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POLISH ECONOMIC OUTLOOK
TRENDS • ANALYSES • FORECASTS

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From the editor

Dear readers,

Six months ago, in addition to our baseline scenario we presented an alternative scenario that posited a more severe slowdown of economic growth. At that time, even our baseline scenario was perceived as overly pessimistic. Subsequently released official data has however proved that the situation was worse than we forecast in the baseline scenario. Other forecasting centres followed suit, revising their forecasts downward. Today our outlook is more biased on the upside. A quarter ago we gave up our more pessimistic scenario as, in our opinion, the biggest threat of recession in the US had receded. This was far more important than the longer and deeper slowdown - already apparent - in domestic demand in Poland. It was this factor that inclined us to revise slightly our GDP forecast for this year. However, 2Q01 turned out much worse than expected. So, was the discarding of the alternative scenario too premature?

In our view, it was not. Not only because we do not envisage a GDP contraction, but also due to the fact that the underlining factor behind slower growth is domestic demand, and in particular household consumption, as well as…an improved foreign trade performance. Slightly faster disinflation gives cause for some optimism. The accommodation of the Polish economy on the supply side proved deeper than expected, which in turn, paradoxically, caused a relatively stronger weakening of demand. This, on the other hand, paves the way for long-term revival.

Due to the above mentioned factors we are more optimistic - as a quarter ago - as to the gradual recovery of economic growth. At that time, we were worried about two things. First, a collapse of public finances, and second, an explosion of the exchange rate bomb. With regard to the former, the blackest scenario of boosting expenditure under social and political pressures has not materialised. However, the amendment to the budget act indicates a very passive attitude on the side of the government toward the mounting problems in the fiscal sphere. I claim, in an article in the first part of the quarterly, that profound changes in mainstream views on public finances are absolutely essential for overcoming this difficult situation. As for the exchange rate, a diffusion appears to be succeeding and the likelihood of an outburst is very low. After a few days of volatile exchange rate in July the zloty stabilised at a level that will mitigate pressure from foreign competition. It is a good starting point for a further gradual weakening of the zloty. Over the longer horizon we do not see any other serious turmoil on the exchange market. The rationale behind this view is presented in the second article which deals with the dilemmas of exchange rate policy. In this article we outline our views on the 'rational volatility of the exchange rate' over the years ahead.

The subsequent part of the quarterly elaborates on the current situation and forecasts up to 2002. Even if the forecasts are too optimistic, we are certain the worst developments have been avoided. We are already on firm ground and will soon be back on the fast track.

Andrzej Bratkowski

Andrzej Bratkowski

CASE
Center for Social and Economic Research

Budget hypertrophy

During the current parliamentary term that is soon to end few government legislative proposals – unlike the budget law amendment – have been supported by the opposition. The necessity of increasing the budget deficit was taken for granted both by the government and almost all parties. The current mainstream of informed opinion on public finances supports the thesis that budgetary expenditures can be divided into fixed and necessary areas. Most expenditures are fixed and simply must be executed from a legal point of view (often according to the constitution law). Other expenditures – those which are more flexible from the legal point of view – operate on the other hand at a more basic level – that of the state's and its citizens' very survival.

One of the reasons behind this political unanimity is the approaching elections – no politician dares to demand budgetary cuts in the run-up to an election. But the mass-media, various professional groups and politicians have furiously attacked the government, and in particular the minister of finance, for a 'meanness' that has driven the budget to the verge of crisis. From this perspective there is no option but to choose a different path out of the crisis – if the vox populi reflects the current situation, a crisis seems to be unavoidable. Either we can curb budgetary expenditures, and in the process starve various public services – the present situation here is already dramatic – or boost expenditure, which would lead to a meltdown of public finances – a version of collective suicide.

There is, however, a way out of this catch-22 situation, but the mainstream views on public finances must change for it to be possible. It is not certain that all 'flexible' expenditures are indispensable. Some 'fixed' expenditures are in fact non-essential. Some lobbying groups in fact managed to get their budget revenues legally fixed so as to avoid the need to compete for financial resources with other areas that are in reality indispensable. Even a very simple statistical analysis provides support for such a conjecture. If budgetary expenditures are spent according to the budget law, they will be higher by 14% as compared to the previous year in real terms. Compensation for relatively low real expenditures last year due to high inflation are only partially responsible for such a significant increase, as, since 1999, budgetary expenditures have risen by only 12% in real terms. Over the same period, debt servicing costs grew by roughly 10% in nominal terms (the GDP deflator increased by 14%, whereas nominal GDP by over 23%). Consequently, the relative burden of debt servicing actually declined sizeably. On the other hand, expenditures on social benefits expanded substantially, though fully justifiably. However, this item may be responsible only for a 2% rise of total expenditures in real terms. So, how can the remaining 10% can be explained? What were the expensive additional services consumed by society? It seems there were no additional services but that the cost of servicing the existing ones skyrocketed. This is reflected in wages growth – in 1Q01 average wages and salaries in the enterprise sector grew by 7.3% yoy, compared to 13% in the bud-

getary sector. For the first time in many years, the average monthly wage in the public sector is higher than in the enterprise sector. The budget sector is not experiencing a crisis at all – quite the contrary, the sector is thriving and on the spending spree.

So, where can the justified savings in public finances be found? This question is always raised when it comes to budgetary cuts. The only practical solution left to the minister of finance is to reduce expenditures equally across the board – both the current spending of the central administration as well as subsidies for local governments. Let local governments and ministries take the initiative in stating what legal amendments are needed to allow for cuts in 'fixed' expenditures. This rather 'mechanical' rule of reducing expenditures would definitely be widely criticised. However, it must be born in mind that the minister of finance cannot simply enforce rational economic behaviour, exactly for the same reasons as it was impossible to administer enterprise efficiency in the command economy. Maybe there is a chance of some improvement in the current fiscal stance by deploying more sophisticated measures of budgetary financing, but no breakthrough could be achieved in this framework. This can be achieved only by a large-scale commercialisation of services provided by the state. The problem with this solution is that it would be met with the opposition similar as in the case of ordinary expenditure cuts.

This catch-22 situation stems from the structural legal framework within which public finances operate. First, the 'purchase' of public services from the state is very different from normal market transaction. In the former case you pay first (via taxes) and only after you learn what have you have bought. Thus, it is absolutely rational that tax-payers seek to benefit as much as possible from the state. Public debates and political decisions on taxes have been separated from those on budgetary expenditures. Thus, unless society has a real choice between paying lower taxes and benefiting less or the other way round, the 'run' on public finances will never stop.

The latter solution, in contrast to what it would look like superficially, would have nothing in common with less egalitarian social policy. Effective tax burdens have already reached the absolute maximum for regional standards. An increase in tax rates or their change in order to make them more progressive could boost the redistributive effect only in a short run, as it would pay off for high-income people to seek – legally or illegally – ways of hiding their incomes or 'transferring' to lower rate zones. If one invested in the 'infrastructure of tax dodging' one could have effective tax rates below the average or even the lowest ones. There are many reasons to believe that the current tax rates in Poland (i.e., average rates in the subsequent income ranges) are more regressive than progressive. Thus, it is the poorest not the richest who pay for the state's activities. At present, the effective PIT rate on revealed incomes is about 16%. In this situation, the adoption of a linear tax rate of a similar size would probably bring about an increase in budgetary revenues without diminishing the scope of income redistribution. Under the linear tax rate system, it would be easy to relate various expenditures to a percentage of tax rates. This fact would have very important educational consequences and would facilitate a gradual reduction in the engagement of the state in areas where it would be successfully replaced by private firms.

At the same time, measures aimed at 'unfixing' some expenditures should be immediately pursued. One way of doing so is to wind up various budgetary funds. It is interesting that no one question this necessity, though after winding up one budgetary fund another is set up. The second measure should consolidate all subsidies and subventions to local governments into one transfer. At the same time, decisions on what they will be spent on should be left entirely to local governments themselves. The next measure should be to give independence in tax policy to local governments and eliminating transfers from the central budget. If local government set tax rates on its own, there would then be tax arbitrage – businessmen would seek those places with the lowest tax burdens. Consequently, local authorities would be forced to lower tax rates and to economise expenditures.

If the above measures were introduced it would be politically possible to reach society-wide agreement on the exclusion from the budget sector (in return for lowered taxes and introduction of appropriate subsides to people with lowest income) services that are currently provided only for redistributive purposes, i.e. education and health care. This solution would allow for a reduction of the budget by roughly one fifth. Also many

other administrative functions could be run by private entities. This would bring an additional positive effect – namely the criteria used to undertake administration decisions would be more clearly defined and the legal protection of society against the state's arbitrariness strengthened. In such a framework of 'skimmed' public finances, it would be much easier to control the legitimacy of incurred expenditures.

All these reforms are not needed to consolidate the budget deficit, as this could be achieved via across the board cuts in expenditures, but in order to improve the quality of services provide by the public sector. This is significantly worse than the quality of private services. The sizeable increase in budgetary expenditures over the last two years proves that higher spending is not associated with a better quality of services provided.

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A gradual decline or a fall: perspectives for the zloty and monetary policy dilemmas

The evolution of the exchange rate regime

In January 1990, at the beginning of the reform process, Poland opted for a fixed exchange rate regime. From January 1990 to April 1991 the rate was set at 0.95 zlotys (9,500 zlotys before denomination) to the US dollar. The peg served as a nominal anchor in the fight against hyperinflation. In mid-May 1991, the zloty was devalued and pegged to the basket of five major currencies (weights reflected the shares in foreign trade turnover). On 14 October, 1991 another policy change took place and the crawling peg system was introduced with a monthly depreciation rate of 1.8%. This rate was reduced on several occasions during the next few years, and several correcting devaluations were also administered. May 1995 witnessed the introduction of the +/- 7% band around the central parity. In May 1999, the monthly depreciation rate was reduced to 0.3%, while the band was widened to +/- 15%. Finally, on 12 April 2000, the Polish Ministry of Finance decided to float the zloty. The central bank (NBP) still retains the right to intervene in the forex market. The current regime de jure classifies as a managed or 'dirty' float. However, as the NBP has not actually intervened so far the regime is de facto a free float.

Under the crawling peg the rate of the zloty's nominal devaluation was below the inflation rate. Unexpected correcting devaluations constituted an exception to that rule. However, they did not reverse the zloty's real appreciation trend. There have been several incidents of rapid depreciations after the floating of the zloty. However, they have proved short-lived and the real appreciation trend even strengthened in that period. Since the end of 2000 a new phenomenon has been observed – the zloty continued to appreciate for several months not only in real but also in nominal terms. Even though the zloty lost slightly against other currencies in July 2001, it is still stronger than a year ago. This is one of the major direct causes of the slowdown in domestic output. Consequently, calls were made to review the exchange rate policy that has been in operation for more than a year now. They pointed to the risk that the imbalances brought about by the strong zloty could eventually lead to a sudden depreciation or even a currency crisis. In this article we argue, firstly, that the strong real appreciation of the zloty does not impact negatively on the economy – as is often claimed and secondly, that a policy of deliberate weakening of the national currency is not a good way of boosting economic growth. In the current situation of a de facto pure free float, adopting a currency board or pursuing euroisation constitute real options. On the other hand, even under the present regime there are reasons to believe that the probability of turmoil on the forex market is low. However, regardless of the choice of the exchange rate system a case should be made for strong external competitive pressure and the ensuing risks of macroeconomic meltdown cannot be fully ruled out, although the right policy can considerably reduce the risk of such a scenario.

Competitiveness and the exchange rate: mind the side effects!

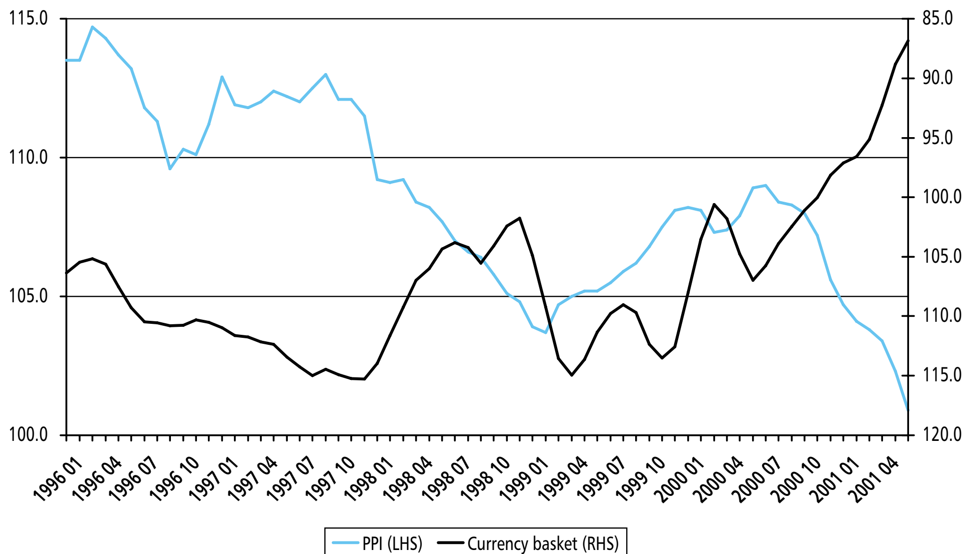
The exchange rate is commonly regarded as one of the key economic variables. It determines, ceteris paribus,

the competitiveness of a given economy. It is precisely this fact that leads many economic policy-makers and some economists to support using exchange rate policy to preserve competitiveness of domestic production. However, they make an important mistake by unwittingly accepting the ceteris paribus assumption. In fact, this policy can only be sanctioned for very short periods. Even an analysis of a couple of months yields false results. This is because changes of the exchange rates bear several other – equally important – side effects which are more spread over time and therefore are often underestimated in 'common sense' reasoning.

The exchange rate has a sizeable impact on inflation. The weakening of the domestic currency leads to an increase in prices of imported goods and services, and appreciation results in a decline of these prices. Consequently, these price changes are transmitted – with some time lag – to domestically produced goods. The strong link between exchange rate movements and inflation is visible in the case of the consumer price index (CPI) as well as the producer price index (PPI). In the latter case, the link is even stronger.

There are also important indirect links between exchange rate policy and inflation. The transmission mechanisms work through capital inflows and the money supply. Under the free float regime, when an exchange rate is determined solely by market demand and supply, capital flows are neutral with respect to domestic base money supply and interest rates. The stability of nominal money supply is achieved at the cost of exchange rate volatility. On the other hand, under the currency board regime (or euroisation), changes in the monetary base are equal to the difference between the current account balance and the financial account balance of the balance of payments. Interest rates become practically exogenous as in the case of the fixed exchange rate any gap between domestic and foreign interest rates would trigger arbitrage and the ensuing capital flows would bring domestic rates to the level of respective foreign rates augmented by a risk premium. In other words, under such regimes exchange rate stability is achieved at the cost of money supply volatility. As the exchange rate knock-on effect on inflation is faster than the money supply channel, under a fixed exchange rate system prices are more stable than under the free float.

Chart 1. Currency basket and the PPI, 1996–2001 (% change, yoy)



Source: CSO and NBP.
Note: The currency basket: 40% of the dollar and 60% of the euro – 3 month moving average (RHS axis); PPI – LHS axis.

Both the above discussed solutions are better suited to serving the objective of price stability than the managed float system aiming at preventing exchange rate appreciation. In the case of growing capital inflows, such an exchange rate policy results in the coexistence of inflationary pressures typical for both solutions. The purchase of foreign currencies in the forex market (prevention against appreciation) swells money supply and leads to the weakening of a domestic currency. Even though the monetary effects of forex interventions can be sterilised by open market operations, this enforces the need for high interest rates. This – apart from other negative effects – attracts speculative capital inflows, forcing the monetary authorities into making further interventions and leads to even faster monetary expansion. So we end up in a vicious circle. The above discussion is supported by analyses of the Czech Republic and Slovakia experience carried by JP Morgan (Global Data Watch, July 6, 2001). Forex interventions in these countries proved to be effective only in the short-term and failed to stop the long-run real appreciation.

Even if intervention proves successful the positive impact on economic growth will be short-lived. After some time higher inflation partially reduces competitiveness gains. The supply-side effects of the weakening of the domestic currency are even more spread over time. A weaker domestic currency translates into more expensive imports and higher labour costs in terms of a unit of foreign currency gained in exports. Consequently, the argument that the strong zloty creates jobs abroad on the expense of the domestic labour market can be counterweighted by an argument that the weak zloty is a form of subsidy to other countries. Moreover, the policy aiming at protection of the domestic sector from foreign competition weakens the incentives for improving efficiency. Finally, higher inflation not only diminishes the pro-competitiveness effects of depreciation, but also makes it more difficult to effectively allocate resources and forces the maintenance of high interest rates. These persistent supply-side effects of interventions against the domestic currency have a more profound negative impact on the long-run growth prospects than the positive short-term demand-side effects.

At first glance the managed exchange rate system has at least one advantage over other solutions. By preventing excessive appreciation of a domestic currency, it appears to protect the economy from a currency crisis. Overvaluation of a domestic currency – regardless of whether it results from strong nominal appreciation under the free float regime or from long-term real appreciation under the fixed exchange rate system – leads to the growth of the current account deficit and may eventually provoke a rapid capital outflow and a financial crisis – both on the side of enterprises as well as public finances. In the case of a floating exchange rate, capital outflow brings strong depreciation and resulting rapid increase of the cost of servicing foreign debt. In the case of a currency board or euroisation, capital outflow sends interest rates up. The Argentinean example illustrates that this can also cause debt servicing problems. On the other hand, the Lithuanian and Estonian experiences from the period after the Russian crisis of 1998 shows that the probability of such a scenario in Poland is rather low.

Still, historical experience demonstrates that managed exchange rate systems do not provide an effective cushion against currency crises either. The monetary authorities' decision to engage in market interventions triggers a series of further moves in both directions – either supporting or weakening a domestic currency. There are several factors making it impossible for such a policy to prevent excessive foreign borrowing, rapid capital outflows and consequently currency crises. These factors include problems with controlling money supply and inflation, provoking speculative capital inflows, lack of incentives to enhance competitiveness on the side of enterprises, as well as difficulties in assessment of when either appreciation or depreciation is 'disproportionate'. There have been several episodes during the last two decades when a regulated exchange rate regime did not preclude a rapid depreciation or devaluation and debt default. The examples include Mexico in August 1982, Southeast Asian economies in 1997 and Russia in August 1998.

The above mentioned arguments make it rather unlikely that the NBP will engage in forex interventions. On the other hand the possibility of adopting a fixed rate regime cannot be ruled out. It seems to be especially well suited for Poland, given the country's strong trade links with the EU and not far prospect for the accession. The lack of interest in such a solution in the past can be attributed to the belief that market would determine the zloty's depreciating trend against the euro and the dollar – at least in nominal terms. The experience of the last

few months has demonstrated that such confidence is illusory and consequently one observes increased interest in the other exchange rate policies. However, a change of system cannot be introduced overnight. The free float will remain in place therefore for some time to come. Hence, we based on this assumption our exchange rate forecasts presented in this quarterly.

When presenting our point forecasts we naturally do not take into account the measure of exchange rate risk. The experience of 2000 and 2001 could suggest that anything is possible with respect to exchange rate developments. And this holds true, though, one can still ascribe different probabilities to various scenarios.

Determinants of the exchange rate in the free float system – theory vs. practice

What determines the nominal exchange rate? The simplest answer points at demand and supply. These are influenced by the current account and the financial account balances. However, as both items are in turn dependent on the exchange rate, such a presentation does not allow for establishing an equilibrium exchange rate. The adjustment of real economic processes to exchange rate movements takes time and the exchange rate is not the only determinant of these processes. The current account balance is determined by supply side characteristics of an economy along with the pace of growth of domestic demand and external developments, i.e., by factors that remain fairly stable in the short-term. Capital movements, apart from very volatile determinants such as the exchange rate and interest rate, also reflect more fundamental factors, especially the perceived growth prospects of a given economy. This applies particularly to FDI but also to portfolio investments that – along with interest rate differentials – take into account the default risk.

Fundamental factors establish a range of 'rational volatility' in capital flows and exchange rates, but the estimation of this range in a particular macroeconomic environment is far from straightforward. Within this range one can speak of co-determinism between capital flows, interest rates, money supply and the exchange rate.

In multi-purpose textbook theories, analysis of these processes concentrates on international arbitrage and interest rate parity conditions. The basis for this theory is the assumption that in the world of fee capital mobility the rate of return on financial instruments (e.g. treasury bills) denominated in one currency should be equal to the expected rate of return on deposits denominated in other currencies. If domestic interest rates in any particular country are higher than abroad resulting capital inflow props up domestic currency appreciation.

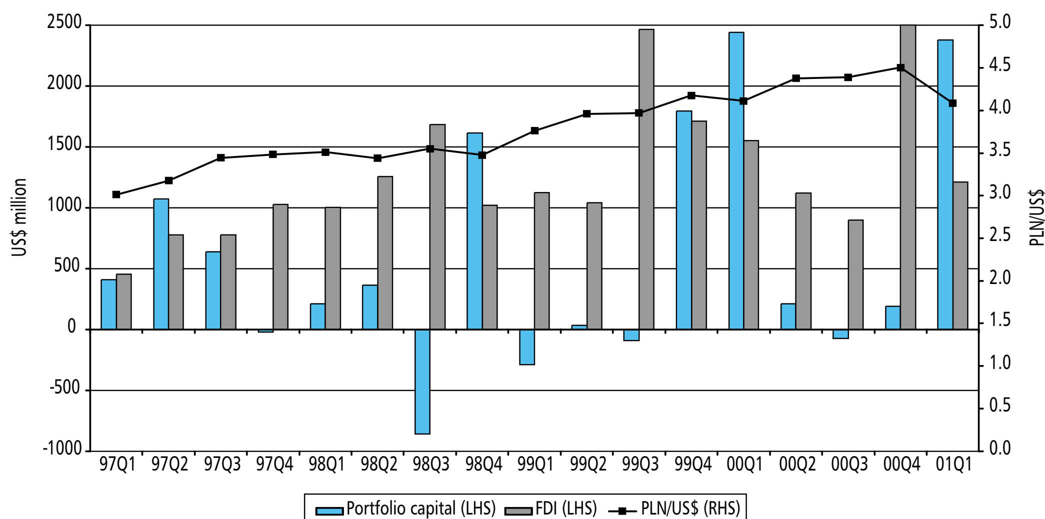
The interest rate parity theory is an adaptation of the law of one price and purchasing power parity (PPP) to financial markets. The law of one price suggests that free trade ensures equal prices for identical goods (as measured in any chosen currency using market exchange rates). This is warranted by international arbitrage, i.e. trade. However, in reality trade arbitrage is complicated due to several limitations – barriers to trade and capital transfers, transaction costs, imperfect and asymmetric information, herding behaviour and differences in perceived risks in different countries.

Table 1. FDI inflows, 1993–1999

	1993	1994	1995	1996	1997	1998	1999
Czech Republic							
FDI (US$ million)	654	878	2568	1435	1286	2734	5093
FDI over financial account balance ratio (%)	21.5	19.5	31.2	34.2	114.6	94.0	203.8
Hungary							
FDI (US$ million)	2350	1144	4519	2274	2167	2037	1951
FDI over financial account balance ratio (%)	38.6	34.0	63.8	-331.1	329.1	67.5	41.8
Poland							
FDI (US$ million)	1715	1875	3659	4498	4908	6365	7270
FDI over financial account balance ratio (%)	73.3	-20.7	39.5	67.4	66.2	47.9	69.5

Source: IMF IFS.

Chart 2. Portfolio capital and FDI inflows to Poland and the zloty exchange rate, 1997–2001



Source: NBP.

Institutional arrangements also need to be taken into account. Liberalisation of capital flows does not apply to all countries. There are differences in the development of financial markets. These factors determine market depths and investment potential and consequently demand for a particular currency. It could well turn out that interest rate arbitrage proves unimportant in shaping an exchange rate due to financial infrastructure limitations. On the other hand, in small financial markets even relatively small portfolio capital flows can exert a strong pressure on an exchange rate. Poland fits these characteristics reasonably well, with its daily turnover on the spot market hovering around US$1 billion, whereas for example in the Czech Republic it amounts to around US$ 5 billion. On the other hand, the importance of the derivatives market has been increasing in Poland with daily turnover rising to around US$5 billion.

Financial operations (around 90% of total turnover), rather than payments related to flows of goods and services in international trade account for most short-term exchange rate volatility. Therefore, short-term exchange rate movements are mostly influenced by current economic and political news and the expectations that stem from them regarding the future development of economy. As these expectations are highly volatile, psychological factors and ensuing speculative transactions strongly influence market behaviour. An build-up of negative or positive news can in the short-run lead to significant and unjustified (from the economic fundamentals point of view) changes in the exchange rate. It should be noted that such volatility in capital flows and exchange rates have some impact on economic fundamentals. Market expectations thus bear some characteristics of the self-fulfilling prophecy. The initial state of an economy never fully determines the range of what is 'sensible' speculation. Therefore even very large swings in exchange rates cannot be precluded.

Occasionally, the effect of a self-fulfilling prophecy can cause a permanent shift in the 'rational volatility band', however this is usually unlikely. For this reason we can present an exchange rate forecast assuming that its level will be determined so as to balance the current account deficit with non-speculative capital inflows. The exercise involves calculating alternative scenarios for capital inflows and respective economic growth rates along with adopting some assumptions about external developments to be able to later work out the exchange rate level consistent with the above equilibrium criteria. Analysis of these scenarios allows the construction of range bands within which the annual average exchange rate will fall with very high probability. We refer to the annual average as due to the specific nature of the forex

market. The exchange rate can occasionally depart from the discussed range for a period of several days or weeks.

Trade balance, real exchange rate and economic growth

As mentioned above, real exchange rates give basis for conclusions on the international competitiveness of domestic production. A precise indicator of competitiveness is provided by the real effective exchange rate. One first calculates a nominal effective rate as a rate against a weighted (by trade shares) average of currencies of major trade partners. The real rate is than computed taking into account price changes (usually the PPI) in the respective countries – the weights again correspond to shares in trade.

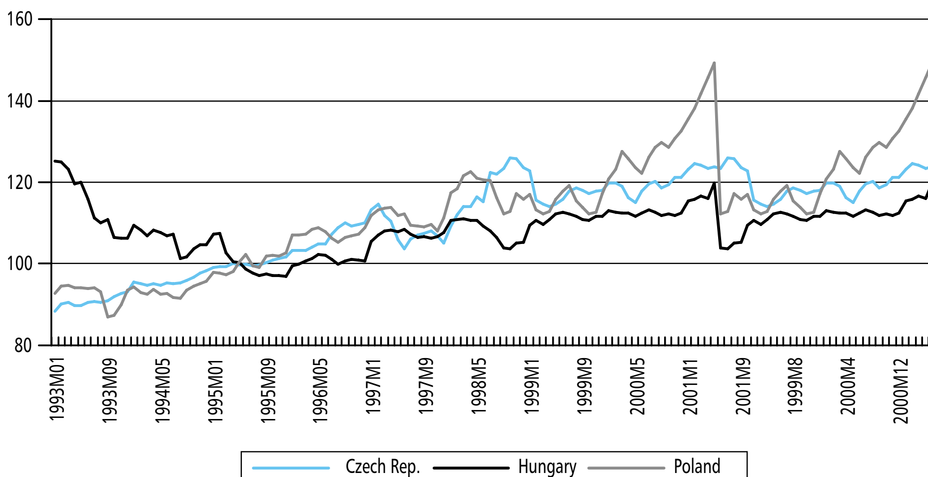
Does the real appreciation that is currently taking place in Poland need to weaken the competitiveness of domestic production? The answer is negative. It turns out that most developing and transition countries are characterised by higher – in comparison to developed countries – labour and capital productivity growth. This results in wage increases and – by the so-called Balassa-Samuelson effect – higher inflation compared to domestic currency depreciation rate augmented with foreign inflation rates.

Thus, the real appreciation of the zloty is not the exception to the general rule. Chart 2 clearly shows that the Hungarian forint and the Czech koruna also followed similar trends, though there are significant differences in the scale of appreciations.

It should be emphasised that real effective appreciation due to the Balassa-Samuelson effect does not diminish a country's competitiveness as it results precisely from enhanced competitiveness due to higher-than-abroad productivity growth. However, real appreciation can also result from capital inflows. In this case some deterioration of competitiveness – especially in the short-term – is possible. This mechanism balances the current account and financial account of the balance of payments. As we have already shown, in the long-term capital inflows bring about a number of positive supply side effects. Therefore, despite widespread views, to the contrary real appreciation does not necessarily result in lower economic growth. In an environment of capital inflows and ensuing real appreciation of the zloty, exports might still be on the rise, although imports are likely to expand even faster. Domestic demand for home production can also increase despite the effect of imports crowding out part of domestic production.

Generally, one could assume that while in the short-term the exchange rate can affect the economic growth

Chart 3. Real effective exchange rate, 1993–2001 (1995=100)



Source: OECD – Main Economic Indicators.

rate by the trade balance channel, in the longer perspective growth prospects are more reliant on factors such as the country's legal system, its level of development, geographical location, etc. This claim is underpinned by the existence of several corrective mechanisms due to co-determinism between the exchange rate and several other macroeconomic variables. For example, should the zloty appreciate very strongly in real terms, it would lead to an export slowdown, a widening of the current account deficit and slower GDP growth. Consequently, foreign investors would start withdrawing capital from Poland, thus exerting a depreciation pressure on the zloty and in the end bring about more vibrant economic growth. Another possible adjustment scenario in this case involves lowering inflation, and thus also interest rates, a fall in capital inflows and the resulting weakening of the currency and the return of faster growth. The analogous scenario could be presented starting from a strong depreciation – improved trade balance and faster growth would then result in higher inflation, tighter monetary policy, and capital inflows thus leading to domestic currency appreciation and moderation of growth.

Currently, in Poland we are observing adjustment to the situation brought about by the interest rates hike. This led to lower growth, thus leading to a short-term improvement in the trade balance. The latter, combined with high interest rates, propelled the zloty's appreciation and slower GDP growth, but also lower inflation. Economic slowdown has already limited capital inflows and helped to push a slight weakening of the zloty. Currently, one can expect gradual lowering of interest rates and a revival of growth. The whole process should be viewed in terms of natural oscillations along the long-term growth path. The nervous reactions of market participants can be blamed for the fact that in some periods the zloty exchange rate was outside the range of 'rational volatility' (autumn 2000, July 2001). However, these incidents did not have a significant impact on real economic processes and should not affect the estimates of the 'consistent with fundamental factors' exchange rate level.

Exchange rate forecast – different scenarios

Below we present exchange rate forecasts based on alternative assumptions concerning mid-term economic growth prospects and non-speculative capital inflows.

In the slow-growth scenario (which is possible due to the existence of structural and supply-side rigidities) the zloty is expected to depreciate faster than in the baseline scenario. This stems from the assumption that sluggish growth would reduce FDI inflows as well as portfolio capital inflows. The latter would be impaired by higher macroeconomic risk, despite the relatively higher borrowing requirements of the budget. The economic slowdown would also result in bearish prospects for the stock exchange and lower interest in share capital investments.

In the fast growth scenario the general tendencies would go in the opposite direction. Nominal depreciation would be much weaker. Better macroeconomic prospects would reduce risk, prompting investment in both stocks and debt securities. FDI inflows would also soar, ensuring a 'healthy' structure of current account deficit financing.

It should be noted that none of the presented scenarios envisage any dramatic changes in the zloty exchange rate. In our opinion, the existing exchange rate regime does not generate a risk of a serious macroeconomic instability. However, we also think that a unilateral euroisation or adopting a currency board system would further diminish this risk at the same time allow

Table 2. Zloty exchange rate scenarios, 2001–2004

	Baseline scenario			'Slow growth' scenario			'Fast growth' scenario		
	GDP	PLN/US$	PLN/Euro	GDP	PLN/US$	PLN/Euro	GDP	PLN/US$	PLN/Euro
2001	2.4	4.14	3.73	2.2	4.40	3.96	2.6	4.12	3.71
2002	3.9	4.41	4.32	2.9	4.72	4.62	4.9	4.27	4.19
2003	4.9	4.48	4.62	3.9	5.18	5.34	5.9	4.32	4.45
2004	4.7	4.58	5.05	3.7	5.28	5.81	5.7	4.41	4.85

Source: CASE.
Note: Annual averages.

for faster growth and lower inflation (discussion of this proposition goes beyond the scope of this paper). As indicated, none of the possible exchange rate systems can fully eliminate the risk of extreme volatility in capital flows and the transmission of forex markets volatility to the whole economy. However, any measures preventing rapid capital outflows can only to a very limited extent be supported by an exchange rate policy. It should therefore not be a sole field of interest in thinking about the future of the zloty. The goal of minimising risk requires all instruments of macroeconomic policy to be focused on domestic stabilisation - lowering inflation and enforcing fiscal discipline. At the microeconomic level the policies should aim to enhance economic effectiveness. In our forecasts we assume that implemented policies would not diverge significantly from these schemes. If this does not hold true, all scenarios of our forecast will prove overly optimistic.

The economy in 2Q01

Katarzyna Piętka

Economic growth

GDP and demand factors

- **Economic Growth close to zero**
- **Stagnation of all growth elements**

After stabilising in 1Q01 close to the level reached in 4Q00, growth slowed further in 2Q01. According to our estimates, growth barely reached 0.5%. This reflects stagnation of all the key growth factors. We estimate that household consumption dropped below the level registered in the same period last year. The factors behind the slow growth are weak wage and salary growth, and the equally low growth of mixed incomes. The increase in monetary savings was less than in the same period last year. This was also the case with non-monetary savings (including stock exchange deposits). However, the fall in the propensity to save did not compensate for the drop in real incomes.

Since cuts in government expenditures have been ongoing, we do not expect growth in government consumption. We estimate that fixed investment dropped for the first time in several years. Ongoing declines in construction output, along with a decrease in apartment floor space, reflect further declines in building investment. Decreasing sales of transportation products, as well as of imports of machinery and transportation equipment, also suggest declines in other kinds of investments. In addition, signs of a worsening financial situation for exporters, along with a drop in industrial production, suggest a deterioration in the profitability of enterprises – hence smaller funds for investment. Resources from the banking sector were also limited – the increase in corporate credits was only slightly higher than the increase in enterprises' deposits.

We estimate that after the deep fall in inventories in 1Q01 their accumulation slightly increased. As a result, drops in overall investments were shallower than drops in fixed asset investments.

Weaker conditions in the economies of our trading partners weakened exports. However, the increase in imports – depressed by stagnating internal demand – was even smaller. The gap between the two, however, fell against the previous quarter – though net exports still provided a positive contribution to GDP growth.

It is worth noting that, according to recent GDP revisions for 2000, the real GDP growth fell from 4.1% to 4.0%. The revisions concerned only the first three quarters of 2000. Furthermore, the estimate of nominal GDP was also lowered. Particularly surprising are real growth of exports and imports.

Question marks surround the estimates for the 1Q01 figures – particularly the real increase of net taxes in value added based GDP. In nominal terms they

dropped 1.8%, though in real terms increased by 3.6%. Moreover, in expenditure based GDP, we question the significant drop in changes in inventories (-216%). These facts may suggest that the estimates for 1Q01 will be revised, and in our opinion downwards rather than upwards.

The real sector

- **Decline in industrial production**
- **Deepening of the recession in construction**
- **Small growth in other sectors**

Stagnation of domestic demand and a slowdown of exports in 2Q01 caused annual industrial production to drop for the first time since the Russian crisis. According to our estimates, the value added in industry dropped as well. After an increase in industrial production in April, drops in the next months accelerated. The biggest was registered in the mining sector, with a slightly smaller increase in manufacturing. On the other hand, the energy sector registered significant growth. Within manufacturing, the biggest drops was seen in branches that have been struggling over a long period due to high excise rates and a slowdown in domestic demand (tobacco, transportation, metal, machinery and equipment, wood and leather industries).

The construction industry experienced further declines in building as well as installations. We attribute these drops to decreases in investment demand and demand for apartments.

In the services sector, consumer services (trade, transport and telecommunication and hotels) did far worse than corporate services (real estate, renting and business activities and financial services). Value added in transport and communication did not change. This is reflected by a smaller increase in new telephone connections line, drops in transportation of goods and numbers of passengers, as well as a real drop in the wage bill in these branches. Based on turnover in retail and wholesale, as well as real drops in wage bills in the trade sector, we estimate that trade registered a small drop in value added. Growth of the wage bill in other branches allows us to estimate a much faster growth of their value added than in trade. Overall, we estimate value-added growth in the market services sector at 2%.

Value added in agriculture grew only slightly. The quality of the winter sowing is good and there was no spring freezing (which caused considerable damaged last year). This allows us to expect growth in plant production. The reduction in breeding stock, however, reflects drops in animal production.

External sector

Rafał Antczak

Exchange rate

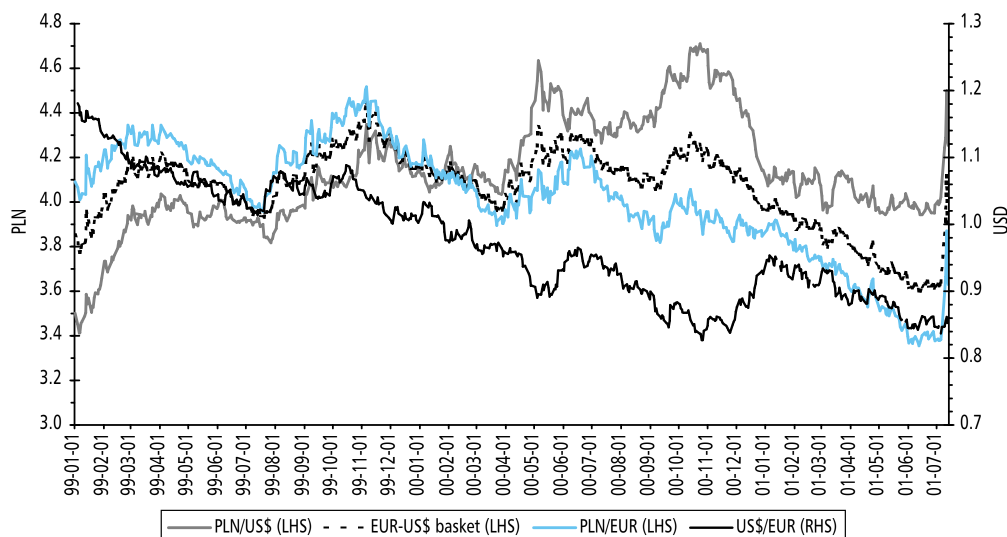
- **Weakening of the zloty – finally**
- **Calm in forex market has returned**

In 2Q01 the zloty's nominal appreciation continued. From March to June the zloty's monthly average exchange rate increased by 2.2% against the dollar and 8.3% against the euro. Such strong appreciation against the euro was mainly the result of the euro's weakening against the dollar (6.1% in 2Q01). In 1H01 the zloty appreciated in nominal terms by 7.9% against the dollar, 12.7% against the euro, and 10.6% against the currency basket (60% of the euro and 40% of the dollar).

The strong appreciation of the zloty resulted from the foreign currency operations of banks in Poland and the sale of the German marks to pay for compensation transfers for Nazi-era slave labourers (DM1.3 billion in June out of the a planned total of DM1.8 billion). From October 2000 to April 2001 Polish banks' currency deposits abroad increased (capital outflow from Poland). In May and June 2001 banks began to retransfer their foreign currency deposits back to Poland. However, the share of foreign investors' participation in tenders on Treasury papers – oscillating at around 10% of the total sale (10.2%% in April, 12.9% in May, and 8.4% in June) – was too little to roll over the previous investments – consequently 2Q01 saw a net capital outflow.

During the mid-year point the zloty nominally appreciated, though since the start of July it has seen a correction following the Ministry of Finance's announce-

Chart 2.1. Dollar, euro and the currency basket exchange rates against the zloty, 1999–2001



Sources: NBP.
Note: The currency basket: the euro (60%) and the US dollar (40%).

ment that an increase in the budget deficit of about 17 billion zloty is unavoidable and growing uncertainty over further government actions in the sphere of public finance. Between end-June and July 11, the zloty depreciated by almost 13% against the dollar, reaching its lowest point, of 4.5004 PLN/USD, since the end of November 2000. As well as domestic factors, the financial turmoil in Argentina in July also had an impact on exchange rate developments in Poland, though the dollar-euro exchange rate was a neutral factor (on July 11, the euro cost 0.8614 to the dollar, i.e. close to the level of 0.8474 at the end of June).

Between July 11–14, the zloty strengthened and stabilised at around 4.2 PLN/USD. Developments on the forex market in mid-July 2001 were similar to those at the beginning of May 2000. In both cases, the zloty's weakening was triggered by news on worsening deficits – in May it was the current account deficit, in July the fiscal deficit. In both cases, this was accompanied by some turmoil in international financial markets and comments from senior Polish politicians on "economic crisis". Such comments impact on the forex market in second and third generation currency crises and in fact can lead to crises through self-fulfilling prophecy. The fact that the situation stabilised indicates that restrictive monetary policy worked well in maintaining the strong credibility of Poland's monetary authorities.

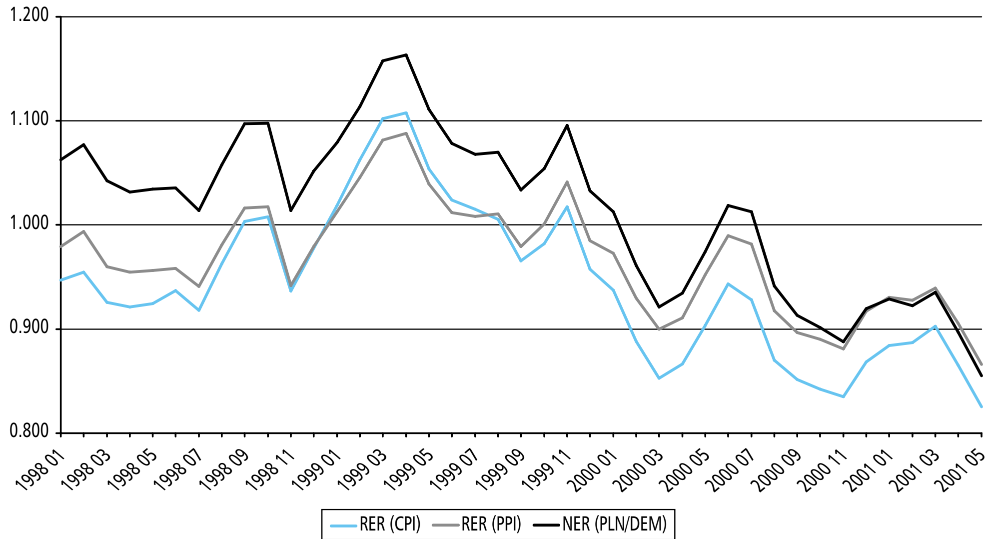
Łukasz Rawdanowicz

Foreign trade

- **Improvement in terms of trade alleviated consequences of zloty appreciation**
- **Exports still on the fast track**

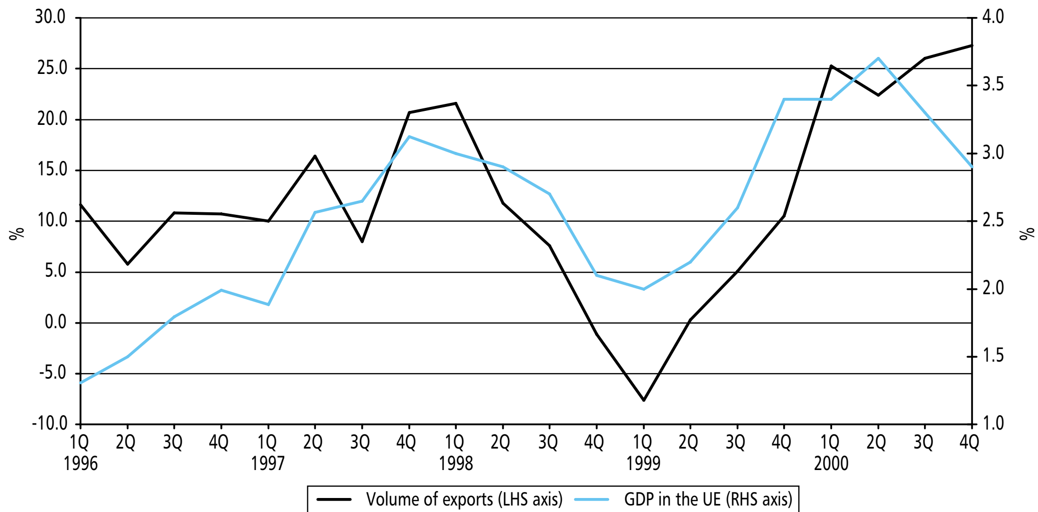
Exports remain an engine of economic growth in Poland. According to preliminary NBP estimates, exports in the balance of payments amounted to US$7.59 billion in 2Q01, i.e., 11.1% higher than in the same period of last year. Throughout 1H01, exports performed well despite strong zloty appreciation and deteriorating economic conditions in the EU. It would appear that the exchange rate was not that significant a factor. Manufacturers accommodated the exchange rate shock to a large extent via a reduction in labour costs, achieved primarily at the cost of higher unemployment and lower growth in wages and salaries. In addition, since the beginning of this year, growth in

Chart 2.2. German mark exchange rate against the zloty, 1998–2001



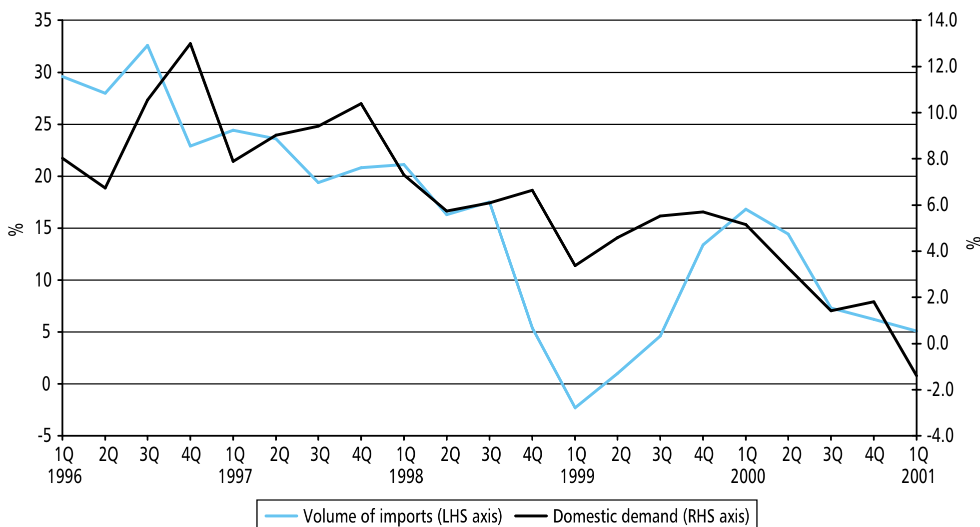
Notes: 1. Corresponding period of previous year = 1
2. RER (CPI) – real exchange rate deflated with CPI for Poland and HICP for the euro zone.
3. RER (PPI) – real exchange rate deflated with PPI.
4. NER – nominal exchange rate.

Chart 2.3. Volume of exports and GDP in the UE, 1996–2000 (% change, yoy)



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

Chart 2.4. Volume of imports and domestic demand, 1996–2000 (% change, yoy)



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

the PPI in the euro zone was higher than in the Polish PPI. Hence, real appreciation of the zloty against the euro calculated on the basis of PPI was not as strong as the nominal appreciation. Even if producer prices in the euro zone have been driven largely by energy prices, other commodities prices have been on the rise as well. Thus, Polish exporters were able to increase their euro denominated prices and in turn alleviate appreciation consequences. GUS data confirm such a hypothesis. Export prices (zloty denominated) actually increased in 1Q01 by 0.7% yoy and at the same time nominal appreciation of the zloty against the euro amounted to 14.6% yoy and against the dollar 8.9% respectively. Also the commodity structure of Polish exports seems to be consistent with this scenario. Poland exports many low value-added and raw commodities, i.e. goods whose prices in the EU increased most significantly.

The exchange rate factor proved more significant for imports. The strong zloty fuelled robust import demand – especially for consumer goods in 2Q01. The NBP estimates imports at US$10.32 billion in 2Q01. This would appear to be quite a large number (1H01 saw an increase in imports of 4.4% yoy) given weak domestic demand, in particular on the side of households. Regardless of the decline in industrial production, imports also grew in 2Q01 – raw commodities and fuels make up roughly 45% of total imports. This suggests that cheaper imports successfully competed with domestic output.

1Q01 saw an improvement in the terms of trade. For the first time in 12 months export prices increased, though by a mere 0.7% yoy. On the other hand, import prices dropped by 0.9% yoy. This situation stems from strong nominal appreciation of the zloty. This, coupled with low fuel prices, drags the prices of imported goods (denominated in zlotys) down. A similar terms-of-trade figure should be expected in 2Q01.

Łukasz Rawdanowicz

Balance of payments

- **The current account deficit – flat**
- **Unexpected deterioration in the income balance**
- **Outflow of portfolio capital**

In 2Q01 the merchandise trade deficit of the balance of payments stood at US$3.74 billion, an

improvement both on 2Q00 and the previous quarter. The improvement turned out to be so strong that it offset the unexpected slump in the income balance. The income deficit reached a record high of US$626 million. The simultaneous shift in interest payments on foreign debt (from March to April) and payments abroad of dividends of US$284 million that took place in June were the main factors behind such a significant deterioration. The annual current account deficit (the sum over the last four quarters) stood at 5.23% of annualised GDP – the best results for two years. The more balanced external equilibrium is a corollary of the slowdown of domestic demand. Low economic activity dampens import growth as well as boosts exports via the "crowding-out" effect.

News on the capital and financial accounts centred on the outflow of portfolio capital. Foreign investors have been withdrawing primarily from the government debt securities market. This is very interesting in the light of the zloty appreciation. These outflows were offset by FDI inflows and the return of Polish banks' capital that had been deposited abroad. Thus, even high interest rates were not capable of improving the mood of foreign investors.

At the end of 2Q01, official reserve assets amounted to US$27.1 billion – lower by US$890 million compared to the end of March, though still enough to cover payments of 7-month average imports.

Małgorzata Markiewicz

Public finances

- **Adjusted results for 2000**
- **Amendments to the budget law expected**

In 2Q01 the Ministry of Finance announced corrected public sector results for 2000. The economic deficit was 2% of GDP, instead of a preliminary estimation of 2.7% of GDP. The lower deficit was down mainly to the better financial results of ZUS. The tax collection rate was higher than expected (98 instead 96.9%) and ZUS was able to pay back most of its credits to commercial banks. Therefore, the deficit of extra-budgetary funds was 600 million zlotys, as opposed to the estimated 3.7 billion zlotys. Hence, the financial results of local governments were better than expected: the deficit was 3.1 billion zlotys, instead of 3.3 billion zlotys and the financial results of regional health funds were surprisingly good: they recorded a surplus to the tune of 700 million zlotys, instead of the expected 900-million zloty deficit. The revised data suggest that fiscal adjustment took place last year and that the budget law for 2001 was based on mistaken assumptions concerning the financial results of different segments of the consolidated public sector in 2000.

When looking at the financial results of the public sector, one should pay attention to the financial results of the independent public health sector entities. In 2000 their outstanding liabilities were as high as 3.8 billion zlotys, with the majority coming from hospitals' debts. These debts have been continuously growing and in mid-2001 stood at 5–6 billion zlotys. Hidden budgetary imbalances are growing over the whole of the health sector despite the cash surplus that was recorded in regional health funds in 2000.

In 2001, despite the government's earlier declarations, fiscal policy has been eased. The macroeconomic assumptions included in the 2001 budget law were unrealistic, especially concerning GDP growth. As a result, in the middle of the year the budget law had to be revised. In the face of decline in revenues, the government – with the approval of parliament – decided to increase the deficit without any changes on the expenditure side. However, on the basis of fiscal projections it seems clear that expenditure cuts will be unavoidable at the end of the year. This means that the amended budget will not be realised. Parliament knows about this even as it votes on the budget amendment. This kind of policy should be strongly criticised as it undermines the credibility of macroeconomic policy.

In 2Q01, budget revenue collection remained low. Despite the pessimism of our last outlook, tax revenues in 2Q01 turned out even lower (by 1.2 billion zlotys) than our forecast. This stemmed mainly from the drop in CIT revenues – reflecting shrinking domestic demand and low profitability of enterprises. In 2001 the nominal CIT and indirect tax revenues were lower than in 1H00. With regard to PIT revenues, they

were higher than expected even after taking into account seasonal factors. It is likely that PIT tax repayments were shifted to 3Q01.

The state budget deficit reached 91.1% of its planned annual amount in 1H01.The improvement in the fiscal balance observed in June were due to the transfer of NBP profits from the previous year and the inflow of the second tranche of UMTS licence payments.

Low budget revenues were not reflected on the expenditure side of the budget. Expenditures 47.6% realised. This means that there were almost no cuts in spite of the sharp reduction in the tax collection rate. In 1H01, subsidies to local governments were higher than planned. Subsidies to the Labour Fund grew the fastest (82.4% of their planned annual amount) due to an increase in the unemployment rate.

Social Insurance Board (ZUS)

Despite the difficult macroeconomic environment, the financial stance of ZUS has improved. The payroll tax collection rate rose and there was no reason to increase liabilities except for short time liquidity management purposes. However, the difficult situation of the state budget was reflected in the amount of funds transferred from the budget to ZUS. In 1Q01, the amount transferred was equal to 25% of the annual plan, whereas in 2Q01 it was only 14%. This reduction in subsidies moved also to the second pillar of the pension system, as the amount of money transferred to the second pillar from ZUS decreased. In June it was only 620 million zlotys – the lowest amount since the beginning of the year. This indicates that problems of the state budget are being shifted to the pension funds.

The state budget deficit was financed mainly from domestic sources. Privatisation proceeds remained negligible (1.9 billion out of 18 billion zlotys assumed for the year as a whole). There is concern that progress on the structural front in privatisation will not be satisfactory and will lead to a drop in funds available to the government. The higher risk concerns the privatisation of PZU, a failure to sell would mean a drop in privatisation proceeds of about 5 billion zlotys. The privatisation of the following entities is also in doubt: TP SA (about 10 billion zlotys of planned inflows), PKO BP (1–2 billion) and PKN Orlen (2 billion).

Piotr Bujak

Labour market

Unemployment

- **Seasonal drop in unemployment**
- **Further reduction in employment**
- **Decline in growth of real wages and salaries**

In 2Q01, the negative trends on the labour market observed in previous quarters were maintained. Unemployment was higher and employment lower than in the corresponding period of last year. Wages and salaries declined in real terms. This stemmed from the further slowdown in economic growth in 2Q01 and signals that companies are pessimistic on future demand and their financial stance.

In June, the official unemployment rate stood at 15.8% in comparison with 15.9% in March. This fall, resulting exclusively from seasonal factors was, however, weaker than in preceding years. The rate of unemployment at the end of 2Q01 was 2.2 percentage points higher as compared to the analogous period of last year. The number of unemployed also increased in annual terms (about 411,6 thousand) and stood at 2,849 thousand in June. Developments on the labour market reflect lower business activity in 2Q01. In the face of higher unemployment and subdued growth in real wages and salaries, no significant revival in household consumption should be expected in the coming months.

A much grimmer picture is painted by Labour Force Survey data (BAEL) in 1Q01. The number of unemployed (according to the definition of the International Labour Organisation) increased qoq by about 398 thousand to stand at 3,158 thousand. The increase in the number of unemployed in the first months of the year has also been observed in previous years, though the hike was never as high – by 278 thousand – as in

1Q00. Unemployment mounted across the workforce. In March, the BAEL unemployment rate reached an all time high of 18.2%, which translates into an increase of 1,5 percentage points over a one-year period. Long-term unemployment, which comprises over 40% of the total, was also on the rise on an annual basis.

The regional variations in the unemployment rate remain stark. The highest unemployment rates persist in the following voivodships: Warmińsko-Mazurskie (26%), Lubuskie (24.1 %), Dolnosląskie (23.6%), and Zachodniopomorskie (22.8%), with the lowest rates in: Małopolskie (13.5 %), Mazowieckie (13.7%), and Lubelskie (15%).

The situation for young people on the labour market is increasingly dramatic. Unemployment among 15–24 year olds grew over the year most rapidly, hitting a high of 41.2%. More difficult still is the situation for people with basic education and without vocational education. However, those with higher education are also in a tough situation. Unemployment in this group was 5.5%. Among graduates roughly one fifth are out of work.

Most unemployed are those who lost a job and immediately made efforts to find a new one. Their share of all unemployed has been on the rise for several quarters. This indicates that – apart from demographic factors – the main cause of rising unemployment is enterprise restructuring. As we mentioned in the previous issue of PEO, restructuring is taking place mainly in the private sector this year. Unemployed in this sector comprise 72.1% (last year it was 67.3%). In particular layoffs in market services have been significant.

Employment

GUS data indicate that since March the downward trend in employment in the enterprise sector has been maintained. In June, employment fell by 3.3% yoy and for 2Q01 by 3% yoy. This means that after some slowdown in the rate of decline in employment in 1Q01 it reaccelerated and in June was even higher than a year ago.

1Q01 saw a further decline in labour demand, reflected in BAEL data. The working population was lower both in comparison to 4Q00 and 1Q00. As a result the participation rate dropped both on an annual and quarterly basis. In 1Q01, those in work comprised only 46% of the total population of working age (15-year olds and above). A fall in the average working week and in the number of people with more than one job also indicates that labour demand is waning.

Wages

In June average wages and salaries in the enterprise sector grew only 4.9% yoy in nominal terms, but declined 1.3% in real terms. On average, 2Q01 marked a fall in wages and salaries by 0.4%. This, coupled with the decline in employment in the enterprise sector, resulted in a fall in the wage bill in real terms.

2Q01 saw some acceleration of social benefits growth, attributable mainly to compensation for higher inflation last year.

Mariusz Jarmużek

Prices

- **Weak economic activity and the strong zloty facilitated continued disinflation**

In 2Q01, inflation – both the CPI and PPI – continued to fall. The downward trend resulted from continued appreciation of the zloty and restrictive monetary policy. The zloty appreciated by 4.5% qoq against the basket made up of the US dollar (40%) and the euro (60%). This contributed to some substitution of domestically produced goods with imported goods. According to our estimates, domestic demand dropped by 0.5% yoy in 2Q01 while retail sales and real wages also dipped. Substantial growth of food prices during last two quarters induced the substitution effect, manifesting itself in a reduction of household expenditures on non-food products and services not related to housing. This supported the downward trend of non-food prices and other services' prices.

Favourable developments on the supply-side also contributed positively to the disinflation process. Since crude oil prices have stabilised on world markets and the zloty strengthened against the basket, the prices of fuel on the domestic market declined. The strong zloty and the introduction of import quota increased supply of cereal, whereas a fall in livestock limited a demand for cereal – over 50% of cereal crops are used to feed livestock. This resulted in a drop in cereal prices. Procurement prices of livestock rose insignificantly, as demand from CIS countries remained weak. However, considerable seasonal growth in fruit took place in April and May. This influenced the general level of food prices, which was slightly higher than last year.

The PPI also experienced a substantial decline. This stemmed from appreciation of the domestic currency and a decline in domestic demand. Prices in the manufacturing sector grew by 0.4% yoy, indicating significant problems with sales.

Katarzyna Zawalińska

Agricultural commodity prices

According to CSO latest estimates, the total crops sowing area this year is about 1.8% smaller than 2000, though sowing conditions have been far better than a year before, even by the average standards of 1991–1995. At the beginning of June, the forecast for this year's harvest was very optimistic and prices were expected to wane in 2H01. However, during the last week of July floods wreaked havoc. It is still too early to estimate the consequences for the harvest especially as the flood alert is still on. This situation puts question marks over the expected seasonal fall in crop prices. The hitherto trend may even reverse.

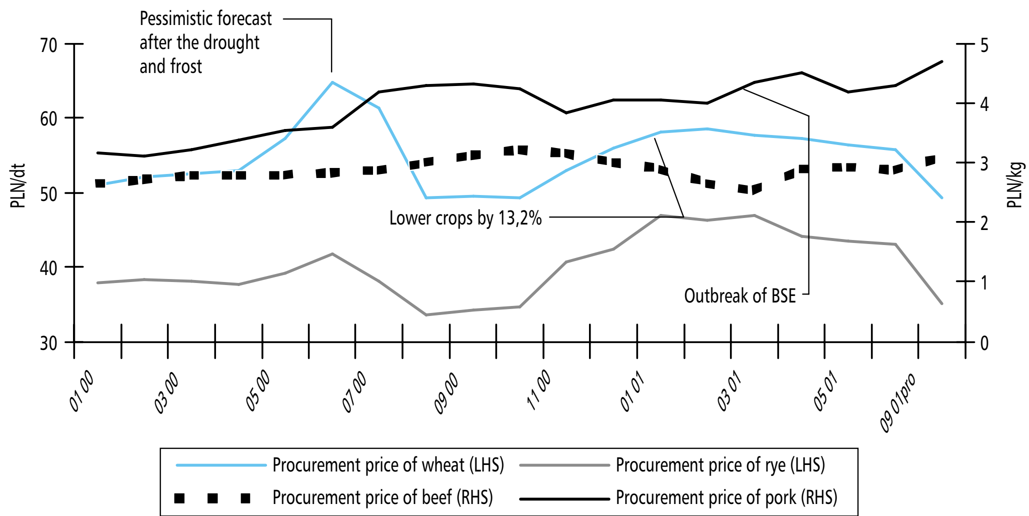
Imports of crops and crop products during the season July 2000/June 2001, were 70% yoy higher, reaching a level of 2,376 thousand tonnes. This caused a significant build-up in stocks. Imports of crops during this season are traditionally dominated by wheat (32% of total imports), rye (18%), barley (12%) and corn (18%). Imports of rye, barley and corn were realised under a ceiling scheme. At the beginning of 2Q01 imports of wheat were low despite the tariff-free quota scheme. In June, the imports of wheat increased significantly. The price of imported wheat was up to 6% lower than the price of domestic procurement.

Generally, turnover at domestic commodity exchanges during the last few months was much smaller than usual at this time of the year. This could be attributed, on the one hand, to the high level of crop stocks and, on the other hand, to the high level of crop imports.

Increased supply in the crop market, together with abundant stocks, exerted pressure on domestic prices. Since February, intervention wheat prices have been on a decline of about 1–2% per month. Nevertheless, until April prices were higher on average than during the same months of the previous year. Similar price patterns were seen in the case of rye – its prices have also experienced a fall since the beginning of 2Q01. However, rye prices dropped (by 2.1% from April to June) less than wheat prices (2.6%). Due to the floods, we expect a setback in downward price pressures in next quarter, even despite the seasonal downward pressure characteristic for the harvest time. Wheat prices in September should be about 12% lower and rye prices about 19% lower than the prices of corresponding crops in June (see Chart 2.5).

Because of the low supply of swine (3.5% yoy lower), which resulted from the low profitability of swine production, intervention (as well as market) prices since the beginning of the year have generally been higher than the year before. Increased demand contributed to this price development as well, through the substitution effect of beef with pork. The increase in pork prices, together with the simultaneous fall in crop prices, if continued, should improve profitability of pork production and consequently cause an increase in pork supply. However, according to the Agricultural Markets Agency (ARR), overall production of swine in 2001 will be 8% lower than a year ago. Pork prices after the seasonal-holiday induced increase in April decreased and stabilised in 2Q01. Beef prices have been on the decline since the beginning of 1Q01 on the back of weak demand due to BSE. April saw a significant increase and prices stood

Chart 2.5. Prices of main agricultural commodities, 2000–2001



Source: Based on CSO and ARR (Agricultural Markets Agency).

close to their last-year levels. The price changes were determined by interventions by the ARR – in March 46% more beef was bought than at the same time last year.

Between January and May the red meat trade was significantly limited both on the import and export sides. Poland imported 80% less beef and 55% less pork, mainly due to the threat of livestock diseases. At the same time, exports of meat decreased almost by a half because of the Russian ban on imported meat from the CEECs. Only trade of poultry increased during this time – imports increased by half compared to last year. Since mid-May, after Russia removed the ban on meat imports, Polish meat and meat products trade significantly increased.

Based on the forecasts of independent experts, meat prices are expected to continue their upward trend. In September, pork prices may be about 9.6% higher and beef prices about 8% higher than in June (see Chart 2.5).

Prices at world commodities markets behaved differently. After a four-month decrease in wheat prices, the trend reversed in May. Wheat prices increased on the USA and Argentinean markets and then also on the German market. Generally, world wheat prices are on average higher this year than last. This resulted partly from a pessimistic forecast from the United States Department of Agriculture (USDA) and the Food and Agriculture Organisation (FAO) for wheat production this year, which they predicted would be lower by 1.6% yoy and well below the average for the past five years. Tightening of overall cereal supply, together with falling stocks (for the third year in a row), would put further upward pressure on wheat prices on world markets.

World meat prices, after a significant increase in 1Q01 (due to tightened supply caused by BSE and foot-and-mouth disease) decreased – mainly in the European and American markets. Thanks to the favourable relation of feed prices and meat prices, a 1.5% increase is expected in meat production in 2001. However, this increase would be the lowest in the last five years. The FAO estimates a general decrease in meat prices (measured by the world price index) in 2001 as compared to last year. However, the world price index of beef prices is expected to increase by 1.3%, while the world price index of pork is expected to decrease by 6% this year compared to last year.

Przemysław Woźniak

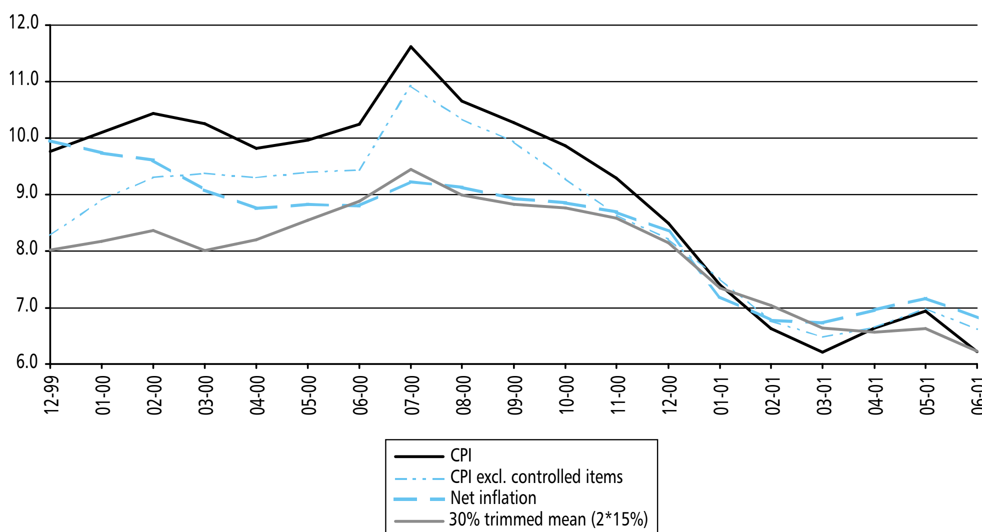
Core inflation

After several months of uninterrupted decline, in 2Q01 all core inflation indices were hovering in the range of 6–7%, hitting a local maximum in May. The core inflation index calculated excluding administratively controlled prices reached 6.62% and slightly exceeded the CPI (6.22%). This index has exceeded headline inflation since the beginning of the year, pointing to the diminishing pro-inflationary role of administrative price increases.

Goods and services excluded from this measure of core inflation include: alcohol, tobacco, fuels, pharmaceuticals, the majority of municipal and telecommunication services. Substantial increases (on a 12-month basis at the end of June) were registered in just a few non-free market prices: central government services (91%), monthly fees for telephone users (75%), cold water supply (15%) and gas (13%). Most of them grew at a pace slightly exceeding headline inflation (pharmaceuticals 9.4%, hot water supply 9.3%, electricity 8.9%) while some registered significant price falls (fuels -12.2%, telephone installation fee -34.8 %). It is noteworthy that administratively controlled prices – which used to be an important factor shaping short-run inflation – do not play such a role at present. On average, their price changes do not differ from those of the rest of the CPI.

Net inflation excludes from the CPI two important elements: food and fuels prices that together account for more than 30% of expenditures of an average household. This core inflation measure has been above the CPI since the beginning of 2001, which indicates that food and fuel exhibited higher price dynamics than headline inflation. This situation is due to a number of factors. First, fuel prices on the world markets

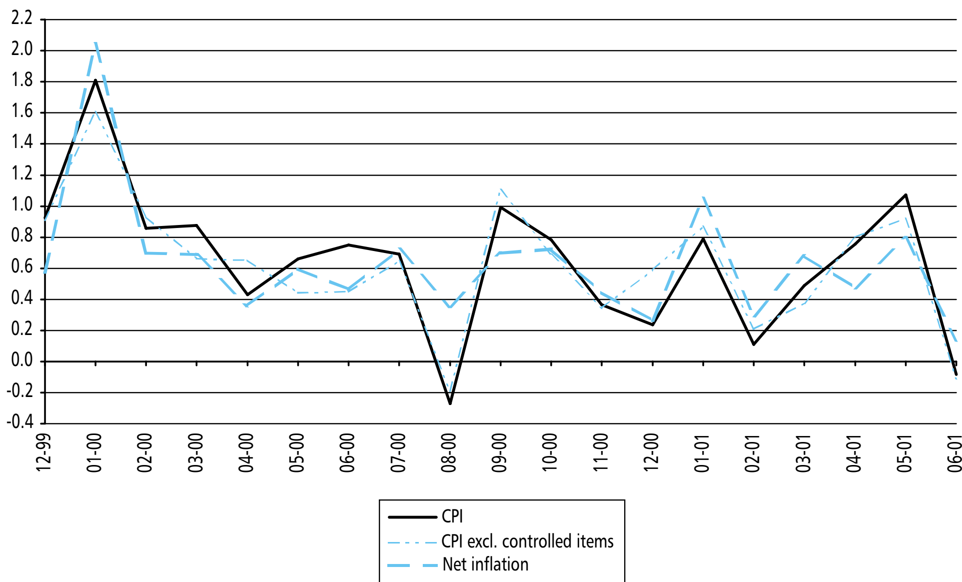
Chart 2.6. Core inflation 1999–2001 (% changes, yoy)



Source: CSO, NBP, and CASE.

*) The analysis in this section is based on the dynamics of core inflation calculated according to the methodology used by NBP. In this issue we also introduce a selected monthly core inflation series. This will allow for a more profound examination of prices in key sectors of the economy due to the elimination of the so-called "base effect" inherent in yoy indices and responsible for distorting inflation signals. Mom and yoy inflation indices belong to the group of indicators that are very closely monitored by the RPP. Examining their dynamics can be very helpful in predicting the degree of restrictiveness of monetary policy decided upon by the RPP during its monthly meetings.

Chart 2.7. Core inflation 1999–2001 (% changes, mom)



Source: CSO, NBP, and CASE.

have stabilised, which, combined with the appreciating zloty (at least until the end of June), yielded a significant drop in the retail price of gasoline.

Second, the agricultural commodities market did not register any negative supply shocks as was the case a year ago. Hence last year's upward inflation impulse triggered by flour and sugar price jumps is no longer felt and the price dynamics of these and other related foodstuffs (bread and cereals) declined several times in the course of the past 12 months and currently does not deviate from the dynamics of the CPI. Moreover, the market for foodstuffs has seen a continued price decline of butter and coffee in recent months and remarkably large supply of fruit and vegetable that has kept prices low. All these phenomena ensure that food prices will be falling in the summer months and consequently net inflation will exceed headline inflation for the next couple of months.

The trimmed mean excludes those goods and services whose registered prices changes in a given month were extremely low or high regardless of the CPI category they belong to. This procedure reflects the notion that extreme price changes are unrepresentative of the "core" price movements. The NBP computes a 30-% trimmed mean discarding the 15% lowest as well as the 15% highest price changes. The dynamics of the trimmed mean has been decreasing consistently since August 2000 (with a slight rebound in May 2001). It is clear from Chart 2.6 that the trimmed mean performs better than any other core inflation index in smoothing out short-term headline inflation deviations.

Currently, the trimmed mean is below headline inflation but the difference is rather negligible and may reverse itself anytime soon. Summer months are usually marked by substantial price declines in the fruit and vegetables component and this year will be no exception. Furthermore, these declines will no doubt be accompanied by decreasing dynamics in several other foodstuffs (butter, sugar) and fuels. Consequently, symmetric trimmings involved in the calculation of the NBP's trimmed mean will eliminate significant decreases to a much larger extent than increases and as a result will yield a measure that will be higher than the CPI.

Rafał Antczak

Monetary policy

- **Not only fiscal but also monetary loosening**
- **Money demand still high**

At the end of June, the Monetary Policy Council (RPP) decided to cut the NBP's reference interest rates by 150 basic points irrespective of the increase in the budget deficit to over 4% of GDP. Until mid-year interest rate cuts totalled 350 basis points. Over the same period the annual CPI rate decreased by 230 basis points. This indicates a loosening of monetary policy in 2Q01. However, transaction and thesaurization demand on money has been increasing, and inflation, both core and underlining, has been on the decline.

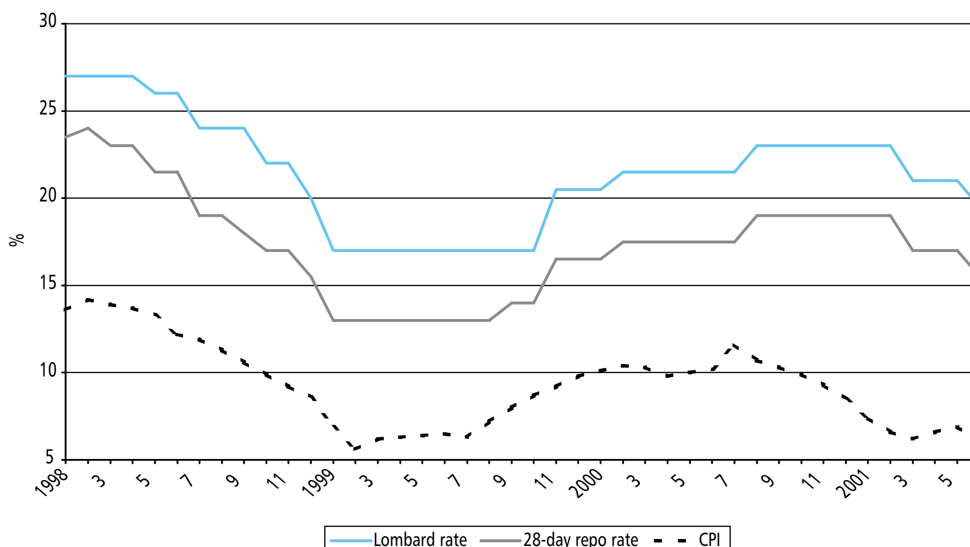
In 2Q01, the supply of reserve money remained lower than at the end of 2000. Both foreign and domestic components contributed negatively to money supply. Net foreign assets declined as a result of nominal appreciation of the zloty, whereas net domestic assets decreased due to the shrinking of public finance debt.

Since February 2001, there has been a gradual growth in the supply of NBP bills in open market operations (from 15.8 billion zlotys in March to 18 billion zlotys in May, and 22.3 billion zlotys in June) as a result of an increase in liquidity of the banking sector. The reasons for the growing liquidity are the increase in net credit in the budget and the transfer of NBP profits to the budget. The total value of NBP bills in circulation increased by 7.5 billion zlotys (from 19.5 billion zlotys in January to over 27 billion zlotys in June). Due to weak demand on Treasury papers, the NBP may be unable to reach the operational target of removing over-liquidity from the banking sector for a second year in a row.

The banking system and broad money

An increase in the M2 aggregate came from a rise in credits to the private sector. The positive contribution of 'other net items' to broad money supply resulted from a transfer of NBP profits (5 billion zlotys) to the budget. Until mid-2001, the growth in M2 supply

Chart 2.8. Monetary policy instruments, 1998–2001



Source: NBP.

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	-4.46	-5.93	-6.69	0.76	9.45
	2Q	-0.48	-14.83	-5.28	-4.85	-0.43	19.71

Source: The NBP Bulletin and authors' calculations.

Note: 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 the broad money supply, 1998–2001 (cumulative % change)

		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	2.22	0.44	-0.26	-1.82	1.57	2.03
	2Q	4.46	-1.97	2.01	-0.49	2.50	4.42

Source: The NBP Bulletin and authors' calculations.

Note: 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.

was the lowest since the beginning of the transformation in 1989 and amounted to 4.5% yoy.

The decline of zloty claims on enterprises coupled with an increase in zloty claims on individuals had the main impact on broad money supply. There was strong growth of money in circulation together with deposits of physical and legal persons in foreign currencies. The latter stemmed from rational expectations of a zloty depreciation. An increase in demand on cash money in June is typical (holiday season), but it might also be an effect of the partial realisation of compensation payments for Nazi-era slave labourers in cash.

The increase in individuals' zloty deposits up to the end of 2Q01 resulted from a stronger growth in time deposits than growth in current deposits which was close to the same period of last year (after netting out the base effect). The annualised growth in money aggregates is partially explained by a high-base effect – privatisation of PKN Orlen in June 2000. This effect is also responsible for a decline in some of the aggregates in the banking sector – such as money supply or individuals' deposits.

Growth in deposit of physical and legal persons was at very low level in 2Q01 despite the fact that June is historically the month when their average growth is highest. In 1H01, household indebtedness increased by 4.1%, while in 1H00 it jumped by 39%. However, analysing only 2Q01 there is a noticeable growth of foreign currencies credits drawn by individuals. There was especially strong growth of credits on mortgages, which constitute around 50% of foreign currency credits of households. This took place irrespective of growing currency risk. The explanation lies in the high interest rate spread between home and abroad.

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%
	June 28, 2001	NBP rediscount rate 18.0% Lombard rate 19.5% Refinancing rate 19.5/20.5% 28–day repo rate at least 15.5%

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

The main factor hampering debt growth is the high level of interest rates – the weighted average for zloty credits on individuals declined only from 22.9% in January to 22.1% in May. In June there is usually an increase in claims on legal persons and this year – for the first time since March 2001 – there has been a small growth in claims. The mid-year saw an increase in claims on legal persons of only 3.4% – against 9.5% in the respective period of last year. Subdued growth in credits to enterprises is surprising given that the costs of credits for legal persons lowered from 20.7% in January to 19.1% in May (one-year credits in zlotys) – significantly more than for households.

Net claims on the government sector in the banking system declined from the beginning of the year by 2.8% (9.4% in the corresponding period of last year). The decline resulted from a diminishing value of Treasury papers in the portfolio of banks and a growth of deposits on budget accounts (central budget and extra-budgetary funds).

Piotr Bujak, Mariusz Jarmużek

Financial markets

Interbank deposit market

The expected NBP rate cut was gradually reflected in the market prices of financial assets. In the aftermath of the RPP decision to lower interest rates WIBOR rates dwindled. Also, prior to the April RPP meeting WIBOR continued its downward trend as market participants anticipated another cut. However, as the NBP's rates were left unchanged there was a corrective rise in rates of money market instruments. It should be noted that for the first time since November 2000 the 3-month WIBOR remained above the reference rate over almost all of May. 1-month FRA transactions also were on the rise as a consequence of unfavourable food price data for the second half of April, reducing the probability of interest rates cuts in May and June. A shift in market expectations on further RPP's cuts until July stabilised 6x9 and 9x12 FRA transaction rates. FRA rates dropped only at the end of May. All WIBOR rates with maturity of 1-month and longer remained stable in the first half of June until the publication of May inflation data. In the second half of June investors gradually anticipated a cut in interest rates, though as it turned out later, of only one third of their actual move. Thus, the market was surprised not only with the timing of the RPP's decision but also with the size of the cut.

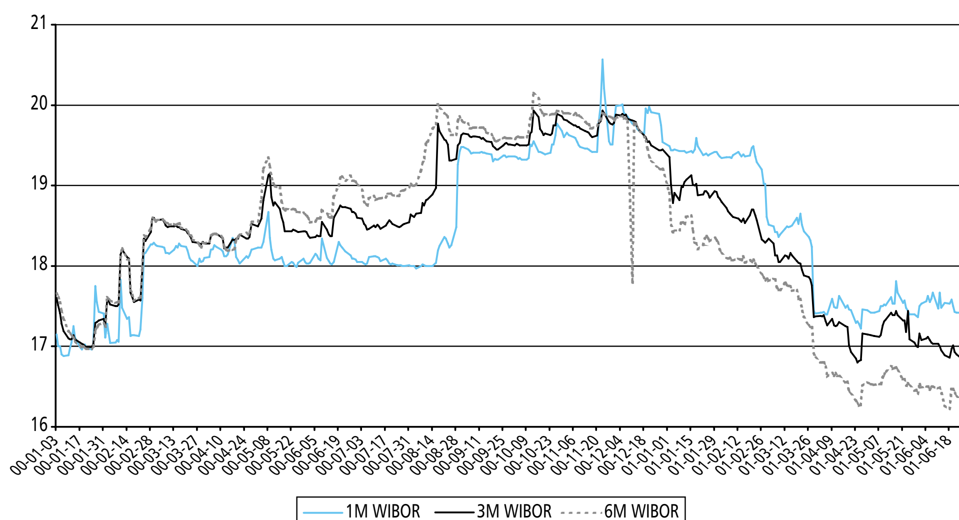
Analysis of interest rates derivatives indicates that at the beginning of 3Q01 market participants, expecting a continuation of the inflation trend and a slowdown of economic growth, anticipated future cuts in the NBP's rate of 150 basis points in the course of this year.

The Treasury debt securities market

Prices of bonds remained stable until 25 April – when food price data for the first half of April was released. This caused an abrupt increase in bond yields, particularly with 2-year maturity. Market sentiment worsened after the RPP's decision to leave interest rates unchanged and the publication of further unfavourable data on food prices. This process was strengthened by pessimistic data on the budget deficit. Investors started to anticipate an increase in country risk due to the boosted supply of treasury securities and its influence on the decline in prices of bonds offered by the Ministry of Finance. The significant appreciation of the zloty also contributed to the perception of higher country risk. The threat of currency correction and only gradual reductions in interest rates gradually inclined foreign investors to withdraw from the Polish market. However, the threat of ensuing substantial depreciation cooled investors' rush to flee the bonds market. Expectations on foreign exchange flows due to privatisation proceeds and Nazi-era slave labour transfers and the consequently stable exchange rate in the derivatives' market meant that the withdrawal of foreign investors from Polish market did not lead to exchange rate losses.

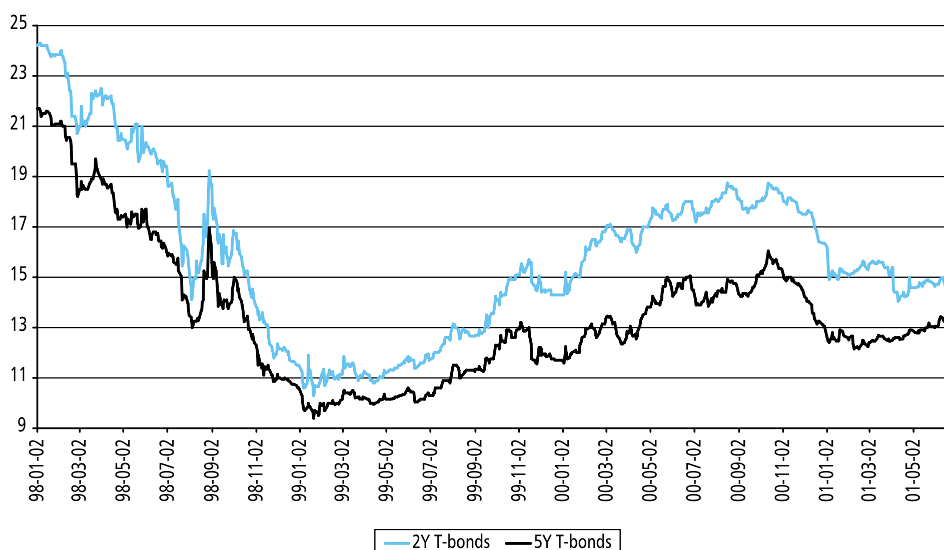
During 2Q01 there was a change in the structure of debt papers held by foreign investors. Higher medium-term risk reduced investment in 2-year and

Chart 2.9. 1-month, 3-month, and 6-month WIBOR, 2000–2001 (daily quotations)



Source: NBP.

Chart 2.10. 2Y and 5Y treasury bonds, 2000–2001 (daily quotations)



Source: NBP.

5-year bonds. On the other hand, the share of treasury bills and 10-year bonds in investors' portfolios increased. The former instrument secures higher liquidity. Demand on bonds with the longest maturity resulted from the still positive prospects for the Polish economy.

Center for Social
and Economic Research

Outlook for the economy in 2001 and 2002

Andrzej Bratkowski

We hope for a gradual recovery

Economic indicators in 2Q01 were worse than expected, with the zloty's appreciation mainly to blame. We interpret this as a deepening and extending in duration of stagnation trends. As a consequence we believe the gradual recovery in economic growth will come one quarter later. Our optimism is underpinned by the continued good performance of foreign trade (due to the depreciation of the zloty), the gradual revival of domestic demand alongside interest rate cuts as well as higher propensity to save.

However, if exports do not grow as we forecast in the baseline scenario this year, economic slowdown may be more severe. The baseline forecast depends to a significant degree on enterprises' ability to adjust to the zloty's strong appreciation and is also based on the assumption of a moderate real depreciation of the zloty over the next quarters. We cannot rule out, though, that all the negative effects of the earlier appreciation have not yet materialised. If this turns out to be the case, the current moderate weakening of the zloty would allow only for stabilisation of exports, and their further growth would be jeopardised. If the zloty strengthens again, one should expect a decline in exports. Economic growth may also lose momentum in the case of a more distinct slowdown in the EU, and especially in Germany. In addition, the GDP growth figure may turn out lower for purely statistical reasons – we do not rule out the downward revision of GDP estimates for 1Q01.

Domestic demand growth is another risk factor. Our rather optimistic outlook for investment demand is based on the assumption of a relatively quick reaction of the economy to the lowering of interest rates. We expect enterprises to take into account in their investment decisions not only the current level of interest rates but also expectations of looser monetary policy. We cannot rule out, though, the possibility that enterprises may behave more cautiously. Also real income growth is not definitely determined. High unemployment may make enterprises adopt a tighter remuneration policy. The uncertainty of such a scenario is increased by the lack of data on the financial state of enterprises. The lagged effects of stronger external competition in 1H01 may turn out to be more far-reaching than we currently think. In that case the financial state of enterprises would be worse than in 1Q01, with all the ensuing negative consequences on wage and salary growth and investment spending.

An additional risk to economic growth over the next few years comes from the fiscal side – i.e. further easing under the new government. The statements of some politicians on the left appear to indicate a lack of regard for the threats posed by the choice of such a policy. Fiscal loosening would increase tensions between monetary and fiscal policies and jeopardise macroeconomic equilibrium. In such a scenario a postponement

Table 3.1. Main macroeconomic indicators, 1996–2002

		1996	1997	1998	1999	2000	forecast		forecast			
									2001			
							2001	2002	I	II	III	IV
GDP	% growth	6.0	6.8	4.8	4.1	4.0	2.4	3.9	2.3[e]	0.5	2.1	4.5
Domestic demand	% growth	9.7	9.2	6.4	4.9	2.8	1.2	4.6	-1.4[e]	-0.4	1.7	4.3
Budget deficit	%of GDP	-2.4	-1.3	-2.4	-2.0	-2.2	-4.4	-4.1	-9.0[e]	-3.7	-2.9	-2.8
Unemployment rate	%	13.2	10.3	10.4	13.0	15	16.8	17.7	15.9[e]	15.8[e]	16.2	16.8
Balance on current account	% of GDP	-0.9	-3.0	-4.3	-7.5	-6.3	-5.0	-5.5	-5.3[e]	-5.2	-4.9	-5.0
Balance on merchandise trade	US$ billion	-8.2	-11.3	-13.7	-14.4	-13.2	-12.6	-14.0	-3.1[e]	-2.7[e]	-3.2	-3.6
M2	PLN billion	134.8	176.4	220.8	263.5	294.4	333.3	364.9	301.0[e]	307.5[e]	319.5	333.3
CPI	%	19.9	14.9	11.8	7.3	10.1	5.9	5.2	6.8[e]	6.5[e]	5.2	5.0
Exchange rate against US$	PLN/US$	2.70	3.28	3.49	3.97	4.35	4.16	4.41	4.09[e]	3.99[e]	4.23	4.34
Exchange rate against euro	PLN/euro	–	–	–	4.23	4.01	3.68	4.23	3.78[e]	3.49[e]	3.63	3.82
Lombard rate	%	25.0	27.0	20.0	17.9	23	17.5	17.0	21.0[e]	19.5[e]	18.5	17.5

Source: data and estimates (e) – CSO and NBP; forecast – CASE.

by a couple of years of Poland's entry into the EU should be expected.

*Łukasz Rawdanowicz**

External conditions

- **Risks of global recession recede though growth momentum is on the decline**
- **US economy expected to lead the gradual recovery in 2H01**
- **Continued downward growth revisions for the euro-zone**
- **Japan dipped into recession**
- **Financial turmoil in Argentina**
- **Inflationary pressures after recent highs expected to ease**

Recent developments in the global economy make world recession less likely, though the picture is far from satisfactory. Growth momentum this year is forecast to weaken considerably and the bottoming-out should take place around mid-year, depending on the region. The US is expected to lead the gradual recovery on the back of the Fed's recent aggressive easing and announced tax rebates in 2H01. The broad-based revival is dependent on a pick-up in enterprise investment spending – so far consumer spending has been keeping the economy afloat. On the other hand, the euro zone is experiencing a more acute slowdown than previously expected. The downturn is led by Germany – the biggest economy of the single currency area. Most leading forecasting institutions continue to downgrade the growth figure for Germany this year. France (the second largest economy), which has enjoyed stable and robust growth so far, has also revealed some signs of weakness both on the consumer and business sides. Such a marked slowdown is ascribed to reduced real incomes (due to high inflation) and weaker external demand. Very high inflation rates in the euro zone put the ECB in a difficult position with respect to possible cuts in interest rates.

* The text based on the ***Global Economy 3/2001*** (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, 1996–2002 (% change, yoy)

	1996	1997	1998	1999	2000	*2001f*	*2002f*
OECD	3.1	3.4	2.7	3.2	4.2	*1.3*	*2.4*
USA	3.6	4.4	4.4	4.2	5.0	*1.5*	*2.9*
Japan	5.0	1.6	-1.1	0.8	1.2	*-0.4*	*0.8*
European Union	1.7	2.6	2.8	2.6	3.3	*2.1*	*2.8*
Germany	0.8	1.4	2.1	1.6	3.0	*1.2*	*2.3*
France	1.1	2.0	3.5	3.0	3.3	*2.3*	*2.6*
Italy	1.1	1.8	1.5	1.4	2.9	*2.1*	*2.5*
United Kingdom	2.6	3.5	2.6	2.3	3.0	*2.2*	*2.7*
Poland	6.0	6.8	4.8	4.1	4.1	*2.4*	*3.9*
Russia	-3.5	0.8	-4.9	5.4	8.3	*4.0*	*3.3*
Turkey	6.9	7.6	3.1	-4.7	6.1	*-4.0*	*4.0*
China	9.6	8.8	7.8	7.1	8.0	*8.0*	*7.5*

Source: Data – OECD, IMF, statistical agencies; forecast (f) – market consensus and CASE.
Note: Differences in data between the current issue and the former ones stem from the change of their source – in previous issues of PEO it was the IMF World Economic Outlook.

Japan, again dipping into recession, faces a grimmer economic situation. Results from a recent Tankan survey fully confirm this. Added to the poor performance of domestic demand, there were severe cutbacks due to weaker exports – the result of global downward growth. Export losses were mainly noted in IT goods. The government will no longer prop up domestic demand by fiscal stimulus and thus any rebound should be expected only in the event of a global recovery. The outlook for Asia excluding Japan is also far from bright, with the only exception being China – which, less susceptible to the global downturn, remains on the fast track. Political uncertainties overshadow economic issues in a number of countries. Some signs of a possible rebound have been observed in Korea.

The transition economies in Central and Eastern Europe are generally performing well, though slowing economic activity in the euro zone may have more damaging effects than expected. Most economies in the region should record robust rates of growth, though Turkey and Poland will lag behind. The former is experiencing recession on the back of financial turmoil encountered at the end of 2000, start of this year. As IMF and World Bank lending programmes were recently resumed, one should expect a gradual recovery over the course of the year. Poland, on the other hand, has stepped down onto a slower track, with domestic demand cooling off considerably. In addition, it has suffered serious fiscal problems and a substantial increasing of the budget deficit is unavoidable.

The prospects for Latin America are currently less rosy that a quarter ago. The financial and political turmoil in Argentina has spilled over to virtually all economies in the region, leading to further currency depreciations and a significant widening of spreads on countries' assets. The situation in Argentina has dominated news from the region and had a significant impact on the performance of currency and asset markets in many emerging economies around the world. The country remains in a very difficult position. Even if the latest austerity plan is actually implemented the rebound of strong growth remains a key condition for avoiding debt default and devaluation in the future. To this end no signs of improvement have been recorded so far. Positive growth is still possible in 2H01, but at the same time the possibility of financial crisis cannot be ruled out entirely.

2002 should see growth accelerating. The US economy will once again be the engine of the gradual global recovery – especially for Japan and other Asian economies as well as for the EU – though to a lesser extent. In 2002, the US may reach its potential rate of growth of around 3% – unless, as we warned in the previous issue of Global Economy, the inflation outlook

deteriorates significantly and ensuing interest rate hikes make this impossible. The rebound in the EU next year will be less pronounced, likely to expand at a rate of around 2.8%.

After reaching highs in May, inflation in the US and the euro-zone declined in June. This may be a tentative sign of a trend reversal. In Japan, deflationary pressures will increase on the back of the recession. Most forecasts for industrialised countries suggest an ebbing of inflation over the course of this and next year. After supply-side effects (mainly energy and food) fade away a downward momentum in economic growth should abate price pressures. Although (as we have already warned), in the event of aggressive monetary easing and a prompt economic recovery, there are serious upside risks to global inflation next year.

In 2Q01 crude oil prices remained within the band targeted by OPEC. The period was marked by high volatility in prices with a strong upsurge in May. The analysis of differences in European vs. US prices supports the hypothesis that some of this variability can be explained by speculative actions rather than by fundamental factors. The IEA forecast for global demand growth this year has been revised downward to a low level of below 0.5 mb/d. OPEC is expected to keep its production within agreed limits. World prices are expected to remain at the lower end of OPEC's preferred range, i.e. between US$22–25/bbl in 2H01.

Table 3.3. Inflation in selected countries, 1996–2002 (% change, yoy)

	1996	1997	1998	1999	2000	*2001f*	*2002f*
USA	2.9	2.3	1.6	2.1	3.4	*3.1*	*2.1*
Japan	0.1	1.8	0.7	-0.3	-0.7	*-0.4*	*-0.2*
European Union	2.1	1.8	1.8	1.2	2.5	*2.2*	*1.5*
Euro area (HICP)	2.2	1.6	1.2	1.1	2.4	*2.4*	*1.6*
Russia	22	11	84.4	36.5	20.8	*23.0*	*18.0*
Turkey	82.3	85.7	84.6	64.9	54.9	*55*	*35.0*
China	8.3	2.8	-0.8	-1.4	0.3	*1.8*	*1.4*

Source: Data – OECD, IMF, statistical agencies; forecast (f) – market consensus and CASE.
Note: Differences in data between the current issue and the former ones stem from the change of their source – in previous issues of PEO it was the IMF World Economic Outlook.

Table 3.4. Long-term interest rates in selected countries, 1996–2002 (%)

	1996	1997	1998	1999	2000	*2001f*	*2002f*
USA	6.4	6.3	5.6	6.2	6.1	*5.7*	*5.0*
Japan	3.0	2.3	1.5	1.8	1.7	*1.3*	*1.3*
Euro zone	6.2	5.7	4.7	4.7	5.4	*5.0*	*5.0*
United Kingdom	7.8	7.0	5.5	5.1	5.3	*4.9*	*5.0*
LIBOR (US$/year)	5.6	5.9	4.8	5.4	6.5	*5.2*	*5.3*

Source: Data – OECD, IMF, statistical agencies; forecast (f) – market consensus and CASE.

Table 3.5. The euro and yen exchange rate vs. the US dollar, 1996–2002

	1996	1997	1998	1999	2000	*2001f*	*2002f*
Euro	1.270	1.134	1.121	1.066	0.924	*0.889*	*0.971*
Yen	108.8	121.1	131.0	113.7	107.8	*125*	*120*

Source: Data – ECB; forecast (f) – market consensus and CASE.

United States

- **Tentative signs of recovery in 2H01**
- **Consumer confidence robust, though may still wane**
- **More marked downturns in the technology sector**

The 1Q01, the GDP figure was twice consecutively revised downward, with a final estimate of 2.5% yoy, i.e. lower than in 4Q00. 1H01 saw a decline in inventories, which is consistent with the cyclical downturn. 2Q01's results should tell us if the economy has already bottomed out or not. An acceleration of growth momentum in 2H01 is very likely given the Fed's aggressive easing during the past six months. On top of this, personal incomes will receive a fiscal boost. Tax rebates to the tune of roughly 1% of GDP are expected to materialise in 2H01. Although the household sector continued to surprise on the up-side – consumer spending remained robust – some deterioration in confidence may yet come on the back of past losses in equity markets and the worsening situation in the labour market. Both the number of unemployed and the rate of unemployment have been on the rise in 2Q01 – the latter reaching 4.5% in June.

The corporate sector, on the other hand, shows more signs of weakness. Profits have been falling as firms were forced to cut prices in order to maintain sales volumes. Consequently, corporate spending, in particular on investment, has been very weak. In May, industrial production declined for the eighth consecutive month. The downturn in the economy was especially pronounced in the technology sector. Traditional sectors have suffered to a considerably lesser extent, laying to rest for good the new economy paradigm that heralded a permanent boom on the tails of advancements in new technology sectors.

2Q01 marked two subsequent cuts in the American federal funds rate by a total of 75 basis points to 3.75%. May's reduction of 50 basis points and June's of 25 basis points were engineered on the back of continued concerns about growth prospect. The smaller size of the latest reduction may indicate that the Fed is coming to the end of its easing cycle. Despite the continued presence of downside risks to economic activity, it seems that concerns over price stability will start to outweigh Fed monetary decision – as was indicated in the Greenspan testimony to Congress. However, one more easing action in August is still probable.

Euro zone

- **Worsening economic conditions**
- **Fiscal boost dampened by higher inflation**
- **Germany leading the downturn**
- **Strong inflationary pressures maintained – primarily on the PPI side**

The 1Q01 GDP figure for the euro zone has been revised upwards to 2.6% yoy from 2.5% yoy. Nevertheless, 2Q01 may bring a more marked slowdown. The moderation in activity occurred mainly in the industry sector, as industrial production is more cyclically sensitive than is the services sector. Growth of domestic demand remained below GDP growth – net exports were still therefore the main engine driving overall economic expansion. Private consumption will not see any acceleration in the near future given deteriorating consumer confidence on the back of high inflation and little improved labour market conditions. Unexpectedly high inflation reduced real incomes and thus neutralised the effects of the fiscal ease pursued in a number of member states. The worst therefore may be still ahead. 2Q01 and 3Q01 should see subdued growth rates and the euro zone economy may not gain momentum until the end of the year. More vigorous domestic demand should be also accompanied by stronger external demand. The more acute than expected slowdown is reflected in leading forecasting centres' recent downward revisions of GDP growth figures for the euro zone this year. Currently, the market consensus points at about 2.1% growth for the euro zone in 2001.

The present cooling has also taken its toll on business sentiment, with business confidence indices (e.g., the Ifo index for Germany) heading downward. The industrial downturn is also reflected in waning manufacturing order indicators. These developments do nothing to improve the situation on the labour market. Employment growth has slowed considerably (in the industry sector it is even declining) and the seasonally adjusted unemployment rate flattened in recent months, reaching 8.3% in May.

The ECB surprised markets with its decision to cut interest rates by 25 basis points on May 10 as the deci-

sion contrasted with the bank's earlier declarations. The bank remained tough on its central commitment to price stability rather than growth. At the time of the cut, a positive inflation outlook was not certain, whereas signs of slowing growth were rising. During subsequent meetings in June and July the minimum bid rate on the main refinancing operations was left unchanged at 4.50%. The ECB is still caught between price stability and boosting economic activity. Currently, both pillars of monetary policy (HICP and M3) are exceeding their targets. However, when supply-side inflationary shocks abate and the downward trend in the HICP becomes more certain, further cuts should be expected in the autumn.

Germany

Germany seems to be leading the European downturn. After rising 1.6% yoy in 1Q01, GDP is expected to be close to zero in 2Q01. Weakened consumer confidence due to high inflation led to a fall in private consumption. On top of the weaker-than-expected performance of domestic demand, any boosts from the external sector have also lessened. This indicates that Germany is more susceptible to external slowdown than previously thought. Growth in manufacturing output this year has been gradually slowing and in May it actually decreased. Interestingly, domestic orders have declined more than foreign orders. The calendar and seasonally adjusted index of industrial production declined in 1Q01. Weakness in the economy is also evident on the business side. The Ifo business survey index has been subsequently falling since January this year to a low of 89.5 in June – the lowest result since August 1996. Against this background, the IMF and the DIW, among others, lowered their GDP forecast for this year to roughly 1% from above 2%. Next year growth momentum is expected to reverse and a rate of 2.3% is possible.

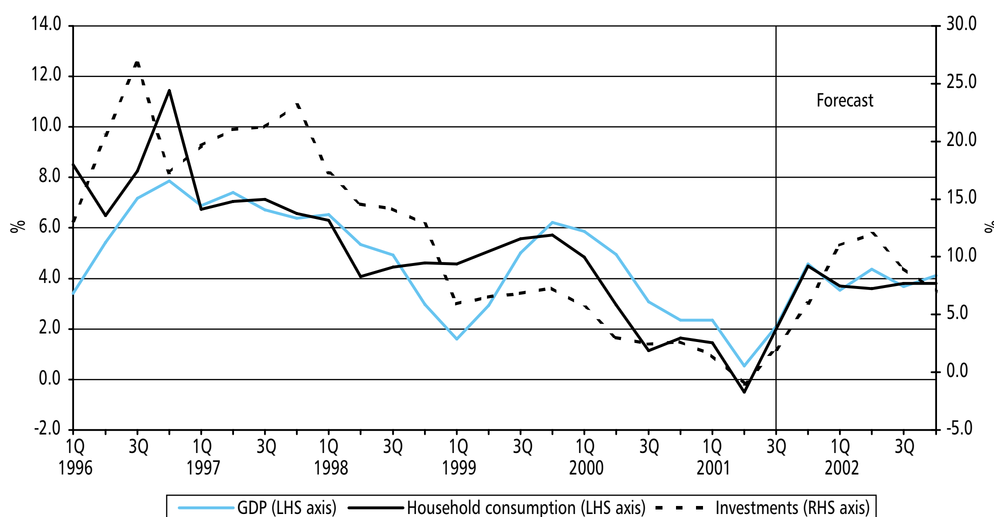
Łukasz Rawdanowicz

Economic growth

- **Subsequent downward revision of GDP growth this year**
- **The expected recovery only in 4Q01**
- **Net exports still contribute positively to GDP**

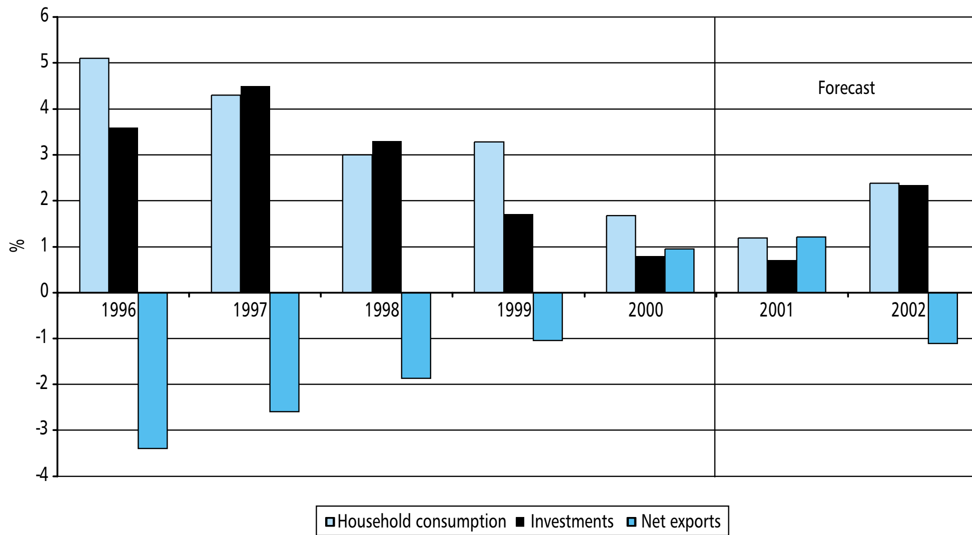
Our forecast of economic growth for 2001 has been once again downgraded. We forecast 2.4% growth,

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



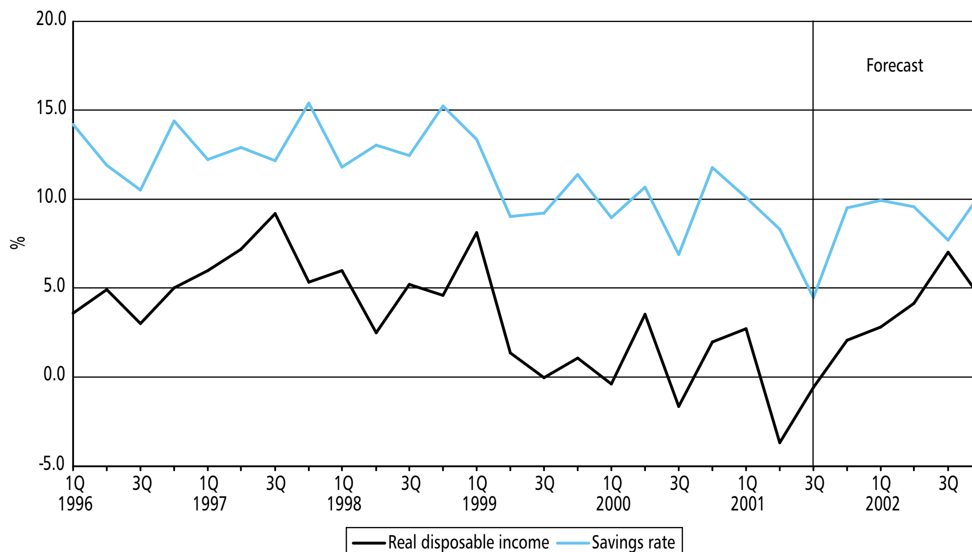
Source: CSO and CASE.
Note: CASE forecasts starting from 3Q01.

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



Source: CSO and CASE.
Note: CASE forecasts starting from 2001.

Chart 3.3. Change in real household disposable income and savings rate, 1996–2002 (%)



Source: CSO and CASE.
Note: CASE forecasts starting from 3Q01.

0.5% less than we predicted a quarter ago. The more pessimistic appraisal of the economic situation this year results from the deeper and more prolonged slowdown of domestic demand.

Household consumption, after a decline in 2Q01, will rise moderately in 3Q01 and then in 4Q01 grow by 4.5% yoy. The more pronounced stagnation of consumption was caused by a deeper-than-expected decline in wages and salaries. The decline was probably induced by the worsening financial situation of enterprises due to the persistently strong zloty. Household wages and salaries in real terms decreased in 2Q01. The subdued growth in wages and salaries was particularly pronounced in the enterprise sector. The V-recovery in household consumption in 4Q01 will be possible due to forecast higher growth of wages and salaries.

We are also less optimistic on investment growth, regardless of our forecast of faster interest rate reductions. Our pessimism stems from the deeper slowdown in economic activity in 2Q01 which will to a greater extent diminish enterprises' propensity to invest.

We are also less optimistic with regard growth prospects in 2002. In our view, less robust investment activity will be coupled with lower propensity to consume both on the side of households and the government. As a result, GDP will grow by only 3.9% against our former forecast of 4.3% a quarter ago.

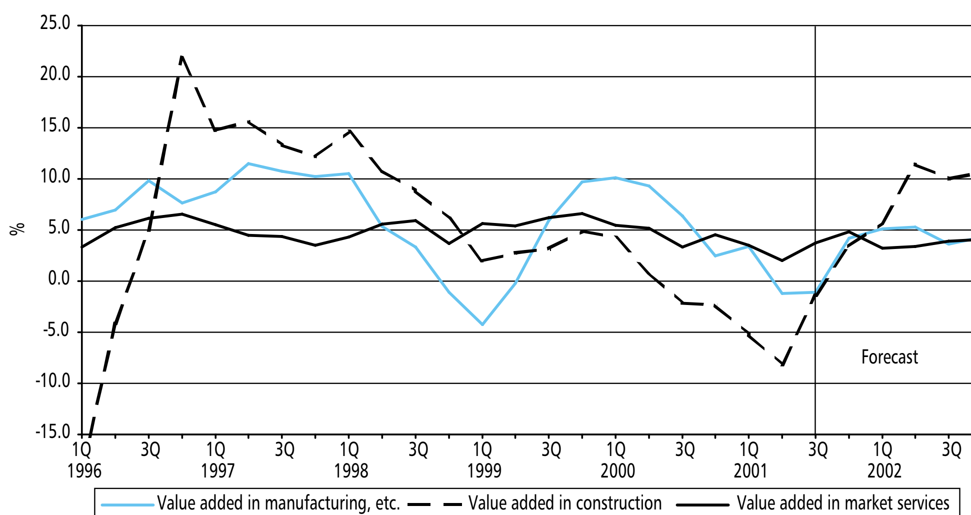
Due to the prolonged slowdown of domestic demand, this year the contribution of net exports to GDP growth will be positive, like last year. However, it will become negative in 2002 alongside the recovery in import demand.

Real sector

- **The contraction in industrial production and construction will be maintained in 3Q01**

A slower investment revival will increase the duration of the recession in the construction sector. In 3Q01, we still predict a decline in value added as well as output. A more sound improvement will take place only in 2002. However, high growth indices will reflect also a low base effect.

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



Source: CSO and CASE.
Note: CASE forecasts starting from 3Q01.

The deeper slowdown will also impact negatively on economic activity in the industry. We expect the industrial production index to decline. Its stronger growth in 4Q01 will reflect higher domestic consumption as well as high exports.

External sector

Rafał Antczak

Exchange rate

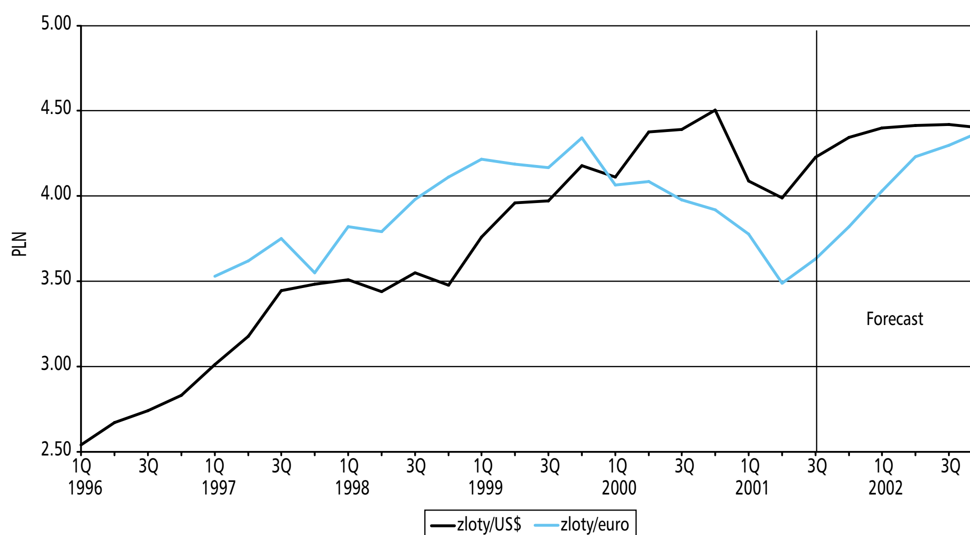
• **High uncertainty – continued**

Until the end of this year we expect a volatile nominal zloty exchange rate against the dollar and the euro. The main cause is Poland's increased macroeconomic risk, reflected in the higher current account deficit, problems with the budget and a change of government. The other key factor is uncertainty related to privatisation proceeds. If the planned revenues are met at the level of 18 billion zlotys (which is highly improbable), we would see a cumulated inflow of about 16 billion zlotys in 4Q01. As a result, it would be necessary to obtain no less than 8 billion zlotys on the Treasury market in 3Q01.

The external factor increasing uncertainty with regard zloty exchange rate developments is the dollar-euro cross exchange rate. A significant slowdown of growth in the USA in 2Q01 would probably result in the weakening of the dollar against the euro. However, it might not be very pronounced, because economic growth in Germany and Italy is also losing momentum. The differences in monetary policy between the USA and the EU should also be taken into account. The very accommodative monetary policy of the Fed led to a lowering of the rate of return on US financial assets. In the case of the ECB we expect monetary policy to be tighter in the face of money supply growth and inflation exceeding their targets.

We do not expect significant weakening of the zloty or repeated strengthening. We assume that with strong periodic volatility the average nominal exchange rate over the next few quarters will gradually depreciate – at a faster rate during the next four quarters and then at a slower rate.

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



Source: NBP and CASE.
Notes: CASE forecasts starting from 3Q01.

Łukasz Rawdanowicz

Foreign trade

• Exports keep the economy afloat

We have changed substantially our views on the prospects for foreign trade this year as well as next year. The changes stem primarily from a more optimistic export outlook. It is possible to maintain the positive rate of export growth (in nominal terms in the balance of payments) despite the weaker growth in the EU, though the rate will decline. This more optimistic view is backed both by the better-than-expected abilities of Polish exporters to accommodate the exchange rate shock and a stronger crowding-out effect (weak domestic demand boosting exports). In addition, the good performance of exports contributed to a strengthening of Polish exporters' position on foreign markets. Thus, one should not expect this position to be lost in 2H01 and next year.

Due to higher exports we have also increased the imports forecast despite weaker economic growth. This stems from high import intensive production for exports.

Łukasz Rawdanowicz

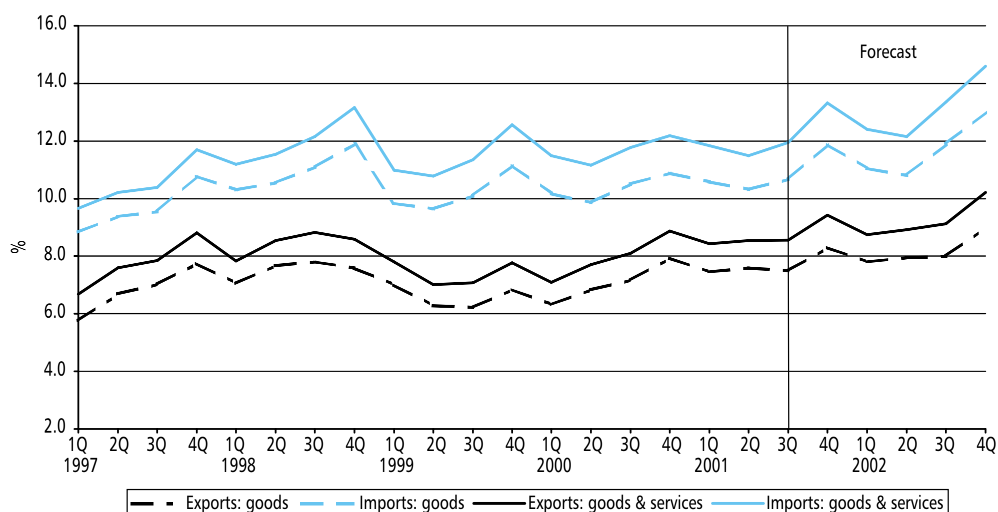
Balance of payments

• Marked improvement in the current account deficit this year and gradual deterioration next year

Given the current merchandise trade deficit, 3Q01 will see a stable current account deficit at roughly US$2 billion. Its deterioration will only come in 4Q01 on the back of increased imports due to seasonal factors as well as a recovery in household consumption. In 2001 as a whole the current account deficit will amount to 5.0% of GDP, a marked improvement on the last two years.

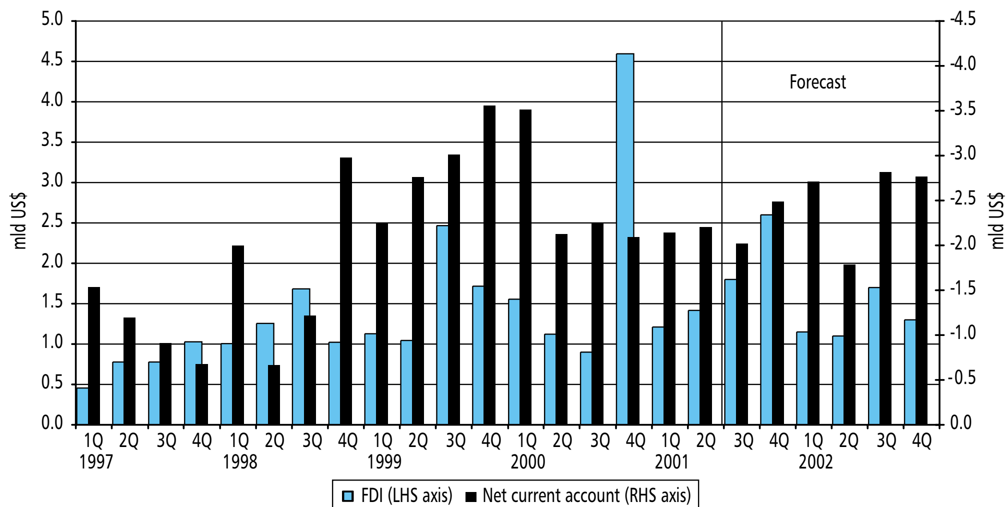
Next year, despite sustained high growth in exports the merchandise deficit will increase. Higher GDP growth will on one hand drive import demand and on the other weaken the crowding-out effect. Consequently, given limited growth in the unclassified current transactions surplus, the current account will gradually widen and in 2002 will reach 5.5% of GDP.

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



Source: NBP and CASE.
Note: CASE forecasts starting from 3Q01.

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



Source: NBP and CASE.
Note: CASE forecasts starting from 3Q01.

A relatively high inflow of foreign capital in spite of the deteriorating economic situation and increased investment risk in other emerging markets inclined us to change our forecast for the capital and financial accounts in the balance of payments.

Małgorzata Markiewicz

Public Finances

- **Growth of public sector hidden liabilities**
- **Increased imbalances in the public health sector**

In our view, the nominal depreciation forecast for 2H01 will facilitate growth in the indirect tax collection rate. Moreover, the recovery of domestic demand at the end of the year will alleviate tensions in the fiscal sector. The amendment to the budget act assumed a lowering of revenues by 8.6 billion zlotys in comparison to the earlier budget act. But this seems to be only a halfway solution. According to our calculations, government budget revenues will be 5.2 billion zloty lower than the amount assumed in the amended budget act. Thus, cuts in expenditures of this magnitude at the end of the year will be unavoidable. There is a risk that these expenditures will be shifted to the next year or hidden by accruing liabilities.

It is already obvious that in comparison to last year fiscal policy will be relaxed in 2001. If assumed privatisation revenues are not met this will lead to an increase in the issue of treasury securities and put upward pressure on interest rates. A higher public sector borrowing requirement combined with privatisation proceeds shifted to the second half of the year will lead to the appreciation of zloty, which will consequently be reflected in low tax revenues. The current tensions in fiscal policy will also impact on next year budget. We hope these tensions will also be reflected in a realistic budget act for 2002.

Piotr Bujak

Labour market

- **Unemployment will remain high**

We expect unemployment to reach 16.2% in 3Q01. The situation on the labour market this quarter will be determined primarily by the inflow of graduates. This year will see the entrance onto the market of the so-called 'baby-boomer' generation born in 1983, which is extremely numerous. Also, those who were in further

education in the second half of the 1990s will be seeking jobs. Unfortunately, the macroeconomic background gives little hope for increased labour demand in 2H01. On top of this, enterprise restructuring will continue in the months ahead. There will be lay-offs at PKP (the Polish railway company), in the metallurgy sector, amongst others, and in car manufacturing, which has been in trouble for some time now. The private sector as a whole faces demand constraints. According to CSO surveys, firms are saying they will have to lay off a very high number workers. Furthermore, no legislative changes have been introduced to mitigate unemployment. We forecast an official rate of unemployment of 16.8% at the end of the year. Next year's GDP growth at roughly 4% will not be sufficient to secure a net increase in the number of jobs. This, coupled with higher inflow of young people onto the labour market, will drive unemployment up to 18.0% at the end of 2002.

Wages and salaries

In 2H01 we expect some increase in real growth of wages and salaries. Alongside the gradual recovery of economic growth at the beginning of next year, real remuneration growth will accelerate. However, one should note that wage and salary growth will be suppressed by the difficult situation in the labour market.

Mariusz Jarmużek

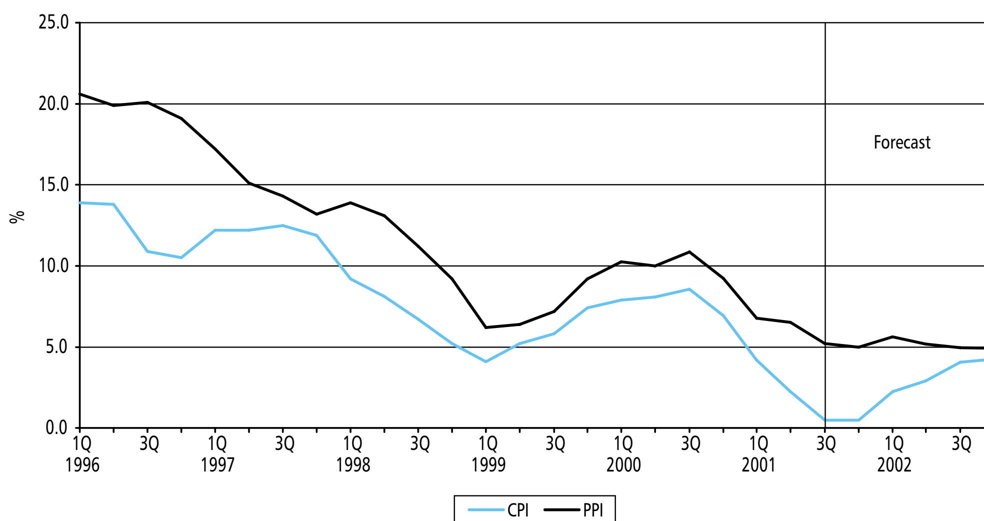
Prices

• Disinflation to continue

We forecast continued disinflation in 2H01. Inflation should then increase as a result of zloty depreciation, the gradual recovery of domestic demand and the low-base effect. However, the expected good harvest in 2001 could partly offset an increase in import prices in 4Q01 and 1Q02.

We assume that disinflation will still be underpinned by restrictive monetary policy, and therefore only modest and gradual reductions in real interest rates are expected in 2001–2002. We envisage a weakening of the zloty in 4Q01 and 1H02 followed by a stabilisation in real terms.

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



Source: CSO and CASE.
Note: CASE forecasts starting from 3Q01.

We expect the good harvest and modest growth in exports to the CIS countries will suppress growth of cereal product and meat prices. Consequently, foodstuff prices will fall. However, we predict some acceleration of meat prices in 2H01 when the impact of lower swine livestock and domestic demand recovering will materialise. Cereal prices will be stable as this year's favourable weather conditions will facilitate a better harvest. In the coming years we predict a leap harvest cycle.

In 2H01 we forecast exceptionally low PPI growth. This will be attributable to the strong domestic currency in 1H01, waning domestic demand and low prices of raw commodities. In the coming quarters the PPI will accelerate, as we forecast a weakening of the zloty and domestic demand recovery.

Przemysław Woźniak

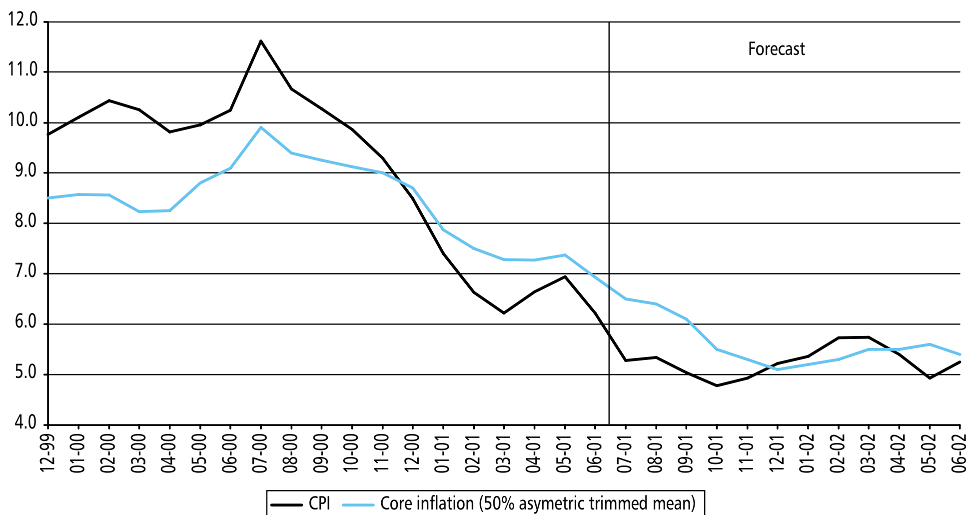
Core inflation

We augment our analysis of core inflation presented in the chapter on the current situation with the presentation of an alternative measure for core inflation along with a forecast for the next 12 months. This alternative measure is the asymmetric trimmed mean that eliminates 28.5% and 21.5% of the lowest and highest price changes respectively (percentages refer to expenditure shares). It has better inflation forecasting properties than measures used by the NBP.

Chart 3.9 presents the dynamics of the asymmetrically trimmed mean together with CPI inflation. The trimmed mean has exceeded headline inflation since the end of 2000 and we predict that this will continue in the months ahead. The position of the two inflation measures (core above headline) follows from the fact that the fall in the CPI is mainly fuelled by a radical drop in the rate of price growth of relatively few products. This fall did not touch the majority of prices to a comparably large extent, hence after eliminating extreme price changes (extremely low as well as extremely high), the 'core' that remained turned out higher than the total index.

Price falls shaping inflation processes in 1H01 were registered mainly in foodstuffs (butter, sugar, and coffee), but also included fuels, cars and various telecommunication services. After two years of poor crops, we

Chart 3.9. Core inflation, 1999–2002



Source: CSO and CASE.
Note: CASE forecasts starting from 3Q01.

expect this year's supply of fruit and vegetables to be visibly better. This will additionally strengthen disinflationary pressures. Consequently, we predict that core inflation will be above headline inflation until the end of the year. This trend will be reversed in the early months of 2002. We expect the trimmed mean to continue to present inflation trends just as it has done so far and will be relatively stable and insensitive to short-term distortions. The rate of growth of the trimmed mean will decrease from today's 6.9% to approximately 5% towards the end of the year and will hover in the range of 5.0–5.5% in 1H02.

Rafał Antczak

Monetary policy

We assume that the NBP's reference interest rates will be cut by only about 100 basis points until the end of the year. Therefore, monetary policy will not be loosened significantly and the growth of the broad money supply will remain subdued. As a result of still high nominal interest rates the increase in deposits, including those of physical persons, will continue. The rise in individuals' deposits will also result from compensations payments to Nazi-era forced labourers. One can expect part of the compensation to be exchanged into zlotys thus increasing the amount in circulation.

In our opinion, as a result of a decline in real interest rates and expected stabilisation of the nominal exchange rate, a gradual upward trend of credit demand will be maintained during 2H01. It seems that due to high demand on mortgage credits and high interest rate spread (between home and abroad), foreign currency credits on the side of households will rise.

During 2002, we also predict restrictive monetary policy, which will result in a very gradual decline in real interest rates. However, alongside a decline in nominal interest rates we expect lowering of the propensity to save and a decline in deposit growth. Due to the same reasons credit growth will accelerate. This trend will be strengthened by the forecast boost to economic growth.

Early warning crisis indicator

2Q01 saw a decline in our indicator down to 5.30 points, indicating an improvement in the general macroeconomic balance. This is largely attributable to the improved external balance forecast in terms of the lower deficit of the the balance of payments' current account . Over the next four quarters the deficit will go down to 5.0% of GDP. GDP growth prospect will also be more optimistic. On top of this, Poland's short-term debt and real WIBOR rates dropped. Unfortunately, real interest rates remain very high by regional standards.

On the negative side, a further deepening of the budget deficit should be noted first. According to our latest forecast, it will reach 4.6% of GDP (assuming no cuts in expenditures). Higher risk stemmed also from a nominal appreciation of the zloty in 1H01 that boosted appreciation in real terms. The credit expansion as a percentage of M2 was on the increase as well. This could be a result of cuts in interest rates in February and March of this year.

Table. Early warning crisis indicator

	Weights	3Q99	4Q99	1Q00	2Q00	3Q00	4Q00	1Q01	2Q01
1. Annual GDP	0.10	6	4	4	4	6	6	4	4
2. Annual unemployment rate	0.05	6	10	10	4	6	10	10	4
3. Annual average CPI forecasts for 4 consecutive quarters	0.06	10	6	4	4	4	0	0	6
4. Government deficit forecast for 2001 as a % of GDP	0.10	5	5	5	5	5	6	6	10
5. CA balance forecast for 4 consecutive quarters as a % of GDP	0.15	6	6	10	0	4	4	6	0
6. Real effective exchange rate	0.15	0	0	6	6	6	6	10	10
7. Credit expansion as a % of M2 (end of quarter)	0.07	4	4	4	6	6	4	4	6
8. Polish foreign short term debt as a % of liquid reserves	0.15	6	6	6	10	6	4	4	4
9. Total Polish foreign debt as a % of GDP	0.07	6	6	6	6	6	6	6	4
10. Real 3M WIBOR	0.10	6	10	4	6	6	6	6	4
Indicator		**5.10**	**5.26**	**6.04**	**5.18**	**5.48**	**5.10**	**5.80**	**5.30**

Source: CASE.