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POLISH ECONOMIC OUTLOOK
TRENDS • ANALYSES • FORECASTS

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Nihil novi?

No surprises

1Q02 did not bring any major economic surprises. As we expected, trends in the main macroeconomic variables were sustained: contraction in industrial production and construction, rising unemployment and falling inflation.

A very good performance of the retail trade sector in 1Q02 points to relatively strong household demand – despite the drop in the wage fund in real terms. In our view this was possible due to high growth in social benefits and mixed income, as well as to lower savings. In the face of retail trade results, the flash CSO estimate of 1Q02 GDP suggesting stagnation of annual growth at the level of 4Q01 seems to us over pessimistic – even after taking into account the contraction in industry and construction. We estimate GDP growth at 0.8% yoy – i.e. close to a level forecast in the previous issue of the PEO and higher than the rate of 0.3% in 4Q01.

1Q02 marked a record-low merchandise trade deficit. Despite a drop in merchandise exports in dollar terms,

Table 1.1. CASE Outlook, 2002–2003

	2000	2001	2002	2003
GDP (% change)	4.0	1.1	1.8 ↘	3.5 ↗
Domestic demand	2.8	-2.0	0.5 ↗	4.6 ↗
Household consumption	2.6	2.1	2.3 ↗	2.9 ↗
Investment	2.7	-10.2	-4.6 ↘	11.8 ↗
Unemployment rate (%)	15.1	17.4	18.8 ↗	18.9
CPI (% change, annual average)	10.1	5.5	3.2 ↘	3.5 ↘
Trade balance (US$ billion)	-13.17	-11.66	-11.77 ↘	-14.36 ↘
Current account balance (US$ billion)	-9.98	-7.05	-7.81 ↘	-9.85 ↘
Current account balance (% of GDP)	-6.3	-4.0	-4.2 ↘	-5.2 ↘
Central budget balance (PLN billion)	-15.4	-32.6	-44.4 ↗	-42.5 ↗
Public sector balance (% of GDP)	-2.6	-5.3	-6.5	-
Exchange rate (annual average)				
PLN/US$	4.35	4.09	4.11 ↘	4.30
PLN/Euro	4.01	3.67	3.68 ↘	3.89 ↘
Broad money supply M3 (% change)	12.1	9.1	5.8	7.0
Interest rate of NBP (28-day reference rate)	19.00	11.50	8.50 ↗	7.75 ↗
WIBOR 3M	19.6	12.3	8.7 ↘	7.7 ↘

Source: Data – CSO and NBP; forecasts – CASE.
Note: Arrows point the direction of changes compared with the previous outlook.

imports declined at a higher rate. However, this was not proportionally reflected in the current account deficit. The latter was high due to the changes in tax legislation. A rise in excise tax on imported second-hand cars induced increased imports before the new tariffs came into force. Imports of second-hand cars were financed with sources changed in exchange bureaus and from private banking accounts. Such transactions are recorded in the unclassified current transaction account, which experienced a marked decline in 1Q02.

Falling headline and core inflation as well as waning inflationary expectations gave ground for the second interest rate cut this year. The RPP's decision resulted in further declines in interest rates on deposits and credits offered by commercial banks. This time, however, drops in credit prices were higher for households than for the corporate sector. This fact may contribute to boosting consumer demand in the near future.

A brighter outlook for the global economy

The only new development in the economic environment is the very optimistic news coming from the global economy. Contrary to the recessionary moods as of the end of 2001, at the moment optimism is prevailing among economists. The IMF, OECD and many investment banks have revised upwards their forecasts and are expecting faster recovery. Changes in forecasts apply primarily to the US, and to a lesser extent to the EU. For the time being we remain cautious with regard to our forecast of an economic revival in the EU, although such a shift in the general outlook is good news for Polish exporters and may be an important determinant of GDP growth in Poland in 2H02.

Economic outlook – broadly unchanged

Against this background, we see few reasons to alter our forecast for 2002. Minor changes to GDP, and its components, growth rates and other macro variables should be interpreted as corrective ones, not as altering our general view on growth prospects for this year.

At the same time, it should be stressed that risks to our forecast have became more balanced. On the one hand, there is a threat of halting household consumption growth. On the other hand, we see chances for higher investment and exports. If the latter materialise on the back of an improved external environment we should not worry about household consumption developments. Hence, upward revisions of our forecast are more likely than downward revisions in the near future.

In this issue we present a somewhat more optimistic economic outlook for 2003. However, as with changes in our forecast for 2002, the alterations should be viewed as corrective only. In our view, the more favourable external environment, previous cuts in NBP rates and relatively stable inflation allow us to expect higher growth in domestic demand (both with regard to household consumption and investment in fixed assets). In such a scenario, however, we will see a faster widening of the current account deficit.

Monetary policy vs. the budget

Despite the lower forecast for annual inflation for 2002 (in comparison to the previous issue of the PEO), we still expect an upturn in prices in 2H02 on the back of, amongst other things, revitalisation of GDP growth. This, coupled with risks associated with oil price changes, should keep the RPP from cutting interest rates significantly. In addition, the lagged effects of previous cuts have not yet materialised. In the remainder of this year we should see room for at most two additional fine-tuning cuts – probably in June and August – to the cumulative tune of 100 basis points. In 2003, on the other hand, as the mid-term inflation target appears to be unthreatened at the end of next year, NBP rates may be lowered by 75 basis points in total.

We maintain our concerns with regard the budget deficit this year. Given our forecast of GDP growth and inflation, it will be impossible to achieve the planned level of budgetary revenues. If expenditures are not trimmed, the central budget deficit will turn out higher by approximately PLN 4 billion. As this amount is not astronomic, an amendment to the budget law seems unlikely. The government would rather pursue cuts and shifts in expenditures. Nevertheless, the government will face more serious fiscal challenges next year. Sticking with the rule of 1% real increases in budgetary expenditures will be very difficult to achieve due to the higher costs of debt servicing, the announcement of an 'unfreezing' of

wage growth in the budgetary sector and postponed salary increases related to the Teachers' Charter (*Karta Nauczyciela*), as well as increased indexation of social benefits.

The beginning of 2002 was marked by a few worrisome developments that may have a profound bearing on the future course of monetary and budgetary policy in the remainder of this year. First, the rise of cash in circulation – at the end of last year this was perceived as a temporary phenomenon due to the introduction of tax on income from savings – was sustained throughout all of 1Q02. Second, the massive supply of treasury papers in 1Q02 not only crowded private investment out (in this case cuts in NBP rates are useless) but also drained the interbank market. This, in turn, led to lower demand on the side of domestic banks for securities offered by the Ministry of Finance in April. Recognising this fact, foreign investors entered the market and offered lower prices. An increase in the share of foreign investors led to mounting pressures on the appreciation of the zloty at the turn of 1Q02 and 2Q02.

The zloty exchange rate – the next culprit after interest rates

Cuts in NBP rates by 950 basis points since the beginning of 2001 and the drop in inflation of 450 basis points during the same period clearly indicate a marked loosening of monetary policy. At the same time loose fiscal policy has been pursued – the budget deficit will rise from 4.5% of GDP in 2001 to at least 5.2% of GDP in 2002. These stimuli have not yet brought economic boom. After pursuing 'interest rate' treatment, coupled with mistakes in the policy mix, the political authorities sought another miracle cure for the ailing economy. This time it is a depreciation of the zloty. Under the present exchange rate regime, the authorities (exchange rate policy lies in hands of both the government and the NBP) may only affect the exchange rate via foreign exchange interventions. The current level of foreign assets at the NBP – US$ 27 billion – attracts the interest not only of Polish politicians but also of financial market players. The latter could get involved in zloty speculation when a target exchange rate is set by the government and NBP. As there has been no such target rate so far investors have effectively been discouraged from taking the risk. At this point, one should note that only in a very few cases have central banks (and governments) won out in the face of financial markets speculation.

Economy in 1Q02

Economic growth

Katarzyna Piętka

GDP and demand factors

- **Acceleration of GDP growth, though very moderate**
- **Plummeting investment continues**

According to our estimates, GDP grew by 0.8% in 1Q02. This indicates a minor improvement compared to 0.3% GDP growth in 4Q01. At the same time, domestic demand registered a much smaller fall than in the previous quarter. This positive development took place despite a worsening of annual dynamics of all GDP components (except the accumulation of inventories). This results from two facts. Firstly, the CSO's quarterly GDP estimates are not seasonally adjusted; secondly, we assumed GDP component weighting equal to the weighting in 2000. The flash estimate of the second factor suggests that the growth of GDP in 1Q02 may turn out to be closer to the 4Q01 result. Clearly we are not dealing with a robust economic recovery.

With regard to private consumption we estimate stable growth of over 2%. This represents somewhat slower growth than in the previous quarter, though we see high growth in 4Q01 as a one-off (related to the exchange of European currencies before the introduction of euro). The steady growth in consumption was continued due to a slightly faster growth in real incomes and a lower savings rate than a year ago. In addition, seasonal factors may also have played a role, as Easter fell in March this year as opposed to April in 2001.

The wage fund seems to be the weakest component of incomes. According to our estimates it tumbled by close to 4% in real terms. The continuing downward trend of the wage fund reflects falling employment as well as slowing growth in overall average wages in the economy. On the other hand we still observe robust growth of pensions (over 9% in real terms). They will be subject to higher indexation until end-June. Moreover, given the good performance in services (see *Real sector*) and signs of shadow economy expansion (see *Monetary policy*) we estimate a more dynamic growth in mixed incomes.

The increase in household savings was smaller than in 1Q01. This indicates that households, alongside growing incomes, diminished their saving rate. The net increase in deposits was PLN 3 billion smaller than in 1Q01. This reflects a much smaller increase in household deposits accompanied by very slow credit expansion. The smaller accumulation of deposits was partly offset by a significant growth in cash outside of the banking system (as opposed to the cash contraction in 1Q01). We can observe that households have turned to banking deposits with long-term savings outside of the banking system, which is not included in the M3 money supply measure. Additionally, investments in individual construction kept growing, although at a lower rate. This allowed for maintenance of investment in individual housing at a similar level to 1Q01.

Lack of clear acceleration in consumption growth and no improvement in consumer confidence failed to boost investment. We estimate further and even deeper plummeting of investments by over 15%. On the back of this we have a continuing poor financial situation in enterprises and only a slender increase in demand for bank credits. The withdrawal of substantial funds from bank accounts in 1Q02 (PLN 12.6 billion out of PLN 10.8 billion accumulated in 4Q01) we explain in reference to higher enterprises demand for cash over investment activities. In 4Q01, the investment fall hit all types of investments. We estimate that in 1Q02 the largest fall was in investments in buildings.

According to our estimates, export growth registered a slow down compared with 4Q01. This corresponds with ongoing the EU's weak performance. Therefore, the positive contribution of net exports to GDP growth has diminished.

Katarzyna Piętka

Real sector

- **Contraction in industry and construction continues**
- **Compensation coming from growth in services**

Industrial production contracted for the fourth consecutive quarter (-1.6%), although slightly less than in 4Q01 and roughly in line with our forecast. Mining and quarrying registered the biggest fall in sold output. Manufacturing output fell less steeply. In the manufacturing sector over a half of all branches experienced an output fall. These are mostly branches which produce investment goods or durables (like clothes, transportation equipment, metals, machinery and electronic equipment, wood and wood products, coke and refined petroleum products, printing staff). The contraction in the sales of manufacturing was accompanied by further cuts in prices. The energy sector's good performance continued, albeit at a slower pace.

In 1Q02 we saw a deep tumble in construction output sales (by over 16%). The only component still in positive territory, although increasingly less so, is private building, which constitutes a significantly growing share in overall construction. This implies a serious setback in other building activities and corresponds with the contraction of enterprise investments.

The stable consumer demand was conducive to services. The retail sector registered quite robust growth (twice the tempo from 4Q01). Also, the negative dynamics in goods transportation volumes continued to decelerate. Employment in other sections like real estate, renting and business activities, and financial intermediation, increased. In 1Q02 we estimate that total market services value added kept growing by over 4%.

We do not expect any change in trends in the agriculture sector until the new harvest. This points to a continued fall in agriculture value added.

Anna Myślińska

Enterprise finances

- **Continued critical financial situation in enterprises**

The profits on sales for enterprises employing over 49 people improved significantly in 4Q01 (yoy), though this growth is largely explicable only when compared to the difficult situation a year ago – in 4Q00 enterprises failed even to match the nominal results from 4Q99. In 2001 as a whole, the profits on sales were considerably down on 2000. Enterprises also saw exceptionally poor results on other operational activities and financial operations, which led to a worsening of profitability, both in the private[1] and public sectors. Public sector profitability was in fact negative. This deterioration was connected mainly with the dramatic (over 13% in nominal terms) drop in sales in the sector. The faster growth of wages in industry and construction in the public sector as compared to the private sector further heightened this already desperate situation.

[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 or public stakes is the key determining criterion for statistical classification purposes.

Enterprises have also become more wary of borrowing from banks. According to the NBP's monetary data, in 4Q01 loans to enterprises increased by a mere 5 percent in comparison with 4Q00. Small firms tended to be more courageous in this regard – loans for small entities grew by over 13%, as oppose to loans for big companies (employment over 49 people) which grew according to CSO by a mere 2%. Trade credits stabilised at US$ 5.8 billion. However, other foreign loans taken by non-state and non-financial sectors continued to rise markedly (by 18.7%). This indicates that enterprises are looking for cheaper sources of financing than the domestic market offers. The share of foreign loans in total loans continued to increase, today exceeding 25% (compared with approximately 20% at the beginning of 1999). Enterprises' deposits in 4Q01 rose rapidly – by over 13% in comparison with 4Q00. As a result, net loans (after deducting deposits) changed little.

One should not expect 1Q02 data (soon to be released by the CSO) to show any significant improvement in enterprises' financial situation. A decline in sales in industry and construction, accompanied by a modest price growth, does not bode well for revenues. Additionally, the strong zloty and weak foreign demand – that will slow down exports, have also exacerbated exporters' plight. In the CSO survey of business tendencies, entrepreneurs said they saw a worsening not only of their own production but also the overall economic climate in 1Q02 compared to 4Q01.

Piotr Bujak

Labour market

- **Stronger drop in employment in the enterprise sector and...**
- **...increase in number of unemployed deleted from the register**

1Q02 saw a further deterioration on the labour market. This was not only due to seasonal factors – unemployment rose and employment dropped in comparison with the corresponding period of the previous year as well. Both the nominal and real pace of wage growth abated.

Unemployment

According to the CSO, the number of registered unemployed at the end of March was almost 3.26 million and the unemployment rate reached 18.1%. Although both measures grew in comparison with the previous quarter as well as with the analogous period of the previous year, the growth rate slowed somewhat. This was due to the rise in the number of unemployed who were deleted from the labour office register, including those who found jobs, while new registrations increased slowly. Moreover, the number of job offers in 1Q02 increased significantly in comparison with the corresponding period of the previous year for the first time since mid-1998. The average number of job offers during 1Q02 amounted to 35,000, 15.6% higher yoy. However, any hypothesis about higher labour demand is put into question by the growing rate of dismissals in the enterprise sector. Thus, the lower growth in unemployment results to some extent from the increased activity of labour offices in monitoring the stock of unemployed. The rise in the number of unemployed deleted from the register due to finding employment was lower than the total number of unemployed deleted from the register.

Labour Force Survey for 4Q01 confirmed the tendencies observed in the previously released data from labour offices for the same period. In 4Q01, the number of unemployed grew to 3.186 million and the unemployment rate to 18.5%. This means an even stronger hike in unemployment over the year than in the case of registered unemployment. Unemployment among 15–24 year olds is particularly high, recording the strongest increase in 2001 – in 4Q01 it hit 41.1%. This record level stems partly from the ever-increasing number of new entrants onto the labour market.

Aide from the increased inflow of new entrants onto the labour market, another key cause of rising unemployment is on-going restructuring in enterprises, mainly in the private sector. However, the 4Q01 CSO's data point to the growth in employment in private companies employing more than 9 persons. This leads to the conclusion that a strong employment reduction in the private sector took place in small enterprises (up to 9 employees), including self-employed.

According to the survey, the primary cause of job losses in 4Q01 was, as previously, either the liquidation of

the work position or the liquidation of the plant. The proportion of people who lost jobs for these reasons was 46.9%, similar to the level in 4Q00. On the other hand, the share of people losing jobs due to the expiry of temporary contracts increased. In 2001, the percentage of unemployed previously working in the private sector grew significantly. In 4Q01 it was 74.3%, an increase of 7 percentage points yoy.

Employment

In contrast to unemployment, where 12-month growth waned, negative trends in enterprise sector labour demand strengthened. On average, in 1Q02 employment in the enterprise sector dropped by 4.8% yoy. A newly emerging phenomenon is the widening of diversity in employment dynamics between sectors. On the one hand, the already negative employment dynamics in industry and construction deteriorated. On the other hand, trends in services, for example in trade and repairs, hotels and restaurants, reversed with increases in employment recorded. The revival in trade is supported by data showing a strong growth in retail sales in 1Q02. Employment in real estate operations is also still growing. Differential employment patterns across sectors reflect diversification in sales. The deepest drop in employment was observed in manufacturing and construction, which experienced very weak output results.

LFS results confirm the drop in labour demand in 4Q01 indicated by CSO data for the period. The working population decreased in comparison with the previous year. The real exploitation of existing labour also fell as a result of the shortening of the average working week and decreasing number of people with more than one job. The worsened situation on the labour market is also characterised by a significant drop in the number of people looking to change jobs. This should constrain wage pressure.

Wages

In March the average wage in the enterprise sector increased by 4.8% yoy, and for 1Q02 by 5.3% yoy. The purchasing power of wages in 1Q02 was on average 1.9% higher yoy. This suggests a slowing if compared with the growth rates in 3Q01 and 4Q01. The clear conclusion to draw from this is that the pressure on nominal wage growth abated, in particular if we take into account the fact that inflation in 1Q02 was expected to be slightly higher.

The larger drop in employment in the enterprise sector in 1Q02 caused a stronger fall in the real wage bill than in two previous quarters, albeit increasing the purchasing power of the average wage.

Prices

Mariusz Jarmużek

Main price indices

• Disinflation continues

In 1Q02, inflation – both the CPI and PPI – continued to fall. This downward trend resulted from an insignificant depreciation of the zloty against the basket as well as a continued lowering of domestic demand and favourable developments on the supply-side.

The depreciation of the zloty against the dollar in February was compensated by the zloty's stable exchange rate against the euro. The zloty-euro rate principally affects transaction import prices, which, in turn, shape the PPI and CPI. Producers and importers were obliged to take into account the economic slowdown and rise in inventories followed by increased competition on the domestic market. Thus they were not able to pass any increases in costs related to the depreciation of the zloty against the dollar on to consumers.

Monetary policy also continued to encourage the disinflationary process, as the reduction of nominal interest rates was slightly higher than the decline in inflation. This allowed for a retention of the internal balance and laid the ground at the same time for sustained price increases in the future. The low wage trends, both in nominal and real terms, illustrated furthermore the lack of inflationary pressure from wages.

Favourable developments on the supply-side also contributed positively to the disinflationary process. An

increase in crude oil prices on the international markets in March was offset by the strengthening of the zloty. Last year's cereal harvest, along with moderate demand for cereals, caused continued oversupply of cereals. A similar situation occurred on the meat market where retail prices stayed on a downward path. This was due to the oversupply of cheap imported meat. In 1Q02, there were no significant hikes in administrative and quasi-administrative prices. The prices of gas did not increase, as the Energy Regulatory Office (URE) had not yet approved PGNiG's (Polish Oil and Gas Company) new tariffs by that time.

In 1Q02, the PPI index increased insignificantly. This resulted from the stable zloty exchange rate against the euro, increased competition on the domestic market followed by the slowdown in economic growth as well as lack of hikes in energy prices. The annual PPI index in the manufacturing sector continued to fall, in line with a process, which started in June. Annual dynamics in other sectors such as mining and quarrying as well as electricity, gas and water supply continued to be higher than the overall PPI index. This reflected the ineffective structure of the economy where monopolies continue to distort production costs.

Katarzyna Zawalińska

Agricultural commodity prices

• **Agricultural prices keep falling**

In 1Q02, the supply of crops and meat was significantly larger than in 1Q01. This ample supply was far higher than the relatively weak demand, thus resulting in an annual decrease in the prices of these commodities – with the exception only of beef.

In 1Q02, crop prices were on average lower yoy, 17% in the case of wheat, and 20% in the case of rye, while procurement purchases were higher by 30% and 35%, respectively. Although crop prices have revealed a slight growth trend during recent months (wheat prices since November and rye prices since August last year), they have generally persisted at the low level of last year's harvest. According to the Agricultural Market Agency (ARR), crop prices will increase until June, by about 6% in case of wheat, and 4% in case of rye against the current level. In September, however, they are expected to drop, to the current level or even below as a result of post-harvest higher supply. Generally, this year's harvest is expected to be smaller than in 2001, estimated at 25–26 million tons. This should not, however, put pressure on price increases because supply should still surpass demand (high stocks and cheaper imports from Western markets). The situation on the domestic market leaves little room for additional imports – according to the ARR, between July 2001 and February 2002 only 536 thousand tons of crops and crop products were imported, i.e. 64% less than during the same period last year. It also seems that further imports will not be extended beyond 2002 quota-free agreements.

In 1Q02 meat supply was 17% higher yoy. This was to a large extent the result of higher imports. In response to this large supply, pork prices have been falling since 4Q01, though this trend was reversed in March. Despite the fact that in 1Q02 the average procurement price for pork was 3% lower yoy, market prices were on average 1.5% higher than in 1Q01. According to the ARR's forecasts, prices of pork should remain fairly stable at the current level (both procurement and market) until September. That is to say still below last year's levels. In 1Q02 the average price of poultry was 17.3% lower yoy. The only market where prices grew in 1Q02 yoy was the beef market. The average procurement price during the quarter was 7.6% higher than last year's level, and the market price 6.5% higher. Beef prices should not change significantly during 2Q02 and 3Q02 compared to the current level, which means that they will also remain stable on a yoy basis. Beef imports need time to recover after last year's bans and should remain weak during the next two consecutive quarters.

Przemysław Woźniak

Core inflation

• **Core inflation indices continue to fall**

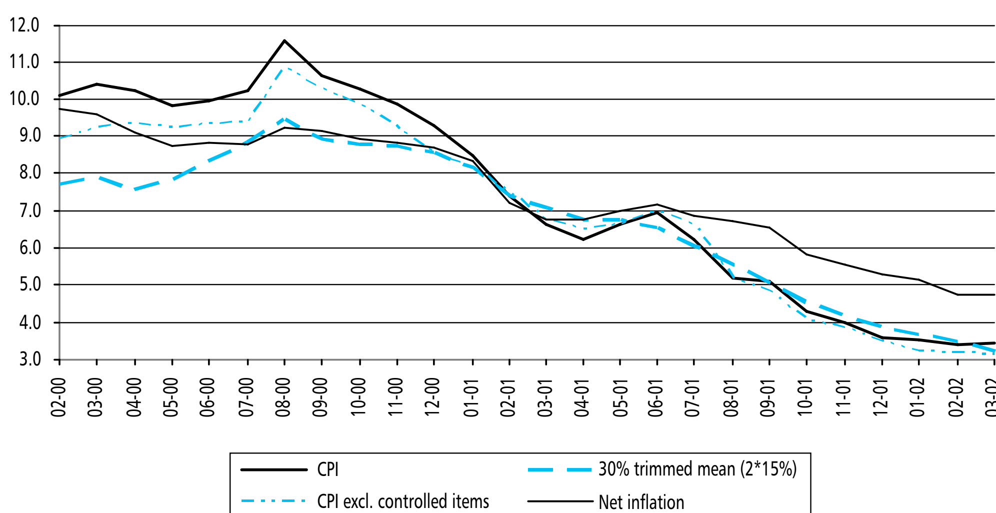
Core inflation trends from the second half of 2001 continued in 1Q02. All indices calculated by the central bank fell considerably and the alignment of the core series with respect to the headline inflation series remained unchanged. Net inflation (calculated without prices of food and energy) still substantially exceeds

headline inflation, although the gap between the two measures narrowed during the first 3 months of 2002 and amounted to 0.86 percentage points at the end of March (as compared to 1.66 percentage points in November 2001). This is certainly due to the deceleration in the rate of falling fuel prices (a 3.8% drop on an annual basis as of end-March vs. 11% drop as of end-2001) and stabilisation of the rate of growth of food prices. Food and fuel prices still constitute a significant source of the disinflationary pressure although its strength is weakening somewhat and may soon vanish as a consequence of the rise of world gas prices or weaker domestic agricultural crops. Thus, we expect net and headline inflation to come closer together in the months to come.

Core inflation excluding administratively controlled items has been below headline inflation since July 2001. This points to still existing inflationary pressures stemming from goods and services under state control. These pressures have gone up slightly since the end of 2001 as reflected in the widening gap between the two measures, from 0.1 percentage points in November 2001 to 0.3 percentage points in March 2002. The biggest price hikes (as of end-March) were registered by: state administration fees (over 20% on an annual basis), the public radio and tv subscription fee (about 12%) and central heating and electricity (over 7%). The smallest price growth took place in transport services, while telecommunication services and fuel were cheaper compared with a year ago. Electricity and gas price increases scheduled for 2Q02 and 3Q02 will certainly contribute to a widening of the deviation between headline inflation and this measure of core inflation.

Of all core inflation indicators the 15% trimmed mean performs best in filtering out reversible shocks that destabilise headline inflation (see Chart 2.1). The two indices have been running roughly parallel during the past 12 months, which suggests that disinflationary processes are relatively comprehensive. The inflation drop witnessed in recent months is not just a consequence of conducive supply-side phenomena (low prices of fuel and some foodstuffs) but also reflects the situation in most consumer goods markets. Low (or negative) rate of price growth persists also in the following sectors: furnishings and household goods (2.5% as of end-March), food and beverages (2.2%) and clothes and shoes (-0.5%). For that reason, the trimmed mean reflecting the price developments of a core of the consumption basket (from which 15% of extreme price hikes and drops were eliminated) and headline inflation exhibit similar trends.

Chart 2.1. Core inflation, 2000–2002 (% change, yoy)



Source: CSO, NBP, and CASE.

These tendencies are also confirmed by the remaining two core inflation measures calculated by the NBP: core inflation excluding most volatile prices as well as core inflation excluding most volatile prices and the price of fuel (not represented in the chart and not analysed thus far in PEO). Both measures indicate developments for the most stable (exhibiting lowest price variance) groups of consumer goods. In line with other indices, these two series have pointed to consistent disinflation stretching beyond sectors prone to supply shocks for several months now.

External sector

Rafał Antczak

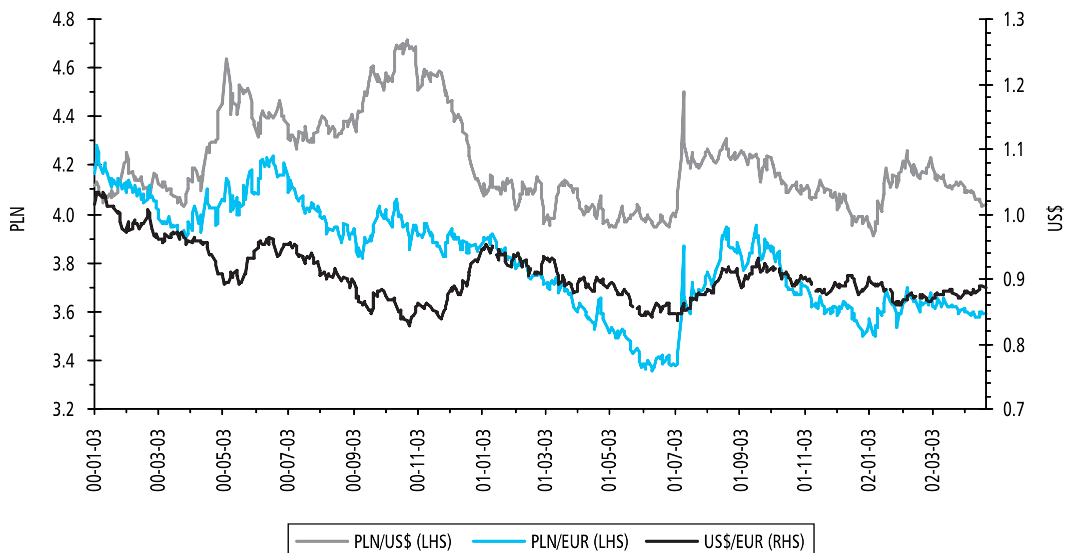
Exchange rate

- **Stabilisation of euro-dollar rate continues**
- **Zloty fluctuations**

Stabilisation in the euro–dollar exchange rate, which started in 2H01, continued during 1Q02. The average euro–dollar rate was 0.877 in 1Q02, with up to 5% fluctuations in January and not more than 1.5 percent in February–March. The reasons behind the stable euro–dollar rate for three quarters running are the convergence of GDP growth in the USA and EU (in 4Q01 0.5% against 0.6%, yoy), inflation rates (respectively, 1.8% against 2.0%), and the narrowest spread between the Fed's and ECB's interest rates since the introduction of the euro (1.75% against 3.25%).

With a stable euro–dollar exchange rate the fate of the zloty against the euro and the dollar was mainly influenced by domestic factors. In 1Q02 the average zloty rate at the NBP weakened by 3.2% against the dollar and 1.3% against the euro compared to 4Q01. However, since March the zloty has started to strengthen, both against the dollar and the euro. In April the zloty was stronger than in December 2001 (a nominal appreciation of the zloty by 2.2% against the dollar and by 0.4% against the euro). The reason for the zloty's weakening in February was the lower risk premium after the interest rate cut in January (by 150 basis points), which temporarily diminished foreign investor interest in the Polish market. The purchase of bonds by foreign investors on primary market went down by PLN 200 million. This was also against a backdrop of familiar statements by some politicians in favour of zloty devaluation (this time, in the

Chart 2.2. Exchange rates, 2000–2002



Sources: NBP.

context of Poland's accession to the ERM-2). In March–April the zloty strengthened on the back of expectations of further cuts in interest rates and as a result of the significant purchase of Treasury papers by foreign investors. By the second ten days of April their bond portfolio had increased by PLN 8.8 billion compared to end-December 2001, and by PLN 2.5 billion compared to end-March, amounting to PLN 28 billion.

In 1Q02 the zloty's real exchange rate did not strengthen as much as in the previous quarters. This was for two reasons: firstly, the zloty against both the euro and the dollar depreciated in nominal terms for most part of the quarter; secondly, the difference between consumer price dynamics in the euro-zone and in Poland narrowed (changes in consumer prices are used to calculate the real exchange rate). At the same time, the relationship between producer price indices in the euro-zone and in Poland also worsened. This lowered the competitiveness of Polish products on European markets. A more favourable situation was seen between January and September 2001, when producer prices in the euro-zone grew faster than prices in Poland. Therefore, the strengthening of the zloty's real exchange rate, deflated by producers' prices, was not as strong as it was deflated by consumer prices. But from November 2001 to January 2002, producers' prices in the euro-zone registered higher growth than in Poland. This, combined with a nominal appreciation of the zloty in 4Q01, reversed this favourable trend.

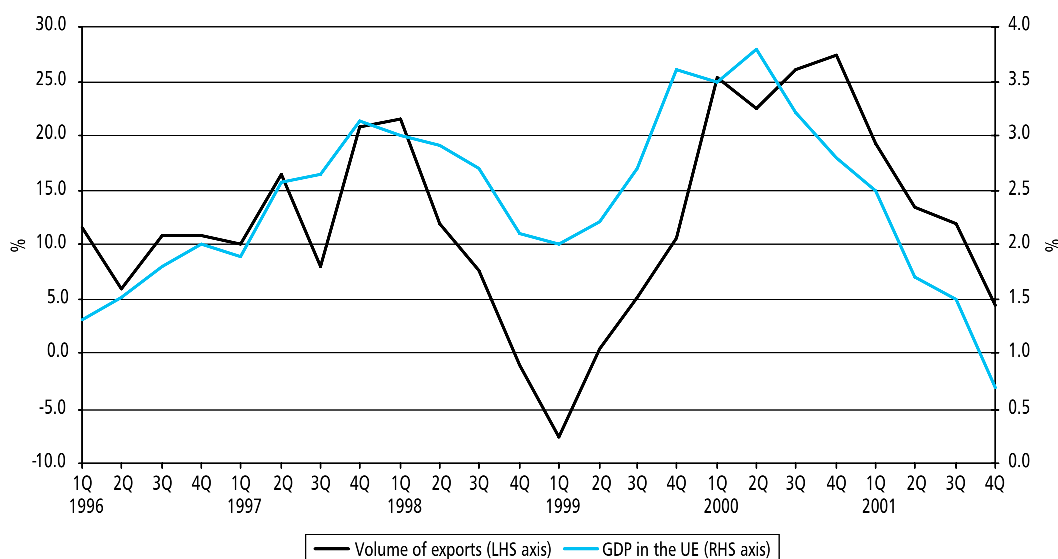
Łukasz Rawdanowicz

Foreign trade

- **Improvement in the merchandise trade deficit in 2001**
- **No new developments in 1Q02**
- **Stable commodity and geographical structure of Polish foreign trade**

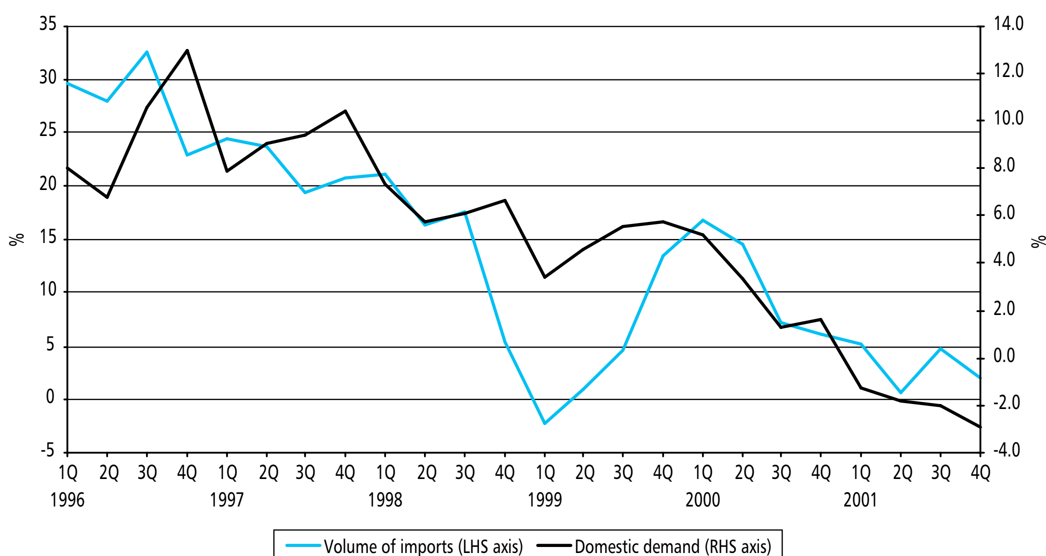
2001 was the second year in a row of improvements in the merchandise trade balance (both according to the CSO and NBP data). This situation is not only associated with the significant slowdown in imports but also with good export performance. As the real (and also nominal) zloty exchange rate appreciated in 2000–2001, one should conclude that demand factors were more important in shaping the trade deficit. Such a conjecture

Chart 2.3. Volume of exports and GDP growth in the UE, 1996–2001 (% change, yoy)



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

Chart 2.4. Volume of imports and domestic demand growth, 1996–2001 (% change, yoy)



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

Table 2.1. Geographical structure of foreign trade, 1992–2001

	Exports	I	II	III	IV	Imports	I	II	III	IV
	US$ billion	%	%	%	%	US$ billion	%	%	%	%
1992	13.2	71.9	58.0	12.7	15.4	15.9	72.4	53.2	11.3	16.3
1993	14.1	75.1	63.2	11.6	13.3	18.8	74.1	57.2	10.3	13.5
1994	17.2	75.4	62.6	10.1	14.5	21.6	75.1	57.5	10.6	14.2
1995	22.9	75.0	70.0	7.7	17.3	29.0	74.3	64.6	10.3	15.4
1996	24.4	71.7	66.2	7.8	20.5	37.1	73.6	63.9	10.9	15.6
1997	25.8	69.0	64.0	6.6	24.4	42.3	73.5	63.8	11.6	14.9
1998	28.2	73.6	68.3	6.0	20.5	47.1	74.7	65.6	12.1	13.1
1999	27.4	76.3	70.5	6.7	17.0	45.9	74.1	64.9	11.7	14.2
2000	31.7	76.3	69.9	6.3	17.3	48.9	70.9	61.2	10.6	18.5
2001	36.1	75.1	69.2	6.6	18.4	50.3	70.0	61.4	11.9	18.2

Source: CSO.
Note: Country groups:
group I: Canada, the US, European countries excluding those listed in group III and IV, Australia, New Zealand, Israel, Japan, the Republic of South Africa and group II;
group II: EU countries (until December 31, 1993 – EC) (since January 1, 1995 Austria, Finland, and Sweden);
group III: countries of Africa (excluding the Republic of South Africa), Central and South America, Asia (excluding Israel and Japan but including Asian FSU countries), Ocean rim (Polynesi , Micronesia, Malaysia) and countries of former Yugoslav (since January 1, 1996 excluding Slovenia);
group IV: Belarus, Estonia, Lithuania, Latvia, Moldova, Russia, Ukraine, Albania, Bulgaria, Czech Republic, Romania, Slovak Republic, Slovenia (since January 1, 1996), and Hungary.

Table 2.2.1. Commodity structure of exports, 1992–2001 (%)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
0. Food and Live Animals	12.8	10.2	10.1	9.2	10.1	11.9	10.1	8.5	7.5	7.4
1. Beverages and Tobacco	0.6	1.0	1.4	0.7	0.5	0.4	0.3	0.4	0.4	0.4
2. Crude Materials, Inedible, Except Fuels	8.5	5.5	4.7	4.5	3.4	3.2	2.8	3.1	2.8	2.5
3. Mineral Fuels, Lubricants And Related Materials	10.7	9.7	9.1	8.2	6.9	6.6	5.5	5.0	5.1	5.6
4. Animal And Vegetable Oils, Fats And Waxes	0.1	0.1	0.1	0.2	0.2	0.2	0.1	0.2	0.1	0.0
5. Chemicals And Related Products	8.6	6.8	6.7	7.7	7.7	7.9	6.7	6.2	6.8	6.3
6. Manufactured Goods Classified Chiefly By Material	27.1	26.4	27.5	27.5	25.8	26.5	25.2	25.5	24.8	23.9
7. Machinery And Transport Equipment	19.2	20.9	19.8	21.1	23.4	21.6	28.4	30.3	34.2	36.2
8. Miscellaneous Manufactured Articles	11.7	19.4	20.5	20.8	22.0	21.7	20.8	20.9	18.3	17.6

Source: CSO.
Note: According to the SITC classification.

Table 2.2.2. Commodity structure of imports, 1992–2001 (%)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
0. Food and Live Animals	9.6	9.7	8.7	8.0	8.5	6.8	6.4	5.5	5.2	5.4
1. Beverages and Tobacco	1.0	0.8	0.9	0.7	0.7	0.7	0.6	0.8	0.4	0.5
2. Crude Materials, Inedible, Except Fuels	5.4	4.6	5.2	5.4	4.7	4.2	3.5	3.1	3.4	0.3
3. Mineral Fuels, Lubricants And Related Materials	16.8	12.5	10.5	9.1	9.2	8.7	6.4	7.2	10.8	10.1
4. Animal And Vegetable Oils, Fats And Waxes	0.6	0.6	0.7	0.7	0.6	0.6	0.6	0.4	0.3	0.3
5. Chemicals And Related Products	13.5	13.3	14.7	15.0	13.8	13.8	13.7	14.3	14.1	14.6
6. Manufactured Goods Classified Chiefly By Material	11.8	18.5	20.2	21.6	20.1	19.6	20.8	20.7	20.0	20.6
7. Machinery And Transport Equipment	29.9	29.4	28.8	29.9	33.0	36.0	38.3	38.2	37.0	36.4
8. Miscellaneous Manufactured Articles	10.3	10.2	9.9	9.3	9.3	9.4	9.5	9.5	8.6	8.8

Source: CSO.
Note: According to the SITC classification.

is consistent with empirical research on import and export demand found in the literature. Both import and export elasticity with regard to price (the exchange rate) is lower than with regard to demand.

In 1Q02 the main trends from 2H01 were continued – both export and import growth softened. As the decline in nominal imports (in dollar terms) was markedly higher than in exports, the balance of merchandise trade recorded a 4-year low, amounting to US$ 2.6 billion.

Using the annual data on Polish foreign trade based on customs records we analysed trends in the commodity and geographical structure of Polish trade. Based on data

gathered in tables 2.1 and 2.2.1–2.2.2, we conclude that the last three years brought little change in both structures. On the positive side, we observe a rise in the share of exports of machinery and transport equipment in total exports. Unfortunately, this level of data aggregation makes it impossible to state whether the increase refers primarily to low- or high-value-added commodities. When analysing these data, one should remember that the shares are computed in current prices. Thus, some changes may stem from changes in relative prices of selected commodity groups. With regards the geographical structure of foreign trade, we point to the slow reconstruction of exports to Russia and other European CIS countries. In 2001 exports to Russia and Ukraine in dollar terms were still below the levels recorded in 1998 (i.e. prior to the Russian crisis) – 66.3% and 92.3% of exports in 1998, respectively.

In line with our expectations, 4Q01 saw continued improvement in the terms of trade. Although both export and import prices were on the decline, the latter declined faster. Consequently, the terms of trade amounted to 104.4. In 1Q02 this positive trend may have been reversed – primarily on the back of an increase in oil prices and some depreciation of the zloty.

Łukasz Rawdanowicz

Balance of payments

- **Deterioration in the current account deficit**
- **Contraction in unclassified current transactions**

In 1Q02 despite the 4-year-record-low merchandise trade deficit, the current account balance deteriorated. It amounted to US$ 2.3 billion – markedly higher than in 4Q01 (by US$ 550 million) and in 1Q01 (roughly by US$ 160 million). This resulted from a contraction in the unclassified current transactions surplus – US$ 480 million in 1Q02 vs. US$ 1.3 billion in 4Q01 and US$ 730 million in 1Q01. This low reading was driven by very high imports of second-hand cars spurred by the introduction of excise tax. The imports of second-hand cars were financed with money changed at exchange bureaus and/or drawn from foreign currency personal bank accounts, and thus are classified under the unclassified current transactions item of the balance of payments. In addition, the high deficit in the income item – due to the payment of interest on the foreign debt in March – impacted on the current account deficit.

On the side of the financial account of the balance of payments, small FDI inflows should be mentioned. In 1Q02 they stood at nearly US$ 1.0 billion – well below quarterly readings during the past four years. On the other hand, portfolio capital inflows were remarkable – nearly US$ 1.5 billion (and only in March US$ 1.1 billion). However, it must be stressed that the capital inflow was associated only with debt instruments (including government papers – see *Financial markets*), while investment in shares was withdrawn.

At the end of 1Q02 the level of gross official foreign assets remained broadly unchanged and amounted to US$ 27.1 billion. This was sufficient to cover nearly 8 months of average imports.

Małgorzata Markiewicz

Public finances

- **1Q02 budget execution complies with our previous forecast**

The 2002 budget bill was signed by the President on March 14, 2002. During the budgetary process in parliament, revenues and expenditures were increased by PLN 1.1 billion. On the revenue side, the planned VAT increase was PLN6 25 million (despite the government withdrawing the proposal to raise VAT on construction materials and services). The plan for non tax revenues was also extended in the parliament. The budget bill assumes growth in VAT revenues of 9.6%. Such a jump is expected due to an increase in VAT rates on skates, skis, sleighs and toys, from 7% to 12%, and due to a higher assumed VAT collection rate. If this plan is executed, the reserve funds will be spent on education reform, higher teachers' wages, an increase in endowments for the Agriculture Market Agency and the construction of roads and highways. However, the approval of a higher VAT collection rate is in contrast to the dynamic growth in VAT tax arrears (VAT outstanding liabilities at the end of September 2001 equalled PLN 7.5 billion, a 23% growth since the beginning of the year). The situation is similar to the one from the

Tabel 2.3. Budget for 2002 – consecutive versions, PLN million

	Revenues	Expenditures	Deficit
Budget proposal of September 25, 2001	154.77	194.77	40.0
Budget proposal of November 2001	143.97	183.97	40.0
Budget Law of March 14, 2002	145.10	185.10	40.0

Source: Ministry of Finance, Public Debt Department and NBP.

previous year, when the government's revision to the budget assumed 16.4% growth in VAT revenues, while the final execution showed a mere 2.3% increase.

The 2002 Budget is based on prudent macroeconomic assumptions: a GDP growth rate of 1% and average inflation at 4.5%. In 2Q02 the Ministry of Finance lowered its inflation forecast. In the face of this change budgetary revenues seem now to be somewhat overestimated, something we mentioned in our previous forecast. The government approved changes in excise tax and introduced excise tax on energy. There was some delay against budgetary assumptions in launching these changes (the law was approved on March 26).

According to the government's declaration, expenditures will grow by 1% in real terms over the next few years. Unfortunately, the 2002 budget seems to have already broken this rule – according to the budget law expenditures grow by 7.1%, and with the inflation rate assumed in the budget this means a 2.5% increase in real terms. If we take into account our inflation forecast (3.2%) real expenditures will expand by 3.9%.

In 1Q02 the budget was executed in line with the plan. Revenue collection reached 21.6% of the annual plan and expenditures 25.8%. Budget deficit execution in 1Q02 equalled 41.4% of the plan, which is a relatively good result in comparison with 73.3% in 2001 and 45.1% in 2000. The worse level of execution was registered for PIT revenues – they continue to fall in real terms. CIT revenues gained a clear momentum, which is somewhat surprising when compared with the 27% real drop in the previous year and lack of evident signs of recovery. Therefore, it is difficult to judge how sustainable the change is. There are no surprises on the expenditure side. A higher execution has been seen in endowments to the Labour Fund (unemployment benefits and pre-retirement allowances) as well as endowments to local governments. The Social Security Fund has been receiving its endowments on time (in 1Q02, 26.7% of the annual plan). Hence, ZUS has transferred 22.3% of the annual plan (PLN 11.5 billion) to the pension funds, which means that new arrears have not been accumulated.

The budget deficit of PLN 16.4 billion was financed on the domestic market mainly through the issue of government bonds. Also funds, which were transferred from the previous year to the tune of PLN 6.2 billion, were used in 1Q02 for deficit financing. Privatisation revenues remain insignificant: PLN 0.6 billion versus PLN 6.6 billion planned for the whole year. In April 2002, the Ministry of Finance announced preliminary estimates for the economic deficit and general government sector deficit in 2001. According to these figures, the economic deficit grew from 2.0% of GDP in 2000 to 4.8% in 2001, and the general government deficit from 2.6% to 5.3%.

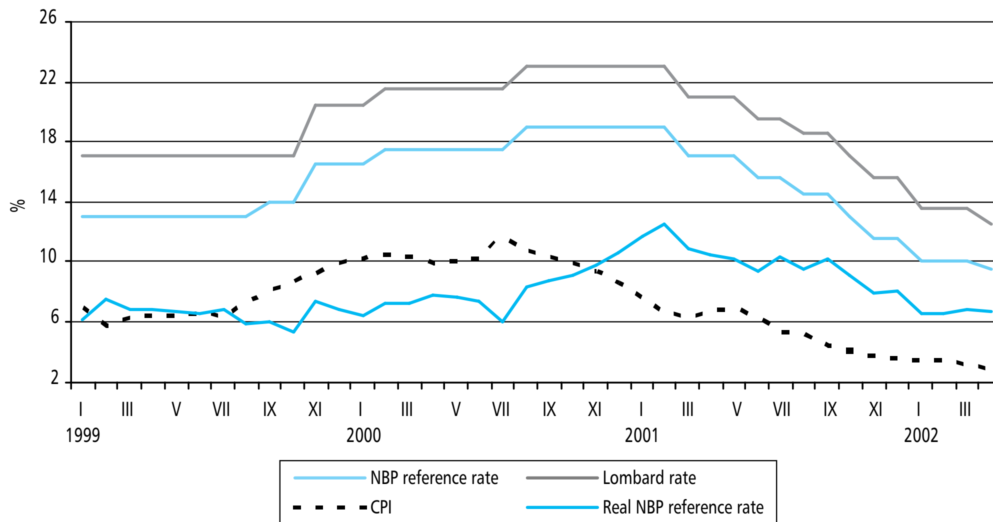
Rafał Antczak

Monetary policy

- **NBP statistics adjusted to ECB standards**
- **Fine-tuning interest rate strategy introduced**
- **Lowering deposits versus growing cash in circulation**

Since March, the NBP has launched European Central Bank standards in its presentation of monetary aggregates. The money supply is represented by M3 (the main monetary indicator used by the European System of Central Banks) together with the components of its

Chart 2.5. Monetary policy instruments, 1999–2002



Source: NBP and CASE.
Notes: The real NBP reference rate is calculated as a difference between NBP reference rate and CPI inflation.

creation. Additionally, the classification of sectors was modified. Amongst other things, a 'households' category was introduced. As well as physical persons and farmers this includes individual entrepreneurs employing up to 9 workers. The new data still have a preliminary character, as some aggregates are based on proxies (from, e.g., GUS, ZUS, KRUS). One cannot rule out the possibility of changes in the forthcoming months, also in respect to data for 1Q02. The full introduction of the ECB standards has yet to take place and will require more detailed information. Therefore, the NBP plans to widen the data set during the next stage of standardisation.[2] The above changes have been taken into account in analysis and forecasts of monetary aggregates in this issue of the PEO.

Cuts in interest rates by 50 basis points on April 26 began the anticipated period of interest rate fine-tuning by the RPP. The April cut was the eighth in a row since the beginning of 2001. Since then, interest rates have been cut by 950 basis points, while inflation has dropped by 450 basis points. As a result, the real NBP interest rate has been halved and maintained at a level of 6.5% annually.

In 1Q02 the supply of reserve money fell due to the decline of net foreign assets (an effect of valuation adjustment), but most of all due to a significant decline in government sector indebtedness to the NBP (by PLN 9.5 billion compared to December 2001 and by PLN 6.3 billion in February–March alone).

The banking system and broad money

After the RPP's January cut in interest rates of 150 basis points, in February the interest rate spread for companies increased, while for households it decreased. This reversed the trend of previous months. The decline of the latter resulted from an average cut in credit interest rates by 160 basis points, i.e. by more than cuts in the NBP's interest rates. This tendency

[2] Detailed information on changes in classification are available on the NBP site (www.nbp.pl).

Table 2.4. Contribution to money supply dynamics, 2000–2002 (cumulative, %)

	2000				2001				2002
	I	II	III	IV	I	II	III	IV	I
Reserve money (RM)	-14.4	-1.8	-3.2	-7.6	-1.0	-0.5	-1.0	22.4	-2.8
Net foreign assets (NFA)	0.4	-5.7	12.0	18.8	-1.5	-12.2	-25.3	-11.9	-9.8
Net domestic assets (NDA)	-1.9	9.2	1.0	-9.5	-5.9	-3.3	-7.3	5.6	-16.3
Net claims on government (NCG)	-1.6	9.8	1.5	-9.1	-6.7	-4.8	-11.7	7.7	-15.9
Claims on deposit money banks (CDMB)	-0.3	-0.7	-0.6	-0.4	0.8	1.5	4.4	-2.1	-0.4
Other items net (OIN)	-12.9	-5.3	-16.2	-16.9	6.5	15.2	31.5	28.8	23.4
Broad money (M3)	0.2	8.8	7.7	12.1	2.7	4.5	8.3	9.1	-2.9
Net foreign assets (NFA)	1.8	0.5	3.8	9.5	1.0	-1.5	-4.5	2.0	-3.3
Net domestic assets (NDA)	0.4	8.9	9.3	6.9	0.3	2.3	7.5	10.6	-1.7
Net claims on government (NCG)	-2.5	-1.3	-1.3	-4.4	-0.9	0.1	0.2	4.1	-1.7
Claims on deposit money banks (CDMB)	3.0	10.2	10.4	11.3	1.5	2.4	6.4	5.3	-0.1
Other items net (OIN)	-1.9	-0.6	-5.4	-4.3	1.4	3.7	5.3	-3.6	2.1

Source: NBP and CASE.

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.

continued in March – according to preliminary information from the biggest banks credit interest rates to households were significantly lowered, especially consumer credits (cash credits). Their rates dropped by 290 basis points between December 2001 and March 2002. The difference in credit interest rates to households and companies declined from 460 basis points in February to 390 basis points in March, though it is still significant. Such a discrepancy results from the lower elasticity of households than companies to changes in credit interest rates and the quality of credit portfolio to households. The share of impaired debts in total credits reached 20%, with a growth in bad consumer debts.

The annual growth in the M3 money supply lowered to 3.1% in March (from over 7% during the previous months). In comparison with end-2001, the supply of M3 dropped by 2.9% in March. This resulted from a decline in net credit to the government, credit to the private sector, and net foreign assets (an effect of the valuation adjustment). The decline in government indebtedness in the banking system reflected the decline in government debt towards the central bank, though not towards commercial banks. The indebtedness of the budget in commercial banks has increased. In 1Q02 there was a decline in net government debts to the NBP by as much as PLN 9.5 billion, and in the overall banking system by only PLN 5.5 billion. The decline in government debts to the NBP resulted not only from debt repayments by the budget but also from an increase in deposits on the central budget accounts due to the sale of 10-year eurobonds (around PLN 2.6 billion) and the huge emissions of Treasury papers.

A small decline in credits to the private sector during 1Q02 was an effect of the drop in credits to units other than companies and households. Credits to the latter increased slightly. On the other hand, we observed a deeper decline in deposits to the private sector (by PLN 10.3 billion, including PLN 12.6 billion in company deposits). Some of the declines, e.g. in deposits of non-monetary financial institutions (i.e., banks) may be explained by a shift in the maturity of deposits to over 2-year periods. The operation excludes these deposits from the M3 money aggregate. Such a situation already

Table 2.5. Calendar of the most important events in the NBP's monetary policy, 2001–2002

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
J NBP No. 17	October 25	Rediscount rate 15.5% Lombard rate 17.0% Refinancing rate 17.0/18.0% Reference rate at min. 13.0%
J NBP No. 20	November 28	Rediscount rate 14.0% Lombard rate 15.5% Refinancing rate 15.5/16.5% Interest rate on NBP current deposits 7.5% Reference rate at min. 11.5%
J NBP No. 23	December 19	Reserve rate requirement at 4.5% since January 1, 2002
J NBP No. 2	January 30, 2002	Rediscount rate 12.0% Lombard rate 13.5% Refinancing rate 13.5/14.5% Interest rate on NBP current deposits 6.5% Reference rate at min. 10.0%
J NBP No. 3	February 8	Conversion of 6-, 7-, 8-year NBP bonds into 10-year bonds worth PLN 7.8 billion
J NBP No. 6	March 15	Changes in system of calculation and maintaining required reserves (in compliance with ECB standards)
J NBP	April	Rediscount rate 11.0% Lombard rate 12.5% Refinancing rate 12.5/13.5% Interest rate on NBP current deposits 6.5% Reference rate at min. 9.5%

Source: Journal of the NBP, Monitor Polski, and own compilations.

took place in household' deposits in November 2001, when the attempt to avoid taxation on bank interest caused the outflow of PLN 11.8 billion from the banking sector. In 1Q02 household deposits, including physical persons, increased respectively by PLN 7.1 billion and PLN 7.4 billion (indicating a drop in deposits of small firms by roughly PLN 300 million, a trend in line with the big companies). However, the pace of household deposit growth has experienced a slow down – by 5.9% in December 2001 and 3.5% in March 2002.

The most worrisome feature in the structure of the M3 money is the consolidating trend of growing cash in circulation. From the beginning of 2002, cash grew by 1.5% in nominal terms (that is, by PLN 580 million), however the annual growth rate reached almost 16% in 1Q02. A decline in inflation and real interest rates lowers the opportunity costs of cash use. However, the main reason behind such a development might be an expansion of the shadow economy in response to weak economic conditions and worsening of the fiscal burden. The change in the structure of the money supply may lead to a change in its velocity that could eventually result in purely monetary factors influencing inflation in 6–9 months time.

Piotr Bujak

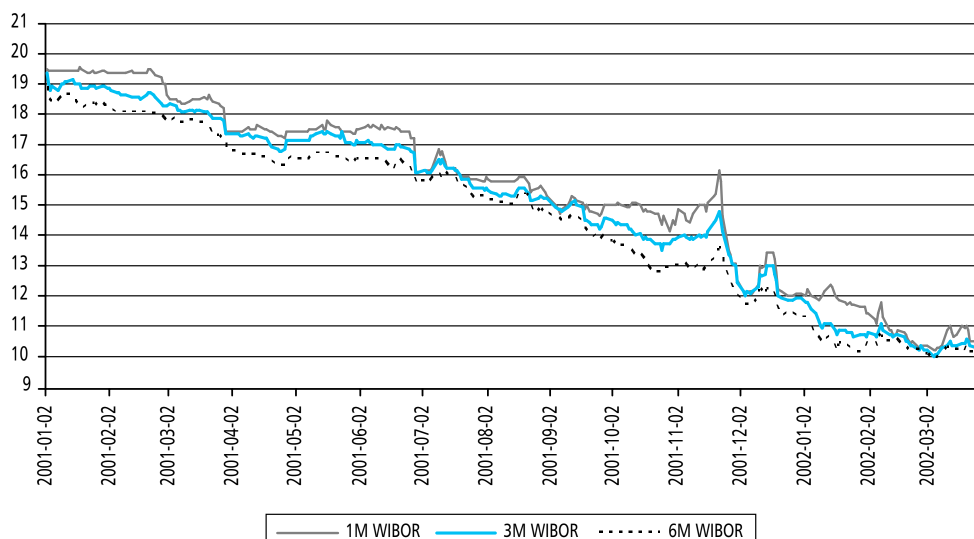
Financial markets

- **Record high sales of treasury bills**
- **Gradual fall in interest rate cut expectations**

Short-term interest rates

After a parallel downward shift of the yield curve in 4Q01, it flattened in 1Q02 falling stronger at the short end (that is with maturity up to 1 month). The liquidity situation of banks stabilised after some difficulties in the previous quarter. As a result, volatility of the shortest market interest rates waned and their deviation from the reference rate decreased. The shrinking current account deficit at the end of 2001 and the downward inflation trend evoked expectations of an interest rate cut in January. This was supported by a belief that the central bank would give in under the strong political pressure. This resulted in a fall in interest rates on papers with maturity above 1 month in the first half of January. Then, after information on headline inflation at 3.6% yoy in

Chart 2.6. 1-month, 3-month, and 6-month WIBOR, 2001–2002 (daily quotations)



Source: NBP.

December, market rates remained stable up to the MPC's meeting on 29th and 30th of January. Expectations of NBP interest rates cuts were supported by data on a fall in industrial output and increase in unemployment as well as interest rate cuts in the Czech Republic and Hungary. At that time, on the basis of swap and FRA rates, the market expected cumulative cuts in 2002 of about 350 basis points.

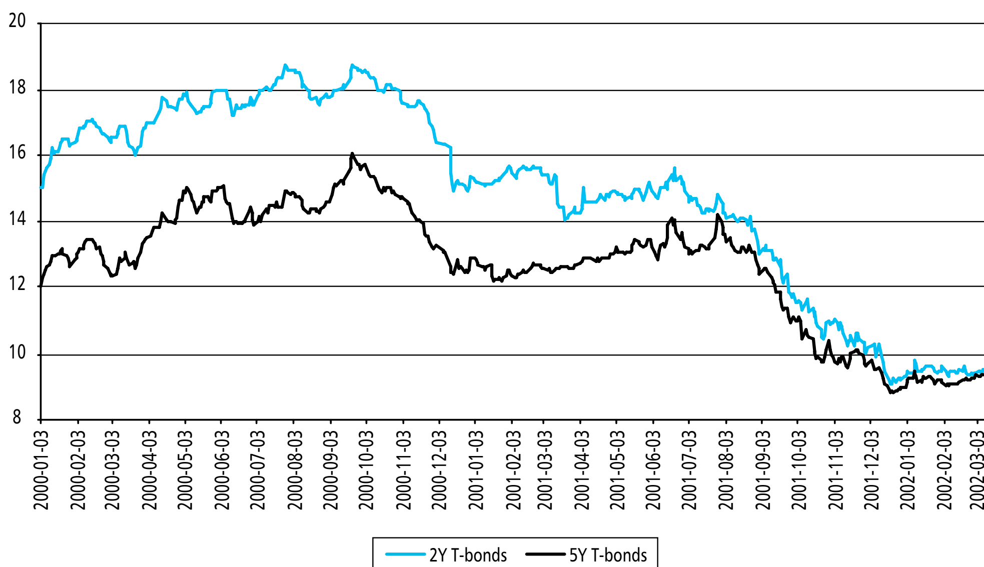
The MPC's decision to cut rates by 150 basis points in January was in line with market expectations. After the MPC's meeting the 1-month WIBOR rate fell gradually, although remained significantly above the new level of the reference rate. This tendency stemmed from the low level of liquidity in the banking sector after speculative purchases of the NBP bills before the MPC's meeting. WIBOR rates with longer maturities remained stable. As a result, the yield curve in the segment between 1 and 6 months flattened, indicating diminishing expectations of a further interest rate cut in the 6-month horizon. This was confirmed also by an increase in FRA rates after the MPC's meeting, albeit stemming to some extent from liquidity problems.

Better-than-expected data on inflation in January released in mid-February caused some increase in expectations of interest rates cuts over the 6-month horizon. The process of yield curve flattening on the money market was continued. Up to the end of 1Q02, apart from temporary tensions between 8th and 12th of March, WIBOR rates fell gradually, to lesser extent in the case of long maturities. Positive data on inflation announced in March did not affect the scale of expectations of interest rates cuts. Better-than-expected data on industrial output in February confirmed the market in the conviction that the next rate cuts will take place no earlier than at the MPC's meeting in April.

The Treasury debt securities market

Similar to the money market, expectations of interest rates cuts as early as at the MPC's first meeting in 2002 intensified also on the treasury market. Up to 10th of January, after the release of data on the balance of payments in November 2001 and food prices in the second half of December 2001, a significant increase in bond prices took place. However, investor optimism at that time was limited by the growing conflict between the MPC and the government and uncertainty over the results of the meeting of the two bodies on 9th of January.

Chart 2.7. Yield to maturity of 2Y and 5Y Treasury bonds, 2000–2002 (daily quotations)



Source: NBP.

After the interest rate cut in January, investors' evaluation of monetary policy evolved somewhat. Market participants recognised that the next cuts may be not large and may be distant. This was the main reason behind the yield increase.

An additional factor constraining incresaes in bond prices was the concern about the substantial increase in the supply of Treasury papers. Indeed, 1Q02 saw record issues of 2-year bonds in January and 5-year bonds in February. Despite the large issuance, the Ministry of Finance was able to sell the whole offer. Nevertheless, this was possible only at the expense of lower prices. Higher yields on the primary market worsened sentiment on the secondary market in February and March.

On 29th of March, the Ministry of Finance announced the introduction of new 20-year Treasury bonds. These will be fixed income instruments with a coupon of 5.75% paid on 23th of September between 2002 and 2022. At the same time the Ministry of Finance decided to suspend its issuance of floated 10-year bonds.

The introduction of 20-year bonds is aimed at the creation of a new benchmark for long interest rates in Poland and an extension of the average maturity of the public debt. At the moment, it seems that the issuance of 20-year bonds will lead to an increase in liquidity in the 10-year bond segment.

Outlook for the economy in 2002–2003

Łukasz Rawdanowicz

Economic growth

GDP and demand factors

- **Higher investment not before 2003**
- **Uncertain household consumption demand**

Against the background of economic developments in 1Q02 we see no reasons to alter significantly our outlook for 2002. Although we lowered our forecast for annual GDP growth to 1.8%, this is supported by the worse-than-expected results from 1Q02 and fine-tuning changes in the forecasts of specific variables. In this context, current changes should be interpreted as corrective ones and not as affecting our general view on economic prospects.

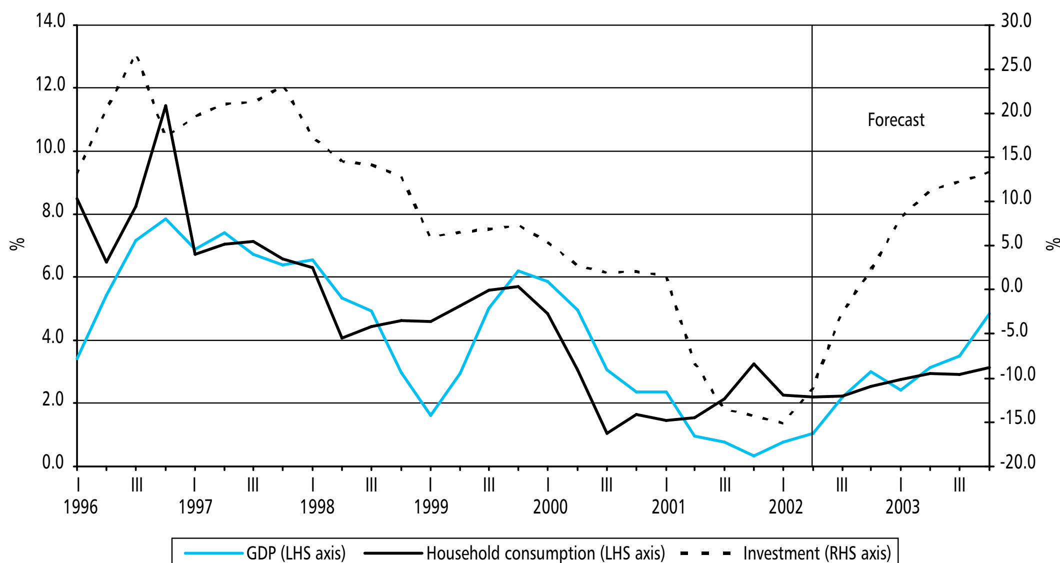
In the face of a contraction in the real labour fund and high unemployment in 4Q01 and 1Q02, growth in household consumption over that period was very robust. To a large extent this was possible due to lower savings. This situation may, however, lead to a sudden halt in spending caused by a deterioration in household confidence – for instance on the back of no signs of a strong economic recovery. In this respect, household consumption poses the main risk to our forecast. So far, we project only a minor slowdown in annual growth in consumption in 2Q02 and 3Q02 – as compared to 1Q02. Over this period signs of recovery will not yet be clearly evident and unemployment will remain high. In our view confidence factors will be more important in determining household behaviour than the increasing – in real terms – labour fund starting from 2Q02.

We uphold our forecast of a continued contraction in fixed investment until 3Q02. In the face of a better external environment and future cuts in interest rates (in the short-term this is more of a psychological factor), it may turn out that enterprises will be willing to start new investments earlier than we have anticipated.

With regard to foreign trade growth, we have altered our forecast considerably. We now anticipate both higher export as well as import growth. The better export performance is linked to the change in our appraisal of export elasticities and to the more optimistic external outlook. So far, however, we have changed our forecast of GDP growth in the EU only a little – disregarding the more upbeat outlook of the IMF, OECD, and many investment banks. Our caution is based on the fact that economic optimism relates primarily to the US (see *Global Economy*) and so far there are no fundamental factors underpinning faster-than-expected recovery in the EU. Finally, higher exports will drive higher imports.

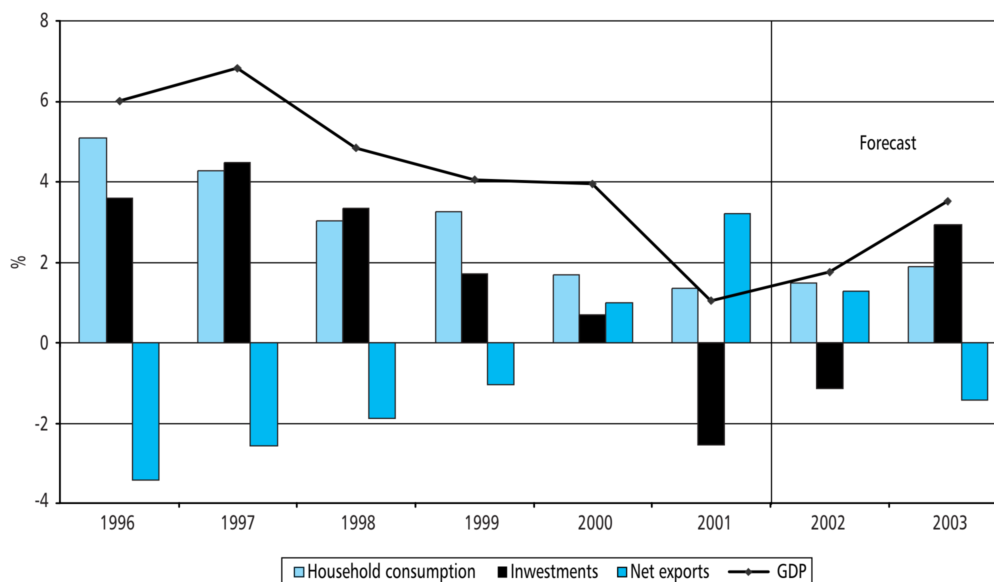
Due to changes in our foreign trade forecast its contribution to GDP in 2002 has been changed accordingly. Under the current outlook, the positive contribution of net exports will be smaller than

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



Source: CSO and CASE.
Note: CASE forecasts starting from 2Q02.

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



Source: CSO and CASE.
Note: CASE forecasts starting from 2002.

previously anticipated. As a corollary, the positive contribution of domestic demand will be higher. Similar changes, though larger, apply to the forecast for 2003.

It should be stressed at this point that the current risks associated with our forecast are more balanced, and that we should expect upward rather than downward revisions in subsequent quarters. On the one hand, there is a threat of halting household consumption growth. On the other hand, we see chances for higher investment and exports. If the latter materialise on the back of an improved external environment we should not worry about household consumption developments.

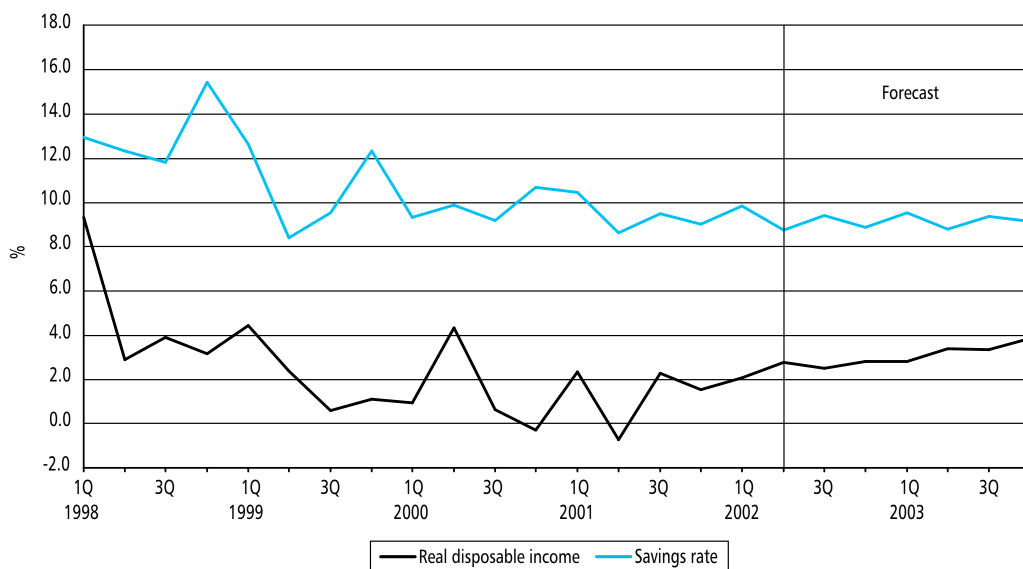
We have raised our forecast of GDP growth for 2003 from 3.2% to 3.5%. This change, as in the case of this year's forecast, stems from corrective adjustments in the growth of separate GDP components and not from changes in general macroeconomic trends. We expect higher momentum in investment and also in household consumption. Low inflation and real interest rates will be conducive to growth of both variables of domestic demand. However, as a consequence of higher domestic demand imports will expand even more rapidly. So, GDP growth is unlikely to increase proportionally to the rise in domestic demand and the negative contribution of net exports will be higher than the forecast 3 months ago.

The real sector

- **Industrial production outlook – unchanged in 2002 and brighter in 2003**
- **Contraction in the construction sector to continue in 2Q02 and 3Q02**

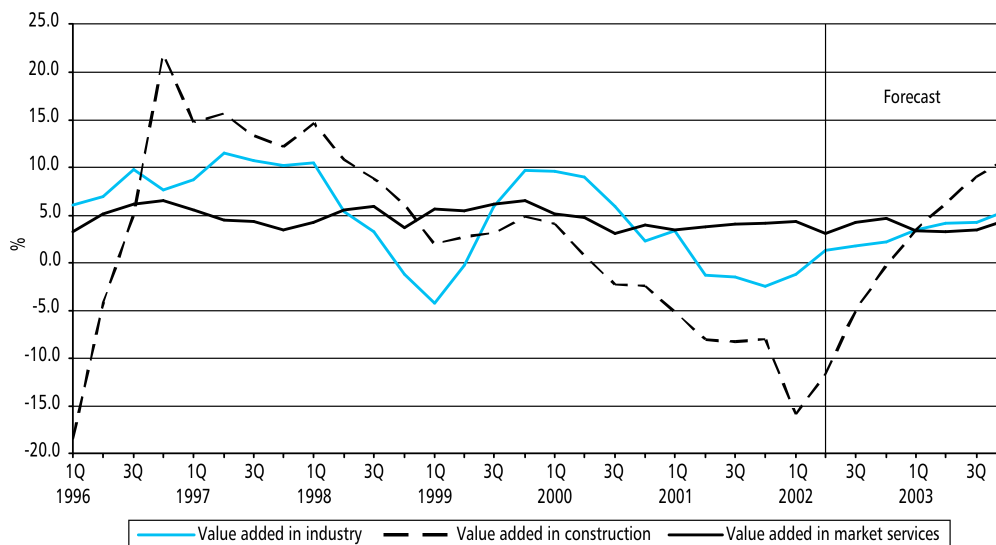
We have held our latest forecast for industrial production growth in 2002 broadly unchanged – altering only the quarterly dynamics. However, it seems that the risks are on the upside. In the event of a stronger-than-expected recovery externally and/or higher domestic investment, industrial production may record higher growth. On the other hand, we have already raised our outlook for industrial production in 2003. Higher household consumption, investment in fixed assets or foreign demand (as compared to the previous forecast) should underpin better performance in industry.

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



Source: CSO and CASE.
Note: CASE forecasts starting from 2Q02.

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



Source: CSO and CASE.
Note: CASE forecasts starting from 2Q02.

Deeper changes in our forecast have been made in the case of the construction sector. We now expect the contraction in this sector to extend well into 2Q02 and 3Q02. This is associated with our more pessimistic outlook for building investment. On the other hand, 4Q02 and 2003 should see faster recovery. In 2003 construction should expand by 8%.

Piotr Bujak

Labour market

• Slower increase in unemployment

We forecast that unemployment will keep rising in 2002. However, we expect the rate of growth in unemployment (yoy) to diminish in consecutive months. The moderate pace of economic growth will limit any faster improvement in the situation on the labour market. Moreover, the gradual economic recovery will not automatically lead to an increase in employment in the enterprise sector as we face continued work productivity improvements. The restructuring process that has been carried out recently enables enterprises to increase output without the necessity of hiring new workers.

A potential factor that may additionally constrain unemployment growth (in comparison to our forecast) is the introduction of the government's economic program, in particular in relation to graduates and entrepreneurs, i.e. the "First job" and "First of all entrepreneurship" sections. Their impact on the labour market will depend on the final shape of new regulations approved by parliament. However, substantial positive effects should not be experienced if the program is not accompanied with a reduction in labour costs related to wages.

We forecast an improvement on the labour market in 2003. This should stem from faster economic growth, including a revival in investments. In our prediction we do not take into consideration any planned amendments, as the final version of the new regulations is still not available. The most crucial will be amendments to the labour code and the tax law.

A slower pace of registered unemployment growth in 2002 and 2003 may also result from more effective unemployment monitoring by labour offices (that is, requiring the registered unemployed to actively seek

work – or be deleted from the register). This will allow a statistical reduction of the number of unemployed – as has probably already taken place in 1Q02. Additionally, the effectiveness of the labour market could be strengthened by an increased activity of labour offices in communicating with employers and stimulating labour supply according to their needs.

Mariusz Jarmużek

Prices

- **Stable medium-term inflation with some acceleration after 1H02**

We forecast stable inflation until 3Q02. Inflation is likely to hit its low-point in May. Subsequently, in 2H02 and 2003, we envisage a gradual recovery in domestic demand and a depreciation of the domestic currency followed by acceleration in prices. Over the forecast period, we assume a gradual relaxation of monetary policy and an alternating harvest.

In our view, the Energy Regulatory Office (URE) will allow an increase in energy prices of 10–14% this year. In 2003, we assume a strong growth in energy prices of 5–7%.

The PPI should also gradually increase. This will be due to the recovery in domestic demand and gradual depreciation of the zloty. However, we expect prices in sectors such as mining and quarrying as well as electricity, gas and water supply to rise faster than the overall index due to the lack of essential reforms in these sectors.

External sector

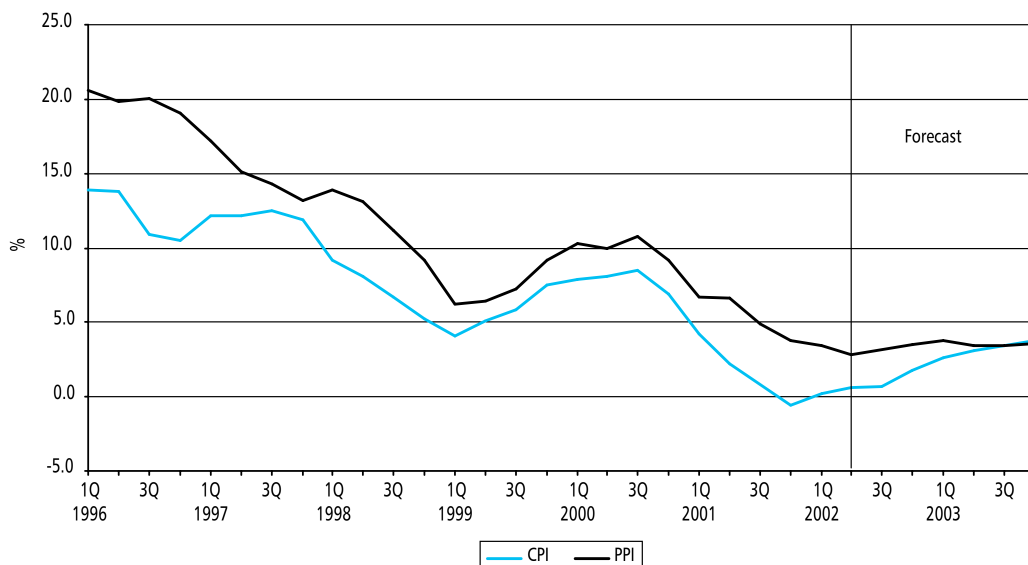
Rafał Antczak

Exchange rate

- **Euro-dollar exchange rate dilemma**
- **Appreciation of zloty**

The main economic indicators of the USA and EU may gradually diverge in 2002. The recovery in the US economy,

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



Source: CSO and CASE.
Note: CASE forecasts starting from 2Q02.

where GDP growth in 1Q02 reached 5.8%, came sooner than in the EU (growth forecast at 1.0% for 2002). Furthermore, the recovery in the US was not accompanied by inflationary pressure – contrary to the EU, where inflation has been hovering around 2%. However, there is a concern, shared by financial markets, as to the strength of the US revival. The high growth rate in 1Q02 with an improvement in inventories and decline in the growth of household consumption may turn out to have been a one-off. If, however, the recovery in the US lasts the expected Fed interest rates hikes from mid-2002 will become less controversial than the dilemma faced by the ECB of a short-term trade-off between faster growth and restraining inflation. The choice is even harder because the German economy has yet to show any signs of recovery. It is additionally experiencing problems keeping its budget deficit below 3% of GDP and interest rate increases cannot be ruled out. Parliamentary elections around the corner also add to the uncertainty. Therefore, a strengthening of the dollar against the euro in 2H02 seems the more likely scenario.

The zloty exchange rate is likely to be influenced not by further downward fine-tuning of interest rates but developments in the Treasury market and any surprises in the main economic indicators, such as inflation, the current account deficit (especially exports) and fulfilment of fiscal policy. The accumulation of only slightly negative results, e.g. a worsening of the trade balance as a result of weakening exports, or increase in inflation in 2H02 as well as uncertainty concerning recovery (which determines budgetary revenues) may lead to weakening of the zloty. However, in the short-term the active participation of foreign investors in the Treasury papers market guarantees a continuation of pressure on zloty appreciation.

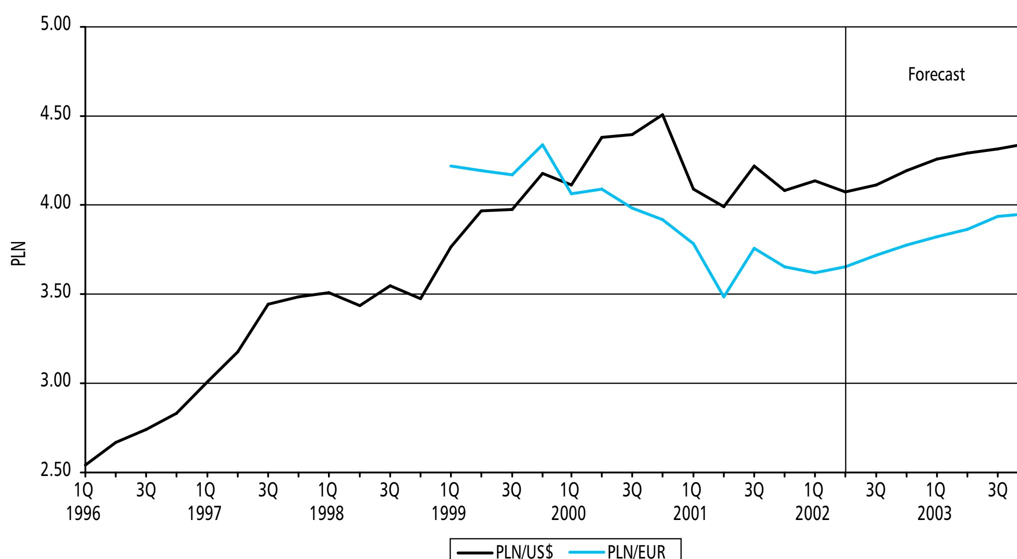
Łukasz Rawdanowicz

Foreign trade and balance of payments

- **No major changes in the export forecast for 2002**
- **Higher imports in 2003**
- **Rising current account deficit**

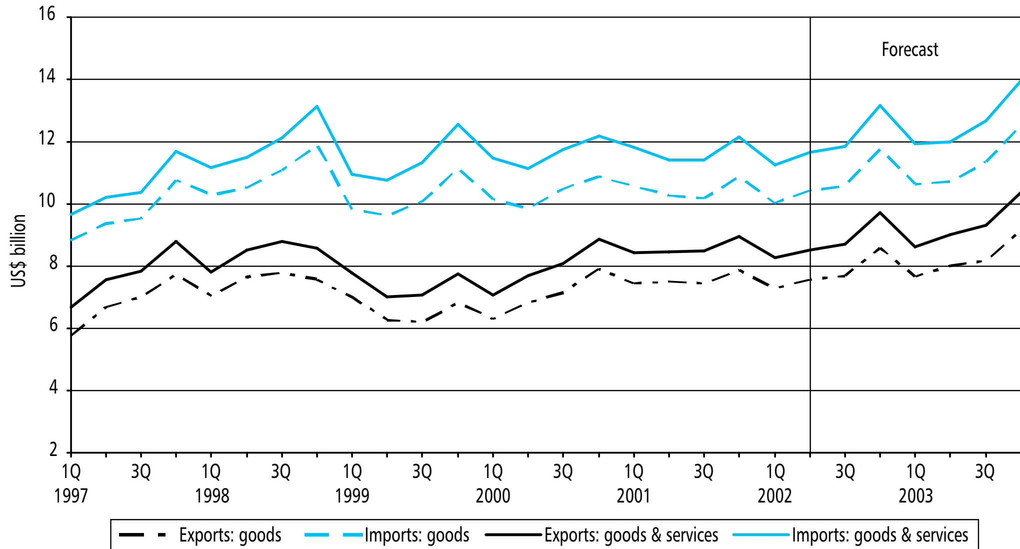
Despite the more upbeat outlook for the global economy we have not so far changed our forecast for nominal exports in the balance of payments in 2002. A potential upward revision in the export outlook will be possible if there is strong evidence of rapid and sustained recovery in the EU. Apart from more favourable external demand, any nominal depreciation of the zloty will have a positive influence on export performance via weakening

Chart 3.6. Basic exchange rates, 1996–2003



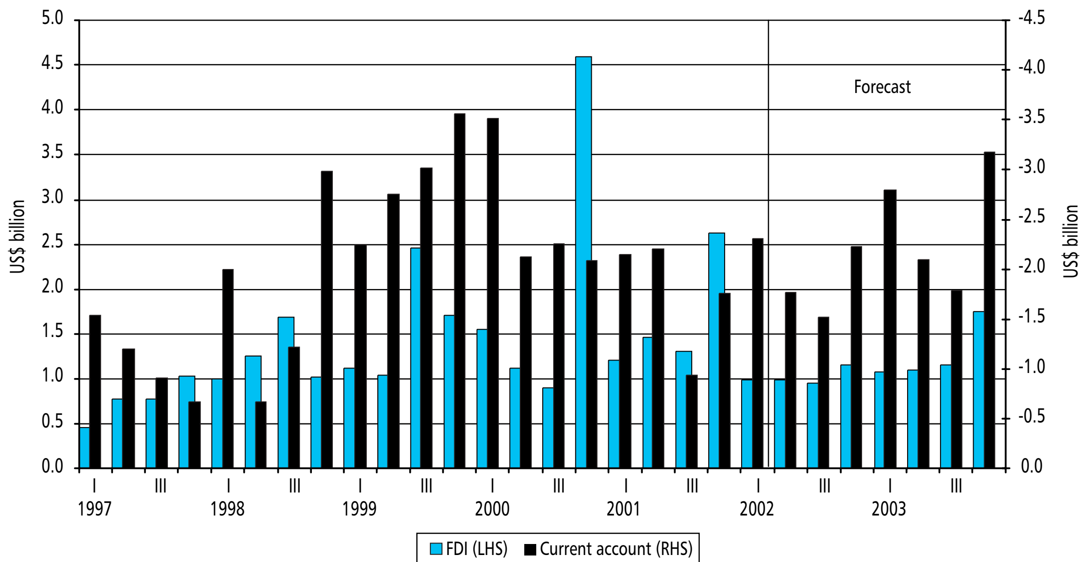
Source: NBP and CASE.
Notes: CASE forecasts starting from 2Q02.

Chart 3.7. Exports and imports, 1997–2003 (US$ billion)



Source: NBP and CASE.
Note: CASE forecasts starting from 2Q02.

Chart 3.8. Balance of the current account and FDI, 1997–2003 (US$ billion)



Source: NBP and CASE.
Note: CASE forecasts starting from 2Q02.

pressures on its real appreciation. On the other hand, forecast GDP growth acceleration in 2H02 will reduce the crowding-out effect that played an important role last year.

The minor change in domestic demand growth this year has not inclined us to alter significantly our forecast for nominal imports in the balance of payments. On the other hand, we expect a boost in imports in 2003. As a result the merchandise trade deficit will be higher than anticipated a quarter ago.

The current account deficit is likely to develop in line with a widening of the merchandise trade balance. The deficit as a percentage of GDP is expected to be 4.2% in 2002 and 5.2% in 2003. After the one-off decline in unclassified current transactions recorded in 1Q02, we expect a resumption of this item to its medium-term trend.

Lower inflow of FDI will be offset to some extent by the inflow of portfolio capital and other investments. Consequently, the structure of financing the current account deficit will worsen.

Małgorzata Markiewicz

Public finances

- **Gap of PLN 4 billion on the revenue side in 2002**
- **2003 budget requires further expenditure cuts**

In our forecast we assume that state budget expenditures in the current year will be equal to PLN 185.1 billion, as approved in the budget, and will grow by 1% in real terms over subsequent years. Based on such assumptions and our macroeconomic forecast, we estimate a revenue gap of about PLN 4 billion this year. This implies a need to either revise the budget or cut expenditures by such an amount.

The budget for 2003 seems to be much more challenging. At the beginning of April the government presented a proposal for macroeconomic indicators for the 2003 budget: GDP growth at 3.1%, average inflation at 3.0%, wage growth in the budgetary sector at 1% in real terms (wages in this sector are "frozen" in 2002). The indexation of pensions paid by ZUS will assure real growth of 3.2% (compared with 0.5% in 2002). Higher expenditures will be financed through a higher tax burden. The government has been discussing new changes in PIT: introduction of two additional rates, 0% and 12%, lowering tax brackets and raising the tax rate for people with highest incomes. It was also proposed to cancel the tax-free amount, to which every PIT taxpayer is today entitled. The Ministry of Finance estimates additional revenues of PLN 1.7 billion in 2003 due to tax changes.

In 2003, sticking to the rule of 1% growth in expenditures does not allow for financing of "unfrozen" budgetary expenditures such as public sector wages, teachers' wages and increased indexation of pensions. Additionally, growth of the public sector borrowing requirement this year will result in higher debt servicing in 2003. This means that cuts in other expenditures will be necessary. Moreover, the room for manoeuvre is limited. The following systemic changes are inevitable: continuation of disability system reform; reform of the farmers' pension system; recovery of control over public funds in extra-budgetary funds, agencies and budgetary units; introduction of a state auditing service; reform of public administration and actions supporting economic growth such as a decrease in the tax burden and payroll taxes. If the government launches these reforms and is able to limit the growth of expenditures up to 1% in real terms, then the state budget deficit will decrease. However, if growth in expenditures is not under control then fiscal disequilibrium will grow to way over 6% of GDP.

Rafał Antczak

Monetary policy

- **Introduction of the ECB standards**
- **Careful fine-tuning of monetary policy**

"The National Bank of Poland's Plan of Action for 2002−2004," which was published in the beginning of 2002, indicates that the main goal of the central bank is maintaining stability of the monetary and financial systems and the introduction of banking standards in line with ECB rules. Limiting over-liquidity in the banking system is the central operational target. The NBP has failed for 3 years now to achieve this. Commercial banks experiencing financial over-liquidity may pursue credit activity without drawing on NBP resources, something which effectively

weakens the influence of interest rate policy on the banking market. Therefore, any accomplishment of targets (limiting or expanding credit emissions) is more difficult. As a result, the NBP maintains interest rates higher than the potential level and this leads into overly restrictive monetary policy. The outright sale of converted Treasury bonds remains as an instrument for restraining structural over-liquidity, while end-day deposits of commercial banks at the NBP, introduced in December 2001, are supposed to absorb short-term over-liquidity.

The next goal of the NBP is widening the scope of money market instruments through the introduction of shorter (14-day) and longer (3-month) instruments for open market operations offered through more regular tenders. A decline in the reserve requirements ratio from 4.5% to 2% and the change in its calculation are likely to result in an increase in banking sector liquidity. This would contradict the goal of achieving an operational deficit of resources, which is why the NBP plans a gradual adoption of ECB standards, also dependent to some extent on the economic situation.

Given the above situation, monetary policy will be assessed not only from the perspective of interest rate changes. During 2002–2003 we are likely to witness periods of growth in inflation, starting from 2H02. But further cuts in interest rates should not exceed 50 basis points, in order to avoid excessive cuts in real NBP interest rates. We maintain our forecast of NBP interest rate cuts by a maximum of 100 basis points before the end of 2002. In 2003 we may expect a reduction in interest rates of 75 basis points under the mildly optimistic developments in fiscal policy (budget deficit around 6%).

Rafał Antczak, Małgorzata Markiewicz

Co-ordination of fiscal and monetary policies

- **Record high supply of Treasury papers**
- **From over-liquidity to drainage of the market**

In 1Q02 the Ministry of Finance sold record numbers of Treasury papers (including Eurobonds), totalling PLN 36.1 billion, of which PLN 18.8 billion financed the budget deficit. The financing of the deficit was relatively high, reaching 58% of the yearly plan. Already after the first quarter the issue of bills has exceeded the yearly plan (PLN 6.75 billion against PLN 5.85 billion). The sudden increase in indebtedness in 1Q02 resulted from the particularly high financing needs of the state budget. This situation is to some extent typical, as the current government like previous governments, expects the main chunk of its privatisation revenues in the second half of the year. However, the expected remaining privatisation revenues due in 2002 (around PLN 6 billion) are too small to provide any financial reserve in the event of any difficulties selling Treasury papers or an increase in the budget deficit. Increasing the debt in short-term papers (Treasury bills) at the very beginning of the year increases refinancing risk and interest rate risk. It also goes against the objective of the strategy of public debt management for 2002–2004. The objective is to lower the financial costs of debt repayment through reducing the share of Treasury bills. It is therefore already clear after the first quarter that the budget lacks financial reserves. This may lead to a revision of privatisation plans, the search for non-conventional sources of deficit financing or put pressure on market interest rates hikes (assuming no budget revisions – restraining from pushing the budget deficit higher).

Treasury paper auctions in the first quarter saw divergent roles played by domestic and foreign investors. The latter reduced their portfolio in January and February (respectively, by PLN 80 million and PLN 180 million) and increased them by PLN 140 million in March. The situation on the bonds market was the opposite. In March, the share of foreign investors on the primary market dropped to 4.3% (PLN 220.8 million). The very high rise of Treasury papers in banks' portfolios in January (by PLN 6.7 billion compared to December 2001) reflected, on one hand, the higher demand from banks expecting NBP interest rate cuts, and on the other hand the release of a significant supply of papers by the Ministry of Finance. Also in January, the NBP addressed the concern over the increase in banking liquidity and auctioned bills totalling PLN 28.4 billion, almost three times more than in December 2001. Such a double drainage of financial resources from the banking sector in January led to its inability to cover average reserve requirements. Banks were forced to draw Lombard credits from the NBP of PLN 18.6 billion on January 28–30. With a difference in Lombard and 28-day open market operation interest rates at 350 basis points this

meant a loss of roughly PLN 5.5 million to banks. Eventually, banks reported lower demand for the NBP bills in February and the typical over-liquidity in the banking sector returned in March–April.

At the beginning of April the excessive supply of Treasury papers did not meet sufficient demand from domestic investors. Foreign investors, however, did make bids on Treasury papers, though at a lower price and the profitability of Treasury papers went up in April (despite the decline in inflation). Therefore, bonds in foreign investors' accounts grew by PLN 2.5 billion up to the second ten days of April compared with end-March. This explains to a large extent the appreciation pressure on the zloty since March. Limiting the supply of Treasury papers, combined with the NBP's reduction of over-liquidity in the banking sector, may lower the appreciation pressure on the zloty. One should keep in mind, however, that there are fundamental reasons underpinning the zloty's appreciation in the longer term, such as increases in factors of production productivity, the Balassa-Samuelson effect, or a decline in investment risk coming from the integration of Poland into the European Union and the euro zone.

*Łukasz Rawdanowicz**

Global economy

- **US-led global recovery becomes a fact**
- **Better outlook for the US, but recovery may be staggered**
- **EU to follow suit, though at slower pace**
- **Uncertain oil price outlook threatens price stability and growth revival**
- **Interest rate hikes in industrialised countries on the horizon**

Recent information on the condition of the global economy and its outlook have become increasingly upbeat in comparison to economic assessments from the end of last year. International organisations and investment banks now tend to agree that a US-led recovery will soon materialise. Both the IMF and OECD have revised upwards their forecast for 2002 and 2003.

Just as last year the US economy led the global downturn, this year it is expected to lead the recovery, with better-than-expected 1Q02 results in the US already raising spirits. Higher momentum in domestic demand will be a key factor underpinning the recovery, with investment in particular the main engine of revival. One should not count too much on a boost from personal consumption, as it did not decline significantly during last year's recession. Despite the more optimistic outlook the risks to balanced growth have not receded entirely, something that was recently stressed both by the Fed chairman, Alan Greenspan, and the IMF in its April edition of World Economic Outlook. The sustained large current account deficit (reflecting low savings in the economy) raises concerns in particular. Such a situation cannot be sustained on a permanent basis. There is a risk that households will start to save more and enterprises borrow less. In such a scenario stagnation or a contraction in private consumption could lead to halt in new investment. In addition, there is a question mark as to whether the over-investment from the previous cycle of 1998–2000 has yet been absorbed and whether there is scope for new investment.

The improved economic environment in the US is the main factor affecting business sentiment in the European Union. This gives grounds for expectations of improvements across the EU – notwithstanding internal growth determinants. Better business sentiment allows us to expect a strengthening of investment activities, which could be the main driving mechanism in the recovery. The pick-up in private consumption will depend on developments in the sphere of prices and on the labour markets – the two main factors affecting consumer confidence.

There is good news also for Japan and the emerging markets of Asia. Japan seems to be poised to see recovery later this year. Growth will be driven primarily by stronger foreign demand mainly from the US and EU. The improved global environment has already taken its toll on business confidence, as reflected in the higher readings

* 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	2001	2002f	2003f
OECD	3.1	3.4	2.7	3.2	4.2	1.1	*1.7*	*3.2*
USA	3.6	4.4	4.4	4.2	5.0	1.0	*2.2*	*3.5*
Japan	5.0	1.6	-1.1	0.8	1.2	-0.5	*-1.1*	*1.1*
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	*0.9*	*2.8*
United Kingdom	2.6	3.5	2.6	2.3	3.0	2.4	*2.1*	*3.0*
Russia	-3.5	0.8	-4.9	5.4	8.3	5.0	*3.8*	*3.7*

Source: Data – 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	2001	2002f	2003f
USA	2.9	2.3	1.6	2.1	3.4	2.8	*1.5*	*2.3*
Japan	0.1	1.8	0.7	-0.3	-0.7	-0.7	*-1.2*	*-0.5*
European Union	2.1	1.8	1.8	1.2	2.5	2.5	*2.1*	*1.7*
Euro zone (HICP)	2.2	1.6	1.2	1.1	2.4	2.6	*1.9*	*1.5*
Russia	22.0	11.0	84.4	36.5	20.8	18.6	*15.5*	*13.0*

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

Table 3.3. The euro and yen exchange rate vs. the US dollar, 1996–2003

	1996	1997	1998	1999	2000	2001	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 – ECB; forecast (f) – market consensus and CASE.

of the Tankan survey. The investment-led recovery in industrialised countries is set to benefit most of the emerging countries in the region, which are heavy exporters of investment commodities.

The protracted crisis in Argentina has so far had very little impact on other emerging markets. Most of the economies of Latin America are expected to benefit substantially from a stronger recovery in the US. The economies of Central and Eastern Europe, with the exception of Poland, have performed significantly better than EU countries and this is likely to continue in 2002. Despite a modest slowdown in CIS countries expected this year (after record growth in 2001), their pace of expansion is set to remain strong.

Uncertainty about oil prices poses the biggest threat to global economic recovery at the present. The crisis in the Middle East, alongside a relatively stringent compliance to oil production quotas, point to higher prices. In the event of longer-term turmoil in this market, any sustained increase in the prices of oil may dampen the upturn in industrialised countries – via inflationary pressures impacting on the purchasing power of households, monetary policy decisions as well as deteriorated terms of trade. Political developments in the

Middle East will be the decisive factor shaping oil price dynamics for the remainder of the year.

As the global economy improves – perhaps restoring inflationary pressures (higher growth and oil prices) – markets will most likely start to price in interest rate hikes into the main industrialised economies. 1Q02 saw no changes in monetary policy in the US, euro zone or the UK, though the first hikes in rates on the economic periphery were announced, for instance in Sweden and Canada. The nearest increase in interest rates may come as early as 2H02 and probably first in the UK. On the other hand, central bankers in Central and Eastern Europe find themselves in a different position. Given the sustained disinflation in the region they decided to lower interest rates further in 1Q02. However, like their Western partners, mounting inflationary pressures will impact on their future policy decisions – both with regards the timing and size of future cuts. The Czech Central Bank got itself involved in verbal and direct interventions against the strengthening of the koruna due to concerns about external balances.

Early warning crisis indicator

1Q02 saw a deterioration in our early warning crisis indicator in comparison to previous quarters and amounted to 6.08 points. Contrary to 4Q01 the balance of positive and negative developments was uneven with the latter outnumbering the former.

The deterioration of the indicator (higher value) is underpinned primarily by a more pessimistic outlook for the current account deficit. In addition, the still grim forecast of developments in the central government budget (a deficit of 5.8% of GDP in 2002) keeps the indicator's value high.

Negative trends were observed on the side of financial indicators. Measures of foreign debt and credit expansion rose, indicating a deterioration of economic equilibrium (bear in mind the change in the money aggregate definition – see notes under the table). The real appreciation of the zloty has had a negative impact as well, although its magnitude has not been as significant as in 4Q01. In addition, the increase in unemployment contributed to the higher value of the overall indicator.

Of the positive trends we note the better outlook for economic growth and lower inflation over the next four quarters. Cuts in NBP rates and fast declining inflation have led to a considerable drop in the real 3-month WIBOR. This, coupled with the two previous positive developments, to some extent offset the negative trends.

Table 3.4. Early warning crisis indicator

	weights	1Q00	2Q00	3Q00	4Q00	1Q01	2Q01	3Q01	4Q01	1Q02
1. Annual GDP for 4 consecutive quarters	0.10	4	4	6	6	4	4	6	6	4
2. Annual unemployment rate (end of quarter)	0.05	10	4	6	10	10	4	6	10	6
3. Annual average CPI forecast for 4 consecutive quarters	0.06	4	4	4	0	0	6	0	4	4
4. Government deficit forecast as a % of GDP	0.10	5	5	5	6	6	10	10	10	10
5. CA balance forecast for 4 consecutive quarters as a % of GDP	0.15	10	0	4	4	6	0	4	0	10
6. Real effective exchange rate	0.15	6	6	6	6	10	10	6	10	6
7. Credit expansion as a % of M3 (end of quarter)	0.07	6	6	6	4	4	6	6	6	6
8. Polish foreign short term debt as a % of liquid reserves (end of quarter)	0.15	6	10	6	4	4	4	6	4	6
9. Total Polish foreign debt as a % of GDP	0.07	6	6	6	6	6	4	6	6	6
10. Real 3M WIBOR	0.10	4	6	6	6	6	4	6	4	0
Indicator		6.18	5.18	5.48	5.10	5.80	5.16	5.74	5.68	6.08

Source: CASE.

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.

3. Following CSO's change from M2 to M3 the historical values of the indicator were re-calculated using M3 – this implies the change in position 'credit expansion as a % of M3'.

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European Union accession hurdless

As the negotiation process gathers momentum, we face a barrage of information on Poland's negotiations with the European Union. Each new day sees new statements and declarations from both sides being verified by the negotiation process. Poland's entry date of 1st January 2004 seems to have become a kind of totem, as if Poland wishes to join the EU on that date it will have to conclude the negotiation process before the end of the current year. Time drips away with every passing moment …

All of this has obliged to consider Poland's prospects for closing all negotiation chapters on time and thus seeking to answer the troubling question: will we make it?

Poland has made the following achievements since the beginning of the negotiation process: it has managed to adhere to 23 chapters of the Union's *acquis communautaire* and consequently to close them temporarily. This means that there remain 7 negotiation areas unfinished – unfortunately, these are considered to be the most complicated. Officials claim that four of them will be closed by the end of the Spanish presidency of the EU (i.e. by June 31, 2002). By end April the government managed to pass 24 so called European laws, out of 74 that are supposed to be passed by the end of the year. According to the government's further predictions, 80 per cent of the outstanding laws should be passed by the July vacation. A want, a might, a must... But what is the reality?

Seven Stairs

Justice and Home Affairs is the negotiation chapter that should probably be considered the least problematic. Poland has presented a comprehensive report on how it plans to secure the safety of its eastern frontiers – a kind of strategy for governing the borders. However impressive this one – hundred page report is, it appears to be insufficient for the European Commission (EC), as first and foremost it did not include a calendar for the implementation of visa policy. Eventually the required plan was delivered to Brussels on February 15. In this plan, Poland will introduce visas for Russian, Belarussian and Ukrainian citizens as of July 1, 2003. Additionally, the Polish side made an obligation to introduce visas for Macedonians as of 1 October 2002. As this requires the development of the Polish consular system, this year's budget sets aside 11 million EUR for re-building existing consulates and building new ones, as well as for equipping them with computer systems. A further 4 million EUR (for employing extra staff) will be guaranteed in next year's budget. If the EC finds these commitments credible and satisfactory (which will probably take about two months from receiving the documents), it will be possible to close the chapter in late May or June.

Theoretically there was one more issue that could have hindered prospects for closing this chapter – one might have expected the EC to want to wait until it

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resolves the issue of the Kaliningrad district. Polish negotiators had taken a strong line on this question, stating that no extra-territorial corridor could be discussed and that no visa-free regime would be allowed for the citizens of Kaliningrad who would have to obtain visas from July 1, 2003 just as Poland's other eastern neighbours will have to. Having taken Polish arguments into consideration, the EC said it would not condition Poland's accession to the EU on a settling of the Kaliningrad case.

It seems meanwhile that the likelihood of concluding talks on Transport Policy and Fisheries has increased due to amendments to the Polish negotiating positions in this area.

The first outstanding impediment that has been removed is the transition period for the ban on large EU fishing vessels fishing in Polish waters. In convincing the Polish negotiators to accept this line, the EU said the current level of mutual access to Baltic Sea resources would be maintained in the Polish agreement with the International Baltic Sea Fisheries Commission (IBSFC). So would be for Sweden or Denmark cases. The only novelty would be the way the fisheries limits granted would be fulfilled – they would be possible not only in Poland's own fishing territories. On the other hand this would mean allowing Swedish or Danish fishing vessels to catch in Poland's national 200-nautical-mile zone. According to fisheries organisations, this will unavoidably ruin the Polish fishing territories and consequently Polish fishery. As was pointed out, the Polish fishing fleet, with its six large vessels, does not have the capacity to compete with EU fleets (Sweden and Denmark have almost a hundred large vessels a piece, for example). Probably it was the opportunity to be granted structural funds for restructuring the fishery branch that eventually convinced the Polish negotiators. These funds are estimated at 180 million EUR (1.3–1.4% of all Polish structural funds estimated for the period 2004–2006) for restructuring fishery and – combined with it – manufacturing industries, as well as for the development of harbour infrastructure. These ventures will be financed from state coffers and the firms involved, so that they should be worth about 300 million EUR .

In an amendment to its negotiation position in the area of Transport Policy the government resigned from the transition period it had been putting forward. In this way it complies with the EU Council directive within which motor vehicles with a single axle load limit of 115 kN are permitted to use the roads freely. In return, the EC agreed with Poland's proposition of transport fees, though under one condition – that Polish carriers will be charged equivalently. The problem is that most of the Polish road network admits a lower single axle limit of 80 kN. This is why in its amended negotiation position Poland indicated only the main road network to be used by the heaviest EU lorries, giving itself time necessary for the adjustment of the remaining roads up to 2015. The question is where the money will come from. It seems that the government program 'Infrastructure – the key to development' may somehow be the answer. It plans for the building of 550 km of motorways, 200 km of express roads, more then 40 ring-roads and the modernisation of more than 1.5 thousands km. The main sources of financing this are revenues from excise duty (PLN 7.8 billion), funds from the EU (including PLN 1.8 billion from the ISPA project and PLN 5.4 billion from the Cohesion Fund), revenues from vignettes (estimated at PLN 2 billion in 2003, PLN 2.1 billion in 2004 and PLN 2.2 billion in 2005). Furthermore, the program would be based also on loans from the EBRD and the World Bank (PLN 5.5 billion combined) and money from licensees and the state budget (about PLN 580 million).

The issue of rail transport remains outstanding. The key is whether the EC will be willing to accept the Polish request for a three-year transition period (i.e. to January 1, 2006) for PKP – Poland's largest railway carrier. The Polish side justifies this by the need to carry out restructuring, commercialisation and privatisation of PKP. This process is indispensable if PKP is to be able to handle competition from EU rail carriers. The EC tends to incline towards a solution that is in line with its policy of large modernising investments and developing the 'Trans-European railway network'. Railways that are 'less environmentally damaging and use tracks free from the possibility of collision' [1] is seen by the EC as the key way of unblocking Europe's traffic jams. Consequently, it seems that it is not the quality of PKP's restructuring

[1] The communication adopted by the EC on 23 January 2002 'Towards an integrated European railway area' may be downloaded from the following web page: www.europa.eu.int/comm/transport/rail/newpack/np_en.htm.

plans that will convince the EC but the indisputable fact that it will take some time to upgrade Polish railways.

The issue of cabotage (transport services offered by non-residents) remains formally open. In practice, however, one should expect the EU to try to protect its lucrative transportation market from candidate country companies (with the exception of Slovenia, due to the fact that its wages are at almost the EU average) for about five years, i.e 2+2+1 (two years of the strict ban, two years of the limited ban and one further year for a ban should the need arise). This sort of formula would not be any novelty to Poland; let's remind ourselves that the relevant transition period was accepted by the Polish side in the area of free movement of labour. Poland will most likely have to agree to this proposition, as it covers the relevant transition period for liberalisation of cabotage in occasional passenger transport services (i.e. local and regional tourism, transport services for workers and school children, trips, etc.). This should allow for a conclusion of the ongoing privatisation and restructuring of PKS – Poland's state road carrier, since occasional passenger transport services constitute its core business.

The government recently submitted to Brussels the last part of its proposals on the Air Law currently being discussed by the Polish parliament.

All the changes presented here are designed to help Poland climb the next stair on its way to EU (to close the chapter on Justice and Home Affairs) or even jump over the next two (Transport Policy and Fisheries). Probably in June.

This sort of negotiation scenario is reasonably optimistic. But while some of the impediments to accession have been removed, others remain. The closer Poland gets, the steeper it becomes...

In the field of Competition Policy two questions bother the EC: the level of state aid granted to Poland's Special Economic Zones and the program for restructuring the Polish steel industry. Currently the principles governing the granting of state aid in Poland (and especially those concerning income tax facilities) clash with EU criteria on the 65% ceiling on investment value to be granted to small companies and 50% to large enterprises. In its negotiation position Poland has requested a transition period to 2017 in this area. This is motivated by an obligation to respect the rights of those entrepreneurs who have already started business activity in the zones and the fact that they contribute to Poland's economic growth. According to data for end-March 2002, the value of investments carried out so far in the 14 zones was PLN 7.2 billion and employment stands at 32,000. Additionally, the Polish side argues that small and medium enterprises are not yet competitors to their EU counterparts. These arguments failed to find any great EU understanding. The EU is highly sensitive about ensuring freedom of competition and a level playing field on its markets. Re-negotiations with those entrepreneurs already operating in the zones seems to be unavoidable. The question is whether with each one or with the minor ones, if the EU agrees to their transition protection. The matter of re-negotiation is highly relevant today as it implies a possible need to pay out compensation worth up to PLN 2 to 5 billion depending on the outcome.

Also state aid granted to the Polish steel industry is currently subject to EU concern within this negotiation area. Steelworks were obliged to prepare their preliminary privatisation programs by 2 April, on the basis of which the plan for privatisation of the whole sector (harmonised with the EU State Aid Guidelines) would have been prepared and submitted to the EC. Ironically, the problem now lies on the EU side and its capacity to analyse the report in due time. So the closing of the chapter is possible probably no sooner than in November anyway.

By far the steepest

By far the toughest to meet but at the same time the most important are those issues to be settled in the last days of negotiations. Due to the lack of negotiating positions in the areas of Agriculture, Regional Policy and Co-ordination of Structural Funds and Financial and Budgetary Provisions, Poland's negotiating stance in these areas are poorly understood by the EU. Rather they constitute a set of autonomous stipulations and demands. Although the EU budgetary guidelines (Agenda 2000) up to 2006 provide means both for enlargement after 1 January 2004 and for pre-accession programs, they also assume admitting six new members (and not ten as is now considered). Moreover, they do not even mention the issue of direct payments for agriculture.

This is why it is difficult to consider these matters on individual basis. Together they provide the strongest clue as to whether the EU will finance Poland or *vice versa*. The EU announced (at the latest negotiation session on 22 April), that it would expect Poland to pay the full contribution to the EU general budget. In this way it practically rejected the Polish request for a five-year transition period during which the Poland's contribution (estimated at about EUR 2.5 billion a year) would be at a reduced rate following the corrective scheme below: 10% of the contribution due in 2003, 30% in 2005, 50% in 2005, 70% in 2006, 90% in 2007 and finally the full amount after 2008. This would ensure 'an adequate relationship between expenses borne due to contributions to the EU general budget upon the accession versus actual level of the absorption of funds from the EU general budget benefiting Poland'.[2] , i.e. also the absorption of direct agriculture payments. This explains why the EU's preliminary proposal to offer Polish farmers 25% of the payments granted to EU farmers is hard for the Polish side to accept. Translated into real terms it is a question of whether a combination: full amount of the contributions + lack of direct agricultural subsidies would make Poland a net payer to the EU budget or not. The '15' reject this speculation. However cautious and thoughtful the EU's declarations are they should be taken at face value; although the EU is ready to guarantee that Poland will not pay more money than it receives, it can't assume Poland's position as being that of a net recipient even as of today (i.e. PLN 1 billion).

Most probably the proposition of 25% of direct subsidies (under the ten-year transition period to reach their full amount) will be sustained and presented by the end of June. This would appear reasonable in the EU's terms. Poland will have two months (because of the July – August vacation) to work out its official response.

In the meantime – with only an opportunity to hold talks on concrete issues in the above mentioned areas – Poland has got to work on organisational matters aimed at establishing a system of payment agencies (i.e. the Agricultural Market Agency (AMA) and the Agency for Restructuring and Modernisation of Agriculture) that will administer the structural funds for agriculture. In the forthcoming months the ARMA will be audited on three levels: (an audit carried out by internal authorities, then by the Ministry of Finance or Ministry of Economy and finally by the EC). The inspection should be completed by December 2003 and the AMA should then be authorised to operate as a payment agency. This works as follows: introducing quality control systems and granting import and export licences or agricultural subsidies supporting domestic demand.

Let's suppose, for the purposes of this paper, that having succeeding in complying with the EU's criteria, Poland has finally closed all its accession negotiations and is now ready to sign the accession treaty. What next? One more hurdle to leap...?

The eighth step – how come?

A symbolic eight stair that appears to might have posed a threat to the Poland's joining the EU is the state referendum. A referendum should reflect whether or not most Poles want to be a part of European society or not. It seems, however, as if Poland is building the extra step for itself. If this is confusing, two words of explanation. Firstly, the politically and socially sensitive matter of information policy – reporting the results of negotiations, both achievements and failures. As the latest (March 2002) OBOP public opinion pool suggests, only 30% of Poles surveyed said they felt well informed about the problems concerning integration with the EU. People treat all the amendments to negotiation positions as real failures instead of informing theme, that for example, Poland has managed to persuade the EC to agree to the longest transition period (compared to those granted to other candidate countries) in the area of the purchase of land by non-citizens. The same is the case with direct subsidies for Polish farmers – not many people realise that they were not included in the above-mentioned Agenda 2000.

Secondly, legislative aspects. The constitution states that for the referendum to have validity the turnout must exceed a *quorum* of 50% of voters registered to vote. One would, however, look in vain for a paragraph

[2] 'Poland's negotiation position in the area of Financial and Budgetary Provisions adopted by the Council of Ministers of the Republic of Poland on February 6, 2001.

explaining what the procedure would be should this not happen. Consequently it might be that it is the Poles' unwillingness to participate in democracy that closes the EU door and not the negative outcome of the referendum. The referendum issue awaits settlement in the Polish parliament. The Polish President is expected to use his statutory legislative initiative and forward a project for a referendum law.

Straight ahead

If Poland finally manages to close all 30 negotiation chapters by the end of the year, the EU should be in a position to draft the accession treaty within the subsequent two-three months. The treaty would then need to be ratified by parliament) and society (via the referendum) and the parliaments of all EU – member states. The European Parliament would then be the last to decide. Apart from the case of the Polish referendum ratification should not pose any threat or hinder the last stage of the accession process.

There is one more factor that merits attention, though is very hard to classify. I have termed it 'the factor of intentions.' It defines the degree to which both sides are determined to close the negotiations. In other words, the factor deals with what more can be sacrificed to join the EU, and – on the other side of the negotiating table – when the EU would want to open itself to enlargement.

As this factor may in fact be the decisive one, it is very hard to name the exact date on which Poland will join the EU. Unfortunately, there appear to be more issues of this kind, i.e. unpredictable in their outcome but still influencing the accession process. Let's take the elections in key EU – member countries like Germany, the Netherlands, Sweden or France, for example. Few politicians want to tease their electorate by making controversial declarations on EU enlargement, especially in the countries which are net payers to the EU general budget (as is the case with the first three above-mentioned countries). Consequently, they try to avoid the topic (especially when being asked about agricultural issues) or even postpone taking a position on the question until after elections, i.e. at least until the autumn.

To sum up, it is not only the complexity of the separate problems that may endanger Poland's efforts to become an EU member from the 1 January 2004. Even if the Polish negotiators managed to pave the way (by preparing the necessary laws, decrees and other executive acts – which takes up a lot of time), the EC needs, in return, time to analyse and make approvals.

All the above-mentioned assumptions that condition Poland's accession will be verified very soon. The decision is forecast to be made at the EU's general meeting in Brussels on 24 October 2002 on the basis of the report on the progress made by candidate countries towards meeting the EU criteria. If the evaluation is satisfactory, the access treaty can be signed with the ready candidates probably on 12 December 2002 in Copenhagen. With the benefit of hindsight we will then be able to judge these final days of negotiation and finally get the answer to the troubling question we rised at start of this paper.

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The future of the CAP in Poland – effects of joining the CAP on Polish agriculture and economy

The current circumstances, including on-going accession negotiations, divergence of positions and difficulties in predicting final solutions, make it impossible to give a straight answer to questions about micro and macroeconomic effects of the CAP in Poland. The issue is additionally complicated by uncertainties concerning the post-accession framework of the CAP. Moreover, to support their negotiation positions, both parties often use contradictory arguments as regards the micro- and macroeconomic effects. This paper nevertheless tries to discuss the potential effects of the CAP on Polish agriculture and economy, depending on the suggested accession scenarios.

A big problem in a small sector – is it worth fighting over agriculture?

At the very beginning it is worth asking whether the agricultural negotiations concern only the interests of this smallish sector in itself or perhaps whether the conditions of joining the CAP might significantly affect the whole economy. The scale of macroeconomic CAP effects in Poland will depend not only on the share of agriculture in the economy, but also on the framework of the CAP at the time of Poland's accession to the EU and on how the CAP will be implemented in Poland.

The macroeconomic importance of agriculture, measured in terms of GDP share, is rapidly declining (from 8% in 1990 to 3.0% in 2001). However, the share of agriculture in employment (approx. 27%) is maintained on a significantly high level. Such a high rate of employment must undoubtedly be reduced. However, given the high rate of unemployment this reduction is becoming a political rather than an economic problem.

The direction of CAP changes in the near future is to a great extent predictable, unlike the pace of such changes. This is why the CAP still remains a moving target. The basic mechanism of CAP reform is a gradual replacement of price support with direct support (something forced through at the beginning of the 90s by the provisions of the Uruguay Round of GATT). For Poland, as a prospective EU member state, such a change in CAP instruments means a shift of the significant cost burden of agriculture support from the Polish consumer to the Community budget. This also means less distortion on agricultural markets (domestic as well as world markets) and fewer transfer 'leaks' to unintended beneficiaries (e.g. to input manufacturers, processors or agricultural trade). This also means more transparency and better social control over the costs of that policy – the transfers, as opposed to price support, constitute one of the elements of the common budget. This also is a better solution in macroeconomic terms – it favors more effective allocation of resources due to less distorted food prices

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while facilitating technical change in agriculture. The cost to pay, however, is the strengthening of the Polish currency as a result of capital transfer.

At present, the least certain element is the CAP framework to be introduced in Poland. The most serious effects on the economy (to be precisely, the difference in effects of accession between the alternative scenarios) would result from a long transition period for Polish agriculture to take full advantage of the major support instruments of the CAP – direct payments, which was lately proposed by the Commission.

To summarize, the effect of the CAP on the Polish economy shall be significant, not only in economic terms, but also political terms, and tough negotiations on this issue should not come as a surprise. The CAP is the most expensive EU policy and the one which interferes in the market in the deepest way. The policy provides for agriculture support accounting for approx. 35% of sector revenues, as compared to 12% in Poland. Moreover, approx. 40% of total CAP support takes the form of budget payments (including direct production payments), while the remaining part is support through internal prices generating transfers from consumers to producers[3]. Consequently, the implications of this policy in Poland will not only concern the agriculture sector.

The main bones of contention

The main EC proposals concerning the EU-15's negotiating position were officially announced on 30 January, 2002[4]. The most important contentious areas concerning agriculture and other sectors in this proposal, include: (i) financial frameworks for enlargement (maintenance of EU enlargement costs in the framework of Agenda 2000 ceilings for 2004–2006 is suggested); (ii) limitation of direct payments in the case of the prospective new member states (a 10-year transition period for gaining 100% direct payments, starting from 25% as of 2004); (iii) production quotas and so called reference values, on the basis of which the amount of the national pool of direct payments is calculated (lower than those proposed by Poland and based on the 1995–1999 average, i.e. the period when the level of Polish agricultural production was lower than in the preceding years); (iv) resources for structural funds (they are to increase gradually between 2004–2006 up to the level of 2.5% of each candidate country's GNP, which is perceived by Poland as not too generous); (v) EU budget contributions (burdening the candidate countries with a full contribution may jeopardise the expected positive result of net transfers).

The EC's above proposals have caused a lot of controversy in Poland and made everybody aware that the EU's common interest is achieved via a continuous struggle for particular interests. It has turned out that Polish negotiational goals must, in many cases, concern basic rights related to membership rather than additional privileges. This concerns, amongst others, the question of direct payments, the full accession to which were to be extended to 10 years, and the question of production quotas, which, in the case of the EU member states, are based on the periods of agricultural production surpluses (caused by the high support for that sector), and in the case of Poland – on the period of production decline. Objective constraints on the EU side, such as the increase of budgetary costs for the CAP, or the delay of CAP reform, only partially explain the EC proposals, especially as concerns the length of the transition period delaying the full accession of Poland to the CAP. On the other hand, though, one might blame Poland for postponing full EU membership by requesting long transition periods, e.g. for the purchase of agricultural land. Paradoxically, according to economic theory, both parties' greatest gains from the single market should result from the liberalisation of the movement of products and production factors alone. From this point of view, faster liberalisation of land trade in Poland could be a better alternative, as conditions could be created for foreign investment, meaning the implementation of modern technologies in this sector. The same concerns the liberalisation of labour movement between the candidate countries and the EU. The EU's stubborn demands of a long (up to 7 year) transition period, which protect the interest of certain groups only, do not benefit the entire

[3] Based on the PSE analysis, OECD, average between 1999–2001.

[4] European Commission, 'Enlargement and Agriculture: Successfully integrating the new Member States into the CAP' – Issues paper (SEC(2002)95 of 31.1.2002), http://europea.eu.int/comm/agriculture/external/enlarge/index_en.htm and European Commission, 'Common Financial Framework 2004–2006 for the Accession Negotiations' (SEC(2002)102 of 31.01.2002).

EU economy. This is why all these proposals, which create asymmetry in liberalisation, are not optimal from the theoretical point of view.

Appraisal of the macroeconomic implications

CAP related transfers of a budgetary (e.g. direct payments) and market (higher agricultural prices) character may affect such parameters as: economic growth, exchange rates, investment and the welfare of various social groups. Assessment of results is made mainly by means of computable general equilibrium models, which typically require many simplifications and assumptions. An analysis of the macroeconomic implications of accession in the area of agriculture, performed with the use of such a model, has been presented in table 4.1.[5] Based on the model, the following conclusions may be drawn: the 'CAP with direct payments' scenario shall influence macroeconomic variables more positively than in the case of the 'no direct payments' scenario. In the case of the 'direct payments' scenario, three years after EU accession GDP growth will be higher by 1.3 p.p., the level of investment in the economy will be higher by 5.6 p.p., value added within and outside agriculture will be higher by 2.8 p.p. and 1.4 p.p. respectively, and farm incomes approximately 20% higher. A serious negative effect of this scenario is, however, a significant (by 3.8 p.p. as compared to the 'no direct payments' scenario) strengthening of Polish

Table 4.1. Macroeconomic implications of various accession scenarios connected with the Common Agricultural Policy for Poland (changes in comparison with the scenario of accession without the CAP, three years after accession, in % points)

Specification	Non-accession	3-years after accession		
		No CAP	CAP without direct payments	CAP with direct payments
Wages				
blue-collar	-4.6	0	-0.3	1.3
white collar	-4.8	0	-0.3	1.6
GDP	**-4.8**	**0**	**-0.3**	**1.0**
Exchange rate	4.6	0	1.0	-2.8
Gross investments	-12.2	0	-1.3	4.3
Incomes of private households		0		
rural households	-7.4	0	0.3	21
urban households	-4.0	0	-0.2	1.0
Production				
value added in agriculture	-7.6	0	0.3	2.6
value added in non-agricultural sectors	-4.0	0	-0.3	1.1
Trade				
agricultural and food import	2.6	0	0.1	2.9
agricultural and food export	-12.8	0	0.3	-4.8
other import	-5.6	0	-0.5	1.8
other export	3.1	0	0.8	-4.4
Net transfers from the EU (in billion EUR)	**0.0**	**0**	**1.79**	**4.76**

Source: Banse, M (2000) Macroeconomic Implications of EU accession. Chapter in: Central and Eastern European Agriculture in an Expanding European Union. Edited by S. Tangermann and M. Banse, CABA Publishing.

[5] Banse, M. (2000) Macroeconomic Implications of EU Accession. Section in Central and Eastern European Agriculture in an Expanding European Union, edited by S. Tangerman and M. Banse, CAPA Publishing.

currency, which will affect the competitiveness of the whole economy. Therefore, in pure macroeconomic terms, direct payments will be a reasonable solution only if they result in an increase in the sector's productivity sufficient to compensate for the loss of the economic competitiveness due to the stronger real appreciation of the zloty as assumed in the model presented herein.

The pessimistic scenario ...

Doubts as to the effective use of transfers are related to the fragmented structure of Polish farmland. A significant portion of payments may be received by small farms with little or no development opportunities and their amount will not enhance these opportunities. The increase of these farms' incomes could slow down structural changes (understood, among others, as reallocation of land to bigger, more effective, farms and reduction of employment), as it could facilitate the increase of consumption in one social group at the cost of worsening competitiveness of all tradables sectors (including also agriculture) as a result of a stronger real appreciation of Polish currency and thus an increase in the current trade deficit. In the case of agriculture itself the effect would be stronger because of slowing down the restructuring process. Such a scenario has become one of the EU's negotiation arguments aimed at justifying a 10-year transition period for implementing full direct payments.

... and the optimistic scenario

According to the other scenario, which seems to be equally credible, the majority of support in the form of direct transfers will be converted into investments improving sector productivity and competitiveness. This scenario can be assumed based on the following circumstances:

One can estimate that the majority, i.e. about 60% of these payments, will be received by farms with more than 10 ha of farm land with good development prospects in the new conditions of the single market and the CAP. The remaining portion of payments will be received by farms which might have difficulties with the development of marketable production and which will consume rather than invest these payments.

The improvement of economic conditions as a result of market stabilization and production support will accelerate the allocation of land resources (and thus the rights to transfers) from ineffective (non-commercial) farms to effective (commercial) ones. The majority of the latter still operates below the level of a minimum efficient scale of production[6] and extending their area will be one of the most effective investment goals. In the case of non-commercial farms, on the other hand, due to limited benefits from participation in the single market, including eventual price increases, the costs of unproductive maintenance of land resources will increase and eventually exceed the revenues from direct payments. Then, on the one hand, the sale of land at a new, higher price, and on the other hand, the purchase of land, which will increase farm efficiency and viability, will become an attractive alternative for both sides.

In the years shortly after EU accession, however, Polish farms and agri-food operators will focus equally strongly on modernization investments as well as on the purchase of additional areas. Modernization investments shall be necessary in order to maintain competitiveness on the single market and to fulfill the technical requirements of acquis communautaire concerning e.g. food safety standards and environmental protection. The issue here is not only the need to limit the inherited technological gap but also the necessity of keeping up with technological change and market preferences in the future. Due to the fact that EU-15 agricultural producers (i.e. future competitors of Polish farmers on the single market) receive investment transfers in the form of direct production payments, maintaining competitiveness in Polish agriculture will require high modernization efforts. In such a situation equal access to support instrument for all EU agricultural producers is an important, although not the sole, guarantee that the technological gap between Polish and EU agriculture will not deepen.

[6] This is the size of farm, beyond which the increase of scale does not lead to a significant reduction of unit costs or to a significant increase of unit revenue.

Budget savings and costs concerning CAP implementation

The introduction of the CAP in Poland will involve certain budget savings (related to the relinquishment of certain state policies), as well as certain costs (mainly resulting from adjustments to EU requirements and the necessity for the state budget to be burdened with CAP implementation costs). The most important question is the balance between the two effects. One can cite the

Table 4.2. Estimation of savings connected with the abandonment of national agricultural policy and the costs of institutional adjustment to the EU, 2002–2006 (PLN million)

Specification	2002	2003	2004	2005	2006	2002-06
I. Savings connected with abandonment of national agricultural policy:						
- Scenario A = (1):	**0**	**0**	**479**	**479**	**479**	**1 437**
(1) abandonment of intervention policy in the agricultural market [(a)]	0	0	479	479	479	1 437
- Scenario B = (1) + (2):	**0**	**0**	**2 338**	**2 338**	**2 338**	**7 015**
(1) abandonment of intervention policy in the agricultural market [(a)]	0	0	479	479	479	1 437
(2) abandonment of national support instruments [(b)]	0	0	1 860	1 860	1 860	5 579
II. Costs of adjustments to the EU = (1) +(2) + (3) [(c)]:	**1 214**	**1 785**	**508**	**508**	**307**	**4 322**
(1) building of administrative structures in agriculture [(d)]	788	387	471	471	270	2 386
(2) implementation of agricultural policy instruments (WPR) [(e)]	289	1 161	1	1	0	1 451
(3) monitoring, fishery policy and structural activities [(f)]	138	237	37	37	37	485
Balance for scenario A (net savings) = I.-II. [(g)]	**-1 214**	**-1 785**	**-29**	**-29**	**172**	**-2 886**
Balance for scenario B (net savings) = I.-II. [(g)]	**-1 214**	**-1 785**	**1 830**	**1 830**	**2 031**	**2 693**

(a) Includes: payments for producers of cereals, payments for tobacco, payments for the storage of butter, payments for the storage of hard cheese, expenditures for the maintenance of agricultural stocks, export refunds, except for sugar, because in the case of this product, the costs of export refunds are covered by consumers (the average value for 1999–2001, except for payments for tobacco and for the storage of butter and hard cheese, which were introduced in 2001 has been used).

(b) Includes instruments for the maintenance of which Poland has applied in its negotiation position in the area of agriculture – state aid. They are the following: (a) compensation of losses resulting from natural disaster; (b) promotion of agricultural products; (c) interest rate subsidies on agricultural loans; (d) refunds for agricultural fuel; (e) infectious animal disease control; (f) biological progress; (g) subsidies to calcium fertilisers (only payments to soil liming, as a means of reducing weed growing); (h) subsidies for scientific research in the field of agriculture and implementation of its achievements; (i) maintenance of agricultural investment relief. Poland stated in its negotiation position that it also considers the maintenance of: (a) geodetic, land consolidation activities. When estimating costs of these instruments, the average value for 1999–2001, except for payments for agricultural fuel, in the case of which the amount for 2001 was taken into account, because the instrument was not utilised in previous years has been used.

(c) According to: Agriculture and Rural Areas – Priorities of Activities in the Years 2002–2005 (MRiRW).

(d) Includes: building up of payment agencies (based on ARiMR and ARR) and IACS system, adjustment in the field of the veterinary science, setting up of a plant protection system. Additional employment, whose cost has been estimated at PLN 270 million, has been covered as of 2004.

(e) Refers to the following markets: milk and dairy products, starch, sugar, dried fodder, wine, alcoholic beverages, and producers' groups in the market of fruit and vegetables, evaluation of seeds and varieties, introduction of the carcass classification (EUROP), adjustment of the supervision and control system over animal feeding.

(f) Refers to: modernisation of the utilisation sector, implementation of a common fisheries policy, adjustment of institutions to implement CAP accompanying measures, organic agriculture, implementation of the FADN system, implementation of the Integrated Agricultural Market Information System, implementation of the agri-food commercial quality control system.

(g) This is merely a partial balance of budgetary effects related to accession in the agriculture sector since it does not take account of that share of Poland's contributions to the EU budget, which is attributable to CAP expenditures. It also does not take account of allocations from the national budget on co-financing rural development programs within the 2nd pillar of the CAP.

Source: SAEPR/FAPA, "Analysis and Evaluation of the European Commission Proposal of January 30th 2002, for Candidate Countries". Calculations of SAEPR/FAPA based on data from ARiMR, ARR, MRiRW.

results of an analysis recently carried out by SAEPR[7], which includes two saving scenarios: scenario A – assuming resignation from a state intervention policy on the agricultural market (intervention activities, subsidies, export subsidies) and scenario B – assuming additionally a resignation from other support instruments, the retention of which Poland has requested in its negotiation position (e.g. compensation due to natural disasters, subsidies to agricultural fuel and subsidies to agricultural credit interests, funding agricultural research, etc.). Table 4.2 shows that, by a stable level of costs in both scenarios, first net savings resulting from giving up state policy instruments appear in scenario B in the first year of Poland's membership in the EU (2004), but in scenario A as late as in the third year. Prior to accession there are only costs concerning adjustments, such as e.g. administration building and the implementation of CAP instruments', which should decrease from the moment of accession. The cumulated savings and costs balance between 2002–2006 indicates contrary results – in scenario A the balance is negative, equaling PLN 2.9 bn and in scenario B net savings achieve a positive value of PLN 2.7 bn. Although the probability of both scenarios is difficult to assess, the negotiation of a low level of direct payments at the beginning of accession (or an extended period of acquiring full payments) may increase the pressure to maintain some support instruments financed from the state budget as a means of transitional leveling of the difference in support offered in the framework of the CAP in the conditions of the single market. This would mean only small savings at the beginning of EU membership. Thus, the most probable reality is closer to variant A than B.

One should clearly indicate that this is a partial analysis of the budgetary implications of accession in agriculture, as it does not account for the Polish contribution to the EU budget, which might be attributable to the CAP, i.e. a new agricultural policy in Poland. This is not a small amount if we consider that in 2000 CAP spending accounted for 44.5% of the total EU-15 budget and that following EU enlargement this spending will rather

Table 4.3. Estimation of net transfers from the EU budget to Poland, 2004–2006 (EUR million)

Specification	2003	2004	2005	2006	2004-2006
Pre-accession funds (PHARE, ISPA, SAPARD)	**952**	-	-	-	-
Estimated allocations from the EU budget after accession:					
- Common Market Organisation	-	258	375	367	1000
- Direct payments	-	0	575	690	1265
- Rural development (payments*)	-	374	594	865	1833
- Structural funds (payments*)	-	1237	3016	4352	8605
- Internal policies	-	588	548	536	1672
Total allocation from the EU budget to Poland	**952**	**2457**	**5108**	**6810**	**14375**
Poland's contribution to the EU budget	**-**	**2425**	**2497**	**2572**	**7494**
Net transfers from the EU budget before the compensation	**952**	**32**	**2611**	**4238**	**6881**
Difference in net transfer compared to 2003	-	-920	1659	3286	4025
Minimum budgetary compensation	**-**	**920**	**0**	**0**	**920**
Net transfers from the EU budget after the compensation	**-**	**952**	**2611**	**4238**	**7801**
For comparison: appropriations for commitments for Poland*	-	5146	6421	7677	19244

** Appropriations for commitment-set limits for sums that can be committed in the given budgetary year and which can be realised over 3 years (n+2). Appropriations for payments pertains to sums that can actually be paid out in the given budgetary year.*

Source: SAEPR/FAPA, "Analysis and Evaluation of the European Commission Proposal of January 30th 2002, for Candidate Countries". Calculations of SAEPR/FAPA based on the EC proposal.

[7] SAEPR/FAPA, 'Analysis and Appraisal of European Commission Proposal of January 30, 2002 for the Candidate Countries' – March 2002, Warsaw.

increase. According to such a view one might say that if Poland were to pay a full contribution, i.e. approximately EURO 2.5 bn in the first year after accession to the EU, then the considered amount will equal at least EUR 1.125 bn. Another important element are expenses from the state budget allocated for the co-financing of rural development instruments in the framework of the so called 2nd CAP pillar (the 1st pillar includes market stabilization and price support instruments as well as direct payments to production)[8]. According to EC proposals co-financing could amount to 20% of total public support, which corresponds to approx. EUR 93 ml in 2004 and EURO 216 ml in 2006.

New agricultural policy and new challenges

It is worth paying attention to one very important aspect. Both the solution proposed by the EC as well as the full participation of Poland in the CAP after a possible reform of this policy, involve a significantly greater participation of structural instruments in total EU transfers to Polish agriculture and rural areas as compared to other traditional forms of support (table 4.3). However, the compatibility of such a transfer structure with the specific tasks faced by Poland is only one issue. The second is the challenge of absorbing these new forms of transfers. Firstly, there is the necessity of co-financing structural transfers from the state budget (certainly CAP reform in such a form leads to a partial re-nationalization of funding of this common policy). Secondly, there is a need for adequate resources and time for the establishment and maintenance of an administrative system necessary to implement structural programs. The third element is the ability of state implementation institutions and beneficiaries as such to identify and elaborate the approvable investment projects. Certainly these components of absorption abilities will be critical in the first year of EU membership and might seriously limit the flow of aid.

Does the introduction of the CAP mean loss of autonomy over agricultural policy?

Full participation in the CAP will not be a quick remedy for all the concerns of the agricultural sector in Poland. The main challenges for this sector include fighting hidden unemployment and activating rural areas. These will still remain the main tasks for state policy and not the CAP, most of all because they require comprehensive solutions beyond sectoral policy. Two final comments result from the last sentence:

The problems of Polish agriculture, although very important and difficult, are not a threat to either the EU budget (financial destabilization), or the progress of CAP reforms. On the contrary, one may say that from the micro- and macroeconomic points of view the reformed CAP will be more beneficial for Poland as a future member of the EU than the former CAP based only on price support with a small amount of resources allocated for the support of rural development. Considering purely economic arguments one can expect that Poland, as a member state of an enlarged EU, should not hamper further CAP reforms.

The second comment for Poland is that the termination of negotiations will be an important, but nevertheless only a first, step towards the use of opportunities for the improvement of the situation in Polish agriculture related with the country's accession to the EU and the CAP. The extent of using these opportunities will still depend on the efforts taken in state policy.

[8] We ignore here co-financing of structural funds, part of which will be allocated to agriculture and rural areas.