National Bank of Poland

Monetary Policy Council

INFLATION REPORT
1999, III Quarter

Warsaw, December 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 23 35, Fax: (48-22) 653 13 21

CONTENTS

SUMMARY*

Following a period of stabilisation in the first and second quarters of 1999, the third quarter of the year brought a surge in the rate of inflation. The inflation witnessed in this quarter proved higher than that projected by the central bank, coming to 8% in September. Given the development of inflationary processes forecast for the fourth quarter, it can be assumed that the short-term inflation target for 1999, set by the Monetary Policy Council at 6.6% – 7.8%, will now be overshot.

The marked acceleration in price growth seen in the third quarter was primarily attributable to strong, hard to predict supply shocks. Firstly, these involved the snowballing effects of the reduced supply of certain agricultural produce, linked to escalating price-support purchases by the Agricultural Market Agency and greater tariff protection, and secondly – an increase in fuel prices on the domestic market. Inflation was additionally stimulated by the depreciation of the zloty. The developments cited above had such an adverse effect on price growth because they occurred on markets that are characterised by a high degree of monopolisation. This is particularly true of the markets for fuels and energy; the monopolised nature of the latter made it possible to pass on higher world prices, increased excise duty and price deregulation in the shape of higher retail prices. At the same time, the first three quarters of the year saw greater cost push towards price growth, as evidenced by the more rapid increase in producer prices than in the previous year.

Macroeconomic developments in the second and third quarters of 1999 indicate that fiscal and monetary polices created a favourable environment for the unfolding of inflationary processes triggered by supply shocks. The increase in the consumer price index (CPI) outstripped underlying inflation from the second quarter of the year onwards, which confirms that inflation was fuelled by movements in the most volatile prices, although underlying inflation – following a period of stabilisation – also began to rise in the third quarter. The increase in underlying inflation suggests that faster price growth may also be rooted in monetary factors. The maintenance of this trend in the future could also reflect the indirect consequences of the supply shocks emanating from the markets for fuels or foodstuffs.

The fact that macroeconomic policies were less restrictive than expected was mirrored in a rapid growth in consumer demand. This demand, to a certain degree directed towards imported goods (cars and consumer durables), exacerbated the deficit on the current account and the weakening of the zloty. This increased demand also contributed to a decline in the propensity to save among households, which made itself apparent as the growth in outstanding lending outpaced that of new deposits taken by the banks.

Another important factor stimulating demand was the size of the public sector financial deficit, which was higher than projected.

Demand pull effects within the economy were also heightened by factors of a structural nature. These included the large potential for deferred consumption, the expanding range of bank loan products, and the active presence of non-bank financial intermediaries. At the same time, mounting consumer loan demand was encouraged by the illusion of nominal interest rates and the conviction that further rate cuts were in the offing.

The Council admits that the relaxation of monetary policy performed at the turn of 1998 and 1999, intended to correspond to the Government's declared level of fiscal policy restrictiveness, proved to be too far-reaching, with the result that the money supply and supply of credit rose faster than was desirable. Fiscal pol-

* The present *Report* was compiled on the basis of statistical data available by the end of November 1999.

icy, instead of being tightened as expected, was in fact slackened, as demonstrated by the information now available – after considerable delay – on the Social Insurance Board (ZUS) and health trusts, which substantially overran their planned deficits. In parallel with this, the rapid growth of the current deficit acted to undercut the zloty, indirectly impacting inflation.

Recognising the dangers signalled by the available information on macroeconomic developments up to August – the emerging trend for swifter growth in the CPI, in the Producer Price Index (PPI) and in underlying inflation, the strong expansion of consumer lending and the difficulties in reducing the public sector financial deficit – the Council took the decision to raise the NBP reverse repo rate by 100 bps. This decision had not been generally expected by the financial markets and caught part of them by surprise. September's rise in the reverse repo rate primarily represented a sign that the central bank was prepared to defend its inflation target for the year 2000, while also constituting a warning to borrowers that the price of credit could go up.

The third quarter of the year saw a continuation of the tendency for slow growth in personal deposits, which was to some extent offset by faster growth in bank liabilities to the corporate sector. At the same time, the depreciation of the zloty contributed to an increase in the zloty equivalent value of foreign currency deposits. The most important counterpart to changes in money stocks at this time were bank claims on persons and corporates. Outstanding personal borrowings grew around 2.5 times faster than corporate borrowings. However, September then brought an increase in corporate borrowings, which could constitute confirmation of an upturn in output and a more positive corporate view of business prospects. The impact of the general government sector, on the other hand – in contrast to the first half of the year – was to weaken money supply growth in the third quarter, as this sector reduced its debt to the banks.

The third quarter of 1999 was marked by an increase in investment risk on various segments of Poland's financial markets. This is primarily traceable to internal factors: a deterioration in the transparency of public finances and problems in controlling the deficit in this sector; the large shortfall on the current account, which coincided with symptoms of an upswing in business activity and a continuation of poor export figures; and inflation running higher than expected. Polish asset prices were also impacted by other factors, such as the "Y2K" problem, and the rise in interest rates expected or actually experienced on the most important global financial markets. As a result, the yield curve for Polish Treasuries shifted upwards. In addition, the curve took on a positive slope out to two years, with a negative slope thereafter, which could indicate that the market expects inflation to steady temporarily at a higher level than previously anticipated, and then to come down.

The factors outlined above also served to push down zloty exchange rates, which – thanks to the abolition of the "operational" or "trading" character of the fixing in June 1999 – became more flexible in both formal and practical terms. The trend witnessed for some time for the zloty to appreciate in real terms seems to be helping to improve the competitiveness of at least some Polish exporters, together with those businesses competing against imports on the domestic market. An analysis of the surveys that have been conducted fails to support the conclusion that at the end of the third quarter the commercial banks were increasingly expecting a major depreciation of Poland's currency – if this were the case, it could be a factor fuelling inflationary expectations.

The third quarter of 1999 was a period of further acceleration in industrial output and GDP growth, despite the lack of any distinct recovery in exports. The upturn in economic activity was made possible by renewed demand for capital equipment and production supplies, prompted by brighter forecasts of future sales prospects. Domestic demand also continued to be strengthened by higher public sector expenditure.

The balance of payments figures for the third quarter suggest that the current deficit for the year as a whole could amount to some 7% of GDP. An analysis of the evolution of particular items within the balance of payments indicates that the key factor aggravating the current deficit over the first three quarters of 1999 was the collapse of trade with the East, which led to a drastic decline in the surplus on unclassified current transactions and the loss of revenues from transportation services. An important element in the deterioration of this situation is also the rapid growth in imports of modern services which is primarily a result of the higher involvement of foreign capital in the Polish economy. The third quarter seems to have brought some visible symptoms of improvement in Polish exports. However, despite a greater volume of incoming foreign direct investment (FDI) over the first three quarters of 1999 than in the corresponding period of 1998, these stable inflows now covered a smaller proportion of the current deficit.

In addition to raising the reverse repo rate in the third quarter of 1999, other decisions were taken of major significance for both the effectiveness of monetary policy and the competitiveness of the Polish banking industry. Reserve requirements were made uniform for all eligible bank liabilities and the reserve ratio was lowered to 5%. Cutting reserve requirements was also combined with the conversion of non-negotiable central government liabilities into negotiable Treasury securities. The central bank will be able to use these to drain surplus liquidity from the banking sector. The funds released under this operation are to be applied by the commercial banks to the purchase of non-negotiable long-term bonds from the NBP.

Inflationary processes in the third quarter of 1999

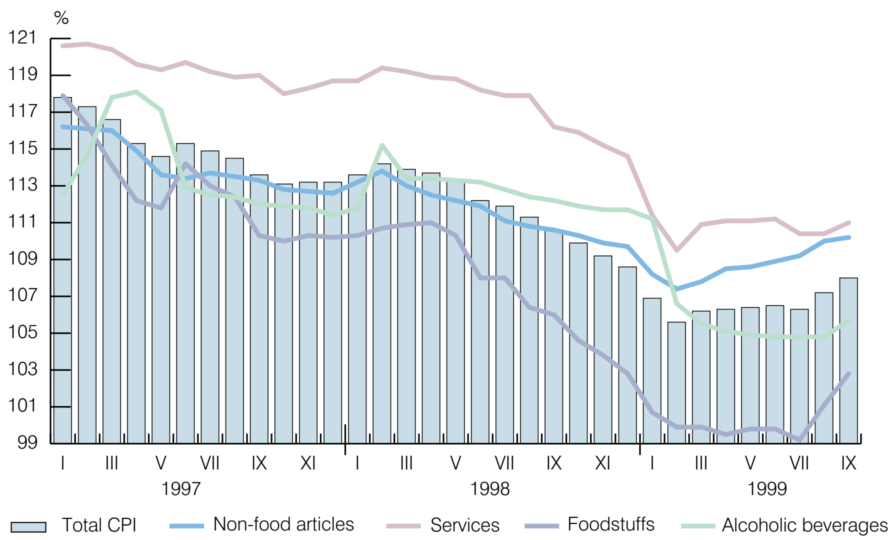
Consumer prices

During the third quarter of 1999, annualised inflation rose from 6.5% in June to 8.0% in September, breaking through the upper limit of the inflation target set by the Monetary Policy Council for year end (6.6% - 7.8%). The Council had anticipated that inflation would rise somewhat in the second half of the year. However, this increase proved faster and greater than projected (cf. Fig. 1). Thus, the Council's inflation forecasts for the current year, included in the previous *Report*, were not borne out.

Inflationary processes in the third quarter of the year had a diverse character. In July, owing to a seasonal decrease in foodstuff prices, annualised inflation fell a further 0.2 points, to stand at 6.3%. However, for the remainder of the quarter annualised inflation grew sharply from one month to the next, gaining 0.9 points in August and another 0.8 points in September. The distinct climb in annualised inflation in August was due to the strong acceleration of annualised price growth in foodstuffs and non-alcoholic beverages, and in non-food

Figure 1

***Consumer price growth** (corresponding period previous year = 100)*



articles. The further steep increase in inflation seen in September was primarily linked to a continuation of swifter food price growth, and also to a faster rise in service prices. The price of non-food articles also continued to go up relatively quickly.

Total consumer price growth over the period from June to August came to 1.7%, as against a decrease of 0.2% during the same period of 1998. Monthly price growth is depicted in Fig. 2.

The basic trends at work within consumer price movements are presented in Table 1 below.

The clear acceleration of annualised inflation, particularly in the last two months of the third quarter, was largely caused by developments on the domestic market for foodstuffs and on world commodity markets.

By the end of September 1999, year-to-date inflation came to 6.6%, a level not much lower than that seen twelve months previously, when it had stood at 6.9%. (cf. Fig. 3).

Compared to the previous year, major changes took place within the pattern of consumer price growth. In August and September 1999, there was a marked increase in the impact of foodstuff prices on overall price growth. In August, the price of foodstuffs and non-alcoholic beverages showed a small seasonal drop on the previous month (down 0.1%), while the corresponding

Figure 2
Consumer price growth (previous month = 100)

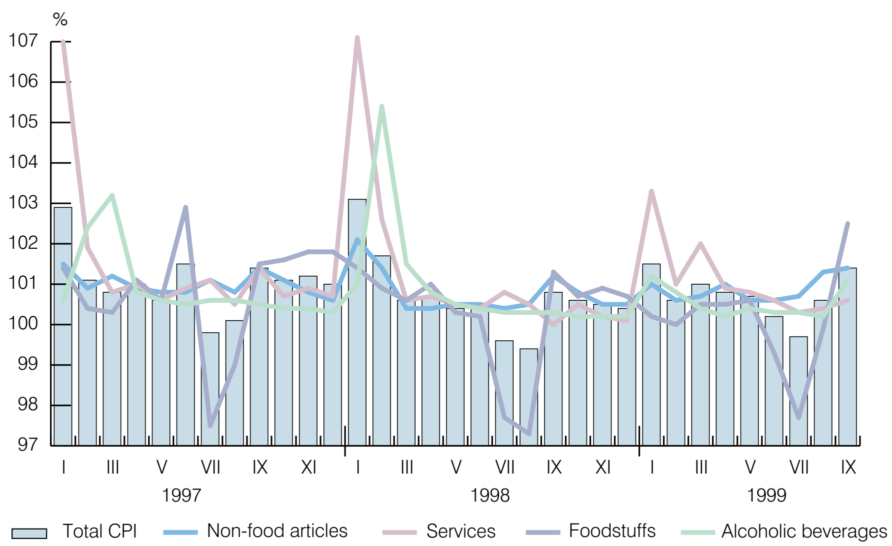


Table 1
Inflation trends, 1999

Month	CPI	Foodstuffs and non--alcoholic beverages	Alcoholic beverages and tobacco products	Non-food articles	Services
			annualised price movement		
January	6.9	0.7	14.3	7.4	11.4
February	5.6	-0.1	9.5	6.9	9.5
March	6.2	-0.1	9.2	7.2	10.9
April	6.3	-0.5	9.2	7.9	11.1
May	6.4	-0.2	8.8	8.1	11.1
June	6.5	-0.2	9.1	8.3	11.2
July	6.3	-0.8	9.5	8.6	10.4
August	7.2	1.1	9.6	9.5	10.4
September	8.0	2.8	10.6	9.6	11.0
			price movement, quarter-on-quarter		
Q1	3.1	0.7	4.3	2.0	6.4
Q2	1.6	0.5	1.9	2.2	2.3
Q3	1.7	0.0	2.6	3.5	1.2

decrease in August 1998 came to 2.7%. In September 1999, the price of foodstuffs and non-alcoholic beverages went up 2.5%, which is almost twice as much as the increase seen in September 1998 (1.3%). The impact on

Figure 3
Consumer price growth (December previous year = 100)

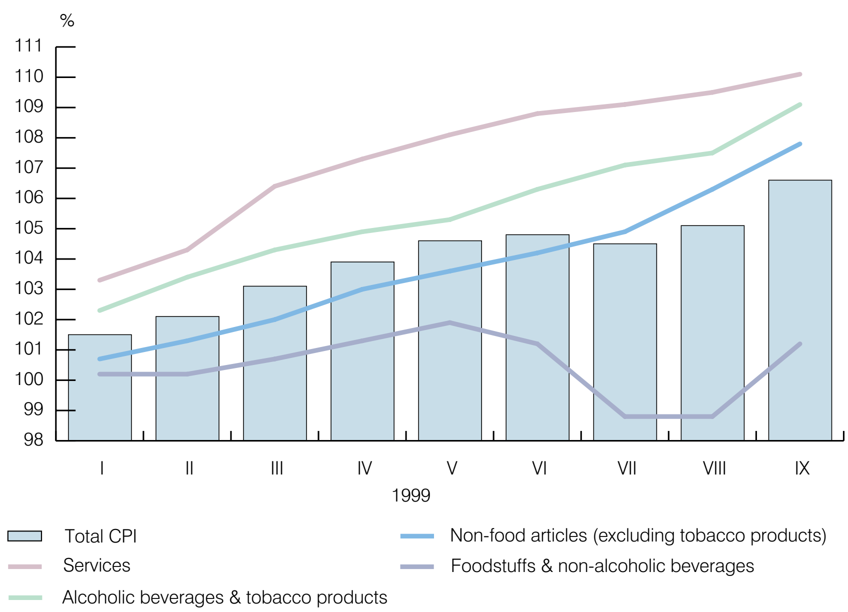
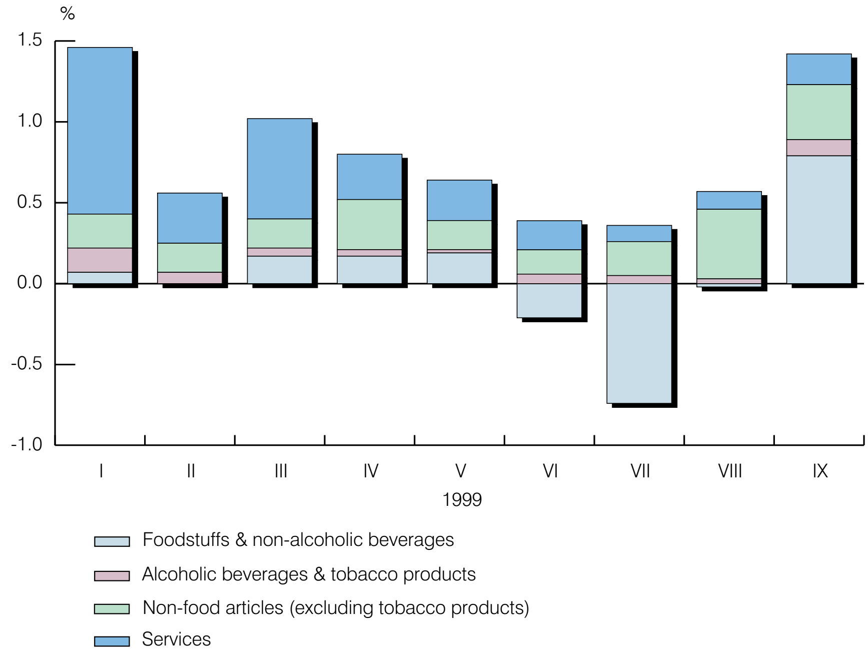


Figure 4
Contribution of product categories to overall CPI growth (previous month = 100)



overall consumer price growth of price movements in the respective categories of consumer goods and services in the particular months of 1999 is presented in Fig. 4.

Of the major factors behind the renewed acceleration of inflation in the second half of 1999, the following deserve mention:

- the substantial increase in the level of protection (in broad terms) afforded to the domestic market for agricultural produce, achieved using administrative measures;
- the very large rise in domestic fuel prices, which yielded considerable direct effects, and also various non-specific, indirect effects that are difficult to quantify;
- the sharp depreciation of the Polish zloty;
- a clear relaxation of fiscal policy compared to the previous two years;
- a less restrictive monetary policy.

The second half of 1998 saw the continuation of a large surplus supply of agricultural produce. With no adequate government intervention forthcoming, this period was marked by a considerable fall in prices and a significant deterioration in the profitability of agricultural production.

This year, the farming industry adjusted its level of output in response to lower returns and poorer weather conditions. This naturally reduced supply. At the same time, the Government intervened on the market for agricultural produce, both boosting demand (through official purchases) and containing supply (through tariffs). This intervention on the agricultural market produced a leap in foodstuff prices. This explains why foodstuff prices showed no seasonal drop in August, as they had in past years, but in fact went up. The end result was a bounding increase in inflation, which then extended into September.

Meanwhile, foodstuff prices on world markets continued to stay low, at around 80% of the previous year's prices up until July, then spurting to 90% in subsequent months.

Until May, agricultural commodities were trading on world markets at lower prices than a year before, fetching higher prices than last year's in the period from June until September. Transaction prices for imported foodstuffs and livestock remained at last year's levels from April to September. The external pricing environment on agricultural markets was thus less favourable than it had been in both the second half of 1998 and the first half of 1999.

From March 1999 onwards, a strong inflationary impulse – resembling a shock effect, although over a longer time horizon – was generated by movements in fuel prices. These movements were rooted in the changes occurring on world markets, and also by a build up of other factors driving up domestic fuel prices in Poland.

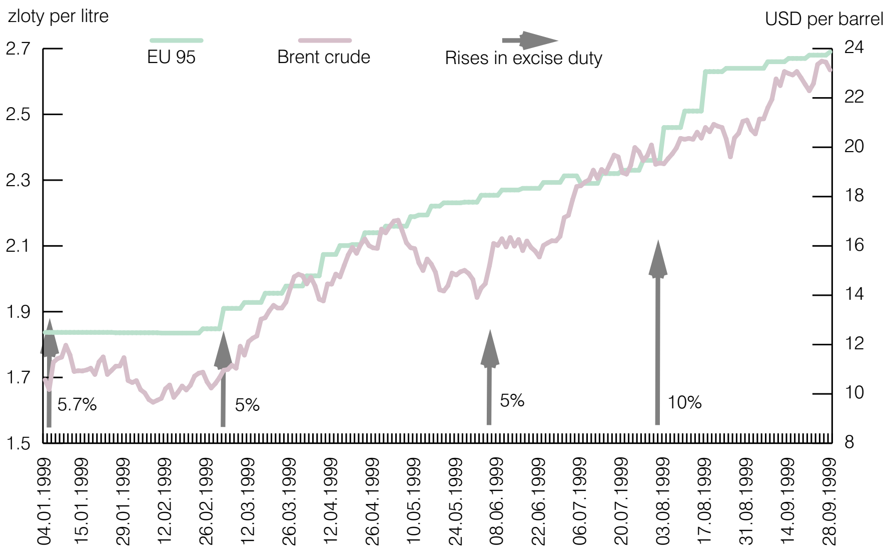
The third quarter of 1999 brought an accentuation of the upward trend in world oil prices that had been present since February, with short intervals in May and June. From January to September, world oil prices had shot up 115%, with the increase from July to September alone coming to some 37%. The effects of rising world oil prices should partially have been neutralised in Poland by certain shifts within the structure of imports by volume. The great majority of imported raw materials for the production of fuels (energy feedstock) come from Central and Eastern Europe; this region's share in Polish imports of these materials went up from 82% in the first half of 1998 to 89% in the first half of 1999, while the share attributable to the countries of the European Union fell from 11% to 6%. At the same time, there was a substantial increase in the proportion of finished fuel products imported from Central and Eastern Europe (up from 18% in the first half of 1998 to 40% in the first half of 1999), with an accompanying drop in the proportion of these imports coming from the EU (down from 80% to 60%). In all, imports of finished products (petrol, oils and kerosene) from Central and Eastern Europe rose 132.9% year-on-year in the first half of 1999, while imports of those products from the EU fell 24.4%.

The average purchase price of energy feedstock, expressed in zloty, rose some 24% in the first half of the year compared to the second half of 1998 **(figures taken from SAD documents**; in dollar terms, the increase was 13%). Over the same period, the average zloty purchase price of finished fuel products went up around 14% (2% in dollars). Yet crude oil prices on world commodity exchanges climbed 44% in dollar terms in the period from June 1998 to June 1999.

Polish importers, by altering their source of supply, were able to limit the impact on fuel production costs of rising input prices resulting from more expensive crude oil and premium petrol on world exchanges. However, factory-gate prices at Polish refineries went up in parallel with the price increases recorded on those exchanges. The refineries set their fuel prices in relation to an "import parity" that is based on world prices plus excise duty, customs duty and other purchasing expense. According to experts that monitor the domestic fuel market, 25% of the gross price derived from import parity represents the zloty equivalent of world prices for premium petrol, while around 60% constitutes excise duty and VAT. The rise in factory-gate fuel prices therefore also includes the effects of increases in excise duty, which in the first half of 1999 totalled 16.5%. On August 1, excise duty was again raised, this time by 10%. This was the fourth rise since the beginning of the year, and was performed a month earlier than projected in the target assumptions for the 1999 Budget (cf. Fig. 5).

In the third quarter of the year, with Premium petrol up around 36% in price on world markets and excise duty having been raised 10%, and with exchange rate risk unhedged, the increase in factory-gate fuel prices at the refineries should have amounted to around 16%, and this is what it did in fact come to. The increase in retail

Figure 5
Average Polish retail fuel prices vs upper world oil prices, 1999



prices was thus a result of the pricing mechanism adopted, and may partially not have reflected the actual cost of importing fuel.

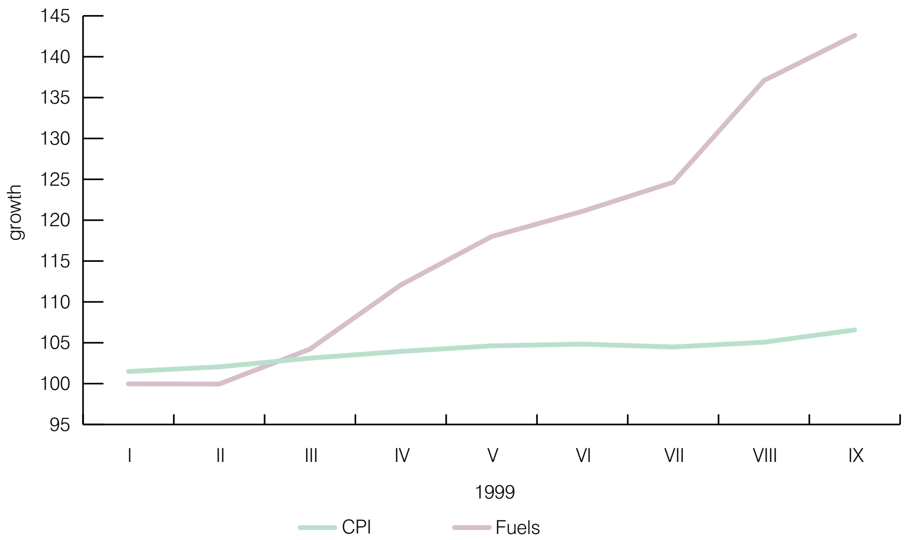
In these circumstances, it can be presumed that the large size of the fuel price increases seen on the domestic market was to some degree a consequence of the monopoly structure of the market, something that was additionally reinforced by the establishment of Polski Koncern Naftowy - the Polish Petroleum Corporation (cf. Fig. 6).

In the course of the third quarter, the direct effect on inflation of higher fuel prices was felt most powerfully in August, when the rise in fuel prices pushed overall price growth up 0.3 points, taking it to 0.6%.

At the end of the third quarter, domestic retail fuel prices had risen 42.6% since December 1998, while excise duty had gone up 28.2% during the same period.

It is also apparent that fuel prices have been factored into corporate costs, with producer prices climbing sharply compared to 1998. This has been an important element in the upward trend in producer prices recorded in 1999. In a situation whereby – particularly in the third quarter – economic growth was speeding up and business was picking up in industry, one reason being the contin-

Figure 6
Movements in CPI vs movements in fuel prices (GUS figures) (December previous year = 100)



uation of strong domestic demand, companies found passing higher production costs on to consumers easier than in the second half of 1998 and first half of 1999.

Over the first three quarters of the year, transaction prices for imported goods also went up. Nine months into the year, year-to-date growth in these prices was in the region of 5.5% (as against 4.1% in the corresponding period of 1998).

Due to the impact of the factors described above, the rate of price growth for non-food articles trended upwards without interruption from March to September, and by the end of the latter month annualised growth here came to 9.6%, thus surpassing the rate of inflation. At the same time, it is noticeable that the differential between price growth for non-food articles and inflation became larger as the months went by. In the first quarter of the year, annualised price growth for non-food articles was 0.5 - 1.3 points ahead of inflation, while in the second quarter it was some 1.6 - 1.8 points ahead. In the first two months of the third quarter, i.e., in both July and August, prices for non-food articles were now climbing 2.3 points faster than inflation, while in September this differential again narrowed to 1.6 points. This accelerated price growth for non-food articles is partly the result of higher fuel prices and other production costs being incorporated in the price of consumer goods and services.

As regards administratively controlled prices – apart from the situation already outlined concerning fuels – the third quarter also saw other factors here which temporarily pushed up inflation. These involved price movements engendered by further increases in September in excise duty on tobacco products and alcoholic beverages.

In the course of the third quarter, service prices rose 1.2%, i.e., at a rate considerably below that of inflation (up 1.7% in the same period). On an annualised basis, service prices displayed the most stable growth of all four primary categories of consumer prices. Nonetheless, it was also in this category that growth steadily continued to be relatively highest. At the end of September, year-to-date growth in service prices stood at 10.1%, substantially above the growth in the other categories of consumer prices and 3.5 points higher than inflation.

Underlying inflation

The figures for underlying inflation presented below refer to the core long-term component of consumer price growth, and illustrate movements in the CPI after excluding the effects of seasonal fluctuations and price swings produced by temporary supply shocks.

In the present *Report*, underlying inflation rates are again shown on an annualised basis. This approach eliminates seasonal fluctuations and paints a better picture of the real trends in inflation.

The *Report* presents figures for underlying inflation calculated as follows:

- the rate of underlying inflation as adjusted to exclude those prices that exhibit the highest volatility[1],
- the rate of underlying inflation as adjusted to exclude administratively controlled prices[2],

[1] Underlying inflation excluding the most volatile prices is calculated by eliminating those groups of consumer prices that exhibited steep surges or slumps in the period under examination.

[2] Underlying inflation excluding administratively controlled prices is calculated by eliminating those groups of consumer prices that are not determined by market mechanisms. This inflation rate cancels out the impact of administrative policies on inflation, since the group of controlled prices includes those subject to direct administrative control (official prices); those subject to indirect control, where a major price component is excise duty (fuels, alcoholic beverages, tobacco products) or where ceilings on price growth are in place (electricity, district heating); and those prices that are uniform throughout the country or in particular regions (municipal transport fares).

Figure 7
CPI vs underlying inflation (excluding most volatile prices)
January 1998 - September 1999 (same month previous year = 100)

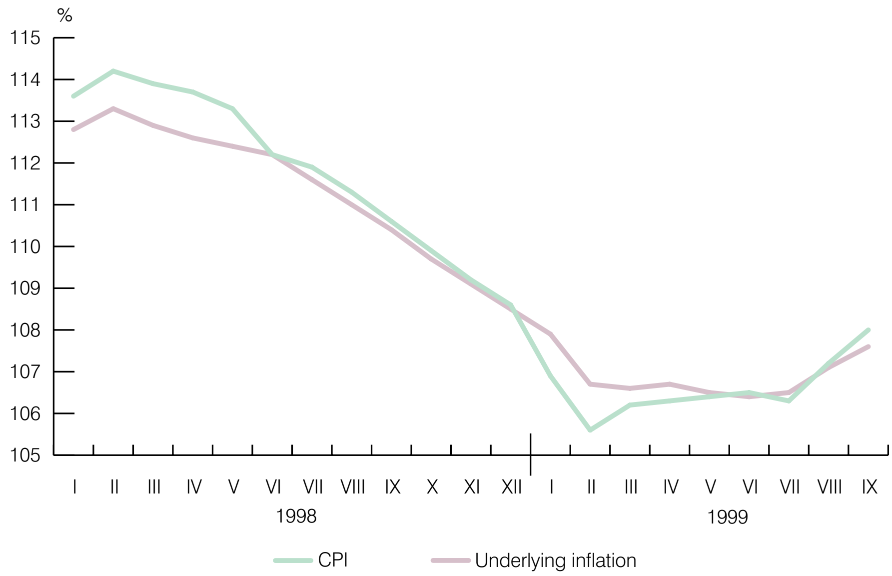


Figure 8
CPI vs underlying inflation (excluding administratively controlled prices)
January 1998 - September 1999 (same month previous year = 100)

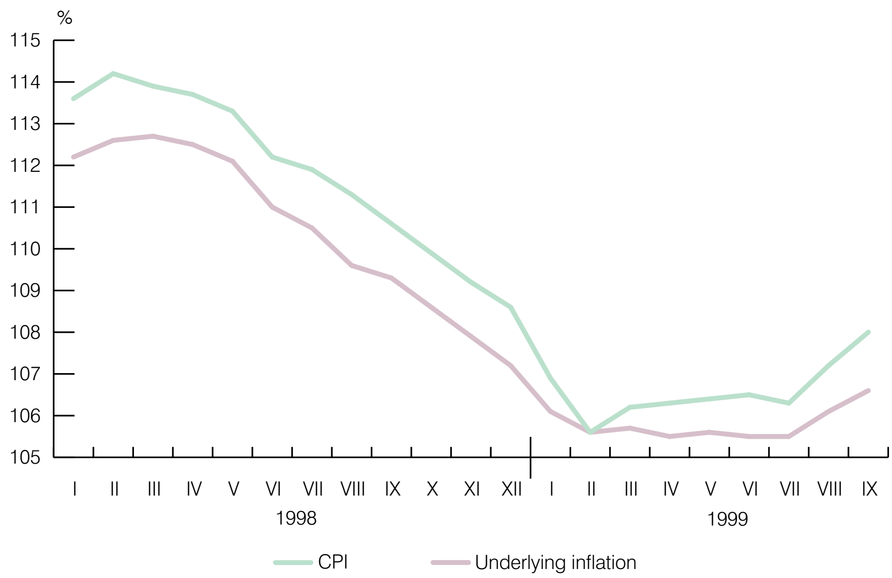


Figure 9
CPI vs 15% trimmed mean, January 1998 - September 1999
(same month previous year = 100)

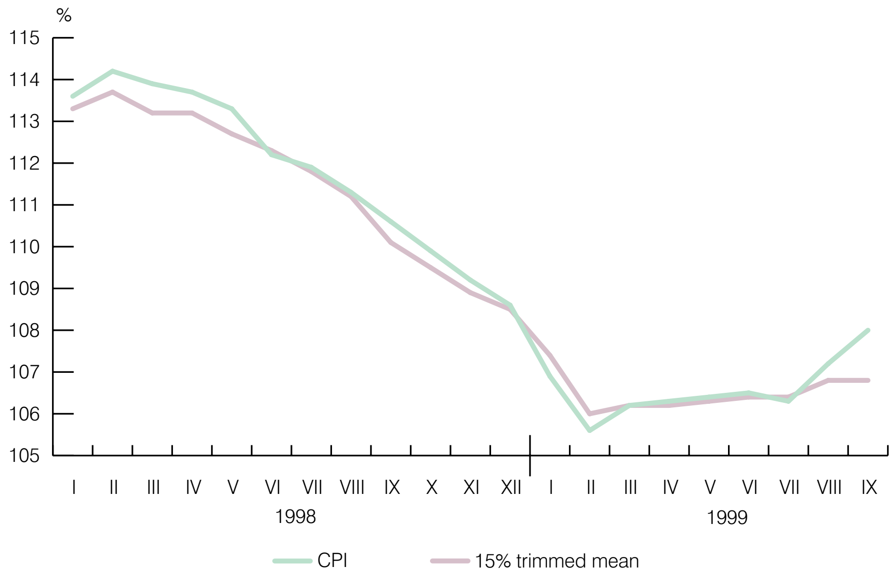
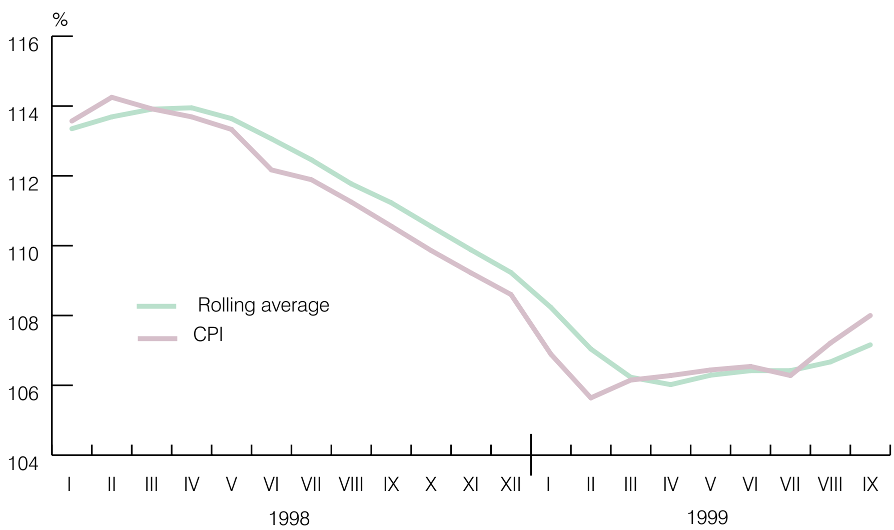


Figure 10
CPI vs 3-month rolling average *(same month previous year = 100)*



- a 15% trimmed mean obtained from a disaggregated CPI.

In addition, for information purposes, the Report includes a 3-month rolling average CPI.

Annualised rates of underlying inflation, compared to movements in the CPI, are set out in Figures 7-10.

The soaring growth in consumer prices seen in the third quarter of 1999 was also accompanied by a rise in underlying inflation. August and September brought a distinct rise in underlying inflation (on an annualised basis) as adjusted to exclude the most volatile prices (cf. Fig. 7), and as adjusted to exclude administratively controlled prices (cf. Fig. 8). Underlying inflation as calculated using a 15% trimmed mean edged up slightly in August compared to July, and then stayed flat in September (cf. Fig. 9).

In addition, a 3-month rolling average has been computed (cf. Fig. 10), which corresponds to the course of underlying inflation, both excluding the most volatile prices and excluding administratively controlled prices. This measure of price growth also points to underlying inflation gaining speed.

The movements in indicators of underlying inflation demonstrate that the escalation of consumer price growth is also rooted in monetary factors.

Producer prices

At the end of the third quarter of 1999, producer prices were up 5.0% year-on-year, which was 3.0 points less than twelve months before. The distribution of price growth in the particular sections of industrial activity was not uniform in the period under review. Prices rose most sharply in electricity, gas and water supply, having gone up 9.2%, i.e., 0.7 points less than a year previously. Prices rose more slowly than the PPI as a whole in both manufacturing (up 4.4%) and mining and quarrying (up 4.0%). Compared to the situation at the end of the third quarter of 1998, price growth was considerably more restrained in both of these sections, down 2.8 points in manufacturing, and 5.9 points in mining and quarrying.

Despite overall, year-on-year producer price growth coming down during the first three quarters of the year compared to the corresponding period of 1998, a clear acceleration of growth was seen on a year-to-date basis

(December 1998 - September 1999). Viewed in these terms, producer prices were up 5.5%, which is 1.1 points more than a year previously. In the particular sections of industrial activity, year-to-date price growth was also higher over the first nine months of 1999 than it had been in the same period of 1998. The greatest increases were reported in electricity, gas and water supply, where producer prices were up 10.6% on December 1998 (0.9 points more than twelve months earlier). Prices in mining and quarrying were 4.9% higher (2.5 points more than twelve months before), while in manufacturing they were up 4.7%, whereas a year earlier growth had been 1.1 points less (cf. Fig. 11).

In the third quarter of 1999, producer prices rose 5.8% compared to the same quarter of 1998, which represents 0.9 points lower growth than in the corresponding period of the previous year. Compared to the third quarter of 1998, the sharpest price increases were in electricity, gas and water supply (up 11.0%), with prices up 5.4% in mining and quarrying, and 5.0% in manufacturing.

Although producer price growth was markedly lower in each of the three quarters of 1999 as compared to the same quarters of 1998, the underlying trend was clearly

Figure 11
Producer price growth, by section of industrial activity
(December previous year = 100)

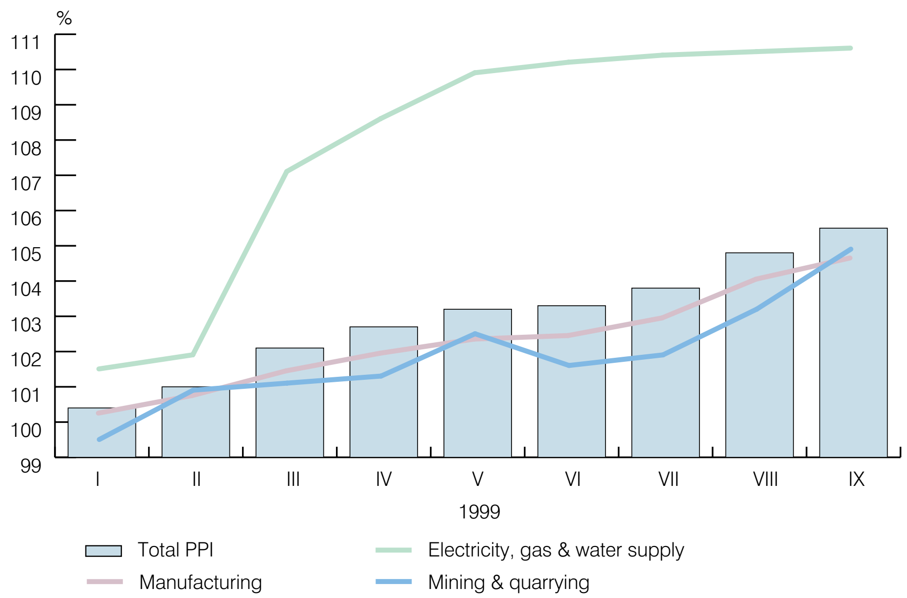
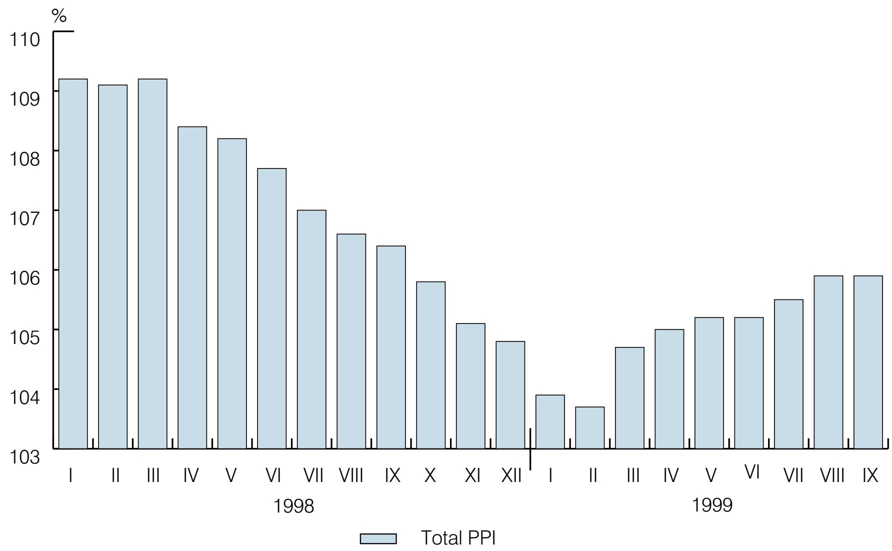


Figure 12
Producer price growth *(same month previous year = 100)*



different. In 1998, producer price growth slowed from one quarter to the next, while in the first three quarters of 1999 growth became increasingly sharper (4.1% in Q1, 5.1% in Q2, and 5.8% in Q3).

Annualised producer price growth rose during the third quarter of 1999 from 5.2% at the end of June to 5.9% in September (cf. Fig. 12).

With consumer demand on the rise in 1999, the circumstances were more favourable than in 1998 for companies to pass the above producer price rises onto the consumer.

Factors conditioning inflation in the third quarter of 1999

The money supply and prices on financial markets

The money supply in the third quarter of 1999

At the end of the third quarter of 1999, the total money supply[3] stood at 246.0bn zloty. Compared to the end of June, this constitutes an increase of 9.7bn zloty. Nominal money supply growth in the third quarter came to 4.1%, while in real terms growth amounted to 2.4%. In the corresponding period of 1998, nominal money supply growth came to 5.9%, while real growth was 6.1%. Compared to the end of December 1998, total money stocks had risen 25.2bn zloty by the end of September 1999. By contrast, in the first three quarters of 1998 this increase amounted to 27.1bn zloty. The year-to-date growth in the total money supply recorded at the end of September (11.4% in nominal terms and 4.5% in real terms) was lower than in the same period of 1998 (when it had stood at 15.4% and 7.9%, respectively) (cf. Fig. 13).

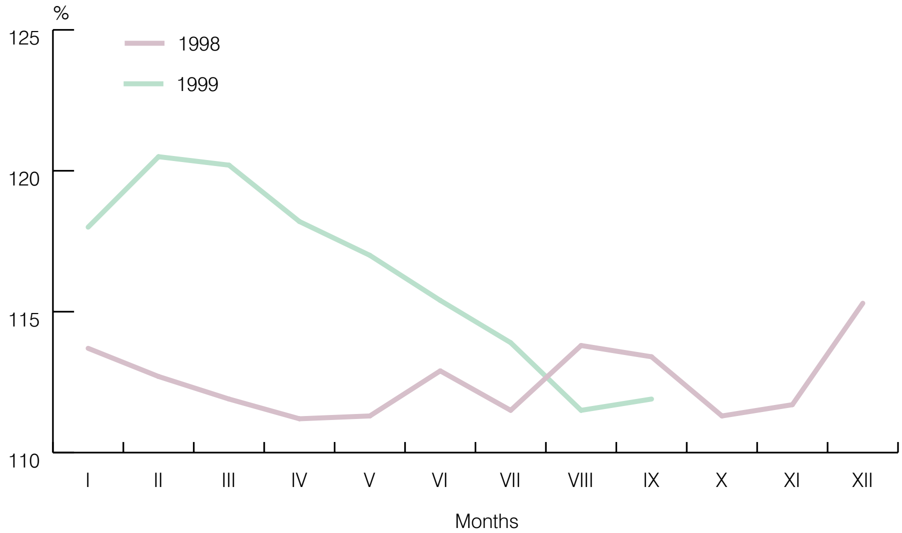
Annualised growth in the total money supply trended downwards as of March 1999 (cf. Fig. 14). In September, this trend levelled off. At the end of the third quarter, this measure of the money supply had risen 20.9% year-on-year in nominal terms (and 11.9% in real terms). By comparison, annualised growth at the end of June stood at 22.9% in nominal terms (15.4% in real terms). In January 1999, total money stocks were 26.2% higher in nominal terms than they had been at the end of January 1998 (18.0% in real terms).

Zloty deposits held within the Polish banking system by non-financial counterparties totalled 173.3bn zloty at the end of the third quarter of 1999. Compared to the end of June, these balances had increased 7.1bn zloty, representing nominal growth of 4.3% and real growth of around 2.5%. In the same quarter of 1998, growth in

[3] The total money supply is defined as the sum of domestic money stocks and foreign currency deposits. Domestic money stocks represent the sum of notes and coin in circulation (excluding vault cash) and zloty balances held at banks by the non-financial sector (corporates and persons).

Figure 13
Total money supply growth, real terms (previous month end = 100)

Figure 14
Total money supply growth, real terms (same month previous year = 100)



these balances had been much stronger, coming to a nominal 7.1%, and 7.3% in real terms.

Compared to year end 1998, deposits taken from the non-financial sector were up 16.4bn zloty in September 1999, i.e., 10.5% in nominal terms and 3.6% in real terms. By comparison, the year-to-date increase over the first nine months of 1998 had come to 23.9bn zloty, representing nominal growth of 20.2%. Thus, nominal growth in 1998 was almost twice as high as in 1999. In real terms, the difference was even greater. Real growth in the first three quarters of 1998 amounted to 12.4%, over three times more than the 3.6% recorded in the same period of 1999.

Annualised growth in these deposit balances has been slowing since the beginning of 1999. Figures for the end of September show that zloty deposits from the non-financial sector were 21.8% higher in nominal terms than they had been at the end of September 1998 (12.8% higher in real terms). At the end of June 1999, the corresponding figures stood at 25.1% and 17.5%. In January 1999, annualised growth had reached the level of 33.9% (nominal terms) and 25.2% (real terms).

The much slower growth in zloty deposits taken from the non-financial sector witnessed in 1999 is chiefly attributable to the low increase in personal deposits. At the end of September, the balances held by persons totalled 122.4bn zloty. In the course of the third quarter, these balances rose 3.2bn zloty (2.6% in nominal terms, 0.9% in real terms). During the corresponding period of the previous year, i.e., the third quarter of 1998, the same deposits went up 6.7bn zloty, giving nominal growth of 7.0% and real growth of some 7.2%.

Annualised growth in personal deposits has also been coming down since the beginning of 1999. At the end of September, personal zloty deposits were up 20.2% year-on-year in nominal terms (11.3% in real terms). By comparison, nominal annualised growth stood at 25.4% in June (with real growth of 17.7%), while in January annualised growth came to 35.2%, and real growth amounted to 26.4%.

The monthly growth in personal zloty deposits reported since the beginning of 1999 has also been considerably lower than that seen in the corresponding months of 1998 (cf. Fig. 15).

The factors responsible for the slow growth in these deposits include the zloty deposit rates on offer from the banks and the current high propensity to consume.

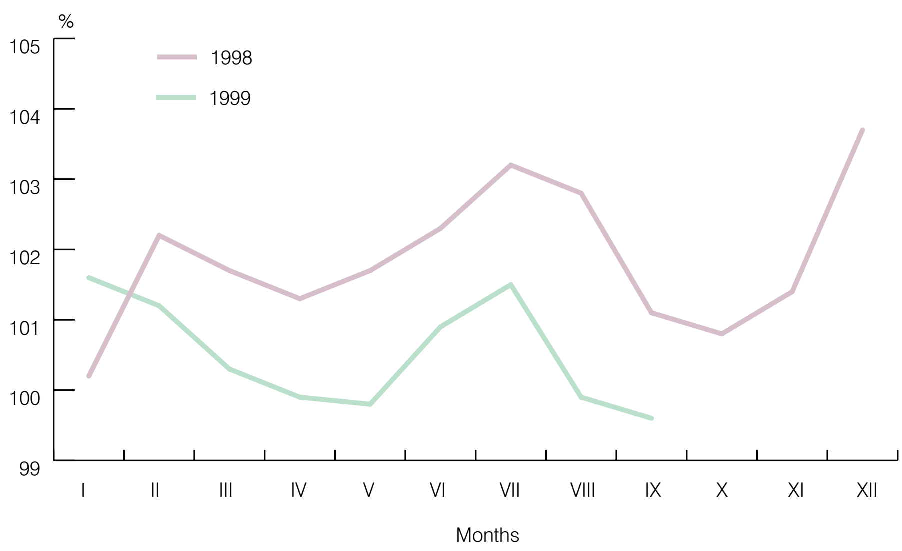
The third quarter of 1999 saw the growth of corporate zloty deposits continuously pick up speed. Figures for the end of September show corporate deposit balances of 51.0bn zloty at the banks, up 4.0bn zloty on the end of June. In nominal terms, this gives 8.4% growth, which is equivalent to 6.6% growth in real terms. The principal reason for this, particularly in September, was the upswing in business activity and the ensuing improvement in corporate finances.

Annualised growth in these balances also became faster. At the end of September, corporate zloty deposits were up 25.8% on the end of September 1998 in nominal terms and 16.5% in real terms. In August, the corresponding growth rates stood at 20.5% and 12.4%, respectively, while in July they had come to 19.5% and 12.4%.

At the end of September 1999, the banks' foreign currency liabilities to the non-financial sector totalled USD 9.3bn. These liabilities rose USD 0.1bn over the third quarter. Personal foreign currency deposits grew USD 0.3bn during the quarter, while corporate foreign currency balances fell USD 0.2bn. Compared to the end of 1998, the volume of foreign currency deposits taken from the entire non-financial sector decreased USD 0.3bn. This came as the result of personal foreign currency deposits rising USD 0.3bn, with the same corporate deposits dropping USD 0.6bn.

The foreign currency deposits held by persons and corporates at the end of September 1999 represented the equivalent of 38.5bn zloty. In relation to the level of these balances at the end of June, this constitutes an increase of 2.1bn zloty. Growth stood at 5.7% in nominal terms and 3.9% in real terms. The growth witnessed in the third

Figure 15
Personal zloty deposit growth, real terms *(previous month end = 100)*



quarter was therefore similar to that seen in the corresponding period of 1998, when nominal growth came to 4.0%, while real growth amounted to 4.2%. Compared to year end 1998, the foreign currency balances held by the non-financial sector increased 4.8bn zloty. This represents nominal growth of 14.3%, and real growth of 7.2%. It should be underlined that this period brought a weakening of the zloty against the dollar[4].

In the period from March to September 1999, annualised growth in foreign currency deposits from the non-financial sector held relatively steady. Figures for the end of September show nominal growth in these deposits, as expressed in zloty, of 24.3% compared to the end of September 1998, equivalent to real growth of some 15.1%. The corresponding figures for June stood at 22.4% and 14.9%, respectively. In January, annualised growth came to 8.2% in nominal terms and 1.2% in real terms.

At the end of September, the personal foreign currency deposits held at the banks represented the equivalent of 30.2bn zloty. Compared to the end of June, this constitutes an increase of 2.3bn zloty, giving nominal growth of 8.3% and real growth of 6.5%. Since the beginning of 1999, there has been a gradual increase in the rate of annualised growth shown by these deposits. Figures for the end of September indicate that personal foreign currency deposits had risen by a nominal 23.2% in zloty terms since the end of September 1998 (corresponding to real growth of 14.1%). In June, annualised growth stood at a nominal 15.4% (8.3% in real terms).

The third quarter of the year saw a continuation of the increasing speed of monthly growth in these deposits. This development should be linked to the declining value of the zloty against the dollar over this period, which automatically resulted in an increase in foreign currency deposits as expressed in zloty.

The foreign currency deposits held by corporates at the end of the third quarter amounted to the equivalent of 8.3bn zloty. This represents a nominal decrease of 2.9% compared to the end of June (a drop in real terms of 4.6%).

[4] The nominal zloty exchange rate against the dollar recorded at the end of September 1999 was 4.7% down on that recorded at the end of June. In the third quarter, the increase in the zloty value of the foreign currency deposits held by the non-financial sector that was attributable exclusively to exchange rate movements (i.e., leaving aside movements in the dollar value of those deposits) came to 1.7bn zloty. The corresponding figure for corporate foreign currency balances was 0.4bn zloty, while for personal foreign currency balances it was 1.3bn zloty.

The fluctuations in the annualised growth of these balances seen since the beginning of the year have primarily been caused by the volatility of zloty exchange rates against the dollar. Figures for the end of September show corporate foreign currency deposits up by a nominal 28.7% in zloty terms compared to the end of September 1998 (a real increase of 19.1%). By comparison, the nominal growth recorded in June stood at 52.4% (real growth of 43.1%), while in January it came to 45.4% (36.0% in real terms).

The gradual acceleration in monthly growth observable in July and August[5] was subsequently checked in September, when the foreign currency balances on corporate accounts declined by the equivalent of 0.9bn zloty.

At the end of September 1999, notes and coin in circulation (excluding vault cash) totalled 34.2bn zloty. This represents an increase in the supply of currency during the third quarter of 0.6bn zloty. Compared to the end of June, this constitutes a nominal rise of some 1.6%, giving a slight decrease in real terms of 0.1%. Since the beginning of the year, annualised growth in currency in circulation has been relative stable. Figures for the end of the third quarter show the supply of currency rising 12.7% in nominal terms compared to the end of September 1998 (up 4.4% in real terms). By comparison, June 1999 saw nominal annualised growth of some 13.3% (6.4% real growth), while annualised growth in January was also 13.3% (although 6.0% in real terms).

The highest monthly growth in the quarter under review came in July. This month traditionally sees an increase in the consumer demand for cash to fund summer holiday spending.

Compared to year end 1999, currency in circulation had risen 3.9bn zloty by September 1999, an increase of 13.0%, or 6.0% in real terms. By comparison, the nominal growth of currency in circulation over the first three quarters of 1998 came to 11.2%, while real growth stood at 4.1%. The relatively faster growth in the volume of notes and coin from January to September 1999 may be interpreted as the result of the lower cost of holding funds in cash.

The growth in total money stocks in the third quarter of the year was conditioned by several basic factors. First and foremost, the growth in personal zloty deposits was

[5] The faster growth seen in August was mainly due to the decline in zloty exchange rates relative to the dollar.

clearly low[6]. However, this was to some degree offset during the quarter by the increasingly rapid growth of corporate zloty deposits. At the same time, personal foreign currency deposits, expressed in zloty, began to grow more swiftly. Nevertheless, it should be stressed that the rising pace of growth in this category of deposit is mainly traceable to the weakening of the zloty against the dollar in August and September.

Counterparts to changes in money stocks

Claims on persons and corporates have for several years been the prime source of money supply growth within the banking system. At the end of the third quarter of 1999, the contribution of these claims to the expansion of the money supply had increased compared to year end 1998, although so had that of net foreign assets (particularly in the third quarter itself). These movements are illustrated in Table 2.

At the end of September 1999, claims on persons and corporates[7] accounted for 68.0% of total money stocks[8] within the banking system, with claims on corporates representing 54.8% and claims on persons constituting 13.2%.

The total volume of debt outstanding under claims on persons and corporates stood at 167.4bn zloty at the end

Table 2
Counterparts to changes in money stocks, third quarter 1999

	Q3 1999 year-to-date growth million zloty	Share in year-to-date growth %	Q3 1999 growth million zloty	Share in Q3 growth %
Total money supply	25,195.7	100.0	9,736.6	100.0
Net foreign assets	13,609.0	53.6	9,990.4	102.6
Claims on persons and corporates	28,869.3	114.6	11,559.8	118.7
General govt. debt	399.4	1.6	-3,602.4	-37.0
Other items (net)	-17,581.9	-69.8	-8,211.2	-84.3

[6] In real terms, August and September in fact both brought a decrease in these deposits (albeit small - 0.1% and 0.4%, respectively).
[7] These claims consist of all categories of loan irrespective of risk classification, and also of purchased debt, funds disbursed under guarantees and endorsements, interest receivable, and claims arising on interest subsidies to preferential agricultural loans.
[8] Calculations include balance of other items.

of September 1999, which represents a rise of 20.8% on December 1998, i.e., an increase only 0.1 points less than that recorded a year earlier (with personal borrowings up 35.4% and corporates borrowings up 17.8%). The growth in these outstandings came to 7.4% in the third quarter, although lending to persons grew some 2.4 times faster than lending to corporates – the relative growth rates stood at 14.3% and 5.9%, respectively. In the third quarter, corporates (mainly public-sector enterprises and private companies, and also cooperatives) accounted for 65.0% of the increase in borrowing at the banks (as against 86.1% in Q1 and 58.3% in Q2). The largest increase in outstanding debt – 5.4.bn zloty – came in September, when corporates borrowed more from the banks (4.0bn zloty) than in July and August together. After a period of very slack business activity, corporates saw the summer months bring an increase in both industrial and construction output, which had a positive impact on their financial performance and improved their capacity for development, thus also increasing the funding they required from the banking industry. The improvement in corporate finances also gave companies better opportunities to obtain bank loans and subsequently repay them. In addition, the overall business climate within the corporate sector brightened, as did expectations of corporate debt service capacity. The increase in outstanding borrowings may also have been linked to lower interest rates and movements in zloty exchange rates.

Claims in zloty represented 73.0% of the total growth in claims on persons and corporates in the third quarter of the year. While outstanding foreign currency claims (both on persons and corporates) grew faster in the third quarter than claims in zloty, this was not the result of any larger increase in the former in absolute terms, but rather of the relatively low reference point provided by the volume of foreign currency claims at the end of the second quarter.

Short-term claims on the non-financial sector[9] (maturing in up to one year) rose 8.1% in the third quarter of the year, constituting 43.9% of the total increase in

[9] Claims on the non-financial sector are smaller than claims on persons and corporates, since they exclude claims on insurance companies and other non-bank financial institutions, and also the value of debt securities held and repurchase transactions performed.

claims on that sector. Long-term claims went up 7.3% in the same period.

Net foreign assets[10] grew USD 1,363m in the third quarter of 1999, to stand at USD 26,687m at the end of September[11].

The current deficit in the third quarter came to USD 2,985m, up USD 1,770m on the deficit registered in the third quarter of 1998.

Receipts from merchandise exports, as registered by the banks for balance of payments statistics, totalled USD 6,219m in the third quarter of 1999, having fallen 20.3% year-on-year. With import payments coming to USD 10,075m, a drop of 9.2%, the deficit on visible trade amounted to USD 3,861m.

Service credits came to USD 865m in the third quarter, representing a fall of 15.9% compared to the corresponding period of 1998, while debits rose 18.3%, to stand at USD 1,246m. This produced a deficit of USD 381m. The shortfall on services was primarily the result of a deficit on other commercial services, construction services, foreign travel, and patents, copyrights and licence fees. At the same time, a small increase was noted in the surplus on transportation services.

The deficit on income generated by the foreign assets and liabilities of domestic counterparties amounted to USD 313m. Revenues amounted to USD 402m, whereas remittances totalled USD 715m. This deficit is related to the negative balance on income from direct investment and interest payments on borrowings. The deficit on income as a whole was narrowed by the surplus obtained on income from debt securities, this principally representing income from NBP investment of the foreign exchange reserves.

[10] Net foreign assets comprise amounts due from or to non-residents (parties not resident or domiciled in Poland), in both convertible and non-convertible currencies and also in zloty, excluding the equity and supplementary capital of banks paid in by foreign parties, which – according to guidelines provided to the banks – are to be treated on a par with capital paid in by residents (parties resident or domiciled in Poland).
The "foreign assets" and "foreign liabilities" referred to in the present *Report* retain the same scope as those in previous reports.
All items presented in the tables other than "foreign assets" and "foreign liabilities" represent transactions conducted with residents.

[11] The precise assessment of the influence of movements in the exchange rates of the US dollar against other currencies refers to the gross official reserves, which constituted a substancial portion of net foreign assets. The gross official reserves rose USD 184m, to come to USD 26,032m; assuming that currency cross rates were constant, however, the reserves would have risen USD 335m.

The servicing of Poland's foreign debt in the third quarter of 1999 involved payments of USD 1,053m, of which USD 502m constituted interest payable on borrowings and debt securities, and USD 551m represented repayment of principal.

The surplus earned on current transfers, at USD 417m, was the result of positive balances on both official transfers (USD 55m) and transfers in other sectors (USD 362m). Official transfers were predominantly composed of donations and non-refundable assistance from foreign governments. The surplus on transfers in other sectors was primarily due to funds remitted by Poles resident abroad to their families at home.

The net surplus of revenues over payments on unclassified current transactions amounted to USD 1,153m in the third quarter of 1999, a decrease of USD 716m on the surplus recorded a year earlier. However, a positive development was that the surplus of over USD 400m in August was sustained at that level in September. In the third quarter of the year, the surplus on unclassified current transactions funded 29.9% of the deficit on registered merchandise trade, which represents a major improvement on the first half of the year, when it absorbed just 25.6% of the deficit.

In the third quarter of 1999, the surplus on the capital and financial account totalled USD 3,255m, as against USD 2,638m in the third quarter of 1998. The largest differences here were in direct investment and other investment.

The net inflow of capital on direct investment was up almost 45% on the previous year, at USD 2,478m. This is related to the continuation of privatisations. With a positive view being taken of Poland abroad (despite the emergence of difficulties affecting the Polish economy), the continuation of structural reform and the prospects of Poland's admission to the EU, and with Poland being given more favourable ratings from international agencies, there has been continuing interest from foreign investors in investment in Poland and participation in the privatisations.

The third quarter of the year saw a net outflow of capital on portfolio investment, amounting to USD 90m (this includes both foreign and Polish capital). What is noticeable in this respect is a net outflow of foreign capital invested in Polish debt securities, with a simultaneous net inflow of investment in Polish equities.

Drawings of long-term credits came to USD 1,526m (as against USD 528m during the same period of 1998), while principal repayments stood at USD 551m (as against USD 445m).

The third quarter of 1999 also brought a USD 970m increase in foreign deposits at Polish banks (compared to an increase of USD 335 twelve months previously). At the same time, the deposits placed by Polish banks at banks abroad rose USD 1,210m. By contrast, in the third quarter of 1998 Polish banks reduced their placements abroad by USD 1,503m.

Following a steep increase in **net general government debt** in the first half of the year (when it climbed 4.0bn zloty), in the third quarter the net liabilities of general government to the banks dropped 3.7bn zloty. As a result, at the end of September 1999 net general government debt showed a slight year-to-date increase of some 0.3bn zloty, standing at 61.6bn zloty.

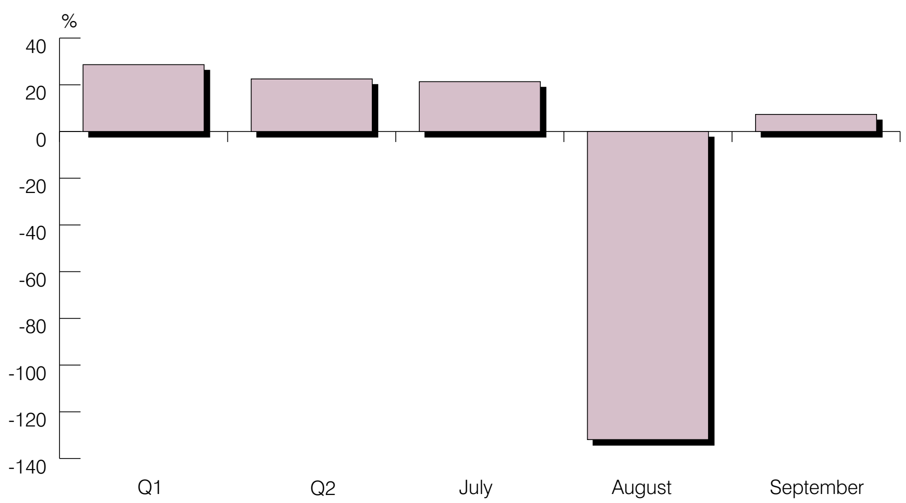
The major decrease in net general government debt in the period under review was on the one hand a consequence of lower public sector borrowing requirements (in August and September, central government reported a surplus of receipts over expenditures), while on the other hand it reflected a large influx of funds from the sale of privatised national assets.

Despite the fact that the third quarter of the year witnessed a major decline in investment by non-banking institutions – both domestic and foreign – in Polish Treasuries (the drop in debt to the non-banking sector came to a huge 1.0bn zloty), the high revenues generated by privatisations not only made it possible to cover the ongoing shortfall represented by the public sector borrowing requirement, but also to put aside considerable sums on government accounts at the NBP. By the end of September, central government was holding some 5.9bn zloty on account at the NBP, of which around 56% represented time deposits.

The fall in net general government debt in the third quarter was determined by the events of August. Thanks to central government receipts being boosted by the proceeds from the sale of a 50.1% equity interest in Bank Pekao SA, some 4.3bn zloty in all, general government was able to cut its net liabilities to the banks that month by almost 4.5bn zloty. A further surge in funding to central government occurred in August, when the revenues from the privatisation of Bank Zachodni were received, these amounting to around 2.3bn zloty. It can therefore be concluded that net general government debt dropped so dramatically in the third quarter not because of an improvement in central government finances, but rather as a result of the concentration within a short space of time of large privatisation receipts. The proceeds obtained from privatisation during the two months in question accounted for almost 70% of the total revenues gained by central government from this source over the first three quarters of the year, taking these revenues to a level 37.7% above that projected for the whole of 1999.

It should nevertheless be emphasised that the fall in net general government debt was restricted by the rising debt of other sections of this sector, i.e., local government and special purpose funds, which testifies to their deteriorating financial condition. The third quarter of the year saw a major, 2.9bn zloty increase in the net debt of these other institutions within the general government sector, whereas in the first half of the year they had enjoyed a 2.8bn zloty surplus of funding over liabilities. The soaring growth of the net debt of other components of the general government sector is primarily the result of the swelling liabilities of the Social Insurance Fund. The deepening shortfall suffered by this special purpose fund forced the Social Insurance Board (ZUS) to borrow at the

Figure 16
Contribution of net general government debt to total money supply growth, 1999



commercial banks. By the end of September, the Board's outstanding borrowings stood at 3.0bn zloty.

Net general government debt can be said to have been a factor constraining the growth of the total money supply in the third quarter, in contrast to the first half of the year, when this debt played a significant role in the expansion of money stocks. As a result, at the end of the third quarter net general government debt accounted for 1.6% of the growth in the total money supply, as against 5.8% in the corresponding period of 1998.

The contribution of net general government debt to money supply growth in the period from January to September 1999 is presented in Fig 16.

Transmission mechanisms in the third quarter of 1999

The interest rate channel

In the third quarter of 1999, the situation on Poland's financial markets was determined more by domestic factors than by international ones. The deterioration in a number of major macroeconomic indicators (including the public sector financial deficit, the current deficit and inflation) aggravated investor uncertainty. The impact of this negative information was only slightly cushioned by positive tendencies in the shape of strong industrial output growth in August and a halt to the rise in the fiscal deficit.

Polish financial markets were also influenced by events on emerging markets and on those of the developed countries. The situation on emerging markets stabilised. Nonetheless, a lasting consequence of the Russian and Brazilian crises proved to be changes in the attitudes of foreign investors, who now demanded higher risk premiums.

In the developed economies, expectations gradually built up that monetary policy was about to be tightened. The reinforcement in the third quarter of anticipation that official interest rates would be raised in the US and the euro area affected investor behaviour on emerging markets, including the Polish market. The rate increases on the major financial markets led to higher yields on emerging market instruments.

A factor of a technical nature that exerted increasing impact on the behaviour of financial institutions as the year wore on, thus also influencing asset prices, was the issue of "Y2K". This, too, pushed interest rates upwards.

The factors outlined above increased the investment risk associated with particular sectors of Poland's financial markets: the interbank deposit market, the Treasuries market, and the FX market. The end result was that interest rates moved up, and as of July pressure intensified for zloty depreciation.

Market interest rates

Interbank deposit rates gradually rose during the third quarter. Indeed, on two occasions they leapt upwards. The first of these was at the beginning of August, when news was released of a further rise in the fiscal deficit and of the financial troubles at the Social Insurance Board, and when the Ministry of Finance first announced, and subsequently cancelled, an additional T-bill tender. The increase in rates at that point proved temporary. The second occasion rates vaulted up – this time on a more lasting basis – was in the wake of the September 22 decision of the Monetary Policy Council to raise the reverse repo rate. Rates on 6-month deposits then rose 50 bps, while 1-month rates climbed 69 bps (cf. Fig. 17).

The Council's decision to raise the reverse repo rate had only been partially priced in earlier by the interbank market through higher rates. To a substantial section of the market, the Council's move came as a surprise. The increase in rates directly preceding this move was principally the result of speculative trading by part of the market following publication of August's inflation figures. The market's uncertain view of future rates was evidenced by a widening of the spread between WIBOR and WIBID (the Warsaw Interbank Offered Rate and the Warsaw Interbank Bid Rate). Seeking to hedge themselves against any possible losses should the Council not raise rates, the banks began quoting WIBOR higher, while at the same time holding WIBID flat (cf. Fig. 18).

The subsequent major rise in WIBOR and in spreads on 3-month deposits towards the end of September was due to the banks' expectations that the end of 1999 would bring a temporary liquidity squeeze related to Y2K (see accompanying box), and also to their taking a view, via the FX swap market, on the weakening of the zloty (some foreign and domestic banks borrowed zloty

Figure 17
Money market rates

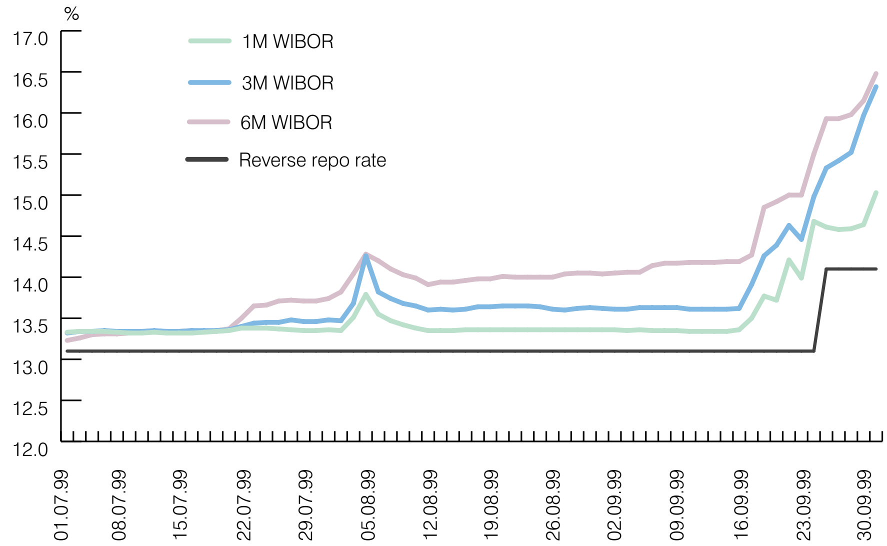
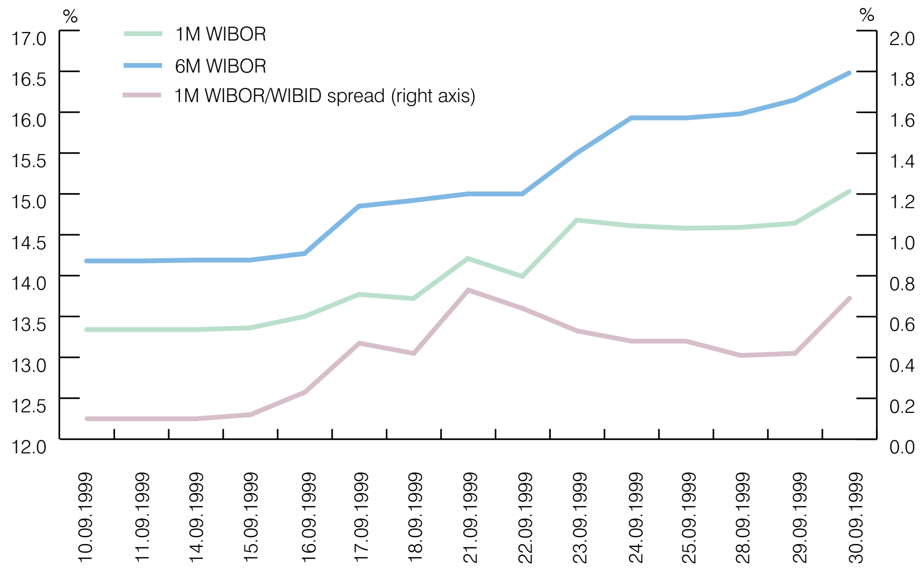


Figure 18
WIBOR rates and 1M WIBOR/WIBID spread, September 1999



for resale in swap trading, in the hope that a decline in zloty exchange rates would bring them larger gains than the interest expense incurred).

Poland's financial markets and Y2K

The danger posed by the possibility of computer system failure following the date change on January 1, 2000, affected the pricing of money market instruments worldwide. A general expectation emerged that settlement risk would increase. Fearing a loss of liquidity or foreseeing that the cost of accessing liquid funds would be high, banks attempted to safeguard themselves against this danger. The increase in interest rates on certain assets may be regarded as the price of Y2K risk. In Poland, this development additionally fuelled the trend for yields on financial instruments to rise.

The problem of Y2K made itself felt on various segments of the money markets, although it was most visible on the interbank deposit market, which in the first half of the year was characterised by a negatively-sloping yield curve. Deposits with longer maturities earned lower interest than shorter-dated deposits.

In the second quarter of the year, rates on six-month deposits could already be seen to be trending upwards. The increase involved here was greater than that for other deposits. By mid-July, this led to a (re-)inversion of the interbank yield curve, with deposits maturing in the year 2000 now earning more than those maturing prior to the end of 1999. Expecting increased outflows to customers (both retail and institutional), the banks collected funds to allow them to avoid any potential problems with the loss of part of their deposit base. In September, mounting concern that there would be a temporary shortage of liquidity within the banking system triggered a steep rise in 3-month deposit rates. Furthermore, certain banks put in place internal policies prohibiting the extension of loans maturing in the year 2000. This restricted the volume of lending on offer on the market, which – with demand constantly rising – contributed to the move in prices.

In consequence, the issue of Y2K was one of the factors at play in (re-)inverting the interbank yield curve, moving it from negative to positive.

The messages being sent out by the economy and by international markets caused a change in the level and shape of the Treasury yield curve. At the beginning of the third quarter, the yield curve was relatively flat at the short end, and negatively-sloped over the remainder. During the course of the quarter, and particularly towards the end, a gradual alteration took place in the slope of the curve in the maturity band out to two years. In addition, the curve as a whole shifted upwards. By the end of September, the curve had acquired a distinctly positive slope out to two years, while still remaining negative for longer maturities (cf. Fig. 19).

The change in the shape of the yield curve was the product of a combination of factors. The first of these was the change in inflationary expectations among participants in the financial markets. The fact that inflation in August proved higher than projected, the further increase in the current deficit, the maintenance from July onwards of pressure for zloty depreciation – these factors could have been interpreted by market players not as an interim set of circumstances, but as a medium-term trend. The appearance of a positively-sloping yield curve for maturities of up to two years may indicate that market participants expected inflation to level off temporarily at around the current rate, which was higher than previously seen.

Where there are no expectations that inflation will come down rapidly in the immediate future, the primary factor determining the slope of the yield curve becomes the liquidity premium associated with the maturity of a given financial instrument. Given that, in an environment of stable or rising inflation, investors demand higher rates of return as maturities lengthen, the yield curve assumes a positive slope. The maintenance of a negative slope for maturities of two to ten years attests to investors expecting inflation to resume a swifter downward course in the longer time frame.

Confirmation of the proposition that inflationary expectations shifted within the financial sector can be found in the responses given by banks to a Reuters poll. In August and September, the banks' expectations concerning inflation over the coming twelve months diverged from the previous trend (cf. Fig. 20).

The raising of the reverse repo rate applied during NBP open market operations contributed to an increase in yields on Treasury securities with maturities of from one month to three years. This increase was greatest at

Figure 19
Yield curves for month end March, June and September 1999

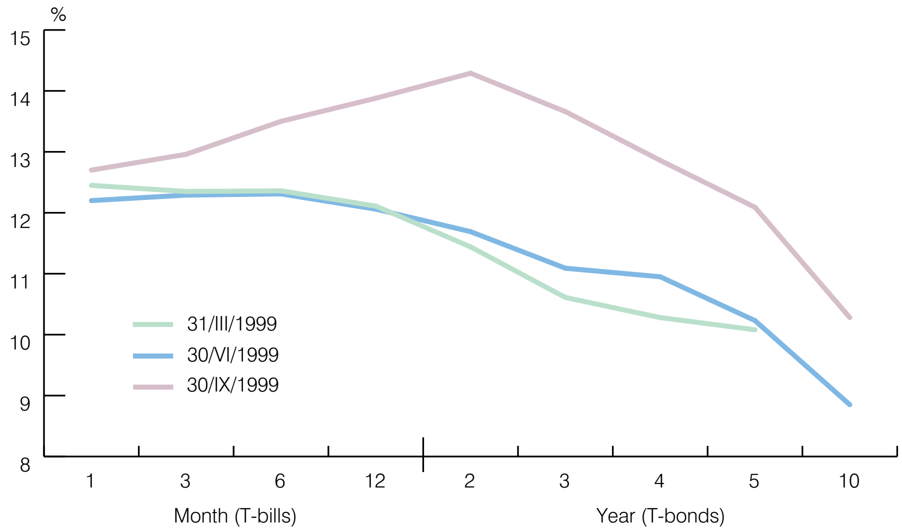


Figure 20
Inflationary expectations at banks

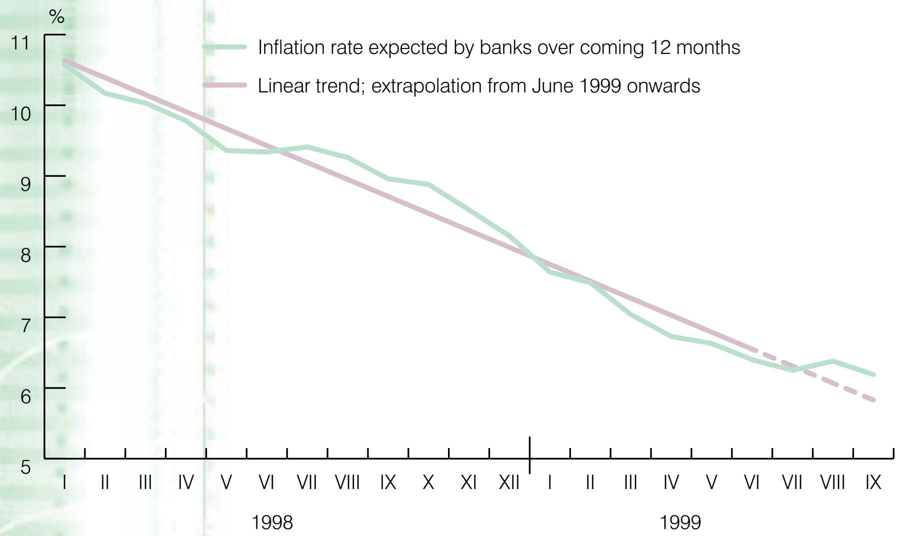
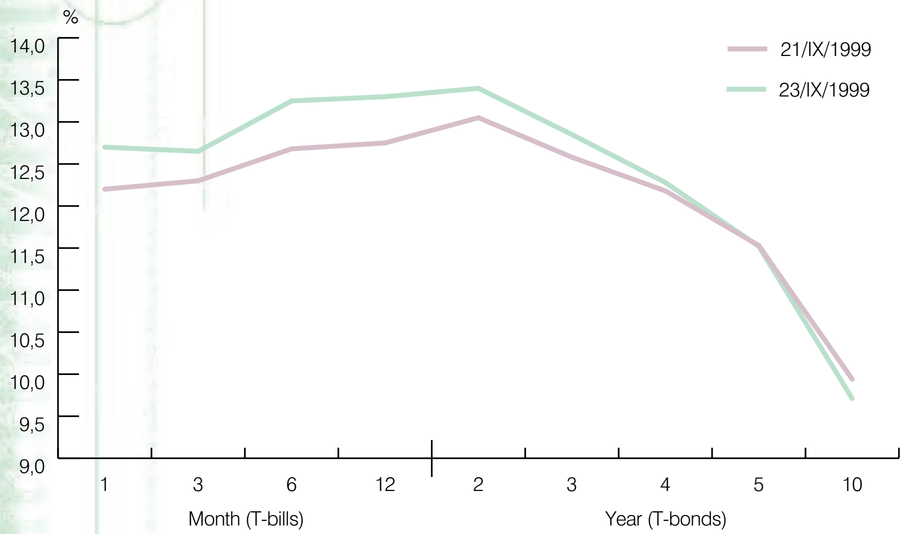
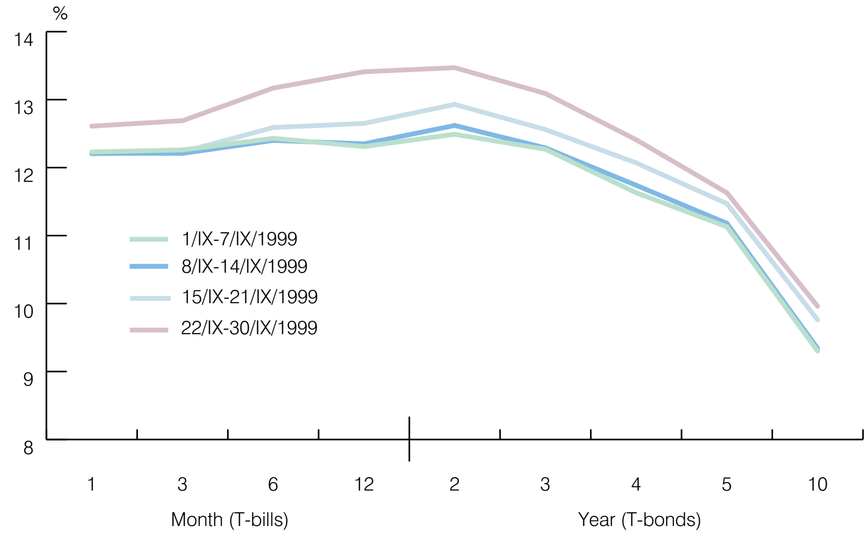


Figure 21
Yield curves before and after reverse repo rate raised by Monetary Policy Council, 22/IX/1999



the short end of the yield curve (cf. Fig. 21). Yields on 1-month T-bills rose 50 bps. The fact that yields on these bills rose less than the increase in the NBP rate was a result of market demand shifting from long-term instruments to short-term ones. Heightening investor uncertainty was reflected by mid-month in higher yields on

Figure 22
*Yield curves, September 1999**



* weekly average yields on T-bills and T-bonds, based on 5 quotations (final curve based on 7 quotations)

medium- and long-dated Treasuries. Over the period from September 14 to September 22, i.e., directly prior to the decision taken by the Monetary Policy Council, the yield obtainable on 5-year bonds climbed from 11.23% to 11.50% (cf. Fig. 22).

Over the whole of the third quarter, the upward shift in the yield curve ranged from 50 bps for 1-month Treasury bills to 260 bps for 2-year Treasury bonds. A rise in yields on 5- and 10-year T-bonds, considered market benchmarks, caused the curve to shift clearly upwards at the long end as well. For example, the yield on 5-year bonds rose 183 bps from July onwards, with a large part of this increase coming in September (cf. Fig. 23).

The upward shift at the long end of the yield curve testifies to mounting investor uncertainty as regards the further development of the Polish economy. Additional stimulus to the yield curve shifting upwards was provided by third-quarter trends in the US and euro area, and by supply and demand factors (waning demand for Polish securities among foreign investors, in a situation where greater supply was expected).

The third quarter was also marked by expectations of a rise in interest rates in the US and the euro area (cf. Figs 24 and 25). This pushed up yields on longer-dated secu-

Figure 23
Yields on 2-, 5- and 10-yr fixed-rate T-bonds; deviation of zloty exchange rates from central parity

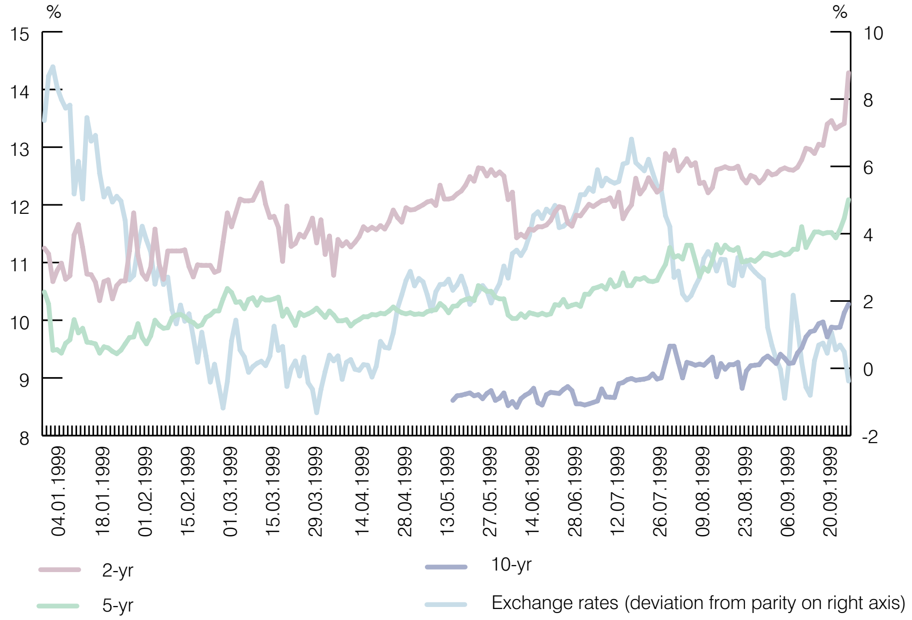
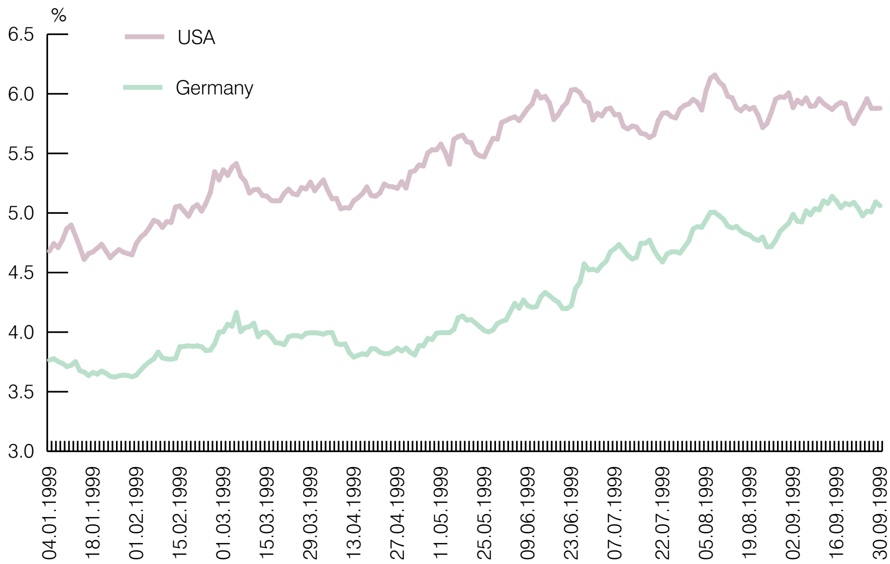
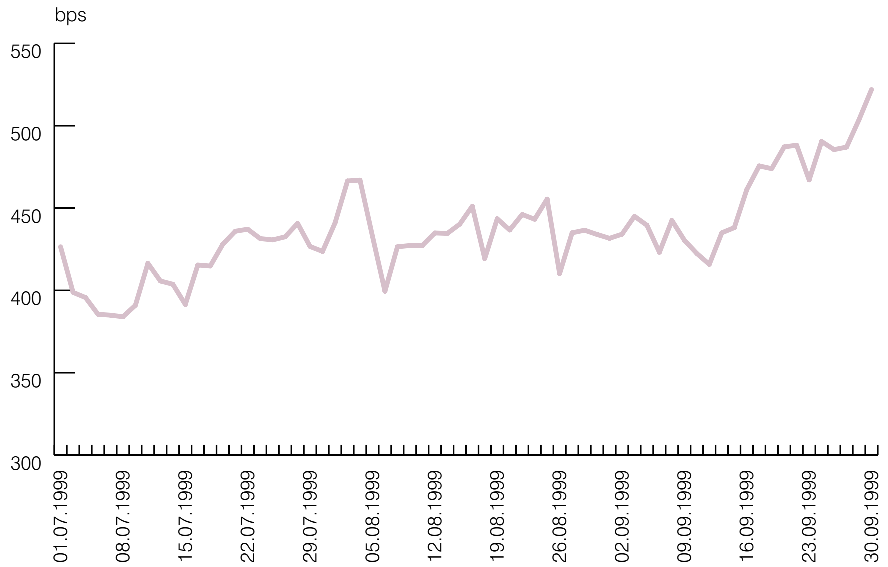


Figure 24
Yields on 10-yr US and German T-bonds, January-September 1999



rities. The yields on government bonds on the most highly-developed financial markets largely condition the level of world interest rates. An increase in rates on developed markets entailed, all other things being equal, a relative

Figure 25
Yield differential, 10-yr Polish and German T-bonds



decrease in the yields on emerging market instruments. Since investors were not prepared to accept such a decrease (given that there had been no change in the factors determining the risk premium they required for investing on emerging markets), interest rates on those markets went up. The integration of local financial markets with the global market meant that long-term rates in Poland followed the path set by foreign rates.

The Polish Treasury portfolios held by foreign investors primarily comprised fixed-rate bonds. In anticipation of further developments on financial markets, investors refrained from expanding those portfolios. Moreover, owing to the increasing liquidity of the market for interest rate swaps (with maturities of 1-10 years), these instruments represented an attractive alternative to Treasury securities. The low demand for Polish Treasuries from foreign investors also contributed to the increase in domestic interest rates because it came at a time when an increased supply of those securities was expected. These expectations were founded on several factors. July saw a further growth in the fiscal deficit (which reached 97.2% of the target set in the Budget for the entire year), and the financial condition of the Social Insurance Board deteriorated. In addition, news that non-negotiable central government liabilities to the NBP were to be converted into negotiable Treasury securities led the market to anticipate a greater supply of Treasuries from this particular source. Counting on increased central government funding requirements, market players exerted pressure for higher Treasury yields.

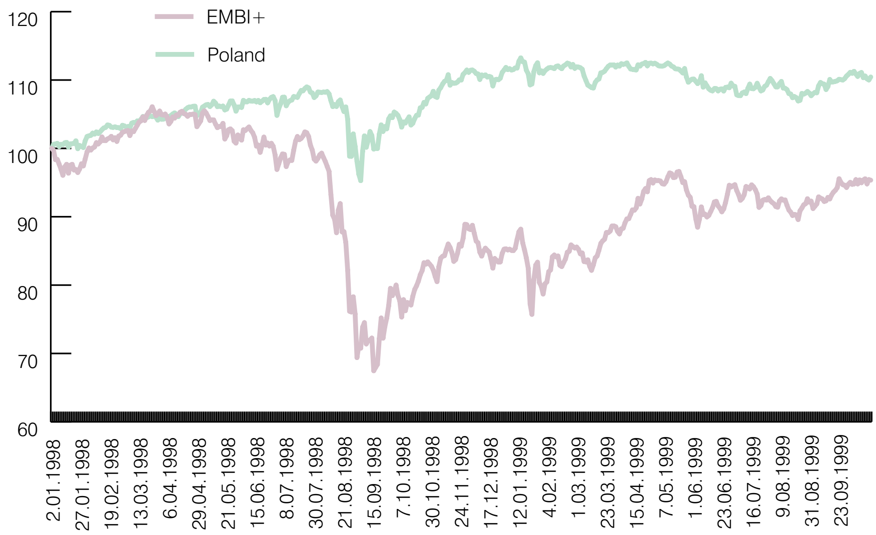
Factors related to market liquidity were particularly important in the case of yields on 10-year T-bonds. These bonds have only been quoted on the market for a few months now, with the face value of issues up to the end of September coming to no more than some 760m zloty. The market for long-term government paper is thus fairly shallow, which makes yields here more sensitive to changes in the relationship between supply and demand, and also to changes in the level of risk premium. At the same time, however, yields on these instruments are particularly significant, in that they constitute one of the criteria for accession to EMU[12].

The impact of events on emerging markets on Polish investment risk can be analysed by reference to the Emerging Market Bond Index Plus (EMBI+) developed by JP Morgan. This shows the total return obtainable on particular types of emerging market financial instrument (bonds denominated in foreign currencies, loans, Eurobonds and other local instruments). Assuming that fluctuations in the EMBI+ are primarily linked to movements in the price of the assets concerned, the conclusion can be reached that asset price volatility in Poland is weaker and less frequent than in other emerging market countries. This also signifies that foreign investors consider the Polish financial market to be relatively stable. This positive perception of Poland was reflected in the Moody's rating of the credit quality of Polish foreign-currency denominated debt, which was increased from Baa3 to Baa1. The crises that have so far afflicted emerging markets have had less impact in changing Polish indicators than in changing those of other countries classified within this group of markets (cf. Fig. 26).

Although the trends observable on emerging markets strongly impacted the behaviour of investors on Poland's financial markets in the first half of 1999, this impact was not apparent in the third quarter.

[12] These yields should be no more than 200 bps above the average yields on the corresponding instruments issued by the three euro area countries with the lowest rates of inflation. The yields at tender on these Polish bonds in September stood at 9.53% - 322 bps in excess of the qualifying criterion (taken for simplification to be the average yields on 10-year German fixed-rate Treasury bonds plus 200 bps); by comparison, in June the qualifying criterion was overshot by 234 bps.

Figure 26
EMBI+ index (Poland vs emerging markets)

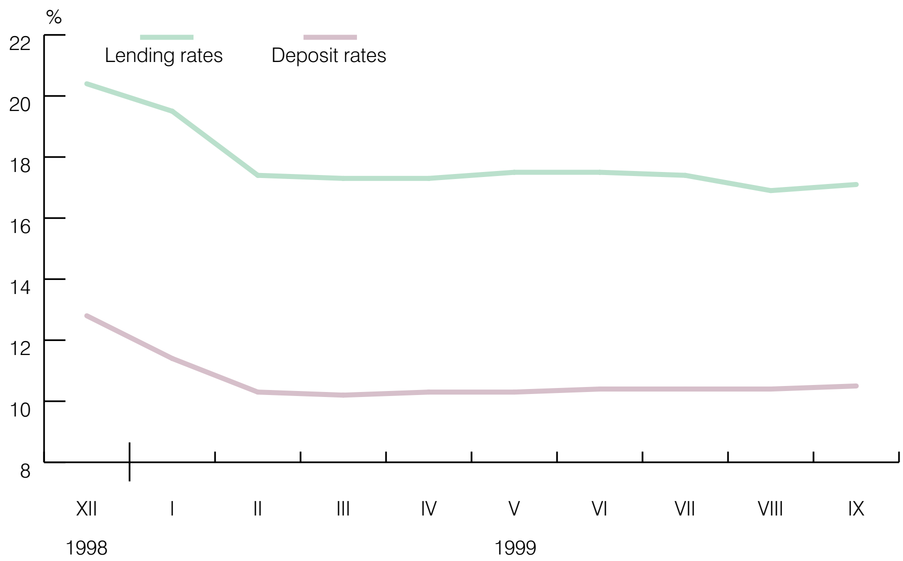


Reaction of commercial banks to central bank policies

Throughout virtually the whole of the third quarter, the central bank held its official base interest rates (the lombard, rediscount and reverse repo rates) at the level set in January. It was not until the third week of September that the reverse repo rate was raised by 1 point; the reaction of the commercial banks to this change in monetary policy parameters will not therefore be known until the fourth quarter. Only very few banks adjusted their rates in the final days of September. As a result, the third quarter saw little change in deposit and lending rates at the commercial banks. Personal deposit rates remained steady, although the rates offered on corporate deposits rose slightly. On the other hand, lending rates for both consumers and corporates, following a minor dip in July and August, began to rise again in September. The spread between rates on time deposits and on loans narrowed somewhat (cf. Fig. 27).

Up to now, the banks have reacted to a tightening of monetary policy by raising their interest rates to a lesser extent than the central bank, one reason for this being the strong competition on the market for corporate and personal loans, and another being the relatively low elas-

Figure 27
Deposit and lending rates, weighted averages



ticity of deposit supply relative to interest rate movements at those banks that enjoyed full Treasury guarantees for the deposits they took. Most probably, the banks will again not raise their rates by as much as the increase in the NBP rate.

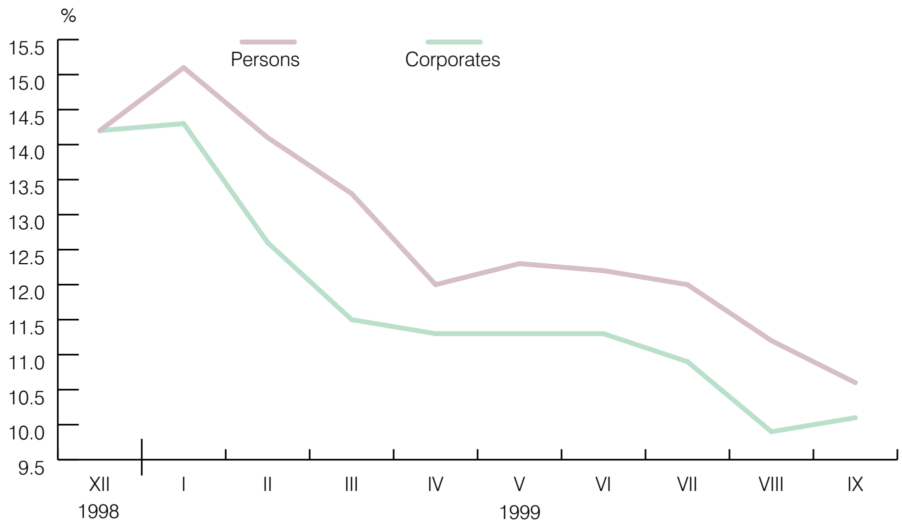
In the third quarter, the central bank reached agreement with the commercial banks on the conditions that would apply to the lowering of reserve requirements with regard to the regulatory reserves placed by the banks on account at the central bank as of October. The reduction in the reserve ratio could have encouraged the banks to increase deposit rates. As it was, in July and August the banks generally held back from announcing any rise in the rates offered on personal deposits, although – as already mentioned – they did raise rates on corporate deposits. This mostly involved 3- and 6-month deposits. The small increase that was seen in September in rates on personal deposits was not only related to the rise in the reverse repo rate and the cut in reserve requirements, but also to the difficulties banks faced in attracting deposits from households in a situation where loan demand had been running high since the beginning of the year.

Interest rates and loan demand

The gradual lowering of lending rates at the banks, allied to the acceleration of inflation, as measured both by the CPI and the PPI, resulted in lending rates falling in real terms in the third quarter (cf. Fig. 28). Real interest rates are one of the factors determining loan demand. In the course of the quarter, aggregate loan demand remained steady, although consumer loan demand rose strongly, as it had in the first half of the year.

While the lowering of real interest rates undoubtedly stimulated consumer loan demand in the third quarter, this does not appear to have been the main factor behind such a sharp rise in this demand (in real terms, year-on-year lending growth climbed from 32.5% in June to 36.7% in September, i.e., going up 4.2 points). The basic fall in interest rates occurred in the first quarter, and we estimate the time lag in consumer reactions to the rate cut to be about two to four months. One of the reasons for the high growth in outstanding loans is the desire of households to realise deferred consumption. Other significant factors include the increasing ease of access to personal loans, the large number of non-bank intermediaries on this market, the softening of collateral requirements, and probably also the announcement by the Ministry of Finance of alterations to personal income tax regulations as of the year 2000. Uncertainty as to the future system of tax relief might have prompted households to increase purchases – including those financed by borrowings – of goods earmarked for the repair of dwellings and residential buildings. It should also be noted in this respect that the banks

Figure 28
Real lending rates



have drawn attention to the substantially greater interest shown by customers in housing loans in 1999.

The impact of faster loan growth on inflation was indirect rather than direct. As in the first half of the year, the price of those goods normally purchased using credit facilities – transport equipment, consumer electronics, photographic and computer equipment, home furnishings and household appliances – rose more slowly than consumer prices overall. Given that a considerable proportion of these goods are imported or require imported production supplies, lending growth played a part in the widening of the current deficit, and thereby also in the depreciation of the zloty. Figures from GUS (the Central Statistical Office) on the pattern of imports indicate that the first three quarters of this year brought an increase in the relative importance of consumer imports, with a decline in imports of capital equipment and production supplies.

Corporate loan demand remained primarily influenced by the relatively weak business climate in Poland and in the countries that are Poland's major trading partners. Thus, despite the gradual decline in real interest rates, loan demand in the corporate sector ran low. In real terms, year-on-year growth in outstanding loans to corporates dropped 2 points, coming down from 18.8% in June to 16.8% in September. The improvement in business activity that began to emerge in August will work to increase loan demand in the final months of the year.

The exchange rate channel

Zloty exchange rates in the third quarter of the year were subject to the same crawling band regime as previously, with 0.3% monthly devaluation and a permissible trading band of ±15% relative to central parity.

The third quarter of 1999 was the first full quarter in which, as a result of the changed procedures applicable at the fixing, the NBP was not involved in obligatory foreign exchange transactions with the commercial banks. Moreover, as in the preceding two quarters, the NBP once again did not intervene directly on the FX market. Thus, during the third quarter zloty exchange rates moved solely in line with the market.

A visible feature of the third quarter was the gradually deepening depreciation of the zloty. At the fixing, the average deviation from central parity narrowed progressively from one month to the next during the quarter, standing at 5.6% on the upside in July, 2.9% in August and 0.5% in September. Over the quarter as a whole, the average divergence from parity came to 3.0%, which was 0.9 points more than in the previous quarter. The range of exchange rate fluctuation rose in the third quarter to 7.4%, as against 6.0% in the second, although it was still lower than in the third quarter of 1998 (9.6%). The largest single deviation of market exchange rates from parity on the upside took place in July and came to 6.4%, while the zloty traded at its lowest point during the quarter in September, at 1% on the downside (cf. Fig. 29).

During the third quarter, zloty exchange rates were essentially influenced by factors related to the health of the Polish economy. The sinking value of the zloty was mainly conditioned by the mounting deficit on the current account and the increasing risk ensuing from the deterioration of public finances. The losses taken by the zloty were reinforced by the clear acceleration of inflation in August and September. Rising inflationary expectations and the maintenance of relatively rapid lending growth strengthened the likelihood of interest rates being raised, which fuelled pressure for the zloty to depreciate. Projections that the zloty would be boosted by the influx of foreign capital due to privatisations were weaker in the third quarter than they had been in the

Figure 29
Deviation of zloty exchange rates against reference currency basket, 1998-1999

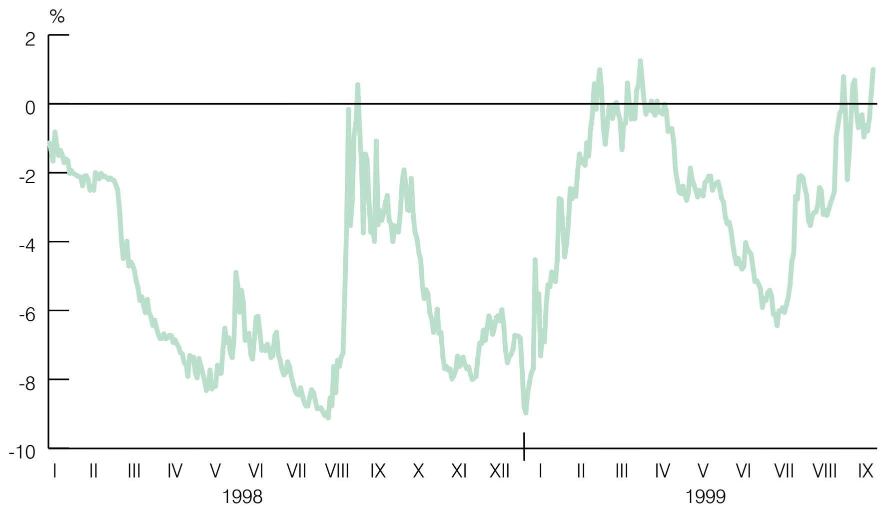


Figure 30
Effective nominal zloty exchange rates, 1998-1999

first and second (this is particularly true of the latter half of the third quarter).

The outcome of the trends affecting the Polish FX market in the third quarter of the year was that effective nominal zloty exchange rates declined 4.6% in relation to the fourth quarter of 1998 (cf. Fig. 30).

To summarise, it has to be said that the movements in zloty exchange rates seen in the third quarter of 1999 brought into focus the mechanism whereby the value of the zloty was adjusted to reflect the deepening external disequilibrium of the Polish economy. This was made possible by the fact that the zloty is to a great extent already floating freely, and also by the marked predominance of domestic factors in determining exchange rate trends. In a situation where signs of external demand reviving are weak and where domestic consumer demand is growing at a fairly dynamic pace, the depreciation of the zloty serves to temper the sharpening of the imbalance present in Poland's external payments. Owing to the relatively greater time lag in the response of exports to exchange rate movements, the effects of zloty depreciation on export receipts may be expected at the end of 1999, at the earliest. This is especially true in that the scale of zloty depreciation over the first nine months of the year indicates that a certain improvement has now been achieved in the indicators of the competitiveness of the Polish economy (see accompanying box).

The competitiveness of the Polish economy in 1999

The first three quarters of 1999 point to a general improvement in the international competitiveness of the Polish economy. As regards indices of effective real zloty exchange rates relative to the currencies of Poland's major trading partners, all of those reviewed underwent depreciation compared to the previous year. The enhancement of Poland's competitive position was principally the result of the substantial decline in nominal zloty exchange rates.

Over the period from Q4 1998 to Q3 1999, the zloty lost 0.9% in real terms (as adjusted by reference to movements in producer prices within manufacturing), whereas over the same period of 1998 it gained 2.8%.

Significant depreciation occurred with reference to transaction prices for exports, with the large change here stemming from the sharp drop in these prices (transaction prices for exports fell 6.4% in the first half of 1999, as against a rise of 3.4% in the corresponding period of 1998). Clear improvement is also seen when zloty exchange rates are tracked against changes in the index of unit labour costs. Zloty depreciation in this case is the result of the substantial fall in nominal zloty exchange rates in the first quarter of the year, combined with the intensive rise in labour productivity in the second.

Indices of real zloty exchange rates in particular quarters, based on various deflators, are presented in Fig. 31.

A factor of major importance for the level of effective real zloty exchange rates in 1999 and for the international competitiveness of the Polish economy in this period was the deepening depreciation of the euro against the dollar. The external exchange rate environment, allied to the weakening of the zloty on the domestic FX market, did much to support the improvement of Polish competitiveness in relation to those trading partners basing themselves on the dollar. However, the strengthening of the dollar against the euro limited the opportunity for Poland to improve its competitive position with respect to the countries of the EU, which constitute our main sales market (cf. Fig. 32).

An analysis of competitiveness in microeconomic terms, on the basis of the profitability of Polish companies producing for export in the first half of 1999, indicates that the period in question brought an improvement in the financial condition of exporters included in the section of economic activity titled "**manufacturing**". At the end of Q2, the pre-tax margins of these companies had risen 0.6 points on Q1, although still remaining 1.6 points lower than Q2 1998. The same trend, although slightly weaker, was visible in gross operating margins. The period under examination also saw a marked improvement in the financial condition of non-exporting companies due to faster growth in consumer demand, as a result of which the superior profitability enjoyed by exporters relative to companies producing for the domestic market dwindled from 2 points at the end of Q1 to 0.8 points at the end of Q2.

However, the financial condition of **all** exporters worsened. At the end of Q2, their pre-tax margins had slipped 0.2 points on Q1, and had dropped 1.9 points compared to the corresponding period of 1998. The profitability of non-exporting companies, thanks to a very rapid improvement, particularly in certain service industries, was 0.1 points higher than that of exporters at mid-year, whereas at the end of Q1 exporters had reported margins 1.5 points above those of non-exporters.

The second quarter of 1999 witnessed a strengthening of price/cost indices of domestic export competitiveness when compared to the same quarter of 1998. The overall index of transaction prices for exports rose 1.7% year-on-year against producer prices, and 1.8% against unit labour costs in industry.

Figure 31
***Effective real zloty exchange rates, 1993-1999, by quarter; deflators: export prices; manufacturers' producer prices; consumer prices; unit labour costs** (1st quarter 1993 = 100)*

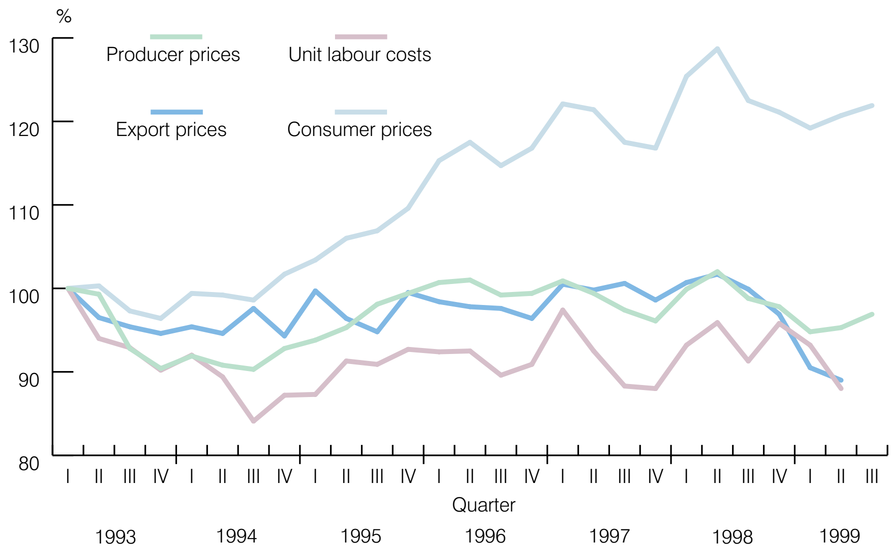
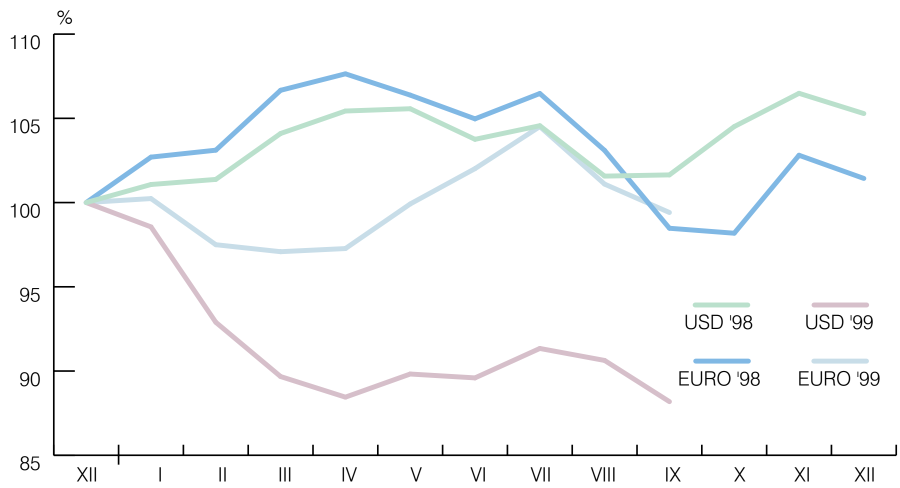
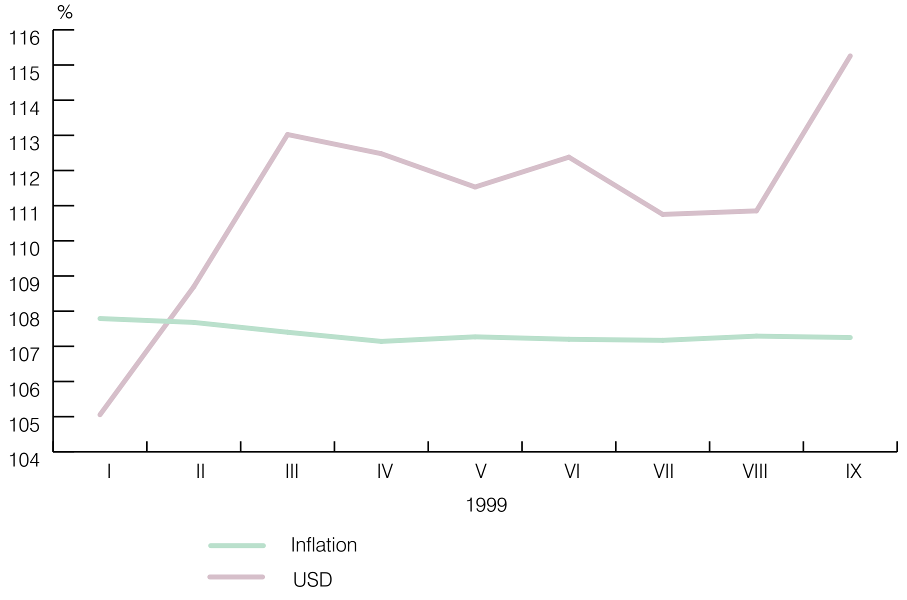


Figure 32
Effective zloty exchange rates against currencies of major trading partners, 1998-1999
(December previous year = 100)



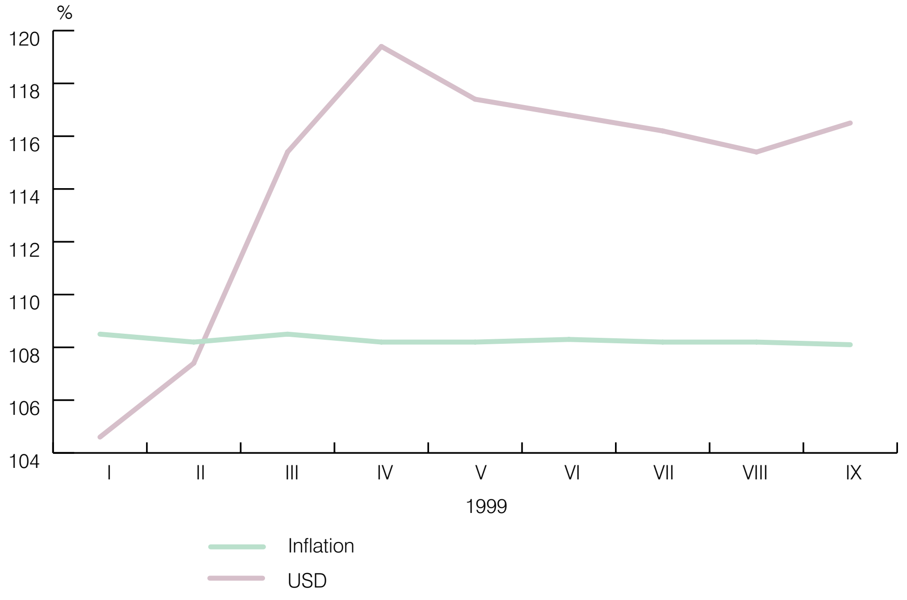
An important mechanism by which exchange rates impact inflation are the expectations held of future movements in those rates. To investigate the influence and power of exchange rate expectations on inflationary expectations, an analysis has been performed of data obtained through polls of the banks conducted by

Figure 33
Expectations of US dollar appreciation and inflation *(December 1998 = 100)*



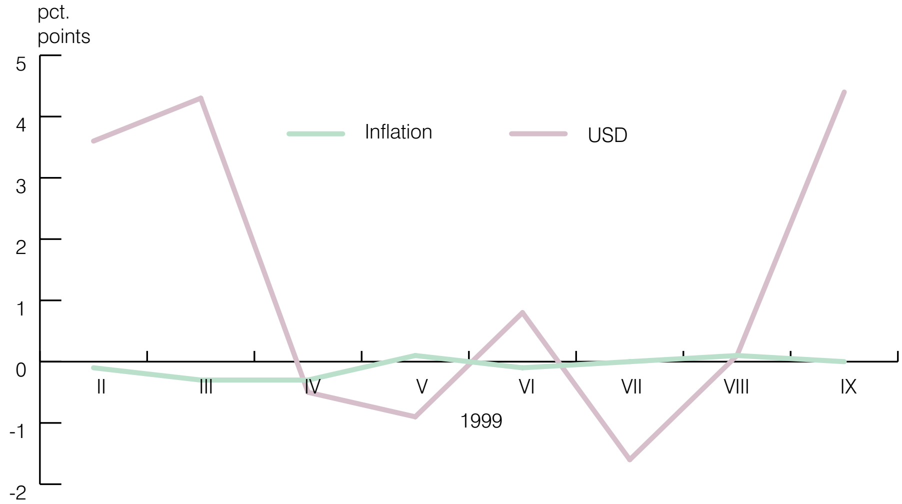
Source: Own calculations based on Reuters poll.

Figure 34
Expectations of US dollar appreciation and inflation *(December 1998 = 100)*



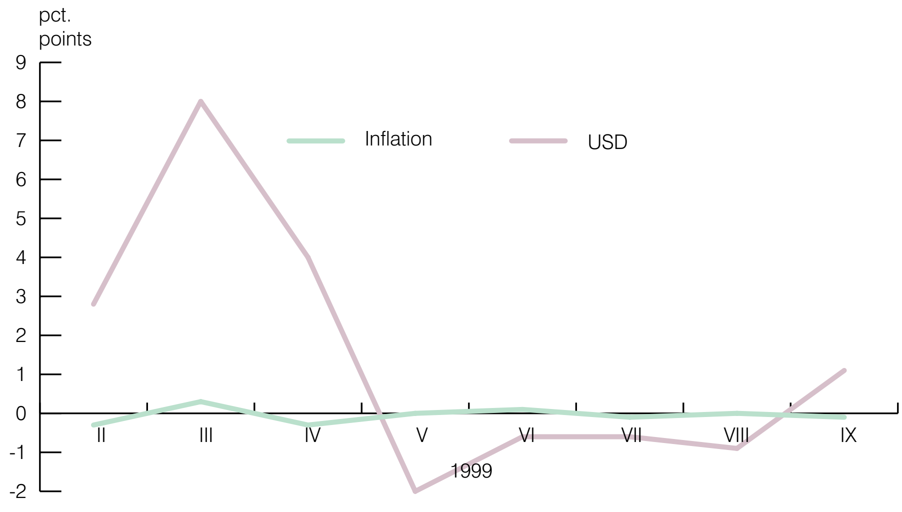
Source: Own calculations based on Pentor Institute poll.

Figure 35
Changes in expectations of December-on-December indices
(as against forecast made in previous month)



Source: Own calculations based on Reuters poll.

Figure 36
Changes in expectations of December-on-December indices
(as against forecast made in previous month)



Source: Own calculations based on Pentor Institute poll.

Reuters and by the Pentor Market and Opinion Research Institute over the period January-October 1999[13].

[13] In these polls, respondents were asked each month about their forecasts for the rate of inflation, December-on-December, and the exchange rate of the zloty against the dollar at year end.

As Figures 33 and 34 show, in the first quarter the banks clearly revised upwards their expectations of dollar exchange rates at the end of the year. This tendency was reversed in the second quarter and at the beginning of the third, with the zloty now evidently projected to strengthen in comparison to previous forecasts. In the latter half of the third quarter, expectations of higher nominal depreciation resurfaced. Expectations concerning inflation, however, changed little.

In analysing the changes in expectations concerning US dollar exchange rates and the rate of inflation (cf. Figs 35 and 36), it is noticeable that in the case of the Reuters respondents there is no definite relationship between the scale or even direction of change in expectations of exchange rates and of inflation – these expectations are frequently opposite to each other (they in fact exhibit a negative correlation). As to the results of the Pentor poll, on the other hand, changes can be seen to go in the same direction in most cases, although the interrelationship is not unequivocal (there is a weak positive correlation).

The above observations allow us to conclude that exchange-rate expectations played no discernible role in shaping the banks' expectations as to the level of inflation at year end. Even were we to assume that exchange rate expectations were taken into account in forecasting price growth, then the effect of other factors must have been strong enough to neutralise or even reverse the change in inflationary expectations suggested by the change in exchange rate expectations.

It would thus appear that, on the one hand, exchange rate expectations, which are highly changeable, do not develop under the dominant influence of stable inflationary expectations, but rather are derived from observations of the balance of payments situation and express convictions as to the need to adjust the level of real exchange rates. On the other hand, the replies given by the respondents communicate the opinion that an adjustment to real exchange rates can be performed effectively, i.e., that a movement in the nominal exchange rate need not necessarily translate into higher inflation (at least not in the period referred to in the poll). Nevertheless, it should be stressed that this picture could change in the hypothetical situation where a major exchange rate adjustment came as the expression of a loss of ongoing payments equilibrium.

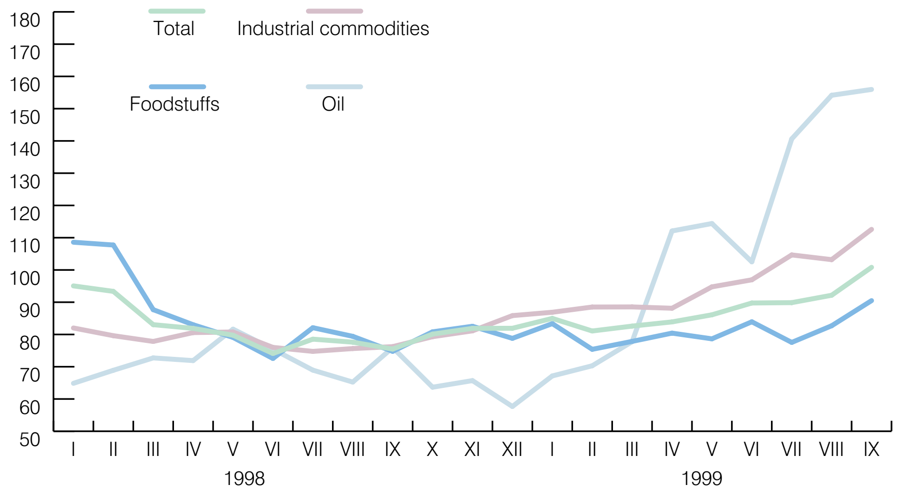
The expectations of the banks cannot, however, be taken as representative of society as a whole. It is likely that the results of any equivalent poll of non-financial organisations would show a closer relationship between exchange rate and inflationary expectations.

Impact of external prices on inflation

With industrial output picking up worldwide, the third quarter of 1999 brought an intensification of upward trends in prices on international markets. Over the period July-September, 1999, the dollar index of commodity prices rose 2.9%[14], the result of a continuation in the rising trend of oil prices and of a certain speedup in price growth for industrial goods (cf. Fig. 37). As Fig. 38 demonstrates, movements in prices for industrial goods were governed by two contradictory trends: on the one hand, metal prices were rising on world markets, while on the other – agricultural commodity prices were falling. In September, the increase in world market commodity prices came to 41% year-on-year (in the corresponding period of 1998 there had been a decrease of 25%)[15].

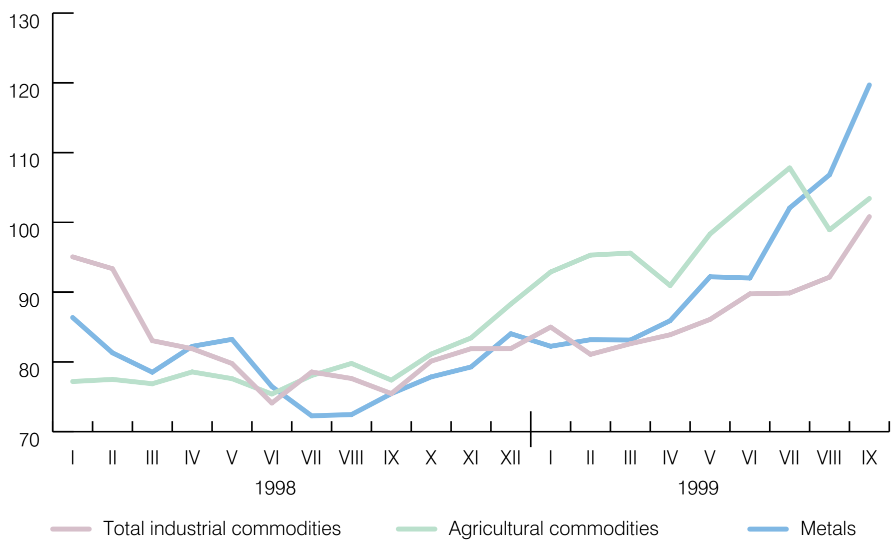
Relatively speaking, the strongest upward trend was exhibited by oil prices; these rose over 40% from June to

Figure 37
Indices of basic commodity prices, world markets
(same month previous year = 100)



[14] *Source:* The Economist, 1998, 1999.
[15] *Source:* HHWA, Institut für Wirtschaftsforschung, Hamburg.

Figure 38
Indices of basic commodity prices, world markets
(same month previous year = 100)



September 1999, going up from USD 16.35 per barrel to USD 23.04 per barrel[16]. The rapid growth of oil prices stemmed from the application by the OPEC countries of a common policy aimed at restricting supplies of this commodity at a time when the upturn within the world economy was consolidating.

These tendencies on the commodity markets contributed to faster growth in both consumer and producer prices within the euro area, the largest market for the Polish economy. The harmonised Consumer Price Index for the euro area came to 1.2% in August, whereas in June and July it had still stood at 0.9% and 1.1%, respectively[17]. The main reason for this swifter price growth was the increase in energy prices caused by the sharp upward trend in oil prices.

The prices actually obtained and paid in Polish foreign trade over the period January-September 1999 have yet to show signs of this upward trend. The dollar prices obtained for Polish exports in the period January-September 1999 were 4.3%[18] lower than in the same period of 1998. At the same time, the prices paid for

[16] *Source:* Reuters; refers to Brent, month-end prices.
[17] *Source: ECB Monthly Bulletin*, October 1999.
[18] *Source:* GUS.

Figure 39
Cumulative indices of Polish import transaction prices *(corresponding period previous year = 100)*

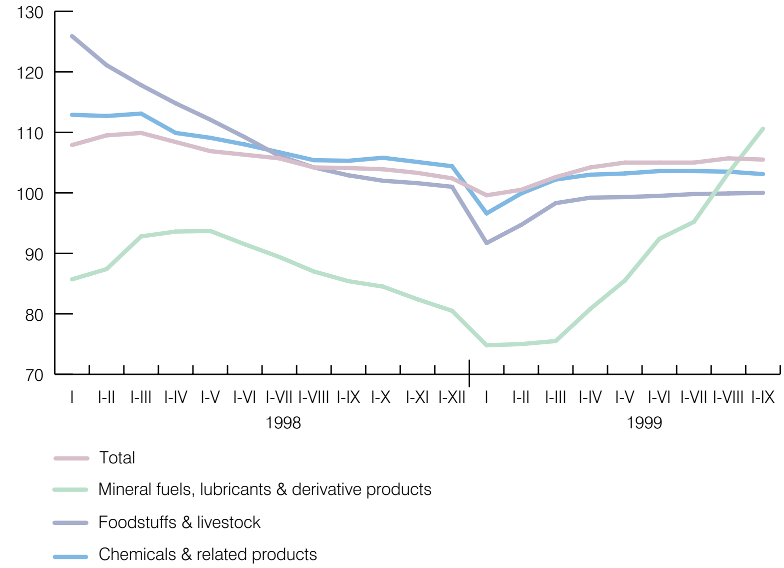
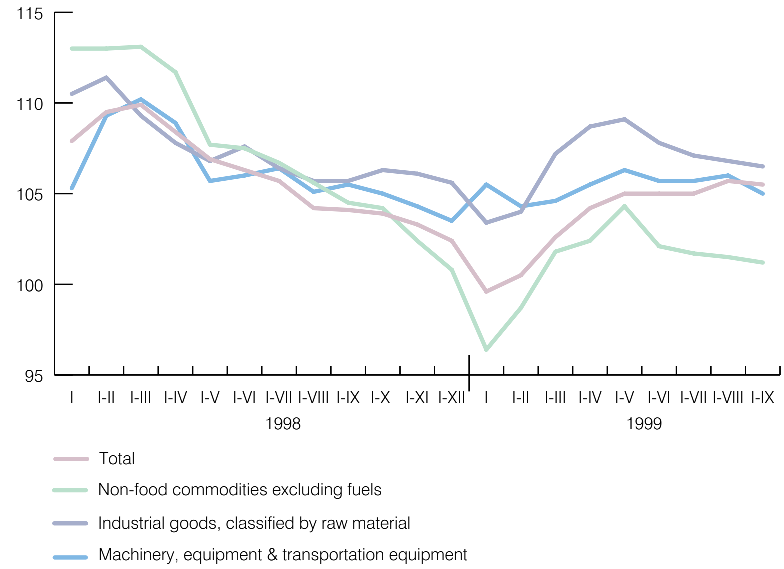


Figure 40
Cumulative indices of Polish import transaction prices *(corresponding period previous year = 100)*



imports in the first three quarters of 1999 were 6.5% lower than in the same period of 1998, and in July had been virtually flat.

Average zloty transaction prices for imports in the period January-September 1999 were 5.5% higher than in the corresponding period of 1998 (as against an increase of 4.1% twelve months before). Price growth in total imports speeded up in the second and third quarters of the year. Figures 39 and 40 indicate that the third quarter brought a clear acceleration of price growth for imported mineral fuels, lubricants and derivative products.

The zloty transaction prices obtained for exports in the first nine months of 1999 were up 6.6% on the first nine months of 1998 (a year previously this increase had been 8%).

The consequences of the above price trends was a deterioration in Poland's terms of trade, which nine months into 1999 stood at 101.0% (compared to 103.7% a year previously).

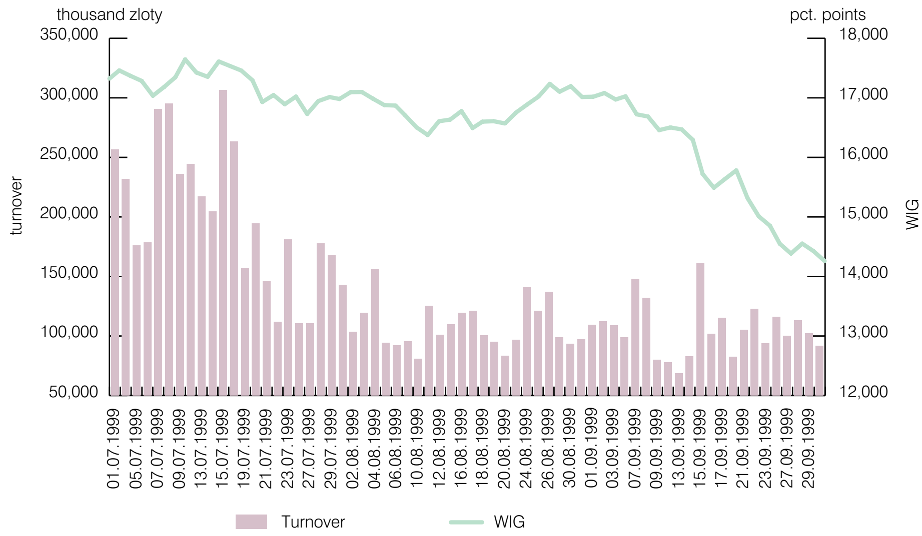
Share prices

In the third quarter of 1999, no longer-term trends were discernible on the Warsaw Stock Exchange. July and August saw share prices hold steady, while in September they fell. Poland's capital market was greatly affected by the figures being released on the state of the economy. In addition, a statistical correlation was clearly noticeable between the behaviour of the Warsaw Stock Exchange Index (WIG) and New York's Dow Jones.

The downward trend in September was connected with investor impatience in awaiting the publication of positive macroeconomic information. However, the release in mid-month of figures for August showing that the fiscal deficit had contracted and industrial output had risen was not enough to induce investors to expand their portfolios. These figures were overshadowed by the negative information on increases in the current deficit and inflation. Furthermore, investor activity (as measured by turnover) was discouraged by news of financial troubles at the Social Insurance Board and market uncertainty connected with Y2K.

The period under discussion was one of buoyancy on international capital markets. The driving force behind this was stock market performance in New York. Periodic fluctuations in the Dow Jones were traceable to investor expectations that US interest rates would be raised. Indeed, on August 24 the Federal Reserve increased its key official rate by 0.25 points. The US market's response to this decision was to take most share prices up higher, which in turn had a positive effect on European stock

Figure 41
WIG and turnover on first-tier market, July-September 1999



exchanges. At this point, the Warsaw Exchange rallied briefly as well.

On July 12, the WIG hit a high since January of 17,645.9 points, while a year-to-date low of 14,259.4 points was reached on September 30. Third-quarter turnover in shares quoted on the first-tier market totalled 9.1bn zloty, with average daily turnover of 138,004,000 zloty (cf. Fig. 41).

The increase in the reverse repo rate by the Monetary Policy Council came as a surprise to the capital market, depressing share prices on the Warsaw Exchange.

Aggregate supply and demand

In the third quarter of 1999, the real economy saw a continuation of the trends observable in the first half of the year. This produced a further acceleration of GDP growth. Personal consumption rose at a relatively rapid pace, outstripping that of incomes. As a result, despite the absence of any marked improvement in exports, the growth in industrial output continued to gain speed. No major change was forthcoming to the factors that emerged in the second half of 1998 constraining the possibility of increasing exports eastwards from Poland or to Western Europe. Although in the first half of the year exports had risen fastest to Russia and Ukraine, the economic difficulties of these countries remained. The modest improvement in the economies of the EU countries, particularly Germany, has not yet yielded any significant increase in external demand for Polish goods. However, it seems correct to believe that recent months have seen an improvement in the competitiveness of domestically-produced goods relative to those imported into Poland.

Better sales opportunities on the domestic market bolstered corporate investment. Although corporate finances were still less robust than in previous years, capital expenditure is estimated to have grown faster in the third quarter than it did in the first half of 1999. Stronger business activity and positive views of future demand helped support the tendency to replenish corporate stocks of raw materials and intermediates, which had been cut back very sharply at the beginning of the year. With consumer demand continuing to grow rapidly, the acceleration of growth in the demand for producer goods meant that by August industrial output was already 7.1% above the level seen in August 1998 (when the Russian crisis had still not affected output levels). In September, industrial output was 8.6% higher year-on-year.

Taking the third quarter of 1999 as a whole, industrial output was up 7.4% year-on-year. With sales growth sustained in commercial services and a slightly higher growth in construction output, third-quarter GDP growth can be estimated at over 5%. Nonetheless, domestic demand was still rising faster than GDP. The

Table 3
Basic macroeconomic indicators

	1998	1999			
	Q1-4	Q1	Q2	Q3	Q1-3
	corresponding period previous year = 100				
Total value added	**104.4**	**101.3**	**102.8**	**104.7**	**103.0**
Industry	104.7	97.0	101.3	107.6	102.0
Construction	110.3	100.2	103.2	104.8	103.6
Services	104.6	104.1	104.2	104.7	104.3
GDP	**104.8**	**101.5**	**103.0**	**105.1**	**103.3**
Domestic demand	**106.6**	**103.2**	**104.3**	**105.3**	**104.4**
Capital expenditure	114.5	106.0	106.7	109.0	107.4
Personal consumption	104.9	104.2	104.8	105.1	104.8

Source: 1998 and Q1, Q2 1999 – GUS; Q3 and Q1-3 1999 – own estimates.

shortfall in exports relative to imports deepened. Preliminary estimates[19] of growth in GDP and domestic demand are presented in Table 3.

Domestic demand

Initial estimates put domestic demand growth in the third quarter of 1999 at 5.3% (as against 3.2% in Q1 and 4.3% in Q2). Swifter growth in demand is mainly attributable to the acceleration of gross capital formation. Growth in the first quarter came to just 1.1% year-on-year, yet this rose to 6.4% in the second and over 9% in the third. Capital formation picked up speed due to faster growth in capital expenditure (gross), up from 6.7% in the second quarter to around 9% in the third, and to a further increase in the value of current assets. Despite this acceleration, however, capital formation is still slower than in previous years. Gross capital formation over the first three quarters of 1999 is estimated to have come to some 7% year-on-year, as against a corresponding 14.1% in the same period of 1998, 20.8% in 1997, 19.5% in 1996, and 24.1% in 1995.

Consumption growth seems to have edged up slightly in the third quarter compared with the second. Total consumption was up 3.7% year-on-year in the first quarter, 4.1% in the second, and some 4.5% in the third, with personal consumption running at 4.6%, 4.8% and over 5%, respectively. In the second and third quarters, personal consumption growth was higher than it had been in the corresponding periods of 1998, despite slower growth in real household disposable incomes.

Personal consumption

Real growth in household disposable incomes in the third quarter of 1999 was similar to that recorded in the first half of the year. There was no slowdown in the growth of incomes from employment and from non-agricultural economic activity. It can be assumed that the purchasing power of social benefits increased following

[19] During the preparation of the present *Report*, national accounts statistics were available solely for the first half of the year. To provide a fuller description of developments, the authors have presented certain estimates of their own. However, it should be noted that these are of a preliminary nature and could be subject to a greater margin of error than in the past due to the absence this year of various statistical data available in previous years (including monthly figures on corporate finances, various data on social benefits, etc.).

June's upward revaluation of old-age and disability pensions. Compared to the second quarter, household incomes related to agriculture remained unchanged.

The increase in incomes from employment occurred alongside a decrease in corporate sector employment that was slightly greater than in the first half of the year, and similar growth in average employee earnings. Average employment in the corporate sector in the first nine months of the year was 0.7% down year-on-year, while average gross employee earnings were up 3.6% in real terms. The purchasing power of wages grew somewhat more slowly than in 1998. However, while 1998 saw a gradual slowdown in growth from one period to the next, the tendency in 1998 has been the reverse, with real wage growth slightly picking up speed.

Owing to the systemic reforms performed in 1999, complete data are not available on benefit payments; nonetheless, on the basis of the information that is accessible, growth in these payments may be estimated to be faster than a year previously, and also faster than in the first half of the year. The revaluation of old-age and disability pensions for employees and farmers was carried out in 1999 in a single operation on June 1, using a uniform index of 108.7% for all pensioners. Over the first three quarters of 1999, average old-age and disability pensions for employees and farmers showed real year-on-year growth of 4.3% and 4.4%, respectively (compared to 3.2% and 3.5% in the first half of the year). Unemployment benefits rose by a nominal 19%. A rapid rise was registered in unemployment and pre-retirement benefits paid to those out of work (up 42.2% in the first three quarters of the year, with 83.2% monthly growth in September).

With growth in household disposable incomes similar to that seen in the second quarter, the bank savings ratio improved slightly. Personal deposits at the banks rose 5.6bn zloty in the third quarter, with personal borrowings growing 4.1bn zloty, while in the second quarter personal lending growth had outstripped personal deposit growth (by 542.9m zloty). Despite this improvement, the role of credit in financing consumption is still believed to be greater than a year previously, while the overall household savings ratio was there times lower than in the third quarter of 1998.

GUS figures indicate that the volume of retail sales performed by large and medium-sized companies (both within and outside the distributive trades) rose over 18% year-on-year in the third quarter of 1999 (as against 10.4% in Q1 and 16.5% in Q2). Taking into account changes in the structure of sales outlets, i.e., the substantial decline in the relative proportion of sales at open-air markets and small retail outlets not included in monthly statistical surveys, sales growth can be estimated at just under 8%, which is considerably more than the increase in the purchasing power of household disposable incomes. High sales growth was maintained at companies classified as being involved in the sale of vehicles, fuels, radio and television equipment and household appliances, and also furniture and lighting.

Personal consumption growth in the third quarter is estimated at slightly over 5% (compared to 4.2% in Q1 and 4.8% in Q2). The gap between GDP growth and consumption growth narrowed from 2.7 points in the first quarter of the year and 1.8 points in the second to some 0.1 points in the third.

Investment

Following a slowdown in capital expenditure growth in the first half of the year, the third quarter brought signs that capital spending was again on the rise. An increase was recorded in the number and cost-estimate value of new investment projects. Output in the industries mainly producing capital equipment was up 7.1% year-on-year in the third quarter (as against a 1.6% decrease in Q1 and a 0.9% increase in Q2). After a temporary slump in July, the months of August and September saw a rise in construction output (up 4.3% and 5.2%, respectively). The trend consolidated for capital construction and modernisation projects to increase their share in building works carried out within Poland by large and medium-sized companies.

Gross capital expenditure was up 6.0% year-on-year in the first quarter of the year, and up 6.7% in the second. A preliminary estimate would be that capex grew some 9% in the third quarter. In all, capital expenditure was some 7.4% higher year-on-year in the first three quarters of 1999, compared to a rise of 14.5% in 1998.

Central government finances

Following a large increase in the fiscal deficit in the first half of 1999, primarily attributable to the concentration of major spending programmes connected with instituting several structural reforms, central government reported a small surplus of receipts over expenditures in the third quarter, amounting to 64.7m zloty. Thanks to a clear growth in central government receipts, chiefly from indirect taxation and personal income tax, and thanks also to spending cuts[20], in August and September a fiscal surplus was achieved of 0.4bn and 0.9bn zloty, respectively. As a result, at the end of the third quarter the tendency for the fiscal deficit to increase had been curbed; at the end of September, the deficit stood at some 11.3bn zloty, i.e., 87.8% of the target for the year, representing better performance of the Budget than at mid-year, when the corresponding figure came to 88.4%.

The faster growth of the Polish economy seen in the third quarter, coupled with the balancing of the budget, produced an improvement in the relationship between the balance of central government receipts and expendi-

Table 4
1999 Budget, performance against plan, first three quarters

		Performance			
	Plan	Q3	Q1-3	2:1	3:1
		million zloty		%	
	1	2	3	4	5
Receipts	129,287.8	32,483.5	89,016.4	25.1	68.9
Expenditure					
of which:	142,099.8	32,418.8	100,271.7	22.8	70.6
- public debt service	20,536.6	4,129.8	14,294.3	20.1	69.6
- subsidy to Social Insurance Fund	9,643.5	1,877.1	7,261.0	19.5	75.3
- subsidy to Farmers' Social					
Insurance Fund	13,388.8	3,370.2	9,558.6	25.2	71.4
- general grant, local govt.	22,123.0	5,236.9	18,087.5	23.7	81.8
Primary balance	7,724.6	4,194.4	3,039.0	54.3	39.3
Balance, national budget	-12,812.0	64.7	-11,255.3	-0.5	87.8

[20] The spending cuts involved here were mainly the result of reducing primary expenditure, allowing central government to generate a high primary surplus of 4.2bn zloty in the third quarter. In the first quarter, there had been a 3.8bn deficit, although by the second there had also been a surplus, of 2.6bn.

tures and GDP; from -6.5% in the first quarter and -1.8% in the second, this moved to +0.04% in the third.

Year-to-date performance of the Budget at the end of the third quarter is presented in Table 4 (compiled on the basis of a preliminary report from the Ministry of Finance on the performance of the Budget over the period January-September, 1999).

Although the third quarter witnessed an improvement in central government finances, as expressed in the surplus attained, there was a simultaneous increase in the deficits incurred by other components of the public sector, i.e., the Social Insurance Fund and health trusts. Faced with the danger that the Fund would lose its liquidity, the Social Insurance Board, which is responsible for running the fund, financed ongoing payouts of old-age and disability pensions by borrowing at the commercial banks. By the end of September, the outstanding borrowings involved totalled 3.0bn zloty. At the same time, the health trusts were reporting an acute shortage of funds. This shortage is generating more debt at health service establishments; by the end of August, units of the health service had amassed outstanding liabilities of around 7.5bn zloty, which represents almost 1bn zloty more than in December 1998.

The desire to hold the fiscal deficit within the limits set by the Budget led to certain expenditure being "shifted" to other public sector organisations. Were the fiscal deficit at the end of September to be supplemented by just the aforementioned debt of the Social Insurance Fund and health trusts, it would rise to around 15bn zloty (2.6% of GDP), thereby overshooting the maximum provision included in the 1999 budget.

In addition, the debt of local government is mounting. As a result of the local government reform, local councils have been given responsibilities which they are unable to finance using their own resources and the funds received from central government. Initial figures from the Ministry of Finance put the volume of local government debt at the end of June at some 4.8bn zloty, which represents 1.8% of total public sector debt, having risen 0.3bn zloty since March[21].

It can thus be concluded that, compared to the first half of the year, the pressure for increased public sector spending did not ease off in the third quarter. This sector

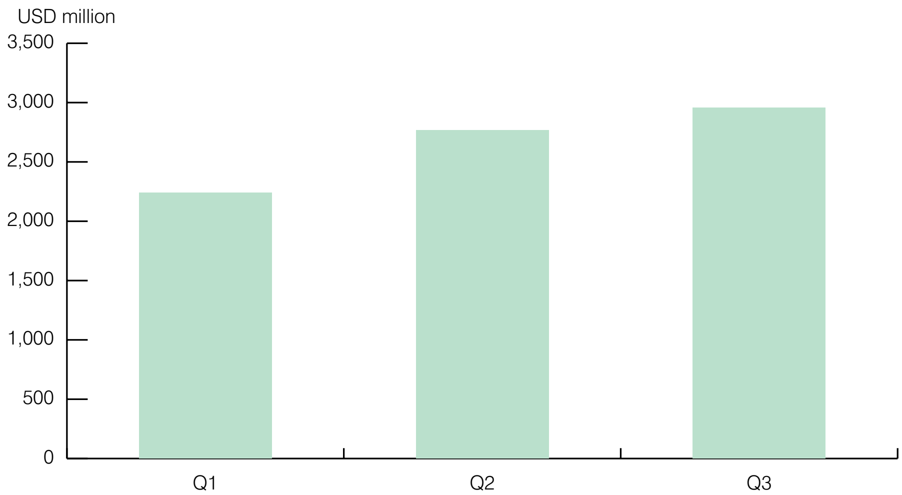
[21] Figures on local government debt are published quarterly, with a 3-month time lag.

continued to be a major factor in the expansion of domestic demand, mainly consumer demand, and thereby contributed to the increase in the current deficit and in Polish inflation.

External disequilibrium and inflationary threats

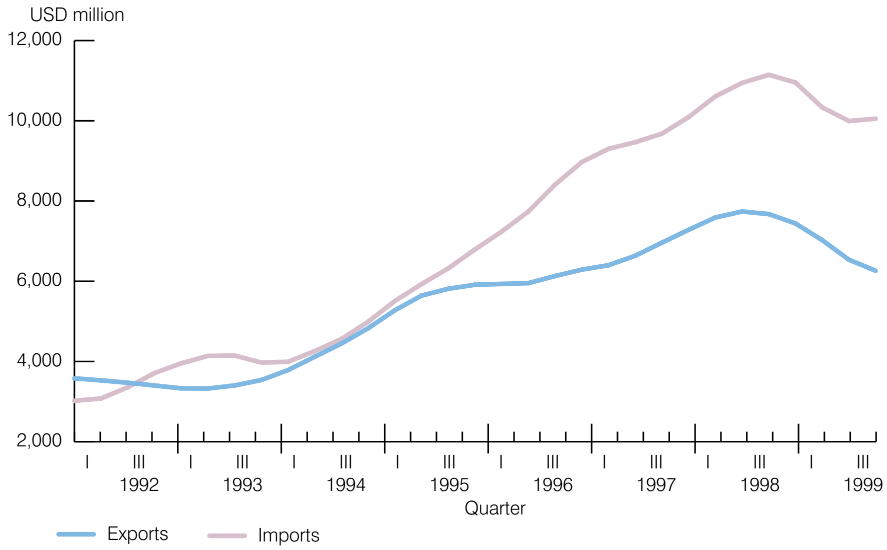
With domestic demand still rising rapidly, accompanied by an increase in the net indebtedness of general government as a whole, the third quarter of 1999 brought a further aggravation of the external disequilibrium of the Polish economy. The current account deficit recorded in the quarter, at USD 2,986m, was almost 2.5 times higher than the deficit reported in the third quarter of 1998. However, the absolute increase in the deficit in the third quarter relative to the preceding quarter, USD 220m, was less than the USD 527m increase in the second quarter relative to the first (cf. Fig. 42). It is estimated that the ratio of the current deficit to GDP could have been just under 7% on an annualised basis[22].

Figure 42
Current balance, 1999



[22] Taking the current account deficit and GDP of Q3 1999 as the sum of Q4 1998, and Q1, 2 and 3 1999.

Figure 43
Export and import trends



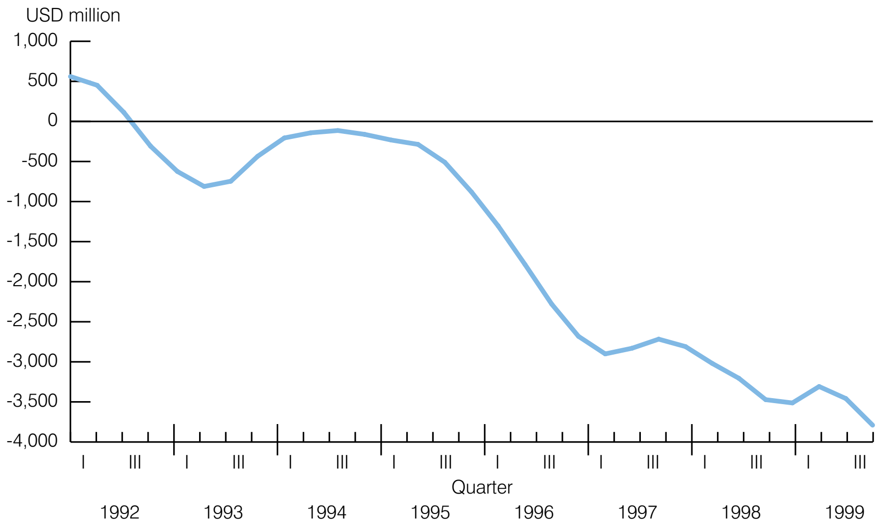
The deterioration on the current account in the third quarter of the year can primarily be traced to the widening gap in registered merchandise trade. Contrary to the situation in the first two quarters of the year, however, this was not accompanied by a worsening of the adverse balance on services, or of the balance on unclassified current transactions. The surplus on the latter rose to USD 1,153m in the third quarter, whereas in both the first and second quarters it had been in the region of USD 790m. The negative balance on services stood at USD 381m, as against USD 402m and 364m in the second and first quarters, respectively.

These developments may to some extent be derived from seasonal factors. Nevertheless, they may well also constitute evidence that the downward trend in Poland's current balance is gradually bottoming out. To determine the long-term trends in merchandise trade, original balance of payments figures can be cleansed of seasonal and irregular fluctuations[23]. This was done to arrive at an approximation of the trend at work in exports and imports over the period from the first quarter of 1992 to the third quarter of 1999. The series thus obtained were used to calculate the size of the trade deficit.

As Figures 43 and 44 show, there was a marked upward trend in both exports and imports until around

[23] Using the Census X-11 procedure.

Figure 44
Trade deficit (based on trends)



mid-1998, although import payments were growing significantly faster, which was reflected in the constant widening of the trade gap.

In analysing movements in the trade deficit (cf. Table 5), it is apparent that the upward trend in exports broke down in the third quarter of 1998, since when there has been a continual trend downwards. In the first and second quarters of 1999, export receipts shrank from one quarter to the next by 6 – 7%. In the third quarter this sinking trend slowed down, with the fall in receipts coming to 4.2%, which could signify a gradual return to a rising trend.

Similar developments affected import payments, although the reversal of the upward trend here did not occur until later, in the fourth quarter of 1998, and last-

Table 5
Movements in trade deficit, based on trends (previous quarter = 100)

Period		Exports	Imports
1998	I	104.20	105.10
	II	101.98	103.17
	III	99.17	101.85
	IV	96.95	98.26
1999	I	94.42	94.34
	II	93.04	96.72
	III	95.80	100.58

ed for a shorter time. The fall in imports seems to have already been checked in the second quarter of 1999, with an upward trend reasserting itself in the third quarter. This explains the tendency for the trade deficit to grow further in the third quarter in relation to the first two quarters of the year.

Certain symptoms of a possible improvement in Polish trade performance correspond with the clear signs in the third quarter that Poland's most important foreign markets are coming out of recession.

In the euro area as a whole, indices of industrial output growth have been positive since May; in August, industrial output was up 2.5% year-on-year. The strongest growth has been recorded in the manufacture of durables and consumer goods, and in the production of raw materials and intermediates. Further, third-quarter surveys of the business climate in the particular countries of the EU indicate a marked increase in orders and higher capacity utilisation in manufacturing[24].

Customs statistics point to a certain weakening of the downward trend in exports. At mid-year, export receipts were 8.1% lower in dollar terms than in the corresponding period of 1998, yet by the end of the third quarter this decline stood at 6.3%.

The third quarter also witnessed a distinct improvement in Russian economic growth indicators, principally thanks to the increase in oil prices and the effects of rouble devaluation. Over the first nine months of the year, Polish exports to Russia were down 65.3% in dollar terms on the same period of 1998, yet this decrease is less than that recorded in the first half of the year (a fall of 72.3%). Nevertheless, such a large drop in exports to the most important of Poland's Eastern markets still represents a grave problem for the Polish economy. The crisis in Russia upset a long-term trend of dynamic growth in Polish exports to that country; in the years 1994-97, these exports rose almost 3.5 times. In consequence, at year end 1997 trade with Russia totalled almost USD 5bn, and Russia constituted Poland's second largest export market and third-largest source of imports, accounting for 8.4% of Polish exports and 6.4% of imports. Nine months into 1999, Russia's share of Polish exports had fallen to 2.5%. Meanwhile, exports to Poland's second largest Eastern market, Ukraine, were

[24] *Source:* ECB Monthly Bulletin, October 1999, Handelsblatt, 27/X/1999.

down nearly 45% year-on-year at the end of the third quarter.

Customs statistics indicate a certain faltering of the downward trend in imports: at the end of the third quarter, import payments, expressed in dollars, were 5.9% lower year-on-year (the corresponding decrease in the first six months of the year came to 6.6%). Within the pattern of imports, there is a noticeable tendency for the relative share of consumer imports to rise, going up from 19.5% in the period January-August 1998 to 20.4% in the same period of 1999, while the share of capital equipment and production supplies remains steady.

The mounting current deficit in the first three quarters of 1999 and deterioration in financing for that deficit suggest certain threats to the stability of the zloty, with these threats having an adverse impact on the process of bringing down inflation.

At the end of the third quarter of 1999, the deficit on the current account was over twice as large as in the same period of 1998, while the surplus on the capital and financial account was some USD 2bn lower, and the total balance on all transactions was negative. The same period saw the structure of financing external disequilibrium take a turn for the worse. Whereas in the first three quarters of 1998 the net inflow of FDI absorbed the entirety of the current deficit, in the same period of 1999 this

Figure 45
Financing of current deficit by FDI, 1998-1999

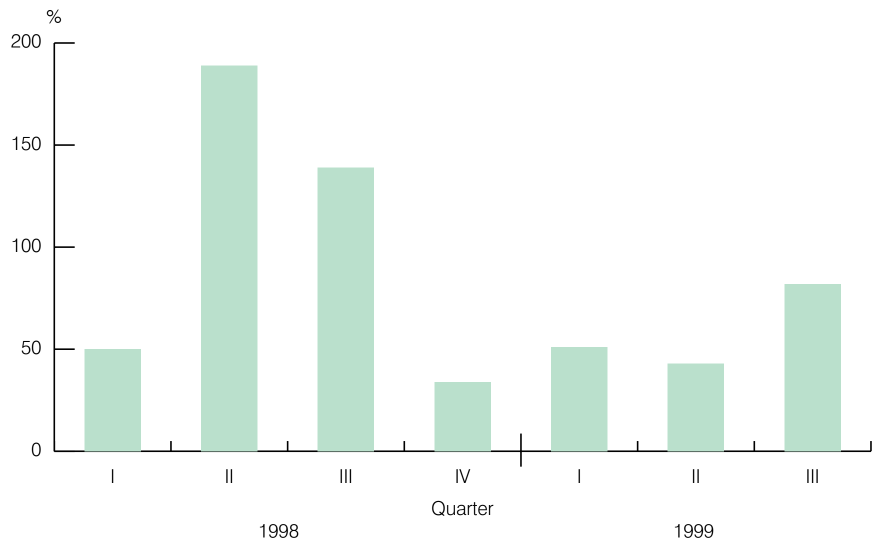
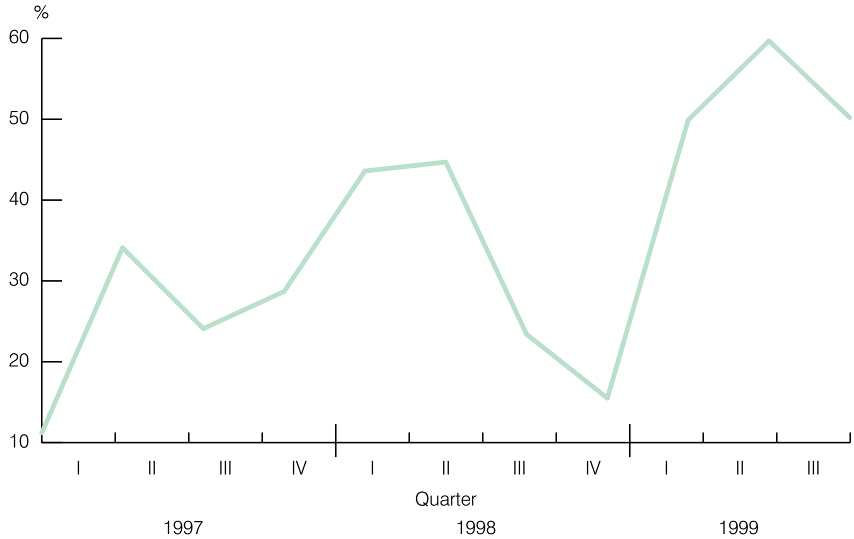


Figure 46
Borrowings from foreign investors as proportion of total FDI



ratio fell to 60% (cf. Fig. 45). At the same time, the period under discussion brought an increase in the balance of borrowings from foreign direct investors as a proportion of the balance of FDI, with this ratio standing at 52.5% at the end of September, whereas twelve months previously it had come to 35.5% (cf. Fig. 46).

Aggregate supply

Following the slowdown in growth in the second half of 1998, linked to the external shock to the Polish economy and the curtailing of domestic demand growth, the first half of 1999 was marked by a gradual return of the upward trend in domestic supply. Despite the lack of any major external impulses, supply grew faster in the third quarter than it had a year before, influenced by the acceleration of growth in domestic demand. The upturn in business activity served to increase the demand for raw materials and intermediates, and helped stimulate investment demand. Despite this, there was no significant rise in purchases abroad. Over the first seven months of 1999, the volume of imports was 1.1% lower year-on-year. On the basis of figures for import remittances in August and September, it can be concluded that, when compared to 1998, the volume of imports remained essentially unchanged over the first nine months of the year as well.

With industrial output low in the first quarter of the year, there were signs that the downward trend was about to be halted. In the second quarter, industrial output was indeed up 1.2% year-on-year, and in the third it rose 7.5%. While sales in mining and quarrying declined, output went up in manufacturing – in the third quarter, this increase came to 8.3%. The fastest growth was reported by companies manufacturing production supplies. Following the first-quarter decrease in sales of production supplies of almost 8% year-on-year, it can be estimated that the second quarter saw an increase of over 2%, while the third quarter yielded an increase of over 9%. In those divisions of industry manufacturing capital equipment, the corresponding figures for output growth stood at –2%, +1% and +7%, respectively, while for manufacturers of consumer goods they came to –5%, +1% and +8%.

The expansion of domestic business activity contributed to an increase in demand for transportation services, which had run low in the first half of the year. Assuming that the rapid growth of sales in the retail and wholesale industries was sustained, and that further growth took place in the services provided by companies classified in the sections "real estate, renting and business activities" and "financial intermediation", the increased demand for transportation services should have sped up growth in the gross value and value added generated within commercial services. Construction output also rose faster than in the second quarter. By contrast, growth in value added remained at the level of the previous quarter in non-commercial services – in the sections of public administration and defence, education, and health and social work.

Preliminary figures indicate that the harvest of staple crops was smaller in 1999 than in 1998, leading to a decline in gross crop production. The adverse trends in the production of beef cattle, decrease in milk procurement and changes in the composition of the pig herd (pointing to a substantial reduction in the herd in the months ahead) indicate that – despite the procurement of fat pigs and table poultry still continuing to rise in the third quarter – livestock production has also fallen. It can be estimated that the third quarter then brought a fall in both gross output and value added in this section of the economy.

Trends in corporate costs and prices

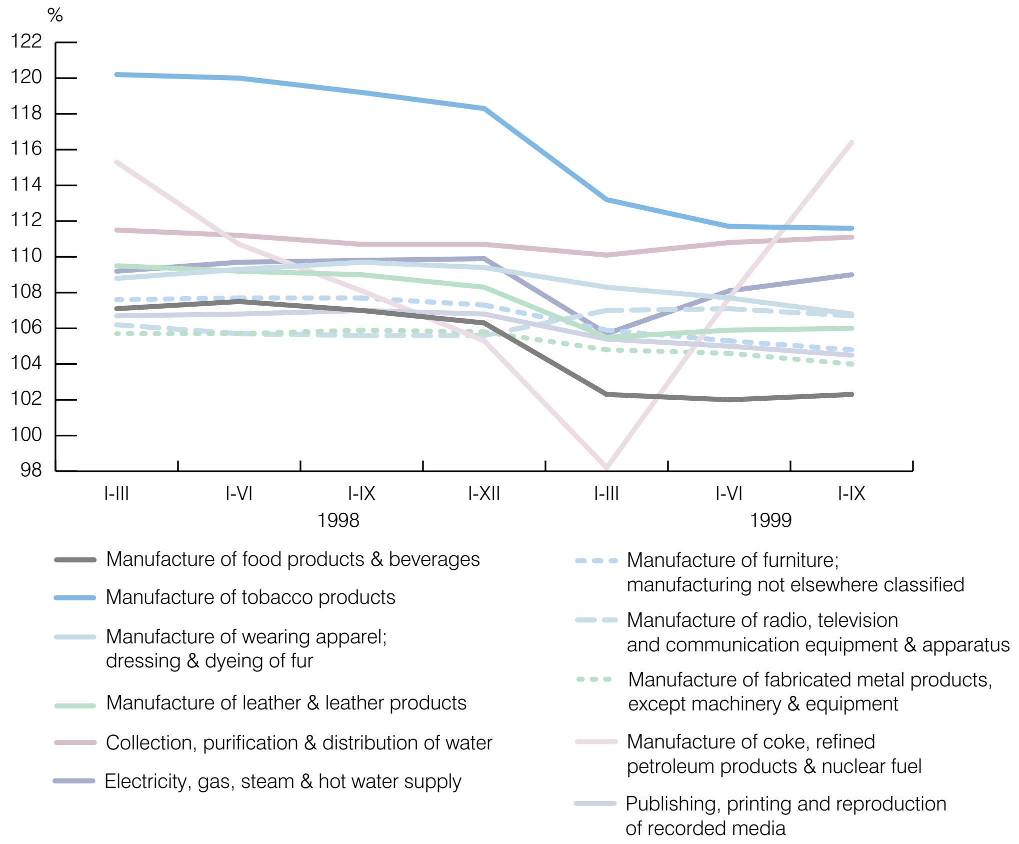
Owing to the maintenance of high cost-output ratios[25], industrial companies can be seen to be constantly at the ready to raise their sales prices in order to protect their margins. Any suitable development on the market is therefore seized on to increase factory-gate prices, which then feeds through into higher consumer price growth. In the third quarter of 1999, due to the acceleration of economic growth and upswing in industrial activity (one reason for this being the maintenance of higher domestic demand than in previous quarters), conditions were favourable for companies to pass on increased production costs to the consumer. The rise in the CPI observed in the third quarter was undoubtedly the consequence of escalating producer prices, raised due to cost factors.

The increase in consumer price growth seen in the third quarter, especially in the latter two months, encourages attempts to locate the causes of this increase, in selected divisions of industry, in movements in producer costs and producer prices earlier on, i.e., in the first half of 1999. This chiefly refers to those divisions where producer prices exert a particularly strong influence on consumer prices. The situation in 11 divisions within the sections of manufacturing, and electricity, gas and water supply has therefore been analysed (these divisions are listed in Table 6). The divisions selected are those whose products consume the largest portion of household budgets.

An examination of indices of producer price growth in the divisions selected over the course of 1998 and the first three quarters of 1999 (with growth calculated on a cumulative basis relative to the same period of the previous year) indicates a clear shift in the trends in price movement. The trend towards limiting the pace of producer price growth in these divisions, visible in 1998, and especially at the turn of 1998/99, was subsequently transformed into an upward price trend (cf. Fig. 47). This particularly applies to the following divisions: manufacture of coke, refined petroleum products and nuclear fuel; electricity, gas, steam and hot water supply; collection, purification and distribution of water; and also manufac-

[25] The average cost/sales ratio in industry as a whole stood at 98.5% in the first six months of 1999, having worsened by 1.5 points in comparison to the same period of the previous year. The third quarter brought a further deterioration in this ratio, which stood at 98.9% for the period January-September 1999.

Figure 47
Producer price indices, selected divisions of industry, 1998-1999
(cumulative, corresponding period previous year = 100)



ture of food products and beverages. Price growth (on a cumulative basis) in the division of electricity, gas, steam and hot water supply, and in that of collection, purification and distribution of water was impacted by price deregulation, which pushed up producer prices mainly in the first half of 1999; in the third quarter of the year, producer price growth in these divisions was negligible.

In the third quarter, an acceleration of price growth relative to the second quarter occurred in only two divisions: manufacture of food products and beverages, and manufacture of tobacco products (cf. Table 6). Very steep growth in producer prices was continued in the division of manufacture of coke, refined petroleum products and nuclear fuel. This indicates that producer price growth can be identified as having impacted the consumer price growth seen in the third quarter mainly with respect to the three divisions mentioned above, and it is in the pattern of costs within these divisions in the first half of the

Table 6
Producer price indices, selected divisions of industry, 1998-1999

SIC no.		Producer price indices						
		1998				1999		
		Q1	Q2	Q3	Q4	Q1	Q2	Q3
		Previous quarter = 100						
15	Manufacture of food products and beverages	101.8	100.9	100.8	100.6	99.9	100.3	102.0
16	Manufacture of tobacco products	105.6	104.3	102.4	102.6	103.3	101.6	103.3
18	Manufacture of wearing apparel; dressing and dyeing of fur	101.9	102.1	102.3	102.2	101.4	101.0	100.1
19	Manufacture of leather and leather products	101.1	101.1	102.0	102.0	100.3	101.8	101.9
22	Publishing, printing and reproduction of recorded media	101.4	101.3	101.9	101.4	100.7	100.5	100.8
23	Manufacture of coke, refined petroleum products and nuclear fuel	99.6	97.0	100.8	100.6	100.0	116.1	114.3
28	Manufacture of fabricated metal products, except machinery and equipment	101.7	101.0	101.6	101.3	100.9	100.5	100.3
32	Manufacture of radio, television and communication equipment and apparatus	100.6	101.2	101.8	101.7	102.2	101.3	100.8
36	Manufacture of furniture; manufacturing not elsewhere classified	101.5	101.6	101.5	101.4	101.3	100.7	100.6
40	Electricity, gas, steam and hot water supply	107.6	101.6	100.3	100.1	103.5	106.2	100.9
41	Collection, purification and distribution of water	106.8	101.7	100.4	101.4	106.2	103.0	100.7

Source: GUS data, as calculated by NBP.

year that confirmation has to be sought for producer price growth having been based on cost factors.

In the first half of 1999, the share of sales revenue generated in these divisions as a proportion of total industrial sales revenue stood at: 19.3% (manufacture of food products and beverages), 2.7% (manufacture of tobacco products) and 6.2% (manufacture of coke, refined petroleum products and nuclear fuel). Together, these three divisions accounted for 28.2% of total industrial sales revenue.

In the three divisions in question, the cost deflators in the first half of the year were higher than the pace of producer price growth in the same period[26]. This situation encourages producers to raise prices.

[26] This analysis was conducted using data on 26,339 companies that maintain books of account and submit quarterly financial statements to GUS using the F-01 form. The companies in question employ in excess of 50 people (in mining and quarrying or manufacturing), or in excess of 20 people in other sections. The data did not include figures on the performance of companies in agriculture, hunting or fisheries, nor of banks, insurance companies or colleges.

An analysis of particular cost components during the first half of 1999 in the 11 divisions selected for examination yielded the following findings:

– total costs had the biggest impact on producer prices in the division of manufacture of coke, refined petroleum products and nuclear fuel; in this division, all of the cost deflators were higher than producer price growth (cf. Fig. 50),
– in the division of manufacture of food products and beverages, it was only taxes and duties, together with material costs, that did not push towards price growth (the higher prices of agricultural produce as a result of drought were not yet in evidence in the first half of the year) (cf. Fig. 48); within the total costs incurred in this division, taxes and duties and material costs together

Figure 48
Producer price growth: manufacture of food products and beverages, and basic cost deflators, 1998-1999
(cumulative, corresponding period previous year = 100)

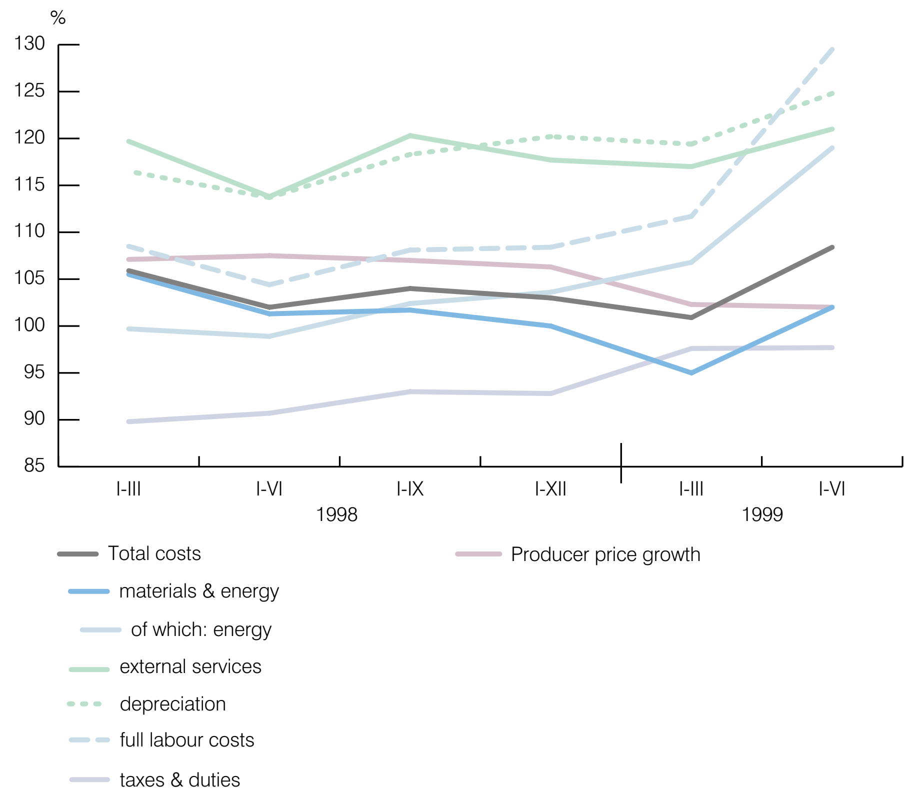
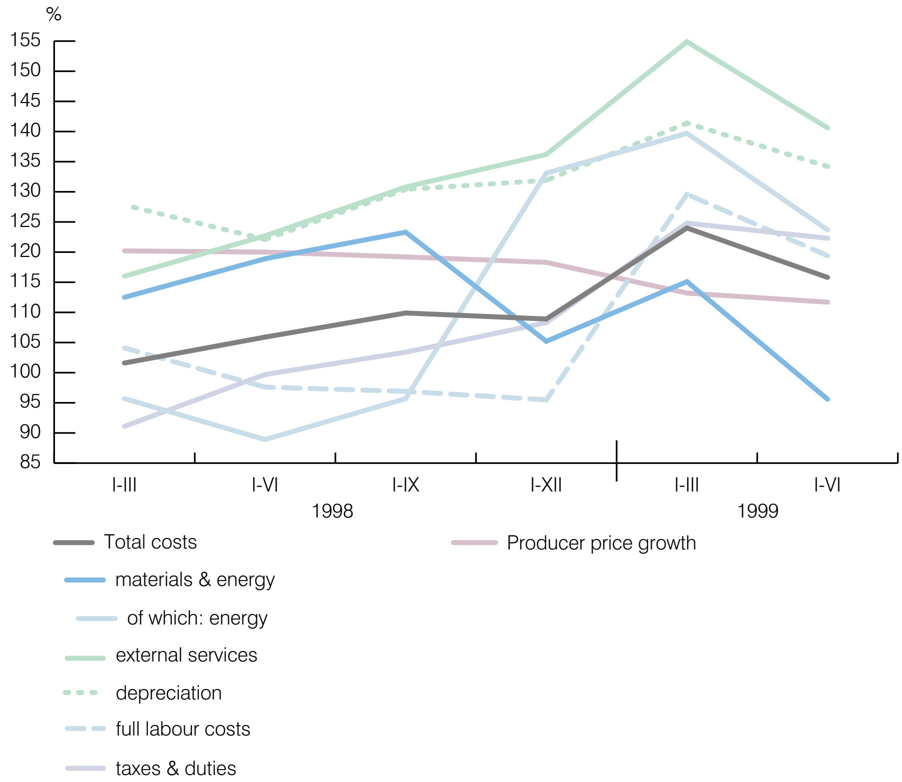


Figure 49
Producer price growth: manufacture of tobacco products, and basic cost deflators, 1998-1999
(cumulative, corresponding period previous year = 100)



accounted for a huge 66.5% of total costs in the first half of the year,

– in the division of manufacture of tobacco products, all the deflators – with the sole exception of material costs, which made up 20.5% of total costs – outpaced producer price growth (cf. Fig. 49),

– the cost of external services had the strongest impact on producer prices in the divisions of manufacture of tobacco products and of manufacture of coke, refined petroleum products and nuclear fuel; the deviation of the external services cost deflator from producer price growth was highest in these divisions, at 28.9 points and 26.2 points, respectively,

– in the division of manufacture of food products and beverages, the most powerful pressure on prices was exerted by labour costs (this cost deflator was 27.5 points higher than producer price growth),

– of the remaining eight divisions reviewed, circumstances inclining producers to raise prices due to cost factors were also present in the first half of the year in the divisions of publishing, printing and reproduction of recorded media; manufacture of fabricated metal products; and manufacture of radio, television and communication equipment and apparatus; however, no major increase in producer prices was observed in these divisions in the third quarter,

– no cost push effect on producer prices was noted in the remaining five divisions (manufacture of wearing apparel, and dressing and dyeing of fur; manufacture of leather and leather products; manufacture of furniture; electricity, gas, steam

Figure 50

Producer price growth: manufacture of coke, refined petroleum products and nuclear fuel, and basic cost deflators, 1998-1999 *(cumulative, corresponding period previous year = 100)*

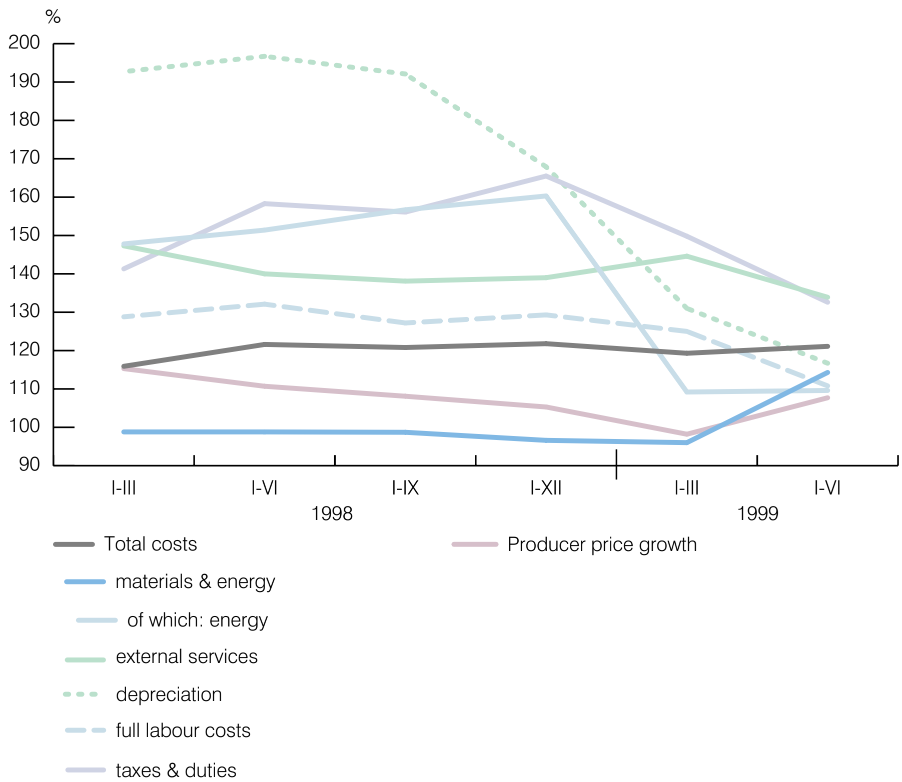


Table 7
Deviation of total cost deflators from producer price growth, selected division of industry, 1998-1999

SIC		1998				1999	
no.		I-III	I-VI	I-IX	I-XII	I-III	I-VI
		pct. points					
15	Manufacture of food products and beverages	-1.2	-5.5	-3.0	-3.3	-1.4	6.4
16	Manufacture of tobacco products	-18.6	-14.1	-9.3	-9.4	10.8	4.1
18	Manufacture of wearing apparel; dressing and dyeing of fur	4.2	3.4	-3.4	-5.3	-10.1	-3.3
19	Manufacture of leather and leather products	-7.1	-5.6	-3.4	-1.4	-10.7	-9.7
22	Publishing, printing and reproduction of recorded media	0.5	7.3	8.1	3.4	8.2	7.2
23	Manufacture of coke, refined petroleum products and nuclear fuel	0.6	10.9	12.7	16.5	21.1	13.4
28	Manufacture of fabricated metal products, except machinery and equipment	-2.5	-0.7	-0.2	-0.8	5.8	1.8
32	Manufacture of radio, television and communication equipment and apparatus	-2.1	3.9	6.9	7.0	5.0	6.8
36	Manufacture of furniture; manufacturing not elsewhere classified	2.3	9.2	4.3	3.1	-1.4	-7.1
40	Electricity, gas, steam and hot water supply	8.9	7.5	7.5	5.1	-3.3	-0.6
41	Collection, purification and distribution of water	2.4	1.4	2.4	1.1	-1.3	-0.3

NB: The total cost deflators and the producer price indices used to calculate the deviations are shown on a cumulative basis, with growth being given year-on-year.
Source: GUS data, as calculated by NBP.

and hot water supply; and collection, purification and distribution of water) (cf. Table 7),

– however, in the five divisions listed above there were also cost deflators that were above the level of producer price growth in particular divisions; this primarily applies to external services (with respect to leather manufacture, electricity supply and water distribution), and to depreciation (with respect to wearing apparel and furniture).

There is no doubt that, in the first half of the year, the costs incurred by companies manufacturing food products and beverages, tobacco products, and coke and refined petroleum products generated pressure for higher producer prices, which subsequently, in the third quarter, impacted both the PPI for those divisions, and the CPI.

Monetary policy instruments in the third quarter of 1999

In the third quarter of 1999, the Monetary Policy Council resolved to raise the reverse repo rate and to reduce reserve requirements. The latter reduction was made possible thanks to the issue of NBP bonds bearing interest equivalent to inflation, and to the conversion of central government liabilities to the NBP, an operation that had been under preparation for some considerable time.

The decision to raise the reverse repo rate by 1 point came as a response to a series of negative developments that were apparent on the basis of the macroeconomic figures available in September. Preliminary balance of payments figures proved unfavourable, and this was accompanied by a weakening of the zloty. The discrepancy between lending and deposit growth was accentuating. Fiscal policy was not being conducted in a transparent manner, with the scale of the deficit in social insurance still unknown. Both the CPI and the PPI had risen, as had underlying inflation. In these circumstances, the Monetary Policy Council, meeting on September 22, decided to raise the reverse repo rate from 13% to 14%. While the strong increase in headline inflation was primarily attributable to changing trends on commodity and foodstuff markets, an analysis of various measures of underlying inflation indicated symptoms of supply impulses being transmitted to the prices of other product groups. The Council concluded that this threatened to kindle inflationary expectations that could jeopardise achievement of the inflation target in the year 2000. September's Council decision should therefore be considered in terms of its demonstration effect – the central bank sent out a message that interest rates could be raised when the inflation target was endangered. The increase in the reverse repo rate was also intended to act as a clear warning to borrowers. This served to indicate that the acceleration of consumer lending growth, which was exacerbating the adverse trends affecting the current account deficit, would not fail to elicit a response from the NBP, and that the price of credit could go up. This decision largely came as a surprise to the market, which had not expected such a preemptive measure from the NBP. The increase in market interest rates produced by the Council's decision did not contribute to a strengthening of the zloty, since at that point the detrimental macroeconomic figures and risk associated with Y2K restrained short-term foreign capital from investing in zloty-denominated instruments.

While the decision to raise the reverse repo rate gave notice of a change in the current monetary policy stance, the lowering of reserve requirements was a systemic measure. The system of averaged regulatory reserves is a structural monetary policy instrument whose main role is to reinforce the impact of interest rate policies by generating demand for central bank currency and smoothing out fluctuations in market interest rates. This is why the reduction in the reserve ratio is a move of strategic and lasting character. This decision, the associated conversion of claims on central government into negotiable securities, the issue of NBP bonds indexed to inflation and the gradual floating of zloty exchange rates, together comprise a package of measures designed to contain, and subsequently eliminate, the excess liquidity present within the Polish banking system. In the first half of 1999, the National Bank of Poland had already taken steps to restrict the principal source of liquidity, consisting in the purchase of foreign currency, reflected in the balance sheet of the NBP as growth in the gross official reserves. This objective was attained by widening the trading band of the zloty and then abolishing the existing mechanism for the zloty fixing. These moves brought about significant changes in the structure of the NBP balance sheet, which resulted in reducing the level of structural surplus liquidity at the banks, and above all curbed its further increase.

On September 30, the conversion of central government liabilities to the NBP took place, in conjunction with the lowering of reserve requirements. This operation consisted in:

- the conversion of non-negotiable central government liabilities held as assets of the NBP into negotiable Treasury securities,
- the reduction of the reserve ratio to 5% for all categories of eligible deposit,
- the issue of long-term NBP bonds indexed to inflation, which the banks purchased with the funds released by the lowering of reserve requirements.

The reduction of the reserve ratio was desirable due to the need to improve the competitive position of domestic banks, and at the same time created an opportunity to narrow the differential between lending and deposit rates at the banks. Easing the burden placed on the banks by reserve requirements is a process that has been observable for many years now in a number of countries, including those of Central and Eastern Europe. The continued maintenance of high reserve requirements at a time of increasing deregulation and globalisation of financial markets could have led to Polish banks being forced out of the market for servicing corporate customers, and even personal ones, and could also have indirectly weakened the impact of monetary policy instruments. A reorientation by residents towards deposit and loan products offered by foreign banks would have undermined the influence of NBP instruments on this segment of the market.

The lowering of reserve requirements is usually associated with softening the restrictiveness of monetary policy, since the banks can invest a large part of the deposits they take in lending activity. Where there is a lasting shortage of liquidity within the banking system, cutting reserve requirements does indeed constitute a substitute for permanent (and cost-free) central bank refinancing. However, this interpretation is hardly applicable to Polish circumstances. In terms of the shorter time frame, most of the funds now released were immediately absorbed for a long duration by NBP bonds with a total face value of 13.03bn zloty and maturities of 6-10 years, bearing interest at par with inflation. Only those banks that have to hold less than 5m zloty to meet their requirements were exempted from acquiring these central bank securities. The funds thus released, of minor importance relative to the scale of the whole operation, were absorbed by the issue of NBP money market bills as part of normal open market operations. In the longer time frame, the banks will on average be required to hold less funds on account at the NBP, the difference stemming from the fact that deposit growth at the banks will be subject to a lower reserve ratio, yet the sum involved will be of an entirely different order than the monthly increase in outstanding lending. This should not therefore increase the banks' readiness to extend credit, particularly since they are in any case holding an incomparably larger liquidity cushion, built up through short-term open market operations that mature each month. The volume of lending is in these circumstances the joint product of loan demand and the lending policies of the commercial banks, which are linked to their assessment of borrower credit capacity, and also of a risk-based evaluation of alternative investment vehicles, including Treasury securities and open market operations. A situation of excess liquidity means there are no supply constraints on lending, since any increase in loan portfolios can be refinanced by the banks by scaling down their involvement in open market operations.

Within the framework of this integrated operation, September 30 also saw the conversion of central government debt to the NBP into 3-, 4-, 5- and 10-year fixed-rate Treasury bonds to a total face value of some 12.3bn zloty. Under the second stage of the operation, the NBP is to receive 2-year zero-coupon bonds at the end of December 1999, with a face value of over 3bn zloty. The central banks will thus find itself in possession of negotiable Treasuries totalling over 15bn zloty, which can be earmarked for sale to the banks and used to soak up liquidity.

The sale of these converted bonds in the year 2000 could generate an operational liquidity shortfall. This means that the conversion operation, allied with the issue of NBP bonds and lowering of the reserve ratio, will allow a lasting reduction in surplus liquidity, while also lightening the burden of reserve requirements on the banks and restoring their competitiveness in relation to foreign institutions. In circumstances where there is an operational liquidity shortfall, central bank interest rates cease to determine the marginal cost of funds, signifying to the banks solely the rate of return on an alternative investment. Central bank rates then exert a weaker influence on commercial bank pricing behaviour, since they are connected with asset substitution rather than with the need to access funds at a price set by the central bank. Measures to restrict excess liquidity will therefore act to strengthen the effectiveness of interest rate policies as a basic monetary policy instrument.

The conversion operation, coupled with the lowering of reserve requirements, will enhance the competitiveness of the Polish banking industry while at the same time improving the conditions for the conduct of monetary policy.

Prospects for inflation

The fall in inflation at the turn of 1998-99, which was sharper than expected, came as the result of a disruption in the long-term trend of declining inflation in Poland. This was caused by the decrease in world oil prices that had been continuing since 1997, by the collapse of Russian demand for Polish agricultural exports in the wake of that country's economic and financial crisis in the latter half of 1999, and also by the trend for zloty appreciation that predominated in 1998.

In the second half of 1999, inflation again began to pick up momentum due to the reversal of the factors that had brought it down to a lower level than projected at the turn of 1998-99 (this particularly applies to the increase in world oil prices). The Monetary Policy Council had expected a partial reversal of the movements in commodity and foodstuff prices that had encouraged disinflation. However, the strength of these supply shocks, which pushed up inflation in Poland, came as a universal source of surprise. Nevertheless, the return of inflation to higher levels was also rooted in a series of factors of an incidental nature. These included the cost of key structural reforms performed in 1999, which proved higher than the Government had forecast, thereby imparting to fiscal policy a stronger impact on domestic demand growth than had been outlined in Government announcements, and also the powerful pressure applied by certain social groups, the results of which included an increase in government intervention on the market for agricultural produce (with an associated increase in tariffs on imported foodstuffs) and the need to finance that intervention by obtaining additional central government receipts (via increases in excise duty). On the other hand, the rise in world fuel prices laid bare the negative consequences of government failure to pursue a consistent approach in developing market structures, particularly in permitting the maintenance of an oligopolistic situation in the oil and energy sector.

The reappearance of higher inflation is also partially traceable to monetary factors, although the monetary policy decisions taken in 1998 and 1999 were based on what was at the time a consensus of opinion regarding macroeconomic forecasts. This was especially visible in the case of lending to households and the downward trend in the zloty that emerged in the latter half of 1999.

The decisions to cut NBP interest rates at the turn of 1998-99 were taken in consideration of declarations that pointed towards a tighter fiscal stance than was in fact adopted. In addition, contrary to general expectations, the gradual upturn in business activity in the course of 1999 was not accompanied by any tangible halting of the adverse trends in Polish exports. This resulted in the deepening of the current deficit and depreciation of the zloty, which fuelled inflation.

The coincidence of all these circumstances restored real inflation to a level corresponding to the previous long-term trend. As a result, the inflation target for 1999 set in March will be overshot, while the annual inflation rate at year end will be higher than that at year end 1998.

The Monetary Policy Council is maintaining its target for the year 2000, which involves slowing year-on-year consumer price growth to no more than 5.4%-6.8% at the end of 2000. In the second half of November 1999, the Council concluded that it was essential to tighten monetary policy considerably, and raised the reserve repo rate by 2.5 points, and the other NBP official interest rates by 3.5 points. This decision is designed to reinstate a disinflationary trend within the economy that conforms to monetary policy objectives in the short and medium time frame. Stepping up the restrictiveness of monetary policy should lead to slower growth in credit and the money supply, and should counter secondary shock effects on the markets for foodstuffs and liquid fuels. However, for the process of bringing down inflation in Poland to be effective given its current relatively low level, it is imperative that this tighter monetary policy be supported by a tighter fiscal stance. A fiscal stance of this kind should be accompanied by restricting protectionist measures on the part of government and accelerating the development of competitive markets.

Taking into account the time lags in transmitting the impulses of central bank monetary policy, and the possibility that negative price trends on the markets for foodstuffs and fuels will continue for a certain time, the Council anticipates that year-on-year price growth will rise in the months immediately ahead. However, the exhaustion of the shock effects mentioned above and the consequences of a firmer monetary policy should mean that in subsequent months – most probably at the end of the first quarter of 2000 – inflation will reassume its long-term downward trend.