National Bank of Poland

Monetary Policy Council

INFLATION REPORT
1999, I-II Quarter

Warsaw, September 1999

Design:
Ryszard Piwowar
Piotr Chodorek
Ed Polinski

Layout and print:
NBP Printshop

Published by:
National Bank of Poland
Office of the President
Promotion and Information Division
00-919 Warszawa, ul. Świętokrzyska 11/21
Tel (48-22) 653 2335, Fax: (48-22) 653 1321

CONTENTS

OVERVIEW

In the first half of 1999 the rate of CPI growth declined to 6.5% in June 1999, down from 8.6% in December 1998. This underscores some positive trends in inflationary processes, close to the *Monetary Policy Guidelines for the year 1999* and the targets laid down in the *Medium-term Strategy of Monetary Policy, 1999-2003*. What was noticeable, however, was the uneven pace of inflation: the reduction in the rate of inflation did not last long - it ended in February. Thereafter, in line with NBP forecasts, the declining trend ceased, the rate of inflation stabilised and even slightly climbed back.

The continued low growth or stabilisation in food prices did in fact curtail the growth of the general price index. Prices of services, on the other hand, many of these being regulated, have been conducive to inflation growth. This is also confirmed by the examination of core inflation, pruned off regulated prices. The ratio corresponding to this inflation was, throughout the first half-year, lower than the general CPI ratio.

The rate of price growth is also conditioned by other external factors. Whereas in 1998 oil prices fell rather dramatically, 1999 saw their pick-up, which coupled with a multiple growth in excise taxes and the weakening of the zloty rate of exchange have contributed to a slower pace of disinflation.

In the first half of 1999 economic growth was low, amounting to merely 1.5% in the first quarter, while in the second quarter it was estimated at 3.0%. The main stimulant of growth was internal consumption, funded partly out of credit and savings. On the other hand, one main factor contributing to the low GDP rate was low external demand and drop in the external competitiveness of the Polish economy.

In the first quarter 1999 the total industrial output sold was lower than in the first quarter of the previous year, whereas in the second quarter it slightly increased on the previous year's second quarter. In summarising the first half of 1999 it should be noted, however, than the total industrial output sold was slightly lower that in the first half of 1998 (by about 1%).

Earnings at enterprises in the second quarter of 1999 were much stronger than in the first quarter, which pushed up their performance ratios in the first half-year (compared to the first quarter of the current year). The net sales margin climbed into positive territory (slightly above zero). The cost to sales ratio on total operations slightly improved, but it was still rather high (98.4% for the enterprise sector). The financial problems of enterprises early this year made them less interested in investing than in the corresponding period of the previous year. In contrast, enterprises reported increased demand for working capital loans. The decreased demand for investment and consumer goods along with growing internal and external competition led to a situation when it was no longer possible for enterprises to compensate with prices for their high production cost.

The money supply increased in the first half of the year, in June being 7% higher than at December-end 1998. Very importantly, the second quarter of 1999 witnessed a markedly declining rate of growth in personal zloty deposits, both on the first quarter of 1999 and the second quarter of 1998. The main factor in money creation during the first half of 1999 were claims on non-financial sector. Particularly strong was the growth in household loans: 18.5% on top of last December-end in contrast to the moderate and stable growth in loans to corporates (up 11.3%). What was more and more disquieting was the ever broadening gap between the faster growth in lending and slower in deposits.

Another factor in money creation - foreign assets increased in the first half of 1999 by 3.5 billion in zloty terms, contributing about 23.0% to total money creation. However, in dollar terms these declined USD 2.1 billion. The lowering of foreign assets was the result of growing disequilibrium on the current account, primarily due to a strong growth in the deficit on merchandise trade. The reason for the high trade deficit was the considerable drop in exports to Russia and CIS countries and the low rate of growth in exports to the European Union. There was a simultaneous decrease in unclassified receipts which in previous years covered a large part of the trade deficit. The shrinking surplus of this item was influenced first all by a decreasing number of personal arrivals from Russia and CIS, where most shopping tourists were coming from, due to administrative restrictions on personal travel into Poland, and then the outbreak of the crisis. This led to receipts on unclassified transactions declining about 50% on the first half of 1998.

A distinctive feature of the first half of 1999 was the faster than previously growth in cash circulation. One may hypothesise that this resulted from the declining opportunity cost of keeping money in cash rather than in bank deposit, after the significant reduction of interest rates clearly observable at the beginning of the year.

The position of general government in the first half of the year was more difficult than expected. The receipts of the budget were lower and the outlays were high, primarily this was financing social security reform. This ruled out any further monetary policy relaxation, due to unmatched fiscal policy. This was coupled with issues of low transparency of the budgetary position and the financial health of local government budgets and extrabudgetary funds (Social Insurance Fund and Health Funds), quickly going from bad to worse.

The conditions for implementing monetary policy differed from those of 1998 and capital inflow was low. That's why the NBP less frequently intervened to soak up surplus liquidity from the banking system. The level of the gross official reserves stabilised. Moreover, the volatility of the zloty rate of exchange increased pushing up exchange risk and dampening the interest of short-term capital in securities investment. In order to increase exchange rate flexibility, the foreign exchange fixing changed its character as from June 7. From now on the fixing is no longer used to carry out transactions with the central bank, but only to establish the rate of exchange at a given time. From late January the zloty started to gradually slump vis a vis the dollar (and the Euro, to a lesser extent), which was contributed to by international developments and Poland's deteriorating economic performance (a spiralling fiscal deficit and a growing deficit on the current account). In the second quarter the zloty rebound thanks to an improved credibility of Poland's economy and the expected surge in privatisation revenues.

There was one change of base interest rates in the first half-year in order to realign them with the inflationary target. Actually it was deeper than those made so far, so market participants would not be waiting a few more months for further interest rate changes, and the market relatively stabilised for some months to come.

INTRODUCTION

This *Inflation Report* for the first two quarters of 1999 is already the second analytical paper of this kind published by the Monetary Policy Council, the previous one having been a summary for 1998. The annual *Report,* prepared on the basis of the complete data, will comprise more analytically substantiated material. Quarterly *Reports,* often based, as they must be, on incomplete data, will be more information oriented, but not without some detailed interpretation and presentation of the Council's point of view. Nonetheless, they will be published relatively promptly upon completion of the second and the third quarter.

In the first quarter of 1999, as per the Council's expectations, after a considerable drop in the year-on-year inflation ratio (as measured by CPI), in March the disinflation process halted. This followed primarily from the hikes in regulated prices, and was also conditioned by the trends in commodity prices on the world markets, especially oil. There has also been some clear acceleration in December-to-date producer prices, compared to the corresponding period of the previous year. This may be traceable to the impact of cost pressure on producer price rises.

After an initially fairly rapid growth in the money supply, the second quarter saw its reduction which brought it back on the track of the growth projected for the whole of 1999. But there are concerns about the relatively low growth rate in bank deposits, in contrast to the relatively high credit demand from households. It seems that in the first half of 1999, given the suppressed rate of personal income growth, perceived as temporary, households tried to defend their consumption levels at the cost of a reduced savings rate.

It was exactly the consumer demand which played the main role in overcoming the declining trends in manufacturing, as the demand for Polish exports continued to be subdued and investments grew at a lower rate. Given the continued downturn in the European Union and the collapse of Polish CIS exports, the deficit on the current account continues to grow. What also dampened the macroeconomic situation of Poland during the period in question were problems with maintaining restrictive enough fiscal policy under the simultaneous implementation of the four key state-level reforms.

The first half of 1999 saw the broadening of the crawling band used to determine the permissible deviation of the zloty exchange rate from parity, while the rate of central parity depreciation was reduced. In the anticipation of a considerable drop in inflation early this year, meeting in January the Council significantly reduced the base interest rates in order to adjust their levels to the implementation of the 1999 inflationary target.

This *Inflation Report* was prepared basing on statistical data as available by mid-September 1999.

Inflationary processes in the first and second quarter of 1999

Consumer prices

In line with the Monetary Policy Council Resolution of June 1999 amending the *Monetary Policy Guidelines for the year 1999*, the fundamental monetary policy target in the current year, one which enables the implementation of the medium-term objective, is to reduce the rate of CPI, so that by year-end 1999 it is no higher than 6.6%-7.8% compared to year-end 1998.

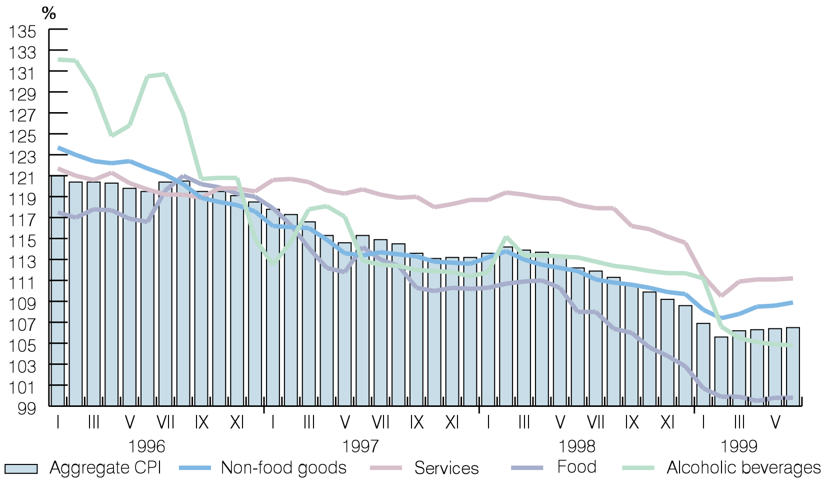
During the first half-year the year-on-year rate of inflation slipped from 8.6% in December 1998 to 6.5% in June 1999 (see figure 1) landing slightly below the lower limit of the band of the inflationary target for year-end 1999, as laid down by the Monetary Policy Council. The evolution of monthly inflation rates within the period in question was rather typical. Until February thus measured price increment was slowing down, but then - among other things due to regulated price hikes - it climbed back for a while and steadied a little, in order to clearly drop in June. What was unusual, by recent years' standards, was the distribution of monthly year-on-year inflation rates (on the corresponding month of the previous year). More specifically, since March we have witnessed acceleration in thus calculated price growth.

Such evolution of inflation in the first half of 1999 was conditioned primarily by non-monetary factors, especially in the external economic environment. While analysing year-on-year inflation during the first half of 1999 the following phases in the evolution of inflationary processes can be observed.

January - February 1999: period of substantial cuts in the year-on-year rate of inflation

The downward inflation trend for the whole year since March 1998, as measured on a year-on-year basis, was also sustained in the first two months of the new year. CPI slipped from 14.2% in February 1998 to 5.6% in February 1999. However, the strong reduction in February 1999 inflation was connected with the high base used for calculating the price growth index. It was

Figure 1
Rate of CPI growth *(corresponding period of previous year = 100)*



in February 1998 that the level of year-on-year inflation was actually the highest (over and above seasonal adjustments) in all of 1998.

During the first two months of 1999, i.e. from December 1998 to February 1999, prices of consumer goods and services (CPI) went up 2.1%. The growth of prices was clearly slower than the year before, as they climbed to 4.9% in the corresponding period last year. The relatively low inflation in the first two months of 1999 resulted from many factors pushing and pulling in different directions[1].

Early 1999 regulated prices were raised, according to plan for the period. These covered: administered prices, prices uniform across the country and prices conditioned by changes in indirect taxes (figures 2 and 3). The scale of the price rises effected in the first months of current year (in terms of their planned percentage growth) was, on average, 1.5 to 2 times lower than last year. This was one of the reasons for the declining year-on-year inflation. Despite this, under a lower price growth than last year, the regulated price hikes certainly produced a major inflationary impulse. This can be illustrated by the

[1] Since January 1999 in calculating CPI the Central Office of Statistics GUS has employed the EUROSTAT recommended COICOP classification (the classification of individual consumption according to purposes). This produced a change in the manner of aggregating prices of individual consumer goods and services into basic groups. This in turn has led to some major changes in the internal structure of the basket (weights) employed in calculating price ratios. The key groups of prices,

growth in this period of consumer prices, in which regulated prices have the highest share. Consumer prices grew 4.3%, more than twice as high as general growth (2.1%). A growth faster than average over the first two months of this year - 3.4% - was also shown by prices of alcohol beverages and tobacco products. These were influenced by rises in the rates of excise on these products.

---

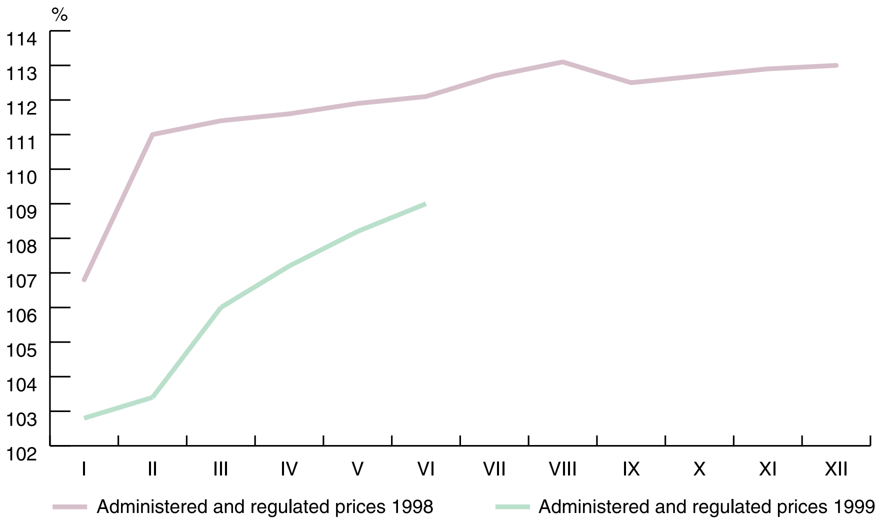
now presented by GUS, differ in terms of their scope and, by the same token, in the structure of weights from those employed in previous years. The structure of prices and weights based on personal consumption according to purposes used to calculate the 1999 price ratios comprises 12 groups, which are as follows: food and non-alcoholic beverages (31.62%), alcoholic beverages and tobacco products (6.40%), clothing and footwear (6.96%), usage of an apartment or house and forms of energy (18.44%), apartment equipment and running of a household (furniture, equipment, home appliances and services in connection with running of a household - 5.09%), health (4.45%), transportation (7.82%), communication (2.36%), culture and recreation (6.12%), education (1.09%), restaurants and hotels (3.65%), other goods and services (6.00%). Currently, each of the above-mentioned groups, except the first two, covers prices both of products and services. In order to bring the currently used breakdown of prices by types somewhat closer to the previous classification, this year GUS is using also a rough breakdown of products and services into 4 basic groups, this being a breakdown into the following groups and weights:

in 1999: food and non-alcoholic beverages - 31.62%,
alcoholic beverages and tobacco products - 6.40%,
non-food-stuffs (exc. tobacco products) - 30.63%,
services - 31.35%,

in 1998: food - 36.27%,
alcoholic beverages - 3.91%,
non-food-stuffs (incl. tobacco products) - 32.90%,
services - 26.92%.

Figure 2
***Rate of infation and regulated prices: 1996 - 1999 (CPI)** (previous month = 100)*

Figure 3
***Index of regulated prices:** 1998 - 1999 (previous year's December = 100)*



At the beginning of the year supply on primary domestic agricultural markets continued to exceed demand. On the cereals market this was caused by the relatively high stockpiled commodities from last year's good crops and imports. There was also oversupply on the pork market, pork being the main item in Poland's meat consumption structure. Problems with disposing of the high surpluses were compounded by last year's crisis in Russia, as well as the restrictions imposed on food exports to European Union countries, which resulted in a diminished share of Polish agroproducts in foreign trade transactions.

Food prices were also pulled down by trends on the world markets at the time. Consequently, prices of food imports, adjusted for rate of exchange fluctuations, were slightly lower than a year ago. During the first two months of the year the average food price level worldwide was almost 20% lower than last year, while for raw materials of farm origin it remained unchanged. However, during the first two months of the year transaction prices of food and livestock imports were 5% lower than last year.

As a result of the above-mentioned factors in January and February 1999 food prices continued to underperform the general inflation rate. After the first two months of this year the growth in food and non-alcoholic beverage prices was negligible - merely 0.2% up on December 1998.

At the beginning of the year consumer demand on the domestic market declined somewhat on the previous year. Personal consumption in the first quarter rose 4.2% compared to a growth of 4.6% in the fourth quarter of the previous year and 6.4% in the first quarter of 1998. One of the reasons for this development was lower than in previous periods rate of households' real growth of income derived a.o. from wages, social insurance benefits and agricultural production revenues. This met with a continued very high supply of Polish-made consumer goods and accumulated stocks and imports, additionally augmented by the falling foreign demand for Polish products. The supply was high, despite an almost 7% drop in the amount of industrial output from January to February of 1999 compared to the corresponding period of the previous year.

The first two months of 1999 reversed the previous year's falling trends on the world markets for basic commodities (other than those of farm origin) including oil prices. However, the pick up in prices was initially rather weak, thus despite some world price acceleration, the price levels in the period under discussion were generally similar to last year's levels. This was an additional factor which coupled with the internal supply and demand environment constrained growth trends in industrial products early this year.

Such situation on the domestic market at the beginning of 1999, with growing competition, was still hardly conducive to more aggressive producers' price hikes on their products, despite the ever rising production cost pressure. Growth in producer prices continued not to boost consumer price rises in the period. In February, producer prices increased 1.0% on last December.

Consequently, during the first two months 1999 non-food prices went up 1.3%, underperforming the general CPI for that period. It should be added that the first of this year's hikes in excise taxes on fuels did not as yet result in any major acceleration of fuel prices on the domestic market, although these were no doubt moderated by the still low, 20% lower than last year, level of oil prices on the world markets and drop in transaction prices of mineral fuels, lubricants and related products.

March - June 1999: steady acceleration of the rate of year-on-year inflation

This period calls for separate treatment. It was then when the phase of gradual growth in consumer prices started. The year-on-year inflation level increased to 6.2% in March, up from 5.6% in February 1999. In subsequent months of this period year-on-year inflation rate kept rising from month to month by 0.1 percentage point to reach 6.5% in June 1999.

From February to June consumer prices increased 2.6%, showing thus somewhat stronger growth than last year, when the growth in prices was 2.1% in the corresponding period. Nonetheless, throughout the half-year, i.e. from December 1998 till June 1999, this year's growth reached 4.8% (figure 4), thus being much lower than last year's growth, which came to 7.1%. This implies a different distribution pattern of inflation over time, in the corresponding periods of the current and the previous year (figure 5, 6 and 7).

The March-to-June growth in the year-on-year inflation rate was accompanied by changes in conditions impacting the Polish economy as well as factors from the external environment which can be material to the inflation processes in the period.

The domestic food market has retained the surplus of supply over demand. In the first half-year changes in prices on primary agricultural markets were still low, with prevalent falling trends. At the same time prices on the world markets were still below last year's prices and in the later months of the first half-year the trend towards the deepening of price drops became very pronounced. Food and livestock import transaction prices, after a nosedive at the turn of the year, bottomed out in March and started to rise again to reach last year's levels after the first four months.

Nevertheless, due to the still low prices of agricultural produce, combined with the continued surplus of supply over demand, prices of food and non-alcoholic beverages rose 1.0% over the last four months, from February to June, while inflation was 2.6% during the period. The negligible price growth in foodstuffs over the period was mainly on account of seasonal growth in prices of vegetables -19.8% and fruits - 8.6%, with minor price rises in other primary food groups. In June 1999 the level of food prices and alcoholic beverages was generally 1.2% high-

Figure 4
Rate of CPI growth *(previous year's December = 100)*

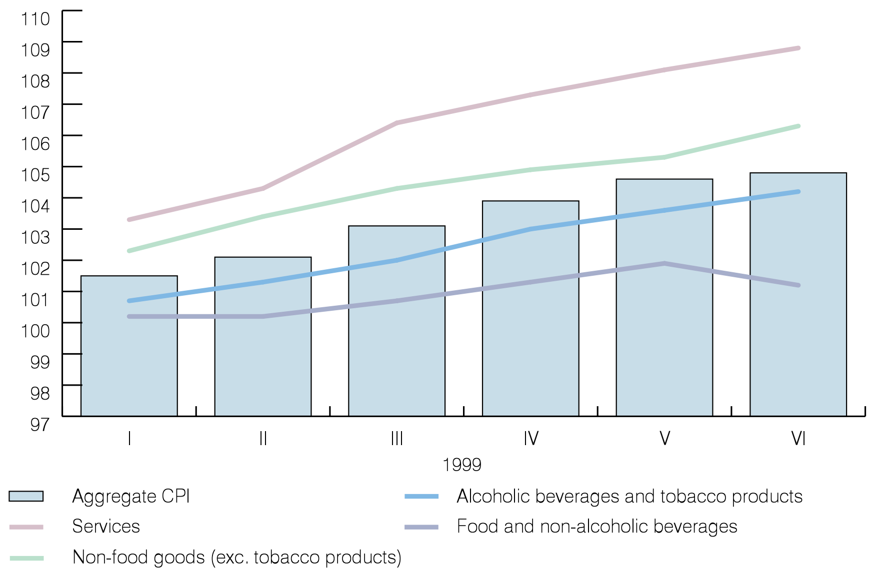
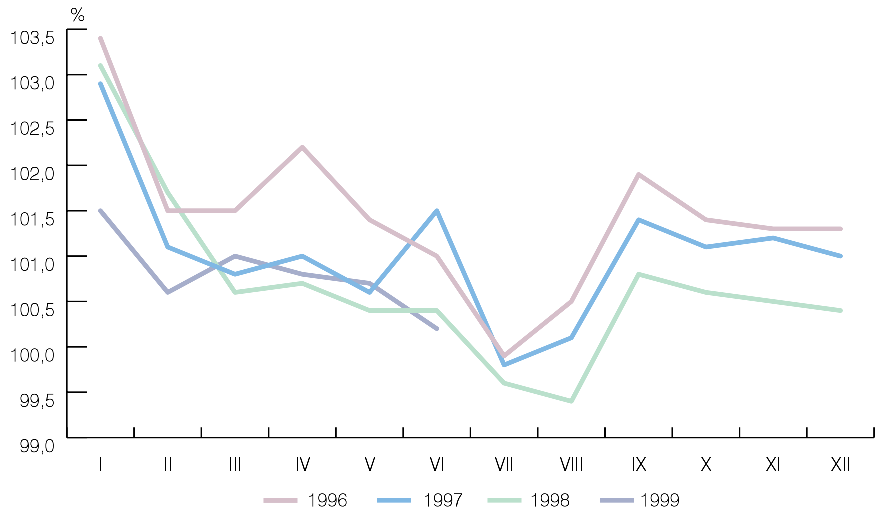


Figure 5
CPI rates *(previous month = 100)*



er than last December, displaying at the same time a four times lower growth than the inflation of the time. Thus over the twelve months (June-to-June) food prices slightly decreased - by 0.2% - compared to the previous year.

Throughout the period, changes in the fuel market proved to be a powerful shock inflationary impulse. This

Figure 6
Rate of CPI growth *(previous month = 100)*

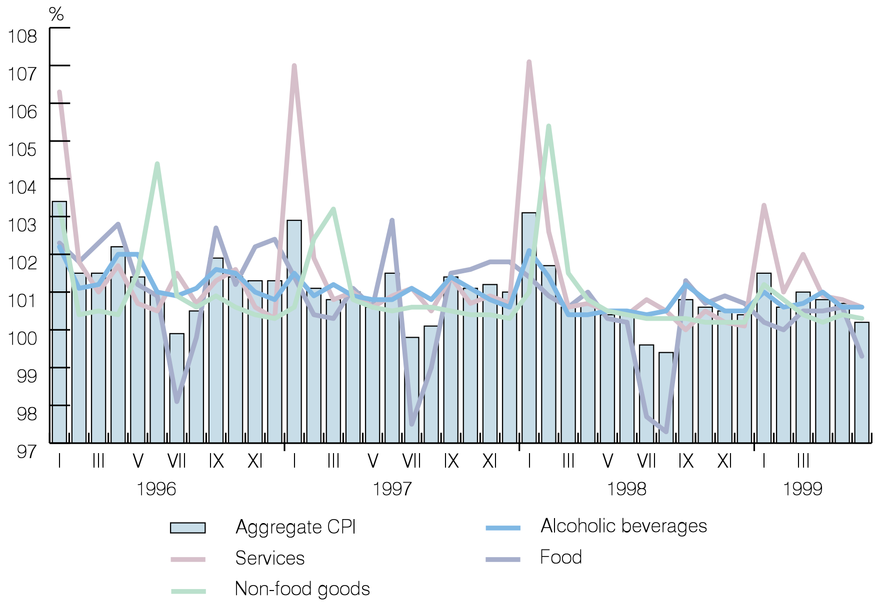
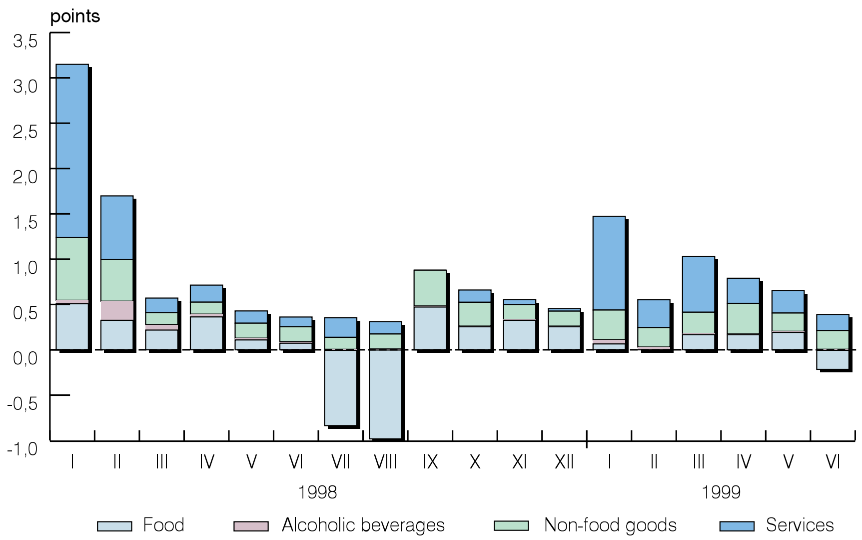


Figure 7
Shares of prices for main groups of goods and services in total CPI growth *(previous month = 100)*



was influenced both by the change of the situation on the world markets as well as the cumulation of factors causing a price rally in Poland's fuel market. Let us recall that 1998 was the period of a dramatic and deep downturn in oil prices throughout the world. The average price of Brent oil (which can be considered representative for the whole oil market) was USD 12.74 a barrel last year, while in 1997 it had been as much as USD 18.94 a barrel. The December 1998 Brent oil price was 42% lower than in December 1997 (figures 8 and 9).

During the time consumer prices of fuel increased 4.7%. In December 1998 excise and VAT tax accounted for 66% of the retail price of unleaded petrol. The 27% growth in excise rates over 1998 (December 1997 to December 1998) was largely wiped out by the large drop in world prices of oil and thus by import transaction prices. This allowed to avoid higher fuel price hikes on the domestic market (zloty/USD exchange rate stayed at the same level, from December 1997 to December 1998).

The year 1999 saw a breakthrough on the world fuel markets. OPEC member states in their consistent pursuance of the supply reduction policy led to rises in oil prices. Powerful growth trends for oil prices on the world markets returned at the end of February 1999. From December 1998 to June 1998 the price of Brent oil went up 60% and reached the level of over USD 19 a barrel. Such robust growth in world prices clashed in Poland with three increases in excise by an average of: 5.7% in January, 5% in March and 5% in June (by 17% in total) and pushed up fuel prices in the domestic market 21.1% over the first half-year (December 1998 to June 1999). All this growth happened from March to June, as for the first two months fuel prices did not move (figures 10 and 11). It cannot thus be ruled out that such growth will occur also later this year due to powerful cost pressure produced by so many fuel price rises in 1999. Other groups of prices, within the non-food group, did not display any major price growth.

Whether fuel prices rises will transfer to prices of final products largely depends on the behaviour of enterprises. In the second quarter the rate of growth in consumer demand slightly nudged up, as shown by a 4.3% growth in personal consumption over the second quarter this year. Continued personal demand in connection, among others, with the slight acceleration in average real wages

Figure 8
Maximum listed prices of Brent Oil (Jan 2, 1997 to June 30, 1999) (data from Nafta Polska SA)

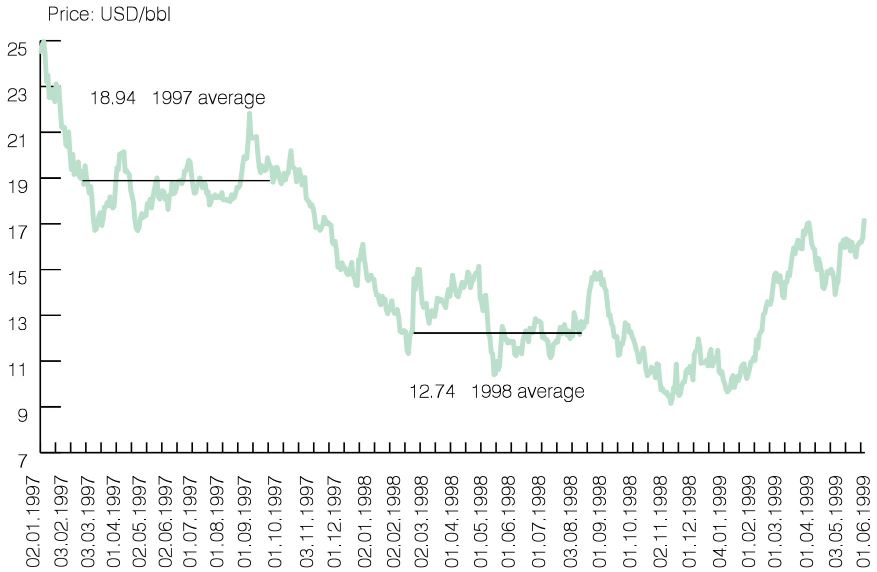


Figure 9
Comparison of selected ratios: June 1999 on December 1998 and December 1998 on December 1997 (I)

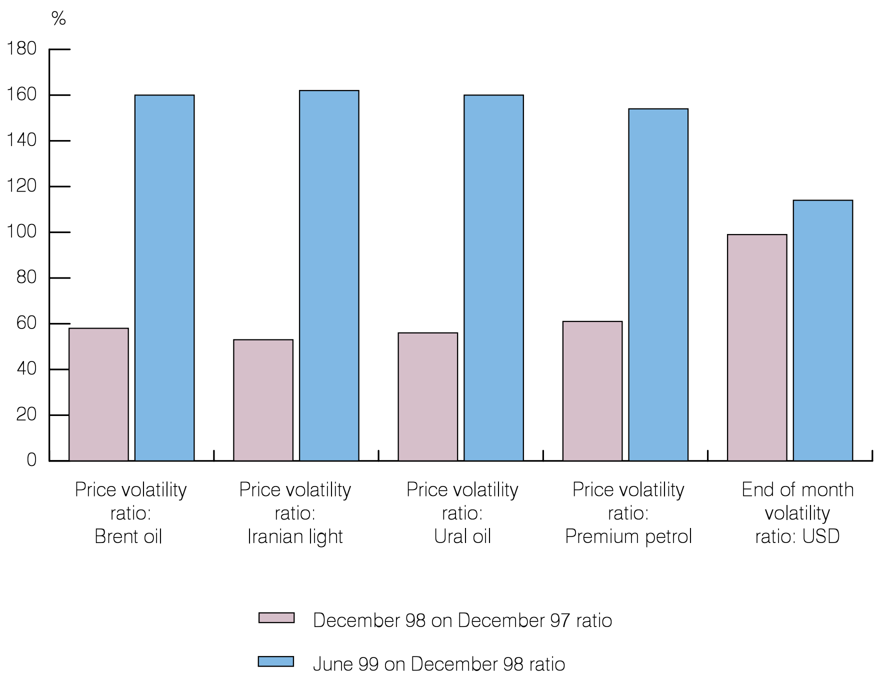


Figure 10
Comparison of selected ratios: June 1999 on December 1998 and December 1998 on December 1997 (II)

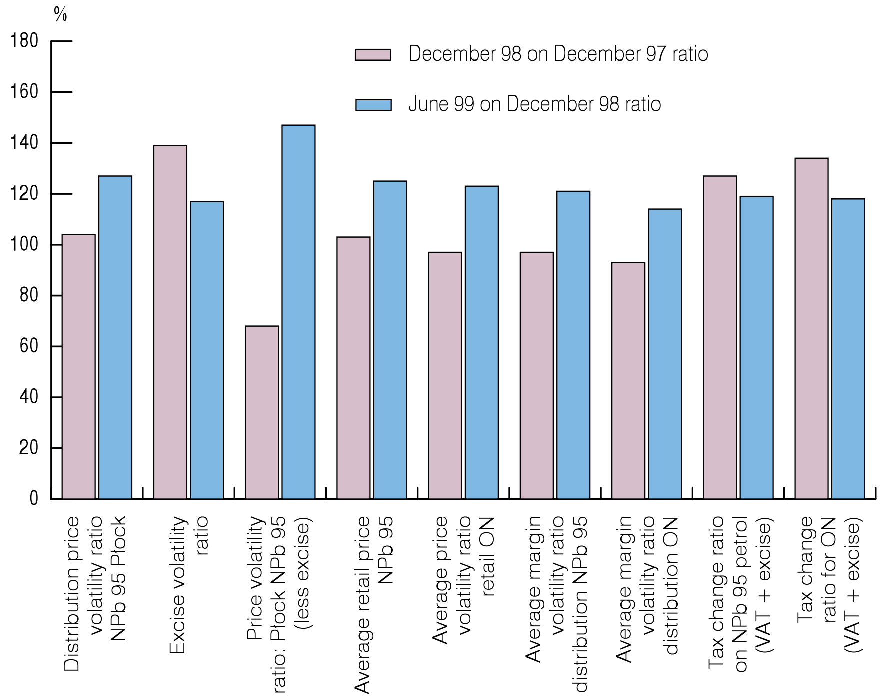
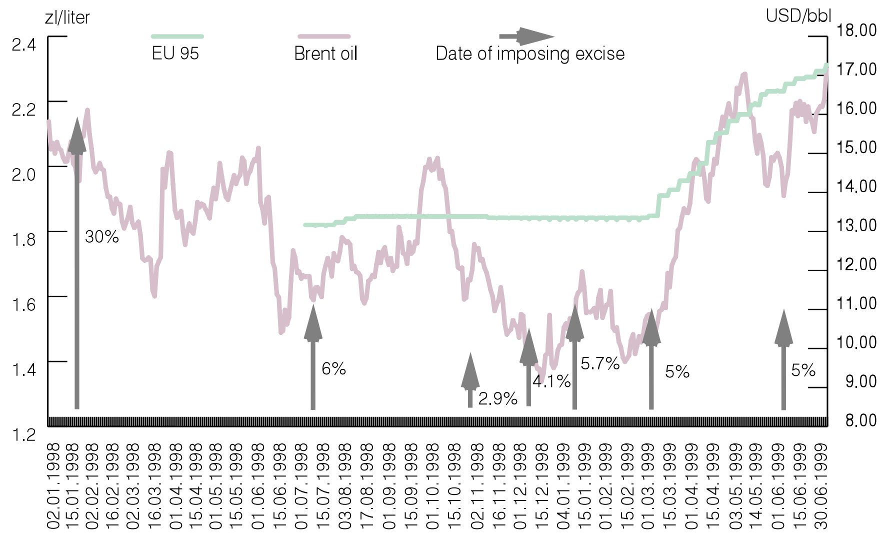


Figure 11
Comparision of average retail prices for fuels on Polish market and maximum listings for oil prices worldwide from July 1, 1998 to June 30, 1999



and faster growth in lending stimulated higher production growth, which after a 3.1% drop in the first quarter climbed back 1.2% in the second quarter compared to the previous year. With mounting production cost pressure, the period under discussion saw certain trends, albeit not very strong yet, to speed up the rate of growth in industrial output prices. While in previous periods (January - February 1999) the rate of growth in producer prices increased slower than last year, from last March we witnessed even stronger growth in producer prices than last year: from March to June those grew 2.4% (up from 0.9% a year ago), nudging just below the inflation rate for the period (2.6%).

In the same period transaction prices for industrial imports showed a growing trend. After the first four months of the current year the rate of growth for the prices was similar to last year's, i.e. about 8%.

As a result of the above factors prices of non-food items grew 2.9% from March to June, over and above the inflation rate for the period (2.6%). But during the first half-year (December 1998 to June 1999) due to the volatile trends for the subperiods in question, prices of non-food items increased by the total of 4.2%, below the rate of inflation for the period: 4.8%.

As regards regulated prices, in addition to the above-discussed situation in fuel prices there were also other factors which temporarily pushed up inflation - from March to June. These include changes resulting from hikes in energy carriers and further surges in excise rates (figures 12 and 13).

Despite the fact that under the Energy Law prices of forms of energy, i.e. power (electricity) and heat have been liberated, in 1999 these are still subject to controls through the approval of tariffs and the possibility of setting administrative ceilings for their rises. This year's guidelines envisaged that price rises on power imposed by generators must not exceed 13%. As a result in March there was a one-off increase in the price for the distribution of power. This sent power prices up by 12.6%. In all of the first half of 1999 energy prices rose 12.9%.

In four months - from March to June this year - prices of services rose 4.3% and almost doubled the rate of inflation in the corresponding period. In all of the first half-year (December to June) prices of services went up 8.8%, definitely ahead of the remaining price rises for basic goods and services and beating the period's inflation by 4.0 percentage points.

As a result of two more excise tax rises (of those scheduled for 1999) which happened in March and June, also

Figure 12
Rate of inflation and regulated prices in 1999 *(Dec 1998 = 100)*

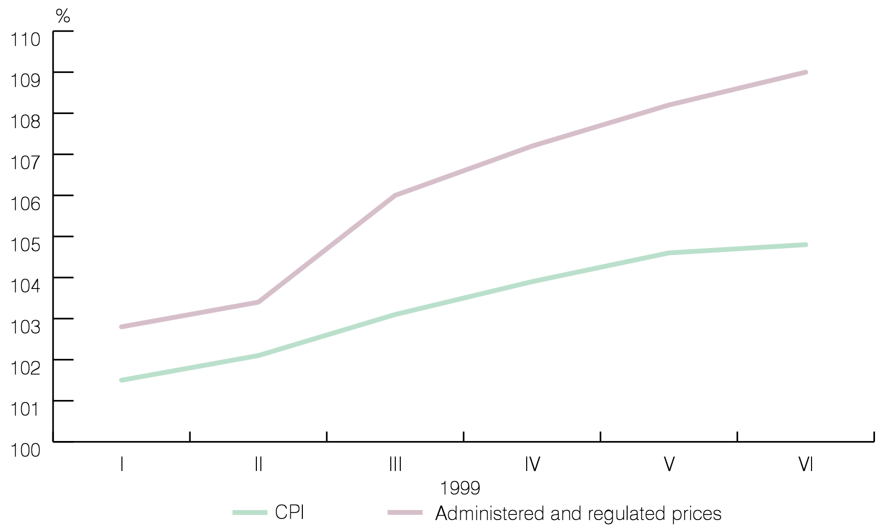
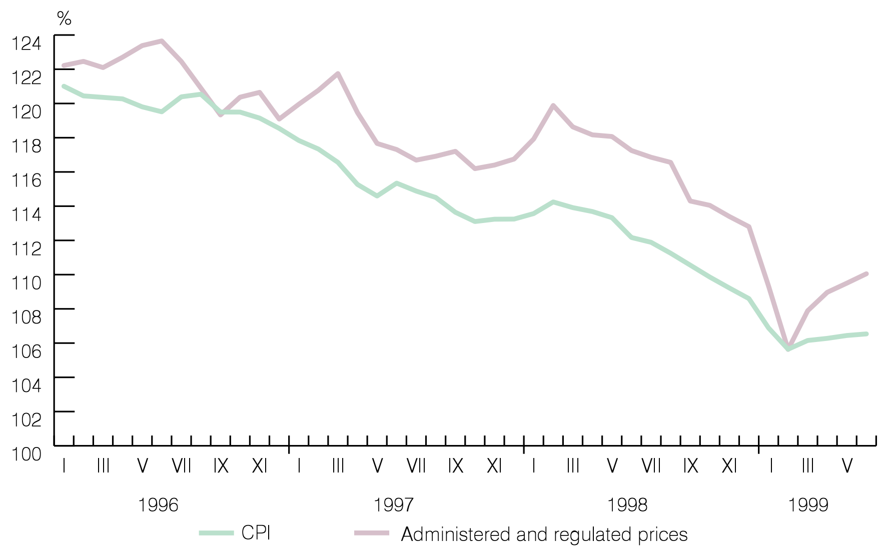


Figure 13
Rate of inflation and regulated prices 1996 - 1999 *(corresponding month of previous year = 100)*



prices of alcoholic beverages and tobacco products grew faster than inflation from March to June (2.8% compared to 2.6%). After the first half-year the prices grew 6.3%, showing a higher growth than the inflation for the period: 4.8%.

Alternative measures of inflation

The purpose of core inflation indices is to present the long-term trend of prices after the elimination of supply shocks, as these distort the picture of real evolution in inflationary processes. In developed market economies which have studied the pattern of core inflation, the relevant time series cover several decades. In Poland, the relatively short time series of data useful for inflation studies largely rules out any testing if the core inflation measures employed do indeed represent the underlying long-term trend. And thus whatever conclusions can be formulated pertain merely to short-term relationships between core inflation and the CPI ratio. The parallel employment of several measures of core inflation renders a fuller picture of its evolution.

This *Inflation Report* prepared by the NBP presents, for the second time now, some core inflation ratios calculated by means of different methods. The following ratios have been calculated so far:

1) core inflation ratio excluding prices showing highest volatility,

2) median CPI ratio,

3) 15% trimmed mean of the disagregated CPI ratio,

4) core inflation ratio excluding regulated prices.

The core inflation ratio excluding prices showing highest volatility is arrived at through leaving out the disagregated groups of consumer goods and services whose standard deviation exceeds certain level. This excludes those groups of consumer goods and services which did not display a uniform character. Considerable volatility is displayed both by groups of prices subject to market mechanisms and prices subject to administrative regulations. The total weight of groups of consumer prices subject to exclusion in 1992 - 1999 varied between 13.2% - 15.1%.

In the 1998 *Inflation Report* core inflation ratios were presented on an accumulating („year-to-date") basis, previous year's December taken as 100. Twelve month disagregated data (month on the same month in the previous year) have only been available since recently. Ratios calculated on the basis of year-on-year (12 month) data are more effective in the presentation of real trends of core inflation, having been adjusted for seasonal volatility. Also the period for which core inflation ratios have been calculated is longer now. Core inflation ratios are now available from January 1992 to June 1999.

It should also be noted that the ratio arrived at after regulated prices having been left out represents a slightly different aspect of inflationary processes than the remainder of ratios presented above. What it highlights are inflationary trends ex fiscally motivated prices. After all, regulated prices also include prices whose prime component are taxes (excise), which are set by local government (urban transport) or are subject to caps (electric energy).

Year-on-year core inflation rates, when superimposed on CPI trends (see figures 14-21), allow to interpret the clear fall in inflation (CPI) at the turn of 1998 and 1999, and its gradual but steady pick-up until the end of the first half of 1999. In the final months of 1998 and early 1999, core inflation, as measured by its median, 15% trimmed mean and with the exclusion of prices showing highest volatility, charted above the CPI ratio. The results obtained through the analysis of 12 monthly (year-on-year) ratios, adjusted for seasonal price changes, have demonstrated that the faster drop in inflation as measured by CPI, which occurred late last year and early this year, may have been caused by the unusual drop in prices of certain groups of merchandise which occurred during the period (among others as a result of the Russian crisis) and did not necessarily signify a permanent lowering of the inflation trend. As forecasted, this trend was later reversed (since March).

The inflation ratio pruned off regulated prices allows one to notice that in the first half of 1999 regulated prices were a factor which fuelled consumer prices. The regulated price index in the first half of 1999 climbed above inflation, as measured by CPI. This was caused by the high growth in prices, in excess of the inflation rate, for tobacco products, electric energy, network gas, hot water, fuels, transportation and haulage, postal and telecommunication services. Thus the ratio pruned off the impact of these prices is plotted below CPI throughout the first half of 1999 (see figure 20).

Three of the core inflation indices presented here show a decrease in inflation in the first half of 1999, albeit slower than last year. Only the ratio calculated as the 15% truncated mean suggests a growth of core inflation in the first half of 1999.

Figure 14

CPI and core inflation after exclusion of prices showing highest volatility Jan 1997 - June 1999

(corresponding month of previous year = 100)

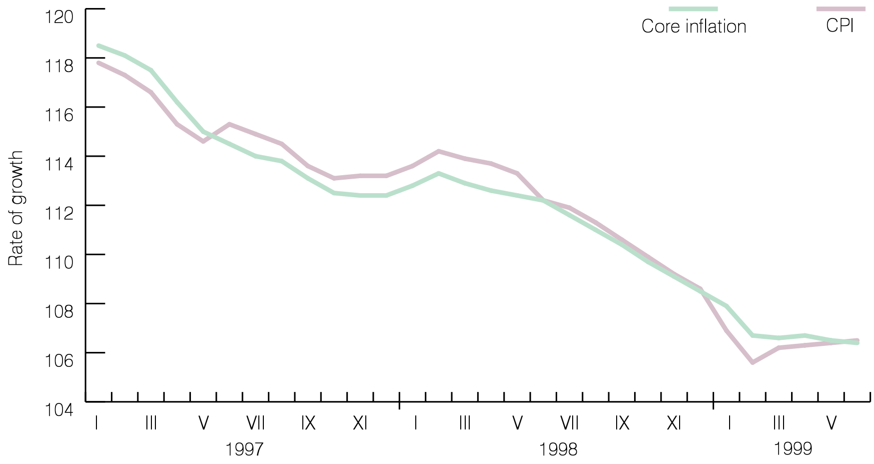


Figure 15

CPI and core inflation after exclusion of prices showing highest volatility Jan 1992 - June 1999

(corresponding month of previous year = 100)

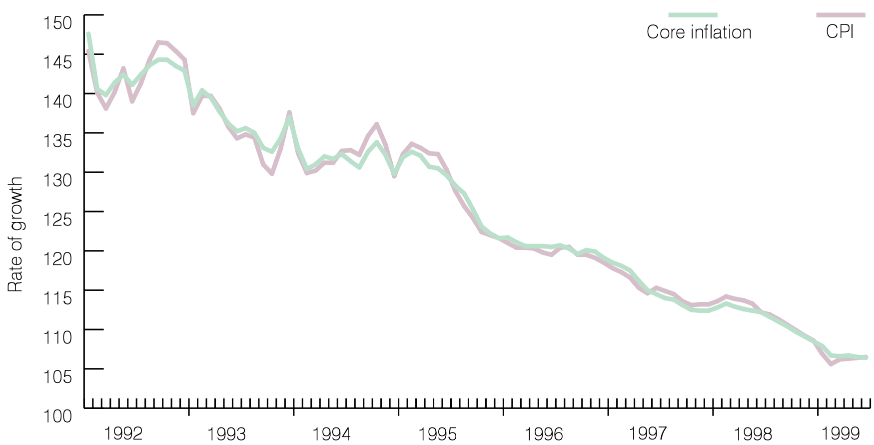


Figure 16
CPI and median: Jan 1997 - June 1999 *(corresponding month of previous year = 100)*

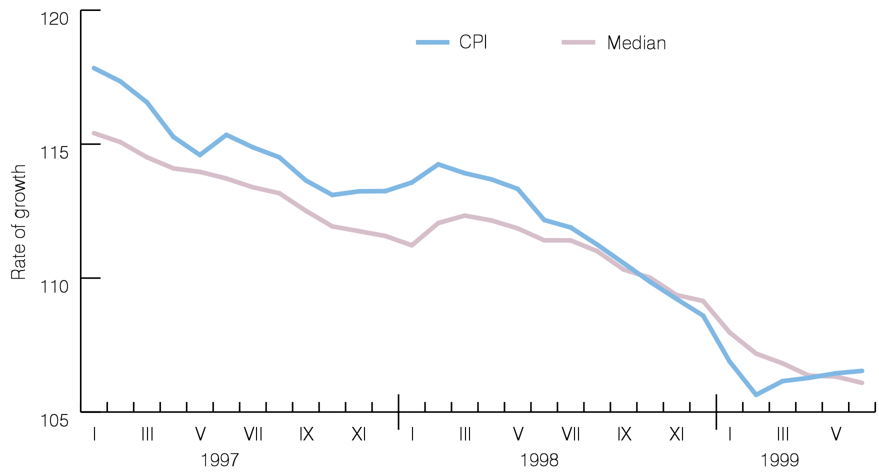


Figure 17
CPI and median: Jan 1992 - June 1999 *(corresponding month of previous year = 100)*

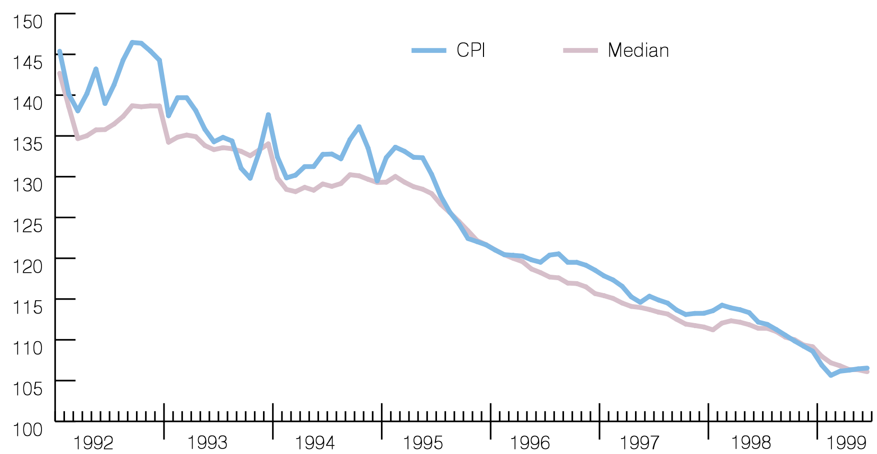


Figure 18

CPI and 15% trimmed mean: Jan 1997 - June 1999 *(corresponding month of previous year = 100)*

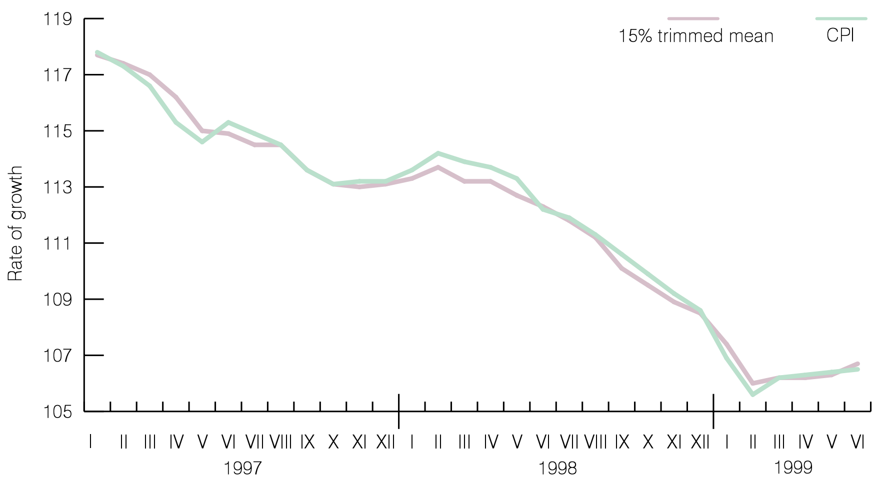


Figure 19

CPI and 15% trimmed mean: Jan 1992 - June 1999 *(corresponding month of previous year = 100)*

Figure 20
***CPI and core inflation after exclusion of regulated and administered prices Jan 1997 - June 1999** (corresponding month of previous year = 100)*

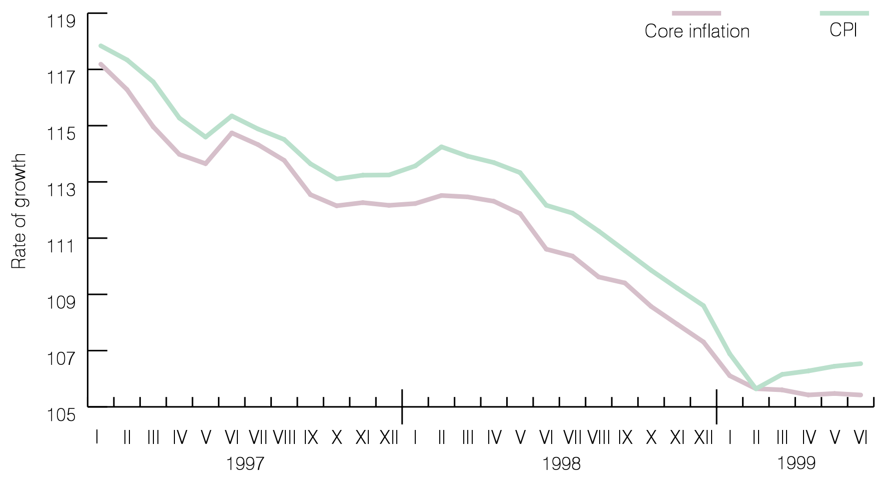
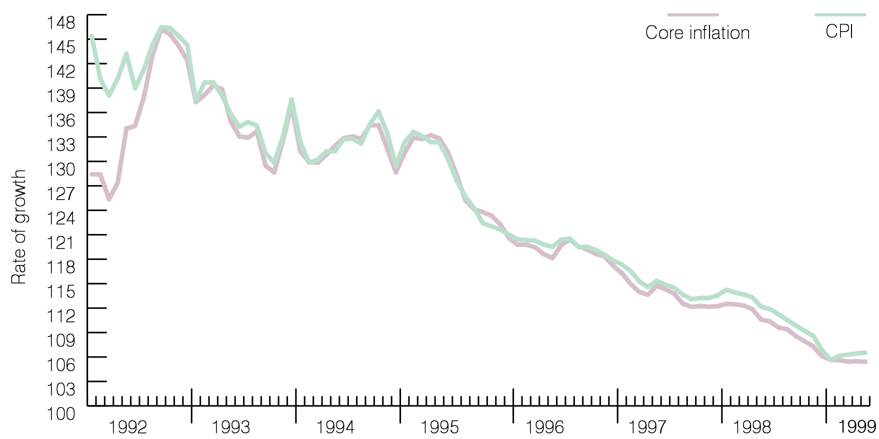


Figure 21
***CPI and core inflation after exclusion of regulated and administered prices Jan 1992 - June 1999** (corresponding month of previous year = 100)*



Producer prices

In the first two quarters of 1999 producer prices showed a slower growth than in the corresponding quarters last year. In the first quarter the prices grew 4.1% compared to 9.2% in the first quarter last year, in the second quarter the growth was 5.1% compared to 8.1% a year ago. Despite the clearly lower growth than last year, the reversal of trend in price growth distribution is quite remarkable. Whereas last year a stronger growth in the first quarter was followed by the slower pace of growth in the second quarter, this year the trend is actually the opposite: the second quarter saw the quickened pace of growth in producer prices. Growth in such prices from December 1998 to June 1999 was higher than a year ago, at 3.3% against 2.9% in the same period last year. It should be stressed the acceleration of producer prices, on the previous year, became particularly manifest in the second quarter of 1999, for whereas from December 1998 to March 1999 the prices grew 2.1%, i.e. slightly slower than a year ago (2.2%), from March to June the growth was 1.2%, while in the corresponding period last year the prices increased 0.7%.

Figures 22 and 23 illustrate the pattern of producer price growth in the years 1997-1999.

The most important factor in the growth of producer prices in the first two quarters of 1999 were on the one hand growing production costs, resulting among others from rises in prices for forms of energy, costs of transportation and other services by external providers. On the other hand, the price growth was conditioned by some acceleration, compared to the situation at last year-end, in price growth relating to raw material imports, particularly noticeable in the second quarter last year. At the same time there was still much competition in the domestic market and the current levels of consumer demand and limited export opportunities hampered any possibilities of excessive production price hikes.

Nonetheless, some industrial sectors displayed clear price growth trends, resulting from strong cost pressure.

In the mining and quarrying sector, with poor production performance, price growth from last December to June 1999, at 1.6%, was higher than last year. Back then it was merely 0.3%. However, in the whole of the first half-year the growth was definitely weaker than in the corresponding period of the previous year.

Figure 22
Rate of PPI growth *(corresponding month of previous year = 100)*

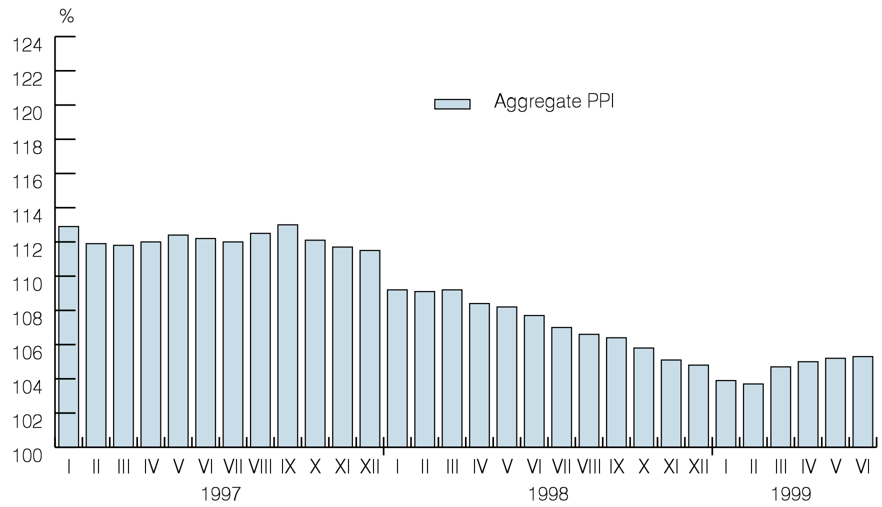
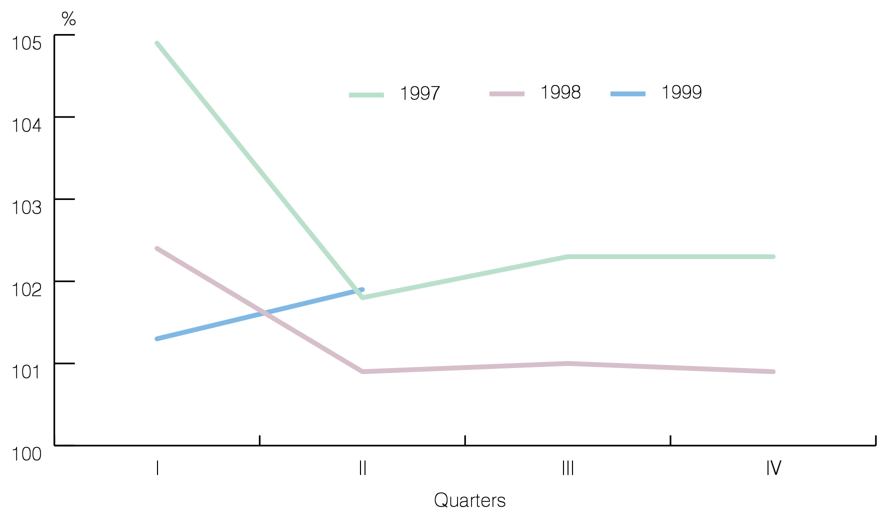


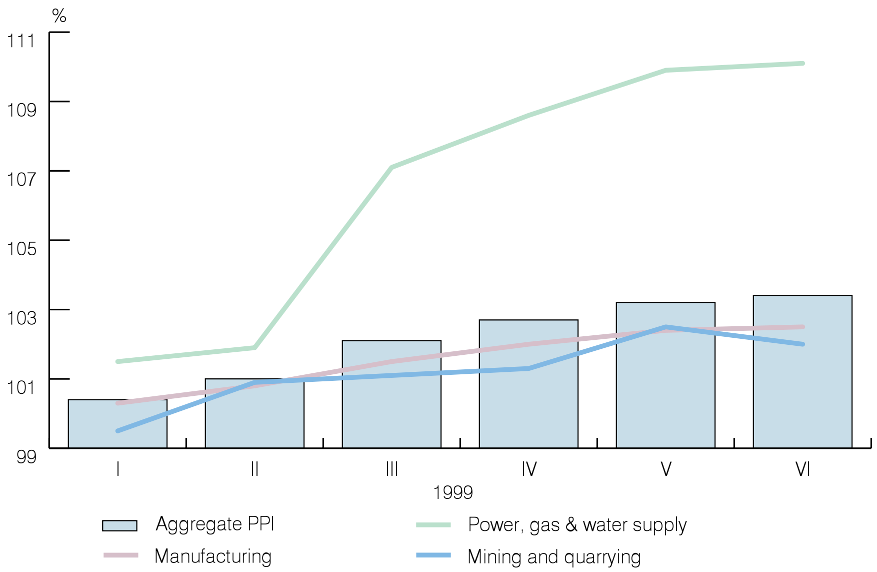
Figure 23
PPI ratio *(previous quarter = 100)*



Slower than last year was also price growth in the manufacturing sector, in both quarters of the first half-year, compared to the corresponding periods last year. The growth was also below average producer price growth. In the first quarter the growth was on average 3.9% (8.2% last year), in the second quarter it increased to 4.4% (7.4% last year). Nonetheless, in this industrial

Figure 24

***Rate of growth in PPI by major sectors** (previous year's December = 100)*



sector too December-to-June growth in prices was higher than a year ago - 2.5% - as against 2.1% a year ago.

During the first half of 1999 there was high growth, much higher than average, in producer prices in sectors: power distribution, gas and water supply. In the first quarter the growth was 6.0% (9.5% last year), in the second quarter as much as 10.5% (10.3% last year). Year-to-date, sector price growth in the first quarter was 10.2% and was higher than in the corresponding period last year: 9.4%. This resulted mainly from the significant growth of prices in sectors “water intake, treatment and supply” and “power, gas, steam and hot water supply”. As shown by the above-mentioned price rises, cost pressure was the highest in this sector. Moreover, there is still no competition in this particular industrial sector to discipline price pressures. Price growth evolution in the three industrial sectors is shown in figure 24.

Factors determining inflationary phenomena in the first and second quarter of 1999

Money and prices in the financial market

Money supply in the first and second quarter of 1999

In the first half of 1999 the total money supply[2] came to 236.2 billion zloty. It increased 15.5 billion zloty compared to the end of December 1998. In nominal terms, the money supply increased 7.0% in the first half of 1999, while its real growth was 2.1%. To compare, the nominal growth rate of the item under consideration during the first six months of 1998 was 9.0%, in real terms: 1.8%.

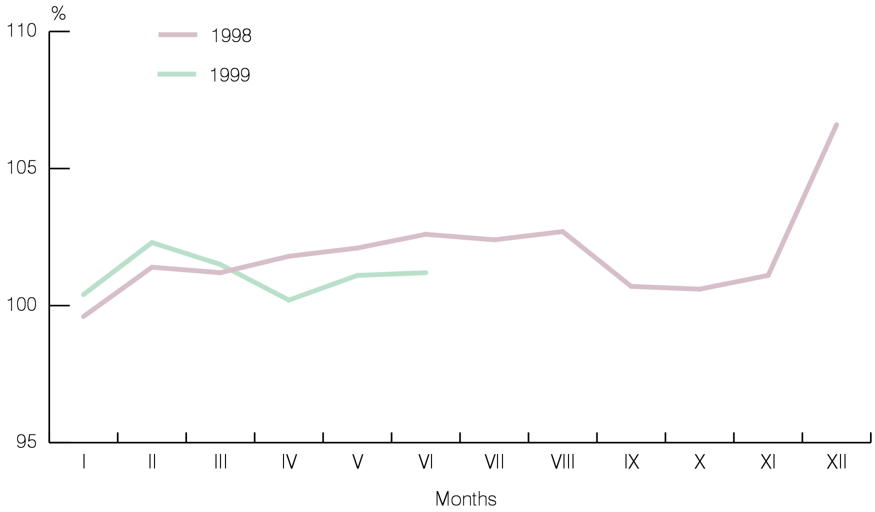
The first quarter of 1999 brought a 9.5 billion zloty growth in the money supply, in the second quarter the money supply increasing 6.0 billion zloty. While in the first quarter of 1999 the rate of growth in the money supply was higher than in the corresponding period last year, in the second quarter of 1999 a considerable weakening of the growth rate was recorded compared to the second quarter 1998 (figure 25). In the first quarter of 1999 the nominal growth of the item in question was 4.3% (in real terms: 1.2%), while in the corresponding period last year nominal growth stood at 2.3% (it fell in real terms: 3.1%). In the second quarter of 1999, in turn, nominal growth reached 2.6% (in real terms: 0.9%), while in the second quarter of 1998 the nominal growth rate was 6.6% (in real terms: 5.0%)[3].

In the first quarter of 1999 there was a growth in the zloty translated value of households' FX deposits. The value of the deposits increased 3.5 billion zloty in the period in question. It grew 14.2%, in nominal terms, on

[2] The definition of the item "total money supply" comprises domestic money stocks together with foreign currency liabilities. The item "domestic money stocks" includes notes and coin in circulation (excluding vault cash) and zloty liabilities in banks on non-financial party accounts (liabilities to persons and corporates).

[3] The compare the rates of growth in money supply in half-yearly and quarterly periods of 1998 and 1999 nominal rates of money supply in the respective periods were used. Real growth rates were calculated employing the accumulating ("period-on-period") CPI rates for the same periods of 1998 and 1999.

Figure 25
Growth in total money supply, nominal terms *(end of previous month = 100)*



last year's end, in real terms:10.7%. The growth was caused by the depreciation of the zloty versus the dollar. In February and March 1999 the rate of growth in notes and coin in circulation was also high.

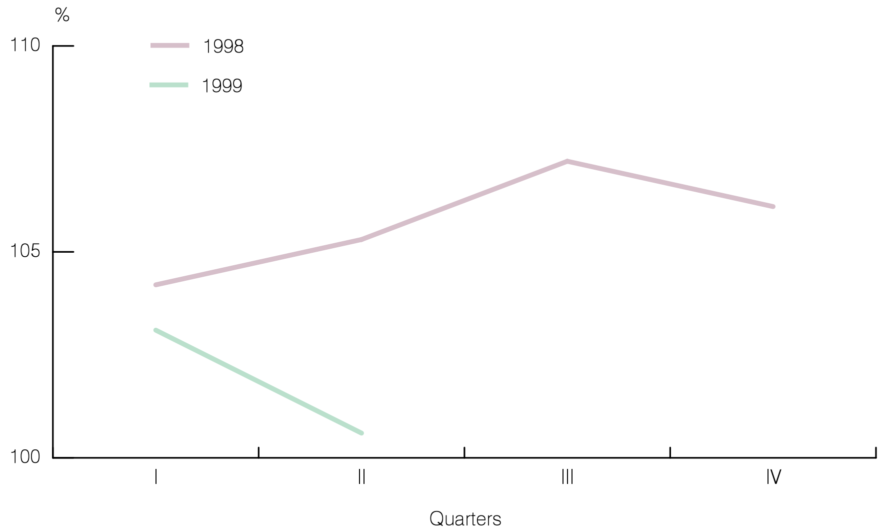
The significant weakening of the rate of growth in the total money supply in the second quarter 1999 is first and foremost the result of a clear decrease in the rate of growth in personal zloty deposits. Zloty appreciation over the successive months of the second quarter resulted in the drop of the rate of growth in FX deposits. At the same time a decrease was recorded, in April and May, in the rate of growth in notes and coins in circulation.

The amount of zloty deposits kept by non-financial parties in the Polish banking system reached 166.2 billion zloty at the end of the first half of 1999. This signifies a growth of 9.3 billion zloty on year-end 1998, i.e. 5.9% in nominal terms (in real terms: 1.1%).

The first half of 1999 witnessed a definite slowdown of growth in personal zloty deposits. By the end of the first half of 1999 deposits kept by persons in bank accounts amounted to 119.2 billion zloty. There was a 9.6 billion zloty growth on top of year-end 1999, which constituted 8.8% in nominal terms and 3.8% in real terms. Nominal growth in the first half of the previous year was 17.5%, while real growth 9.7%.

The downward trend in the real rate of growth in personal deposits started to develop in the fourth quarter of the previous year (figure 26). This phenomenon is attrib-

Figure 26
***Rate of growth in personal zloty deposits, real terms** (end of previous quarter = 100)*



utable to two fundamental reasons. The first half of 1999 saw slower growth in personal incomes, a.o. due to the lower rate of growth in enterprise sector wages. The declining interest of private persons in keeping zloty deposits was also caused by the large cuts in interest on time deposits. In total, from October 1998 to May 1999 the commercial banks slashed average interest on personal zloty time deposits from 16.5% to 10.3% per annum. A particularly severe cut (3.9 percentage points) occurred in the last quarter of the previous year. The severity of cuts in interest rates on zloty deposits may have resulted in households' lower propensity to save.

Corporate zloty deposits amounted to 47.0 billion zloty at the end of the first half of 1999. Compared to year-end 1998 the decline was 0.3 billion zloty. The item in question went down nominally: 0.7%, but in real terms: 5.2%. Significantly weaker growth in corporate zloty deposits occurred in the first quarter of 1999. This was traceable to the more bearish business outlook. In the second quarter of 1999, especially in May and June, the pace of the item in question quickened, on some improvement in the financial standing of corporates.

FX liabilities to the non-financial sector reached USD 9.3 billion at the end of the second quarter of 1999, showing a drop of USD 0.3 billion on last year-end. The zloty translation of FX personal and corporate deposits reached 36.4 billion zloty at the end of the first half of

1999. The increment on year-end 1998 was 2.8 billion zloty and the rate of growth was; in nominal terms: 8.2%, in real terms: 3.2%.

Personal FX deposits, translated into zloty, rose 3.4 billion zloty in the first half of 1999, i.e. up to 27.8 billion zloty. The nominal growth was 13.8%, in real terms: 8.5%. Personal FX deposits at the end of June 1999 totalled USD 7.1 billion. The growth on year-end 1998 was USD 0.1 billion. A drop of the zloty against the dollar, by as much as 14.2%, was an immediate reason why the first quarter of 1999 saw a dramatic growth of such deposits in zloty terms. It should be noted that the February and March zloty depreciation pushed upwards the relative yield on USD deposits. The second quarter 1999 saw a slight drop in the amount of personal FX deposits in zloty terms (in nominal terms: 0.4%), which (especially in May and June) may have resulted from the withdrawal of FX funds in connection with holiday spending in the summer vacation season (figure 27).

The value of zloty deposits kept on corporate accounts reached 8.6 billion zloty by the end of June 1999, showing a nominal drop of 6.7% (in real terms: 10.9%) from year-end 1998. The dollar value of corporate FX deposits increased USD 0.4 billion over the first half of 1999, up to the level of 2.2 billion USD. The steady rise in the rate of growth in corporate FX deposits observable in subse-

Figure 27

Rate of growth in personal FX deposits, nominal terms *(end of previous month = 100)*

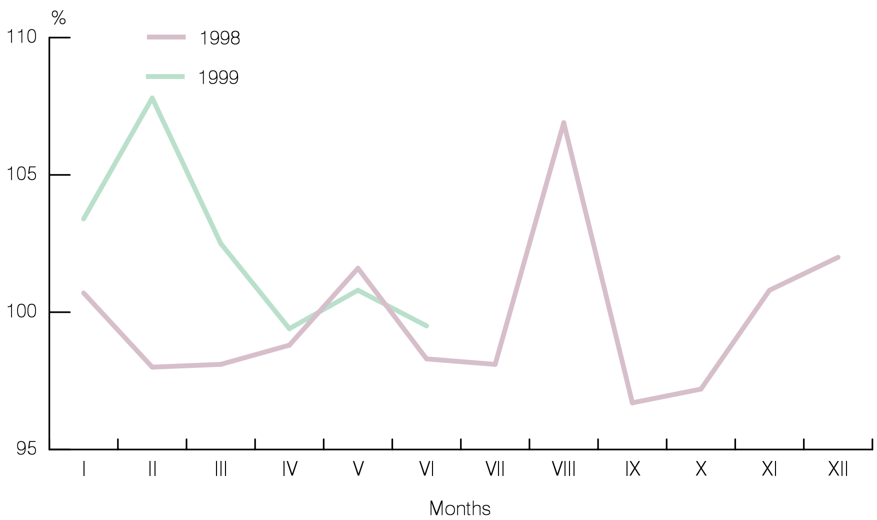
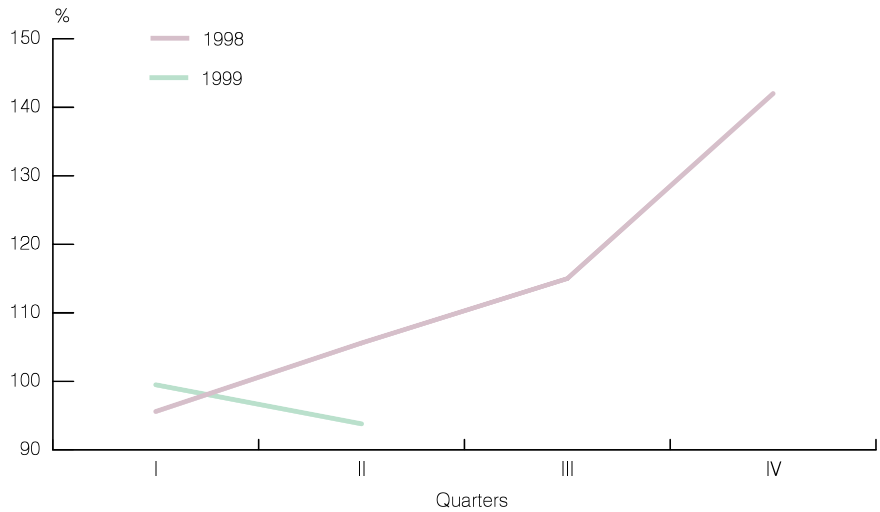


Figure 28
Rate of growth in corporate FX deposits, nominal terms (end of previous quarter = 100)



quent quarters of last year ceased during the first half of 1999 (figure 28). The first quarter brought a slight (0.5%) nominal drop of the item in question. The drop of deposits was much higher in USD terms, but the strong zloty versus dollar depreciation contributed to maintaining the amount of deposits in zloty terms at a largely unchanged level. The second quarter brought a considerable nominal drop (6.2%) in zloty translated FX deposits.

Let us recall that last December saw a surge in corporate FX deposits primed by the floatation of Telekomunikacja SA bonds on international markets totalling USD 1 billion. The fall in deposits which was noted in the first half of 1999 can thus be interpreted as return to the level resulting from the stable growth trend line before December 1998.

Zloty versus dollar volatility directly impacts the amount of the non-financial sector's FX deposits which is recorded on the balance of the banking system in zloty translation. At the same time on-going changes in the rate of exchange, as well as future rate of exchange expectations, are becoming important criteria with which to assess the appeal of depositing funds of the non-financial sector on FX accounts, especially in the environment of steady reduction of interest on zloty deposits by commercial banks.

The supply of notes and coin in circulation (excluding vault cash) reached the level of 33.6 billion zloty at year-end 1999 and grew 3.4 billion zloty on last year-end. The nominal rate of growth in this item in the whole of the first quarter of 1999 was 11.2%, of which the growth in the first quarter was 6.0% and in the second quarter it was 5.0%. The real rate of growth in notes and coin in circulation in the first half of 1999 was 6.1%.

The high growth rate of notes and coin in circulation in the first half of 1999 resulted, not unexpectedly, from additional wage and salaries payouts at the end of the year, as well as wage-rises in the general government sector. It should also be noted that in the second half of 1998 commercial banks were systematically lowering interest on funds kept in personal accounts (ROR). Between June 1998 and May 1999 rates were cut 5.5 points (from the average level of 12.8% per annum to about 7.3%). The most dramatic monthly rate cut - of 2.6 percentage points - happened in January. The falling opportunity cost of keeping money in cash may have also contributed to the increasing of amount of notes and coin in circulation.

April and May 1999 witnessed a slower rate of growth on this item. However, as early as June the rate of growth of notes and coin in circulation clearly ascended, which may be in connection with the disbursement of the overdue “thirteenth salaries” in part of the general government sector units, as well as withdrawal of part of the

Figure 29

Rate of notes and coin in circulation, nominal terms *(end of previous month = 100)*

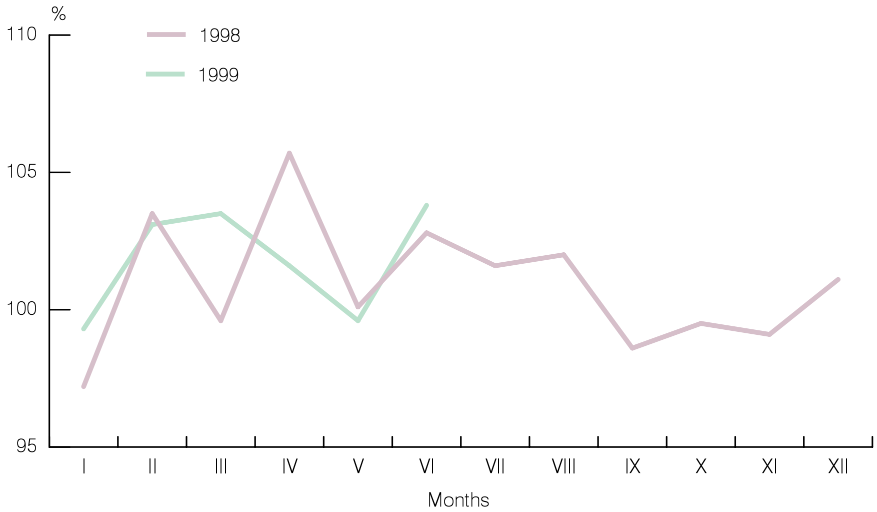


Table 1
Factors in money creation in the first half of 1999

Items	Increment, I half of 1999 million zl	Share in half-yearly increment %
Total money supply	**15,459.1**	**100.0**
Net foreign assets	3,518.6	22.8
Claims on persons and corporates	17,309.5	112.0
General government debt	4,001.7	25.9
Net balance of other items	-9,370.7	-60.7

money for holiday spending during the summer vacation season (figure 29).

The recent years saw some growth in demand for money in connection with the growing monetisation of the economy. This trend results from the steady fall in inflation, as well growing availability of services offered by financial institutions, both to persons and corporates. Consequently, the share of the sector's financial assets is growing. These assets are not used directly for transaction purposes. Still, their growth has some impact on the rate of growth in M2.

Factors in money creation

Claims on persons and corporates have for some years now constituted the main factors of money creation within the banking system. At the end of the first half of 1999 the basic trends in the growth structure of the money supply have been kept unchanged compared to the situation at year-end 1998. This is illustrated by table 1.

In the first half of 1999 65.9% of the total money supply[4] in the banking system was created by claims on persons and corporates[5], of which claims on corporates accounted for 54.0% and claims on households 12.0%. Total assets resulting from claims on persons and corporates reached by the end of June 155.8 billion zloty. In the first half of 1999 nominal assets grew slower than the year before, reaching by the end of June a growth of 12.5% on

[4] The balance of the remaining net items was included in calculations.

[5] The claims include all types of loans, irrespective of their standard, as well as purchased debt, guarantees (bank, Civil Code and endorsements), interest, claims on subsidies to intererest on agricultural preferential loans.

December. The year-on-year rate of growth in personal and corporate loans was lower than last year (compared to the corresponding month of the previous year). The rate of growth in personal loans was higher than that of corporate loans (18.5% and 11.2%, respectively). Starting from March this year also monthly growth rates of personal loans were higher than those for corporate loans. However, borrowing demand resulted mainly from the requirements reported by enterprises, as these accounted for 74.4% of six monthly debt increment in the banking system (86.0% - in the first quarter and 58.3% - in the second quarter). Moreover, the funding of enterprise operations out of non-banking sources (payables, foreign loans, equity) was not high enough to radically bring down their demand for loans from the banking system. The analysis of reports from particular enterprises (F-01) has pointed to a rather high concentration of indebtedness - the funding of operations by means of bank credit facilities was used mainly by the biggest enterprises. A large part of credits did also go to unprofitable enterprises. Besides, due to the subdued financial performance of enterprises, there was less credit repayment capacity out of total revenues. The share of assets classified as irregular from the non-financial sector rose slightly to constitute 11.3% of total claims on the non-financial sector.

In the particular quarters of 1999 the distribution of growth in corporate and personal loans was uneven. The rate of growth of claims was 7.3% in the first quarter and 4.9% in the second quarter.

Of all claims on persons and corporates at June-end zloty claims constituted 80.0% and their share increased on last December, while the share of FX denominated claims in the corresponding period decreased to 20%. The reduced share of foreign exchange denominated claims resulted from their slower growth in the first half of 1999 compared to last year (this is particularly true of the second quarter of this year). The magnitude of changes in the structure of claims was determined by the considerably decreased interest of businesses in foreign exchange loans (negative rate of growth) in the second quarter of this year.

Short-term claims of the non-financial sector[6] (up to and including one year) at half-year-end 1999 grew faster

[6] Non-financial sector claims are lower than claims on persons and corporates by the group of claims from insurance institutions, from other non-bank financial institutions and the value of debt securities and repo operations.

from December 1998 than long-term claims, standing at 12.5%. These constituted 41.5% of total claims on the non-financial sector. Down also went the proportion of short-term foreign exchange denominated claims.

Net foreign assets[7] in the first half of 1999 decreased USD 2,081 million to reach by the end of June 1999 USD 25,397 million and their drop was fairly evenly distributed over the particular quarters - by USD 982 million in the first quarter and USD 1,100 million in the second quarter.

The declining trend was caused first of all by the strong appreciation of the US dollar vis a vis other currencies which resulted in the reduction of the dollar value of net foreign assets[8].

The first half of 1999 saw the widening of deficit on the current account compared to the corresponding period last year. This resulted first and foremost from an increased deficit on merchandise trade and services and reduction of the surplus on unclassified current transactions.

In the first half of 1999 the deficit on the current account stood at USD 5,001 million and was USD 2,338 million higher than the deficit in the first half of 1998. The year-on-year ratio of the current account deficit to GDP significantly deteriorated: it was 4.6% for the first quarter of 1999 and 5.9% for the second quarter of 1999[9].

Receipts from the statistically registered balance of payments in merchandise exports totalled 13,284 in the first half of 1999. They have thus fallen 9.8% from last year (in the two subsequent quarters: USD 7,012 million and USD 6,272 million, respectively). With import

[7] Net foreign assets cover the gross official reserves disposed of by the NBP, other foreign assets in convertible currency, less short-term bank liabilities and IMF loans, as well as other claims on non-residents, such as loans oustanding, issue of securities, subordinated debt, borrowings with stated maturities over one year, claims in non-convertible currency and other illiquid assets.

[8] The more precise determination of the impact of movements in the US dollar against other currencies pertains to the gross official reserves constituting the bulk of net foreign assets. The gross official reserves fell 1,534 million USD to the level of 25,848 million USD. However, the fall resulted solely from the rallying USD. This factor sent the reserves down by 2,108 million USD. Had the value of the dollar in world markets stayed unchanged in the first half of 1999, the official reserves would have climbed 574 million USD in the period. The scale of reduction in net foreign assets and the gross official reserves was similar in the period, which contrasted with 1998, when in the first half of the year the official reserves grew 75% faster than net foreign assets.

[9] The current account deficit and GDP are presented, respectively, for the first quarter as the total of the second, third and fourth quarter of 1998 and the first quarter of 1999; for the second quarter as the total of the third and fourth quarter of 1998 and the first and the second quarter of 1999.

remittances totalling USD 19,474 million and signifying a drop of 6.6% (in the subsequent quarters USD 9,833 million and USD 9,641 million), the deficit on merchandise payments stood at USD 6,190 million (quarterly: USD 2,821 million and USD 3,369 million).

The balance of foreign trade was negatively impacted mainly by falling demand for Poland's exports. What played a stabilising role though were the factors which kept dragging import growth down, namely the reduced growth in domestic demand, as well as in zloty depreciation.

Receipts on services in the first half of 1999 totalled USD 1,516 million, signifying a 8.5% drop compared to the corresponding period in 1998 and remittances grew 21.4%, reaching the level of USD 2,279 million. Consequently, a deficit of 763 million USD arose. The source of widening disequilibrium were first of all negative balances on other trade services, construction services, foreign travels and patents, copyright and license fees, with a simultaneous wipe-out of the surplus on transportation services. Disequilibrium in service transactions has been widening since early 1998[10]. In the first months of 1999 a trend could be observed towards lower receipts along with a slight growth trend in outlays. In transportation services (which have so far compensated for the deficits arising in all other types of services) this phenomenon is connected first and foremost with the fact that the level of merchandise trade has been reduced - primarily in the Eastern direction - and with the administrative restrictions on Polish hauliers imposed by EU partner countries. Poland, due to its rapid economic development, its accelerated integration with its environment and the structural gap in most modern services can be expected to be their net importer in the coming years.

The deficit on settlements resulting from income on foreign liabilities and assets held by domestic parties stood at USD 364 million (in the first half of 1998: USD 192 million). Proceeds totalled USD 1,018 million (USD 1,196 million, respectively) and outlays USD 1,382 million (USD 1,388 million, respectively). The emergence of the deficit was contributed to by negative balances of set-

[10] This is caused by the shrinking positive balance of services: other trade services, foreign travels, postal, courier and telecommunication services, patents, copyrights and licence fees, financial, IT and information services. In 1996, 1997 and 1998 the total deficit in all types of services, except transport, stood at: USD 574 million, USD 376 million and USD 974 million, respectively. In the first half of 1999 it was USD 822 million.

tlements on income from foreign direct investments and the repayment of interest on borrowings. Surpluses reducing the deficit on the overall income item came from income on debt securities, primarily from the foreign exchange reserves placed by the NBP in securities.

The surplus on transfers totalling USD 732 million resulted both from the positive balance of governmental sector transfers (USD 99 million) and the positive balance of transfers from the remaining sectors (USD 633 million). Official transfers were chiefly composed of donations and non-refundable assistance from foreign governments. Critical to the surplus in transfers to the other sectors were primarily funds transferred by Poles living abroad to their families at home.

The surplus of receipts over outlays on the item "unclassified current transactions" stood at USD 1,584 million in the first half of 1999. This was thus USD 1,294 million less than in the previous year, a considerable drop; in quarterly terms USD 799 million and USD 785 million, respectively. To compare, in 1998 the surplus earned in the second quarter (USD 1,715 million) was actually higher than the first quarter surplus (USD 1,163 million). This item of the balance of payments consists of foreign exchange bank operations resulting from cross-border trade, as well as unregistered export and import operations (primarily with countries of the former USSR), tourism, unregistered remittances from work undertaken by Polish people abroad, resale of cash. The collapse of cross-border trade, which became manifest in September and the subsequent months of 1998, was still the case in the first half of 1999. The devaluation of the rouble and the other CIS currencies altered price differentials and reduced the appeal of shopping at Polish open-air markets. Furthermore, there is growing competition from Asian countries. A drop in purchases was noticed primarily in Warsaw (Mazowieckie Voivodship) and Eastern voivodships: Lubelskie (Lublin), Podkarpackie (Rzeszów) and Podlaskie (Białystok) Voivodships. The drop in purchases affected first of all US dollars, which in the first half of 1999 constituted merely 29.7% of total purchased funds. The surplus of receipts over outlays on unclassified current transactions in the first half of 1999 covered merely 25.8% of the deficit on registered merchandise trade.

In the first half of 1999 the surplus on the capital and financial part of the balance of payments totalled merely

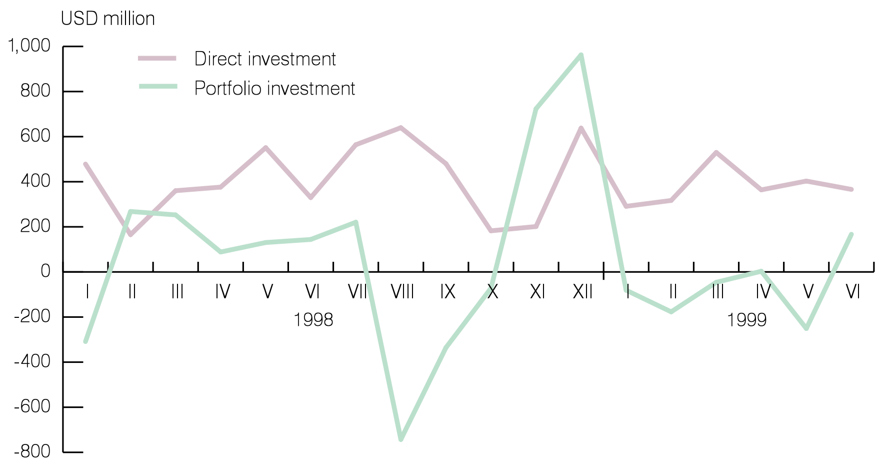
USD 2,880 million and in the first half of 1998 it was USD 5,434 million. The main differences were observed in portfolio and other investments.

The net inflow of capital in the form of foreign direct investments remained at last year's level, standing at USD 2,287 million. Thanks to favourable opinions on the Polish economy, continuation of the structural reforms, prospects of Poland's EU accession and also its favourable ratings from world rating agencies, there has been continued interest of foreign investors in investments and participation in Poland's privatisations.

The first half of 1999 saw an outflow of capital in the form of portfolio investments of USD 385 million (which includes both foreign and Polish capital). There's been a significant increase in securities based operations. The inflow and outflow of capital on this account came to the level of USD 26 billion compared to USD 15 billion in the first half of 1998. The breakdown has also changed: in the first half of 1999 Polish capital dominated in portfolio investments abroad, mostly in debt securities (and presumably derivatives) - see figure 30.

The use of long-term loan instruments accounted for USD 1,382 million (USD 1,259 million in the corresponding period of the previous year). On the other hand, what has significantly gone up is the value of repaid principal instalments from USD 592 million to USD 954 million.

Figure 30
Balances of direct and portfolio investments, Jan 1998 - June 1999



There was a drop of USD 236 million in foreign deposits at Polish banks (in 1998 those grew by USD 201 million). At the same time Polish banks were withdrawing deposits from foreign banks, but the scale of such operations was much lower than in the first half of 1998. The balance of receipts and outlays on current accounts and placements of Polish banks with foreign banks stood at USD 600 million (compared to USD 1,792 million in the first half of 1998). Placements withdrawn from foreign banks increased the surplus on the financial account of the balance of payments.

The servicing of the foreign debt in the first half of 1999 totalled USD 1,850 million, of which USD 896 million was paid on account of interest on loans and debt securities and USD 967 million on account of principal instalments.

Net general government debt with the domestic banking system increased 3.9 billion zloty on December 1998, i.e. 6.4%, to reach 65.2 billion zloty at the end of June 1999.

A dynamic growth of net general government debt resulted from the high public sector borrowing requirements, in particular the necessity to fund the growing fiscal deficit of the central government. The level of debt was also influenced by the amount of funds raised from other than banking system sources of funding, i.e. from the sale of privatised national assets and from non-banking parties (including foreign ones), investing in the domestic market of Treasury securities. The rate and direction of changes in net general government borrowing in the period under consideration were conditioned by the above factors.

Despite the fact that in the first three months a considerable inflow of funds was recorded, both from the non-banking sector (about 4.0 billion zloty) and privatisation (about 1.9 billion zloty), it was not enough to cover the high requirements reported by general government. The high budget shortfall - reaching 8.7 billion zloty, i.e. 68% of the acceptable level approved in the 1999 Budget Act - came primarily from extraordinary items, mainly relating to the funding of structural reforms being launched and foreign commitments totalling of 0.7 billion zloty - was covered mainly by funds from the banking sector. In consequence, in the first quarter general government contracted a bank credit of 2.6 billion zloty.

In April and May of the current year the surplus of general government outlays over receipts was largely curtailed (the negative balance of the budget deepened merely 1.5 billion zloty), which coupled with a still high involvement of the non-banking sector in the purchase of securities (about 3.4 billion zloty) allowed to decrease by 0.8 billion zloty the net general government debt to the banking system.

The significant deterioration of fiscal equilibrium largely contributed to the renewed growth of net central government debt in June. The fiscal deficit grew about 1.1 billion zloty to reach at the end of June this year 11.3 billion zloty, or almost 88.4% of the ceiling for the whole of 1999. This was compounded by lack of funding from non-bank sources and low privatisation revenues, which under the high public sector borrowing requirements contributed to a dramatic growth, of 2.1 billion zloty, in net lending to general government from the banking system. As a result, in the second quarter of 1999 net lending to general government grew almost 1.3 billion zloty and its rate of growth was 2.0% against 4.3% recorded in the first three months of 1999. Despite June results the pressure of general government on growth in money stocks can be said to have weakened in the second quarter.

It should be emphasised that a factor which kept pushing up the level of net general government debt in the second quarter of 1999 was growth in net liabilities of the remaining components of general government (local government budgets and non-budgetary funds). This was indicative of their deteriorating financial situation. In the first quarter this year other general government still showed high surpluses of assets over liabilities, and thus helped reduce the debt level.

The adverse financial situation of general government in the first half of this year increased the role of this sector in generating money supply. Although not a prime source of increment in the money supply, its share in money creation was still high: 25.2%. It should be underlined that in the corresponding period of last year a drop in general government debt with the banking sector was noticeable, which means that general government was a factor causing absorption of total money stock.

The share of net general government debt in the change of the money supply for the months of the period in question is illustrated by figure 31.

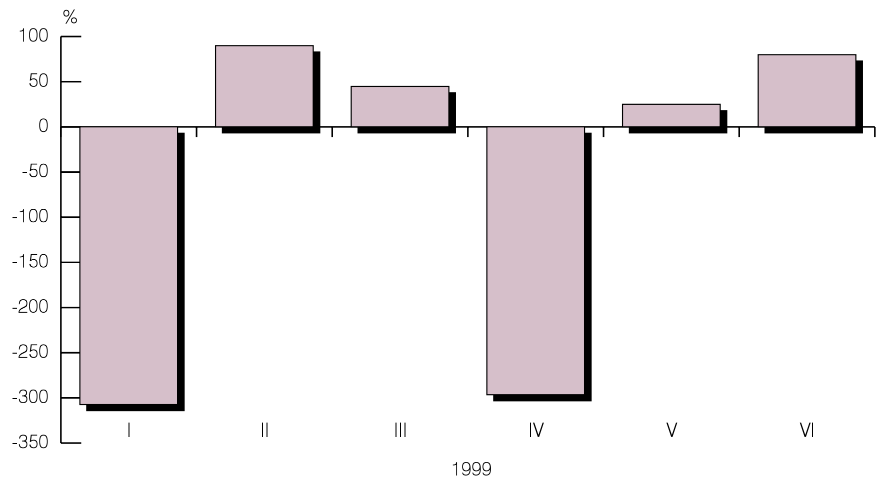
The effectiveness of transmission channels in the first and second quarter of 1999

Interest rate channel

The central bank's interest rate influences interest on short-term interbank deposits, and the latter impacts interest on loans and deposits at commercial banks. Interest on loans and deposits, in turn, has bearing on households' decisions relating to savings and consumption and on corporate decisions to invest. Consequently, the interest rate is one of the factors which determine demand and inflation.

Since last year the NBP has employed the so-called strategy of direct inflation targeting. The interest rate is the main instrument used to achieve targeted level of inflation. The fundamental problem which one has to face when an inflation target is to be achieved by means of an interest rate is uncertainty as to the model of transmission and its stability. Due to disturbances that affected the aggregate supply curve underwent in the past, it is difficult to trace the exact shape of the short-term relationship between inflation and the output gap. Under the

Figure 31
Share of net general government debt in change of total money supply, Jan - June 1999



considerable uncertainty interest rate policy should be gradualist. Last year, the NBP rates changed rather often.

NBP interest rate policy in the first and second quarter of 1999

The cuts in base interest rates (by 250 - 300 basis points) done by the Monetary Policy Council on January 20, 1999 ment the continuation of the practice to gradually adjust monetary policy instruments. Such policy was employed in 1998. However, such manner of conducting interest rate policy resulted in certain side-effects. The expectations of further interest rate reductions acceptable by the central bank in 1998 under tumbling inflation, became undesirable in 1999 when economic activity was declining fast. The strong expectations of further cuts in interest rates could result in undesirable pressure on zloty appreciation, resulting from the inflow of short-term capital and the widening of the current account deficit.

As the Monetary Policy Council was expecting a significant drop in inflation (as measured by the year-on-year CPI) at the beginning of 1999 and then its slight rebound, the Council took the decision to change interest rates to such extent that it simultaneously made it possible to achive to target and dump expectations of further, significant reductions in interest rates. The reduction of interest rates under growing inflation could be interpreted by businesses as the loosening of monetary policy, even if the achievement of the inflation target was not endangered.

Reaction of market interest rates

The intention of the Monetary Policy Council is to control interest on interbank deposits with maturities comparable to the maturity of the main type of NBP open market operations (in the period in question it was the issuance of 28-day NBP bills). The yield on instruments with longer maturity is to be determined by the market, to enable the monitoring and analysis of the inflation and short-term interest rates expectations.

After the lowering of NBP interest rates of interbank deposits with maturities comparable to the maturities of open market operations stabilised above the NBP intervention rate (figure 32). The yield on instruments with longer maturity after the initial drop started to rise gradually. This influenced the shape and positioning of the yield curve.

Promptly after the decision of the Monetary Policy Council the yield curve of Treasury securities went down by 123 basis points in the short end (3 months) and 18 basis points in the long end (5 years) (figure 33).

The yield curves in the first half of 1999, just like in the whole last year, had a negative slope. The main factor determining the beginning position of the curve in the first half-year was the decision of the Monetary Policy Council to lower NBP interest rates. Soon, after the lowering of interest rates, the yield on Treasury securities fell to the lowest point in the whole period under analysis. Subsequently, the yield started to rise gradually, which was reflected in the upward shift of the curve, with a simultaneous change in its shape. Investors' growing uncertainty as to the future economic situation of Poland led to more violent, than in the last quarter of 1998, swings in the yield on Treasury bonds and upward movement of the yield curve.

Diversified signals, received by the financial market in the first half of this year, led to a situation when the yield on Treasury securities with a longer maturity (two-year and five-year bonds) showed dramatic swings. The maximum rise in five-year bond yield from the January mini-

Figure 32
NBP intervention rate and WIBOR 1M/3M/6M rates

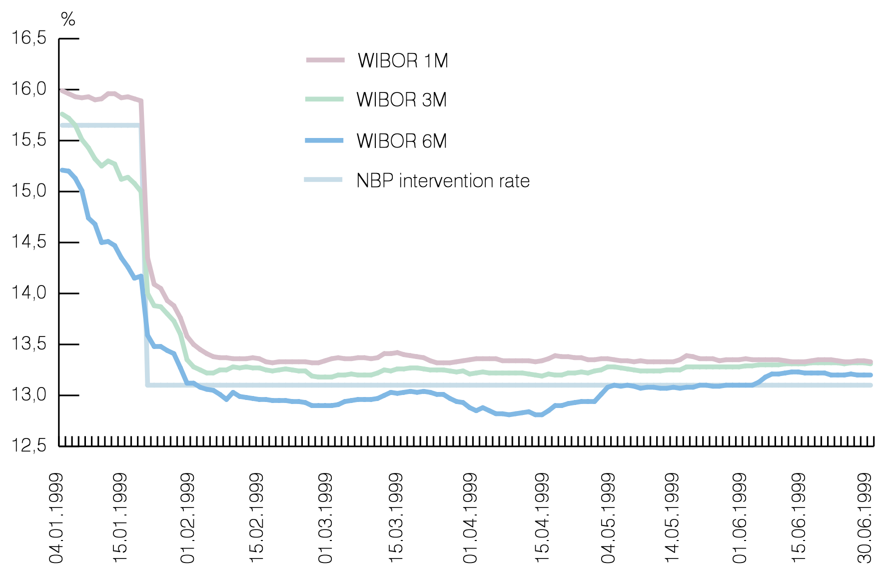
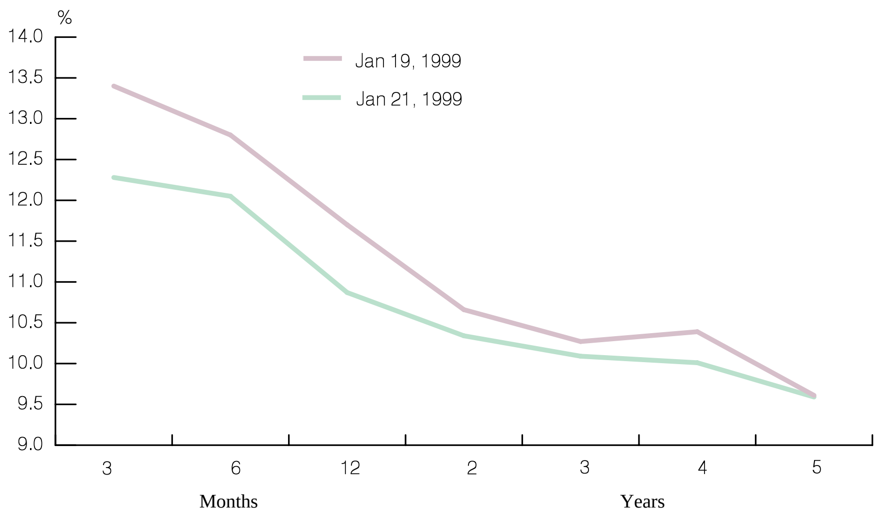


Figure 33
Yield curve day before and day after change in interest rates Jan 20, 1999



mum was about 120 basis points (end of May 1999). These trends resulted in the long end of the curve (bonds with maturities up to 5 years) climbing from February to June by 33 basis points and the short end only by 11 basis points[11]. The yield on one-to-three-year bonds (from about 65 to 95 basis points) went up most, which resulted in the change of the curve's shape into a more concave[12] (figure 34).

The stability of the short end of the curve can be explained by the lack of changes in the NBP reference rate. A considerable growth in the yield on instruments with medium maturities resulted from the emergence of factors increasing - in market perception - investment risk within this time horizon. The relatively low drop in prices of the instruments with a long maturity reflected a favourable long-term perception of Poland and of expectations as to the yield on Polish financial instruments converging with Euroland levels.

The upward movement of the yield curve for Treasury securities could reflect growing inflationary expectations in the financial market. But this was not confirmed by surveys. Polish banks' inflationary expectations were systematically falling (figure 35). The figure presents inflationary expectations formulated with respect to CPI, 12

[11] This is the difference between the average monthly yield levels.

[12] A function is concave towards the origin, if its second derivative is negative (its shape is similar to reversed U).

Figure 34
Monthly yield curves - Treasury securities market

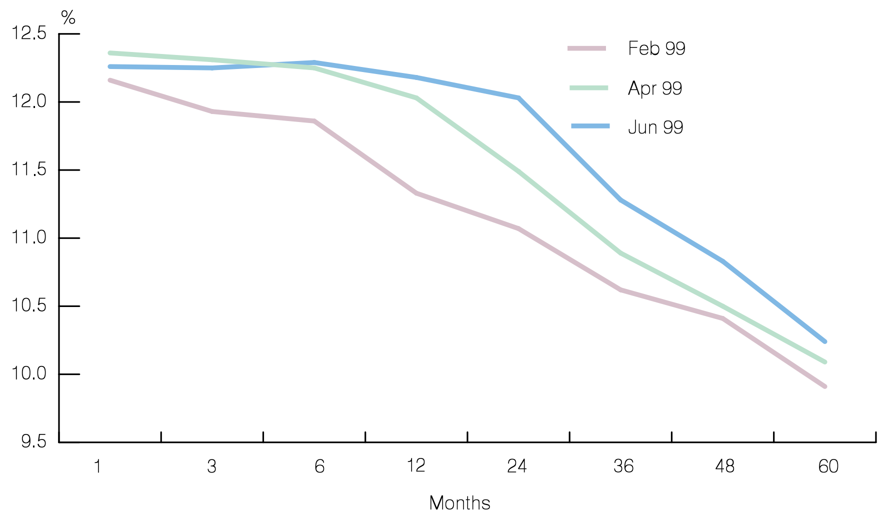
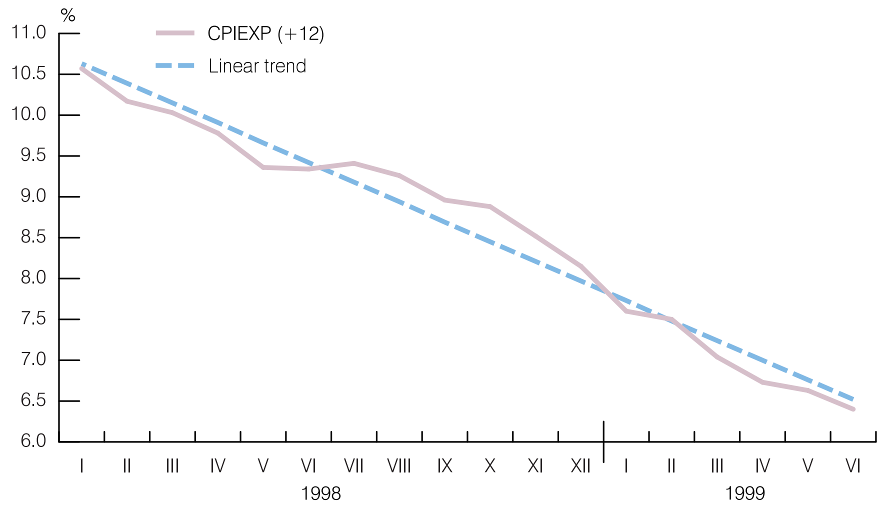


Figure 35
Rate of inflation expected by banks over next 12 months



months ahead, obtained from Reuters questionnaire. It should be emphasised that the events of the first half of 1999, especially the NBP interest rate cuts, exerted no major impact on such expectations. The upward shift of the yield curve and particularly growth in the required yield on medium-term instruments may reflect the emergence of factors which, in the market's opinion, rise the risk of NBP interest rate hikes in order to sustain the falling inflation trend.

The growth of the risk was the result of the interaction of several factors spread over time: negative signals as to the economic situation in Poland (low rate of economic growth, deterioration of internal and external conditions), expiration of the market's expectations of further fall in interest rates, negative signals received from other emerging markets, as well as a general growth trend in long-term interest rates in developed economies.

The first of the factors causing the reversal of the falling trends in mid and long-term interest rates was the information on Poland's economic activity in the fourth quarter of 1998 and early 1999. The news of the accelerated growth of the fiscal deficit that resulted in growing supply of Treasury securities, and signals of the deteriorating current account of the balance of payments, were negatively received. Also the projections of the 1999 economic growth in Poland, published by many research centres, were considerably revised downwards, compared to the official assumptions. All those factors contributed to the depreciation of the zloty in the first quarter of this year and rise in investment risk. This was reflected in the growth of the minimum yields of the financial market instruments required by the investors.

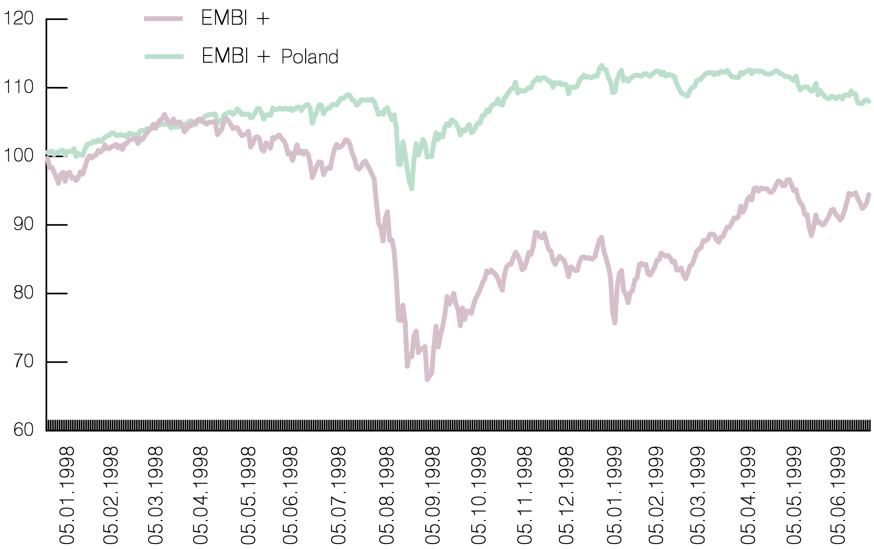
A second factor pushing in the same direction was the fact that the arrival of more bad news and events could no longer be offset by expectations of further interest rate cuts. In the fourth quarter of 1998 many domestic and foreign financial institutions were buying Treasury securities speculating on further growth in their prices (drop in yield) and capital gains. The reason was that so many cuts in interest rates led market participants to believe that investments in fixed securities bring high and secure income. The investment strategy assuming regular and frequent cuts in interest rates constituted one of the reasons for the fast drop in the yield of securities over the period in question. The stream of speculative capital in the expectation of lower interest rates created a trend of falling yield on such instruments. Investors paid less attention to other factors possibly relevant in the valuation of bonds. With no more expectations for further interest rate cuts, investors were more concerned about the trends in real economy. Investors' uncertainty about its health was reflected in the gradual increase of the required return.

Due to the fact that Poland is classified by foreign financial institutions as one of the emerging markets, Polish financial market is considerably exposed to events in other countries within the same group, even if Poland does not have economic ties with them. Early first quarter of 1999 the situation in emerging markets was affected by the Brazilian crisis resulting in the growth of the premium required by investors for risk of investing in the countries. The crisis impacted the behaviour of investors, foreign and domestic alike, until the end of February. With the gradual appreciation of the Brazilian real, the contagion effect produced by the Russian crisis in August 1998 has vanished. This factor and lack of expectations for further NBP interest cuts contributed, on the one hand, to growth in yield on securities and, on the other, to the weakening of the zloty. Also the war in Yugoslavia prompted investors to close out their investment positions in Europe, which led to an increase in yield on European long securities (including the ones issued by East European countries) interrupted briefly after the cuts in Eurozone interest rates.

The impact of the developments in emerging markets on the risk premium for investing in Poland can be analysed by using of the Emerging Markets Bond Index Plus (EMBI+) developed by JP Morgan. It shows the total of gains realised on certain types of financial instruments (foreign currency denominated bonds, loans, Eurobonds and other local market instruments) issued on emerging markets. Assuming that movements of the EMBI+ index are connected primarily with changes in prices of the assets in question, it can be hypothesised that Poland, as against other emerging markets, has less volatile financial market (see figure 36).

The fourth factor critical to changes in trends on the domestic financial market was the evolution of the situation on mature markets. In the first half of the year interest on 10-year US and German government bonds was systematically going up along with the stabilisation of the situation in emerging markets, approaching the level from before the Russian crisis. In the first quarter of this year the rising yield on such instruments resulted from a correction following its sharp drop after the Russian crisis and the phenomenon described as "flight to quality".

Figure 36
Poland vs. emerging markets

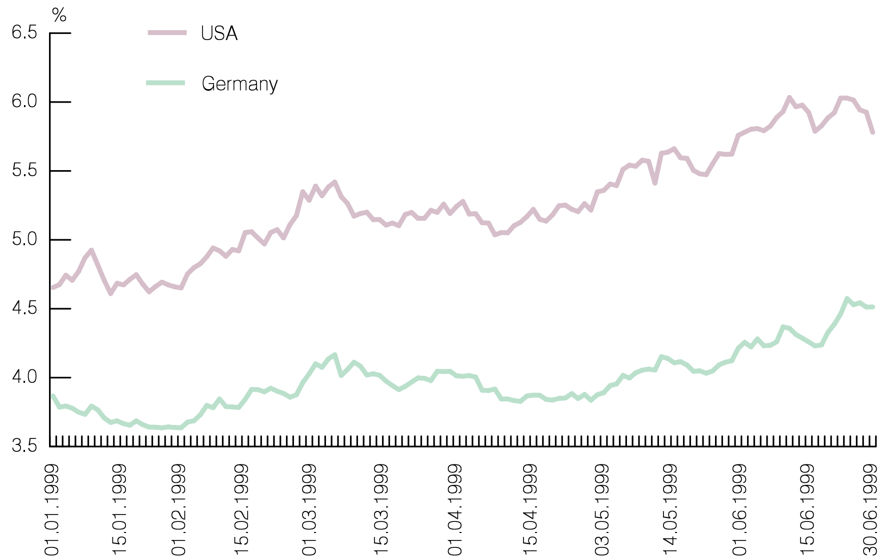


The figure presents the values of EMBI+ and EMBI+ for Poland, their values as of Jan 2, 1998 taken as 100.
Source: JP Morgan.

The yields of zero-risk instruments then fell to one of the lowest levels since the end of the Second World War. In the second quarter, particularly in June 1999, growth in yield on long-term instruments was boosted by strong interest rate rise expectations in the USA (figure 37). As it was expected by financial markets, on June 30 FED increased the interest rate on federal funds by 25 basis points to 5%. It was the first change since November 1998 when in order to stabilise the situation on the world financial markets FED added liquidity to the US economy. The US interest rise expectations influenced, in turn, the level of interest rates in the Eurozone. Despite the fact that on April 8 the European Central Bank cut the repo rate (the principal ECB refinancing rate) by 50 basis points to 2.5%, the associated drop in short-term interest rates, did not hamper growing trend in long-term interest rates.

The growth in long-term interest rates in countries with highest investment ratings could not pass unnoticed in the Polish securities market. The bond market reacted to signals coming from the international financial markets with a growth of yield on Treasury securities (figure 38), including ten-year bonds issued for the first time in May 1999. This was an important milestone, because

Figure 37
Yield of 10-year US Bonds and German Bunds

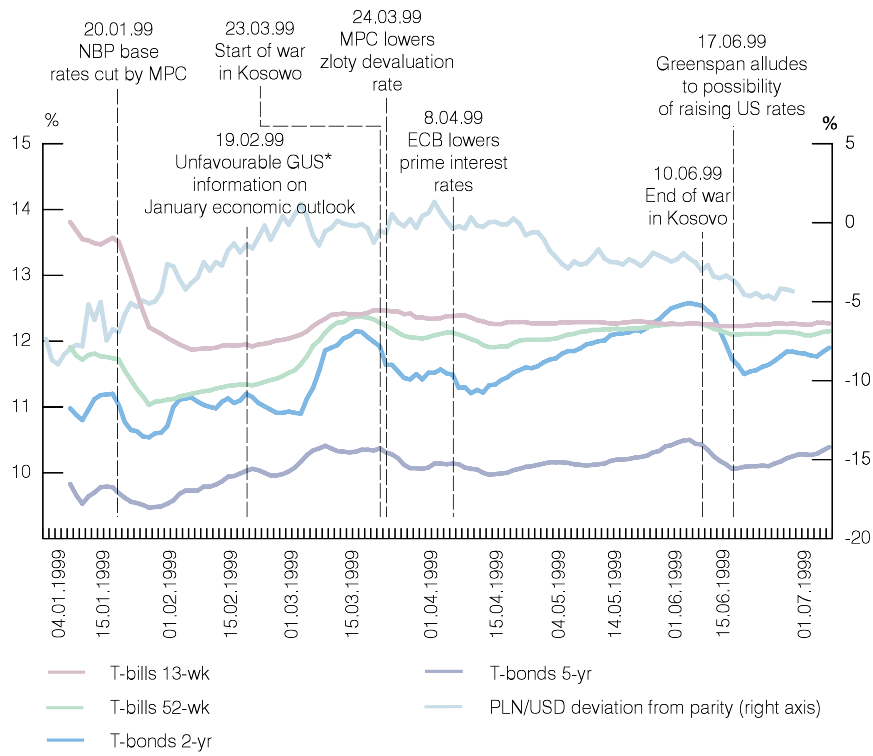


the level of long-term interest rates is a criterion to qualify for the Economic and Monetary Union as represented by the yield on ten-year fixed rate Treasury bonds. It cannot exceed - by more than 200 basis points - the average level of yield on the same instruments issued by three Eurozone countries with the lowest inflation rate. At the first tender in May 1999, the average yield on the ten-year fixed rate bond was 8.61%, the issue totalling 200 million zloty. By the end of June the yield on this instrument rose to 8.85%, while the yield on a similar reference instrument in the Eurozone (i.e. ten-year Bund) was 4.51%. Consequently, in mid-1999 the gap between the yield on the Polish ten-year bond and the reference yield constituted 434 basis points and exceeded the Maastricht eligibility criterion by 234 basis points.

Interest rate response at banks to central bank policy

NBP decisions have also been reflected in interest rates on instruments offered by commercial banks to non-financial system. It follows from NBP research that the biggest commercial banks usually set interest on deposits mostly in relation to the lombard rate, although of interest in the interbank market and interest offered by the major competitors are important. Interest on loans is mostly influenced by interest rates on the interbank mar-

Figure 38
Yield on 13- and 52-week T-bills and 2- and 5-year T-bonds (weekly moving average) against major events



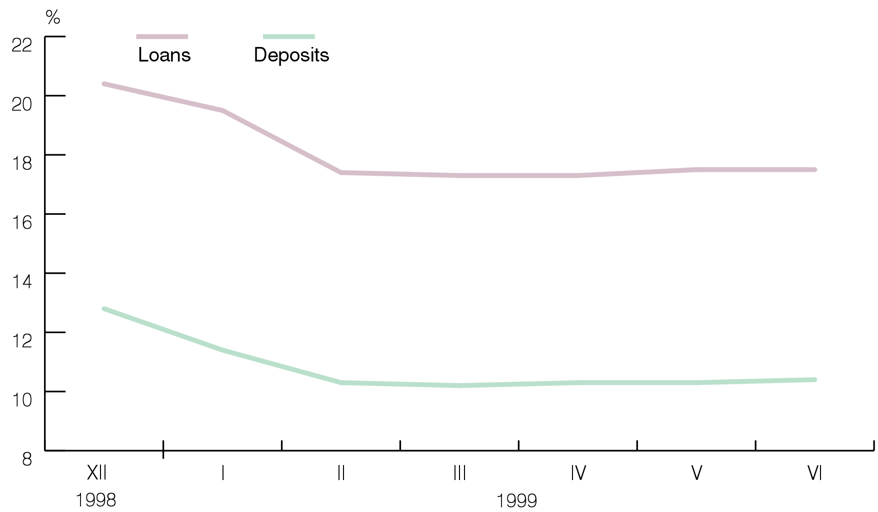
*Central Statistical Office - GUS

ket (primarily the one-month WIBOR rate). The WIBOR 1M, in turn, strongly depends on the rate of interest on 28-day NBP open market operations.

Interest on deposits and loans was falling mainly in January and February, following two cuts in base interest rates by the NBP - the first one last December and the second in January 1999. In the first half of January interest was changed by these banks which had not cut interest in the wake of the December change in NBP base interest rates. At the end of January and in February banks changed their interest rates after the lowering of NBP rates in January. Interest on loans and deposits remained unchanged or was slightly going up from March. The exception was interest on personal loans, which after some monthly stabilisation, fell again significantly in April, despite lack of any changes in the base interest rates. All in all, in December and January the lombard rate was lowered 5 percentage points, the rediscount rate 4.5 percentage points and rate for open market operations 4 points. On the other hand, the commercial banks, from December to February, shaved 4.8 percentage points off interest on time deposits for individuals. What fell most was interest on 6-, 12- and 24-month deposits, least fell deposits with shortest maturities (1- and 3-month). Slightly less than in the case of personal deposits, namely 4.6 percentage points, fell interest rates on corporate time deposits. Interest on personal loans fell 4.9 percentage points, on corporate loans 5 percentage points.

In the second quarter, primarily in May and June, some major commercial banks made minor interest rate rises on deposits. As loans made by banks to the non-financial sector rose faster than deposits, banks were looking for such a level of interest rates which would secure them sufficient inflow of funds. In connection with the growth of interest rates on the interbank market (WIBOR) - in April interest on corporate loans increased slightly, in May the same happened to personal loans. Consequently, in June interest on corporate loans was about 0.4 percentage point higher than the lowest level, achieved in March. In turn, interest on personal loans reached the lowest level in April, being 0.4 percentage point higher in June, too. The gap between interest on time deposits and interest on loans narrowed on December only very slightly (see figure 39).

Figure 39
Interest on time deposits and loans



Interest rates and loan demand

The interest rate is only one of the factors which determine borrowing demand. The demand is also influenced by such (interdependent factors), as the current and expected business outlook in Poland and in the countries being our main trading partners, the financial standing of corporates, households' propensity to consume, etc.

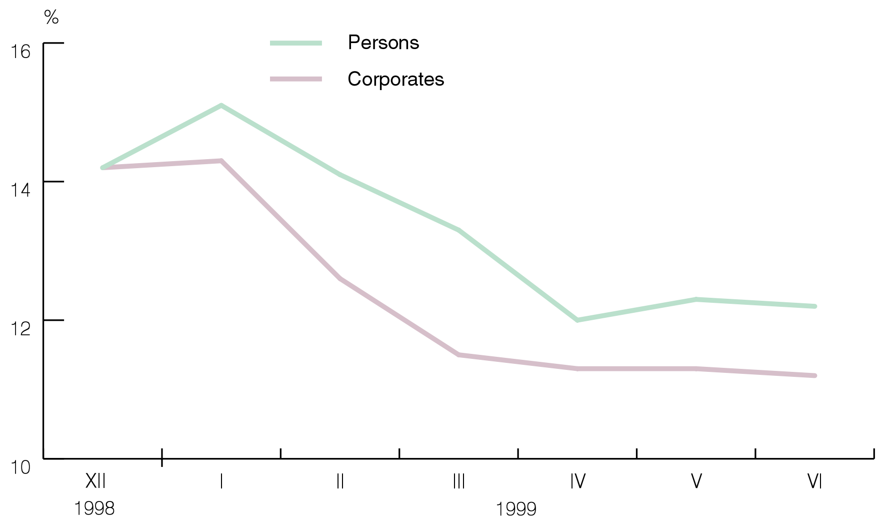
The influence of the central bank on demand for loans depends on the effectiveness of transmission mechanism of any change in the base interest rates to interest rates, offered by banks. Despite the considerable nominal drop of the credit interest rate in the first half-year, the real interest[13] was still relatively high (figure 40).

The first half of 1999 saw a steady growth in demand for households' loans. In real terms, claims on households' loans increased from 20% year-on-year last December to over 32% in June 1999[14]. No doubt, demand for loans was stimulated by falling interest rates, although what probably played more important role was households' trend to avoid the cut-back, perceived as temporary, in consumption caused by the lower growth in disposable incomes. Consumption decisions may have also been influenced by falling interest rates on deposits. A factor making consumer demand less elastic has also been a considerable potential of deferred consumption and thus high rate of time preference. This factor will continue to exert pressure on consumption, including consumption on credit. No less important are increasingly better terms of obtaining a loan by individuals, the large number of non-bank intermediaries, less stringent collateral requirements, new banking products offered to clients, etc.

It is no easy task to evaluate to what extent such significant growth of credit drawn by individuals fuelled the rate of inflation. During the first six months the growth of prices within the group of products whose purchases are customarily made on credit (means of transport, audio and video equipment, photographic equipment and IT hardware) was much lower - compared to the corresponding period of last year - or similar (furniture and appliances) to the general rate of CPI growth. But as the

[13] Real interest on loans to households was calculated based on CPI and on loans to corporates based on PPI.
[14] CPI was used as deflator.

Figure 40
Interest on personal and corporate loans, real terms



considerable part of these goods are imports or goods requiring intermediate imports - the growth of lending contributes to a surging deficit on the current account, which may in future cause the depreciation of the zloty, growing import costs and inflation acceleration.

Demand for corporate lending evolved differently. In real terms[15], its year-on-year growth in the first half-year oscillated between 18.4% and 24.2%, however, in the second quarter real growth of claims on corporates credit dwindled markedly. The demand of corporates for credits has not as yet responded to the drop in interest rates. It seems that more important was the weakening of the economic outlook in Poland and in countries being our main trade partners as well as the weakening in the rate of investment growth. However, the weakening of own activity and deterioration of earnings at enterprises could to some extent increase their borrowing requirements in order to finance current operations.

Exchange rate

In the first half of 1999 the zloty rate of exchange was still determined by the old crawling band system. The half-year witnessed the effects of the efforts taken by the Monetary Policy Council in order to make the rate of exchange mechanism more flexible.

On March 25, 1999 the Monetary Policy Council broadened the band for NBP mid-rates to ±15% relative

[15] CPI was used as deflator.

to central parity. The further broadening of the band around parity and change in the principles of the fixing in December 1998 was coupled with the limitation of NBP presence on the foreign exchange market. The balance of fixing transactions fell from USD 3,401.9 million in the first quarter of 1999 to USD 658.1 million in the second quarter of 1999. In the first half of 1999, like in the second half of 1998, there were no direct NBP interventions on the FX market. A consequence of the changes in the principles of the fixing on June 7, 1999 was the abolition of FX transactions obligatory for the NBP between the central bank and the commercial banks at the fixing.

At the same time, on March 25, 1999 the Monetary Policy Council reduced the monthly rate of zloty crawling devaluation from 0.5% to 0.3% zloty, adjusting its pace to the new inflationary target for 1999 and the narrowing gap between the domestic and foreign rate of growth in prices.

The strengthening of the market character of establishing the zloty rate of exchange helped the implementation of monetary policy in the first half of 1999. Thanks to the stabilisation of the gross official reserves coupled with growing demand for reserve money, the excessive liquidity of the commercial bank sector decreased. In the environment of a flexible rate of exchange the adjustment impact of the external demand shock on the exchange rate started to take effect. Due to the relatively speedy reaction of imports to movements in interest rates[16] zloty depreciation, being the strongest in the first quarter of 1999, impacted to a certain extent the drop of imports in the first half of 1999, and by the same token, helped to narrow the growing deficit on the current account of the balance of payments.

A considerable flexibility of the rate of exchange within the broad trading band, with a simultaneous refraining of the NBP from any interventions on the FX market allowed to automatically adjust to balance of payment trends and enabled more efficient monetary policy. This self-regulation mechanism was, however, distorted first of all by the impact of foreign exchange funds on the back of large privatisation transactions and expectations of large growth in the supply of foreign exchange coming

[16] Statistical analysis shows that the strongest and statistically most significant relations between the real effective exchange rate and imports can be observed after the period of about I quarter.

from this source, which was a driving force behind the appreciation of the zloty.

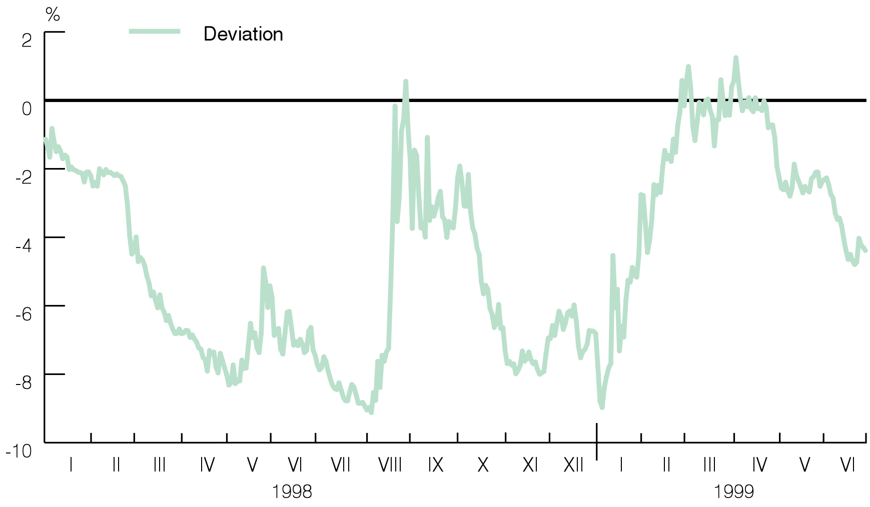
In the first half of 1999 the average deviation of the market rate from central parity went clearly down, on the side of appreciation, to about 2.5%[17] compared to 6.3% in the fourth quarter of 1998. The volatility of the zloty rate at the time rose to 10.2% (compared to 7.5% in the first half of 1998); in the first and second quarter of 1999 it was at 10% and 6%, respectively. The biggest deviation of the market rate from parity of almost 9% on the side of appreciation occurred in January, while in April the zloty swung strongest towards depreciation - the deviation was equal to 1.2% (see figure 41).

The first quarter of 1999 witnessed a gradual and dynamic depreciation of the zloty against foreign currencies. The most important external events which contributed to a weaker zloty were: the crisis of the Brazilian real and the outbreak of the Kosovo conflict. Both the crisis situation in Brazil and the Balkan conflict resulted in dampened sentiments on the world markets and limited the involvement of foreign investors' capital on emerging markets, Poland being no exception. The symptoms of a poorer outlook in the Czech Republic and Hungary and the deteriorating situation on the current account of the balance of payments in those countries influenced the depreciation of their currencies. Also, the poorer image of countries in our region, with the noticeable interdependence of local markets, contributed to the reduction of foreign capital inflow also to our country. The Balkan crisis exacerbated the investment climate primarily in Europe's emerging markets.

Zloty depreciation was also conditioned by the internal economic situation of Poland. Among the factors critical to the weakening of the zloty in the first half of 1999 the following could be mentioned: significant drop in the GDP growth rate, growth in the current account deficit, disquieting results of budget completion and lack of discipline and transparency in fiscal policy. An impulse towards stronger zloty depreciation was the lowering by the Monetary Policy Council, in January, of base interest rates, which contributed, in the environment of bad news about the Polish economy and the whole emerging region, to a decrease in foreign capital interest in invest-

[17] In the first quarter it was around 2.9% and in the second quarter about 2.1%.

Figure 41
Zloty rate deviation from basket of currencies, 1998 -1999



ing at the Polish market. The depreciation pressure on the zloty was also strengthened by the speculative activities of Polish banks.

In the second quarter of 1999, after the zloty stabilised at parity level, a trend towards zloty appreciation became manifest. The strengthening of the Polish currency resulted from a generally healthier investment climate worldwide and foreign investor growing confidence in the Polish economy thanks to the improvement of its economic performance and bringing forward of privatisation processes. Privatisation transactions and positive ratings of the Polish economy, as illustrated by the upgrading of Poland's investment rating by foreign agencies, were conducive to a general strengthening of appreciation expectations in the Polish FX market.

As a result of the above trends the nominal effective rate of the zloty weakened in the first half-year (June 1999 compared to December 1998) by 3.3% which contrasted with the situation in 1998. Back then the corresponding period brought a nominal appreciation of 2.3%. During the first three months of 1999 the rate of nominal depreciation was 6.6% on December 1998 (see figure 42), while the nominal effective rate hit the lowest level in the nineties. In June the nominal effective rate appreciated by 3.5% on March 1999.

The zloty, in real terms, after factoring in the swings in PPI, weakened in the first part of 1999 (December

1998 on June 1999) by 0.9%, compared to the appreciation of 5% in the corresponding period of 1998. The evolution of appropriate ratios of the real rate of exchange in particular quarters is presented in figure 43.

In the first half of 1999 the considerable depreciation of the Euro versus the USD (a drop of 12% on average) negatively impacted the competitiveness of Polish exporters in the EU market (see figures 44 and 45).

The relatively long-term depreciation of the zloty in the environment of growing oil prices on the world markets contributed to the significant acceleration of price growth in Poland's foreign trade.

As shown by studies on the impact of the effective nominal rate of exchange on the evolution of CPI[18] this impact starts to bite as early as 2 - 3 months after the emergence of the rate change impulse. As the nominal depreciation of the rate of exchange happened from February to April 1999, any price impact on the domestic market could be expected as early as April and May. However, no acceleration in inflation could be observed at the time and the speeding up of the rate of price growth occurred mainly in fuels.

It seems that the relatively low impact of zloty depreciation on the speeding up of inflation in the first half of 1999 resulted from growing competition pressure on the domestic market, mainly due to the external symptoms of crisis.

[18] The study was performed for the period from January 1993 to May 1999; it incorporated monthly data relating to nominal effective rates of exchange and monthly price indices for selected consumer goods. The criterion for the selection of the groups included in the study was the share of imports in retail sales. The study has shown the existence of a Granger-causality of the rate of exchange on the prices of food and non-food items and the special item: petrol. No correlation between the ratios in question has been detected.

Figure 42
Nominal effective exchange rate; 1997 - 1999 monthly data *(December 1997 = 100)*

Figure 43
Real effective exchange rate; 1994 - 1999 as measured by changes in consumer and producer prices in manufacturing, monthly data *(December 1993 = 100)*

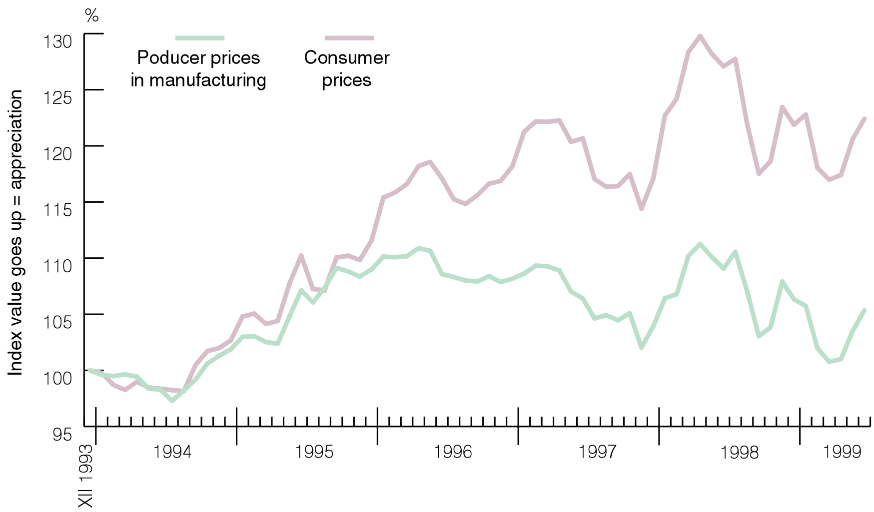


Figure 44
Real zloty exchange rate against currencies of main trading partners in 1998 - 1999 (previous year's December = 100)

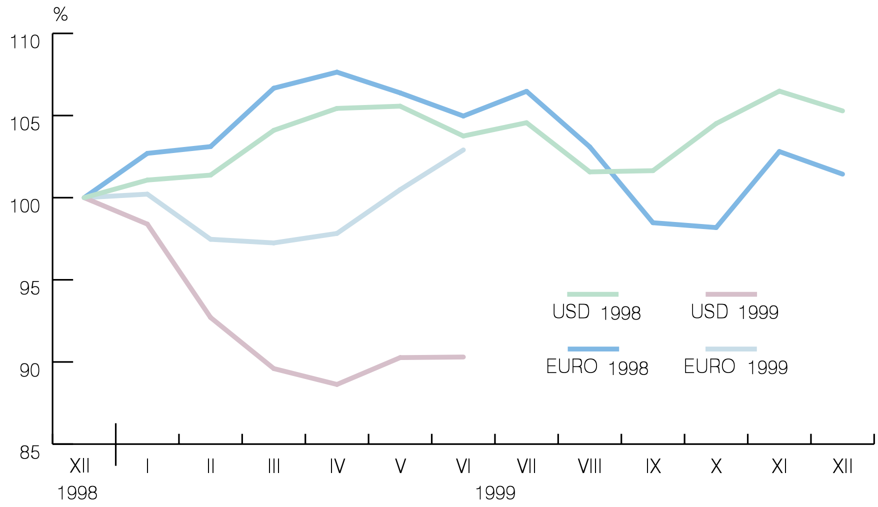
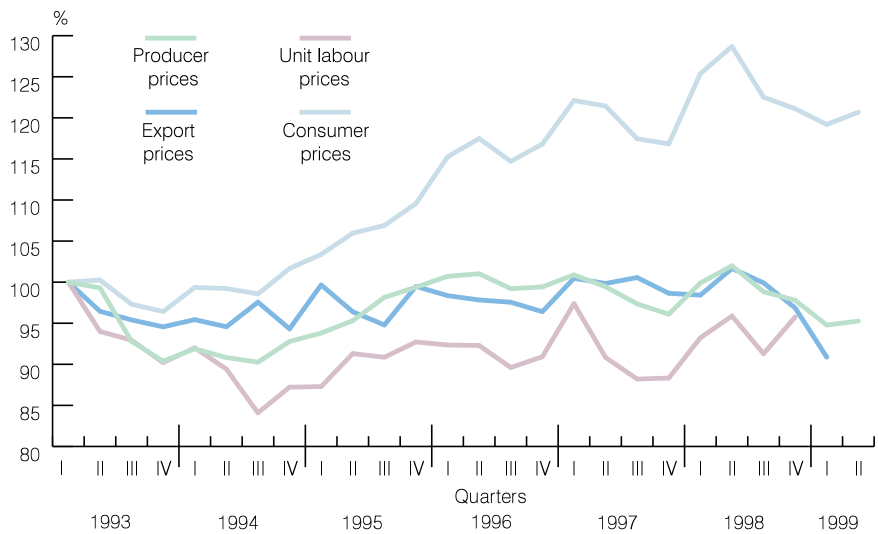


Figure 45
Real effective exchange rate 1993 - 1999, quarterly; deflator: export prices, producer prices, consumer prices, unit labour costs (I quarter of 1993 = 100)



Impact of external prices on inflationary processes

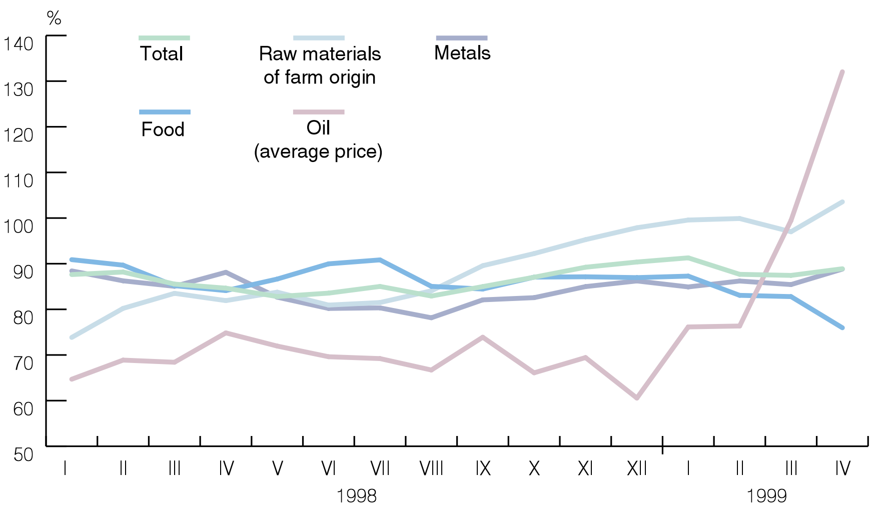
In the first half of 1999 first symptoms could be observed of reversing the falling trend in prices on the world commodity markets, such trend having intensified in 1997 and 1998. This followed first of all from the expectations of growing global demand in the face of the increasingly recovering world economy.

The general index of prices for the raw materials in the world market showed a growth of 13%[19] after 6 months of 1999 compared to an almost 19% fall in the corresponding period in 1998. Such clearly rising trend was primarily fuelled by oil price rises (figure 46). The price of this strategic raw material increased in the first half of 1999 by some 60% from USD 9.85 a barrel in December 1998 to USD 15.85 a barrel in June 1999[20]. So high a rate of growth in oil resulted first of all from the curtailing of supply in connection with the implementation of OPEC common policy oriented towards cutting the supplies of this raw material. For a while, oil prices went up on the Balkan crisis.

In the first half of 1999 prices of the remaining raw materials continued to show a falling trend, although the rate of price cuts was generally weaker compared to the

[19] HWWA - Institut für Wirtschaftsforschung, Hamburg.
[20] Reuters - this pertains to Brent, listings at month ends.

Figure 46
Price indices for basic commodities on world markets *(corresponding month of previous year = 100)*



corresponding period of 1998. In consequence, after the six month of 1999 the index of raw material prices, excluding energy raw materials, continued to show a drop of 4.2% compared to the drop of 13.3% in the first half of 1998[21].

The slower rate of growth in prices in the world market was also influenced by the strong appreciation of the US dollar versus top international currencies. In the first half of 1999 the dollar strengthened about 12% against the Euro.

And thus foreign exchange prices were conditioned by trends which were generally non-uniform. Dollar prices for Polish exports fell by 3.0% during the first half of 1999 compared to the corresponding period of 1998. Prices paid for imports, on the other hand, lowered 5.5% during the first six months of 1999 compared to the first half of 1998.

As a result of the price trends the terms of trade ratio in Polish foreign trade slightly deteriorated: after the six months of 1999 it stood at 102.4%, as against 102.8% in the corresponding period of 1998.

Zloty depreciation, which continued for the better part of the first half-year, influenced the speeding up of the rate of growth in zloty transaction prices relating to Poland's foreign trade. This became evident since March. Import prices went up 8.0% in May 1999 compared to May 1998 (in the corresponding period of 1998 the growth was 0.7%), however the rate of growth in export transaction prices was - in the corresponding period - 10.3% (compared to 8.2%, respectively in 1998). The average level of import transaction prices from January to June 1999 was 5% higher than in the corresponding period last year (the corresponding increase in 1998 was 6.3%), while the average level for export transaction prices from January to June 1999 was 7.5% higher than in 1998 (the corresponding increase in 1998 was 9.3%). As shown by figures 47 and 48, during the first four months of 1999, just like in 1998, the most sluggish growth rate was shown by prices of imported raw materials, with clearly faster growth in prices of processed imports.

And thus as shown by the above-mentioned trends, there were two basic factors which speeded up growth in the sector of merchandise subject to foreign trade: depreciation of Polish currency and growth in oil prices.

[21] HWWA - Institut für Wirtschaftsforschung, Hamburg.

Figure 47

Indices of Poland's import transaction prices *(corresponding period of previous year = 100)*

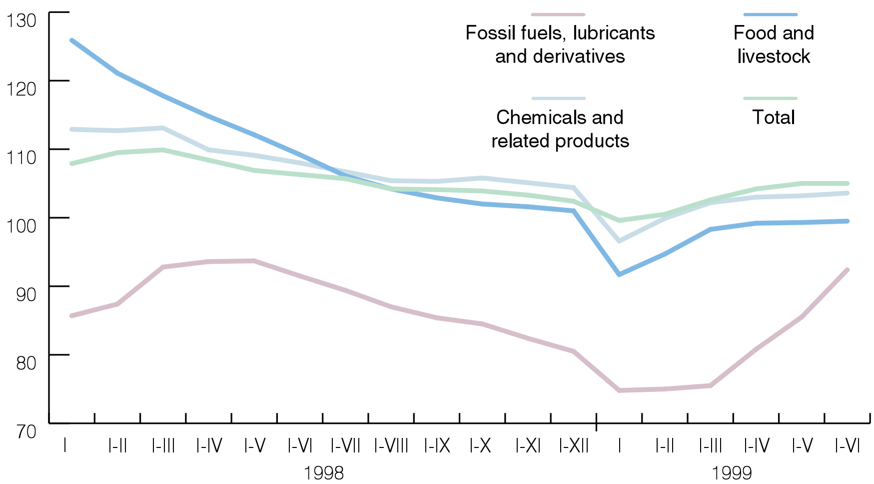
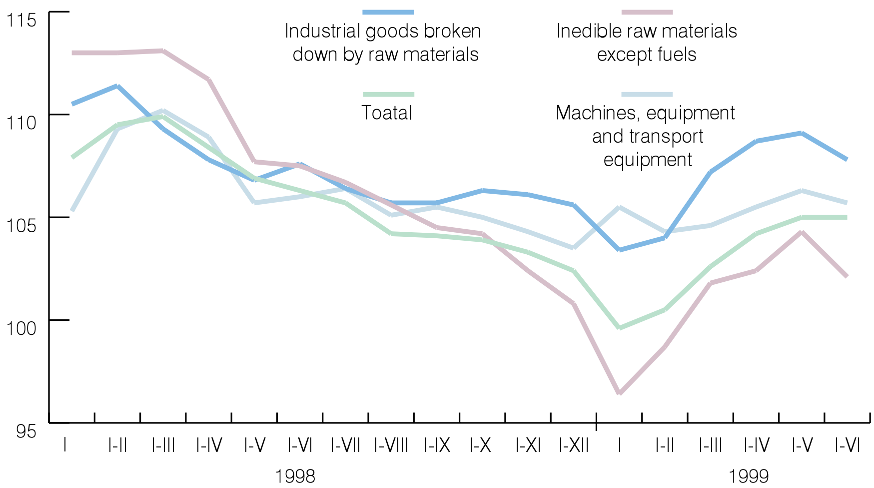


Figure 48

Indices of Poland's import transaction prices *(corresponding period of previous year = 100)*



However, due to the continued low rate of growth in domestic demand the price growth did not significantly impact inflationary processes in the economy; apart from crude oil rises in the world market which contributed to the growth of fuel prices on the domestic market. On the other hand, the improved terms of trade in Polish foreign trade had a more favourable impact on the development of price and cost competitiveness ratios in the export sector of the Polish economy in the first quarter of 1999.

Share prices

The first half of 1999 on the Warsaw Stock Exchange was a period of recovering from the losses incurred in the aftermath of the Russian crisis. From January 1 until June 30 WIG (the Warsaw Stock Exchange Index) climbed back by 31.5%. Total turnover in shares listed on the main floor of the WSE totalled 21.3 billion zloty.

The period in question can be divided into two clear subperiods. In the first subperiod covering January and February no long-term trend developed. This period showed much volatility in share prices. What had a positive impact were the relatively low share prices in the wake of the Russian crisis, as well as positive trends on stock exchanges in developed countries (mainly the USA - Dow Jones had exceeded the 9,500 point mark). The bad news, on the other hand, was the information about the weaker business outlook in the Polish economy and the poorer 1998 earnings of WSE listed companies, as well as developments on other emerging markets (the Brazilian crisis).

From March to June there was a marked rallying trend on the Warsaw Stock Exchange. The main reason for it were the leading stock exchange indices (particularly in the United States) which kept beating ever new historical records (Dow Jones reached the level of 10,000 points on March 30 and 11,000 on May 30). European bourses followed NYSE. Other factors conducive to growth trends were certain signals on overcoming the negative trends in the economy after the Russian crisis as well as the element of speculation connected with takeovers of joint-stock companies, especially banking sector mergers.

The factors causing periodic deviation of WIG from the growth trend was the war in Yugoslavia and US interest rate growth expectations, which through the fall of world stock indices also influenced the Polish market. On June 22, 1999 WIG reached its peak of 17,046.4 points. Earlier this year, on January 15, 1999 it hit its minimum of 12,591.1 points.

One of the major events on the Polish capital market was the introduction of interest rate futures by the Warsaw Board of Trade SA. The underlying instrument for these contracts is interest on one- and three-month interbank placements (the WIBOR rate). This is the first financial instrument of this type. It allows investors to hedge their investment portfolio against interest rate risk.

Evolution of aggregate demand and supply

In the first half of this year a further weakening of growth in aggregated demand and supply was noted. According to initial estimates the rate of growth in domestic final demand decreased, while external demand declined below last year's level. What did not change were the conditions which arose in the second half of 1998, constraining opportunities of growth in sales on East and West European markets. The difficult situation of Russia and Ukraine persisted. Those were the countries which accounted for the highest growth of exports in the first half of the previous year. The economic outlook in EU countries, especially in Germany, did not improve significantly. The limited possibilities of selling the output resulted in decreased demand from enterprises for raw and other materials and contributed to their cutting back investment activities.

In this situation critical in overcoming the falling trends in industrial output, recorded in the first and the second quarter, was the growth of consumer demand which stayed at a level similar to the second half of the previous year. After the fall in the fourth quarter 1998 and in the first quarter of 1999, the added value in industry increased which contributed to accelerated GDP growth. It is estimated that the rate of GDP growth in the second quarter was 3.0%, i.e. 1.5 percentage points higher than in the first quarter. However, it was still lower than the one achieved in the first half of the previous year (table 2).

Growth in personal consumption was recorded, despite the lower than previously rate of growth in the purchasing power of households' gross disposable income. A further drop in households' savings rate can be estimated to have taken place. The growth in net personal savings (the balance between the growth in deposits and loans) in the banking system during the first half-

Table 2
Rate of growth in basic macroeconomic indicators

	1998			1999		
	Q 3	Q4	Q1-4	Q1	Q2	Q1-2
	corresponding period of previous year = 100					
Total added value	**104.5**	**102.3**	**104.4**	**101.3**	**102.8**	**102.0**
Industry	103.6	98.7	104.7	97.0	101.3	99.0
Construction	110.2	107.3	110.3	100.2	103.2	102.8
Market services	105.5	103.4	104.6	104.1	104.3	104.2
GDP	**104.9**	**102.9**	**104.8**	**101.5**	**103.0**	**102.2**
Domestic demand	**106.3**	**106.6**	**106.6**	**103.2**	**104.5**	**103.9**
Outlays on fixed assets	114.4	113.4	114.5	106.0	106.7	106.5
Personal consumption	104.5	104.6	104.9	104.2	104.8	104.5

Source: 1998 and 1st quarter of 1999 - GUS; 2nd quarter and 1st-2nd quarters of 1999 - own estimates.

year was over 35% lower than in the corresponding period of 1998.

As a result of the continued growth in personal consumption, despite the considerably reduced rate of growth in investment outlays, especially on working capital, the rate of growth of domestic demand was still higher than the GDP rate of growth. The volume surplus of imports over exports increased.

Internal demand

The growth rate of domestic demand[22] in the first half-year stood below 4% (in 1998 it was 6.6%, in 1997 - 9.3%, in 1996 - 9.5%). What contributed to the weaker rate of growth in demand was mainly the decline in the rate of growth in gross accumulation. In the first quarter of 1999 it was merely 1.1% higher than in the corresponding period last year, whereas in the previous quarter it grew by 12.5%, and for all of 1998: 14.1% (in 1997: 20.8%, in 1996: 19.5%, in 1995: 24.1%).

The drop in the rate of accumulation was contributed to by the lowering of rate of investment in gross fixed assets from 13.1% in the fourth quarter to 6.0% in the first quarter and almost the total arresting of the growth

[22] At the time of preparing the report statistics were available referring to the first quarter of 1999 as regards national accounts. To more fully describe the phenomena in question some own estimates are also presented. Their tentativeness and possibility of material errors must be emphasised though, which is connected with the unavailability this year of much statistical information which was available in previous years.

in working capital investment. According to the data from enterprises which keep full-scope accounting the value of inventory at the end of March was slightly lower than at the end of last year, physical inventory having declined by over 8%, and its share in total inventory stood merely at 28.6% (it was 31.6% a year ago and 31.0% at year-end 1998).

There was a slight decline in the rate of consumption growth. In the first quarter of this year total consumption climbed by 3.7% on the previous year, while in the fourth quarter it went up by 3.8%. The rate of personal consumption growth declined from 4.6% to 4.2%.

Individual consumption

In the first months of 1999 real growth of households' disposable income was weaker than last year. Growth in income from hired work and non-agricultural business slowed down. Growth in social security payouts can be estimated to have accelerated. The drop in incomes of private farmers was lower than in previous quarters. This was in connection with the halting of the drop in prices of agricultural produce and its rising sales.

The declining rate of growth in income from hired work occurred against the background of employment cuts and lower rate of growth for the average wages. The average employment in the economy in the first quarter of 1999 went down 0.4% compared to the corresponding period last year. At the same time the average employment in the enterprise sector went down 0.2%, while in industry this drop was as much as 3.4%. Only in services employment kept growing. In the particular months of the second quarter there was a further drop in employment in the enterprise sector, both compared to the previous month and to the corresponding period of 1998. In the second quarter of 1999 average employment in the enterprise sector was 0.3% lower than in the first quarter and 1% lower than in the second quarter of 1998. In the whole of the first half of 1999 average employment in the enterprise sector went down by 0.6% relative to the comparable period last year.

After a steady drop in the rate of unemployment to 9.5% in August 1998, it started to climb back in September 1999, to reach by the end of March 1999 the level of 12.1%, not recorded for two years. From April the rate of unemployment started to decline to 11.6% by the end of June compared to 9.6% in June 1998. The drop in the rate of unemployment, despite simultaneous reduction in employment, resulted from the fact that a significant number of people laid off as a result of restructuring, mainly in mining and steel industry, were awarded prepension benefits. The lay-off of those people did not contribute to the number of the unemployed, because while they collected the benefits they could not register as unemployed (nor be legally employed, for that matter). Moreover, registrations for unemployment of people working in the informal economy considerably declined. In the first months of this year such registrations had a mass character, as the status of an unemployed person (in connection with the pension reform) secured the payment of health insurance contributions by the state.

This year, the system reforms being under way, no full data are available on social security payouts. But it can be estimated on the basis of information available that their rate of growth was higher than last year. The indexation of pensions (old age, disability and farmers') in 1999 was performed on a one-off basis as of June 1 by means of a single index for all those entitled: 108.7%. Average pensions (old age and disability) climbed in real terms by 3.2% in the first half of 1999 on the first half of 1998, whereas agricultural pensions by 3.5% (last year 2.2% and 2.4%, respectively). The disbursement of unemployment benefits, which was declining last year, climbed back. There was a high rate of growth in payouts of unemployment and pre-pension benefits.

Despite the lower rate of growth in households' disposable income rather strong growth in personal consumption continued. In the first quarter of 1999 the growth in individual consumption, at 4.2%, was clearly lower than in the first quarter of 1998 (6.4%). Still it was similar, in scale, to the later quarters of 1998 (in the second quarter a growth of 4.1%, in the third quarter: 4.5%, in the fourth quarter: 4.6%). The growth of individual consumption in the first quarter of 1999 was 2.7 percentage point faster than the rate of GDP growth, whereas in the first quarter of 1998 personal consumption grew at a rate similar to GDP (see figure 49). The early estimates are that in the second quarter and in the whole first half-year the rate of growth in personal consumption also exceeded 4%.

Figure 49
***Rate of growth of individual consumption and GDP** (real terms)*

According to GUS (Central Statistical Office) data, the volume of retail sales realised by large and medium-sized trade and non-trade companies in the first half of 1999 increased by 13.7% compared to the corresponding period of the previous year, in the first quarter going up 10.4% and in the fourth quarter by 16.5%. Having adjusted this for changes in the structure of sales outlets, i.e. the significant percentage drop in sales at the open-air market and small shops not covered by statistical monthly surveys - it can be estimated that the growth of sales was only slightly below 8% and was much higher than the growth in the purchasing power of households' disposable income. What still continued was the high rate in sales of enterprises in the sectors of car dealership and distribution of fuels, radio and television equipment, household appliances as well as furniture and lighting equipment. The bulk of shopping in these sectors was on credit, directly from a bank, or in hire-purchase systems.

In the first half of the year personal loans in the banking system were 2.7 times higher and growth in deposits was 9% lower than they had been in the corresponding period of last year. The growth of net bank savings of households decreased by over 35% compared to the first half-year. The difference between the rate of growth in retail sales and the rate of growth in basic components defining the amount of gross disposable income (salaries, social benefits) demonstrates that growth in the remaining components of households' gross savings (non-bank financial savings and outlays on fixed and working capital assets) was also lower than a year ago.

Investments

As earlier expected, in the first half of 1999 the rate of investment outlays weakened. The weakening in the second half of 1998 of selling opportunities for merchandise output led to abandoning development projects which were prepared earlier. The number as well as cost estimate value of investment starts in the processing industry was lower than it had been a year ago. The negative investment sentiments were compounded by the financial standing of enterprises, deteriorating over the year. The lower amount of profit worked out constrained the equity funding potential of investments. With relatively expensive credit and much risk connected with uncertain returns on investment outlays, the reduction of the operational surplus to plough back into a company affected first of all small and medium sized enterprises. What has also curtailed investment outlays were the cuts in capital outlays envisaged in the central government.

In the first half of 1999 investment outlays at large enterprises climbed by some 7% (in the first half of the year growth in outlays at these units equalled 27.4%). Outlays for construction and erection work were 10.2% higher, machine and equipment purchases increased 5.7%. Among the purchases, the share of imported machines and equipment decreased from 37.1% in the first half of the previous year to 36.4% in the first half of 1999. What has been maintained, on the other hand, is a high growth rate of investments in trade and construction companies, as well as in real estate and corporate services. Much lower was the growth, at 4% in current prices, of outlays at enterprises operating in industry.

Growth in investment demand in the second quarter of 1999 can be evaluated more favourably. In the first quarter of 1999 gross outlays on fixed assets were 6.0% higher than in the corresponding period last year (while as late as in the fourth quarter last year their rate of growth was 13.1% and in the first quarter last year: 17.5%). It can thus be estimated that in the second quarter of 1999 the outlays will go up by over 7%. There has been an accelerated growth in construction output: the share of investment and improvement projects in construction and erection work has also gone up. The output of industrial enterprises which produce mainly investment goods exceeded last year's level. It should thus be expected that despite the negative investment sentiments shown by enterprises surveyed in the first quarter of 1999 and problems with debt repayment capacity in connection with the deterioration in the financial standing, the rate of growth in investment outlays in the second half of 1999 can actually be higher than the one recorded at the beginning of the year, especially that after last year's decline a considerable rebound was noted in the first half of 1999 as regards the number and cost estimate value of new investment project starts.

Central government

1999 saw the simultaneous launching of several structural reforms: the pension, social security and local government administration reforms. This had immediate consequences for the central government. Already in the first months of 1999 a number of problems occurred in reform implementation. In consequence, insufficient funding allocated for the reforms, as well as additional unforeseen expenses, contributed to the surge in the fiscal deficit.

During the first half of 1999 the state fiscal deficit constituted about 11.3 billion zloty[23], accounting for some 88.4% of the amount stated in the 1999 annual Budget Act, of which 68.0% was spent during the first three months.

Central government receipts reached 56.5 billion zloty by the end of June 1999, i.e. 43.7% of the receipts budgeted for the whole year. Low progress in the collection of receipts followed both from the lower than expected rate of economic growth and the lower than expected inflation; a particularly low level of budgetary receipts was recorded from corporate income tax, that being 32.4% of the amount laid down in the annual Budget Act.

Budget outlays over the six months reached 67.9 billion zloty, or 47.8% of the amount planned for 1999. Among the many reasons for the high rate of spending compared to plan, the following ones can be mentioned, in particular: the introduction of the new system for the

[23] Report on central government completion for the period from January to June 1999, Ministry of Finance August 1999.

financing of the Social Insurance Fund, the payout of sickness benefits, the spending of non-budgeted amounts to subsidise miners' packages and to procure pork livestock.

In the period under analysis 56.2% of all budget appropriations went to grants and subsidies, these being spending of a consumption or public allowance nature, while 15% was spent on fixed expenses, in connection with the servicing of the public debt.

Most resources were allocated to general subsidies to autonomous units of local government (58.1% of the planned amount).

The subsidy to the Social Security Fund has already reached the level of 55.8% of the amount budgeted for the whole year. The level of subsidies to the Social Insurance Fund was so high, because, among others, its balance of cash at year end 1998 was very low and insufficient to cover the outlays at the beginning of 1999. Another reason was low income from contributions in the first months of 1999.

It is noteworthy that as the Employment Fund has high balances allowing it to cover the payout of benefits for the unemployed there has been no need, as yet, to credit it with a budget subsidy.

The rate of completion of central government expenses for the servicing of the national debt, at 52.6%, is also higher than average, and made up of the following items: the repayment of interest on new USD bonds, the so-called Brady bonds, higher interest and discount on Treasury securities, as well as higher payments on guarantees for domestic loans and central investment projects. And expenses for the servicing of the foreign debt constituted 39.9% of the total for the whole year.

The completion of the central government in the first half of 1999 is presented by table 3.

An adverse phenomenon noted in the period under analysis is the negative primary balance of the central government[24]. Although its size has been largely reduced - from 3.8 billion zloty in March to 1.2 billion zloty by the end of June - it continues to remain high. The trend and the size of the primary balance in the period in question can be indicative of some temporary reduction in budget capacity to finance the public debt without any support.

[24] The primary balance constitutes the difference between the primary receipts and outlays of the central government, i.e. net of the cost of public debt servicing.

Table 3
Budget completion in the first and second quarter of 1999 (billion zloty)

Items	Plan 1999	Completion Jan to Mar 99	2:1 %	Completion Apr to Jun 99	4:1 %	Completion Jan to Jun 99	6:1 %
	1	2	3	4	5	6	7
Receipts	129.3	27.7	**21.5**	28.8	**22.2**	56.5	**43.7**
Outlays,	142.1	36.5	**25.7**	31.4	**22.1**	67.9	**47.8**
of which:							
- cost of public debt servicing	20.5	5.0	**23.2**	5.2	**24.4**	10.2	**49.5**
- FUS (Social Insurance Fund) subsidy	9.6	3.8	**39.1**	2.0	**16.5**	5.8	**55.8**
- KRUS (Farmer Insurance Fund) subsidy	13.4	3.0	**22.3**	3.2	**24.0**	6.2	**46.3**
- general subsidies to municipalities	22.1	7.6	**34.3**	5.3	**23.8**	12.9	**58.1**
Primary balance	8.5	-3.8	**-44.2**	2.6	**30.6**	-1.2	**-13.6**
Fiscal deficit	-12.8	-8.7	**68.0**	-2.5	**20.4**	-11.3	**88.4**

And it has to be noted that while in the corresponding period last year the primary balance was negative too, its level was only 0.5 billion zloty.

Despite having realised such high fiscal deficit no problems have occured so far with finding sources of its financing.

The main lender continued to be the non-banking sector, which having involved the amount of 6.9 billion zloty covered the budget's funding requirements in 61.2%.

The share of non-bank domestic investors in the funding of the central government increased by 2.4 percentage points on December 1998 and amounted to 65.4%, their investments being mainly into long-term Treasury securities, which is by all means desirable from the stabilisation policy standpoint.

Privatisation revenues realised in the period in question, at 2.4 billion zloty, constituted merely 35% of the amount planned in the annual Budget Act and covered the public sector borrowing requirements in 21.5%. It should be noted that most privatisation revenues so far have been receipts from the sale of shares in BPH SA performed at the end of 1998, which reached the account only in the first days of January 1999.

Of some concern, on the other hand, is the growth in bank funding of the fiscal deficit - its share was some 25.0%, while in 1998 a debt reduction of 2.3 billion zloty was recorded. This means an increased role of central government in creating money supply in the first half of 1999.

The balance of foreign financing in the first two quarters of 1999 was negative, at 0.9 billion zloty, and thus it did not pose a problem in the running of monetary policy.

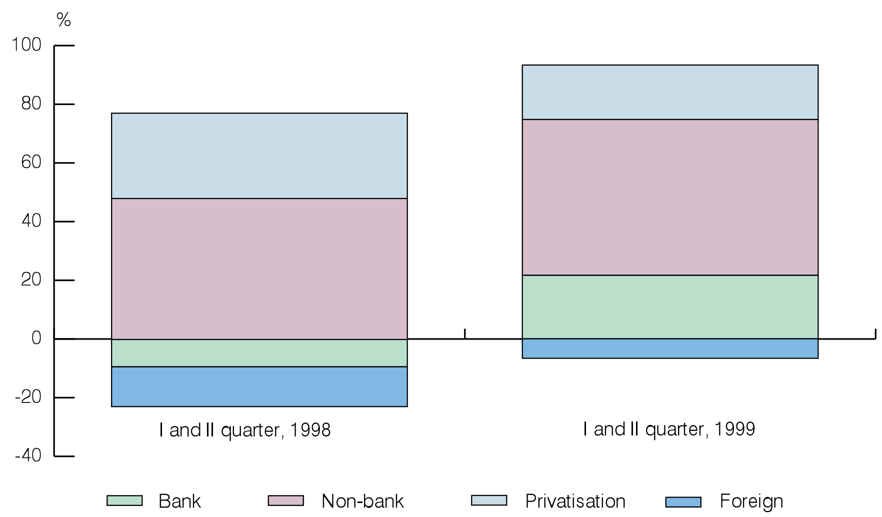
The breakdown, by sources, of fiscal deficit financing is presented by figure 50.

While analysing the situation of public finance, the rest of the general government ought to be mentioned, namely local government budgets and non-budgetary funds, especially the Social Security Fund and Health Funds. The indebtedness of this sector at the end of June stood at some 4.5 billion zloty, accounting for 1.7% of total debt of the public finance sector. Due to the huge outlays in connection with reform implementation, with insufficient funds to effect them, there is a huge risk of widening the disequilibrium of public sector entities other than the central government. This may trigger some growth in the public debt drawn by such entities.

External disequilibrium and inflationary threats

In the first half of 1999 external disequilibrium in the Polish economy widened further still. The deficit on the current account reached the level of USD 5,041 million, up USD 2,378 million on the level of the deficit in the

Figure 50
Structure of fiscal deficit financing (by sources)



first half of 1998 and up USD 846 million on the level of the deficit in the second half of 1998 (see figure 51). A higher deficit under a weaker rate of growth in the Polish economy resulted in the clear deterioration of its ratio to GDP. In view of the stabilisation in the inflow of foreign direct investments to Poland in the first half of 1999 the terms of funding external equilibrium also clearly deteriorated in the period. The rate of coverage of the deficit on the current account with revenues from direct investments declined to about 45% as against 85% in the first half of 1998 (see figure 52).

In the second quarter of 1999 the level of the current account deficit was higher than it had been in the first quarter. This resulted first of all from the significant broadening of the negative balance in June. The June deficit was almost twice as high as it had been in May, reaching the level of USD 1,174 million (compared with the deficit of USD 9 million in June 1998).

The widening of disequilibrium on the current account in the first half of 1999 came from the continuation of a trend of the second half of 1998, namely the growing of the deficit in foreign trade merchandise and service transactions and the declining surplus on unclassified transactions of the current account. The unfavourable trends in demand for Polish exports continued. The collapse in demand from the Eastern market very clearly took down the rate of growth in Polish exports: merchandise and services, both registered and cross-border. In the second half of 1998 the terms of sales in the West European market, particularly in the German one, kept markedly deteriorating. The first half of 1999 did not bring much improvement in the Eurozone economic activity. The GDP of the EMU countries went up by 1.8%[25] in the first quarter of 1999 (compared to the corresponding period of 1998), while in the first quarter of 1998 its rate of growth was 3.4%.

What contributed most to the weaker GDP growth rate were exports, these having declined by 0.9% in the period in question, compared to the growth of 10.3% in the first quarter 1998. The rate of growth in imports of Eurozone countries was much weaker, having climbed only by 0.5% in the first quarter 1999 compared to 12.1% in the first quarter 1998. The markedly lower demand contributed to the declining industrial output in

[25] Monthly Bulletin, European Central Bank, July 1999.

Figure 51
Current account balance in half-years of 1998 and 1999

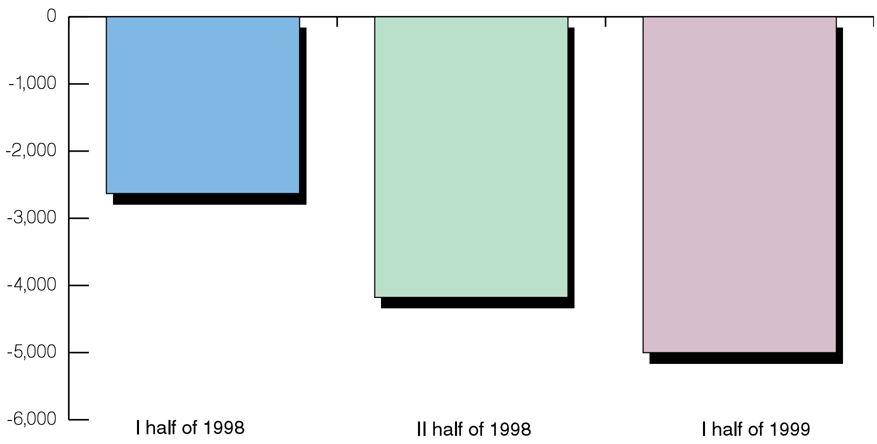
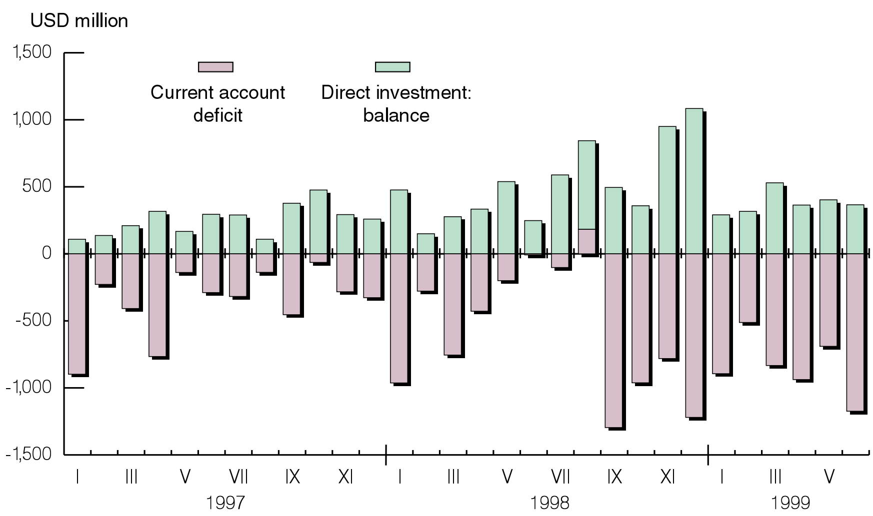


Figure 52
Current account deficit financing by direct investments, 1997-1999



the group of economies in question, observable since December 1998. In April 1999 Eurozone's industrial output declined by 0.7% below the level which it reached in the corresponding period of 1998.

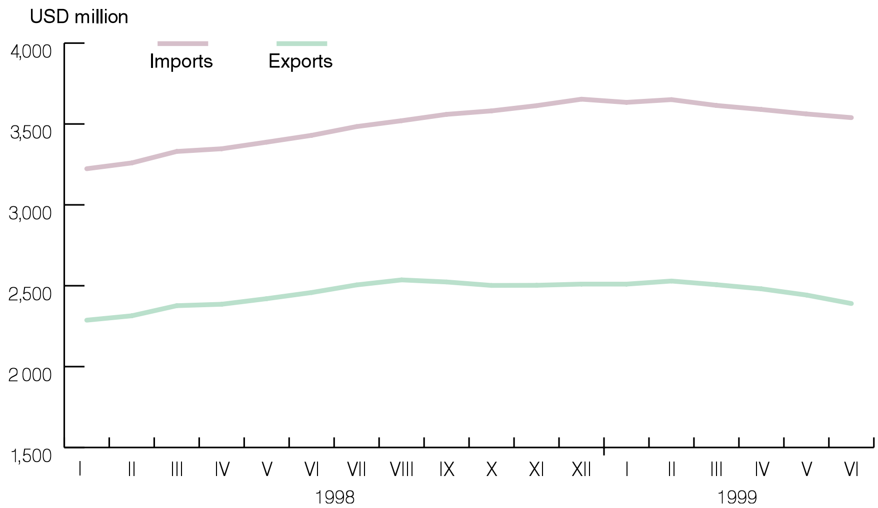
In the German economy, which is Poland's most important foreign market, the stagnation trends clearly deepened after the first quarter 1999. After 3 months of

1999 the rate of GDP growth was 0.8%[26] (on the corresponding period of 1998). Industrial output lowered 0.2% in the same period. A similar decline was recorded in exports: 0.3% and imports: 0.2%. The drop in the industrial output and negative ratios pertaining to the order book were manifest until May 1999[27].

In these circumstances receipts from merchandise exports, as registered by the balance of payment statistics, fell 9.5% in the first half of 1999 relative to the corresponding period in 1998 (see figure 53). At the same time the deficit on services increased almost fourfold, the surplus on unclassified transactions on the current account having fallen by as much as USD 1,294 million. Bad export results are also confirmed by customs statistics. In the first half of 1999 total exports declined some 9.1% compared to the first half of 1998, the drop having been reported from all main destinations. Exports to EU markets declined 0.1% in the corresponding period and exports to Central and East European markets fell 36.6%. In the case of Germany our exports fell 2.9% and exports to Russia lowered 72.9%. In terms of the merchandise structure, the recession in global exports most affected processed food exports, chemical and paper industry products, as well as non-precious metals.

[26] German Monitor, Merrill Lynch, 21 July, 1999.
[27] No data are available for June 1999.

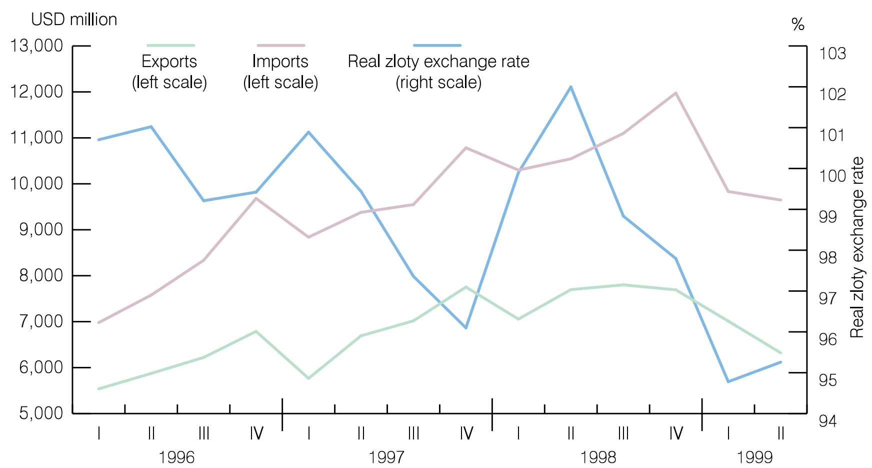
Figure 53
***Exports and imports of goods** (12-monthly moving average)*



In the first half of 1999 some adjustment effects of the external demand shock started to bite. The weaker than in 1998 rate of growth in domestic demand, mainly for investment and intermediate (producer's) goods, contributed to decreased imports. At the same time zloty depreciation (see figure 54) contributed somewhat to constraining import purchases, mainly through increasing prices of inward transport. The acceleration of growth in export transaction prices, in turn, contributed to improved Polish export competitiveness ratios. Any positive effects of the weaker zloty on exports can only appear in the second half of 1999.

In the first half of 1999 import remittances registered by balance of payment statistics fell 6.5% (compared to the corresponding period in 1998). Customs statistics data point to a 6.6% drop in the value of imports in the first half of 1999. Compared to the structure which arose after the 1998, changes in import distribution highlight the decreasing share of intermediate imports, which fell to 63.7% in the first half of 1999 (compared to 64.1% in 1998). But the first half of 1999 brought also some unfriendly trends for external equilibrium towards speeding up consumer imports. The share of those rose to 20.9% in the first half of 1999 compared to 19.7% in 1998.

Figure 54
Exports, imports and real zloty exchange rate: 1996 - 1999



Aggregate supply

After some slow-down in the rate of growth in the second half of 1998 connected with the external shock and barriers to growth in domestic demand, the first half of 1999 saw a gradual return of growth trends in domestic supply, with the still low rate of growth in business activity. Given the continued stagnation trends in West European economies and crisis phenomena in CIS countries, the adjustment processes in the changed situation took longer than expected. Despite some acceleration in the second quarter the rate of GDP growth in the whole of the half-year was lower than in the fourth quarter of 1998. The low rate of growth in business activity contributed to the economy's lower demand for raw materials and resulted in the slackening of investment demand, as shown by more sluggish purchases abroad. During the first four months of this year the volume of imports was lower than a year ago.

With the still low industrial output in the first quarter of the year the first symptoms of reversing the falling trend could be noticed. In February, the trend towards a deeper fall in production was arrested. In March, sales, as reported by industrial enterprises, climbed slightly above the level of the corresponding month last year. In subsequent months the industrial output sold was slightly higher than a year ago. After a drop of sales in mining and quarrying enterprises the production of the processing sector increased. The declining trends continued in the industries which saw some deterioration prior to the external demand shock in the second half of 1998 (a.o. metallurgy, fabrics, processing of leather and manufacture of leather products). In these industries, same as in mining, a considerable drop in employment was noted. Among the manufacturing sectors particularly affected by falling exports to Russia only a slight decrease in the rate of fall was observed in machine building. Sales in the food sector, which has a considerable impact on the economic situation in Poland (this industry manufactures almost 10% of Poland's total goods and services), did not exceed last year's high level. Higher than last year was furniture production, so much dependent on exports to former USSR markets and Germany. The highest growth in sales was achieved by industries strongly connected with the domestic market: office machines and computers, printing, wood and wood products, rubber, plastics and metals. The production of mechanical vehicles, machines and electric appliances also went up.

Higher than last year sales were also observed in industries which manufacture raw and other materials for the building industry whose production stayed at a level close to last year's. After a 1.0% fall in the first quarter, sale of construction and erection projects increased almost by 3% in the second quarter. In both quarters repair and maintenance works stayed at last year's level. As far as the structure of construction and erection work is concerned, considerable growth was noted in the construction of residential houses and shopping and trade premises, while there was a drop in the sector of works connected with the construction of factory buildings for production and storage, public utility buildings and water engineering structures (i.e. water and sewage treatment plants).

The lower level of domestic business activity and lower foreign trade took down demand for transportation services. But it can be estimated that in connection with the high growth of retail and wholesale sales and the further development of corporate, real estate and financial services, there was a higher than last year growth of both total and added value in the market services sector. It is estimated that in the non-market services sector - public administration and national defence, education, health care and social assistance - growth in added value stayed at last year's level. It should be noted, however, that in connection with system changes and cuts in the statistical research programme these estimates are based on much weaker source material than last year.

In connection with the saturation of the domestic market and the limited external demand, sales opportunities for agricultural produce deteriorated. As a result, in addition to adverse trends in the production of slaughter livestock, observable last year, a reduction in milk purchases was noted as well as changes in the structure of pig stock, signifying its considerable reduction in subsequent months.

It can be estimated that the fast, back in the second half of 1998, growth in total agricultural production and the added value of this sector has been largely reduced.

Cost and price trends at enterprises

In the second quarter of 1999 earnings at enterprises markedly improved compared to the first quarter of

1999, as a result of which in the first half of this year their performance (efficiency) ratios improved on this year's first quarter[28]. The net turnover profitability ratio, whose value in the first quarter 1999 was negative both for the whole enterprise sector and industry, climbed into positive values (slightly above zero). In the first half of 1999 net margins stayed negative only in the sectors of mining and quarrying, as well as transport, warehousing and communication.

The cost to sales ratio on overall operations somewhat improved, which is worth emphasising. Having said that, however, the ratio was still rather high (98.4% for the whole enterprise sector). This was true of most sectors and subsectors. But only in some of them the borderline of 100% was crossed. Such unfavourable cost to sales ratio occurred in several industry sectors, among others in textiles (102%), metals (104.6%) and machine building (102.6%). A particularly high cost to sales ratio has traditionally been shown by the mining and quarrying sector. It has now reached the level of 112.6%.

The monitoring of the mutual relationship between the rate of growth in own costs of production and the rate of growth in revenues from the sale of its output (hereinafter, sales) allows to perform a tentative analysis of the trend and scale of the impact of costs on PPI.

Industry, in which more than 70% of product sales is generated, has for some time shown a trend towards faster growth in costs than in sales, which contributed to its declining financial and economic standing. In the second quarter of 1999 a change occurred which can be construed as the first signal of overcoming the negative cost to sales ratio in sales for industry as a whole. However, the issue of bringing down production costs continues to be a fundamental problem at many enterprises, especially with little room for increasing producer prices for one's own output. The observable trend towards a falling rate of increase in producer prices in industry is on the one hand a consequence of the pursuit of anti-inflationary policy and is implied by the macroeconomic situation,

[28] The data pertain to 26,339 parties who keep books of account and which provide GUS (Central Statistical Office) with F-01 quarterly financial reports. These are entities whose number of employees exceeds 50 people - in the mining and quarrying sector and the manufacturing sector - and 20 people in the remaining sector. This data does not take into account the earnings of enterprises in agriculture, hunting, forestry, fisheries (including marine fisheries), as well as banks, insurance institutions and higher schools. Compared to March 1999 the number of such entities increased 3.5%.

and on the other - is driven by growing consumer requirements and fiercer competition.

The trend towards a faster growth in costs than in sales, which since 1996 had troubled the whole enterprise sector and industry, declined slightly in the first quarter of 1999 to disappear completely by the end of the first half-year (see table 4). In the first half of 1999 - for the first time in some period - the rate of growth in sales at industrial enterprises (compared to the corresponding period of the previous year) exceeded by 0.7% the rate of growth in own costs of product sold (see figure 55).

The cost to sales ratio for the sales of industrial products improved, showing a decrease from 97.7% at the end of 1998 to 97.2% at the end of the first quarter of 1999 and 95.8% at the end of the first half of 1999.

In manufacturing, in the environment of growing own costs of products sold, there was a slightly faster growth in sales (in the first half of the year compared to the corresponding half of last year), which resulted in the positive difference between the rates of growth (of sales and costs, respectively - see figure 56).

Extremely positive was the situation in the power, gas and water supply sector. The first half of 1999 brought a radical change in the relationship between the rates of growth in costs and sales. The change was observable as early as the first quarter of the year (see figure 57).

The rate of growth in sales of the power, gas and water supply sector in the first half of the year, exceeded the rate of cost growth by as much as 1.5 percentage point.

Table 4

Rate of growth in sales and own cost of products sold in industry and its three sectors in periods of Jan - Jun 1996 to Jan - Jun 1999 *(corresponding period of previous year = 100)*

	Jan to Jun							
Items	**1996**	**1997**	**1998**	**1999**	**1996**	**1997**	**1998**	**1999**
	Industry, of which:				Manufactoring			
Sales (%)	122.4	120.7	115.5	103.6	123.6	122.1	119.1	103.2
Own cost of products sold (%)	126.1	120.7	118.2	102.9	126.9	122.4	120.3	102.9
Difference between rates of growth (percentage points)	-3.7	-0.0	-2.7	0.7	-3.3	-0.3	-1.2	0.3
	Mining and quarrying				Power, gas and water supply			
Sales (%)	115.3	116.0	89.6	99.3	120.0	115.0	110.7	108.9
Own cost of products sold (%)	120.0	112.1	100.5	96.4	126.0	116.8	117.5	107.4
Difference between rates of growth (percentage points)	-4.7	3.9	-10.9	2.9	-6.0	-1.8	-6.8	1.5

Source: Unit data from GUS: aggregation and calculation by NBP.

Figure 55
***Rate of growth in sales and costs in industrial enterprises: Jan-Jun 1996 to Jan-Jun 1999 and rate of PPI growth** (corresponding period of previous year = 100)*

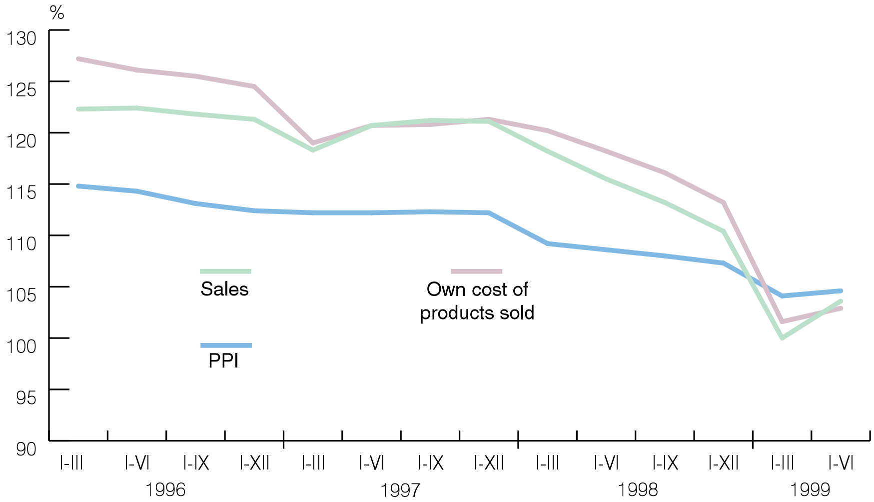
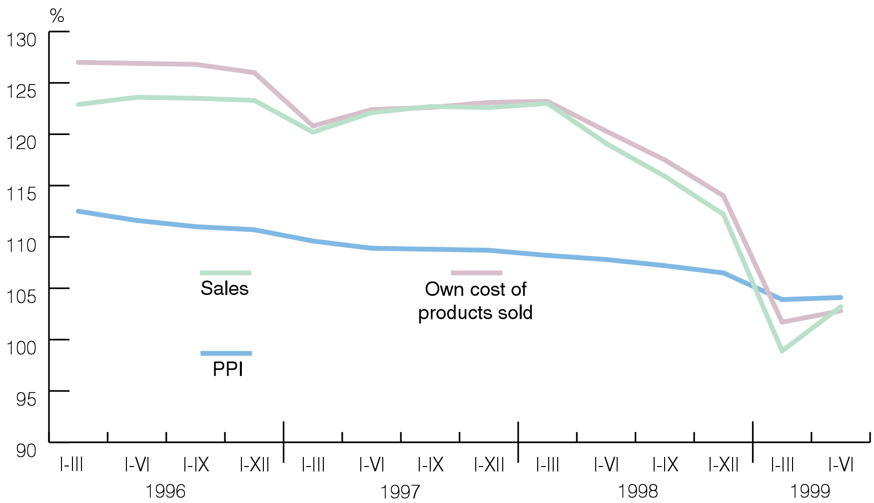
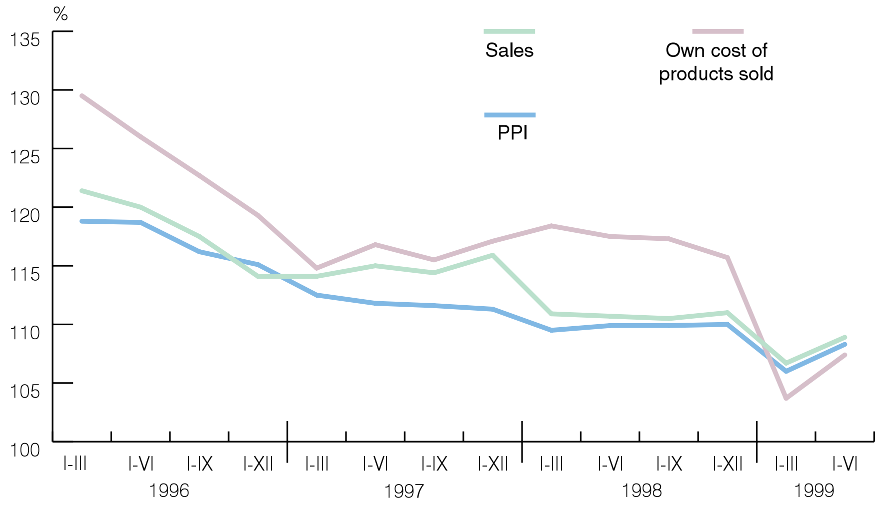


Figure 56
***Rate of growth in sales and costs in manufacturing enterprises: Jan-Jun 1996 to Jan-Jun 1999 and rate of PPI growth** (corresponding period of previous year = 100)*



It should be emphasised that at year-end 1998 it was actually the opposite - the rate of growth in costs exceeded by 4.7 percentage points the rate of growth in sales. Such radical change in a very short period was only pos-

Figure 57
***Rate of growth in sales and costs of enterprises in power, gas and water supply sector: Jan-Jun 1996 to Jan-Jun 1999 and rate of growth in PPI** (corresponding period of previous year = 100)*



sible thanks to price regulations, which indeed were effected for this sector's products. End of 1998 saw the liberation of prices for power and heat. The liberation (incomplete as it was, because price rises were subject to caps) resulted in their rises and enabled a robust growth in sales for the sector generating these goods. Such development was indeed projected at last year-end.

The situation in the power, heat and water supply sector - no matter how we evaluate its causes - has contributed from the beginning of the year to stronger industry earnings, although in the first half of 1999 the sector realised merely 12.2% of sales of products realised by industry as a whole.

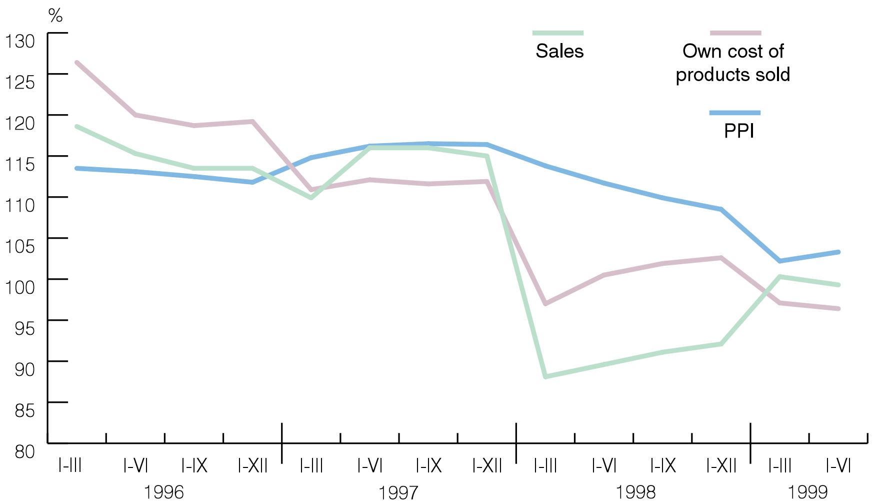
The mining and quarrying sector is a rather special case. Its situation has been caused by many years of neglect, restructuring delays, current problems with selling coal, ad hoc decisions influenced by demonstrations, collieries' debt cancellations, etc. One thus needs to be very careful when interpreting the drop in production costs in the first half of 1999 compared to the first half of 1998 and the emergence of a positive difference between the rate of growth in sales and the rate of growth in costs (compare figure 58). The sector continues to have a high deficit and in the first half had the highest cost to sales ratio of all the sectors. In the first half of this year its share in industry sales stood only at 6.4%.

In the first half of 1999 industry as a whole, just like the three sectors which made it up, continued to have a moderate rate of growth in producer prices (compare figures 55 to 58). But it was also for the first time in some period that the rate of growth in producer prices exceeded the rate of growth in costs. This largely explains the reduction in the difference between the rate of growth in costs and the rate of growth in sales and feasibility of some improvement in the cost to sales ratio. Still it has to be said that this was achieved by price rises rather than thanks to significantly improving management performance at enterprises within the sector.

Three groups of costs, in particular, made it impossible to reduce the costs of production in industry (analogously as in manufacturing). These were: full labour costs, depreciation and costs of services by external providers, of which the last-mentioned rose the fastest. However, growth in the cost of depreciation requires different treatment than the remaining costs. This is on account of depreciation playing the role of a source of funding asset replacement at enterprises. It should be recognised a rule in a development process that depreciation will permanently continue to be not only a very

Figure 58

***Rate of growth in sales and costs of enterprises in mining and quarrying sector: Jan-Jun 1996 to Jan-Jun 1999 and rate of growth in PPI** (corresponding period of previous year = 100)*



important but also growing cost item. The first and main reason is that depreciation costs must include revaluations of fixed assets, performed from time to time. Secondly, fixed assets put into operation are increasingly more costly due to technical and technological progress. Thirdly and lastly, the life of equipment is getting shorter and its replacement accelerated. For enterprises to raise appropriate funds to replace and upgrade their equipment, the share of depreciation in costs must be growing.

The general evaluation of the trends in costs broken down by types at enterprises of industry and its three sectors in the first quarter of 1999 has demonstrated that the cost intensiveness of production is still a problem (especially in the manufacturing sector, which is of key importance for the evaluation of the situation in industry). In a favourable market environment this may become a factor leading to price growth.

Monetary policy in the first and second quarter of 1999

Change of monetary policy targets and guidelines in 1999

The inflationary target for 1999 was originally formulated in June 1998. It was confirmed in the *Monetary Policy Guidelines for the year 1999* prepared in September 1998. The period which elapsed from that date was characterised by unforeseeable shocks (among others, considerable drop in raw material prices, including crude oil, growth of supply on the domestic market because of the Russian crisis), which had a material impact in 1998 on the slower than expected rate of price growth and the slower than expected GDP growth. In the first two months of 1999 a drop of 5.6% in the year-on-year rate of inflation was recorded. The growth in prices was almost twice as low as in the corresponding period last year.

In this situation - although some slow-down in the downward path for the rate of inflation had been expected for the further few months or even its somewhat picking up - the Monetary Policy Council decided to amend the short-term monetary policy target for 1999, as adopted in September 1998, and also some guidelines in its connection.

Meeting on March 24, 1999 and having considered the current economic situation and trends existing on the financial markets, the Monetary Policy Council decided to amend in the short-term monetary policy target for 1999 and expected the target, as measured by December 1999 year-on-year CPI growth, to be within the range of 6.6%-7.8%. The Council envisaged that the target would be implemented in the environment of a 1999 GDP growth at a rate of 4% and a growth in the deficit on the current account to the level of about 5.5% of GDP.

In deciding to amend the inflationary target in 1999 the Council assumed that the monthly distribution of price changes this year would differ from previous years, recognising the possibility of a temporary rise in inflation in the following months of the current year. As these factors are hard to project, the Council defined the infla-

1999 Targets and Guidelines contained in the Monetary Policy Guidelines for the year 1999 (September 1998) and approved by the Monetary Policy Council on March 24, 1999

Target	September 1998	March 1999
1. Inflation reduced to (%)[a]	8-8.5	6.6-7.8
Guidelines		
2. GDP growth (%)	5.4	About 4
3. Growth in the money aupply (M2) (in billion zloty)	34-41	unchanged
4. Deficit on the current account of the balance of payments (% GDP)	-	up to about 5.5

[a] Growth in CPI December-on-December

Source: National Bank of Poland.

tionary target within a broader band than it had been adopted in *Monetary Policy Guidelines for the year 1999* of September 1998.

After the first half of 1999 it can be said that the process of recovery from the stagnation trends in West European economies has been taking slower than expected. This is particularly true of Germany. At the same time no significant recovery in exports to Eastern markets is observed. This situation, resulting in increasing competition on the international markets seems to pose many problems to Polish enterprises which manufacture goods and provide services subject to international trade. At the same time the moderate acceleration in growth, observable in the first half-year of the current year, gradually started to bring higher import expenses. Consequently, the higher than expected trade deficit, services deficit and significantly lower balance on unclassified transactions on the current account contributed most to exceeding the current account deficit forecast.

Monetary policy instruments

In the first half of 1999 the Council took a number of important decisions in the field of monetary policy instruments. These pertained to interest rates and the exchange rate system. What was also discussed was the conversion of central government liabilities to the NBP and the issue of decreasing the mandatory reserve ratio.

The most important decisions of the Monetary Policy Council in the first half of 1999

Date of decision	Decision on:
January 20	- lowering the interest rate on lombard credit from 20% to 17% - lowering the bills rediscount rate from 18.25% to 15.5% - lowering the minimum rate of yield on 28-day open market operations from 15.5% to 13% per annum
March 24	- change the 1999 monetary policy target - widening the permissible range of zloty exchange rate fluctuation from ±12.5% do ±15% around central parity - lowering the monthly rate of zloty devaluation vis a vis the foreign currency basket from 0.5% to 0.3%
April 21	- recommendation to the NBP Management Board to abolish the transaction character of the currency fixing by the end of June 1999

Source: National Bank of Poland.

Given the faster than expected reduction in the rate of inflation in the fourth quarter 1998 and the projections as to the continued drop in CPI in the first quarter 1999, and also the observable lowering of business activity, the Council at the meeting on January 20 decided to reduce the NBP interest rates. Interest on lombard credit was lowered by 3 percentage points (from 20% to 17%), the bill of exchange rediscount rate was reduced by 2.75 percentage points (from 18.25% to 15.5%). As to 28-day open market operations the decision was that the NBP would conduct these at a yield rate no lower than 13%, which was tantamount to lowering their minimum yield from 15.5% to 13%, i.e. by 2.5 percentage points.

In reducing the interest rates the Council stated that the effective reduction of inflation in 1998 and its projected continued drop in the first quarter 1999 allowed to make monetary policy much less restrictive, without jeopardising the implementation of the inflationary target. Making monetary policy less restrictive was all the more justified that Sejm had passed the budget as proposed by the government. Also the absence of any stronger pressure in the form of more aggressive growth in real wages in the final months of 1998 demonstrated that those would not pose a threat to the implementation of the 1999 inflationary target.

On 24 March 1999, as part of their efforts to implement the *Medium-term Monetary Policy Strategy, 1999-2003* and *Monetary Policy Guidelines for the year 1999* in relation to the gradual floating of the rate of exchange, the Monetary Policy Council decided to expand the band of permissible monthly volatility of NBP mid-rates to ±15% around central parity. At the same time the Council lowered the monthly rate of crawling devaluation from 0.5% to 0.3%, adjusting its pace to the new inflationary target for 1999 and the shrinking difference between the Polish and foreign rate of price growth.

In its decision of the April 21, 1999 the Monetary Policy Council recommended to the NBP Management Board the abolition of the transaction character of the FX fixing, no later than by the end of June 1999. Based on this, on May 7 the NBP Management Board took the resolution to repeal the resolution on the introduction of the "By-laws for the purchase and sale of foreign currencies by banks at the NBP", which took effect on June 7 1999. Consequently, the last fixing session between the NBP and commercial banks was held on June 4.

Inflation Prospects

The analysis of the economic situation in Poland in the first half of 1999 leads one to conclude that there are no major threats to the implementation of the 1999 inflationary target, despite the fact that by the end of 1999 the year-on-year price growth index may go up further still. The trend towards reversing the drop in inflation or even its pick-up, which has been in place since March, is not a result of Poland's deteriorated macroeconomic position, but is basically the expected effect of the different than in previous years distribution of growth in regulated prices and indirect taxes, as well as changes in the existing trends related to prices for raw materials on the world markets, mainly oil. The year 1999 should, however, see the continuation of the still rather favourable, from the point of view of inflation control, situation in the food market.

The inflow of foreign direct investments from privatisation, forecasted by the end of the year, creates relatively favourable terms for funding the current deficit.

However, too long a continuation of the trend towards growing inflation can engender additional insecurities as to the stability of the disinflation programme in the economy. The likelihood of such scenario is not very high at the present moment, but the Monetary Policy Council is ready to tighten monetary policy in case of the emergence of relevant premises making such adverse scenario more realistic.