal. More worrying in this respect is the potential situation in 2002–2003.

Turkey

Turkey experienced a second wave of its financial crisis with the collapse of the exchange rate peg and the disinflation program in 1Q01. Allegations of corruption in the government triggered large capital outflows, a stock market decline and a jump in overnight interest rates. The IMF warned that no new emergency loans would be granted to Turkey and advised devaluation, but the government decided to continue defending the peg. When overnight interest rates hit 6000% and US$3 billion flowed out of the country, the government decided to float the currency on 22 February. The lira lost approximately 40% of its value against the dollar.

The exchange rate is officially floating, though it is unlikely that the central bank will allow it to float freely – a managed float without any specific target is the most probable exchange rate regime. The exchange rate (along with past inflation) will remain the most visible indicator governing inflationary expectations. Turkey still has to face profound restructuring of the banking system if it wants to ward off further financial turmoil.

The consequences of the crisis are higher inflation and higher debt payment costs. The Treasury is facing triple-digit domestic borrowing costs. This is particularly troublesome, as there is US$1.3 billion redemption of domestic debt in April and US$8.5 billion in May. Turkey would have to roll-over about US$27 billion of short-term liabilities and amortise medium and long term debt of about US$15 billion in 2001. Higher domestic and external debt payments as well as lower tax revenues (due to the expected recession) will add to the budgetary problems. Moreover, a contraction in GDP is certain this year. Weak demand will be sustained on the back of the general economic uncertainty and tough financing conditions.

Anna Myślińska, Łukasz Rawdanowicz

Economic growth

• Higher GDP growth in 2Q01

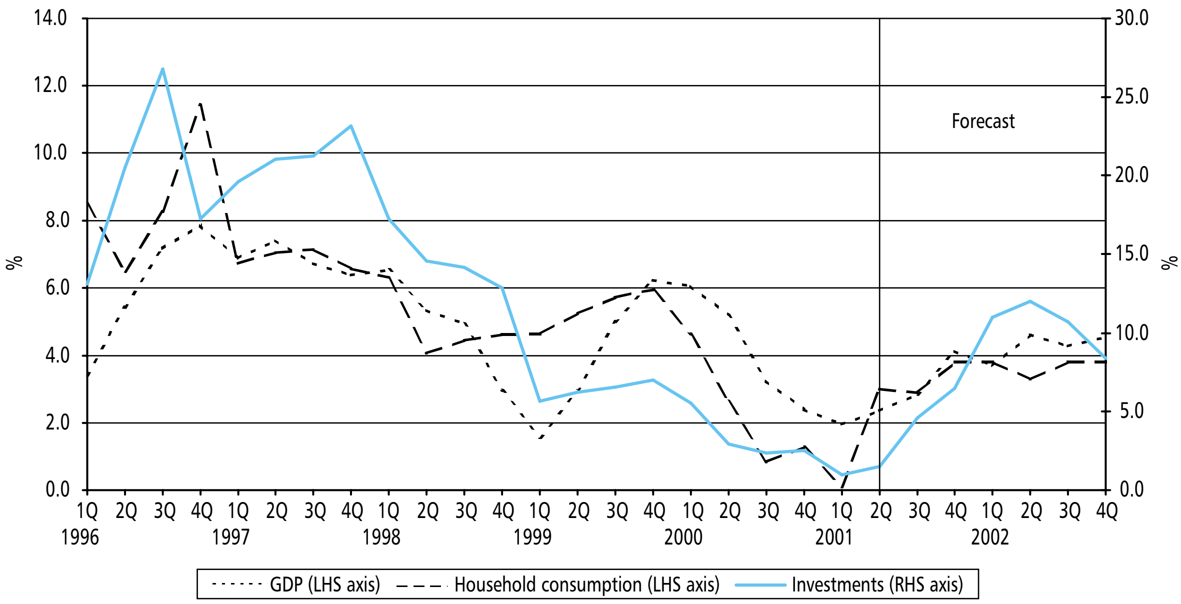
We have lowered our forecast of GDP growth for 2001 from 3% down to 2.9%. We still do not see any reasons for a fast upturn in domestic demand. Low growth in real household income and rising savings will not boost household consumption. Moreover, the high unemployment rate will depress consumer confidence and spending. The continued high interest rates and business pessimism on future sales are sidetracking investments. An upturn in investment will be seen only in 2H01.

The forecast of lower GDP growth this year stems also from a worsened external situation. The EU will expand at a stable rate, though slower than forecast a quarter ago. In the face of weak domestic demand and ensuing low growth of imports, the contribution of net exports to GDP growth will be neutral over the year 2001 as a whole.

The pace of growth in 2002 will accelerate but will be only slightly higher than in 1999 and 2000. In our view, it will not be possible to reachieve growth above 6% due to the slow progress in removing structural impediments in the economy. In addition, huge investments related to FDI inflows will no longer be seen.

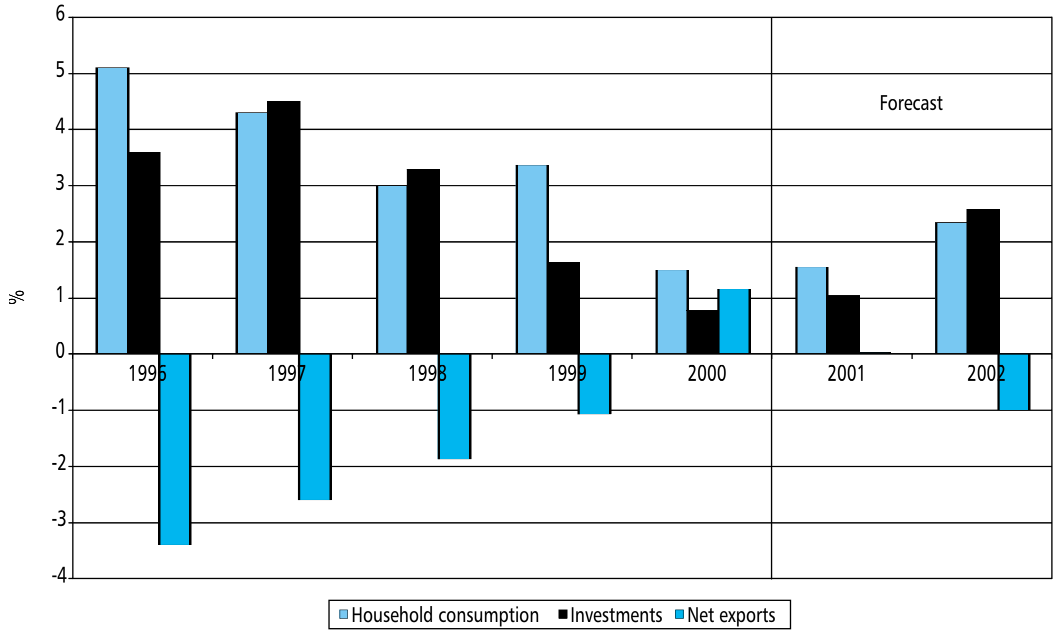
2002 will see the growing importance of household consumption as well as investment in GDP growth. Consequently, growth may reach 4.3%. Faster import growth coupled with stable export growth will result in the negative contribution of net exports to economic growth.

Chart 3.1. GDP, domestic demand and investment, 1996–2002 (% change, yoy)



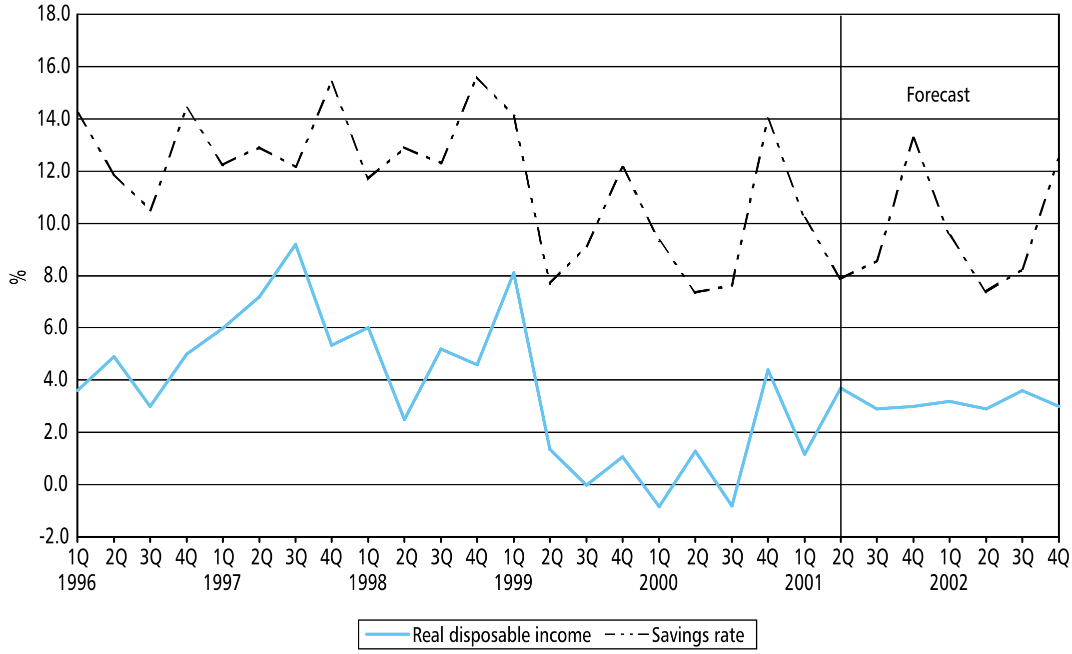
Source: CSO and CASE.
Notes: CASE forecasts starting from 2Q01.

Chart 3.2. Contribution to GDP growth, 1996–2002 (%)



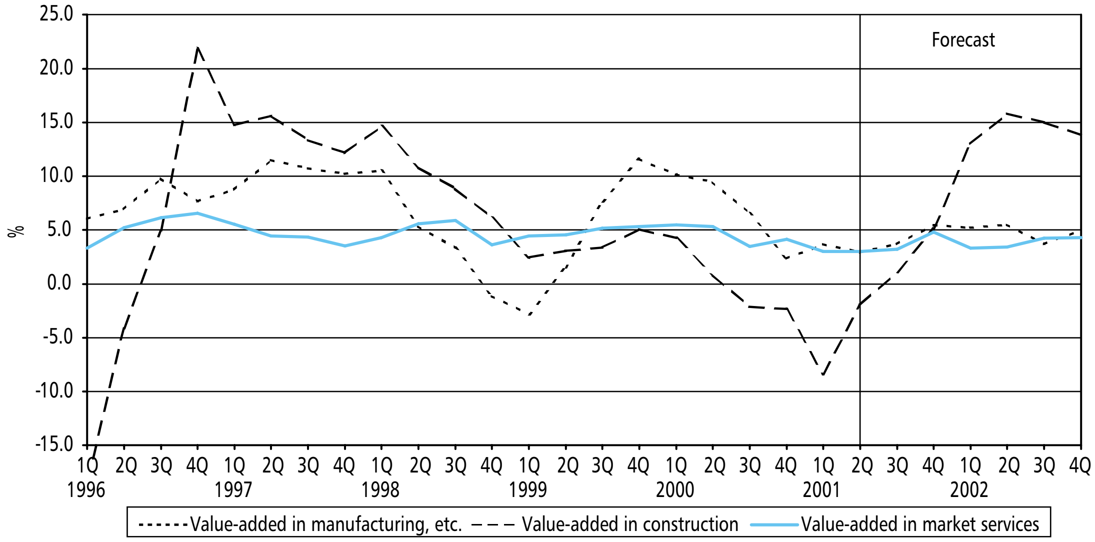
Source: CSO and CASE.
Notes: CASE forecasts starting from 2Q01.

Chart 3.3. Change in real household disposable income and savings rate, 1996-2000 (%)



Source: CSO and CASE.
Notes: CASE forecasts starting from 2Q01.

Chart 3.4. Value-added in major sectors of the economy, 1996–2002 (% change, yoy)



Source: CSO and CASE.
Notes: CASE forecasts starting from 2Q01.

Real sector

Weak domestic demand and lower exports – as compared to 1Q01 – will lead to slower industrial production growth in 2Q01. It may accelerate in 2Q01 on the back of more robust household consumption and a seasonal increase in exports. 2002 will be marked by stable growth in industrial production, though not as high as in 1997.

After a 3-quarter contraction in the construction sector the downward trend will continue in 2Q01. It will reverse only in 3Q01, though the upturn will be moderate. Only in 2002 will there be a full-fledged revival. However, very high growth rates will to some extent result from the low-base effect.

External sector

Rafał Antczak

Exchange rate

- **High uncertainty**

Forecasting exchange rate changes with any real accuracy is difficult due to the situation on the fiscal policy front. According to our estimates, the budget deficit in 2001 will increase from the planned 2.6% of GDP to 4.4% of GDP. The level of deficit is specified in the budget law and its change will have to lead to a budget amendment. In the short-term, the markets may react nervously and zloty exchange rate may experience strong fluctuations. However, a higher deficit has to be financed by the emission of Treasury securities at the net figure of 12 billion zlotys (US$3 billion). A higher share of foreign investors purchasing new emissions would mean an appreciation of the zloty, and their withdrawal from the market would mean a depreciation of the zloty. Any attempt to lower uncertainty stemming from exchange rate risk and increased emissions of eurobonds contradicts the public debt management strategy presented by the Ministry of Finance, in which is outlined the goal of limiting exchange rate risk (and a lower proportion of foreign credits in public debt).

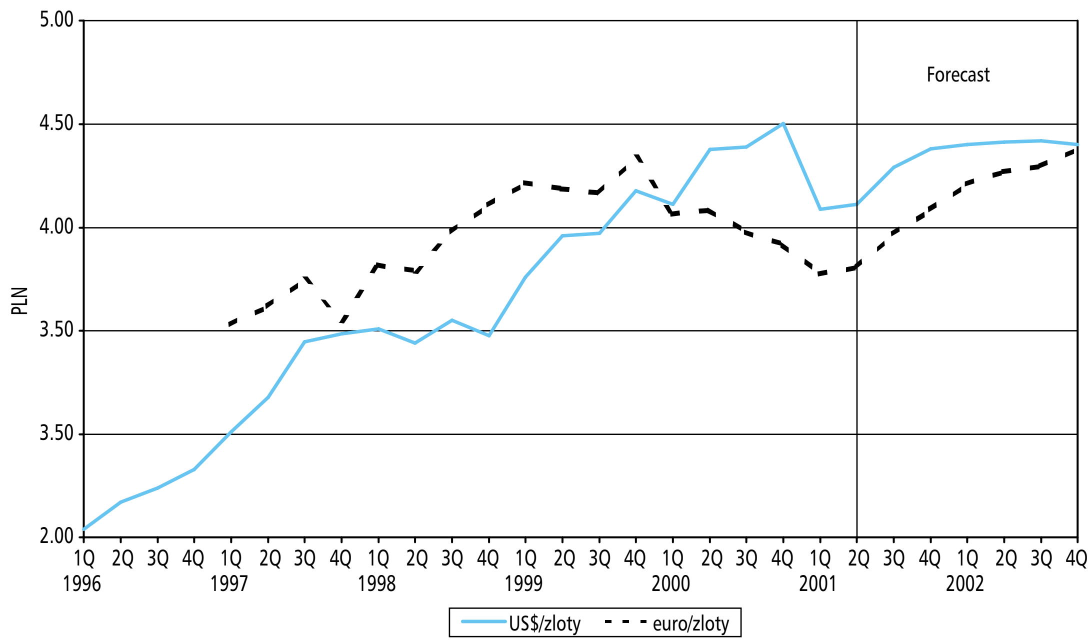
Recouping the approximately 12 billion zloty shortfall in budget revenues is hypothetically feasible via a suspension of transfers to OFE (3.5 billion zlotys) and purchasing remaining Brady bonds (US$4.1 billion) – which would untie the collateral on interest payments to the tune of 4 billion zlotys. Together with the remaining resources on the foreign currency account, of US$1–0.5 billion, could mean that the budget 2001 would survive without amendments. The main precondition for this is fulfilment of privatisation plans (18 billion zlotys).

Accumulation of the planned revenues in 3Q01–4Q01, as in the previous year, will be neutral for the exchange rate as about 80% of revenues may be sterilised with foreign debt payments (30% of revenues were sterilised in 2000). Significant delays or lack of privatisation revenues will push up interest rates in expectation of additional securities emissions by the Ministry of Finance. In the case of portfolio inflows the NBP may face a choice of further appreciation of the zloty or increase of broad money supply and high costs of sterilisation.

Lack of co-ordination between the NBP and Ministry of Finance may finally lead to a situation in which the high budget deficit is financed by portfolio inflows. These aggravate the still dangerously high current account deficit and appreciation of the zloty would additionally increase the attraction of high interest rates. This quasi-equilibrium would last until investors begin translating the expected – and abrupt – depreciation of the zloty into anticipated higher interest rates. As a result rates would likely increase and not decrease. Maintaining an exchange rate of 4 PLN/US$ through the rest of 2001 may increase the risk of an abrupt correction and lower potential zloty revenues from collaterals.

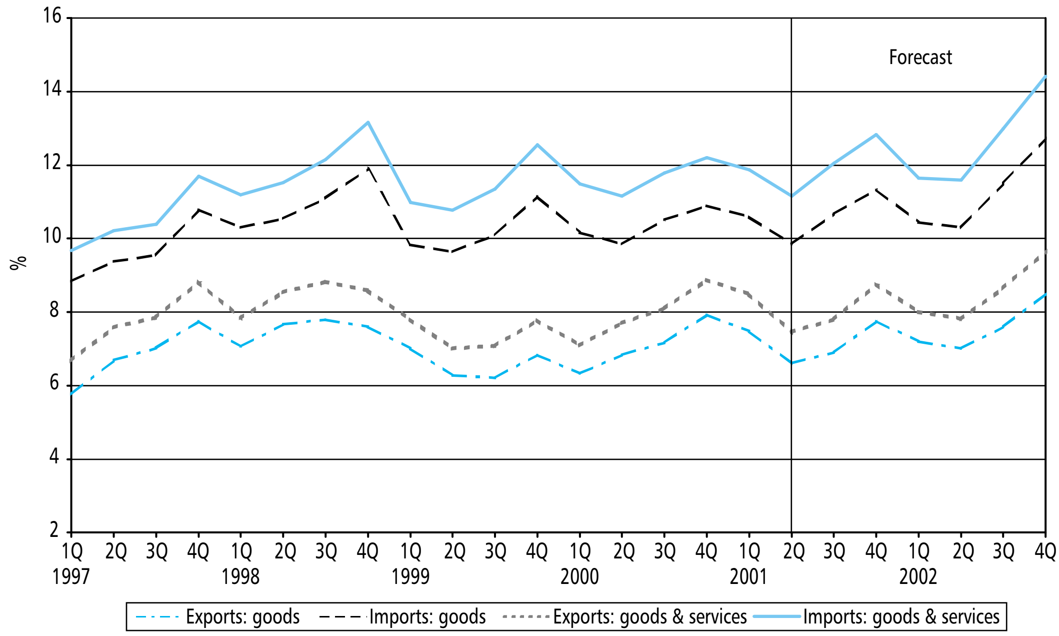
The potential influence of payments for forced labourers in Nazi Germany during the Second World War workers is unclear. The distribution of payments over time would neutralise the consequences of an approximately DM7 billion inflow onto the forex market. Substitute and partial payments in domestic currency would be realised by the Polish organisations (including the budget) playing a sterilisation role (the exchange of payments will take place in the NBP). The payments will inevitably effect monetary policy by increasing domestic demand and supply of M2. The accumulation of payments in the second half of 2001 (pressure owing to parliamentary elections) would additionally complicate an already complex situation on the forex market. In our forecast, we assume, however, that the strong zloty will cause a slowdown in exports and increase in imports. Another factor worsening the current account deficit will be the slow recovery of domestic demand. All these factors, combined with the high budget deficit, weaken the inflow of direct investments as well as the strength of the zloty. High interest rates and war payments will compensate the net outflow, however. Therefore, probable (and desired) is a slow depreciation, which would lessen the current account problems and prevent foreign investment outflow.

Chart 3.5. Basic exchange rates, 1996–2002 (in zlotys)



Source: NBP and CASE.
Notes: CASE forecasts starting from 2Q01.

Chart 3.6. Exports and imports, 1997–2002 (US$ billion)



Source: NBP and CASE.
Notes: CASE forecasts starting from 2Q01.

Łukasz Rawdanowicz

Foreign trade

- **Less favourable outlook for Polish exports**
- **Forecast of higher trade deficit**

The slower-than-previously-expected growth in the EU, and in particular in Germany, obliged us to downgrade our export forecast for this year. The less optimistic outlook for economic situation in Russian also underpinned this decision. The export forecast for 2001 now stands at US$28.7 billion. After the slowdown in exports in 2Q01, 2H01 should bring higher growth boosted by the depreciation of the zloty and an improvement in the global economic situation.

Against the background of stable and GDP growth slightly higher than this year in the EU and in Poland's southern neighbours in 2002, exports are expected to expand by around 7% in nominal dollar terms. The optimistic outlook is also underpinned by an acceleration of structural adjustments and restructuring of domestic industry. Over the last two years the pace of these processes in some sectors was unsatisfactory despite a downturn in both domestic and foreign demand as well as real appreciation of the zloty.

In 2Q01, imports in the balance of payments will remain at a relatively low level due to a slow revival in domestic demand and in household consumption in particular. On the other hand, 2H01 will see faster growth in imports on the back of higher domestic economic activity. However, a weaker zloty may prove an impediment to rapid growth.

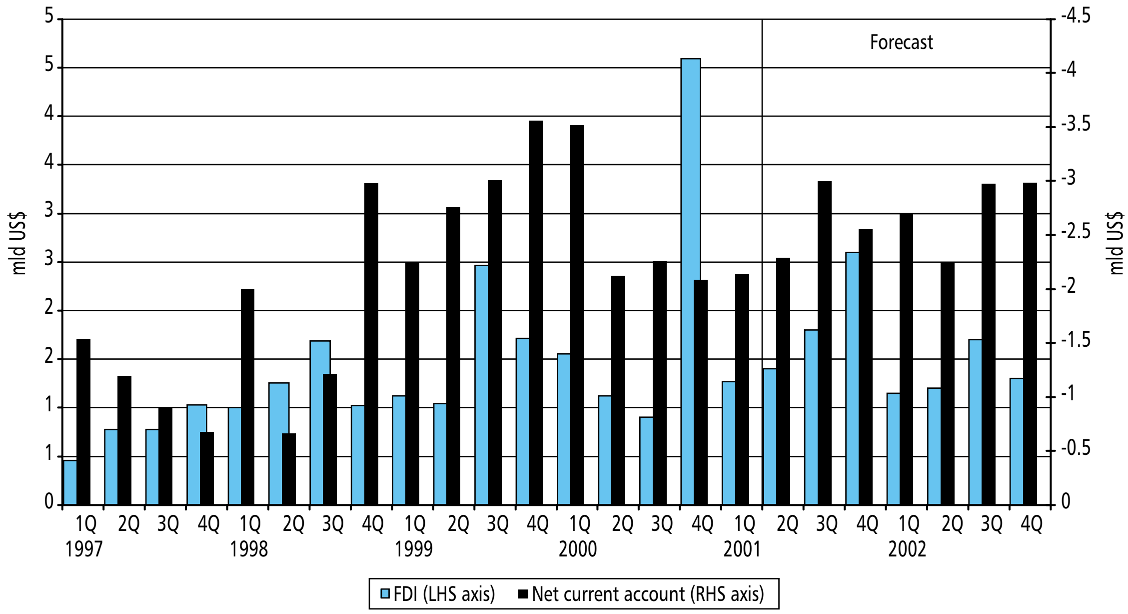
Łukasz Rawdanowicz

Balance of payments

- **Higher current account deficit**
- **Capital flows very uncertain**

Along with stable exports and faster import growth the merchandise trade balance will deteriorate in both 2001 and 2002. In addition, the income deficit will also follow suit due to higher interest payments on foreign debt and the withdrawal of capital gains. On the positive side, surpluses in unclassified current transactions and transfers will grow. Consequently, the deficit in the

Chart 3.7. Net FDI and current account balance, 1997–2002 (US$ billion)



Source: NBP and CASE.
Notes: CASE forecasts starting from 2Q01.

current account of the balance of payments will drop to -5.7% of GDP in 2001 and -5.9% of GDP in 2002 from -6.3% of GDP last year.

Prolonged negotiations over the sale of 10–16% of TP SA shares add to uncertainties with respect to the exact timing of related large inflows of FDI. We expect the negotiations to end in 4Q01. 2001 as a whole should see total FDI inflows of US$7 billion. Smaller privatisation proceeds next year will lower FDI to US$5.4 billion.

Due to weaker economic activity in Poland, problems with the budget deficit and potential political turmoil related to the parliamentary elections, a high volatility in portfolio capital flows should be expected. The timetable and size of the next cuts in interest rates will play an important role in shaping these flows. Despite the cuts, interest rates will remain attractive for foreign investors and the net inflow of portfolio capital over the year will be positive. In 2002, given no financial turmoil, further inflows are expected.

Along the depreciation of the zloty, one should expect a return of US$3.6 billion capital – the foreign currencies sent abroad by banks in Poland at end-2000 and in 1Q01.

Even in the event of no NBP interventions on the exchange rate market, official reserves will be on the rise – mainly as a result of the euro's appreciation against the dollar. We estimate an end-2001 level of reserves at US$29 billion. That would still be sufficient to cover 8 months of average imports.

Małgorzata Markiewicz, Artur Radziwiłł

Public Finances

- **Sequestration of expenditures or changes in the budget law will be necessary**
- **Growth of hidden liabilities in the budgetary sector**

It is already clear that the budget for 2001 will not be executed. The nominal overall deficit rule applying to the central government budget does not allow the deficit to be increased above the level set in the budget act. In the case of a drop in revenues the budget act has to be amended or expenditures sequestrated. The government's decision concerning changes in the budget act is not regulated by fiscal rules. Therefore, a decision on changing the budget act may have a political character and might be shifted to the last quarter of the year.

According to our forecast, state budget revenues in 2001 will be more than 12 billion zlotys lower than planned, mainly due to low indirect tax revenues. The payment of the national bank's profits in 2Q01 will hamper any growth in the deficit. If budget expenditures are executed at the planned amount this would result in a state budget deficit of 33 billion zlotys (over 4% of GDP). Introducing amendments to the budget act to increase the deficit would mean a significant relaxation of fiscal policy. The government can sequestrate expenditures, though it would be difficult to decrease them by as much as necessary (in 2000 expenditures were sequestrated to the tune of about 4 billion zlotys). Probably some mix of these measures will be applied.

Whatever the state deficit is, there could well be financing problems. If France Telecom decides not to take up its option to buy 10% of TP SA shares this would result in a drop in privatisation revenues of 2 billion zlotys. There is a chance that the conflict concerning PZU will be settled, which would mean privatisation inflow of about 5 billion zlotys to the budget.

The following are the main threats to a consolidated public sector: (1) the programme of selling back FUS liabilities worth 2 billion zlotys may not be executed, (2) increase in Labour Fund expenditures due to growth in unemployment, (3) growth in the Regional Health Funds deficit caused by obligation to pay increases in salaries of those employed in the public health sector, (4) growth in indebtedness of public health sector institutions estimated at 3 billion zlotys at end-2000. In the face of tensions in the public sector these problems could be hidden and shifted to a future date via a growth in the debts of public institutions owed to the banking sector. This would lead to a growth of hidden liabilities in the consolidated public sector and blur the transparency of the fiscal accounts.

Piotr Bujak

Labour market

For 2Q01 we forecast a fall in unemployment to 15.6% due to seasonal factors. This fall will be relatively smaller than in previous years, as this year lower budgetary funds are being directed towards active methods of combating unemployment. Thus, fewer workers will be employed in public works.

The medium-term outlook for the labour market will be determined by a continuation of the restructuring and privatisation processes, low investment activity, as well as by demographic and market factors. Demographic factors will impact negatively via the lay-offs of primary school teachers resulting from a decrease in the number of pupils. The supply of workforce aged 18–24 will rise, although this will be partly offset by an increase in the enrolment rate in higher education. This will be spread over time and delay the inflow of baby-boomers onto the labour market. We predict that by the end of 2001 the unemployment rate will stabilise at 16.6%. One should note that economic growth of 3–4% would not be enough to secure a net increase in the number of jobs.

In 2Q01 we forecast still sluggish growth in real wages and salaries on the back of the high unemployment rate and weak consumer and investment demand. As of 2H01 will see a recovery in domestic demand and in turn improvement in the financial standing of the corporate sector and higher real wages and salaries.

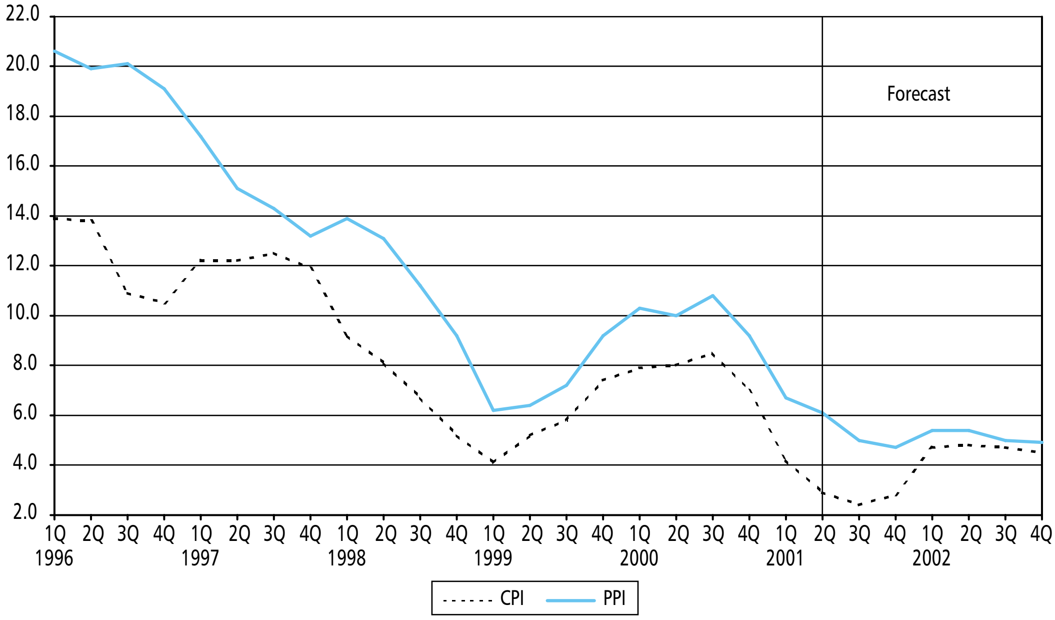
Mariusz Jarmużek

Prices

In 2Q01, we expect cereal imports, weak domestic demand and low exports to CIS countries to cause a further fall in the growth of prices of cereal products and meat. Consequently, foodstuff prices will follow suit. However, we assume an acceleration in the growth of meat prices in 2H01 due to a low supply of livestock and a strengthening of domestic demand. On the other hand, cereal prices will be stable since favourable weather conditions in the first months of the year and low harvests in the previous two years increase the chances of bumper harvest this year. In the forthcoming years we will see changeable harvest cycles.

Given our forecast of a strong zloty, a continuation of slow growth in monetary aggregates and a sustained downward trend in wages growth, rapid disinflation will continue. In addition, we assume that oil prices on the world market will range between US$22.75–27 per barrel. This, coupled with the

Chart 3.8. CPI and PPI, 1996–2002 (% change, yoy)



Source: NBP and CASE.
Notes: CASE forecasts starting from 2Q01.

strong zloty, could to some extent offset the effects of the excise tax increase.

The recently muted possibility that gas prices will rise on a quarterly basis would make it possible to shift higher costs onto consumers – gas and energy prices will rise in 2Q01. An end of energy price hikes is expected to come in July. In 2002 we forecast a rise in quasi-controlled prices at a level of 2–3 percentage points above the CPI.

In 1H01 we forecast that the PPI would decline as a consequence of weak domestic demand, a strong zloty, and low oil prices. For the upcoming quarters we expect some acceleration in the PPI due to a revival in demand, zloty depreciation and stabilisation on commodities market.

Przemysław Woźniak

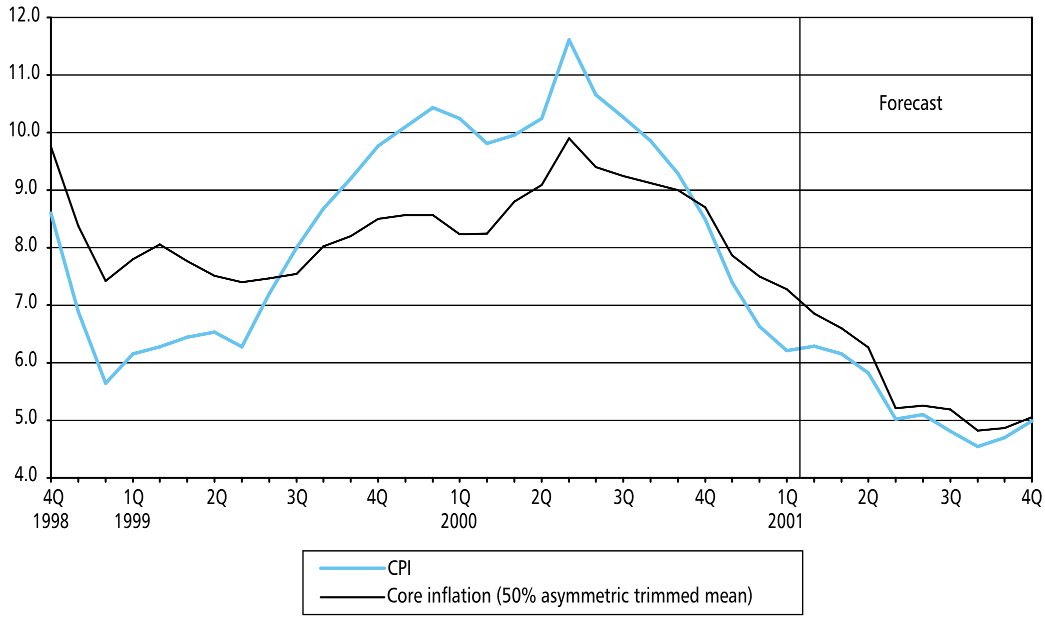
Core inflation

Independent of our monitoring of core price changes with the use of those measures adopted by the NBP, CASE is conducting research on developing superior core inflation measures. The related analyses show clearly that asymmetrically trimmed means perform better in indicating medium-term inflationary trends and have better forecasting properties. This group includes, among many others, the 50%[1)] asymmetrically trimmed mean that eliminates the 28.5% lowest and 21.5% highest price changes (the percentages relate to consumption basket share). This mean exhibits characteristics that are superior to those of the NBP symmetrically trimmed mean in many respects.

Figure 3.9 presents the dynamics of the above-defined symmetrically trimmed mean along with headline inflation. Core inflation has exceeded headline inflation since November 2000, pointing to the fact that the observed slowdown of headline inflation has been fuelled mainly by the marked price decreases of only a handful of products. It is worth mentioning some of these changes: an almost 20% yoy drop in the price of butter (end-March 2001), a drop in the price of domestic phone calls in excess of 15%, fruit and vegetable falls in excess of 10% and an almost 4% drop in the price of fuel.

[1)] The trimmed mean contains the total percentage trimmed from the index. According to this notation the mean calculated by the NBP is the 30% trimmed mean (2*15%).

Chart 3.9. Core inflation, 1998–2001



Source: CSO and CASE.
Notes: CASE forecasts starting from 2Q01.

We predicts that similar phenomena (price falls or significant decreases in the growth rates of individual CPI components) will be in place within the next few months and that as a result we expect a positive deviation of core inflation from headline inflation throughout 2001. Any trimmed mean will eliminate the effect of these falls and, unlike the regular CPI, will not register an equally sharp drop in rates[2]. At the same time, considering the diminishing role of these phenomena in 2H01, we predict a narrowing of the gap between the two measures and finally, an evening out of their rates in late 2001.

Rafał Antczak

Monetary policy

• Interest rate cuts, though moderate

Monetary policy faces the difficult situation of mounting problems with co-ordination of fiscal policy and political pressure for interest rate cuts to stimulate domestic demand. Achieving the mid-term inflation target is still under threat due to the expansion of the budget deficit and the threat of strong fluctuation in the exchange rate and negative external shocks. Also, problems controlling the rate of broad money increases may result in pure monetary factors governing inflation growth in 2002.

Taking into account such threats, we have not changed our forecast of the NBP's reference interest rates in 2001 – a cut of 450 basis points, which means a further cut of 250 basis points until end-2001. It should be more obvious in mid-year the extent to which the government will be able to neutralise low budget revenues – either by appropriate cuts in expenditures or increasing the budget deficit above the planned level. Therefore, the MPC will decide on the basis of the quality of fiscal policy. However, one cannot rule out NBP attempts to surprise the markets if appreciation pressure on the zloty coincides with the actions of the Ministry of Finance. The supply of broad money will stay at 14–16% on the annual basis despite the NBP's efforts to limit the supply of reserve money.

[2] The trimmed mean will eliminate both extreme decreases and increases, but in view of the substantial size of the decreases this will yield a higher value than that of headline inflation.