Quarterly 1/2002 (12)

POLISH ECONOMIC OUTLOOK
TRENDS • ANALYSES • FORECASTS

Contents

Sponsors

BANK PEKAO SA

FORTIS BANK

Graphic Design, Group Printed
CeDeWu Sp. z o.o.
CeDeWu Graphic Design (ANB Studio),
Agnieszka Natalia Bury

Publisher

CASE

CASE – Center for Social and Economic Research Foundation
Sienkiewicza 12, 00-944 Warsaw, Poland
tel. (4822) 622 66 27, 828 61 33, fax (4822) 828 60 69
e-mail: case@case.com.pl, www: case.com.pl
ISSN 1507-3149

Distributor
CASE Advisors Ltd.
ul. Sienkiewicza 12, 00-944 Warszawa
tel./fax (48 22) 525 41 12
e-mail: doradcy@case.com.pl

For information about subscription please contact Ms Katarzyna Szczepańska at the CASE-Advisors Ltd. (pgtop@case.com.pl) or check the web site (www.case-doradcy.com.pl).

X lat CASE

Dear Readers,

We present here the twelfth edition of our quarterly at the start of the new year. It is not going to be an easy year for the Polish economy, for several reasons. Signals from the external environment appear somewhat contradictory – from global recession on the one extreme to quick recovery on the other. Poland, for the first time since the beginning of its transformation, has found itself in stagnation. Added to this there are no clear perspectives for economic reform and plenty of uncertainty over the exact date of Poland's accession to the European Union.

In an attempt to improve the readability of our analyses and forecasts we have decided to change the sequence of sections. We have added sections on the situation of enterprises, the co-ordination of monetary and fiscal policy and an appendix on public and private sector debt. We have also returned to our tradition of publishing summaries of our analyses and forecasts. In this summary you will find a table that will enable you to quickly identify the changes made in our outlook compared to the previous PEO.

Our analyses, estimates and forecasts are based on official statistical data and information available up to January 31, 2002. Any differences in estimates from previous numbers of PEO are the result either of the publication of new official data or modification of preliminary data.

Starting from the twelfth issue, our Editional Board has been in charge of PEO. The board is made up of the very same people who brought you our earlier insights into Poland's economic situation, as well as outlooks for Poland and the world.

We strongly encourage you to read not only the new summary but also individual sections analysing the situation in the fourth quarter of 2001 and forecasts for 2002–2003. Special attention should be given to the article by Prof. Stanisława Golinowska on social expenditures in the public sector.

Rafał Antczak, Katarzyna Piętka, Łukasz Rawdanowicz

Waiting for Godot?

2001 Ends Worse than Expected

Our forecasts of an economic revival in 4Q01 did not materialise, mainly due to the significant decline in investments in fixed assets. This happened for two reasons: firstly, the worsening of the financial conditions of enterprises; secondly, slowing EU growth (especially in Germany).

The slump in enterprise investments for three consecutive quarters was due to weak domestic and external demand, the lower profitability of enterprises and their disinclination to invest. Weaker sales results, under additional pressure from the strong zloty, have been forcing companies to make adjustments. CSO statistics indicate that the private sector is more adjustment-efficient than the public sector. One should not overestimate the impact of high real interest rates on credits, though this is also a significant factor. We also think that the economy is experiencing a temporary over-investment in building and construction.

Lower economic activity has led to a further weakening of demand for labour, resulting in layoffs and a slowing of wage dynamics. Unemployment increased to a record level of 17.4% at end-2001 (over 3.1 million out of work).

The low wage dynamics and mixed incomes of households were compensated by a dynamic growth of social transfers, additionally indexed for 2000 – with a delay. Interesting is that, irrespective of the worsening situation on the labour market during 4Q01, the dynamics of household consumption were significantly higher than in previous quarters. This growth in consumption could be explained as a side effect of the move of the euro-zone currencies to the euro. This estimated US$750 million might have been at least partially reallocated to consumption.

The worsening economic situation has had negative consequences for tax revenues. In none of the tax revenue categories were the amended budget law's prescribed levels met. On the expenditure side, the growth of government consumption in real terms led to fiscal expansion in 4Q01. In 2001, the state deficit as a percentage of GDP doubled, and budget problems were additionally transferred to extra-budgetary funds. Growing public sector debt clearly had a crowding-out effect on private investments from the credit market in year-end.

Monetary policy became less restrictive and the NBP's real interest rate fell in 2001. This was facilitated by disinflation (3.6% end-year CPI) and maintaining the disinflation trend registered by core inflation indices. Supply factors were also favourable.

Expectations for a better 2002

Perspectives for 2002 are slightly better. During 1H02, there is unlikely to be any clear-cut economic recovery either domestically or abroad, and this will do nothing to improve producer sentiment, thus adding to weak investment activities. Export dynamics should stay at a relatively low level in line with lower GDP growth in the EU. Simultaneously, demand for imports is expected to be limited by declining investment and relatively low domestic production. Forecasts for households' incomes,

Tabela 1.1. CASE Outlook, 2002–2003

	2000	2001	2002	2003
GDP (change in %)	4.0	1.1 ↘	1.9 ↘	3.2 ↘
Domestic demand	2.8	-2.0 ↘	0.3 ↘	3.0 ↘
Individual consumption	2.6	2.1	2.2 ↘	2.1 ↘
Investment	2.7	-10.2 ↘	-4.3 ↘	6.6 ↘
Unemployment rate (%)	15.1	17.4 ↗	18.7 ↗	18.9 ↗
CPI (%)	10.1	5.5 ↘	3.9 ↘	4.5
Trade balance (USD billion)	-13.17	-11.58 ↗	-11.69 ↗	-12.37 ↗
Current account balance (USD billion)	-9.98	-6.65 ↗	-7.37 ↗	-7.99 ↗
Current account balance (% GDP)	-6.3	4.0 ↗	-4.0 ↗	4.0 ↗
Central budget balance (PLN billion)	-15.39	-32.58 ↘	-44.61 ↘	-44.38 ↘
Public sector balance (% GDP)	-2.6	-5.5 ↘	-6.5 ↘	
Exchange rate (average)				
PLN/USD	4.35	4.09 ↘	4.14 ↘	4.30 ↘
PLN/Euro	4.01	3.67 ↘	3.76 ↘	4.08 ↘
Proad money supply M2 (change in %)	11.8	13.6 ↗	3.4 ↘	4.9 ↘
Interest rate of NBP (28-day reference rate)	19.0	11.5 ↘	7.5 ↘	6.5 ↘
WIBOR 3M	19.6	12.3 ↘	9.8 ↘	9.0 ↘

Note: Arrows point the direction of changes compared with the previous outlook

interest rates and inflation allow us to expect stable households consumption over 2002 as a whole.

We expect to see economic revival in 2H02, when growth factors are set to strengthen. The revitalisation of external demand alongside stable consumption over the last few quarters should help attract more investment. However, continued restructuring of employment, overlapping with various demographic factors, may aggravate unemployment further. We expect the 2002 budget to be as difficult as in 2001. According to our forecasts, due to non-fulfilment of revenues the budget deficit will increase to PLN44.6 billion from the PLN4.0 billion planned in the budget. 2002 is expected to see a dynamic increase in the budget's financial needs reaching a level of PLN120 billion. The rollover of Treasury bills issued in previous years and a growth in the budget deficit are likely to be the direct causes of this. If the economic recovery is slower than forecast, a slump in public finances will be more probable.

The growing fiscal expansion may lead to a further crowding-out of the private sector and stunt a dynamic recovery in investments. Added to this, the budget shortfall is likely to have a strong influence making the zloty less stable, which in turn may increase inflation followed by interest rate hikes at year-end.

Waiting for Godot?

If we see no economic recovery by the end of 2002 and in 2003 does that mean we will be waiting for the proverbial Godot? Our forecast suggests not. Expectations of a recovery in the global economy are more widespread than those of a slump. Stable consumption, together with improvements in the external situation, offer hope of an economic breakthrough. The price of enterprise restructuring paid in the form of high unemployment should provide a more efficient basis on which such a recovery can be built. The high budget deficit is also sustainable during the current year.

However, this positive outlook could in fact take Beckett's path if the risks outlined in our forecast materialise. These include a delay in the global recovery, unsustainable budget discipline and a slump in public finance, a weakening of households consumption, a strong correction in the zloty exchange rate, as well as fulfilment of the expansionary economic policy plans presented in the government's program. We re-emphasise the necessity of public finance reform, both on the expenditure and revenue sides, as well as liberalisation of the labour market. Lack of reform would rule out the chances of sustainable economic growth and intensify existing problems.

Economy in Q4 2001

Economic growth

Katarzyna Piętka

GDP and demand factors

- **Stagnation of the economy**
- **Falling investment compensated by consumption and export growth**

Data from 3Q01 and CSO (Central Statistical Office, GUS) estimates for 2001 as a whole show that the weak economic situation, growing real interest rates as well as the poor profitability of enterprises impacted on a lowering of investments. Investments continued to fall in 4Q01 (by 14% compared to 4Q00), dampening GDP growth to just above zero. This drop is related to the recession in the construction sector – sold production in the sector continued to fall alongside a slowing rate of growth in space of house and apartment building. Moreover, sold production and imports of machinery worsened and the transportation industry registered only a slight improvement.

An indication of this falling trend are estimates of enterprises' means of financing investments. The already low gross profitability of enterprises deteriorated further. One should note that enterprises finance a large part of their investments from their own funds – 52% in 1999 (latest available data). During this time real interest rates rose, despite the National Bank of Poland (NBP) continuing to cut its rates. This resulted from a faster decline in the PPI than credit rates in the banking system and partly explains why enterprises repaid their credits on a net basis. Taking into account their net deposits enterprises' net savings reached 18 billion zlotys in 4Q01 – three times more than in the same period the year before.

Household consumption gathered pace in 4Q01. We see this more as an effect of the lower savings rate than higher real income growth. Our estimates show that the total wage bill and mixed income dropped in real terms. Only social transfers, which gained from last year's delayed indexation, grew at a significant pace (about 9% in real terms), allowing total household incomes to register growth (close to 1%), though lower than in the previous quarter. Despite government attempts in November to tax interest on deposits under a new capital tax, household savings increased by less than in the same period the year before. This indicates that a slowdown in income growth inclines people to limit their savings, at least in this case. Public consumption also accelerated, in line with the substantial increase in real budget expenditures in 4Q01.

The acceleration of consumer demand did nothing to stave off the falling trend in investments, resulting in domestic demand dropping for the fourth consecutive quarter. On the upside, suppressed demand dampened imports to such an extent that, despite slower export, net exports continued to contribute positively to GDP growth.

2001 saw GDP growth at 1.1%. This was largely due to positive net exports – as domestic demand, driven by lower investment, fell by 2.0%.

At the end of 2001, the CSO corrected its quarterly GDP components for 2000–2001. However, GDP as a whole did not change (either on a quarterly or annual basis).

Katarzyna Piętka

Real sector

- **Deepening recession in construction and industry**
- **Continued growth in market services**

Weak domestic demand impacted negatively on the supply side. In 4Q01 both sold production in industry and construction continued their falls. Stable exports appear to be insufficient in themselves to compensate for weak domestic demand for manufacturing. Drops in manufacturing and mining were accompanied by a more than 10% growth in energy sector sales.

Stable growth in consumer demand meant that market services were able to register an increase in value added, across all the main sectors. In 4Q01 retail and wholesale turnover increased. Transportation volumes and the number of new telephone connections experienced smaller drops than in the previous quarter. We estimate that other sectors saw continued stable growth, with market services' total value added growing faster than in the previous quarter.

According to the CSO, value added in agriculture decreased in 2001. This, oddly enough, after a good year in farming and output increases (in particular in grain production). One would most likely assume a commensurate rise in intermediary consumption on the back of such growth and therefore also a rise in value added. However, in order to follow the CSO estimates, we accept high intermediate consumption in 4Q01 and a fall in value added in the agriculture sector. We do not rule out the possibility that the CSO will soon correct its agriculture figures in plus. These changes, however, do not impact significantly on GDP growth as the share of the agriculture sector in GDP is very low.

In 2001 as a whole, the recession in construction and drops in industry as well as in agriculture were compensated by growth in services.

Anna Myślińska

Enterprise Finances

- **Enterprises face tough financial conditions**
- **Private sector to see relatively better situation**

Central Statistical Office data show that the financial situation of enterprises slightly improved in 3Q01 (in comparison with the previous quarter). However, this improvement is to some extent a result of seasonality: both financial results and profitability remain at a lower level than in the same period the year before. The liquidity ratio of the first degree increased significantly. This indicates that the value of cash equivalents and securities designated for turnover increased faster than the increase in short-term liabilities. Central bank data show that the growth rate of outstanding trade credits extended by foreign firms decreased in 2001, reflecting caution among entrepreneurs.

According to our estimates, the situation of enterprises worsened in the last quarter of 2001 (in comparison to the corresponding period of the previous year). The decline in producer prices and industrial production and construction sales impacted negatively on incomes. Moreover, the increase in nominal wages was larger than the reduction in employment, therefore limiting the possibility of cutting costs. In CSO's December survey of business confidence, the majority of entrepreneurs rated their current financial situation 'bad' and said they also not expected to improve in the nearest future. As a consequence, investment stimuli in 4Q01 were very subdued.

One should note also the growing contrast between the results of the private and public sectors[1]. Private enterprises have tended to cope far better during hard economic conditions. CSO data for the first three quarters of 2001 even suggest an increase in employment in the private sector (in contrast to the reduction in the public sector). Differences can be also observed in the key sectors: employment reductions in industry, construction and trade are smaller in the private sector than in the public sector. Private sector employment increases (in contrast to the drop in the public sector) were seen in private transport, storage and communication – to a large extent caused by the privatisation of TP S.A. (classified as a private sector enterprise since 2001) – as well as in other sectors.

Moreover, wages grew more slowly in private sector than in public sector firms, though are higher in the public sector. The private sector also saw an increase in sold production and only a slight worsening of gross profitability in the first three quarters of 2001. During the same period public enterprises experienced trends in the opposite direction. These indicators remain in line with the more pronounced decline in investments in the public sector.

Piotr Bujak

Labour market

- **Increase in unemployment and drop in employment**

Unemployment

The situation on the labour market continued to worsen in 4Q01. Sharply declining demand for labour led to an increase in the number of unemployed and the unemployment rate. In comparison with the previous quarter, this stemmed from seasonal factors, though on a yearly basis all negative tendencies were maintained. The number of registered unemployed exceeded 3 million in November, and at the end of December was 3.115 million, rising on average in 4Q01 by 15.3% qoq. As a result, registered unemployment at year-end reached 17.4% – a record level of unemployment since the beginning of the Polish transition.

One of the main reasons for unemployment growth is the on-going and deep restructuring of the enterprise sector. At the end of December, enterprises declared over 100,000 dismissals, almost 30 percent more than in the analogous period of the previous year. The number of job offers was lower. Enterprises, adjusting their activity downward to meet weaker demand, cut both investment and employment. The fall in investments over the whole economy, especially in construction, has been a direct cause of employment cuts. The strongest decline of employment was recorded apparently in constructions.

Since mid-2001 the number of unemployed entitled to unemployment benefit has increased, in 4Q01, on average, by 13.5% yoy. Moreover, the total number of people with the right to claim unemployment benefit or pre-retirement benefits increased by almost 30% yoy at the end of December. The situation on the labour market is becoming an increasingly serious political problem and a burden on the public finances.

According to the latest Labour Force Survey data (LFS), the unemployment rate in 3Q01 stood at 17.9%, indicating a seasonal fall in comparison with the previous quarter, but a significant increase with respect to the corresponding period of the previous year. The number of unemployed amounted to 3.127 million in 3Q01. This means even stronger unemployment hike over the year than in the case of registered unemployment.

[1] The public sector is comprised of state and local government administration enterprises. The private sector consists of privately owned units, both domestic and foreign. In the case of enterprises with "mixed" ownership the dominance of either private of public stakes is the key determining criterion for statistical classification purposes. Comparisons of the public and private sectors may be distorted by sales of the state's shares resulting in a change of statistical classification of a given enterprise.

Employment

CSO data indicate that the downward trend in employment in the enterprise sector even strengthened in 4Q01. In December, employment in the sector was by 4.7 percent yoy and in 4Q01 by 4.5 percent yoy lower. This is the largest drop since 1Q93.

LFS results also confirm a further decline in labour demand. In 3Q01, the working population was 14.383 million, a fall by 344,000 or 2.3 percent yoy. A shorter average working week and fewer people with more than one job also indicate that labour demand is waning.

Wages

Average wages and salaries in the enterprise sector grew by 5.3 percent yoy in nominal terms in 4Q01. On average, 4Q01 marked an increase in wages and salaries by 6.5% yoy in nominal terms and by 2.6% yoy in real terms.

Despite increase in real wages in 4Q01, the large fall in employment resulted in a wage bill fall in the enterprise sector in real terms. For 2001 as a whole, wages and salaries in the enterprise sector grew on average by only 1.6% in real terms, a lower dynamic than in 2000.

EU negotiations

On 21st December, Poland tentatively closed its EU negotiation chapter concerning the free movement of labour. The main opponents of full liberalisation in this area immediately after enlargement were Austria and Germany, both concerned about a possible increased inflow of Polish workers on to their markets. Eventually, it was decided that constraints on free labour movement would be maintained up to 7 years after the accession date. However, the negotiation standpoint accepted by the Polish side provides for a possible suspension of such limitations 2 years after entry. Given the demographics of most EU members, including Germany and Austria, one may expect most EU countries to be forced to open their labour markets much earlier to workers from the new members. This also appears to be corroborated by declarations made by various EU figures.

Prices

Mariusz Jarmużek

Main price indices

• Further disinflation

In 4Q01, the disinflation process again speeded up. This was possible due to favourable supply factors, the appreciation of the zloty and general economic slowdown. Among supply factors, falling world oil prices accompanied by the strong zloty allowed for a domestic fuel price reduction of over 13% in 4Q01. Moreover, the high harvest, supported by good weather conditions, as well as stocks of unsold cereals from 2000 and tariff-free imports from the first half of 2001 led to the significant oversupply of cereals and falling prices. Also, meat prices were on a downward trend, mainly due to weak domestic demand and increased imports. Meat imported from the EU is subsidised and this, combined with the strong zloty, makes is cheaper than meat produced in Poland.

Favourable supply factors were accompanied with weak domestic demand. High interest rates discouraged new credits. The wage growth rate lower than in 2000 reflected the weakening of demand for labour and diminishing inflationary expectations. The strong zloty lowered transaction import prices, which contributed additionally to slower growth in consumer prices.

This slowdown in the CPI reflected trends in producer prices. PPI trends were negative in 4Q01, due in part to weak domestic demand limiting sales of products, the stronger zloty and remaining tariffs for gas. The biggest price fall was seen in manufacturing. Energy, gas and water prices, despite the delay in introducing higher gas tariffs, grew three times faster than the CPI.

The URE (Energy Regulatory Office) has not yet accepted the new gas tariffs applied for by PGNiG

(Polish Oil and Gas Company). URE decided that the proposed price hikes are still too high. Settlement of accounts is therefore still according to the old tariffs.

Katarzyna Zawalińska

Agricultural commodity prices

On 14th December 2001 the CSO made a downward correction of preliminary estimates for the grain harvest in 2001. The new figure – 27 million tons – was still 21% higher than in 2000, with wheat and rye production up 9.2% and 21.5% respectively. The procurement of basic cereals between July and November 2001 was 13% higher than in the same period the year before. According to CSO preliminary estimates, winter grain sowing for the 2002 harvest, was 2.4% lower than for the 2001 harvest.

Grain imports in the trading year July 2001/ June 2002 did not increase substantially. The size of the imports – 240,000 tons – was 80% lower than in the same period of the previous year. Higher imports of wheat for consumption were registered only in November 2001 (20,000 tons). On the other hand, meat imports rose. This, combined with November drop in meat exports, led to an increase in the meat supply on the domestic market.

The three-month stagnation of cereal prices came to an end in the middle of 4Q01. Both retail and wholesale prices changed. In December, the average procurement wheat price fell 12% to 46.5 PLN/dt (yoy), and the rye price – although higher than in previous months – dropped by 12.5% yoy.

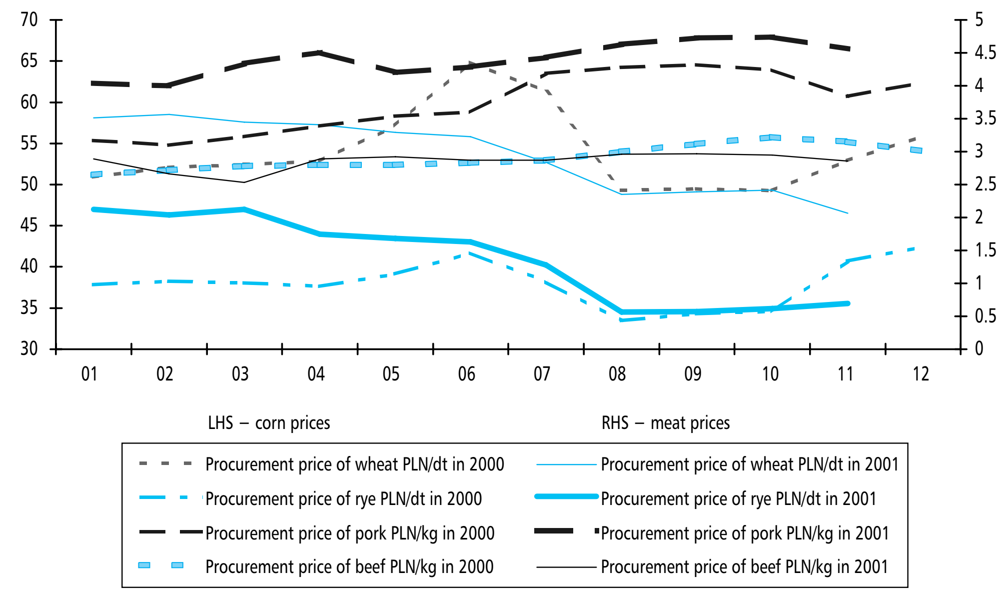
Both market and procurement beef prices were fairly stable over the quarter, though procurement prices saw a 7% drop compared to 4Q00. Pork, on the other hand, was more expensive – market and procurement prices increased by 14% and 13% respectively compared to the same period the year before.

Przemysław Woźniak

Core inflation

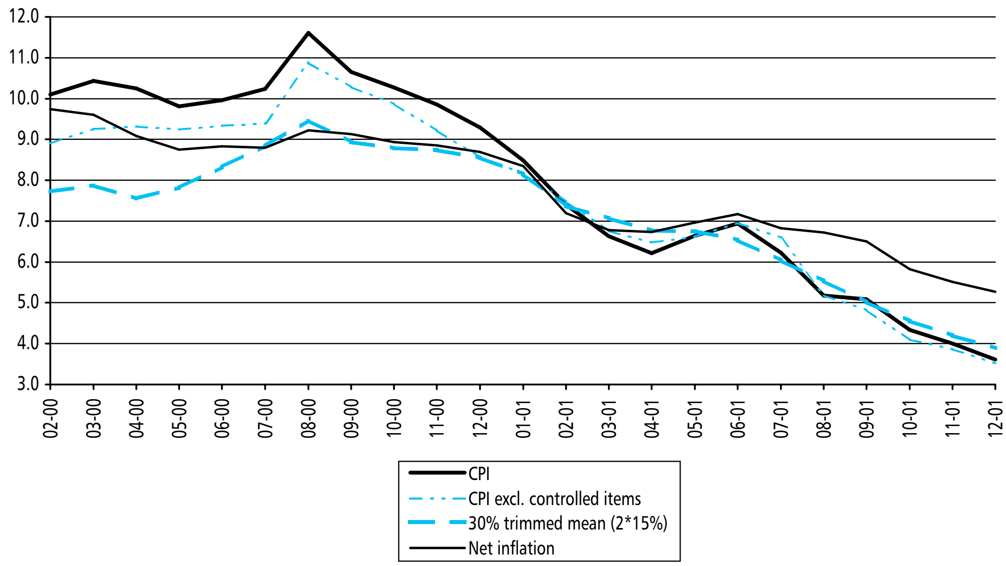
In 4Q01 all core inflation indicators calculated by the (central bank) NBP fell, though not all at the same rate: core inflation excluding administratively controlled prices fell most, with the net inflation index

Chart 2.1. Prices of main agricultural commodities, 2000–2001



Source: Central Statistical Office and Agricultural Market Agency.

Chart 2.2. Core inflation, 1999–2001 (% changes, yoy)



Source: Central Statistical Office, Central Bank NBP, and CASE.

seeing the smallest drop. Since early 2001 the disinflation rate, measured by net inflation (eliminating food and energy prices), has been significantly slower than that indicated by headline inflation and the remaining core indices. This is due to the fact that food and energy prices (excluded from net inflation) were subject to sizeable cuts over the period and were driving the entire disinflation process in the Polish economy. In December 2001 fuel was over 10% cheaper than during the same month the previous year and many staple foods registered significant nominal price declines, among them: poultry, almost 12%, eggs, butter and flour of almost 10% and sugar, 7% (yoy). These decreases dampened the inflation rate for the entire food component of the CPI to 1.6 % in December 2001 (on an annual basis). This was the primary reason behind the widening deviation of net and headline inflation to 1.5 percentage points.

Core inflation excluding administratively controlled goods has been running parallel to headline inflation in recent months. This clearly indicates a neutralising of inflation pressures coming from these goods and services (pressures that were substantial in previous years). Currently, price adjustments exceeding the rate of headline inflation are being witnessed only in the energy sector: electricity prices rose by 14% (end December yoy), pipeline gas prices by 15% and hot water prices by 10%. The telecommunication sector has recently been dominated by price decreases (with the exception of a rise in the telephone subscription fee in May 2001). Prices of remaining controlled goods roughly mirrored headline inflation or fell in nominal terms (for example bottled gas, water, air transport and gasoline). The cumulative effect of those changes was neutral on the headline index, with both indices exhibiting matching downward trends in recent months.

A similar trend has also been exhibited by the trimmed mean (which eliminates the 15% largest and 15% smallest price changes). This measure is considerably more stable than other core indices because it eliminates short-term reversible shocks. The convergence of trimmed mean and headline inflation indicates that the acceleration of the disinflation process witnessed in recent months has not been the result of temporary, reversible, supply-side phenomena (their effect is eliminated from the trimmed mean), but is solidly grounded and encompasses all prices. The low annual growth of the trimmed mean (3.7% in

December) confirms the strong disinflationary tendencies across the economy and its near-equality with the headline inflation (3.6%) suggests that these tendencies are likely to prevail in the coming months.

External sector

Rafał Antczak

Exchange rate

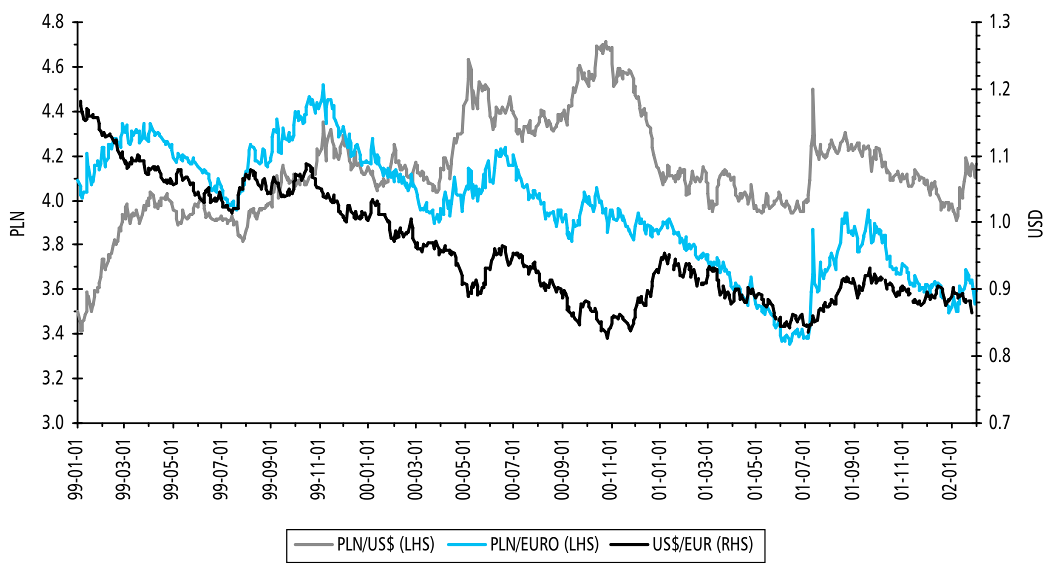
- **Nominal zloty appreciation in 2001**
- **Stabilisation of euro-dollar exchange rate**

During 2001 the zloty appreciated by 3.8% against the dollar and 8.6% against the euro. Zloty appreciation was especially strong in 4Q01 – 5.9% against the dollar and 9.3% against the euro. There were several key factors pushing this year-end appreciation. Firstly, foreign investors' share of Treasury papers on the primary market continued to grow, reaching 6.9% in November and 9.2% in December, after a decline to 1.8% in September. These were mainly investments in two- and five-year bonds. This growth in foreign investor activity on the bond and derivatives markets in 4Q01 followed cuts in NBP interest rates and expected cuts as a result of government pressure on the Monetary Policy Council (RPP).

The second factor was the US$2.9 billion decline in the current account deficit compared to the previous year. Capital inflow into the capital and financial accounts was over US$4 billion lower than in 2000. However, this was mainly the result of a settlement of Poland's sovereign debt to Brazil prior to maturity (US$2.5 billion), which at the same time reduced the level of international reserves from US$28.9 billion in September to US$26.1 billion in November. The lower surplus on financial account was largely the result of the government's failure to bring in any more than one third of all planned privatisation receipts in 2001. FDI fell US$1.7 billion compared to 2000 as a consequence.

During 4Q01, the euro-dollar exchange rate had negligible influence on the zloty exchange rate. After a significant depreciation in 1H01 and a low-point of 0.837 euro/US$ (July 5, 2001) the rate stabilised at around 0.90 euro/US$ in 2H01. During 2001 as a whole the dollar strengthened 3.9% against the euro, or two-times lower than in 2000. The stabilisation of

Chart 2.3. Zloty exchange rates against the dollar, euro and the currency basket, 1999–2001



Note: The currency basket is made up of the euro (60%) and the US dollar (40%).
Sources: Central Bank NBP, The Federal Reserve.

the euro-dollar exchange rate since the beginning of 2H01 was made possible by the convergence of interest rates in the USA and in the EU, in line with weakening and increasingly similar GDP performances in both economic areas.

Łukasz Rawdanowicz

Foreign Trade

- **Trends from previous quarters maintained**
- **Good export performance**
- **Improvement in terms of trade**

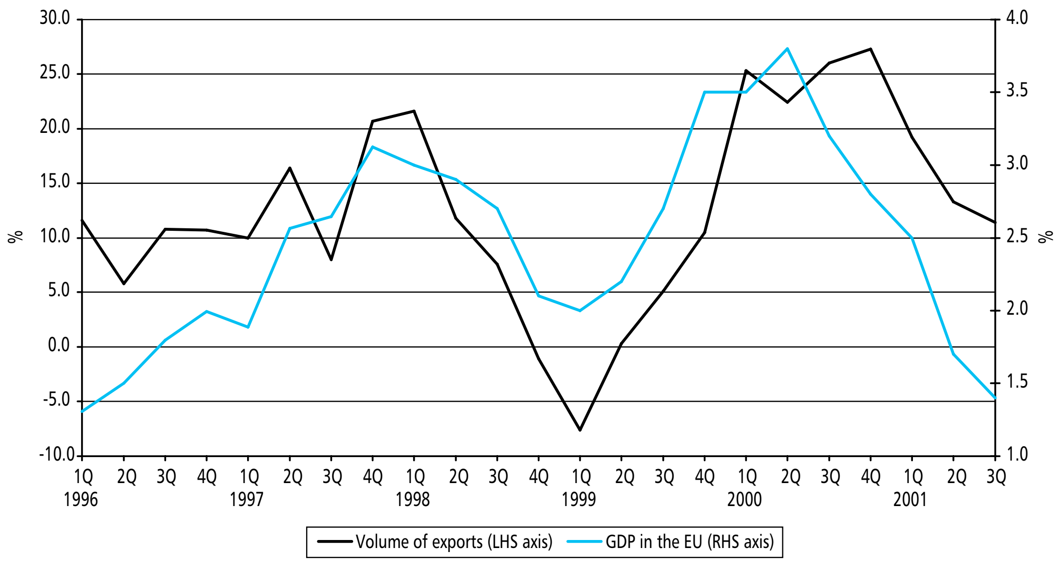
The main trends in Poland's foreign trade stayed on the same tracks in 4Q01 as in previous quarters, with both import and export growth slowing. Weaker exports stemmed from the poorer economic performances of Poland's main trading partner, the EU, and imports were dampened by weak domestic demand.

According to preliminary NBP data for 4Q01, exports in the balance of payments amounted to US$7.9 billion. This is a good result given the strong zloty and the significant downturn in the EU, in particular in Germany, which may even see GDP contraction in 4Q01. On the other hand, robust economic growth in Russia and Ukraine boosted Polish exports. Advanced figures for Ukraine and Russia point to 9.0% and 5.0% GDP growth in 2001 respectively. Both countries are among Poland's ten biggest export markets. Exports to Russia and Ukraine (in dollar terms) saw some of the highest increases in the period January-November. Weak domestic demand and continued decline in the PPI were still factors boosting export activity.

The low level of imports (according to preliminary data US$10.9 billion in the balance of payments) was caused by very weak domestic demand. Neither demand for investment and intermediate input goods (investment and industrial production continued to decline) nor consumer demand (moderate household spending) stimulated imports, despite the strong zloty.

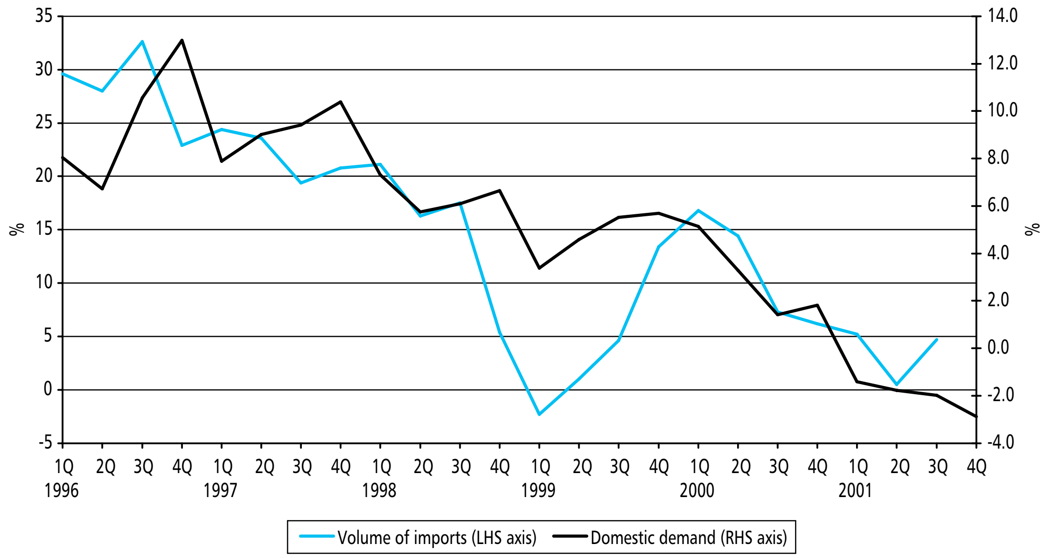
3Q01 saw a continuation of the favourable trend in the relative prices of exports and imports. The terms of trade stood at above 100 and they improved in comparison to previous quarters. The lower growth in import than in export prices stemmed primarily from falling world oil prices. We expect to see a similar figure in 4Q01 for terms of trade as in 3Q01.

Chart 2.4. Export volumes and GDP in the EU, 1996–2001 (% change, yoy)



Note: Volume of merchandise exports only.
Source: Central Statistical Office and Eurostat.

Chart 2.5. Volume of imports and domestic demand, 1996–2001 (% change, yoy)



Note: Volume of merchandise imports only.
Source: Central Statistical Office and CASE.

Łukasz Rawdanowicz

Balance of Payments

- **Record-low current account deficit in 2001**
- **Moderate capital inflows**

In 4Q01, the current account deficit (US$1.7 billion, according to preliminary data) increased slightly over the previous quarter. This was due to the postponement of interest payments on foreign debt from September to October. Had the payment been made on schedule, the current account would have been almost US$300 million lower. Nonetheless, the deficit was still smaller than the previous year.

In 4Q01, on top of a stable merchandise trade deficit (US$ 3.0 billion), the unclassified current transactions surplus remained high (US$1.3 billion). However, it should be noted that the data on unclassified current transactions for November and December were adjusted for the changeover of currencies in the euro zone. The total amount of these transactions, estimated at nearly US$740 million, was finally classified in the balance of payments errors and omissions item. The unprecedented increase in foreign currency transactions at exchange bureaux and banks during the last two months of 2001 was key reason behind this adjustment in the data. Moreover, there were no reasons to expect a sudden revitalisation of cross-border trade in 4Q01. The extrapolation of trends in the number of crossings of Polish borders from the first three quarters of 2001 indicates no change in 4Q01. In January-September 2001 the number of people crossing Polish borders declined in comparison to the corresponding period of 2000. This concerns both Polish citizens and foreigners. Only crossings of the Polish-Ukrainian border saw an increase.

According to preliminary data, 2001 saw a current account deficit of US$7.0 billion, i.e. 3.96% of GDP. This result constitutes a significant improvement as compared to previous years. The more balanced external position is attributable to the slowdown in domestic economic activity as well as restructuring of the Polish economy and its resulting higher competitiveness. The lowering of the deficit is very good news, especially in the face of smaller FDI inflows, which are an important source of financing the deficit.

4Q01 saw significantly higher FDI, of US$2.5 billion, in comparison to the previous quarter. Despite this, total FDI inflows in 2001 were almost US$1.7 billion lower than in 2000. Portfolio capital hit US$621 million in 4Q01, primarily in debt instruments. However, December saw an outflow of US$141 million and over 4Q01 the Polish banking sector once again transferred abroad a large amount of money: US$2.6 billion was placed in foreign banks' current and saving accounts.

At the end of 2001 official gross reserve assets stood at US$26.6 billion, lower in comparison to the end of September. This was due to the repayment of debt to Brazil. Notwithstanding, at the end of December official gross reserves were still large enough to cover more than 7 months of average imports.

Małgorzata Markiewicz

Public Finances

- **Second budget revision in 2001**
- **Expenditure cuts at end of the previous year**
- **Significant growth in public sector borrowing requirements**

In 4Q01 the newly elected government announced plans to cut expenditures by 8.5 billion zlotys. As a consequence, in the middle of December parliament adopted a second revision to the 2001 budget. In the face of a sharp decline in budget revenues it was decided to increase expenditures and the budget deficit by 3.8 billion zlotys.

Preliminary Ministry of Finance data on the execution of the 2001 budget indicate that revenues were more than 12 billion zlotys lower than had been assumed in the second revision of the budget. It is not clear where the parallel expenditure cuts were made. However, official data indicate that payments to the Social Security Fund (ZUS) were 4.6 billion zlotys lower than planned, which indicates a shifting of budgetary problems to the extra-budgetary fund. Lower payments to ZUS caused in turn lower transfer of funds to the second pillar of the pension system. Instead of the planned 14.1 billion zlotys at the beginning of 2001, ZUS transferred to the pension funds only 8.7 billion zlotys over the year. This means that the outstanding liabilities towards pension funds accumulated in previous years were not paid back, and new debts accrued. In a governmental decree on expenditure cuts issued in October 2001, the highest cuts were earmarked in defence, justice and higher education. It was also assumed that special reserves of 1.8 billion zlotys would not be spent.

There were also some savings on foreign debt servicing expenditures, which were 0.5 billion zlotys lower than expected. This enabled a limitation of cuts in other areas. Additionally, the government shunted further expenditures of 52.4 million zlotys into 2002.

In 2001, state budget revenues, as well as indirect tax revenues in real terms (deflated by the CPI) fell by about 2%. VAT revenues dropped more than excise tax. The highest drop was recorded on CIT corporate tax (in real terms by about 27%). As concerning PIT income tax revenues fell in real terms by more than 4%.

Preliminary data confirm public sector institutions' accumulation of debt. This will be reflected in the economic deficit and in public debt figures. At present there is limited data on how state budget difficulties have been reflected in the finances of other public sector bodies.

Table 2.1. Budget 2001 – consecutive versions and execution (in billions of zlotys)

	Revenues	Expenditures	Deficit
Budget law for 2001	161.0	181.6	-20.5
Amendment to the Budget Law of July, 28 2001	152.5	181.6	-29.1
Amendment to the Budget Law of December, 13 2001	152.5	185.4	-32.9
Estimates for execution of the 2001 budget	140.3	172.9	-32.6

Source: Public Debt Department at Ministry of Finance, Central Bank NBP.

There were also difficulties financing the state budget deficit, mainly due to the fact that only 64% of total planned privatisation revenues were incoming (6.5 billion zlotys instead of 10.1 billion zlotys assumed in revised 2001 budget).

Lack of privatisation revenues led to an increase in Treasury securities issues. Moreover, the decision on the repayment of debt to Brazil before maturity led to a growth in domestic public debt doubled the amount planned at the beginning of 2001. Foreign debt was replaced with domestic debt. The government issued Treasury securities nominated in foreign currencies, which were purchased by the central bank (NBP). As a consequence, the structure of NBP assets changed: growth in government securities was balanced by the drop in foreign reserves.

The increase in the supply of Treasury securities did not lead to their higher profitability. On the contrary in fact, the interest on Treasury bills followed cuts in central bank interest rates. This situation was possible only in 2001 due to the significant disparity between interest rates in Poland and on foreign markets and foreign investors' expectations of drops in the NBP's official interest rates.

Local government

At the end of 3Q01 local government noted a total surplus of 2.4 billion zlotys. At the same time, local governments increased their deficit forecasts for the whole 2001 from 5.6 billion zlotys to 6.1 billion zlotys. Local government debts grew, at the end of 3Q01 equalling 10.1 billion zlotys. They are expected to have reached 15.8 billion zlotys by the end of 2001. However, this is mainly due to the inclusion – for the first time – of data on debts of entities controlled or managed by local government in the measure of overall local government debt.

The 2002 budget bill

The 2002 budget bill has already been submitted to parliament, along with a bundle of related bills. The shape of 2002's budget law will be determined by if and in what form these related bills are passed. The second reading of the bill is planned for the beginning of February and up to that point parliament is set to examine the additional bills. Evaluation of the budget law for 2002 will be possible only when it is approved. Until then we only have government declarations to go on.

According to the coalition agreement and the prime minister's inauguration speech public expenditures in the next few years will grow in line with inflation, and the state budget deficit in 2002 will not be higher than 40 billion zlotys. However, execution of expenditures in 2001 was lower than expected. As a result, fixing expenditures for 2002 at 184 billion zlotys means growth in real terms of 2.5%.

The budget bill is based on a cautious forecast for economic growth in 2002 of 1%, though average annual inflation of 4.5%, in the light of recent forecasts, seems to be an overestimation.

Parliament has already fundamentally amended the PIT and VAT bills and bills related to various expenditures. Changes in PIT are expected to stimulate growth in budget revenues of 4.3 billion zlotys in the current year due to (i) the freezing of tax brackets (651 million zlotys), (ii) the introduction of a fixed limit on the deduction of the health system contributions from PIT revenues (830 million zlotys), (iii) the cancellation of tax relief for the building of the premises (198 million) and tax relief for systematic savings in 'dwelling funds,' (iv) the introduction of a capital tax (2 billion zlotys). This growth in the tax burden is expected to lead to a drop in disposable incomes.

A new excise tax on electricity and changes in excise tax rates on cigarettes, fuels and gas have been proposed (a growth in budget revenues of 1.8 billion zlotys). Revenues from the introduction of an excise tax on electricity are estimated at 2.3 billion zlotys.

Only a handful of the proposed changes to the VAT bill have been approved so far. The VAT rate on the sale of dwellings was increased from 0% to 22% and rates for handicrafts were increased from 3% to 22%. The proposal to increase the rate for construction inputs and services from 7% to 22% was not approved (it was expected to increase the budget's tax revenues by 1.3 billion zlotys). It is important to recall that there was an attempt to increase VAT on construction inputs and services a year earlier as a supplementary bill connected with the 2001 budget.

On the expenditures side the government proposed changes in rules governing the indexation of unemployment benefits and the rules for granting pre-retirement and social security allowances. The government-proposed social expenditure measures combined would mean lower budgetary outlays of 2.5 billion zlotys.

Rafał Antczak

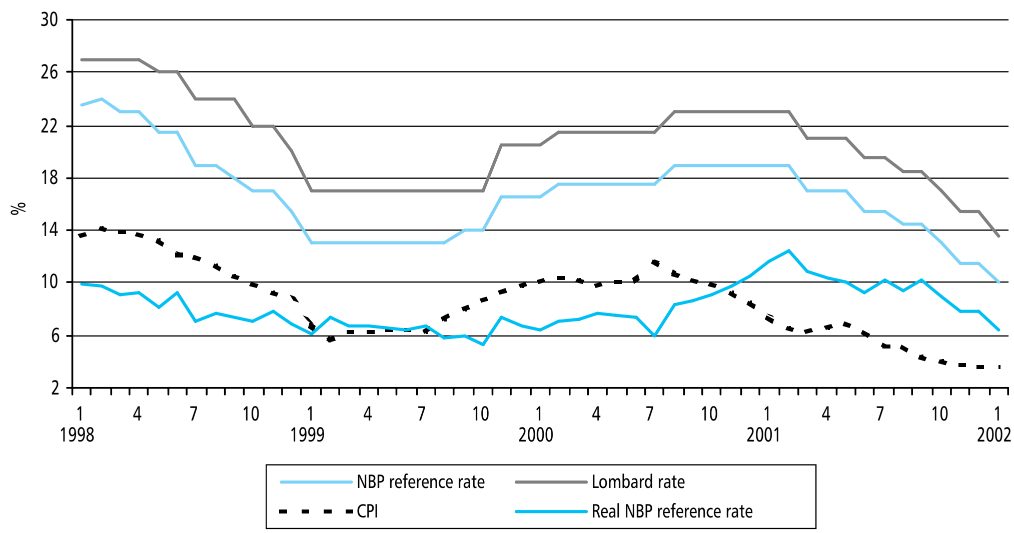
Monetary policy

- **Loosening of monetary policy and disinflation**
- **Decline in savings and beginning of crowding-out effect**

At the end of 2001, the RPP decided to further loosen monetary policy. Two cuts in NBP interest rates (on October 25 and November 28) by 150 basis points each time meant a total of six cuts (750 basis points in total) in 2001. With disinflation at 490 basis points, the NBP's real interest rate (28-day open market operation rate) fell to 7.9% in December 2001 (comparing to 10.5% in December 2000). A further cut in NBP rates by 100–200 basis points in January 2002 reduced real NBP rates to 6.4%, assuming that the inflation rate remained unchanged.

The growth in the supply of reserve money by 22% in 2001, alongside a decline in net foreign assets in the course of 4Q01 resulted from the growth in credits to the budget and private sector as well as a valuation adjustment as a result of the zloty's nominal appreciation. In November, the net budget debt grew on the back of the issuance of US$8.7 billion dollar-denominated bonds to the NBP in exchange for foreign currency reserves on payment of sovereign debt to Brazil before maturity. In December, net budget debt increased again (by PLN6 billion) due to the withdrawal of all budget sector deposits in the NBP. As a result, net budget debt to the NBP increased by PLN3.8 billion in 2001, reaching the level of PLN10.7 billion in December.

Chart 2.6. Monetary policy instruments, 1998–2001



Notes: The real NBP reference rate is calculated as the difference between the NBP reference rate and CPI.
Source: Central Bank NBP and CASE.

Table 2.2. Contributions to money supply dynamics, 1999–2001 (cumulative % change)

	2000				2001			
	I	II	III	IV	I	II	III	IV
Reserve money (RM)	-14,4	-1,8	-3,2	-7,6	-1,0	-0,5	-1,0	22,4
Net foreign assets (NFA)	0,4	-5,7	12,0	18,8	-1,5	-12,2	-25,3	-11,9
Net domestic assets (NDA)	-1,9	9,2	1,0	-9,5	-5,9	-3,3	-7,3	7,6
Net claims on government (NCG)	-1,6	9,8	1,5	-9,1	-6,7	-4,8	-11,7	7,7
Claims on deposit money banks (CDMB)	-0,3	-0,7	-0,6	-0,4	0,8	1,5	4,4	-0,1
Other items net (OIN)	-12,9	-5,3	-16,2	-16,9	6,5	15,2	31,5	26,7
Broad money (M2)	-0,6	8,1	6,5	11,8	2,2	4,4	8,9	13,6
Net foreign assets (NFA)	1,8	0,5	3,9	9,7	1,0	-1,5	-4,6	1,9
Net domestic assets (NDA)	-0,5	8,1	8,1	6,3	-0,3	2,0	7,6	10,8
Net claims on government (NCG)	-3,6	-2,3	-2,6	-5,3	-1,8	-0,5	1,0	5,8
Claims on deposit money banks (CDMB)	3,1	10,4	10,7	11,5	1,6	2,4	6,6	5,1
Other items net (OIN)	-1,9	-0,6	-5,6	-4,2	1,5	4,0	5,9	0,9

Note: Contributions to money supply dynamics are calculated using the following formula: $\Delta M/M_{-1} = \Delta NFA/M_{-1} + \Delta NCG/M_{-1} + \Delta CDMB/M_{-1} + \Delta OIN/M_{-1}$ 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.
Source: Central Bank NBP and CASE.

The banking system and broad money

Commercial banks' reaction to the significant NBP rates cuts in October and November 2000 was even weaker than the NBP cuts spread over March, June, and August 2001. Starting from 2Q01, commercial banks' spread has increased, reaching around 850 basis points at end-year. A comparison of the central bank and commercial bank rates in January-October, 2001 (taking into account a one-month lag in commercial banks' moves after RPP decisions) indicates that a cut in the NBP rates of 600 basis points resulted in 450 basis points cuts in credits to companies and only 100 basis points cuts in credits to households. At the same time, interest rates on deposits were down by 450 and 520 basis points, respectively. Commercial banks' scepticism towards lowering interest rates to households was therefore continued – which is understandable in the context of worsening macroeconomic and labour market performances.

The pace of broad money growth in 2001 was determined by an increase in domestic credit, equally divided by credit to the government and private sector. Government debt continued from November, resulting from growth in debt to the NBP. All central and local authority bank deposits had already been emptied by December.

One key negative trend observable during the last months of 2001 was growth in short-term budget debt. While short-term budget debt fell by PLN4.9 billion in 2000, it increased by PLN7.3 billion in 2001 and by PLN2.8 billion in December 2001 alone.

Irrespective of the different attitude of banks towards creditors, credit dynamics lowered both for households and companies – in December, credit growth was, respectively, 14.6% and 5% (against 31.7% and 13.5% in 2000). Companies also increased bank deposits (by PLN13.2 billion in 4Q01), which may indicate a flight to liquidity together with growing business risk.

A decline in interest rates, together with levied tax on bank interest rates and a worsening of household incomes resulted in a significant weakening of growth in zloty household deposits (to 11.7% in December 2001 compared to 24.7% in December 2000). Preliminary November data (the last month of 2001

Table 2.3. Calendar of the most important events in the NBP's monetary policy, 2001

Source	Date of the resolution	Events
J NBP No. 3	February 28, 2001	Interest rate on NBP current deposits 6.6%
J NBP No. 3	February 28	Rediscount rate 20.5% Lombard rate 22% Refinancing rate 22/23% Reference rate at min. 18%
J NBP No. 4	March 28	Rediscount rate 19.5% Lombard rate 21% Refinancing rate 21/22% Reference rate at min. 17%
J NBP No. 5	March 30	Interest rate on NBP current deposits 6.3%
J NBP No. 8	June 21	Rediscount rate 18.0% Lombard rate 19.5% Refinancing rate 19.5/20.5% Reference rate at min. 15.5%
J NBP No. 9	June 29	Interest rate on NBP current deposits 5.85%
J NBP No. 12	August 22	Rediscount rate 17.0% Lombard rate 18.5% Refinancing rate 18.5/19.5% Reference rate at min. 14.5%
J NBP No. 13	August 24	Interest rate on NBP current deposits 5.55%
MP No. 34/562	September 26	Release of the monetary policy guidelines for 2002, inflation target for end-2002 set as 5% +/- 1percentage point
Dz. Urz. NBP Nr 17	October 25	Rediscount rate 15,5 proc. Lombard rate 17,0 proc. Refinancing rate 17,0/18,0 proc. Reference rate at min. 13,0 proc.
Dz. Urz. NBP Nr 20	November 28	Rediscount rate 14,0 proc. Lombard rate 15,5 proc. Refinancing rate 15,5/16,5 proc. Interest rate on NBP current deposits 7,5 proc. Reference rate at min. 11,5 proc.
Dz. Urz. NBP Nr 23	December 19	Banks reserve rate 4,5 proc. From January 1, 2002
Dz. Urz. NBP	January 2002	Rediscount rate 12,0 proc. Lombard rate 13,5 proc. Refinancing rate 13,5/14,5 proc. Interest rate on NBP current deposits 6,0 proc. Reference rate at min. 10,0 proc.

Source: Journal of the National Bank of Poland, Monitor Polski, and own compilation.

when it was still possible to avoid taxation on interest) indicates the establishment of long-term bank deposits in total amounting to PLN11 billion and an flow of PLN4 billion into investment funds.

Growth in currency in circulation in 4Q01 appears to go against the post end-2000 tendency. It is difficult to provide definitive reasons of this, though they perhaps include the increase in cash transactions resulting from enterprises' payments difficulties, the increase in the grey economic activity, the decline in interest rates on bank deposits strengthened by nominal money illusion (quick disinflation), as well as the introduction of the euro and the exchange of withdrawing currencies (especially Deutsche marks) on the zloty.

The increase in broad money supply in 2001 was high, amounting to 13.6% at the end of 2001. The money multiplier fell to the level of mid-2000, together with limited credit activities of banks. It combines low interest in credits offered by both the commercial banks and creditors. The value of Treasury papers in banks' portfolio increased by PLN12.2 billion in the period November 2000-November 2001 – in the same period of 1999–2000 it declined by PLN2.7 billion. This indicates a 'crowding-out' effect in the banking sector of private investments by credits to the state budget.

Piotr Bujak

Financial markets

- **Continued expectations of interest rates cuts**
- **Liquidity problems on money market**
- **Operations aimed at reducing refinancing risk of public debt**

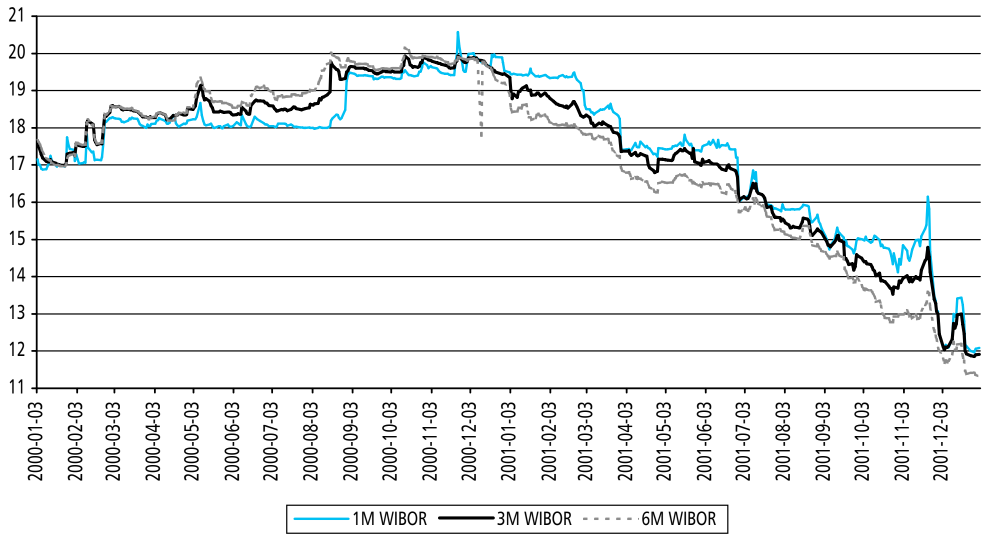
Short-term interest rates

4Q01 saw a gradual fall in interest rates on the interbank money market. In the beginning of October, the NBP's directly controlled 1-month WIBOR rate stood at 15.01%, at the end-December dropping to 12.08%. At the same time, 3- and 6-month WIBOR rates fell from 14.50% and 13.77% to 11.91% and 11.32%, respectively. However, the direction of rate changes was not uniform over 4Q01 as a whole.

During the first twenty days of October FRA (Forward Rate Agreement) rates gave the strongest indications of expectations of official rate cuts over a 3-month horizon from the start of the year. The expectations become even stronger after the MPC's decision to reduce the national bank's base rates in October and fell only after subsequent next cuts in November.

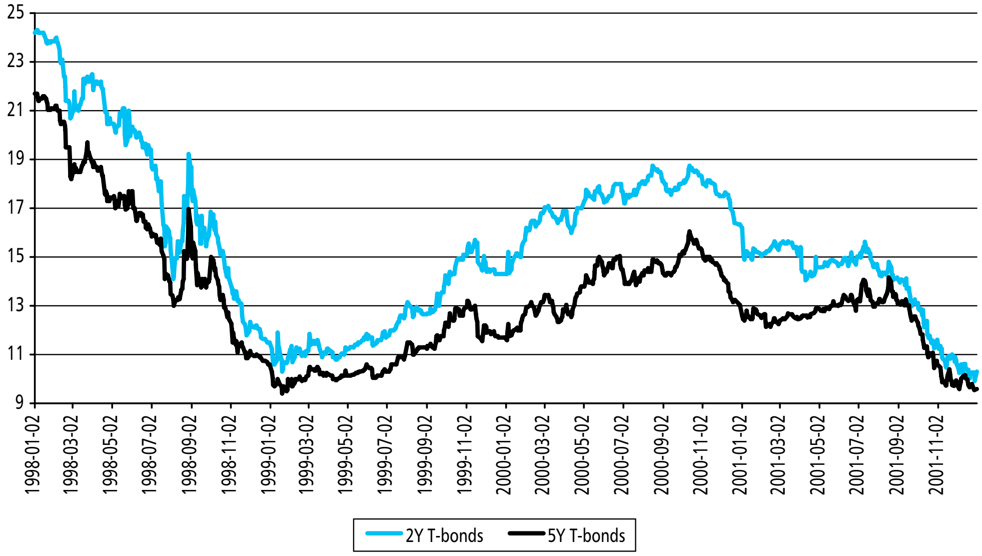
Up to the MPC's October meeting all interbank money market rates were gradually falling. Subsequently rates increased and stayed high until the MPC's November 22nd meeting. Market rates rose far above the reference rate of 13%. On November 21st, 1-month and 3-month WIBOR rates rose to 16.15% and 14.79%, respectively. This was the result of several factors, which, occurring simultaneously, caused serious liquidity problems on the money market. The key reason was that a handful of commercial banks

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



Source: Central Bank NBP.

Chart 2.8. Yield to maturity of 2Y and 5Y Treasury bonds, 1998–2001 (%, daily quotations)



Source: Central Bank NBP.

overbid on NBP bills market. Thus, their speculative purchases of NBP money market bills forced them to borrow on the interbank market. Additionally, the liquidity of the market was limited by the fact that banks had to replenish reserve requirement balances between 10th and 20th of November. At the same time the NBP withheld making any extraordinary operations that would have injected some liquidity into the banking system. However, at its November meeting, the MPC announced the introduction of a deposit facility to reduce volatility of short-term interest rates. In order to facilitate banks' liquidity management the NBP also announced the introduction of intra-day credit and the publication of daily information on reserve requirements and banks' balances at the NBP. These changes bring the NBP's instruments closer to those used by the ECB.

Towards the end of November the liquidity situation on the money market stabilised, mainly due to the inflow of liquidity from maturing NBP bills. In December, apart from a temporary and small mid-month increase, all money market rates fell.

The Treasury debt securities market

The prices of all Treasury debt securities rose in 4Q01. This resulted in a parallel downward shift of the yield curve. Temporary yield increases were seen only in the middle of November and the beginning of December. This stemmed from turmoil on foreign markets, which inclined some investors to cash in any gains from the Polish market.

In November, the Ministry of Finance introduced a new instrument of a public debt management – switching operation in which one type of security may be bought in exchange for another one. The main goal of the operation is a limitation of risks involved in the refinancing of public debt.

Also, in order to avoid cumulating of refinancing needs the Ministry of Finance and NBP agreed to convert part of the government's liabilities into new securities with longer maturities.

Outlook for the economy in 2002–2003

Łukasz Rawdanowicz

Economic growth

- **1H02 still slow ...**
- **...but expecting a recovery in 2H02**

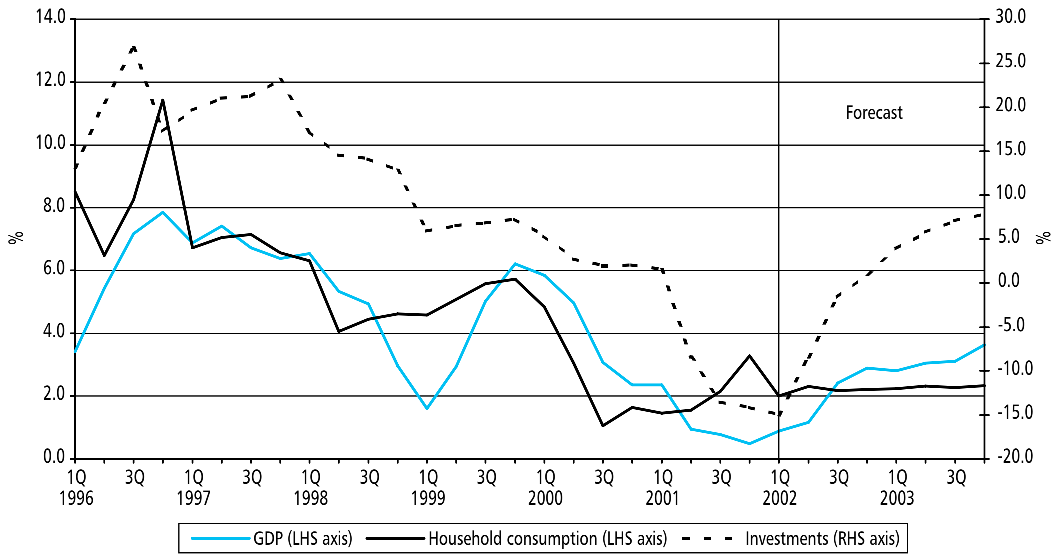
Against the background of recent economic developments – both in Poland and abroad – we have decided to modify our forecast for 2002–2003. In 1H02 we anticipate a continuation of trends from the previous year and the stabilisation of economic growth at a low level. In the area of domestic demand, we expect to observe moderate and stable growth in household consumption and continued contraction, though at a slower rate, in investment. The slowdown in domestic demand will dampen import growth. These factors, combined with moderate exports (the still subdued economic activity in the EU and the strong zloty), will determine slow GDP growth in 1H02.

During the subsequent two quarters we forecast an upturn in economic activity. Domestic demand will gain momentum – stable household consumption is expected to be met by growing investment starting from 4Q02. Stronger domestic demand is likely to spur higher imports, although exports should be growing at a faster rate due to the strengthening of external demand (see Global Economy). As a result net exports should continue to contribute positively to GDP growth. Against this backdrop we forecast 1.9% GDP growth in 2002 as a whole.

Stable, though relatively slow growth (compared to previous years) in household consumption is consistent with our forecast for income dynamics and the situation on the labour market. In 1H02 income growth is expected to be driven mainly by social benefits, which until June will be indexed at the current rate. On the other hand, mixed income should gather steam in 2H02. Such forecasts, we would like to make clear at this point, are, however, subject to a degree of uncertainty. The economic environment in which households operate has changed considerably recently. Households have not to date been faced with the combination of inflation below 5%, diminishing interest on bank deposits, unemployment at over 17% and a recessionary atmosphere. Bearing this in mind, one should note that forecasting household behaviour based on past experience is a risky endeavour.

2003 is expected to see a further strengthening of growth momentum, with GDP likely to increase by 3.2%. This should come on the back of a recovery in investment. In the face of stable household consumption, healthier domestic and foreign economic activity, low inflation and lower interest rates, firms should be more inclined to invest. This would pave the way for a resumption of investment that has faltered in 2001–2002. On the other hand, stable income will allow for a gradual increase in household consumption. Furthermore, favourable developments in the EU are

Chart 3.1. GDP, domestic demand and investment, 1996–2003 (% change, yoy)



Note: CASE forecasts starting from 1Q02.
Source: Central Statistical Office and CASE.

likely to strengthen export growth, which would in turn offset, at least to some extent, higher import growth.

We don't expect to see any fundamental reform of public finances, as the economic recovery is likely to be moderate, the costs of debt servicing higher and the political will to push through such changes weak.

The real sector

- **Industrial production – weak but growing**
- **Recession in construction to continue until the end of 2002**

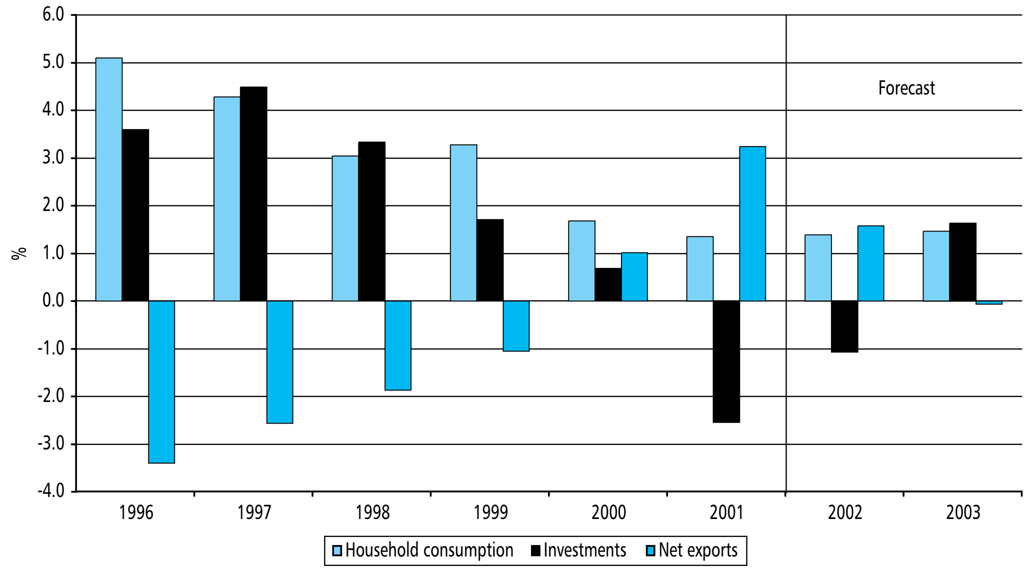
Industrial production is expected to continue to contract in 1Q02, but start to grow again in the subsequent months. The performance in 1Q01 is likely to be the result of the continued drop in investment (including investment in machinery and transport equipment), the moderate growth in private consumption as well as weak external demand.

We expect to see a reversal of these trends in 2H02. This should be reflected in stronger growth in industrial production, likely to continue well into 2003, in particular in the manufacturing sector. We forecast a steady decline in mining sector production over the entire two year period under discussion here.

In the face of the less optimistic forecast for a recovery in investment, the long-awaited revival in the construction sector is likely to be postponed once again. We now expect it to arrive not before the beginning of 2003.

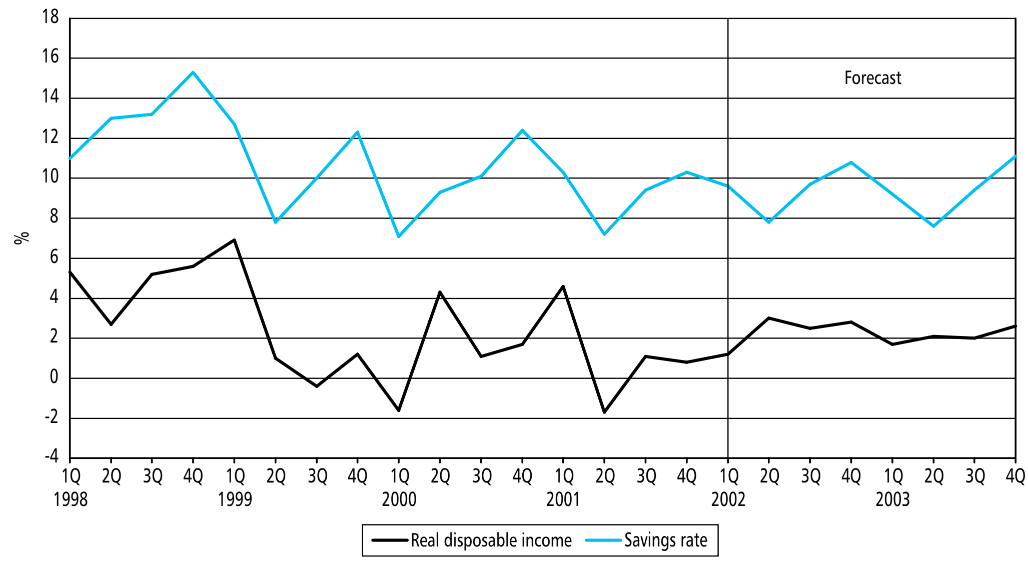
In our view, recession in the construction sector – aside from the impact of the general economic slowdown – has underlying structural causes. Weaker economic activity has impacted on lower income growth and demand for flats as well as on subdued enterprise investment outlays on buildings. In addition price developments have not been conducive to growing demand. PPI growth in the construction sector has tended to outpace PPI increases in industry. This was particularly evident in 1996–1999 and 2001. Added to these factors, we believe Poland has also experienced over-investment in construction. In 1996–1999, production in the construction sector expanded at an annual average

Chart 3.2. Contribution to GDP growth, 1996–2003 (%)



Note: CASE forecasts starting from 1Q02.
Source: Central Statistical Office and CASE.

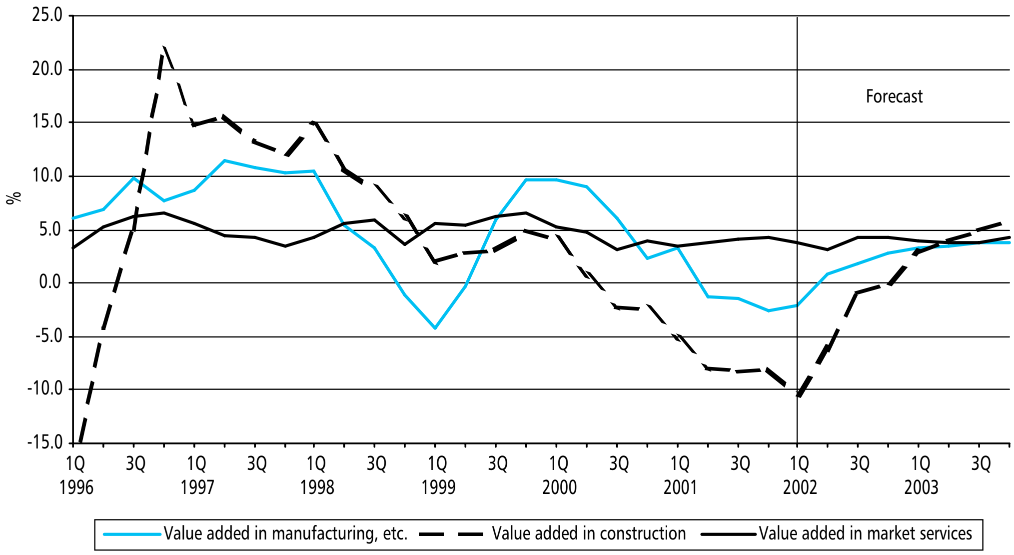
Chart 3.3. Changes in real household disposable income and savings rate, 1998–2003 (%)



Note: CASE forecasts starting from 1Q02.
Source: Central Statistical Office and CASE.

rate of 12.5%. For the sake of comparison, the corresponding figure for industrial production was 6.1%. Such extensive construction outlays could lead to a temporary saturation of the market. This applies particularly to non-residential buildings such as shops, supermarkets, offices, etc. Thus, we should not expect a fast recovery in this type of construction. In this context, the present recession in construction

Chart 3.4. Value added in major sectors of the economy, 1996–2003 (% change, yoy)



Note: CASE forecasts starting from 1Q02.
Source: Central Statistical Office and CASE.

seems to be an effect of the construction boom in previous years.

Piotr Bujak

Labour market

Unemployment

• **Further unemployment growth**

The latest data on the situation on the labour market and on economic activity incline us to maintain our forecasts for employment and unemployment. In 2002, we expect a continuation of the strong upward trend in unemployment. This will most likely stem from the forecast low level of overall economic activity. In 1H02, there should be continuing deep falls in employment. The number of declared group dismissals is also still growing – in 4Q01, the largest construction companies and shipyards announced such lay-offs, among others.

A turnaround in the situation, in our opinion, is unlikely to be seen any earlier than in 2003. Employment should then begin to rise and the pace of growth in unemployment wane. Nevertheless, unemployment is likely by then to stand at close to 19%. In 2003, unemployment growth will be more an effect of demographic processes (inflow of new entrants onto the market) than restructuring ones.

Prices

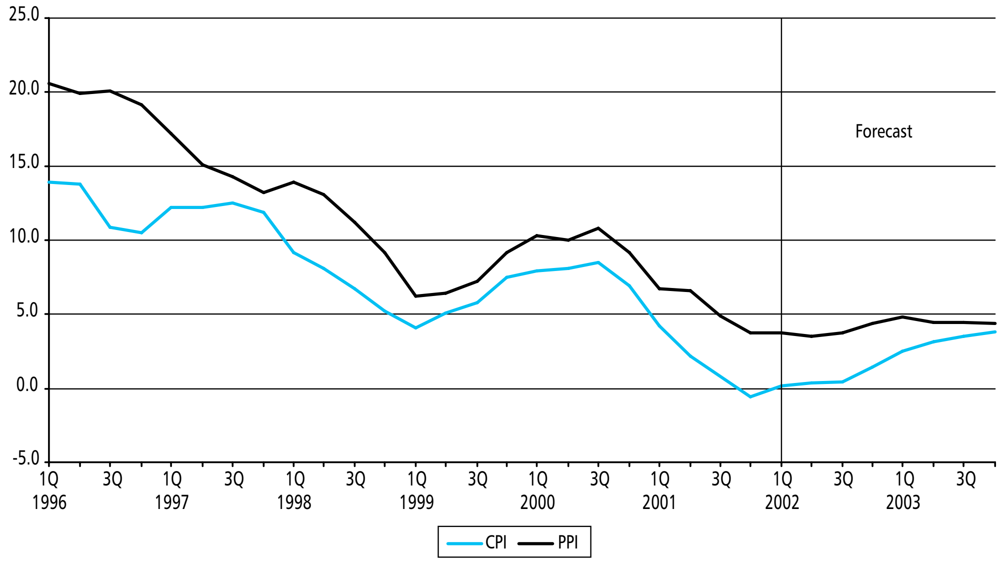
Mariusz Jarmużek

Basic price indicators

• **Uncertainty concerning quasi-administered prices**

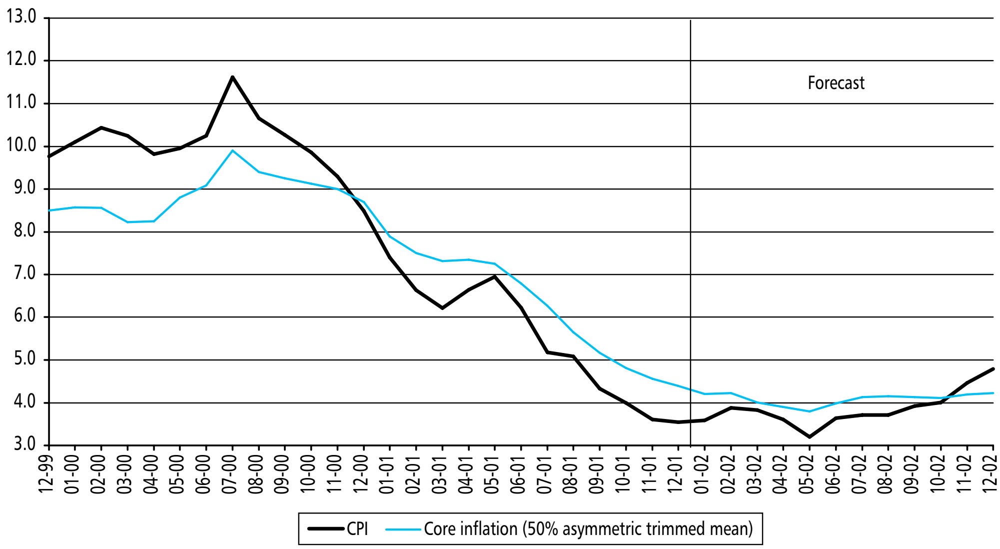
We forecast stable inflation below 4% until mid 2002. This should result from the very strong zloty in the last quarter of 2001 and the clear slowdown in the economy. In the second half of 2002, we expect a reversal of trends and therefore increased inflation.

Chart 3.5. CPI and PPI, 1996–2003 (% change, yoy)



Note: CASE forecasts starting from 1Q02.
Source: Central Statistical Office and CASE.

Chart 3.6. Core inflation, 1999–2002



Note: CASE forecasts starting from 1Q02.
Source: Central Statistical Office and CASE.

Among our assumptions for 2003 we foresee loosened monetary policy, a gradual nominal zloty depreciation and recovery in domestic demand allowing producers and intermediaries to pass higher costs on to consumers and increase their mark ups. This will slightly speed up inflation.

Moreover, we assume a leap cycle of crops for the period 2002–2003 and increases in gas and energy prices of 6–7% above inflation. We also believe that the energy excise tax imposed in 2002 will not be subject to annual rises.

We still do not know the schedule for energy and gas price rises in 2002. An energy excise is being introduced on February 1st on energy producers (power generators and heat producers). Two such producers have already announced plans to rise their prices to energy distributors by 20%. We believe that the URE will not accept an increase in tariffs proportional to the excise tax. Additionally, at the turn of 2Q02 energy prices will be increased according to the annual schedule. All together, we expect final energy prices to grow by 10–14%. We assume also that in 1Q02 the URE will finally accept PGNiG's new tariffs, which would result in a 10% rise in gas prices.

The good harvest in 2001 will stabilise food prices during 2002. Stable prices of grain and grain products should encourage farmers to expand livestock (both swine and cattle). This – to some extent – should offset the lowering livestock of swine and prevent substantial increases in meat prices.

Producer prices will continue to temper consumer price growth. We forecast that the improvement in the economic situation will not take place before the second half of 2002. Such a development, together with a very limited depreciation of the zloty, will not allow producers to rise their prices, particularly in manufacturing. The inflationary impulse will rather come from energy and gas prices as they account for a substantial share in production costs.

Przemysław Woźniak

Core inflation

In our core inflation forecast we rely on the asymmetrically trimmed mean, which eliminates, respectively, 28.5 % and 21.5 %, of the smallest and biggest price changes in a given month (the percentages refer to consumption basket weights). This indicator has better forecasting properties than core inflation measures calculated by the central bank. The rate of growth of the trimmed mean and headline inflation, along with the 12-month forecast, are presented in Figure 3.6.

We predict that the trimmed mean will fall somewhat in the beginning of 2002 before stabilising at a level of about 4% in subsequent months. Both rates of growth are expected to be very similar throughout this period and should only deviate from each other in the event of significant supply shocks. Since, according to our forecast, increase in demand and currency depreciation should be moderate in 2002, our asymmetrically trimmed mean will reflect the stability of the disinflation process. The expected inflationary impulses from gas and electricity price increases will not be visible in its dynamics.

External sector

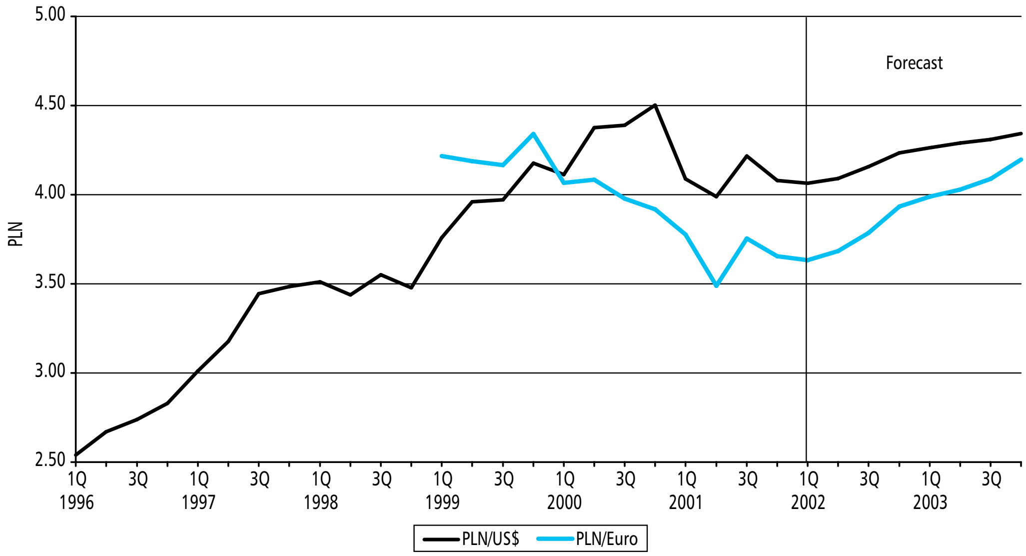
Rafał Antczak

Exchage rate

- **Strong zloty fluctuations and increased exchange rate risk**

The zloty's fluctuations at the turn of 2001 may be a precursor to currency's likely behaviour over the course of 2002. After breaching 4 PLN/US$ on December 17, 2001 a period of speculation on the zloty's appreciation began. Given the shallowness of the Polish currency market transactions of a few tens of millions of dollars were able to significantly influence the zloty exchange rate. The withdrawal of the euro-zone currencies increased demand for zlotys, followed by a period of sharp zloty weakening. Between January 8–18, 2002, the zloty fell by 6.5% against the dollar and 5.3% against the euro, eating up its appreciation gains from 2001. Depreciation speculation resulted from a combination of the market view that the zloty was overvalued and fears raised by the on-going government-central bank conflict over interest rate policy.

Chart 3.7. Basic exchange rates, 1996–2003 (in zlotys)



Note: CASE forecasts starting from 1Q02.
Source: Central Statistical Office and CASE.

The zloty is likely to be mainly influenced in 2002 by speculation on further developments on the domestic market. Although macro fundamentals in 2002 are set to remain close to those in 2001 (GDP growth 1–2%, unemployment rate 18–19%, and current account deficit 4–5%) any change not in line with market expectations may have a strong impact on the zloty. Continued pressure for cuts in NBP interest rates, together with stabilisation of inflation at 2–5% and loose fiscal policy, could additionally attract foreign capital and increase volatility.

We believe that there is no clear proof that the zloty is over- or undervalued. This depends on the construction of the index (choice of deflators and base periods) of the real exchange rate. We are inclined to believe that the zloty has in fact grounds for appreciation in real terms together with a growth in microeconomic efficiency. However, this cannot be taken for granted. If the budget deficit stays at a level of over 4% of GDP and the current account deficit remains high this would mean a shortening of their financing. Therefore, any change in investors attitudes may lead to a correction in the zloty's exchange rate.

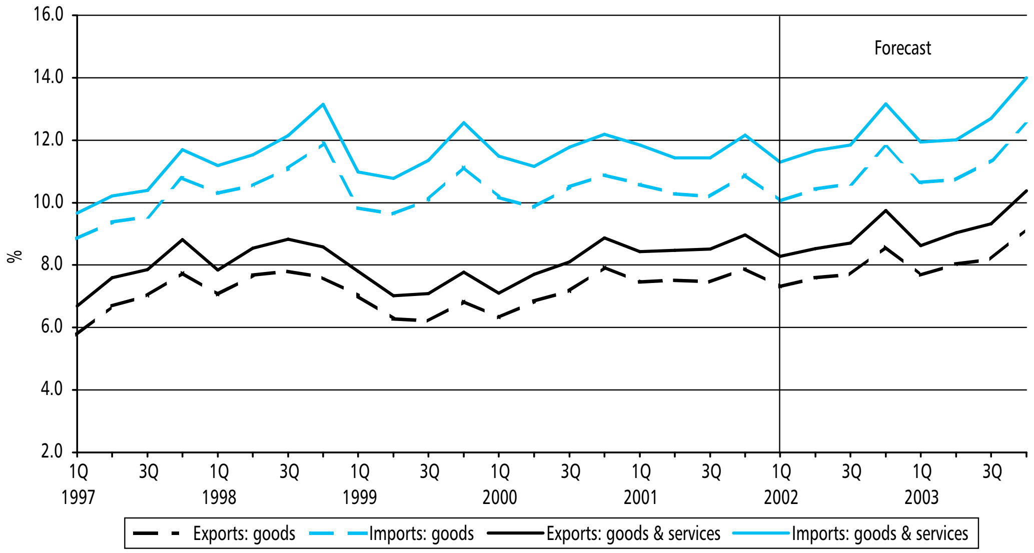
Łukasz Rawdanowicz

Foreign trade

- **Concerted slowdown in imports and exports in 1H02**
- **Gradual widening of the merchandise trade deficit**

In 2002 the merchandise trade deficit is expected to gradually increase, though should not be significantly higher than last year's. This will be possible due to the synchronisation of import and export trends. 1H02 should see subdued growth in exports (poor economic performance in the EU and the strong zloty) as well as in imports (contracting domestic demand). The slowdown in imports will largely affect investment and intermediate input commodities. This type of imports constitutes roughly 60% of total imports. In 2H02 foreign trade trends are likely to reverse as domestic and foreign demand gain momentum. In 2003 the trade deficit is expected to continue to widen, though at a moderate rate. Given robust external demand exports should maintain momentum and the forecast GDP growth should not be sufficiently strong to spur a massive import boom.

Chart 3.8. Exports and imports, 1997–2003 (in billions of US$)



Note: CASE forecasts starting from 1Q02.
Source: Central Statistical Office and CASE.

The economic slowdown and the far-reaching restructuring of enterprises that took place last year have enhanced the competitiveness of Polish producers, affecting both import and export activities. As a result, enterprises would appear to be better prepared to deal with exchange rate shocks and any temporary strengthening of the zloty should not put too much additional competitiveness pressure on them.

Over the 2002–2004 horizon we anticipate lower inflows of FDI than in previous years. This stems from a conclusion of the main privatisation processes (a factor already discounted in our previous forecasts) as well as from a relatively poorer economic performance (as compared to previous years) and uncertainty over the exact date of Poland's accession to the EU. In spite of this, FDI inflows should be enough to cover over 60% of the current account deficit.

Łukasz Rawdanowicz

Balance of Payments

- **Current account deficit hike**
- **Lower foreign capital inflows**

The current account deficit is likely to widen in 2002–2003, following developments in the merchandise trade deficit. However, its nominal growth should be slower than GDP growth at current prices. Consequently, the deficit as a percentage of GDP will remain at an unchanged level.

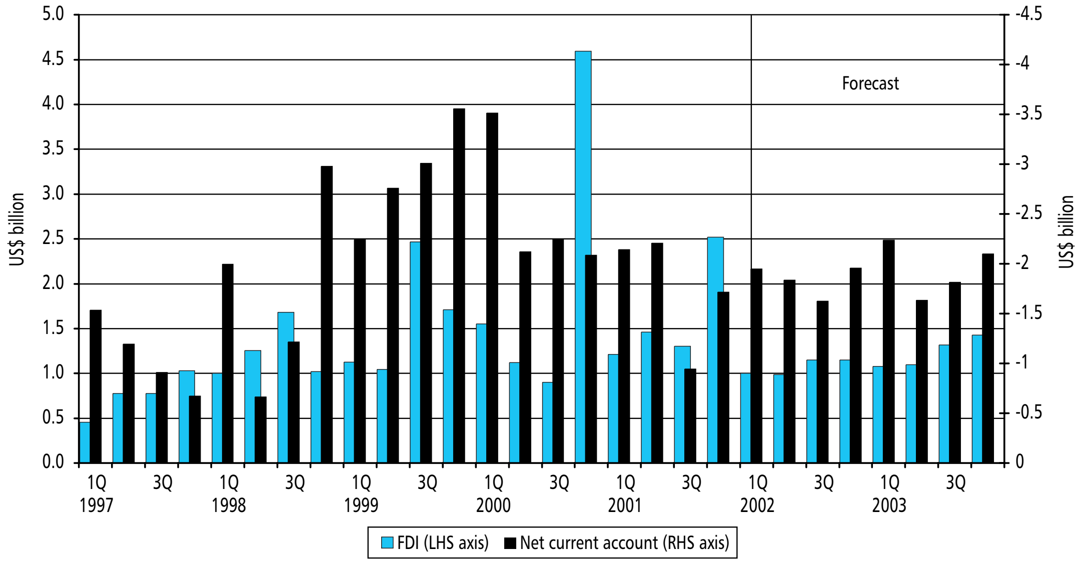
Małgorzata Markiewicz

Public Finances

- **Growth in budgetary disequilibrium in 2002**
- **Increase in public sector borrowing requirements and public debt**

Government assumptions are that state budget expenditures in 2002 will be 184 billion zlotys and that in the subsequent years will grow in real terms by 1% annually. According to our projection, it will be not

Chart 3.9. Net FDI and the current account balance, 1997–2003 (in billions of US$)



Note: CASE forecasts starting from 1Q02.
Source: Central Statistical Office and CASE.

possible to finance this level of expenditures. Therefore, cuts or amendments to the budget act will be necessary. We estimate the gap at above 4 billion zlotys in 2002.

Resumption of economic growth will allow a gradual improvement of the budget balance, though the deficit will remain relatively high. Two threats are possible. Firstly, if the budget deficit comes in at 5% of GDP, depending on its financing, this could lead to an appreciation of the zloty and growth in public debt at a rate not allowed for in the law on public finances. There is likely to be a significant growth in public sector borrowing requirements in 2002 to a level of over 100 billion zlotys, mainly due to the rolling-over of securities and the financing needs of the current state budget. If resumed GDP growth is lower than expected, the problems of public finances will be exacerbated.

Secondly, a state budget deficit of 5% of GDP is not sustainable and may lead to a drop in foreign investor confidence. The actions undertaken by the government and those presented in the governmental strategy are not sufficient to eliminate this possible change in market sentiment.

Rafał Antczak

Monetary policy

- **Inflation target 4–6% in 2002**
- **Further loosening of monetary policy**

The monetary policy baseline for 2002 has a CPI inflation target of 5% in 2002 within a band of +/-1 percentage points. This band takes into account uncertainty in meeting targets in relation to the budget deficit, exchange rate volatility and supply shocks in 2002.

The NBP's significant rate cut in January (by 100–200 basis points) now leaves room, in our opinion, for only a further 100–150 basis points cut in the course of the rest of 2002 – and exclusively in the form of tuning cuts (by 50 basis points a time). One cannot rule out rate hikes at the end of 2002 due to the loosening of fiscal policy, the fact that the 2002 budget project may turn out higher than expected, and that the effects of rate cuts in 2001 are likely to be seen in mid-2002, plus increasing exchange rate risk.

At the beginning of 2002, the RPP lowered the required reserve ratio from 5% to 4.5% to compensate for the ban on the counting of cash held in banks into obligatory reserves. Both changes together have neutral consequences for liquidity in the banking sector. Further reductions in the required reserves ratio to a similar level as in the ECB (2%) would probably include obligatory conversion of freed resources (around PLN3 billion) into Treasury papers as was already seen in March 1999. One should not expect this, together with an increase of credits to the budget, to cause any problems.

Rafał Antczak, Małgorzata Markiewicz

Coordination of fiscal and monetary policies

At the end of 2001 the mix of monetary and fiscal policy changed. Restrictive monetary policy, in operation since August 2000, compensated for the loosening of fiscal policy that was begun at the end of 2000. However, cuts in NBP rates in 2001 and January 2002 resulted in a decline in real NBP rates. The overlapping of several favourable factors on the supply side and the appreciation of the zloty led to a decline in inflation from 8.5% in December 2000 to 3.6% in December 2001. But this coincidence of factors may not be repeated in 2002. As for the exchange rate, the risk of strong fluctuations has increased. The RPP accepts a temporary increase in annual inflation, on condition this leaves the direct inflation target in 2003 unchanged. It has also indicated the necessity for structural changes in the economy, such as deregulation of the labour market, demonopolisation and an increase in foreign competition (on the food market), a completion of privatisation, lowering of the fiscal burden together with a fiscal deficit. Therefore, the expected increase in inflation in mid-2002, with NBP interest rates unchanged, would further loose monetary policy.

The government program announced at end-January 2002, may involve significant risk of fiscal expansion and growth in budget debt, in contradiction to the majority of the RPP's expectations. The government clearly sees state interventionism as a way of reviving the economy. The mechanisms introduced include investments in infrastructure (housing and highways), restructuring of state enterprises, subsidies to agriculture, export guarantees, and warranted credits. Funds for the realisation of the plan would come from ORFs (Open Retirement Funds), preferential bank credits, issuance of Treasury papers, and EU programs.

*Łukasz Rawdanowicz**

Global economy

- **Global recession a fact**
- **Cyclical decline in inflation, rise in unemployment**
- **US-led recovery on the horizon**
- **Low oil prices**
- **End of monetary easing cycle in US, euro zone and UK**

Developments in the global economy in 4Q01 have showed that our previous outlook was somewhat over-optimistic. Global recession has become fact. Contraction in economic growth in the US was accompanied by a marked slowdown in the euro area. This, coupled with the on-going recession in Japan, has taken its toll on the plight of economies in Asia and Latin America. Countries in Central and Eastern Europe have been more resilient to the concerted cyclical downturn.

The slowdown in developed economies has been characterised by industrial production contraction (as industrial tradable goods are highly vulnerable to cyclical swings) and rising unemployment. One the positive side, the downturn in economic activity has contributed to the easing of inflationary pressures. Inflation figures in industrial countries have been declining from their highs recorded in the middle of

* This text is based on ***Global Economy 1/2002*** (http://www.case.com.pl/index.php3?page=pgtopge&lang=en). ***Global Economy*** is a CASE quarterly publication (only in English) broadly covering the current world economic situation and outlook.

Table 3.1. GDP in selected countries, 1996–2003 (% change, yoy)

	1996	1997	1998	1999	2000	2001e	2002f	2003f
OECD	3.1	3.4	2.7	3.2	4.2	1.1	1.5	3.1
USA	3.6	4.4	4.4	4.2	5.0	1.0	1.3	3.2
Japan	5.0	1.6	-1.1	0.8	1.2	-0.5	-1.0	1.5
European Union	1.7	2.6	2.8	2.6	3.3	1.5	1.0	2.9
Germany	0.8	1.4	2.1	1.6	3.0	0.6	1.0	2.7
France	1.1	2.0	3.5	3.0	3.3	2.1	1.7	3.1
Italy	1.1	1.8	1.5	1.4	2.9	1.8	1.0	2.9
United Kingdom	2.6	3.5	2.6	2.3	3.0	2.4	2.1	2.9
Russia	-3.5	0.8	-4.9	5.4	8.3	5.0	3.5	3.5

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

Table 3.2. Inflation in selected countries, 1996–2003 (% change, yoy)

	1996	1997	1998	1999	2000	2001e	2002f	2003f
USA	2.9	2.3	1.6	2.1	3.4	2.8	1.6	1.9
Japan	0.1	1.8	0.7	-0.3	-0.7	-0.7	-0.8	-0.3
European Union	2.1	1.8	1.8	1.2	2.5	2.5	1.3	1.3
Euro area (HICP)	2.2	1.6	1.2	1.1	2.4	2.6	1.4	1.3
Russia	22.0	11.0	84.4	36.5	20.8	18.6	15.0	12.0

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

Table 3.3. Euro and yen exchange rates vs. the US dollar, 1996–2003

	1996	1997	1998	1999	2000	2001e	2002f	2003f
Euro	1.270	1.134	1.121	1.066	0.924	0.896	0.914	0.954
Yen	108.8	121.1	131.0	113.7	107.8	121.3	119.9	112.4

Source: Data – European Central Bank; forecast (f) – market consensus and CASE.

last year. The disinflationary trend has also been attributable to falling oil prices – the average price for Brent in 4Q01 was US$20.5 per barrel vs. US$26.6 per barrel in 3Q01.

As recession becomes fact and the inflationary environment improves central banks have continued the easing cycle. The biggest cutter has been the US Fed, cutting interest rates by 75 basis points since October. The ECB and Bank of England have cut far more modestly, by 50 basis points a piece.

At the end of November, the American National Bureau of Economic Research officially declared that recession in the US had started from March 2001. The final GDP estimate for 3Q01 was 0.5% yoy, i.e. significantly lower than the advanced figure. Despite GDP growth in 4Q01 coming as a surprise, it will also probably be revised downwards. Industrial production continued to decline and unemployment rise, edging up from 5% in September to 5.6% in December. At the same time the CPI dropped from 3.6% in May to 1.6% in December 2001.

The global slowdown has taken its grip on the economies of the EU. GDP, after nearly levelling off in 2Q01 and 3Q01, is expected to decline in the last three months of 2001. The 4Q01 downturn is evident not only in Germany but also in France, a country that has so far seemed to have survived the euro-zone downturn better than other big economies in the eurozone. In Italy, economic activity is slightly above the euro-zone average (in terms of GDP growth). The UK earlier appeared surprisingly immune to the global recession thanks to booming domestic consumption driving the expansion in the service sector. But the economy seems to have geared down in 4Q01. As in the US, EU economies have experienced similar symptoms of a slowdown: declining export volumes and business confidence as well as rising unemployment. The HICP in the euro-zone (EU) declined from 3.4% (3.1%) in May to 2.1% (2.0%) in December.

Germany is one of the poorer performers among the economies of the euro-zone. Official advanced estimates point to 0.6% GDP growth in 2001 – the worst result since 1993. 4Q01 was particularly bad, with annual growth possibly entering negative territory. Industrial production in seasonally adjusted terms declined both in October and November. Softening investment and the ensuing recession in construction are additional drags on economic growth. Added to this, consumer demand surprised on the downside despite tax rebates introduced this year that were expected to boost household spending. Dampened economic activity has taken its toll on the labour market, with unemployment standing at 9.6% in December. It is worth noting that the discrepancy in unemployment between western and eastern Germany persists – unemployment in Germany's eastern lands reached 17.6% in December. On the positive side, the CPI has been brought down from 3.5% in May 2001 to 1.7% in December 2001. The PPI followed suit, dropping from 5.0% in April to 0.1% in December.

In these circumstances what should we expect to see in the future? Every recession comes to an end, and this one will be no exception. The global economy most likely bottomed out in 4Q01. According to the market consensus, the rebound should materialise around mid-year, with the US economy expected to take the lead.

It would appear that in the US after a period of inventory draw down, its subsequent build-up and rising investment will help to revitalise growth in the near term. The improvement in consumer confidence also bodes well for the recovery. However, a sustained upturn will depend on the resumption in household demand. The incipient signs of gaining momentum suggest that there will be no further interest rate cuts, and, on the contrary, if recovery in 2H02 materialises, inflationary pressures will increase and interest rates hikes are very likely.

A recovery in the EU should also take place this year. Its exact timing and pace will be to some extent determined by developments in the US. On top of standard trade links, psychological factors (i.e., business and consumer confidence) will be of key importance. The latter will have a significant impact on investment and consumption activities. In 1H02 we expect a stabilisation of economic growth in the EU at a low level. The revival should materialise around the mid-year. This, however, will not be sufficient to achieve GDP growth at last year's level. A positive sign of recovery is the increase of the Ifo business confidence index in December 2001 and January 2002. This is a good leading indicator for economic activity in the euro-zone. In addition, expectations of stable and low inflation in 1H02 offer hope for higher household purchasing power. This in turn bodes well for private consumption. As in the US, the ECB is rather unlikely to pursue further interest rate cuts. On the other hand, the Bank of England in the face of an overheating economy, will probably increase interest rates in 1H02.

Early warning crisis indicator

Our early warning crisis indicator improved slightly in comparison to the previous quarter. In addition, positive and negative trends were also more balanced.

Positive developments prevailed mostly among financial indicators. We still forecast that inflationary pressures will abate. The drop in nominal WIBOR was large enough to lower it also in real terms. Moreover, credit expansion and short-term foreign debt shrank. External equilibrium improved. According to our forecast, the current account deficit over next four quarters will be lower than the corresponding forecast made three months ago.

On the negative side, unfavourable developments in the real economy and public finances should be mentioned. Both higher unemployment and weaker growth prospect in comparison to our previous forecast have impacted negatively on our indicator. The situation in the budget remains difficult and the deficit this year may reach 5.8% of GDP. Finally, one should note an appreciation of the zloty's real effective exchange rate.

Table 3.4. Early warning crisis indicator

	weights	3Q99	4Q99	1Q00	2Q00	3Q00	4Q00	1Q01	2Q01	3Q01	4Q01
1. Annual GDP	0.10	6	4	4	4	6	6	4	4	6	6
2. Annual unemployment rate	0.05	6	10	10	4	6	10	10	4	6	10
3. Annual average CPI forecasts for 4 consecutive quarters	0.06	10	6	4	4	4	0	0	6	0	4
4. Government deficit forecast for 2002 as a % of GDP	0.10	5	5	5	5	5	6	6	10	10	10
5. CA balance forecast for 4 consecutive quarters as a % of GDP	0.15	6	6	10	0	4	4	6	0	4	0
6. Real effective exchange rate	0.15	0	0	6	6	6	6	10	10	6	10
7. Credit expansion as a % of M2 (end of quarter)	0.07	4	4	4	6	6	4	4	6	6	4
8 Polish foreign short term debt as a % of liquid reserves	0.15	6	6	6	10	6	4	4	4	6	4
9. Total Polish foreign debt as a % of GDP	0.07	6	6	6	6	6	6	6	4	6	6
10. Real 3M WIBOR	0.10	6	10	4	6	6	6	6	4	6	4
Indicator		5.10	5.26	6.04	5.18	5.48	5.10	5.80	5.30	5.74	5.54

Notes: 1. The methodology of indicator calculation is available at the CASE web site: http://www.case.com.pl/index.php3?page=pgtopwsk&lang=pl&submenu=6
2. The annual forecast for the budget deficit in a given year is introduced in every fourth quarter of the previous year.
Source: CASE.

Stanisława Golinowska*

Center for Social
and Economic Research

Social expenditures in light of the 2002 budget bill

The 2002 budget bill provides for cuts in social expenditures. From the macroeconomic perspective this is undoubtedly a worthy aim, though the cuts are most likely insufficient in themselves to fully wipe out the problem of fiscal imbalances. But, all the while, the conditions within which it is possible to achieve various social objectives are deteriorating and the symbolic amounts earmarked for them start looking like little more than – "plasters covering gaping wounds". The net result is in turn simply a waste of public resources.

There are many myths intertwined with the various opinions on social expenditures in Poland. Perhaps the biggest myth of them all is that high social expenditures are the result of the state's over protectionist approach, when in reality the relatively high level of social expenditures is mainly due to high levels of social insurance payments. The non-insurance related parts of social expenditures (education, health care, social assistance and social protection) are all relatively small and have been falling consistently. Health care and social assistance expenditures are particularly low.

Previous social expenditure policies have created a situation today in which any decision made is seen as dramatic. There is as yet no reserve for financing reforms which would allow a rationalisation of spending in areas not covered by the reforms – in particular in the disability and farmers' insurance systems. The largest stream of non-insurance related expenditures goes on support incomes for employees working in the social services and benefit recipients (although, indexed, with a time lag). There is also a scarcity of resources for programs to improve the quality of social services or encourage and help benefit recipients and other socially protected groups to wean themselves off the state's help. Also missing is an effective supervisory and control system to eliminate inefficiency and the "leakage" of public funds.

The following is a synthetic presentation of the problem of social expenditures in Poland. We point out the main elements responsible for the extremely difficult situation in this area:

- the size of social expenditures (consolidated, including local government budgets and social funds) is relatively big**;
- the structure of social expenditures is imbalanced, a major disproportion between insurance and non-insurance related expenditures. The latter, which covers support for weaker social groups, is significantly relatively underfunded.

* Stanisława Golinowska is a professor of economics, a specialist in the area of social policy and the labour market. She is a former director of the Institute of Labour and Social Affairs and currently a professor at the Jagiellonian University in Krakow. She is also a deputy head of the CASE Council.

** Analyses of consolidated social expenditures compared with expenditures in other countries is included in the paper entitled "Społeczne wydatki w Polsce z odniesieniami do innych krajów" (Social expenditures in Poland related to other countries) by the Author and Krzysztof Hagemejer, papers PBZ, IPiSS 1999.

Table 4.1. Structure of the social expenditures* in 2000

Social expenditures	2000		
	million zlotys	Share of total social expenditures, %	Share of GDP, %
Social insurance	103,931	56.2	15.2
FUS**	89,616	48.5	13.1
KRUS***	14,315	7.7	2.1
Education	40,527	21.9	5.9
Health system	28,959	15.7	4.2
Family allowances	140	0.1	
Aliments	1,097	0.6	
Social protection of unemployed	7,160	3.9	1.0
Social assistance	2,960	1.6	0.4
Total	**184,774**	**100.0**	**27.0**

** consolidated social expenditures, that is, including extrabudgetary funds and local budgets, though excluding estimates – of tax relief.*
*** Fundusz Ubezpieczeń Społecznych (FUS) – a fund in the non-agriculture social insurance system, managed by ZUS.*
**** Kasa Rolniczego Ubezpieczenia Społecznego (KRUS) – a fund in the farmers' social insurance system.*
Source: own calculation on the basis of Ministry of Finance and Ministry of Labour and Social Policy data.

- cuts in non-insurance related areas have been ongoing for several years. As a result, unit expenditures (expenditures divided by the number of entitled beneficiaries) are irrationally low and in reality are a drain on the public purse.

The 2002 budget bill strengthens those tendencies that have shaped the structure of social expenditures. The main points are as follows:

1. Expenditures on social insurance continue to grow. In effect we see a huge relative (compared with other countries) over-excess of insurance-related expenditures (56% of all social expenditures, see Table 4.1.) over non-insurance related expenditures. In particular, this is witnessed perhaps most clearly in the area of social services (health protection, education) and other outgoings in the income support bracket (family allowances, social assistance). A proper balance has yet to be found since the beginning of the transition.

During the first period of the transition the main cause of such strong disproportional growth was the introduction of automatic wage indexation of pensions (one of the key insurance expenditures). Moves away from this mechanism were only seen gradually, with the main changes introduced in 1996 and 1999 (the year of pension reform). They exchanged a wage-based indexation system for a mixed systemwhere inflation has a substantial share.

At the same time, some non-insurance related expenditures were shifted out of the insurance system to non-insurance areas – in particular family

Table 4.2. Subsidies* to the social insurance system, in millions of zlotys

	1998	1999	2000	2001	2002 - plan
to FUS	8,792.8	9,459.0	15,366.0	26,150.3	27,379.3
to KRUS	10,652.3	12,891.3	13,212.7	15,287.9	15,399.2
Total	**19,445.1**	**22,350.3**	**28,578.7**	**41,438.2**	**42,778.5**
% GDP	**3.5**	**3.6**	**4.2**	**5.7**	**5.8****

** subsidies include also the cost of pensions financed directly from the budget.*
*** assumed 1% GDP growth, according to the Budget bill proposal for 2002.*
Source: own calculations based on CSO data (Statistical Yearbooks, section – public finances) and Budget bill proposal for 2002 (Council of Ministers – November 2001).

Table 4.3. Expenditures increased or not reduced in 2002, according to the Budget bill

Type of expenditure	Tendency in recent years	Planned increase in 2002 compared to the amended Budget bill for 2001	Comments
Health system*			
1. Medical life-saving	A new kind of expenditures. A result of the law from 2001	+85.3%	Cancelling of expenditures for Medical transportation *(Kolumna Transportu Sanitarnego)*
2. Clinical hospitals	In 2000, increase by 13.4% (3% in real terms)	+24.1%	
3. Highly specialised medical procedures	In 2000 expenditures lower than planned	+16.0%	Not efficient enforcing, financing *ex post*
4. Public blood service	Downward tendency	+2.9%	
Education			
1. Student credit and loan fund	Gradual implementation of the system	+44.0%	Development of the system
2. Polish schools abroad		+64.7%	Result of the political declarations
3. Teaching in the higher education system	In 2000 increase by 13.0% (2.9 in real terms)	+1.2%	Delayed indexation
4. Artistic education		+2.8%	little plaster
Social assistance			
Combating malnutrition among pupils	Funding planned only from the budget reserve	Increase in the budget reserve with the direct recommendation of its use	Substantial increase

** based on the NIK's (Supreme Chamber of Control) inspection of the budget's execution in the health system in 2000.*
Source: Budget bill for 2002, Council of Ministers – November 2001.

allowances, which, since 1995, have been financed directly from the budget and addressed solely to the poorest families. The shift however did not lower the level of social insurance expenditure. Moreover, **the relative disproportion between the two main groups of social expenditures is still present.** Its present source lies in the high costs of pension reform and lack of reforms in the remaining part of the social insurance system – that is in disability system and the separate pension system for farmers.

The cost of pension reform is related to the long-term investment aimed at lowering the financial burden of the system in the future. However, this investment is very costly – more costly than expected – and has had some implementational difficulties. During a period of economic slowdown and strong budgetary tensions this has tended to crowd out other budget expenditures. Despite the high budget subsidy to FUS, the budget's debt to the OFE will not be repaid in 2002.

2. In the non-insurance related areas of social expenditure we are dealing mostly with increased expenditures on the Labour Fund (+77%). This is justified by growing unemployment. However, we do not know the structure of those expenditures, and it is this structure that conditions any evaluation of the effectiveness and rationality of these expenditures. The questions are: is it only a financial support for the unemployed or is it a help for the unemployment in finding a job? The share of pre-retirement pensions and allowances in the Labour Fund is still high. This limits the possibility of reshuffling these expenditures towards policies that would encourage benefit recipients to move away from state assistance. Other kinds of expenditures are also growing (see Table 4.3).

3. In the non-insurance related areas we see the following reductions (see Table 4.4).

The family allowance system was substantially modified in 1995. What had previously been allowances open to all were limited to the poorest families, that is where the average income per person in the household did not exceed 50% of the average wage in the economy. The number of entitled families dropped by over 20% overnight. Consequently, its

Table 4.4. Expenditures decreased in the Budget bill for 2002

Expenditures decreased	Tendency in recent years	Planned decrease in 2002 compared to the amended Budget bill for 2001	Comments
1. Education, incl.:			
• Primary education		-22.0 %	
• Training of teachers • Life-long learning centres	Reductions	-64.9% -15.0%	Are teachers supposed to finance extended education by themselves?
• Financial aid for students	In 2000 increase by 7% (3% drop in real terms)	- 4.5%	Further shift towards credits and loans
• Social expenditures in education, incl.: • Financing of kindergartens	Reductions Reductions	- 8.1% - 28.0%	Increasing financing needs imposed on local governments and parents
2. Health system		**- 29,9%**	
• Public health policy programs	Increase by 32% in 2000 (19% in real terms)	-36.6%	Is there a complete list of cancelled and remaining programs, and what were the criteria behind each of the decisions?
• Medical and nursing care- institutes	Increases	- 64.2%	From now on only several of these institutes will be financed from the budget
• Psychiatric treatment	Strong growth in 2000 ? by almost 70% (over 50% in real terms)	-29.1%	
• Labour medicine	Stable	-33.3%	Involvement of employers?
• Addressing drug and alcohol addictions	Increase of expenditures for drug addictions and slight reductions of these for alcoholism	-38.8%	Higher involvement of local governments and NGOs? What about PARPA*?
• Medical practises and specialisations		- 46.3%	Who will financially support medical graduates undergoing medical specialisation?
3. Social assistance			
• Allowances	Reductions	-16.8%	Rising the threshold for permanent allowances
• Nursing houses	Reductions	-10.8%	Further growth of individual expenditures?
• Foster-care institutions and substitute families	Reductions in case of the foster-care institutions	-20.0%	High level of impoverishment who will support them?
• Guidance, intervention institutions, ?	Reductions	-50.1%	Active forms of support will be financed only by local governments
4. Family, nursing and parental allowances	Reduction in case of parental allowances; stable access to family allowances; increase of nursing allowances	-12.5%	Raising the income threshold entitling to allowances

** PARPA (Państwowa Agencja Rozwiązywania Problemów Alkoholowych) – State Agency for Solving Alcohol Problems*
Source: Budget bill for 2002, Council of Ministers – November 2001.

share of expenditures in GDP decreased as well. Analyses of the beneficiaries (Topińska*) showed firstly, that very few allowances are addressed to farmers, some of the most impoverished families with a highly differentiated level of incomes. Secondly, as household budget surveys suggest, there is plenty of evidence to suggest that much of this type of support goes to the wrong groups of people. Most worrying is that some of the poorest families did not get any support. Thirdly, the allowance is low. The basic amount is 3% of the average wage, against around 7% at the start of the 1990s. The average family allowance in 1999-2000 reached 40 zlotys. This drop was mainly the result of price indexation; rates of nominal wage growth were higher than price growth.

4. In the 2002 Budget bill various types of social expenditure disappear altogether or the planned amounts are very low. These are the following items:

- Club-rooms at schools,
- General and specialised education institutions
- Financial aid for pupils
- Post-secondary schools,
- Teachers' collegiums,
- Dentist treatment,
- Sanatoriums,
- General hospitals,
- Regional social policy centres,
- Financing of NGOs involved in social assistance

Each of these cancelled expenditure item should be exposed to detailed analyses. In some cases the expenditures are redirected, e.g. the financing of general hospitals becomes the responsibility of health funds and the financing of dental treatment is found in different resources (health funds, ZUS, KRUS, individual resources). However the basis range of services is to be financed from local budgets, private resources or by employers. Cuts in expenditures for social protection in education have been met with a great deal of alarm. Reducing financial support for families with children (family allowances) can only lead to a further increase in the impoverishment of this group of people.

Conclusions

The above-mentioned reductions in budgetary financing of social objectives demand the following steps:

1. The introduction of a coordination mechanism to oversee expenditures from different levels of the government or extra-budgetary funds which fulfil the same objectives (e.g. combating malnutrition among children) or are addressed to the same groups of beneficiaries (e.g. families with addicted people). The fact that these expenditures are financed from decentralised funds or extra-budgetary resources enjoying a large degree of autonomy often leads to inefficient use; inefficiency means excessive concentration of many streams among the same group of beneficiaries. During a period of severe budgetary constraints, the coordination of such expenditures plays and an important role in the effective use of public resources. This instrument should already be in use.

2. Coordination of the funds would also be justified in the case of private resources, e.g. voluntary activities or charities. Such coordination, however, should have a strong civil character in order to respect the autonomy of donors as well as NGOs.

3. There is also a dire need for improved efficiency in:

- greater accuracy in addressing financial support
- eliminating inefficiency, bad management, or wasting of resources.

Improving efficiency requires the monitoring and supervision of all public expenditures. It calls for related regulations and funds to finance the monitor-supervision process.

4. The government has to prepare a strategy for social expenditures with its main aim the gradual elimination of imbalances embedded in them and eradication of their low effectiveness. Such a strategy would have to be prepared at the central government level. The system where voivodships are responsible for social policy strategies adjusted to their regions deprives the government of any real instrument for rationalising social spending.

* S. Golinowska, I. Topińska "Pomoc społeczna. Zmiany I warunki skutecznego działania" ("Social assistance. Changes and conditions of effective policy"), CASE 2002.

International Conference:

BEYOND TRANSITION – DEVELOPMENT PERSPECTIVES AND DILEMMAS

BEYONDTRANSITION
Development Perspectives and Dilemmas

Preliminary Programme

April 12–13, 2002 in Falenty (Warsaw, Poland)

Session I
Is there a room for national monetary policy in the global economy?
Marek Dąbrowski | Vittorio Corbo
Andrew Berg | Ricardo Hausman

Session II
The EU enlargement: the way of candidate countries to the Euro zone.
Jacek Rostowski | Andrzej Bratkowski
Daniel Gros | Richard Portes
Charles Wyplosz

Session III
International tax competition and tax reforms.
Nicholas Stern | Yegor Gaidar
Alari Purju

Session IV (panel)
How to make national labour markets more flexible?
Marek Góra | Juan Jimeno
Tito Boeri | Jeffrey Sachs
Jan Rutkowski | Olivier Blanchard

Session V (panel)
The EU enlargement: Consequences of free labour movement for the West and East.
Stanisława Golinowska | Klaus Zimmermann

Session VI
Privatisation and corporate governance - the remaining agenda.
Simon Johnson | Barbara Błaszczyk
Dmitrii Vasilev | Marko Simoneti
John Nellis

Session VII
The EU Enlargement: consequences for the CIS countries.
Anders Aslund | Lajos Bokros
Vladimir Mau | Sergiei Tieriokhin

Organized by: CASE - Center for Social and Economic Research
Poland, Warsaw, Sienkiewicza 12 Str., tel. (+ 48 22) 622 66 27, e-mail: case@case.com.pl

For further information, please contact: Mr. Jarosław Neneman, Conference Secretary e-mail: neneman@krysia.uni.lodz.pl, www.case.com.pl