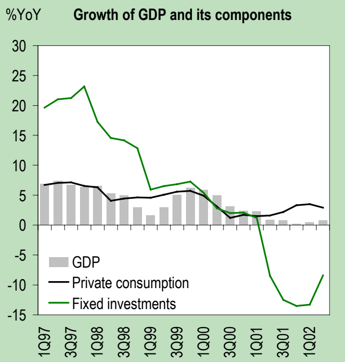
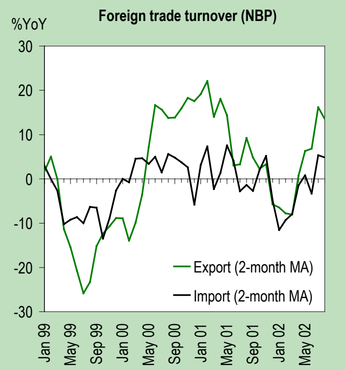
Bank Zachodni WBK

MACROscope

Polish Economy and Financial Markets





Optimism *ex officio*

■ **In October's special focus we present our assessment of the next year's budget draft.** We estimate that in a pessimistic scenario the revenues gap may reach PLN5bn, but this amount would not be much higher that the shortages observed in the last couple of years, and therefore should not be a reason for budget amendment. Much bigger problem is connected with the spending side of the budget - expenditures of the total public sector are rising by PLN7bn comparing with Marek Belka's draft. While in Grzegorz Kołodko's budget, the central budget deficit is lower by PLN4.3bn, the deficit of total public finances sector is higher by PLN3.8bn, which shows the scale of spending increase outside the central budget. Much higher fiscal policy expansiveness, comparing with Belka's plans, is also visible in economic deficit estimation. However, in our opinion, the deficit may be even higher and it is not very likely that it would fall to below 5% of GDP next year.

■ **Macroeconomic data published last month hold two signs.** Firstly, the drop in inflation has proved far deeper and probably considerably more persistent than predicted and there is still no suggestion of rising inflationary pressure in the medium term. Secondly, the long-expected acceleration in economic growth and improved performance in industry have started to materialise, although to a very moderate degree up to now, and there is no guarantee that vast progress will be made in the next few quarters. Moreover, positive signals from some sectors of the economy are coupled with less optimistic news from the others, which raises concern about stability of economic recovery. However, the overall outlook remains moderately positive.

■ **In September the Monetary Policy Council decided to cut all main interest rates by 50bps.** Since September 26 lombard rate amounts to 10%, reference rate 7.5%, and deposit rate 5%. The MPC maintained the neutral bias in its monetary policy.

■ **The European Commission released the report saying that ten countries will be ready to join the EU.** Further steps in EU accession process will include: summit in Brussels on 24-25 October (setting financial proposal for candidates), the final stage of negotiations in November, summit in Copenhagen on 12-13 December (the end of negotiations), signing accession treaties in 1H03.

In this issue:

Maciej Reluga
Chief Economist
(+48 22) 653 4663

Piotr Bielski
(+48 22) 653 4733
Piotr Bujak
(+48 22) 586 8341
Aleksander Krzyżaniak
(+48 22) 586 8342

Email: firstname.secondname@bzwbk.pl

Financial market on 30 September 2002					
NBP deposit rate	5.00	WIBOR 3M	7.73	PLN/USD	4.1482
NBP reference rate	7.50	Yield on 52-week T-bills	7.10	PLN/EUR	4.0782
NBP lombard rate	10.00	Yield on 5-year T-bonds	6.74	EUR/USD	0.9831

Special focus

Assessment of the budget draft

At the end of September, a special meeting of the government was held, at which the budget draft, which was sent to Sejm on the last day of the month, was approved. The parliamentary debate started this month (on October 11) and second reading is scheduled for November 20, and the final vote for November 22. In line with this schedule, the Budget Act would be enforced, having been signed by the President, at the beginning of next year. It would be the first time when the Budget Act was adopted on time. However, the question remains: "does fast mean well?". We can definitely expect a heated debate on both the next-year deficit and the structure of expenditure and budget income. Of course the MPs can make some changes and only time will tell to what extent they are (un)resonable, however it is possible to assess the budget draft produced by the government already now. The Monetary Policy Council has already conducted its assessment. Below, we are presenting our opinion on the macroeconomic assumptions, deficit level and the expectations concerning performance of the budget next year. The final version of the draft budget is available on the Ministry of Finance web site.

Macroeconomic assumptions – not entirely consistent

The most controversial macroeconomic assumption of the next-year budget is relatively high GDP growth, as the government decided to revise the GDP growth projection for 2003 up to 3.5% from the level of 3.1% projected by Marek Belka. It is relatively difficult to find an explanation for such an adjustment as the recent relatively strong economic figures for July and August confirm the scenario of gradual and moderately strong recovery rather than indicate a substantial growth next year. Interestingly enough, the government adjusted upwards the GDP projection at the moment when the central bank is more into adjusting the economic projections downwards and the world-wide GDP growth forecasts disclose such a tendency. It might seem that the most realistic change would be to adjust upwards the investments' growth projections. However, following the announcement of lower than expected CIT reduction, such a solution would also seem strange. The paper that sets out to explain faster GDP growth sent by the press office of the Ministry of Finance says that consumer trends and exports are to grow much faster (details in the table below). What is interesting, the change in the pace of imports growth is more significant (even though it is still too slow taking account of the import-based consumption and investments), therefore the change of the impact of net exports on GDP is not that obvious. On the other hand, however, growth in consumption could trigger growth (even minimum) in inflation pressure. This should be surprising as the government has recently adjusted downwards the average annual inflation projected for 2003 (from 3.0% to 2.3%). Of course, adjusting inflation projections downwards allowed to boost the real growth of wage bill and social benefits (4.4% in nominal terms acc. to both ministers). However, what is interesting, the real growth is lower than the growth in private consumption envisaged by the government. This means another year of consuming up the savings, whereas, according to the government, the savings ratio should stay flat in 2003.

With regard to investments – the above-mentioned paper merely states that "the improvement of operations in the enterprises sector should bolster the level of investments". This "improvement" is mainly seen as the project of restructuring indebted businesses on the verge of bankruptcy, and not as reducing taxes for all operating businesses in line with

Macroeconomic assumptions for 2002-03

	2002 Act	Belka's budget		Kołodko's budget	
	2002	2002 P	2003	2002 P	2003
GDP, nominal in PLNbn	764.8	741.8	786.3	742.5	784.1
GDP, % growth YoY	1.0	1.0	3.1	1.2	3.5
Total consumption %YoY	0.8	2.3	2.4	2.4	2.8
Private consumption, % YoY	1.0	2.6	2.8	2.6	3.2
Fixed investments % YoY	1.1	-5.5	5.5	-5.5	5.6
Exports, %YoY	4.1	4.6	7.9	5.0	8.5
Imports, % YoY	3.6	3.3	7.1	3.3	7.8
Average annual inflation, %YoY	4.5	2.5	3.0	2.1	2.3
Average wages PLN	2 154	2 127	2 213	2 120	2 195
Average employment '000	9 283	9 137	9 227	8 835	8 909
Unemployment rate, %	18.6	19.2	18.7	18.7	17.7-18.3
Annual average intervention rate %	10.0	8.8	7.2	9.0	7.2
Current account deficit, USDbn	8.62	8.19	9.93	6.77	8.74
Foreign direct investments, USDbn	5.54	5.7	6.7	4.41	5.90

Note: P – planned realisation *Source: Ministry of Finance* the original plan, which had determined the investment decisions in the past and could bring real investment growth.

The Ministry of Finance envisages reduction of unemployment rate and increase in current account deficit. What is interesting, higher income from privatisation is expected (however not as the double digit recently suggested by the Prime Minister and the Treasury Minister), paralleled by growth in the inflow of direct foreign investments. The central bank's reference rate is at 7.2% (next-year's average), which means that the Ministry did not take into account recent cuts when planning budget for 2003. The Ministry of Finance did not present the expected FX rates. However, the estimated current account balance to GDP ratio suggests that the PLN/USD rate expected by the government is at 4.10-4.15.

Revenues – are not they too high?

Definitely, next year's budget income projections are very optimistic. However, the key questions are: "to what extent is this level (un)realistic?", and "will there be a problem with implementing the budget next year?". The general conviction is that the GDP growth projection was adjusted upwards (from 3.1 to 3.5%) with a view to increasing the projected budget income. Undoubtedly, this was one of the reasons. However, if the change in the GDP projection paralleled by the change in the inflation projection (from 3.0 to 2.3%) are taken into account, as a total, they do not generate any additional income. On the contrary, the downward adjustment of inflation projection by 0.7pp may trigger income reduction more substantial than the additional income stream achieved owing to upward adjustment of GDP projection by 0.4pp. Assuming that the GDP growth is at 3% (our projection), the budget income loss could be at some PLN600m. There would be no problem in reducing the annual expenses by this amount (i.e. deciding to include them in budget 2004) without the need to revise the Budget Act. Interestingly enough, when revising the projected inflation and GDP growth, the Minster of Finance risked two-fold criticism. First of all (we will discuss it in details when presenting the expenses), assuming lower inflation, breaking the 'Belka's rule' became more evident and the public sector along with pensioners received higher wages and benefits (as the second arrangement with the Trilateral Committee did not work, the expenses were up PLN1.25bn). Secondly, contrary to the common expectations, Grzegorz Kołodko departed from the prudential budget income practice applied by his predecessor, in order to avoid unpleasant surprises. Of course, if the projections had not been adjusted, the Minister of Finance would definitely be criticised for overstating the average annual inflation projection. It seems that the natural optimism of the new Minister of Finance, which he wishes to share with the rest of the society, has won with the prudential approach applied by Marek Belka.

As mentioned above, the surprising overshot of the GDP growth does not have to be that painful for the budget performance. Therefore, when criticising the level of expected budget income, we would not draw too much attention to this change as in this case, the flexibility of budget income is not dramatically high. Definitely a much bigger problem, mainly due to the impossibility to estimate the actual performance, is posed by one-off income lines envisaged in the Budget Act – improvement in the tax collection, inflows from the restructuring fee and tax abolition. More effective recoverability of tax receivables was said to be a *filler* of gaps in income already in the previous draft budgets. In Grzegorz Kołodko's version, this line brings additional PLN1.8bn – PLN1.2bn from improved recoverability of VAT, PLN400m of excise tax and PLN250m of PIT. We should realise that growth in income arising from these lines might just as well be nil.

Other one-off income arises from the so-called 'rescue package' of Grzegorz Kołodko. It should bring the

Budget income in 2002-03 (in PLNm)

	Belka's budget		*Kołodko's budget*	
	2002 Act	*2003*	*2002 Plan*	*2003*
State budget income	145 101.6	149 500.0	145 102.0	154 762.0
Tax income, including:	131 698.7	136 492.5	130 505.5	138 563.6
- goods and services	58 050.9	61 716.6	57 388.1	61 588.2
- excise	32 493.6	33 517.9	32 016.6	33 765.0
- Personal Income Tax	26 540.4	26 717.6	25 041.1	27 995.7
- Corporate Income Tax	13 833.8	13 780.4	15 379.7	14 394.7
- custom duty	3 479.0	3 183.6	3 735.0	3 535.0
- lottery tax	780.0	760.0	680.0	860.0
Non-tax income, Including:	13 336.9	12 945.2	14 129.6	16 021.2
- income of budget units	6 009.8	5 332.5	6 055.4	6 051.8
- distribution of the NBP profit	1 961.8	2 836.4	2 582.2	3 567.0
- other non-tax	1 039.3	808.3	828.0	598.2
- dividend	600.0	530.0	682.0	670.0
- municipal payments	247.0	254.4	247.0	275.4
- restructuring fee				1 323.8
Foreign income	66.1	62.3	466.9	177.2

Source: Ministry of Finance

additional PLN1.3bn from the restructuring fee and PLN600m from tax abolition. This means that if this additional income was not generated, the Ministry of Finance would lose over 1% of the projected income. Detailed assessment of the rescue package was presented in August's MACROscope. Already then we indicated that income from restructuring might be overstated (at the time, the Ministry projected income of as much as PLN1.9bn). Tax abolition assumes that all of the citizens who now disclose the concealed income will pay only one-off tax and 'their sins will be forgiven'. There are no strong or accurate estimates in this regard which has been confirmed both by the Minister of Finance and a member of the Public Finance Committee. While Irena Ożóg, Deputy Minster, claims that as Sejm has increased the one-off tax rate from 7.5% to 12%, income in this regard will be lower, Marek Olewiński states that it will be higher. In our opinion, both of these assumptions are uncertain.

Sticking to one-off income issue: we should also note the increase in the projected central bank income by over PLN700m against Belka's budget. Let us hope that this amount was entered in the budget following consultations with the NBP and that it does not represent a source of potential loss next year.

Additional income streams were obtained by way of changing the plan of CIT reduction, which we mentioned above. Instead of the long-awaited reduction from 28% to 24%, the government will propose a mild 1pp reduction. Moreover, we have not received any rational explanations concerning the changes in this tax in 2004 (just to remind you – according to the act from 1999, the tax was to be reduced down to 22%). Contrary to the government's expectations concerning accelerated GDP growth, such a change might lead to slowdown in capital expenditure, as the bulk of it is financed with own funds (after-tax profit). According to the communication of the Ministry of Finance, if the rate is reduced by 1% in 2003 (and not, as previously projected, by 4%), the state budget will be fed with additional funds of around PLN1.5bn. However, if we compare these nominal income lines in the budgets of Belka and Kołodko, we will see that the difference is much smaller and totals merely around PLN600m.

As presented in the table on the previous page (comparison of income assumptions in the budgets of Marek Belka and Grzegorz Kołodko), the total difference in income is at almost PLN5.3bn. Much bigger difference is recorded in the case of non-tax income. Apart from the income flow from the NBP and the restructuring fee, the PLN700m difference under *income of budget units* is also interesting. In Belka's budget we read that the state income projection for budget units takes account of, e.g., lower payments for telecom licences in 2003. There is no such explanatory in Kołodko's Budget Act.

Expenditures – definitely too high

Grzegorz Kołodko criticised Belka's "inflation+1%" rule referring to budget expenses, stating that "the rule is wrong and will no longer be applied", adding that it imposed unnecessary 'political constraint on expenses'. It was relatively surprising as the government originally promised that it would stick to it and, until recently, Grzegorz Kołodko had explained that it still applied for budget expenses excluding salary rise in the public sector and larger subsidies for some of the institutions. Instead, the new minister introduced its own rule, stating that, as of now, the budget expenses would increase "parallel to the financial potential of the state and the budget priorities". In line with the new rule, the real growth in expenses is to be below the real GDP growth, which should allow to curb fiscalism in the economy. Indeed, it would be difficult to continue something that has never been enforced (this year expenses grow faster than "inflation+1%"). To be honest, we have never been too enthusiastic about Belka's rule, as it allowed to limit budget deficit only in the environment of strong GDP growth and low inflation. However, the good point was that it represented an anchor for the fiscal policy in the years to come. "Kołodko's rule" is less favourable as it places much weaker constraints on the expenses than real growth by 1% - there is less certainty that the fiscal imbalance will be limited going forward. However, the truth is that, irrespective of whether the anchor of expenses exists, the Minister of Finance will have to limit the state deficit within 2-3 years to ensure that the Maastricht fiscal convergence criterion is met. The problem is that the lack of such a simple rule as Belka's can make this exercise much more complicated. On the other hand, this exercise could be easier as, according to the methodology of the EU and the Maastricht Treaty, Polish budget deficit (and the public debt) is lower than that calculated by the Ministry of Finance based on the existing principles.

Who sets the rules?

Both rules put forth by the two ministers of finance are far from ideal as they do not guarantee control over the budget deficit. Let us just imagine that, in the downside scenario, against the expectations of the optimists, the GDP growth does not accelerate in 2003 and, as a result, the budget income is much lower. Then, the budget established with the level of expenses determined by Belka's rule would have to be revised pro rata to deficit growth. Of course, Kołodko's rule would be worse in this respect as the deficit would be even higher at the level of expenses calculated based on it. In our opinion, setting rules in planning fiscal policy should focus on reducing the public finance deficit and not on hoping that the economic revival will bring additional income and the deficit will go down despite high level of expenses. Curbing expenses and changing their structure could lead to reducing the deficit even at lower GDP growth; at higher GDP the effect would simply be more evident. The fact is that the principles of fiscal policy are not set by the European Union which requires that the Maastricht Treaty criterion (deficit at 3% GDP) should be met. We should remember that even if the EU and EMU did not require us to reduce the deficit, we still could not afford to keep it at 5% GDP.

The state budget expenses go up 4.5% against this-year budget, which means 2.2% growth in real terms. Unfortunately, as usual in the past years, the share of the so-called fixed expenses (legally determined) in total expenses is growing – from 66.3% to 67.8%. In line with the priorities adopted by the government, growth in expenses is recorded in education and culture (5.2%), security (8.8%) and EU integration. The break-down of expenses into core economic groups discloses substantial growth of expenses in the following categories: capital outlays (12%) and benefits for private individuals (9.8%). Current expenses of the budget units as well as the expenses related to the repayment of public debt grow faster (5.2% and 5.3%, respectively) than total expenses. On the other hand, subsidies, which represent as much as 55.7% of total expenses, and mainly comprise the subsidies for the local government units and specific funds, grow by 3.2%. All in all, it can be stated that the structure of expenses has not changed much and the low level of transfers to budgetary funds can indicate that the expenses are shifted outside the central budget. E.g. the subsidy for the Social Security Fund totalling PLN28bn represents 27% of the Fund's total income, however this income does not cover the projected expenses. Moreover, it should be added that the projected expenses are merely up 1.7% on this-year expenses. Therefore, it could be assumed that in reality they might turn out even higher and, as a result, increase the Fund's deficit. The situation with the Labour Fund seems even worse. Subsidy from the central budget totals almost PLN4bn, representing 40% of total income. However, the projected expenses are up on income by over PLN2bn. In this case, there is also the risk of underestimating the expenses as the unemployment is unlikely to fall down to the level expected by the government. As the projected expenses are higher than the projected subsidies, the government agencies, e.g. Agricultural Market Agency and Agency for the Restructuring and Modernisation of Agriculture, also forecast deficits. What is interesting, there is no information concerning the finances of other flagship government agency (Industrial Development Agency), which is responsible for a part of the rescue programme of the Minister of Finance.

Budget expenses in 2002-03 (in PLNm)

	Projected performance 2002	Budget Draft 2003
State budget expenses	185 101.6	193 496.0
Subsidies	104 444.8	107 775.5
Benefits for private individuals	14 515.1	15 941.4
Current expenses of local government units	30 127.4	31 704.5
Settlements with banks	2 041.8	1 735.8
Public debt repayment	25 690.0	27 058.0
Capital outlays	8 282.6	9 279.9

Source: Ministry of Finance

Fiscal deficits – should be lower

Budget deficit, as compared to Marek Belka's proposal has decreased by PLN4.3bn. However, assuming that all additional revenues found by Grzegorz Kołodko are realised, budget deficit would be even lower if Belka's rule was binding. As we showed above, overestimation of budget revenues may suggest that in the most pessimistic scenario some problems with executing next year's budget may appear. Let's analyse such a scenario, assuming no revenues from restructuring and tax abolition (PLN1.9bn), no revenues from better tax collection (PLN1.85bn) and lower revenues because of too high GDP growth projection (PLN0.6bn). This gives a sum of potential revenues gap of PLN4.35bn. Of course our assumption of GDP growth of 3% may turn out to be overly optimistic and as a result realised revenues may be even lower. However, the main question is "whether a revenue gap of PLN5bn (3.2% of total revenues) creates problem with realising next year budget?". And the answer is "not necessarily". In 1998-2000 the average budget income gap amounted to PLN3.7bn representing on average 2.5% of total revenues. In 2000 it amounted to PLN5.2bn or 3.2% and budget amendment was not necessary. Of course, to a large extent spending were not cut, but only postponed for the next year (well, next year of 2001 was very special with revenues gap of PLN20bn and two amendments of the Budget Act). Maybe minister Kołodko hopes that even in case of lower revenues next year, he will convince the cabinet to lower spending, not to revise budget. But once he failed to convince other ministers to cut spending when preparing the budget, why should we expect this to happen during the realisation. Therefore we expect exactly the same scenario as in previous years – even if there is a revenue gap expenditures are postponed for 2004 and no budget amendment is needed. Well, such an effect may be visible not only because of overestimated revenues, as the spending side (possibly underestimated) is the main problem in the budget draft. Because subsidies to budgetary funds and agencies may turn out to be insufficient, we could expect an increasing activity of taking commercial credit in these institutions, which may lead to an increase of total public finances' sector deficit. Grzegorz Kołodko said that lower than earlier planned budget deficit of PLN38.7bn, which makes below 5% of GDP, is below market consensus, which suggest that finance minister expected a positive markets' reaction. The reaction was very moderate, maybe because of the fact that the deficit of total public finances sector, not only central budget, is important.

Central budget in 2002-03 (in PLNbn)

	Budget Act 2002	Belka's budget	Kołodko's budget
Revenues	145.1	149.5	154.8
Expenditures	185.1	192.5	193.5
Deficit	40.0	43.0	38.7

Source: Ministry of Finance

And if we compare the whole public finances sector deficit, Kołodko's proposal is not more restrictive at all. The table below shows that while planned revenues are higher by PLN3bn, public spending are higher as almost PLN7bn. Central budget deficit in Kołodko's proposal is lower by PLN4.3bn, but the deficit of public finances sector is higher by PLNN.8bn, which again shows a scale of spending increase outside the central budget.

More significant fiscal policy's expansiveness is also shown in the estimation of economic deficit. During the final stage of preparing budget for 2003, we have seen many different economic deficit forecasts. Minister Kołodko said that economic deficit would remain "slightly above 4% of GDP", deputy minister Halina Wasilewska-Trenkner mentioned the level of 4.8-5.0%., while the Ministry of Finance put a statement on its website reading that economic deficit for 2003 is planned at 4.4% of GDP (PLN34.1bn) comparing with 5.1% (PLN38.1bn) for 2002. Interestingly, during the press conference concerning budget draft, Wasilewska-Trenkner said that economic deficit will amount to 4.8% and 4.5% in 2002-03, respectively. Well, the final version of the draft shows something different – the economic deficit will fall to 4.7% in 2003 from 5.5% this year. Let's assume these projections will not change. But are they realistic?

Public finances sector in 2002-03 (PLNbn)

	Belka's budget		Kołodko's budget	
	2002	**2003**	**2002**	**2003**
Revenues	300.4	311.4	296.3	314.4
Expenditures	346.4	356.2	346.0	363.0
Deficit	46.0	44.8	49.7	48.6
Deficit (% of GDP)	6.2	5.7	6.7	6.2

Note: Without EU subsidies *Source: Ministry of Finance*

As shown in the table on the next page, lower economic deficit next year results from the assumptions of no deficit in the healthcare funds (similarly as in Belka's budget) and budgetary funds' deficit of 0.6% of GDP (Marek Belka assumed – maybe too optimistically – a surplus). In reality, the shortage outside the central budget may be higher, especially as we take into account *other elements* position. This includes the results of Agricultural Market Agency (deficit of 0.2% of GDP) and Agency for the Restructuring and Modernisation of Agriculture (deficit of 0.1% of GDP). However, the Ministry did not include in its calculations Industrial Development Agency, which could spend money from the budget or from commercial credits guaranteed by the government. Also, quite controversial is an assumption of local governments' deficits in 2003 lower than this year and it has to be noticed that the Ministry may have problems to exactly estimate their budgets and it has limited influence on their deficits.

Moreover, for the first time the Ministry of Finance deducted from economic deficit calculations the costs of servicing debt paid for pension funds, arguing that the money are government's expenses, but at the same time they are income of pension funds i.e. do not influence domestic savings. The Ministry of Finance plans to transfer PLN11.4bn to the pension funds (in Belka's budget it was PLN12.1bn), although it is not certain whether the Ministry will also transfer delayed contributions, which together with due interests make some PLN7-8bn.

Despite the fact that the government announced already the liquidation of healthcare funds, in the budget draft we cannot find an explanatory note concerning the influence of such operation on public finances. Not to mention, government's concept of "medicines for a penny" or roads building programme.

We should remember, however, that the Ministry could lower economic deficit even more by deducting transfers from the European Union.

It is quite satisfactory that the Ministry of Finance has agreed that this year's economic deficit will be higher than previously assumed (although in reality it may be even higher) and may be above than 5% of GDP. However, in our opinion, next year's economic deficit is also unlikely to fall below 5% limit. It is difficult to estimate whether this would be 5.2% or rather 5.8%. But we can state for sure that next year's budget will not be a step towards more restrictive fiscal policy, despite earlier promises.

Economic deficit in 2002-03 (% GDP)

	Belka's Budget		*Kołodko's budget*	
	2002	**2003**	**2002**	**2003**
Central budget	-5.4	-5.5	-5.4	-4.9
Local governments	-0.7	-0.4	-0.5	-0.4
Healthcare funds	0.0	0.0	0.0	0.0
Other funds	-0.1	0.1	-0.6	-0.6
Other budget entities	0.1	0.1	0.0	0.0
Other elements	-0.1	0.0	-0.2	-0.3
Compensation scheme	-0.4	-0.4	-0.4	-0.4
Second pillar pension fund transfer	1.6	1.6	1.3	1.5
Costs of servicing debt paid for pension funds	n/a	n/a	0.2	0.3
Economic deficit	**-5.0**	**-4.5**	**-5.5**	**-4.7**

Source: Ministry of Finance

In Marek Belka's budget draft we could find forecasts of the economic deficit of public finances (and of other macroeconomic variables) for the next three years. He expected a fall in deficit to 3.8% and 2.8% in 2003 and 2004, respectively. For the new minister the Ministry of Finance has only calculated the deficit consistent with Maastricht Treaty and the EU methodology, which shows that the next year fiscal deficit will amount to 3.9% of GDP and will fall to 2.1-2.6% in 2004 and to 1.0-2.0% in 2005. It is consistent with the declaration of the joint committee of the central bank and the MinFin to meet Maastricht criteria in 2005. Of course lowering budget deficit in the following years is possible, however, it would require a political will to cut expenditures. While for the financial markets the above-mentioned statement will be sufficient for the next few months (or a year), concrete plans of public finances consolidation will be expected next year. Especially, as spending side of the budget will be affected by some fixed expenditures on co-financing the EU projects.

Budget deficit financing

Figure below shows the breakdown of next year's budget financing needs. The Ministry of Finance said that deficit will be financed with PLN5.1bn on the foreign markets, while remaining PLN33.6bn will be financed domestically. Domestic financing will be covered to a large extent by treasury papers' issuance, which, according to the Ministry will be bought in a large scale by non-banking institutions. The increase of this sector's share in financing the deficit is based on an assumption of higher assets of pension funds (although delayed contributions may not be returned), higher potential of investments funds and insurance institutions. Comparing to this year, the Ministry of Finance plans the lower share (fall from 24.8% to 13.9%) of foreign investors and of banking institutions (fall from 5.1% to 3.2%) in financing the next year's deficit on domestic market. According to the Ministry, foreign investors will hold 14.7% of total government's debt next year comparing with 14.4% in 2002, while the share of domestic banking sector in total debt will decrease to 29.3% from 32.6% in 2002. At the same time the budget draft assumes that the central bank will continue to sell government's bonds with an amount of PLN5.2bn.

From budgetary financing needs' point of view, privatisation will be more important as it will make almost 20% of total financing, while this year this share amounted to only 9%. This may be connected with

Financing budget deficit (in PLNm)

	Projected performance 2002	Structure (%) 2002	Budget Draft 2003	Structure (%) 2003
Deficit financing	40 000.0	100.0	38 734.0	100.0
1. Domestic	37 348.1	93.4	33 632.8	86.8
1.1. Privatisation	3 680.0	9.2	7 400.0	19.1
1.2. Banking sector	2 047.0	5.1	1 232.2	3.2
1.3. Non-banking sector	21 721.1	54.3	19 600.6	50.6
1.4. Foreign investors	9 900.0	24.8	5 400.0	13.9
2. Foreign	2 651.9	6.6	5 101.2	13.2

Source: Ministry of Finance

intentional delaying of some privatisation transactions (see the box below). Domestic financing needs include also compensation scheme (below the line in central budget) and small amount of money connected with given credits.

It is better to postpone privatisation... by one year

It is certain that this year's privatisation target will not be met and the Ministry of Treasury will receive possibly only PLN1bn. Does it mean problems for financing budget deficit? Not necessarily, assuming that privatisation revenues will be achieved next year. What is more, from the Ministry of Finance point of view, these revenues are not necessary this year, as it may finance most of this year's budget deficit from debt issuance taking advantage of high demand and excellent sentiment on the Polish fixed income market. Privatisation revenues would be realised next year instead, allowing for smaller issue of government treasuries in 2003, when expectations for interest rates fall will be less significant. Therefore, the key issue is to delay privatisation by not more than several months, as it undoubtedly bodes well for economic growth. Maybe both ministers (finance and treasury) have agreed to postpone privatisation one year? Especially, as prices for public assets could be higher in 2003.

Treasuries' net issuance on domestic market (in PLNm)

	Projected performance 2002	Budget Draft 2003
Treasuries	36 025.4	29 330.1
1. Market treasuries	37 766.5	31 845.0
1.1. Treasury bills	7 663.4	1 886.5
1.2. Treasury bonds	30 103.2	29 958.5
1.2.1. variable rate T-bonds	-1 119.1	617.4
1.2.2. fixed rate T-bonds	35 587.5	33 776.9
1.2.3. bonds denominated in USD	-4 365.2	-4 435.8
2. Saving bonds	1 229.6	234.1
3. Non-market bonds	-2 970.7	-2 749.0

Source: Ministry of Finance

Planned foreign financing includes issuance of foreign currencies denominated bonds worth PLN11.6bn (USD1.3bn and €1.5bn). On the other hand, net issuance of treasury papers will make almost 90% of domestic financing. That is why, the breakdown of papers' issuance will be the most important for financial markets' participants. Total issuance would amount to PLN58bn of local market bonds (out of which PLN55.6bn of fixed-rate bonds) and PLN53.3bn of T-bills. The net issuance is presented in the table above, which shows a decrease of net issuance in the t-bills sector. This is consistent with the Ministry of Finance's strategy of increasing duration of government's papers. On the other hand, the Ministry still expects relatively high demand for fixed- rate bonds, also from foreign investors, amid interest rate disparity and decreasing investment risk of the country (EU accession perspective).

Rising public debt

Grzegorz Kołodko said that public debt would remain below 50% of GDP this year, but would cross over this threshold in 2003 amid higher borrowing outside central budget for infrastructure program of roads construction. Undoubtedly, the significant growth of government's loans and guarantees observed in 2001-02 may be problematic, as part of them may require payments from the budget in the medium term increasing public debt.

It is better to exceed 50% public debt threshold this year

According to the Ministry of Finance's estimation this year's public debt including expected payments connected with government's guarantees will amount PLN358.2bn or 49.8%. Paradoxically, in our opinion it would be better if public debt to GDP ratio exceeds the 50% threshold already this year, because from economic point of view, there is no difference between 49.8% or 50.2% figure. However, there is difference from the perspective of planning budget for 2004. According to the Public Finances Law, if public debt exceeds 50%, the budget deficit planned for 2004 would be constrained by special prudential measures (e.g. the ratio of deficit to revenues could not be higher than in previous year in both central and local governments' budgets). Therefore, in such circumstances it may be easier for the Ministry of Finance to prepare more restrictive budget for 2004. Public debt into GDP will exceed 50% threshold anyway, but if this happens only in 2003, the prudential measures will be introduced when planning the budget only for 2005..

As a result of high fiscal deficit, public debt will increase to PLN395.4bn or 50.4% GDP nest year (comparing with 48.2% in 2002), out of which the government's sector's debt makes above 90% and the remaining part is local governments' debt. However, if we include expected payments from the budget connected with government's loans and guarantees, public debt would amount to PLN411.7bn or 52.5% GDP. According to the Ministry, the amount of possible government's payments connected with loans and guarantees would be at PLN28.6bn in 2002, which would mean an increase of some 5%YoY. While in the justification to the budget draft we read "policy towards new loans guarantees will be more restrictive", the number of planned loans and guarantees increases by PLN23bn (especially amid roads building programme). The Ministry estimates that, assuming some debt repayments, the amount of possible government's payments connected with loans and guarantees would be at PL41.1bn in 2003. This would represent a 43.7%YoY increase!

MPC assessment of the budget draft and conclusions for monetary policy

On 4 October the Monetary Policy Council have discussed government's budget draft for 2003 and released its official opinion. However, already after September's meeting Leszek Balcerowicz said that the MPC had a preliminary discussion about the budget. MPC members agreed that there are no crucial systemic changes in the budget draft that would constraint growth of expenditures and changed the structure of spending in the most wanted direction. They were concerned about maintaining high deficit of public finances, which after cyclical adjustment signals further expansion of fiscal policy.

The official opinion, as one could expect, proved to be very critical and MPC pointed out all weaknesses and inconsistencies of the bill. The MPC's conclusions were broadly consistent with our assessment of the draft. In the first sentence of the appraisal MPC said that the budget draft is not supportive for realising the objectives declared by the government, i.e. permanent improvement of public finances, creating pre-conditions for long-term economic growth and reducing unemployment. The only thing that was assessed positively by the MPC was budget's forecast of the inflation rate. As we expected, the Council described government's GDP growth predictions as overly optimistic and based on inconsistent assumptions. They also slashed the idea of financing budget expenditures by one-off revenues that were impossible to estimate credibly. As a result actual fiscal policy in 2003 might prove to be more relaxed than planned by the government. According to the MPC's opinion abandoning Belka's "inflation+1%" rule undermines the credibility of fiscal policy and therefore monetary policy decision would have to be made on basis of actual realisation of fiscal policy, not on the government's forecasts. The MPC noticed hardly any positive changes in budget expenditures. Reductions of some central budget's spending made by the government could lead to higher fiscal deficit of the local governments and other funds. The MPC predicted that maintaining budget deficit at the level planned for 2003 would imply that long-term interest rates would remain high amid huge borrowing needs of the state. According to NBP's forecasts economic deficit is supposed to reach 5.8% of GDP in 2002 and 5.4% in 2003, which implies no progress in tightening fiscal policy next year.

While we expected such hawkish statement from the MPC, we also said before that it would probably not prevent the Council from cutting interest rates in the near term, probably even before year-end. And indeed after the release of the opinion we have seen a number of MPC members' statements in the newswires, saying explicitly that interest reduction is still possible this year. Janusz Krzyżewski said that there is still room for further rate cut, as there are no threats for inflation development in the near term. Dariusz Rosati, who added that possible negative effects of the fiscal policy would be visible in 2H03, shared such a view. Even the MPC member, who was the most critical about the budget draft, Bogusław Grabowski, said that accepted budget draft does not exclude a possibility of further rates cut if GDP growth is low and unemployment high.

Clearly, the central bank has still quite pessimistic assessment of the Polish economy and rather gloomy expectations for the economic activity in the future. Consequently, it also does not foresee any significant inflationary pressure in the medium term, which allows for further reductions of interest rates. Of course the fact that budget draft is unsatisfactory and that its realisation might be even more problematic, limits the scope for monetary easing. All in all we maintain our prediction of 50bps rate cut in November, which will be followed by additional 50bps in 1H03, probably in two steps 25bps each.

Economic update

- **Another shy signs of economic recovery**
- **Negative net exports' contribution to GDP**
- **...amid higher external trade turnover**
- **Deepening collapse of inflation – no threat for monetary policy**

Macroeconomic data published last month hold two signs. Firstly, the drop in inflation has proved far deeper and probably considerably more persistent than predicted and there is still no suggestion of rising inflationary pressure in the medium term. Secondly, the long-expected acceleration in economic growth and improved performance in industry have started to materialise, although to a very moderate degree up to now, and there is no guarantee that vast progress will be made in the next few quarters. Moreover, positive signals from some sectors of the economy are coupled with much less optimistic news from the others, which raises concern about stability of economic recovery. However, the overall outlook remains moderately positive.

Business climate is still improving...

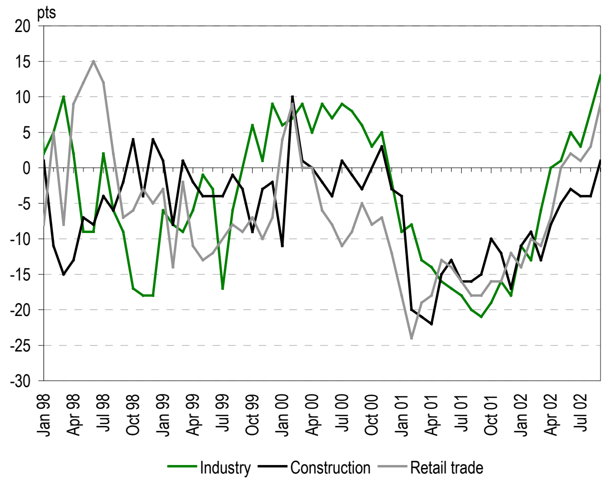
For some months Polish research institutions have been telling us that the economic climate is improving. Indices calculated on the basis of entrepreneur polls are systematically rising, and although most are still negative, they are usually higher than a year ago. Businesses are reporting fairly good current demand and optimistic outlooks for the future. Foreign demand is still strong, and the domestic market has also picked up slightly.

Results of business climate survey in September released by the CSO show that indices in industry, construction and retail trade changed only marginally in relation to August, but in all three sectors there was a considerable growth in annual terms. Companies recorded slight deterioration of current demand, mainly from abroad, while domestic demand was better than last month. Entrepreneurs decided to expand the production, though at slower pace than in August and their expectations regarding future demand and production levels remained optimistic. The level of inventories continued to fall though it was still perceived to be excessive. Similarly to previous months, companies planned continuing labour shedding at unchanged pace.

In construction total portfolio of new orders declined, with some improvement recorded only in public sector companies. Nevertheless the forecasted future orders and future production was optimistic (but worse than in August). Construction companies also planned to keep reducing the number of employees.

In retail trade overall climate assessment was negative, though it was positive among the largest entrepreneurs (employing more than 250 people). Much more companies reported deterioration of current situation than the improvement; they also expected fall of future turnover, reducing new orders and accelerating staff reduction. What is more, prices in retail trade were expected to decline in the future at the fastest rate than before. Notwithstanding this there was clear improvement in retail trade in annual terms (index was 9 points higher than in Sep-01).

Business climate indices, %YoY change



Source: CSO, BZ WBK

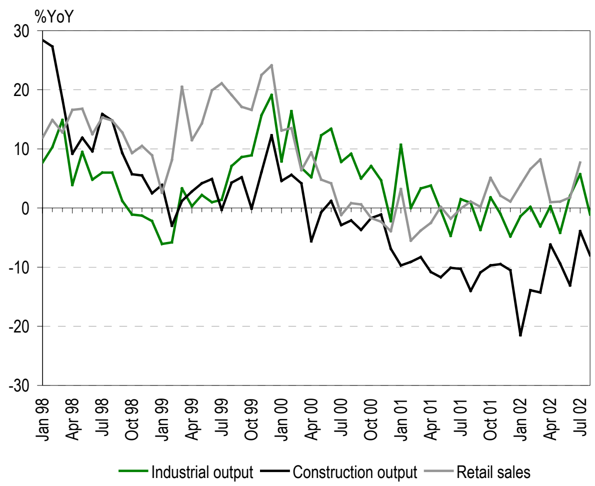
... and consumer's optimism increases

Overall optimism index calculated by Ipsos-Demoskop institute improved in September for the third consecutive month, reaching the level 11% higher than in September 2001. Households' propensity to spend money slightly declined, mostly due to seasonal factor (though still remained well above last year's level), and the overall assessment of current economic climate rose sharply (nearly 27%YoY). The negative features of the survey were higher households' inflationary expectations and still high fear of unemployment. The latter, together with worse assessment of households' financial situation, were the main forces hampering consumer's propensity to spend and their demand for durable goods. The propensity to spend surged only among public sector employees - up by 17 points.

Negative output dynamics, but... it's not so bad

Signals from business climate and consumer confidence surveys are gradually finding reflection in the real performance of industry and trade. Industrial output declined in August by 1.2%MoM and 1.1%YoY. The figures were in the lower end of market expectations (ranging from –2 to +2.5%YoY), and much lower than the result recorded in the previous month: 5.7%YoY (revised down from previous 6%). Nevertheless we believe the data was not as bad as it might seem at first glance. First of all, because the headline figure was negatively influenced in August by seasonal and one-off factors (e.g. lower number of working days), and secondly, because it should not be compared directly to astonishing July's results, which have been biased upwards significantly by similar one-offs, but working in the opposite direction. CSO announced that seasonally adjusted industrial production increased 0.8%YoY in August. What is more, if one took a glance at output growth adjusted only for a difference in working days, it turns out that August figures perform even better than those of July.

Real growth



Source: CSO

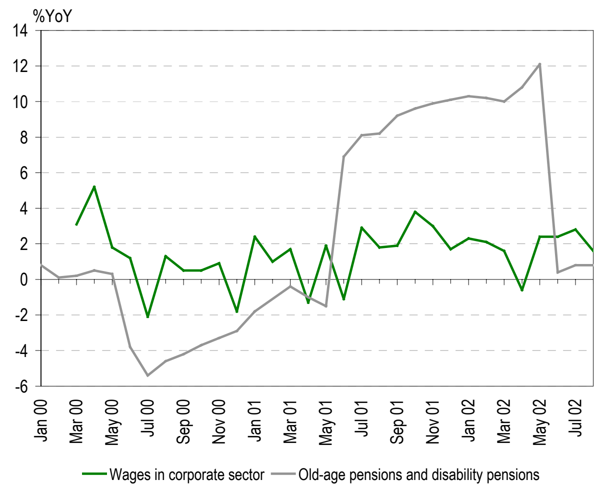
Retail sales keep on growing...

Rising consumer's optimism was reflected in another growth of retail sales, which increased by 5.1%YoY in nominal terms in August after growing 8.6%YoY in July. While the fastest growth was recorded in non-specialised shops selling mostly groceries and tobacco (26.8%YoY), substantial increase also took place in cosmetics and pharmaceuticals (21.4%), clothing and footwear (14.1%) as well as furniture and house appliances (6.1%). While price growth in retail trade decelerated substantially in recent months, real growth was probably very close to the nominal figure The figures confirmed that private consumption growth remained quite robust.

...despite bad situation on the labour market

In August the data about wages and employment in corporate sector were worse than expected. Average wage declined by 1.6%MoM and its annual growth rate decelerated to 2.8% from 4.1%YoY recorded in July. Companies continued to reduce labour force, average employment declined 0.2%MoM and 3.9%YoY. As a result, nominal wage bill in the enterprises sector contracted by 1.7%MoM and 1.3%YoY. In general the data were not very bad, though they did not provide the arguments supporting the hypothesis about improvement on the labour market. As long as employment and wage bill in corporate sector keeps declining, reducing the purchasing power of households, one cannot be sure about the persistence of consumption demand growth. Nevertheless those figures do not change dramatically our assessment of economic situation. We believe that private consumption growth would weaken somehow later this year, however this would be offset by gradual pick up of investments.

Wages and social benefits, real growth



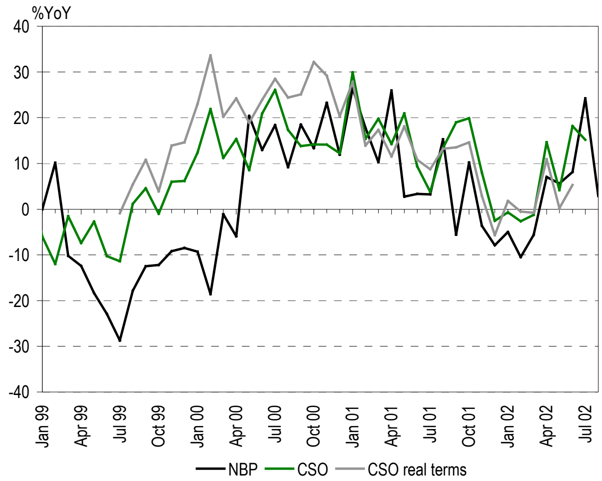
Source: CSO

Registered unemployment rate remained flat in August at 17.4%, in line with earlier hints given by the Labour Ministry officials. The number of unemployed remained broadly the same as in July, just slightly above 3.1m. According to data from corporate sector released earlier this month, companies still keep reducing labour force. However, for the second month in a row the number of new job offers was significantly higher than last year (+15.5%YoY), signalling that in some sectors of economy the situation has already started improving. In subsequent months the unemployment rate is expected to increase, probably to around 19% by the year-end, amid fast inflow of new graduates on the labour market.

Good CSO data on foreign trade

Improvement of the economic situation was visible in foreign trade data. According to the CSO data, after the first seven months of 2002, exports in dollar terms have increased 6.5%YoY and imports 4.4%YoY. The same figures expressed in euro showed growth of 5.3%YoY and 3%YoY, respectively. In July alone, both exports and imports rose by about 15%YoY. The figures generally confirmed the picture drafted earlier by NBP's data on payments basis. External demand for Polish products still seems to remain strong, meanwhile recovering imports might signal that something starts moving also on the domestic market. A more detailed CSO data on foreign trade turnover in the first half of this year reveals a series of processes that increase the probability of further improvement in subsequent quarters. For example the import growth recorded in the first six months of 2002 (3.2%YoY in PLN terms) proved to be fuelled mostly by the accelerating imports of consumption goods (10%YoY) and investment goods (9.2%YoY), while imports of intermediate goods declined by 2.5%. Such data confirm robust private consumption growth observed also in other statistical data (e.g. retail sales), but also might suggest that companies are increasing their willingness to invest and that we could expect gradual investment recovery later this year. Nevertheless, the fall of intermediate goods imported in 1H02 shows at the same time that business activity remains limited. According to the CSO, Polish export growth in 1H02 (5.1%YoY in PLN terms) was driven mainly by the improvement in sectors producing more value-added goods, i.e. industrial goods, machines, equipment and transport vehicles. This may be positive news in the long run, because external demand for such products should be more stable than for unprocessed goods, for which the price elasticity may play more significant role (it is easier to find cheaper substitute). In general, foreign trade figures seem to provide support for our economic scenario of gradual investment recovery in course of this year and also suggest that export performance should remain rather strong in subsequent quarters, although it would of course depend on economic activity in our main trading partners.

Export turnover



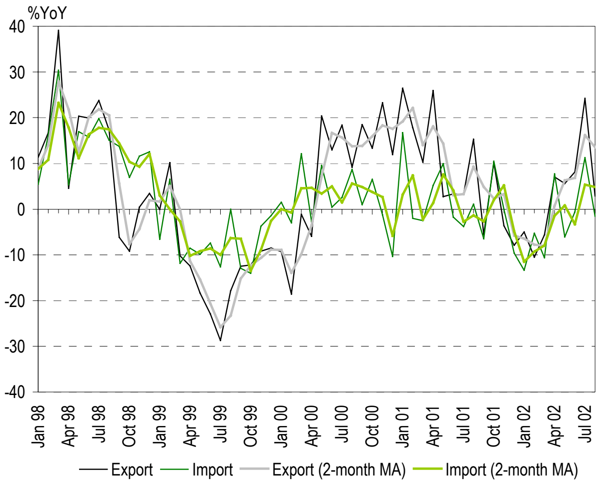
Source: CSO, NBP

... observed also in the NBP statistics

Current account deficit in August reached US$290m, very closely matching our forecast of US$296m. Trade gap amounted to US$887m amid significantly lower trade turnover than in July. Export reached US$2.7bn and import US$3.6bn, both falling in nominal terms by 15.2%MoM and nearly 5%MoM, respectively. Annual export growth fell to 2.9%YoY (from ca. 24% in July) and import contracted by 1.6%YoY after 11.3% growth in previous month. One has to remember that such results came after surprisingly strong July's data that clearly grew much above the trend. Please recall that in July there were series of unusually strong economic figures resulting from a few one-off factors: higher number of working days and sale of some ships from Szczecin shipyard. Meanwhile, in August industrial output figures and other series have been adversely affected by lower number of working days. Additionally, August is usually a month when both exports and imports go down on a monthly basis; only 2001 was an exception from this rule, which explains why YoY growth rates contracted as well. Therefore we believe it is too early to claim that recorded decline in foreign trade turnover signals the trend reversion and significantly worsens economic perspectives for the rest of the year. If we take a look at 2-months moving average, both import and export growth remains strong. Later this year we might easily see again two-digit rate of export growth and continuing improvement of imports.

We estimate that in August the C/A-to-GDP ratio declined to 3.5% (down from 3.6% in July).

Foreign trade turnover



Source: NBP

GPD growth and its components, %YoY

	1Q01	2Q01	3Q01	4Q01	1Q02	2Q02
PKB	2.3	0.9	0.8	0.2	0.5	0.8
Domestic demand	-1.3	-1.8	-1.7	-2.8	0.0	1.0
Total consumption	1.2	1.3	1.8	2.9	3.2	2.7
Private consumption	1.5	1.6	2.2	3.3	3.5	2.9
Public consumption*	0.0	0.2	0.2	1.4	2.0	1.9
Gross accumulation	-13.5	-12.6	-13.2	-14.5	-18.4	-6.0
Fixed investments	1.2	-8.5	-12.5	-13.5	-13.3	-8.4
Change of inventories*	-303.0	-77.0	-28.0	-43.0	31.0	125.0
Net export*	-42.5	-42.0	-46.0	-51.0	-10.0	7.0

Source: CSO, BZ WBK ** BZ WBK estimate*

Slight acceleration of GDP growth

The theory that the economy is gradually, if slowly, pulling out of this phase of stagnation is also confirmed by the latest CSO data on GDP in Q2 2002. According to these statistics, GDP growth in Q2 was 0.8%YoY, following increases of 0.5% in Q1 and 0.2% in the last quarter of 2001. Although this cannot be called a significant acceleration, these data do confirm previous suggestions that the Polish economy is slowly drawing away from the bottom of its cycle. The improved economic growth figures in the second quarter were mostly the result of an increase in private consumption (by 2.8% YoY) and a lower drop in investment in fixed assets than in previous quarters (-8.4%YoY), which corresponds entirely to our forecasts. As a result, internal demand rose for the first time in almost two years (for detailed data on GDP, see table above). Unexpectedly, the impact of net exports on GDP growth was negative, after ten quarters of a positive contribution. The change in inventory levels had a tangible positive effect on GDP (estimated growth of 125 y-o-y), but this category is rather difficult to analyse due to its residual nature in the national accounts. This information indicates clearly that the Polish economy really is starting to climb out of stagnation and slowdown.

Budget on track also after August

After eight months of this year budget gap amounted to PLN27.3bn i.e. 68.3% of the annual plan. Revenues reached 63.4% of plan for whole 2002, growing 1.8%YoY in Jan-Aug (and 6.6%YoY only in August) and the expenditures amounted to 64.4% of plan, being 7.2% higher than in eight months of 2001 (6.4%YoY in August). In general, total budget revenues performed quite well, mostly due to tax inflows. Revenues from indirect taxes decelerated somehow to 11%YoY in Jan-Aug from 12.2% after July, but this was expected as the one-off effect of extending tax repayment time for exporters died off. The positive feature is that the growth rate of indirect taxes remained in line with the target for the whole year (ca. 11%), despite significantly lower than assumed inflation rate. This, together with accelerating CIT revenues (which grew 9.5%YoY in Jan-Aug and 9.7%YoY in Aug, compared to 4.2%YoY whole-year target), seems to reflect the ongoing improvement of business climate. On the other hand, the acceleration of PIT revenues (to 2.9%YoY after eight months from 1.3% after July) seems to reflect lower than last year tax deductions than actual improvement of households' financial situation.

Budget spending appears to remain under control, reaching 64.4% of annual plan in August, which is broadly in line with the average realisation of expenditures after eight months during last four years. The fastest growth rate was recorded in subsidies to the Labour Fund (42.2%YoY), which reflects still high unemployment rate, and subsidies to the Social Security Fund (24.6%YoY). Overall, the government should have no problem with realising this year's planned deficit target.

After eight months of the year state treasury received only PLN866m from privatisation, which makes up for merely 13% of the plan for 2002. As we have written in our analysis of the budget the substantial part of privatisation deals is very likely to be postponed until 2003.

Headline inflation plummeted again

CPI inflation in August fell to 1.2% from 1.3% in July. As it was announced in the preliminary data of food prices, this component was mainly responsible for another 12-month inflation drop. While fuel prices increased by

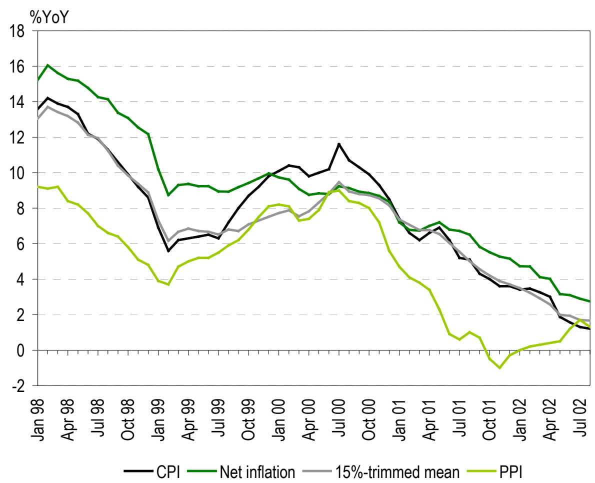
0.8%, the second round effect of higher excise tax on electricity was very moderate. Other components' prices were roughly the same as last month - stable or falling (clothing prices down by 0.5%MoM).

...core inflation and inflation expectations follow CPI

All five measures of core inflation declined in August, following the headline inflation rate. The scale of reduction was smaller than a month ago and in most cases it was very close to CPI's decline of 0.1pp. Similarly as in July four out of five measures were well below 2% – the lower end of MPC's target for 2002 – and one (inflation excluding controlled prices) fell to 0.7%YoY. The highest was 'net inflation', i.e. CPI excluding prices of oil and foodstuff, reaching 2.75%YoY. The most important (in our opinion) 15% trimmed mean measure fell moderately from 1.75% to 1.66%. All core inflation measures deliver hardly any evidence for mounting inflationary pressure in the economy. To the contrary, they seem to suggest that medium- and long-term inflationary prospects are rather positive, given there is no adverse supply shocks.

Although above-mentioned results of Ipsos-Demoskop survey indicated rising inflation expectations in September, the NBP data, which are used by the MPC in a decision making process showed that the households' inflationary expectations fell from 1.2% in August to 1.0% in September. This means a continuation of downward trend started in mid-2000.

Measures of inflation



Source: CSO, NBP

...while food prices stopped dropping

Finally, the trend has ended. After four months of continuous declining, prices of food and non-alcoholic beverages increased in the first half of September by 0.5% in relation to second half of August and 0.3%MoM. As usually, the most rapid changes took place in prices of fruits and vegetables. While the prices of fruits continued to fall, vegetables went in the opposite direction, offsetting the former trend. Prices of food after excluding fruits and vegetables dropped by 0.1%MoM. The result broadly confirmed our expectations. Under the assumption that food prices would grow moderately also in the last two weeks of September, we estimate CPI inflation to rise moderately to 1.3%YoY. In October planned reduction of excise tax on alcohol and fall of long-distance telephone calls should bring inflation rate back to around 1%YoY (maybe even slightly below), which means that at the end of this year inflation would be most likely below 1.5%YoY.

Public debt increased to 48.3% of GDP after 1H02

In September, the Ministry of Finance released the information about Poland's public debt after 1H02. According to the report total debt of public finance sector reached PLN354.5bn after six months of this year, growing by PLN39.8bn or 12.6% since December 2001. The relation of public debt to GDP increased to 48.3% from 43.6% recorded at the end of 2001. The bulk of the public debt increase was caused by surge in state treasury's debt (PLN36.9bn or 13%). The debt of non-budgetary funds and other entities also mounted considerably by PLN2.3bn (14%), while local governments were very cautious in increasing their borrowing: their debt inched up by PLN0.6m or 4.2%.

In general the figures confirmed that the debt-to-GDP ratio keeps growing fast. Nevertheless in the remaining two quarters of 2002 the increase should be much less pronounced. Budget deficit should increase by additional PLN15bn in 2H02 (while it amounted to PLN25bn in 1H02), at least some of privatisation revenues are expected in 2H02 and finally, FinMin is sitting on top of cash pile at the moment (in August the value of treasury's deposits exceeded PLN11bn), which may be used to buy back some of the outstanding debt or to finance the deficit. Assuming the most pessimistic scenario for 2H02 of virtually no privatisation revenues and substantial increase of local government debt, there is a risk indeed that by the end of this year Poland's public debt will exceed 50% level. In the most likely scenario, however, we still see the chance of ending this year with the ratio slightly below this threshold level. In any case, however, the negative impact on the fixed income market should be rather limited.

Also external debt increased after 2Q02

According to NBP statistics Poland's external debt reached US$78.4bn at the end of 2Q02, growing nearly 8%QoQ and 11%YoY. In relation to 1Q02 foreign debt increased by US$5.8bn, out of which US$2.9bn growth was recorded in government's sector (9.6%QoQ and 4.5%YoY), and US$3bn increase materialised in private non-banking sector (8.7%QoQ and 18%YoY). In the public sector, the increase could be explained mostly by the issuance of foreign bonds - in June FinMin placed Eurobonds worth EUR750m and US$1bn of Yankee bonds. The trend in the private sector is more worrisome. Credits from mother companies to their Polish affiliates grew by ca. US$800m while other loans increased by US$1.8bn. Such significant rise in 2Q02 might surprise a bit, while continuing process of interest rate reductions in Poland should increase the interest in zloty-denominated loans. One could guess that behind higher companies' demand for foreign credits was their belief that zloty would appreciate in the future. Meanwhile, the Polish currency weakened in 3Q02, which surely pushed up foreign debt servicing costs. This might have detrimental effect on companies' financial results in 2H02. On the other hand, such data cast some light on the very low credit growth recorded in 2Q02 in Polish banking system. The increase of private sector's external debt in the second quarter (in PLN terms) amounted to PLN12bn, which was nearly 50% higher than the increase of private sector's domestic liabilities at the same time (PLN8bn).

The increase of external debt was observed almost totally in long-term credits, while short-term indebtedness increased by a mere US$400m. This means that ratio of short-term debt to foreign exchange reserves remained at very low and stable level of 38.4% in 2Q02 (comparing with 37.7% in 2Q01). One should also remember that data released by the NBP are denominated in dollar terms, while a part of foreign debt is denominated in euro, which means that changes of euro/dollar exchange rate affected the figures.

Central bank watch

- **MPC cut interest rates once again**
- **...without taking into consideration budget for 2003**
- **MPC members' comments suggest further cuts**
- **Monetary policy guidelines for 2003 approved**

MPC cut rates, budget not considered

On its regular meeting in September the Monetary Policy Council decided to cut all main interest rates by 50bps. Since September 26 lombard rate amounts to 10%, reference rate to 7.5%, and deposit rate 5%. MPC maintained the neutral bias in its monetary policy.

NBP governor Leszek Balcerowicz started the press conference after the meeting by saying that "budget draft prepared by the government did not affect MPC's decision, and the official opinion on it will be presented later" (we discuss it in the Special focus section of this report). After examining other information and data describing economic situation MPC assessed that the factors limiting inflationary pressure in the future outweighed those, which might fuel price growth and threaten inflation stabilisation. In particular, among factors supporting rate cut decision MPC mentioned:

- decline of headline inflation rate and all measures of core inflation;
- fall of broad money supply;
- significant deceleration of credit growth, both to households and to companies;
- moderate growth of wages amid persistently high unemployment;
- worsening of growth prospects for global economy, especially for Germany.

On the other side, several factors called for caution in monetary policy:

- continuing fall of deposits in banking sector;
- rapid surge of cash in acceleration;
- high uncertainty regarding oil prices;
- interest rate cuts made so far were very deep and their effects did not appear yet.

Interestingly, real activity indicators (industrial output, retail sales, GDP growth) were not mentioned on whatever side. However the MPC stated that recent industrial production figures confirm that downward trend of output growth has been reversed. Moreover they expect GDP growth in upcoming quarters to increase, however it is not certain whether the acceleration would be substantial and persistent.

Summing up, it seems that the MPC cut interest rates for the next time because their general assessment of the Polish economy is still rather pessimistic. They do expect some improvement of economic situation in subsequent quarters, though apparently it is supposed to be rather slow and not necessarily long lasting. No improvement on the labour market and stagnant loans in the banking sector also contribute to this picture. Hence, the Council also does not foresee any significant threats for inflation in the medium-term (except for unpredictable developments on the oil market). In our opinion this line of reasoning will not change dramatically in the near term, and therefore we think that another rate cut of 50bp is in the pipeline.

Another rate cut possible in November

Last weeks delivered at least a few pieces of information suggesting that September's interest rate reduction was not the last one in this year. The NBP governor Leszek Balcerowicz admitted for the first time that inflation in December would be below the central bank's inflation target. Moreover, comments of the most of the MPC members suggest that they do not see any serious threats, which could trigger significant acceleration of CPI in the next year, endangering realisation of the medium-term inflation target. In the end of September, director of research department of the NBP Adam Czyżewski revealed GDP growth forecasts of the central bank for the remainder of the year, which indicate quite pessimistic scenario of economic revival. Low GDP growth expected by the NBP in next quarters and no expectations of any inflation pressure in the medium-term are information that support expectations for further monetary easing in the nearest term. A possibility of continuation of downward tendency in interest rates was also suggested in recently published *Guidelines for monetary policy in 2003* (see below). Possibility of another rate cut before year-end was also explicitly mentioned by the MPC members, e.g. Dariusz Rosati, even after last interest rates reduction in September and publication of negative opinion about the budget (see table on page 18)

Guidelines for monetary policy in 2003

At the end of September, the central bank released *Guidelines for monetary policy in 2003*, approved by the MPC during its last meeting. The document outlines the objectives and framework of monetary policy to be conducted next year. As was announced in June, inflation target for 2003 is set at 3% ±1pp. Such target –

stated MPC – implies transition from disinflation to the phase of inflation stabilisation. Stabilising inflation at low level would in turn allow for further reductions of interest rates leading to narrowing the differential between rates in Poland and in EMU countries. However, the pace of those reductions would depend heavily on factors independent on monetary policy, mostly on fiscal policy. Meanwhile, available information about budget draft for 2003 suggests further expansion of fiscal policy. Such development amid improvement of economic situation raises the MPC's concerns and could limit the manoeuvre for monetary policy. According to the MPC the primary goal of macroeconomic policy in the upcoming years should be fulfilling Maastricht convergence criteria so as to allow Poland to adopt euro as soon as possible. The Council predicts that in 2003 GDP growth in Poland would revive to no more than 2-3%

The *Guidelines…* announced changes of instruments and rules of open market operations in 2003. Planned changes almost exactly match our expectations and confirm earlier hints given by Dariusz Rosati. For the in-depth analysis of modifications of OMO rules please refer to the Special focus section in September's issue of MACROscope.

MPC announced that it would not aim at eliminating operational excess liquidity of banking sector in 2003. Such operation would require high issuance of NBP's bonds, which would be a competition for treasuries leading to undesired upward pressure on market yields. Instead, NBP would ensure that market remains in operational overliquidity by buying back inflation-indexed NBP bonds issued in 1999. The document says also that NBP is going to complete the process of harmonisation of obligatory reserve system in line with Eurosystem's directives, though the adjustments will be gradual. We guess it means reduction of reserve requirement to 2% (possibly in few steps) and introducing interest payments on obligatory reserves.

Who voted for rate cuts in 2Q02?

Before we will see voting results of September's meeting in mid-November (it is interesting whether Janusz Krzyżewski has changed the view since Monday), we can analyse quarterly In *Inflation report for 2Q02* released by the NBP one can get know with the detailed list of motions voted by the MPC in the past with the distribution of votes of the MPC members (official Government's monitor publishes only voting results of those meetings that ended up with decision).

Votes over interest rates in 2002 are summarised in the table below. Please note that the trio of doves Ziółkowska-Rosati-Wójtowicz consequently opted for deeper interest rate cuts of 75-100bp in 2Q02, even after MPC officially decided to adopt 'small steps approach'. The difference of views between those three and other MPC members is also visible in the fact that they voted against the reduction of MPC's inflation target for 2002 to 2-4%. Moreover, Ziółkowska and Rosati were also against approving the report about realisation of monetary policy guidelines for 2001, probably judging MPC's policy in that period as overly restrictive.

Voting pattern of MPC over interest rate reductions

	Apr	Apr	May	May	Jun	Jun	Aug	Sep
reduction (bp)	100	50	75	50	100	50	50	50
decision	no	yes	no	yes	no	yes	yes	yes
Balcerowicz	-	+	-	+	-	+	n/a	n/a
Dąbrowski	-	-	-	-	-	-	n/a	n/a
Grabowski	-	+	-	+	-	+	n/a	n/a
Józefiak	-	+	-	+	-	+	n/a	n/a
Krzyżewski	+	+	-	+	-	+	n/a	n/a
Łączkowski	-	+	-	+	-	+	n/a	n/a
Pruski	-	-	-	+	-	-	n/a	n/a
Rosati	absent	absent	+	+	+	+	n/a	n/a
Wójtowicz	+	-	+	+	+	+	n/a	n/a
Ziółkowska	+	-	+	-	+	+	n/a	n/a

Source: NBP, Reuters

Comments of the MPC members and central bank representatives

Last month the NBP officials' statements concerned mainly published economic data and government's budget proposals. The members of the 'doves' faction assessed the August industrial output figures as 'pessimistic' and 'below expectations', saying that the economy still remains in stagnation and there is more room for monetary easing. It suggested that they would press for interest rate cut during September's meeting (and it turned out that they were efficient). The NBP governor admitted for the first time that inflation in December may fall below the lower end of the inflation target despite other MPC members still talked about CPI in December around 2%.
Kołodko's budget draft raised concerns of the MPC members, mainly due to GDP growth and incomes forecasts, which were perceived as " too optimistic, risky and unjustified". Bogusław Grabowski (one of the MPC hawks) slashed the bill saying it is the worst budget draft for many years, with poor transparency, huge economic deficit, that by no means can ensure stable and persistent economic growth. Also members of the "dovish" faction of the MPC expressed their doubts concerning the governments assumptions of GDP growth and incomes. However both Rosati and Grabowski admitted that more interest rate cuts are possible in the following months. Rosati confirmed it also after the last MPC decision.
Ahead of MPC meeting we have seen contrasting opinions about rate cut perspectives from various MPC members. While Wiesława Ziółkowska argued that budget draft was not an obstacle to an interest rate cut, Janusz Krzyżewski said that basing on available information he saw no reasons for cutting rates in the near term. One could wonder whether he was really honest, as according to the 'anonymous source' September's monetary easing was voted with a majority of six members against three, while one member (from the doves' faction) was absent. Who was absent? Perhaps Krzyżewski, who announced no rate cut already on Monday, has decided to leave the meeting when it was obvious his belief would not materialise? But maybe it was Dariusz Rosati who goes abroad very often and missed a few MPC meetings before. We will know all the answers in mid-November.
Leszek Balcerowicz said that last MPC's decision did not take into account next year's budget draft, nevertheless he criticised the bill several minutes later. He said that MPC members agreed during preliminary discussion that announced budget assumptions imply further expansion of fiscal policy in 2003. The official MPC opinion of the draft were also very critical but it did not prevent MPC members from expressing hopes for another rate cut before year-end.
Director of research department at the central bank revealed NBP's expectations for GDP growth in the remainder of the year saying that it is likely to amount to 1.1-1.3% in 3Q02 and 1.1-1.4% in 4Q02, which would give whole year growth at 1.0-1.1%. According to Czyżewski growth will be driven mainly by domestic factors, while net exports and investments development are still uncertain. However, one should remember that at the end of June Czyżewski expected only 0.2-0.3% GDP growth in 2Q02, then this forecast was updated at the beginning of September to "above 0.6%", while the figure turned out to be at 0.8%.
The NBP officials spoke also about the zloty. At the beginning of October deputy NBP governor Andrzej Bratkowski presented strategy for the road to the euro worked out jointly by the NBP and the Ministry of Finance. He confirmed strong commitment to fast EMU entry and Maastricht criteria fulfilment in 2005. Until the moment of EMU entry free float exchange rate is to be maintained. Moreover, Poland could apply to shorten the period of obligatory presence in this system if macroeconomic conditions justify it. Commenting on possible parity rate of the zloty against the euro, most of the MPC members mentioned average market exchange rate preceding fixation of the rate. Only Grzegorz Wójtowicz stated that exchange rate from the past should not be taken into account when considering the parity rate for the future.

WHO, WHEN, WHERE	COMMENT
Leszek Balcerowicz, the NBP governor PAP, 1 Oct	The central bank is not going to abandon free float FX regime. There are no reasons to change our position. Monthly data should not be overvalued. Since April we have observed upward trend in exports, but our export depends on external situation, particularly in Germany, and this not favourable.
PAP, Reuters, 25 Sep	It was not the budget that decided [about interest rate cut], but other factors – low inflation persists, almost all measures of core inflation declined and the trend of M3 money growth deceleration continues. MPC would issue the opinion about budget draft after the government formally approves the bill, which is supposed to take place on Saturday. MPC had preliminary discussion about the budget proposals. MPC members are concerned about budget's effect on growth acceleration. In light of available assumptions and after cyclical adjustment there will be further fiscal policy easing in 2003. There is high probability that inflation would be around 2% at the end of 2002, maybe even below, due to deeper than expected decline of food prices and excise tax on alcohol. Assuming cautious monetary policy there is high probability of fulfilling next year's inflation target. The more interest rate cuts was made, the smaller probability of subsequent cuts. One has always consider how deep interest rates have been reduced up to date, analyse the impact of the budget and also consider interests of those who save and attractiveness of saving. There is an agreement that Poland would benefit from meeting Maastricht criteria in 2005, in order to join Eurozone in 2006, under the assumption that EU enlargement takes place in 2004. We have no reason to believe the government has changed its view on meeting the (Eurozone) entry criteria in 2005. We assume that in 2005 budget deficit will meet the criteria.
PAP, Reuters, 6 Sep	I do not rule out that it [inflation] may be below two percent, but surely it will be close to two than to three percent [in December 2002]. [...] We have to maintain low inflation but also we should have much lower budget deficit in Poland. The limit is 3% with tendency to balancing the budget. This is a condition of the economy development. It is crucial so that finance ministry Kołodko's pledges would materialise, that the whole public finances deficit will be significantly lower than previously planned. I think it is possible.
Andrzej Bratkowski, NBP deputy governor PAP, Reuters, ISB, 8 Oct	If there is no extraordinary economic turbulence, we would like to enter Eurozone two years after ERM2 accession. Whether we will make it in 2006 is not only up to us, [...] but also on the procedural talks with EU. So we cannot rule out that it would be 2006 or 2007. NBP would prefer 2006. The joint committee did not discuss the issue of entering ERM2. Formally we can do this after EU accession. NBP intends to enter ERM as soon as possible, without any delay. Negotiations [about entering ERM2] would start after entering EU, but informal talks can start earlier. They should not last longer than a couple of months [...] We cannot rule out that the period of presence in ERM2 would be shorter than predicted. Poland could ask for shortening this period if macroeconomic situation justifies it. Presently we are working on the issue what factors should determine the central fixed parity [against euro]. It's too early to say what exactly will be the reference period, but for sure this does not mean pure arithmetic reference rate. NBP does not exclude FX intervention in special circumstances before ERM2 entry. It would depend on situation. If NBP judges the zloty to be overvalued then we cannot rule out intervention [...] but we have very serious concerns over the effectiveness of such action. We have no reasons to believe that such special circumstances would happen on the road to ERM2. Zloty devaluation is not possible under fully floating exchange rate regime.
Dariusz Rosati, MPC member PAP, 10 Oct	This pact [of Stabilisation and Development] is breaking down. Portugal has recently exceeded the limit. Germany, France and Italy are at the edge of the limit. If the pact will be broken the common interest will be broken. (...) One of reform proposals says that it is worth to appoint Fiscal Policy Council for 6 years term, which would establish a

	level of allowed deficit for this period. A path of reducing a deficit should be established for the whole business cycle.
Rzeczpospolita, 10 Oct	Taking into account local governments sector, the overall scale of deficit “spill over” outside the budget may reach in 2003 about PLN7-8bn. In these conditions, it is difficult to state that budget deficit will be actually lower than this year.
	Assuming that the potential GDP growth for the Polish economy stands presently at 4-4.5%, the economic deficit should be around zero already in 2004. From this point of view (...), planned lowering of the economic deficit by 0.5% of GDP in the next year may turn out to be insufficient.
PAP, 9 Oct	One of possible solutions for setting central parity is market average, but there is no agreement on that yet, because it’s too early.
PAP, 4 Oct	Given lack of inflation threats there is still room for interest rate reductions in the nearest months. Possible negative effects of the budget leading to increase of inflation will be seen in the second half of the next year.
	The announcement of reducing the budget deficit in the next year is little credible because of too optimistic forecast of incomes, and if one takes into account predicted faster pace of GDP growth, planned deficit means actually looser fiscal policy.
	Uncertainty concerning actual level of the next year’s deficit, increasing borrowing needs of the state do not make monetary policy easier, but monetary policy should respond to facts, not to potential risk factors.
	One cannot exclude another rates’ reduction this year assuming that positive signals in the economy will prevail.
PAP, 26 sep	The MPC will carefully analyse budget draft trying to explain uncertainties connected with financial stance of budgetary funds and agencies as well as problems with EU structural funds. Fiscal policy and oil prices risks are the only for inflation development.
TVN24, 23 Sep	The promise to lower CIT to 24% was made when there was no awareness of public finances’ problem. It explains government’s decision to some extent, though it is still not good news.
	There is no effort to solve fundamental and structural problems in this budget, i.e. high share of fixed expenditures, expenditures on social security and social benefits. They all rise in relation to previous year, despite this money is spent in highly ineffective way. No shifts can be seen in this budget from fixed expenditures to spending on pro-growth and pro-development objectives.
	Kołodko undertook some effort to limit KRUS spending, e.g. the number of beneficiaries is lower.
	At the start Kołodko had bigger persuasive power and he could have undertaken reform of public finances, nevertheless it did not happen. One can hope that Sejm reduces spending of entities remaining outside of central budget’s control.
	It would be useful to have the anchor in order to stabilise market’s expectations. But there is some anchor in this budget: it’s the announcement that Poland must meet Maastricht fiscal convergence criteria, i.e. lower fiscal deficit below 3% of GDP in two years time.
	Budget revenues are highly optimistic, but smaller doubts are related to CIT and VAT inflows than to two other items: restructuring and tax abolition, giving total PLN2bn. This is simply wishful thinking.
Reuters, 19 Sep	Minister Kolodko truly wants to lower the budget deficit, not only because of his desire to enter the Eurozone, but also to build his own credibility. On the other hand he is under tremendous pressure to increase state spending....so the only way out was to set a fast GDP growth target and inflate inflows. But we still have too little information to accept the macroeconomic as credible, especially the GDP forecast. I think the Finance Minister expects more rate cuts, which is natural to expect during a period with no price pressure. In such a situation (if no price pressures emerge), then there would be room to lower interest rates further. Financial markets are already expecting a cut of some 100 basis points this year and next year reductions by 50-100 points.
	MPC used to be too cautious and maintained overly restrictive monetary policy for two years. It is visible ex post that inflation went down much below MPC’s desire, and by the way economic costs in terms of GDP growth and unemployment are much higher. If the trend of food prices does not reverse, there is no crisis on the oil market and fiscal situation clarifies, then one can say for sure that there are no inflationary threats in 12-18 months horizon. In such case there would be a room for further rate cuts.
	We have to negotiate (the entry terms) so that we don't have to wait in this storage room, but jump straight into the European Monetary Union from the present regime. ERM-2 could create speculation and be too tight of a policy corset for a converging economy...which is much different than previous Eurozone entrants, who were developed economies. No significant zloty depreciation is expected, to the contrary, the trend has probably changed to a medium-term upward one. We are declaring our will to fulfil Maastricht (entry) rules, knowing this will be painful...especially the inflation criteria which will slow economic growth. Western partners are afraid that we, in some sense, may soften monetary policy through our input to ECB decisions, but these are some sort of political speculations. Our partners must have faith that Poland will act responsibly. Surely, the National Bank of Poland has clearly shown its determination to curb inflation. We seek to enter the EU in 2004 and the Eurozone in 2006 -- that is practically at the earliest possible date. At that time (2006) our economy will be in a period of robust growth and surely our deficit will be below three percent of GDP.
PAP, 19 Sep	I am pleased with this budget’s restrictiveness. Deficit has been reduced below this year’s level, it is some progress anyway. But I also look at the credibility of the assumptions, especially those regarding GDP and revenue growth. These are main question marks. Revenue increase is supposed to be effect of higher tax revenues, but also effect of arbitrary extra revenues. Those are very hard to predict, they are like “dunes”.
Reuters, PAP, 18 Sep	I forecast GDP at 3% in 2003. I used to think that 3.5% is possible only six months ago, now we can see that there is a delay in economic recovery in Poland and abroad. But 3% is still realistic. 3.5% is very optimistic, although theoretically possible, e.g. amid very strong growth of private consumption and net exports. I think this year GDP will grow 1.2%. August industrial output was disappointment for me, I have thought that recovery would be more pronounced.
PAP, 16 Sep	These figures are disappointing and they show that there are no signs of sustainable economic growth, particularly when contrasted with two months of good performance. Exceptionally upbeat six-percent year-on-year growth in output in July was largely due to one-offs, such as a sale of one ship. [...] Still, there is a change for GDP growth above 1%. Industrial output makes up for one third of GDP, and the services are main driving force for growth. Meanwhile consumption grows robustly by at least 3.5%YoY. Nevertheless output figures show that economic recovery, if any, is very shaky. Poland’s economy is still in stagnation. .
Polish Radio 3, 16 Sep	There is a room for interest rates reduction until the end of 2002 if there remains no inflationary pressure and assuming no threats from the next year’s budget.
	Inflation collapse to 1.2% is a record, but it is the end for sure. We should expect inflation rise to 1.5% in September and to 2% in December. But there are currently no threats for realising inflation targets in this and next year. Inflation growth might be the effect of oil price surge amid potential conflict with Iraq, nevertheless only a disaster in the Middle East would create a serious danger.

Rzeczpospolita, 9 Sep	Growth acceleration in 2003 is very likely, even 3.5% growth forecast of minister Kołodko is realistic, although very optimistic. We need to know what are assumptions of such forecast, as fixed investments are still falling and net export net may be affected by downward revision of world growth forecast.
	In the last 2-3 months we have observed signals suggesting a gradual growth acceleration, but other factors also influence MPC decisions, especially inflation development, which is favourable at the moment, but we cannot exclude a possibility of fuel prices increase.
TVN, 3 Sep	The revision [of forecasted GDP growth in 2003 to 3.5%] is very risky. There are no signs of recovery that would justify such optimistic change. In my opinion it is the super optimistic approach to economic situation, considering that the government has no concept for more significant changes in economic policy. [...] If the forecast does not materialise, we would have higher budget deficit next year.
PR 1, 3 Sep	The news, which we have heard, that despite lower inflation we will have higher indexation [of wages and benefits] is a risky step. This may not be dangerous under a condition that the economy will grow faster than 1.7% and employment in public sector would be rationalised. All that was achieved thanks to the lower inflation, with high cost (...) after two years of very restrictive monetary policy – now, the government promises, in not very sensible way, to spend.
Reuters, 3 Sep	But we still have high level of unemployment and so far there have been no signs that it is going to fall. In such situation on the market, accompanied by very low level of GDP growth, there exist some room [for further monetary easing] but under a condition that necessary fiscal discipline would be maintained.
	Similarly to the US economy there are more and more signs that we are coming out of crisis or stagnation. We had very good data on industrial production for two consecutive months, there were also very good results in retail sales. Actually, there are many optimistic signals from the economy. I think that within next two or three months we will be able to say with certainty that the situation is improving.
	I expect the government to be very conservative in both its inflation and growth forecast, cutting the GDP growth forecast to 2.2-2.5%.
Bogusław Grabowski; MPC member; PAP, 7 Oct	Continuation of loosening of monetary policy, coupled with such fiscal policy, will be possible only if GDP growth will be low and the unemployment high. This fiscal policy does not have to result in tightening of monetary policy at all. [...] The fundamental problem is a fulfilment of Maastricht criteria, i.e. criteria concerning inflation, interest rates and the most difficult challenge – fiscal criterion [...]. It's a tremendous challenge, because if we want to join the common currency area as fast as possible, i.e. in 2007, then [Maastricht] criteria will have to be met in 2005, because 1H06 will be the period for checking our eligibility. Therefore not much time was left, and everyone knows that the structure of public finances call for deep reform. Additionally budget would have to bear the costs of co-financing accession to EU.
	[Budget draft for 20o3] does not make us closer to meeting the criteria next year, nor it creates the ground for meeting them in subsequent years. On the other hand there is announcement about fiscal policy in 2004 and 2005 in this draft with very optimistic forecasts of public finance deficit reduction.
RadioZet, 23 Sep	It's the least transparent budget for many years. There is no forecast of public finance situation for the next two years. The government has broken "inflation+1%" rule that it approved itself in February 2002. [...] This budget does not try to overcome all those bad trends in public finances that we experienced in past years. We have fiscal expansion [...] We have higher share of social expenditures [...] We have higher share of rigid expenditures [...] One cannot build budget draft on one-off revenues, that cannot be forecasted credibly anyway. I can say it is the worst budget draft for many years. [...] It can really end up very badly.
	Not only do we have a much faster growth in spending, but we also have a lot of expenditures pushed outside of the central budget as well as artificially bloated revenues level. Poland runs a large fiscal deficit this year of around 5.5 percent of GDP, and according to my estimates that level will remain unchanged also next year.
	Public finances are one of the most important, though not the only factor that we consider [making decisions about interest rates]. Please consider that interest rates are being lowered despite a large fiscal deficit, and perhaps it would be continued. But even if they continue falling then taking into account such large state borrowing, that will not allow for much faster economic growth or lower unemployment.
Reuters, 19 Sep	It is highly disturbing that with such ease the government abandoned its strategy of controlling the fiscal deficit through curbing real term growth of state expenditures. This is a blow to the government's fiscal credibility in the medium- and long-term perspective...Now any long-term fiscal tightening plans will have to be ignored by monetary policy makers. Investors may now doubt the credibility of long-term fiscal plans and as a result Polish long-term nominal rates may stay higher than they would otherwise.
Reuters, 18 Sep	In my view the most probably scenario is the one most analysts expect, that economic growth will be around one percent this year and some 2.5-3.0 percent next year. Just as July (industrial output) figures did not mean we are entering a recovery period, these August figures don't mean that a recovery has not arrived or that it has burned out.
ISB, 9 Sep	I do not know what was the government's rationale to do such changes two months after approving previous assumptions. It seems to me that the government must expect higher consumption, because growth forecasts in our main economic partners have been decreased. If the government would like to boost the economy by the consumption growth it would the most inflationary solution. Then, scenario for monetary policy would be different than assumed by the MPC at the moment.
Cezary Józefiak, MPC member PAP, 9 Oct	It's too early to ask about details, under which rate we would peg zloty to euro. The things that have been agreed are very important – the declaration that 2006 is the beginning of EMU participance.
PAP, 25 Sep	MPC meeting planned for 3 October will be devoted to analysing budget draft for 2003 and I think that we will meet to accept the opinion about the budget.
ISB, 25 Sep	If Poland faces deflation gap by the middle of 2003, it will be the government's economic policy to be blamed for it and not monetary policy. The threat [of deflation gap] is likely to appear in mid-2003.
	The investments crisis is usually broken through certain reduction of production capacity, as one of the factors stimulating investments demand, while the current process aims at upholding ineffective production capacities, which increases the deflation gap as demand shrinks simultaneously.
	The government upholds ineffective capacities while protecting ailing enterprises with importance to the labour market. Interest rates are important, but I would not regard them as the only factor stimulating investments and in this situation the idea that it should be monetary policy who stimulates investments is not convincing.
PAP, 16 Sep	I did not expect that downward food prices trend may be so long. An increase of inflation starting in September should be expected and CPI will rise to above 2% by year-end. Although inflation next year will be higher than in 2002, I do not see any major threats for low inflation. The MPC aims at stabilising CPI at such a level. We still remain under impression of declining inflation that surprised us.
Reuters, 9 Sep	Until I see some arguments from the government, this seems to be an unjustified decision. Until there is not such information, they may create different speculations, e.g. that this motivated by the need to close the budget and

	decrease the deficit. We all observe both in Poland and in the world that economic results are declining compared to what was previously expected. Everywhere, downward revisions are taking place. I expected that next year's growth will be below 3%.
Grzegorz Wójtowicz, MPC member PAP, 9 Oct	One cannot talk about the period, which would be used for setting central parity within currency band. What happened in the past [should not affect] fixed rate for the period in future. Historically based exchange rate would not be credible, because of huge fluctuations ranging to 20%. The exchange rate to be determined would not differ significantly from market exchange rate. [...] We are determined to join EMU in 2006 or at latest in 2007, therefore setting the central parity is a task for 2H03.
PAP, 30 Sep	After August 12-month cumulative C/A deficit reached 3.6% of GDP, remaining at the same level as in July. There is growing probability that current account deficit will reach ca. 4% at the year-end. August export and import figures show slight signals of recovery. I believe that GDP forecast of 1.2% this year is more and more realistic. I think there is a chance to see high export growth in subsequent months.
ISB, PAP, 20 Sep	First quarter was better than last quarter of 2001, and second quarter was better than first one. Data for third quarter suggest that it would be better than the second. There is improvement from one quarter to another, therefore it is likely that 4Q02 would be better than third one.
PAP, 18 Sep	Information about retail sales, industrial output cannot be called unfavourable. They signal that 3Q02 would be better. Let's hope that clearer recovery takes place in 4Q02. One cannot rule out that GDP growth would be higher than 1%. It would be a reasonable result.
Reuters, 16 IX	August figures are not optimistic, they differ from expectations, and the economic recovery is visible mostly in the media. Nevertheless I would not see the August data in too dark colours. One has to remember that it was the month of summer holidays. CPI data are in line with my expectations. We had four months of deflation and it is to be seen how inflation will perform in coming months. Weather is still favourable and we will see lower than usual prices' increase in the last quarter of the year. It is highly probable that inflation will be lower than 2% in December.
Wiesława Ziółkowska, MPC member	3.5% GDP growth [forecasted by government] raises my doubts. Concerns also regard planned privatisation revenues and increase of public finance deficit.
Reuters, 24 Sep	The budget does not assume excessive fiscal loosening. I would be glad if the government meets the proposed targets...This budget is not an obstacle to an interest rate cut. There are still risks to (Poland's) economic rebound.
ISB, 18 Sep	Wages are still blocking demand...Inflation remains an argument for easing with prices falling in the food and other sectors, such as clothing and shoes. Also the external situation should necessitate rate cuts.
	I warn against excessive optimism. Analysis of past months suggests that industrial production, retail sales and inventories exhibit sinusoidal pattern, i.e. after month of growth comes a month of decline. It is very ambivalent situation when it comes to recovering from low economic growth rate that lasts in Poland for a number of quarters.
TVN24, 16 Sep	Falling inflation shows also that signs of economic recovery are very moderate. We are waiting for another business climate index, but we have to remember that Polish GDP growth depends also on world growth outlook. Therefore government's assumption about 3.5% GDP growth next year may be overly optimistic. The MPC decisions are always very careful, but I think they were too cautious last year. We have to remember that disparity between Polish and foreign rates is still considerable.
PAP, 9 Sep	Increased GDP growth forecast for the next year is too optimistic. We observe downward revisions in neighbour countries, there is unclear outlook for the German economy, and uncertainty grows, which is effect of possibility of war against Iraq.
Reuters, 5 Sep	Despite recent upbeat exports and retail sales figures it is way too early to speak about economic recovery. There is certainly room for further cuts in interest rates in coming months. With real interest rates running at around seven percent, there is plenty of room for manoeuvre.
Janusz Krzyżewski; MPC member; PAP, 4 Oct	As long as there is no unfavourable change in CPI we do not have reasons to tighten monetary policy. Still, there is no threat of inflation acceleration. We do not see danger for inflation target. However, realisation of this threats indicated in the MPC opinion will make monetary policy more difficult.
Reuters, 23 Sep	Taking into account what we know now, I see no reason to cut rates in the near-term. We should not take a decision on rates until we have a common position on the budget. Falling inflation is a clear reason to cut rates...but the scope for easing is limited by that fact that we should avoid having monetary loosening leading to foreign exchange shocks. We need clarity about the budget and not about the budget draft. One has to be careful with planning rate moves and not much can be done if questions remain. [Dropping inflation+1% rule] is a kind of fiscal loosening unless some protection mechanisms are put into place. But the most important is final effect, i.e. lowering budget deficit. If I see announcement of deficit reduction, then I assess such plans optimistically. Planned GDP growth for 2003 is unrealistic.
Adam Czyżewski, NBP Chief Economist PAP, 26 Sep	GDP growth is likely to amount 1.1-1.3 in 3Q02 and 1.1-1.4% in 4Q02 and whole year growth would be at 1.0-1.1%. Growth will be driven mainly by domestic factors, while net exports and investments developments are still uncertain.
PAP, 7 Sep	We estimate that GDP grew above 0.6% in 2Q02. In third and fourth quarters we expect acceleration of GDP growth to above 1%, which will translate into ca. 1% growth in whole year.
Anonymous source PAP, 26 Sep	September's rate reduction was voted with a majority of six members against three, while one member (who usually votes for rate cut) was absent.

Government and politics

- **Focus on the budget**
- **Verbal intervention of deputy finance minister**
- **NBP and FinMin agree on fast EMU entry**

Budget over all

Last month government's members and politicians' comments were focused on budget draft for 2003. The bill prepared by minister Grzegorz Kołodko was subject to discussions and consultations on several cabinet's sessions, until it was approved during the last weekend of September. We have presented comprehensive analysis of the budget draft in the Special focus section of this MACROscope. In the table on page 24 you can find the most relevant politicians' comments regarding budget for 2003.

Earlier pension rise for teachers

In September the government approved the amendment to the so-called teacher's charter that would allow earlier than planned wage increase for teachers. The bill assumes that the wages would rise already in October, instead of December. The amendment is a consequence of earlier conditional construction of this year's budget act, which assumed that the additional money for teachers' wage increase could be spent if budget revenue from indirect taxes exceed certain amount in 1Q-3Q02 period. The revenues have been higher indeed, which triggered the teacher's charter amendment. This would cost the budget additional PLN350m.

The government also accepted the Healthcare Ministry's proposal of so-called "medicine for a penny" programme. It assumes that people older than 65 would be able to buy medicines for one zloty each. It is expected that in a pessimistic case scenario this would cost the budget slightly above PLN100m, but one has to notice that this estimation does not take into account a possibility of abuses.

Michalski tries to talk down the zloty

Polish deputy finance minister Ryszard Michalski was interviewed by Reuters during annual World Bank-IMF summit elaborating on exchange rate perspectives, which is quite important as Michalski co-heads the joint NBP-FinMin's committee appointed to work out the FX strategy for Poland ahead of EU and EMU entry. He said that while central bank officials want to preserve free floating of the zloty until ERM-2 entry, FinMin tries to persuade them to active management of exchange rate. The most striking was Michalski's statement that "Poland would not necessarily join ERM-2 shortly after EU entry", suggesting that Poland would also not aim to adopt euro as soon as possible. Such a comment stands clearly at odds with views presented earlier not only by the central bankers but also by the Ministry officials including deputy PM Grzegorz Kołodko. Both sides underscored many times that they agree on the final objective: early euro adoption (though might disagree on the ways to achieve it). In fact it contrasts even with Michalski's earlier statements, as in the interview published officially on FinMin's website in August he supported Poland's Eurozone entry as early as possible. Therefore we guess that one should not attach too much weight to Michalski's recent comment. Especially that it was followed the next day by the response from NBP governor Leszek Balcerowicz, who said that there were no reasons to change central bank's view on the exchange rate policy. Also deputy PM Marek Pol commented on the zloty, saying that it is still overvalued and weakening of domestic currency would be better for exporters. However, he suggested also that government would not engage in depressing the zloty rapidly, as "it is key for exporters to have a stable exchange rate" and this is why the government had asked the central bank for changing the currency regime. Apparently, there is still difference of opinions between NBP and the government regarding FX policy in the short term. However at the beginning of October we have seen joint statement from NBP and FinMin about foreign exchange strategy on the road to EMU.

Strategy for the road to the euro

The joint committee of the central bank and the Ministry of Finance informed that intention of Poland's macroeconomic policy will be to meet Maastricht criteria in 2005 and to adopt the single currency as soon as possible, even in 2006. However, the NBP deputy governor Andrzej Bratkowski told that it would not depend only on Polish authorities but also on the negotiations with the EU, which means that euro adoption in 2007 cannot be ruled out. The strategy assumes that Poland would join ERM2 two years before entering EMU, within the fluctuation band of +/-15%. With regard to the parity rate Bratkowski said that it will be set up at a level, which „ensures long-term growth and avoids pressures on the currency market". The parity rate will be tied to market rate but it is not decided what reference period will be chosen. Moreover, Bratkowski warned the rate will certainly not be „an arithmetic choice" and will be affected by other factors as well. Assuming our exchange rate forecasts for the next year, both two- and three-year average exchange rates against the euro will amount to some 3.85 PLN in 2003. If we take into account other factors (e.g. government's view to weaken the zloty), one could expect that the parity set against euro would be higher by some 5-7%. This would imply level of around 4.1 PLN, which would be consistent with our scenario presented in July's edition of our monthly report MACROscope.

The parity rate is to be agreed with the ECB and the NBP deputy governor announced that negotiations would start after Poland joins the EU. According to Bratkowski, Poland does not have to be in the ERM2 for two years and Poland could apply to shorten the period of obligatory presence in this system if macroeconomic conditions justify it. Asked about interventions on the FX market Bratkowski answered that there is such a possibility, but they are rather unlikely. He does not expect that any extraordinary circumstances could arise that would justify FX interventions. Moreover, the NBP has „very serious doubts about effectiveness of such a policy".

Foreign exchange law liberalised in October

Since October 1st there are new regulations regarding the foreign exchange law in Poland. The new bill, passed by the parliament in June, eliminated restrictions in capital flows between Poland and countries from European Union, European Economic Area and OECD. One of the consequences of law liberalisation is a freedom for Polish citizens to have banking accounts abroad, buy offshore securities and borrow abroad.

It seems that the change of the foreign exchange law regulations should not have significant impact on the outflow of domestic savings, or on the situation on Polish financial market. According to the latest public opinion poll approximately one fourth of Poles could be interested in placing their savings abroad. But the road from customer's interest to real allocation is long and we believe one should not expect significant outflow of savings from Poland. Individual decisions would surely depend on the attractiveness of offshore deposits, assuming that foreign banks would decide to offer zloty-denominated facilities. One should not expect massive outflow of savings into foreign currency denominated deposits, especially considering the scope for zloty appreciation amid prospective EU and EMU accession. The choice of foreign accounts would be probably plausible mostly for those who receive revenues in foreign currencies. Considering the above, one can suppose that the impact of foreign exchange law liberalisation on domestic savings would be limited. Also the impact on the financial market should be small, as the new facilities that are available under new regulations (e.g. short selling zloty by non-residents) were in practise available also before by using derivative instruments.

Comments of the government members and politicians

Government's representatives were quite active in the media, particularly in the second half of the month, just before the final budget approval. We have seen several statements regarding actions planned for the next year and the budget itself.
Finance minister Grzegorz Kołodko once again assured that the budget deficit next year will be smaller than in 2002 and stressed that in order to maintain low inflation tight fiscal policy and co-ordination between the central bank and the government is needed. After food prices finance ministry maintained its inflation forecast for August at 1.2%YoY. The ministry is also optimistic for September expecting stabilisation of inflation at August's level. Other FinMin's official informed that Poland would use funds from increased Yankee bonds offer for an early buy-back of some part of foreign debt.
We have heard a few different estimations of economic deficit in 2003. First, minister Kołodko said that economic deficit would remain "slightly above 4% of GDP", then deputy minister Halina Wasilewska-Trenkner mentioned the level of 4.8-5.0% during press conference, and late in the evening FinMin put a statement on its website reading that economic deficit for 2003 is planned at 4.4% of GDP. Interestingly, the budget draft available on the website later shows different calculations (5.5% of GDP in 2002 and 4.7% of GDP in 2003) than figures given by deputy finance minister Hanna Wasilewska-Trenkner on the day of budget approval. She said that economic deficit would amount to 4.8% and 4.5% of GDP in 2002 and 2003, respectively.
Deputy finance minister Ryszard Michalski's surprised the market with a statement in the interview with Reuters that "Poland would not necessarily join ERM-2 shortly after EU entry". It seems that it was not very lucky statement. In the strategy for the road to the euro announced in joint statement of the NBP and the Ministry of Finance revealed in the beginning of October that macroeconomic policy would be aimed at meeting Maastricht criteria in 2005 and adopting the euro as soon as possible.
We have a preliminary date of EU accession referendum in Poland. Prime Minister Leszek Miller said that 11 May is reasonable date, while opposition's politicians said it is too early to set the date if the negotiations are not finished.
President Kwaśniewski said if Nice treaty referendum in Ireland will be rejected, "Guinness consumption could fall dramatically" in Poland. European affairs minister Danuta Huebner is afraid that in case Nice treaty was rejected in Ireland, the EU enlargement could be delayed for at least half a year. What interesting, her deputy minister Jarosław Pietras told that "no" in Ireland does not have to mean significant delay of Poland's accession.
Polish Foreign Direct Investments Agency president Antoni Styrczula said that he expects higher FDI inflow next year, and most of foreign investors will decide about new investment in 4Q02, as they are waiting for the signals of economic recovery. However these decisions will depend also on the EU accession process.
Deputy labour minister said that the issue of increasing investment limits for open pension funds might be considered again in the next year.
Treasury minister Wiesław Kaczmarek admitted that not all privatisation transactions may be finished until the end of this year but they will be shifted for the next year increasing next year's revenues from privatisation to over PLN10bn.

WHO, WHEN, WHERE	COMMENT
Aleksander Kwaśniewski, President Tagesspiegel, 29 Sep	If it all goes badly [in Ireland], we won't go to war, but Guinness consumption could fall dramatically because the beer will taste more bitter to us. In the case of an invalid referendum [on EU accession in Poland], the decision would automatically be delegated to parliament. No one can then say they were not asked.
Leszek Miller, Prime Minister PAP, 29 Sep	We can consider holding the EU accession referendum on Sunday, 11 May. I believe this is reasonable date. It depends on whether accession treaty is signed in March, but if it happens, I think it is a good date.
PAP, 27 Sep	I'm always pleased with central bank decisions cutting rates. There is still room to cut rates.
Reuters, 7 Sep	If it is possible, it is worth having the EU entry referendum in May 2003. This is a month when Poland's constitution was created (in 1791) - the first democratic constitution in Europe. Let May become a month of conquering divisions over Europe ...and taking advantage of the opportunity for Poland.
Grzegorz Kołodko, deputy PM, finance minister, Polish Radio 1, 10 Oct	Yes, introducing the euro in Poland as also our money will undoubtedly be the end particular stage of Polish economy transition. Some time ago, in 1996, in a framework of "Strategy for Poland" I prepared a program, which was named "Euro 2006". Criticisers and scoffers laughed then that this was illusion, but now it is obvious that it was more vision than illusion. It is possible for us, as I think, and it is confirmed by the NBP – the central bank we co-operate very well with. There is chance for introducing the euro, but it requires meeting several criteria. First, we have to be in the EU, which almost all of us - and since yesterday it become political declaration - assume will become a fact in 2004. With regard to inflation we have already met the criterion, which would bind us now. With regard to public debt, we are entirely on the right side (...) and in no case it will exceed the limit. With regard to budget deficit, according to the criteria binding in the EU it will amount to only 3,9% in the next year. (...) The most problems we still have with interest rates. Interest rates are much too high in comparison to Maastricht criteria. But we still have much time and inflation is very low, we stabilise our public finances in the framework of the budget of stabilisation and development. Thus, market will surely enforce further interest rate reductions. I think that in 2006 Poland should be ready to enter the area, the land, which we call "Euroland".
Rzeczpospolita, 1 Oct	Everything is so exposed that has never been before. There are not many countries around the world where every citizen can check the budget bill in the day it is submitted to the parliament. We don't hide anything in there.
PAP, 28 Sep	The economic climate keeps improving. We have the idea of gradual step-by-step progress, this year and the next one and in the following years. In 4Q03 GDP growth should exceed 4%YoY. It is possible and our government knows how to achieve it.
Polish Radio 1, 26 Sep	Budget draft for 2003 was the most difficult one that I dealt with. But budget for 2004 will be difficult as well. Not because of worse economic climate, but because of EU accession. Deep restructuring of public finance will be necessary. I've been working for the IMF for a while and I know this institution very well. And I can tell you that IMF, its analysts and experts are not like the Pope, they are not infallible. [...] The Fund often makes mistakes, for the number of reasons. We have colossal [budget] discipline, there has not been such a discipline for past 10 years that we are going to introduce next year, I hope. In IMF's report they also mention potential growth rate for Poland, and they say it is around 4-4.5%. Undoubtedly yesterday's MPC decision [...] must have taken into account the fact that it is good budget. Let's recall that what I've found on the desk three months ago after being appointed for the post looked very badly. We had PLN149.5bn on the revenue side and on the expenditures side minimal expectations amounted to PLN209bn. The difference amounted to PLN60bn, and it was real danger of the deficit.
PAP, Reuters, Gazeta Wyborcza, 23 Sep	The inflation-plus-one rule is simply not good, and we will stop using it in the future. We will adjust spending to needs, such as helping the economy recover and curbing unemployment. But at the same time we will make sure GDP growth will be higher than real growth in budget spending.

PAP, Reuters, 20 Sep PR1, 19 Sep Trybuna, 14 Sep PR1, 12 Sep Reuters, 9 Sep Reuters, 7 Sep PR 1, 5 Sep	Based on EU rules Poland's 2003 debt-to-GDP ratio will stand at nearly 45 percent and will likely be around that level in 2005, well below the 60 percent cap set by Maastricht. In the worst-case scenario the level of public debt to GDP, counted in line with EU standards, will stand at 45.4 percent in 2005. That means that Poland already fulfills the Maastricht criteria for debt to GDP ratio and inflation. Budget deficit computed according to EU standards is 1.2-1.5pp lower than 4.9% of GDP planned in budget draft for 2003. In 2005 we will have a budget gap below three percent of GDP. Government's policy disciplines public finance and it improves the co-ordination between fiscal and monetary policies. In 3Q02 GDP growth would reach 1.7%YoY. I can say today that GDP growth in 2002 will amount to 1.2%. I must admit that revenue from tax abolition is planned with some degree of risk. Spending are rising consistently with the rule "inflation+1%" 9...0 but expenditures of non-central budget entities increased by 33.7%. Economic deficit will fall by 0.5pp – the scale similar to a fall of central budget deficit, but the final figure will depend on deficits of healthcare funds and local governments. The government proposes to decrease corporate income tax rate to 27%, which will give around PLN1bn for Polish entrepreneurs. Activities of Polish enterprises, local governments and all of you who will create additional demand will drive GDP growth of 3.5%. Domestic demand will increase by 3.4%, as fixed investments will grow by 5.6% after a significant fall in 2002. Export should also increase amid higher competitiveness and better external demand. I do not expect 50% threshold of public debt into GDP to be reached this year, but next year it is very likely amid financing road construction programme. Assuming higher GDP growth and maintaining fiscal discipline we are quite safe. And GDP is likely to accelerate to 1.5-2.0% already in 3Q02 (around 1.8%). This year's deficit of PLN38.7bn or 4.9% GDP is much smaller than some analysts expected, but it is still a high level. But we are definitely aware that it will have to be significantly and gradually lowered in future years to maintain (state) debt within safe levels. Revenues will increase by 4.55 in real terms, and spending will rise by 2.4%. Higher spending level come from the fact that we will achieve additional PLN1.5bn from better taxes collection and around PLN900m from restructuring fees and tax abolition programme. Budget deficit should be much lower and the path of decreasing it will be substantial in 2004-05. We need deep restructuring of public finances and I will show such proposals at the beginning of next year. Today, I can say that we expect at least 1.2 percent (GDP growth this year). An increase of 0.4 percent is a mark of realistic optimism...This sort of manoeuvre has only a scant impact on the budget. We believe that various restructuring bills, some of which are already passed, will have a positive impact on growth. The budget draft is ready but there are some consultations. Next week, the budget will finally be in ministers' and the whole cabinet's hands. Premier (Leszek) Miller has announced that he wants this budget of stabilisation and development to be passed by the end of next week. We decrease budget deficit in relation to previous year and both in relation to this year and compared to what was assumed by the government at the beginning of July. We discussed the 2003 budget... The good news is that we revised the growth forecast to 3.5 percent. In this context, we set the priorities for the budget -- fast GDP growth, fighting unemployment and crime, as well as investing in human capital. In third quarter of the year some recovery is occurring, which we observe in sharp changes of exports and industrial production. There are many signals that this low inflation level can be sustained. But for that we need tight fiscal policy and good co-ordination between the government and the central bank. The budget is being finalised now... Certainly, the deficit will be smaller next year than in 2002. We have to find a level that's safe to finance. Inflation in August will reach no more than 1.2% against 1.3% in July.
Halina Wasilewska-Trenkner, deputy finance minister; PAP, 28 Sep PAP, 23 Sep	After being criticised by analysts we've calculated economic deficit one more time. Without the proceeds from EU it would amount to 4.5% of GDP. Those forecasts would be adjusted. Even this year's deficit of 4.9% GDP could be adjusted before year-end. Economic deficit will reach 4.8-5.0% of GDP in 2003, with transfers from OFE at PLN11.4bn. We have 4.9% of budget deficit. It adds up with ca. 1% from different funds and other entities of public finance sector, local governments, and healthcare funds. But on the other side we take away PLN11.4bn ftarsfers to OFE. There are also PLN6bn of support funds [from EU]. We forecast exchange rate against euro and USD at similar level around PLN4.0.
Irena Ożóg, deputy finance minister; PAP, 3 Oct PAP, 1 Oct PAP, 11 Sep PAP, 5 Sep	So far, estimations of inflows from tax abolition are not being changed. (...) We have assumed average efficiency at 2% and tax incomes amount to ca. PLN 30bn. This brings PLN 600m. Increasing of basic rate from 7.5 to 12% can cause that predicted inflows to the state budget might be lower. Everything depends on a risk scale. Somebody who previously thought that could make use of tax abolition may think now that with 12% rate it is not beneficial and will risk. Therefore, the higher rate will cause smaller tax base, i.e. fewer persons will declare hidden incomes. We do not know how much tax payers will declare their incomes. However, we assumed average efficiency of abolition in other states, which ranged between 1.5 and 2.5% of actually paid taxes. In countries, which introduced tax abolition (...) the effectiveness of abolition was ranging between 1.5 and 2,7% of actually collected taxes, which abolition concerns. Assuming such result and assuming PIT incomes planned in the budget in the amount of around PLN 26-27bn, multiplying it by the average effectiveness ratio of abolition at level of 2% we should receive about PLN 600m. This is [7,5%] only a governmental proposal. It will be decided by the parliament if it will be 7,5% or not. We proposed 7,5%. We calculated it on a basis of effective PIT rate. We do not assume taxes' hikes. We do not carry out work on introducing additional tax rate amounting to 12%. Of course, there will be no tax decreases. In the current situation of budget, we do not see possibility to decrease taxes.
Ryszard Michalski, deputy finance minister Reuters, 30 Sep	Polish ministers hope to weaken the zloty via a managed float before locking in a central exchange rate parity ahead of adopting the euro. My colleagues from the central bank argue let's keep the exchange rate of the zloty as it is - free floating. And we say 'oh no', let's try to make it a little bit weaker like the Czechs and the Hungarians are trying. [...] Poland would not necessarily join ERM-2 shortly after EU entry. I'm not quite sure if it is advisable to start with these exchange rate criteria just at the beginning of our entry to the EU. I don't know whether you have noticed but our friends from the south have started today saying oh, we are not in such a rush, we may wait some months or years with this exchange rate mechanism. The zloty appreciated last week for example because the Czechs observed they would like to enter EMU in 2007 or 2010. [...] This is convergence play. This is something we must take into account. This is a game. [...] Poland will move to a managed float when we can convince our friends in the

	central bank. [...] We must ask them [ECB] what they think about this issue. [...] While managed float would be the best way to weaken the zloty, an interest rate cut would also help stimulate growth to bring down unemployment rates, and weaken buying pressure on the zloty. [...] Another rate cut is on its way. It is inevitable to make the zloty more competitive.
Wiesław Ciesielski; deputy finance minister; Reuters, 3 Oct	The government plans to lower CIT (corporate income taxes) to envisaged levels, but this will depend on the situation with the national budget. I am unable to declare what will be the CIT rate in 2004 and 2005
Elżbieta Chojna-Duch, advisor to finance minister; PAP, 2 Oct	If there [in CIT act amendment] is no clear date that would concern 2003, then this is general statement and it may be the case that CIT rate will be maintained at 27%. In line with possibilities we should return to lowering of tax rates in coming rates (...). It will depend on general economic needs.
Jacek Krzyślak, head of research at FinMin PAP, 27 Sep Reuters, 6 Sep	We estimate that inflation rate would fall to 0.9%YoY in October from 1.2% in September. In December inflation would be at September's level, reaching 1.2%. We maintain our forecast of inflation in August at 1.2%YoY. Inflation in September should remain stable with focus on food prices. At the end of the year inflation should reach 1.6-1.7%.
Edward Basiński; deputy chief of the FinMin's debt dept.; Reuters, 6 Sep	The funds from this increase [additional issuance of global bonds] will be used for an early buy-back of some foreign debt.
Jerzy Hausner, labour minister PAP, 30 Sep	I think we would have stable unemployment in September, or only a slight increase. Nothing suggests that we have dramatic problem that we cannot cope with. Official data will be available in second half of October. Local labour offices can now run their services and sign contracts with graduates and with employers [as a part of govt's "First job" programme]. We intentionally supply funds for this programme right now to weaken the inflow of graduates looking for a job, which can be expected in September-November.
PAP, 6 Sep	We estimate that this autumn 200 thousand graduates will register in labour offices. We hope that thanks to the government's efforts unemployment will cease to rise on the turn of the year and the and the unemployment rate will not exceed 19%. The unemployment might fought by development of small and medium-sized enterprises and the governmental program "The first job". There are needed financial resources from economy ministry and finance ministry for that. I have promises that such resources will be found.
Reuters, PAP, 3 Sep	According to recent forecasts by the finance ministry, the average annual inflation in next year will be at 2.3 percent and that figure has been approved as the assumption for the next year's budget draft. The government approved 1.7% real growth of wages in public sector in 2003 compared to previously planned 1.0%. The budgetary spending cap [of inflation plus one percent] will be kept except wages in public sector and social benefits. Finance minister received declaration from other ministers that "inflation plus 1%" rule will be kept next year. The government does not plan to increase budget deficit as a result of higher real wages increases. Additional wages will be higher by PLN 0.25bn and social benefits by PLN 1bn. This means, however, that PLN 1.25bn will not increase budget deficit because the amount directed for additional wages and benefits means that there would be spent less in other place. The change of inflation forecast will imply different changes but we have not discussed it so far. (...) Finance minister did not presented implications of changed inflation assumptions but it will most likely result in rethinking of the whole macroeconomic construction. That pledge [to narrow the 2003 budget gap from a previous 43 billion zlotys] is still in force. We have undoubtedly stopped rise of upward trend in unemployment. Now, the target is to stop the increase alone. I think that achieving the target is possible on the turn of 2002 and 2003.
Krzysztof Pater, deputy labour minister PAP, 2 Oct PAP, 17 Sep	I expect that cumulating of repayments [for open pension funds] will take place in the second half of 2003 and at the beginning of 2004. The schedule is correlated with improvement of contribution's identification. I still expect that ZUS [Social Security Fund] indebtedness will be paid off in bonds. I think that we will return to the issue of extending limits for offshore investments for OFE next year. Amendments to legal regulations in this subject are possible next year.
Anna Warchoł, ZUS spokesman PAP, 7 Oct	According to ZUS estimates, the outstanding debt [to OFE] excluding interest would amount to PLN6.5bn at the end of 2002.
Danuta Huebner, European affairs minister; PAP, 8 Oct	[Rejection of Nice Treaty in Ireland] would surely mean the delay in EU enlargement, I think by at least six months. I do not accept such thought that the referendum could end up with rejection of the Treaty. I believe it would be unfavourable not only for the EU enlargement but also for EU consistency.
Jan Truszczyński, EU chief negotiator PAP, 10 Oct	We surely cannot say that shifting part of funds from rural development programs to direct subsidies for farmers is not possible. The understanding for our needs and sense of such solution is growing, under condition that it would be temporary, decreasing from year to year, and will not reduce funds for rural developments programs there were they can be efficiently used. [With regard to selective market protection] The matter is not to have prohibition customs tariffs for import of some products. The matter is to have protection clause based on a system of the European Commission permissions and a possibility to withdraw such permissions on the appeal of interested country in case of major market distortions. What is important [this instrument] it is not inconsistent with the single market and acquis. Thus, one cannot say that this is impossible to achieve. It will be very difficult for a Polish budget to use tax payers money for subsidies for Polish farmers.
PAP, 1 Oct	If new members would pay their contribution at once and don't receive full direct subsidies for farmers Poland would be the fifth biggest net contributor to the EU budget, co-financing CAP, far behind Germany and the Great Britain, behind Italy, slightly behind Belgium, but before all other EU members. We still decisively work on reduction of our contribution, [although] the EU members' stance is unanimously against such idea.
Jarosław Pietras; senior EU membership negotiator; Reuters, 6 Sep	Enlargement does not have to be delayed [if Irish voters will say "no" to the Nice Treaty]. The talks showed that problem of steel industry restructurisation is not easy to solve, but there are some chances for progress. Thus, there is a chance that closing of negotiations chapter concerning competitiveness policy will be possible in the nearest months but I am rather moderate optimist whether it will take place already at the end of September or at the beginning of October.
Jacek Piechota, minister of economy PAP, 10 Oct	I hope that CIT rate in 2004 will be reduced, but it depends on whether we will be able to achieve assumed GDP growth in the next year and improve situation of public finances.

Krystyna Łybacka; education minister; PAP, 2 Sep	Wage increases [for teachers] will come into effect from October 1. Effectively they will be paid off a little bit later – I predict – in the middle of October. Earlier the Lower House has to approve change "Teacher's Charter" act. The government will discuss it in the nearest term. We knew much earlier about the fact that we have money for December. Decision about the rest of resources depended on the situation of public finances.
Marek Pol, deputy PM, infrastructure minister PAP, Reuters 2 Oct PAP, 12 Sep	A weaker zloty would be better for exporters and it seems the unit is still overvalued. We need to decide at what levels we enter the EU before adopting the euro. There is no need to change the currency level much beforehand. It seems the zloty will act in predictable ways and we will not see any dramatic changes...It is key for exporters to have a stable unit. Dramatic changes are lethal. The government has asked the central bank for the currency regime to be more managed but found no understanding for this in the central bank, which is not good. Introduction of road fees will enable to receive PLN6bn of funds from the EU. Revenues from road fees will be a Polish input necessary to get subsidies from the EU and bank credits
Aleksander Nauman, deputy healthcare minister, PAP, 7 Oct	Healthcare Ministry will submit the bill to the government, proposing that all citizens older than 65 would be eligible for the "medicine for a penny" programme. The cost for the budget would be PLN83m. If the age threshold was 70, it would cost PLN20m less.
Michał Tober, cabinet's spokesman; PAP, 10 Sep PAP, 9 Sep	Wage increases [for teachers] will concern October, November and December's payments. We want the increased salaries to paid as soon as possible. If the Lower House will pass the act at the nearest session – and this is realistic – then it is most likely that teachers will receive money in October. Even if there will be any lag, money for October will be paid to teachers. Finance minister decided that there are foundations to assume more optimistic GDP growth than previously. Circumstances, both external and domestic allow assuming more optimistic forecast.
Antoni Styrczula, PAIZ chief PAP, 18 Sep	If extraordinary events do not appear and privatisation revenues are consistent with the plan, this year's FDI inflow may be roughly the same as in 2001. September is not a good month for forecasting, as most of foreign investors will decide about new investment in 4Q, as they are waiting for the signals of economic recovery. Information about FDI in 1H02 will be presented in October. Next year an increase of FDI inflow is possible, but this will depend on EU accession process, especially if we look at Asian firms. At the moment we see a lot of interest from Japanese, Chinese and other firms from this region, which would like to enter Western European markets via Poland.
Mieczysław Czerniawski; head of parliament's public finance committee; Reuters, 10 Sep	There is no need to hurry with this bill. Talks between the government and the central bank are taking place and we are waiting for the budget draft. We simply have more important things to deal with and I do not see the need to work on this bill currently. I don't know [if work on the central bank bills will continue at all this year].
Zbigniew Kuźmiuk, PSL caucus leader RadioZet, 8 Oct	If European Commission's proposals [for agriculture] are accepted by Polish delegates, undoubtedly PSL would call its members and its supporters to vote against EU accession in the referendum.

EU negotiations watch

- **The European Commission gives Poland and nine other candidates green light for EU accession**
- **Poland closed next negotiations chapter**
- **The support for Nice Treaty rises in Ireland**

Ten new EU members in 2004

On October 9 the European Commission released the report summarising the progress of candidate countries on their road to the EU. The report did not surprise. It said ten countries, including Poland, “will be ready” to join the EU in 2004. The Commission discussed whether the expression “will be ready” should be replaced by “should be ready”, as some of members were afraid that “Warsaw opens champagnes too early”. Therefore, despite positive assessment of Poland’s progress towards meeting entry conditions, the Commission pointed out several elements that Poland needs to improve. Poland was criticised for corruption, inefficient courts, overcrowded prisons and weak condition of the agriculture sector. Additionally, the Commission announced it would closely analyse further process of adjustment in the Polish law, saying among the others that Polish central bank has to be independent. Also, Poland was asked for faster restructuring and privatisation (heavy industry, financial sector, energy sector and agriculture) and for the reform of public finances (some constraint on public spending is needed).

However, the most important was the explicit statement that Poland will be able to cope with the competitive pressure in the EU and should join the EU together with other candidates in 2004. Further steps in EU accession process will include: EU countries’ meeting in Brussels on 24-25 October (setting financial proposal for candidates), the final stage of negotiations in November, EU summit in Copenhagen on 12-13 December (the end of negotiations), and signing accession treaties in 1H03.

The progress in the EU accession negotiations

At the beginning of October, Poland formally completed its negotiations with the EU related to regional policy. This way it closed 27 out 30 negotiation chapters. Three chapters have remained open: competition policy, agriculture and budget. The EU has not defined precisely the terms and conditions of financial support within the regional policy, i.e. what amounts can Poland expect to be granted by the EU within the so-called structural and cohesion funds. It has only been declared that Poland would be granted 57.6% of the total amount assigned to the structural fund allocated to all new EU members and 45.8%-52.8% of the consistency fund. According to some unofficial calculations of the European Commission this may represent the total grants for Poland of ca. € 5.7bn in 2004-2006.

Contrary to what was declared earlier, Poland did not manage to close the “competition policy” chapter by the end of September due to the EU’s reservations to the programme of restructuring and support for the Polish steelworks. Only at the beginning of October, after some additional negotiations, did Poland manage to obtain a positive opinion of the EU’s experts on the proposed solutions. This chapter should be closed in the course of a special negotiation session planned for 22 October.

On 24-25 October, heads of the EU’s member states will meet in Brussels. In the course of the meeting they are to agree EU accession financial conditions for individual candidates. This decision as well as the ultimate EU membership conditions are to be presented to the candidates at the summit in Denmark on 28 October. Unfortunately, no consensus has been reached within the EU in respect of the financial issues as yet. In the course of the recent meeting of the diplomatic heads of the EU member states in Brussels, it was impossible to obtain a unanimous opinion if the new members should be granted more in net figures than they were granted in the pre-accession period. According to the initial calculations of the Commission, there is a risk that 4 of the candidates (Cyprus, Czech Republic, Malta and Slovenia) may actually pay more to the EU’s budget in the first years of their membership than they will get from it. According to the estimates, in the first year following the accession Poland may be granted € 24mln “net” more from the EU than it was granted before the accession, but this amount should go up quickly in subsequent years.

Poland seeks the reduction in the membership premium paid to the EU’s budget in the first years after the accession. Otherwise, Poland would be “the fifth biggest net payer co-financing the common agriculture policy”. Poland assumes it will pay only 10% of the total premium in the first year of membership and a gradual increase up to 100% after 5 years. Unfortunately, this position has met clear-cut objection of the EU.

Government has decided on its stance on agriculture and VAT on construction and building

On 8 October, the government made the decision on the change in its negotiation position related to VAT on construction and building as well as agriculture. As regards VAT, Poland will seek the maintenance of the decreased VAT on housing construction and building services by 2007. This means the necessity to reopen the negotiations in the area of taxes, which was closed already in March 2002 (the then stance assumed VAT of 22% to be introduced in January 2004). The Polish negotiators hope that this issue will be agreed with the EU at the special session in October, in the course of which the issues related to competition will also be finalised.

The other change related the forms of support for the Polish agriculture which would allow for ensuring competitiveness of the Polish farmers on the European market. The government proposed that after the EU accession there should be the possibility of supporting the domestic agriculture within the domestic budget, which would represent a supplement to the support from the EU's funds. This is to offset to the potentially lower direct subsidies to the agricultural production in Poland. The proposal includes also relocation of the part of the EU's funds assigned for the development of rural areas to the direct subsidies as well as the EU's consent for he customs protection of some agri-products. The negotiation position includes also a postulate to maintain a zero -rate VAT on agri-machines and equipment and a 3% VAT on the none-processed and semi-processed agri-products.

Agriculture will certainly be one of the most difficult negotiation areas and working out an agreement favourable for Poland with the EU would be a tremendous success. Franz Fischler, the EU's Commissioner for Agriculture, criticised severely two proposals included in the new stance of the Polish government (i.e. the relocation of funds to the direct subsidies and a selective market protection), suggesting that they would not be supported by the European Commission.

The EU accession referendum to be held in Poland on 11 May?

The initial date for the referendum on Poland's accession to the EU has been set. As at the end of September, Leszek Miller, Prime Minister proposed that the accession referendum should be held on Sunday, 11 May 2003. The opposition parties state that nobody should define the date for the referendum as long as the negotiations are still in place. However, according to the Polish diplomats responsible for the negotiations with the EU, this date seems to be a "decent" one. Ms. Huebner, the EU Affairs Minister, believes that the sooner the referendum is held after signing the accession treaty, the better. This is because it will be the time the Poles' interest in the European issues will the highest. According to Ms. Huebner, the accession treaty should be signed in the first half of April 2003.

Will the Irish delay the EU expansion?

The Irish government set a date to rerun the referendum re. ratification of the Nice Treaty. The referendum will be held on Saturday, 19 October. The ratification of the Treaty of Nice creates the necessary arrangements for the union's expansion into Central and Eastern Europe. As early as in June 2001, the Irish voted against the ratification which was driven by their unwillingness to support the EU transformation into a defence alliance and establishment of European army rather than their resistance against the extension or the institutional reforms. In the first referendum, 54% of the population cast the "no" vote, and the frequency was very low – the number of voters accounted for ca ⅓ of the total population with voting rights.

The existing Irish government got highly committed to the pro-Nice campaign. Recently, the Catholic Church joined in the campaign. It seems that the campaign has brought first effects. According to a recent survey carried out at the request of Citigroup, 44% of the respondents declared that they were ready to support the document (against 29% in the previous month), still 22% wanted to vote against (19% in the previous month), while the ones who have not made up their minds represented 27% (44% previously). Unfortunately, the support for the Nice Treaty continues to be similar to the level shortly before the first referendum. Still, it is possible that the wide-scale governmental campaign will convince some who have not made up their minds yet to vote in favour of the Treaty. However, another factor which complicates the situation is the growing part of the Irish population who are very upset with the recent decisions made by the government, which after winning the election have now forgotten the slogans used during the campaign and have gone for painful cuts of expenses and savings programme. According to analysts, some of the Irish may want to cast the "no" vote just to express their unhappiness with the policy pursued by the existing government.

The failure of the October ratification referendum in Ireland will mean a necessity to renegotiate the Treaty. Theoretically, this could be a pretext for holding up the talks on the enlargement. In our opinion, however, even if the Nice Treaty is rejected, the EU extension will not necessarily be delayed, as the regulations governing the accession of new members can be transferred from the Nice Treaty to the accession treaties, and only other stipulations of the Nice Treaty could be renegotiated within the EU. As a result, we expect that even in a moderately pessimistic scenario, the Poland will join the EU in mid 2004, at the latest.

Market monitor

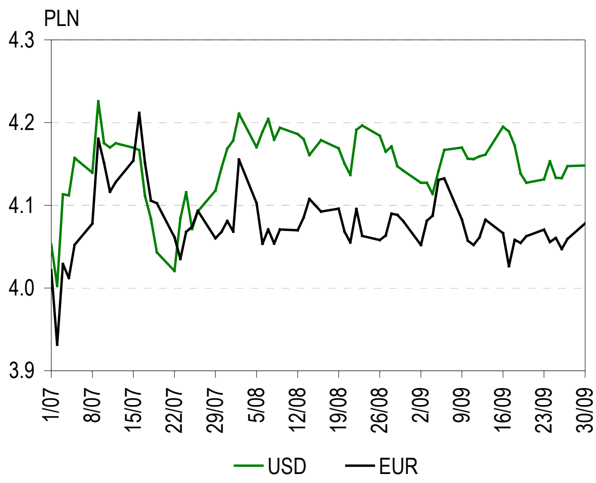
- **Stagnation on FX market**
- **Significant strengthening on fixed income market**
- **The second auction of 20-years treasury bond**

Extremely stable FX rates

After significant movements on the Polish FX market in July and stable situation in August, the market was calm in September. For the most part of the month both turnover and volatility on the market was very low. In comparison with August the zloty was slightly stronger against the dollar and the euro.

In the central bank the dollar was fixed between 4.1138 PLN (September 4) and 4.1951 PLN (September 16), and on average at 4.1499 PLN (versus 4.1755 PLN in August). The euro was fixed between 4.0265 PLN (September 17) and 4.1324 PLN (September 6), and on average at 4.0695 PLN (4.0804 PLN in August).

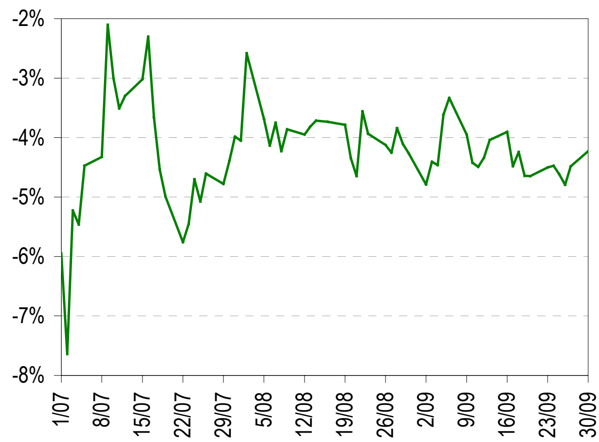
Zloty FX rate in recent months



Source: NBP

Only in the first week of September the trade on FX market was quite active with turnover reaching average levels from previous months and high volatility. Significant weakening of the zloty was recorded at that time as a result of substantial sale of the zloty by foreign investors. Deviation from the old parity decreased then from almost 5% at the beginning of the week to slightly above 3% on Thursday, September 5. Such picture of the market was to some extent also a consequence of a mood on the global market, which saw the euro strengthening against the dollar. It was September 5 when the euro was close to the parity but eventually it was not reached.

Deviation from the old parity

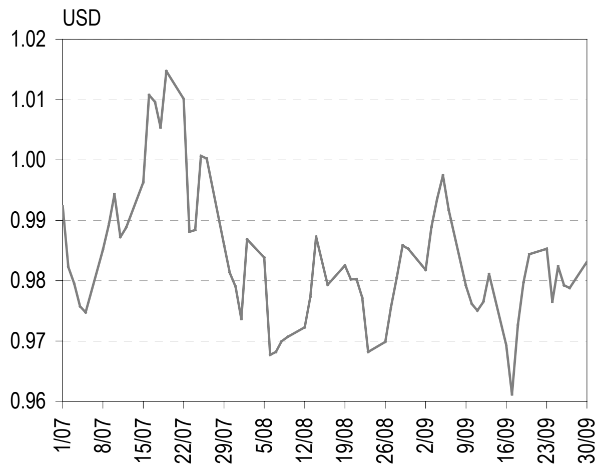


Source: NBP, BZ WBK

For next three weeks nothing significant happened on the market. It was very shallow. Stagnation was interrupted for a short period after publication of the most important data (inflation and industrial production) and revealing unofficial information on the budget draft. However, market reaction was very moderate. The MPC decision to cut interest rate did not affect market at all. During first three weeks of the month volatility of the zloty exchange rate was limited. The zloty was traded between 3,9% and 4,8% of the deviation from the old parity.

It seems that in October FX market should be more active as a result of expected important events related to accession with the EU. Above all, on October 19 referendum on the Nice Treaty will take place in Ireland, which may cause negative market reaction if the result will be “no”. However, we think that possible weakening on the FX and fixed income market will not be long lasting, as the Treaty rejection would mean only a few months delay in the EU enlargement process.

EURUSD FX rate



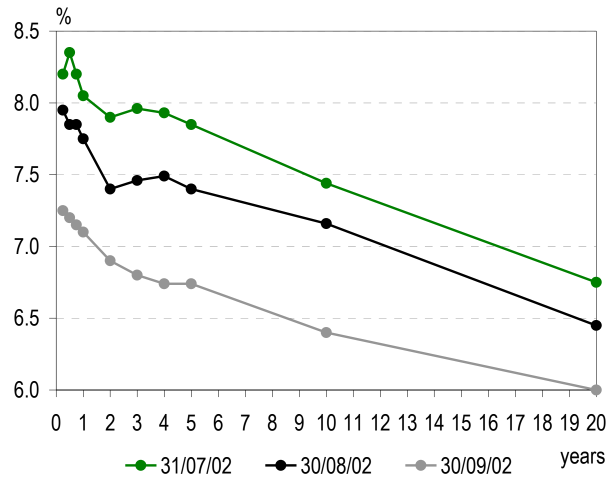
Source: NBP, BZ WBK

Treasuries market strong

In September market of treasury securities was determined by waiting for the MPC meeting and expectations for interest rate cut. A positive sentiment prevailed on it, especially that majority of data released supported these expectations, so after every such a release the market strengthened. Unofficial information on budget draft did not stop the trend, since market mainly focused on lower deficit and rather ignored higher spending and overestimated revenues.

Similarly to FX market, also in case of the treasuries' market higher volatility in October may be expected.

Yield curve

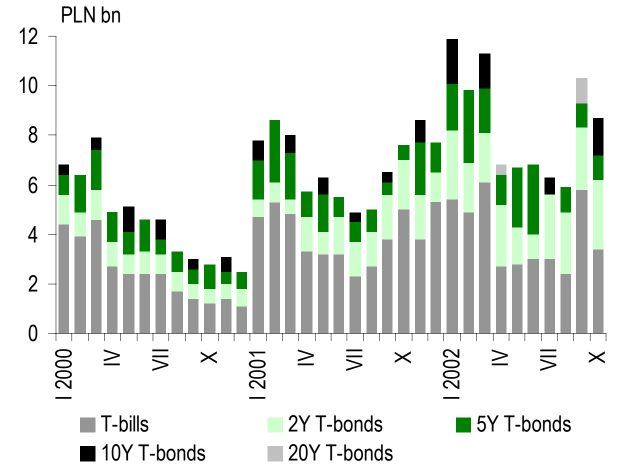


Source: BZ WBK

At the auction on 11 September the finance ministry sold all offered 20-year T-bonds (WS0922) of value of PLN1.0bn. Demand was relatively high and the average yield was at the lower end of expectations' range. It was a second tender of these papers in history. First one took place in April this year and PLN400m of bonds were sold. Such a low issue results in low liquidity on secondary market and this diminishes investors' interest in this segment, especially of banks.

At T-bond auction on Wednesday, 2 October the Finance Ministry offered two-year bonds (OK0804) worth of PLN2.8bn and five-year papers (PS0507) of PLN1.0bn. Total demand amounted to slightly above PLN8.5bn, so it did not reach record level, as it happened a month earlier, when it exceeded PLN14bn on similar supply. However, certainly auction results may be perceived as satisfactory, since the Finance Ministry sold all offered bonds easily and average yields fell significantly compared with last month's tender and they also were lower by a few basis points than at secondary market closing a day before.

Supply of treasuries



Source: Finance Ministry, BZ WBK

Treasury bill auctions (PLN m)

	OFFER (SALE)			
Date of auction	*13-week*	*39-week*	*52-week*	*Total*
02.09.2002	-	-	800 (800)	800 (800)
09.09.2002	100 (100)	-	700 (700)	800 (800)
16.09.2002	100 (100)	-	700 (700)	800 (800)
23.09.2002	-	-	800 (800)	800 (800)
30.09.2002	-	1300 (767.1)	1300 (1766.9)	2600 (2534.0)
Total in September	**200 (200)**	**1300 (767.1)**	**4300 (4766.9)**	**5800 (5734.0)**
07.10.2002	100	-	800	900
14.10.2002	100	-	800	900
21.10.2002	-	-	800	800
28.10.2002	-	-	800	800
Total in October	**200**	**-**	**3200**	**3400**

Source: Finance Ministry

Treasury bond auctions in 2002 (PLN m)

month	First auction							Second auction			
	date	*T-bonds*	*offer*	*sale*	*T-bonds*	*offer*	*sale*	*date*	*T-bonds*	*offer*	*sale*
January	09.01	OK1203	2 800	2 800	PS1106	1 900	1 900	16.01	DS1110	1 800	1 800
February	06.02	OK1203	2 000	2 000	PS1106	2 900	2 900	13.02	DZ0811	500	495.5
March	06.03	OK1203	2 000	2 000	PS1106	1 800	1 800	20.03	DS1110	1 400	1 400
April	03.04	OK0404	2 500	1 756.5	PS1106	1 200	1 200	10.04	WS0922	400	400
May	08.05	OK0404	1 500	1 500	PS0507	2 400	2 400	-	-	-	-
June	05.06	OK0404	1 000	1 000	PS0507	2 800	2 800	-	-	-	-
July	03.07	OK0404	2 600	1 922.1	-	-	-	17.07	DS1110	700	700
August	07.08	OK0804	2 500	2 500	PS0507	1 000	1 000	-	-	-	-
September	04.09	OK0804	2 500	2 500	PS0507	1 000	1 000	11.09	WS0922	1 000	1 000
October	02.10	OK0804	2 800	2 800	PS0507	1 000	1 000	09.10	DS1013	1 500	1 500
November	06.11	OK0804	-	-	-	-	-	20.11	PS0608	-	-
December	04.12	OK1204	-	-	-	-	-	-	-	-	-

Source: Finance Ministry

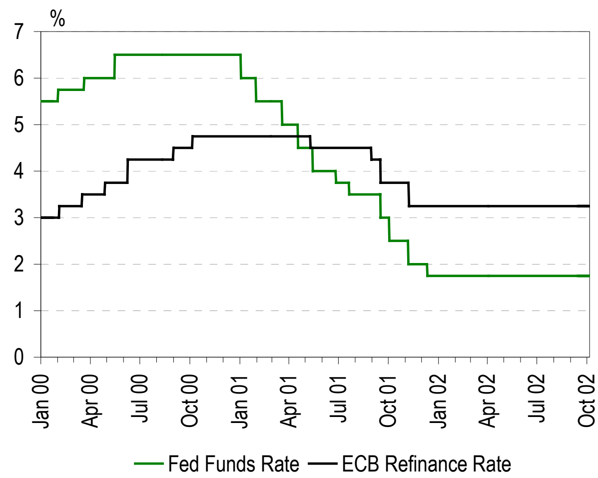
International review

- **No changes in monetary policy in the United States and the Eurozone**
- **Continued rise in inflation**
- **Slowdown of economic growth**
- **Poor activity and sentiment indicators**

At September's meeting Federal Open Market Committee left interest rates unchanged, in line with market expectations. Federal fund rate remained at 1.75%, the lowest level for 40 years. In the statement Fed pointed out that American economy still faces a threat of slowdown, also because of geopolitical tension. However, in their opinion, recently released data suggest that demand is moderately increasing. Next Fed meeting is scheduled for 6 November.

Also, the Council of the European Central Bank decided to leave Eurozone's interest rates unchanged at the meeting in September. The decision matched market expectations. Refinance rate (main interest rate) has remained at 3.25% since November last year. The same decision was taken on 10 October, after shortly before the meeting the president of the ECB Wim Duisenberg assessed before committee of the European Parliament that current ECB policy is correct.

Interest rates in the USA and Eurozone

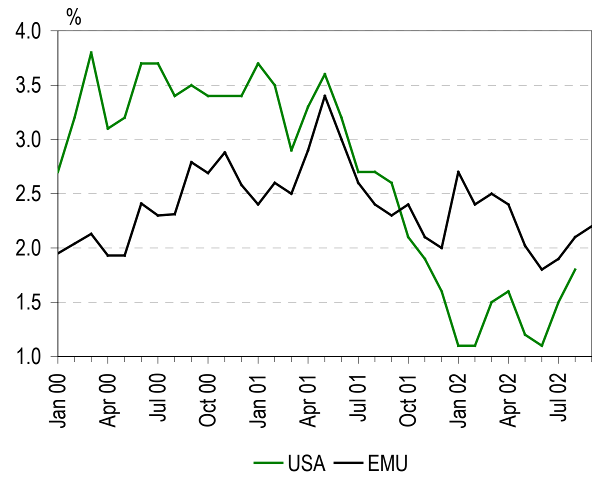


Source: Reuters

Final data release confirmed preliminary estimations of inflation in the Eurozone. In August it increased to 2.1% YoY from 1.9% in July. Compared to July, consumer prices rose by 0.1%, while stable price level was expected. Also, according to preliminary estimations, annual inflation rate in the Eurozone rose for a third consecutive month in September, reaching 2.2%, while analysts forecasted stable annual price growth rate. It seems that after three-month break (May-July) the inflation will again remain for a long period above 2.0%, i.e. target ceiling imposed by the ECB, as medium-term price stability indicator.

In the United States August's inflation amounted to 0.3% and it also was higher than analysts' forecasts pointed (0.2%). Annual inflation rate increased to 1.8% from 1.5% recorded in July.

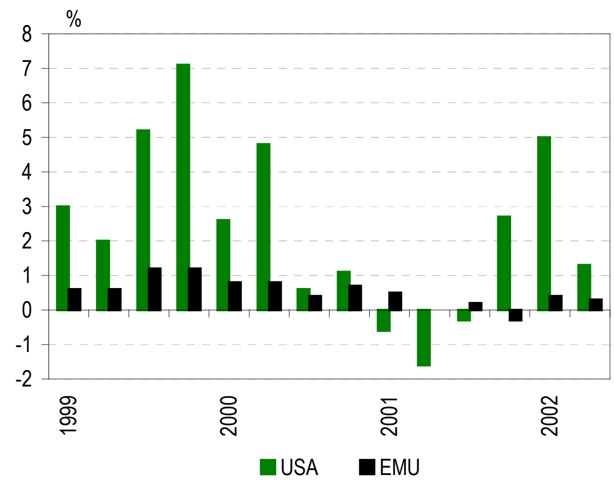
Inflation YoY



Source: Reuters

According to the final data, in 2Q 02 American GDP rose by 1.3% QoQ. It means, that US economy was developing at faster rate than suggested by preliminary estimations (1.1%) and faster than forecasted by analysts (1.2%). Despite this correction, in 2Q02 a significant slowdown in from 5% in 1Q took place.

GDP growth QoQ



Source: Reuters

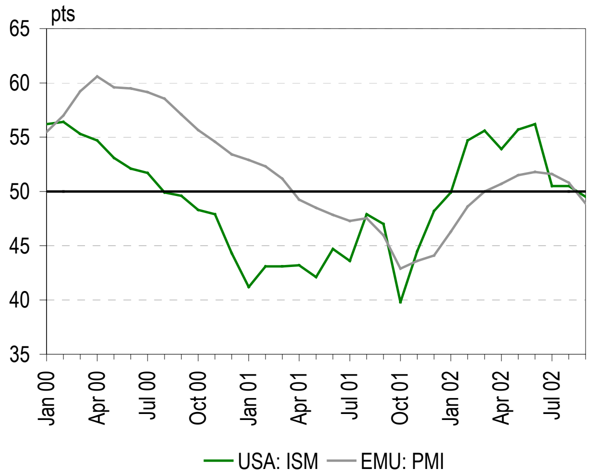
Eurozone's industrial production fell by 0.9%MoM and 0.5%YoY in July, which was a figure below analysts' forecasts, since they forecasted falls of 0.3% in both terms. Sold industrial production prices fell by 0.1%MoM, exactly in line with forecasts, which translated into a fall in annual deflation rate to 0.2% from 0.4% (revised) in July. Moreover, in July

Eurozone's retail sales recorded much better results than analysts forecasted. It increased by 0.6% MoM and 1.4% YoY, compared to 0.0% and 0.1% expected respectively.

In the United States Industrial production fell by 0.3%MoM in August, which was significantly worse than forecasts, as markets expected an increase in production of 0.2%. At the same time, August's data from the United States on producer prices and retail sales proved to be better than expected. Prices of sold industrial output remained unchanged compared to July while an increase of 0.2% was expected. Retail sales rose by 0.8% MoM while markets expected a rise of 0.5%.

Eurozone's M3 money supply growth recorded a slowdown amounting to 7.0%YoY in August against 7.1% in July, while 6.8% was expected. For a long time M3 aggregate growth remains clearly above 4.5%, the level determined by the European Central Bank, above which monetary factors exert inflationary pressure. However the ECB gives clear signal, that due to economic slowdown such a threat does not exists at present.

Activity Indicators

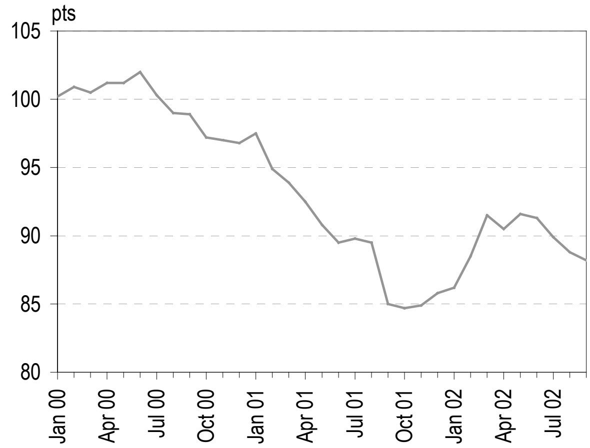


Source: Reuters

In September economic activity in Eurozone's industry deteriorated substantially. Reuters PMI index amounted to 48.9 pts against 50.3 pts expected, compared to 50.8 pts recorded in August. A fall below 50 pts limit suggests that Eurozone's industry might pass from development to recession. Among Eurozone's countries the weakest activity was recorded in Germany, where BME/Reuters PMI index fell to 46.0 pts in September from 49.1 pts in August, while analysts expected a fall to 48.8 pts only. Analogous index for the United States – ISM also pointed to stopping development in industry, falling to 49.5 pts in September from 50.5 pts in August, while it was expected to remain above 50 pts and even to rebound slightly to 50.8 pts.

Exactly in line with analysts' expectations, index of German entrepreneurs' sentiment IFO, major business climate indicator for German economy, recorded a fourth consecutive fall in September to 88.2 pts from 88.8 pts in August. A subindex of assessment of current situation rose but that of expectations for future economic stance fell, which increases uncertainty concerning future economic activity and this is why IFO governor called the ECB to cut Eurozone's interest rates.

IFO index



Source: Reuters

American consumer confidence indicator fell in September for a fourth month in a row, reaching 93.3 pts, against 94.5 pts in August (revised from 93.5 pts). Deterioration in sentiment mainly resulted from falls in stock exchange and a threat of war against Iraq. September figure though the lowest since November last year was better than analysts' forecasts of 92.3 pts. US consumer sentiment indicator by University of Michigan fell to 86.1 pts in September from 87.6 pts in August and it was slightly lower than 86.2 pts recorded in preliminary survey. However, on the other hand the revision was less than 85.9 pts expected by analysts.

What's hot this month

Monday	Tuesday	Wednesday	Thursday	Friday
30 September POL: Balance of payments (Aug) POL: T-bill auction (PLN 2 600m) *EMU: Inflation preliminary (Sep)*	**1 October** *EMU: PMI (Sep)* *EMU: Retail sales (Jul)* *USA: ISM (Sep)*	**2** POL: T-bond auction OK0804 & PS0507 *EMU: Producer prices (Aug)* *EMU: Unemployment (Aug)* *EMU: Economic sentiment (Aug, Sep)* *EMU: Business climate (Aug, Sep)*	**3** *USA: Factory orders (Aug)*	**4** *USA: Unemployment (Sep)*
7 POL: Food prices (2H Sep) POL: T-bill auction (PLN 900m) *GER: Industrial orders (Aug)*	**8** *GER: Unemployment (Sep)*	**9** POL: T-bond auction DS1013 *GER: Industrial output (Aug)*	**10** *EMU: ECB meeting* *EMU: GDP (2Q)*	**11** POL: 1st reading of budget bill *FRA: Inflation preliminary (Sep)* *USA: Producer prices (Sep)* *USA: Retail sales (Sep)*
14 POL: Money supply (Sep) POL: Wages & employment (Sep) POL: T-bill auction (PLN 900m) *ITA: Inflation final (Sep)*	**15** POL: Inflation (Sep) *FRA: Industrial output (Aug)* *ITA: Industrial output (Aug)*	**16** *EMU: Inflation final (Sep)*	**17** POL: Industrial output (Sep) POL: Producer prices (Sep) *USA: Industrial output (Sep)*	**18** POL: Business climate (Oct) *EMU: Industrial output (Aug)* *USA: Inflation (Sep)* *USA: Foreign trade (Aug)*
21 POL: T-bill auction (PLN 800m)	**22** Negotiation session with EU POL: MPC meeting POL: Core inflation (Sep) *EMU: Foreign trade (Aug)*	**23** POL: MPC meeting (decision)	**24** Beginning of EU summit in Brussels *FRA: Inflation final (Sep)*	**25** POL: Food prices (1H Oct)
28 POL: T-bill auction (PLN 800m) *EMU: Money supply (Sep)*	**29**	**30** *ITA: Inflation preliminary (Oct)*	**31** POL: Balance of payment (Sep) *EMU: Inflation preliminary (Oct)* *EMU: Retail sales (Aug)* *USA: GDP (3Q)*	**1 November** *EMU: PMI (Oct)* *USA: Unemployment (Oct)*
4 POL: T-bill auction	**5**	**6** POL: T-bond auction OK0804 POL: Food prices (2H Oct) *USA: Fed meeting*	**7** *EMU: ECB meeting*	**8**

Source: CSO, NBP, Finance Ministry, Reuters

Data release calendar for 2002

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
MPC meeting	29-30	26-27	26-27	24-25	28-29	25-26	18-19	27-28	24-25	22-23	26-27[a]	17-18[a]
CPI	15	15[b]	15[c]	15	15	17	15	19	16	15	15	16
Core inflation	21	-	21	18	20	21	22	26	23	22	25	23
PPI	18	19	18	18	20	19	17	20	18	17	20	18
Industrial output	18	19	18	18	20	19	17	20	18	17	20	18
Gross wages, employment	15	14	14	15	17	18	12	14	13	14	18	13
Trade	about 50 working days after reported period											
Balance of payments	31	28	28	30	29	28	31	30	30	31	29	27
Money supply	14	14	14	12	14	14	12	14	13	14	14	13
NBP balance sheet	7	7	7	5	7	7	5	7	6	7	7	6
Business climate indices	7[d] i 21[e]	20	20	18	21	19	18	22	19	18	21	19
Food prices, 1-15	-	8[e] i 27[f]	27	26	27	27	26	27	27	25	27	30
Food prices, 16-30	3	8	8	5	7	6	5	6	6	7	6	6

[a] according to preliminary schedule,
[b] preliminary data, [c] final data (January, February), [d] December 2001, [e] January 2002, [f] February 2002
Source: CSO, NBP

Economic data and forecasts

Monthly economic indicators

		Aug 01	Sep 01	Oct 01	Nov 01	Dec 01	Jan 02	Feb 02	Mar 02	Apr 02	May 02	Jun 02	Jul 02	Aug 02	Sep 02	Oct 02
GDP	%YoY	x	0.8	x	x	0.2	x	x	0.5	x	x	0.8	x	x	1.5	x
Industrial production	%YoY	0.9	-3.7	1.8	-1.0	-4.8	-1.4	0.2	-3.1	0.3	-4.2	2.1	5.7	-1.1	4.6	1.8
Retail sales ***	%YoY	3.0	1.3	5.8	2.4	2.4	4.7	6.7	9.9	3.1	1.8	2.5	8.6	5.1	-	-
Unemployment rate	%	16.2	16.3	16.4	16.8	17.4	18.0	18.1	18.1	17.8	17.2	17.3	17.4	17.4	17.5	17.7
Gross wages **	%YoY	6.9	6.2	7.8	6.6	5.3	5.7	5.5	4.8	2.3	4.2	3.9	4.1	2.8	3.6	3.0
Export (acc. to NBP)	USDm	2 616	2 287	2 778	2 555	2 540	2 308	2 141	2 467	2 739	2 610	2 678	3 175	2 691	2 691	3 095
Import (acc. to NBP)	USDm	3 635	3 176	3 953	3 509	3 430	3 418	2 952	3 148	3 521	3 416	3 360	3 763	3 578	3 685	3 870
Trade balance (acc.to NBP)	USDm	-1 019	-889	-1 175	-954	-890	-1 110	-811	-681	-782	-806	-682	-588	-887	-994	-775
Current account balance	USDm	-354	-304	-838	-417	-500	-847	-820	-612	-643	-549	-408	-108	-290	-754	-425
Budget deficit (cumulative)	PLNbn	-21.0	-21.8	-24.6	-27.7	-32.6	-6.9	-13.7	-16.4	-20.0	-23.0	-25.0	-25.7	-27.3	-28.8	-31.2
CPI	%YoY	5.1	4.3	4.0	3.6	3.6	3.4	3.5	3.3	3.0	1.9	1.6	1.3	1.2	1.3	1.0
PPI	%YoY	1.0	0.7	-0.5	-1.0	-0.3	0.0	0.2	0.3	0.4	0.5	1.2	1.7	1.3	1.0	1.9
Broad money (M3)	%YoY	13.5	12.6	11.4	7.5	9.2	7.8	6.9	3.2	2.4	3.2	2.5	1.3	-0.2	-	-
Deposits	%YoY	15.0	13.6	12.0	7.3	8.9	6.9	5.7	1.7	0.6	1.3	0.5	-0.8	-2.5	-3.0	-2.5
Credits	%YoY	11.8	11.5	9.7	8.9	9.3	9.0	8.8	7.1	6.6	7.9	9.4	7.5	5.9	6.0	8.0
USD/PLN	PLN	4.25	4.22	4.13	4.09	4.01	4.06	4.19	4.14	4.06	4.05	4.03	4.12	4.18	4.15	4.12
EUR/PLN	PLN	3.82	3.85	3.74	3.64	3.58	3.59	3.64	3.63	3.59	3.71	3.85	4.09	4.08	4.07	4.05
Reference rate *	%	14.50	14.50	13.00	11.50	11.50	10.00	10.00	10.00	9.50	9.00	8.50	8.50	8.00	7.50	7.50
WIBOR 3M	%	15.35	14.73	14.01	13.91	12.29	11.00	10.60	10.32	10.20	9.88	9.30	8.89	8.55	8.07	7.75
Lombard rate *	%	18.50	18.50	17.00	15.50	15.50	13.50	13.50	13.50	12.50	12.00	11.50	11.50	10.50	10.00	10.00
Yield on 52-week T-bills	%	14.61	14.01	12.64	11.80	10.66	9.62	9.68	9.62	9.56	9.22	8.54	8.35	7.86	7.25	6.80
Yield on 2-year T-bonds	%	14.40	13.57	11.36	11.00	10.70	9.11	9.37	9.32	9.22	9.03	8.27	8.12	7.60	7.16	6.70
Yield on 5-year T-bonds	%	13.50	12.92	11.32	10.13	9.91	8.91	9.26	9.11	9.02	8.90	8.17	8.11	7.62	7.07	6.60
Yield on 10-year T-bonds	%	11.97	11.57	10.31	9.19	8.92	8.25	8.34	8.25	8.19	8.02	7.55	7.63	7.29	6.79	6.20

Source: CSO, NBP, BZ WBK

* at the end of period   ** in corporate sector   *** in nominal terms

Quarterly and annual economic indicators

		1998	1999	2000	2001	2002	2003	1Q01	2Q01	3Q01	4Q01	1Q02	2Q02	3Q02	4Q02
GDP	PLNbn	553.6	615.1	685.0	721.6	750.8	791.3	165.4	176.5	179.6	200.0	171.4	182.8	186.2	210.4
GDP	%YoY	4.8	4.1	4.0	1.0	1.2	3.0	2.3	0.9	0.8	0.2	0.5	0.8	1.5	2.0
Total consumption	%YoY	4.2	4.4	2.4	1.8	1.7	2.1	-1.3	-1.8	-1.7	-2.8	0.0	2.7	2.3	1.9
- Private consumption	%YoY	4.8	5.2	2.6	2.1	2.7	2.3	1.2	1.3	1.8	2.9	3.2	2.9	2.5	2.1
Fixed investments	%YoY	14.2	6.8	2.7	-10.2	-1.0	6.5	0.0	0.2	0.2	1.4	2.0	-8.4	-3.5	3.3
Industrial production	%YoY	3.5	3.6	6.8	-0.2	0.8	3.4	4.5	-0.7	-0.8	-2.6	-1.6	-0.3	3.1	2.3
Retail sales (real terms)	%YoY	2.6	4.0	1.0	0.2	-	-	-3.1	-0.2	1.2	3.7	5.8	0.7	-	-
Unemployment rate *	%	10.4	13.1	15.1	17.4	18.8	19.0	16.1	15.9	16.3	17.4	18.1	17.3	17.5	18.8
Gross wages (real terms)	%YoY	4.3	3.3	1.3	1.6	2.1	1.1	1.7	-0.3	2.2	3.2	1.9	1.4	2.2	2.8
Export (acc. to NBP)	USDm	30 122	26 347	28 256	30 276	32 563	35 000	7 436	7 508	7 459	7 873	6 916	7 347	8 557	9 063
Import (acc. to NBP)	USDm	43 842	40 727	41 424	41 955	42 523	47 000	10 584	10 286	10 193	10 892	9 518	9 621	11 026	11 682
Trade balance (acc.to NBP)	USDm	-13 720	-14 380	-13 168	-11 679	-9 960	-12 000	-3 148	-2 778	-2 734	-3 019	-2 602	-2 274	-2 469	-2 619
Current account balance	USDm	-6 862	-11 558	-9 946	-7 075	-6 655	-9 000	-2 170	-2 205	-945	-1 755	-2 279	-2 075	-1 152	-1 624
Current account balance	% GDP	-4.3	-7.4	-6.3	-4.0	-3.6	-4.4	-4.9	-5.2	-4.2	-4.0	-4.1	-4.0	-4.0	-3.9
Budget deficit (cumulative)*	PLNbn	-13.2	-12.5	-15.4	-32.6	-40.0	-40.0	-15.0	-18.8	-21.9	-32.6	-16.4	-25.0	-28.8	-40.0
Budget deficit (cumulative)*	% GDP	-2.4	-2.0	-2.2	-4.5	-5.3	-5.1	-9.1	-2.2	-1.7	-5.3	-9.6	-3.4	-2.1	-5.3
CPI	%YoY	11.8	7.3	10.1	5.5	2.0	2.4	6.7	6.6	4.9	3.7	3.4	2.1	1.3	1.2
CPI*	%YoY	8.6	9.8	8.5	3.6	1.4	3.0	6.2	6.2	4.3	3.7	3.3	1.6	1.3	1.4
PPI	%YoY	7.3	5.7	7.8	1.6	1.2	2.5	4.2	2.2	0.8	-0.6	0.2	0.7	1.3	2.6
Broad money (M3)	%YoY	25.3	24.6	15.2	12.1	3.4	5.0	14.7	11.8	14.1	12.9	5.9	2.7	-	-
Deposits	%YoY	28.4	26.4	17.2	13.5	0.4	10.5	17.1	13.6	15.7	13.3	4.8	0.8	-2.1	-2.0
Credits	%YoY	30.0	28.6	24.7	11.3	8.2	15.0	15.4	9.7	11.3	8.1	8.3	8.0	6.5	10.0
USD/PLN	PLN	3.49	3.97	4.35	4.09	4.09	3.91	4.09	3.99	4.22	4.08	4.13	4.05	4.15	4.06
EUR/PLN	PLN	3.92	4.23	4.01	3.67	3.86	3.91	3.78	3.49	3.76	3.65	3.62	3.72	4.08	4.02
Reference rate *	%	15.50	16.50	19.00	11.50	7.00	6.50	18.00	15.50	14.50	11.50	10.00	8.50	7.50	7.00
WIBOR 3M	%	21.34	14.73	18.78	16.08	9.12	6.95	18.53	17.09	15.37	13.45	10.64	9.79	8.50	7.57
Lombard rate *	%	20.00	20.50	23.00	15.50	9.50	9.00	22.00	19.50	18.50	15.50	13.50	11.50	10.00	9.50
Yield on 52-week T-bills	%	18.59	12.95	17.77	14.77	8.31	6.30	17.02	15.70	14.67	11.72	9.64	9.11	7.82	6.68
Yield on 2-year T-bonds	%	18.08	12.41	17.37	13.91	8.08	6.30	15.59	14.91	14.37	10.83	9.27	8.84	7.63	6.58
Yield on 5-year T-bonds	%	15.83	10.87	14.00	12.59	7.98	6.20	13.12	13.38	13.43	10.45	9.09	8.69	7.60	6.52
Yield on 10-year T-bonds	%	x	9.60	11.79	10.74	7.40	6.00	10.46	11.22	11.81	9.48	8.28	7.92	7.24	6.15

Źródło: GUS, NBP, BZ WBK

* at the end of period

Bank Zachodni WBK S.A.

TREASURY DIVISION

plac Gen. Władysława Andersa 5, 61-894 Poznań

secretary tel. (+48 61) 856 58 35, fax (+48 61) 856 55 65

This analysis based on information available until 11.10.2002 r. has been prepared by:

ECONOMIC ANALYSIS UNIT

ul. Marszałkowska 142, 00-061 Warszawa, fax (+48 22) 653 46 79

Email: ekonomia@bzwbk.pl Web site (incl. Economic Service page): http://www.bzwbk.pl

Maciej Reluga – Chief Economist

tel. (+48 22) 653 46 63, Email: maciej.reluga@bzwbk.pl

Piotr Bielski	(+48 22) 653 47 33
Piotr Bujak	(+48 22) 586 83 41
Aleksander Krzyżaniak	(+48 22) 586 83 42

TREASURY SERVICES DEPARTMENT

Paul Polaczek tel. (+48 61) 856 55 73, fax (+48 61) 856 55 65

Poznań

pl. Gen. W. Andersa 6, 61-894 Poznań
fax (+48 61) 856 55 65

Piotr Kinastowski

tel. (+48 61) 856 58 22, fax (+48 61) 856 55 65

Juliusz Szymański	(+48 61) 856 58 25
Katarzyna Kamińska	(+48 61) 856 58 25
Robert Król	(+48 61) 856 58 25
Adam Wandzilak	(+48 61) 856 58 25
Waldemar Polowczyk	(+48 61) 856 58 14
Zbigniew Mańke	(+48 61) 856 58 14
Hanna Nowak	(+48 61) 856 58 14
Żaneta Czerniak	(+48 61) 856 58 14
Wojciech Kusik	(+48 61) 856 58 14

Warszawa

ul. Marszałkowska 142, 00-061 Warszawa
fax (+48 22) 653 46 79

Tomasz Dziedzic	(+48 22) 586 83 67
Maciej Jędrzejak	(+48 22) 586 83 70
Piotr Żagan	(+48 22) 586 83 66
Marek Cisek	(+48 22) 586 83 19
Grzegorz Wróbel	(+48 22) 586 83 57

Wrocław

ul. Rynek 9/11, 50-950 Wrocław
fax (+48 71) 370 26 22
Krzysztof Pietrkiewicz
tel. (+48 71) 370 25 87, fax (71) 370 26 22

Maciej Błęcki	(+48 71) 370 26 63
Jerzy Rybczak	(+48 71) 370 24 26
Aleksandra Skiba	(+48 71) 370 24 86
Anna Tarnacka	(+48 71) 370 26 24
Damian Syzdek	(+48 71) 370 25 25
Maciej Makarewicz	(+48 71) 370 24 86
Marcin Mostowy	(+48 71) 370 26 25